CHAPTER - I

1.1. Introduction to Economic Transition

Since the fall of the Berlin Wall on the 9th November, 1989, a sizable number of economists have studied the process of transition of economies from socialism to capitalism in the former socialist economies. This process is called economic transition, or transformation of economies (Gerard Roland, 2004). Soviet Union, Central and the Eastern European countries undertook major reforms in their economic systems. These included certain major restructuring of their economies (Dharmendra Dhakal, et al., 2007). Transition has been a dynamic historical process, imposing changes on almost every element of the society. Success in recovering output, however, readily suggests itself as a useful unifying theme for economic assessment, not in the least because of the importance policymakers in transition economies attach to output growth and its immediacy for the welfare of every country (Oleh Havrylyshyn and Thomas Wolf, 1999). In the transition perspective, many countries have passed, and are currently passing, through significant transition phases. For the present, it is important to discuss transitional economics with reference to non-transitional economics. Thus, in the 20th century, underdeveloped regions have adopted a transition policy to catch up with the industrialised nations.

Definition Economic Transition:

“A transitional economy is one, which is changing from a centrally planned economy to a market economy. These economies undergo radical reforms towards free market economy through Price Liberalisation, where market forces set prices, rather than a central planning organisation and trade barriers are removed is undertaken, along with, massive privatisation of government-owned enterprises and resources, the creation of private property and also financial sector to facilitate the total transformation towards a market economy” (Wikipedia encyclopedia).

During the period of 1917 to the 1950s, countries, having one-third of the world’s population, transform them the market economy, and launched an experiment in constructing an alternative economic system. Initially, in the former Russian Empire and Mongolia, Central and Eastern European countries (CEECs), Baltic nations, China, Northern Korea and Vietnam, much effort was made to control the means of production
and allocation of all resources through state planning. This approach was a failure. Thereafter, the same countries sought to rebuild the markets and reintegrate themselves into the world economy. Most of these economies rejected central planning and embarked on a new path – transition-towards decentralised market mechanisms and widespread private ownership.

The long-term goal of transition is that economic reforms should help to build a thriving market economy and also ensure long-term improvements in the living standards. Transition is a still very much in progress and many important questions do not yet have definitive answers. However, countries will have completed their transition, only when they overcome have problems and undertake further reforms come to resemble those of long-established market economics at similar levels of income (World Development Report, 1996).

Figure 1: CLASSIFICATION OF TRANSITION ECONOMIES

<table>
<thead>
<tr>
<th>Transition economies in Europe and former Soviet Union</th>
</tr>
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<tbody>
<tr>
<td>CEE: Albania, Bulgaria, Croatia, Czech republic, RYR Macedonia, Hungary, Romania, Slovak Republic, Slovenia.</td>
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<tr>
<td>BALTICS: Estonia, Latvia, Lithuania</td>
</tr>
<tr>
<td>CIS: Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyz Republic, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine, Uzbekistan.</td>
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<table>
<thead>
<tr>
<th>Transition economies in Asia</th>
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<tbody>
<tr>
<td>Cambodia, China, Laos, Vietnam.</td>
</tr>
</tbody>
</table>

Sources: encyclopedia

The race to transform centrally planned economies into market economies had led, ten years later, to one group of countries approaching the finishing line, others lost the power at various points along the track and a few were barely off the starting blocks. Some Central and Eastern European economies (CEEEs) and the Baltics are knocking on the doors of the European Union. But in many economies in the Commonwealth of Independent State (CIS), including Russia, there has been uneven progress and prospects remain blurred.

China adopted market-oriented reforms in 1979, while India initiated market-oriented policies, in 1991, due to BoP crisis. China has successfully pursued its transition during this decade.

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economy, while the Eastern European countries experienced negative growth, falling living standards and mounting inflation. China’s story is quite opposite and outstanding - even compared to the tigers of South-East Asia with respect to growth and development.

The experience of the command economies has not been a happy one. Both countries had faced a number of problems. The command economies, East European and the former USSR, China and India suffered more or less from the following ailments: (a) Stagnation in agriculture (b) Stagnation in Industrial sector; and (c) Balance of payments (BOP) crisis (Manmohan Agarwal and Dipankar Sengupta, 1999).

1.2. Background of Economics reforms in China and India towards Economic Transition

Since China and India are two great ancient civilizations, adjacent to each other, with a long history of cultural relationships, comparison between these two countries would help discussion of long time economic performances. China’s national economic output was on par with that of Europe around 1400 A.D. In ‘The Wealth of Nations’ (1776), Adam Smith attributed the economic stagnation and finally the decline of China to its policy of virtual isolation and self-sufficiency after 1433 - a policy that was not abandoned until 1978. According to Maddison (2001), China was still richer than India in 1820, but India overtook China in the 1950s, though. China has seen more accelerated growth than India in the last quarter of the 20th century (Orvaldur Gylfason 2005). China’s new economic reforms began in 1978 with institutional market oriented economic policies. However, India’s 1990s reforms began as a gradual process towards market orientation. Even though the economic policies of both countries were quite different, economic growth has been rapid in both China and India.

Since the beginning of the 21st century, both China and India have earned the label of emerging economies in Asia, as well as in the world, plus the present ‘Asian Tigers’. Economist Davide Dollar (2009) termed it as ‘the Rise of Asia’. Both countries had recognised the importance of trade and economic relations for strengthening bilateral trade. After the events of the 1990s, both economies had integrated themselves into the global market. This effect was mutual benefit for economic development and increase in the growth rates. The economic transitions in China and India had experienced similar reforms pattern at present and sharing long geographical boards, is attracting greater attention around the world. However, due to numerous historical political and economic
reasons, relationships between China and India have generally been at a standstill in the past few decades.

India and China would face many challenges in the present global economic scenario. Since both the countries have created new world class companies and infrastructure, foreign investment firms, expansion in trade, domestic markets of these countries have been attracted towards global companies. Therefore, these will be creating competitive conditions in the local domestic markets and also put a strain on macroeconomic management. Anyway, this will create new challenges for both the countries.

1.2.1. An Overview

World’s top population superpowers have long been fascinated by the West, but until recently, they were small players in the international economic scenario. Before the 1980s, both the countries’ growth rates were relatively disappointing. From the early 1990s, the world has witnessed rapid economic transformation and growth because of market–oriented and long-term reforms, based on improvements in living standards. However, by virtue of sheer size, here the potential to be dominant forces in the international economy exists (Bloom, Canning, Liu, Mahal and Yip, 2006).

The competition between the two Asian giants is in the great economic race in the early 21st century and Indian public watches it with excitement and pride. In the world scenario, one has the largest Communist Party in rule and the other is the largest Democracy. Indian economy is the fourth largest in the world, in terms of the purchasing power parity (PPP) standard; the population is 1.21 billion (2011 census). Similarly, China’s population is 1.3 billion (2010) and it is second largest economy by the PPP measurement. The success of economic growth has depended on factors, such as large number of skilled human capital, differences in the government policies and social and cultural factors as well. In spite of all these immediate factors, any country would address development wave from sectors like industries, trade and services, infrastructure and information technology (IT), foreign direct investment and so on. To compare both the economies, the fact is that the variables are similar to a greater extent and their differences have led both the countries to take similar paths towards economic development (Mayuri Guntupalli, et. al., 2006).
a. Economic Growth and Development

In 1970s, the per capita GDP of both China and India was at a similar level, but the gap between the two has continued to widen thereafter. In 2010, the GDP of China and India stood at 10.6% and 8.5% respectively; growth in China was much faster than India. According to “Human Development Index (HDI, 2009),” which includes per capita GDP (in PPP terms) and factors such as life expectancy and education levels, China ranks 89th in 2010, while India languished in the 119th place. When we consider the fact that India’s population increases at almost 1% faster than China, the difference in growth in terms of per capita GDP becomes larger.

<table>
<thead>
<tr>
<th>Indicators</th>
<th>1980</th>
<th>1990</th>
<th>2000</th>
<th>2009</th>
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<tbody>
<tr>
<td></td>
<td>India</td>
<td>China</td>
<td>India</td>
<td>China</td>
</tr>
<tr>
<td>Population growth (% annual)</td>
<td>2.3</td>
<td>1.3</td>
<td>2.0</td>
<td>1.5</td>
</tr>
<tr>
<td>GDP Growth (annual %)</td>
<td>6.7</td>
<td>1.3</td>
<td>5.5</td>
<td>1.5</td>
</tr>
<tr>
<td>GNI growth (% annual)</td>
<td>6.6</td>
<td>7.7</td>
<td>5.7</td>
<td>3.6</td>
</tr>
<tr>
<td>FDI Inflows GDP</td>
<td>0.043</td>
<td>N.A.</td>
<td>0.07</td>
<td>0.98</td>
</tr>
<tr>
<td>Services (% GDP)</td>
<td>39.6</td>
<td>21.6</td>
<td>43.8</td>
<td>31.5</td>
</tr>
<tr>
<td>Trade (% GDP)</td>
<td>15.6</td>
<td>21.7</td>
<td>15.7</td>
<td>29.2</td>
</tr>
</tbody>
</table>

| Manufacture (% GDP)         | 16.7  | 40.2  | 1     | 32.7  |

*Source: World Bank Development Indicator, 2011*

In addition, economic development of both countries depends on macroeconomic indicators, which have to be encouraged by high growth rates in industry, foreign direct investment, and trade and services sectors. In China, mainly in areas like manufacturing, automobiles, textiles, trade and services, the inflow of FDI is high.

Meanwhile, India has also increased its productivity and economic development recently due to the growth in services and trade, industries and agricultural sectors. Thus, the growth rates of both countries have been rapid since the 1990s. Moreover, both countries have been made remarkable changes in the market-oriented direction and became open to integration into the global economy. The different geographic regions tend to specialise in particular products, because of comparative advantage in both the
countries. China’s success in the field of technology has been mostly in hardware, while India’s is in software. Both these aspects were quite opposite.  

1.3. Reforms and Economic Progress in Transition Economic Cycle Aspects

The transition economic cycle aspects explain how the transition process takes place in an economy. It is interesting to seek the differences between vicious and virtuous circles in a country in the transition phase. In the vicious circle; the initial step towards market reform creates opportunities for rent seeking and corruption. It results in an open entry to the market, fostering competition, establish a solid rule of law. Its outcome is the emergence of an underground economy. However, limited competition, incomplete liberalisation, incentives to go underground and the poor rule of law can make the transformation go out off-track. Consequently, it does slow down the economic progress, a reversal of growth and a collapse of financial stabilisation.

Virtuous circle allows economies to make steady progress towards an open, liberal market. It results in an initial pain and political opposition (because of the ‘pain’ element). Still, there will also be earlier recovery and new economic opportunities.  

According to Alan A. Bevan & Saul Estrin (2004), the vicious and virtuous circles show similar results. However, opportunities can encourage output growth, new firms and jobs will be created as the builds of reform now begin to spread. A stronger economy improves a country's fiscal position and introduces confidence in financial institutions. These conditions provide the basis for a credible and well-financed government, which, in turn, is able to impose the discipline of law, secure Intellectual Property Rights and provide an adequate social safety net. This market-friendly environment encourages savings, new investments and further growth.

The below given figures (see.2) contrast between the vicious and virtuous circles. The decisive factor that permits a country to move from the vicious to the virtuous circle is, “in our view, the political will to impose the rule of law and establish the security of property rights” (Oleh Havrylyshyn & Thomas Wolf, 1999).

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7. In 2002, then Chinese Premier Zhu Rongji visited the campus of Infosys in Bangalore, India. Addressing 4,000 software engineers, he said, “You are number one in software. We are number three in hardware. If we put these together, we are the world’s number one”.

3. According to, the World Bank and European Bank for Reconstruction and Development (ERBD), due to the influence of output key of reform; indeed, the reform is painful absolutely right. In the initial the (decline) reforms period, the relationship between growth and reform traces a U-shaped curve.
1.4. Significance of Study

- Opposition to open-entry Competition and full liberalisation
- Vested interests develop
- Opposition for rent Seeking and corruption
- Partial market reforms

REFORMS AND ECONOMIC PROGRESS
Vicious circles

- Poor rule of low
- Underground and virtual economy
- Market retransformation frozen
- Low growth and reversal
- Financial Stability reversed

REFORMS AND ECONOMIC PROGRESS
Virtuous circles

- Speed benefits strong fiscal position Confident in banks
- Growth in output employment new firms
- Credible and well-financed government
- Steady improvement in rule law sufficient revenue to finance social safety net

- Early pain and opposition
- Early recovery and new economic opportunities
- Steady progress to open, liberal market
- Market-friendly environment
- New investment further growth
- Ability to attract foreign investment
a. How do FDI and Trade Influence an Economy

Figure 2 emphasises how Foreign Direct Investment (FDI) and trade would be affecting the entire economy. A transition economy is nothing but economic reforms are held in particular economy. The FDI cycles theory explains the development and why it had been adopted by the CEES countries and particularly highlights the role of FDI into the trade sector (Richard 2008). Even though different countries could work out reforms in different circumstances, transition countries consider new economic reforms would adopt liberalisation, privatisation and globalisation (LPG) for promoting sustainable economic development and introduce the (LPG) reforms, through creating FDI at a large scale and through trade and other factors. Shiva & Makki (2004) conclude that the FDI and Trade have a positive impact economic development. Thus, LPG would be affecting an entire the economic structure in the economy.

Who these reforms would influence is determined by other indicators in the economy. Impact of FDI and trade are: effect on economic growth (Borensztein, Gregorio and Lee; Balasubramanyam and Salisu and Sapsfored); as well as the effects of economic growth on FDI (Barrel and Pain; Lipsey, Shiva K Makki). This kind of behaviour of changes would occur during the transition phase. However, the transition process includes economic liberalisation in domestic and foreign trade, free capital flow mechanisms, elimination of price controls and privations of state-owned enterprises. Thus, economic growth is being determined by economic factors such as international economics, micro and macro economics, welfare economics, development economics, labour and industrial economics, environment and, finally, public finance.

- International trade can change the entire market structure in the economy. It should depend on export and imports which, in turn, influence other activities. Trade provides the motivation for efficient production of goods and services by shifting the production pattern. FDI and trade are having a vital role to play in economic growth, as well as trigger institutional developments in the recipient country. These factors should influence exogenous and endogenous factors in the absolute market structure in an economy.

- Development economics, it focuses not only on promoting economic growth and structural change, but also on improving the living standard of the population. Trade

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4. Initially, FDI investments flow into manufacturing sectors and later on highly industrialised sectors which require higher capitalisation, longer time horizons, high pay offs for the investors and greater risk. During these phases, one would expect FDI into the tradable sector to increase as well.
and FDI are among the most important players to improve the social and cultural activities in an economy. These create conditions for institutional development, services and also income generation.

The economic growth of families and individuals would probably increase their expenditure. With sharp increase in income, it would lead to growth in human development index as well. Thus, the increase in consumption, health and education, in turn, brings forth changes in an economy. Examples of these include: health, education and poverty eradication to run the development programme. This may involve restructuring market incentives.

- Welfare economics is a branch of economics which uses microeconomic techniques to evaluate economic well-being of the people; relatively general equilibrium would have an effect on the economic efficiency and income distribution. These indicators study society, group, community and how it leads to social welfare. Trade and FDI are creating a new market system which is affecting the economy. These effects would improve the living standard of the society.

- Labour and industrial sectors: trade would facilitate for employment generation at various levels in domestic markets, including small, medium and large sectors. FDI is introducing new technological skills, to provide labour training and encourage new input and technology. Labour and industrial sectors have a major role to play for both un-skilled and skilled labour, since the large numbers of non-technical labourers are high in developing countries. Thus, Trade and FDI create a comparative advantage and also provide a wide range of opportunities. Both factors have a significant role to play in the economic development of a country.

- Monetary and fiscal policies: these have a crucial role to play in controlling the whole economy. These factors are important for stabilisation of the entire economic structure by the money accumulation, distributing, taxes, interest rates, stable prices and control of inflation. If the economy is stable, both would create full employment and promote economic growth. In this way, both Trade and FDI are influencing the economy.

- Environment effect: Establishing of new firms can create issues of environmental pollution, urbanisation, and migration - sometimes leading to adverse effects on the economy. The effect of trade and FDI can lead to negative outcome to on economy.
Figure 3: The Influence of FDI and Trade on Economy

Transition
Price Liberalisation, Privatisation, Globalisation

Foreign Direct Investment

Trade

Export Imports

Markets

Macroeconomic Indicators

- GDP
- Unemployment
- Output
- Income
- Consumption
- Savings
- Investments

Industry & Labour

Organised, Unorganised

Banking, Services, IT

Vendors, Individual

Small, Medium, Large

Unskilled

Skilled

Justice, Inequality

- General Equilibrium, Economic Efficient
- Income Distribution

Population, Health, Poverty

- Promoting Growth, Structural Change

Fullemployment, Stable Price, Output

Interest rates, Exchange rates, Inflation, Money multiplier, CRR

Monetary & Fiscal Policies

Expenditure, Collection of revenue (Taxes)

Taxes, tariffs, Quotas, TR, TR Reposition, Anti-dumping duties

Urbanisation, Land, Forest, Migration

Environment effects

- Monopoly
- Oligopoly
- Perfect competition

Domestic

Monopoly, Oligopoly, Perfect competition
- Macroeconomics: it deals with the performance, structural behaviour and decision making in the entire economy. Macroeconomic policies and institutional stability can lead to economic growth. These policies have been the driving forces for trade and FDI in the country. This development models have a relationship between factors such as national income, output, consumption, savings and investment.

- Microeconomics: it studies the behaviour of the individual modern households and firms. It examines how these decisions and behaviours impact the supply and demand for goods and services. It mainly deals with the issues of growth, inflation and unemployment. Trade and FDI create opportunities for employment in the host economy. Inflation can also be controlled by the import of products. In this way, transformation in the economy can take place.

Consequently, trade and FDI would cater for the new innovations, so essential for the sustainable economic growth in the economy. Some works (Helpman et al., 2004; Antras and Helpman, 2004; Hiranya K. Nath, 2008) have discussed the product differences for determining the patterns of trade and FDI, which can lead to sustainable economic growth.

1.4. Significance of the Study

In the 21st century, comparisons of the economic development of both countries have gained a lot of significance, following diversified decisions taken by policy makers. In the process of transition economics, many countries have been trying to adapt the experience of successful developing countries. The main intent in an economy is market-orientation and industrialising it, which has led to an open economy. Indeed, any emerging country requires huge amount of investments. As brought out in Figure -3, both FDI and Trade would have a strong influence on the entire economy. A similar experience picture was seen during the transition in EU, where FDI, as a substitute for trade, was an extremely important part of the marketisation process because it allowed for quick absorption and implementation of goods and services to fill the gap in the transition economy (Richard, 2008, pp. 330). In addition, both China and India are similarly in many indicators. Though there has been several research studies on the subject, of research is still going on regarding both comparison and development aspects. In the 21st century, both countries have been playing a significant role in market-oriented towards approach the world economy.
The researcher has chosen China and India because both have similar indicators and relatively same level of economic development. So, at this juncture, after transition, which kind of transformation has taken place? How transition process emerged in both countries? What are the effects of transition economics on foreign direct investment (FDI) and trade? Do FDI and trade confer a comparative advantage to both countries? What can these countries learn from each other in the 21st century?

1.5. Objectives of the Study

1. To analyse the process and phases of economic transition in China and India.

2. To investigate and compare the FDI and Trade variables, with reference to economic transition in both economies.

1.6. Hypothesis of the Study

1. Ho. Both countries’ economic growth is positive and transition countries are more significant in the globalization scenario.

1.7. Data and Methodology

The data is drawn mainly from secondary sources of date like, various publication of Government of India, Reserve Bank of India (RBI), World Bank transition reports, International Monetary Fund (IMF), World Economic Survey and the Organization for Economic Coordination and Development (OECD) Economics Outlook reports, Reports such as the European Bank for Reconstruction and Development’s (EBRD) transition Report and the United Nations Conference Trade and Development (UNCTAD), the China’s statistical yearbooks and official statistics of China and India, as well publications of research institutions. Data is employ mostly deals with the period 1978 to 2010. This study is mainly focused on theoretical and empirical analysis. The study would be using the multiple regression data analysis.

1.8. Limitations of the Study

The present study is a comparative analysis of India and China. Indeed, development variables sought are more macroeconomic variables only. But, in both countries, microeconomic variables are entirely different. However, more critical issues need to be addressed in future research. The limitations of this research include:

a. It is very difficult to obtain the entire data on India and China over the period. In the case of India, these were one decade after China introduced its reforms.
b. Reforms were introduced in both countries in different periods. In the case of India, these were one decade after China introduced its reforms.

c. Consequently, sample selected economic variables has taken for analysis.

Data is relied upon mostly pertains to the period of 1978 to 2010.

1.9. Chapterisation of the Study

This chapterisation is as follows; the first chapter is introduction and gives an understanding of transition. The second chapter is a review of literature. Chapter third discusses the theoretical background of the transition economies. Fourth chapter gives a comparison of “transition in China and India” perspective analysis. Fifth chapter is discusses economic indicators such as, a) Foreign Direct Investment; and b) Trade. Sixth chapter is summary and conclusion.