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Reforms, Regionalism, and Trade in PRC and India

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ADB

Context and Aim

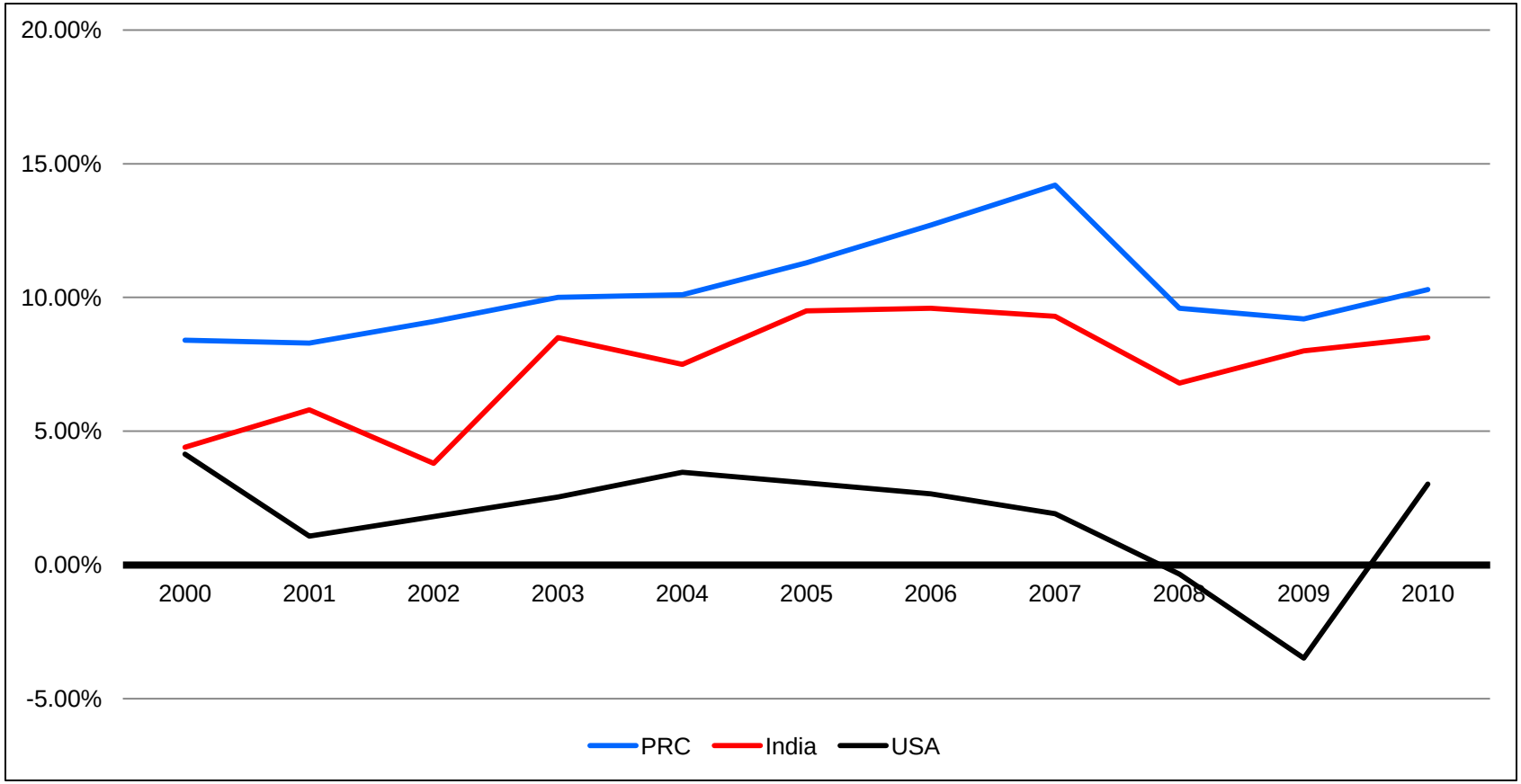
- With the world economy in the recovery ward, Asia‘s giants under scrutiny as among the few exciting sources of growth
- Lively debate on the giants economic strategies and global impact
- Topical issues:
  - How do the giants compare?
  - What explains the giants rise?
  - Can India outpace PRC?
 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

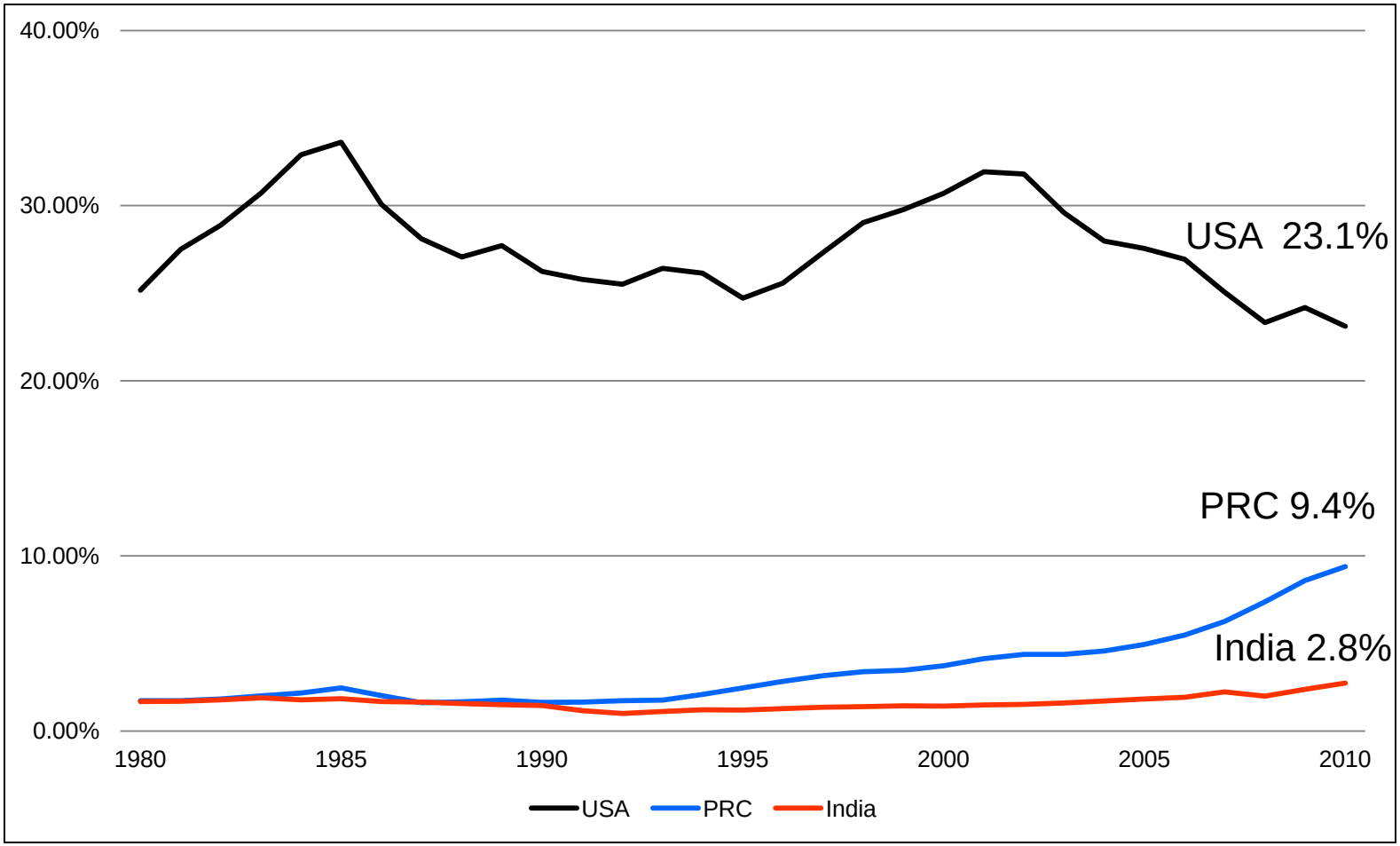
I. Comparing the giants

GDP growth (% per year)



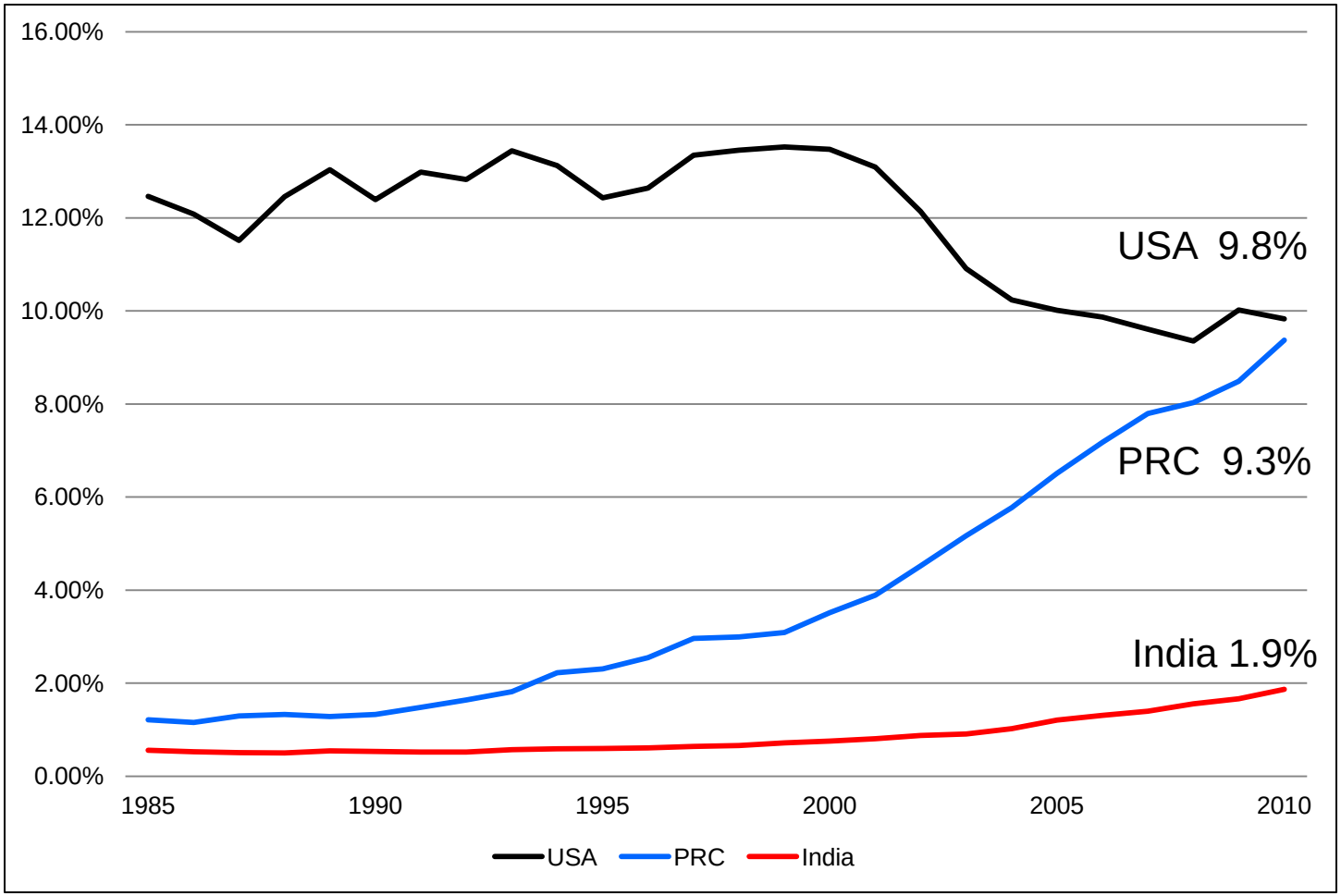
Source: ADB (2012) for India and PRC, IMF (2012) for USA

Share of World GDP



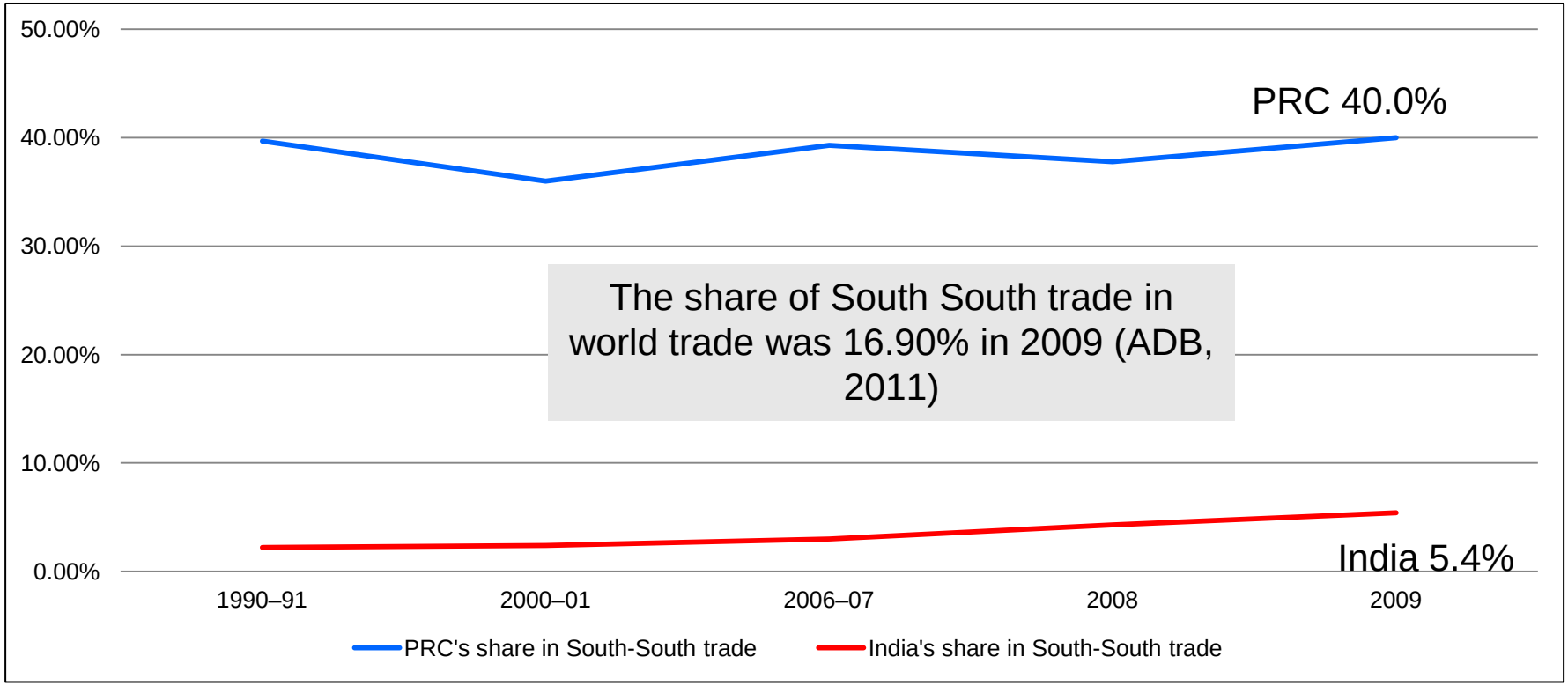
Source: World Development Indicators (2012)

Shares of Exports in World Exports



Source: World Development Indicators (2012)

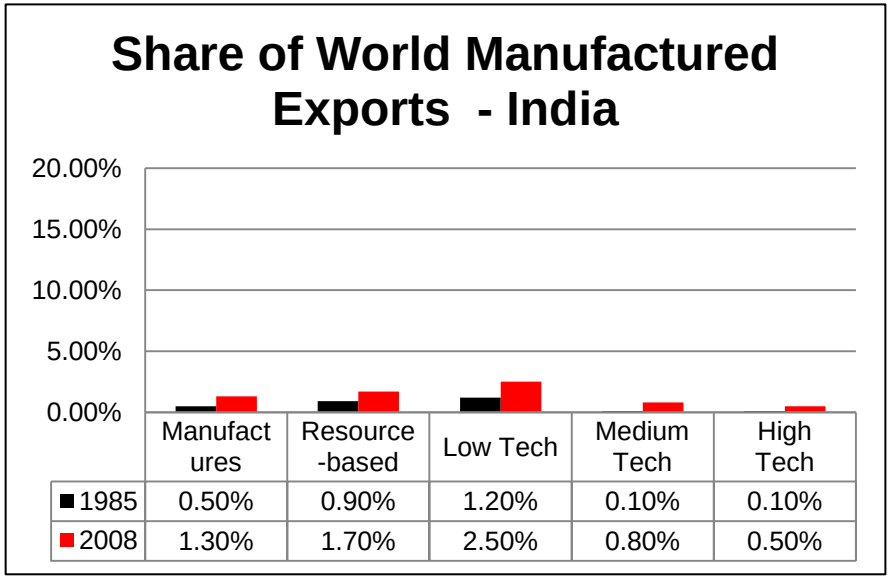
Participation in South-South Trade



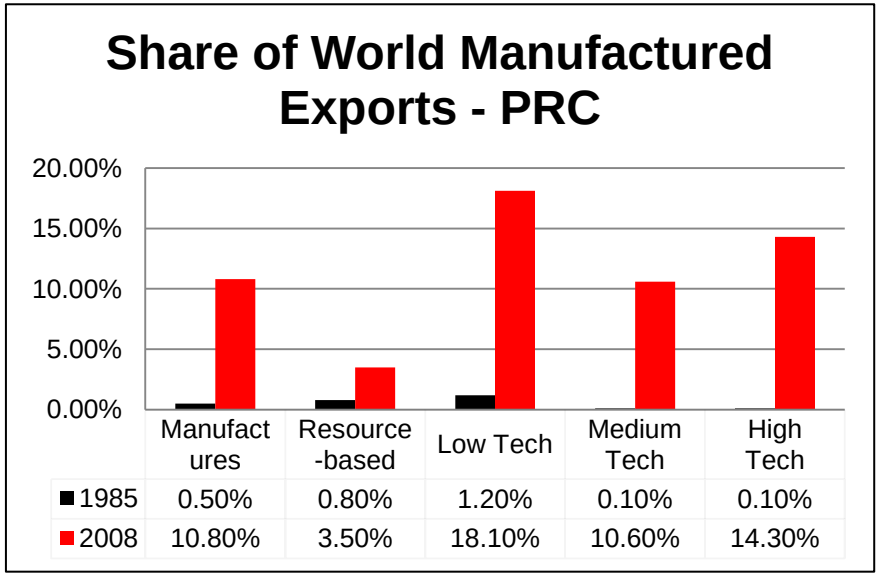
Source: Asian Development Outlook (2011)

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)

Export Composition



	Manufactures	Resource-based	Low Tech	Medium Tech	High Tech
1985	0.50%	0.90%	1.20%	0.10%	0.10%
2008	1.30%	1.70%	2.50%	0.80%	0.50%



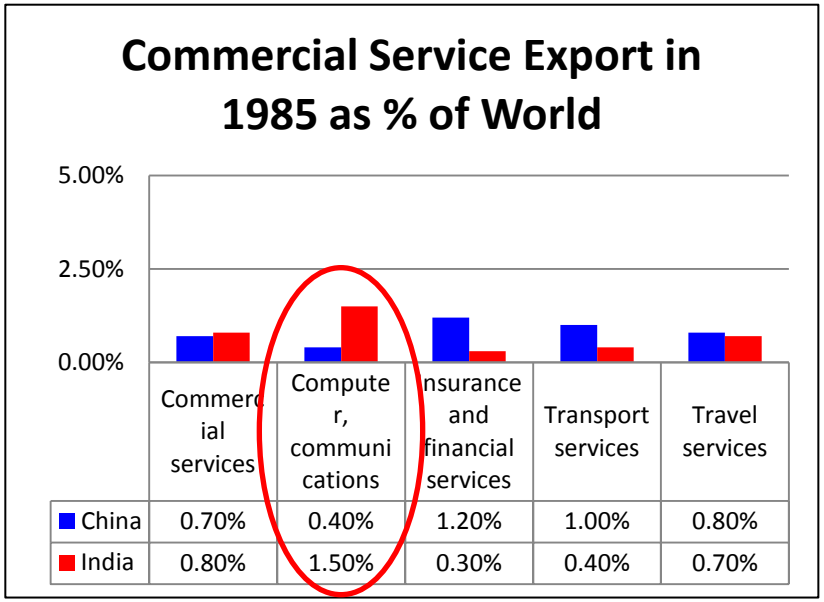
	Manufactures	Resource-based	Low Tech	Medium Tech	High Tech
1985	0.50%	0.80%	1.20%	0.10%	0.10%
2008	10.80%	3.50%	18.10%	10.60%	14.30%

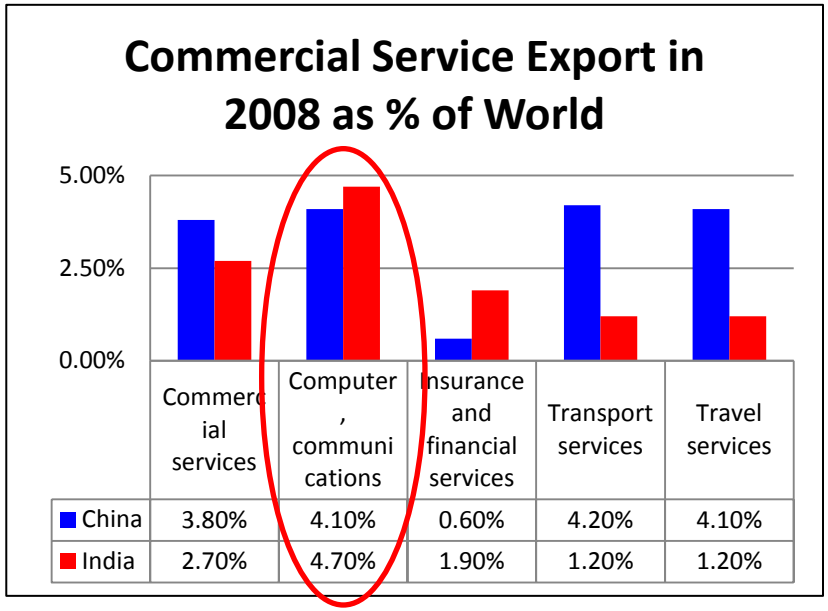
Both giants witnessed increasing technological upgrading

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?

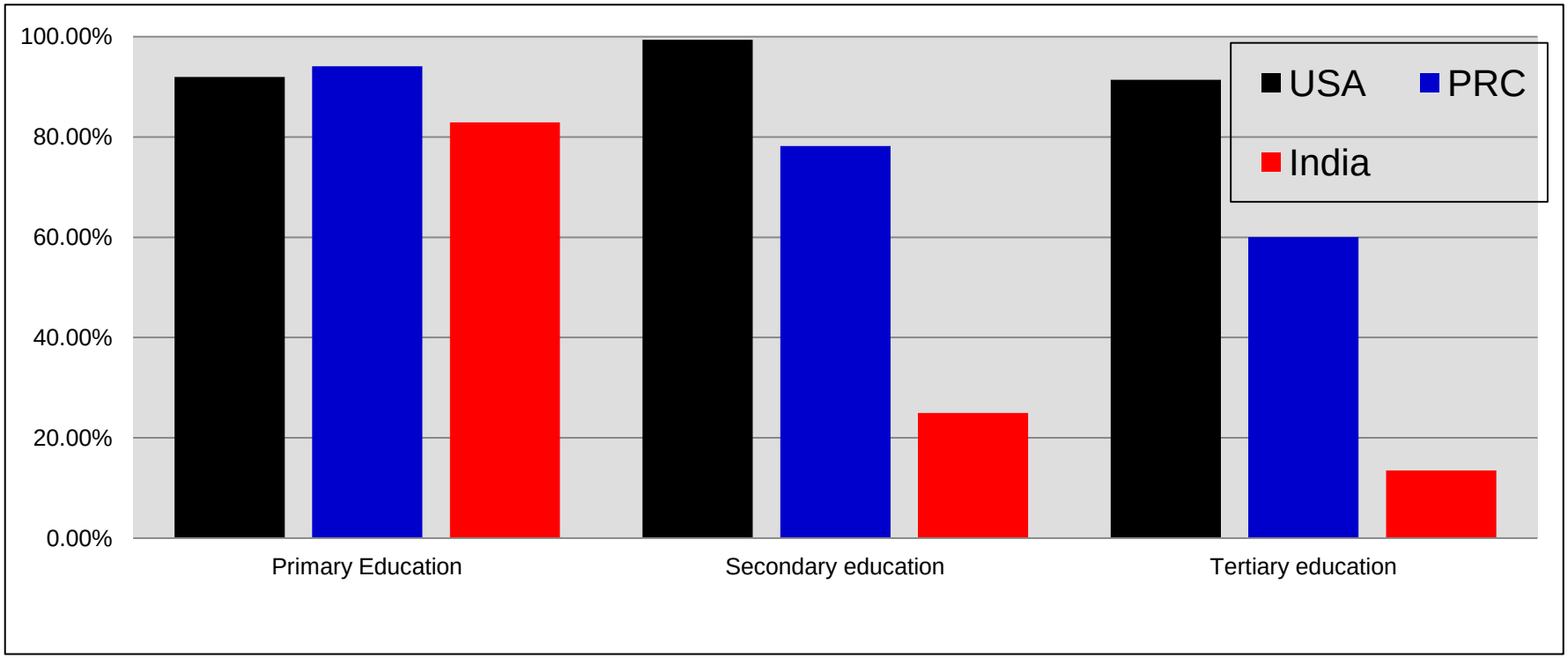
1. Demographics

- 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

Indicator	Years	PRC	India
Working age population rate (%)	2011 to 2020	71.6	**69.4**
	2021 to 2030	66.7	**67.4**

- **However**, additional fundamentals such as education, technology and infrastructure may also play a role

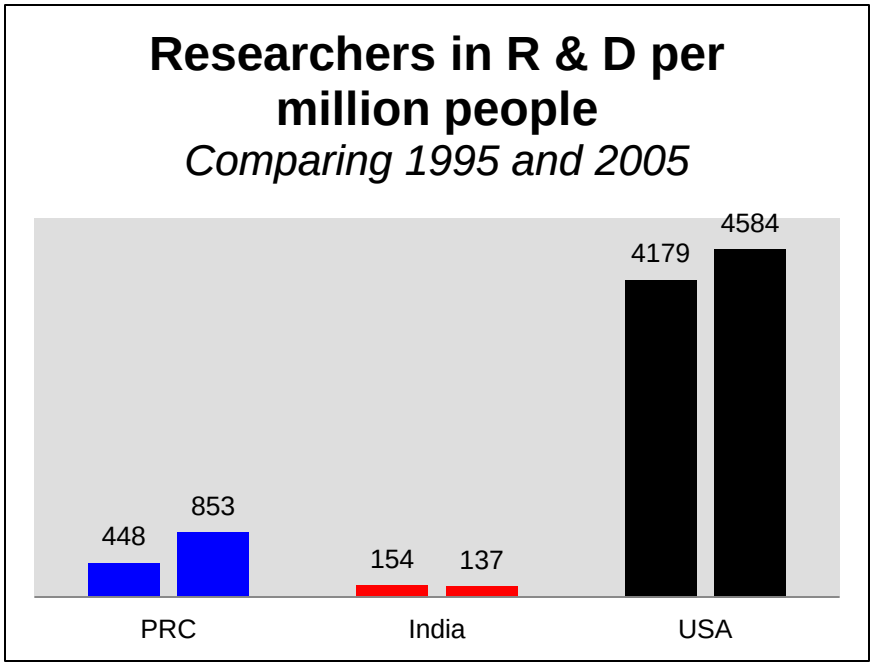
2. Education

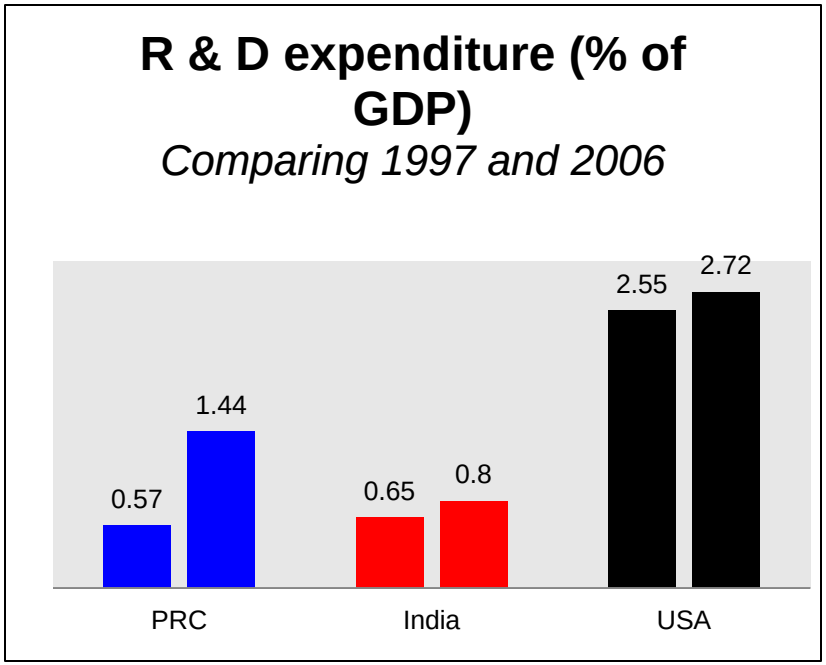


- Data: Enrollment rates in percent
- Difficult to adapt workers with little formal education to advanced production processes and techniques.
- Lack of basic education can therefore become a constraint on business development.
- Long term, investment in basic education is essential

Sources: Human Development Report 2011; Global Competitiveness Report 2011

3. Technology



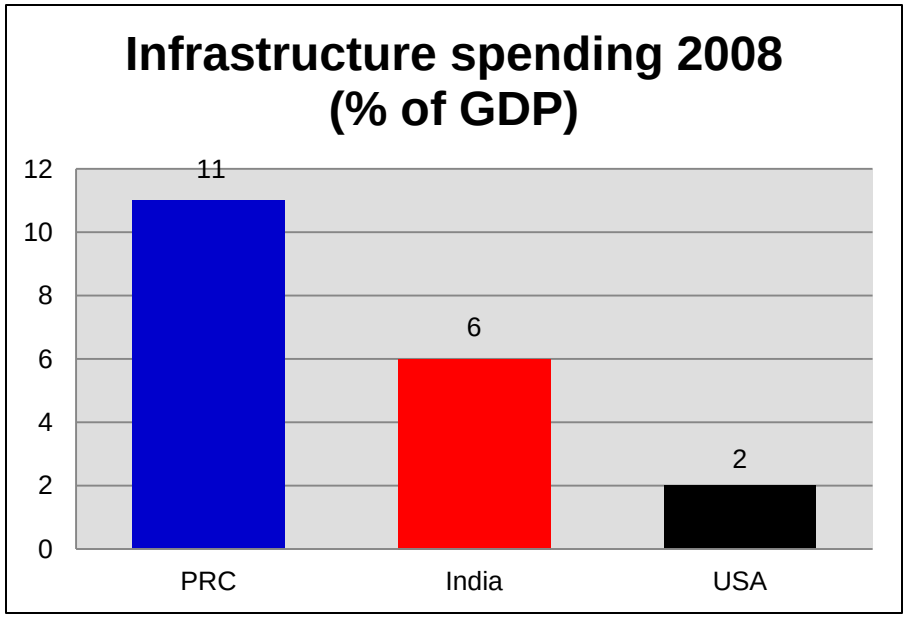


Source: WDI (2012)

- 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

	USA Rank (out of 142)	**PRC** Rank (out of 142)	**India** Rank (out of 142)
Overall infra	24	69	86
Quality of roads	20	54	85
Electricity supply	32	49	112



- 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*

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

Challenges (cont.)

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