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POLICY INSIGHT

China's belt and road initiative and India's options: Competitive cooperation

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ABSTRACT

India and China have a competitive yet cooperative relationship. India has not signed on to the Belt and Road Initiative as it has concerns over some aspects of it—especially the China-Pakistan Economic Corridor and the Maritime Silk Road—and has proposed its own "Spice Route" or SAGAR project, with India at the centre of Indian Ocean relations. Nevertheless, India has joined the new financial institutions of the New Development Bank, the Asian Infrastructure Investment Bank (AIIB) (as its second largest shareholder after China) and most recently the Shanghai Cooperation Organisation (SCO). These new banks are a potential source of long-term infrastructure finance for India, however small in magnitude. China and India have growing, yet somewhat unbalanced, economic linkages—with a large trade deficit in favour of China. This paper explores how China and India can contain their contentious issues as they find ways to cooperate for mutual benefit.

Keywords: *new Silk Road; New Development Bank; AIIB; spice route*

1. Introduction

There are conflicting views in India on whether China's One Belt and One Road (OBOR) strategy, now also called the Belt and Road Initiative (BRI), represents a threat or an opportunity. Some view it as a strategy which China will use to encircle India. Some consider it as a great opportunity to attract the much-needed infrastructure finance into India to fill its infrastructure growth and boost growth and employment. Also, some regard it as a *fait accompli* in which India must engage to derive as much benefits from it as possible (Panda 2014). What is emerging is a competitive yet cooperative approach from both China and India, in the Indian Ocean, in the South China Sea and in parts of East Asia.

China and India must cooperate rather than compete if an Asian century is to be realized. According to Maddison (2004), India and China 200 years ago became almost 50% of the global economy. However, by 1950 their share of the global economy had dropped to only around 15%. Since 1980s, both economies saw a steep increase in their growth rates—more so in the case of China, which saw almost

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three decades of spectacular growth rates. India also shed its slow-growing so-called "Hindu" growth rate and began to grow much faster, especially after liberalising and opening its economy in 1991 some 13 years after China began opening its economy.

Both face huge internal challenges, with China facing rising debt and problems in transitioning from a largely investment- and export-led growth to a more consumption-based economy, and India struggling with difficult second-generation reforms in land and labour markets and the need to finance its glaring infrastructure gaps. If both China and India could continue to grow rapidly, they are projected to become more than 50% of the world economy by 2030—roughly where they were 250 years ago. China and India have much to gain if they cooperate and much to lose if they compete in a manner that pulls each other down. They need some form of "competitive cooperation".

2. India and China's strategic concerns in Asia

India has not signed on to the BRI and has concerns especially with the Maritime Silk Route (MSR), whereas China has expressed opposition to Indian interference in the South China Sea. India is upset about the Chinese President's recent commitment to invest USD$47 billion in rail, road infrastructure and a virtual trade corridor connecting West China to the strategic Gwadar port in Pakistan. This would enable China to carry oil and gas from Iran and Arab countries via Gwadar port, which was also built by China. India's objection is that the trade corridor and rail-road link goes through Pakistan-occupied Kashmir. Nevertheless, India has signed on to become a founding member of the Asian Infrastructure Investment Bank (AIIB) and the New Development Bank (NDB) (BRICS Bank), and has expressed support for the Kolkata–Kunming road corridor connecting Bangladesh, China, India and Myanmar.

At the same time India has begun its own long-overdue initiatives in the Indian Ocean to counter the Chinese and ensure that China does not start to dominate the Indian Ocean through its "String of Pearls". India's maritime initiative on the Indian Ocean has been variously presented as "Project Mausam", "Spice Route", "Cotton Route", the Blue Revolution (from the Ashoka Chakra on the Indian flag) and SAGAR—'Security and Growth for All in the Region'. The initiative envisions India as the center of the "Indian Ocean world", which stretches from Africa in the west to Southeast Asia in the east. Like China's Maritime Silk Road, Project Mausam would boost regional commercial and cultural linkages—whereas the MSR would have all roads leading back to China, Project Mausam seeks to return India to its role as the center of Indian Ocean trade. The project has a three-dimensional approach: first, to deepen cultural bonding; second, to ensure maritime security; and third, to broaden economic connectivity with nations of the Indo-Pacific Region.

China has tried hard to get India to find ways to bring the MSR and India's Mausam (Spice Route) projects together. On the surface, the two projects do have much in common—both seek to expand regional integration, especially when it comes to trade and commerce. However, on a deeper level, both the MSR and Project Mausam are about expanding influence—culturally, economically, and even strategically. India devised Project Mausam to counter perceptions that China is becoming the major Indian Ocean power. The Indian Ocean carries one half of world's container shipments, one-third of the bulk cargo traffic and two-thirds of the oil shipments, though three-fourths of this traffic goes to other regions of the world and is just trans-shipped through the Indian Ocean.

China's MSR is all about trade and infrastructural investment and China has been willing to put considerable resources behind the MSR. It has helped build the ports of Gwadar (in Pakistan), Hambantota (in Sri Lanka), Chittagong (in Bangladesh) and Sittwe (in Myanmar). In addition, China has offered USD$500 million in soft loans for infrastructure and housing projects to the Maldives and over USD$700 million to Mauritius for expansion of its airport and special economic zone. Additionally, in Sudan, China has invested over USD$10 billion in infrastructure projects, including a railway line between Khartoum and the crucial Port Sudan on the Red Sea, and is financing and building a USD$10 billion port at Bagamoy in Tanzania.

China has had success in other cases tying its MSR to another country's own development goals (Zhao 2015). However, when it comes to India, China faces deeper distrust, given China's border dispute with India and its support to Pakistan. China's military-strategic intent behind the MSR cannot be discounted. The unprecedented docking of a PLA Navy submarine at Colombo port, Sri Lanka, in September 2014 is a bellwether for future developments in the Indian Ocean. China is likely to seek naval access to the maritime infrastructure that it is helping to create, thereby increasing its strategic presence in India's backyard. The PLA Navy could seek replenishment facilities in Chittagong, Colombo, Gwadar, Hambantota, and so on.

While China is acting across the Indian Ocean region, India is working with nations surrounding the South China Sea and restricting its activities to the water-body. The most visible Indian presence is off the shore of Vietnam. India started looking for hydrocarbons in Vietnamese waters in 1988, and since then there have been a series of deals, including those signed in 1992, 2006, 2011 and 2014. India has also asserted the right to free navigation through the South China Sea as almost one-quarter of India's trade passes through those waters. India has also signalled greater involvement in East Asia—with an Act East rather than just a Look East policy. Landlocked Mongolia has declared India its "third neighbour" in addition to its two giant neighbours China and Russia.

One view is that China's "String of Pearls" is not directed at India but is China's response to reduce its vulnerability on oil and trade shipments through the Straits of Malacca. If China's oil supplies are threatened through the Straits of Malacca, it needs alternative options with access to the Indian Ocean and the Gulf. India also needs to overcome infrastructure-related constraints to enhance connectivity for its overseas trade, which contributes substantially to the national economy. The MSR could be an effective maritime supplement to the land-based Bangladesh-China-India-Myanmar (BCIM) Economic Corridor which has support from India. It could be dovetailed with India's own 'Sagarmala' project whereby India wants to build twenty ports along the Indian Ocean, and thereby contribute to the nation's efforts to enhance sea-trade connectivity while also progressively leading to 'port-led development' of the hinterland and the SEZs.

3. China and India's economic relations in South Asia

With the exception of China's extensive economic relationship with Pakistan, China's growing influence in South Asia is a relatively recent phenomenon. The China-Pakistan axis stands as a special and separate case, one that reflects a unique strategic logic unparalleled with other South Asia countries. China's most recent economic commitment to Pakistan, a declared package of USD$46 billion in infrastructure development and assistance, thus represents an intensification of, but not a strategic change in, a longstanding relationship going back five decades. Their current two-way trade volume is around USD$20 billion.

In the past decade, China has emerged as a top exporter of goods to the region, including to India, breaking into South Asian markets with its export-led growth strategy. Bangladesh provides the starkest example of this trend. Around 2005, China overtook India as Bangladesh's top trading partner. China displaced many Indian goods in Bangladesh, offering cheaper Chinese products (especially cotton and other fabrics central to the garment industry) without the visa, transport, and customs challenges that had limited trade between India and Bangladesh. The 2015 Land Boundary Agreement between India and Bangladesh, however, positions both countries to address border issues affecting trade in the near future.

China's trade with Sri Lanka still lags behind India's, but the gaps are narrowing. Sri Lanka is among India's top trading partners in South Asia, and India is Sri Lanka's largest trade partner. Since 2005, however, Chinese exports to Sri Lanka have quadrupled to about USD$4 billion, coming closer to Indian levels. China and Sri Lanka are also negotiating an FTA to further boost trade and provide better access for Sri Lankan goods in Chinese markets; the current trade balance overwhelmingly favours China.

Labour migration reflects economic and cultural linkages among South Asian countries. Here, India is linked much more deeply than China across South Asia. The remittances resulting from such migration represent substantial economic ties. Around five million South Asian migrant workers in India sent more than USD$7.5 billion in remittances back to their home countries in 2014, while just twenty thousand workers in China sent USD$107 million (including to India), according to the World Bank. In the case of Bangladesh, remittances from India inject the Bangladeshi economy with more than USD$4 billion, eight times the value of the USD$557 million in Bangladeshi goods imported by India in 2014, making remittances a vital economic component of the relationship (Table 1)

Table 1. Remittances in South Asia from China and India

WORLD BANK BILATERAL REMITTANCE ESTIMATES FROM INDIA AND CHINA TO SOUTH ASIA, 2015 ($ US MILLIONS)									
REMITTANCE - RECEIVING COUNTRY	**Afghanistan**	**Bangladesh**	**Bhutan**	**India**	**Maldives**	**Nepal**	**Pakistan**	**Sri Lanka**	**Total**
FROM INDIA	**0**	**4,450**	**1**	**-**	**1**	**962**	**0.329***	**491**	**5,906**
FROM CHINA	**0**	**10**	**0**	**61**	**0**	**5**	**21**	**21**	**118**

*According to State Bank of Pakistan, in FY16 inward remittances from India to Pakistan were $329,000.

Much of the recent attention to China's growing footprint in South Asia focuses on its development assistance and government investment programs, particularly for large infrastructure projects. This component of economic interaction is also the one for which apples-to-apples data is hardest to find. Figure 1 provides the most recent updated information on China and India's financial footprint in South Asian countries. Soft loans, as defined by the OECD, requires a grant element of at least 25 per cent (OECD 2016) meanwhile, the debt-servicing conditions on Chinese loans often fall outside of OECD standards and is a source of rising concern in Pakistan and Sri Lanka, even though they are on concessional terms. According to Beijing's 2014 foreign aid white paper, concessional loans represent more than half of China's aid.

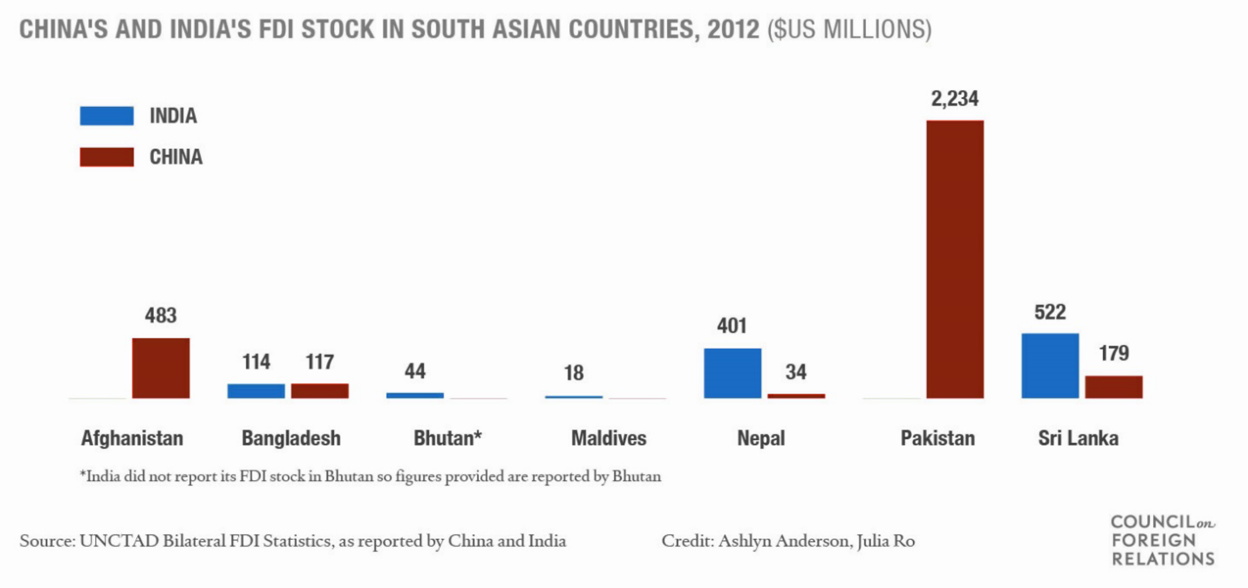

Figure 1. China's rising investment in South Asia

Projects funded by Chinese concessional loans must also be awarded to Chinese companies and source Chinese goods, linking Chinese aid to its government investment activities. Lack of transparency also hinders comparison: while India releases its figures publicly, China provides only outlines. The data suggests some general trends, but problems in the classification of Chinese development assistance for well-known infrastructure projects in South Asia further complicate the picture.

The increase in Chinese development assistance to Sri Lanka, mostly in the form of concessional loans, began in 2009 after the Sri Lankan civil war and then spiked dramatically in 2011. Chinese support for a port, airport, and cricket stadium in Hambantota, the hometown of the former Sri Lankan president, revealed an increasingly close relationship between the two countries.

The upgrade of the China–Sri Lanka relationship to a "strategic cooperative partnership" in 2013 demonstrated the geopolitical influence of China's generous support to Sri Lanka. Detailed loan disbursements available from the Sri Lankan government show a dramatic gap between Indian and Chinese contributions. Between 2012 and 2015, China disbursed almost USD$2.5 billion, of which more than 75% came from the Export-Import Bank of China. During the same period, India extended USD$660 million in lines of credit.

Sri Lanka also features prominently in China's Maritime Silk Road project. Beijing's focus on deep seaport development plays on New Delhi's fears of a Chinese "string of pearls" encircling India. The Colombo port of call of two Chinese submarines in late 2014 and reports that Sri Lanka granted Chinese state-owned enterprises (SOEs) operating rights at the Hambantota port exacerbated Indian concerns. However, upon taking office, Sri Lanka's new president, Maithripala Sirisena, suspended several Chinese projects, including the USD$1.4 billion Colombo port city due to the opacity of financing terms.

4. China's rebalancing and the BRI

China's ambition to become an industrial country in the near future is a major goal of the Xi Jinping administration (NDRC, 2015). China is following a trajectory laid down earlier by Japan and South Korea (Figure 2). Whether China will be able to manage this transition remains an open question. China's weakness remains its financial sector and its over-reliance on state enterprises (Ahuja and Nabar, 2012). China has so far considered this a source of strength. In fact, some have argued that China's successful state enterprise-led growth model has emerged as a rival to western capitalist models of growth.

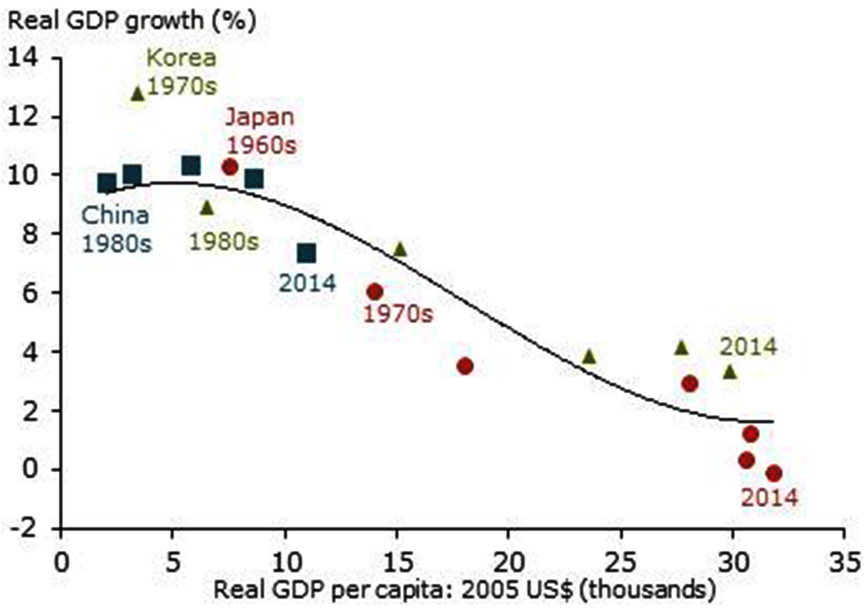

Figure 2. Will China follow Japan and South Korea?
Source: Penn World Tables, IMF. Curved line shows fitted trend taken from Zheng Liu (2015)

Japan and South Korea also were built on export-led models with strong state support for their economy, but it was largely private conglomerates that led the way. China has followed, so far, the same export-led model but state-owned enterprises have remained a large component of the economy. This model has made the badly needed rebalancing difficult because corporate savings have remained high and are re-invested by corporations rather than being paid back as dividends. Moreover, corporates have also borrowed heavily and corporate debt has grown exponentially since 2007. China's debt-to-GDP ratio has risen from around 150% of GDP in 2007–2008 at the time of the global economic crisis to over 280% of GDP (Figure 3) (see also Sharma (2015)).

This credit fuelled growth has led to poor financial decision-making and it now takes eight units of incremental credit to finance one incremental unit of GDP, according to IMF's latest economic report on China. Despite best efforts, China continues to see high savings rates and an investment-led recovery rather than a consumption-led one (Figure 4). China is trying to rebalance but the transition is very slow and old institutions still control many of the levers of economic activity.

Ultimately it is also political issue, as the Chinese communist party must loosen control over levers of the economy which would reduce its ability to steer the economy. The BRI is seen by some as a way to invest some of the surplus capital in SOE's abroad by building infrastructure and exporting this surplus through the new financial institutions and directly in bilateral projects (He, 2014 and Huang and Bosler, 2014). It is a huge and ambitious gamble that will be played out across the new Silk Road with many pitfalls and challenges. Whether enough of these projects will be commercially viable or just huge white elephants leaving many countries in debt to Chinese financial institutions such as the AIIB remains to be seen. (Aiyar, 2015; Pettis, 2015; Elek, 2014; Esteban and Otero-Eglesias, 2015; IISS, 2015).

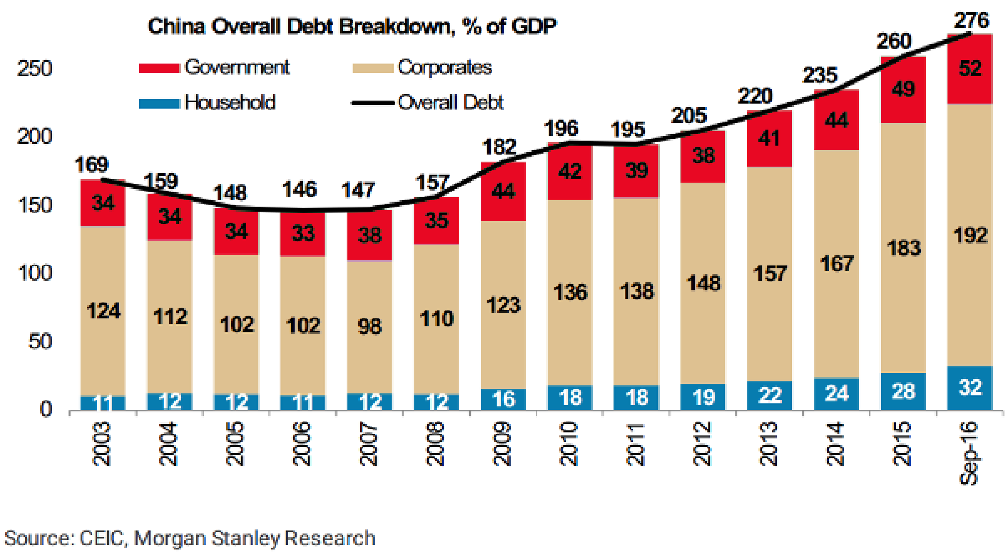

Figure 3. Rapid and worrisome rise of China's debt

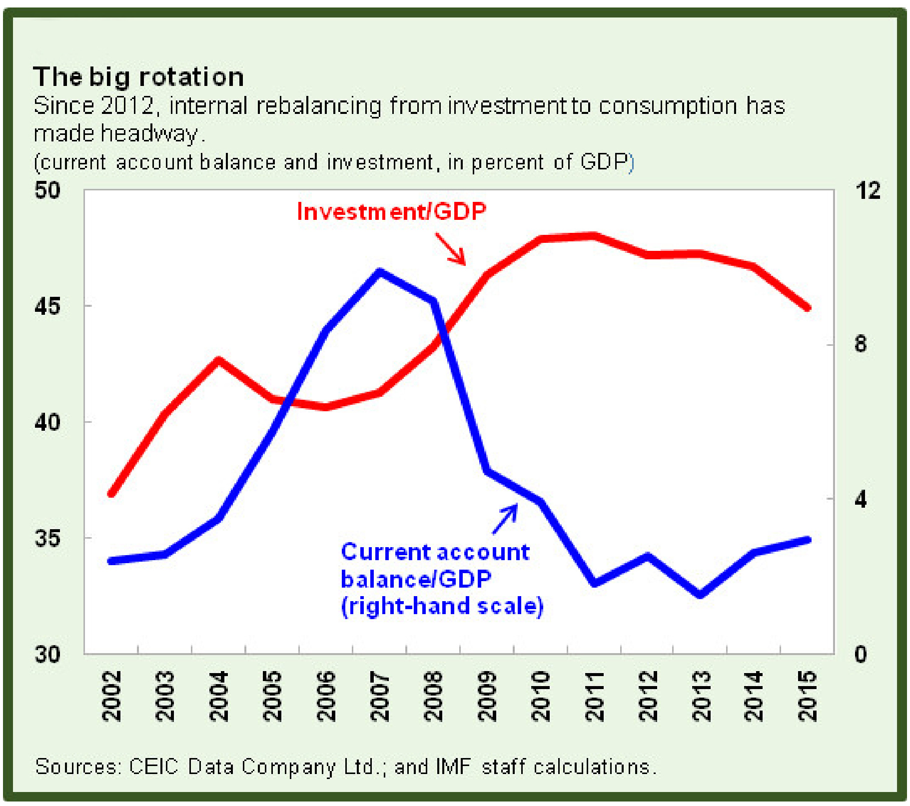

Figure 4. China's struggle with rebalancing

5. India and China's economic relations

India began its economic liberalisation in 1991 on the back of an economic crisis some 13 years after China began its economic reforms. While the two economies are substantially different, it is surprising as shown by Kala *et al.* (2015) using data from UNCTAD that India followed a path of growth, investment and even exports very similar to China's with a lag of 13 years (see Figure 5). The surprising figure is India's export performance, as India is considered much more dependent on domestic demand instead of foreign markets. Nevertheless, whether India will be able to track China's impressive 30 year record will depend on India's ability to carry out second-generation reforms which have so far proven difficult in a democratic country.

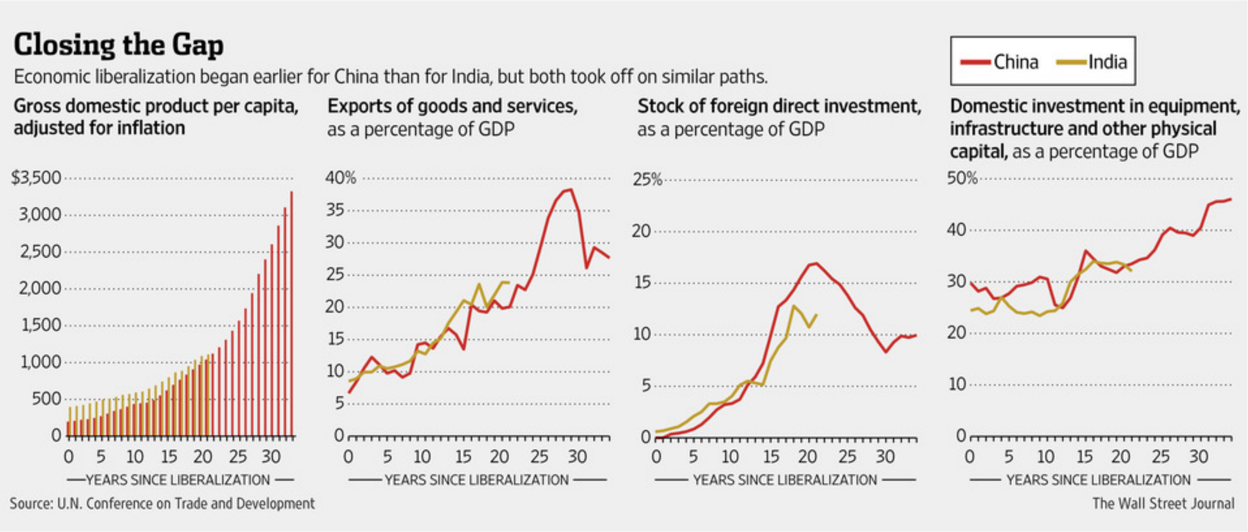

Figure 5. India follows China 13 years later?
Source: Kala et al. (2015)

India has opened up many sectors to FDI and has started to receive much greater levels of FDI than at any time in the past. It is also reforming its tax system with a Goods and Services Tax (GST) which was introduced on July 1, 2017. However, India's democratic system does not allow it to take centralised decisions on major economic issues such as labour and land reforms in the way China can. In addition, while India does not have the huge debt that China is saddled with, its banking system needs to deal with a growing non-performing loan problem that is holding back future growth.

China and India historically did not have huge economic relations despite being two huge Asian countries bordering each other. Greater trade and investment will provide more incentives to cooperate rather than compete with each other. Trade between the two Asian giants is increasing but still remains quite small. India's trade with China in 2000–2001 was USD$2 billion, and it became USD$65.86 billion in 2013–2014, with the potential to top USD$100 billion in the coming years. The growing trade should mean tremendous opportunities for traders and investors in both countries. Yet, India's trade deficit with China has increased from USD$1 billion in 2001–2012 to USD$36.22 billion in 2013–2014, and exceeded USD$50 billion in 2015–2016 (see Figure 6). Some of China's biggest exports to India are telecommunications equipment, computer hardware, industrial machinery and other manufactured goods. India sends back mostly raw materials, such as cotton yarn, copper, petroleum products and iron ore.

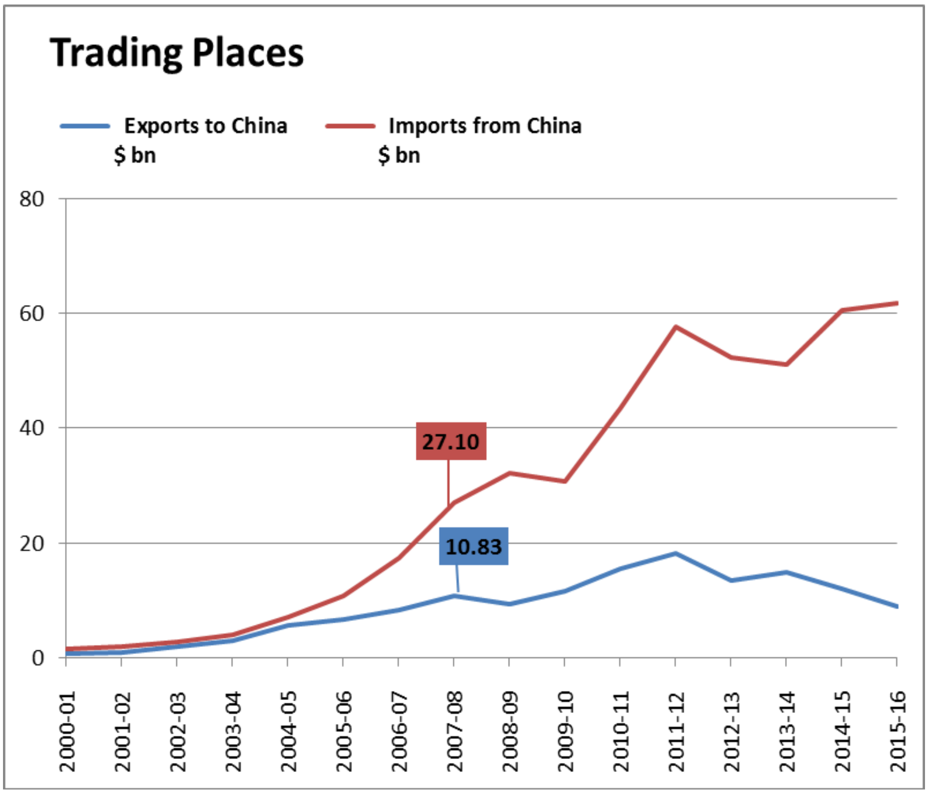

Figure 6. China-India's growing trade imbalance

Source: Kala et al. (2015); updated by author

Given China's huge trade imbalance with India, one obvious solution would be to have Chinese companies invest and manufacture in India. According to data from United Nations Conference on Trade and Development, China was the third biggest source of foreign direct investment in 2016 having invested more than USD$100 billion in other countries. In the seven years to 2012, it invested more than USD$25 billion in the 10 members of the Association of Southeast Asian Nations alone (Ba, 2014).

India's emergence as an investment hub can be seen as average net inflow increased to USD$13.6 billion during 2006–2011, up from an average net inflow of USD$3.8 billion during 2001–2005. The average net inflow increased to USD$36 billion in 2015–2016 and should remain at that level in 2016–2017. This reflects rising demand and fresh business-friendly initiatives by the new government, such as 'Make in India', but a large share remains equity investments and not new investments. While Chinese companies have been great at selling their products in India, they have been surprisingly reluctant to invest there. China has invested less in India than even South Korea or Hong Kong (Figure 7).

There is a strong call in India to increase tariffs on Chinese manufactures to manage the trade imbalance and to encourage Chinese companies to invest in India, as wages have risen in China and the Chinese yuan has appreciated considerably relative to the rupee[1]. However, with weak infrastructure and the huge costs of doing business, as well as an overvalued exchange rate, India remains uncompetitive.

1. India increased duty on steel imports by 20% on Sep 13, 2015 in response to reported Chinese dumping

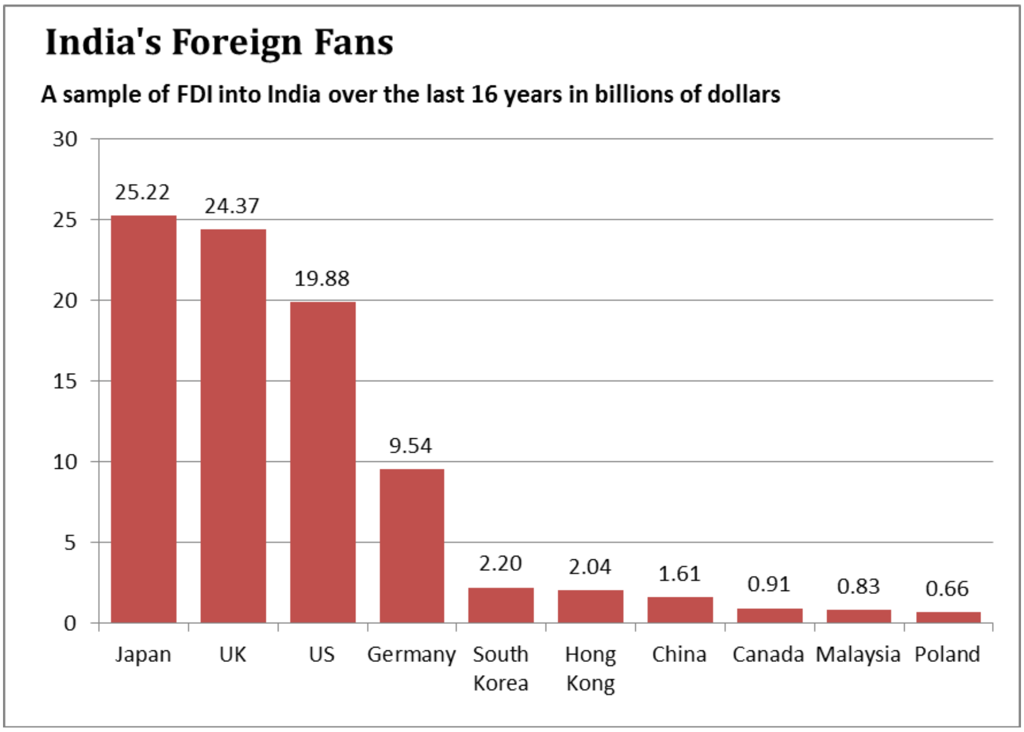

Figure 7. FDI into India by China and others
Source: Kala et al. (2015); updated for this paper

Yet, given India's already high trade deficit with China, it will increase the clamour for higher import tariffs on Chinese products. India's rupee, which is already overvalued, will need to devalue faster to maintain competitiveness and avoid an even larger trade deficit with China in the future. The rupee has devalued more than the yuan, but in real terms over the last few years the rupee has appreciated against the yuan. While there are many reasons why India cannot compete with China, these can only be fixed over a period of time. In the meantime, the rupee should not appreciate against the yuan to make India's competitiveness even worse. It will also make more difficult India's 'Make in India' campaign. India must also find ways to attract more Chinese capital to invest in India.

A key component of Prime Minister Modi's 'Make in India' scheme is the attraction of foreign investment. India is trying to increase its infrastructure investment but faces serious fiscal constraints. India invests some 5% of GDP in infrastructure investment compared to 17% of GDP in China. Even to raise India's infrastructure spending to 8% of GDP will be a herculean task. The India Infrastructure Finance Company estimated that India needed USD$1 trillion, of which USD$750 billion in debt, to finance its infrastructure deficit in the period 2012–2017. The debt required is more than twice the size of Singapore's economy, and five times the existing 9.2 trillion rupees (USD$144 billion) of bank loans to Indian infrastructure projects.

The new financial institutions offer one new source of finance for India. India has become a founding member of both the New Development Bank, whose first President is an Indian, and the AIIB, where India is the second largest shareholder. It remains to be seen how much financing India itself will receive from these new institutions, whose main focus is infrastructure financing. Given the current size of the AIIB and the NDB, India can expect to get at best no more than USD$1 billion annually from these two institutions. This is a very small amount compared to India's vast infrastructure needs but is nevertheless a welcomed long-term funding, provided it comes on the right terms and conditions. As a founding member of these two financial institutions, India hopes to ensure acceptable terms for this financing.

6. Conclusions

India and China are playing a competitive and yet cooperative game on many levels. India has not yet signed on to the BRI and has concerns on CPEC and MSR. It has given positive signals to the BCIM initiative connecting Kolkata to Kunming through Bangladesh and Myanmar. China has not taken kindly to India's Act East policy, especially to its investments in oil exploration in the South China Sea in collaboration with Vietnam. India has countered MSR with its own Spice Route or SAGAR project and is also strengthening its relations with ASEAN, Japan, Mongolia, Iran and countries in Central Asia.

India's trade with China has grown rapidly but suffers from huge imbalances and is alone responsible for almost half of its trade deficit. India could potentially benefit from greater Chinese investments—as Chinese investments abroad increase by leaps and bounds and India is becoming an attractive FDI destination—especially if they were to help reduce the huge and growing trade imbalance between the two countries. Chinese investment in infrastructure could also help India meet its infrastructure deficit if Chinese companies learnt to operate under Indian conditions. So far, Chinese FDI into India remains very small.

India has joined the new financial institutions of the NDB, the AIIB and more recently the SCO. These new banks are potential sources of long-term infrastructure finance for India but, given India's huge infrastructure gap, will only be able to provide a very small part of it. They nevertheless represent a very visible and tangible symbol of cooperation between India and China which can fructify and grow. If China and India cooperate rather than compete, they could become almost 50% of the world's economy—where they were some 200 years ago. Disputes will only derail them from reaching that goal. For now, "competitive cooperation" will remain the way forward and, if handled with wise leadership on both sides, can benefit both countries and the neighbourhood as well. The dragon and the elephant must find ways to cooperate as open confrontation will be very costly.

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