

Future of India-China Economic Relations: Towards De-Coupling, Reduced Dependency, or a New Equilibrium?

Key Takeaways

Webinar Organised By:
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Future of India – China Economic Relations: Towards Decoupling, Reduced Dependency, or a New Equilibrium?

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ICS – KAS Conversation
**Future of India-China Economic Relations: Toward De-Coupling, Reduced
Dependency, or New Equilibrium**

Wednesday, 12 August 2020 | 3:00 P.M IST | Zoom Webinar

Key Takeaways

- India-China economic relations are presently in a flux. The basic paradigm, under which India sought to expand trade and economic linkages with China, insulating them from the boundary question and other outstanding issues, appears to have broken down. As the relationship between India and China has deteriorated sharply post-Galwan, the future of economic engagement between the two countries is currently uncertain.
- There are several other factors at work. The outbreak of the Covid pandemic has exposed the vulnerabilities of the global value chains and the risk of excessive dependency on one country, China in particular. The escalating US-China strategic competition and unfolding economic decoupling between the two largest economies of the world have impacted the broader geopolitical landscape. There are growing concerns internationally about China's aggressive behaviour on issues ranging from the pandemic (with its origin in China) to Hong Kong, Taiwan and South & East China Sea, in pursuit of its aspirations of a China-dominated world order. Despite these concerns, there are attractions of the Chinese market, especially at a time when China's economy is the only large economy growing in the Covid era amidst a major global recession. Outside the USA, the call for economic decoupling with China has not gained much traction, even though there is recognition of the need for reduced trade dependency vis-a-vis China.
- Many countries are trying to counter China's muscular actions by transforming negative public sentiment into stricter economic policies. Global supply chains and China's position as the second-largest economy in the world are making this a complicated process. Even at the lowest point of the US-China trade war, bilateral trade has exceeded US\$ 600 billion.
- There is a major asymmetry in India-China trade, with China accounting for 30% of India's trade deficit, which has not been sufficiently offset by FDI inflows from China. In addition, there is a worrisome import dependency to the extent of 45% in electronics, 32% in capital goods, 38% in organic chemicals, and 57% in furniture, 68% in active pharmaceutical ingredients, 80% in compressors for ACs and 95% in motors for washing machines. Prime Minister Narendra Modi has launched the *Atmanirbhar Bharat* (Self-reliant India) mission, which, *inter alia*, addresses the issue of excessive trade dependency on China.

- The Government of India has taken three major measures to exert pressure on China – a) imposed an approval requirement for investments from neighbouring countries; b) banned 59 internet applications from China; and c) made registration including security and political clearances mandatory for participants from neighbouring countries in public procurement tenders. India is expected to unveil more such measures, including possibly excluding Huawei from the 5G network. India's trade dependency on China in several sectors has come under sharp focus with calls for self-reliance. There is talk of boycott of Chinese products.
- Looking ahead, various scenarios are being explored in India. One possibility is radical economic decoupling with China but is that feasible or desirable? Alternatively, are we looking at something more focussed and targeted like reduced economic dependency vis-a-vis China? Or will India-China economic relations settle down at a new and dynamic equilibrium? While a radical economic decoupling with China is perhaps not anticipated, there is a growing acceptance of the logic for reduced dependency vis-à-vis China, pursuing a pathway which is focussed, selective, sector-specific and ushered in a phased manner, building up domestic capacities and competitiveness.
- Economic analysis reveals that, as the 2nd largest economy, the largest trading and manufacturing nation in the world, a leading trade partner and a major emerging source of investment, China is closely intertwined with the Indian economy; their connections cannot be snapped as a kneejerk reaction without incurring serious economic costs.
- Since only 3% of China's exports are to India, the current leverage on China is relatively limited. Similarly, Chinese investments in India are only of the order of about US\$ 10-15 billion. However, the potential in India is very attractive for China in terms of both investment/risk ratio and market, so that constitutes a positive potential leverage. Thus, Chinese apps such as TikTok have a large market in India which may now be in jeopardy. Chinese entities have acquired a significant presence in the digital, technology and start-up space in India.
- While it might be difficult to opt for a hard decoupling from China, these leverages can be used in a strategic and planned manner. A calibrated approach that blends both positive and negative incentives can be pursued with China while balancing various considerations – risk, dependency, employment and growth in an economy which is already badly affected by the pandemic. Radical economic disengagement will also translate into greatly reduced leverage.
- The India-China economic relationship can be divided into four baskets: a) technology (which includes digital, internet and telecommunication); b) bilateral trade; c) investment; and d) infrastructure.
- The technology basket may move in the direction of gradual decoupling unless India implements a stringent regulatory framework to guard against data and national security risks; India's ban on internet applications is seen as a global bellwether move, with the USA following up with actions against WeChat and TikTok.

- The trade basket may witness a gradual sector-wise reduction in dependency through a combination of the search for alternative sources and domestic manufacturing. Policy initiatives have already been taken to promote domestic manufacturing in specific sectors, such as, electronics, Active Pharmaceutical Ingredients, and textiles. The government can support Indian industry through production linked incentives, preferential treatment to domestic players in public procurement, aggressive anti-dumping measures and non-tariff barriers such as quality standards. To mitigate against retaliation from China, India should stay within the parameters of the WTO and other multilateral and bilateral agreements. India's engagement with the world in trade and investment should be open and we should be a member of inward and outward global value chains. Global investors will not find India attractive if there are all manner of limitations on their linkages into these chains.
- Investment flow from China into traditional manufacturing industries may arrive at a new equilibrium based on desirable domestic linkages and financial investors such as VC funds will employ innovative investment structures to comply with India's regulatory preferences. High risk/strategic areas may be put on a negative list. In other areas, Chinese investments may continue, as required for the continued economic growth. There is the need for a (Committee on Foreign Investment in the United States) CFIUS-like national security regulatory regime to vet investment inflows.
- It is important to ensure foreign investor confidence, so India's rules should not seem capricious. It should be WTO-compliant. Rules and go/no-go areas should be clear to all. Security risk, export development and employment generation can be given emphasis. All those who choose to invest in India under these conditions should be given national treatment. India is attempting to attract foreign investment through easing the way to do business. This must be carried on, and a tempting return to the days of protectionism and/or bureaucratic controls should be avoided. India should also maintain openness towards international trade and investment linkages to avoid risks of economic isolation.
- Participation of Chinese companies in infrastructure or public procurement sector may evolve on a case-to-case basis with projects funded by multilateral institutions such as AIIB and NDB receiving more priority. Overall, a reduction in the presence and operations of Chinese entities is anticipated.
- The policy of compartmentalising the boundary question and other outstanding issues and not letting them come in the way of development of India-China relations, including in trade and economic fields, seems to have run its course now and it may not be business as usual any longer. The realistic way forward in the long term for India might be one of calibrated economic engagement with China while adopting a firm stance towards national security and incremental reduction in dependency that can generate leverage for the broader dynamics of India-China relations.