

## BOOK REVIEWS

### **China and India: Learning From Each Other—Reforms and Policies for Sustained Growth**

Jahangir Aziz, Steven Dunaway, and Eswar Prasad, eds.  
Washington: International Monetary Fund, 2006, 282 pp.

This book's title promises more than it delivers. It compiles presentations at a seminar in October 2005 organized by the International Monetary Fund, China Society for Banking and Finance, and the Stanford Center for International Development in Beijing. The book provides interesting insights into the Chinese and Indian experience in several areas: banking sector reforms, securities market development, domestic financial liberalization, international financial integration, fiscal dimensions of rapid growth, and Sino-Indian economic cooperation, but ultimately adds up to much less than a comprehensive look at what the two countries can learn from each other.

Zhou Xiaochuan, governor of the People's Bank of China, notes that household consumption in China accounts for only 40 percent of GDP, against 65 percent in India, and says this should be increased. What remains unanswered in this book is why consumption is so low in a poor country. The absence of economic security in old age in China is not a convincing explanation: lack of such security is common in all developing countries, which have low savings rates nevertheless. Zhou notes that services account for only 40.7 percent of China's GDP against 51 percent in India, and says China needs to do better. However, this ratio is a poor indicator of development: services are as high as 54 percent of GDP in sub-Saharan Africa. China's ratio of services to GDP is the lowest in the world, but this is an indicator of success rather than failure: it is a consequence of having the highest ratio of industrial output to GDP in the world (51 percent).

Six chapters in this book carry succinct accounts of reforms in banking and securities markets in the two countries. On most parameters, India has sounder banks and securities markets, thanks to reforms over the last 15 years. Indian banks have greatly reduced their gross ratio of nonperforming loans (NPLs) to 3 percent of advances, raised capital adequacy to above 11 percent, and are moving toward Basel-2 norms. Yet over 500

million rural Indians have no access to banks, and bank credit is less than 60 percent of GDP, less than half China's rate. So, India has much to learn from China in financial depth if not asset quality.

The chapter by Nicholas Hopé (deputy director of Stanford's Center for International Development) and Fred Hu (managing director, Goldman Sachs, and professor of economics, Tsinghua University) notes that NPLs of Chinese banks, historically very high, have been falling dramatically. The NPLs of the "big four" banks fell from 31.1 percent in 2001 to 10.1 percent in 2005, according to official data. (Unofficial estimates are much higher.) But the improvement helps explain the huge enthusiasm of foreign investors for minority stakes in Chinese government-owned banks. China views foreign banks as sources of technology and good practice, and encourages them to buy stakes in Chinese banks. Not so in India. Government-owned banks still account for 70 percent of bank credit in India, so the space opened up by economic reform to private-sector and foreign banks is quite limited.

Stock market reform is one of India's big success stories. The Indian stock market, once called a "snakepit," has been transformed into one of the best in emerging markets. It has electronic trading, a strong regulator, rules for transparency and corporate governance, and T+2 rolling settlements. The reforms of the 1990s were driven partly by domestic market scams and partly by pressure from foreign portfolio investors. Chinese markets are still poorly developed, and the government is cautious about opening up to foreign securities firms. More aggressive reform is needed, say three Chinese economists in their chapter.

China has resisted currency appreciation and instead accumulated foreign exchange reserves of more than \$1 trillion. India has followed suit on a more modest scale. One chapter by three former IMF economists argues that currency flexibility should come before full capital account convertibility. A period of learning to float will help overcome China's fear of floating. India and China both survived the Asian financial crisis unscathed. China had a firm dollar peg reinforced by capital controls. India had complete convertibility for foreigners but none for Indian citizens. This strategy gave it most of the advantages of convertibility with few of the risks.

Two really big issues on which the two countries want to learn from each other are ignored by this book. Rapid growth in China has been associated with deflation or low inflation, whereas it has been associated in India (and indeed in most of the world) with rising inflation. Inflation in India dropped to barely 4 percent when the economy slowed down after the Asian financial crisis. But now that GDP has grown by 8 percent for four years, wholesale-price inflation has accelerated to 6 percent. Consumer-price inflation has risen even faster to 8 percent, and exceeds 13 percent in rural Uttar Pradesh, India's largest state. So, inflation has become a political hot potato.

In China, double-digit growth for over a decade caused little inflation. Indeed, inflation was zero some years ago. It has now risen to 2.8

percent, which has so alarmed the government that it seeks to cool the economy by shrinking bank credit and limiting investment in industries like steel. One possible explanation for China's low inflation is that it has used imported technology, foreign investment, and migration of workers from agriculture to industry to greatly increase labor productivity, even while using its reserve army of labor from the interior provinces to keep wages low in the industrial seaboard provinces. So, unit labor costs have actually fallen for a wide range of manufactures, dampening inflationary impulses elsewhere in the economy. However, India and other developing countries also have reserve armies of labor, yet have failed to combine high GDP growth with low inflation. Indeed, China's *hukou* system of work permits is a barrier to internal migration that does not exist in India.

China wants to learn from India how to become a global outsourcing hub for services such as computer software and back-office work. This may prove difficult, maybe impossible. Two centuries of British colonialism made India an English-speaking country, and that today gives India a huge advantage. China is now teaching English in schools to try and catch up, but the script and grammar of Mandarin Chinese are so radically different that progress in schools is slow. The few Chinese who can speak good English command salaries of \$100,000 per year, too much for back-office work. Given the key importance of the English language in service exports, the main challenge to India may come not from China but from some other British ex-colony, such as Bangladesh.

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