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India's Blunt Economic Weapons Require Sharpening

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The renewed border flare-up with China has affirmed India's view that China presents a problem that can neither be ignored nor managed alone. In recent years, trade protectionism has been the primary tool India has employed to balance ties with China, though in a very blunt fashion that has harmed economic ties with the United States and other countries. Protectionism is bad policy, especially as India seeks to be a more meaningful player in global supply chains. But if new trade protections are part of India's reaction to China's new provocations—and it appears they are—they should be sharpened to become more effective.

Since coming to office in May 2014, the Narendra-Modi-led Bharatiya Janata Party (BJP) government has re-oriented India's foreign policy. Many of these changes revolved around a recognition that China's ability to engage and influence matters in the Indo-Pacific had grown, and often conflicted with India's own interests. Defense cooperation with the United States has deepened in meaningful ways; the Quadrilateral Security Dialogue is limping its way into a renewed existence, and India's ties with Japan have deepened. India has engaged its own neighborhood more actively and even used its military to protect a smaller neighbor's sovereign integrity during the China-Bhutan border crisis in late 2017.

However, India's policymaking under Prime Minister Modi has been less constructive in confronting China on another front—trade. As with many nations, China regularly tops the list of India's goods trading partners (swapping places with the United States every few years). And the balance of trade is strongly in China's favor. For the current fiscal year through February, India-China goods trade total $77 billion, but India's exports to China make up just 20 percent of this amount. Over the last seven years, India's annual trade deficit with China averages out to $49 billion, representing over one-third of India's total deficit.

The Modi government has adopted trade protectionist policies during its six years in office. These protections have taken a variety of forms including:

- **Customs Duty Hikes.** In nearly every budget there have been customs duty increases on dozens of products. For example, in the 2020-21 Union Budget released on February 1, 2020, the Ministry of Finance announced customs duty hikes on over 60 product groups including autos, home goods, mobile phone components, and toys.
- **Local Content Rules.** India has expanded the number of sectors where local content rules apply to win government contracts. For example, in February 2019, the Ministry of Shipping announced "made in India" ships will get a chartering preference. Such examples are manifold.

KEY DATA

-11.4%

U.S.-INDIA GOODS TRADE, 12-MONTH COMPARISON, PER U.S. CENSUS BUREAU

+7.5%

FOREIGN DIRECT INVESTMENT, 12-MONTH COMPARISON, PER RBI

$-8.5 bn

FII ASSETS NET FLOWS, LAST 12 MONTHS, PER NSDL

- **Backing Out of Trade Deals.** India's November 2019 withdrawal from the Regional Comprehensive Economic Partnership (RCEP) trade talks is most notable. But India's pending negotiations with a wide range of countries—including the European Union, Australia, Canada, and New Zealand—are all dormant, if not dead.

The problem with these protectionist steps is that while they ostensibly target India's trade deficit with China, the customs duty hikes and import substitution rules are applied globally. And although India's withdrawal from RCEP is driven by trade concerns with China, it unsettles other members who desire stronger trade linkages with India. Further, these steps increase tensions in India's overall relationship with key partners and reduce momentum in their respective partnerships with India. And, these trade barriers do not appear to be working. India's deficit with the world, and China specifically, appears unfazed by these protectionist steps.

The United States has mostly been able to keep its positive momentum on the strategic relationship separate from its contentious ties with India over economic matters. The two countries have taken specific trade actions against each other, such as the U.S. withdrawal of preferential trade access under the Generalized System of Preferences program in June 2019 and India's adoption of retaliatory tariffs against the United States that same month. Fortunately, these trade tensions have not deterred substantial progress in their defense relationship. A few months later, the two nations' foreign and defense ministers met in Washington for the annual "2+2 Ministerial Dialogue." But the firewalls between U.S.-India defense and economic relationships are starting to crack, most notably on Capital Hill, where U.S. companies harmed by India's protections are actively petitioning their elected representatives to challenge India's trade policies.

The escalation of tensions between India and China are already triggering new economic policies in India to reduce China's economic linkages with India. On April 17, 2020, India implemented an expanded investment review mechanism for investments by neighboring nations in reaction to "opportunistic investing" in Indian companies by Chinese firms. On, June 23, 2020, India adopted mandatory "country of origin" labelling for items sold on the government e-marketplace. On June 29, 2020 India announced a ban on dozens of Chinese mobile apps. There are unconfirmed reports that India may also increase customs duties on a range of products, including items related to renewable energy.

Trade economists would correctly contend that barriers of any type are a method of self-harm. A basic "balance-of-trade" number as the trigger for trade sanctions does not fully capture the value of trade. But if the Indian government feels trade sanctions are required, the approach should be thoughtful and targeted. Taking steps that are broadly applied—and trigger new economic tensions with key strategic partners—could ultimately be self-defeating.

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