China plus one: Will the dragon now make way for the elephant?

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2 October 2023

India's manufacturing sector is riding the tailwinds arising from a Western shift in interest away from China. As a result, large conglomerates from sectors like electronics, renewable energy and automobiles have expressed their intent to set up shop in the country. A case in point is Apple, whose new plant in Tamil Nadu began production of the latest iPhone 15 last month. Similarly, Tamil Nadu also roped in two new factories from the Denmark-based Vesta, the world's largest wind turbine manufacturer.

The rupturing of global value chains (GVCs) during the pandemic gave the West an opportunity to look away from China towards countries such as India, Vietnam, Malaysia and Mexico. However, the first instance of a deliberate movement of trade away from China can be traced back to the US-China trade war, which began in 2018. India's chemicals, pharmaceuticals and metal sectors immediately benefitted from tightening US-China trade, thanks to their competitive advantage.

While India's electronic exports were not immediate beneficiaries of trade diversion from China, they have shown tremendous gains over time. Policy backing through the Production Linked Incentive (PLI) scheme has helped catalyse the exports of this sector. For example, India's electronic exports to the US (as shown by data under the HS-85 category) shifted from a trade deficit of about $300 million in 2017 to a surplus of $3.12 billion in 2022. This also indicates a rise in value addition. Within electronics, the largest increase came from mobile phones, the exports of which to the US grew by 48% between fiscal years 2020-21 and 2021-22.

To be sure, the tailwinds arising from a dampened China have benefitted East Asian economies such as Vietnam, Taiwan and Malaysia more than India. This is primarily due to the first-mover advantage that these nations possess, as they are far more integrated with GVCs. The beginnings of some of the East Asian GVCs go back to the 80s, even before China occupied its space in supply chains. For example, by the early 2000s, Malaysia had developed a significant presence in the electronics value chain, and Thailand had grown a niche in automobiles. In comparison, India's integration into GVCs is relatively nascent. However, unlike these East Asian economies, India offers the prospect of a large local market, which makes the decision to set up local manufacturing units easier for foreign firms to take. India's young, expanding middle-class provides these firms with significant potential demand to tap.

As India seeks to integrate further with US (and generally Western) supply chains, it helps to learn from the experiences of East Asian economies. Generally, these economies have relied on a two-pronged strategy of trade-cost reduction and investment facilitation. As

GVCs are designed for cost minimization, countries such as Malaysia, Vietnam and Taiwan have sought to reduce their trade-related costs over time. In this regard, India has ramped up its logistical efficiency over the past decade, as observed from our latest ranking now by the World Bank's logistical performance index (LPI). From No. 54 on a list of 139 countries in 2014, India has ascended the chart and ranks No. 38 in 2023. The second prong, investment facilitation, includes measures to increase and stabilize foreign investment in the country. In this context, the PLI scheme facilitates high-quality foreign investment by creating a market-linked incentive structure for firms to follow.

Over the medium term, India's value chain integration with the West would target areas like renewables and high-end technology such as artificial intelligence, semiconductors and next-generation telecommunication. These areas have been included in agreements such as the Australia-India FTA and US-India Clean Energy Partnership. Trade contours in these areas have already begun to take shape. For instance, looking at the HS codes for green technology (such as solar water heaters, waste recycling machines and wind turbines), we observe a $1 billion rise in these exports to the US since 2018. On the ground, major US and European renewables manufacturers such as First Solar, Vesta and Scatec have begun operations in India to seize the green transition opportunity.

Finally, can India replace China as the global factory floor? As we argue above, while India's gains have been substantive, integration into a GVC does not happen instantly. For instance, Malaysia took nearly 30 years to establish itself in the electronics value chain. While the initial 20 years involved low-value-added electronics manufacturing, Malaysia rapidly integrated deeper and moved up the global electronics value chain over a decade. Moreover, it should be noted that a diversion in interest from China does not imply a reduction in the country's value chain primacy in the short to medium term. Rather, a shift away from China is likely to happen over time.

As the West increasingly looks towards India to friend-shore its supply chains, it is imperative that we double down on our advantages of a large domestic market, macroeconomic stability and policy consistency.

These are the authors' personal views.