Prospect of India-Ethiopia Investment and Trade Cooperation (Policy Brief- February 2015)

Background

The overarching importance of trade and foreign direct investment (FDI) has long been recognized as the key element of sustainable development in both developed and developing countries.

The endogenous growth theory (Grossman and Helpman 1990 and Barro and Sala-i-Martin 1995) emphasize on the role of international trade and FDI in achieving a sustainable rate of economic growth.

Inspired by the gains from trade, countries have long adopted an outward looking, export-oriented development approach aiming at restoring internal and external economic stability and enhancing efficiency of resource allocation. Trade and investment liberalization are seen as a means of achieving industrialization and modernization through securing economies of scale, market access, and trade expansion.

In the above context, both India and Ethiopia have been liberalizing trade and FDI policies since early nineties and accelerate the process of integration into the global economy.

Further, to boost trade and investment, both countries have signed two important agreements (Bilateral Investment Promotion and Protection Agreement in 2007 and Double Taxation avoidance treaty in 2011).

More importantly, India provides Duty-Free Trade Preference (DFTP) scheme to Least Developing Countries (LDCs) on the lines of Hong Kong Declaration, 2005. As a result, Economic ties between India and Ethiopia have grown over the years.

While Ethiopian exports to India recorded a CAGR (Compound Annual Growth Rate) above 19 per cent, the same from India recorded 35.5 per cent between 2005 -13.

India is the third most important source of imports for Ethiopia, contributing 7.5 per cent of all Ethiopian imports in 2013.

However, it has been observed that in spite of several incentives being given by the Indian Government to all LDC's (including Ethiopia), there has been no substantial improvement in exports from Ethiopia to India. In fact, there are several barriers that come in the way of increasing trade and also Indian investments into Ethiopia.

Given the importance of this subject, this study critically examines the trade and investment relationship between India and Ethiopia and suggests a set of recommendations to remove barriers to trade and investment so as to give a boost to bilateral trade and investment relations between the two economies.

The rest of the policy brief is structured as follows: Section II presents the existing trends in trade relations between the two countries. Section III presents the impact of DFTP scheme on Ethiopian exports. Section IV details Indian investment in Ethiopia. Section V puts forth the major hindrances to trade between India and Ethiopia. Section VI presents concluding remarks and policy recommendations.

II. Trade between India and Ethiopia

In recent years, with the opening up of the Ethiopian and India economy, investment and trade ties between the two countries have grown significantly.

As a first step, a trade Agreement between the Government of India and Ethiopia was signed on March 6, 1997 and a Joint Trade Committee (JTC) set up. Since then various bilateral agreements have been signed by the two countries. In addition, a bilateral Investment Promotion and Protection Agreement (BIPPA) was signed on July 5, 2007.

India and Ethiopia also have signed Double Taxation Avoidance Agreement (DTAA) on May 25th, 2011. As per the mandate of WTO Hong Kong Ministerial, India became the first developing country to extend Duty Free Quota Free (DFQF) market access to all Least Developed Countries (LDCs).

Ethiopia is also a beneficiary of the scheme. With recent bi-lateral agreements and actions, trade between the two countries has increased from a meagre $53 million in 2000 to $290 million 2010 and further to $1 billion in 2013.

Annual Exports from Ethiopia to India increased from $2 million in 2000 to above $28.6 million in 2010 and remained the same in 2013. On the other hand, India's annual export to Ethiopia increased from $51 million in 2000 to $974 million in 2013.

Notwithstanding growing trade between India and Ethiopia, trade balance remained highly in favour of India. This is a major area of concern between the two countries. Although India's export to Ethiopia increased by 19 times between 2000 and 2013, its export to Ethiopia as ratio of total exports is still below 0.3 percent.

Similarly, Ethiopia's export to India as ratio of total exports, counts only 1 percent. The low trade share between India and Ethiopia suggests that there is large scope to expand trade and promote trade with each other.

The import basket of Ethiopia indicates that Ethiopia mainly imports manufacturing products like chemicals, machinery and transport equipment's, iron and steel, pharmaceutical products, miscellaneous manufactured articles and road vehicles.

The export basket of Ethiopia indicates that Ethiopia mainly exports primary goods such as food and live animals, vegetables, leather, crude materials, coffee, tea and cocoa. Over the years, export and import basket has not changed significantly between the two countries.

Trade complementarity index (TCI) between India and Ethiopia indicates that Ethiopia clearly lacks the export complementarity with India as TCI is less than 0.2 for all years.

This is mainly justified by comparing the composition of Ethiopia's exports and India's imports.

While Ethiopia's major exports are food and live animals, coffee and tea, crude materials and vegetable and fruits, India's major import items are manufactured products and fuels. Thus Ethiopia's exports are not diversified enough to meet the import demands of India.

III. India's DFTP Scheme and Ethiopian Exports

India was the first among the emerging economies to launch a duty-free quota free market access scheme for the least-developed countries (LDCs) following the Hong Kong Ministerial Declaration of 2005.

The duty-free trade preference (DFTP) scheme, which was announced at the India-Africa Forum Summit in April 2008, became fully operational in October 2012. The DFTP provides for preferential treatment (duty free or Margin of Preference (MOP)) to 94 per cent of the Indian tariff lines, whereas 6 percent of tariff lines are in the exclusion list that can be exported to India at MFN tariffs.

The Indian government announced the revised DFTP scheme in April 2014. As per the revised scheme, the lists of preference products (that is, products on which lower-than-MFN tariffs are applied) and excluded products in the original notification are significantly shorter than their original versions.

With these changes, the DFTP scheme will now effectively provide duty free treatment to about 98 per cent of tariff lines, up from 85 per cent initially. The number of tariff lines in the exclusion list has shrunk from 326 to 97; the new MOP list features 114 tariff lines compared to 468 originally.

To assess the impact of India's DFTP scheme, Ethiopia's exports are divided into pre-DFTP period (2004-2007) and the post-DFTP period (2009-2012), using 2008 as a cut-off point.

Between the two periods considered, the export of duty-free products observed the highest growth rate (251 per cent), followed by exclusion products (235) and MOP products (148 per cent).

Even though the combined share of duty-free and MOP products over total exports had a slight decline in the post-DFTP period (1.6 per cent), preference products still make almost 85 per cent of Ethiopia's export basket to India.

In particular, duty-free products make almost half of the export value in the post-DFTP period and their share increased by almost 7 per cent in comparison with the period immediately before the coming into effect of the DFTP.

Overall, it looks like the DFTP scheme has stimulated Ethiopia's exports of preference products to India, particularly duty-free products.

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Notwithstanding the benefits of DFTP scheme for Ethiopia, this scheme has many problems. Currently, the exclusion list constitutes 2 per cent of Indian tariff lines, but, in value terms, it excludes around 68 per cent of total exports of Ethiopia. These numbers clearly indicate that the current architecture of the scheme is not favourable for Ethiopia as many products of export interest such as coffee, sesame seeds, sweet corn, oil seeds, other agricultural products and certain type of meats are not granted preferential market access.

IV. Indian Foreign Direct Investment

Ethiopia has been following a liberal foreign investment policy since 1992. As a result FDI inflows to Ethiopia increased from $135 million in 2000 to $970 million in 2012. The major sources of FDI include Turkey, China, Saudi Arabia, India, Sudan, Britain, Germany and Netherlands. Between 2003 and 2014, roughly 632 Indian firms invested over USD 4.7 billion.

Indian firms have been active in sectors such as agriculture, floriculture, cotton and textiles, plastics, and health care. The Ministry of External Affairs, Government of India, in a July 2014 note on India Ethiopia Relations estimates that out of the $5billion invested so far, approximately US$2billion is already on the ground or in the pipeline. About 48% of Indian companies are in Manufacturing and 21% in agriculture and rest are in services sector. About 40 per cent of Indian investment is in the field of commercial agriculture.

Sector-wise Indian investment indicates that, since 1998, India has invested more than $1.5 billion in the primary sector of which approximately 97 per cent has been directed towards the growing of crops: fruit, vegetables, flowers, and beverage crops. The next largest destination for Indian investment, a little more than 1 per cent, was animal farming. Mining and quarrying, the third largest location for FDI attracted $7.3 million.

Between 1998 and the first quarter of 2014, the Industrial sector attracted the lion's share, roughly 54 per cent, of total Indian investment in Ethiopia. In contrast to investments in the primary sector, FDI flows to the secondary sector were more diversified with significant investments made in a variety of industries including leather tanning, textiles, chemicals, furniture, food and beverages, paper products and metal products.

Cumulative Indian investment in the services sector is valued at approximately USD 720 million between 1998 and 2014. Indian firms have invested in a variety of industries including: computer and IT related activities (24 per cent of total services investment), machinery rental (21 per cent), hotels and restaurants (15 per cent), health and social work (13 per cent), education (9 per cent), construction (9 per cent), and real estate (9 per cent).

Indian investment in Ethiopia created significant employment as well. Overall, 2 lakh 40 thousand jobs have been created in Ethiopia. However, most of the jobs were created in the primary sector.

In addition, India also made a commitment to raise Lines of Credit (LOC) facilities to Ethiopia's agricultural and infrastructure sector. According to the Exim Bank Report, the largest single LOC approved by the Exim Bank so far is the one to Ethiopia ($640 million) for its Tindaho Sugar Project.

V. Barriers to India-Ethiopia Trade and Investment Relations

There are many hindrances which are affecting bilateral ties between the countries. These are: poor investment and trade climate; infrastructure bottlenecks, higher level of corruption, and lower human capital development in Ethiopia. Evidence from primary survey conducted by CII, indicates that transportation and logistics costs are major problems for promoting trade and investment in Ethiopia. Ethiopia is a landlocked country and relies majorly on Djibouti for access to shipping lines. The existing rail link is old and is in dire need of upgradation. Coupled with this is the issue of high inland transportation cost which is estimated to account for as much as 40 per cent of the total cost of the product.

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TRADE AND INVESTMENT

Access to finance is the second major barrier which India faces. The banking sector in Ethiopia is mainly state run and is not geared to cater to the needs of trade. Indian exporters therefore find it extremely difficult to obtain foreign exchange as well as funds for project financing.

The volatility in the exchange rate was a major deterrent for Indian companies trading with Ethiopia. The financial sector is highly regulated and foreign investment is not allowed. In addition to this other problems highlighted by Indian companies include repatriation of profits, confusion about VAT, difficulties in accessing Ethiopian buyers, delays in costumes and procedural issues.

From an Ethiopian perspective also, there are several factors hindering trade and investment. Access to trade finance is ranked number one problem. As per Doing Business (Doing Business Indicators, 2014, The World Bank*)*, Ethiopia stands at 104 in the ranking of 185 economies on the ease of getting credit. Similarly, the Global Competitiveness Report 2013-14 highlighted that access to finance remained the major problem in Ethiopia. Ethiopia is mainly dependent on state run banks with very low banking density and consequently has one of the lowest financial inclusion ratios of Sub-Saharan Africa, with only 14 percent of adults having access to credit. According to a recent World Bank study, the cost of finance in Ethiopia has decreased in recent years. But the average value of collateral taken relative to loan size has increased dramatically, indicating that only firms having higher collateral can access loans.

VI. Conclusions

Given the growing importance of India's economic relationship with Ethiopia, this study has attempted to identify barriers to trade and investment between the two countries.

Trade between the two countries has also increased rapidly, particularly after the Bilateral Investment Promotion and Protection Agreement 2007. However, trade balance consistently has remained in favour of India.

Even though trade and investment relations between India and Ethiopia have consistently increased, several barriers continue to exist and act as a hindrance.

Steps to improve business climate, measures to reduce logistic and trade cost, infrastructure development, removal of exchange control, diversification of exports, financial development, further liberalization of FDI and measures to develop light manufacturing would help Ethiopia improve its trade and investment climate.

Like Ethiopia, India also needs to reduce level of corruption, simplification of investment and business approval processes, further revision of DFTP scheme to include products of export interest to Ethiopia, relaxation of rules of origin and greater participation in institution and skill development in Ethiopia.

In addition, other initiatives such as the annual India-Africa Conclave is an important forum to bring buyers and sellers together and spreading awareness among traders and policy makers regarding the policy environment in both the countries. These recommendations are equally applicable for other LDCs and emerging countries that are trying to improve trade and investment relations with India.

KPP is a South-South cooperation programme promoting knowledge sharing in the areas of Food Security, Resource Scarcity and Climate Change; Health and Disease Control; Trade and Investment; and Women and Girls. KPP is funded by the Government of UK's Department for International Development (DFID) and managed by a consortium led by IPE Global Private Limited under its Knowledge Initiative. The main objective of KPP is 'Gathering and uptake of evidence on issues central to India's national development that have potential for replication in LICs and impact on global poverty'.

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