From China to India

by George Friedman - June 2, 2020

U.S.-China relations have been in decline for a long time. The United States had for years provided China with relatively free access to the American market. The United States wanted equivalent access to the Chinese market, but China was unable to grant this. Its industrial base produced more products than the Chinese people could consume, in terms of quantity, price and the types of products produced. China was a compulsive exporter because only exports could sustain its industrial base and hence its economy and financial system. Giving the United States broad access to the Chinese market, on the financial order of Chinese exports to the United States, would have undermined the financial foundations of the Chinese system – a system that had to a great extent funded the creation of China's industrial system, and depended on both domestic consumption and foreign sales to balance it.

Under Pressure

China's financial system had been under pressure since before 2008. And so the Chinese could not permit the U.S. to have equivalent trading rights, leading to the imposition of U.S. tariffs. The Chinese were in no position to agree to America's demands because of the financial consequences it would have, and the United States was in no position to drop the tariffs because of social realities within the U.S. Many industries benefited greatly from reduced production costs and access permitted selectively to the Chinese market, even though Chinese imports had devastated some American industries. Each represented different social groups, and partly define the tensions in the American economy.

This was not a new story in the history of capitalism. From about 1890 until the late 1920s, it was the United States that held China's place. In the late 19th century, the United States launched an industrial revolution that depended on access to foreign markets as domestic consumption was not able to support the industrial plant. Cheap U.S. goods flooded Europe until after World War I, which shredded the market for the U.S. The U.S. continued to try to surge exports but also to limit imports of, for example, Japanese textiles. In the end, the collapse of global demand for American goods led to essential but self-defeating foreign imports, and was a significant force in driving the U.S. into depression.

The China story is an old one replete with social tension on all sides and the chance of war. Global capitalism, built on a global supply chain, doesn't require but enjoys an efficient, low-cost producer of products. The name for it now is Supply Chain. The U.S. supply chain is critical to the functioning of a large part of the global supply chain. The same is true with China. World War I constricted imports and hit the American leg of the supply chain. The same has happened to China as a result of the COVID-19 crisis. The damage to affected economies cut demand in most countries, leaving China in a difficult position.

But there was another dimension. The heightened demand for some products, such as pharmaceuticals, could not be met. The virus had also struck China, and its own internal supply chain was disrupted or redirected to Chinese needs. So as the loss of export markets staggered the Chinese economy, it was also being hit by importers' realization that depending on one country for their supply chain was too risky. China had been regarded as a reliable exporter, one of its main virtues. But even if it could offer products at a low cost, it was no use to importers if the products they needed weren't available. It is not that trust in China is necessarily shaken; rather, it is that the lack of redundancy in the supply chain has revealed its risk.

The Best Alternative

Two questions arise. First, China has reached the political limits of an export-based economy with a range of tensions with the United States and wide distrust of the robustness of its supply chain. It has to do what the U.S. did, after two decades of depression and war, and create massive domestic demand to drive its economy. Since global capitalism prefers a low-cost producer – or many low-cost producers – the question now is: Who will take China's place? The obvious first option is India, a country with a massive, diverse and generally poor population, but which has a degree of discipline and entrepreneurialism, similar to China in 1980.

India, however, is not in a take-off situation. It is the fifth-largest economy in the world and is also a major exporter already. China exports $2 trillion a year, India only $345 billion. Exports account for 19 percent of China's gross domestic product, and 14 percent of India's. China has a population of about 1.4 billion, roughly the same as India. When you look at these numbers, you can see a large, available workforce. More important, India is a nation much less dependent on exports to drive its economy, yet it is still poor. The basic characteristic of the U.S.-China model of development is a workforce that is paid relatively low wages but an existing political order with a demonstrable economic system.

Put simply, India has grown on domestic demand, and its next stage of growth should be a surge in exports. Thus at the very moment when China is in a deep and multidimensional conflict with its largest customer, India has a unique opportunity to charge its economy from these problems. And since India and China see each other as adversaries – there was a minor skirmish in the Himalayas last week – India has a strategic as well as economic interest in this move.

The Indo-Chinese confrontation, going back more than half a century, gives the United States an opening that would make economic alignment between the two more attractive. The United States, Japan, Australia and India are also developing a naval alliance called the Quadrilateral Security Dialogue. India in particular is wary of any formal alliance that requires any commitment. Unable to see the forces that might change its future, the Indian navy has merely carried out maneuvers in the Western Pacific with its Quad allies. The Chinese have noted this, of course, but they have assumed that India would not be eager to do anything formal, and that no war plan in the Pacific would be created that did not have a formal commitment.

Opportunity Waiting

The United States as a nation, and many individual companies, now see that depending on a single country as the root of a supply chain is a mistake. The situation in any one country, including how a global pandemic might impact its economy and its demand for a critical product, cannot be predicted. However attractive Chinese low-cost labor is to American companies buying from or producing in China, and however expensive redundancy might be, redundant supply chains are essential. India is the logical addition or alternative to China, and indeed already serves that role, although at an insufficient level as its export numbers show. But those numbers also show where we can expect India to demonstrate the greatest growth.

India has been a major economic power for a long time. But its historical goal is to move into the GDP ranks of Germany, Japan and China. The opportunity presented by the pandemic and China's current poisonous relations with the United States means that U.S. companies are already choosing to move out, and India is clearly eager to host them. Inevitably, however, the economic move becomes entangled with the political and military. China and India are already hostile toward one another, and the U.S. and China are increasingly hostile. The shift in supply chains is partly related to that hostility. China would have more economic options were it not confronting the U.S. The fact that it is creates economic possibilities for India.

And India certainly knows that there are many other countries that could fill and want to fill that gap. Shifting the supply chain takes time in some cases. Deciding where to shift does not.

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