Too many cheers for Chindia

The first of this two-part article argues that the risks to growth are more serious than markets recognize

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There has been a world-wide bout of ‘Chindiaphoria’—the widespread conviction that China and India can continue with their current growth rates for a long time, possibly decades. While everything is possible, I believe the risks to economic growth in these two countries are much more serious than markets and pundits recognize. I shall focus on three risks: The risk of a sharp credit contraction and cyclical downturn, domestic and political risk, and environmental risk. The second is obviously not independent of the third.

First, the cyclical risk. Both India and China are in the terminal stages of a credit boom. So there will be a cyclical slowdown in both. If the monetary and fiscal authorities act in time (they seem well behind the curve in both countries), and if they have the right instruments and the political will and freedom, the credit boom can end with a whimper.

A hard landing seems more likely, since the politically feasible tools for restraining credit growth are only partly effective. China’s authorities rule out the most effective and least distortionary policy response: Raising interest rates and allowing the yuan to appreciate more rapidly. Instead they rely on ineffective increases in reserve requirements and distortionary command-and-control techniques—basically selective credit controls from the central planning days. In India, the belated increases in the Reserve Bank of India’s (RBI) key policy rate to 7.75, and the accompanying increase in reserve requirements by 50 basis points, is rather late and still too little. The effectiveness of these and earlier RBI restrictive measures last year has also been undermined by the extraordinary spectacle of the finance minister, P. Chidambaram, cajoling public-sector banks not to pass on interest-rate increases to borrowers. Other populist, distortionary and, in all but the short run, ineffective anti-inflation measures of the Union government have included a ban on wheat exports.

Second, domestic political risk to growth is seriously under-priced by domestic and global investors. In China, economic liberalization is proceeding side by side with continued political repression. Growing wealth and rising average prosperity levels are accompanied by equally spectacular increases in inequality and, more recently, by growing numbers of people who are worse off and often reduced to living in absolute poverty. The sustainability of such a social-political-economic configuration has never been tested. India has had a representative form of government for 60 years. I believe this is an important socio-political safety valve.

Unfortunately, India needs such a safety valve. It is hamstrung by the widening gap between the urban and rural communities, by the continuing debilitating effects of its caste system, and by serious religious tensions, especially between fundamentalists in the Hindu and Muslim communities. India also has an atrocious record for educating its underprivileged in general, and its women in particular. The Maoist Naxalite terrorist movement is a serious internal threat to security and stability. There is a clear risk of greater religiously motivated extremism and terrorism, and of unholy alliances between home-grown and domestically oriented terrorism and international terrorist movements, especially the fundamentalist Islamist terrorist networks. There is no evidence that the political establishment is about to come up with a policy that is tough on domestic terrorism and tough on the causes of domestic terrorism. Blaming Pakistan for every bomb that explodes is not a policy.

Third, and probably most importantly, the environmental risk. Environmental constraints on growth in Chindia rarely figure prominently in discussions. The same omission invalidates the recent growth accounting exercise for India and China by Barry Bosworth and Susan M. Collins of the Brookings Institution. In this approach, the growth of output is the sum of the contributions of physical capital accumulation, agricultural land area growth, labour input growth and total factor productivity growth. Output is seriously mismeasured and a key input—the services yielded by the stock of environmental capital—is ignored completely. For Chindia, this omission matters even in the medium run.

The environmental constraints I want to focus on are not India's and China's contribution to global climate change and to other global environmental externalities, although these are of growing significance. Global warming may bring some benefits to parts of the globe (especially the current cooler and colder regions of the northern hemisphere). It will be an unmitigated negative for the Indian subcontinent and for China.

Tomorrow, I will focus on how the local or national natural resources of clean, fresh water and fertile land may in no more than a decade become binding constraints on economic growth in Chindia.

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