

India's Trade Deficit with China

How to Bridge the Gap?

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India's trade deficit with China widened from \$23 billion in 2010 to \$35 billion in 2013, accounting for 25% of India's total trade deficit. What is driving this widening of the trade gap and what options does India have to close the gap?

Bilateral trade between India and China has grown rapidly since the beginning of the last decade, from \$2.3 billion in 2000 to nearly \$68 billion in 2013 after reaching its peak of \$72 billion in 2011. Today, China is India's largest trading partner. However, with the increase in bilateral trade, India's trade deficit with China has increased exponentially. The bilateral trade deficit with China widened from \$23 billion in 2010 to \$35 billion in 2013, accounting for 25% of India's total trade deficit in that year. The burgeoning trade deficit with China has raised concerns among Indian policymakers and economists who are looking for possible solutions to the problem. In fact, the issue of the rising "trade deficit" was the focal point of discussions during Chinese President Xi's visit to India in September 2014. The Indian and the Chinese governments agreed that for bilateral trade ties to prosper, both countries need to work out solutions to lower India's growing trade deficit.

We explore two key issues here: (i) What has constituted the trade deficit between India and China? (ii) How can this deficit be bridged? In the latter case, there are three options to deal with the trade deficit problem. First,

India could curtail imports from China; second, it could boost exports to China; and, third, India could seek more investment from China.

1 Composition of Trade

A look at the composition of India's exports to China highlights the fact that exports to China have been extremely concentrated in a few products. In 2013, the top five export commodity groups (at HS 2-digit level classification) from India to China included textile and textile products, mineral products, base metals and articles, chemical and allied products, and machinery and mechanical appliances, electrical equipment, electronics and parts, which accounted for 81% of total exports to China (Chart 2, p 19). However, at the 4-digit HS classification in 2013, India's top four major export products to China were cotton (not carded or combed), cotton yarn, refined copper and copper alloys, iron ores and concentrates, which accounted for 48.7 % of Indian exports to China (Table 1). India's exports of manufactured products such as refined petroleum, transport and machinery account for a smaller share of its exports to China.

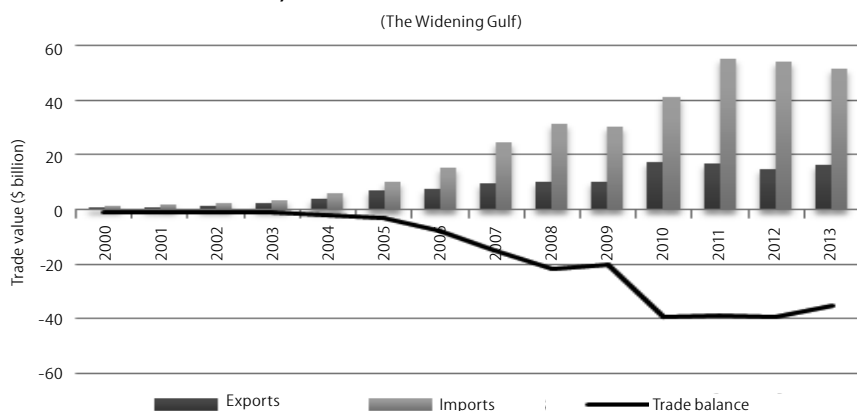
India's imports from China, in comparison to its exports, are much more diversified; it imports a diversified basket of technology-intensive manufactures from China. Chart 2 shows that in 2013 the top five import commodity groups from China consisted of machinery and mechanical appliances, electrical equipment, electronics and parts, chemical and allied

Table 1: India's Product-wise Trade with China at HS 4-Digit

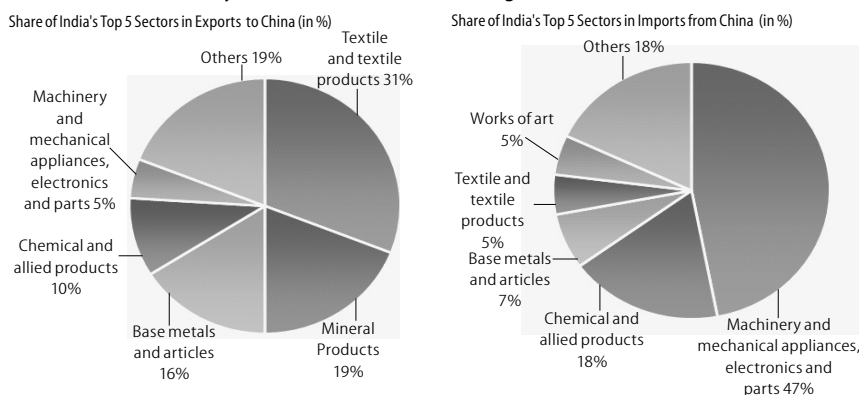
Commodity	2010 (in Million \$)	Share (in %)	2013 (in Million \$)	Share (in %)
Exports				
Cotton, not carded or combed	1,767.8	10.1	2,766.5	16.9
Cotton yarn (other than sewing)	320.9	1.8	2,016.9	12.3
Refined copper and copper alloys	3,616.8	20.7	1,939.1	11.8
Iron ores and concentrates	5,744.3	32.9	1,279.6	7.8
Petroleum oils and oils	322.1	1.8	690.1	4.2
All others	5,668.1	32.5	7,724.6	47
Imports				
Electrical, telephonic, telegraphic equipments	6,534.9	15.8	6,837.6	13.2
Automatic data processing machines	1,463.1	3.5	2,967.6	5.7
Commodities not specified acc. to kind	3,185.9	7.7	2,459.7	4.8
Mineral or chemical fertilisers, ni	446.4	1.1	1,242.1	2.4
Mineral or chemical fertilisers con	874.2	2.1	964.8	1.9
All others	2,8744.5	69.7	8,8799.1	72.1

Source: Authors' calculation using UN COMTRADE Database.

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Chart 1: India's Trade with China, 2000–13

Source: Authors' calculation using UN COMTRADE Database.

Chart 2: India's Commodity-wise Trade with China at HS 2-digit in 2013

Source: Authors' calculation using UN COMTRADE Database.

products, base metals, and textile and textile products and contributed to 82% of total imports. Among these, machinery imports accounted for the largest share of 47% of total imports from China. However, the top four products at the 4-digit HS level accounted for just 26.2% of total imports from China in 2013 (Table 1).

A more insightful inference can be drawn if we classify traded items into raw materials, intermediate goods, capital goods and consumer goods based on the classification provided by the World Trade Organization (WTO). Table 2 shows that 85% of India's exports comprised raw materials and intermediate goods, while 80% of imports comprised capital goods and intermediate goods (Table 2).

Table 2: Composition of India's Trade with China in 2013 (WTO Classification)

India's Exports to China	Proportion	India's Imports from China	Proportion
Intermediate goods	49%	Capital goods	47%
Raw materials	36%	Intermediate goods	33%
Consumer goods	7%	Consumer goods	14%
Capital goods	7%	Raw materials	6%

Source: Authors' calculation using UN COMTRADE Database.

Thus, India's export basket indicates that exports fall mainly in labour-intensive and resource-based products. Other significant exports include pharmaceuticals, animal products, vegetable products, plastics and rubber, etc. An interesting observation is that consumer goods comprised only 14% of total imports. Within consumer goods too, India mostly imports articles of plastic for industrial use and refractory bricks, blocks, tiles and similar refractory ceramic construction goods.

2 Bridging the Deficit

We consider here if the deficit can be bridged by curbing imports, increasing exports and increasing foreign direct investment (FDI) inflows from China.

Can Imports Be Curbed?:

As mentioned earlier, India's imports from China comprises intermediate and capital goods used by Indian industry. Clearly, these intermediate inputs at competitive rates from China

are essential for India's manufacturing sector to meet domestic demand and exports, and would contribute towards the industrialisation process and therefore should not be curtailed. As an emerging economy, India should not restrict imports of technology-intensive products from China especially in the medium term. Rather, embarking on its new "Make in India" initiative to intensify domestic industrialisation, India's dependence on import of technology-intensive products from China can be increased further with China gaining global reputation as a competitive supplier of machineries (Mohanty 2014).

Can Exports Be Increased?: If India does not curb its imports from China, it should make an attempt to increase its exports to China. Any change will depend on whether India can export products that meet the demand of the Chinese market. It is recognised that China is one of the important market destinations where India's export potential has not been adequately realised.

Existing trade patterns between the two countries, as mentioned earlier, clearly indicate that India's exports to China have been dominated by low value added raw materials, such as cotton, ores, slag and ash, copper and copper products, and mineral fuel. However, trade in such items is often unpredictable as it is governed by government policies related to natural resources. For instance, in 2010, iron ore was the single largest item comprising 32.9% of India's exports to China (Table 1). However, in 2011, the Indian government imposed restrictions on exports of iron ore in the form of duties and banned iron ore mining in the top producing states of Karnataka and Goa. These policy changes have resulted in a decline in overall exports of iron ore from India, with the share of iron ore exports decreasing to just 7.8% of total exports to China in 2013.

Thus, unless India diversifies its export basket to include items other than primary goods, it is unlikely that it will be able to bridge its trade deficit with China exports. Therefore India must look for a demand-based export basket

diversification approach with emphasis on technology-intensive manufactured products. In this context, it is important to look at India's export potential and the products that can possibly find their way to the Chinese market.

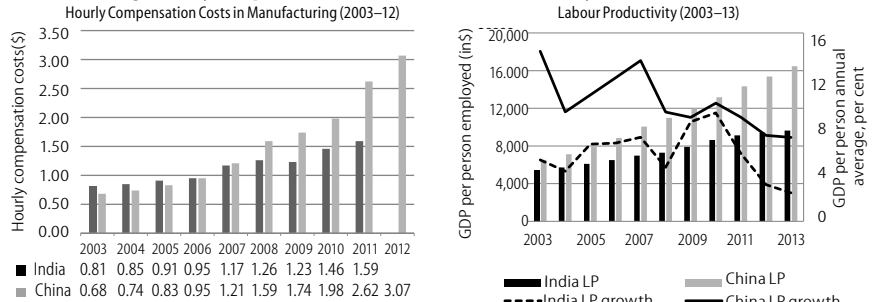
Export possibilities exist for India in those products that China could import from India in which it is competitive instead of importing from elsewhere in the world. We compute the magnitude of export possibilities from India to China referred to as "export potential." Products having export potential can be identified as those with (a) adequate demand in China, and (b) adequate supply capabilities in India.

To assess global competitiveness, we have computed Balassa's revealed comparative advantage (RCA) index for all products exported by India. For estimating India's export potential to China, the analysis is restricted to commodities where India has a $RCA > 1$. Untapped export potential for any globally competitive commodity being exported from India to China is given by:

$Min (IE_x, CI_m) - ET_{IC}$ where IE_x = India's global exports, CI_m = China's global imports, and ET_{IC} = Existing trade between India and China.

Using trade data of 2013, the results of the exercise indicate that India's export potential to China is \$95.5 billion, which is 5.8 times larger than the current export of \$16.5 billion. At a disaggregate level, the potential in mineral fuels is \$31.4 billion accounting for 33% of total export potential. The top 10 products accounted for 56% of India's total export potential to China valued at \$53.5 billion. The important items other than mineral fuels include medicaments, diamonds

Chart 3: Average Hourly Compensation Costs and Labour Productivity in India and China



For India, estimates of compensation costs refer to formal manufacturing only, rather than to total manufacturing in the country. Labour productivity is defined as GDP per person employed (in 1990 US\$). Source: The Conference Board, Database, 2014, <http://www.conference-board.org/data/>

and aeroplanes and other aircraft, vehicle parts, and cotton (Table 3).

These estimates have to be treated with caution and are merely indicative of export possibilities. The estimate of export potential is the maximum possible trade that the two countries can have if the two countries sourced from each other all items, which they sourced from the rest of the world. However, this can never be the case as relative prices and information asymmetries could play an important role. Also, these estimates vary depending on the year of reference which in this case is 2013.

Realisation of the large potential has been inhibited by market access barriers (for example, tariffs, regulatory and other complexities) imposed by China that pose hurdles in raising exports to China in sectors such as pharmaceuticals, marines, agricultural products and other fresh and processed produce. For instance, in the case of pharmaceuticals, Indian companies entering China have to go through lengthy and cumbersome regulatory processes with approvals taking more than three years. One of the MOUs signed recently between the two countries addressed this issue by entering

into cooperation on drug regulations. This could help pharmaceutical products from India increase inroads into China's pharma market. Such barriers need to be identified and addressed for other sectors as well.

Another way India could possibly increase its exports to China is by manufacturing products where China is losing its cost advantage largely due to the changing demographic structure. China's average hourly labour costs in the manufacturing sector have increased from \$0.68 in 2003 to \$3.07 in 2012 (Chart 3). One of the main reasons for this increase has been the unfavourable demographic structure which China is experiencing. The country witnessed a decline in its working age population by almost 3.5 million in 2012, which has resulted in the demand-supply mismatch for labour in China (KPMG 2013). On the other hand, India has lower labour costs as well as a demographic advantage, which can help India become a competitive manufacturing destination globally. As highlighted in India's *Economic Survey 2013-14*, the proportion of working-age population in India is likely to increase from around 58% in 2001 to more than 64% by 2021, with a large number of young persons in the 20-35 years age group, making it younger than China and the US. However, India's labour productivity remains low in comparison to China's labour productivity (Chart 3). India has to put in place appropriate skill development plans to realise its potential demographic advantage and increase in labour productivity.

Can Investment Be Increased?: Another way to reduce this deficit could be by

Table 3: India's Export Potential to China in 2013 (\$ Billion)

Product Code	Product Description	India's Exports to World	China Imports from World	India Exports to China	Export Potential
271019	Petroleum oils	47.0	28.3	0.5	27.8
300490	Medicaments	8.4	7.0	0.0	7.0
710239	Diamonds, non-industrial	27.1	5.7	0.1	5.6
271011	Light petroleum oils and preparations	19.8	3.8	0.2	3.6
870899	Vehicle parts	2.6	2.3	0.1	2.3
880240	Aeroplanes and other aircraft	2.3	20.0	0.2	2.1
520100	Cotton, not carded/combed	4.5	8.4	2.8	1.8
710231	Diamonds, non-industrial, unworked	1.8	1.3	0.0	1.3
721049	Flat-rolled products of iron/non-alloy steel	1.1	1.1	0.0	1.1
290243	p-Xylene	1.1	13.8	0.0	1.0

Source: Authors' calculation using UN COMTRADE database.

increasing Chinese investment in building manufacturing capacities in India. There are enough opportunities for Chinese investors in the manufacturing sector, especially in power, telecom equipment, metals, electronic components, healthcare and pharmaceuticals, and auto components. Investment from China will not only bring in capital but would also provide the much-needed impetus to the manufacturing sector. Unlike trade, levels of investment between India and China remain at relatively low levels. Total cumulative FDI inflows during April 2000 and February 2014 from China were a meagre \$396 million accounting for just 0.2% of total cumulative FDI inflows received by India during this period. Investment flows during 2000–01 and 2010–11 were almost negligible, but picked up considerably during 2011–12 and 2012–13, which accounted for FDI inflows worth \$224 million from China (DIPP 2014). Although this is way below the potential levels of investment flows from China, it is an indication of the synergies that can be realised between the two countries.

A more fundamental question, thus, is why FDI inflows from China have been so low. In the past, India has had a restriction on inward investment flows from three countries—Sri Lanka, Bangladesh and Pakistan—which were removed by 2012. Even though China has never been on the negative list for inward FDI, it is not too clear whether there is a non-transparent policy that inhibits FDI inflows from China. Firstly, lack of trust between the two countries could have been inhibiting FDI from China. Thus, Chinese business people have reported that they find it difficult to obtain the multiple-entry or employment visas to India, which are issued to other countries' nationals (Martin 2014). Secondly, China has been linking obtaining work permits with larger investment flows, which the Indian government is reluctant to offer. Third, Chinese investment in emerging markets (mainly from Chinese state-owned enterprises) has tended to focus on the natural resource sectors such as oil, natural gas and coal for its strategic priorities. India has not attracted much of this investment

as it is a net importer of these energy resources and has a heavily regulated energy sector.

3 Concluding Remarks

As discussed above, India's exports to China have been concentrated heavily in a few low value added products. India needs to diversify its export basket to include items other than primary goods. In comparison, 80% of India's imports from China consist of capital and intermediate goods, which are essential for the country's industrialisation process and therefore should not be curtailed. India should rather focus on increasing exports to China as there is a lot of untapped export potential. India's export potential to China is \$95.5 billion (5.8 times larger than the current export of \$16.5 billion); the important items having export potential include mineral fuels, medicaments, diamonds, aeroplanes and other aircrafts, vehicle parts, and cotton. However, various barriers related to tariffs, market access, regulatory and other complexities in entering the Chinese market place hurdles in the path of raising Indian exports to China and need to be removed.

On the other hand, the investment flows between India and China are at very low levels at present. In order to facilitate a sustained inflow of FDI from China, governments of both the

countries would need to address the barriers that have restricted these flows so far. The Indian government is already trying to promote the country as a manufacturing hub with its "Make in India" initiative and is taking measures to make India a better place to invest in and have an environment more conducive for manufacturing. Not only would FDI bring benefits, such as technical know-how, jobs, and higher productivity, but it would also rejuvenate the manufacturing sector that would help India increase its exports and lower its trade deficit in the coming years.

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