Economics & Strategy

DBS Focus

Trade war and India: Five factors to watch

Economics/Growth/Monetary/Rates/India

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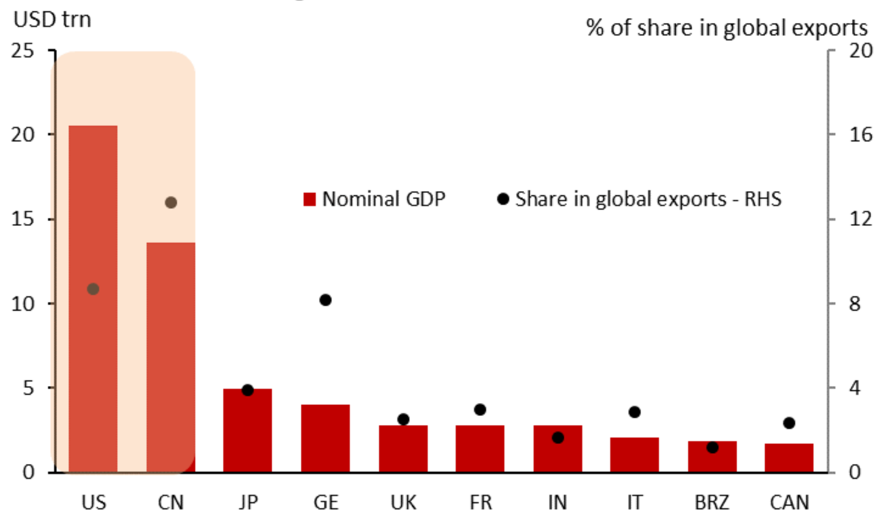
- *We highlight five reasons why the trade war matters to India*
- *First: India tracks global exports closely, with every one percent increase in the latter, raising India's by half a point*
- *Second: There are considerable trade diversion opportunities*
- *Third: US actions on India are substantive*
- *Fourth: India has its own closet of protectionism*
- *Fifth: INR's co-movement with CNY has risen substantially*
- *Constructive domestic policies will be necessary for India to counter the economic impact of tough global conditions*

Trade conflicts and protectionist policies dominate the narrative. For India, developments on the US-China trade dispute and other protectionist policies, present both a challenge and opportunity. We highlight five reasons why the trade war matters to India.

Nominal GDP and share in global trade

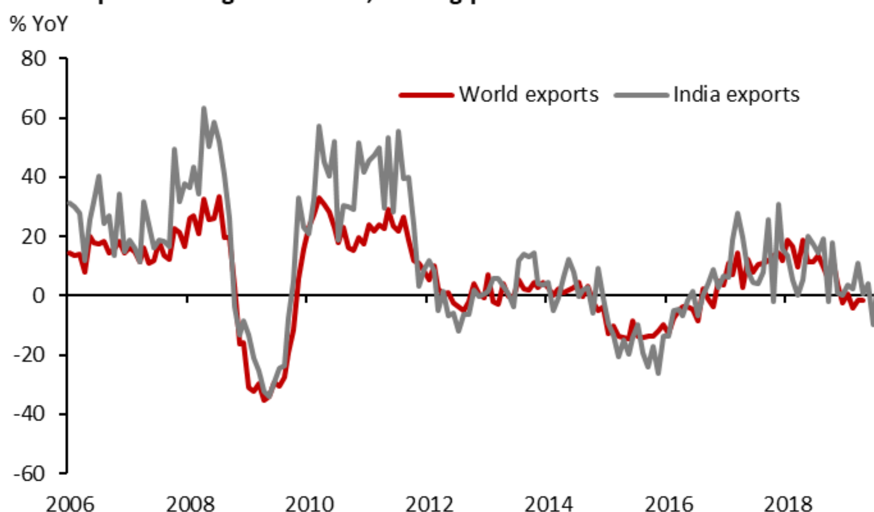


Source: World Bank, UNCTAD, DBS

1. India tracks global exports and growth closely

The dominant narrative suggests India is immune to the ongoing trade conflicts and global growth trends. We disagree. **Despite making a small share of global exports, India's shipments track the latter closely.**

India exports track global trends; holding pattern



Source: Bloomberg, CGA, DBS

In the past decade there have been three bouts of weak trade performance, worst amongst which was the plunge during the global financial crisis. That was followed by flattish growth until two years back before stronger growth conditions in the G3 space higher in 2016-2017 and turning south since in the past year. Regressing past data suggests that for every one percentage point increase in global exports, India's shipments tend to rise by half that much and vice versa. Hence, scaling back in global trade expectations is a pertinent risk for India's trade, even as its stronger domestic sector helps neutralize some of this weakness.

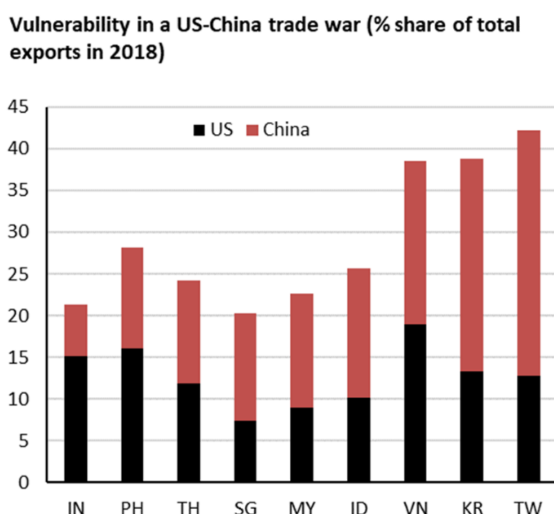
Even as India's goods exports account for a modest ~20% of GDP vs higher weightage amongst peers, most phases of strong growth in India has coincided with its exports also rising by double digits. Over time, exports as a driver for growth has built strong backward linkages with the capex in the export-reliant sectors and being beneficial for demand, by extension.

An ICRIER [1] paper reveals that the import content in India's goods exports has increased steadily from 11% to 22% in 2011 from two decades prior. Add to this, while India's exports take direction from global trends, when compared on the grounds of foreign value-added share in aggregate exports with other emerging economies, India lags in degree of integration in global value chains [1], compared to the likes of Taiwan, Korea, Philippines and Vietnam.

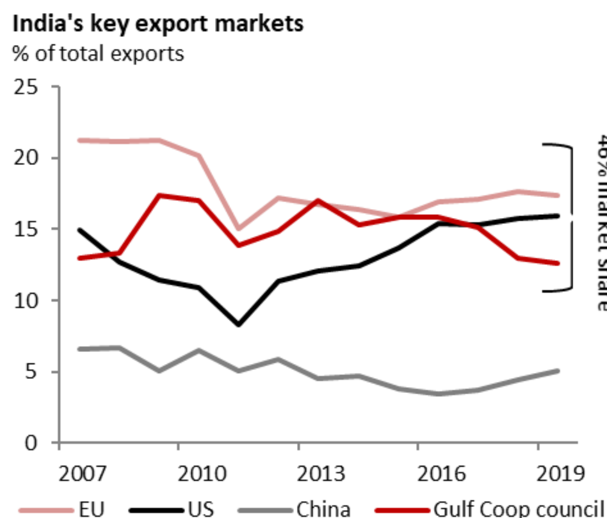
Apart from the direct impact, there are three areas of indirect effects as highlighted by the World Economic Forum: a) productivity suffers due to inefficient allocation of resources, b) higher cost of capital due to financial stress and c) lower investments due to uncertain business conditions. In India's context, ongoing conflicts and a domestic turn towards protectionist policies could hasten the pace of imports substitution, raising costs and introducing inefficiencies. Add to this, a tougher global environment could further dampen the already lackluster private sector activity.

2. The fallout from US-China trade conflicts

India's direct exposure to the US and China is modest compared to its regional peers. China (5%) and US (16%), totally account for a fifth of total merchandise exports. By contrast, regional economies are more exposed, particularly Taiwan, South Korea and Vietnam where a cumulative ~40% of their total exports head to US and China.



Source: CEIC, DBS



Source: CEIC, DBS

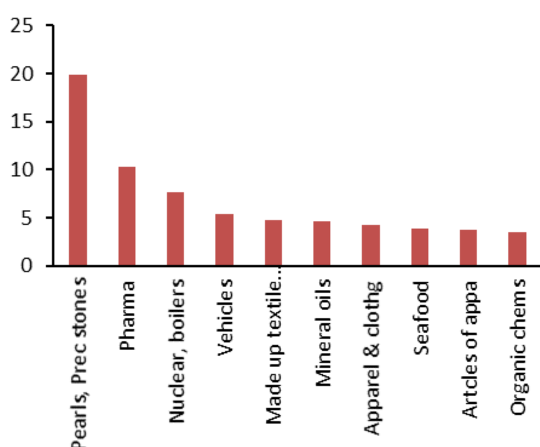
Between the two, India is more exposed to the US, even as their bilateral trade surplus has been narrowing in recent years. Despite this, India's overall trade balance is in deficit, led by a sizeable gap with China.

The ball on tariffs was set rolling last year by 25% tariff on all steel imports and 10% on aluminum imports. Making up roughly 3% of India's exports to the US, shipments slowed in FY19 with iron & steel shipments down by a third, part of which could be put to the tariff

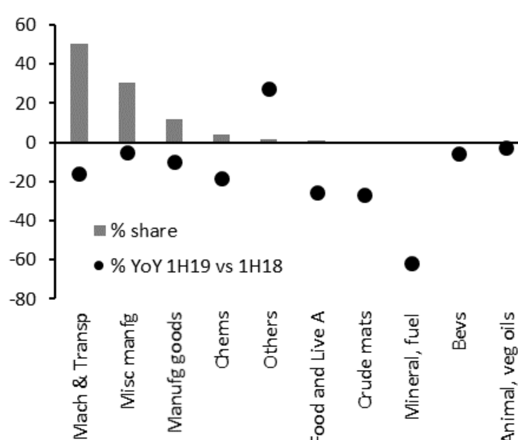
impact. We also note that the sector's exports to the US has been moderating in recent years due to series of bilateral anti-dumping cases.

India could increase its trade footprint in midst of the US-China trade conflict, particularly under categories on which US has imposed tariffs on China; half comprises of intermediate manufacturing products, 30% capital, and 20% consumers', according to the UNCTAD, with the rest including agricultural exports. A further breakdown reveals inclusion of consumer products, chemical and construction materials, textiles, tools, food and agricultural products, commercial electronic equipment, vehicle/automotive parts, and plastics, amongst others. The threat of additional tariffs on the remaining USD300bn, will affect consumer goods, capital goods, automotive supplies, industrial goods and lastly, food products.

Out of the total US imports, China accounts for 16-17% of the share, while India makes up for ~2%. Factoring in India's relatively smaller share in the US imports and displacement of demand from China, suggests that India could stand to gain from 0.5-5.0bn from a likely boost in segments such as chemicals, animal/ vegetable products, minerals, gems & jewellery, basic metals and machinery and equipment. Assuming equal competitiveness levels, the UNCTAD estimates that India might benefit from ~USD11bn (5% of total exports) in diversion flows, led by higher purchases of chemicals, plastics, machinery, motor vehicles and transport equipment etc. A bigger boost is, however, hindered by the relatively smaller proportion of manufactured goods in India's export basket, while raw materials and intermediate goods dominate the spread.

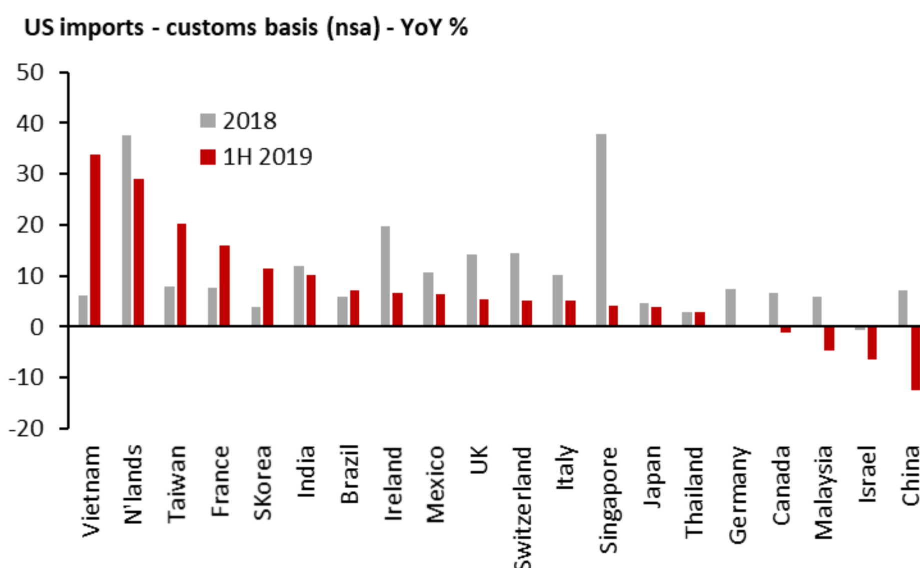


Source: CEIC, DBS



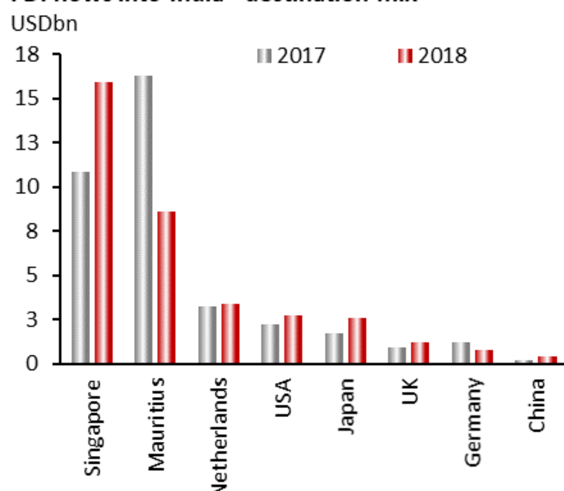
Source: CEIC, DBS

Since the tariff wars surfaced, US imports data between 1H 2019 vs 2018, shows that US importers have turned to other economies to source their requirements. Purchases from China and Malaysia declined in 1H19. The biggest beneficiary of this shift has been Vietnam, whose exports to the US were up 33%, followed by Taiwan, South Korea and Brazil. Trade with India is largely stable in the period.

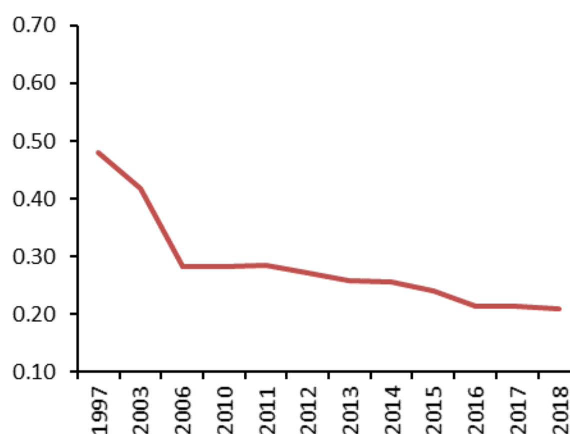


Source: CEIC, DBS

Apart from trade, diversion in investment flows is an opportunity that India could benefit from, as manufacturers seek alternative origination destinations. US FDI into India jumped in 2018, accounting for 6% of total investment flows. There has been also notable pick-up in flows from China. The modest (~1%) share of China's direct investment flows into India is likely understated, as some part might be routed through countries with favourable tax treaties. Notable names that invested in the past two-three years, include, Xiaomi (electronics), CNTC (real estate), SANY (construction equipment) SAIC's purchase of GM India's assets, China Electronics Technology Group and Longi are into renewable energy, Fosun Pharma bought Gland Pharma and Tsingshan invested into India's steel sector. In the space of technology and start-ups, sector leaders Alibaba, Tencent and OPPO are notable names. India's trade ministry is also reportedly considering financial incentives to draw in more investments, identifying electronics, consumer appliances, electric vehicles, footwear etc. as targeted sectors.



Source: CEIC, DBS

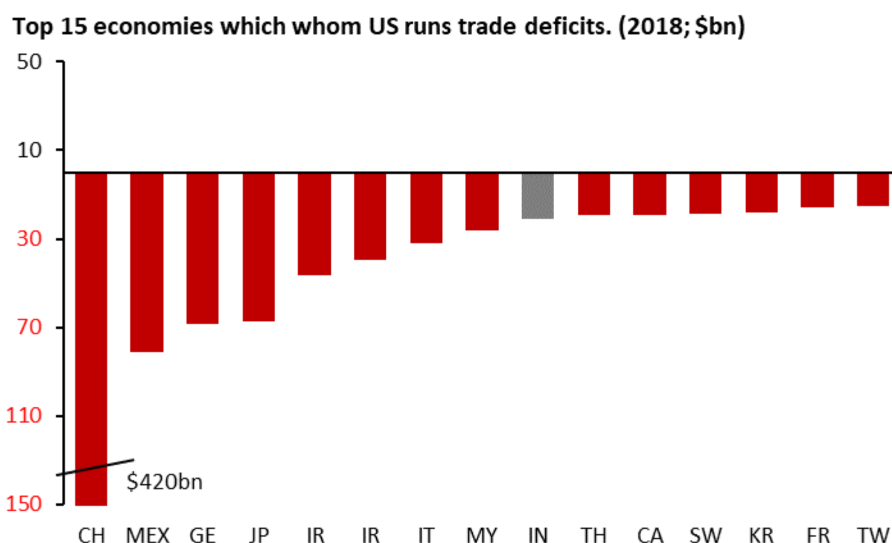


Source: OECD database, DBS

Larger gains are likely in the medium-term as India continues to work on easing FDI regulations. The OECD's FDI regulatory restrictiveness index has been easing in recent years (see above). A survey of businesses by A.T.Kearney [3] points to top five factors that influence investment decisions: firstly tax rates and ease of tax payments, followed by technological and innovation capabilities, general security environment, regulatory transparency & lack of corruption, and strength of investor and property rights. Improving competitiveness, ease of doing business, unified taxation system and lowering thresholds have been amongst the focus areas for the government.

3. US has also initiated direct action on India

Apart from the collateral impact, the US has also initiated protectionist action against India, as the latter runs a trade surplus with the US. The US withdrew favourable treatment meted under the Generalised System of preferences (GSP) on India earlier this year. We had noted here (PDF, HTML), that the impact on exports (nominal terms) is modest as GSP makes 10% of India's exports to the US and a small 1-2% of overall India's exports. There has also been disagreement on market access, with US' expressing concern over restrictions on foreign companies in the e-commerce and retail space, sector-specific regulations in pharma and dairy, data localization rules, etc. These have strained trade relations but both parties continue to negotiate to reach a common ground.



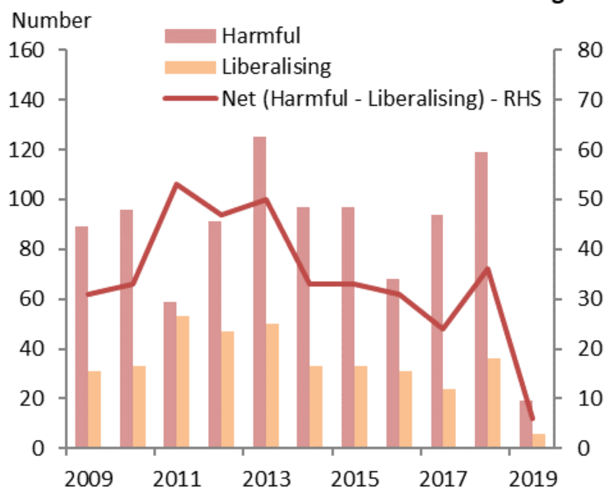
Source: CEIC, DBS

India retaliated by imposing counter tariffs on 28 products imported from the US, reacting to the withdrawal of the duty-free imports scheme. The product groups which include agricultural items, are expected to fetch USD217mn in revenues according to the Indian press. **In response, the US initiated a WTO dispute against these duties** as they held India's moves as inconsistent with provisions of the WTO's General Agreement on Tariffs and Trade by unfairly discriminating against US imports vs other members. Ensuing a larger threat, the White House has also threatened to pull the US out of the WTO, as the organisation's dispute settlement mechanism as well as system by which countries are declared as 'developing' (eg. India and China) is being perceived as being discriminatory.

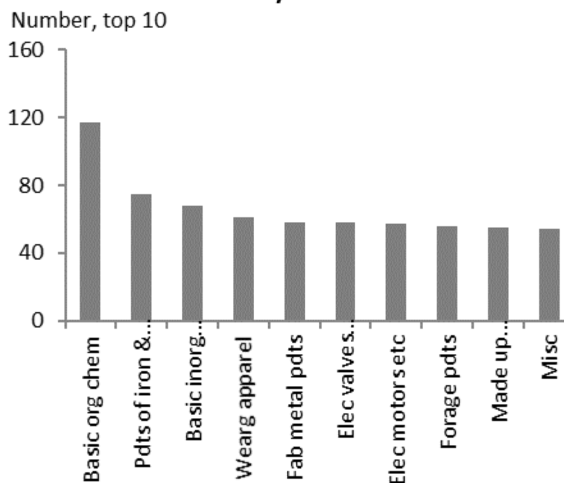
The US is also looking to tackle India's sizeable services surplus. Labour mobility rules have been tightened over the years stricter visa regulations and higher income thresholds, impacting Indian software and information technology services.

4. India has its own closet of protectionism

At its stage of development, it is not surprising that India has undertaken protectionist actions, via commercial and trade interventions in recent years. Data from the Global Trade Alert database highlights India as amongst the top few countries with the highest number of restrictive trade practices, even after adjusting for liberalizing measures.



Source: Global Trade Alert, DBS



Source: Global Trade Alert, DBS

The top five sectors that have faced tightening measures include basic organic chemicals with over 100 interventions, followed by products of iron and steel, basic inorganic chemicals, wearing apparel, and other fabricated metal products, amongst others.

More measures were initiated last year, starting with the February 2018 Budget and 3Q, when tariffs were imposed on over 50-60 goods. Further increases followed in July 2019 Budget, including items like tiles, metals fittings, cashew kernels, CCTV camera etc., while customs duty exemptions on others were removed. Add to this, tariffs were raised on 28 products imported from the US, in June 2019, including products like almonds, pulses etc.

Worried over potential dumping by trading peers owing to the trade war, India continues to initiate investigations within the WTO framework to implement temporary tariffs under the Agreement on Safeguards. In addition, additional policies to support affected sectors have also been extended, by way of subsidies to agriculture and support to state owned enterprises additional policy actions. **The table below and in the Appendix provide a comparative picture of tariffs vs peers and across different import groups.**

Trade Weighted Average MFN applied tariff (imports profile)

	All	Agri	Non-agri
Brazil	10.0	13.0	9.8
China	4.8	11.8	4.3
India	11.7	63.0	8.2
Indonesia	5.4	5.5	5.4
Korea	8.1	79.3	3.9
Malaysia	3.8	8.6	3.4
Philippines	5.7	10.6	5.1
Thailand	5.3	16.8	4.6

Source: WTO, DBS

On the policy front, India has been hesitant to join multilateral trade agreements. More recently, this includes the Regional Comprehensive Economic Partnership (RCEP) – comprising of 10 ASEAN countries and their six free trading agreement partners – India, China, Australia, New Zealand, Japan and South Korea.

As India runs trade deficits with two-third of these economies, it is seeking stricter terms of trade and preset conditions. Few points of contention include India's suggestion for an auto-trigger mechanism as a safeguard measure, under which levies can kick in once imports cross a certain threshold. Other differences include a) proposed inclusion of the controversial investor-state dispute settlement (ISDS) in the pact by members like Japan and Singapore (India does not wish for its domestic laws to be challenged by international tribunals), b) strict rules of origin (ROO) clause to stop third country imports (to prevent dumping), c) better offers in services and extend protection to a number of sensitive dairy and farm items and industrial goods. Other RCEP members are keen to conclude talks by end-2019 and bring it to fruition thereafter. India is likely to approach this and more such multilateral trade agreements with caution, in a bid to also protect its domestic industry from intense global competition, especially low prices and excess supplies.

While these protectionist measures are understandable, it might also benefit India to lower some of its barriers at a time when the global players seek alternative trade and investment destinations across the region. Domestically as well, ad hoc tariff increases not only run the risk of inverting the duty structure but also introduces inefficiencies for the local industry.

5. Increasing influence of CNY movements on the Indian rupee

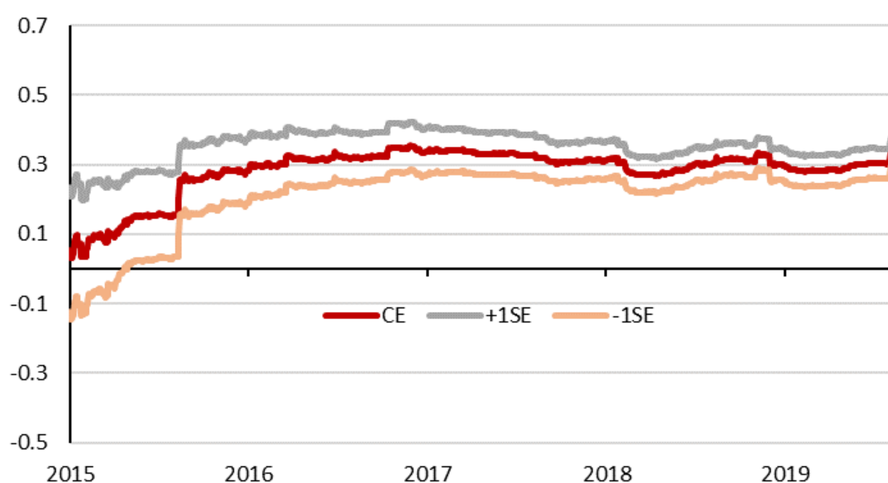
After a stable 1H19, the Indian rupee has weakened more than 4% vs USD in 3Q, under pressure from broad US dollar gains. We also note the rising influence of the Chinese yuan's movements on the Indian rupee, with a sharp rally in the USDCNY past 7.0 last month, contributing to USDINR testing past the 70-71 mark. We conducted an empirical study to assess if there is indeed a linkage between the CNY and INR, compared to other G3 counterparts. To neutralize a one-sided bias, we base all key currencies (INR, USD, EUR, JPY and CNY) on a common base currency i.e. Swedish Krone. Using daily data over the past five years, we regressed the data to establish correlations. We make the following observations:

a) US dollar dominates INR's direction. While linkages are still strong, the coefficients have moderated since 2015

b) Ties with the EUR are weak, while slightly negative with the JPY

c) Prior to 2014, linkage with the CNY was weak to negligible. The relationship began to tighten since 2015, particularly since the CNY's one-off devaluation. Since then, correlation has risen to 0.33

CNY and INR on common base currency: Standard error bands around the coefficients



Source: Bloomberg, data transformations are by DBS Group Research

While the US dollar direction is still the main driver for the rupee, yuan's influence is rising. Intuitively some of this might also be tied down to the Chinese authorities' efforts to keep the CNY movements close to the AXJ peers. Our FX Strategist has pegged the CNY direction

to the level of tariff increases, expecting the USDCNY to rise to 7.2 by end year (and higher if tariffs are raised aggressively), which leaves the door open for further weakness in the INR.

Constructive domestic policies necessary

As a counter to tough global conditions, domestic policies will have to constructive to revive demand. Righty so, the Indian government announced several sector specific measures recently (see here). This marks a coordinated policy response, after the central bank lowered rates by 110bps so far this year (see here and here), in response to a slowdown in the past four quarters and growth slipping to 5.8% YoY at the start of this year.

Policy intervention is directed at breaking the cycle of weak sentiments amplifying weak activity. These measures are timely as the government looks to reverse the cyclical slowdown in certain sectors that are under stress. With most of these steps concerned with streamlining existing measures, clearing credit blockages and expediting already announced measures, fresh fiscal costs will be limited. While they have steered clear of broad-based fiscal stimulus, the odds for fiscal support will rise if growth risks turn starker in second half of the year and into 2020.

These measures will help improve sentiments and buoy economic activity, but we continue to see 30-40bps downside risks to our full-year growth forecast. Consumption is midst of a weak patch, along with soft private and public investments (due to elections in 1H19) and sub-par services sector. 3Q growth is also likely to stay weak but stabilise as government spending resumes after the elections. An accommodative monetary policy stance accompanied by a jumpstart in the transmission process is also expected to lower lending rates.

Notes:

[1] Working paper 332; Domestic Value addition and Foreign Content: An Analysis of India's Exports from 1995 to 2011; ICRIER; January 2017

[2] UNCTAD; 2018; Key Trends Trade Policy

[3] A.T. Kearney.com, Foreign Direct Investment Confidence Index, 2019

Appendix

Tariffs and imports by product groups

Product groups	Final bound duties	MFN applied duties	Imports
	Avg	Avg	Share (%)
Animal products	104.5	32.5	0.0
Dairy products	63.8	34.8	0.0
Fruits, vegs, plants	101.1	32.4	1.8
Coffee, tea	133.1	56.3	0.1
Cereals & prep	114.1	37.1	0.4
Oilseeds, fats & oils	165.1	54.1	2.9
Sugars and conf	126.2	51.5	0.3
Bevs and tobacco	120.4	74.7	0.2
Cotton	110.0	26.0	0.2
Other agri prods	105.6	29.0	0.5
Fish & products	135.7	30.0	0.0
Minerals & metals	38.3	11.0	33.9
Petroleum	-	9.2	19.8
Chemicals	39.6	10.1	10.6
Wood, paper etc.	36.4	10.0	2.0
Textiles	27.1	20.7	1.2
Clothing	37.7	20.5	0.2
Leather, footwear etc.	34.6	12.1	1.0
Non-electrical machinery	28.6	7.8	8.3
Elec machinery	27.8	8.8	10.4
Transport equipment	35.7	31.1	3.3
Manufacturers nes.	33.5	11.1	2.9

Source: WTO, DBS

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Sources: Data for all charts and tables are from CEIC, Bloomberg and DBS Group Research (forecasts and transformations).

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