A Geopolitical and Geo-economic Overview: On the Rise of China and India as Two Asian Giants

Wolfgang Schürer

China and India are transforming the politics and economics of the entire world. They are two of the global economy's emerging stars. This is not news. But the breathtaking scale, scope, pace, and interconnectedness of these dynamics make imperative a change in all attempts to chart perspectives for the world economy. Moreover, an understanding of this phenomenon that goes beyond mere analysis of the quantifiable data is also a prerequisite to designing a risk and opportunity strategy for investing in and trading with these two global giants.

Together representing almost 40 percent of the world's population, China and India—along with other emerging markets not addressed here—are changing the dynamics of international markets, challenging the economic status quo on many fronts, and altering the nature of the competition among global economic players for access to export markets, foreign capital, fuel, commodities, power, and other natural resources, including water. They are also raising the stakes on environmental questions that result from the increased consumption of minerals, energy, and natural resources, as well as agricultural commodities and

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manufactured goods. They are already changing the realities of global transportation and promise to change the realities of global finance and banking.

Other players on the international economic stage, including present economic leaders like the United States, Europe, and Japan, must sit up and take note. Above all, they will need to adapt to the new geopolitical, economic, social, and environmental landscape. Economists and analysts have started to speculate whether the tiger, India, will ultimately overtake the dragon, China, which currently outstrides India handsomely on most economic indices. Several analysts believe that India will surge ahead within the next two decades because of the two nations' relative demographics (China's aging population versus India's younger and faster growing population), and because several long-term trends within the two countries speak well for India's prolonged economic growth. But the more important questions are how these two mammoth countries will affect the global economy, and how the rest of the world will adapt to, benefit from, and take advantage of this dynamism, while appreciating the realities and inherent risks of new global economic and political paradigms.

The effects of the Chinese and Indian economic debuts are indeed far-ranging. They include: the reduced significance of borders in the global job market (a contribution to the phenomenon of outsourcing) and the increase in extensive foreign direct investment (FDI), especially in China; negative environmental impacts, caused by a rise in the consumption of energy resources; an increased competition for resources and its attendant impact on world commodity markets; increased competition for FDI and both import and export markets; the concomitant expansion of foreign currency reserves; and the impact of a constant flow of skilled and trained labor into the global job market. Virtually no segment of the global economy remains untouched by this chain of events.

Today, it is taken for granted that we wear clothes that are "made in China" and that a telephone call to customer service about a computer or cell phone problem is routed to India. Manufacturing, white collar, and other jobs in the richer Organization for Economic Co-operation and Development (OECD) countries are likely to become jobs in India and China or in other poorer countries. This outsourcing process offers multinational corporations (MNCs) and their suppliers a way to decrease costs and raise productivity and profits. Companies like Dell Computer, Wal-Mart, Siemens, and Rolls-Royce handily profit from this outsourcing process, as lower costs lead to a rise in demand for goods. In an ideal world, FDI allows companies in the richer countries to develop more high-level jobs and new products and technologies at home. We must not, however, entrench our perceptions of these paradigms. While merchandise tags today support the notion that most goods at least touch China during their manufacturing, and that most information technology (IT) services involve India, both countries are increasing their competitiveness in the other's primary

sphere. Similarly, while the United States and Britain have had the strongest trading relationships and opening of borders with the new economic giants to date, this could soon change. The European Union (EU), for example, is heavily courting China as a trading partner. Simultaneous economic growth in the two Asian giants and enlargement of the EU has exerted external pressure on labor markets while triggering new economic demands. Indeed, the competitive edge of Western Europe is significantly challenged—both internally by bureaucratic rigidity and regulatory inefficiencies, and externally by globalization dynamics, the "death of distance," and the implications of new technologies. The impact of the EU's new member countries' labor force, which consists of both skilled and unskilled workers, exerts further pressure on Europe as a whole.

The tension inherent in this process has fostered some protectionist reflexes over the short term in the richer countries, creating concern about jobs, investment, and currencies. But over the longer term, the mutual benefits of this process will increase, and the world stands to benefit from the enlargement of its markets and the enrichment of the Chinese and Indian populations. According to the globalization paradigm, the United States has a flexible labor market and has already reaped benefits from this process: when jobs are exported to India or China, the leading-edge U.S. companies are likely to generate new and more high-level jobs at home to replace those functions and services. Thus, the net outflow is less, the economy at home is energized and motivated by the process, and the market for U.S. goods and services is enlarged. But European jobs are less flexible and mobility is less common. Therefore, European workers on all levels have suffered more and profited less from this dynamism.[1]

As the world begins to approach a single market for jobs in certain key sectors, education becomes a central public policy issue. For instance, the neglect and demise of natural sciences within Europe's educational systems accelerates the movement of skill bases to countries like India and China. Over the next decades, India, and to a lesser extent China and other countries, will become an increasingly important producer of high-tech and other services. Those countries whose educational and training systems place emphasis on mathematics and the natural sciences will benefit in the marketplace both in the traditional industrial sectors as well as in information technology (IT), and in biotechnology and pharmaceuticals, to name but a few. The dynamic interaction of demographics with economic, technological and educational trends suggests that European states will drop still further relative to the United States in the global top rankings.

The economic rise of the two Asian giants, and their demand for resources as their economies surge, has taken commodity markets by surprise. Within the energy sector alone, the Chinese demand for oil for the period up to 2020 is expected to grow by almost as much as U.S. demand in absolute terms.[2] This gives the two Asian economies a new significance in oil-producing regions of

Africa, the Middle East, and Latin America. Moreover, this development also has major implications for the relative stance of multinational energy companies vis-à-vis their national and re-nationalized counterparts. Such a realignment calls for an increased cooperation beyond their traditional realms. For both India and China, a productive relationship with Russia will be key to ensuring regional stability, strong export markets, and the ability to import essential resources—particularly oil—as Russia's oil production continues to rise (between March and May of 2004, the country's oil output actually exceeded that of Saudi Arabia).[3]

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In addition to their effect on global demand for energy, the growth of China and India will influence world supplies of a broad range of natural resources including, but not limited to, timber, iron ore, non-ferrous metals, oil, gas, rubber, cotton, rice, and cocoa.

The local, regional, and global effects of India's and China's influence on commodity supply and demand can be seen in the area of foreign direct investment and trade. The combination of high foreign investment inflows to China and India, and the considerable expansion of their domestic and export markets, has led to an accumulation of foreign currency reserves. This has major implications for the status of the world's leading currencies, as well as for the importance of currency baskets.

The large U.S. dollar reserves held by China, however, accord it less leverage than is commonly assumed. China is captive to its enormous dollar reserves. China accrued these reserves—in an atmosphere of tight regulation and a pegged exchange rate—because of the enormous market for Chinese goods in the United States, and because of the massive FDI by the United States into China. Unless China handles these reserves with the respect they merit and invests them wisely, Beijing stands to undermine the paradigm that established it economically. This situation differs vastly from that of a country with large reserves gained in a flexible market with no major distortions. Under such circumstances, a country enjoys a major structural advantage in the longer term.

To fully appreciate the benefits, risks, nuances, and changing realities flowing from the emergence of these two Asian giants, an explanation of context and history is instructive.

THE CONTEXT

The fall of the Soviet Empire and the shift of China and India from socialism to market liberalization marked a turning point for the world economy.

Although the blossoming of their economies in the world market stems from this coincidence of history, China and India cannot be assessed as if they were one. The two countries differ in many ways, including in their geopolitical, economic, ideological, and societal dynamics, and their divergent developmental pathways.

India's population is growing more rapidly than China's, in large part the result of China's one-child policy. India's annual growth rate is 1.15 percent, while China's is only 0.87 percent per year. In 1980, India's population stood at about 687 million people, which was 300 million fewer than China's population. Even so, living standards in the two countries, measured by per capita purchasing power, were nearly comparable.[4] By 2002, however, while India's population had nearly caught up with China's—it now had 1.05 billion people against China's 1.28 billion—China's national per capita income had risen to nearly double India's—China's GNP per capita was $890 compared to India's $450 per person.[5] Between 1990 and 2000, the annual real GDP growth averaged 5.5 percent in India, while China's GDP grew almost twice as quickly at 9.6 percent. Nonetheless, because of huge wealth disparities and a much longer period of capital accumulation, the middle and upper classes in India are considerably better off than the middle and upper classes in China. At the same time, the poor in India are notably poorer. In China, five percent of the population lives below the national poverty line, compared to the nearly 25 percent in poverty in India.[6] Moreover, between 1992 and 2002, the number of undernourished people decreased by 52 million in China, but only by five million in India. With 216 million people going hungry, India is still home to a quarter of the world's undernourished. Indeed, 47 percent of those under five years of age are underweight in India, compared with only 10 percent in China.[7]

The two countries have progressed rapidly both by exploiting the opportunities created by their huge, hard-working, and relatively low-cost labor pools, and by exploiting the productivity gap that exists between them and the world's leading economies. But China has been much more successful at attracting FDI, not least because of its promise as the largest possible global market and its relatively strong infrastructure. The paradox related to FDI in China is that Chinese political dogma is literally anti-capitalist, while much of the present economic practice follows key capitalist principles.

India, lagging behind in attracting FDI, has started to engage in a reform drive to open its markets. One focal area for India's economic development is the rapidly growing service sector. Indeed, the Indian manufacturing industry has, until recently, grown much more slowly than services and has provided only a few new jobs. Nevertheless, the service sector is still an extremely small part of the Indian economy and will remain so for some time. As such, it can make only a small contribution to overall growth. Therefore, the Indian government under Prime Minister Manmohan Singh is also concentrating its limited resources on

improving the fortunes of farmers, delivering elementary education and primary health care, and raising levels of investment, especially in infrastructure. As a case in point, international funds are sought for the modernisation of airport infrastructure. The government leverages such investment by allowing private Indian carriers to fly head-to-head with state-owned airlines and by progressively opening the skies to genuine international competition. Mobility of people and goods will again serve as a catalyst for economic growth.

In terms of infrastructure and domestic investment, China is 15 years ahead of India. During the past two decades China has made impressive progress in building airports, harbors, expressways, handling facilities for intermodal transportation, and power and communication supplies. China also has an impressive domestic savings rate of 43 percent of GDP, which will provide it with great economic strength as long as it is invested wisely. India's savings rate, by comparison, is almost half that, at around 24 percent.[8]

Both India and China face a formidable challenge in rising energy prices. The real test will come when oil prices remain above the $50 or even $60 per barrel level for an extended stretch. This will have far-reaching consequences for the overall globalization paradigm, as will the environmental challenges that flow from the rapid global rise in energy consumption. Increased energy prices will only marginally offset this development.

GEOPOLITICAL CONSIDERATIONS

China's civilization is inseparable from the state, while India's is inseparable from the social structure in that country. This distinction raises important issues for the relative sustainability of the two systems and the two giants' regional and geopolitical roles. Both countries face external and regional issues that could also impact economic stability.

Current Polities, Relative Power Structures, and Border Issues

China's President and General Secretary of the Communist Party, Hu Jintao, consolidated his leadership position in 2004 by becoming the chair of China's powerful Central Military Commission, and therefore leader of China's 2.5 million-strong People's Liberation Army. Today, China is highly centralized, although its global economic role is starting to rattle the control of the central government.

Since 2004, India has had a reform-minded coalition government dubbed the United Progressive Alliance (UPA) and led by Prime Minister Manmohan Singh, who handles policy. It is widely believed that Congress Party President Sonja Gandhi handles politics and steers the coalition. The government's parlia-

mentary majority relies upon two Communist parties outside the coalition, which comprise a left-wing bloc that vacillates between ideological doctrine and reformist pragmatism. Recently, the government has been opening sectors of the economy such as banking, civil aviation, and telecommunications to foreign investment. Economic growth sputtered under the previous government, which opened the country to more FDI and allowed the private sector to become stronger. The main opposition party has taken a sharp shift to the right, capitalizing on growing anti-Muslim sentiment in India. Although recent state elections in Haryana, Bihar, and Jharkhand support the strength of the UPA, the results also highlight the fact that Congress and the Bharatiya Janata Party (BJP)—the challengers for national power—are only minority parties in many states.

China is larger, richer, and militarily stronger than India. Despite being a nuclear power, India laments its relative military weakness. In addition, an accident of history made China one of the five permanent, veto-wielding members of the UN Security Council. Today, this seat seems a rightful possession, and substantiates China's ambitions to become a premier international power in the long term. India aims for a permanent seat on the Security Council as well, but it must vie with several other countries to get it (India recently launched a joint bid for permanent seats with Germany, Brazil, and Japan).

China, although not a democracy, is also more politically 'stable' than India—at least in the short run—because its polity is dominated by the Communist Party state apparatus. The one-party governing body in China has enjoyed two decades of relative tranquility. Apart from domestic grievances related to Tibet, Xinjiang, and Tiananmen Square, China's political leadership has been able to focus on economic development. The issue of Taiwan continues to dangle unresolved before China, however, and China does not rule out the possibility of future tension with the United States—and perhaps even Japan—over Taiwan. This has led to a focus on the procurement of more advanced weapons systems. Taiwan remains a strategic issue for China and a potential political card for various factions. The risk of an acute crisis over the Taiwan issue, however, appears to be declining for the time being, in no small part because of the growing economic interdependence of the two regions.

India is a sprawling, messy democracy, driven by the constant—and generally successful—readjustment of the division of power and influence between the central government and the states. This relatively weak federal system does, however, leave a lot of space for a free-market system and the private sector to flourish (by contrast, in China's command economy, the growth of the private sector is hampered). India has also been plagued with an ongoing and volatile dispute with Pakistan over Kashmir, and India's preoccupation with this conflict has constrained its geopolitical role in the world. The struggle in neighboring Nepal, a failing kingdom, presents another danger to the stability of India and other

neighbors. In particular, the failing government has abandoned much of the country to Maoist guerrillas, who have formed links with India's Maoist insurgents, the Naxalites. The Naxalites now pose a serious security threat in at least six Indian states, including three of the largest states. Were the Maoists to triumph in Kathmandu, the Naxalites would certainly be emboldened. This issue does not threaten the survival or integrity of India, but it portends problems—especially for the poorest states like Bihar, which would have little chance of developing socially or economically with a civil war in their midst. There is also a risk that, without United Nations peacekeepers in the region, India might be tempted to intervene in Nepal, which would cause disquiet to Nepal's other neighbor, China.

Becoming International Actors

As their economic growth affords them growing international economic functions, both India and particularly China are keen to play greater political roles in the world as well. China's rapidly growing dependence on imported resources, its vast quantities of dollar reserves, and its integration into the world economy challenge China's earlier nationalistic and isolationist view of international relations. A case in point is the fact that Hu Jintao, on his first foray as president, attended the G-8 summit in Evian in June 2003.

The great challenge for China is going to be whether its political and social systems and values can keep up with its integration into the world economy without becoming destabilized. Can evolving free markets in China thrive in the context of a one-party state with mostly state-owned companies? Such issues challenge India less; its slower economic growth is easier for its other institutions to digest and track, and, because of its colonial history with Britain, it has not been isolated for generations. In addition, India has a strong tradition of the rule of law, while China does not. The rule of law will provide crucial protection for the physical and intellectual property assets of foreign companies as FDI in the two countries becomes more sophisticated and demanding. China has far more serious issues of corporate governance than India. These problems are difficult ones for China to address, given that most publicly listed companies in China are run by the state. India also faces corporate corruption and governance issues, but not nearly on the same scale.

Oil is the key to continued rapid growth in Asia, and crucial growth indicators will fluctuate with the price of oil. Sources of supply will increasingly become critical strategic assets. This is one key reason the relationship with Russia will be extremely important to countries in the region. Indeed, President Putin's third visit to India in December 2004 underpinned the importance of the Indo-Russian partnership. The bilateral trading volume between India and Russia cur-

rently amounts to just $2.5 billion. It is restricted by the rupee-ruble-clearing agreement, requiring both parties to balance import costs with export revenues. This results in high transaction costs. In the armaments sector, the share of Russian technology transfer continues to increase. India so far has not granted Russia corresponding intellectual property rights, although it has signed an agreement on the mutual transfer of technology with the United States.[9]

The greatly enhanced energy consumption in the two countries, and the growing wealth and consumption patterns of their populations, are creating mounting environmental problems and challenges—a critical geopolitical consideration as well.

"The issue of Taiwan continues to loom, however, and China ... [continues to] focus on the procurement of more advanced weapons systems."

In another geopolitically significant development, China's People's Liberation Army imported billions of dollars worth of advanced weapons systems from Russia during the EU ban on arms exports to China following Tiananmen Square.[10] The EU embargo on arms to China might be lifted partially—an event that promises to cause tensions between the United States and the EU. The Taiwan-China issue, which is America's main concern with an increasingly armed China, is certainly volatile, but is unlikely to escalate particularly as the United States has withdrawn what appeared to be unconditional support for Taiwan.

The proliferation of nuclear weapons is also a key geopolitical ingredient. The joint concerns of proliferation between the United States and the Soviet Union during the Cold War period prompted the two countries to have a paradoxical element of partnership within the context of their adversarial relationship. In a similar vein, and in today's era of creeping proliferation, the enhanced global role of India and China, and their potential partnership on the proliferation issue, offers a major global incentive to renew proliferation control.

The ascent of China and India will have a growing effect on the U.S. preponderance in Asia. Japan is likely to respond with efforts to renew an exceptional partnership with Washington—perhaps by seeking a relationship comparable to that of the United States and the United Kingdom. The biggest wild card for the region, however—if not for geopolitics—will be Pakistan's future course.

These developments, the potential impact of economic dynamics, and the sheer size of China's and India's populations shift the global center of gravity away from the Atlantic and toward the Pacific. The more successfully the two Asian giants emerge in the global economy, the more they could contribute to peaceful and sustainable development, both domestically and internationally. Europe needs to accept the reality that the world's "economic locomotives" are moving to

Asia. EU members, particularly key Western members, will need to make painful choices based on the realities of this new economic policy landscape. The United States will need to increase its domestic savings rate. Indeed, global competition will shift (and will be sustained) well beyond the mark established by Japan in the heyday of its economic success.

ECONOMIC CONSIDERATIONS

Overview

China and India merit special attention among emerging economies because they represent almost 40 percent of the world's population. China's economic growth has been significantly faster than India's, although the latter's long-term potential is promising. In particular, China outstrips India in industrial growth, especially in manufacturing. In 2002, manufacturing made up just 15 percent of India's GDP, compared with 35 percent of China's.[11] As the Middle Kingdom is still very much at the low end of the technology scale, its government has been pushing the "leapfrogging" of technology. The Chinese authorities leverage their bargaining position to combine the pull of demand opportunities with a push for technology transfer. By doing so, they "leapfrog" the development time that it takes to build export-oriented industries. For example, China has determined that the electronic industry, particularly integrated circuits, is the key to its macroeconomic development, and that it must strive to get beyond its lack of competitiveness in that arena. Today, China has to import 80 percent of its demand for microchips; in technological terms, it is at least a decade behind Taiwan in this arena. China's negative balance of trade in electronic goods, components, and machinery mostly offsets its enormous positive balance of trade with the United States. At present, foreign companies operating in China dominate the technology field and its exports.

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The Chinese government is also striving to make the public sector more efficient and effective while simultaneously starting to acknowledge the contribution of the private sector, which already accounts for about two-thirds of China's GDP. The Chinese Constitution has recently been revised to incorporate protection of legally-acquired private property and to affirm equal treatment of the private and public sectors. But China has a long way to go before its compa-

nies will be world-class, despite its "unlimited" supply of low-cost labor. Because of the plethora of state-owned and state-run companies, with all their attendant baggage, Chinese capitalism to date has mostly been effective at making more products more cheaply, while lagging in the area of technological breakthrough, innovation and research, and indigenous development of new technology.

The biggest red flag remains the current condition of China's banking sector, which is technically insolvent because of its bias of lending heavily to unprofitable state-owned enterprises (SOEs). Reform of the banking system and of SOEs is therefore interlinked. Unfortunately, the necessary separation of control of the banks from the state is unlikely to occur for some time. Reforming the banking sector will be significantly more challenging for China than the two other major reforms it now faces—namely, reforming the agrarian and state-industry sectors. As such, reform of the banking sector will be the ultimate test for both China's reform process and its leadership. The risk of a real estate bubble also lingers.

Finally, it should be noted that China is engaging in strategic investments abroad beyond the energy sector. Other Chinese industries, including steel, aluminum, coal, metals, and manufacturing, are also venturing into the global market. But outgoing FDI from China is still a mere fraction of the FDI coming into China. By contrast, Japan and Korea achieved economic global equality and carved out their own economic personalities more rapidly.

This type of analysis makes India's longer-term prognosis look potentially promising. India's government allows the potential inherent in the private sector to flourish. As a result, India has a well-developed indigenous private sector and a strong tradition of entrepreneurship. Economic enterprises that better correspond to technological and corporate governance standards in OECD countries have existed in India for more than 100 years, especially in Mumbai and Calcutta. Traditional companies like the Tata, Birla, and Ambani groups, to name but a few, have a long history in India. It is thus unsurprising that the 2002 edition of the Forbes 200 list includes 13 Indian firms, but just four from mainland China. The new Indian government actively solicits input from private sector leaders in the process of developing economic policy.[12] Nonetheless, India must play catch-up to China's economy; it will be in that race for at least two decades.

Like China, India faces its own macroeconomic problems. It has a large public sector budget deficit of about 10 percent of GDP, taking all levels of government into account. In addition, India's banking sector must undergo further reform not just to overcome current weaknesses, but also to rejuvenate the sector as a key pillar for economic development. In addition, India's crucial challenge to GDP growth will be meeting its energy needs. India's economy is still largely agricultural; the acceleration of overall growth requires a substantial improvement in the productivity of the agricultural sector. Nonetheless, India's service

sector benefits from an English-speaking workforce. Its foreign exchange reserves are also currently strong, and the climate for foreign investment in India is likely to become more promising.

Finally, India's prospects for prolonged economic growth remain powerful and are perhaps more sustainable in the long term than China's. China faces many challenges, including structural anomalies between its economy and its sociopolitical structures (open versus closed), huge misdirected investments stemming from centrally planned and manipulated economic policies, and its banking problems. It is assumed that China will eventually face a major recession, although this is unlikely to happen in the next five years.

Climate for Foreign Investment

To date, China's development approach has been heavily FDI-dependent—to the tune of $53.5 billion in 2003—with the majority of investment coming from Taiwan and Hong Kong.[13] Its export-driven manufacturing boom and preference for development through FDI has discouraged local entrepreneurship. This tendency has been reinforced by state ownership of commercial enterprise. Foreign firms entering China have had rather bleak prospects for profitability in the past, although the outlook is improving—while U.S. companies earned an aggregate profit of zero in 1997, by 2003, foreign firms operating in China reported $8.2 billion in profits. This figure remains relatively small; in the same year, U.S. companies alone earned $14.3 billion in Mexico and made another $7.2 billion in Australia, a market of only 19 million people.[14] China's huge internal market remains the real attraction. It is easier for companies to make enormous profits by buying their goods from China and reselling them at home. Wal-Mart's success illustrates this point.

The Chinese currency, the yuan, is pegged to the U.S. dollar. It is generally acknowledged that the yuan is undervalued. A revaluation—either as a discrete step or as a likely outcome of the introduction of a more flexible exchange rate—would help reduce global payment imbalances. A revaluation would lighten the burden on the Euro to provide a corrective movement to stabilize currency markets. Furthermore, a flexible exchange rate would free up the interest rate instrument to address domestic monetary conditions, such as the presently overheated economy. It would discourage large capital inflows, which are currently leading to unprofitable lending by banks and resulting in excessive investment. An appropriate exchange rate also would contribute to achieving sustainable output growth and job creation to absorb the huge number of entrants to the labor force. The challenge of keeping economic growth high enough and volatility low enough to create some 20 to 25 million jobs annually, to maintain social stability, remains a primary concern for China.

On the other hand, several arguments have been put forward by various analysts against an appreciation of the yuan and/or the introduction of exchange rate flexibility at this point. A few economists believe that there is no clear evidence of an undervaluation of the yuan at this time. They argue that an appreciation may not result in a significant reduction of China's trade surplus, because of the high import content of the country's exports. As such, an appreciation would reduce the yuan cost of imports. However, as goods manufactured in China often have major component parts from other countries, the restraining impact of a possible appreciation would be mitigated on exports. Furthermore, it is argued a strengthening of the domestic economy, particularly the banking system, should precede the introduction of the floating exchange rate. As mentioned above, there is the concern about the broader employment effects of an appreciation. Against this background, the Chinese authorities have repeatedly expressed their intention to introduce flexibility into the exchange system, but without any indication of a timetable.

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Whatever course the Chinese government pursues, the current pattern of global capital flows and corresponding currency constellations is unsustainable. When consumption and investment in the world's biggest economy massively outstrips production in the long term, global readjustments are necessary. A new balance between exchange rates, domestic growth, and saving rates must be found, calling all partners in the triad to act. An old lesson will thereby turn into a new challenge—monetary and fiscal discipline matter to success or failure.

India's approach is different. FDI figures are far lower for India, but it is slowly building an infrastructure that promotes free enterprise and entrepreneurship. Unlike China, India allows its conglomerates and entrepreneurs to collaborate freely with Western companies. All the while, India is making fuller use of its domestic skills and resources, suggesting that its mid-term economic outlook is stronger, and that its course of economic development might well be more sustainable than China's.

Moreover, the regulatory climate for foreigners is improving in India. India's capital markets are more efficient and transparent than China's. Although distortions exist, India's stock and bond markets permit companies with solid prospects and reputations to list and to obtain the capital needed for growth. In China, by contrast, the state tightly controls capital allocation and severely restricts the ability of private companies to list on the stock exchange.

India also has a more advanced, reliable legal system, although it is not without its flaws. The rule of law generally prevails, despite being hampered by

unwieldy administrative procedures, and the country has a sophisticated accounting industry. The protection of property rights and intellectual property is far stronger in India than in China, where the commercial legal system is in its infancy and there are large lacunae in the protection of patents and intellectual property, especially in remote areas. China's urban areas are making some progress in developing legal protections, especially since China acceded to the WTO.

Both countries have public corruption and bureaucratic arbitrariness. It is noteworthy, however, that the new cabinet in New Delhi has an impeccable anti-corruption record and that India is well on its way to building both domestic and international trust in its legal and regulatory climate. On the other hand, China has a long road ahead.

India is building its economy from the bottom up, while China pursues a top-down approach. India's slower economic progress is the price it pays for a more democratic, free-enterprise approach. Over the longer term, however, and despite some political disorder, India is building a sound economy based on local entrepreneurship and real competition. This type of economic framework is likely to be more attractive to foreign investors in the long term.

China's top-down approach—that is, the imposition of substantial legal and regulatory constraints on private companies within China to protect SOEs—has indirectly benefited foreign investors. China's private companies are kept down, and Chinese public companies are generally uncompetitive in the global arena, although there are exceptions. China faces a paradox: the grand economic reforms the government launched to spur China's growth are succeeding, but their success undermines the pervasiveness of the government's influence.

SOCIETAL CONSIDERATIONS

Demographics will also heavily influence future economic growth in the two countries. China has handicapped its future economic growth with its one-child policy. China has a rapidly aging society, with a declining workforce and large social security burdens. The latter will be magnified by the urban revolution generated by China's rapid economic growth, which has weakened family ties and support systems. By 2015, more workers will leave the job market in China than will enter the job market. By contrast, India's population is young. About half are younger than 35 and, by 2020, only 11 percent of the population in India will be over 60, compared with 16 percent in China.[15] India's working-age population is growing, which can buttress its economic growth and dynamism. The female population in both countries is, however, considerably impeded: China keeps this segment artificially low, with all of the implicit consequences that brings, whereas India does not grant women fair access to education, training, and careers. Both trends hurt development.

The AIDS issue is a big problem for India. It is about to overtake South Africa as the country with the greatest number of HIV/AIDS infections—despite the fact that the adult HIV-positive infection rate in India is only 0.9 percent, well below South Africa's 20 percent HIV-positive rate.[16] India's AIDS campaign urgently needs a stronger political commitment and more funds. If this goes unaddressed, the population picture could change for India.

Both countries are also undergoing generational shifts that will affect their futures, politically and economically. Although China has a long revolutionary tradition (dynasties have historically come to a brutal end, once they lose the 'mandate of heaven'), the current leadership has no personal recollection of the Chinese Revolution, or even of World War II. China's economic and intellectual opening is a fairly recent phenomenon, brought about by its political transformation under Mao, and the historic economic reforms of Deng Xiaoping. In a similar vein, the current generations in power in India have moved past the post-colonial British Raj and Partition traumas, as well. In both countries, therefore, entrenched perceptions and biases are rapidly changing, particularly among the young.

Both countries are also assisted in their rapid economic growth by their large diasporas. The Chinese diaspora numbers 55 million people and consists largely of entrepreneurs, which has helped it become the world's factory. The Indian diaspora, about 20 million strong, consists mainly of professionals; this has helped India to become the world's technology laboratory.[17]

In the coming years, critical challenges for both countries will include the management of regional differences and the sharing of wealth among the entire population. Just six of India's 29 states attract almost all incoming investment, while China faces a gap between its booming coastal provinces and poorer interior. China's central government, however, seems more determined and better able to dictate provincial policy and to invest in the poorer western regions.

Literacy, education, and English language skills also have an economic impact. China has a high adult literacy rate throughout the country. China's educational priorities include technology and the natural sciences, but do not yet sufficiently emphasize independent thought or creativity, management skills, or professional training skills. India's literacy is substantially underdistributed and needs urgent attention, particularly in the northern regions. Indians are at a global advantage, however, on account of their English language skills, particularly in the arena of IT services. India's freedom of the press and freedom of information policies will also place it in relatively good stead for long-term development.

CONCLUDING THOUGHTS

As the world adapts to the globalization of China and India and to their remarkable economic dynamics, the inherent nuances of the phenomenon are instructive.

First, the paradox of economic and social modernization and globalization is that the more successful the process is, the more the likelihood of profound political change becomes inevitable. This will be much more significant in China than in India—a messy democracy with a long history of contacts with the West. China, over time, will have to establish the rule of law to satisfy international economic and governance standards, or it will lose its edge. The virtuous circle will rattle the very foundations of its polity. Additionally, China will be affected by regional political power struggles, environmental degradation, demographic challenges, and the fact that Chinese capitalism (unusually open to trade and investment) is antithetical to its closed political system. This points to future political change in China unless the state reasserts control over the economy. Put another way, China's society and regulatory and judicial frameworks need to catch up with its stunning economic growth to ensure its perpetuation. This process could be destabilizing in itself. India, although it has its political upheavals and its weaknesses, does not face the same issues. The challenge for India, although grand, pales in comparison: India must find a way to achieve unity in its diversity.

"China faces an inherent paradox: the grand economic reforms launched by the government to catapult China into first place are succeeding, but their very success undermines the pervasiveness of the government's influence."

Second, there is a litany of potential stumbling blocks to economic growth in both countries. Generally, these are not huge menaces, and must be put in perspective. They include: energy supplies; the high price of oil and potential pitfalls of energy policy (as artificially low energy prices cause waste, pollution, traffic congestion, and the cooking of growth statistics); resource supplies; air and water pollution; health issues (noting lessons learned from the outbreak of SARS against the prospect of pandemic Asian flu, HIV/AIDS, or other epidemics); issues related to economic sustainability (as FDI must be profitable to be sustainable and requires a climate that is safe for investing); potential disruption in both countries as a result of problems on their borders (in Nepal, Taiwan, and Bangladesh); significant shifts in the cost and patterns of global transportation (including a choking of the ports); the impact of corporate governance issues (especially in China where state companies are politically run and there is no tra-

dition of independent boards of directors); and litigation risks, as well as reputation risks, related to the lack or gap of standards on which litigation specialists or NGOs are likely to focus. Political stability is also an issue for both countries but may present a particular challenge for China.

Third, the world must continue to focus on this tectonic shift. The economic expansion of these two great countries will have an enormous effect on the rest of the world. Crucial societal elements (such as the rule of law, values and morals, government practices, and protection of intellectual and physical property) should guide assessments and future planning by other players as much as should hard factors (such as GDP growth, savings indices, export and import tables, and the price of fuel). Due to these "soft factors," India is currently more likely than China to achieve sustainable development, but that could change. By the middle of this century, the combined economic output of India and China could well be greater than the combined GDP of today's top six industrial nations (the United States, Japan, Germany, Italy, the United Kingdom, and Canada). China may surpass the United States as the world's largest economy by the year 2040.[18]

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Fourth, globalization portends a major shift in economic power and perhaps some of the other powers that flow from it. By mid-century, the group of the world's ten largest economies will look quite different. The largest economies, as measured by GDP, will no longer be the richest economies, as measured by income per capita. China might overtake Germany in terms of GDP within three years, Japan within a decade, and the United States within three decades.[19] Within thirty years, India's economy will be surpassed only by the economies of the United States and China. During this period, the center of economic gravity might shift even further if the Russian economy takes off. The multinational processes of decision making will become ever more interdependent and strategic, and companies in the economic sphere will become more complex.

Fifth, nothing remains static in the context of lightning growth. Today, China is a huge player in the manufacturing industry, and India shows prowess in services. This causes their economies to be complementary rather directly competitive with each other, and allows both countries to mutually profit from their trading relationship. As such, both countries have set in motion forces that ensure direct cooperation. They are becoming less fearsome economic rivals; that image

stems from the poor relations between them in the first half of the twentieth century, culminating in the 1962 Himalayan border war. There was little bilateral trade during that period. Their political relationship today is warming. Over the past decade, Sino-Indian trade increased from $300 million to $10 billion.[20] An easing of trade restrictions between China and India has fuelled further growth, and thus leverages the two giants' geo-economic potential. For example, a combination of India's software skills with China's hardware production capacity could catapult the two countries into a leading global position.

Sixth, as economic growth in the two countries exerts pressure on energy and oil resources, capital supplies, and transportation capability, China and India will emerge as important loci of demand growth and spending power, motivating greater global prosperity. But with China, India, Japan, and South Korea all becoming major energy importers, as well as the prevailing instability of key supply regions, the security of energy supplies must be continually reevaluated; major price shocks could occur. The growth in demand for energy resources will cause increasing strain on prices for at least the next decade. After that, the pressure should lessen as many emerging-market economies move to a lower-demand phase. In the meantime, Asian countries have heightened their quest for energy security and are raising the stakes. Asia currently imports about 80 percent of its oil from Middle Eastern producers, whereas U.S. and European refiners have a more diverse set of suppliers. In the near term, the stress on global oil prices could have an impact on the expected global recovery during 2005; that recovery, therefore, should not be taken for granted.

"...there is a tendency to underrate India, as most observers are infatuated with China's growth. Such an assessment underestimates India's relatively favorable demographics, its sounder economic system ..., [and] its stronger tradition of the rule of law."

Seventh, the fundamental question is how the rest of the world—particularly the United States, Japan, and Europe—will adapt to the economic emergence of China and India. The relative competitive position of Europe will decline as jobs relocate to Asia and Central Eastern Europe. European countries' ability to finance the high standards they have set for social welfare could be impaired. The United States will fare better and respond more flexibly to the new economic paradigm. As a major capital exporter, it will retain influence and power. Furthermore, the United States will continue to be a military global leader based upon advanced technology. China has already applied its economic and diplomatic leverage to become the premier regional power. As such, it indirectly

contests the United States and Japan. The United States' role as the established arbiter of Asian security is to be challenged.

Eighth, there is a tendency to underrate India's growth; most observers are infatuated with China. Such an assessment underestimates India's relatively favorable demographics, its sounder economic system based on genuine local entrepreneurship, its stronger tradition of the rule of law, and free access to information. Whether reform dynamics clean chronic bureaucratic minefields, tackle public inefficiency, extenuate omnipresent overregulation, and pave the way for inclusive prosperity will be crucial. Therefore, the present government's 'dream team' will, in the end, be appraised as to whether it sped the decision-making process significantly, streamlined the bureaucracy, improved public health, and integrated the female population, translating reform rhetoric into action. This would awaken people's dormant energies, and give meritocracy a chance. Such an emphasis would be decisive for the sustainability of India's development, as it would start to close the gap vis-à-vis China. This would be a tipping point in the rise of two Asian giants, rather than 'just' one as is most commonly perceived.

Ninth, growth and reform will trigger major tensions within both countries. Indeed, the manner in which China and India each cope with the risk-opportunity paradox, overcome environmental challenges, and manage resulting societal tensions will determine the sustainability of their current growth. The two Asian giants share the challenge of ensuring that their entire society benefits from economic growth. In this respect, last year's general election in India gave a clear mandate to the government. Contrary to some claims, it was not a vote by the neglected rural poor against reform, nor was it a deliberate disconnection of the agricultural sector from the BJP's "India Shining" campaign; rather, it was a vote against a non-performing government. The election result can thus be read as a call for more radical change and a more adequate distribution of wealth and benefit. This message should serve as an important warning to the leadership of the People's Republic of China. The generic question remains how long China can absorb wide-ranging reforms without threatening its internal stability, and indeed its political system. While China has so far not found a sustainable development formula, it is fair to say that it would take dramatic changes to reverse the achievements made since Deng Xiaoping unleashed his economic reforms.

Finally, it is worth noting that this paper has focused on China and India, only two of Asia's emerging giants—albeit the most heavily populated ones, and the fastest-growing economies in the region. However, the economic rise of Asia extends far beyond these two countries, and the West has only just started to digest the implications. The resulting risk-opportunity paradox calls for expectation management—both positive and negative—and, implicitly, for checks and balances. It calls for a strategic prioritization vis-à-vis Asia. ■

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