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CHINA AND INDIA -- THE CHALLENGE

Crouching Tigers, Hidden Dragons

The economic momentum isn't unstoppable. China and India face huge obstacles to growth

Plenty of forces can still throw the Chinese and Indian economies far off course. The economic fundamentals of both nations, with their enormous populations of young workers and consumers, point to strong growth for decades under almost every forecast. But it is instructive to remember that financial crashes, coups, political strife, and plain bad management have derailed many other miracle economies from Southeast Asia to Latin America. And the same huge populations that can translate into economic power for China and India also could prove to be a double-edged sword if social, political, and environmental challenges are not deftly managed. Indeed, growth doesn't have to slow all that much to pose serious social problems. Both China and India need annual growth of at least 8% just to provide jobs for the tens of millions joining the workforce each year. Fear of worker unrest is a big reason Beijing has kept stoking its boom with massive lending and growth in the money supply, despite economists' warnings that it is setting the stage for a nasty bust. If India grows only 6.5% a year, which seems a respectable rate, its jobless rate would still jump, resulting in another 70 million unemployed by 2012, forecasts India's Planning Commission.

Slower growth also could keep China and India from fulfilling the widespread predictions that they will become superpowers. For example, in forecasting that India will rank just behind the U.S. as the world's No. 3 economy by mid-century, with a gross domestic product of \$30 trillion, Goldman, Sachs & Co. ([GS](#)) assumes 8.5% average annual growth. But what if India grows at less than 6%, its average for the past 20 years? By 2050, it would have only a \$7.3 trillion economy -- smaller than Taiwan's even then and just 2.6% of global GDP, notes Stephen Howes, the World Bank's former chief India economist. Worse, India's masses would remain extremely poor. "If you don't grow fast enough, will you have social forces that bring everything to a stalemate?" asks Infosys Technologies Ltd. ([INFY](#)) CEO Nandan M. Nilekani. "That's the worry."

To achieve the high growth predictions, China and India will have to overcome formidable challenges. Some of the biggest:

ENVIRONMENT

Both countries have paid a steep ecological price for rapid industrial and population growth, with millions of deaths attributed to air and water pollution each year. Air quality in big cities like New Delhi, Chongqing, and Bombay is among the world's worst. And forests are vanishing at alarming rates.

Enforcement of environmental laws in both nations is poor. Many power plants and factories depend on coal and don't invest in clean technologies. China is one of the world's most wasteful users of oil. If it does not act quickly, the long-term costs of health problems linked to the environment and the required cleanup will

skyrocket. A growing scarcity of water in both nations could slow industry within two decades.

POLITICAL BACKLASH

China's Communist Party harshly represses dissent. But virtually each week brings new reports of big protests in cities and villages over corruption, pollution, or worker abuse. They underscore China's lack of democratic institutions and the widening gap between rich and poor. Serious challenges to Communist rule can still erupt, especially if the economy stalls. Judging from history, the process could be tumultuous.

India has a democracy, but it also has extremely unbalanced growth and rampant corruption. The surprise electoral defeat of the ruling Bharatiya Janata Party by a more populist coalition led by Sonia Gandhi's Congress Party in 2004 served as a warning of mass discontent. The new government also is reform-minded, but the pace of economic liberalization has slowed. Further electoral setbacks for reformers are possible if the poor don't see the benefits of growth. Tensions between Hindus and Muslims have eased after bloody riots in 2003 and 2004. But communal violence remains a threat.

FINANCIAL CRISIS

Debt and currency crises have derailed many high-flying emerging markets. India needed an International Monetary Fund bailout in 1991. China withstood the 1997 Asian financial crisis mainly because they lack convertible currencies. Also, Beijing controls the banks. Bailouts and the banks' near-monopoly over China's vast domestic savings have kept them solvent despite mountains of bad loans to state firms.

In 2006, however, Beijing will start letting foreign banks compete for deposits and domestic loans. That could put more financial pressure on state banks. China also is starting to loosen its currency controls a bit. China has plenty of foreign reserves now. But if Beijing can't whip its banks into shape, there's a danger that financial market liberalization will go wrong, leading to a crash. India's financial system is in stronger shape, but its public finances remain a mess, with budget deficits at the federal and state level reaching 10% of GDP.

HEALTH

Perhaps China's biggest worry over the long term is inadequate medical care for its rapidly aging population. In 20 years, China will have an estimated 300 million people age 60 or older. Yet only one in six Chinese workers now has a pension plan, and just 5% have guaranteed medical benefits. What's more, many retirees will not be able to rely on children for support. Beijing promises to build a broader safety net, but adequate health care and pensions could consume a huge portion of GDP and deplete China's economic strength in the future.

Both nations also could face full-blown crises with AIDS, tuberculosis, avian flu, and other infectious diseases, and their health systems have been slow to mobilize. At least 5 million Indian adults are infected with HIV, one of the world's highest rates outside sub-Saharan Africa. India's National Intelligence Council predicts the number could pass 20 million in 2010. The U.N. estimates the number of Chinese with HIV could hit 10 million in five years. Some 200,000 Chinese also die annually of TB. And a serious flu epidemic could kill millions. "Many investors don't appreciate the economic damage a serious outbreak would cause in our crowded cities," says Subroto Bagchi, chief operating officer of Bangalore info-tech services firm MindTree Consulting Ltd.

WAR

India and neighboring Pakistan have fought three times since their independence in 1947 -- and have had many border skirmishes over Kashmir. Now, both nations possess nuclear weapons, so a war could be catastrophic. New Delhi and Islamabad have recently eased tensions and begun peace talks. But the rise to power of a radical Islamic regime in Pakistan, or election of a stridently Hindu nationalist government in India, could easily reignite tensions. China's biggest flash point remains Taiwan. Beijing has cooled its fiery rhetoric lately, but still vows to invade should the island declare independence. Any war in the Taiwan Strait would likely involve the U.S. and possibly Japan -- China's two biggest trade partners -- and paralyze

shipping in and out of China's southern ports. It also would likely result in long-term Sino-U.S. tensions that would spill into trade.

It's too much to expect for any developing nation to avoid military, financial, environmental, and health crises for decades. But the test for a great power is how well it manages a great crisis.

By Pete Engardio

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