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Keeping pace with the dragon

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As is often the case between neighbouring countries, China and India have many outstanding issues between them: among others, a disputed border; China's Pakistan card and the stapled visa issue; and China's stance on India's claim for a permanent seat on the UN Security Council. But when the premier of one country visits the other country, both governments work hard to put their best foot forward. They look for outcomes that would qualify the visit as a success. Chinese Prime Minister Wen Jiabao's visit is no different. In the run-up to the visit, both sides have highlighted the positives and downplayed the challenges. It is interesting in this context to ask why bilateral trade has been identified as one of the important items on the agenda for this visit, with a huge delegation of business leaders accompanying Wen.

At one level the answer is fairly straightforward. The growth of China-India trade is a dramatic success. Until the 2008 crisis, trade between the two countries was doubling every year. Every time a target was set, it was exceeded ahead of time. When Wen visited India in 2005, the two countries agreed to grow the value of their trade to $20 billion by 2008 and $30 billion by 2010. But the 2008 target had already been crossed when President Hu Jintao visited in 2006, so it was reset to $40 billion by 2010. But that target too was crossed before 2008; hence, in 2008 the target for 2010 was raised again to $60 billion. As a consequence of these giant leaps, China has now become India's largest trading partner. India is the 10th largest trade partner for China, and its 7th largest export market. It is quite likely on present projections that China and India will become the world's largest trading partners within a few decades.

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But there the good news ends, because embedded in this partnership is also a huge imbalance. India currently has a trade deficit vis-a-vis China of about $30 billion. Now, it is not the expected norm that every country should have balanced trade with

every other country. It is not even expected that every country should have an overall balance of total exports and total imports. Normally, some countries would have an overall surplus of exports over imports and others a deficit. Net deficits of the deficit countries are financed by other current account flows such as factor incomes or unilateral transfers, and capital inflows.

That being said, the fact remains that a trade deficit is a net leakage from the country's domestic income expenditure circuit, a diversion of demand to other countries. It acts like a negative stimulus. Hence, when a country has a large trade deficit, especially a large deficit vis-a-vis another particular country, that is a matter of concern. India's trade deficit of $30 billion vis-a-vis China is certainly very large, amounting about 2 per cent of India's GDP, about half the size of its overall current account deficit, and about three times the size of India's total exports to China. That sounds rather grim. So we return to the question, why is trade one of the important items on Wen's agenda?

The answer seems to be that the problem is solving itself. Though the absolute size of the trade deficit is still very large, it is actually on a declining path. How is this so? Though imports from China have been growing very fast until recently, the rate of growth has actually been declining for several years. It declined from 61 per cent in 2006-07 to 55 per cent in 2007-08, and further to 20 per cent in 2008-09. In 2009-10, the growth of imports from China actually turned negative with imports declining by over 5 per cent. In contrast, export from India to China shows a mixed trend. After growing by 30 per cent in 2007-08, exports shrank by 14 per cent during the crisis year 2008-09. They then bounced back to 24 per cent growth in 2009-10. The net impact, combining exports and imports, is that the absolute size of the trade deficit is still growing rapidly, but at a declining rate compared to the past. Its growth rate has come down from 76 per cent in 2007-08 to 43 per cent in 2008-09 and further to 26 per cent in 2009-10.

If the present trend persists, the trade deficit could disappear within a decade with no further intervention. However, the pace of deficit reduction can be stepped up if Wen's delegates find additional things to buy or expand their orders of existing export items from India. If the two governments now credibly set targets to reduce India's trade deficit at an accelerated pace, Wen's visit will be counted a success.

The same mechanism can be used to also correct a different aspect of the trade imbalance, namely the composition of trade. Value added products such as chemicals, machinery, electronics, iron and steel account for nearly half of China's exports to

India, but they account for only 15 per cent of India's exports to China. Low technology products account for over three-quarters of India's exports. Wen's team could fix this imbalance too if they so desire.

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