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BACKGROUNDER

Trade and International Policy

Does Canada Have an India Strategy?

Why it Should and What Both Sides Can Gain from Comprehensive Trade Talks

Wendy Dobson

In this issue...

For Canada, it makes sense to aim high in a deal with India. But the record of each country's Asian initiatives suggests a lack of strategy and political will on both sides.

The Study in Brief

The Author of This Issue

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After years of an economic relationship that can be described fairly as cool, Canada and India have begun negotiating a Comprehensive Economic Partnership Agreement (CEPA).

For both countries, the size of the economic relationship with the other is comparatively modest. Moreover, both also have long lists of uncompleted trade agreements begun with third countries. Accordingly, considerable commitment and enthusiasm will be required on both sides to overcome differences that were apparent in the 2010 report of a Joint Study Group of officials. To live up to the title of "comprehensive" for an enlarged bilateral economic relationship, the CEPA negotiations will need vision and ambition.

What is the significance of the talks for Canada? How do they fit into Canada's overall trade strategy and economic relationships? This *Backgrounder* examines the status of the Canadian-Indian bilateral economic relationship, the basis for the talks, and the prospects for comprehensive liberalization of trade and investment between the two countries.

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Many thorny issues potentially stand in the way to achieving the mutual benefits available.

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Essential Policy Intelligence

In November 2010, after a year of joint study, the Canadian and Indian governments launched bilateral trade negotiations on a Comprehensive Economic Partnership Agreement (CEPA). At the time, a Canadian newspaper colourfully touted the talks as "free trade" that would lead to a new Silk Road, and Canadian government spokespeople often also refer to the CEPA as a free trade agreement.[1] Indians, however, carefully refer to the talks as a closer economic partnership. What is the reality?

The answer to this question matters because the talks are taking place at the same time as the ambitious Trans-Pacific Partnership (TPP) negotiations involving the United States and eight developed and developing countries on both sides of the Pacific Ocean, which aim to be "high quality and comprehensive," covering most areas of trade in goods, services, and investments (for details, see Dobson and Kuzmanovic 2010). Neither Canada nor India is involved in these talks.

The terms CEPA and comprehensive economic cooperation agreements (CECAs) have gained common parlance in East Asia with the proliferation of sub-regional trade arrangements over the past decade. Despite their titles, however, such agreements usually have more modest and pragmatic aims than do free trade agreements – talks may be comprehensive in that they may include discussions of goods, services, and investment, but the completed agreements typically settle for what can be liberalized in the short run, leaving further trade liberalization for future negotiation. For example, India's 2010 CECA with the 10-member Association of Southeast Asian Nations (ASEAN) includes only goods, while negotiations on services and investment continue (see Table 1).

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Canada has signed eight free trade agreements since the implementation in 1994 of the North American Free Trade Agreement (NAFTA). Seven of these are with small economies that account for little of Canada's total trade and produce few trade gains. Eleven more agreements are pending, but only three are with dynamic Asian economies – South Korea, India, and Singapore – and the negotiations with Singapore, which began in 2001, have been on hold since 2007. This scattershot record raises questions of whether Canada has a trade strategy or is simply proceeding on an ad hoc basis.

Taking the long view, a trade agreement with India, the world's second-most-populous country, has considerable potential. In the past seven years, in particular, India's economy has displayed increasing dynamism – indeed, measured at current exchange rates, Canada's and India's economies are about the same size (11th and 12th largest in the world, respectively), while on a purchasing-power-parity basis, India jumps to 4th and Canada drops to 14th.

But India is still a very poor country with huge political and economic challenges. Until serious economic reforms began two decades ago, it was a relatively closed and slow-growing economy. Since then, however, as the Indian government has gradually opened the economy, Indian producers have found they can compete in world markets.

1 *The Globe and Mail* editorial, Nov 15, 2010. "Free Trade with India is a new Silk Road."

Table 1: Selected Indian Trade-Liberalizing Agreements

Partner Country	Two-way Trade, 2009 *(US$ billions)*	Tariffs on Goods	Services	Investment	Other
Japan: Economic Partnership Agreement (agreed Feb. 2011)	11	• Japan cuts tariffs to zero on most industrial imports from India • Japan excludes rice • India cuts tariffs on 85% of goods within 10 years • India excludes assembled vehicles	Included; Japan resists movement of health and care professionals	Strengthened protection; includes intellectual property rights protection	No cooperation reached on civilian nuclear power
Singapore: Comprehensive Economic Cooperation Agreement (agreed Aug. 2005)	16	Duties eliminated on 2,700 product lines; many exceptions	Included; India pushing for mutual recognition agreements for health professionals, architects, accountants	Included	Review every 3 years
South Korea: Comprehensive Economic Partnership Agreement (in effect Jan. 2010)	18	India cuts tariffs on 75% of South Korean imports; South Korea cuts tariffs on 93% of Indian imports	Movement of professionals facilitated	Included	• Review every year • Competition policy included • Further liberalization of tariffs, visas under way
ASEAN: Comprehensive Economic Cooperation Agreement (goods only, implemented Jan. 2010)	40	80% of import tariffs reduced	Opening delayed by lack of agreement on movement of professionals	Negotiations still under way	

Source: Asian Development Bank, Asia Regional Integration Center, available online at www.aric.adb.org/FTAbycountryAll.php.

Canada's economic future, of course, will continue to be determined largely by its proximity to the huge and familiar US market, but since 2004 its trade and investment flows have become more diversified, largely driven by market forces. Between 2004 and 2010, the US share of Canada's total merchandise trade dropped from 73 to 63 percent while the share from countries that are not members of the Organisation for Economic Co-operation and Development (OECD), rose from 11 to 17 percent of the total, with China accounting for more than 40 percent of the "non-OECD" share. Growing unease about Canada's economic dependence on the US market continues to spur enthusiasm for further diversification, making India, despite its distance as a market, of interest to business in both countries because of its economic potential, the significance of its commercial services, pharmaceutical, machinery, and auto parts industries, and its growing outward direct investment.

Table 2: Major Trading Partners, Canada and India

Canada		India	
(merchandise trade, imports + exports, ranked, US$ billions)			
1. United States	$ 488	1. United Arab Emirates	$ 44
2. China	56	2. China	42
3. Mexico	26	3. United States	37
4. United Kingdom	26	4. Saudi Arabia	21
5. Japan	22	5. Germany	18
6. Germany	15	6. Switzerland	15
7. South Korea	10	7. Singapore	14
8. France	8	8. Australia	14
9. Italy	6	9. Iran	13
10. Brazil	6	10. Hong Kong	13
15. India	**4**	**33. Canada**	**3**
Total, world	**$ 780**	**Total, world**	**$ 467**

Note: Data for Canada are for 2010; data for India are for the period April 2009 to March 2010.
Sources:
Canada: Industry Canada, Trade Data Online, available online at http://www.ic.gc.ca/eis/site/tdo-dcd.nsf/eng/Home (accessed April 26, 2011); and C.D. Howe Institute calculations.
India: India Department of Commerce, Export Import Databank, available online at http://dgftcom.nic.in/ (accessed April 26, 2011).

At the outset of the CEPA negotiations, where does each country fit into the other's economic priorities? The answer is "low on both sides" on most key indicators:

- Merchandise trade flows between Canada and India are tiny: between 2000 and 2010, two-way merchandise trade doubled to US$4 billion, but that figure pales in comparison with Canada's trade with China ($56 billion) or with Mexico ($26 billion).
- India is Canada's 15th-largest trading partner, while Canada is only number 33 on India's list (see Table 2).
- Merchandise trade flows between the two countries are concentrated in only a few areas: Canada's merchandise exports to India in 2010 were largely in pulp and paper (21 percent), agriculture, mainly pulses (20 percent), fertilizers (16 percent), and machinery and electrical equipment (13 percent), while India's exports to Canada were dominated by textiles and apparel (17 percent) and organic chemicals (13 percent). Trade, however, is balanced, with Canada registering large surpluses in pulp and paper and vegetable products, while India registers large surpluses in textiles and textile products. Canada also registers a surplus in machinery and equipment, while India registers a surplus in other manufactured and other agricultural goods.
- India's tariffs are much higher than Canada's: as much as 16 percent on exports from Canada, while Canada imposes average tariffs of 9 percent on exports from India; by comparison, Canada's average rate for countries with "most-favoured-nation" trading status is just 4 percent.

- Services trade between the two countries is valued at less than C$1 billion, and is growing only slowly; in 2007, for example, Canada's services exports to India totalled just C$324 million, dominated by travel, transportation, and government services (82 percent), while India's services exports to Canada were valued at just C$421 million, a third of which was commercial services.
- Bilateral stocks of foreign direct investment (FDI) are also small, with Indian FDI in Canada valued at C$3 billion in 2009, largely due to recent acquisitions of resources and resource processing companies – such as Hindalco's 2007 acquisition of aluminum producer Novelis. Canadian FDI in India totalled just C$601 million in 2009, reflecting in part India's continued ambivalence to FDI and the fabled difficulties of doing business there. Indeed, a 2011 survey (World Bank and IFC 2011) ranked India 134th out of 183 economies on the ease of doing business there, with rankings on specific issues of 44th on protecting investors, 165th on starting a business, 177th on dealing with construction permits, and next-to-last on enforcing contracts – indicators suggestive of why Canadian businesses have had to be quite focused in their penetration of Indian markets.

In short, taking into account the two countries' relative economic size, distance, inflation, and such variables as membership in the World Trade Organization (WTO), existence of a free trade agreement, and a shared language of business, trade between Canada and India is 31 percent less than a gravity trade model would predict, suggesting there is considerable unrealized potential in the bilateral trade relationship (Canada 2009a, 86-88).

Negotiations on a CEPA were foreshadowed by a 2008 report of the Canadian Council of Chief Executives and the Confederation of Indian Industry (CCCE and CII 2008) that aimed to facilitate more business exchange and investment, particularly in India's power and infrastructure priorities. The report recommended reducing tariffs on goods, freeing up services trade, promoting mutual recognition of professional qualifications, and promoting greater transparency in services trade. It also called for Canada to review visa restrictions and provincial variations in residency rules and for India to reconsider continuing restrictions on FDI in financial and retail services. The report did not call, however, for a comprehensive, high-quality agreement covering "substantially all" trade.

Then, in late 2009, after the two governments had agreed to initiate exploratory discussions toward a CEPA, a Joint Study Group of officials was struck to evaluate the state of the economic relationship and make recommendations; its report was published in 2010 (see Canada 2010). The CEPA is a welcome initiative following mutually indifferent, sometimes frosty, relations following India's nuclear tests in 1974 and 1998.

Canada's main interests in the CEPA are to secure transparency and non-discrimination for Canadians in the Indian economy, to take advantage of the efficiencies available from Indian information technology (IT) services providers, and to gain greater access to both the Indian and wider Asian markets using India as a platform for regional operations. For India, the strategic priority could be to gain greater access to the US market through Canada, given that a comprehensive US-India bilateral free trade agreement does not seem to be in the cards (see Bery, Bosworth, and Panagariya 2005). A negotiation with Canada could be a second best route to this objective as a strategic signal of India's potential importance to the North American economies.

Since the beginning of major economic liberalization in 1991, successive Indian governments have opened the economy using the multi-track liberalization path Canada also chose more than two decades ago. To date, India has initiated 33 trade-liberalizing agreements, of which 12 are in effect, including limited preferential trade agreements in the Americas with Mercosur, Colombia, and Chile, while the remainder, including discussions with Australia, the European Union, and the European Free Trade Area, are at earlier stages (India 2010). Most, however, are with Asian neighbours as part of India's "Look East" policy, which Asians welcome as a check on China's growing regional influence. The ASEAN agreement, for example, even though it is restricted to goods, contains to

reduce import duties on 96 percent of traded goods but excepted more than 490 agricultural, textile and chemical products. The South Korean agreement, which includes services, is riddled with similar exceptions.

How Much Liberalization Is Likely Under a CEPA?

Trade liberalization realizes gains when foreign imports increase competitive pressures on previously sheltered domestic producers, forcing them to become more productive and encouraging the reallocation of resources to areas of comparative advantage. Some of the largest gains come from removing trade barriers in industries with differentiated products that both sides produce, allowing each to specialize and expand intra-industry trade.

Mutual gains are available to both sides. The Joint Study Group (Canada 2010) estimated that, in a pure free trade scenario in which all tariffs and restrictions on services are eliminated, each side could realize gains of between C$6 billion and C$15 billion and total bilateral trade could grow from its very small base by 53 percent. Free trade in goods would see sectoral gains for India's textiles and apparel manufacturers and for Canadian agriculture, natural resources transportation equipment producers, and machinery and equipment, while trade costs in services could decline by as much as 20 percent on each side.

The Joint Study Group's recommendations imply the need for comprehensive talks, but the details are revealing as to potential areas of agreement and disagreement. Areas for tariff reductions on goods are far less clear than is the call for substantial sectoral coverage on services. Existing goods trade is largely complementary (each exports different goods to the other) with the exception of agriculture, which is significant to both sides and where intra-industry gains are possible through adjustment and specialization. Yet agriculture is the sector that both countries protect above all, as illustrated by India's agreements with ASEAN, South Korea, and Japan and Canada's expensive and outdated supply management programs for farm produce.

Moreover, despite business enthusiasm about potential gains from liberalizing services trade, the talks are likely to encounter some thorny issues. Since Canada's standards with respect to government procurement, labour, and the environment are in large part determined by NAFTA provisions, it would not be surprising to see disagreement with India over such matters.

The Joint Study Group called for implementation of the long-delayed Foreign Investment Protection and Promotion Agreement (FIPPA), which would spell out rules and enforceable rights for private investors, and recommended separate chapters in that agreement on financial services, telecommunication services, and the temporary movement of people (one of India's sticking points with both ASEAN and Japan). Indeed, although each side approaches services negotiations differently, both have expressed the ambition to come to a better agreement than would be possible in the WTO.

Both sides have agreed to address intellectual property, to exchange information on electronic commerce, and to consult on competition policy, monopolies, and state enterprises, where Canada has much higher standards for competition than does India. But, as the security and intellectual property issues that Research in Motion has encountered in providing services to Indian Blackberry users demonstrate, many aspects of services trade remain contentious for India.

These issues suggest that a Canada-India CEPA, like the countries' other agreements in East Asia, will be a work in progress, making it essential that the agreement include provisions for periodic review and for further negotiations during the phase-in period to see if deeper integration is possible as India continues to open up and as Canada comes to grips, as it must, with its supply-management programs.

Both sides undoubtedly have much potential for bargaining in services. Private-sector players in both countries have shown interest in each other's markets through their respective investments. Canadians have built on their strengths in

financial services, IT and engineering services in power generation, and the energy sector, while Indian software companies export their services to Canadian customers and establish affiliates to supply the more sophisticated services that require face-to-face contact. While there are few trade barriers to IT services, other services industries are constrained by a scarcity of trained people and by barriers to their movement, which also make it difficult to satisfy customers' desire for face-to-face contact with services providers.

Services comprise a heterogeneous group of products having the common characteristic of government intervention and regulation. Accordingly, negotiations between the two countries should establish obligations and disciplines to free up market access, ensure non-discriminatory treatment of each other's services providers, and commit partners to make public all domestic measures that constitute barriers to trade. All four modes of services trade – supply by foreigners, the purchase of services by consumers traveling in each other's country, direct investment by producers in local affiliates, and the movement of people from one country to the other – should be on the table.

The sticking point will be how to reconcile the different approaches the two countries have taken: India continues to rely on the cumbersome positive-list approach – used at the WTO – in which liberalizing measures apply only to those sectors in which commitments are made. Canada, in contrast, has adopted the more streamlined negative-list approach in which liberalization applies to all sectors unless specified in the agreement, an approach used in agreements the United States has signed with both Singapore and Australia.

Entrenched interests in both countries are likely to resist more foreign competition (see Dobson 2006), as Canada is relatively restrictive on market entry in engineering and legal services while India is more resistant to competition in accountancy, banking, and telecommunications. Canada has more restrictions on establishment – with respect to, for example, licensing, investment and the permanent movement of people – and on operations - such as those concerning the temporary movement of people – in architecture and legal services while India has more in accounting and telecommunications.

What a CEPA Should Include

Despite the potential gains from a CEPA, such an agreement seems to lack strategic importance for either country. Indeed, one must ask if Canada's interest is more political than economic, reflecting the enthusiasm of its million-strong Indian diaspora. Accordingly, since each side is willing to commit only limited resources to the negotiations, they should be deployed in a strategic framework that includes the following factors:

- **Leadership and the big picture:** The Doha multilateral negotiations at the WTO will die if governments are unable to find the political will in 2011 to bring them to a conclusion; moreover, major political transitions begin in most of the key countries in 2012. In light of these realities, a successful CEPA would provide a wider range of options for give and take in the negotiations to address such sensitive issues as agriculture. The bilateral talks also could add forward momentum to the global talks by, for example, improving on existing WTO rules and objectives of non-discrimination and transparency, by tackling new areas such as e-commerce, and by negotiating on telecommunications and financial services, rather than merely talking about them.
- **More ambition on goods liberalization:** The two governments should be prepared to liberalize goods trade even more extensively than the Joint Study Group report recommends.
- **Services:** The talks should signal the services sector's importance by extending umbrella national treatment and most-favoured-nation rights to each other, and by adopting the more streamlined negative-list approach to negotiating.
- **Movement of people:** The talks should result in the liberalization of barriers to the movement (both temporary and permanent) of professional and technical personnel by aiming for best practices in the objectivity and transparency of national regulations.

- **Government procurement:** Restrictions on government procurement should be replaced gradually with more open competition that includes each other's suppliers.
- **Domestic adjustment strategies:** Both governments would have to improve the efficiency and flexibility of their domestic economies in adjusting to a CEPA. Canadian policy should address the constraints on the growth of firms, both domestic and foreign, flowing from the shortage of engineering and technical talent and from the lack of world-class communications and transportation infrastructure (where Canada used to be a leader), and encourage clusters of advanced firms that compete with and learn from each other. India, for its part, faces the need to cut through the thicket of obstacles created by interest groups seeking to retain protected positions and by the high transaction costs of doing business there.

There will be costs and uncertainty: the liberalization of India's trade and FDI regimes is unleashing private sector dynamism, but bureaucratic and ideological interests continue to hinder infrastructure and to maintain bureaucratic interventionism. The dynamism of India's clusters of advanced services masks the huge unmet demands of hundreds of millions of low-income rural voters for jobs and basic services.

Conclusion

It makes sense to aim high in a deal with India for its own sake. But the demonstrated record of each country's Asian initiatives suggests a lack of strategy and political will on both sides.

There is another reason to aim high: the Trans-Pacific Partnership has set out to conclude a comprehensive, high-quality free trade agreement that both Canada and India could join were they to commit to talk about "all" trade. If these talks attracted more large Asian players such as Japan, South Korea, and even China, they would become the game-changing path to trans-Pacific trade liberalization – and beyond, if the Doha round fails.

If the Canada-India CEPA talks do not measure up to this standard of comprehensiveness, one has to ask if they are worth the expenditure of scarce negotiating resources.

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