

Global Hot Topics

India flirting with China: How far can it go?

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This note offers our views on Modi's visit to Xi Jinping, starting tomorrow May 14th to 16th 2015. We believe that while stronger bilateral trade and investment cooperation would continue to drive the Modi-Xi dialogue, it would, nevertheless, be influenced by four key geostrategic issues:

- 1) China's and India's recent diplomatic overtures with other economies.
- 2) Dynamics of newly founded multi-lateral development banks, especially the Asian Infrastructure Investment Bank (AIIB) but also the BRICS Bank.
- 3) China's role in upgrading India's poor infrastructure.
- 4) Need for India to elevate its strategic significance in South Asia, in order to seal even-handed trade deals with a dominant China.

India chooses to drink China's alphabet soup – AIIB – despite US criticism

Over recent months, China has underpinned its intentions to re-align the world's economic order. It has spearheaded the new 57 member multilateral development bank, AIIB, which exudes potential to counter Bretton Woods Institutions and overshadows the BRICS Bank by its sheer size and scope. Furthermore, China launched the ambitious USD 40 billion Silk Road Infrastructure Fund (SRF), and expanded Shanghai Cooperation Organization (SCO).

Amid China's growing clout, India needs to reimagine its outreach with its extended neighborhood or risk rendering itself irrelevant in regional trade and investment flows. India's decision, therefore, to accept the membership of AIIB, despite US criticism, and its anticipated acceptance of the SCO membership (an observer until now), stems from its economic imperatives to correct domestic trade imbalances and secure infrastructure funding. Particularly so, given India's stretched government finances at home and the lack of private sector funding interest amid regulatory delays and governance issues.

India so following China's South-South leadership, but how far can it go?

India signed in as a member of the AIIB despite pressure from its ally, the US, which criticized the new Bank for lacking transparency while raising doubts over AIIB's lending sources and its adherence to environmental safeguards. The decision to overlook US concerns reflects India's willingness to flirt with China while keeping the US slightly out of focus in order to further its medium term interests. India could be hoping to receive development finance from AIIB to fund its coal fired power projects (bulk of India's electricity is generated through coal), as the World Bank doesn't fund them amid US reluctance on environmental grounds. Another case in point is India's purchase of 36 Rafael fighter jets from France last month through the government to government route. Furthermore, Japan, France and China together are bidding for a share of modernizing India's creaking railway infrastructure, in which India seeks USD 137 billion over the next five years.

By playing the delicate balancing game on the diplomatic stage for long, India may be pushing the envelope. While Mr. Modi attempts to reset ties with all, friends and foes alike, he needs to be careful not to be blinded by 'Sino-Mania', lest he gets trapped in China's own game, which is driven by Mr. Xi's vision to be the regional security heavyweight. In this context, China's recent USD 46 billion dollar

investment commitment to India's rival Pakistan furthers China's plan to place a strategic counterweight to India in the sub-continent.

India should negotiate with China for a strategic space of influence in South Asia

Notwithstanding diplomatic undercurrents, the central element of Modi-Xi meetings and accompanying industry interactions would be to achieve breakthroughs in closer economic collaboration while putting geopolitical issues on the backburner. Of priority would be to pursue Chinese authorities to expedite and effectively honor recent trade policy and investment commitments. These include, 1) Expediently pursue market access issues for Indian goods by tackling non-tariff barriers in the Chinese markets through the existing 'India-China Joint Group on Economic Relations, Trade Science and Technology (JEG), 2) Enhance participation of Indian exporters in trade fairs to educate Chinese importers about Indian products, 3) Ensure USD 20 bn investment commitment by China into India's industrial Parks is materialized and 4) Successful and early implementation China's planned USD 36 billion bullet train project in India.

Meanwhile, we are less sanguine about new breakthrough achievements during Mr. Modi's China visit, especially in the form of Free Trade Agreements (FTAs) in sectors such as Pharmaceuticals, IT and farm products, where India has proven export capabilities. That said, we believe that FTA's are no panacea for improving trade and if framed loosely it may heighten competition from cheaper Chinese products in Indian markets. Nevertheless, an even-handed goods and/or services trade agreement between India and China is unlikely unless India elevates its strategic significance in South Asia, beyond its size and economic potential. Reassuringly, India does have a hard-nosed negotiator in Mr. Modi who could drive a bargain with China for India's strategic space of influence in the region. But will he talk tough or perform his trademark delicate balancing act? Let's wait and watch.

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