

CHINA & INDIA

The Challenge And The Opportunity 50

China and India are rapidly rising in tandem—and changing the world in the process

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Companies from both nations are eager to go global. But are they ready?

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Beijing and New Delhi are pushing ambitious agendas in the schools, but there's still a long way to go

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India and China, in Theory: Leading economists offer their views on the future of the two nations and how their speedy modernization will both help and hurt the U.S.

Is the Orient Express Slowing Down? Asian and Pacific shares have had a good run, but China's economy is losing steam and Indian stocks are already highly valued

Historical Timeline: For both the dragon and the tiger, the seeds of success were sown centuries ago

No Wasted Opportunity: Veolia Environnement sees endless potential in China, whether it's in water, transportation, or waste treatment

A Braintrust in Bangalore: Sarnoff and other big tech names are setting up research operations in India—and not just because of the cheap labor

Furniture, Cappuccino, Consulting: By offering all these things to potential customers, Michigan office furniture company Haworth has distinguished itself in the ultratough China market

CHINA & INDIA

The Challenge The Opportunity

Chapter I

52 The Massive Power
Of Asia's Giants

60 What Could Go
Wrong

PHOTO: Inside the
Shanghai Shidongkou
Power Plant

nd tunity

What you need to know now
about the two nations that will
transform the global economy

A New World Economy

The balance of power will shift to the East as China and India evolve. **BY PETE ENGARDIO**



IT MAY NOT TOP THE MUST-SEE list of many tourists. But to appreciate Shanghai's ambitious view of its future, there is no better place than the Urban Planning Exhibition Hall, a glass-and-metal structure across from People's Square. The highlight is a scale model bigger

than a basketball court of the entire metropolis—every skyscraper, house, lane, factory, dock, and patch of green space—in the year 2020.

There are white plastic showpiece towers designed by architects such as I.M. Pei and Sir Norman Foster. There are immense new industrial parks for autos and petrochemicals, along with new subway lines, airport runways, ribbons of expressway, and an elaborate riverfront development, site of the 2010 World Expo. Nine futuristic planned communities for 800,000 residents each, with generous parks, retail districts, man-made lakes, and nearby college campuses, rise in the suburbs. The message is clear. Shanghai already is looking well past its industrial age to its expected emergence as a global mecca of knowledge workers. "In an information economy, it is



very important to have urban space with a better natural and social environment," explains Architectural Society of Shanghai President Zheng Shiling, a key city adviser.

It is easy to dismiss such dreams as bubble-economy hubris—until you take into account the audacious goals Shanghai already has achieved. Since 1990, when the city still seemed caught in a socialist time warp, Shanghai has erected enough high-rises to fill Manhattan. The once-rundown Pudong district boasts a space-age skyline, some of the world's biggest industrial zones, dozens of research centers, and a bullet train. This is the story of China, where an extraordinary ability to mobilize workers and capital has tripled per capita in-



SHANGHAI'S FUTURE
A model of Shanghai in
2020 at the Urban
Planning Exhibition Hall

come in a generation, and has eased 300 million out of poverty. Leaders now are frenetically laying the groundwork for decades of new growth.

INVALUABLE ROLE

DAVID HARTUNG NOW HOP A PLANE TO INDIA. It is hard to tell this is the world's other emerging superpower. Jolting sights of extreme poverty abound even in the business capitals. A lack of subways and a dearth of expressways result in nightmarish traffic.

But visit the office towers and research and development centers sprouting everywhere, and you see the miracle. Here,

Indians are playing invaluable roles in the global innovation chain. Motorola, Hewlett-Packard, Cisco Systems, and other tech giants now rely on their Indian teams to devise software platforms and dazzling multimedia features for next-generation devices. Google principal scientist Krishna Bharat is setting up a Bangalore lab complete with colorful furniture, exercise balls, and a Yamaha organ—like Google's Mountain View (Calif.) headquarters—to work on core search-engine technology. Indian engineering houses use 3-D computer simulations to tweak designs of everything from car engines and forklifts to aircraft wings for such clients as General Motors Corp. and Boeing Co. Financial and market-research experts

at outfits like B2K, Office-Tiger, and Iris crunch the latest disclosures of blue-chip companies for Wall Street. By 2010 such outsourcing work is expected to quadruple, to \$56 billion a year.

Even more exhilarating is the pace of innovation, as tech hubs like Bangalore spawn companies producing their own chip designs, software, and pharmaceuticals. "I find Bangalore to be one of the most exciting places in the world," says Dan Scheinman, Cisco Systems Inc.'s senior vice-president for corporate development. "It is Silicon Valley in 1999." Beyond Bangalore, Indian companies are showing a flair for producing high-quality goods and services at ridiculously low prices (page 64), from \$50 air flights and crystal-clear 2¢-a-minute cell-phone service to \$2,200 cars and cardiac operations by top surgeons at a fraction of U.S. costs. Some analysts see the beginnings of hypercompetitive multinationals. "Once they learn to sell at Indian prices with world quality, they can compete anywhere," predicts University of Michigan management guru C.K. Prahalad. Adds A. T. Kearney high-tech consultant John Ciacchella: "I don't think U.S. companies realize India is building next-generation service companies."

SOUTHWEST STYLE Shanghai's Rancho Santa Fe subdivision



SIMULTANEOUS TAKEOFFS

CHINA AND INDIA. Rarely has the economic ascent of two still relatively poor nations been watched with such a mixture of awe, opportunism, and trepidation. The postwar era witnessed economic miracles in Japan and South Korea. But neither was populous enough to power worldwide growth or change the game in a complete spectrum of industries. China and India, by contrast, possess the weight and dynamism to transform the 21st-century global economy. The closest parallel to their emergence is the saga of 19th-century America, a huge continental economy with a young, driven workforce that grabbed the lead in agriculture, apparel, and the high technologies of the era, such as steam engines, the telegraph, and electric lights.

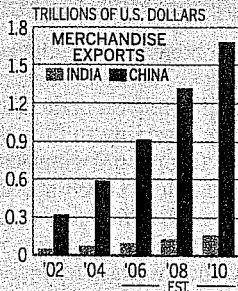
But in a way, even America's rise falls short in comparison to what's happening now. Never has the world seen the simultaneous, sustained takeoffs of two nations that together account for one-third of the planet's population. For the past two decades, China has been growing at an astounding 9.5% a year, and India by 6%. Given their young populations, high savings, and the sheer amount of catching up they still have to do, most economists figure China and India possess the fundamentals to keep growing in the 7%-to-8% range for decades.

PHOTOGRAPH BY DAVID HARTUNG; CHARTS BY ALBERTO MENA/BW

The Strengths and Weaknesses

China and India have radically different economic models. But given their relative advantages and flaws, both are expected to deliver very high growth for decades.

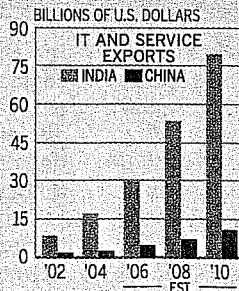
China will remain the manufacturing giant...



*BASED ON FINANCIAL DISCLOSURES OF 132 TOP PUBLICLY LISTED CHINESE COMPANIES AND 214 TOP INDIAN COMPANIES

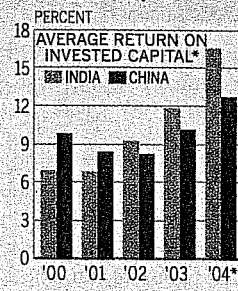
Data: Global Insight Inc.

...while India soars in tech and services



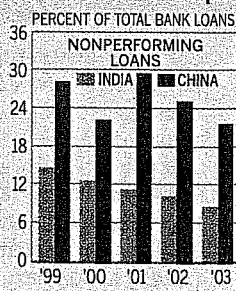
Data: Evalueerve

India's companies are more profitable...



Data: Standard & Poor's Compustat

...and its banks are in better shape...

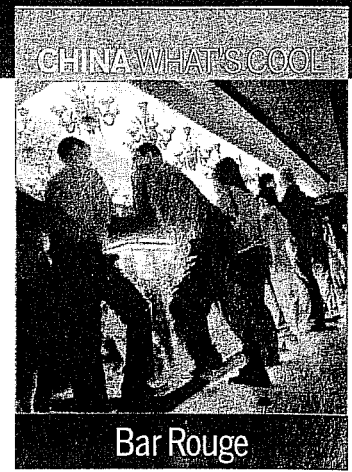


Data: International Monetary Fund



technical and managerial skills in both China and India are becoming more important than cheap assembly labor. China will stay dominant in mass manufacturing, and is one of the few nations building multibillion-dollar electronics and heavy industrial plants. India is a rising power in software, design, services, and precision industry. This raises a provocative question: What if the two nations merge into one giant "Chindia?" Rival political and economic ambitions make that unlikely. But if their industries truly collaborate, "they would take over the world tech industry," predicts Forrester Research Inc. analyst Navi Radjou.

In a practical sense, the yin and yang of these immense workforces already are converging. True, annual trade between the two economies is just \$14 billion. But thanks to the Internet and plunging telecom costs, multinationals are having their goods built in China with software and circuitry designed in India. As interactive design technology makes it easier to perfect virtual 3-D prototypes of everything from telecom routers to turbine generators on PCs, the distance between India's low-cost laboratories and China's low-cost factories shrinks by the month. Managers in the vanguard of globalization's new wave say the impact will be nothing less than explosive. "In a few years you'll see most



It's 4 a.m. Do you know where the A-listers are?

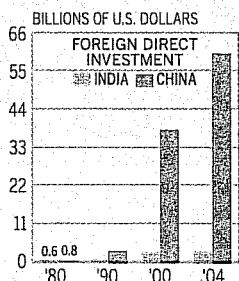
For Shanghai insiders, Party Headquarters these days is Bar Rouge on the waterfront Bund. With its scarlet upholstered alcoves draped with billowing curtains, the room looks like a cross between an Austin Powers movie and a belle epoque salon. The bartenders are known for dousing the 33-foot-long bar with vodka and setting it alight, and there's a terrace with spectacular views. By 2 a.m. the place is in full wail, but unless you're on the A-list, you'll be seven floors below, stranded on the street. For those with their party credentials in order, the action stretches till dawn.

Barring cataclysm, within three decades India should have vaulted over Germany as the world's third-biggest economy. By mid-century, China should have overtaken the U.S. as No. 1. By then, China and India could account for half of global output. Indeed, the troika of China, India, and the U.S.—the only industrialized nation with significant population growth—by most projections will dwarf every other economy.

What makes the two giants especially powerful is that they complement each other's strengths. An accelerating trend is that

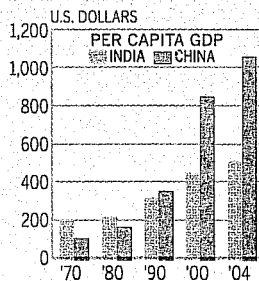
Handicapping the Race

...but China lures more investment



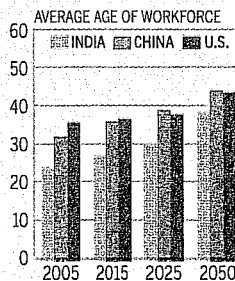
Data: World Bank, Reserve Bank of India

China has surged ahead of India...



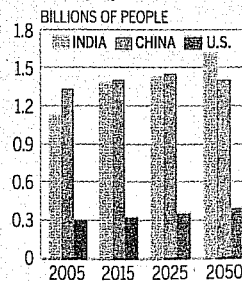
*ASSUMES CHINA ANNUAL GROWTH RATE PEAKS AT 8.8% IN 2010, TRENDING DOWN TO 3.7% BY 2046. INDIA GROWTH PEAKS AT 7.3% IN 2025 TRENDING TO 5.9% BY 2046. Data: World Bank, Global Insight Inc.

...but India's younger work force...



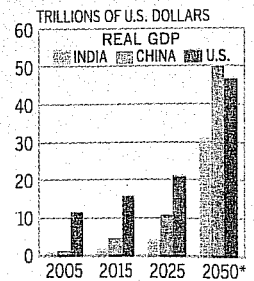
Data: U.N. Population Division

...and swelling population...



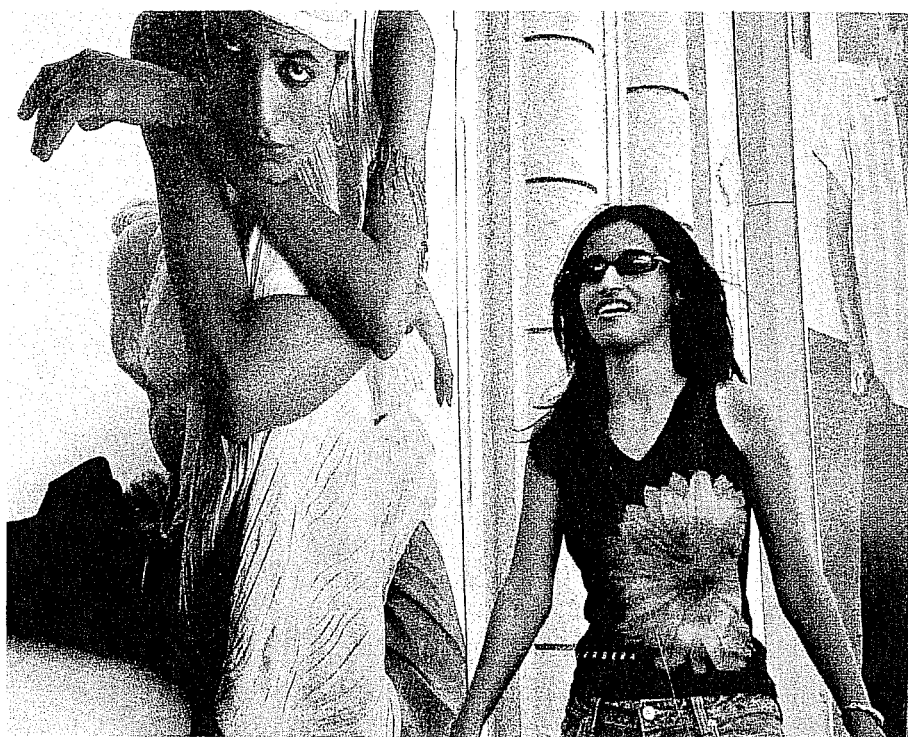
Data: U.N. Population Division projections

...will help it catch up



Data: Keystone-India

THE CHALLENGE



A Profile of Youth in India and China

| CHINA | INDIA |
|---|---|
| 66% OF YOUNG CHINESE ADULTS REGARD THEMSELVES AS INDIVIDUALISTS | 62% OF YOUNG SINGLE WOMEN SAY IT IS O.K. TO HAVE FAULTS THAT OTHERS CAN SEE |
| 23% OF YOUNG CHINESE ADULTS SAY IT IS NOT IMPORTANT TO HAVE A CHILD | 76% OF YOUNG SINGLE WOMEN SAY THEY SHOULD DECIDE WHEN TO HAVE A CHILD |
| 64% OF YOUNG ADULTS SAY MARRIED MEN SHOULD DO HOUSEWORK | 51% OF YOUNG URBAN WOMEN SAY A BIG HOUSE AND CAR ARE KEY TO HAPPINESS |

Data: Grey Global Group

FASHIONABLE Shopping in a Bombay suburb

companies unleashing this massive productivity surge,” predicts Infosys Technologies CEO Nandan M. Nilekani.

To globalization’s skeptics, however, what’s good for Corporate America translates into layoffs and lower pay for workers. Little wonder the West is suffering from future shock. Each new Chinese corporate takeover bid or revelation of a major Indian outsourcing deal elicits howls of protest by U.S. politicians. Washington think tanks are publishing thick white papers charting China’s rapid progress in microelectronics, nanotech, and aerospace—and painting dark scenarios about what it means for America’s global leadership.

Such alarmism is understandable. But the U.S. and other established powers will have to learn to make room for China and India (page 134). For in almost every dimension—as consumer markets, investors, producers, and users of energy and commodities—they will be 21st-century heavyweights. The growing economic might will carry into geopolitics as well. China and In-

dia are more assertively pressing their interests in the Middle East and Africa, and China’s military will likely challenge U.S. dominance in the Pacific.

One implication is that the balance of power in many technologies will likely move from West to East. An obvious reason is that China and India graduate a combined half a million engineers and scientists a year, vs. 60,000 in the U.S. In life sciences, projects the McKinsey Global Institute, the total number of young researchers in both nations will rise by 35%, to 1.6 million by 2008. The U.S. supply will drop by 11%, to 760,000. As most Western scientists will tell you, China and India already are making important contributions in medicine and materials that will help everyone. Because these nations can throw more brains at technical problems at a fraction of the cost, their contributions to innovation will grow.

CONSUMERS RISING

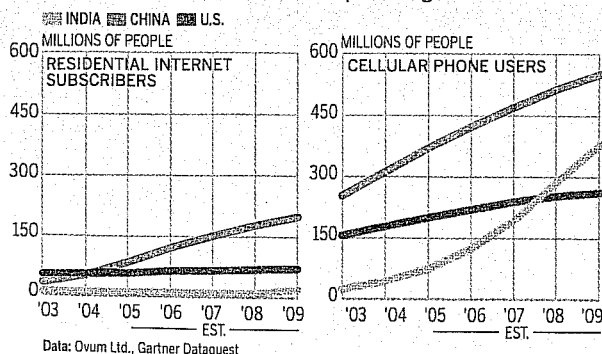
AMERICAN BUSINESS ISN’T just shifting research work because Indian and Chinese brains are young, cheap, and plentiful. In many cases, these engineers combine skills—mastery of the latest software tools, a knack for complex mathematical algorithms, and fluency in new multimedia technologies—that often surpass those of their American counterparts. As Cisco’s Scheinman puts it: “We came to India for the costs, we stayed for the quality, and we’re now investing for the innovation.”

A rising consumer class also will drive innovation. This year, China’s passenger car market is expected to reach 3 million, No. 3 in the world. China already has the world’s biggest base of cell-phone subscribers—350 million—and that is expected to near 600 million by 2009. In two years, China should overtake the U.S. in homes connected to broadband. Less noticed is that India’s consumer market is on the same explosive trajectory as China five years ago. Since 2000, the number of cellular subscribers has rocketed from 5.6 million to 55 million.

What’s more, Chinese and Indian consumers and companies now demand the latest technologies and features. Studies

Surging in Tech Adoption

China and India are the most important growth markets



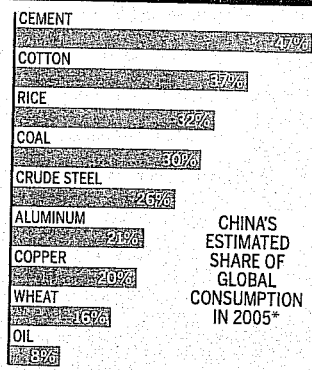
show the attitudes and aspirations of today's young Chinese and Indians resemble those of Americans a few decades ago. Surveys of thousands of young adults in both nations by marketing firm Grey Global Group found they are overwhelmingly optimistic about the future, believe success is in their hands, and view products as status symbols. In China, it's fashionable for the upwardly mobile to switch high-end cell phones every three months, says Josh Li, managing director of Grey's Beijing office, because an old model suggests "you are not getting ahead and updated." That means these nations will be huge proving grounds for next-generation multimedia gizmos, networking equipment, and wireless Web services, and will play a greater role in setting global standards. In consumer electronics, "we will see China in a few years going from being a follower to a leader in defining consumer-electronics trends," predicts Philips Semiconductors Executive Vice-President Leon Husson.

For all the huge advantages they now enjoy, India and China cannot assume their role as new superpowers is assured. Today, China and India account for a mere 6% of global gross domestic product—half that of Japan. They must keep growing rapidly just to provide jobs for tens of millions entering the workforce annually, and to keep many millions more from crashing back into poverty. Both nations must confront ecological degradation that's as obvious as the smog shrouding Shanghai and Bombay, and face real risks of social strife, war, and financial crisis (page 60). Increasingly, such problems will be the world's problems. Also, with wages rising fast, especially in many skilled areas, the cheap labor edge won't last forever (page 122). Both nations will go through many boom and harrowing bust cycles. And neither country is yet producing companies like Samsung, Nokia, or Toyota that put it all together, developing, making, and marketing world-beating products.

Both countries, however, have survived earlier crises and possess immense untapped potential. In China, serious development only now is reaching the 800 million people in rural areas, where per capita annual income is just \$354. In areas outside major cities, wages are as little as 45¢ an hour. "This is why China can have another 20 years of high-speed growth," contends Beijing University economist Hai Wen.

Very impressive. But India's long-term potential may be even higher. Due to its one-child policy, China's working-age population will peak at 1 billion in 2015 and then shrink steadily. China then will have to provide for a graying population that has limited retirement benefits. India

China's Hunger For Raw Materials



*2004 FOR CEMENT AND METALS
Data: U.S. Geological Survey, Energy Dept., Agriculture Dept.

has nearly 500 million people under age 19 and higher fertility rates. By mid-century, India is expected to have 1.6 billion people—and 220 million more workers than China. That could be a source for instability, but a great advantage for growth if the government can provide education and opportunity for India's masses. New Delhi just now is pushing to open its power, telecom, commercial real estate and retail sectors to foreigners. These industries could lure big capital inflows. "The pace of institutional changes and industries being liberalized is phenomenal," says Chief Economist William T. Wilson of consultancy Keystone Business Intelligence India. "I believe India has a better model than China, and over time will surpass it in growth."

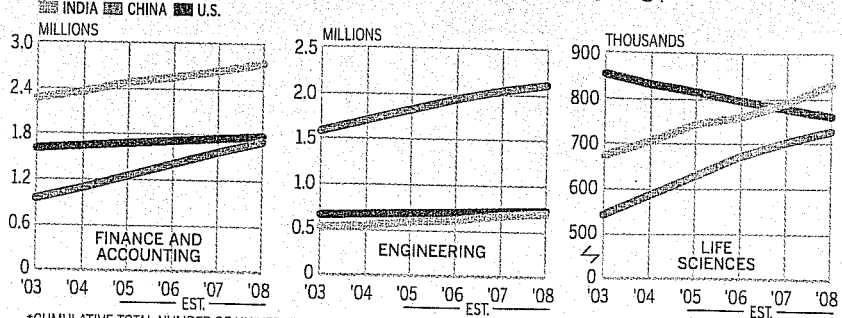
For its part, China has yet to prove it can go beyond forced-march industrialization. China directs massive investment into public works and factories, a wildly successful formula for rapid growth and job creation. But considering its massive manufacturing output, China is surprisingly weak in innovation. A full 57% of exports are from foreign-invested factories, and China underachieves in software, even with 35 software colleges and plans to graduate 200,000 software engineers a year. It's not for lack of genius. Microsoft Corp.'s 180-engineer R&D lab in Beijing, for example, is one of the world's most



NO DRAS LAK
Scientist Bharat
at Google India
in Bangalore

Booming Growth in Young Professionals

China and India are racing ahead of the U.S. in numbers of young professionals*



*CUMULATIVE TOTAL NUMBER OF UNIVERSITY GRADUATES WITH SEVEN OR FEWER YEARS OF EXPERIENCE
Data: McKinsey Global Institute

PHOTOGRAPHS BY (L TO R) ROB ELLIOTT/AFP/GETTY IMAGES; NAMAS BHOJANI

CHARTS BY ALBERTO MENA/BW

THE CHALLENGE

productive sources of innovation in computer graphics and language simulation.

While China's big state-run R&D institutes are close to the cutting edge at the theoretical level, they have yet to yield many commercial breakthroughs. "China has a lot of capability," says Microsoft Chief Technology Officer Craig Mundie. "But when you look under the covers, there is not a lot of collaboration with industry." The lack of intellectual property protection, and Beijing's heavy role in building up its own tech companies, make many other multinationals leery of doing serious R&D in China.

China also is hugely wasteful. Its 9.5% growth rate in 2004 is less impressive when you consider that \$850 billion—half of GDP—was plowed into already-glutted sectors like crude steel, vehicles, and office buildings. Its factories burn fuel five times less efficiently than in the West, and more than 20% of bank loans are bad. Two-thirds of China's 13,000 listed companies don't earn back their true cost of capital, estimates Beijing National Accounting Institute President Chen Xiaoyue. "We build the roads and industrial parks, but we sacrifice a lot," Chen says.

India, by contrast, has had to develop with scarcity. It gets scant foreign investment, and has no room to waste fuel and materials like China. India also has Western legal institutions, a modern stock market, and private banks and corporations. As a result, it is far more capital-efficient. A *BusinessWeek* analysis of Standard & Poor's Compustat data on 346 top listed companies in both nations shows Indian corporations have achieved higher returns on equity and invested capital in the past five years in industries from autos to food products (page 73). The average Indian company posted a 16.7% return on capital in 2004, vs. 12.8% in China.

SMALL-BATCH EXPERTISE

THE BURNING QUESTION IS whether India can replicate China's mass manufacturing achievement. India's info-tech services industry, successful as it is, employs fewer than 1 million people. But 200 million Indians subsist on \$1 a day or less. Export manufacturing is one of India's best hopes of generating millions of new jobs.

India has sophisticated manufacturing knowhow. Tata Steel is among the world's most-efficient producers. The country boasts several top precision auto parts companies, such as Bharat Forge Ltd. The world's biggest supplier of chassis parts to major auto makers, it employs 1,200 engineers at its heavily automated Pune plant. India's forte is small-batch production of high-value goods requiring lots of engineering, such as power generators for Cummins Inc. (page 82) and core components for General Electric Co. CAT scanners.

What holds India back are bureaucratic red tape, rigid labor laws, and its inability to build infrastructure fast enough. There are hopeful signs. Nokia Corp. is building a major campus to make cell phones in Madras, and South Korea's Pohang Iron & Steel Co. plans a \$12 billion complex by 2016 in Orissa state. But it

What Should the U.S. Do? Join the Discussion

Roundtable: Are India and China natural partners? Is China's rise to be feared? Thirteen experts offer their opinions. Post your own, and look for a new topic every day

What's Cool: A slide show of the people, places, and trends that make China and India hot

BusinessWeek Online

www.businessweek.com/go/china-india/

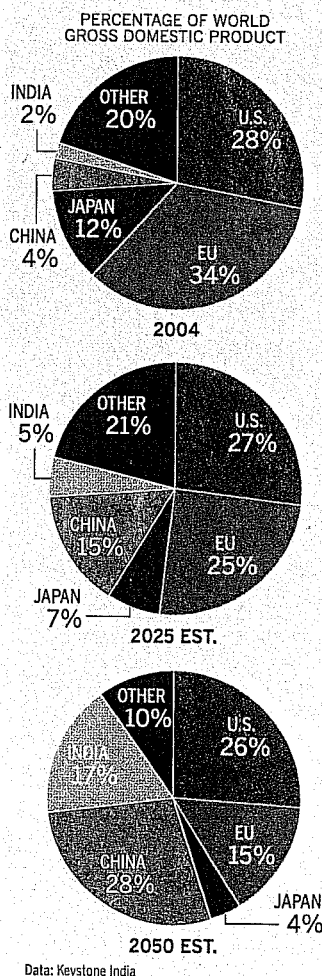
will take India many years to build the highways, power plants, and airports needed to rival China in mass manufacturing. With Beijing now pushing software and pledging intellectual property rights protection, some Indians fret design work will shift to China to be closer to factories. "The question is whether China can move from manufacturing to services faster than we can solve our infrastructure bottlenecks," says President Aravind Melligeri of Bangalore-based QUEST, whose 700 engineers design gas turbines, aircraft engines, and medical gear for GE and other clients.

However the race plays out, Corporate America has little choice but to be engaged—heavily. Motorola illustrates the value of leveraging both nations to lower costs and speed up development. Most of its hardware is assembled and partly designed in China. Its R&D center in Bangalore devises about 40% of the software in its new phones. The Bangalore team developed the multimedia software and user interfaces in the hot Razzr cell phone. Now, they are working on phones that display and send live video, stream movies from the Web, or route incoming calls to voicemail when you are shifting gears in a car. "This is a very, very critical, state-of-the-art resource for Motorola," says Motorola South Asia President Amit Sharma.

Companies like Motorola realize they must succeed in China and India at many levels simultaneously to stay competitive. That requires strategies for winning consumers, recruiting and managing R&D and professional talent, and skillfully sourcing from factories. "Over the next few years, you will see a dramatic gap opening between companies," predicts Jim Hemerling, who runs Boston Consulting Group's Shanghai practice. "It will be between those who get it and are fully mobilized in China and India, and those that are still pondering."

In the coming decades, China and India will disrupt workforces, industries, companies, and markets in ways that we can barely begin to imagine. The upheaval will test America's commitment to the global trade system, and shake its confidence. In the 19th century, Europe went through a similar trauma when it realized a new giant—the U.S.—had arrived. "It is up to America to manage its own expectation of China and India as either a threat or opportunity," says corporate strategist Kenichi Ohmae. "America should be as open-minded as Europe was 100 years ago." How these Asian giants integrate with the rest of the world will largely shape the 21st-century global economy. ■

Reshaping the Global Economy



Crouching Tigers, Hidden Dragons

The economic momentum isn't unstoppable. China and India face huge obstacles to growth. **BY PETE ENGARDIO**



CHINA & INDIA

PLENTY OF FORCES CAN STILL throw the Chinese and Indian economies far off course. The economic fundamentals of both nations, with their enormous populations of young workers and consumers, point to strong growth for decades under almost every forecast. But it is instructive to remember that financial crashes, coups, political strife, and plain bad management have derailed many other miracle economies from Southeast Asia to Latin America. And the same huge populations that can translate into economic power for China and India also could prove to be a

double-edged sword if social, political, and environmental challenges are not deftly managed. Indeed, growth doesn't have to slow all that much to pose serious social problems. Both China and India need annual growth of at least 8% just to provide jobs for the tens of millions joining the workforce each year. Fear of worker unrest is a big reason Beijing has kept stoking its boom with massive lending and growth in the money supply, despite economists' warnings that it is setting the stage for a nasty bust. If India grows only 6.5% a year, which seems a respectable rate, its jobless rate would still jump, resulting in another 70 million unemployed by 2012, forecasts India's Planning Commission.

Slower growth also could keep China and India from fulfilling the widespread predictions that they will become superpowers. For example, in forecasting that India will rank just behind the U.S. as the world's No. 3 economy by mid-century, with a gross domestic product of \$30 trillion, Goldman, Sachs & Co. assumes 8.5% average annual growth. But what if India grows at less than 6%, its average for the past 20 years? By 2050, it would have only a \$7.3 trillion economy—smaller than Taiwan's even then and just 2.6% of global GDP, notes Stephen Howes, the World Bank's former chief India economist. Worse, India's masses would remain extremely poor. "If you don't grow fast enough, will you have social forces that bring everything to a stale-

mate?" asks Infosys Technologies Ltd. CEO Nandan M. Nilekani. "That's the worry."

To achieve the high growth predictions, China and India will have to overcome formidable challenges. Some of the biggest:

ENVIRONMENT Both countries have paid a steep ecological price for rapid industrial and population growth, with millions of deaths attributed to air and water pollution each year. Air quality in big cities like New Delhi, Chongqing, and Bombay is among the world's worst. And forests are vanishing at alarming rates (page 128).

Enforcement of environmental laws in both nations is poor. Many power plants and factories depend on coal and don't invest in clean technologies. China is one of the world's most wasteful users of oil. If it does not act quickly, the long-term costs of health problems linked to the environment and the required cleanup will skyrocket. A growing scarcity of water in both nations could slow industry within two decades.

POLITICAL BACKLASH China's Communist Party harshly represses dissent. But virtually each week brings new reports of big protests in cities and villages

The Numbers Are Ominous

1

Million

PREMATURE DEATHS EACH YEAR IN CHINA AND INDIA ATTRIBUTED TO AIR POLLUTION

Data: World Bank

30

Million

INDIANS AND CHINESE PROJECTED TO BE INFECTED WITH THE HIV/AIDS VIRUS BY 2010

Data: National Intelligence Council of India, U.N. Program on AIDS

203

Million

WORKERS WITHOUT FULL-TIME EMPLOYMENT BASED ON UNOFFICIAL ESTIMATES

Data: CIA World Factbook Based on a 9.2% unemployment rate in India and 20% in China



FOTOE/EYEPRESS



IN TRAINING A war threat perpetually hangs over China

over corruption, pollution, or worker abuse. They underscore China's lack of democratic institutions and the widening gap between rich and poor. Serious challenges to Communist rule can still erupt, especially if the economy stalls. Judging from history, the process could be tumultuous.

India has a democracy, but it also has extremely unbalanced growth and rampant corruption. The surprise electoral defeat of the ruling Bharatiya Janata Party by a more populist coalition led by Sonia Gandhi's Congress Party in 2004 served as a warning of mass discontent. The new government also is reform-minded, but the pace of economic liberalization has slowed. Further electoral setbacks for reformers are possible if the poor don't see the benefits of growth. Tensions between Hindus and Muslims have eased after bloody riots in 2003 and 2004. But communal violence remains a threat.

FINANCIAL CRISIS Debt and currency crises have derailed many high-flying emerging markets. India needed an International Monetary Fund bailout in 1991. China withstood the 1997 Asian

financial crisis mainly because they lack convertible currencies. Also, Beijing controls the banks. Bailouts and the banks' near-monopoly over China's vast domestic savings have kept them solvent despite mountains of bad loans to state firms.

In 2006, however, Beijing will start letting foreign banks compete for deposits and domestic loans. That could put more financial pressure on state banks. China also is starting to loosen its currency controls a bit. China has plenty of foreign reserves now. But if Beijing can't whip its banks into shape, there's a danger that financial market liberalization will go wrong, leading to a crash. India's financial system is in stronger shape, but its public finances remain a mess, with budget deficits at the federal and state level reaching 10% of GDP (page 86).

HEALTH Perhaps China's biggest worry over the long term is inadequate medical care for its rapidly aging population. In 20 years, China will have an estimated 300 million people age 60 or older. Yet only one in six Chinese workers now has a pension plan, and just 5% have guaranteed medical benefits. What's more, many retirees will not be able to rely on children for support. Beijing promises to build a broader safety net, but adequate health care and pensions could consume a huge portion of GDP and deplete China's economic strength in the future.

Both nations also could face full-blown crises with AIDS, tuberculosis, avian flu, and other infectious diseases, and their health systems have been slow to mobilize. At least

5 million Indian adults are infected with HIV, one of the world's highest rates outside sub-Saharan Africa. India's National Intelligence Council predicts the number could pass 20 million in 2010. The U.N. estimates the number of Chinese with HIV could hit 10 million in five years. Some 200,000 Chinese also die annually of TB. And a serious flu epidemic could kill millions. "Many investors don't appreciate the economic damage a serious outbreak would cause in our crowded cities," says Subroto Bagchi, chief operating officer of Bangalore info-tech services firm MindTree Consulting Ltd.

BOTH NATIONS ARE VULNERABLE TO EPIDEMICS OF HIV AND TB. HOW QUICKLY COULD THEIR HEALTH SYSTEMS REACT TO CRISES SUCH AS AVIAN FLU?

WAR India and neighboring Pakistan have fought three times since their independence in 1947—and have had many border skirmishes over Kashmir. Now, both nations possess nuclear weapons, so a war could be catastrophic. New Delhi and Islamabad have recently eased tensions and begun peace talks. But the rise to power of a radical Islamic regime in Pakistan, or election of a stridently Hindu nationalist government in India, could easily reignite tensions. China's biggest flash point remains Taiwan. Beijing has cooled its fiery rhetoric lately, but still vows to invade should the island declare independence. Any war in the Taiwan Strait would likely involve the U.S. and possibly Japan—China's two biggest trade partners—and paralyze shipping in and out of China's southern ports. It also would likely result in long-term Sino-U.S. tensions that would spill into trade.

It's too much to expect for any developing nation to avoid military, financial, environmental, and health crises for decades. But the test for a great power is how well it manages a great crisis. ■

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