

CHINA AND INDIA: WHY DO THEY NEED TO LEARN FROM AND TRADE WITH EACH OTHER?*

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1. INTRODUCTION

A few years ago, the title of China and India comparison was suddenly brought into the eyes of businessmen and politicians, and has become a must-read in mass media. Who will surpass whom? Can India catch up China? Will China lose to India eventually? etc.

In the early summer of 2006, the trading route that links China and India suddenly became a national coverage for days in all Chinese media. The event that attracted eyes ball of people in China is the reopening of Nathula Pass. The most influential English newspaper in China, China Daily, said that the reopening of the Nathula Pass demonstrates the two countries' determination to strengthen economic and political exchange. The pass, which was closed after China and India fought a brief border war in 1962, is about 460 kilometres from the Tibetan capital Lhasa and 550 kilometres from Calcutta, India's second largest city.

When I traveled in India two years ago, people told me that more Indian people are talking about China than Chinese people. But today I am sure Chinese people learned much more of India, ranging from its film making to IT sector. More interestingly, more Chinese people know that India does better than China in some aspects of its economy. Of course, eating Chinese people began to love Indian cuisine. Indian restaurants are mushrooming now in Chinese metropolitan cities like Beijing and Shanghai.

China-India comparison has become a must-do topic in the conference about the economic future of China or India. Not only does international business and finance media continue to cover the told stories of China-India comparison, but Chinese and Indian domestic media keeps on reporting the political and economic events of these two nations. Business elites in the two countries were frequently invited to speak to the public. Scholars on China and India were much interviewed for and published their views on the dragon and elephant.¹

Mainly because of conflicting border of territory issue in the past, China and India were closed up to each other for quite a long time. Only up to recent years have both countries begun returning to the status of close ties in trade and investments. Given the rapid economic growth that is going on in both sides, the two countries try to avoid being neglected.

There are a lot more gains for both China and India to learn from the experiences of economic

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¹ On July 1-2, 2006, for example, the International Conference on the Dragon and Elephant: China and India's Economic Reforms, was held in Shanghai. There were more than 20 papers presented at the conference by scholars from various countries including India, China and the USA.

success and to trade and cooperate in economic field. China and India have followed divergent ways to promoting their economic development. India has some elements of success that need to be learnt by China; China has elements of success that can be considered for the future of India. China has better infrastructure and manufacturing capability than India, and India has better knowledge of corporate governance than China. China has been more open to foreign participation than India, and India has more open to its indigenous private sector than China.

To India, China is the second largest trade partner only after the US today. Bilateral trade between China and India shot up to US\$18.7 billion in 2005 from US\$1.16 billion in 1995, with a surplus of US\$ 833 million for India. In 2008, the trade between the two most populous nations is expected to surpass the target of US\$20 billion set by the two governments.

2. THE DIFFERENCES THAT LOOK ALIKE

This section will highlight the differences in the outcomes of economic liberalization and reform programs in China and India. Though China and India were on the similar level of development in around 1970s and both of them began to liberalize their regulated domestic economies, the results of economic liberalization and reform programs are different. These differences are either due to the political constraints, initial conditions or due to the policies the governments implemented.

In the pre-reform period, both countries had a legacy of heavy-handed regulations originating either from their socialist or communist political leanings. China started its reform exercise in 1978 and the objective was to move from a planned to a market economy driven by labor-intensive exports (and investment) while keeping its political system intact. Reforms through the responsibility system started in the least resistant areas (rural areas and collective ownerships) and moved on to the relatively more resistant areas (urban areas and SOEs) in the early 1980s.

By contrast, the objectives of reforms in India were more modest – to retain its mixed economy model but to deregulate the economy and provide opportunities for its private sector to benefit from a rapidly globalizing world. The bulk of the resources for development were to be generated from within the economy and a balance was sought between domestic demand (mainly consumption spending; investment rates in India have been one-half those of China) and exports to drive the economy.

Accordingly, the reform process started in India in the mid-1980s when efforts were made to dismantle the “license raj” for the industrial sector and international trade. Reforms became much more systematic in 1991 when a package of stabilization (in response to the then prevailing balance of payments crisis) and a wide range of structural reforms were implemented.²

² I thank the anonymous referee for providing me with this point.

China enjoyed better level of infrastructure and healthcare in 1970s and 1980s, whereas India did not. Chinese economic system was more distorted than Indian one prior to 1980s, so the gains from partial liberalization of the economic control were different. In 1980s, the reform programs initiated by Ghandi government was primarily to reduce the regulations and constraints on Indian private sector, and nothing more had been done effectively to promote the opening-up to foreign direct investments and to trade, the exception was the opening of capital account. China, however, did not officially open its capital account even today. But Chinese economic reform programs are more comprehensive and more market-oriented. China has opened its domestic markets to foreign participation and has reduced the barriers to entry substantially. In the past 5 years, China has honored its commitments to open its financial, agricultural, services, and telecommunication markets to foreign investments.

Privatization of state owned enterprises in India has been extremely difficult given the nature of political system and the resistance of leftist parties. Unlike India, China began its reform on state owned enterprises as early as 1980s, and accelerated the privatization of small and medium sized SOEs after 1995 and onwards. Today, the number of SOEs in manufacturing sector is small, and Chinese government only controls about 167 large SOEs locating in energy sector, banking, transportation, commodities, and IT sector. These SOEs are, of course, quite profitable today due to the boom of Chinese economy.

China enjoys higher national saving rates than India so that China can sustain its rapid growth of capital formation, with a investment/GDP. India's saving rate is about 25% of GDP, and China has doubled this figure in the last decade. Chinese central government has much smaller percentage of fiscal deficits than that of India. Inflows of FDI to India are stated to be one-tenth of that in China.³ Chinese labor markets are much more efficient and flexible than Indian labor markets.

Compared to China, it seems that the policies of Indian government were largely skewed towards the small business, whereas in China, small businesses have been contained and regulated by the governments. Only until recently has Chinese governments begun to allow more small businesses to access to many of industrial sectors that previously dominated by SOEs or even by FDIs. But even that, the financial constraints are still the number one concern to the Chinese small enterprises.

Thought Indian reforms have become more comprehensive more recently, and China has announced to decide to move toward consumption-led growth model, outcomes of economic reforms in both countries have been divergent so far.

The biggest difference that can be found in economic development between China and India is that China has much better level of physical infrastructure in urban cities and better results

³ Some have challenged this view because the level of capital inflows into India is larger as India receives a significant amount of portfolio investment (about \$9 billion a year) and deposits from non-resident Indians. But, of course, it is only FDI that has the spillover effects, namely technology transfer and improved management system.

of poverty reduction in rural areas. The most of areas of India, especially in the north, are still very poor. In China, the speed of poverty reduction has been much faster. And even though the inland provinces in China are lagging behind the east coastal areas, with continuous efforts to rural industrialization, the growth rates of investments in manufacturing and infrastructure as well as the real per capita income have been on increase continuously. Because China enjoys better infrastructure than India, the manufacturing industries are better developed in China than in India. India's industrial sector has accounted for much smaller percentage of GDP than that of China, as Table 1 presented.

But India enjoys much better corporate governance than China. China has much better level of administrative efficiency, or "quality of governments". India has large numbers of internationally competitive private companies following international best practice of business rules and transparency. A recent World Bank index, which takes into account protection of minority shareholders, quality of training, and nepotism, ranks India 32 and China 73 out of 104.⁴ Chinese large business enterprises are state owned or state controlled with government link and governments interests.

3. WHY DID CHINA FLY AND INDIA WALK?

Mr. Rajiv Sikri, Special Secretary, Ministry of External Affairs, Government of India, once summarized the stylized facts of Indian economic success in comparison with China. He said, "Firstly, the Indian economy has grown within a *democratic, federal framework* that necessitates consensus and imposes many well-known constraints. Secondly, *the indigenous private sector* has played an important role in the growth of the economy and the process of economic reforms. Thirdly, the bulk of the resources for India's economic development have been generated from within the country, *not from FDI*".⁵

What Mr. Rajiv Sikri describes above actually characterizes the different institutional settings that both China and India triggered their economic growth. China decided to give up much of the centrally planned regime and shifted on to the market economy shortly after the death of Chairman Mao and the end of decade-long cultural revolution. The target of rapid economic growth was set by the communist party of China and the growth target was fully implemented vertically within the authoritative governance. In order to accomplish the growth target the party has to discipline its officials and continue to improve the efficiency and structure of its governance. To this extent, managing the economic growth in China is generally a matter of managing the politics.

China has experienced a process of fiscal decentralization as early as mid-1980s which allows the local officials to retain a percentage of local fiscal revenues, delegates the decision making power to the local governments. But such fiscal fragmentation or fiscal federalism is maintained within the vertical political control. The local officials are appointed by the party, not

⁴ More details can be referred to <http://www.worldbank.org/wbi/governance/pubs/gcr2004.html>.

⁵ This speech was given by Mr. Rajiv Sikri during the opening ceremony of the international conference on 25 Years of Economic Reforms in China, held in Delhi on 10-12 March, 2004.

elected by local votes. The combination of political centralization and fiscal decentralization creates a built-in dynamics of investment-driven growth. Local officials are induced to pursue its career by implementing the plan of capital formation and growth targets.

One of the brilliant results of such dynamics is the continuous upgrading and construction of physical infrastructure by local governments to attract the inflow of external direct investment including FDIs. In a recent study on the determinant of China's physical infrastructure, we find that local governments are strongly induced to attract the inflow of FDIs and therefore to improve the level of physical infrastructure. Indeed, a panel data covering Chinese 29 provinces for 1987-2001 shows a clear positive correlation between the spending on infrastructure and inflow of FDIs, both in per capita terms (see Figure 1). This institutional setting and the incentive structure facing Chinese local officials explain the pattern of Chinese economic growth and opening up to foreign direct investments (FDIs).

In sum, China enjoys higher investment/GDP ratio, FDI/GDP ratio, and the growth of capital formation than other big emerging economies like Russia, Brazil and India. The investment in capital construction and, especially, the physical infrastructure, has continued to accelerate in China than any other countries in the world. These features are better explained by the nexus of political governance and economic/fiscal decentralization in China.

But in India, the economic growth is largely brought in by a given opportunity of integrating it into the world economy, and is by nature a result of return to assets of English speaking and a dividend of demography. Politics is separated from economics in India. Not like China, Indian government under its political system, has to defend, not offend, the existing traditional sector and the loss making state sector. The industrialization and structural change of Indian economy has been much slower than China.

Pranab Bardhan, Professor of Economics at UC Berkeley, explains why Indian industrialization has been so slow. He wrote "both China (since the early of 80's) and India (since the early of 90's) went for serious decentralization, but their nature was quite different in the two countries. In India this took the form of regular elections at the local level, but there has been as yet very little devolution of real authority and revenue-sharing powers to local governments. The role of elected officials at the village or district level in most parts of the country is largely to select beneficiaries of projects (like employment or credit programs) funded from above. In many states the resources meant for the poor have been diverted to non-target groups through collusion between the local powerful people and the bureaucrats. In China, the Party functionaries at the local level (non-Party leaders occasionally chosen in village elections were less effective if their agenda differed from that of the Party functionaries) had some real authority and some local revenues shares which motivated them to play a leading role in local business development particularly in the coastal areas. Unlike the case of the Chinese TVE's (up to the end of the 90's), in India local business development has not usually been in the agenda of local governments."⁶

⁶ See Bardhan(2006).

4. GAINS OF BILATERAL TRADING AND INVESTMENTS

Since the signing of the new trade protocol between China and India in 1984, the bilateral trade between the two countries has been growing faster. In 1990, the total value of trade between China and India was only US\$260 million. This figure increased to US\$ 2 billion in the year of 2000. In 2005, the bilateral trade between China and India grew by 37.5% compared with 2004, and the total value of bilateral trade reached US\$18.7 billion. The trade has been growing at an average of 44% annually in the past 5 years.

The \$18.7 billion level of total trade between the two dynamic countries in 2005 is still low in both absolute and as well as relative terms (comprising only 1.3% of East Asia's total trade but 7.8% of South Asia's total trade). In the past few years India has continuously become the largest trade partner of China in South Asia. And a couple of years ago, China, replacing Japan, became the largest trade partner of India in Northeast Asia. It was forecasted that the total trade will be over US\$20 billion this year and reach the level of US\$100 billion in 2015. By that time, China should have become the largest trade partner of India.

A major factor behind this trend is undoubtedly the fact that the two regions are becoming more "complementary" to each other. It is beyond just the frequently mentioned case of India specializing in computer software and China in hardware. The most of Indian exports to China are the primary goods which rely on the metal minerals and agricultural produce. For example, about 56% of Indian exports to China was minerals and services. Chinese exports to India are machinery, electronics, chemical and textiles, etc.

Panagariya (2006) argues that in the 1980s and early 1990s China saw a massive growth in exports of light manufacturing: apparel, toys, sporting goods, footwear, and the like. Subsequently, as physical and human capital accumulation progressed, China moved into somewhat more sophisticated products that, nevertheless, still employed large volumes of labor. These products have included office machines, telecommunications and electronic apparatus and equipment, and electrical machinery. In contrast, most of the leading exports of India are either skilled-labor intensive or capital intensive: IT, textiles, petroleum and petroleum products and iron and steel. Apparel is a major contributor but it has declined in recent years. Even auto and auto parts and pharmaceutical exports are now growing rapidly.

Another reason for the optimism is that both countries have realized that military force is not the right way to accumulate wealth in the world today and that China and India have reached a consensus and are increasingly focusing on economic development. These issues are discussed in the last part of the paper. It could also be pointed out that India and China have started to cooperate to secure strategic natural resources. An example is India's announcement in January 2006 that it had acquired a 20% share in the development of Iran's biggest onshore oilfield, which is operated and 50% owned by Sinopec, China's state-owned oil company.

Though there is an imbalance of trade in favor of India, India still implements the trade protection policies against Chinese exports. In fact India is one of the major countries in the world today that seek to deal with China via anti-dumping. It was estimated by Chinese Embassy in India that China is the victim of anti-dumping cases. Since 1994, the total cases of antidumping towards China have gone up to about 100. Chinese media reported that India did not recognize the status of market economy of China and therefore Chinese enterprises in India were not fairly treated. It looks like India takes China as serious competitor, especially in manufacturing industries.

The most controversial items of trade are textiles and chemical products. This reflects the major Indian exports to the rest of the world, and both China and India do compete in the same line of exports, especially the textiles. But China is more competitive than India in these manufactured exports. India has not well developed its manufacturing industry and China has obviously become the workshop of low-end manufacturing in the world.

Though China and India both has been experiencing the rapid growth of inward FDIs, the two-way flow of direct investment between Chin and India is relatively slow and small. In the past decade, as Figure 2 shows, China has continuously been receiving almost the largest amount of FDIs from the rest of the world, mostly from Asia and North American. India began to accelerate the inflow of FDIs. Last year, the inflow of FDIs to India grew by 72%. It is believed that, at least before 2010, China will still be the largest recipient of FDIs in the world. This year the inflow of FDIs to China is expected to be around US\$86 billion, and India will be expected to receive about US\$10 billion. These figures will be adjusted upward to US\$ 80 billion to China and US\$14 billion to India by the year of 2010, respectively. But by June of last year, Chinese enterprises totally invested US\$26.33 million in India, putting China a place of the 60th among the over hundred countries that have investments in India.

It was much reported in China that India, however, has been quite alert about the inflow of Chinese direct investment to India. There have been quite a few cases that direct investments from Chinese (Mainland and Hong Kong) were not officially approved. Chinese investments and corporations were not allowed to participate in the bid for construction projects of Indian ports or telecommunications. A proposed investment of U\$600 million from Huawei, Chinese most competitive IT equipment provider, was refused in India. At the same time Indian has been very couscous about doing business in China as well. By last year, over 150 Indian companies are already in China participating in over 2000 projects, and Chinese companies in India are about 50.

Indian IT companies such as TCS, Infosys and Wipro, have entered Chinese markets, and Indian National Bank has opened its office in Shanghai. Last year, Mital, Indian steel manufacturer, entered Chinese market through holding a Chinese company, Hualing Group. However, Indian government was reluctant to approve the plan of Chinese IT equipment providers, such as Huawei, Zhongxing to invest in India. It is not difficult to understand that if India politicians can be more open to Chinese exports and direct investments from China, both economic interests will be further enhanced.

5. LEARNING FROM EACH OTHER

To both China and India, there are a lot more to be learnt from each other. Chinese governments have played very important role in initiating projects to promote economic growth. They have also been extremely instrumental in bringing in opportunities for investments and in providing supporting services to foreign direct investments. When a market system that is based on clearly defined private property rights and effective enforcement of legal rules was not ready and in place in China, most of productive investments were made in connection with local governments. To this extent, the institutional setting that governs and supports Chinese economic growth is largely a transitional one in the sense that the economic growth depends on the political stability. When the economy is on the early stage of growth and development, such arrangement may be superior, because it complements the lacking of the effective market governance. Compared with India, Chinese political governance facilitates the growth of capital formation, especially the investment of physical infrastructure and the inflow of foreign direct investments.

India needs to put economic growth on the top agenda of local governments. For generating a rapid and continuous growth, India should diversify its sources of economic growth and raise the investment over GDP ratio. And if it is to raise the investment/GDP ratio, it needs to work out a better governance structure within its political system. Indeed, India should improve its efficiency of administration, and make its local governments more accountable for local economic development. Without a better level of governance at local governments, physical infrastructure in India will be hard to improve and manage substantially, and without a good level of infrastructure, India will be difficult to catch up with the growth of GDP and manufacturing investments.

Given the political constraints facing India right now, it could be very difficult for India to push the process of economic decentralization, especially when India is facing a policy gridlock at the central level where the coalition government comprising over 20 parties opposes virtually every reform measure that is proposed. China met with similar situation 25 years ago when political orthodoxy was sharply in conflict with opening up and capitalist spirit of market economy. But Chinese reformers decided to set up small experiment plots geographically (called special economic zones, or SEZs) and then gradually introduced the model of SEZs on to the most part of China. By the same token, for India, an alternative initiative which could be a more politically-palatable option in the medium term is to learn from Chinese strategy to establish SEZs as these zones can support policies that are difficult to implement at the national level.

As reported by media, in February 2006, Indian government announced a plan to establish the special economic zones (SEZs), hoping to promoting domestic and foreign direct investment and also to develop infrastructure within the SEZs. The response has been encouraging. It is said that so far there are 267 SEZs approved by the governments. Like the experience of

China in 1980s, initially, the critics of SEZs have also been plentiful in India.⁷ The difference between China and India is that Chinese political opposition within the Party was weaker than India, and when Chinese reformer, Dong Xiaoping, called for stopping taking about for and against SEZs, it was all set.

In order to finance the infrastructure India also needs to learn from China about how to open its markets to foreign participation and how to treat foreign investors. India has faced little room for its households to raise its saving rate, it should raise its government saving, and the FDI/GDP ratio as well. It should also need to reform its banking sector to alleviate the financial constraints in India.

In the case of China, with further development and marketization of its economy, and with the nature of economic development becoming more complex, it needs and will be gradually leading towards a transparent political system with more democracy. Though China has done much better than India to induce the inflow of foreign direct investments, it also needs to learn from India how to treat and encourage Chinese indigenous private sector financially and institutionally. India has encouraged the proliferation and growing up of internationally competitive enterprises in private sector, and India has done much better in build-up of corporate governance for its commercial businesses than China. China should produce more policies in favor of small and private businesses, and put more emphasis on the introduction and build-ups of corporate governance to its enterprises, and learn to encourage Chinese companies to go globally.

Access to natural resources is vital to both China and India for the continuation of their economic growth in the long run. Can China and India peacefully face up such competition? Recently a Chinese expert published an article titled "How much possible may China and India collide?" He outlines the details of military competence in India and China, analyzing the external conditions of developing military capacity of the two nations. Though he evidences that India has more favorable conditions than China and there exists already the military imbalance between India and China, he believes the military collision between China and India is not much possible in the next two decades (Han, 2006).

The reason he presented in his paper includes: first, both India and China have reached a consensus and are increasingly concentrating their focus on economic development; second, both countries realize the necessity of reserving the buildups of military capacity because the race between countries is not merely a matter of military forces but a comprehensive competitiveness. Third, military capacity is not the major means to the accumulation of wealth in the world today. It is therefore not a wise choice for India and China to follow the strategy of military conflicts.

⁷ As the referee of this paper pointed to me, the MOF in India has expressed concerns about revenue losses from the proliferation of tax exemptions, the central bank about the unbalanced development that SEZs may cause, the IMF about perverse incentives and simply shifting existing outfits into new locations, and Mrs Sonia Gandhi about the poor farmers who could be displaced. Besides, the average size of proposed SEZs is too small (about 4 square kilometers), hardly enough to result in significant economies of scale. In the face of all these concerns, the commerce ministry of India is laying out new guidelines designed to increase the minimum size of SEZs by specifying minimum investment levels and net worth of projects as well as tighter restrictions of activities that may be undertaken in SEZs.

The time for economic cooperation is right on the corner. It looks that India is now actively implementing its Look East policy as witnessed, among others, by the large number of FTAs either signed or being negotiated with East Asia and its involvement in the ASEAN+1 process, and membership in the East Asia Summit and most recently in the ASEM process.

It is necessary for both countries to implement more measures to enhance economic integration. These could, among others, comprise (i) further tariff and NTB reductions in India and NTB reductions in China, because tariffs are already low, (ii) measures to reduce transportation costs between two countries, (iii) measures to improve customs procedures and logistic support, and (iv) trade promotion through skillful economic diplomacy. As we outlined in this paper, each of two countries also has valuable experience of economic reform and strategies that is of great reference to each other.

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Table 1: Sectoral Composition of GDP in India

	Agriculture	Industry	Services	GDP
1997-98	-2.4%	4.3%	9.8%	4.8%
1998-99	6.2%	3.7%	8.4%	6.5%
1999-00	0.3%	4.8%	10.1%	6.1%
2000-01	-0.4%	6.6%	5.6%	4.4%
2001-02	5.7%	3.3%	6.8%	5.8%
2002-03	-3.1%	6.1%	7.1%	4.0%
2003-04	9.1%	6.5%	8.4%	8.1%
weights	22.1	26.9	50.8	

Sources: Confederation of Indian Industry.

Figure 1: Infrastructure Spending Per Capita and Inward FDI Per Capita
(log, provincial panel data, 1987-2001)

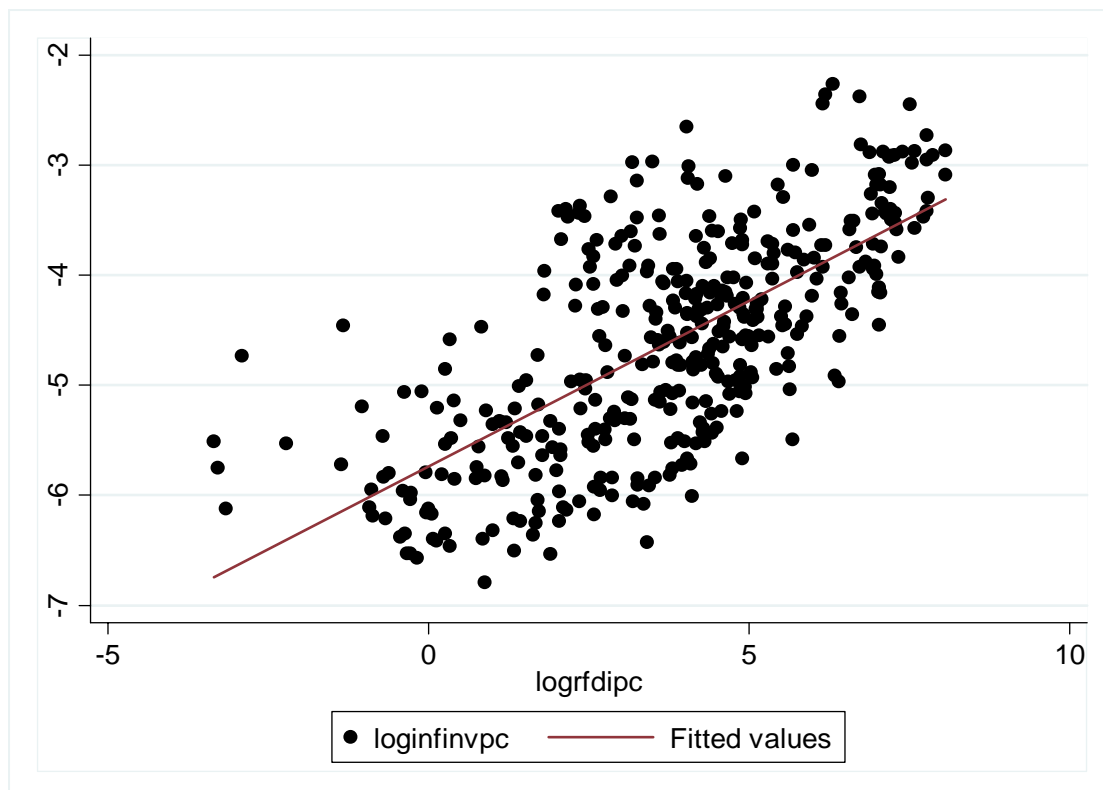


Figure 2: Influx of FDIs to China (USD billion)

