Reforms, Regionalism, and Trade in PRC and India

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Context and Aim

• With the world economy in the recovery ward, Asia‘s giants under scrutiny as among the few exciting sources of growth
• Lively debate on the giants economic strategies and global impact
• Topical issues:
  – How do the giants compare?
  – What explains the giants rise?
  – Can India outpace PRC?
  – What lies ahead in a turbulent world?
Key Messages

• Giants rise impressive. PRC ahead in world trade due to manufacturing. India leads in skill-intensive IT exports.

• Why?
  ✓ On balance, initial conditions seem to have favoured PRC.
  ✓ Reform approaches similar but differ in timing, sequencing, implementation and complementary policies.
  ✓ India made reform strides since 2000 but PRC seems more pro-active with first mover advantage.

• PRC likely to remain ahead in world trade in next decade, but India has opportunity to close gap with policies

• Uncertainties lie ahead. How each giant tackles them will ultimately determine performance.
I. Comparing the giants
GDP growth (% per year)

Source: ADB (2012) for India and PRC, IMF (2012) for USA
Share of World GDP

Source: World Development Indicators (2012)
Shares of Exports in World Exports

Source: World Development Indicators (2012)
The share of South South trade in world trade was 16.90% in 2009 (ADB, 2011)

Definition of South-South trade: North comprises the EU27, Australia, Canada, Iceland, Japan, Liechtenstein, New Zealand, Norway, Switzerland, and the US; South comprises all other economies (Wignaraja and Lazarro, 2010)

Source: Asian Development Outlook (2011)
Both giants witnessed increasing technological upgrading. PRC dominated low tech manufactured exports for more than a decade and can be seen as a threat by other high-tech exporters. India’s progress in exporting high tech products is less pronounced – export growth is based on services.
Which role do services play?

Source: WDI (2011)

- India is keeping up with China when it comes to IT services
  - 4.7% of world share compared to 4.1% of China
  - Also in insurance services India is ahead of China (1.9% vs. 0.6%)
Poverty Reduction

• Both of the giants were successful in reducing poverty in the last 25 years
  • Applying 1.25 US$ per day headcount of extreme poverty:
    – PRC: 84.% in 1981 to 15.9% in 2005
    – India: 65.8% in 1978 to 41.6% in 2005
• But India and China together have 664 million people living on less than 1.25$ a day (2005)
• Rural – Urban inequality is a rising issue

Source: World Bank (2011)
II. Explanations
Role of initial conditions

1. Geography:
   – China: Proximity to fast growing East Asia
   – India: Shares greater ties with Europe (due to legacy of British rule)

2. Presence of large domestic markets (that allows for exploiting economies of scale)
   – Although the population is almost identical:
   – China: Domestic market of about 1 trillion $, India: 250 – 300 billion $

3. Ample supply of low-cost, productive manpower
   – Some studies find that labor is more productive in China
   – India’s success in IT is based on the exposure to English, decreasing communication costs and the establishment of the Indian Institute of Technology

4. Institutions
   – China: Prominent role of Township Village Enterprises (TVEs)
   – India: Small firms in India seem to be severely constrained (e.g. access to finance), consequently only larger firms become exporters

• On balance initial conditions seemed to favour PRC
Previous Inward-Oriented Strategies

• China:
  – Private sector completely eliminated in 1958 (Great Leap Forward)
  – Quotas and other restrictions led to inefficient capital intensive production by large, state-owned enterprises
  – Fixed and overvalued exchange rate
  – FDI was strictly regulated
  – Commodity trade was solely determined by central planning
  – 1978: Huge and protected manufacturing sector that represents 41% of GDP, exports were stagnant and dominated by primary products
  – Reforms started in late 1970s

• Similar picture in India:
  – Import substitution in the 1950s
  – Highly protected and inward-oriented trading regime
  – Significant reforms were not introduced until 1991
Reforms in China

• Trade and investment reforms to attract FDI in the late 1970’s:
  – Law to encourage joint ventures between foreign and local investors
  – Establishment of Special Economic Zones (SEZs) on the Southern coast
  – Tax incentives to direct FDI to SEZs
  – Duty drawback system to ensure duty-free access for all imported raw materials, parts and components for export processing
  – Liberalization of export quotas
  – Stable exchange rate

• Import Liberalization WTO Accession and Exchange Rates:
  – 1980’s central import planning was substituted by import quotas and licenses (share of imports with quotas fell from 46% to 18 %).
  – More tariff cuts with adoption of socialist market economy in 1992
  – Accession of WTO in 2001: China was part of GATT was a milestone in China’s trade integration with the rest of the world
Reforms in India

3 Phases of India’s reforms:
- Inward oriented state controlled policies (1950-1975)
- Partial liberalization (1976 – 1991)
- Major reforms starting 1991

Key points of third phase (post-1991)
- Import licensing on machinery and raw materials was abolished in 1991.
- Gradual compression of top tariff rates and at the same time rationalization of tariff structure (reducing number of tariff bands)
- Depreciated / stable exchange rate
- Formal FDI policy was adopted in 1996
- SEZs were established
- Tariff cuts on non-agricultural products
- Average tariff rates remain higher than in China’s (tariffs on agricultural products in India are double those of China)
Effects of the reforms on FDI

- From 1990s onwards China attracted a record level of FDI of $54 billion per year in 1991-2010 compared to $9.5 billion in India
- Positive but lagged increase of FDI in India after 1991
- China became second biggest recipient of FDI
- Through the access to marketing channels, world-class technologies and organizational methods FDI contributed largely to the rise of Chinese exports
- Also positive effect on FDI in India, 2010 figures match FDI in China in the 1990s
- FDI in India more directed towards domestic market
- It seems that Indian policies to attract FDI were not comprehensive enough
Similarities / Differences in Reforms and Outcomes

• Both giants have pursued distinctive reforms and became outward-oriented, market-based economies
• Both followed a gradual approach (unlike the “Big Bang” in Russia)
• Both giants had a managed float exchange rate regime and a relatively stable exchange rate
• However, processes of implementation differ:
  – Overall PRC was swifter, more coordinated and more credible and also introduced reforms earlier
  – China introduced more comprehensive measures and attracted export-orientated FDI
  – PRC was slower in adopting such a comprehensive FDI framework and at first only restrictions on foreign ownership were altered (SEZ legislation was only introduced in 2005)
  – Nonetheless, surge in FDI flows in the second decade of reforms in India
  – Despite India’s efforts and the abolition of import licensing: India’s average tariffs for raw materials and machinery remain higher than China’s
  – PRC used some industrial policy instruments while India relied more on market forces
FTA-led Regionalism

• Both giants pursued bilateral/regional FTAs alongside WTO multilateralism
• Concerns expressed by some:
  – Limited coverage of FTAs and vague formulations compared to FTAs in the Americas or Pacific
  – “Asian Noodle Bowl” of overlapping FTAs
• Using economic evaluation criteria to examine FTA quality:
  – Mixed Picture: out of 22 FTAs of the giants 10 are WTO-compliant on goods liberalization and 3 are comprehensive in services coverage
  – China’s FTAs seems to better in goods liberalization (e.g. China – NZ FTA that eliminates 35% of tariffs with immediate effect)
  – China’s FTAs seems better in service coverage (7 of China’s FTAs cover partial liberalization in services
• Is the Asian “Noodle Bowl” an issue?
  – Only 6% of the interviewed enterprises in China think that considerable transaction costs arise due to overlapping FTAs (ADB Surveys)
III. Can India outpace China?
1. Demographics

- Argument by “The Economist”: Demographics and Democracy will help India to overtake PRC
  - India’s population will grow faster than PRC’s
  - India assumed to overtake PRC in terms of % of population that is working age in the next twenty years

- ADB’s projections on demographics confirm this view

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<th>Indicator</th>
<th>Years</th>
<th>PRC</th>
<th>India</th>
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<tr>
<td>Working age population rate (%)</td>
<td>2011 to 2020</td>
<td>71.6</td>
<td>69.4</td>
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<tr>
<td></td>
<td>2021 to 2030</td>
<td>66.7</td>
<td>67.4</td>
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- **However**, additional fundamentals such as education, technology and infrastructure may also play a role
2. Education

- Data: Enrollment rates in percent
- Difficult to adapt workers with little formal education to advanced production processes and techniques.
- Lack of basic education can therefore become a constraint on business development.
- Long term, investment in basic education is essential

Sources: Human Development Report 2011; Global Competitiveness Report 2011
3. Technology

Source: WDI (2012)

- PRC’s R&D expenditure (relative to GDP) more than doubled in the last decade whereas India’s R&D spending stagnated
- Also reflected by the number of researchers
4. Infrastructure

- **India must invest in infrastructure to**
  - improve connectivity,
  - enter supply chains
  - promote regional integration
  - promoting multi-modal infrastructure

- **Potential is high**
  - 25 out of the 50 fastest growing cities in Asia are in India - 8 in PRC*

### Table: Infrastructure Rankings

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<th>USA Rank (out of 142)</th>
<th>PRC Rank (out of 142)</th>
<th>India Rank (out of 142)</th>
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</thead>
<tbody>
<tr>
<td>Overall infra</td>
<td>24</td>
<td>69</td>
<td>86</td>
</tr>
<tr>
<td>Quality of roads</td>
<td>20</td>
<td>54</td>
<td>85</td>
</tr>
<tr>
<td>Electricity supply</td>
<td>32</td>
<td>49</td>
<td>112</td>
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### Graph: Infrastructure Spending 2008 (% of GDP)

- USA: 11%
- PRC: 6%
- India: 2%
- USA: 0%
III. Scenario, Challenges and Prospects
Evolving Scenario & Challenges

• World Economy – slow growth scenario in the medium term
  – IMF forecast: average of 0.9% GDP growth in Euro Area (2009-1016) and 1.4% GDP growth in G7
  – ADB projections: on average 5.03% growth between 2011-2020 in Asia

• PRC and India are key players in a rising Asia and face many related challenges:

  1. Rebalancing growth
     – Increase intra-regional trade and stimulate domestic demand
     – Unleash PRC-India trade, foster financial integration, and infrastructure investment
2. Strengthen production networks
   - Upgrading in PRC; entry in India
   - Promote FDI, technology development & SMEs

3. Poverty & inequality
   - Global economic crisis and rising food prices
   - Growth and social expenditures critical

4. Exchange rate adjustment
   - Currencies and trade balances often linked
   - Diplomacy & continuing unilateral adjustment to minimize risk of trade wars
Challenges and Prospects

5. Transpacific Partnership

- Potential game changer for US-Asia ties but PRC & India not in negotiations
- Evaluation, domestic reforms for future accession, and link with ASEAN+ project

• Prospects for PRC and India:
  - Future trade and growth largely depends on how each copes with challenges
  - Enhanced business competitiveness with supportive policies can help giants escape the “middle income trap” and prosper