THE ECONOMY 2030 INQUIRY

SHAPING A DECADE OF CHANGE

A presage to India

Assessing the UK's new Indo-Pacific trade focus

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The Economy 2030 Inquiry

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Summary

Leaving the EU means the UK is able to develop an independent trade strategy for the first time in decades. A cornerstone of the UK's approach is a desire to pivot towards new liberalisation opportunities beyond Europe, to mitigate some of the openness lost from increasing barriers with our largest trading partner. The key question, then, is where should the Government pivot trade policy towards as it seeks to put flesh on the bones of the 'Global Britain' agenda. For many, the prize here was a free trade agreement (FTA) with the US. But as the chances of such a deal have receded under President Biden, the Indo-Pacific strategy has taken centre stage as the pivot of, inevitably constrained, choice.

The approach seeks to target global import growth in the Indo-Pacific region through joining the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and delivering the recently announced India FTA. While most policy debates have focused on the CPTPP, the bulk of the potential economic benefits from adopting such a strategy come from liberalisation with India. This is for two reasons. First, existing UK trade deals cover almost all of the trade with CPTPP countries, reducing the scope for new liberalisation. According to the Government's own analysis, CPTPP accession would only marginally increase the proportion of UK exports to members subject to tariff free access from 97.8 per cent to 99.9 per cent and would only reduce non-tariff measures on goods for all members, except Mexico and Malaysia, by less than the equivalent of a 2 per cent tariff. Second, while CPTPP is very large, expected growth rates of CPTPP members will be below the global average.

Because an FTA with India is the more important part of the strategy, this paper provides an assessment of the short- and longer-term dynamic effects. In particular, we focus on the implications of this deal for the UK's domestic economic strategy, drawing on comparisons to a US FTA to illustrate the different implications. This is important because there is a tendency to focus on the impact of trade deals on exports, neglecting the impact of changes to our imports and the important effects that this can have on the domestic economy and workers.

In the short term at least, India represents a considerably smaller UK trade partner than the EU and the US. UK-India trade accounts for 1.6 per cent of total UK trade, compared to 15.5 per cent with the US and 48.0 per cent with the EU. However, India offers greater scope for liberalisation than the US as India has much higher starting barriers to trade, including tariffs and services restrictions. For example, UK firms face an average tariff of 19 per cent exporting to India compared to around just 2 per cent for the US.

Based on current trade patterns, India is a politically attractive FTA partner insofar as liberalisation is not expected to introduce strong import competition to competitive UK manufacturing sectors, nor result in the net loss of relatively well-paid manufacturing jobs. Rather, the Government's analysis of the impacts suggests manufacturing sectors are set to see the majority of the gains from significant tariff and non-tariff liberalisation, with the largest gains expected to be in transport, machinery and electrical equipment manufacturing sectors. However, textiles is the sector expected to experience the biggest increase in import competition, negatively impacting the domestic textile industry, which is among the only UK manufacturing sectors with a majority female workforce.

The upsides may be more limited for the UK's importers seeking to diversify their supply chains or find alternative suppliers of consumer goods, however. India does not specialise in exporting many of the goods UK firms and consumers currently seek to import. Compared to the US, India will likely present less competition to UK manufacturing, but India's trade is also less complimentary and so will provide a less effective substitute for EU suppliers in UK supply chains or alternative suppliers for consumer goods. For example, motor vehicles account for 5 per cent of UK imports but less than 1 per cent of Indian exports.

Given the strategy seeks to target fast growth, consideration of the longer-term, dynamic impacts is vital. India's high import growth potential, particularly in services; recent increases in trade barriers; and low levels of existing liberalisation all support larger potential gains for UK firms than an analysis of the immediate impact might suggest. The Government's trade forecasts suggest India is expected to account for 7 per cent of global import growth to 2050, rising from the 8th to 3rd largest import market. An FTA would support the UK seeking to capitalise on such huge – and services concentrated – growth. For example, demand for business services, and telecommunication and computer services, two competitive UK export sectors, is expected to more than triple in real terms between 2019 and 2030. Government analysis indicates that while the export gains in 2030 may be similar in scale between an India and US, by 2050 import growth gains will have tripled for India compared with doubling for the US.

The barriers to trade with India are not only high across both goods and services but have been growing in recent years, with applied tariffs rising between 2017 and 2021 by as much as 20 percentage points in some sectors. An FTA would provide future certainty for UK firms even where liberalisation is not achieved, as it would lock-in the status quo and limit their exposure to future policy changes. Finally, as India has implemented just

11 FTAs, which give preferential access to just 3 other OECD members, the UK has the opportunity to gain a first-mover advantage in establishing itself as a high value-added services supplier.

Considering the deal from a long-term perspective also suggests there could be significant opportunities for UK business service exporters. The region's demand for services is expected to grow sharply and the UK is currently underperforming in India: while the UK makes up 4 per cent of Malaysia and Singapore's business services imports, it accounts for just 1.7 per cent of India's.

But a longer-term assessment of an FTA with India should recognise not only the potential benefits from a strategy targeting growth markets, but also the significant uncertainty involved. The Government's assessment of the gains and costs to the UK of liberalising trade with India are based on current trade flows and industrial structures. Yet a deal with India exposes UK business to much greater future uncertainty than it would, for example, in the case of a deal with the US. Indeed, we find that India's export specialisms are changing at a far faster rate than the US, with eight sectors emerging with a new comparative advantage compared to just one in the US in the past 10 years. While it is difficult to accurately predict the sectors India will specialise in future, regulatory reform and industrial policy, including subsidies, population growth and investment in human capital will all drive further industrial change and affect India's future growth prospects. Any deal with India, therefore, combines improved access to a fast-growing market with exposure of UK firms to unpredictable future competition.

While the Government's published analysis focusses on the upsides for goods exporters, set to gain from large tariff and non-tariff liberalisation in the deal, it neglects an important story on impacts to UK business services. India stands out among comparators in the region in that its exports are highly concentrated in service sectors, with services accounting for over 40 per cent of Indian exports compared to just 17 per cent for the East Asia and Pacific region in 2019. Although UK business services have underperformed in India so far, UK services sectors have been more successful at integrating into Indian supply chains with services making up 76 per cent of UK value added in Indian exports, compared to just 32 per cent of the total foreign value added in Indian exports, in 2018. Although India is a competitive exporter of business services, there's reason to believe UK exporters could be well positioned to maintain their international competitiveness, adapting to any increased competition by specialising in the highest skill activities drawing on the UK's quality infrastructure, a highly skilled workforce and the benefits that come from agglomeration in areas such as London.

Overall, the Indo-Pacific strategy should be seen as a high-risk, high reward strategy to generate long-run export growth potential for UK firms. It's success rests on the

judgement that the UK will avoid a services version of the so-called 'China shock' in the US, where exposing domestic manufacturing firms to competition from a trading partner with cheaper labour cost quality jobs. Instead the UK must seek to emulate the German experience with China, which would require the UK to use the FTA to correct existing underperformance and increase exports of high value-added services to India, while enabling cheaper Indian imports to be used in UK supply chains to enhance competitiveness. Business services and financial services are not only among the UK's most internationally competitive sectors, they create high-quality and well-paid jobs for UK workers. Successfully supporting higher value-added business service sectors through the deal could not only benefit UK exporters but support a wider strategy to build a sector that is robust to threats from technological change and future foreign competition.

The UK is targeting trade growth through an 'Indo-Pacific tilt'

After leaving the EU, the UK is looking to forge new trading relationships. This is not surprising. As set out in our previous work, increasing barriers with our biggest single trading partner will leave the UK less open. It also means it has the opportunity to strike new deals elsewhere. Doing so is important to the UK public, who are among the most supportive of trade.[1] But it is also central to the 'Global Britain' agenda, and in signalling the UK will be an open, outward-facing and free-trading economy post-Brexit. This raises the important question of which countries to pivot towards, and how that will support the UK's economic strategy more broadly.

As hopes of a deal with the US have faded, a pivot towards the Indo-Pacific has become the priority. That deal with the US was seen by many as the prize of Brexit. But after a promising start to negotiations, progress stalled when the US administration changed in January 2021. Delivering an agreement with the UK is not now considered a trade priority for the current US administration. This has led to a reorientation of UK trade policy. And, as set out in Box 1, the emerging trade strategy prioritises targeting growth through a so-called 'Indo-Pacific tilt'. Other countries are seeking to follow similar approaches, for example, the US is expected to set out an Indo-Pacific Economic Framework this year, as it too seeks to benefit from the region's growing middle class and import growth.[2]

1 J Lyon et al., Trading places: Brexit and the path to longer-term improvements in living standards, The Economy 2030 Inquiry, October 2021.
2 U.S. to set 'common goals' on Indo-Pacific economic cooperation in early 2022, Reuters, January 2022.

BOX 1: The UK Government's Trade Strategy

The UK Government has put the 'Indo-Pacific tilt' at the heart of its export and international strategies. Indeed, the Department for International Trade (DIT) recently made explicit the desire to trade more with the region. In particular, in its published overall export strategy it noted, "...we are pursuing an ambitious programme of new trade agreements, including in the fast-growing Indo-Pacific region." And also noted that, "Our strategy responds to and anticipates changes in the global economy, by tilting towards the Indo-Pacific".[3]

Moreover, this desire has been echoed in the recent Cabinet Office review which stated that, "The Indo-Pacific is the world's growth engine: home to half the world's people; 40 per cent of global GDP; some of the fastest growing economies.... we will work to build [existing trade and investment relationships] further, including through new trade agreements, dialogues and deeper partnerships".[4]

The more important part of this strategy is a trade deal with India

While the 'tilt' is broader, the key part of this strategy is a trade deal with India. The strategy is to be delivered through the UK's accession to the CPTPP, which has been supported through first delivering bilateral deals with members, including Australia and New Zealand and a digital agreement with Singapore. But the key additional component of the broader strategy here is a new FTA with India, for which negotiations were launched on 13 January. In this section will show that India is expected to represent the majority of the new value both because the scope for liberalisation is wider, and because import growth across CPTPP members is expected to be below the global average.

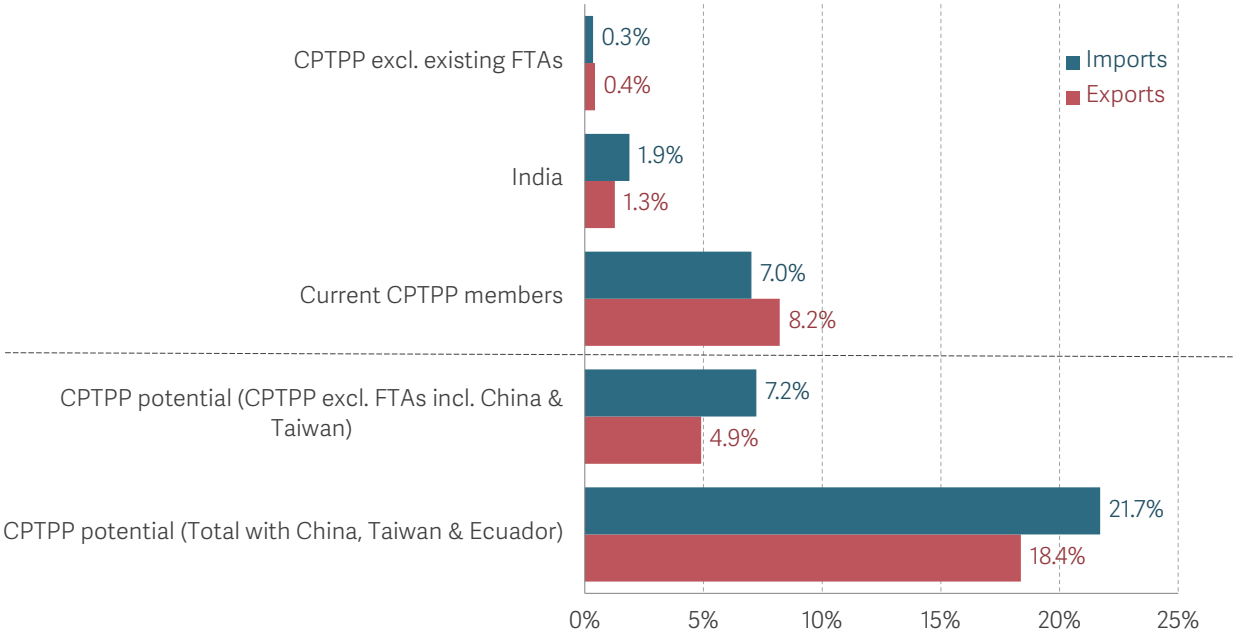
The scope for liberalisation with CPTPP members is limited

Although CPTPP is bigger than India overall, existing agreements cover the majority of members. Figure 1 shows the current membership of CPTPP accounts for 7 per cent of UK imports and 8.2 per cent of its exports. Meanwhile India accounts for just 1.9 per cent and 1.3 per cent of imports and exports respectively. But the UK has already successfully rolled over or negotiated bilateral agreements with nine of the 11 CPTPP members, all but Malaysia and Brunei, covering 95 per cent of the UK's trade with CPTPP members leaving just 0.3 per cent and 0.4 per cent of UK imports and exports uncovered by an existing FTA.

3 Department for International Trade, Made in the UK, Sold to the World, September 2021.
4 Cabinet Office, Global Britain in a Competitive Age: the Integrated Review of Security, Defence, Development and Foreign Policy, March 2021.

FIGURE 1: **India represents a larger market for new liberalisation relative to CPTPP**

Share of UK trade by trading partners: 2017-2019



SOURCE: Analysis of ONS, UK total trade: all countries, non-seasonally adjusted.

Future expansion of the CPTPP could increase the value of joining for the UK but that is a long way off. To date, three countries have joined the UK in applying for membership to the CPTPP: China, Taiwan and Ecuador, which together would almost double the share of UK trade covered by CPTPP. Others have expressed interest in joining in future, such as Thailand and South Korea. As shown in Figure 1, should China and Taiwan successfully join, the expected value of new trade liberalisation would be higher for CPTPP than India. There is, however, no immediate prospect of China either being willing or able to meet the core CPTPP standards, for example on state-owned enterprises.[5] All this leaves the prospect of trade liberalisation with China a distant prospect (as well as politically awkward).[6]

It's worth keeping in mind that, although CPTPP does not offer much scope for completely new liberalisation with its current members, it could be argued the agreement will create some marginal liberalisation with partners with an existing FTA. It will effectively upgrade some of the older existing agreements, for example by further reducing tariffs and introducing new digital provisions. However, the UK Government's assessment of CPTPP indicates little additional liberalisation is anticipated, especially with partners the UK has more modern FTAs with such as with Japan and Canada. For example, joining CPTPP is expected to increase the proportion of UK exports to CPTPP

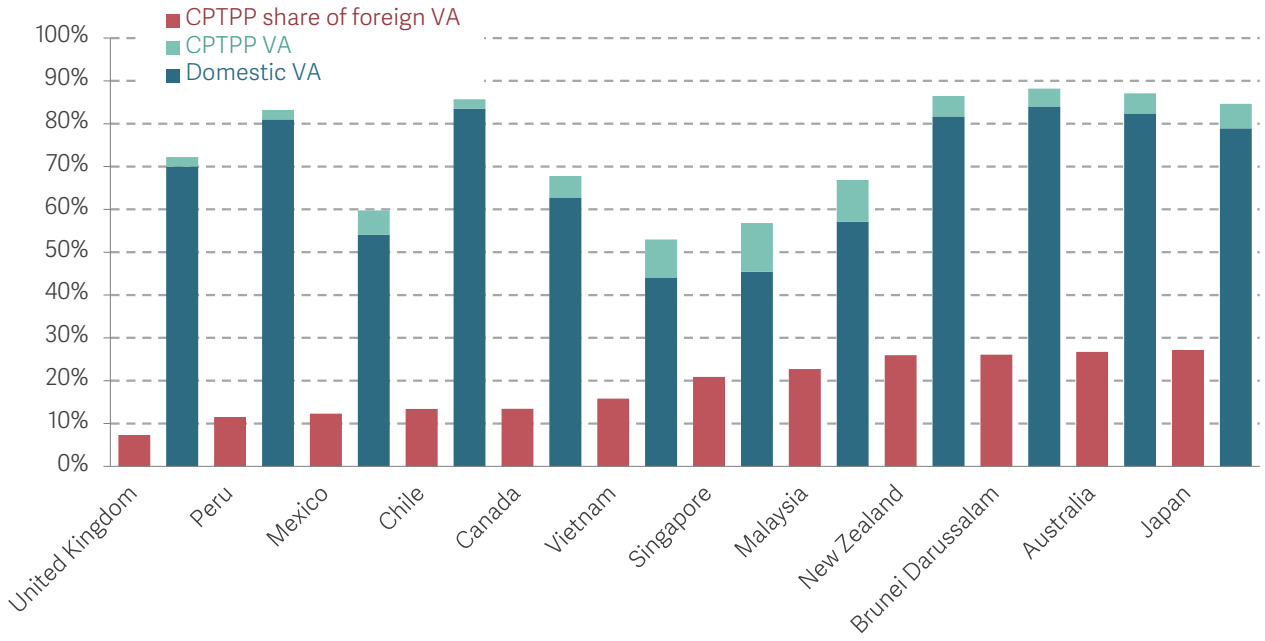
5 Brookings, China moves to join the CPTPP, but don't expect a fast pass, September 2021.
6 J Lyon et al., Trading places: Brexit and the path to longer-term improvements in living standards, The Economy 2030 Inquiry, October 2021.

members subject to tariff free access from 97.8 per cent to 99.9 per cent (subject to staging and rules of origin requirements).[7] Liberalisation of non-tariff measures on UK goods exports is also expected to be limited, with the removal of barriers equivalent to less than a 2 percentage point tariff cut with the majority of CPTPP members.

Another marginal benefit of CPTPP is that it will also enable UK suppliers to include inputs from all members within rules of origin requirements, not possible under existing bilateral deals. While this could benefit some UK exporters, Figure 2 shows that CPTPP accounts for just 7 per cent of UK manufacturing exports foreign value added. This is the lowest share among existing CPTPP members, indicating they are currently better integrated in each other's supply chains. This means these countries have more to gain from CPTPP rules of origin requirements, although this could of course change in time. Figure 2 shows that while the value added in UK exports sourced from CPTPP members is low, the share of domestic value added in UK manufacturing exports is high, compared to say Vietnam or Singapore. As such, UK firms may still be in a better position to meet rule of origin requirements, even if the cumulation across CPTPP members will not add much economic value.

FIGURE 2: **If the UK joined CPTPP it would be the least-integrated member in CPTPP manufacturing supply chains**

Share of value added in manufacturing exports: 2018



SOURCE: Analysis of OECD, TiVA database.

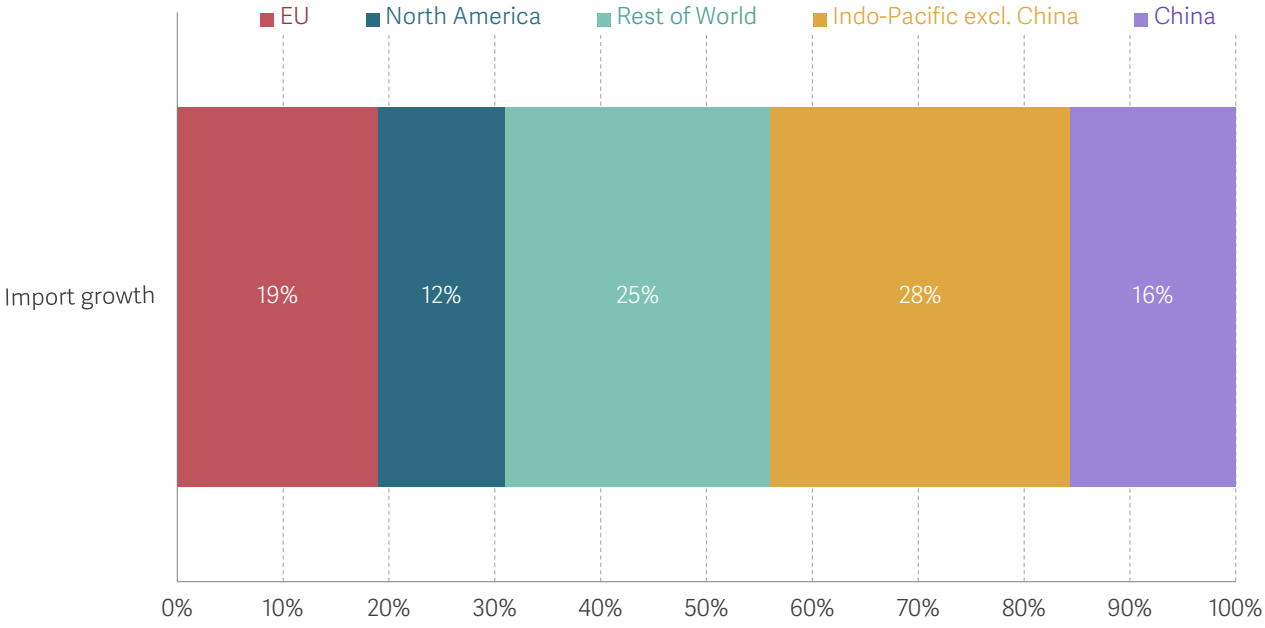
7 Department for International Trade, UK accession to CPTPP: the UK's strategic approach, June 2021.

CPTPP is not where fast Indo-Pacific growth is happening

In addition, while the Indo-Pacific contains several of the world's fastest-growing economies, the average import growth rate of the CPTPP group as a whole is below the global average. The share of global imports covered by current CPTPP members is expected to fall from 15 per cent in 2019 to 13 per cent in 2050.[8] It does contain some particularly fast-growing import markets – such as Vietnam which is expected to rise from the 24th to 10th largest import market by 2050. But the larger, higher-income members, such as Japan and Canada, are expected to have below average growth. By comparison, countries such as China, Indonesia and the Philippines, not covered by the current approach, are expected to experience import growth significantly above average global import growth. Figure 3 shows that Government projections suggest China will remain an engine for growth, driving more than a third of the import growth in the region.

FIGURE 3: **Indo-Pacific growth potential is high but China will remain an engine for growth in the region**

Regional drivers of global import growth in real terms: 2019-50



NOTES: Projections account for the recovery from Covid-19 informed by IMF trade forecasts, which assume trade will rebound more slowly than GDP. Includes trade within regions, for example intra-EU trade growth.
SOURCE: Global Trade Outlook, Department for International Trade (2021).

Overall, then, the bulk of the liberalisation and economic impacts of the current Indo-Pacific strategy is likely to come from closer ties with India. In order to consider the implications, this note provides an assessment of an Indian FTA, illustrating the different strategic impacts it may have, and contrasting those to the previous US-orientated strategy. We start with the near-term benefits of such a deal – that is, those that stem

8 Department for International Trade, Global trade outlook - September 2021 report, September 2021.

from the current configuration of trade with India – before turning to the scope for longer-term benefits beyond that.

The near-term gains from an India deal are significant but it will not replace the EU

India is small compared to the EU and US, but a deal would offer substantial liberalisation

When compared to the lost openness we're trying to replace (i.e. trade with the EU), or the alternative of focussing on liberalisation with the US, overall output and trade flows from India look small. UK-India trade accounts for 1.6 per cent of total UK trade, compared with 15.5 per cent with the US, and 48.0 per cent with the EU. And despite fast growth in India, the US is expected to remain a lager economy and import market beyond 2050. The 'gravity' approach to thinking about trade, which links the level of trade between two countries to their size and distance, indicates the US will remain a larger export market for the UK.[9] If the UK maintains its current market share with both India and the US, exports to India would more than double while exports to the US would increase by 50 per cent by 2030. Nonetheless, exports to the US would remain 10 times those to India.

However, India presents greater scope for liberalisation than the US. UK firms face an average tariff of 19 per cent exporting to India compared to around just 2 per cent for the US.[10] In addition, the scope for reducing restrictions to services trade, measured by the OECD's services trade restrictiveness index, is also higher for India.

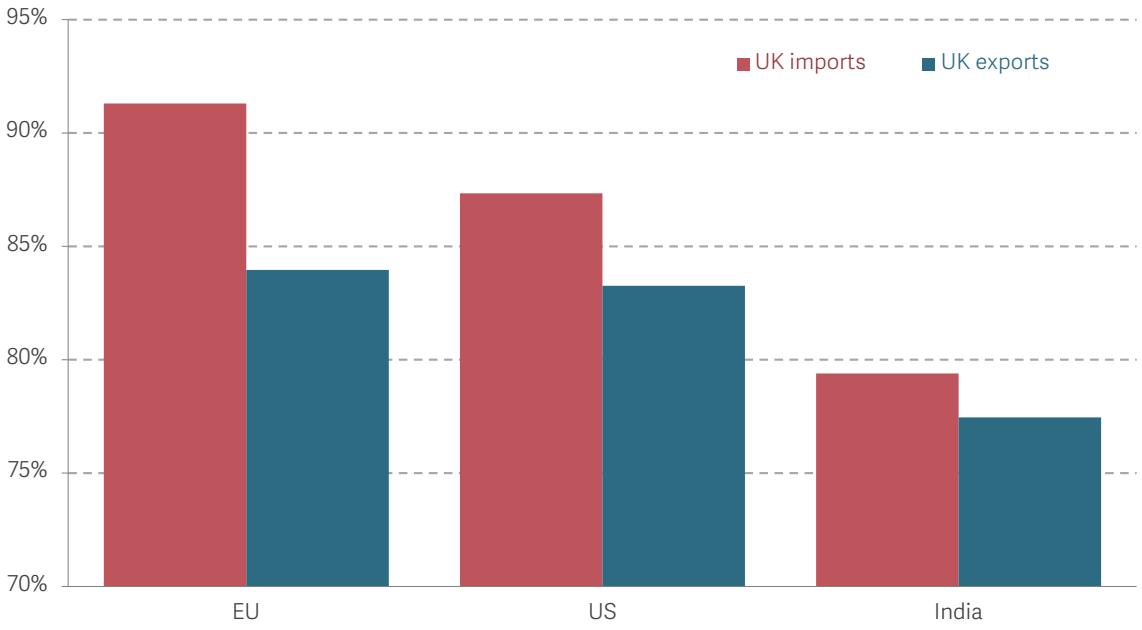
Unlike an FTA with the US, a deal with India would not be about replacing the EU trade

Ultimately, for deals with the Indo-Pacific to be beneficial for the UK, trading partners in the regions must either produce the goods and services UK consumers and business want to import, or demand the goods and services the UK exports. Figure 4 shows the UK and EU are highly complementary trading partners meaning the pattern of EU imports well matches UK exports and vice versa, as expected following decades of highly-integrated trade. The US offers a fairly close substitute to the EU, but India is notably less complementary with the UK.

9 Y Yotov et al., An Advanced Guide to Trade Policy Analysis: The Structural Gravity Model, UNCTAD WTO, 2016.
10 Source: Department for International Trade, UK approach to negotiating a free trade agreement with India, January 2022; Department for International Trade, The UK's approach to trade negotiations with the US, March 2020. Based on different years (US – 2017 and India – 2021).

FIGURE 4: **India is less well matched to UK trade**

Trade complementarity (similarity of export and import patterns) with the UK: 2017–2019



NOTES: Similarity index is calculated as the sum of the absolute differences between the share of UK imports and country groups exports of each goods (HS6) and service sector (UK imports), and between UK exports and country groups imports (UK exports). This is then halved and taken from 1 to give the index. UK exports are highly concentrated in financial and insurance services which causes UK exports to consistently be less well matched than imports.
SOURCE: Analysis of ITC Trademap data.

This suggests the FTA strategy will not enable UK firms to easily pivot to India by replacing EU firms with Indian suppliers in their supply chains. It also suggests that demand will be less well matched to UK exports. For example, at present, transport and fuels account for 23 per cent and 15 per cent of Indian imports respectively, but cumulatively make up just 9 per cent of the UK's exports. Similarly, key UK export sectors requiring imported inputs make up much smaller shares of Indian exports, for example motor vehicles, which account for 5 per cent of UK imports but less than 1 per cent of Indian exports.

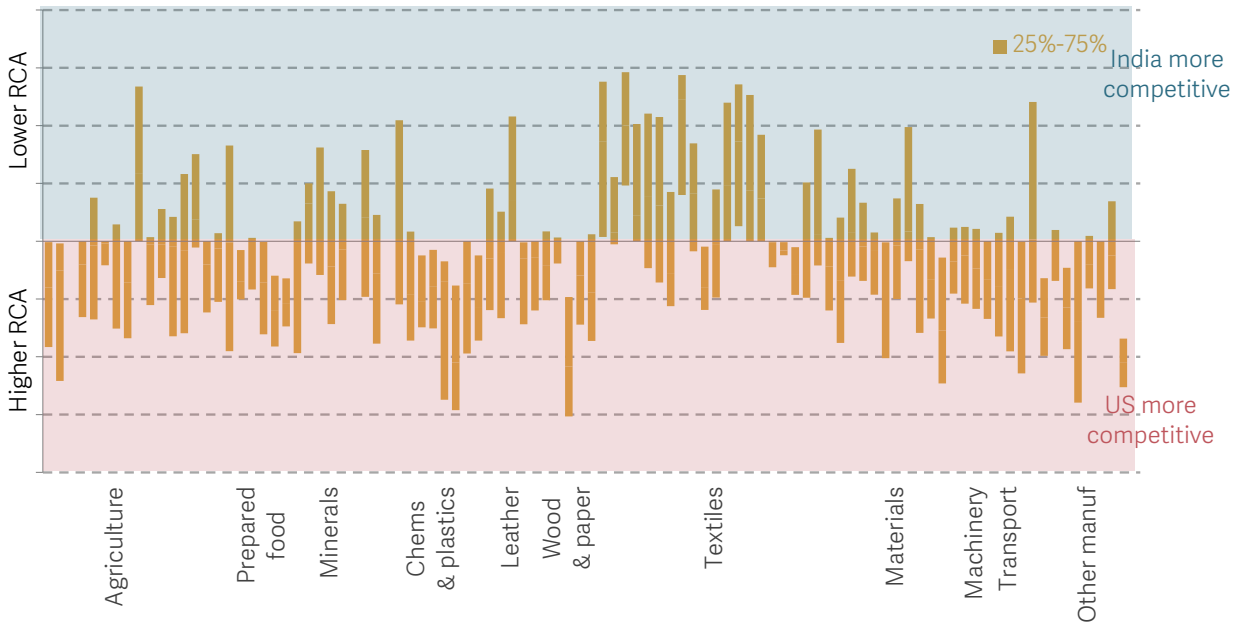
Rather than fill the gap left by lower trade with the EU, tilting to the Indo-Pacific tilt could instead aim to shift the structure of the UK's trade. Complementarity will change as UK imports adapt to the new arrangements. For example, imports from the EU are already estimated to be 24 per cent below their expected level if the UK remained within the EU.[11] So how might trade with India affect the structure of the UK economy? That depends on the industrial mix of India exports and the extent to which difference sectors are successfully liberalised in any eventual deal. Figure 5 goes 'under the hood' of the difference in complementarity shown in Figure 4. It shows that – relative to the more EU-like specialisms of the US – India is much more specialised in textiles. This suggests

11 UK Trade Policy Observatory, Post-Brexit: Trade in goods and services (II), November 2021.

that liberalisation with India could lead to cheaper consumer goods, such as clothing, in sectors that are already import intensive and where the UK is not a competitive producer. Where the US is more competitive and may have better substituted EU manufacturing imports, this strategy could increase the attractiveness of domestic substitutes in UK supply chains relative to a US-focussed strategy.

FIGURE 5: **India is less specialised in most manufacturing sectors**

Difference between India and US revealed comparative advantage (RCA) in individual trade categories: 2017 to 2019



NOTES: Revealed comparative advantage is an index for calculating the relative advantage or disadvantage of a country in a sector as evidenced by realised trade flows. RCA here is equal to the proportion of the country's exports that are in a given sector divided by the proportion of world exports that are in that sector. RCA above is calculated for each HS6 product line (more than 6,000 sectors), made symmetric by taking (RCA-1)/(RCA+1), then the quartiles were calculated for each HS2 level sector (97 sectors).
SOURCE: Analysis of ITC Trademap data.

While UK manufacturers are expected to benefit the most from a deal, textiles is a notable exception

On this basis, India is a politically attractive FTA partner as liberalisation is not expected to introduce strong import competition to competitive UK manufacturing sectors, nor result in the net loss of relatively well-paid manufacturing jobs.[12] Rather, the Government's analysis of the impacts suggests manufacturing sectors are set to gain from significant tariff and non-tariff liberalisation, with the largest gains expected to be in transport, machinery and electrical equipment manufacturing sectors.

12 Although Indian priorities around mobility provisions may make the negotiations politically challenging within the UK Government.

However, the textile industry is a notable exception here. As suggested in Figure 5, domestic textile producers are likely to face increased import competition from India leading to a notable decline in output. While the industry in the UK is relatively small (around 100,000 jobs), and internationally uncompetitive, increased import competition from India is expected to lead to job losses and impose adjustment costs for the workforce in one of few manufacturing sectors which is female dominated, and which disproportionately employs lower-income workers. The sector is also important to other internationally competitive sectors, such as creative services.

In addition, while no services sectors are expected to experience declines in sectoral gross value added (GVA) of more than -0.05 per cent, the analysis does indicate the FTA will lead to several service sectors accounting for a smaller share of economy, with business services expected to experience a relatively large fall in its share of total GVA and employment. The extent to which this is driven by import competition as opposed to a simple reallocation to sectors experiencing larger gains, is difficult to ascertain as sectoral trade impacts are not published. Nonetheless, business services and financial services are not only among the UK's most internationally competitive sectors – they create high-quality and well-paid jobs for UK workers.[13] So in the next section we consider the longer-term prospects for business services and other sectors and discuss what all this might mean for the UK's overall route to economic success.

In the long term, a deal with India is a gamble

India offers a growing import market and a first mover advantage

India has significant upside potential for UK firms, as India is fast growing, has significant scope for liberalisation and has not struck deals with many other developed services-orientated exporters. Indeed, the thinking behind the Indo-Pacific strategy is that it taps growing markets, enabling UK firms to embed in newly-forming supply chains and export to countries where consumption patterns are changing in the UK's favour. In particular, rising global incomes are expected to result in the share of global services trade rising from 25 per cent to 28 per cent by 2030 at the same time that technological change enables services to be increasingly tradeable.[14,15] As a specialised services exporter, the UK is well positioned to capitalise on this shift in import demand generally.[16]

India is expected to be among the fastest growing import markets. It is forecast to account for 7 per cent of import growth to 2050; rising from the eighth to third largest

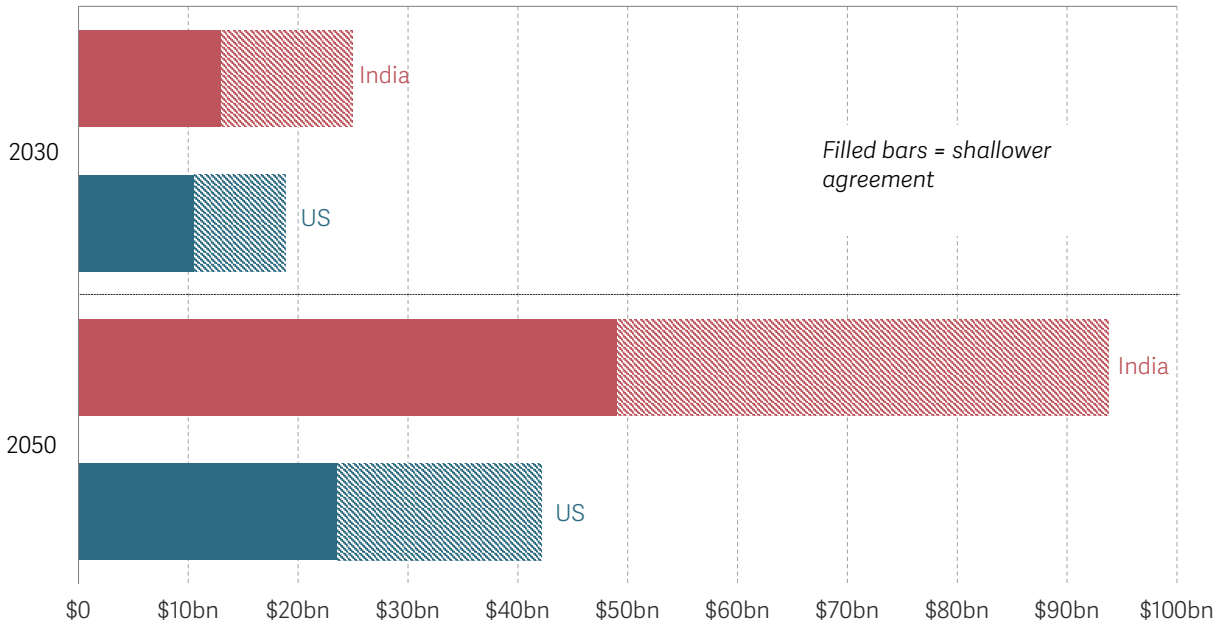
13 ONS, EARN02: Average weekly earnings by sector, January 2022.
14 Department for International Trade, Global trade outlook - September 2021 report, September 2021.
15 WTO, World Trade Report 2018: The future of world trade. How digital technologies are transforming global commerce, 2018.
16 J Lyon et al., Trading places: Brexit and the path to longer-term improvements in living standards, The Economy 2030 Inquiry, October 2021.

import market, smaller than just the US and China. While the relative complementarity of UK and Indian trade is currently low, as India grows its import demand will also change. For example, demand for business services and telecommunication and computer services, two competitive UK export sectors, are expected to more than triple in real terms between 2019 and 2030, exceeding growth in currently larger import sectors such as oil and gas and transport services.[17] If realised, this would increase complementarity of UK exports and Indian imports in future.

The potential gains from an Indian FTA are also driven by the large and changing barriers to trade with India. Between 2017 and 2021, Government analysis suggests that the tariffs applicable to UK exports increased, by as much as 20 percentage points in some sectors, such as vehicles.[18] Any FTA would not only reduce tariffs on some products, but it would also protect UK firms from future tariff increases.

FIGURE 6: **India creates more long-term export potential than the US**

Increase in exports under a US deal compared to a deal with India



NOTES: Assumes FTA impacts on market share are fully captured by 2030 so the change between 2030 and 2050 capture the impact just from changes in the size of the import markets in nominal terms. Shallow and deep scenarios are not equivalent across India and US as they are based on different input assumptions - the input assumptions for the deeper US agreement scenario assumes 50 per cent of actionable trade barriers are removed for goods, but the deeper India agreement assumes the agreement is equivalent to the reductions seen in CPTPP.
SOURCE: Global Trade Outlook and India, CPTPP and US Scoping Assessments, DIT.

17 Department for International Trade, UK approach to negotiating a free trade agreement with India, January 2022.
18 Department for International Trade, UK approach to negotiating a free trade agreement with India, January 2022.

Overall the scope for substantial liberalisation with India is high and the Government's analysis suggests UK exports to India could increase by up to 95 per cent. By comparison, Government analysis suggests the US FTA could increase exports by 4 to 8 per cent.[19] However, Figure 6 shows there are likely scenarios (for example, if a deep FTA with the US is attainable but there was only a shallow deal with India) in which the export gains from a US deal will initially be higher, but these will eventually be outweighed by gains from the India deal (and CPTPP) in the long run. This reflects the faster growth and higher scope for liberalisation.

In addition, the UK may also gain a first- (or early-) mover advantage over its main competitors. For example, services exporters such as Ireland and the US, would also like to exploit Indian import growth. But, as India has implemented just 11 FTAs in the past, the UK would be just the second G7 country and fourth OECD member to gain preferential access to India's import market. While competitors may eventually negotiate their own FTAs, UK exporters would already have a foothold in the Indian market. As trade persistence is high, even transitory trade shocks can be long-lasting and have an implied half-life of five years. Persistence arises from the fixed investments made by firms in distribution and service networks overseas.[20] This suggests UK firms may be able to maintain their increased market share for many years, even if the UK's preferential access was ultimately eroded.

There is evidence that this effect could be substantial. For example, UK firms have had some success at defending their market share in China: despite rapid economic and import growth, UK firms have kept their share of Chinese goods imports relatively constant since around 2002.[21] This has been resistant to changes in the composition of trade, for example the share of Chinese pharmaceutical imports sourced from the UK fell from 9 per cent to 3 per cent while the share of car imports and printed media from the UK rose from 1 per cent to 5 per cent and 5 per cent to 12 per cent respectively.

Overall, this suggests India has substantial upside potential for UK exporters if an FTA can be successfully delivered. India's import market is growing and changing to better align to UK export specialisms and a deal would set up UK firms to benefit from substantial liberalisation across sectors and a first-mover advantage in accessing growing services import demand.

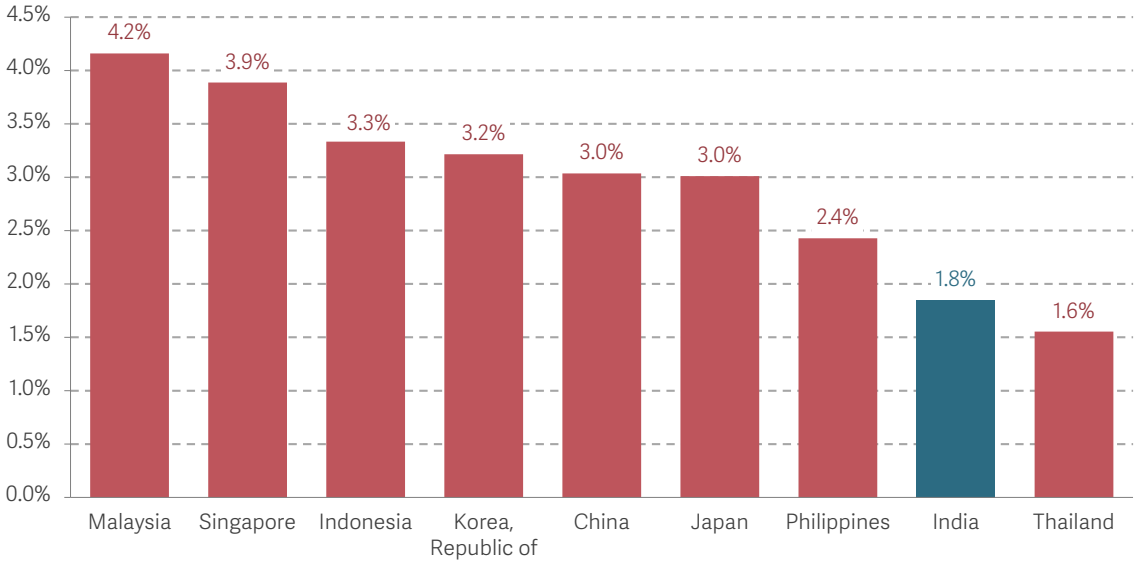
19 Note that these numbers are produced in different ways: while the US estimate uses a 'Melitz style' model, India uses an 'Armington' specification which increases the responsiveness of trade to liberalisation of tariffs and other trade costs.
20 M Bun & F Klaassen, The Importance of Dynamics in Panel Gravity Models of Trade, SSRN Electronic Journal, April 2002.
21 Source: ITC trademap.

Opportunities in services may be larger than implied by the Government's own analysis

Although the scoping assessment of an FTA with India indicates high potential gains for UK goods sectors, there are a number of reasons for thinking that the upside for services may be larger than the analysis suggests. First, Indian import demand growth is expected to be much faster for service sectors than goods on average, but modelled impacts do not account for future sectoral import growth. There is clear scope to reduce barriers, Indian business services score highly on the OECD service trade restrictiveness index and changing domestic regulations create uncertainty. This is supported by responses to the Government's public consultation on an Indian FTA, in which "respondents highlighted the professional and business services sector as an area of key interest".[22] Finally, it is UK services that have been most successful in penetrating Indian supply chains to date, with services making up 76 per cent of UK value added in Indian exports, compared to just 32 per cent of the total foreign value added in Indian exports in 2018. Despite this, the UK is still underperforming in business services. Over 10 per cent of global exports of such services come from the UK between 2017 and 2019 and yet the UK provided only an estimated 1.8 per cent of India's imports. Figure 7 shows this is low compared to several comparators in the region, both with FTAs (such as Japan and Singapore) and even those without (Malaysia and Indonesia).

FIGURE 7: **UK business services are underperforming in India**

UK business services exports as a share of total imports for India and comparators in Asia: 2017 to 2019



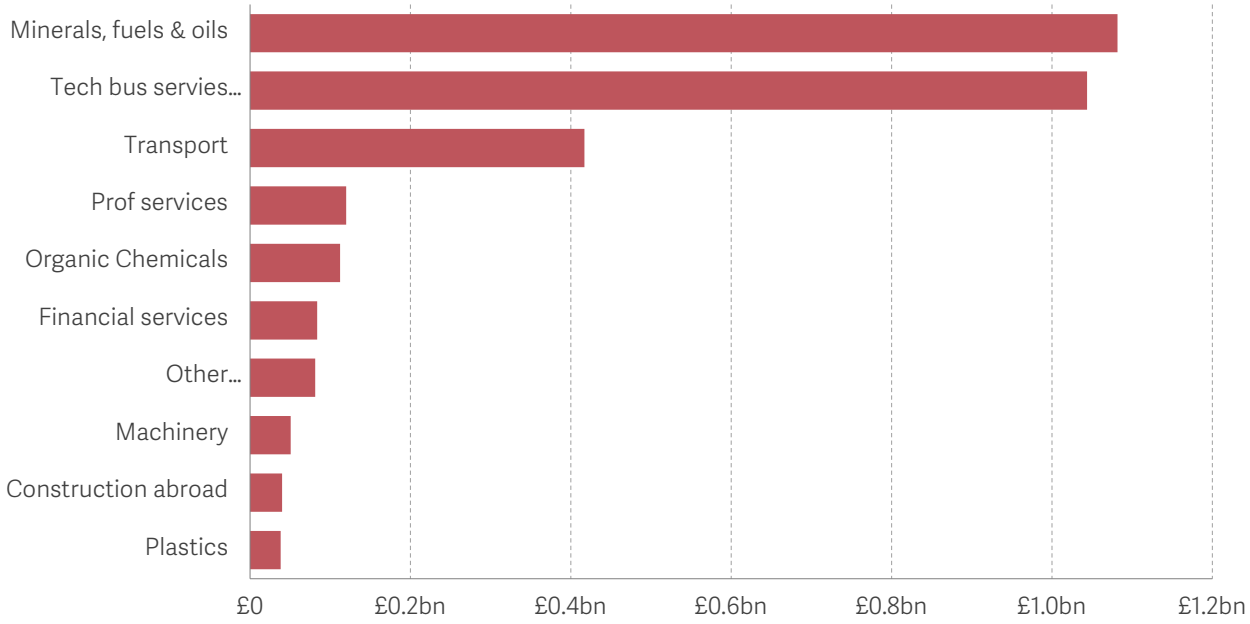
NOTES: Estimates share using UK bilateral export data over the countries reported imports (from ITC trademap). Data converted using annual average exchange rates.
SOURCE: Analysis of ITC Trademap; ONS, UK trade in services: service type by partner country; and Bank of England, exchange rate data.

22 Department for International Trade, UK approach to negotiating a free trade agreement with India, January 2022.

Meanwhile, the Government's analysis suggests only small value-added gains are expected in service sectors even under an ambitious Indian FTA. This conclusion reflects analysis using Computable General Equilibrium (CGE) modelling – relatively large-scale models that show how different sectors are linked, both within and between economies. Such an approach is an effective one for modelling interactions between sectors, but the use of so-called 'Armington' specifications – which govern the responsiveness of trade to liberalisation – in the scoping analysis will effectively lock-in pre-existing trade patterns, preventing the models from generating large changes in trade in sectors with little trade even if there are large changes in prices.[23] The modelling is therefore limited in its ability to highlight opportunities for services suppliers currently locked out of the market by prohibitive trade barriers. Also, as this is a 'static' analysis – i.e. one that looks at the eventual change starting from where we are today – it is also not well suited to capturing the opportunities from fast growing and evolving services imports in India.

FIGURE 8: **Potential annual underperformance in business services is among the biggest in monetary terms**

Underperformance of UK sectoral exports to India relative to the share implied by UK share in world trade: 2017 to 2019



NOTES: Results are calculated as the difference between the value of exports achieved to India and the share of exports if the UK managed to export its global share in each sector, weighted by its share of Indian imports (1.7 per cent) compared to its share of world exports (3.5 per cent).
SOURCE: Analysis of ITC Trademap; ONS, UK trade in services: service type by partner country.

As an alternative to this approach, Figure 8 shows cross-sector underperformance – that is, the difference between the value of exports to India and the amount implied if the share was consistent with the UK's share in world trade. It suggests that business

23 A practical guide to Trade Policy Analysis, Chapter 5. UNCTAD, 2012.

services present the largest upside potential for future exports if it can be corrected through an FTA.[24]

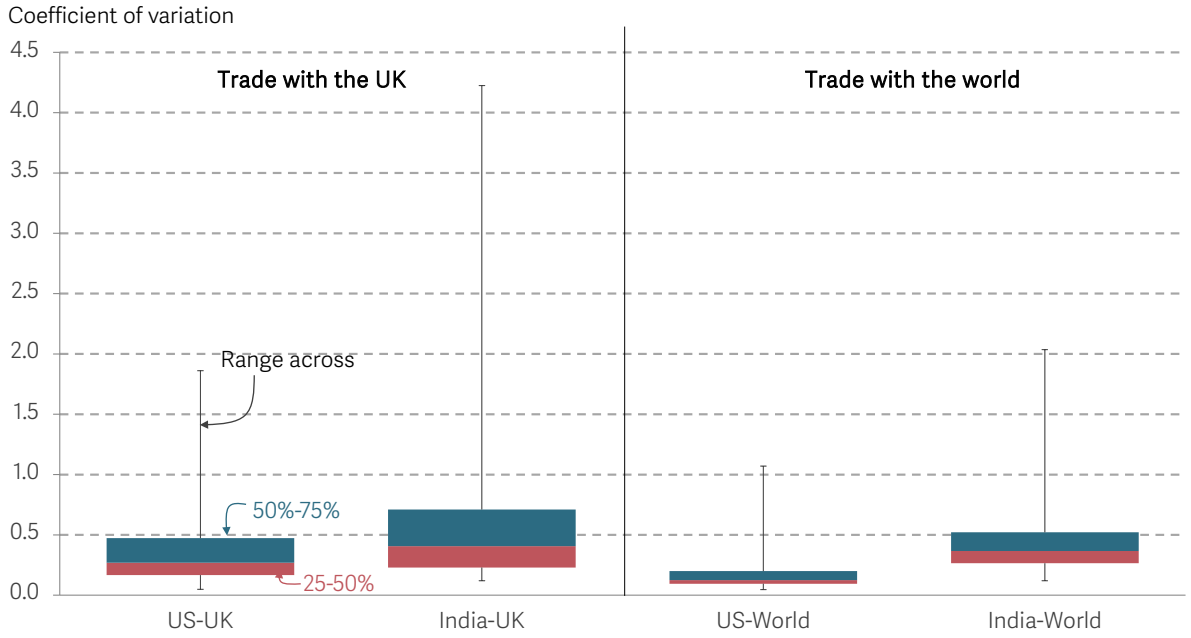
Taken together, all this suggests that gains to UK services exporters could be larger than estimated as part of the Government's scoping analysis.

But liberalising trade with India means accepting more uncertainty

Given the high potential for export growth, pursing trade liberalisation with the fastest growing economies seems like a 'no brainer'. Yet, the abundant literature on the negative economic consequences for the US (and to a lesser extent the UK) of rapid trade growth with China, among the fastest growing economies of the past 20 years, should suggest reason to reflect on the risks.[25] Distributional consequences and adjustment costs are inherent with expanded trade but often overlooked when taking decisions based on aggregate trade and output gains. In the case of fast-growing economies such as India, future uncertainty means it is less clear where adjustment costs will fall.

FIGURE 9: **Indian trade has been more volatile over the past 10 years**

Volatility of quarterly Indian and US goods exports across sectors with the UK and World: 2010 to 2019



NOTES: Values are calculated as the coefficient of variation of the quarterly trade data at HS2 aggregation between Q1 2010 and Q4 2019. Quarterly data from 2020 and 2021 were excluded to exclude the impact of Covid-19 on global trade flows.
SOURCE: RF analysis of ITC Trademap.

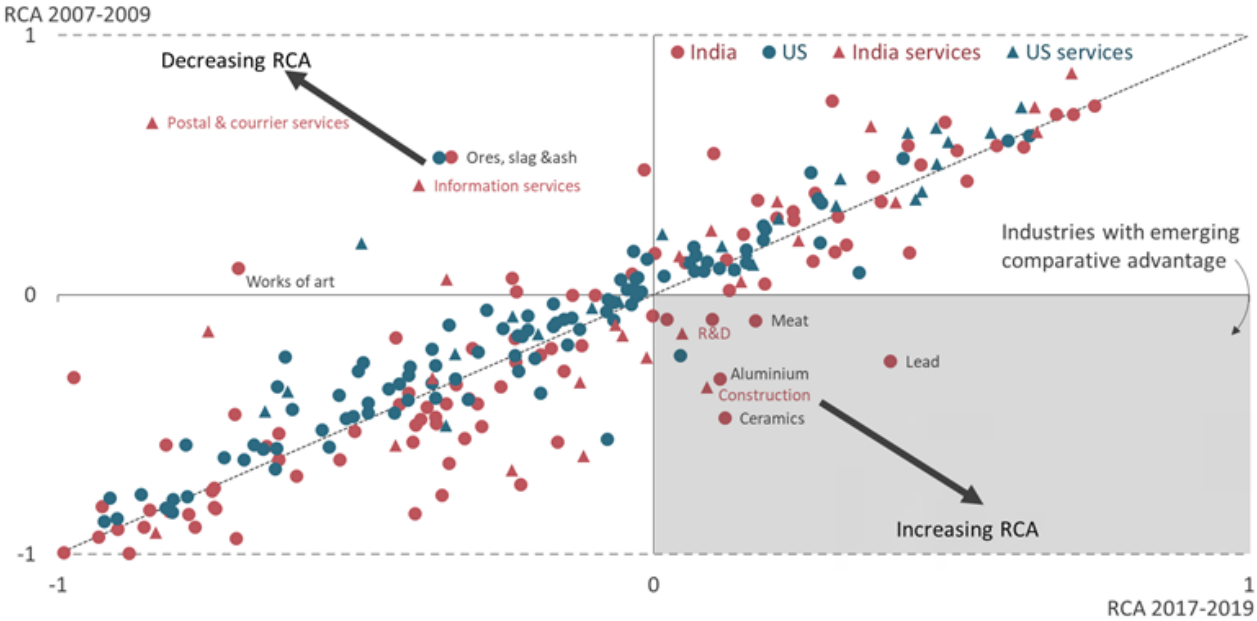
24 The assessment excludes the precious metals sector which is distorted by non-monetary gold investment trade. In addition, increasing fuels exports would not present long-term export potential consistent with the net zero transition.
25 D Autor, D Dorn & G Hanson, The China Shock: Learning from Labor Market Adjustment to Large Changes in Trade, NBER Working Paper 21906, January 2016.

Compared with more developed but slower-growing economies, such as the US, the pace of industrial change is anticipated to be higher in India. In the past 10 years, the share of employment in industry in India has increased by 4 percentage points and in services by 6 percentage points, while the corresponding US shares have not changed.[26] These aggregate figures disguise even greater sectoral changes which, in turn, lead to higher volatility in trade flows and faster changing export specialisms. In turn, this will ultimately lead to less predictable trade and competition facing UK firms. Figure 9 shows that volatility of Indian exports exceeds that of the US, both globally and with the UK. If the UK increases its share of trade with India, it will increase UK firms' exposure to this trade volatility. Higher uncertainty will make it more difficult for firms to plan and make exporting decisions, in part by introducing further price and availability uncertainty into supply chains.

It is not just the size of trade flows from India that are volatile – the competitiveness of those exports are changing too. Figure 10 shows this is happening more quickly for India than for the US: in the past 10 years, India has developed a new revealed comparative advantage (RCA) in eight sectors (bottom-right quadrant), compared to just one for the US. As India is expected to continue growing rapidly, so too will its industrial structure and export specialisms develop in the coming decade.

FIGURE 10: **India's export specialism is changing over time**

Revealed comparative advantage (RCA) of US and India: 2007 to 2009 and 2017 to 2019



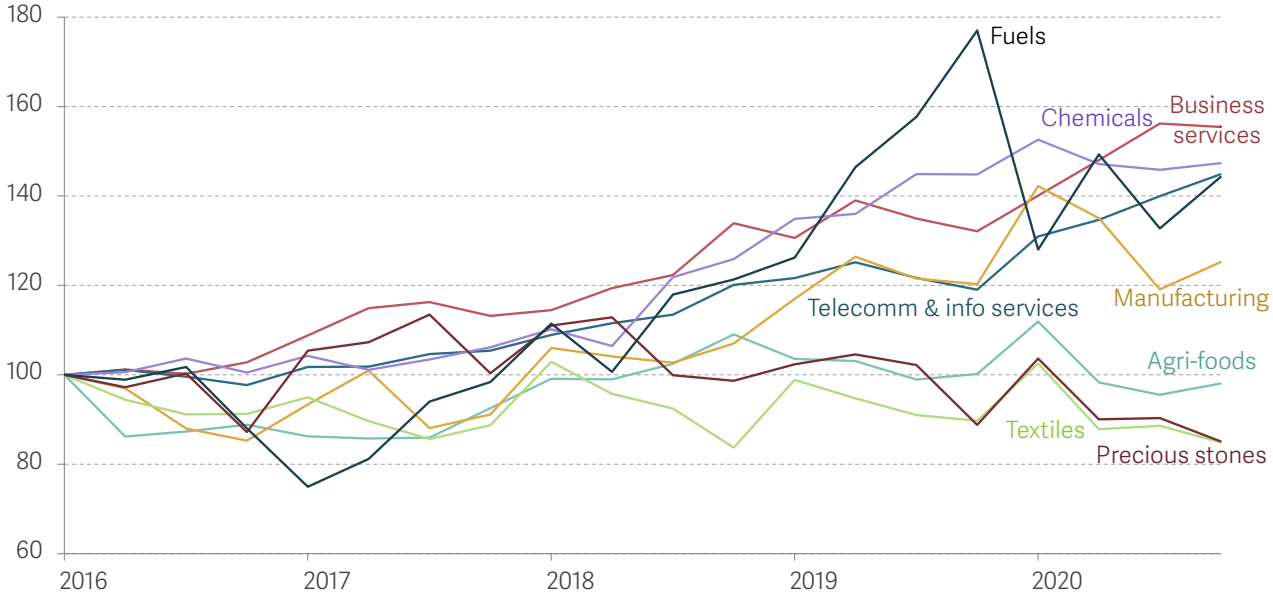
NOTES: Calculates and compares US and Indian revealed comparative advantage at HS2 goods sector aggregation and services at BPM level 2, where available, and level 1 otherwise.
SOURCE: RF analysis of ITC Trademap.

26 Source: World Bank, ILOSTAT database.

For the UK, competition from the sectors in which India's RCA has increased the most in the past 10 years, would not represent a major domestic competition and labour market risk but this could change. This is because any FTA would secure UK market access for Indian exporters which may not be competitive today, but could become so over the next decade. India already stands out for its export-orientated services and key competitive UK services sectors could face enhanced competition in future. For example, Indian exports of R&D services have quadrupled as a share of total Indian exports between 2009 and 2019 (growing from 0.2 per cent of all exports in 2009 to 0.9 per cent in 2019). India is also becoming a global leader in the tech sector, where, for every dollar invested in Chinese tech in the third quarter of 2021, $1.50 went into India.[27] Big investment and specialism in technology could enable India to experience big productivity jumps in its services sectors, potentially allowing India to become a bigger player in exporting fintech or other advanced tech-based services in the future.

FIGURE 11: **India's traditional exports have grown slowest while higher value-added sectors, such as chemicals and business services, have grown fastest**

Index of Indian exports by aggregated sectors (100 = Q3 2016)



SOURCE: ITC Trademap.

The most recent data for India (Figure 11) shows that in the past five years, export growth was slowest in India's traditional export specialisms, including textiles and precious stones. While the fastest growing export sectors were: chemicals; manufacturing; and business and telecoms services. While trade has been distorted by the pandemic, if this

27 Source: Asian Venture Capital Journal according to FT, Investors pivot to India after China's tech crackdown, November 2021.

pattern were to resume after the pandemic, India would be on the path to compete more directly with UK firms.

The expectation is India will continue to grow at pace with both structural and policy support. In each year from 2018 and 2020 India was among the 10 most improved countries on the ease of doing business scores, rising from 130th in 2017 to 63rd in 2020. This points to fast-paced regulatory reform put in place to support domestic growth and attract more foreign investment. India is also introducing a new 'production-linked incentive' – a $6 billion, five-year scheme which will provide short-term subsidies for goods made in India if the companies hit targets set by the Government – designed to promote investment in the manufacturing sector.[28]

India also looks set to be able to continue to take advantage of a growing and better-educated workforce. While India's population growth has slowed, it is still expected to overtake China as the world's most populous country in the next decade. Educations levels are also rising; current low education levels are likely to be a key factor holding back Indian productivity growth.

However, although the pace of Indian growth is fast, it is unlikely to match the exceptional growth and industrial change experienced in China guided by a powerful and centralised state. Even at a slower pace of change, India's large and low-cost labour market makes it a potentially powerful competitor.

So, a trade policy which seeks to develop trade relations with the Indo-Pacific will at the same time expose UK firms to the risks associated with more volatile trade and changing export specialisms, which will only be partly dampened through import substitution.

A trade deal with India also raises questions about the UK's transition to net zero

Increased trade with India may not be fully consistent with other Government objectives, such as the transitions to net zero. India remains a major user of coal and one of the world's top polluters (although emissions per capita are significantly below the UK). If the UK were to follow the EU in introducing a carbon border adjustment mechanism, imports from India could face border taxes again in a number of goods sectors, forcing UK importers to, once again, adapt their supply chains in response. This would reduce the benefits from any enhanced trading relationship. To fully understand the implications of such measures and the compatibility of the UK's trade strategy with ambitions of reaching net zero by 2050, an assessment of the carbon content of trade flows, and their implications for the net-zero transition would be required. This is something we will return to in future work.

28 Financial Times, Manufacturers look to India to tap market and diversify supply chains, December 2020.

An Indian FTA should pay more attention to services

In order to minimise these risks, more attention should be paid to the story of services, particularly business services. The UK and India are two of the biggest services exporters in the world and both specialise in the export of business services. The current FTA analysis does not consider how these two major exporters may compete or complement each other's business services trade nor how the evolving Indian economy could create different impacts in future.

India already stands out among its peers, as over 40 per cent of Indian exports were services exports (in both 2019 and 2020). By comparison, the share of exports accounted for by services is just 17 per cent for the East Asia and Pacific region as a whole, and 28 per cent for lower-middle income countries (in 2019).[29]

As India continues to develop a larger skilled workforce, there are clear reasons to believe there will be further increase in business services exports, and an FTA will expose the UK to greater competition. The UK would face this enhanced competition with or without an FTA. But an FTA would increase the exposure. Despite this, there is still scope for the UK to benefit from such a deal. In terms of an analogy with trade liberalisation in China, the UK must emulate the German experience rather than the US experience.[30] In particular, replicating the German experience would require the UK to use the FTA to create new opportunities for firms to export high value-added services to India, while enabling cheaper Indian imports to be used in UK supply chains to enhance competitiveness. The US experience, by contrast, was that valued manufacturing sectors, that created higher-paying jobs, were undercut by Chinese producers benefiting from lower labour costs.

To prevent this, UK services firms will need to adapt to enhanced competition by specialising further in the higher-value added activities within business services. Such firms are in a good position to specialise in this sort of activity, as they have access to quality infrastructure, a highly skilled workforce and the benefits that come from agglomeration in areas such as London. Domestic policy will also be key to support any within-sector adjustments required, including by maintaining and improving access to such important resources, through investment in skills and infrastructure.

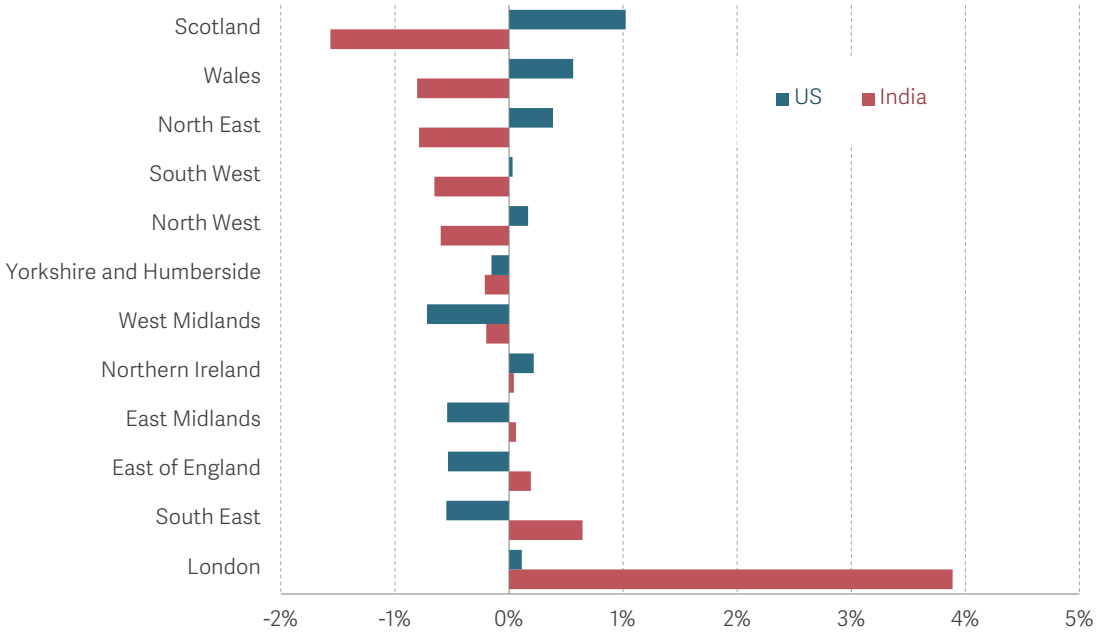
The UK has successfully off-shored some lower skilled business services activities for many years to lower wage countries, such as India. Indian business services have increasingly been imbedded in supply chains, supporting UK export competitiveness. For example, India's share of the foreign business services value added in UK exports has grown from less than 1 per cent in 1998 to more than 3 per cent in 2018.

29 Source: World Bank, Exports of goods and services as a percentage of trade and services exports as a percentage of trade.
30 W Dauth, S Findeisen & J Suedekum, 'The Rise of the East and the Far East: German Labor Markets and Trade Integration', Journal of the European Economic Association, 12(6), 2014.

If UK businesses are able to adapt, exposing UK services to enhanced competition from India to drive specialisation in higher-value added activities, this could also ensure UK services are better prepared for the impact of technological change. Technology will likely change the shape of global services trade over the next 10 years, both through enabling new technology-facilitated services trade to the automation of lower skilled white-collar jobs.[31] Failing to manage this adjustment and adapt, could result in the UK facing high-quality job losses concentrated in London as shown by Figure 12. This could exacerbate existing regional pressures from the leaving the EU, as service sectors lose access to the integrated EU Single Market.[32]

FIGURE 12: **Immediate labour market impacts will disproportionately impact workers based in London**

Difference in share of total workers by region and the share of workers by region for sectors where India and the US have a revealed comparative advantage over the UK: Q4 2018 to Q3 2021



NOTES: For both India and the US the profile of sectors is made covering sectors which the country has a greater positive RCA than the UK. These are mapped to SIC codes and the share of employment in those sectors by region is calculated. For some regions where the difference from the share average is small any difference may just represent sample variation, but the difference with London is expected to be significant.
SOURCE: Analysis of ONS, Labour Force Survey and ITC Trademap.

This highlights the importance of an Indian FTA in successfully addressing the barriers facing UK services exporters, to ensure any existing underperformance can be corrected. Given the potential risks facing the UK in opening up to a fast-growing economy the UK's asks must be clear and targeted, and informed by the country's overall economic

31 R Baldwin & R Forslid, Covid 19, globotics, and development, VoxEU, July 2020.
32 S Kerckhoven, Brexit heralds a bleak future for the City of London. March 2021.

strategy. In this context it is worrying that the scoping analysis which suggest an asymmetric ambition between goods and services even under deep integration. Goods liberalisation is assumed to be equivalent to that achieved in multilateral agreements with high levels of integration, such as CPTPP. But the maximum services liberalisation assumed would undertake just 60 per cent of the average CPTPP services liberalisation. Of course, liberalisation and competition in services is not equivalent to manufacturing for many reasons. The delivery of services, for example, will be more affected by non-removable trade barriers, such as language and time differences, than goods. And while technological change and digitally enabled services may help reduce the impact of these barriers, services will likely remain less tradeable than goods for many years to come.

Overall, a deal with India provides opportunities – but it also comes with risks

Over the past year, the Government has set out a trade strategy that seeks to pivot trade towards the Indo-Pacific. This strategy includes accession to CPTPP, which we argue will not generate much scope for new liberalisation with members, and an FTA with India, which we conclude will present larger upside potential for UK exporters.

The Government's analysis highlights how a deal with India would create opportunities for UK exporters, particularly for transport, machinery and electrical equipment manufacturers. However, the strategy does not offer UK firms a close substitute markets for declining EU trade. While some consumer gains may be available, for example cheaper clothing, UK firms looking for alternative suppliers in their supply chains would have seen more benefits from the previous US-focussed strategy, given the more closely-aligned export profiles. While this could incentivise more onshoring of supply chains, the net result is one in which UK firms are less productive.

Our analysis suggests the upsides and the uncertainties are larger than the Government's assessment might imply when the longer-term implications are accounted for. It is important that the Government looks beyond the positive, but ultimately short-term, story of potential manufacturing gains for UK exporters and also considers the longer-term implications for the UK's competitive services sectors.

In summary, a deal with India is something of a gamble with broader implications for the UK's economic strategy. While it could provide big opportunities in manufacturing and services – it does so with risks. Targeting the fast growth in India will mean exposing UK firms to more uncertain competition in the future with a country that has the potential to undercut domestic firms through lower labour costs. This puts UK jobs –

and particularly higher-quality service-sector jobs – in danger. But if we are confident about the competitiveness and dynamism of our higher value-added business service sectors, then the deal could not only benefit UK exporters but support a wider strategy to build a sector that is robust to threats from technological change and future foreign competition.

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