

THE STRATEGIC CONTEXT OF INDIA'S ECONOMIC ENGAGEMENT WITH CHINA¹

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Recent scholarship has focused on China and India as the world's fastest growing economies, their expanding bilateral trade, and the vast potential for closer cooperation. There is, however, little attention devoted to what prevented cooperation in the past, how economic engagement factors into their respective "grand strategy," and how it influences the scope, pace and context of bilateral economic interaction.

This study addresses some of this deficit. Section One examines the changing position of each country in the other's security calculus. Section Two analyses domestic imperatives driving mutual economic cooperation. Section Three discusses the specifics of current and proposed engagement, including respective strengths and weaknesses. Section Four assesses elements of current cooperation and competition, and which security considerations might promote or inhibit future economic cooperation.

INTRODUCTION

A spate of recent academic and policy scholarship has focused on the rapid economic growth of China and India, comparing them across myriad indices of development. A similar body of scholarship has focused on the historical Sino-Indian security disputes, and how their current military modernization and geo-political interests will influence bilateral security ties in the future. However, there has been relatively little attention devoted to exploring the linkages and overlaps between the security and economic dimensions, and even less attention to what factors prevented cooperation in the past, how economic engagement factors into their respective "grand strategies," and how it influences the scope, pace and context of bilateral interaction.

This article addresses some of these overlapping issues. It begins with a review of the evolving template of Sino-Indian security relations, and then identifies key factors that underlie their recent decision to explore closer economic ties. It then discusses the spectrum of current and proposed bilateral economic engagement, and concludes by assessing whether and which security factors might curtail economic cooperation in the future.

¹The author gratefully acknowledges the *US-Japan Foundation Center for Global Partnership, U.S. Institute of Peace* and the United States government for supporting his work on China, India and Southeast Asia.

I. THE LONG SHADOW OF SECURITY DISCORD

India's relationship with the People's Republic of China over the past fifty years has traversed the entire spectrum: the initial phase of *camaraderie* jolted by outright hostility, followed by a protracted period of mutual antagonism, gradually ushering in a phase of "uncomfortable co-existence." In the past decade, both sides were seeking to identify a domain of minimum convergence when the fall-outs of the Indian nuclear tests of 1998 rudely disrupted this process.

The ensuing period has witnessed a new phase of incremental rapprochement (Sidhu and Yuan, 2003)², notably underlined during Chinese Premier Wen Jiabao's April 2005 visit to India when the two sides signed an agreement identifying the core principles and parameters within which their security disputes would be resolved. The agreement, elaborated within its 11 articles, is based upon "Panchsheel", or *Five Principles of Peaceful Coexistence*. It states their strong preference for a political solution to the boundary dispute, "convinced that an early settlement will advance their basic interests... and should therefore be pursued as a strategic objective."

To better appreciate the significance of this and other recent developments, it is instructive to review the changing position of China in India's strategic calculus, and *vice versa*. Following its independence in 1947, and the onset of the Cold War that pitted the world in East v. West camps, India avoided joining either camp as that would have narrowed its options for external assistance to meet its pressing developmental imperatives. Instead, along with Egypt, Indonesia, Yugoslavia and China, it led the non-aligned movement to promote South-South cooperation and improve North-South dialogue and policy coordination.

However, India's early cooperation with China was soon shattered by an intense border war in 1962 along the British-designated McMahon Line that was not well delineated on the ground. The war resulted in a decisive military and psychological victory for China. The new ceasefire line is designated as the Line of Actual Control (LAC), with about 90,000 square km of disputed territory between the two sides.

The war was soon followed by China's first nuclear weapon test in October 1964, India's second war with Pakistan (1965), Pakistan leasing to China (in 1966) parts of the strategically-located Mount Karakoram (K-2) Pass in Kashmir that it acquired during the first Indo-Pak war (of 1947-8), and the start of a robust politico-military partnership between China and Pakistan. For the next two decades, Sino-Indian relations went into a deep freeze, interrupted by an occasional skirmish or frosty diplomatic exchanges. However, the end of the Cold War provided both India and China the space, and the need, to begin recalibrating their strategic policies toward Asia and toward each other.

Post-Cold War Rapprochement

India and China signed a landmark Peace and Tranquility Agreement (PTA) on September 9, 1993, which created a Joint Working Group tasked to resolve the boundary dispute. This was followed by the creation of the India-China Diplomatic and Military Expert Group on November 29, 1996 to clarify respective positions regarding LAC and implementation of confidence building measures, including regular communications between their Directorate Generals of Military Operations and relevant field offices.

Thirteen bilateral meetings within the above auspices culminated in India recognizing Chinese sovereign control over Tibet, with China tacitly accepting Sikkim as Indian territory, although this issue has re-surfaced in subsequent bilateral talks (Kondapalli, 2005). Further, both sides have exchanged maps of the least-contentious middle sector of their border, and reviewed each other's claims regarding the eastern and western sectors. In 2003, each side appointed a Special Representative to expedite the delineation of LAC, after which joint cartographic and survey teams would begin to pinpoint the boundary on the ground. From India's perspective, it would like to move its security dispute with China away from the earlier hostility to one of greater pragmatism and mutual accommodation.

From China's standpoint, accommodation might not be on terms acceptable to New Delhi. India had remained a significant but relatively minor component of China's global strategic outlook until the post-Cold War period. During the Cold War decades, from Beijing's perspective, New Delhi grossly underestimated the currency of power that nuclear weapons would eventually wield in international relations, and squandered its head start by concentrating on civilian nuclear research, and lobbying for universal nuclear disarmament. For its part, although China's nuclear program started after India's, it concentrated exclusively on the weapons dimension. It also managed to secure substantial early assistance from the Soviet Union until ideological and other differences terminated this assistance by 1960. Nevertheless, China was able to conduct its first nuclear test in October 1964, well within the January 1, 1967 deadline set by the Nuclear Nonproliferation Treaty (NPT) under which China is recognized, along with the United States, Britain, France, and Russia, as the Permanent Five (P-5) nuclear weapon states (NWS), who are also the permanent five members of the UN Security Council.

By contrast, India missed this deadline by championing the demand for disarmament and delaying its first nuclear weapons test until May 1974, followed by a self-imposed moratorium until May 1998.³ In the interim, so much had changed in the arms control landscape that ironically India, which had first proposed the Comprehensive Test Ban Treaty (CTBT) as far back as 1954, was forced to vote against its adoption at the Conference on Disarmament in Geneva in July 1996. The reason was a last-minute amendment to the proposal, reportedly on the insistence of China and Australia, to insert an Entry Into Force (EIF) clause requiring all 44 countries with active nuclear programs to sign before the treaty could go into effect. For India, signing the CTBT would have meant relying on its lone test of a first-generation fission device in 1974 for its nuclear weapons arsenal. As expected, it voted against the treaty, although it was adopted at the September 1996 session of the UN General Assembly.

This turn of events precipitated the Indian decision to conduct 5 subterranean nuclear explosions on May 11 and 13, 1998, including advanced fusion and thermonuclear designs. Prime Minister Vajpayee's letter to President Clinton, leaked to the press, cited the threat from China's nuclear arsenal, and its assistance to Pakistan's nuclear and missile programs, as the primary rationale for India's decision to overtly weaponize its potential.

While these developments elicited a sharp negative reaction from Beijing, its leadership also began to note New Delhi's growing resolve to improve its power position within the international system. Until then, Beijing perceived India as a second-rate

player, lacking determination and cohesive purpose to project power beyond South Asia. This is borne out by declassified US government documents of 1969-72 that reveal the extremely disparaging language used by Chairman Mao, and by Henry Kissinger, President Nixon's National Security Advisor, in describing India and its then-Prime Minister, Indira Gandhi.

Changing US Role

India's rejection of the CTBT and its subsequent nuclear tests led to the United States imposing non-proliferation related sanctions. Within weeks, however, Washington entered into an intensive (Talbot-Singh) dialogue⁴ with New Delhi that led to the lifting of almost all sanctions, followed by President Clinton's visit to India in March 2000 that speeded up broad-spectrum normalization of relations. This process was catalyzed under the Bush administration, which has welcomed India as an emerging global power (CIA Report, May 2005), and both sides are pursuing closer military-security cooperation. While the broader shared goal is to ensure peace and security in Asia, a related US expectation is to partner with India to curb the rapid rise in China's power.

Pursuant to the growing congruence in US and Indian strategic priorities, on June 29, 2005, they signed a 10-year defense agreement that paves the way for Washington to supply state-of-the-art combat systems, and engage in co-production and collaboration of sophisticated weapons systems with India. Since 2002, the Pentagon has conducted a series of assessments reviewing its defense co-production options with NATO and Asia-Pacific partners and contrasted them with newer options such as partnering with India. The net assessment is that given India's comparative advantage in select segments of high-technology, if technology safeguards in India were to be beefed up to prevent unauthorized diversion of US technologies, then the two sides can profitably partner to produce weapons systems and components that could be absorbed by their respective armed forces, and also exported to select destinations.

To an extent, this assessment has complemented bilateral efforts to deepen defense cooperation and improve "firewalls" between and within India's defense and civilian sectors, most notably through the High-Technology Cooperation Group (2003) and the Next Steps in Strategic Partnership (2004). Success in both paved the way for the Joint Statement of July 18, 2005 by President Bush and Prime Minister Singh that commits each side to a series of reciprocal steps that will eventually permit US civilian nuclear assistance to India. In return, India will separate its civilian nuclear facilities from those dedicated to weapons, place civilian facilities under the International Atomic Energy Agency safeguards, strengthen its export controls, and align its nuclear and missile control lists with those of the Nuclear Suppliers' Group and the Missile Technology Control Regime. While India will not sign the NPT as a non-nuclear weapon state, this new agreement provides a *modus vivendi* for US, and international, nuclear (and broader hi-tech) cooperation with India.

While the above steps of building a technology-embedded US partnership with India will advance respective economic and security interests, both countries also share a growing concern over the rise of China, including whether aggressiveness will return to Chinese behavior once it calculates that the costs of challenging US supremacy in Asia and beyond are outweighed by the gains (Tellis, 2005). And while India's interests are

not perfectly aligned with those of the United States, this tripolar dynamic certainly affords it the opportunity to improve its position vis-à-vis both China and the United States. That is why, as noted earlier, an unspoken element of this cooperation is for India to develop the capability for joint operations with the United States and provide it military basing and logistical assistance to curb any Chinese activism that might undermine Asian security and prosperity in the future. The strategic undertones of the growing US-India ties have factored heavily in Beijing's calculations as it formulates its economic and security policies toward India.

II. DOMESTIC IMPERATIVES FOR ECONOMIC ENGAGEMENT

The preceding section discussed the changing security relations between India and China, and the influence of US policy in their respective strategic calculations. This section elucidates the factors that have prompted China and India to modify their approaches and seek greater economic cooperation in pursuit of their respective aspirations within Asia and beyond.

For China, three essential factors underlie its motivation to pursue economic cooperation with India. First, the Chinese Communist Party (CCP) has identified sustained economic growth as a national security priority, for that alone would provide it the resources to pursue all other developmental and security imperatives, as well as sustain the legitimacy of its single-party rule. In this context, while China has substantially expanded trade ties with East and Southeast Asia over the past decade, it wants to tap the massive Indian market to sustain its upward growth trajectory.

Second, China seeks to leverage improved ties with India to penetrate the other economies of South Asia. Aside from Pakistan with which it has strong economic and security ties, China's past attempts to improve relations with Nepal, Bangladesh and Sri Lanka have met with limited success, in part because of India's growing concern about Chinese meddling in its "sphere of influence." India represents almost 80% of South Asia's economy, and its pivotal regional role is reinforced by the fact that it is the only South Asian country that shares land or sea boundaries with all the other 6 countries of South Asia. Beijing recognizes that improved ties with India would facilitate its goal of expanding ties with Maldives and Bhutan, apart from the more strategically-located Nepal, Bangladesh and Sri Lanka.

Perhaps in recognition of these realities, in early 2005 China sought an "observer status" within the South Asian Association for Regional Cooperation (SAARC). At the November 2005 summit, Afghanistan was admitted as the 8th member of SAARC, and the heads of state agreed "in principle" to grant an observer status to both China and Japan, the modalities of which will be worked out by SAARC's Council of Ministers at their next meeting in July 2006.⁵ While Nepal's threat that it would veto Afghanistan's membership if China was not granted an observer status foreshadows emerging political realignments, Beijing's approach for an institutional status is designed to dampen suspicions regarding its intentions. The expectation is that the lure of sharing in China's economic boom might outweigh concerns that its low-cost products could wipe out domestic producers and stifle indigenous growth prospects in South Asia.⁶

A third factor propelling China's search for closer economic ties with India stems from Beijing's concerns over the rapidly improving US-India relations, and the growing rift in Sino-US ties. Thus, on one side, the Bush administration has publicly welcomed India's rise as an emerging global power, and wants to assist India in reaching its potential (The White House, 2005). And on the other, the Pentagon's July 2005 report to the US Congress warns of the risks that China's rapid military modernization and policies pose for the United States in Asia. The security concerns add to the growing range of US economic disputes with China relating to its large trade surplus (over \$100b), valuation of its currency (renminbi),⁷ under-pricing of its commodities (notably, textiles), and the aggressive overseas purchases of oil fields and exploration rights by China's state-owned oil and natural gas companies.⁸

While the import of the changing US approach toward India and China will be assessed in the concluding section of this article, suffice it to say here that China views expanded economic ties with India as a "hedge" against a future US-Indian coalition to contain China's rise in Asian and international affairs.

For India as well, three sets of factors anchor its decision to enhance economic cooperation with China. First, it seeks to penetrate and profit from the immense market that China represents, with an average per capita income of about \$1200 and a rapidly growing middle class. Although China's national savings rate has grown to 42% in 2004, compared to 40% in the 1990s and 35% in the 1980s (World Bank Indicators), the urban middle class has higher disposable income and a growing preference to consume, in part because of the uncertain returns on savings in China's opaque and inefficient public-owned banks, and severe restrictions on investments abroad and even at home. Further, with an export-led growth approach becoming an important component of India's growth strategy, and observing the success of this approach in East Asia and China, seeking China as a destination for India's exports has become a natural outgrowth of the new strategy.

The second Indian imperative is to leverage improved economic ties with China to deepen engagement with the Asia-Pacific. This meshes well with the "Look East" policy that India adopted in the mid-1990s. In essence, it stated that while the European Union and the United States are, and should remain, India's largest trading partners, it should also expand trade ties with its eastern neighbors. Apart from lower transportation costs, these markets offer greater opportunities for domestic manufacturers and service providers, and growing linkages facilitate the pursuit of broader foreign policy and national security goals (Baru, 2000).

India's "Look East" approach has already yielded some positive dividends, including membership of the ASEAN Regional Forum (ARF) and of the influential ASEAN+3+1 (joining China, Japan and South Korea). Further, India concluded an FTA with Thailand in May 2005 and a Comprehensive Economic Cooperation Agreement with Singapore in June 2005. Earlier, in February 2004, it concluded an agreement to establish BIMST-EC, a regional economic cooperation agreement with Bhutan, Myanmar, Sri Lanka, Bangladesh and Thailand. Despite these gains, New Delhi recognizes that Southeast Asian capitals will look for "signals" from Beijing in re-calibrating their economic and broader ties with India.

A third Indian imperative is to reduce friction with China as India attempts to address its rapidly growing energy shortfall. Despite all efforts to tap domestic reserves, India still imports about 75% of its oil, most of it from the volatile Middle East. The recent hike in crude prices to over \$60 a barrel has meant that oil imports constitute the largest item on India's import bill. The high price of crude is unlikely to abate much since it is driven in large measure by the rapidly growing demand from China and India.

This untenable situation has underlined the need for India to diversify its sources of supply. India's public-owned Oil and Natural Gas Commission (ONGC) is prospecting for oil in Sakhalin and Tatarstan in Russia, and eyeing natural gas reserves in Central Asia, Caucasus, Iran, Bangladesh and Myanmar. In each case, China's greater resources and competing interests counsel that Delhi improve its ties with Beijing. This is particularly true in the case of Central Asia, where China and Russia spearhead the Shanghai Cooperation Organization (SCO), which includes Kazakhstan, Kirgystan, Turkmenistan and Uzbekistan. In July 2005, India was awarded the status of a "dialogue partner" in the SCO, but its ability to access Central Asia's energy will in part depend on improving ties with China. This became painfully obvious in August 2005 when a last-minute change meant that India's ONGC lost its bid for *PetroKazakhstan* to China's National Petroleum Corporation.

Table
Comparative Statistics of China and India

<i>Index of Measurement</i>	<i>Period</i>	<i>India</i>	<i>China</i>
Exports as % of GDP	2000-2005	14.3	28.6
Imports as % of GDP	2000-2005	15.1	26.0
GDP growth rate	2000-2005	8.1	9.3
Savings as % of GDP	2000-2005	22.08	42.55
Consumption as % of GDP	2000-2005	77.92	57.45
Household Consumption as % of GDP	2000-2005	72.94	44.37
National Gross Savings Rate as % of GDP	1997-2004	22.6	43.4
Investment as % of GDP	1997-2004	23.0	40.0
FDI as % of GDP	1997-2004	0.7	4.2
FDI (absolute figures) ¹	2005	5.6b	63.2b
CAGR ² of Labor productivity	1990-2003	3.3	7.3
ICOR ³	2000-2005	2.9	4.2
Imports from USA	2005	7.4b	34.6b
Exports to USA	2005	20.2b	202.7b
Trade Balance	2005	+ 12.8	+168.1b

Notes: 1 = According to the International Finance Corporation, an arm of the World Bank, China's official FDI figures are about two times higher than their actual value, given the practice of "round-tripping" i.e. money that went out from the Mainland returns disguised as foreign capital via Hong Kong. India's FDI calculations, on the other hand, are too low, because it excludes reinvested earnings, subordinated debt, and overseas commercial borrowings – all included in other countries' FDI statistics. Even so, China's FDI is at least 3 times higher than India's, even if not 10 times greater as the official figures indicate.

2 = compounded annual growth rate

3 = incremental capital output ratio

Sources: World Bank Development Indicators Online; Economy Watch; Center for Monitoring the Indian Economy; Economic Survey of India, and CII-McKinsey Analysis 2005.

A related Indian imperative is to break out of the South Asia “box” and emerge as an Asian power. Its omni-directional politico-economic diplomacy has begun to yield positive results, but improved ties with China would perform remain a significant part of its strategic calculus.

III. GROWING BILATERAL ECONOMIC TIES

Sino-Indian economic engagement has a short history but a sharply rising trajectory. Although the two had signed an accord in 1984 granting MFN status to each other, bilateral trade was only about \$332m until 1992. It has grown steadily since then, except during 1998-99 following the Indian nuclear tests, reaching \$5b in 2002, and \$13.6b in 2005. China now ranks as India’s third largest trading partner, although India remains a distant 12th in China’s foreign trade statistics.

During Premier Wen’s April 2005 visit, India and China set the foreign trade target of \$20b by 2008, and \$30b by 2010. Given the compounded annual growth rate of over 30% since 1999, reaching these goals should not prove difficult. What is more noteworthy, however, is the massive untapped potential for broader cooperation, but also the problems and challenges that these aggregate figures do not reveal.

The foreign trade volume of \$13.6b in 2005, with India’s exports valued at \$7.67b and imports at \$5.93b, is notable for two reasons. First, China has typically permitted its smaller neighbors to enjoy a trade surplus with it, whereas China’s own largest trade surplus is with the United States. This approach, not unlike the US practice while aiding the recovery of Germany and Japan from their destruction during World War II, helps China reinforce the image of its “peaceful rise” (*heping jueqi*) and enhance interdependence with these Asian economies. This is borne out in the recent Japanese and South Korean economic revival, with China displacing the United States as their largest trading partner. This is significant given that foreign trade comprises about 40% of the GDP of these major world economies, and trade with China—especially for Japan - has curbed adverse policies despite their respective bitter memories of World War II.

The second and somewhat related aspect of India’s minor trade surplus is the “irrational exuberance” that it generated about India’s ability to successfully compete with China. However, a simple review of the basket of commodities that comprise India’s exports to China reveals a more somber picture. Thus, iron ore, slags, ash, and steel account for over 60% of India exports, followed by plastics, organic chemicals and cotton yarn. Further, the high earnings from iron and steel exports are buoyed by the current high international price of these items, fuelled in part by China’s booming demand, which now accounts for almost one-third of the global iron and steel demand. And while China’s infrastructure needs might sustain this demand and high prices for some years, India needs to rapidly diversify its export basket to sustain and increase its exports over the longer term. On the other hand, India’s imports from China are dominated by electrical machinery and equipment, organic chemicals, machine tools and mineral fuels. The import basket thus reveals the clear cost advantage enjoyed by China in these higher value-added items over India.

Clearly, India risks becoming a supplier of minerals and semi-manufactured goods to China unless it rapidly steps up the production of higher value-added goods at

internationally competitive prices and builds a more mature and balanced trading relationship with China. This in turn raises the more complicated issue of how India can successfully compete with China in increasing its exports of similar products and services globally, while also deepening trade and manufacturing ties with China. Public statements and policy signals emanating from New Delhi so far do not clarify how it seeks to resolve this Catch-22 situation or even whether it fully comprehends this dilemma.

Government-Industry Collaboration

The efforts by the two governments to deepen and widen economic cooperation became focused during 2000-01 as India negotiated with China and then supported its entry into the World Trade Organization. From about the same time, Beijing has displayed a growing interest in harnessing Indian IT strengths for its broader benefit. Thus, in mid-2000, the political leadership of Xinjiang province invited IT professionals from India to help develop this backward region.⁹ Similarly, India's IT prowess has piqued the interest of the Chinese armed forces (PLA), whose military modernization emphasizes greater use of IT in C⁴SIR (command, control, communications, computers, software, intelligence and reconnaissance).¹⁰ While China appears keen to exploit India's IT and software strengths to integrate it with its hardware capabilities, a corresponding Indian strategy—either to protect its commercial edge or secure a reciprocal bargain from China in another field—is not visible.

On a broader front, the Indian Navy has since 2000 undertaken a successful annual initiative called "Operation Milan" under which its ships make port calls in most countries through Southeast Asia and Japan. In 2004, Indian ships made their first-ever port call in Shanghai, and the two countries plan to conduct a joint maritime exercise in the near term. Here too, while India is pursuing a broader confidence-building approach, China's strategy—of developing close naval (military) ties with India's neighbors (Pakistan, Myanmar and Bangladesh)—has not generated a corresponding Indian response in the public domain.

In any case, bilateral governmental efforts have generated a strong positive response from the business community, and greater synergies are beginning to emerge. The Confederation of Indian Industry (CII), India's premier consortium of primarily high value-added manufacturing companies, has partnered with Indian diplomatic missions in Beijing and Shanghai to organize two successful "Made in India" road shows during 2003 and 2004. In May 2005, it partnered with the China Council for the Promotion of International Trade to organize a conference, "China's Miracle" attended by business majors and top commerce ministry officials from both countries. In addition, in recent years numerous business delegations, seminars and workshops at leading academic and policy institutions on each side have enriched the bilateral economic discourse, and generated optimism about expanding commercial ties.

Further, in a 2005 report entitled "India-China: The Road Ahead," the CII has recommended several areas where India's merchandise exports to China have bright prospects: a range of grains, fruits and marine products, granite, cement and plastering materials, chemicals and pharmaceuticals, and cotton-based fabrics. There is significant potential for growth in the services and knowledge-intensive sectors as well, particularly

biotechnology, IT and ITES, health, education, tourism and the financial sector, although here too governmental activism will be critical to harness mutual complementarities.

India's private sector in the IT and related hi-tech fields enjoys certain advantages over China. The IT sector developed during the 1990s from a combination of entrepreneurial ingenuity and governmental inattention. Consequently, firms were forced to optimize operating costs and compete for larger shares of the global off-shoring and BPO market. Over time, they moved up the value chain to provide customized business solutions to global clients, created increasingly seamless division of labor between local entities and their partners abroad, and have now accelerated global acquisitions to produce and supply to distant markets.

By contrast, it was only in 1999 that China's private firms were provided the same constitutional protection that was available to foreign businesses and the domestic public sector since the 1980s (Yasheng and Khanna, 2003). A related problem, stemming from China's decision to direct FDI and domestic capital toward its inefficient SOEs is that most private firms remain strapped for cash. This "unfair treatment" in turn prevents them from scaling up production to improve productivity, and consolidate operations by resorting to mergers and acquisitions in China or abroad (Srivastava, 2005; China Academy of Social Sciences, 2000).

Further, with the Indian IT industry providing the technical backbone, high-throughput research in genetics and manufacture of generic and patented drugs and chemicals have accelerated. A range of domestic and foreign companies are taking advantage of the wide gene pool of available human, animal and plant pathologies to conduct clinical trials and manufacture customized medicines. In recent years, the Indian government has begun serious efforts to improve the legal and regulatory framework for technology security. This has been prompted by the abuse of the lax regulatory and enforcement standards in the past, and the growing need to provide international-caliber patents to propel future growth. India passed the Patent (Amendments) Act in March 2005 to comply with its WTO obligations of providing product and process patent protection. And while robust enforcement might still take a long time, industry standards are getting increasingly aligned to global standards, and India now leads international patent filing amongst the developing economies.

By contrast, in spite of the remaining weaknesses in India, China's IPR protection is comparatively much weaker. As a new entrant to the WTO in 2001, China is obligated to improve its regulatory framework and enforcement mechanisms, and to curb the widespread patent infringement of foreign products and technology—from audio-visual to dual-use aerospace and nuclear items (March, 2005). This is expected to take considerable time given the institutionalized form of corruption in the system, continued constraints on the operations of the private sector, and the sheer scale of the national industries that need training and supervision. This presents India with the opportunity to exploit its relative head-start and increase the share of its value-added exports to China.

Finally, India's banking and financial services sectors are also more developed than China's. With over 20 million shareholders, India has the third largest investor base in the world after the United States and Japan. The Indian capital market is significant in

terms of degree of development, volume of trading and growth potential. Its stock market capitalization of \$41 trillion as of March 2005 was the highest amongst the emerging markets, compared to \$450 billion in China. Clearly, India is in a position to assist in the development of China's nascent stock market and its relatively weak and non-transparent banking sector.

Indian Business Presence (and Issues Facing them) in China

A diverse range of prominent Indian companies are expanding their operations in China—by setting up branch offices, joint ventures (JVs) or training facilities. In the pharmaceutical and IT area, these include Ranbaxy, Aptech, Aurobindo Pharmaceuticals, Tata Consultancy Services, and Dr. Reddy's Laboratories. Indian business majors that have established Wholly Foreign-Owned Enterprises (WFOEs) include Infosys, NIIT, Orissa Industries Ltd., and Essel Packaging. The IT giant Infosys, which has 250 employees in its China operations, announced in August 2005 that it will invest \$65m to set up facilities in Shanghai and Hangzhou that will train up to 1,000 Chinese engineers as well as house some of its back office and BPO tasks in China. This follows the lead of NIIT and TCS, each of whom have training facilities and business operations in several provinces of China. Sundram Fasteners Ltd has set up a factory in Haiyan Economic Development Zone in Zhejiang province to manufacture and sell high tensile fasteners to the Chinese automobile industry. The Aditya Birla Group has set up a Carbon Black plant to supply directly to the Chinese tyre manufactures. JK Tyres and Apollo Tyres have established technology transfer routes to produce from China primarily for third country exports but also to supply to the domestic market. In addition, Indian banking organizations including State Bank of India, Bank of India, Bank of Baroda, Punjab National Bank, and ICICI Bank have set up representative offices in China.

However, as Indian companies set up JVs and WFOEs in China, the US (and European) experience in dealing with China over the past decade might be instructive. It is well known that Deng Xiaoping's reform policy started in 1979 has altered the economic landscape of China, making it the 7th largest economy (at \$1.65t) and the third largest foreign trader (at \$1.2t) in the world by 2005. But the share of high-tech items in China's exports remains very low even today. That is why during the 1990s, the Chinese government promised tax breaks and access to its vast domestic market if US high-tech companies, particularly in IT and telecommunications sectors, would set up JVs with indigenous Chinese companies. A related government expectation was that "technology transfer" from such JVs would improve China's S&T base and, over time, permit Chinese companies to competitively market their own products and software within the country and abroad.¹¹

The JV model required US companies to seek concurrence from their Chinese counterparts at each stage of business decision-making. Delays and disagreements hobbled progress, and the unsatisfactory JV model forced US companies to withhold larger investment of financial and intellectual capital into these collaborations. However, from Beijing's standpoint, the JV model was a partial success because of the advanced domain knowledge and business model training it provided to several thousand Chinese high-tech workers.

However, the relative failure of this model persuaded the Chinese government to offer substantial incentives to “wholly foreign-owned enterprises” (WFOEs). Under this scheme, a WFOE would not be required to have a Chinese partner, and would be permitted greater latitude in negotiating how its IPRs are safeguarded when a Chinese employee hired and trained by the foreign company decides to leave the company.

While the WFOE model promises to be relatively successful in boosting China’s foreign trade, the scope for high technology transfers to Chinese entities has considerably diminished. It is a less appreciated fact that in spite of China’s booming exports that crested at \$600b in 2004, the share of Chinese entities in the exports is less than 40%, and the majority of those are State-owned enterprises (SOEs). Further, the share of high technology in these exports is estimated at less than 10%. The import of this discussion is that until the Chinese government and its indigenous industry provides international standard protection to technology security and IPRs, multinational companies will hesitate to enter into technology-embedded partnerships with Chinese entities, instead electing to exploit price advantage by locating their production in China. There is no publicly available information to confirm whether India’s government or its business majors have taken these factors into their consideration, or how they plan to negotiate any problems that might arise in the later stages of their operations in China.

Chinese Business Presence (and Issues Facing them) in India

India’s economic reforms, started in July 1991, were prompted in part by a severe balance of payments crisis. Over time, the government initiated reforms to simplify administrative procedures for economic transactions at home and abroad, reduce structural barriers to the entry and operation of domestic and external actors and investors, and enhance the overall export-orientation of the economy. The result is a strong affirmation of the salutary dividends to the Indian economy: with GDP growth averaging 6.5%, the economy grew from \$280b in 1991 to \$692b in 2004-05, making India the tenth largest economy in the world. During the same period, exports grew to \$80b and imports to \$104b, while foreign exchange reserves (\$142b) were sufficient to finance over 15 months of imports. Equally significantly, peak import tariff duties of 300% in 1991 have declined to 15% in 2005 (compared to 10.5% in China), and are slated to reach 5% (i.e. ASEAN-levels) by 2008, with receipts from direct (i.e. income) taxes estimated to exceed indirect (i.e. customs and excise) taxes in 2006, mirroring the situation in developed economies.

On the other hand, these positive macro-statistics conceal a staggering array of problems that need urgent attention. For example, the fiscal deficit remains at a high level (8% in 2005), rigidities in the labor market thwart foreign participation and productivity gains, while distortions in factor prices and other NTBs discourage technology-embedded capital investments from abroad (Srinivasan and Tendulkar, 2003). Infrastructure remains chronically weak and unreliable, although in recent years successive governments have committed massive funds, and project implementation oversight authority, to overcome these problems.

In any case, the investment opportunities in India’s infrastructure development, coupled with the country’s 250m-strong middle class and the rising disposable income in the hands of the rural rich, are making India an increasingly attractive market for

China, among others. Partly in recognition of these opportunities, in recent years China has steadily expanded its merchandise trade with India. Concurrently, a range of Chinese companies that specialize in the manufacture of a range of engineering, metallurgical and petroleum products have begun to increase their presence in India. These include China Petroleum Technology & Development Corporation, China Metallurgical Import and Export Corporation, China Shougang International Trade and Engineering Corporation, Wuxi Machine Tools, and Sichuan EMEI Diesel Engine Joint Stock Co. Ltd. In addition, M/s ZTE Ltd, a prominent software company, has set up its operations in India while Konka and TCL, two of China's leading consumer durable companies, have set up joint ventures. Similarly, Haier, China's largest white goods manufacturer, has set up a manufacturing facility in India. Apart from the above, the focus of most of the other Chinese companies is on infrastructure projects.

A notable exception to the above trend is the presence of companies that produce dual-use goods and technologies, i.e. those with both civilian and military applications, who are also large vendors for the Chinese armed forces. These include China Precision Machinery Import and Export Corporation (CPMIEC), Sinochem and Huawei Technologies. CPMIEC is selling technology for mini blast furnaces in India, but is the producer of critical components for China's nuclear weapons and missile complex. Sinochem is currently supplying Schedule III dual-use chemicals under export license to the Indian commercial sector.¹²

Finally, Huawei Technologies Inc. has recently set up IT and BPO operations in Bangalore through its Indian subsidiary, Huawei Telecommunications (India) Company Pvt Ltd. In August 2005, the company sought permission from India's Foreign Investment Promotion Board to invest an additional \$60m to set up a manufacturing base and another \$40m for an R&D centre in Bangalore. It is notable that Huawei is a major producer of defense-related IT products for the Chinese armed forces and has been sanctioned several times by the US government.¹³ Since a number of India's critical aeronautical and defense electronics facilities are located in Bangalore and neighboring Hyderabad, the government has initiated informal queries relating to defense intelligence implications of Huawei's presence.¹⁴ At the same time, there is no information available in the public domain about any tangible decisions by the Indian government to monitor or limit the operations of Huawei. But scaling up and consolidating their market presence in India will remain a challenge, particularly for China's dual-use industry, until bilateral security differences are resolved or minimized.

IV. ASSESSMENT AND CONCLUSION

The Economic Dimension

In addition to targeting rapid improvement in bilateral foreign trade and value composition, in April 2005 the two governments established a study group to examine the feasibility of an FTA. An FTA, as described by the WTO, implies zero duty on goods, but does not cover services, FDI or the movement of persons. Since India's agricultural and non-agricultural tariffs are still higher than China's, entering into an FTA could result in considerable trade diversion and welfare loss (Virmani, 2005). Besides, with companies from India establishing JVs or branch offices in China and *vice versa*, intra-company transfers of capital and technologies are not going to be directly affected by an

FTA. As such, it might be better if both sides identify and remove trade and non-tariff barriers that are the true impediments to expanding bilateral economic relations. Those solutions can be pursued without an FTA.

Moreover, as developing economies, they will continue policy coordination within WTO to secure their interests in the multilateral trading system. This is evident in the on-going Doha round of negotiations relating to tariffs, agricultural subsidies, market access, and environmental safeguards. Finally, both are identifying complementarities in their product and services profiles to improve trade flows and minimize trade diversion and consequent welfare losses.

An area of growing competition, along with limited cooperation, relates to energy sourcing. Given that India's ONGC and China's National Petroleum Corp. (CNPC) are aggressively competing for oil and gas fields in Central Asia, Africa and Latin America, the two governments have proposed signing a MoU to coordinate efforts so as to not bid up the procurement prices. On August 8, 2005, India approved ONGC's contract to lay a 741-km pipeline and expand the extraction capacity of an oil refinery in Khartoum.¹⁵ On November 1, 2005, China announced that it will build a major hydroelectric plant in Myanmar with an eye to selling electricity to India.¹⁶ In mid-November 2005, CNPC and ONGC made their first-ever joint bid to buy out Petro-Canada's stakes (of \$1 billion) in a major oil and gas venture in Syria. Beyond these, India has offered to extend the proposed Iran-Pakistan-India gas pipeline to southwestern China, and proposed creating an Asian Energy Grid so that China and India, and other neighboring countries, could access assured supply of oil and natural gas. While China has remained silent on India's more ambitious proposals that in any case entail significant economic and security considerations, over time both sides might be persuaded to consider imaginative proposals to address their serious energy needs.

Bilateral competition is likely to intensify for a greater share of global high-technology products and services. China has made skillful use of FDI and domestic savings to establish itself as the world's leading source for low-cost, low-specialization, manufactured goods. However, its policies to use JVs and other measures to attract high-technology have met with limited success. And unlike India, China has relied extensively on an export-led growth strategy with relative inattention to developing its domestic market as a driver of growth (Morgan Stanley, 2005). Thus despite rising national savings, the share of household consumption in China's GDP has steadily fallen from 52% during the 1980s to 44% by 2003. Continued regulatory constraints on the capacity of the domestic private sector to raise capital and acquire assets abroad inhibit its operational flexibility and related productivity gains.

By contrast, India's private sector in high-technology faces few such regulatory constraints, and is scaling up operations and establishing foreign collaboration to secure greater market share at home and abroad. Further, with less than a fifth of the FDI that China has annually attracted, capacity utilization of scarce capital resources has steadily improved. One measure of this is the incremental capital output ratio, where a 2005 CII-McKinsey study showed that India's ICOR has fallen to 2.8 in 2004 from a high of 4.0 in 1991, while China's ICOR has risen from 3.0 to 4.1 during the same period. It is likely then that China and India will compete aggressively in the global hi-tech sector, with certain advantages to India in the near term.

The situation is almost reverse in the cottage and small sectors where the Indian government had imposed heavy restrictions on foreign investment and hiring of labor from outside the local region. By contrast, China's manifest success in adopting more liberal norms for attracting capital and hiring of domestic labor has belatedly persuaded the Indian government to pursue China-style reforms. Even so, China's cost and quality advantage is expected to endure at least in the near term.

Another area of growing competition would be in textiles, including yarn and finished products. With the phasing out of the GATT-era multi-fiber agreement and import quotas, Sino-Indian competition for greater global market share has already begun to intensify. And with the United States and the European Union imposing curbs on China's textile exports, their Indian counterparts are positioning themselves to take advantage of this situation.

The Security Dimension

India remained a peripheral consideration in China's strategic calculations until the end of the Cold War. Given sustained Indo-Pakistani animosity, China's robust politico-military relationship with Pakistan was sufficient to keep India "tied down" and prevent it from emerging as a competitor on the Asian stage. During the 1990s, however, with growing pragmatism in India's security policies, China visibly adjusted its overall approach. It is deepening economic and military ties with India's neighbors and with the Indian Ocean littoral countries to neutralize the superiority of the Indian Navy (Garver, 2005). In addition, it has invested heavily in building all-weather transportation links with Myanmar, expanded runways at military airports near the Indian border, and established a signals listening post barely 25 miles from India's territory. Similarly, China conducted a naval exercise with Bangladesh in 2003 and is expanding economic ties with that country where anti-India sentiments remain a powerful political force.

China is pursuing a range of collaboration to develop Pakistan's advanced conventional military capabilities, including upgrading a deep-sea port in Gwadar in Pakistan's northwestern province. This new investment is in addition to extensive prior assistance to develop Pakistan's nuclear weapons and missile capabilities. At the same time, China has of late begun to distance itself from overtly supporting Islamabad's claims over Kashmir. And after 9/11, China has expressed concerns over the growing Islamic militancy in Pakistan and Southeast Asia, which it fears might radicalize its own Muslim populations in the Xinjiang, Shandong, Hebei or Yunnan provinces. It is notable that immediately following the 9/11 attacks on US soil, China closed its land border via the K-2 Highway with Pakistan, and re-opened it two days later only to allow travel to Pakistan from China, but not the other way around. This suggests that despite all other forms of support to Islamabad, Beijing is loath to pursue policies that might endanger the internal stability of China.

This shared sense of "vulnerability" has been discussed in China's recent dialog with India, and counter-terrorism represents an important avenue for bilateral cooperation. But by far the most critical variable to influence China's approach toward India will be the evolution of US relations with India, which can directly impact China's goal of becoming the decisive factor in Asian economic and security affairs.

In the near term, a worsening of Sino-US relations is not assured. One measure that provides an insight into Beijing's calculations is "Comprehensive National Power" (CNP), defined as a sum of military, economic, scientific, technological and political power.¹⁷ The United States has the highest CNP score and will continue to do so into the foreseeable future, but China sees its current rank of 5, behind US, Japan, Germany and Russia, improving to 2 by 2025. India is ranked 13th and not expected to move higher than 9th. It is likely that China will continue its current strategy of improving economic and military cooperation with key Asian states to enhance its overall situation vis-à-vis the United States in Asia. In this context, Beijing would seek to develop stronger economic ties with India and minimize the risks that their security disputes persuade New Delhi to move closer to Washington.

From Washington's perspective, its current policy toward China is characterized by the term "con-gagement," i.e. a sum of containment and engagement, as the best response to China's "grand strategy" (Swaine and Tellis, 2000). Briefly, it postulates that the United States should encourage China to become a member of key multilateral economic and security institutions and over time an increasing stakeholder in the stability of the international system. Concurrently, given the massive military modernization undertaken by Beijing over the last two decades and the possibility of a crisis or conflict, Washington is improving ties with Delhi, Moscow and Seoul that can be leveraged to contain China. Taiwan remains the most probable lightning rod for such an eventuality, but developments relating to North Korea or Japan could also precipitate a crisis.

Beyond that, both China and the United States are cultivating closer ties with key Asian states, and India is becoming increasingly important to their respective grand strategy. Beijing's strong aversion to interference in its "sphere of influence" was underlined in 2003 when the Indian Navy escorted high-value US cargo ships across the Straits of Malacca, a strategic waterway shared by Singapore, Malaysia and Indonesia. In the same year, the US Defense Secretary Rumsfeld visited Delhi, Seoul and Tokyo, but not Beijing, to discuss cooperation regarding the US plans to build a National Missile Defense (NMD) and possibly deploy a theater version in Tokyo and Seoul. Indo-US cooperation on NMD is well under way, including the possibility of integrating US Patriot Advanced Capability (PAC-3) systems into the open-architecture missile defense shield that India is building with Russian and Indian assistance (Srivastava, 2001). This is an area of serious disagreement between China and India, and is expected to worsen with growing US-India defense collaboration.

In sum, since direct military conflict ranks very low on the strategic calculus of both India and China, bilateral economic ties are expected to grow and diversify in the near term, along with slow progress in resolving the border dispute. The problem in realizing the economic potential would boil down to whether India can compete with China in increasing its share of products and services globally and also cooperate with China without becoming a supplier of raw materials and components to its massive industry. For now, improved economic ties directly promote national priorities on both sides, with the possibility that increased mutual stakes might minimize adverse security policies in the future.

Over the longer term, however, Beijing's grand strategy of dominating the economic and security architecture of Asia, and in the process marginalizing India's role,

contradicts sharply with New Delhi's aim to significantly enhance its reach and influence beyond South Asia. Both countries are expected to intensify efforts for closer relations with the buffer states (Myanmar, Nepal and Bangladesh) while India will seek to limit China's relations with Sri Lanka, Bhutan and Maldives and China will seek to limit India's ties with Southeast and Central Asia.

At this time, it is not certain whether economic ties will provide the necessary and sufficient conditions to avert a crisis in the security arena, or whether such a confrontational build-up will constrain the pace and scope of economic cooperation in the future. Nevertheless, the likeliest long term scenario is that India and China will avert direct conflict, and a more fluid "sphere of mutual influence" will emerge whose boundaries and dimensions would be a function of the evolving economic and military capabilities, and postures, of both these Asian powers.

NOTES

1. The author gratefully acknowledges the US-Japan Foundation Center for Global Partnership, U.S. Institute of Peace and the United States government for supporting his work on China, India, and Southeast Asia.
2. Sidhu, W.P.S. and J. Yuan (2003), *China and India: Cooperation or Conflict?* Lynne Reinner Publishers, Inc., Boulder and London. See also, A. Srivastava, "Re-calibrating India's Relations with China", in Bajpai, K. and A. Mattoo, eds. (2000), *The Peacock and the Dragon: India-China Relations in the 21st Century*, Har-Anand Publications Pvt Ltd, New Delhi, 229-250.
3. By 1956, India had a civilian nuclear reactor becoming operational—well before China. And in 1961, the U.S. State Department discussed providing India assistance to conduct its nuclear weapons test before China. Although this option was never pursued, it was predicated on the logic that if China tested after India, it would not have as much influence on international opinion at a time when the US government was projecting that communism was not conducive to technological excellence.
4. On the Talbott-Singh talks, see review of Talbott's memoirs in Appu K. Soman, "Diplomatic illusions," *Bulletin of the Atomic Scientists*, March/April 2005 pp. 65-66; www.thebulletin.org/article.php?art_ofn=ma05soman
5. Dhaka Declaration, 13 November 2005", SAARC webpage, <http://www.saarc-sec.org/main.php?id=159&t=7.1>
6. Kripa Sridharan, "Beijing's Role in Saarc Expansion Unsettles Delhi," *Straits Times*, November 23, 2005.
7. China has recently up-valued renminbi by 2.1% and permitted its "managed free-float" against an undeclared basket of currencies, but the US side contends that renminbi is still devalued by about 18%.
8. In August 2005, growing pressure in the US Congress led the Chinese oil company (CNOOC) to withdraw its bid to purchase the US company, Unocal, but US concerns remain about Beijing's unfair patronage of CNOOC and China National Petroleum Corporation to seize control of US and international energy resources. In July, similar US concerns prompted China's giant appliance maker Haier Group Ltd. to withdraw its \$1.28b offer to buy its American rival Maytag Corp. See, E. Kurtenbach, "U.S.-China tensions likely to rise", *Business Week Online*, August 4, 2005.
9. "China calls for India's participation in development campaign", *Times of India*, October 2, 2000. See also, "India, China sign IT accord", *The Times of India News Service*, July 17, 2000.
10. This issue was first discussed in April 2001 during the visit to China of a high-ranking Indian delegation led by Lt. General Kalkut, Commander-in-Chief of the Eastern Command. See, R. V. Prasad, "Battle of the Mouse: Sino-Indian Cyber warfare capabilities compared," *The Telegraph*, March 20, 2001.

11. "U.S. Commercial Technology Transfers to the People's Republic of China," Study Group on Enhancing Multilateral Export Controls for US National Security, Department of Commerce, U.S. Government, 2003, <http://web.archive.org/web/20030108030147/http://www.bxa.doc.gov/osies/DefMarketResearchRpts/TechTransfer2PRC.html#TechTransferPRCPoliciesProcesses>
12. Like India, China too is a member of the Chemical Weapons Convention (CWC), and both maintain national control lists that categorize materials and technologies according to their relevance in the manufacturing of chemical weapons (CWs). Schedule I items can directly contribute to the manufacture of CWs, while those listed in Schedules II and III have decreasing significance for CWs. Sinochem is one of the only two entities authorized by the Chinese government to engage in export and import of Schedule I chemicals and precursors.
13. The latest US sanction was because Huawei was setting up a secure, underground, fiber-optic communications platform in the "no fly zone" of Iraq for Saddam Hussain's government, which was largely destroyed during the US-led attack on Iraq in March 2004.
14. Author off-the-record interviews with officials of the Ministry of External Affairs and the defense scientific establishment in India.
15. The refinery is equally owned by the Sudanese government and China National Petroleum Corp.
16. "China to tap Tibet's hydel potential to sell power to India," The Hindu Business Line, November 1, 2005.
17. A China Academy of Military Sciences study quantifies CNP as a sum of eight variables. A total CNP score of 1.0 is a summation of a country's natural resources (0.08), domestic economic capability (0.28), external economic capability (0.13), scientific and technological capability (0.15), social development level (literacy, health and other human development indicators, 0.10), military capability (0.10), governmental capability as manifested in ability to regulate and control economic activity (0.08) and foreign affairs capability (diplomatic influence and reach, 0.08).

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