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Gravity Shift: Thinking about China and India in 2030

By Wendy Dobson

As Prime Minister Harper travels to China just weeks after his visit to India, it is inevitable that comparisons will be made between Asia's two emerging giants. Author Wendy Dobson argues that, while it is certain that the world's centre of economic gravity in the coming decades will be pulled toward the Asian powerhouses, their roles in the world will be constrained by the need to rebalance significant distortions in their domestic economies.

The world economy in 2009 is contracting. The advanced economies will shrink by nearly 4% according to the IMF, while China and India will motor on at nearly 8% and 5% growth rates, respectively. While both suffered large drops from their 2007 peak rates of 13% and 9%, positive growth helped them weather the Great Global Recession of 2008-09.

This performance has fed expectations that China, which is now much more developed than India, will somehow replace the legendary US consumer in pulling the rest of the world out of recession in the short-term and in the long term will reshape the world order. China and India are the world's two fastest-growing large economies and, with more than a billion people each, its the most populous countries. They are in close proximity and are fuel the dynamism of the Asian region. Imagine the impact on their neighbours if the two giants' talks on bilateral free trade, underway since 2005, were to bear unexpected fruit; if they and the other Asia-Pacific members of the G20 (Australia, Indonesia, Japan and South Korea) were to develop a coherent voice at the global leaders' table. Indeed, acting together, as Europeans have demonstrated, is a powerful antidote to the future risks of large powers in the region competing with each other and pulling the region apart rather than together. These developments will hasten the emergence of a multi-polar world in which the United States is first among equals; a leader in both soft and hard power but no longer able to act without consulting and persuading other large countries to join.

Can China and India sustain their growth through 2030?

But let's not get ahead of ourselves. Predictions of a changing geo-economic future are based on a popular assumption that China and India will be able to sustain their economic dynamism over the next two decades. Will they?

About The Author

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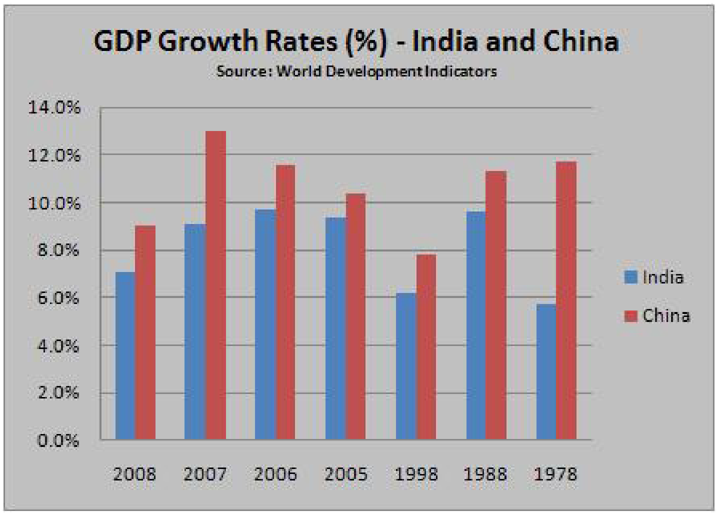
Looking beyond the short-term cyclical data to the sources of an economy's long-term growth, there is little doubt they will be economic powerhouse's, but not in the ways that simple extrapolations of pre-global crisis 2007 data imply. Long-term growth is driven, not just by a growing labour force, or rising savings, or new sources of natural resources, or innovation, but by the incentive structures embedded in an economy's institutions. An expanding labour force is a growth asset if workers have incentives to be productive. It is a burden if they are poorly educated and poorly motivated. Economic growth is sustained by labour market institutions that reward education, skills training and productive employment. It is sustained by financial institutions that allocate capital efficiently and reward savers; by legal institutions that



record and protect property rights; and by openness to international trade and finance.

Changes in key institutions kick-started China's 30-year dash for growth as central planning was replaced by far-flung experiments with new ways of rewarding farmers for their work, restructuring State Owned Enterprises (SOEs), and modernizing the financial system (still a work-in-progress). Changes in some of India's institutions set the stage for its recent growth sprint after the 1991 balance of payments crisis when protectionist institutions such as the 'licence raj' were dismantled, the fixed exchange rate was liberalized, and India's markets were re-opened to foreign competition.

By 2030 China's economy will be a third larger than the US economy, double the size of India's and seven times larger than Japan's. Together, China and India will account for a third of the world's economy. Both will matter to our future because they are growing faster than anyone else. Their dynamism is shifting the world's centre of economic gravity to Asia as they re-emerge to a prominence they knew 500 years ago. But by 2030 China's economic growth will have slowed to a 6-8% annual average and India's will only accelerate if it makes some major changes in its institutions.

China's challenges

China's surprisingly slower economic growth is "baked in" because of decisions taken 30 years ago to slow population growth. China's population is now aging. The number of 15-24 year olds entering the labour force is shrinking; by 2030 they will number around 178 million, some 30% fewer than the 229 million in 2010. The effects of this shrinkage will be felt in a number of ways: wages will rise and employers will try to offset these higher labour costs by increasing productivity, moving labour-intensive operations to lower-wage locations and by moving up the value chain to produce their own sophisticated components rather than importing them. Employers will look for better educated and more skilled workers but since most migrant labourers have only nine years of education, China faces a major challenge to upgrade the skills of its labour force.

To compensate for its aging and shrinking population China will also have to find more growth from existing resources and from new knowledge and industries. This means a major overhaul of its monetary and financial systems. Directed lending in the government-owned bank-dominated system is linked to the managed renminbi exchange rate and administered interest rates which price capital too cheaply. Cheap capital is used wastefully and too much of it is directed to unproductive borrowers in the state sector. These factors lie behind China's investment-driven boom, which was extended by its successful stimulus efforts last November that relied heavily on banks lending to infrastructure projects. The central government knows this investment-based framework is unsustainable and has set out to rebalance economic growth more toward domestic consumption.

The debate about China's ability to achieve this rebalancing anytime soon is both heated and worried. Rebalancing not only requires deregulation of the financial and monetary system (which would provide household savers with better returns) but also a big change in household behaviour which emphasizes precautionary saving to self-insure for health care and pensions and to cover the costs of education. Many households have seen the commune- and SOE-based public health system dismantled in their lifetimes; it will take time -- possibly a generation or more -- for the central government to convince them to trust its promises to provide insurance coverage for primary health care, rebuild the rural health care system and raise rural incomes.

Continued government ownership of banks and industry and intervention in markets also inhibit the transparency required for markets to function efficiently. SOEs continue to enjoy privileged positions with the regulatory authorities; they still occupy the commanding heights of the economy, dominating rail and air transport, finance, energy, telecommunications, utilities, and heavy and defence industries. In contrast, many parts suppliers in the electronics and electrical equipment and other industries, retailers and much wholesale commerce are privately owned. These have a return to capital that is 50% higher than wholly-owned SOEs and yet small and medium private enterprises are shunned by the big banks as borrowers. As one senior banker put it, "The big banks are like pawnshops: they demand real collateral from borrowers and lots of it." Non-state enterprises, therefore, obtain their financing at high cost from informal sources, either from people they know or from informal financial institutions. Recent changes initiated to encourage financial institutions that specialize in smaller firms will take time to develop into sound and mature institutions.

Nor have Chinese governments overcome their ambivalence about protecting property rights to ensure innovators are rewarded for the risks they take, a key driver of sustained long-term growth. China has managed to grow so far because of alternative protection provided by informal trust-based networks, the disciplines and protocols of global supply chains and access to Hong Kong's sophisticated business services. Some local governments have differentiated their jurisdictions with promises of property rights protection, but this is a long way from a reliable national framework.

Finally, China's political institutions are still primarily preoccupied with control. As the country relies more heavily for its future growth on technological advance -- the sine qua non for sustainable growth -- tensions will increase between political control and the increasingly market-based economy. New technologies are generated by people who think independently and even disagree with the prevailing science and government directives. Public institutions that tolerate mavericks and failure and financial institutions that can evaluate and manage risk will be important elements in this business environment.

Added together, China's stunning economic progress has vastly reduced poverty, opened the economy to world markets and generated amazing industrial growth and employment, but the shrinking labour force and rising costs from inequality, environmental degradation and tensions between market forces and political control have to be addressed. The size of these challenges illustrate

To compensate for its aging and shrinking population China must get higher productivity from workers in knowledge-based industries like information technology.

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why it is very likely China's growth will slow markedly by 2030.

India's challenges

India's prospects for 2030 show obvious potential for gains simply from making better use of existing labour, capital and knowledge. This should be a straightforward task in a democracy, especially when the gains will accrue to the millions of low-income voters. Surprisingly, India is still labouring under deep suspicions of capitalism, an ideology of 'poor but pure,' and rigidities created by its top-down socialist past in which well-organized interest groups vigorously protect their interests in political debates and do not hesitate to take their grievances into the streets.

India's growing labour force is often considered central to its future. In contrast to China, the number of 15-24 year olds in 2030 will be 242 million -- larger than the populations of many countries in the world -- and slightly larger than the number in 2010. Indeed by 2030 nearly a billion Indians will be of labour force age. A huge potential labour force and a growing number of entrants will only drive growth if the population is educated and productive. Literacy is still only 61% compared to 91% in China and 60% of India's population still depends on agriculture. Absolute poverty has declined in India, as it has in China, and India's highly skilled knowledge professionals are frequently in the headlines. But no developing country, let alone one of India's size, has modernized without moving people out of agriculture into more productive labour-intensive industrial production.

What is it about India's educational and labour market institutions that they have not prepared nor do they utilize the full potential of much of its population? So far, Indian labour is moving out of agriculture at a pace half of that of China. Labour-intensive manufacturing has not taken off the way it did in China because of institutions that hinder the ability of workers to acquire skills and employers to achieve economies of scale and create large numbers of productive industrial jobs. The IT services sector employs only about three million skilled and educated Indians. Pro-worker regulations such as the Factories Act of 1948 and the Industrial Disputes Act of 1947 along with dozens of other central and state laws prescribe what employers can do to adjust their work force size. As a result entrepreneurs have moved away from labour-intensive manufacturing and services to capital-intensive production. By default, Indian workers are left to find casual employment: some 90% of India's growing labour force is still casually employed in the informal or 'unorganized' sector which offers no benefits or job security. The other inhibiting factor is India's poor record of infrastructure investment. An investment plan is helping to rectify this deficiency but there are no signs that the Congress Party is using its strong mandate to address the labour laws; as one journalist put it "paying villagers to dig holes and break stones is easier than undertaking reforms that create sustainable jobs."

Can India's relatively well developed financial system help compensate for the labour market deficiencies? Not really. Like China, SMEs that will create new ideas, industries and jobs are unable to obtain adequate funding from the formal financial institutions. Like China, too, India's government uses the banking system for political ends and owns the majority of Indian bank assets, although the fastest-growing bank is privately-held. India's stock markets are models for emerging markets but banks, insurance companies and other financial institutions are required to buy government bonds to fund governments' consumption-oriented deficit spending. Indeed, unlike China, India has persistent public sector deficits at all levels which inhibit the public sector from tackling capital-absorbing projects like better physical infrastructure.

Can science, technology and innovation take up the slack? Not surprisingly, both countries still depend on the technologies of others despite their recent space exploits. The dazzling process innovations of India's experienced IT services entrepreneurs have created world famous companies and brands, and auto parts and pharmaceuticals are not far behind. Well-earned fame but it also serves to dramatize the yawning gap between these export successes and the domestic economy where even existing knowledge has not yet diffused to India's host of tiny enterprises that create most of its jobs.

Indians are fond of blaming their slow progress on the inefficiencies of the democratic process. The validity of this argument is now testable since the May 2009 general election delivered a strong mandate to the incumbent Congress Party led by Mrs. Sonia Gandhi. So far there are few signs that the mandate will be used to deliver major economic change. Instead, the central government has interpreted the results as a political reward for a massive program of subsidies for the poor through the National Rural Employment Guarantee Scheme introduced in 2004. The global financial crisis is also regarded as a reason to put financial sector liberalizing reforms on hold. Changes are coming to educational funding, which is being beefed up to address growing shortages of skilled professionals and to ensure primary school learners achieve basic literacy, but there are no signs yet of reforms to the archaic institutions that regulate India's education. Liberalizing restrictive labour and land laws is undoubtedly controversial; if boldness has been rejected, could stealth be an alternative way to open the doors to the long-terms payoffs from creating labour-intensive manufacturing and services as avenues off India's farms?

India has a relatively developed financial services sector but it is hamstrung by government regulations and investment controls.

In summary, economic change in India is likely to continue to be incremental. Bold changes in incentive structures like those that restructured the telecommunications industry in 1999 and set the stage for meteoric rates of growth in mobile phone usage by 2007 seem unlikely unless they are engineered by the private sector. India's entrepreneurs have produced a number of innovations using a 'bottom of the pyramid' business model to supply IT, transportation, marketing and housing to low-income customers. But change in the public sector that will free up India's potential growth through investment in people's literacy and skills, in infrastructure to connect rural to urban areas, and diffusing knowledge that is already available is likely to be a slow process. Without a modernized incentive structure Indians deny themselves the 10% growth rates that China has demonstrated are entirely possible.

Taken together, the impressive strengths in Asia's two emerging giants that drive the gravity shift are offset by persistent domestic weaknesses. China's pragmatic combination of cheap capital and labour, openness and its unique mix of state and market institutions has delivered rapid growth at home and powered international markets. But heavy reliance on investment and producers has created a lop-sided economy with rising income inequality and environmental degradation. India's choice of inclusiveness over growth has achieved neither very well, excluding large swathes of the population from the modern sector except where the private sector is filling the innovation gap.

The global economic order in 2030

Even so, by 2030 the shift in the centre of economic gravity will be well advanced for the simple reason that both countries will grow faster than the advanced economies. Even with conservative growth assumptions, the Chinese and Indian economies combined could be nearly twice the size of the slower-growing US economy. Maintaining their rapid growth trajectories, however, will depend on the two giants addressing their domestic stumbling blocks. Both governments realize they cannot continue with business as usual. China has to avoid moving to a markedly slower growth path while Indian voters will push to sustain its hoped-for 10% growth rate.

Expectations that the rising economic prominence of these powerhouses will reshape the world order are, however, getting far ahead of ourselves. Such predictions may eventually be proven correct but they are unlikely to be borne out in the next decade, or even two. The translation of economic clout into political power will depend first on their abilities to weather the global recession. Both have passed this test but mainly because China has thrown what has been called a 'great wall of cash' at the economy through the banking system and because India is still a relatively closed economy.

Second, their abilities and choices, both to cooperate with each other and their Asian neighbours and to take on more responsibilities in the global institutions, will be important factors as well. The evolution of their relationships with the United States will be particularly significant now that China is the world's largest creditor and the United States its largest debtor. The multi-polar world order of 2030 will be without a dominant leader. Global progress will depend on forging a common vision and working together. The G-20 leaders' summits are early steps in this direction.

The current climate change discussions provide an example of the kind of role we can expect them to play in the years ahead. China has committed that its emissions will peak by 2050 and that 20% of energy will come from renewables by 2020 -- not because of international aspirations but because of domestic pressures for cleaner air. India is resisting any target, arguing that as a poor country its global footprint is still-modest and its need to develop still great. US leadership is still required: a serious commitment on climate change is necessary for the two giants to follow and new technologies are urgently required to replace existing polluting industrial techniques.

To conclude, the gravity shift associated with Asia's rise is simply that. Astonishing. Large. But not a power shift because of the pull of this gravity toward domestic priorities that will make their transformations sustainable. During the next two decades governments in both China and India will be preoccupied with addressing their lopsided economies. China's is unbalanced because its monetary and financial system supports high investment at the expense of consumption and the environment. India's is lopsided because of its rigid labour market institutions whose impacts are serious but felt entirely at home. How each country reconciles industrial growth with these domestic weaknesses will affect its soft power and international standing. China's economy in 2030 will be larger and richer than India's but the gap could be narrower than projected if government continues to own and direct much of China's financial system and if India were to have greater-than-expected success in educating, connecting and financing the integration of it vast low-income population into more productive activities.

DO YOU WANT TO KNOW MORE?

GRAVITY SHIFT – How Asia's New Economic Powerhouses Will Shape the 21st Century, by Wendy Dobson, University of Toronto Press, Toronto, 2009.

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