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中国

CHINA AND INDIA

Learning From Each Other

Reforms and Policies for Sustained Growth

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भारत

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Foreword

On October 27 and 28, 2005, the international seminar *Changing Economic Structures in China and India: Domestic and Regional Implications* jointly organized by the International Monetary Fund, the China Society for Finance and Banking, and the Stanford Center for International Development was held in Beijing. Representatives from central banks and monetary authorities as well as research institutions in China, India, Japan, Korea, Singapore, and China's Hong Kong Special Administrative Region attended the Seminar and discussed the subject from six perspectives, that is, banking sector reform, securities market development, domestic financial liberalization and international financial integration, fiscal dimensions of sustaining high growth, Sino-India economic cooperation, and the implications of China and India's emergence for the regional and international financial system.

It is a pleasure to know that the IMF has compiled the presentations and discussions of the seminar into this book. I would like to take this opportunity to offer my own views on the subject, especially the changing economic structure in China.

Since the inception of reform and opening up in 1978, the Chinese economy has been growing in a steady and rapid manner, with GDP growth averaging 9.4 percent annually. However, like many other countries in the world, the prospect of sustainable economic development hinges on its economic structure. At the moment, the structural problems are mainly reflected in the excessive investment growth on the one hand and slow growth of consumption (both domestic consumption and imports) on the other; economic growth relies heavily on manufacturing while service industry is relatively underdeveloped; the inequality of income distribution has somewhat deteriorated. Consequently, these structural problems caused over-consumption of energy and raw materials, excess capacity and associated excessive competition in investment goods, induced export, external account imbalance, and rapid build up of foreign exchange reserves.

Having acknowledged these problems, the Chinese government has adopted structural adjustment measures. The direction of such adjust-

ment is clearly explained in the *Outline of the Eleventh Five-Year Plan* adopted at the Fourth Session of the Tenth National People's Congress. We are going to build a harmonious society and, in particular, a socialist new countryside, in order to solve the problems facing agriculture, rural areas, and farmers with preferential fiscal policies to improve and build rural infrastructure; we also advocate a principle of giving priority to efficiency while attaching importance to equality in income distribution; and we have taken measures to lower the domestic saving rate and increase consumption by boosting domestic demand. Unlike other countries, China can not depend on short-term investment to raise domestic demand. Rather, we need to encourage household consumption. According to statistics, household consumption accounted for only 40 percent of China's GDP. There is a large potential for further expansion. However, due to limited land and energy resources, adjustment of consumption structure will have to rely on service sector growth. It is worth mentioning that as a populous country, China's labor market is very flexible, because a large number of farmers look for jobs in cities and coastal areas. China has benefited a lot from such flexibility of the labor market.

Despite statistical factors, compared with India, Russia, and Brazil, China's service industry still has much room for further growth. For example, the share of China's service output in GDP was only 40.7 percent in 2004. In contrast, India's service industry made up more than 50 percent of its GDP in 2003. Take the film industry as an example. The output of Bollywood might be about 20 times that of the Chinese film industry. After allowing for culture, language, and other factors, we ought to reflect on the reasons behind such a difference, and find out why and how the service industry in China is lagging behind.

While some countries have called for greater liberalization of the service industry and some news magazines are also busy discussing the possibilities to further grow the global service trade with the support of the increased transportation capacity and advanced technology like the Internet, it should be recognized that even liberalization of the service industry could only play a limited role in fixing the imbalances in goods trade. For example, the service industries including travel, catering, and hotel and entertainment are mostly concentrated in the fields of culture and arts, which carry a strong local flavor, thus are on most occasions classified as domestic trade. Except by international sea and air transport, domestic shipments are hard to deliver across the border. Some sensitive sectors such as the telecommunication industry are yet to be liberalized completely for competition. Even with enforced protection of intellectual property rights, the transaction volume of service trade between China

and the United States is limited to tens of millions of dollars, with barely any significant impact on the Sino-U.S. trade.

Take the financial industry as an example. With the pace quickened to open the domestic financial sector to foreign competition, China has started allowing foreign investors to buy stakes in domestic financial institutions and become participants in the domestic financial market. These include the Bank of America's equity investment in the China Construction Bank, the Royal Bank of Scotland's investment in the Bank of China, New Bridge's equity taking in Shenzhen Development Bank, and the introduction of qualified foreign institutional investors in the domestic market. These foreign investors usually send a few people only to hold key positions in risk control and business management in the invested companies while leaving all other responsibilities to the staff from the Chinese side. Based on rough calculations, we could see there is only a fairly limited amount of service trade in these transactions. Even in terms of the insurance industry, which takes a relatively large proportion of the financial service trade, only a bit more than US$6 billion of deficits was recorded in China's balance of payments in 2005. Intermediary services like the accounting service display some similarities to the financial sector. All in all, the financial sector usually does not account for a large proportion of the total service trade, and its role particularly needed in certain countries to compensate for the deficits in goods trade is even more limited.

According to relevant reports, commercial banks are developing soundly in India with low NPL ratios, proper order, and a good legal environment. In terms of capital market development, India also has relatively advanced stock and equity markets. Despite the fact that China has a high saving rate and the Chinese financial sector maintains a comparatively high liability ratio (with broad money supply accounting for 180 percent of the GDP), there exists a great potential for growth of the financial industry. Compared with India, what are the reasons behind some of the weaknesses that have emerged in the course of financial development in China? The answers, according to our own studies, may lie first in the "financial eco-system" of China. "Financial eco-system" comprises not only environment at the macro level such as the legal, supervisory, regulatory, and government intervention policies, but also micro conditions related to efficiencies of the financial institutions' business operation. Besides, the centralized planning economic system adopted in the past has consequently resulted in low efficiencies of the financial sector in many aspects as well as some mistakes in the building of institutions, policy framework, management framework, and the

regulatory system. These mistakes need to be corrected continuously in the ongoing reform process.

China and India are both large developing countries and we face similar challenges in developing our respective economies. In this regard, the experiences and lessons gained by our two countries are worth learning from each other. I believe frequent exchange and cooperation between our two countries will help to strengthen mutual understandings and economic growth in the region, thus benefiting people of both countries.

DR. ZHOU XIAOCHUAN
Governor of the People's Bank of China

Preface

Over the last 15 years, China and India have added more than US$2¼ trillion to global GDP, 120 million in employment in China alone, and have pulled 220 million people out of poverty. These are large numbers: like adding a country with the economic size of Greece to the world each year; creating as many new jobs in a year as Australia's total employment; and completely eradicating poverty in Ethiopia, Nigeria, Tanzania, and Zambia combined. It is, therefore, not surprising that the international community has paid a lot of attention to economic developments in China and India. This surge in attention has resulted in a large number conferences on the countries in the last few years. More often than not, the focus of these conferences has been on what the rise of China and India as economic powerhouses means for the world. This is an important question.

Another, equally important, question is: what can the two countries learn from each other's experiences? With this in mind, the IMF and India's National Council of Applied Economic Research (NCAER) organized the first China-India conference in New Delhi in November 2003, bringing together policymakers, officials, and academics from the two countries to share their experiences.[1] That conference stimulated lively and productive discussions, and encouraged us to organize a follow-up meeting two years later; this time in Beijing in October 2005, with the help of the China Society for Finance and Banking (CSFB) and the Stanford Center for International Development (SCID).

This book is a compilation of selected papers presented at that conference. Its unique contribution is that a majority of the chapters are written by policymakers and practitioners, rather than just academics. For instance, Reserve Bank of India Deputy Governor Rakesh Mohan discusses how the forces of globalization can complicate the challenges facing monetary policymakers in emerging economies, such as China and India. In his contribution, People's Bank of China Governor Zhou Xiaochuan contrasts the growth of the services sector, including financial

[1]Papers from that conference were published in Tseng and Cowen (2005).

services, in China and India and discusses the importance (and difficulties) of developing this sector in China. Other contributions bring to bear perspectives from the financial sector, banking regulators, securities regulators, stock exchange officials, planning commissions, and think-tanks closely affiliated with decision makers. Thus, the analytical discussions in this book are all infused with a sense of pragmatism and policy relevance.

Financial Sector Reforms: Banking

Financial sector reforms are a key component of the economic reform strategies of both China and India. The important role of the banking sector in financial intermediation in these countries has focused particular attention on this aspect of financial reforms.

Nachiket Mor, R. Chandrasekhar, and Divya Wahi provide a brief history of bank regulation in India and then review the main banking reforms since the early 1990s. They note that banking sector performance has improved in many dimensions and may have contributed to improved growth performance over the last decade. They argue, however, that further reforms are needed, including improvements in the financial services infrastructure, reductions in the cost of intermediation, and scaling up of banking services to provide broader access to financial services, especially in rural areas.

Reform of the Chinese banking system was pushed into high gear earlier in the current decade. While some progress has been achieved, however, Nicholas Hope and Fred Hu contend that the core problems of the banking system remain unresolved. Their paper enumerates the priorities for banking reform and provides an assessment of the role that foreign strategic investors could play in the reform process. They conclude that foreign investors could catalyze improvements in corporate governance, disclosure standards, and asset quality, but they also caution that these very issues could pose risks and obstacles for foreign investors.

Luo Ping compares the structure and robustness of the Chinese and Indian banking systems as well as the effectiveness of their banking supervisory systems. He observes that both countries have accomplished a great deal in reforming and improving their banking industries in recent years. But the Indian banking system has, by virtue of India's earlier start in the reform process, attained greater improvements in asset quality, capital adequacy, and quality of supervision. He notes

that the Indian experience may provide some useful lessons for Chinese policymakers.

Financial Sector Reforms: Securities Markets

A well-rounded financial sector that does not rely solely on banks is important for effective financial intermediation. In their papers, G.N. Bajpai and Narendra Jadhav describe the importance of securities market development. Bajpai provides an overview of the steps that India has taken to build a well-supervised world-class infrastructure for trading securities, and discusses how this has been associated with improvements in corporate governance among listed companies. Jadhav traces the development of specific securities markets in India—equities, corporate debt, and government securities—and discusses how policy reforms have contributed to these outcomes. Bajpai and Jadhav concur that, despite all of the progress that has been made, deepening of the corporate debt market and some refinements in regulation of securities markets are still needed in India.

Xinghai Fang, Ti Liu, and Donghui Shi argue that opening the Chinese securities industry to both internal and external competition could play a crucial role in enhancing its efficiency. They argue forcefully that fears that foreign competition could overwhelm the domestic securities industry are misplaced and that, in the absence of innovation and discipline stimulated by increased competition, development of the securities industry could in fact be greatly hampered.

Financial Integration

Suman Bery and Kanhaiya Singh provide an overview of the literature on the costs and benefits of integration with international capital markets, and how the cost-benefit tradeoff is related to domestic financial liberalization. They then trace the evolution of India's financial liberalization and financial integration processes, including the relationship between policy reforms and outcomes in terms of the nature and level of liberalization and integration, respectively. Bery and Singh conclude that, while one cannot ignore the risks of international financial integration, further integration could have significant benefits for India in terms of stimulating financial sector development and improving macroeconomic policy discipline.

Eswar Prasad, Thomas Rumbaugh, and Qing Wang contend that, while capital account liberalization could play an important role in China's economic development, undertaking further liberalization *before* allowing for greater exchange rate flexibility could pose some risks. They note that the Chinese banking sector has limited net foreign exchange exposure and could withstand fluctuations in the exchange rate. But banking system weaknesses could make premature capital account liberalization risky. Exchange rate flexibility would provide room for an independent monetary policy oriented to domestic objectives, which would help foster macroeconomic and financial stability.

Other Policies for Sustaining Growth

Rakesh Mohan provides a sweeping overview of some challenges facing modern monetary policymakers. He sets the stage by providing an analytical characterization of a number of contemporary "puzzles," including the strength of the U.S. dollar despite soaring twin deficits in the United States, low consumer price inflation in major economies despite abundant global liquidity, and continued strong global growth despite the surge in oil prices and low investment rates. He contends that rising globalization may make traditional monetary policy instruments less potent, and uses the examples of China and India to illustrate that this point is particularly relevant for developing economies.

Steven Dunaway and Annalisa Fedelino discuss fiscal policy in China. Chinese fiscal policy has been prudent in recent years, with low levels of fiscal deficits and debt (relative to GDP), especially compared to many other emerging market economies. These authors note that fiscal policy has been guided largely by the government's medium-term focus on fiscal consolidation to make room for financing contingent liabilities, including in the state-owned banking system, and rising spending pressures as the population ages. They argue that, to make greater use of fiscal policy for demand management, broader and better coverage of fiscal accounts, an improved budget classification system, and better cash management to facilitate coordination of fiscal and monetary policies are needed.

Arvinder Singh examines the factors behind, and the implications of, labor mobility in China and India. He notes that, unlike the *hukou* system in China that restricts movement of labor from rural to urban areas and across provinces, there are few legal restrictions on labor mobility in India. Nevertheless, in both economies, cultural and social

factors play important roles in determining the levels and patterns of labor mobility.

Indo-China Economic Cooperation

Arvind Virmani examines the rising trade linkages between China and India. While the level of bilateral trade has grown in recent years, it remains low in absolute terms. Virmani argues that the bilateral trade potential is very high, given the size and dynamism of the two economies and their complementary production and trading patterns. He discusses the main barriers to realizing the full potential of China-India trade—including customs rules and procedures, certification and regulatory practices, nontariff barriers, and rules of origin—and makes some specific recommendations to reduce these barriers. Virmani also makes the case for a comprehensive economic cooperation agreement between the two economies.

Nalin Surie describes how, despite following different reform trajectories, both China and India have now moved on to high growth paths. He compares and contrasts the two development models, picking out some important lessons from each country's experience. In India, stable financial markets have facilitated an efficient allocation of resources, but public sector inefficiencies and an underdeveloped infrastructure have held back growth. China's rapid integration into the global economy, especially through rising trade linkages, has boosted its growth, but the underdeveloped financial sector remains a weak spot. Surie notes that both countries face similar socio-economic challenges—unemployment, rural-urban inequality, environmental and water problems, needed improvements in health and education, the status of women, etc. He concludes that China-India development cooperation is not a zero-sum game and that effective cooperation between the two countries could have broader benefits for the Asia-Pacific region and the global economy.

Jahangir Aziz, Steven Dunaway, and Eswar Prasad

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The Editors