The Impact of China and India on the Global Economy

Dr. Wendy Dobson
Professor of Business Economics
Director of Institute for International Business
University of Toronto

The following is the text of a speech given at the Institute for Global Economics' Distinguished Lecture Forum on Tuesday, May 10, 2005.

The topic this morning is one that is quite dear to my heart. I lived in India in the 1960s when the population was less than half what it is now. At that time, we thought the infrastructure in India was adequate. Any of you who have been to India recently, though, would not share that view today.

I am going to talk about "Chi-ndia", as the word has been coined, and the integration of these two large economies into the world economy. We are fascinated when something like this happens: very rapid growth of two major economies over a span of ten years, as India has emerged following China's emergence. But we are also a little fearful. Together, India and China these days account for just over 2 billion of the world's population. India is the 12th largest economy. China is the 6th largest. By 2050, because India's population is growing more rapidly, India is going to have the larger population. By then, both China and India are going to account for about 3 billion people, which will probably be about 30% of the world's population.

Some say that by 2020, even though their average standards of living are much below those of ours in the OECD economies, the very size of their populations will mean that their economies will be very important in "power" terms. There have been some projections of which some of you are probably aware. In 2003 Goldman Sachs economists published a paper called "The BRICs", meaning Brazil, Russia, India and China. The report projected that the size of the Chinese economy in US dollar terms would reach US levels by 2040. And India's economy in US dollar measures would reach Japan's level by 2030.

So size is what catches our attention. Of course, it raises important questions about what the governments of these two future giants see as their roles and objectives in the world. Will their objectives be peaceful and cooperative, or competitive and hegemonic? Those are large questions that I am not going to be able to answer this morning. What I would like to talk about are some of the assumptions upon which these projections are based.

I don't think anybody would disagree that, as things stand today, China's performance is superior to that of India. There are a number of reasons. One is, of course, that China is not a democracy so it's much easier to accomplish economic change on a top-down basis. Another is that China chose manufacturing and India chose services. A third one is that China looked at its neighbors, not least of them Korea, and adopted the export-led growth model a decade or so before India. India persisted with an import-substitution policy, which had long before been discredited or overtaken in eastern Asia.

I will argue that, by themselves, none of these three explanations explains the differences in China and India's performances. If I look back, I would say that what was crucial was that windows of opportunity for economic reform opened and governments responded. If I look forward, I would say that what's crucial in the future will be—and this won't sound strange to a Korean audience—the role of institutions in the economic reform process.

The test of whether China will become a great power or simply, as one Indian economist put it, a great manufacturer, and whether India will become a power to be reckoned with or will simply be a great democracy, is whether governments can bring themselves to withdraw from intervening in their economies in time. In China's case, government intervention is still pervasive in every aspect of the economy. In India, it's not just one government, but governments at a number of levels that cannot seem to stop meddling with market forces.

If we look back before we look forward, there are a couple of things that might be of interest. First, both countries became independent early in the post-war period. Both adopted Soviet style planning models. China went so far as to completely abolish private property and private ownership, while India accepted capitalism but set out to curb what were seen its excesses through government oversight and controls. Both closed their economies for most of the 1950-1970 period and intended to go it alone and to do it themselves. That, as we all know, was a period, not only of indifferent economic growth, but also disastrous setbacks: the Great Leap Forward and Cultural Revolution in China and very serious crop failures in India in the mid-1960s.

In both cases, crisis opened windows for economic reform. Someone in each case put a reform package into the open window. In 1978 Mao and his crowd had left the scene. Economic growth was slower than China's population was growing. Deng Xiaoping had noticed what was going on in Taiwan, Korea and what had gone on in Japan. He introduced a profound set of policy changes, beginning with the "one child" policy. It didn't stop there. His new policies included very cautious reform in rural areas where producers that used to be part of the communes were allowed, as long as they met government quotas for production, to keep the excess and sell it. There was an unexpected and dramatic production response to that freeing of restraints. What followed was the cautious freeing of market forces elsewhere in the economy, starting with an opening to the rest of the world through the special economic zones. The initiative to join the WTO, which goes back to 1986, had as one of its intentions to lock those reforms into an international agreement so that they could not be changed.

This was a period during which India was muddling along, relying heavily on its major trading relationship with the Soviet Union and, increasingly in the 1980s, on government stimulus to keep growth going. But when the Soviet Union collapsed in 1990, India's main export market went with it. In 1991, India had a balance of payments crisis when it actually ran out of foreign exchange and had to go to the IMF. This was when Manmohan Singh, the current prime minister, was the finance minister.

With the crisis a window of opportunity opened and Manmohan Singh, with the support of the prime minister of the time, introduced radical economic policy changes. He liberalized the trade regime, freed up the exchange rate and removed a number of restraints on importing and exporting. What he was unable to do was to abolish a bureaucratic superstructure that had been built over the past 50 years.

So growth paths in the two countries developed in slightly different directions and I will touch on four areas of difference. One is in macroeconomics. China definitely has a better base. It has a federal structure, like India's or like Argentina's, but it has managed to keep fiscal balance. India, on the other hand, has had persistent fiscal deficits, particularly at the state level, and therefore a growing burden of domestic debt. India also saves at about half the rate that China does.

As we all know, China is now the world's third largest trading nation, after Germany and the US. It accounts these days for about 6% of world exports. India, in contrast, accounts for about 1%. China's trade in goods is nearly half (50%) of its GDP. In India, it's about one fifth (20%).

A second area of difference is the role of FDI in each economy. This was something where China has encouraged. It has provided special incentives to the diaspora to come home and start businesses. India is still ambivalent about FDI. It only recently changed its policies toward its diaspora to encourage them to return home.

China's emergence as the workshop of the world has relied disproportionately on the diaspora, as well as on multinationals who have set up export platforms in the country. Indian manufacturing, on the other hand, still exists behind a bit of a wall of protectionism. You've probably heard of the term "the license raj". To save foreign exchange and to allocate it to uses of which the government approved importing required permits or licenses. While the rationale was to save foreign exchange, in practice it was a way for corruption to become rather deeply seated. So dismantling what the Indians call their "license raj" was one of the biggest economic changes that was accomplished in 1991.

But even so, more than a decade later, the two countries' participation in world export markets differs. In the garment market, for example, China's share between 1980, at the beginning of liberalization, and 2000 grew from 4% to 21%. India's share was 4% at the beginning and 5% at the end of 20 years. In other manufacturing, a whole basket of manufacturing activities, China's 1% share in 1980 grew to 18% by 2000. India's didn't change at all: it was a third of one percent (0.33%) and there it stayed.

Some of the reasons for the differences relate to the over-burden of regulation in India. Yet those regulations, which made it very difficult to import goods, had a perverse effect. They are one of the factors behind the IT revolution in India. There are interesting anecdotes told by the IT firms in India. The import restrictions made it so difficult to import computers in the 1970s and early 1980s, that entrepreneurs had the bright idea to forget about hardware and concentrate on software. In effect, they created a virtual industry in order to get around the obstacles in the economy.

The third difference is the availability of infrastructure. China's savings have made it possible to invest in every kind of infrastructure. Finding the financing to build parks, highways and communications infrastructure is difficult because of the fiscal imbalances of governments.

The fourth area that's really important is the environment for entrepreneurship and innovation. India has a vibrant entrepreneurial tradition and sector. Some Indian entrepreneurs have returned from abroad, but some of them, like the founders of Infosys which has become a global firm, grew in India despite all the obstacles. So far, China lacks comparable entrepreneurial success. When you ask about it, you're pointed to all sorts of investments in government-sponsored R&D research parks where there's competition at different levels of government to create such institutes. But government provides the funds and because it is pervasive in their activities, influences the incentives to succeed and the penalties of failure.

How should we understand future prospects? There are a number of lessons to be learned from what you have learned here in Korea. If we put things in perspective, living standards in China today relative to a US dollar-measured standard would be where Korea was in 1972 and where Japan was immediately after the war. India today is where China was in 1986 when it was still early in its reform process.

The debate in Korea over the last decade or more about how you have to reform the economy to sustain economic growth in the long-term is something that perhaps you take for granted. But it is really important in understanding and predicting what will happen in China and India. Most Koreans would agree that long-term growth depends on the accumulation of inputs in both labor and capital, but to sustain it over the long haul what really matters is technology, technological change and innovation, as well as an institutional environment that is welcoming and encouraging.

Korea opened up to trade—not investment—but trade with the rest of the world in order to catch up. Korea went through a period where government's role was very important in mobilizing capital, allocating labor and, not least, developing an educated labor force. The growth achievements here that were so spectacular have been put in perspective. As the economy industrializes, it becomes more complex. The role of government in mobilizing capital and perhaps directing things from the top has to change. The awareness of this and the changes you've taken in Korea make you almost unique in eastern Asia.

There's still a great deal to do. As *The Economist* pointed out a couple of years ago, Korea has developed its own brand. It's cool, it's wired and it's pragmatic. But Koreans would also be the first to say a lot more has to be done to release resources from enterprises that aren't productive, to ensure the rights of minority shareholders, to develop and to diffuse innovation, to encourage new business formation and to develop the human resource potential that is the basis for a knowledge-based economy.

So the future prospects for India and China come back to their willingness to restructure and modernize their economies. The question for the future is whether they will be able to restructure in ways that free up the private sector. Each has high savings rates and capital accumulation but, as I said, India has a chronic budget deficit. The non-performing loans in the banking sector in China tell us that they system there is not yet very good at allocating capital.

China is far ahead of India, though, in the competitiveness of its economy. Its WTO commitments, when fully implemented, will make it one of the most open of the emerging market economies. For example, China's ratio of imports to the size of its economy is around 30%, compared to India at around 12%. The fact that imports are welcomed and used enhances competition in the Chinese economy. Competition in China is also enhanced by the sales of foreign affiliates that are located there. They sell about 60% of what they produce into the Chinese market.

In contrast, one of the really remarkable things about the Indian economy is a reluctance to compete. I've been repeatedly struck by what Indians call "attitudes". It seems to be a code word for corruption and vested interests. One of India's most persistent constraints is the informal self-serving arrangements among politicians and bureaucrats. This *you-scratch-my-back-and-I'll-scratch-yours* arrangement has grown over the past 50 years. Bureaucrats have taken their role in regulating markets very seriously. The civil service, instead of keeping an eye on what should be the national interest, has tended to join with politicians in pursuing their own interests.

Is India different than other countries in this regard? There is an argument that, yes, India is different. One of the biggest obstacles they have to overcome is that there is really no aspect of Indian life that hasn't become corrupted and dependent on this mutual self-serving relationship. That's an obstacle to sustained growth in India.

Another source of growth is labor and what goes on in labor markets. If there's anything these two countries have in abundance it is labor. One of the main differences is in labor skills. We hear a lot about India's education system and the engineers, particularly software engineers, that have been produced. The fact is that India's education system is, if anything, distorted toward post-secondary education. India produces hundreds of thousands of engineers and technicians, but its accomplishments in basic education are dismal.

The statistics in primary education show this. Around 2000, in China 98% of children had five years of primary education. In India the number was 47%. The literacy differential between men and women is very much more marked in India. Illiteracy among women tends to be about twice what it is among men.

The structure of employment is quite different, too. India's formal sector—that is, the private or market sector—employs less than 10% of all Indians. China's formal sector employs about 20%. The explosion of jobs in low-end manufacturing in China has helped to absorb tens of millions of people from the state-owned enterprises as they've restructured and thrown people out of work and those moving from the countryside.

In China, some of you may be familiar with a commitment to move 300 million people from the countryside over the next 25 years. In India, there's no hope of a commitment like that. The message in the May 2004 election, where the incumbent government was thrown out by the voters in the countryside, "We want jobs, we want clean water, we want education and healthcare." The response that has been possible so far by Manmohan Singh's government has been to promise everyone who wants 100 days of paid work a year, and even that commitment has been watered down.

Addressing the problems in the countryside inevitably depends upon the long-term growth of the economy. In the long-term the key determinant is technological change and greater efficiency. This is what brings me back to the role of the state in the economy. Mainstream economists would agree that government's role is to set the framework for the private sector, to create a social safety net and to encourage and reward innovation.

The Chinese government has shown a greater willingness to provide its labor force with basic educational skills and to promote flexibility in labor markets. For example, in China employers can hire and fire. One of the huge problems in India is 50 years of policies promoting small businesses and making, in effect, labor an overhead cost. Once you've employed somebody, it's almost impossible to fire them, especially if you're a small business. So you can imagine what kind of disincentive that is to job creation in the small business sector which is supposed to be the engine of new jobs.

Another dimension that's also very important is the financial system. Strong financial systems benefit an economy. They give savers realistic rates of return and provide entrepreneurs and innovators access to funds.

India has financial markets that most of us would recognize. They probably have the most diversified financial system in the emerging market economies. Banks are dominant in India, as they are in all of the Asian economies, and many of the banks are still state-owned. There are 37 banks listed on the stock exchanges in India. As many as 59 banks, whether they're listed or not, are sufficiently transparent that when I was in India in December one of the year-end business publications actually listed, ranked and compared all those 59 banks on their transparency, profitability and corporate governance. The annual performance of banks is one that can be monitored.

In India you can also find insurance, consumer financing, consumer leasing, investment banks, underwriting, portfolio management, venture capital and foreign exchange advice all through a mixture of both state-owned and private entities. There are several stock exchanges, most of which are highly automated, and all are supervised by the Reserve Bank of India.

You probably know more than I do about China's financial system. It doesn't have a capital market yet. There is not a bond market. Up until now, Chinese stock markets have been considered to be casinos. The banking system consists of the large state-owned banks. They are not yet able to intermediate domestic savings. Indeed, funds are leaving the formal banking system in order to do private placements that generate income that is tax exempt.

Without capital markets, it’s very difficult to undertake venture financing in China. If you want to do an IPO, you have to do it either in Hongkong or Singapore, or sometimes they come to the TSX Venture Exchange in Vancouver. The small entrepreneurial firms have a very difficult time finding financing if they can’t come up with the financing from within their family or among their friends.

Yet, China is committed to open its financial system to the rest of the world by January 2007. That’s why there is a big push to clean up bad loans and push the state-owned banks toward IPOs. We’ll see what happens. I rather doubt China will be able to solve all the problems in its financial system by December 2006. How, using national treatment, can the Chinese authorities allow foreigners into the Chinese financial system without severely disadvantaging the incumbent Chinese firms?

The endogenous capability to innovate is also very interesting. India did not abolish private ownership back in the immediate post-war period and has an entrepreneurial tradition, a well-regarded post-secondary education system and a more mature financial system. At the present time, these create a better environment for an endogenous self-generating ability to innovate. In China, there are far too many accounts, still, of private sector entities that must rely on bureaucrats and officials. They are in silos, more concerned about their patrons than about the lateral exchange and competition that generates new ideas and new innovations.

The political systems are also different. There are some really interesting questions, particularly about China, as to how, with the emergence of a private sector and therefore more autonomy for business, the Beijing government will manage the inevitable tensions between economic liberalization and continued political control. The Olympics in 2008 and the Shanghai exposition in 2010 will require China to open in ways in which it has not done before. With the spotlight on the country, will there be pushes toward more democracy, where the authorities worry they will lose control? That’s one of the very interesting issues for the future.

Will China fulfill the predictions for 2030 and 2050 that I talked about at the beginning of my lecture? It will depend on whether there are setbacks: political setbacks because of Taiwan or North Korea, or natural setbacks like an avian flu outbreak or an environmental meltdown. It will also depend on China’s ability to modernize its financial system. This is not something you can do overnight.

As you know in Korea, it's not easy to take a bank which, in China, used to be just one more government department, and reform it. If somebody from a state-owned enterprise, which was another government department, needed funds, he would go to the bank "department" and say, "Give me some money." No is very different from a credit adjudication; no risk management. China's future economic prospects depend very much on modernizing the financial system and managing the withdrawal of the state from the economy. The two go together.

You may expect me to address exchange rates and oil demand. I see both as short-term issues. Since I am running short on time, we can discuss in the Q&A if you wish.

What does this mean for the rest of us? I've been looking at capital, labor and technology as sources of long-term growth in the two economies. With the emergence of China and India and with their weaknesses and their strengths, what does all this mean for the rest of us? Obviously, there are both threats and opportunities. Both countries have venerable civilizations and histories where they've seen periods of greatness. Each is very interested in developing a role for itself in tomorrow's world.

For the foreseeable future, there will be a focus and preoccupation with domestic development that will probably preclude adventurism outside their borders. Starting with India, the warming of cultural ties, sports and economic ties between India and Pakistan are very much to be welcomed. In fact, I would suggest that India and Pakistan should get serious about negotiating an FTA. Pakistan looks at India in the same way that Canada looks at the US: there's an elephant next door that really affects our prospects. The more closely knit we are economically, the better off both will be. Significantly, in April there was an accord signed in New Delhi between China and India. That may turn out to be a watershed leading to closer cooperation throughout Asia.

This means there is a power shift of which you are all aware, but which we in North American are slowly becoming aware. Neither China nor India barring an unimaginable catastrophe, is going to turn inward. They're going to become poles and hubs of economic activity within the region and with each other. But whether they will just be big players in this region, or they will become global powers, will depend on how they resolve the role of the state in the economy.

The lesson they can learn from the OECD economies and their rise out of poverty to sustained wealth is that economic growth, to be sustained, requires market-friendly institutions and policies and a large amount of autonomy for the private sector. Even if they fall short of dramatic predictions that they will be the world's leaders in the future, they are still going to be major systemic influences. Their economic performance and policies are going to spill over onto their neighbors and, possibly beyond, because of global supply chains and growing interdependence.

We all have a stake in them adopting good policies and good institutions. It's obvious they should be included in global economic management institutions. Both are now members of the WTO, but neither is yet a member of the G8. A very obvious expansion is required in that area.

Finally, they will provide us with both challenges and opportunities. All of us are going to face challenges from China in manufacturing, and for us in North America particularly in the auto sector. China is already exporting auto parts and will soon be exporting autos to the rest of the world. The response of the importing countries is going to be very important. The obvious response is to try to protect. The desirable and sustainable response is to adjust and to move out of direct competition with Chinese manufacturers. India is also likely to become a major force in biotechnology and IT, but it's too soon to see or to predict what kind of impact that's going to have on the rest of us.

The challenges are from China in manufacturing at the present time. The opportunities will come through—and it's not surprising that an economist would say this—the operation of the principle of comparative advantage. It's quite popular for commentators to say, "China's eventually going to produce everything." Sometimes, even the Chinese themselves give the impression that they want to produce everything that can be manufactured.

But by principle of comparative advantage China will produce goods it makes relatively more cheaply than its trading partners and it will then import what it is relatively less efficient at producing. There are substantial opportunities there. We in the more advanced economies have to get our costs down, increase our productivity and deepen the knowledge-based economy that produces the goods and services that China and India will need to import. Governments have to get out of the way and remove bureaucratic obstacles and tax burdens that raise the costs of production and of doing international business.

For producers, it means moving upmarket into higher value-added activities. The top priority there is going to be people. The education systems that produce skilled and creative workers are going to be a source of comparative advantage.

As you might expect, China and India's emergence mean greater competition but also a plethora of opportunities, both for cooperation and for investment in those areas where we have relative strengths. The principle of comparative advantage will require that, as China and India continue with their economic reforms, we will have to adjust faster.

Questions & Answers

Question #1: You covered just about everything in the institutional politics and economy, but one aspect you didn't cover that has been talked about but never proven is that one of the problems that India faced historically is their aversion to physical labour. While being excellent in philosophy and religion, they had a certain aversion toward labor.

Combining that with the corruption you mentioned, with the litany of problems India has, it's almost a wonder how they got to where they are today, despite, of course, the fact that they did manage somewhat in the service sector or with software, rather than on the physical labor side. More interestingly, how do you see them moving forward to overcome all those tremendous amounts of difficulties?

Secondly, the Chinese have been much more efficient, but nonetheless face enormous problems with the regional differences, the sheer magnitude and size, though they've done a magnificent job so far managing this entity as a government. The task they have going forward is also such that, just looking back at the past percentages and projecting into the future makes me wonder what that future path might be. What are your thoughts?

Answer #1: I'm not sure I would agree with the characterization of "aversion to hard labor". Indian peasants work just as hard as Chinese peasants. But there is a different philosophical framework that comes out of the Indian experience of colonialism and a desire to avoid or curb the excesses of capitalism and foreign involvement in the economy. Put that together with Mohandas Gandhi using labor intensive techniques such as spinning to create jobs as well as non-violent protest against the British.

Prime Minister Nehru continued in that framework of paternalism and job creation. Part of the regulatory framework that India still has to throw off comes from this romanticized past that, to avoid the exploitation of labor, you should not allow them to be fired. So there's a lot of traditional Indian manufacturing that is hobbled by the wrong kinds of restrictions. It's almost impossible to take this on head on with a coalition government in a democracy.

Instead, the current strategy is to try to find a way around these laws and a set of measures that allows for labor-intensive manufacturing to take off in India. Textiles and apparel are very important. Now that the Multi-Fiber Agreement has come to an end in January 2005, India has an opportunity to become a major textile producer. The challenge is to find a way to work around those old regulations. It's a very difficult challenge to overcome.

So one of India's biggest challenges is to be able, with some certainty, to make the type of modern employment commitment China has. There is enough dynamism in labor-intensive manufacturing that it provides employment for the people from the countryside.

With respect to your second question, are regional strains going to be too severe in China? I agree with you that regional disparities are probably one of China's big challenges. Again, it's the role of the state that is the problem in the interior of China. If you take the area around Chongqing, there are more than 30 million people just in the urban area alone. How do you remove the restrictions? How do you create frameworks that rely on market forces rather than on relationships with officials and official decision-making? How do you do that in a part of China that has traditionally not had good infrastructure and is not close to export markets, as the coast is? Those are not easy problems to solve.

But where both countries are now, China has a good chance of addressing regional disparities through rapid growth in major centers. They won't "solve" it, but they may be able to ameliorate the problem fast enough to avoid instability. It seems that India, with its regular electoral elections, has a safety valve that can throw out the incumbents as punishment for not improving the conditions in the countryside. India's challenge is to create jobs for people who want to move out of the countryside. It is something that I don't think India's going to solve any time soon. But I don't think it's going to bring about a collapse of the economy or have systemic implications.

Question #2: In your talk, you mentioned the Goldman Sachs "BRIC" report. You mentioned that, measuring GDP in US dollar terms, China would reach the level of US GDP in 2040 and that India would reach the level of Japan GDP in 2030. I suppose the basic assumptions there are rather optimistic. Do you agree with this?

Answer #2: I think the BRIC assumptions are heroic ones. For India, the assumptions the Goldman Sachs study used were that India has a labor force that will continue to grow. That's true. Over the long-term, India will have momentum from its labor force growth. But where will the demand for that labor be created? Goldman Sachs' prediction just waves its hand and says that, by assumption, the jobs will be created. I'm not sure, though, that there will be the labor available that will be in demand. They could have very high structural unemployment in India, with a good supply of the wrong kind of labor.

Question #3: The World Bank supported a study by a well-known economic historian some time ago. In the year 1820, the Chinese GDP was 33% of the world. At that time, India was 16% of the world. Today, China is about 4% of global GDP. So these two countries have that much potential. In fact the "emergence" of these countries is the wrong word; this is a "re-emergence" of these economies. They have this great potential. If you look at it from this side, you will tend to be a bit more optimistic, particularly about China. I don't know much about India, but, to me, the Chinese policy makers and the Chinese people as a whole work hard to get the old glory back in a way. The many difficulties they face today may be overcome by this very strong commitment.

This is a critical question. Many people are interested in this. There are almost as many "China pessimists" as there are "China optimists". I am an optimist until China reaches a *per capita* income level of about USD 4'000 or so. The political system can go on until then. Afterward, I don't know, and in the mean time, anything can happen.

> **Answer #3:** You are very optimistic. One of the really interesting questions in economic history is, when China was on top of the world—it had the largest, strongest economy on earth—why didn't it continue to grow. The answer on which most would agree is probably the correct one. It had to do with the role of the state and the fact that growth, for itself, was not valued. Growth in terms of human welfare was not valued. That's certainly not the case today, but what's important is whether or not they can come to grips with the withdrawal of the state from the economy in ways that would allow for a vibrant private sector while still keeping central political control. As I have said, there are some significant reasons for doubt.

Question #4: I have a question about the trade side. During the recent historic summit between the two countries, it is reported that they discussed a free trade agreement. How soon do you think a bilateral free trade agreement between these two countries will be put in place? Second, considering Korea's heavy dependence on exports to China, how do you expect this bilateral free trade agreement between the two countries will impact outsiders, particularly other Asian countries?

Third, both countries are very much interested in a free trade agreement with other countries, like ASEAN, Korea or Japan. So do you expect in the near future to see the whole of Asia formed into one large regional block, like the EU or the NAFTA?

> **Answer #4:** I don't think that China and India will jump into the negotiation of a free trade agreement. I think that their neighbors will let them know that that's a very frightening prospect. Rather, both of them will use ASEAN. The 10+3 will expand. Seoul will have the summit in December that includes India, as well as Australia and New Zealand. That's the right way to go.
>
> I'm a skeptic on the China-ASEAN, India-ASEAN, Japan-ASEAN or Korean-

ASEAN FTAs. Wouldn't it be better for all to sit down and have an area-wide free trade agreement? It would be very difficult to negotiate because of sensitivities in agriculture, autos and electronics.

The other reason a China-India FTA is probably not in the works is because of agriculture. That's the same reason why every other FTA has trouble. China is the one economy that is willing to adjust in agriculture. India isn't. Most of the ASEAN countries are having a hard time with agriculture. Yet you can't have an FTA without agriculture. You could have a "closer economic relationship" or some other euphemism, but you cannot have a full trade FTA.

Question #5: You stated that the exchange rate policy issue and the oil price hike are short-term problems. I tend to believe that both economies will tend to grow more or less along the planned path, but for occasional short-term setbacks. The Chinese economy, between the period of 2000 and 2020, according to the government plan is to quadruple its economic size. According to, once again, the Chinese government scenario, the Chinese economy will quadruple once again between 2020 and 2050. So 50 years from now, the Chinese economy will have grown by 16 fold, compared to its size in 2000. If the Chinese economy continues to maintain its current dynamism, its economic size will continue to increase very rapidly.

My concern is that the sustained growth of these two giant economies will crowd out other economies in the commodities market. Do we have to prepare for the continued sustained rise of oil prices as well as the price of other commodities, to the detriment of such economies as Korea? I would have expected to hear from you that the oil price is probably one of those prices that will continue to rise.

Secondly, the Chinese economy will certainly continue to be led by exports. I think you're indicating that the Indian economy could follow that path as well. So long as they adhere to an export-led growth strategy, there is a systematic bias toward undervaluing the currencies and the current account surpluses. Also, we know it will be very difficult for the US economy to be weaned from its dependence on federal budget deficits. So I would have said that exchange rate policy issues would tend to persist throughout the region. You say, though, that this is likely to be a short-term problem. What is your opinion on this?

Answer #5: The reason I see both the exchange rate regime and the oil price as a short-term problem is that I assume that, with respect to export-led growth in China, China is already reaching some kind of limit. It is so dominant as a goods exporter now, it is going to provoke protectionist responses. It is going to come under increasing pressure, not just from importers but from its competitors as exporters as well. I don't see export-led growth at the same rate in China's future. It has to move to domestic demand-led growth.

I don't know when China will fix or modernize the exchange rate regime. I'm not one to say they should be shouted at by others. There should be external pressure, but it should be carefully and respectfully applied. China has to find a solution that serves its interests. So far, its interest has clearly been stability in the exchange rate and macroeconomic stability to support the development and increasing complexity of the economy.

There are intermediate steps I think the Chinese have to take. They are starting to talk about recycling their reserves by liberalizing the capital account in respect to capital outflows. This way, not only Chinese people but also Chinese entities could acquire assets outside the country. One of the big hunts for outside assets is for oil and commodity producing assets.

I'm persuaded that we have a world oil market and that it works according to price rationing. The Chinese and the Indians are both in a search for oil-bearing assets around the world. Their state-owned enterprises are leading that search. I see that as going in the direction of making all sorts of mistakes and bad investments. These companies are not good at exploration. Yet they are not good at development. There are lots of established entities in the oil market that are good.

What we have in the oil market right now is an unexpected surge of demand because of China's rapid industrialization. I think the market will adjust. The unexpected demand appeared in a market that was producing and refining activities—all along the value chain that were aimed at demand that didn't anticipate China. So the oil market has to go through an adjustment. It will. We will see low oil prices again because of conservation, substitution and a supply response that is larger than demand.

You're absolutely right that, under a very optimistic scenario, China and India will gobble up available oil and other commodities whose prices will rise. Again, we've repeatedly seen over the last 30 or 40 years that when prices rise, substitutions take place and new supplies appear. I don't see that process will be any different going forward. For commodity-poor countries like Korea and Japan, part of the adjustment is to find substitutes and to increase efficiency.

Question #6: I was in India last month. I met Prime Minister Manmohan Singh. He would like to come to Korea and learn about Korean economic development. Minister Il SaKong is a good friend of his. What do you think Minister SaKong would advise or teach him?

Secondly, you know about India so well. Sonia Gandhi still has full power. Do you think she'll become prime minister in the future?

Answer #6: No. She will not be prime minister. Now, if I were Minister SaKong, I'm sure he would say to Prime Minister Manmohan Singh, "You don't have a lot to learn from me. But from Korea, India has a lot to learn."

A lot of it is about the withdrawal of government from the economy. He could learn a lot from the difficulties you're having in Korea. Both are among the world's best economists. They will think the same about the policy issues. But the political realities are really difficult. They are difficult in Korea, but they are ten times more difficult in India. The governing coalition in New Delhi is held together in part by the support of the Communist Party. So India has a very wide range of political interests that have to be satisfied. That's what keeps change in that democracy moving at such a slow pace.

Question #7: I think we in Korea can share a lot of our experiences, particularly our failures so that they will not repeat them. We made so many mistakes. China could learn a lot from us, not to repeat our mistakes, particularly when opening capital accounts. You mentioned the exchange rate issue, but the important thing is how China will gradually change its exchange rate regime. A one-shot re-evaluation is not critical.

What’s critical is how you move from a dollar-peg system to a floating system. There are many different steps. In that process, they could learn a lot from our experiences. In the mid-1980s, we used a spot-peg system, then a fixed-, then a basket, then we widened the band, then we finally abolished the band and it became a fully floating system.

Today, it’s totally irresponsible for outsiders to push China to move directly to a fully floating system. That’s totally irresponsible, not only for China by for the rest of the world. Can you imagine what would happen if China has a financial crisis? The Asian Financial Crisis in 1997-1998 was triggered by the Thai baht crisis. The Thai economy is such an insignificant economy when compared to China. It’s very important for the outside world to advise China properly. The Chinese policy mix should be ready for this. In this regard, the IMF should really advise China how to design a proper exchange rate regime. Don’t just go directly to a floating system, which I don’t think they will do. In doing so, you have to clear your financial sector and all these balance sheet problems have to be solved. The whole package of programs is very, very important. They can learn a lot from Korea’s failures and the outside world can advise and support them. That is true for India, too.

> **Answer #7:** I couldn’t agree more.

Question #8: You said the role of government is critically important in China and India. It seems to me the cumulative effect of market and technology is critically important. What is your personal opinion about emerging markets and technological innovation?

> **Answer #8:** The role of government in innovation is to change institutions in the economy as per Schumpeter is creative destruction. The government must allow more autonomy for the private sector to experiment, to keep earnings of successes, to live with failures and to allow failures to occur. Those kinds of changes are necessary if the economy is trying to emerge from one where the state has had control over economic decision-making to a complex modern industrial and knowledge-based economy.

..