

# Focus on Economics

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## Emerging economies China and India: heavyweights facing big challenges

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China and India have become global geopolitical and economic players. Their socioeconomic development in the last decades is impressive. Nevertheless, both countries still present typical features of developing countries, and their economic boom has created or exacerbated problems that require decisive action. Besides, the success indicators obscure economic-policy mistakes that have led to questionable results and should be corrected in order to lead China and India on a sustainable development path.

China and India have been geopolitical heavyweights for a long time. Together they are home to more than one third of the earth's population and are nuclear powers. China is a permanent member of the UN Security Council and India is aspiring to become one. China and India play an important role in the G-20 and, as part of the BRICS, they are admired as ambitious emerging economies. The latter is due to their rapid economic development.

### Steady economic progress

Whereas China liberalised its system of a centrally planned economy already at the end of the 1970s, thereby initiating an economic upswing, this did not occur in India until 1989. During the period of 1990 to 2012 China and India achieved very high GDP growth rates averaging 10.3 % and 6.4 % per year, respectively, while the industrialised countries only reached 2.1 % per annum. Consequently, their economic weight also increased. In 1990 China's and India's shares of global GDP were still a modest 1.8 % and 1.5 %, but in 2012 they were already at a high 11.6 % (China) and a

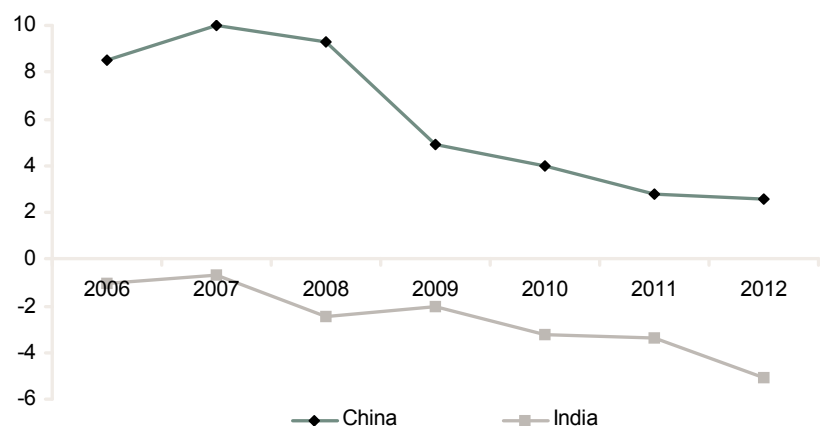
respectable 2.7 % (India).

In both countries growth was accompanied by significant economic structural change. Agriculture, which had low productivity rates, lost significance while the importance of the service sector increased greatly. What is interesting is that the share of manufacturing in GDP in both countries did not rise but remained steady during this period (at around 30 % in China and around 15 % in India). This means industrial production increased substantially, of course, but not more strongly than the economy as a whole. Besides, India in particular is still characterised very much by agriculture, which accounts for approximately 20 % of GDP and over 50 % of total employment. In India, industries such as world-class information technology contrast with traditional agriculture with low productivity, illustrating the vast spectrum of the economy. In China this is less pronounced.

In both countries the expansion of production capacities could be financed from domestic as well as foreign sources. Here as well, China has the edge. The gross savings rate of the overall economy in China is a high 52 % and in India still 32 % (Germany 23 %). China in particular has become an attractive location for foreign investors. Foreign direct investment (FDI) in China has increased enormously since the year 2000 and rose to USD 205 billion in 2012. FDI increased in India as well, but with USD 30 billion in 2012 the country looks more like a second-division player compared with China.

Often, emerging economies are flatly associated with high external surpluses, which is then anxiously commented because external imbalances are regarded as the cause of global crises. However, the empirical findings for China and India render a very differentiated picture. On the one hand, China actually posted consistent current account surpluses since 1990 while India ran deficits. On the other hand, the times in which China's surplus was a high 8 to 10 % of GDP are over (see Figure 1). The harsh criticism of China on this topic therefore has quieted down. China's fallen current account surplus is by no means the result of declining goods exports – on the

Figure 1: Current account balance in percent of GDP



Source: IMF

contrary, exports have increased steadily (with the exception of the global crisis year 2009). What has increased disproportionately, however, were goods and services imports (Chinese tourists overseas!).

Finally, the increase in international reserves is also remarkable, particularly in China, which now holds USD 3.3 trillion, more than one fourth of global reserves (India only has USD 300 billion).

The accumulation of international reserves in China is part of its exchange rate policy. The central bank intervenes in the forex market by absorbing part of the currency inflow, thus increasing forex reserves and preventing an excessively rapid appreciation of the renminbi (RMB). So far the RMB has little significance as an international trading currency and is completely insignificant as a reserve currency. The Chinese government wants to change this in order to reduce the dependence on the US dollar and to reinforce its claim as a global player. However, the road to becoming an international reserve currency is still long and would require incisive reforms for which China is not yet ready. These include full convertibility of the RMB, opening the financial sector to foreign investors, liberalising interest rates and moving from a current account surplus to a deficit so that sufficient liquidity can circulate on the international market.

**Improving living conditions**

As part of the economic boom, per capita income in China has grown twelvefold since 1990. The share of the population with an income below the poverty line has dropped sharply from 60 to 12 %.<sup>1</sup> In India these two indicators have improved as well but not as drastically. Per capita income "only" tripled and the poverty rate dropped from 54 to 33 %. Thus, in India some 400 million people still live below the poverty line – the same number as in all of Sub-Saharan Africa! Despite all progress, India still performs poorly in a number of other human development indicators as well (e.g. life expectancy, maternal and infant mortality). China therefore is more advanced than India in human development, but with a per capita income of USD 4,940 (2011) it remains classified as a developing country

(Germany: USD 44,230).

**Corrections are urgently needed**

China's and India's rapid development have created problems that do not permit "business as usual" but require policy makers to take countermeasures. At the same time, a number of current problems have also resulted from questionable policies that are in place, and these mistakes should therefore be corrected now.<sup>2</sup>

**a) Demographic change**

It is general knowledge that China's and India's populations have grown immensely in the past decades from a combined 920 million people in 1950 to 2.6 billion today. What is less known is that growth rates are falling rapidly and China's population will actually begin to shrink from the decade of 2020 and India's population from the decade of 2060 as the fertility rate (number of children per woman) is dropping sharply. From a global perspective, this population forecast is certainly to be welcomed, but for both countries it means a considerable need for action. The age structure of the population will change significantly. Experts have defined a so-called "dependency ratio". It counts the population both under 15 years and over 64 years of age and places these two groups in relation to the economically active population of 15- to 64-year-olds. Chart 2 shows that China is currently at a turning point for this indicator. Under the one-child policy the dependency ratio has dropped but is

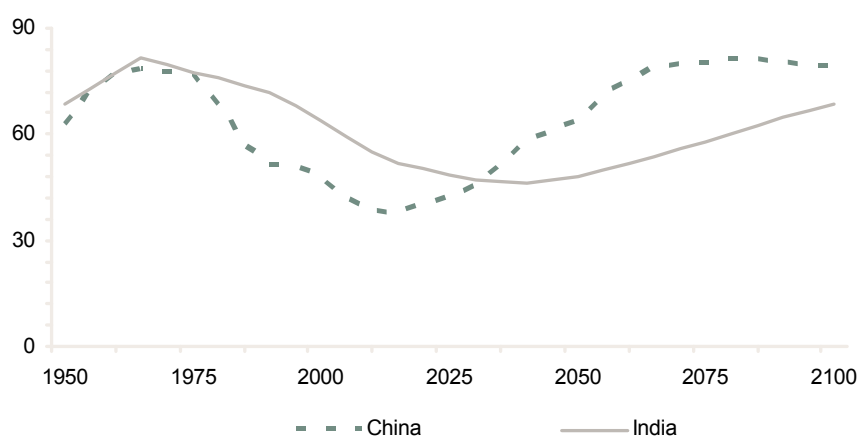
now rising again; China is already on its way towards an ageing society. In India the curve shape is similar, but here the turning point will not be reached until around 2040. Nevertheless, China and India are scarcely prepared for the challenges which an ageing society presents in regard to the pension system, health and nursing care, age-appropriate housing, etc.

**b) Fiscal policy distortions**

India's state finances are obviously in very bad shape. But fiscal policy reforms are necessary in China as well. However, China's public debt indicators are largely uncritical, with a budget deficit of 2.1 % and total debt of 23 % for 2012 (even if the reality is probably not as bright).<sup>3</sup> Things are completely different in India, where the budget deficit of 8.3 % and total public debt of 67 % have reached alarming proportions. A high 20 % of India's public expenditure now goes to interest payments alone. Another 15 to 20 % of the budget is spent by the Indian government on subsidies (energy, water, etc), which is intended to benefit the poor but hardly reaches them and is generally very questionable. China and India also maintain a defence apparatus that commands 16 to 18 % of government expenditure<sup>4</sup> (industrialised countries spend an average of 9 % on defence). The size of the military apparatus does not lend itself to a purely economic assessment, but it is clear that these funds are missing elsewhere.

**Figure 2: Demographics: dependency ratio**

(Population < 15 and > 64 years in relation to 15–64 years in percent)



Source: United Nations

The revenues of industrial countries average 36 % of GDP. China and India are significantly lower at 22 % and 19 %, respectively. It is true that there is no way to define what government expenditure rate is "right" for the economy as a whole, so the industrialised countries do not necessarily have to be regarded as the universal benchmark. However, the comparison shows that China and India still have untapped potential for raising state revenues. Particularly in India many taxpayers succeed in evading income tax completely, encouraged by a weak tax administration. In China indirect taxes play a very important role, which is questionable from the aspect of fair distribution. The main factor that accounts for the considerable difference between government expenditure rates in China and India and in the industrialised countries is social insurance (which also forms part of the government budget). Social protection systems that protect against elementary life risks (age, disease, unemployment) so far are almost inexistent in China and India. This is one of the major challenges given the outlined demographic trend.

**c) Inadequate economic and social infrastructure**

Both countries should invest more in the expansion, modernisation and operation of public infrastructure. In India the areas of electricity supply, roads, railroads, ports and airports have evolved into a serious impediment to growth. These infrastructures have inadequate capacities, and service quality is poor. Complaints about power cuts, traffic jams, long waiting periods in ports etc are commonplace. Besides, the Indian government is misallocating resources within the electricity sector. The excessive losses of 22 % of generation in electricity transmission and distribution (Germany 3.9 % in 2010) are not being addressed through targeted investments in the electricity grid, for example, but very largely through the construction of new power plants. As thermal power plants (coal, oil, natural gas) are the backbone of electricity supply, India is producing unnecessary amounts of carbon emissions and has high potential for improving energy efficiency.

The latter also applies to China. How-

ever, electricity losses there have been reduced to industrialised-country levels. China has also invested massively in transport infrastructure. Bottlenecks continue to exist and the strong focus on individual transport must be assessed critically. Nevertheless, China must be commended for being one of the very few countries that has substantially expanded its railroad network (including high-speed lines).

We have mentioned the urgency of expanding social insurance systems and improving healthcare. Education is another area that requires considerable intervention. In India one third of adults are still illiterate, the same rate as in Yemen and a higher rate than in Eritrea or Laos (China: 6 %). India's own claim to being an aspiring emerging economy is at odds with this reality.

**d) Urbanisation**

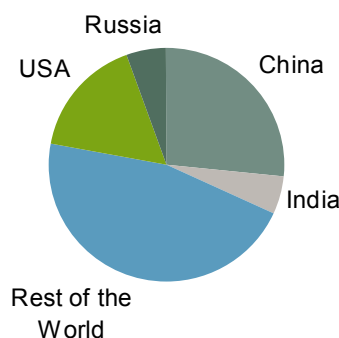
While the two vast states of China and India continue to be characterised by small towns and villages, urbanisation is advancing at a fast rate. Today almost one billion Chinese and Indians live in urban areas, many of which have evolved into megacities. These cities have enormous problems in the areas of transport, social integration and environment. For example, around 350 million of the one billion urban dwellers do not have hygienically acceptable sanitation. Yet the rural exodus continues. In China the development gap between the poor western interior and the booming eastern seaboard ensures continuing migratory pressure.

**e) National and global pollution**

Last winter headlines showed images of massive smog from transport and industry in Chinese cities. In addition to air pollution, the contamination of water bodies and soils also poses a serious threat in both countries. Both governments are well aware of these problems and there is definitely no shortage of environmental protection laws. What is inadequate, however, is often the enforcement and control of regulations. Environmental agencies lack expertise, funding and staff, and corruption is likely to play a role as well in many cases.

In regard to global environmental goods, rising carbon emissions are a particular topic of debate. These two countries are not the focus in terms of per capita emissions, which are still quite low. In absolute emissions, however, China and India already rank first and fourth in the world rankings of carbon emitters. Together they account for one third of global carbon emissions (see Figure 3). Effective global climate protection is therefore inconceivable without the inclusion of China and India. Both countries acknowledge in principle their shared responsibility for the global climate but want to secure their chances of continued economic growth. However, it would be very well possible to achieve economic growth even with lower carbon emissions. As mentioned before, both countries have enormous potential for improving energy efficiency, and renewable energies could also be put to more use. Much could be achieved through sector reforms because the sometimes

**Figure 3: Distribution of global carbon emissions (2011)**



Quelle: International Energy Agency

questionable policy in the energy and transport infrastructure sectors (subsidised energy prices, priority of individual transport over public transport, etc) has contributed significantly to the sharp increase in emissions. Besides, sector reforms would not only benefit the global climate but would indeed also improve living conditions in China and India.

#### f) The question of the political system

Finally, it must be asked how sustainable the political system is. India is regarded as the world's biggest democracy; civil rights such as freedom of opinion, freedom of press and freedom of assembly are guaranteed in principle. China's system, on the other hand, is not pluralistic, Communist Party rule is established in

the constitution and civil rights are very inadequately protected. It is very unlikely that this system can sustain itself in the longer term. Already it is evident that China's middle class, which has grown to around 300 million people, is increasingly demanding political rights and individual freedoms. However, there is cause for concern on the political system in India as well. Smaller regional parties have considerable influence at central government level which they use to assert particular interests, and the needs of the state as a whole are repeatedly under threat of being overlooked. Furthermore, the ruling government coalition in India does not have a parliamentary majority of its own, so that major reform projects fall by the wayside.

#### Conclusion: China and India are at a crossroads

Both countries have made impressive progress but are now at a stage where many policy decisions should be revised in order to embark on a path of sustainable development. However, this requires political courage and perseverance. To achieve this, India requires an effective government which it does not have at the moment. In China the new party and government leaders have recognised the need for reforms in many of the areas mentioned, but there are no clear implementation prospects yet. ■

<sup>1</sup>This is based on World Bank indicators. One of them is gross national income per capita in US dollars, determined according to the so-called "Atlas method", the other is the international poverty line of USD 1.25 per capita per day.

<sup>2</sup> The following statements do not claim to be exhaustive. There is also a reform agenda in the financial sector, job market policy and in the reform of state-owned enterprises and privatisation, for example. Due to space limitations these will not be addressed in this paper.

<sup>3</sup> These include, in particular, obligations which local territorial authorities have entered into with little transparency through off-budget financial vehicles as well as contingent liabilities for possible payment problems of the state-owned banks. The IMF estimates overall government debt at currently around 50 % of GDP.

<sup>4</sup> Data source: World Bank. These data are particularly uncertain – actual defence spending may indeed be much higher.