

EXIM BANK: RESEARCH BRIEF

Self-Reliant India: Approach and Strategic Sectors to Focus



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Manufacturing plays a key role in economic growth and development. A weak manufacturing sector often translates into high import dependence and large trade deficit. Recent data on India's manufacturing sector indicates that manufacturing accounted for only 15.1 percent of India's gross value added in 2019-20, as compared to a share of 18.35 percent in 2010-11. This contraction in manufacturing is in spite of the strong growth in private consumption in the country, which registered an annual average growth rate of 12.7 percent during 2011-12 to 2019-20. Prima facie, this is indicative of a greater share of the domestic demand

being channelled towards consumption of foreign goods and services.

Further analysis of India's imports by end-use (capital, intermediate, and consumer goods) indicates that nearly 79 percent of the imports by India in 2019 were intermediate goods, signifying the dependence of India's manufacturing sector on imported intermediates. The significant dependence of Indian manufacturing on imports is also corroborated by the analysis of financial data of a sample of 8558 Indian companies, which shows that the foreign exchange spending accounted for 25.5 percent of the total sales of

these companies in 2018-19. The high import intensity in the manufacturing sector also translates into a higher level of foreign value-added content in India's manufacturing exports. The import intensity of exports is especially high in case of basic metals, fabricated metal products, computer, electronics and optical products, electrical equipment, and machinery and equipment.

Strategic Sectoral Focus for Self-Reliant India

Capital Goods: The trade deficit in capital goods sector currently stands at around US\$ 17 billion. Strategies for indigenization in the sector could

Identified Focus Sectors with High Trade Deficit

Capital Goods
(US\$ 16.6 bn)

Chemicals and allied
(US\$ 3.8 bn)

Electronics
(US\$ 41.3 bn)

Defence Equipment
(US\$ 7.8 bn)

Pulses & Edible Oil
(US\$ 10 bn)

Plastic and products
(US\$ 7.3 bn)

Solar Cells and Modules
(US\$ 2.1 bn)

Other Sectors - Iron & Steel
(US\$ 2 bn)

Trade deficit in these sectors = US\$ 91 bn (57 percent of India's total trade deficit in 2019-20)

Note: 1. Values in parenthesis indicate India's trade deficit in the sector in 2019-20.

2. The Study also includes rare earth elements as securing these strategic minerals is very important for India to enter high-tech manufacturing; auto-components are also included even though there is trade surplus in this sector, as there is significant import dependence in certain sub-categories.

include: encouraging technology transfer and investments in the capital goods sector, fostering innovation-led start-up ecosystem through mechanisms such as Innovation Challenge Funds and Innovation Vouchers, support for creation of testing and certification infrastructure and introduction of scheme for refund of expenses incurred on certifications, expanding the scope of public procurement by relaxing conditions of prior supply in the technology-intensive areas, among others. The Government could consider promoting capital goods for intelligent manufacturing through a national policy for adoption of Industry 4.0, which could inter-alia include schemes for facilitating domestic manufacturing of high-technology products like sensors, creation of industry standards for Industry 4.0 products, and incentive scheme for MSMEs to encourage adoption of Industry 4.0. The Government may also like to look at addressing the issue of inverted duty structure as well as revisiting the duty concessions under free trade agreements (FTAs). Further, Hi-tech Manufacturing Zones could be developed by the Government in collaboration with State Governments. Additionally, the Government could also consider promoting technology acquisitions and technological upgradation by encouraging mergers and acquisitions through an Alternative Investment Fund.

Chemicals and Allied Products: The chemical industry has emerged as one of the fastest growing industries in India. While the industry has registered significant growth in the last two decades, India faces significant trade deficit, amounting to US\$ 4 billion in this industry. Some of the products in which India has import dependence are phosphoric acid, styrene, aluminium oxide, and anhydrous ammonia. The Study highlights that India has a significant dependence on China for imports of antibiotics, penicillin, and heterocyclic nitrogen compounds. Further, India's dependence (backward linkage) on China is higher for some critical inputs used by the chemical and

pharmaceutical industry. To reduce the import dependence and boost chemical exports from India, greater focus should be laid on enhancing India's integration into the Global Value Chains (GVCs). Further, the Study recommends that the Government could enter into strategic partnerships with top global importers like the USA, Germany, Japan and South Korea to attract investments, besides providing conducive business environment to manufacture in India.

Defence Sector: India was the second largest importer of major weapons in the world during 2015-2019. India's trade deficit in defence equipment amounted to US\$ 7.8 billion in 2019-20. Possible strategies for promoting indigenization in the sector could include: revisiting the FDI limit under the strategic partnership model, removing tax impediments to create a level-playing field, addressing the ambiguity in procurement categories, and bringing out policies to ensure greater accountability, among others. It may also be important to carry out some revisions in Draft Offset Guidelines 2020 such as revising the quantum and threshold for offset, considering differential quantum levels for single-source procurement vis-à-vis competitive tendering, and reconsidering the multiplier coefficient for parts and components. Further, a Defence Development Fund could be created by the Government, which could be managed by Exim Bank, for facilitating medium to long term credit for exports of defence equipment from India. Additionally, the Government could also launch a credit-linked capital subsidy scheme through this Fund for the players in this sector.

Electronics: India currently has a trade deficit of over US\$ 41 billion in electronics. Electronics components, computer hardware and peripherals, consumer electronics, electronics instruments, and telecom instruments are some of the major segments contributing to the trade deficit in the electronics industry. Some of the plausible steps which could be taken up by the government for boosting domestic manufacturing in electronics

include: recalibration of the recently launched production-linked incentive schemes for attracting large scale GVC oriented investments, increasing customs duty on select non-ITA-1 import items, renegotiating FTAs in the context of electronics, providing thrust to investment in medical electronics / devices, encouraging strategic electronics through adoption of a model similar to the USA's Trusted Foundry Model, and promoting innovation and R&D through financial and fiscal incentives. There is evidence that availability of low cost working capital to electronic companies in countries such as China and Vietnam enhances their cost competitiveness. Therefore, the Government could consider setting up a Fund to provide interest subvention for working capital.

Plastics and Allied Products: India has attained significant diversification in the plastics industry over the past few years. However, the sector has a significant trade deficit of nearly US\$ 7 billion. Challenges exist especially in the area of sourcing of raw materials needed for plastic manufacturing. It is suggested that the Government may consider production linked incentive scheme for the sector, along the lines as in the electronics sector, which could position India as a viable alternative to countries like China in the long term. There is also a need for the plastics industry to be included in a Comprehensive Economic Partnership Agreement focusing on technology transfer and investments, besides the trade with select countries such as the USA, Germany and Mexico that are strong in plastic manufacturing technology.

Pulses and Edible Oils: India runs a trade surplus of nearly US\$ 15 billion in the agriculture and processed food category, but faces significant import dependence in products like edible oil (crude palm oil, crude soya bean oil, safflower oil), and pulses (dried shelled lentils). Indonesia and Canada were the largest import sources for edible oils and pulses for India in 2019. The Study notes that backward

linkages in India's agricultural exports are substantially higher than the forward linkages, and there is a need to increase the GVC participation in agriculture, forestry and fishing through forward linkages with the global food processing industry. There is also a need to promote agricultural investments in CLMV region, as well as the African continent, where opportunities exist. This would entail long-term assurance towards buying back the produce from these regions at a rate not less than the minimum support price for the same produce in India. The Government also needs to diversify its import sources and put in place a consistent policy for import of these two key products.

Rare Earth Elements: Rare Earth Elements (REEs) are needed in various industries such as defence, electronics, and renewables, amongst others. India accounts for 5.8 percent of global reserves of REEs. The significant requirement of REEs in India is met through imports, particularly from China. As a way forward, India could explore the feasibility of sourcing REEs from other countries such as Brazil, Vietnam, Russia, Australia and the USA. India could also collaborate with other countries for joint exploration activities and thereby securing REE assets within India and abroad. Indian state-run companies can form joint venture to secure minor mineral assets such as lithium and cobalt that could fuel India's plan for mass adoption of electric vehicles by 2030. A dedicated overseas strategic Investment Fund for the purpose of securing RRE assets could be considered, which could be housed and administered by a specialised government financial institution, akin to the Chinese model. The Government also needs to promote R&D in order to find better substitutes for priority minerals, as also in the recycling and material recovery areas.

Solar Cells / Modules: India has progressed immensely in the renewable energy sector, but significantly lags behind in manufacturing of photovoltaic cells, and consequently faces a huge

trade deficit, with particularly high dependence on China. To reduce import dependence and enhance domestic production, an extension of the safeguard duty on solar cells and modules is required. Further, to stimulate the demand for solar cells and modules in the market, mandatory uptake of domestically manufactured solar devices by the State and Central Government offices is also recommended. Besides, domestic capacities also need to be built up for silicon wafers and ingots used in the manufacturing of solar cells and modules. The Government could consider providing a viability gap funding to projects for setting up such facilities.

Auto-components: India has overall trade surplus in the auto-components industry but depends significantly on China for its imports of certain critical components such as drive transmission and steering parts, cooling systems, suspension and braking parts, due to cost competitiveness of China and lower technological competence of Indian players in the segment. To enhance domestic capacities, the Government could consider setting up technology upgradation fund for facilitating upcoming technological changes in the sector. The resources of the Fund could be utilized for incentivising capital investments and low-cost funding. The Government could also consider rationalizing the GST levied for auto components from the current levels of 18-28 percent to 5-12 percent. The GST could be reduced to 5 percent on components for Electric Vehicles (EV), bringing it at par with the GST for EVs.

Steel: While India is the world's second-largest iron and steel producer, it is still dependent on imports. India had the highest trade deficit in iron and steel with South Korea in 2019, followed by China and Japan. India's deficit in iron and steel with South Korea and Japan has almost doubled in the last decade, since it signed FTAs with these nations. Going forward, India may like to review the implications of FTAs on the industry. India also needs to raise awareness on

the utilisation of preferential tariffs. Better utilisation rate, in the long term, can increase India's exports and ultimately reduce the trade deficit. Besides, to produce iron and steel at globally competitive prices, Indian steel producers need to modernise their plants with state-of-the-art technology in order to increase the productivity, improve quality and reduce maintenance costs. The capacity utilisation of the steel industry in India is just over 75 percent, and needs to be increased substantially, given the demand for steel.

Strengthening the Eco-System for Indigenisation

Attracting Foreign Investments:

While the Government has brought out several policies to attract and encourage investments to boost the manufacturing and exports, it is important to foster an investment ecosystem whereby global lead firms are incentivized to invest and upscale their operations in India. This would entail a focussed approach involving sector-specific investment promotion strategies, which are also WTO compatible. The Study has identified sectors such as renewable energy, food and beverages, plastic, pharmaceuticals, and biotechnology for targeting greater investments through appropriate incentives, which could include production and capital investment incentives, R&D incentives, tax exemptions, interest subvention on capital investments, among others.

Leveraging Public Procurement:

Public procurement accounts for around 20-30 percent of India's GDP, making the Government an important buyer for the manufacturing companies. India needs to focus on quality in its procurement guidelines, taking cues from the "price-quality ratio" put in place by the EU. The Government may also consider making the procurement processes more favourable to MSMEs. In this regard, the Government could consider unbundling large procurement contracts into several smaller ones. There is also a need to introduce a separate law for public procurement, as the absence of a

central procurement legislation leads to ambiguity and procedural delays.

Role of States: It may also be noted that the federal structure in India empowers the states to design their own investment policies and sector-specific incentives to attract investments and promote industrial growth. Therefore, it is essential for the State Governments to actively engage in improving the 'ease of doing business' in the States along with designing a sound incentive structure for enhancing industrial development.

Recalibrating FTAs: Domestic manufacturing faces stiff competition from imports under some of the existing FTAs. The Government may explore the possibility of having a 'graduation clause' for the developing country FTA partners, a 'sunset clause' on some concessions, and a 'trigger mechanism' in case the imports surge from a country for a given product.

Promoting innovation and R&D could be a key game-changer for India to attain self-reliance in manufacturing. Fund allocation for incentivising R&D could be increased, along with introduction of other suitable policy interventions to promote R&D, such as reinstating greater Income Tax deduction on expenditure incurred on R&D. The Government could also consider providing dual tax credit allowances system that rewards both incremental expenses in R&D, in addition to the level of spending in R&D, as provided by countries such as Canada. The Government could also consider allowing the tax exemption on R&D under Section 35 (2AB), in addition to the lower corporate tax rate of 22 percent, in order to incentivize the domestic companies to invest in R&D.

Capacity Building Of Industrial Clusters: To ensure continued progress across existing industrial clusters in the country, it is essential to develop a

mechanism for assessing the performance of these clusters, review the current status of existing clusters and identify sectors/subsectors for developing newer clusters. This would require state-level support and collaboration, as majority of these clusters are developed through state-level initiatives. The Central Government could incentivize the States to assess the clusters, through financial support under the Market Access Initiative scheme. Upon assessment of the clusters, relevant capacity building activities can be undertaken. State Governments could also avail financial support for capacity building activities under the Micro & Small Enterprises - Cluster Development Programme.

Improving Ease Of Doing Business: India has undertaken major reforms across various areas of doing business, which have improved the investment climate in the country. However, the country still lags in areas such as enforcing contracts and registering property. Simplifying property registration and acquisition of land will be important for further improving the business environment in the country. There is also a need to overhaul the judicial processes for commercial disputes in the country. Leveraging technology will be an important step towards this, particularly at lower rungs of the judiciary. There is also a need to expand the arbitration and mediation centres in the country and enhance the judicial capacity through specialized commercial courts, complemented by a conscious effort by stakeholders to reorient the way alternate dispute resolution mechanisms are perceived.

Skill Development: The Government and the leading organizations could invest in creating Sector-specific, specialized Centres of Excellence in academic institutions to inculcate the research mind-set towards high technology sectors. The National Skill

Development Corporation and the State-Level Skill Development Councils would have a major role to play in implementing this strategy. Further, a fund could be created separately to provide focussed trainings to popularize and demystify Industry 4.0 technologies in higher and vocational educational institutions.

Conclusion

The recent performance of the manufacturing sector has been indicative of an underlying inertia. The sector-specific strategies are one facet of the mosaic of elements which would influence the manufacturing landscape in India. Encouraging R&D and skill development, strengthening industrial clusters, correcting inverted duty structures, utilizing public procurement for capacity development, developing efficient customs and port procedures, state-level interventions for encouraging industrial development, creating reliable standards and certification system and developing robust infrastructure would be the other key tenets of the revitalization plan for the Indian manufacturing sector.

The contents of the publication are based on information available with Export-Import Bank of India. Due care has been taken to ensure that the information provided in the publication is correct. However, Export-Import Bank of India accepts no responsibility for the authenticity, accuracy or completeness of such information.

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