India Needs to Complement Its FTA Drive with Reforms Push

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The landmark 1991 reforms set India decisively on the path of economic liberalization. By easing highly restrictive import controls, dismantling broad-based industrial licensing and initiating the transition to a market-determined exchange rate system, the reforms opened up the Indian economy to foreign trade and investment and strengthened its external position. This raised the share of trade in India's GDP from around 14% in the 1980s to 38% in the 2000s. But India did not pivot to an export-led growth model. It continued to rely mainly on its large domestic market to drive growth. The trend GDP growth rate rose from 4% in the pre-reform period to 6.3% in the 2000s and has stayed around that level since.

Renewed Turn Towards Trade & New-Generation FTAs

In recent years, though, the quality of growth has turned suspect. A K-shaped recovery from the Covid-19 pandemic and lack of adequate employment opportunities have highlighted the limits of the inward-looking growth strategy. This has put renewed focus on the potential for trade to create more broad-based opportunities, raise the growth rate and support India's transition to a developed economy.

The signals from the government have been mixed. Trade policy has continued to lean protectionist, which has undercut export promotion efforts. At the same time, import duties have been lowered selectively to support production and exports in high priority industries, like mobile phones. The recent surge in trade deal activity, including the conclusion of the long-delayed free trade agreements (FTA) with the United Kingdom and European Union in 2025 and 2026, provides the clearest signs yet that New Delhi may be rethinking the role of trade in India's growth trajectory more broadly.

The timing of these deals couldn't be more opportune. The protectionist turn by the United States, growing competition from Chinese manufacturers and rising global trade and investment fragmentation, have made it more challenging for countries to increase international market shares for their products. Indeed, geopolitical considerations likely played a role in driving New Delhi to act faster on the deals. A larger portfolio of FTAs could not only open up new avenues for trade, investments and knowledge transfer for India, but also boost its position as a "China plus one" destination and limit the negative fallout of higher US tariffs.

Why Earlier FTAs Disappointed

Admittedly, India's historical experience with FTAs has been challenging. A faster increase in imports from the FTA countries than exports to them has given rise to the popular narrative that the trade deals have benefited the partner countries more. This, in turn, has soured public opinion on trade liberalization, pushing New Delhi to take nearly a decade-long break from trade agreements until 2021 and stay out of the Comprehensive and Progressive Agreement for Trans-Pacific Partnership (CPTPP) and the Regional Comprehensive Economic Partnership (RCEP).

The challenge partly lies in the design of the older FTAs. The agreements signed with Asian partners in the late 1990s and early 2000s are shallow, led more by foreign policy than trade considerations. Not only do they narrowly focus on goods trade and tariffs, but they also exclude a substantial share of bilateral or intra-regional trade from tariff elimination – or subject them to long phase-out periods – to protect sensitive domestic sectors.

Still, the available tariff concessions have translated into market access gains for partner countries, especially Japan, South Korea and the Association of Southeast Asian nations (ASEAN), due to India's relatively higher most favored nation (MFN) tariffs. Indian exporters, on the other hand, have not benefitted much. This is because the preference margins are invariably too small for them to justify the compliance costs imposed by the complex rules of origin or the upgrading required to match partner country standards, resulting in low utilization rates of the FTAs. This has resulted in widening trade deficits with these countries, especially the ASEAN member states.

The recent FTAs present a significant upgrade on the first-generation agreements. They are both wider in breadth and greater in depth. The UK-India FTA, for instance, promises to drive supply chain linkages, technology diffusion and innovation by deeper commitments on services, digital trade and environmental standards, in addition to extensively liberalizing trade on both sides. The EU-India FTA is expected to be similarly ambitious. This raises the likelihood of economic benefits accruing to both India and the signatory countries.

Having said that, the design of the older FTAs alone doesn't explain why India's share in global manufacturing exports has stagnated around 2%. The trade deals have primarily led to an increase in raw and intermediate goods imports. Empirically, such input trade liberalization is generally found to be positive for domestic production and export competitiveness. That this did not transpire in India's case points to other constraints on exports, including high duties on intermediate imports from non-FTA partners and weak domestic manufacturing capabilities.

A study commissioned by the Ministry of Finance in 2014 concluded as much. It found that India's deteriorating trade deficits with partner countries owed more to the weaknesses in the domestic manufacturing sector than to the trade agreements themselves.

Weak Domestic Manufacturing Hindering Export Gains

This is an enduring challenge for India's export ambitions. Despite the improvements made in infrastructure in the last decade and the launch of the production-linked incentive (PLI) scheme in 2020 to actively support some industries, India's manufacturing competitiveness gap with its regional peers remains notable.

This is effectively illustrated by the textile sector, where higher operational expenses and lower labor productivity have more than offset cheap labor costs according to the government think-tank NITI Aayog. NITI notes that India's commercial electricity costs are 20-70% higher than China, Vietnam and Bangladesh, while its real output per worker is nearly half of China's and 14% below Vietnam's. Indian corporates also face a 30% tax rate in comparison to 25% in China, 20% in Vietnam and 27.5% in Bangladesh. Alongside elevated logistic costs, this undermines the Indian textile sector's competitiveness and has steadily eroded its export share in global markets, despite India's annual wages being 74% lower than China's, 58% lower than Vietnam's and 218% higher than Bangladesh's.

On the other end of the spectrum is the electronics sector, where a concerted policy push through industrial policies, tariff concessions and regulatory streamlining has successfully created global value chain linkages and turbocharged exports. India's share in global mobile phones and telecom equipment exports has increased from just 0.14% in 2015 to 3.5% in 2024. But further gains require India to review its high tariff structure, which leaves it at a disadvantage to China and Vietnam, the top two global exporters. India's tariffs on intermediate imports from China, which is the top supplier for smartphone components, average 8.74%. In comparison, China applies an average tariff of 7% on intermediate goods and Vietnam 5.8%.

Closing these cost and productivity gaps is essential for India to enhance its forward and backward linkages in global value chains and lift its share in global manufacturing exports. So far India's manufacturing push has been fragmented, lacking urgency and hesitant to expose domestic firms to foreign competition. This needs to change if the country is to fully reap the benefits of its growing portfolio of FTAs.

FTAs Must Be Matched by Domestic Reforms

This does not mean India should hold back on trade agreements. Rather it should simultaneously pursue domestic manufacturing reforms, and an export-oriented trade policy that includes further import liberalization and next-generation FTAs. This will create a virtuous cycle between manufacturing and exports, which will be reinforced over time. The productivity gains could be larger if India reconsiders joining comprehensive multilateral pacts, like the CPTPP and RCEP, that offer greater prospects of supply chain integration and a disciplined push for the structural transformation of the domestic sectors.

Ultimately, concluding deeper FTAs with major trading partners in the West and the East would create both imperatives for reforms and conditions for more competitive exports. But the anticipated gains will materialize only if domestic reforms keep pace. While it may be tempting for the government to lean more on industrial policy to advance manufacturing and drive exports, such measures should be used judiciously in both their scope and scale. India's limited fiscal space constrains the extent to which it can offer costly concessions to investors. Hence, the trade-off between allocating scarce resources to one-off investment incentives and to structural reforms that could deliver a lasting transformation of the manufacturing sector needs to be weighed carefully.

To that extent, the implementation of the long-overdue labor codes in November 2025 marked another step forward in Indian manufacturing reforms, raising the threshold for retrenchments in industrial establishments and expanding social safety nets for employees. Much ground, however, remains to be covered if India is to unlock its full export potential. JS

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