



The New World Order: Importance of China and India



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Presentation at Mont Pelerin Meeting
Sydney
October 15, 2010

PART I

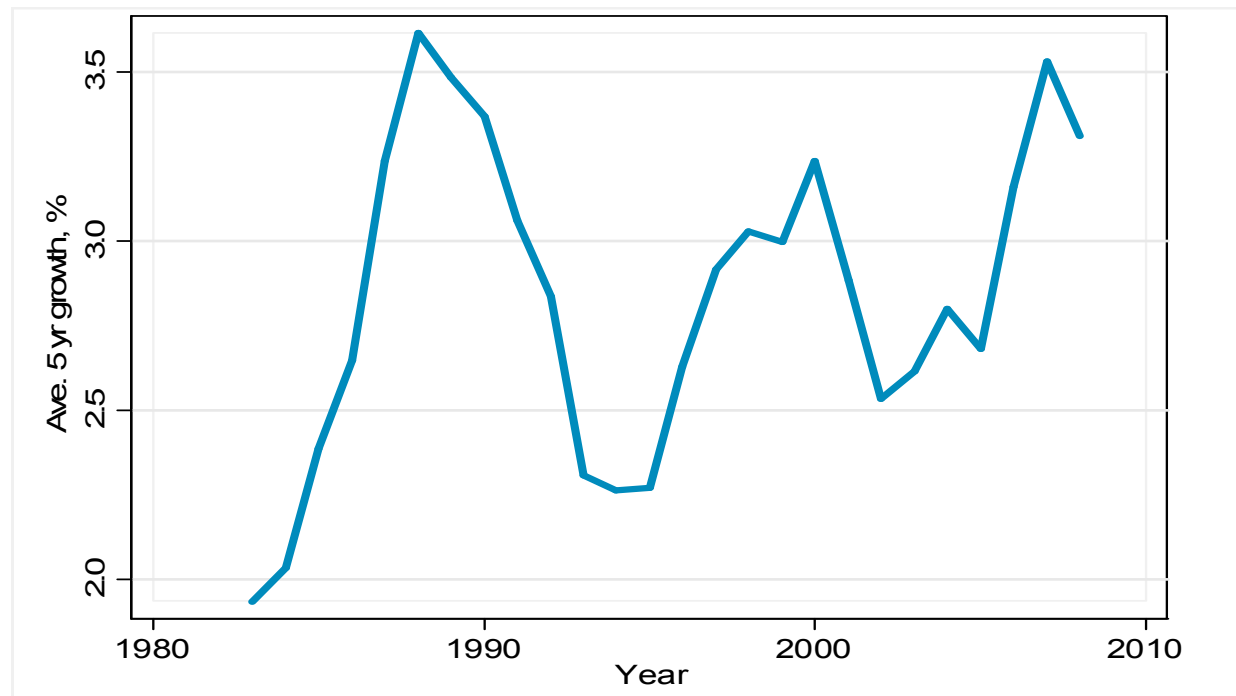
The New Order World Economy

An Economic Revolution Bigger than Industrial Revolution

- We are in the middle of an economic revolution that is much bigger than the Industrial Revolution
- No matter what the indicator – growth, inequality, inflation – the world is at its intra-temporal best
- Growth and inflation at around 3 percent

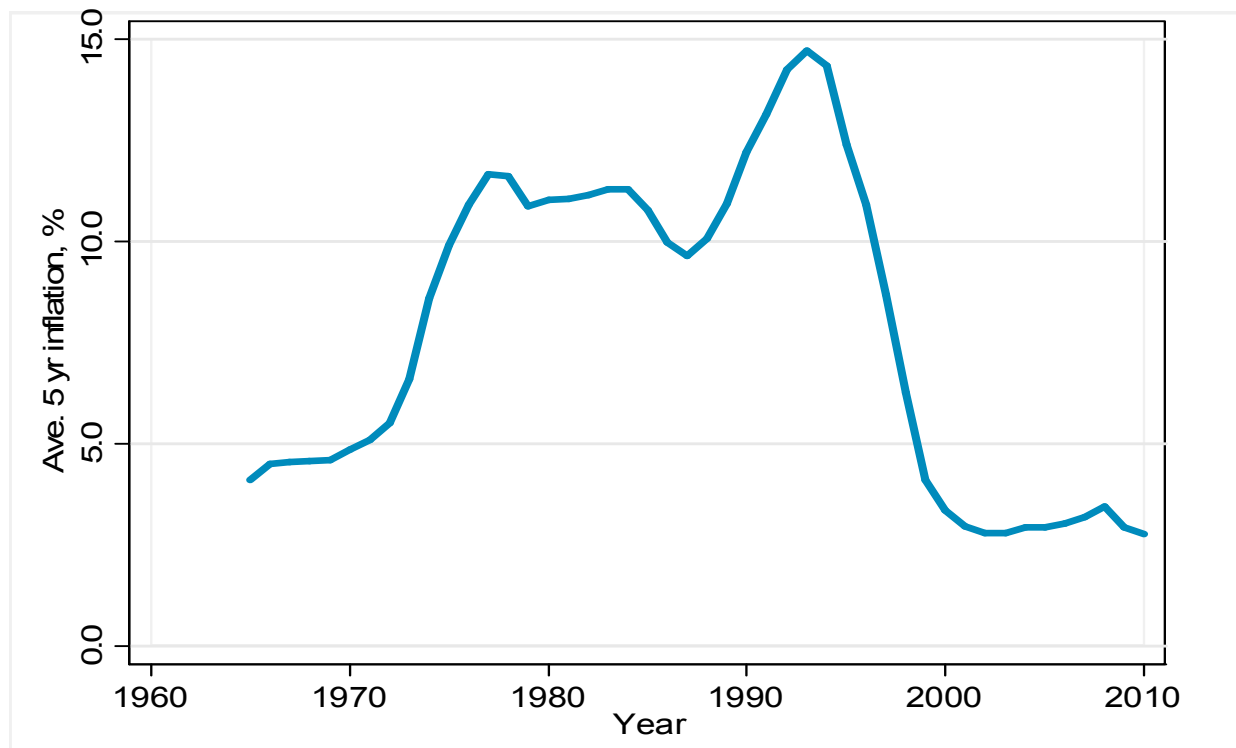
World Growth

- Average 5 year world growth - steady at above 3 percent real



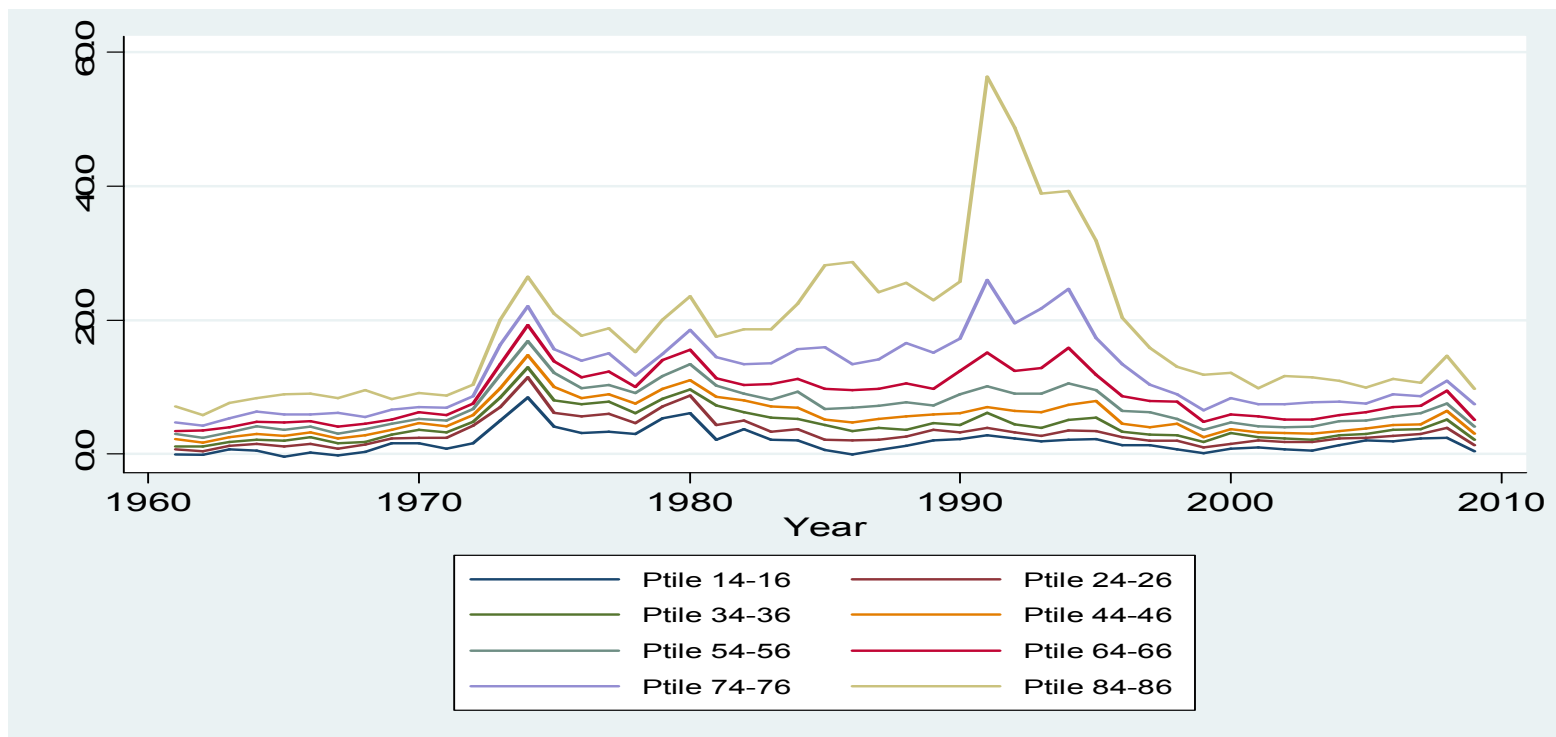
World Inflation

- Lowest in the post-war period, and across the world, and only 3 percent



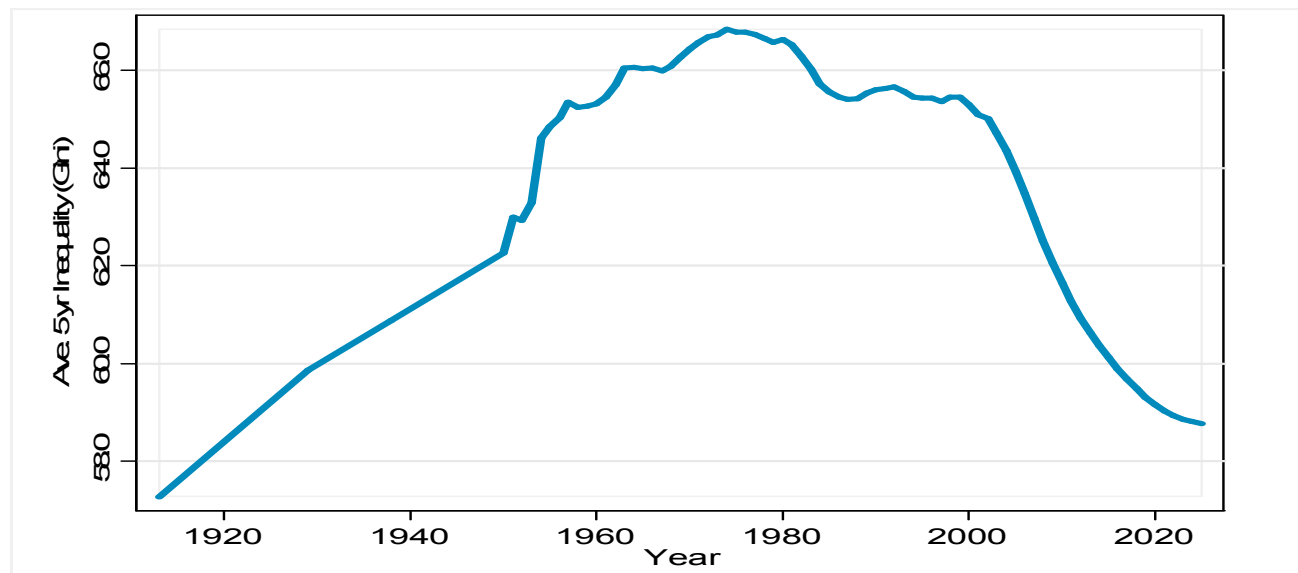
Declining and Low Inflation – same for different countries

- Even countries that don't have a central bank show the same pattern i.e. declining inflation most likely *not* a function of central bank independence, inflation targeting etc.



World Inequality

- Lowest and trending lower – by 2020 will be lowest in a century – Gini at 0.58
- Simple explanation for seemingly controversial proposition – the bottom half (China India) is growing much faster than the top half

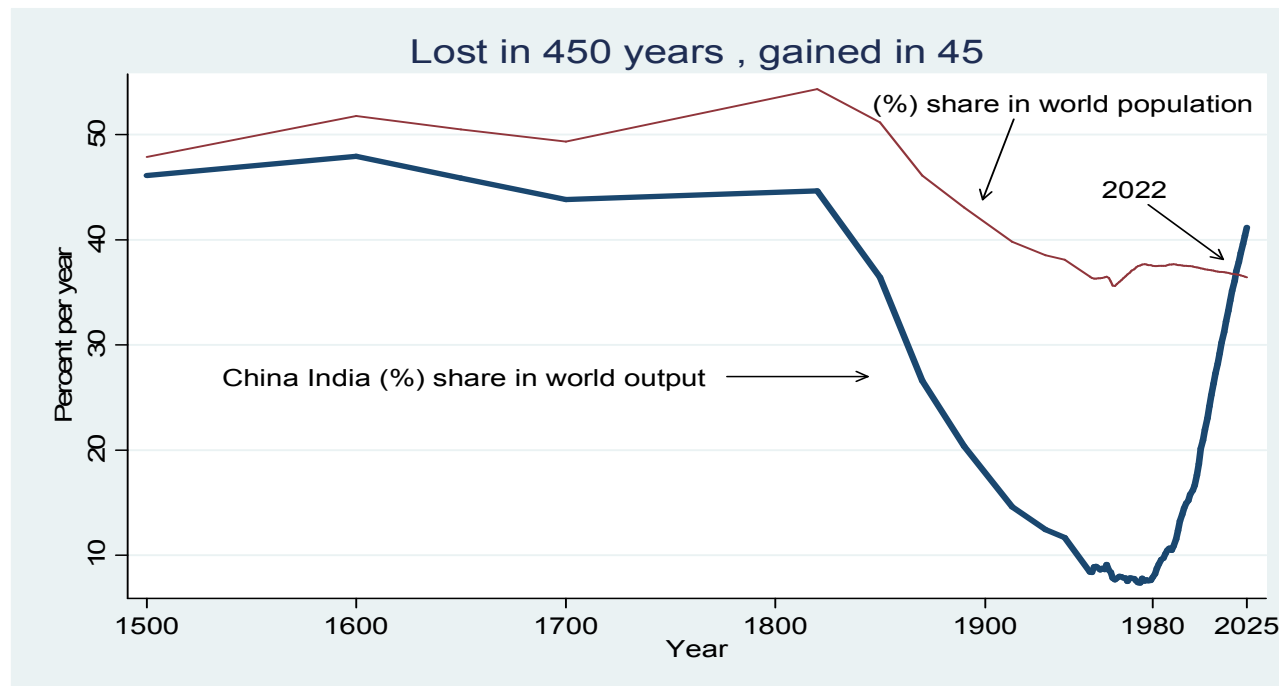


PART II

Shift of Balance of Economic Power

The India-China Story: Lost in 450, Gained in 45

- The China India story says it all

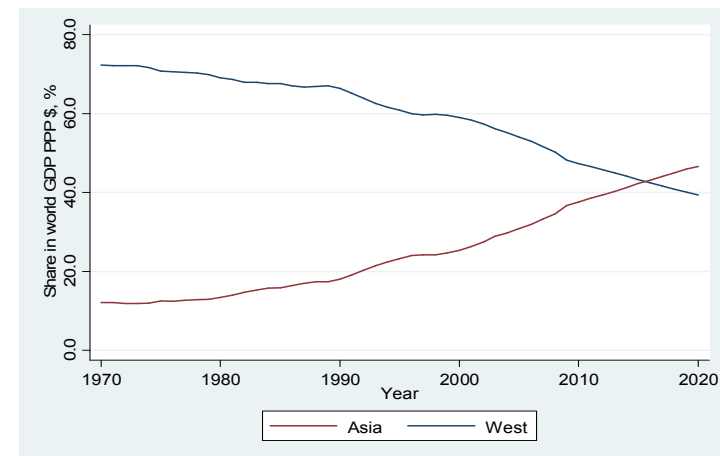


Source: Bhalla, Surjit S, *Second Among Equals: The Middle Class Kingdoms of India and China*, 2007

The Shift - The Rise of Asia

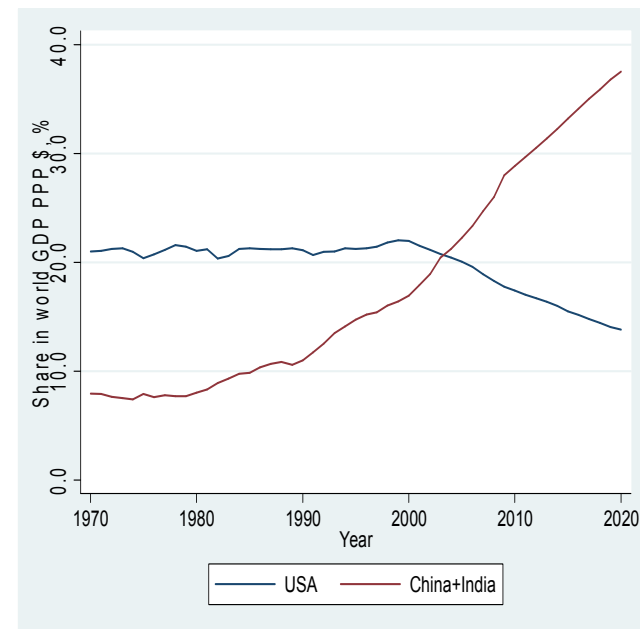
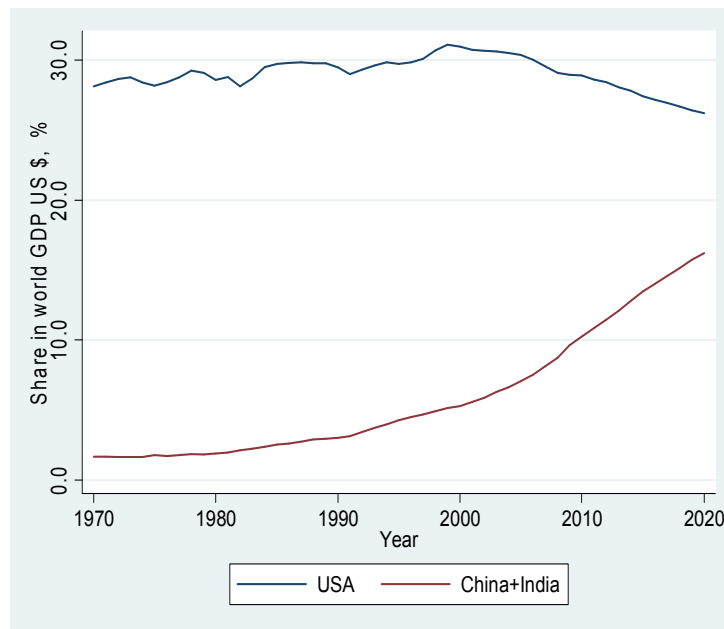
- Economic power and influence – the 20 percent share of GDP rule
- Balance of power shifted to Asia around the mid-1990s .

In constant US and PPP \$ - Asia vs. the West



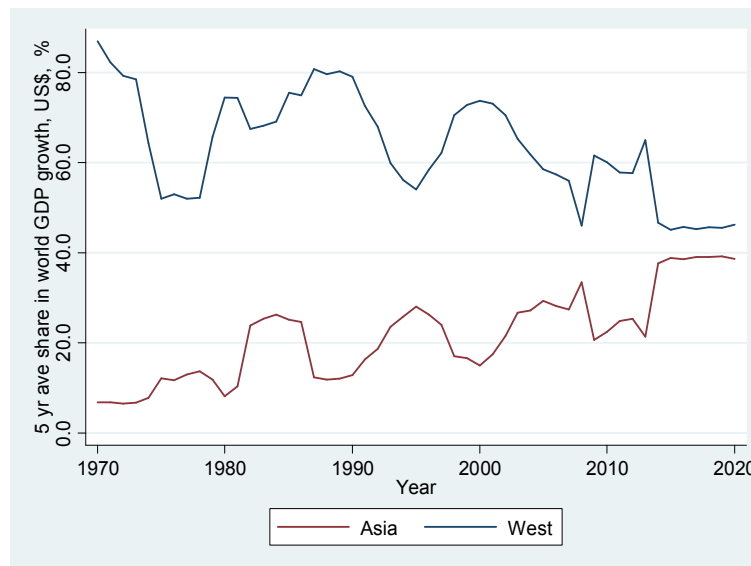
The Shift – the Rise of China+India

- In constant US and PPP \$ - USA vs. China+India

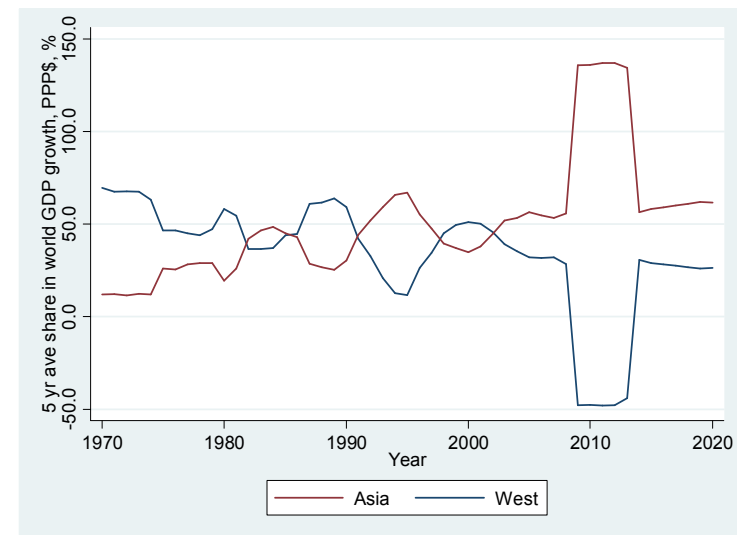


The Shift - Importance in World Growth

- Asia accounts for close to half of world growth
- In constant US \$

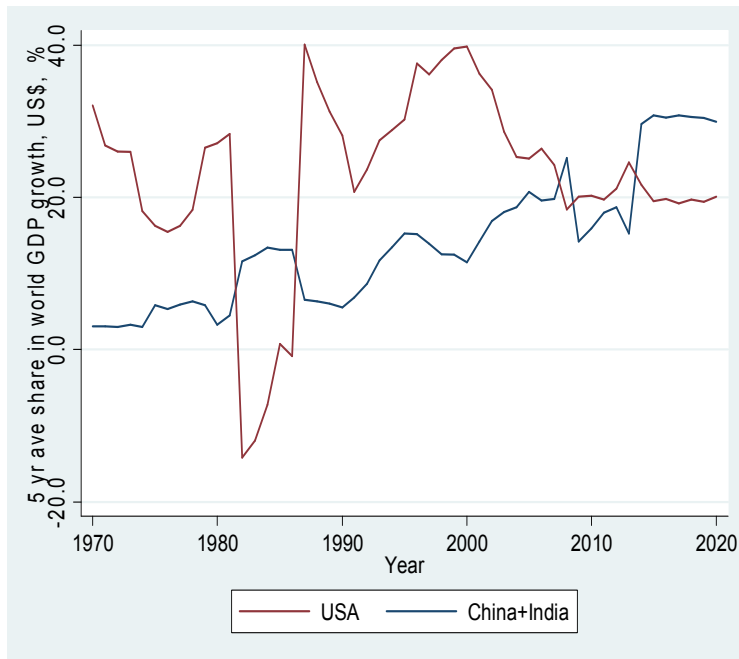


In constant PPP \$

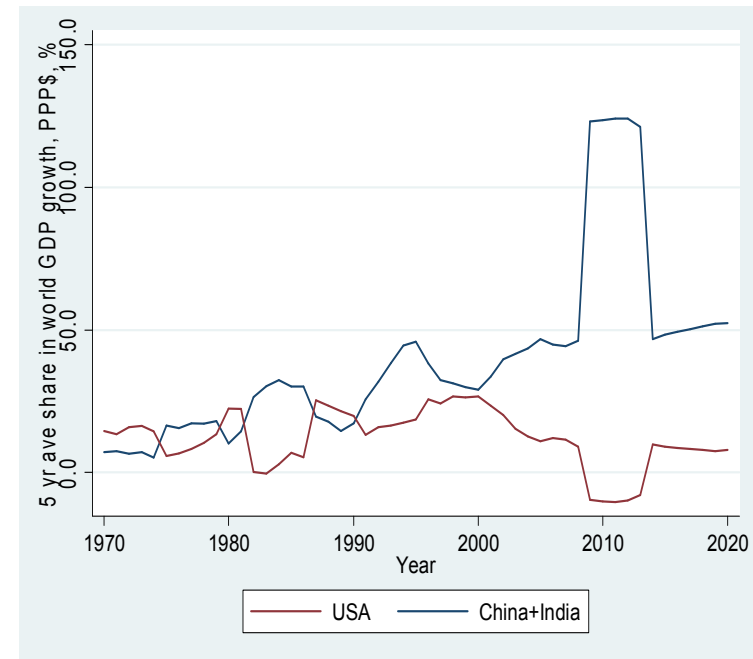


Importance in World Growth – USA at 20 %

- USA converges to 20 percent share; China+India to 30 % (US \$) and 50 % (PPP \$)
- In constant US \$



In constant PPP \$



Determinants of Growth: The Importance of a Cheap Currency

- Real exchange rates and currency undervaluation – The S-shaped relationship

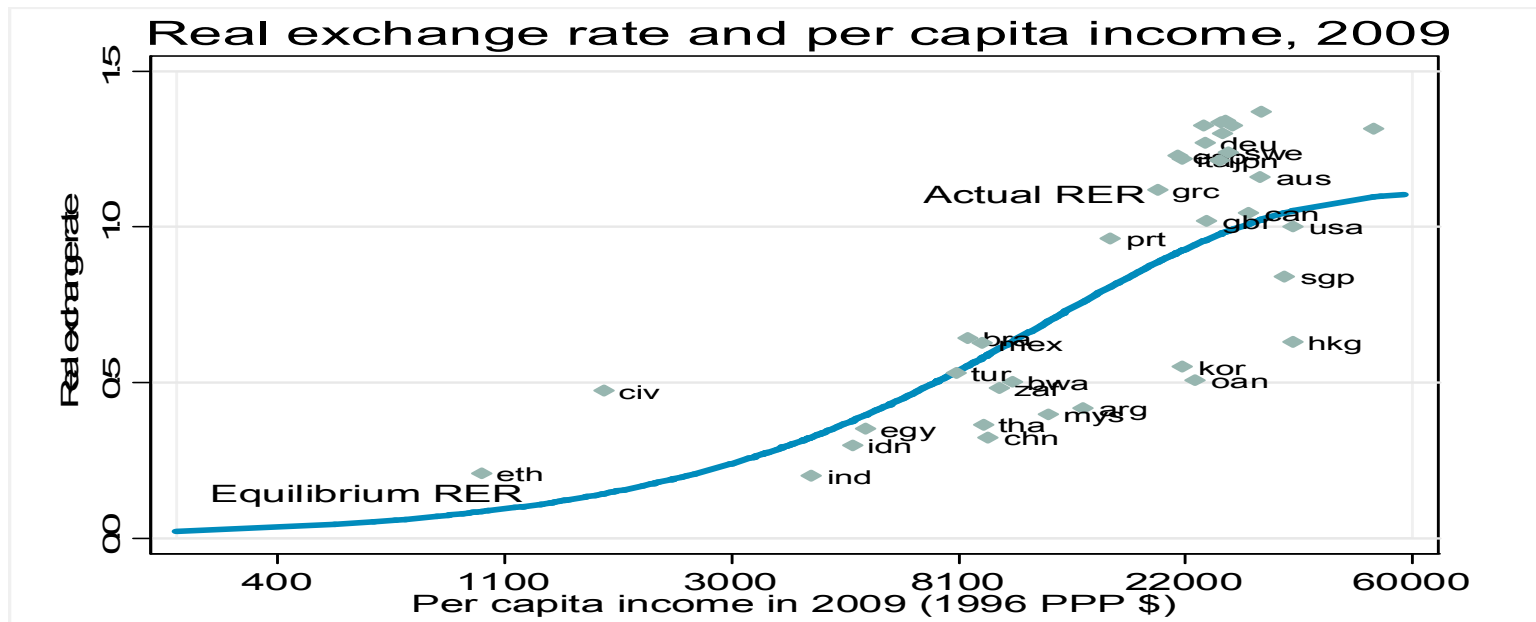


Chart from Bhalla, Surjit S, "Devaluing to Prosperity: Misaligned Currencies and their growth consequences, forthcoming, PIIE 2010

Source: Penn Tables 6.1, IMF WEO database, April 2010

Notes: 1) The S-shaped line is the predicted RER obtained from equation 3, $RER = 1.2 * (1 - 0.097^y)$

2) Country codes are from the World Bank, World Development Indicators.

China Growth Deconstructed

- Exports-led Growth, Mercantilism; period
- Each 10 percent undervaluation leads to an extra 0.4 percent GDP growth
- Yuan today more than 60 percent undervalued
- China accomplished between 1980 and 1994 the fastest and largest real devaluation anywhere, anytime, and by any country.
- The value of the yuan in 1994 was one-sixth of its 1980 real value .
- Over the subsequent sixteen years (1994 to 2009), the Chinese yuan further depreciated, in real terms, to be at two thirds of its 1994 value, or close to one-tenth of its 1980 value.

World Response to the Chinese Miracle

- Strangely, most studies do not even mention the contribution of undervaluation to growth
- The refrain: *Other determinants besides currency undervaluation matter ; Changes in nominal exchange rates do not matter - the “real exchange rate is endogenous”; China’s growth is overstated, it is still a very poor country, inequality is rising*
- Investment strongly influenced by currency undervaluation – cheap labor and high corporate profits
- But reserve accumulation and export growth do not lie.
- 1980 and 1994, GDP growth in China 7.8 % per annum; rising to
- 1995 to 2010 , GDP growth at 8.9 % per year, (including the East Asian Crisis and the Great Recession)

Indian Growth - Deconstructed

- India changed course in 1991 when it decided, some 13 years after China, to join the real world
- This lag is now reduced – Today, *India is China with a 5 to 10 year lag*
- 1980 to 1994, GDP growth at 5.4 % per annum; *rising to* 1995 to 2010 , GDP growth at 7.3 % per year
- What happened to the Hindu rate of growth of 3.5 percent per annum?
- Incidentally, Inequality the same in 1983 and 2004

The Three Stages (Puzzles) of Indian growth

- Growth 1950-1980 : Hindu rate of growth, avg. of 3.5 percent – but misleading – includes the stagflation 1970s;
- Growth 1980-1990 : acceleration to 5.9 percent – no meaningful reforms;
Explanation: movement of labor from low productivity agriculture to high productivity non-agriculture (manufacturing and services)
- Growth 1991-2002 : steady at 5.6 percent; Big time reforms (for India) in 1991; but growth acceleration arrested because of belief in overheating and a tight monetary policy.
- Growth 2003-2010 (and continuing) : steady at 8.4 percent, per capita at 7 (6.9 percent); what happened – interest rate reforms, real interest rate brought down by 500 to 600 basis points compared to 1991-2002

World response to the Indian mini-miracle

- India too poor to save and invest; there is Rising Inequality;
 - Cannot proceed much beyond 5 – 6 percent; will lead to overheating; and what about the high fiscal deficits?
 - Most significant – the world’s mindset about India, led by India!
 - Even in 2010, politicians in India rewarded for boasting about higher and higher poverty figures; According to World Bank, poverty in India same as in Ethiopia.
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- On the World Bank \$ a day poverty line:
 - official estimate in 1983 – 45 percent poor (accepted by all)
 - In 2004/5 (after a 140 percent increase in per capita income) there is Big Time Divergence
 - GOI -- 25 % poor; World Bank 35 percent poor
 - NC Saxena study (member of the prestigious National Advisory Council) – 50 %
 - Arjun Sen Gupta study (Congress MP and ex-Executive Director, World Bank) – 78 percent poor.

Why we miss the great stories ?

- Moral of the story – we are prisoners of our own ideology; our old mind-set.
- There is an economic revolution under way, a fundamental change in the balance of economic power, and we are still debating whether absolute poverty has increased in India!
- Or that the Chinese exchange rate is not severely undervalued
- (Parenthetically, the two controversies tell a lot about the two countries!)

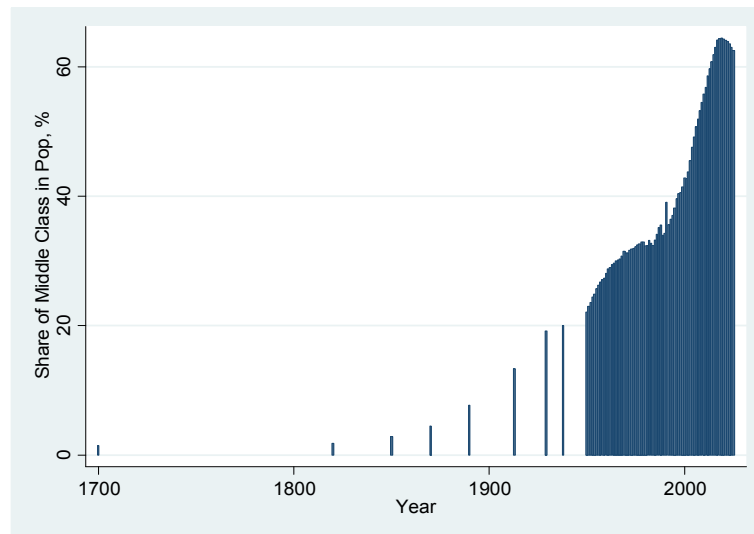
While we were debating...

- The real story of the Great Revolution was emerging
- The Emergence, Rise and Proliferation of the World's Middle Class
- Why does the middle class matter – **Ask Aristotle;**
- Because of its ethics, values, belief in a level playing field, and provision of checks and balances, is an institution par excellence.
- Each 10 percentage point increase in this share adds about 0.4 percent to GDP growth.

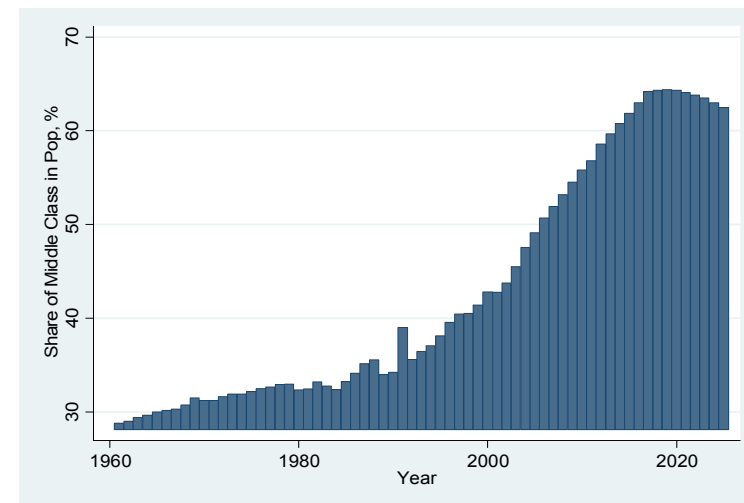
The Rise and Rise of the Middle Class

- Growth has led to a sharp decline in absolute poverty (less than \$ 1 a day) , and an almost equally sharp increase in the middle class. The middle class defined as the beginning of the non-poor line in the developed world, or roughly between PPP\$10 and PPP\$100 per person per day; the poor are less than \$ 10 a day, the rich more than \$ 100 a day

- From 1700 - 2025



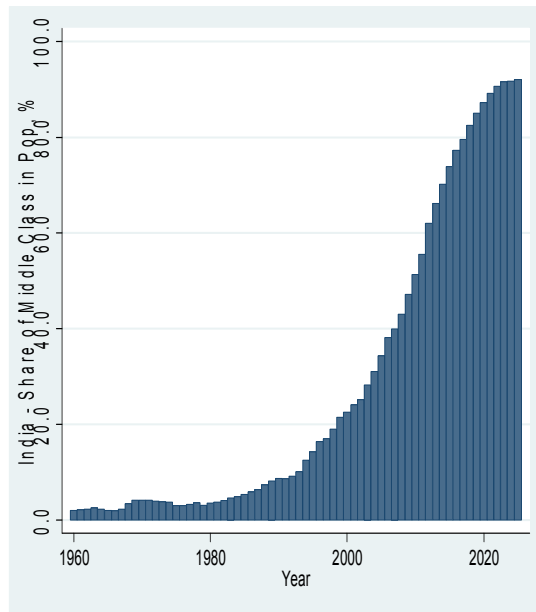
- From 1960 - 2025



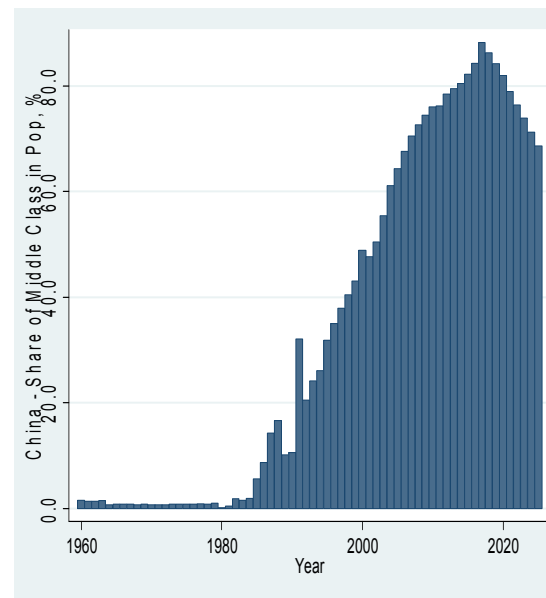
The Role of the Middle Class

- The obsession with poverty made us miss the middle class story in India, and the world. Today, middle class is about 45 percent or about 500 million; in China, about 70 percent or about 900 million

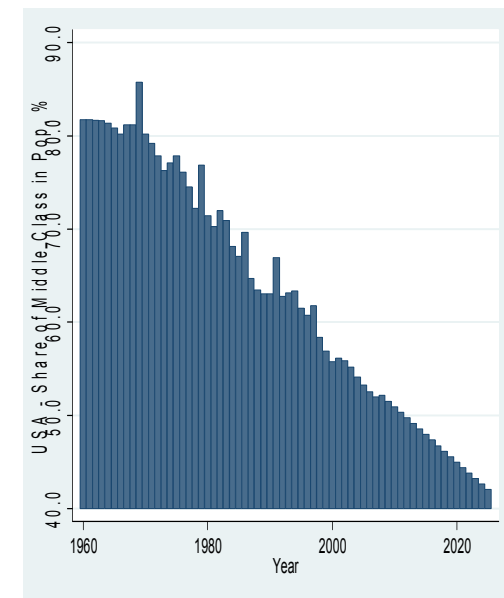
- India



- China



- USA



PART III

The Future: Where are we headed ?

The Middle Income Trap – Not Likely Today

- First, will China and India be able to avoid the “middle income trap”? The middle income trap hypothesis, whose origins are unclear, contends that once countries enter the middle income zone, as India has just entered, growth falters. Historical examples are few but Brazil post 1980 is often cited.
- Evidence is not supportive.
- Almost success stories faltered on the altar of an overvalued exchange rate.
- Unlikely to happen now that the world knows about the advantages of an undervalued currency and the pitfalls of an over-valued one.

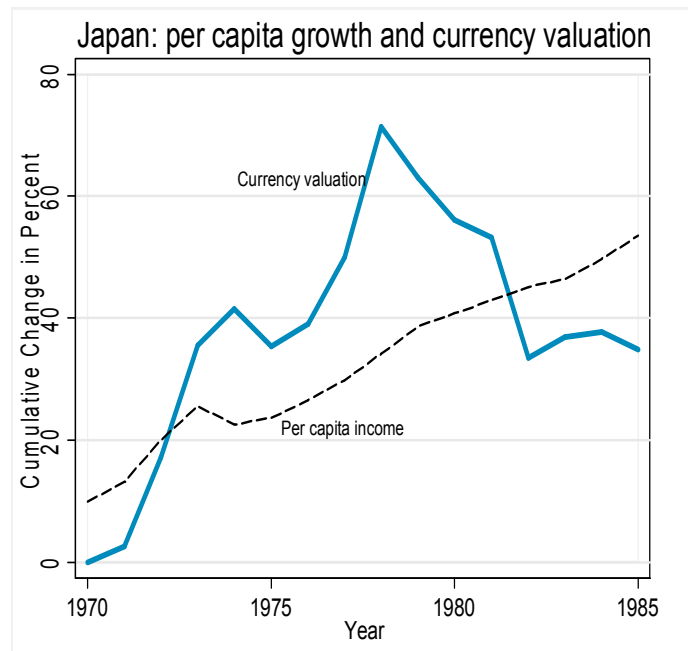
The Reality and Necessity of Global Rebalancing

- Traditional views of the “fair value” of the US dollar centered on its value relative to Europe and Japan. Global rebalancing demands that China start the process of making its currency considerably less undervalued. If this does not happen, the Goldilocks world economy is liable to lose a considerable part of its luster.
- Old story and pre-occupation, \$ vs yen and euro; new story \$ vs. Asia -depreciate and \$ vs. yen and euro, appreciate?
- But will China not go the way of Japan with a significant re-valuation ? Unlikely, if not impossible.
- Starting points, initial conditions, very, very different

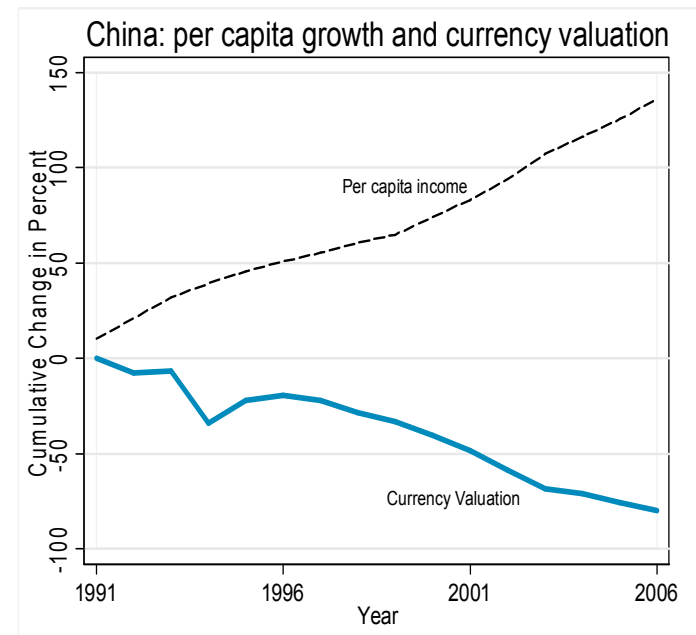
The Yen and the Yuan – No Comparison

- Two similar time-periods

1970 to 1985 Japan



1991 to 2005 China



Can China make up for the US ? Yes, of course..

- Big and reasonable debate – Global imbalances and prospects for balancing
- New normal – US and Europe to grow somewhat slower, Japan somewhat faster
- Loss of about \$ 100 to \$ 150 billion of consumption purchasing power
- Who will make it up ? China, rest of emerging Asia, and India
- At 35 % of GDP, China consumption is not low, but super low
- Norm for the world is close to 60 percent

- Assume China increases share of consumption in GDP by 1 percent a year; and also assume that real appreciation of the yuan is 5 percent a year
- This will give the world an extra \$ 150 billion; add rest of Asia, including Japan, and the world Goldilocks economy can continue

A new twist to the emerged China-India story - India to grow faster than China

Consider the following:

<i>Growth determinant</i> (in percent per annum)	China 2010+ %	India 2010+ %
Labor Force (Employment growth)	0.4	2.5
Capital stock	10 (and declining)	9 (and rising)
Total factor productivity	4 (and declining)	3 (and rising)
Exchange Rate Appreciation	3 to 5 % a year	0 to 2
Potential GDP growth (for 2010-20)	6 to 8	8 to 10

References

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