

Decoupling or diversification?

**Dilemmas of India, Japan, and Australia in shaping
economic relations with China**

Leválasztás vagy diverzifikáció?

India, Japán és Ausztrália dilemmái a Kínával
való gazdasági kapcsolatok alakításában

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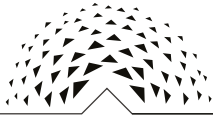
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Abstract: US allies in the Indo-Pacific region, India, Japan, and Australia are all making considerable efforts to reduce economic dependence on China. In the case of India, border clashes boost the political motivations of the trend, while in the economic sense the country's trade deficit, the import of the pharmaceutical and automotive industries, and the determinative role of Chinese capital in the tech sector result in a unique dependency. As for Japanese companies, China remains a key manufacturing base and market, and therefore Tokyo is interested in the diversification of supply chains and manufacturing locations instead of downsizing the relationship completely. Regarding Australia, the overwhelming weight of China in the country's export is considered a major exposure; however, in the case of iron ore, which is a key item in bilateral trade, the dependency also exists on China's side. Although for all three countries it is a reasonable goal to enhance the resilience of supply chains and diversify economic relations, the "China plus one" strategy seems to be more beneficial for the future than cutting off economic relations with China across the board.

Keywords: Supply chain, China, economic decoupling, Japan, India, Australia

Összefoglalás: Az Indo-csendes-óceáni övezetben lévő amerikai szövetségesek, India, Japán, és Ausztrália jelentős erőfeszítéseket tesznek, hogy csökkentsék a Kínától való gazdasági függésüket. India esetében a trendet tovább erősítik a határvillongásokból fakadó politikai motivációk, miközben a gazdaság síkján az ország kereskedelmi deficitje, a gyógyszer- és autóiipari import, valamint a kínai tőke tech szektorban betöltött meghatározó szerepe különösen erős függést eredményez. A japán vállalatok számára Kína továbbra is kulcsfontosságú gyártási bázis és felvevőpiac, így Tokió nem a kapcsolatok oldásában, hanem az ellátási láncok és gyártási helyszínek diverzifikálásában érdekelt. Ausztrália számára Kína túlsúlya az ország exportjában nagyfokú kitettséget jelent, ugyanakkor a bilaterális kereskedelemben kulcsfontosságú vasérc Kína számára is függést jelent. Bár mindhárom ország számára logikus cékitűzés az ellátási láncok és a gazdasági kapcsolatok diverzifikálása, a "Kína plusz egy" stratégia sokkal előnyösebbnek látszik a jövőben, mint a kínai gazdasági kapcsolatok visszanyesése.

Kulcsszavak: ellátási láncok, gazdaságok szétválasztása, India, Japán, Ausztrália

INTRODUCTION

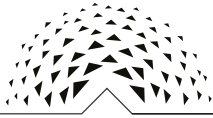
In the wake of the COVID crisis the vulnerability of global and regional supply chains, and especially the exposure to China-centred manufacturing within them, has increasingly come under the spotlight. The United States' efforts to

reduce this exposure in a growing number of sectors have evolved into a decoupling swell, which has been reinforced by the global pandemic. The allies of the US in the Indo-Pacific region, India, Japan, and Australia seem to follow a similar path, although due to their geographic proximity and other motivations and exposure factors, it is unlikely that they would consider the decoupling strategy of the US as a model. This policy brief explores the factors that drive the trend of reducing economic dependency on China in the case of India, Japan, and Australia, and also whether decoupling or diversification could be the way to follow in the future.

INDIA: ECONOMIC MOTIVATIONS AMPLIFIED BY NATIONAL SENTIMENTS

As a result of the COVID pandemic, the issue of economic self-sufficiency and the vulnerability of supply chains has also been high on Indian politicians' agenda. [In his speech on 12 May, 2020](#), PM Narendra Modi emphasized that through achieving self-reliance, India could overcome the COVID crisis and emerge as a global leader. While the prelude of the *Self-reliant India* vision is the global pandemic crisis, the concept fits perfectly into the economic policy strategy represented by PM Modi in recent years. In 2014 the Indian Prime Minister already launched the *Make in India* campaign, which primarily addressed job creation through the strengthening of domestic production. Nevertheless, the *Self-reliant India* campaign soon became a synonym of economic distancing from China following the [Galwan Valley incident of Chinese and Indian soldiers](#) in the disputed border region, which left 20 Indians dead. The negative experiences of China-centred supply chains during the COVID-19 outbreak and the anti-China sentiments reinforced by the border clash together gave particular emphasis to reducing economic dependency on the neighbouring power.

Trade is one of the segments in which the Indian Government aims to overcome exposure towards China. In June 2020 it was reported throughout the global media that as a step of achieving self-reliance and distancing from China, [India planned to raise tariffs and trade barriers](#) for around 300 products imported from its neighbouring country. In response, in August 2020 [China extended an anti-dumping tariff](#) on an Indian fibre-optic product. Since then, India has announced tariff hikes on Chinese products in multiple rounds. The country's latest budget, tabled in the Parliament on 1 February, 2021 contained [further tariff hikes](#) on product categories such as electronic goods in which India highly depends on Chinese import. In March India also imposed an anti-dumping tariff on certain antibacterial drugs in order to protect its domestic market from low-cost Chinese import. Beside the growing anti-Chinese sentiments, the country's trade deficit, which had been unchanged for several years, has also played a role in



the formation of such a 'mini trade war'. In 2020 India imported goods from China in a total value of USD 19 billion, while the country's export towards its neighbour amounted to USD 58.8 billion.

However, reducing dependency may face substantial headwinds in the case of two key industries of the Indian economy. Based on data from the Auto Component Manufacturers' Association of India, in 2019 [over a quarter of India's auto part imports came from China](#), in a value of USD 4.2 billion. According to industry experts, Chinese import dominates throughout the automotive value chain; therefore, the sector is not yet prepared for any decoupling. The pharmaceutical industry perhaps struggles with an even more significant exposure. Although India is well-known to be the leading global supplier of generic drugs, it purchases [70% of the active pharmaceutical ingredients and raw materials](#) for its generic finished products from China. In this case as well, the elimination of the exposure could only be feasible in the long run. [According to the chairman of Pharmaceuticals Export Promotion Council](#), even if India makes the first steps today, it will take at least ten years to end the industry's dependency on China.

Afraid of the effects of low-cost Chinese import, the Indian Government pulled out of the Regional Comprehensive Economic Partnership (RCEP) negotiations close to the finish line. The story was different in the case of the Belt and Road Initiative (BRI), as India opposed China's signature project from the very beginning for the reason that one of its corridors passed through Pakistan-occupied Kashmir.

In terms of foreign direct investments (FDI), India depends on China to a lesser extent compared to trade relations. [Based on Indian governmental data](#), between April 2000 and March 2021 Chinese FDI inflow amounted to only USD 2.5 billion, which makes China just the 19th largest source of FDI for India. Interestingly, the Chinese Ministry of Commerce (MOFCOM) recorded a USD 8 billion Chinese outward FDI stock in India, a much higher level compared to the Indian figures. [According to data from Invest India](#), there are 800 Chinese companies operating in the country with 75 manufacturing units for smartphones, construction equipment, power gear, automobiles, and chemicals. A more significant exposure can be identified in the country's technology sector, which has been attracting Chinese capital intensively since 2016. Beside tech giants like Alibaba and Tencent, Chinese venture capital funds have also invested in the leading start-ups of India, pumping roughly USD 4 billion into 75 companies. In 2020, [18 of India's 30 unicorns were Chinese funded](#). This dominance is mainly due to the lack of major Indian venture investors for Indian start-ups. China also has an overwhelming presence in the country's online ecosystem through smartphones and apps. For example, video sharing app TikTok has 200 million subscribers and has overtaken YouTube in India. As of February 2020, Chinese smartphones like Oppo and Xiaomi [had a market share of 72% in India](#), outperforming Samsung and Apple. As a result of increasing tensions with China, the Indian Government launched 'decoupling' in this field as well, by banning TikTok and further 58 Chinese apps in June 2020. [The ban was retained](#) by a government decision in January 2021.

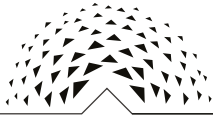
Based on a report from analytics firm AppsFlyer, the [market share of Chinese apps dropped to 29% in 2020](#) compared to 39% in the previous year, while Indian applications managed to fill the vacuum and strengthen their market presence.

On 17 April, 2020, Indian officials announced that governmental approval will be required in the case of all direct and indirect investments from neighbouring countries. Although the regulation does not mention China explicitly, the main motivation behind it is not a big mystery. Since March 2021, when the new regulation entered into force, the country has received altogether 120 China-related FDI project proposals, although none of them have been given the green light yet. Beside the concerns related to the foreign takeover of domestic companies weakened by the COVID crisis, the tightening of the regulation can be explained by the consequences of the border clash. Beyond that, the Indian Government has excluded Chinese companies from large-scale highway construction projects as of 1 July, 2020, forbidding their participation even in the form of joint venture. In a similar way, Huawei, ZTE, and other Chinese tech companies that had been operating in India for several years did not receive the approval of the Indian Government to participate in the 5G rollout, [based on a statement from May 2021](#).

JAPAN: AVOIDING OVER-DEPENDENCE WHILE KEEPING THE BENEFITS

In the case of Japan, trade with China can be considered relatively balanced compared to India, as in 2020 merchandise import amounted to USD 163.9 billion while export totalled at USD 141.4 billion. Regarding the import, the largest exposure can probably be identified in the field of rare earth elements, and Japan has already experienced the risks of such dependency. In 2010 China was close to stopping the export of rare earth elements to Japan as tensions rose following the collision of a Chinese fishing boat and a unit of Japanese coast guards in the waters of the disputed Senkaku Islands. As a consequence, Japan started to actively seek diversification of import. In 2010, 89% of rare earth element imports came from China, and Japan managed to [reduce this ratio to 58% by 2019](#). The goal is to [lower the share of Chinese import to less than 25%](#) by 2025. Similarly to a number of other countries, the COVID pandemic opened the eyes of Japanese policy makers to the substantial exposure towards Chinese import in the field of surgical masks and other protective gears; however, the country could soon reduce this kind of dependency through [ramping up domestic production capacities](#).

In Japan the issue of supply chains and the manufacturing activity of Japanese companies in China were probably the main factors that have turned the spotlight on economic decoupling over the past year. According to [statistics from the Japan External Trade Organisation](#) (JETRO), by the end of



2019, Japanese FDI stock in China amounted to USD 130.3 billion, while Chinese companies have invested USD 4.9 billion through FDI projects in Japan. The former makes up only 7% of the total Japanese outward FDI stock; nevertheless, as a result of the COVID pandemic, the reshoring of Japanese manufacturing from China has been put into focus. As reshoring and diversification had been raised high on the agenda worldwide, the Japanese government launched two subsidy programs to strengthen supply chains. The first supports the reshoring of production activities, while the second provides subsidy virtually for Japanese companies relocating to the ASEAN countries. However, the Japanese government allocated around 90% of the budget to the first program. Although the regulation did not explicitly mention the aim of moving Japanese manufacturing from China, all of the companies in the first eligible group of firms are receiving subsidy for relocating their operation from there. According to an [announcement in June 2020](#), out of the first 87 eligible companies 57 will relocate their production activity from China to Japan, while the remaining 30 would move from China to the ASEAN region.

On hearing the announcement, [some reports](#) tended to compare the process to the decoupling of the USA and China. Nevertheless, the majority of Japanese companies that are receiving subsidy for leaving China are small and medium-sized enterprises producing low-cost healthcare products and protective gear for which there was an increased demand in their homeland in order to gain control over the pandemic. The main reason for the large enterprises being reluctant to leave is that a substantial share of Japanese manufacturing companies in China produce goods for the local market. Based on statistics from 2018, [the Chinese market accounted for 73% of the annual sales](#) of these companies. According to a [JETRO survey](#) in 2020, 63.5% of Japanese companies operating in China remained profitable despite the crisis, and the majority of respondents anticipated that business in China will get back to normal earlier than elsewhere. Another [JETRO survey in September 2020](#) found that only 7.2% of Japanese companies operating in China either planned or considered shifting production out of the country. It seems that the size of the Chinese economy and its short-term growth prospects that surpass every rival's outlook continue to be an attraction that cannot be ignored by Japanese manufacturing companies. The profit achieved in China makes it possible for these companies to spend more on R&D, which is the basis of their future competitiveness globally. Last but not least, the production of complex goods like automobiles requires a huge number of components and a vast network of suppliers, which is available in China but not necessarily in emerging manufacturing hubs like Southeast Asia.

In a similar way to India, the Japanese government has also tightened the controlling of foreign investments in the country. The [regulation that had entered into force in May 2020](#) lowered the threshold of ownership acquisition that made a governmental approval necessary from 10% to 1% in the case of listed Japanese companies in designated business sectors. Although the

Japanese regulation at first seems to reflect less anti-China sentiment than the monitoring system in India, surely one of the legislators' main motivation was the anxiety about a possible 'shopping tour' of Chinese companies. For similar reasons, foreign ownership has been restricted since 2019 in the case of high-tech companies.

As for the 5G infrastructure rollout and the participation of Chinese companies, Japan sidelined Huawei and ZTE from the project in 2018. Nevertheless, Chinese firms are keen to increase presence in the technology sector although the concentration and the exposure cannot be compared to the one in the Indian start-up scene. Chinese tech giant Tencent has recently acquired a 3.7% stake in Rakuten, a Japanese e-commerce and telecommunications service provider. The Japanese government indicated that [it would monitor the transaction closely](#); at the same time, this does not mean an inevitable rejection as it would have been almost surely the outcome in India in the case of a similar transaction.

Although officially Japan has never joined the initiative, in 2017 it still seemed that [the country is ready to cooperate with China](#) on the implementation of certain BRI projects. However, since Joe Biden's inauguration, Japan has already been working together with the US on launching an alternative to China's project. Overall, the modification of the Japanese attitude towards the BRI is not catalysed by decoupling intentions from China, it mostly derives from changes in the US foreign policy, which is focusing again on cooperation with its traditional allies.

AUSTRALIA: FACING DIFFICULTIES IN DISTANCING ITSELF FROM CHINA

Different reports provide a rather mixed overall picture about Australia's trade dependency on China. The most reliable source of information could be an [interim report](#) ordered by the government and published in March 2021, which aimed to evaluate the vulnerability of key supply chains of Australia. Regarding China, the most important and rather unexpected finding of the report is that merely 5% of the country's total import can be considered as vulnerable, and China supplies only two-thirds of this proportion. This finding is especially contrary to perceptions that dominate media and public opinion, which suggest that the country is highly dependent on Chinese import. To a certain extent, general trade statistics confirm this perception, as China accounted for 28.8% of the country's total import in 2020. At the same time, analysing the vulnerability of the import can modify the consequences that can be derived from general trade statistics, as proven by the interim report prepared for the Australian government.

In trade relations, real exposure from Australia's side is manifested more evidently in the structure of exports. Shipments to China accounted for 40.9% of the total export of the country in 2020. Within that, iron ore can be considered



undoubtedly the most important item, as 60% of China's iron import originated from Australia in 2020. Since exposure exists in both directions in this case, it is not a surprise that iron ore shipments were not affected by the [latest Chinese tariffs on certain Australian goods](#). Beijing responded by imposing tariffs following Canberra proposing an [international inquiry into the origins of the coronavirus pandemic](#).

Without Australian iron ore, China's ongoing infrastructure investment programs would be delayed or cancelled, hindering the country's economic growth. Such exposure is undesirable also for China, and therefore the country is engaged in exploring new opportunities of supply. Brazil is considered to be the second largest source of iron ore import for China; however, its mining sector has been hit by the COVID pandemic, while explorations in Guinea can be seen rather as a promise for the future. At the same time, it is highly unlikely that amid rising tensions between the two parties the Australian government would halt iron ore shipments to China, as its economy, which is struggling with the crisis, simply cannot disregard a market worth tens of billions of dollars.

Beyond trade, there are some other sectors as well in which the Australian economy highly depends on China. In 2018 China overtook New-Zealand as the number one source of foreign tourists in Australia. [1.4 million Chinese visited Australia in 2019](#), spending USD 12.4 billion altogether, which highly exceeds the spending of US tourists, the second most lucrative group of visitors to the country. Beside tourists, Chinese students also generate substantial income for Australia. The country's tertiary education institutes are [increasingly dependent on spending by Chinese guest students](#), and this revenue [climbed almost two and half times between 2014 and 2019](#) and totalled at USD 12.1 billion. A future standoff is a real hazard for the Australian higher education, and the COVID pandemic is not the only possible reason for that. Amid deteriorating ties, it seems that Beijing is ready to use this weapon. In February 2021 [the Chinese Ministry of Education warned Chinese students](#) who were preparing to study in Australia to assess the risks, as a 'series of vicious attacks on Chinese students that have happened recently in multiple places in Australia have posed a serious threat to their personal safety'.

As for FDI inflow from China, the exposure of Australia can be seen as minor. Between 2016 and 2020, the share of Chinese FDI within the total inflow [remained below 5% in most years](#). However, the Australian government – in a similar way to India and Japan – tightened the control of foreign companies' investments, and as a result, in August 2020 [Canberra blocked a Chinese takeover for the first time](#) in the food industry, pointing out that 'the proposed acquisition would be contrary to the national interest'.

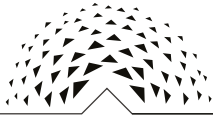
Regarding the technology sector and the 5G rollout, Australia was the first country worldwide that sidelined Chinese companies from the development of the 5G infrastructure due to national security reasons. The [local chief corporate affairs officer of the company explained](#) that as a response Huawei has cancelled R&D investments of USD 72.3 million in Australia since the ban and terminated around 1,000 high-tech jobs at its local subsidiary.

Considering China's mega project, the [Australian PM has made it clear](#) that the BRI was inconsistent with Australia's national interests. Nonetheless, Victoria state signed an agreement with China on joining the BRI. In line with the new legislation announced in late 2020, the federal government was authorised to terminate agreements of local governments and foreign countries that are inconsistent with national-level foreign policy. On 21 April, 2021, the federal government used its newly minted authority and [cancelled the agreements](#) signed by Victoria state and China.

CONCLUSIONS

Based on the findings above, the three countries all show similarities and disparities in terms of their economic distancing from China. In the case of India, the flaring up of the border conflict in 2020 is no doubt a strong emotional factor ensuring that the Modi government's decisions are also driven by retaliation beside economic considerations. As for Japan, existing territorial disputes with China do not have such a strong influence on the distancing process, and in the case of Australia we cannot talk about such motivation. As a consequence, it is not surprising that out of the three countries India is the one in the case of which reducing trade exposure to China is coupled with a sort of 'mini trade war'. In terms of trade, India, Japan, and Australia are equally struggling with a kind of exposure towards China that can only be managed successfully in the long run. In the case of India, the overall huge trade deficit and the import of pharma API and automotive parts can be described as such, while in connection with Australia, the critical point is the iron ore export, although it reflects a two-way dependency. In turn, Japan is on its way to reducing exposure to China drastically in the import of rare earth elements, providing a good example that such dependencies can be diminished, but only in the long run.

When analysing the progress of distancing in the case of India, Japan, and Australia, it seems obvious that exaggerated narratives are also published in the media regarding the dependency on China-centred supply chains. As for Australia, the report ordered by the government clarified that Chinese import did not imply an exposure of the extent that had been perceived by the public, and therefore the restructuring of the supply chains could not be seen as an urgent national security issue. Interestingly, this finding has not resulted in a substantive change in the general perceptions on economic relations with China. Regarding Japan, the governmental subsidy program for reshoring Japanese firms has been evaluated at first as a sign of decoupling; however, the analysis of the process has made it obvious that Tokyo was not interested in cutting off ties but in the diversification of supply chains and manufacturing locations. Altogether, for Japanese companies China will remain an essential production base and market in the future as well.



Furthermore, in the case of India and Australia, particular economic factors can be identified that give a unique nature to the decoupling or distancing process. As for India, the tech sector and the start-up ecosystem are the fields in which the presence of Chinese capital makes decoupling hard to imagine even in the middle run, while the economic benefits from the spending of Chinese tourists and students would be difficult to replace in Australia. The distancing process of the three countries is expected to be similar to the decoupling strategy of the US in a way that it will primarily take place in sectors of strategic importance, like technology and communication. However, the scale of bilateral economic relationships cannot be compared to the China-US relation; therefore, the impact will be smaller on the global economy.

Based on the aspects analysed in this policy brief, it is a reasonable goal in the case of all three countries to diversify economic relations and to enhance the resilience of supply chains. However, a complete decoupling with China would face serious headwinds or would be economically irrational in a number of sectors. That is to say, in the coming period the “China plus one” strategy seems to be the appropriate choice for the three countries instead of downsizing economic relations with China across the board. It is rarely mentioned, but the economic rise of China in the last decades has contributed to the increasing wealth in other countries as well, Australia being one of the best examples. In terms of diversification, the three countries could join forces in a couple of ways. As a sign of recognising this, in late April 2021 India, Japan, and Australia launched a joint program ([Supply Chain Resilience Initiative](#)) to establish more resilient supply chains in the Indo-Pacific region. The [critical reaction from the Chinese ministry of foreign affairs](#) proves that the initiative and the shaping of supply chains in general is seen as not only an economic but also a geopolitical issue in the region.