India and China: Two Pathways to the Market

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Overview

38% of the world's people

- What are the differences in the pattern of liberalization ?
- What causes these differences ?

Snapshots, 2012

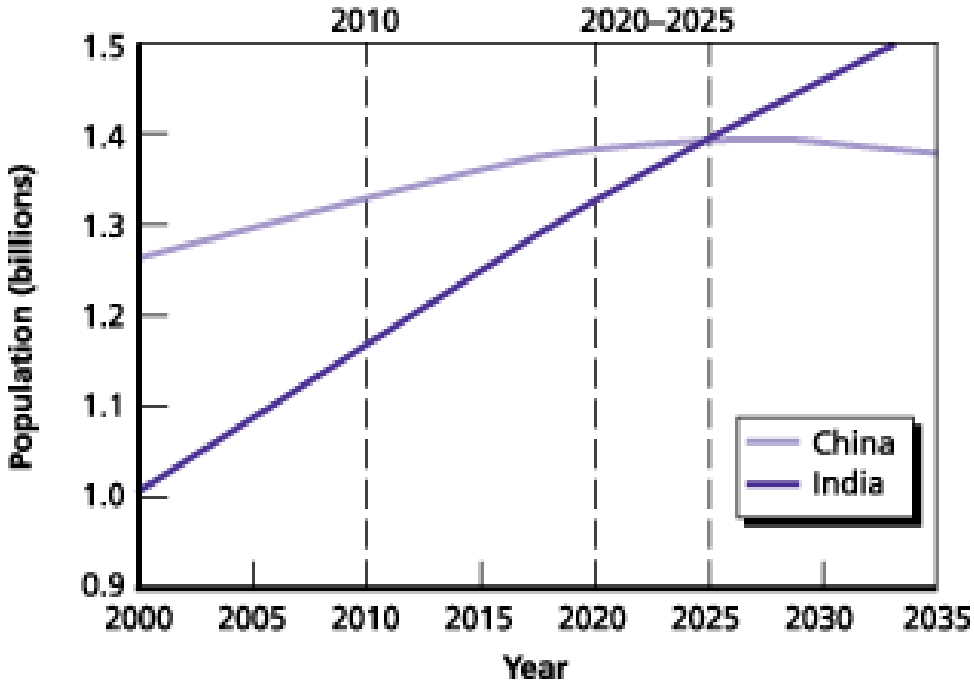
China

Population	1.365 Billion
Fertility Rate	1.54
Life Expectancy	73
Literacy (%pop.)	96%
Poverty 2005	8.1%
GDP	8.23 Trillion
GDP per capita	6,091 USD
FDI Stock 2012	832B (USD) (3.7% global)
Share Global Merchandise Trade	11.1%
Public Debt as proportion of GDP	23%

India

Population	1.291 Billion
Fertility Rate	2.65
Life Expectancy	69
Literacy	74%
Poverty 2005	28.6%
GDP	1.84 Trillion
GDP per capita	1,489 USD
FDI Stock 2012	226B (0.9% global)
Share Global Merchandise Trade	1.6%
Public Debt as proportion of GDP	67%

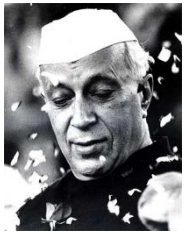
Total Population Sizes, China and India, 2000–2035



SOURCE: U.S. Census Bureau, International Data Base, 2010.

Economies Roughly Comparable

in income per capita at the Close of WWII, then…



China

- **A Leninist State b. 1949**
  - All political authority resides in the Party
  - Command Economy: By the mid-1950s, all enterprise is owned by the state
  - Planning dominates, but less than in the Soviet Union
- Significant growth, but catastrophic political initiatives from the late 1950s to the mid-1970s disrupt the economy

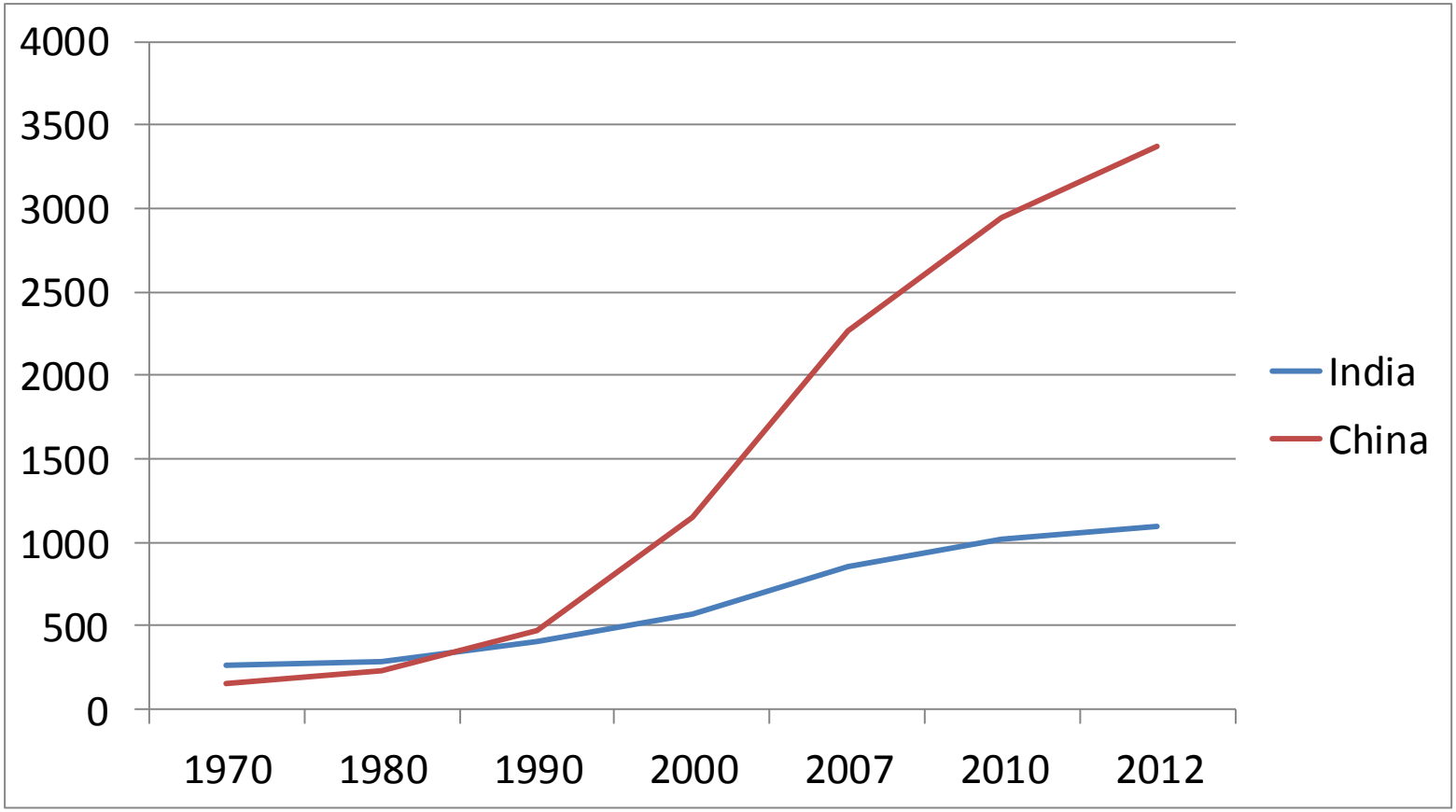
India

- **A Fabian State b.1947**
  - The world's largest democracy
  - Command Economy: Large state sector co-exists with a (heavily regulated) private sector
  - Planning tries to dominate: "The Licence Raj"
- Planning fails to ignite development:

  "The Hindu Rate of Growth"

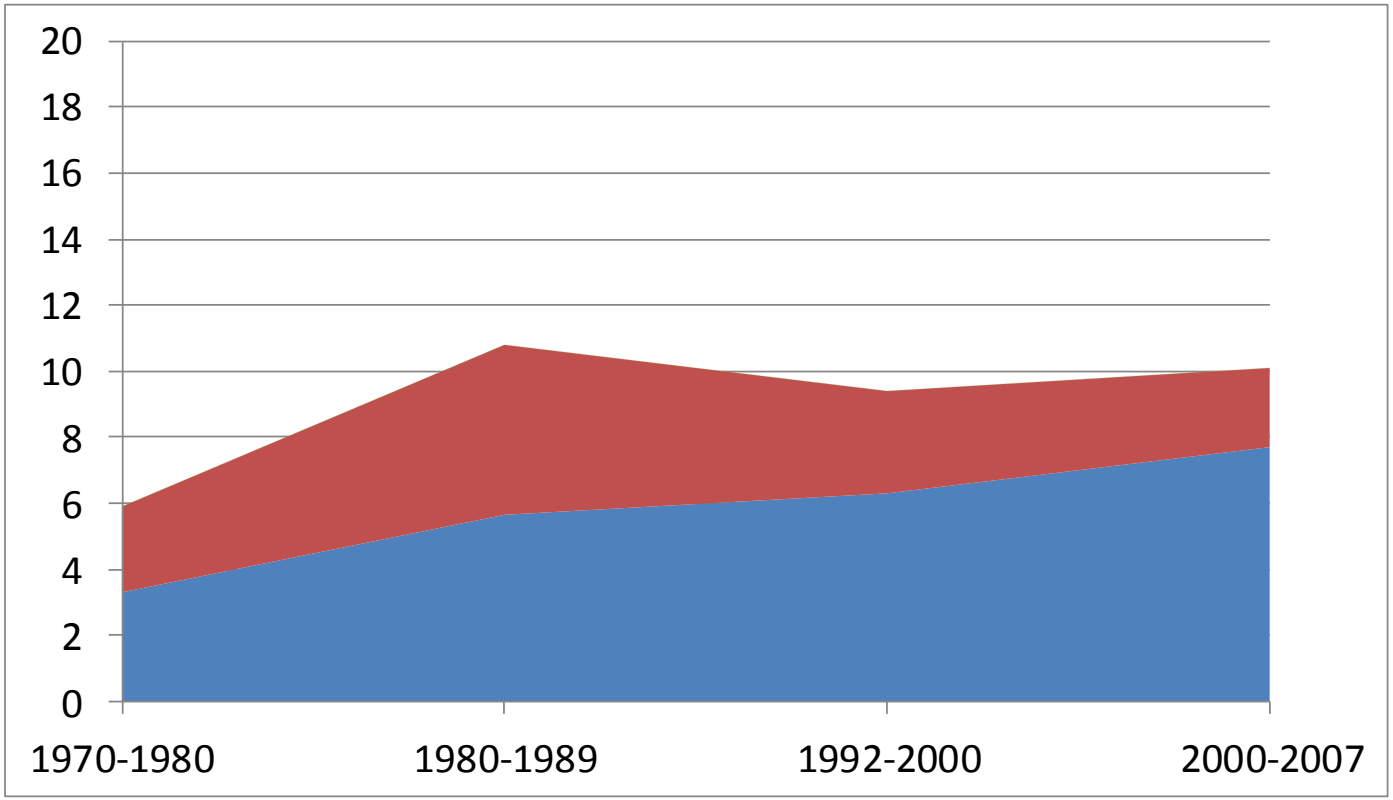
GDP per capita

USD@2005 prices and foreign exchange rates **Source: UNCTAD**



Growth Performance

Average annual rate of GDP growth by (roughly) decade



Source: UNCTAD

Trade Comparison

Source: International Trade Centre, OECD

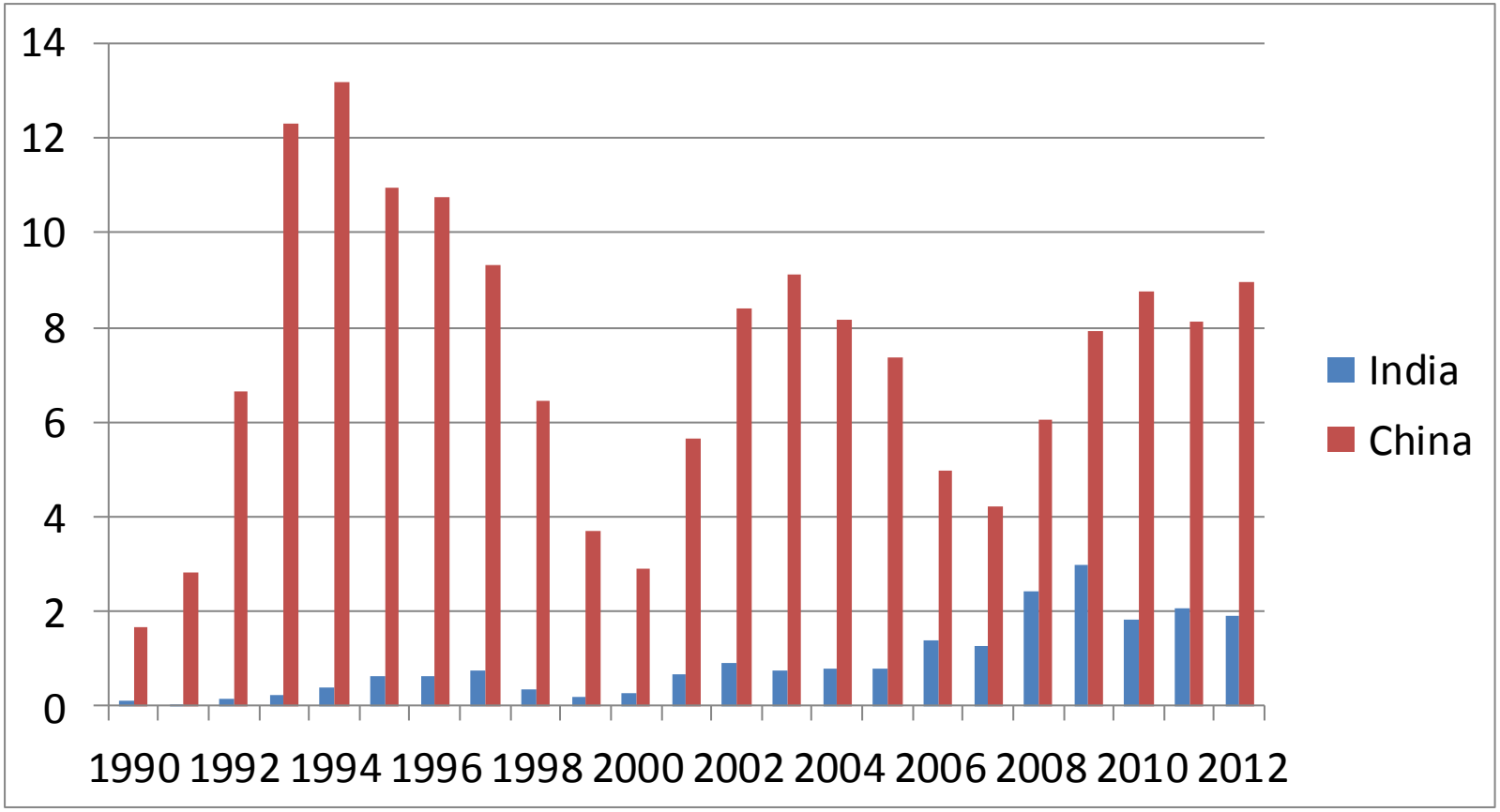
China	
Export of Goods, 2012	1.90 Trillion US$
World Rank	1st (9.9%)
Trade Balance, Goods, 2012	155 Billion US$
Export of Services, 2012	191Billion US$
Computer and Information Services	4.3 Billion US$
Remittances (2013 est.)	60 Billion US$
Trade Balance, Services, 2012	(90 B US$)
World Bank Ease of Doing Business Index Rank	91st

India	
Export of Goods, 2010	220 Billion US$
World Rank	18th (1.5%)
Trade Balance, Goods, 2010	(129 Billion US$)
Export of Services, 2010	123 Billion US$
Computer and Information Services	37 Billion US$
Remittances	71 Billion US$
Trade Balance, Services, 2010	7 Billion US$
World Bank Ease of Doing Business Index Rank	132nd

Inward FDI Comparison (1)

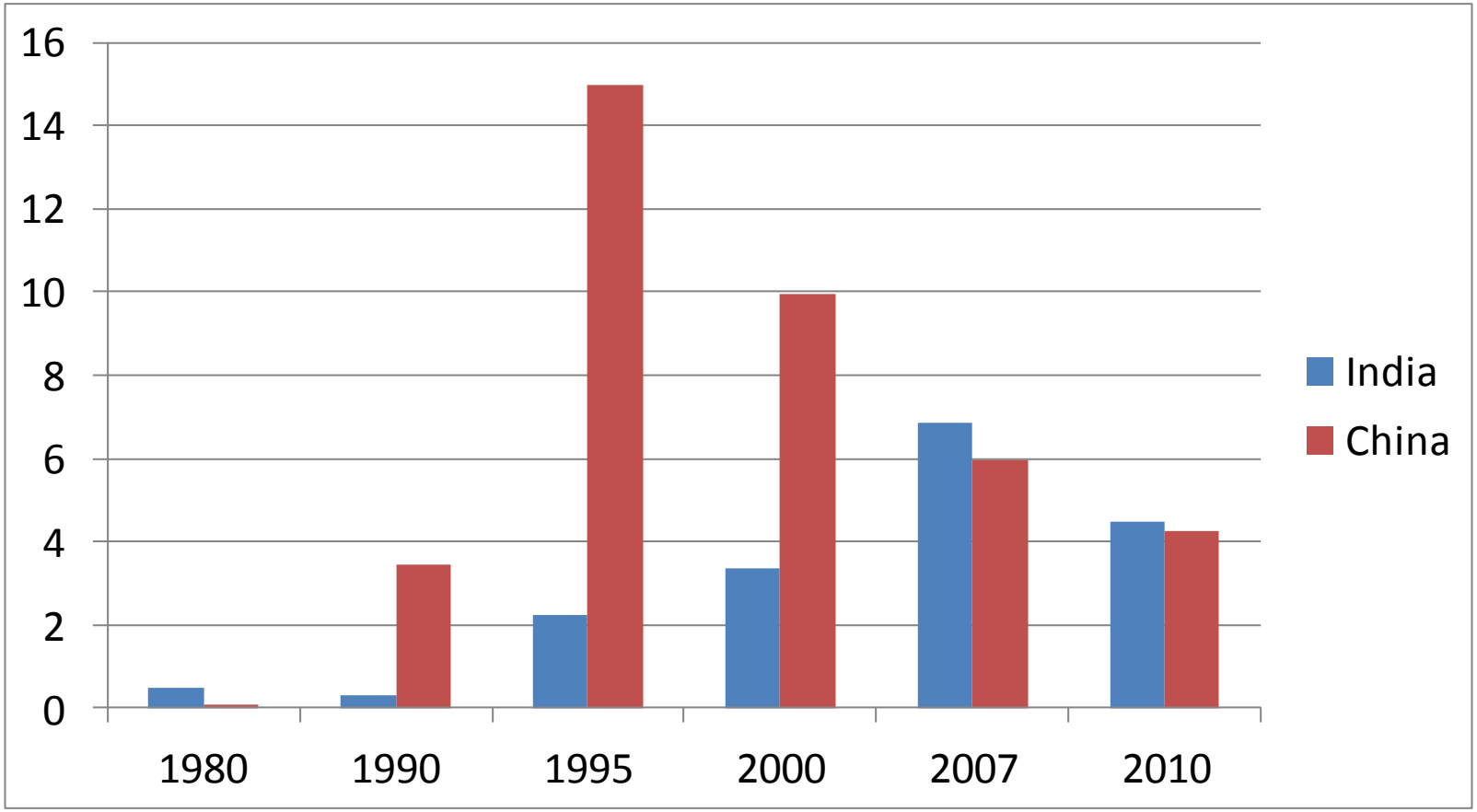
Inward FDI as a percentage of total world FDI

Source: UNCTAD



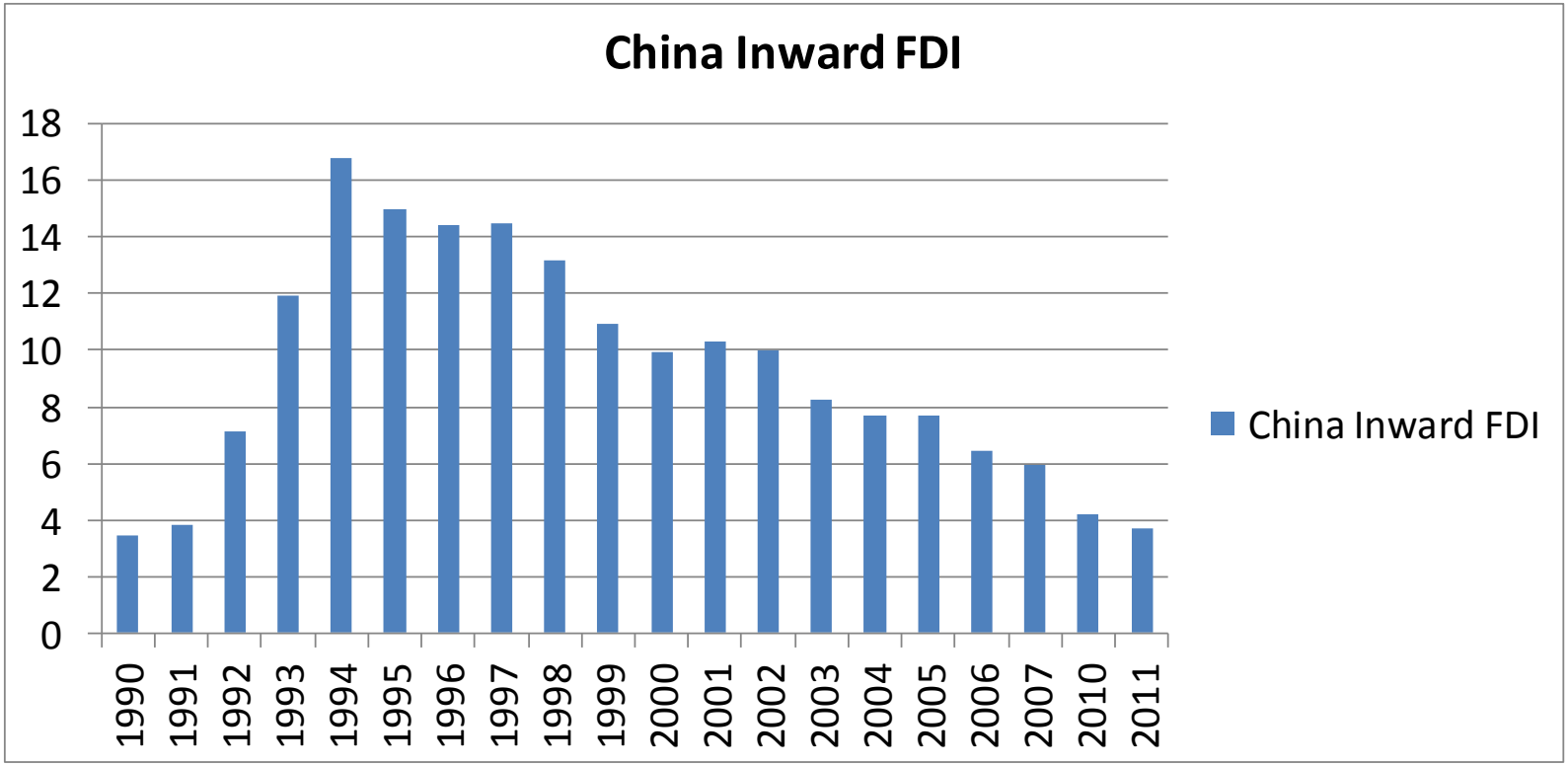
Inward FDI Comparison (2)

FDI as a percentage of gross fixed capital formation
Source: UNCTAD



China's Unique FDI Experience, 1990-2007

Inward FDI as a percentage of gross fixed capital formation
Source: UNCTAD



Manufacturing: A Tale of Two Countries

China: 40% of GDP

India: 16% of GDP

So…

- China's growth performance has greatly exceeded India's over the last twenty years
- China has become a manufacturing and merchandise trade powerhouse
- FDI has played a key role in the Chinese growth story
- India is a modest player in merchandise trade
- India's balance of payments is dependent upon the export of services and upon remittances (Services = 53.4% GDP in 2008)
- India has never really been competitive with China for FDI
- China has outperformed India in human development since WWII (although the official Chinese poverty figures are not credible)

Development 101

- Why do nations' development patterns differ?
  - Natural Resource Endowments/Geography
  - Culture
  - History
  - Politics/Policy/Institutions

The Command Economy Syndrome

- **Command economies on the Soviet model suffered from standard weaknesses:**

  - Overemphasis on heavy industry
  - Obsession with self-sufficiency
  - Poor alignment of incentives, low productivity
  - Misallocation of resources
  - Quantity over quality, delivery, variety, design, customer service...
  - Over-diversification of firms: too many products and processes in a single management structure
  - Closed national economies and rationing of foreign exchange (“Import Substitution Industrialisation”, or ISI)
  - No innovation except in the defence sector
  - Neglect/exploitation of the agricultural economy
  - Pervasive rent-seeking
- **Postwar India and China: Prime examples of dirigisme**

The Retreat from Statism

China

- Turning Point: 1978
- Mao's political campaigns damaged the economy immensely
- After his death (1976), the elders who ruled knew that the credibility of the regime was in danger
- The rural economy had moved from famine to stagnation
- Foreign exchange crisis
- In 1978, the CCP
    - Dissolved agricultural collectives and initiated the "Household Responsibility System"
    - Began a two track (plan and market) pricing system
    - Liberated the rural economy beyond agriculture – era of the TVE
    - Established first four "Special Economic Zones" to attract FDI

India

- Turning Point: 1991
- Rajiv Gandhi regime in the 1980s exposed India to foreign bank liabilities
- The First Gulf War raised oil prices and cut off remittances from Indian workers in the Gulf
- In 1991, India was down to two weeks' foreign exchange, and had to ship gold to London to get financing
- Inflation rate 17%
- In 1991, the Congress coalition government
    - Devalued the rupee by 24%
    - Cut public spending
    - Began loosening of licensing and tariff regimes
    - Opened up to FDI
    - Permitted convertibility on the current account

Liberalization:
The Stylized Facts of the Washington Consensus

Fiscal discipline	Government should run a primary surplus before debt service Government should maintain an operational deficit of less than 2% of GDP
Public expenditure priorities	De-emphasize defence, subsidies and administrative expenditure Emphasize health, education and infrastructure expenditure
Tax reform	Broaden tax base and cut marginal rates Improve administration
Financial liberalization	Move toward market-determined interest rates
Exchange rates	Unified rates at minimally competitive levels
Trade liberalization	Remove quotas; lower tariffs progressively
Foreign investment	
Privatization & Deregulation	
Property rights	Secure property rights

Resource Endowments and Geography

- Both countries are continental economies with abundant natural resources
- Both countries are dependent upon low quality domestic coal and imported oil (China consumes more coal than all the other countries in the world combined.)
- China has two important geographic advantages
    - A vast and wealthy Chinese mercantile diaspora in Taiwan, Hong Kong, Singapore and Malaysia – led FDI into the SEZs starting in the 1980s
    - Access to OECD-style capital markets and corporate governance, in Hong Kong
- India's neighbours have stagnant economies and its traditional trading partners are mostly culturally foreign
    - Indian trading diaspora in SE Asia and East Africa not nearly as large or wealthy as its Chinese counterpart

Agriculture

- China: about 15% of GDP and 40% of the labour force
- India: about 16% of GDP, and over 55% of the labour force

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Patterns of Development

Source: NASA

Culture and History

China

- Chinese have a tradition of manufacture, commerce and internal trade
- South-eastern coast has a long history of trading links in the South China Sea and beyond
- Postwar regime interrupted but did not terminate these advantages
- Postwar regime achieved land reform by adopting then rejecting communist agricultural dogma
- Minorities constitute 9% of the population

India

- The imperial power reshaped Indian trade in its own interests, severing historical linkages with SE Asia and the Persian Gulf
- The imperial power also left India with a legacy of institutions and infrastructure, including...
- 250 million English speakers – a decisive factor in the successful export of services
- Postwar regime failed to achieve land reform
- Indian caste norms devalued manufacturing and trading activity
- Minorities constitute about one-third of the population.

Politics/Policy/Institutions: State Capacity

China

- Decision-making depends upon intraparty politics
- By the mid-1990s, as consequence of its early success in liberalizing, the Chinese Communist Party (CCP) had become able to impose major costs on specific social groups
- The CCP has an implicit bargain with the Chinese people: it ensures the material progress of the country as a whole, and the people accept limitations on their political freedom
- The CCP has broken internal opposition to economic reform
- The CCP has adapted by emphasizing education in its recruitment and promotion; as of 2003, entrepreneurs may join the party

India

- Decision-making depends upon intra-bureaucratic politics, with an overlay of electoral veto power
- The Indian government has little capacity to impose costs upon specific social groups
- Democratic politics is about distribution and recognition (caste, language, religion), not about development
- Liberalization is a subject the political class prefers to avoid
- The Indian bureaucracy is a powerful set of interest groups, composed of competing “services”, each jealous of the other’s prerogatives; policy implementation becomes a consequence of intragovernmental corporatist competition

Politics/Policy/Institutions: Federalism

China

- Chinese provinces and local governments are highly competitive
- Since the mid-1990s they have a relatively stable fiscal regime
- They are development- rather than distribution-oriented: Prime criteria of assessment for promotion are development indicators
- Other organs of the Chinese state have also been enlisted in the interests of economic development
    - PLA, railways, utilities and SOEs encouraged to compete with one another in contiguous sectors
- Ability to attract FDI and land development have been major sources of prestige, patronage and rents for provincial and local officials

India

- Indian states are feeble; dependent entirely upon grants from the centre for their revenue
- Some of them (UP, Bihar) are the sub-national version of failed states
- They are saddled with bankrupt SOEs which defy restructuring and with huge structural deficits
- State-level politics pays lip service to development, but executives lack resources and competence
- At least half of the Indian states, containing more than half of the population, receive near-zero FDI and have seen only modest employment creation from liberalization

India's Development Axes

- **Growth axes**: Punjab, Hayana, Delhi, Gujarat, Maharasthra, Andhra Pradesh, Karnataka, Tamil Nadu
- **Frontier states**: Northeast states, Jammu & Kashmir
  - Conflict prevents development
- **Failed/Predatory states**: Bihar, Uttar Pradesh - The Heart of the "Cow Belt"
  - Crime prevents development
- **Lost in translation**: Chattisgarh, Uttarakhand, Jharkhand, Madhya Pradesh, Orissa –The Rest of the "Cow Belt"
  - Large tribal populations, low capability, weak governance
- **Remittance state**: Kerala
  - Agricultural exporter, forex importer
- **In a world of its own**: West Bengal
  - Marx, Malthus or millionaires ?
- **Desert tourism**: Rajasthan
- **Life is a beach**: Goa
- **Mountain tourism**: Himachal Pradesh

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Politics/Policy/Institutions: Structural Adjustment

China

- **The 1978 opening for the rural economy created TVEs which by the late 1980s severely eroded SOE market share in many sectors**
- **In the second phase of reform in the mid-1990s, the Chinese decided to restructure the SOEs**
- **In 1998, the Chinese abolished many sectoral ministries in favour of regulatory agencies**
- **Between 1996 and 2001, many SOEs were shut down and their work forces reduced: *50 million SOE and urban collective workers lost their jobs***
- **In 1998-2000, the CCP leadership removed the PLA from the economic sphere**
- **In 1998, Beijing cracked down on smuggling by state entities, incl. the PLA**

- **All this was feasible because of the credibility lent the CCP by the success of initial economic reforms and the unexpected magnitude of FDI**

India

- **In 1991, India designated telecom and electricity as priority targets for liberalization**
- **There ensued a long tug of war while the state arm-wrestled itself over implementation, the entrenched sectoral bureaucrats against the small rump of central liberalizers**
- **Telecom was ultimately a success**
- **Both the World Bank and the centre prioritized electricity**
- **Electricity is still largely unreformed:**
  - State jurisdiction
  - State electricity utilities are effectively bankrupt – deficits of $7B per annum
  - State regulators not independent
  - Pilferage, non-payment, “free” and subsidized electricity, obsolescent plant, corruption
  - It has proven impossible to introduce market incentives into the sector
- **Unreliable power is one of the major reasons why foreign investors avoid India**
- **The Indian state contains both the proponents of and the resistance to developmental policy**

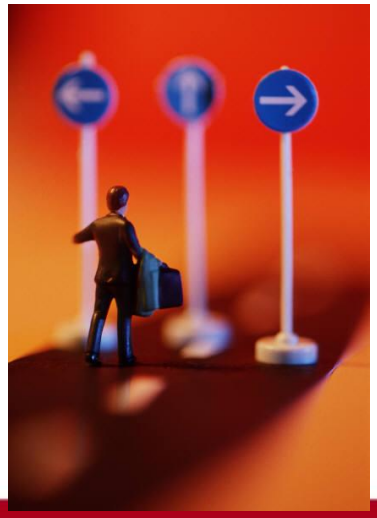
Politics/Policy/Institutions: Corruption

- Corruption is a major issue in both countries
- External perceptions are that both countries have a serious problem
    - Transparency International (2012) rates China as 80th and India 94th out of 180 countries in combating corruption – superior to Argentina, Egypt, Indonesia, Nigeria, Pakistan and Russia
- Surveys show that corruption is the single biggest domestic issue for the Chinese population
    - Between 90,000 and 120,000 public disturbances per annum in China serve as a rough barometer for public dissatisfaction, often turning upon corruption (or pollution)
- Indians did not show the same consistency of concern, but the issue has recently hit the boiling point

FDI: Benefits and Risks

Why Invest ?

- **Four investor motives for FDI:**
  - Lower factor costs
  - Access an attractive domestic market
  - Access raw materials
  - Learning opportunity



Why Not Invest?

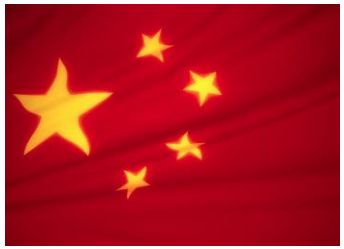
- **Risk in emerging markets:**
- 1. Rapid growth and weak institutions bring volatility
- 2. Lack of market, costs, and supplier information
- 3. Ubiquitous and unpredictable bureaucracy and judiciary
- 4. Unsophisticated and thin financial markets
- 5. Political risk: sudden political and policy reversals
- 6. Opacity and corruption
- 7. Social unrest and ethnic conflict
- 8. Geopolitical risk [terrorism, armed conflict]

Politics/Policy/Institutions: FDI

- China is a low-cost **blue**-collar labour economy
- India is a low-cost white-collar (technical) and pink-collar (back office) economy
- Indian blue-collar labour is mostly poorly trained and low productivity (exceptions: pharma and auto-parts)
- The Chinese regime, exceptionally, favoured FDI over the domestic private sector until 2003, because they saw FDI as less politically threatening
- Chinese private sector still has difficulty accessing financing; public authorities dominate much bank lending and favour SOEs

Politics/Policy/Institutions: Why Software?

- India's software body-shopping in the 1980s and 1900s was the country's first real export success in the postwar period
- The challenge has been to move up the value chain and it appears that Indian companies are successfully doing that
- This success also provided a kind of blueprint for back-office outsourcing to India and some of the same companies are involved
- The success of these sectors is non-trivially related to the fact that they were not regulated and not subject to the licence raj
- The software entrepreneurs were the first Indian business people who did not have to defer to the Indian bureaucracy
- Export of these services brings much-needed foreign exchange, but it is enclave development that does not build linkages to the ambient economy – unlike manufacturing



Challenges for the Future

China

- Regional equality
- Corruption
- Corporate governance
- Capital markets, banks and entrepreneurial finance
- Environmental sustainability, agricultural land and water
- Preserving a favourable international trading environment
- Demography
- **A Post-Leninist State**
- **High competence**
- **Weak legitimacy**

India

- Regional equality
- Corruption
- Rigidity in labour markets
- Training, mfg. productivity
- Fiscal discipline and federalism
- Public sector reform
- Infrastructure bottlenecks
- Human development

- **Slowly Dissolving Nehruvian Settlement**
- **Low competence**
- **Stronger legitimacy**

Democracy vs. Autocracy for Development?

Most anecdotal evidence and most experience suggest that autocracy is advantageous for development , however...
All multi-country, multi-variable empirical work shows that democracy does not hamper development.

The Future?

- CCP must eventually fall off the tiger,

probably during this (Xi Jinping) administration's mandate

- China's growth is slowing
    - Catch-up phase is over; China will have rely on its own R&D and innovation, rather than relying on foreign sources
    - Rural-urban migration of workers is about over - Lewis turning point, c. 2020-2025
    - Export growth is slowing
    - Unsustainable levels of investment, especially in housing
    - Weak domestic consumption
- The Xi Jinping administration felt that little progress in addressing China's structural problems had been made during the past five years
- In November 2013, the Central Committee published, with explicit support from Xi Jinping and Li Keqiang, an ambitious reform program

“383 Plan”, November 2013

The National Bureau of Asian Research, “The Third Plenum: Prospects for Reform in China”, December 4, 2013

- The plan recommended three broad areas for reforms touching the roles of markets, government, and enterprises
- Identified eight sectors in need of special attention
    - finance, (more transparent budgeting)
    - taxation, (Local-Central fiscal relations)
    - state assets,
    - social welfare, (end one-child policy, comprehensive social security system)
    - land,
    - foreign investment,
    - innovation, and
    - good governance. (labour camps, supervision of the Internet, anti-corruption, “consultative democracy”)
- Described three desired breakthroughs
    - broader market access,
    - a basic social-security scheme covering both urban and rural people, (Hukuo: residence permit equality)
    - the ability to sell collectively owned rural land. (rural land rights)

Dual Process Reform

- Bold measures to deepen reform of the economy in the direction of market forces…
- Combined with a “stronger leadership role for the party”, i.e., increased discipline over dissent and debate on the Internet, continued party supervision of the judiciary

The Future?

- India's FDI performance has been weakening
- The rupee has depreciated against the dollar
- Inflation, especially of food staples such as onions, has been testing Indians' patience with the status quo
- Election of April-May 2014 resulted in a decisive victory for the BJP over the United Progressive Alliance, led by the Congress Party
    - This might give a shot in the arm to the largely becalmed process of economic reform
    - The BJP Prime Minister is Narendra Modi, a chauvinist Hindu, who seems to be attempting to shed his communalist image
    - Foreign investors seek increased certainty on taxation and fiscal policy