AP WIDEWORLD

Can India Overtake China?

What's the fastest route to economic development? Welcome foreign direct investment (FDI), says China, and most policy experts agree. But a comparison with long-time laggard India suggests that FDI is not the only path to prosperity. Indeed, India's homegrown entrepreneurs may give it a long-term advantage over a China hamstrung by inefficient banks and capital markets.

By Yasheng Huang and Tarun Khanna

Stitching the future: A weaver at a privately owned textile mill in Muradnagar, India, near New Delhi

Walk into any Wal-Mart and you won't be surprised to see the shelves sagging with Chinese-made goods—everything from shoes and garments to toys and electronics. But the ubiquitous "Made in China" label obscures an important point: Few of these products are made by indigenous Chinese companies. In fact, you would be hard-pressed to find a single homegrown Chinese firm that operates on a global scale and markets its own products abroad.

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That is because China's export-led manufacturing boom is largely a creation of foreign direct investment (FDI), which effectively serves as a substitute for domestic entrepreneurship. During the last 20 years, the Chinese economy has taken off, but few local firms have followed, leaving the country's private sector with no world-class companies to rival the big multinationals.

India has not attracted anywhere near the amount of FDI that China has. In part, this disparity reflects the confidence international investors have in China's prospects and their skepticism about India's commitment to free-market reforms. But the FDI gap is also a tale of two diasporas. China has a large and wealthy diaspora that has long been eager to help the motherland, and its money has been warmly received. By contrast, the Indian diaspora was, at least until recently, resented for its success and much less willing to invest back home. New Delhi took a dim view of Indians who had gone abroad, and of foreign investment generally, and instead provided a more nurturing environment for domestic entrepreneurs.

In the process, India has managed to spawn a number of companies that now compete internationally with the best that Europe and the United States have to offer. Moreover, many of these firms are in the most cutting-edge, knowledge-based industries—software giants Infosys and Wipro and pharmaceutical and biotechnology powerhouses Ranbaxy and Dr. Reddy's Labs, to name just a few. Last year, the *Forbes* 200, an annual ranking of the world's best small companies, included 13 Indian firms but just four from mainland China.

India has also developed much stronger infrastructure to support private enterprise. Its capital markets operate with greater efficiency and transparency than do China's. Its legal system, while not without substantial flaws, is considerably more advanced.

China and India are the world's next major powers. They also offer competing models of development. It has long been an article of faith that China is on the faster track, and the economic data bear this out. The "Hindu rate of growth"—a pejorative phrase referring to India's inability to match its economic growth with its population growth—may be a thing of the past, but when it comes to gross domestic product (GDP) figures and other headline numbers, India is still no match for China.

However, the statistics tell only part of the story—the macroeconomic story. At the micro level, things look quite different. There, India displays every bit as much dynamism as China. Indeed, by

Yes, chairman: Workers at a government-owned shoe factory in Beijing

GOH CHAI HIN/AFP

relying primarily on organic growth, India is making fuller use of its resources and has chosen a path that may well deliver more sustainable progress than China's FDI-driven approach. "Can India surpass China?" is no longer a silly question, and, if it turns out that India has indeed made the wiser bet, the implications—for China's future growth and for how policy experts think about economic development generally—could be enormous.

THE STIFLING STATE

The fact that India is increasingly building from the ground up while China is still pursuing a top-down approach reflects their contrasting political systems: India is a democracy, and China is not. But the different strategies are also a function of history. China's Communist Party came to power in 1949 intent on eradicating private ownership, which it quickly did. Although the country is now in its third decade of free-market reforms, it continues to struggle with the legacy of that period—witness the controversy surrounding the recent decision to officially allow capitalists to join the Communist Party.

India, on the other hand, developed a softer brand of socialism, Fabian socialism, which aimed not to destroy capitalism but merely to mitigate the social ills it caused. It was considered essential that the public sector occupy the economy's "commanding heights," to use a phrase coined by Russian revolutionary Vladimir Lenin but popularized by India's first prime minister, Jawaharlal Nehru. However, that did not prevent entrepreneurship from flourishing where the long arm of the state could not reach.

Developments at the microeconomic level in China reflect these historical and ideological differences. China has been far bolder with external reforms but has imposed substantial legal and regulatory constraints on indigenous, private firms. In fact, only four years ago, domestic companies were finally granted the same constitutional protections that foreign businesses have enjoyed since the early 1980s. As of the late 1990s, according to the International Finance Corporation, more than two dozen industries, including some of the most important and lucrative sectors of the economy—banking, telecommunications, highways, and railroads—were still off-limits to private local companies.

These restrictions were designed not to keep Chinese entrepreneurs from competing with foreigners but to prevent private domestic businesses from challenging China's state-owned enterprises (SOEs). Some progress has been made in reforming the bloated, inefficient SOEs during the last 20 years, but Beijing is still not willing to relinquish its control over the largest ones, such as China Telecom.

Instead, the government has ferociously protected them from competition. In the 1990s, numerous Chinese entrepreneurs tried, and failed, to circumvent the restrictions placed on their activities. Some registered their firms as nominal SOEs (all the capital came from private sources, and the companies were privately managed), only to find themselves ensnared in title disputes when financially strapped government agencies sought to seize their assets. More than a few promising businesses have been destroyed this way.

This bias against homegrown firms is widely

Competing Giants

	Population (2002)	Population Growth Rate (2002)	Infant Mortality (2002)	Average Annual Real GDP Growth Rate (1990–2000)	Foreign Direct Investment (2001)
China	1.28 billion	0.87 percent	27 (per 1,000 live births)	9.6 percent	$44.2 billion
India	1.05 billion	1.51 percent	61 (per 1,000 live births)	5.5 percent	$3.4 billion

Sources: *CIA World Factbook 2002* (Washington: Central Intelligence Agency, 2002); *The Economist Pocket World in Figures* (London: Profile Books, 2002); World Development Indicators CD-ROM (Washington: World Bank, 2002); *Financial Times* acknowledged. A report issued in 2000 by the Chinese Academy of Social Sciences concluded that, "Because of long-standing prejudices and mistaken beliefs, private and individual enterprises have a lower political status and are discriminated against in numerous policies and regulations. The legal, policy, and market environment is unfair and inconsistent."

Infosys conquers: **Clockwise from top, Infosys founder Narayana Murthy and Microsoft's Bill Gates; an Infosys engineer in the server room of the company's Bangalore, India, campus; Infosys Technologies' campus, Bangalore**

TOP LEFT: PALLAVA BAGLA/CORBIS-SYGMA; TOP AND BOTTOM RIGHT: PAWEL KOPCZYNSKI/REUTERS

Foreign investors have been among the biggest beneficiaries of the constraints placed on local private businesses. One indication of the large payoff they have reaped on the back of China's phenomenal growth: In 1992, the income accruing to foreign investors with equity stakes in Chinese firms was only \$5.3 billion; today it totals more than \$22 billion. (This money does not necessarily leave the country; it is often reinvested in China.)

THE MOGUL AS HERO

For democratic, postcolonial India, allowing foreign investors huge profits at the expense of indigenous firms is simply unfeasible. Recall, for instance, the controversy that erupted a decade ago when the Enron Corporation made a deal with the state of Maharashtra to build a \$2.9 billion power plant there. The project proceeded, but only after several years of acrimonious debate over foreign investment and its role in India's development.

While China has created obstacles for its entrepreneurs, India has been making life easier for local businesses. During the last decade, New Delhi has backed away from micromanaging the economy. True, privatization is proceeding at a glacial pace, but the government has ceded its monopoly over long-distance phone service; some tariffs have been cut; bureaucracy has been trimmed a bit; and a number of industries have been opened to private investment, including investment from abroad.

As a consequence, entrepreneurship and free enterprise are flourishing. A measure of the progress: In a recent survey of leading Asian companies by the *Far Eastern Economic Review* (*FEER*), India registered a higher average score than any other country in the region, including China (the survey polled over 2,500 executives and professionals in a dozen countries; respondents were asked to rate companies on a scale of one to seven for overall leadership performance). Indeed, only two Chinese firms had scores high enough to qualify for India's top 10 list. Tellingly, all of the Indian firms were wholly private initiatives, while most of the Chinese companies had significant state involvement.

Some of the leading Indian firms are true start-ups, notably Infosys, which topped *FEER*'s survey. Others are offshoots of old-line companies. Sundaram Motors, for instance, a leading manufacturer of automotive components and a principal supplier to Gen-

Population in Poverty (2002)	Labor Force (1999)	Fixed Lines and Mobile Phones (2001)	Size of Diaspora
10 percent	706 million	247.7 (per 1000 people)	55 million
25 percent	406 million	43.8 (per 1000 people)	20 million

eral Motors, is part of the T.V. Sundaram group, a century-old south Indian business group.

Not only is entrepreneurship thriving in India; entrepreneurs there have become folk heroes. Nehru would surely be appalled at the adulation the Indian public now showers on captains of industry. For instance, Narayana Murthy, the 56-year-old founder of Infosys, is often compared to Microsoft's Bill Gates and has become a revered figure.

These success stories never would have happened if India lacked the infrastructure needed to support Murthy and other would-be moguls. But democracy, a tradition of entrepreneurship, and a decent legal system have given India the underpinnings necessary for free enterprise to flourish. Although India's courts are notoriously inefficient, they at least comprise a functioning independent judiciary. Property rights are not fully secure, but the protection of private ownership is certainly far stronger than in China. The rule of law, a legacy of British rule, generally prevails.

With the help of its diaspora, China has won the race to be the world's factory. With the help of its diaspora, India could become the world's technology lab.

These traditions and institutions have proved an excellent springboard for the emergence and evolution of India's capital markets. Distortions are still commonplace, but the stock and bond markets generally allow firms with solid prospects and reputations to obtain the capital they need to grow. In a World Bank study published last year, only 52 percent of the Indian firms surveyed reported problems obtaining capital, versus 80 percent of the Chinese companies polled. As a result, the Indian firms relied much less on internally generated finances: Only 27 percent of their funding came through operating profits, versus 57 percent for the Chinese firms.

Corporate governance has improved dramatically, thanks in no small part to Murthy, who has made Infosys a paragon of honest accounting and an example for other firms. In a survey of 25 emerging market economies conducted in 2000 by Credit Lyonnais Securities Asia, India ranked sixth in corporate governance, China 19th. The advent of an investor class, coupled with the fact that capital providers, such as development banks, are themselves increasingly subject to market forces, has only bolstered the efficiency and credibility of India's markets. Apart from providing the regulatory framework, the Indian government has taken a back seat to the private sector.

In China, by contrast, bureaucrats remain the gatekeepers, tightly controlling capital allocation and severely restricting the ability of private companies to obtain stock market listings and access the money they need to grow. Indeed, Beijing has used the financial markets mainly as a way of keeping the SOEs afloat. These policies have produced enormous distortions while preventing China's markets from gaining depth and maturity. (It is widely claimed that China's stock markets have a total capitalization in excess of $400 billion, but factoring out nontradeable shares owned by the government or by government-owned companies reduces the valuation to just around $150 billion.) Compounding the problem are poor corporate governance and the absence of an independent judiciary.

DOLLARS AND DIASPORAS

If India has so clearly surpassed China at the grassroots level, why isn't India's superiority reflected in the numbers? Why is the gap in GDP and other benchmarks still so wide? It is worth recalling that India's economic reforms only began in earnest in 1991, more than a decade after China began liberalizing. In addition to the late start, India has had to make do with a national savings rate half that of China's and 90 percent less FDI. Moreover, India is a sprawling, messy democracy riven by ethnic and religious tensions, and it has also had a longstanding, volatile dispute with Pakistan over Kashmir. China, on the other hand, has enjoyed two decades of relative tranquility; apart from Tiananmen Square, it has been able to focus almost exclusively on economic development.

That India's annual growth rate is only around 20 percent lower than China's is, then, a remarkable achievement. And, of course, whether the data for China are accurate is an open question. The speed with which India is catching up is due to its own efficient deployment of capital and China's inefficiency, symbolized by all the money that has been frittered away on SOEs. And China's misallocation of resources is likely to become a big drag on the economy in the years ahead.

In the early 1990s, when China was registering double-digit growth rates, Beijing invested massively in the state sector. Most of the investments were not commercially viable, leaving the banking sector with a huge number of nonperforming loans—possibly totaling as much as 50 percent of bank assets. At some point, the capitalization costs of these loans will have to be absorbed, either through write-downs (which means depositors bear the cost) or recapital-

Home Improvement: An Indian Tale

By V.S. Arunachalam

It was an ambitious task for someone who has lived almost exclusively in apartments and government bungalows. About a year ago, I decided to rebuild and modernize my ancestral home in Bangalore without the help of a contractor. I hired the laborers, bought all the parts, rented the necessary accessories, and supervised the renovations. My inexperience showed: The project ran well behind schedule and over budget. And, of course, now that it is done, I don't have anyone to blame for the few blemishes I notice in my living room.

But it was ultimately a rewarding undertaking, and not just because it restored a lovely house. I was afforded a glimpse of the changes occurring at the working-class level in India, and they are deeply impressive.

The average worker is now more professional, technologically savvy, and conscious of time frames and schedules than in the past. Machines are fast replacing muscle power. One builder refused to accept my offer of a contract unless I guaranteed electric supply for his drills. Thanks to the ubiquitous cell phone, I was able to contact him and his colleagues at any time. For them, cell phones are too empowering to be switched off.

More impressive than the gadgetry was the diversity. The laborers I employed came from all over the country. They spoke different languages and practiced different religions, but they worked well together. They had a common goal: In rebuilding my house, they were building better lives for themselves. This goal had brought them to Bangalore, India's Silicon Valley. Its emergence as an information technology hub has made it a magnet for young professionals from across India, and for workers eager to cater to the city's newly affluent. Indeed, India's working class is displaying unprecedented mobility and enjoying its first real taste of prosperity. While polishing the mosaic floor, a worker from Bihar told me he moved to Bangalore because people in his village had talked of the "boom in the south." He found plentiful work and an absence of xenophobia. His family had joined him, and he spoke proudly of his wife's mastery of the local language, Kannada.

A nation rising: Construction workers at a building site in Bangalore, India

AP WIDEWORLD

Of course, Bangalore is hardly representative of the rest of India, and it will take many more such miracles to spread the wealth to other parts of the country. Neither is Bangalore's continued success by any means assured. The city is choking on congestion and could well go the way of chaotic, dysfunctional Bombay. Corruption remains rampant in Indian politics and thwarts economic and social progress. The judicial system is burdened with frivolous lawsuits that hamper development projects.

But Bangalore is a robust and organic phenomenon that draws its strength from enterprises large and small. It is a phenomenon based on knowledge, education, ambition, and a willingness to travel far in pursuit of opportunity—intangible assets, to be sure, but precious and elevating resources that India should be proud to possess.

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ization of the banks by the government, which diverts money from other, more productive uses. This could well limit China's future growth trajectory.

India's banks may not be models of financial probity, but they have not made mistakes on nearly the same scale. According to a recent study by the management consulting firm Ernst & Young, about 15 percent of banking assets in India were nonperforming as of 2001. India's economy is thus anchored on more solid footing.

The real issue, of course, isn't where China and India are today but where they will be tomorrow. The answer will be determined in large measure by how well both countries utilize their resources, and on this score, India is doing a superior job. Is it pursuing a better road to development than China? We won't know the answer for many years. However, some evidence indicates that India's ground-up approach may indeed be wiser—and the evidence, ironically, comes from within China itself.

Consider the contrasting strategies of Jiangsu and Zhejiang, two coastal provinces that were at similar levels of economic development when China's reforms began. Jiangsu has relied largely on FDI to fuel its growth. Zhejiang, by contrast, has placed heavier emphasis on indigenous entrepreneurs and organic development. During the last two decades, Zhejiang's economy has grown at an annual rate of about 1 percent faster than Jiangsu's. Twenty years ago, Zhejiang was the poorer of the two provinces; now it is unquestionably more prosperous.

India may soon have the best of both worlds: It looks poised to reap significantly more FDI in the coming years than it has attracted to date. After decades of keeping the Indian diaspora at arm's length, New Delhi is now embracing it. In some circles, it used to be jokingly said that NRI, an acronym applied to members of the diaspora, stood for "not required Indians." Now, the term is back to meaning just "nonresident Indian." The change in attitude was officially signaled earlier this year when the government held a conference on the diaspora that a number of prominent NRIs attended.

China's success in attracting FDI is partly a historical accident—it has a wealthy diaspora. During the 1990s, more than half of China's FDI came from overseas Chinese sources. The money appears to have had at least one unintended consequence: The billions of dollars that came from Hong Kong, Macao, and Taiwan may have inadvertently helped Beijing postpone politically difficult internal reforms. For instance, because foreign investors were acquiring assets from loss-making SOEs, the government was able to drag its feet on privatization.

Until now, the Indian diaspora has accounted for less than 10 percent of the foreign money flowing to India. With the welcome mat now laid out, direct

Detroit's slice of Shanghai: An auto worker at a General Motors plant in Shanghai, China

LIU JIN/AFP

investment from nonresident Indians is likely to increase. And while the Indian diaspora may not be able to match the Chinese diaspora as "hard" capital goes, Indians abroad have substantially more intellectual capital to contribute, which could prove even more valuable.

The Indian diaspora has famously distinguished itself in knowledge-based industries, nowhere more so than in Silicon Valley. Now, India's brightening prospects, as well as the changing attitude vis-à-vis those who have gone abroad, are luring many nonresident Indian engineers and scientists home and are enticing many expatriate business people to open their wallets. With the help of its diaspora, China has won the race to be the world's factory. With the help of its diaspora, India could become the world's technology lab.

China and India have pursued radically different development strategies. India is not outperforming China overall, but it is doing better in certain key areas. That success may enable it to catch up with and perhaps even overtake China. Should that prove to be the case, it will not only demonstrate the importance of homegrown entrepreneurship to long-term economic development; it will also show the limits of the FDI-dependent approach China is pursuing. FP

Want to Know More?

Speculating about Asia's economic prospects has long been a favorite parlor game for policy wonks and journalists. Two of the best recent attempts are Jim Rohwer's ***Asia Rising*** (New York: Simon and Schuster, 1995) and Nicholas Kristof and Sheryl WuDunn's ***Thunder From the East: Portrait of a Rising Asia*** (New York: Alfred A. Knopf, 2000).

The role of democracy and individual rights in promoting or hindering growth is one of the most vexing questions confronting economists. Economist Hernando de Soto has produced not one but two seminal works on the subject: ***The Other Path: The Invisible Revolution in the Third World*** (New York: Harper & Row, 1989) and ***The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else*** (New York: Basic Books, 2000). Nobel-winning economist Amartya Sen has also made a career of studying the relationship between freedom and growth. His most recent book, which includes much material on both India and China, is ***Development as Freedom*** (New York: Alfred A. Knopf, 1999).

For a closer look at India, see Gurcharan Das's ***India Unbound*** (New York: Viking, 2000) and Stephen Cohen's ***India: Emerging Power*** (Washington: Brookings Institution Press, 2001).

China's reform process is an inexhaustible topic. See Yasheng Huang's ***Selling China: Foreign Direct Investment During the Reform Era*** (New York: Cambridge University Press, 2003), as well as his article **"Why China Will Not Collapse"** (FOREIGN POLICY, Summer 1995). Other noteworthy works on China's economy include Stephen Green's ***China's Stock Market: The Players, Institutions and the Future*** (London: Profile Books, 2003) and ***China's Emerging Private Enterprises: Prospects for the New Century*** (Washington: International Finance Corporation, 2000). For a look at how reform is playing in China, check out Minxin Pei's **"Cracked China"** (FOREIGN POLICY, September/October 2001), a review of the *2001 Social Blue Book*.

To read more about how homegrown companies in emerging markets become global players, consult two papers by Tarun Khanna, both cowritten with Krishna Palepu: **"Is Group Affiliation Profitable in Emerging Markets? An Analysis of Diversified Indian Business Groups"** (*Journal of Finance*, April 2000) and **"Emerging Giants: Building World-Class Companies From Emerging Markets"** (Boston: Harvard Business School Publishing, 2002).

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