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India's Economic Potential in Looking East

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Following Indian Prime Minister Narendra Modi's visit to Japan in mid-August 2014, his first state visit outside South Asia, there was talk of a new Indian Look East Policy 3.0. Amid the risks and uncertainties in the world economy, the Modi Government has a critical opportunity to reinvigorate economic ties with Japan and the rest of East Asia. By looking to East Asia, business and government can work together and foster economic gains for India.

Before 1990, India and East Asia were relatively isolated from one another in economic terms. There was little trade or foreign direct investment (FDI) and little dialogue on India-East Asia integration through regional integration policies. The relative isolation of India from East Asia before 1990 can be attributed to a lack of political signals to foster India-East Asia economic integration, barriers to regional trade and investment, poor regional transport and logistics links, as well as cultural and linguistic barriers.

India's Look East Policy of 1991, alongside its historic economic reforms, signaled its intention to revitalize cultural, defense, and economic ties with East Asia. Trade between India and East Asia has grown rapidly from a low base since the 1990s. India's exports to East Asia grew at 14.7% per year from 1990-2013 while its imports from East Asia grew at 16.1% per year. Annual average FDI inflows from East Asia to India amounted to \$8.6 billion from 2003-2013 and FDI outflows from India to East Asia amounted to \$4 billion per year.

East Asian markets currently account for as much as one-fifth of India's exports and a quarter of its imports. Regional FDI flows have increased but regional trade has lagged. India has a limited presence in the global supply chain trade led by East Asia, and India accounted for less than 1% of global supply chain trade in 2013. Thus, the data indicates that the country's Look East Policy has resulted in increased trade integration with East Asia, but has yet to achieve FDI integration or involve India in the global supply chain trade.

Since the mid-2000s, India has concluded several free trade agreements (FTAs) with East Asian economies, including a plurilateral agreement with ASEAN, as well as bilateral agreements with Singapore, South Korea, Japan, and Malaysia. These agreements were spurred by growing economic ties, the need to reduce barriers to trade and FDI, and slow progress in the World Trade Organization Doha Round trade talks.

A mega-regional trade deal — the Regional Comprehensive Economic Partnership (RCEP) — encompassing India, Australia, New Zealand and major East Asian economies, is currently being negotiated. The RCEP would establish FTAs between member countries, creating agreements that India lacks with China, Australia and New Zealand. The FTAs will grant Indian businesses greater access to a larger market and integration into the regional value chains led by East Asia.

Ganeshan Wignaraja, Director of Research at the Asian Development Bank Institute in Tokyo, explains that “India has a comparative advantage in services sectors and RCEP provides inroads for Indian services in China and the rest of East Asia.”

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Developing trade preferences and regional, rules-based trade with China offers important advantages to India. However, some business sectors in India, particularly in manufacturing, are concerned about expanding India–China trade. There is a fear that Indian businesses will be adversely affected because they cannot match the quality and price of China’s cheap manufactured goods. Concerns have also been raised about opening sensitive economic sectors and infrastructure to FDI from China, particularly investment from state-owned enterprises that may unfairly benefit from government subsidies.

Yet the preoccupation with the absolute advantage of Chinese traders and investors is misplaced. Simulations using a computable general equilibrium model indicate India can achieve potential income gains of 2.4% by implementing the RCEP. India has a comparative advantage in services sectors and RCEP provides inroads for Indian services in China and the rest of East Asia. India has also shown growth in manufacturing sectors in world markets including pharmaceuticals, automobiles, textiles, and food processing, and this trend is likely to continue under RCEP. FDI inflows from Japan, China, and Korea could result in technology transfers and marketing connections with overseas markets which are vital to the development of a competitive manufacturing sector in India. Moreover, India has emerged as an important destination for tourists from the Asia Pacific region, presenting further opportunities for Indian businesses.

Lobbying for exemptions for sensitive sectors or more protection for declining manufacturing sectors would be an unproductive and defensive approach to RCEP negotiations. Instead, Indian businesses should prepare for a gradual opening of the market under the RCEP by developing quality, cost-competitive goods and services, and investing in delivery systems that meet international standards. If India is to be internationally competitive it will need new technology, quality management, timely procurement systems, research and development, relationships with overseas buyers, and technical training.

The Indian government can support Indian manufacturing firms by implementing second generation structural reforms such as investing in transportation and energy infrastructure, providing access to SME finance, and increasing Science, Technology, Engineering, and Mathematics universities. Accelerating the development of the Delhi-Mumbai Industrial Corridor, a potential magnet for Japanese FDI and foreign aid, is a particularly important infrastructure initiative. Also crucial is improving the port facilities in Chennai, Kolkatta and Mumbai, gateways for trade with East Asia.

The Indian government can also facilitate the continued competitiveness of the services sector through a combination of policy reforms such as productivity improvements and investment in infrastructure and human capital. India should also use the RCEP negotiations to push for lower barriers to services trade and more transparent investment rules. In addition, it would be worthwhile to suggest better monitoring of non-tariff measures in overseas markets, anti-dumping measures, and trade remedies against legitimate unfair competition.

So far, India’s approach to the RCEP negotiations has been positive. Prime Minister Modi’s new pro-business government has unveiled economic reforms including liberalization of entry regulations for FDI and proposals to simplify taxation. More ambitious domestic reforms, investment in infrastructure, and upgrading of skills are necessary if India is to consolidate the benefits of an eventual RCEP agreement. Indeed, India and East Asia stand to gain from closer economic ties in the future.

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