Strategy – Accelerating the Indo-China Economic Engagement

Confederation of Indian Industry

Executive Summary

CII China Core Group Report

AVALON Consulting

Key Recommendations – Increase Gross Trade and Reduce Net Deficit Growth

1. **Leverage India's Importance - Market and Investment Destination for China.**

2. **Push for Market Access in Key Sectors where India can Add Value to Chinese Economy – Pharma, IT, Tourism, Media and Entertainment, Auto Components**

3. **Priortise Chinese FDI in 18 identified industry sectors and a Sovereign Deal to Attract Investment in Indian Infrastructure**

4. **Set up an institutional basis (Government cum industry) within the PMO or MOCI to direct and monitor the achievement of Goals**

While China has weathered the post Financial Crisis period admirably, it has come at an expense – the future will be a period of adjustment with different priorities

- Growth in China has continued apace between 2008-13, still driven by investment and trade
- It has continued to be an important destination of intra-Asian FDI and has also continued to pursue an aggressive outbound FDI policy driven by its need for energy and other resources
- However, this growth has come at a cost – capital efficiency has touched an all time low and debt to GDP is at an all time high
- The urgency to move the economy away from an export and trade focus to a domestic consumption driven one has increased and measures in this direction are evident in recent years – this will increase costs and reduce competitiveness
- Challenges remain in making the above adjustment, but the China of the future will have different priorities relative to the past

Indo-China trade has seen rapid and unbalanced growth since 2008 resulting in India's trade deficit touching $35 bn in 2013 with little FDI across each other's markets

- The bilateral trade between India and China has crossed $65bn – Chinese imports have grown sharply relative to Indian exports resulting in a record deficit of ~$35 bn in 2013
- India has emerged as one of the key markets for China growing at a faster rate than most of the other key trading partners except Vietnam. India is as large a market for China as some of the key European countries
- India's export managed to grow despite a sharp decline in iron ore exports. Overall growth has been much lower than exports to RoW. Cotton and copper cathodes made up the bulk of the growth in exports
- Thus, India's imports from China continues to be dominated by high-skill and technology intensive manufactured products and exports by primary commodities
- FDI between India and China continues to be negligible relative to the total FDI in both countries - <1% of each country

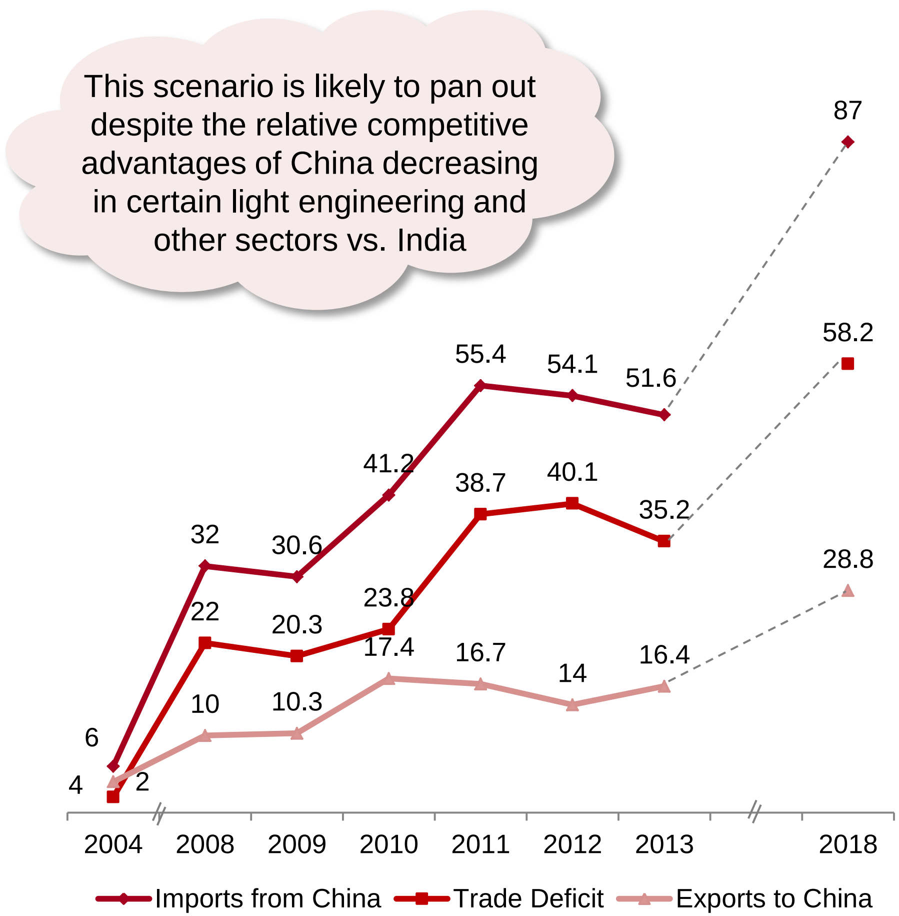
This has happened despite China's cost and pricing advantage vs. India coming down in recent years

- China's manufacturing cost competitiveness vis-à-vis India continues to endure but the magnitude of the advantage has declined in recent years driven by cost increases in basic raw materials and relative movement of the currencies in opposite directions
- Some of the drivers of competitiveness are also likely erode in the future:
  - Power tariffs are likely to rise as losses in SOE utilities continue to mount
  - Leeway in social security payments to manpower will be reduced as industries get more organised and streamlined with better systems and processes
  - Low interest rate regime will likely fade away as deposit rates are liberalised and financial reforms deepen
  - Tax subsidies introduced to encourage growth may not endure as most have now achieved significant scale
- The advantages related to logistics and higher productivity will sustain but the gap between India and China across primary industries will continue to reduce
- This will have a cascading impact on value added industries and ASEAN Supply Chains will need to be re-configured

We forecast the trade deficit with China to increase substantially to reach $58 Bn by 2018 in a business as usual scenario, despite changes in relative competitiveness

Projections: India – China Bilateral Trade

Projection for India – China Trade Deficit, 2018E



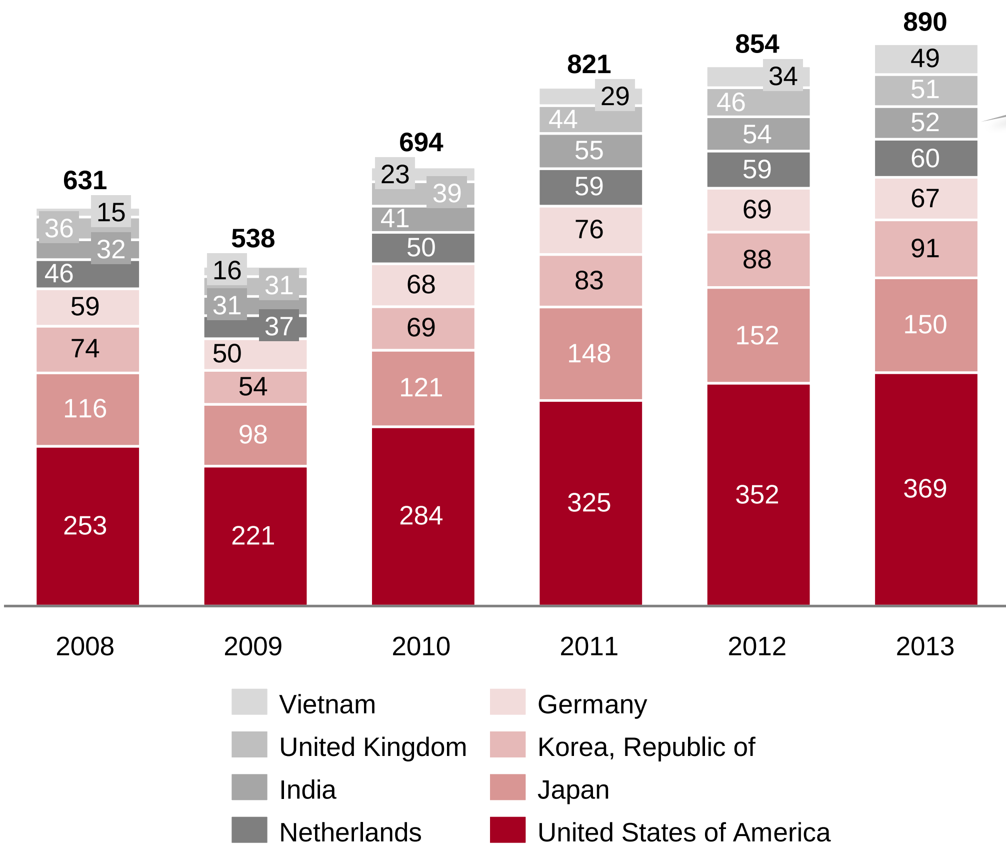
CAGR (04-08)	CAGR (08-13)	CAGR (13-18E)
24%	10%	11%
82%	10%	10%
25%	10%	12%

Source: Trade Map, Avalon Consulting Research and Analysis

Thus India will become an even more important export market for China given the relative growth rates vs. other trading partners

Leading Export Destinations for China

Top Export Destinations for China Excluding HK (USD Bn)



Destination	2008	2009	2010	2011	2012	2013
Vietnam	15	16	23	29	34	49
United Kingdom	36	31	39	44	46	51
India	32	31	41	55	54	52
Netherlands	46	37	50	59	59	60
Germany	59	50	68	76	69	67
Korea, Republic of	74	54	69	83	88	91
Japan	116	98	121	148	152	150
United States of America	253	221	284	325	352	369
Total	631	538	694	821	854	890

India's imports from China are expected to touch $87 Bn by 2018 from the current $52 Bn in 2013

- In 2013, India's imports from China constituted 2.2% ($52 Bn) of total Chinese exports
- These imports are expected to touch $ 87 Bn by 2018 growing at a CAGR of 11%
- Given that exports to other Chinese partners are growing at single digit CAGR, it is likely that India's position in China's total exports will increase substantially

Source: Trade Map, Avalon Consulting Research and Analysis

Hence, India's importance for China will increase substantially in the future – both as a market and an investment destination to offset declining competitiveness

Setting the Context - Implications for Indian Industry's Engagement with China

India will become a substantially important market / investment destination for China…

- China is diversifying its exports markets and investment destinations
- China is intent on becoming more global and open in its economic outlook (including taking Chinese brands global)

- Likely slowing growth rate of China in future
- China's competitiveness gap with India is narrowing
- This will make India an attractive destination of Chinese investment

- Growing strategic and geo-political importance of India-China ties - hence the need for China to proactively engage with India

Source: Avalon Consulting Research and Analysis

In this context, our recommendations to accelerate the India China economic engagement are structured to answer three key questions

1. **How should we perceive China and what should our approach be to the engagement process?**

2. **What are the key actions required to accelerate the economic engagement and make it more balanced?**

3. **What are the underlying drivers required in India to ensure success of the above actions?**

We need to approach the engagement process from a position of strength and with a clear objective to make the economic engagement more balanced for India

1 How should we perceive China and what should our approach be to the engagement process?

China – in the short term

- Will **accelerate the shift** to a **domestic consumption** driven economy while maintaining a **target GDP growth** of **~6%**
- Will focus **greater attention** on the **internal challenges** - corruption, **balanced geographic development, financial reforms,** environmental policy changes and effective implementation, supporting the **creation of global Chinese brands** and businesses, etc.
- Will **continue** to be the country with one of the **largest investible surpluses** – hence will have the ability to manoeuver the economy as required
- Will look for **Asian counter balances** to the Western world and a **possible investment destination** to counter its declining export competitiveness in certain sectors

Implications - India

- Need to **approach** the engagement process with **China** from a **position of strength** – we are now the **6th largest market for China** in export terms and given the changing macro economic dynamics, can be a **potential destination** for **investments from China**
- Need to **measure the security threat issue** with the **balance required** to leverage **Chinese investment** as a **counter balance to trade**. **Security** issues need to be addressed in a **routine and time bound manner** across relevant sectors
- Need to firmly **push at the highest levels**, for **market access in key sectors** which can **add value to China** and reduce the trade imbalances in the short term
- Need to **coherently work together** as **Government and Industry** to **invest** and realise the **opportunities in China** when market access is available

Specific actions are required to accelerate the economic engagement and make it more balanced

Key Actions Required

2

What are the key actions required to accelerate the economic engagement and make it more balanced?

WINNING IN CHINA by Promoting Exports and Investments

- India will need to **push for specific actions** in certain identified sectors like **IT Services, Pharmaceuticals, Auto Components, Tourism and Entertainment**
- Across these targeted sectors, India has a **potential to generate revenues > $10 bn in 4-5 years** – nearly 80% of the exports of India to China in 2013
- However, while these opportunities hold real potential, **Winning in China** will require companies to **change their mindset towards China** and **invest for the long term** by **committing resources** in terms of technology, capital and **senior management** and **work in close co-ordination** with the **Indian Government**, which has a **critical role** in **enabling market access in China**

LEVERAGING CHINA FOR INDIA by Encouraging Chinese FDI

- We need to **prioritise 18 sectors** for **Chinese FDI** in **specific areas** under **Capital Goods, Specialty Products, Consumer Goods and Infrastructure**
- India should **actively consider a sovereign deal** with China for active **investment in Indian infrastructure projects** which can benefit both countries immensely
- Further detailing and **sector specific actions** will be required to **attract Chinese FDI** in each of these sectors which need to be **detailed** through **interactions with the Indian industry**

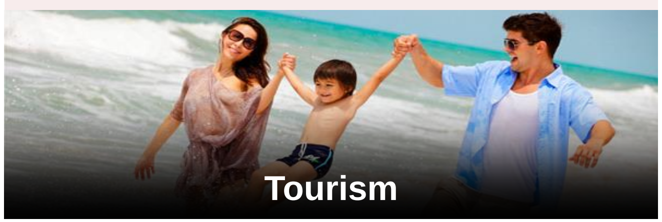
Pushing for specific sector specific market access in China and enabling actions in India are critical to realise >$10bn revenues from China across 5 identified sectors

- Indian Government to present a case to China for ‘fast tracking’ approvals of select molecules by reputed Indian pharma
- Favorable pricing and hence lower healthcare costs for China
- China FDA set up in India

- Focusing on select components with design capability and price competitiveness
- Target specific Chinese OEMs with interest in sourcing from India
- Include components in MLFPS

- Invest in relationship building in China through collaborative productions, selecting appropriate customised content, negotiating quotas and undertaking specific marketing campaigns

- Target the outbound tourism market through specific initiatives like Visa on Arrival, targetted marketing campaigns, financial incentives, cinema led tourism promotions, partnering with the right tour operators, etc.



- Substantial push from the Indian Government to get China to provide preferred access to Indian companies in SOEs
- Commitment from Indian IT companies to invest in strategic initiatives in China

Chinese FDI needs to be attracted across 18 high priority sectors identified basis an appropriate sector prioritization framework

Key Actions – China FDI in Prioritized Sectors

Key Categories

Capital Goods & Machinery	*Power Equipment*	*Construction Equipment*	*Telecom Equipment*	*Machine Tools*	*Dies, Moulds and Press*
	Textile Machinery	*Plastic Process M/C*	*Process Plant Equip.*	*Agriculture Machinery*	
Commodity Products	*Metals - Steel*	*Articles of Steel*	*Metals - Aluminium*	*Metals - Copper*	*Mining & Quarrying*
	Petrochemical	*Basic Organic Chemicals*	*Inorganic Chemicals*		
Specialty Products	*Formulations*	*APIs & Intermediates*	*Fertilizers & Specialty Chem*	*Auto Components*	*Industrial/ Auto/ IT Elec.*
	Electronic Chips & Semi.	*Dyes & Paints*	*Solar Modules*	*Defence Equipment*	*Medical Devices*
Consumer Products	*Auto – 2W*	*Auto – 4W*	*Auto - CV*	*Apparel*	*Footwear*
	Furniture	*Consumer Appliances*	*Consumer Electronics*		
Core Infrastructure[1]	*Roads*	*Ports*	*Industrial Parks*	*Townships*	*Power Plants – Coal/ NG*
	Railways/ MRTS	*Airports*	*Irrigation*	*Water Supply & Sanitation*	*Power Plants – Solar & Wind*

Source: Avalon Consulting Research and Analysis

India should actively consider a sovereign deal with China for active investment in Indian infrastructure projects which can also benefit them immensely

Key Actions - Sovereign Investment Opportunity

Sovereign Investment Opportunity from China in Indian Infrastructure

- **China** has about **$ 4 trillion** in accumulated **foreign exchange reserves** which are mostly **invested** in **US treasury bonds** and some EU bonds
- Any **adverse movement** in the **yields of US bonds**, or slight **weakening of US dollar hurts** the **Chinese investment** of their foreign exchange reserves. Even if this combined movement is as low as **1% per annum** (in terms of **returns**) it results in a **loss of $40 billion**
- While **China** may see this as a cost of sustaining its key export market (USA) and is not concerned with returns, it has also **sought diversification** through **investing in Africa, Iran and Indonesia** in **oil, gas and mineral asset**, which also are strategic moves and an attempt to diversify away from US treasury bonds without addressing the returns issue
- In such a scenario, **India** can make a sovereign to **sovereign deal with China**, inviting **capital investment** into **long term (20+ years) infrastructure assets** in India, preferably as **equity** (hence FDI)
- The **return on such investment** can be **quasi-guaranteed** (even at 5%) in **Chinese currency terms**, thus bypassing US dollar risk, given that there are **several infrastructure investment opportunities** in India which can **sustain** such a **return over a long term**
- The nature of these projects could be determined by us (possibly Industrial Parks, Water Supply and Sanitation, Townships, etc. identified earlier) and some of these could be tied sale (of capital goods)
- Such a **capital flow** is a **win-win proposition**, since it gets the **bilateral deficit plugged** by much needed **capital inflow** into **infrastructure**, for India while **China** gets an **assured return**, in their own currency
- In case China is reluctant to take a sovereign risk on India, such a **"bilateral" capital flow** can possibly be **routed** through the **"multilateral" BRICS bank**
- Such an **opportunity** could start with $2-3 bn and could potentially **expand to $ 40 bn** (~1% of China's FE reserves)

Specific underlying drivers will need to be addressed to ensure success of the above actions

Key Underlying Drivers

3 **What are the underlying drivers required in India to ensure success of the above actions?**

- **Substantial changes** are required to the **manufacturing ecosystem in India** to make it **globally competitive** to **attract MNC production networks** to leverage Indian manufacturing **for exports to China and the World**
- In addition, **India will need** to have **policies and infrastructure** directed towards **export oriented manufacturing** and **create Chinese Investment Parks**, possibly as **JVs** with their **Industrial Park developers**, given the specific needs of Chinese investors
- For **attracting Chinese FDI** in the shortlisted sectors, **a specific proposition** for **targeting key companies** needs to be developed - based on an understanding of the **nature of ownership** and its **existing manufacturing network**, calling for **micro-targeting**
- **Capability creation** in the areas of **Chinese language** and **China studies** in general - covering translation and interpretation, academic and student / youth exchanges, ease of India-China travel and conferences, media and communication, business facilitation services such as law, documentation and diligence
- Set up an **institutional basis** (Govt cum industry) to **monitor** the achievement of the **Core Group goals** after they are finalised, to **facilitate and coordinate** regular contacts and **meetings** between **Indian and Chinese organisations**, and to **support SMEs** in particular

Substantial changes are required to the manufacturing ecosystem in India to make it globally competitive and attract MNC production networks to leverage Indian manufacturing for exports to China

Key Factors Driving Indian Manufacturing Sector Linkage to Global Supply Chains

Efficient logistics

- Increase vessel handling capacity of major ports
- Improve rail and road connectivity to ports
- Ensure single window paperless processing of documents
- Set up dedicated freight corridors and access controlled expressways

Investor friendly labour laws

- Review Contract Labour Act to make it more contemporary
- Simplify rules for downsizing workforce
- Allow employment contract for fixed term
- Modify trade union laws

Surplus and good quality power

- Reduce T&D losses
- Significantly increase power generation
- Improve quantity and quality of coal supply by improving efficiency and governance of Coal India Limited (CIL) and facilitating private capital flows

Competitive tariff structure and EZs

- Eliminate import duty on parts and components and raw materials to eliminate inverted duty structure
- Create international standard export manufacturing infrastructure to attract investment from global players

Dedicated financial institutions

- Set up a dedicated financial institution for MSMEs to provide them comprehensive solution
- Simplify rules and processes to deal with financial institutions

Easier Internal tax structure

- Introduce Goods and Service Tax (GST) at the earliest
- Abolish multiple taxes like entry tax, octroi, etc.
- Establish single authority for tax collection

In addition, India will need to have consistent policies and world class infrastructure directed towards export oriented manufacturing

Key Requirements of Export Oriented Manufacturing

To attract export oriented manufacturing FDI, India will need to address the following issues in locations where it seeks to attract such investments :

- World class internal infrastructure in terms of power, water, sewage treatment, other utilities
- High speed connectivity to ports and airports
- Availability of labour and flexibility with regard to retrenchment and severance issues
- Policy certainty with regard to available tax waivers and other incentives (these should not be changed or withdrawn mid-way)

Large export oriented FDI has to be conceptualized with world class infrastructure in mind. The seven manufacturing clusters being set up along the DMIC are being conceptualized at a large scale (> 5000 ha each) and ambition – some of these locations should be explored specifically for Chinese FDI

Change in Thinking and Orientation

- The existing SEZ policy lacks the vision to create "pockets of excellence" required to attract large export oriented FDI
- Most of the SEZ are sub-scale in size and concept and are not oriented around an "anchor tenant" which can drive the development of the SEZ and its linkages
- The infrastructure development has been left to the private developers who have not delivered – the State has failed to provide the necessary high speed road connectivity
- Policy flip-flops have been a huge deterrent e.g. the imposition of MAT and DDT (Dividend Distribution Tax) created negative perceptions about the attractiveness of SEZ
- Thus, examples of successful SEZ have been those where a large private company has undertaken the bulk of the development (e.g. Sri City in Andhra, Reliance in Jamnagar) or where government has been actively involved (e.g. Dahej multi-product SEZ with ONGC and Gujarat government)

Attracting Chinese FDI will also involve creating Chinese Investment Parks possibly as JVs with their Industrial Park developers, given the specific needs of Chinese investors

Need for Chinese Investment Parks

- India and China have agreed to set up two Investment Parks for Chinese manufacturing companies setting up operations in India
- Chinese companies evaluating their investment decision in these Parks will require world class internal infrastructure inside the Park, terms of power, water, etc. and several common facilities (which they are used to having as part of Industrial Parks in China) like effluent treatment, steam and other utilities, etc.
- India lacks the skill sets and experience required for developing and maintaining such Industrial Parks
- Hence, there is a need to identify such infrastructure developers (which set up Industrial Parks) in China, who can help set up these projects – probably as JVs with Indian companies (private or with State Industrial Development Authorities)
- World class infrastructure provision through private development will be a strong first step to demonstrate India's commitment to enabling China to succeed in India and can build on the infrastructure needs like road and port connectivity and policy stability (which are more long term in nature)

Micro-targeting through specific propositions for key target companies is critical to attract FDI in the shortlisted sectors. This needs to be based on an understanding of the nature of ownership and its existing manufacturing network within these sectors

Proposition for FDI

Proposition for FDI

There is a need to understand the India proposition to China for each of the prioritised sectors. This will vary by sector and by the type of Chinese companies present in that sector

Hence, to develop a game-plan for attracting Chinese FDI, we need to answer the following questions:

- What are the type of companies that we need to attract ? Are these Chinese SOEs, Chinese private cos., MNCs or companies present outside of China (Taiwan, Hong Kong etc.)
- Are these companies manufacturing in China or outside of China, i.e. South East Asia?
- Would investing in India mean, that they would be investing in the facility for local Indian market or would they also use the Indian facility to feed into their SE Asian value chain?

Examples of Select Sectors

Telecom Equipment

- Mainly Chinese private companies (but having significant government backing) besides a few Taiwanese private players
- The India proposition for them would be to cater to the large domestic market as well as complement / supplement their operations in China and ASEAN

Electronics and IT products

- In the Mobile phones and IT products and consumer appliances segment, manufacturing may be done in-house or through an EMS – many of these have an ASEAN base
- Hence the evaluation of investment in India will need to be done with both the OEM and the EMS – to consider India as alternative to ASEAN as well as cater to domestic market

Power Equipment

- Most Chinese players – including SOEs and private companies do not have a manufacturing facility in ASEAN
- The proposition for them would be to use India mainly for domestic market – ASEAN may well continue to be catered from China

Source: Avalon Consulting Research and Analysis

Set up an institutional basis (Government cum industry) within the PMO or MOCI to direct and monitor the achievement of the CII Core Group goals

Create a China Cell cum Knowledge Centre (KC) within the PMO or MOCI with the Secretariat being managed by CII. Some of the key tasks of this KC will be:

- Be the key co-ordination arm of the Core Group responsible for the implmentation of the outlined actions and others emerging from ongoing review and deliberations between the Government and Core Group members
- Deepen and disseminate information about China – opportunities, challenges, business practices, etc.
- Organise events which allow Indian and international executives with experience in working and dealing with Chinese business community to share their experiences and learnings
- Work with the India Business Forum and Indian Embassy in China to disseminate information about Indian businesses and brands to raise the profile of India and equate it to the Western World in the eyes of the Chinese decision makers and consumers
- Help the Indian business community to network with the Chinese business community
- Showcase our knowledge, skills and expertise in the management sciences to enable Indian manpower to work with Chinese businesses
- Develop a program to have, say, 100 high quality interpreters, who are available to serve the Indian Business Community. If required and found appropriate, seek the help of the Chinese Government in creating and expanding this program

Source: Avalon Consulting Analysis

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