Chapter VI

Prospects for India and lessons for latecomers

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The rapidly expanding international production networks driven by multinational firms has stimulated economic and trade integration between Asian countries during recent decades. The major countries in East and South-East Asia have benefited from the expanding IPNs, especially in terms of export growth, employment creation and technology transfer. However, the remainder of the region, especially low-income countries, has found increasing their presence in existing IPNs to be a difficult challenge.

Building on the examination of India’s performance in IPNs, this study also offers some policy recommendations to other low-income countries that have been missing out on the opportunities presented by the IPN phenomenon. This study examines the current performance of India, and evaluates its prospects and challenges for catching up in this process, while taking into account India’s ongoing economic reforms and efforts to utilize PTAs as a vehicle for integrating with the rest of the region. The lessons from India are used to formulate policy recommendations relevant to fostering IPN participation by countries that are trailing behind in this area.

Examination of India’s economic performance shows that the country has followed a distinctive pattern of development, especially when compared to major participants in Asian IPNs, including China. Recent trends reflect the fact that in creating value-added India is continuing to focus on some services, which are relatively skill-intensive with little prospects of generating demand for unskilled labour. The growth pattern of India does not appear to be in line with the country’s overall factor endowment, which reflects a relative abundance of unskilled labour; therefore, concerns have been raised about “job-less” growth of India during the past two decades.

The trade performance of India reveals that, so far, there has not been any clear evidence of the country entering into Asian IPNs that have created extensive trade opportunities in the machinery and transport equipment sectors of East and South-East Asian countries. Overall, the share of manufacturing exports in total exports by India has been declining (from 56% in 2000 to 42% in 2010). Manufacturing exports by India are still concentrating on resource-based manufacturing products and materials such as leather products, gems and jewelry, and textiles and garments. However, there is evidence of integration by some parts of the automotive and electronic industries into
IPNs. Multinationals such as Toyota, Suzuki and other MNCs have been increasingly adding their operations in India to the evolution of their IPNs.

The reasons behind this rather unimpressive performance by India’s manufacturing exports are pointed out in existing literature that is referred to in this study. Many of the reasons relate to distortions created by import substitution policies that India adopted prior to the economic reforms initiated in 1991. Those policies were translated into tight controls of foreign and domestic investment, heavy public sector involvement in production, and policy biases in favour of capital- and skill-intensive industries. Consequently, production by the Indian manufacturing sector has been focused on capital-intensive, large-scale and heavy manufacturing industries, notwithstanding India’s comparative advantage in labour-intensive production. The distorted economic patterns remain despite the fact that the economic reforms have removed some policy impediments.

At the same time, foreign investment in India was discouraged by highly restrictive investment regulations, industrial licensing, rigid constraints imposed to businesses on their entry to, and exit from the market as well as high protection for workers and small-scale firms. The lack of policy flexibility led to India being perceived as an unattractive place for FDI, particularly for those firms driven by efficiency-seeking motives.

Those policies contributed to the underperformance of India’s manufacturing sector when compared to East and South-East Asian economies, whose economic policies were relatively more open. Although the economic reforms started in 1991 have increasingly opened the Indian economy, comparisons show that there is still a large gap between India and rapidly growing East and South-East Asian economies. India still needs to reduce tariffs further, especially on raw materials, parts and components, and semi-processed goods, if it wants to match the level of ASEAN and East Asian countries. Most importantly, steps are necessary to address significant concerns about non-tariff barriers and the “behind-the-border” issues. Private investors are still required to apply for permission from a large number of government offices to start a business. Once permits and clearances are obtained, investors are still faced with a high level of

103 A comprehensive analysis is provided by, for example Athukorala, 2008; Grabowski, 2009; Kochhar, Kumar, Rajan, Subramanian and Tokatlisdis, 2006; and Srinivasan, 2003.
104 According to Henry (2004), starting a new business in India required, on average, 10 permits, compared with the six permits required to legally establish the same business in China. In addition, the permit process took 90 days on average in India, three times longer than in China.
government oversight – the so-called “inspector Raj.” The management time required to accommodate a steady stream of inspections becomes burdensome for private investors.\textsuperscript{105}

Further reforms are needed in the labour market. While it is important to adhere to high workers’ protection in the organised labour market, for the purposes of efficiency reforms could be taken at the same time to improve market functioning. For example, labour laws designed to protect workers makes it difficult to dismiss employees or to employ temporary workers. As a result, factories are reluctant to take on new workers unless they are confident that demand for their output will be steady. Exiting a market by unviable and uncompetitive business units remains difficult in India, making it urgent to introduce competition mechanisms that will allow the more efficient firms to enter and the less efficient firms to exit more easily. For infrastructure services, significant reforms and upgrading have been made in telecommunications and road systems, but other crucial infrastructural elements such as power, freight and cargo services have not undergone significant improvements (Kalish, 2006).\textsuperscript{106}

Despite the reforms and recent rapid growth of FDI inflows, India is still having limited success in attracting FDI into manufacturing sector. This could be attributed to four factors. First, heavy regulations have not been completely removed. Second, reservation of products for production by small-scale firms prevents utilization of full market size to utilize benefits from scale economies. Third, inadequate soft and hard infrastructure limits India’s productive capacity and reduces its attractiveness to MNCs. Furthermore, India has been at a disadvantage with regard to first-comers in this international specialization, particularly by China and ASEAN countries, as there is considerable agglomeration of companies that have already fixed their location in those countries.

However, prospects for India to emerge as a player to be counted on in the specialization process of IPNs do exist. Important advantages of India arise from the sheer size of the country’s economy and population, the large pool of engineers and

\textsuperscript{105} In India, 16 per cent of senior management’s time may be occupied by interactions with government officials, compared with 9.9 per cent of management time in China (Henry, 2004).

\textsuperscript{106} For example, highways comprise a very small share of India’s roads. Of 3.3 million kilometres of Indian roadways, only 195,000 kilometres are highways. In contrast, China has approximately 1.4 million kilometres of highway. There is insufficient capacity to service today’s large cargo ships at Indian ports, and which have yet to prepare for the next generation of container ships that will be even larger and more sophisticated, requiring long docks, deep harbours and very tall cranes. Again, in contrast, China already handles one fifth of the world’s container shipments and is developing massive new ports in Shenzhen and Shanghai (Kalish, 2006)
relatively sound intellectual property protection. An initial requirement for a country to integrate into IPNs is to offer low trade costs. Clearly, India has to further liberalize its economy and rapidly upgrade crucial infrastructure in order to bring down trade costs to an adequate level.

India is building upon some positive results from its autonomous reforms by scaling up its efforts in preferential liberalization. Since the early 2000s, India has embarked on bilateral trade arrangements with all those countries in Asia that have proved to be successful participants in the Asian and global IPNs, i.e., Japan, the Republic of Korea, Malaysia and Singapore. Furthermore, it has signed a comprehensive trade agreement with ASEAN, thus securing links to potentially useful suppliers in Indonesia, the Philippines and Thailand. An inspection of these agreements from a perspective of fitting into the “deep integration” type of PTAs (WTO, 2011a) finds that indeed only these latest agreements feature disciplines in those policy areas that matter for the development of IPNs, including competition, investment and intellectual property protection. Other agreements, including those signed with neighbours in South Asia, are all shallow agreements.

Anecdotal evidence supports the view that efforts in securing deeper PTAs were a reaction to a demand that had built up as a result of the increasing amount of production network trade (parts and components amounted to 10% of India’s manufacturing exports and 23% of manufacturing imports, on average, during 2006-2007). However, the long implementation periods negotiated for agreements with these strategic partners (2021 with Japan, 2019 with Malaysia and the Republic of Korea, and 2015 with Singapore) could prove to be a deterrent to some investors who are now having a second look at Asia and deciding on alternate locations, given the changes in China’s labour costs and issues with the exchange rates.

India is not saved from the similar problems arising from exchange rate management. A managed float system was introduced in India in 1992-1993. There is considerable evidence that the Reserve Bank of India has intervened to keep the exchange rate from appreciating in order to preserve export competitiveness. However, there are limits to what the Reserve Bank of India can do to keep the Indian rupee from appreciating, given rising capital inflows and a high inflation rate. Although attempting to keep the exchange rate low may help the IT, textiles and tourism sectors, as their exports generally have low imported input content, it may increase the production costs of industries participating in IPNs because imported inputs, parts and components are a critical element of their production for export.
The ongoing weak prospects for the global economy will make competition for market share tougher and the achievement of inclusive growth more difficult. While the previous episode of global collapse in international trade enforced the adverse effects of strong interconnectivity among economies, the ability of Asian economies to recover their trade equally quickly also proved the value of being connected to the production networks. Asian economies have shown stronger resilience to external shocks. It is not possible for all countries to be part of IPNs. Some could prosper even without participating in these vertical specializations, based on their specific endowments and patterns of production and trade. However, those low-income countries that are only labour-abundant and are facing the challenges of unemployment would do well to consider introducing similar policies to those followed by other significant players, and which are reviewed in this study, in order to become players in IPNs.
References


