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Asia's Best-Kept Secret

Growing Economic Ties Between India and China

On March 15, 2013, Mr. Li Keqiang was elected by the Communist Party Congress as premier, the second most important position in the Chinese government after General Secretary and President Xi Jinping. Two months later, Premier Li embarked on his maiden official visit outside China. The first stop on his tour? A three-day visit to India. Hopping over to India so early in his term was a clear signal of China's foreign policy priorities. As the premier remarked upon his arrival in New Delhi: "We are one-third of the world's total population and our interactions attract the world. Without doubt, China-India relations are [among the] most important global relations."¹

As is true for many neighbors, the relationship between India and China remains full of tensions—both economic as well as geopolitical—which we discuss later in this chapter.



THE SILK ROAD REDISCOVERED

These tensions are unlikely to ease any time soon. Yet there are good reasons to predict that the economic ties between the two countries will continue to strengthen and, by 2025, will be among the ten most important bilateral ties between any two countries in the world.

Even if the Chinese and Indian economies were to grow at only a 5–6 percent annual rate over the next ten years, by 2025 they would rank as the largest and fourth-largest economies in the world, the other two being those of the United States and Japan.² Both countries have also become springboards for the emergence of global champions across a range of industries from technology (Tata Consultancy Services, Infosys, Huawei, and Lenovo) to heavy manufacturing (Tata Motors, Mahindra, Geely, and Chery) to fast-moving consumer goods (Godrej and Shuanghui). Given the size and growth rate of the two economies, growing numbers of Chinese and Indian companies with global ambitions have little choice but to look across the Himalayas and think of their neighbor as one of the world's largest markets sitting right next door.

To date, economic ties between India and China have been dominated by trade rather than investment. Bilateral trade between the two grew from less than \$3 billion in 2000 to \$69 billion in 2012—an annual growth rate of almost 30 percent, significantly faster than the 19.4 percent and 19.2 percent annual growth rates, respectively, in China's and India's trades with the rest of the world, or the 9.2 percent growth rate in world trade.³ In contrast, the stock of foreign direct investment has been small. At the end of 2012, the stock of Chinese investment in India added up to only about \$800 million.

Asia's Best-Kept Secret

The stock of Indian investment in China was also equally small—about \$500 million.⁴ However, the picture is changing rapidly. India's Mahindra Group is currently the fifth-largest tractor manufacturer in China, with a market share of about 9–10 percent. It aims to move up to a number three position within the next five years. Tata Motors' Jaguar Land Rover subsidiary (JLR) has been the fastest-growing luxury auto seller in China over the last five years. In November 2012, JLR established a 50:50 joint venture (JV) with China's Chery. The partners are investing more than RMB 10 billion in a new manufacturing plant and R&D facilities in Changshu, near Shanghai, which are expected to go onstream in 2014. China's Huawei has had its second largest R&D center in Bangalore since the late 1990s. Huawei currently employs over five thousand people in India and has also started manufacturing operations in the country to make telecom hardware. Haier, the home appliance giant, currently manufactures refrigerators at a plant in Pune, India. Given its robust growth in the Indian market, it is now planning to expand its manufacturing base in the country. These are just some of the new developments presently under way in both countries.

This book is targeted at the leaders of both Indian and Chinese multinationals for whom the other country could be a supplier, a customer, a competitor, and a partner and who view their Himalayan neighbor with a sense of mystery and perhaps trepidation. It should also be of high interest to policy makers in both countries (since they serve as important gatekeepers) as well as to leaders of multinational corporations in the United States, Europe, Japan, South Korea, and other countries with operations in both countries. Growing integration

THE SILK ROAD REDISCOVERED

between India and China will offer new opportunities as well as new competitive challenges to their companies. It is important for them to know what's afoot.

In this chapter, we discuss the evolving ties between India and China. Although our primary focus is on economic linkages, we begin with a discussion of the historical ties between the two civilizations, the recent history of geopolitical tensions between them, and how their citizens view each other. This multifaceted examination of cross-country ties is important because economic relations are not only embedded in and influenced by cultural linkages, personal attitudes, and geopolitical relationships but, in turn, also shape them.

Subsequent chapters discuss the potential opportunities that Indian companies could pursue in China and the challenges that they are likely to face. We also present detailed case studies of some of the pioneering Indian companies that have made a long-term commitment to China and are beginning to see that commitment pay off. These case studies may inspire and offer lessons to other Indian companies contemplating a move into China. Rounding out the story, we also include a chapter on corporate moves in the other direction—that is, the entry of Chinese companies into India. We close by offering a China-focused roadmap for Indian companies.

THE HISTORICAL BACKDROP

But for a brief border war in 1962 and the subsequent tensions that remain alive, China and India have enjoyed a harmonious relationship going back more than two thousand years. Unlike,

Asia's Best-Kept Secret

say, the relationship between China and Japan, there is no fundamental fault line between the Indians and the Chinese. Yes, there is wariness (on the part of the Indians) and a degree of disdain (on the part of the Chinese). However, there is no emotional dislike between the two peoples.

In ancient times, the ties that brought China and India together were religious and intellectual as well as economic. Serious cultural interactions began in the fourth and fifth centuries A.D. when Indian and Chinese scholars traveled to each other's countries and played a key role in bringing Buddhism to China. Two of the key players were the Chinese monk Fa Xian and the Indian scholar Kumarajiva. Fa Xian visited India in the early part of the fifth century, stayed there for ten years and, upon his return to China, translated many Sanskrit and Buddhist texts into Chinese. Kumarajiva collected and translated many important Buddhist texts into Chinese at a large Buddhist complex in Chang-an (today's Xian). He lived there until his death in 413 A.D. The scholarly exchanges continued for many centuries, with people such as the Indians Dharmakshema and Bodhidharma and the Chinese Fa Hein, Xuan Zhang, and I Ching taking the Silk Road to share ideas with each other's cultures.

In the eighth century, an Indian scientist was appointed by China as the president of its Board of Astronomy. And the famous fifteenth century Chinese admiral Zheng He (who reportedly had a more impressive fleet than that of Christopher Columbus) visited India often and played an important role in expanding trade links between the two countries.

THE SILK ROAD REDISCOVERED

Although cultural exchanges remained dormant during the colonial period in both countries, the underlying warmth endured. In the early twentieth century, the poet and Nobel laureate Rabindranath Tagore visited China and was welcomed with love and respect. Following both countries' independence from occupying powers, the 1950s promised to usher in an era of exceptional warmth in the relationship. India was one of the first countries to end formal ties with Taiwan and recognize the PRC as the legitimate government of China. Alas, the Sino-Indian war of 1962—rooted in border disputes and India's decision to give sanctuary to the Dalai Lama—brought an end to any further talk of "*Hindi Chini Bhai Bhai*" (Indians and Chinese are brothers).

Indians remain bitter about the war to this day. Across the Himalayas, however, the Chinese soon found themselves consumed by events far more dramatic and much closer to home—the Cultural Revolution. For the average Chinese citizen, the outside world ceased to matter and the war with India receded from memory. In 1976, the cultural revolution came to an abrupt end with the deaths of both Mao Zedong and Zhou Enlai. As the new leaders started experimenting with opening up and reforms, China met India again—through films such as *Awaara* and *Do Bigha Zameen*. Following the oppressiveness of the Cultural Revolution, these films were like a breath of fresh air. Here is a personal account from Haiyan Wang, a Chinese and a coauthor of this book, who lived through this period.

Asia's Best-Kept Secret

***Awaara*—A Cultural and Emotional Landmark
for Millions of Chinese***Awaara boon, Awaara boon ...**Ya gardish mein boon**Aasman ka tara boon ...*

Hum this song today to any Chinese man or woman born in the mid-1960s or earlier, no matter in what rank of position or field of work, and the chances are pretty high that he or she will hum back. It's the title song from Raj Kapoor's 1951 movie *Awaara*. Screened in 1977 in cinemas across China, *Awaara* swept across the country like a spring breeze melting winter's frozen ground, a breathtaking experience for millions of Chinese people.

Humming the songs from this film was the coolest and trendiest thing back then. I remember huddling around a borrowed cassette player with a dozen of my middle school classmates. We played the songs "*Ghar Aaya Mera Pardesi*" and "*Ab Raat Guzarne Wali Hai*" over and over again for hours to learn to sing them, so that we could perform on stage in school.

The year 1977 was at the end of the cultural revolution and the dawn of China's opening and reform. Having been allowed to see only a small number of revolutionary films during the cultural revolution, we were blown away by the artistry, the imagery, the radiant beauty of the main

THE SILK ROAD REDISCOVERED

characters, Raj and Rita, the songs, and the sensual scenes. For the first time, watching a movie was not about getting a lesson in communism but about letting your imagination run.

Oh World! I am devastated,
but I sing songs of happiness.
My chest is full of wounds,
but my carefree gaze laughs ...

So sings Raj, the vagabond. Having endured the anguish of life and hardship of poverty like Raj did, we found it refreshing and uplifting to find in Raj an unyielding free spirit and romantic passion.

Before there was Hollywood in China, there was Bollywood. It was this Indian film that first gave millions of Chinese people a window on the outside world—a world that was not about ideology or revolution, but about the pursuit of freedom, love, and humanity.

—Haiyan Wang

The Chinese fascination with Indian culture remains alive and well. With growing affluence, urban Chinese are once again turning to Buddhism in increasing numbers. As well, the practice of yoga is spreading to every corner of China. There is even the distinct possibility that Bollywood films and songs may make a comeback. *Life of Pi*—set in India, although not a Bollywood film—was extremely popular throughout China.

Asia's Best-Kept Secret

During the summer of 2012, we were pleasantly surprised to find dozens of Chinese couples dancing to the tunes of a Bollywood song in the public square in Xian. A Chinese studio is even working on a cross-cultural Chinese and Indian film due for commercial release in late 2014.

Might *Gold Struck* Strike Gold?

In August 2013, Hong Kong-based Light House Productions announced that they will shortly begin shooting *Gold Struck*, a cross-cultural film complete with Chinese martial arts and Bollywood songs and dances. The film is expected to be the story of two Indian and Chinese research students who become friends at an American university and then embark on a time-travel adventure that takes them back to 220 B.C. in China's Qin Dynasty era.

The film will be directed by Tony Cheung and Cory Yeun and feature dialogue in English, Mandarin, and Hindi. It will be shot in the United States, China, and India and released in all three countries as well as other markets such as Australia, Canada, and the United Kingdom, which have high numbers of both Chinese and Indian immigrants. Light House is collaborating with Gayathiri Batra, an Indian media executive. Cindy Shyu, Light House's CEO, explained that her motivation for making this film originated with the realization that,

THE SILK ROAD REDISCOVERED

although Chinese audiences have long been interested in Indian films and dance, they currently have little opportunity to experience Indian cinema. Because the film is being produced by a Chinese company, it will not be considered an import and thus will be free from import restrictions on foreign films.⁵

GEOPOLITICAL TENSIONS: AN IRRITANT BUT NOT A SHOW STOPPER

Ask any observer of India and China—in the government, the industry, academia, or the media—to describe the relationship between the two neighbors, and it is a near certainty that “trust deficit” will emerge as one of the top two observations. Geopolitical tensions are the root cause of the ongoing lack of trust.

Unresolved border disagreements and China’s enduring support for Pakistan are the two biggest factors behind the geopolitical tensions.⁶ Other contributing factors include India’s hosting of the Dalai Lama as an “honored guest” and growing competition between the two countries in the Indian Ocean region.⁷ It is our contention that, although all of these are significant irritants for both sides, none poses any foreseeable danger to a more rapid and deeper economic collaboration between the two countries. In fact, deeper economic engagement, especially via direct investments, holds the prospect of helping both sides mitigate and perhaps resolve the geopolitical tensions in due course.

Asia's Best-Kept Secret

Consider border disputes, the single most contentious issue. India and China share a 2,500-mile border. Ever since India's independence in 1947 and the formation of the People's Republic of China in 1949, the two countries have never agreed on the boundaries that divide them. To the north of India, China controls a vast area that India claims to be part of its territory. And on India's northeastern frontier, the Indian state of Arunachal Pradesh is claimed by China as its South Tibet. After the 1962 war, both sides started placing observers and troops along the line of actual control. Until 1987, daily exchanges of gunfire were routine. That year, the two countries even came close to another war.

The December 1988 visit to China by Rajiv Gandhi served as a turning point. This was the first visit to China by an Indian prime minister since the 1954 trip by Jawaharlal Nehru. Gandhi's visit resulted in an agreement to seek a peaceful and mutually acceptable solution. India and China would set up a joint working group on the boundary question and hold annual consultations between their foreign ministers. The two sides also agreed to establish direct air links and cooperation in economic and scientific matters.

Twenty-five years later, the two countries are no closer to resolving the boundary disputes than they were in 1988. Each also routinely accuses the other of incursions along the line of control. From time to time, China also starts stapling (rather than stamping) its visa on the passports of Indian nationals from the states of Jammu and Kashmir and Arunachal Pradesh—a practice that infuriates India, whose Foreign Affairs Ministry will not accept the stapled visas as legitimate.

THE SILK ROAD REDISCOVERED

In 2012, China began issuing new passports to its citizens that included a map showing various disputed territories to be part of China. Immediately thereafter, the Indian government started using a new visa stamp that included its own version of the map of India.

While these skirmishes continue, it is critical to remember that for almost twenty-five years the guns have been silent. Leaders of both countries appear to believe that the most important agenda for them is economic development. This requires peace on the borders. As Mrs. Nirupama Rao, India's Ambassador to the United States—and former foreign secretary as well as former ambassador to China—noted in a 2012 speech at the Hudson Institute: “The foremost task of India's foreign policy is to enable the domestic transformation of India ... This requires us to work for a supportive external environment that is peaceful, thus enabling us to concentrate on our growth and development.”⁸

President Xi Jinping's remarks after a 2013 meeting with Prime Minister Manmohan Singh on the sidelines of the BRICS (Brazil, Russia, India, China, and South Africa) summit in Durban, South Africa, echo a very similar viewpoint: “China and India should broaden exchanges and cooperation between their armed forces and deepen mutual military and security trust ... [Both sides] should continue to safeguard peace in their border areas and prevent the issue from affecting bilateral relations ... [Both sides] have a similar mission to boost their social and economic development ... in an important period of strategic opportunities.”⁹

Asia's Best-Kept Secret

Consider also the views expressed by Premier Li and Prime Minister Singh in a joint address during the former's visit to India in May 2013:

Premier Li: "We don't deny that there are problems between the two sides. We need to improve border related mechanisms and make them more efficient. Both Mr. Singh and I believe there are far more common interests than differences between our two sides. We need to confront issues with a broad mind and tackle them in a mature way."

Prime Minister Singh: "[India and China] have agreed that our special representatives will meet soon to continue discussions seeking an early agreement on a framework for a fair, reasonable and mutually acceptable boundary settlement. Peace and tranquility on our border has to be preserved."¹⁰

Entirely consistent with these viewpoints, a 2011 U.S. Defense Department study, based on confidential interviews with policy advisors in both India and China, summed up the situation as follows: "Indian and Chinese officials and analysts recognize that despite ... tensions between them, they have strong incentives to keep the relationship stable. Both countries confront serious economic development and domestic stability issues at home, and both countries are trying to promote peaceful security environments that are not hostile to their rise in power."¹¹

Interestingly, the contentious issue of Pakistan also forces China and India to maintain stable and peaceful relations with

THE SILK ROAD REDISCOVERED

each other. Although it is undoubtedly true that friendship with Pakistan gives China some leverage over India, the future stability of Pakistan is a major and shared concern for both China and India. Should Pakistan's internal situation worsen or its nuclear arsenal fall into the hands of extremists, that would be a nightmarish scenario for both countries.

There are four reasons why we believe that the odds favor a stable and peaceful rather than a turbulent relationship between India and China. First, as already noted, political leaders in both countries realize that their nations face extremely large opportunities for economic and social development. Realizing these opportunities requires peace on the borders. Second, leaders on both sides openly accept their mutual destiny as two of the world's leading superpowers by the middle of the century. Thus they have little choice but to keep searching for a way to coexist amicably and join as responsible large powers in the governance of global institutions. Given also their rapidly growing economies, they have much to gain from stronger economic ties.

Third, two of China's immediate neighbors (Japan and South Korea) already have defense treaties with the United States. Others (such as Philippines and Vietnam) are moving in that direction. India too is developing an increasingly close relationship with the United States. A serious deterioration in the India-China relationship will significantly increase the likelihood of a formal treaty between India and the United States. Given the existing global rivalry between China and the United States, it is more advantageous for China if India

Asia's Best-Kept Secret

remains a relatively neutral player rather than becoming solidly aligned with the United States.

Last but not least, India is boosting its defense capabilities aggressively through both internal efforts as well as procurement from and technological collaboration with the United States, Russia, France, and the United Kingdom. These efforts include building and/or acquiring nuclear weapons, stealth aircraft, nuclear-powered submarines, aircraft carriers, as well as missiles capable of reaching almost anywhere in China. As with the cold war between the United States and the U.S.S.R., this build-up is creating a *détente* whereby neither side could risk starting a hot war with the other.

In light of these factors, we believe that there are solid reasons to accept at face value President Xi's public statements after his March 2013 meeting with Indian leaders in Durban, South Africa: "The border question is a complex issue left from history and solving the issue won't be easy. However, as long as we keep up friendly consultations, we can eventually arrive at a fair, reasonable and mutually acceptable settlement. Pending the final settlement of the boundary question . . . we should harness each other's comparative strengths and expand win-win cooperation in infrastructure, mutual investment and other areas."¹²

PEOPLE'S ATTITUDES: GROWING WARINESS AMIDST MUTUAL RESPECT

Since the turn of the twenty-first century, growing numbers of Indian and Chinese tourists have been travelling to and getting a direct exposure to each other's country. Since 2005,

THE SILK ROAD REDISCOVERED

the numbers of Chinese tourists visiting India and Indian tourists visiting China have each grown at an annual rate of about 25 percent, well above the 15-percent and 11-percent growth rates in worldwide outbound tourism from China and India, respectively. In absolute terms, however, the numbers remain small. The 600,000 Indian tourists who visited China in 2012 accounted for less than 1 percent of the more than 60 million visitors to China that year. Similarly, the 150,000 Chinese tourists who visited India in 2012 made up about 2.5 percent of the 6.6 million visitors to India that year.

It's important to note that this growing mutual exposure has not resulted in a more positive attitude toward or growing trust in each other. If anything, the result has been quite the contrary. Yes, the two peoples have enormous respect for each other. Indians think of the Chinese as extremely disciplined and driven. In turn, the Chinese think of the Indians as very creative and very smart. Nonetheless, on both sides, people are more wary of each other now than they were in 2006. Results from ongoing surveys conducted by the Pew Global Attitudes Project are telling. Figure 1.1 provides trend data for 2006–2012 regarding the percentage of Indians and Chinese who hold a favorable attitude toward the other country.

As Figure 1.1 tells us, in 2006, there were far more Indians with a favorable attitude toward China than there were Chinese with a favorable attitude toward India. By 2012, however, both numbers had declined significantly—to 23 percent. As a benchmark, note that, in 2012, both the Indians and the Chinese hold a much more favorable attitude toward the United

Asia's Best-Kept Secret

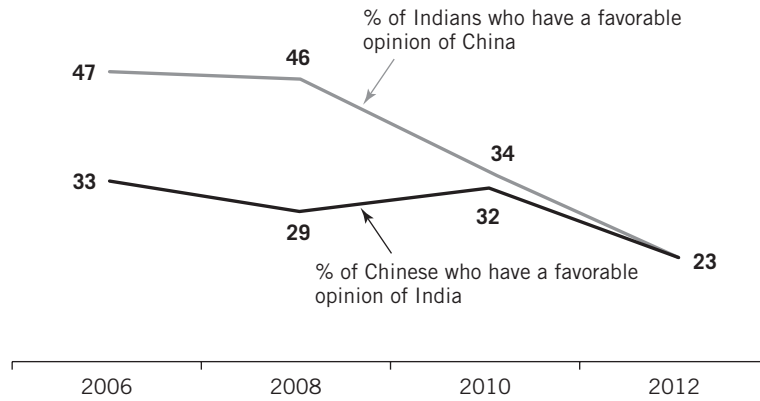


Figure 1.1 Growing Wariness Among the Two Peoples

Source: Pew Global Attitudes Project.

States (41 percent and 43 percent, respectively) than they do toward each other.

Table 1.1 contains results from survey data regarding how the Indians and the Chinese look at the relationship between their two countries. Indians appear to be more wary of the Chinese than vice versa. As of 2012, more Chinese saw the relationship as one of cooperation rather than hostility (39 percent versus 24 percent, respectively). In contrast, fewer Indians saw the relationship as cooperative rather than hostile (23 percent versus 24 percent, respectively).

What factors lie behind this growing wariness? Our analysis and interviews suggest that Indians' growing disenchantment with China stems from three major factors:

1. *Unresolved border tensions.* India lost the 1962 war with China. As is nearly always the case, the loser has a tougher time forgetting the past than the winner does. Among adult

THE SILK ROAD REDISCOVERED

Table 1.1 A Mixed Motive Relationship

Responses to the question:

Overall, how would you describe the relationship between India and China?

	One of Cooperation	One of Hostility	Neither/Don't Know/Refused
Indian Respondents	23%	24%	53%
Chinese Respondents	39%	24%	37%

Note: India data from 4,018 face-to-face interviews representing 86 percent of the country's urban and rural adults. China data from 3,177 face-to-face interviews representing 64 percent of the country's urban and rural adults (with the caveat that the sample was disproportionately urban).

Source: Pew Global Attitudes Project, Spring 2012.

Chinese today, very few are aware that there has ever been a war between China and India. In contrast, almost all Indians seem to know about the war. What makes Indians particularly wary is China's all-weather friendship with Pakistan, a country with which India has fought numerous wars and whose terrorists were responsible for the Mumbai massacre in 2008. Most Indians also believe that China is gaining the upper hand in terms of economic and military relationships with its other neighbors such as Sri Lanka, Myanmar, and Nepal, thereby encircling India with a "string of pearls."

2. *India's large and growing trade deficit with China.* Although oil imports are the single biggest contributor to India's ballooning trade deficit, the imbalance in trade with China has become a growing challenge for the country. Our analysis, presented

Asia's Best-Kept Secret

later in this chapter, suggests that India's weakness in manufacturing is the primary reason for the trade deficit with China. Yet government ministers as well as media articles in India attribute the trade deficit largely to trade barriers erected by the Chinese government.

3. *Growing economic disparity between the two countries.* As recently as 1980, China and India were equally poor and at near parity in terms of GDP and per capita income. Over the last thirty years, however, China has raced ahead. In 2012, China's GDP was over four times that of India. Two factors have contributed to this gap. First, India did not launch major economic reforms until 1991, fully thirteen years later than the launch of China's reforms in 1978. Second, even though India has been the world's second fastest-growing large economy after China, the power of compounding has made a difference. The growing economic gap between the two has made Indians increasingly envious of their northern neighbor.

In turn, the growing wariness of the Chinese toward India stems from a somewhat different set of factors.

1. *Disdain for India's weak infrastructure and seeming chaos.* When Chinese travelers visit India, they are taken aback by the stark difference between the first-world infrastructure in most Chinese cities and the still third-world infrastructure even in Tier 1 cities such as Delhi and Mumbai. Added to this, given their government's obsession with order, Chinese visitors cannot fathom how Indian authorities could permit the chaos that seems to prevail on almost any Indian road—disorganized

THE SILK ROAD REDISCOVERED

traffic, two- and three-wheelers intermingling with cars and trucks, and the common sight of cows sharing the road with everybody.

2. *Materiality versus spiritualism.* It is widely accepted that contemporary Chinese society is one of the most materialistic in the world. More than half a century of communist rule succeeded in converting most Chinese into atheists. Although there is now a growing search for spirituality, especially among the urban affluent, it is still in the early stages. Thus, when the Chinese assess other countries, the most important criterion is “How well off are you?” On this measure India comes up short, and the country’s spirituality doesn’t quite make up for its economic backwardness. As a result, the Chinese have a mixed attitude toward India. Chinese media routinely lauds India’s creativity and global power in software and IT services. Indians have also outpaced the Chinese in the race for global CEO positions at blue-chip Western corporations, such as Deutsche Bank, Citigroup, PepsiCo, Diageo, and Microsoft. Thus the Chinese have high respect for India’s IT sector and tend to regard Indians as well-educated and brainy. At the same time, they view the Indian government as, by and large, not particularly competent.

3. *The U.S.-India Civil Nuclear Agreement.* In 2005, India’s Prime Minister Manmohan Singh and U.S. President George W. Bush signed a framework agreement for the transfer of civilian nuclear technology and fuel. In 2008, the framework agreement became law on both sides and had also been ratified by the world’s Nuclear Suppliers Group. This agreement made India the only known country with nuclear weapons that had not signed the Non-Proliferation Treaty but was still able to engage

Asia's Best-Kept Secret

openly in nuclear commerce with the rest of the world. The U.S. government positioned this agreement as part of a broader strategic partnership aimed at accelerating India's emergence as a superpower. Since then, the geopolitical alliance between the United States and India has grown stronger. The Chinese media have portrayed these moves as designed to "contain" China.

To sum up, in our view the wariness between India and China is likely to persist for some time. As foreign direct investment ramps up and Indians and Chinese find themselves working for each other, this will help rebuild liking and trust. Real transformation in mutual trust, however, will have to wait until the border disagreements begin to be resolved. In the meantime, governments, academia, and media should explore all possible opportunities to encourage mutual visits by policy makers at not just the national but also local level, as well as the exchange of scholars and students. At the very least, ongoing dialogue through these channels will reduce the likelihood of a further worsening in the existing low level of trust.

CHINA AND INDIA IN 2025

During the dozen years from 2000–2012, China and India have been the world's two fastest growing economies (see Figure 1.2). The fact remains, however, that both economies have slowed down considerably during 2011–2013 (see Figure 1.3). Compared to its twelve-year average of 10.2 percent a year, China's economy is expected to grow by about

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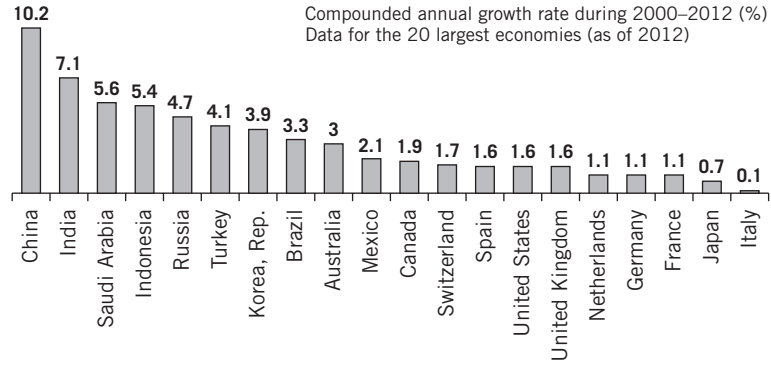


Figure 1.2 The World’s Two Fastest-Growing Economies

Source: The World Bank.

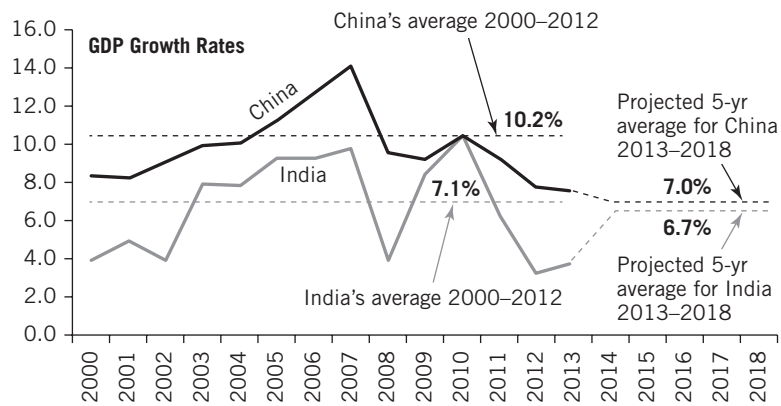


Figure 1.3 Recent Slowdown but Expected to Maintain Rapid Growth

Source: The World Bank (for 2000–2012) and IMF (for 2013–2018 projections).

Asia's Best-Kept Secret

7.5 percent in 2013. For India, compared to its twelve-year average of 7.1 percent, the economy is expected to grow by only 3.8 percent in 2013.

The slowdown raises an important question: Is the China-India growth story over? The answer lies in an analysis of the factors behind the slowdown.

Take China. There is enough evidence to conclude that the slowdown in China is structural and that the era of over 10 percent annual growth is over for good. However, even at a much slower 5- to 7-percent annual growth rate, China will overtake the United States to become the world's largest economy by 2025 (see Table 1.2 for trend data and our predictions about the world's top twelve economies in 2025).

The structural slowdown is a result of the fact that China can no longer sustain economic growth fueled by massive expansion in fixed asset investment, exports, and a growing supply of cheap labor. In 2012, investment reached close to 50 percent of GDP and was financed largely by credit taken on by local governments and state-owned enterprises. Public debt now stands at about 200 percent of GDP. Counting off-budget spending by local governments, China's fiscal deficit has reached almost 10 percent of GDP. These figures are no longer sustainable.

Consider also the trend in exports and labor supply. From 2000–2012, China's exports grew at average annual rate of 19.4 percent relative to a growth rate in world exports of 9.2 percent. As a result, China's share of world exports grew from 3.9 percent in 2000 to 11.1 percent in 2012.¹³ If these trends were to continue, by 2025 China's share of world exports would be

THE SILK ROAD REDISCOVERED

Table 1.2 World's Top Twelve Economies

2000	2012	2020	2025
1 United States	1 United States	1 United States	1 China
2 Japan	2 China	2 China	2 United States
3 Germany	3 Japan	3 Japan	3 Japan
4 United Kingdom	4 Germany	4 Germany	4 India
5 France	5 France	5 India	5 Germany
6 China	6 United Kingdom	6 Brazil	6 Brazil
7 Italy	7 Brazil	7 France	7 Russia
8 Canada	8 Russia	8 Russia	8 France
9 Brazil	9 Italy	9 United Kingdom	9 United Kingdom
10 Mexico	10 India	10 Italy	10 Italy
11 Spain	11 Canada	11 Canada	11 Canada
12 South Korea	12 Australia	12 Australia	12 Indonesia
13 India			

Note: For 2000 and 2012, based on data from The World Bank. For 2020 and 2025, projections are based on the following assumptions about GDP growth rates: China 6 percent; India 6 percent; Brazil 3 percent; Russia 3 percent; Indonesia 6 percent; other economies 2.5 percent. For the BRIC economies and Indonesia, we also assume an average 2-percent higher inflation than in the developed economies.

Source: China India Institute analysis.

35 percent. This is simply impossible unless the large importing countries (such as the United States, Europe, and India) decide to commit economic suicide, which is unlikely. Clearly, from here on, China's exports would grow at about half the

Asia's Best-Kept Secret

pace of that over the last decade. In terms of labor supply, during 2000–2010 China's labor pool grew at an average annual rate of about 1 percent. Since 2011, it has stopped growing—an after-effect of the government's one-child policy. From 2015 onward, it will start declining at the rate of about 0.5 percent per year.¹⁴

A slowdown in China's economic growth does not, however, mean economic collapse. China is still a developing country with tremendous opportunities for ongoing productivity growth. Its infrastructure is excellent, its savings rate high, and its people increasingly better educated. Thus the prospects remain high that China will be able to sustain economic growth at a 5- to 7-percent rate for the next decade or more.¹⁵ As the IMF noted in its most recent *World Economic Outlook*:

Growth in China has been on a decelerating path... . Imbalances between private consumption and investment have intensified, even as the economy's external imbalances have narrowed. A decisive move to contain these imbalances may be accompanied by lower medium-term growth than achieved by China in recent decades, but this is a trade-off worth making, since it is likely to usher in permanently higher living standards than under the extension of the status-quo.¹⁶

Table 1.3 summarizes the key factors that have driven rapid economic growth in China, the primary reasons behind the current slowdown, and the key drivers that will keep China's

THE SILK ROAD REDISCOVERED

Table 1.3 China's Growth Drivers and Constraints

Primary Drivers of GDP Growth During 2000–2010	<p>Growing labor force</p> <p>Very high rate of savings and investment</p> <p>Rapidly growing urbanization</p> <p>Rapid advances in infrastructure</p> <p>Emergence as the world's manufacturing powerhouse</p> <p>Rapid growth in exports</p>
Key Factors Behind the Current Slowdown	<p>Overinvestment in infrastructure</p> <p>End of growth in size of labor force</p> <p>Rapidly rising wages resulting in slowdown in growth of exports</p>
Expected Growth Drivers 2014–2025	<p>Ongoing urbanization</p> <p>Productivity growth driven by rising automation rather than cheap and growing migrant labor pool</p> <p>Growth in services sector</p> <p>Moderation in oil prices (a key import commodity)</p>

economy growing at a still-robust annual growth rate of 5 to 7 percent over the next decade.

The factors behind India's slowdown are a mirror image of those in the case of China. Although China's challenges stem from too much investment and too little consumption (relative to GDP), India's stem from too little investment and too much consumption (see Figure 1.4).

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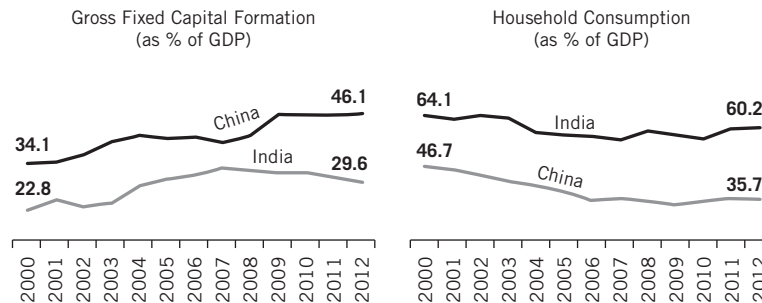


Figure 1.4 China Is Investment Led; India Is Consumption Led

Source: The World Bank; China India Institute analysis.

The slowdown in investment has been particularly sharp since 2009, when the ruling Congress Party and its coalition partners returned to power. Owing to a number of factors (coalition politics, a barrage of corruption scandals, and weak leadership), policy making has been mired in near paralysis. As a result, the leaders have failed to make the needed short- to medium-term trade-offs among competing goals (economic growth, protecting the environment, and providing economic security to the weakest segments of society). Inadequate investment in infrastructure and factories has resulted in supply-side bottlenecks and, as a direct spillover, higher inflation. Driven by its mission to keep inflation under control, the central bank has kept interest rates high. These in turn have further discouraged investment—creating a vicious cycle.

Like China, India is also one of the world's major oil importers. However, unlike China, India is very weak in manufacturing. As a result, India has been unable to balance its large import bill with an equally large export base. The

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large and growing trade deficit has meant that India also faces the challenge of a growing current account deficit and a weakening currency.

In short, India's economic slowdown is driven by policy paralysis rather than structural constraints. The saving grace is that, time and again, Indian governments have tended to undertake major economic reforms only when confronted with a crisis. That is the situation now. During 2013, the government has launched a series of reforms including a sharp relaxation in the constraints on foreign direct investment in a number of industries, approval of a large number of backlogged investment projects, and plans to open up the banking sector to new entrants, both domestic and foreign. At the time of this writing, we believe that the pace of reforms will continue. The next round of national elections is due by May 2014. The leading opposition (Bharatiya Janata Party) appears even more committed to economic reforms than the Congress Party.

The IMF's most recent report forecasts that, during 2013–2018, India's GDP is likely to grow at an average annual rate of 6.7 percent.¹⁷ *In short, notwithstanding the slowdown, China and India are expected to remain the world's two fastest-growing large economies for the near future.* As indicated earlier in Table 1.2, our own analysis suggests that, even if India's GDP were to grow at only a 5- to 6-percent growth rate (plus inflation at a 2- to 3-percent higher rate than in the rich economies), by 2025, it would become the world's fourth-largest economy, ahead of Germany and only slightly behind Japan.

Table 1.4 summarizes the key factors behind India's rapid economic growth over the last decade and the recent

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Table 1.4 India's Growth Drivers and Constraints

Primary Drivers of GDP Growth During 2000–2010	<p>Growing labor force</p> <p>Very high rate of savings</p> <p>Growing urbanization</p> <p>Better infrastructure (especially in telecommunications)</p> <p>Emergence as the world's information technology services powerhouse</p>
Key Factors Behind the Current Slowdown	<p>Policy paralysis leading to underinvestment and supply bottlenecks in mining, energy, and infrastructure</p> <p>Growing current account deficit due primarily to rapidly rising imports of oil and coal</p> <p>Inflationary pressures, which led the central bank to drive up interest rates</p>
Expected Growth Drivers 2014–2025	<p>Young population resulting in continued growth in labor force</p> <p>Rapid growth in urbanization</p> <p>Rapid improvements in infrastructure</p> <p>Faster growth of the manufacturing sector</p> <p>Diffusion of broadband internet access, resulting in rapid improvements in literacy and access to financial services</p> <p>Moderation in energy prices (a major import commodity)</p>

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slowdown, and the reasons why the slowdown is likely to be temporary rather than structural.

THINK CONVERGENCE, NOT COMPLEMENTARITY

China and India are also mirror opposites of each other in terms of the structure of their economies (see Figure 1.5).

For China, industry accounts for the biggest share of its GDP. For India, it is services. This contrast has led many observers to argue that the two economies have complementary strengths. We disagree. The “services” sector is made up of many different industries, including defense, financial services, telecommunications, air transportation, hotels, information technology (IT), and so forth. It is true that India is a global leader in IT services and much stronger than China. However, IT services comprise just a small share of India’s

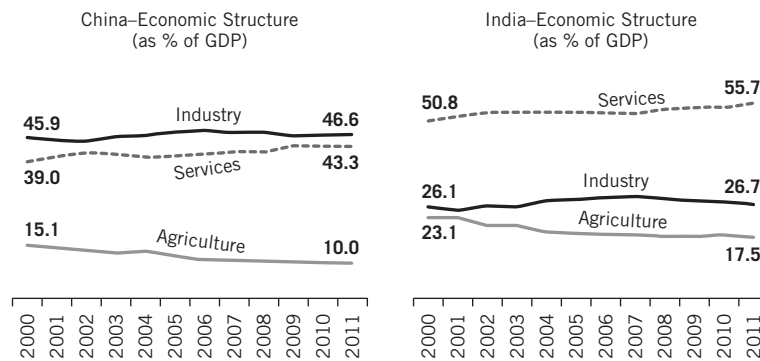


Figure 1.5 China and India: Economic Structure

Source: UNCTAD; China India Institute analysis.

Asia's Best-Kept Secret

GDP—about 5 percent. The reason why India's economy appears to be stronger in services is not because its overall service sector is necessarily stronger than China's but because its manufacturing sector is much weaker than China's.

Looking ahead, we anticipate that the next ten years will see a growing convergence in the two economies. As India starts investing more aggressively in infrastructure, its manufacturing sector will become much stronger. The rise of the manufacturing sector will also be aided by India's growing scale, its strong engineering skills, and labor costs that are lower than China's.

Across the mountains, we anticipate that, over the next decade, China will become much stronger in services than it currently is. The bulk of the development in China's services sector will take place on the eastern coast. This is the most developed region of China; it has the highest education levels and also, not coincidentally, the highest wages. As manufacturing migrates to central China, the east coast will focus increasingly on services and knowledge-intensive industries. The Shanghai Free Trade Zone set up in September 2013 and aimed at liberalizing the country's financial sector is just one of several services sector-oriented initiatives currently under way in China.¹⁸

The emerging convergence between the two economies means that Chinese and Indian policy makers as well as business leaders will need to think increasingly in terms of a multidimensional engagement with each other. Such engagement will encompass not just trade but also investment in each other's countries as well as partnerships to pursue opportunities in third countries.

THE SILK ROAD REDISCOVERED

CHINA-INDIA TRADE: EXPLOSIVE GROWTH BUT GROWING TENSIONS

The story of trade between China and India is one of explosive growth accompanied by underlying tensions. Table 1.5 presents data on the two countries' trade with each other as well as with other economies.

These data reveal several important trends. First, India's trade has grown at almost the same explosive pace as China's (19.2 percent and 19.4 percent, respectively). Second, with some exceptions, for both China and India trade with emerging economies has grown faster than trade with the developed economies. Third, from the perspective of both China and India, their trade with each other has grown faster than their trade with any other country. The 29.7-percent growth rate in bilateral trade between China and India is more than three times as fast as the 9.2-percent growth rate in world trade during this period.

In 2012, China was India's second-largest trading partner, after the United Arab Emirates. In turn, India was China's twelfth-largest and fastest-growing trading partner. During their meeting in May 2013, Premier Li Keqiang and Prime Minister Manmohan Singh set a goal of growing the bilateral trade between the two countries to US\$100 billion by 2015. In light of historical trends, the odds of achieving this goal appear to be reasonable. These data also reinforce our prediction that, by 2025, the China-India economic relationship is likely to be among the ten most important bilateral relationships in the world.

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Table 1.5 China-India: The World's Fastest-Growing Trade Relationship

Trading Partner	China's Bilateral Trade (US\$billions)			India's Bilateral Trade (US\$billions)		
	2000	2012	Growth Rate (%)	2000	2012	Growth Rate (%)
India	3	69	29.8%	–	–	–
China	–	–	–	3	69	29.8%
U.S.	74	486	17.0%	14	62	13.2%
E.U.	75	579	18.6%	27	123	13.5%
Japan	84	330	12.1%	4	19	13.9%
South Korea	39	257	17.0%	2	18	20.1%
Russia	8	88	22.1%	2	7	11.0%
Association of Southeast Asian Nations (ASEAN)	39	400	21.4%	10	78	18.7%
Latin America	12	259	29.2%	2	44	29.4%
West Asia	14	204	25.0%	9	190	28.9%
Africa	11	198	27.2%	8	69	19.7%
World	474	3967	19.4%	95	780	19.2%

Note: During 2000–2012, world trade grew at a compounded annual rate of 9.2 percent.

Source: UNCTAD; China India Institute analysis.

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While the data on bilateral trade tell a story of growing economic ties, they hide an important substory: the growing imbalance in favor of China (see Figure 1.6). Although China's trade surplus with India is consistent with its trade surplus with other economies, such as those of the United States and Europe (and indeed, the rest of the world), that has not been much of a comfort to India. The lopsided trade has been a source of growing tension between the two countries.

However, if we place India's trade deficit in the context of its overall trade deficit with the world at large, it becomes clear that the primary challenge for India lies *not* in its trade relationship with China but in its rapidly growing worldwide import bill. Figure 1.7 provides data on (a) India's worldwide trade deficit and (b) the trade deficit with China as a ratio of the worldwide trade deficit.

As Figure 1.7(b) tells us, India's trade deficit with China has hovered at around a fifth of its total trade deficit for more than a decade. Clearly, other goods accounting for four-fifths of India's trade deficit are an even bigger challenge for the country. Table 1.6 sheds light on the composition of India's trade with China as well as worldwide.

From these data, it is abundantly clear that India's primary trade challenge arises from its dependence on imported fuels and its citizens' love of gold. The trade deficit with China is important but not the biggest challenge.

It is difficult for us to see a quick resolution of the trade tensions between the two countries. Government and corporate leaders in India routinely lament that the trade imbalance would somehow vanish if only China would remove barriers

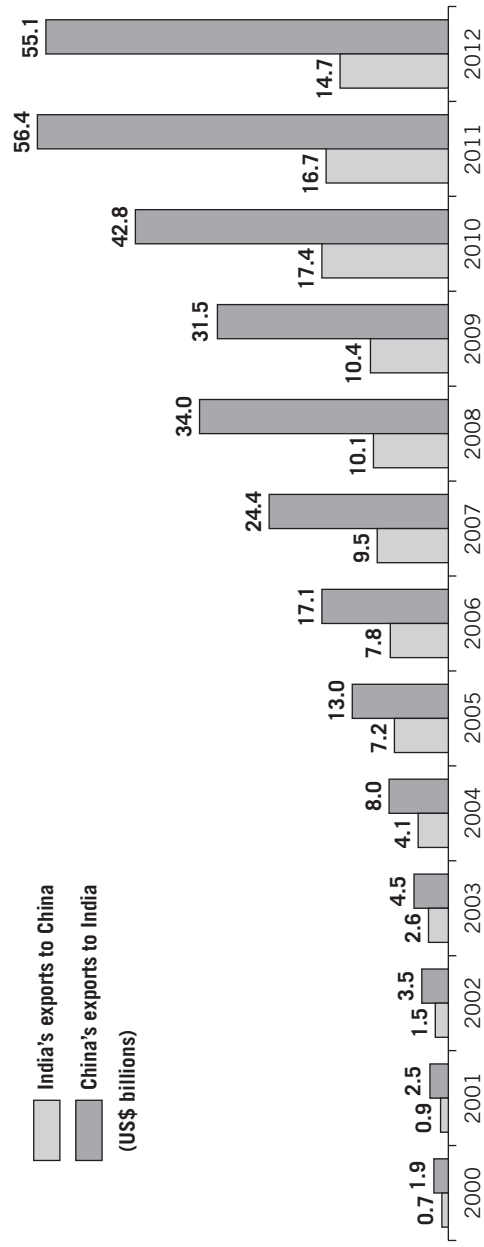


Figure 1.6 India's Growing Trade Deficit with China

Source: UNCTAD; China India Institute analysis.

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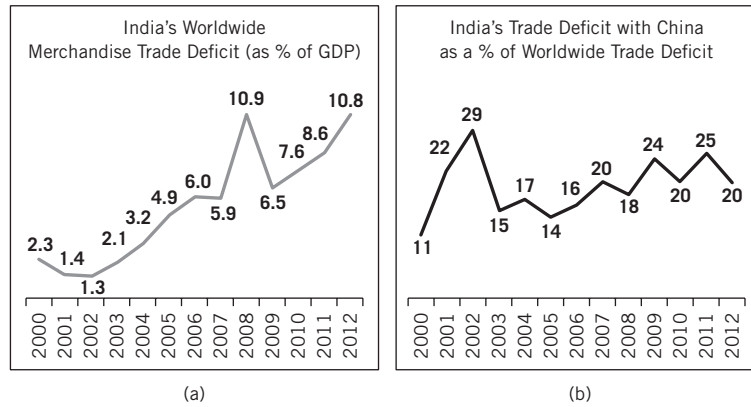


Figure 1.7 India's Trade Deficit with China in the Context of Its Worldwide Trade Deficit

Source: UNCTAD; China India Institute analysis.

to market access to Indian pharmaceuticals and IT services. As proponents of free trade, we agree that both governments should continue to press upon each other the need to start lowering and eventually removing many remaining barriers to international trade. At the same time, however, we believe that, given the differing nature of the two countries' comparative advantages, India would still continue to suffer from a trade deficit with China for several more years.

India is indeed a global power in generic pharmaceuticals and IT services. However, given the very low price of generic drugs, in 2012 India's global exports of pharmaceutical products added up to only US\$11 billion. And given the brutal competition and extreme price sensitivity of the Chinese pharmaceutical market, we see the potential for Indian exports of such products to China as relatively limited. As for IT services, another sector

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Table 1.6 India's Primary Trade Challenge: Large Dependence on Imported Energy Resources

Product Category	India's Merchandise Trade in 2012 (US\$billions)					
	Worldwide			With China		
	Exports	Imports	Balance	Exports	Imports	Balance
Fuels	54	191	(137)	–	–	–
Nonmonetary gold	–	39	(39)	–	–	–
Pearls, precious stones, and the like	23	23	–	–	–	–
Other primary commodities	53	51	2	10 ^a	–	10
Manufactured goods	157	176	(19)	5	48 ^b	(43)
Miscellaneous other	3	9	(6)	–	6	(6)
TOTAL	280	489	(199)	15	54	(39)

^aMainly iron ore, copper, cotton, and other commodities.

^bMainly capital goods such as power plant equipment, telecom equipment, and other types of electrical equipment. Also includes about US\$8 billion in organic chemicals and fertilizers.

Source: UNCTAD; China India Institute analysis.

where India is a global leader, language differences are a natural barrier to Indian companies' ability to export such services to Chinese customers. This is precisely why the bulk of India's IT services are exported to English-speaking markets such as the United States, Canada, the United Kingdom, and Australia.

THE SILK ROAD REDISCOVERED

Other sectors where India is a significant exporter, such as automotive and textiles, also pose challenges. In both sectors, the scale of Chinese companies is much larger than that of their Indian peers. Thus it is hard to imagine how Indian companies could make much headway in either sector by attempting exports from India to China.

*The long-term solution to India's unbalanced trade lies in reducing the country's dependence on imported fuels (by eliminating subsidies for consumers and aggressively promoting exploration and production within its borders), giving its citizens channels other than gold for investing their savings, and becoming a manufacturing power to rival China. On the last point, we believe that, in the short to medium term, Chinese exports to India should generally be welcomed rather than discouraged, as many of them are competitively priced capital goods.*¹⁹

Chinese capital goods are often about 30 percent less expensive than imports from the United States, Europe, or Japan. They also come with low-cost financing from Chinese banks such as the Export Import Bank of China and China Development Bank.²⁰ As a result, Chinese capital goods unwittingly help accelerate the buildup of India's infrastructure and the eventual emergence of India as a manufacturing rival to China. India's policy makers might want to look at China's trade relationship with Japan, Germany, and South Korea. Despite the fact that China is extremely powerful in manufacturing, it continues to run a trade deficit with all three countries—a primary reason being that all three are major suppliers of top-end capital equipment to China.

Asia's Best-Kept Secret

DIRECT INVESTMENTS: THE NEW FRONTIER

Economic ties between China and India have begun to diversify beyond trade to include direct equity investments in R&D and manufacturing. At the end of 2012, the total stock of Chinese foreign direct investment (FDI) in India was about US\$800 million. Conversely, the total stock of Indian FDI in China was about US\$500 million.²¹ These are still the early days of investment-based ties. We anticipate that, by 2020, the picture will look dramatically different.

To put the China-India numbers into context, the stock of Indian companies' FDI in China is less than 1 percent of their total FDI stock globally. For Chinese investments in India, the equivalent figure is about 0.2 percent. Notably, too, both China and India are still at an early stage in the game of creating global champions. At present, China's and India's worldwide shares of outbound FDI stock are 2.15 percent and 0.15 percent, respectively, a fraction of the numbers for the United States (22.0 percent), Japan (4.5 percent), or Germany (6.6 percent). Over the next ten years, as the global shares of the Chinese and Indian economies grow, these numbers are likely to grow significantly.

Prominent examples of Indian companies operating (not just trading) in China include companies in the information technology sector (Tata Consultancy Services, Infosys, and NIIT) as well as manufacturing (Birla Group, Mahindra Tractors, Thermax, and the nuts and bolts business of Sundaram Fasteners). In addition, as we noted earlier, Tata Motors'

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Jaguar Land Rover subsidiary is currently erecting a large manufacturing and R&D base in China. These facilities, being set up through a joint venture with Chery Automobile, are scheduled to become operational in 2014.

Prominent examples of Chinese companies with investments in India include Huawei (telecommunications equipment), Lenovo (personal computers), Haier (home appliances), Shanghai Auto (cars), and Sany (construction machinery). Examples of other Chinese companies contemplating investment in India include CNR and CSR (railway locomotives), Great Wall Motor (cars), and Wanfeng (aluminum wheels for the automotive sector).

Given India's current weakness in manufacturing, is there any reason to believe that Indian companies can enter China via investments and succeed? We believe that the answer is "yes" for the following reasons:

- Many of the larger Indian companies are world class in terms of their leadership and organizational capabilities. If they decide to play in China by manufacturing in China (or, in the case of the services sector, by producing the services in China), they are no longer constrained by India's weakness in infrastructure. Organizational capabilities are highly fungible across borders. True, China poses many challenges for all multinationals (as we discuss in Chapter Two). However, in many industries, given time and commitment, companies can learn to overcome many of these challenges. It is also important to remember that the new leadership in China appears

Asia's Best-Kept Secret

committed to opening up larger sections of the economy to entry by foreign players.

- The odds of success go up significantly if Indian companies design their China strategies with a global mindset. In most cases, it would be counterproductive to think in terms of “how to compete with Chinese companies for Chinese customers in China.” Instead, the more relevant questions should be: “How can we leverage our global (including Indian) capabilities and relationships to win in China? How can we leverage our Chinese presence to become a stronger competitor in India, the rest of Asia, and worldwide? Could we partner with a Chinese company to take on Chinese and other multinational companies not just in China but also globally?”

- In many cases, the road from India to China (and similarly from China to India) may run not across the Himalayas but via a third country such as Singapore, South Korea, Japan, the United States, the United Kingdom, Germany, or France. Take Tata Motors and Jaguar Land Rover. Globally, Indian car companies are not known as either brand or technology leaders. Thus any attempt by Tata Motors to crack the Chinese market via direct entry would have been enormously risky. However, by acquiring JLR, Tata Motors has been able to leverage the brand and technical strengths of JLR to become hugely successful in China. With the rapid growth of cross-border acquisitions by both Chinese and Indian companies, we anticipate that the indirect route will become increasingly common as a way for Indian and Chinese companies to enter each other's markets. This is precisely how Lenovo entered

THE SILK ROAD REDISCOVERED

India in 2005 after acquiring IBM's PC business. As other examples, look at Mahindra Group's acquisition of the Korean company SsangYong and its plans to leverage this base to enter the Chinese market for SUVs, the Chinese company Geely's acquisition of Volvo Cars and the relative ease with which it could now enter the Indian car market, or Sany's acquisition of the German pump maker Putzmeister and its plans to leverage the acquired company's brand name and technologies globally. This process has just begun.

There are also interesting new developments under way with regard to Chinese investments in India. As signaled by Premier Li Keqiang's decision to visit India on his maiden official trip, Chinese leaders accept the inevitability of India's rise as one of the four or five largest economies by 2025. They have also publicly accepted the nonsustainability of trade ties that remain hugely unbalanced in China's favor. As a result, China's leaders are also extremely keen to transform the economic ties between the two nations to include not just trade but also investments. At the time of this writing, a high-powered Chinese delegation comprising government as well as corporate leaders from a number of sectors (banking, water, power, tourism, and agriculture) was visiting India to meet with senior officials in the states of Haryana and Uttar Pradesh. Their mission: discuss opportunities to set up industrial parks in these states. China has large reserves of capital as well as enormous experience in setting up well-functioning industrial parks. A collaboration in this area, perhaps through a joint venture with an Indian partner, has the potential to be a major win for both sides.²²

Asia's Best-Kept Secret

To paraphrase Amazon CEO Jeff Bezos' oft-repeated observation about his company, this is still "day one" in the evolution of economic ties between India and China. The opportunities are large, but so are the challenges. In an increasingly competitive global environment, there are no easy or quick wins. Indian and Chinese companies that emerge as global winners by 2025 will be those that commit to the other country for the long haul. Corporate leaders who decide to play this game will need to be *shrewd*, so as not to lose their shirts; *creative*, in order to overcome initial handicaps; and *global thinkers*, in order to compete effectively with local players.

