



# CHINDIA - SHOULD INDIA AND CHINA MERGE?

**T**he terms ‘China rising’ and ‘India rising’ are almost clichés these days on the global conference circuit. Providing both countries can deal decisively with their numerous domestic commercial, economic and public policy challenges, China and India will play an increasingly important role in world affairs in the coming decades. However, China and India could well leverage their commercial and economic influence by better integrating their two economies into a Chindia.

A Chindia economy, if realised, would constitute the second largest economy in the world behind the United States. Indeed, on current patterns, Chindia is likely to be larger than the United States by 2050.

If China and India did decide to co-operate and integrate their economies, many other economies in the world will be dramatically impacted.

Most affected will be other large economies such as the European Union, the United States and Japan, who would find themselves competing with Chindia for markets and resources.

However, both China and India face a sizeable list of domestic, and international, challenges which must be overcome if they are to realise their full commercial and economic potentials.

## CHINA – THE CROUCHING TIGER

Since the late 1970s, China’s economy has grown by an average of around 9 per cent per annum, but is now sitting at around 10 per cent.

China is the world’s most populous nation, with some 1.3 billion people, yet its annual population growth is quite low - close to only half a per cent.

In the last three decades, China’s development has helped to lift several hundred million people out of absolute poverty – the largest poverty reduction program in human history.

China alone has accounted for over 75 per cent of the poverty reduction in the developing world over the last 20 years. According to the World Bank, poverty has been reduced to just 10 per cent of the population as at 2004.

China has a rapidly increasing urban middle class, commanding considerable spending power.

According to a report by the McKinsey consulting group, the average middle class Chinese currently earn around US\$12,500 a year, commanding nearly 10 per cent of urban disposable income despite accounting for just 1 per cent of the total population.

In the next two decades, the number of middle class Chinese will steadily grow.

Today, 77 per cent of urban Chinese households live on less than US\$3,125 per annum, but within 25 years, this share is expected to drop to just 10 per cent, with a vast number of Chinese moving up into the US\$12,500 p.a. middle class.

The Chinese middle class has already demonstrated a voracious appetite for globally branded goods, allowing many foreign companies to succeed in China without significantly modifying their product offerings or the business systems behind them.

Since this segment is currently concentrated in the biggest cities, it is easy to serve, both for companies now entering the Chinese market and for old hands seeking a steady revenue stream.

China’s phenomenal economic growth stems both internally from the exporting of low-cost manufactured goods as well as massive investment in infrastructure, and externally from large amounts of foreign direct investment.

China is currently undertaking its 11th Five Year Plan (due for completion at the end of 2010), aiming to sustain its rapid development as well as achieving the “five

balances” – those between rural and urban development, interior and coastal development, economic and social development, people and nature, and domestic and international development.

China’s education system is also improving rapidly.

The nation has quite a high literacy rate, around 91 per cent, and people now entering the labour force have eleven years of schooling, nearly three times more than retirees did.

## CHINA’S CHALLENGES

Despite all of China’s economic promise, there are several major issues the nation needs to acknowledge and address in order to maintain its current growth and continuing prosperity in the long term.

First, China’s growth is creating massive demand for the world’s resources, such as energy, food and raw materials. Although China’s population only consumes a relatively small amount of resources per capita, the sheer size of the population drives the situation.

Second, it is expected within the next quarter-century that two-thirds of the Chinese population will live in cities, up from one-third today.

In an increasingly urbanised society, resentment over corruption and unequal access to social services, for example, that now seems manageable, could turn more volatile and disruptive to public order, particularly if rapid economic growth falters.

Third, there is an increasing disparity between the quality of life of coastal and western China.

A World Bank study has found that for businesses in coastal cities, taxes make up a smaller percentage of sales revenue, interaction with local bureaucracies is much less and expenditure on entertainment and travel makes up a much smaller percentage of revenues.

Most alarming, though, is the differences in child health and education. Infant mortality in the west is almost four times that of the coastal cities and education spending is close to one-tenth.

Fourth, China’s financial system is plagued by government intervention.

A massive and lumbering banking sector dominates China’s financial system, accounting for around 70 per cent of its financial assets, providing more than 95 per

cent of new corporate financing last year.

Unfortunately, China’s state-owned enterprises (SOEs), many with low productivity, receive most of the available funds for investment in order to (artificially) maintain employment levels.

## INDIA – THE LUMBERING ELEPHANT

India’s development, though not as impressive on paper as China’s, constitutes nonetheless an amazing performance.

Over the past year, economic growth has averaged 9.2 per cent, up from its average of around 8 per cent for the last three years.

If an economy is measured in purchasing power parity terms, India should soon overtake Japan and become the third biggest economy behind the United States and China.

With a population of roughly 1.1 billion people, India is the second most populous nation in the world behind China.

But, with a growth rate of 1.6 per cent per annum (China’s is 0.6), India is likely to overtake China well within the first half of this century.

Unlike China’s growth, which stems from the exporting of low-cost manufactured goods, infrastructure development and massive foreign direct investment inflows, India’s growth is underpinned by strong domestic demand and a burgeoning trade in services – information technology, back office functions and call centres servicing companies across the globe.

India is attempting to follow China’s example and increase its attractiveness to foreign investors.

However, the low standard of living, poor levels and condition of infrastructure, and the excessive and non-transparent nature of regulations are constraints. Currently, India attracts only a tenth of the foreign investment enjoyed by China.

Nevertheless, an important advantage for India is its enormous room for improvement.

For example, only one million people are employed in India’s highly successful IT industry, though it accounts for almost 4 per cent of the nation’s GDP. Revenues from this sector are growing by 38 per cent a year, and analysts predict sales of \$US70 billion by 2008.

Also, India has many highly skilled professionals, scientists and engineers, but, like its IT experts, they represent only a small fraction of the total population.

These professionals are helping India become a major global source of research and development (R&D), but in order to take full advantage of this, India must take in more foreign investment.

## INDIA'S CHALLENGES

Like China however, India also has several pressing issues affecting its economy and limiting its growth. If these issues are not addressed, India's economy is likely to overheat and it will not sustain its current pace of expansion.

First, India's infrastructure needs to be upgraded substantially if current levels of growth are to continue.

A report by the World Bank found 25 per cent of India's firms see poor infrastructure as a key obstacle for growth.

India's water infrastructure is crumbling due to poor maintenance and the nation as a whole suffers from severe power shortages.

Forty per cent of firms in India have their own generators because of the unstable power supply and 40 per cent of the population, mostly in rural areas, lacks access to electricity.

The average manufacturing firm loses 8 per cent of sales each year as a result of power cuts.

India currently spends only 4 per cent of its GDP on infrastructure, compared with China's 9 per cent. In absolute dollar terms, China spends seven times as much on its infrastructure.

This situation needs to be remedied as a matter of priority, for if India's growth continues without being matched by a substantial growth in spending on infrastructure, the increasing demand on its already severely overtaxed infrastructure will cause major problems.

Second, and related to India's infrastructure problems, is the massive urban-rural disparity.

Thirty-five per cent of the nation lives in poverty, and because less than one in three people reside in urban areas yet these cities generate over two-thirds of the GDP, it can be said that the majority of those suffering from poverty in India live in rural areas.

Third, like China, India's population, expected soon to be the largest in the world, is also rapidly increasing its demand on the world's resources.

By some estimates, India's oil use has doubled since 1992 and coal now provides half of India's energy needs.

India must look at increasing the efficiency of its use of resources through undertaking more sustainable patterns of consumption and conserving resources where possible.

Fourth, also much like China, India's financial system suffers from tight government control, as does its labour market.

A strong equity market dominates India's financial system, from which the government itself diverts a good deal of capital to finance its rural investment priorities and large fiscal debt.

According to the McKinsey consulting group, the results of this financing are wasteful and returns are negligible.

India needs to reform its financial sector in a way that reduces government regulation, ownership of institutions and privileged borrowing. It is quite possible such reforms could raise India's GDP growth to a sustainable 9.4 per cent per annum.

India's labour market is, quite simply, home to some of the most restrictive labour laws in the world.

Examples of such laws include that firms employing more than 100 people cannot dismiss staff without government permission and that the labor commissioner must be notified of every single person working on a night shift.

India's restrictive labour market discourages business expansion, without which India's economy will be unable to grow at its optimal level.

A fifth problem is the quality of public services.

Major services ranging from education and health to provision of water are severely underdeveloped.

India's average literacy rate stands at 68 per cent, and this figure is much lower for women. Dropout rates for regional junior high schools are around 40 per cent, and half of all urban children are in private schools due to the poor quality of public ones.

Half of urban households lack drinking water within the home and one quarter of households have no access to a toilet, either public or private.

Also, many public services have worsened in recent years. In Bangalore, for instance, water is now available for less than three hours a day, compared with 20 hours in the early 1980s.

## TOWARD A CHINDIA

The formation of a Chindia economy is not just as easy as China and India getting together and combining their economies.

There are many forces at play, acting both as a driver towards a Chindia as well as pushing away from it.

What China and India must decide is whether the positive forces pushing towards a formation outweigh those working in the opposite direction.

Not surprisingly, there are factors beneficial to the formation of a Chindia economy, and those detrimental to it.

Both China and India have massive populations, low average incomes and rapidly increasing GDPs.

Both currently benefit from massive skilled, yet relatively inexpensive, labour forces.

Commentators often say that if China is the workshop of the world, then India is the globe's (back-) office. Logically, both could work together to better penetrate foreign markets.

Chinese and Indian economic strengths are complementary in nature - for example, China is perceived to be strong in manufacturing and infrastructure and India in services. In information technology, China is stronger in hardware while India is stronger in software.

Also, China is stronger in physical markets while India is stronger in financial markets.

There is also a natural "partnership" between the Indian spirit of entrepreneurship and the Chinese desire to create wealth, and their socio-cultural similarities could make this team arrangement easier.

Taking advantage of the synergies between Chinese and Indian markets would increase their strength in the global economy as well as increasing the prosperity of the 'domestic' market of 2.5 billion consumers they would bring together.

Indeed, Indian and Chinese economic co-prosperity seems to be increasing rapidly along with increased trade between the two nations.

In recent years business ties have dramatically increased the economic engagement between the two nations, with the value of two-way trade having risen from a few hundred million dollars in the mid-1990s to \$13 billion in 2004.

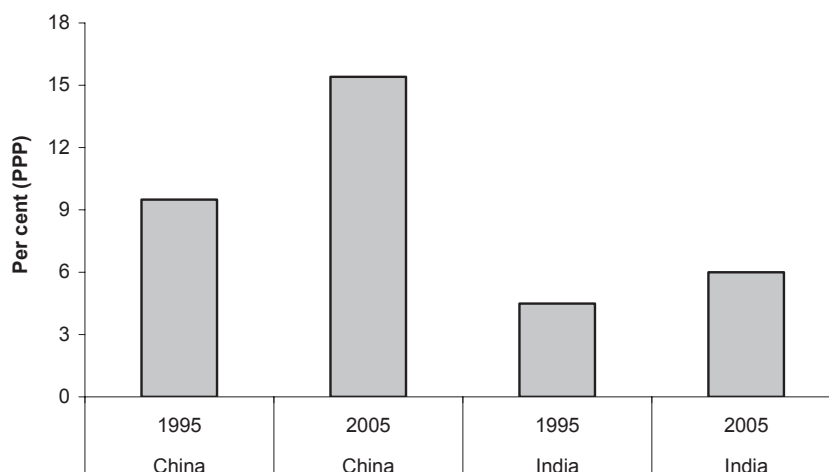
Despite the potential opportunities flowing from the better integration of the Chinese and Indian economies, there are still several potential impediments.

## COUNTERVALING PRESSURES

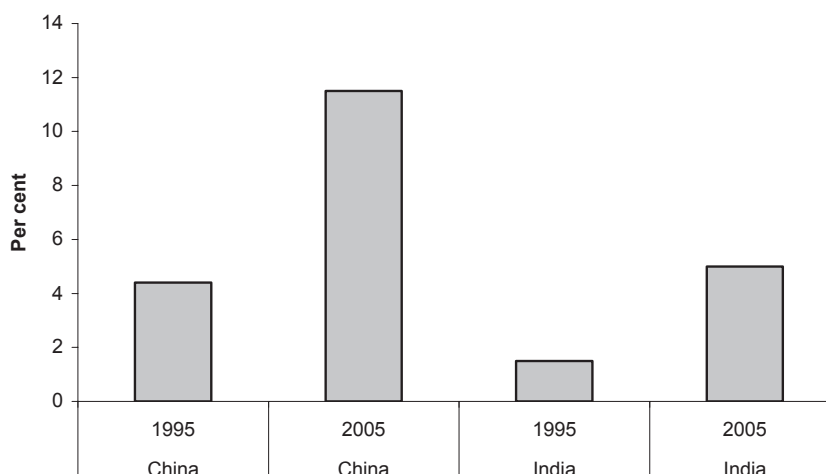
Most discussions on Chindia look at the marvel of a possible change to the world economic order Chindia would bring.

However, there are several issues that would challenge the feasibility of a Chindia economy, at least in the short to medium term.

Figure 1  
Share of World GDP



**Figure 2**  
**Share of Australian Exports**



One of the biggest forces likely to impede the formation of a Chindia economy is the rocky political and strategic relationship that has existed between China and India for years.

India's harbouring of the Dalai Lama along with the Tibetan Government-in-exile from China, both of whom fled from Tibet in 1959, is a sore point in the bilateral relationship.

Another example is the Sino-India War of 1962, caused by the two nations sharing a disputed border.

The border problem, which remains unresolved, is only currently 'off the agenda' due to recent increasing investment and economic growth between the two nations taking a front seat ahead of resolution of such political issues.

China and India are also considered alternatives and competitors in a number of ways.

For instance, one is an autocracy with its political roots in communism and the other is a former British colony and liberal democracy with ties to the West.

India recently finalised a nuclear deal with the United States, much to the displeasure of China.

Both nations are also fast becoming two of the largest consumers of hydrocarbons in the world, leading to competition for global reserves.

And recently, moves to include India as well as Japan as permanent members of the United Nations Security Council (UNSC) were voted against by China.

Another issue is the differences in the quality of

infrastructure between China and India.

India's infrastructure is greatly lacking compared with China's, and without sufficient sustainable investment in infrastructure by India, many investors, as well as goods and service providers, will not be able to function in India effectively.

India has focused much of its time and money reforming its inventive private sector and keeping it free from bureaucracy, yet has left its infrastructure such as roads and power woefully inadequate.

One comparison of modern facilities in China and India found India lags behind in almost every field, from highways with 4-6 lanes and households with PCs and TVs to internet access and mobile phone subscriptions.

Government influence in both China and India has also put heavy constraints on the ease of doing business, with the financial system in each country plagued by government intervention, albeit in different ways.

China's financial system is dominated by a massive banking sector from which the government takes a large amount of money to fund SOEs in order to maintain employment levels.

The Indian government finances its rural investment priorities and large fiscal debt by extracting money from India's massive equity market.

Both governments are wasting money on unproductive endeavours, instead of reforming the economy to make doing business easier and in turn attracting more investment and increasing growth.

According to the McKinsey consulting group, if reforms

were undertaken in both countries to create a modern financial sector, GDP in China could be boosted by \$US321 billion a year and in India by up to \$US48 billion.

At present starting a business in India takes 71 days on average and 48 days in China, a clear deterrent to the much needed entrepreneurship in each country.

When exporting goods, it takes an average of 36 days in India and 20 in China to get any necessary licences, and the average number of hours for a medium-sized company to complete its tax returns is 264 in India and 584 in China, respectively.

## CONCLUSION

Many in commerce and industry are excited by the concept of Chindia because it would represent a fundamental change in the world economy.

If the 1900s were the 'American Century', the 21st century is likely to see Asia, led by China and India, come into its own.

However, given the forces at play it is unlikely Chindia or a similar arrangement will emerge in the near future, as the forces pushing against it far outweigh those driving towards it.

A number of pressing issues must first be resolved such as:

- previous grievances between India and China over the Dalai Lama, Tibet and Kashmir;
- the strong need for infrastructure upgrades in India;
- the need for urban-rural and rich-poor disparities to be narrowed substantially in both countries; and
- the need for government intervention which raises the burden of doing business to be lessened.

While it is exciting to think about a shift in the world economy away from the dominance of the West and into the East, and the possible formation of an economy comprising 40 per cent of the world's population, such a shift is very unlikely to happen in the foreseeable future without massive reforms by both countries.

There are too many impediments that simply cannot be overcome in a short time frame.

Nevertheless, a China - India Free Trade Agreement (CIFTA), which would more closely link the two economies, may not be fanciful given the current global interest in such arrangements.

Closer economic engagement between China and India, whatever form it may take, would have profound implications for the global economy.

### An Official View

"So how long might China's exceptionally high growth rates be sustained?"

A crude look at the history of Japan and Korea in the post-war period might suggest a reasonable expectation of three decades of growth in the vicinity of 10 per cent per annum.

But that may well understate the potential of China and India.

China took off from a much lower base than either Japan or Korea so that today, even after three decades of rapid growth, it is still well behind the relative income levels of Korea and Japan when they started to slow down. And India is a lot further behind still.

On that basis, there is at least the potential for this process of catch-up growth in the two most heavily populated countries to continue for decades to come."

Dr Malcolm Edey, Assistant Governor (Economic)  
Reserve Bank of Australia  
Address: "The Australian Economy In 2007"  
Sydney, 7 March 2007