INDIA & JAPAN: Co-creating the Future

Relations between India and Japan have entered a qualitative new phase with Prime Minister Manmohan Singh's visit to the Land of the Rising Sun in mid-December 2006, writes **N. Chandra Mohan**

Executive Summary

Indo-Japan relations entered a qualitative new phase with Indian Prime Minister Manmohan Singh's visit to the Land of the Rising Sun in mid-December 2006. The tone and tenor of his meetings with his Japanese counterpart, Shinzo Abe clearly indicated that the new relationship would go well beyond steps to improve economic cooperation and engineer a transformation in the strategic aspect of the bilateral relationship. Shinzo Abe, Japan's youngest-ever Prime Minister has written in his book Towards A Beautiful Society, that, he will not be surprised, if in ten years' time, Japan-India relations overtake Japan-US and Japan-China relations. Both countries must translate this vision into reality.

Both countries are seeking a closer engagement with each other.

❖ Large Japanese businesses that staked

out a presence in India are making profits and expanding capacities.

- Decks have been cleared for Japanese SMEs, who are innovation drivers, to come to India in a big way.
- Increasing investments are bound to drive faster growth in bilateral trade.
- Both countries are expected to start working together to realise their common dream of pan-Asian integration.
- Beyond economic cooperation, there is the likelihood of Japan and India partnering to develop Asia's new security architecture.

Introduction

Shinzo Abe's ascendancy as Japan's 90th Prime Minister offers the most favourable conjuncture for radically transforming India-Japan relations. He wants to start on a different footing with India to leverage the immense possibilities of bilateral economic cooperation. As Japan shares universal values such as freedom, democracy, human rights and the rule of law with India, he has unfolded his vision of integrating the latter into the New Asian Order — a broad coalition of democracies in the region.

Manmohan Singh, for his part, too is a visionary like Shinzo Abe and economic diplomacy is his forte. While addressing the 3rd India-ASEAN business summit in Delhi in October 2004, he outlined his vision of a pan-Asian community encompassing ASEAN, China, Japan, Korea and India rivaling NAFTA and EU. Such a bold conception is bound to strike a deep chord in Japan that similarly conceives of a vast East Asian economic free trade zone that includes China, India, ASEAN, Australia, Japan, New Zealand and South Korea. Towards this end, Japan has proposed starting negotiations in 2008 and concluding a pact by 2010.

Economic Co-operation

To be sure, there is a vast agenda before Japan and India on economic cooperation.

For long, there has been only talk of the immense potential of India; that the level of Indo-Japanese trade and investment is still very far from tapping that potential and so on. Looking to the future, Abe wants this state of affairs to change drastically. The India of ten years ago is not the same India ten years later. If the Japan-India relationship is to blossom and overtake that of Japan-US and Japan-China in ten years' time, this vast potential must be harnessed. For starters, Japan's gaze must firmly turn towards India.

Japan, the world's second largest economy, and India, the world's fastest-growing free market democracy, have similar concerns about the rise of China and its implications for the New Asian Order. From the point of view of Japanese business, however, the present context is ripe for reworking their strategies towards India. The current prospect, in fact, is one where 90 per cent of multinationals (including Japanese) are making profits in India when compared to 45-50 per cent in China.

Many MNCs are also reporting higher profitability in India than they do globally, according to the Boston Consulting Group.

To tap the unfulfilled promise of their bilateral relationship, both Japan and India must exploit their natural synergies and complementarities. Japan is a "hard" power with world-class manufacturing prowess. India is a "soft" power in IT and services. Japan must look closely at collaborations with India in this field. Japan is short of natural resources. India has abundant raw materials. Japan has capital. India's strength is the availability of a skilled workforce with a strong engineering and scientific capability and not just low wages. Japan seeks markets. India has a flourishing domestic market.

When Abe talks of universal values that both nations have in common, this includes a strong commitment to quality. India today bears, in fact, the strong imprint of Japan's influence in this regard. None other than Hiroshi Okuda, former chairman of the world's biggest car company, Toyota Motor Corporation, who led a Keidanren delegation to India last year, stated that "India and Thailand are growing fast because of their focus on quality in manufacturing", adding significantly that they soon would "overtake Japan if Japanese companies do not pay attention to quality."

To buttress his statement, Okuda mentioned that despite appeals at the highest levels to devote greater attention to quality, Japanese companies are not interested in winning awards like the Deming prize while the total quality movement (TQM) was spreading fast in India and many companies are winning this coveted prize. When he headed the Deming award committee, three Indian companies were among the six Deming awardees. Okuda lamented that no Japanese company has won this award of late! Ever since the Deming award was constituted, Indian companies have won 15 out of 30 such prizes.

The TQM movement in India is an enduring legacy of Japanese involvement in India since the early 1980s. It was fostered by the dedication of gurus like Hajime Ishikawa, Yoshikazu Tsuda and Shoji Shiba through the good offices of the Confederation of Indian Industry that started a TQM division way back in 1988. Clusters of 8-14 enterprises were formed in which they shared mutual experiences and learnt together in order to improve their performance. From modest beginnings in Nashik in the state of Maharashtra, 65 clusters now operate all over the country to internalise TQM.

The sea change in Indian manufacturing during the last ten years is basically driven by this commitment to quality, cost and delivery. The engineering industry in the country has seen the development of strong support industries in the form of capital equipment and tooling manufacturers and a credible and mature supplier base has emerged — from which many have become world-class companies with global aspirations in their own right. Japanese MNCs who have not treated India as a global sourcing and manufacturing hub can thus develop India as either a dominant sourcing hub or alternative to China.

Toyota itself happens to be one of the

beneficiaries of the new India as it could roll out its first vehicle within 18 months with 75 per cent local content — the fastest implementation as yet amongst its overseas plants! The company has major stakes in India's booming car market and has plans to rollout a small car to take on Suzuki's entry-level model. The factory in India, slated to open in 2009 at the earliest, will have the capacity to produce 150,000 low-cost cars a year. Indications are that India would be the first country to produce that car, much before Toyota expands its car production all over the world.

Similarly, the Suzuki-controlled Maruti Udyog Ltd is also stepping up its investments in a big way. This company, which expects to sell 650,000 cars and is aiming at a million in sales by 2010, is, in fact, the flagship venture of Japanese collaboration with the government of India. At a time when few businessmen from his country dared to venture into the Indian economy, Osamu Suzuki was the first to enter into a joint venture with the government as a minority partner in the early 1980s. At present, this company is one of the most successful and profitable among the various Japanese businesses in India.

It was the advent of Suzuki that triggered the automobile revolution in India with its hatchback model. This became India's Volkswagen — people's car — that symbolised the Great Indian Middle Class Dream. Being the lowest priced small car in the world, it brought car ownership to the reach of the urban salariat, including working women. Riding on the success of the Maruti-800, the company acquired and still retains a position of dominance in India's car industry, with a market share of 50 per cent. The government also decided to exit the auto business and allowed Suzuki to gain control in 2003.

Being a flagship Japanese venture, the vicissitudes of Suzuki's experiences — frictions in doing business in India — naturally became the barometer of the India-Japan relationship. The experience of such ventures is crucial in sending signals back home that India is or isn't a good place to invest. Japanese business had a good excuse to sit on the wall so long as the Indian government faced off with Suzuki in the late 1990s over Maruti. The negative feedback was indeed overwhelming. But once its problems finally were resolved, matters dramatically improved for Japanese business in India.

More importantly, when problems of a flagship venture blow over, it sends an all-clear signal, especially to small and medium enterprises (SMEs) from that country. SMEs are typically risk-averse, as they cannot absorb the setbacks that bigger companies perhaps can. They are technology and innovation drivers and typically are family-owned. Which is why they keep putting up a lot of conditions and queries before they foray into unknown and distant markets. These include the sanctity of contracts; intellectual property rights regimes in the country — patents, trademark, and copyrights — among other things.

Now that Suzuki's problems are a thing of the past, the decks have indeed been cleared for SMEs from Japan to come to India in a big way. For instance, the Japan External Trade Organisation has already set up a Business Support Centre that should help Japanese SMEs launch their business in this country and seize the booming opportunities across a wide range of industries such as chemicals, textiles, R&D, biotechnology and food processing. Tapping the innovation of Japan's SMEs is a major agenda for the Japan-India relationship in the future.

At a different level, the resolution of Japan's flagship venture's woes in India has also resolved another bogey fostered by quite a few studies. Notably, that foreign direct investment from, say, American firms were observed to have a more positive and significant impact on export-intensities of India's non-traditional sector when compared to investments by Japanese firms. This may have been true to some extent in the past. But if Suzuki's example in India of late is any indication, this might well not be true at present or in the future.

Maruti is fast becoming the global hub for the Japanese parent's small car manufacture as it will soon turn out more passenger cars than the 705,190 cars made by Suzuki's factories in Japan last year. As an integral element of this MNC's global strategy, Maruti's latest best-selling model, the Swift, also happens to be its first car to be launched in India only a few months after its debut in Japan and Europe. Besides exporting cars to Europe, Suzuki also plans to increasingly source its component requirements worldwide, including diesel engines, from Maruti's facility and vendors.

This is the way forward for other Japanese MNCs as well, especially those who have built up considerable volumes in their joint ventures in India. Honda is a case in point as its joint venture with the Munjal Group expects to sell roughly as many motorcycles in India as it sells in Japan. With such tremendous growth in volumes, exports and sourcing of components that are of the most demanding engineering specifications are bound to figure in its calculations. The upshot is that more foreign direct investments from Japan will be export-intensive as well.

Reflecting the growing self-confidence of Japanese business in India, Nissan recently decided to dump its alliance with Suzuki to manufacture cars. Nissan and Suzuki had earlier agreed in June 2006 to broaden their business plans to include the use of each other's manufacturing facilities in India. Japan's second largest car manufacturer — in which Renault has a 44 per cent stake — which has since decided to team up with India's Mahindra and Mahindra. Carlos Ghosn, head of both Renault and Nissan, has said the India move must succeed if Renault is to hit its 2009 output goal of 800,000 vehicles.

Thanks to the booming fortunes of Japan's flagship venture, more and more Japanese businesses are ramping up their capacities. Besides Toyota, Mitsubishi

Chemicals is also expanding its capacities to produce purified terephthalmic acid. Honda, too, is thinking of growing its presence notwithstanding an industrial relation problem at its facility last year in the state of Haryana. If this incident had happened any time during the 1990s, when Japanese were debating whether or not to come to India, it would have given them just the excuse not to stay put. But times are now a-changing, thanks to China.

All these current plans aggregate to investments of $600 million per annum over the next three years but still represent only a teeny-weeny fraction of Japan's exposure to China and the Association of Southeast Asian Nations (ASEAN). For all the talk of investment plans, India accounts for less than 4 per cent of the 4,100-odd Japanese companies worldwide while more than a half of them do business with China. For a sense of perspective, the cumulative actual Japanese investments in India so far are less than their investments in China in a single year - but this is a love affair that is rapidly souring.

For more Japanese investments to head towards India, both countries must harness their synergies and complementarities. Japan's investments in China are partly of a defensive nature. In the two-wheeler industry, for instance, Honda, Kawasaki and Suzuki are forced to invest in the mainland to stop Chinese two-wheeler manufacturers from dominating the country's market with their knock-offs! Japan's rising investment profile in India now and in the future is somewhat different as it reflects their growing confidence in a strategic partner who shares common values of a strong commitment to quality.

The ultimate synergy, of course, is when the "hard" power trucks with the "soft" power beyond the hubs and global sourcing requirements in manufacturing. This will be in the area of services where India is a major global player as a knowledge power. More than 150 MNCs have already set up R&D facilities in the country to tap its pool of 157 scientists and engineers per 1,000 persons. But Japan has 30-times more such skilled people and it will be truly befitting if it becomes a partner and shares its expertise with India in high-end R&D by shifting some of its facilities to the country in the future.

Trade naturally follows investments. China gets more Japanese FDI and its trade with the Land of the Rising Sun also rises in tandem. Japan's investments, in fact, are 30 times higher than its exposure in India. Japan's trade with China is also 30 times higher than its two-way trade with India. Is it therefore any surprise that the low levels of Japanese investment in India translate into below par levels of bilateral trade as well?

However, considering the rapidly changing investor perceptions in favour of India — Singh's visit resulted, for instance, in an agreement to develop an industrial corridor along the Delhi-Mumbai multi-modal freight corridor — big-ticket Japanese investments are likely and bilateral trade is bound to explode beyond current level $6.5 billion.

The Pan-Asian Vision

While the Doha Round of WTO multilateral trade negotiations miss crucial deadlines and head for failure, there is a veritable stampede in signing regional or bilateral free trade agreements (FTAs). The Asian region, for instance, is witness to a rapid proliferation of such trade agreements - 81 such agreements are in existence, with over 100 being either proposed or under negotiation according to Haruhiko Kuroda, president of the Asian Development Bank. The fact is that they are no Promised Land either for Japan or India, for that matter. This only deepens their yearning for a wider pan-Asian agreement

These agreements form an unruly mass of criss-crossing strings that Kuroda called a "noodle bowl" that hamper rather than facilitate free trade, especially for those left out. Such FTAs entail different rules of origin and preferences that benefit only member countries. But whether the trade creation for such member countries is welfare-improving for their stakeholders like farmers and industry, however, is a different matter. According to him, they pose greater challenges for harmonisation and broader regional stability as they fragment the efficient global supply chains that have evolved in the region.

Why then did both countries ink bilaterals in Asia? There is no doubt that it was their common pan-Asian vision to forge a regional bloc rivaling the EU in terms of income and the Nafta in trade that was largely responsible. With the shadow of China looming over Asia, both countries also felt that they had to defend their turf by concluding agreements with countries in the region like Thailand and Singapore. But the big problem both Japan and India face is that the building blocks to realise this vision are of varying size and shape that might prove to be stumbling blocks to this process.

India, for its part, also signed these bilaterals as it was extremely frustrated by the slow pace of regional integration in its neighbourhood. BIMSTEC or the Bay of Bengal grouping of Bangladesh, India, Myanmar, Sri Lanka and Thailand thus appeared alluring, thanks to the ongoing tensions between India and Pakistan that have virtually put paid to cooperation, if not integration, in South Asia. Besides an FTA with Thailand, it signed a comprehensive economic cooperation agreement (CECA) with Singapore and is now finalising one with ASEAN. The ones with Thailand and Singapore are in operation

India's experience so far with such bilaterals is highly instructive as they have entailed trade-offs between macro and micro objectives, between political and strategic economic considerations. Accordingly, it is felt that any scrutiny of their overall cost-benefits for the country must also give adequate attention to the cost-benefits for farmers and industrialists; as to whether more effective domestic policy measures need to be adopted to protect the interests of such stakeholders if they are affected. The Indo-Thai FTA, in particular, also has the potential to cast a shad-

ow over the warming Indo-Japan relations.

For starters, India Inc's ambivalence over the Indo-Thai FTA has been fueled in large measure by the skewed pattern of trade in favour of Thailand after the agreement came into effect in September 2004. The recent trade numbers indicate, in fact, that much of the gains have accrued to Thailand for the 82 items that form part of the Early Harvest Scheme, which includes items like auto parts and electronic goods. During 2005, Thailand's exports to India rose by 71 per cent, while India's exports fell by 33.8 per cent - which was a sharp reversal from an earlier situation when India registered surpluses.

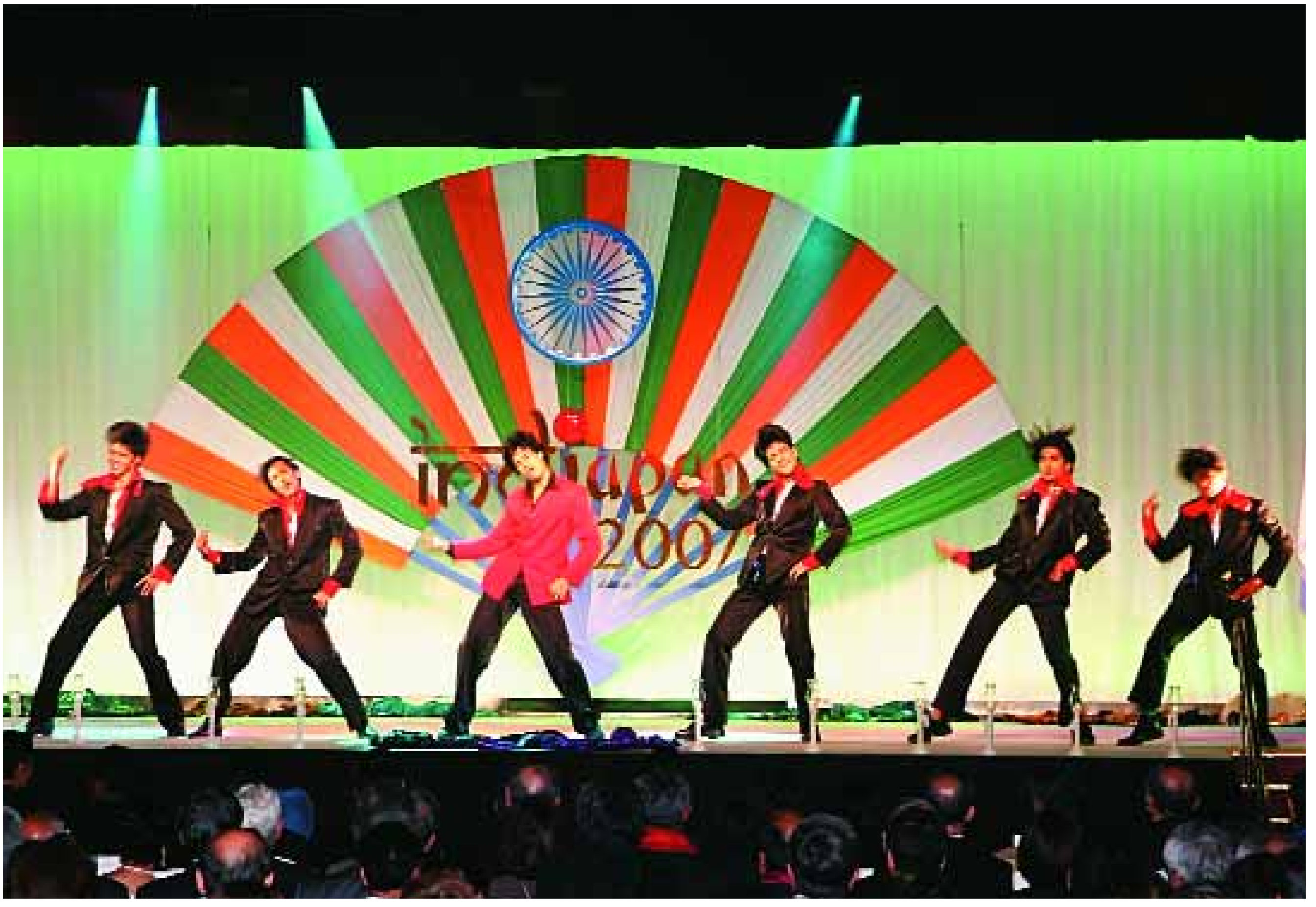
From a broader perspective, there are concerns over the prospect of diversion of foreign direct investments as a consequence of such bilaterals, especially from Japan; that the major beneficiaries of its investment shift away from China are likely to be Thailand and ASEAN rather than India. This possibility of investment diversion is why certain segments of India's automobile and consumer electronics industry oppose the Indo-Thai FTA as they fear that Japanese companies will increasingly use bases like Thailand as a staging ground for their assault on the Indian market.

India Inc is similarly ambivalent about the CECA with Singapore. Here again, its fear is that foreigners (read China) will misuse such agreements as a base for cheaper exports to India. They consider the city-state to be mainly a trading rather than manufacturing hub although it has 4,000 plus MNCs operating in that country. Although the CECA allays these concerns with clearly laid out rules of origin or value addition norms of 40 per cent, India Inc's doubts nevertheless still persist. But it is expected that they will ease somewhat when these bilaterals get into full stride.

Notwithstanding such transitional problems, both Japan and India are determined to press ahead with pan-Asian integration. In April this year, Japan formally proposed the formation of a vast Asian economic free trade zone that would cover about half the global population and rival the EU and Nafta. The 16-nation zone would include China and India, the world's two fastest growing major economies, along with the 10-member ASEAN, Australia, Japan, New Zealand and South Korea. Japan has even proposed a concrete time frame for starting negotiations and concluding the pact.

Japan's proposal drew a positive response from Thai businessmen who welcomed the idea of an East Asian Free Trade zone to integrate economies in the region, but they were sceptical about whether the former would liberalise its sensitive agricultural sector. If Japan's idea came to pass, it would help countries in the region overcome the "noodle bowl" effect of proliferating bilateral free trade agreements with different trade rules. It is worth noting that the ongoing negotiations for a Thai-Japan economic partnership agreement exclude Thai farm produce such as rice, sugar and tapioca.

India, for its part, has no problems with Japan's proposal in principle as the crucial



building block towards this end is ASEAN. As Kuroda — whose views accurately reflect the Japanese standpoint — puts it, " intra-ASEAN integration is crucial for pan-Asian integration. ASEAN represents a sizeable economic entity in Asia with a combined GDP of $861 billion and total trade of $1 trillion in 2005." Consequently, he welcomed the formation of an ASEAN economic community to create a common market by 2020, which has since been fast-forwarded to 2015.

Simply put, Japan's reasoning is that all the major economies of the region, notably, China, India, Japan and South Korea have all signed framework agreements with ASEAN. Negotiations are also on with Australia and New Zealand. "As a result, ASEAN is potentially well placed to minimise the "noodle bowl" effect of proliferating FTAs by providing a feasible opportunity to formulate an ASEAN + 3 (China, South Korea and Japan) and even a Greater East Asian FTA that embraces ASEAN + 3, India, Australia and New Zealand", argued Kuroda. This is indeed Japan's roadmap for pan-Asian integration.

With Manmohan Singh sharing a similar vision, India naturally is bound to go along with Japan's proposal. But the challenge that the government faces is to overcome apprehensions to its agreement with ASEAN, especially as the stakeholders concerned are farmers in politically sensitive states. Here again, trade-offs are involved between political and strategic economic considerations - whether to proceed ahead with such FTAs even if they do not translate into electoral support in states like Kerala as against significant macro-economic benefits for the country as a whole

Mention thus is made of the problems being faced by that southern state's plantation economy being buffeted by imports of spice and plantation products from ASEAN routed through Sri Lanka which has an FTA with India. Similarly, while palm oil is being imported into India at a duty of 80 per cent, the finished product enters duty free and so on. Here again, both India and Japan face similar problems. The latter, too, is similarly sensitive to freer imports of agricultural imports into the country such as rice, sugar and tapioca from major exporters like Thailand.

In the face of such daunting odds, realising the larger pan-Asian vision is indeed the challenge before India and Japan. When Abe and Singh met in Tokyo, they also agreed to initiate negotiations to ink a Comprehensive Economic Partnership Agreement that will perhaps address some of the concerns of India Inc raised in connection with the distortions of the Indo-Thai FTA. It is also expected that Japan will support India's bid to become a member of the Asia-Pacific Economic Forum. But these are mere stepping-stones to a larger reality in which the entire Asian region gets integrated.

As Singh noted, this larger pan-Asian integration is an idea whose time has come — "of an integrated market, spanning the distance from the Himalayas to the Pacific

Ocean, linked by efficient road, rail, air and shipping services. This community of nations would constitute an 'arc of advantage', across which there would be large-scale movement of people, capital, ideas, and creativity. Such a community would be roughly the size of the EU in terms of income, and bigger than Nafta in terms of trade." This is a bold vision that both Japan and India share in common and must strive together to achieve in the future.

Regional Security Architecture

Beyond economic cooperation, Abe also plans to integrate India into the emerging security architecture of Asia. This is bound to radically transform the global partnership between the two countries, extending to uncharted areas of maritime defence, diplomacy and energy cooperation. The groundwork for this objective has already been laid earlier this year with the high-level visits to India of Admiral Takashi Saito, chief of Japan's Maritime Self-Defence Force, General Tsutomu Mori, head of Japan's Ground Self-Defence Force and General Tadashi Yoshida, chief of Japan's Air Self-Defence Force.

These visits of Japan's service chiefs represent the most intensive security-related interactions Japan and India have had to date — a process that went much further when the then defence minister of India Pranab Mukherjee visited Japan, China and Singapore in May 2006. Both Japan and India expressed their "determination to pursue cooperation" in the defence and security domain to promote "stability and prosperity in Asia and the world at large". Some of the shared objectives included the objective of "contributing to the safety and stability of regional maritime traffic", among others.

Just like Japan, India, too, is having a renewed focus on protecting its maritime interests, especially in the Indian Ocean. This was indeed the objective of Admiral Saito's visit - notably to discuss on how better to ensure safety at sea as also to promote good relations between the navies of Japan and India. This deepening of security cooperation with Japan (among other nations as well) clearly signals the emergence of a regional security strategy befitting India's rising power status. India has been tremendously beefing up its navy of late to make up for what it considers the security deficit in the Indian Ocean.

Energy is at the heart of what Abe has in mind for involving India in the regional security architecture in Asia. As Japan totally depends on imports for all its requirements for oil and gas, there appears to be a profound rethink going on in that country regarding the strategic importance of energy; that Japan has been found lagging behind the changes occurring in the rest of the world in which "quarrels between countries or players in the energy market are now complicated by the fact that matters such as defence, economic and trade policies, environment and education become entangled in energy problems."

The above quote is from a high-profile

report "The establishment of an international energy security system" prepared by The Policy Council of the Japan Forum on International Relations, which went on to make recommendations as to how Japan can better respond to the threats to its strategic interests in energy. Significantly, this report noted "India is in a unique position of being capable of serving as a bridge between the oil-consuming nations of East Asia and the oil-producing nations of the Middle East, and in that respect needs to be emphasised as a partner in the area of energy cooperation."

From a maritime cooperation perspective, therefore, the strategic requirement that is uppermost in Japan's mind is to basically ensure the security of energy transport routes, including the problem of safe passage through the Straits of Malacca — which carries half of the world's oil and a third of global trade. India, which also depends on imports for 70 per cent of its requirements of oil, shares these imperatives with Japan. The country has, in fact, already geared up to this crucial challenge of ensuring the free flow of oil and trade between the Middle East and the Asia-Pacific through the Indian Ocean.

> Intra-ASEAN integration is crucial for pan-Asian integration.

The Indian Navy, for its part, has already held joint patrols with the Sri Lankan, Thai and Indonesian navies as a crucial instrument of the country's Look East policy of ensuring maritime safety in the Indian Ocean, including the Straits of Malacca. It has held combat exercises with the American, Russian and French navies. Japan now joins the list of 18 such navies that it is interacting with: Goodwill exercises between the Indian Navy and Japan's Maritime Self-Defence Forces thus will be held, graduating to "future possible exercises in areas of mutual interest" of a "progressively advanced nature".

There are no prizes for guessing what these areas of mutual interest are! Towards this end, Abe (a self-confessed Indophile) unfolded his vision of integrating India into the New Asian Order, comprising a broad coalition of democracies in the region, in his meetings with Singh. This relationship thus will be many-sided and go beyond the narrow focus on only improving bilateral economic cooperation. Singh's visit thus was a highpoint of sorts that presages a deep-going transformation in the strategic aspect of a bilateral relationship - much like Sino-Japanese relations blossomed not so long ago.