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CAN INDIA REPLACE CHINA AS THE WORLD’S FACTORY?

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India needs to embrace global value chains and remove regulatory barriers to take on China’s mantle as the factory of the world

Chinese aggression in recent years has given new life to the Quadrilateral Security Dialogue or “Quad"--a multilateral group comprising India, the US, Japan and Australia. The four nations, which resumed dialogue after a decade-long hiatus in November 2017, have stepped up their efforts to counter Chinese dominance in the Indo-pacific region.

The group is an important counterbalance to China’s growing aggression in the region, and is perhaps a strategic necessity for India. But its capacity to provide an alternative to China in trade is rather limited at the moment.

China continues to be the most important hub of global value chains. Japan, the US, Australia are all dependent on supplies from China to manufacture products that they export.

India’s own dependence on China is significant. Over one-fourth of the value added in Indian exports is contributed by China alone. This was not the case at the turn of the century. India’s reliance on China has increased manifold over the past two decades.

This dependence hasn’t eased even in recent months. Even as Indian troops have been engaged in a tense confrontation with China since April, the share of Chinese imports in India’s trade basket has only gone up, despite the rhetoric of ‘self-reliance’. Imports from China accounted for 14% of Indian imports in the fiscal year ending March 2020. So far this year, the same share has gone up to 19%. Data on the share of Chinese value-add in Indian exports are not yet available for the current year. Dependence on Chinese pharmaceuticals and safety kits to battle the pandemic has meant that other quad members too have been heavily dependent on Chinese imports this year.

“The quad cannot offer an economic alternative to the mighty Chinese economy as yet," said Happymon Jacob, associate professor of disarmament studies at Jawaharlal Nehru University (JNU). “These countries will have to continue to engage China economically even while seeking to balance Chinese military power, and it is going to be a tough balancing act."

With covid-19 disrupting global supply chains, many multinational companies have been considering shifting parts of their production platforms not away from China. But while there are benefits to diversification, it is neither easy nor cheap. The covid recession has starved companies of cash, and not many may be able to invest in other countries immediately.

We might see some relocation but that relocation may not be a large-scale one, said Amita Batra, a trade economist at JNU. With wages increasing in China, some companies had started looking for alternatives in other markets, even before the pandemic disrupted supply chains. But those companies have moved elsewhere, not to India, Batra pointed out. To capitalize on the opportunity, India needs to improve ease of doing business, and undertake reforms relating to land, labour, and taxes, said Batra.

In the short run, it will be difficult for India, or any large economy, to decouple from China, economists said. But over the long run, India has the potential to give China a run for its money. There is a growing recognition, at least among the quad countries, on the need to economically decouple from China, and India may stand to gain from such decoupling over time, said Jacob.

“China’s unique selling proposition is that it has the capacity to produce at a big scale at low costs," said Biswajit Dhar, another trade economist at JNU. “The only country other than China, that can produce at that kind of scale and at similar prices, is India. We are still a low cost production centre."

Apart from the unease of doing business here, India’s deficits in physical and social infrastructure pose a major challenge to realize such ambitions of being the next factory of the world.

South Asia can become the next manufacturing powerhouse if it improves business climate, links domestic firms to global value chains, and improves capabilities of workers and managers, a 2017 World Bank report said.

Participation in global supply chains has two aspects: how much value a country contributes in the making of foreign exports (forward participation) and how much it depends on foreign input for production of its domestic exports (backward participation). While India has a relatively higher backward participation due to high import dependence in many industries, its forward linkages are much lower.

An analysis of data from the UNCTAD-EORA GVC database shows that not only has India’s participation in global production declined since 2008, its gains from integration have also declined. India is now using more high value inputs from abroad to produce its exports and adding less value to the exports of other countries.

Efforts to reduce trade barriers, enhance infrastructure, and improve access to finance can aid further integration with value chains. Some of the recent policies such as industrial corridors, de-licensing, and the Make in India initiative, are steps in the right direction but have fallen short in impact. Other policies such as the rise in tariff walls may have been counterproductive since they ultimately end up hurting Indian industries by raising input costs.

Another challenge is the lack of enough lead firms, wrote Saon Ray and Smita Miglani in an ICRIER working paper earlier this year. Lead firms, typically transnational corporations, create networks by breaking down the production chain into distinct functions and locating them wherever they can be carried out most effectively.

Tata Motors in the automobile sector and Reliance in the petrochemicals sector, for instance, play key roles in transferring technology, establishing supply chains, and attracting foreign investment, according to Ray and Miglani. But India, in general, has very few such sectoral lead firms. Skill shortage, lack of access to finance, regulatory uncertainties all prevent lead firms from developing in India.

Deeper domestic policy reforms with focused attention on ease of doing business, efficient logistics and infrastructure will be needed to make Indian firms more competitive before they can start producing for the world.

This is the concluding part of a two-part series on trade and cross-border flows in the post-covid world. The first part examined the implications of India’s restrictions on Chinese tech firms.

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