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The tortoise and the hare

Regardless of which new normal we choose, the Chinese economy will remain much larger than the Indian economy for several decades

Photo: Reuters

Starting in the 1980s, year after year, decade after decade, the Chinese economy continued to grow at rates approaching 10% or more. This was historically unprecedented. The western world watched in awe—admiration combined with apprehension. The rise of China became the staple narrative everywhere, from university classrooms to corporate boardrooms, from cocktail circuits to official intelligence briefs.

In the early years of Chinese growth acceleration, India was largely ignored, a country that had failed to get its act together. A friend of mine, an Indian professor at the University of Chicago, once remarked in frustration: "For these guys, India is just the largest most unimportant country."

That narrative started changing from the 1990s, as India's growth also started accelerating. It came to be seen as the other emerging Asian giant. The new narrative gathered momentum as China's growth started faltering, and some economists even predicted that India's growth rate would surpass that of China by around 2015.

This new narrative peaked earlier this year, when the International Monetary Fund's April World Economic Outlook and the World Bank's June Global Economic Prospect predicted that India would grow at 7.5% in 2015, exceeding China's expected growth of 6.8% and 7.1%, projected, respectively, by the IMF and the World Bank. The Asian Development Bank also projected that India will grow at 7.8% this year compared with China's 7.2%. The Indian tortoise was finally overtaking the Chinese hare.

These forecasts were received with much jubilation in India. They made newspaper headlines. Analysts, commentators and politicians celebrated India's new status as the fastest growing major economy in the world. Some even suggested China's slowdown presented a great opportunity for India to step up its own growth. The implicit assumption is that there is a zero-sum equation between economic performance in India and China, or that China's loss is India's gain.

This is dangerously misleading. The China-India economic relationship is now quite complex. There are indeed significant supply-side benefits that India is already enjoying from the recent Chinese slowdown. But these benefits are offset by significant costs, mainly on the demand side, that also need to be factored into the equation. Thus, an assessment of the net effect of China's economic slowdown on India's economic performance has to be more nuanced.

Also, while making that assessment, it has to be kept in view that China is now a $10.4 trillion economy, more than five times the size of India, and possibly already the largest economy in the world in purchasing power parity terms. Trends in the Chinese economy are now a major driver of global trends, whether positive or negative, and shocks in the Chinese economy now reverberate throughout the global economy.

Turning first to the benefits, the slowdown in China and the consequent reduction in its gigantic demand for commodities, especially minerals, is the factor primarily responsible for the dampening of global commodity prices. India has gained a great deal from this decline in commodity prices, especially that of oil. The Reserve Bank of India estimates that a $1 reduction in crude oil prices yields a reduction of $1 billion in the net POL (petroleum oil and lubricants) import bill. Consequently, the 50% decline in crude prices between June 2014 and March 2015 has led to a net savings of more than $26 billion in 2014-15.

It has brought down the current account deficit (CAD) to a comfortable 1.3% of gross domestic product from a worrying 4.8% recorded as recently as in 2012-13. In the first quarter of 2015-16, the CAD is estimated to be still lower at 1.2%.

The decline in crude prices, along with de-regulation of diesel prices, has also allowed a sharp 48% reduction in the budgeted petroleum subsidy. This will go a long way in enabling the government to meet its fiscal deficit target of 3.9% for 2015-16.

That being said, it also has to be said that the slowdown in China is not the only factor responsible for the decline in oil and other commodity prices. The slowdown in China comes along with weak recovery in Europe and Japan, resulting in subdued global demand despite strong recovery in the US. More importantly, the decline in crude oil prices is also a consequence of old producers, led by Saudi Arabia, driving down prices through excess supply to crowd out new higher cost producers of shale-based hydrocarbons, especially in the US. We have probably not yet seen the end of this process. Some global financial institutions are even considering scenarios where the price of crude could drop to $20 a barrel.

The increased flow of foreign capital into India is another benefit at least partly attributable to the slowdown in China, though the picture here is mixed. Foreign portfolio investors brought $41 billion worth of equity and debt capital into India during 2014-15, making it the most attractive emerging market destination. Net foreign direct investment also increased to around $35 billion in 2014-15, the highest recorded since 2008-09. The Indian central bank attributes this to an improved investment environment in India. But the slowdown in China was also surely an important push factor.

Because of negative market sentiments, foreign portfolio investment has been flowing out of China during the past couple of years. Estimates of the outflow vary widely, ranging from about $400 billion to $800 billion for the past year. Much of this capital may have flowed to the US and other destinations, but a part of it also clearly flowed to India.

Unfortunately, some of this gain has been wiped out during the past few weeks, as panicky fund managers have pulled their investments out of most emerging markets, including India. This flight to safety has been triggered by a combination of the Chinese stock market meltdown, the devaluation of the yuan and the expected increase in the US policy interest rate.

What is the downside for India of growth deceleration in China? Harvard economists Lant Pritchett and Lawrence Summers argued in a widely quoted 2013 paper that the three decades of high growth observed in China and India were abnormal. They demonstrated the statistical robustness of a pattern that all high-growth economies eventually tend to regress towards the mean global rate of growth of around 2%.

Citing their research, Ashoka Mody has suggested that both China and India may decelerate towards a growth path of around 3-5% (*The Indian Express*, 27 August). His argument is that high GDP growth is not sustainable in the absence of high productivity growth and dynamic institutional reform. He claims China has been the lynchpin of global growth during the past decade, and if China swoons, so will India.

What is the causal link through which declining growth in China will drive down growth in India? The link is trade. During the past decade, India's exports to China grew from about $5.6 billion to $11.9 billion, while it's imports from China grew from $7.1 billion to $60.4 billion. The trade deficit with China thus ballooned from a mere $1.5 billion in 2004-05 to a massive $48.5 billion in 20014-15.

This diversion of demand from the domestic market to China will increase as declining Chinese growth reduces the growth in Chinese demand for imports. Demand diversion to China will be further reinforced if the recent devaluation of the yuan is not just an adjustment of China's overvalued exchange rate, as claimed, but a return to China's earlier mercantilist policy of undervaluing it's exchange rate to capture global markets.

There is an even deeper causal link between manufacturing growth in China and India. The composition of Indian exports to China has undergone a dramatic change during the past decade as Biswajit Dhar has pointed out (*Economic & Political Weekly*, 15 September). The share of raw materials, which accounted for over 62% of India's exports to China in 2005 is now down to less than 24%. Conversely, the share of intermediate exports has risen to about 51%, and that of capital goods to over 10%. Thus, Indian manufactures are now well integrated into Chinese supply chains. In a period of high Chinese growth, this would be most welcome. But when the Chinese economy is slowing, this relationship works in reverse gear.

A final thought as we celebrate the growth rate victory of the tortoise over the hare. Whether we take the optimistic forecasts of 6-8% growth for China and India, or the Pritchett-Summers expectation of 3-5% growth, both indicate that India's growth will not exceed that of China by more than one percentage point. Meanwhile, the Chinese economy is five times the size of the Indian economy. So regardless of which new normal we choose, high growth or low, the Chinese economy will remain much larger than the Indian economy for several decades to come.

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