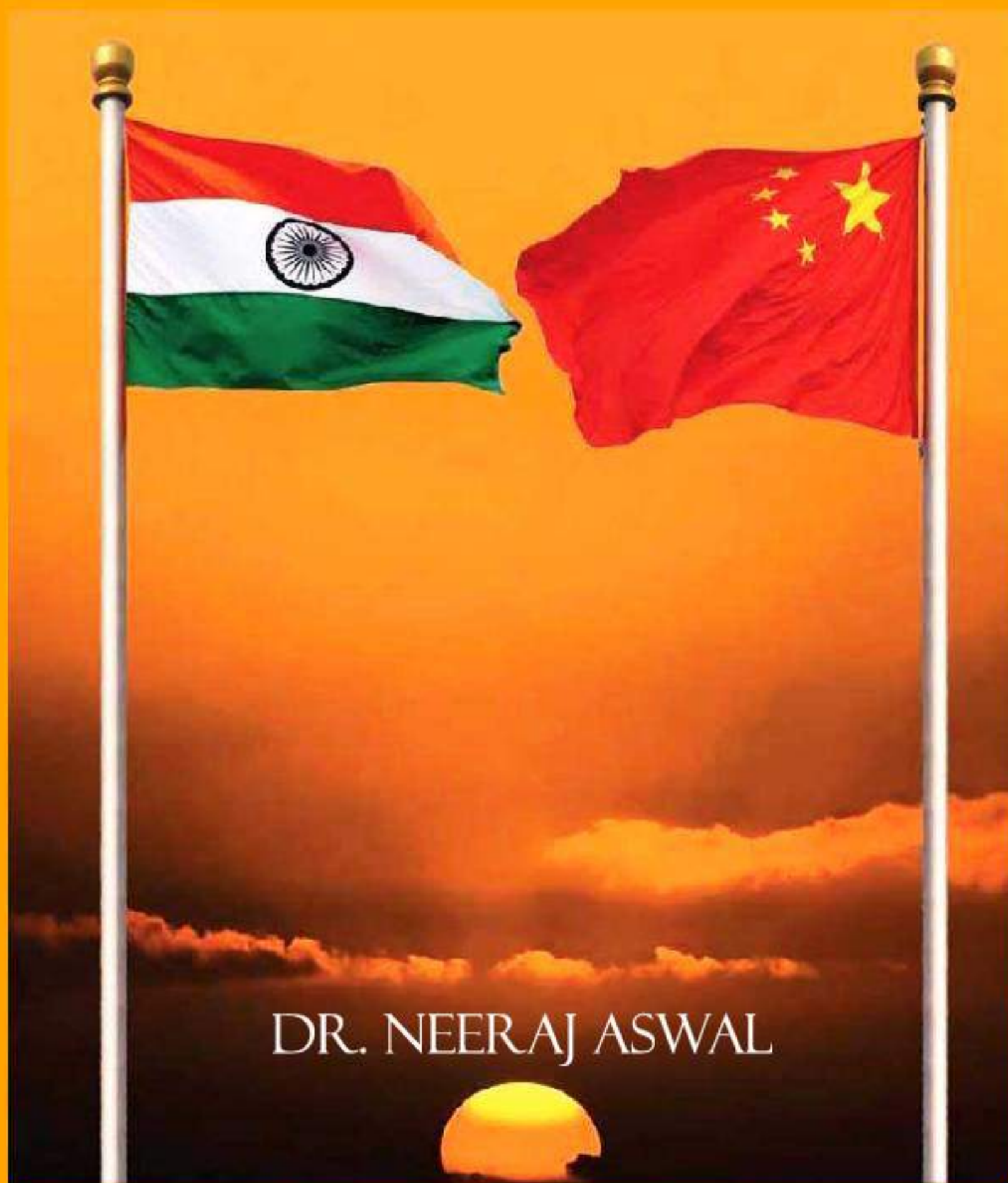


# CHINA'S INTEGRATION INTO GLOBAL TRADING SYSTEM AND ITS IMPLICATIONS FOR INDIA



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China's Integration into  
Global Trading System  
and its Implications for India

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**1.1 STATEMENT OF THE PROBLEM**

Economic globalization has made tremendous strides in recent decades as evidenced in the huge expansion in world exports, vast FDI flows and Tran's nationalization of production, among other factors. The first wave of globalization was witnessed on a massive scale in the 19<sup>th</sup> century. However, there are several parameters distinctive to the contemporary process of globalization, making it the kind of deep integration that was not seen in the previous period. The tendency of the market towards relentless expansion so as to bring the entire globe under its reign-in other words, economic globalization-has been visible from the time of its birth, though undoubtedly marked by severe interruptions. The extensive or widening phase of globalization, in the sense of bringing the entire planet under the sway of the market, had been completed by the end of the 19<sup>th</sup> century.

China's rise from an isolated giant to one of the world's fastest growing economics and a poster-child of globalization is a well-known story. But how China's commissar achieved this feat bears retelling. China's total foreign trade in 1978 was only US\$20 billion, making it an insignificant player in world trade. Only half a million tourists visited the country that year, and they found themselves ensconce, not in luxury hotels, but in Spartan, Soviet-style guesthouses build during the 1950s. Between 1978 and 2002, however, transnational exchanges boomed. By 2002, the amount of goods passing though Chinese ports had increased almost ten-fold, while the number of tourists had leapt to over 10 million. How did China do it? How did this isolated, communist-run country with a command economy develop such intense global links in such a short period of time? And, did Communist Party officials and bureaucrats help or hinder this process? Many factors lie behind the remarkable transition. However, self-interested bureaucrats, mainly at the local level, played the key role. The more they opened the economy, the more they gained - "no flow, no dough" - and so they facilitated China's opening.



China expert David Zweig tells how local bureaucrats played a big role in bringing the country out of its isolation. Through the 1970s, Zweig says, upper-level officials in the Communist Party had a right grasp on the Chinese economy. There was little tourism, and the country was an insignificant player in global trade. Today, tourism and transnational exchanges are booming, largely thanks to self-interested bureaucrats in towns and cities across the country. Zweig explains that significant differences in prices inside and outside China, created by decades of economic autarky and cheap labor, meant that those who controlled international trade could earn large profits. Local officials - who gradually became the gate-keepers of global commerce - therefore had a strong financial incentive to harbor close relationships with foreign investors and with China's businessmen overseas. Ironically, the very bureaucrats that made the first round of China's opening a great success now pose the greatest obstacle to further internationalization; few are willing to relinquish control, and many resist further deregulation. Thus, the WTO and the international community must work "to break the stronghold local officials have on trade policies and thus continue the opening of China.

When the late Deng Xiaoping took his famous "Southern Tour" of the Shenzhen Special Economic Zone in January 1992, he called on local officials to "move faster and be bolder." His words gave them the green light to open the economy to internationalization and market exchanges. Significant differences in the value of goods and services inside and outside China, created by decades of economic autarky and cheap labor, meant that those who could move goods, services, technology or themselves across China's borders could earn large profits in either the domestic or international market.

Similarly, many foreign products faced limited competition in Chinese markets and could earn what economists call "extra-normal profits." Local government officials regulated these imports and harbored close relationships with China's businessmen overseas. They were therefore able to ensure themselves a piece of the profit, which gave them an incentive to be helpful. Hoping to control the process, the central government used various administrative units and legal institutions to create channels of global transaction", empowering bureaucrats as gate-keepers of the state's global commerce. All foreign aid donors, for example, had to

work through bureaucratic offices and educational exchanges were handled by "foreign affairs" offices in universities. Government policy created incentives for local organization and governments to link globally. These factors consistently conspired to advance internationalization throughout China. However, the way the manifested varied depending on the distinct characteristics of the region and, specifically, on whether the area was rural or urban.

China's economy has shown cyclical fluctuations. These cycles of change appear in obvious statistical patterns-faster growth and then slower growth, higher price inflation, stronger investment flows and then weaker investment-and all are accompanied by other cyclical fluctuations in a range of variables and policy initiatives. Most of these fluctuations influence others and, by extension, which policies might make a difference in managing China's economy. Throughout the reform era, the priority of economic policy has been to maintain an overall growth rate high enough. There has been considerable debate about this rate of growth. A consensus emerged in the late 1990s that an average rate of real GDP growth of around 7-8 % per year was sustainable and necessary for China. In the 1980s and until the late 1990s a major part of the impetus behind rapid growth was the incremental role of economic reforms.

The opening of China's economy was an integral part of its economic reforms and a central element in its growth. Between 1978 and 1995 the value of exports and imports as a share of GDP tripled and China became the world's second-largest recipient of Foreign Direct Investment (FDI) after the United States. The links between trade, FDI and China's high saving rates have been a key factor in its rapid growth.

These links will also be crucial for future growth. Deepening integration with the world trading system will bring further benefits of China's comparative advantages and provide clearer domestic signals on where to allocate resources. Increasing integration with international financial system will help lower the cost of capital and deepen domestic financial markets. Sustaining FDI will bring new management know-how, the latest technologies embodied in capital equipment, and the most recent techniques in international marketing.

After a long period of isolation, China's visibility with the international trading system has increased dramatically over the past two decades. Its share of world trade has risen from less than 1 percent in 1979 to 5.50 percent in 2003. This dramatic (more than five fold) increase in its share of world exports over relatively short period has sparked a number of questions and concerns about the China's trade particles. Particularly shrill concerns about the impact of Chinese export have been raised in India based on perception the Chinese goods are flooding in Indian market and are posing stiff competition in global market too.

China's foreign trade has expanded steadily since the opening of the economy in 1979. This process began relatively slowly in the 1980's after the relaxation of pervasive and complex import and export controls. The expansion of China's trade gathered steam in the 1990's with a range of trade reforms including broad tariff reduction, and was further boosted by China's accession to the World Trade Organization (WTO) in 2001. Average tariff levels declined from more than 40 percent in the early 1990 to 12 percent by 2002 with further reductions to 10 percent scheduled to be implemented in the near future. In 2002 China's exports and imports both grew by about 21 percent - faster than in any other major economy-at a time when total global trade was essentially flat. This already remarkable base of trade growth has strengthened further in exports and imports growing even more rapidly, by over 40 percentage.

China's output growth has been remarkable. Over the past decade, GDP has grown at an average annual rate of 8-9 percent. Investment levels have been very high, averaging close to 37 percent of GDP over the past decade and 42 percent in 2003. Put in a global perspective, China's investment rates are twice that of the United States or the euro area and higher even than the average of the newly industrialized Asian economies. In absolute terms China has the world's third highest level of investment, after the U.S. and Japan. Its investment is supported by very large domestic saving. In fact, China has one of the highest saving rates in the world, estimated at 43 percent of GDP in 2002.

China's promises to the WTO became the new blueprint for restructuring its more mature economy and enabling further market opening. The accession documents

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are available to foreign companies and governments to use in their lobbying and negotiations with Chinese officials and enterprises.

Chinese authorities' compulsion to regulate will remain strong. In fact, as the by-products of rapid growth become more troublesome (e.g., pollution of all sorts-traffic congestion, waste disposal and contaminated water), the Chinese government is likely to flex its lawmaking muscles even more. Within the next two or three years, foreign companies growth will be dampened by anti-monopoly legislation. The shape of China in the next 30 years will be a fully capitalist economy but with continuing reluctance to call it that and greatly improved infrastructure, especially the road system, which will allow the diffusion of wealth –and foreign investors-deep into China's interior. In light of the dazzling reversal in its economic fortunes, the notion that China's global influence will also quickly grow through "soft power"-a term coined by Joseph Nye of Harvard University-is gaining currency among Chinese and foreigners alike.

In conjunction with its high output growth and investment, China has assumed a greater role in world trade. While the dollar value of world exports grew at an average rate of 6 percent over the past decade, China's annual export growth averaged 17 percent. At same time, China gained greater share in foreign markets. Its exports now account for 11 percent of U.S., import 19 percent of Japan's and 7 percent of the European Union's. Its exports are also becoming more diversified. While labor intensive light manufacturing goods still account for large share of total exports the shares of electronics -(for example, the office machines and telecommunications and sound equipment ) furniture, travel goods and industrial supplies have been growing rapidly. Import, too have been growing rapidly. Annual import growth averaged 16 percent over the past decade increasing demand for imported materials for China's export is only part the story. Domestic demand has increased markedly, and accession to World Trade Organization (W.T.O) in 2001 and the associated further opening of domestic markets have also contributed to rising imports. The sustained growth of Chinese imports has also had knock on effect: helping to fuel the strong export performance in, Asian region and contributing to recent strength in world prices for several commodities.

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It is imperative to mention here that the non-resident Chinese are mainly businessmen, with a strong representation of billionaire tycoons in Hong Kong, Macao and other south-east Asian countries [Howard and Banik 2001 a, Howard and Banik 2001 b, Banik 2003]. The point in this context is to negotiate between the national and global, as well as the historical and the contemporary diasporas [Banik and Bhaumik 2004]. The distribution of actual foreign direct investment in China according to industrial sector during the period 1979-2000. It reveals that FDI in manufacturing sector in China contributes about 61 percent of the total actual investment. The bulk of FDI in this sector appears to be dominated by intermediate technologies. FDI in the service sector on the other extreme contributes about 23 percent of the total investment. On the whole, the inflows of FDI in China appear to be highly export-intensive. Technology transfers in China have led to an important transfer of 'software' –managerial and export marketing technology.

“China on the other hand has the considerably harder task of having to grow in the future by building its economic and political institutions and having to cope with the shocks that process will entail. Its property regime needs to be improved and its legal system made more transparent. China’s economic performance has been running way ahead of its underlying institutional realities, and is therefore arguably more fragile than India’s on that account. China’s rapid growth in trade has been accompanied by big increase in capital inflows. A World Bank index shows that China’s financial integration with the world economy has grown sharply since the mid-1980s. By 1995 net flows had reached \$ 38 billion, accounting for 13 percent of domestic investment, 13 percent of industrial output, 12 percent of tax revenues, and 16 million jobs. Much FDI has been in special economic zones, under-pinning the rapid growth of trade. In 1995 one-third of China’s exports and half of its imports involved joint ventures between Chinese and foreign partners. FDI goes largely to coastal regions-the nine coastal provinces and three municipalities have consistently attracted more than 85 percent of the total-and have been concentrated mainly on tradable manufactures. Recently, however, the range of investing countries has widened, and some FDI has been going into import-substituting activities. Over the long term sustaining FDI and improving its efficiency the number of FDI transactions in infrastructure is increasing. Foreign investors are involved in a dozen power generation projects, each with a capacity of over 100 megawatts, as well as in ports,

highways, and railways. Several provinces are packaging publicly financed assets into ventures, selling shares to foreign investors, and using the proceeds to finance new projects. In China, this is known as “cascading finance”.

Foreign commercial ending has expanded as market perceptions of China’s creditworthiness have improved. By the end of 1996 external debt totaled about 4 130 billion, with both the debt to exports ratio (85 percent) and the debt to GNP ratio (20percent) standing at less than half the developing country average and among the lowest in Asia. Even the currency composition of China’s debt has been diversified.

To ensure that its external liabilities remain manageable and that it maintains easy access to international capital markets, China needs to continue displaying prudence in its foreign borrowing program. In the past, foreign borrowing bolstered foreign exchange reserves. But these reserves now cover more than eight months of imports. In the near future, China does not need to borrow much. The potential for portfolio investment is huge. So far, inflows into China have been equivalent to less than 0.5 percent of GDP; the sixteen developing countries that attracted most developing country portfolio flows in 1995 averaged about 2 percent of GDP.

Portfolio flows into China are limited to buying those equities that can only be subscribed by and traded among foreigners (including Hong Kong residents). These are the designated B share on the Shanghai and Shenzhen stock exchanges; shares are reserved for Chinese residents. B share, introduced in 1992, have attracted about \$ 2 billion of portfolio investment in sixty stocks so far. In addition, some Chinese companies are listed on the Hong Kong and New York stock exchanges. By 1995 about \$ 4 billion in equities had been issued in overseas markets by Chinese companies. Financial integration with the rest of the world is still unfolding in China. At the same time, technological progress, financial innovations, and deregulation have spurred considerable private inflows. So integration China financially with the world economy is not a choice for policymakers to make. Markets are making it for them.

Moreover, international private capital flows have grown explosively in recent years, responding to cross-border opportunities and driven by deregulation in many countries. Although FDI is still the biggest component of private capital flows, cross-border sales of bonds and equities have increased more sharply in recent years, and

are now 30 percent of the total. This world wide expansion presents great opportunities for China. For example, competition from foreign banks could promote the efficiency of domestic banks. Similarly, portfolio inflows could increase liquidity in domestic capital markets and encourage improvements in market infrastructure and the regulatory framework. On balance, the benefits and risks of financial integration suggest a cautious approach to liberalizing capital flows.

While China's annual trade surplus has remained moderate at around \$30-40 billion in past several years, with strong export growth to the industrial countries and imports growth from Asian economies, bilateral trade patterns have shifted considerably, surpluses with the U.S. (and to a lesser extent, with the European Union) have grown large, so have trade deficits with Japan, Korea, Taiwan province of China and Southeast Asian economies. During this period China's external current account surplus has fluctuated around 2 percent of GDP. China's ability to attract foreign direct investment (FDI) is taken as a sign of its economic strength. Since launching market reforms in 1978, Inflows have recently averaged more than \$40 billion a year; China attracted more FDI than the U.S., making it the largest FDI recipient in the world. The increasingly outward orientation of the economy, along with the surge in inward flows of FDI, shows how rapidly China is integrating into the world economy in terms of increased trade and financial links.

India and China two Asian giants and neighbors-have a history of ups and down in their relations. In 1976 India and China reestablished their political relations after gap of 14 years i.e. after 1962 Sino- Indian war. India, on gaining independence, chose a path of import substitution (“self-sufficiency”), moderately-centralized state direction (“planning”), and a mix of private and public enterprise, with the latter having a monopoly over “the commanding heights of the economy.” An inward-looking economic orientation allowed Indian policy makers to shape external economic links in ways complementary to India’s perceived international political interests. At independence, India’s trade links had been concentrated in the British Commonwealth. Subsequently, during the cold war, particularly under the premiership of Indira Gandhi, India enjoyed a special economic relationship with the USSR, and selectively cultivated trade with the nonaligned countries. These factors—



combined with galloping population growth, the constraints of an active democracy, and an undeveloped post-colonial infrastructure—produced a low annual gross domestic product (GDP) growth rate hovering around 3 percent. Domestic economic deregulation began in the mid-1980s under Rajiv Gandhi.

China has moved from ‘security of existence’ to security of ‘sustainable development’. The foreign policy of China is based on a perception that mutual interest and economic prosperity are achieved by international solution to existing disputes and conflicts. The Indian foreign policy has also witnessed an increasing focus on economic development which has led to shift as the ‘look east’ policy, improvement of relations with countries like the US to get more foreign direct investment and more crucially, break out of the nuclear straitjacket. Despite a trust a lot more needs to be done and bilateral relations must be taken to higher plane Political leadership on both sides should develop a farsighted view beyond the horizon and keeping in mind the shadow of the future’. This will give both the side new and more important reason to cooperate. As China and India grow, they will inevitably loom larger on each other’s radar screens, economic growth will give Beijing and Delhi the resources to pursue wider strategic interests across the Asian continent.

In the early 1990s, the collapse of socialist economies worldwide coupled with a foreign exchange crisis at home allowed the Indian government to push through pioneering reforms. There were five major components to the reforms: export promotion, domestic deregulation (including ending state monopolies in several sectors), privatization of loss-making state enterprises, and permission for foreign capital to enter the economy, and reduction of tariff and non-tariff barriers on imports. Incremental but significant globalization—integration with the international economy—has gone hand in hand with domestic economic liberalization. Indian policy makers also reoriented foreign economic policy along more commercial lines. Officials from the ministry of commerce, as well as representatives of industry groups, think tanks and foundations, and even private business interests, gradually began to play a larger role in foreign economic policy. These reforms facilitated a period of high growth, which shows no signs of slackening. From 2000 to 2006, India’s mean growth was nearly 7 percent, and in

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April 2007, the International Monetary Fund (IMF) predicted that GDP growth for the next two years would be around 8 percent. The agricultural sector's share of the trillion-dollar economy (in purchasing power parity terms) has fallen from 38 percent in 1980 to only 22 percent in 2006. The highest growth rates in recent years have been in services, such as software, accountancy, financial and legal services, health, tourism, and air transport, which contributed 54 percent of the GDP in 2003. International economic links also have multiplied. For example, from 1990 to 2005, India's merchandise trade to GDP ratio more than doubled, rising from 13 to 29 percent, while annual net foreign direct investment (FDI) inflows exploded from \$0.2 to \$6.6 billion. Portfolio inflows in the form of foreign institutional investment (FII) have recently averaged \$1.5 billion annually.

The growth of Sino- Indian trade has been phenomenal in recent years. The total two way trade crossed U.S. \$7 billion in 2003. China from no where now ranks sixth in terms of its total import which is accounted to 4 percent of India's total imports. Whereas China is its fifth biggest export partner. India's exports to China are accounted 2.12 per cent of its total export.

Since 1991 India has been exercising the both liberalization and globalization. A lot of policy decisions have been/will be taken to remove restrictions in the Indian economy. As it has already been discussed in detail that China began to open up-its economy in the late 1970s. In short a comparison of two economy show that:

- China's F.D.I. in flows of \$ 45 billion is 10 times higher than what India is able to attract.
- Their market for most products is 3-4 time the size of the Indian market.
- Its annual export of \$ 280 billion is five times that of India.
- It's forex reserves of \$ 285 billion are three times India's reserves.
- It's GDP (\$ 1.2 trillion) and per-capita incomes (\$ 1100) are more than double of India's.
- China's spectacular urban infrastructure is at least a generation a head of India's.

These are facts and figures that provide insights that China is miles ahead of India. Therefore, it is obvious question whether China's rapidly economic drive towards globalization fan adversely elect India's move in this direction. An effort will be made to try to answer this question in details.

## **1.2 IMPORTANCE OF STUDY:**

Globalization means different things to different things to different people. Some interpret it to mean the global reach of new technologies (particularly in information and communication); some refer to the tentacles of corporate capitalism or US hegemony in military, economic and cultural matters. In the present context globalization in the rather limited sense of openness is to foreign trade and (long-term) investment. Over the last two decades both China and India have made major strides in these aspects of globalization (China dramatically so, with the merchandise trade ratio to GDP in 2005 exceeding 60 percent, more than double that for India, and Direct foreign investment of \$ 79 billion a year, about 13 times that for India).

The standard argument by-globalizes has been that the opening up of the economy leads to dynamic benefits, which improve the growth rate, The static allocation effect may also be pro-poor as it expands job opportunities for unskilled labour, which is plentiful in poor countries. China has captured the world market in may labour-intensive manufactures, and this economy, improving the rate of growth and of poverty reduction. Total factor productivity in Chinese industry grew at an annual average of 3.1 percent in 1978-93 and at double that rate in 1993-04 (Bosworth and Collins 2007). If one takes the admittedly crude World Bank poverty line of \$ 1 a day per capita (at 1993 purchasing power parity), the proportion of people below that poverty line in China fell from 63.8 percent in 1981 to 9.9 percent in 2004 (Ravallion and Chen 2007b). If instead one takes a national poverty lie (of 850 Yuan per year for rural China and 1,200yuan per Yuan for urban ay 2002 prices), the National Bureau of Statistics data suggest that the poverty proportion declined from 53 percent to 8 percent between 1981 and 2001 (Ravallion and Chen 2007a). Since all this happened while the country had a phenomenal opening up of the economy, China has become a poster boy for the international financial press and free-trade economists. Much of the extreme poverty was concentrated in rural areas,

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ad its large decline in the first half of the 1980s is perhaps mainly a result of : (a) the spurt in agricultural growth following de-collectivization (agricultural output grew at 7.1 percent per year on an average during 1979-84 compared to 2.7 percent during 1970-78) [Lin 1992]; (b) land reform, which by an egalitarian redistribution, subject only to differences in regional average and demographic size, provided a floor to rural income; and (c) readjustment of farm procurement prices. These are mostly internal factors that had very little to do with global integration.

Some trade economists have pointed out that even in the 1980s; China had a trade expansion in labour-intensive products. There was some expansion in the trade ratio to GDP in the 1980s, and the special economic zone (SEZ) of Shenzhen was in operation by the mid 1980s. But in much of the 1980s the most important exports of China were natural resources-intensive products; as late as 1985 the largest single export item was petroleum. Since export/import ratios are endogenous, one may look at the decline in (weighted) average tariff rates over the 1980s: the mean tariff rates went down only slightly, from 31.9 percent in 1980-83 to 29.2 percent in 1988-90.

In India, the reduction of trade barriers since the 1990s seems to have been associated with an expansion of exports of mostly capital-and skill-intensive products (software and business services, pharmaceuticals, vehicles, auto parts steel, etc), and a more vigorous and competitive corporate sector but most of the economy and workers are outside the corporate sector. Bosworth and Collins (2007) note a rise in the total factor productivity in industry, from 0.3 percent in 1978-93 to 1.1 percent i.e. in 1993-2004. The more significant rise in India is of course, in the service sector grew from an annual average of 1.4 percent in 1978-93 to 3.9 percent in 1993-2004. The Indian growth process has been described as services-sector-led growth, whereas in China it has been more manufacturing-centered. One immediately thinks of the widely acclaimed performance of Indians software and other information technology-enabled services sector growth in the period 1993-2004 not all of the growth can be explained by finance, business services or telecommunication where global integration may have made a difference.

A large part of the growth in the service sector, at a rate higher than that in manufacturing, has been in the traditional or “unorganized sector” services, which even in the last decade formed nearly two-third of the service sector output. These are

provided by tiny enterprises, often below the policy radar, unlikely to have been directly affected substantially by foreign trade policy reforms. Official poverty estimates show that the poverty percentage declined from 44.5 percent in 1983 to 27.5 percent in 2004-05. Again the international financial press often attributes this significant (though not dramatic) decline to globalization. National Sample Survey (NSS) data actually suggest that the rate of decline in poverty has somewhat slowed down in 1993-2005, the period of intense opening of the economy, compared to the 1970s and 1980s. There has also been a decline in the rate of growth of real wages in the period 1993-2005 compared to the previous decade 1983-93. India's exports expansion in recent years has largely been in capital and skill-intensive industries, unlike in China or Vietnam, and as such may not have helped large numbers of unskilled workers.

Global integration does not seem to have helped some of the non-income indicators like those of health. The Gini coefficient of land distribution in rural India was 0.74 in 2003; the corresponding figure in China was 0.49 in 2002. India's educational inequality is one of the worst in the world: according to a table in the World Development Report 2006, published by the World Bank, the Gini coefficient of the distribution of adult schooling years in the population, a crude measure of educational inequality, was 0.56 in India in 1998-2000, which is not just higher than 0.37 in China in 2000 but even higher than almost all Latin American countries (Brazil: 0.39).

Comparing across states in India, as Dutt and Ravallion (2002) point out, the growth elasticity of poverty reduction depends on initial distribution of land and human capital. Purifield (2006) indicates that in the period 1977-2001, this elasticity was quite low in high growth states like Kerala and West Bengal. Similarly, comparing across states in China, Ravallion and Chen (2007a) find that growth had more poverty-reducing impact in initially less unequal provinces.

While a decade's hectic pace of economic growth in China has provided the engine for growth to global trade. The Central Bank of China raised cash reserve ratio three times in years 2003 and 2004 forcing banks to keep more cash on hand instead of lending it out. Economists and policy makers have been worried that the huge investment boom in China would lead to excess capacity and massive recession

worldwide. The only way to ward off this danger was to ensure cool down the economic activities by raising interest rates and making some key changes to the manner in which Chinese banks lend to industry. Chinese government has explained that the surprise announcement was aimed at slowing growth of investments in fixed assets. Analysts believe that the latest move sends a strong signal that the government is not yet loosening its grip on the pace of economic growth, and indicates the determination to cap speculation and runaway growth in order to lead the economy towards a more sustainable path of development for the medium term. Indo-Chinese trade is growing at a rapid pace. The price tags on items will go up, leading to changes in profit margins. However, a 2 % appreciation does not make a major impact currently. But in the long run, sourcing from China will only get more costly (The Economic Times, July 25, 2005). It has also made possible to imports from other destinations at a cheap rate in comparison to China. This is primarily because of a gradual weakening of the US dollar against other major currencies including rupee. In order to see its impact on Indian business in world market, the present study is of much importance. Major Western countries have been blaming China for its undervalued Yuan as a basic reason for their economic fall out. American has always blamed the undervalued Yuan for its huge trade deficit with the Chinese running a \$ 165 billion trade surplus with the US. The US, members of the senate and Congress have introduce several pieces of legislation which are aimed at authorizing the administration to take retaliatory action against China for what was denial of benefits of trade concessions arising from misalignments in currency.

China's (The People's Bank of China) announced that Chinese currency would be henceforth be determined by a managed floating exchange rate regime with reference to a basket of currencies. China scrapped 11 year old link to the US dollar raised the Yuan value by 2.1 % 8.11 up from the virtually fixed rate near 8.28. Rob Subbaraman a leading analyst said China had left many aspects of the new currency regime internationally ambiguous. In fact, the scale of change was nothing but moderate and merely done to please the American's who were calling for a Yuan revaluation ever since the fall in dollar value caused by American's burgeoning twin trade and fiscal deficits. Moreover, it can affect cost benefit analysis of India's external economic sector. Therefore, the main objective of the research is to find out what are implications of Yuan revaluation on India's external economic sector.

Robert Mundell predicated in April 2005 that a revaluation would just be a “drop in the bucket”. It could yield even the opposite of what the US wants, by cooling-off prices in the recently inflating economy; that will make Chinese exports not only more price-competitive, but will also divert investments away from real estate into tradable or imports-competing sectors. It is also estimated that even a 10 % revaluation of the Yuan would improve the US trade balance by \$ 3.6 billion, a mere 0.02 % change in the current account as a percentage of GDP. Therefore, just a 2 % revaluation would hardly be of significance Kumar, 2005.

China’s economy is three times large than India’s and contributes significantly more to global economic growth. India has also grown rapidly following reforms in the early 1990s and more recently, has become a global economy as so far been more limited. Though both the economies are fast becoming global economic power houses, a lot of lessons they can learn from each other’s experiences of success (Burton et al 2006). In this quest the Chinese successful experiences into attracting Foreign Direct Investment (FDI) may prove very useful to other countries especially to India which has aimed to become global economic power by 2020. Therefore in this study an attempt was made to find out as what India can learn from Chinese success into attracting FDI at a large scale. China whose growth has been moved by manufacturing has tapped into domestic savings and foreign investment to build an impressive infrastructure. India’s progress, by and large owes to private businesses. As India being to capitalize on the improving skills of its workforce and advantages in age distribution (35 % of population is under the age of 15), the gap will probably narrow (Lim 2006). A considerable part from considerable inflows of FDI. China’s policy of opening up its economy aimed at promoting export on one hand protecting the domestic market on the other hand. It has achieved remarkable growth in manufacturing sector, and turning the country into a global for MNC. Around 50 % of China’s exporters are either foreigners or partly foreign \$ owned (Sharma, 2002) China received \$ 72.41 billion FDI in 2005, while India received \$ 6.59 billion FDI in the same year. MNCs enter china to take the advantage of cheap lab our resources especially in manufacturing sector. At the same time, the Chinese Government provides huge incentives to foreign companies and MNC s in the form of tax concession (Chinniah, 2006).



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On other hand India has received \$ 50.1 billion since 1991 of which \$ 16 billion-or 32 % has come since April 2004, reflecting the rising interest of the country. FDI inflows were the highest during 2006 and Mauritius was the top contributor of greenbacks to the country. Of the \$ 5 billion-odd FDI inflows, \$ 1.3 billion was from Mauritius. US and UK are a distant second and third with inflows, amounting to \$ 346 million and \$ 261 million respectively. India received more than two-thirds of the total FDI coming to South Asia. The sectors that have attracted large amount of FDI include electronic equipment, telecom, transport, fuel, food processing, drugs and pharmacy and metallurgy. The top 10 investing countries continue to remain Mauritius, the US, Japan, Netherlands, U.K, Germany, Singapore, France, South Korea and Switzerland. In terms of outward FDI flows, it is estimated that Indian firms had, till 2003, invested \$ 5.1 billion abroad putting India at number 14 in the developing country sweepstakes. Despite opening up at roughly the same time in the late nineties, the insurance sector in China has-raced ahead of India insurance companies in China, have better underwriting and capitization than India.

Most Indian manufacturers believe that even through China is cheaper than India; the US companies would want to de-risk themselves by reducing exposure to China. However, initially benefits would accrue to the large and experienced players and to be followed by smaller business houses, which have deep pockets to increase capacities, step up quality and upgrade their system to align with the needs of the global payers. The lowering of imports duties on capital goods and the intermediates would further help industry. India should follow China, which had the foresight to encourage the scaling up of manufacturing in textiles quite early on. Thus, we must jettison restrictive land, labour laws and stop protecting certain textiles despite SII-de-reservation of apparel (The Economic Times, New Delhi, and Oct. 22, 2004).

China, which has been consuming a loin's share of world production of copper, steel, iron ore and crude oil, may soon slow down of their imports. China is a major importer of steel and iron ore from India. On the other hand in the past years due to Chinese demand of these products, domestic prices of steel hiked in India. In addition, declined of Chinese demand of crude oil has been considered as a major factor to stabilize world crude oil prices. This may impact India's trade deficit positively because India fulfils 70 % of oil demand through its imports.

China's low labour costs, supported by a large pool of unskilled as well as skilled labour, have been the primary determinant of China's external competitiveness. However, a number of hidden and explicit subsidies like artificially low interest rate, cheap electricity etc has provided impetus to its competitiveness. The recent hike of interest rate will make funds more expensive for Chinese businesses. This may affect competitiveness of Chinese products in world markets. It is matter of time that China has to appreciate the Yuan against US dollar. Moreover, China has joined the WTO and there is pressure on China to peg Yuan to a basket of currencies so that market-oriented exchange rate comes into existence. This will create much more breathing space to Indian business, which compete with their Chinese counterparts in the world markets. Market speculation has been rife that China may soon loosen its grip on the Yuan by win dining its thin trading band near 8.28 per dollar or re-pegging it to a currency basket or some combination of these options.

### **India and China economic cooperation:**

Going forward, from a global perspective, everybody knows that China has been the fastest growing economy, averaging 9.5 percent for the past 25 years, but not many people know that India has been the eighth or ninth fastest growing economy over the past 25 years. This is because many people think that India's reforms started in 1992 and that India has been lagging by about a decade. The fact is that India's reforms started around the same time as China's (1980), but its average growth rate has been slower (Virmani, 2005). The East and Southeast Asian economies that have grown faster than India during the past 25 years are likely to slow during the next decade. India, in contrast, has been on a rising growth rate trend since the reforms of the 1990s. It is therefore likely to be among the five fastest growing economies (if not among the top three) along with China. It will become one of the primary global growth drivers by the end of the decade along with China. By 2010, it is likely to be the fourth-highest contributor to world GDP growth after the United States, China and Japan. The possibilities for trade and economic cooperation between China and India will therefore continue to expand.

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Once the identified barriers are removed (hopefully in a year or two), we should be in a position to start discussing a comprehensive economic cooperation agreement. Given the high reinvestment, “vent for surplus” approach of the socialist-owned part of China’s economy, a free trade agreement is likely to benefit China more than India. So there has to be a trade-off. Researcher thinks both sides need to recognize that one cannot have these special agreements unless both sides can balance the gain and losses. There are already some special losses to certain manufacturing sector such as toys. However, India expects some gains in service sector. The agreement has to be a comprehensive one that includes trade in both goods and services. Another area of economic cooperation that is very important for the future of Asia is that Indian and Chinese economic cooperation to be embedded in an Asian context. India and China have either framework agreement or ongoing discussions for a free trade agreement/Common Economic Partner Agreement with the Association of Southeast Asian Nations (ASEAN), Japan, and Korea. This needs to harmonize these by developing an East Asian commodity in which ASEAN, China, Japan, and India are equal partners. In December 2005, there was a meeting of the East Asian Economic Community, in which both India and China were involved. China’s attitude toward India inclusion will be closely watched by people in India and Asia as an example of its general approach to hegemonic competition versus mutually beneficial cooperation. It is too early to deem India a global power, although “Its stable democratic political system, huge middle-class population, immense military clout in South Asia, rising economic fortunes and global ambitions make it a potential power that could (if things go well) play a very important role in world affairs.” In their view

To become an economic powerhouse and catch up with its bigger rival [China], India will have to sustain at least 8% growth, over a long period of time. Its first challenge will be to address some structural issues in the economy. These include reining in the runaway fiscal deficit, freeing its manufacturing sector from antiquated labour laws, selling state-owned assets and using the freed-up cash for investments in physical infrastructure. It is also the case that international trade theory is often preoccupied with cost of production, while a large part of success in exports depends on marketing and distribution, which often require large initial investment, managerial skills and development of networks. The international retail chains that provide the latter often charge monopoly margins, which absorb much of the gains of trade

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liberalization, and very little may trickle down to the poor producers in small farms and firms.

Empirically, there are very few reliable studies for China or India that test a casual model linking globalization with inequality at the appropriate disaggregate level. At least two major problems beset the empirical analyst in this matter. One is that so many other changes have taken place in the last quarter century in these two countries; it is difficult to disentangle the effect of globalization from that of other ongoing changes (like technological progress-often skill-based-demographic changes or regulatory and macroeconomic policies). Secondly, in both countries there are reasons to suspect that economic inequality (or its rise) is underestimated. There is very little analysis as yet to show that this rise is primarily due to globalization. Even if global integration were to be causally linked with higher growth, the link between growth and inequality is not always clear. In China, as Chaudhuri and Ravallion (2006) shows, the periods of rapid growth did not necessarily bring more rapid increases in income inequality; the periods of falling inequality (1981-85 and 1995-98) had among the highest growth rates in average household income. In China, provinces with more global exposure and higher growth did not have larger rise in inequality. As Benjamin, Brandt, Giles and Wang (2005) show, while the Gini coefficient of income in coastal China went up from 0.35 in 1991 to 0.39 in 2000, the corresponding rise in the interior provinces was from 0.39 to 0.48. In the coastal provinces a more rapid job growth in the non-state sector helped reduce the urban-rural income differential there. In India, the relative income divergence between states is increasing (more than in China) but it is hard to separate the effects of globalization from those of differential conditions of infrastructure and business-friendly policies in different states.

In both China and India, it is again difficult to separate the effect of the ongoing skill-based technological progress from that of globalization. But compared to China, the backwardness of India in the education sector (for example, even among new entrants in the labour force among the 15-24 age-group nearly a quarter in India are illiterate, almost none in China) and in the status of women (for example, female labour force participation in urban China is above 70 percent, only 24 percent in urban India) imply that the forces that penetrate wages inequality are stronger in

India, and these forces are largely domestic in origin. The contentious debates on globalization in the media as well as in academia often lead to a volley of sweeping and unthinking generalizations, in particular about China and India the two awakening giants in the global economy. It is time for a great deal of caution and reasoned and rigorous empirical analysis before we pronounce judgments on the effects of globalization on trading and inequality in these two countries.

### **1.3 JUSTIFICATION OF THE STUDY:**

Trade talks and tie-ups between the two 'Asian tigers' will surely cause many sleepless nights for the rest of the world. Statistics reveal that almost two out of every five people on the planet are either Indian or Chinese. The two most populous countries of the world constitute about 2.5 billion of the total world population. Thus, trade ties between these two have the potential to disturb the world trade balance. The huge population of both the countries has also played to their advantage by adding to their workforce. Bilateral trade between the two countries (including Hong Kong) was as high as \$ 13.6 bn last year. The growth surprised the countries themselves as the figure was a mere \$ 1 bn a decade ago. Expert feels that if this rate of growth continues, China may overtake US as India largest trading partner in a couple of years. Indo-US trade stood at about \$ 20 bn in 2004. India and China have set a bilateral trade target of \$ 20 bn by 2008 and are strongly positive about achieving it. But China still feels that the Indian economy is not opening up to Chinese investment, which Indian investment in China crossed \$ 100 million last year.

As China assume a central plane in the world economy, its growth and stability will become increasingly important to the world trade system at large. For example China now accounts for 11 percent of U.S. imports compared with 10 percent of Japan, and 3 percent of Korea. China's increasing access to advanced country markets since its accession to the W.T.O. has meant that more of its export now go directly to those markets rather than being routed through third world trade has risen from less than 1 percent in 1979 to 5.5 percent in 2003. This dramatic increase in its share of world exports over a relatively short period on the other hand India industrialists are terrified of competing with China. Chinese export drive has affected adversely our presence in the global markets.

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In 1978, at the inception of its reforms, China's per capita GDP (in constant 1995 US \$) was \$ 148, whereas that of India in the same years was \$ 236. Seven years after it began its reforms, in 1986, China caught up with India in per capita GDP terms (4278 VS \$ 273) and a decade after reforms in 1988 was comfortably ahead of India with a per capita GDP of \$ 342 compared with India's \$ 312. In the first post-reform decade the Chinese economy grew at 10.1 percent while the Indian economy grew at 5.7 percent in the corresponding decade. Quite clearly that was India's lost decade. But what did we achieve in the first decade of our reforms? In 1992, the first year of its reforms, India's percapita GDP was \$ 331. This grew to \$ 477 in 2001. In the same period the Chinese percapita GDP surged from \$ 426 to 878 in 2001.

In the 1990s China grew at the rate of 9.7 percent while India grew at 5.9 percent. Quite clearly far from beginning to catch up, we fell well behind. China's GDP (1995 constant US \$) has grown eightfold since 1979 and stood at \$ 1.1 trillion in 2001. Chinese GDP was lower than that of India in absolute terms in 1978 but caught up with India in the very next year. Size of the Chinese economy now is twice that of India. In 2001 India's GDP stood at a mere \$ 492 billion. We seem to be catching up with China's GDP still remains a distant and difficult target. It's true both countries have transformed themselves after they embarked on the path of economic reforms. But the transformations were entirely different. In 1980 the sectoral break-up of China economy was as follows: agriculture 30 percent, industry 49 percent and services 21 percent. In 1990 that changed to agriculture 27 percent, industry 42 percent and services 31 percent. In 2000 that picture transformed further. Agriculture fell to 16 percent; industry grew further to 51 percent; while services stood at 33 percent. Note the growth in the share of industry now. This was primarily made possible by overseas investment, which amounted to \$ 290 billion (source: Ministry of Foreign Trade and Economic Cooperation) during the decade, which also created millions of new jobs. Nothing manifests this better than the surge in China's R and D expenditure. The latest OECD science technology and industry scoreboard has ranked China as the third largest R and D spender in the world. China's total R and D spending in 2001 stood at \$ 60 billion (PPP). Through India ranked among the top 10 spenders world wide it spend only a third (\$ 19 billion) of what China invested in R and D in 2001. Such huge Chinese investments in furthering knowledge only fall back further in terms of industrial growth rates and competitiveness. Much has been

made of the contrasts and similarities between the recent economic performance of India and China. Some of the motivation for this is plain silly, rooted in a marital conception of economics, and portraying India and China as in some zero-sum game rivalry. Economic growth in China and India and increasing trade by and between them will, of course, be mutually beneficial and positively reinforcing. But there is one interesting contrast that is relevant (and one that has not been made so far) for their future economic trajectories.

Industrial countries will benefit unequivocally from China's rising demand for capital and knowledge-intensive manufactures and primary products and from significant terms of trade gains.

Among developing countries the effects of China's integration will depend on how much they trade directly with China and how closely they compete in third markets. Countries that trade heavily with China but are not close competitors (such as Korea) will likely gain substantially. Low- and middle-income countries that are close competitors (India, Indonesia, the Philippines, and Thailand) will experience some terms of trade losses on their exports of labor-intensive manufactures. But their total trade will keep growing, and perhaps their world market shares as well. Regions with fewer trade ties to China (Latin America, Sub-Saharan Africa, Eastern Europe, and Central Asia) will neither make significant gains nor suffer major losses.

Many observers argue that global integration damages the jobs and incomes of unskilled workers in industrial countries. From this some conclude that China's vast size and the rapid growth of its trade will exacerbate the damage. Historical evidence suggests otherwise, however. In industrial countries most of the decline in employment in labor-intensive industries such as clothing occurred well before Chinese exports had significantly penetrated these markets. Looking at indexes of revealed comparative advantage across 129 industries for a set of large developing countries, China's pattern most closely resembles that of India, Indonesia, and Thailand. Moreover, their trading structure has grown more like China's over the past decade.

In the future China's comparative advantage is expected to shift toward intermediate technology manufactures and away from low-technology clothing. By



2020 China is projected to gain 10 percent market share in light manufactures (leather, fabricated metal products, and miscellaneous manufactures) and 8 percent in transport equipment and other machinery. Its fast-growing Asian neighbors-Indonesia, Malaysia, and Thailand, for example- are also expected to gain market share. In highly capital-intensive heavy manufactures (chemical, rubber, plastics, paper, iron and steel, nonferrous metal) China is projected to increase its market share by 4 percent, but industrial countries will maintain their dominance.

While some difference between the performances of India and China can be attributed to the Chinese entrepreneurs in Hong Kong and Taiwan, who have been eager to escape rising wages in their respective home economies by moving to China, a more central explanation lies in the two countries. Among developing countries, India is unique in having a very large share of its GDP in the mostly informal part of the services sector. Whereas in these countries, a decline in the share of agriculture in GDP has been accompanied by a substantial expansion of the industry in the early stages of development, in India this has not happened. For example, in 1980, the proportion of GDP originating in the industry was already 48.5 percent in China, in India it was only 24.2. Services, on the other hand, contributed only 21.4 percent to GDP in China but as much as 37.2 percent in India.

In the following 20 years, despite considerable growth, the share of industry did not rise in India. Instead, the entire decline in the share of agriculture was absorbed by services. Through a similar process was observed in China, the share of industry in GDP was already quite high there. As a result, even in 2000, the share of services in GDP was 33.2 percent in China compared with 48.2 percent in India. India's growth follows a sluggish 4 percent rate recorded in 2002-03 coming after a Ninth Plan (1997-2002) averaged growth of 5.5 percent, which, in turn, reflected a marked slowdown from the reform-driven growth surge of 6.7 percent experienced in 1992-97. Much of the economic dynamism of 2003-04 simply reflects an exceptional rebound in agriculture from a drought-affected 5 percent drop in 2002-03 to a strong 9 percent recovery thanks to the best monsoon in over 20 years. Services also grew strongly and industry did moderately well. If the last two years are averaged, then agriculture reverts to the recent trend of 2 percent growth and overall GDP shows a healthy but unremarkable 6 percent increase. Quite clearly, there is no compelling

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evidence here supporting medium-term growth exceptions of 8 percent aspired to in the tenth plan.

The Indian sartorial picture makes for a study in contrasts. The share of agriculture fell somewhat from 31 percent in 1990 to 28 percent in 2000. The share of industry to fell from 28 percent to 26 percent. Services grew from 41 percent to 46 percent. Software apart, the biggest contributing factor to the growth of India's services sector has been the growth of public administration, which has been bounding at an average rate of 32.5 percent each year from 1993-94 onwards. In 2001 alone, central, state and local governmental salaries together topped Rs 1, 67,715 crores. This kind of spending was not what Keynes had in mind when he advocated public spending to stimulate the economy.

Poddar K Saroj (Senior Vice President, FICCI) summarized Indo-China relationship and import-export opportunities as under: Together India and China could reshape the world order. Economic partnership between them can unleash forces to realize the goal of a larger Asian economic community. Both have become not only the world's fastest growing economies, but are also destined to become the world's largest. If they do manage to work together, they will surely create the new world. The transformation in recent years in India-China economic cooperation is to be seen in the light of deeper economic association of our two countries with South East Asia, together with emerging RTAs and FTAs and participation of India in the same. Pushing the trade frontier greater economic engagement would be beneficial for both the countries. Based on recent growth trends, it is estimated that bilateral trade would touch US \$ 30 billion by 2009. However, if India focuses on China's top global imports and diversifies its exports the 2009 target could be beaten with trade possibly touching US \$ 50 billion. China is the world's third largest importer well on its way to take first position phenomenal growth seen in China's global imports in recent years so where lies the opportunity for India. To bring it all together China is India's 3<sup>rd</sup> largest trading partner; for China India is the 13<sup>th</sup> largest trade partner. Exports from India's to China in recent years have shown strong growth. However, India's exports to China are concentrated and skewed towards primary products. India's presence in China's vast and growing market is negligible-In China's top 10 imports valuing US \$ 447 billion India's share is just about US\$ 2.3 billion.

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The Board of Trade has set a target of raising India's merchandise exports from the present US \$ 80 billion to US \$ 150 billion in the next four years. China, in terms of its global imports, is a giant by focusing on China; India can achieve and surpass the target set for its merchandise exports. 81 % companies perceive China as an important export market. Key attractions-sheer size of the market and its proximity to India. 53 % currently exporting to China, 47 % are not. Companies exporting to China say exports restricted to select few commodities and are of recent origin. Of companies presently not exporting to China, 75 % intend to export to China in near future. Companies already exporting want to export more. China can be a window for 3rd country exports with greater value addition-a view shared by companies from the engineering goods, auto and auto components and IT sector. Products that can be exported auto and auto components, electronic components, drugs and pharmaceuticals, metals and metal based products, electrical machinery, textile yarns and fabrics, agri products (grain, tobacco, oilseeds), mineral products, fruits and vegetable, seafood, medical equipment and construction material.

The BRICs countries (Brazil, Russia, India, and China) have shared a common experience of rapid and substantive economic change over the last decade. While economic growth has had varied consequences for India's foreign policy, we focus on India-China relations, asking whether economic interdependent could lead to more wide-ranging political cooperation between the two largest BRICs. This dyadic interaction is of great geopolitical significance: The two countries are home to over a third of the world's population, have nuclear arsenals, and have been involved in an actual shooting war with each other. Moreover, the India-China case study can help us understand how the rising economic power of the BRICs may affect global stability. In the last decade, India and China have enjoyed the best bilateral relations since the early 1950s. Could new economic ties be impelling this improvement in their relationship? In this article, we examine the impact of a number of economic factors on the strategic relationship between India and China. In the article's first section, we briefly summarize the troubled history of Sino-Indian relations.

In this context it has provided evidence refuting the basic claim of the skeptics that the response of the economy to liberalization has been an order of magnitude weaker in India than China. Exports of goods and services grew at annual rates of

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12.9 and 15.2 percent during 1980s and 1990s respectively in China's total trade to GDP ratio from 18.9 percent in 1980 to 34 percent in 1990 and to 49.3 percent in 2000.

On the foreign investment front, differences are even starker. FDI into China has risen from \$ 0.6 billion in 1980 to \$ 3.49 billion in 1990 and then to a whopping \$ 42.10 billion in 2000. China has slower to open its market to portfolio investment but once it did, inflows quickly surpassed those into India reaching \$ 7.8 billion in 2000. Even if we allow for an upward bias in the figures for India, there is little doubt that foreign investment flows into China are several times those into India.

Goldman Sachs reports puts Brazil, Russia, India and China (BRICs) as fastest growing economies over the next four decades. This will lead to a possible shift in the economic power axis from the US-Euro-Japan grouping to these emerging market economies by 2040. It is said that co-operating an economic, social and political matters may actually enable China and India to dominate the globe a hundred years from now rather than considering each other's rivals. "Today, yesterday's adversaries' China and India are all set to be tomorrow's allies. And together they can make for a literally world. Therefore the present study has much relevance in India's long-term economic interest.

#### **1.4 OBJECTIVE OF THE STUDY:**

Specifically, the objectives of the study are:

- (i) To identify the factor that can help to explain the sustained growth in China's exports.
- (ii) To determine the factor that have changed trade patterns.
- (iii) To examine the expansion of China's trade in future too.
- (iv) To measure its effects on Indian trade.
- (v) To find out whether India and China are moving towards becoming close economic allies.
- (vi) To identify lessons which can learn from the experiences of China.
- (vii) To suggest an-alternative strategy for India's competitiveness vis-à-vis China.

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## 1.5 REVIEW OF LITERATURE:

Sino-Indian trade relations have attracted the attention of many investigators. But a little research is available on China's integration into the global trading system and its implication for India. However, Anandalingam (2002, 2003), Sharma (2002, 2004), Srivastava (1992, 2004) have done some work in this direction. Our analyses reveal interesting insights that explain foreign investment inflows to countries, both developed and developing. The approach in the form of neighborhood and extended neighborhood is deepening and widening our understanding of FDI flows. Although there are some apparent similarities between the concept of 'psychic distance' as proposed by some Swedish economist [Johansson and Wiedersheim-Paul 1975; Johansson and Vahlne 1977; Vahlne and Wiedersheim-Paul 1977], later elaborate and extended by other authors [Child et al 2000], and the neighborhood model proposed, there are significant differences in concepts, explanations and consequences of models. 'Psychic distance' presents a static concept, wherein investments and their sequence is attempted to be explained through the 'psychic distance' between the home country and the host country. In neighborhood model, the role and importance of 'psychic' or 'culture' distance itself changes decimally as investments move from the original to the intermediate and the extended neighborhoods should be equally applicable in explaining the FDI flows of other FDI sources.

Similarly, the eclectic paradigm of Dunning (2001) hypothesis that firms make their international production decisions based on perceived ownership (O advantages), locating (L advantages) and internationalization (I advantages) related factors. When stretched from the micro to the macro, this leads to the concept of the investment development path (IDP). As a country develops the attractiveness of its OLI advantages change for potential investor (both inward and outward) and the country is likely to go through five relatively well-defined stages. The IDP is a useful heuristic model and attempting to find the position of a country on its IDP can lead to meaningful policy debates. In a way, the O advantages are related to the push factors of the home country, the L advantages to the pull factors of the host and the I advantages to how of the involvement insofar as an international production decision is concerned. Although the basic structure of the model is attractive, its details have

been evolving over time [Dunning and Narula 1996] and may contain too many explanatory variable-many with limited predictive value. On one side' this may be too general a theory and on the other it ignores the possibility of any special advantage for a pair of countries. Countries in the neighborhood have a role in the reduction of perceived risk and Dunning (1988) also argues that firms from developing countries are likely to perform activities in neighboring countries that are politically and economically stable.

As noted by Arndt (2001), one of the innovative features of the current phase of globalization is the fragmentation of production into production network based on component specialization and intra-product trade. It offers groups of small countries the opportunities to make open regionalism work by enhancing their productivity and competitiveness as well as welfare of their nationals. This concept is equally applicable to the Caribbean, although Arndt (2001) justifies it for the ASEAN. As production networks grow in the ASEAN region, this provides an opportunity for both China and India to participate in these networks in their extended neighborhood, with their respective component specializations. With the objective of deepening its political and economic relations with ASEAN countries, India launched its Look-East policy in 1991 [Asher et-al 2003]. India graduated from being a sectoral dialogue partner in 1992 to a full dialogue partner in 1995, and went on to become a member of the Asia Regional Forum where regional security issues are discussed. India's evolving co-operation is reflected in the annual ASEAN-India summit being held since 2002. In October 2003, India signed a framework agreement on comprehensive economic co-operation, which will lead to an ASEAN-India free trade area in 10 years [ASEAN 2003]. Earlier, during the ASEAN summit in November 2002, China signed a framework agreement on comprehensive economic co-operation, which included elements of the establishment of ASEAN-China Free Trade Area (ACFTA) [Srivastava and Rajan 2003]. The strengthening of the neighborhoods may have some impact on the future FDI flows of both India and China.

It is now open to question as to why some economies have attracted large FDI flows and grown fast (for example east Asia and now China) over the last 40 years and others have not. The Latin America and Caribbean economies are geographically closer to the highly developed economies. Yet, these regions could not take advantage

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of this physical proximity. Their economies could not become part of the original, intermediate or even extension of the intermediate neighborhoods, perhaps due to the fact that most people came from cultures where neighborhood was too weak.

The impact of reforms can also be seen in terms of higher industrial growth. Discussing the changes in the domestic industrial policy, Desai (1999:21) notes. "The changes were complex and arbitrary, but they led to an acceleration of industrial growth from 4.5 percent in 1985-86 to peak of 10.5 percent in 1989-90". Industrial growth during 1998-91 at 9.2 percent was particularly high when compared with earlier periods.

According to Goldar and Renganathan (1990), the import penetration ratio in the capital goods sector rose from 11 percent in 1976-77 to 18 per cent in 1985-86. This trend appears to have continued substantially. Malhotra (1992) notes that the incremental capital-output ratio, which had reached as high as six at times, fell to approximately 4.5 during the 1980s. These observations are consistent with the finding by Joshi and Little (1994) that the productivity of investment increased during the 1980s, especially in private manufacturing.

But more systematically, Chand and Sen (2000) have recently studied the relationship between trade liberalization and productivity in manufacturing using 3-digit industry data spanning 1973-88 econometrically. They take 30 industries, which accounted for 53 per cent of gross value added and 45 percent of employment in manufacturing over this period. These industries divide approximately equally among consumer, intermediate and capital goods. They measure protection by the proportionate wedge between the Indian and US price and estimate total factor productivity growth (TFPG) in the three industry groups averaged over three non-overlapping periods: 1974-78, 1979-83 and 1984-88. They then relate this productivity growth to liberalization.

Chand and Sen (2002) According to their measure also, protection declines over the sample period in intermediate and capital goods sectors but not in the consumer goods sector. Moreover, there is a significant improvement in TFPG in all three sectors in 1984-88 compared with the two earlier periods. Thus, the jump in TFPG coincides with the liberalization in capital and intermediate goods.



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Chand and Sen (2000) do some further tests by pooling their sample and employing fixed-effects estimator to allow for intrinsic differences across industries with respect to the rate of technological progress. Their estimates show that on average 1 percentage point reduction in the price wedge leads to 0.1 percent rise in the total factor productivity. For the intermediate goods sector, the effect is twice as large. The impact of the liberalization of the intermediate goods sector on productivity turns out to be statistically significant in all of their regressions.

Joshi and Little (1994: Ch 13) also address the issue of the shift in the growth rate. They analyze the years 1960-61 to 1989-90 dividing them into a low-growth period from 1960-61 to 1975-76 and a high growth period from 1976-77 to 1989-90. Average annual growth rates during these periods were 3.4 and 4.7 percent, respectively, and statistically significant. A key finding of Joshi and Little is that increase investment cannot be credited with the increase in the growth rate during 1976-90 over that during 1960-76. To quote them [Joshi and Little 1994:327]: Public real investment averaged 7.7 percent of GDP in the first period and 9.9 percent in the second period. Private real investment averaged 12 percent of GDP in the first period and 11.7 percent in the second period. Thus the whole of the rise in the investment level took place in the public sector (ignoring errors and omissions.) However, the rate of growth of public sector GDP decline (from 7.8 to 7.2 percent a year), while that of the private sector rose (from 2.6 to 3.7 percent a year). Joshi and Little find increased demand through fiscal expansion, more efficient use of the existing resources (due to liberalization) and the rise in the real yield of investment in private manufacturing as the principal sources of the shift in the growth rate.

Neither Joshi and Little nor Chand and Sen would hold even more strongly for this period 1988-91, which is crucial to obtaining comparable growth rates between 1980s and 1990s. Prima facie it would seem that the results of Chand and Sen would hold even more strongly for this period. The reason is that average annual industrial growth of 9.2 percent during 1988-91, was significantly higher than 6.2 percent growth achieved during 1984-88. In view of the fact that private investment as a proportion of GDP did not rise, the substantially higher growth in industrial output is likely to be the result of increased productivity and therefore related to the 1980s reforms.

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In 1978, after nearly 30 years of largely self-imposed isolation, China finally seemed ready to rejoin the world economy. On the domestic front, the need for economic adjustment was felt due to a variety of reasons. For example, the per capita GNP had grown since 1957 at an average annual rate of 2.5-3.0 percent, well below the average for China's neighboring countries such as Japan and South Korea. Likewise, total factor productivity of the Chinese industry had either been stagnant or actually declined since 1957 [Kamath 1990].

At the second session of the fifth national people's congress in July 1979, the 'Law of the People's Republic of China on joint ventures using Chinese and foreign investment' was adopted, granting foreign investment a legal status in China [Kamath 1994]. By 1980, four special economic zones (SEZs) had been established along the south-east coast—Shenzhen, Zhuhai, Xiamen, and Shantou. During the period 1979-2000, a total FDI of US \$ 348300 million was invested in China, about US \$ 174099 million (50 percent) of which was accounted for by Hong Kong and Macao. The share Japanese, Taiwanese and American investment in China remains more or less constant during the period. The average investment per annum was about US \$ 16585 million. It seems important to mention that Hong Kong and Taiwan have never been recognized as major source of advanced technology. Likewise, these countries have been less known for adoption of new technology. Thus, to China has been in the form of low or quite standardized technology [Banik and Subbayamma 2000].

Most non-official growth forecast for 2004-05 (as available in September 2004) cluster around a modest 5.5 to 6 percent. However, the growth optimism of recent years also draws strength from a set of analytical papers that have appeared over the past year propounding the case for rapid, long-run growth of the Indian economy. Three main contributions: the much talked about 'BRICs report' by Goldman Sachs of October 2003 [Wilson and Purushothaman 2003], Vijay Kelkar's April 2004 Narayanan oration at the Australian National University [Kelkar 2004] and Rodrik and Subramanian (2004) in EPW (henceforth referred as RS). While these papers vary substantially in their scope and emphasis, they share a very bullish outlook on India's medium and long-run growth prospects.

The main factors on which such growth optimism is based are; India's demographic outlook for the next 40 years, past and projected trends in productivity,

the country's institutional strengths and underlying optimism about reforms. Despite well known vulnerabilities resulting from fiscal deficits that are as large today as in the late 1980s, and slow pace of banking reforms, few pundits are predicting an external crisis today. The external-debt-to GDP ratio has been declining and foreign exchange reserves at more than \$ 100 billion exceed the currency in circulation. Indeed, in a recent careful examination of India's vulnerability to external crises, Ahluwalia (2002) points to several key weaknesses in fiscal and banking areas and emphasizes the urgency of tackling them. But he stops well short of predicting a crisis.

A study of Hugo Restall reveals that India's approach has been almost exactly the opposite of China's-it nurtured its own entrepreneurs and held multinationals at arm's length. Its largest private firms are about 10 times the size of China's. India's trade barriers are still high, with peak tariff levels at 20 %, compared to China's 10.4% and a developing country averaged of 13.4 %. Nevertheless, it has been gradually opening and finding that its companies not only cope with competition, they thrive. Success in the IT sector has been the catalyst, showing Indians that they can be world-beaters. India has a huge advantage in its financial institutions and capital markets. Its bank are largely privately owned, and while their levels of nonperforming loans are relatively high at around 15 %, they conduct credit risk analysis on their borrowers and are run along commercial lines, in contrast to China. India also has a functioning stock market. As a result, Indian companies use capital more efficiently. The country's incremental capital-output ratio is generally lower than China's and in recent years it has actually been falling. As is normal for a developing country, its saving rate, currently around 25% of GDP, is not sufficient to finance its investment. This reflected in higher interest rates: India's prime lending rate is consistently over 12 %, compared to 8 % in China. But now the vast pool of global capital is discovering India. The country is set to reap the benefits of higher levels of investment as FDI and portfolio investment increase in the coming years. It's also revealing that they are pursuing advanced educating with a zeal that was formerly through of as Confucian trait-American universities enroll 80,000 Indian students, compared to 62,000 Chinese.

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According to economic survey 2007-08 the global trading system in India has been visualized in the following categories:

**(i) India's merchandise trade:**

India's merchandise exports (in US dollar terms and on customs basis), which have grown continuously at more than 20 percent since 2001-02 and 2006-07. The value of merchandise exports reached US \$ 111 billion in April-December 2007 with a growth of 21.6 percent. For the year 2007-08, an export target of US \$ 160 billion was set and during the first nine months of the current year, 69.4 percent of the export target has been achieved despite the appreciating rupee.

During 2006-07, export volume increased by 15.8 percent mainly due to items like crude materials, machinery and transport equipment, and mineral fuels and lubricants. The unit value of such exports increased by 8.1 percent mainly due to the three categories: manufactured goods classified chiefly by materials; food and food articles; and mineral fuels and lubricants.

Growth of the unit value index of exports, decelerated in the late 1990s and early 2000s to reach a negative value of -1 percent in 2001-02. Since then it has accelerated smartly to average a growth of 8.6 percent per annum during 2003-04 to 2006-07. In contrast, the growth rate of the unit value index of imports has fluctuations in the global prices of oil and other commodities and partly due to unit value changes in machinery and transport equipment and chemicals and related products. Though the quantum/volume of imports has shown a rising trend since 2000-01, the 48.2 percent growth in 2005-06 was way above this trend. The sample average growth of India's exports from 2000 to 2006 was 19.3 percent per annum. The growth of 29.8 percent in 2005 was above the trend, due to a rise in the export of refined petroleum products and textiles and clothing in the year of dismantling of the quotas.

**(ii) India's merchandise imports:**

Merchandise imports grew by 24.5 percent to US \$ 185.7 billion in 2006-07 due to the high growth of 30 percent of POL and 22.2 percent of non-POL. POL import growth was due to both volume growth by 13.8 percent and increase in import price of the Indian crude oil import basket by 12.1 percent.

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Trade deficit increased to US \$ 59.4 billion (as per customs data) in 2006-07 and US \$ 57.8 billion in the first nine months of the current year. However, net POL import growth peaked at 41.4 percent in 2005-06 and decelerated sharply to 19 percent in 2006-07, despite the 30 percent growth in POL imports, as a substantial part was input for export production. In the first half of 2007-08, there was a further moderation in the growth of net POL imports.

**(iii) Trade composition:**

The composition of exports shows a perceptible shift in this decade from light manufactures to heavy manufactures and petroleum crude and products. The share of textiles and ready-made garments (RMG) has fallen dramatically by 11.1 percent points in 2006-07 over 2000-01 followed by gems and jewelry, leather and leather manufactures and handicrafts. Share of engineering goods and petrol products has increased by 7.6 percentage points and 10.7 percentage points, respectively. Export growth in 2006-07 was driven mainly by petroleum products with 59.3 percent growth and engineering goods with 38.1 percent growth. The perceptible increase in the share of petroleum products in total exports reflected not only the rise in POL prices but also India's enhanced refining capacity.

China has been dominating the market for low-end products such as toys, textiles and tree-products. In recent years China has also entered the hi-tech markets. It is the world's fourth largest industrial producer behind U.S, Japan and Germany. It makes more than 50 % of the world's cameras, 30 % of air-conditioners and televisions, 25 % of washing machines and 20 % of the refrigerators. It has become the world's largest producer of mobile phones, DVD players, laptop computers and CTV sets (Anandlingam, 2002). A number of Chinese products especially hi-tech are successfully competing with MNCs in its soil. The main destination of exports of India and China shows that India's exports to developing countries in Asia constitute around 24 % of its total exports as compared with a share of about 33% of China. Country-wise while share of exports to USA is around 21% both the countries, India's exports to Japan and Hong Kong constitute around 9 % of its total exports as against China's share of around 35% to these parameters suggest that China is very successful in its export drive in comparison to India.

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The composition of imports showed much less change than that of exports. POL continues to be the single major item of import with its share stabilizing at the 30-31 percent level. The share of capital goods imports shows the sharpest rise of about 4.9 percentage points in 2006-07 over 2000-01 due to a 3.7 percentage point rise in the share of transport equipment and 1.6 percentage point rise in the share of non-electrical machinery (excluding machine tools). It has, however, plateaued at 13 percent in the first half of 207-08.

**(iv) India's services exports:**

With a sustained high growth of export of services, including a growth of 32.1 percent in 2006-07, export value reached US\$ 76.2 billion last year. Growth has been particularly rapid in the miscellaneous services category consisting of software services, business services, financial services was 70.5 percent in 2004-05, 37.5 percent in 2005-06 and 36.7 percent in 2006-07. Travel services exports grew by 16.2 percent and transportation by 27.3 percent in 2006-07.

**(v) Foreign Direct Investment:**

With reforms in policies, better infrastructure and a more vibrant financial sector, FDI inflows into India accelerated in 2006-07. On a gross basis, FDI inflows into India, after rising to a level of US \$ 6.2 billion in 2001-02, fell to US \$ 4.5 billion in 2003-04. After a recovery, the proportion has risen to reach US \$ 23 billion in 2006-07. FDI grew appreciably on both gross and net basis. While on a gross basis, the growth in 2006-07 was 150.2 percent, on a net basis it was 179.5 percent. Even as FDI into India (credit side) grew substantially, a simultaneous pick up in outward investment moderated the overall net inflows. Outward investment by India shot up from levels less than US \$ 14.4 billion in 2006-07. Thus, overall net FDI in 2006-07 was at US \$ 8.5 billion.

The bulk of FDI inflows going to China are of exports-oriented type. Economists estimate that FDI flows and export growth has accounted for more than half of the growth in China's GDP since 1981. Around 50% of China's exports are either foreigners or partly foreign owned (Sharma, 2002). Since launching market reforms in 1978 China has received over \$ 500 billion FDI. In 2002 FDI into China was \$ 52.70 billion, in Hong Kong it was \$ 13 .72 billion compared with \$ 4.66 billion in India. In China FDI accounted for 91 % of exports of electronic circuits and

96 % of mobiles phones. Thus, FDI had added competitive edge to the Chinese exports. In India through just a minute 10 % of manufactured exports is based on FDI. However, recent revaluation of Yuan may likely affect China's relative attractiveness for FDI overtime on two counts: the cost of investments will increase for investors while price competitiveness products will decline in export markets (Srivastava, 2005).

**(vi) Foreign Exchange Reserve:**

Foreign exchange reserves of India, denominated in dollars, rose from a level of US \$ 151.6 billion in end-March 2006 to reach a level of US \$ 199.2 billion, implying a reserve increase of the order of US \$ 47.6 billion. Though there is no one-to-one correspondence between sources of capital flows and reverse, the major sources of capital inflows (and implicitly of reserve accretion excluding valuation gains) were ECBs and foreign investment in 2006-07. The appreciation of other major currencies against the S dollar resulted in a valuation gain of the stock of reverse of the securities market and net outgo of FII flows in the initial months and later again in March 2007 moderated the other rapid pace of accretion to reverses in 2006-07. As per the BoP data released by the RBI for the current financial year (April-September), reverse rose by US \$ 48.6 billion including a valuation gain of US \$ 8.2 billion.

The sources of reverse were broad-based. Foreign exchange reverse on stock basis at the end of February 8, 2008 were US \$ 290.9 billion, implying an accretion of US \$ 91.6 billion in the current financial year so far over end-March 2007. It was fully in evidence in 2007-08 with the exchange rate of rupee appreciating sharply in tandem with rising capital flows .With the demand for foreign exchange (debt side of BoP) not keeping pace with the supply of foreign exchange (credit side of BoP), the rupee appreciated against the US \$ by 4.5 percent in April 2007 (over March 2007) and by 3.4 percent in May 2007 over April 2007. The extent of appreciation or depreciation of the rupee varies according to the time horizons as reference period. The rupee appreciated by 9.8 percent against the US dollar during the current financial year between April 3, 2007 and January 16, 2008. The rupee appreciation against the US dollar over the past 12 months on year-on year basis (December 2007 over December 2006) was a higher 13.2 percent.



**Tax reforms:**

One of lesser known aspects of China's emergence as a global manufacturing hub is the manner in which it completely revamped its tax system in the early 1990's to drive growth. Such modernization of the tax system which took place by 1993 was an integral part of the Chinese strategy for export driven and manufacturing-driven growth. In addition in recent past China's Central Bank has taken a number of monetary measures including hiking lending bank rate; revaluation of its currency Yuan and to peg it to a basket of currencies (Srivastava, 2005).

Finally, India is attractive to multinationals because it has a commitment to the rule of law and protecting intellectual property. This explains why India has home-grown, innovative companies, and is becoming a base for multinationals to conduct research in high-tech fields. Narayan Murty, founder of Infosys, was shocked it took months just to conclude a land agreement for a 15,000-employee facility in Hang Zhou. Of Chinese officials he complains, "Sometimes you can get confusing signals" Getting money out of Chinese clients is not easy either; Infosys gets paid in 56 days on average in India, but in China it must wait 120 day.

Andy Xie, Morgan Stanley's chief Asian economist, recently released a report entitled "Time to Change," which concluded: "Rising internal tension over inequality and external friction over China's trade success suggest that China's government-led and export/investment-driven development model may be reaching its limits". At or above the current level of 8% growth, some believe, India is able to pursue reform and use its increased revenues to compensate sectors of the population who are temporarily left behind.

Therefore a complete picture does not emerge from it. This is the gap, which will be filled through the present study.

**1.6 METHODOLOGY:**

Though there are different methods of collecting data, examining, plotting, analyzing the data but here in the present study the secondary data collection method has been used. In this process the data which have already been collected earlier have already been passed through the statistical process have the main objectives.

To achieve the above cited research objectives in a systematic manner a comprehensive effort has been made to collect secondary data mainly from the following sources:

- (i) Director General of commercial intelligence and statistics (D.G.C.I. & S.), Calcutta.
- (ii) Reserve Bank of India's Bulletin, Mumbai.
- (iii) Economic Survey, GOI, New Delhi.
- (iv) IMF, Direction of Trade Statistics.
- (v) Technical and trade journals.
- (vi) Reports and publications of various documents connected with economic reforms, exports, imports, Foreign Direct Investment, Joint Ventures etc and
- (vii) Publications of government of International bodies and their subsidiary organizations.

To achieve the afore said research objectives some analytical tools such as annual growth rate, comparative assessment and interpretation has been made on year wise growth pattern.

A step-wise procedure of collection of data, examining, plotting, analyzing the data and also tools used have been discussed among the subject experts.

## **1.7 AREA OF THE STUDY:**

The present study has been confined mainly with China's integration into the global trading system pertaining to pre and post phase of economic reforms, trends in China's foreign trade, Foreign Direct Investment, Foreign Exchange Reserves and Exchange Rate Policy. It has also been limited in terms of Sino-Indian trading relations particularly with exports, imports, joint ventures and Foreign Direct Investment only.

## **1.8 LIMITATION OF THE STUDY:**

In order to achieve the objectives of the present study, the researcher has delimited upto secondary data collection technique from various sources. The already available data have been used with due precaution if they are readily available from authentic sources and are sufficiently reliable, valid, suitable and adequate. In this process a minute scrutiny of secondary data have been made in the context of the research problem.

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## 2.1 INTRODUCTION

China's economic reforms initiated in the early 1980's, took an observable twist only in the late 1990's. Prior to globalization China's economic weakness was a constraint on its foreign policy. In the initial stage China took one major step of shifting from centrally planned economy to marketed economy. When China began to open to world market in 1978, the measures in retrospect was less than bold. Pragmatically economic success was most urgent for the regime's long term survival then trying to get the "real world". Subsequently, China's first phase of economic reform mainly concentrated its aim is to promote exports, encourage inward investment, development special economic zones, attract investment and open up infrastructure for development.

The essence was to introduce more market around the plan. The result was that Chinese government initiated second form of economic reform from 1990. The rapid of China's economic growth was just achieved by opening the economy but its careful and judicious planning towards market liberalization. China with its intelligence approach could success in minimizing the negative impact of the economy. The sequence of reform plays a vital role in bringing the success. Source of the key elements of the China's reform process mainly aimed at: development of private sector price liberalization in the domestic market, shifting of centrally planned economy towards market oriented economy, development of legal framework of private enterprises and encourage local production for export markets. The reforms included export promotion policy, import of foreign capital, the creation of export processing zone and importation for foreign technology.

Meanwhile foreign investment rate grew consistently until the boom years of the late 1990's when inward investment came to account for up to 13 percent of total investment for one year. Trade rediscovered the benefits to be derived from a long coast line, market. This exploit the mainland's near inexhaustible supply of cheap

labor and to secure foreign capital. One of the most abundant resources in China is the very high rate of saving both domestic and foreign.

It is scarcely an exaggeration to say that agricultural reform was initiated by the peasantry. Together with this the mainland attracts 40 percent of foreign direct investment flows to developing countries, 10 percent of banking lending, 10 percent of portfolio entry flows and 5 percent of bond flows. China's demand for energy is driven by high rates of industrial production, the automobile revolution, the surge in air travel and complex pricing control. China has its own peculiarities, the thrust of policy to accelerate the pace of modernization, upgrade private property rights and more decisively to join the WTO. In the case of China, the high growth during the last 20 years has indeed been accompanied by substantial productivity gains. Economic reforms greatly liberated people's thinking and other desire to pursue economic gain.

## **2.2 FIRST PHASE OF REFORM 1970-1993**

The promulgation of the equity joint venture law (Sino-foreign joint venture) in July 1979 formally opened up China's market to the world. This provided the legal framework for foreign investors to form equity joint ventures with Chinese partners. China permitted foreign companies, enterprises, other economic entities or individuals to incorporate themselves in the territory of China. Some states were granted special autonomy in dealing with foreign trade and investment with the central government. Later in 1979 four SEZs were established and were granted special autonomy in dealing with foreign trade and investment with the objectives as to develop the coastal area of China's window to the outside world. After the new policies and incentives were promulgated in 1986, investment into China increased dramatically. Between 1986 and 1991, the total foreign investment actually used was US \$ 33.2 billion, an average of US \$ 6.6 billion per year. This figure increased by 142 percent compared with the previous period. The following steps, in the direction of economic reform, have been taken. These are:

### **2.2.1 STATE OWNED ENTERPRISES**

From 1978 onwards Chinese State Owned Enterprises (SOEs) embarked on a new path of reforming their internal and external operating mechanism. The whole

reforming process could be generally divided into three phases: the first phase ranged from 1978 to 1984 when the reform aimed at the restructuring of highly centralized management system and giving more incentive to SOEs through profit retention scheme. During 1984 to 1993, SOEs went through the second phase of reforming along the line of “Power division and profit redistribution” (Fanqquan Rangli) to individual firms. Despite those reforms major both productivity and profitability of SOEs had lucked behind by the non state enterprise resulting in the decline of SOEs share in total industrial output 57 percent in 1993 (CSSB, 1999). Since then SOEs into some industrial independent producer entered the third stage and shifted his employees towards ownership restructuring.

During the year between 1949-1985 total capital investment in SOEs was about Rmb 100.5 billion but such investment only generate Rmb 81.3 billion profits and taxes in return (Loic 1989). The return rate of country administrated SOEs was 81 percent only half of the average return rate of all SOEs.

During the first round of decentralization, 8,100 SOEs amounting to 87 percent of all SOEs and producing 25.9 percent of national industrial output had been developed to state government with only 1,200 SOEs still affiliated with central authorities by 1958 (Zhon 1984). Approximately 10,000 SOEs accounting from 46.1 percent of al SOEs industrial output were decentralized.

Economically it was believed that the formulation of regional self reliance was to simply the requirements of coordination in the economy by localizing allocation decision so that the function of planning could be carried out by articulated local bureaucracy without resources of market mechanism (Riskin,1987). As a result capital investment into China’s SOEs which has been regarded as key instrument industrialization strategies were subject to centralized planning and administration before reforms.

This process has been made to give greater attention to the types of economic incentives for local governments in the forms of fiscal revenue sharing system and capital investment funding and project approval. The investment project that required approval by the state planning commission and the state council had been raised from Rmb 10 and 1, 00 million to 30 million and 200 million respectively since the 1980’s (Peng. 1989).As a result China’s reform of fiscal capital investment system have in

terms of property rights, several to clarify the ownership right of local government over the asset of SOEs within governments over the asset of SOE that they administrated. The reforming process was in-effect a level of downsizing reallocation of property right over SOEs within government hierarchy (Walder 1995). The growth and development of SOEs are scalar differentiated according to their administrative affiliation with various levels of government. Such policy of scale shows that the SOEs at the lowest level of administrative hierarchy exhibited the lowest performance in both productivity and profitability.

A review of Chinese government effort to reform SOEs reveals that prior to 1993 the financial reform is simply an administrative, loans by banking replace the previous budgetary allocation of investment and enterprises became responsible for the repayment of principle and interest existing studies have concluded that budget constraints did not harden but actually softened as a result of government continued influence over back leading decision. There is no doubt the government is strongly committed to SOEs. Since 1984 the central committee of China Communist Party (C.C.P) decided to undertake economic restructuring in China where economy was a planned economy based on public ownership. Later on 1987 a theory of primary stage socialist in China market forces and even private ownership were permitted and harnessed to help develop productive forces (Jiang, 1992).

Some leading theorist in China has attempted to rationalize the insistence of the dominance of public ownership especially for larger SOEs. Jiang stress that it facilitates the ability of the state to maintain control.

The main difference between state owned industrial enterprises and reform of Chinese agriculture is that privatization was not adopted for SOEs. The lure of material supplies wanted to retain its control over the distribution of major materials. The entire system for industrial products had to be changed to enable state enterprises to produce efficiently once they are allowed to be finally independent. Twelfth central committee of CCP adopted a major decision on Oct 20, 1984 on economy reform and resolved to give individual state enterprises autonomy in decisions, regarding production, supply, marketing price, investment and personal to function as profit seeking economic unit. It developed a macro-economic control mechanism through the use of taxes, interest rate and monetary policy under an improved banking and

financial system the slogan was “invigorate the macro economic units and controlled by macro levers”.

### **2.2.2 Foreign Direct Investment**

For China FDI flows had brought about an economic miracle. More than two decade experience of rapid growth and increasing openness the kind of policy regime that has facilitated the infusion of a massive flow of FDI has been world wide acclaimed. The year 1978 marks the beginning of the first reform. The establishment of the household responsibility system, the introduction of urban price reform of 1988 was the two landmark events in the decade. The political crises of 1989 then marked new reform strategies in its expression in the official motto, coined by then Prime Minister and party Secretary Zhao Ziyang. FDI was to start with accorded a legal status superior to that enjoyed by indigenous private firm. The 1982 constitution offered protection (Article 18) to the legal status of foreign enterprises and other Chinese organizations. The government removed in 1992 a number of sectoral and regional restriction on FDI, shifting simultaneously the investment approval authority from the central government to local governments. This had implications for the growth scenario. Also a number of agreements with other's were put in place committing the Chinese got to increase market access and strengthen intellectual property rights protection (Lardy 1998).

Over the two decades of reforms, FDI has emerged as a significant source of investment financing. This was the reason that it amounted to 6 percent of GDP in early 1990 through the absolute amount increased during that period. FDI provided a critical catalytic and dramatic impact on the growth of small and medium sized industries in rural and urban areas. This was facilities through extensive decentralization of power to regional authorities and utilization of local resources and development of local industries and development of local industries. Town and Villages Enterprises (TVE's) actively sponsored assisted by local government became especially the major medium for foreign investment (Naughton 1995). Local government had a strong incentive to promote (TVE's), these contributed substantially and the local government retained the revenue sharing arrangement. One of the most important contributing factors was the major agricultural boom coming in the wake of economic reform in agriculture with better prices and land tenure with the

farmers acquiring fixed term land use rights. Political regime as deployed FDI as a solid supporting mechanism for the modernization of Chinese industries and expansion of its trade in first two decade of reforms. The flow of FDI increased in an effective growth.

China seems to have discovered its own reform model with “Chinese characteristics”. A western observer calls it, is the “Beijing consequences” (Ramo 2004). During many years in 1990’s China claim to be the world’s largest recipient of FDI but the fact is that even in some of the most remote provinces in China. FDI accounts for surprisingly high proportion of fixed assets investments. Unlike these for Guangdong province FDI figure are usually to be contaminated by a statistical distortion known as “round trip FDI”.

Researchers and business analytics have suggested that China macro fundamentals include political stability, rapid market expansion, cheap labor forces and its financing requirements thereby China has one of the highest saving rates in the world. In 1990’s China has not only one of the world largest recipients of FDI, but it been also one of the largest capital exporters its current account surplus, as a percentage share of GDP came to 2.7 percent. This dynamic means that FDI has not contributed to an increase in China capital formulation. In 1992 Chinese government decided to significantly liberties its FDI regime.

As FDI rose in 1990’s contractual capital inflows decline substantially. One possibility is that in 1990’s many foreign investor took over export production facilities previously owned an independently run by Chinese enterpenurers. Lou wells (1993) observe “two concepts are rather widely held among research considered with FDI.

- (a) To survive abroad a firm needs some kind of advantage over local competitions.
- (b) A firm must have some reason to internalize that advantage through ownership rather than contracting with another firm”.



Stephen Lymer (1970) widely argues that FDI is “an instrument which allows business firms to transfer capital technology and organizational skills from one country to another”.

The prevalence of equity arrangements in China suggest that there are putative benefits associated with FDI in excess of contract export production. Since FDI arrangements in China are pervasive in manufacturing and export of products such as garments, furniture, and leather and for products on the surface, the prevalence of FDI arrangements must be due to benefits other than transforming ‘R and D’ content and propriory intangible assets. It is important to note that like a production contract between a foreign and domestic firm FDI is a contract as well. No doubt the institutional foundation argument differs from many of the standards prospective of FDI in two aspects.

- (i) It focuses on the motivation of constraints on Chinese firms to account for some of the FDI pattern.
- (ii) It makes the calm that institutional features of Chinese economy powerfully create and save these motivation and constraints. As evidence of the growing competitiveness of domestic private firms, the decline of FDI dependency was mainly driven by huge increase in investment by domestic private firm rather than by an absolute decline of FDI inflows.

### **2.2.3 Banking and Finance**

The major aims of reforms in banking and finance are as follows:

1. To supply currency in circulation and funds (credits) to state enterprises. It includes other government units under the direction of central planning and accepts saving deposits from the people with assistance of its branch banks in various locations.
2. To reform the banking system in order to serve a market oriented economy progressed.
3. To strengthened the structure of balance sheet of various banks in operation.
4. To encourage the finance system in order to achieve the stable regulatory reform.

Economic reform that began in 1978, China's banking was performed by the people bank and its branch bank. The main functions of the people's bank were to supply currencies in circulation under the direction of central planning. With the eminent accession of China's into the world organization the whole landscape of Chinese banking and financial system faces a dramatic change : as foreign business were allowed to compete on a more level playing field in China's domestic market, the policy makers had stepped up the pace of reform ahead of new challenges. China admits banking system remain inherently unstable initially and given a serious SOE and nonperforming loans problems.

Following economic reforms towards a more market oriented economy, the People's Bank was changed to a Central Bank of China, Agricultural Bank of China, Peoples Construction Bank of China were established in addition to Bank of China dealing with international transaction. Reforms of banking system to serve a market economy progress gradually in the late 1980's and early 1990's.

Chinese government official and economist were aware of the possible weakness of the current banking system and were trying to improve its performance. With the reason they had made serious efforts to invite outside expert to train the staff of the Central Bank and Commercial Bank. Zhu Rougji (1999) stated in his government report China should accelerate the reform of state owned commercial bank, insure autonomy in the operation of bank, and continue to make progress in the efforts to establish bank branches and sub branches based on the economic division, work loads and tightened interval control. Further, China should rectify and standardized the insurance market to promote the sound development of the insurance industry. Significant achievement has been attained since China adopted its reform and open door policy in 1978. During the progress of subsequent years China's annual GDP increased at an average rate of 9.6 percent, far faster than the annual GDP growth and at a higher rate than the World's average 3 percent growth for the same period. China soon entered into its tenth five year development plan, therefore, need to speed up its pace of financial system reform and improve the competitiveness of China's financial sector in entering the 21<sup>st</sup> century. Forming various financial institutions and separating their work ahead enhancing cooperation, will adopt the system of financial organization under the new policy of reform and openness. In

accelerating the reform of China state-owned Commercial Banks, China formed four financial asset management companies to purchase, manage and dispose of non performing asset so as to separate these from the banking sector, through the implementation of debt equity swaps for certain qualified SOEs. The emergence of shareholding Commercial Banks employed financial market competition, promoting the formation of a competitive environment within the banking sector and in turn, supporting the development of small and medium sized enterprises. Although the four banks were intended to act as commercial banks they remained in reality the government policy tools to achieve its economic and social goals.

The decline in household consumption as a share of household disposable income in GDP. Part of explanation of this decline may be increasing financial repression. China's financial sector has been undergoing far reaching reform for more than a decade suggesting that the degree of repression has ceased in recent years. However from the past of the view of household this appears not to be the case. The decline contribution of interest earning of disposable income was even greater since the government introduce a 20 percent tax on interest income. More importantly interest earning loan in line with the household bank deposit would have been greater than the actual contribution.

China's banking transformation is indeed interlocked with the entire change of reform in insurance securities market, pension and other currencies or interest rate liberalization. All these effort had led to some improvement in transparency, efficiency, corporate governance, management and share holder value which will lead to higher investor demand, thus fascinating the privatization and reform process. All the above facts point that's China's complex and huge economy is on the rise and the long cherished goal is in view.

#### **2.2.4 Foreign Trade and Foreign Exchange**

From 1949 to 1978, China was a planned economy and trade follows was entirely controlled by state. Meanwhile, a few state owned and state run trading companies and their subsidies controlled almost all foreign trade, insurance monopolies in many goods. Import and Export volumes for each trading company were centrally planned and prices and volumes for each trading company were strictly

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administer by state to unified income and pavement rules. Since 1978 China has been moving towards a market economy and thus, a more liberal trade system. China's trade system can be divided into two periods in terms of reform demarked by 1992.

During the first period China's tractions towards a market system was gradual. In second terms, China first opened its market for considerable next; it liberalized trade in certain in fracture industries and intermediated. Therefore, it gradually opened various services activators to international al competition that s China promoted decentralized since 1992 China's trade system has begun to better reflect international norms and trade liberalization has accelerated. At a first broad measure, the government lowered its tariff rates for only 81 of about 6,300 duty codes by 30.85 percent. By contrast in December 1992 China reduced import tariff for 3596 duty codes by an average of 7.3 percent. In another more non tariff barriers were reduce and China has retracted all list of substute imports goods. China reduced the average rate in a subsequent manner year on year.

To lower its tariff on agricultural products from 31.5 percent to 14.5 percent overall tariff on industrial products have been lowered heir products from 35 to 75 percent but foreign manufactures showed in their products directly to domestic consumers without having to go through Chinese trade organization. Tariff agricultural products felt sharply both prior to Chinas accession to the WTO. Agricultural trade reform I China shows that protection was quite strongly negative for most commodities and particularly for exported goods. Since then the taxation for agriculture has declined and reduction in trade distortion for both imported and exported goods, Infect Schiff and valder (1991) concluded that the indirect taxation for agriculture resulting from protection to other sector and exchange rate over valuation was generally more important then direct distortion to agriculture. In case of China there has been an enormous amount of liberalization of non agricultural barriers including tariff, exchange rate overvaluation through the two tire system, quotas and licenses. In essence each farm household was assigned a piece of land was held responsible for delivering a given quantity of a specified product in other that the Cummins could satisfy its procurement price requirement. This responsibility system has the economic characteristics of private farming in market economy. According to the account of Zhaw (1996) revealed that farmer attempted unorganized grassroots land reform in many parts of rural China farm economy in essence returned to the

private economy. China still has state firms, but they produce less than 1 percent of agricultural output.

In China total value of foreign trade grew from US \$ 21 billion in 1978 to US \$ 237 billion in 1994, a secular ten fold increase. China had now become firmly integrated into the world economy. The rapid increase in foreign trade and investment was successful due to its foreign trade system.

Trade liberalization has now become one of the top priorities in the marketization of the Chinese economy. The major thrust of trade reform was to turn away the policies of self sufficient or an import substitution strategy towards the strategy of export led growth. The main role of foreign trade was to make up for domestic shortage by imports and to smooth out excessive supplies of domestic goods by exports within the framework of the national economic plan. Two major components in the Chinese economic reforms programs: one is decentralization of economic decision making power and rationalization of prices. Trade reform has involved restoration of price based incentives mainly through reform of the foreign exchange system. The export pattern in China's trends. China's foreign exchange rate had little role influencing the allocation of resources and performed largely on accounting function. The two major elements of reforms are introduction of foreign exchange system and devaluation of Rmb Yuan for trade related transaction. Chinese government introduced internal settlement rate for trade and is calculated from the average cost of earning as US dollar through export and was set as Rmb Yuan 2.8 to 1 US dollar. This represented an 80 percent defactor devaluation as the official rate was only Rmb Yuan 1.55 to 1 US dollar, by 1993 80 percent of foreign exchange earnings were priced at the swap rate. China continued to apply the foreign exchange retention system and to increase retention rate. Martin simulated the effects of depreciation of the official rate by 10 percent using a computable general equilibrium model of the Chinese economy.

### **2.3 SECOND PHASE OF REFORM: 1994 to 2008**

The noticeable inflow of foreign capital surged into China in the period of high growth. The phenomenon began after the southern tour of former leader Deng Xiaoping in 1992. He urged the country to accelerate economic reform and open up further. In the meanwhile, many previously suspended reform policies were ready to

be implemented after three years of harsh measures had brought inflation under control. However, unlike in the 1980s the reform policy in the 1990's shifted from costal region to western inland areas. This was mainly because the large amount of foreign investment in the costal areas had widened the income gap between the coast and west of China. There cities enjoyed the same policy treatment as that given to costal open areas Foreign capital followed into China from 150 countries, the majority in Asia. In December 2001, China became the 143<sup>rd</sup> member of WTO. The state government has committed to a wide range of reforms as part of WTO accession in late 1990s and early 2000s. The reform includes:

1. Boosting transparency to both legal and administrative systems.
2. Improving intellectual property protection.
3. Reducing tariffs and tax: and
4. Privatizing SOEs.

### **2.3.1 State Owned Enterprises**

There is a scope for the process of restructuring about SOEs. Just between 1995 and 1997, for example, the total number of industrial SOE employees dropped by 3.6 million over the same period. However, private sector employment rose by 12 million and overall employment was more than 16 million, despite the loss in SOEs position. Officially reported net profit of SOEs in aggregate have fallen by half in the several past years and are infact negative in the first five months of 1998. Moreover subsidies reported in the official balance sheet fail to tell full story. Much of the lending to SOEs as noted is policy based and constitutes a hidden subsidy at that sector.

Most of the elements of restructuring the SOEs are by now well understood. In some cases the prospects for restructuring that closing will be the preferred option at the other extreme many are already making profits, even burden with social expenditures. There may be room for improvement but these enterprises are a drained on neither the financial system nor the government. In between are the difficult judgment call cases where restructuring may be possible. Investigation shows that hard budget constraints, which mean not only phasing down subsidies but also eliminating soft loans-, are important in providing incentives for restructuring. But as

China marks a transition to a market socialist economy, the debt equity ratio matters a great deal. In China the government is both the owner and the leader in the process. The value of loans will have to be written down and a direct subsidy to the restructuring agency may be required.

Since 1994, however, the SOEs have discovered another important source of capital apart from bank loans and retained profits: namely equities. This is the direct result of the introduction of the so called "modern enterprises system". There have been two key steps in SOEs reform since 1994: the introduction of MES in 1994 and the three year program to turn around SOEs from 1998 through 2000. It is evident that a primary strategy of the three year program was to introduce the MES to a majority of the targeted large and medium sized SOEs. However from 1997 the government significantly stepped up its exploitation of the stock market as a source of chief finance for SOEs. In fact the Chinese stock market expanded raising on average Rmb 100 billion a year for the listed companies during 1997-1999 and as much as Rmb 210 billion in 2000. On the other hand between 1998 and 2002 a total of Rmb 600 billion in long term Treasury bonds was issued.

The authorities recognized the need to complete the decentralization process by insulating the SOEs from government interference and giving them complete autonomy in management. In March 1996 the government announced to consent to rate reform on 1,000 large SOEs and to dispose of the roughly 90,000 small SOEs through mergers, leasing or sale. Through research it had been identified that from 1985 to 1995 the proportion of SOEs that suffered from a loss has risen from 9.6 percent to 33.8 percent (Lo 1999:p-699). Over the same period of time losses incurred by SOEs, increased almost twenty fold from Rmb 3.2 billion to Rmb 63.9 billion (CSSB : 1998 p-52).

The first explanation draws its inspiration from an institutional perspective and attributes the difficulties of SOEs to the ambiguous property rights or ownership rights. It was argued that public property rights. SOEs were not clearly defined the only solution for SOEs would be to redefine it along the line of complete privatization (Jhang: 1997). It is believed that a reduction of entry barriers to the non state sector and subsequent erosion of monopolistic profit previously enjoyed solely by SOEs (Naughton; 1995). The overall compensation of the workers in SOEs suggests that the

sum direct and indirect expenditure of SOEs had increased much more than the growth of labor productivity, resulting in the decline of profits. This interpretation has correctly pointed out that progress in welfare reform was a necessary pre-condition for the success of China's SOEs reform.

### **2.3.2 Foreign Direct Investment**

In continued efforts of FDI reform private sector was expected a component of, rather than as a supplement to the Chinese economy. In the March 1999, notwithstanding the progressive removal of legal disabilities, private firms continued to face discrimination from the banking system in the availability of credit. Until 1998 in the largest Chinese banks were under instructions not to lend the private firms. It was only in July 2001, after the announcement of President Jiang Zemin that the communist party would welcome private entrepreneurs to join their ranks that things eased somewhat for the domestic private sector. China accepted in recognition of ground realities that FDI could be deployed as a change agent between 1993 and 1997. FDI accounted for over 30 percent of fixed asset investment by the non state firms: if one adds to it enterprise in which foreign investment has been made, the figure is 53 percent. Some 1504 manufacturing FIEs were operating in 1995 (Wang; 1995). They accounted for over 60 percent of Chinese export in these industries. The impressive development of rural industries was primarily due to their connection to the international market. In these TVEs the area of highest growth was also the areas of deepest foreign penetration. A trend is sharply different from what has been observed in other developing countries. In these countries, in the production of labor extensive exports products, local investor, learn the skills and crafts and displayed crafts the foreign producers. The case in China was reverse as perceived in many other developing countries where there had been strong FDI's alliance through technologies licensing and marketing arrangements with local entrepreneurs. The upsurge of indigenous entrepreneurship with the benefits of FDI inflow acquiring to the economy the regime felt encourage to introduce steadily the concepts of and institution of private into the Chinese economy. The domestic private sector had increased output five fold from 1998 to 2003. During this period it created 80 millions jobs while SOEs set 22 million jobs and added many jobs prior to it. The private sector shares in Chinese economy is as much as two-third (OECD; 2005). With the



observed benefits following from FDI the political regime felt in allowing significant relaxation that had virtually become a bible with the banking system. This causes a rapid increase in export processing organization by private firms from \$ 6.3 million to \$ 536 million from 1996 -2000. FDI flows were mainly restricted to the collective and joint venture in provinces and selected regions. As benefits started flowing from FDI with the surge of domestic entrepreneurship the regime could afford to shift gear. In 1997 President declared the state do not have to dominate every sector or have majority ownership in every enterprises in order to maintain broad control of the economy and should focus mainly few enterprises (Steinfeld ; 1998). It follows naturally that large FDI inflow would have lead to a substantial role of FIE's in China's economy. As of 1995, FIEs controlled over half of China's manufactured exports, or 51.2 percent. FIEs accounted for 45.5 percent of Guangdong's exports in 1995, 49.5 percent in 1997, 51.8 percent in 1998, and 50.7 percent in 1999.

Lemoine (2000) in his study conducted that despite the size of the China's economy, the part taken by foreign affiliates in its manufacturing industry and export is comparable with that they play in other developing Asian economies. She revealed that the low employment share at 11 percent in China compared with 23 percent in Taiwan, 38 percent in Malaysia and 14 percent in Indonesia is easily explained by the excess employment among SOEs in China, Summarizing the theoretical work on FDI. Moran (1998) writes "barriers to entry imperfect competition are the sine qua non for the FDI process to be possible". In 1995 the average FDI/capital formation ratio for fourteen interior and western provinces was 4.9 percent; if investment by SOEs is excluded, the ratio was 14.9 percent. From 1992 to 1998 period this 4.9 percent figure put the provinces above Taiwan (2.2 %), Korea (1.2%), India (2.2%) and Russia (2.0%). Lemoine in her own study shows that the FDI stock/GDP ratio for interior provinces was 10.9 percent in 1998 where the FDI stock/GDP ratio for North America was 10.5 percent, for the central and eastern Europe 12.9 percent and for South east Asia 10.5 percent. This indicates that round trip FDI has an effect on China's that capital inflow as the capital that is imported is cancelled out by the capital that is first exported.

Institutional factor exert relatively few influences on this type of FDI. It is possible that China's economic and financial institution improve, China will become

more attractive to conventional FDI. One category of FDI concern, the operations of MNC's seeking to sell "global products" to prospects national resources, or to locate production facilities of highly technological products close to their customers. Wei (1996) reports that the usual pull factor in fact over predict China's FDI's incidence, that is the predicted level generated by China's market size, economic growth and human capital endowment is greater that the actual level of FDI absorption.

Chinese firm can be divided into four category first category consist of SOEs but variant types of SOEs, second one is composed of collection firms closest to SOEs in urban area owned by SOEs. The third categories of firm encompass purely private firms and are more likely to be partnerships or proprietorship. The fourth category of firms with mixed ownership structure which includes FIEs as listed on China's stock exchange and firms with substantial employee's stock holding.

FDI which surplus US \$ 50 billion 2002 (an increase of 20% year on year) can be called the single most significant drive of China's economic expansion. This is especially true since FDI experience a growth spurts starting in 1998: and 2001, utilized FDI amounted to over US \$ 173 billion. In addition the economy beyond the heavy industrial base, led the education of generation of Chinese professional in different ways of doing business. Zhu Rongjit's landmark SOE reform program in 1997, still act as a dead system is dominant by the "big four" bank which accounts for over 67 percent of deposits and 60 percent of loans. In 2002 the private sector accounted for over 60 percent the service industry 50 percent of export and 24 percent of current GDP. As current growth rates, it will comprises as much as 40 percent of GDP by 2010. It is also a potential sauce of investment into the state sector with one recent example being the purchase of 18 percent of China's eastern airlines by private sector. Even then the government needs to make a more concentrated effort to embrace and support the private sector. The key elements of approach to reform are that the development of new sector and charges of economic sector will create and improve the conditions for reform of the old sector. The overall economic growth, supported by the growth of non state sector has made it possible for the government to mobilize some resources to compensate the unemployment state sector has workers. Some reports indicate that in some region 70 percent of small SOEs have seen privatized including employees share holding companies as the first step in the

process of reforms. For a country like China it may take long time to complete its industrialization process which more than 400 million rural laborers will have to find new jobs in non farming sectors in the current global environment of technology revolution and oversupply.

### **2.3.3 Banking and Finance**

The most dramatic turning point for China's financial reform occurred in 1994. The People Bank of China together with identities such as the state commission for reform of economic system the ministry of finance and state administration of foreign exchange control underwent an adjustment leading to both banking foreign exchange and tax reforms which brought China's financial system with international standards. Zhu develop a system of "macro economic control" cutting credit lines and money supply. By 1995 the inflation dropped to 10 percent barely higher than the rate of the economic expansion. By 1997 inflation closed the year at 1.1 percent while growth registered in impressive 9.7 percent. At the end of 1999 growth was still high at 7.6 percent while inflation has turned to disinflation at falling by negative 3.6 percent.

Reforms of the insurance system gained momentum in 1996, with the implementation of a separation of property and life insurance. China maintained its foreign exchange reserves assuring exchange rate stability when the Asian financial system was in crisis. Foreign exchange reserves were at US \$ 153 billion in 2000, putting pressure on the Rmb to revalue upward rather than devalue.

State was in structuring the new asset management companies as to which enterprises should be undertaking depth to equity swaps. The state council has selected some 500 enterprises for the ground experiment which in principle is based on models adopted in other countries but with Chinese characteristics.

In March 1999, Chinese government step-up four management companies each serving to restructure to bad debt of large back. The purpose was to strengthen the structure of balance sheet of the Commercial Bank. The asset management companies in turn try to collect from the state enterprises part or whole of the debt in

the conjunction. It has the power to supervise and monitor the financial position of the state enterprises.

By the end of 1999, a breakdown shows that the asset state-owned commercial bank amounted to Rmb 10.4 trillion or 60.5 percent the assets of various shareholding commercial banks amounted to 2 trillion, or 11.6 percent and urban and rural credit cooperative and trusts and investment financial institution amounted to Rmb 10.4 trillion accounting for the remaining 27.9 percent.

China, there are more than 39,000 rural credit cooperative. At the end of 1999 China had 90 securities investment funds. In future the market will be managed on the principles of market economy according to the direction of low supervision, self-discipline and standardization. During this period insurance premium was Rmb 139.3 billion, insurance density was 1.67 percent and penetration was worth Rmb 10.85 billion. China intended to increase the number of insurance companies to complete the development of its market. In recent years monetary market situation leading to the general expansion of the scale of financial institution transaction emerged sharply. There was an important reform carried out in the management system of the Peoples Bank of China involving management was abolishment of the former 32 provincial autonomous region and municipality branches directly under the central government. This measure reinforced the independence and fairness of the Central Bank in fulfilling its responsibility. There were 182 financial institutions in operation of which 87 were foreign financial institution and group enterprises from 22 countries and region established in China. This will push further to participate in the process of financial globalization. After joining WTO China's economy has further integrated into the global financial market. China successfully conducted foreign exchange management system reforms realizing the mergers of dual foreign exchange rates: establishing a single and managerial floating exchange rates system based on market supply and demand. The People Bank of China through open market operations purchase US \$120 billion in foreign exchange then rapidly increased foreign exchange reserve and established the exchange rate. From 2000 China's international balance of increase and expenditure has been good, foreign exchange supply new exceeds demand and the Rmb exchange rate has been stable.

In future based on the principles of four competition and mutual benefit China will strengthen cooperation among national and among the Central Bank of Asian countries. It will continue to support IMF in international financial affairs. It must actively seek mechanism for maintaining current stability for future economic integration into the world.

Part of the explanation about financial systems shows that household deposits in the banking system as a share of GDP almost doubled between 1993 and 2003, the extreme of pre tax interest earnings generated by these saving declined from an average of about 5 percent in 1992-95 to only 2.2 percent of GDP in 2003. Most importantly if interest earning by household bank deposit had grown up, the government had not introduce a tax on interest income the contribution by 2003 would have been 7.5 percent of GDP, 5.7 percent points greater than the actual contribution. Apparently the newly found power of the restructured Central Bank was evidenced from the closer of some bad local financial institution. Nevertheless POCB had paid more attention to these problems and attempts were made to recapitalize the program and important tools were invented to resolve the huge NPL problem. The POCB believes that the utilize loss will be below 9 percent on an NPL ratio of 25 percent employing a recovery of 64 percent.

#### **2.3.4 Foreign Trade and Foreign Exchange**

At the beginning of 1994 the main features of reforms included, confining the official and market exchange rate by merging the former with the latter and the abolition of approval procedures for acquiring and using foreign uses for current account transaction.

Reform over two decade lowered the simple average tariff to 23 percent by the end of 1996. However, high tariff still prevailed for some goods of China's 6,549 tariff lines, 28 percent had rate in excess of 30 percent. The number of products still subject to quota and licensing requirement was 36 percent. These made up about 15 percent of Chinese import in 1996.

Over the past 50 years many countries have protected them agricultural sector reflecting concerns for food security and for the welfare of farmers. In 1994 these

three revenue sources earned the government 62.2 billion Yuan accounting for 26 percent of its total tax collection. In April 1996 it undertook last tariff reduction and eliminated a number of special exemptions, as expected, tariff revenue increase.

We estimate that for 1994, China's consumer surplus loss from trade protection for these 25 goods totaled \$35 billion, which suggests that liberalizing trade for these 25 products would create a significant consumer surplus again. The gain would be about 6.2 percent of GNP using nominal exchange rates. The 25 selected products represent 30 percent of Chinese total merchandise import in Cost Insurance and Freight (C.I.F) values. Many Chinese observers question whether increased imports would benefit the average Chinese firm. Primary resources accounted for 14.2 percent of total imported goods in 1994, while manufactured products accounted for 85.5 percent of the total.

Reduction employment in the protected industries would be one of the major drawbacks of liberalization. Job losses of about 11.2 million, about 26.9 percent of employment in affected industries from total liberalization. Thus trade liberalization would do only negligible damage to the already distorted Chinese industrial labor market. In 1994, China still maintained a system of high tariffs. Despite prior reductions, nominal tariffs remained high; at an average of nearly 36 percent about 30 percent point higher than most developed countries and 15 to 20 percent point higher than many developing countries in Asia. If the tariff rates on these items are strictly enforced and if value-added and consumption taxes were imposed on top of the tariffs, then the gross tariffs plus tax on such imports would exceed 100 percent and sometimes reach 40 percent. However, duties were not strictly enforced.

Since WTO membership requires China to lower tariffs on agricultural and manufactures products and allows foreign firm to enter China's manufacturing services sector there will be structural change in China's economy. Hundreds of companies joined in a high powered alliance to get the US to back China's admission to the WTO. Bankers say that concrete gain is accepted from the reduction of agriculture tariff from 31.5 to 14.5 percent overall by 2004 and the termination of subsidies to China's export.

Li, et al, (1999) applied a dynamic computational journal equilibrium model of Chinese economy consisting of 41 sector and ten types of household to study the impact of WTO membership. The impact of WTO membership on economic growth comes from the gains from speculation through international trade. The study estimates that China's real GDP in 2005 was 1.5 percent higher from the first source due to the above policies if the gain in total factor productivity is incorporated, the average annual growth rate in GDP from 1997 to 2000 will be 1 percent higher from the entry into the WTO. The annual growth rate projected for this period is 7.5 percent.

China is now the ninth target trading nation, ahead of Korea and Spain for example, and is likely to become the second largest trading nation by 2025 exceeded solely by the United States. Given the direction of economic reform the outlook for China's growth is bright. The average growth rate of China's real GDP is estimated at 7 percent per annum between 2001 and 2025, well above the United States 3.4 percent and Europe 2-3 percent GDP growth rate. By the end of May 2000 there were over 47.7 million stock investors in China. Domestic savings have also increased about eight times from 1990, reaching US \$ 24 billion. This establishes a considerable market for assets management. Capital markets continued to be a positive influence on China's economy. There are 25 balanced and index funds with total assets of US \$ 9.56 billion.

In 1999 there were 90 securities companies and 203 trust investment companies operating in the securities market. Private and foreign Joint Ventures companies are now responsible for 70 percent of industrial output, and are growing at an 11 percent per annum, creating more than 1,00 million jobs. The improvement in markets, the number of villages that have become specialized producer of a single commodity rose from less than 20 percent in 1995 to nearly 40 percent in 2004 [Rosen, et al, 2004]. Such integration also had allowed relative small and poor farms to participate in emerging markets and the substantial income gains associated with moving from substance market orientation [Wang, et al, 2007, Bi, et al, 2007].

The Economic Intelligence Unit forecast that GDP growth after recording 9.3 percent and 9.2 percent in 2003 and 2004, will slow just a little over the of non performing loans. Ending unprofitable lending has been a slow and incremental

process which continues today. For further performance on NPL ratio of about 5.6 percent in a strong economy should be consider great for a Chinese Bank.

Growth in fixed asset investment which is not a national account measure is believed to run consistently higher than gross fixed investment as defined in national account terms. Net export has provided a large boost to GDP growth. However slowing investment growth and a slight higher trajectory for imports following the late July 2005, revaluation of the currency will bring down the contribution of next export and thus slow over all GDP growth. Later report on NPL ratio of China's bank, the China banking regulatory commission the country's principle banking regulator noted that the big four Rmb 1.72 trillion [US \$ 213 billion] to Rmb 1.28 trillion.

True the Chinese banks has slowly being improving, but the improvements have been incremental, with all of the big four generally perceived as only marginally in better shape. More over their new foreign partners can help China's bank to better identified stronger less risky loan opportunities the banks in terms will find themselves contributing to sustain and sustainable economic growth. As significant as bank listing for China's financial sector reform is the reform of the countries a share market. Some 30 new securities investment front were launched in the first half of 2005 and big end- June. The next asset value of all such funds had risen by 20.4 percent since the end of 2004, to Rmb 391 billion.

In order to maintain its track record China needs to its careful review of the long term challenges and develop strategies to next two years, but still average 8 percent on the prior to it. It is be that theirs will be on measure dip from 2007 afterwards at least for economic reason the main one of there is that China's manufacturing capacity now around 7 percent of world total, should continue to expand. China's biggest impact on trade shows that foreign inverted business accounts for 55 percent Chinese export; there are forecast of keeping growing by around 20 percent a year, and of course required continuing huge of foreign investment.

Li Lihui, President of Bank of China announced Rmb 53.3 billion (US \$ 6.4 billion) of operating profits for the first ten months of the year a Rmb 250 billion fall in non performing loans NPLs to Rmb 96.4 billion, just 4.6 percent of its total loan



and a more than respectable capital adequacy ratio of 8.6 percent. The result make the bank the most profitable of China's big four stated owned bank the mark a huge turned around in its fortune. China Construction Bank it was selected to blaze the way towards the establishment of a more independent, profit oriented banking system. A key incentive for this was the time table for market liberalization notable the entrance of foreign bank in 2006 agreed in China's WTO accession agreement. Now, along with the wide ranging internal shake up, the BOC is looking for a strategic investor from abroad to help it, advanced its plans for an international public listing in 2005, probably before China's construction bank which also received a US \$ 22.5 billion injection.

In 1998, when NPLs made up nearly half of the assets of the big four the ministry of finance injected Rmb 270 billion (US \$ 32.5 billion) of new capital. Then in 1999 and 2000 four especially created vehicles so called asset management companies, took on Rmb 1.4 trillion (US \$ 170 billion) to meet them. Brown estimates that China per capita annual demand for grain could increase from the current 300 kg to at least 400 kg by 2030. He suggests that production is likely to decline over the same period by as much as 20 percent. It concludes that in an integrated world economy China's rising food price will become every bodies land scarcity and water scarcity in China will affect the entire world. China also had several avenues to increase agricultural productivity. In 1995 Jiangsu provincial government established eight agricultural "export zone" and implemented many incentives to attract investors who could offer advanced agricultural, technologies, management system and equipment.

In finance, insurance, science, technologies as well as legal services accounts and audits China's demands needs international support and assistance for bringing there services to the level that the economy demands. With increased emphasis on service sector development China can except to tackle its employment problem with about 8 percent per annum growth of GDP between 2000 and 2020.

Reform of SOE sector matter in competition not ownership China's increased competition in the non state sectors. The results have been on the whole quite impressive flow of fund data prepared by the PBC indicates that the SOEs sector has saving of over 15 percent of GDP, which is more than saving rate of the entire

economy in many countries such as the US. The self finance ratio for investment of SOEs is quite high in China and higher in non SOE sector.

Even with the four in oil consumption and eight fold increase in natural gas consumption and a seven fold increase in hydroelectricity and nuclear power production, coal use would need to provide about two third of China's commercial energy by 2020. This corresponds to an increase in coal consumption from just over 1 billion ton in 1990 to 3 billion ton 2020. China thus becomes the largest economy by 2020. It will only be just remaining its normal ranking for much of the world recorded history.

### **2.3.5 Housing and Social Welfare**

The largest obstacle to enterprises reform has been the employee welfare system that guarantees the workers cradle to grave benefits. These benefits are provided directly by the State Owned Enterprises (SOEs) and constitute a heavy burden on them, especially in the face of increasing market competition from other type of firms-such as collectives, township and village enterprises, and foreign owned business.

Reform in having, medical care, children education and old age pension were started before 1994, some of these have been accelerated. Although little progress has been made on medical care and education because of lack of funds, reportedly 70 percent of the urban workers have joined some sort of pension system and 53 percent are new covered by unemployment insurance. In addition, 50 million rural workers have joined a national rural old age pension plan. Out of a total rural population of 900 million this is a more fraction. Nevertheless, it is a significant beginning.

China's economic growth has been exceptionally strong over a long period 9.8 percent per year an average since 1980. A rapid increase in China's weight and influence in world economy have accompanied this. In 2005, China's GDP amounted to US \$ 2,200 billion, or 5.5 percent of world GDP. This is more than three times the level in the world total. The Chinese GDP amounted to 1.5 percent of the total. The Chinese economy now ranks four that world level, behind the US, Japan and Germany and ahead of the UK and France. In terms of foreign trade, Chinese exports

accounted for 7 percent of total world exports in 2005, behind the US (9.5 %) but ahead of Japan (5 %). Thus, China's economic expansion has mixed consequences on social development.

This formidable growth has been accomplished by a very significant improvement in living standards. Since the 1990s, China has claimed in places in the Human Development Index (HDI) ranking to 85 in 2005. In 25 years, average per capital purchasing power has been multiplied by 4.5 (in dollars at nominal exchange rates) and by a factor of seven (in dollars at purchasing power parity). At the same time as wealth has increased poverty has declined dramatically.

Based on the official criterion i.e. a minimum energy intake of 2,100 k cal per day, the number of poor people in rural area has dropped from 260 million in 1978 to 85 million in 1990, and to 28 million in 2003. The World Bank's estimates are two times higher than the official government figures. Despite the differences in estimates, the downward trend in poverty since economic reform was introduced in 1978 is disputable.

Poverty reduction was above all concentrated in the first five years following the launch of reforms. During this period, reform focused on agriculture with the de-collective vision of agricultural production, equitable land distribution and a certain freedom in terms of the choice of crops. Reforms were substantially implemented in industry and foreign trade. While these have been successful in economic terms, they appear to have been less successful in reduction poverty than the first phase.

In addition, the reduction in poverty has not been evenly spread across the country. Poverty is greater in inland areas than in coastal areas, which were the main beneficiaries of liberalization. Poverty has almost disappeared in urban areas since the mid 1990's but still concerns around 10 percent of the rural population which appear to have received a smaller share of the benefits of China's strong economic growth?

### **2.3.6 Education**

Progress was made in education development, which is a national priority. The goal of making nine-year compulsory education generally available and basically

eliminated illiteracy among young and middle-aged adults are realized in an additional 83 countries. Reform of the mechanism to guarantee funding for compulsory education and middle school students in 2006. Each elementary school student paid 140 Yuan less an average and middle school student 180 Yuan. A total of 37.3 million students from poor rural families in the central and western regions received free textbooks and 7.8 million rural students living on campus were provided with living allowances. A fund of 4 billion Yuan from the central government budget was invested to support the building of 2,858 boarding schools and facilities for providing modern distance learning at 85,800 elementary and middle schools. A further 2.85 billion Yuan from the central government budget was allocated to fund the construction of 321 practice laboratories for vocational education, 28 deconstruction vocational college, 478 secondary vocational schools and country level vocational education centers. The secondary gross enrollment ratio reached 59 percent and the tertiary gross enrolment ratio 22 percent.

Further improvement in the public health system and family planning was made last year. Funds totaling 2.7 billion Yuan from the scale of Treasury bond and 1.7 billion Yuan from local government were pumped into infrastructure development of 5,436 town and township health clinics and 672 country level hospitals; Chinese medical hospital and maturity and child-care centers.

A community based health service network covering all big and medium sized cities across the country were established. People received more real benefits in 2006. Per capita, net income of rural residents and per capita disposable income of urban residents grew by 7.4 percent and 10.4 percent respectively in real terms. The urban workforce expanded by 11.84 million, and urban registered unemployment at the end of the year stood at 4.1 percent. A system to provide basic cost of living allowances to rural residence was introduced in 25 provinces, autonomous region and municipalities directly under the central government. A number of small infrastructure projects were built in poverty stricken area to create jobs and replace assistance allowances. Inspections were conducted of the prices of products and services such as electricity, grain, fertilizers, drugs, refined oil and real state as well as charges levied on farmers and enterprises, educational fees, medical charges and taxi fares.

## 2.4 CONCLUSION

There are mainly three set of forces affecting the Chinese reform process in the early 21<sup>st</sup> century. The role of government which is by and large positive in initiating reform in state enterprises and the banking system, and in promoting foreign trade and investment. It also allows privatization to take place in Agriculture Township and Village Enterprises to develop. For economist who believes in limiting the role of government in market economy, the experience in China confirms the important role of government in carrying out institutional reform and implementing economic policies to deal with crisis. Private enterprises and foreign investments are important components of such forces in China. After its joining WTO have added impetus in that direction.

For almost two decade of continued economic growth and reform had been the too most important characteristic of the Chinese economy. Reform of banking system and state enterprises remained to the most important task facing the Chinese government. In case the Asian financial crisis let to a re-examination of existing economic revolution that will benefit the outcome of reform in the long run. Although China has become essentially a market economy to anticipate and access the future economic policies it has been attempting to understand them in a pragmatic way whose objective will be to improve the market economy of China. It took that economy will continue to grow rapidly in the next decade two because of the resourcefulness of the Chinese people.

One might call the Chinese economic as bureaucratic market economy is socialist market economy. The state owned institution, including the commercial banks and the state enterprises are controlled and run by bureaucrats. The non state enterprises both domestic and foreign have to deal with bureaucrats in the government, and sometimes also in the state sector to conduct their business. Both institutional characteristic hamper the growth of the Chinese economy and are unlikely to change in the near future.

Reforms process includes housing reform, labor mobility in the formation of human capital, the banking and financial, sector SOEs, the non state sector, foreign trade and foreign investment, legal reform and education. In the mean time a two tire

price system was introduced to allocate scarce resources formally under the control of central planning including material inputs to state enterprises and foreign exchange.

Becoming a member of WTO in December 2001 China attached more importance to redefining the roles and responsibilities of government and making transformation accordingly. This comprises economic tuning up and regulation at macro level market monitoring and supervision, social control and management and public services delivering. WTO membership also posed challenges to China financial system (Banking and Insurance sector) and many industries like agriculture, automobiles, Information Technology and Telecom. China needs a stock market that is to encourage people for investment and to dispose of state assets to fund their social liabilities. All these efforts have led to some improvement in transparency, efficiency, corporate governance and shareholder value which will lead to higher investor in facilitating the privatization and reform process. In fact the leadership with its long standing practice may help to explain the beginning of the preparation process. But there are two aspects which may be, have not yet attracted enough attention especially in view of their implications not only for the future evaluation of the country but also with respect to China being fully able to fulfill its role and obligations in context of WTO.

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**3.1 HISTORICAL PRESPECTIVE**

With the abandoning of the Maoist legacy of self-sufficiency and import substitution in favor of a policy of 'openness' that has encouraged foreign trade and investment since the late 1970s, China has become one of the most dynamic trading countries in the world. Total value of foreign trade grew from US \$ 21 billion in 1978 to US \$ 237 billion in 1994, a spectacular ten-fold increase. Actual direct foreign investment into China grew from nil to US \$ 33.8 billion over the same period of time. China has now become firmly integrated into the world economy with its trade dependence ratio (share of total value of foreign trade in the total national output) having increased to over 30 per cent in 1994, a figure which is much higher than what would be expected for a large country.

The rapid increase in foreign trade and investment was due to successful reforms of China's economic and foreign trade systems. Economic reform has led to increases in productivity (through better allocation of economic resources and improvement in efficiency) and hence to a higher growth rate of the Chinese economy. Real GNP has quadrupled since 1978 providing an increasing amount of products for export and creating both an increasing capacity and an ever growing need for imports. Reform of the foreign trade system has led to an improvement in institutional supporting systems for foreign trade and an incentive framework.

Despite the fact that much has been achieved in reforming China's foreign trade system, China still has a long way to go in replacing direct administrative intervention with ice-based instruments for managing its trade policy, particularly with respect to imports. Trade liberalization has now become one of the top priorities in the marketization of the Chinese economy. China has become a much more important player in the international economy and trade since reform and opening began in 1979. This raises an important issue about the need for China to undertake further reform in its economic and foreign trade system in order to advance its credentials in the international trading community. It also raises a

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related issue about the need of investment of efforts by the international trading community in the accommodation of internationally-oriented growth in China. In fact, these two issues are inter-related as the accommodation of China's growth by legitimating China's status in the World Trade Organization (WTO) will put pressure on, and provide assurances for, the continuing economic and trade reform in China.

Asia-Pacific countries have also become a more important source of Chinese imports. Within the Asia-Pacific economies, Japan has the largest share of China's total imports, but that share has tended to fluctuate considerably and trend downwards since the mid 1980s. The large drop in imports from Japan reflects the sharp rise of the yen and the resultant shift in the import source of producers' goods from Japan to "Other APEC". The US share of Chinese imports remained quite stable at around 12 per cent during the past decade. Unlike exports, Hong Kong has been a much less important source of Chinese imports, accounting for only 8.2 per cent in 1994. Chinese imports from Australia increased from US \$ 1.1 billion in 1980 to US \$ 2.5 billion, but Australia's share in Chinese imports decreased from 5.3 per cent to 2.1 per cent over the same period. This indicates that Australian exporters were outperformed by exporters from other countries.

One important development in China's bilateral trade relations since 1990 has been a shift in China's trade with the US from a deficit into a surplus. According to Chinese figures, China's trade surplus with US reached US \$ 7.5 billion in 1994. The US figures put this number even higher, at US \$ 30 billion. Since the beginning of the 1990s, booming foreign direct investment (FDI) has become an important factor behind the successful expansion drive of China's foreign trade. Foreign direct investment, both pledge and actual, has grown rapidly in recent years. The growing FDI has greatly improved China's export performance through the provision of new technology and marketing skills. During 1990-94, the share of exports from firms, in which there was foreign investment, in the total value of the country's exports rose from 17.4 per cent to 28.4 per cent. There is a higher import intensity (imports as a share of total

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output) of firms in which there is foreign investment. FDI has also contributed significantly to the growth of imports in recent years.

On the whole, China's economy has become increasingly open. This can be seen not only in the increasing share of foreign trade in China's gross national product (GNP) but also in the growing importance of China in the world's total trade. Growth in foreign trade has been faster than that in GNP resulting in an increase in China's trade dependence ratio. The real trade dependence ratio went up from 15 percent in 1978 to over 30 per cent in 1994, with imports accounting for 15 percent. In 1994, China's share of the world's total imports reached 2.7 per cent compared with less than 1 per cent in the late 1970s.

One question is whether the momentum of growth in China's foreign trade will continue in future. Lau predicts that the share of exports in GNP will fall in future because the world economy will have some difficulty in adjusting to a continued rapid expansion of China's exports and there is a scope to increase the relative importance of internal demand. However, this view is challenged by Garnaut and Huang who argue within an effective, rule-based international trading system, and with continued trade liberalization in the framework of the Uruguay Round settlement, China's foreign trade *will* continue to grow more rapidly than output. Although the average trade growth rate of the reform era so far might reasonably be considered an upper limit to future growth.

Applying this upper limit for growth rate, Garnaut and Huang estimate that China's share in the world's trade of goods and non-factor services would increase from 1.6 per cent in 1990 to 2.9 per cent in 2000, and would increase as 5.3 per cent in 2010. Garnaut and Huang further show that the challenge which China poses for adjustment in industrialized economies would be no greater than that which has already been faced in the rise of Japan in the 1960s or the newly industrialized economies (NIEs) in the 1970s. Garnaut and Huang's view is supported by Drysdale and Song whose argument is, however, based on an understanding of the nature of industrialization in the East Asian economies. Drysdale and Song stated:

“Chinese economic modernization is not an independent event. In all major East Asian economies, domestic market growth *as well as* openness to international market disciplines has been key elements in the development of dynamic comparative advantage and internationally competitive economies. China is far from reaching its full potential in the development of externally oriented activities and will continue to realize significant gains through trade, investment and technology flows and integration into the international economy.”

In sum, despite the large size of its domestic market, foreign trade appears now to have become the main engine of growth for China and will continue to be so for some time to come. Therefore, trade policy within and outside China is critical to the growth prospects for China's foreign trade and economy.

### **3.2 TRENDS IN CHINA’S FOREIGN TRADE**

Prior to 1978, foreign trade was not a significant part of China’s economy. However, as a key component of the 1978 economic reform program, the government sought to attract foreign investment to China and develop foreign trade. Since then, foreign trade has become an increasingly important part of People’s Republic of China (PRC) economy. Imports provide China with advanced technologies and equipment, which China needs to modernize its economy, and equipment, as well as increased employment opportunities. Although overall foreign policy is formulated by the central government, the local government and enterprises have enjoyed autonomy in conducting foreign trade activities. China’s trading over 200 countries and regions throughout the world.

China’s foreign trade has grown significantly since 1978 in both value and in the range of products traded. Overall foreign policy is formulated by the central government. However, local governments and enterprises enjoy increasing autonomy in conducting foreign trade activities. Individuals and privately owned enterprises can now import and export further enhanced its trade relationships with other countries and regions.

China's entry into World Trade Organization (WTO) on December 11<sup>th</sup> 2001 further promoted the trade. China's total foreign trade volume increased from US \$ 1,154.6 billion in 2004 to US \$ 1,421.9 billion in 2005. China's export in 2005 increased by 28.4 % to US \$ 762 billion and its import increased by 17.6 % to US \$ 660 billion, each as compared with 2004.

As a result of rapid industrial growth and the inflow of foreign capital, manufactured goods have become China's major exports in recent years. The composition of import has also changed in recent years as import of manufactured goods has steadily out paced imports of primary goods.

### 3.2.1. CHINA'S SHARE IN WORLD TRADE

**Table 3.2.1**  
**Growth of China's Trade**

Unit: RMB/USD 100 Million %

Year	China's GDP in RMB	World Trade USD	CHINA'S TRADE								
			Export					Import			
			Volume		Rank in world	% in GDP	% in World	Volume		% in GDP	% in World
			RMB	USD				RMB	USD		
1980	4518	19906	271	181	26	6.00%	0.90%	299	200	6.60%	1.00%
1981	4862	19724	368	220	19	7.60%	1.10%	368	220	7.60%	1.10%
1982	5295	18308	414	223	17	7.80%	1.20%	358	193	6.80%	1.10%
1983	5935	18078	438	222	17	7.40%	1.20%	422	214	7.10%	1.20%
1984	7171	19019	581	261	18	8.10%	1.40%	621	274	8.70%	1.40%
1985	8964	19277	809	274	17	9.00%	1.40%	1258	423	14.00%	2.20%
1986	10202	21157	1082	309	16	10.60%	1.50%	1498	429	14.70%	2.00%
1987	11963	24969	1470	394	16	12.30%	1.60%	1614	432	13.50%	1.70%
1988	14928	28382	1767	475	16	11.80%	1.70%	2055	553	13.80%	1.90%
1989	16909	30361	1956	525	14	11.60%	1.70%	2200	591	13.00%	1.90%
1990	18548	34700	2986	621	15	16.10%	1.80%	2574	534	13.90%	1.50%
1991	21618	35300	3827	71.8	13	17.70%	2.00%	3399	638	15.70%	1.80%
1992	26638	37000	4676	849	11	17.60%	2.30%	4443	806	16.70%	2.20%
1993	34634	36870	5285	917	11	15.30%	2.50%	5986	1040	17.30%	2.80%
1994	46759	41683	10422	1210	11	22.30%	2.90%	9960	1156	21.30%	2.80%
1995	58478	50200	12452	1488	11	21.30%	3.00%	11048	1321	18.90%	2.60%
1996	67885	52540	12576	1511	11	18.50%	2.90%	11557	1388	17.00%	2.60%
1997	74463	55364	15161	1828	10	20.40%	3.30%	11807	1424	15.90%	2.60%
1998	78345	53750	15232	1837	9	19.40%	3.40%	11626	1402	14.80%	2.60%
1999	82068	53595	16160	1949	9	19.70%	3.60%	13737	1657	16.70%	3.10%
2000	89404	63640	20635	2492	7	23.10%	3.90%	18638	2251	2.080%	3.50%

*Sources: China Foreign Economic and Trade Statistical Yearbook, various years.*

Table 3.2.1 clearly reveals that one direct outcome of China's economic reform is the expansion of China's trade with the rest of the world. External trade has become a very important element of China's economy. During the past 20 years, China's total trade increased from US \$ 38 billion in 1980 to more than US \$ 474 billion in 2000. In 1980, China's export and import account for 0.9 % and 1% of world total in 1980. The importance of China's as a large trading nations had been growing steadily. In 2000, the figures are 3.9 % and 3.5% of world trade, respectively. China is the world number 7 largest exporter in 2000, up from number 26 in 1980. At the same time, trade also becomes increasing important as a percentage of China's GDP. In 1980, the ratio of export and import in GDP are 6.0 5 and 6.6% respectively. In 2000, they increased to 23.1% and 20.8%.

**Table 3.2.2**  
**The share of China in the world trade**

Year	World Trade	Export			Import	
		China's Trade	China's %	World Trade	China's Trade	China's %
2005	761953	130283	5.84	659953	135084	4.88
2006	969380	148853	6.51	791605	153651	5.15
2007	1015100	122137	8.31	796900	123670	6.44

*Sources: China Foreign Economic and Trade Statistical Yearbook, various years.*

At insight at Table 3.2.2 reveals that during 2005 to 2007 China's export and import increased at an average 1.4 % and 1.32 % of the world total next only to South-East Asia, Central-East Europe recorded the strongest growth in 1994. After the peak of 1990, their economies had been running down-hill and only in 1994 they recorded sharply the strongest growth in imports, bringing them to the 1990 level of 11 % spurred by the import demand and high share of intra regional trade of Asia, alongside Japan, the major player is China. It shows that the phase of that China's trade growth is a regular occurrence.

**Table 3.2.3**  
**China's Export Ratio and Trade Balance, 1980-2002**

Year	Export/GDP(A)	Export value (US billion)	Import value (US balance)	Trade balance
1980	6	181.2	108.9	-11.4
1985	9	273.5	422.5	-149
1990	16.1	620.9	533.5	87.4
1991	17.7	719.1	637.9	81.2
1992	17.6	849.4	805.9	43.5
1993	15.3	917.4	1039.6	-122.2
1994	22.3	1210.1	1156.2	53.9
1995	21.3	1487.9	1320.8	167
1996	18.5	1510.5	1388.3	122.2
1997	20.4	1827.9	1423.7	404.7
1998	19.4	1837.1	1402.4	434.7
1999	19.7	1949.3	1657	292.3
2000	23.1	2492.1	2252	241.1
2001	23	2661.5	2436.1	225.4
2002	26.1	3256	2951	305

*Sources: China Foreign Economic and Trade Statistical Yearbook, various years.*

When the Chinese government introduced its reform and opening up policy in 1978, China's foreign trade level was quite low, with the value of total trade only US \$ 36 billion. After twenty-five years, China now stand's as a world trading power. In 2003, the total trade value reached over US \$ 700 billion dollar. The China's exports rose from 1 percent of the world total in 1978, to over 5 percent today. During this time the ratio of exports to GD steadily increased from a low level of 6 percent in 1980 to a high level of over 25 percent in 2002. One direct consequences of the rapid export expansion has been the growth of foreign exchange reserves. As shows China has maintained a trade surplus throughout the time since 1994. In 2003, the trade surplus reached US \$ 30 billion, and foreign exchange reserves exceeded US \$ 300 billion, next only to Japan. The RMB has remained stable since a sharp devaluation in 1994. China has achieved a successful transition from foreign exchange shortage to surplus. Until 1901, China's, foreign trade had been conducted mainly by domestic

enterprises. Among domestic enterprises, the role of Township and Village Enterprises (TVEs) had steadily increased since the middle of the 1980s. From 1992 onwards, the proportion of FIEs in China's foreign trade rapidly increased, reaching over 50 percent by 2003. In the meantime, the proportion of TVEs witnessed a sharp decline, while the proportion of state-owned enterprises remained basically unchanged.

**Table 3.2.4**  
**China's Merchandise World Trade, 1979-2005**

(Unit- \$ billion)

<b>Year</b>	<b>Exports</b>	<b>Imports</b>	<b>Trade balance</b>
<b>1979</b>	13.70	15.70	-2
<b>1980</b>	18.10	19.50	-1.4
<b>1981</b>	21.50	21.60	-0.1
<b>1982</b>	21.90	18.90	2.90
<b>1983</b>	22.10	21.30	0.80
<b>1984</b>	24.80	26.00	-1.1
<b>1985</b>	27.30	42.50	-15.3
<b>1986</b>	31.40	43.20	-11.9
<b>1987</b>	39.40	43.20	-3.8
<b>1988</b>	47.60	55.30	-7.7
<b>1989</b>	52.90	59.10	-6.2
<b>1990</b>	62.90	53.90	9.00
<b>1991</b>	71.90	63.90	8.10
<b>1992</b>	85.50	81.80	3.60
<b>1993</b>	91.60	103.60	-11.9
<b>1994</b>	120.80	115.60	5.20
<b>1995</b>	148.80	132.1	16.70
<b>1996</b>	151.10	138.80	12
<b>1997</b>	182.70	142.20	40.50
<b>1998</b>	183.80	140.20	43.60
<b>1999</b>	194.90	165.80	29.10
<b>2000</b>	249.20	225.10	24.10
<b>2001</b>	266.20	243.60	22.60
<b>2002</b>	325.60	295.20	30.40
<b>2003</b>	438.40	412.80	25.60
<b>2004</b>	593.40	561.40	32.00
<b>2005</b>	762.00	660.10	101.90

*Source:* International Monetary Fund, *Direction of Trade Statistics*, and official Chinese statistics.



A close look at Table 3.2.4 demonstrates that economic reforms have transferred China into a major trading power. Chinese exports rose from \$ 14 billion in 1979 to \$ 762 billion in 2005, while imports over this period grew from \$ 16 billion to \$ 660 billion in 2005. In 2004, China surpassed Japan as the world's third-largest trading economy (after the United States and Germany). China's trade continues to grow dramatically: From 2002 to 2005, the size of China's exports and imports more doubled. In 2005, exports and imports rose by 28.4 % and 17.6 % respectively. China's trade surplus, which totaled \$ 32 billion in 2004, tripled to \$ 102 billion.

Data for the first three months of 2006 indicate that China's rapid trade growth is continuing, although at a slight slower pace than 2005 levels. During this period, exports and imports rose by 26.6 % and 24.8 %, respectively over the same period in 2005.

### **3.2.2 Structure and Direction of China's Foreign trade**

The rapid expansion of China's foreign trade has been accompanied by a significant shift in the commodity structure which was more in line with China's relative resource endowment. China's exports was more concentrated on labour intensive products such as textile and clothing products, in which China has a distinctive comparative advantage. During 1978-92, the share of labour intensive products rose from 31.3 percent to 55.7 percent mainly at the expense of exports of agricultural and mineral intensive products. China's import trade is dominated by capital intensive products in which China has a comparative disadvantage. The pattern of China's foreign trade indicates that China has now been following a typical 'export-led growth' path many developing countries have already taken.

**Table 3.2.5**  
**China's trade by partner**

(Unit- million US \$)

Export	1980		1985		1990		1994	
	Value	Share%	Value	Share%	Value	Share %	Value	Share%
Japan	4,032	22.3	6,109	22.3	9,011	14.5	21,573	17.8
U.S	983	5.4	2,352	8.6	5,179	8.3	21,461	17.7
Hong Kong	4,401	24.3	7,206	26.3	26,650	42.9	32,365	26.7
Australia	224	1.2	187	0.7	455	0.7	1,489	1.2
Other APEC	1,319	7.3	3,581	13.1	5,411	8.7	11,132	9.4
APEC Total	10,959	60.5	19,435	71	46,706	75.2	88,200	72.8
E.U	2,135	11.8	2,367	8.7	5,830	9.4	14,580	12
Rest of world	5,025	27.7	5,562	20.3	9,555	15.4	18,258	15.2
<b>Total Import</b>	<b>18,199</b>	<b>100</b>	<b>27,364</b>	<b>100</b>	<b>62,091</b>	<b>100</b>	<b>121,038</b>	<b>100</b>
Japan	5,169	25.8	15,035	35.6	7,588	14.2	26,321	22.7
U.S	3,830	19.1	5,090	12	6,588	12.3	13,970	12.1
Hong Kong	1,253	6.3	4,797	11.4	14,258	26.7	9,488	8.2
Australia	1,063	5.3	1,134	2.7	1,354	2.5	2,450	2.1
Other APEC	867	4.3	2,781	6.6	7,104	13.3	23,505	20.4
APEC Total	12,182	60.9	28,837	68.3	36,892	69.2	75,734	65.5
E.U	2,726	13.6	6,390	15.1	8,350	15.7	16,939	14.6
Rest of world	5,109	25.5	7,025	16.6	8,103	15.2	23,020	19.9
<b>Total</b>	<b>20,017</b>	<b>100</b>	<b>42,252</b>	<b>100</b>	<b>53,345</b>	<b>100</b>	<b>115,693</b>	<b>100</b>

Notes: EU refers to EU12. EU for 1980 covers France, West Germany, Italy and U.K. only.

Sources: *Statistical Yearbook of China*, various issues; *China's Customs Statistics*, December 1994.

Table-3.2.5 indicates that changes were also observed in China's export and import destination in the case of export markets. Asia-Pacific countries as a group have become a more important destination for Chinese exports with their share having increased from 60.5 percent in 1980 to 72.0 percent in 1994. Within that group, Hong Kong was the most important export destination for China, but a substantial portion of exports of Hong Kong are re-exported (about 60 percent since the 1990s). Japan's share of China's total exports has declined in China's total exports has increased since the mid 1980s but the absolute value has remained relatively small. The issues

covered by this survey have important policy implications for Australia. Bilateral trade between Australia and China rose from US \$ 1.29 billion in 1980 to US \$ 3.9 billion in 1994, with China becoming a more important destination for Australia's exports. But Australia's share of total Chinese imports declined over the same period, reflecting in part the fact Australia's export are largely based on primary commodities whose real price has showed a declining trend and whose trade policy, and in parts, the trade restrictions imposed by China on such commodities as wool in which Australia has a distinctive comparative advantage. It is important that Australia ensure China makes a firm commitment to reduce this trade restriction as part of its negotiations for accession to the WTO.

**TABLE 3.2.6**  
**China's top five trading partners: 2005**

(Unit: \$ billion)

Country	Total trade	Chinese Exports	Chinese imports	China's Trade balance	Trade Balance as Reported by Partner
Hong Kong	246.80	124.50	122.30	2.20	-4.7
European Union	219.30	143.70	75.60	68.10	-132
United States	2116	162.90	48.7	1142	-201.6
Japan	184.50	84.00	100.50	-16.5	-28.5
'ASEAN* 1	130.40	55.41	75.01	-20	N/A

**Sources:** Official Chinese trade data and *Global Trade Atlas*.

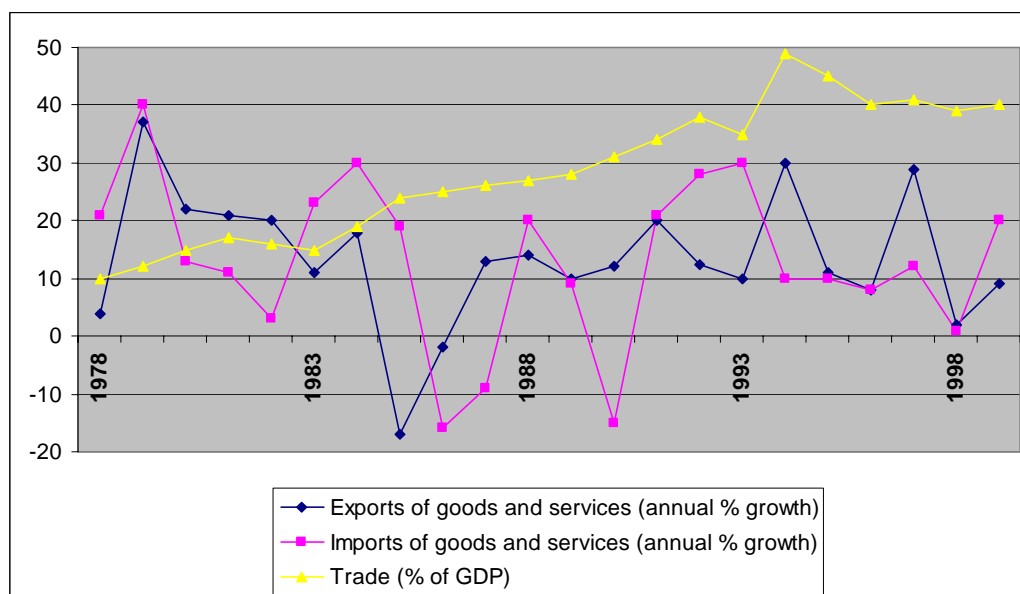
**Note:** Chinese data on its bilateral trade often differ substantially from the official trade data of other countries on their trade with China.

\* Association of Southeast Asian Nations (ASEAN) member countries are Indonesia, Malaysia, the Philippines, Singapore, Thailand, Brunei, Cambodia, Laos, Myanmar (Burma), and Vietnam.

An analysis of Table 3.2.6 shows that China's trade data often differ significantly from those of its major trading partners. This is due to the fact that a large share of China's trade (both export and import) passes through Hong Kong (which reverted back to Chinese rule in July 1997 but is treated as a separate customs area by most countries, including China and the United States). China treats a large share of its exports through Hong Kong as Chinese exports to Hong Kong for statistically purposes, while many countries that import Chinese product through Hong Kong generally attribute their origin to China for statistical purposes. According

to Chinese trade data, its top five trading partners in 2004 were the European Union (EU), the United States, Japan, Hong Kong, and the 10 nations that constitutes the Association of Southeast Asian Nations (ASEAN). China's largest export markets were the United States, Hong Kong, and the EU, while it's top source for imports were Japan, the EU, and Taiwan (the United States ranked sixth). US trade data indicate that the importance of the U.S market to China's export sector is likely much higher than is reflected in Chinese trade data based on U.S data on Chinese export to the United States (which, as noted, do not agree with Chinese data). And Chinese data on total Chinese exports, it is estimated that Chinese export to the United States as a share of total Chinese export grew from 15.3 % in 1986 to 32.0 % in 2005.

A growing level of Chinese exports is from foreign- funded enterprises (FFEs) in China. According to Chinese data, FFEs were responsible for 58 % of Chinese exports in 2005, compared with 41 % in 1996. A large share of these FFEs are owned by Hong Kong and Taiwan investors, many of whom have shifted from labor intensive, export-oriented, firms to China to take advantage of low-cost labor. A significantly share of the product made by such firms is likely exported to the United States.



**Figure 3.2.1: Foreign Trade**

*Source:* World Bank (2001) and author's calculations based on data from this source.

As shown in figure 3.2.1, one of the most remarkable features of the post-reform economic performance of China is the rapid growth in exports. Measured in constant Yuan, exports of goods and services grew at an average annual rate of 13.1 % from 1978 to 1999. At 12.0% per year on average, imports grew nearly as fast. The result has been a sharp increase in the share of trade in China's GDP. In 1978 imports plus exports constituted less than 10% of GDP. Today, the ratio hovers around 40%, having come down from nearly 50% in 1994. According to Nordas (2002), in 2000 China was the world 7<sup>th</sup> largest exporter, with shares of world merchandise and services exports of 4% and 2%, respectively. In terms of imports, China ranked 8<sup>th</sup>, its share in world merchandise imports being 3.5%. It had a share of 2.5% in the world's service imports.

Foreign enterprises accounted for as much as 52% of imports and 48% of exports in 2000 (Nordas 2002). Inflows of foreign direct investment (FDI) really took off after 1992, propelled by Deng Xiaoping's strong endorsement of the need for reform in his famous tour of the south and the liberalization measures that followed in its wake. The country has progressed from being the 16<sup>th</sup> largest net recipient in 1982 to 6<sup>th</sup> place in 1999. In cumulative terms, China's performance is even more impressive. Based on the data in World Bank (2001), I have calculated that by 1999 China's cumulative net FDI flows since 1982 (the first year in which there is a non-zero entry for China) stood at a staggering 298 billion dollars. Over 1982-99, it ranks third overall, only being surpassed by the US and the UK . Among developing countries, China is the star performer, having received more than twice the amount of the runner-up, Brazil, and three times the net flows going to third-placed Mexico. In fact, net FDI to China in this period amounted to more than the combined flows to Argentina, Malaysia, Thailand, Chile, South Korea, and Indonesia!

Table 3.2.7

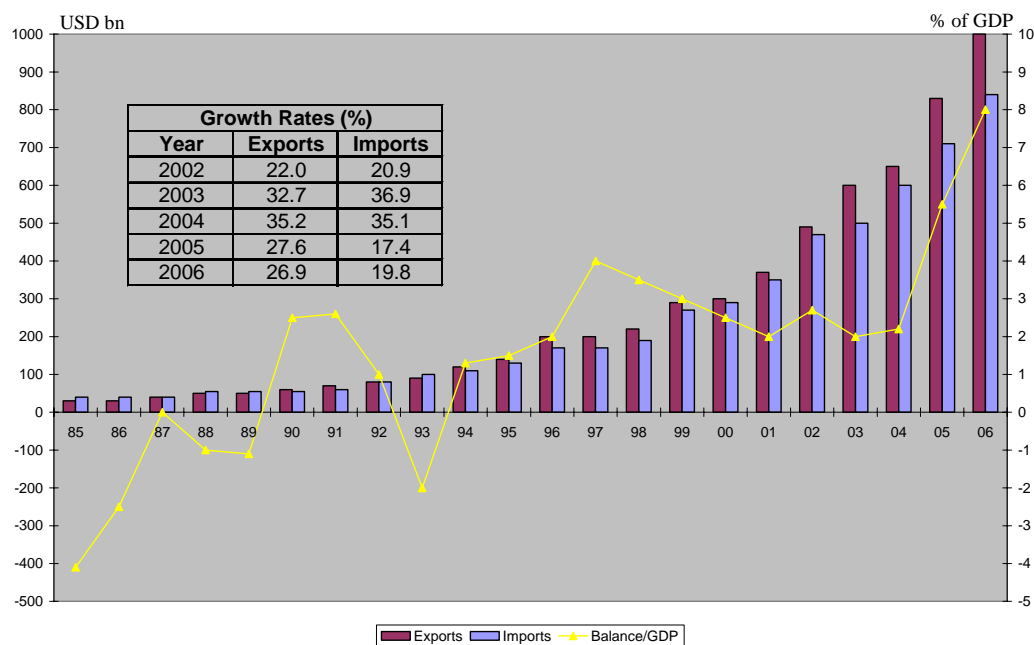
## Exports and imports of foreign capital-invested enterprises (FIEs) 1985-2005

Year	Export Amount (US \$100m)	As % of Total	Import (US\$ 100m)	As % of Total	Balance (US\$100m)	Balance of China's Total foreign trade (US\$100m)
1985	31.00	1.10%	21	4.97%	-18	-149
1986	5	1.62%	26	6.06%	-21	-120
1987	12	3.04%	34	7.87%	-22	-38
1988	25	5.26%	59	10.67%	-34	-78
1989	49	9.35%	88	14.88%	-39	-66
1990	78	12.59%	123	23.09%	-45	87
1991	123	17.12%	169	26.56%	-46	81
1992	174	20.44%	211	26.23%	-38	44
1993	252	27.51%	418	40.24%	-166	-122
1994	347	28.68%	529	45.78%	-182	54
1995	469	31.51%	629	47.66%	-161	167
1996	615	40.72%	756	54.46%	-141	122
1997	749	40.98%	777	54.59%	-28	404
1998	810	44.07%	767	54.70%	42	435
1999	886	45.47%	859	51.83%	27	292
2000	1194	47.93%	1173	52.10%	22	241
2001	1332	50.06%	1259	51.67%	74	225
2002	1693	52.00%	1624	55.00%	69	304
2003	2403	54.84%	2319	56.17%	84	255
2004	3386	57.07%	3244	57.81%	141	321
2005	4442	58.30%	3875	58.71%	567	1020

Sources: *Zhongguo Tongli Nianjian* [China Statistical Yearbook], various issues; Wang Luolin (ed.) (1997) *Report on Foreign Direct Investment in China*, Beijing, Economic Science Press.

As can be seen from Table 3.2.7 those FIEs have accounted for a rapidly expanding share of China's total exports, exceeding 40% from 1996 and 50% from 2001. Yet, it is also true that FIEs have accounted for an even larger share of total imports. For 13 years from 1985 to 1997, FIEs ran a sizeable foreign trade deficit every year, quite in contrast to China's overall trade surplus for most years after 1989. And, although FIEs have enjoyed trade surplus every year from 1998, such

surplus has in most years accounted for only a minor part of the national total. It is, of course, noted that parts of the imports by FIEs are production equipment which they bring along with their investment. The possible contribution to TFP growth in this regard then comes down to two forms: technology transfer to FDI-receiving firms which use the imported equipment, and the potential for FIEs to become important net exporters over the long term-the latter possible contribution, as noted, did not really material until the very recent years.



**Figure 3.2.2: Exports, Imports, and Trade Balance Share in GDP, 1985-2006**

*Note:* Trade magnitudes represent goods and non-factor services as reported in the balance of payments in US dollar terms. Conversion to common currency units for comparison with GDP is based on the yearly average exchange rate value.

*Source:* State Administration of Foreign Exchange & National Bureau of Statistics

It can be seen from Figure 3.2.2 that economic imbalances have emerged forcefully in mid-2000s China in the context of extraordinarily rapid economic growth. The imbalance in the trade account shot upward suddenly starting from 2005. Through the early 2000's the trade surplus had been modest at around two and a half percent of gross domestic product or less (see Figure 3.2.4). But in 2005, it jumped to 5.6 percent of GDP and continued to climb to 8.0 percent in 2006. Both exports and imports rose at a fast clip in the wake of China's 2001 entry into the World Trade Organization with growth of imports actually outpacing that of exports in 2003. But in 2005 import growth slowed sharply as export growth pushed on, and the surplus flared open.

Behind this increase in the trade surplus lays a domestic counterpart in saving rising faster than investment. Saving not absorbed in investment at home is directed abroad as a net capital outflow, where the counterpart of a net capital outflow is an excess of export revenues not spent on imports. In China's case, the capital outflow has largely taken the form of mounting foreign reserve asset held by the central bank. This accumulation of reserves would be mitigated if Chinese consumer consumers increased their demand for goods and services. The increase in domestic consumption demand would be by a combination of rising imports and division of resources from production for export to production of domestic market. In consequences, the central bank would be relieved of having to absorb large rates.

**Table 3.2.8**  
**China's processing trade, 1990-2005**

<b>Year</b>	<b>Exports</b>	<b>Imports</b>	<b>Value-added rate</b>
<b>1990</b>	254	188	26.20%
<b>1991</b>	324	250	22.82%
<b>1992</b>	396	315	20.39%
<b>1993</b>	443	364	17.81%
<b>1994</b>	570	476	16.51%
<b>1995</b>	737	584	20.80%
<b>1996</b>	843	623	26.16%
<b>1997</b>	996	702	29.51%
<b>1998</b>	1045	686	34.33%
<b>1999</b>	1109	736	33.64%
<b>2000</b>	1377	926	32.76%
<b>2001</b>	1474	940	36.26%
<b>2002</b>	1799	1222	32.08%
<b>2003</b>	2419	1629	32.64%
<b>2004</b>	3280	2217	32.40%
<b>2005</b>	4165	2740	34.21%

*Sources: China Foreign Economic and Trade Statistical Yearbook, various years.*

Table 3.2.8 provides some figures indicating the actual performance, particular note-worthy the production characteristics of China's processing trade



since 1990. It is noted that the value-added rate, defined as the ratio of net to gross exports, first increased steadily but then has from 1998 onwards ceased to further increase. The rate has remained at a lower level, 34 % both in 1998 and 2005. This low rate of domestic value-added for a major part of China's foreign trade might have well been significantly responsible for the secular trend of deterioration of China's pursuit of upgrading its industrial structure. And those are why the state leadership has been in recent years strongly promoting the development of indigenous, independent technological capabilities.

### **3.3 TRADE POLICY**

Reform of foreign trade policy has played an important role in boosting China's foreign trade since the late 1970s. The major thrust of trade reform was to turn away from a policy of self-sufficiency or an import-substitution strategy towards a strategy of export-led growth.

China's pre-reform foreign trade regime was an extreme example of import substitution. Under that regime, foreign trade was regarded as a necessary evil which had no merit in itself and which could not contribute substantially to a viable strategy for China's development. The main role of foreign trade was to make up for domestic shortages by imports and to smooth out excessive supplies of domestic goods by exports within the framework of the national economic plan. Foreign trade was heavily controlled by the central government with a very limited number of foreign trade corporations (FTCs) allowed to be in the foreign trade business. Prices, including the foreign exchange rate, had virtually no role in resource allocation.

Trade reform has been closely related to broader economic reform in China which was initiated in December 1978 at the Third Plenum of the 11th Central Committee of the Chinese Communist Party, when Deng Xiaoping assumed power. There are two major components in the Chinese economic reform program: one is decentralization of economic decision-making power and the other is rationalization of prices based on market forces. These two elements, interacting with each other, have contributed to the transformation of China's economic system from one in which, at the start of the reform period, nearly all economic activities

were planned, to one in which the market mechanism now plays a major role in determining prices of both consumer and producer goods. Recent reports show that as a result of successful economic reform over the past fifteen years the state's share of total national output now accounts for less than 50 per cent. In addition, over 90 per cent of consumer goods and 85 per cent of producer goods are now transacted at prices set by the market.

Trade reform has followed basically the same strands of broader economic reform. It has involved decentralization of trading rights and restoration of price-based incentives mainly through reform of the foreign exchange system.

### **Decentralization of foreign trade rights:**

Trade reform in China started with the decentralization of trading rights to local authorities, industrial ministries and production enterprises. This also has been accompanied by a substantial reduction in the scope of direct foreign trade planning. Historically, China's foreign trade was monopolized by only a dozen FTCs through a rigid state planning system. However, this situation has changed rapidly since 1979 when reform in China's foreign trade system began. By 1986 there were already 1200 FTCs in operation. This number was further increased to over 8 000 in 1994 of which 30 per cent were productive enterprises. In addition, there were 174 000 foreign-invested enterprises which enjoyed foreign trade rights. Simultaneously with the decentralization of trading rights, there was a reduction in the importance of the national foreign trade plan. Prior to economic reform, the foreign trade plan governed nearly 3 000 export commodities. The import plan was similarly comprehensive, covering 90 per cent of Chinese imports. However, after successive reductions in the scale of the foreign trade plan over the past fifteen years, the number of plan-controlled export commodities has been reduced to 38 and import' commodities to 11. For the limited number of commodities which were still subject to foreign trade planning, the nature of planning has also changed. Mandatory planning was subsided and replaced by guidance or indirect planning which is less specific and non-binding. In the process of decentralizing its foreign trade activities, the Chinese government has strengthened macro economic control and improved the administrative system governing foreign trade, including the implementation

of a more rational approach to the regulation of foreign trade through more effective management of exchange rates, custom duties, taxes and credits.

**Foreign Exchange System:** A further element in the reform of China's foreign trade system was to provide incentives to firms for engaging in foreign trade. This was achieved mainly through the reform of China's foreign exchange system. Before the 1980s, there was stringent control of foreign exchange in China. The exchange rate had little role in influencing the allocation of resources and performed largely an accounting function. Under this system, Chinese enterprises had little incentive to export. They were paid in domestic currency for the goods delivered to foreign trade corporations. The price they received was the same regardless of whether goods were sold abroad or at home. Enterprises gained no explicit claim to the use of any of the foreign exchange earned.

Since 1979, there have been substantial reforms in the foreign exchange system in China. Wu, in his analysis of China's foreign exchange regime since 1979, identified three distinctive stages of reform: the foreign exchange retention and adjustment system within the planning framework from 1979 to 1986; the planning-market double track system from 1987 to 1993; and unification of foreign exchange rates after 1994.

#### **1979-86: Reforms-within the planning framework :**

There were two major elements in the reform of the foreign exchange system in this period: one was the introduction of a foreign exchange retention system and the other was the devaluation of RMB yuan (Chinese currency unit, A\$1=6.4 RMB yuan in 1994) for trade-related transactions.

The foreign exchange retention system was first introduced in 1979. Under this system, exporting enterprises and their super ordinate level of government administration were allowed to retain the right to use a certain portion of the foreign exchange they earned above the level set by the plan. But the amount of retained foreign exchange was small during this period and its use was heavily regulated.

Although the relaxation of foreign exchange control was modest, there was substantial devaluation of RMB yuan during this period. In 1981, instead of devaluating the official exchange rate, the Chinese government introduced a shadow rate known as the Internal Settlement Rate for Trade. This rate was calculated from the average cost of earning a US dollar through exports and was set at RMB yuan 2.8 to one US dollar"). This represented an 80 per cent *de facto* devaluation as the official rate was only RMB yuan 1.55 to one US dollar at that time. The difference between the official and shadow rates, however, had to be financed by the government as a subsidy. Initially this subsidy only applied to exports but later also to imports because of the lag in adjusting the domestic price for importable. The rapid increases in subsidies as a result of growth in foreign trade led to successive devaluation of the official rate from 1982. In 1985, the official rate merged with the shadow rate. The overall effects of reform on trade in this period appeared to be relatively small. This is reflected in a much slower growth of foreign trade in this period than the period after 1986. The main reasons for this were that reform of the whole economic system was at that time in its early stage and planning still dominated the system. Moreover, there was a lack of well-developed secondary markets, which undermined the effectiveness of the incentive system.

**1987-93: Dual foreign exchange system :**

More market-oriented reforms to China's foreign exchange regime began with the formal introduction of a swap market or secondary market in late 1986. This was the beginning of the transition from a planned foreign exchange regime towards one which was more market oriented. Although there were substantial devaluations in the first half of 1980s, the foreign exchange rate in China was still overvalued in the mid 1980s. This can be seen in the substantial devaluation of RMB yuan on the swap market from 1986. After the introduction of the swap market, its importance grew substantially. By 1993, 80 per cent of foreign exchange earnings were priced at the swap rate. This clearly indicated that market forces had already played a dominant role in determining the foreign exchange rate.

At this stage, China continued to apply the foreign exchange retention system and to increase retention rates. Considerably higher rates were applied to corporations trading in priority sectors - light industries, arts and crafts, clothing, machinery, and electronic products - and to open coastal cities and special economic zones such as Guangdong, Fujian and Shenzheng. Incentives provided by this system for firms to participate in foreign trade were because: (1) the emergence of the swap market and the devaluation on that market allowed firms to make higher earnings on their exports; (2) the declining importance of the plan in the national economy and in foreign trade meant that there were less import restrictions, which allowed firms to import technology and raw materials in their export-oriented production or to import items which sold well on the domestic market and hence allowed them to make even higher returns than those on the swap market.

The double-track foreign exchange rate is systematically analyzed by Martin who shows that the system has the characteristics of an overvalued official rate and an undervalued swap rate. An overvalued official rate constituted an implicit tax on exports and an undervalued swap rate an implicit duty on imports. Martin simulated the effects of depreciation of the official rate by 10 per cent using a Computable General Equilibrium (CGE) model of the Chinese economy. The results show an appreciation of the swap rate (6.6 per cent) and dramatic expansion of GNP, trade volumes and labour intensive industries.

Despite the shortcomings of the double-track foreign exchange system, reform in this period greatly enhanced China's export performance. Within just seven years China's total exports tripled, rising from US\$31 billion in 1986 to US\$92 billion in 1993.

#### **After 1994: Foreign exchange rate re-unification :**

At the beginning of 1994, China took another bold step in reforming its foreign exchange regime. The main features of this round of reform included (1) unifying the official and market exchange rate by merging the former with the latter; (2) abolishing the foreign exchange retention system and replacing it with a RMB settlement system for all export earnings; (3) replacing the swap system by

an inter-bank foreign exchange market with a system of managed float; and (4) the abolition of approval procedures for acquiring and using foreign exchanges for current account transactions.

Since the unification of the double-track system, the exchange rate for RMB has remained basically stable and has even appreciated slightly thanks to improvements in the reserve position due to stronger growth in exports (in 1994, China's exports grew by over 30 per cent and in the first eight months of 1995 by 37 per cent) and continuing inflows of foreign capital.

The 1994 reform constituted a watershed in China's efforts to bring the Chinese currency towards full convertibility. In view of the remarkable export performance following unification and achieving a stable unified exchange rate, Chinese officials are now talking about achieving full convertibility of RMB yuan by the year 2000.

One important implication of the 1994 reform is that foreign exchange control will no longer be a major instrument for controlling imports. With market forces dominating the economy and increasing responsiveness of firms-to price signals, other measures (such as quotas and tariffs) will become more important factors influencing China's future foreign trade. Past reform of China's foreign trade and exchange system has been concentrated on introducing measures to stimulate exports. Reform of the import regime, particularly with respect to reduction in trade barriers, has remained comparatively neglected and is now taking on some urgency.

Since the late 1980s, as a part of China's bid to attain full membership status in the GATT and as part of its bilateral trade negotiations with the US, China unilaterally undertook several cuts in its import tariffs. In 1991, China reduced tariffs on 265 import commodities. Regulatory duties on imports were abolished in 1992. From December 1993, China adjusted import tariffs on 2,898 commodities, reducing the average tariff rates by 9 per cent.

Despite these reductions, import tariffs remain high by international standards China's 1992 average rate, measured on a trade weighted basis, was equal to that of Brazil and was the third highest among the listed countries.

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One point worth noting about is that the rate of actual duty collection (total tariff revenue divided by total value of imports) is low, at 5.6 per cent. This was mainly due to high levels of duty exemption in China. Raw material imports which were used in producing export goods were duty free for foreign-funded enterprises received a 50 per cent duty concession; a range of imports for priority projects was also exempted. However, the duty collection rate cannot be used as an indicator of effective protection as the method of calculation biases it downwards. The duty collection ratio depends on the commodity import structure as well as on tariff rates. If the low proportion of manufactured consumer goods imports is caused by high effective tariff rates, the calculated duty collection ratio reminds nothing about the true degree of protection. An example illustrates this point clearly. It shows the commodity pattern of tariff systems in China and some other developing countries. Like many other developing countries, China imposes a much higher tariff rate on manufactured consumer goods than producer goods. In some cases (for example private passenger cars), tariff rates are so high that they sometimes become prohibitive. In the extreme case, there could be zero imports. This is obviously a source of bias, if the duty collection ratio is used as an indicator for effective protection.

On the other hand, price comparison data suggest that there appears to be considerable 'water in tariff (which means that tariffs are not binding constraints on imports) for many products as Chinese industries in a broad range of import categories are globally competitive. While this tariff redundancy indicates that the effective protection rate is lower than suggested by the nominal rate, the existence of such tariff barriers could become a threat to China's trading partners in future.

In line with its bid to obtain full WTO membership, China has also made some advances in reducing quantitative restrictions. For instance, China abolished import licenses and quotas on more than 280 commodities in 1993, reducing the number of commodities subject to quantitative restrictions to 1300.<sup>36</sup> China announced a plan to reduce the number of these commodities to 200 by the year 2000, but this number is still large.

In addition to tariff and quota restrictions, administrative controls are still pervasive. The most important method of administrative control is to assign import

rights to one or a few FTCs. The World Bank called this process 'canalization'. Currently there are 12 categories of commodities subject to canalization, including such important items as wheat, fertilizers, rubber, steel products, timber, wool, acrylic fiber and cotton. These products accounted for 32 per cent of total imports in 1993.

Although in most cases trading rights are assigned to more than one FTC, it is not unusual for FTCs to be in collusion with the government administration. This is because canalization gives FTCs import monopolies and FTCs have a vested interest in retaining this power by adopting a cooperative approach.

In sum, despite substantial decline in trade planning since 1979, China still operates a relatively complex trade regime particularly with respect to imports. As the importance of import planning has shrunk and foreign exchange control has been relaxed, border restrictions and administrative controls stand out as the main instruments for controlling imports. The need to have a further reform in China's import regime has been recognized by the Chinese government as well as by China's major trading partners.

The World Bank suggests that China is currently well positioned to implement bold measures in the area of import liberalization because of:

- its comfortable reserve position;
- the advanced state of price reform;
- the expanding role of the non-state sector and growing flexibility in domestic resource allocation; and
- evidence of tariff redundancy which implies that cuts in tariffs and non-tariff barriers (NTBs) will not entail major contractions even in the most protected sectors such as textiles and machinery.

The World Bank also argues that the early implementation of a bold program of import liberalization will contribute to the growing momentum of China's drive to become a full member of the international trading community. It can also help improve the efficiency of state-owned firms which has been a mounting concern. Furthermore, given China's positive outlook on exports and



the availability of external capital, including FDI, the favorable balance of payments situation leaves much scope for increasing imports.

There are signs that China has begun to move in the right direction. China had promised at APEC summit in Osaka in November 1995 a sweeping reduction in trade barriers from 1996. Under the plan, China will remove quotas and licensing on 170 items accounting for more than 30 per cent of the commodities now subject to import quotas and licensing requirements. China will also reduce its overall tariff level by a margin of no less than 30 per cent. The tariff cuts would be applied to more than 4000 of the 6000 items that China imports and would mean that the nation's average tariffs will be lowered to about 22 per cent from a current 35.9 per cent.

### **China's entry into the WTO and its role in APEC**

With deeper integration into the world economy, China has shown a strong interest in seeking global and regional economic and trade cooperation through mechanisms such as WTO and APEC.

China made its formal application for re-joining the GATT (now the WTO) on 10 July 1986. WTO membership is desirable for China as it will cement non-discriminatory trade relations with its trading partners and give China access to a rules-based system of dispute settlement. Since lodging its application for WTO membership, China has accelerated reform in its economic and trade system. China has also started to proceed unilaterally with its trade liberalization program as discussed earlier.

China's bid for WTO membership was rejected in December 1994 when the United States, leading other members, contested China's claim that it should be admitted as a developing country with reduced commitments on the pace and extent of trade liberalization. Western nations have insisted that China's accession must be based on respect for WTO rules and the achievement of meaningful market access.

Failure to enter the WTO was a stunning setback for China as it had put a high priority on becoming a founding member of WTO on 1 January 1995. Perhaps

more significant is the fact that liberal forces within China which had intended to use the WTO-entry as a means of assurance for continuing reforms found themselves politically exposed.

China now seems to be in no hurry for accession and some voices even query the value of membership. Accession to the WTO requires that China make substantial concessions in terms of foreign access to its domestic market and this could be politicized in the current uncertain political and economic transition period. It appears that at present none in the Chinese leadership could risk taking a clear stand on the extent of Chinese concessions because of the difficulty of building a coalition of support. The current standstill prolonged, could add to future uncertainty not only for China but also for the world trading system given the increasing impact China now has on world economy and trade.

Currently, issues affecting China's accession to the WTO include whether special safeguard measures should be applied to Chinese exports, whether China should be allowed to protect its infant industries, whether it should be mandatory or voluntary for China to join some multilateral agreements such as the Government Procurement Agreement and Civil Aviation Agreement, and the time period for implementation of new rules on, for example, intellectual property rights would be met. However, the key issue in the negotiation of China's membership is whether China should be admitted to the WTO as a developing or developed country.

There are some major differences in the entry requirements between a developing and developed country. Membership based on a developing country status means that China has to commit much less in terms of extent and pace of trade reform. On the other hand, China's entry based on a developed country basis would require a larger extent and faster pace of trade liberalization. But if China's admission to the WTO has to be based on a developed country basis, some of the entry requirements may simply be impractical. For instance, under the Uruguay Round, rules for intellectual property rights are to be strictly enforced, and developed countries are committed to meet new requirements within one year. But China does not at the moment have the institutions to comply in this timeframe.

It seems now critical to define an end point to China's achieving equal status within GATT/WTO. The definition of such an end point is by no means an easy task as no precedent exists by which to set the standards for China's entry. For that reason, Drysdale and his colleagues believe that the resolution of terms of entry requires a considerable measure of trust and understanding which will not be achieved at the high political level. They propose negotiating a binding agreement at the outset, which provides for full membership in the WTO, in return for agreement to a protocol based on actual reforms or set out the timetable for reforms steps such as further removal of quantitative restrictions to trade.

A key argument behind this idea is that China has a good record in terms of adhering to international undertakings, so that any agreement to a future program of reform towards full compliance with GATT can be expected to be honored' Another argument is that in view of the 'gradualist' approach being taken to reform of the Chinese economic system and its apparent success in the past, the international trading community should allow some time for China to adjust its trade policy to the full application of WTO principles.

Drysdale and his colleagues believe that locking China into its own self-declared reform agenda through the negotiations on the terms of entry is an important means for assuring continuing economic reform in China and for avoiding retrogression towards a costly 'import-substitution' development strategy which is the last thing the world trading community wants to see.

Alongside efforts made in seeking an early entry into the WTO, China has also actively participated in APEC activities. Akira and Hiromi outlined three major reasons why China has a special interest in APEC. First, as discussed earlier, APEC includes China's major trading partners, covering 73 per cent of its exports and 65.5 per cent of imports. The bulk of foreign direct investment also comes from the region which was 80 per cent in 1993 (Wu 1994). Second, APEC could potentially provide a mechanism for settling trade disputes (currently under discussion), even if more limited than the WTO. As China is not yet a WTO member, APEC provides an alternative framework for solving trade disputes. Third, APEC adopts a 'concerted unilateralism' approach to trade liberalization,

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which China feels more comfortable with in determining the pace and scope of its own trade liberalization.

Klintworth notes that China's APEC diplomacy is aimed, in large part, at dealing with the US which has been a main obstacle for China's WTO entry. By using the tactic of coalition building among most APEC member countries, China hopes to moderate America's tough stance on China's WTO entry. Some member countries are now suggesting that APEC should play a complementary role in defining the terms of China's accession to the WTO, for example, the development of the idea that China commits to the rules of the world trading system but not need to meet all those rules immediately upon entry while adopting a definite timetable for meeting its commitments.

In sum, the emergence of China as a large economic power poses a major challenge for both global and regional trading communities. China's participation in global and regional economic cooperation will greatly *affect* the world trade system. Negotiation of the issues of China's involvement in the world system is important to successful management of the adjustments involved, both for China and the rest of the world.

### **3.4 FOREIGN DIRECT INVESTMENT**

FDI is the category of international investment that reflects the objective of a resident entity in one economy ("direct investor" or parent enterprise) obtaining of a 'largest interest' in an enterprise resident in another economy ("direct investment enterprise). The two criteria incorporated in the notion of "lasting interest" are the existence of a long term relationship between the direct investor and the enterprise and the significant degree of influence that gives the direct investor an effective voice in the management of the enterprise.

The concept of lasting is not defined by IMF in terms of a specific time frame, and the more pertinent criterion adopted is that of the degree of ownership in an enterprise. A direct investment relationship is established when the direct investor has acquired 10 percent or more of the ordinary shares or voting power of an enterprise abroad. Thus, the IMF threshold is 10 percent ownership of the ordinary shares or

voting power or the equivalent for unincorporated enterprise. Direct investment comprises not only the initial transaction establishing the FDI relationship between the direct investor and the direct investment enterprise but all subsequent capital transactions between them and among affiliated enterprises resident in different economies. According to the above criteria:

Direct Investment enterprises are those in which the foreign direct investor owns an amount of shares or voting power that allows him to participate effectively in the management of the enterprise or in its control. It explains that “most direct investment enterprises are either (i) branches or (ii) subsidiaries that are a rather small proportion of the universe”.

There could be cases in which a foreign investor controls a company even owning a rather small amount of shares or when an investor owns a significant amount of shares but does not have an effective voice in the management of the enterprise.

FDI includes as many as twelve different elements, namely; equity capital, reinvested earnings of foreign companies, inter company debt transaction including short term loans, overseas commercial borrowing (financial leasing trade credits, grants, bonds, non-cash acquisition of equity, investment made by foreign venture capital investor, earnings data of indirectly-held FDI enterprise, control premium, non-competition fee and so on.

FDI reflects the objective of obtaining a lasting interest by a resident entity in one economy (direct investor) in an entity resident in an economy other than that of the investor (direct investment enterprise). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise and a significant degree of influence on the management of the enterprise.

The concept of Direct Investment includes the capital funds received by the direct investment enterprises from the direct investor. Direct investment involves both the initial transaction establishing the relationship between the investor and the enterprises. Both incorporated and unincorporated. Direct investment enterprises often represent units in a multinational operation, the overall profitability of which depends

on the advantage to be gained by deploying the various resources available to the investors in units located in addition to the investment income that may accrue on the capital that they invest (e.g. The opportunity to earn management fees or other sorts on income). Such extra benefits are likely to be derived from the investors' associations with the enterprises over considerable period of time.

The OECD like the IMF also recommends the 10 percent numerical guidelines of ownership of ordinary shares or voting sock to determine the existence of a direct investment relationship. If the criteria are met, then the concept of FDI includes the following bodies:

- Subsidiaries (in which the non-resident investor owns more than 50 percent).
- Associated (in which the non-resident investor owns between 10 and 50 percent) and
- Branches (unincorporated enterprises, wholly or jointly owned by the non-resident investor).

An important part of the economic reform process in China has been the reinforcement of FDI. Investment began to pour into China after 1992, and annual inflow have been over 40 billion dollar since 1996. Trending steadily upward, FDI inflows were around 70 billion dollars in both 2005 and 2006. These inflows are by far the largest of any developing country and have remained remarkably stable despite disparities in the Asia and global economies. Inflows to China in 2006 reached an calculated US \$ 69 billion, which represented 10 percent of the world FDI flows. China's FDI outflows increased 32 percent over 2005 to US \$ 16.1 billion in 2006. It traces the development of China's economic policy in context of FDI the resulting changes in both inflows and outflows. The objective is to discuss the determinants and the impact of FDI of China's economic development. It provides an overview of the trends and pattern of FDI into and from China with special reference to world, region, sector and direction of trade in special economic zones. These reflect some future trends of China's development, and are analyzed in detail separately below.

Numerous studies have been conducted to explain the level of FDI activity in China since the reforms in late 70s. From the aspect of conventional microeconomics, firm seeking business abroad are motivated by production cost, resource acquisition, minimization of competition risk and market penetration. From the location advantage aspect FDI is influenced by four categories of factors: and the investment environment improving factor: macro economic factors: and the development strategy of the host country. As there are international differences in production resources and market imperfections of one kind or another, firms move across the borders and produce in higher-return countries. Early literature tried to explain FDI at the micro-economic level in terms of market imperfection, ownership, product superiority, cost advantages, economies of scale, multi-plant economies, advanced technology, marketing and product distribution. In macroeconomics terms, FDI focused in the positive effects of exchange rates, as a depreciated exchange rate lowers the cost of production and investment in the host countries. Alternatively explanations for FDI have focused on regulatory restrictions, tariffs, quotas, infrastructure quality and political stability. FDI in China can be grouped in three categories the most important factors that attracted FDI inflow were average wage, labor quality, market size and level of infrastructure development location distribution of FDI shows that transaction cost, firm size, and quota effects are all significant in the location choice of foreign firms. The last category is concerned with the aspect of investors from various countries and the motivation behind Western and Asian direct investment direct investment are significantly influenced by labor quality and are more sensitive to local market demand.

Since the late 1970s, Chinese government has pursued policies aiming at opening up the economy and attracting foreign participation. FDI inflow in China has grown continuously and rapidly at time, from its very low level in the early 1980 to over US \$ 40 billion annually in recent years. Various preferential treatment offered by the Chinese government in different level are no doubt favored by region investors. Other factors also contributed to the surge of FDI inflow in China, such as low labor cost, growing market potential, and so on. China has become the world second largest FDI recipient countries and the largest among developing countries in the late 1990s.

### 3.4.1 Direct Impact of FDI

Evidently, FDI brings capital. A sufficient amount of capital has been necessary to build-up China's economy and FDI has made a substantial contribution to this. The ratio of FDI to GDP rose to 15 % of domestic gross investment in 1994, stayed around 13 % up to 1998 and stabilized around 11% in the necessary to counter insufficient domestic saving. Indeed, the current account (which measures the difference between domestic saving and investment) has been in surplus for all but one year since 1991. Rather, the role of foreign companies has been to use management skills and technology, together with local labor, to exports and improve the overall productivity of the economy.

The creation of employment opportunities-either directly or indirectly-has been one of the most prominent impacts of FDI on Chinese economy. The report evaluates those foreign firms' employed around 20 million workers (3 % of China's total employment) at the end of the 1990 FDI has been at the core of China's foreign trade expansion. It has furthermore been a decisive factor in China's involvement in the international segmentation of the production process. OECD (2000) emphasizes the role of foreign investment enterprises (FIEs) in the modification of China's industrial structure, the diversification of our incentive products export and the strengthening of China's competitive position in rapidly expanding markets an important specificity of FIEs is that while investment in Chinese firms is mostly devoted to the expansion of production capabilities, FDI incorporates much more equipment and technology knowledge. This is consistent with findings of greater allocate and technical efficiency in labor utilization in production in FDI firms compared to domestic firms. FIEs have improved the overall efficiency with resources are used. Their efficiency can be judged from the level of their overall productivity, which was over 90 % greater than that of directly controlled state companies (OECD, 2005).

The contribution of some imperfection in the banking sector and state investment policies to the inflow of FDI into China, there is some evidence of a FDI contingent finance growth relation in China.



FDI can help to alleviate the costs associated with financial distortions, and could provide an explanation for why as discussed by Allen (2005). China is a counter example to the findings of the finance growth literature, being characterized by malfunctioning finance institutions and phenomenal growth rates.

There are also concerns that FDI may bring about detrimental effects. Some claim that foreign companies can crowd the access to credit of domestic firms. FDI can also have a negative impact on the local economy by substituting for domestic saving or lending to balance of payment deficits as a result of rising equity repayment obligations.

### **3.4.2 Inflow and Outflow of FDI in China:**

#### **3.4.2.1: Trends and patterns of FDI**

Chinese government has formulated a series of preferential policy for the growth of FDI. Share of China in the national volume of investment in capital construction during different five year plan periods have estimated each year. A comparative analysis has been done with the world economy and China's FDI growth year on year. Summary of results by different statistical sources have been treated as a core of study in this section below:

**Table 3.4.1**  
**FDI in China 1980-2001**

(Unit: US \$ 100 million)

<b>Year</b>	<b>Number of Projects</b>	<b>Contractual FDI</b>	<b>Realized FDI</b>	<b>Realized/Contractual</b>	<b>Average size (realized)</b>	<b>Average size (contract)</b>
<b>1980-82</b>	904	4459	1168	26.20%	1.29	4.93
<b>1983</b>	474	1767	636	36.00%	1.34	3.73
<b>1984</b>	1856	2619	1250	47.70%	0.67	1.41
<b>1985</b>	2962	4611	1653	35.80%	0.56	1.56
<b>1986</b>	1498	2833	1870	66.00%	1.25	1.89
<b>1987</b>	2233	3670	2305	47.70%	1.03	1.65
<b>1988</b>	5945	5298	3193	60.30%	0.54	0.89
<b>1989</b>	5579	5600	3392	60.65%	0.61	1.00
<b>1990</b>	7273	6596	3487	52.90%	0.48	0.91
<b>1991</b>	12978	11977	4366	36.50%	0.34	0.92
<b>1992</b>	48764	58124	11008	18.90%	0.23	1.19
<b>1993</b>	83437	111436	27515	24.70%	0.33	1.34
<b>1994</b>	47549	82680	33767	40.80%	0.71	1.74
<b>1995</b>	37011	91282	37521	41.10%	1.01	2.47
<b>1996</b>	24556	73278	41726	56.90%	1.70	2.98
<b>1997</b>	21001	51003	45726	88.70%	2.15	2.43
<b>1998</b>	19799	52102	46463	87.30%	2.30	2.63
<b>1999</b>	19846	41238	40398	98.00%	2.04	2.08
<b>2000</b>	22347	62380	40715	65.30%	1.82	2.79
<b>2001</b>	370700	711286	378073	53.20%	1.02	1.922

Sources: Pomfret (1994) &amp; NBSC, China Foreign Economic Statistics Yearbook, 1991-2002.

An insight at Table 3.4.1 clearly reveals that FDI facilitates the Chinese transition process. In a similar vein, FDI has improved the reform of the state owned enterprises (SOE) form. Directly, foreign enterprises have joined SOE-restructuring initiatives through joint ventures (JV) or mergers and acquisitions. Indirectly, FDI influenced SOE-reform by the demonstration effects from the operations of FIEs. Foreign Companies preferred to minimize their resource and management committee

by using flexible arrangements such as contractual joint ventures (CJVs), subcontracting and compensatory trade arrangements. As a result of the importance of joint explorations (JEs), the average size of FDI projects was not small as companion with later stages. FDI in this initial stage was characterized by slow pace, small size, and high concentration in terms of source countries and sub-national allocation. More than 80 percent of FDI came from Hong Kong, the US and Japan. The location of FDI was largely concentrated in the four SEZs in south China. The ratio of realized FDI to total FDI increased to 47.3 percent in 2000. The number of projects increased from 904 in 1982 to 26139 in 2001. This caused 2.03 percent more realized/contractual percentage during the same period. Simultaneously the ratio of average size realized and contracted shows a variation effect year on year for 1980 to 2001. It indicates that countries with high productivity, large market and an advanced structure were eager of investigating more in China, and thereby, enjoyed a higher FDI value in comparison to other countries.

**Table 3.4.2****China's Outward FDI Flows in Relation to the World's Total FDI Flows\***

	2002	2003	2004	2005	2006
China's outward FDI flow(US\$ Bn)	2.70	2.85	5.50	12.26	16.10
World's total FDI flow(US\$ Bn)	539.50	561.10	813.10	778.70	N.A.
Percentage (%)	0.50	0.51	0.68	1.57	N.A.

\*The percentages reported in this table are, slightly different from those reported in the Ministry of Commerce's Statistical Bulletins from 2003 and 2004. The percentages reported in these bulletins were taken as percentages of the world's total FDI flows in the preceding instead of the same years.

**Table 3.4.3****China's Outward FDI Stocks in Relation to the World's Total FDI Stocks by Year End"**

	2002	2003	2004	2005	2006
China's outward FDI stock (US\$ Bn)	22.90	33.20	44.80	57.20	73.30
World's total FDI stock(US\$ Bn)	7684.10	9046.30	10325.20	10671.90	N.A.
Percentage (%)	0.29	0.37	0.43	0.54	N.A.

\*The percentages reported in this table are slightly different from those reported in the Ministry of Commerce's Statistical Bulletins from 2003, 2004 and 2005. The percentages reported in these bulletins were taken as percentages of the world's total FDI stocks in the preceding instead of the same years.

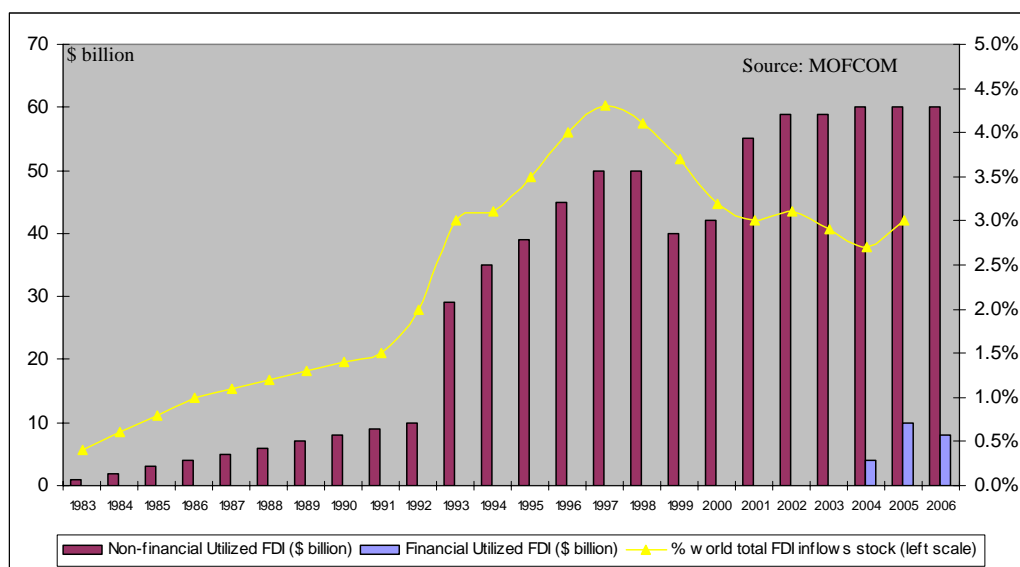
The flow of China's FDI from 1990 to 2006 is depicted in Table 3.4.2, where the data from 1982 to 2001 were based on UNCTAD's World Investment Report while data from 2002 were provided by MOFCOM based on international definitions and data collection methods. Despite of the rapid growth of China's FDI in recent years, its share of the world's total FDI remained very small. As shown in Table 3.4.3, China's FDI flow in 2002 and 2003 accounted for a miniscule 0.5 %, but it was tripled to 1.57 % in 2005. China's FDI stock over the same period accounted for an even smaller percentage of the world's total FDI stock. As shown in Table 3.4.4. China's global share in 2002 was 0.29 %, and grew to 0.54 % in 2005.

By the end of 1996, China's total stock of FDI outflows was over US \$ 18 billion. It surpassed South Korea (US \$ 13.8 billion) and Brazil (US \$ 7.4 billion) to move up to the number four position among developing economies, behind Hong Kong (US \$ 112 billion), Singapore (US \$ 37 billion) and Taiwan (US \$ 27 billion) (Cal, 1999, p861). For the period of 1979-93, almost two thirds of China's FDI was found in Asia, including Hong Kong and Macau. The other regions in descending order were North America (15 %)Oceania (8 %), Central and Eastern Europe(5%) ;Africa(2 5% ), Latin America (2%),; Western Europe (2 %) (Cal, 1999, p 864).60 % of China's FDI up to 1994 was in the service sector, mainly to service and promote its exports. The remaining FDI was in natural resources (25 %) and manufacturing (25 %), mainly in textile and clothing, and other labor-intensive industries, located primarily in Africa, Asia and Pacific).

Hong and Sun (2004), also using UNCTAD's FDI statistics, reported that the stock of China's outward FDI flow reached about US \$ billion by the end of 2002. ranked No 6 among 188 developing economies. They found that China's aggregate FDI outflows during 1988-2002 were quite similar to those of South Korea during the same period, and to Japan's FDI, with 40-50 % of shares in the non-trade category, was similar to that of South Korea in the 1980's and that of Japan in the 1960s and 1970s.

As a matter of comparison, China's FDI and stocks were not only much smaller than those of the world's major industrial economies, but smaller than some small developed economies. For instance, its FDI flow in 2005 at US \$ 12.26 billion

was more than doubling its flow in 2004, but still below those of Ireland (US \$ 12.93 billion) and Norway (US \$ 14.46 billion). When compared with developing economies, its flow in 2005 exceeded Singapore (US \$ 5.52 billion) for the first time in history. China's FDI stock at the end of 2005 stood at US \$ 57.2 billion. As a latecomer in outward FDI, this stock was slightly below those of Austria (US \$ 67.24 billion), Brazil (US \$ 71.56), and Finland (US \$ 74.41), and significantly behind Singapore (US \$ 110.9 billion) and Russia (US \$ 120.42 billion). However, given the expectation that China's FDI flows in the future will continue to grow, its ranking by flow and stock can be expected to move up reveals the average share of GDP, trade and FDI for each of China's provinces between 1995 and 2000 (for FDI Figure-3.4.1, between 1990-1996 and 1995-2000). The GDP volume reveals the economic capacity within each province, while trade and FDI statistics represent the level of international attachment to the world and assess the economic dynamism of the provinces. The data suggest the existence of five spatial clusters, which are either the traditional centers of concentration of GDP, trade, and FDI, or areas that have a higher growth rate for these indicators than the national average.



**Figure 3.4.1: FDI inflows to China: 1983-2006**

Source: Sandra Poncet, *Inward and Outward FDI in China* (Panthéon-Sorbonne-Economie, Université Paris 1 CNRS and CEPII), April 28, 2007

### **3.4.2.1.1. Inward FDI**

#### **3.4.2.1.1.1- Inward FDI: trends and policies**

Over the past decade, China has established itself as the top recipient of FDI among developing countries and as the second destination in the world after the United States. FDI flows to China have increased massively in recent years, reaching an estimated \$69 billion in 2006, which represented 10% of world FDI flows (UNCTAD, 2006, p. 51). Since economic reforms launching in 1979, China has received a large part of international direct investment flows. China decided to accept foreign investment in 1978 and broke sharply with socialist orthodoxy in establishing SEZs in 1979 and 1980. Nationwide the impact of FDI was moderate until the early 1990s. As Figure 3.4.1 shows, beginning in 1992-1993, the stream of incoming FDI turned into a flood.

China moved from restrictive to permissive policies in the early 1980s, then to policies encouraging FDI in general in the mid-1980s to policies encouraging more high-tech and more capital intensive FDI projects in the mid-1990s (Fung et al., 2004). During the permissive period, the Chinese government established four Special Economic Zones (SEZs) in Guangdong and Fujian provinces and offered special incentive policies for FDI in these SEZs. While FDI inflows were highly concentrated within these provinces, the amounts remained rather limited (Cheung and Lin, 2004). After 1984, Hainan Island and fourteen coastal cities across ten provinces were opened, and FDI levels really started to take off. The realized value of inward FDI to China reached US \$3.49 billion in 1990. This kind of preferential regimes policies resulted in an overwhelming concentration of FDI in the east.

The expected spillover effects from coastal to inland provinces failed to materialize. In reaction to the widening regional gap, more broadly-based economic reforms and open door policies were pushed forward in the 1990s. In the spring of 1992, Deng Xiaoping adopted a new approach which turned away from special regimes toward more nation-wide implementation of open policies for FDI inflows. New policies and regulations encouraging FDI inflows were implemented and produced remarkable results.

Since 1992 inward FDI in China has accelerated and reached the peak level of US\$45.5 billion in 1998. After a drop due to the Asian crisis, FDI inflows into China surged again, so that by 2003 China received US \$53 billion in FDI, surpassing the United States to become the world's largest single recipient of FDI. The peak of \$72 billion recorded in 2005 is partly related to changes in the methodology underlying Chinese FDI statistics - for the first time data on Chinese inward FDI include inflows to financial industries (UNCTAD, 2006, p51). In 2005, non-financial FDI alone was \$60 billion, and it registered a slight decline after five years of increase. FDI into financial services surged to \$12 billion, driven by large-scale investments in China's largest State-owned banks. However, a significant share of China's inward FDI might be the result of round-tripping. FDI to China may be overstated by between 25% and 50%.<sup>2</sup> The United Nations put China's stock of inward FDI close to \$400 billion, around 16% and 43% of China's GDP and Gross Fixed Capital Formation respectively.

#### **3.4.2.1.2-Inward FDI: main features**

Naughton (2007) emphasizes that three distinctive characteristics have marked FDI in China over the past decade and that each of these characteristics reflects the dominant role played by the cross-border restructuring of export-oriented production networks that originally developed in other, neighboring East Asian economies. The first specificity stressed by Naughton (2007) is that foreign direct investment has been the predominant form in which China has accessed global capital (as opposed to portfolio capital or bank loans). Between 1979 and 2000, China's actual usage of foreign capital amount to more than \$500 billion of which more than two third are in the form of direct investment (Fung et al., 2004). The second specificity is that an unusually large proportion of Chinese FDI inflows are in manufacturing industry, as opposed to services or resource extraction. The third specific characteristic of China's FDI inflows is the predominance of other East Asian economies, especially Hong Kong, Taiwan and Macao as sources.

An additional important feature of China's FDI inflow is that it is mostly concentrated in the eastern coastal regions. For the 11 years from 1993-2003 the average annual incoming FDI/GDP ratio was 13% for Guangdong and 11% for Fujian. Other open coastal areas include Shanghai, Jiangsu and Beijing. The

contractual forms in which FDI is embodied in China have evolved steadily toward modes that permit the foreign investor a higher level of control. In the early 1980s, FDI was dominated by contractual joint ventures (JVs) and joint development projects. After the mid- 1980s, China began to strongly encourage the use of equity joint ventures (EJVs), which became the dominant mode of investment<sup>4</sup>. As China evolved toward a market economy, the share of FDI in the form of wholly owned subsidiaries of foreign companies has climbed steadily, and in 2005 it accounted for two-thirds of total realized FDI inflows.

As a consequence, Foreign-invested enterprises (FIEs) play a large role in China's economy, accounting for 27% of value-added production, 4.1% of national tax revenue, more than 58% of foreign trade in 2005, and 88% of high-technology exports, nearly all under Export Processing arrangements. Companies from 190 countries and regions have invested in China, including 450 of the world's Fortune 500 companies. By the end of 2005, FIEs in China employed more than 24 million workers. Manufacturing accounted for 63% of registered foreign capital at the end of 2005 (see Table 1). To a large extent, this emphasis is explainable in terms of the restrictions that China has maintained on foreign entry into the most important service sectors (Naughton, 2007).

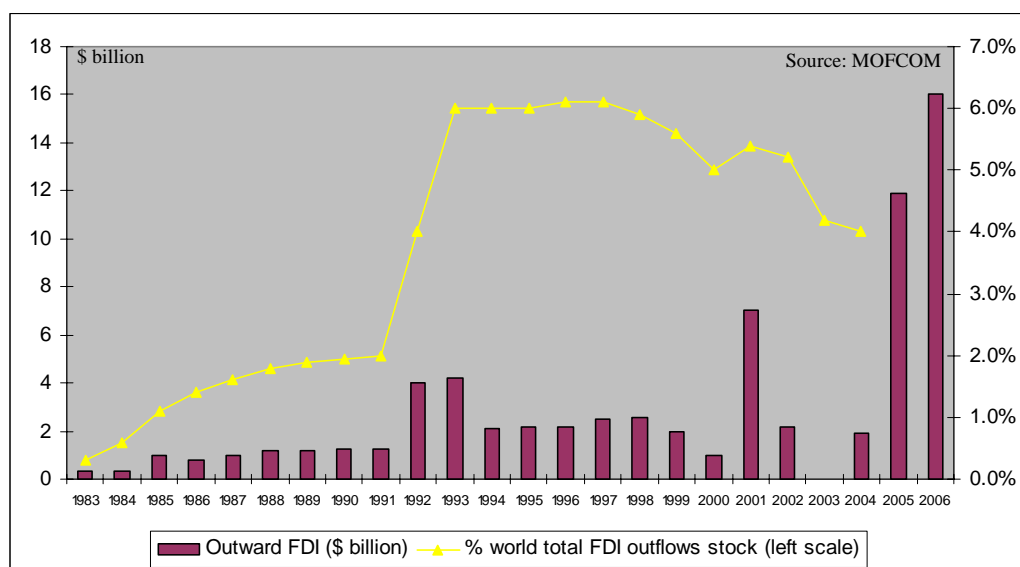
While large proportions of FDI inflows in all developing countries typically go to wholesale and retail trade, transport and telecommunications and finance, wholesale and retail trade, they are clear underperformers in China. Naughton (2007) notes that these three sectors together account for 27% of world developing-country inflows (including China) but only 4% of inflows into China itself. In China, by contrast, incoming FDI in the service sector is highly concentrated in real estate, specifically in property development. This sector accounted for 11% of total investment in 2005. The real estate industry has indeed become a hot spot for FDI, attracting as high as \$9 billion annually in the recent years (UNCTAD, 2007). According to SAFE estimates, FDI now accounts for 15% of China's real estate market.

The high tech sector has just begun to catch up and cross border M&A barely took form. In these areas, there is still a large gap between China and developed countries. It seems nevertheless that FDI in China's manufacturing sector is shifting



towards more advanced technologies. The number of foreign-invested R&D centers has risen to 750 in China by the end of 2005 (UNCTAD 2006, p. 56), with at least 107 set between October 2004 and September 2005 (Locomonitor, 2005).

### 3.4.2.1.2 Outward FDI



**Figure 3.4.2: FDI outflows to China: 1983-2006**

Source: Sandra Poncet, *Inward and Outward FDI in China* (Panthéon-Sorbonne-Economie, Université Paris 1 CNRS and CEPII), April 28, 2007.

#### 3.4.2.1.2.1. Outward FDI: trends and policies

Although China's Outward Direct Investment (ODI) is still small in absolute terms, especially compared to the huge inward flow, its overseas enterprises have been quietly gaining importance as new sources of international capital. As China's economy continues to grow and becomes a capital-surplus economy and its policies encourage the development of brands that can be considered "national champions", FDI originating from China has been growing at a considerable rate.

China's ODI, excluding the financial sector, reached \$16.1 billion in 2006, up 32 % over 2005. It now represents the fourth largest outflow from developing and transition countries. The United Nations put China's stock of FDI held in other countries at \$62 billion, around 0.6% of the world total and 3% of China's GDP.

UNCTAD (2006) considers, however, that as many large Mergers & Acquisitions (M&A) deals undertaken by Chinese companies are financed outside, China's outward investment may be significantly underestimated. Wong and Chan (2003) describe China's ODI as having undergone four stages of development. During the first stage (1979-85) when foreign trade was still under state monopoly and foreign investment was under state guide, only state-owned trading corporations as well as local enterprises regulated by the State Economic and Trade Commission (SETC) were allowed to invest overseas. During that period of time, the scale of the projects was small and the total investment was limited amounting around \$200 million.

During the second stage (1986-1991), the liberalization of restrictive policies and the authorization for more enterprises, including non-state firms, to apply for permission to establish subsidiaries provided they had sufficient capital and know-how and a suitable partner, led to a sharp rise in ODI, reaching \$ 200 million annually.

The third stage (1992-98), witnessed a big surge in local and provincial enterprises investing abroad as national- level support for ODI was mirrored at the local levels. Annually ODI reached \$ 700 million. It appeared that part of the outflows engaged in real estate and stock market speculation in Hong Kong and many overseas branches suffered from heavy losses and were characterized by nepotistic and corrupt management. In a reaction to what Beijing saw as a serious loss of state asset and leakage of foreign currency, MOFTEC applied a stricter and more rigorous screening and monitoring.

This stage corresponds to the consolidation of China's "going global" strategy. The strategy, envisaged in the mid-1990s and formally adopted in 2000, intends to promote the international operation of capable Chinese firms with a view to improving resources allocation and enhancing their international competitiveness (UNCTAD, 2006, p210). The Ministry of Commerce (MOFTEC) is responsible for implementing and coordinating of the strategy and encourages ODI through provision of information about foreign locations, the granting of incentives and a gradual relaxation of foreign exchange controls. It seems that the conjunction of these

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preferential measures with the successful penetration of Chinese manufactured exports into the world market boosted ODI.

As a result, an increasing number of Chinese firms are now among the largest Transnational Corporations (TNCs) from developing countries, in terms of foreign assets: while only seven Chinese enterprises were among the top 50 largest TNCs from developing economies in 1994: by 2001, twelve Chinese TNCs were in the top 50 largest TNCs from developing economies, and as many as six had foreign assets of above \$ 2 billion (UNCTAD, 2003b).

#### **3.4.2.1.2.2 Outward FDI: main features**

Chinese TNCs emerged later than their counterparts in the Newly Industrialized Economies (NIEs). The first generation of Chinese TNCs mainly large State Owned enterprises operating in monopolized industries such as financial services, shipping, international trading and natural resources. Hong Kong (China) was usually the first stop along the path of the internationalization of these first-generation Chinese TNCs Hong Kong played an important role in giving them international experience and training their management team for further internationalization and it remains the major location for their “overseas” operations (UNCTAD, 2006, P. 130). The second generation of major Chinese TNCs emerged after the early 1990s in competitive manufacturing industries, in particular those related to electronics and Information and Communication Technologies (ICT). These TNCs have diverse ownership structure, including private ownership, local government ownership and foreign participation. Selective support policy to these firms has been adopted in the recent years. In October 2004, a circular issued by the National Development Research Council and the Export- Import Bank of China explicitly promotes M&A that could enhance the international competitiveness of Chinese enterprises and accelerated their entry into foreign markets through preferential credit and accelerated screening process.

While mainland shareholding companies and private companies are stepping up their investment, large State-owned enterprises account for the bulk of investment. By the end of 2005, China’s cumulative FDI abroad had reached \$ 57.2 billion, 81%

of which was from state-owned enterprises that are directly managed by the State Assets Supervision and Administration Commission (SASAC). Beijing and the nation's coastal cities were the second major overseas investors after the largest SOEs under the central government. The top sources of outbound FDI from China were coastal and border provinces-specially Fujian, Guangdong, Heilongjing, Jiangsu, Shandong, Shanghai, and Zhejiang-which together accounted for 62.5 % of China's outbound FDI.

The main activities attracting Chinese investment are business activities, trade and mining (40,18 and 14 % respectively of total Net ODI in 2005). In recent years, FDI in manufacturing has grown especially fast.

**Table 3.4.4**  
**Major Foreign Investors in China: 1979-2005**

(\$ billions and % of total)

Country	Cumulative Utilized FDI Amount		Utilized FDI in 2005 Amount	
	(\$ billion)	% of Total	(\$ billion)	% of Total
Total	620.7	100.0	60.3	100.0
Hong Kong	259.5	41.8	17.9	29.7
Japan	53.3	8.6	6.5	10.8
United States	51.1	8.2	3.1	5.1
British Virgin Islands	45.9	7.4	9.0	14.9
Taiwan	41.8	6.7	2.2	3.3
South Korea	31.1	5.0	5.2	8.6

**Source:** Chinese government statistics. Top six investors according to cumulative *FDI* from 1979 to 2005,

Table 3.4.4 evidences that Hong Kong and tax havens, such as the Cayman Islands and than British Virgin Island, received 80 % of total Chinese outbound investment (and perhaps explaining why these destinations in turn are some of the largest sources of "foreign" investment coming back into China). Although Africa accounts for a minor share of China's total ODI, China is now among the top 10 sources of FDI in Africa.

China's trade and investment reform and incentives led to a surge in foreign direct investment (FDI), which has been a major source of China's capital growth. Annual utilized FDI in China grew from \$ 636 million in 1983 to \$ 60 billion in 2005. The cumulative level of FDI in China stood at about \$ 621 billion at the end of 2005. Analysts predicted that FDI will continue to pour into China as investment barriers are reduced under China's WTO commitments and Chinese demand for import continues to increase.

Based on cumulative FDI for 1979-2005 about 42 % of FDI in China has come from Hong Kong. In 2005, Japan replaced the United State as second largest overall investor in China. The United States ranked third accounting for 8.2 % (\$ 51.1 billion) of total FDI. Other major investors including the British Virgin Island, Taiwan, and South Korea. US FDI in China for 2005 was \$ 3.1 billion (compared to \$ 3.9 billion in 2004), accounting for 5.1 % of FDI in China for that year, and ranked 5<sup>th</sup> after Hong Kong, the British Virgin Island, Japan, and South Korea.

### **3.4.3 Regional patterns of FDI :**

Since the late 1970s, the costal areas of east China have markedly outstripped central and west China in the rate of economic growth. Scarcity of inbound foreign capital in the capital in the central and west regime is a major reason behind this situation. Two factors; first the efforts of central and local governments in wooing foreign investors by offering better investment environments and most preferential policies; second, with China's accession to the WTO, THE Chinese policy towards foreign investment will be so liberal as to allow foreign investors in more fields and more flexible modes of investment. There are several reasons behind the fact that Central and West China is trailing way behind East China particularly when FDI inflow and outflow are taken into consideration. Major description of FDI characteristics of China's economy by region is illustrated and analysed in this section below:

**Table 3.4.5**  
**Provincial distribution of FDI in China**

(in million \$ US)

YEAR	1979-1982	1990	%	1992	%	1994	%	1996	%	1998	%	2000	%
<b>EASTERN REGION</b>	<b>99.9%</b>	<b>2974</b>	<b>85.5</b>	<b>9802</b>	<b>89.1</b>	<b>29087</b>	<b>86.1</b>	<b>34974</b>	<b>83.8</b>	<b>39490</b>	<b>83.0</b>	<b>35411</b>	<b>87.0</b>
Beijing	7.4	277	7.9	350	3.2	1374	4.1	1553	3.7	2168	4.6	1684	4.1
Tianjin	0.1	35	1.0	107	1.0	1015	3.0	2006	4.8	2114	4.4	1166	2.9
Hebei	0.0	39	1.1	110	1.0	509	1.5	826	2.0	1429	3.0	679	1.7
Liaoning	0.1	244	7.0	490	4.4	1437	4.3	174	0.4	2190	4.6	2044	5.0
Shandong	0.0	151	4.3	973	8.8	2532	7.5	2590	6.2	2203	4.6	2971	7.3
Shanghai	3.0	174	5.0	481	4.4	2473	7.3	3941	9.4	3602	7.6	3160	7.8
Jiangsu	0.0	124	3.6	1460	13.3	3763	11.1	5210	12.5	6632	13.9	6426	15.8
Zhejiang	0.0	48	1.4	232	2.1	1144	3.4	1521	3.6	1318	2.8	1613	4.0
Guandong	88.3	1460	41.9	3552	32.2	9397	27.8	11624	27.9	12020	25.3	11281	27.7
Guangxi	0.2	29	0.8	178	1.6	815	2.4	656	1.6	886	1.9	525	1.3
Hainan	0.0	103	3.0	453	4.1	918	2.7	789	1.9	717	1.5	431	1.1
Fujian	0.8	290	8.3	1416	12.9	3712	11.0	4085	9.8	4212	8.9	3432	8.4
<b>CENTRAL REGION</b>	<b>0</b>	<b>154</b>	<b>4.4</b>	<b>766</b>	<b>7.0</b>	<b>2798</b>	<b>8.3</b>	<b>4177</b>	<b>10.0</b>	<b>4630</b>	<b>9.7</b>	<b>3883</b>	<b>9.5</b>
Ahhui	0	10	0.3	50	0.5	370	1.1	507	1.2	277	0.6	318	0.8
Heilongjian	0	24	0.7	71	0.6	342	1.0	548	1.3	526	1.1	301	0.7
Jilin	0	18	0.5	66	0.6	242	0.7	452	1.1	409	0.9	337	0.8
Shangxi	0	3	0.1	54	0.5	32	0.1	138	0.3	245	0.5	225	0.6
Jiangxi	0	6	0.2	97	0.9	262	0.8	301	0.7	465	1.0	227	0.6
Henan	0	10	0.3	52	0.5	386	1.1	524	1.3	617	1.3	564	1.4
Hubei	0	29	0.8	203	1.8	602	1.8	680	1.6	973	2.0	944	2.3
Hunan	0	11	0.3	129	1.2	325	1.0	703	1.7	818	1.7	678	1.7
Shaanxi	0	42	1.2	46	0.4	239	0.7	325	0.8	300	0.6	288	0.7
<b>WESTERN REGION</b>	<b>0</b>	<b>40</b>	<b>1.2</b>	<b>155</b>	<b>1.4</b>	<b>1923</b>	<b>5.7</b>	<b>755</b>	<b>1.8</b>	<b>733</b>	<b>1.5</b>	<b>795</b>	<b>2.0</b>
Sichuan	0	16	0.5	102	0.9	889	2.6	425	1.0	372	0.8	437	1.1
Inner Mongolia	0	11	0.3	5	0.0	40	0.1	72	0.2	91	0.2	106	0.3
Guizhou	0	5	0.1	20	0.2	64	0.2	31	0.1	45	0.1	25	0.1
Yunnan	0	3	0.1	23	0.2	65	0.2	65	0.2	146	0.3	128	0.3
Gansu	0	1	0.0	0	0.0	88	0.3	90	0.2	39	0.1	62	0.2
Qinghai	0	-	0.0	1	0.0	1	0.0	1	0.0	-	0.0	0	0.0
Ningxia	0	0	0.0	4	0.0	4	2.2	6	0.0	19	0.0	17	0.0
Xinjiang	0	5	0.2	-	0.0	-	0.1	64	0.2	22	0.0	19	0.0
<b>Central Ministries &amp; Commissions</b>	<b>-</b>	<b>319</b>	<b>9.1</b>	<b>284</b>	<b>2.6</b>	<b>687</b>	<b>2.0</b>	<b>-</b>	<b>-</b>	<b>179</b>	<b>0.4</b>	<b>382</b>	<b>0.9</b>

Sources: NBSC, China Foreign Economic Statistics Yearbook, 191-2002

As Table 3.4.5 provides, around mid-1980s coastal region received US \$ 1 billion of foreign capital while the central and western regions to the tune of US \$ 50 and 7 million. Although in the next 13 years to the FDI to central region increased to over US \$ 6 billion and to the western to almost 1.5 billion, this was still not enough compared to the absolute inflow of over US \$ 38 billion in the coastal region. A look at it suggest the coastal provinces were losing some of their share of over 90 percent which they provides, around mid-1980s coastal region received US \$ 1 billion of foreign capital while the central and western regions to the tune of US \$ 50 and 7 million. Although in the next 13 years to the FDI to central region increased to over US \$ 6 billion and to the western to almost 1.5 billion, this was still not enough compared to the absolute inflow of over US \$ 38 billion into the coastal region. A look at got in mid-1980 and the beginning of the 1990s in the total FDI inflow, which then decrease to 85.9 in 1997. It suggests another interesting aspect of the regional distribution where it says the area like Guangdong and Fujian garnered more than 70 percent of the foreign capital. This over concentration of capital came down substantially over the years, yet both secured a combine share of almost 44 percent. As can be seen from Table 3.4.5 Hainan the fifth SEZ, was with less than 2 percent of the overall investment in the coastal provinces, not a major destination for attracting FDI. The unevenness of the distribution of FDI inflows by province is well perceived. In flows to the ten eastern provinces which each took more than 2.5 percent of cumulated FDI inflows in 1985-96 accounted for 83.8 percent of the total inflows in the same period. The distribution of 500 largest foreign funded enterprises is even more skewed. The top 500 FIEs were mainly engaged in electronics; machine making; food processing; textiles and clothing and automobiles and more than half of them (257) were funded with capital from Hong Kong and Macao. Of the rest, Japan accounted for 66 and the USA for 50. The top 500 were distribution among 24 provinces and municipalities, 91 percent along coast.

**Table 3.4.6**  
**Values and Shares of China's FDI Flows by Region**

	2003	2004	2005
<b>Values of China's Outward FDI Flows (US\$ Million)</b>			
Asia	1498.95	3000.27	4374.64
Africa	74.79	317.42	391.68
Europe	151.14	170.92	505.02
Latin America	1038.15	1762.72	6466.16
North America	57.74	126.49	320.84
Oceania	33.88	120.15	202.83
<b>Shares of China's Outward FDI Flows (%)*</b>			
Asia	52.51	54.57	35.68
Africa	2.62	5.77	3.19
Europe	5.29	3.11	4.12
Latin America	36.37	32.06	52.74
North America	2.02	2.30	2.62
Oceania	1.19	2.19	1.65
<b>Relative ratio of China's Outward FDI flows**</b>			
Asia	2.32	2.22	1.54
Africa	0.79	2.39	0.95
Europe	0.10	0.09	0.08
Latin America	4.63	2.66	5.37
North America	0.18	0.12	0.16
Oceania	0.48	0.34	-0.47

*Sources:* Ministry of Commerce, China (2004, 2005, 2006), *World Investment Report* (2006).



**Table 3.4.7**  
**Values and Shares of China's Outward FDI Stocks by Region**

	2003	2004	2005
<b>Values of China's Outward FDI Stocks (US\$ Million)</b>			
Asia	26559.39	33409.53	40629.04
Africa	491.22	899.55	1595.25
Europe	531.52	746.66	1598.19
Latin America	4619.34	8268.37	11469.62
North America	548.49	909.21	1263.24
Oceania	472.26	543.94	650.28
<b>Shares of China's outward FDI Stocks (%)*</b>			
Asia	79.94	74.61	71.02
Africa	1.48	2.01	2.90
Europe	1.60	1.67	2.79
Latin America	13.90	18.47	20.05
North America	1.65	2.03	2.21
Oceania	1.42	1.21	1.14
<b>Relative ratios of China's Outward FDI Stocks**</b>			
Asia	5.08	4.83	4.15
Africa	0.61	0.81	1.07
Europe	0.03	0.03	0.06
Latin America	1.85	2.47	2.43
North America	0.08	0.10	0.11
Oceania	0.47	0.36	0.42

*Sources:* Ministry of Commerce, China (2004, 2005, 2006), *World Investment Report* (2006).

Table 3.4.6 and 3.4.7 show the geographical distribution of China's FDI flow and stock, respectively. In 2005, 52.7 % of China outward FDI flow was destined for Latin America, exceeding the share of Asia for the first time in history, but much of the investment in Latin America was made in three tax havens. Investment in these and other tax havens typically result in reinvestment in other host economies, including China itself. Asia ranked second as a destination of China's FDI, and accounted for a total of 35.7 %, including 27.8 % for Hong Kong alone. The other regions in the

world were not important destinations for China's FDI at all with Europe accounting for 4.1 %, Africa accounting for 3.2 %, North America accounting for 2.6 % and Oceania accounting for 1.7 %. When compared with the share of world's aggregate FDI flows to different regions, we see that the shares of China's FDI flows in Asia and Latin America were significantly higher than those of the world's but its share in Europe, North America and Oceania were very low, where as its share in Africa was below the world average in 2003, above, the world average in 2004, and close to the world average in 2005.

Asia's shares of China's FDI stocks in 2003-2005 were more than three times those of Latin America, the second largest share among all regions in this period. Clearly, China's substantial flows to Latin America were a relatively recent phenomenon; the shares of Africa, Europe, and North America were in the range of 1-3 %. When compared with the share of world's aggregate FDI stocks in different regions, we see that the shares of China's FDI stocks in Asia and Latin America were significantly higher than those of the world's but its shares in Europe, North America and Oceania were very low, whereas its share in Africa was below the world average in 2003 and 2004, and slightly above the world average in 2005.

Ignoring Cayman Island and British Virginia, the top 10 recipients of China's FDI in 2005 were Hong Kong (which is also a tax haven), South Korea, US, Russia, Australia, Germany, Sudan, and Kazakhstan. In 2004, Indonesia, Singapore, and Nigeria replace South Korea, Germany, and Kazakhstan. Both lists were inductive of the role of natural resources found in Africa, central Asia, and Southeast Asia.

Given that 81 % of China's total FDI in 2005 was made in the world's tax havens, and at least 78 % of its FDI in 2004 was made in three tax havens which led the list of top 10 destinations, the true breakdown of the destination of China's FDI was basically unknown. Our attempts to obtain and the annual reports of publicly listed Chinese companies, unfortunately, proved to be unsuccessful.

#### **3.4.4 Sectoral distribution of FDI**

The dramatic increase in China's outward FDI inflows can be in part ascribed to the rise of transactional co-operations. The share of FDI in terms of amounts

actually used across sectors fluctuated slightly from 1997 to 2002. In accordance with the growth trend of inward FDI across sectors, foreign investors have realized the importance of China's advantages in terms of a large market, fast economic growth and low labour costs for their investment and operations. Shares of actually used FDI in amount by sectors have been critically examined in this section. A detail description is mentioned as below:

**Table 3.4.8**  
**Sectoral distribution of contracted FDI in China**

(Unit: US \$ billion)

Sector	1979-86 FDI (%)	1987-91 FDI (%)	1992-94 FDI (%)	1979-No of projects (%)	1998 FDI (%)
<b>Total</b>	<b>19.18</b>	<b>33.18</b>	<b>252.21</b>	<b>324,620</b>	<b>573</b>
<b>Agriculture forestry, animal husbandry and fishing</b>	0.57	0.8	2.84	8772	9355
	(2.98)	(2.41)	(1.13)	(2.70)	(1.63)
<b>Industry</b>	7.6	25.66	127.87	237054	338
	(39.59)	(77.33)	(50.70)	(73.03)	(59.08)
<b>Construction</b>	0.31	0.56	8.11	8579	17.8
	(1.63)	(1.68)	(3.22)	(2.64)	(3.10)
<b>Transport, warehousing, post &amp; telecom</b>	0.28	0.29	5.06	3516	13.9
	(1.48)	(0.87)	(2.01)	(1.08)	(2.42)
<b>Wholesale &amp; retailing, catering</b>	1.42	0.44	9.97	16,733	20.8
	(7.40)	(1.33)	(3.95)	(5.15)	(3.63)
<b>Real Estate</b>	5.99	4.48	85.71	31,731	143
	(31.21)	(13.51)	(33.98)	(9.77)	(24.93)
<b>Health care, sports &amp; Social Welfare</b>	0.07	0.15	2.85	971	4.55
	(0.34)	(0.46)	(1.13)	(0.30)	(0.79)
<b>Education, Culture, art, broadcasting films &amp; T.V</b>	0.08	0.13	1.16	1,288	1.97
	(0.42)	(0.39)	(0.46)	(0.40)	(0.34)
<b>Scientific research &amp; technical services</b>	0.01	0.06	0.92	2,348	1.74
	(0.05)	(0.18)	(0.37)	(0.72)	(0.30)
<b>Other</b>	2.86	0.61	7.72	13,628	21.6
	(14.89)	(1.85)	(2.86)	(4.2)	(3.77)

*Sources:* Data for 1979-94 from Lee (1997); Data for 1979-98 MOFTEC (1999).

It can be seen from Table 3.4.8 that through the end of 1998, China has the establishment of over 3, 00000 foreign investment enterprises, involving of \$ 522.4

billion in foreign capital. Of these, over 150,000 FIEs representing \$ 221.04 billion investment commenced operations by the end of 1997. During 1986-89 over 70 % of Direct Foreign Investment projects were involved in manufacturing industries. The share of total industrial output in China made by FIEs reached 18.6 percent .Maximum contracted FDI in China is distributed in agriculture, forestry, fishing and animal husbandry industries and increased gradually from 1979 to 1998.

**Table 3.4.9**  
**Values and Shares of China's Outward FDI by Sector**

		FLOW			STOCK		
		2003+	2004	2005	2003	2004	2005
<b>Agriculture, forestry, animal husbandry, fishery And</b>	Value (US\$ M)	85.5	288.66	105.36	332	834.23	511.62
	Share (%)	3	5.25	0.86	1	1.86	0.89
<b>Mining, quarrying and petroleum</b>	Value (US\$ M)	1380	1800.20	1675.22	5900	5951.37	8651.61
	Share (%)	48.40	32.74	13.66	18	13.29	15.12
<b>Manufacturing</b>	Value (US\$ M)	620	755.55	2280.40	2070	4539.07	5770.29
	Share (%)	21.80	13.74	18.60	6.20	10.14	10.09
<b>Services</b>	Value (US\$ M)	763.80	2643.40	8198.58	24833	33470.90	42280
	Share (%)	26.80	48.08	66.87	74.80	74.75	73.91
<b>Business Services</b>	Value (US\$ M)	280	749.31	4941.59	1992	16445.50	16553.60
	Share (%)	9.80	13.63	40.30	6	36.73	28.94
<b>Wholesale and Retail</b>	Value (US\$ M)	360	799.69	2260.12	6530	7843.27	11417.90
	Share (%)	12.60	14.55	18.43	19.70	17.52	19.96
<b>Transportation and Storage</b>	Value (US\$ M)	85.50	828.66	576.79	1992	4580.55	7082.97
	Share (%)	3	15.07	4.70	6	10.23	12.38

\*The 2003 figures are subject to rounding errors, because the values by sector, if not explicitly provided in the *2003 Statistical Bulletin of China's Outward Foreign Direct Investment*, are calculated from the sector percentages and aggregate FDI figures.

As seen in Table 3.4.9 in 2005, 40.3 % of China's FDI flow went into business services: 18.6 % went into manufacturing (mainly, telecom equipment, computer and

other electronic equipment, transportation equipment, general equipment, textiles, wood products, metallurgy); 18.4 % went into wholesales and retail( mainly, imports and exports); 13.7 % went into mining and petroleum; 4.7 % went into transportation and storage. Also given in Table 3.4.9 are the sectoral compositions of FDI flows in 2003, 2004 and 2005. As can be seen, mining and petroleum accounted for close to almost one half in 2003 and one third in 2004, but dropped to less than 14 % in 2005. In contrast, business services rose from less than 10% in 2003 to over 40 % in 2005.

By the end of 2005, business services accounted for the largest share of China's outward FDI stock (28.9 %), to be followed by wholesale and retail (20 %), mining and petroleum (15 %), transportation and storage (12.4 %), and manufacturing (10 %).

**Table 3.4.10**  
**Shares of Actually Used in Percentage (%) by Sector (1997-2002)**

Year	1	2	3	4	5	6	7	8	9	10	Total
1997	1.39	64.21	4.58	3.21	3.66	3.10	11.42	4.39	0.64	3.41	100.00
1998	1.37	57.54	6.82	4.54	3.62	2.60	14.10	6.33	0.79	1.87	100.00
1999	1.76	57.44	9.18	2.28	3.85	2.39	14.10	6.33	0.79	1.87	100.00
2000	1.66	64.91	5.51	2.24	2.49	2.11	11.63	5.37	0.53	3.57	100.00
2001	1.92	67.66	4.85	1.74	1.94	2.49	11.03	5.54	0.59	2.24	100.00
2002	1.95	70.87	2.61	1.36	1.73	1.77	10.94	5.58	0.69	2.50	100.00

Sector 1 consists of farming, forestry, animal husbandry and fisher.

Sector 2 represents secondary industry which consists of mining, quarrying and manufacturing.

Sector 3 consist of production and supply electrical power, gas and water.

Sector 4 consist of construction, geological prospecting and water conservancy.

Sector 5 consists of transport & storage, post and telecommunication services.

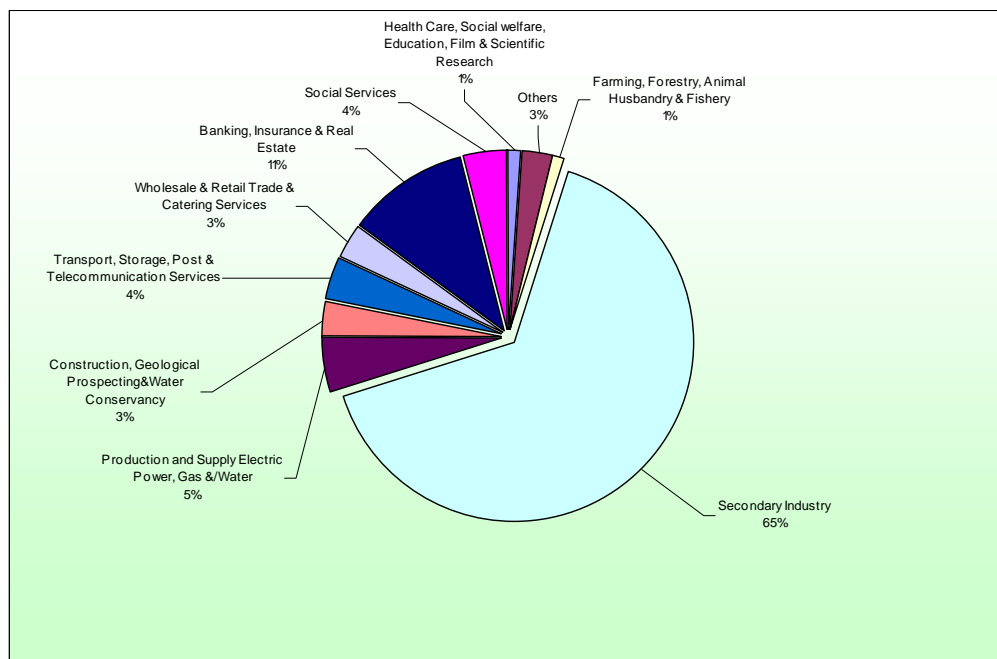
Sector 6 consists of wholesale & retail trade and catering services.

Sector 7 consists of banking, insurance and real estate.

Sector 8 consists of social services.

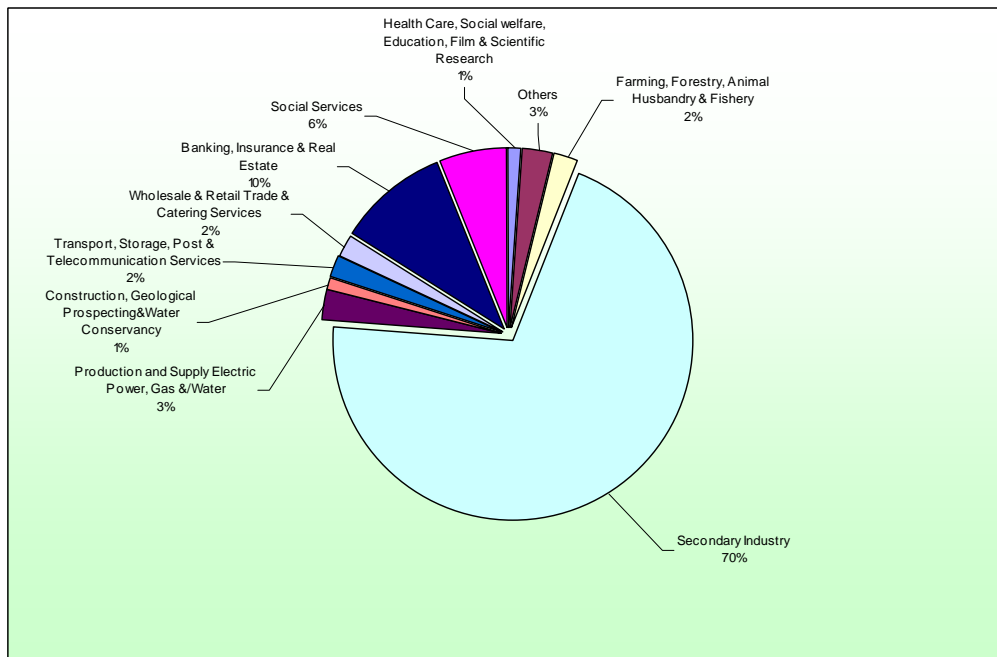
Sector 9 consists of health care, sports, social welfare, education, art, films, scientific research and polytechnic services.

Sector 10 consists of others industries.



**Figure 3.4.3: Shares of actually used of FDI in 1997**

*Source:* China Statistical Yearbook, 1998



**Figure 3.4.4: Shares of actually used of FDI**

*Source:* China Statistical Yearbook, 1998

The share of FDI in terms of amounts actually used sectors fluctuated slightly from 1997 to 2002. Accordingly to the available statistical data, as shown in Table 3.4.10 and Figure 3.4.3 and 3.4.4, Sector 2 or manufacturing, mining and quarrying had the strongest attraction for foreign investment, accounting for 64 percent of the total actually used amount of FDI in 1997. This figure then dropped somewhat nearly 57 percent in 1999 but it then rose to almost 71 percent in 2002, with the highest percentage of shares from 1997 to 2002. The sector with the second most inflow of FDI is sector 7, which consist of banking, insurance and real estate. The movement of percentage shares of sector 7 was quite different from sector 2 and sector 7 had approximately 11 percent of the total amount of FDI used in 1997 and increased to about 14 percent in the year 1998 and 1999, but its share then dropped slightly back to nearly 11 percent from 2000 to 2002. Note that the sum of the shares between Sector 2 and 7 accounted for more than 70 percent of the total amount FDI used over 5 years (75% share in 1997: 72 % share in 1998: 71.5 % share in 1999: 76.5 % share in 2000: 78 % share in 2001:and 81.81 share in 2002).

However, some sector was less attractive to foreign investment from 1997 to 2002. It can be noticed that the shares of the actually used FDI in Sector 3,4,5,6 and 10 decreased its share from 3.2 % to 1.4% in 2002. Sector 5 dropped from 3.7 % to 17% in 2002. Sector 6 moved down slightly to 1.8 % in 2002 from 3.1 % in 1997. Sector 10 also moved down slightly from 3.41 % in 1997 to 2.5% in 2002. Thus it is clear those different sector attracted different levels of FDI.

In accordance with the growth trend of inward FDI across sector, foreign investor have realized the importance of China's advantages in terms of a large market, fast economic growth and low labor costs for their investments and operations. The huge population means there are more potential customers and investors would be willing to move in.

### **3.4.5 Special Economic Zones:**

A special economic zone is a specific, delineated and duty free geographical region that has different economic laws of developmental process. It is a trade capacity development tool, with the goal to promote rapid economic growth by using tax and business incentive to attract foreign investment and technology. In China a

large number of SEZs are established which explores and details the procedure to be followed. This section explains the development pertaining to SEZs in China.

Many developing countries felt that the foreign capital has the necessary wherewithal in terms of providing monetary value, the required technology, the management practices and techniques and a sense of heightened competition essential for achieving higher economic growth. Various studies observed that foreign capital inflows to Asiatic region witnessed a continuous rise. The Foreign Direct Investment (FDI) inflow to Asia rose from a meager US \$ 5,280 million in 1983-85 to US \$ 15,588 million in 1990 and finally reached US \$ 80,299 million by 1998. China's story wasn't very different. Embarking on an open door policy in 1978, its initial modernization drive was accomplished due to the significant contribution of FDI. In a span of 15 odd years, China had become the second only to the US and by far the largest receiving country among developing countries.

All countries used different methods or instrument to attract foreign investors. One such important instrument was setting up of special geographical regions, popularly known as Export Processing Zones (EPZs) in the world. EPZs were practiced by many countries in the world to register high growth, promote exports and to create employment in the eighties and nineties the experiment with EPZs experienced an upward trend, totaling them to more than 850 around the world in 1998. In 2003, about 116 countries across the world had established EPZs and the number further went up to reach 3000- mark (World Economic Processing Zones Association). In China, they were better known as Special Economic Zones (SEZs). Chinese initiative of developing the SEZs in 1979 is a conscious and carefully planned effort. Central Government provided Guangdong and Fujian province with external autonomy including the competence to establish and regulate SEZs. Soon after the regulation on SEZs in Guangdong province was adopted in August 1980.

Special status was thus granted to these two coastal provinces to experiment with an alternative form of economic development apart from the mainstream policies of socialism. The year 1978 marked a watershed in the history of Chinese economy. The development strategy underwent a new paradigm shift-from import substituting policies to export led growth. Closer proximity to the sea coast and having access to free port system in Hong Kong the southern region became the favorite location for



Chinese leaders to established SEZs. With the establishment of SEZs, China could invite large amount of FDI for its economic development and got an access to international trade to integrate its economy with the world. During the 1980s developing countries received about US\$ 15 billion, about one-third of the total world trade flows.

In 1987, 70 percent of FDI came from Hong Kong and Macao, Taiwan, Malaysia and Singapore. This share, however, decreased over the years to 67 percent in 1996 and 54 percent in 1997. By 1995 it was also found that 96 percent of Shenzhen's textile industry and 95 percent of its garments industry were owned by Hong Kong investor (Lau, 2001). This indicates that the foreign flow from these countries to China is still controlled and decided by the overseas Chinese.

When China initiated its process of attracting foreign investment, it never meant it for SEZs only. Investment for the rest of the country was possible. That is why only part of the investment came to SEZs. Until mid-1980s the share of FDI in SEZs was 30 percent of the total foreign investment. And about 80 percent of the FDI in SEZs only came from Hong Kong and Macao.

Inflow of FDI also showed pattern of destinations. Some investors were attracted towards SEZs because of the preferential conditions while other located themselves in the major cities such as Beijing, Shanghai, Guangzhou, Dalian, etc. These investors were mostly interested in the manufacture of high-tech products as a result they were to keen have the skilled workers who can adapt and able to handle the technology application, plus demanded good infrastructure, wanted to remain closer to the political decision makers and invested larger volumes of capital in the individual projects. These investments came from developed countries like US and Japan who were interested in High-tech products and wanted to have strong foothold in the Chinese market. Examples are Volkswagon and Schindler in Shanghai and Beijing.

### **3.5 FOREIGN EXCHANGE RESERVE**

To keep the nominal exchange rate of the RMB against the US \$ stable at around 8.28 to protect export competitiveness, China's central bank began

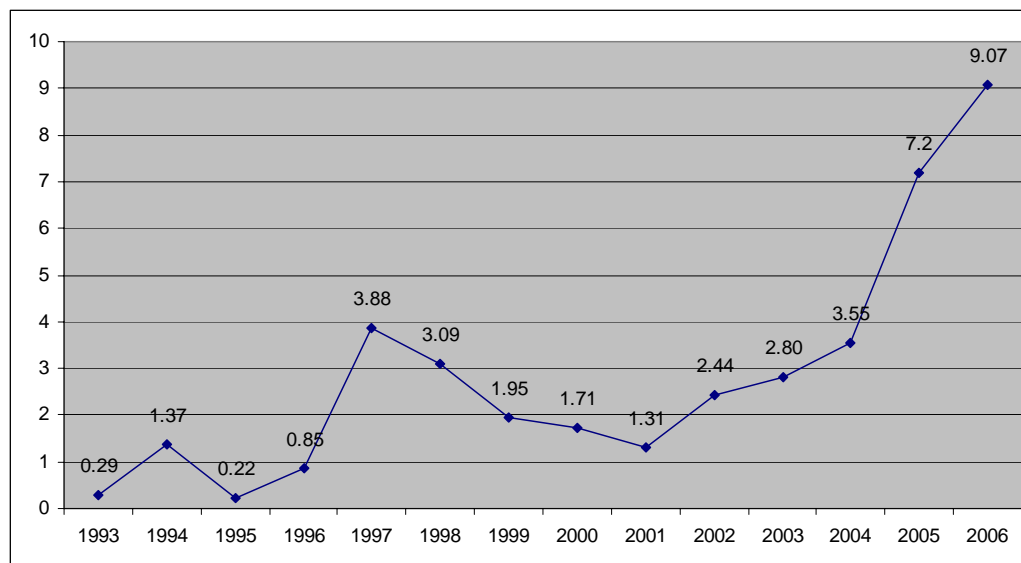
accumulating foreign exchange reserves as a result of its dollar purchases on the Shanghai inter bank foreign exchange market. Until 2003, however, reserve accumulation was considerably slower than the country's balance of payments surpluses (both on current and on capital account) would have suggested, because there was significant capital flight every year through 2002. The IMF estimate that the unexplained outflow of capital from China, reflected on the "errors and omissions" account of the balance of payments, averaged almost \$ 14 billion during that 9 year period. China is probably the only developing country that was able to build up official reserve in spite of significant capital flight over an extended period.

From 1994, China had current account surpluses every year through 2003 and capital account surpluses in all years, except 1998, when foreign banks sharply reduced their expose in China's in the wake of the Asian financial crisis. Even in 1998, however, China's official reserve increased, through only modestly, by \$ 6.2 billion.

Reserve accumulation accelerated in 2001 and 2002 when capital flight fell sharply. A dramatic turnaround occurred in 2003 capital flight reserved. Large amount of "hot" money, triggered by market expectations of RMB appreciation entered the country. This, together with continuing current account and "normal" capital account surpluses, explain the unprecedented increase in official reserves-more than \$ 160 billion-in the course of 2003. On the last day of 2003, PBOC transferred \$ 45 billion from official reserves to the accounts of two state-owned commercial banks (China Construction Bank and Bank of China) to strength their capital base. Without this transaction official reserves at the end of 2003 would have amounted to \$ 403 billion. Market expectations of RMB appreciation was not only fed by China's surprisingly strong economic performance in 2003-inspite of SARS-but also by growing international political pressures on China to revalue.

There are four indicators which indicate external imbalance and its exchange rate policies Indicator number one China's *global current account surplus* has grown without interruption over the past five years, mushrooming from about 1 percent of its GDP in 2001 to roughly 9 percent of GDP in 2006; (see Figure 3.5.1) China now has the largest global current account surplus in the world in absolute dollar terms and one that is

larger relative to the size of the economy than even the troublesome US global current account deficit <sup>3</sup> And in the first quarter of 2007, China's trade balance-which typically makes up the lion's share of the current account was twice as large as in the first quarter of 2006. In short, the Chinese government has been allowing China's global external imbalance to expand out of control.

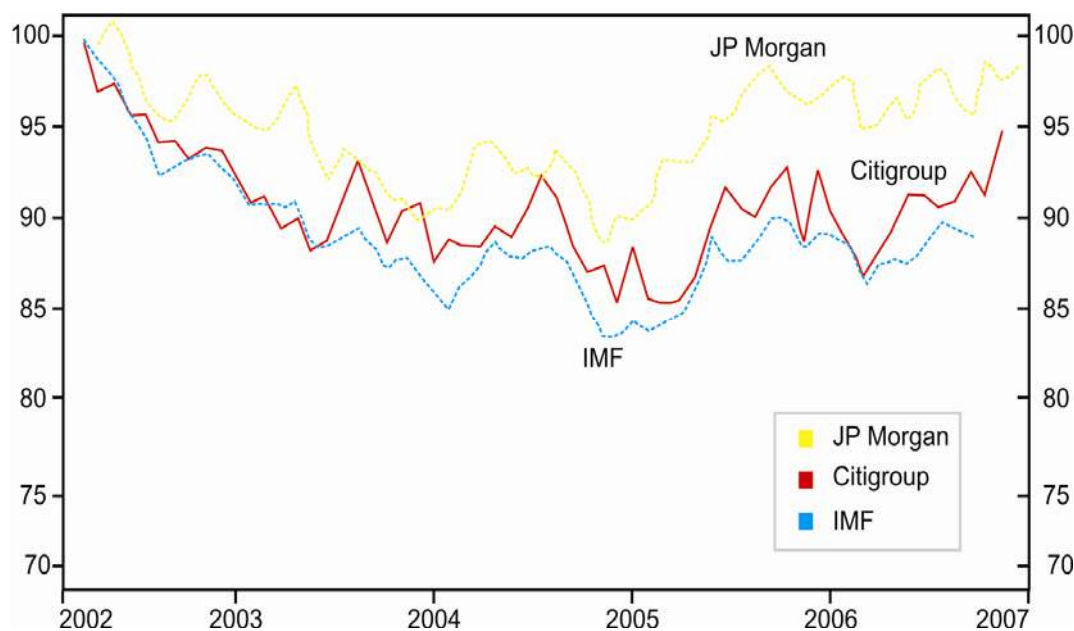


**Figure 3.5.1: China's global current-account balance (as a percent of GDP, 1993-2006)**

*Source:* China State Administration of Foreign Exchange and IMF.

Indicator number two: It is evident from Figure 3.5.1 that China's *real effective exchange* rate-widely regarded as a more comprehensive and superior measure of China's overall competitive position, than the nominal exchange rate between the US dollar and the Chinese RMB-has actually *depreciated* since the dollar peak in February 2002 (the qualitative conclusion is similar if the dollar's average value in 2001 is used as the base period). The depreciation ranges from 2 to 11 percent, depending on measures chosen; External payment adjustment call for appreciations of real effective exchange rates, that is, for declines in competitiveness, in countries with large global current account surpluses. But China's real effective exchange rate has moved in a direction opposite to what is needed. It is believed that because the RMB-US dollar rate has appreciated by about 6<sup>1</sup>/<sub>2</sub> percent since June of

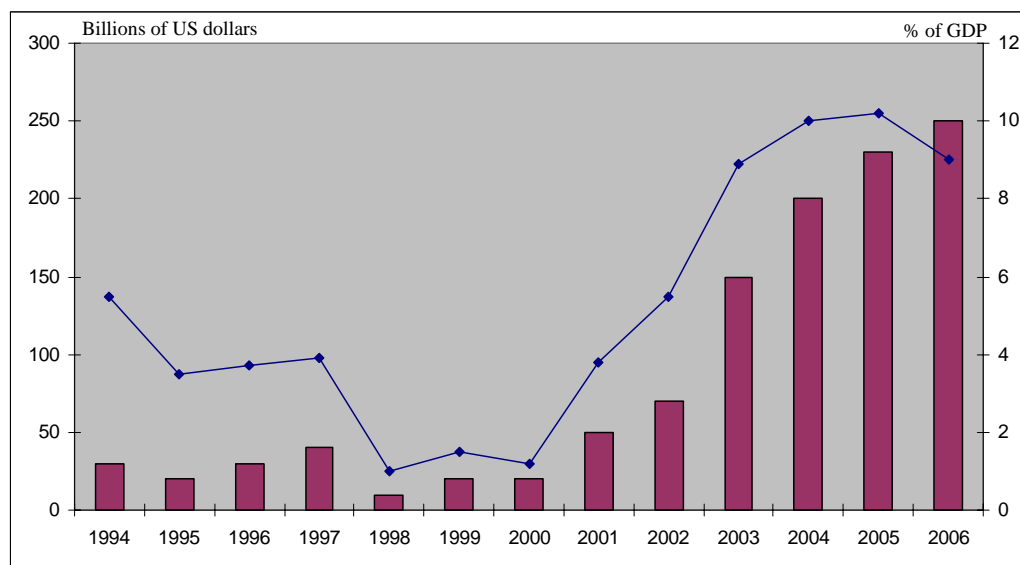
2005 from 8.28 RMB to the dollar to 7.73 (as of April 25, 2007) it must be making real progress on the exchange rate front. The sad truth is that the RMB is now grossly undervalued on the order of 30 percent or more against an average of China's trading partners and 40 percent or more against the US dollar-and that the appreciation of the RMB that has taken place to date against the dollar is completely inadequate to make a real dent in this huge surplus.



**Figure 3.5.2: Real effective exchange rate of the renminbi**

Indicator number three. This indicates is well known by analyzing Figure 3.5.2 When China launched its much-heralded currency reform in July 2005, the Chinese authorities said that they intended to increase *the role of market forces in the determination of the RMB*. No such thing has happened. The Chinese authorities have continued to intervene in the foreign exchange market in massive amounts-to the tune of about \$20 billion a month in 2006 and \$45 billion a month in the first quarter of 2007 to keep the RMB from rising if anything, the level of monthly intervention has been increasing relative to that prior (e.g., the first half of 2005) to the announcement of the "new" exchange rate system. In each of the past three years, China's exchange market intervention has amounted to roughly 10 percent of its GDP-a truly extraordinary amount; see Figure 3.5.3. Moreover, this heavy exchange market intervention has been accompanied by large so-called sterilization operations, thereby short-circuiting the

process (of domestic monetary expansion and rising inflation) by which large reserve accumulation would otherwise lead to a deterioration in China's competitive position even with little flexibility in the (nominal) RMB exchange rate. Whatever the rhetoric, the facts say that the RMB remains a heavily managed, quasi fixed exchange rate.



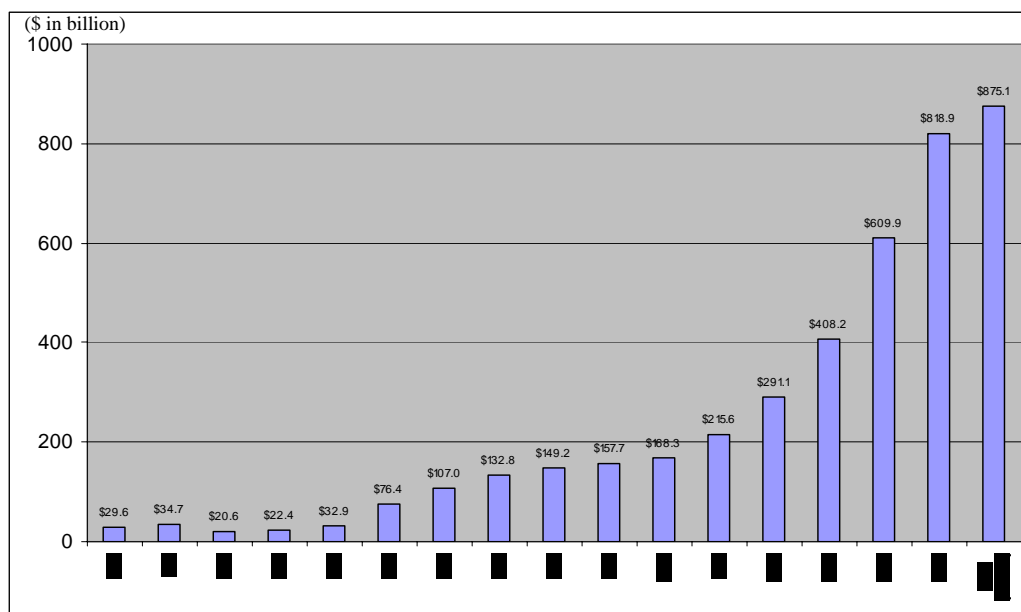
**Figure 3.5.3: Change in China's foreign exchange reserves, USD billions and as a share of GDP**

*Note:* The bars show billions of dollars and the line tracks percent of GDP.

*Source:* China State Administration of Foreign Exchange.

Indicator number four: compliance with China's obligations on exchange rate policy as a member of the IMF. Although each member country is obligated under the Fund's charter to desist from " ... manipulating exchange rates " and although one of the leading pointers of currency manipulation is large-scale, prolonged, one-way intervention in exchange markets, the *Chinese authorities continue to assert that they do not accept the concept of currency manipulation and that the level of the RMB exchange rate is solely a matter of China's national sovereignty.*" Simultaneously, although that same IMF charter enjoins the Fund to exercise "..., firm surveillance over the exchange rate policies of member countries" the Fund's Managing Director, Mr Rodrigo de Rato, has maintained repeatedly that he rejects a role for the fund as global "umpire" of exchange rate policies. Meanwhile, the US Treasury Department, while increasingly critical of China's exchange rate policies, has ruled rapidly in its recent reports to Congress (on international and exchange rate policies) that it cannot find

China guilty of currency manipulation because it cannot prove “intent” to manipulate. The practical upshot of this is that the international community is operating without an enforced international code of conduct on exchange rate policies. Indeed, it’s as if a new IMF charter has been informally agreed under which there are two guidelines on exchange rates. Guidelines I cover the obligation of countries; it states: “member countries shall do as they wish on exchange rate policies.” Guideline II covers the obligations of the IMF for exchange rate surveillance: it states: “Sorry, it’s not our job”.



**Figure 3.5.4: China’s Foreign Exchange Reserves: 1990-March 2006**

*Source:* Official Chinese government data

Merchandise trade surpluses, large-scale foreign investment, and its peg to the US dollar have enable China to accumulate the world’s second largest foreign exchange (after Japan). As seen in Figure 3.5.4, China’s accumulation of foreign exchange reserves has been particularly acute over the past few years. China’s total reserves reached \$ 875.1 billion at the end of March 2006; more than double the level China’s had at the end of 2003. As of February 2006, China has become the world’s largest holder of foreign exchange reserves. Many analysts contend China’s reserve could hit \$ 1 trillion by the end of 2006.

A quality distribution of Foreign Exchange Reserve is mentioned in Table 3.5.1 where China's exchange reserve has increased to a peak value of 1248.57 in the fourth quarter of 2007. The surge in China's foreign exchange reserves proves that the continuous economic growth distinguishes the contribution of the trade surplus to foreign exchange accumulation as well as speculative capital inflows.

**Table 3.5.1**  
**Foreign Exchange Reserve: Quarterly Indicators**

Year	Foreign Exchange Reserve ( US \$ Billion)
2004(a)	444.427
2004(b)	475.10
2004(c)	519.00
2004(d)	614.5
2005(a)	663.19
2005(b)	714.95
2005(c)	772.26
2005(d)	821.51
2006(a)	877.61
2006(b)	943.61
2006(c)	990.45
2006(d)	1068.49
2007(a)	1106.81
2007(b)	1159.37
2007(c)	1204.04
2007(d)	1248.57

*Sources:* Economic Intelligence Unit, China Country Report, March 2008

### 3.6 EXCHANGE RATE POLICY

#### **Main Characteristic:**

After exchange rate unification, the system of retention rights was no longer needed; it was abolished on 1 January 1994. The Foreign Exchange Certificate, special currency for foreign tourists and foreign residents in China, issued at the official exchange rate, was also discounted. At the same time China began the process of gradually eliminating the system of differential domestic pricing for foreigners and local access to shops and markets that had until then been reserved for foreigners. Therefore, exchange rate unification also triggered significant movement towards domestic market integration and price harmonization. Today, few in China remember the differential of markets for foreigners and locals that existed only ten years ago.

Although, one can safely say that China's exchange rate unification of 1 January 1994 was extremely successful and a significant step forward in the reform process. At the same time, an important source of corruption and market distortions had been removed.

Proponents of currency revaluation cite the balance of payments situation, and the fact that following a 33% cut in the official rate on January 1, 1994, the dollar rate has effectively been pegged at 8.3 RMB, with a fluctuation range of 0.3% from the previous day's rates. The exchange rate has thus not been adjusted to reflect productivity growth and differences in inflation rates.

Putting aside the complex debate on the issue of calculating fair currency value and the disparity with the actual value, the policy options available to Chinese authorities make it unlikely that the currency will be revalued in the near future. As already seen, a high growth rate must be sustained to absorb the surplus labor from state-owned companies and the rural sector, as well as to reduce the relative size of the bad loan problem and alleviate the fiscal imbalance. Market opening in goods and services to 2006, as stipulated by the conditions of WTO accession, will increasingly affect the balance of payments structure and fair exchange rate level. As long as the preconditions for deregulating capital transactions and implementing a variable exchange rate system are not achieved—including a sound and strong financial system, regulatory oversight, corporate governance, and accounting system—the central government is apt to limit deregulation of capital transactions, and prioritize currency stability to boost exports and direct investment.

### **The Nominal versus the Real Effective Exchange Rate of the RMB:**

After exchange rate unification on 1 January 1994, inflation in China continued relatively high for some times. The economic overheating problem was not brought under control until the end of 1996 when China claimed to have made a “soft landing”. Reflecting the progress in domestic macroeconomic management, China felt confident enough to subscribe to Article 8 of the IMF Charter at the end of 1996. This means that China agreed to a bid by IMF rules for currency convertibility for current account transactions, another significant step forward on the road of market reforms.



In the meantime, China's real effective exchange rate, which is a much more meaningful indicator of changes in the country's export competitiveness than the US \$, because domestic inflation in China was higher than in the United States. This changed in 1998 when China began to experience domestic price deflation for the first time, while low inflation continued in the United States. China's real effective exchange rate appreciated against the US \$ (all major currencies) until the end of 1997, depreciated in 1998 and 1999, appreciated again in 2000 and 2001, and depreciated thereafter until the time of writing. On balance during the period 1994-2003 the RMB appreciated by about 10 % against the US\$. If December 1997 is taken as the base period instead of January 1994, China's real effective exchange rate depreciated by about 10 %. The answer to the question whether China's real effective exchange rate has appreciated or depreciated against the US \$ depends critically the choice of base period. In the mid-1990s, the RMB was the only major currency to appreciate against the strong US \$ of that time, both in nominal and real effective terms. Naturally, since the RMB was effectively pegged to the US \$, China's real effective exchange rate appreciated even more strongly against the European currencies and the Japanese Yen in that period. Relative to 1994, the real effective exchange rate of the RMB had appreciated some 40 % against the real effective exchange rate of the Yen by the end of 2003.

#### **China's Currencies during the Asian Financial Crises of 1997-1998:**

China was the only major Asian economy that was relatively unaffected by the crisis and the RMB was the only major currency that did not depreciate. It did not have to be devalued, because China's balance of payments remained strong during the crisis, while size and maturity composition of its external debt gave no reason for concern. Moreover, China kept strict controls on capital account transactions, which made it very difficult to speculate against the RMB, even if market operators had wished to do so. Nonetheless, many in China feared that the sharp currency devaluation in neighboring countries triggered by the crisis would undermine the country's export competitiveness; there was considerable sentiment in China in favor of devaluation. Discounts for the RMB on domestic black markets for foreign currencies revealed that many expected devaluation. However, the government decided wisely not to devalue and to maintain the fixed dollar rate that had prevailed

since 1994. China was praised for its decision by the United States and by countries in the region.

### **Exchange Rate Policy**

Most Directors noted that there is no clear evidence that the renminbi is substantially undervalued at this juncture. Director also felt that a currency revaluation would not by itself have a major impact on global current account imbalances- particularly given China's relatively small share in world trade. Nevertheless, Director considered that the rapid build-up of foreign exchange reserves indicates some pressure on the exchange rates and imposes cost on the Chinese economy, especially difficulties in preventing excessive monetary expansion. In the context, Directors observed that increased flexibility of the exchange rate over time would be in the best interest of China. In particular, it would allow more room to pursue an independent monetary policy help cushion China's economy against adverse shocks, and facilitate adjustment to the major structural reforms that are underway. Directors considered that China could, in a phased manner, introduce more flexibility to its exchange rate without causing major disruptions to its economy. Most Directors stressed that a move towards flexibility should be carefully planned and sequenced with ongoing structural reforms that are crucial to its success, and emphasized the need to move speedily with these reforms. They felt that the timing of a shift towards greater exchange rate flexibility should be left to the authorities to decide. A number of Directors, however, felt that the authorities should take advantage of the present circumstances to take quickly an initial step toward greater exchange rate flexibility. Directors underscored the need to improve the functioning of the foreign exchange market by eliminating trading restrictions and surrender requirements, widening the base of participants, and developing instruments for foreign exchange risk management.

### **Exchange rate policy as an instrument of export promotion**

As other East Asian countries previously, China has relied extensively on an undervalued exchange rate of the national currency to promote exports (Pomfret, 1997). The Bank of China was aggressively purchasing foreign currency to build up its reserves, so that renminbi remained strongly under priced during the whole period of reforms. The ratio of Chinese foreign exchange reserve to GDP increased from 5

percent in 1980 to 16 percent in 1998, where as the ratio of reserves to monthly imports of goods and services increased from 6 to 11 during the same period (World Bank, 2000b). For other developing countries, excluding those in East Asia, the ratio of reserves to GDP is typically much lower (for the world as a whole it is only about 8%). As a result of these persistent efforts to keep the exchange rate low, Chinese domestic prices in dollar terms remained at a level of 20%-25% of the US prices (for other developing countries this ratio is typically around 50%), which in turn created obvious advantages for Chinese exporters.

After the 1997 currency crises and devaluations in many Asian countries, China promised not to devalue its currency. Such a stand was based on political rather than economic considerations. China tried to avoid competitive devaluations, which would make it even more difficult for other East Asian countries to endure the storm, even though the policy of stable yuan involved obvious costs - in 1998 the rates of growth of Chinese exports dropped from double-digits to zero. In 1999-2000, however, the strong growth of exports resumed.

The currency of China is Renminbi; its unit is yuan (Y). As China's legal currency, Renminbi is issued and controlled solely by the People's Bank of China (PBoC). The exchange rates of the Renminbi are decided by PBoC and published by the State Administration of Exchange Control (SAEC). China adopts a regulated, floating-exchange-rate system based on market supply and demand. Along with its financial reform, China will further explore and improve the exchange-rate regime based on its economic development and performance as well as international balance of payment. On December 1, 1996, China formally accepted the Article Eight of the Agreement on International Monetary Fund, and realized the Renminbi's convertibility under the current account ahead of schedule.

On July 21, 2005, China cut the yuan's decade-long peg to the dollar, allowing its currency to move in a restricted float. China's central bank announced that the renminbi would no longer be pegged to a single currency following the rate reform. Instead, as the value of the yuan will be adjusted with reference to a basket of currencies, the mutual changes of major currencies in the world market would reduce the yuan's fluctuation.

Dominant currencies used to determine the value of the yuan are the US dollar, the euro, the yen and South Korea's won. The Singapore dollar, pound sterling, the Malaysian ringgit, the Russian rouble, the Australian dollar, the Thai baht and the Canadian dollar are also considered in the calculation.

An exchange rate left unchanged for 11 years generated great interest in case of China. Outside government circles calls for greater exchange rate flexibility also became the norm from economist in the international organization such as IMF etc. A year wise variation in exchange rate gives a clear perception of exchange rate from the following Table 3.6.1

**Table 3.6.1**  
**Exchange rate: Quarterly Indicators**

(US\$ Billion)

<b>Year</b>	<b>Exchange Rate</b>
2001-2005(b)	8.277
2005(c)	8.092
2005(d)	8.07
2006(a)	8.017
2006(b)	7.996
2006(c)	7.909
2006(d)	7.809
2007(a)	7.734
2007(b)	7.616
2007(c)	7.74
2007(d)	7.73

*Sources:* Economic Intelligence Unit, China Country Report, March 2008

### 3.7 CONCLUSION

The so-called "half way house" economy which characterized China's economic growth for a period of a decade and a half performed extremely well, which goes against the basic beliefs among economists. One such belief is that market socialism cannot work. This belief however, went against the Chinese approach towards reform, which stressed the need to combine virtues of market and plan. Many

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observers stressed that the transition from a socialist to a market economy should be fast and done quickly. Another belief among economists is that enterprises will not respond in desirable ways to market signals unless private property rights are established. In all important areas of China's economy in the 1980's, however, transparent and legally protected individual property rights were the exception. In a village community, property rights for a piece of land were not distinguished in any tangible form such as a deed. China managed to succeed under these conditions, because the ability to gain from entrepreneurialism was absent, and ownership rights were ill-defined. Exports were promoted and imports were controlled according to administrative decisions at the industrial bureau or foreign trade corporation level, rather than by individual enterprises. Despite what economists would predict as a poorly performing economy, a striking shift occurred in China's growth. China outperformed all other developing countries in terms of exports and output growth in real terms. Performance-based monitoring and rewarding system become an organic part of Chinese politics. One party government gives Chinese central authority a power to implement its policies effectively and to reward or punish its local officials. Under such governance, a yardstick competition among local governments is introduced to generate the sources of dynamics in investment and output growth. China did not copy any model to trigger its economic growth. What it did was to give up the ideology that constrains its will to choose the right way to catch up. China set the growth target when it began the slow process of economic reform, and when China began economic reforms, its aim was not to replace the old system, but to make some change of it. The evolutionary process of China's economic reform helps induce rather than retard economic growth.

China finds a better governance to serve its goal of growth. And during the early phase of economic development, when the average income of population is much lower, the growth target is easier to be placed on the top of government agenda. What challenges China in the future is how Chinese system responds effectively to diversified interests of society and how Chinese government enforces its cohesion when growth target is no longer on consensus. For instance, China's rapid growth from below has increasingly enlarged the regional income disparity and social income gap in the past decade. These problems threat social and political stability in China. China needs to manage these social problems. Recent experience has indicated that

China is on the crossroad between implementation of growth target and moving towards to more distributional policies.

Economic growth is not the same as economic development. In the past 17 years, China has achieved rapid economic growth, but made little progress in economic development. Without the essential parallel development of supporting market institutions and conventions, eventually the economic costs of growing chaos and wastefulness will override whatever remains of the economy's growth potential. Second, the comprehensive reform program launched in 1994 reflects the authorities' recognition of the numerous basic deficiencies in the economy, requiring correction. In the last two years, considerable progress has been made in foreign trade and foreign exchange liberalization, the development of a modern tax code and revenue-sharing arrangements, as well as in social and economic legislation. However, despite these impressive achievements, enormous difficulties continue to confront enterprise reform, housing and social welfare, tax administration, financial reform, and law enforcement. China's output growth is sustainable into the next century, say, to 2010, if and only if it succeeds in implementing its current comprehensive reform program. Predictions of China's becoming a great economic power by the year 2010 are greatly exaggerated. At best, it could become another newly industrialized country. Nevertheless, because of its sheer size China remains an attractive market for businesses that are experienced in trading with or investing in developing economies. China's role in the world economy, the nation's open-door policy has contributed greatly to the success of its economic growth but, at the same time, exposed its economy to the vicissitudes of the world economy and world politics. That is the price of being a member of the world community. Like all other members, China too must be prepared to accept the rules and obligations of the community-both in form and in spirit.

In the coastal region of China, which possesses a pool of intelligent educated R&D staff and skilled labor and hosts most of China's R&D activities and top universities and research institutes and where inward FDI has evolved from labour-intensive processing activities to more strategic asset-seeking type FDI by major MNEs, FDI has played a significant role in promoting regional innovation capacity as well as regional innovation efficiency over the 2000-2004 period. This increased

regional innovation and technological capability contribute further to the fast regional economic growth in this region. However, in the inland provinces, they have not experienced such innovation-growth-promotion effect of FDI. China's export competitiveness hinges on the coincidence of several factors: the favorable exchange rate, low wages and available supplies of unskilled labor, the reduced cost of communication and transportation, the flow of foreign direct investment and foreign management and its implications for China's productive abilities, the large scale of the potential Chinese domestic market, the opening of world markets, and the encouragement of Chinese foreign trade policy. On the other hand, certain considerations have special importance. For example, Chinese export growth is more than a matter of low wages and an undervalued exchange rate. Chinese producers have become greatly more proficient at meeting world requirements for quality and product design. The large inflow of foreign direct investment and entrepreneurship, which is responsible for much of the export flow, has facilitated this process, and, in turn, reflects the favorable economics of export production in China. The shift of Chinese production toward more advanced products with technological content is also notable.

Credit growth and investment growth have slowed down from the torrid rates of the end of 2003 and the first quarter of 2004. But credit, investment in real estate, overall investment and above all exports are still growing more rapidly than the overall economy. All were already large in relation to China's GDP, and all are still growing relative to China's GDP. Real investment is now close to 50% of GDP – and China's capital stock is no longer so small that it is obvious that China can *profitably* re-invest half of its yearly domestic product. China now exports over \$600 billion worth of goods to the rest of the world – not all that much less than the US. It is not clear that its exports can keep on growing at 35% y/y.

China's growth is strong, but it is based on the rapid expansion of sectors of its economy that are already well developed. That can work for a while, but it also adds to China's internal imbalances. The last time around when investment rate spiked from 35% to 45% of GDP in the early 1990s, the outcome was a hard landing. The risk of another – economically painful and socio-politically destabilizing - hard landing is still high. China's existing growth model looks to be running up against

real limits, both internally and globally. Sustaining growth will require reorienting China's economy – and relying, at least on while, on rapid expansion of domestic consumption to sustain growth. Its rapid rate of GDP growth and the boom in exports and international reserves are without precedent. The latter phenomenon of course is a joint product: not only is it unprecedented for an emerging market to be such a large creditor, but it is equally unique for a reserve currency country to be such a large debtor. Still, the reserve buildup is at least in part a testimony to China's competitiveness and of course to its massive savings rate. Moreover, by joining the WTO and welcoming capital inflows, it is signaling a desire to open its economy to international influences and, in turn, to influence international developments.

The Chinese government currently faces a number of major policy choices relating to the foreign investment policy framework its priorities are:

1. To continue to attract high-technology, large ticket investment, in order to pursue industrial restructuring and to foster import-substituting investment;
2. To attract large sums of FDI into infrastructure, where expenditure of over nearly \$750bn is expected to be needed;
3. To attract investment into the interior provinces, consonant with the aim, enshrined in the current ninth Five Year Plan, of spreading development inland;
4. To design an investment regime which, while it does not conflict with the demands of membership of the World Trade Organization, also allows for the pursuit of industrial reform at a measured pace; and
5. To open the domestic market to foreign investment across a broader spectrum.

With its entry into the WTO, China has emerged as a leading trading power in the global market. To meet its commitments to the WTO, it has reduced tariffs and removed most of non-tariff barriers. Low wages are the main source of China's comparative advantage along with high labor productivity. China has developed a strong comparative advantage in assembly stage of technology/capital intensive products and processing trade for number of products. The supply of skilled labor is high in China, which increases its potential to produce skill intensive products. China will intensify competition in developing countries domestic market. However, the



safeguard measures and restrictions that are included in the protocol of accession of WTO may limit its ability to some extent. For all developing countries, including India, competition with China has intensified in the third markets for labor-intensive goods such as textiles, clothing, light manufacturing products, leather products and marbles and granites. China is also fortunate in the sense that its high savings rate, cheap labor force and attractive domestic market means that it does not face the same opportunity cost other developing countries might when retaining capital controls. It is incorrect to say that China has not liberalized capital controls. Restrictions over FDI have been gradually liberalized to the extent that in 2002 China received more FDI than any other country in the world. Consequently, the opportunity cost to China of maintaining the capital controls that support exchange rate stability is foregoing access to more non-FDI capital (that in aggregate it does not really need anyway) and the chance for domestic savers to earn higher returns abroad. Given that macroeconomic stability, foreign trade and FDI have underpinned the rapid growth in living standards during the reform period, forgoing the opportunities of higher returns abroad is likely to be considered an acceptable sacrifice by the average Chinese saver.

China's foreign exchange reserves are reported to have reached \$ 853.7 bn in late February 2006 when China surpassed Japan's \$ 650.1 bn to become the world's largest holder of foreign exchange. Beijing is now faced with the growing challenge as to how to handle these vast reserves effectively. China's soaring foreign exchange reserves not only show how its overall strength has grown, but have also created internal and external pressures on the balance the Chinese economy. The accumulation of large foreign exchange reserves was beneficial during the process of economic reforms, but the recent further rise has tended to exacerbate its imbalance of payments, with risks for China's financial system. The Chinese government has started to consider whether its accumulated foreign exchange reserve are excessive and intends to undertake effective measures to address the issue. China's steady accumulation of foreign exchange reserve was beneficial over the past two decades, but the recent rapid build-up has brought about implied risk and problems for the Chinese economy. In particular, rapid and huge speculative capital inflows have contributed to a huge rise in its reserves and increased risk to the financial system. With strict controls on capital flows, it is safe and necessary for the government to reduce its foreign exchange reserves gradually and carefully. It is estimated that

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foreign exchange reserves of around \$ 400 bn would have been appropriate in 2005 under circumstances of a managed floating exchange rate regime and capital control. China's actual reserves have far exceeded its normal demand. The spending and investing of foreign exchange reserves should be undertaken in combination with liberalization in the capital account, given careful consideration of assets duration match and risk problems. Liberalization should be extended further but gradually in order to allow companies and individuals to adjust to changes in financial markets and to manage a portfolio to avoid financial risks. During the first two months of 2006 the contributed rapid build-up of foreign exchange reserves suggests that speculative inflows, although they have abated somewhat, are still strong. The increase in the first two months of the year of about \$ 35 bn is partially accounted for by the first two months of the year of about \$12 bn and another \$ 5 bn surplus in foreign investment, with the remainder consisting largely of speculative inflows. As foreign exchange reserves continue to increase, the government must beware of speculative capital inflows and encourage reasonable outflows in the near future.

China should not change its exchange rate policies simply because other countries are urging it to do so. But by the same token, the fact that many are recommending a revaluation of the RMB is not sufficient reason for rejecting that policy option if it is the best one available. The main reason for revaluing the RMB by an appropriate amount is that it increases the odds that China will be able to achieve the economic objectives it has long pursued, namely, domestic financial reform, domestic macroeconomic stability, open market access for its exports, and a healthy, sustainable rate of economic growth. One cannot rule out the possibility that China will be able to rein-in excessive bank lending and rising inflationary pressures without exchange rate action by implementing administrative controls and (if that fails) by increasing domestic interest rates.<sup>56</sup> But the effectiveness of administrative controls over the medium term is uncertain, and higher domestic interest rates may suck in further capital inflows. If these measures do not do the job, imbalances will eventually grow in size, and there will be a need for more draconian policy adjustments thereafter. The exchange rate debate in China has emerged as one of the most talked about topics in international economics. There are numerous myths purporting to be facts and the debate regarding the appropriate degree of exchange rate flexibility is more one-sided than is desirable. There is little solid evidence that China's currency is

undervalued and even if it were, given the variation in equilibrium exchange rate estimates offered by economists, reluctance on the part of China's policymakers to significantly revalue the RMB is unsurprising. Many of the benefits currently accruing to China as a result of a stable exchange rate also appear insufficiently recognized and similarly many of the costs involved in moving to a flexible regime. Perhaps the most prominent shortcoming of the consensus position is that it fails to convincingly demonstrate how exchange rate stability is at the root of problems in China's economy today. China's economic performance over the past decade suggests that it has not been hopelessly trying to reconcile the "irreconcilable trilemma" from macroeconomic theory, which states that a country cannot simultaneously pursue free capital mobility, a fixed exchange rate and an independent monetary policy. While its capital controls are certainly porous to a degree, when combined with partial sterilization and monetary policy in which administrative tools remain effective, China has been able to maintain both macroeconomic stability and a stable exchange rate.

### **3.7 CONCLUSION**

The so-called "half way house" economy which characterized China's economic growth for a period of a decade and a half performed extremely well, which goes against the basic beliefs among economists. One such belief is that market socialism cannot work. This belief however, went against the Chinese approach towards reform, which stressed the need to combine virtues of market and plan. Many observers stressed that the transition from a socialist to a market economy should be fast and done quickly. Another belief among economists is that enterprises will not respond in desirable ways to market signals unless private property rights are established. In all important areas of China's economy in the 1980's, however, transparent and legally protected individual property rights were the exception. In a village community, property rights for a piece of land were not distinguished in any tangible form such as a deed. China managed to succeed under these conditions, because the ability to gain from entrepreneurialism was absent, and ownership rights were ill-defined. Exports were promoted and imports were controlled according to administrative decisions at the industrial bureau or foreign trade corporation level, rather than by individual enterprises. Despite what economists would predict as a

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poorly performing economy, a striking shift occurred in China's growth. China outperformed all other developing countries in terms of exports and output growth in real terms. Performance-based monitoring and rewarding system become an organic part of Chinese politics. One party government gives Chinese central authority a power to implement its policies effectively and to reward or punish its local officials. Under such governance, a yardstick competition among local governments is introduced to generate the sources of dynamics in investment and output growth. China did not copy any model to trigger its economic growth. What it did was to give up the ideology that constrains its will to choose the right way to catch up. China set the growth target when it began the slow process of economic reform, and when China began economic reforms, its aim was not to replace the old system, but to make some change of it. The evolutionary process of China's economic reform helps induce rather than retard economic growth.

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foreign exchange liberalization, the development of a modern tax code and revenue-sharing arrangements, as well as in social and economic legislation. However, despite these impressive achievements, enormous difficulties continue to confront enterprise reform, housing and social welfare, tax administration, financial reform, and law enforcement. China's output growth is sustainable into the next century, say, to 2010, if and only if it succeeds in implementing its current comprehensive reform program. Predictions of China's becoming a great economic power by the year 2010 are greatly exaggerated. At best, it could become another newly industrialized country. Nevertheless, because of its sheer size China remains an attractive market for businesses that are experienced in trading with or investing in developing economies. China's role in the world economy, the nation's open-door policy has contributed greatly to the success of its economic growth but, at the same time, exposed its economy to the vicissitudes of the world economy and world politics. That is the price of being a member of the world community. Like all other members, China too must be prepared to accept the rules and obligations of the community-both in form and in spirit.

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With its entry into the WTO, China has emerged as a leading trading power in the global market. To meet its commitments to the WTO, it has reduced tariffs and removed most of non-tariff barriers. Low wages are the main source of China's comparative advantage along with high labor productivity. China has developed a strong comparative advantage in assembly stage of technology/capital intensive products and processing trade for number of products. The supply of skilled labor is high in China, which increases its potential to produce skill intensive products. China will intensify competition in developing countries domestic market. However, the safeguard measures and restrictions that are included in the protocol of accession of WTO may limit its ability to some extent. For all developing countries, including India, competition with China has intensified in the third markets for labor-intensive goods such as textiles, clothing, light manufacturing products, leather products and marbles and granites. China is also fortunate in the sense that its high savings rate, cheap labor force and attractive domestic market means that it does not face the same opportunity cost other developing countries might when retaining capital controls. It is incorrect to say that China has not liberalized capital controls. Restrictions over FDI have been gradually liberalized to the extent that in 2002 China received more FDI than any other country in the world. Consequently, the opportunity cost to China of

maintaining the capital controls that support exchange rate stability is foregoing access to more non-FDI capital (that in aggregate it does not really need anyway) and the chance for domestic savers to earn higher returns abroad. Given that macroeconomic stability, foreign trade and FDI have underpinned the rapid growth in living standards during the reform period, forgoing the opportunities of higher returns abroad is likely to be considered an acceptable sacrifice by the average Chinese saver.

China's foreign exchange reserves are reported to have reached \$ 853.7 bn in late February 2006 when China surpassed Japan's \$ 650.1 bn to become the world's largest holder of foreign exchange. Beijing is now faced with the growing challenge as to how to handle these vast reserves effectively. China's soaring foreign exchange reserves not only show how its overall strength has grown, but have also created internal and external pressures on the balance the Chinese economy. The accumulation of large foreign exchange reserves was beneficial during the process of economic reforms, but the recent further rise has tended to exacerbate its imbalance of payments, with risks for China's financial system. The Chinese government has started to consider whether its accumulated foreign exchange reserve are excessive and intends to undertake effective measures to address the issue. China's steady accumulation of foreign exchange reserve was beneficial over the past two decades, but the recent rapid build-up has brought about implied risk and problems for the Chinese economy. In particular, rapid and huge speculative capital inflows have contributed to a huge rise in its reserves and increased risk to the financial system. With strict controls on capital flows, it is safe and necessary for the government to reduce its foreign exchange reserves gradually and carefully. It is estimated that foreign exchange reserves of around \$ 400 bn would have been appropriate in 2005 under circumstances of a managed floating exchange rate regime and capital control. China's actual reserves have far exceeded its normal demand. The spending and investing of foreign exchange reserves should be undertaken in combination with liberalization in the capital account, given careful consideration of assets duration match and risk problems. Liberalization should be extended further but gradually in order to allow companies and individuals to adjust to changes in financial markets and to manage a portfolio to avoid financial risks. During the first two months of 2006 the contributed rapid build-up of foreign exchange reserves suggests that speculative inflows, although they have abated somewhat, are still strong. The increase in the first



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two months of the year of about \$ 35 bn is partially accounted for by the first two months of the year of about \$12 bn and another \$ 5 bn surplus in foreign investment, with the remainder consisting largely of speculative inflows. As foreign exchange reserves continue to increase, the government must beware of speculative capital inflows and encourage reasonable outflows in the near future.

China should not change its exchange rate policies simply because other countries are urging it to do so. But by the same token, the fact that many are recommending a revaluation of the RMB is not sufficient reason for rejecting that policy option if it is the best one available. The main reason for revaluing the RMB by an appropriate amount is that it increases the odds that China will be able to achieve the economic objectives it has long pursued, namely, domestic financial reform, domestic macroeconomic stability, open market access for its exports, and a healthy, sustainable rate of economic growth. One cannot rule out the possibility that China will be able to rein-in excessive bank lending and rising inflationary pressures without exchange rate action by implementing administrative controls and (if that fails) by increasing domestic interest rates.<sup>56</sup> But the effectiveness of administrative controls over the medium term is uncertain, and higher domestic interest rates may suck in further capital inflows. If these measures do not do the job, imbalances will eventually grow in size, and there will be a need for more draconian policy adjustments thereafter. The exchange rate debate in China has emerged as one of the most talked about topics in international economics. There are numerous myths purporting to be facts and the debate regarding the appropriate degree of exchange rate flexibility is more one-sided than is desirable. There is little solid evidence that China's currency is undervalued and even if it were, given the variation in equilibrium exchange rate estimates offered by economists, reluctance on the part of China's policymakers to significantly revalue the RMB is unsurprising. Many of the benefits currently accruing to China as a result of a stable exchange rate also appear insufficiently recognized and similarly many of the costs involved in moving to a flexible regime. Perhaps the most prominent shortcoming of the consensus position is that it fails to convincingly demonstrate how exchange rate stability is at the root of problems in China's economy today. China's economic performance over the past decade suggests that it has not been hopelessly trying to reconcile the "irreconcilable trilemma" from macroeconomic theory, which states that a country cannot simultaneously pursue free

capital mobility, a fixed exchange rate and an independent monetary policy. While its capital controls are certainly porous to a degree, when combined with partial sterilization and monetary policy in which administrative tools remain effective, China has been able to maintain both macroeconomic stability and a stable exchange rate.

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## 4.1 HISTORICAL PERSPECTIVES

### 4.1.1 INDIA AND CHINA PRE 1962:

India became independent two years before the Chinese Communist Party (CCP) secured power in China in 1949. India's first prime minister, Jawaharlal Nehru, initially conceived of a synergistic relationship between New Delhi and Beijing. Both countries had huge populations and immense developmental challenges, and were assumed thus natural partners. China and India also shared a wariness of Western political meddling. India, in fact, was the first noncommunist state to formally recognize the People's Republic of China (PRC). In 1954, talks in Beijing between Premier Zhou Enlai and an Indian government delegation resulted in the signing of the *Panchsheel* Agreement, which formally envisioned "peaceful coexistence" between China and India. The India-China honeymoon of the 1950s began to show signs of strain by the latter half of the decade. In 1956, the CCP promulgated its first official map of China and the surrounding area, rejecting the McMahon line first demarcated by the British colonial authorities in 1914. The map showed large swathes of Indian territory within the borders of China. The Indian government reacted angrily, accusing the CCP of arbitrarily extending China's borders. In 1958, to improve Chinese leverage in the altercation, the CCP ordered the covert construction of a network of roads. The Indian response—the construction of military posts along the McMahon line—proved unacceptable to the Chinese. In October 1962, the People's Liberation Army (PLA) launched a preemptive assault, obliterating India's weak and unorganized defenses. After a month of intense fighting, China declared a unilateral ceasefire. The PLA withdrew from some of the conquered areas, but retained over 38,000 square kilometers of disputed territory. Diplomatic and economic relations between Beijing and New Delhi collapsed after the 1962 war. In the three subsequent decades, bilateral trade figures dwindled to negligible amounts.

The Sino-Indian Agreement was signed on April 29, 1954. There was nothing new in these principles which should normally guide the relations between two

independent countries not at war with each other. The first article of the agreement allowed the establishment of Trade Agencies by India in Yantung, Gyantse and Gartok and by China in New Delhi, Calcutta and Kalimpong. The second article fixed the trade marts in the respective countries. The government of China also agreed to specify ten places as trade marts and reserved the right to obtain from India as and when the need arose. Article 3 allowed pilgrims from India to go to Mount Kailash, Mansarovar and Lasha and from Tibet to Benaras, Sarnath, Gaya and Sanchi and certain passes were fixed for the pilgrim traffic. Subsequently in the month of October, 1954, a Trade Agreement was signed between the two countries at Delhi according to which China got two important concessions: the establishment of branches of the People's Bank of China in India. Both the Agreement had gone entirely in favor of China and against the interests of India. Moreover, the main commodity from Tibet, for which there was great demand in India, was Tibetan wool, and the Chinese diverted the entire wool trade to China. So there was little left for exchange.

In China, starting in the early 1950's, trade flows came to be controlled through a centralized planning system under the Ministry of Foreign Trade (MFT). A limited number of centralized Foreign Trade Corporation (FTC) under the MFT organized along product lines such as iron and steel and textiles and clothing and having branch offices in the main provinces that produced export products or used imported inputs conducted all trade. So inward looking did China become that its total trade in current dollars grew from \$ 3.15 billion in 1955 to just 4.6 billion in 1970. In December 1978 when China launched its "open door" policy, 12 such FTCs centrally controlled all its trade.

Christopher J. Rusko and Karthika Sasikumar Since the late 1950s, "relations between India and China have been fraught with tension and conflict. Yet the two countries have recently enjoyed a significant improvement in bilateral relations. In this article, we explore potential economic reasons for this rapprochement. We set out three possible mechanisms by which commercial interdependence could lead states toward peace, and then examine their operation in the India-China case. We conclude that the most likely explanation for the relational change is the concerted effort in both countries to be seen as responsible participants in the global economy. Thus,

general economic prudence, rather than any specific bilateral factor, may be having a positive effect on the India-China relationship”.

#### **4.1.2 INDIA AND CHINA POST 1962:**

Meanwhile, China was engaged in a similar, though even more far-reaching, transformation of its domestic economic regulatory framework. Most analysts point to the Third Plenum of the CCP (December 1978) as the harbinger of China’s economic transformation. Deng Xiaoping’s speech at this plenary went much further toward establishing a new economic model for China than any other previous reform. Deng pursued a policy of economic modernization, decentralization, and privatization.

Although he maintained a rhetorical focus on the “socialist” benefits of economic change, Deng parted with Mao’s trenchant anti private sector and anti-market exhortations. He also rejected Mao’s hostile attitude toward the West and the international system in general. The bellicosity of Mao’s “war and revolution” slogan was replaced with a declaration of “peace and development.” Deng stated that a world war was unlikely in the next decade, and argued that China’s constant state of war readiness was financially taxing, unnecessary, and counterproductive to the national interest. Rather than rejecting economic engagement outright, as Mao had done, Deng tied Chinese nationalism to the pursuit of wealth and commercial achievement. Upon taking over the leadership of the CCP in the early 1990s, Jiang Zemin continued Deng’s broad reforms. Jiang’s rhetoric and policies were even more explicitly global than Deng’s; China, he argued, could use its growing economic power to secure its rightful place at the table of the great powers. Jiang connected Chinese national identity to shrewd fiscal and commercial policy, innovative business practices, and robust market competitiveness.

Decentralization was crucial to China’s economic overhaul. Even before Deng’s landmark 1978 speech, the control of a number of state-owned industrial enterprises was transferred from the central government to local governments. By 1985, the central government controlled only 20 percent of the output from state-owned enterprises, whereas provincial, city, and county governments controlled 54 percent. The decentralization of state enterprises attracted more foreign capital; foreign investment increased from \$ 4.5 billion in 1985 to \$19.2 billion in 1992. In

1979, China created four special economic zones: Shenzhen, Zhuhai, Shantou (across from Hong Kong), and Xiamen (adjacent to the Taiwan Strait). After the fall of communism in Europe, some within the CCP reflexively sought to protect the party through re-centralization.

However, the winning factions within the leadership resisted this temptation, understanding that an end to economic growth would actually challenge the legitimacy of the CCP more than anything else. Moreover, the semi-privatized economy was now far too massive and dynamic for the CCP to rein in. Meanwhile, a bureaucratic transformation also helped usher in economic reform. Mandatory retirement age forced revolutionary veterans to step down, allowing less ideologically rigid civil servants to move into the public service. Bureaucrats were also allowed to move away from public service to join the business community. This educated group of ex-bureaucrats—comfortable with and well versed in the Byzantine nature of the Chinese business climate—formed a new entrepreneurial, commercially oriented class. From 1979 to 2003, China's economy grew at an annual rate of 8 to 9 percent. China's foreign trade volume increased twenty-four times in the same period, reaching \$1 trillion in 2004.<sup>24</sup> Between 1987 and 2000, China's exports grew from \$39.44 billion to \$249.2 billion. China's rapprochement with the United States—which began after President Richard Nixon's visit to China in 1972, and gained additional impetus after Deng's policy shift—facilitated a massive increase in the China-U.S. trading relationship. Between 1987 and 2000, Chinese exports to the United States, as a percentage of total U.S. imports, rose from 7.7 percent to 20.9 percent.

Following that, it provide a brief overview of the key changes in the Indian and Chinese economies in the last three decades, and concomitant changes in their political and diplomatic behavior. In the article's third section, we lay out three potential mechanisms linking economic interdependence and strategic de-escalation. The next section examines the operation of these mechanisms in the India-China case. We conclude with our predictions concerning the future conduct of Sino-Indian relations.

In 1971, India supported East Pakistan (later Bangladesh) in its war of secession from Pakistan. The role India played in the partition of Pakistan—a close



ally of China—and its refusal to renounce its nuclear ambitions, put China on guard. In the summer of 1974, India detonated an underground atomic device, proving its nuclear-weapon capabilities. Although Prime Minister Indira Gandhi (1967-1977; 1980-1984) ordered the 1974 test, she also pursued the renewal of the Beijing-New Delhi diplomatic relationship. Ambassadorial-level relations were restored in 1976. Although diplomatic tension reemerged as a corollary of the 1979 Sino-Vietnamese war, this was merely a small bump in relations; in 1980, Indira Gandhi returned to power and met with the Chinese premier, reaffirming her desire to maintain friendly ties with Beijing. She also indicated that she shared the Chinese aspiration for greater economic cooperation. China and India granted one another Most Favored Nation (MFN) trading status in August 1984. Nonetheless, as late as 1990, bilateral trade amounted to a mere \$190 million.

“Clash of the Titans,” *The Economist*, November 6, 2004. Rajiv Gandhi (1984-1988), more than any other Indian prime minister, focused his diplomatic efforts on reconciliation with China. In 1988, he made an historic visit to Beijing, the first prime ministerial visit in thirty-four years. These overtures led to the creation of a Joint Working Group (JWG) to address the border issue. Rajiv Gandhi and the CCP leadership also signed several scientific and cultural exchange agreements during this meeting. Prime Minister Narasimha Rao (1991-1996) continued Rajiv Gandhi’s diplomatic efforts. In 1993, Rao and Jiang Zemin signed an agreement for “the maintenance of peace and tranquility along the Line of Actual Control (LAC).” They also set up the India-China Expert Group of Diplomatic and Military Officers, tasked with advising the JWG.<sup>3</sup> These diplomatic steps led both the CCP and the Indian parliament to ratify mutual troop reductions along the LAC in 1997. Starting in the mid- 1990s, China also began to adopt more even-handed rhetoric in discussing Indo-Pakistani relations, and the issue of Kashmir in particular. The incremental advances made in Sino-Indian diplomacy were dramatically set back after India conducted tests of its nuclear weapons in 1998. A letter, sent by Prime Minister Vajpayee (1996; 1998-2004) to U.S. President Bill Clinton, was leaked to the New York Times. In the missive, Vajpayee defended the nuclear tests by pointing to China as a potential threat to Indian security. The Chinese government repudiated Vajpayee’s reasoning, calling his justification “utterly groundless.” China then declared Pakistan’s nuclear tests a necessary “reaction” to India’s “hegemonic designs.” Beijing also expressed

discontent by canceling the annual JWG meeting. However, shortly afterwards, India commenced a conscious process of reestablishing relations with China. There were several high-level meetings between the leaders of both countries, and the nuclear issue was put firmly on the back burner. When India and Pakistan were embroiled in a short, sharp war in the summer of 1999, China refrained from overt support for the Christopher J. Rusko and Karthika Sasikumar latter. In 2006, a Memorandum of Understanding on Defence Cooperation was signed during the Indian defense minister's visit to China. The agreement increased the number of military exchanges between the armed forces of the two countries. The move was hailed in India and abroad as facilitating a joint concentration on economic growth. The Chinese defense and foreign ministers made specific reference on the occasion to the goal of promoting prosperity in the region.

In sum, numerous diplomatic efforts have been made to expand Sino-Indian rapprochement over the last three decades. However, there remain points of genuine contention, with the demarcation of the border being the most salient. Although the JWG has met thirteen times, it has failed to bring about any formal alteration to the border. With China accepting Sikkim as one of the states of India, one of the long standing border disputes between the two countries has come to an end. This can be considered as a milestone in the relation of the two countries and the overall economic and business impact it will have on them .A free trade Agreement (FTA) between the two countries is on the cards, which if materialize will create a market housing 40 % of global population. India 's Foreign secretary, Shyam Saran in a press conference said , On both international and regional issues, we have common concerns and common objectives. Therefore, the merit is in working together than as rivals". But concerns about the domestic industry over trade pacts are pressurizing the government to open up trade with China only in phased manner. This will mean that the FTA will actually take several years to materialize. A panel has been set up to study the feasibility of the proposed FTA through China has currently agreed to the study, it is likely that it will pressurize India to hasten the process. However, the pacts on civil aviation, tourism, energy, science and technology and education will be a counterbalance for the hesitation showed by India in welcoming the FTA deal. As Joseph Nye, Professor at Harvard has commented, "The two countries recent rapprochement marks a huge change from the hospality that bedeviled their relations

following their 1962 war over a disputed border in the Himalayas. While the domestic industry is not very keen on the agreement, many are excited about the FTA. The chief mentor of CII, Tarun Das commented that. "A real gain from an FTA will be lower costs of products and services and competitiveness of the industry in the long-term, focusing on a massive twin market- of India and China". Experts are of the opinion that the fears of the domestic industry over increased competition and flooding of market are baseless, as India Inc. is itself a force to reckon with. Through India lags behind in the field of manufacturing (China's manufacturing is nearly 50 % of its GDP, at about \$ 650 bn per year, whereas India stands at about \$ 110 bn compared to its GDP of \$ 440 bn) it has indeed come a long way and is now exporting and investing internationally. Foreign companies have also shown increasing interest in Indian manufacturing sector and many have set up their outlets in the country. O.P Garg, President of the Federation of Indian Export Organization (FIEO) opines that, "FTA will boost investment as both Indian and Chinese majors would be willing to invest in the integrated market since market risk and uncertainty are minimized through preferential agreement" Liberalization of services under a compressive agreement will mean greater benefits to India, since services contribute to 51 % of the country's GDP as compared to 30 % in the case of China. India is strongly component in the field of financial services as well when compared to China's deeply-fawned banking system. India also has the upper hand in education and technical services with nine times more engineers than China. Retarding tourism, both are considered to be equal, and therefore it will be mutually beneficial for them in this sector. The Chinese Premier Wen Jiabao on his visit to India commented, "I strongly believed that if we join hands together, we will certainly be able to set a new trial in the IT business world. In the days to come, it will signify the coming of the Asian century of the century of the IT industry. Cooperation is just like two pagodas. One hardware and one software. Combined we can take the leadership position in the world" India Inc. has already made a mark on the land of the dragon. Almost all the major Indian companies have looked at manufacturing bases, forays or tie ups with China, are it the Tatas and Birlas or the new generation Narayan Murthys and Azim Premjjs. Even the 'Man of Steel' – Lakshmi Narayan Mittal is setting up a \$ 100 mn steel plant in the mineral rich Liaoning province.

Both countries, scared by their bitter experiences of foreign invasion, resisted any economic interests shown by foreign countries. After the Sino-Indian war of 1962, India and China severed their ties with each other and became complete strangers, even though they shared a common border. But the visit of Rajiv Gandhi to China in 1989, the then Prime Minister of India, brought a great deal of positive changes in the Sino-Indian ties. Now with both the giants walking hand-in-hand, instead of crossing each other's paths, there's little the rest of the world can do to stop them from becoming global economic powerhouse.

### **Growing bilateral economic ties:**

Sino-Indian economic engagement has a short history but a sharply rising trajectory. Although the two had signed an accord in 1984 granting MFN status to each other, bilateral trade was only about \$ 332m until 1992. It has grown steadily since then, except during 1998-99 following the Indian tests, reaching \$ 5 b in 2002, and \$ 13.6b in 2005. China now ranks as India's third largest trading partner, although India remains a distant 12<sup>th</sup> in China's foreign trade statistics. During Premier Wen's April 2005 visit, India and China set the foreign trade target of \$ 20b by 2008, and \$ 30 b by 2010. Given the compounded annual growth rate of over 30 % since 1999, reaching these goals should not prove difficult. What is more noteworthy, however, is the massive untapped potential for broader cooperation, but also the problems and challenges that these aggregate figures do not reveal.

The foreign trade volume of \$ 136b in 2005, with India's exports valued at \$ 7.67b and imports at \$ 5.93b, is table for two reasons. First, China has typically permitted its smaller neighbors to enjoy a trade surplus with it, whereas China's own largest trade surplus is with the United States. This approach, not unlike the US practice while aiding the recovery of Germany and Japan from their destruction during World War II helps China reinforce the image of its "peaceful rise" (helping *jueqi*) and enhance interdependence with these Asian economies. This is borne out in the recent Japanese and South Korean economic revival, with China displacing the United States as their largest trading partner. This is significant given that foreign trade comprises about 40 % of the GDP of these major world economies, and trade with China-especially for Japan-has curbed adverse policies despite their respective bitter memories of World War II.

The second and somewhat related aspect of India's minor trade surplus is the "irrational exuberance" that it generated about India's ability to successfully compete with China. However, a simple review of the basket of commodities that comprise India's exports to China reveals a more somber picture. Thus, iron, ore, slag, ash and steel account for over 60 % of India exports, followed by plastics, organic chemicals and cotton yarn. Further, the high earnings from iron and steel exports are buoyed by the current high international price of these items, fuelled in part by China's booming demand, which now accounts for almost one-third of the global iron and steel demand. And while China's infrastructure needs might sustain this demand and high prices for some years, India need to rapidly diversify its exports basket to sustain and increase its exports over the longer terms. On the other hand, India's imports from China is dominated by electrical machinery and equipments, organic chemicals, machine tools and mineral fuels. The imports basket thus reveals the clear cost advantage enjoyed by China in these higher value-added items over India.

Clearly, India risk becoming a supplier of minerals and semi-manufactured goods to China unless it rapidly steps up the production of higher value-added goods at internationally competitive prices and builds a more complicated issues of how India can successfully compete with China in increasing its exports of similar products and services globally, while also deepening trade and manufacturing ties with China. Public statements and policy signals emanating from New Delhi so far do not clarify how it seeks to resolve this Catch-22 situation or even whether it fully comprehends this dilemma.

### **Government-Industry Collaboration:**

The effort by the governments to deepen and widen economic cooperation became focused during 2000-2001 as India negotiated with China and then supported its entry into the World Trade Organization. From about the same time, Beijing has displayed a growing interest in harnessing India IT strength for its broader benefit. Thus, in mid-2000, the political leadership of Xinjiang province invited IT professional from India to help develop this backward region. Similarly, India's IT prowess has piqued the interest of the Chinese armed forces (PLA), whose military modernization emphasizes greater use of IT in CSIR (command, control, communications, computers, software, intelligence and reconnaissance). While China

appears keen to exploit India's IT and software strengths to integrate it with its hardware capabilities, corresponding Indian strategy-either to protect its commercial edge or secure a reciprocal bargain from China in another field-is not visible.

On a broader front, the Indian Navy has since 2000 undertaken a successful annual initiative called "Operation Milan" under which its ships make port calls in most countries through Southeast Asia and Japan, In 2004, Indian ships made their first-ever port call in Shanghai and the two countries plan to conduct a joint maritime exercise in the near term. Here too, while India pursuing a broader confidence-building approach, China's strategy-of developing close naval (military) ties with India response in the public domain.

In case, bilateral governmental efforts have generated a strong positive response from the business community, and greater synergies are beginning to emerge. The Confederation of Indian Industry (CII), India's premier consortium of primarily high value-added manufacturing companies, has partnered with Indian diplomatic missions in Beijing and Shanghai to organize two successful "Made in India" road shows during 2003and 2004. In May 2005, it partnered with the China Council for the Promotion of International Trade to organize a conference, "China's Miracle" attended by business majors and top commerce ministry officials from both countries. In addition, in recent years numerous business delegations, seminars and workshops at leading academic and policy institutions on each side have enriched the bilateral economic discourse and generated optimism about expanding commercial ties.

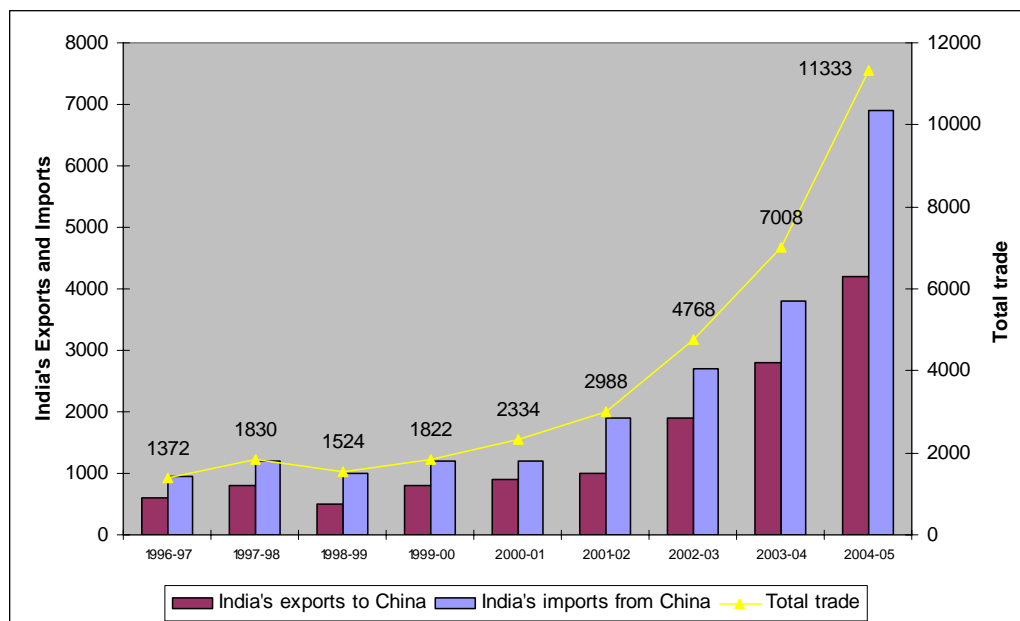
India's private sector in the IT and related hi-tech fields enjoys certain advantages over China. The IT sector developed during the 1990 from a combination of entrepreneurial ingenuity and governmental inattention. Consequently, firms were forced to optimized operating costs and complete for large shares of the global off-shoring and BPO market. Over time, they moved up the value chain to provide customized business solutions to global clients, created increasingly seamless division of lab our between local entities and their partners abroad, and have now accelerated global acquisitions to produce and supply to distant markets.

By contrast, it was only in 1999 that China's private firms were provided the same constitutional protection that was available to foreign business and the domestic public sector since the 1980s (Yasheng and Khanna, 2003). A related problem, stemming from China's decision to direct FDI and domestic capital toward its inefficient SOEs is that most private firms remain strapped for cash. This "unfair treatment" in turn prevents them from scaling up production to improve productivity, and consolidate operations by resorting to mergers and acquisitions in China or abroad (Srivastava, 2005; China Academic of Social Science, 2000).

By contrast, in spite of the remaining weakness in India, China's IPR protection is comparatively much weaker. As a new entrant to the W.T.O in 2001, China is obligated to improve its regulatory framework and enforcement mechanisms, and to curb the widespread patent infringement of foreign products and technology—from audio-visual to dual-use aerospace and nuclear items (March 2005). This is expected to take considerable time given the institutionalized form of corruption in the system, continued constraints on the operations of the private sector, and the sheer scale of the national industries that need training and supervision. This presents India with the opportunity to exploit its relative head-start and increase the share of its value-added exports to China.

Finally, India's banking and financial services sectors are also more developed than China's. With over 20 million shareholders, India has the third largest investor base in the world after the United States and Japan. The Indian capital market is significant in terms of development, volume of trading and growth potential. Its stock market capitalization of \$ 41 trillion as of March 2005 was the highest amongst the emerging markets, compared to \$ 450 billion in China. Clearly, India is in a position to assist in the development of China's nascent stock market and its relatively weak and non-transparent banking sector.

## 4.2 TRENDS IN INDIA AND CHINA BILATERAL TRADE



**Figure 4.2.1 Trends in India China Bilateral Trade**

According to the Indian Commerce Ministry data, India's imports from China rose from a paltry \$ 18 million in 1990-91 to approximately \$ 5.3 billion in 2004-05. India's imports from China expanded equally rapidly, from \$ 35 million to \$ 6.8 billion over the same period. So rapid has this expansion been that from an insignificant suppliers until the beginning of the 1990s. China trails the United States as India's top source of imports by less than \$ 100 million. In the last three years, India's exports to China have grown at the annual rate of almost 80 percent. Its imports have grown almost 50 percent per annum over the same period.



Table 4.2.1

**India –China Bilateral Trade Growth (1992-2004)**  
**Pattern and rate of Bilateral Trade growth (1992-2004)**

(Unit: \$ million)

Year	Indian Imports	Indian Exports	Trade Balance	Trade Volume
1992	158.44	180.1	+21.66	338.54
Growth	9.6%	49.6%		27.8%
1993	259.16	416.57	+157.41	675.73
Growth	63.5%	131.3%		99.6%
1994	573.00	322.00	-251.00	894.00
Growth	121%	-22.75%		32%
1995	765.00	398.00	-367.00	1,162.00
Growth	34%	24%		29.9%
1996	689.54	719.16	+29.62	1,406.00
Growth	-10.1%	80.9%		20.9%
1997	933.06	897.26	-35.8	1,830.32
Growth	36%	24.7%		30.2%
1998	1,016.59	905.70	-110.89	1,922.30
Growth	8.9%	0.9%		5%
1999	1161.890	825.792	-336.098	1,987.68
Growth	14.3%	-8.8%		3.4%
2000	1569.465	1350.414	-219.051	2,914.223
Growth	34.3%	63.9%		46.6%
2001	1896.268	1,699.966	-196.302	3,596.234
Growth	21.5%	25.6%		23.4%
2002	2671.728	2274.180	-397.548	4945.908
Growth	40.8%	33.7%		37.5%
2003	3344.993	4252.802	+908 (apprx)	7597.79
Growth	25.1%	86.9%		53.6%
2004	5927	7677	+1750	13604.1
Growth	77.3%	80.6%		79.1%

Source: China PRP

It can be observed from Table 4.2.1 that the bilateral trade between the two countries is steadily growing. India-China bilateral trade reached US \$ 13.6 billion in 2004 compared to US \$ 7.6 billion in 2003, from a low base of US \$ 338 million in 1992. India ranked 20<sup>th</sup> as the top trading partner of China in 2003 and this position went up to 12<sup>th</sup> in 2004. China is now the second largest trading partner of India after the USA.

Growth was witnessed both in exports and imports. According to the countries statistics, the balance of trade turned in India's favor with a surplus of US \$ 1750 million in 2004. Bilateral trade recorded consistent growth of over 20 % since 1992, except in 1998 and 1999 when it was less than 5 %. The total bilateral volume between the two countries has reached US \$ 13.6 billion in 2004, 79.1 percent higher than that in 2003, India's Exports to China reached US \$ 7.67 billion in 2004 up 80.6 percent compared to 2003 and the imports accounted for US \$ 5,927 billion up 77.3 percent.

#### **Resumption of Border Trade:**

Border trade, though small in volume, also plays a significant role in enhancing bilateral trade and economic cooperation. Moreover, it contributes to generate opportunities for the export of the commodities across the bordering provinces/states of the two countries.

- a. **Nathu La Pass:** India and China have signed a historic agreement to resume border trade through the strategic Nathu La Pass from July 6 after 44 years of closure, a move that could also signal Beijing's implicit recognition of Sikkim as part of India. The Nathu La Pass is 4,545 metres above sea level. It is 460 kilometers away from Lhasa and 550 kilometers from Calcutta. The pass used to be an important trade passage between China and India and part of the fabled 'Silk Route'. Currently China and India trade mostly by sea transportation.

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The reopening of the border trade route after 44 years since the Sino-India war of 1962 will give a major boost to the local economies of the land-locked mountainous regions of the two Asian giants. The reopening of Nathu La has implicitly signaled that the Chinese government has abandoned its policy of treating Sikkim as an independent nation “annexed” by India in ’75, the analysts said. Trade through Nathu La Pass accounted for 80% of the total border trade volume between China and India in the early 1900s. But the trade was suspended in ’62 after the India-China border conflict.

The agreement allows residents living on the border areas of the two countries to trade about 28 items mentioned in the border trade agreements of 1991 and 1992 as well as 2003. The items that could be traded includes agricultural implements, blankets, food grains, agro-chemical products, dry fruits, beverages and canned food. “The resumption of (Sino-Indian) border trade is a great historic event, not only for enlarging trade, but also for greater relations between the two great countries”. With the reopening of Nathu La Pass, iron ore and livestock products from India and wool, herbs and electric appliances from China can be transported into the other country through the short cut, Hao said.

- b. Shipki La Pass:** The border trade between India and China is conducted through Namgya Shipki-la village in Pooch sub-division of Kinnaur along the Namgya-Shipkila-Shipkl Jijubu land route.

The trade agreements between the two nations allowed residents of Tibet (China) and the Kinnaur district living along the border areas to import-export about 30 items only. The items allowed for export through Shipki la are agricultural implements, blankets, textiles, copper products, clothes, cycles, coffee, tea, barley, rice, flour, dry fruit, dry & fresh vegetables, vegetable oil, gur and misri tobacco snuff, cigarettes, canned food, agro-chemical, local herbs dyes spices, watches, shoes, kerosene oil, stationery, utensils, wheat etc. On the other hand, major items of import from China via Tibet include raw silk, goats, sheep, China clay, wood, utensils, textiles (mostly readymade garments), shoes etc

### 4.3 INDIA'S EXPORT TO CHINA

**Table 4.3.1**

**India's top 15 exports to China (2003 and Jan-Nov 2004)**

	Value (US \$ million)		% Share in India's total exports to china		% Change in 04/03
	2003	2004	2003	2004	
<b>INDIA</b>	3701.17	6928.4	1	1.36	87.2
Ores, slag, ash	1109.59	3894.82	29.98	56.22	251.02
Iron and steel	1007.45	543.05	27.22	7.84	-46.1
Plastic	292.2	362.1	7.9	5.23	23.92
Organic chemicals	245.51	319.12	6.63	4.61	29.98
Inorg Chem; rare earth mat	110.72	239.51	2.99	3.46	116.32
Cotton +yarn fabric	104.93	227.93	2.84	3.29	117.22
Precious stones, metals	150.92	213.32	4.08	3.08	41.35
Salt; sulfur; earth, stone	130.60	184.68	3.53	2.67	41.41
Machinery	60.03	119.62	1.62	1.73	99.26
Hides and skins	58.37	95.13	1.58	1.37	62.98
Copper+articles there of	31.38	77.64	0.85	1.12	147.4
Electrical machinery	37.57	69.15	1.02	1	84.04
Aluminum	12.82	56.58	0.35	0.82	341.41
Artif flowers feathers	35.09	44.36	0.95	0.64	26.41
Optic, nt 8544; med instr	30.84	39.77	0.83	0.57	28.93

*Source:* China PRP

It can be seen from Table 4.3.1 that substantial proportion of India's exports are raw materials. 56 percent of exports from India in 2004 were iron ore, slag and ash. The main products in India's export basket to China in 2006-07 were iron ore (US\$ 3.3 bn), other ores & minerals (US\$ 664.6 mn), raw cotton (US\$ 655.9 mn),

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non-ferrous metals (US\$ 590.7 mn), plastic and linoleum products (US\$ 318.9 mn), processed minerals (US\$ 346.0 mn), primary & semi-finished iron & steel (US\$ 354.5 mn), and dyes intermediates & coal tar chemicals (US\$ 221.9 mn).

China is the largest market for India's exports of iron ore (86.4% share in total), raw cotton (62.8%), mica (32.5%), processed minerals (30.4%), and ferro alloys (20.8%). China is also the second largest market for India's exports of guar gum meal (12.2%), primary & semi finished iron & steel (11.5%), and inorganic/organic/agro- chemicals (10.7%). Composition of India's export basket to China is skewed in favor of primary products. Key item of India's exports to China in 2003-04 included ores, slag and ash; iron and steel; plastics; organic chemicals; cotton. India's exports to China are highly concentrated as in 2003-04.

The momentum for increased bilateral trade is further reinforced by a high and sustained economic growth that is invariably accompanied by a higher and more broad-based propensity for consumption. India and China have revealed significant economic dynamism in the 1990s. The average GDP growth of China between 1990 and 2003 was as high as 9.3 %, and the annual GDP growth rate of India was 6.2 % between 1994 and 2002. In the oil meal and iron and steel bar/ore have registered a growth of over 100 percent in this period. The share of primary and semi finished iron and steel, processed minerals and cotton yarn has however declined in total exports from India and China. Iron ore and iron and steel accounted for a major share (about 47 %) of the total exports. Exports of other ores and minerals, marine products, inorganic/organic/agro chemicals registered a decline, both, in terms of percentage growth and as share of total exports from India and China in this period.

**Table 4.3.2**  
**Commodity Structure of Indian Exports to China**

HS		Export Volume (2003)	Percentage	Export Volume (1995)	%age
26	Ores, scoria, and mineral ashes	1,220,794,783	31.5	152,841,469	38.4
72	Iron & Steel	1,074,909,828	25.5	17,508,166	4.4
39	Plastic & plastic products	323,962,825	7.7	18,741,977	4.7
29	Organic chemicals products	273,293,830	6.5	21,220,758	5.3
71	Jewelry, noble metals & their products; modeled jewelry; coined	164,207,519	3.9	10,424,098	2.6
25	Salt, sulfur, soil and stone material; limestone & cement	144,580,172	3.4		
52	Cotton	126,845,770	3	24,401,789	6.1
28	Inorganic reactor, boiler, machinery equipment and their spare parts	127,216,583	3	17,666,368	4.4
84	Nuclear reactor, boiler, machinery equipment & their spare parts	78,361,988	1.9		
41	Peltry(furs excluded)& leather	65,969,329	1.6	24,276,701	6.1
15	Animal & plant oil, fat & wax; refined edible grease			28,688,752	7.2
3	Fish & other aquatic invertebrate animal			26,338,666	6.6
	<b>Total</b>	<b>3,710,142,627</b>	<b>88</b>	<b>342,108,744</b>	<b>85.8</b>

Source: China PRP

According to Chinese statistics based on Table 4.3.2 shows that top 3 export items accounted for 70 % of total exports. Top 5 export items accounted for 70.1 % of total exports. Top 10 export item accounted for 83.9 % of total exports. And in the top 10 exports ore, slag and ash accounted for 35 % of the total exports.

Mineral ores have always enjoyed a predominant status in India exports to China . The percentage of ores has however, reduced from 38.4 % in 1995 to 31.5 % in 2003. The percentage of two primary products of cotton, peltry and leather has also decreased by large margin. In the same period, the percentage of manufacturing products has considerably increased. The percentage of iron & steel rose by large margin from 4.4 % to 25.5 %, plastics and plastic products from 4.7 % to 7.7 % and

machinery equipments begin to rank among the top ten products in terms of total export volume recently. The percentage of organic and inorganic chemical products has remained around 10 % in total.

#### 4.4 INDIA'S IMPORTS FROM CHINA

**Table 4.4.1**

**India's top 15 imports from China (2003 and Jan – Nov 2004)**

	Value (US \$ million)		% Share in India's total exports to china		% Change in 04/03
	2003	2004	2003	2004	
<b>INDIA</b>	2960.32	5228.2	0.76	0.99	76.61
Electrical machinery	580.01	1219.56	19.59	23.33	110.27
Organic chemicals	561.9	727.23	18.98	13.91	29.42
Machinery	256.19	664.42	8.65	12.71	159.34
Mineral fuel, oil etc.	208.41	439.74	7.04	8.41	111
Silk; silk yarn, fabric	220.3	318.68	7.44	6.1	44.66
Impregnated text fabrics	110.87	158.86	3.75	3.04	43.28
Manmade filament, fabric	91.34	144.31	3.09	2.76	58
Inorg chem; rare earth metals	82.5	112.43	2.79	2.15	36.28
Plastic	50.31	103.74	1.7	1.98	106.21
Iron/steel products	49.86	101.68	1.68	1.95	103.93
Optic, nt 8544; med instr	57.56	72.2	1.94	1.38	25.44
Cotton+yarn, fabric	40.97	66.93	1.38	1.28	63.36
Iron and steel	20.24	64.76	0.68	1.24	219.89
Furniture and bedding	39.4	58.63	1.33	1.12	48.8
Glass and glassware	29.68	58.26	1	1.11	96.27

*Source:* China PRP

Table 4.4.1 clearly reveals that composition of India's imports from China presents a balanced picture with both resources based and manufactured products listed in the top 10 imports. Key items of India's imports from China in 2003-04 included electrical machinery and equipment; organic chemicals; nuclear reactors, boilers, machinery etc; silk; mineral fuels and oils. India's imports from China are somewhat less concentrated vis-à-vis India's exports as in 2003-04. Electronics goods and organic chemicals constitutes a major proportion (about 46 %) of China's exports to India. India's top ten imports from China in 2003-2004 have registered growth over the previous year. Items such as silk yarn and fabrics, machinery except elect, and electronic goods, inorganic chemicals have registered an increase in growth by over 50 percent with silk yarn and fabrics having registered the maximum growth in this period.

Trade has been in favor of China between 1998-99 to 2003-2004. In 2003-2004 India had a trade deficit of over US \$ 1 billion with China. Trade between India and China has witnessed a transformation in recent years, both, in terms of volume and percentage growth. In 2003-2004 totals bilateral increased by over 45 percentages. According to Chinese statistics, India had a trade surplus of US \$ 0.91 billion with China in 2003.

India's major imports from China during 2006-07 included electronics goods (US\$ 5.0 bn), non-electrical machinery (US\$ 1.8 bn), iron & steel (US\$ 1.5 bn), organic chemicals (US\$ 1.3 bn), coal, coke & briquettes (US\$ 1.1 bn), electrical machinery (US\$ 544.6 mn), and medicinal & pharmaceutical products (US\$ 469.4 mn). China is the third largest market for exports of castor oil (15.2%), oil meals (12.8%), project goods (11.9%), plastic & linoleum goods (11.6%), non-ferrous metals (8.8%), and finished leather (5.5%).



**Table 4.4.2**  
**Commodity Structure of India's imports from China**

	<b>Export Volume 2003</b>	<b>Percentage</b>	<b>Export Volume 1995</b>	<b>Percentage</b>
Electric machinery, electronic & audio-video equipment & their spare parts	657,817,747	19.9	47,981,998	6.3
Organic chemicals products	630,571,494	19.1	181,807,913	23.8
Nuclear reactor, boiler, machinery equipment and their spare parts	292,087,577	8.8	68,254,973	8.9
Mineral fuels, mineral oil& its products, asphaltum, etc	235,635,480	7.1	107,594,604	14.1
Silk	224,170,411	6.8	98,244,918	12.8
Soaked, wrapped or laminated fabric industrial-purpose fabrics	125,560,779	3.8	...	....
Chemical fiber thread	98,952,450	3	...	....
Inorganic chemical products, compounds like noble metal	91,066,972	2.8	57,334,705	7.5
Optical, photographing and medical equipments and their spare parts	65,686,470	2	...	....
Iron and steel products	57,340,189	1.7	...	....
Edible vegetables, roots and tubers	.....	.....	20,999,805	2.7
Paper and paper boards; pulp, paper or paper board products	.....	....	20,772,732	2.7
Salt, sulfur, soil and stone materials; limestone and cement	.....	....	20,727,168	2.7
Iron and Steel	.....	....	16,444,748	2.1
<b>Total</b>	<b>2,478,889,56</b>	<b>75</b>	<b>640,163,564</b>	<b>83.6</b>

*Source:* China PRP.

According to Chinese statistics based on Table 4.4.2 clearly indicates that top 3 import items accounted for 57.3 % of total imports. Top 5 import items accounted for 68.3 % of total imports. Top 10 import items accounted for 77.6 % of total imports. As per the Chinese data, compared with the commodity structure of China's exports to India in 1995, electric machinery, electronic and audio-video equipment has registered a sharp increase from 6 % to 20 % and, this has become the largest export category from China to India. The percentage of textiles, chemical fibers, optical photographing and medical equipment as well as iron and steel products have also increased considerably, ranking among the top ten products in terms of export volume recently. The percentages of mineral fuel and silk have fallen considerably from 14.1 % and 12.8 % to 7.1 % and 6.8 % respectively.

#### **4.5 JOINT VENTURES**

Prominent Indian companies are expanding their operations in China- by setting up branch offices, joint ventures (JVs) or training facilities. In the pharmaceuticals and IT area, these include Ranbaxy, Apteck, Aurobindo Pharmaceuticals, Tata Consultancy Services, and Dr. Reddy's Laboratories. Indian business majors that have established Wholly Foreign-Owned Enterprises (WFOEs) include Infosys, NIIT, Orisia Industries Ltd, and Essel Packaging. The IT giant Infosys, which has 250 employees in its China operations, announced in August 2005 that it will invest \$ 65m to set up facilities in Shanghai and Hang Zhou that will train up to 1,000 Chinese engineers as well as house some of its back office and BPO tasks in China. This follows the lead of NIIT and TCS, each of whom have training facilities and business operation in several provinces of China, Sundram Fasteners Ltd has set up a factory in Haiyan Economic Development Zone in Zhejiang province to manufacture and sell up a Carbon Black plant to supply directly to the Chinese tyre manufactures, JK Tyres and Apollo Tyres have established technology transfer routes to produce from China primarily for third country exports but also to supply to the domestic market. In addition, Indian banking organizations including State Bank of India, Bank of India, Bank of Baroda, Punjab National Bank and ICICI Bank have set up representative office in China.

However, as Indian companies set up JVs and WFOEs in China, the US (and European) experience in dealing with China over the past decade might be instructive. It is well known that Deng Xiaoping's reform policy started in 1979 has altered the economic landscape of China, making it the 7<sup>th</sup> largest economy (at \$ 1.65t) and the third largest foreign trader (at \$ 1.2t) in the world by 2005. But the share of high-tech items in China's exports remains very low even today. That is why during the 1990's the Chinese government promised tax breaks and access to its vast domestic market if US high-tech companies, particularly in IT and Telecommunications sectors, would set up JVs with indigenous Chinese companies. A related government expectation was that "technology transfer" from such JVs would improve China's S& T base and over time, permit Chinese companies to competitively market their own products and software within the country and abroad.

The JV model required US companies to seek concurrence from their Chinese counterparts at each stage of business decision-making. Delays and disagreements hobbled progress, and the unsatisfactory JV model forced US companies to withhold larger investment of financial and intellectual capital into these collaborations. However, from Beijing's standpoint, the JV model was a partial success because of the advanced domain knowledge and business model training it provided to several thousand Chinese high-tech workers.

However, the relative failure of this model persuaded the Chinese government to offer substantial incentives to "wholly foreign-owned enterprises" (WFOEs). Under this scheme, a WFOE would not be required to have a Chinese partner, and would be permitted greater latitude in negotiation how its IPRs are safeguarded when Chinese employees hired and trained by the foreign company decide to leave the company.

While the WFOE model promises to be relatively successful in boosting China's foreign trade, the scope for high technology transfer to Chinese entities has considerably diminished. It is a less appreciated fact that in spite of China's booming exports that crested at \$ 600b in 2004, the share of Chinese entities in the export is less than 40% and the majority of those are State owned enterprises (SOEs). Further, the share of the high technology in this export is estimated at less than 10%. The import of these discussions is that until the Chinese government and its indigenous industry provides international standard protection to technology security and IPRs,

multinational companies will hesitate to enter into technology-embedded partnership with Chinese entities, instead electing to exploit price advantage by locating their production in China.

There is no publicly available information to confirm whether India's government or its business majors have taken these factors into their consideration, or how they plan to negotiate any problems that might arise in later stages of their operations in China.

#### **4.6 FOREIGN DIRECT INVESTMENT**

Large and growing market opportunities in China and India are widely seen and understood as evidenced by the large flows of foreign direct investment to China, both for production for the domestic market, but also to use exports to the rest of the World, with China as a low cost export platform. Although India has attracted far less FDI, it is not because of the lack of potential opportunities in India, but largely because of policy hurdles and other constraints on investment. This restrictive environment is expected to change – recognition by policy makers of the need for change has resulted in the recently enacted legislation for the creation of Special Economic Zones in which the incentives for profitable investment are expected to be higher. Turning to implications for domestic policy in China and India, there are several studies documenting various barriers to greater integration in India. It is clear that one policy that has no merit is the so called “industrial policy” that ostensibly picks potential industries that will be winners in the global markets and targets policy support to ensure their success. Contrary to the continuing belief in “industrial policy” as the source of successful growth and development in Japan and other East Asian countries, the empirical evidence underlying this belief is not entirely persuasive (Noland and Pack, 2003). What is far more relevant is the general incentive structure or climate that is supportive of and not an impediment to innovation, risk taking and efficient resource allocation in the economy.

Various factors have hindered India's integration. Despite substantial tariff reductions in recent years, India remains a relatively protected economy, with tariffs averaging 22 percent (18 percent in trade-weighted terms)-above the average emerging Asia and global tariff rates of 9 ½ percent and 11 ½ percent respectively-

and significant non-trade barriers remain. Moreover, a range of structural; impediments-including restrictive labor laws and onerous red tape-have retarded the growth of manufacturing, which has been the main driver of export-oriented growth in Asia. Reflecting this, the contribution of industry to GDP and employment, at 27 percent and 34 percent respectively, remains well below that of Asia as a whole. Foreign direct investment (FDI) has been hindered by a difficult business climate as well as by caps on FDI in certain sectors (Jain-Chandra, 2005). And the growing inadequacy of 34 July 21, 2006 India's infrastructure constitutes a major obstacle to private investment and export potential.

The World Bank collaborated in two investment surveys carried out by the Confederation of Indian Industry (CII) in 2000 and 2003. McKinsey Global Institute (MGI, 2001) came out with its report based on a fifteen-month long project on India's economic performance. It examined 13 sectors in detail, two in agriculture, five in manufacturing and six in services, accounting in all for about a quarter of India's GDP. The World Bank (2004) report begins with the assertion that differences in investment climate explain variations in competitiveness, growth and prosperity across countries or across sub national units within countries. The constituents of investment climate are institutional and policy variables that have a crucial bearing on business performance, but on which firms have no control individually.

The report of the McKinsey Global Institute in many ways comes to a similar conclusion as the report of the World Bank. It finds that (MGI, 2001, pp.2-5):

- (i) Product market barriers and the rules and policies governing different sectors of the economy impede GDP growth by 2.3 percent a year.
- (ii) Particularly damaging features of the current regulatory regime are: inequitable and ill-conceived regulation, uneven enforcement, reservation of products for small-scale enterprises, restrictions on FDI, and licensing and quasi-licensing requirements.
- (iii) Unrecognized land market distortion accounts for close to 1.3 percent of lost growth per year. These distortions include unclear ownership, counter-productive taxation, and inflexible zoning, rent and tenancy laws.

- (iv) Government-controlled entities, accounting for 43% of capital stock and 15% of employment outside agriculture have lower productivity of capital and labour compared to their private competitors. Their suppression of potential competition and productivity improvements result in the loss of 0.7 percent GDP growth per year.
- (v) Contrary to common belief, inflexible labour laws and poor transport infrastructure are minor barriers to growth and together account for less than 0.5 percent of lost GDP growth.

Both China and India have been ranked among the top FDI destinations in the world. China hosted 54 billion USD FDI in 2003 and India hosted 4.3 billion USD. Outward FDI from the two countries has been increasing, as well. The relatively small amount of mutual investment between China and India reflects the great potential for future cooperation. Investment cooperation is an important field for the development of future bilateral economic relationship.

#### **China's Policies on Inward FDI**

China has been improved its investment climate to attract FDI since the end of 1970s. There are three laws regulating FDI, which are The Law of Foreign Wholly Owned Enterprises of the People's Republic of China, the Law of Chinese-Foreign Equity Joint Ventures of the People's Republic of China, the Law of Chinese-Foreign Contractual Joint Ventures of the People's Republic of China and Catalogue for the Guidance of Foreign Invested Industries. The government has also formulated industrial and regional guidance for FDI. The government provides preferential treatment toward FDI. All laws and regulations were revised after China's WTO accession to meet the requirements of WTO rules and its commitments.

Industrial distribution of FDI is mainly guided by the Catalogue of Guidance for Foreign Investment Industries. The Catalogue classifies FDI projects into 4 kinds: "encouraged", "allowed", "limited" and "prohibited". "Encouraged" projects include 262 categories, "limited" 75 categories and "prohibited" 34 categories. The main fields where FDI is encouraged are: first, agriculture sector, such as renovating traditional agriculture, developing modern agriculture and promoting agricultural industrialization; second, infrastructure and basic industries like transportation, energy

and raw materials; third, high-tech industries like electronics and IT, biotechnology, new materials and aviation and spaceflight, and establishing R&D centers in China; fourth, to adopt advanced and appropriate technologies to renovate such traditional industries as machinery, light industry and textiles, and to realize the upgrading of equipments of the industries; fifth, such projects as comprehensive utilization of resources and recyclable resources, environment protection and municipal projects; sixth, investment in advantageous industries in western regions; and seventh, foreign investment in projects whose products all go for exports. FDI in western areas is guided by the Catalogue of Guidance for Foreign Investment Industries in Western Areas. Regional guidance for FDI has been in work ever since the beginning of China's opening up. FDI is encouraged in special economic areas, Western areas and Northeastern industrial bases. There are various types of special economic areas in China, such as Special Economic Zones (SEZs), Economic and Technological Development Zones (ETDZs), Hightech Industries Development Zones (HIDZs), Bonded Areas and Export Processing Zones (EPZs), etc.

### **India's Policies on Inward FDI**

The New Industrial Policy (NIP) announced on 24 July 1991 marked a major overhaul of the Indian FDI policy. Firstly, the industrial licensing (or approval) system in all industries has been abolished except where it is required for strategic or environmental grounds. In order to bring greater transparency in the FDI approval system and expedite their clearance, a system of automatic clearance was put into practice for FDI proposals fulfilling the conditions laid down, such as the ownership levels of 50 percent, 51 per cent, 74 per cent and 100 per cent foreign equity allowed in sectors specified for each limit. The cases other than those following the listed norms are subject to normal approval procedures. A new package for enterprises in EPZs and 100 per cent export-oriented units was announced including automatic clearance for proposals fulfilling specified parameters on capital goods imports, location and value addition etc. The guidelines have been laid down for this approval process as well. The Foreign Exchange Regulation Act (FERA) of 1973 was amended in 1993 and restrictions placed on foreign companies by it were lifted. New sectors such as mining, banking, insurance, telecommunications, construction and management of ports, harbors, roads and highways, airlines, and defence equipment,

have since been thrown open to private, including foreign owned, companies. However, the extent of foreign ownership continues to be limited in some of these service sectors, e.g. 74 per cent in banking, 26 per cent in insurance, 51 per cent in non-banking finance companies, 49 per cent in telecommunications, 74 per cent in internet service providers, 49 per cent in domestic airlines, 74 per cent in shipping, 51 per cent in export-oriented trading, 49 per cent in broadcasting, 74 per cent in advertising, 51 per cent in health and education services. Foreign ownership up to 100 per cent is permitted in most manufacturing sectors – in some sectors even on automatic basis - except for defence equipment where it is limited to 26 per cent and for items reserved for production by small-scale industries where it is limited to 24 per cent. However, FDI above 24 per cent is permitted in small-scale industries (SSI) reserved items subject to a mandatory export obligation of 50 per cent of annual production; this export obligation also applies similarly to a large domestic enterprise. The dividend balancing and the related export obligation conditions on foreign investors, which applied to 22 consumer goods industries, were withdrawn in 2000. The Indian FDI regime with progressive liberalization has been rated as ‘one of the most liberal in the world’<sup>3</sup> by business consultancy services. In order to boost investor confidence and provide a catalytic push to bilateral investment flows, India has embarked upon the path of concluding Bilateral Investment Promotion and Protection Agreements (BIPA) with other countries. Currently, BIPAs are in place with 46 countries and another 11 are in the process of ratification. India is also a member of Multilateral Investment Guarantee Agency (MIGA). For settlement of investment disputes, India though not a signatory to the International Centre for Settlement of Investment Disputes (ICSID) convention does use the additional facility available for non signatory states for settlement of Investor-State disputes. However, India does subscribe to the Arbitration Rules of the United Nation Commission on International Trade Law (UNCITRAL) and has incorporated the spirit of the same in its Arbitration Law.

### **China’s Policies on Outward Investment**

As a developing country, China’s currency is not freely convertible under capital accounts and the government exercises control on outflow investments. However, with China’s increasing integration into the global economy as well as the



improvement of its balance of payments (BOP), Chinese government has gradually liberalized its policies on outflow investment since the late half of 1990s. In 2001, Chinese government proposed the “going out” strategy and adopted encouraging measures on outflow investments that confirm with the State’s foreign economic strategy. China has speeded up its steps in loosening the control on overseas investment in recent years. In 1999, China adopted encouraging measures on the investment of overseas processing trade<sup>4</sup>. Afterwards, China has gradually adopted a series of measures to loosen the control and enhanced its guidance on enterprise outflow investment, for example, in deregulating the authority of the governments to examine and approve outflow investments and abolishing profit remittance deposit requirement. In July 2004, Chinese government issued the Catalogue of Countries and Industries for Guiding Outflow Investment (NO. 1) for the first time, stipulating the countries and industries where the State encouraged outflow investment. The article 2 of the Regulation on the Approval Matters of Outflow Investment and Establishing Enterprises stipulates that: “the State supports and encourages all kinds of enterprises of different ownership with comparative advantages to go out to invest and establish enterprises abroad.”

### **India’s Policies on Outward Investment**

The policy governing Overseas Direct Investment (ODI) has been liberalized since the early 1990s. The Guidelines for Indian Joint Ventures and Wholly Owned Subsidiaries Abroad as amended in October 1992, in May 1999 and July 2002 provide for the automatic approval of outward FDI proposals up to a certain limit that has been expanded progressively from US\$ 2 million in 1992 to \$ 100 million in July 2002. In January 2004 the limit of \$100 million has also been removed and Indian enterprises are now permitted to invest abroad in JV/WOS up to 100 per cent of their net worth on automatic basis. Indian companies are investing in an increasing number of projects over the past few years with actual investments exceeding a billion dollars annually. Manufacturing sector accounts for nearly 55 per cent of cumulative Indian Outward Direct Investments with about 40 per cent in services. Major areas of their operation are in pharmaceuticals, metal products, auto components, edible oil processing, fertilizers and chemicals, oil exploration, software services, among others.

## **Bilateral Investments between China and India**

### **Indian Investments in China**

The presence of Indian companies in China has also increased significantly, especially in sectors such as iron and steel, textiles, chemicals, automobile components, and pharmaceuticals. Indian companies in China are active in services sector like restaurants, entertainment, culture and banking. According to the Indian Ministry of Finance, total Indian investments approved by the Government over 1996-2004 (June) in China amount to US\$ 96.5 million. According to the Chinese Ministry of Commerce, India had invested in 101 projects in China by the end of 2003 and the actual investment was US\$ 79.1 million. In 2003, 30 new projects involving about US\$ 15.9 million were undertaken. Among the Indian companies that have set up joint ventures or subsidiaries include pharmaceuticals companies like Ranbaxy, Aurobindo Pharmaceuticals, Dr. Reddy's Laboratories, and IT software companies like Aptech, NIIT, Tata Consultancy Services, and Infosys. In manufacturing Sundram Fasteners Ltd. for high tensile fasteners, and Aditya Birla Group for carbon black production have also set up base in China. Many others have opened trade/representative offices in China and might deepen their presence in future. A number of Indian companies are also planning investments in various fields in China in the coming years.

### **Chinese Investments in India**

China is also emerging as an important source of FDI in Asia as both state owned and private Chinese companies are starting to invest abroad. According to statistics released by the Ministry of Commerce, China, Chinese companies invested \$2.7 billion abroad in 2002. According to the Ministry of Commerce and Industry, Government of India, during the period January 1991 to March 2004, India has approved Chinese FDI of US\$ 231.6 million. The approved investments, however, have been slow in materializing as actual inflow has been only to the order of US\$ 0.63 million. According to the statistics of the Chinese Ministry of Commerce, total quantum of Chinese investments in India till 2003 was about US\$ 20.6 million covering 97 Chinese proposals for foreign collaborations mainly in the telecom, metallurgical, transportation, electrical equipment and financial sectors. Chinese

sources suggest that the official figures might underestimate the actual investment, as some Chinese companies tend to invest before they declare their investment to the government. Obviously there is need for reconciling the statistics of FDI inflows in India where Indian and Chinese sources diverge substantially. A part of the reason for discrepancy is the fact that some of the Chinese investments in India are routed through Hong Kong. Even after reconciliation of the figures, the existing bilateral investment flows between the two countries hardly represent the potential and synergies that exist between the two large and dynamic economies.

### **Areas of Future Investment Cooperation**

Sustainable efforts by the Chinese and Indian governments have improved their investment climate and made them top FDI destinations in the world. The huge domestic market, complementary characteristics of the two countries and improving political atmosphere between the two countries will provide great opportunities for bilateral investments. Chinese enterprises may find fruitful opportunities for investment in India, among other sectors, in power generation projects and other infrastructure sectors, manufacture of electronic hardware, food processing etc for which there is growing market in India. There may be fruitful opportunities for Chinese enterprises to manufacture garments in India for export to the EU as GSP benefits will be phased out for Chinese garment exports. Aiming to develop the bilateral economic and trade relations, Chinese government is encouraging Chinese enterprises to invest in India in fields such as crop planting, coal, iron ore, manufacturing of apparatus, meters and office equipment, electric power machines as high-pressure and low-pressure switch and dynamotor, mechanical manufacturing of refrigeration equipment and air conditioners etc., electric equipment such as TV sets, plastic products, pharmacy, trade, software, construction, transportation, tourism, infrastructure and generation and supply of electricity etc. Indian enterprises may also find attractive investment opportunities in China in the areas of pharmaceuticals, auto components, light engineering goods, automotives, financial services besides IT software and training. Chinese and Indian enterprises may find mutually rewarding opportunities of pooling their complementary strengths by building consortia for jointly undertaking third country projects and investments. Such opportunities may exist in design engineering and construction industry and other heavy industries. They

could also consider entering into strategic alliances or joint ventures for exploiting the synergies for mutual benefit. IT industry provides many such opportunities but there may be opportunities in other areas such as biotechnology, especially in applications relating to agriculture and health.

### **Enhancing India-China Investment Cooperation**

India and China have already signed an Agreement on the Avoidance of Double Taxation in July 1994. A Bilateral Investment Promotion and Protection Agreement (BIPA) are currently under negotiation. The JSG feels that an early signing of BIPA will be an important step towards promotion of bilateral investments and boosting investor confidence. Investment dispute settlement mechanism should be improved. Companies should be encouraged to enhance coordination, communication and negotiation. Disputes should be resolved through mutually accepted international arbitration organizations.

The present study compares and contrasts the performance of India and China in attracting foreign direct investment (FDI). Both economies are large emerging markets that had rather similar profiles in 1978. Today, China ranks number one as the world's preferred foreign investment destination. Closer examination of the FDI statistics suggests that India's performance has been significantly understated while China's performance continues to be overstated. However India still lags for a number of reasons. These include a high tariff regime, poor infrastructure (power, ports, roads and railways), a regulatory system that is too often not business-friendly, a policy of reservation of many potentially export-oriented sectors for small businesses and inflexible labour laws. The government's large budget deficit is preventing investment in necessary physical infrastructure yet India needs to increase the rate of private investment to enhance the economic growth rate and reduce poverty. Based on China's experience of promoting FDI, further economic devolution to state level is the best way forward. While this is likely to exacerbate inter-state income inequality in the short term, it does offer the possibility of redistribution in the longer term.

Over the last two decades the policy stance of governments in emerging markets towards foreign direct investment (FDI) has changed dramatically. This has been brought about by the mounting evidence of the positive association of FDI with

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increased growth rates and in improvements in total factor productivity (TFP) {de Mello, 1997 & 1999 and Buckley et. al., 2002}. Notwithstanding calls for a nuanced assessment of the spillover benefits of FDI from some observers, FDI is much sought after by governments seeking a catalyzing boost to economic growth through technology transfers, employment generation, and improved access to managerial expertise, global capital and product markets, and marketing and distribution networks. Multinational enterprises (MNE) seeking a global rate of profit are generally unsentimental about where it is achieved. A concomitant of the global trend towards increasingly liberal trade and investment regimes and fierce competition to attract investors is the need for serious investment and leadership by governments and their agents at many levels, to create and maintain the necessary business-friendly policy environment.

This study also examine why India and China that represent examples of very large emerging markets perform so markedly differently in attracting FDI despite the increase in the importance of global drivers behind FDI. Explanation will be sought in the way in which national and sub-national governments have gone about the task of promoting inward foreign direct investment. It will also consider how the governments of the two countries have faced the challenge of reconciling the many, often contradictory, interests of groups affected by economic liberalization and foreign investment in the domestic economy.

Conventional analysis of the drivers behind FDI focuses on the distinction between horizontal market-seeking investment and vertical cost-minimizing investment seeking a low cost production location (Shatz and Venables, 2000; Lim, 2001). A large and growing market that permits economies of scale is particularly attractive to FDI. Fieldwork was carried out in November 2001, May 2002 and May 2003 in India and November 2002 in Western China. The author is grateful for the generous way in which people gave of their time to discuss the challenges of investment and export promotion in each country. It is hoped that those opinions are accurately reflected in this paper. However views expressed in this report are the responsibility of the author and do not imply endorsement by any Indian or Chinese authority, the Sichuan Academy of Social Sciences or UNIDO. For example, Rodrik (1999) argues that the effect of FDI on economic growth tends to be weak or even that

much of the superior economic performance is driven by favorable domestic factors to which foreign investors respond market-seeking investment. Market servicing costs that favor foreign direct investment over exporting include the presence of import tariffs, non-tariff barriers, transport costs and local competition offering customer responsiveness. Recent work by Albuquerque et al (2003) suggests that global factors have increased in importance in explaining FDI flows. They argue global drivers are increasing in importance, domestic drivers (growth in local productivity, trade openness, financial depth, low government burden and macroeconomic stability) still account for a sizeable amount of inter-country variation in foreign direct investment. The impact of FDI on growth is complex. First, growth occurs through capital accumulation and the introduction of newer technology, management systems and innovative products associated with FDI.<sup>4</sup> Second, FDI improves the efficiency of locally-owned firms through contact and demonstration effects and exposure to increased competition. Third, FDI under the right economic conditions leads to technological progress through the introduction of new varieties of knowledge-based capital equipment. Fourth, the FDI 'package' proceeds through specific productivity enhancing management development and skills training programmes. Fifth, just as local firms learn from contact with FDI so do governments, institutions and public service providers.

### **Comparing the economic performance of India and China**

China is a natural comparator for India for obvious geopolitical, economic and demographic reasons. They both have populations in excess of one billion China at 1.27 billion and India with 1.03 billion people in 2001. According to the World Bank (2003), on a purchasing power parity (PPP) basis, they are respectively the second and fourth largest economies in the world. In A T Kearney's September 2002 survey of the leaders of the world's 1000 largest corporation's anticipated FDI intentions and preferences; China was ranked first, ahead of the USA for the first time, as the most attractive investment destination in the world. India was ranked fifteenth, down from seventh in 2001. It is when changes in the participation of India and China in world trade are compared that one of the sharpest differences between the two countries is apparent. In 1978 external trade represented around 12 per cent of GDP for India and 10 per cent for China. By 2001, India's merchandise trade amounted to 19.7 per cent

of GDP and China's trade had expanded to 44 per cent of GDP reflecting China's emergence as one of the world's major trading powers. In 2000, China generated 4 per cent of world merchandise exports compared to 0.7 per cent from India. In terms of merchandise trade, China ranked as the seventh largest exporter and eighth largest importer in the world in 2002. A major difference in the composition of the output of each country is the relative importance of the contribution of the service sector, particularly computer software, in India. When trade in services is included, India's relative openness to trade improves significantly. Trade in goods and services amounted to 28.6 per cent of GDP in the case of India and 47.1 per cent of GDP in China. Even so, in 2001, China was a bigger exporter of commercial services ranking as the world's twelfth largest exporter while India was nineteenth. One of the most obvious differences in the trade regimes of the two countries is the tariff regime. The average Most Favored Nation (MFN) tariff rate in China has fallen from well over 50 per cent in the early 1980s to 15.3 per cent in 2001 (Tseng and Zebregs, 2002). India's standard applied MFN tariff averaged 32.3 per cent in 2001/2002 and is amongst the highest in the world (WTO, 2002, p.31). In addition, there is a Special Additional Duty (SAD) which is estimated to raise the un-weighted average customs duty on all goods to 35 per cent in 2002/03 (World Bank, 2003, p. 53). The government's stated aim is to reduce the simple average applied MFN tariff rate to ASEAN country levels of less than 15 per cent (WTO, 2002, p.5). However this poses a major problem for the government because of its heavy reliance on customs tariffs for tax revenue – 30 per cent of net tax revenue was derived from import tariffs in 2001/2002. By contrast, the Chinese central government only raised around 7.4 per cent of its revenue from import duties in the period 1995-98 (IMF, 2002). The potential benefits for India of liberalizing trade in manufactures are clear. Wood and Calandrino (2000) estimate using China as a benchmark that was India to reduce its existing barriers to trade, especially to exports, to Chinese levels it could double its per capita income and increase exports five fold within two decades. Tariff reform would be a lot easier to implement in India were it not for the size and continuing deterioration of the fiscal deficit.

The Central Government's deficit has risen from 4.2 per cent of GDP in 1995/96 to 5.7 per cent of GDP in 2001/2002, while the overall public sector deficit (which includes the deficits of the Centre, of States, central public sector enterprises

and the oil pool account) was 10.6 per cent of GDP in 2001/2002. The overall revenue deficit was estimated at 6.9 per cent of GDP in 2002/03 (World Bank, 2003, p.16). This is larger than the crisis level of 1991 and is projected to go higher still in 2003/04. Partly this is because agriculture and the services sector, which make up more than three-quarters of Indian GDP, go virtually untaxed unlike in China. It is certainly a difficult task to separate and quantify the complex package of resources that FDI confer to the host country. There have been a number of macro studies attempting to determine the nexus between FDI and growth. By and large, studies have found a positive links between FDI and growth, though FDI appears less positive in least developed economies, suggesting the existence of “threshold level of development” (Blomström and Kokko, 2003 and Blomström et al., 1994).

**Table 4.6.1**  
**Comparative Inward FDI**

FDI ( percent of GDP)	Year							
	2003	2004	2005	2006	2007	2008	2009	2010
<b>India</b>	0.7	0.8	0.8	1.9	1.7	1.8	2.0	2.1
<b>China</b>	2.9	2.8	3.4	2.8	2.9	2.1	1.8	1.6
<b>FDI</b> (percentage of gross fixed investment)								
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>India</b>	2.9	3.2	2.9	6.4	5.2	5.5	5.9	6
<b>China</b>	7.3	7	8.4	6.9	7	5	4.3	3.8
<b>FDI per head</b> (US\$)								
	<b>2003</b>	<b>2004</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>
<b>India</b>	4	5	6	16	16	16	18	19
<b>China</b>	37	43	61	60	60	64	65	68

*Source:* EIU (2007)

Note: Data from 2007 on are estimates for India and China 2008-2010 are projections.

A close look at Table 4.6.1 clearly reveals that according to UNCTAD (2007), India has emerged as the second most attractive destination for FDI after China and ahead of the US, Russia and Brazil. While India has experienced a marked rise in FDI inflows in the last few years (doubling from an average of US\$5-6 billion the previous



three years to around US\$ 19 billion in 2006-07) it still receives far less FDI flows than China or much smaller economies in Asia like Hong Kong and Singapore was ahead of India. Not surprisingly India's growth strategy has depended predominantly on domestic enterprises and domestic demand as opposed to FDI and export demand.<sup>1</sup> For instance, India's FDI as a share of GDP in 2007 represented only about 1.7 percent compared to 2.8 percent in China, and its share of gross fixed investment is 5.2 percent compared to 7.0 in China. FDI has been a relatively limited source of external financing and reserve buildup in India.

China is one of the world's largest recipients of FDI. Although FDI inflows actually fell slightly in 2006, to US\$78.1bn, this was still one of the highest totals in the world. Despite concerns about rising cost pressures, China remains a favored base for foreign companies wishing to reduce production costs. Nevertheless, companies wishing to sell into the domestic market still find the country's business environment a difficult one in which to operate. Despite improvements in recent years, the Chinese market is characterized by intense competition, bureaucratic hurdles and an opaque legal system. Nevertheless, many foreign companies are now starting to make good profits (even if there are significant variations across sectors). China is also becoming an important outward investor, and this trend will continue. Owing to its rising stock of foreign-exchange reserves, as well as booming demand for natural resources, in particular oil, China will become an increasingly important source of investment for many resource-rich countries in Africa, Central Asia and Latin America over the forecast period. Overall, these countries have given a cautious welcome to Chinese investment.

Recognizing that the Indian economy could easily absorb a much higher level of FDI, the government is progressively raising its annual FDI target; it stands at an ambitious US\$25bn for fiscal year 2007/08 (April-March)—although continued problems of the business environment are likely to keep actual inflows below these targets. Foreign investors will be attracted by major new opportunities in infrastructure projects. Telecommunications and energy are likely to emerge as other high-potential industries for FDI.

**Table 4.6.2**  
**A comparative analysis of FDI into China and India**

(Unit: \$billion)

	2004	2005	2006	2007	2008	2009	2010	2011
<b>Population (m)</b>								
China	1299.9	1307.6	1314.5	1323.1	1331.1	1336.7	1342.5	1351.0
India	1065.1	1080.3	1095.4	1110.4	1125.4	1140.2	1155.0	1169.7
<b>GDP (US\$bn at market exchange rate)</b>								
China	1936.5	2278.3	2720.2	3250.2	3832.6	4481.9	5232.0	6080.6
India	692.7	805.6	922.9	1131.9	1329.1	1512.4	1719.4	1955.2
<b>GDP (US \$ bn at PPP)</b>								
China	7642.3	8692.3	9903.8	11192.9	12587.2	13993.8	15453.8	16970.8
India	3389.7	3814.6	4293.8	4765.5	5283.6	5834.0	6438.1	7096.5
<b>GDP(% real change)</b>								
China	10.1	10.4	10.7	9.9	9.3	9.0	8.4	9.4
India	8.3	9.2	9.4	8.5	8.0	7.5	7.5	7.5
<b>Foreign direct investment inflows (US\$ bn)</b>								
China	54.9	79.1	78.1	79.5	84.1	86.5	90.9	92.9
India	5.8	6.7	17.5	17.0	18.0	20.0	22.0	25.0
<b>% of GDP</b>								
China	2.8	3.5	2.9	2.4	2.2	1.9	1.7	1.5
India	0.8	0.8	1.9	1.5	1.4	1.3	1.3	1.3
<b>% of gross fixed investment</b>								
China	7.0	8.4	6.8	5.7	5.0	4.3	3.8	3.3
India	3.2	2.9	6.4	4.8	4.2	4.0	3.8	3.7
<b>Inward foreign direct investment stock (US\$ bn)</b>								
China	542.3	621.4	699.5	779.0	863.1	949.5	1040.4	1133.4
India	43.6	50.3	67.7	84.7	102.7	122.7	144.7	169.7
<b>% of GDP</b>								
China	28	27.3	25.7	24	22.5	21.2	19.9	18.6
India	6.3	6.2	7.3	7.5	7.7	8.1	8.4	8.7
<b>Foreign direct investment outflows (US\$ bn)</b>								
China	1.8	11.3	17.8	26.0	37.0	48.0	65.0	72.0
India	2.2	2.5	9.0	10.0	12.0	14.0	14.5	16.0
<b>Outward foreign direct investment stock (US\$ bn)</b>								
China	52.7	64.5	82.3	108.3	145.3	193.3	258.3	330.3
India	10.1	12.1	21.1	31.1	43.1	57.1	71.6	87.6
<b>% of GDP</b>								
China	2.7	2.8	3.0	3.3	3.8	4.3	4.9	5.4
India	1.5	1.5	2.3	2.7	3.2	3.8	4.2	4.5

Sources: Economic Intelligence Unit 2007.

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On the basis of data from Table 4.6.2 the following inferences can be drawn from various dimensions of Foreign Direct Investment (FDI):

**1. Stocks and flows:**

In absolute terms at least, China is one of the world's largest hosts of FDI. In 2006 FDI inflows totaled US\$78.1bn (in balance-of-payments terms). FDI inflows into China have generally been increasing over the past two decades, with annual average inflows rising from US\$3.9bn (again in balance-of-payments terms) in 1985-92 to US\$37.8bn in 1993-2000 and US\$59bn for 2001-06. FDI inflows are forecast to remain high and to increase gradually throughout the forecast period, averaging US\$87bn in 2007-11. The stock of inward FDI reached US\$699.5bn by end- 2006, although it has actually been falling as a share of GDP in recent years (largely because the economy has been growing faster than FDI inflows). FDI data for China should, however, be treated with caution. FDI inflows are inflated by "round tripping", whereby domestic investment from the mainland is taken offshore, usually to Hong Kong, and then returned to the mainland to take advantage of the preferential tax rates offered to foreign investors. The World Bank has estimated that round-tripping could account for up to 25% of total FDI into China. FDI into India is rising rapidly. FDI inflows totaled US\$17.5bn in 2006, compared with US\$6.7bn in 2005 and US\$2bn-3bn for most of the 1990s (although these figures are not strictly comparable, since in 2000/01 the government changed the means by which it measures FDI to include, for example, reinvested earnings). However, inflows of FDI into India are low by global standards (equivalent to 1.9% of GDP in 2006), as is the stock of inward FDI, at around US\$68bn in 2006 (equivalent to 7.3% of GDP, or US\$62 per head). This is below the figure for Pakistan (US\$91 per head), and a fraction of the level in China (US\$532 per head).

**2. Origin and distribution:**

The major investors in China are Hong Kong, South Korea, Japan and the US. Most investment goes to the coastal provinces and provincial-level cities, despite attempts to attract investors inland. The three most important investment locations can be described as "greater Guangdong" (which comprises Guangdong, Fujian and Hainan provinces), "greater Shanghai" (Shanghai, Jiangsu and Zhejiang provinces)

and “greater Beijing” (comprising the capital, together with Tianjin municipality and Hebei province). According to the Secretariat for Industrial Assistance, the largest source of FDI in 2006/07 was Mauritius, which accounted for 40% of total inflows. Many companies incorporate in Mauritius to invest in India because of tax benefits. The UK was the second most important foreign investor, with 11.9% of the total, followed by the US (5.4%), the Netherlands (4%), Singapore (3.7%) and Germany (0.8%). Historically the electrical equipment sector, which includes India’s highly successful computer software industry, has attracted the most FDI, but in 2006/07 it was overtaken by the services sector. Financial and non-financial services drew in US\$4.7bn in investment, well above the US\$2.7bn garnered by electrical equipment. The next most important sectors for FDI were construction activities (US\$985m), telecommunications (US\$521m) and transportation (US\$466m). Foreign investment has been concentrated in the southern and western states, where more reform-minded administrations are in power. The top five destination states for FDI in recent years have been Maharashtra, Delhi, Tamil Nadu, Karnataka and Andhra Pradesh. FDI accounted for 6.4% of gross fixed investment in 2006, up sharply from 2.9% in 2005.

### **3. Determinants**

Most foreign investors have been attracted by China’s vast domestic market and low labour costs. Early arrivals, however, were largely disappointed with the initial results of their China operations, and either lived with losses or left the market. However, an increasing number of foreign-invested companies are now in profit, and the outlook for the economy is healthy, which suggests that there will be continued strong interest from foreign companies. Lingering barriers to trade are coming down, but high non-wage costs remain a concern. Problems of overcapacity, and strong competition from domestic companies, will continue to cause problems for many foreign firms. India’s skilled, English-speaking workforce has been a significant attraction for FDI, particularly in the information technology (IT) sector. Caps on FDI in protected industries have been steadily lifted: in January 2004 the limits on foreign investment in oil production and oil refining were abolished, and in private banking the limit was raised to 74%. In October 2004 the sectoral caps were raised in insurance (to 26%), civil aviation (to 49%) and telecoms (to 49%). The limit for some telecoms services, for example Internet service providers (ISPs), was subsequently

raised to 74% in February 2005, and all basic, mobile, and value-added telecoms services were moved under the 74% limit in November 2005. In February 2006 FDI up to 51% was permitted for retail trading of “single brand” products. However, fuller liberalization of the retail sector has been held up by political opposition, and some sectors, such as agriculture, remain off-limits to foreign investment. The approval process is gradually being simplified, and the government is expanding the number of industries that are subject to automatic approval. However, state-level impediments can be severe, and companies have been known to abandon FDI projects mid-way through the implementation stage.

#### **4. Impact:**

FDI has had a profound impact both on the overall level of industrial development in China and on its geographical distribution. The coastal provinces have seen the greatest transformation, with central and western provinces left on the sidelines. There is growing concern among some policymakers in China that the economy, and in particular the export sector, is becoming overly dependent on foreign investment. In 2006 foreign-invested enterprises (FIEs) accounted for over 50% of China’s total exports, and FIEs will remain a key driver of China’s export dynamism for years to come. FDI has had the greatest impact on India’s software industry and on IT enabled services. Call centers and other forms of back-office administration have become important industries. The pharmaceutical, telecoms and power sectors have also been influenced significantly by FDI.

#### **5. Potential:**

China has been attracting sizeable amounts of FDI for some years, and FDI inflows are forecast to remain high during the forecast period. China is still ranked by many international firms as their preferred investment destination. The stock of inward FDI accounts for a high share of GDP (at 25.7% in 2006), but remains small per head of population. This suggests that China has the potential to absorb considerable additional FDI. China is committed to meeting its World Trade Organization (WTO) obligations, which should boost FDI. The gradual opening up of sectors such as domestic commerce, financial services, insurance and tourism is under way. Geographical restrictions on where foreign companies are allowed to set up

operations will also be relaxed in 2007-11. But the government is becoming more choosy about approving certain investment projects, and increasingly priority will be given to projects in the interior of the country or those that promise a greater degree of technology transfer. However, if the government's plan to encourage more FDI in the interior is to be successful, the region will need better transport connections to international markets. India's potential to attract increased FDI inflows is vast, although poor infrastructure, excessive bureaucracy and interdepartmental wrangling will slow the pace of opening in many sectors. The infrastructure, energy, telecoms, IT and insurance sectors are likely to be the main magnets for FDI. Producers and assemblers of cars and automotive components are also re-evaluating India's potential, as are biotechnology firms. The establishment of special economic zones, in which 100% foreign ownership is allowed, in order to promote exports should attract increased FDI inflows into export-oriented industries. India's privatization programmed accelerated in 2003/04 with the sale of shares in major car and oil companies, but since then has stalled owing to opposition from the Left Front, on the support of which the government relies.

**Table 4.6.3**  
**FDI Overview-India and China**

(Unit: \$ million)

Year	INDIA		CHINA	
	FDI inflow (millions US \$)	FDI inflow as percent of GFKL	FDI inflow (million US\$)	FDI inflow as percent of GFKL
<b>1985-1995</b> (annual average)	452	1.9	11,715	6
<b>2001-2002</b>	3,403	3.2	46,878	10.5
<b>2002-2003</b>	3,449	3	52,743	10.4
<b>2003-2004</b>	4,269	3.2	53,505	8.6
<b>2004-2005</b>	5,335	3.4	60,030	8.2

*Note:* Gross Fixed Capital Formation (GFKF)

*Sources:* UNCTAD World Investment Report, 2006

**Table 4.6.4**  
**FDI Overview-India and China**

(Unit: \$million)

Year	INDIA		CHINA	
	FDI inflow (millions US \$)	FDI inflow as per cent of GFKF	FDI inflow (million US \$)	FDI inflow as per cent of GFKF
<b>1980-1981</b>	452	0.2	1,074	0.5
<b>1990-1991</b>	1,657	0.5	20,691	5.8
<b>2000-2001</b>	17,517	3.7	193,348	17.9
<b>2002-2003</b>	30,827	5.2	228,371	16.2
<b>2004-2005</b>	38,676	5.9	245,467	14.9

*Note:* Gross Fixed Capital Formation (GFKF)

*Sources:* UNCTAD World Investment Report, 2006

An analysis of data from Table 4.6.3 and Table 4.6.4 indicates that India that is known for the heterogeneity of its society-the diversity of its language, religion and geophysical attributes. Its democratic political system, western-style financial and legal institutions and the felicity of its business should provide India a niche in international markets for goods, services and foreign capital. However, India ranks well below China on exports and inflows of Foreign Direct Investment (FDI.). It is the relatively low level of FDI in India, barely one-tenth of the inflows into China. Which has attracted much attention? A variety of explanations have been offered for the low levels of FDI in India. Although India could do with much larger volumes of FDI than that it attracts now, the concern that it is well below the levels of FDI is misplaced. Given the structure, composition and factor endowments of her economy which are significantly different from that of China, India may not need larger volumes of FDI, in any case, not the scale that China attracts.

It is often said that if India were to shed its inhibitions about foreign direct investment and flow in the footsteps of China, India would be in a position to realize her full potential. This misses out the true significance of the Chinese experience. China's FDI saga has been a textbook replay of what institutional economists would call "adaptive efficiency" on the part of its political regime. The country made courageous but careful choices in difficult circumstances, signaling radical departures from the belief system it had been accustomed to for decades.

## 4.7 CONCLUSION

China and India have a unique advantage of being able to view their ties in a long term perspective spanning centuries. It was not until the late 19th century that British Indian and Chinese empire came face to face and the British expeditions to Tibet introduced an imperial orientation into China-India ties. Before this, it was only pilgrims and traders who had ventured into interiors of each other. Even the 1962 China- India war has come under revision with both sides coming to more candid conclusions about their mistakes. However, the influence of that period remains decisive nevertheless and should provide lessons. By the time the China and India liberated themselves from their colonial subjugation the two had come vary far and moved in different directions which were to complicate their efforts at evolving their political equations and especially their bilateral economic interactions. Especially, as both these most dynamic Asian societies now prepare to face the 21st century world order, increasing economic cooperation has become all the more imperative – and indeed the most potent tool – for materializing their visions of peace and prosperity between themselves and by extension in this larger region. But there is also a lot that remains in their control and results of this have been visible in recent past. There is definitely a far stronger need today to encourage such fresh thinking in their mutual policy initiatives. In this their bilateral trade and commerce has been one area where this new thinking has been most effective. Therefore, it is only imperative that one must let their economic engagement provide the lead to their mutual interactions and policies. And there is still greater need then to rectify imbalances and to help promote each others role and contribution in building sustainable peace and prosperity for themselves and for the larger region.

India and China are the economic powerhouses of the Asian region. Both countries are growing at a faster rate. The bilateral trade between the two economies is increasing at rapid rate and Indo-China two-way trade has crossed \$13.6 billion in 2004. India's exports to China touching \$7.7 billion and imports from China reaching \$5.9 billion are the pointers. The leaders of both the countries have set a target of \$20 billion for 2008 and \$30 billion for 2010. This target appears very much achievable in the context of present growth scenario. Rapidly increasing bilateral trade between India and China suggest that the trade target set up by the two governments is



achievable. China has become an important trade partner for India but same can not be said for India. The product diversification is high in case of Chinese export to India but it is not so in case of India. Of late, Indian exports also diversified, however, it needs more. In Chinese export basket to India, medium and high-tech products dominate but Indian export basket to China is dominated by primary and resource based products, from this angle, Chinese exports to India are more sustainable than India's exports to China. Increase in Indian export to China is due to competitive factors. Similar is the case for rise in Chinese exports to India. In Indo-China bilateral trade inter-industry trade plays a significant role. The intra-industry trade is not major factor. To enhance trade complementarities India needs to diversify into medium and high-tech products. The Chinese products are more competitive in Indian market due to lower prices and acceptable quality. China has an edge over India in third country markets due to its competitive power, this is more so in the case of labor-intensive products. The FDI has played significant role in enhancing Chinese exports but this not the case with India. Both India and China joining the ASEAN led Free Trade Area would help to expand inter-sea trade between the two countries.

Certain bottlenecks (such as, poor physical infrastructure) and policy induced rigidities in the factor markets (such as those in the organized labor market) stand in the way of resource reallocation process and export activities in India. The exports (and imports) of the large majority of the products have expanded since the 1990s from India. China's gain of market share (or comparative advantage) in a given product does not necessarily mean India's lose of market share) in the same product and vice versa. The two countries have been expanding their exports by specializing in different product lines within each of the product categories. Findings indicate the growing significance of intra-industry specialization under trade liberalization in both the countries. The apprehension that import liberalization would lead to a large-scale demise of domestic industries is unwarranted. The policy changes are necessary also to induce the multinationals to conduct FDI of the "vertical type" and hence to augment the process of integrating the Indian industry with the fragmented structure of global production activities. Needless to say, the policy environment should be neutral for the domestic and foreign enterprises unlike in China where domestic private entrepreneurs have been discriminated against for various reasons, as

elaborated in Huang (2002). It is important not to borrow the wrong aspects of the policies from China as much as it is important to borrow the right aspects.

A contentious policy issue in India is the liberalization of merger and acquisition (M & A) activity and, by implication, removal of exit barriers for foreign investors. The Planning Commission Report (2002, pp. 35-46) makes some very important recommendations in this regard by proposing the removal of most of the remaining sectoral equity caps on foreign investment and the deletion of almost all exit barriers. One of the characteristics of contemporary corporate strategy is the constant search for new high margin business opportunities that fit with an enterprise's core competencies and its global positioning. This means that MNEs are constantly taking on new activities and shedding old ones. India's market for corporate control has recently risen sharply so that in the period 1999-2000 around half of all FDI inflows have been in the form of mergers or acquisitions (UNCTAD, 2001). Many MNEs have been taking advantage of the relaxation of sectoral equity caps to buy out minority Indian shareholders in order to exit from the local stock market. The increasing competitive pressures on large Indian business houses have encouraged several to quit joint ventures. There are a few examples of the reverse process. For example, Toyota sold 10 per cent of its equity to Kirloskar, raising its Indian joint venture partner's share to 11 per cent in 2003. More usually the high capital requirements have ensured foreign partners have typically held most of the equity in vehicle manufacturing ventures. Similar arrangements either continue to favor the foreign party or have been abandoned. Famously, TVS, a south Indian scooter maker, broke off with its partner, Suzuki, after rows over sharing of technology to go it alone. Unsurprisingly, increased M&A activity has raised concerns about competition in consumer goods markets (Nagaraj, 2003, Chalapati Rao, et al., 1999).

Investors need to be able to enter or exit new or existing undertakings with a minimum of transaction costs. Nowhere is this more important than with respect to joint ventures where the foreign partner normally uses a joint venture as a way of testing the market. Equity caps have undoubtedly distorted and sometimes deterred the only significant barrier not included in the list recommended for deletion is the prohibition on local borrowing by foreign investors to fund purchases of shares

market-testing investments in some sectors in India. At a certain point, one partner is likely to want to exit the venture yet it apparently takes on average nine years for the foreign partner to exit from India with the agreed sale proceeds. Clearly this puts the foreign partner at a disadvantage in negotiating with the local partner over the sale price. Of course, liberalization of the capital repatriation processes introduces an element of volatility but this also creates opportunities for domestic enterprises with lower cost profiles than MNEs to acquire new assets often at a discount on a willing seller- willing-buyer basis. The Planning Commission's recommendations to remove equity caps and exit barriers are important because they increase the range of strategic options available to foreign investors appraising the Indian economy.

China is a large recipient of FDI and it is successful in attracting huge export-oriented FDI. Foreign Invested enterprises played a significant role in export expansion of China. Share of MNC's is over 50 per cent in case of China as compared to mere 3 per cent for India. The Chinese government assured certain key conditions for profitability such as low taxes, reliable infrastructure, adequate power, and decent logistics for imports and exports, besides reducing tariffs and removal of non-tariff barriers. In contrast, India focused on infrastructure, power, capital goods and food processing. Among these sectors, many of them do not fall under export activities. In late 1990s over 40 per cent of FDI has taken the route of acquisitions rather than green field ventures. As opposed to this, FDI is concentrated in export-oriented and high technology manufacturing industry in China. Further, import duties are also high in India as compared to China. To some extent, the export-oriented production model is replicated in India in service sector, particularly in software development and business processes. The FDI in India has hardly entered export-oriented industries and has been domestic market-oriented and not efficiency seeking. The Special Economic Zones have contributed in a large measure to China's exports; however, it has not been the case with India. India and China have begun to invest in each other's economies. The current investment hardly represents the potential that exists between the two large economies.

Inflows of foreign direct investment (FDI) into India (equity capital components only) during the first quarter of the current financial year 2006-07 (April-June), was US \$ 1.74 billion compared to US \$ 1.18 billion in the same quarter of

2005-06. China and India are rivaling one another and aggressively challenging the US for the spot of most favored FDI destination. China still maintains the No. 1 position, but India ascended from No. 6 to No. 3, just behind the US. India and China may be similar in many ways but the main difference is that while China is viewed as the “Factory of the world”, India is being recognized as the “Brain of the World”. China’s FDI inflows are larger and primarily capital-intensive, while Indian FDI inflows are smaller and skill-intensive, in IT areas. The policy changes are necessary also to induce the multinationals to conduct FDI of the “vertical type” and hence to augment the process of integrating the Indian industry with the fragmented structure of global production activities. Needless to say, the policy environment should be neutral for the domestic and foreign enterprises unlike in China where domestic private entrepreneurs have been discriminated against for various reasons, as elaborated in Huang (2002). It is important not to borrow the wrong aspects of the policies from China as much as it is important to borrow the right aspects.

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## Chapter 5.0

### **IMPLICATIONS FOR INDIA**

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Over the past 20 years China has emerged from isolation to become the world's sixth largest trader. Its increasingly outward orientation of the economy along with the surge in inward flows of FDI shows China is integrating into the world economy in terms of increased trade and financial links. However, in 1990 the ratio of GDP of total trade in goods and services in both India and China stood at about 15 %. By 2001, this ratio had more than triple to about 50 % in China, while India it had raised to around 25%. A variety of reasons like implementation of economic reforms with bold initiatives, better infrastructure facilities, inflows of FDI in large size, attractive tax structure, etc are cited for remarkable success in China. It reveals that India could learn a lot lessons from the Chinese success in its economic performance. It is widely believed that the Indian Diasporas should play a key role in bringing FDI rather just deepen on MNCs. The same happened in China after the Chinese government offered special sops to the overseas Chinese community. This will deter growth of certain selected areas and boost the over-all economy.

The key to explain why India nevertheless continues to lag behind China is the slow growth of the conventional industry. The policy implication is that India must free the industry of continuing restraints if it is to maximize the benefits of what has been done to-date. Gives a virtual ban on exit and retrenchment and reassignment of workers, continuing reservation of most of the labour-intensive industries for small-scale firms, the absence of effective bankruptcy laws and continuing high protection, India industry cannot match the performance of its Chinese counterpart. In some ways, given the advantage India enjoys in the information technology sector over China, its overall prospects for growth are even better than those of China but only if the conventional industry is given a fair chance.

Assuming stable policies, how these macroeconomic and sectoral 'growth factors' will play out in the next few years is hard to say. Sustaining IT's growth rates will be hard, but it has its proportion to GDP increases, smaller growth has greater impact. Absent a fiscal crisis, consumer demand should continue to fuel consumer durable and housing development. The end of the Multifiber Agreement-under which

international textile and apparel trading has been governed for decades by country quotas-should cause some concern among garment exporters, but may ultimately have little positive effect on India. A buoyant international economy will obviously help. How much further reform or 'de-reform' will occur and what its productive impact will be is hard to say as well-though the McKinsey report is certainly confident on that score. It promises us a 4 to 5 percent jump in the rate of economic growth-or at least a one-time 8 percent growth in labour productivity-if 13 easy reforms are adopted. They are confident that the new investment will occur and that other factors will not cause decreasing returns. The ultimate challenge, not for forecast of the future but for Indian entrepreneurs is to identify growth sectors of the next period-perhaps agriculture, biotechnology, more IT, tourism, or education and health.

There are many aspects of trade reform including further liberalization of industrial goods, agriculture and services: restraining the use of antidumping: opening sector such as retail trade to the FDI in India and bilateral and multilateral negotiations that deserve further attention. Currently, the Doha Round is at an impasse. Both India and China have large stakes in the reveal of the negotiations and eventual conclusion of the round they both stand to benefit from further liberalization of their own and of their trading partners. Peak tariffs in the developed countries apply to products in which these countries have a comparative advantage. Both can also emerge as competitive in many agricultural sectors once the protection and subsidies in the rich countries are ended. Equally important there is also some danger that a failure to complete the Doha Round will weaken the multilateral system and may encourage protectionist lobbies around the world to push their favorite agendas more aggressively. In the negotiation to-date, subdued by the challenge it faces from the United States on the exchange rate and imbalance in global flows. China has taken a backseat. India has been more active but less forthcoming with proposals of its own that would help move the process forward.

The impact of sectoral growth rates is reflected in the job creation patterns for the two nations. Today China's workforce is 705 million (1999). About half of this workforce or 353 million is employed in agriculture, 28 percent or 190 million in services, and 22 percent or 162 million in industry. By contrast India's total workforce is 397 million (1999). The major employer is still the agricultural sector



with 60.5 percent or 240 million, industry is a relatively small 16.8 percent or 67 million, services seems rising but employs only 22.7 percent or 90 million (of this government alone accounts for 19.42 millions). Quite clearly in terms of employment we are still an agrarian society. But there is something else we must also understand here. China's population in terms of age break-up is passing through a phase of great demographic advantage. The cohort in the productive phase (15-60 years) of the life cycle is at its peak, whereas the dependency ratio in India is, relatively speaking, somewhat adverse. While 64 percent of China's population currently falls in the productive cohort, the corresponding figure for India is 59 percent. However in 20 years from now, while China's productive population will stagnate at 64 percent and hence catch up with China. That entails that India tool up to create amore productive and able workforce, stimulate investments and create a much bigger market for goods and services.

The important agreement was on trade with the two sides agreeing to boost bilateral trade, to \$ 20 billion by 2008. Currently it stands at \$ 13.7 billion, which is only 1 percent of India's China's global trade and 9 percent of India's. China's trade with Japan, South Korea and Taiwan is on a much larger scale and is expected to grow faster in the target of a \$ 20 billion turnover in bilateral trade as a modest one. The Chinese Premier observed the "complementaries" of the two economies. He said in Banglore that with India's expertise in software and the Chinese mastery over hardware, together the two countries could make great strides. The Indian Foreign Secretary mentioned biotechnology, nanotechnology and space as some of the areas in which the two countries could cooperate. New Delhi seems to be a little worry of creating a free trade zone between the two countries. Indian industries give the impression of being overawed by the competition form China at this juncture. A "report of India-China Joint Study Group on Comprehensive Trade and Economic Cooperation" (JSG), jointly prepared by the Indian and Chinese Commerce Ministries, stressed the need to take further "comprehensive measures" to expand trade and economic cooperation between the two countries. The JSG Report also talks about the benefits of a regional trading arrangement between India and China. Since the Doha Round of the World Trade Organization talks, the two countries have been coordinating their negotiating position on agriculture, intellectual property rights, investment and related issues.

After Wen Jiabo's visit, India and China signaled that they intend to cooperate more closely in the international energy sector. A small beginning has been made in Sudan where Indian, Chinese and Malaysian companies have packed up a joint stake in a big petroleum venture. The Energy Ministers of the two countries have appointed a joint task force to work out the details of cooperation. The leaders of the two countries have indicated that they will take up joint projects in the hydrocarbon sector in Central Asia. There is a proposal from the Indian side to have China as an end-user for gas from Iran and Central Asia. Both Turkmenistan and Iran want to build gas pipeline to India. These pipelines could be extended to China through Myanmar.

There is the suggestion that in India, at present, it is not FDI which promotes growth but it is growth which attracts foreign firms. This may be so but FDI could accentuate the growth process in progress. FDI is a catalyst in the growth process. It enhances the efficiency of other inputs in the growth process through this well known role as a supplier of technology and know-how. The efficiency of FDI as a catalyst depends on the extent to which the technology and know-how it contributes are assimilated and dispersed in the economy. Effective assimilation of imported know-how requires the adaptation of the imported by know-how to suit local labour and factor markets. Equally essential for the efficient utilization of FDI is the dissemination of imported technology and know-how to locally owned economic units. In other words, technology and knowledge imparted by FDI should spillover into contiguous areas of economic activity and enhance their productivity. Such spillover of technology constitutes an important source of externalities from FDI. The training and work experience gained by labour employed in foreign firms are also often disseminated to locally owned firms or set up their own establishments. The larger extent of these sorts of externalities from FDI, higher would be the social rate of return to the host country from a unit of FDI.

The empirical work on spillovers from FDI yields mixed results, some report negative spillovers. Those that report positive spillovers identify availability of skilled labour, high level of technological capabilities on the part of host firms and quality of infrastructure as key factors that report promote spillovers. India may be much better endowed with these ingredients than China. The Kearney report (2004) on the opinion of businessmen on the sort of investment incentives China and India

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provide is instructive: “Investors favor China and India for its market size, access to export markets, government incentive, favorable cost structured and macro economic climate” and “These same investors cite India’s highly educated labour force, management talent, transparency, cultural affinity and regulatory environment as more favorable than what China provides.

As a confident India Inc has started bidding for more and bigger deals abroad, in 2007-08 overseas investment from India will be around \$15 billion-surpassing foreign direct investment (FDI) inflows in the country. The bulk of outward FDI flow will be driven mainly by India's booming manufacturing sector. Indian companies' preferred investment destinations are the European countries and the US, as also Africa taking advantage of its cost competitiveness.

Further, in a 2005 report entitled “India-China: The Road Ahead” the CII has recommended several areas where India’s merchandise exports to China have bright prospects: a range of grains, fruits and marine products, granite, cement and plastering materials, chemicals and pharmaceutical and cotton-based fabrics. There is significant potential for growth in the services and knowledge-intensive sectors as well, particularly biotechnology, IT and ITES, health, education tourism and the financial sector, although here too governmental activities will be critical to harness mutual complementary.

Sectors such as pharmacy and automobiles will give a major thrust to the FDI outflow, though IT will continue to dominate the scene. 'Riding on strong balance sheets, good credit ratings and confidence shown by global business community, Indian manufacturing is leading India Inc.'s global quest,' The main factors fuelling the growing hunger for mergers and acquisitions (M and A) among Indian companies are huge fund supply, globally competitive business practices and favorable regulatory environment, besides higher margins, revenue, volumes and growth prospects. 'The number of outbound M and A deals has increased sharply over the past six years from about 37 in 2001 to more than 170 in 2006. The transactions gathered tremendous momentum in 2005'. 'The total number of deals actually doubled in 2005 from 2004 to reach a figure of close to 150 from 70 in previous year.' According to an investigation, the Indian conglomerates that are upbeat on inorganic growth are the Tata group, Bharat Forge, Ranbaxy, ONGC, Infosys and Wipro. 'The

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sectors attracting investments by Corporate India include a whole gamut of sectors - metal, pharmaceuticals, industrial goods, automotive components, beverages, cosmetics and energy in manufacturing; and mobile communications, software and financial services in services'.

More critical is the problem of excessive labour regulations, which China eliminated first in special economic zones and then national wide. This is the key to raising productivity and income-at present, the roughly 60 % of the population engaged in agriculture produces just 22 % of GDP, and output is growing at less than 2 %. A close second is opening up retail sector fully to foreign competition, and here again India could learn from its neighbor. By allowing in firms like Wal-Mart and Carrefour, China has benefited consumers, stimulated demand, helped to develop a host of other industries and fostered the creation of distribution networks. Until now, both moves have been blocked by leftwing parties in the ruling coalition. Nevertheless, the incremental steps being made show that these changes are within reach. For more than a decade, China has been the darling of the global business community, which falls over its “miraculous” growth. Now India is poised not only to shine, but even to eclipse China.

There is an imminent possibility in medium-term that Chinese currency Yuan will be revalued upwards. So that Chinese exports will prove costly. In other words, Indian products will be attractive to the foreigners. This will give impetus to Indian exports and its outsourcing activities. In India, a gradual weakening of the US dollar against other major currencies including Yuan has also influenced the rupee-dollar rates through cross-currency volatility. In fact, a large portion of India’s external trade is invoiced in dollar. This has made exports costlier and imports cheaper in India. The appreciation in rupee was also largely driven by surge in foreign capital in India stock and debt market Srivastava, 2005. A direct implication of the revaluation was that the cost to manufacturing in China would increase, but the domestic needs of China could offset this. There is a shortage of workers, electricity, steel and oil in China and revaluating the Yuan may make the import of raw materials cheaper. At the same time India exporters would get some relief for time being due to Yuan revaluation. The move may enhance the competitiveness of Indian products vis-à-vis China in the world markets. There are apprehensions that

China which is one of the world's largest importers of raw materials might lose appetite to import it. China is a major importer of steel and iron ore from India. There could be slow down in Indian exports to China Srivastava, 2005.

The Chinese success could be attributed to investment in the export-oriented sectors. Investments have flown mainly in labor intensive industries such as textiles and toys. FDI has increased the productivity across the industries. Chinese government provides financial incentives such as tax incentives and a lower duty coupled with the huge domestic economy has resulted in low cost products. There is a lot of scope for attracting FDI into Small Scale Industries (SSIs) (Chnniah, 2006).

Chinese performances in infrastructure sector have been remarkable and it should be looked into. Its success in manufacturing sector main drawbacks in India's economic development is lack of infrastructure facilities like power, roads, railways, oil and gas, aviation, telecomm nations, etc. Though some developments have been made in operational levels but a lot of initiatives are still required. China opened up FDI in retail sector in 1992 through joint venture route. Its success in retail can be replicate in India. But in India a consensus has not been yet developed for opening up retail sector for FDI. All new companies in China have the flexible to retrench workers and to pay productivity-based wages. In India entrepreneurs are forced to choose labour savings techniques due to its archaic labour laws. Therefore, there is a need to overhaul Indian labour laws.

One of China's biggest achievements has been in the area of primary and secondary education. Having implemented free, compulsory nine-year education in 1986, China reduced its illiteracy rate from 23 percent in the 1980s to just over 6 percent in 2000, China has higher enrolment ratio (94.6 vs. 87.5) and better pupil/teacher ratio (21) compared to India (41). Another spectacular success of China has been in the area of gender equality. The gender Related development Index ranks China at 65<sup>th</sup> while India is placed 98<sup>th</sup>. But beyond the ranks, it is the underlying statistics that make the picture starker. Female life expectancy is 73.5 years in China (India-65). China has a significant edge over India female literacy (86.5 percent vs. 47.8 percent) and female employment levels (2.4 percent vs. 42.5 percent). Among reasons for extraordinary success has been the decentralization of central government's control over foreign trade and foreign exchange has been

central to China's trade reforms. China turned from a net importer to a net exporter of grain. China created a liberal and flexible economic environment through the setting up of Special Economic Zones (SEZs). These zones served as focal point for investment. By the 90s, the SEZs and open cities accounted for over 50 percent of total realized investment and more than half of total exports.

India is still considered by foreign investors as a high cost, un-competitive manufacturer. It should take bold steps towards a modern and efficient tax system that incorporates the international best practices.

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## Chapter-6

# **AN ALTERNATIVE STRATEGY FOR INDIA**

Does India's indeed have any overarching strategy? On the surface, the answer may be negative. A deeper analysis, however, suggests that there is indeed a unifying theme underlying the Indian development paradigm. This theme can be summarized as openness to ideas, private initiative and reduced role for government. While the later has been a result of deliberate action, the first two have been ingrained into the Indian psyche over thousands of years and are highly path dependent. While it would be difficult to replicate them, the Chinese should strive to create an atmosphere for their development. In conclusion, the world today offers immense opportunities to both India and China . While the two countries have succeeded in exploiting some of them, they could accelerate the process by learning from each other. Through contextual differences might need changes in some policies and strategies, there is very little doubt that the two countries would ultimately benefit from this learning process.

It is important, however, to recognize that India's choice of placing political freedom ahead of economic liberalization puts a cap on the pace of development. Democracy, poverty, and large agriculture-based voter base have caused Indian governments to massively subsidize agricultural sectors at the expense of industrialization. Indian policy-makers have to balance between long-term social benefits-China is less constrained in this regard. China's emphasis on economic freedom before political freedom has served it well in some areas, especially in the context of delivering sustained and methodical growth. Is such a trade-off between political freedom and economic development worthwhile for developing countries? This is a question with no easy answer.

Without a well-articulated strategy for balanced economic development, India is destined to fall farther behind China even as it celebrates its shining success in the Software and Information Technology Services (SITS) sector. India's growth has been sporadic and opportunistic, with no strong central guiding policy. India's leaders need the vision for an economic agenda that recognizes democracy, sustainability, and



widespread socio-economic development. There is something useful for India to be learned by other developing nations from the experiences of China.

From the inter-sectoral picture it is quite clear that China is a fast industrializing country whereas India seems to be entering the post-industrial phase without having industrialized. We need to reverse this trend by stimulating industrialization, especially since it creates more jobs and has great multiplier effects on the economy.

The challenge ahead of us is not catching with China's growth rate, which inevitably must slow down. When nations compete, growth rates matter little if one is already well ahead. Can we do what China did to us in 1986? To do that in 2020 we need to grow at 11.6 percent and to do that long after most of us are gone in 2050. India must grow at 8.9 percent every year. Catching up with growth rates is not good enough. If that were the game we are already doing much better than the US, Europe and Japan. So if Montek Singh Ahluwalia says we will do 7 percent, that's very good. But that's just one swallow and that doesn't mean that our season in the sun is at hand.

The quantum of receipts and number of companies in India so far by way of disinvestment of PSUs is less than target (Economic Survey, 2002-03). In addition, reforms in State sector undertakings are much worst, i.e. at non-starter level. In this context Chinese experience is very useful and can break the ice. Many of the large State-owned enterprises (SOEs) in China have been reformed in a number of different ways including mergers and conglomerations to take advantage of economies of scale, corporation to induce private sector like management and scale to private hands through Initial Public Offerings (IPOs). Whereas the focus was on privatizing the small and medium SOEs, the diversification of ownership in large SOEs has had a wide-ranging impact.

Typically, under liberal trade policies, developing countries are much more likely to be able to expand exports and imports if a large proportion of their output originates in industry. Not only is the scope for expanding labour intensive manufactures greater, a larger industrial sector also requires imported inputs there by

offering greater scope for the expansion of imports. In India, the response of imports has been just as muted as that of exports. Imports have simply failed to absorb the foreign exchange generated by remittances and relatively modest foreign investment flows.

This same factor is also at work in explaining the relatively modest response of FDI to liberal policies. Investment into industry, whether domestic or foreign, has been sluggish. Foreign investors have been hesitant to invest in the industry for much the same reasons as the domestic investors. At the same time, the capacity of the formal services sector to absorb foreign investment is limited. The information technology sector has shown promise but its base is still small. Moreover, this sector is more intensive in skilled labour than physical capital.

Therefore, the solution to both trade and FDI expansion in India lays in stimulating growth in industry. The necessary steps are now common knowledge: bring all tariffs down to 10 percent or less, abolish the small-scale industries reservation, institute an exit policy and bankruptcy laws and privatize all public sector undertaking. In India entrepreneurs are forced to choose labour saving techniques due to our archaic labour laws. Whereas all the new companies in China have the flexibility to retrench workers and to pay productivity-based wages.

The optimum level of FDI could be defined as that level of FDI which maximizes social rate of return. Social rates of return to FDI would be a function of not only the quality of FDI, signified by the nature and extend of ownership advantages possessed by the foreign firms but also the ability of local management and labour to assimilate the technology and know-how imparted by foreign firms. Prerequisites for the effective assimilation of imported technology and know-how include the presence of research and development facilities which would facilitate adaptation of imported technologies, skilled labour which is adapt at learning by doing and adequate communication networks.

FDI inflows into China can provide a stimulus for India and other developing countries. Its success is clearly in terms of benefits gained from FDI inflows. The four major constraints which appear to play a dominant role in influencing FDI inflows into India are: (a) lack of policy initiatives, (b) inadequate

infrastructure facilities (c) rigidities in labour laws, (d) high fiscal deficit. A strong surge of FDI inflows into India may come true if these bottlenecks are removed.

Chinese experience in FDI is an eye opener to the Indian policy-makers that how it has attracted more FDI than the US, making it the largest FDI recipient in the world. China's FDI procedures are easier and decisions can be taken rapidly. The government provides infrastructure at affordable rates and foreign investment approvals are cleared by the local administration very quickly (Srivastava, 2005).

India is still considered by foreign investors as a high-cost, uncompetitive manufacturer despite some tax reforms. The ingredients of China's success in the global markets are very clear: low to zero duties on industrial inputs and capital goods, reasonable prices for power and capital, better infrastructure and labour flexibility. India should take bold steps towards a modern and efficient tax system that incorporates the international best practices.

The distinctive features have contributed to the success of Chinese SEZs. They include FDI from non-resident Chinese, attractive incentives, low indirect taxes, other tax benefits, flexible labour laws, liberal customs procedure, decentralization of power to local authorities, etc. India is creating SEZs on a large scale. Indian debate on SEZs is centered on tax breaks and land grabs. But there is a need to replicate Hong Kong like procedures in India (Aiyer, 2006).

The government is considering a proposal to increase the foreign direct investment (FDI) limit in scheduled domestic carriers to 74 % from 49%. The idea is being mooted to increase the funding options for domestic airlines, which have drawn up huge expansion plans. Various foreign private equity firms, institutional investors and NRIs have been increasing their stakes in Indian carriers. Foreign stake in Spice Jet and Air Deccan has already reached closer to 40 %. Analysts are of the view that a higher FDI cap would help bring in foreign investments in this sector which will go a long way in funding the fleet and operation expansion plans of the airlines companies. FDI in airports and airlines is considered important for government to achieve its long-term plan of creating an aviation grid across the country by developing 400 airports and airstrips. The government has already allowed 100 % FDI in airports through the automatic route.

The benefits of Software and Information Technology Services (SITS) sector in India have been constrained to educated elite and to urban areas. On contrary, with its focus on manufacturing, China has achieved a growth pattern that is more robust and balanced than that of India, and has created employment opportunities to absorb large agricultural workforce in industrial sector.

How has India fared on the manufacturing front? Despite a serious lack of world class infrastructure, the manufacturing sector is evolving in India. Large industrial house from South Korea, such as LG and Hyundai, are expanding their Indian manufacturing operations at a rapid pace to serve not just the Indian markets, but to use.

India as a base for export to Latin America, Asia, Eastern Europe, and Africa. Indian companies such as Tata Motors, Bajaj Auto Ltd, Mahendra and Mahendra, and Sundaram Clayton Ltd, have begun to venture into global markets. Unfortunately, while much needs to be done in terms of empowering the manufacturing sector with skilled workers and better infrastructure. This sector has not received the same attention and is hounded by numerous regulatory burdens that are waived for the SITS sector.

The main hindrance in India's economic development is lack of infrastructure facilities like power, roads, railways, oil and gas, aviation, telecommunication, etc. In this context Chinese performances have been remarkable and it should be looked into it. Its super success in manufacturing sector is mainly because of its world-class infrastructure facilities.

Unless the Central and State governments in India vigorously work to improve the basic infrastructure related to power, water, communication, and transportation, the manufacturing sector will not grow at a rapid clip. Yet, as China's experience suggests, for a relatively poor nation with a burgeoning population, rapid growth in manufacturing is the stairway out of the basement of poverty. India's development policies do not determinedly point in this direction at the moment.

Recently China has declared to adopt a managed floating exchange rate regime with reference to a basket of currencies. Consequently, Yuan has appreciated

against dollar by 2.1 %. It could move at the most by 0.3 % against the dollar, its implications are very crucial from the point of performance of external sector of the Indian economy. This is primarily due to China in recent years has emerged as a big trade partner of India.

A revaluation is likely to affect China's relative attractiveness for investments will increase for investor while price competitiveness products will decline in export markets. Hence, it is likely the Multinational Corporations (MNCs) may begin to diversify the location of investments away from China to spread risks especially since the Yuan may tend to appreciate in future to find its correct value. This may help India that is increasingly seen by the MNCs as an emerging destination for such investments.

Indian currency regime is already market determined and there is future. Therefore, India is likely to receive greater attention from MNCs as a platform for export oriented investments and for sourcing of products in the coming years. So the Chinese move is good news for India as far as the potential of FDI inflows and exports is concerned. However, to able to exploit the full potential of the emerging opportunities, we will need to fix the infrastructure and other bottlenecks and efficiently (Kumar, 2005).

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On the basis of analysis and interpretation of data the following conclusions have been drawn:

- (1) The comprehensive reform program launched in 1994 by China reflects the authorities' recognition of the numerous basic deficiencies in the economy, requiring correction. In the last two years, considerable progress has been made in foreign trade and foreign exchange liberalization, the development of a modern tax code and revenue-sharing arrangements, as well as in social and economic legislation. However, despite these impressive achievements, enormous difficulties continue to confront enterprise reform, housing and social welfare, tax administration, financial reform, and law enforcement. Here, China's economy has transformed from a centrally planned economy dominated by the state sector to a market-oriented economy consisted of firms with various ownership form.
- (2) One direct outcome of China's economic reform is the expansion of China's trade with the rest of the world. External trade has become a very important element of China's economy. During the past 20 years, China's total trade increased from US\$ 38 billion in 1980 to more than US\$ 474 billion in 2000. In 1980, China's export and import account for 0.9% and 1% of world total in 1980. In 2000, the figures are 3.9% and 3.5% of world trade, respectively. The importance of China's as a large trading nations had been growing steadily. China is the world number 7 largest exporter in 2000, up from number 26 in 1980. At the same time, trade also becomes increasing important as a percentage of China's GDP. In 1980, the ratios of export and import in GDP are 6.0% and 6.6% respectively. In 2000, they increased to 23.1% and 20.8%.
- (3) After 17 years of successful reform, the authorities still retain some remnants of distrust of the price mechanism. As stated, most of the prices have already been freed of government controls. But, it is in the remaining areas deemed by the authorities to be of critical importance to the national economy that

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price controls still remain. These areas include basic materials, such as steel and cotton; energy, such as coal and electricity; transportation, such as railroad; staple food, such as grains and edible oil. Policies designed to ensure their plentiful supply at low prices are precisely those that retard production, contribute to shortages, and add to the burden of budgetary subsidies. Administered interest rate is another example of misconceived policy that distorts credit allocation and thwarts the development of money and capital markets in China.

- (4) Following the communist party take over of Mainland China in 1949, the national trade policy was based on self-reliance, where the economy was mainly controlled and planned by the central government. Almost 90 % of China's population were rural and employed in the agriculture sector, which contributed 70 % of the national income. The central government ruled all aspects associated with the development of the economy. It made decisions on macro-economic activities and monopolized purchasing, marketing of commodities and the supply and allocation of materials. Moreover, all production processes and products manufactured were determined according to the state plan and all profits generated by enterprises and local government and to be handed over to the state government. During the continuous development stages, the state extended its open-door policy towards more provinces. A noticeable inflow of foreign capital surged into China in the period of high growth. The central government started lifting its ban on foreigners from having joint ventures. The open policy in the 1990s shifted from costal regions to the western inland area. The Chinese government begins to open more inland cities and region investment. In the late 90s, China continued to open up more markets and reduce barriers to foreign investors in an effort to enter World Trade Organization (WTO).
- (5) From 1978-2006 China has maintained its strong growth momentum and continued its integration into the global economy. Despite the difficult world economic environment and domestic uncertainties, China's GDP growth has remained above 7.50 percentages in recent years, supported by appropriate macroeconomic policies and structural reforms. Spurred by accession to the WTO in December 2001, China's exports have expanded rapidly, at the same



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time, robust domestic demand and further market opening under China's WTO commitments have also led to strong import growth. Real GDP grew by 8 percent in 2002, underpinned by the strength of exports fixed investment, which registered growth rates of 22 percent and 17 percent, respectively. In 2003, the outbreak of Severe Acute Respiratory Syndrome (SARS) in the second quarter temporarily dampened GDP growth as activity in the services sector weakened. However, external trade continued to expand rapidly, and the services sector appears to have made a quick rebound in the first three quarters of 2003, GDP grew by 8.50 percent (year -on -year), led by strong fixed investment. Deflationary pressure has been easing. After declining by 0.8 percent in 2002, consumer prices increased by 0.7 percent in the first nine months of 2003. Despite the strong GDP growth, unemployment continues to rise: registered unemployment in the urban areas increased to 4 percent in 2002, up 0.4 percentage points from 2001. The level of surplus labor in the agricultural sector is estimated to be larger, and rural-urban income disparities have continued to widen.

- (6) China's overall external position has strengthened further. The current account surplus rose from 1.5 percent of GDP in 2001 to 2.75 percent in 2002, mainly on account of increase in the trade surplus and private transfers. The financial account posted another large surplus in 2002, as foreign direct investment (FDI) inflows amounted to \$ 53 billion and there was a repatriation of other capital from abroad. Official reserves increased by 4 76 billion in 2002. In the first 9 months of 2003, the trade surplus decline sharply as imports surged by 41 percent, while exports grew by 32 percent. However, official reserve rose by \$ 98 billion, reaching \$ 393 billion by end-September (equivalent to around 10.50 months of import). While FDI inflows have remained strong, the pickup in the pace of reserve accumulation in 2003 mostly reflects other capital inflows.
- (7) In the coastal region of China, which possesses a pool of intelligent educated R&D staff and skilled labor and hosts most of China's R&D activities and top universities and research institutes and where inward FDI has evolved from labour-intensive processing activities to more strategic asset-seeking type FDI by major MNEs, FDI has played a significant role in promoting regional

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innovation capacity as well as regional innovation efficiency over the 2000-2004 period.

- (8) China finds a better governance to serve its goal of growth. And during the early phase of economic development, when the average income of population is much lower, the growth target is easier to be placed on the top of government agenda. China did so and what China did better than India is because it is much easier to make out an effective governance of growth under China's political system than under federalism India. What challenges China in the future is how Chinese system responds effectively to diversified interests of society and how Chinese government enforces its cohesion when growth target is no longer on consensus. For instance, China's rapid growth from below has increasingly enlarged the regional income disparity and social income gap in the past decade. These problems threaten social and political stability in China. China needs to manage these social problems. Recent experience has indicated that China is on the crossroad between implementation of growth target and moving towards to more distributional policies.
- (9) China's output growth is sustainable into the next century, say, to 2010, if and only if it succeeds in implementing its current comprehensive reform program. Predictions of China's becoming a great economic power by the year 2010 are greatly exaggerated. At best, it could become another newly industrialized country. Nevertheless, because of its sheer size China remains an attractive market for businesses that are experienced in trading with or investing in developing economies.
- (10) China's export competitiveness hinges on the coincidence of several factors: the favorable exchange rate, low wages and available supplies of unskilled labor, the reduced cost of communication and transportation, the flow of foreign direct investment and foreign management and its implications for China's productive abilities, the large scale of the potential Chinese domestic market, the opening of world markets, and the encouragement of Chinese foreign trade policy. On the other hand, certain considerations have special importance. For example, Chinese export growth is more than a matter of low wages and an undervalued exchange rate. Chinese producers have become

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greatly more proficient at meeting world requirements for quality and product design. The large inflow of foreign direct investment and entrepreneurship, which is responsible for much of the export flow, has facilitated this process, and, in turn, reflects the favorable economics of export production in China. The shift of Chinese production toward more advanced products with technological content is also notable.

- (11) Chinese producers have become greatly more proficient at meeting world requirements for quality and product design. The large inflow of foreign direct investment and entrepreneurship, which is responsible for much of the export flow, has facilitated this process, and, in turn, reflects the favorable economics of export production in China. The shift of Chinese production toward more advanced products with technological content is also notable. On one hand, this represents competition with other East Asian countries. On the other, it reflects a collaborative symbiotic relationship with South Korea, Singapore, and Taiwan whose cost structure has outgrown the simpler high technology goods that supported earlier phases of their industrialization. China's competitive ace in the hole continues to be its large and potentially mammoth domestic market. Foreign firms seek entry to China not only to take advantage of low cost export platforms, but also as a way to position themselves for future local sales. Aside perhaps for India, there is simply no other developing economy with such promise as a market percent of their products on the domestic market.
- (12) The Chinese government currently faces a number of major policy choices relating to the foreign investment policy framework. Its priorities are:
- To continue to attract high-technology, large ticket investment, in order to pursue industrial restructuring and to foster import-substituting investment;
  - To attract large sums of FDI into infrastructure, where expenditure of over nearly \$750bn is expected to be needed between 1995 and 2004;
  - To attract investment into the interior provinces, consonant with the aim, enshrined in the current ninth Five Year Plan, of spreading development inland;

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- To design an investment regime which, while it does not conflict with the demands of membership of the World Trade Organisation, also allows for the pursuit of industrial reform at a measured pace;
  - To open the domestic market to foreign investment across a broader spectrum.
- (13) In the early years after China's opening, FDI is mostly in the form of contractual joint ventures, where the risks of foreign participants are lower. As the reform deepened and the business environment improved significantly, equity joint ventures increased in their importance. In recent years, wholly foreign owned enterprises become increasingly important. Foreign-invested firms have become a very important part of the Chinese economy.
- (14) From 1978 to 2000, China's GDP grew by 9.5% annually on average from RMB 36 billion to RMB 882 billion. GDP per capita also increase dramatically at an annual rate of 8.3% from RMB 379 to RMB 7,078. FDI increase from a very level in the late 1970s to more than US\$ 40 billion a year the in the late 1990s. FDI and FIEs formed an important element in China's economic growth in both the national level as well as regional level.
- (15) After more than two decades of China's economic reform and open-door policy, enterprises funded by external investment have become an important and the most dynamic part of the economy. This is particularly true for the eastern part of the country. FDI from Hong Kong, Taiwan and other neighboring economies make up the bulk of the investment. These investments concentrated primarily in the two southeastern provinces of Guangdong and Fujian. Since 1992, FDI have increased dramatically. FDI from industrial countries, in particular, have increased significantly in both the total amount and the relative importance in total FDI. These investments are also more geared towards the domestic Chinese market.
- (16) Adding to total industrial output and value-added is not FIEs. Increasing the number of FIEs intensifies competition in the domestic market and forces domestic SOEs and non-SOEs to respond more quickly to market signals. More and more interaction between FIEs and local government official as

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well as local businesses also help facilitate the development and adoption of rules and the laws suitable for a market-oriented economy.

- (17) Like in many other development countries, Chinese authorities encourage technology transfer through various forms of foreign investment in the economy. China's FDI policies since the reform have been formulated to reflect those objectives. In recent years, FDI in China increased significantly and, at the same time, more and more projects are in industries. In 1995, about 30% of all the firms in Garment and other fiber products are FIEs. They produce 50% of the industry's total output and value-added. In 2000, FIEs' contribution to output and value-added decreased slightly. In textile, FIEs are not as important but still account for about 20% of the industry's total in number of firms, in output, and in value-added.
- (18) FIEs have increased their share in industries with relatively high technology sophistication in recent years. These FIEs produce 72% of the industry's total output, and generate 65% of the industry's total value-added. In 2000, China exports 4.7% of the world total in manufacturing export and ranked number 6 among countries. In 2000, China is among the top 15 exporters in all sub-categories of manufactures except automotive products. This suggests that FDI in China has played an important role in helping China move up the technology ladder and to industrial restructuring. The initial pattern of export promotion in low-tech, labor-intensive industries has been augmented with more and more FDI in more advanced industries with higher technology requirement.
- (19) China's growing foreign exchange reserves do not imply wealth that is disposable at any time, but rather a sizeable indirect debt. In 2005, only half of China's accumulated foreign exchange reserves was consistent with its wealth, which allowed Beijing to fulfill international payment obligations. The remaining capital inflows (FDI and short term capital inflows) could be interpreted as implied debts (long run and short term foreign borrowings) that China would have to pay back eventually. In particular, the 22% short term capital inflows could easily reverse. Asian and Latin American experiences show that financial crises have often been triggered by such hot money flows.

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- (20) There is little solid evidence that China's currency is undervalued and even if it were, given the variation in equilibrium exchange rate estimates offered by economists, reluctance on the part of China's policymakers to significantly revalue the RMB is unsurprising. Many of the benefits currently accruing to China as a result of a stable exchange rate also appear insufficiently recognized and similarly many of the costs involved in moving to a flexible regime. Perhaps the most prominent shortcoming of the consensus position is that it fails to convincingly demonstrate how exchange rate stability is at the root of problems in China's economy today. China's economic performance over the past decade suggests that it has not been hopelessly trying to reconcile the "irreconcilable trilemma" from macroeconomic theory, which states that a country cannot simultaneously pursue free capital mobility, a fixed exchange rate and an independent monetary policy. While its capital controls are certainly porous to a degree, when combined with partial sterilization and monetary policy in which administrative tools remain effective, China has been able to maintain both macroeconomic stability and a stable exchange rate.
- (21) New parts of the world, long considered underdeveloped backwaters, are now taking center stage in the global economy. Rapid ascendancy of China's economy is much publicized as it transformed into a major venue for manufacturing of cheaper goods sought after by global consumers. India also is exhibiting a vigorously growing economy partially fueled by companies around the world trying to reduce their costs by outsourcing some of their operations to India. The first sign that something was up came around the late 1990s, stories began to appear in the international media that India was "stealing" jobs from the U S and other wealthy nations. These were not just industrial jobs like those that migrated to China, but many white-collar jobs of well-educated people. Today everyone knows that the small trickle of jobs from developed nations to India which started in the late 1990s has become a veritable flood.

India now is said to be the back office of many banks, a magnet for labor-intensive, tedious programming, and the customer service voice of every company from British Airways to Microsoft. It is reported that during the past

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five years alone, over 100 Information Technology (IT) and scientific companies have located their Research & Development (R&D) labs in India. These are not routine drudge jobs. High-tech companies are coming to India seeking innovators of the future world. Their recruits are young graduates fresh from the Indian universities and elite Indian Institutes of Technology (IIT). The knowledge revolution is on and some senior scientist and officials believe that India can short-cut the established path to industrial development and move straight to a knowledge economy. It is observed that India has long possessed a strong market-driven economy, private corporations, democratic government (the largest democracy in the world), western accounting standards, an active stock market, wide-spread English usage, and schools strong in computer science and Math. As Sender states, India's English speaking, highly educated workforce has been a source of low-cost technology and service labor.

- (22) China's growth is strong, but it is based on the rapid expansion of sectors of its economy that are already well developed. That can work for a while, but it also adds to China's internal imbalances. The last time around when investment rate spiked from 35% to 45% of GDP in the early 1990s, the outcome was a hard landing. The risk of another – economically painful and socio-politically destabilizing - hard landing is still high. China's existing growth model looks to be running up against real limits, both internally and globally. Sustaining growth will require reorienting China's economy – and relying, at least on while, on rapid expansion of domestic consumption to sustain growth. In the contemporary world, both India and China are fast growing economies. Now, the bilateral trade and investments are growing between the two countries indicating the presence of vast potential for growth. China is emerging as a critical link in the manufacturing chain while India's potential for knowledge based services and manufacturing is recognized. In labor-intensive products, both countries are competitive. China has agreed to provide non-discriminatory treatment to all WTO members, elimination of dual pricing between domestic and export products, price controls, elimination of export subsidies on farm products, reduction in tariff duties and removal of non-tariff barriers to name but a few. China's joining

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of the WTO has coincided with rapid rise of Indo- China bilateral trade. The two-way trade grew over 25 per cent per annum. Indian exports to China increased by 26 per cent and imports from China increased by 24 per cent during 2000–2004 periods.

- (23) Major change in product composition of China's exports to India occurred in 2003 with the entry of large number of electric and electronic products. However, the product concentration remained stable during 1996–2003. The analysis reveals that an increase in Chinese import demand, product diversification and influence of competitiveness has contributed to rise in Indian exports to China. When all the products exported from India are taken, the competitive factor emerges as most important with 50 per cent changes in India's exports. Similarly, for China, increase in competitiveness is a major factor and it is followed by the demand factors. India showed a comparative advantage over its competitors in the Chinese market in certain items of textiles, leather products, chemicals, engineering and granite. Advance and medium technology products dominate Chinese export basket to India. Trade margins are relatively high for large number of products imported from China, particularly electrical and electronic products. China has diversified its exports to India. An increasing number of companies are sourcing input supplies from China. This is due to lower prices, acceptable quality and prompt delivery.
- (24) China incurred 46 percent of its import expenditures on machinery and transport equipment. The corresponding expenditure by India was only 19 percent. This reinforces the point made earlier: for its needs, India is far more specialized in the capital goods industries than China. The difference between India and China looks even more impressive when we consider the absolute levels of their expenditures on the SITC 7 imports: \$253 billion by China versus just \$22 billion by India.
- (25) Foreign direct investment (FDI) is also an area where India appears to lag behind China. In 2006, China attracted 10 times more FDI than India owing to its more liberalized policies for foreign investors. Moreover, the Chinese economy is growing faster and its infrastructure is better. Although strict protection policies remain in place in selected sectors in China, such as



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automobiles, India's restrictive labour laws and limits affecting foreign shares in ownership restrain foreign investment in general. In particular, India's inadequate infrastructure development makes it very difficult for multinational companies to ship products in and out of the country, and even within the country. China is certainly a star performer in attracting FDI, but India did not perform commensurately badly, given the large disparity in performance. China accounts for 5% of world GDP and India for about 2%, at current exchange rates. As bigger economies normally attract more investment, China currently tends to be the preferred destination for foreign investors. But in terms of FDI percentage of GDP, China's figure is less stunning—only two and a half times that of India.

- (26) The statistics suggest that the productivity of FDI in India is higher than that in China. This suggestion, through it needs detailed statistical verification at the disaggregate level of sectors of industry, provides yet another expansion for the observed differences in volume of FDI in the two countries. It is that India may not require as large a volume of FDI as China harbors. India attracts now may not be adequate for generating a 10 percent rate of growth aspired for by India's planners but the optimum level of FDI the country needs may not be much higher than the present level of inflows of FDI. In the meantime Indian exports are now facing the direct, short-term prospect of being more competitive in the marketed vis-a vis Chinese goods. This is primarily because of increasing the cost of manufacturing in China.

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