Natural Partners: India's Expanding Economy & Prospects for the Japan-India Economic Relationship

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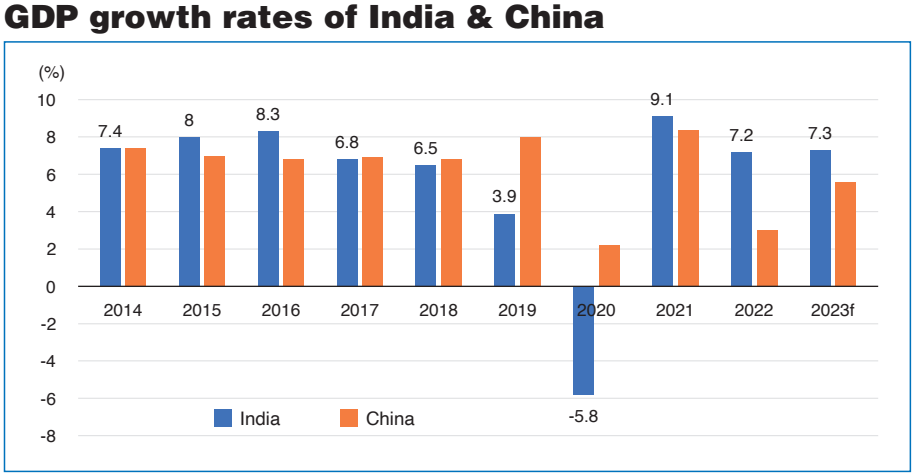
Introduction

Japan and India are the two most important democratic powerhouses in Asia. Since World War II both have held firm to parliamentary democracy: Japan was quicker to recover from the ravages of war, achieved high economic growth and joined the club of developed nations, while India achieved its own new levels of economic growth to reach its current status since the 1990s. In 2023 India exceeded China to become the world's most populous country, enjoying the highest economic growth rates among the world's major nations. India projects annual GDP growth of 7.3% for FY 2023-2024, surpassing the 7.2% recorded for FY 2022-2023 *(Chart 1)*. At its current pace, India's GDP will likely reach third place in the world by FY 2027-2028, exceeding Germany and Japan. The government has set the goal of emerging as a developed nation by the 100th anniversary of its independence in 2047.

India served as a chair country of the G20 meeting in 2023, which is one of many major strides raising its profile and status in terms of economy, political influence and diplomacy. With the United States and Australia, both Japan and India are members of the Quadrilateral Security Dialogue (the Quad). India is becoming the anchor in ensuring security and economic prosperity for the Indo-Pacific region. In this article I discuss future prospects for the Japan-India economic relationship, focusing on the latest trends in India's economic expansion as it elevates its manufacturing sector.

CHART 1

GDP growth rates of India & China



Note: India's data refer to fiscal years. F=forecast.
Source: National Statistical Office, Government of India; World Bank

How to Make Manufacturing Another Growth Engine

India now ranks among the leading manufacturing nations. In 2022 it ranked second in steel production worldwide, ahead of Japan, fourth in automobile production by volume, leading Germany, and third in sales volume, also leading Japan. That said, it is the service sector, including IT (software and business services), telecommunications, banking and insurance, that has powered the country's economic growth since the 1990s.

IT in particular, thanks to the abundant supply of personnel who major in science and engineering and are proficient in English, is typical of the kinds of industry that have put India at a relative advantage and given it success, taking advantage of the globalization trend. Under service sector-led development, India has achieved high annual economic growth rates of over 5% through the 1990s and over 7% through the 2000s. With its manufacturing industry still relatively lagging behind, during his first term (2014-2019), the government of Prime Minister Narendra Modi implemented the "Make in India" initiative, but the campaign fizzled due to a lack of focus in trying to cover everything and its emphasis on protective measures like tariff hikes. With GDP growth peaking in FY 2016-17 the Indian economy slowed afterwards, partly because its financial institutions, increasingly burdened with nonperforming loans, were reluctant to lend.

Make in India 2.0

Under the second Modi government, starting in 2019, the Indian economy staggered initially, especially during the pandemic, as the number of Covid sufferers exploded and Modi ventured to impose the world's tightest lockdown. Still, in May 2020 he announced the ambitious Atmanirbhar Bharat Abhijan (Self-Reliant India Mission) and introduced a series of policies with

longer-term growth in mind, including the Production Linked Incentive (PLI) scheme to boost manufacturers, promotion of digital public infrastructure, large-infrastructure development, and a green growth strategy.

We must not overlook that strong growth-oriented reforms had been underway in India since the first Modi government. These included introducing the Goods and Services Tax (GST) to help integrate the domestic market, promotion of the Digital India campaign geared to financial inclusivity, with a digital identity-verification program (Ahdhaar), universal bank accounts for all citizens (Jan Dhan) and a unified payment interface, and expansion of the physical and digital infrastructure network for better linkage nationwide.

The PLI scheme, launched as "Make in India 2.0" was intended to establish manufacturing hubs directly linked with the global supply chain, with a budget of 1,970 billion rupees ($2.4 billion) covering 14 industry sectors. Eligible firms may receive incentives of 4-15% on their relative increases in investment and sales over a five-year period. The target sectors include automobiles and automotive parts, batteries, mobile phones, bulk drugs and pharmaceuticals, and home appliances. The PLI scheme is utilized by many companies, both domestic and foreign, with production bases in India. The Japanese companies using it include Suzuki Motor, Toyota Motor, Mitsubishi Motors, NIPRO (medical equipment), Daikin and Panasonic (home appliances, air conditioners).

Electronics Industry Showing Remarkable Growth

Since the PLI scheme began there has been a remarkable increase in production of consumer and industrial electronic products. The value of electronic products produced in India grew from $60 billion in FY 2017-18 to $101.9 billion in FY 2022-23, and the sector's exports, at $23.57 billion, were above those of apparel. Under the goal of achieving a trillion-dollar digital economy by 2025, India is working to expand the production capacity of its electronics industry to $300 billion ($120 billion for export) by next year.

The mobile phone trend is the most remarkable on India's electronic-products front. Mobile phones account for 44% of the electronics industry by value, with 1,100 million-plus subscribers. Most mobile phones in India had been imports from China or South Korea – a far cry from achieving domestic self-sufficiency. But domestic mobile phone production in India has grown from 60 million units in FY 2014-15 to over 310 million in FY 2022-23, the second-highest volume in the world. Along with the rapid increase in domestic mobile phone production, the trade deficit in mobile phones shrank from $31.1 billion in FY 2017-18 to $3.6 billion in FY 2022-23, with its exports growing from $1.1 billion to $11.1 billion in the same period.

Spearheading this trend is Apple. Its production by value in India reached $7 billion in FY 2022-23, $5 billion of which was for export. In the second quarter (April-June) of FY 2023-24 it beat Samsung to become India's largest exporter. Apple reportedly plans to increase India's share of its global production to 25% by 2025. The company has outsourced its production in India to three Taiwanese electrical manufacturing services firms: Foxconn (Hon Hai Precision Industry), Pegatron and Wistron. The Tata Group acquired Wistron's assets in India in November 2023, making Tata Electronics the first Indian firm to produce the iPhone and paving the way to a broader electronics-production ecosystem in the country.

Semiconductor Industry Beginning to Take Shape

We should bear in mind that semiconductors are at the heart of every electronic product, and as the semiconductor content in electronics is constantly increasing, India will find itself requiring more semiconductors, making its import costs for semiconductors an increasingly serious problem. India's Ministry of Electronics and Information Technology projects that the nation's semiconductor market will expand from $15 billion in 2020 to $64 billion by 2026 with growing demand related to smartphones, cloud servers, electric and hybrid cars, industrial automation, key infrastructure, and defense systems.

In December 2021, the government opened its Semiconductor India Program to help foster growth in the chip industry. The 760-billion-rupee ($10 billion) initiative features an exceptionally generous monetary incentive, bearing fully half the cost, for building semiconductor or display plants. Including monetary assistance from state governments, 70% of project costs can be covered by the public sector. Three companies applied when the first window opened in January 2022, but all fell short of the technical requirements. A second application window opened in June 2023 under the revised Semiconductor India Program.

Geopolitical Risk as a Booster & Challenges Ahead

Noteworthy is a recent shift in the semiconductor supply chain, from offshoring (overseas outsourcing) to friend-shoring (sourcing from allied or friendly countries) with the new emphasis on globalization under growing geopolitical risk related to conflict between the US and China. This has been a significant tailwind for India in building up its chip industry. Since the collapse of the Cold War structure, the US and India have been getting closer than ever in terms of economy, security and population-to-population exchanges. Conclusion of the Initiative on Critical and Emerging Technologies (iCET) by the heads of the two nations in May 2022 illustrates the high level of trust between the US and India. In January 2023, their National Security Advisers presented specific directives, including cooperation in building resilient semiconductor supply chains.

The joint statement adopted when Modi visited the US as a state guest in June 2023 includes the following specific items in terms of strengthening semiconductor supply chains: (1) an announcement by Micron Technology, a vertically integrated US manufacturer of LSI chips, to invest up to $825 million to build a new chip-assembly and test plant in Gujarat ($2.75 billion in total including support from the Indian government), (2) a proposal from Ram Research, a leading manufacturer of chemical machinery polishing, to support the

training of 60,000 engineers, and (3) an announcement by Applied Material (AMAT), the world's largest manufacturer of semiconductor manufacturing equipment, to invest $400 million to establish a collaborative engineering center in India.

When Yasutoshi Nishimura, the then minister of Economy, Trade and Industry, visited India in July 2023 he signed a memorandum of understanding with his Indian counterpart to boost semiconductor collaboration, covering semiconductor design, manufacturing, equipment research and talent development. It does not include specific details, but India hopes that Japan will share and transfer experience and knowledge related to semiconductor ecosystems. This would specifically mean that Japanese companies related to chip production, special-device manufacturing, gases, material supplies and ultraviolet lithography will begin operating in India. Japan for its part expects much from the many excellent chip designers available in India.

For India to secure both high and sustainable growth in the years to come, it must seriously undertake economic reforms, overcoming vested interests, and avoid succumbing to populism to win elections. Remaining challenges include labor law reforms, land acquisitions, and power sector reforms. To start up the semiconductor industry in particular, infrastructure development issues of how to secure water and energy supplies will be particularly important. To build the semiconductor hardware industry, India reportedly plans to focus first on back-end processing, followed by entering front-end processing related to circuit manufacturing. Indian authorities say that they are committed to drawing up and administering policies with the coming 25 years in mind. It will likely take years to build a functioning semiconductor ecosystem.

Natural Partners

A recent noteworthy trend in the Japan-India relationship is that a framework for a stronger tie-up on national security as well as economy is being steadily consolidated. Since formation of the Japan-India Global and Strategic Partnership in 2006, summit meetings have been scheduled every year. The Joint Declaration on Security Cooperation between Japan and India was signed in 2008, followed by the start of 2+2 ministerial dialogues. In 2014 the bilateral relationship was upgraded to a Special Strategic and Global Partnership.

Japan had already established an important economic relationship with India while it was still under British rule, suggesting the formation of bilateral relations as natural partners. During and following the Meiji Era (1868-1912) Japan was successful in modernizing its economy based on the strength of its textile industry, which was made possible by securing low-cost imports of cotton from India. After World War II, Japan put policy priority on the production of coal and steel to drive reconstruction, focusing all its resources there. In those days, a newly independent India played a major role as primary supplier of iron ore for Japan.

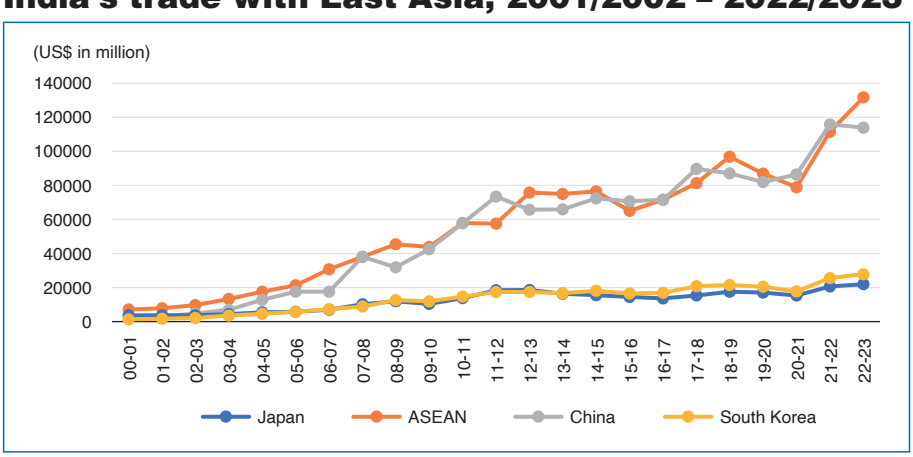
Japan Contributing to India's Infrastructure Development

Ever since high economic growth put Japan in the developed-nations club in the 1960s, its trade with India has hovered at relatively low levels, even in the new century *(Chart 2)*. Meanwhile, Japan has been a major contributor to India's infrastructure development through official development assistance. India was the first recipient of Japan's ODA when it started in 1958, and since 2004 it has received its largest share each year. India expects a great deal from Japan as a development partner. By the same token, Japan values its deepening relationship with India, especially in terms of drawing its future growth strategy.

The largest share of Japanese yen loans to India has been going to subway construction. The Delhi Metro, opened in 2002, is a success story in which Japan's culture of construction and safety technologies was transferred to India along with the railway operation system. Japan's assistance to India's mass-transit systems has expanded to other Indian cities. Currently, Japan is committed to the two gigantic infrastructure-development projects in India. One is the Western Dedicated Freight Corridor, serving as a railway logistic backbone for the Delhi-Mumbai Industrial Corridor (DMIC). The section between Delhi and Gujarat has been operating since July 2021. The other is the Mumbai-Ahmedabad High-Speed Railway (MAHSR), based on Japan's shinkansen system, which is scheduled for completion in 2028. Japan is also playing a major role in improving connectivity between less developed northeastern India and other regions. In January 2024, the 21.8-kilometer Mumbai Trans Harbour Link (MTHL) was completed. Japan funded 75% of

CHART 2

India's trade with East Asia, 2001/2002 – 2022/2023



Source: Data taken from Export Import Bank, Ministry of Commerce and Industry, Government of India

TABLE

Main investing countries' FDI in India, 2021/2022 – 2023/2024

(US$ million)

Rank	Country	2020-21 (April-March)	2021-22 (April-March)	2022-23 (April-March)	2023-24 (April-Sept.)	Share of total FDI inflow (April 2000 – Sept. 2023)
1	Mauritius	5,539	9,392	6,134	2,952	25%
2	Singapore	17,419	15,878	17,205	5,224	23%
3	US	13,823	10,549	6,044	2,052	10%
4	Netherlands	2,789	4,620	2,498	1,927	7%
5	Japan	1,950	1,498	1,798	2,098	6%
6	UK	2,116	1,657	1,738	638	5%
Total Inflows		59,638	58,773	46,034	20,488	655,050

Source: Ministry of Commerce and Industry, Fact Sheet of Foreign Direct Investment (FDI)

the total cost through yen loans. The MTHL is expected to enhance inter-regional links and alleviate traffic jams.

Japanese Companies' Investment in India Surging

Given the Indian economy's potential for gaining strength over the medium and longer terms and a growing geopolitical risk for doing business in China, we can witness a noteworthy surge of direct investment in India by Japanese companies. Statistics released by the Indian Ministry of Commerce and Industry show that Japanese direct investment in India grew from $1.498 billion in FY 2021-22 to $1.798 billion in FY 2022-23, and $2.098 billion is already recorded for the first half of FY 2023 (April-September), up 17% from the figure for FY 2022-23 as a whole *(Table)*.

Active investment by Japan companies covers a broad range of manufacturing fields, including automobiles, air-conditioners, steel products, medical equipment and sporting goods. Suzuki Motor recently announced investment of 2 trillion yen by 2030 for EV development, with a view to increasing its annual production capacity in India from 2.25 million now to over 4 million cars. Toyota's India subsidiary and the Nissan-Renault alliance have also announced that they will each invest about $600 million in India for EV and new-model development. World-class air-conditioner maker Daikin Industries has invested 30 billion yen to build a new plant in southern India to produce low-cost air-conditioners equipped with inverters. Nippon Steel will reportedly invest 410 billion rupees (730 billion yen) via its joint venture with ArcelorMittal, to more than triple its production capacity in India by 2030 to 30 million tonnes.

New things are happening outside the manufacturing sector as well. NTT has positioned India as its top-priority Asian market, and has already invested $800 million to build data centers across the country. In addition it has announced annual investments of $500 million over the coming few years. Leading Japanese banks, including MUFG Bank, are rapidly centralizing administrative work in India, including risk management, money transfers and document checking, in response to expansion of their overseas operations and for compliance with local laws and regulations. The same trend is also seen among real-estate developers. Sumitomo Realty and Development, for instance, will reportedly undertake new investment of 500 billion yen to complete its urban redevelopment project in central Mumbai in the early 2030s.

The latest JBIC Survey Report on Overseas Business Operations by Japanese Manufacturing Companies (JBIC), published in December 2023, shows India ranked first among promising countries to do business not only over the long term (the coming decade or so) for the 11th consecutive year, but also over the medium term (about three years) for the second consecutive year. India ranks first as a promising country for many specific industries, including automobiles, electrical equipment and electronics, chemicals and general machinery. The reason most cited by responding companies for India as a promising country is "future growth potential of the local market". The latest JETRO Survey on Business Conditions for Japanese-Affiliated Companies Overseas, published in November 2023, also highlights India as a promising country to do business. Some 72.5% of the Japanese companies operating in India are forecasting profitable sales for the current fiscal year, maintaining the same high levels reported the previous fiscal year, and 75.6% anticipate their business expansion in India over the next year or two, conspicuously higher than the average 45% of Japanese companies operating worldwide, putting India by far at the top.

Conclusion

What is ultimately most important for consolidating the foundation for further expansion of the bilateral relationship between Japan and India is cultivating mutual understanding through active people-to-people exchanges. This will also be indispensable for promoting a much-needed IT alliance between the two countries. According to the forecast by the Ministry of Economy, Trade and Industry based on the medium scenario, Japan will face a shortage of 450,000 IT personnel and 124,000 AI talents in 2030, and see average AI demand growth of 16.1%. To ensure that the short supply of personnel won't become a missing link for the expansion of the Japan-India relationship, how to promote people-to-people exchanges is becoming a priority issue to be addressed by using every channel across the industrial, academic and government sectors concerned.

Article translated from the original Japanese by Comwest (Keiko Odani and Steven Ayres) JS

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