

FINANCIAL SYSTEM CONSTRAINTS IN CHINA AND INDIA A COMPARATIVE PERSPECTIVE

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China and India are currently among the fastest growing economies in the globe. Continued growth at the current rates or higher, has enormous implications for the globalisation process underway and the consequent re-structuring of world economic order itself. However, economic history is strewn with examples of countries such as in Latin America and lately in East Asia that had grown promisingly at first but only to falter later and fall behind because of an economic crisis. Such countries have been therefore unable to regain their earlier momentum. On the other hand, the US and West European nations constitute another category of nations which grew in a sustained way to become and remain by modern standards developed countries. Focusing on the financial sector, this paper explores the question: into which category of nations will India and China fall?

I. INTRODUCTION

China and India are currently among the fastest growing economies in the globe. Together the two nations represent 38 percent of the global population. Continued growth of the world's second and fourth largest economies respectively [measured by PPP based GNP] at the current rates or higher, has enormous implications for the globalisation process underway and the consequent re-structuring of world economic order itself.

In 1997-98, several of the most dynamic and fast growing East Asian economies suffered severe financial crisis that devastated them. This event revealed that growing economies could not be sustained with a weak financial system.

Economic history is strewn with examples of countries that grew promisingly at first, only to falter and fall behind because of a crisis, and then were unable to regain the earlier momentum. Such examples are found in Latin America and now in East Asia.

There are, on the other hand, examples of countries, such the US or in Western Europe, that in the modern period (starting from nineteenth century) experienced sustained growth and matured economically to become *and remain* developed countries.

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Moreover, whatever crises they faced, were overcome without losing their long-term growth momentum.

Into which of the two categories will China and India find themselves in two decades from today? We seek an answer to this important question from economic history.

Professor Richard Sylla [15] in his 2001 Presidential Address to the Economic History Association summarized succinctly his and other scholars' research on this binary categorization of nations. According to the findings of these scholars, an efficient financial system is an essential and defining condition determining into which of the two categories nations will sooner or later find themselves in.

By that defining condition, we propose to show here that China and India will, *ceteris paribus*, fall into the first category in the company of nations of Latin America and East Asia, unless of course both countries carry out timely fundamental reforms of their respective financial systems. Whether the political constraints and compulsions permit such reforms is a question of deep interest here. The moment of truth for both nations is near, maybe 2010.

Can the two nations reform their respective financial systems to obviate a financial crisis and also meet the requirement of sustained growth, or are there constraints that would prohibit China and India from carrying out these reforms? I propose to argue here that political constraints and economic compulsions in both countries are such that these required reforms cannot be carried out. Financial crisis thus seems highly probable. However, India appears better placed than China institutionally, and being a democracy, to rectify itself subsequent to a crisis through the electoral process, as past experience shows. For China, not being a multi-party democracy, such rectification would require a major political upheaval.

The main function of the financial system is to mobilize resources through financial assets or debt instruments and to facilitate the allocation and deployment of these mobilized resources spatially and over time efficiently and optimally. The goal, in an uncertain environment, is to maximize the growth rate of the economy and achieve the highest rate of return on the resources deployed.

This function encompasses a 'financial architecture', i.e., payment system with a medium of exchange, a transfer mechanism for resources mobilized from savers to borrowers/investors/other users of resources, and eventual repayment to savers, with a reduction of risk through insurance and diversification.

Financial architecture is constituted by the following: (1) Institutional regulators such as the Security Exchange Commission; (2) International standards of accounting to ensure transparency in transactions; (3) Corporate governance norms for management, shareholders and stakeholders; and (4) Sound banking and prudential norms such as those posted by Basel II norms that limit moral hazard and soft-budget constraints.

The system's ability to perform the main functions stated above while remaining stable, depends on the following three factors:

[a] Macroeconomic fundamentals

[b] Structural Parameters

[c] Institutional Quality

By current international standards, both China and India have impressive macroeconomic fundamentals such as a high growth rate in the range of 6 to 8 percent per year, a relatively low annual inflation rate below 5 per cent, a foreign exchange reserve level exceeding 10 months of imports, and a declining headcount ratio of poor people. Therefore the perception today is that both economies are going strong and will fuel global growth in the future.

While today's popular perception of China and India in this regard may be pleasing, it is important to remember that economic history is full of such favourable perceptions evaporating before the reality that dawns with a bang. At one stage in the nineteenth century, many countries of Latin America were considered more wealthy than North America. Now, the exact opposite is true. In the 1980s, it was widely perceived that Japan would overtake the US. In fact Japanese business had begun to buy up prized US real estate, and became owners of major corporations in the North American mainland. That trend has now been completely reversed. In the case of the 'Asian Tigers', the World Bank published a volume entitled *The East Asia Miracle* [16], which was an unabashed prescriptive advocacy of the export-led free trade strategy of East Asian economies. The celebrated World Bank remark that these economies had gotten their "basics right" —by implication other developing countries had not—came back to haunt the World Bank after the 1997 financial crisis. East Asia, especially Japan, has yet to fully recover from that crisis.

Although the Bank did attempt damage limitation by subsequently publishing another volume entitled *Rethinking East Asia's Miracle* [12], the institution's credibility was hit hard because the very area where the East Asian countries had gotten their basics quite wrong was in the financial system when monitoring financial systems was one of the main tasks for which the World Bank and IMF were set up in the first place.

However, the unexpected 1997 East Asian crisis, and its contagion effect on other countries, led to considerable research in the IMF under the umbrella topic of "financial architecture" that has vastly improved our understanding of the financial system. Measures of crisis vulnerability and crisis prevention have been developed [e.g., *Compilation Guide to Financial System Indicators, IMF 2004*] that now enables the IMF to estimate the probability of a financial crisis back to 1996, just six months before the East Asian crisis. The Guide reveals a relatively low probability of a currency crisis in either China or India at that point in time.

II. THE FINANCIAL SYSTEM IN CHINA AND INDIA

The current macroeconomic fundamentals have been secured in China and India by milking the financial system, without nurturing it by more reforms, and by sweeping the malaise in the system under the carpet. That is, macroeconomic fundamentals have been ensured in both countries increasingly at the cost of deteriorating structural parameters and institutional quality.

As a consequence, now in 2005 the structural parameters in the banking and fiscal sectors indicate a looming crisis. More crucially, as presently structured, the banking

sector in the two economies is internally ill-equipped to meet the challenge inherent in the developing financial crisis. The institutional quality of the financial system of the two countries is out of sync with the needs of increasing globalization, because even today Soviet vintage prudential norms and opacity in transactions are present in the system.

The financial systems of the two countries are bank and budget centric because their capital markets are underdeveloped, and therefore prone to insider trading, rigging, and scams that frighten off small investors. Their respective bond markets are in their infancy (Swamy [13]).

Moreover, the sector is (1) dominated by government ownership, (2) lacks modern prudential and governance norms, (3) suffers from weak non-independent regulatory bodies, and (4) and straitjacketed by directed credit and captive finances. Besides, the fiscal budgeting has limited scope because of large contingent liabilities and irreducible heads for fund allocation, e.g., subsidies, interest payments re-capitalization of lending institutions, pensions and defence.

Hence, because of these above two factors, the financial systems in China and India are subject to a double jeopardy that causes the systems to under perform by sub-optimising the allocation of resources in conversion to productive investment, and by creating excess capacity.

It needs to be stated here, however, that India's financial system is relatively institutionally better structured than China's, although Indian Regulators have yet to fully emerge out the shackles of the Soviet-style command mindset of yesteryears. For example, even today, government-owned banks, which receive 80 percent of all deposits, are compelled to deploy about half of the funds in low interest, albeit low risk, government securities [to finance the government budget's fiscal deficit]. Another 20 percent is directed credit, and 25 percent is kept in mandatory reserves. Such straitjacketing of fund dispersal via government direction applies to other financial institutions in insurance, provident fund and employees state insurance as well. Thus, the Indian financial intermediation relies less on market based risk management and depends more on government policy even today.

III. THE POSSIBILITY OF FINANCIAL CRISIS IN CHINA AND INDIA

Empirically, it has been observed that a financial crisis envelops an economy via three different routes of causation:

- (1) A run in the foreign currency market that induces a banking collapse, which in turn triggers a fiscal crisis.
- (2) A banking collapse that causes a fiscal crisis, which then induces a foreign currency run.
- (3) A fiscal crisis that triggers a banking crisis, which subsequently induces a foreign currency run.

The first route was observed in the 1997-99 East Asia crisis. Gerard Caprio and Daniela Klingebiel of the IMF have documented 117 systemic banking crises in 93

countries since the 1970s. A subset of these 117 cases document the second and third routes to a financial crisis listed above. A financial crisis thus is not a one-way causation. The routes of causation can mutually reinforce each other, and can ricochet or cascade to a bubble which then can theoretically implode by any of the nine possible routes.

Which routes are China and India likely to take to an expected financial crisis? Both countries presently face severe financial systemic problems but of different kinds that require different corrective measures to rectify them and stave off a crisis.

It is the thesis of this study that the imminence of a financial system crisis in China will be triggered by a banking failure, and in India by the unsustainable fiscal deficit in the union and state government budgets.

Based on a predictor model of two IMF economists, Andrew Berg and Catherine Pattatilo[1], it can be ruled as improbable that a financial crisis in China or India will come via the 1997 East Asian route, that is, triggered by a currency crisis. The structural parameters in the balance of payments accounts are such in both countries that the estimated probability of a currency crisis is low. Thus an East Asian type crisis is indicated if the following conditions exist:

- (i) Short-term foreign debt, including portfolio investment, the diaspora's repatriable deposits, loans which become due for payment within the fiscal year, and short-term foreign exchange loans of banks and companies reaches a level such that the foreign exchange reserves falls below 80 percent that level. At present, this is estimated in China and India to be well above that level [in fact, exceeding 100%]. But since 2002, the foreign exchange reserves as a ratio of short-term debt has been falling because of a sharp acceleration in the latter. In 2003, short-term debt in China rose 38.1 percent to \$ 78 billion while total current value external debt rose by just 13 percent to \$ 194 billion. In India, since 2002, short-term external debt has doubled.

It could be argued that the 80 percent level is too low as an indicator of potential crisis, since in terms of the three Keynesian motives to hold reserves, the present level of foreign exchange reserves in China and India are all easily accounted for. On the question of how much cash to hold, John Maynard Keynes had suggested three motives for holding cash: transaction, precautionary and speculative. Thus, enough reserves to cover the import bill of a few months is the *transaction motive*. There are reserves necessary for other motives as well. Reserves are essential to cover the payment obligations on maturing debt. This is the *precautionary motive*. Finally, to provide the short-term commercial credit and portfolio investment, i.e., for 'hot' money that could move out quickly, reserves are essential as buffer for the *speculative motive*.

East Asian countries that suffered the 1997 melt down did have enough reserves for the transaction motive, but not for the precautionary and speculative motive. The question here is if India and China have enough reserves for all three motives. There is also an opportunity cost to consider. The reserves that India and China hold are in low yield US Treasury bills that fetch just two percent interest rate. But the rates paid by the two countries for foreign investment are much higher. Hence, the reserves that India and China hold should be enough to cover for all the three motives, and not more. Any excess over this norm level imposes a cost that is a dead weight loss to the economy.

Allocating for these three motives as shown in Table-1 the foreign exchange reserves appear to be sufficient in both countries to meet the contingencies arising out of a developing currency crisis on postulated four months import cover. However, if the cover is taken as eight months, reserves are insufficient.

Table 1
Adequacy of Foreign Exchange Reserve: (\$US billions)

<i>Motive</i>	<i>CHINA</i>		<i>INDIA</i>	
	<i>2000</i>	<i>2003</i>	<i>2000</i>	<i>2003</i>
Transaction ¹	65.07	144.96	25.60	38.62
Precautionary ²	21.42	27.07	6.24	15.09
Speculative ³	57.25	81.02	7.90	19.11
Total Required	122.04	263.05	39.74	72.82
Available	157.80	416.21	42.30	107.45

1. Four months import cover 2. Debt Service 3. Portfolio and other short-term debt.

Source: Statistical Abstract of China, National Bureau of Statistics, Beijing, 2001. Statistical Abstract of China, Central Statistical Organization, New Delhi 2004.

- (ii) Net present value of foreign debt is more than 37 percent of GDP. At present, this ratio is 16 percent in India and 13 percent [of uncorrected official GDP] in China.
- (iii) Current account deficit in the balance of payments accounts is larger than minus 2.5 percent of GDP. At present this ratio is + 1.1 percent in India and +1.9 percent in China. Although both ratios are positive i.e., in surplus, but it has declined in China from 4.1 % in 1997. In the case of India, the surplus has risen from a negative 2.0 % but it is not yet a sustainable trend.
- (iv) Foreign Direct Investment is less than 60 percent of the total capital inflow. At present FDI (using IMF definitions) is 62 percent in India and 67 percent in China. But this ratio due to rising portfolio investment has been declining during the last four years in both countries and on present trend could fall below the 60 percent mark by 2007.

Fitting these parameters into the Berg-Pattatilo model, it can be inferred that the probability of an imminent currency crisis—of liquidity—is low in China and India, less than 10 percent unless the crisis is exogenously induced by a banking or fiscal crisis or both, but as of now or in the foreseeable future, a currency crisis is not likely to be the trigger for a general financial crisis.

It is now an accepted view in the literature that even with healthy macroeconomic fundamentals, an economic system can experience a financial crisis induced by a policy mismatch such as the “unholy policy trinity”. Thus, capital account convertibility [CAC], a fixed or pegged exchange rate regime, and an expansionist monetary policy [M3 rising at a rate exceeding 15 percent annually] are seen together, a currency crisis is likely. At present, China has the first two of the trinity and India just the third. Recent credit squeeze policy in China has brought M3 further below the 15 percent cut-off level [In 2004, it was 14.5%, below the 2003 level]. Hence, the financial system should be sufficiently developed to provide intermediation to avoid such a mismatch. It is thus

important, since the Chinese financial system is bank-centric, to assess first the state of banking in China.

IV. BANKING SYSTEM IN CHINA

Chinese banks have been nearly bankrupted by an apparently unshakeable State commitment to a soft-budget constraint, and “policy loans” that are allocated on non-market principles and on government directives [11].

By the end of 2002, the total assets of the Chinese banking sector were 26.4 trillion yuan, representing 85 percent of the total assets of the entire financial sector. Although the role of capital markets is growing, the size of these markets remains quite small, with a capitalization of 1350 billion yuan by end June 2003. Hence the Chinese financial system is bank-centric. Since the banks have a total value of non-performing loans (NPL) exceeding the assets, today China has a banking crisis that is hidden by the monopolistic system and the State’s commitment to bail it out.

China’s banking sector comprises many institutions [13]. These include state-owned banks (SOB), joint-stock banks, city commercial banks, and credit cooperatives. However, banking is dominated by the four state-owned commercial banks, which account for 61 percent of the loans. Some academics argue that this is typical of an oligarchic market, which tends to lower the efficiency for allocating financial resources and result in distortions in the system. Further, dominant state ownership in the banking sector tends to erode the credibility of the threat of market failure and the effectiveness of the banking supervisory authorities to enforce prudential rules and requirements.

The second tier of the banking market comprises eleven joint-stock commercial banks with a diversified ownership structure. However, the key shareholders of these banks are local governments and the state-owned or state-controlled enterprises. In September 2003, their assets represented 13.7 percent of the total banking sector assets of 26.4 trillion yuan. These banks have expanded rapidly in recent years. For example, in 2001 alone, their assets increased by 24 percent. At present, five joint-stock banks are already listed in local stock exchanges.

In September 2003 there were 112 city commercial banks, most of which were created by way of restructuring and consolidating urban cooperatives. These banks represented 5 percent of the total banking assets. In addition, there were 35,588 urban and rural cooperatives, accounting for 10 percent of the total banking assets.

Foreign banks for now play a rather limited role in the system. In September 2003, there were 191 licensed foreign banking institutions in China, among which 157 were foreign bank branches, 11 sub-branches, and 15 subsidiaries incorporated locally with 8 branches. Foreign banks represent 0.3 percent in the local currency lending market and around 13 percent in the foreign currency lending market.

Despite the improvement of the asset quality in recent years, the size of NPL is a major threat for the banking system in China. In September 2004, the NPL of the banking sector, including state owned banks, policy banks and joint stock banks, amounted to 2,532 billion yuan (\$309 billion) measured according to the five-category supervisory loan classification system, and the NPL ratio thus was 18.7 percent. The

non-performing loans of state-owned commercial banks reached 1,999 billion yuan and the NPL ratio was 21.4 percent, an equivalent of 20 percent of GDP of 2002.

The asset quality of the joint-stock banks varies. Some have healthier balance sheets than the state owned banks. The NPLs for joint-stock commercial banks is 8.5 percent on average. The asset quality of other banking institutions is just as worrisome. Most of them are still using the four-category loan classification system based on the status of past-dues. This old classification system is less stringent. Although the figure for NPLs for these banks is not comparable with that for the state-owned banks and shareholding banks, it is generally believed to be higher.

However, data weaknesses and judgment bias adopting the supervisory loan classification also suggest that the scale of problem loans may be higher. These weaknesses include the relatively large share of loans classified as special mention and doubtful, the lack of proper treatment of restructured loans and foreclosed assets, and not to mention, losses from non-credit activities.

At present, the capital adequacy ratio for most Chinese banks is below regulatory requirements. At the end of September, 2004, the composite capital adequacy ratio (CAR) of the state-owned commercial banks is merely 4.61 percent, significantly below the minimum regulatory requirement of 8 percent (Basel I) and 12 percent (Basel II). The same ratio for joint-stock commercial banks and city commercial banks are 6.83 percent and 6.01 percent respectively. Capital adequacy should, however, be calculated on the assumption of sufficient provisioning for loan losses. Therefore, allowing for deficiency of provisions for loan losses, the capital adequacy ratio for Chinese banks becomes much smaller than stated above. As Luo Ping of the China Banking Regulation Commission in a speech in New Delhi [14/11/03] stated, pre-provisioning CAR for SOBs would be just 2%.

The resolution of the problems in the banking sector depends critically on the reform of the state-owned enterprises (SOEs). These enterprises represent the vast majority of the state-owned commercial banks' loan book and recurring non-performing loans. In this context, the structural problems of these banks cannot be successfully addressed unless the SOEs are at least partially rehabilitated and have become credit-worthy borrowers.

In the interest of social stability, banks largely bear the reform cost of the SOEs. For example, by the end of 2000, 51.2 percent of the 62,000 firms that had completed their change of ownership failed to repay bank loans. In fact, there has been so much stress on the appropriate terms of settlement for employees of the bankrupt enterprises that some restructuring of SOEs proceeds at the expense of banks when enterprises are closed down or declared bankrupt.

As a consequence, a banking crisis is already at hand because of the following reasons: Firstly, with the huge amount of existing NPLs [\$309 billion; according to S&P \$864 billion to maintain], maintaining the status quo would require 40% of GDP or \$600b to restructure the SOBs and at the regional cooperative banks' level [who have even higher NPLs due to lack of sound risk analysis and more on "policy considerations" at the local level].

Secondly, Chinese banks do not have any prudential norms for bank exposure to real estate that are prone to asset bubbles building up quickly. There is also considerable pump priming for automobile credit purchase.

At present, 17% of new loans are going to real estate activity [India's is 1.5%] which is highly leveraged, and since 2000 these prices have been rising sharply. Property bubbles do burst—Japan in the 1980s is a case in point, not to mention other East Asian nations in the 1990s. Overall urban land and property prices rose by the end of 2004 to 70% above the 2001 level (*Business Week* USA April 4, 2005). In Shanghai, property values doubled in 2004, while rental rates fell.

In addition, it is estimated by Automotive Resources Asia [*Economist*, March 20, 2004], that at the present rate of investment in the sector, the gap between capacity and sales will widen from half a million on sales of 2.2 million to a gap of 3 million excess in automobiles alone by 2007. Profit margins at 8% are comfortable but have been moving downwards since 1999.

Provisioning for these bad loans has, of course, meant a less tight monetary policy. China had already been pump priming for the last five years. Broad money to GDP ratio rose from 62.3% in 1990 to 171.4% in 2002 to 183.2% in 2003 [for India it was 43.5% to 69.3%. In the US, it is 65%]. China's government debt including quasi-fiscal liabilities [e.g., bonds to recapitalize banks, pension] is now at 95% of GDP [uncorrected], is much higher than India's 81%. In ten years 1990-00, China's pension fund contributors doubled, while retirees tripled. The contribution at 227.8 billion yuan is slightly higher than the distribution of 211.5 b Y. By 2007, the former will fall short of the latter.

This has meant creating inflation potential since the rate of growth of fixed assets in China has declined from 24.3% in 1998 to 10.9% in 1999 to 9.9% in 2000, and to even lower [9.8%] in 2003. In that, more than half is accounted for by increases in capital construction and property related projects. One estimate from China [*News From China*, April 2004, p.20] was that of the 8% growth rate in 2002, real estate contributed 1.85%].

Further, the official consumer price index in China has also accelerated to 5% an year on year basis, up from 3.6%.

VI. CONSEQUENT FISCAL AND CURRENCY CRISIS IN CHINA

As a result of the soft budget constraint facing the SOEs and above mentioned factors, China's corrected fiscal deficit at the central level is now 6% of GDP [uncorrected has risen to 3.6%]. Thus, the new Governor of the People's Bank of China, Dr. Zhou Xiaochuan, has to solve the crucial problem of calibrating the inevitable revaluation of the yearn-dollar exchange rate, preventing a spike in inflation, and checking the possible ballooning of NPLs of state-owned banks in order to maintain the growth rate with macro-economic stability. Government total fiscal deficit including provincial deficits may be as high as 13% today. This is one of the highest in the world [In 2000, out of 74 countries tabulated, only 7 had fiscal deficits exceeding 7%, and only four including China and India had deficits exceeding 10%]. The ensuing banking crisis thus has thus already affected the fiscal budgetary health of China.

The consequent inflation and the continued fast export-led growth will mean commensurate wage increases to sustain consumer demand and to meet demand for skilled labour in exporting firms. Even though a currency crisis has a low probability of direct occurrence in China and India, such a crisis can be indirectly induced. Thus, because of the peculiar and precariously balanced structure of China's foreign trade [as described in paragraphs below], in which reprocessed imports from East Asia are exported to the US and EU and thus a surplus on the current account is earned to cover the deficit in trade with East Asia, a rise in wages and transaction costs can induce a currency crisis.

More importantly, China's foreign trade comprises two rather different components: (1) imports that are processed and re-exported and (2) "domestic" or "own" trade, i.e., exports of goods primarily originating in the domestic economy, and imports for domestic consumption and production use. The former reflects China's rising role as a labour-intensive processing and assembly centre, fueled by outsourcing and external final demand, while the latter is more strongly influenced by domestic economic trends.

If we divide China trade into its these two component parts, we find two very revealing trends. The current trade surplus is completely due to the positive balance on processing trade, i.e., value added in China before re-exporting to final-destination markets, which reached US\$40 bn last year. At the same time, China's own domestic-centered foreign trade is increasingly in deficit, with the balance declining from a positive level of nearly US\$20 bn in 1998 to a deficit of the same magnitude in 2001. The primary driver of this deficit has been rapidly growing domestic-centered imports, which more than doubled over the last three years compared with domestic-centered export growth of only 50%—a testament to the strength of ongoing import liberalization and domestic demand growth in China.

Over the past 15 years, the opening of the Chinese economy and the rise of the ASEAN nations have added another link to the production 'chain' that changed the regional division of labour. Capital goods are now shipped from Japan to economies like Taiwan and Korea, which in turn send capital-intensive inputs to China and ASEAN for labour-intensive processing and assembly before re-exporting to developed markets. Thus, each time a new link is added to the Asian production chain, recorded intra-Asian trade value jumps significantly, while the final value of goods exported to end markets outside of Asia may not have risen at all.

This means that a good part of China's rapid trade growth is, in effect, 'double-counting'. Because China records high import and export growth and has become the main exporter to the G3, it appears as though China is grabbing world trade share and US market share at a phenomenal pace while the Asian NICs appear to be losing out. Over the last decade, the Chinese mainland has recorded an ever-increasing trade deficit with the Asian NICs, reaching US\$40 billion in 2001, and an ever-increasing surplus with the US.

Yet after we adjust for 'production chaining', we find that China's 'true' export penetration into the G3 markets over the last ten years has been much less pronounced. China still runs an underlying surplus with the US, to the tune of about US\$40 billion; however, the Chinese mainland is either in balance or deficit with every other trading

partner (including, despite the hype, Japan). In GDP terms, surprisingly, China has no discernible effect on any of the G3 countries; even the US\$40 billion surplus with the US represents only 0.4% of US GDP, and this figure has not changed much over the last ten years, so that the net annual growth impact is negligible.

It can be expected therefore that China's current account will turn negative in the first decade of the 21st century because of a rapidly increasing deficit in domestic trade. This will cause a currency crisis once a banking collapse takes place. That is, even without a crisis, continued high growth rates will cause skilled workers' wages to rise which could put Chinese exports at comparative disadvantage against South Asian countries or even East Asian countries, thereby slowing exports, upsetting the regional trade balances, and thus cause a currency crisis especially if a banking collapse occurs.

Furthermore, China's high domestic saving which is keeping the SOBs flushed with funds. Two problems will, however, arise soon. First, China's rate domestic saving has peaked (see Modigliani, Franco, and K.Cao [04]). Moreover, China's incremental capital-output ratio is estimated after conforming data to international practice at 6.0, which is very high. Further, if China is unable to keep its commitments to the WTO on the financial sector, FDI which is already very high at \$ 50 billion, could consequently taper off.

Second, savers will have alternatives if and when China implements its WTO commitment to open to foreign banks on "national treatment" basis by 2007. That will hit the SOBs and undermine the Communist Party's main controlling tool of financial authority. So far economic reforms have been successful in legitimizing the CCP, which it had lost during the Great Proletarian Cultural Revolution. But the implementation of this particular assurance to the WTO on opening the banking sector to foreigners will undermine the authoritarian political control that financial patronage affords to the CCP. Therefore, it is doubtful this commitment will be implemented.

But if China does keep its commitments to the WTO, the SOBs would suffer a sharp drop in depositors because the WTO enabled foreign banks would be able to attract them with a higher deposit interest rate. At present, SOBs give merely 2 percent as interest on deposits. Such a desertion by depositors will make the SOBs wholly untenable financially and would lead to their crash. Already in 2004, bank deposit growth has slowed with the advent of limited foreign bank freedom to operate.

In turn, the SOEs, of which two-thirds are in the red and surviving because of loans from SOBs that are not paid back [soft-budget constraint], would have to restructure rendering millions unemployed.

Furthermore, foreign banks in China would find it profitable to lend to the private sector that at present gets less than five percent of all bank loans. As a result, according to [*Beijing Review* 8, 2004], 77 percent of the private enterprises are facing financial difficulties. This sector is relying on informal sources for finances. Enterprises will have to, as the Review suggests, increasingly rely on commercial banks for their existence in the near future. This would enable the private sector to emerge as a serious competitor to the SOEs, but with less padded employment potential. Will the prevailing political constraints permit that? According to George Gilboy [04], that is unlikely since it will mean permitting the private sector to emerge as an independent economic power decisively weakening the Party's control over the financial system.

VII.A FINANCIAL CLEFT STICK OR CATCH -22 FOR CHINA

Thus we see a Catch-22 situation for China. It means either being resigned to an inevitable financial crisis arising from:

- (i) 50% NPL
- (ii) 2% CAR
- (iii) Fiscal deficit of 13% of GDP implying inflation
- (iv) Contingent liabilities to provide for enhanced pension, increased social security to meet the rising layoffs & migrants, and rural subsidies to contain food prices
- (v) M2/GDP rising towards 200%.
- (vi) A depleting current account surplus.
- (vii) The deteriorating balance of trade in Chinese-origin products and switch processing trade, or facing a political upheaval arising from the consequences of essential financial sector reforms.

Judging by the continued rise of new NPLs of SOEs, and that there appears to be no Chinese determination to allocate bank funds more efficiently, e.g., by privatizing or permitting the SOBs or foreign banks to finance the private sector firms that squarely face a hard budget constraint, a banking crisis appears inescapable. Instead the attempt is to re-capitalise bank capital or shift the NPL burden to asset management companies. Such measures can only buy time or postpone the crisis. What is required are reforms that will bring about market efficiency in the allocation of capital as indicated above. This will require squarely confronting the issue of the loss-making SOEs.

Small and medium enterprises, which are mostly private, account for 60% of the industrial output and yet get less than 5% of all bank loans. They are charged a higher interest rate of 8-10% against the official 5.3%. yet they rarely default. Hence, they have to rely on the gray market for the balance of the required capital paying interest rates as high as 18%.

The trigger for the financial crisis in China will be the present credit squeeze aimed at containing accelerating inflation. Judging by reports, it will cause a slow down in investment growth over the next three years, and drive the private sector at the margin to cut back investment and cause a serious unemployment problem. Chinese macro economic stability to date has been maintained on two wheels: pump priming and public confidence in banks, i.e., that government will bail out banks, *and can bail out banks in the future*. This is one reason why households save so much in low interest deposit accounts in banks.

However, this credit squeeze will further increase the NPLs in banks or cause closure of private companies. It is the private sector that has in the last thirteen years [1990-2003] absorbed 36 million excess labour freed from SOEs and was expected to absorb 9-14 million in 2004. According to the IMF, since 1997, 27 million workers have been laid-off as a result of closing of loss-making SOEs.

At present, total deposits held by financial institutions are \$2.1 trillion while loans are \$1.7 trillion. The surplus of deposits over loans is dangerously low, may become

lower because the credit squeeze will probably increase NPL especially of SMEs and real estate property developers. Liquid liabilities of banks as a ratio of GDP has already exceeded 200%, the world's second highest after Japan (India:52%, US:6%). Coupled with a very low Basel ratio, the fragility of Chinese banks is obvious for all to see.

Moreover, China will also have to find funds to import 30 million metric tons of foodgrains beginning in 2007 to make up for the food deficit arising from falling acreage productivity, water tables, and disrepair of public irrigation system. Developing food imports dependence is thus an untold Chinese story that is implicit in the declining foodgrains output from 512 (1997) to 432 (2003) million metric tons. This will put additional burden on the budget, and on the farmers who will find that imports depress farm prices.

The credit squeeze is moreover cutting consumer demand for durables, but is not containing food prices. To contain rising food prices, the Chinese government has decided [at a Cabinet meeting on July 14th 2004], to pump \$18 billion into agricultural subsidies to farmers in 2005. The funds for these subsidies will probably come from currency printing.

In addition, there is the under researched topic of provincial governments dependence on transfer of resources from the central government. In 2002, the provinces own revenue as a ratio of GDP was 8.1% but it's expenditure was 13.5%. The balance was made up by central government transfers and bank credit. This imbalance will continue to widen at the cost of investment because it means further state impounding of bank funds from government expenditure.

The Chinese financial system thus is now prone to a crisis if adequate correctives are not applied immediately. Interestingly, this is recognized by leading officials of China. Speaking at the plenary session of the National Peoples Congress in March 2004, China's Prime Minister Wen Jiabao stated that on banking system reforms "China is engaged in a last ditch fight that we cannot afford to lose".

However, ground level corrective action today does not reflect this official acknowledgement. Whatever action has been taken to date is quite inadequate to stave off the crisis.

The Communist Party of China had in the past courageously undertaken reforms but more because it was necessary *and which also legitimized the Party* especially after a prolonged disorder, which had damaged the party's credibility nationally and internationally. After the Great Leap Forward, the Great Proletarian Cultural Revolution and the Gang of Four, the Communist Party's standing with the people was eroded. Chairman Deng understood that and skillfully launched reforms.

Dramatic as the financial crisis scenario appears, it is the reality in China. There is today clearly a Catch-22 type of political bind regarding the financial system. Either China will have to carry out financial reforms and face a possible political upheaval arising from a large number of urban workers laid off, or retain the political levers on the financial system and face an economic crisis caused by a banking bankruptcy that cannot be bailed out by fiscal measures.

With a peaked domestic saving rate, a high incremental capital-output ratio, and uncertainty about FDI, there is no scope for raising or even sustaining the present

growth rate in GDP without reforms that are able to increase total factor productivity. The last few years of sustaining demand by “pump priming” has already been reversed since June 2004 by new credit restrictions, leading to open discussion of whether a “soft-landing” of the economy is possible.

Hence, consider the possibility of a banking crisis deepened by this credit squeeze, which is accentuated by the ticking pension bomb that will require funding of \$600-800 billion [by 2025, China’s 65+ years population will have risen from 10% to 25%]. At present, the IMF estimates that there are 105 million contributors and 32 million beneficiaries. But the implicit pension liability is 90% of GDP with a financing gap of 70% of GDP. At present, the pension system however covers only 20% of the workforce. Beijing cannot print more money to meet these gaps without risking a major destabilising inflation.

Add to the banking crisis possibility the threat of private savings shifting to foreign banks as per WTO mandate for 2007, plus a rise in wages of skilled workers caused by continued high growth and through increased labour demand of more and more multinationals coming to China, that will erode China’s comparative advantage. Last March at the NPC, the Chinese authorities had hoped for a soft landing [lower inflation and growth rates], but hard landing appears certain to most analysts [unemployment, inflation, recession, slump in growth rates]. But as a foreign banker was quoted by Wall Street Journal as saying: “If Chinese banks can’t be fixed, then the government will not open up the banking industry, because they know local banks can’t compete.”

On top of it all, the off loading of the yuan equivalent of the \$300 billion exports net of deductions parked in US Treasury bonds plus FDI of \$50 billion, and the inflow of dollars by the continued speculation especially by the Sinic diaspora, that the yuan will appreciate, thereby flooding China with more speculative dollars for windfall profits in a future exchange for yuan, the “bubble burst” scenario is clearly visible. It is well known that defending a fixed rate has been everywhere a cause for crisis. Even if the WTO assurance on foreign banks is not implemented, these ingredients (plus the need to finance food and oil imports) are sufficiently fissile to cause a bubble to burst. To me, therefore, a crash landing seems probable by 2010.

VIII. THE FISCAL CRISIS IN INDIA

In India, unlike in China, it will not be the bankruptcy of the banking sector that will be trigger the crisis. That will come from the failure of the fiscal budgeting system. There is already ‘a comprehensive fiscal failure’ as now admitted by the leading person of the government in economic affairs, the Deputy Chairman of India’s Planning Commission, Dr. Montek Ahiuwalia. In July 2004 he told a news daily that India was experiencing “a comprehensive fiscal failure.”

It is also widely recognized that a major new generation of reforms are required to stave off this failure but which political constraints will not permit to be implemented. In my view, as on the last occasion of a balance of payments crisis in 1990-91, it will be only at the brink of the precipice when Indian political constraints will melt and allow a new generation reforms to be initiated. As before, it may require a regime change, of course brought about democratically.

The malaise in the Indian financial system as we saw is not in its macro economic fundamentals *per se*. It is that these fundamentals have been attained by running the fiscal system to the ground, e.g., inflation has so far been contained by financing the large government deficit by a surplus of private saving over private investment. The growth rate in GDP has been sustained by a disproportionate rise in the service sector, which is now 52% of GDP.

However, Indian financial institutions are in place even if straitjacketed by the government. India has a long functioning central bank [The Reserve Bank of India], a well-defined capital market regulator [The Securities and Exchange Board of India], and a modern IT-savvy, paperless stock market.

The banking system is also not in shambles as in China. NPL are not more than 15% of GDP and bad debt is about \$15 billion. The capital adequacy ratio (CAR) requirement of 12% is also met by most banks.

India's problem is that the government budget is a can of worms. At the Central government level, the budget finances are in a debt trap, made inflexible by politically irreducible commitments for amortization, defence subsidies, counter guarantees and pensions, which account for 95% of all revenue mobilized in the budget. This is compounded by the political inability to prune what can be pruned with greater political determination: defence, subsidies, and government administration expenditure, or to raise new taxes substantively.

Moreover, the provincial governments are increasingly dependent on transfers and grants from the Centre, and are getting close to defaulting on their employees' salaries. Early in 2004, the Supreme Court ordered the state government of Bihar to pay employees their six months overdue salaries. The order was complied with thanks to an extraordinary grant from the central government, which is run by a new coalition in which the state party is also a constituent.

Moreover, most public sector enterprises units are in the red, and the State Electricity Boards are bankrupt. The Central government is making the provisions for these government enterprises out of loans squeezed from the SOBs. This has had a negative effect on the private industry investment whose ratio as a percent of GDP has been declining since 1995.

Total investment in agriculture has also declined, while a small rise in the service sector investment has neutralized the decline in public sector savings to keep the total domestic savings ratio roughly constant. In fact, in the Central Budget, the Capital Account Budget has to be increasingly, year after year, in surplus to finance the Revenue Account Budget deficit.

Given that the decade long constancy of the savings ratio continues, there is no way to raise growth rates or even keep it from falling (due to the law of diminishing marginal returns), unless domestic industry increasingly modernizes, e.g., by utilising the IT industry's software output [at present only 2% of that output goes into domestic industry] for which additional investment can come from the government reducing its budgetary deficit, or through FDI, or both.

Foreign direct investment, even using the IMF definitions, does not exceed \$6b annually, and is unlikely to rise further unless infrastructure and labour laws are vastly

reformed. The new government in New Delhi is battling its Communist partners even for a small concession on FDI in the Budget proposals, and have threaten to withdraw parliamentary support. As for labour laws, there is not a remotest chance that the Communist coalition partners would agree.

The trigger thus will be this Budgetary debt stick—the impossibility of finding new resources, coupled with the rising demand for funds from a newly invigorated private corporate sector. At present, 90 percent of the financial household saving is being deployed to finance the gap between public saving and public investment. The former is negative at $-2\frac{1}{4}\%$. The economy will not be able to find the resources for both. Therefore, the following economic trends are expected to occur:

- (i) The real interest rate will rise to exceed the growth rate in GDP, causing investment decline, followed by the growth rate falling below the real interest rate. This can then spiral the economy into a depression, and a return to the “Hindu” growth rate below 4 percent, which is below the unemployment clearing, poverty reducing minimum of 6 percent.
- (ii) The rise in the real interest rate will put debt dynamics on an explosive path as well. According to a study by Dr. Kalpana Kochhar [8] of the IMF, the real effective interest rate on government debt [defined as the ratio of interest payments in a year to outstanding liabilities at the end of the previous year] has risen already from $3\frac{1}{4}\%$ in 1997-98 to $6\frac{1}{4}\%$ in 2000-01. As Martin Feldstein [4] showed mathematically, when the rate of interest exceeds the growth rate, debt will follow an explosive path.
- (iii) This will send the government budget headlong into an internal debt trap. At present the Budget is already on the verge of a debt trap. Hence, this will mean a down grading by international rating agencies as happened in 1990-91.
- (iv) The NRIs, studies show, behave just as any other nervous investor, and will hence begin pulling out their deposits because of what is called ‘a herd mentality’. Along with “hot money”, this withdrawal will be sizeable and enough to cause a currency crisis.
- (v) The rising fiscal deficit will impact on the external current account balances either by the private sector reaching out abroad for funds or for the government seeking financing of debt through floating bonds or asking SOBs to seek short-term loans from abroad, both of which will carry heavy servicing obligations.
- (vi) To rescue the Indian economy from this inevitable spiral, it will need a paradigm shift in current political outlook and require a non risk—averse leadership as in 1990-96 India had, to complete the reform process to totally dismantle the remaining Soviet style controls on the economy.
- (vii) The task of reforms was interrupted in 1996 once well past the crisis by an electoral defeat of pro-reform Prime Minister Mr. Narasimha Rao, a defeat organized by the rentier class and the crony capitalists. Since then, successive governments have made *ad hoc* and sporadic efforts to reform but no new generation of reforms have been initiated to succeed the first generation of deregulating and liberalization of 1991-96.

(viii) The provinces in India are also equally in the red, getting close in some states to defaulting on payment of salaries to its own employees. According to a tabulation obtained from the Planning Commission, the majority of the provinces of India are “debt-stressed,” i.e., close to insolvency. Most of the state public sector enterprises are making losses while the State Electricity Boards with monopolies on transmission are deeply in the red with accumulated losses that are staggering. India is clearly headed towards a budgetary dead-end.

Given the decade long constancy in the domestic savings ratio, the long term decline in the agricultural investment rate, a stagnant private investment because of a record fiscal deficit of 11 percent of GDP, there is no way the growth rate of the Indian economy can be raised or prevented from falling due to the law of diminishing returns, unless productivity is increased by modernization of domestic industry for example by using IT software. FDI, which on the most inclusive definition does not exceed \$ 6 billion per year, is unlikely to increase to raise the level of investment unless infrastructure and labour laws are brought to international standards. Both of these problems, at the very least, require new legislation, which under the present political dispensation appears a remote possibility.

CONCLUSION

In India and China, political factors led to economic reforms being implemented during the two decades since 1980. Growth rates thus accelerated and exports boomed. Foreign investment increased and many poor people were lifted above the poverty line.

However, since the late 1990s, both countries have experienced severe problems in their financial systems. In China, the government owned banking system is in crisis and almost bankrupt. It is being kept afloat by liberal recapitalization by the State. In India, it is the fiscal budgetary system that is locked in a debt-trap and inflexible commitments for current expenditure that require large pre-emption of bank funds for meeting the revenue deficit, funds that otherwise would have been available for private investment.

To rectify these imminent bankruptcies, a banking one in China and fiscal one in India, a new generation of financial reforms are required that may hurt political interests. Hence politics in the coming decade is expected to be the constraining factor in the implementation of these reforms.

A crisis, *ceteris paribus*, appears probable in both countries. India is institutionally better equipped to fire fight the crisis once it envelopes the economy because of the flexibility of democracy in being able to replace failed leadership. The Chinese institutional system is still underdeveloped, its political order is more brittle, and the leadership is not only not directly accountable but less capable of political change as demonstrated during the 1989 Tiananmen incidents. As Gordon Chang [2] has aptly observed, the collapse of the Soviet Union came about because it reformed politically “too fast;” China would collapse, according to Chang, because it erred by moving too slowly. Therefore, I expect, *ceteris paribus*, that India is potentially more likely to get ahead of China after the crises in the two economies.

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