



Scenarios for India and China 2015: Implications for the City of London





**Oxford
Analytica**

Scenarios for India and China 2015: Implications for the City of London

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Foreword

Michael Snyder
Chairman, Policy and Resources Committee
City of London

The City of London Corporation has long recognised the critical importance of China and India, both to the world economy at large, and to the international financial services industry which raises the capital, provides the advice and facilitates the trading on which that economy so heavily depends. It was for this reason that we funded the establishment of City Representation in Beijing, Shanghai and Shenzhen over the past year, and that we are now establishing representation in India. This representation, operating under the “City” brand, is intended to promote UK-based financial services in China and India, to facilitate the business development of City firms by providing support for their visits to these countries, and to support Indian and Chinese companies in working with the City.

This research report represents another part of our contribution to matching the established expertise of UK financial services with the opportunities and challenges of the world’s largest and most vibrant emerging markets. The report has a number of unique features.

First, it is built around an exercise in scenario analysis. Three alternative visions of the possible development of each country up to 2015 and how these might produce changes in the relationship of each to the rest of the world were constructed by our consultants, St Andrews Management Institute and Oxford Analytica. Each set of scenarios consists of a base case in which the current pace of growth is maintained, and alternative cases in which change is either retarded or accelerated by the interplay of economic forces and political developments.

Second, the scenarios were explicitly constructed to examine the scale and nature of financial services developments that each would produce and to assess the opportunities and challenges that could arise for the City as a global provider of all of the major types of financial services and products.

Finally, the research was carried out by asking the City itself what it thought of these visions of the future. India and China, although often bracketed together, differ significantly on a range of dimensions arising from their very different political and economic histories and attitudes to the future. Three day-long seminars were held at which a wide range of practitioners discussed the potential rewards and risks that each scenario might produce, and offered informed opinion on how their businesses might be developed or affected.

Given the range and scale of possibilities, and the many uncertainties that attend them, these conclusions are complex. If there is one overriding theme, however, it is that China and India will present significant possibilities for business that the City simply must do everything it can to capitalise upon. Equally, both India and China have much to gain through a closer relationship with the City. I commend the report to all interested parties as an essential contribution to understanding exactly how these possibilities could evolve, and how they might be exploited.

Michael Snyder
London
October 2006

Executive Summary

- India and China are two vast, diverse, economic systems, both containing a number of distinct economic sub-systems. **The countries are often bracketed together but differ significantly on a range of dimensions, arising from their very different political and economic histories and attitudes to the future.** India's democratic heritage makes regulatory systems overt and recognisable; China's communist legacy makes issues of regulation more arcane and harder to discern. Notwithstanding these very different backgrounds, both countries have exhibited strong economic expansion over recent years.
- This report on the impact of India and China on the future of financial services in the City of London is based on specifically developed scenarios for India and China to 2015, which were used as the basis for consultations across the City. The scenarios for each country – which are detailed fully in the report – describe three plausible scenarios for both India and China: the development of existing trends, as a baseline; a revolutionary scenario, in terms of accelerated change; and a scenario of instability and difficult adjustments. While the methodology of scenario development was common to each country, the scenario outcomes are distinctly different.
- **All scenarios see positive rates of economic growth for both countries over the next 10 to 15 years, and at an average annual rate which will probably exceed that of both the US and the EU, but not necessarily a smooth one.**
- **Both societies have embarked on major economic expansion that poses substantial challenges to existing political and social structures.** Thus, careful navigation through the cross currents of societal evolution is required for financial services and other organisations wishing to maximise opportunities and minimise threats during transitional phases. **Throughout the momentous changes in both countries, it should be remembered that the cultures of both India and China seek continuity, pointing to a need to be patient in developing and nurturing links and relationships in India and China.**
- **Both India and China have much to gain from closer relationships with the City, which can provide valuable expertise and expedite necessary financial transactions for the development of both the corporate and personal sectors in the two countries, to the benefit of all parties.**
- **China has been in the headlines for several years as an economic powerhouse; India has had a lower profile but is becoming increasingly recognised as attractive.** Organisations from a range of competitor countries have already taken initiatives and the field is growing. It is vital that the City seizes the fast-emerging opportunities ahead of others if it is to establish a strong competitive position in these two countries.
- In analysing and prioritising the financial services opportunities in India and China, a fundamental point needs to be emphasised: there is an important difference in the financial structure of the two countries. **India has too little capital;** it has a heavily leveraged economy, access to finance is quite costly, and it has a relatively greater need for foreign capital than China – particularly for infrastructure investment. **China's exceptionally high savings rate and positive trade balance provides abundant capital,** and has had the advantage of extensive foreign investment, **but there is inefficiency in capital allocation.**

- **India has a more stable banking system – both in terms of the institutions themselves as well as the regulatory system. The Chinese banking system is burdened by its links to the State-owned Enterprises (SOEs), which continue to be heavily subsidised.** Major banking reform and liberalisation are overdue. They are pre-requisites for longer-term economic progress, and are likely to open up a variety of new opportunities in banking and other financial services, including through joint-venture and use of technology, such as the internet, that can facilitate long-distance communication and interaction. India appears to be taking steps to address some current regulatory concerns, whereas the system in China remains somewhat opaque.
- **There is evidence of Chinese multinational companies (MNCs) moving up the value-chain,** from basic manufacture and assembly. At the same time, **Indian MNCs are also expanding rapidly,** and in this respect India has an advantage in that its current financial services linkages have developed ahead of those of China. International banks are able to offer a bundle of services in both these cases and the City banking sector needs to be aware of the need to ensure it captures a significant share of these opportunities. Such activities include providing corporate banking services, trade financing for Chinese and Indian expansion overseas, and possible listings on AIM or London Stock Exchange (LSE).
- **In China, the state no longer provides a comprehensive lifetime employment and social security system for its citizens.** The change in expectations by Chinese citizens – particularly in the context of China’s ageing population – provides huge opportunity in the field of pensions under all scenarios.
- **The non-life insurance business in China finds it difficult to attract capital as the very high rate of Chinese savings is mostly directed at life insurance.** This needs to be monitored closely for any propensity for change and emergence of new opportunities for foreign players, given the shift in state support for citizens and business.
- Further specific opportunities in China are likely to be in capital markets and financing – including debt and equity, and project financing; wealth management for individuals; and consultancy, advisory and regulatory services.
- **The Indian insurance market is still protected by trade barriers: when they are reduced or removed,** the result will be a battle for market share, with state and private sector companies possibly going under. This **rationalisation and restructuring may create opportunities for new players** – providing both opportunity as well as competition for the City since Indian insurance companies are already competing with the US on complex products such as litigation, product recall and medical malpractice insurance.
- In India, further specific opportunities are first in FDI, particularly in India’s established success stories such as the IT, pharmaceuticals and media sectors, and also possibly in the emerging biotech industry; and secondly in providing retail financial services products for the middle class’s banking, insurance, pension and mortgage needs.

- **Both countries – particularly India – are creating a well educated labour force with highly trained graduates.** This represents an opportunity for international financial services institutions to recruit local expertise. Conversely, a threat may come from the use of local expertise to establish a separate rival indigenous financial services industry that shifts the balance of global services towards Asia. This threat is more likely to come in the first instance from China, which under certain scenarios could start to develop as a major Asian financial hub. It cannot, however, be ruled out that Indian expertise in financial services may be the foundation for longer-term success compared to China, particularly given India’s growing IT expertise.
- **In principle, both countries are rich with opportunity – but also with risk.** The scenarios contain examples of each in both countries. In fact, the risk profile is different between the two countries, and is driven largely by the risk emanating from the respective governments, in terms of changes in the pace and/or direction of policy. The main opportunities are for the City to capitalise on its strengths: its reputation; the agglomeration of business services including, but not limited to, financial services; its global expertise, reach and quality of management; and above all, its drive for innovation.
- There will also be opportunities in the dislocations that could impede the smooth path of expansion. Such opportunities may include offering a safe haven for funds of indigenous investors and companies; providing expertise in moving money in difficult times; and also being a proven source of probity in a turbulent political world.
- Perhaps the surprise conclusion to emerge from this study is **the strong perception that the attractiveness of India as a business partner has been underestimated by financial services organisations.** While its role as a supplier of back office services, software and call centres is well established, India has a number of significant advantages over China and other countries, such as embedded English language skills; shared legal/commercial culture; democratic government; and a significant Indian business community in the City and other parts of the UK.
- The main threat that has been identified from the explosive growth of China is the potential for disruption of world trade – with competition for raw materials in the short-term and in due course for heightened international trade tensions and strife.
- Hence, a number of the implications and potential action areas that follow are focused on ways in which the City can act as an “honest broker” and provide informal as well as formal links across the cultural divide, to reduce the likelihood of potential disruption threatening global stability.

Implications and Potential Action Areas for the City

(a) India

- There are an estimated one and a half million people of Indian descent living in the UK, including a large number of Indian entrepreneurs who could potentially facilitate trade between the UK and India. India shares a common language and institutions, such as legal and property systems, with the UK. This should provide an invaluable platform for building financial services business in India based on City expertise, also taking advantage of established frameworks such as the Indo-British Partnership, Trade Associations and Alumni networks. Hence, **the City should be more active in seeking to establish links with the Indian business community, and with Indian companies operating internationally, to build financial services links, particularly insurance, banking, legal services and public private partnerships (PPP).** At present, Indian business networks appear to co-exist with those of the City, but are not necessarily as well connected as they should be. Building such links would offer significant business potential for the City.
- India's economy embraces a large internal regional diversity, and these regional differences are likely to persist under all scenarios. In some cases, the particular policy variances among the respective regions of India could have a significant impact on the way in which opportunities and threats play out for specific business initiatives. **It is vital therefore, for financial services organisations to be alert to these regional divergences when developing strategies for India, and not focus narrowly on the traditional financial centres of Mumbai and Bangalore.** Judicious selection of regional – as well as sectoral – investments is crucially important as a means of managing financial risk.
- Each of the scenarios for India, suggest a different strategy for investment. Some opportunities, however, span all scenarios. These are investment in infrastructure; wealth management for individuals; a wide range of consultancy and advisory services; and back office, IT and call centre services. While many of these opportunities present no surprises, it will be important that the early indicators described for each scenario are monitored regularly to prioritise the emerging opportunities and discern potential risks.
- **City institutions need to identify Indian MNCs of high potential and start to form relationships,** given the potential opportunities to offer trade and export finance; merger and acquisition (M&A) services; corporate banking and finance; stock exchange listings; and corporate development services. Such one-to-one relationships might well assist in the broadening of contacts with the Indian business community as a whole, to beneficial effect.
- **The scenarios that have been developed for India all point to the considerable need for physical infrastructure (power, transport, water and habitation); and yet India suffers from capital shortage, pointing to significant opportunities ahead for project financing in general.**
- A key infrastructure question is how India will be able to provide sufficient energy to underpin growth, particularly given global pressure on energy supplies and the fact that the country's lack of indigenous finance is one of the major Indian constraints. **Opportunities exist to capitalise on City expertise in areas such as commodities trading, energy futures, carbon trading and, again, project finance.**

- Off-shoring to India has been an important cost-reduction tool for a number of City financial services businesses, assisting them in maintaining overall international cost-competitiveness. There is also the prospect, in one of the Indian scenarios, that India's success will drive local costs to a level where this off-shoring process in turn moves from India to other lower cost, less developed countries (see section 4.3). While at one level this would have significant implications for the recent wave of financial services off-shoring to India, it is also likely to be accompanied **by the emergence of new opportunities further up the value chain – in privatisation, private finance initiatives (PFIs) and foreign exchange markets; and listings on AIM or the LSE.**
- This prospect might offer a way of involving the Indian diaspora in the development of Indian financial services. Such involvement could open the way to greater FDI by the diaspora in onshore financial services.

(b) China

- While China has long been on the UK commercial radar screen (The China-Britain Business Council has been in existence since 1954), **many other countries have been more pro-active in developing links with China** and the wider international Chinese community. The importance of building long-term relationships cannot be over-emphasised. **City financial services organisations should seek to develop direct links with the Chinese community and Chinese organisations, drawing Chinese representatives more closely into their various networking circles.**
- It should be recognised that China's huge economy embraces a large internal regional diversity, which will persist under all scenarios. Policy variances among the respective regions of China could have a significant impact on the way in which opportunities and threats play out for specific business initiatives. **Financial organisations should be alert to these regional divergences when developing strategies, and not be over-influenced by the traditional perspective from the eastern seaboard of China.**
- **Chinese MNCs are moving up the value chain**, towards undertaking product design and development and branding their own products, in part by means of international acquisitions. **It is essential that City businesses identify and establish links with such companies to provide services in export finance; M&A; stock exchange listings; and other corporate services.** Such links might well lead to the development of a wider set of beneficial relationships with this expanding group of companies.
- China's companies have used the Hong Kong Stock Exchange for an "international" listing, but there are increasing numbers of companies coming to London, particularly to the AIM. This trend is important to the City in building ongoing links.
- **China's ageing population is no longer protected by comprehensive state employment and social security provision, and in all scenarios will be looking for savings vehicles allied to personal and company pensions.** The City has undoubted expertise both in designing pensions schemes, and in adjusting investment portfolios to the changing circumstances of scenario evolution. **The City should urgently investigate this huge opportunity and exploit it.**

- As China faces enormous challenges from pollution of air, water and land from coal burning, chemicals and other sources, **opportunities will arise for City institutions to assist in the search for solutions, not only through the provision of finance, but also in the development of turnkey solutions, involving innovative pricing and funding packages, including PFI.** This could provide a model that could be extended to other infrastructure projects.
- Opportunities could arise in privatisations; and in retail services for the middle class. There also needs to be awareness of possible down-stream implications of the opening up of the Chinese securities markets. This could stimulate direct competition, particularly in the Asian arena, from an increasingly strong and sophisticated Chinese financial services sector, whether it be focused exclusively on Shanghai or through a number of financial centres from Beijing to Hong Kong.
- **China is undoubtedly seen as a big opportunity of high growth and high potential; yet one with more inherent risks because of its potentially unstable political culture and the potential for future international trade friction.**
- **Moreover, China does not yet have robust systems of regulation and legal and intellectual property protection – and certainly not of enforcement.** It is vital that financial services organisations be alert to the possibilities of transfer of intellectual capital that might ultimately strengthen potential competitors. Continued strong focus on risk management and strategic and operational flexibility will be paramount.

(c) City Competitiveness

- Nearly half of all skilled worker visas issued annually by the US are granted to Indians, giving an indication of the size of the two-way flow of skilled workers – into the US, and potentially back to India. These skilled workers will be inclined to look to US sources for financial services when they return to India. Similarly, the flow of skilled workers from China to the US is smaller but still about 50,000 per year, with possibly similar results in terms of preferred sources of financial services. Hong Kong and Singapore are also both internationally recognised sources of financial services, with predominantly Chinese staffing. The conclusion from this brief analysis is that the UK is not necessarily the only or even first choice for Indian or Chinese organisations looking for financial services, and that **the small contribution to UK financial services balance of payments from India and China will not increase substantially without focused attention from UK companies.**
- Labour flexibility is an important aspect of the attractiveness for firms to locate in the City and will enhance the City's image as a place where modern firms come to do business. It was suggested by study participants that a number of the large European financial services firms have located major operations in London owing to the greater flexibility of labour and other markets in the UK, and the greater ease of adjusting to structural or cyclical market change. To this end, **the City should continue to lobby the UK government to maintain the UK's advantages of labour flexibility, particularly against the background of developments in EU legislation.**
- **Another important aspect of the City's reputation is that of its pre-eminence in the area of financial regulation. It is vital that this is not weakened** and that the City does not move from principles-based standards and regulation to a

rules-based model such as that of the SEC. **The major City financial institutions and regulatory bodies have a key role to play here. They also have a role to play in advising on the development of enlightened regulatory frameworks in India and China.**

- The essential importance of business networks has already been noted for both India and China. Further, given the key role of alumni loyalties, the City should actively support the universities in London in their continuing initiatives to develop relevant and attractive Undergraduate, Masters and Doctoral programmes in financial services topics. There is much scope to develop bi-lateral links with Chinese and Indian universities, and to develop courses not only for Indian and Chinese students wishing to work in the City – or other Western financial centres – but also for those wishing to return home to work, where appropriate skill sets need to take account of local structures and regulatory environments.
- The growth in Islamic banking may become a significant factor in exploiting Indian markets, where Muslims constitute over 13% of India's population. **The potential growth of alternative financial centres such as Dubai could be addressed through such initiatives as the City being more proactive in offering Islamic banking schemes, perhaps also supporting centres such as Dubai.**
- A major strength of the City, as has been emphasised throughout this study, is not so much in the provision of specifically-focused financial services but in the capability to bring together a portfolio of business services – legal, regulatory, IT, large complex projects (such as infrastructure and urban construction) – and in the development of new and innovative products. The City should consider actively developing and marketing this portfolio view.
- Within the scope of this study, it has not been possible to develop a detailed sector by sector analysis of the City's financial services under each scenario for India and for China. **All City organisations need to be alert to the nature of the competitive threat and the opportunities that could arise in their own sub-sectors and local markets**, owing to the overseas activities of Indian and Chinese MNCs and other businesses. **Indian companies have links with the US and Dubai, and Chinese companies have links with the US, Singapore and Hong Kong. To counter this threat, City companies will need to seek out and develop long-term relationships with people at all relevant levels within the Indian and Chinese financial and business communities.**
- **Success in capitalising on opportunities in the Indian and Chinese markets will increasingly require skills in Hindi, Mandarin, as well as other local languages.** In China – where Chinese language penetration of the internet is a harbinger of change – Mandarin speakers are the majority of the population, but 86% of the population also speak regional Chinese dialects. In both India and China, the middle class represents only about one-fifth of the total population; even in the middle classes, skills in the English language are unevenly spread.
- London already has a huge advantage with the Indian and Chinese diaspora, but this does not yet appear to be fully recognised. It needs to be developed and harnessed. The Task Force set up by the Chancellor in March 2006 to “co-ordinate London's development as a financial centre and to promote it overseas” is a very welcome initiative and should be used to develop better cultural understanding and intercommunication.

PART I

1 Introduction

1.1 Research Aims

This report sets out the overall findings of a project, commissioned by the City of London Corporation, to:

- analyse the potential long-term future development of India and China;
- assess the possible impacts, both positive and negative, of such patterns of development on the City of London's financial services sector;
- consider what further analysis may be necessary and what actions might be taken to maximise potential opportunities and minimise threats.

It is hoped that the report and its conclusions will be used to stimulate wider debate and appropriate action among City financial institutions, government and other interested parties.

1.2 Structure of the Report

Part I of the report initially describes the approach and methodology of the project, and then summarises some of the "baseline" data and views expressed by workshop participants concerning the broad strengths and weaknesses of the City in an international competitive context. Chapter 3 reviews some of the key global trends anticipated up to 2015, in order to give a context for the possible ways in which China and India might evolve. Chapters 4 and 5 describe the scenarios for India and China, together with the implications for financial services. Chapter 6 discusses the lessons learned and draws overall conclusions. Part II of the report (Chapters 7 and 8), describe the detailed scenarios for India and China.

1.3 Methodological Approach

The project was divided into two stages. The first stage involved identifying the key features of China and India that will bear on the City in the coming years. To enable a long-term perspective to be considered, the two countries were studied independently using a scenario approach. Michael Porter defines a scenario as "an internally consistent view of what the future might be...not a forecast but one possible future outcome."¹ Scenarios are possible views of the world, providing a context in which organisations can make decisions. By seeing a range of possible worlds, decisions will be better informed and a strategy based on this knowledge and insight will be more likely to succeed. Scenarios may not predict the future, nor do those chosen as the basis for analysis necessarily represent all possible outcomes. Indeed the actual outturn may comprise a combination of events from different visions or scenarios of the future. Scenarios do, however, illuminate significant drivers of change including those that may not necessarily have a high probability of occurrence: understanding these drivers can only help organisations to take greater control of their situation.

The specific scenario time horizon selected for the current study was to the year 2015, although some developments and indicators examined will have an influence, of which the major impact could extend well beyond this date. The initial scenarios were developed by Oxford Analytica, in conjunction with SAMI Consulting, and are reproduced in full in Part II of the report. They provide a very rich picture of the

¹ Porter, M. (1985), *Competitive Advantage*, Free Press.

dynamics underlying the two countries, and are worth studying in detail by those considering what amount of time – and money – to devote to India and China, and where to invest.

In the second stage of the project, the scenarios were used as a basis for workshops and discussions with representatives from across the City, to explore the impact on the City's financial services sector. Over 60 representatives contributed their views and reactions freely, on a non-attributable basis.

1.4 Building the Scenarios

The scenarios for China and for India were built independently of each other over the period from August to October 2005. In each case, Oxford Analytica led a short workshop to gather intelligence on the main drivers for the scenarios. The methodology involved the following activities:

- researching and analysing the important trends and uncertainties determining the future of China or India;
- constructing an “influence diagram” to understand the drivers and their relationship to one another, and extracting two main drivers to explore the range of possible futures and develop the initial scenario ideas;
- enriching the basic scenario ideas through discussing the nature of politics, society and the economy under each scenario end-state, and developing the timeline for the evolution of the country into each scenario end-state;
- brainstorming external or internal events that could put the country on a path to a particular scenario end-state.

The chosen scenarios were then researched and developed further by the Oxford Analytica team, which also developed the detailed story lines and scenario names, documenting them as set out in Part II of the report. The scenarios as presented contain estimated growth rates. These are intended to be no more than indicative of possible rates of development under various scenarios, and have been chosen by Oxford Analytica on the basis of their country research. It should be noted that for the evolutionary scenarios, the estimates are similar to those published by Goldman Sachs as the BRIC (Brazil Russia India China) scenarios in 2003.²

1.5 Workshops and Interviews

The second stage of the project was to use the scenarios as a basis for workshops and discussions with representatives from across the City, undertaken between September 2005 and February 2006, to explore the impact on the City's financial services sector. The Scenario Summaries of the scenarios (in Part II) and the comparison tables showing milestones for each scenario (as in Chapters 4 and 5) were used as the main means of briefing the essence of the scenarios in advance to workshop participants and before one-to-one interviews.

Three workshops were held, the format being based on a mixture of presentation and syndicate working, so that participants had plenty of opportunity to consider the implications of each scenario for their organisation. The first workshop had participants from a wide range of financial services and international institutions. The second workshop focused on asset managers. Participants at the third workshop were from a wide variety of financial services and business institutions with knowledge of the City as well as Asia. Additionally a number of people were interviewed representing organisations unable to attend the workshops.

² Dreaming With BRICs: The Path to 2050, *Global Economics Paper No. 99*, Goldman Sachs (October 2003).

2 Background

2.1 The Role of the Financial Services Sector

The City of London plays a leading role in global financial markets, including capital markets, insurance and foreign exchange, through matching savers to borrowers, helping to manage risk, and providing firms and individuals with the means to make and receive payments. In the performance of these roles, the City makes an enormous contribution to the UK economy, and it continues to grow as a share of UK output and employment. It is estimated that the City of London accounts for 41% of all City-type financial services in the EU.³

As a source of comparative advantage, the City provides the UK with a significant net trade surplus, and its level of productivity is rising more rapidly than the economy as a whole.⁴ Given the importance of such service sectors to the UK economy, it is vital that financial services maintain, if not increase, their competitive edge in the global economy. The ability to continue to compete successfully in global financial services will be a touchstone for the continued prosperity of the whole UK economy. The Chancellor of the Exchequer has recently announced the creation of a Taskforce to co-ordinate London's development as a financial centre and to promote it overseas. This move is seen as recognition by the Chancellor of the City's importance to Britain's economic health.

While this report is focused on financial services much of what is said also applies to the wider arena of business services, such as legal, IT, planning and design, regulatory and accounting services. Further, when the opportunities and threats of India and China are considered, it can be seen that tackling many of these requires the City to use its capability to bring together a wide range of expertise – for instance, privatisation of state assets requires regulatory, legal and financial expertise; and large projects such as infrastructure and urban development, require architects and engineers, as well as financial muscle.

London is also a centre for other knowledge industries, such as education (further and higher) and research; and media and creative industries. It is also a major centre of the tourist industry. Each of these centres, are also being directly affected in different ways by the growth of India and China.

2.2 The Changing Balance in the World

The City is regarded as the world's leading financial centre, providing a global hub for financial institutions, firms and investors.⁵ The City has responded well in the past to the challenges of change, but now the world is changing at an ever more rapid pace and becoming more complex and less predictable. Fast rates of economic growth in emerging economies, coupled with the dynamic of demographics, are transforming the global economy, creating new challenges and opportunities. The acronym "BRIC" (Brazil, Russia, India and China) reflects the focus on new areas of the world that are re-ordering the existing patterns of economic and political activity and influence. A report from Goldman Sachs, suggesting that by 2050 the economies of the BRIC countries could be more than 50% larger in total GDP terms than the current G6 economies, has been widely quoted.⁶

³ *The City's Importance to the EU Economy 2005*, (2005), Centre for Economics and Business Research (cebr): Report to the City of London Corporation.

⁴ Budget Speech, House of Commons (22 March 2006).

⁵ *The Competitive Position of London as a Global Financial Centre* (November 2005), Z/Yen Limited: Report to the City of London Corporation.

⁶ Goldman Sachs BRIC Report, *op cit*.

Brazil, Russia, India and China are, nevertheless, all very different from each other. Brazil's population is growing strongly and supplies many raw materials to the rest of the world. Russia's raw materials – particularly of energy – are re-shaping world energy markets, while her population is shrinking fast.

This report focuses on China and India as examples of new economies that are transforming not only the dynamics of the world economy, but also the balance of power. They are poised to be the drivers of a potential new centre of economic gravity, covering the whole of Asia, which has previously been dominated by the major economies of the US, Western Europe and Japan.

China and India comprise nearly 40% of the world's population, and now account for approaching 20% of global GDP (on a purchasing power parity basis). Moreover, they are widely projected to be among the top tier global economic super powers in the next couple of decades, returning to their world predominance at the end of the eighteenth century.

China is already the third largest exporter in the world, behind the US and Germany, according to some recent estimates.⁷ India is expected to increase its volume of services exports by over 160% by 2015.⁸ Currently, however, neither country figures significantly in financial services, trade with the UK (see Table 1).

Table 1: Trade flows in financial services between UK-China and UK-India

	£ (million)	
	<u>2002</u>	<u>2003</u>
UK exports to China	70	78
UK imports from China	<u>23</u>	<u>31</u>
Trade balance in financial services	47	47
UK exports to India	69	85
UK imports from India	<u>12</u>	<u>20</u>
Trade balance in financial services	57	65
Total UK exports of financial services	20,210	19,337
Total UK imports of financial services	<u>3,980</u>	<u>4,336</u>
Total UK financial trade balance	16,230	15,601

Source: Latest data published by Office for National Statistics. Data for 2004 will be published later in 2006. It should be noted that the data for India and China could fail to include some transactions classified elsewhere, but the overall position is consistent with other published data.

Table 1 suggests that the 1.5 million or so people of South Asian extraction in the UK⁹ are not an automatic source of linkage into Indian and Chinese markets for the UK in terms of financial services, and that UK companies are not currently making their competitive case effectively in these markets. Continued failure to exploit such links may result in a considerable number of lost opportunities, particularly if other competitor nations, such as the US, are more proactive.

⁷ HM Treasury, based on EIU data.

⁸ Economist Intelligence Unit country data, quoted in HM Treasury report *op cit*.

⁹ Home Office Statistical Monitor.

Nearly half of all skilled worker visas issued annually by the US are granted to workers from India,¹⁰ giving an indication of the size of the two-way flow of skilled labour – into the US, and potentially back to India. These skilled workers will be inclined to look to US sources for financial services when they return to India.

Similarly, the flow of skilled workers from China to the US is smaller but still about 50,000 per year, with possibly similar results in terms of preferred sources of financial services. Hong Kong and Singapore are also both internationally recognised sources of financial services, with predominantly Chinese staffing.

The conclusion from this brief analysis is that the UK is not necessarily the only or even first choice for Indian or Chinese organisations looking for financial services. Further, the small contribution to our financial services balance of payments from India and China will not increase substantially without focused attention from UK companies.

2.3 Strengths and Weaknesses of the City

In order to develop a baseline for analysing the potential implications of developments in India and China on City financial services, an assessment of the strengths and weaknesses of the City was developed during the three workshop sessions. This was augmented by discussions with key stakeholders in one-to-one interviews, and by incorporating the conclusions from the City of London's Research Conference on "The Future Competitiveness of London and the City", held in November 2005. It is important to recognise these strengths and weaknesses because, while they may be of a general nature, it was clear from the workshops that they will nevertheless have a significant bearing on the long-term ability of the City to respond competitively to the threats and opportunities that might arise with respect to India and China.

Strengths

It is widely recognised that the City possesses four major strengths:

- reputation for sound governance, principles-based regulation and integrity;
- agglomeration advantages of clusters of services – including financial and legal, accountancy, IT, engineering;
- global expertise;
- quality, diversity and depth of City managers and employees.

The City's long-established reputation owes much to the institutional and regulatory framework that has evolved over many years. This encompasses a range of institutions from the Bank of England and the Stock Exchange, to the more recent Financial Services Authority (FSA), and includes an extensive body of law and jurisprudence that binds the structures together. The City is still regarded as a haven of probity in the world, and its systems of governance are likely to be seen as highly resilient and adaptable in coping with the growing global complexities.

It is well known that many economic advantages accrue to those involved from the clustering of like activities within a common operating zone, such as the City. There is a depth and breadth of skills, not just stemming from the clustering of financial expertise, but also in related services such as legal, accounting and IT. This acts as a clear attraction for firms to be drawn to, and remain in the supportive environment of the City. Such an environment is facilitated by the UK's market-based economy and trading traditions, and supported by a pluralist political system, independent

¹⁰ <http://economictimes.indiatimes.com>

media and an English-speaking culture, with English forming the predominant language of commerce worldwide. London is, for instance, a “one-stop shop” for many major privatisation or infrastructure projects, in the sense that all the services required are located conveniently together in and around the City.

The City commercial environment makes it attractive to high-quality managers and employees as a place to live and work. This, coupled with the UK’s liberal approach to immigration and capital movements, has encouraged the inflow of human capital. Indeed, the number of different nationalities¹¹ working in the City, not least of which are the Indian and Chinese diaspora, is testament to the attractive quality of life in many dimensions that London offers. This has created a multinational and multi-lingual environment of ownership and employment that has added to the expertise in international finance, and has brought openness together with a spirit of innovation and creativity which has enhanced the City’s reputation.

These pillars of the City’s strengths are supported by other factors, such as London’s extensive international communications and transport links – airports, Eurostar, ports – and a time-zone that is conveniently mid-way between that of Asia and the US.

Weaknesses

Four main areas of weakness were identified by project workshop participants:

- the high operating costs of London, and the cost of living for staff;
- London’s transport and housing infrastructure;
- a perceived declining quality of the UK education system;
- a perception of threats from terrorism.

London is regarded as a relatively high cost location for business operations, in terms of such factors as office rents, utility prices and staff salaries. The cost of living, especially for low wage employees, can affect the ability of firms to attract and retain staff in more routine functions. One response to this has been to move many back-office functions out of London, with India being a notable recipient.

A second key weakness is what is regarded as the unreliability of the commuter rail services, London underground and the crowded roads, which hamper buses and taxis. This compounds the problems of commuting, and makes travel within London both expensive and subject to delay.

The third area relates to what is seen in some quarters as the declining quality of the UK education system, from what has traditionally been regarded as a marked source of competitiveness. This results in firms being unable to recruit the quality of staff they require, especially as far as basic skills are concerned. While individual firms do engage in training their staff, this increases business operating costs.

The fourth principal area of weakness identified is the perceived threat from terrorism. While the reality of the threat cannot be denied, London is not unique as a potential target.

These perceived weaknesses, individually, might seem to be outweighed considerably by the City’s strengths. In fact a recent study published by the City of London found the City to be ahead of all European competitors such as Frankfurt and

¹¹ “Londoners speak over 300 languages and belong to at least 14 different faiths. Nearly a third of the city’s population is from Asian, black or other minority ethnic groups and over the next 10 years they will account for 80% of the increase in London’s working age population” – excerpt from www.london.gov.uk.

Paris and with New York lying in second place, just behind London.¹² The weaknesses could constitute vulnerabilities to competition from evolving lower-cost international centres, such as Dubai, Hong Kong, Mumbai and Shanghai, which might have the potential eventually to catch up with London's financial strength. Such trends could erode London's advantages, as skilled staff could be lured away and any migration eastwards in the global balance of financial activity could also erode London's current time zone advantage.

¹² Z/Yen (Nov 2005), *op cit.*

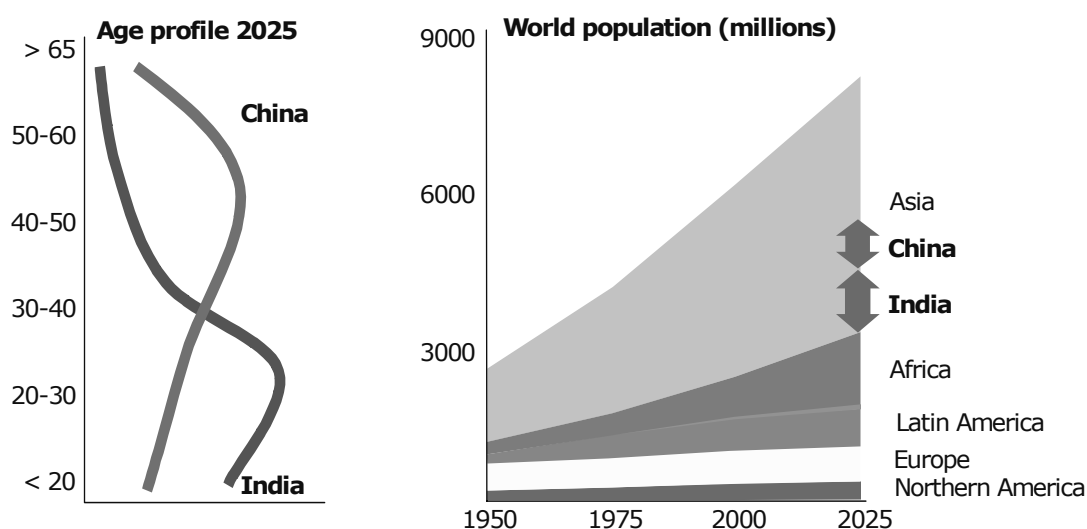
3 The Future of India and China in a Global Context¹³

3.1 Demography

One of the most profound drivers of change in the world is demography. World population growth is taking place almost entirely in the developing world. The developed world has a largely static, ageing population; the developing world has overall a growing, younger population.

India is typical of this trend, with large numbers of young people entering the work force between now and 2015. China is singular among developing countries in facing a decrease in the numbers of people of working age after about 2035. Overall, Asia will experience the largest increase in population over the next 10 to 20 years and, as shown in Figure 1, India and China will represent nearly half of this Asian population. UN population projections show that the population of India could eventually exceed that of China.

Figure 1: Demographic trends to 2025



3.2 Changes in World Industrial Activity

Recent decades have witnessed a very fast expansion in manufacturing value-added in the developing world, both in terms of output and exports. In Figure 2, the top graph highlights the fact that for all levels of technology – whether resource-based, low-technology, or medium-to-high technology – the developing countries as a whole have demonstrated average annual growth rates of value-added in manufacturing which have been two to three times those of the industrialised world. The lower graph illustrates a similarly superior performance by developing countries, in relation to the industrialised world, in the extent of value-added in manufacturing exports in 2000. The developing world now represents not only a source of lower-cost sourcing, but of high-value manufactures.

¹³ Unless otherwise stated, all charts in this chapter are from The Challenge Network, derived from the World Bank, OECD, IMF, Pew Research and other data.

Figure 2: Value-added in manufacturing

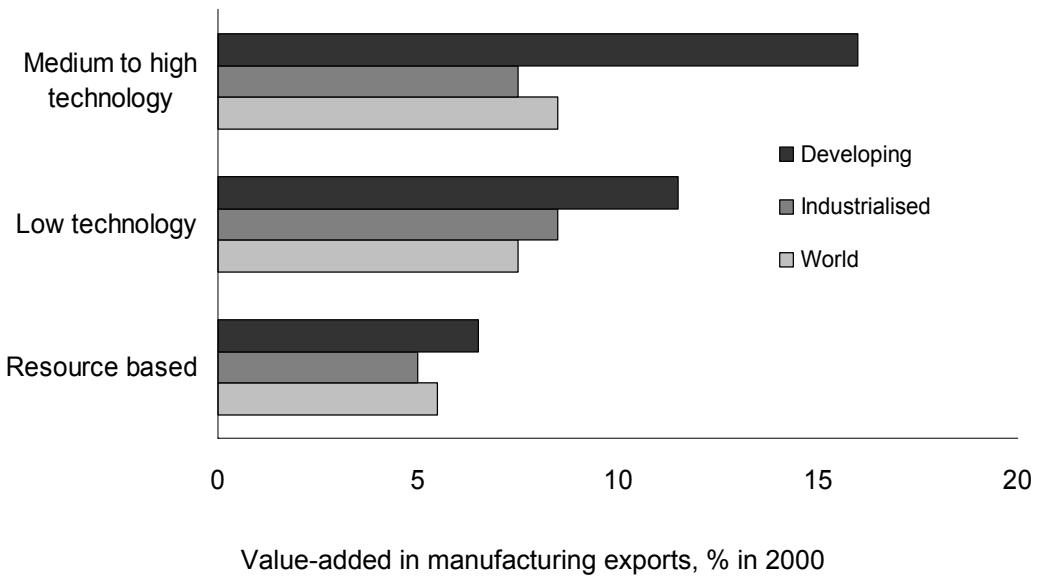
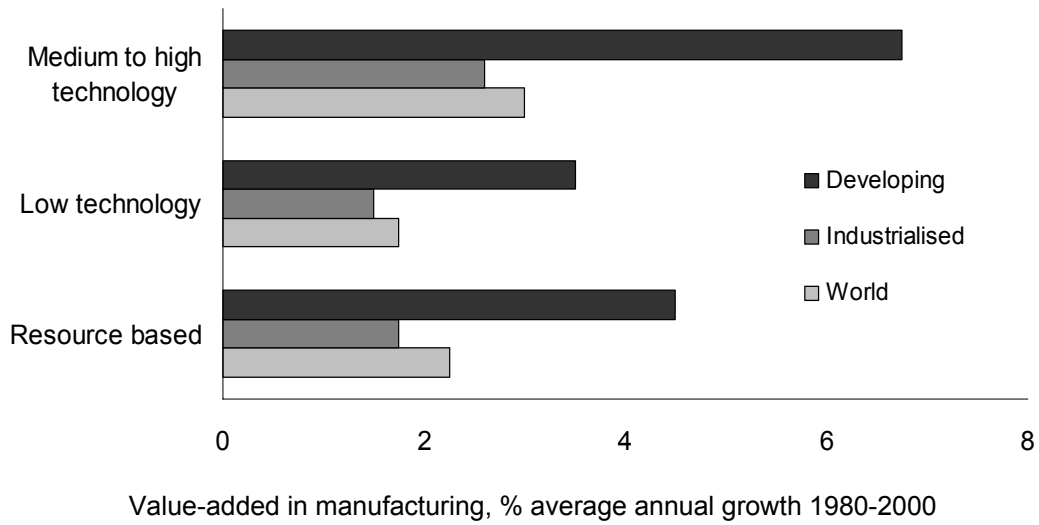
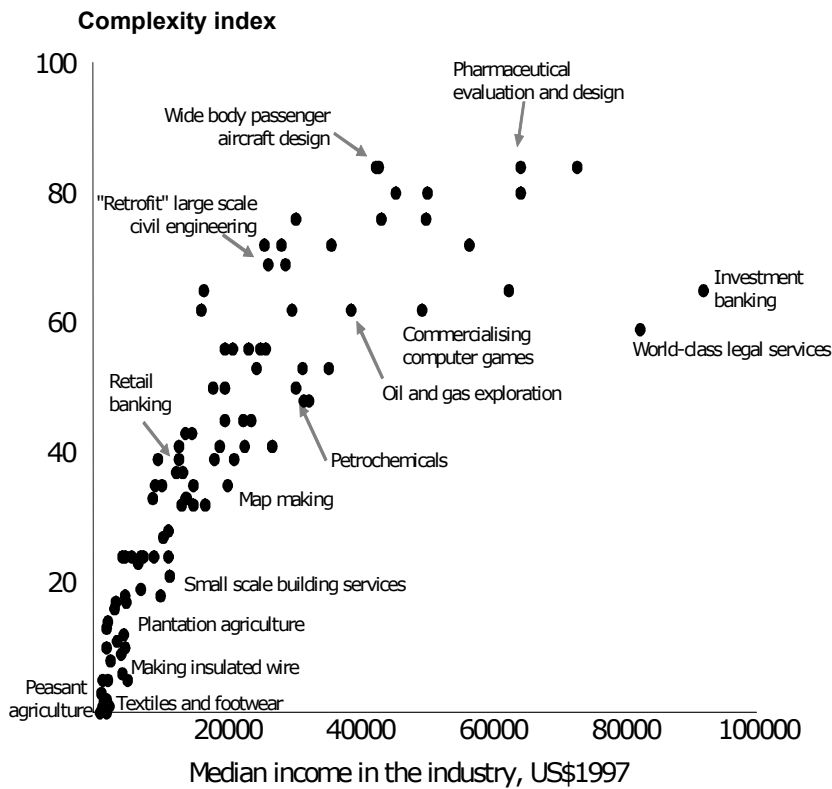


Figure 3 compares the organisational and operational complexity for specific industry and service sectors with the median incomes of the sectors. The graph shows a clear relationship between the complexity of activities undertaken in industrial sectors and the median incomes of the sector.

Figure 3: The complexity of an industry versus median income



At one extreme, are commodity-type low wage, low-margin activities (such as textiles and footwear) undertaken in low-wage countries. At the other end of the scale are high-margin complex activities, such as aerospace and pharmaceuticals, requiring complex infrastructure. In between are a host of highly “specified” and usually free-standing activities (e.g. petrochemicals).

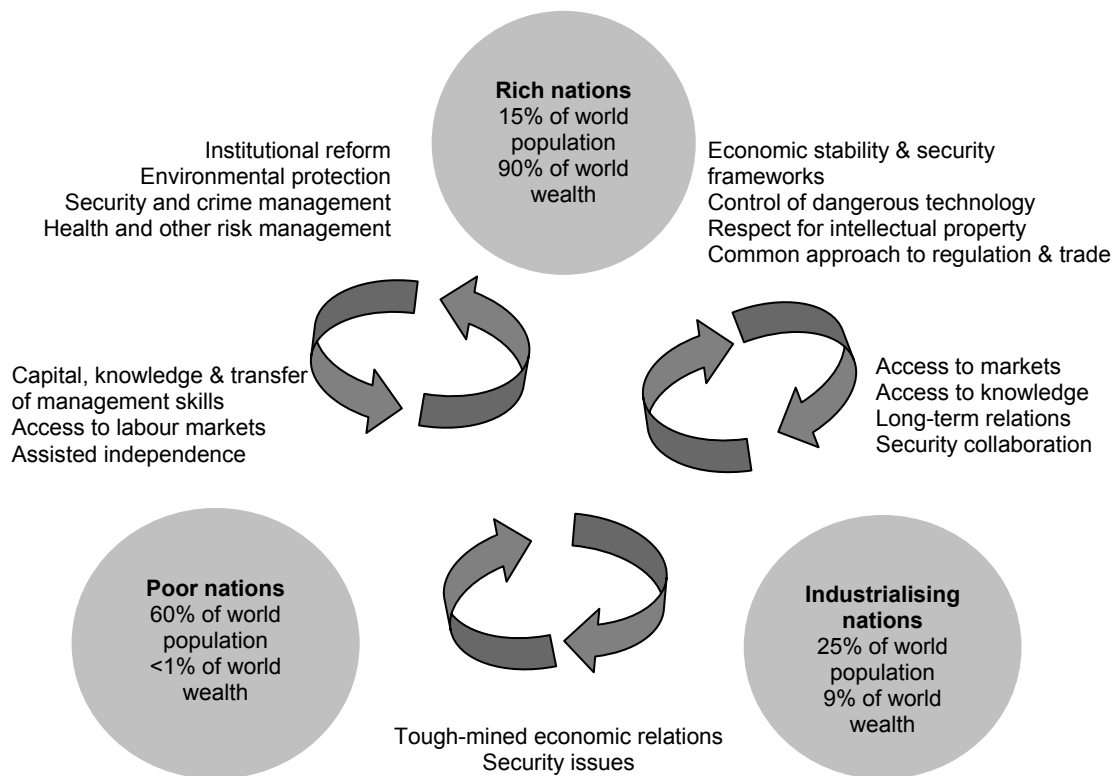
While for the moment complex activities remain in the province of the developed world, one of the effects of the worldwide ICT revolution is that it is becoming much easier for developing countries to undertake parts or all activities with more complex facets; a factor which City financial services can ill afford to ignore. In addition, there will be a continuing relocation of less complex activities to areas of the world where they can be performed at the lowest average cost of production.

3.3 Global Relations

Looking ahead, the world will continue to be faced with continuing tensions surrounding the relationships between rich and poor countries; between energy and raw material importers and producers; and between the developing nations themselves, in competition for resources and markets.

The transparency and connectivity of the world has changed the expectations of people. The presumptions of the rich western nations are likely to apply with much less certainty in the future, as poorer nations begin to industrialise and the more-recently industrialising countries aspire to the living standards enjoyed by rich nations. The evolving global web of expectations is illustrated in Figure 4.

Figure 4: Changing global relations



The issues raised by this diagram are profound. There is now a triangulation of the three major economic blocs: the rich countries, the poor countries and the industrialising countries. Each bloc has an agenda of a likely nature summarised in Figure 4 that it seeks to negotiate – both explicitly and implicitly – with the other two, based on economic aspirations and expectations, access to resources and markets, and global governance and security. The world is now less predictable and more volatile. This will create a very different economic and political environment from that which has characterised most of the twentieth century.

This is the evolving world into which the dynamics of the Indian and Chinese economies are playing an increasing part. India and China cannot easily be labelled. In macro terms they are industrialising powerhouses. Yet they also account for some 60% of the world's poor. These issues and paradoxes are examined further below.

3.4 What is Different/Similar About China and India?

India and China are two vast economic systems, both containing a number of distinct economic sub-systems and disparate regions, as a result of the diversity of social culture, geographic terrain and climate, and structure of economic activity. In India, while Hindi speakers represent 30% of the population,¹⁴ there are fourteen other official languages. In China, while Mandarin speakers are 53% of the population (in the cities the figure is two-thirds), 86% of the population also speak regional Chinese dialects.¹⁵

Within a global context, India and China are often considered in the same breath. But while there are similarities, there are also significant differences.

¹⁴ Online Computer Library Center: <http://www.oclc.org/languagesets/educational/languages/india.htm>.

¹⁵ China Daily: http://www.chinadaily.com.cn/english/doc/2004-12/26/content_403419.htm.

Similarities

The first point of similarity is that both countries are very ancient societies, with deep-rooted and complex cultural traditions that extend back for thousands of years. While the histories of both countries have been characterised by extensive international involvement, there have also been periods of relative isolation.

The politics of both modern states were forged by events in the 1930s through to the late 1940s. 1947 saw the creation of the modern state of India, following the post-independence partition of the sub-continent. India has never accepted partition, nor the partition of Kashmir, but remains largely passive in relations outside the sub-continent.

In China, 1948 marked the year of the Communist takeover of the country and the defeat by Mao Tse-tung of the nationalist forces of Chiang Kai-shek, who fled to Taiwan. China has been aggressive in Tibet (1948) and Korea (1951) and has had border clashes with India and Vietnam. It maintains its claim of sovereignty over Taiwan, and its potential for aggression is supported by the largest military machine in Asia.

In physical terms, each country occupies a vast landmass, with a population of 1.1 billion (India) and 1.3 billion (China). China's income level places it as a lower middle income country; India a low income.¹⁶ The size of the population and the rise of a middle class in both countries, however, presents large target markets for symbols of affluence.

As Figure 5 highlights, both countries have a lower rate of urbanisation than would be expected for their national income level, although this is more pronounced in India, which has encouraged people to stay in rural areas. The sheer scale of both countries masks huge internal regional differences, as a result of geographical distance, topography and way of life. In economic terms, both countries have a large agricultural sector, although this has declined steadily over recent decades, and at a faster rate in China, as shown in Figure 5. The under-development of the rural areas of both India and China can only be rectified by investment and education. Some limited success has been achieved through the local use of micro-credit in India, but greater scale is needed if economic progress beyond survival is to be achieved.

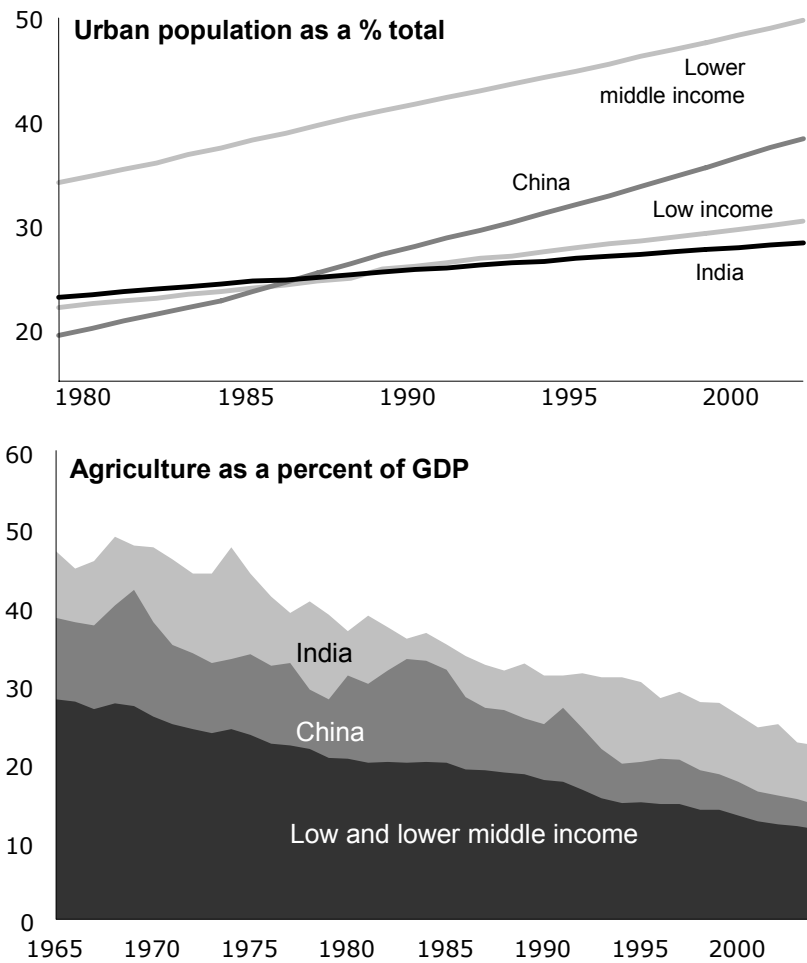
China has to date not discouraged the flow of migrant workers from the countryside to seek better fortunes in the cities. There is, however, now discussion as to whether more rural support should be put in place to reduce the rural-urban disparities,¹⁷ which could be a source of further social tension. The fact that China experienced some 87,000 riots in 2005¹⁸ underlines the need for action to improve rural life compared with that which city dwellers are reported to enjoy.

¹⁶ www.worldbank.org.

¹⁷ FT report 28 February 2006.

¹⁸ Unofficial reports from within China.

Figure 5: The move to the cities



As might be expected from the continued significant role of agriculture in India, India's manufacturing value-add as a percentage of GDP remains below the level typical for a lower or lower middle income country.¹⁹ China's level of manufacturing value-add is higher than the typical lower or middle income country, as can be seen in Figure 6.

Both countries have experienced healthy rates of economic expansion over the past two decades, with China having grown at a somewhat faster rate. While economists have cast some doubt as to the reliability of Chinese GNP statistics, the overall picture is clear and even accentuated by the recent recognition and enumeration of the size of the services sector in China.²⁰

¹⁹ For definitions of low and middle income countries, see for instance www.worldbank.org for definitions. Examples of lower middle income countries are Bulgaria and El Salvador.

²⁰ Upwards revision of Chinese GDP – China National Statistics Bureau, December 2005.

Figure 6: China focuses on manufacturing

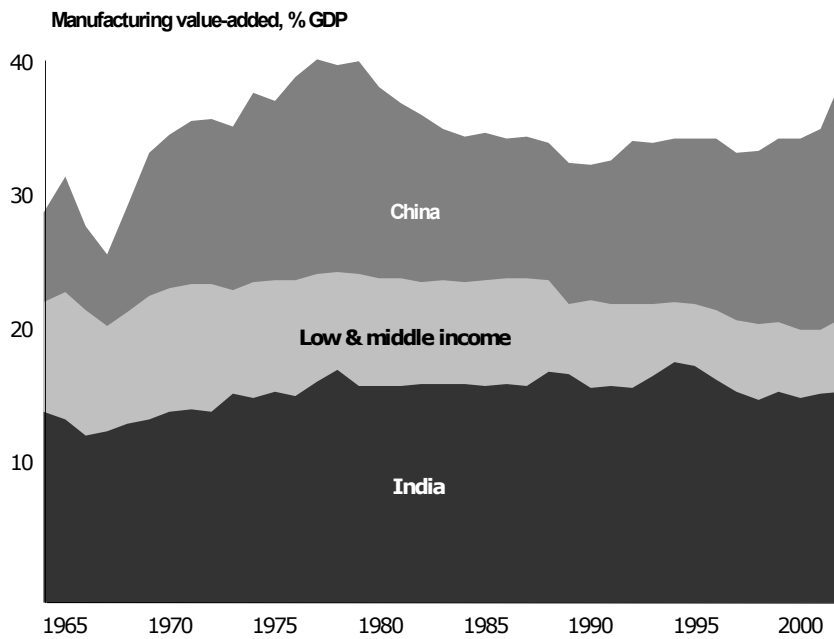
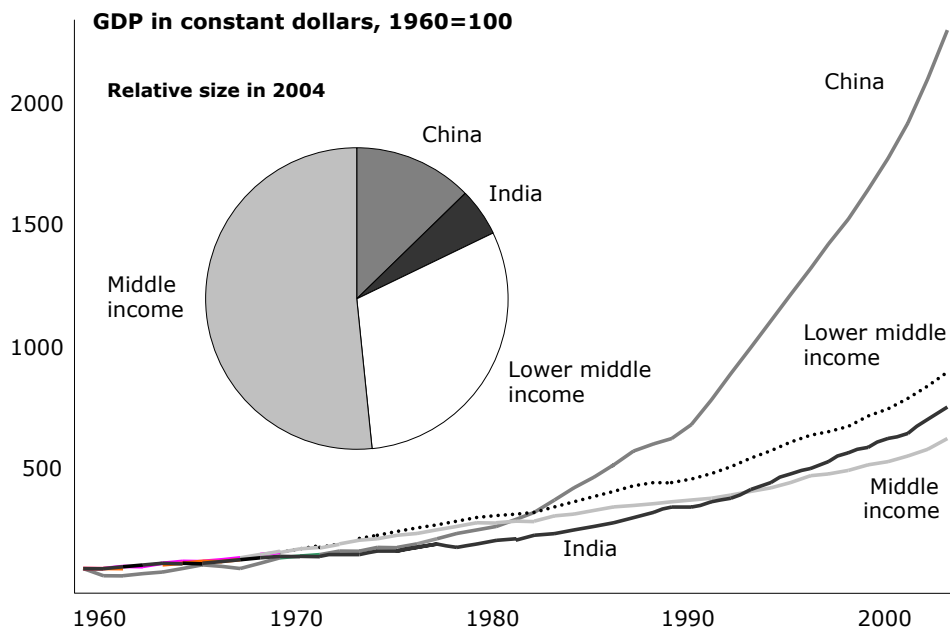


Figure 6 indicates that the share of manufacturing in China's GDP has remained stable. This needs to be viewed alongside the growth in GDP for China and India since 1975, as shown in Figure 7. The figure emphasises that the manufacturing sector in China, in absolute terms, has risen at a very rapid rate, even if stable as a share of GDP, given the estimated growth in GDP.

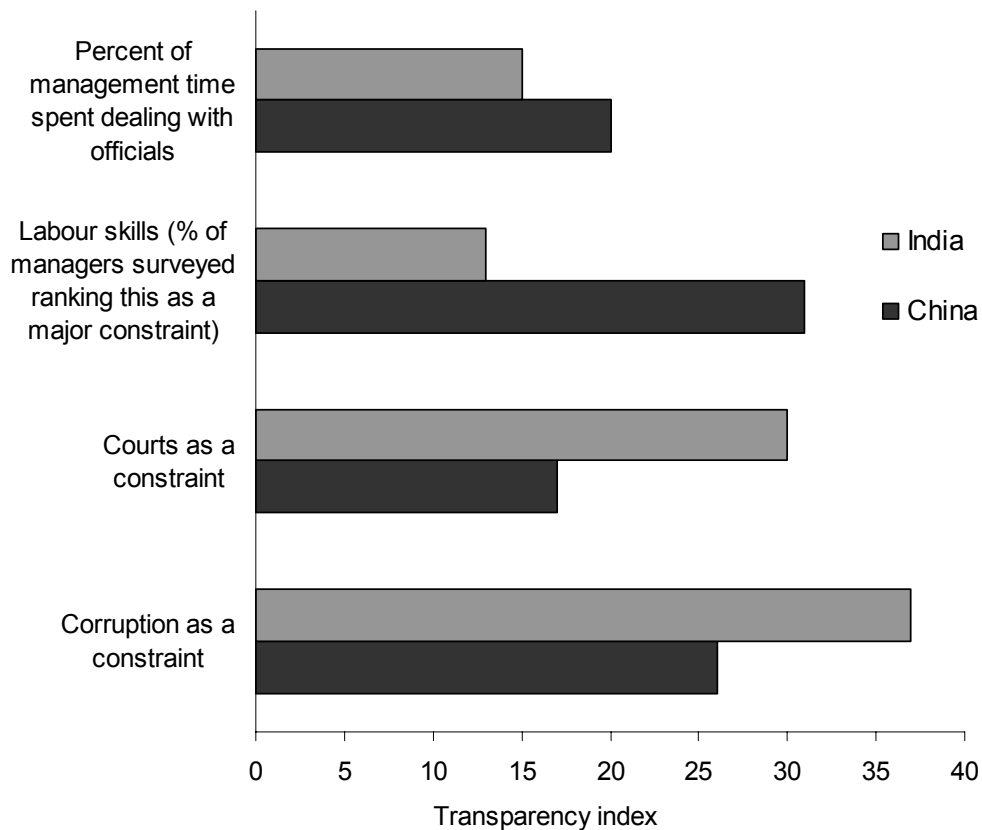
Figure 7: GDP growth for China and India



The pie-chart in Figure 7 also shows the relative size of the economies of China and India in 2004, as a share of the total for all 94 middle income and 59 lower middle income countries. It highlights that China's GDP was considerably larger than India's in 2004.

India and China both present various problems to western businesses undertaking transactions in those countries. As Figure 8 indicates, corruption is seen as one of the constraints in both countries. Similarly, managers in both countries report that they spend between 15% and 20% of their time dealing with officials. The Court system in India is also widely viewed as a problem. Further, it should be noted that labour skill shortages are highlighted by western businesses as a constraint on operations in China.

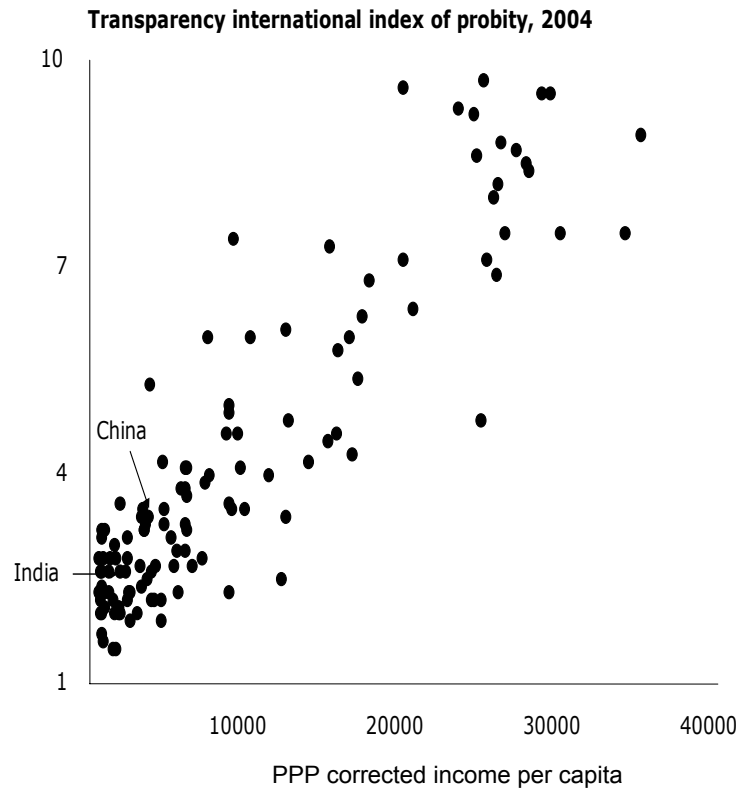
Figure 8: Doing business in India and China



The internationally respected “Transparency Index”²¹ shown in Figure 9 illustrates the connection between this index and the average income in a range of countries. India and China are on the virtual trend line, but at a relatively low level in terms of both income per capita and transparency. This suggests that unless transparency is increased in China and India, the growth enjoyed to date will be difficult to sustain.

²¹ The Transparency Index is taken from surveys on the perceived level of corruption in a country: for more information see www.transparency.ca.

Figure 9: Transparency and income



Differences

While the similarities between China and India are broad, the differences are quite deep. Fundamentally, the stark difference being that China is a communist system, whereas India is a democracy.

China's communist system has left a deep legacy of SOEs, with the state having a strong hand in major sectors of the economy. The Communist Party dominates the governance of most aspects of Chinese life. English is not widely spoken, although growing among the young.

India's economy has been basically liberal, despite there having been much state intervention in the post-war period, which is now being rolled back. In practical business terms, India is largely Anglophone commercially, with legal and governance systems akin to the UK. English is widely spoken, although literacy in general is lower in India than in China due to differences in policy and in expenditure. China has invested in universal primary education and is now turning its attention to secondary and tertiary education. India is yet to address universal primary education but does possess some world class universities.

China's one-child policy has produced a relatively ageing population, whereas India has a much younger and faster growing population profile. Further, the behaviour of the diaspora differs between India and China. Until recently the Indian diaspora has tended to invest off-shore, for example, in the Middle East rather than in India. The Chinese diaspora, including Taiwan, has been active in investing in the growth of the private sector in China.

Figure 10: China has a high rate of savings

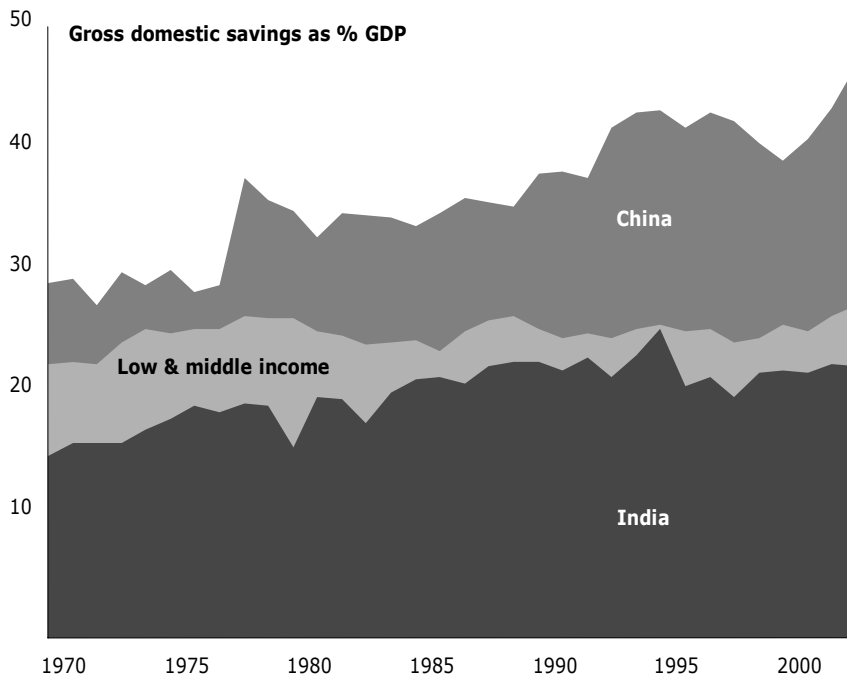
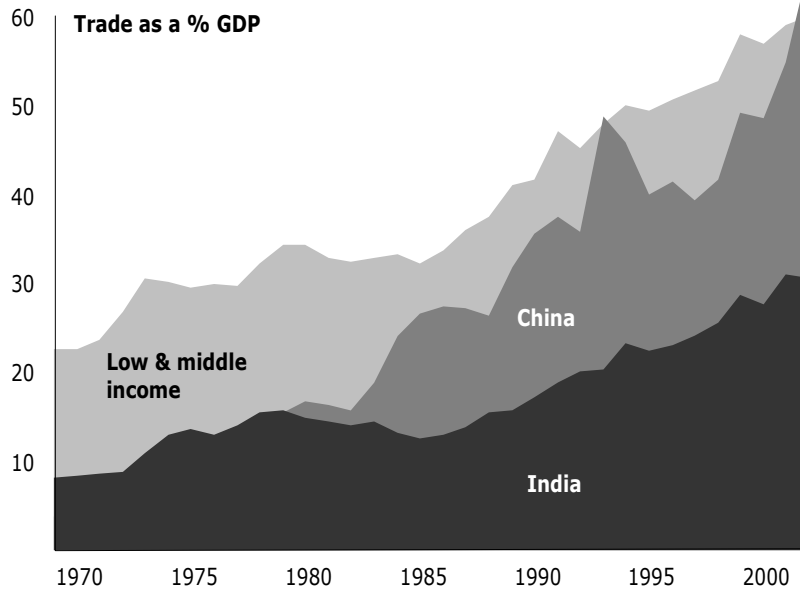


Figure 10 compares the position of the two countries as regards savings. China has a significantly higher level of domestic savings compared both to India and other countries of comparable national income.²² Similarly, China is far more trade dependent than India, as a result of its rapid manufacturing-driven export expansion over recent years, as shown in Figure 11.

Figure 11: China is more dependent on trade than India



²² *China's Pension System*, (February 2006), Deutsche Bank Research.

Banking

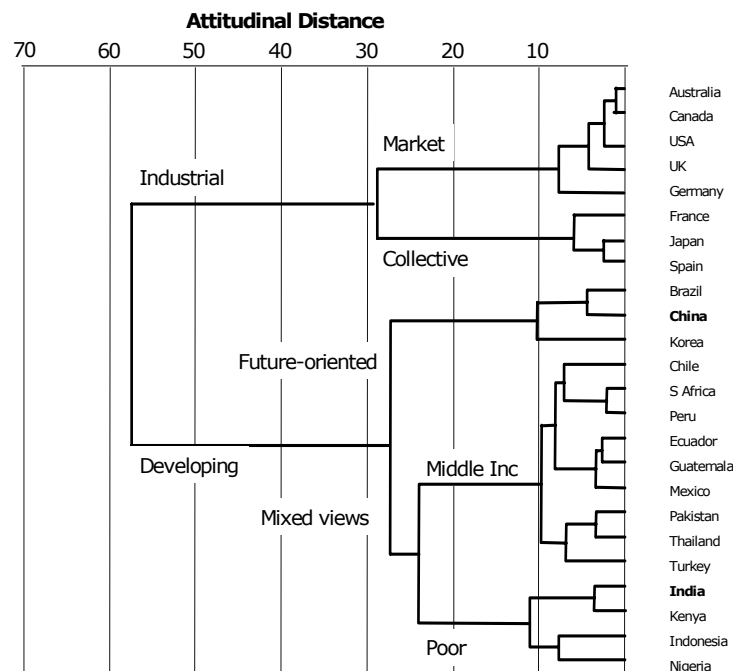
In terms of the banking sector, India has a more stable banking system. Banking dates back to 1786, when the first bank was established in India. The banks were nationalised in 1969 with more recent liberalisation since 1991 and major reform in the financial and banking sector. There continue to be public and private sector banks, co-operative banks and regional rural banks. The Reserve Bank of India (RBI) acts to regulate and act as banker to banks and government. The Industrial Development Bank of India is the tenth largest development bank in the world rankings.²³

The Chinese banking system is burdened with its links to the SOEs, which are technically bankrupt, but which continue to receive subsidisation. Although the government has taken steps to reduce the number of SOEs, which effectively have acted as a social security system, the problem is far from fully resolved. The major banks are heavily overextended by debt, and are regularly re-capitalised by the state. Major banking reform and liberalisation are overdue.

Attitudes to “progress”

Differences in history and social structures have a strong effect on economic prospects. A recent analysis has examined the value systems of a range of developed and developing countries.²⁴ The scaling is based on how far attitudes among countries vary in relation to the “distance” on a number of parameters that were assessed for each country, both in terms of objective status (income levels) and prevalent socio-political structure and psyche of the population. It has found that attitudes towards the future vary widely, as might be expected, where India’s values are very different from China’s. China is more positive about the future, India is less sure.

Figure 12: Comparing attitudes to “progress”



²³ http://finance.indiamart.com/investment_in_india.

²⁴ Conducted by The Challenge Network, based on World Bank and Pew Research data.

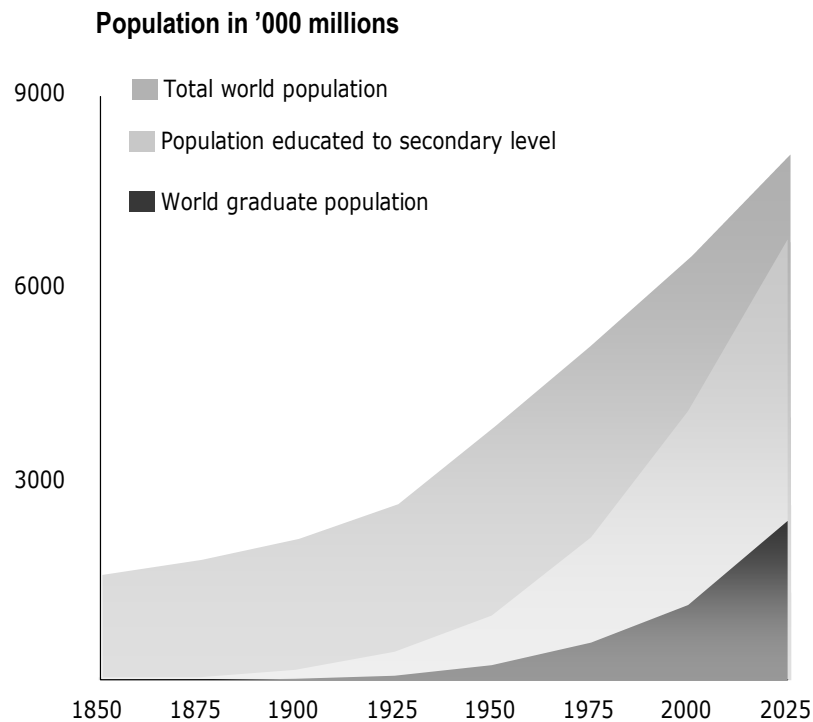
This is reflected in the different challenges in relation to energy and transportation. India has not invested in an infrastructure sufficient to deliver electricity or other forms of energy reliably to many of its people. Similarly road and rail systems remain a hurdle. Airports too are a bottleneck: for instance Bangalore’s international airport was conceived in 1993 and work started in 2005.²⁵ China on the other hand is investing massively in infrastructure, partly as a way of using unskilled labour from the land. As described in the World Bank literature, “during the past two decades, China has invested heavily in public infrastructure as part of a national poverty alleviation program”.²⁶

China also faces enormous challenges from pollution of air, water and land from coal burning, chemicals and other sources. According to the World Bank, 6 of the 10 most polluted cities in the world are in China.²⁷

Education

The two countries have taken a different approach to education. The expenditure in India is comparable – as a share of GDP – with other low and lower middle income countries, whereas China’s focus on primary education and universal literacy is funded by expenditure amounting proportionately to half that of India. Both however, spend considerably less than developed countries on education, highlighting the fact that although the number of students from China and India seem large, they represent a smaller proportion of the population than in developed countries. Of concern to some western economies such as the UK is the projected proportion of people with secondary level education by 2025, as indicated in Figure 13. Both countries – particularly India – are creating a well-educated labour force with highly trained graduates, which is in itself, is an opportunity and a threat.

Figure 13: Secondary level of education becomes the standard



²⁵ <http://www.airport-technology.com/projects/bangalore/>.

²⁶ www.worldbank.org.

²⁷ *ibid.*

4 Scenarios for India and Implications for the City

4.1 Drivers of Change

India has an immensely old and complex society. It contains rich and varied religious traditions, and extensive social and economic disparities. The Indian caste system is a highly complex matrix of hierarchies, where castes and subcastes are a product of birth, occupation and sometimes even geography. This has controlled the pace of change; has prevented the erosion of the privileges of the beneficiaries; and has weakened potential rivals to the existing social system. India has a number of tribal areas in which live people whose way of life has not changed for hundreds of years. This complexity led to the development of a planned economy based on economic autarchy, with a bureaucratic system of price controls and industrial licensing. In the past, India has also had fractious relationships with some of its neighbours. The overall result was slow economic growth and low social mobility.

Over the past decade or more, there have been steady moves in the direction of economic liberalism through dismantling much of the central control of economic and business activities in the country. This has been driven by a new generation, more technocratically minded, which has been influenced by Russia's collapse and by China's example of economic liberalisation and its evident material success. To a considerable extent, India has been overshadowed by China's success. Recent growth rates have accelerated with some estimates of 7 to 8% for 2005,²⁸ reflecting rising consumerism in India.

The country research and workshop that took place in the first stage of the project revealed two key questions, or uncertainties, that will determine the evolution of Indian society. Consequently, these have been chosen as the drivers of change and the principal building blocks for the scenarios, namely:

- Will economic liberalism accelerate or be reversed?
- Will governance remain primarily centralised or move to greater regional autonomy?

Will economic liberalism accelerate or be reversed?

Further economic liberalisation is necessary to release the economic potential of India and to ensure a sustained high rate of economic expansion. There is the risk that future Indian governments will slow down economic liberalisation if it should threaten social cohesion. Nevertheless, there is limited scope for action as India requires an annual growth in GDP in excess of 4% in order to match its high birth rate.

Will governance remain primarily centralised or move to greater regional autonomy?

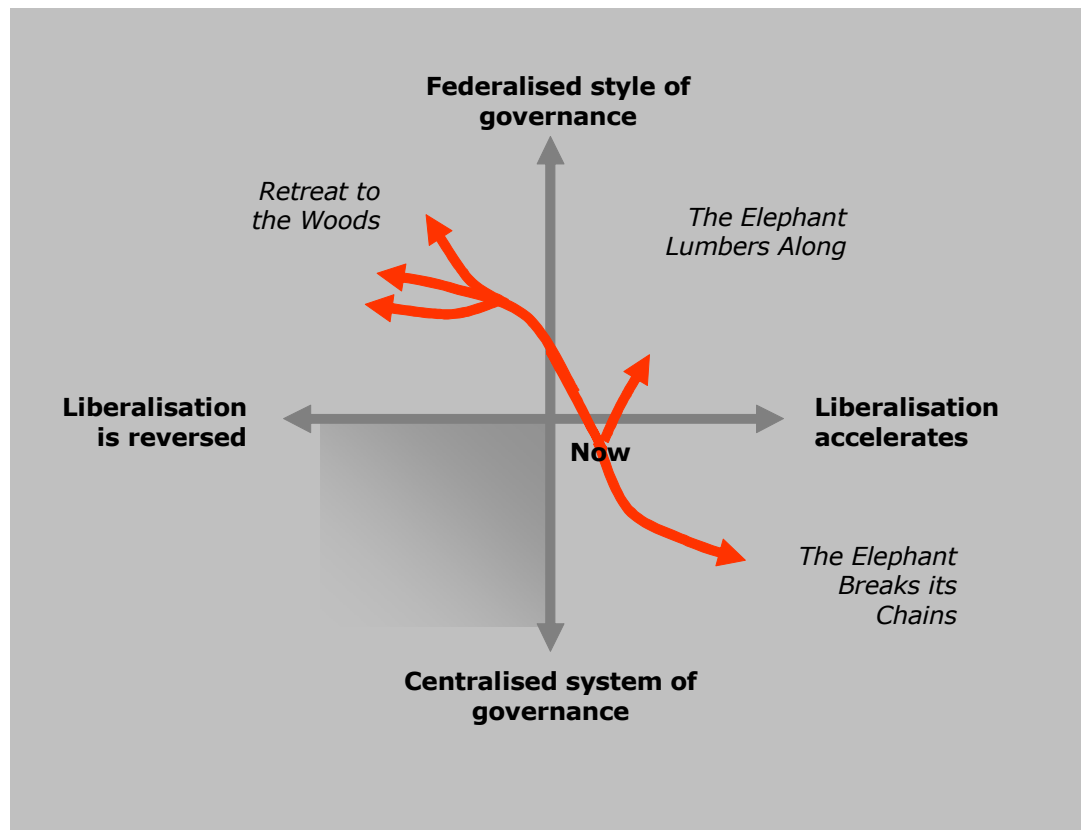
As the Indian economy develops, the capacity of a centralised system of governance to manage the complexity of economic tasks will be stretched. "Complexity management" requires more regional autonomy but this will be resisted if it is seen to be running out of control. The balance between centralisation and regional development will be crucial in India's development.

²⁸ UN Economic and Social Commission for Asia and the Pacific (ESCAP):
<http://www.thehindubusinessline.com/2005/04/27/stories/2005042701600700.htm>.

4.2 India Scenarios for 2015

The interaction of the drivers of change is shown below in Figure 14.

Figure 14: Three scenarios for India



It gives rise to three credible scenarios for India:

- A. "The Elephant Breaks Its Chains", in which economic liberalisation accelerates, and takes place alongside an increasingly centralised system of governance. This is a revolutionary scenario (in terms of accelerated change).
- B. "The Elephant Lumbers Along", in which economic liberalisation continues, and the system of governance moves towards being more federal and subsidiary. This is an evolutionary scenario.
- C. "The Elephant Retreats to the Woods", in which economic liberalisation is reversed, but combined with clear moves towards a more federal, subsidiary system of governance. The effect on the economy is a sharp slowdown in growth.

A full description of the three scenarios for India is set out in Chapter 7. The factors considered under each scenario include the domestic economy; external trade position; foreign investment and external loans; and the political situation.

This chapter brings out the key features, and considers their potential implications for the City of London financial services sector. The following table contains a summary of the timeline for each of the scenarios, highlighting the external and internal economic factors and the political situation associated with each scenario.

Three scenarios for India in 2015 – main highlights

	The Elephant Breaks its Chains (revolutionary scenario)	The Elephant Lumbers Along (evolutionary scenario)	The Elephant Retreats to the Woods (growth slows or halts scenario)
2007/08	<ul style="list-style-type: none"> - Oil price \$90 - Trade deficit 5% of GDP - Fiscal deficit 10% GDP - IMF concern over fiscal deficit: foreign capital starts to withdraw - Tensions with Pakistan & China - Government falls due to opposition to reforms - New BJP-led government on nationalist protection ticket 	<ul style="list-style-type: none"> - Oil prices settle back at \$60 - Fiscal deficit 8% of GDP - GDP growth 6.5% - Foreign investment inflows \$20bn - External relations improve, e.g. Pakistan gas pipeline to Iran - Congress government pursues moderate reforms 	<ul style="list-style-type: none"> - Oil price >\$70 - Trade deficit 4% of GDP - Fiscal deficit 9% of GDP - GDP growth 5% - Foreign investment inflows <\$8bn - Government falls due to communist opposition to reforms - New Congress-led government. Communists in opposition
2009/10	<ul style="list-style-type: none"> - Oil price \$90 - Trade deficit 3% of GDP - Fiscal deficit 11% of GDP - GDP growth falls below 4% - IMF withdraws support & foreign capital flees - Government falls due to split in BJP party - New government BJP + Congress reformists, Parliament suspended for six months 	<ul style="list-style-type: none"> - Fiscal deficit 8% of GDP - GDP growth 5.5% - Foreign investment inflows \$25bn - Free trade agreement for sub-Continent - Public sector insurance linked to foreign MNCs - Government loses election & BJP led coalition emerges - Reduces power of BJP nationalists 	<ul style="list-style-type: none"> - Oil price \$80 - Trade deficit 6% of GDP - Fiscal deficit 10% of GDP - GDP growth 3% - IMF concern & foreign capital starts to ebb - US/EU/China trade wars & protectionism - Government falls as regional allies object to reforms - BJP-led coalition "national protection"
2014/15	<ul style="list-style-type: none"> - Oil price \$60 - Trade balance in surplus - Fiscal deficit 5% of GDP - GDP growth 8-9% - IMF support, World Bank investment, FDI \$50bn. - Government completes 4 year reform programme. Parliament completes first solid year since 2010. Civil riots in northern & eastern India. Government wins landslide victory. 	<ul style="list-style-type: none"> - Fiscal deficit 8% of GDP - GDP growth 6.5% - Foreign investment inflows \$30bn. India joins ASEAN - Banks & insurance into private sector. Government loses election. Congress-led coalition keeps on with moderate reform. 	<ul style="list-style-type: none"> - Oil price >\$80 - Trade deficit reduces - Fiscal deficit 12% of GDP - GDP growth 3% - IMF & World Bank withdraw support. Foreign capital flees - Government falls. Attempts to set up BJP-Congress government fail. Elections lead to no coherent result.

4.3 The Elephant Breaks Its Chains – A Revolutionary Scenario

In this revolutionary scenario, India is confronted with a series of external threats, including increasing competitive pressures from China, high oil prices, and heightened tensions with Pakistan, together creating a growing sense of crisis. These pressures galvanise the right wing of the Congress Party and the left wing of the BJP to come together in a centrist government. The Congress-BJP partnership uses its authority and the mood of national crisis to pursue a faster pace of liberalisation, which includes accelerated privatisation, cuts to subsidies and changes to restrictive labour practices. The reforms serve to bolster investment and help in overcoming the country's long-standing infrastructure bottlenecks.

These improvements provide a dramatic boost to the traditionally under-performing manufacturing sector. Combined with continuing strong growth in services, manufacturing output helps drive economic growth to 8-9% by 2014/15. In spite of the rapid pace of growth, internal wealth disparities become sharper. In order to press ahead with the economic reforms in the face of significant popular opposition, the government becomes more authoritarian and adopts coercive responses. These centralising tendencies provoke a separatist backlash, particularly from the wealthier regions that resent having to support their poorer neighbours.

On the international stage, India aspires to the role of a Great Power and pursues strategic advantages by playing off China and the US.

Early indicators

If this scenario were developing, the following developments would be expected to occur in the short- to medium-term:

- international oil price stays at or above \$70 a barrel
- trade deficit widens to 5% of GDP and fiscal deficit reaches 10% of GDP
- inflows of foreign capital begin to dry up
- Congress Party-led government falls when main communist supporters oppose 'emergency' reforms
- general election returns another Congress-led coalition, but backed by regional parties with communists in opposition, which advances limited reforms
- Indian companies off-shoring to lower wage economies.

Opportunities for the City financial services sector

In this scenario, the major opportunities arise after 2010 as India becomes more integrated with the global economy. With a centralised system of governance, combined with accelerating liberalisation, there are likely to be widening wealth disparities. Consequently, as with the other scenarios, regional and sector knowledge and selectivity will be one of the important keys to success, along with strong local relationships. Early movers who have a basic infrastructure established are likely to be well placed to seize the rapidly developing longer-term opportunities.

(i) Investment

By 2015, as a consequence of 'political breakthrough' and accelerated liberalisation, rapid growth and higher consumer charges, India's attractiveness for FDI is strong, and the City's skills will be at a premium, especially where such investments will involve joint ventures for penetrating consumer markets. Also assisted by looser capital controls, the leading industrial conglomerates become aggressive players in global markets. They seek cheaper sources of capital on foreign markets, and develop relationships with foreign investment houses, as manufacturing gains ground

alongside the already successful and expanding domestic and international services sector. Traditional and non-traditional corporate financing requirements will consequently expand.

With accelerating liberalisation leading to the break-up of traditional state firms and monopolies, there are also likely to be more potential opportunities for foreign financial services firms to provide financing, investment, as well as advisory services related to privatisation, restructuring and merger and acquisition (M&A). Several of the leading public sector banks and insurance companies are privatised. India's savings rate increases and puts new resources at the disposal of global markets.

As Indian capital markets expand and deepen, and become more transparent, with an increase in indigenous share ownership, there will be a need for rigorous governance and accounting standards to support these developments. Economic growth coupled with the expansion of capital markets are likely to lead to new forms of mid-size financing opportunities, such as for hedge-fund like vehicles. In addition, the successfully expanding services and manufacturing sectors will lead to the formation of new business ventures and consequent opportunities for venture capital.

Within India, increasing affluence will provide a ready role for wealth management, involving the advice and utilisation of both off-shore and on-shore funds. Further, the rapid growth of foreign trade in this scenario leads to the need for more innovative ways of deploying its foreign reserves: a major opportunity for the City.

(ii) Transaction systems

In this scenario, there will be substantial growth in demand for basic financial services as the rapidly-expanding middle class looks for pensions, savings, banking mortgages and other consumer credit. A key issue will be how far this demand is met by domestic firms and how far – and rapidly – liberalisation proceeds to open up opportunities for non-Indian financial services institutions. Even where local companies take the lead, there may be considerable opportunities for City organisations to provide advisory and other support services for a fee, or in joint-venture, with respect to product and systems development, including corporate consumer credit and risk management. Expertise in the area of foreign exchange dealing will also be required, as successful Indian companies expand their international business.

(iii) Insurance

In this scenario, tariff barriers are reduced, resulting in a fierce battle for market share, with state sector enterprises cutting prices, some privatisation, and some companies going out of business. Privatisation, rationalisation and restructuring could, however, lead to opportunities for new players from abroad; possibly in joint venture with local partners. Exporters lead the demand for insurance, shipping, trade credit and other services, as Indian MNCs expand their operations. Life insurance and consumer insurance markets thrive, with the expansion of the Indian middle class.

(iv) Other

Greater economic liberalisation and growth after 2010 will provide opportunities for involvement in privatisation schemes and in initiatives that take the form of Private Finance Initiative (PFI)-type schemes, as long-standing infrastructure bottlenecks are progressively reduced. In addition, there is likely to be scope to provide expertise and facilities in the whole area of the financing of infrastructure, for which India has a growing need. India's government becomes increasingly interested in attracting foreign capital to finance the public debt.

Emerging sectors within India, such as regulation and debt management will present opportunities for financial advisory services. Convertibility of currency will be required – and is anticipated under this scenario – if capital markets are really to develop, and if investment is to be financed from a pool of local savings, which raises issues of currency volatility and the need for a sound regulatory structure. Another issue of importance will be that of long-term debt financing for pension funds, particularly in monitoring and managing changing risk profiles.

Other opportunities could arise in Indian firms seeking listings on the London Stock Exchange (LSE), provided that a favourable cost-competitive regulatory environment is maintained and also in providing a two-way linkage with the Indian diaspora. Despite expansion at home, dynamic Indian companies will be seeking expansion opportunities abroad, not only through export but also including through organic expansion and M&A abroad, with consequent financing requirements and local insurance, banking and other commercial services. The City's financial services organisations, with their global reach and knowledge, are not only well placed to provide such services and financing in the UK, but also probably in many third country territories. London's historical and cultural links with India also provide an advantageous base for attracting the European headquarters of expanding Indian MNCs.

Threats to the City financial services sector

(i) Boom/Bust

The direction outlined in this scenario will be bumpy, leading to disruption, not only within India itself, but also spilling over to cause disruption in a regional dimension. Such risks could arise not simply from a general deterioration in the economy, which ultimately forces “revolutionary” change, but could also take the form of a potential series of unpredictable boom/bust cycles. Companies engaging with India will need to manage their operations and risks accordingly, as success is likely to require deep local knowledge.

(ii) Rising wage levels

One potential consequence of a longer-term increase in the pace of growth is a rise in Indian wage levels. While this would cause problems across the board, it would have particular significance in the outsourcing/off-shoring industry, which has been a high-spot in the recent evolution of the economy. The growth of this sector could well level off as a result of loss of international competitiveness. Indian companies, however, could in turn be expected to off-shore activities to lower wage economies. It would also encourage the development of higher-skill activities, which would be commensurate with higher wage levels.

(iii) Competition

At the same time, with a successful track record in service sectors such as ICT, Indian companies in the financial services sector could be expected to build their indigenous expertise. This could be achieved by moving to supplement current activities through the development of labour-intensive support service activities further up the value chain. In addition, other local financial services could be built, competing on lower-complexity financial products and/or involving competing for higher value-added activities, such as research and analysis. This could lead to the loss of higher value roles from the City to India.

The City's response to this rests on exploiting its global expertise; on its ability to innovate continuously to develop new and higher value-added activities; and on its capacity to bring a range of specialists together to deliver a project or service. Joint

ventures or other collaboration with companies in the Indian financial services sector may be a way of managing this process so as to develop outlets for their own higher-end expertise, to compensate for possible loss of more routine activities.

4.4 The Elephant Lumbers Along – An Evolutionary Scenario

This scenario represents a playing out of the current trends in India. India consolidates its internal political stability at the expense of more aggressive economic growth. A series of coalition governments featuring either the Congress or BJP in combination with regional and special interest parties produce broadly similar policy outcomes. As a result, many of the familiar bottlenecks, shortages and infrastructure weaknesses continue to act as a drag on the economy. The services sector thus continues to be the main economic driver, particularly as it succeeds in upgrading to higher value-add activities – examples of which could be R&D in pharmaceuticals and medical services, where India is starting to make its mark internationally.

Economic liberalisation proceeds cautiously with a gradual opening up of capital markets, though foreign investment continues to be limited by capital controls and foreign ownership ceilings. Portfolio investment remains the preferred route to gaining exposure to the Indian market. The granting of greater federalism reduces separatist tendencies, and serves as a model for pursuing closer relations with smaller south Asian neighbours.

Delhi moderates its desire for Great Power status focusing instead on seeking economic benefits through improving ties with other powers such as China.

Early indicators

Early indicators that this scenario may be evolving, include:

- A general absence of major crises or shocks.
- International oil prices settle back at \$60 a barrel.
- GDP growth reaches 6.5%. Rates of inflation and interest retain their low levels and the fiscal deficit marginally closes to 8% of GDP.
- Foreign capital inflows (portfolio and direct) reach \$20 billion.
- The Congress Party-led coalition government is able to pursue moderate measures of economic reform as its communist ‘supporters’ reduce their opposition to all privatisation of the public sector and subsidy curtailment.
- Relations with neighbouring states improve, especially in matters of trade where India and Pakistan sign agreements for a joint gas pipeline to Iran.

Opportunities for the City financial services sector

This scenario envisages continuing current trends of liberalisation, but combined with a federal, subsidiary style of governance. The pace of change is steady rather than rapid, with internal stability coming at the expense of economic growth. Risks however, are consequently less pronounced than in the “revolutionary” scenario. Wealth is projected to double in 12 years, so providing various opportunities for financial services, especially in lightly regulated service sectors. Due to the nature and pattern of development under this scenario, with persistent bottlenecks and variable regional performance, careful selectivity of regional centres and sectors for investment and provision of services is again important.

(i) Investment

In this scenario, by 2015, some restrictions remain on foreign investment, and while foreign investors remain nervous at the potential consequences of the fiscal deficit, foreign investment nevertheless does increase. The Indian Stock Exchange

becomes more transparent and the ceiling for foreign investment in many industries is lifted. Foreign investors, however, are subject to special regulatory arrangements, and the opportunities for FDI and venture capital are primarily limited to media/film, knowledge-based industries – obvious examples of which could be IT and pharmaceuticals, and infrastructure. Joint-ventures and other forms of collaboration with Indian financial services companies may be necessary as a means of containing market entry risk, by providing access to local know-how.

The Reserve Bank runs a tight regulatory framework but the major Indian MNCs manage to buy foreign assets and take on foreign debt. Indeed, steady rather than rapid growth at home, with services proving to be the main engine of that growth, drives increasing numbers of MNCs to take export or local production initiatives in overseas markets, albeit with some difficulty. This is achieved through organic growth or acquisition and thus provides a variety of financial services, advisory and capital-raising opportunities for City financial services companies with their detailed knowledge of overseas markets. Equally several foreign MNCs widen their sphere of operations in India in order to integrate Indian production into global networks.

Foreign reserves grow steadily and the drain on them to pay for imports is less than in *The Elephant Breaks its Chains*. Controls on the rupee capital account continue to limit possibilities for drawing Indian savings into the global economy on a large scale. Specific opportunities for managing the international transactions of Indian conglomerates and government foreign exchange reserves steadily increase.

While at a slower pace than in *The Elephant Breaks its Chains* scenario, *The Elephant Lumbers Along* does anticipate continued growth and wealth accumulation among the Indian middle classes and entrepreneurs. At the same time, the pace of liberalisation constrains the speed and extent to which indigenous financial services and products develop. Consequently, there are likely to be opportunities in offshore investment and wealth management for Indian entrepreneurs and savers, with London seen as a secure offshore home for Indian savings. This is a perception that could no doubt be increased with careful nurturing of links with the Indian diaspora, particularly given historical links between India and the UK and the advantages of similarities in commercial and legal systems, and language.

(ii) Insurance

In this scenario, opportunities arise for helping MNC's as they expand globally, using the City's bundles of services and providing potential to sell various commercial insurance products and services. There is also increasing demand from the growing, wealthy middle class, including the return of non-resident Indians.

(iii) Transaction systems

The expanding middle class, coupled with the return to India of larger numbers of non-resident Indians (bringing skills and capital from abroad), offers a big market and a big incentive, to establish and develop a local presence in retail financial services such as pensions, credit, savings, investment banking as well as insurance. The public sector financial institutions, continue to play a significant role alongside private sector banks, insurers and pension funds. Opportunities exist for foreign financial institutions to participate in joint-schemes with local organisations to provide services and more sophisticated products in areas such as management of pension funds.

(iv) Other

Other potentially fruitful areas are project finance and also provision of support (e.g. PFI) to the private sector. The commercial attractiveness and availability of such opportunities, however, are likely to vary regionally. In particular, the scenario anticipates liberalisation in the power sector; longer-term development of modern toll-roads linking the major cities; and the development of metro transport systems in the latter, but elsewhere infrastructure provision remains basic.

The growing educated workforce in India can provide financial services software development and higher-value back-office services. This may offer further scope for cost reduction (rather than job losses) by City financial services firms, if at the same time they seize new business opportunities in India and continue to move up the value chain with innovative products and services.

Threats to the City financial services sector

In this scenario specifically, India continues to play a role in off-shoring as an integral part of the City's activities. There is little boom or bust, and there is less longer-term pressure on wage levels than in *The Elephant Breaks its Chains*. In the detailed descriptor in Part II, growth under this scenario is insufficient to resolve all India's social and economic constraints and difficulties, and there will be marked differences in sector and regional performance with risks of social strife. Recognition of these differences, together with careful selectivity and thorough risk assessment will be crucial to success. There may be greater risks in index tracking than in targeted investment. Data and security issues may arise for the financial services sector, but these might not be as serious as in *The Elephant Retreat to the Woods*.

There is a risk that if London fails to engage positively with the Indian diaspora, others (such as the US) might do so successfully, to London's cost. The US is already boosting US university links with Indian students, and has recently increased its diplomatic offensive. Failure by the UK to court India may result in a loss of opportunity.

(i) Competition

Could India present a competitive threat in this scenario? India is producing a large number of highly educated citizens, who have demonstrable presence in the financial sector. The threat to the City would be in failing to seize the financial services business opportunities offered by India. This would create a vacuum filled indigenously or by other financial centres – existing or emerging – while at the same time losing the edge in developing innovative financial products. While this is less of a threat in this scenario, the response is as in *The Elephant Breaks its Chains*.

4.5 The Elephant Retreats to the Woods – It All Goes Wrong

Under this scenario, India suffers as the global economy undergoes major disturbances, including an extended period of high oil prices, recessions in larger economies, and a retreat into protectionism by the US and the EU. India experiences these traumas through a withdrawal of foreign capital, worsening trade and fiscal deficits, and depreciation in the rupee. The economic turmoil is reflected and amplified by increasing fractiousness, populism and corruption in the country's politics.

As the formal institutions of the state are weakened, effective authority migrates to local political bosses. While pockets of growth remain, particularly in services, many activities move to the black market and illegal channels of exchange proliferate. Increased middle class emigration takes high quality Indian skills out of the country, further damaging India's competitiveness. Intensifying competition for declining

opportunities to work drives down real wages and promotes more open forms of exploitation, including the resurgence of child- and bonded-labour. The Indian economy is less able to cope with the vagaries of the monsoon, leading to the return of famine in some parts.

Early Indicators

The early indicators that might suggest that this scenario is developing could include the following:

- International oil prices stay above \$70 a barrel.
- Trade deficit widens to 4% of GDP and fiscal deficit reaches 9% of GDP.
- GDP growth declines to 5% following a poor monsoon.
- Inflows of foreign capital fall below \$8 billion.
- Congress Party-led coalition government falls when main communist supporters oppose 'emergency' reforms.
- General election returns another Congress-led coalition, but backed by regional parties with communists in opposition, attempting to press ahead with reforms. The reforms, however, are too tepid to meet deteriorating international conditions.

Opportunities for the City financial services sector

This scenario postulates a reversal of liberalisation, combined with a federal, subsidiary style of governance, producing a difficult business climate within India. While there may be opportunities for City firms within India, these are increasingly likely to be of a niche nature. Indeed, increasing regional fragmentation, social and political unrest, deteriorating infrastructure and a growing informal economy underline the critical importance of careful selectivity in region, sector and company/customer segment.

(i) Investment

A consequence of India's condition might be that Indian MNCs and entrepreneurs focus even more strongly outside India, giving scope for an important role for City institutions in raising capital and also providing a variety of support services. Under this scenario, such companies would not necessarily cease domestic investment, but developing links to provide services internationally could lead to opportunities to support those companies and entrepreneurs in India itself. The City would also likely be seen as a safe haven for Indian funds.

There would probably still be selective investment opportunities in knowledge-based new industries and in services, aimed at the middle-class in specific regions or high growth pockets of the country. Again, a large premium would accrue to those having an in-depth know-how of Indian sectors, regions and people.

Other opportunities could exist in private banking and wealth management, with Indian middle class savings being channelled into overseas investments and funds. Finally, there could be some limited opportunities for providing project finance in the more successful Indian states.

(ii) Transaction systems and insurance

In this scenario, foreign companies that had established a presence would be at risk from local sentiment. One way of providing some protection from such risks would be through operating in joint-venture, or similar arrangement, as the back-office partner providing the product, service and systems expertise – perhaps in part on a fee basis – with an Indian partner who has a strong local presence and brand.

(iii) Other

In this case, India's woes might become a recruitment opportunity for the City, as a result of an exodus of high-quality staff from India. This would not necessarily detract from India's attractiveness as a location for call centres and back-office processing, which could increase along with a continuing requirement for development of financial services software. Under this scenario however, risk surrounding data integrity and related issues could increase. In that event, a greater level of hands-on management and focus on security systems would be paramount.

There might later be opportunities in bank restructuring and private equity, particularly if the need for regulatory and legal systems, similar to those used in the City, eventually comes to the fore.

Threats to the City financial services sector

(i) Internal instability and restructuring

The major threats seen in this outlook emerge mainly from internal instability. For example, data security and/or identity threat increases if the social fabric crumbles. More generally, a weak national government could lead to internal unrest/disruption, which could also destabilise the Southern Asia region. The problems of doing business in India will increase.

Domestic funding costs could rise, non-performing loans could increase, together threatening bank balance sheets, forcing controls and government financial intervention, defaults and/or mergers and restructuring. This could even result in the need for foreign assistance and longer-term sales to foreign buyers. Equity-based international investment would suffer.

(ii) Wage levels

In this scenario, the rupee declines in value and inflation increases. Exchange controls become progressively draconian. Individuals would withdraw savings from formal financial sector institutions and shift their resources abroad, for instance to Dubai, or into land or gold. The strong presence of the Indian population and business community in Dubai could reinforce its attraction for Indians. (It should also be noted, in this context, that Muslims constitute over 13% of India's population, making them a potentially attractive target for Islamic banking services.) This could reinforce the opportunities, referred to above, for the City to provide offshore private banking and wealth management services.

(iii) International stability

Internal instability might threaten to bring about a 'dollarisation' of the traded economy. In any event, MNCs operating in India may require greater assistance in transferring money in and out of the country. For City firms, there could be a threat that international investors are unable to move funds, leaving them with stranded assets. Equity-based (international investors) business could suffer.

(iv) Competition

This is less of a challenge in this scenario than in others. Continued lack of investment, energy shortages and other infrastructure weaknesses, together with possible IT continuity and security problems all act to constrain the further development of India's offshore capability.

4.6 Which Scenario Is Most Likely?

The Elephant Breaks its Chains – the essence of Indian society is for consensus and therefore it is difficult to see “revolutionary” change. In the longer term beyond 2015, the additive effect of incremental change as in *The Elephant Lumbers Along* could amount to the extensive liberalisation described in this scenario.

The Elephant Lumbers Along – this is “business as usual”, and given the historic relative stability of India, could be considered as the scenario with the highest overall probability of occurring. In this scenario it is important to understand the existing predictors of change, such as the Indian government’s ambitious targets for growth and development and the reduction of poverty.²⁹

The Elephant Retreats to the Woods – was thought by workshop participants to be unlikely and less plausible than the negative scenario for China (see Chapter 5).

4.7 Opportunities and Threats Across All Scenarios

It is essential, in any discussion of India, to emphasise the cultural imperative of developing trust over an extended period, and therefore to take a long-term view.

With this caveat, the specific opportunities across all scenarios include:

- Capital markets and financing (debt and equity, project – but different aspects in each scenario).
- Wealth management (for individuals, particularly outside India).
- Working with Indian MNCs as they expand globally.
- Consultancy, advisory and regulatory services.
- Benefiting from back office, IT and call centre services.

The potential threats common to all scenarios include those arising from extensive off-shoring. These are often discussed under two main headings – loss of control in the supply chain and IT systems, and the more long-term threats arising from the development of competitive capability. The first is encountered by more formally specified interfaces between systems, while countering competition will need to be based on the City’s strengths: mastery of complexity and global reach.

It is worth emphasising that in two of the three scenarios – *The Elephant Breaks Its Chains* and *The Elephant Lumbers Along* – the opportunities for financial services are very positive. This is driven by the growth and sophistication of the middle class household economy, which will provide scope for provision of higher quality services in pensions, savings, banking, mortgages and other credit services. In *The Elephant Breaks its Chains*, the international financial services industry becomes an important conduit for middle class savings.

In addition, foreign financial services companies can provide expertise in accessing international capital markets to Indian conglomerates and government, including the management of reserves in the latter case. In *The Elephant Lumbers Along*, there are more constraints on the speed and extent to which foreign financial services can increase their market share at the expense of Indian public sector financial institutions. Scope will still be offered through joint-venture arrangements with the public sector.

²⁹ www.undp.org.in/ihdg.htm.

The Islamic banking sector, though still relatively small, is growing fast – making London the largest centre for Islamic finance outside the Muslim world. There is currently much development and innovation taking place in the City, and this area represents a considerable opportunity for the City to develop its position as a centre for Islamic banking. There is not only scope to develop Islamic financial products and services for the Muslim population of India, but also for the Indian population in such centres as Dubai.

Both scenarios foresee the evolution of Indian business – and government – away from the margins of the global financial services sector and towards a closer integration into the world economy. The faster pace of opportunity in *The Elephant Breaks its Chains* brings increasing engagement with international capital markets, which could result in a greater risk of instability arising from external volatility than would be the case in *The Elephant Lumbers Along*.

Overall, we found that India represented a good balance of stability and growth in the long-term.

5 Scenarios for China and Implications for the City

5.1 Drivers of Change

The China workshop held in Stage 1 of the project concluded that the answers to three key questions will largely determine the future direction in which China's society, will evolve:

- How long can China's rapid economic growth persist?
- Can China cope with the complexity it is creating?
- How will China interact with the rest of the world?

How long can China's rapid economic growth persist?

Over the past 10 years, China's rate of economic growth has averaged 8%-10% per year (see Figure 7). The rate at which growth continues will depend on factor inputs, institutional adequacy; and external forces.

In terms of factor inputs, China currently has a fast growing labour force, which is increasingly better educated and benefiting from the country's heavy investments in basic education and in research and development. This has been reflected in an increasing quality of the labour force and of total factor productivity, which looks set to continue to provide China with an excellent platform for strong economic growth. There is some risk of wages being bid up as demand for labour increases, but this is more likely in the higher-skilled end of the market. There are however, other factor inputs that are more problematical in terms of enabling further strong growth.

China is becoming a vast consumer of energy, reflected not least in its impact on the world oil market and world oil price. Chinese energy consumption is projected to double over the next 10-15 years, of which more than 75% will come from coal.³⁰ Car ownership is relatively quite low compared to national income, but this looks set to take off in the coming years. In addition, demand for mineral raw materials as key factor inputs required to propel China's growth, will have a significant impact on world commodity markets.

There is consequently a significant risk of international antagonism and backlash, particularly if China's rapid growth destabilises export and commodity markets, and leads to climate-change related tensions. Any retaliation against China could dampen growth rates and cause internal political tensions, since economic growth of 8% per annum is generally regarded as the minimum necessary to absorb China's labour force, as people leave the land and SOEs and migrate to the cities.³¹ Balancing these various strains will require an increased sophistication in the way China copes with complexity.

Can China cope with the complexity it is creating?

To answer this question requires an examination of the likely degree of cohesion that will prevail in Chinese society at large. Cohesion comes from four sources of legitimacy: the elite, social, ideological, and institutional.

In terms of the elite, there is a relatively united leadership at the top, with fewer of the strains seen in some previous regimes. This should be a positive factor if it can be maintained in the face of internal pressures for change.

³⁰ <http://www.energybulletin.net/1252.html>.

³¹ www.fpri.org/orbis/4802/dreyer.limitschinagrowth.pdf.

In terms of social cohesion, the tendencies towards control and stifling of dissent are potentially destabilising for China, as the attempts to police the internet have shown.³² Social stability will depend on maintaining economic growth and sharing its fruits equitably.

The traditional intensely political ideology of the past has been superseded by pragmatism and consumerism. This will succeed provided that the public believes that it is to their material advantage, and that the Chinese Communist Party (CCP) is prepared to support the ideology by its actions.

This leads to the fourth source of legitimacy, the institutional framework. It is the CCP – not the state or the nation – that is the focus. Vigour and vitality of the CCP defines the strength of institutions. On this score there are grounds for concern in relation to the lack of connection, not only between the people and the CCP, but also other institutions such as the People's Congress, the Courts, and the financial institutions. There is also concern at the corruption at all levels of the Party. In addition, it remains to be seen whether the highly centralist nature of the CCP can cope with the inevitable requirement for more decentralisation and recognition of minorities if China's economic aspirations are to be achieved.

Overall China seems likely to cope with the increasing level of economic complexity arising from its rapid development. The issue of managing social complexity is not yet proven and is a source of uncertainty. This is the factor that might prove pivotal in determining China's evolution. A contributing factor is also undoubtedly China's ageing population and its compulsion to build a dominant position in Asia before it is overtaken by demographic imbalance.

How will China interact with the rest of the world?

It was noted earlier that China's rapid growth is bringing new challenges in its relations with the outside world. Its export drive risks retaliation through a variety of potential trade barriers. Its need for increasing amounts of raw material and energy supplies exposes it to the charge of destabilising world markets and increasing price levels or causing temporary shortages elsewhere – an outcome that could reinforce the retaliatory instincts of the rest of the world.

China's drive to open up new markets and sources of cheaper materials in Africa and elsewhere is likely to meet increasing resistance from the developed world. Relations with Japan are tense and complicated by its protection of North Korea and by territorial claims to off-shore islands. South Korea, Vietnam and the Philippines remain wary of Chinese hegemonic ambitions. There may be an outside risk of China seeking to annex the Russian Far East if it is under pressure, since the area is sparsely populated by Asian people but rich in minerals.

Alternatively, the outside world could see China as a land of commercial opportunity, with a billion consumers, a dynamic environment, scope for access to new technologies and partners. Then it would welcome China as a vital force in the world economy.

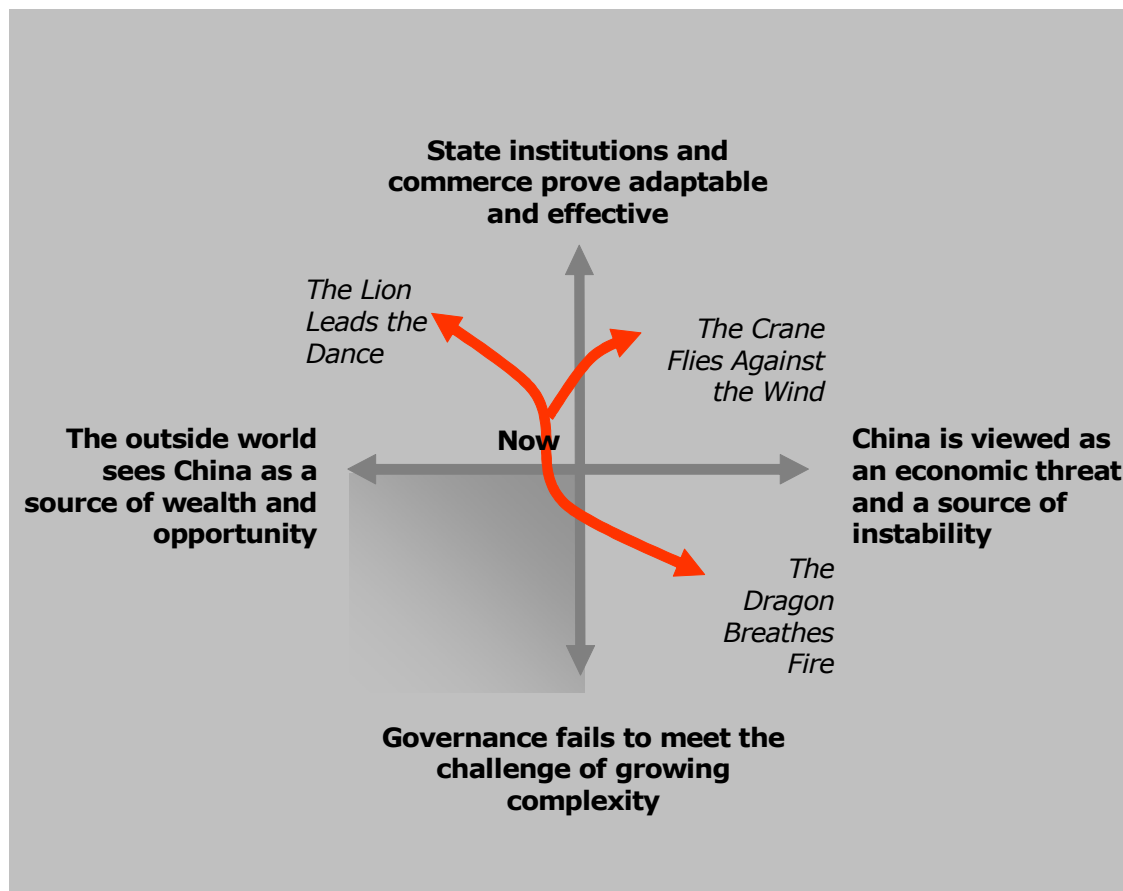
5.2 China Scenarios for 2015

Following careful consideration of these issues in the China scenario-building workshop, two drivers of change in China have been selected to form the axes of the scenarios. These are whether or not state institutions prove adaptable and effective,

³² British TV Channel 4.

and whether China will be viewed externally as a threat or an opportunity. The interaction of these dimensions is shown in Figure 15.

Figure 15: Three scenarios for China



This gives rise to three credible scenarios for China:

- A. "The Crane Flies Against the Wind", in which state institutions and commerce prove adaptable and effective, but the outside world sees China as an economic threat. This is a revolutionary scenario (in terms of accelerated change).
- B. "The Lion Leads the Dance", in which state institutions and commerce prove adaptable and effective, and the outside world sees China as a source of wealth and opportunity. This is an evolutionary scenario.
- C. "The Dragon Breathes Fire", in which Chinese governance fails to meet the challenge of growing complexity, and the outside world sees China as an economic threat and a source of instability. This is a scenario in which there is a long-term reduction in the growth of China's economy.

The three scenarios are each described in depth in Chapter 8. The factors considered under each scenario include the domestic economy, external trade position, foreign investment and external loans, and the political situation. This chapter explores the key features, together with their potential implications for the City of London financial services sector. The following table contains a summary timeline for the three scenarios.

Three scenarios for China in 2015 – main highlights

	The Crane Flies Against the Wind (revolutionary scenario)	The Lion Leads the Dance (evolutionary scenario)	The Dragon Breathes Fire (growth slows or halts scenario)
2006-10	<ul style="list-style-type: none"> - Securities market reforms (to 2007) - Beijing Olympics (2008) - Renminbi becomes fully convertible (2008) - Many SOEs partially privatised - Auto exports start hitting EU & US dealers (by 2010) - US raises barriers against China imports 	<ul style="list-style-type: none"> - Banking reforms to prepare for market opening (to 2007) - Beijing Olympics (2008) - Renminbi continues effective dollar peg - Minmetals acquires leading Australian mining company - GDP growth starts to moderate from previous high levels - Kuomintang (KMT) party wins Taiwanese elections - Government loosens control on Internet traffic - Airbus starts manufacturing A350 parts in China 	<ul style="list-style-type: none"> - Failure of Six Party talks on North Korea - Beijing Olympics (2008) - Property market collapses (2009) - GDP growth rate falls sharply - Widespread political protests against CCP (to 2013) - Banking crisis (to 2010)
2011-15	<ul style="list-style-type: none"> - Trade frictions mount. EU imposes quotas - GDP growth (2012 to 2015) 6-7% - ASEAN+3 free trade fully implemented - China signs up to Kyoto II - US refuses trade promotion authority to new government - Renminbi as peg of regional currencies - Wang Huning appointed as President to the People's Republic of China (PRC) - Large scale riots start (to 2014) - Local elections start across China (2014) 	<ul style="list-style-type: none"> - Numerous Chinese companies seek listings on NYSE and LSE - GDP growth 5-6% - China supplies nearly 30% of all ICT exports - New sources of oil from Chinese foreign investments - Oil imports reach 75% of Chinese oil consumption - Communist Party re-appoints Hu Jintao (2013) 	<ul style="list-style-type: none"> - GDP growth drops below 3% then settles to 4-5% by 2015 - Japan revises Article 9 of its constitution (2011) - Communist Party appoints President with military credibility (2012) - China imports oil via new Venezuela-Columbia pipeline (2013)

5.3 The Crane Flies Against the Wind – A Revolutionary Scenario

Under this scenario, the economic relationship between China and the OECD undergoes a transformation as Chinese businesses begin competing in higher value-added activities. As an increasing range of industries, such as automobiles, becomes exposed to Chinese competition, the US and the EU succumb to protectionist pressures.

While Western countries turn increasingly fearful of China's economic ascendance, China becomes the standard-bearer for free-market capitalism. The success of Chinese entrepreneurs, engineers and professionals is reflected in rising consumerism. The Chinese economy becomes more balanced between exports and consumption, thereby lessening the domestic impact of the trade restrictions. Rising Chinese demand draws in exports from neighbouring economies. China therefore, becomes the centre of a regional trading hub and the renminbi becomes the dominant currency in the region.

With capital account liberalisation, the lifting of exchange controls, and securities market reforms, Shanghai becomes a major regional financial centre, displacing Hong Kong and rivalling other major centres such as London. While the middle class reaps the benefits of these developments, the urban and rural poor become increasingly discontent. Further, China displaces the US as the dominant power in the region, and gains international prestige by playing a constructive role in international relations.

Early indicators

Indicators that this scenario might be evolving, include:

- Effective reforms of the Chinese securities markets.
- Acrimonious disputes with the EU and US over various trade issues.
- Heavy overseas investment by China to acquire commodity resource producers.
- Appearance of more 'own brand' designed/built China goods on world markets (i.e. a move from assembly to complete production).
- More Chinese takeovers of major Western companies.
- China making inroads into international services – and not just markets for manufactures.
- Retaliatory imposition of Chinese controls on Western firms doing business in China.

Opportunities for the City financial services sector

The major opportunities in this scenario arise from the privatisation of the SOEs and in services provision to the increasingly numerous, wealthy and educated Chinese middle class. Areas such as pensions, savings and credit, where soaring consumer demand and concentration of wealth among that middle class – with its very high savings rate – generate a huge increase in demand for a wide range of financial services. Liberalisation of markets, combined with strong Chinese growth, may lead to more joint-venture opportunities in these and other areas in the short- to medium-term, but there are risks of longer-term difficulties arising under this scenario, particularly where significant assets have been committed locally.

(i) Investment

Under *The Crane Flies Against the Wind*, early financial reforms result in the Shanghai stock market beginning to perform as a source of finance for the corporate sector. Initial public offerings (IPOs) as well as secondary offerings begin to pick-up

significantly, drawing large foreign portfolio inflows as restrictions on the level of the latter are progressively lifted and the renminbi is allowed to float freely.

This scenario would also provide 'early' opportunities for financial services and investment support to expanding Chinese MNCs overseas, which are seeking new sources of resource and materials supply and new markets for increasing levels of Chinese designed and branded products. There are further opportunities as Chinese MNCs shift some production activities to other parts of Asia in an attempt to by-pass increasing trade restrictions. These financial services may encompass capital raising, M&A advisory and other services, export finance, and consumer credit packages in third markets (e.g. finance for consumers purchasing Chinese produced cars). This could continue longer-term outside China, although mounting protectionism and political tensions could act to undermine such activity.

In addition, early liberalisation of financial markets could initially be good for foreign investors who gain increased access to China's securities markets. This would provide City financial services organisations with opportunities to support growth in Chinese IPOs and M&A.

The City would be seen as a safe haven for Chinese investors and for Chinese savings, with Chinese households benefiting, as a result of financial reform and the opening of the capital account, from the opportunity to diversify their portfolios by investing abroad. Despite the growth of Shanghai as an increasingly vibrant regional financial centre, the City, with its critical mass and track record of financial innovation, could offer greater expertise than domestic Chinese financial services companies.

(ii) Insurance

In this scenario, barriers to trade continue to be lifted outside the cities, and British insurers are potentially well placed to exploit the resulting opportunities. The non-life insurance business in China finds it difficult to attract capital, as the very high rate of Chinese savings is mostly directed at life insurance, which leaves a shortage of capital for non-life business: an opportunity for the City.

A particular opportunity likely to arise is in export-credit risk analysis and insurance, as Chinese companies become increasingly active on the international stage, move into new geographical product markets and tap new overseas supply sources. This exposes them to new and unfamiliar geopolitical and other business risks.

Although China signs up to WTO Commitments, the implementation, however, is not transparent. The rule of law, intellectual property (IP) issues, and bureaucracy, all present hurdles to successful foreign investment in insurance – and in other areas.

(iii) Transaction systems

The City's credentials in integrity and impartiality would fit the role of "honest broker" between China and the West in Chinese export finance/distribution, also embracing the insurance sector (export credits).

Pensions are seen as an important area, given the retreat of the state from universal lifetime economic and social provision, the ageing population, the growing wealth of the entrepreneurial classes and the rising disposable incomes of the urban middle classes. While China's long-term ageing population implies that it is 'too late for some' on the pensions front, there will still be very large absolute numbers of Chinese for whom pension saving is a viable and realistic option.

(iv) Other

The City has vast expertise to offer in the field of institutional development, covering regulation and the effective operation of markets; a central tool in privatisations. Precisely how fast and in what direction the regulatory and legal structure evolves remains uncertain. There would be clear advantages were Western financial institutions and regulatory authorities to be in a position to influence the evolution of China's regulatory systems.

While the scenario anticipates increasing trade barriers in goods, this might have less effect on high margin financial services. Those targeted at Chinese MNCs would likely be less affected.

Other areas to explore would be commodities trading, foreign exchange trading, major project financing (e.g. in the environmental control area) and working with the Chinese government to develop bond markets. Liberalisation of the exchange rate regime leads to a rapid development of local wholesale capital markets, centred on the renminbi trade in Shanghai and the development of associated hedging and financial products. The development of regional bond markets provides the Chinese government with a vast source of new funds to tap, to finance development and investment in the poorer regions.

Threats to the City financial services sector

(i) Boom/bust

The Chinese economy could be subject to potential bubbles, leading to unpredictable government reactions. These are most likely in *The Crane Flies Against the Wind* scenario as it encompasses the highest growth rate but also the greatest disparities of wealth. The scale of consequences will be affected by, among other things, how and when the government intervenes, and the regulations or blunter instruments, it uses.

(ii) Competition

In this scenario, reforms in China's securities markets boost China's domestic economy but also have the effect of moving the centre of gravity in global markets eastward. Western financial services doing business in China with local partners, increasingly find that the latter are "learning at their expense" in terms of management, processes, systems and products. Shanghai becomes a major international financial centre, rivalling London in terms of market capitalisation, having financed much of the expansion of China's infrastructure and companies. Renminbi trading is supported by hedging and financial products. Initially, the focus of Chinese financial services companies is Asia, but as their confidence and expertise grows, they will turn increasingly to additional geographical areas for business, supporting Asian business in those territories. A key influence on the time horizon for these developments will be the extent to which the Chinese are able to put together successfully, and nurture, a comprehensive and deep cluster of expertise.

Important aspects that will govern the net impact of Chinese competition are likely to be the extent to which China is able to fund its development internally; the extent to which external funding is required; and the extent to which the renminbi becomes a truly global currency. These outcomes are likely to have big implications for precisely how China's financial sector develops, and its impact on non-Chinese financial services companies and other financial centres. It is also likely to have an influence on Chinese government action towards the sector in the event of rising trade protectionism and possible restricted access to other financial centres. Here, the

government would wish to have recourse to other funding to compensate for any weakening of export earnings. Further under this scenario, Chinese companies are likely to build up re-insurance portfolios to support export industries.

(iii) International stability

A dominant China could see Chinese banks seeking to acquire foreign banks. Global developments could result in a switch of economic power away from City financial services customers – and hence a shift of emphasis away from the City. The most obvious threats emanate from the assumed onset of protectionism i.e. being on the wrong side of trade barriers, which could prove highly disruptive to modern supply chains.

5.4 The Lion Leads the Dance – An Evolutionary Scenario

The model that the current government employs – the Hu Jintao-Wen Jiabao model – is based on promoting balanced and sustainable growth, which is successful at raising living standards in both urban and rural areas of China. This provides the Chinese leadership with the confidence to expand gradually political and social freedoms. The line, however, is drawn at one-party rule. The CCP retains its hold on power, though it allows greater room for civil society. Foreign MNCs play a crucial role in sustaining high levels of economic growth by providing the capital, technology, management know-how, and market access that sustain Chinese exports to OECD countries.

The economic interdependencies between the US and China ensure that protectionist pressures remain contained. On the downside, China's growth remains considerably dependent on exports and is therefore, vulnerable to a downturn in the US or the global economy. The banking sector reforms are successful, reducing a potential source of instability. China only allows limited opening of the capital account, and maintains control over the exchange rate. In its foreign policy, China acts cautiously, avoiding confrontation with the US on sensitive issues, developing ties with a wide range of countries, and advocating multilateralism.

In summary, ultimately China has to manage its way through two major barriers: firstly, the internal issue of how to manage its growing complexity – command and control will not serve; secondly, on the issue of external relations that involves China finding its place as a partner rather than as a threat.

Early indicators

Indicators that this scenario might be evolving include:

- Reforms of the Chinese banking sector leading to market opening.
- US – EU textile rows resolved through WTO.
- Gradual liberalisation of the exchange rate.
- North Korean (and Iranian) situation contained with Chinese involvement.

Opportunities for the City financial services sector

This scenario is the most favourable of the three scenarios for multinationals and the City. In this scenario, the opening of the Chinese financial services markets in line with its WTO commitments provides opportunities to first movers. The prospective introduction of foreign competition into the banking sector forces the government to tackle the weaknesses of state banks.

(i) Investment

Chinese capital markets generally become progressively more sophisticated and more open to direct investment flows. The City consequently has opportunities for

involvement: firstly in FDI into China, where the flow of such investment into the country is expected to be substantial, as MNCs increasingly transfer more complex manufacturing activities to China; secondly, through the Chinese companies buying and developing overseas assets, including energy resources and other raw materials. This will in turn lead to the need for a range of financing and related advisory services, as well as subsequent banking support, possibly provided through Chinese banks in foreign partnership as a result of government moves to strengthen state banks. The success of such partnerships for foreign banks is likely to hinge, among other factors, on the degree of managerial control secured within the joint-venture, and the extent to which the venture addresses niche markets with more sophisticated needs.

Chinese companies could also themselves become big borrowers on international markets, and there could be further openings in financing the Chinese diaspora. Opportunities for provision of private equity and venture capital could increase as Chinese manufacturing operations continue to expand, both to serve domestic markets and as integration into more global supply chains continues.

The misallocation of capital seen in recent years slows, but there will remain many 'legacy' problems, and under the changing political and institutional framework, corporations and enterprises will be allowed to fail. This points to the need for selectivity and caution by those acquiring investment stakes in Chinese financial services and other organisations, as well as by overseas fund managers investing in bonds and equities. Further, investment management markets could be expected to expand substantially as steady liberalisation of financial markets leads to increasing levels of overseas investment by the growing Chinese entrepreneurial and middle classes, including in pension products.

(ii) Insurance

In this scenario, companies pay more attention to risk management through appropriate insurance products and FDI funds for non-life insurance. Opportunities for provision of a range of personal insurance products for Chinese consumers could open up among the expanding middle classes, owing to lack of an adequate state social security net.

(iii) Transaction systems

There would be major expansion of demand for retail banking systems in China, with the expanding middle classes again being a key demand driver for products such as credit cards and mortgages. Chinese reluctance to allow strong foreign influence however, may act as a constraint on how far this market growth presents opportunities for City banks. The latter may be forced to take a back seat, with a less than desirable degree of control, but there might still be profitable opportunities to be gained, particularly as noted above in niche markets, on the back of provision of their expertise in product development and systems. An improved institutional framework should allow for better pricing of risks by banks.

Opportunities for financial services provision in China include those delivered through initiatives with remote technology. This embraces financial consulting services (pensions,³³ financial management), credit control and risk management, currency trading, and big banking/investment management in China. In this scenario, the inland, western and rural areas, where the social safety net is weaker, also provide opportunities for retail banking, insurance and savings, although this broader market may tend to remain principally the preserve of the state banks.

³³ *China's Pension System*, (2006), Deutsche Bank Research.

(iv) Other

More generally, the opening up of Chinese capital markets and relaxation of capital controls, provide a growing raft of opportunities in currency markets – although development of Asia as a trading zone could lead to some shift of foreign exchange business away from London. Although this would mean having a proportionately smaller share of the cake, it would be a larger cake and would not necessarily mean an absolute fall in the volume of business.

The City could export its experience in financial services activities and standards, particularly if trust and dialogue can be established between the City financial institutions, regulatory authorities, professional practices and their Chinese counterparts. This could work both ways through facilitating the listing of Chinese firms on LSE or AIM and their development outside China. If London is to remain an attractive centre for listings by Chinese companies, it will have to ensure that it stays competitive and accessible in terms of cost and regulatory requirements.

Threats to the City financial services sector

In this scenario, China's expansion is seen as being in harmony with the economic interests of the West. Chinese nationalism could still generate resistance to strong foreign influence in financial services.

The threat of competition in financial services is less than in *The Crane Flies Against the Wind*. As the Chinese domestic financial economy expands further and as markets develop, Chinese financial institutions can be expected to develop their own expertise, capability and services, moving into high value added areas. Their Asian regional presence and outreach is likely to increase, and some may in due course, seek to acquire overseas financial institutions. This threat might be offset by the growing absolute volume of business opportunities in China and the Asian region, as long as City institutions are proactive in developing the necessary network of local relationships and business partners, together with the products and services that are truly tailored to local need.

(i) International stability

In broader terms, there is a greater threat of the Chinese environmental problem not being tackled effectively. The risk of unexpected 'shocks' to the system, perhaps emanating outside China, which causes economic momentum to stall, leading to internal unrest, is likely to remain as a background threat, albeit not on the scale envisaged in *The Dragon Breathes Fire* scenario.

The City would also suffer if OECD economic growth were to be impacted by high energy/commodity prices, stemming from China's surging expansion. This scenario, however, sees low threat to stability from boom/bust or from militarism.

The delicate balancing act that this scenario requires with respect to Chinese external relations and the management of internal complexity has been noted earlier. The failure on this front could lead events to revert to the difficulties that would be seen under *The Dragon Breathes Fire* scenario, with the attendant risks to City firms engaging with China.

5.5 The Dragon Breathes Fire – It All Goes Wrong

Much of the legitimacy of the CCP rests on its ability to deliver improvements. Under this scenario, this is called into question when a property market crash, after the Beijing Olympics in 2008, is the trigger for a banking crisis and major economic and social dislocation. The economic hardship, which affects numerous sections of society, leads many to question the benefits of single-party rule, and brings about intense popular anger. The government cracks down harshly on dissent, and, in attempting to deflect the blame for economic failings, stokes up anti-Western and anti-Japanese sentiment. The curtailing of political freedoms is mirrored with repressive economic measures aimed at containing capital outflows.

The operating environment for foreign MNCs becomes increasingly fraught, as the rule of law deteriorates and the government passively supports infringements of intellectual property rights against foreign firms. China's aggressive nationalism is reflected in its foreign policy as it becomes more belligerent against Taiwan, and relations with Japan become in turn increasingly tense, sparking a regional arms race.

Early indicators

Indicators that this scenario might be evolving include:

- Pre-Olympics investment boom.
- Marked increase in civil unrest.
- Escalation of environmental concerns and disasters.
- Back tracking on WTO commitments.
- Break down of the Six Party talks on North Korea.
- Focus on opposing the US's dominance in Asia Pacific.

Opportunities for the City financial services sector

In these circumstances, the City might have an advantage in not being associated with the political connotations of the US or Japan, as far as China is concerned. There would generally be a protectionist mindset that pushed out 'visible' foreigners competing with domestic players. Opportunities are consequently likely to be relatively limited under this scenario (as noted in more detail below), and tied primarily to overseas investment and business activities of Chinese MNCs, as well as wealth management and private banking for wealthy Chinese seeking overseas safe havens (as Swiss banks and Dubai) for their funds.

(i) Investment

Under *The Dragon Breathes Fire*, domestic economic difficulties, the problems faced by banks and other SOEs, and the resulting financial pressure on the urban middle classes, are likely to limit investment-related opportunities for foreign financial services organisations. There could, however, be opportunities for the provision of quality-assured banking services to China, including private banking and wealth management for affluent Chinese wishing to move assets offshore, and in acting to create a market for distressed assets. This could provide, albeit not without risk, some attractive speculative investment opportunities for the much longer term.

In a more positive vein, while the economy would not be looking good in this scenario, business would not collapse, and thus Chinese MNCs needing to raise capital abroad could turn to the City.

(ii) Insurance

In this scenario, the general economic climate and the sharp slowdown in growth of disposable income of the urban middle classes, are together likely to limit the growth of opportunities for provision of life and other personal insurance products.

The opportunity for foreign firms to provide financing or management of insurance is also likely to be limited, perhaps to insurance of exports. This is one area of economic activity that is likely to hold up relatively well under this particular scenario.

(iii) Transaction systems and retail banks

The banking crisis would set back the market for retail financial services by 10 years, reinforcing the Chinese preference for cash. The government also backtracks on its WTO commitments to open up the banking system to foreign competitors, by delaying licences and by withholding administrative approvals to open new branches. "Visible" foreign banks could be particularly at risk and minority stakes in banking could reduce in value, suggesting that opportunities might be limited to viable "behind the scenes" system support, perhaps on a fee basis with limited equity exposure.

(iv) Other

The UK could be seen as a safe haven for funds, substituting for weak financial services in China, and as a means of getting money out of China, maybe through innovative foreign exchange (FX) transactions. Mounting environmental issues might lead to opportunities in carbon emissions trading markets.

Threats to the City financial services sector

The starkest threat is that a Chinese protectionist mindset isolates visible foreign involvement, which results in existing western financial assets in China being appropriated. Domestic banks would be seriously exposed, with the likelihood that a number would be taken back into national ownership or parcelled out into 'safe' hands at a knock-down price. There is a switch of Chinese savings into gold, Swiss Banks and Dubai (rather than London) and contagion spreads to Russia, Brazil and other emerging markets – and to equity markets in general.

More generally, there could be a "flight to quality" within China, emphasising the desire for safety and assurance in investment decisions and products. This suggests the need for very careful selection of business partners, equity investments and the like, by those engaging in business in China in order to provide some protection in the event that this scenario unfolds.

In this scenario, China increasingly uses its FX reserves to make strategic investments in countries for natural resources. This would reduce the opportunity for the City in global markets. Overall, there would likely be a fall in outward Chinese FDI.

There is also a very real threat to international stability from boom/bust (as in the Asian crisis in the 1990's) and from militarism as the surplus of young males is employed in the army on the borders. Other risks could include forced "distress selling" by the Chinese of certain overseas assets, causing volatility of asset prices in certain markets; repatriation of dollars; expropriation of foreign-owned assets in China; introduction of exchange controls on foreign accounts; export dumping; and forced technology transfer.

5.6 Which Scenario Is Most Likely?

The Crane Flies Against the Wind – in which Chinese governance works, yet China is viewed as an economic threat – was considered as being a realistic and plausible outcome, especially in the longer-term. The challenge would be to manage the dynamics between threats to international stability and opportunities for synergistic growth.

The Lion Leads the Dance – in which governance works and the outside world sees China as a source of wealth and opportunity – was considered to be very likely in the short-term. Longer-term, it would be difficult for China to sustain, as it would require a major ideological catalytic change in the CCP, and at least partial separation of legal and legislative systems, while maintaining strong central leadership and control of policy.

The Dragon Breathes Fire – where Chinese governance fails, and the country becomes viewed as a threat – was considered to have a relatively low probability. China is well meshed in international treaties; the domestic economy has considerable momentum; and the authorities have successfully endured previous shocks and would intervene again to deal with eventualities which threaten their control of events. Were events to be such that a massive flight of capital occurred, then this scenario could plausibly begin to become manifest.

5.7 Opportunities and Threats Across All Scenarios

As noted earlier, China, like India, is composed of many disparate regions, which need to be understood before identifying opportunities and threats. The fast growing coastal areas, with their cities and burgeoning middle class, have been the focus of much Western interest. The Chinese government has recently³⁴ indicated a greater emphasis on developing the interior, with its consequent opportunities.

The age demographic in China means that pensions will provide an opportunity across all scenarios. Sectors which, subject to adequate analysis and understanding of risk, provide opportunities across all scenarios include:

- Capital markets and financing (debt and equity, project).
- Wealth management (for individuals).
- Pensions for middle class.
- Insurance and other services for Chinese MNCs.
- Consultancy, advisory and regulatory services.

China is taking a more traditional path than India, with an initial emphasis on manufacturing and a subsequent growth of services. While recent corrections to the Chinese GDP figures were based on the identification of a previously invisible services sector,³⁵ it is expected that these will remain mostly domestically focused for the foreseeable future.

Opportunities for the City abound in both *The Lion Leads the Dance* and *The Crane Flies Against the Wind*, although under *The Crane Flies Against the Wind* scenario, there are risks of adverse repercussions from trade disputes and protectionism. The expanding middle class, together with the opening of the Chinese financial services markets, will provide fertile ground for the provision of both established retail banking services and the development of innovative routes to access the hitherto, less

³⁴ <http://www.index-china.com/index-english/agr-challenge-s.html>.

³⁵ http://www.chinadaily.com.cn/english/doc/2005-12/20/content_504997.htm: 2004 GDP revised up 16.8%, ranking 6th largest economy.

mainstream regions of China, outside the eastern seaboard. There will be scope for advisory services both to inward investors into China, as well as to Chinese corporations looking to expand internationally, including through M&A. The City will need to ensure that it is geared up to increase its market share of these opportunities in what could be a very attractive market for all-comers.

In *The Crane Flies Against the Wind* there is a further twist to these developments through the growth in importance of the renminbi and a clear shift of gravity towards Asia as the centre of world finance, which the City must be prepared to address the “honest broker” role. The City has many potential advantages in securing the higher ground on which to advance its expertise and credentials as a long-term partner in the Chinese economic phenomenon.

The growth of China’s economy is causing a shortage of skilled labour – particularly management skills. This must pose a threat to any financial services organisation doing business in China.

On the less optimistic side, *The Dragon Breathes Fire* envisages the development of the financial services industry being held back by an adverse political and economic environment. In these circumstances, the City is likely to seek opportunities in alleviating financial distress through a number of advisory services, including funds transfer and management. Growth opportunities would be quite limited, though the desire to hang in as a “bank for all seasons” for better times ahead would be strong.

While China potentially offers a rich vein of opportunities for the City, there are clear risks, on the economic and particularly on the political front. China’s institutions, legal framework and external commercial culture are relatively fragile. The government is capable of volatile, unpredictable reactions to events, and is much more of a determinant of the outcome than in, say, India. Both *The Dragon Breathes Fire* and *The Crane Flies Against the Wind* contain strong hints of China as a source of international instability.

6 Conclusions and Contrasts

6.1 Economic Prospects

Both countries have exhibited strong economic expansion over recent years. China, in particular, has pursued strongly export-driven growth, built on low labour costs and debatably, an undervalued currency.

Both sets of scenarios see positive rates of economic growth over the next 10-15 years, and at an average annual rate which will exceed that of the US and the EU. Both India and China, however, need to grow at significantly higher growth rates than the developed world in order to absorb their rapidly expanding labour forces. In the case of India, the expansion comes from a combination of migration from the land and a young population; in the case of China, from migration from the land. If growth falters in either case – even if it remains healthy by historical standards – then the risk of an increase in social unrest and political disruption is high.

6.2 Countries in Transition

Research over the course of the project identified two major axes of uncertainty for both India and China, which were adopted as the key drivers behind the scenarios:

- External economic developments, and
- Internal governance.

External economic developments

For India, the external economic pressures – from global competition, energy and raw material prices – will have a constraining effect on the country's ability to invest to improve its infrastructure, which is considered to be a major block to development. The governance issue in India relates to the question of managed devolution to the states, and the ability to make decisions within a diffuse and complex democratic system.

China is investing extensively to ensure supplies of raw materials and has engaged with Russia to develop energy sources. The potential threat to China is trade retaliation – provoked by unrestrained exporting, and aggressive acquisition of world raw materials and energy supplies. The internal governance question for China is whether the Communist party apparatus can come to terms with the institutional change necessary to manage a more complex and demanding society.

Internal governance

Both societies have embarked on major economic expansion, posing substantial challenges to existing political and social structures. Unless the resulting conflicts are resolved through reforms, economic progress is unlikely to be sustained in the longer term. In the short- to medium-term, such conflict resolution rarely occurs smoothly.

In China, it may be that there is a short sharp drop in GDP growth, for instance after the Beijing Olympics in 2008. India is less likely to see a fall in GDP growth, but could see a period of stagnation arising from political pressures. Thus, careful navigation through the cross currents of societal evolution is required for financial services and other organisations wishing to maximise opportunities and minimise threats during transitional phases.

Throughout the momentous changes in both countries, it should be remembered that the cultures of both India and China respect continuity: they expect that relationships

will be nurtured over time and cannot be hurried. These factors have strong implications for the City, and point to a need to be patient in developing and nurturing links and relationships in India and China.

6.3 Financial Services Issues

Implications for the City's financial services sector as a result of the future development of India and China arise at two levels:

- First, via the general impact of developments in India and China on key areas of the world economy, and hence on existing City customers and their businesses.
- Secondly, as a result of the sector's response to specific India and China-related opportunities and threats to the City.

Global effects of developments in India and China

International stability

There are risks for both India and China that the internal conflicts inherent in their respective growth paths spill over and cause disruption and dislocation in the wider regional and global economy. This is probably a greater risk for China than India because of its history of hegemony (such as Tibet, Korea), as well as its more prominent external profile, as shown in Figure 11. India also has a history of conflicts with its neighbours, and this cannot be discounted as a source of potential regional instability.

China has been a voracious importer of oil and raw materials; a factor that has already had an impact on world supplies and prices. Its currency reserves have played a significant role in financing US deficits. Destabilisation, caused from internal or external pressures, could lead to higher interest rates, world economic slowdown, and harm the business prospects of City customers – and hence City firms. One mitigating factor in this sequence is that MNCs account for a large share of Chinese manufactured exports. This could make Western governments, especially the US, reluctant to push trade sanctions too far, although rationality does not always determine the course of world history.

Relations between India and China

While India and China have been considered separately to this point, it should be remembered that they share a frontier and the relationships between the two powers are complex. War between India and China has been a possibility within living memory, and Chinese manufactures are replacing Indian goods in markets such as textiles.

Sector specific threats and opportunities

During the study, the suggestion has been made that India will “leapfrog” the industrial stage of development to a large extent, and develop a “post-industrial” society. There are some signs that this may be so, as evidenced by strong presence internationally in IT and back office services, pharmaceutical R&D and manufacture, and Bollywood. While energy supply remains a weakness, some of the infrastructure problems may be ameliorated by jumping to newer technologies – for instance, mobile phones instead of fixed-line telecommunications, and private sector low cost airlines as an alternative to the state owned railways. These trends bear close watching.

There is an important difference in the financial structure of the two countries. India has too little capital; it is a heavily leveraged economy, access to finance is quite costly, and it has a relatively greater need for foreign capital – particularly for infrastructure investment. India has traditionally constrained the inward flow of funds but allowed capital to be exported.

China's exceptionally high savings rate and a positive trade balance (see Figure 10) provides abundant capital, but there is a deficiency in capital allocation. China does not rely heavily on foreign investment currently, after a surge in the 1990s; but this may change as China becomes more of a consumer society and savings rates fall.

The Indian insurance market is still protected by trade barriers. When they are reduced or removed, the result will be a fierce battle for market share, with state sector companies cutting process costs and private sector companies going under. Indian insurance companies are competing with the US on complex products such as litigation insurance, product recall insurance and medical malpractice.

In China, the state no longer provides universal social provision for its citizens, and the state is no longer the provider of support to, for example, oil companies as a last resort. The non-life insurance business in China finds it difficult to attract capital as the very high rate of Chinese savings is mostly directed at life insurance, and this is not expected to change.

6.4 Summary

GDP and GDP per capita

China and India are examples of new economies that are transforming not only the dynamics of the world economy, but also the balance of power. They are poised to be the drivers of a potential new centre of economic gravity, covering the whole of Asia, that has previously been dominated by the major western economies of the US and Western Europe. While both nations still have average levels of GDP per head at or below those of Bulgaria, Iran or El Salvador, the sheer size of the population makes for a major effect on world trade and politics.

Boom/bust

The evidence of the recent expansion of these two economies is impressive from a whole series of standpoints. Both have the potential to rise to the very top tier of world economies, and many forecasts see this as a certainty at some point in the future. Evidence of economic history would also indicate that straight-line projections are not necessarily a reliable guide to the evolution of the future. It is quite possible that China's growth may falter after the Beijing Olympics but the strength of the domestic economy is such that observers believe that this will be short-term. India's growth could stall through political impasse but again observers believe that this will be relatively short-term. These considerations reinforce our finding, that the cultures of both countries require long-term engagement as a pre-requisite for successful relationships.

Diversity

It should also be recognised that these two vast economies embrace a large internal regional diversity. Looking forward, these regional differences are likely to persist under all scenarios. In some cases, the particular policy variances among the respective regions of both India and China could have a significant impact on the way in which opportunities and threats play out for specific business initiatives. Financial organisations should be alert to these regional divergences when developing strategies for each country.

Human Resources

The other aspect that has been flagged by the scenarios is that of human resources. Both countries, particularly India, are creating a well-educated labour force with highly trained graduates that is of itself a source of opportunity and threat. The IIMA MBA programme³⁶ for example, is well regarded and successful in terms of attracting foreign students to India. The growing presence of Indian and Chinese staff in key positions in academic institutions across the world could produce new competitive tensions both within and without of China and India. At another level, experience in the US and UK is currently seen as an important stage in the education of future Indian and Chinese leaders: but it is not clear how long this will remain the case.

Indian and Chinese expertise can be harnessed directly through recruitment. City know-how and contacts can be extended by working in the Chinese and Indian markets. The threat comes from a failure to engage in this more positive way, which results in the Chinese and Indian expertise establishing a separate rival indigenous financial services industry that shifts the balance of global services to Asia.

Opportunities across all scenarios

In principle, both countries are rich with opportunity – but also with risk. The scenarios contain examples of each in both countries. The main opportunities are for the City to capitalise on its strengths:

- its reputation for probity and innovation, and its expertise not only in the specific areas and of financial products and services, but also in the field of regulation and governance. These latter aspects will also be in high demand as both countries seek to establish a sound financial infrastructure as a basis for sustained, and not just transitory, economic expansion.
- the agglomeration of clusters of services in and around the City – legal, accountancy, regulatory, engineering, IT, as well as financial.
- its global expertise and reach reflecting its history.
- the quality and diversity of City managers and specialists.

There will also be opportunities in dislocations that could impede the smooth path of expansion. As in other fields, consultancy services can in principle be sold in bad as well as in good times – in such areas as being a haven for funds of indigenous investors and companies; expertise in moving money in difficult times; and also being a source of quality assurance.

This might be of more significance in the case of China, where there are perceived to be more threats of a financial/political breakdown at some stage in the future. The “honest broker” role would be a natural one for the City, provided the risks can be managed.

Perhaps the surprise conclusion from this study is the strength of the perception that has emerged, that the attractiveness of India as a business partner has been underestimated by financial services organisations. While the role as a supplier of back office services, software and call centres is well established, India has a number of significant advantages, such as:

- shared language;
- shared culture in terms of a legal system, commercial and property system;
- democratic government with its stability;
- the presence of a significant Indian business community in the UK.

³⁶ <http://www.iimahd.ernet.in/>.

This offers significant potential opportunities for City financial services organisations willing to invest the time and resources in developing the necessary local knowledge and business networks. The City needs to adopt a position of purposeful, yet cogent realism in its approach to each country. India and China both have their distinctive high-level opportunities and threats – as summarised in very broad terms in the following table.

INDIA AND CHINA – COMPARED AND CONTRASTED

India	China
Opportunities steadier (returns not so high?)	More threats: higher risk (higher reward?)
Role of government in shaping the future <i>less</i> important	Role of the government in shaping the future <i>very</i> important
Property rights <i>possibly</i> secure	Property rights <i>possibly</i> less secure
India has too little capital: India is a highly leveraged country – requires foreign financing	China has too much capital (and not sure how to use it)
Institutional/legal framework more akin to that of the UK	Government control a barrier to foreign influence and ability to make money
Major infrastructure bottlenecks and natural resource constraints	Chinese energy demand growth cannot be met
Some opportunities may have been under-exploited by the City	Less “low-hanging fruit”, in terms of easy opportunities to seize
Relatively stable banking system	Government more pragmatic and decisive with SOEs but still many financial problems to resolve
Political and social system likely to be more resilient in the longer term	Current (CCP and economic growth) model probably vulnerable

PART II

7 Detailed Scenarios for India 2015

7.1 Scenario Summaries

The Elephant Breaks its Chains

India is confronted with a series of external threats, including increasing competitive pressures from China, high oil prices, and heightened tensions with Pakistan, creating a growing sense of crisis. These pressures galvanise the right wing of the Congress Party and the left wing of the Bharatiya Janata Party (BJP) to come together in a centrist government. The Congress-BJP partnership uses its authority and the mood of national crisis to pursue a faster pace of liberalisation, which includes accelerated privatisation, cuts to subsidies and changes to restrictive labour practices.

The reforms serve to bolster investment and help in overcoming the country's long-standing infrastructure bottlenecks. These improvements provide a dramatic boost to the traditionally underperforming manufacturing sector. Combined with continuing strong growth in services, manufacturing output helps drive economic growth to 8%-9% by 2014/15. In spite of the rapid pace of growth, however, internal wealth disparities become sharper. In order to press ahead with the economic reforms in the face of significant popular opposition, the government becomes more authoritarian and adopts coercive responses. These centralising tendencies provoke a separatist backlash, particularly from the wealthier regions that resent having to support their poorer neighbours.

On the international stage, India aspires to the role of a Great Power and pursues strategic advantages by playing off China and the US.

The Elephant Lumbers Along

Under this scenario, India consolidates its internal political stability at the expense of more aggressive economic growth. A series of coalition governments featuring either the Congress or BJP in combination with regional and special interest parties, broadly produce similar policy outcomes. As a result, many of the familiar bottlenecks, shortages and infrastructure weaknesses continue to act as a drag on the economy. The services sector thus continues to be the main economic driver, particularly as it succeeds in upgrading to higher value-add activities such as R&D and medical services.

Economic liberalisation proceeds cautiously with a gradual opening up of capital markets, though foreign investment continues to be limited by capital controls and foreign ownership ceilings. Portfolio investment remains the preferred route to gaining exposure to the Indian market. The granting of greater federalism reduces separatist tendencies, and serves as a model for pursuing closer relations with smaller South Asian neighbours. Delhi moderates its desire for Great Power status focusing instead on seeking economic benefits through improving ties with other powers such as China.

The Elephant Retreats to the Woods

The global economy undergoes major disturbances, including an extended period of high oil prices, recessions in major economies, and a retreat into protectionism by the US and the EU. India experiences these traumas through a withdrawal of foreign capital, worsening trade and fiscal deficits, and depreciation in the rupee. The

economic turmoil is reflected and amplified by increasing fractiousness, populism and corruption in the country's politics.

As the formal institutions of the state are weakened, effective authority migrates to local political bosses who are most likely intertwined with the criminal underworld. While pockets of growth remain, particularly in services, many activities move to the black market and illegal channels of exchange proliferate. Increased middle class emigration takes high quality Indian skills out of the country, which further damages India's competitiveness. Intensifying competition for declining opportunities to work drives down real wages and promotes more open forms of exploitation, including the resurgence of child- and bonded-labour. The Indian economy becomes more exposed to the vagaries of the monsoon, leading to the return of famine in certain regions.

7.2 Scenario A: The Elephant Breaks its Chains

Uncertain times

- **External pressures**

Initially, the impact of China's manufacturing prowess and its entry into the WTO on the global economy threatens India with the loss of key export markets – especially in the textiles sector – and through domestic de-industrialisation. Furthermore, for several years after 2005, international energy prices remain at very high levels, increasing pressure on India's balance-of-payments position – where it imports 60% of its oil and increasing amounts of its gas needs – and on domestic prices. International competition also begins to erode its comparative advantage in services exports, especially in IT-related industries. The fall of President Musharraf and the installation of a more Islamicist government lead to a deterioration in India's relations with an increasingly unstable Pakistan. Tensions also rise with other neighbours, including China, thereby intensifying an arms race that leads Delhi to increase its procurement of foreign armaments. As a result of these various challenges and uncertainties, India's GDP growth is unable to break away from the 5-6% range it experienced for the previous decade.

- **Internal frictions**

At the political level, a series of general elections between 2006-10 produce fractious, short-term coalitions headed by one or other of the two main parties; the Congress Party and the BJP. These coalition governments attempt to muddle through the series of crises without implementing systemic change. In particular, they seek to cushion the effect of rising prices and declining sales by raising subsidies and tightening the regulation of domestic markets. These policies sustain economic growth in the short-term but at the expense of the government's own finances, where deficits swell and international confidence in the rupee starts to deteriorate. This threatens the withdrawal of foreign portfolio capital and the cancellation of new projects involving FDI. In response, the government tries to quicken the pace of liberalisation by slashing subsidies and further exposing the economy to market forces. These shifts in policy, however, fail to restore international confidence and also provoke strong domestic resistance. More specifically, an alliance of leftist, special interest and regional political forces intensifies its demands for the retention of populist economic policies and the protection of specific vested interests.

Breaking the deadlock

- **Political breakthrough**

Under the pressure of the numerous external and domestic economic and political threats, and a growing sense of crisis, the right wing of the Congress Party and the left wing of the BJP – which share a common economic philosophy – break away from their respective parties to form a new centrist government. This develops greater authority to address the problems with the economy. As a result, from 2010, economic liberalisation proceeds at a much faster pace, involving the privatisation of major public-sector undertakings (PSUs) and the reform of restrictive labour practices. Foreign trade grows substantially, providing 45% of GDP compared to 30% in 2005, while foreign investment also rises sharply.

In particular, the new government forces through higher consumer charges, such as tolls and tariff rates, which significantly bolsters private and foreign investment, and helps to overcome the country's long-standing infrastructure problems. The dramatic improvement to infrastructure begins to benefit the manufacturing industry which sustains double-digit growth and, in areas where India has comparative advantages (such as metals, light engineering, pharmaceuticals). This performance begins to challenge China's competitiveness. Thus, after weathering a series of external and internal crises, India's GDP growth undergoes a step-change where, from an average of 5-6% year-on-year growth in 1995-2005, it leaps to 8-9% in 2010-2015.

- **Increasing vulnerability**

The shift in the pace of economic growth is far from stable. India's increased engagement with the global economy makes it increasingly vulnerable to volatility in international commodity and capital markets. Moreover, Delhi begins to assert itself more strongly in the international arena by using its possession of nuclear weapons to gain recognition as a 'Great Power', and bolsters its efforts to seek economic security through access to essential raw materials, such as oil. This heightens tensions with the other major military and economic powers, especially China and the US, which Delhi seeks to play off against each other in order to gain strategic advantages.

- **Widening wealth disparities**

Meanwhile, internal wealth disparities become sharper. Although the middle class expands and new sections of skilled labour are better off as a result of the rapid growth in the manufacturing sector, a wider gulf opens up between the rich and poor. Large parts of the agrarian economy, where over 40% of the population is employed, remain backward. Even in rural areas that experience advanced commercialization, the failure of international regulatory regimes to open up free trade in agricultural commodities severely limits employment opportunities. The deepening social inequality leads central governments to adopt more authoritarian methods of rule.

Politics

- **Authoritarian tendencies**

The government becomes more authoritarian and inclined to restrict the scope of democratic representation in order to press ahead with economic reforms in the face of multi-sided political opposition. Since the opposition is split between leftist communist and right-wing nationalist opponents of liberalisation, 'formal' democracy and the framework of the existing constitution are not abandoned. Nonetheless, popular protest at the direction of government policy becomes more vociferous and –

because it is ineffective at the ballot box – expresses itself on the street and through petty acts of violence. This provokes more coercive responses from government. The close relationship between the police and the army becomes tighter yet and military force is regularly used to disperse riots.

- **North-South divide fuels separatism**

The central government's attempts to press ahead with unpopular reforms revive problems of regional separatism as the re-assertion of central authority reverses the previous trend for political decentralisation towards regional political parties and state governments. Previously, that trend emerged to counter threats to separate from the Union from a series of regional political movements in the 1970s and 1980s, and was broadly successful at re-incorporating the nation along more federal lines. Its weakening after 2010, however, revives the threat of separatism in a new and perhaps more dangerous form. Previously, it was regions on the margins of India such as Punjab, Assam and Kashmir, which were at risk of breaking away. Now separatism threatens to split the country in half. Liberalisation policies exacerbate regional differences in wealth, where the better-endowed regional states in the south and west develop more rapidly. Disparities in per capita income growth between the fastest and slowest growing states increased from three times to four times between 1980 and 2000. By 2015, the difference in per capital income growth increases to six times. This makes the more advanced states increasingly restless at the burden imposed on them by the poverty and backwardness of the poorer states, especially those in the north and east.

In order to counter these separatist tendencies, centrist political forces propagate a stronger ideology of national integration, which is based increasingly on the identification of the Indian nation with majoritarian Hinduism. This carries awkward implications for the status of India's cultural 'minorities' as well as for some of its regional neighbours. As a consequence, the religious tensions seen in the 1980s return to India and are characterised by episodes of serious public violence.

India's economy: broad-based growth

- **Services re-focus**

By 2015, the economy is growing at an annual rate of 8-9% of GDP. The services sector continues to perform strongly, but is no longer the leading sector of growth. The expansion of export-related IT services and business process outsourcing (BPO) slows, owing to greater international competition. The sector re-focuses inwardly to take advantage of the growth in domestic business, which now accounts for 60% of earnings compared to 40% in 2005. It also upgrades its technological capabilities, becoming more involved in R&D and other higher value-added activities. Indeed, this is also true of a wider range of other service sectors, such as medicine and education. These developments help to keep the middle-class economy booming.

- **Industrial awakening**

Ongoing growth in services is joined by a new, faster pace of growth in industry, which spreads employment growth and other benefits more widely. Increased infrastructure investment stimulates the expansion of the flagging capital goods industries. This intensifies the search for domestic sources of oil and gas and leads to heavy investment in alternative energy sources, such as coal and hydroelectric power, which are plentiful. Improved infrastructure and the steady reduction of protectionist barriers also improve growth in the manufacturing industries so that other sectors of industry, outside of textiles and gemstones, enjoy overseas success.

India now possesses a comparative advantage, even over China, in metals industries, light engineering, agro-processing and high technology industries, such as pharmaceuticals. Furthermore, the textiles industry overcomes the shock of Chinese competition through restructuring. Between 2010-2015, manufactured exports grow at 25-30% per year, compared to 15% during 1995-2005.

- **Favourable demographics**

Between 2015-2030, the labour force is set to grow at an annual rate of 4% as the population passes through a favourable phase in its demographic cycle – when labour participation rates rise. Employment growth, which was barely 1% during 1995-2005, increases as a result of faster industrialisation and is propelled, in particular, by shifts in policy favouring Special Export Zones, the easing of restrictive labour practices, and the rationalisation of both the taxation system and investment allocation. Nevertheless, the very poor quality of human capital at the lower end of the skills chain, which is still suffering from lack of investment in primary education and public health, continues to limit employment growth. As a result, a very large part of the labour force is unfit for work in India's new modern, industrial economy. Although increased social spending made possible by faster GDP growth is improving this situation, the full impact on the quality of human capital may not be felt until 2030, or even 2050.

Capital markets

- **Portfolio influx**

India has long possessed a basic institutional framework for managing its domestic capital markets. Until the 1990s, these had been largely closed to foreign participants, dominated by government and the public-sector, and rendered opaque by vested interests and antiquated practices. Reform is slow at first, but accelerates after 2010 as the new party of 'national unity', formed by Congress and BJP 'reformists', comes to power. As a result, foreign capital inflows rise rapidly. They remain principally concentrated in the portfolio sector of Indian-owned companies, where foreign investors increase their holdings in the Bombay Stock Exchange from 20% in 2005, to 40-50% by 2015. FDI is more limited owing to the difficulty which foreigners continue to experience in penetrating domestic consumer markets. Nonetheless, FDI increases substantially in infrastructure and in manufacturing that is linked to global production networks.

- **Capital account loosening**

The capital markets also become more open to international influences in other ways. From 1991, the government partially opened exchange rates on the current account, and placed the Indian rupee on a managed float. This management becomes progressively less direct and, by 2015, the rupee is effectively free-floating. After 2005, governments become increasingly interested in attracting foreign capital as a source of financing of India's public debt. This creates pressure for greater freedom on the capital account and controls become progressively looser.

This loosening greatly benefits several of India's leading industrial conglomerates, which become aggressive players in global markets. They intensify their overseas activities by raising capital on cheaper, foreign capital markets, and pursuing foreign acquisitions and investments to improve their positions in overseas markets. In particular, these conglomerates penetrate the economies of neighbouring countries, where they reinforce the Indian hegemony over the whole South Asia region. They

are also significant players in the developed economies, particularly in those global industries where India holds a comparative advantage (e.g. IT services).

- **Deploying its foreign reserves**

Rapid trade and investment growth bolsters India's foreign exchange reserves, which rise from \$140 billion in 2005 to \$250 billion by 2015. Strong growth in imports resulting especially from the need to cover the burgeoning oil deficit, however, limits India's trade surpluses. Moreover, outflows used to finance industrial acquisitions and other foreign investments partially balance out capital imports. The steady appreciation of the rupee against the dollar also draws the domestic economy closer to international purchasing parity levels. India moves away from accumulating US treasuries and other forms of government securities, to more innovative ways of deploying its foreign reserves, such as for financing domestic infrastructure.

Financial services: expanding opportunities

The development of financial services in India expands rapidly. The burgeoning middle class increases its demands for higher quality services in pensions, savings, banking, and mortgages than what was available in 2005. The opportunities available to private and foreign companies and investors expand greatly, while several of the leading public-sector banks and insurance companies are privatised. Moreover, in a context of weakening capital controls, India's high savings rate – which is over 30% by 2015 and concentrated in the middle class – puts new financial resources at the disposal of the international financial services industry.

Further, the expertise possessed by foreign financial services companies becomes more important in integrating Indian enterprise more closely into the global economy. As Indian conglomerates seek to raise larger amounts of capital on overseas markets, they develop much closer relations with foreign investment houses. The government also seeks an expanding range of overseas expertise in the management of its reserves and in accessing international capital markets. Increasing engagement with international capital markets, however, brings greater risks of instability arising from external volatility. Whether international institutions can successfully manage problems in the global economy is much more relevant to India in 2015 than it was in 2005.

Key developments 2005-2015:

2007	<ul style="list-style-type: none">• International oil price stays at \$70 a barrel.• Trade deficit widens to 3% of GDP.• Consolidated fiscal deficit reaches 9% of GDP.• Inflows of foreign capital begin to dry up.• Congress Party-led government falls when main communist supporters oppose “emergency” reforms.• General election returns another Congress-led coalition, but backed by regional parties with communists in opposition, which advances limited reforms.
2008	<ul style="list-style-type: none">• International oil price hits \$90 a barrel.• Trade deficit widens to 5% of GDP and fiscal deficit to 10% of GDP.• IMF expresses ‘concern’ at the deteriorating fiscal position and foreign capital begins to withdraw.• Tensions with Pakistan mount over ‘terrorism’ in Kashmir and with China over trade disputes.• The government falls when it attempts more radical reforms and is deserted by its regional allies.• The general election is won by a BJP-led coalition with regional parties promising stronger ‘national’ government and policies of protection.
2010	<ul style="list-style-type: none">• International oil price stays at \$90 a barrel.• Trade deficit temporarily closes to 3% of GDP but fiscal deficit widens to 11%.• Inflation and interest rates rise sharply, GDP growth falters below 4%.• IMF and World Bank withdraw ‘conditional’ support previously offered and foreign capital seeks a hasty withdrawal.• The government falls following a split within the BJP over protectionism.• A new party of ‘national unity’ is formed by Congress and BJP ‘reformists’.• The new party wins the general election by offering to strengthen the nation against both its external and internal ‘enemies’.• Following the formation of the new government, the President immediately uses his constitutional powers to suspend parliament for six months to deal with the ‘emergency’ situation.
2014	<ul style="list-style-type: none">• International oil price moderates towards \$60 a barrel.• India’s trading account moves into surplus. GDP growth reaches 8-9% and the fiscal deficit narrows to 5%. Inflation and interest rates hit record lows.• IMF pronounces itself pleased with the measures of economic reform pursued by the Indian government, which, since 2011, the World Bank has supported with enhanced development aid.• Foreign capital inflows reach \$50 billion.• The government announces the completion of its four-year programme of radical economic reforms, involving extensive de-regulation, privatisation and infrastructure construction.• Parliament completes its first full year of regular sessions without repeated six-month ‘emergency’ suspensions, which have punctuated its meetings since 2010.• The army reports that it was called to disperse situations of ‘civil riot’ on 8,000 occasions in 2013, especially in northern and eastern India, involving Muslim and low-caste ‘disturbers’.• The government wins a landslide victory in a general election held under restricted conditions and close military supervision.

7.3 Scenario B: The Elephant Lumbers Along

Obstacles to growth

The three general elections that take place between 2005 and 2015 produce broadly similar results. Ad hoc coalitions are formed between one or other of the two national parties (Congress and the BJP), and groups of regional and special interest parties. In 2005, a slight shift in the orientation of these coalitions occurs, when the blanket opposition of the communist parties to most aspects of the liberal economic agenda, eases considerably. This is a result of these parties' own experiences of government in their regional states – especially West Bengal, where liberalisation proves to be fairly successful. Nonetheless, both the communists and other smaller parties representing regional and low-caste groups continue to advocate policies sustaining the regulation of certain markets, the distribution of some public subsidies, and the protection of organised labour union.

As a result, the public sector continues to play an important role in the economy where foreign and private capital both remain excluded from certain activities. Moreover, it remains difficult to develop infrastructure where customer (and voter) resistance to higher charges is strong. Nevertheless, some progress is made in allowing liberalisation in certain areas of the infrastructure sector, for example, in the power industry, where the rate of growth in generation increases from an average of 3.5% per year in 1995-2005 to 6% in 2010-15. Moreover, modern toll roads and metro transport services now serve and interlink the major cities. Outside these areas, infrastructure provision remains extremely basic. Equally, the shortage of resources means that primary education and public health continue to be chronically under-funded and poorly managed. Thus, attempts to improve the quality of human capital at the lower end of the skills chain are limited.

Growth is further held back by episodes of high-energy prices, the decline of export markets, and poor monsoons, which not only harm agriculture but also domestic demand. Their impact is moderated by expansion in international (and domestic) oil production, shifts in the international community towards certain forms of protectionism, largely to counter the economic emergence of China, and by favourable turns in the short-term weather cycle. As a result, India continues to develop along its established paths of steady and cautious economic liberalisation and improving relations and trade with both its immediate neighbours and with the international community at large. While GDP growth rates fluctuate according to variations in the price of oil and the monsoons, in 2015 growth is in the range 5-7%, much as it was in 2005.

Politics: a source of stability

- **Empowered regions**

The gains to internal political stability made during the 1990s and early 2000s are consolidated. Coalition governments at the centre defer increasingly to the federal principles of the constitution, giving the regional state governments greater responsibilities. In effect, the role of the central government is progressively reduced to setting frameworks and general regulations, while the state governments increasingly implement policy. While this leads to growing divergence between the economic performance of the regional states with the south and west moving ahead, it defuses political tensions between them. In certain cases, this trend alters long-standing patterns in the regional distribution of wealth. For example, no longer subject to discrimination by central governments, communist-led West Bengal

located in the 'backward' north and east of the country, rapidly improves its economic performance.

- **Tensions diffused**

Despite the limitations on economic growth, social and political tensions inside India are less manifest than in earlier periods, especially the 1980s and early 1990s. This is not because problems associated with economic inequality and cultural discrimination are resolved. Instead, the deepening federalism and regionalisation of the political system disperses these pressures in ways which reduce their threat to national integrity. Violent conflicts associated with Hindu nationalism, militant Islamism, low-caste deprivation and agrarian poverty still colour political relations, but they are managed at the regional level.

- **Accommodative foreign policy**

Deepening federalism and regionalisation starts to take the edge off India's desire to assert itself as a new Great Power. Rather, in local South Asian countries, India uses its internal model of federation to appeal to smaller neighbours in the hope of gaining closer relations with them. Delhi begins to pursue free trade zones and wider forms of co-operation. These approaches improve relations with Pakistan, where trade-based détente makes steady progress. India also seeks membership of a widening range of regional multi-lateral institutions, such as the Association of South East Asian Nations (ASEAN). Moreover, Delhi's foreign policy strategy also leads to improving ties with other major powers, such as China, where complementary patterns of services-for-manufactures trade are viewed as more important than strategic rivalries for dominance over Asia.

Admittedly, this drift in foreign policy is constantly being checked by the demands of determined centrists, especially resurgent Hindu nationalists, who continue to pursue the traditional privileges of Great Power status. To this extent, the debate over India's future place in the world is far from settled within India itself. As with non-alignment in the 1950s, India's re-entry into the international community brings a different and original perspective to bear on world affairs.

India's economy

- **Services lead the way**

The services sector largely remains the main driver of economic growth. The pressures of increased competition in the provision of basic services in IT and BPO, and of protectionism in the developed economies are offset by growth elsewhere. In particular, India establishes strong, complementary relations with China through services-for-manufacture trade and with other emerging economies. Moreover, the domestic market for services grows as a result of new patterns of middle-class consumption, modernisation in certain industrial sectors, and the return to India of larger numbers of non-resident Indians (NRIs), bringing skills and capital from abroad. Medical services and institutions of higher education for the middle class expand rapidly. Further, several services industries succeed in upgrading their skills to become leaders in R&D and technological innovation.

- **Manufacturing limits**

The manufacturing industry continues to grow through the production of goods for domestic markets which, as the international community turns away from the pursuit of greater free trade, still enjoy a measure of protection. A few Indian industries establish themselves in world markets, such as metals, light engineering, agro-

processing and pharmaceuticals. Overall, Indian industry has only limited success in export markets and the proportion of GDP produced by overseas trade increases from 30% in 2005 to only 35-40% by 2015. Also, industry is unable to sustain growth at double-digit levels for any length of time. This partly reflects short-term oscillations in domestic demand, but also political failures to make up the deficit in infrastructure provision, reform restrictive labour laws, and improve the quality of human capital at the lower end of the skills chain.

- **Agricultural and employment drags**

Agriculture and unemployment are serious drags on economic performance. Although a few regional pockets of agriculture, as in Gujarat and Punjab, become more highly commercialised and serve markets both nationally and in adjacent countries in the Gulf and the Middle East, the sector struggles to raise growth above an historic rate of 2.5% per year. Lack of infrastructure investment sustains the sector's vulnerability to the vagaries of the monsoon season, while continued protectionism in the developed markets limits opportunities for growth. Equally, the inconsistent pace of industrialisation leads to a failure to adequately absorb either new entrants to the labour force, or the experienced workers moving across from agriculture. Employment growth, while improving, does not exceed 2.5% compared to the 4% increase in (would-be) workforce participation rates. Further, the export of surplus labour to other economies falls away as non-Muslims are put off from seeking employment in the oil economies of the Gulf, while the developed economies increasingly restrict the import of all but the most skilled workers.

- **Subsidies burden**

Governments continue to support high levels of public subsidy, restrictive labour practices, and a large and inefficient public-sector industry in order to assist the disadvantaged sections of society. This reduces availability of resources required to invest in the structural problems that are limiting growth. Also, governments largely finance their subsidy expenditure through fiscal deficits, which remain at the equivalent to 10% of GDP. This reflects the weakening of central authority, which reduces the central government's ability to raise taxes. In this respect, India remains a country that possesses one of the lowest ratios of revenue to GDP in the world.

The financing of cumulative fiscal deficits eats into current revenues. It also absorbs savings, which otherwise might be more productively invested, and puts upward pressure on interest rates and inflation. Foreign investors remain nervous at the potential consequences of the fiscal deficit, which accounts for the lack of any increase in capital inflows. Public debt is almost entirely denominated in Indian rupees, and, thus, is de-linked directly from the international economy where India's external debt position, given its high level foreign reserves, is very strong. Predicted fiscal disaster continues to be held off so long as India does not release the tight controls on its capital account, or seek to sell its own treasuries overseas.

Capital markets

- **Cautious opening**

The opening of Indian capital markets to foreign investors proceeds at a slow and cautious pace, and even in 2015, restrictions remain. Stock market regulation becomes more transparent, while opportunities for both foreign portfolio and direct investment widen as foreign investment ceilings in many industries are gradually lifted. Many of these ceilings, however, remain, along with provisions subjecting foreign investors to special institutional and regulatory arrangements. Foreign

investors may participate in Indian markets but not entirely on equal terms with domestic players. Nonetheless, foreign investment increases, especially in the form of portfolio investments, and by 2015 foreign investors hold 30% of the Bombay stock market. With the exception of a few industries, such as pharmaceuticals, metals and IT, and especially designated infrastructure projects, few opportunities for direct investment exist.

- **Capital account control**

Controls also remain on the capital account, not least to insulate the domestic economy from sudden inflows and outflows of foreign capital. In effect, the central bank, the RBI, continues to run a tight regulatory framework. Nevertheless, Indian conglomerates manage to work within this framework to extend their international activities in acquiring foreign companies and raw material rights, and, also, in taking on foreign debt. A few of these companies, such as Tata and Reliance, become truly multinational operators. Equally, several foreign MNCs widen their sphere of operations in India in order to integrate Indian production into global networks. Both inward and outward FDI stocks are small and effective barriers to the international movement of capital are lifted, far less for new and smaller companies.

India's foreign reserves continue to grow steadily and, by 2015, approach \$250 billion. While, the speed of their accumulation is less than it would be under a more open capital account (as in the case of Scenario A), the drain on them to cover escalating import bills and a larger scale of capital exports is also smaller.

Financial services

The development of financial services, particularly associated with the modernisation of the middle-class household economy, is very strong. Foreign financial services companies participate in these developments, via banks, insurance companies and pension funds. Indian public-sector financial institutions, however, which are not entirely privatised, continue to occupy a significant place in financial markets. While the services which these public-sector institutions offer may not be as sophisticated or profitable as their privately owned counterparts, the government backing which they enjoy makes them appear more secure from the consumer's perspectives. Nevertheless, greater opportunities exist for foreign financial institutions to participate in joint-schemes, such as management of pension funds, with Indian PSUs.

Controls on the rupee capital account continue to limit possibilities for drawing Indian savings into the global economy on a large scale. Specific opportunities for managing the international transactions of Indian conglomerates and government FX reserves steadily increase, moving India away from the margins of the global financial services sector.

Key developments 2005-2015:

2007	<ul style="list-style-type: none">• International oil prices settle back at \$60 a barrel.• GDP growth reaches 6.5%, rates of inflation; interest rates retain their low levels and the fiscal deficit marginally closes to 8% of GDP.• Foreign capital inflows (portfolio and direct) reach \$20 billion.• The Congress Party-led coalition government is able to pursue moderate measures of economic reform as its communist 'supporters' reduce their opposition to all privatisation of the public sector and subsidy curtailment.• Relations with neighbouring states improve, especially in matters of trade where India and Pakistan sign agreements for a joint gas pipeline to Iran.
2009	<ul style="list-style-type: none">• Conditions in the international economy remain benign.• GDP growth falls marginally to 5.5% following a poor monsoon, but the fiscal deficit is held at 8% of GDP.• A 'free-trade' agreement is signed between India and several neighbouring states, including Pakistan.• The government brokers a 'partnership' between the leading public-sector insurance companies and a series of foreign financial services MNCs.• Foreign capital inflows reach \$25 billion.• The government loses the statutory general election. Despite the Congress Party's share of the vote increasing, a re-shuffling of alliances between the regional parties gives a BJP-led coalition a majority in parliament.• The new government clips the wings of extreme Hindu nationalist elements within the BJP and settles down to ruling by negotiation with its regional partners very much as before.
2014	<ul style="list-style-type: none">• Conditions in the international economy remain benign.• GDP growth touches 6.5% following a satisfactory monsoon and the fiscal deficit is held at 8% of GDP.• India supports the conversion of the South Asian Association for Regional Co-operation (SAARC) into a trade-regulation authority and also joins ASEAN.• The government permits a majority of the equity in the major public-sector banks and insurance companies to be held 'privately'.• Foreign capital inflows reach \$30 billion.• The government loses the statutory general election as a result of a re-shuffling of alliances between regional parties which gives the Congress Party-led coalition a majority in parliament.• The new government gains assent from its communist party allies to press ahead with moderate economic reform – and settles down to ruling by negotiation as before.

7.4 Scenario C: The Elephant Retreats to the Woods

Global recession

In the decade after 2005, the global economy experiences major disturbances and periods of low growth, accompanied with a recession caused by sustained high-energy prices, as well as the impact of Chinese manufacturing. Global instability and insecurity is further exacerbated by the spread of terrorism, and intensified strategic rivalry between the US, EU, China and Russia. The US and EU retreat into stronger forms of protectionism, while international capital withdraws from emerging markets to be concentrated within the developed economies.

India experiences these traumas in a number of ways. Faced with escalating oil costs and dwindling opportunities for export earnings, energy use is restricted, thereby reducing levels of industrial output. While India discovers alternative sources of non-petroleum energy such as methane from coal beds and hydro-electric power, these add to costs and prove inefficient. Also, foreign capital disengages from India, especially through portfolio markets. Although in 2005, foreign investment had not established a dominant position in Indian markets, it had become psychologically important in boosting domestic confidence in the financial system. The withdrawal of foreign capital provokes a weakening in consumer and investor confidence, lowers demand, causes falls in stock prices, and increases the number of bankruptcies. Thus, by 2015, Indian GDP growth falls to an average of 3-4% per year.

India turns inward

The withdrawal of foreign capital, and worsening trade and fiscal deficits, leads to a depreciation of the rupee against other foreign currencies. This depreciation follows an adverse reaction in international markets to Indian domestic fiscal policies, which seek to cushion the impact of the slowdown by expanding subsidies and spending freely on current expenditures. Domestic public debt escalates, seriously squeezing out productive investment, and inflation becomes rampant.

The political consequences of these traumas are a series of general elections between 2006 and 2012 that produce weak, multi-party coalition governments. Congress and the BJP each try to lead these governments but have little success, as they are unable to accommodate the demands of their regional and special interest partners. The liberal wings of both parties attempt to form a new party of national government, however, policies of more radical liberalisation have little effect in a context where the global economy is turning towards protectionism. The leftist parties and the communists call for a return to the protectionism and socialism of the Nehruvian era. In those days, India had important links to the world economy via its close ties with the Soviet Union, which no longer exist.

An entirely closed, inward-focused economy cannot meet India's own requirements for economic development. Nor can it satisfy the new, expanded middle class, used to better days, which clings to hopes of a revival of globalisation and resists attempts to close the economy off from the rest of the world.

Politics go local

- **Populist forces run rampant**

Although the institutions of government remain formally intact, at both the national and the regional levels, their authority is widely dismissed or manipulated, by powerful private actors. The middle classes withdraw from national politics as far as they can, as had occurred in the 1990s and early 2000s. This leaves politics even more open to populist forces, many of which have links with the criminal underworld. This process of withdrawal of the middle classes is greatly facilitated by the increasing weakness of the state, where corruption and the growth of private security services allows the middle class to operate behind high walls, where their privileges are protected.

The regionalisation of politics – noticeable from the 1990s – unravels increasingly into localisation. Effective authority lies with local political bosses who are able to commandeer shrinking resources in a very direct way, often with force. They either neutralise, or take over the residual institutions of the state. These bosses represent

dominant local power groups, socially defined by particular caste or religious-community membership, whose authority is based on little more than coercive capacity. The growing influence of these bosses lead caste and communal riots to become a common feature of politics, even in the major cities. In this respect, the political models established in north and east India, especially in Bihar and Uttar Pradesh, from the 1990s spread across most of the country.

These models do not involve outright challenges to the integrity of the national and the regional state. Instead, they reflect ambitions which are much more parochial and responsive to traditional rather than modern norms of conduct. They also demonstrate the extent to which large sections of Indian society in the past were excluded from the positive aspects of modernity, such as education, public healthcare and wealth. The failed attempts of Indian governments since 1947 to incorporate these groups into a history of progress, has now come back to haunt the country as under the duress of economic contraction, they overrun the modern state itself.

- **Ineffective coalitions**

By 2015, central government reverts to an exaggerated type of small party coalition governments that were last seen between 1996 and 1998 as the United Front coalition. It consists of regional and special interest parties, but is not dominated by either of the two national parties. Government policy is influenced by both the left and the right, but without any consistency. Indeed, decision-making increasingly defers to the non-democratic institutions of the bureaucracy and the law. These however, follow principles left by precedent and by a Constitution written in 1950, which broadly set out the main functions of the state to be the re-distribution of wealth and not its creation. As a result, they have no formula for dealing with the slowdown of growth.

Due to the authority of government weakening, the state becomes increasingly hollowed out. This goes much beyond the increasing autonomy of the regional state governments, and involves the encroachment of the black economy. Corruption soon becomes ubiquitous and the criminal and political worlds are ever more deeply intertwined. As a result, violence though local, social and political conflicts erupts, even on the streets of the major cities.

India's economy

- **Loss of competitive edge**

Despite the damaging impact of the global contraction, India sustains a low growth momentum. In part, this is generated by the effects of the demographic cycle, which is pushing more people into the workforce. Moreover, a few pockets of high growth still exist. One of these is at the high end of the services sector, where the need for high-quality Indian human capital of the developed economies is still strong. R&D and other non-labour intensive forms of production continue to develop mostly in IT and in science parks, cut off from the rest of society. The trend set in early 2000 of highly educated NRIs returning to India and the retention of more middle-class professionals working at home, comes to an end.

Once again middle-class ambition lies strongly with emigration, and high-quality Indian skills are being used mainly outside of the country. Moreover, India starts to lose its competitive edge in the provision of IT and BPO services as a result of stiffer overseas competition and US/EU protectionism. In turn, this harms growth in the

education and medical service industries, where many of the private colleges that had developed in the early 21st century are forced to shut down owing to a lack of applicants.

- **Infrastructure and labour conditions deteriorate**

Certain pockets of industry also continue to grow, mainly to service residual middle-class consumption. This is also the case in areas where India has major advantages, such as metals, pharmaceuticals and light engineering. The industrial context, however, is not expansive. On the one hand, the already poor state of infrastructure deteriorates, especially because government spending is entirely directed towards meeting immediate consumption needs and private capital is reluctant to pick up the slack. The only successful industries are those that can provide their own infrastructure. Labour conditions are also rapidly deteriorating. While highly protective labour laws remain in place, they are widely ignored in practice. Intensifying competition for declining opportunities to work drives down real wages and promotes more open forms of exploitation, including the resurgence of child- and bonded-labour.

Rural to urban migration increases on a larger scale, leading to an expansion of shantytown settlements that threaten to overrun all available urban space. A few pockets of high-end farming survive to service residual middle-class and overseas demand. Declining labour costs threaten to undermine more capital-intensive methods of production and agriculture reverts to more of an emphasis on local subsistence provision. In this context, the impact of periodic monsoon failures is devastating and famine returns to certain regions once again.

Capital markets

- **Expansion of the black economy**

The government introduces heavy exchange controls, even on the current account, in order to quell the initial outflow of capital. Moreover, in a context of weakening government authority, the controls are only partially effective in retaining capital already inside India. New forms of illegal exchange, especially via the Gulf, emerge as fast as the Indian authorities try to stop them. The middle class shifts an increasing amount of their savings abroad and those Indian companies with export earnings, also keep their profits overseas. The illegal channels of exchange also draw a limited amount of capital back into the country to invest in the few areas of the economy that still have international value. The increasing use of these illegal channels, where US dollars and gold are the effective currency, increases the relative size of the black economy.

- **Inflation makes a comeback**

In the formal sector, the rupee declines steadily in value. After 2007, successive weak coalition governments step up borrowing and increase the fiscal deficit in order to meet increasing consumption demands from their major political constituencies. This leads to a decline in international confidence in the rupee. The IMF attempts to impose tighter fiscal discipline but successive governments fail to implement its measures in the face of domestic political opposition. Governments even resort to printing money to cover their escalating expenditure, though the residual authority of the RBI makes this only a periodic activity. Inflation rises back towards levels last seen in the 1970s in the range of 15-20%, and interest rates follow suit. To meet its own deficits, the government reverts to 'commandeering' savings from the banks

which have less money anyway, as savings are withdrawn while domestic investment is in serious decline.

The withdrawal of savings from formal financial-sector institutions partly reflects a loss of confidence in financial markets and attempts by the middle classes to shift their resources abroad by illegal means. However, it also reflects the growth of investment in non-financial assets. Land and houses within the safer and security-protected middle-class enclaves rise sharply in value. India also experiences a massive increase in gold imports, which boosts the international price of gold.

Financial services

Demand for legal, private-sector financial services shrinks. Governments seek to protect and expand the sphere of public-sector institutions, not least to improve their ability to commandeer savings. As a result, the role of foreign financial institutions is limited. Their contraction reflects no more than the overall contraction of demand for financial services. The middle classes turn to the black economy to provide them with more effective forms of financial services. Here, Indian financial institutions, which hovering on the edge of legality but possess strong political and criminal connections, have a distinct advantage.

Key developments 2005-2015:

2007	<ul style="list-style-type: none">• International oil prices stay above \$70 a barrel.• Trade deficit widens to 4% and fiscal deficit reaches 9% of GDP.• GDP growth declines to 5% following a poor monsoon.• Inflows of foreign capital fall below \$8 billion.• Congress Party-led coalition government falls when main communist supporters oppose 'emergency' reforms.• General election returns another Congress-led coalition but backed by regional parties with communists in opposition, attempts to press ahead with reforms. Reforms however, are too tepid to meet deteriorating international conditions.
2009	<ul style="list-style-type: none">• International oil price is sustained at \$80 a barrel.• Trade wars between the US, EU and China lead to the spread of protectionism.• Trade deficit widens to 6% of GDP and fiscal deficit to 10% of GDP.• GDP growth falls to 3% – worsened by a poor monsoon.• IMF expresses 'extreme concern' at Indian economy and foreign capital begins to withdraw.• The government falls when its attempts more radical reforms and is deserted by its regional allies.• The general election is won by a BJP-led coalition with regional parties, promising stronger policies of 'national' protection. As these fail to improve the economic situation, it soon loses credibility.
2014	<ul style="list-style-type: none">• International oil price stays above \$80 a barrel.• Trade deficit closes but fiscal deficit widens to 12%. Inflation and interest rates rise sharply and GDP growth falters to 3%.• IMF and World Bank withdraw 'conditional' support previously offered and foreign capital seeks a hasty withdrawal.• The government falls following a split with regional allies over the distribution of subsidies and within the BJP itself over protectionism.• A new party of 'national unity' is formed by Congress and BJP 'reformists' but fails to win support outside the middle classes.• The general election returns over 40 different parties to parliament, which struggle to form any kind of government. Eventually, a de facto combination of regional parties emerges, but it is held together entirely by patronage and has no coherent policy agenda.• The business of government passes to the bureaucracy and the courts which, in so far as they are not captured by corruption, issue a plethora of rules seeking to regulate all forms of economic and social activity. Their authority, however, lacks powers of enforcement.• Law and order deteriorates as local power brokers seize franchises in the state, which they enforce with violence and are resisted with violence.• Much of the real economy turns 'black' – especially as the middle classes withdraw from society behind barricaded enclaves and pursue their economic interests 'offshore'.

8 Detailed Scenarios for China 2015

8.1 Scenario Summaries

The Crane Flies Against the Wind

The economic relationship between China and the OECD undergoes a transformation as Chinese businesses begin competing in higher value-added activities. As an increasing range of industries, such as automobiles, become exposed to Chinese competition, where the US and the EU succumb to protectionist pressures. While Western countries turn increasingly fearful of China's economic ascendance, China becomes the standard-bearer for free-market capitalism.

The success of Chinese entrepreneurs, engineers and professionals is reflected in rising consumerism. The Chinese economy becomes more balanced between exports and consumption thereby lessening the impact of the trade restrictions. Rising Chinese demand draws in exports from neighbouring economies. China therefore becomes the centre of a regional trading hub, and the renminbi becomes the dominant currency in the region.

With capital account liberalisation, the lifting of exchange controls, and securities market reforms, Shanghai becomes a major regional financial centre, displacing Hong Kong and rivalling other major centres such as London. While the middle class reaps the benefits of these developments, the urban and rural poor become increasingly discontent. China displaces the US as the dominant power in the region, and gains international prestige by playing an assertive yet constructive role in international relations.

The Lion Leads the Dance

The Hu Jintao-Wen Jiabao model, based on promoting balanced and sustainable growth which the current government is implementing, is successful at raising living standards in both urban and rural areas of China. This provides the Chinese leadership with the confidence to gradually expand political and social freedoms; however, the line is drawn at one-party rule. The CCP retains its hold on power, though it allows greater room for civil society.

Foreign MNCs play a crucial role in sustaining high levels of economic growth by providing the capital, technology, management know-how, and market access that sustain Chinese exports to OECD countries. The economic interdependencies between the US and China ensure that protectionist pressures remain contained.

On the downside, China's growth remains considerably dependent on exports and is therefore, vulnerable to a downturn in the US or the global economy. On the other hand, the success of banking sector reforms reduces a potential source of instability. China only allows limited opening of the capital account, and maintains control over the exchange rate.

In its foreign policy, China acts cautiously, avoiding confrontation with the US on sensitive issues, developing ties with a wide range of countries, and advocating multilateralism.

The Dragon Breathes Fire

Much of legitimacy of the CCP rests on its ability to deliver improvements in living standards to the majority of the population. This however, is called into question when a property market crash in 2009 is the trigger for a banking crisis and major economic and social dislocation.

The economic hardship, which affects numerous sections of society, leads many to question the benefits of single-party rule, and brings about intense popular anger. The government cracks down harshly on dissent, and, in attempting to deflect the blame for economic failings, stokes up anti-Western and anti-Japanese sentiment. The curtailing of political freedoms is mirrored with repressive economic measures aimed at containing capital outflows.

The operating environment for foreign MNCs becomes increasingly fraught, as the rule of law deteriorates and the government passively supports infringements of intellectual property rights against foreign firms. China's aggressive nationalism is reflected in its foreign policy as it becomes more belligerent against Taiwan. Relations with Japan become increasingly tense, sparking a regional arms race.

8.2 Scenario A: The Crane Flies Against the Wind

Key milestones:

2005-2006	US-EU textile row
2005-2007	Securities market reforms
2008	Beijing Olympics
2008	Renminbi becomes fully convertible
2010	Auto exports start hitting US and EU dealerships
2010	US imposes barriers to Chinese imports
2011	EU imposes quotas
2011	ASEAN+3 free trade fully implemented
2011	China signs up to Kyoto II
2012	US Congress refuses to grant trade promotion authority to a new administration
2012	Wang Huning appointed as president to PRC
2012-2014	Large-scale protests and riots take hold in a number of cities and regions across China
2014	Local elections take place across China

International environment

China's entry into the WTO proves to be a greater challenge than expected for many OECD countries. While it has broadly benefited consumers worldwide by providing a flood of inexpensive goods ranging from textiles to electronic equipment, an increasing range of industries, previously thought to be invulnerable, become exposed to competition from China. The disputes over textile exports in 2005-06 prove to be but a little squall when compared to the later 'auto wars'. In 2010, the first Chinese designed, produced and branded automobiles begin to hit the roads in North America and Europe at a significant discount to similar domestic or Japanese-branded models.

Combined with faltering growth and rising unemployment in both the US and the EU, protectionist pressures rise to bursting point. The domestic business lobbies prove unable to staunch the anti-free trade voices emerging from across the political

spectrum. The US Congress is the first to react and raises trade barriers to a wide range of Chinese imports. As the pressure becomes unbearable on EU countries, the European Commission follows suit, first imposing strict quotas on auto imports but eventually extending these to a host of other products. While the decisions in both cases are couched in terms of preventing Chinese dumping and unfair trade practices, there is little doubt that they represent a fundamental shift in economic power and attitudes from West to East.

These actions cause a major crisis in the global trading system. The death knell for the multilateral trade regime is sounded when the US Congress, in 2012, refuses to grant a new US administration trade promotion authority. This signals a rejection of free trade principles by the world's leading economy. In other words, it sends out the message that globalisation is good as long as it benefits the US, otherwise not. Ironically, as Western nations turn increasingly protectionist, the Chinese become the standard-bearers of free-market capitalism.

China's economy

- **From exports to consumption**

From 2005 until 2010, the Chinese economy and Chinese business go from strength to strength, despite slowing demand from the West. Chinese scientists, entrepreneurs and managers, many of them having learned their skills at US universities and business schools, prove adept at developing products and businesses that can compete internationally. As a result, China begins competing in higher value-added activities such as R&D and marketing. Initially, Chinese businesses focus their attention on meeting domestic demand. This requires building new business models, processes and supply chains for developing and marketing products that are within the purchasing power of the average Chinese family. These innovations prove to be highly disruptive to established companies and brands when they are eventually targeted at Western consumers. Thus, the nature of Chinese manufacturing and exports gradually shifts from assembly by and for foreign MNCs, to products wholly designed and manufactured by Chinese enterprises and marketed directly to Western consumers, often through the internet.

The principal beneficiaries within China of this shift into higher value-added activities are the educated middle class, becoming increasingly numerous, wealthy, and Western-minded in their aspirations and outlook. As a result, consumer appetite takes off; creating an economy that is more balanced between exports and domestic consumption. This provides the Chinese economy with a buffer against volatility in external demand. By 2015, private consumption is the driving force behind economic growth in China – accounting for 50% of GDP compared to 42% in 2005 – particularly as exports are constrained as a result of the protectionist policies pursued by the US and EU post-2010. The shift to consumption has the further beneficial effect of reducing the overall energy intensity of the economy.

The immediate effect of the trade restrictions is a sharp fall in exports growth to 10% (as compared to in excess of 30% in 2003-2004). The impact of the trade barriers is most felt among the many enterprises, including foreign MNCs, producing manufactured goods for export from China. This is particularly damaging in view of the role these enterprises play in providing employment to millions of workers, many of them migrants from rural areas. Fortunately, domestic demand goes some way to cushioning the impact. In the aftermath of the trade war, China experiences a loss of 3% to its GDP annual growth rate. With time, Chinese manufacturers adapt to the protectionist environment by shifting production to other parts of Asia and by focusing increasingly on the domestic market. Over the medium-term, while growth slows

somewhat from the heady levels of the early part of the decade, it remains solid. Between 2012 and 2015, China's economy grows at an average rate of between 6% and 7%.

Completing the liberalisation process

- **Fixing the stock market**

For much of the 1990s and the early part of the 2000s, the Chinese securities markets were a source of disappointment and unfulfilled expectations for Chinese and foreign investors alike. Stock market returns, either tepid or negative, seemed to bear no relation to the impressive growth rates experienced in the real economy. The completion of the financial liberalisation process, however, required the authorities to finally grasp the nettle and implement a range of reforms to enable the securities markets to operate efficiently.

Part of the challenge facing the authorities lay in the interdependence of securities market reforms with a host of other liberalisation measures. Any attempt to increase the liquidity and efficiency of the securities market required complementary reforms, to avert an overwhelming sickly market with excessive supply and to revive confidence among retail investors.

The series of stock market reforms implemented by the government and the China Securities Regulatory Commission (CSRC) between 2005 and 2006, including improvements in corporate governance and changes to share structures, begin to bear fruit by early 2007. These are accompanied by measures to increase the demand for stocks such as opening the way for more pensions and mutual funds, and raising the quota for foreign funds. The Shanghai stock market at long last begins to perform as a source of finance for the corporate sector and IPOs, and secondary offerings begin picking up significantly.

The success of the reforms draws in large amounts of foreign portfolio inflows. Initially, these come against the limits set by the CSRC, but with the further opening of the capital account, the restrictions are eventually lifted. The Shanghai stock exchange posts impressive gains and is the best performing market in the world for the period. Following the successful securities market reforms, many SOEs are partially privatised through share auctions on the stock exchange. While the restructuring of former SOEs leads to significant lay-offs, their impact is moderated by the vibrant private sector.

- **Opening the capital account**

While Western governments begin to take a less optimistic view of the impact of globalisation and unconstrained market forces, China's conversion to its version of capitalism appears complete when, in 2008, it allows the renminbi to float freely. China opens the capital account to bi-directional portfolio and direct investment flows. This move becomes possible with the modernisation of the four largest commercial banks, and the resolution of their NPL problem. Chinese households benefit from the opportunity to diversify their portfolios by investing abroad. Foreign investors gain increased access to China's securities markets, now on a stronger footing. Over the period, the renminbi appreciates by 50% against the US dollar on the basis of advantageous differentials in GDP growth and short-term interest rates, and a continued, though diminished, surplus in direct investment flows.

The lower demand for US assets (as the Chinese central bank ceases to accumulate US dollars) has the effect of raising long-term bond yields, which in turn leads to

higher mortgage rates, and a substantial drop in US house prices. This brings the highly indebted US household sharply down to earth. The fall in confidence feeds into lower consumption, a weaker economy, and increasing unemployment. While Chinese exporters are hardly to blame for the drop in wealth and rise in unemployment among US homeowners and workers, they bear the brunt of the disgruntlement.

- **Regional trade and investment**

The Chinese consumer increasingly acts as the source of final demand for regional economies, partly making up for the waning and less accessible US consumer. Chinese companies also begin investing heavily in neighbouring countries such as Vietnam, where labour costs are equally competitive, and location and infrastructure factors are advantageous. This process is reinforced by US and EU protectionism, since Chinese manufacturers shift production to other countries in the region in order to evade the protectionist quotas. This has the effect of boosting regional trade and reinforces the drive to establish an ASEAN+3 regional free trade agreement, which is fully operational by 2011.

In view of the rising importance of regional trade centred on China, by 2012 most countries in the region have pegged their currencies to the renminbi, thereby consolidating the renminbi's status as a hard currency. This process is reinforced by the development of local-currency debt markets. This provides Chinese and other Asian corporates with a new stable source of long-term capital, and insulates their economies from exchange-rate shocks. Deeper regional bond markets also allow governments to pursue more aggressive counter-cyclical policies and to fund major improvements in infrastructure and education.

Society and culture

The success of Chinese enterprise and the middle class is not reflected across society as a whole. The dislocation in exports resulting in part from a combination of OECD protectionism, weaker global demand, and rising competition from other developing economies, interrupts flow of labour out of the poorer rural regions of China and into manufacturing industries. By 2012, China reaches a peak in its demographic cycle, with over 70% of its population of working age. The result is rising unemployment, especially at the low skills end of the labour market. Increasingly visible inequality, as unemployed workers, homeless and rural migrants fill the streets of major cities, drives a wedge through Chinese society. The discontent among the urban poor is reinforced by the conspicuous wealth of the entrepreneurial class and the rising disposable income and consumer habits of the middle classes. This leads to mounting levels of criminality and protests by unemployed workers, which become increasingly organised from 2012 onwards.

The consequences of the slowdown in exports are also felt in rural and less industrialised regions such as Gansu, Jiangxi, and much of the newly-opened western parts of China. A decrease in worker remittances and returning workers seeking opportunities back on the land, are also reflected in greater unemployment and poverty. Without a proper political outlet for their frustrations and unfulfilled expectations, a number of regions experience violence and riots on an increasing scale, mostly directed at local officials.

China's social problems are matched by an endemic public health crisis. Except for the most acute ailments, proper medical treatment is available to only those who can afford to pay (i.e. the urban middle class). The sense of crisis and inequality means that, despite crackdowns, interest grows in religions such as Falun Gong and

evangelical Christianity. Many other Chinese turn to the increasingly relevant legal system, and sue local officials and firms for redress.

Politics

- **Single party rule**

Over the period, the CCP survives the challenges and retains its monopoly over power. It proves flexible in handling the repercussions of the 2012 protests and riots. It does so by placing as much of the blame as possible on local and provincial governments, prosecuting and sentencing officials, and instituting democratic practices at a local level. The Party also cautiously allows further freeing of the media, encouraging consumer investigation style reports that criticise local corruption and poor services; as long as they keep clear of criticising the central government. Spurred by the sense of crisis – albeit somewhat belatedly – it also directs high levels of public investment in infrastructure and public services (health and education) to under-developed regions. In particular, it places much more emphasis on a specific “social contract” which involves a guaranteed level of housing and social welfare.

- **Succession**

The Hu-Wen leadership is credited with bringing China to its next stage of economic development, of successfully managing a series of complex economic reforms, of increasing China’s influence in the region, and raising China’s profile internationally. Despite its emphasis on welfarism, it is less successful in spreading the benefits of that development far beyond the coastal regions. In 2012, the presidency and party leadership pass to Wang Huning, former head of the Central Party School. This is not unprecedented; Hu Jintao himself had previously headed the School, but it is a sign of a shift away from the more welfarist policies of the Hu-Wen era. Wang, who had helped former leader Jiang Zemin – still alive and well as an older statesman – to draft the “Three Represents” policy of the 1990s, seeks to draw more on the free enterprise notions of his mentor Jiang. While welfarism remains important, Wang’s appointment signals a desire to seize the opportunity for Chinese leadership in the world trading community while the US and EU turn protectionist.

- **International**

China’s growing regional economic weight, reflected in its trade and investment relations is mirrored at a diplomatic level. Its role in defusing the North Korea nuclear threat and spearheading the ASEAN+3 agreement raises its stature within the region. Equally, it shows restraint in its relations with Taiwan. By 2015, China has largely displaced the US as the dominant power in the region. China also develops further international prestige after acting as a “honest broker” in crisis areas such as the Middle East, and becoming a party to the Kyoto II Agreement in 2011 (which comes into force in 2012).

Financial markets

The successful 2006-2008 reforms to China’s securities markets not only provide a boost to China’s domestic economy, but also shift the centre of gravity in global financial markets eastward. By 2015, Shanghai has displaced Hong Kong as the most important Chinese financial centre, and even begins to rival major European exchanges such as London and Euronext in terms of market capitalisation. Much of the expansion of China’s MNCs has been financed through the Shanghai stock market. Moreover, the liberalisation of the exchange regime leads to the rapid development of local wholesale capital markets, centred on the renminbi trade in Shanghai, and the development of associated hedging and financial products.

SOE privatisation, consolidation and reform provide a fertile ground for investment bank participation, both in terms of providing capital as well as advisory services. The development of regional bond markets provides the Chinese government with a vast source of new funds that it can tap, in order to finance development and investment in its poorer regions. It also provides Chinese corporations with an alternate, and cheaper, source of debt finance to bank loans. Western multinationals also turn to the renminbi bond markets as an alternate source of debt. On the retail side, the expanding middle class, both in terms of size and wealth, generates a large demand for a wide range of financial services, ranging from mortgages and credit cards to life insurance, motor insurance and mutual funds.

8.3 Scenario B: The Lion Leads the Dance

Key milestones:	
2002-2007	Banking sector reformed in preparation for market opening
2005-2007	US-EU textile row tests commercial and political relations
2006-2007	US economic downturn
2008	Minmetals acquires leading Australian mining company
2008	Beijing Olympics
2008	KMT party wins Taiwanese presidential election
2010	Airbus begins manufacturing parts of the A350 in China
2012	Communist Party re-appoints Hu Jintao, confirming the Hu-Wen partnership
2015	Crude exports from non-conventional sources begin to flow

Governance improvements

The success of the 2008 Beijing Olympics is emblematic. On the one hand, there is China's advent as a responsible member of the international community; on the other, its growing confidence in its own internal development model of balancing economic growth with social and environmental considerations. China's opening to the world is mirrored domestically in its general loosening of controls, its more tolerant approach towards freedom of expression and association, and an improving human rights record. The Hu-Wen government successfully manages to steer sustainable economic development, and to spread its benefits more broadly across regions and sectors of society. This in turn provides the Communist Party with the legitimacy and the confidence to permit a gradual expansion of political and social freedoms. In particular, China loosens controls on internet traffic, creating a powerful new forum for the emergence of a "civil society", which is not closely monitored from above.

The central government also initiates an effort to improve the governance at a local and regional level with a view to eventually ceding more powers to lower levels of government. While the Party does not relinquish its monopoly over power, it becomes more tolerant of civic organisations and gives them more of a say in the policy-making process. Policy making, particularly at a central level, thereby becomes more transparent and consultative. Thus, for example, the views of environmental groups are increasingly incorporated in the development of environmental policy. The rights of ethnic minorities in Tibet, Xinjiang, and elsewhere in China, are also given more prominence in policy, in a calculation that allowing some room for expression will prevent more destructive social unrest.

The trend towards greater transparency and good governance at political and institutional levels is also reflected in improvements to the legal system. This is through a strengthening in the administration and enforcement of the rule of law and increasing access to the law for a larger proportion of the population. The government also acknowledges the importance of efficient and fair regulation as a platform for business. A fundamental element of this wide-ranging set of reforms includes improvements to the protection of intellectual property rights, and, in particular, the enforcement of those rights. Although the Party remains supreme, many of the items in China's constitution are now made justiciable, i.e. lawsuits can be brought citing articles in the constitution as their basis.

China's economy

- **Foreign multinational dominance**

The combination of these reforms provides further encouragement to foreign investors. MNCs increasingly transfer complex manufacturing activities to China, ranging from pharmaceuticals to aircraft assembly plants. By 2010, part of the fuselage of the new A350 Airbus is being manufactured in China and then shipped to Europe for final assembly. China therefore, maintains the export-led growth model that formed the basis of its rapid development in the early 2000s.

Between 2005 and 2015, China consolidates its position as a manufacturing powerhouse. Chinese exports, however, continue to be dominated by the activities of MNCs. Few Chinese companies prove capable of competing internationally in their own right. For most, the focus remains on integrating into global supply chains, usually controlled by US and European multinationals, or supplying inexpensive goods which are marketed by leading Western retailers. While China's dominance in the production of a wide range of goods is virtually complete – for example, by 2015 China is supplying close to 30% of all ICT exports – it has been far less successful at developing new products and creating home-grown brands with international recognition. The division of labour whereby China provides manufacturing and where OECD countries maintain their comparative advantage in innovation, R&D, and marketing, is reinforced.

Thus, the economic and financial system by which western companies provide the capital, technology, management know-how, and market access, and China provides a vast pool of labour, proves to be highly robust. On the one hand, FDI provides China with the necessary fuel to drive its economy and employment to the large swathe of workers, particularly from the interior and western rural regions. On the other hand, Western multinationals gain access to a rapidly expanding market with a huge potential, as well as a seemingly limitless supply of inexpensive labour, at least at the low end. For the Chinese, MNCs are particularly valuable partners because of their role in countering protectionist sentiment in the OECD, thereby ensuring that markets in industrialised countries remain open to Chinese exports.

- **US-China dynamics**

The interdependencies and mutual interests between China and the OECD nations extend deeper than the role, albeit a crucial one, played by multinationals. China's phenomenal export capacity is reflected in rising current account surpluses, particularly vis-à-vis the US. While many on the left of the US political spectrum as well as nationalist politicians consistently maintain that China is playing mercantilist games by keeping its currency undervalued, there are many equally forceful voices that call for restraint.

The dynamic which first became apparent in the early 2000s, according to which China's current account surplus and capital inflows are recycled into US assets, (primarily US Treasuries and state, municipal and agency debt, but increasingly as an overseas acquisition currency by China's state enterprises), shows remarkable persistency. China's currency remains effectively pegged to the dollar within the post-July 2005 exchange rate regime, with only incremental and slow appreciations of the renminbi.

China's accumulation of US assets and the liquidity this brings to global markets benefits the US and world economy by maintaining real interest rates at historical lows. Inexpensive credit is the fuel that provides US households with the means and the confidence to sustain their lifestyle and consumption habits. Although there is the occasional outburst over claims that the renminbi continues to be undervalued, tensions over trade never overflow into a major dispute. OECD protectionist pressures are contained by a pro-China business consensus, aided by significant extension of trade liberalisation to services and by an international investment protocol, honoured by China. China also does its share to maintain the support of liberal economic interests by implementing its WTO commitments promptly and fairly.

- **Restricted capital account**

China's capital account becomes progressively more open to direct investment flows. A broader set of Chinese enterprises are authorised to access the FX market to conduct overseas acquisitions and green field investments. The Chinese government however, remains concerned about the possibility of large capital inflows and outflows and its implications for currency volatility.

The capital account therefore remains largely closed for portfolio transactions, and the Qualified Foreign Institutional Investor (QFII) scheme continues to be the only vehicle for foreign access to the Chinese stock market. (QFII is a scheme according to which a number of foreign registered institutional investors are able to trade in Chinese securities.)

- **Export dependence**

The major drawback to China's export-led growth model is its increasing dependence on the US and European economies. While protectionist pressures are kept at bay much less can be done to avoid an eventual slowdown in US demand. This has inevitable repercussions for Chinese growth. Fortunately for the Chinese, the timing of the US slowdown falls conveniently into the run-up to the Beijing Olympics, when high levels of public investment serve as a counterweight to lower US demand for Chinese exports.

Over the period between 2005 and 2015, China's exports growth gradually converges to levels more consistent with overall world trade growth levels. China's real GDP growth rate therefore, moderates from the high rates of 9-9.5% recorded in 2004-2005, to a more sustainable level of between 5-6% in 2015.

- **Meeting energy needs**

China's export-oriented economy is increasingly dependent on the supply of vast amounts of imported energy and other raw materials such as iron. By 2015, oil imports have reached 75% of Chinese oil consumption (compared with less than 50% in 2005). With the backing of the state, Chinese energy companies and major SOEs, seek to secure key inputs by acquiring assets around the world. Following a string of initial failures such as its attempt to acquire Unocal in 2005, China learns to target assets that do not carry a particular strategic or symbolic value. Their appetite

is not limited to the Asia Pacific region or to the developing world. Facilitated by the deployment of China's huge FX reserves, Chinese investment plays a major role in developing vast new resources of non-conventional oil such as the heavy crude fields of Orinoco Belt in Venezuela and the Canadian oil sands. By 2015, production from these non-conventional resources begins to ease the global supply constraints.

The Chinese spending spree however, is not limited to the energy sector. Between 2005 and 2007, state-sponsored Chinese resource companies make a string of investments, in the form of joint ventures and acquisitions of metals and extractive companies in Latin America, Africa and Asia. In 2008, Minmetals, a Chinese metals producer, breaks into the industrialised world by acquiring a leading Australian mining company.

- **State-owned Enterprises (SOEs)**

In spite of the encouragement to foreign investment and the importance of foreign MNCs to China's economy, the Chinese government seeks to maintain a strong presence in the economy. It does so by maintaining controlling stakes in large SOEs, particularly those with strategic significance in the energy and natural resource sector. While it promotes reforms and consolidation in order to strengthen the international competitiveness of these enterprises, the government draws the line at full privatisation. Moreover, China's vast foreign reserves provide a deep source of capital and an acquisition currency for its leading SOEs, thus avoiding the necessity to resort to private sources of finance.

- **Banking system reforms**

The Chinese government is less reticent about allowing foreign investment into the state banking sector, though this is principally driven by China's WTO commitment to open its banking market to foreign competition. The prospective introduction of foreign competition into the banking sector forces the government to tackle the weaknesses of the state banks. A key component of the strategy for reforming and strengthening the state banking system involves introducing Western management expertise and technology improvements. This is, so that state banks are better placed to resist foreign competition. The government does this by encouraging its banks to seek "strategic partners" through foreign listings. From 2002 through to 2007, the government also provides relief for the balance sheet of the four major state commercial banks by transferring bad assets to asset management companies and recapitalising them with their foreign currency reserves.

In spite of the banking sector reforms, the state banks continue playing a key role in supporting SOEs. This eventually causes conflicts between the banks' majority shareholder (the state) and their mostly foreign minority shareholders who wish the institutions to be managed on a more commercial basis. Foreign banks are more successful when they operate in a joint venture with Chinese banks and where they have greater influence over the management of joint ventures. Many of these operations are commercially successful, particularly when they target niche markets with more sophisticated needs such as the wealthy urban population. Nevertheless, state banks continue to dominate the broader market.

Attempts to reform the securities market proceed very cautiously and ultimately fail to achieve their objective of creating a market which acts as a source of risk capital for private enterprise. Private Chinese enterprises that seek alternatives to bank finance turn to regional markets such as Singapore or, in the case of the larger corporations, to New York and London, rather than Shanghai.

Society and politics

The government is successful in improving income distribution, particularly to the benefit of farmers whose living standards had suffered greatly since 1997. The combination of strong inflows of FDI and state support for SOEs, provides employment and generates opportunities in manufacturing industries for the millions of labourers wishing to leave the land for a better life in the cities. This has the further beneficial effect of providing stimulus to domestic consumption as the new working class seeks to acquire the basic amenities of modern life such as fridges and televisions. Improving working conditions, health care and housing also contribute to a better quality of life for factory workers.

Policy also boosts living standards in rural areas, partly through the flows of remittances from family members working in the cities and partly as a result of land reforms which boost the productivity of agriculture. In addition, significant progress is made in the government's mid-term goal of urbanising around half of the population. A significant proportion of the "new urbanites" are re-housed in the new townships of western China, opened up under the expansion policy of the early 2000s.

By the time of the leadership convention in 2012, the Hu-Wen partnership is viewed as having been largely successful in lifting millions out of poverty, and reducing the inequalities that could have threatened stability. The Party therefore, opts for stability and continuity, and renews the mandate of both Hu and Wen who are consequently confirmed as President and Prime Minister at the National People's Congress in 2013.

International relations

Much of the focus of Chinese diplomacy between 2005 and 2015 is on securing access to energy and other inputs that are necessary to sustain China's export led-growth model. China proceeds cautiously in this respect, so as not to cause alarm in Washington. While it develops diplomatic ties with Venezuela, it refrains from directly threatening US energy security, and focuses instead on developing new capacity there. Beijing also maintains close and friendly ties with Moscow, particularly as China remains eager to secure energy from Russia, and with Central Asian governments, for the same reason. It also concludes arrangements with South East Asian countries for the shared use of water resources, allaying fears of "water wars" that could destabilise the region.

China's relationship with the US is dominated by economic considerations. While in the long-term each considers the other as a strategic competitor, in the medium-term, China views its trade and investment ties with the US as fundamental to its economic growth model. It therefore, does not attempt to challenge the US's dominance in the Asia Pacific region and seeks to avoid potential flashpoints, such as a confrontation over Taiwan. Politics in Taiwan also prevents deterioration in cross-strait relations. The victory of Ma Ying-jeou of the Kuomintang (KMT) in the 2008 Taiwanese presidential elections leads to a significant improvement in relations between Taipei and Beijing. China's foreign policy over the period is balanced and pragmatic. Beijing actively fosters relationships with a wide range of countries and is a strong advocate of multilateralism.

Financial services

The opening of the Chinese financial services market in line with its WTO commitments provides opportunities to first-mover financial services institutions. The expanding middle class is the principal driver of demand for retail financial services, particularly credit cards, mortgages and personal insurance products. For innovative

financial services institutions there are also opportunities to market to the inland, western and rural areas of the country, where the social safety net is much weaker.

International investment banks play an important role in supporting FDI into China, through advisory services and financing. The international expansion of Chinese corporates also creates demand for wholesale finance and M&A advisory services going in the opposite direction. Numerous Chinese companies seek listings on the NYSE and London.

8.4 Scenario C: The Dragon Breathes Fire

Key milestones:

2006	Failure of Six Party talks
2008	Beijing Olympics
2009	Property market collapse
2009-2010	Banking sector crisis
2010-2013	Widespread political protests against CCP
2011	Japan revises Article 9 of its Constitution
2012	Communist Party appoints a leader with strong military connections as president
2013	Pipeline from Venezuela to Colombia completed

Banking sector breakdown

The first sign that all is not well in China's economy is the slump in property prices in major urban centres in early 2009. While the authorities successfully manage to curb investment in overheating sectors where excess capacity had been building up such as steel, they are less capable of staunching speculative investment into property. The property crash has a number of negative implications. The resulting investment slump and slowdown in construction activity leads to substantial job losses in the sector, which extends into a broader loss of consumer confidence.

The banking sector is the most affected as a new wave of bad loans hits the balance sheets of lending institutions at a time when the sector is opening up to foreign competition. The authorities act quickly to ensure that no major bank fails by providing liquidity and recapitalising the most vulnerable institutions through injections of US dollar assets drawn from the central bank's huge foreign reserve holdings. A number of regional banks, left to their own means, fail as depositors take flight. While the closed capital account averts a full scale run on the renminbi, substantial leakage leads to a weakening of the currency against the dollar and other major currencies, and the central bank is forced to raise interest rates in order to stem deposit outflows.

Crisis implications

- **Economic**

In the medium-term, the impact is felt most strongly through a reduction in bank lending. The companies that are hardest hit are the SOEs and those in the construction sector; many having survived in large part because of government directed credit policies. The weakening of the banking sector makes such unprofitable lending practices unsustainable. A number of SOEs go bankrupt, while others are forced into restructuring, leading to significant lay-offs and an increase in unemployment.

Also affected by the problems of the banking sector are households, particularly the new middle classes that had begun to discover the benefits of credit. They have been responsible for a large portion of the increasing demand for financial products such as mortgages, consumer loans and credit cards. Consumption suffers heavily as a result of the rationing of credit.

The combined slowdown in both investment and consumption cuts GDP growth rates sharply from 8% down to 3% within the space of a year. The one sector that holds up is exports, as by 2010 over 60% of exports are generated by foreign MNCs invested in China, and they are less dependent on credit from the domestic financial sector. The lower level of investment leads to a long-term reduction in China's growth rate, and growth in the period 2010-2015 settles down to between 4% and 5%. Internationally, a sharp drop-off in investment, and particularly in the construction sector, results in a reduction in demand for commodities such as steel, iron ore, aluminium, and copper, with attendant implications for global commodity prices.

- **WTO commitments**

The weakness of the domestic banking system leads the government to backtrack on its commitments to opening the banking sector to foreign competition. This is due to fear that well-capitalised and well-managed international banks will overwhelm the disabled domestic banks. It does this by delaying approval for new licences, and, for those already established, thwarting their ability to expand by preventing them from opening new branches through administrative measure, if need be. Banks that operate through partnerships with Chinese banks, however, are less affected. These actions lead both the US and EU to file complaints to the WTO dispute resolution body on behalf of their financial institutions.

- **Social**

The repercussions of the banking sector crisis are felt among many sections of society. Foremost among these are many of former SOE workers who find themselves unemployed and with poor prospects for any imminent return to the formal sector. They form a cohesive and organised group with a clear notion of who is to blame for their plight: the factory managers and owners, and by extension, the state. They are effective at mobilising and do so in highly visible ways through demonstrations and sit-ins of government offices.

The attempts made after 2005 to build a new, basic welfare and medical infrastructure for the poorest in society left behind by the reforms now fall by the wayside, and SARS-like diseases, which were retreating, now become endemic. The other group that is very vocal in its condemnation of the government's management of the crisis is the urban middle class, which suddenly sees its disposable income and spending power being sharply curtailed. Areas of the country such as the Northeast, Southwest, and Hainan, which have tied themselves to a strategy of growth through the encouragement of domestic tourism, are particularly badly hit as consumers cut back on non-essentials such as vacations.

The manifestations of disaffection are considerably different from expressions of popular anger earlier in the decade. Whereas many previous incidents were directed towards local government and corrupt local officials, protests are now more clearly aimed at central government, and by extension, the CCP. The unfulfilled expectations among the middle class and workers, lead many to question the rationale for single party rule and to demand political reforms. What's more, on this occasion, the protesters, despite being from disparate regions and social classes, are united in what they view to be the causes of the crisis. They are also successful at

co-ordinating among themselves, and establishing a common platform and organisation.

One notable phenomenon that is related, but separate in its leadership, is the rise of religious cults. Previous groups of this sort, such as the Falun Gong, were contained with relative ease during the economic boom. At a time when the state seems to be incapable of protecting its people's interests, such other-worldly alternatives, always traditionally popular in China, make a significant comeback, with illegal but substantial underground networks and financial resources (many of the latter from overseas Chinese).

- **Government response**

The government, while at first caught off-guard by the scale and level of organisation of the protests, does not take long to revert to a self-preservation mode, acting with force and repression, imprisoning the ringleaders without much concern for even the appearance of justice. Basic freedoms achieved over the previous decade are severely curtailed. The media is tightly reined in, and many organisations, whether linked to the protest movements or not, are banned. China comes in for harsh criticism by the US and the EU for its crackdown on individual freedoms, and allegations of human rights abuses by a number of civil society organisations. The crackdown also extends to the new religious organisations, although as they do not aspire to operate in dialogue with the state, it proves much harder to undermine them.

As a means of deflecting attention away from the domestic situation, and shifting blame away from itself, the government responds with fierce anti-Western and anti-Japanese rhetoric. The government promotes a version of Chinese nationalism which is defensive and in opposition to Western values of individualism. It accuses the West of trying to suppress China's development through protectionism, and engineers protest against US and Japanese companies. As a result, the situation in China becomes increasingly fraught for many foreign investors. Boycotts, which were extremely widespread in the early twentieth century, once again become common. Consciously echoing the language of that period, the Chinese are encouraged to reject foreign goods in favour of "national products."

Business environment

The failure to implement WTO commitments in the financial services sector is emblematic of a general deterioration in the regulatory environment and in the administration of the rule of law. Both become increasingly subject to encroachment by the state. The enforcement of rules and legal judgements are often arbitrary at best and politically motivated at worst. The legal environment becomes biased against foreign investors. To make matters worse, the lack of transparency in developing, applying and enforcing rules creates increasing space for corruption. As foreign investors become wary, overseas Chinese and ethnic Chinese with Western citizenship find themselves under particular pressure to do business the Chinese way, with emphasis on contracts and transparency being portrayed as discriminatory and evidence of ethnic betrayal.

Another area where gains achieved in the early part of the decade are quickly whittled away is in the recognition and enforcement of intellectual property rights (IPR). The government passively supports infringements of IPRs. This develops into a broader policy aimed at acquiring Western technologies for both commercial and military purposes. While the government does not seek to expropriate or prevent foreign investment (as it continues to recognise the economic role played by foreign

investment), it nevertheless views the transfer of significant new technologies into Chinese hands as a strategic objective.

MNCs operating in China, particularly those in high-tech sectors such as IT, also face pressures from the other side as the US attempts to prevent the transfer of technologies (including non-military ones) and processes that might enhance the ability and effectiveness of the Chinese state to wage war. The difficulties for foreign MNCs in China are compounded by the strengthening of capital and exchange controls in the wake of the banking crisis. While ostensibly aimed at averting capital flight, they have the secondary effect of making it difficult for foreign investors to repatriate profits.

Politics

The banking crisis and its aftermath cause a re-assessment by the Chinese leadership of its growth model based on export-dependence, foreign investment, and a market economy. While it does not advocate a return to state planning, it nevertheless seeks to ensure that the state retains control over key sectors. Most SOEs, including the smaller ones, therefore remain under state ownership, and investment is largely state-directed.

There are few winners in post-2010 China. One group which gains in influence and for which few resources are spared in spite of the economic difficulties, is the armed forces. Spending on the military increases and is focused primarily on acquiring naval and air force assets aimed at countering the US's military dominance in the region. Most of this hardware is acquired from Russia, though China increasingly develops a capability to manufacture its own weapons systems.

The increased influence of the military within the leadership reflects a change in strategy by the CCP. With waning growth and increasing unemployment, the CCP can no longer claim, as the basis of its legitimacy, to be indispensable for ensuring sustainable economic growth and improved welfare for the majority of the Chinese people. The Party begins adopting a much more nationalistic programme, with an emphasis on protecting China's gains from a hostile world that it believes wishes to undermine its progress.

The shift to a more militaristic attitude is reinforced in 2012, when the Communist Party selects a hard line replacement to the Hu-Wen partnership, with stronger ties to the People's Liberation Army. The move towards a welfarist model of development is regarded as a failure and instead a model much discussed, and originally rejected during the boom times, of late nineteenth-century Germany, is used as a starting-point for policy. Prompted in part by the hundredth anniversary of the Great War's outbreak in 2014, China explicitly portrays itself as a rising power which, like Germany a century before, is in danger of being encircled by hostile powers. It declares, however, that it will not make Germany's errors.

International relations

- **Foreign policy**

As early as 2006, China's foreign policy becomes focused on opposing US dominance in the Asia Pacific region in particular, which it views as its natural sphere of influence; but also further afield. The rising tensions and mistrust between the two sides are crystallized by the collapse of the six-party talks on North Korea in November 2006. The failure of the talks is accompanied by mutual recriminations

with the Chinese accusing the US of intransigence, and the US criticising China for being unwilling to put sufficient pressure on North Korea.

The Chinese are equally mistrustful of the Japanese as a result of historical antagonism between the two nations as well as Japan's close relations with the US, exemplified by the Japan-US Mutual Defence Pact. The Chinese leadership also makes ample use of the traditional public hostility within China towards its eastern neighbour as a means of stoking nationalist sentiment. China's military build-up and more aggressive nationalism cause alarm among countries in North East Asia and provokes a regional arms race. In 2011, with tacit support from the US, Japan revises Article 9 of its Constitution, which had prevented it from developing offensive military capabilities.

Initially, China views the EU as an important economic player, yet, a largely ineffective one because of its inability to project its power beyond its immediate neighbourhood, and its lack of a unified foreign policy stance. Following the crackdown and widespread human rights violations which take place after 2010, the EU joins with the US in strongly condemning China. This reinforces the view of the Chinese that the US is heading an international coalition aimed at impeding China's 'peaceful rise'.

China evolves as the unofficial head of a non-aligned group of countries. It reinforces its ties with countries such as Venezuela and Iran, and supports the rogue North Korean regime. Where it is less successful is in developing links with other emerging powers of Russia, India and Brazil. While they remain on good terms with China, all three countries seek to maintain an independent and balanced foreign policy. In addition, relations with China's Southeast Asian neighbours worsen considerably after China unilaterally withholds riverine resources for its own internal needs, causing widespread drought and environmental damage in Vietnam and Laos.

- **Taiwan**

China's aggression is not only directed at what it considers to be its strategic rivals, the US and Japan. It also becomes more belligerent towards Taiwan, demanding in 2012 that the Taiwanese leadership officially declare that it has abandoned any goal of independence, and is committed to eventual reunification with the mainland. When the Taiwan government refuses to bow to Beijing's demands, the Chinese impose trade and travel restrictions between the island and the mainland. The government however, stops well short of all-out war, realizing that the diplomatic and economic costs would be so heavy that they might rebound on the government and cause it to become victim to further instability.

- **Chinese outward investment**

While the majority of its investments are aimed at securing key energy and mineral resources, and are executed via state-controlled companies, China increasingly uses its reserves as a foreign policy tool to make strategic investments in countries with which it has good relations or wishes to co-opt. Latin American countries, in particular Venezuela, Bolivia and Ecuador, are prime recipients of China's attentions given their large oil and gas reserves, and the fact that some of their ruling regimes are strongly anti-American. Chinese investment plays a key role in financing a pipeline from Venezuela to Colombia's Pacific coast, thereby facilitating Venezuelan oil exports to China.

Financial services

The adverse political and economic environment imposes significant constraints on the development of the financial services industry. First, the banking crisis and the subsequent fall in growth rates and increasing unemployment hold back demand for retail financial services in particular. In spite of the problems facing domestic banks and the urgent need among Chinese corporates for credit, foreign banks are prevented from filling the gap because of the administrative obstacles raised by the authorities.

Despite the imposition of capital and exchange controls, there are significant outflows from the banking system, many of which find their way to Singapore. Foreign banks with operations in Singapore are the principal beneficiaries of the capital flight from China. Many Chinese corporations, faced with tight financial conditions in China, use their foreign subsidiaries to raise capital wherever possible. While there is little in the way of FDI flows entering or leaving China, investment banks advise foreign MNCs on how best to repatriate profits and import/export capital into and from China.

Appendix: Workshop Participants

Through the workshops and during one-on-one interviews some 60 representatives of a range of City and financial services interests were consulted. They took part under the Chatham House Rule. The project sponsors would like to thank the workshop participants listed below, and the Universities' Superannuation Scheme, Morgan Stanley and ABN Amro for their support, contributions and for hosting workshops. The organisations consulted were:

Advent Capital Management	Sanderson Asset Management
Amiya Capital	Scottish Development Agency
Association of British Insurers	Shell International
Aviva	Silver Point Europe
Baader Wertpapierhandelsbank	Standard Bank
Bank of England	Swiss Re
Banker	The Leading Edge Strategy Company
Boyer Allan	Tisbury Capital Management
C60 Capital LLP	Tokyo Mitsubishi Asset Management
Canada Life Assurance Company	UBS Global Asset Management
Cass Business School	Universities' Superannuation Scheme
Centre for the Study of Financial Innovation	Western Asset Management
China Britain Business Council	
Citigroup	
City Capital	
Clareville Capital	
Corus	
Credo Group	
CSES LLP	
DIT Allianz Dresdner	
Fidelity Investment Management	
Fidelity Investments	
Financial Ombudsman Service-	
Financial Services Authority	
GATKO	
GIC	
HBOS	
International Economist (formerly with UN)	
International Underwriting Association	
Irish Life Investment Management	
Leo Fund Managers Ltd	
Lloyds of London	
London Development Agency	
London Stock Exchange	
Matterhorn Investment Management	
Merrill Lynch Investment Management	
Morgan Stanley	
Nomura Asset Management	
Norges Bank Investment Management	
People's Bank of China	
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Reuters	
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