# The risks to China and India growth

The emerging countries face huge challenges to continuing robust growth rates. What will this mean for the chemical sector?

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In recent years, it has become received wisdom that China and India will reach developed economy status. This will result in "the end of economic cycles," as one excited chemicals industry executive said in 2008, because of the strength of their future growth.

For a while, it seemed as if he might be right as China's economy expanded at more than 10% per year. At the same time, India began long-awaited economic reforms necessary to unlock its enormous potential.

But as we discuss in chapter six of "Boom, Gloom and the New Normal," the new International eChem/ICIS eBook, there are major risks to this rosy scenario, including China's demographic time bomb.

Its one-child policy was introduced in 1978, to counter fears of overpopulation and famine. By China's own accounting, about 400m births were prevented between 1979 and 2010.

This has reduced today's 25-to-35-year-old age group by 75%. As demographer Kenneth Gronbach notes, "the 30-somethings will have to do the majority of China's production, consumption and taxpaying, and when you have a 75% reduction in the group that is chiefly responsible for those activities, you've got a real problem."

China and India's "middle class" also have incomes that are only a tenth of those in developed markets, as we discussed in chapter four. This has major implications for the nature of consumption in China and India – and for the type of products that companies will need to make to prosper.

The transition to developed economy status is therefore not guaranteed.

It takes 50 consecutive years of 7% annual growth for a country to boost per capita income from $500 to $20,000, says Nobel Prize-winning economist Michael Spence. China's per capita GDP was only $4,382 at the end of 2010, and India's $1,371, according to the International Monetary Fund. So both countries still have a long way to go.

Recent growth in China and India has also come at a price – poor air quality, chronic water shortages and deforestation.

Equally, China needs to rebalance its economy away from overreliance on exports.

India must improve its infrastructure and reform the harmful government subsidies that are holding back the agricultural sector.

### THE CHINA REALITY

The theory about the inevitably of China's continued rapid economic rise was partly founded on its extraordinary growth in terms of trade, particularly after its accession to the World Trade Organization in 2001.

But continuation of this export-based growth depended on credit remaining easy to obtain in the West. This, of course, is no longer the case.

China contributed to the West's credit boom by creating "a virtuous circle" in 2000–2008. Heavy investment by China and other foreign governments in US government bonds helped keep long-term US interest rates low, thereby making it easier for US consumers to keep on buying goods from China.

This also provided the cash that allowed US financial institutions to develop new lending products, including most importantly mortgage derivatives. These were the root cause of the 2008 economic crisis, as we discussed in chapter two.

Yet as long ago as 2003, China's leaders had recognized that the export growth model was unsustainable, as its success was founded on subsidies that were damaging the economy.

The massive economic stimulus package of 2009–2010 – the largest in history for an economy the size of China's – was therefore a case of turning the clock back.

### INVESTMENT PUSH

Money poured into investment in real estate and new industrial capacity, reducing domestic consumption as a driver of GDP growth. Consumption as a percentage of GDP has fallen from more than 50% a decade ago to just 33%, according to official statistics.

### CRITICAL SUCCESS

Critical success factors for companies in the new normal focus on meeting future market needs "Make what you can sell most cost-effectively"

- **Flexibilty:** Able to adapt to changing circumstances and compromise
- **Scenario Planning:** Thinking through a wide range of potential outcomes
- **Action Orientation:** Overcoming passivity and stimulating creativity
- **Real Needs:** Focus on reliable market drivers close links to key customers
- **Change Management:** Coping with rapid and unpredictable change

Rex Features

Excess investment in 2009–2010 has left China with a legacy of deeply entrenched inflation, a real estate bubble that could burst and non-performing loans on a scale that might disrupt its whole economy.

Turning the economy around towards a greater reliance on domestic consumption is therefore crucial because of not only the wasteful nature of overinvestment, but also because too much wealth is concentrated in the hands of the big, state-owned enterprises (SOEs). They have benefited from low labor costs and poor environmental standards in manufacturing – to the detriment of the vast majority of the Chinese population.

China is attempting such a turnaround under its 12th Five-Year-Plan (2011–2015). But the SOEs, and other powerful interest groups, which have benefited greatly from the current growth model, are likely to fight hard against change.

## INDIA'S CHALLENGES

For a while, it felt as if the traditional Indian economic dance of one step forward, two steps back, had been abandoned due to the political stability achieved by Prime Minister Manmohan Singh's government.

But now the government has been discredited and severely weakened by corruption scandals. These include bloated construction and other contracts awarded during the build-up to the Delhi Commonwealth Games, and allegations that telecom companies grossly underpaid for 2G licenses.

Foreign direct investment fell by 25% to $24.2bn in the fiscal year ended March 2011, as overseas companies were deterred by the slowdown in economic reform, corruption scandals, high inflation and high interest rates.

Indian companies invested $43.9bn outside their home market during the same financial year, according to the Reserve Bank of India. This was a 144% increase over the previous year.

With economic reforms held-up by politics, and with less investment available to resolve India's chronically overburdened infrastructure, growth is likely to stall. And crucially, as could be the case with China, India might fail to spread its wealth more evenly among a population that remains predominantly "dirt poor" by Western standards.

Here are a couple of facts about India that illustrate the scale of the challenge:

- It is home to a third of the world's poor, with 37.2% of its people (about 410m) classified as poor, according to the World Bank.
- Overall literacy is 61% and just 47.8% for women, according to the CIA World Factbook. China's overall is 92.2%, and 88.5% for China's women.

## IMPLICATIONS FOR CHEMICAL FIRMS

Chapter six discusses what slower growth in China and India could mean for chemical companies. We also revisit the critical success factors we introduced in chapter five and reflect on what success might be in China and India.

One example shows what may be required. A leading producer of the polymers used to make baby diapers tells us that China has abundant capacity to make the front and back panels for baby diapers, but labor costs in the coastal provinces are now too high to justify final assembly.

India doesn't have the manufacturing capacity to make the panels. Infrastructure problems and restrictive labor practices have held back investment in state-of-the art factories.

So in an example of flexibility, China ships the panels to India for final assembly in village workshops and people's homes, where labor costs are lower. The diapers are then sold profitably in the Indian market, for as little as 1 rupee each. This is the kind of thinking that is likely to separate the winners from the losers as the New Normal evolves. ■

### THE NEW NORMAL

Chapter five of "Boom, Gloom and the New Normal – How Western Baby Boomers are Changing Global Chemical Demand Patterns, Again" is now available free to download at **icis.com/NewNormaleBook**. It is co-authored by Paul Hodges, chairman of International eChem, who writes the ICIS Chemicals and the Economy blog, and John Richardson, director, ICIS training Asia, who writes the Asian Chemical Connections blog. ICIS and International eChem have also launched a training course, aiming at helping companies to become a winner in the New Normal. **icis.com/NewNormalSeminars**