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Negotiations on a Free Trade Agreement between India and the EU

Ambitions, expectations, obstacles, and incentives

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In summer 2022, the European Union (EU) and India resumed negotiations on a free trade agreement to strengthen their strategic partnership. In addition, both sides are negotiating an investment protection agreement and an agreement on the protection of geographical indications. In this way, the EU wants to diversify its relations with the Indo-Pacific states and underscore India's prominent position. Through cooperation with the EU, India aims to advance its economic and technological modernisation, which is indispensable if the country is to play a greater international role. Unlike the negotiations that failed in 2013, the current negotiations are paradoxically both simpler and more complicated. They are simpler because the EU and India are now more aligned on geopolitical issues than ever, especially with regard to China. But they are also more complicated because the success of the negotiations still depends on difficult concessions on both sides. A repeat failure is not an option, however, for either India or the EU in terms of the future of their strategic partnership.

India is Asia's new growth story. Already for the years 2023 and 2024, the International Monetary Fund and the Asian Development Bank are forecasting high economic growth rates for India of more than 6 per cent, which is significantly higher than in the case of China. India's size, the demographic dividend expected from its young age base, and the enormous need to catch up in terms of industrialisation and export-led growth all point in its favour. With a share of 10.9 per cent, the EU is India's third-largest trading partner (2021) and could benefit enormously from the country's economic growth.

In 1948, India was one of the first 23 signatories of the General Agreement on Tariffs and Trade (GATT), but it subsequently relied on domestically oriented economic development and isolated itself from world markets. Subsidies and tariff protections were intended to create a powerful national industry through import substitution. However, the average rate of economic growth until 1991 was too low to achieve development successes similar to those of the newly industrialising economies of East and South-East Asia. It was only in the course of the liberalisation starting in 1991 that Indian governments began to unilaterally

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and successively lower the average (applied) tariff rates from 150 to 13 per cent. The reforms led to a significant increase in exports from 1995 to 2018, which was otherwise observed only in Vietnam and China. According to the United Nations (UN), these achievements in growth also led to a reduction in the number of people living in poverty in India by 271 million between 2006 and 2016. Nevertheless, the period of domestic and external economic liberalisation did not continue in the wake of the 2007/08 global financial crisis.

New realism in India's trade policy

When Prime Minister Narendra Modi and the Bharatiya Janata Party (BJP) came to power in 2014, there were high hopes for further economic reforms and an even greater integration of India into the global economy. However, New Delhi initially erected new import barriers, selectively increased critical tariff lines — for example for shoes, clothing, and mobile phones — and terminated existing investment protec tion agreements in 2016 and 2017. This also led to multilateral and bilateral conflicts.

Multilaterally, India's reluctance to compromise has on several occasions hindered progress in negotiations at the World Trade Organization (WTO), for example on the capping of agricultural subsidies. Furthermore, no other country has been subject to WTO dispute settlement proceedings as frequently as India, with the exception of the trading powerhouses the EU, the United States, and China. In 2019, India withdrew from negotiations shortly before the signing of the Regional Comprehensive Economic Partnership (RCEP) free trade agreement. In the 2000s, India agreed to various bilateral free trade agreements, for example with Korea, Japan, and the regional economic organisations ASEAN and Mercosur. However, these agreements contained practically no substantial tariff reductions or opening of the import market and therefore did not result in any significant trade expansion. The Modi government did not conclude any new bilateral trade agreements until 2021.

At the national level, New Delhi provided specific incentives for investment and production in key industries through government programmes such as "Make in India", "Skill in India", and "Digital India" using subsidies, tax rebates, and targeted import protections. In addition, the Modi government took additional pro-business measures, including public investment in infrastructure, corporate tax cuts, price liberalisation, the removal of investment restrictions, and the implementation of a national value-added tax. As a result, India improved its ranking in the World Bank's Ease-of-Doing-Business Index from 142nd (2014) to 63rd (2019). In May 2020, during the Corona pandemic, Prime Minister Modi announced a new economic policy ("*Atmanirbhar Bharat*"). He thus emphasised national autonomy even more strongly, but without reviving the former import substitution policy. Instead, Modi is focussing on privatising unprofitable state-owned enterprises and providing targeted support for domestic companies.

Modi wants India to become a developed economy by the time it celebrates 100 years of independence in 2047. To achieve this goal, however, the country would have to generate annual economic growth rates averaging 7 per cent over 20 years. To do so, the country would have to exploit its comparative advantage of low labour costs in the international division of labour to a much greater extent, expand the domestic manufacturing sector, and thus create jobs for the large number of low-skilled workers. Given India's low savings rates and lack of fiscal leeway, exports are the only plausible growth driver. Measured by its potential, India would in principle be well-positioned to sell a rapidly growing industrial production output on world markets, if necessary by displacing other Asian suppliers.

However, there are many discrepancies between the country's lofty ambitions and actual economic developments. Since liberalisation in 1991, the country has achieved considerable development successes in the information technology and pharmaceutical sectors. In aggregate economic terms, however, India's industrialisation has stagnated. The manufacturing sector's share of India's gross domestic product remains deceptively low at 14 per cent (2021). The number of employees in the manufacturing sector has even fallen by a good 20 million. With an industrial capacity utilisation rate below 70 per cent, investment has remained weak despite the improved economic environment under Modi.

Internationally, India under Modi has manoeuvred itself into a difficult situation with its mercantilist trade policy. Apart from the limited number of highly competitive companies in the IT and pharmaceutical sectors, the international competitiveness of India's manufacturing sector is not in the best shape. Trade in goods with foreign countries registers high deficits every year. In addition, the Corona crisis has revealed dependencies and vulnerabilities in the import inputs from China. The border incident on the Galwan River in the summer of 2020 — in which 20 Indian and at least four Chinese soldiers were killed — has noticeably soured bilateral relations in general and has negatively affected trade relations. Despite the already high tariff protection and a number of other protective and boycott measures directed against China, the trade deficit with China widened further in the first nine months of 2022.

Since India is neither a member of the RCEP free trade area nor of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), it is sidelined in the Indo-Pacific in terms of foreign trade. Thus, India's exports have to overcome the customs and import hurdles of countries in the RCEP and the CPTPP. At the same time, India's manufacturing production is burdened by comparatively higher costs, as the imported inputs from RCEP and CPTPP countries are subject to tariffs. In any case, the generally applied tariff rate (the "most-favoured-nation applied tariff") in India for others is on average significantly higher than elsewhere in the region, namely 14.9 per cent in the manufacturing sector and almost 40 per cent in the agricultural sector (2021). As a result, the country is only integrated to a limited extent into the Asian value chains and is at a disadvantage when it comes to competing for new industrial investments.

With a new generation of free trade agreements, India wants to find a way out of its self-inflicted isolation, secure and diversify supply sources, open up new export markets, and attract new capital and technology. An important political motive is to reduce its economic and technological dependence on China. In the face of increased economic and political pressure, India is now clearly willing to negotiate seriously on sensitive issues such as sustainability, public procurement, and digital trade. In 2021, the country concluded a free trade agreement with Mauritius, and in 2022 one with the United Arab Emirates (UAE). In the same year, it agreed on a fast-track interim "Early Harvest" agreement with Australia to pave the way for a comprehensive free trade agreement. India is also negotiating free trade agreements with the Gulf Cooperation Council, the United Kingdom, Israel, and Canada. India is also a partner in the US Indo-Pacific Economic Framework Initiative (IPEF). However, the negotiations with the EU, which will be launched in June 2022, are likely to be the most important.

Untapped potential in economic relations

The EU and India — the world's third- and fifth-largest economies — are already important trade and economic partners. With a foreign trade volume of 88 billion euros (2021), India is Europe's tenth most important trading partner and its fourth most important one in Asia. Europe's economic importance for India is even greater: Europe is the third most important trading partner and the second most important sales market, after the United States. Among the EU member states, Germany leads with a share of 21.4 per cent (2021), followed by Belgium, France, Italy, and the Netherlands. The largely balanced European-Indian trade covers the entire range of the manufacturing economy.

In contrast, agricultural trade and India's energy and raw material exports to Europe play a subordinate role. Politically, however, they can be highly relevant. Agricultural supply chains, for example, are often linked to differing preferences between producer and consumer countries in terms of sustainability, for example on the question of what level of animal welfare should apply in agriculture. In addition, protective measures in this sector can upset global food supplies, such as India's recent bans on agricultural exports as a response to increasing global agricultural prices due to Russia's invasion of Ukraine.

In recent years, the services trade has developed far more dynamically than the trade in goods and is concentrated on the areas of transport, information, communication, and business services. However, with a volume of almost 40 billion euros (2021), it is still significantly below the level of trade in goods. In terms of direct investment, the EU is one of the most important foreign investors in India, along with Mauritius, Singapore, the United States, and the United Kingdom.

Political relations between India and the EU have further intensified in recent years. A strategic partnership was agreed in 2004. The Roadmap 2025, adopted in 2020, sets out the plan for the expansion of relations. In 2022, the EU and India agreed on a joint trade and technology council. In geopolitical terms, the two sides have come closer in recent years with regard to China and see themselves as politically indispensable partners. However, the erosion of democracy, freedom of opinion and expression, and the rule of law in India since 2014 has fuelled doubts in Europe as to whether the country can really be a "like-minded" partner.

Despite the extensive bilateral trade, there is repeated criticism that its potential has not been fully realised. One important reason for this is the lack of binding, confidence-building bilateral trade and investment protection agreements. So far, the only legal basis for bilateral trade and services is the most-favoured-nation principle enshrined in the WTO treaty. Although the EU grants tariff preferences to India, it temporarily suspended them at the beginning of 2023 because the initiated increasing Indian imports in the EU exceeded the defined safeguard thresholds. There are currently no agreements for bilateral investment trade since India unilaterally terminated almost all existing older nationally agreed investment protection treaties with EU member states.

New negotiations alongside three individual agreements

The first attempt to reach consensus on a free trade agreement failed in 2013 after seven years of fruitless negotiations due to irreconcilable differences over content. The new negotiations launched in 2022 are taking place under more favourable auspices. Both sides want success and cannot afford failure. Relations between the EU and India are based primarily on economic cooperation, whereas in foreign and security policy issues, both sides focus on their relationship with the United States. The raison d'être of the European-Indian partnership would be called into question if there were another failure to conclude forward-looking agreements on bilateral trade and investment. This time, negotiations in the areas of trade, investment protection, and geographical indications (GI) will be conducted separately and not, as is often the case, as chapters of one single, comprehensive agreement. This increases the likelihood that a result can be reached in at least one or two areas.

In the case of *geographical indications*, agreement seems easiest, as the EU has already been able to reach a corresponding agreement with China. However, India would first have to establish its own implementation and control regime for GIs to be defined. In total, fewer conflicts are to be expected compared to other comparable agreements with partners facing similar production patterns, and thereby similar GI interests. Europe's and India's production patterns tend to complement each other.

An *investment protection agreement*, on the other hand, will be particularly difficult to reach. Since this is an area of mixed competence in the EU, not only must the European Parliament (EP) and the Council of the EU approve the agreement negotiated by the EU Commission, but the EU member states must also ratify it. Yet, the investment protection chapters were some of the most controversial parts of the trade agreements and provoked great resistance in the past, especially from civil society. In the same way as in the agreements with Canada, Singapore, and Vietnam, the EU is also pursuing its ambitious new model of improved investor-state arbitration with India: In addition to an appeal option, this includes a commitment by both sides to support a multilateral court. For the EP and some member states, such improvements are crucial preconditions for ratifying an agreement. Although India — after defeats in investor-state arbitration — itself harbours strong reservations about the older procedures still in use worldwide, an agreement appears difficult due to the limited room for manoeuvre in European negotiations.

There are still also obstacles to the *conclusion of the third part, the trade agreement,* although both sides have moved closer together. India signed important International Labour Organization (ILO) conventions on child labour in 2017. In the agreement with the UAE, the country has partially opened its public procurement markets. In addition, as a result of the recently decreed temporary suspension of EU tariff preferences, India has a special incentive for legally binding, duty-free access to the EU's internal market. In view of the rampant shortage of skilled workers, the EU may be also more open to an influx of individuals than in the past, for example in the IT sector.

Negotiations in troubled waters

However, the positions of the negotiating partners are still miles apart in many areas. First, it is unlikely that India will be willing to substantially liberalise imports in the socially and politically sensitive agricultural sector. In particular, the dairy, beef, poultry, and grain sectors are likely to remain sacrosanct. Modi's agricultural reforms failed in 2021 due to resistance from farmers, who are also likely to oppose an overly generous opening towards world markets. Second, European demands for a substantial opening of India's manufacturing and services markets continue to be met with opposition from powerful lobby groups and a protectionist-nationalist attitude in politics and administration. India's small retailers are part of the core constituency of the ruling BJP, making it difficult to imagine an opening of the market to large European retailers. Third, the European catalogue of sustainability demands is considerably more extensive than it was in 2013. In addition to the multilateral labour, environmental, and climate commitments to be met, the EU proposal text also includes other issues such as gender equality, biodiversity, and sustainable food systems, including animal welfare.

Conflicts seem inevitable. Europe not only criticises India for its failure to ratify the ILO core standards on collective labour law and its poor climate record. There are also doubts as to whether even accepted sustainability standards are effectively implemented at the state level. India, on the other hand, sees these demands to some extent as hidden "neo-colonial" protectionism on the part of the EU. In principle, India continues to insist on its national sovereignty in these matters.

In general, expectations on both sides of the agreement are likely to diverge in terms of the level of ambition and the conducting of negotiations. India is keen to conclude an agreement as quickly as possible and has its sights set on easily achievable liberalisations. The EU, on the other hand, is striving for a broad trade agreement that will not only bring about substantial improvements in access to sensitive market segments such as motor vehicles, wine and spirits, banking, and business services. It should also contain provisions that commit India in the long term. According to the EU's wishes, these would concern, for example, rules of origin, technical barriers to trade, regulations, subsidies, intellectual property right protections, and the sustainability issues mentioned above.

Europe's political interest in India requires special efforts to find a compromise in trade policy. The WTO principle of special and differentiated treatment of developing countries already implies that an asymmetric tariff liberalisation, that is, one that accommodates India's interests, must be implemented. Europe should then give in on the demanded opening of the Indian market and offer longer transition periods in particularly sensitive sectors. For the sake of sustainability, the EU should draw up a joint implementation plan with India. At the same time, it should definitely insist that India's import liberalisations have substance. The opening of the markets must be sufficiently attractive economically to make the trade expansion and foreign trade integration that Europe and India are mutually striving for possible.

In view of the existing differences, it will take a great deal of flexibility and willingness to compromise on both sides to reach a viable conclusion in these difficult negotiations. There is good reason to doubt whether the two parties' differing visions of open markets, liberalisation, and sustainability can be reconciled. These European demands can only be met over several rounds of negotiations, if at all. In the socially and politically critical areas of dairy farming, poultry farming, and retail trade, they are likely to once again be met with resistance from non-governmental organisations in Europe and India.

However, there is also reason for cautious optimism, as there are promising approaches for solving the critical issues: The fast-track Early Harvest Agreement of 2022 between India and Australia offers starting points for negotiations with the EU on the agricultural sector. This could help to counter India's concerns about a destructive surge in imports, for example in the dairy sector, by requiring only low tariff reductions of India or longer phasing-in periods for tariff cuts, as well as through possible safeguard clauses in the event of an increase in imports. The EU should pursue its own agricultural interests through GIs for special quality products rather than via demands for market access. At the same time, this approach can also support India's interests in certain segments: For example, individual Indian GIs in a relevant agricultural area could be accompanied by EU support programmes as part of broader economic development.

On the issue of sustainability, the new EU Strategy for Enhanced Partnership, published in summer 2022, can help to resolve contentious issues in the sustainability chapters of trade agreements. According to this strategy, joint priorities, concrete timetables, and options for support should be defined for intermediate goals. However, the EU should also help India comply with the EU's new due diligence requirements for the sustainability of supply chains for sales in the EU, which will soon have to be met anyway, irrespective of whether a trade agreement is concluded. These new obligations can then serve as an incentive and opportunity for India to accept the sustainability requirements of an agreement that have so far been perceived as a threat.

Foreign and geopolitical interests as driving forces

A successfully concluded trade agreement will reap gains in terms of income, employment, and welfare. In addition to the economic benefits, the agreements also have an important political dimension, as a successful outcome serves the geopolitical interests of Germany and the EU. First, the agreements underpin the strategic partnership between Europe and India, which, as discussed above, rests on economic cooperation at its core. Second, both the EU and

India are seeking to diversify their external economic relations, reduce their respective dependencies on China, and raise their trade and foreign policy profiles in the Indo-Pacific region through a bilateral agreement. Third, such an agreement would send clear signals to Beijing and Washington, as Brussels and New Delhi repeatedly emphasise their strategic autonomy. Fourth, a successful conclusion of the negotiations would be an unmistakable trade policy statement against the global tendency towards protectionism. And fifth, Germany and Europe must be interested in a prosperous India that is capable of balance vis-à-vis China.

Since the breakdown in negotiations in 2013, the foreign policy and trade policy environment has fundamentally changed for both sides. In world trade and the global economy, the weight of the Global South, especially China, has increased considerably. At the same time, trade policy has also become geopolitics. Although the Sino-American rivalry forms a defining geopolitical framework internationally, the EU and India are each seeking as independent a role as possible. Like the United States, Europe and India see China's totalitarian governance, mercantilist industrial policy, and expansive power projection as an existential threat to peace, stability, the international order, and their own prosperity. Despite their fundamental accord with the United States, they are not prepared to subordinate their political and economic relations with China to Washington's geopolitical imperative. Whereas the United States is using punitive tariffs, sanctions, and technology boycotts to decouple itself economically from China, India and the EU are only partially following US guidelines in their foreign trade policies. Instead of general decoupling, both are concerned with reducing economic dependencies and vulnerabilities. Diversification through closer bilateral exchanges is therefore in the common Indian-European interest.

For European industry, India is — measured by its size and growth potential — the only plausible, medium-term, attractive alternative to China as an investment and production location and as a sales market. Like India, the EU is also isolated in the Indo-Pacific region in terms of trade policy, as it is not part of the RCEP and CPTPP trade alliances. A free trade agreement with India — complementing those with Japan, Korea, Singapore, and Vietnam — would raise the EU's trade profile considerably. In addition, the agreement would contribute towards strengthening the EU's global partnerships.

For India, Europe is an indispensable trade and economic partner thanks to its huge domestic market; a provider of investment capital, technology, and infrastructure; and a gateway to global sales markets. India rejects integration into Asian trade alliances and supply chains if this increases its dependence on China. At the same time, however, India will be denied non-discriminatory access to the US market for quite some time. Therefore, the only substantial trade policy option remaining is the envisaged free trade agreement with the EU. In the foreseeable future, India's free access to the European single market and the establishment of European companies in India could provide an effective impetus for the development of a competitive industry envisaged by New Delhi. This would be a significant step towards achieving the desired high level of economic growth on a sustained basis.

Last but not least, it is also geopolitically important for India to develop substantially in economic terms. In view of an increasingly China-centred Asia and Russia's increasing dependence on China, India needs sustained high-level economic growth in order to realise its foreign policy ambitions, and thus assert itself in the future multipolar concert of powers. This can only be achieved through greater integration in the international division of labour. An economically strong India that can serve as a counterweight to China in the Indo-Pacific is also in Europe's geopolitical interest.

European institutions face various challenges in this regard. The Commission must find a compromise between the diverging perspectives of the Directorate General for

Trade (DG Trade) and the External Action Service (EEAS) in order to live up to its self-imposed claim of being a geopolitical commission with regard to India. In the EP, the parties have to reconcile economic interests with political issues, especially concerning the autocratic tendencies in India and the restrictions on freedom of expression, freedom of the press, and civil society.

Outlook

The negotiations paradoxically are both easier and more difficult than the previous one's from 2007 to 2013, which ultimately failed in 2013. Today, India and the EU have more in common on foreign policy than before, for example with regard to their international role and their relationships with China and the United States. But their respective internal developments have caused the EU and India to drift apart in recent years. Put simply, the EU has become more "sustainable" and "normative", whereas India has become more "nationalistic" and "protectionist". However, renewed failure is not an option for either side, as bilateral relations would otherwise be severely damaged. A success factor on the European side could be the flexible handling of the ratification mechanisms in the three individual agreements envisaged. Even a small success in one area could be a big step towards continuing negotiations in other areas, thus strengthening European-Indian relations in the long term.

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