Japan-India Economic Relations: Current Reality and Issues

By Kojima Makoto

IN the past, India has always had a strong image of following an inward-looking pattern of economic development under a robust, mixed economic system and lagging behind the growth trends of the world economy. However, over the past quarter of a century, India has achieved 5-6% annual growth on the back of a broad foundation of agriculture, manufacturing and services with a high-level sustainable growth trajectory. Since the 1990s, in particular, a new leading sector – the IT service industry – has emerged in India, and this has powered the economy to even stronger growth. The emergence of the IT service industry in India has been the result of a strong conduit formed between US corporations and India under the influence of the currents of globalization and the IT revolution.

India introduced economic reforms in 1991 in an attempt to achieve full-bodied economic liberalization, and since then, the country has followed a "Look East" policy. Up to that time, India's main trading partners were limited to the United States, the EU, the former Soviet Union and Japan; India generally had rather distant economic relations with the countries of East Asia. Following its "Look East" strategy under the new open door policy, India moved to strengthen economic ties with the countries of East Asia including the ASEAN nations, China and South Korea.

Since the 1990s, India has remained receptive to the tides of globalization and has grown strongly, expanding its economic relations with the United States and the countries of East Asia while raising its profile in the world economy. But despite these major changes, and so far quite at odds with trends, economic relations between Japan and India have remained stale. The economic relationship between the two countries has remained clearly stagnant in the areas of trade, investment and official development assistance (ODA) for India for the last 10 years. But very recently, new signs of an expansion of the relationship have finally begun to appear. While providing an overview of Japan-India economic relations, this paper will examine the background that pushed the relationship into stagnation, and will attempt to discern the prospects for an expansion of the economic relationship between the two countries in the future.

Current State of Japan-India Economic Relations

First, let us look at trade. While the total value of trade between the two countries in 1997-98 was $4.02 billion, by 2002-03 it had fallen to $3.7 billion. After that, despite increasing bilateral trade, the total value of that trade was only $4.38 billion for 2003-04 and $4.98 billion for 2004-05. In 2003-04, trade between Japan and India was overtaken by bilateral trade between India and China. As of 2004, the total value of India's exports stood at $73 billion, and Japan was not among the top five markets for those exports (the EU, the United States, the United Arab Emirates, Switzerland and South Korea). By total value of trade, Japan's position as a trading partner with India slipped from 3rd place in 1997 to 10th in 2004. Japan-India trade almost constantly favors Japan, which remains in surplus. The fact that trade between the two nations has not been brisk is reflected in the composition of the traded items. The three main items imported from India by Japan are: gems and jewelry, seafood and iron ore, a situation that fails to reflect the dynamic progress of the Indian economy in recent years.

What about Japan's investments in India? By total amount of foreign direct investment (FDI) in India (1991-2005), Japan was India's 3rd biggest investor after Mauritius and the United States. Japan's FDI in India peaked in 1997 at $434 million, then continued to consistently slide, with the lone exception of 2003. The amount of Japanese FDI in India in 2004, for example, was $97 million, which represented 0.3% of Japan's total overseas FDI for that year, and only 3.1% of all the FDI flowing into India in the same year. A breakdown by sector of Japan's FDI (on the basis of investment implemented) in India up to now reveals that the automotive sector attracted the largest amount of investment. Investment in transportation equipment (60.4%) was followed by electrical equipment (7.2%), services (3.7%), ceramics (2.2%) and textiles (2.2%). As illustrated by the fact that Suzuki and Honda have the largest market shares in the automobile and motorcycle areas respectively, there is something noteworthy in the fact that Japanese companies moving into India have played a role in the advancement of India's automotive industry. Eyeing the expansion of India's automobile market, more and more Japanese corporations are expected to move into India in the future. These will include assemblers, as well as automotive parts and machine tool companies. In non-automotive areas, the movement of Japanese corporations to India has been generally low-key, apart from some exceptions. Those that have made the move include consumer electronics, finance, IT services and infrastructure development companies. Particularly in the consumer electronics field, the share of the Indian domestic market held by Japanese corporations is a long way behind the share held by South Korean companies. Worthy of note in Japan's investment in India is the tendency toward portfolio investment, which totaled $5.4 billion in 2005 alone.

In the past 10 years, Japan-India trade and Japan's FDI in India have stagnated, and for both countries the importance

Photo: Embassy of India

The IT service industry has brought about strong economic growth in India

of the Japan-India economic relationship has consistently diminished in relative terms. However, in the area of economic cooperation, and in this area alone, both countries are forming mutually highly important relationships. When Japan started to provide ODA in 1958, the first recipient country was India. Since then, the balance of loan funds delivered to India up to March 2005 has totaled ¥1,575 billion, making India the 3rd largest recipient of Japanese ODA, after Indonesia and China in terms of the balance of loan assistance. Most of Japan's soft loans for India have been allocated to infrastructure. A breakdown by spending target of the total amount of approved soft loans delivered over the period 1975-76 – 2004-05 reveals that electricity accounted for 43% of the total disbursement, followed by transportation at 12%, water supply and sewerage systems at 8%; afforestation at 6%; irrigation at 3%; and tourism at 1%. When India pushed ahead with nuclear testing in 1998, Japan temporarily froze new funding for India, but after the resumption of ODA to India, since 2003-04 India has become Japan's largest ODA recipient, although this actually reflects a substantial reduction in Japanese ODA to China. Japan's soft loans to India totaled ¥134.5 billion in 2004-05, 19.2% of Japan's total soft loans that year and equivalent to 24.7% of all the foreign aid received by India in that period.

The Background to Misunderstandings in the Japan-India Economic Relationship

India has great strengths in abundant and diverse agricultural production, large numbers of cheap and highly sophisticated human resources, and operation of a global software industry. On the other hand, Japan, which specializes in industrial production, is forced to import most of the agricultural commodities it consumes (with the exception of rice), but in the area of manufacturing it enjoys strengths that are second to none. In the manufacturing area, with the importance of embedded software growing and the effects of the baby bust and the first of the baby boomers reaching retirement age, Japan is facing the problem of a shortage of human resources in the IT sector. Looking at the differences between the two countries' factor endowments and the industrial structures of their economies, the two have a high-level of complementarity in their relationship. In addition, considering the fact that India's economy, which enjoys a huge domestic market, is expanding strongly, it would benefit both countries to form closer economic relations. Despite this fact, the two have failed to mesh their needs – a long-term situation that has persisted up to today.

While Japan has faced the stagnant relationships with India since the 1980s, it has moved to deepen the economic dependence with East Asian countries. The driving force for this was the growth in Japanese companies moving into the region. The growth of Japanese FDI in East Asia increased the international division of labor between corporations and resulted in strengthening the trading relationships between Japan and East Asia. Over the 1980-2004 period, the percentage of Japan's trade with East Asia grew, with exports to the region expanding from 34.4% to 46.4% of all Japan's exports, and imports from East Asia growing from 24.7% to 44.9% of all Japanese imports. As Japan's economic ties with East Asia have strengthened, so have India's strengthened with East Asia since 1991 under India's "Look East" policy. With both Japan and India expanding their relationships with the East Asian region, why has the economic relationship between Japan and India not grown and been left to stagnate? The biggest reason is that Japanese FDI in India has been anemic, apart from some exceptions, and Japanese companies have failed to make a determined move to establish themselves in India. In the consumer electronics and infrastructure development areas, Japanese corporations already lag well behind their South Korean and Singaporean counterparts in setting up operations in India. Accordingly, the cycle of growing FDI and expanding trade that has formed in East Asia has not yet been established between Japan and India.

While interest in the move of Japanese corporations into India has been palpably mounting with the growth expected in India's domestic markets, on the individual level, companies are still slow to get involved. To be sure, from the viewpoint of Japanese companies, India, where they would be investing, certainly provides numerous causes for concern. Top of the list is the infrastructure deficiencies in such areas as electricity, roads, and seaports. In particular, the much-maligned electricity sector gives cause for alarm.

With daily outages and unstable power supplies, it is essential for corporations to set up their own generating facilities, and this is a major impediment for small and medium-sized enterprises (SMEs) contemplating moving there. Also, the opaque and tangled govern-

Photo: Embassy of India

The Delhi Metro was constructed with the help of Japanese ODA

ment procedures, relatively high customs duties, and rigid labor laws and regulations that prevent companies from easily folding or shedding staff are some of the many factors that make potential investors hesitate. On the other hand, despite these conditions, it is a fact that South Korean companies are boldly investing there and have garnered the largest share of the consumer electronics market. It is also a fact that Singaporean companies are investing in a wide range of areas, including communications and hospitals as well as the infrastructure field that gives Japanese companies pause. This suggests that what Japanese companies identify as areas of concern are not necessarily critical factors that would deter South Korean or Singaporean companies. It is bad enough that India has many problems that make investors think twice, but one reason that India has not attracted Japanese investment is because Japanese corporations have a rather negative image about India's investment environment. As a result, they find they cannot sufficiently overcome a sense of psychological distance in regard to that country.

To the extent that the Japanese cannot excise the psychological distance they feel in regard to India, IT outsourcing faces the same problems as investment. With the worsening shortage of IT personnel and growing calls to reduce costs, overseas outsourcing of IT functions is a growing trend among Japanese corporations. Much of the outsourcing goes to China and so far there are few IT services carried out between Japan and India. As of 2004-05, Japanese overseas IT outsourcing to China totaled $1.56 billion as against only $500 million to India. From China's perspective, Japan is a major export market with a 60% share of all China's IT service exports. On the other hand, Japan's share of India's IT service exports is only 2.8%. An issue in overseas IT outsourcing is overcoming the communications gap caused by differences in language and culture. Essential to achieving this is the presence of bridge software engineers (SE's) with the ability to smoothly communicate between the customer and IT vendor. Producing such human resources requires active people-to-people exchange through study programs and similar activities. Around two million Indians reside in the United States, and this community serves as a robust human pipeline for expanding US-Indian IT collaboration. The reason that Japanese corporations look toward China rather than India for IT outsourcing is because of access to large numbers of IT engineers who have studied in Japan and have mastered Japanese. As of 2005, while there were 62,916 Chinese students enrolled in Japanese universities and post-graduate programs, only 364 Indian students were studying in Japan. Indian students were outnumbered by both Bangladeshi and Sri Lankan students in Japan. The active exchange of people, including through overseas study, overseas business trip and tourism, forms a very important base for expanding the relationship between two countries. In addition to the few contacts between the people of India and Japan, only ten regular flights, including both direct and indirect, operate between the two countries. As of 2004, only 97,000 Japanese tourists visited India. Overall, contact between the two peoples remains at a low level.

Initiatives for Expanding the Japan-India Relationship and Future Prospects

Historically, bilateral relations between Japan and India have tended to be distant. Recently, however, for political and economic reasons on both sides, the relationship is moving into a new era of growth. Both Japan and India share the goal of obtaining a permanent seat on the UN Security Council, and India is recognized as a country Japan should ally itself with as it moves to realize this goal. And with the rise of China, and Japan-China relations moving into a difficult phase politically and diplomatically, there is suddenly a new recognition of India's importance as a bargaining chip vis-à-vis China for Japan. This fact is reflected in the Japanese government's policy of seeking to emphasize the framework of an East Asian Summit based on an ASEAN 3 + 3 configuration (Japan, China and South Korea + India, Australia and New Zealand) in parallel with the ASEAN + 3 (Japan, China and South Korea).

To ensure that the Japan-India relationship is grounded and enlarged, it is vital to deepen and expand the economic dependence between the two countries through Japanese corporations expanding their FDI in, or IT outsourcing to, India. To achieve this, it is vital that Japanese corporations bury the psychological distance they feel from India through combined public and private activities utilizing various channels, including people-to-people exchange and ODA. The following two initiatives are attracting interest as means to achieve this. The first is the Eight-Fold Initiative, with its eight points for strengthening the Japan-India Global Partnership. This was announced after a bilateral summit held at the time of Prime Minister Koizumi Junichiro's visit to India in April 2005. The Initiative includes specific policies for the stimulation of bilateral dialogue and people-to-people exchange, including increasing the numbers of Indian students learning Japanese by introducing Japanese as an optional foreign language subject at Indian junior high schools. It is important as an agreement that offers ways to expand the Japan-India relationship in the future.

The second initiative is the movement toward the establishment of an Economic Partnership Agreement (EPA)/Comprehensive Economic Partnership Agreement (CEPA) between the two countries. In July 2005, a joint study group was set up to explore the possibility of establishing an EPA between Japan and India. Subsequently, final deliberations were undertaken on the content of a report submitted to the prime ministers of both countries in the 4th meeting held in June 2006, and the joint study group then concluded its duties. The conclusion of the report referred to the way the two economies complemented each other in various ways, and recommended the start of inter-government negotiations toward the establishment of an EPA. The EPA/CEPA that the report aims at will not be simply restricted to the framework of a free trade agreement (FTA), but will have a broad organizational framework that will include the liberalization of trade in services, utilization of ODA to promote economic partnership, and other forms of economic cooperation such as people-to-people exchange. In relation to ASEAN, India has already formed an FTA frame agreement with Thailand and a CEPA with Singapore, and is preparing to establish an FTA with ASEAN itself in January of 2007. Japan, too, has formed an EPA with Singapore and Malaysia, to be followed by EPAs with Thailand and the Philippines. Accordingly, if an EPA is signed between Japan and India, this will not only directly expand relations between the two countries, but should also help augmenting the bilateral relationship indirectly through ASEAN.

The enlargement of ties with India, which seems very likely to maintain sustainable economic growth over the long term and leads a large supply of IT human resources, has a very significant meaning for the Japanese economy, especially for the following two reasons. The first is India's infrastructure problem, which has become an issue. Up until now it has been regarded as an impediment for Japanese companies contemplating moving to India, but through effective use of ODA, it can actually provide major future business opportunities for Japanese companies. In the infrastructure development field alone, over the next five years, India has investment needs that will absorb $150 billion. The Delhi Metro is regarded as a success story based on ODA applying sophisticated Japanese engineering technology. In the future, other projects in the infrastructure development field that will be strong candidates for the application of Japanese ODA projects are construction of subways, high-speed rail freight transportation and special economic zones in other major cities such as Bangalore.

Through the utilization of ODA, opportunities for Japanese corporations to be involved in infrastructure development projects in India are expected to grow. Furthermore, if infrastructure development advances through the use of ODA, this should also encourage Japanese companies to expand their FDI in India.

The second reason for expanding ties with India is that, while Japan is one of the world's most competitive nations in manufacturing industries on the hardware side, today, hardware and software are merging, and in leading-edge manufacturing areas, dependence on embedded software is growing. Because of more sophisticated functions, shorter development times, addition of functions, updatability of product and other needs, software development demand is growing all the time. But there is now a serious shortage of the human resources in Japan to meet these demands. Japan is already short of 75,000 engineers in the embedded software field, and in the future the shortage of Japanese IT engineers is expected to become still more serious because of the baby bust as well as the general reluctance of young people to study sciences. In this sense, the strengthening of ties with India, which produces large numbers of IT personnel and where science and technology education is highly popular, is important from the perspective of keeping Japan's manufacturing industries internationally competitive. Certainly, China outperforms India when it comes to providing a good supply of IT personnel. But the idea of Japan being still more dependent on China in the software field, when it is already highly committed to China in hardware areas, may not be wise from the perspective of Japan's long-term national interests, including the problem of security (confidentiality of information and protection of intellectual property). In particular, when considering Japan's response to global business, India has large numbers of human resources able to be effective on the global stage, and strengthening ties with India would be a powerful option for Japan's corporations in the future. JS

Kojima Makoto is a professor of International Development at Takushoku University.