

# Effect of China Economic Slowdown on India

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## **Introduction**

The Chinese economy has slowed from a growth rate of 10% to an officially estimated 6.5%. This has affected the world economy in ways that are still not

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clear to most people. This note analyses the effects of Chinese growth slowdown on the world economy and on the Indian economy.

## **Global Economy**

The World economy moved from a position of excess demand during the 2000s to a position of excess supply after the Global financial crisis of 2008. The Developed economies, primarily the USA and secondarily the EU, the primary drivers of demand in the global economy began to slow in the 2000, but were propped up by a credit growth bubble. The bursting of this credit bubble manifested itself as the US/Global financial crises (GFC).

Recovery from the crisis has been hampered by the supply/investment driven economies, the most globally significant of which is China. The investment-export driven development model of China, continued to produce new capacity in tradable goods, which kept the global balances from being restored. The effect of this excess supply is felt most widely in "undifferentiated tradable goods" like metals. As economies have varying proportion of such goods in their GDP, the negative effect of this global excess capacity is strongest on economies in which this proportion is high and lowest in economies in which the proportion is low. India because of its domestic oriented, export neutral development strategy falls at the lower end of this spectrum, while highly export oriented economies such as those in S. E. Asia tend to fall at the upper end of the spectrum. Among the developed countries, US is at the lower side, EU on the upper side.

The developed economies of the EU and the USA, the drivers of growth in the 20th century up to the global financial policies have also contributed to slower demand recovery, by mis-judging the nature of the crises and consequently adopting wrong fiscal-monetary policies.

## **China's Economy**

Chinese economy has grown at an average rate of a little less than 10% for 30yrs, since the reforms of 1978-80. As only a few countries in history have sustained such high rates for 15-20yrs, the issue since the mid-1990s has been, how long China could sustain such rates. The author forecast in early 2000s that China's economic growth would slow around the middle of the 2010s. This was based on two elements (1) the catch-up theory of growth which suggests a gradual slowing of high growth as an economy closes the gap with Developed countries operating at the technology frontier, and (2) an understanding of China's Socialist market economy, in which in 1980s the Chinese communist party(CCP) , owned 100% of national assets, received all profits and controlled

all investment. Based on this analysis the projected slowdown was about 2% points to 8%.

The Global financial crises ensured that this slowdown occurred right in the middle of the 2000s. The Chinese economy was severely affected by the GFC given its Investment-export model of growth, because of the collapse of world GDP and Trade growth. A large and speedy Chinese fiscal cum monetary(credit) response helped moderate the collapse and disguise the underlying weakness. We anticipated that the unusually high trend growth of world, which had helped maintain high Chinese from mid1990s to mid 2000s, would grow at slower trend. Further the US credit bubble which had accelerated both US growth and World trade above trend would be compensated by below trend growth. In this environment, Chinese credit growth could not be sustained beyond 3 to 5 years without damaging medium-long term growth prospects. The bursting of this credit bubble in June 2015, 6 yrs after the GFC has therefore reduced China' growth prospects by another 2% points to about 6%.

A growth rate of 6-7% was feasible if China had abandoned its Investment-net growth model and liberalized its economy. This required a shift from investment to consumption, from manufacturing to services and from export orientation to export neutrality/domestic orientation. A dramatic liberalization of wage rates to close the wide gap between per capital GDP & organized sector wages, was the easiest & most effective way to raise consumption from the low point of 35% of GDP. After allowing some wage increases in 2010 and 2011, this reform has stalled, with consumption share stuck at 35% to 37% of GDP. Rising wages would also have lowered profits and retained earnings, thus reducing investment. Little effort seems to have been made to reform the party controlled banking sector to give credit based on risk and return on fresh investment based on expected profitability. The ratio of fixed investment which initially fell marginally to around 45% of GDP then drifted back up to a higher than previous level of 47% of GDP. Attempts to raise the growth of the service sector through credit fueled real estate & financial sector development inevitably floundered without genuine policy reforms. Thus the well known and recognized market reforms that would have reduced the role of exports and manufactures and raised the role of domestic demand, consumption and services have remained on paper. The political economy of communist party control of the levers of power will make it impossible to institute such reforms and change the Chinese development-growth model. Thus a growth rate of 6% to 7% is not feasible, and the underlying growth rate has already fallen below 6% (in my judgement).

China however did not accept this growth decline, and is still attempting to maintain official growth at or above 6.5% through further credit-fiscal-exchange

rate measures and control regulations. This has led to fluctuations in some sub-sectors of GDP that give the impression of change in growth drivers. The denouement from this second credit bubble will come by 2018, with a further decline in underlying growth rate to between 4 & 5%, a number that is consistent with empirical studies of growth rate slowdown from fast "catch-up" growth.

## China Trade

China's current account surplus is the international face/side of its Investment-net export model of development & growth. It is intimately linked to its pattern of trade and economic relations with the rest of the World. This has two prongs or faces: With developing countries and emerging economies it's a modern version of the Prebisch-Singer hypothesis developed to explain the pattern of trade & development of USA viz Latin America (LAC). China is an importer of natural resources & raw materials from these countries and an exporter of manufactures to them. Declining Net imports of manufactured goods (Mmf-Xmf) from them and rising net exports of natural resources (Xnr-Mnr) reflect this over time.

With developed countries, instead of natural resources, China the objective is to import high tech capital goods and components, but to increase net exports of manufactures over time by progressively substituting them through domestic manufacture (ISI). Besides equity & management control of high tech D.C. firms, Reverse engineering, forced transfer of technology (FDI firms) and commercial espionage are essential elements of this (ISI) strategy.

## India-China

India, as an emerging market economy fits into the above trade paradigm of China, in terms of exporting natural resources & resource based products and importing manufactured goods. A decade ago India's trade imbalance with China was built on an import-export ratio of 3:1. This trade imbalance has expanded over the last decade to 5:1. In general, it is much easier to find alternative sources of imports than to find new export market, India would suffer much less than China from any disruption in bilateral trade. As there is little FDI or debt flows from China to India this conclusion applies more broadly to economic relations.

By the same logic, the USA, which had a large trade deficit with China, would suffer less than China from a purely bilateral trade war.

## **Effect of China Growth Slowdown**

The official GDP data indicates that economic growth is still around 6.5%. Many China analysts believe that real growth has already fallen well below 6%, with most estimates ranging between 4.5% to 5.5%. To the extent this is true, the negative effects of China's deceleration are already present & accounted for in the World economy. Any further fall, from 5.5% to 4.5% (say) would have an impact less than 1/4th of the impact which has already been felt in going from 10% to 5.5%. The direct effect on the Indian economy was & would be negligible.

Even if we take the 6.5% official estimates as face value, the main direct effects of a further China growth slowdown to 4-4.5% will be on countries which export natural resources to China. Any reduction in global demand for natural resources & commodities, reduces prices, and hurts all natural resource exporters. India suffers only in a few commodities like iron ore & steel but benefits from falls in energy prices and other natural resources & commodities, resulting in a net benefit. In the medium-long term India and the world would benefit from a sharp fall in China's manufacturing profits and investment as this will restore the balance of supply & demand in tradable goods.

China's investment is driven by State & local govt companies and related party owned organizations. This investment is financed by retained earnings and profits. As excess capacity has increased, profits have fallen and investment is financed by a much larger fraction of credit from govt/party controlled banks & financial institutions. As the decline in growth will be accompanied by, driven by a bursting of the credit bubble, credit will decline sharply along with profits, leading to a forced reduction in investment in manufacturing. This will reduce pressures on prices and profitability of manufactured goods across the world, allowing investment in manufacturing in developing countries and emerging market economies(EMEs), to recover gradually.

## **Geo-economics: USA-China-India**

China has been the largest "contributor" of World growth since 2001. India overtook USA to become the second largest contributor to World Growth by 2008. During the period 2008 to 2014, China's contribution to world growth was 38.5% of total growth. During the same period India's contribution was 13.3% a little more than a third of China's, but a little more than twice that of the USA. The Euro area's contribution during this period was negative.

The image shows a presentation slide titled "Contribution To World Aggregate Growth". The slide contains a table with the following data:

Country/Group	1992 to 2000	2001 to 2007	2008 to 2014
China	18.0%	23.0%	38.5%
USA	24.3%	11.3%	6.3%
India	7.2%	8.3%	13.3%
Euro Area	12.7%	7.9%	-0.7%
Russian Federation	-5.2%	5.3%	1.8%
Brazil	2.8%	2.5%	2.9%
United Kingdom	2.8%	2.0%	0.4%
Japan	2.0%	2.0%	0.1%

At the bottom of the slide, it says "November 2nd, 2015" and "Follow @dravirmani on Twitter".

It is relevant to note the difference between "contribution" to world growth and a "driver" of rest of world (ROW) growth. An IMF econometric study showed that neither China nor India is a significant "driver" of ROW growth, with USA being the most important driver and EU in second position.

Virmani(2004) projected the Chinese economy to become the second largest in a decade, and that its rise to "great power" would be much faster than projected by US studies (e.g. By NIA). Virmani (2005) projected that Indian economy would also grow to become the third largest, 15 to 20 years after China becomes number two. Subsequent projections, including the latest, confirm that India is on track to acquire the economic capacity to become a "potential great power" (authors definition) after 2030. This will place it in third place behind USA and China (ahead of Germany and Japan) during the decade of the 2030s (ie before 2040).

## Conclusion

The direct negative effect of Chinese growth slow-down is, and will be, mainly on exporters of natural resources and exporters of sophisticated capital

goods & components like Germany. Steel suffers indirectly from lower global prices because of excess supply and dumping by Chinese producers.

India has benefited from reduction in energy prices and could benefit from the accompanying reduction in investment in manufacturing.

India benefits in the medium-long term from Chinese growth slowdown and its affect on profits, retained earnings and investment in manufacturing. China's investment is driven by State & local govt companies and related party owned organizations. This investment is financed by retained earnings and profits. As the decline in growth will be accompanied by, driven by a bursting of the credit bubble, credit will decline sharply along with profits, leading to a forced reduction in (party controlled) investment in manufacturing. This will reduce pressures on prices and profitability of manufactured goods in India, allowing Indian investment in manufacturing to recover gradually.

With the recent rise in Chinese wages, closer to "market levels" The artificial gap with wages in India has been eliminated. Indian wages are now competitive with Chinese wages, making a shift of labor intensive China based manufacturing to India possible. With excess capacity reduced/eliminated foreign invested enterprises would find it both profitable and less risky to manufacture these goods in India, both for the Indian market and other markets. Thus some of these will gradually shift to India, benefiting Indian growth.

## **Conclusion**

The US can create a stable balance of power in Asia, that will allow it maintain its global primacy, by helping India close the gap between it and China; This requires,

(1) Recognizing that India is still a relatively poor country, and give it (till ~2030), the same benefits & forbearance from new IPR & other US rules (mostly instituted in last 15 years), given to S E Asia, S Korea and China at similar levels of Per Capita GDP. In applying any new trade restrictions, USA must also distinguish between a non-market economy controlled by the Chinese communist party (CCP) & a basically free market economy like India.

(2) Allow India free access to (confidential) dual use & military technology which can help India close the technological gap with China (many of these technologies were stolen/reverse engineered by China because of US forbearance).

(3) Allow India to purchase front line (secret) strategic & military equipment, and sub-systems for its "Made in India" equipment, which will help India deter any Chinese attack on India (perhaps connected to the passing away of the Dalai Lama and/or unrest in Tibet or designed to "Teach India a lesson").

(4) The threat to Peace emanating from the emergence of a tacit strategic and military alliance between China and Pakistan & the role of Gwadar port & its North-south connectivity through J&K to China is increasing. Pakistan is the only country that opposes comprehensive connectivity between Afghanistan & India (it vetoed 3 connectivity agreements at SAARC summit in Nepal 2014). *US should allow India to develop a competitive trade & transit corridor between Chhabhar port in Iran & Afghanistan.*

(5) The Salafi-Takfiri-Wahhabi (STW) ideology, which motivates Daesh, has been spread by Pakistan to a majority of its own Sunni population & increasingly to J&K. The radical terrorism promoted by the Pakistani establishment therefore requires a zero tolerance policy from the USA. One element of a policy for stopping its spread in S Asia is for USA to recognize the Line of Control in J&K as the international border between India & Pakistan.

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