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CHINA AND INDIA: MACRO ECONOMIC PROSPECTS AND PROBLEMS

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Abstract

This paper draws on "China and India: Macroeconomic prospects and problems." China and India had similar development strategies prior to their breaking out of their deliberate insulation from the world economy and the ushering in of market-oriented economic reforms and liberalization. China began reforming its closed, centrally planned, non-market economy in 1978. India always had a large private sector and functioning markets, which were subject to rigid, state control until the hesitant and piecemeal reforms of the 1980s. These became systemic and far broader after India experienced a severe macroeconomic crisis in 1991. The political environment under which reforms were initiated and implemented in the two countries and their consequences were very different. India continues to be an open, participatory, multiparty democracy, while China has an authoritarian, one party regime, though it is liberalizing policies. China and India

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have a lot to gain, both from trading with each other and cooperating in the WTO. Each can learn from the other's policies, their successes and failures. This paper discusses a subset of economic issues common to both countries without touching on others, such as privatization of SOEs, reforms of the labour market (e.g., dealing with the "hokou" system in China and labour laws in India), financial sector reforms and, above all, political reforms. Although it may sound chauvinistic and naive, there is no doubt that China can learn a lot from the functioning of a vibrant, but somewhat chaotic, multiparty participatory democracy in India. After all, as the Chinese become richer and economically free, they are likely to demand personal and political freedoms. Hopefully, the Communist Party of China will anticipate and accommodate such demands, as it seems to have started doing already.

1.1 Introduction

China and India had similar development strategies prior to their breaking out of their deliberate insulation from the world economy and the ushering in of market-oriented economic reforms and liberalization. China began reforming its closed, centrally planned, non-market economy in 1978. India always had a large private sector and functioning markets, which were subject to rigid, state control until the hesitant and piecemeal reforms of the 1980s. These became systemic and far broader after India experienced a severe macroeconomic crisis in 1991. The political environment under which reforms were initiated and implemented in the two countries and their consequences were very different. India continues to be an open, participatory, multiparty democracy, while China has an authoritarian, one party regime, though it is liberalizing. This paper draws on "China and India: Macroeconomic prospects and problems. "

1.2 Macroeconomic Prospects and Problems

1.2.1 Sustainability of Growth

Maddison's (2002) estimates of China's and India's per capita real incomes show that, starting from roughly equal levels in 1870, India forged ahead of China until the outbreak of the First World War. Though both experienced decline in their per capita incomes thereafter (China more so than India) by 1950. India's per capita income was about 40% higher than China's, and it took roughly the next three decades for China to catch up. Since 1980, China has forged much farther ahead **(Table 1)**.

Table 1. GDP Per capita (1990 International Dollars) : 1700 – 1998

S.No	Year	Countries	
		China	India
1.	1700	600	550
2.	1820	600	533
3.	1870	530	533
4.	1913	552	673
5.	1950	439	619
6.	1973	839	853
7.	1998	3117	1746

Source: Madison (2002)

China and India were the star performers in aggregate GDP growth in the 1980s and 1990s. China's average growth of 10% per year during 1980-2001 had slowed to a range of 7-8% per year during 1998-2002. It was projected to grow at 8% in 2003 **(World Bank 2003a; World Bank 2003b)**. In light of the facts that China was hit by the SARS epidemic in 2003, and economic growth in China's major markets in Europe and North America had slowed since 2000, its performance is remarkably good. Growth continues to be fueled by a rising ratio of fixed investment to GDP, which was expected to reach 42.2% in 2003. **(World Bank 2003b)** notes that this rate of investment exceeded the levels reached in the early 1990s when the economy was believed to be overheating. Furthermore, much of the investment is apparently supported directly or indirectly by poorly monitored sub-national entities. Clearly, a rapid growth of such investment would erode its efficiency and could threaten future macroeconomic stability. In India, the average annual rate of growth of GDP was close to 6% during 1980-2001. It reached a peak of 7.8% in 1996-97 from the low of 1.3% in the crisis year of 1991-92. Since then, it has fluctuated between a low of 4.0% in 2002-03, a year in which the economy was affected by a serious drought to a high of 6.5% in 1998-99. With bountiful monsoon rains in 2003, growth is expected to be in the range of 7.5% to 8% in 2003-04, as per the Finance Minister's budget speech to the Parliament in February 2004. Investment as a proportion of GDP has ranged 23.1% to 27.7% of GDP since 1991-92 **(RBI 2003a)**. Macroeconomic data in general and savings and investment rates in particular, are subject to potential biases and significant measurement errors in both countries. One has to avoid reading too much from such data. Also, China is still not a market economy and prices in China may not have the same role and meaning as they do in a market economy. One cannot, therefore, lightly dismiss the argument of those who claim that measured Chinese growth may be overstated going by official Chinese data, the rate of inflation is low and the current account is in surplus. This means that at least there is no evidence of excess demand, a symptom of overheating. Macroeconomic data on savings and investment seem to be inconsistent with balance of payment data in China. If we assume a domestic savings rate of 30% and a current account surplus of 3%, rate of investment would be 27%, not much higher than India's (***Economist*, November 13, 2003**) perhaps by as much as 2-3% per year. They also claim that in contrast, the Indian statistical system, though not as biased as the Chinese, nonetheless does not cover all output, and this bias may be growing over time. This in turn would imply that Indian GDP, and possibly its growth, may well be understated in official data. If these claims are conceded, the difference between the "true" Chinese and Indian growth rates could be insignificant. However, taking official data of both countries at face value, there is a difference of about 4.1% between Chinese and Indian growth rates during 1990-2001. Since Chinese fixed investment rates exceeded India's by about 15% on average, one could argue that this difference in investment alone is enough to explain the difference in aggregate growth between the two countries. Such an argument would be somewhat simplistic since investment in physical capital is not the only source of growth and in part it could be substituting for other sources, which could be contributing more to India's growth. Indeed, growth in total factor productivity according to some estimates was higher in India, in at least part of the 1980-2001 periods. In both countries, the issue of sustainability into the future (of say, the next two decades or so) of current growth rates is important. Clearly, if the high rates of savings and investment are not sustainable, and the efficiency of investment is doubtful, then Chinese growth rates will decline. Indeed, with greater quality and a larger number of various consumer goods (including durables, such as passenger cars) becoming increasingly available in the market, Chinese households may consume more and save less out of their rising incomes than they are doing now. Also, the process of phasing out of SOEs and ushering in of truly private enterprises that **(Rawski 2001)** speculates that cumulative GDP growth during 1997-2001 was no more than one-third of official estimates and possibly much smaller. His speculation is not widely shared. For example, **Lau (2003)** has questioned the methodology underlying Rawski's speculation. On the other hand, growth may be understated if national growth estimates are based on output and growth data supplied by provincial governments. The reason is that they may have an incentive to understate output and growths to the extent the central government's share of taxes provinces collect depend on their reported output respond to market signals may not be smooth and could affect growth adversely. On the other hand, China's accession to the WTO and its further integration with the world economy could be expected to improve the efficiency of resource use through greater competition, inflow and adoption of better technology, and improvements in financial intermediation from the operation of foreign banks and other intermediaries could more than offset the effects of any decline in investment.

In India, the official **Tenth Five-Year Plan (2002-07)** projects an 8% average rate of growth for the period of 2002-07. Given the slower average growth of 5.5% per year in the recent past (1997-98 – 2002-03), legitimate queries have been raised about the feasibility of attaining and sustaining an average annual rate of growth of 8% or more in the next couple of decades. Of course, failure to do so would doom the prospects of any substantial reduction in mass poverty. However, there are reasons to be optimistic. India has farther to go in integrating its economy with the world economy and in attracting foreign direct investment (FDI) than China, and both could have growth augmenting effects. India's domestic reform process, after having slowed down since the late nineties, is gathering momentum. Clearly, with an augmentation of the forces of competition (domestic and international) and acceleration of the pace, broadening and deepening of reforms, the target of 8% growth could be attained and exceeded. Whether these necessary steps would come about is an issue: for example, the overall fiscal deficit of all levels of government taken together, and not including the losses of SOEs, was 10.4% of GDP in 2002-03 and is projected to be 9.8% in 2003-04. These exceed the 9.3% reached in 1990-91 on the eve of the macroeconomic crisis **(World Bank, 2003c)**.

Unless the fiscal deficit is brought down significantly, the prospects of reaching and sustaining 8% growth are dim. Progress in some vital aspects of reforms, such as privatization, liberalization of restrictive labour and bankruptcy laws; reform of electricity generation, transmission and distribution has been chequered—with steps forward as well as setbacks. Hopefully, after the next general elections, expected to be held in April 2004, a government will come to power with credible commitment to reforms (i.e., with a willingness to enact reforms) and a parliamentary majority to pass needed legislation (i.e., with the ability to enact reforms), without watering it down too much for achieving a political accommodation with conflicting interests.

1.2.2 Fiscal Situation

China appears to be in a much better fiscal position as compared to India, with a very modest fiscal deficit of 3.3% of GDP and a debt/GDP ratio of only 26.3% in 2002 **(World Bank 2003b)**. In contrast, the central government's fiscal deficit in India in 2002-03 was 5.9% of GDP with the deficits of states adding another 4.6% of GDP. The overall debt/GDP ratio was 75.3% **(RBI 2003a)**. However, **(World Bank 2003b)** points out that a costly reform agenda lay ahead for China that includes pension/social security reforms and dealing with accumulated non-performing loans (NPLs) of the four largest publicly owned banks. Although

NPL to assets ratio had declined to 26% by the end of 2002, this is believed to be the outcome of large increases in new loans rather than a contraction of old NPLs through better collections. The sterilization of the enormous inflows of foreign capital through the issue of ad hoc bills by the central bank at interest rates exceeding the rates earned on foreign assets of the bank in effect **(Bahl and Martinez-Vazquez 2003)** argue that China's governance is much less decentralized than indicated by the large share of sub-national governments, which have little by way of formal revenue raising powers. In their view, the present system is probably not sustainable. It is hard to predict the effect of greater decentralization on China's future fiscal health adds to the fiscal deficit, if it is properly treated in budget accounting. Although the current level of budget deficit could be sustained indefinitely by restricting expenditures to 22% - 23% of GDP, the costs of future reforms might require a combination of policies on the tax and expenditure sides.

The potential budgetary impact of addressing the NPL of state-owned banks in India is more serious than in the case of China because of the better fiscal health of China, as noted earlier. This is so even though the ratio of gross NPL to total gross assets of commercial banks was only at 4.8% at the end of 2001-02 **(RBI 2003b,)** compared to the reported figure of 26% for China. The reason is that first of all, the Indian norms for recognition of NPLs is more liberal compared to international norms and the practice of "ever-greening," i.e., of rolling over loans so that they are not deemed non-performing, though denied by the regulatory authorities as happening, is said by other knowledgeable sources to be significant. **Battacharya and Patel (2002)** note that the Indian banking system suffers from a large and increasing role of the government in the financial sector, high regulatory forbearance and the absence of efficient bankruptcy procedures. With the dominance of large public sector banks in the financial sector, the "too big to be allowed to fail" syndrome is very much evident: one of the government owned banks has been recapitalized three times in the last decade! With the rupee not convertible for capital account transactions, and with controls on capital outflows continuing, and foreign exchange reserves exceeding $105 billion in February 2004, there is no imminent threat of a speculative attack on the rupee. This in turn means that the pressure to clean up the NPLs of the banking system from a fear of exchange rate crisis is not there. However, the fact that NPLs of public sector banks represent contingent liabilities of the government is in part reflected in the rating of India's sovereign debt by international credit rating agencies. Clearly, sooner or later the NPL problem has to be faced if the Indian rupee is to be made convertible on capital account.

1.2.3 Trends in Poverty

Finally, the fact that poverty has declined significantly in both countries since the 1980s after both experienced substantial acceleration in their growth of per capita GDP has been widely noted. However, in India, because of changes in design of the household expenditure survey in the 1990s, a problem of potential non-comparability of poverty estimates over surveys has emerged. This has led to research on alternative ways to check on the seriousness of no comparability and to adjust for it to provide comparable estimates. In addition, there were issues relating to the price indices used to update poverty lines. Needless to say, some strong assumptions have to be made in all such exercises, and researchers naturally differed in their assumptions and methodologies and reached varying conclusions about the decline in poverty. It is fair to say that all of them agree that the poverty ratio did not increase in the 1990s, and differ only on whether it declined, and if so, whether the decline was faster in the 1990s than in the 1980s, when growth started to accelerate and poverty began to decline. Official estimates **(GOI 2003)** show that the proportion of poor in the population (using national poverty lines) declined from 45.7% in 1983 to 27.1% in 1999-2000 in rural areas, and from 40.8% to 23.6% during the same period in urban areas. For the country as a whole, poverty declined from 44.5% to 26.1%. **Sundaram and Tendulkar (2003)** estimate the decline to have been from 49% to 29% in rural areas, from 38% to 23% in urban areas, and from 46% to 27% in the country as a whole. Deaton's (2003a) calculations show that rural (urban) poverty declined from 37.3% in 1993-94 to 30.2% in 1999-2000 and from 32.2% to 24.7% in urban areas. **Sen and Himanshu (2003)** dispute some of the assumptions underlying the estimates of **Sundaram and Tendulkar (2003) and Deaton (2003a)**. Their exercise, based on survey data for 1987-88, 1993-94 and 1999-2000, lead them to conclude that, although the proportion of poor did probably decline, the reduction was no higher during 1994-2000 than it was during 1987-94, and the absolute number of poor did not decline.

Historically, the Indian statistical system led the world in measurement of poverty. Large-scale sample surveys were pioneered by **P. C. Mahalanobis** at the Indian Statistical Institute in the 1940s, and it was but natural that after independence in 1947 steps were taken to undertake large-scale household expenditure surveys, initially to supplement national accounts statistics and later to measure trends in levels of living. India also has a distinguished tradition of attempts to crosscheck estimates from various sources of data and of vigorous debate about, as well as experiments with, alternative methodologies **(Srinivasan and Bardhan 1974; Deaton and Kozel 2003)**. In China, household surveys and poverty estimates based on them, as well as a debate on the statistical system, are fairly recent **(Park**

and Wang, 2001). This has to be kept in mind in interpreting the data. **Hu, Hu and Chang (2003)** report that, according to official data, the proportion of poor in the rural population of China fell steadily from 33.1% in 1978 to as low as 3.7% in 1999. **World Bank (2003d)**, estimates (using $a day consumption poverty line) suggest that the poverty proportion fell from 32.9% in 1990 to 16.1% in 2000.

1.2.4 Widening Regional Disparities

In both China and India, there was significant widening of regional disparities in growth and poverty reduction as is evident from **Table 2**, rural China and western regions lag far behind urban China and coastal regions.

Table 2. Regional Disparities of Income Per Capita: China
(at current prices in US dollars)

Regions	1990	2002
Urban	316	930
Rural	144	299
Rural Income as a percent of urban	45	32
Coastal Region	481	1857
Shanghai	1184	4020
Western Region	240	596
Guizhou	167	373

Source: IMF (2003)

The top panel of **Table 3** provides data on growth of net state domestic product in five fastest and slowest growing states among sixteen large states in India during the 1980s and 1990s (the crisis year of 1991-92 has been omitted).

Table 3. Regional Disparities in Growth and Poverty: India

Low Growth*				High Growth*			
1980-81-1990-91		1992-93-1999-2000		1980-81-1990-91		1992-93-1999-2000	
Kerala	3.00	Assam	2.20	Delhi	7.30	Delhi	9.20
Assam	3.20	Orissa	3.40	Harvana	6.30	West Bengal	7.10
Orissa	3.90	Bihar	4.10	Rajasthan	6.30	Karnataka	6.90
Madhya Pradesh	4.00	Punjab	4.10	Maharashtra	5.80	Tamil Nadu	6.60
West Bengal	4.40	Uttar Pradesh	5.00	Andhra Pradesh	5.50	Rajasthan	6.40

* Trend growth rate per year in (real) state net domestic product.

High Poverty**				Low Poverty**			
Rural		Urban		Rural		Urban	
1987-88				1987-88			
Orissa	58.7	Bihar	51.9	Punjab	12.8	Himachal Pradesh	7.2
Bihar	53.9	Karnataka	49.2	Haryana	15.3	Assam	11.3
West Bengal	48.8	Madhya Pradesh	47.3	Himachal Pradesh	16.7	Punjab	13.7
Tamil Nadu	46.3	Uttar Pradesh	44.9	Andhra Pradesh	21.0	Delhi	15.1
Madhya Pradesh	42.0	Orissa	42.6	Gujarat	28.6	Haryana	18.4
1993-94				1993-94			
Bihar	58.0	Madhya Pradesh	48.1	Punjab	11.7	Assam	7.9
Orissa	49.8	Orissa	40.6	Andhra Pradesh	15.9	Himachal Pradesh	9.3
Assam	45.2	Tamil Nadu	39.9	Gujarat	22.2	Punjab	10.9
Uttar Pradesh	42.3	Karnataka	39.9	Kerala	25.4	Delhi	16.1
West Bengal	41.2	Andhra Pradesh	38.8	Haryana	28.3	Haryana	16.5
1999-2000				1999-2000			
Orissa	47.8	Orissa	43.5	Punjab	6.0	Himachal Pradesh	4.6
Bihar	44.0	Madhya Pradesh	38.5	Haryana	7.4	Punjab	5.5
Assam	40.3	Bihar	33.5	Himachal Pradesh	7.5	Assam	7.5
Madhya Pradesh	37.3	Uttar Pradesh	30.8	Kerala	9.4	Delhi	9.2
West Bengal	31.7	Andhra Pradesh	27.2	Andhra Pradesh	10.5	Haryana	10.0

** Ratio of poor among the population using state wise poverty lines

Sources: Poverty Estimates: Deaton (2003), Official Estimates for 43rd (1987-88), 50th (1993-94), and 55th (1999-2000) Rounds of the National Sample Survey.

The bottom panel of **Table 3** provides data on rural and urban poverty ratios for three years—1987-88, 1993-94, and 1999-2000—in five highest and lowest poverty states. It is seen that the fastest growing state, Delhi, grew at nearly 2.5 times or more than the slowest growing state of Kerala in the 1980s and more than five times the then slowest growing state of Assam in the 1990s. Also, the highest poverty state had a poverty ratio which was anywhere between 4.5 times to nearly 10 times the poverty ratio in the lowest poverty state, depending on the year and region (rural or urban). Turning to rural poverty, Bihar, Orissa and West Bengal are high poverty states in all three years. Punjab and Haryana are low rural poverty states in all three years. Four states are common among low rural poverty states in any two years. Orissa and Madhya Pradesh are high urban poverty states in all years. Three states are common among high poverty states in any two years. The same five states happen to be low urban poverty states in all three years.

The relation between growth and poverty is rather muted. Delhi, which is largely urban, has low poverty in all years and high growth in both periods. Orissa has low growth in both periods with high rural and urban poverty in all years. Punjab and Haryana have low urban and rural poverty in all years, but Haryana had high growth in the 1980s and Punjab low growth in the 1990s. Put another way, while there is considerable stability over the three years in which states happened to have high or low poverty ratios, there is considerable change in growth ranking of states between the 1980s and 1990s. Unless rapid growth is sustained over a reasonably long period of time, its impact on reducing entrenched poverty cannot be expected to be significant.

This is consistent with the lack of close association between poverty and growth states in **Table 3**, given that there was a considerable change in growth ranking over time. In the Chinese case, the deliberate policy choice of the government to concentrate reforms and external opening to coastal cities and special economic zones contributed to their growing faster and moving ahead of the other regions, particularly in the West. In India, there was no such deliberate policy choice. However, as is to be expected and natural, those individuals, groups and states that were initially better placed in terms of their infrastructure and human capital grew faster than others not so well placed. To a considerable extent, this is also true of China. The real issue is not so much the widening disparity but whether there are forces and policies in place that would enable the lagging regions to catch up and converge to the leading ones over time. On this, the evidence is mixed, if one goes by the empirical findings of several cross-regional growth regressions as reported in **Srinivasan (2004)**. Clearly, if there are no prospects of relatively rapid convergence, the stability of India's federal democracy and the control of the Communist Party in China could be put in doubt.

1.3 Conclusion

China and India have a lot to gain, both from trading with each other and cooperating in the WTO. Each can learn from the other's policies, their successes and failures. This paper discussed a subset of economic issues common to both countries without touching on others, such as privatization of SOEs, reforms of the labour market (e.g., dealing with the "hokou" system in China and labour laws in India), financial sector reforms and, above all, political reforms. Although it may sound chauvinistic and naive, there is no doubt that China can learn a lot from the functioning of a vibrant, but somewhat chaotic, multiparty participatory democracy in India. After all, as the Chinese become richer and economically free, they are likely to demand personal and political freedoms. Hopefully, the Communist Party of China will anticipate and accommodate such demands, as it seems to have started doing already.

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