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Advancing India's Rise as a Leading Power

POLICY BRIEF

Navigating a Derisking World

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Cover Photographs:

President Biden signs the Inflation Reduction Act into law on August 16, 2022. (Source: The White House/ Official Twitter)

President of the European Commission Ursula von der Leyen delivers a speech on on EU-China relations at the Mercator Institute for China Studies and the European Policy Centre on March 30, 2023. (Source: Ursula von der Leyen/Official Twitter)

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Contents

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Introduction

Economic resilience initiatives by the major powers are gaining traction, for several reasons. China's non-market practices, economic disruptions during the pandemic and from the ongoing Ukraine conflict, imperatives of climate commitments and their fast approaching target dates, and possible dual use/abuse of newer technologies, including AI, have all made countries rethink about supply stability, perils of overdependence, and who could be deemed as trusted partners without ulterior geopolitical objectives. There are also the likely ramifications from a potential conflict over Taiwan, the impact of which would be far more devastating.

US moves towards resilience

In March this year, the rules proposed under the US Chips and Science Act revealed restrictions on the recipients of US funding for investments in the US (including South Korean and Taiwanese companies) from also investing in the expansion of semiconductor manufacturing in foreign countries of concern (read China, Russia, Iran and North Korea), effectively asking the recipients to choose one side or the other. The US Inflation Reduction Act signed into law in August 2022, with a massive outlay of US$ 390 bn, was inter alia intended to accelerate private investment in green energy solutions. It also features incentives for domestic content requirements, and for strengthening domestic manufacturing. Already, more than US$ 200 bn has been reportedly[1] committed to manufacturing in the US in these areas.

Additional duties imposed on steel and aluminium in March 2018 by the US on national security grounds are still in force, including on imports of Indian steel and aluminium. Several measures have also been taken in recent years towards preventing strategic investments from some sources, restricting technology transfers, and expanding export controls. Support of allies and partners is also being sought. The toolkit is steadily expanding.

[1] https://www.ft.com/content/b1079606-5543-4fc5-acae-2c6c84b3a49f

EU's initiatives on reducing dependence and going green

The EU's proclivities towards doing business with China are changing even as differences persist among its members. The European Commission's proposed Net Zero Industry Act (NZIA) and the Critical Raw Materials Act (CRMA) launched last month show how the EU is aiming to reduce dependence on China and other sources, and increase diversity of supply. The NZIA identifies eight strategic areas including solar, wind, geothermal, biogas, batteries and grid technologies for this purpose. The CRMA is intended to strengthen different stages of critical raw material manufacturing in the EU. No strategic raw material at any stage of processing is to rely more than 65% on one source. Both these proposals add further to the EU's carbon border adjustment mechanism (CBAM) being readied on six energy intensive areas (electricity, iron and steel, aluminium, cement, hydrogen and fertilisers), which could be expanded. Its carbon-related levies will affect third country exporters, including India. The European Parliament has formally adopted on April 18, 2023 the compromise package 'Fit for 55 in 2030' which it had earlier reached with EU governments after extended discussions. This revised CBAM which plans to reduce greenhouse gas emissions by 55% by 2030 compared to 1990 levels now has to get the formal nod by the EU Council before it is signed into law, that could happen soon.

Admittedly, all of this do not imply that all EU countries or companies consider the need to decouple/derisk from China similarly as was evident during French President Macron's recent visit to China. But Commission President Ursula von der Leyen's speech[2] to two EU think tanks on March 30, 2023 candidly brought out how the Chinese Communist Party's clear goal is now a systemic change of the international order with China at its centre, and its imperative for security and control has now trumped the logic of free markets and open trade.

China is responding with its own initiatives

China, a key source of concern behind the foregoing initiatives, is also doubling down with its own initiatives on strengthening research and advanced manufacturing. In some cases, such as those of investment restrictions or export controls imposed by the US, China is also responding with its own actions[3].

[2] https://ec.europa.eu/commission/presscorner/detail/en/speech_23_2063

[3] See for example the news item ' China escalates tech battle with review of US chipmaker Micron' accessible at https://www.ft.com/content/79ddb4bb-cbfc-4e4f-bca8-ef52ea0157c1

The issue for India

The issue for countries like India is to understand whether this protectionist turn by the developed countries, which were earlier at the forefront of promoting market economy principles, is a temporary phase or is it likely to stay. Is there any way India can shield itself from the negative fallout, while gaining from opportunities created by derisking? And it must be added here that India itself has in the last few years tried to boost its domestic manufacturing through the PLI and other schemes.

There are three possible ways by which this global turn towards resilience can get reversed. One is rigorous and full adjudication by the WTO in all cases, bringing greater predictability and adherence to the rules-based order. The other is China itself seeing merit in reversing course to become an open market economy. A third possibility is that this entire idea of resilience and trusted partnerships will go against the grain of competitiveness and efficiency, and may eventually fizzle out. Some economic commentators indeed consider it a mistake[4]. These three possibilities are examined below.

Will the WTO dispute resolution system address the challenge?

The 2-tiered WTO dispute settlement mechanism(DSM) is non-functioning at present, with the collapse of its Appellate Body. A DSM panel, the first tier, for example ruled against the national security reasoning behind the US steel and aluminium tariffs in December 2022, but was sharply criticised by the Biden Administration which has conveyed that it will appeal, meaning that the panel ruling will remain in abeyance. USTR Katherine Tai opined[5] that the WTO panel was getting itself "on very very thin ice" in making such a ruling by second guessing the national security judgement of a democratic government such as the United States. This sense of US exceptionalism raises a question whether the direction of the WTO Ministerial held in May 2022 asking members to hold discussions to restore a well-functioning DSM by 2024 will actually happen and, if it did, whether it will have the strength to be able to hear all cases, including some of foregoing measures. Present indications are not optimistic. A WTO panel has also recently ruled against India's duties on certain ICT products, and India too has responded to say it will appeal.[6]

[4] See https://www.ft.com/content/92d95586-f1eb-4148-ae32-1864f7deeb43
[5] https://ielp.worldtradelaw.net/2023/01/katherine-tai-on-national-security-.html
[6] https://economictimes.indiatimes.com/news/economy/foreign-trade/india-to-challenge-wto-panel-ruling-on-ict-import-duties-at-appellate-body-no-adverse-impact-on-industry/articleshow/99566224.cms?from=mdr

China's trade practices and counter measures

A key factor, but not the only one, behind the increasing resort to resilience is China's non-market practices. The excess capacities it has built in steel, aluminium, solar panels, rare earths processing, and several other areas may have benefitted consumers of these items, but has unfairly impacted their competitor producers and stood in the way of their further development. China's opaque regulatory practices have also worried technology investors and limited reciprocal market access for its partners. Statements made by several WTO member countries during China's trade policy review meetings at the WTO make this evident[7]. India's own statements on these occasions have flagged the high level of bilateral trade deficit, difficulties faced due to NTBs and other barriers, including on agri-food products, generic medicines and IT services. Furthermore, China has also used such trade or economic dominance as a means of coercion for pushing strategic objectives.

Is China likely to change? Unlikely, seems to be the answer. Nor is it certain that agreements signed by China will be honoured. For example, the implementation of the Phase-1 trade deal signed with the US is only partial, with significant commitments unmet, as per a USTR report for 2023.[8] Meanwhile, China will continue mounting charm offensives with European powers with some sweetener deals from time to time, so that they remain divided. Diplomatic efforts will also be made, such as the recent brokering of normalised relations between Saudi Arabia and Iran, to polish up its image. But there is nothing to suggest China's modus operandi will change.

Will resorting to derisking bring economically sustainable outcomes?

This may be the most difficult question to answer. It would also depend on what share of trade could be affected by derisking: will it be confined to only some strategic and high-tech products, or will it be more wide-ranging in scope? Derisking from over-dependence on any source of supply is in any case a normal and good business practice. In certain areas that are capital intensive or technology driven, it also takes years to achieve capacity, making policy support essential.

[7] See for example https://docs.wto.org/dol2fe/Pages/SS/directdoc.aspx?filename=q:/WT/TPR/M415.pdf&Open=True

[8] See page 65 of https://ustr.gov/sites/default/files/2023-03/2023%20NTE%20Report.pdf

It could also be argued that if countries have a broad portfolio of WTO members as their FTA partners, then there is in any case a good chance of promoting economic efficiency and integration with those partners. Some have even suggested widening CPTPP as an option, but with US not showing any interest and with the CPTPP being a high standard agreement for several developing countries, this may not work.

Proponents of decoupling/derisking could also argue that this is really the last resort against countries which are undermining the market economy system through their policies, regulatory frameworks and implementation mechanisms that do not always work on a market basis. If the derisking pressures result in getting them to make appropriate changes in their system then this will still be worthwhile.

How should India be navigating this turn towards derisking?

From the foregoing, it seems reasonable to arrive at an assessment that resilience initiatives by trade majors may only gather strength in the near and medium term, particularly also in view of climate targets by 2030. The question then is how should India navigate this trend? While India has already taken several steps in this regard, a more coordinated strategy may be useful which could include the following:

- Successfully implementing PLI schemes and establishing semi-conductor manufacturing will be more important than ever to reduce import dependence and improve the manufacturing ecosystem. Ushering in more competitive manufacturing, however, has to be a key objective. India should try and become a derisking solution globally.

- Continue focus on the ongoing FTA negotiations with the UK, Canada, the EU, and the comprehensive agreement proposed with Australia. Gaining deeper and comprehensive access into these developed markets will be important for India. Provisions on access to reliable supply of critical minerals and technologies will also be useful. Incorporating an understanding on climate-related trade measures should be attempted so that access for Indian goods remains unaffected. Simultaneously, India also needs to pay attention to the review of FTAs with Korea, Japan and ASEAN. Such a wide portfolio of FTAs should assist India in moving towards economic efficiency.

- The US, is the leading destination for India's exports of goods and services. It will be very important to resolve pending issues (steel and aluminium duties, restoration of GSP and the totalisation agreement) with the US. Can the forthcoming visit of Prime Minister Modi to the US yield some breakthroughs?

- The Indo-Pacific Economic Forum (IPEF) also can have a substantial impact on supply chain resilience. India needs to stay closely engaged in IPEF negotiations.

- Russia has become an important source of more affordable energy purchases for India. Maintaining this relationship will be in India's interest, even as it will pose a continuing test for our diplomacy. An FTA with the Russia-led Eurasian countries could also be a possibility, as indicated at a recent event in New Delhi.[9]

- India now has a good understanding of China's strategic objectives, and how it seeks to achieve them by whatever means. India's economic exchanges with China must be freed of illusions and examined not only commercially, but also strategically.

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[9] https://www.business-standard.com/economy/news/india-russia-talk-free-trade-agreement-in-a-bid-to-strengthen-ties-123041701198_1.html

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