

The insidious charms of foreign investment

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China's cup overflows; India catches the spillage



You name it, we make it

IN 1976, during one of Deng Xiaoping's spells of political disgrace, he was the object of a national campaign of criticism. Among the most heinous of his alleged crimes was writing an essay in which he argued, in Marxist terminology, that it was possible to import foreign "means of production" without importing the "relations of production"—in other words, opening up the economy need not change China's political and social system.

His critics—the Maoists shortly to be vanquished as the "Gang of Four"—saw this as heresy. Looking around China now, they might feel ashamed but vindicated, despite the Communist Party's enduring grip on power. Foreign trade and investment have transformed the party and the country. Some of the changes—to the environment, in particular—are hideous. But it is hard to argue that life in China was better 30 years ago than it is now.

No other country attracts as much foreign direct investment (FDI) as China does. Last year some \$60 billion poured in, about twelve times the amount that flowed into India. Between 1979 and 2004, China absorbed a total of about \$560 billion in FDI. According to a survey of big firms by A.T. Kearney, a management consultancy, India is the next most popular destination for foreign investment in manufacturing after China. But in the past four years it has received almost \$200 billion less in FDI than China has.

Rakesh Mohan, a respected economist who now works in India's Ministry of Finance, argues that this difference is overstated. Besides FDI, India attracts several billion

dollars a year in portfolio investment (\$9 billion last year). It also draws in billions of dollars in deposits from non-resident Indians (\$33.3 billion outstanding last year), says Mr Mohan. Add all this up, and India is not so far behind China—especially if you allow for Chinese domestic investors “round-tripping”, using foreign vehicles to take advantage of tax breaks.

It is not just a matter of money, however. Minority portfolio investors do not bring foreign technology and management systems, or competition that helps raise the efficiency of domestic firms. As for Indian banks, they are much healthier than their Chinese counterparts and hence better placed to intermediate between savers and investors. But they still keep some 40% of their assets in government bonds.

The foreign-investment boom in China was started by overseas Chinese. From 1985 to 1996, two-thirds of foreign investment in China came from Hong Kong, Macau and Taiwan. There China has, close at hand, some 30m ethnic Chinese, many of them with close ties to the mainland. Moreover, these places specialised in labour-intensive manufacturing industries for export. Wage costs were rising fast, so, in effect, they exported their trade surpluses with America to coastal China. They were made very welcome, for political as well as economic reasons, and paved the way for the big multinationals.

Overseas Indians, in contrast, are scattered around the world and across professions. There are a number of global tycoons, tens of thousands of software engineers who powered Silicon Valley's dotcom boom, and millions of others. It is not surprising they have played a different role to that of the Chinese diaspora.

Build it and they will come

China has two main attractions for foreign investors: a potentially vast domestic market; and an environment from which it is easy to export. The first of these has often proved chimerical in the past, and people with money for discretionary spending are still in a minority, though a far larger one than in India: 300m as against 50m, on one multinational's estimate.

Calculations by Asian Demographics showed that average urban household incomes in the two countries in 2002 were roughly similar. However, China has far more urban households. Because of the one-child policy, they are smaller—usually three people rather than five, as in India—and therefore have more money to spend. In 2002, some 70% of urban Chinese households earned between \$2,000 and \$7,500 a year. In India, a higher proportion earned more than \$7,500 (6.4% compared with China's 1.2%), but 73.5% earned less than \$2,000. China has a fairly broad-based middle class. India has a narrow affluent elite.

To take one example, consider the market for personal computers. India, despite its information-technology prowess, has one of the lowest penetration rates in the world. Forrester, a research outfit, expects this to increase by 37% a year until 2010, which means an extra 80m computers. But in the same period China will add 178m.

China's other big advantage over India is its infrastructure. It has 30,000km (19,000 miles) of expressway, ten times as much as India, and six times as many mobile and fixed-line telephones per 1,000 people. Although last summer saw serious power shortages in parts of China, India's supply is far more unreliable. In India, 61% of manufacturing firms own generators, compared with 27% in China, where the cost of power is 39% lower than in India.

There are pockets of excellence in India, such as the "campuses" built by the big software-development firms. But, by and large, they have had to do everything themselves, relying on their own power, communications systems and even bus services. Leave the campus and you re-enter the third world.

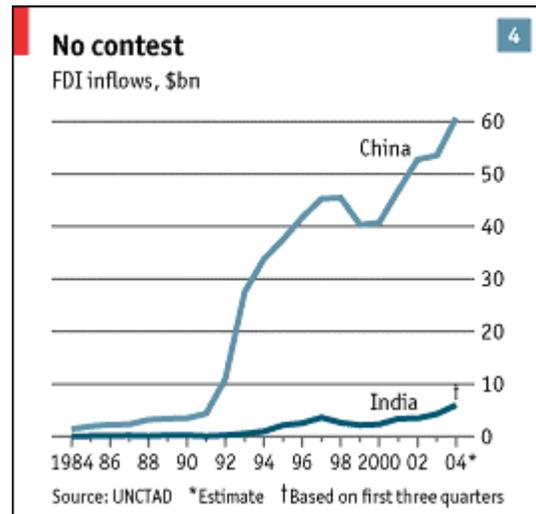
Even Bangalore, epicentre of India's IT industry, suffers from traffic jams, overflowing hotels, power cuts and an inadequate airport. It risks throwing away its great advantage: that it has attracted a critical mass of the world's high-technology firms to what could be a self-sustaining cluster and boomtown.

In China, provinces compete to lure investment. Paran Balakrishnan, of India's *Telegraph* newspaper, once accompanied a party of Indian businessmen to China and explains that they were flabbergasted, on approaching the northern town of Datong, to find their bus joined by the local mayor and given a police escort. Few Indian state officials or politicians go out of their way to attract foreign investors.

Hangzhou, the capital of Zhejiang province, makes an interesting comparison with Bangalore. Both have populations of around 6.5m and a wealth of colleges. Bangalore enjoys the best climate in India, and Hangzhou has an idyllic lakeside setting, so both have obvious attractions for technology firms. But Hangzhou's new airport opened in 2000, whereas Bangalore's has languished for years on the drawing board. Hangzhou is linked to Shanghai by a fast 100km (62.5-mile) expressway. Its charm may have been buried under new concrete, but it is ready for business.

Softly, softly

Ah! say Indians, but what about the people, and the "soft infrastructure", of laws, institutions and financial markets? Surely there India has a lead? Certainly, at the high end of the market, China cannot equal India's supply of technical wizards with fluent English. India's failures in elementary education should not obscure the excellence of some of its colleges.



Dan Scheinman of Cisco, the world's largest maker of networking equipment, says that Shanghai, too, has achieved a critical mass in the numbers of software engineers available. He finds it hard to differentiate between the two countries, either in the quality or the cost of their labour. In both, firms like Cisco are dealing with just a tiny fraction of the population, a group of exceptional people—though the churning of a workforce constantly on the lookout for a better job is a bigger problem in Bangalore than in Shanghai.

In labour-intensive manufacturing, however, Chinese workers, with their better elementary education, have a big advantage. World Bank research suggests that they are 25% more expensive than India's, but 50% more productive.

Corruption hampers business in both countries. In an index of perceptions produced by Transparency International, a monitoring group, India's score of 2.8 has remained constant for a decade. Anything below 3 indicates "rampant corruption". Last year it ranked 90th out of 146 countries (with the 146th being the most corrupt). In 1995 perceptions of China were even lower: a mere 2.16. But it has since climbed to 3.4, and ranks 71st.

Even India's elaborate and well-developed legal system is not as much of an advantage over China as you might think. It is true that in some areas, such as the protection of intellectual property, India is far ahead. But Raj Pande, a lawyer with the firm Paul Hastings, observes that China, starting "with a clean slate" and unburdened by outdated rules, has the chance to build better regulatory frameworks.

Only a few years ago, Chinese outfits preferred contracts you could write on the back of an envelope and wriggle out of at will. Now, however, says Andrew Halper, who has worked in Shanghai for Eversheds, a British law firm, "waves of foreign investment battering away", not to mention competition between locations, have brought more investor-friendly contracts.

Private-property rights are still far behind those of the developed world. But, argues the World Bank's Mr Dollar, China's property rights have improved far faster than other countries', and they are better than those in many other developing countries.

Enforcement of rights and contracts, however, remains troublesome, with the judicial corruption you would expect in a one-party state. But India is not a model in this regard either. It has a judicial backlog of an astonishing 26m cases. The contracts may be watertight, but you can get soaked waiting for a judgment. As Mr Pande points out, this clearly has a damaging effect on compliance.

Foreign investment in some sectors of the Indian economy—such as insurance and the media—is limited to a minority stake. In others, such as retailing, it is banned altogether. Even when liberalisation arrives, as it did in civil aviation late last year, it sometimes comes with perverse conditions attached (in this instance, that foreign investors were welcome—unless they were foreign airlines).

China, too, has its limits, of course. But having entered the WTO on much tougher terms than did India, it is liberalising far faster. The remarkable thing, says Gordon Orr, of the Shanghai office of McKinsey, a consultancy, is how China has allowed foreigners to come in and dominate entire industries—carmaking, for example.

Jairam Ramesh, of India's ruling Congress party, blames the difference on the Indian bourgeoisie. China's capitalists were wiped out in the various purges of the 1950s and 1960s. India's middle class, however, nurtured under British colonialism and the "licence raj" of government-sponsored internal protectionism, is still a force to be reckoned with. So, too, unlike in China, are trade unions, although they probably represent less than 5% of India's 400m-strong labour force.

India's trade unions and employers sometimes unite against a common foreign enemy. In January, for example, both groups opposed the government's decision to lift, for future projects, a rule known as Press Note 18 that acted as a deterrent to investment by giving Indian firms a veto over their foreign joint-venture partners' other investments in India. In China, communism had beaten both capital and labour into submission, though Deng's reforms were opposed by party conservatives and state-owned industry.

Who wants it anyway?

Is all that foreign commercial influence in China an unqualified boon? For unadventurous foreigner and cosmopolitan Chinese alike, it may be a comfort that the country has 150 Starbucks coffee shops, but does it stunt native skinny-latte entrepreneurs, such as those behind India's Barista chain?

In a more sophisticated form, this was the question asked in an article in *Foreign Policy* in July 2003 by Tarun Khanna of Harvard Business School and Yasheng Huang of MIT. It caught Indian eyes with its mouth-watering title, "Can India Overtake China?", and its even juicier conclusion: that India's path "may well deliver more sustainable progress than China's FDI-driven approach".

In a book about FDI in China published in the same year, "Selling China", Mr Huang argues that the FDI China takes in shows up the huge deficiencies of its own corporate sector. "The cumulative result is that Chinese firms are less competitive than they would be otherwise." When a Chinese company emerges into the limelight, it is usually for a blunder or for sheer clout. Lenovo, for example, a computer-maker, late last year agreed to buy the personal-computer business of America's IBM. This said much about Lenovo's ambitions, but also about its inadequacies.

India, for its part, has fostered genuine entrepreneurship in some industries by favouring domestic investment over foreign. It has produced IT firms such as Infosys, Wipro and Tata Consultancy Services that are among the world's best. Mr Khanna says that, since the *Foreign Policy* article appeared, he has revised his opinion of Indian companies downwards. Outside the IT industry, many retain the bad habits and feuding that often afflict family firms. The biggest private-sector firm of them all, Reliance, a textiles and mobile-telephony giant, is torn by a bitter public squabble between its bosses, the late founder's two sons. Mr Khanna's view of Chinese companies, however, remains that most are "anything but world class".

This is a fascinating debate. But, to put it crudely, so what? It hardly impinges on the big issue: how does a poor country become less poor? China has produced no great companies, although it is now the world's third-largest spender on research and development. Yet, in just two decades, China's people have, on average, become

twice as rich as India's. Andy Xie, an economist at the Hong Kong office of Morgan Stanley, an investment bank, points out that very few of the firms that built the American economy at the end of the 19th century are world-beaters today—and yet they laid the foundation for the country's sustained long-term growth.

It pays to be profligate

The “so what?” also applies to the argument that India is much more efficient than China at using capital. Having invested an average of 22-23% of GDP for a decade, it has seen average economic growth of about 6% a year in real terms. China has invested twice as much, but its average growth rate has been only about 50% higher than India's. It is indeed staggering how much investment is needed to power Chinese growth. This measure (the incremental capital output ratio) has been climbing in recent years, but the investment figures include land sales, which makes them unreliable.

All the same, China has undeniably enjoyed an investment boom, which is why pessimists expect its economy to come crashing to earth. Its growth of 9.1% in 2003 required investment of 42% of GDP, and last year's 9.5% probably needed an even higher ratio. Anywhere else, capital accumulation on that scale would look like a bubble. However, few economists in China and Hong Kong expect a hard landing, let alone a crash. First, they argue, there is no reason to expect investment suddenly to dry up. And second, there are signs that consumption is stronger than in recent years, and may withstand a falling-off in investment. For the first time in 20 years, consumption growth may be uncoupling itself from investment. Retail sales in December were up 14.5% on the same month in 2003.

India, meanwhile, is grappling with an even more fundamental difficulty: how to raise investment rates. To emulate China's growth, India would need to increase its investment to 30-35% of GDP, and there is little sign it can do that. Dominique Dwor-Frécaut, of Barclays Capital in Singapore, jokes that China's trouble is capital that costs zero. India's is zero capital.

Suman Bery, head of the National Council for Applied Economic Research in Delhi, says both countries face the same challenge: a failure of financial intermediation. Neither has found efficient ways to translate high rates of private savings into productive investment. China's answer has been FDI, leading to what Mr Bery calls the “idiocy” of Chinese peasant savings financing the American Treasury. In India, the consequences have been underinvestment and a big fiscal deficit, financed by the banking system.