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Watch India - it may outgrow China

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THIS year will be a momentous one for China and Asean. China will overtake Japan as the world's second largest economy in terms of current United States dollar exchange rates. (China has already overtaken Japan in terms of purchasing power parity exchange rates). And on Jan 1, the China-Asean Free Trade Area (Cafta) came into effect, establishing the world's third largest free trade area.

The Great Recession of 2008-09 made clear the importance of China to the world economy. While the economies of Europe and the United States sank into recession, China continued to grow. Following a four trillion yuan (S$825 billion) stimulus, the Chinese economy grew by an estimated 8.7 per cent last year.

China's continued growth hugely benefited major exporters to China, notably Australia, which also did not experience a recession. China continued to buy US government and agency securities, thus helping to finance US deficit spending and cushion the impact of the recession.

China's new importance is evident worldwide. At Phillips Academy, an elite American college preparatory school, Chinese has overtaken Spanish as the top choice among foreign languages. When my family travelled through Egypt last December, we were greeted with ni hao more frequently than the konnichiwa that Singaporean tourists had become accustomed to.

So is Asean the lucky region - as Australia is the lucky country - to be closely integrated with the world's second largest and fastest-growing major economy?

Yes, since the Asian Financial Crisis of 1997-98, foreign direct investment into Asean has diminished, while investment into China has exploded. To some extent, multinational companies have diverted their investments from Asean to China.

However, with the increasing integration of global supply chains, Asean has benefited from China's growth. We produce and export to China, which then adds value and exports to the end-user market. In the opening essay of this series, my colleague Professor Tilak Abeysinghe showed that China's growth has substantial multiplier effects on the Asean economies.

Looking forward, as China climbs the ladder towards the production of higher value-added goods and services, Chinese investors will seek out lower labour costs in Vietnam and Indonesia. As they saturate their own markets, Chinese businesses will also invest in Asean to produce differentiated goods and services that appeal to local tastes.

In another signal of market trends, Chinese sports manufacturer Li Ning has agreed to sponsor the Singapore Badminton Association. It replaces Japanese manufacturer Yonex. Chinese businesses and individuals are major investors in Singapore, with investments ranging from Singapore Petroleum to condominium apartments.

But dark clouds loom over the rosy scenario. One is political stability. The economic inequality within China -

between coastal and interior regions, and between the fabulously rich and the average worker, not to speak of the poor migrant workers - poses a serious challenge.

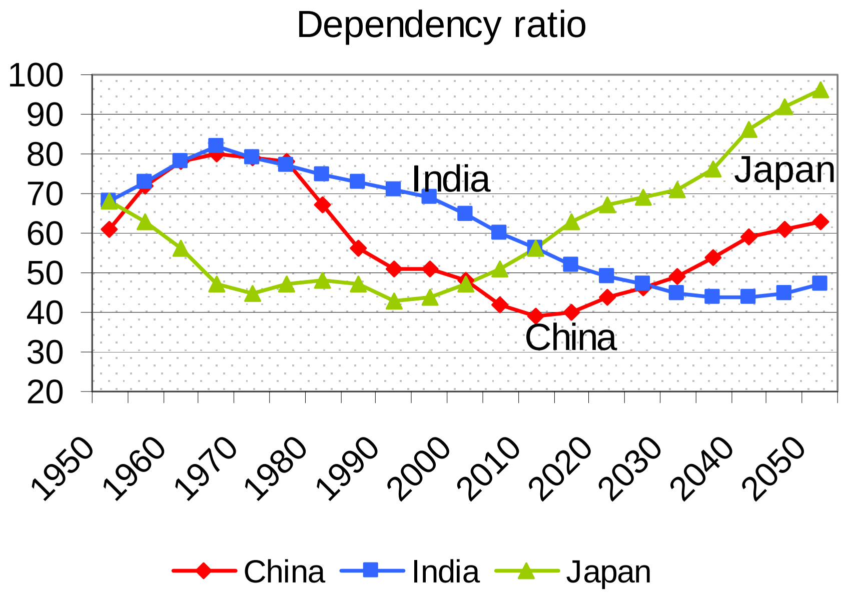
Another worry, as pointed out by Dr Helen Qiao, a Goldman Sachs economist, is demography. China's economic growth took off around 1980. As the accompanying chart shows, China's economic take-off neatly coincided with the beginning of a long and steady decline in its population dependency ratio. The dependency ratio is the ratio of the dependent population (aged 14 and below or 65 and above) to the population of working age (between 15 and 64).

To the extent that economic growth is linked to a decline in the dependency ratio, China will continue to grow until the end of this decade. Thereafter, with an ageing population - the inevitable result of its one-child policy - economic growth will slow down.

The same chart also depicts Japan's dependency ratio. Remarkably, the Japanese economy began to falter around 1990, when its dependency ratio began to increase. So apparently, the bubble economy of the 1980s and the lost decade of the 1990s might have been due to demographics as much as speculation.

The chart also suggests that India will be the locomotive of the future. Owing to a fast-growing population, its dependency ratio has been falling steadily since 1970. Based on demographic trends, its dependency ratio will continue to decline until the middle of this century.

So perhaps Asean should focus more on integration with India?


Dependency ratio
100
90
80
70
60
50
40
30
20
1950
1960
1970
1980
1990
2000
2010
2020
2030
2040
2050
India
Japan
China
China
India
Japan

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