



December 16, 2005

India as a global power?

India is a potential world power. India's stable democratic political system, huge middle-class population, immense military clout in South Asia, rising economic fortunes and global ambitions make it a potential power that could play a very important role in world affairs.

But it still must address numerous challenges. In order to become an economic powerhouse, India must tackle several structural issues, such as reining in the runaway fiscal deficit, freeing its manufacturing sector from antiquated labour laws, selling state-owned assets and using the freed-up cash for investments in physical infrastructure.

India's relations with Pakistan, the US and China will be crucial. Peace and stability will be critical in attracting and keeping foreign investment. If India follows a pragmatic foreign policy and lets its economic priorities dictate foreign policies, it will reap the dividends of peace.

India's policies embody a blend of pragmatism and nationalism, and its goals include both close relations with the US and recognition as one of the leaders in a more multipolar world. India's economic growth and ability to manage its key diplomatic relationships will determine the size of the international role it crafts over the next fifteen years. Its leaders' skill in balancing the competing objectives of its foreign policy will help shape the direction taken by both India and the world.

www.
dbresearch.com

Authors

Teresita C. Schaffer*
Prमित Mitra
CSIS, Washington

Editors

Maria L. Lanzeni
Jennifer Asuncion-Mund
+49 69 910-31714
jennifer.mund@db.com

Technical Assistant

Bettina Giesel

Deutsche Bank Research
Frankfurt am Main
Germany
Internet: www.dbresearch.com
E-mail: marketing.dbr@db.com
Fax: +49 69 910-31877

Managing Director

Norbert Walter



* Guest authors express their own opinions which may not necessarily be those of Deutsche Bank Research. Please see page 2 for a short biography of Teresita C. Schaffer.

Teresita C. Schaffer is the Director of the South Asia Program at the Center for Strategic and International Studies in Washington. She has served for thirty years as a US diplomat and as one of the US State Department's principal experts on South Asia. From 1992-1995, she served as US Ambassador to Sri Lanka. Her previous diplomatic assignments included New Delhi, Islamabad, Dhaka and Tel Aviv. She is the author of numerous articles and monographs, including "Rising India and US Policy Options in Asia" (CSIS, Washington: 2002).

India is going through a series of remarkable transformations. Economically, its growth rate has accelerated. Politically, an era of single-party dominance has given way to a roughly two-party system, but one where both national parties require large coalitions to form a government. India's security policy has been transformed by its own needs and Pakistan's nuclear tests of 1998, as well as by major changes, both past and prospective, in Asian power relationships. These transformations began in about 1980, when economic growth started to accelerate, and were well in place by the time of President Clinton's signature visit to India in 2000.

India's changing geopolitical role grows out of these domestic changes. The end of the Cold War devalued India's long-standing relations with Russia and reoriented India's foreign relations around a much broader network of global friendships, with the United States emerging as India's most important extra-regional relationship. India today is increasingly integrated with the world economy, especially compared to its own previous record. Its foreign policy is built on the pursuit of security and preponderance of power in its broader neighbourhood, and of substantial influence in global governance. India's policy makers, fundamentally pragmatic, recognise that India's continued economic growth is the essential foundation for accomplishing these goals, and that energy supply will be critical to achieving a satisfactory level of growth.

India's foreign policy goals require much more sophisticated and substantive relations with the United States, and strong security as well as economic ties with Southeast Asia and Japan. Developments in Asia and globally have led the United States and key Asian countries to reciprocate India's interest for reasons of their own, and this growing convergence of interests has given a further boost to India's geopolitical reach. Two factors could retard or reverse this process: a renewal of active India-Pakistan hostility and a reversal of India's economic progress.

I. Domestic transformations

A. A closer look at India's economic growth

India's first two transformations are domestic in character and started with the economy. Deutsche Bank Research¹ has examined India's economic record and prospects in some detail, forecasting average real GDP growth of 6 per cent between 2006 and 2020, expanding manufacturing and knowledge-based industries, and population growth tapering to 1.3 per cent. Three other features of India's economic record in the past two decades are also important.

Economic growth among India's states has been uneven

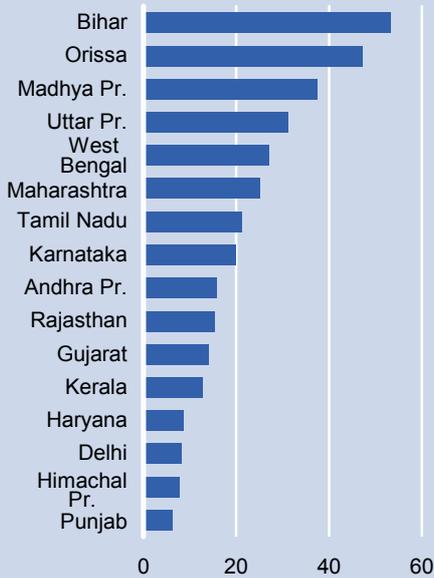
Differences among states: Growth in the states of India's South and West has decisively outstripped that in the North and East. In Gujarat, the fastest growing state in India, the gross state product (GSP) more than doubled between 1993 and 2003, and per capita product increased by 73 per cent. In Uttar Pradesh, at the other end of the spectrum, the increase in per capita product was only 13 per cent during those same ten years. In India's poorest state, Bihar, it was "only" 22 per cent. In fiscal year 2001/2002, per capita product in Gujarat was 3.8 times that in Bihar.²

¹ Asuncion-Mund (2005).

² Indian Ministry of Finance. Economic Survey 2005. Table 1.8.

Large disparities in poverty levels...

% of population below poverty line
1999-2000

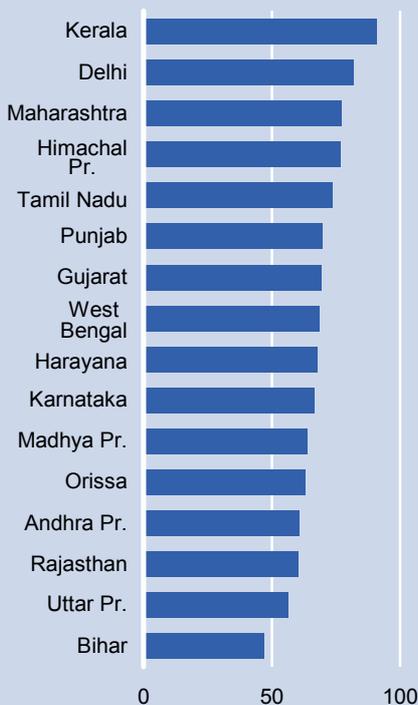


Source: Statistical Outline of India 2004-05, Tata Services Limited

1

... and in literacy rates

Literacy rates in 2001
(ages seven years & above), %



Source: Statistical Outline of India 2004-2005, Tata Services Limited

2

The dynamic states are conscious of their success, and reluctant to be held down by the rest of the country. In several of them, state governments are asserting, and being allowed, to exercise greater policy autonomy with respect to investment and other economic issues. On the other hand, the lagging states include two of the country's largest, which together account for 120 of the 543 seats in the lower house of parliament. They will fight hard to maintain or expand their share of central government resources, and to avoid cutting subsidies that benefit their impoverished population.

Human development strengthening: Poverty has steadily decreased nationwide since 1990 although big disparities among states remain (chart 1). The Planning Commission's figures show a decline of ten percentage points in both rural and urban poverty between 1990 and 2000, with the rural poverty rate dropping from 37 to 27 per cent and the urban rate from 33 to 23 per cent. The states that have experienced the highest economic growth have also enjoyed the sharpest decreases in rural poverty.

Urbanisation and literacy have increased especially in the states with lower poverty levels (charts 1 and 2). Indeed, if one examines the record state by state, those with the most rapid growth in urbanisation are close to eliminating illiteracy, especially for males. In the rapidly growing states there is a striking difference between the growth of rural and urban populations. Promisingly, the social indicators suggest that some of the states that have lagged in economic growth may be about to catch up. Rajasthan, for example, has experienced the fastest growth in female literacy of any state, and has also seen a sharp reduction in both rural and urban poverty.

Recent developments suggest India's society is in rapid evolution. By 2020, the impact of increased urbanisation and literacy should be clearly visible in the labour force, and the expansion of infrastructure will be a powerful spur towards both modernisation of the economy and involvement in international affairs. The increasing presence of Indians overseas will accentuate these trends. Especially in the cities, globalisation is a fact of life for more and more ordinary Indians.

One of the factors that differentiate the fast-moving states from the laggards is the quality and effectiveness of state and local government. This is apparent in the improving track record of two states normally considered far from the cutting edge: Rajasthan, as mentioned above, and Madhya Pradesh. Both have had strong political leadership; both have invested in schools and infrastructure.

One of the biggest question marks about India's future relates to the HIV/AIDS epidemic. The Indian government's figures released in May 2005 estimated that there were 5.2 m people suffering from HIV/AIDS in India, or 0.9 per cent of the population between 15 and 49 years of age. The first AIDS case was identified in Tamil Nadu, and the four largest high-prevalence states are all progressive and fast-growing southern states. Lively economies draw in transient labour and trucking, both of them vectors for infection. Success in mounting an effective counter-attack partly depends on an efficient state government that is aware of the problem and capable of working in sophisticated partnership across bureaucratic lines and with non-governmental organisations. Aside from its inherent importance, the HIV/AIDS issue serves as a good indicator of how effectively India and its various states are providing needed public services.

Global investment: India has a large continental economy in which foreign trade, aid and investment have historically played a relatively small part. India's imports and exports of goods as a share of the economy have risen from 13 to 23 per cent since 1993, but these are far below the levels of China or its Southeast Asian neighbours. Even more significant is the impact of the information technology (IT) sector, which accounts for only 3 per cent of GDP but fully half of services exports, with both numbers rising rapidly.

FDI flows to India remain below those of its neighbours...

Although foreign investment is increasing, it is likely to remain a smaller part of the economy than is true for many emerging markets. Foreign direct investment (FDI) in India has gone up by stair-steps in the past two decades, but remains well below the rate in China, Southeast Asia, or other countries in the immediate neighbourhood. But India is well ahead of these same countries when it comes to investment abroad by its companies.

... but Indian businesses are becoming global players

What this means is that the impact of globalisation is already apparent, and likely to become stronger before 2020. The removal of many import restrictions has brought foreign goods within reach of urban India. Business process outsourcing (BPO) has given the middle class in many parts of India new job opportunities, at wages that are significantly better than traditional ones. The largest Indian businesses are becoming world players, putting their capital at risk, forging alliances, finding joint ventures and, most importantly, operating with the disciplines of the marketplace. This will over time affect the way the Indian market works, both for domestic and for foreign investors. It has also made India's political decision-makers conscious as never before of the importance of the country's economic ties in a global economy.

B. Political changes

The elections of May 2004 brought the Indian National Congress back to power. The Congress Prime Minister relies on the support of 19 parties, drawn both from the ideological left and from a growing array of single-state parties. The opposition, the Bharatiya Janata Party (BJP), known for its strong nationalism, had led the two preceding governments, a far cry from the meagre parliamentary representation their predecessor parties enjoyed in the early years.

Politics have evolved from being effectively a one-party system to a contest between two and sometimes three coalitions

In the past 20 years, what had effectively been a one-party system has become a complex contest between two and sometimes three coalitions. The political parties that have steadily gained through the past two decades are the single-state parties, taken together. They have by definition no basis for unity, but their members have become key coalition partners for both Congress and the BJP. The BJP remains dedicated to its ideological core, especially when in opposition, and the "left parties" remain dedicated to a broadly Marxist approach, though their performance as the leaders of state governments often pays little more than lip service to this ideology. For the other parties, apart from a loose adherence to populism and dedication to local causes, ideology has become largely irrelevant.

The BJP-led coalition that governed India from 1998-2004 proved quite stable, and the same is likely to be true of the present one, led by the Congress. The expense and complexity of elections are such that if a coalition can arrive at a reasonable division of portfolios and can create a consensus programme, its members will be reluctant to bring down the government for fear of having to face the voters ahead of schedule. A stable coalition, one that expects to survive for most of parliament's full five-year term, is able to make policy based

on the country's medium to long-term interests. Political staying power has a greater impact on policy-making than party ideology.

C. Military expansion

India changed from implicit to explicit nuclear weapons status with its nuclear tests in 1998. The tests and the sanctions India faced from most of the world's industrialised countries had a modest effect on India's economy. They temporarily chilled India's political relations with much of the world, but in time most countries came to accept that India would not relinquish its nuclear arsenal. Within three weeks after India's tests, Pakistan had tested as well.

India's military position was based on "no first use"...

In considering India's domestic transformation, we also need to look at the changes in India's military posture. India's nuclear doctrine was based on "no first use", and envisaged treating its nuclear arsenal as a deterrent to nuclear threats. Its aim was to maintain a "minimum credible deterrent".

... while its foreign policy looks upon its economic interests and its greater role in the world

At the same time, the period since 1998 has been a time of major investment in the Indian military. Defence budgets rose by 13 to 25 per cent per year, and the Indian military planned major acquisitions of new equipment and technology. These were intended not only to deal with immediate issues of infiltration from Pakistan-controlled territory, but also for broad-based modernisation, including enhanced power projection capability. India's military strengthening has been an important element in shaping a foreign policy that places greater emphasis on India's economic interests, but that also assumes that India will be taking on a greater role in Asian and global affairs.

II. The geopolitical impact of India's domestic change

The end of the Cold War has brought India closer ties with the United States...

While these political and economic changes were taking place, India was re-tooling its foreign and security policies to take account of the end of the Cold War. India's foreign policy, traditionally built on non-alignment and on a strong security and diplomatic relationship with the Soviet Union, now treats the United States as its most important friend outside the region. India's economic interests have assumed a higher priority in defining India's foreign policy and security goals. India's security posture and its status in the world are based on its continuing possession of a nuclear deterrent. India's quest for a special role in the world remains a strong feature of its foreign policy, but the character of that role has become more India-specific and less visionary than during the years of Nehruvian foreign policy, and the tools India uses to pursue it have broadened.

A. De facto strategic alliance with the US

Indian Prime Minister Manmohan Singh's visit to Washington in July 2005 put the new India-US relationship on display. Its most noteworthy accomplishment was an agreement between India and the United States on civilian nuclear cooperation that could transform the strategic partnership that is emerging between the two democracies. But the broad outlines of cooperation that were sketched out in the two leaders' joint statement were the culmination of a decade of steady intensification of Indo-US relations, based on a growing awareness of common interests.

... as India's economy "globalised" over a decade ago

The Indo-US rapprochement started with expanding economic ties over the preceding 15 years, as India's economy "globalised". India's software exports are growing at a rate of 50 per cent per year, with about two-thirds going to the United States. Indians on temporary work visas also make up a good chunk of the information technology workforce in Silicon Valley; India receives nearly a third of these work permits. Indian-Americans, an increasingly rich and influential community, are lobbying on behalf of India in Washington and investing in their native land. Despite the economic upswing, however, issues connected with the outsourcing of business functions by US companies generate periodic controversy, with domestic forces discontent about US jobs being relocated to cheap overseas labour markets like India.

Indo-US trade ties are strengthening...

US-India trade pales in comparison with Sino-US trade, but it is growing rapidly. According to Indian trade statistics, bilateral trade in merchandise goods and commodities has increased from a paltry USD 5.6 bn in 1990 to approximately USD 18 bn in 2003, a jump of more than 221 per cent. India still does not attract anything close to the amount of US investment going to China, but there are still plenty of opportunities. The pace of India's economic reforms has slowed since last year, but even with a modest pace, the country is regarded as one of the most attractive destinations for foreign investors.

Government-to-government economic dealings have not led to changes as dramatic as the surge in private trade and investment might suggest, but there have been notable accomplishments. In January 2005, for example, the United States and India signed an "Open Skies Agreement" that will facilitate greater trade and economic cooperation between the two countries. Before the agreement, Indian airlines were limited to a few major US cities: Chicago, Los Angeles and New York. Now they can fly directly to these cities as well as to other regional hubs like Houston and Minneapolis. US airlines, meanwhile, are permitted to fly non-stop to Indian cities. The agreement also removes restrictive requirements on cargo flights between the two countries.

... but security remains central to Indo-US relations

The biggest change in India-US relations compared with the Cold War era, however, lies in the security relationship. Today's Indo-US security ties are based on a growing harmony between US and Indian interests, especially those relating to the region from the Middle East through Southeast Asia. India's accelerating economic growth has made its leaders conscious of their need for energy imports, and has propelled energy security and the safety of sea lanes of communication in the Indian Ocean to near the top of India's security agenda. This has been a strong basis for creating a new security relationship, one that involves regular joint military exercises and periodic joint operations. Recent examples include Indo-US cooperation in post-tsunami relief operations as far afield as Indonesia and an Indian offer to escort sensitive US naval cargoes through the Straits of Malacca. These represent a major change from the traditional Indian discomfort with non-regional countries' presence in the Indian Ocean. The framework for the new Indo-US defence relationship was spelled out in an agreement initialled during the visit of the Indian defence minister to Washington in June 2005.

Defence trade and cooperation are gradually being built...

Since 2003, India and the United States have also gone a long way toward removing the restrictions the US had placed on defence trade and cooperation. Under the Next Steps in Strategic

... although nuclear cooperation and sensitive technology remain elusive

Partnership agreement (NSSP), announced in January 2004 and completed in 2005, India tightened up its legal and administrative framework for controlling the export and use of sensitive technologies, making it possible for the United States to remove many of the controls that had prevented export to India of these technologies. In March 2005, the United States announced that it would permit US corporations to bid on a major contract for the supply of advanced fighter aircraft to the Indian air force, including US willingness to license co-production of the aircraft in India. This was a major breakthrough in US licensing policy, and for the first time made it possible for US companies to be serious contenders for a major Indian military procurement contract.

The agreement on nuclear cooperation, the final element in this new structure of security relations and trade in sensitive technology, will be more controversial. The United States undertook to work toward changes in its laws and in international agreements to make possible civilian nuclear cooperation with India, including sales of civilian nuclear equipment. India, on a reciprocal basis, agreed to a package of measures which it described as assuming “the same responsibilities and practices and acquir[ing] the same benefits and advantages as leading countries with advanced nuclear technology such as the United States”. These included most prominently placing their civilian nuclear facilities voluntarily under safeguards, working toward a multilateral Fissile Material Cut-Off Treaty, and participating in the full range of arrangements for control of international trade in nuclear and related technology, including the Missile Technology Control Regime and the Nuclear Suppliers Group. Implementing this agreement will be complex, and will face domestic criticism in India and the United States as well as international questions. But once implemented, the agreement will remove the burden of sanctions from India arising out of its nuclear status and position the country as one of the guardians of the world’s security against nuclear trade.

There has been much speculation about whether Washington’s friendship with India is predicated on US hostility toward China. This notion is exaggerated. At present, both India and the US are actively engaging with China, as further discussed in the next section. However, the fact that India’s rise to greater economic and military power coincides with China’s, coupled with the great potential for clashes some years hence between Chinese and US interests, certainly increases US interest in a strategic partnership with India.

B. India looking east

India-China relations have also transformed...

The China connection: The change in India’s relations with China is nearly as dramatic. For years, Indian security thinkers have spoken of China as their main strategic challenge, and consciousness of the war India lost to China in 1962 is still vivid. Chinese policymakers have looked at India with a mix of apathy and suspicion, and reacted angrily when India justified its 1998 nuclear tests on the basis of the threat from China.

... with trade being the driving force

In the past five years, with India opening up its economy and beefing up its armed forces, Beijing has begun to take notice. Trade is the driving force. Bilateral trade was about USD 2.5 bn in 1999; five years later, it stood at USD 13 bn. Although India represents only 1 per cent of China’s global trade, China has emerged as India’s second largest trading partner after the United States. Indian companies look with envy at China’s manufacturing prowess, while Chinese IT companies want to learn from India’s success in the services sector. Bilateral investment flows are small but growing.

Indian software and services companies, like Tata Consultancy Services, have set up a base in China not just to cater to Chinese firms but, more importantly, to the multinationals doing business there. For Chinese firms, India's huge middle class obviously looks very attractive. Most interestingly, the biggest Indian technology companies are actively seeking out joint ventures with their Chinese counterparts.

India's major trading partners, 2000-2004

Percentage share in total trade (exports+imports)

Country	2000-01	2001-02	2002-03	2003-04	2003-04 April - October	2004-05
1 USA	13.3	12.2	13.4	11.6	12.2	11.1
2 UK	5.7	5.0	4.6	4.4	4.4	3.7
3 Belgium	4.6	4.4	4.7	4.1	4.1	3.8
4 Germany	3.9	4.0	4.0	3.9	3.8	3.5
5 Japan	3.8	3.8	3.2	3.1	3.2	2.6
6 Switzerland	3.8	3.4	2.4	2.7	3.3	3.0
7 Hong Kong	3.7	3.2	3.1	3.4	3.6	2.8
8 UAE	3.4	3.6	3.8	5.1	4.2	5.5
9 China	2.5	3.1	4.2	5.0	4.3	5.6
10 Singapore	2.5	2.4	2.5	3.0	2.5	3.3
Total (1 to 10)	46.7	45.2	46.0	46.1	45.5	44.9

Source: Statistical Outline of India 2004-2005, Tata Services Limited

3

Political relations are also transforming into friendlier terms...

There has been significant progress on the political side of the relationship as well. Border talks, desultory for most of the last forty years, have become more serious. During Chinese Premier Wen Jiabao's visit to New Delhi in March 2005, the two governments formally declared their intention to move toward settling their dispute. More importantly, the Chinese have now accepted Indian sovereignty in the small Himalayan territory of Sikkim, and the two countries have established a system for local trade in part of the disputed border areas. Both these decisions signal their intent to move forward.

... but rivalry and competition appear set to stay...

This does not end the traditional Sino-Indian rivalry, which is still felt more keenly in India than in China. Their size, geographic proximity and contemporaneous rise to greater political and economic power ensure that competition will remain a feature of their relationship. China, increasingly, is a benchmark against which Indians judge their own economic performance and political status.

... with energy security being an issue

Two more concrete issues are likely to ensure that Sino-Indian friendship remains laced with competition. One is energy, with the two countries increasingly locked in a race to secure resources globally, especially oil and gas, to fuel their expanding economies. The other is Indian concern about China's apparent long-term moves into the Indian Ocean. China has a long-standing friendship with Pakistan and played a major role in Pakistan's nuclear programme. In addition, China now has a significant presence in Myanmar (Burma) and an expanding relationship with Iran. China's plans to build submarines, in the view of many Indian security analysts, make little sense unless one assumes that they would be deployed to the Indian Ocean. These moves are a direct challenge to India's increasing focus on the Indian Ocean as a vital element of its security.

The lead countries in India's East Asian strategy are Japan and Singapore

Engaging Southeast Asia and Japan: India is also broadening its profile in the Far East, where it had minimum influence during the Cold War years. India's "Look East" policy is a tacit acknowledgement that India needs to learn from the record of its eastern neighbours. The "Look East" policy reflects, once again, India's interest in protecting its broader economic and political interests throughout Asia.

Bilateral relations with Japan soured when India tested its nuclear weapons in 1998. However, they have improved greatly in the past 3 to 4 years. The fillip to Indo-Japanese relations was provided by the August 2000 visit of prime minister Yoshiro Mori, the first by a Japanese Prime Minister to South Asia in a decade.

The April 2005 visit of Prime Minister Junichiro Koizumi to New Delhi provided momentum to this relationship. Japan and India have a number of mutual interests: preventing incidents of piracy and terrorism in the sea lanes through the Malacca Straits, improving bilateral trade relations, and promoting peace in Sri Lanka. There have also been occasional joint military exercises, although India is also careful in not portraying its relationship with Japan in a too militaristic tone. Giving higher importance to security-related Indian cooperation with Japan is likely to be inhibited by concerns over its likely negative impact on the developing Sino-Indian relations, which are more multi-dimensional than the Indo-Japanese relations.

India's rise in the world economy has been a magnet to Japanese companies

On the economic front, Japanese investments in India have been sluggish. Japan is currently the seventh largest trading partner of India with a share of 3.1% in India's total exports and imports in 2003. Before the Indian economy began to open up in 1990, the Indian market held little interest for Japan. As India opens up, reforms its capital markets and makes it easier for foreign companies to do business, and as the Indian middle-class population gets wealthier, Japanese companies are beginning to pay more attention. Japanese firms have an advantage over their rivals: brand recognition. Sony, Toyota, and Panasonic are household names and Indians admire Japan for its economic and engineering prowess.

Relations with the ASEAN countries are being enhanced by trade

In a similar fashion, India's relations with the ASEAN countries have seen a spurt in high-level visits and expanding trade and investment in the past decade. India has become a formal dialogue partner of ASEAN, and would like to expand its participation in Southeast Asian and Asia-wide institutions. Here too, there has been a modest but increasing programme of joint military exercises and port visits. For India, the big attraction is a more stable set of political and economic relations to the east, as well as the possibility of joint operations in the energy field. India shares with the ASEAN countries an interest in not having China become by default the primary outside power. This has been of particular interest to Singapore, which has taken the lead in encouraging India to play a larger role in the region, and which has supplemented its official interest in India with a growing array of academic programmes focusing on India and on Indian Ocean security issues.

India's greater interest in East Asia ties in with its desire to expand the blue-water capability of its navy. The Indian Navy seems keen to play an active role in Southeast Asia. India's relief operations in the wake of the tsunami disaster last year earned its navy the admiration of many countries in Southeast Asia. Opportunities for such a role in the Persian Gulf are limited because of the heavy US presence there and the likely objections of Pakistan.

C. Competing interests in the Middle East and Central Asia

India's relations with Israel have steadily improved

Before 1990, India's Middle East policy was largely determined by its stance on the Arab-Israeli issue. India voted at the United Nations against the creation of Israel, opposing the concept that religion should be the basis for a nation and wanting to express solidarity with the Arab world and with India's large domestic Muslim population. But since 1992, when the two countries established diplomatic relations, relations have steadily improved. The two most talked about areas of cooperation are defence and intelligence. India has signed, or has in the pipeline, defence agreements with Israel worth USD 3 bn, making Israel the second largest supplier of arms to India after Russia.

At the same time, steady economic growth over the past decade has caused a sharp spike in India's energy requirements. Already ranking sixth in global petroleum demand, India meets 70 per cent of its needs through crude oil imports. By 2010, India is projected to replace South Korea and emerge as the fourth-largest consumer of energy, after the United States, China, and Japan. As a result, Indian diplomats are also looking beyond the Middle East, to places like Venezuela and Sudan, to diversify oil supplies. This quest for securing energy could re-shape South Asia's geopolitical landscape and affect India's diplomatic relations, particularly with the United States. India imports 70 per cent of its crude oil requirement from the Middle East, and its dependence on foreign supplies is set to rise in step with its rapidly growing economy. Saudi Arabia is India's biggest supplier of crude oil, accounting for almost a quarter of India's total imports of 1.9 m barrels per day, while Nigeria accounts for 15 per cent.

India's growing energy requirements are compelling it to strengthen its ties with the world's oil producers

India's energy needs are a major factor in India's deepening ties with Iran. In January 2005, the Gas Authority of India Ltd. (GAIL) signed a 30-year deal with the National Iranian Gas Export Corp. for the transfer of as much as 7.5 m tons of liquefied natural gas (LNG) to India per year. The deal, worth an estimated USD 50 bn, will also entail Indian involvement in the development of Iranian gas fields. A breakthrough moment in India-Iran relations came on January 26, 2003, when President Mohammed Khatami took the podium as the chief guest at India's Republic Day parade, an honour reserved for New Delhi's most trusted friends. Both countries signed the "New Delhi Declaration" promising to expand trade. Since then, bilateral relations have progressed gradually, driven by a mutual desire to expand trade links, India's growing appetite for oil and natural gas, and a common strategic outlook in Afghanistan and Central Asia. The growing economic ties between India and Iran are moving in the opposite direction from Washington's continuing efforts to isolate the Tehran regime. India and the United States have agreed to identify ways to cooperate in preventing the further spread of nuclear technology. But signing long-term deals with Iran would make it hard for India to oppose Iran if it came before the United Nations for sanctions.

Energy and geopolitics both drive India's interest in Central Asia. India's strong interest in Afghanistan goes back to pre-independence days, with Afghanistan seen as India's geographic security frontier. The difficult relations between Afghanistan and Pakistan, and India's desire to maintain close ties with a few well-placed Muslim countries, kept this relationship important after independence. Following September 11 and the collapse of the Taliban government,

the Karzai government came to power with close ties in New Delhi, and India has continued to tend these carefully, much to Pakistan's discomfiture.

The Central Asian countries north and west of Afghanistan, recently separated from the Soviet Union, held many of the same attractions for Indian policymakers and strategic thinkers, but several of them also have oil and gas and hence great interest for India's future energy supplies. India has been eager to expand its influence in these countries for reasons of geopolitics, rivalry with Pakistan, and energy supply. Indeed, India's growing relationship with Iran is based in part on Iran's willingness to give India land access to Central Asia, which Pakistan has thus far refused.

D. The South Asian neighbourhood: India-Pakistan tensions ease for the moment

Indo-Pakistan relations remain central to India's geopolitical position...

One of the hallmarks of India's new foreign policy is that it extends well beyond the traditional boundaries of the South Asian region. Nonetheless, the continuing dispute between India and Pakistan remains central to India's geopolitical position. India's approach to relations with Pakistan and its other South Asian neighbours has not undergone the kind of fundamental change that characterises India's approach to the United States, Asia and the Middle East. The key question is whether India will decide at some point that it needs to push more aggressively for a settlement with Pakistan in order to take full advantage of its new international position.

Relations between India and Pakistan are in fairly good shape at present

The ceasefire agreed in November 2003 remains in place at this writing, and officials and leaders from the two countries continue to pursue the complex peace dialogue they inaugurated in January 2004. The best-known and most difficult issue dividing them, the dispute over Kashmir, is the subject of one working group; a second deals with nuclear risk reduction; and others address six clusters of bilateral issues.

Kashmir remains the disputed issue between India and Pakistan...

India is not only the larger and more powerful country: it also holds the parts of Kashmir that both countries care most about. In a formal sense, India claims all of Kashmir, including the parts now held by Pakistan and China. Pakistan claims that sovereignty over the parts of the state held by India and Pakistan must be decided by a plebiscite in which the inhabitants choose between India and Pakistan, in accordance with UN resolutions from 1949. If one steps back from these formal positions, which many would argue do not represent serious expectations in either country, the two countries have contrasting views of what kind of settlement they could accept. They also differ on how to get there. Pakistan has traditionally wanted to deal with Kashmir first. India has generally sought to address the other, less emotive bilateral issues first, saving for last the Kashmir issue.

... with a settlement nowhere near

The two countries have engaged in unsuccessful settlement efforts several times in the past. But the two leaders' continuing commitment to the current peace dialogue, and their willingness to reassert it even after flare-ups of violence, makes this an important moment for potential progress. The two governments have exchanged high-level visits, expanded people-to-people ties, simplified some visa rules and inaugurated a bus service between the two sides of Kashmir. They have expanded modestly the level of bilateral trade, including resuming direct trade by road, and have spoken about permitting direct trade between the Indian- and Pakistani-controlled parts of Kashmir. Both countries say they are determined to move

India's policy in the rest of the region being transformed toward economics

forward with discussions on a natural gas pipeline from Iran across Pakistan to India. The hope is that these steps will generate the goodwill to permit resolution of the harder issues and eventually a lasting peace.

India's relations with its other South Asian neighbours have always been asymmetrical, reflecting the unequal size and power of the countries involved. India's position of primacy in the region was always an important element in India's approach to the region, together with its expectation that this would translate into a degree of foreign policy deference from the other regional countries. But India is now dealing with a more troublesome security situation in the rest of the region, and as with India's approach beyond the region, its priorities in the rest of South Asia are beginning to shift toward economics.

The ethnic conflict in Sri Lanka has been under way for over two decades. In addition, a ruthless Maoist insurgency has raged for nearly a decade in Nepal, where an ineffective elected government has been pushed aside by a new monarch determined to reverse the democratic changes of the past 15 years. Declining governance in Bangladesh is made more dangerous by the new presence there of a small but vocal Islamic extremist element. India's response to all these security problems has involved a much higher level of international consultation than in the past.

Again, strategic positioning in view of energy needs and trade ties

In the past ten years, India has also become more interested in expanding regional trade and investment. India's agreement in principle with Bangladesh and Myanmar to establish a gas pipeline linking the three countries is one example, and represents a creative way to try to deal with Bangladesh's political anxieties about energy trade with India. In addition, the South Asian Association for Regional Cooperation (SAARC)³ has agreed in principle to move toward a South Asian Free Trade Area, and has taken the first steps in that direction, in the form of a bilateral trade agreement between India and Sri Lanka. At the same time, some of India's major corporations are dramatically expanding their investments in other regional countries. Tata Inc., for example, is working on a USD 2 bn-plus investment package for Bangladesh, and one of its subsidiaries is planning to invest in an IT training institution in Pakistan.

E. Europe, Russia, and the Developing World

Two pillars of India's Cold War foreign policy have become markedly less important. Russia had been India's steadiest diplomatic supporter, major trading partner, and principal military supplier for four decades. Its trade significance has all but disappeared. It remains India's largest supplier of imported military equipment. Russian diplomatic support does not have the significance it once did, but Russia shares India's interest in shaping a more multipolar world. Russia is not currently a significant energy supplier to India, but could become one as energy markets change in the next two decades.

India continues to attach importance to its role as a leader among developing countries, but this has become a much less prominent feature of a foreign policy that today revolves more around relations with the United States and the major Asian countries.

Europe figures in India's geopolitical vision in two principal respects. First, it is a strong trade and investment partner (see table 3), and a

³ Consisting of India, Pakistan, Nepal, Bhutan, Bangladesh, Sri Lanka and Maldives.

critical part of the economic success India is trying to achieve. Second, its political dialogue with the major European countries is essential to the global role India is constructing.

India enjoys good relations with all the nations in the European Community. India has signed Bilateral Investment Protection Agreements (BIPAs) with 16 of the 25 EU member states. The EU (as a bloc of 25 nations) is India's largest export destination and has a share of over 24% in its total exports. In the year 2003, India was 19th largest exporter to the EU and absorbed 1.35% of total EU imports. On the other hand, India was 16th largest importer of the EU's products and had a share of 1.46% in its global exports. The last major summit between the EU and India was held in The Hague on November 8, 2004. India and the EU states are working closely on terrorism, UN reforms, non-proliferation and other strategic issues.

III. India's rise as a strategic power

India's foreign policy during the early decades after independence was based on a global role centred on non-alignment and leadership in the developing world. It relied heavily on India's standing as the largest democracy in the world, and on articulate Indian leaders who appealed to justice and idealism. Its hallmarks included resistance to the then prevailing division of the world into East and West and a push for economic aid and redistribution.

During the 1990s, India had a relatively low profile in global governance. It last served on the UN Security Council from 1990 to 1992, a term largely shaped by the conduct and aftermath of the first Iraq/Persian Gulf war, at a time when India was only beginning to come to terms with the collapse of the Soviet Union. More recently, India's most active role in global governance has been its participation in multilateral trade negotiations. At Cancun in September 2003, India emerged as one of the main opponents of the agricultural trade agreement sought by the developed countries. Its hard line played well to important political constituencies at home.

As the world and India's role in it evolve, India's military power and economic success are key building blocks for the role it aspires to. India seeks greater standing in global affairs and institutions as they are now organised, but it also would like to see a different global organisation emerge, one in which power is distributed more evenly, among a larger number of important powers, including itself.

The big prize in India's quest for a larger role in global governance is a permanent seat on the UN Security Council. India has worked with four aspirants to permanent seats (Germany, Japan and Brazil) to craft an approach that can command substantial global support, and has made this an important element in its global diplomacy. Whether or not it succeeds in the current round of UN reforms, India will continue to work on this as a long-term effort.

India will also be looking for additional platforms for participation in global governance. Prime Minister Singh's attendance at the Gleneagles meeting at the invitation of the G8 is one example. At the regional level, India's involvement in ASEAN forums is intended to raise its profile globally as well as regionally. In the next decade, one can expect to see India more actively involved in Asia-wide organisations and possibly seeking entry into the International Energy Agency (IEA). India will also make greater use of its

India's most recent role in global governance has centred on multilateral trade negotiations...

... while aspiring for a permanent seat on the UN Security Council

... and using other platforms for participation in global governance

leadership position in the Global Fund to fight AIDS, tuberculosis and malaria. In the WTO, India's perspective is likely to continue to evolve, reflecting the shift in India's exports toward more sophisticated goods that can benefit by some measures India has traditionally opposed. And Indian participation in the organisations dedicated to preventing nuclear transfer, should it come about in the wake of India's recent nuclear agreement with the US, would be an important indication of its "coming of age" in global governance.

India's concern until now has primarily been to secure a seat at the table. How India would use these platforms, should they become available, is less clear. It would certainly wish to protect its strong interest in retaining foreign policy autonomy, and would probably oppose interventionist approaches to political, human rights and security problems in developing countries. On the nuclear front, India would want to protect its own freedom of action as much as possible, while preventing Pakistan from joining the non-proliferation organisations.

IV. Conclusion: India as a global power?

At this point, however, it is too early to call India a global power. Its stable democratic political system, huge middle-class population, immense military clout in South Asia, rising economic fortunes and global ambitions make it a potential power that could (if things go well) play a very important role in world affairs.

Many structural factors have been constraining India's impressive growth in recent years

But India's impressive growth in recent years is still held back by structural factors. The economic reforms enacted thus far enjoy a broad political consensus, but this government, like its predecessor, is proceeding cautiously with new ones. Its major achievement since coming to power in May 2004 is the introduction of India's first value-added tax.

To become an economic powerhouse and catch up with its bigger rival, India will have to sustain at least 8% growth, over a long period of time. Its first challenge will be to address some structural issues in the economy. These include reining in the runaway fiscal deficit, freeing its manufacturing sector from antiquated labour laws, selling state-owned assets and using the freed-up cash for investments in physical infrastructure. These are tough choices under the best of circumstances, but India's complicated coalition politics make these decisions even harder.

Second, India's growing HIV/AIDS epidemic could seriously slow down its economic growth and threaten the country's public health structure. Ironically, AIDS has had its most severe effect on some of the most prosperous parts of the country. Unless they take vigorous action soon, it could erode a major economic advantage: a large pool of inexpensive and skilled labour.

India's relations with the US, China and Pakistan are critical to its growth and stability

Third, India's relations with Pakistan, the US and China will be crucial. Peace and stability will be critical in attracting and keeping foreign investment. If India follows a pragmatic foreign policy and lets its economic priorities dictate foreign policies, it will reap the dividends of peace. Continued tensions with Pakistan might prevent India from realising its full economic potential. India's economic fortune will also depend on how it manages its relations with the US: India's growing ties with states like Iran, Sudan and Venezuela to

secure energy resources could create speed-bumps in the bilateral relations of the two countries. This could in turn slow down or disrupt US investment and technology transfers to India.

Bilateral relations with China are perhaps not as important for India as its relations with the US or Pakistan. For the moment, both countries have entered into a pragmatic dialogue that puts more emphasis on trade and commerce than political differences. But as both China and India race to secure energy sources around the globe and flex their naval muscles in the Indian Ocean region, their rivalry could intensify. China has been careful in managing its strategic ties with Pakistan in the last couple of years in order to push its own relations with India.

India's geopolitical future depends on the skill and wisdom of its future political leadership

India's strategic approach enjoys a broad domestic political consensus. It first took shape when the BJP was in power, and has continued with remarkably little change since the Congress took over. The BJP expresses its international security goals in starker terms and takes a somewhat more nationalistic approach to the immediate neighbourhood. Within the Congress coalition, the parties of the political left are sceptical of the emerging relationship with the US. But in practice, major decisions, including those on sensitive issues of relations with Pakistan, have become part of the national consensus.

India's policies embody a blend of pragmatism and nationalism, and its goals include both close relations with the US and recognition as one of the leaders in a more multipolar world. India's economic growth and ability to manage its key diplomatic relationships will determine the size of the international role it crafts over the next fifteen years. Its leaders' skill in balancing the competing objectives of its foreign policy will help shape the direction taken by both India and the world.

© Copyright 2005. Deutsche Bank AG, DB Research, D-60262 Frankfurt am Main, Germany. All rights reserved. When quoting please cite "Deutsche Bank Research".

The above information does not constitute the provision of investment advice. Any views expressed reflect the current views of the author, which do not necessarily correspond to the opinions of Deutsche Bank AG or its affiliates. Opinions expressed may change without notice. Opinions expressed may differ from views set out in other documents, including research, published by Deutsche Bank. The above information is provided for informational purposes only and without any obligation, whether contractual or otherwise. No warranty or representation is made as to the correctness, completeness and accuracy of the information given or the assessments made.

In the United States this information is approved and/or distributed by Deutsche Bank Securities Inc., a member of the NYSE, the NASD, NFA and SIPC. In Germany this information is approved and/or communicated by Deutsche Bank AG Frankfurt, authorised by Bundesanstalt für Finanzdienstleistungsaufsicht. In the United Kingdom this information is approved and/or communicated by Deutsche Bank AG London, a member of the London Stock Exchange regulated by the Financial Services Authority for the conduct of investment business in the UK. This information is distributed in Hong Kong by Deutsche Bank AG, Hong Kong Branch, in Korea by Deutsche Securities Korea Co. and in Singapore by Deutsche Bank AG, Singapore Branch. In Japan this information is approved and/or distributed by Deutsche Securities Limited, Tokyo Branch. In Australia, retail clients should obtain a copy of a Product Disclosure Statement (PDS) relating to any financial product referred to in this report and consider the PDS before making any decision about whether to acquire the product.

Printed by: HST Offsetdruck Schadt & Tetzlaff GbR, Dieburg