

Deloitte.

China and India: The Reality Beyond the Hype

A Deloitte Research Study

Table of Contents

Introductory thoughts	1
Just the facts	1
Sources of growth	3
Doing business in China and India	4
Foreign companies in India and China	9
Economic relations between China and India	9
Consumer markets	10
The future	10

About Deloitte Research

Deloitte Research, a part of Deloitte Services LP, identifies, analyzes, and explains the major issues driving today's business dynamics and shaping tomorrow's global marketplace. From provocative points of view about strategy and organizational change to straight talk about economics, regulation and technology, Deloitte Research delivers innovative, practical insights companies can use to improve their bottom-line performance. Operating through a network of dedicated research professionals, senior consulting practitioners of the various member firms of Deloitte Touche Tohmatsu, academics and technology specialists, Deloitte Research exhibits deep industry knowledge, functional understanding, and commitment to thought leadership. In boardrooms and business journals, Deloitte Research is known for bringing new perspective to real-world concerns.

Disclaimer

This publication contains general information only and Deloitte Services LP is not, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your business. Before making any decision or taking any action that may affect your business, you should consult a qualified professional advisor. Deloitte Services LP its affiliates and related entities shall not be responsible for any loss sustained by any person who relies on this publication.

Introductory thoughts

Why did the price of oil and other commodities rise in the last five years? Why is the US able to fund a massive external deficit without an increase in interest rates? Why have global prices of manufactured products declined in the past decade relative to other products and services?

The answer, in part, to all of these questions is simple: China. Its emergence as a global power via its integration into the global economy has had significant implications. China's strong growth has contributed to higher oil prices. Its policy of maintaining a low valued currency has meant accumulating dollars and thereby funding the US external deficit. And its massive investment in manufacturing capacity has put downward pressure on global prices and margins.

It has become conventional wisdom that China is the biggest story of our time. Now, as India goes through a similar process characterized by historically high rates of growth and further integration into the global economy, it appears that the path that China and India follow will influence the global economy and business environment. Perhaps, then, India is the next big story.

Yet China and India, despite their massive populations and growing importance, are quite different. Their economic structures, sources of growth, areas of competitive advantage, and the impact they have will remain different in the coming years.

Today, many global business leaders believe that they must have a strategy for China and India. For many, China is seen as the place to produce or procure goods while India is the place to procure business and IT services. Yet in the future this discrete division of labor might not be so clear, or even relevant. Moreover, both countries are increasingly seen as burgeoning markets in their own right, although only China has attracted significant investment in this regard.

After a long chill, China and India are developing a significant economic relationship with one another. Trade and investment are booming, potentially creating competitive challenges and opportunities for global companies based in developed countries. Moreover, this relationship will likely contribute to the rapid emergence of global companies based in India and China.

The question, then, for global companies is what to do in each country. And the answer will depend on the circumstances of each company. But surely neither country can be ignored. Yet should they be compared? Is there any basis other than the fact that they are both big and growing rapidly? Perhaps not. If comparisons were made on the basis of a true symbiosis between countries then China might best be compared with the US, Russia, or Japan, but not

necessarily India. Still, the size and sudden importance of China and India is reason enough to make a comparison. Moreover, the integration of more than one billion Chinese and Indian workers into the global economy in the past quarter century was one of the most important economic events ever. Indeed it can be argued that their addition to the global economy was, in part, responsible for the spectacular rise in productivity growth in the West. And as incomes in China and India rise, the addition of more than two billion consumers to the global economy will contribute to global growth as well.

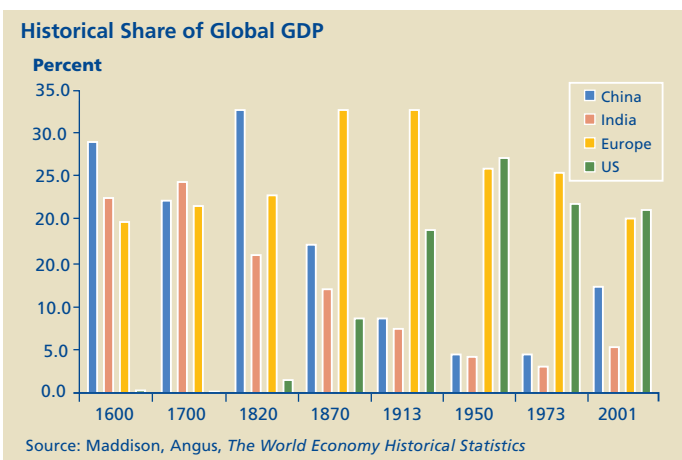
This publication offers some thoughts on the future direction of India and China, the risks and opportunities of doing business in each country, and the likely impact they will have on global business.

Just the facts

Before offering any analysis, let us first consider some basic facts.

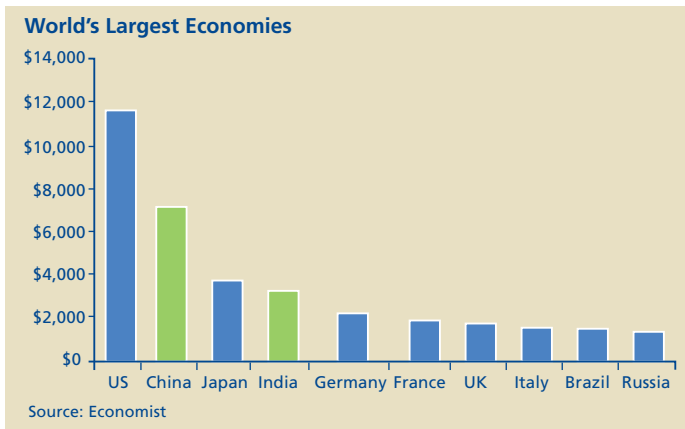
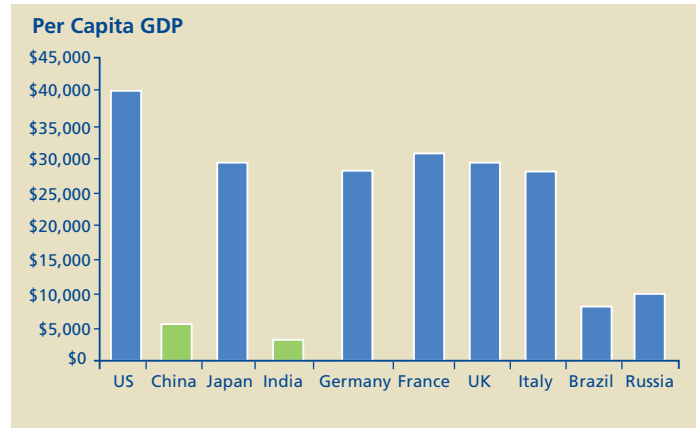
History

For much of human history, what China and India had in common was the fact that they were the richest nations on earth. Long before Europe emerged, China and India had higher standards of living and more numerous technical and scientific inventions. Yet starting in the early nineteenth century this began to dramatically change with both countries experiencing a long relative decline, eclipsed ultimately by Europe and North America. By mid twentieth century, both countries were relatively poor. The reversal of China's fortunes began in 1978 when Deng Xiao Ping came to power and instituted market oriented economic policies. India's reversal began in the early 1990s when, in response to a financial crisis, the government reversed decades of socialistic policies and began a gradual path toward market orientation. Since those policy reversals, both countries have grown rapidly. For the first time since the early nineteenth century, they have expanded their share of global GDP.



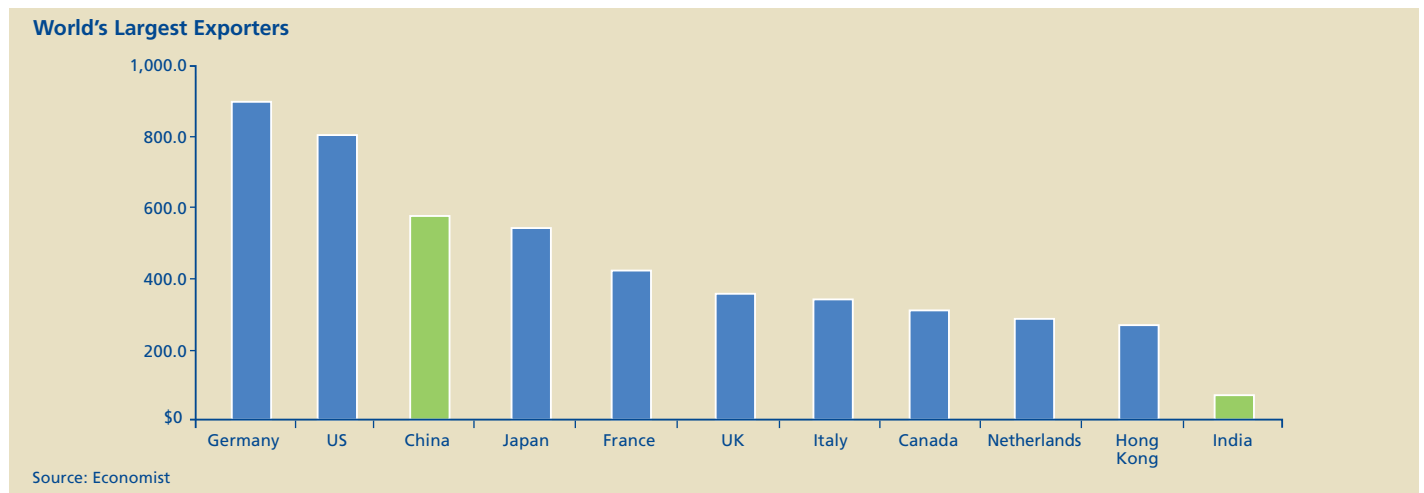
Population and income

China and India together account for nearly 40% of the world's population. The combined output of China and India accounts for almost 25% of global GDP when measured appropriately. Specifically, when GDP is measured using PPP (purchasing power parity) exchange rates which reflect the actual purchasing power of a country's currency, China has the world's second largest economy after the US. India is fourth after the US, China, and Japan. Moreover, China and India together accounted for roughly half of global GDP growth in 2005. On a per capita basis, however, China must be considered a lower middle income country with a per capita GDP roughly one seventh that of the US. India's per capita GDP is a little more than half that of China's. In addition, China's economy has grown faster than that of India throughout the period of economic revival.



Trade

In 2005, China's international trade dwarfed that of India. According to the WTO, China's merchandise exports were US\$764 billion versus US\$96 billion for India. By comparison, Korea's exports were US\$290 billion and Thailand's were US\$110 billion. Roughly 91% of China's exports were manufactured goods versus 75% for India. While India is better known for its exports of services, here again China leads. In 2004, China's service exports were US\$62 billion versus US\$40 billion for India. On the other hand, 60% of China's service exports were travel and transportation services while in India the figure was 22%. A large share of India's service exports were related to information technology and IT related services¹.



Sources of growth:

Why has China's economy grown faster than India's? Pundits offer many explanations. Some say that China's authoritarianism allows the government to make quick, unpopular decisions that are more difficult and time consuming in democratic India. For example, the Chinese government can quickly raze slums with impunity in order to build highways. India's democratic government must satisfy competing interest groups before such decisions can be made. Others suggest that India's strict regulatory environment and aversion to foreign capital diminish investment in India in comparison to relatively more open China. Still others say that China's better physical infrastructure enables more efficient and sophisticated investment than can take place in India.

Each of these explanations offers elements of truth. Yet they do not tell the whole story. Moreover, much evidence suggests they are not entirely correct. For example, China's economic takeoff in the early 1980s took place before much of the investment in infrastructure took place and even before much of China's opening to the global economy took place. Thus it would seem that India's poor infrastructure and insularity are not necessarily barriers to strong growth. In addition, although India has some grievous regulations, its capital markets are far more efficient than those of China. Indeed Indian entrepreneurs probably have a better chance of obtaining capital from local banks than their Chinese counterparts. Finally, democracy can hardly be seen as an obstacle to growth. After all, many democracies have performed exceptionally well (Japan, Ireland) while many authoritarian countries have sunk into poverty and despair (Soviet Union, much of Africa and the Middle East). Indeed in the information age, the argument can be made that democracy and the free flow of information offers an economic advantage.

Perhaps, then, it is best to consider some simple facts about growth. Economic growth is driven in large part by investment in capital. Such investment does two things. It expands the stock of capital used to produce goods and services, thus increasing the economic capacity of a nation. Second, it replaces existing capital with newer and better technology, thereby enabling more efficient production of goods and services. The new technology embedded in the replacement of capital leads to improvements in productivity, the source of most long-term growth. Thus, a country that invests more is likely to grow faster.

China's productivity growth has exceeded that of India. From 1991 to 2003, China's labor productivity rose at an annual rate of 6.7% while the figure for India was 4.2%. China has invested far more than India. In the period 1994 to 2004, Chinese investment averaged 37.5% of GDP versus 22.5% in India. China's stronger investment was due to a higher level of personal and government saving and a much higher level of foreign capital inflow. For example, China saved 39.7% of GDP while India only saved 21.9% of GDP. In part India's low rate was due to its very high budget deficit (10% of GDP in India versus 2% in China) which has eaten into national savings. So it is not surprising that China's economic growth during that period was considerably higher than that of India².

Yet that is not the whole story. For the argument can be made that, given China's high level of investment, it should have experienced even faster growth in the recent past. After all, Germany, Japan, and Korea grew faster than China during similar phases of their economic development with lower levels of investment. The problem is that China did not always invest wisely. One way to measure this is to look at the incremental capital output ratio (ICOR). This measures the extra investment needed to produce each unit of additional output. In China, the ICOR in recent years was 4.4. In India, it was 3.7. In other words, China required \$4.40 of investment to achieve \$1 of growth while India only needed \$3.70 of investment for an additional dollar of growth³.

Why the difference? The answer has much to do with the systems of financial intermediation in each country. Much of China's investment was undertaken by state-run companies borrowing from state-run banks. These companies made investments often on the basis of political goals rather than economic considerations. That is, they invested in order to create productive capacity regardless of the potential economic return. It was more important to create output and employment. And it goes without saying that markets usually allocate resources more efficiently than governments.

Moreover, China's state-run companies ate up much of the country's domestic savings. Entrepreneurs often never had a chance. Instead, to the degree that efficient investment took place, it was often due to the actions of foreign companies investing in China. Indeed it can be argued that China is excessively dependent on foreign capital despite plenty of domestic savings. In India, on the other hand, the private sector has played a bigger role in financial intermediation. Although large government deficits ate up much of the country's savings, the remainder was allocated more efficiently than in China. Small startups had an opportunity to obtain funding. The result was the creation of such companies as Wipro and Infosys. So although China's strong growth can be attributed to very high investment, China was held back by inefficient investment. In other words, China should have grown faster than it did. Notably, if China's financial system becomes more efficient, it can be argued that it can grow even faster in the future.

Another factor that has enabled China to reach a higher stage of affluence than India is the fact that more Chinese take part in the labor force – especially Chinese women. Consider the fact that, in the period 1993-2001, 53% of adult Chinese worked while only 37.7% of Indians worked. This was largely due to the lower female participation in India, itself the result of cultural factors. On the other hand, as India modernizes and more women enter the labor force, this could provide the basis for faster growth.

Next steps

Moving forward, India appears to be shifting gears in a way that should help to boost its economic growth. As mentioned earlier, investment as a share of GDP averaged 22.5% of GDP from 1994 to 2004. Yet this figure was 26.1% in 2003 and is expected to approach 30% in 2006. In addition, India has taken a number of steps to improve economic efficiency. These include a substantial reduction in import tariffs, ending a variety of anti-competitive regulations, and encouraging foreign investment in many sectors. Many analysts attribute India's recently enhanced rate of growth to these factors, while others suggest that the increase is a temporary and cyclical phenomenon. Time will tell.

China, on the other hand, is attempting to slow its economic growth. It can be argued that China's growth has been excessive, leading to overheating, inflation, and misallocation of resources. In part this unsustainable growth has been due to rapid money supply expansion, itself the result of a policy of maintaining a low valued currency. To maintain a fixed exchange rate, China must print money in order to purchase the excess dollars entering the country. The rapid expansion of money supply has fed into the banking system, causing excessive lending by state-run banks and, consequently, excessive investment. Indeed investment spending grew very rapidly in the past several years. To slow the economy, the government has discouraged some investments, curtailed some forms of credit, and started a process of currency revaluation. So far growth remains above the government's target, but this could change.

In the short run, China's growth will probably slow. Moreover, over time the preponderance of growth will shift from exports to domestic demand. In the longer run, China might achieve more rapid growth if privatization of state enterprises and state banks leads to more sensible investments. On the other hand, there are factors that could cause slower growth. For example, faster growth will involve greater demand for natural resources, increasing the price of resources and thus ultimately slowing growth. Other factors that could retard growth are China's poor health care system, onerous environment pollution, and increasing trade tensions with the rest of the world.

Doing business in China and India

What is it like doing business in China and India? What are the advantages and disadvantages of each country?

A World Bank⁴ report indicates that, on balance, there are higher costs of doing business in India than in China. Still, cost alone is not the only determinant. Otherwise there would not be so many global companies rushing into India. Let us consider various factors:

Infrastructure

One argument often made is that China's growth prospects are boosted by its relative abundance of infrastructure. Indeed China has greater modern infrastructure and spends considerably more on developing that infrastructure. For example, in 2002 China spent US\$128 billion on power and transport infrastructure compared to US\$18 billion for India. China's highway network amounts to 1.4 million kilometers compared to 200,000 kilometers for India. Finally, due to insufficient port capacity, the lead time for Indian exports to the US is roughly three to four times greater than Chinese exports.

Yet China's rapid growth in the 1980s took place before the massive investment in infrastructure. This offers hope to India with its paucity of infrastructure. On the other hand, the Chinese takeoff owed much to the proximity of facilities to modern Hong Kong. The city-state acted as a distribution depot, a source of capital, and a source of modern management and production techniques. India lacks a similar physical resource although, like China, it can tap into a large skilled diaspora. Instead, India has benefited from the satellite revolution which has enabled the easy export of digitized information rather than the more costly export of tangible products.

Consider some of the specific aspects of infrastructure issues:

Shipping

According to a commentary in Asia Times, a cargo that takes six days to travel from Singapore to Mumbai could sit in the port for 30 days before it is unloaded. The reason is that there is insufficient capacity to service today's large cargo ships at Indian ports. The problem is that the global shipping industry has undergone a technological revolution in which India has been a minor participant. Containerized shipping and consolidation among shippers has resulted in port consolidation. The major ports have invested in upgrading in order to meet the needs of larger and more sophisticated ships. Yet Indian ports are poorly prepared compared to those in China. The next generation of container ships will be 340 meters in length and 43 meters wide. These require long docks, deep harbors, and very tall cranes. China, on the other hand, already handles one fifth of the world's containers and is developing massive new ports in Shenzhen and Shanghai.

Trucking and rail

A very small share of India's roads is composed of highways. Of 3.3 million kilometers of roadway, only 195,000 kilometers are highways. China, on the other hand, has roughly 1.4 million kilometers of highway. Recently, however, the Indian government committed to a \$24 billion project to dramatically improve the country's roads as part of a larger \$150 billion program to substantially upgrade infrastructure. It is not clear where all this money will come from. After all, the government's budgetary plans call for spending only a small portion of this. Instead, some funding will have to come from the private sector. Also, the government will have to reduce subsidies in order to free funds for government investment. This is politically difficult.

Funding infrastructure

The Indian government is considering a proposal to utilize foreign exchange reserves to fund \$15 billion of infrastructure spending. There are several problems, however, with doing this. First, it undermines the credibility of the government and the independence of the central bank. The result could be higher interest rates. Second, it injects cash into the economy that could be inflationary. The government has made great progress in reducing inflation. This could reverse that progress. Third, the IMF has pointed out that inadequate infrastructure spending may be due to the regulatory environment. Simply reducing regulation may stimulate more private sector funding of infrastructure.

Regulatory issues:

Labor

Although India has promulgated considerable deregulation, there remain many laws that are a legacy of its socialist past. For example, labor laws designed to protect workers have the effect of discouraging new employment. Specifically, the Industrial Disputes Act makes it difficult to dismiss workers or to employ temporary workers. Companies with more than 100 employees require government permission to dismiss workers. As a result, factories are reluctant to take on new workers unless they are confident that demand for their output will be steady. Companies may not take on contract workers for tasks that are deemed to be permanent. Finally, workers have an eight hour day and companies cannot require more than 75 hours of overtime per quarter.

Although China has labor laws, they are not always enforced. For example, labor is restricted to 43 hours per week. Yet this is not the case in practice. Instead, Chinese factory workers tend to work 12 hour days. This difference in labor laws and practices may have enabled China to take greater advantage of the end of trade barriers in the apparel and textile industries, for example. On the other hand, national labor laws in India are administered at the state level. Some states that are less eager to enforce the law have engaged in a kind of reform by default, enabling greater job growth.

Both China and India have a critical need to create large numbers of low skill jobs. In China, two factors are creating a big increase in the supply of labor. First, migrants from rural areas are flooding cities in search of work and higher incomes. Their opportunities in the rural sector are limited. Second, as state-owned enterprises are privatized and rationalized many workers are dismissed. Social stability requires that these workers be absorbed into the market economy. In India, unemployment is high and rural areas have few opportunities. Moreover, unlike in China, the working age population is growing. Hence, there is also a need to absorb millions into the market economy.

Retailing

Another important issue concerns the role of foreign investment in the retail sector. China has recently ended most restrictions on retailing and is experiencing massive investment in modernization of the retail sector. Not so India. There, foreign investment is mostly banned and local retailers remain very small by global standards. The result is a highly fragmented industry with inefficient distribution. The importance of this transcends the retail sector itself. Modernization of retailing in China has played a role in modernizing consumer goods production and distribution thereby enabling lower costs. In India, retail liberalization would probably accelerate the process of modernization and consolidation in the manufacturing sector thereby enabling the development of world class processes.

Trade barriers

Both China and India have reduced tariffs and other trade barriers, leading to a decline in import prices and an improvement in the global competitiveness of local companies. Yet China's liberalization was much greater than India's, where the average tariff fell from 56% in 1990 to 28% in 2004. By comparison, China's average tariff dropped from 32% to 6% over the same period. This means that Chinese producers face more serious foreign competition and, therefore, must be more price competitive and more efficient producers. In addition, Indian export oriented manufacturers that rely on imported components are at a cost disadvantage. Finally, although India is beginning to have special economic zones aimed at encouraging export reprocessing, such zones do not allow free importation of components and raw materials as is the case in China.

Costs of doing business

The World Bank's analysis of costs of doing business found that, in India, it costs more and takes longer to start a business, enforce a contract, and close a business than in China. On the other hand, it found that India ranks better when it comes to obtaining credit and protecting the rights of investors. These latter factors are due to India's relatively more market driven financial system and its greater adherence to the rule of law.

Doing business indicators		
	China	India
Rank in World Bank survey:		
Starting a business	126	90
Dealing with licenses	136	124
Hiring and firing	87	116
Registering property	24	101
Getting credit	113	84
Protecting investors	100	29
Enforcing contracts	47	138
Closing a business	59	118
Starting a business		
Procedures (number)	13	11
Time (days)	48	71
Cost (% of per capita income)	13.6%	61.7%
Minimum capital (% of per capita income)	946.7%	0%
Registering property		
Procedures (number)	3	6
Time (days)	32	67
Cost (% of property value)	3.1%	7.9%
Enforcing contracts		
Procedures (number)	25	40
Time (days)	241	425
Cost (% of debt)	25.5%	43.1%
Closing a business		
Time (years)	2.4	10
Cost (% of estate)	22%	9%
Recovery rate (cents on the dollar)	31.5%	12.8%

Source: Doing Business, World Bank, 2005

Poverty reduction

China and India remain very poor countries. Yet China's relatively strong growth has enabled a more significant reduction in poverty than in India. Consider these figures:

Millions in poverty (millions of people living below \$1.08 per day in 1993 PPP prices)			
	1981	1987	2001
China	633.7	308.4	211.6
India	382.4	369.8	358.6

Source: Bardham, *Awakening Giants, Feet of Clay*, UC Berkeley, 2005

Interestingly, most of China's poverty reduction took place before China's integration into the global economy. It had more to do with deregulating the agricultural sector and allowing farmers to flourish. India's stagnant poverty numbers are somewhat misleading as the country's total population grew while the number of those in poverty did not. In other words, India made significant progress.

Demographics

China's demographics are not dissimilar to those of the leading developed countries. The birth rate having fallen, and life expectancy continuing to rise, the outlook is for an absolute decline in the number of children and young adults as well as a big increase in the number of middle aged and elderly. The end result will be a much older population. Moreover, as the working age population shrinks as a share of the total, economic growth could slow due to slow growth in the labor force barring an increase in productivity growth. On the other hand, further privatization could lead to more productive investments and, hence, faster productivity growth. Also, an older population could eventually lead to a lower personal savings rate.

In India, on the other hand, the population is much younger and continues to grow more rapidly. In the coming years, the number of young adults will continue to rise. Thus India may possess a window of opportunity for a few decades during which its growth could accelerate due to accelerated labor force growth. This depends crucially, however, on having sufficient economic flexibility to allow for the creation of millions of new jobs. Regulatory obstacles to job growth, combined with inadequate saving, high government deficits, and poor infrastructure could stymie the type of job creation India needs. Still, all other things being equal, demographics should work in India's favor.

Services

Can growth in services carry India, or must it become an industrial powerhouse in order to achieve sustainable high growth? Will China become a services powerhouse in competition with India?

Before trying to answer these questions, some facts are in order. In 2003, India's exports of commercial services other than travel, transportation, and finance amounted to US\$18.9 billion. The figure for China was US\$20.6 billion. In other words, China may already be ahead of India in selling IT services to the world. The relatively greater attention paid to India is due to rapid growth and strong investment by Western companies. Also, services account for 51% of India's GDP versus 32% of GDP for China. The figure for India is relatively high for an emerging country.

India's vaunted information technology and IT services industries contributed to 4.1% of GDP in 2005 according to NASSCOM. Yet due to the relatively high productivity of IT workers, this industry employed roughly one quarter of one percent of Indian workers. Hence IT, while having contributed significantly to India's recent growth, has not come close to resolving the country's employment problem. Moreover, while India produces some immensely talented professionals, 75% of India's children leave school before finishing 8th grade. Indeed it is expected that global firms hiring professionals in India will soon face shortages of skilled workers. Consequently, it must be said that the world is hardly flat when it comes to skills and education.

Largest services output

\$US billions 2003	
US	8,633
Japan	3,118
Germany	1,672
UK	1,306
France	1,284
Italy	1,015
Canada	610
Spain	572
China	455
Mexico	395
Korea	377
Netherlands	375
Australia	353
India	285
Brazil	260

Source: Economist

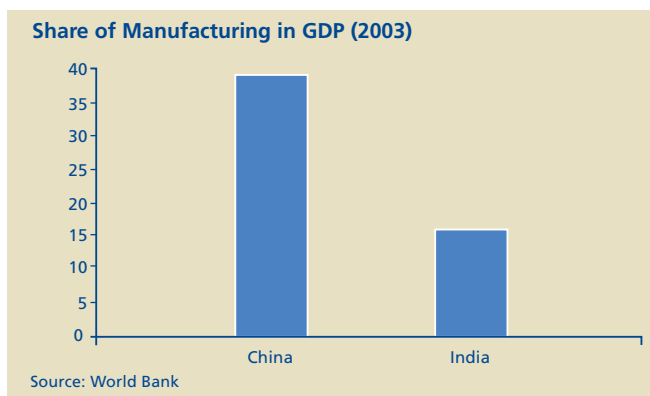
China is actually quite well placed to succeed in services. Roughly 15% of China's population aged 18 to 23 is enrolled in higher education compared to 7% in India. In addition, 91% of Chinese adults are literate versus 61% in India. Among females, the numbers are 87% and 45% respectively. In China, there are 18 pupils per teacher in secondary schools versus 34 in India. Clearly, China has an advantage when it comes to education. Yet that is not all. China spends more money on research and development, has greater ubiquity of computers and internet users, and publishes more articles in scientific and technical journals.

On the other hand, India has one great advantage when it comes to exporting services. That is the high number of fluent English speakers. Yet China's government has decreed that all students must study English after the age of five. This means that, within a generation, India's advantage could be undone. Perhaps this leaves India with a brief window of opportunity to cement its strong position in information related industries.

Despite India's great success in exporting IT related services, this industry remains a small part of India's economy and growth. If India is to maintain sustainable growth and shift millions of poor into the middle class, it is probably the case that a larger manufacturing industry will be needed.

Manufacturing

Is China the world's factory? Can India become competitive in manufacturing?



Clearly, China's success has been related to its vast increase in manufactured exports. Manufacturing accounts for 39% of China's output while in India the figure is 16%. Which is a better situation? While there is no simple answer to that question, it should be noted that the situations for both China and India are somewhat outside the bounds of what is normal. China appears to be excessively dependent on manufacturing and has a somewhat underdeveloped service sector. In part this is a legacy of communism which encouraged industrial output and failed to recognize the value of services. In part it is also due to the encouragement of large-scale investment by foreign manufacturing companies. The result is an export-related manufacturing industry characterized by high productivity, high quality, and low costs.

In India, on the other hand, goods production is relatively low by global standards. This is, in part, due to the legacy of regulations that discouraged economies of scale in manufacturing. Most such rules have been rescinded in the past 15 years. Still, the economic climate in India has been advantageous to small startups (such as service oriented companies) rather than large-scale manufacturers.

Largest manufacturing output

\$US billions 2003	
US	1,398
Japan	894
China	614
Germany	407
UK	291
Italy	216
France	213
Canada	151
Korea	142
Brazil	115
Mexico	103
Russia	103
Spain	96
India	84
Taiwan	74

Source: Economist

On the other hand, India has the benefit of very low labor costs in manufacturing. For example, in 2002 the typical monthly wage of a manufacturing worker in India was US\$23.80 while in China the figure was US\$110.80, according to the IMF. This bodes well for further development of labor intensive manufacturing in India such as textiles and apparel. Yet despite this fact, India has benefited far less than China from the liberalization of global trade in these products. In the first six months after trade quotas were abolished at the end of 2004, China's exports of apparel and textile products to the US rose 200% while those of India rose only 20%. In part this reflects massive investment in Chinese capacity in anticipation of the end of quotas. Such investment failed to take place in India for a number of reasons including poor infrastructure, labor market regulations, and a history of restrictions on foreign investment.

Monthly wages in manufacturing	
Data for 2002, US\$	
India	\$ 23.80
China	\$ 110.80
Brazil	\$ 308.80
Mexico	\$ 366.40

Source: IMF

So what happens next? Will these two countries converge, with India becoming a manufacturing hub? The answer is that, yes, India is likely to move more in the direction of manufacturing. There are a number of reasons. First, as China gradually revalues its currency and as wages in its big coastal cities rise, the cost of producing low value-added goods will become prohibitive. Some capacity will surely switch to lower wage countries such as India, especially as Indian productivity rises.

Second, now that many restrictive regulations have been removed, Indian companies will be in a better position to grow. Indeed many have already begun this process. In such diverse industries as automobiles, pharmaceuticals, and textiles, Indian companies are expanding rapidly, developing low cost processes, and creating global brands.



Financial intermediation

China has a larger stock of capital relative to GDP than India, a legacy of higher savings. The result is that China has a lower cost of capital. On the other hand, India's system of financial intermediation is more efficient than that of China, the result of a more market driven system in India. Of course India's banks hold a sizable share of assets in the form of government bonds due to India's large budget deficits. Indeed government securities account for about 30% of bank assets. Still, many Indian banks are not controlled by the government and do not lend on the basis of politics as in China. Consequently, much of China's investment spending has been wasted on projects that lack a positive economic return.

While China attracts far more foreign direct investment than India, this is necessary in order to generate growth as domestically funded investment is often wasted. Some analysts have argued that China's dependence on foreign capital is a weakness rather than a sign of strength. It could be argued that, if India saved more or ran lower budget deficits, its more efficient use of capital would drive much faster growth. Foreign capital, while attracted to India, is discouraged by excessive regulation and poor infrastructure.

Recently, credit expansion in India has been quite rapid, more so than in China. This probably reflects the much needed deepening of the financial sector. While there are risks associated with rapid credit expansion, it is useful to note that the ratio of non-performing loans to assets in India's banking system remains well below the level in China.

Looking forward, the growth of the financial sector in India bodes well for economic growth. The biggest problem seems to be the persistence of high government budget deficits which absorb so much of the country's savings. Only drastic reductions in politically popular subsidies will allow for an improvement. It is difficult to predict whether this will happen quickly.

In China, the most promising development is the effort by the government to privatize state-run banks. The biggest obstacle is the persistence of lending to loss-making state-owned companies. Only rapid privatization of these enterprises will allow for a slowdown in the growth of bad loans. This will necessarily entail dismissing workers at poorly performing state companies. Indeed there have already been literally millions of workers dismissed due to privatization. Yet much more is needed. The potential social consequences of such actions are of paramount concern to the government. As in India, the political consequences of unpopular actions may inhibit necessary reforms.

Although there has been considerable privatization of state-owned enterprises in China, in most cases the government has only sold minority stakes in the companies, thus retaining effective control. In such cases, the equity markets have been used to keep SOEs in business rather than fund true privatization. Thus, it is not clear that real privatization has truly begun.

Entrepreneurship

While China generates greater investment spending than India, India generates a large number of financially successful private companies. Indeed the overall return on capital in India's private sector is greater than that of China. In part this is due to India's relatively friendly environment for entrepreneurs. While there is much more capital available in China due to its high savings rate, much of that capital is, in a sense, commandeered by state-run institutions. This renders small businesses often unable to attract needed funds. The converse is true in India where the supply of funds is limited, but those funds are more readily available to small business.

Chinese non-state companies often rely heavily on internally generated funds for their growth due to their lack of access to bank loans. A World Bank survey of companies in both countries found that 27% of Indian investment spending was generated internally while 57% of Chinese company spending was generated internally.

There are other aspects of the business environment in China that are detrimental to entrepreneurship. For example, there is uncertainty regarding protection of property rights. This is one of the reasons that putative entrepreneurs seek relationships with foreign investors as the latter usually obtains better protection of property rights. Moreover, foreign investors can provide the capital that Chinese entrepreneurs fail to obtain from Chinese banks. Again, the latter are tightly linked with state owned enterprises.

In India, on the other hand, there is no uncertainty regarding property rights. Nor are local businesses the victims of discrimination by financial institutions. And although the legal system often resembles the Dickens novel *Bleak House*, the rule of law is respected in India.

An interesting example of the difference in entrepreneurial environments comes from the airline industry. In India, low fare airlines have suddenly sprouted, offering cheap tickets for trips between major Indian cities. Tickets can be purchased at electronic kiosks in petrol stations. It is unlikely that similarly entrepreneurial enterprises could develop in China where internal travel is tightly controlled by the government. Instead, China split its state airline into several regional carriers, all state controlled, that completely control domestic air travel.

There are, however, some examples of successful Chinese entrepreneurship. Consider the case of Gome, China's largest appliance and electronics retailer. It was founded by a young, independent investor who built it from scratch into a multi-billion dollar enterprise. Li-Ning is one of China's leading athletic footwear companies and was founded by a popular Olympic athlete. Within the realm of consumer products and distribution, entrepreneurial opportunities do exist.

Foreign companies in India and China

While India rather than China encourages entrepreneurial investment, China, much more than India, encourages foreign investment. The result is that, in 2004, China received \$60.6 billion in foreign investment versus \$5.5 billion going to India. Moreover, a sizable share of China's manufactured output and exports are produced by foreign invested enterprises.

The huge volume of foreign investment in China began in earnest in the 1980s and was largely funded by China's diaspora in Hong Kong, Macao, and Taiwan. This investment funded the growth of export related manufacturing in Southern China. In India, on the other hand, only about 10% of foreign investment has come from the Indian diaspora – although this may change dramatically in the near future⁵. Yet India's diaspora is playing a role in developing the information technology industry in India, if not with funds then with brain power. Silicon Valley in the US is flush with expatriate Indians many of whom are returning home to assist in the development of a world class industry.

Economic relations between China and India

In 2002, then Chinese Premier Zhu Rongji visited the campus of Infosys in Bangalore, India. Addressing 4,000 software engineers, he said "you are number one in software. We are number three in hardware. If we put these together, we are the world's number one."

Was he onto something? What exactly is the relationship between China and India and how will it evolve?

First, it surprised the author of this report to find that there are no non-stop flights between New Delhi and Shanghai. It also turned out to be a terrible inconvenience. It certainly symbolized the lack of a significant economic relationship. Yet this should not have been a surprise. Consider the fact that, until recently, these two countries were not on particularly friendly terms. Indeed they fought a war in the early 1960s. Since then, China has maintained close political and military ties to Pakistan, against which India fought a war on four occasions. Moreover Pakistan and India, both nuclear powers, came quite close to war as recently as 2002. So there is no love lost between India and China.

Yet today, things are changing rapidly – boding well for peace and economic transformation. Indeed, China's current Premier recently said "cooperation is just like two pagodas, one hardware and one software. Combined, we can take the leadership position in the world. When the particular day comes, it will signify the coming of the Asian century of the IT industry."

And why not? After all, until the modern age, China and India were the world's most important nations. For countless centuries, their lifestyles and technologies eclipsed those of Europe until Europe and the US emerged as global economic powers in the mid 1800s. The rise of China and India today is seen within Asia as a return to the normal order of things.

Today, trade and investment between China and India are on the rise. The volume of trade has increased roughly thirty-fold in the past decade. In 2004, China's merchandise exports to India were US\$5.0 billion, less than one percent of China's overall exports. India's merchandise exports to China were US\$7.3 billion, about 10% of India's exports. Clearly, the relationship remains small but growing rapidly.

In addition, Chinese and Indian companies are making significant cross-border investments. For example, India's Infosys is spending \$65 million to build business development centers in southern China. At the same time, China's Huawei has built a research and development center in Bangalore. There are many other similar investments taking place. The result of these investments is a rapid expansion in trade in services such as IT related services.

Still, the notion that China and India supply the hardware and software respectively is too simplistic a way to summarize their global roles. This notion stems from observing the strength of IT services in India and manufacturing in China. Yet while these strengths are real, they are not related to one another nor do they represent complementary skills. Instead, China and India are both moving toward similar goals, increasingly competing in the same industries, but at the same time trading and investing with one another. The notable thing is that the combined market size of these two countries offers huge potential for companies in each country. This means that, in the future, Western companies selling in China will face competition from India companies, and vice versa.

Consumer markets

The world's leading retailers and their suppliers have beaten a path to China, enthralled at the prospect of a billion consumers with rising incomes. Yet while no such mania has taken place in India, it is not for lack of enthusiasm. Instead, it has had more to do with restrictive regulations. Indeed the world's leading retailers are very much interested in India. Moreover, India's Prime Minister is very interested in them, recognizing that more efficient distribution can ultimately lead to vast improvements in overall economic efficiency. The problem is that the Prime Minister leads a coalition of parties, not all of which are keen on allowing foreign involvement in India's retail sector. India's retailers, of whom there are millions, oppose foreigners and the competition they would bring, and their political voice is heard. Hence, the process of liberalization will be slow and gradual at the least.

The future

What will the future bring for India and China?

- Both will grow rapidly, taking a much larger share of global GDP. Yet for the foreseeable future, it is likely that China will continue to grow more rapidly than India. In both countries, the domestic market will become increasingly attractive to global companies.
- The division of labor between India and China will become blurred as both countries excel in services and manufacturing.
- Trade between India and China will expand, enabling companies in both countries to achieve critical mass. For global companies selling in these markets, this means more local competition.
- Both countries will create new world-class companies that will be competitive with companies based in the West. For some Western companies, this will create new challenges.
- Both countries, while remaining relatively poor, will experience rapid growth of the middle class, creating vast new opportunities for Western companies to sell in those markets.



Selected Bibliography

Asuncion-Mund, Jennifer, *India Rising: A Medium-Term Perspective*, Deutsche Bank Research, www.dbresearch.com, May 2005

Bardhan, Pranab, *Awakening Giants, Feet of Clay: A Comparative Assessment of the Rise of China and India*, University of California at Berkeley, 2005

Bradsher, Keith, *Made in India versus made in China*, New York Times, June 12, 2004

Desai, Meghnad, *India and China: An Essay in Comparative Political Economy*, Paper for IMF Conference on India and China, Delhi, November, 2003

Eslake, Saul, *China and India in the World Economy*, Paper presented to the International Conference of Commercial Bank Economists, Bahia, Brazil, July 2005

Farrell, Diana and Tarun Khanna, Jayant Sinha, and Jonathan Woetzel, *China and India: The Race to Growth*, McKinsey Quarterly, 2004 Special Edition

Gordon, James and Poonan Gupta, *Understanding India's Service Revolution*, IMF Working Paper, September 2004

Greenspan, Anna, *The Great Reverse Part III: Burgeoning Sino-Indian Trade Ties May Significantly Alter the World Economic Balance*, Yale Global, September 8, 2004

Huang, Yasheng, *What China Could Learn from India's Slow and Quiet Rise*, Financial Times, January 24, 2006

Huang, Yasheng and Tarun Khanna, *Can India Overtake China?* Foreign Policy, July-Aug 2003

Kroeber, Arthur, *China and India: Myths Exploded*, China Insight, February 2006

Lal, Deepak, *India versus China*, Business Standard, March 15, 2005

Long, Simon, *Survey: India and China*, Economist, March 3, 2005

Maddison, Angus, *The World Economy Historical Statistics*, World Bank, 2004

OECD Economic Survey of China, OECD, December 2005

Special Report: China and India, Business Week, August 22, 2006

Wolf, Martin, *What India Must do to Catch up with and Possibly Outpace China*, Financial Times, March 2006

World Bank Group, *Doing Business*, www.doingbusiness.org/exploreconomies, December 2005

World Economic Outlook, www.imf.org September, 2005

World Trade Organization trade statistics, www.wto.org, March 2006

End notes

¹ The figures quoted in this paragraph come from the World Trade Organization (www.wto.org).

² The figures in this paragraph come from the International Monetary Fund (www.imf.org).

³ It should be noted that the ICOR was even lower for Japan, Korea, at similar levels of economic development.

⁴ World Bank Group, *Doing Business*.

⁵ This is according to Huang and Khanna 2003.

About the Author

Ira Kalish

Deloitte Services LP
Tel: +1 213 688 4765
Email: ikalish@deloitte.com

Ira Kalish is Director, Global Economics and Consumer Business at Deloitte Research. He specializes in global economic issues as well as the effects of economic, demographic, and social trends on the global retailing and consumer products industries. Mr. Kalish conducts research on global economic issues and has authored in-depth reports on economic and consumer issues in many of the world's major countries. In addition, Mr. Kalish has been widely quoted in the news media. His remarks have been published by The Wall Street Journal, Business Week, The Economist, The Financial Times, and USA Today to name a few. Mr. Kalish holds a bachelor's degree in economics from Vassar College and a Ph.D. in international economics from Johns Hopkins University.

Global Economic Thought Leadership

- **China's Consumer Market:** Opportunities and Risks
- **Global Economic Outlook 2005:** Will There Be a Hard Landing?
- **Quotas End, Uncertainty Continues:** Understanding the Impact of the Agreement on Textiles and Clothing
- **China at a Crossroads:** Seven Risks of Doing Business
- **The World's Factory:** China Enters the 21st Century
- **Changing China**
- **Global Recovery at Risk**
- **Globalization at Risk**

Please visit www.deloitte.com/research for the latest Deloitte Research thought leadership or contact Deloitte Services LP at: delresearch@deloitte.com.

For more information about Deloitte Research, please contact Ajit Kambil, Global Director, Deloitte Research, part of Deloitte Services LP, at +1 617 437 3636 or via Email: akambil@deloitte.com.

For Further Information, Please Contact

Global Industry Leaders

Consumer Business

Ed Carey

Deloitte & Touche USA LLP
USA

Tel: +312.374.3048

Email: ecarey@dc.com

Lawrence Hutter

Deloitte Consulting
United Kingdom

Tel: +44.20.7303.8648

Email: lhutter@deloitte.co.uk

Energy & Resources

Chris Nicholson

Deloitte & Touche LLP
USA

Tel: +1.703.251.3455

Email: cnicholson@deloitte.com

Financial Services

Jack Ribeiro

Deloitte & Touche USA LLP
USA

Tel: +212.436.2573

Email: jribeiro@deloitte.com

Life Sciences & Health Care

Robert Go

Deloitte Consulting LLP
USA

Tel: +313.324.1191

Email: rgo@deloitte.com

Manufacturing

Gary Coleman

Deloitte Consulting LLP
USA

Tel: +1.212.492.4119

Email: gcoleman@deloitte.com

Katsuaki Takiguchi

Tohmatsu & Co
Japan

Tel: +81.3.6213.3631

Email: ktakiguchi@deloitte.com

Public Sector

Greg Pellegrino

Deloitte Consulting LLP
USA

Tel: +617.850.2770

Email: gpellegrino@dc.com

Prof. Dr J. (Hans) Bossert

Deloitte Netherlands
Netherlands

Tel: +31.0.70.3372413

Email: jbossert@deloitte.com

Telecommunications, Media &
Technology

Igal Brightman

Deloitte Brightman Almagor
Israel

Tel: +972.3.608.55.00

Email: ibrightman@deloitte.co.il

Global Chinese Service Group

John Jeffrey

Deloitte & Touche LLP
United States of America

Tel: +1.212.436.3061

Email: jjeffrey@deloitte.com

Clarence Kwan

Deloitte & Touche LLP
United States of America

Tel: +1.212.436.4732

Email: clkwan@deloitte.com

Peter Bowie

Deloitte Touche Tohmatsu
China

Tel: +86.21.6141.1688

Email: pbowie@deloitte.com.hk

Chris Lu

Deloitte Touche Tohmatsu CPA Ltd.
China

Tel: +86.21.6335.0202 ext. 1003

Email: chrislu@deloitte.com.cn

Chris Fitzgibbon

Deloitte & Touche
United Kingdom

Tel: +44.20.7007.1827

Email: cfitzgibbon@deloitte.co.uk

About Deloitte

Deloitte refers to one or more of Deloitte Touche Tohmatsu, a Swiss Verein, its member firms and their respective subsidiaries and affiliates. Deloitte Touche Tohmatsu is an organization of member firms around the world devoted to excellence in providing professional services and advice, focused on client service through a global strategy executed locally in nearly 150 countries. With access to the deep intellectual capital of 120,000 people worldwide, Deloitte delivers services in four professional areas, audit, tax, consulting and financial advisory services, and serves more than one-half of the world's largest companies, as well as large national enterprises, public institutions, locally important clients, and successful, fast-growing global growth companies. Services are not provided by the Deloitte Touche Tohmatsu Verein and, for regulatory and other reasons, certain member firms do not provide services in all four professional areas.

As a Swiss Verein (association), neither Deloitte Touche Tohmatsu nor any of its member firms has any liability for each other's acts or omissions. Each of the member firms is a separate and independent legal entity operating under the names "Deloitte", "Deloitte & Touche", "Deloitte Touche Tohmatsu" or other related names.

In the US, Deloitte & Touche USA LLP is the US member firm of Deloitte Touche Tohmatsu and services are provided by the subsidiaries of Deloitte & Touche USA LLP (Deloitte & Touche LLP, Deloitte Consulting LLP, Deloitte Financial Advisory Services LLP, Deloitte Tax LLP and their subsidiaries), and not by Deloitte & Touche USA LLP. The subsidiaries of the US member firm are among the nation's leading professional services firms, providing audit, tax, consulting and financial advisory services through nearly 30,000 people in more than 80 cities. Known as employers of choice for innovative human resources programs, they are dedicated to helping their clients and their people excel. For more information, please visit the US member firm's web site at www.deloitte.com/us.