

Evolving Contours of Global Trade and the Way Forward for India

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Global trade has been resilient despite a series of shock events over the last two decades and growing, though selective, protectionism in recent times. GVC-led trade in parts and components (P&C) continues to be the dominant mode of global trade. Notwithstanding some evident reconfiguration in the Asian value chain hub and acceleration in the China+1 GVC diversification strategy of large corporations, China remains at the centre of global value chains.

In this process of GVC diversification by multinational corporations (MNCs), major benefits have accrued to those emerging market economies (EMEs) that were already well integrated with GVCs. There has also been a further increase in their trade intensity with China. Vietnam is observed to have emerged as the lead beneficiary economy, especially in the electronics sector. Other ASEAN economies, such as Thailand, Malaysia and Vietnam, also benefited as attractive alternative locations for MNC investments. Aside from the ASEAN economies, Mexico has also emerged as a significant alternative source of imports of IGs for the US. India has been a relatively marginal beneficiary in the GVC relocation strategy of MNCs.

Furthermore, it is evident that countries well integrated with GVCs have a higher share of manufactured exports in their total exports and have also gained in terms of their share of global manufactured goods exports. India, which has been a relatively marginal beneficiary in the GVC relocation process, has experienced a decline in the share of manufactured exports in its total exports as well as in its share of global exports of manufactured goods.

In this context, and based on an analysis of available cross-country experience, the paper discusses how participation in GVCs can be an enabling factor in technological upgradation. The case of China, where local manufacturers, not having core technology in the automotive or electronics sector, relied on their association through GVCs with knowledge-intensive intermediaries and key technology suppliers, is a particularly useful example in this respect. The presence of foreign firms in a country, as evident in China and other East Asian and ASEAN economies, helped develop mutually beneficial relationships between foreign core technology providers and local manufacturers. Importantly, given that exposure to foreign technology through foreign investment also involved an open import regime, the consequent increase in foreign value addition relative to



domestic value addition (DVA) is observed across all sample East Asian economies, such as Taiwan, Korea, and China. In fact, the experience of East and Southeast Asian economies, which have successfully integrated into GVCs, reveals the inevitability of a decline in the DVA ratio (DVAR) as the structure of the export basket undergoes a change from predominantly primary, raw material, and resource-based goods to IG-intensive manufactured goods with increasing GVC participation.

Based on this experiential analysis, the paper reflects on the question of whether excessive policy emphasis on the objective of “upgradation” or increase in DVA in the early stages of integration is appropriate. In this context, while the rise of DVA in China offers several relevant lessons, the paper also presents some alternative perspectives on this issue. Several studies have shown that the decline in foreign inputs in Chinese exports coincided with a similar trend at the global level, while some others emphasise the differential DVA component in processed and normal exports from China or the variation in experience across provinces—coastal and inland—in China.

The importance of an open trade regime for technological upgradation is reinforced in the discussion on LCRs. This is an important but relatively less emphasised aspect of trade policy discussions in India. However, it may be useful to note that in a protectionist trade environment, specifying high LCRs and consequent restrictions on imports introduces a lag in technological advancement and deters export-oriented direct investment (FDI). The spillover benefits of LCRs, through implications for technology, are possible only when there is already a modicum of local knowledge for which the components are required to be domestically purchased. Where the knowledge gap between local and foreign firms is too wide, high LCRs do not significantly aid technological upgradation. Even with export-oriented FDI, the scope for technological diffusion depends upon a complementary research and development (R&D) infrastructure in the host economy. The critical importance of R&D infrastructure and IPR norms per international standards for technological diffusion through GVC participation is highlighted in the discussion in the paper.

Incorporating IPR-related provisions in FTAs has become common across developing economies desirous of integrating with GVCs. Increasing number and depth of such provisions in FTAs signal the commitment of the participating member economies towards upgrading of the domestic regulatory framework to international standards in relevant areas for FDI and GVCs. Appropriately designed investment and related regulatory provisions not only help investment inflows and the transfer of technology but also signal commitment towards the upgrading of the domestic regulatory framework in this respect.

The imperatives arising from the altered global context of GVC integration necessitate the inclusion of World Trade

Organization (WTO)-plus provisions relating not just to investment liberalisation and IPR but, importantly, also environment and sustainable governance (ESG) clauses. Political backlash in respect of equity has created the necessity to include worker or labour rights and conditions-related provisions in the FTAs. The discussion in the paper reveals how the average number of environment-related provisions (ERPs) in FTAs has increased over time, even while there is variation across countries and PTAs in terms of the number and depth of provisions included. The United States-Mexico-Canada Agreement (USMCA), which is the upgraded NAFTA, signed in 2019, is a leading example of the number and depth of the ESG provisions. In Asian FTAs, ERPs have been a more recent inclusion. It is interesting to note that China has been a regional leader in this context.

Way Forward for India: Key Policy Measures

Against the above background discussion on evolving global trade contours, the paper proceeds to delineate key trade policy measures for India. As pointed out earlier, India's integration with GVCs has thus far been low relative to some of the comparator EMEs in ASEAN. However, the current global and regional geopolitical context, as well as India's positive and stable macro fundamentals, present it with a new opportunity to integrate with GVCs and consequently enhance its export competitiveness and share of manufactured goods trade.

India has adopted the objective of building complete supply chains domestically. With this perspective, India's flagship production-linked incentive (PLI) scheme was introduced in 2020 for 14 sectors. The financial incentives notwithstanding, the PLI scheme has thus far seen limited success. For more widespread success across sectors, it is considered that India needs to adopt a more open trade policy. As discussed above, an open trade environment is essential for effective LCRs. High LCRs, as is true of India's PLI specification in almost all sectors under the scheme, can assist in developing domestic manufacturing capabilities only when domestic producers are also exposed to competitive pressures through a more open and liberal trade regime. LCRs in a protectionist environment foster inefficient and high-cost manufacturing and, in the process, limit the scope for the development of domestic manufacturing capabilities. The experience of Vietnam in motorcycle production, as discussed in the paper, provides a useful example in this context.

Also, it needs to be understood that undue emphasis on increasing DVA and technological upgradation in the early stages of GVC integration can be counterproductive. Technological upgradation requires complementary R&D infrastructure. In addition, proximity to the global technology frontier in a sector through participation in GVCs can assist in enhancing technological capabilities. The positioning of the domestic firm integrating with the GVCs, particularly a GVC hub, is significant in this respect. Furthermore, the absorptive capacity of domestic producers, as determined

by the domestic R&D infrastructure, is often a crucial determinant of the scope for technological upgradation.

The paper highlights how India's R&D infrastructure and capabilities, proxied by indicators such as the number of patents filed under the Patent Cooperation Treaty and R&D expenditure, remain woefully small in comparison with China, which serves as a leading example of an emerging market economy that has successfully upgraded its technological capabilities. In China, domestic companies in sectors such as automobiles and mobile phones have developed competitive efficiency, enabling them to acquire a substantial share of global exports in these industries over the last two decades.

Furthermore, given the observed benefits of linkages with a leading technology hub in a GVC, it would be advantageous for India to seek FDI inflows from lead firms of developed economies. In this context, the paper discusses the need for a more careful examination of the proposal in the Economic Survey, 2023–2024, to encourage FDI inflows from China. A majority of lead firms in the world today are located in the US, Europe, and Japan. EMEs from Central and Eastern Europe, such as Hungary and Slovakia, have benefited by integrating with the main innovator, Germany, in Europe and the deeper trade and investment integration entailed by their participation in the European Union (EU). Similarly, Mexico has been in an advantageous position through its integration with the US-led GVCs. Mexico's integration with the US has been facilitated by the North American Free Trade Area (NAFTA), USMCA, and Inflation Reduction Act (IRA). The NAFTA and USMCA, as discussed in detail in the paper, have been particularly ahead of other FTAs in terms of incorporating modern-day provisions on ESG-related norms. The IRA encourages North American GVC integration through the specification of facilitative rules of origin.

India would therefore do well to prioritise the early conclusion of a deep FTA with the EU and the UK. Deep FTAs provide the benefit of a lock-in effect for domestic economic reforms, particularly in the context of upgrading domestic regulatory infrastructure in accordance with international norms. For India, successful negotiations with these developed economies will help achieve compatibility of investment liberalisation norms, IPR, and ESG regulations with global standards. This will, in turn, help attract export-oriented FDI, which can further contribute to building domestic absorptive capabilities for technological diffusion.

The paper discusses how, globally, the emphasis on ESG norms and their increased inclusion in FTAs makes India's stance of classifying these issues as “non-trade” outdated. Given the importance of the green energy transition and political exigencies, the consequent accelerated orientation of GVCs and FTAs in this context necessitates a re-think

among Indian policymakers. Both the number and coverage of ESG-related provisions in FTAs have been increasing over the last 15 years.

India also needs to shed its resistance to the inclusion of higher-grade provisions relating to the environment and sustainable governance in its ongoing negotiations with the EU and UK. In this context, the trade-off that is usually at work in trade agreements, and that can prove to be instructive, is based on exchanging stronger IPR (Trade-Related Aspects of Intellectual Property Rights [TRIPS]-plus) in return for greater access to agricultural exports, raw material exports, and low-cost manufactured goods. It is possible that the developed economy may, in return, ask for greater market access to services along with stronger IPRs. India should, therefore, also have its services offer list (which should be derived from the servicification¹ of manufacturing argument rather than based on just mode 4) designed accordingly for the negotiations (Batra, A., Business Standard, March 10, 2022).

Vietnam, the lead beneficiary of the China+1 GVC diversification strategy, has signed deep FTAs with the EU. Through its membership in ASEAN, it participates in all ASEAN FTAs, including those with China, Japan, and Korea. Mexico, also a major beneficiary of the China+1 context, has, through NAFTA and USMCA since 2020, been a participant in deep FTAs. The Central and Eastern European (CEE) economies, by their accession to the EU, have similarly upgraded their regulatory standards to international levels.

In addition to bilateral FTAs, Vietnam is also a member of mega-regional trade agreements such as the Regional Comprehensive Economic Partnership (RCEP) and the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP), both of which are intensive in WTO-plus provisions. Membership in deep trade agreements not only helps countries commit to necessary reforms for attaining global standards in relevant domains of investment and trade liberalisation but also provides a political context to undertake domestic reforms in these policy domains.

As the North American and European trade blocs become increasingly inward-oriented, RCEP and CPTPP remain the only mega-regional trade agreements that are open and non-discriminatory. India needs to actively reconsider its stance on participation in mega-regional trade agreements. India should initiate the preparatory process for making an application for membership in the CPTPP at the earliest. This is particularly relevant given the observed greater stability of intra-PTA trade compared to trade outside PTAs during periods of uncertainty due to climate change, the possibility of another pandemic, as well as trade policy shifts under Trump 2.0. In this context, a necessary reform that India needs to undertake is a reduction in its average applied

¹ Services that come embedded and embodied in manufactured goods and that are increasingly contributing to manufacturing value addition.

most favoured nation (MFN) tariffs and aim to align these with its comparator Asian economies within a time-bound schedule. This will help India attract export-oriented FDI and take advantage of some of the trade diversion resulting from US trade policy shifts.

Finally, the paper draws attention to the need for a careful re-evaluation and understanding of the role of exchange rates in a GVC world. The extant literature provides an account of how conventional exchange rate calculations may not

be appropriate to indicate export competitiveness in the GVC/value-added context when a product is used as an intermediate good for further processing as input in another good that is exported. Traditional exchange rate theory may perhaps be more valid in a context where a product is competing as a final good with another in a destination market. In a complex GVC world, the correlation between exchange rate depreciation and export competitiveness, as dictated by traditional trade theory, may not be so straightforward. This policy aspect needs further discussion and research.

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