

# India's Opportunity to Displace China in Global Supply Chains

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Version 1.0

January 13, 2021

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*This document can be cited as “Manoj Kewalramani, Narayan Ramachandran, Sarthak Pradhan, Anupam Manur, India's Opportunity to Displace China in Global Supply Chains, Takshashila Discussion SlideDoc, January 2021”. For any feedback, please email [research@takshashila.org.in](mailto:research@takshashila.org.in)*



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## Executive Summary

This assessment proposes a mix of two approaches that the Indian government should adopt in order to attract investments from companies looking to exit China.

The first, a geostrategy-led approach, entails working with like-minded partners, particularly focussing on sectors with national security implications. The second, a case-by-case approach, involves identification of sectors in which India enjoys comparative advantages and adoption of targeted measures to attract foreign investment in them.

We argue that political trust and security concerns are likely to play a far greater role in economic decisions for States and companies in the post-COVID world. Given this, these approaches not only leverage emerging geopolitical trends but also harness India's comparative strengths in key sectors. This makes them easier to pursue in the near term, with greater chances of achieving demonstrable success.

# Disruption & De-globalisation



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## Pre-COVID Disruption & De-globalisation

*Even before the COVID-19 pandemic, China's economic rise coupled with its deeper embrace of authoritarianism, populism in the West, and an intensified competition around emerging technologies were presenting serious challenges to the future of economic globalisation.*

Over the past few years, conventional notions of comparative advantage and free trade binding States in a virtuous cycle of prosperity and peaceful coexistence have come under severe strain.

States have increasingly tended to leverage economic interdependence for coercion and to achieve political objectives.

Such activities have ranged from denial of market access, export restrictions, the use of tariff and non-tariff barriers to even sanctions.

In addition, there has been a trend towards deepening systemic competition between the geopolitical West and China.



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## Pre-COVID Disruption & De-globalisation

*Even before the COVID-19 pandemic, China's economic rise coupled with its deeper embrace of authoritarianism, populism in the West, and an intensified competition around emerging technologies were presenting serious challenges to the future of economic globalisation.*

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Three specific factors have amplified this dynamic.

- First, China's economic rise has been accompanied by an authoritarian turn in Beijing's politics. This has eroded faith in the long-standing logic of engagement, i.e., prosperity would eventually lead to political liberalisation in China.
- Second, the disenchantment of Western populations with what they believe are the lopsided benefits of globalisation has fanned a backlash in the form of populist nationalism at home.
- Third, technological advancements promising the Fourth Industrial Revolution have intensified competition among States to pursue and preserve competitive advantages.

All of the above found resonance in the US-China trade war, which further frayed the philosophical threads in the fabric of economic globalisation.



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## Post-COVID Disruption & De-globalisation

*The COVID-19 pandemic has prompted new thinking on supply chain security and resilience. Economic engagement in the future is likely to be far more subservient to the logic of politics and security, with stability and trust being key drivers of decision-making.*

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The pandemic accelerated the currents of disruption and de-globalisation, with the following trends emerging:

- Shutdowns prompted concerns about global supply chain resilience, resulting in calls for developing redundancies via regional and local alternatives.
- There is a growing realisation about the vulnerabilities of dependence on any single market. This anxiety became particularly acute given China's dominance of healthcare and pharmaceutical supply chains.
- Supply chain stability across a wider array of sectors – such as healthcare, pharmaceuticals, information technology and rare earths – is being seen from a national security prism.
- Finally, it is becoming apparent that economic engagement in the future is likely to be far more subservient to the logic of politics and security. Political trust between States is likely to be a key driver for economic decisions.

**Why would companies stay in  
or leave China?**





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## Why exit China?

*The Communist Party's expanding control over the private sector, its use of economic coercion, the US-China trade war, the desire for shorter and more resilient supply chains following the pandemic, along with economic and regulatory changes in China are driving firms to reassess investment decisions.*

**Mitigating political risk:** The Communist Party under Xi Jinping has made it clear that it believes the private sector must pursue the Party's priorities. While opening China's market to greater foreign investment, the Party is structurally expanding its role in corporate decision making, expanding export controls, and engaging in coercion of foreign firms to pursue political objectives. There is greater likelihood now that in the event of geopolitical tensions with another country, China will resort to unfavourable policies targeting companies from that country.

**Desire for shorter supply chains:** The COVID-19 pandemic exposed the vulnerabilities of global supply chains. Less efficient, shorter supply chains might be preferred for manufacturing certain kinds of critical goods, e.g., medical devices.

**Tariffs:** The US-China trade war has incentivised firms to diversify their business risks by investing in one more country apart from China (i.e., a China plus one strategy).



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## Why exit China?

**Total factor productivity:** China's Total Factor Productivity (TFP) growth rate since the global financial crisis (GFC) has been half of its average growth rate in the decade before the GFC.

**Labour costs:** China can no longer serve as the world's factory floor as wages have been steadily increasing - ~\$6.50 per labour hour, which is \$1.50 higher than what it was in 2016. In addition, employers pay housing benefits and social insurance, which makes the labour cost advantage disappear. This is further explained by shifts in production to higher value products, decline in labour force participation rate (entering the Lewis turning point), and increasing minimum wages set by regional governments.

**Tighter environmental regulations:** China tightened its Environmental Protection Law in 2016, which has increased the cost of compliance to companies. The tighter laws have increased penalties and given more power to the authorities and inspectors, resulting in a drastic increase in fines collected and even suspensions of factories.



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## Why be in China?

*Over the years, a range of economic factors have driven large amounts of foreign investment into the Chinese economy. These include its consumer base to availability of cheap and skilled labour, linkages with global supply chains and sustained government support for business.*

**Consumer:** China has a 1.4-billion consumer base, of which 400 million have a per capita income similar to European countries. Per person consumption spending has increased 8% per year in real terms in the last 4 decades. According to some estimates, China is poised to become the largest consumer market by the end of this decade.

**Capital:** China has the world's largest banking system, the second largest stock market and the third largest bond market. In addition, the government heavily subsidises domestic companies.

The total subsidies to domestically listed companies was \$22.3 billion in 2018. In May 2020, China announced equal government support to foreign firms. China has consistently featured among top economies in terms of improvement in business environment.



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## Why be in China?

**Capability:** China accounts for the second highest R&D spending as a percentage of GDP. It has surpassed the US in terms of scientific research papers published per year. It attracts some of the best technologies and technological talent.

**Connected supply chains:** China is increasingly playing an important role as a supply and demand hub and in simple global value chains. Also, Asian economies are tightly linked with China.

# Assessing India's comparative advantage



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## Assessing India's Comparative Advantage

India does not fare favourably on most economic parameters when compared with either China or Southeast Asian economies like Singapore, Malaysia and Thailand.

Yet, there are certain institutional strengths pertaining to investment, financial and trade freedom where India enjoys advantages.



We illustrate more on these points in the following slides.



# Assessing India's Comparative Advantage

*As per the World Economic Forum's Competitiveness Index, China performs better than India in most of the parameters - Infrastructure, Skills, Labour Market, Financial Systems, Size of Market.*

| <b>Competitiveness Index Rankings<br/>(141 countries)</b> | <b>China</b> | <b>India</b> |
|---|--------------|--------------|
| <b>Institutions</b>                                       | 58           | 59           |
| <b>Infrastructure</b>                                     | 36           | 70           |
| <b>ICT adoption</b>                                       | 18           | 120          |
| <b>Macroeconomic Stability</b>                            | 39           | 43           |
| <b>Health</b>   | 40           | 110          |
| <b>Skills</b>   | 64           | 107          |
| <b>Product Market</b>                                     | 54           | 101          |
| <b>Labour Market</b>                                      | 72           | 103          |
| <b>Financial Systems</b>                                  | 29           | 40           |
| <b>Market Size</b>  | 1            | 3            |
| <b>Business Dynamism</b>                                  | 36           | 69           |
| <b>Innovation Capability</b>                              | 24           | 35           |

|   |                  |
|---|------------------|
|  | <b>Better</b>    |
|  | <b>Worse</b>     |
|  | <b>Too Close</b> |



## Assessing India's Comparative Advantage

*India's performance is comparatively better than China for some factors measuring economic freedom: Investment Freedom, Financial Freedom, Tax Burden. But China does better in terms of Judicial Effectiveness, Labour Freedom, Business Freedom etc.*

| <b>Heritage Economic Freedom Scores</b> | <b>China</b> | <b>India</b> |
|---|--------------|--------------|
| <b>Property Rights</b>                  | 60.9         | 63           |
| <b>Judicial Effectiveness</b>           | 76.3         | 64.1         |
| <b>Government Integrity</b>             | 46           | 47.2         |
| <b>Tax Burden</b>                       | 70.4         | 79.4         |
| <b>Government Spending</b>              | 67.9         | 77.9         |
| <b>Fiscal Health</b>                    | 67.5         | 13.1         |
| <b>Business Freedom</b>                 | 76.8         | 65.6         |
| <b>Labour Freedom</b>                   | 64.4         | 41.2         |
| <b>Monetary Freedom</b>                 | 71.1         | 73           |
| <b>Trade Freedom</b>                    | 72.4         | 73.4         |
| <b>Investment Freedom</b>               | 20           | 40           |
| <b>Financial Freedom</b>                | 20           | 40           |

|            |                  |
|------------|------------------|
| Green      | <b>Better</b>    |
| Red        | <b>Worse</b>     |
| Light Blue | <b>Too Close</b> |





High

Low

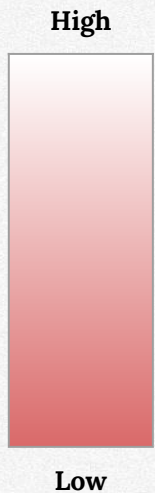
| Competitiveness Rankings | Institutions | Infrastructure | Macroeconomic Environment | Health and primary education | Higher education and training | Goods market efficiency | Labour market efficiency | Financial market development | Technological readiness | Market size | Business sophistication | Innovation |
|--------------------------|--------------|----------------|---------------------------|------------------------------|-------------------------------|-------------------------|--------------------------|------------------------------|-------------------------|-------------|-------------------------|------------|
| Vietnam                  | 79           | 79             | 77                        | 67                           | 84                            | 91                      | 57                       | 71                           | 79                      | 31          | 100                     | 71         |
| India                    | 39           | 66             | 80                        | 91                           | 75                            | 56                      | 75                       | 42                           | 107                     | 3           | 39                      | 29         |
| Malaysia                 | 27           | 22             | 34                        | 30                           | 45                            | 20                      | 26                       | 16                           | 46                      | 24          | 20                      | 22         |
| Singapore                | 2            | 2              | 18                        | 3                            | 1                             | 1                       | 2                        | 3                            | 14                      | 35          | 18                      | 9          |
| Thailand                 | 78           | 43             | 9                         | 90                           | 57                            | 33                      | 65                       | 40                           | 61                      | 18          | 42                      | 50         |
| Philippines              | 94           | 97             | 22                        | 82                           | 55                            | 103                     | 84                       | 52                           | 83                      | 27          | 58                      | 65         |
| Indonesia                | 47           | 52             | 26                        | 94                           | 64                            | 43                      | 96                       | 37                           | 80                      | 9           | 32                      | 31         |
| Taiwan                   | 30           | 15             | 5                         | 15                           | 17                            | 12                      | 25                       | 19                           | 25                      | 20          | 21                      | 11         |
| China                    | 41           | 46             | 17                        | 40                           | 47                            | 46                      | 38                       | 48                           | 73                      | 1           | 33                      | 28         |

Among countries in India's neighbourhood, Singapore, Malaysia and Taiwan perform much better than India in terms of competitiveness.

Table 3 Source WEF



| Country     | Export Similarity Score | Institutional Quality Score | Wages Score | Ease of Doing Business Score |
|-------------|-------------------------|-----------------------------|-------------|------------------------------|
| Vietnam     | 1.5                     | -0.3                        | 0.5         | 0.4                          |
| Thailand    | 1.3                     | -0.3                        | 0.2         | 1.2                          |
| South Korea | 0.9                     | 0.8                         | -2          | 1.6                          |
| Taiwan      | 0.8                     | 1.1                         | -0.7        | 1.4                          |
| Japan       | 0.7                     | 1.4                         | -2.4        | 1                            |
| Malaysia    | 0.7                     | 0.3                         | 0.2         | 1.3                          |
| Philippines | 0.6                     | -0.3                        | 0.5         | -0.4                         |
| India       | 0.4                     | -0.1                        | 0.5         | 0.3                          |
| Singapore   | 0.3                     | 1.6                         | -1.5        | 1.7                          |
| Indonesia   | 0                       | -0.2                        | 0.4         | 0.4                          |
| Sri Lanka   | -0.7                    | -0.1                        | 0.6         | -0.1                         |
| Laos        | -0.8                    | -0.7                        | 0.6         | -0.9                         |
| Cambodia    | -0.8                    | -0.7                        | 0.6         | -0.6                         |
| Pakistan    | -0.9                    | -1                          | 0.5         | -0.6                         |
| Myanmar     | -1.1                    | -0.9                        | 0.6         | -1.4                         |
| Bangladesh  | -1.2                    | -0.8                        | 0.6         | -1.6                         |
| Mongolia    | -1.9                    | 0                           | 0.8         | 0.4                          |

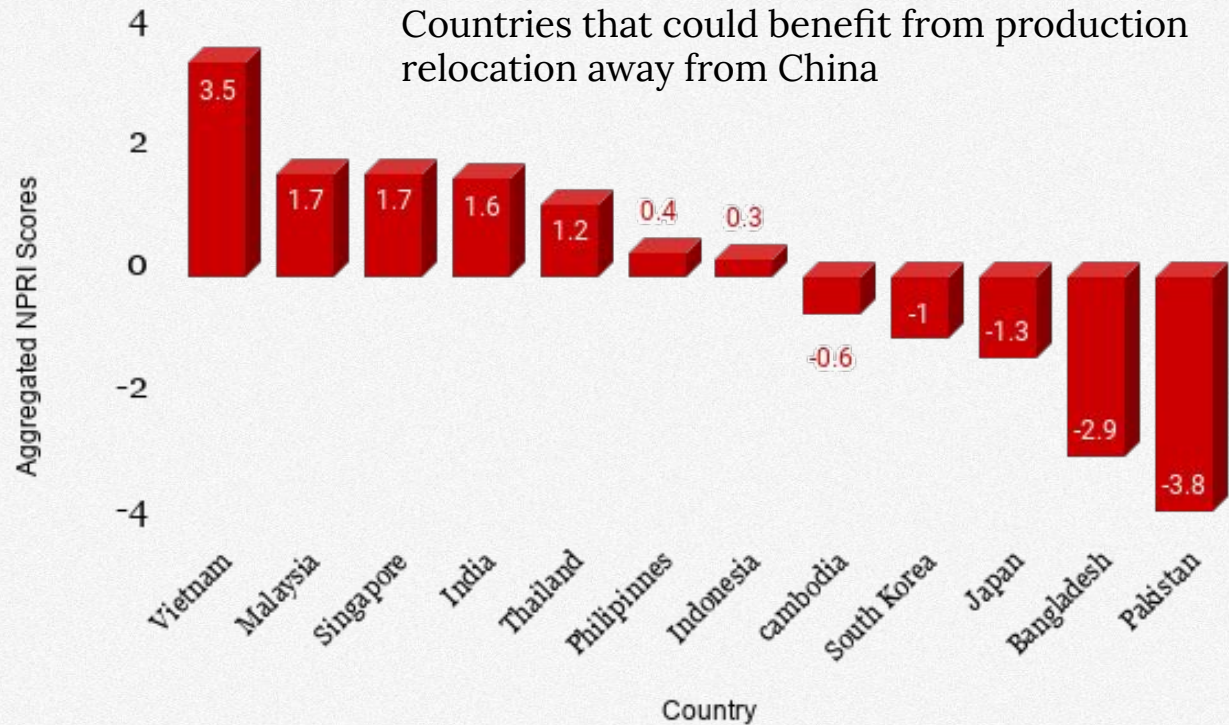


*As per a report by Rabobank, Thailand, Malaysia, Vietnam and Taiwan are more likely to benefit if firms choose to relocate from China because of export basket similarity, lower/similar manufacturing wages, attractive long-term investment climate and sound institutional quality.*

Table 4 Source [Rabobank](#)



*If firms decide to relocate from China, they might prefer Vietnam, Malaysia and Singapore over India. This is as per the Nomura Production Relocation Index (NPRI) scores, which are calculated on the basis of Export Similarity Index, qualitative surveys of MNC and FDI attractiveness.*



# Alternative Approaches for India



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## Alternative Approaches for India

Taking into account emergent geopolitical trends and India's comparative strengths vis-a-vis potential competitors, in this section, we outline the following four potential approaches that India can adopt in order to attract businesses seeking to exit China.

- 1. Efficiency-based Approach**
- 2. Case-by-Case Approach**
- 3. Risk-based Approach**
- 4. Geostrategic Approach**

After detailing them, we examine each of these approaches on ease of implementation in the short run and potential impact in terms of attracting investment in order to arrive at a recommended course of action.



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# 1: Efficiency-based Approach

*This approach calls upon the Indian government to seek out investments based on the opportunities afforded by the Indian economy. This on its own, however, does not play to India's strengths or leverage the geopolitical changes that are underway.*

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**What it entails:** This approach implies that policymakers should rely on economic arguments to make the case for India as a global manufacturing hub.

**Pros:** In this pursuit, policymakers must emphasise key factors that make India a comparatively attractive manufacturing destination. These include India's institutional strengths, investment environment, availability of skilled labour, increasing global connectivity, capacity for innovation along with the size of the domestic market.

**Cons:** The challenges of this argument are evident from the discussion in the previous section. India lags behind China in terms of key economic parameters. In addition, it faces stiff competition from states like Vietnam, Thailand, Singapore and Bangladesh when it comes to attracting low-end manufacturing.

Moreover, while factor market reforms and investment in infrastructure can buttress the Indian proposition, these are unlikely to take place in the short run.



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## 2: Case-by-Case Approach

*The Indian government could focus on sectors in which India enjoys comparative strengths. This can result in the government choosing winners and losers. But if it yields demonstrable success, this approach can catalyse greater investments in the future.*

**What it entails:** This implies focussing on attracting investment in sectors in which India enjoys comparative strength. The objective is to expand activities in these sectors and build adjacencies in order to develop clusters of strength. Some sectors that could be prioritised under this approach are pharmaceuticals, auto, small gems and gem design, biotechnology, etc.

**Pros:** The obvious advantage of this approach is that it leverages sectors where India is already competitive. Consequently, the economic logic can be expected to align with the political imperative. Moreover, there is a high likelihood of having demonstrable victories, which could enhance the overall attractiveness of India as a investment destination.

**Cons:** On the flip side, such an approach will result in policy makers picking winners. In addition, increased investment in chosen sectors is unlikely to have a significant impact on boosting employment. Unlike low-end manufacturing, the sectors identified above generally require skilled manpower.



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### 3: Risk-based Approach

*India could emphasise its institutional strengths and level of political trust with partner States as factors that can help mitigate supply chain risks. The challenge to this approach lies in demonstrating political stability, policy predictability and openness to global economic integration.*

**What it entails:** India could leverage the desire among States and firms to build supply chain resilience, pitching itself as an alternative. In this context, it is important to emphasise India's institutional strengths, democratic governance and levels of political trust with partner States. Political trust as opposed to economic logic will have to be the driver of this approach.

**Pros:** Geopolitical trends and supply chain disruptions amid the pandemic have likely made India an attractive alternative. Policymakers and firms can pursue coordination under existing partnership frameworks. Such an approach also provides opportunities to achieve demonstrable victories across a range of sectors, which can lead to increased investments in the future.

**Cons:** The challenges of this approach lie in the political and economic realms. Its success will depend on ensuring internal political stability and policy predictability. In addition, an India that is drifting towards autarky is unlikely to be viewed favourably. Finally, for early investments to yield demonstrable victories and then impact broader sentiment, it is important to enhance India's economic competitiveness.





## 4: Geostrategy-led Approach

*Under this framework, India needs to focus on key bilateral and multilateral partnerships as it works simultaneously on sector-based geostrategic collaboration. Current geopolitical trends favour such an approach. But doing so effectively will require making adjustments to domestic laws and regulations and harmonising standards with partners.*

**What it entails:** India should work with partners concerned about the strategic implications of China's dominance in key supply chains. Security concerns, political trust and strategic implications are likely to be the drivers of cooperation under this framework.

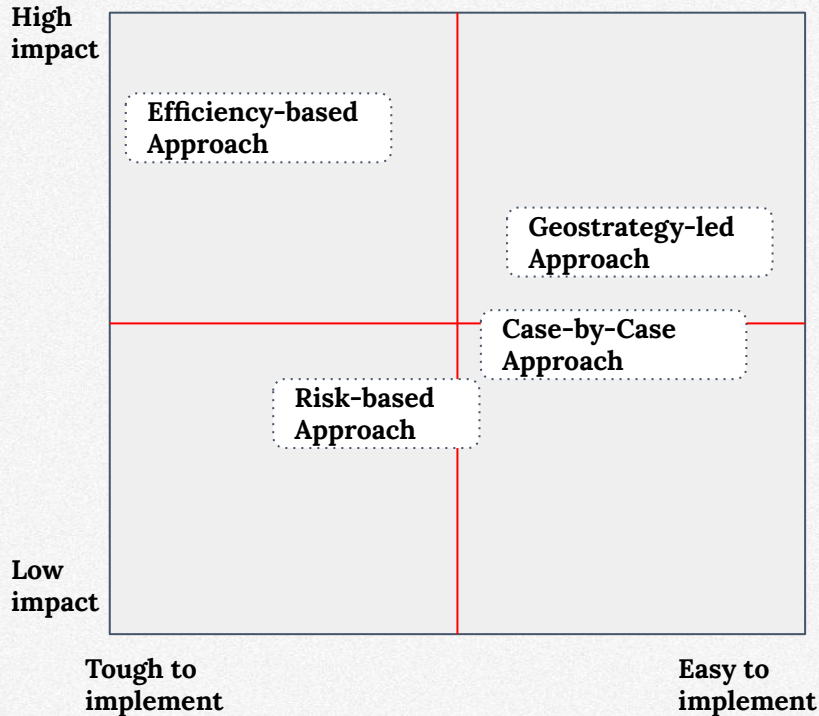
**Pros:** Prevailing geopolitical trends create a window of opportunity, as concerned States are likely to prioritise strategic implications over India's economic inefficiencies. This could facilitate partnerships in fields like emerging technologies, pharmaceutical APIs, etc. Strategic collaborations could also aid innovation and the development of these sectors in India.

**Cons:** A major concern with such an approach is that it will have implications for India's strategic autonomy. However, this must not be overstated. Such partnerships are products of mutual interest and build interdependence.

Another challenge is that strategic partnerships will require arriving at common rules and standards. This will require harmonising domestic laws and regulations. Finally, it is likely that such an approach could limit India's ability to attract Chinese capital and access China's market.



## 4: Assessment of Alternatives



In this section, we assess each of the alternatives on two parameters, i.e., ease of implementation in the short-run and potential impact in attracting investments to India. In doing so, we find that:

- Simply pursuing an efficiency-based approach is unlikely to prove effective. From an economic perspective, India does not fair well when compared to China or alternative destinations for firms looking to diversify. Moreover, reforms, even if implemented, are unlikely to bear fruit in the short term.
- The risk-based approach offers a stronger argument for relocating supply chains to India, but is likely to be stymied by the slowness of economic reforms, the emerging trend of self-reliance and domestic political challenges.
- In contrast, the case-by-case and geostrategy-led approaches allow for harnessing India's comparative strengths and emerging geopolitical trends. This not only makes them easier to pursue but also improves the chances of tangible success in the short-term.

**Conclusion**



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## Conclusion

The COVID-19 pandemic has created fresh impetus for States and corporations to diversify supply chains, with political and security risks dominating their thought process. This creates opportunities for India, particularly since it does not fare favourably vis-a-vis its competitors on economic indicators.

Consequently, we recommend a mix of case-by-case and geostrategy-led approaches to attract companies looking to exit China. These will require India to work with like-minded partners, focussing on sectors with national security implications. The government should identify sectors where India enjoys comparative advantages and adopt targeted measures to attract foreign investment. India's trade missions should actively seek out investments and domestic clearances need to be fast-tracked. State governments should be engaged to boost diplomatic capacity.

Finally, it is important to not view any of this as a substitute for structural reforms. Macroeconomic stability, tax stability, factor market reforms, infrastructure development and a liberal trading regime, along with investments in human capital, are critical to India's long-term economic growth and competitiveness.



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