The Tiger and the Dragon

India and China can learn a lot from each other as they advance in their development journeys

Murtaza Syed and James P. Walsh

CHINA and India are the giants of the emerging world. With more than a third of the world's population between them, these two countries would have an immense effect on global trends even if they were not growing rapidly. But over the past 10 years, China and India have also been among the fastest growing economies in the world. Since 1995, average income in China has increased almost tenfold, while in India it has nearly quadrupled. Despite very different political and economic systems, both countries have lifted millions from poverty, while income inequality and environmental degradation have worsened. Given the scale of these changes, the emergence of India and China has had profound implications for the rest of the world.

Chinese technician speaks with Indian worker about concrete machinery in Pune, India.

But China and India have pursued very different development paths. China's economic model has focused on gearing its manufacturing industries toward exports for the rest of the world. India has also become increasingly integrated with the rest of the world, though under its model, domestic demand and services have played a more important role. As this process has played out, China has become the workshop of the world.

India's growth has been less spectacular, but in many industries, from petrochemicals to software, India has achieved success on the global stage. Chinese goods—from T-shirts and air conditioners to iPod components and furniture—are for sale in almost every country on the planet. By contrast, Indian engineers automate office processes, call centers troubleshoot software glitches, and pharmaceutical companies produce generic drugs for clients around the world.

How can two countries, with seemingly similar initial conditions—very low incomes, large rural populations, decades of self-imposed economic exile, and a great deal of central control—have charted such different development paths? And given these differences, what might they learn from each other as they move forward?

How did reforms begin?

China began its reform not by building the factories and skyscrapers that impress visitors today but by changing the countryside. In 1978, peasants living hard lives on collective farms made up 80 percent of its population. At that time, communal land was leased to individual households, who were given permission to choose which crops to grow and to sell any production above the state quota on the free market. These agrarian reforms—dramatically increasing agricultural productivity and allowing large parts of economic activity and labor to move out of central planning and into the industrial sector—sparked the changes that led to China's economic transformation. Next, China began reconnecting to the rest of the world by setting up special economic zones along its eastern coast in 1980. Armed with discretionary powers over taxation, streamlined business rules, and modern infrastructure, these zones attracted large-scale investments from abroad, and the experiment soon spread to other areas.

Meanwhile, growth was unleashed by the state-owned enterprise reforms of the mid-1990s, relieving corporations of social responsibilities and freeing them to invest in new technologies and seek out new markets. With support from wide-ranging government policies, companies in export sectors learned to become highly efficient by competing in the global marketplace. In this way, following the east Asian export-oriented model espoused by Japan and Korea, China was able to successfully connect its excess labor supply to the global production system. With a further boost from China's World Trade Organization (WTO) accession in 2001, total trade (exports plus imports) mushroomed from less than 10 percent of GDP in the late 1970s to nearly 50 percent today, and foreign direct investment rose from virtually nothing at the beginning of the 1980s to more than $150 billion a year over the past five years.

India's reforms began later, in 1991. With less need to focus on property rights and less state oversight, these reforms were initially aimed at improving the economy's flexibility following a balance of payments crisis. The first round of reforms lifted restrictions on manufacturing and trade. Before 1991, licensing requirements were almost universal in India, foreign competition in most industries was minimal or nonexistent, and government intervention in industries from transportation to finance stifled entrepreneurship and growth. During the 1990s, licensing requirements were lifted across many industries, tariffs fell, and India's financial markets began to open to the world. Financial inflows rose from almost nothing in the early 1990s to nearly 8 percent of GDP in 2007, the last year before the global financial crisis.

Time may be running out on the sustainability of China's growth model.

While India's manufacturing sector grew quickly after the early 1990s, the standout growth was seen in services, as India's large population of well-trained English-speaking engineers were able to adapt western business models to a lower-cost environment. Services exports rose from 2 percent to 7¾ percent of GDP between 1994 and 2011. What began as outsourcing of simple tasks like customer service and software programming broadened to development of new business processes and software, handling of routine legal and medical issues, and other services. India has also found a niche in other knowledge-intensive industries, such as pharmaceuticals. Although India's export growth has not matched China's, by 2011, exports of goods and services accounted for 24½ percent of GDP, only slightly below China's 28½ percent.

Where are India and China today?

China's head start and more rapid growth have put its income levels above India's. As the world's largest exporter, China produces more toys, shoes, car parts, and computers than any other country and employs more than 100 million people in manufacturing. But with the global crisis weakening external demand and population aging set to shrink its labor force, time may be running out on the sustainability of China's growth model.

Over the past decade, reforms have largely taken a back seat even as China's economic structure has become more and more unbalanced. Investment has ballooned by nearly 13 percentage points of GDP and now accounts for almost half of output, while private consumption has fallen sharply from 45 to 35 percent of GDP. If this imbalance persists for too long, elevated investment could derail China's growth by aggravating excess capacity, lowering productivity, and burdening banks with bad loans. High levels of pollution and energy demand are other reasons why the model needs to change.

As acknowledged in China's latest Five-Year Plan, a better internal balance between investment and consumption must be found to sustain growth in the coming years. To achieve it, the artificially low cost of investment needs to be redressed by increasing the price of capital, further raising the price of other key inputs (such as land, energy, and water) in line with international levels, and better protecting the environment (see "A Change in Focus," in this issue of *F&D*). And consumption needs to be spurred both by boosting household income—through an expansion of the labor-intensive service sector and increased employment in higher value–added and more human capital–intensive activities—and by lowering household and corporate savings—through a stronger social safety net and financial reform that remunerates households more fairly and allocates capital more efficiently. It is encouraging that most of these reforms are on the radar screen of the Chinese government, but timely implementation will be key.

In India, a vibrant services sector has given the country something highly unusual among emerging market economies: many world-beating private companies in high value–added areas. Companies like Infosys, Wipro, and TCS compete at the top rank of information technology services around the world. But information technology employment in India is estimated to cover only 2½ million people, or less than half a percent of the working-age population. And with average income only around $1,500 a year, wages remain low for most.

As India's working-age population grows rapidly over the coming decades, more people than ever will enter the labor force. Providing them with good job opportunities will require a host of reforms. Education and health care will have to be improved, and regulation of labor-intensive industries, especially in manufacturing, will have to be overhauled. Constraints on growth—from inadequate port capacity and overcrowded roads to clumsy allocation of mining rights and electrical blackouts—will have to be addressed. Improving the business climate by simplifying rules, removing red tape, and lowering barriers to foreign trade is also crucial. And the financial system will have to be improved so more people have the ability to save and borrow, and so corporations can more easily undertake long-term investments.

Without sustained reforms, job creation could stall. And all this will have to be done while the government and Reserve Bank of India keep a lid on both inflation, which in recent years has risen to high levels, and the budget deficit, which has stubbornly refused to fall since the global financial crisis and might be crowding out investment and hampering capital market development.

Sharing common challenges

India and China also face some common challenges. In particular, growth needs to be made more inclusive in both countries. China and India's records in poverty reduction are without historical precedent. In India, between 1993 and 2009, the number of people living below the poverty line fell from 36 to 22 percent of the population. Since reforms began in China, more than 400 million people have been lifted out of poverty. Impressive as these numbers are, many have been left behind. In India, 250 million people remain poor, and the quality of public education and health services for many, particularly in rural areas, remains very low. In China, rural productivity has stagnated in recent years, and public services must adapt to meet the aspirations of a rising middle class for better-quality education and health care.

In addition, inequality has risen rapidly in both countries. Wages for educated groups, particularly in urban areas, have risen far faster than wages for the poor, especially in the countryside. The difference between the lives of middle-class urbanites, whose living conditions increasingly approximate those of people in developed countries, and the large numbers of still-poor people in the countryside and in regions that have not benefited fully from rapid growth, has bred social tensions in both countries.

Learning from each other

To sustain their impressive growth performance, both China and India need to move toward an economic structure that better balances domestic and external demand, as well as manufacturing and services. In achieving this balance, the two countries—which so far have relied on very different development strategies—would do well to take a leaf or two out of each other's books.

First, given China's head start, what can India learn from its neighbor's longer record? One area that is often overlooked is the role that agrarian and rural reforms played in spurring China's initial development. Growth in agricultural productivity both freed up labor to work in the industrial sector and released pent-up demand for a variety of industrial products. While India underwent its own Green Revolution in the 1960s and 1970s, broader issues of pricing and public investment remain unresolved. To capitalize on its ongoing reforms, India must look to create greater synergies between agriculture and industry, as China was able to do at the beginning of its take-off period. After all, half of India's workers and one-sixth of its output are dependent on agriculture.

Another area where China has been more conspicuously successful is international trade and drawing in foreign investment, in turn leading to job creation. China has become the world's most central trader by allowing imports and foreign direct investment access to the economy, though admittedly often with strings attached, while creating the conditions for domestic companies to adjust to strong foreign competition.

The policies that have supported this success included the establishment of flexible special economic zones and a liberal foreign investment regime, a business climate and regulatory environment supportive of export industries, stable macroeconomic policies, and reform of state-owned enterprises. Although no country's experience is perfect, India could learn something from China on how to open domestic markets to competition and how government policies can help develop manufacturing and facilitate employment.

In addition, the factor that has been a roadblock for India has become a driver of Chinese growth: China has long been the world's largest investor in infrastructure, building roads sometimes even before the towns that they will eventually serve exist. China's focus on exports has led the country to invest heavily in freight and now passenger rail, port facilities, airports, and even highways. Urban infrastructure in China's large cities has developed rapidly, with subways in Shanghai and Beijing now among the world's most extensive. China's investment in energy—traditionally in coal but now encompassing all varieties of renewable energy sources as well—is also the world's largest.

In India, conversely, infrastructure has been a stumbling block. Investment in railroads is complicated by direct government ownership. Some airport privatizations have been successful, but investment in port facilities has been lagging, and energy generation and transmission have been hurt by poor pricing models and regulations that greatly add to the costs of investment. This leaves plenty of room to improve how India implements infrastructure plans to support development, improve connectivity, and lower the cost of exporting. The rapid pace of China's infrastructure development may not be fully or easily replicated in other countries, but it certainly presents lessons for tying infrastructure investment to development goals.

On the other hand, what lessons could India offer to China? One key area is India's relatively more advanced and market-based financial sector. In particular, despite its relatively low level of income, India has a highly sophisticated and transparent stock market. Its openness to foreign investors means that listed companies have effectively open access to the investment capital of foreigners. This has not only been an important source of finance for Indian companies that might otherwise have been unable to gain access to foreign capital, but has also introduced transparency and openness in the corporate culture. Listing a company on India's equity markets requires a similar level of disclosure to that in developed economies. This has improved market discipline and faith in large corporations.

And while both countries' financial systems remain state dominated and opportunities for foreign investors remain limited, India's is more market oriented. Deposit rates at banks are fully liberalized, improving the returns that savers can receive. Both public and private banks compete for the business of large companies, encouraging efficiency and a better allocation of resources. By contrast, China's stock market is significantly more closed to foreign investors and relatively nontransparent. Improving oversight of the stock market and opening it up to foreigners would increase the information available to investors, improving market discipline and the allocation of capital. Companies that have little prospect of engaging in joint foreign direct ventures with foreign companies would also be able to raise capital more easily. A more competitive banking system would have similar beneficial effects, as well as increasing household financial income.

In addition, as China's economy rebalances, it could also pick up some tricks from how India has managed to develop services. India's more market-driven financial system, though far from perfect, allocates capital to companies with less government interference and fewer distortions. Similarly, with concerns rising about the ability of its manufacturing industries to innovate, China might learn from India's "invisible human infrastructure." Through support for vocational education as well as export-oriented technology parks that have fostered the growth of clusters, India's government has been able to develop and sustain advantages in the kinds of industries that China will need to develop to avoid the middle-income trap. In all these areas, India's strong protection for intellectual property has also been crucial.

With the right policies, the importance of China and India to the global economy will only increase.

With the right policies, the importance of China and India to the global economy will only increase as they sustain their brisk growth and their populations become even more interconnected with the rest of the world. Both countries have come a long way since opening their economies a generation ago. From countries with very large but poor populations with minimal linkages to the rest of the world, China and India have become the world's second- and third-largest economies in purchasing-power-parity terms. Their differing economic models demonstrate that there is no single way for countries to develop, and present varied challenges for sustaining their growth over the medium term.

Nevertheless, in both countries many people remain behind, with poor access to high-quality public services and few prospects for economic improvement. In India, improving infrastructure and opening the manufacturing economy to competitive forces would help accelerate growth and make it more inclusive. China knows a thing or two about these areas. In China, weaning the economy away from manufacturing and exports toward services and consumption and making the financial system more market oriented would help sustain growth and broaden its benefits. In these areas, India has had successes.

While China and India have come a long way down very different roads, they have plenty to learn from each other as they chart the next phase of their remarkable development. ■

Murtaza Syed is the IMF's Deputy Resident Representative in China. James P. Walsh is a Senior Economist in the IMF's Asia and Pacific Department.