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Policy Brief

India-EU FTA: Export Competitiveness and Strategic Rebalancing

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Executive Summary

The conclusion of the India-EU Free Trade Agreement (FTA) in January 2026 marks one of the most consequential developments in India's trade policy architecture in over a decade. By granting preferential, near duty-free access to Indian exports particularly in textiles, apparel, leather, footwear, and marine products the agreement directly addresses a long-standing structural disadvantage faced by Indian labor-intensive manufacturing in the European market.

The agreement should not be interpreted narrowly as a tariff-reduction exercise. Rather, it constitutes a repositioning of India within a rapidly fragmenting global trade system characterized by rising protectionism, regulatory divergence, and bloc-based economic integration. In this context, the FTA serves three simultaneous functions:

- An export competitiveness shock for labor-intensive sectors,
- A catalyst for firm-level upgrading and scale-driven productivity growth, and
- A geopolitical hedge that strengthens India's outside options amid heightened uncertainty in U.S. trade policy.

While the agreement has been politically concluded, implementation remains subject to legal finalization and ratification processes on both sides. Nonetheless, the economic direction and implications are already clear.

Impact of EU-India FTA

- ## Structural Shift in Relative Competitiveness

  Prior to the agreement, Indian textile and apparel exports to the EU were subject to EU MFN tariffs on many clothing and apparel lines that are typically in the low-teens (often around 12 percent), with variation by product category. In contrast, key competitors such as Bangladesh and Vietnam benefited from preferential or zero-duty access under separate EU trade arrangements. This tariff wedge placed Indian firms at a persistent price disadvantage despite India's advantages in integrated supply chains, domestic cotton availability, and manufacturing scale.

  The elimination of EU tariffs on Indian labor-intensive manufactures removes this structural wedge. From a partial equilibrium perspective, in sectors characterized by relatively elastic demand, tariff reductions of this magnitude can produce disproportionately large quantity responses. Using typical estimates from the empirical trade literature for apparel demand elasticities, even moderate tariff-driven price declines can generate materially larger increases in export volumes.

  The immediate implication is that Indian exporters can either pass through tariff savings to buyers to regain price competitiveness or retain part of the tariff rent to finance capacity expansion, compliance investments, and product upgrading. Both channels strengthen medium-term export performance and firm-level risk tolerance.

- ## Employment and Inclusive Growth Transmission

  Textiles and apparel are among the most labor-intensive sectors of the Indian economy, employing over 45 million workers directly and indirectly. The sector's high employment elasticity implies that export growth translates relatively efficiently into job creation. From a Stolper–Samuelson perspective, preferential access to a large external market raises the relative demand for labor-intensive goods, increasing returns to labor relative to capital. In practice, this mechanism implies that real wage gains and employment growth are likely to be concentrated among semi-skilled and low-skilled workers, particularly in secondary urban and peri-urban manufacturing clusters.

  Leather and footwear manufacturing exhibit similar characteristics, with high labor intensity and strong scope for SME participation. The agreement therefore strengthens the export-employment linkage, reinforcing export-led growth as a vehicle for inclusive industrialization.

- ## Trade Diversion and Global Sourcing Reallocation

  Consistent with Vinerian customs union theory, the FTA is expected to generate both trade creation and trade diversion effects. While some EU imports may replace higher-

cost domestic EU production (trade creation), a significant portion of adjustment is likely to involve reallocation away from third-country suppliers towards Indian producers.

In practical terms, this implies potential displacement of exports from Bangladesh, Vietnam, and Türkiye in specific product categories. This reallocation reflects the increasing importance of preferential access as a determinant of global sourcing patterns. India's transition from a preference-disadvantaged to a preference-aligned exporter constitutes a major repositioning within global value chains.

- ## Dynamic Firm-Level Effects and Productivity

In models of monopolistic competition and heterogeneous firms, expanded market access raises average firm size, induces reallocation toward more productive exporters, and generates endogenous productivity gains. Preferential access to the EU effectively increases the relevant market size for Indian exporting firms, strengthening scale economies and reducing average costs. Over time, this process is likely to result in:

a. Exit of low-productivity firms
b. Expansion of high-productivity exporters
c. Greater investment in process upgrading and quality compliance
d. Higher average firm productivity within export clusters

International experience suggests that such dynamics are often accompanied by increased Foreign Direct Investment, as overseas buyers and manufacturers seek to internalize preferential access through local production and sourcing partnerships.

- ## Regulatory Substitution and Carbon Constraints

A critical medium-term constraint arises from the EU's Carbon Border Adjustment Mechanism (CBAM). Although tariffs are eliminated, carbon-related compliance requirements introduce a new dimension of market access costs. In effect, tariff liberalization is partially offset by regulatory pricing of embedded carbon.

From a political economy of trade perspective, this represents a classic case of regulatory substitution, in which governments shift from tariff barriers to standards and environmental regulation as instruments of market access control. The economic implication is that India's long-run export competitiveness will increasingly depend on energy efficiency, renewable energy adoption, and firm-level carbon accounting capabilities.

Table 1 Key Economic Channels and Quantitative Anchors

Channel	Mechanism	Data / Quantitative Anchor	Expected Impact
Tariff elimination	Relative price decline	EU MFN apparel tariffs typically ~12% (varies by HS line)	Significant improvement in price competitiveness
Export coverage	Preferential access	~99–99.5% of Indian goods covered; ~96.6% of EU goods liberalized	Broad-based export expansion
Employment intensity	High labor share	Textiles employ >45 million workers	Strong employment multiplier
Trade diversion	Preference reallocation	EU sourcing shifts from Bangladesh/Vietnam	Market share gains for India
Regulatory substitution	CBAM carbon pricing	No CBAM exemption; EU pledged ~€500m for decarbonization	Rising importance of green production
Scale effects	Larger effective market	EU is India's 2nd largest export market	Firm size and productivity increase

- **Rebalancing and Bargaining Power**

Beyond sectoral impacts, the agreement materially improves India's outside options in the global trade system. By deepening access to the EU market, India reduces its vulnerability to unilateral trade actions by other major partners. In bargaining theory terms, a stronger outside option improves India's threat point in future negotiations, enhancing its strategic leverage.

This is consistent with India's broader pattern of concluding multiple preferential agreements in recent years, reflecting a shift towards bloc-based integration in response to weakening multilateral disciplines.

Policy Implications for Pakistan

- Pakistan should intensify efforts to diversify export markets and deepen preferential access to the EU and other major blocs to mitigate trade diversion effects arising from enhanced India-EU tariff preferences.
- In light of improved EU access for Indian textiles, chemicals, leather, and engineering goods, Pakistan should implement targeted industrial upgrading, productivity enhancement, and standards compliance programmes to safeguard and expand its share in EU markets.

- Pakistan may consider reinvigorating dialogue with the EU on trade facilitation, GSP+ continuity, and potential sector-specific arrangements to ensure continued preferential treatment given evolving EU regulatory and sustainability frameworks.
- The agreement underscores a shift in EU strategic and economic engagement in South Asia; Pakistan should proactively position itself through economic diplomacy to avoid marginalisation and to attract European investment in value-added manufacturing and services.
- Given the EU's carbon border measures and climate-linked trade provisions, Pakistan should accelerate domestic carbon accounting, green certification, and decarbonisation strategies to preserve long-term access for exports and remain competitive vis-à-vis India.

Conclusion

The India-EU FTA represents a structural reconfiguration of India's export strategy and its position within the evolving global trade regime. Preferential access for textiles and leather provides an immediate competitiveness boost, while dynamic firm-level and employment effects reinforce export-led industrialization. At the same time, the agreement raises the importance of regulatory capacity and green transformation as determinants of long-run success. In this sense, the FTA both expands India's opportunity set and raises the bar for sustained competitiveness. Viewed through a political economy lens, the agreement signals India's emergence as a central player in bloc-based trade architecture, using preferential integration not only to expand exports, but to enhance autonomy in a more fragmented and uncertain global system.

About the Authors

Dr Aneel Salman holds the OGDCL-IPRI Chair of Economic Security at the Islamabad Policy Research Institute (IPRI), Pakistan. He previously served as Chair of the Government of Pakistan's *"National Artificial Intelligence Policy, 2025*" and his work has informed policy design and strategic planning processes across multiple public-sector institutions in the country. In a teaching capacity, he has been affiliated the Rensselaer Polytechnic Institute (USA); King's College London (UK); Institute of Business Administration (Pakistan); Pakistan Institute of Development Economics; University of Bern (Switzerland); Université Côte d'Azur (France), Ghulam Ishaq Khan Institute of Engineering Sciences and Technology (Pakistan), and Tsinghua University (China). In addition to his academic and policy work, Dr Salman is a Master Trainer for civil servants, law enforcement agencies, military officers and diplomats. His areas of specialization include monetary economics, macroeconomics, behavioural economics, transnational trade dynamics, strategy-oriented policy formulation, and the economic dimensions of climate change. He is the editor of "*Economy: Backbone of National Security* (2025) which examines the role of economic structures and policy frameworks in shaping national security outcomes.

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