Adjustments to the Global Economic Crisis by India and China

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Purpose of the Study

The re-emergence and growing influence of India and China as economic powers is now widely accepted. The global business revolution that has been unfolding in India and China over the past 15 years is currently also having, and will continue to have a major impact on the economies of the US, the EU, and on other parts of Western Europe, Africa, Latin America and South Asia over the next two to five decades; albeit in varying degrees. However, the difference in performance on measures of human development as well as adjustments to the present crisis could shape the future progress of both countries.

This discussion paper aims to address a number of pertinent issues in relation to the possible outcomes and adjustments being made by India and China in response to the current global economic crisis. The range of questions for which answers will be sought, include, for example, to what extent the crisis is derailing the development achievements in China and India? In what ways are the development malaise manifested (i.e. rising poverty levels, inequality and deterioration rural development programs, education, health and unemployment)? What have been, and are likely to be the outcomes of the stimulus packages in both countries? Is the current global economic crisis likely to increase political instability in Asia and the threat of war? If so, what might provoke such an outcome? What are the international implications of China and India becoming more influential in terms of their rising percentage share of global GDP growth? Is the Renminbi likely to become a regional currency without being floated as an official global reserve currency? Can the two countries compensate for declining demand in export markets through consumption driven growth given the enormity of their internal markets? Are foreign investments likely to be discouraged by both India and China as a result of the crisis and a more inward oriented focus? If yes, will this not lead to retaliation and protectionism? Will the current crisis contribute towards greater cohesion and support of ASEAN by India and China or will it lead to decoupling in Asia, led by China and India? What useful trends (empirical data from the World Bank, the IMF and OECD) do we have to guide us to better understand the magnitude of the tasks that lay ahead for Asia's emerging giants?

The structure of the paper is as follows. The first section focuses on the impact of the crisis on Asia's emerging giants and exposes some the direct ramifications that it is having on the lives of the general population in both India and China. The second section sets out to highlight the type of reforms and changes in government policy that India and China will need to implement in order to overcome the current global economic downturn. The third section draws attention to the present, as well possible future challenges in international relations that China and India are likely to confront. Finally, section four offers some concluding observations and remarks.

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1. THE CRISIS

Collateral Damage on Emerging Asia from Failure of Western Financial Markets

While several Chinese sovereign wealth funds have lost US$ billions by investing in US banks such as Morgan Stanley and Lehman Brothers, on the whole, the sub-prime crisis and toxic assets in the US and in Europe have not directly affected the Chinese economy. The speculative bubble in the luxury housing market in major urban areas of China has also burst, but given that over 12 million migrants gravitate annually to different Chinese cities, the demand for a different type of housing will at least partially absorb decline in demand in the high end housing market. On the other hand, the sharp drop in demand from the US, China's key export market, is clearly having a detrimental indirect impact on employment. China is fortunate to have a number of internal solutions to combat the crisis including, domestic demand and fiscal balance. Private consumption is still less than 50% of GDP. Hence the government is taking measures to increase consumption. The government's fiscal package increases spending on education, health and pensions to 5% of GDP. A US$ 586bn central government initiative in new infrastructure projects will also ensure that economic growth is not derailed. China is a net oil importer and benefits from the drop in oil prices. Lower inflation permitting the central bank to lower interest rates and the reserve requirement ratio may also contribute to growth. The decrease in exports does pose a risk to China, but possibly not a very high one given that the nature of production involves majority of inputs being imported from neighboring Asian countries. Therefore, the fallout of the crisis will greatly harm China's suppliers of inputs (La Caixa Monthly Report, 2009). Moreover, according to Jonathan Anderson, at UBS bank (The Economist, January. 3ed 2008), China's growth is not as highly dependent on exports as commonly thought, than it is to productivity gains. Labor productivity is around 7-8% and average annual growth total factor productivity has been in the region of 4% (by far the highest in the world) over the last two decades (see Chart 1).

While the major Indian IT companies such as Infosys, Wipro and Tata Consulting Services have been hit hard by the financial crisis, due to the fact that many of the loss making US financial institutions were their key clients, on a national scale, India is protected from the decrease in global trade, as exports form a relatively smaller part of GDP. The drop in oil prices will also benefit the country and reduction of subsidies on fuel contributes to the government's ability for maneuver. Nevertheless, India and also China should expect to receive less investment flows, resulting in less liquidity in the financial system, but, the drop in inflation has led to the government's ability to reduce the interest rate and reserve requirement ratio. Moreover in China, the government has released a stimulus package amounting to more than 16% of GDP (1,5% in India) to be spent in 2009 and 2010.

In sum, these policies should enhance the national economic development goals for both countries, but instability and uncertainty around the effectiveness of the stimulus package, coupled with the fact that emerging markets in the region are plagued with liquidity problems raises serious concerns. The risk of rising inflation and demands for currency appreciation adds yet more pressures.

The Impact of the Global Financial Crisis on Poverty Control and Employment

An Estimated 470 million and 827 million people earn less than $2 a day in China and India, which represents the median poverty line for all developing countries. A decline in growth prompted by the recent global economic crisis in China and India, even if in relative terms substantially lower than in OECD countries will surely have a damaging effect on poverty alleviation, unless concrete policies are employed (such as those carried out in China's rural areas mainly to support consumption in non durables), to curtail the knock on effects of gross indulgence by the very wealthy on the lives of the very poor (Bajoria, 2008). The rising prices of basic food items could exacerbate poverty in both China and India. Hence a subsidization program to ensure that essential food items reach the neediest groups should be seen by policy makers as paramount to avoid social and political backlash. In both India and China, a major destabilizing aspect of the global economic crisis is the rise in unemployment. Hundreds of thousands of migrant workers from rural India have had to return back to the countryside due to loss of work produced by declining demand in export markets. Research by Vashist and Pathak (2009) reveal that merchandise exports dropped by 17% from October 2008 to May 2009. Meanwhile monthly figures in December 2009 show that the drop in exports from its peak in July 2008 are still high 23.3% (but lower than 43.6% registered in April 2008). In China, from the onset of the crisis in September to the end of 2008, more than 20 million migrant laborers had lost their jobs due to a decline in demand in export markets. It is estimated that around 25 percent of China's 6.1 million new college students in will be unable find work when they graduate in 2009 (Pei, 2009). The political legitimacy of the Chinese Communist Party, as Minxin Pei rightfully points out, rests on ensuring that economic needs of the masses are satisfied, and more concretely, on controlling the decline of job losses and creating new employment opportunities so that millions of rural migrants are not discontented and ready to carry out protests and demonstrations. If high growth rates are sustained in China in spite of the crisis and the growth rates of developed economies remain bleak for the next three to five years, the likelihood of protests against restricted political freedoms, social and individual liberties are likely to be slim even amongst the Chinese youth. In such case, overheating and currency pressure will be the greatest danger. However, in the event that the stimulus package is withdrawn too soon and growth rates decline substantially in China, neighboring India and the international community in general should expect internal instability in China, and subsequently also within the region. Human rights violations would grow ten fold as millions of protesters battle it out with security forces of the state. The greatest danger in such a scenario is that China may become too focused on controlling domestic unrest and internal political objectives at the expense of absolving its growing responsibility in the region and to the international community, particularly when global demand is for China to play a more active role on issues such as climate change, monetary policy and reducing macroeconomic imbalances (Pei, 2009).

A major drop in exports brought about by the current financial crisis and contraction in western markets has led to the closing down of 67,000 factories across China during the first half of 2008, producing nationwide street protests by laid off workers. (Bajoria, 2008).The Impact on the industrial sector in India has been less severe, as much of India's growth over the past decade has come from the service sector. Nonetheless, both countries are experiencing a massive exodus to rural areas by millions of migrant workers, with no clear signs for the vast majority of returning to urban centers anytime in the near future to earn a more stable living. Poverty levels in China and India have been brought down substantially over the past two and a half decades. No other country in the history of human civilization has been as successful has China in pulling out over 600 million from extreme poverty (those earning less than $1 a day) in such a short span of time (since 1981). This was achieved largely through sustaining 10 percent growth rates since the beginning of the 1980's. India with a 6.2 percent average annual growth over the same period has also succeeded in uplifting 30 million people out of abject poverty. Nevertheless, the World Bank maintains that approximately 100 million Chinese and over 250 million Indians remained under the extreme poverty line in 2005. Kumara and Jayaskera (2009) report that,

"While the Indian and world corporate elite have made much of the 9 percent annual growth India experienced for four successive years beginning in 2004-5, the reality is that the gains of India's boom flowed almost entirely to big business and more privileged sections of the middle class. Rural India, meanwhile, has been ravaged by the flip side of the pro-investor policies pursued by successive Indian governments. State investment in agriculture has been slashed, so governments can lower taxes and pursue the megaprojects required by big business to make India a cheap-labor producer for the world market. Agricultural price supports and subsidies for fertilizer and other inputs have been pared back or eliminated."

A reorientation of focus is hence urgently needed in practice by the incumbent government of Manmohan Singh to ameliorate the growing inequality between urban and rural India and to reduce poverty levels.

2. REFORMS

Political Challenges Facing China

China and India are enjoying sustained economic growth in spite of the current global economic crisis. There are of course serious problems facing both countries in terms of the distribution of wealth. Government policies in areas such as public education, health and social welfare need urgent attention. Otherwise the widening disparities in living standards, in per capita income and well-being in regions within these two countries, between rural and urban areas and within urban areas could result in disastrous consequences which could threaten social and political stability.

China's ruling Communist Party, led by President Hu Jintao, wants continuing economic liberalization and sustainable economic growth alongside enduring political control. The biggest domestic challenge the Communist Party faces are the tens of millions who have lost out since economic reforms began in the 1970s. Economic prosperity has been uneven; many rural areas, outskirts of cities and inland regions have been “left out” from the development gains, creating huge populations of unemployed and disadvantaged citizens who constitute a political liability. Wang (The Chinese Academy of Sciences' and Institute of Psychology) estimates, China had more than 80,000 riots and demonstrations in 2007, a huge increase from 10,000 in 1993. In September 2004, a survey of Chinese scholars and think tank analysts reported that China would likely experience serious social unrest as a result of a combination of social challenges including environmental problems, corruption, a weak financial system, poverty and unemployment. “Accordingly, the balance of economic development is being tipped towards social priorities” (Political Forces, 2005). The rural poor are receiving much more attention, particularly through tax reduction, and cleaning up government corruption is another priority.

Required Educational Reforms in China and India

China’s education system is the biggest in the world, but only a very small percentage of the vast number of university graduates possess the necessary skills and knowledge to be employed for firms specializing in export markets (Farrel, Grant; 2005). China’s educational system is overly biased towards theory, with too few graduates having the necessary practical skills to work in a multinational environment. Poor English and lack of team work experience are other reasons contributing to the perceived weakness of Chinese tertiary level graduates. This shortage of homegrown talent will place limitations on both the ability of domestic firms to globalize and also potentially restrict China’s ability to develop world class service sector companies. An additional problem that China needs to address is the lack of accessibility to primary and secondary education being granted to families of rural migrant workers in major cities. Though the laws on mobility has been uplifted for people to move freely throughout the country to look for stable employment, the rights of individuals are restricted to public services offered by the city if they are not registered residents. Migrant workers from rural China are not automatically eligible to become residents in major cities. This policy foments rather than reduce inequality between citizens of rural and urban China.

While India has a core of highly skilled and educated workers, it too needs to significantly improve many aspects of its education system. An educated and skilled labor force is a critical part of a developing economy, but even more so for India as it aims to exploit its knowledge economy. While India has made substantial progress in literacy and school enrolment rates, it still has the largest number of illiterate people in the world and the participation of girls in elementary education is low. Other areas that India needs to invest in order to educate a large pool of agile and skilled workers is to encourage more on creative learning, rather than on schooling, and focus more on practical skills rather than theory, which has created a “mismatch between education and the labor market.” (World Bank, 2005). The record on education in India however is even more worrisome in many respects than that of China. The high drop out rates at a primary and secondary school level mean that approximately only 10% enter into higher education. Moreover, around 70% of those who do enter higher education end up pursuing studies in law, literature, history and other liberal arts subjects, thus making them less prepared for the job market in technical fields which India is so well reputed in

(Kumar et al, 2007). The gender disparity in India in the area of education is lagging considerably behind that of China. More than 70% of the female population of highly populous states, such as Bihar, with over 100 million inhabitants, is illiterate. Such trends clearly harm India's hopes for balanced future growth and development. Approximately 44% of the country's over one billion population resides in seven of the poorest states such as Bihar, Uttar Pradesh, Jharkhand, Orissa, Assam, Madhya Pradesh and Rajasthan. One of India's major problems is that it places an excessive amount of priority on the service sector. This sector cannot absorb the surplus supply of labor in agriculture. Manufacturing sector development therefore has to be sought to balance the spread of employment creation in India. Both countries will also have to find ways to avoid the loss of brain drain caused by their most gifted scientists relocating to Europe and the US to carry out advanced degrees. Innovation can only be achieved through an expansion of investment in higher education and in R&D. Both countries will need to find ways to provide the right incentives to keep their brightest minds from immigrating to industrially advanced countries.

The crisis will play an important role here. Only sectors with high productivity will maintain strong demand for labor. On the one hand, this may offer strong incentives for the State and private entrepreneurs to promote such sectors and subsequently the skills and know-how, and therefore economic growth. On the other hand if the educational gap persists and incentives are not guided properly, the greatest part of the population could be left behind.

China's Goal of Political Harmony through Focus on Social Welfare Protection

As a result of the total collapse in GDP of western economies brought about by the most recent financial crisis, it is increasingly clear that the growth prospects of the global economy over the next 25 years depend heavily on Asian growth, and especially so on China and India's growth. In both these countries, the growth story will increasingly be about consumption, though India has been focusing on such a strategy since it began economic reforms in 1991. Between 2003 and 2007 the majority of the increase in consumption came from the G3 economies, the US, Euro zone and Japan. Consumption growth in the G3 over the next few years will be anemic at best (though recent trends in the US cast some doubts on this line of reasoning), leaving emerging Asia to pick up the slack, and China definitely has the potential to fill this vacuum. An additional five percentage point increase, for example, of private consumption in China would have meant China offsetting the poor consumption trends of the G3 during the current crisis. There are several reasons to believe that consumption, particularly in China is going to increase, not least because it could hardly get much lower. At a mere 37% of private domestic share of GDP in 2008, consumption in China is the lowest of any large economy (see Chart 2). The figure for the US and Mexico is 71% and 73% , while in Brazil and India, the share of consumption in GDP is 65% and 57% respectively over the same period (Garcia-Herrero and Peters 2010, forthcoming)

Two major underlying factors should accelerate this re-balancing trend in China towards a more consumption driven economy over the next few years. Those factors will come emanate from the Central Government because what China understood from the Asian financial crisis was that liberalization is not as important as prudence or guiding the market is. China’s response to the crisis is going to be continued presence of state owned enterprises and active public sector, as has been the case for the past three decades. Concrete policy measures are being taken by the central government to improve the social safety net and to reduce corporate savings, and such steps will no doubt act as major instruments to foment consumption. One of the main reasons for low consumption in China is that Chinese households tend to save a lion share of their earnings. Gross household savings have averaged in the region of 20% of GDP over the last few years. Thus far, the lack of a social safety net combined with the one-child policy has meant that most people have resorted to precautionary savings in order to support themselves during retirement age. Due to the low penetration of even basic financial products such as life insurance, most households end up saving in excess. The Chinese government has designed several policy measures to increase the social safety since the onset of the recent financial crisis. For example, it has pledged to provide medical insurance to 90% of the population over the next three years (using 1/5 of fiscal stimulus package of $586 billion). A three-pillar pension system has also been introduced in urban areas and a plan is now being worked out to provide pensions for rural residents Plans are starting to be developed to make education financially more accessible to all students, thus reducing the need for parents to save for their children’s college education. Affordable housing has become a top priority for the government (over 5% of the fiscal package has been devoted to it) not only to support growth but also to help develop a middle class in China. An increase in home ownership rates could thus lead to increasing consumption, not just through the “wealth-effect” of owning a home, but also through increased spending on home improvement (Garcia-Herrero and Peters, 2010, forthcoming).

In the developed Asian economies (Taiwan, Korea, and Japan) consumption as a share of GDP increased gradually as per capita GDP increased. China’s GDP per capita has long been nearly at subsistence level, which is generally associated with a low share of consumption to GDP. As GDP per capita increases in China over the next few years, it is likely to follow the same well-trodden path as its Asian peers, and consumption as a share of GDP will gradually increase.

Most of the increase in Chinese savings has also come from the corporate sector. The notable increase in corporate savings, from 2002-2007 is mainly due to the rising profitability of state owned enterprises (SOE’s), which have not distributed their excess profits back to the government. This has started to change since 2007, where 10% of profits have to be paid out as dividends to the government. More steps in this direction over the next few years will help ease government pressures (Garcia-Herrero and Peters, 2010, forthcoming).

The strong consumption oriented focus by both China and India suggest that these two large emerging markets can no longer be relied up on simply as destinations for outsourcing of low cost manufacturing and service sector work. Western companies will need to learn how to sell products and services to these large economies rather than to just export products and services from these countries.

Key Drivers of the New Consumption Driven Growth in China

Though the economic reforms ushered in by Deng Xiao Peng in 1978 has undoubtedly facilitated greater privatization of the national economy, it is still hard to determine in any sort of clear way as to what extent Chinese private entrepreneurs have witnessed visible improvements in their ability to set up and run successful businesses. Although productivity gains have been important, according to Zha Daojiong, Professor of Political Economy at the International University of Beijing, the productivity rate of, for example, an auto worker in China is still only 20 percent of that of his counterpart in Japan (Zorilla, 2006, p.53). Low productivity in China is attributed by Zha to the excessive role played by the state in keys sectors of the economy. The Chinese economy continues to remain highly interventionist in the first decade of the 21st century, in spite of the fact that the general perception is to the contrary. To substantiate this claim, Zha points out that the state has monopoly control in a number of key areas such as, alcohol, tobacco, telecommunications, railways, aviation, petroleum and other strategic industries (ibid, 2006. p.53), for example, such as in banking. The visible and excessively interfering hand of the state can even be seen such small scale businesses as the taxi industry in Beijing. The taxi business in China is cited as one of the most regulated and controlled in the world. How so? Firstly, the cost of obtaining a taxi license is said to be exorbitant. Secondly, taxi drivers are required to hire their vehicles from a specific company that the state obliges them to work with. Thirdly, authorization is required by operators from state regulators to replace an existing taxi with a new one. Fourthly, the make and model of the car to be used as taxis is decided by the state. The taxi driver has no say whatsoever with the brand he would like to have for his car (ibid; p.53). Zha insists that the core of the problem with low productivity in China is directly linked to the lack of institutional reform in the political arena. He asserts that, individuals who normally take decisions on policy matters related to business strategy in China are between 50 and 60 years old. This means that they were either educated in the former Soviet Union or they received their training during the Cultural Revolution. If it were the latter, which is the case for most decision makers in China today, it is unlikely that they got much of an education according to Zha, because studying anything other than Maoist ideology was outlawed in China between 1966 and 1977. From the Communist Party of China's standpoint, the ability to read and write is all that was required to become familiar with Mao's ideas and to learn from his wisdom. Coupled with the fact that most of the current decision makers in China come from humble social class backgrounds without any tradition in education, it is unsurprising to Zha that the end result of policy making is nothing short of corruption and ignorance. He argues that the communist party is the spinal column of China. Even at a technical level, one has to belong to the communist party in order to take important decisions. Zha maintains that leadership within the Communist Party of the People's Republic of China is not based on meritocracy. In order to ascend within the party, seniority (old age) and loyalty to the party oligarchy is much more important than merit. As a result, it is very hard to see any signs of real innovation within Chinese firms. China may be able to send rockets to space, but they are unable to solve problems associated with water leaks in household and public latrines (ibid; 2006, pg 53-54). Any real hope for China to modernize, become innovative and develop its own competitive industries in a continually globalizing world, according to Zha, will only take place after the XVIII Party Congress in 2012, when those such as Hu Jintao, the current President of China and members of his generation who were educated during the Cultural Revolution will have retired from politics. Current encouraging signs however can be seen in the fact that prominent members of the Chinese business community are now being allowed to form part of the central government apparatus (ibid; 2006, p.61). One of the important outcomes of the current financial crisis is that it has legitimized the role of the Chinese State in effectively managing the economy. Hence, what we are likely to witness over the next three years at least, until the change of guard in 2012 and the replacement of Hu Jintao, is an increase in the role of the state, with a greater focus on self-reliance as opposed to export led growth and dependence on foreign direct investment. This policy of heavy state control may become more accentuated depending on who takes over. (Summers, 2009).

Xi Jinping and Li Keqiang, are seen as the leading candidates to succeed Hu Jintao and Wen Jiabao respectively in 2012. President Hu's goal for the remainder of his term in office will be to uphold the necessary political clout so that the transition will be smooth and free of uncertainty and instability. His economic aims are likely to be short term in nature. For the various aspiring candidates however, the process of transition might offer a unique opportunity to radically reform the existing system through ushering in major political and social reforms. Such a contrasting stance could severely undermine the authority of the state and inadvertently provoke further political instability. (Pei, 2009)**.**

Important lessons could be learned by China from looking to its neighbour India, on how to promote private entrepreneurship amongst the local population rather than to be overly dependent on foreign direct investments. India meanwhile could also learn from China on how to develop its manufacturing sector more and to encourage foreign investment, but without becoming overly dependent on this source as major driver for GDP growth, as the service sector boom is not going to be sufficient to absorb India's surplus labour force.

Environmental Challenges

China's economic development, based on manufacturing sector growth, over the past two decades has produced serious environmental problems, which in turn are creating a range of other social, political and economic challenges. Skyrocketing rates of air and water pollution, severe land degradation, and increasing resource scarcity are all creating huge pressures. China's reliance on coal for three quarters of its energy has made its air quality among the worst in the world. In 2001, the World Bank reported that 16 of the 20 most polluted cities in the world were in China. Acid rain, resulting from sulfur dioxide emissions from coal burning, affects over one-fourth of China's land. Unregulated economic development has also contributed to the devastation of China's forests. However, "China's dramatic growth in automobile use poses the greatest future threat to China's air quality. China today has over 20 million cars, trucks, and buses; 20 million agricultural vehicles, and 50 million motorcycles. By 2020, conservative estimates suggest that China will have 110 million cars." (Elizabeth, 2004)

However, the most serious environmental challenge China confronts is access to water, which stems from both growing demand and rapidly increasing levels of pollution. Approximately 700 million people drink contaminated water on a daily basis. More than three-quarters of the water in China's urban areas is considered unsuitable for drinking or fishing. China's water pollution problems were demonstrated in November 2005 by an industrial accident which contaminated a river and left four million residents in Harbin (a major city in the northeast) without water for several days.

China's leadership has recently realized that its environmental practices are having a significant negative impact on the economy. The World Bank reports that the cost of environmental pollution and degradation in China is equivalent to 8-12% of GDP annually. Lost days of work, contaminated crops and fisheries, and industry closures due to lack of water all contribute to such costs. The prospect of social unrest is causing the government to pay closer attention to the environment. As early as the mid 1990s, the Central Committee of the Chinese Communist Party published a report acknowledging that environmental degradation and pollution was one of the four leading causes of social unrest in the country. Moves towards more sustainable development is also supported by academic studies. The "Environmental Kuznets Curve" suggests that as an economy grows and wealth increases, governments allocate more resources to environmental protection. "Rising per capita income spurs consumer demand for luxury goods, including environment protection. Consumers will spur a shift in production away from environmentally very stressful heavy industrial production to the production of environmentally less stressful consumer goods and services." (Peters, 2005) The early signs of this trend are already underway in China.

3. INTERNATIONAL RELATIONS

Status of Bilateral Relations between China and India

There is a notable increase in the body of literature in scholarly journals about China and India and the supposed rise in competition between these two countries along with speculations about the likely winner of the race in the medium to long term (Gibb and Li, 2003; Majumdar 2004; Arora and Athreye, 2002; Contractor and Kundu, 2004; and Srinivisan 2004). Often, erroneous assumptions are made suggesting that China and India are bitter adversaries. Whilst it would be inaccurate to suggest that they do not fear each other at all at a military level, particularly given the relatively recent history of border disputes, the most salient one being the war in 1962, it would be a gross mistake to draw the conclusion that a military threat from each other once again is the main concern that occupies policy makers. This somewhat narrow debate overshadows other relevant issues, such as the growing trade between them. Though there is a healthy amount of competition between China and India to aspire to be the leading player in Asia, most analysts tend to completely overlook that there is also a considerable rise in cooperation and trade between these two countries. For example, the bilateral trade figures between India and China amounted to $43 billion in 2009. This is a notable rise from the year 2001, when bilateral trade figures amounted to a meager $1.2 billion. China for example, surpassed the US and the EU to be India's main trading partner since 2007. The debate over the so called rising competition between China and India also downplays important lessons that both countries could learn from one another, about the benefits of bilateral cooperation as means to reduce the possibility of geopolitical conflicts (ie. such as over access to global energy supplies) and about the positive or adverse impact their re-emergence as global economic powers could have on other countries both within Asia, the EU, the US, Latin America and Africa. To further illustrate the growing closeness between China and India, it may be worth highlighting that as recent as 2002, there were no direct flights between China and India. As of 2007, there are 22 weekly direct flights between major cities in China such as Beijing and Shanghai to Delhi and Mumbai. There are also over 90 Indian companies from various sectors such as pharmaceuticals, IT and automobile components that have registered offices in China as of 2005. As a result of the rise in global demand for IT specialists, more than 25,000 Chinese software engineers have received their training from NIIT, one of India's major software engineer training companies, that has 170 training centers across major cities in China. The FDI's have not been strictly unidirectional in the recent cooperation and growth in bilateral trade between these two Asian countries. Leading Chinese companies such as Huawei Technologies and TCL, specialising in telecommunications and household electronic components have also invested approximately $250 million in setting up production facilities and R&D centres to serve as suppliers to the rising middle class in India and to remain internationally competitive (Peters, 2005).

Impact of China and India's Rise on Industrialized and other Emerging Economies

Irrespective of the current global economic crisis, the adverse or positive affect of India and China as global players varies across countries. For example, Eastern European countries such as Poland, Hungary and Slovakia who have recently gained accession to the EU are likely to suffer more than say, France Italy or Britain, that are producers of technologically advanced goods such as luxury cars, commercial aeroplanes and household electrical components. The mentioned East European countries suffer more because of the export of jobs due to the comparatively lower cost and abundant supply of skilled labour in China and India in manufacturing and services. Boeing, Airbus, Volkswagen, GM and Siemens are the type of multinational firms from industrially advanced countries that are benefiting from China and India's economic rise. The potential for accessing the large internal markets within these two Asian countries, in addition to producing and exporting to other markets in Asia and Europe also mean that East European and other Asian countries which specialise in traditional industries such as textiles and footwear have also suffered rather than benefited from the rise of China particularly. On the other hand, the rise of China and India as major global players has also resulted in higher GDP growth rates in commodity exporting countries from Africa and Latin America that are feeding the industrial growth, particularly in China. For example, for Brazil, China has become the leading export market for minerals, steel and other commodity goods during the past decade.

The rise in commodity prices during the decade of the 2000´s has been directly linked to increase in imports by China and India. This has been a blessing for Africa as a continent, at least over the short term. For example, Sudan, Angola, Burkina Faso, and the Congo are important exporters of cotton to China. Angola and Sudan mainly export oil to China. In addition to cotton, Cameroon also exports wood and oil to China. Over the past 30 years, there has been a 90% demand in growth for oil in developed countries. In Asia, the increase in demand has reached a staggering 400% (Santiso, OECD, 2006). One of the downsides to rising commodity prices and to the commodity goods export trend however is that it encourages developing countries from Latin America as well as Africa to continue to specialise in primary goods exports rather than to diversify into other higher end activities in manufacturing where returns are likely to be greater over the medium to long term. Secondly, the dependency on China for oil, coal, cotton, steel and other primary goods exports could mean that if there is overheating in the Chinese market and consumption is correspondingly reduced, then demand for these commodity goods would subside. Such a scenario would therefore expose these commodity exporting countries to severe unforeseen shocks. In addition, China's footprints in Africa are becoming a great concern for human rights organisations and corruption observers as for unions and political actors. As an example, in Namibia 2009, China companies were accused of bribing authorities, in Sudan authorities accused mining Chinese companies of ignoring local labour force.

Developing countries from Latin America and Africa are not the only ones who have to adapt to developments in China and India. The outward flight of major multinational companies like Samsung and Philips from a one time low cost labour destination such as Spain, to China and India has also resulted in employment loss in certain areas. The phenomenon commonly referred to as "deslocalizacion", which refers to the process of relocation of multinational firms to more competitive overseas markets, has also created new opportunities for agile Spanish firms to increase their international competition by outsourcing R&D and manufacturing activities to these large Asian markets. Given that Spain's main area of comparative advantage is in banking, telecoms, the energy sector, logistics, construction and tourism, areas which fortunately for Spain also happen to be high demand areas for China and India, new business opportunities will present themselves to compensate for losses in other manufacturing areas. The key however will be to identify these challenges and to adapt to the specific conditions and needs of both these Asian markets. Spain, for example, can also play an important intermediary role between China and India in Latin America. Apart from the advantages that certain key sectors such as banking, telecoms and infrastructure have, firms across a broad range of sectors from Spain can benefit from the opportunities presented to them by China and India. The clear beneficiaries of the rise of China particularly, are consumers in the EU and the US. Consumers in both these regions are able to benefit from lower cost goods such as computers, sport shoes, television sets, washing machines and electric blenders produced in China by foreign firms. The quality of these goods is also no longer compromised by lack of technological inputs.

China and India are clearly aiming to become global powers in the 21st century, through exploiting the potential of their huge populations to take their rightful place on the world stage. In terms of the demographic changes that are expected to take place by the year 2030, India is forecasted to have a much younger working population in relation to China, with 28% of the working population between the ages of 15-29 compared to 19% for China. More alarmingly is that 23% of China's population is expected to be in the 50-64 year old group compared to only 9% for India (Financial Times, 2004). These projected demographic advantages do not guarantee that India will be able to achieve higher growth rates than China. Unless the primarily and secondary educational system is improved as well as made more accessible and malnutrition and poverty levels are brought under control, advantages of being younger will not amount to much. In sum, both countries face different economic, political, social and environmental challenges in their ambition to become global leaders and to deal with sudden shocks as the current global economic crisis.

Reform in the Global Monetary System and the Rise of the Renminbi

The British Pound was the main reserve currency throughout a large portion of the 19^{th} century and when the British Empire declined the US dollar replaced it in the 20^{th} century. Early signals in the 21^{st} century suggest a change of guard in the international monetary system with China's Renminbi threatening to replace the US dollar. However, serious doubts remain whether the Renminbi poses a real challenge to the dollar any time before the next decade, as history has shown that it generally takes time for confidence to be acquired by agents to carry out trade transactions and to accumulate foreign exchange reserves in a new currency.

Conflicts of Interest

Considerable resistance would be met by China to have an alternative reserve currency replace the dollar, as this would substantially reduce the ability of the US to inexpensively finance its budget and trade deficits. The burden of responsibility prompted by the fall in value of the dollar has so far been shouldered by its creditors, who lend in the same currency. Commodities priced in dollars have also meant that imports to the US do not become more expensive when there is drop in the value of the dollar. Borrowing hence, would become more expensive for the US if countries were to diversify their reserve currencies. At present 67% of global foreign exchange reserves are in US dollars. There are several other factors which restrict the viability of the Renminbi becoming an alternative regional currency in Asia. For example, China would have to remove restrictions on money entering and leaving its borders, make the currency fully convertible for trade transactions and make its bond market more liquid and transparent. The fact that China means serious business on the other hand, can be seen in the setting up of currency swaps with Argentina, Belarus and Indonesia and permitting financial institutions in Hong Kong to issue bond denominated in Renminbi. This is an important step in creating a significant domestic and international market for its currency. If the Renminbi to were to replace the dollar in the medium term, for the US it would mean that the high cost of borrowing would lead to a decline in consumption, investment and growth. For Asia, transacting in Renminbi's would foment an increase in regional trade. For China, on the other hand, it would mean adopting on a role very similar to that of Germany in the EU, by subsidizing the economically weaker countries in the region. In sum, it would mean shifting the focus to regional security as opposed to solely protecting its national interests. Other substantial challenges facing China up until now has been the political barrier in collaborating with Japan (the only country in the region with international banking experience), its historical adversary in the development of an Asian Currency Unit. The fragility of the existing international monetary structure brought about the current financial crisis has now once again reopened the debate.

Contradiction and Problems with the Existing International Monetary System

The US has gone from being a net lender since WWII to becoming a net borrower, whereas in the 21st century, China has turned into a creditor country with strong growth, low debt in proportion to GDP and large current account surpluses. In the late 1980's, China's foreign exchange reserves were estimated to be around $167 million. At present, China's foreign reserves are in the region of $2 trillion, and approximately $1.5 trillion of it is invested in dollar assets, mainly US treasury bonds and quasi-sovereign securities issued by Fannie Mae and Freddie Mac. With the onslaught of the 2008 global financial crisis, world attention is heavily focused on China's massive stock pile of US dollars in foreign exchange reserves. The Chinese government is understandably very concerned about the safety of its investments in the United States. However, even with an ongoing global recession there seems to be no sign of decline by China to accumulate US dollars, as the Euro is perceived as even less stable than the US dollar due to fears over the future of European Monetary Union. To offset the vulnerability created by the projected decline in value of the dollar, policy makers in Beijing are pushing for a greater role in international trade through the use of special drawing rights (a currency devised by the International Monetary Fund in 1969), while being well aware that the US can veto an IMF decision. Hence China's position can be taken as a warning signal to the United States rather than as any sort of immediate threat or demand for global monetary policy reform. During G20 meeting held in April 2009, China and other emerging economies acquired greater influence within the IMF. The crisis, which resulted in greater harm on the economies of many developed countries, has enabled emerging economies to become more aware of how the world is transforming in terms of power relations and how their own power and influence is rising. China will soon want to have the Renminbi included in the new international currency, which China's central bank governor, Zhou Xiaochuan, describes as a "super-sovereign" reserve currency that doesn't belong to any particular nation, and made up of SDR's (a basket of dollars, Euros, pounds and yen), for use as a means of payment in bilateral trade. In the short run, the existing monetary structure is unlikely to change, but cracks in the system are more visible and it is only a matter of time before the US dollar's influence as the dominant foreign exchange reserve is offset by re-emerging China (Peters, and Garicia-Herrero, 2010, forthcoming).

4. CONCLUSION

Concluding Observations and Remarks

The principle aim of this discussion paper has been to draw attention to the broader social and political implications of the current global economic crisis for both India and China rather than to focus purely on its direct economic outcome on both countries. The paper highlights the significant changes that are taking place in the bilateral relations between China and India and the impact that these two countries are having on industrially advanced and other emerging economies. The paper also identifies the main challenges to governance faced by China and India that stem from the current crisis, which are linked to rising unemployment, controlling poverty, providing universal access to and improving the quality of education, environmental degradation, global imbalances and monetary policy shifts. An additional critical factor that is likely to place serious social and political stress on both countries is regional instability brought about by a decline in economic growth in neighboring countries. Rather remain too focused on meeting national goals both India and China will have to play a more important role at a regional level as well as on a global scale. This challenge will be particularly acute for India, with politically unstable neighbors such as, Pakistan, Nepal, Bangladesh, Myanmar and Sri Lanka. Though India has been largely spared of the direct harmful economic consequences of the global economic crisis, its neighbors certainly have not. Moreover, the austerity measures being carried out by industrially advanced economies suggest that development aid to these mentioned countries in South Asia will likely be scaled back substantially or cancelled altogether. India will hence need to play a much more active role to ensure economic stability in the region instead of focusing purely on national interests. It is in India's long term national interest, for example to have a stable Pakistan as its neighbor. The long standing conflict over Kashmir could become accentuated if Pakistan's economy falls further into a state of disarray and social unrest increases. India runs the risk of having to face large scale immigration into the country from bordering nations and other social tensions connected to Pan-Islamic fundamentalism if it focuses too much on self preservation and solely promoting national interests. The fight against global terrorism may become a secondary priority for countries such as the US and for the EU, in order to address challenging domestic pressures, and India will need to fill this vacuum through international dialogue and greater economic commitment. Regional cooperation in South Asia has one of the poorest records thus far. The countries in the region share public commons such as environmental degradation, water resource management, security and terrorism which cannot be effectively managed by any single country. The signing of the India-ASEAN free trade agreement in April 2009 was a positive step towards sharing the burden of responsibility in economic development in the region.

Both India and China are undergoing a major demographic transformation, with a shift to urbanization of more than half the population in both countries, amounting to one billion people. This process is taking place at exponential speed and both countries will need to adjust to the social and environmental impact of resource use and the availability of services to absorb such a rapidly growing population from rural areas. Inclusive growth will have to be given higher priority in both countries, to avert social unrest. Thus far, the level of inequality in living standards, per capita income and general well being in rural versus urban populations in both countries is one of the most major sources of political and social instability.

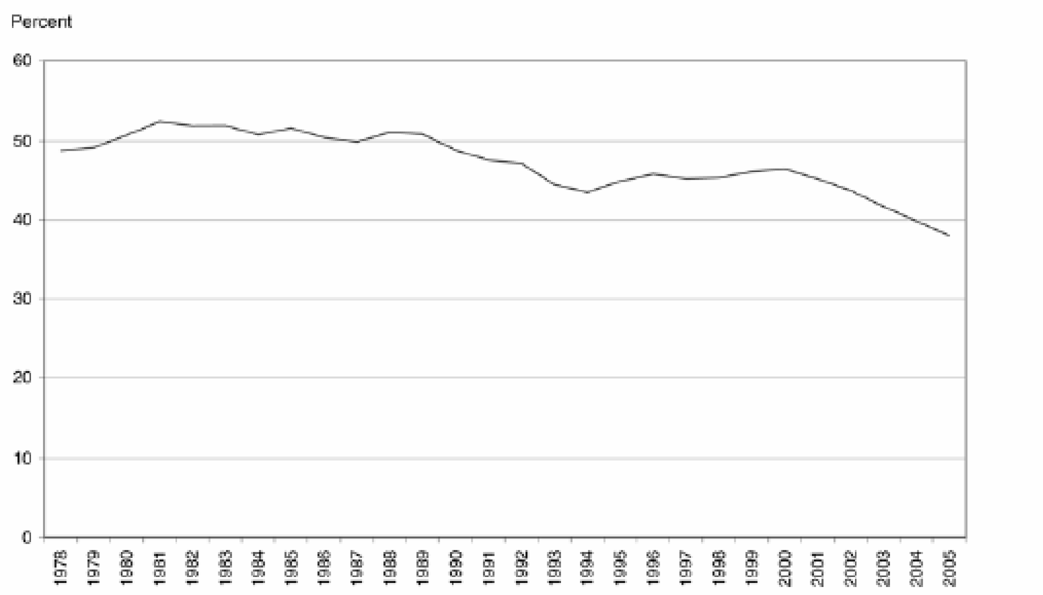
The current global economic crisis is different from previous financial crises, which have either been restricted to a country or to a specific region. The dilemma of addressing global imbalances thus goes far beyond the responsibility of one or two countries such as China and the US, or a specific region of the world. Developed nations of the world will need to cooperate and work closely with economically powerful emerging economies such as China and India rather than to perceive their growing influence as somehow threatening to their own economic stability. It is only through viewing the challenges faced by India and China in sustaining high economic growth to address poverty reduction, minimize inequality, control environmental degradation and achieve socio-political progress as a collective problem that we can collectively find solutions that face an ever globalized and integrated world economy. This harsh realization, fortunately for the welfare of humanity at least in the short term seems to be gaining steady ground over national interests.

ANNEX

Chart 1. Total Factor Productivity, average annual growth 1990-2008, %

Source: The Economist "Secret Sauce" 12th Nov 2009.

Chart 2. China's Household Consumption as Percent of GDP, 1978-2005



Source: China: Rebalancing Economic Growth. N. R. Lardy 2007

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