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Asia’s Challenged Giants

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The two Asian giants, the People’s Republic of China and India, home to nearly two-fifths of humanity, have long been the subject of comparisons. Today, as in the past, the obsession centers on economics. More than 60 years ago, the merits of socialism and capitalism were passionately contested when these two countries—facing similarly massive problems of economic backwardness, poverty, and illiteracy—embarked on diametrically opposed development paths. In recent decades, as both embraced markets and globalization (China in 1978 and India in 1991), considerable effort has been devoted to comparing their market-integration strategies and determining whose development path is more sustainable, what lessons each hold for the other, and more recently, whether late-starter India can “overtake” its giant northern neighbor.

Such comparisons can only inform so much, because China and India are in some ways quite different—not only in their approaches to global economic integration, but also in what each must do to adapt to the vagaries of globalization. The sources of each nation’s growth trajectory are different. And yet, each country has lessons to learn from the other. Indeed, the continued rise of both nations will depend on their ability to address—quickly and effectively—a number of severe economic and structural vulnerabilities.

SEPARATE ENGINES

China and India today have the fastest-growing economies in the world. The once poor and inward-looking China, with growth rates averaging 10 percent per year between 1980 and 2004 (and 9 percent in 2005), now has the fourth-largest economy in the world, just behind the United States, Japan, and Ger-

many. In fact, in terms of GDP measured by purchasing power parity—a metric that adjusts for the relatively low prices of services in developing countries—the World Bank now ranks China as the world’s second-largest economy. While the Communist Party still rules, the billboards scattered across China’s cities no longer spout doctrinaire socialist slogans. They advertise consumer products like Internet service, cell phones, and credit cards.

India’s development is not quite as spectacular, but its post-1991 reforms have helped the economy grow by an average of more than 6 percent annually since 1992. In fact, India’s annual rate of GDP growth reached 7.3 percent in 2003 and more than 8 percent in 2004 and 2005. This growth in both countries has translated into significant increases in per capita GDP. In China, it jumped sharply from \$1,071 in 1978 to \$4,726 in 2003. In India it grew during the same period from \$1,255 to \$2,732.

However, the engines of the two nations’ growth are different. China’s vast and diverse manufacturing sector drives its expansion, while India’s is fueled by extraordinary growth in services, primarily in information technology (IT). China has literally become the world’s factory. Ten years ago, its merchandise trade with the world totaled about \$280 billion. In 2004 it approached \$1.4 trillion.

India ranked only 30th in world merchandise trade (with a miniscule 0.7 percent global share) in 2003. India’s service exports, on the other hand, have been surging at about double the rate of its merchandise exports. Between 1995 and 2000, the Indian IT industry recorded a compound annual growth rate of 42 percent. In 2002, India’s IT exports totaled about \$10 billion, compared to China’s \$1.5 billion. And some 40 percent of China’s IT exports involved Indian IT companies based in China.

Following the manufacturing-led development model employed successfully by Japan, South Korea, and Taiwan, China’s industrial expansion has been facilitated by the nation’s large domestic

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savings (some 50 percent of GDP), its vast pool of low-cost and relatively skilled labor, and economic reforms—bold and deep—that placed few restrictions on foreign ownership and provided a liberal investment regime. These conditions have invited a veritable flood of foreign direct investment (FDI), especially in the export industries. Between 1978, when the reforms began, and the end of 2003, foreign firms invested some \$500 billion in China and accounted for over one-quarter of the country's output of manufactured goods. In 2004, China attracted an estimated \$61 billion more in FDI.

India, by contrast, for over half a century remained obstinately fixated on the austere Gandhian principle of *swadeshi* (self-reliance) and Keynesian import-substitution—which in practice meant distrust of markets and keeping out foreign investment and imports. As a result, India is still a largely closed economy. It accounts for less than 1 percent of total global exports. And average trade tariffs remain as high as 22 percent—far above the 8 percent average for the Association of Southeast Asian Nations (ASEAN).

Along with modest national savings, a still not fully liberalized industrial and manufacturing sector, and restrictive labor laws, India's ambivalent regulatory attitude toward foreign investors has helped prevent it from attracting the FDI needed to modernize its inefficient and uncompetitive manufacturing industries. It has not helped either that India is burdened with an agonizingly unreliable infrastructure. In many parts of the country, a creaky power system continues to hobble industry. Even where supply is sufficient, power is sold through state-owned distribution monopolies, most of which are virtually bankrupt. In 2004, India attracted a mere \$5.3 billion in FDI, a modest increase from \$4.3 billion in 2003.

THE NEW ECONOMY

What, then, explains India's remarkable economic metamorphosis in the absence of China's ostentatious advantages? The answer: the audacious "new economy" ushered in by globalization. By riding the IT wave, India has been able to overcome once insurmountable constraints. Specifically, the global expansion of high-speed Internet and related telecommunications networks has rendered geography largely irrelevant by creating linkages among countries and businesses that simply did not exist a decade and a half ago. This has enabled Indian entrepreneurs and the country's large pool of skilled and low-cost English-speaking "techies" to cash in on the IT revolution.

In a relatively short time India has become the location of choice for a variety of IT-related activities—best symbolized in "Electronics City," Bangalore's main "tech-hub," and in the prime stretch on Bannerghatta Road in southern Bangalore that houses offices of multinationals like Oracle, IBM, Accenture, Dell, Hewlett-Packard, PeopleSoft, Honeywell, Intel, Monsanto, American Express, General Motors, and the ubiquitous Microsoft. Here, everything from advanced software production and programming, data processing, and network management and systems integration to multimedia development, business outsourcing, and call-center processing are performed.

Even the solicitous call-center activity has rapidly climbed up the value chain—moving from filling sales orders, data entry, payroll processing, and real-time customer support for Western companies to handling medical data transcription and complex financial analysis. Indian accountants and financial analysts are hired not only to prepare tax returns for Americans but also to write brokerage reports for Wall Street. Indeed, anything that can be done digitally has already moved, or is in the process of moving, to Bangalore, Chennai, Mumbai, Delhi, and other locations in India because both low-end and sophisticated IT work can be performed there at a fraction of the cost compared to North America or Western Europe.

UP THE VALUE CHAIN

India's services-led strategy challenges some of the fundamental assumptions of international economic theory, which has long suggested that low-wage countries are better off concentrating on labor-intensive production, leaving innovation and capital-intensive activities to developed economies. India has defied these assumptions because globalization has made traditionally "nontradable" jobs in developed nations into tradable ones (and thereby vulnerable to the competitive forces of international trade and investment). India has succeeded in racing to the top of the value-technology chain.

The lesson for China is unambiguous: its economy must graduate up the value chain—because, as Paul Krugman provocatively pointed out in a 1994 essay, "The Myth of Asia's Miracle," growth that is achieved largely as a result of increased inputs rather than increased total factor productivity cannot continue in perpetuity. China's economic growth is so driven by capacity expansion (or fixed-asset investments) that such investments now account for more than 50 percent of gross domes-

tic product—more than for any other country at any time in the history of economic development.

If China's economy is to continue growing—if its economic base is to evolve up the value chain in manufacturing and expand into services and knowledge-based industries, such as advanced software development and pharmaceuticals—the country will need to upgrade its stock of human capital by improving the skills of its workforce and producing large numbers of world-class university graduates, especially in engineering and the sciences. While China has been educating large numbers of college graduates, the vast majority still lack the skills necessary to compete in global markets. Improving educational performance and workforce quality is critical.

BACK ON THE FARM

The experience of China and India confirms that the most powerful force for reducing poverty and raising living standards is sustained economic growth. The proportion of Indians living in extreme poverty (on \$1 a day or less) has fallen from 40 percent a decade ago to about 25 percent today, even though the overall population has grown. This means that about 100 million Indians have been lifted out of extreme poverty over the past 10 years. In China, the effect has been even more spectacular. Between 1981 and 2001, the proportion of the Chinese population living in poverty fell from 53 percent to just 8 percent. This means that across China, more than 400 million fewer people are living in extreme poverty than 20 years previously.

What explains China's phenomenal success in reducing poverty and what can India learn from it? While China's labor-intensive manufacturing-led development is widely credited for large-scale job creation (and thereby poverty reduction), what is not always appreciated is the role of the reforms that preceded it. In particular, agricultural reforms played a significant role in China's economic growth and poverty reduction.

Rising rural incomes, a direct result of these reforms, in turn gave rise to a dynamic new economic sector: township and village enterprises (TVEs). Subject to market competition and hard budget constraints but enjoying the freedom to operate outside state planning, the TVEs experienced astonishing growth, allowing them to absorb millions of surplus agricultural workers into labor-intensive industries.

In India, reforms—and prosperity—have generally bypassed the agricultural sector, which accounts for about 20 percent of GDP yet provides the livelihood of roughly 70 percent of the population (or 700 million people). Still dependent on the vagaries of the monsoon, annual growth in India's agricultural sector over the past six years has averaged less than 1 percent. Both productivity growth and job creation in the rural sector have been slow. And, with annual population growth of about 1.9 percent, rural incomes have been stagnating.

Underscoring the symbiotic relationship between agricultural and industrial growth, incomplete reform of the industrial and manufacturing sector has left the Indian economy still saddled with many uncompetitive firms, and the absence of robust and sustained growth in the industrial sector has limited the scope for mobility of low-skilled labor out of agriculture.

Although successive Indian governments have reduced the number of activities reserved for the public sector and the number of sectors reserved for small-scale industry (units whose investment in

plant and machinery cannot exceed \$250,000), the numbers are still too high. In effect, this "reservation" policy has created protective enclaves within the industrial sector with adverse

impacts on competitiveness, innovation, and job creation. The manufacture of garments, toys, shoes, and leather and textile products, for example, continues to be reserved for small-scale producers, despite the potential comparative advantage of large firms.

Compounding this problem, India's labor laws make it very costly to reduce workforces in enterprises of more than 100 employees. The result is that formal-sector businesses (those that are registered and pay their taxes) are loath to take on new workers. As a consequence, the vast majority of India's employment is informal and involves small, tax-evading, inefficient enterprises. Cumulatively, these rules and practices have severely restricted export competitiveness and job creation.

"SHINING INDIA"

Since India's services sector tends to create jobs for the relatively educated urban-based populace, its growth has had limited impact on income distribution and poverty reduction. Nothing underscores this better than the results of India's most recent national elections, which took place in April 2004. Basking in the glow of the country's eco-

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conomic renaissance, the ruling national coalition led by the Bharatiya Janata Party (BJP) settled on the catchy “Shining India” as its campaign theme. Pundits and pre-election polls almost universally predicted the coalition would return to power with a solid majority. Yet voters unceremoniously ousted the incumbents. How did this happen? Election postmortems revealed that the “Shining India” mantra did not play well in the countryside.

The majority of the rural populace perceive not only that the new affluence has bypassed them, but that economic inequalities have sharpened. They particularly resent the fact that the real beneficiaries of economic reforms are the educated middle classes living in cities. The 2004 vote was a clear reminder that the fruits of reform need to be more evenly distributed.

It is sobering to think that India will need to generate more than 100 million jobs in the next decade simply to keep the unemployment rate from rising. Clearly, high-technology jobs by themselves will not be enough. The stark reality is that India cannot grow into a major economy on services alone. Since the Industrial Revolution, no country has become a major economy without becoming an industrial power. If it is to provide tangible benefits and meet the needs of a growing and expectant population, India will have to significantly improve the competitiveness of its manufacturing base. This means attending to the backbone of India's industrial production and employment—the small and medium-sized enterprises—and reforming the highly distorted and overregulated agricultural sector.

It also means reforming incentives. At the center of China's successful export strategy have been the “special economic zones” (SEZs) that were created in 1980 along the coastline in Guangdong, Fujian, and Hainan. The SEZs assured favorable export conditions for both foreign investors and domestic enterprises. In the SEZs foreign investors were allowed 100 percent ownership, all exporters were permitted to import intermediate products and capital goods duty free, all were given generous tax holidays—and they enjoyed assured access to reliable physical infrastructure, often through the provision of land, power, physical security, and transport to ports, within specially created industrial parks.

With such incentives, the SEZs witnessed a massive influx of foreign investment and factories. In short order, this created large-scale employment opportunities. And the SEZs did not remain as enclaves for very long. They served as a first step to a much wider and deeper opening. In 1984, economic and technological zones were set up,

followed soon after by free trade zones, which were established in 14 coastal cities and later in inland areas.

While India has also created a number of export-processing zones (EPZs), they have failed to live up to expectations. This is largely because neither foreign nor domestic investors enjoy the kinds of incentives offered in China's SEZs. Combined with the limited scale and overcrowding of the EPZs in small enclaves, the inflexible labor laws, the inadequate infrastructure, the especially poor links to ports and airports, and the continued reservation of certain industries for small-scale producers, India's partial or awkwardly packaged incentives have undermined the EPZs' potential as dynamic export zones. India has much to learn from China in this regard.

UNFINISHED REFORMS

President Hu Jintao is fond of saying that China's aim is to lift the size of its economy to \$4 trillion by 2020—effectively quadrupling its gross domestic product of five years ago. His Indian counterpart, Prime Minister Manmohan Singh, has an equally lofty goal: to more than double India's GDP from \$560 billion in 2003 to \$1.75 trillion by 2020. If these ambitious goals are to be achieved—and they are achievable—both countries will have to expeditiously deal with a number of core challenges they face.

Without doubt, the most important is to maintain (and for India to accelerate) the pace of economic growth over the next decade. This is essential if both countries are to further reduce poverty, improve living standards, and provide employment, especially to a large group of young people who will soon be entering the labor market. And the key to sustaining economic momentum in China and India is to strengthen the structural and institutional underpinnings of their economies by continuing the reforms that remain unfinished in both countries.

In the case of India, a burgeoning fiscal deficit is a major cause for concern. The combined budget deficits of the central and state governments have remained at around 10 percent of GDP since the early 1990s. This has impaired national savings, crowded out private investment, circumscribed the government's ability to deliver much needed public spending, and put macroeconomic stability at risk. Accelerating the pace of divestment and privatization of public sector enterprises will reduce the public sector deficit by raising revenues, increasing the efficiency of resource use, and helping to realign government policies in ways that contribute to

faster economic growth. Divestment proceeds could also assist in retiring domestic debt, thereby alleviating debt-service payments.

In addition, the barriers to trade and investment (both internal and external) are still too high. India currently ranks second in the world in terms of high tariffs. FDI, though increasing, is still far lower than that of other emerging market economies because of the poor infrastructure and India's restrictive policies limiting foreign equity ownership. India needs to attract large amounts of foreign investment to help shore up its infrastructure, particularly power supply, roads, ports, and airports. Reliable electricity supply is the most pressing concern. Power outages occur fairly regularly in nearly every city as well as provincial towns. The lack of an adequate power grid is one reason why no foreign company has built a semiconductor fabrication facility in India.

Both India and China must also strengthen their financial sectors. India has a vibrant domestic credit market, with an active corporate and government bond market, including interest rate and credit derivative markets. Indian interest rates are market-determined, and the banking system prices credit based on market signals.

Yet, despite recent achievements in strengthening prudential and supervisory systems, considerable weaknesses remain. At the core of the problem is that a few government-owned banks (particularly the State Bank of India, the country's largest commercial bank) still account for roughly 80 percent of the banking sector. The vast majority of these banks are chronically undercapitalized and burdened with nonperforming loans.

While public ownership of banks has created an aura of invulnerability to shocks, it is urgent that the authorities move quickly to reduce nonperforming loans, restructure the weak public-sector banks, and close the insolvent ones.

CHINA'S FINANCIAL BLACK HOLES

In China, the banking sector's stability and health are an even greater concern. Indeed, a destabilized banking system could provoke a deep recession with severe ramifications for China's trading partners. China's state-owned banking system has historically made loans under government direction to unprofitable state-owned industries, with little regard for repayment or risk. Interest rates are completely controlled by the People's Bank of China, the central bank. And China's four major banks, which

control 95 percent of banking assets, have no credit scoring or credit risk-based pricing mechanisms in place. The result is a substantial portfolio of nonperforming loans estimated at 30 to 40 percent of GDP (compared with 3.5 percent of GDP in India).

By virtue of huge stocks of foreign reserves and the country's extraordinarily high savings rate, Chinese authorities have managed to maintain liquidity in their banking system in spite of the large volume of nonperforming loans. However, at some point a continued escalation of nonperforming loans will restrict further expansion of bank credit, thereby constraining growth, especially in the small and medium-sized sectors—which play a large role in creating jobs. Moreover, China's asset markets are similar to Japan's: heavily leveraged and primarily fueled by property speculation. They are an accident waiting to happen.

It is widely assumed that many Chinese banks are ill-equipped to face increased foreign competition that will come next year. In 2007, under World

Trade Organization accession commitments, China's financial sector will be opened up to foreign banks. The government has made massive capital infusions to the banking

sector—\$15 billion for one bank alone in April 2005. It also has courted foreign banks and financial institutions to partner with domestic banks to provide financial support and sorely needed technical expertise. But these strategies may not be enough.

Clearly, privatization and opening the banking sector to international competition offer a short-term solution to the problem of nonperforming loans. In the long run, China's banking sector problems cannot be resolved simply by readdressing the balance sheets. China needs to build more effective legal, supervisory, and regulatory frameworks to make the financial sector more resilient to internal and external shocks. It must require banks to adopt good corporate governance rules, meet international best practices, and promote a culture of professionalism—in which senior positions and salaries are determined by performance, and lending decisions are made on the basis of risk analysis and the borrower's creditworthiness, not his political connections.

Another constraint on growth comes in the form of China's unwieldy and inefficient state-owned enterprises (SOEs), which consume large amounts of capital, given their links to the state banks, but which produce little or no return on their capital. Many are poorly managed and protected from com-

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petition. Meanwhile, more efficient private enterprises have difficulty raising capital. Closing SOEs or merging them with stronger enterprises is necessary, both to encourage productive activity that responds to market signals and to shift much-needed resources to the private sector. But, with the future of some 370 million to 400 million Chinese workers and over 50 percent of the country's industrial assets tied to SOEs, the process is going to be painful.

At a minimum, SOE sales should be executed through open auctions or stock markets, because this generally brings a fairer price than the typical clandestine "behind-the-door privatization." Moreover, once a sale is made, proceeds must first be used to pay overdue salaries and fair unemployment benefits to laid-off workers. Since SOE reforms will mean large-scale layoffs, an efficient social safety net will be critical for cushioning the transitional effects. Beyond this, an even more costly responsibility lies ahead for the Chinese government: paying for the unfunded obligations of the pension and social security system, as well as the rising expenses associated with a rapidly aging population.

THE FUTURE IS HERE

Currently, India's and China's economic structures are mostly complementary rather than competitive. Bilateral trade has increased more than tenfold over the past decade, with both countries pledging to raise their annual trade volume to \$20 billion by 2007. (It was \$3 billion in 2000.) However, talk about the two countries soon establishing the world's largest free trade area—a desire expressed by the Chinese—seems premature.

And complementarity may not last long. Wage rates in many of China's export-oriented labor-intensive industries are now well above Indian wage rates. This is already diverting Southeast Asia's manufacturing outsourcing to India. Similarly, China, which has long enjoyed a huge advantage in computer hardware production, is losing its edge. India not only has caught up, it is now a real competitor.

Given their voracious appetites for energy and commodities to feed their expanding economies, both China and India will continue to put pressure on a variety of global markets. A sharp increase in net oil imports by China and India (as well as by the United States) since 2000 has been a major factor behind surging oil prices.

On the positive side, with their growing ranks of affluent middle classes, both countries are fast becoming consumers of imported goods. Indeed, China's imports of goods amount to roughly one-

quarter of its GDP, well above the share for the United States and Japan (about 10 percent for each). The growth in China's demand for foreign manufactured goods and raw materials has boosted exports and growth in many economies—not only among China's neighbors, but also in leading commodity exporters such as Brazil and Chile. China as a result is running trade deficits with many countries. The notable exception, of course, is the United States.

China's massive trade surplus with the United States hit \$200 billion in December 2005 (compared with India's overall \$9.5 billion trade surplus with America). It has provoked concerns about job losses in import-sensitive sectors such as textiles and clothing, and has already eroded much of the bipartisan support in the US Congress for free trade with China. Business and political leaders in both the United States and European Union believe China has kept its currency undervalued (notwithstanding a modest revaluation in the exchange rate in July 2005) to give Chinese exporters an unfair competitive advantage, further adding to international economic friction. Similarly, India's emergence as the competitively priced "back office" of advanced countries for financial services, pharmaceuticals, and information technology has heightened its profile as a target for American industries, workers, and politicians fearful of the domestic consequences of outsourcing and "offshoring."

Yet trade linkages between the United States and China and between India and the United States are substantial and important to all three economies. The United States is the most important export market for both nations—already, it accounts for roughly one-quarter of all Chinese exports. Therefore, both China and India have an interest in diffusing protectionist threats in the United States.

At the end of the day this means both China and India have to abide by their commitments under the World Trade Organization—and help advance the Doha Round of talks to further liberalize global trade. It also means that both countries must open their markets to US goods and services, ensuring that imports and foreign firms can compete fairly with domestic products in the rapidly expanding Chinese and Indian markets.

China and India are already major players in the global economy. However, their impact in coming decades on the world's economic and strategic landscape will depend not only on how efficaciously each exploits its comparative advantage, but also, more fundamentally, on how each deals with its structural and economic challenges. ■