India, China and 'Great Depression'

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India China are bot feeling the heat of the global meltdown. Property and stock markets are down in both countries. Export orders are being rapidly cancelled. Yet the whole world seems to think that China will save the day, ignoring the fact that China has contributed much to the creation of this crisis.

The US economy was slowing down in the aftermath of bursting of the dotcom bubble. The Federal Reserve Board lowered interest rates on housing loans and encouraged banks to be liberal in disbursements in order to buoy domestic demand and delay the onset of recession. The US consumers used this money, among others, to import toys, footwear and clothing from China. China acted like the car finance company established by auto majors. They give loans to increase the sale of cars made by them. Similarly, China provided the funds to American consumers to buy Chinese toys. This virtuous cycle was made possible by the huge purchase of US Treasury Bonds by China. The money paid by China for the purchase of these bonds was recycled into housing loans and thence into consumer spending. In the process China has accumulated huge forex reserves to the tune of $1.8 trillion, mostly in dollar-denominated securities.

China had compulsions in following this policy. China has given her economy an export orientation during the last 25 years in her anxiety to quickly obtain advanced manu-facturing technologies. Multinational corporations made a beeline into China in order to benefit from low price of her natural resources and cheap labour. They imported the goods so produced into the US. In this way the Chinese economy was connected to that of the US in two ways. One, China provided part of the money for the creation of the housing bubble. Two, cheap exports from China led to closure of factories in the US and to higher unemployment in that country. This, in turn, led to defaults by sub-prime borrowers and to the present meltdown.

India has not followed this 'car loan' approach. India's forex reserves have risen to only $300 billion in the last five years. While exports are bought, in the main, not from money provided by Reserve Bank of India to the US Federal Reserve Board, but from own incomes of the people of the United States. This difference has a crucial bearing on how the global meltdown will affect India and China differently. The Indian shopkeeper sells his wares to buyer who has his own money to buy. The Chinese shopkeeper sells his wares to a buyer who has no money of his own. Naturally, exports from China will be hit more once this source of easy Chinese money dries up as is happening presently. Furthermore China will take a big hit on the decline in value of her forex reserves. The value of these reserves will decline along with the decline of the US economy. (One should not get carried away by the present rise in value of the dollar vis-a-vis other currencies which is happening due to return of foreign investments. This is a short run rise that will surely be followed by a long term decline due to the basic loss of competitiveness of the US economy).

Chinese economy is more depen-dent on exports than India and will be hurt more deeply as a result. China has laid the red carpet for attracting foreign investments. Foreign investors established factories in China often to serve their

domestic markets. In the result the share of exports in the Chinese economy is nearly double that of India. The impact of the global meltdown on the Chinese economy will accordingly be double that of India.

The nature of Chinese exports is also not helpful. China is exporting mostly consumption goods—TVs, iPods, toys, footwear and clothing. These consumption goods will be the first to get hit as the US economy melts. The US consumer is hardly likely to buy toys when he is unemployed. India's exports are more diversified in comparison. India also exports software and BPO services which are productive in nature. Some analysts anticipate an increase in services' exports. They reckon the pressure to reduce costs will force US corporations to outsource more of their activities to low-wage provision from India.

India is likely to weather the storm better than China for three reasons. One, India's exports are not built upon 'car loan'-type financing through purchase of US Treasury Bonds. Two, China will take a big hit on the value of her huge forex reserves. Three, India's exports are more productive in nature and more diversified hence will face lesser heat than China.

It is tragic that China is trying to overcome this difficult situation by following policies that are exactly opposite of those required. China is trying to buoy her exports in a sinking global market. The Government has recently increased the rebates provided to exporters. This will not deliver. It will matter little to the US consumer whether the Barbie doll imported from China is available at $9 or $10 when he does not know where his dinner is to come from. The Chinese Government is planning to increase spending on infrastructure. This too will not deliver. There will be few takers for highways when factories are closing down.

Other policies proposed by the Chinese Government are better. It is proposed to increase the Income Tax exemption limits. This will put more money in the hands of Chinese people. The resulting domestic demand will partly compensate for declining exports. Another proposal is to allow sale of lease rights on agricultural land. This will enable sale of fallow lands to cultivators and stimulate both production and demand. These policies will be more beneficial. The basic trick lies in increasing domestic demand to compensate for falling export demand. Unfortunately, the policies designed to increase exports-export rebates and investment in infrastructure-have already been implemented while policies to increase domestic demand-raising of IT exemption and allowing sale of land rights-are still under consideration. Thus China is likely to sink for the present.

There is message for India in this. India should lower excise duties and raise import duties in order to encourage domestic production and thereby generate more domestic purchasing power. The government should make a steep increase in IT exemption limits. Also what is required is to increase expenditures on Employment Guarantee Scheme that places money in hands of those who have a high propensity to consume; and reduce payments to government servants who, in comparison, have a lower propensity to consume. These policies may help India fight global slowdown with ease.

There is no reason to get overly worried by the present decline in property and share markets. This decline is not reflective of the under-lying economy. Growth rate at 7-8 percent is stable. Inflation at 10 percent-plus indicates a demand pull. The present decline is, therefore, due to fleeing of foreign investments. □□□