

# Policy WATCH

Volume IX, Issue 5  
May 2020, New Delhi

## India's Place in the World

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RAJIV GANDHI  
INSTITUTE FOR CONTEMPORARY STUDIES

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# Editorial

The Rajiv Gandhi Institute for Contemporary Studies (RGICS) works on five themes:

1. Constitutional Values and Democratic Institutions
2. Growth with Employment
3. Governance and Development
4. Environment, Natural Resources and Sustainability
5. India's Place in the World.

Under the theme, India's Place in the World, there are three sub-themes:

- i. India's Neighbours - China, SAARC and ASEAN - Trade, Investment and Cultural Relations
- ii. The Global Rise of Right Wing Populism - Its Impact on India
- iii. Can Soft Power Enhance India's Place in the World

This issue of Policy Watch is on the theme India's Place in the World and it focuses on the first sub-theme - India's Neighbours - China, SAARC and ASEAN - Trade, Investment and Cultural Relations, with three articles on China, one on SAARC and two on Bangladesh.

The first article on China is an interview with Dr Santosh Mehrotra, Professor of Economics at the JNU, in which he discusses how starting 1978, when India's per capita income was higher than China's, India steadily lost ground. He links it to the economic policies adopted by China and the adroit political management of the transformation of the Chinese economy. This reproduced courtesy Mr Anil Nair of the Policy Circle. The second article summarizes a year-long study by RGICS Senior Visiting Fellow Mona Dikshit on China and India's Trade and Investment relationship, particularly the way forward. She concludes that despite the geo-political rivalry between the two countries, India and China will see increasing levels of bilateral trade and investment. The third piece is an excerpt from Manoj Kewalramani's Eye on China, courtesy The Takshashila Institution, which describes the ongoing tensions on the India-China border in eastern Ladakh, and delves into the background issues behind these tensions.

Prof Partha Ghosh, formerly Professor of South Asian Studies at JNU, and now a Senior Visiting Fellow at the Institute for Social Science, writes on SAARC and traces out the unenviable track record of this formation, which he says is marred by strategic incongruity and power asymmetry. He ends by suggesting a possible way to make the formation more effective.

We carry three articles from Bangladesh – the first by Prof Rashid Titumir of Dhaka University on how the Covid crisis is impacting this neighbor of ours and the second, specially written for Policy Watch by Mr Humaiun Kobir, Secretary for International Affairs, National Executive Committee, BNP, on where do Bangladesh-India relations sit post-COVID19? The last article is an assessment of the impact of Covid on the macro-economic as well as the household micro-economy of Bangladesh, put together by Feisal Hussain of Nathan and Think Ahead Consulting.

We hope you enjoy reading these articles. We look forward to your feedback.

**Vijay Mahajan, Director,  
Rajiv Gandhi Institute for Contemporary Studies**

# How India lost out to China, rest of Asia in development race

Interview with Economist Prof Santosh Mehrotra, Jawaharlal Nehru University

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Anil Nair



*India is facing an unprecedented economic crisis. The world's fifth largest economy was suffering from a demand slump when the new coronavirus pandemic struck. The lockdown announced to stop the pandemic from spreading has virtually stalled the economy, which is facing a recession and a jobless rate unseen since independence.*

**Reviving Jobs: An Agenda for Growth** (Penguin), a book edited by **Prof. Santosh Mehrotra**, traces the current crisis through the history of India's industrialisation. In an interview with Policy Circle's **Anil Nair**, he explains how the Asian Miracle eluded India. Second part of the edited excerpts:

**When the Narendra Modi government came to power, it talked about stepping up manufacturing. It launched the Make in India initiative. During the US- China trade tension, lot of people expected companies to shift base to India. But such companies went to Vietnam, Bangladesh and Mexico. What is stopping India from becoming the manufacturing hub of the world?**

There is a long list of impediments that are stopping us. Since 1991, for almost 30 years, we didn't have an explicit industrial policy. Let us remind ourselves that all East Asian countries including China had industrial policies in place — and within it a specific manufacturing strategy. That we didn't have a manufacturing strategy meant that while manufacturing has grown in India in absolute terms, it did not become the lead sector in our economy. By lead sector, I mean a sector that grows faster than the rest of the economy. Therefore, it can actually drive the overall GDP growth, as manufacturing did for East Asia.

In 1991, the share of manufacturing in India's GDP was 16-17%. Thirty years later, it still contributes the same percentage of the national output. The sector provided employment to 10.5% of the entire 380 million workforce in 1993. Most manufacturing was done in the unorganized sector. Even after 30 years, the share of manufacturing in employment remained at 11.5%. Over a 15-year period, the employment share increased by just one percentage point. It rose between 2004-5 and 2011-12 when it peaked at 12.8%. Had we maintained that trajectory, manufacturing employment would have been in the region of 15-16% of the workforce now.

### **Does the stagnation in Industrial activity coincide with China's rise as a manufacturing power?**

Absolutely. China went on a trajectory set by the National Development and Reform Commission, which was an institution like the Planning Commission we had till 2014. China became the factory of the world since the 1990s. India has had a decline in the number of people employed in manufacturing sector since 2012, despite policies like Make in India. In the six years from 2012, number of manufacturing jobs fell by 3 million, a first in India's history. The sectors that contributed to the decline in manufacturing employment were precisely the sectors that you would want to see growing. These are the labour-intensive sectors that contribute half of the total manufacturing employment — textiles, garment and apparel, wood and furniture, food processing, and finally leather and footwear. Unfortunately, the policy environment for none of these sectors are encouraging. This has led to a decline in manufacturing employment. Compare this with Bangladesh where the share of manufacturing in total employment is 16%. So, we don't even measure up to Bangladesh now.

There is a lot of excitement in India about 1,000 companies planning to leave China. Of the companies that have decided to leave China, only three are coming to India while most are going to Vietnam and elsewhere. Why is the manufacturing sector not growing in India? My new book, *Planning in the 20th Century and Beyond*, published by Cambridge University Press, explains what should be the components of a manufacturing strategy. Let me say a few words about that now. One reason why India is not seen as an attractive destination for FDI compared to Vietnam, Indonesia or Philippines is poor hard infrastructure. But soft infrastructure comprising regulatory institutions and human capital is equally important.

The educational level of the workforce in India is really poor. That has been historically true for nearly 60 years since Independence. That has begun to change only recently. We universalized elementary education by the end of the first decade of this century. Secondary enrolment shot up from 58% in 2010 to about 80-85% by 2015, both among boys and girls. Tertiary enrolment also shot up from 11% of 19-23 year olds to 26% between 2006 and 2016y. The problem is in the quality of education, and

that has been very low compared with China, Vietnam and Indonesia. In addition, they had an explicit industrial strategy for 30 years, and we didn't.

The second difference is that they had a technical and vocational education strategy. For almost 60 years since Independence, until the beginning of the Eleventh Five Year Plan in 2007, we had neglected skill development. The Eleventh Plan was the first document that had a separate chapter on skill development. Then, the government expanded capacity certainly, but the capacity expansion was itself not sufficient; it did not lead to an improvement in the quality of skill delivery. Importantly the expansion of capacity also happened in general education. It resulted in a precipitous decline in quality, which was not very high in the first place. Contrast this with East Asia where they had an education and skilling strategy aligned to the industrial policy. Here, we neither had an Industrial policy, nor an effective skilling plan, let alone quality.

Problem number three is again historical. In the Second Five Year plan, we adopted a strategy of import substituting industrialization, which was focused on heavy industry. There was a particular twist in our strategy that is not reflected in the Mahalanobis model. The Second Plan focused on heavy industry first in the public sector. That was not going to generate jobs. I'm not questioning the second plan strategy. What I'm questioning is what became a corollary of that – agriculture that had received a fair amount of attention in the First Plan went out of favour. As a result, the output and incomes in agricultural sector grew more slowly. This meant demand from the rural sector, which would have created consumer goods demand for new manufactures, never materialized. We became self-sufficient in food since the mid-1970s, but agri incomes have grown much more slowly than incomes in the non-agri sector. Another problem was that the school system was not expanding, especially in the rural areas.

Female literacy was not growing and this impacted adversely our population growth rate. We were a much smaller population than China in 1947. We were merely 330 million people when China was 500 million. We allowed the population to grow, which was a natural outcome of limited investment in education and basic health services, which included reproductive health, family planning and education of girls. We paid the price for that and have become the most populous country in the world. This is a very serious problem that impacted agriculture adversely because it meant that plot sizes kept shrinking and non-agricultural job growth was slow. When agri productivity and rural incomes are not rising, how could the demand for consumer goods rise? This neglect of education and health had a catastrophic effect on many sectors of the economy. This was one of the reasons why we could not attract foreign investment.

The foreign companies made a beeline for East Asia including China because they had much better levels of education and their workforce was better equipped for manufacturing industry. Our advantage, unfortunately, turned out to be in the services sector, because we invested in tertiary education. The better educated from tertiary institutes got absorbed into services sector. That's how India became a services-driven economy. But there is a limit to the labour absorption capacity of services industry. This is an additional problem.

The fourth reason for stagnation of manufacturing output and employment was also policy-induced. We opened up the economy very fast after 1991. Because of the industrial policy followed from 1956,

there was this practice of reserving products for small-scale industry. This was started because of the focus on capital goods industry that could not create too many jobs. We encouraged small scale industries, khadi and village industries and cottage industries. There was a Gandhian mindset at work along with the Soviet style planning that favoured heavy industry in the public sector. The problem with reserving products for SSIs was that the policy killed the SSI's incentive to grow. This had a distortionary effect on the structure of enterprises in our country.

Let me give you some data. You will be stunned to hear that today in the non-agricultural sector, there are 63 million enterprises or units. No country in the world has such a large number of units. They are all concentrated in the unorganized sector. Of that, 70% are unregistered units. The government is practically not aware of their existence. So, it means that you created a registered SSI sector. But the SSI sector needs a whole network of relationships within local suppliers which generated millions of unregistered micro and nano enterprises. We got caught up in this small-scale industry model. There was no incentive for SSIs to grow because if they became medium-sized, they would lose all the special benefits. So, the reservation of products had a disincentivising effect on firm-size growth and distortionary effect on size structure of enterprises in India.

We were burdened with a missing middle, and even a missing small sector that started disappearing after the economy was opened up to international competition. The SSIs should have been opened up to domestic competition first, before allowing international competition. Faced with international competition, the SSIs mostly collapsed. Today, the size structure of India's enterprises is dominated by micro, unorganized units at one extreme, and large corporates on the other hand. Even in Bangladesh, a garment and textiles company will have anywhere between 4,000 and 5,000 workers. If we don't have that scale, how can we compete in today's world?

From 1956 to 1990, the number of products reserved grew to 836. Right after the reforms were initiated, their numbers began to fall. But when the Narasimha Rao government lost in 1996, the process of dereservation of products lost momentum. The process could restart only after 2005. This was already too late. Eliminating reservation could have taught the enterprises to compete with each other and scale up to medium or large firms. But what did we do? We reduced tariffs and allowed foreign consumer goods to flood the market. Tariff rates were sharply reduced from 150% to 40% by 1998 then further down to 10% by 2002. While the intent was right, the sequence of reforms was completely wrong. So, a lot of these SSIs, even the good ones, got destroyed.

**The Chinese experience was different... They opened up sectors at a slow pace to gauge the impact of the policy...**

Yes. In the 1980s, they allowed their township and village enterprises to grow and generate margins. They continued to create jobs while India's SSIs remained dwarfs. You need to grow in order to improve your margins, create jobs, upgrade technology and enhance productivity. And that is a virtuous circle. We got trapped in a vicious circle of low productivity, low technology, and low earnings – with millions of nano enterprises cropping up. This only led to a mass of poor being created. The Lakdawala poverty line tells us that there were 320 million poor in 1973-74. The number of poor remained at 320 million in 1983-84 and in 1993-94. In 2004, we still had 302 million, just a minor decline. In other words, it's only after 2004-5 that we got fast growth in non-agri employment. Non-agricultural growth rate improved, especially in non-farm labour-intensive jobs.

When construction, industry and services jobs grow fast, people start moving out of agriculture. This whole story is narrated in our book. It explains what mistakes we made and what are the elements of a manufacturing strategy that need to be adopted.

(Santosh Mehrotra is Professor of Economics, Jawaharlal Nehru University, who specialises in labour, employment, and the economics of education. He has been an advisor to the United Nations and the government of India. Kindle edition of the book, *Reviving Jobs: An Agenda for Growth*, the third in Samrudha Bharat Foundation's *Rethinking India* series, is available on Amazon.)

<https://www.policycircle.org/economy/how-india-lost-out-to-china-rest-of-asia-in-development-race/>

We thank Prof Santosh Mehrotra, Mr Anil Nair and the Policy Circle for the permission to reproduce this interview.

## Map of the World's Manufacturing Output



Article & Sources: <https://howmuch.net/articles/map-worlds-manufacturing-output>  
 United Nations Statistics Division - <https://unstats.un.org/>

# India-China Trade and Investment: Roadmap for Growth and Employment in India's Manufacturing Sector

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Mona Dikshit, Sr Visiting Fellow, RGICS

*Editor's Note. The RGICS had been conducting a study on the above topic since early 2019 and the Final Report was written a little before the time that the COVID-19 pandemic broke out. Since March 2020, the sentiment against China has hardened. Thus suggestions of any type of heightened collaboration with China are received with skepticism. This is not the first time we have faced this. For example, even earlier with the Doklam incident, there was a rise in tensions and fall in investments, which turned out to be temporary. Since then, major investments such as the Industrial Parks in Gujarat were cleared and a lot more Chinese funds invested in Indian ventures.*

*Even recently, India has imported medical equipment, N95 masks and personal protective equipment, from China to deal with the COVID crisis. The Indian Ambassador to China, Mr. Vikram Misri said that India plans to resume discussion on "outstanding trade issues" with China once the COVID situation stabilizes. In this spirit, we present the summary and highlights of this study.*

This research study analyses India-China Trade and Investment from both the demand side and supply side. On the demand side, India wants to augment investment in its manufacturing sector for generating growth with employment; on the supply side there is a strong economic rationale for China to trade and invest in India.

## **I India-China Trade: profile and issues**

China is India's 2nd largest trade partner after the USA. It accounts for 5 per cent of India's exports and 14 per cent of imports. There is a serious problem in the area of trade deficit with China which is almost 39% of India's total trade deficit of USD 162 billion<sup>1</sup>.

Some of the key sectors of the Indian economy are critically dependent on China. In 2017-18, almost 60 per cent of India's import requirements of electrical and electronic equipment were met by China, as were more than 75 per cent of the active pharmaceutical ingredients (APIs) used by India's generic pharmaceutical industry. Intermediary and capital goods such as steel, machine parts, chemicals and APIs help India's small and medium enterprises thrive. Many goods of Chinese

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<sup>1</sup> <http://commerce-app.gov.in/eidb/iecnttopn.asp>

origin are components of finished goods which India exports to the rest of the world, pharma and auto ancillaries are important examples.

The broad sectoral trends of the exports of China and India show that for the latest year, manufactured products constituted 55 per cent of India's non-oil exports to China, while the corresponding share of China was as high as 95 per cent. There are deep concerns about Chinese restrictions and industrial policies for market access into China.

Restoring balance in trade relationship with China has been one of India's priorities. Following the Wuhan summit (2017) both sides have engaged in follow up negotiations. These have so far yielded rhetorical commitments and marginal outcomes, but failed to ease fundamental Indian concerns. Policy makers have to find ways to manage this huge deficit given that India can neither limit its economic engagement with China in the short term nor continue such a huge trade asymmetry for long.

## **2 Chinese Investments in India: profile and issues**

China ranks at a low 18th position in terms of cumulative FDI inflows compared to various countries investing in India. For China, India figures only after top 30 FDI destinations countries. In the cumulative FDI equity inflows, 80% have been received since 2014 onwards. China is a relatively late entrant in the Indian market.

Chinese FDI investments estimated in July 2018 range at USD 11-12 billion with ~700 active companies in the market. There is major investment in mobile telephone manufacturing - China brands now account for over 51 percent of the smart phones sales in India. China's venture capital investment in the Indian startup ecosystem grew five times at \$5.6 billion in 2018 compared to \$668 million in 2016.

China's tech giant companies and venture capital funds have become the primary vehicle for investments in the country – largely in tech start-ups. Chinese companies are also catering to Indian retail consumer via e-commerce and physical retail route. This is different from other emerging markets where Chinese investments are mostly in physical infrastructure. In addition, Chinese companies have done well in securing contracts from Government organizations in sectors like electric vehicles, power equipment, infrastructure (esp. railways and metro), construction equipment, optical fibres, telecom equipment, etc.

Chinese funding to Indian tech start-ups, unlike a port or a railway line, is mainly to invisible assets of small sizes rarely over \$100 million – and made by the private sector. However given the deepening penetration of technology across sectors in India, it is making an impact disproportionate to its value. This means that China is embedded in Indian society, the economy, and the technology ecosystem that influences it.

So far, majority of Chinese manufacturing FDI in India has landed in provinces Andhra Pradesh (Sricity, Vishakhapatnam), Telangana (Hyderabad), Maharashtra (Pune, Chakan, Ranjangaon), Gujarat (Vadodara, Sanand), Karnataka (Bengaluru), Uttar Pradesh (Noida, Greater Noida), and Haryana (Gurugram, Bawal, Manesar).

### 3 Manufacturing Industry in India: Status and policy recommendations

Before going forward on what can be done for developing a long term mutually beneficial India-China trade and investment engagement, it is important to look at some key points about the manufacturing ecosystem in India. Make in India (MII), one of the first major programs of the new national government was initiated in September 2014 with a vision to transform India into a global manufacturing hub. It set an ambitious target to reach manufacturing share in GDP to 25 per cent by 2022, focusing on liberalisation of FDI policy, emphasis on Ease of Doing Business and improving the infrastructure.

While India has seen record foreign direct investment in this period, it's began falling even as other countries in Asia are undergoing an investment boom with 2019 doing generally worse than 2018 that was already lower than the previous year. Investments fell to a 14-year-low. Indian companies announced very few new projects, 55% lower than the year-ago period.

The Manufacturing sector has been shrinking to about 15 percent of GDP in 2017, from a peak of 18.6 percent in 1995. In December 2019 the DPIIT Secretary-Government of India, admitted that the situation in manufacturing gross value added (GVA) is “worrisome” with growth contracting by 1% in the July-September quarter of 2019-20 from 6.9% expansion a year ago. The Government is working on the Industrial Policy to raise the share of manufacturing from the current 16.4% to over 20% in GVA.

India should develop an ecosystem conducive to the establishment and growth of manufacturing industry. This holds true for both domestic and foreign investment. We give some policy and strategic recommendations:

#### a. Moving from a Functional to an Active Industrial Policy Approach

The current focus on improving the ease of doing business is limited as an industrialization strategy; some of the measures are even counter-productive. We recommend Active industrial policies and interventions that guide and promote investment domestically towards new activities and sectors with higher productivity, better-paid jobs, and greater technological potential. Industrial policy should support firms' participation in global value chains (GVCs) and benefit from their engagement. To some extent this has been successfully tried in the electronics sector (e.g. mobile phones).

#### b. Changing Labour Laws

India should introduce the practice of *Fixed Term Contract* (FTC) in the manufacturing sector to give employers more flexibility in employment. Initially there may be difficulty as the labour market phases in this new channel of employment and gets accustomed to it. It is proposed that to enable employers to tide over any transitional problems, for a limited period of say 10 years; they should have the flexibility to hire contract labour for main line production activities.

The law on *overtime* wages also needs to be brought on par with international practice. Section 59 of the Factories Act, 1948, and Rule 25 of the Minimum Wages (Central) Rules,

1950 should be amended to reduce the overtime wages to the level of 125 per cent recommended by the ILO. In order to consolidate the RSKY unemployment allowance scheme, it should be delinked from ESIC and made applicable to all units in the country in the covered sectors.

Developing the labour market will need to be done in small, politically sensitive but economically smart reforms, devolving more power to states, including the informal sector in the reforms dialogue, and discouraging vested interests by sensible incentive mechanisms.

**c. Preferential market access (PMA) to domestically manufactured products**

The Public Procurement (Preference to Make in India), Order 2017 was issued as part of Government policy to encourage 'Make in India' but has been rendered ineffective. Several qualifying tender conditions ensure that domestic manufacturers do not have a chance at even making an application. A single minded focus on lowest cost procurement has ensured more procurement from China. A Government committee was set up in July 2018 with a mandate to ease the restrictive and discriminatory clauses being faced by the Indian Industry in public tenders. This should be reviewed to ensure Central and State Governments to implement this Order.

**d. Design Policy instruments and intervention for identified Sectors and Products therein:**

- i) Levy of import duties: Graded System without Inverted duties - highest for import of final products, lower levy on intermediaries, parts and components and the lowest on raw materials.
- ii) Relief in direct taxes to all units: This instrument is being considered only for mega investments (> 1Bn USD) in Coastal Economic Zones. The reasons that compel a tax break for mega projects apply equally if not more, to smaller units.
- iii) Tweaking indirect taxes: This worked at least as far as attracting investments into cell phones. Recently the GST has been hiked to 18% from 12% which has reduced the scope considerably. The continuation of the 12% dispensation in the GST regime is now essential for the assembly operations to continue. Deepening this value chain will require extending the differential to parts and components in a phased manner. As of now, the mechanism works only for Customs duty.

**e. Promote MSME Clusters**

A higher budget allocation for cluster development of enterprises is recommended. Promote FDI in the small and medium enterprises sector as presently, the measures taken to promote FDI mainly benefit large industries. Capital for MSME should be enhanced not just from bank credit, but also by access to equity. A specialized stock exchange can be set up for this purpose. For boosting MSME exports, an agency be set up to provide guidance and awareness on standards and certifications for exports.

## 4 Building Indian Manufacturing through India–China Trade and Investment

In the informal leadership summit of October 2019 between PM Modi and President Xi, steps for taking sincere action to reduce trade deficit and specific products and sectors were identified. China welcomed Indian investment in IT and Pharma in China. A High-level Economic and Trade Dialogue Committee and mechanism were agreed upon: to establish manufacturing partnerships by identifying certain Sectors/ Industries where investment could come in, manufacturing could create employment and enhance the market for both sides. In November 2019, the government ultimately decided not to join the RCEP reflecting India's challenges of market access for Indian goods and services in China and the fear of a flood of cheap Chinese imports.

India did open up most of the sectors for FDI investments through automatic route, but investments from Bangladesh and Pakistan, which share borders with India, have to undergo government scrutiny. *In April 2020, India reviewed its' FDI policy expanding this restriction to all countries sharing borders with India. With this, the government has now ruled out investments from China, direct or surrogate, without scrutiny. The Government Circular states this is for curbing opportunistic takeovers or acquisitions of Indian companies due to the COVID-19 pandemic.*

For building Indian Manufacturing through India–China trade and investment, we give **some recommendations on strategy and implementation**

### a. Get Chinese MSMEs to manufacture in India

Two kinds of industries are being compelled to move outside China, India could be a potential manufacturing base for these:

- Industries with long value chains, which have a large domestic (Indian) Market such as Mobile Phones and Home Appliances
- Export-oriented SMEs like Clothing, Leather Goods, which have a short value chain, low value addition and where the output is directly sold to the final consumer

Chinese MSMEs are keen to venture outside China to set up specialized manufacturing in other countries. Private MSME enterprises do not carry the risk of ties with the Chinese deep state that is associated with large Chinese private players like Huawei, Alibaba etc.

The problem is that people in China have limited access to information about the Indian economy and business environment. This has restricted the relatively mid-scale businesses from China to invest in India. India can identify such MSMEs, and identify which Sectors and provinces of China they are from. This information can be matched with Indian States and Sectors where it can be a good proposition for them to invest and make in India.

**We recommend that State, Central Government and MSME associations take up this exercise.** Existing traditional MSME clusters can also be developed and upgraded with Chinese financial and technological investment. Our field research shows that this has happened in the Morbi Ceramic Tile Cluster, Gujarat where technology transfer is taking place in a big way.

## b. Position “Make in India for the World” as the Theme for New Industries

For new industries (including electronics clusters) efforts should be made to locate them in zones that are cost competitive from export point of view. For this, develop country-specific industrial parks in PPP mode in coastal states. Fourteen **Coastal Economic Zones (CEZ)** have been identified along the coastline of the country under the Sagarmala Program. CEZ with incentives and facilities similar to those in SEZs would help in attracting investments and in turn boost both exports and domestic production.

India should avoid the tendency to let foreign owned companies tap opportunities in the global trade by using India as a base for last-leg assembly, rather we should strive to make Domestic Champions wherever possible. Domestic champions holding new positions in GVCs can help us retain our competitive advantage in times of disruptions.

## c. Chinese Industrial Parks in India

As these parks will be developed keeping in mind the requirements of medium to large scale Chinese factories, Chinese can do the job of projecting India opportunities to their own people better than the Government of India ministries, investment promotion agencies, state government agencies, etc. Recommendations for implementation are:

- i) Chinese to support in promotion and facilitation, rather than infrastructure development
- ii) Solicit Interest from Indian states interested in setting up Chinese industrial parks: As a first step, Government of India should finalize a term sheet with Chinese government. Conduct a survey to identify states that can fulfill the requirements from Chinese side and fast-track the project.
- iii) Encourage collaboration between India and foreign private developers: About 8-10 Indian groups own large land parcels across major industrialized/coastal states. These developers have experience of developing industrial parks and are keen to collaborate with Chinese organizations.

## d. Exporting to China

The strategy recommended is focused selection of products/sectors combined with a market-led design of export strategies for each of them. This includes branding and market promotion.

### i) Pharmaceuticals and IT

Indian companies continue to have a range of non-tariff barriers in China, particularly in IT and pharma sectors. India must use the strength of its service and software industry to get a bigger market footprint in China. The ministry should look at establishing an interface between the Food & Drug Administrations of India and China for conduct of regular training programs on regulatory standards, processes of filing and relaxing the product registration time to a year from 3-5 years.

## ii) World Trade Centre lists 20 Products with competitive advantage

A Report by MVRDC World Trade Centre, Mumbai has identified 20 products where Indian exporters have a competitive advantage to export to China. Currently India meets only 3.3 per cent or USD 2.7 billion of the total annual import demands of USD 82 billion for these products in China. We recommend exploration of this potential through:

- Exchange of trade delegations with members from these identified sectors
- Create awareness on this opportunity among India's MSMEs producing them
- Map Indian manufacturing clusters to the cities in China. This will go a long way in establishing the brand pull required to provide comfort to Chinese investors.

## iii) Cultural exports and Services promotion

According to Retd. Ambassador Bambawale trade imbalance cannot be managed only by enhancing Indian primary exports. He suggests:

- Attract Chinese tourists in large numbers
- Attract students for undergrad study so they can learn good English and go for higher studies to the US, etc.
- Export Indian films, Yoga and other products/services of our creative and cultural industries.

## iv) Focused Export Strategies

For the identified products/Sectors, focused export strategies must be designed taking into consideration the external environment of the particular export market, and can include:

- Skilling and training workers on specialized knowledge about the focus market, specific exports for promotion, language training, etc.
- Mandatory standards for manufacturing with adequate testing and certification bodies. Harmonizing Indian standards with global standards to enhance export competitiveness. A National Standards Mission can be instituted for this.
- Dedicated offices tasked with product promotion with special emphasis on markets could be set up on the lines of UK Trade and Investment (UKTI), Buy USA etc. to engage in export promotion activities and linking Indian exporters with local buyers. Attention must be placed on building and promoting "Brand India". The brand building initiatives must be integrated with India's commercial missions abroad through structured engagements with diplomats. To incentivize greater marketing of products overseas, income tax deduction on marketing expenses should be doubled.

## 5 Facilitating India-China engagement (G2G, B2B, P2P)

Chinese provincial economic priorities play a critical role in deciding the limits of their interactions with their Indian counterparts. There has been an increasing mobilisation of provincial party secretaries and officials on trade missions to India. Also seen is a new dynamics, where Chinese municipal and prefectural-level entities are seen exploring possibilities of tie-ups with any of the federal tiers in India.

What's therefore needed is for engagement to be channelised through lower levels of government and society, such as collaboration among businesses, partnerships in technology development, sharing of experiences in urban planning and management and so on. **For this model to be effective, it is better if cities and provinces, as opposed to the central leadership, take the lead.**

INVEST INDIA, established in the Ministry of Commerce & Industry, is the national investment promotion and facilitation department. Foreign investors can avail of its services without any cost. In China, the Indian Embassy does not have enough staff to reach out to Chinese businesses. CII has an office while FICCI has a local representative in China. **We have to develop a mechanism to help Indians invest in China and vice versa. India Inc. could take up the task.**

We further recommend and have framed, a step-by-step process that can be followed by both investment seekers and prospective investors. This can result in effective outcome for industry identification and partnership formation.

Between 2013 and 2015, six pairs of Sister-city agreements and 2 pairs of Sister-province agreements were signed. A State/Provincial Leaders' Forum was established in 2015 during PM Modi's visit to Beijing. This was an important statement of intent. Since Wuhan 2017, both sides have established a High Level Mechanism on Cultural and P2P Exchanges and put together a Plan of Action for marquee events in 2020. In October 2019 the Takshashila Institution<sup>2</sup> had **recommended these steps to take forward India-China engagement:**

- Both sides should announce a timeframe to convene the next State/Provincial Leaders' Forum.
- Both sides should work towards a roadmap for establishing greater connectivity between major metropolises based on sectoral expertise.
- Both sides should announce plans to encourage and facilitate roadshows by provincial and city governments to attract tourists and students.

Since 1997 over the years, a few Indian private non-profit, membership-based agencies and forums have come up. They provide platforms and organise events in India and China, with the objective of facilitating India-China B2B and P2P engagement. A few private Chinese Consulting businesses have been recently set up in India to service Chinese investors to explore and do business in India. There is a China-India Chamber of Commerce & Industry (CCCI) supported by the Chinese Embassy. Chinese Enterprise in India have formed Associations in States/Regions having major Chinese presence. All such efforts can go a long way in building a more organic and cooperative

<sup>2</sup>Takshashila Discussion Document : Modi-Xi Informal Summit:07 October 2019 by Manoj Kewalramani

relationship, strengthening it from the bottom-up. This is critical for deepening people-to-people engagement, a key objective that emerged from the Wuhan Summit 2017.

## 6 Trust and Security issues between India/Indian and China/Chinese

- a. Visa Issues: Several relaxations and simplifications were made in year 2019 for Chinese nationals to obtain business or Tourist visas. For Employment visa, Chinese professionals find the process is cumbersome and difficult on several counts. Meanwhile, Chinese nationals are the largest group among India's neighbors when it comes to workforce who apply for an employment visa to work in India.
- b. Trust deficit and Insecurity: Among common Indian people there is a widespread level of mistrust of China, Chinese businesses and Chinese people. In the Government and Industry circles there is an awareness and suspicion of the Chinese deep state and PLA connection. On the Chinese side - most people in China know very little about India. There is a lot of negative reportage and news about India. The ordinary Chinese has a feeling of insecurity for their assets when investing in India. There is a large cultural difference between Indian and Chinese people. An organic relationship between India and China is yet to develop. Section (5) above covers initiatives and mechanisms to develop an organic cooperative relationship from the bottom-up.
- c. Chinese investment and controlling stakes in India's Digital Sector: A recent Study published by Brookings India states that Chinese investment priorities in India have emerged in the Indian startup ecosystem through venture capital (VC) investment. China's strategic investments in India's digital sector and data-oriented services namely Smartphone Apps, Browsers and Streaming Services are sizeable with among the topmost market shares in India. Chinese investment acquiring controlling stakes in certain sectors bring up wider long-term concerns for India: data security, platform control and propaganda.

The following policy recommendations for screening and regulations<sup>3</sup> have been made:

- A centralised FDI screening mechanism for the IT-BPO industry to protect citizens' sensitive personal information from being shared
- Inter-agency committee to review foreign investments involving collection of sensitive personal data
- Data localisation policy

## 7 Recommendations for an Indian Agenda

Currently with the ongoing COVID-19 pandemic and global economic and geo-political fallout, it is difficult to predict how the India-China engagement will play out after the crisis. However, the long term need to grow India's manufacturing sector and employment, and the need to balance the trade deficit with China remains. The issue of Chinese investment has to be seen both from existing and fresh investment points of view. As recommended by the Takshashila Institution<sup>4</sup>, India should pursue:

<sup>3</sup> [https://www.gatewayhouse.in/wp-content/uploads/2020/03/Chinese-Investments-in-India-Report\\_2020\\_Final.pdf](https://www.gatewayhouse.in/wp-content/uploads/2020/03/Chinese-Investments-in-India-Report_2020_Final.pdf)

<sup>4</sup> Takshashila Discussion Document : Modi-Xi Informal Summit: 07 October 2019 by Manoj Kewalramani

- For trade negotiators on both sides to set a publicly stated target for deficit reduction and also identify key sectors to achieve this target.
- Pursue increased Chinese investments in a range of sectors to boost exports and infrastructure development. It is important that bottlenecks such as information gaps, data requirements and land acquisition issues - impeding investments in roads and railways are addressed.
- India should negotiate on technology cooperation and the role of Huawei in 5G within a broader framework of trade reciprocity.

We also recommend that the idea of mutual FDI for addressing global markets at global scale and quality can be explored; so that investment, technology and management may flow from either side to capture global markets and create jobs and growth in both economies.

India should also engage with China in the International Solar Alliance, Shanghai Cooperation Organisation, trans-border rivers and railway station technology. Work together on creating green economies which will go a long way in lowering carbon emissions globally. They should share their experiences in successful mitigation of and adaptation to climate change. The two countries should also collaborate on international negotiation strategies related to emission reductions and how these would be financed. This common vision towards clean energy will ensure beneficial engagement and increased trade opportunities between India and China.

*(Mona Dikshit is a Visiting Senior Research Fellow at the RGICS, working on the themes of Growth with Employment and Governance and Development. She would like to acknowledge the inputs in this study by Mr Vijay Mahajan, Mr Mohd Saqib, Mr Arun Goyal, Mr Jagmeet Singh and a number of Chinese business entrepreneurs and Indian Government officials.)*

# Eye on China, 23 May 2020

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Manoj Kewalramani, The Takshashila Institution

## I. India-China Ties

**Border Tensions:** Tensions along the disputed Sino-Indian boundary remain high. In last week's newsletter I had covered two incidents, one on May 5 and 6 in Ladakh and the other on May 9 near Sikkim. This week, there's a bit more clarity, but no resolution. [Ajai Shukla reports](#) that "more than 5,000 Chinese soldiers of the People's Liberation Army (PLA) have intruded into five points in Ladakh – four along the Galwan River, and one near the Pangong Lake." He adds: "This is not shaping up like a routine patrol confrontation, or even a temporary occupation of disputed territory of the kind that took place in Depsang in 2013, or in Chumar in 2014. This time the PLA soldiers are digging defences, preparing bunkers, moving in heavy vehicles and have reportedly even moved artillery guns to the rear (albeit in their own territory) to support the intruders, say the sources. The Chinese have pitched close to a hundred tents at four points on the Galwan River between Patrolling Point 14 (PP 14) and another location called Gogra."

[Manu Pubby reports](#): "what started off as one of the many face-offs that occur between troops patrolling the disputed border has taken a more serious turn after the Chinese side brought in troops and heavy equipment from a military exercise that was being conducted in the region this week. It is believed that Chinese troops have also taken up positions along the Pangong Tso Lake in the finger area and are conducting aggressive patrols with motorboats to deter Indian forces in the region." The report adds: "Some temporary structures put up in the finger area are also said to have been damaged. At the Galwan flashpoint, Chinese troops have maintained their presence and are being countered by Indian reinforcements that have also moved in large numbers. Reports coming in suggest that the face-off position at Galwan (valley) is being broadened by the Chinese to almost four kilometres as it rushed in additional troops this week. Sources said that a possible target could be the Darbuk-Shyok-Daulat Beg Oldi (DBO) Road that was constructed last year and is a lifeline for Sub Sector North (SSN)."

[Sudhi Ranjan Sen reports](#) for Bloomberg that talks between local commanders on Tuesday ended in a deadlock. [Global Times had a piece](#) earlier this week, saying that the Galwan standoff wasn't likely to become another Doklam. The piece also said that Indian troops had trespassed into Chinese territory. The Chinese foreign ministry on Tuesday, in Mandarin remarks, [warned](#) of "necessary counter-measures" while asking "Indian personnel to return immediately and restore the control of the relevant areas." In response on Thursday, the MEA [said](#) that "All Indian activities are entirely on the Indian side of the LAC. In fact, it is Chinese side that has recently undertaken activity hindering India's normal patrolling patterns." On Friday, the [Indian Express cited](#) official data to report the jump in transgressions from China across the LAC in 2019 and the first four months of 2020. The report says: "the first four months of this year, according to official data, witnessed 170 Chinese

transgressions across the LAC, including 130 in Ladakh. There were only 110 such transgressions in Ladakh during the same period in 2019.”

Chinese transgressions				
Year	West	East	Middle	Total
2020	130	30	10	170
2019	110	70	7	187

Figures Jan to April

Aerial transgressions				
Year	West	East	Middle	Total
2019	32	64	12	108
2018	31	42	5	78
2017	27	11	9	47
2016	17	4	2	23
2015	19	0	1	20

Chinese transgressions, aerial transgressions

Amid all this, there’s also a bit of a spat between China and the US. Remarks by Alice G. Wells, the Principal Deputy Assistant Secretary of State, Bureau of South and Central Asian Affairs, **terming** Chinese behaviour along the boundary as “disturbing behaviour” piqued Zhao Lijian, who **dismissed** them as “utter nonsense.”

**WHA Resolution:** There was much drama earlier in the week, with the World Health Assembly meeting and the **adoption of a resolution** to investigate the Covid-19 pandemic. At the **end of it all**, China was a co-sponsor of the resolution, which the EU along with others had proposed. And the resolution passed comfortably without any objections. There’s some sections of the Indian media reporting that this is an example of China bowing to international pressure, such as **this** and **this**. I don’t see it that way. The mandate for the probe is very specific and apolitical. That’s not a bad thing from a scientific and public health perspective. But this lowered the political cost for Beijing, making a probe acceptable. From China’s perspective, this is something being done by the WHO, where it enjoys clout. Second, there’s a long and arduous process ahead, which can be monitored and frustrated if need be. Third, it puts to rest all the speculation and pressure around the origins of the virus for a while. Meanwhile, **here’s what Zhao Lijian had to say**.

Anyway, the WHA also elected ten new member states, including India, which will now serve on the executive board for three years. The push for Taiwan’s inclusion in the WHA as an observer didn’t yield results, but this could be back for discussion later in the year.

**FPI Scrutiny:** After tightening scrutiny over FDI from China, now **Reuters reports** that the Indian government has drafted rules proposing tighter scrutiny of new Foreign Portfolio Investors (FPIs) from China and Hong Kong. The report says that a draft proposal put together in consultation with SEBI and the Commerce Ministry is currently with the Finance Ministry. New rules could also entail a “security clearance” from the Home Ministry. For the record, at present, there are 111 FPIs from Hong Kong and 16 from China registered in India. The 16 from the mainland **include** the AIIB and PBOC, among others.

**RCEP Talks:** Suhasini Haidar [reported](#) last week that a deadline to respond to a proposal to rejoin the RCEP had passed on May 15, with no clarity whether the government had responded. The piece quotes Ashok Malik, policy advisor to the MEA, as saying that “if anything the COVID-19 experience, and the experience of countries that have been overly dependent on imports from China or one country would have reinforced and revalidated the decision to stay out of RCEP.” Nevertheless, China’s Vice Commerce Minister Wang Shouwen [told the press](#) on Monday that nearly 80% of the deal’s text has undergone legal review, but the door is still open for India if it would like to join.

**Taiwan Message:** Ananth Krishnan [reports](#) for The Hindu that a joint message from BJP MPs Meenakshi Lekhi and Rahul Kaswan was played during Tsai’s inauguration. It said: “Both India and Taiwan are democratic countries, bonded by shared values of freedom, democracy and respect for human rights. Over the past years, India and Taiwan have enhanced bilateral relations enormously in wide-ranging areas, especially trade, investment and people to people exchanges.” Officially, India was represented at the ceremony by Sohag Sen, the acting director general of the India Taipei Association.

**HK Demarche:** India, meanwhile, is one among many countries to whom China has sent demarches on Thursday night, explaining the need for a new National Security Law in Hong Kong. Sutirtho Patranobis [reports](#) for The Hindustan Times that the statement warns against interference; says that HK has become a “notable source of risk to China’s national security;” and has a not so subtle reference to economic interests, which ends with “we hope that your government will understand and support China’s relevant practices.”

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- [In WHO, India must look past pressure to corner China](#)
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- [Behind new incidents, a changed dynamic along India-China border](#)

We thank Mr Manoj Kewalramani and The Takshshila Institution, Bangalore for permission to reproduce this article.

# SAARC: How to Negotiate the Strategic Trap?

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Partha S. Ghosh\*

## Introduction

The South Asian Association for Regional Cooperation (SAARC), a regional grouping comprising Afghanistan, Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka, is now 35-year old. As per the SAARC constitution the organization should already have held its 34th Summit and been preparing for the 35th. Curiously, however, it has not yet been able to formalize its 19th Islamabad Summit of November 2016. On the question the organization is caught in a technical bind. In the 19th 'Summit', barring Nepal, the then SAARC Chair, all the remaining six members had abstained in deference to India's fury against Pakistan's massive terrorist attack in J&K's Uri town in September 2016, not even two months prior to the Summit. Against this background what sense one makes of the supposedly 'held' Islamabad Summit? On the one hand, Pakistani Prime Minister Nawaz Sharif had 'addressed' the Summit, which means that the Summit was held; and yet on the other hand, he had 'postponed' the Summit, which means he himself meant to announce that the Summit was not to be officially recognized. He had declared that the new dates would be announced soon which has not been done so far. In short, SAARC is a lame duck now.

## Theory of Regionalism

There must be something fundamentally wrong with the organization because for it is not for the first time that an annual meeting could not be held on time. The phenomenon has become the norm rather than an exception. Going by regional theory SAARC is a conceptual oddity. Its contradictions were evident even in 1985 when India and Pakistan, its two leading members, had celebrated its birth rather unenthusiastically. They would probably have been happier had the baby not been born at all. However, since other smaller nations in the region were keen about it, neither of them wanted to give the impression that it was the villain of the piece. They did join the grouping yet continued to remain vigilant about each other's moves so as not to be caught on the wrong foot. Over the years these suspicions have become sharper, and, contrary to the expectations of smaller nations, the SAARC forum has provided them with yet another opportunity to wash their dirty linen. To complicate matters, China, the elephant in the room, has exacerbated the contradictions which smaller member-nations, Pakistan in particular, have taken full advantage of to neutralize India's natural preeminence in the region.

Two basic handicaps plague the SAARC, one, strategic incongruity, and two, power asymmetry. No major regional organization in the world suffers so much from these limitations. During the Cold

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War, nuances notwithstanding, India was seen as pro-Soviet while Pakistan, pro-American. In the post-Cold War period, while India managed to improve its equations with the United States the China factor got further entrenched, Pakistan playing its China card more stridently to the detriment of India's power projection in the region and beyond. India indeed has made up its relations with China over the years, which now has become India's biggest trading partner, but the ghost of India's 1962 defeat in its China war haunts the Indians till this day. Unsettled border issues routinely prick India's sensitivities to the glee of most of India's neighbours, Pakistan in particular. The fact that both India and Pakistan are now nuclear powers have added to the anxiety.

So far as regional asymmetry is concerned, prior to Afghanistan's entry into SAARC in 2007, in terms of size, population, GDP, military strength, and share of the region in global trade, India accounted for almost three-fourths of the region. Afghanistan's inclusion somewhat changed the territorial reality but not in respect of other parameters. If this is compared with other regional organizations like the European Union (EU), African Union, Agadir (free trade agreement among Egypt, Jordan, Morocco and Tunisia), or ASEAN (Association of Southeast Asian Nations) it would be seen that India towers over its neighbours as obtaining in no other grouping. The only exception was NAFTA (now defunct) in terms of certain critical parameters. But, unlike SAARC, America was indisputably the predominant constituent of NAFTA. In the first place it was a superpower and secondly there was no China-type factor influencing the organization. In no way could Canada or Mexico to play ball with Washington. In all practical sense there was strategic congruity. Canada and Mexico could ill afford the luxury of pricking the U.S. strategic sensitivity. Although Mexico's membership in NAFTA did annoy its neighbours like Bolivia, Uruguay and Venezuela, the economic advantages of its American partnership far outweighed those pinpricks.

### **Baggage of History**

From the day India and Pakistan came into being in 1947 over of the ruins of the British Indian Empire the two nations have been at their daggers drawn. Generally it is argued that this conflict emanates from the two fundamentally contesting theories of their nation-building strategies, namely, a two-nation theory versus a composite India theory, that is, a one-nation theory. While true to a large extent, in my understanding the conflict is even more foundational. It is rooted in their respective conceptions of identity after their independence. While India's identity was a rooted one, that of Pakistan has been in the constant search of one. Let it be underlined that both the words/phrases, Pakistan and South Asia, are just 70 odd years old, while the notion of India is eternal, it is there from the cradle days of global history. The Greek warrior Alexander came to India as early as in 326 BCE. The beginning of Christianity in India was marked as early as in 52 CE when St. Thomas had arrived in Kerala. India's western coasts had trade relations with the Arabs even in ancient and medieval times. During the Renaissance, Christopher Columbus and Vasco da Gama searched for sea routes to India. In colonial India Indology was a huge draw in Western academic circles. India was always the reference point to name new areas. Ergo, we had the Indian Ocean, West Indies, East Indies, and Indo-China. The company that pioneered the British Empire in South and Southeast Asia was called the East India Company. Even the name Indonesia was derived from Indos Nesos, 'Indian Island'. The Dutch company that traded in Indonesia was called the Dutch East India Company.

This in-built advantage of India cannot be matched by Pakistan however it may try by obliterating all references to its Indian (read Buddhist/Hindu) past as is evident from its history books that gloss

over the country's ancient pre-Muslim India barring the civilizations of Harappa and Mohenjo-Daro, the physical ruins of which earn substantial tourist revenue for the state. There is rampant distortion of history in the country just to show the greatness of Muslims in general and the sub-continental Muslim rulers in particular. SAARC, therefore, presupposes the overshadowing of Pakistan and the identification of the region primarily with that of India, which logically cannot go well with Pakistan's quest for identity. The resolution of this question is easy to romanticize but difficult to sell politically. Still there is no harm for hoping against hope and to see how SAARC can contribute to regional peace and cooperation, or prepare at least a conducive mood for the same. Here is a brief history to put the subject in perspective.

### **The Genesis**

The idea of South Asian regional cooperation was first mooted in the 1970s. During 1977-80, President Ziaur Rahman of Bangladesh suggested that let the seven states of South Asia (Afghanistan was politically unstable and in 1979 it fell under Soviet occupation) work out a cooperative arrangement to ameliorate the stark economic problems of the region. Although the proposal did not evoke much enthusiasm to start with, it caught the imagination of the regional elites once there were changes in the regional leaderships. It was the time when the political leadership of South Asia was changing hands into a new generation. In India Indira Gandhi's Congress Party had been replaced by the Janata Party led by Morarji Desai, in Pakistan Zulfikar Ali Bhutto was replaced by Zia-ul Haq, and in Sri Lanka Sirimavo Bandaranaike was replaced by Junius Jayewardene. In Bangladesh Ziaur Rahman had consolidated his position and there was no immediate threat to him from the pro-Mujib secularist forces. All these leaders had a pro-US image and, unlike their predecessors, tended to build regional relations upon new premises. In India there were talks of a 'genuine non-alignment' meaning de-staining its pro-Soviet image.

Ironically, however, the first effective step towards building SAARC was taken at a time when the political landscape of South Asia had almost returned to its earlier state. Indira Gandhi had staged a dramatic come-back in India, which coincided with the Soviet intervention in Afghanistan and the return of the US-Pakistan 'special relationship'. Indira Gandhi's virtual endorsement of the Soviet forward move in Afghanistan sharpened the strategic cleavage between India and Pakistan. Still, while all this was happening, in May 1980, Ziaur Rahman sent formal letters to the six South Asian leaders urging serious thought on their behalf for the creation of SAARC. The appeal received lukewarm endorsement. Without directly referring to the political questions and without touching upon sensitive regional issues, the leaders thought it worthwhile to explore areas of mutual economic cooperation just to begin with. It was the time when North-South dialogue had practically run its course and the global recession was increasingly crippling the world economy. Hardest hit was the oil-importing developing world to which South Asia belonged. By the mid-1970s the real growth rates had touched a low of almost two per cent. The 'second oil shock' of 1979-80 worsened the situation. In 1980, the balance of trade record of all South Asian countries was pathetic. Against this background, South-South Cooperation in general, and regional cooperation in particular, occupied high priority on the South's developmental agenda. The creation of SAARC was seemingly a matter of time.

Several meetings soon took place at the secretarial level to identify areas of cooperation. The highlight of these meetings was the evolution of a consensus that no 'bilateral or contentious' issues would be discussed. Interestingly, the first point was on India's insistence and the second, on both India's and Pakistan's, the other countries having no particular reason to worry about them. On the contrary, they would have preferred the inclusion of bilateral issues which could have given them confidence to deal with India, the colossus, which was contemptuously characterized as the 'Big Brother'. In a way, therefore, it was a diplomatic gain for India. In August 1983, the ongoing process was given a political push. At the First Foreign Ministers' Conference in New Delhi, the South Asian Regional Cooperation (SARC) Declaration was adopted. Following this the organizational structure of SAARC was finalized.

### **The Organization**

In December 1985 at the first Summit Meeting in Dhaka SAARC was formally launched. The assembled leaders decided in favour of a Council of Ministers and a Secretariat, certifying their enduring commitment to the organization. In February 1987, the SAARC Secretariat came into being with a secretary general and four directors. Later, the SAARC Council of Ministers was formed consisting of the foreign ministers of respective member states. The organizational structure of SAARC was a four-tier arrangement. At the lowest level were the Technical Committees of experts and officials formulating programmes of action and organizing seminars and workshops. Next was the Standing Committee of Foreign Secretaries to review and coordinate the recommendations of the Technical Committees, which was to meet at least once a year. Above this was the Foreign Ministers' Conference, also to be held at least once every year to grant political approval to the recommendations of the Standing Committees. At the apex was the Summit Meeting to be held annually (more frequently if required) to give political significance to the programmes. In 2007 Afghanistan was added to the group a process which was in the making since 2005.

### **The Record**

So far, eighteen Summits have taken place, namely, Dhaka (1985), Bangalore (1986), Kathmandu (1987), Islamabad (1988), Male (1990), Colombo (1991), Dhaka (1993), New Delhi (1995), Male (1997), Colombo (1998), Kathmandu (2002), Islamabad (2004), Dhaka (2005), New Delhi (2007), Colombo (2008), Thimphu (2010), Male (2011), and Kathmandu (2014). About the 19th Summit there is a technical confusion that we have discussed in the beginning of this essay. Notwithstanding this uneven summitry record SAARC has a fairly impressive list of meetings, seminars, studies and reports that it has sponsored. The Calendar of Activities released by the SAARC Secretariat from time to time enumerates a large number of activities pertaining to such diverse developmental fields as agriculture, animal husbandry, horticulture, health and sanitation, forestry, population, meteorology, postal services, drug trafficking and abuse, integrated rural development, transfer of technology, sports, transport, telecommunication, women's development, trade and commerce, and others.

SAARC's activities are not confined to developmental issues only. Even such an issue as terrorism, which has been hanging fire in Indo-Pak relations for several years and has serious political overtones, has constantly received attention. Despite deep-rooted divisions among the SAARC countries over this question, they have adopted a convention against terrorism. Its highlight was the identification of

offences, which 'shall be regarded as terrorist and for the purpose of extradition shall not be regarded as a political offence or as an offence inspired by political motives.' The convention provides the necessary follow-up through the signing of bilateral extradition treaties, which however have not yet been signed. In the 15th SAARC Summit held in Colombo (2008) the SAARC Convention on Mutual Legal Assistance in Criminal Matters was one of the most significant and tangible step. The Convention, which was signed by the Foreign Ministers of the eight SAARC states sought to provide the legal basis that aimed to harmonize different domestic legal systems of countries which would facilitate mutual legal assistance in criminal matters, namely investigations, prosecution and resultant proceedings. The Convention thus obviated the need to negotiate separate bilateral agreements with individual countries in the region, which has not been carried forward though.

SAARC's biggest success is in the field of energy cooperation and connectivity but the problem here is that they are all being operationalized at the sub-regional level involving Bangladesh, Bhutan, India and Nepal (BBIN connectivity project, for example) thereby re-conceptualizing SAARC sans Pakistan. The choice is one's own, whether to treat it as the organization's success, or its ultimate failure. Obviously the latter, objectively speaking. Also, one of the major thrusts of SAARC when it was launched was to promote free trade in the region. But after all these years of hectic brainstorming by the region's economists and other stake holders the result is virtually nil. Intra-regional trade still accounts for merely 5 per cent of the region's global trade. The hard reality is that even in the best of times, South Asian economies are competitive, not complementary. The economic integration of the region remains a pipe dream.

### **SAARC and COVID-19**

There was a flicker of hope recently to revive the paralysed SAARC when on 14 March 2020, against the background of the scourge of the COVID pandemic, India took the initiative to call a web-based SAARC 'Summit' to address the problem. Though India and Pakistan continued to play ball on their expected lines still at least they all agreed to contribute to a common emergency fund. The respective contributions to the fund in US dollars were as follows: India, 10 million; Sri Lanka, 5 million; Pakistan, 3 million; Bangladesh, 1.5 million; Afghanistan and Nepal, 1 million each; Maldives, 200,000; and Bhutan, 100,000: total US\$ 21.8 million. Two negative points, however, haunt. One, there is still no agreement over following one single procedure in terms of disbursing the funds, and two, compared to, for example, the European Union, the SAARC fund is too small to be meaningful. A similar EU fund goes into hundreds of billions of dollars and administratively it is far better organized.

### **Some Concluding Thoughts**

One does not need to be either a diplomat or a politician to expect a few basic things from the SAARC. Agreed that to ask it to discuss bilateral or contentious issues would still be a tall order. But one can start with a couple of innocent confidence building moves. At academic and Track II levels the region has had enough discussions on CBMs (confidence building measures) which mostly have concentrated on avoiding accidental nuclear wars or escalating border skirmishes. Let the agenda be taken to the people's level now. South Asia is a civilizational space where all kinds of sects and ideologies have coexisted, not always peacefully, but not that unmanageably either. One is not asking for the reordering of the present state system which would amount to asking for the moon.

All that one is asking is to take two small steps, one, more tourist flows, particularly between India and Pakistan, and two, more intra-regional academic exchanges. The region's obsession with security has made the region one of the most insecure in the world.

It is high time that SAARC is rescued from its impending collapse. Let the Indian leadership be statesmanlike by making the situation conducive for Pakistan to summon the stalled 19th Summit without insisting upon it to officially renounce terrorism (such promises were made in the past as well). Let India accept the reality that it is not impossible to deal with a terrorism-promoting Pakistan. India has done so in the past. Pakistan's presence in the SAARC will not make it renounce terrorism as its policy tool but it would, at least potentially, temper its adventurism. A regular SAARC Summit together with a relaxed visa regime that boosts tourism and academic exchanges would go a long way to melt the cloud, hopefully. Let this new regime be tried for just five years. Heaven will not fall if it does not work. Let us concede that most big things start with small dreams.

# From social solidarity to economic solidarity

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Rashed Al Mahmud Titumir | Published in NewAge, Bangladesh May 14,2020

**Rashed Al Mahmud Titumir** *writes on the relaxation of shutdown, a three-year recovery plan and the national budget*

COVID-19 has exposed the fallacious estrangement, alienation and segregation in social relations. As the contagion dispersed from local households to firms to the global sphere, distorted messages were circulated, particularly in the name of social distancing. The official narrative serves at instigating social profiling that has been worsening worldwide in recent times. Nevertheless, a good many citizens have come up with the phrase of physical distancing instead, emphasising social solidarity. They have come forward to distribute relief to people living hand-to-mouth and the frontline workers are putting in utmost efforts. On the eve of the Bengali New Year, social media was flooded with messages reverberating 'may we reunite when all this ends, may we emerge triumphant' whilst many others have echoed 'let there be an end to this pandemic, breaking all shackles of contagion.'

The citizens are aspiring for a transformational mission for a legitimate state to provide for universal basic needs and to ensure fundamental rights of its citizens. On the economic front, the crisis begs a thought-thorough strategic framework to transcend to transformational medium and long-term pathways with an emphasis on the needs of the vulnerable.

A shift from conventional budgetary system to a three-year resuscitation strategy for Bangladesh is the need of the hour to inhibit the contraction of the economy. The medium-term macroeconomic framework, through coordinated fiscal and monetary policies, will have to centre on employment to control erosion and increase income.

## **State of economy and shutdown relaxation**

THE economy had been in distress before the strike of the pandemic with jobless growth, slowed-down poverty reduction, declined export-import and unfulfilled targets of revenue collection. There has been a liquidity crisis in the banking system as the government grabbed the yearly target of borrowing in six months.

COVID-19 blatantly points out the state failure in provision of universal basic needs such as food, health, social security, education, etc. From those living hand-to-mouth to those in the lower-middle class, the citizens are facing an existential threat as they starve and remain out of jobs in the absence of a fully-fledged social security system. A large population is also out of the minimum wage jurisdictions and is deprived of basic amenities as they are employed in informal sectors. The existing social safety

net programmes are inadequate and marred with leaks. The health and education sectors are fraught with negligence and decreasing budgetary allocations. The pandemic has also laid out in the open the frailties of the real sectors — agriculture, manufacturing and services.

Given such contexts, there are discussions regarding the opening up of the economy. First, any relaxation of the shutdown has to be based on science. The shutdown, with its varied enforcements, have resulted in reduction in transmission and mortality despite limitations of the data. One way to understand the dynamics of transmission is to look at the basic reproduction threshold. If the basic reproduction or  $R$  nought is greater than one, the virus will spread exponentially. If the reproduction ratio is less than one, the infection will spread slowly and will eventually die out. The country has not yet reached the level of one. This is complementary to ‘flattening the curve’ public health strategy through which the spread of the epidemic is slowed down so that the peak number of people requiring care at a time is reduced and the pressure on health care system does not exceed its capacity.

Any policymaking on the withdrawal of the shutdown will not put the people in a binary proposition of lives versus livelihood or place a higher value of a life or livelihood in a country compared with others. It rather should devise a comprehensive strategy consisting of a phased approach to relaxation of the shutdown with stringent guidelines by striking a balance between lives and livelihood. A single-minded withdrawal of the shutdown prioritising livelihood will have adverse ramifications for both in view of paucity of health infrastructure.

A phased step-by-step strategy has to contain inbuilt threshold indicators relating to reduction in risks for relaxing the shutdown for a sector, region and demographics. The sufficient condition is the enhancements of diagnostic and surveillance tests, tracking and contact tracing, which are still hugely inadequate. The decision making necessitates a consultative approach involving stakeholders.

And most importantly, if the shutdown is withdrawn, earnings by the low-income rungs are not automatic. As a significant amount of citizens are facing an existential threat in the absence of a fully-fledged social security system, the provision of a universal basic income grant of Tk 15,000 through the banking channel for six months is a must. There are around 20.52 million bank accounts of this stratum, according to the Bangladesh Bank, which can serve for cash transfers. National identity cards may be used to open bank accounts and cards can be issued on an emergency basis who do not possess such. There is also a need for the issuance of food card against the national identity cards to allow access to public food distribution.

### **A three-year recovery plan**

THE prime focus of the three-year plan has to be on the sectors relating to universal basic needs and on the retention and creation of employment, particularly in view of erosion of income and unemployment, aggravated by pre-crisis high unemployment and underemployment due to jobless growth and shortages in skills.

COVID-19 demonstrates the failure in the state provision of universal basic needs as the emphasis has been on capital accumulation emphasising exchange values, including financialisation at the cost of use value generating sectors such as health and education. This originates from a misconstrued

ideology that market is the organising principle and society is equivalent to market. Rather market is subordinated to social, political and cultural norms. The use-value producing public goods is indispensable for augmenting capabilities of citizens to transform economic structure, political settlement and organisation of society. Under such circumstances, fulfilling the basic needs of citizens must be the foundation of the policy framework in any legitimate state. For instances, the private sector-dependent healthcare system has to be reformed to establish a universal national health system and a fully-fledged life-cycle-based social security system is required to serve the people in need.

The real sectors had already been at risk in the pre-crisis period. The agriculture sector is fraught with inadequate technological advancements and increased input prices. Simultaneously, the manufacturing sector witnessed a gradual concentration, tainted by low productivity, subdued competitive advantage and truncated product diversification, and an eventual fall in export volume. The drop in inflow of remittances has been adversely affecting the rural economy. The rate of reduction in poverty diminished because of lesser employment and a drip in return on labour. Inequalities in all forms are mounting. Illicit outflows of capital have been on the rise. There are frequent collapses in the capital market.

The public spending — the money of the public — shall only be allocated to create multiplier effects in an economy, provide public goods and address externalities — negative and positive. The public spending is not meant for a few at the expense of many — clientelism must be checked. Incentives should only go to employment-generating real sectors, with minute details such that enterprises matter, but it is job that counts. Mission-oriented policies can create multiplier effects as well as accelerate growth. Pushing economy to the next rungs as the country aspires to be a middle-income and eventually a developed country warrants a transformative production pathway, ensuring a cleaner, greener and stable production system.

### **Universal basic needs: social security, universal healthcare and education**

MARGINALISED populations, especially those living hand-to-mouth, employed in the informal sector are the worst victims of the crisis. The ongoing predicament has manifested the pitiful state of the low income population with no savings. The objective of keeping poverty below the international poverty line dictates the dire need for social security as the imminent recession will lead to loss of employment, pushing more people into poverty. The social security system has to include, amongst others, income support, national health services, child benefits, housing benefits, disability living allowance, invalid care allowance, state pension, job seekers' allowance. Around 6 per cent of the GDP can be spent in the next budget on social security, which is as high as 11 per cent or more in several countries.

The health sector has been in shambles because of trivial budget allocation, inadequate equipment, deficient infrastructure, low-quality service and high out-of-pocket expenditure. Every citizen may be brought under the auspices of universal health care through the distribution of national health cards based on their national identification cards. While this is under implementation, a health allowance can be provided for the poor. The extra expenditure required for the provision of a family doctor, nurse and infrastructure may be financed by tripling the current budget allocation on health.

The absence of universal education implies that quality education can be availed only by the few, thereby resulting in a skills mismatch. Decent jobs can only be created through improving skills levels. Higher education has been failing in creating new knowledge, skills development and active citizenship. An escalated allocation to the tune of 4.25 per cent of the GDP can be earmarked for education, technology and research.

### **Diversification and productivity enhancement in agriculture**

AROUND 40 per cent of the population depends on agriculture. The limited drive for diversification has not unleashed the potentials. A far-reaching contemplation has to be undertaken in the sector in terms of production and processing. Otherwise, the rural-urban migration may worsen and so will the consequences of an increased import dependence.

To ensure food security for all, the government should embark on direct purchase from farmers to ensure fair farm-gate prices and to keep retail prices affordable. Financial subsidies for fertiliser, seeds and pesticides ought to be continued along with debt relief to maintain the cycle of production for *aus* and *aman* seasons. The association of farmers, poultries, hatcheries and dairy farms can also be mobilised to avoid leaks in distribution of subsidies. These actions would require a 150 per cent increase from the current budgetary allocation.

In total, 669,377 migrant workers, including half a million wage labourers, have returned home since January. Amongst them, around 293,000 individuals have returned in the first 20 days of March only. Given the drop in oil price, Middle Eastern countries may reduce their dependence on overseas workers. This may put a dampener on the retention of and hiring migrant workers and the consequential loss of income from remittance will undoubtedly have a negative impact on the rural economy.

### **Diversification, competitiveness and technological capabilities in manufacturing**

THERE is a dearth of prudent planning in the manufacturing sector, exhibited by over-reliance on export orientation with concentration in a single sector. The entire manufacturing process must undergo drastic makeovers with a balance between domestic consumption and export orientation. While domestic consumption must be raised in order to enhance domestic capability, concerted efforts have to be made to diversify the export destinations, particularly targeting the neighbouring markets of India and China. Thus, specific strategies should be formulated by examining the nature of demand and institutional realities in these markets.

The thrust has to be on the enhancement of domestic capabilities through diversification, productivity augmentation, technological catching up and increased competitiveness in agriculture, manufacturing and service sectors.

Three mission-oriented equity matching facilities — the green industrialisation fund, the diversification fund and the nationwide rural area regeneration industrial fund — can be established to address the massive changes in the post-COVID era, mobilising SMEs and start-ups, and the large firms, with the objectives of employment creation, product diversification, value addition, greening and alternative export creation. To curb the concentration of industrial activities on a few centres, the nationwide rural area regeneration industrial fund can finance an integrated solution, comprising of industrial

plots, utility services including gas, electricity, along the national highways and waterways, creating growth centres across the country. Such would require a six-fold increase in budgetary allocation.

Financial assistance and subsidies, tax holidays and tax exemption at different stages should be disbursed in accordance with the outcomes and targets. Until now, the clientelist networks have been the recipients and the funds have evaded as illicit capital outflows.

### **Use of oceanic and water resources**

THE potentials of marine and water resources are yet to be tapped despite numerous discussions on the 'blue economy'. The country is still unable to delve into the deeper parts of the Bay of Bengal, a capability that can only be achieved through technological advancement.

### **Sources of revenue and deficit financing**

THESE undertakings of the three-year recovery plan will require a sizeable volume of financing. The shrinkage of the economy is leading towards declined income and value added taxes and custom duties. Under such circumstances, the government has to embark upon a concerted strategy.

First, unnecessary expenditures such as capacity charge subsidies in power sector, government largesse and cost over runs will have to be reduced without resorting to austerity measures.

Second, the government should look for easily accessible sources of revenue the likes of at least having 1.5 billion dollars from undocumented foreign workers in Bangladesh, the activation of transfer pricing cell to reduce tax avoidance and re-examination of tax exemptions given to politically influential conglomerates.

Third, efforts shall be made to increase foreign aid from bilateral and multilateral sources.

Fourth, obtaining multilateral and bilateral loans with low rate of interest, longer repayment and grace period shall be the priority to ease debt servicing, besides seeking relief, writing off and deferrals of debts.

Fifth, the government has to primarily source from the central bank even if this requires printing of the currency as banks are already in liquidity crisis and treasury bills and savings certificates are costly. Hence, an out of box flexible functional finance-based creative non-traditional strategy is the way out of the crisis.

For the suggested budgetary allocation, the budget deficit may touch 10 per cent of the GDP. This is not the time to be concerned about the budget deficit and the debt-GDP ratio, which is at an acceptable 30 per cent level. It is often postulated that higher spending by government is anticipated by the consumers as a rise in future tax, which lead them to cut back on consumption and save more in order to compensate for future expenses. In reality, this is not the case. As investment, consumption and export decline during a recession, the government needs to spend more on offsetting the contraction of, and increase in, the GDP as these four constitute the GDP. In order to finance the additional expenditure, a government during recession borrows money which is eventually paid off as revenue increases when the economy recovers.

There is no possibility of a runaway inflation given the current depressed consumption spending and slackened production. Inflation results from nominal spending surpassing real capacity of producing goods and services in an economy. It is, therefore, imperative to inject cash and go for the issuance of new money, if needed, to curb the contraction as money is a creature of the state at all times. The interest rates can also be further adjusted on a gradual basis, reflecting the need, without worrying too much about inflation.

### **Preparing for a new order**

COVID-19 has emerged as the harbinger of changes in social, economic and political structures worldwide. In the absence of a radical transformation, the economy is expected to enter a prolonged stalemate, as well as, there may be severe blows to social stability. The manner in which this change will manifest itself will depend on the nature of relationship between the state and its citizens.

The transformation of an economy, thus, entails an active citizenship as a sufficient condition, which can only claim accountability of the state and ensure a command over authorities and public resources. The history of global development postulates that development is not only subject to the state or market or capitalism. The key ingredient is organizational capability, consisting both formal and informal institutions. A failure in achieving institutional capabilities will deprive citizens from the fruits of development whilst benefiting only a chosen few, heralding the need for a new social contract.

In order to transform this relationship, the state capacity will undeniably have to improve, and foreign and national defence policies are to be devised accordingly. The political farsightedness will determine how successful the country will be in making the most out of a changed global atmosphere. The political settlement is only effective when there exists accountability of the state to its citizens.

*Dr Rashed Al Mahmud Titumir, a professor of economics at the Department of Development Studies at the University of Dhaka, is chairperson of the Dhaka based think-tank Unnayan Onneshan. We thank Prof Titumir and New Age Bangladesh for permission to reproduce this article*  
<https://www.newagebd.net/article/106369/from-social-solidarity-to-economic-solidarity>

# Post COVID 19 world politics: Implications for Bangladesh-India relations

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**Humaiun Kobir**, *Secretary for International Affairs, National Executive Committee, Bangladesh Nationalist Party (BNP) and Special Adviser to Tarique Rahman, Acting Chairperson - BNP*

## A new world order?

The world is certain to be a different place post COVID19. It will take some time for the world political economy to overcome the shock of the devastating impact that COVID19 will have on the world system. People across the world will face challenges with a sharp break from the recent past of day to day life. Thus, it is no surprise to conclude the politics of international affairs will be different or more so conducted and balanced in a different paradigm.

One of the key questions will be, would a post Covid19 world move backwards or forwards in visioning a global future? Another will be, whether the future will be a globally connected one or a draw back to the old *Realpolitik narrative of States*? Unquestionably, the US as the leading superpower will see its designation challenged in the balance of international politics or amongst equals with a powerful and influential China as a leading political and economic counter balance.

I believe, Post COVID19 will provide further opportunity for countries to integrate and engage rather than disintegrate and disengage from global connectivity. The US and the Western democracies albeit incapacitated by economic pressures must not move away from the sponsorship of the democratic project. The more the US integrates and embraces itself with democracies around the globe, the more likely it is to remain an influential and impactful force in *great power politics*. It will need to adjust its foreign policy to collectively leading on the universal values of democracy and human rights rather than attempting to do anything in isolation. Simply speculating that China's post COVID19 dominance is as an ill intended project will not get the global traction it may desire. Rather the US should reach out on the values of freedom, democracy and rights with more priority globally.

China with its economic resources on the other hand, has already started on a goodwill programme following the outbreak of the pandemic by offering support to countries across the region and beyond by placing the importance of people before regime, as part of its outreach to connect globally. The recent example of Beijing distributing masks across political parties in Bangladesh regardless of ideological considerations further qualifies this approach to building diplomatic goodwill and empathy. Post-COVID provides for different kinds of opportunities to integrate, connect and maintain

relevance for powerful state actors rather than choosing the path of disconnection.

Therefore, I foresee big powers in world politics moving more toward projecting a collective approach to leadership rather than a simplified *state centric approach* to foreign and economic policy in balancing their influence across the globe.

### **Where do Bangladesh-India relations sit post-COVID19?**

Neither Bangladesh nor India or any other country in the world had any idea that such a devastating pandemic was on the way. Therefore, to plan to deal with such a crisis in advance of that magnitude was not possible. This pandemic has shown how important it is for countries to establish trust and legitimacy with its citizens in re-assuring the security and future of its people and territory. India in this regard to an extent has been able to establish some of the governance infrastructure to deal with such problems by turning to its own scientific community of experts, on the other hand we have seen a contradictory approach in Bangladesh, where the government has lacked co-ordination and failed to work in a joined up way with scientific experts to establish transparency and trust with its people and instead opting for *malign influence* which may arouse internal and external security concerns. Without dwelling further on internal politics, I would like to stress on the opportunities and challenges post-COVID presents to strengthen relations between our respective countries.

Bangladesh in some way is fortunate to share geographical proximity with two big powers like India and China providing its sovereign space does not become the *battleground* of power struggles between these regional powers. The people of Bangladesh in my view would welcome connectivity and integration providing it does not infringe on their right to development and advancement. India like the US was founded on the principles of liberty and freedom and right to self-determination. Post COVID19 provides an opportunity for South Asian countries to give leadership on formulating and promoting an '*ethical foreign policy*'. Should India integrate its founding principles within its foreign policy and push for an outward looking *ethical foreign policy* to reach out to nations across the neighbourhood and its people, then it can become an influential leader in the region and beyond, given its size, capacity and resources to connect and lead widely across the globe as well.

Political parties in Bangladesh and India will come and go from office, the people and the State will always remain. Therefore, it is important that both India and Bangladesh exercise an ethical dimension within their foreign policy that is based on national security interests and international values of human rights at the heart of it. Such a policy position will ensure that people to people relations remain intact regardless of internal political scenarios. Therefore, Post-COVID19 provides India with an opportunity to become a regional leader in striking an embracing foreign policy entrenched by the values in her formation putting emphasis on people to people outreach to strengthen and sustain relations with Bangladesh and the world.

Bangladesh on the other hand, cannot hedge between regional powers. It must look to its own interests for the development of its people by encouraging trade, development and cooperation with important development partners to ensure its national interest and regional security. Therefore, the exercise of '*soft power influence*' at all levels of the Bangladesh-India relationship might be a more sustainable option for strengthening sustainable relations between both countries in a Post-COVID world.

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# EXTRAORDINARY TIMES EXTRAORDINARY MEASURES

# COVID 19 #BANGLADESH #MICROFINANCE #VULNERABILITY

London, 24<sup>th</sup> May, 2020



*The microfinance industry in Bangladesh represents, in its essence, a national 'safety-net' infrastructure. It reaches more than ½ of Bangladesh's 160 million people - mostly low-income people, women, and the vulnerable – with financial and non-financial services with little or no public subsidy. This MFI mediated safety-net infrastructure offers the most reliable means of keeping liquidity flowing among the millions of people and businesses most impacted by COVID 19 and who will largely be left to fend for themselves given the limited size and duration of the national stimulus package. Yet, credit supply pressures are exposing large sections of the microfinance sector to an existential threat, impacting on the liquidity of low-income families and their businesses. A decade of gains will be wiped out unless there is a massive injection of liquidity through the MFIs system, and everyone acts with extraordinary imagination and speed. Are MFIs, their investors, the Government, and donors willing and able to come together, act and act fast?*

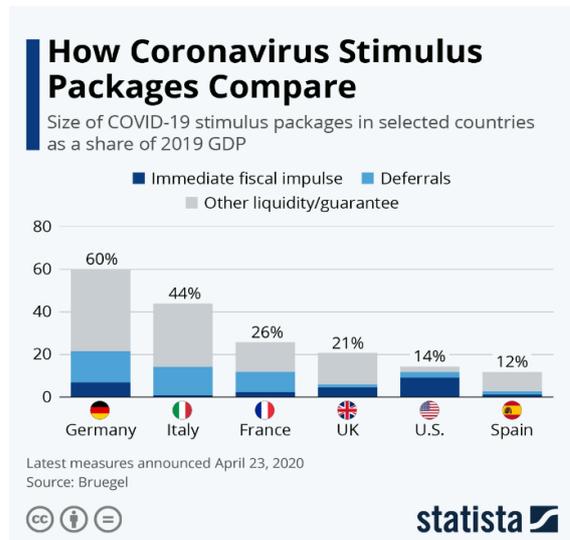
## 1. Context

**The COVID-19 pandemic represents the biggest test for Bangladesh since 1971:** The immediate concern is how Bangladesh's broken public health system will cope with unprecedented levels of infection, ill-being, and death. The pandemic also constitutes an unprecedented macro-economic shock, which has the potential to shunt the country back decades.

This year, the economy is expected to grow by 2 percent (IMF), its lowest level since 1980 – that is \$20 billion less circulating in the economy. It may take more than 2-years for the economy spring back to its pre-COVID level. Nearly 1 million jobs will be lost in the formal sector alone (ADB) if the pandemic lasts for six months as production and supply-chains are disrupted, the costs of doing business goes up, and business confidence and private investment falls. Poverty will double to 40 percent (SANEM), back to the 2005 level.

Importantly, the pandemic will disrupt the livelihoods of over 85 percent of the workforce that work in the informal economy – *day labourers, maids, transport workers, part-time workers*. This informal army who power the nation's economy live on small, irregular and uncertain wages at the best of times, and even the smallest disruption can have a catastrophic impact for them and their families. Economic activities in April dropped by 71 percent in urban and 55 percent in rural areas, resulting in daily income plummeting by 76 percent (PPRC & BIGD).

**The size of the policy and fiscal response lacks credibility.** The scope of the Government's response is laudable, broadly involving a fiscal impulse, deferrals and other liquidity support. These cover support to expand existing safety net programmes for the most vulnerable, support for export-oriented industries,



SMEs, the agriculture sector, and health workers.

Yet, the US\$ 11.5 billion stimulus package is small compared to both the scale of the pandemic and the fiscal space available to the government given a low debt to GDP ratio. To put it into perspective, the size of the stimulus package is roughly half of the projected \$20 billion loss in GDP, or about 70 percent of the \$16.4 billion annual remittances receipts, or the same as Amazon's annual profit for 2018.

The Government's response also fares badly in comparison to other countries. For example, Bangladesh Government's stimulus package is about 3.3 percent of 2019 GDP, compared to 10 percent in India, 60 percent in Germany and 21 percent in the UK (Statista); in Germany nearly 40 percent of GDP has been allocated for liquidity and loan guarantees alone.

The wide variance across these countries begs the question:

*if much larger economies with sparse populations, reasonably well-functioning public health and welfare systems are allocating an unprecedented share of their GDP, is it reasonable to assume that Bangladesh can equally manage the consequences of COVID by spending a fraction of the others?*

**State aid bridges only a limited period and immediate relief-thinking needs to very quickly, transition to thinking about medium-term recovery:** besides the limited size of the Bangladesh Government's response, it is also fairly limited in duration. If the pandemic lingers beyond September and economic activity constrained, it could trigger a full-blown recession, causing widespread defaults, mass migration back into poverty for those who had moved out over the last decade, severe loss of life. Under this scenario, the relief and stimulus funds would fail to revitalise the economy and even larger amounts will be needed in future. Medium-term, recovery-centred thinking needs to be built into the current immediate response.

## 2. Stabilising the Financial System

**Maintaining liquidity flow to businesses and families should be the central focus** if Bangladesh is to avoid a prolonged crisis. Simply put, a company's liquidity comes from sales, while a family's liquidity comes from income. Liquidity can be boosted by drawing on reserves, cashing in time-deposits or selling surplus assets, as well as by borrowing from financial institutions or from family and friends. The pandemic directly disrupts the circulation of liquidity, because businesses and individuals have little or no income; asset sales are difficult either because of few buyers or the discount rate is too high; and it is difficult to secure liquidity from friends and family as they seek to maintain reserves for themselves.

**A well-functioning financial system is essential for the country to recover quickly** from the economic consequences of the pandemic and avoid full-blown recession. Though banks are not being hit by COVID as directly as other retail institutions, they are at the heart of the economy, provide funding to corporates and individuals.

Their stability is crucial to keeping the economy running by continuing to intermediate between savers and investors, and accelerate recovery.

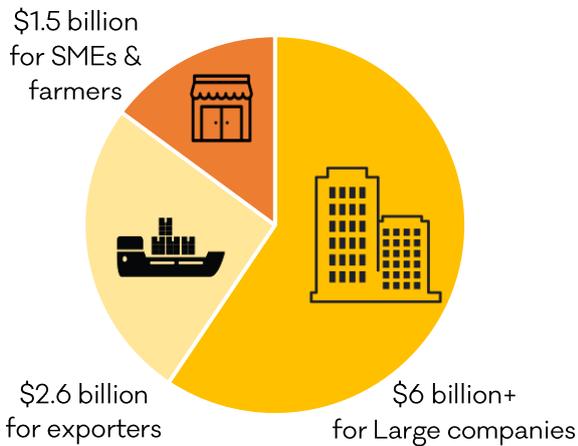
**Pressures on the supply of credit to the real economy have placed the financial system under incredible stress.** Despite the considerable size of the financial system with over \$250 billion in assets, liquidity strains have grown as depositors withdraw funds, credit quality deteriorates, defaults increase, regulators impose price restrictions, and operational costs increase with social distancing. Current liquidity buffers should sustain most banks' funding so that they can withstand the temporary closure of conventional liability markets for up to a quarter or two at a stretch.

**Government's prioritization of liquidity support is a good response but very limited in size.** Over 80 percent of the stimulus package deals with liquidity in the economy. Specifically, Bangladesh Bank has injected about \$10 billion liquidity in the financial system by cutting the cash-reserve-ratio, increasing the advances-to-deposit ratio, reducing the repo rate, and creating small low-cost refinancing funds targeting farmers, micro-entrepreneurs, and SMEs.

**Impact of Government actions will be limited, accruing largely to formal corporates, leaving SMEs and the informal economy to fend for themselves.** Liquidity measures are unlikely to trigger credit growth as most sectors will see credit losses, deposits squeezed as banks are priced out by the Government's savings certificate rates, higher interbank rates will increase cost of finance, and imposed narrow spreads and deferrals will compressed margins.

Conditionalities (e.g. delaying repayments for non-performing loans by six months) accompanying the liquidity stimulus package will likely lead to adverse selection of troubled corporate.

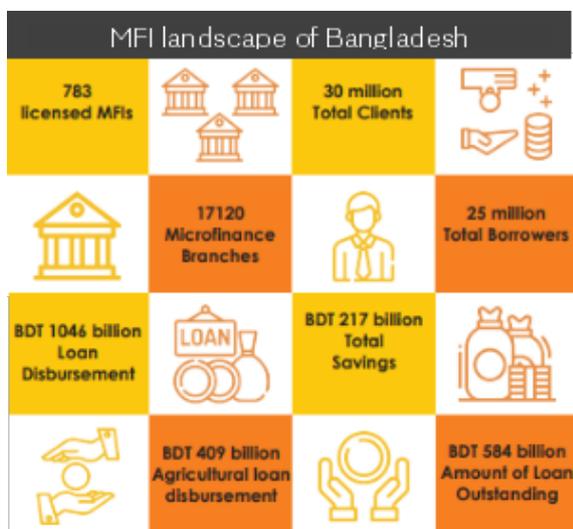
Who Benefits from Government's Stimulus



More than \$6 billion will flow to large companies while an additional \$2.6 billion will flow to exporters (PRI), leaving about \$1.5 billion for SMEs, farmers, micro-entrepreneurs.

### 3. Managing the Existential Crisis for MFIs and Averting Consequences for low income people and enterprises

**MFIs are omnipresent in lives of most Bangladeshis.** Largely outside of the formal commercial banking system, more than 30 million micro-enterprises and low-income

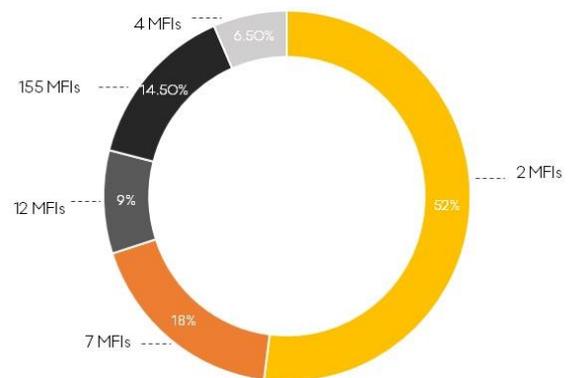


people rely on MFIs to push and pull liquidity between them and the larger financial system, storing more than \$3 billion in deposits, and lending more than \$14 billion to invest in business and manage personal and business liquidity.

In reality though, **MFIs benefit more than 1/2 of all Bangladeshis** given that one client acts as a channel for intra-family distribution of resources (even after discounting multiple accounts with other MFIs).

**The Bangladesh microfinance industry is large, diverse and varying** in size, performance, and asset quality. Over 780 licensed MFIs manage about \$7.9 billion in financial assets, though 28 MFIs manage nearly 90 percent of the assets. This includes two Tier 1 MFIs managing 52 percent of the industry assets, seven Tier 2 MFIs managing 18 percent, 12 Tier 3 MFIs managing 9 percent, and 7 Tier 4 MFIs managing 6.5 percent. Distressed assets are low, below 5 percent.

Distribution of Assets across MFIs



**MFIs are also important sources of non-financial support, especially at times of stress.** Social development origins of MFIs and their high-touch, relationship-based business model have shaped their role as more than just provider of financial services. This is most visible and pronounced at times of stress.

They act as channels for relief during emergencies, as mediators in settling disputes and negotiating with local elites and state institutions, and as trusted providers of information and advice on health and wellbeing.

**Credit supply pressures are exposing large sections of the microfinance sector to an existential threat.**

The best case estimate from interviews with the regulator and leading MFIs is that the industry will need at least an additional \$2.2 billion in liquidity to manage the crisis. This is equivalent to about a ¼ of the industry's assets.

Central to this threat are the:

- i. *Capital structures* of most MFIs, which over the last decade have seen increasingly reliance on expensive, commercial bank debt to fuel their growth.
- ii. *Core low-margin business model of MFIs* whose characteristics include credit secured through social contracts, high transaction costs, low delinquency rates, frequent collections and disbursements, and repayment instalments small enough to be always serviceable under all but the most exceptional of circumstances.

Any one disruption – *an increase in the cost of funds, a reduced line of credit, a sudden income loss of borrower, a delay in the frequency of collections, a slip in repayment rates from 95 percent to 80 percent* – can render many MFIs insolvent in less than a year.

With COVID, MFIs face a “perfect storm” where everything that can go wrong, is going wrong. Branches are closed, collections and disbursements not taking place, delinquencies increasing, revenues lost, credit from wholesale lenders squeezed, and wholesale prices raised. As one of the highly respected, moderately leveraged, top 10 MFIs in Bangladesh reported:

*“between April to June, we will not be able to disburse \$530 million loans as planned. We will not have been collecting \$90 million in savings, and we will be losing \$65 million in interest revenue.”*

The largest MFI in Bangladesh confirms this general condition across its operation as well.

**Consequence of an existential threat to MFIs will be particularly severe for low-income enterprises and families most affected by the economic consequences of the pandemic.**

If the risk is allowed to materialise, millions of poor people will lose access to non-financial services from MFIs at this time of stress. They will also face greater challenges in recovering if financial services are not readily available to resume economic activities. The scale and duration of the Government's stimulus package means there will be no substitutes to MFIs for most low income enterprises and people.

**Most microfinance institutions will be able to limit the haemorrhage if lessons from earlier crisis are acted on and liquidity positions stabilised.**

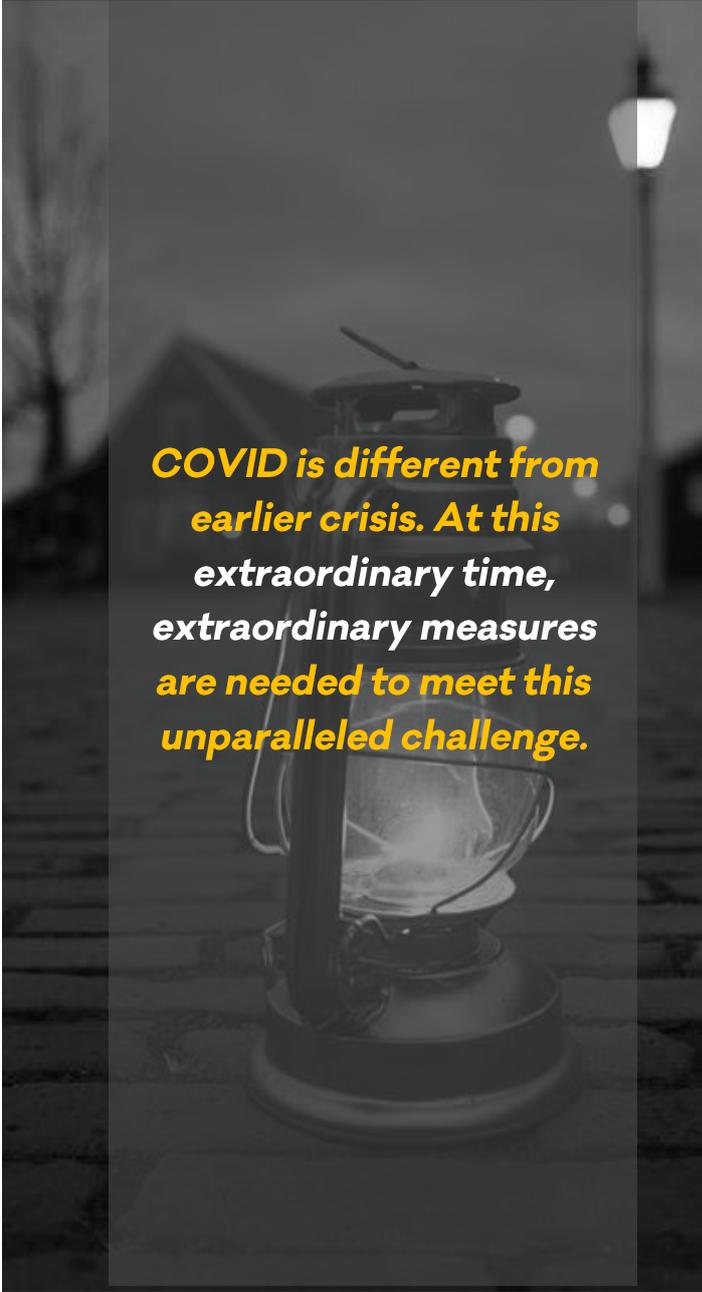
Microfinance institutions have faced earlier crisis, particularly triggered by natural calamities. Adoption of some core strategies during that time enabled MFIs operations to recover within 6-months:

- i. *Maintaining contact with clients throughout*, facilitating safety net transfers and sending a “we have your back” message to clients, enabling more frictionless collection of dues.
- ii. *Making disbursement as soon as possible*, enabling clients to resume economic activity quickly.
- iii. *Ensuring liquidity is allocated to meet demand during seasonal cropping patterns* where financing needs to be timely to catch small windows of opportunity. Stabilising liquidity is an essential underlying condition to adopt these rapid recovery strategies.

**COVID is different from earlier crisis and the scale of the challenge is dawning on most MFIs.** Earlier crisis tended to impact a proportion of MFI operations, enabling more vibrant areas to cross-subsidise those negatively impacted. The duration of the impact was also much better anticipated, enabling plans to be prepared and fundraised. These flexibilities are not present with COVID as it is a universal disaster.

**MFIs have been frantically engaging with funders.** Those with credibility and a diversified funding base are beginning to see some commitments coming through but these are primarily restricted to the top 3- 6 MFIs. The rest are just hoping to 'somehow survive'. The national association of MFIs – *Credit and Development Forum* – has put forward an ambitious \$2.6 billion MFI stimulus proposal to the Prime Minister's Office, which is unlikely to fully materialise given current political-economy and competition for scarce resources.

**Far more collaborative and joined-up strategies will be needed** with all the key actors in the microfinance ecosystem in addition to getting the basics right internally. If the recommendations outlined in the following box are implemented, there is hope MFIs and their clients can recover in a couple of years and be much stronger in dealing with another COVID-like hazard.



**COVID is different from earlier crisis. At this extraordinary time, extraordinary measures are needed to meet this unparalleled challenge.**

## RECOMMENDATIONS

- i. Rapidly assess and revise cash flow forecasts and liquidity model assumptions, and provide support to revise business plans where necessary.
- ii. Proactively share liquidity positions and plans with the regulator, creditors and investors.
- iii. Negotiate service agreements with MFS operators and MNOs to execute social-distancing compliant collection, disbursement, and customer services models.
- iv. Develop a microfinance industry assessment and recovery strategy, securing buy-in of ecosystem players for its execution, especially the Government and the regulator.
- v. Negotiate agreement with banks to act as a 'spare tyre' with temporary liquidity support to kick-start resumption of microfinance operations. This will not be easy given banks' own liquidity constraints, but support should be leveraged from funders, market facilitators and investors.
- vi. Negotiate with regulators agreement to remove artificial and market distorting ceilings on price of foreign currency loans adjusted for currency and country risk.
- vii. Explore with existing wholesale banks, together with interested investors and donors, potential for a large-scale blended securitization, under the leadership of a leading MIV or DFI, of:
  - a. wholesale microfinance assets managed by domestic commercial banks, and
  - b. remittance streams (to secure better rates).

This will be likely be the most bold and transformative action, but also the most complex. Complexity however should not be an excuse to not act.

- viii. Once this crisis abates, the Credit and Development Forum together with regulators and policy makers will need to fundamentally restructure the MFI sector:
  - *Managing and incentivising consolidation* as it makes no sense to have more than 780 MFIs in the country with many operating as risky and ineffective 'mom and pop' operations'. Indeed, the COVID crisis will likely see the natural demise of many. This needs to be properly managed through, for example, liquidation under a voluntary-administration type of scheme. For the rest that do somehow survive but are essentially too small, some form of franchise model needs to be developed to enable small MFIs to work under a franchise model of a larger 'franchisor' MFI, ensuring standards and better risk management while maintaining operational autonomy;
  - *Establishing a tiered regulatory structure*, enabling risk-based regulation of MFIs;
  - *Steering transformation of the larger MFIs* into more specialised banks, regulated by the central bank. This will have the benefit of enabling the largest and most efficient to improve its capital structure, be subject to higher regulatory standards, become better governed, and provide keener prices to its customers.

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