

EABER WORKING PAPER SERIES

PAPER No. 127

THE FUTURE OF CHINA'S ECONOMIC TRANSFORMATION AND INDIA'S ECONOMIC STRATEGIES

**PETER DRYSDALE, SHIRO ARMSTRONG, PAUL
HUBBARD, NEIL THOMAS AND DONG DONG ZHANG**
EAST ASIAN BUREAU OF ECONOMIC RESEARCH, CRAWFORD SCHOOL OF PUBLIC
POLICY, THE AUSTRALIAN NATIONAL UNIVERSITY

ANU, CANBERRA, 25 DECEMBER 2016

EABER SECRETARIAT
CRAWFORD SCHOOL OF ECONOMICS AND GOVERNMENT
ANU COLLEGE OF ASIA AND THE PACIFIC
THE AUSTRALIAN NATIONAL UNIVERSITY
CANBERRA ACT 0200 AUSTRALIA

The Future of China's Economic Transformation and India's Economic Strategies

Peter Drysdale, Shiro Armstrong, Paul Hubbard, Neil Thomas and Dong Dong Zhang
East Asian Bureau of Economic Research,
Crawford School of Public Policy, The Australian National University

China's large-scale structural transformation opens up huge opportunities for the development of the Indian economy through the shift in productive capacity across the region. China is in transition, from an investment- and export-led growth model to an economy based around consumption, services and innovation. This transition is both caused by and further contributing to rising Chinese incomes and Chinese firms moving up global value chains, two factors that are already driving the relocation of manufacturing activity from China to other more price-competitive countries in the region. This process will be further advanced through the gradual liberalisation of China's capital account. While China's commitment to, and thus the timing of, capital account policy changes are uncertain, the process is an inexorable product of the financial market liberalisation already in place. India can best take advantage of this situation by strengthening its own 'Make in India' economic reform agenda through liberalising labour laws, improving infrastructure investment and financing, opening to foreign investment, and pursuing regional economic integration. These measures will enable India to leverage its abundant and growing low-cost labour resources to exploit a comparative advantage in labour-intensive manufactures and services. This process has the potential to transform India into the next industrial superpower and the economic growth leader of the region.

China's Economic Transformation

China is already the world's largest economy in purchasing power parity terms, even though its per capita GDP is still only 34 per cent of the OECD average. This gives China ample room to grow, but China's reform-era economic model of heavy factor investment and export-led growth that drove three decades of double-digit GDP increases has run its course. China's growth rate is now around 6 per cent and is likely to decline further as the country moves closer to its production frontier. At the same time, China needs to resolve many challenging legacies of the old growth model, such as structural imbalances, excess industrial capacity and accumulated debt burdens.

China's demography is a key factor. Its working age population has peaked, and now a much tighter labour market is pushing up wages. Prime coastal areas have seen their populations swell from internal migration and are now already highly developed. Cost pressures will continue to mount, making China's export-oriented growth model

decreasingly viable. Manufacturers in China face the choice of retooling to produce higher-value products, shifting production abroad, or shutting down. The Chinese government has ordered the closure of excess capacity in iron and steel, and in industries that lag behind best practice in technology and environmental protection.

Under the 'new normal' of Chinese economics, policymakers are aspiring to transform China into a moderately high-income economy by relying less on factor accumulation and relying more on meeting the demands of ever-more sophisticated consumers through increasingly complex services. This transformation is being enabled by China's continued investment in the scope and quality of its education system and by growing expenditure on research and development. Innovative, high value-added industries are already emerging. Consumption spending has consistently grown faster than GDP over the past few years, and this situation will continue. Services already account for over half of Chinese output, and the manufacturing share has declined toward 30 per cent.

Deepening Economic Reforms

At the heart of China's reform process is its plans to liberalise domestic financial markets and integrate them with the world through an open capital account. China wants to increase its role in international finance by making the renminbi a global currency. Financial reform and capital account liberalisation are central to driving innovation and productivity growth. Market-determined interest rates and exchange rates will correct misallocation of capital that favour particular regions, state-owned enterprises and the state-owned banking sector. Such misallocations crowded out financing and investment for the more dynamic private sector.

These reforms will need time to unfold. Recent anxiety about Chinese stock market volatility and changes to China's foreign exchange regime gave a taste of the difficulties that reform entails. Global financial history shows that these transitions are never easy. China will continue its policy experimentation, and inevitably make some mistakes.

This is not just a technical economic challenge. The integration of China into international capital markets requires it to have a much more open, transparent and predictable set of institutional arrangements that deliver confidence for those dealing in

Chinese assets. This pushes at the envelope of political reform, but there is no sign that China’s government will retreat from the substantial market reforms already in place.

If successful, these reforms will help China move through the so called ‘middle income trap’. But the ramifications will be much broader than China’s domestic economic growth. Capital account liberalisation could also promote geopolitical stability through facilitating greater economic and financial integration. And the fundamental shift in the structure of China’s economy will transform the structure of regional trade and economics in Asia.

Global Implications

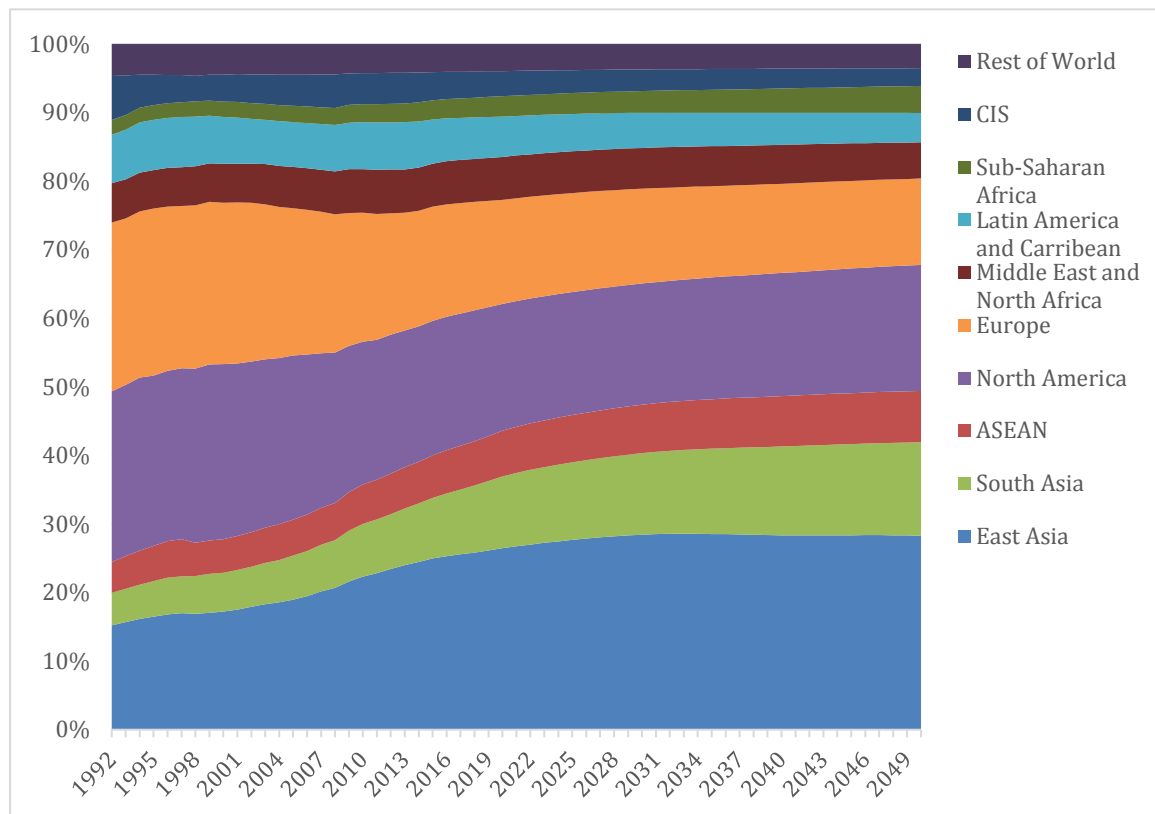
China’s economic rise has fundamentally reshaped the global economic landscape. Two decades ago, Europe and North America produced half of global economic output (see Chart 1). Their share has now fallen to roughly a third, and it is set to decline further as Chinese growth continues (albeit at a slower pace) and India picks up steam. China’s growth rate is likely to moderate over the next decade and then slow down considerably in the 2030s and 2040s. India’s future growth rates are likely to be higher than China’s for two main reasons. First, India is behind China regarding labour productivity, and so India has more room for ‘catch up’ growth relative to China. Second, India has a youthful and still-growing workforce, while China is facing a demographic headwind. India’s ‘demographic dividend’ is unlikely to wind down until after 2050.

Table 1: Projected Growth Rates

	Historic		IMF 2011-2020	Long Term Projection		
	1991-2000	2001-2010		2021-2030	2031-2040	2041-2050
China	10.4%	10.5%	7.0%	3.4%	1.9%	1.7%
USA	3.4%	1.7%	2.3%	1.7%	1.9%	1.9%
India	5.6%	7.6%	7.1%	3.8%	2.7%	2.2%
Indonesia	4.4%	5.4%	5.6%	3.4%	2.5%	2.1%
Japan	1.1%	0.8%	0.7%	1.8%	1.0%	1.0%
Germany	1.9%	0.9%	1.5%	1.2%	1.4%	1.4%
UK	2.4%	1.8%	2.0%	1.9%	1.7%	1.7%

Source: Paul Hubbard and Dhruv Sharma, ‘Understanding and applying long-term GDP projections’, *EABER Working Paper Series*, No. 119, 2016.

Chart 1: Regional Weight in Global GDP



Source: Hubbard and Sharma, 2016. Note: IMF historical data and projections are used up until 2020, after which UN Population projections are used to estimate future GDP while assuming a convergence in labour productivity to an estimated potential based on each country's current Global Competitiveness Index (GCI) score.

Implications for India

China surpassed the United States as India's largest trading partner in 2008. This is a natural consequence of China's economic transformation and India's strong growth. However, the implications of China-India commerce go beyond bilateral relations. Both Chinese investors and foreign companies that previously invested in China are looking for new investment and production opportunities in the region.

With China experiencing rising production costs and an emerging labour shortage, the countries of ASEAN and South Asia now have the opportunity to vastly increase their share in regional trade and investment. Investors already see India as an attractive investment destination, particularly due to abundant low-cost labour. Surveys conducted by the Japan Bank for International Cooperation find that Japanese

manufacturers consistently rank India as the most promising country for medium-term business development.

But success will not come automatically. India's openness to foreign investment is critical to realising this opportunity. This means not only removing direct policy barriers to investment and trade, but also building capacity in the infrastructure and logistics needed to connect India's domestic markets and to link them with the world. Integrating into global value chains is a powerful driver for labour-intensive growth, which can provide employment and higher incomes for India's growing workforce.

As infrastructure building in China slows, Chinese heavy industry will join Chinese manufacturing firms in seeking regional expansion opportunities. Nearly 40 years of rapid industrialisation and urbanisation has helped China develop internationally competitive firms across the construction, infrastructure, transportation and telecommunication sectors. The China-initiated Asia Infrastructure Investment Bank and One Belt One Road initiatives provide platforms for sharing Chinese and international finance and expertise.

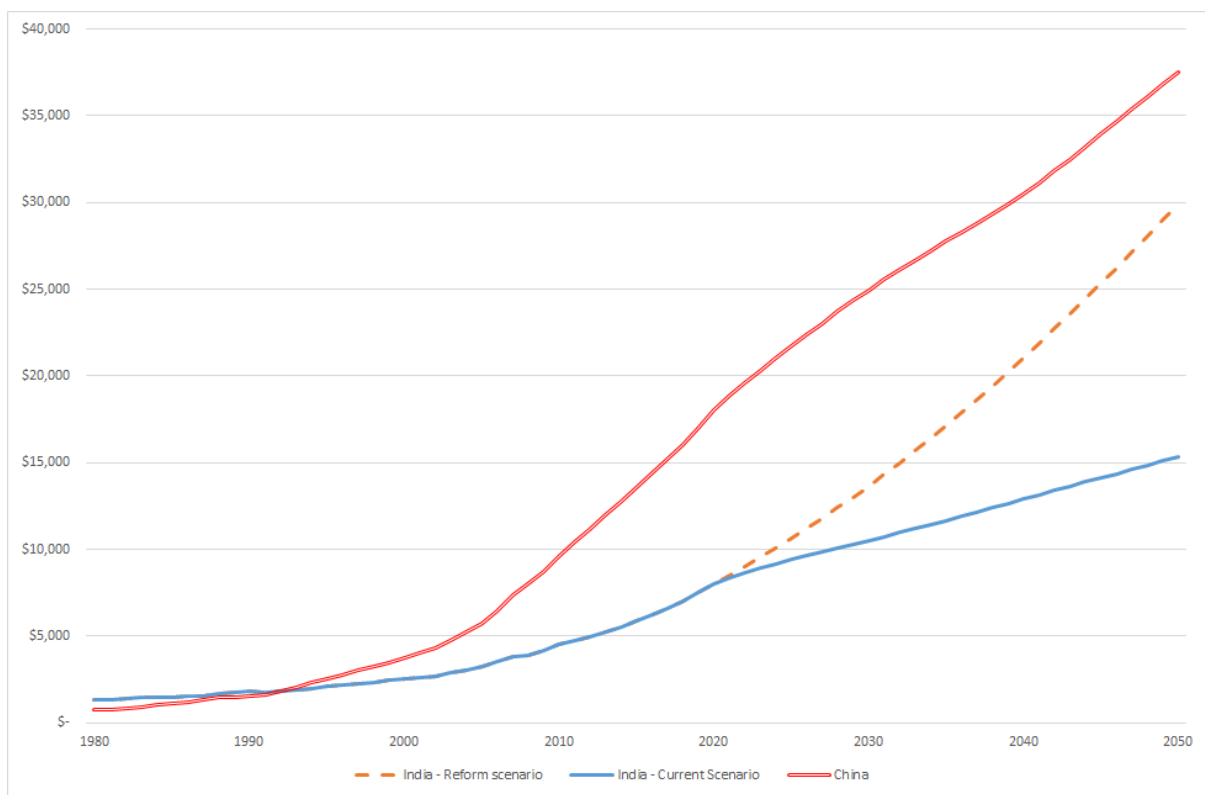
Chinese involvement in Indian infrastructure not only contributes finance and knowhow to India's development, but also lowers costs for everyone doing business in India. Putting policy frameworks in place to deliver infrastructure investment that assists in India's urbanisation — which will provide the base for a competitive manufacturing workforce — and that connects India to global markets will be critical to India's achievement of middle- and higher-income status in the future.

India's growing consumer market has already attracted meaningful investment from Chinese services, high-tech and e-commerce firms. This trend will accelerate in line with China's continuing economic transformation and progressive capital account opening. With China's opening of its services and financial sectors, India's already globally competitive services sector will also enjoy better export and investment access to China's growing middle-income population.

India's Strategic Response

Whether India can realise its development ambitions and respond to external opportunities will depend on its own domestic reforms. The quality of India's institutions and infrastructure as measured by the World Economic Forum's Global Competitiveness Index (GCI) was 4.3 for 2015-16, well behind China's score of 4.9. However, modelling shows that if Indian reforms increased the quality of its market institutions and infrastructure to the level of China, then India's GDP per capita could reach around US\$30,000 by 2050 (Chart 2, in 2012 prices).

Chart 2: China and India: Per Capita GDP Projections (2012 \$US)



Source: Hubbard and Sharma, 2016.

India's external economic diplomacy can provide momentum for these reforms. In the years preceding the election of the current government, India's economy was underperforming. Annual growth dipped as low as five per cent. This low figure reflected regulatory problems and major structural barriers to investment, including poor infrastructure and restrictive labour laws. The successful transformation of the Indian economy to achieve its full growth potential will require productivity-enhancing reforms and the further opening of Indian markets.

India can become a manufacturing superpower. But to realise the *Make in India* program, India needs to pursue labour market deregulation and other reforms that facilitate labour-intensive manufacturing. India must also reduce barriers to foreign investment and trade in order to stimulate growth in areas of comparative advantage. These areas of reform are connected to other problems such as land acquisition laws, reforming the tax system, increasing infrastructure investment and developing India's financial sector.

Make in India

The 1991 *Look East Policy* made significant progress in expanding India's trade during the 1990s. India's current reform agenda aims to address internal problems in order to spur growth and to attract foreign investment. India's new pro-growth and pro-foreign-investment agenda stands in contrast to popular economic policy in India since independence, which has typically occasioned high levels of state involvement and fostered protectionist sentiment in order to encourage industrialisation.

Yet there is huge potential for development, particularly in India's poorest states. Removal of investment barriers would mean that manufacturing in India would be able to significantly expand employment for its large and growing population. Expanding international trade share will further accelerate employment and income growth.

Restrictive labour laws have hampered India's labour-intensive industries, such as textiles, even compared with other countries in South Asia, such as Bangladesh. These laws have sustained high effective wages that choke off manufacturing growth and regional competitiveness. This malaise in labour-intensive manufacturing has led to a large unemployed population in India who are willing to work but too expensive to hire. India can now energise and re-position these industries internationally through domestic regulatory and institutional reform.

India is a labour-abundant economy and, with some 360 million people (29 per cent of the population) below the age of 15, it has a workforce that is growing rapidly and needs employment. Yet OECD analysis shows that India's manufacturing sector has

contributed little to income or employment growth and its share in total merchandise exports has been declining. Furthermore, McKinsey estimates that there will be 68 Indian cities with more than 1 million residents by 2030. In the meantime, the multitude of stalled infrastructure projects in India — estimated to be worth 8 per cent of GDP — makes it seem unlikely that these cities will be equipped with the ability to handle the pressures that come with higher population density or serve to boost productivity of the urban workforce. Surveys by global institutions such as the World Economic Forum continue to see lack of adequate infrastructure ranked as the biggest obstacle to foreign investment in India.

Under the Look East Policy, India pursued a range of economic pacts in East Asia, including a plurilateral agreement with ASEAN and bilateral agreements with Japan, Malaysia, Singapore and South Korea. East Asian markets now account for one-fifth of India's exports and a quarter of its imports, and will be an important aspect of India's economic future. The Regional Comprehensive Economic Partnership (RCEP) negotiations represent the most recent progress in India's advance to secure its trade relations in East and Southeast Asia. RCEP presents a major opportunity for India to integrate more deeply with Asian economies and to promote domestic reform. RCEP will also make it easier to engage in Asian supply chains.

The GDP growth trajectories shown in Charts 3a and 3b below highlight the trade growth potential of Asian-centred open trade arrangements such as RCEP compared with other arrangements, such as the Trans Pacific Partnership (TPP). The collective GDP of RCEP members surpassed that of TPP members in 2007, and this trend will continue to be supported by strong growth mainly from India and China.

Chart 3a: TPP Economies

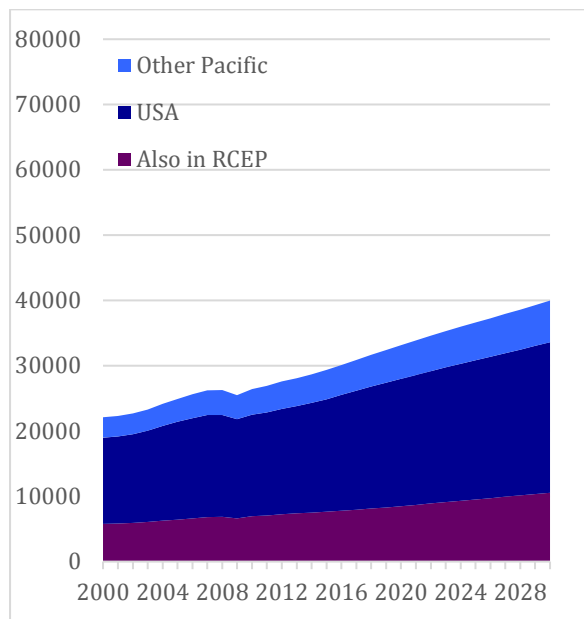
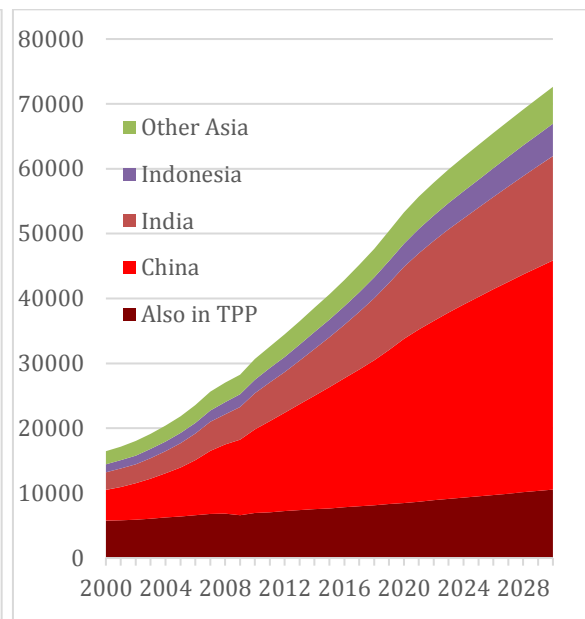


Chart 3b: RCEP Economies



Source: Hubbard and Sharma, 2016.

For India, RCEP will be important for offsetting potential trade diversion resulting from the establishment of the Trans-Pacific Partnership (TPP), the EU-ASEAN Free Trade Agreement and the Transatlantic Trade and Investment Partnership (TTIP), none of which include India. The risk of trade diversion hurting Indian industry after the signing of these agreements is significant if India does not engage in other trade deals that integrate it into the affected regions. Concerns that expanding India-China trade will come at a cost for India's manufacturing sector are misplaced, since China is becoming a far-less attractive location for labour-intensive manufacturing.

Conclusion

China's economic transition provides an unprecedented opportunity for India to reap greater gains from Asian economic integration. This will occur not only through bilateral trade and investment with China, but also through capturing flow-on effects as manufacturers and investors look beyond China. But domestic reforms are essential to harness India's comparative advantage in labour-intensive manufactures and services.