Lowy Institute Paper 01

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THE NEXT ECONOMIC GIANT

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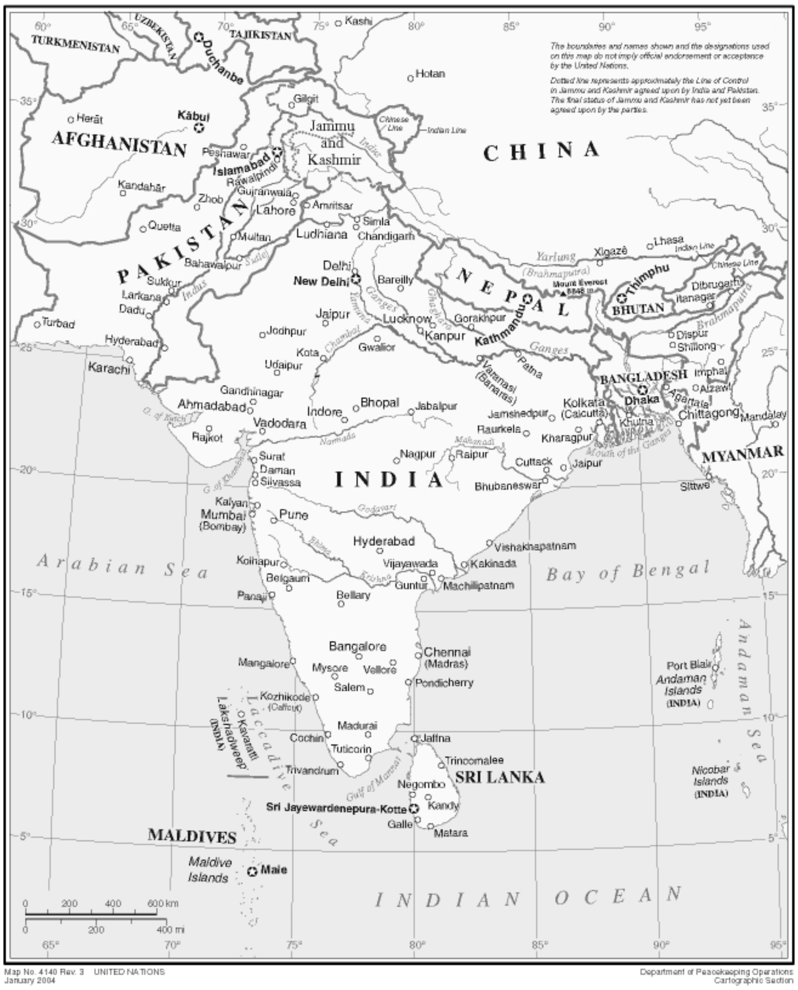

Map No. 4140 Rev. 3 UNITED NATIONS
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Executive summary

The Indian economy is showing clear signs of realising its dormant potential. The impact of more than a decade of economic reforms, instigated by a 1991 balance of payments crisis, has now removed or at least mitigated some of the major economic distortions that have handicapped past economic performance. One important result has been a significant boost to the economy's overall potential growth rate. Another has been India's re-engagement with the global economy, which in turn has transformed the prospects of key sectors of the Indian economy. This transformation has been most visible in the case of information technology-related services exports, where India has already become an important global player. But there are also positive signs in the areas of merchandise trade and international capital flows. These trends will have important consequences for the international economy as a whole and for Australia in particular.

The surprise outcome of the April 2004 parliamentary elections dampened some of the more irrationally exuberant assessments of India's future prevailing at the beginning of that year. While a new government seems likely to shift the emphasis of policy in some ways, however, our judgement is that the broad direction of India's transition to a more important participant in the international economy is unlikely to be reversed. Indeed, we think it likely that the turnaround in the country's economic prospects will ultimately see India following in the footsteps of China and becoming another economic giant in the global economy.

That is not to say that India's emergence as an economic superpower will happen in the same way as China's, or that it will happen as quickly. Economic reform in the years since 1991 has been partial, gradual, and at times, faltering. There remains much to be done. Significant constraints to the country's growth potential, including fiscal fragility, infrastructure bottlenecks, the continued burden of excessive regulation and bureaucracy, shortcomings in the financial and agricultural sectors, and the pressures associated with growing inter- and intra-regional inequality, will all need to be overcome. Reform will also continue to be conditioned and constrained by Indian democracy, most immediately by the ability of India's new prime minister to overcome the political restrictions imposed by yet another minority, coalition government.

Nevertheless, even if India's progress remains more gradual than that demonstrated by Asia's other economic giant, we judge that it will still be sufficient to see India assume a progressively more important role in the international economy. This trend is most visible in services, where India is combining technological progress in the telecommunications sector with a large supply of well-educated, English-speaking and relatively cheap labour to achieve a growing share of the international outsourcing market. Indeed, this development could be said to be leading to the emergence of a truly global labour market, with all of the opportunities, and adjustment strains, for the rest of the world that this implies. To date, India's participation in international merchandise trade and capital flows has been much less prominent, but here too there are clear signs that India will become a more substantial presence in coming years.

The growing importance of India, combined with the impact of an already powerful China, will have consequences for the geographic distribution of global economic weight. Specifically, it will contribute to a gradual movement in economic power back towards Asia. This in turn will have implications for the architecture of international economic diplomacy. Existing mechanisms for governing the world economy such as the G-7 will become less relevant, and will have to be replaced or augmented by institutions that recognise the importance of the emerging Asian economic powers.

These trends will also have significant implications for Australia. A more open and economically successful Indian economy will become a more important bilateral trading partner. Before the onset of reform in the early 1990s, India was Australia's 24th largest trading partner. By 2003 it had risen to 15th place, and had entered the top ten in terms of Australian export markets following several consecutive years of double-digit export growth. India's relative importance is set to continue to rise, bringing new opportunities for Australian exporters but also challenges for those sectors of the economy that will face increased competition from Indian suppliers of goods and especially services. There will also be consequences for Australia's international economic diplomacy as the emergence of a new economic power helps reshape the region.

Historically, Australia's economic prospects have repeatedly benefited from the rise of Asian powers, first with Japan and then South Korea and now China providing dynamic export markets, creating an important stimulus to economic growth. The birth of another Asian economic giant is the latest instalment in this good news story.

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Note

Much Indian financial and economic data is reported on a financial year basis (India's financial year runs from 1 April to 31 March). This Paper uses both calendar and financial year data, with a financial year indicated by, for example, 2004/05.

List of acronyms

ADB	Asian Development Bank
AEC	Asian Economic Community
ASEAN	Association of Southeast Asian Nations
ATC	Agreement on Textiles and Clothing
BIMST-EC	Bangladesh, India, Myanmar, Sri Lanka, Thailand – Economic Cooperation grouping
BJP	Bharatiya Janata Party
BPO	Business process outsourcing
CII	Confederation of Indian Industry
DFAT	Department of Foreign Affairs and Trade
EU	European Union
FDI	Foreign direct investment
FYP	Five Year Plan
GATS	General Agreement on Trade in Services
GATT	General Agreement on Tariffs and Trade
GDP	Gross domestic product
GQ	Golden Quadrilateral
ICOR	Incremental Capital Output Ratio
IMF	International Monetary Fund
IOR-ARC	Indian Ocean Rim Association for Regional Cooperation
IT	Information technology
IT-ES	Information technology-enabled services
JACIK	Japan, ASEAN, China, India and Korea
MERCOSUR	Mercado Común del Sur (Southern Common Market)
MFA	Multifibre Arrangement
NAFTA	North American Free Trade Agreement
NDA	National Democratic Alliance

List of acronyms (cont.)

PPP	Purchasing power parity
QR	Quantitative restrictions
RBI	Reserve Bank of India
RCA	Revealed comparative advantage
SAARC	South Asian Association for Regional Cooperation
SAFTA	South Asia Free Trade Agreement
SAPTA	South Asia Preferential Trading Arrangement
SSI	Small scale industries
TFP	Total factor productivity
UPA	United Progressive Alliance
WTO	World Trade Organisation

Preface

"India's emergence could be one of the world's most important economic trend stories over the next two decades."

— Jay Solomon, *The Asian Wall Street Journal*, 2003[1]

"India will be the next Asian superpower."

— Greg Sheridan, *The Australian*, 2004[2]

India has the "physical, cultural and economic dimensions of a medium-sized continent".[3] It is the seventh largest country in the world in terms of total land area and, with a population of over one billion, is the world's second most populous country.[4] Moreover, on current trends, India's population will top one and a half billion by the middle of this century, seeing the country overtake China in the number one spot. India is already the world's largest democracy and its international economic importance is not negligible. According to World Bank data, India was the world's 11th largest economy in 2002 if output is measured using market exchange rates, and the fourth largest when purchasing power parity (PPP) exchange rates are used.[5] Moreover, in recent years India has also been one of the fastest growing economies in the world, even outpacing China in the final quarter of 2003.

Yet relative to its size, India's global impact to date, particularly in economic terms, has been modest. Charles De Gaulle reportedly once said of Brazil "it has enormous potential, and always will". For much of its post-colonial history, the same description could have applied equally well to India. Indeed, for most of the period since independence India's participation in the international economy was declining, rather than increasing, and its performance relative to the fast-growing economies of East Asia looked lacklustre. This created a perception that the real action in the world economy would always be found elsewhere.

That negative view of India's prospects is now undergoing a profound shift, with growing signs that India's great potential is finally starting to be realised.

The emergence of a more positive outlook has been driven by a combination of improved economic performance, India's increasingly visible role in the international information technology (IT) sector, and progress in the troubled bilateral relationship with Pakistan.[6]

The main grounds for greater optimism about India rest on the country's recently improved economic performance. However, there are both cyclical and structural aspects to this improvement, and too much weight should not be placed on the former. Thus India's economic performance over 2003/04 has been lifted by the beneficial effects of an exceptionally good monsoon on the still-crucial agricultural sector.

This helped GDP growth in the December 2003 quarter reach an annual rate of 10.4%, making India Asia's fastest growing economy over that period. The resurgence in economic growth in 2003 after the relatively disappointing performance of the preceding two years — also weather related — has undoubtedly helped re-focus attention on India's economic prospects.[7] Given the cyclical nature of the present upswing, however, it is important not to overplay current growth rates. That said, it remains the case that the Indian economy has moved decisively onto a higher growth path, breaking out from the so-called 'Hindu rate of growth' of about 3.5% to become one of the world's fastest growing large economies over the past decade (1994–2004).

Brightening growth outcomes — and growth prospects — have encouraged investors to look ahead to a much greater role for India in the international economy over the course of this century. In a much-cited report in 2003 Goldman Sachs estimated that India's economy could grow to be the third largest in the world by 2050.[8] Similarly, Standard Life forecasts that by that same year India's stock market will have achieved an equivalent global ranking.[9]

The turnaround in economic performance has also been recognised by the international ratings agencies, which have flagged an improvement (reduction) in country risk. In early 2004, two of the three major rating agencies — Moody's and Fitch — upgraded India's foreign currency debt rating. Most noteworthy was Moody's decision to raise India to investment grade, with the agency upgrading India's country ceiling to Baa3 from Ba1 on 22 January, citing "a reduction in external vulnerability, rising foreign investment, and vibrant economic growth".[10] Also in January, Fitch Ratings upgraded India's long-term foreign currency rating to BB+ (one notch below investment grade) from BB, due to "India's strengthening balance of payments position and rapidly improving external balance sheet".[11] The third of the big three rating agencies, Standard & Poor's, has not yet upgraded India's rating, but at the end of 2003 it did revise the outlook on India's BB foreign currency rating to stable from negative, again citing "improving external finances".[12]

Importantly, improving economic performance may also be changing attitudes within India, where it is creating an awareness of the benefits of greater integration with the world economy. It is notable, for example, that both major political parties in the run up to the April 2004 elections emphasised economic reform in their campaigns, with the outgoing government having stressed plans to turn India into an economic superpower, and the new government targeting annual economic growth of 7–8 %.

Along with stronger economic growth and better credit ratings, India is also drawing increasing attention because of the growth of international outsourcing, or offshoring, and India's increasingly visible role in that process. This in turn has prompted hopes — and some fears — that "India may do for services what China already does for manufacturing".[13]

Finally, growing optimism about India's place in the international economy also reflects recent political progress in the often fraught relationship with Pakistan. Since partition in 1947 India and Pakistan have fought three wars, not to mention repeated border skirmishes, and, as recently as 2002, the two countries appeared to be on the brink of (possibly nuclear) war. Then in April 2004, India's then-Prime Minister Atal Behari Vajpayee launched a renewed effort to secure peace with Pakistan and the two countries began their first formal peace talks in six years on 16 February 2004.[14] While no-one expects the peace process to be a smooth one, and the risk of another breakdown in relations remains high, at least prospects for peace look better now than they have for a considerable time.

So does all this mean that India is on the cusp of becoming a much bigger player in the global economy? Sceptics argue that the current bout of enthusiasm for India is overdone, resting on little more than a cyclical upturn driven by better weather, and a high profile but still small-scale role in business offshoring and related industries. This Paper argues that this position is much too pessimistic. There are grounds to believe that India's economy is benefiting not just from a good monsoon but also from cumulative gains from the series of reforms enacted since the 1991 financial crisis, along with significant benefits from the use of so-called New Economy technologies. Economic reform has produced a "radical shift from the dysfunctional development strategy of the previous four decades".[15] This in turn has boosted India's potential growth rate. At the same time, improvements in IT and communication technology have stimulated significant growth in India's service sector and allowed the economy to overcome some existing infrastructure constraints. Granted, economic reform has been partial, gradual, and at times faltering. Nevertheless the process has appreciably increased India's integration with the global economy and has also laid some foundations for future growth. If reform can be sustained and reinvigorated, and international economic integration enhanced, India's economic prospects will indeed be bright.

But *can* reform be sustained, given India's political environment? The surprise April 2004 election results — which saw the defeat of the Bharatiya Janata Party (BJP)-led National Democratic Alliance (NDA) coalition and the ouster of several leading reformers at state level — have already been put forward as evidence that Indian voters have rejected further economic reform. Again however, this seems to be too gloomy. It is equally possible to interpret the election outcome as a vote primarily against incumbency, and as a call for *more* reform in those areas, particularly in rural India, that have been relatively neglected to date. Certainly, early indications are that the new coalition government, which is to be led by Manmohan Singh, the architect of India's liberalisation program in the early 1990s, will continue to pursue reform, albeit with some changes in emphasis, and within the constraints permitted by a coalition government. On balance therefore, we judge that while the 2004 election results, and the market turmoil that followed, have served as a useful reminder of the political constraints that still face Indian economic development, they are unlikely to lead to a fundamental change in the direction of the Indian economy.

A larger and more successful Indian economy will have significant consequences for the global economy. To date, India's impact on global merchandise trade has been fairly small; as of 2002 India's share of world goods trade was still below the level it had reached in the 1950s and 1960s, with India accounting for less than 1 % of world merchandise exports. But if policymakers can overcome some of the major obstacles to growth, such as inadequate infrastructure, perverse regulations and fiscal fragility, then India will play a much larger role in global markets. This is already the case in the service sector, where over the past decade (1992–2002) India has seen its share of global services exports almost triple, to 1.5 % of the world total. Further reform could also bring a similar increase in India's market share of global goods exports.

The rise of India will also have important implications for Australia. Historically, bilateral economic relations between the two countries have been limited by India's inward-looking development model (and the much less extreme version pursued by Australia until the 1980s reforms). But India's re-entry into the global economy has changed the relationship. India has moved from being Australia's 24th largest trading partner at the start of the reform period to its 15th largest trading partner in 2003, and is now one of Australia's top ten export markets. Australian merchandise exports to India have risen by more than 400 % over the same period, and Australian exports of services have also increased. There are also indications of an increase in investment flows between the two economies.

As India's reintegration with the international economy progresses, and as its significance as a global economic player increases, the importance of the bilateral economic relationship for Australia is set to rise. While this should create important opportunities for Australia, however, it will also create potential challenges. In particular, the growing competitiveness of Indian service exports may create some economic and political adjustment strains. Finally, there will also be spillover effects into other areas of Australian international policy, including trade diplomacy and the future structure of the global financial architecture.

Structure of the Paper

Chapter 1 reviews India's progress along the road to reform, charting the transition from an inward-looking development strategy based on government diktat to a greater willingness to engage with both the market and the international economy. It also reviews the relationship between India's democracy and the pace of economic reform, and discusses the use of China as a benchmark against which to measure

India's economic progress.

Chapter 2 looks at how the effects of the reform process have been felt in terms of India's greater integration with the global economy. It reviews the evidence on economic openness in general and then looks at India's experience in terms of international trade in goods and services, and international capital flows. It also examines India's participation in regional economic integration in South Asia.

Chapter 3 reviews the prospects for India sustaining a higher rate of economic growth, and highlights some of the obstacles to continued improvements in economic performance including fiscal fragilities and infrastructure bottlenecks.

Chapter 4 sketches out some of the potential consequences of a more economically successful India for the global economy, including the shifting global distribution of economic weight, changes in the flows of goods, services and capital, and the impact on global poverty and international economic diplomacy.

The Paper then concludes with a discussion of some of the implications for Australia.

Chapter 1
The road to reform

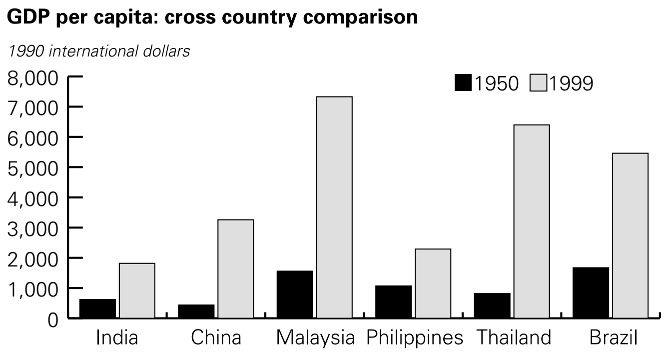
"India's post-1991 era of reforms stands in sharp contrast to the earlier period of its postcolonial economic history. The 1950s' legacy of public-sector-dominated, centrally planned, autarkic industrialization has given way to promarket, prointernational trade policies."

— Srinivasan et al., *Reintegrating India with the world economy*[16]

Starting point: India at Independence

When India gained independence from Britain on 15 August 1947, the prospects for economic development looked mixed. On the downside, India had ended its period under colonial rule as an extremely poor country. The economic historian Angus Maddison estimates that India's GDP per capita in 1950 was just $619 in PPP terms, making the country among the poorest in the world (Figure 1.1). Moreover, growth in output per capita had also been extremely sluggish during the closing years of British control.[17]

Figure 1.1



Source: Adapted from Maddison (2001)

Yet in other ways the starting point for economic catch-up seemed reasonably positive. Deepak Lal, for example, notes that India had the advantages of a potentially large domestic market, a relatively diversified natural resource base, a fairly large supply of skilled and unskilled labour, a history of domestic entrepreneurship and a relatively efficient bureaucracy. And while India at independence was still overwhelmingly an agrarian economy, it also had a tradition of industrial development that had produced the world's fourth largest cotton textile industry and its second largest jute manufacturing industry by 1914.[18] India could also boast a well-developed financial system that included a 20-year old central bank and one of Asia's oldest and largest stock markets.[19] On balance, therefore, and taking into account the economic costs of the violence and disruption associated with partition, India's starting position seemed to provide reasonable scope for delivering faster economic growth together with grounds for hoping that India would be one of the better performing developing countries.

Birth of the 'Licence Raj'

India's post-colonial development path drew inspiration from a variety of sources, including the apparent success of Soviet state planning, the expansion of state control throughout much of the economy during World War II, and a reaction to the perceived failures of economic policy under British rule. Srinivasan and Tendulkar describe how the foundations of India's development strategy after independence were laid in the pre-independence era, with an emphasis on public sector ownership of the commanding heights of the economy and an industrialisation policy based around import substitution. They characterise the resulting economic regime as a combination of economic nationalism and autarkic industrialisation.[20]

The subsequent implementation of this program of state-led industrialisation and development occurred within the context of a series of Five Year Plans (FYPs) and took the form of nationalisation of the industrial and financial sectors, the creation of state monopolies, and the reservation of a growing share of the economy for the public sector. Unfortunately, the results would often prove to be perverse. To take just one example, India started with a "world class textile industry, which it chose to stifle in its search for employment intensive growth".[21]

Along with outright public ownership, policy was also pursued through the creation and enforcement of a complex system of controls, licences and regulations. These various restrictions all acted to reinforce one another and so increase the bureaucratic grip on the economy. For example Williamson and Zagha describe how the decision to implement a new investment would require an industrial licence from the Ministry of Industry. This in turn would then allow the recipient to seek a licence to import capital goods from the Ministry of Commerce, and for the

Reserve Bank of India to authorise the sale of foreign exchange needed to purchase the imports.[22]

The pervasiveness of these administrative requirements led to the description of the Indian economy as a 'Licence Raj'. As well as increasing transactions costs for business and distorting economic decision making, widespread controls and regulations also led to the creation of what has been described as a "vast politically determined set of entitlements".[23] This in turn created a constituency that had a vested interest in opposing any subsequent reform and deregulation.

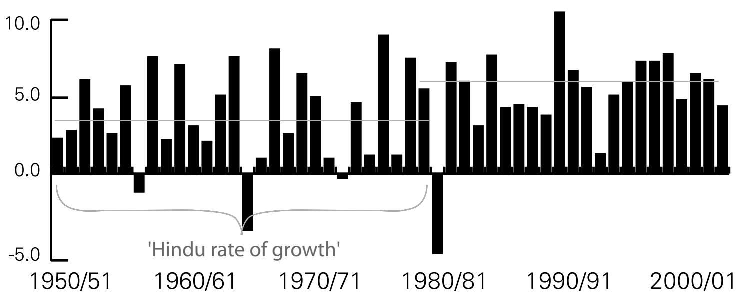
'Hindu rate of growth'

India's experience of planning did at least deliver reasonable GDP and GDP per capita growth rates in the 1950s. But subsequent plans produced slower growth, with average GDP growth declining for three consecutive decades. Indeed, India's relatively lacklustre growth performance over these decades came to be characterised as the 'Hindu rate of growth', indicating an economy thought incapable of growing at an annual rate much faster than around 3.5 % (Figure 1.2).

Figure 1.2

Real GDP at factor cost

Annual growth rate, 1994/95 prices



Source: Adapted from Reserve Bank of India (2003) and Central Statistical Office (2004)

India's growth performance looked particularly disappointing when it began to be compared to the fast-growing economies of East Asia. Thus while per capita incomes in India between the 1960s and 1980s grew at an annual rate of less than 2 %, economies in East Asia were attaining growth rates of 5–6 % over the same period.[24] The International Monetary Fund (IMF) found that East Asia's better relative growth performance was due to a combination of higher investment and higher total factor productivity (TFP) growth.[25] Higher investment is the main difference between the two growth experiences, explaining nearly the entire growth gap between Indian and East Asia in the latter period (Table 1.1).

Table 1.1 Output growth and contributions

Average annual percentage change in real terms

	GDP	Capital	Labour	TFP
1960–88				
East Asia	7.4	3.8	1.7	1.9
India	3.1	1.7	1.0	0.3
1980–88				
East Asia	6.2	3.2	1.4	1.6
India	4.8	1.3	1.2	2.3

Source: Adapted from Table 2.8 in Chopra, et al. (1995)

While India's growth performance lagged behind that of East Asia, some economists have pointed out that when viewed in a more general context the country's growth experience prior to the 1980s was not especially bad, merely unexceptional. For example, the economic historian Brad DeLong argues that India's performance during this period is better described as 'normal' once it is compared to the typical pattern of post-World War II economic growth. DeLong looks at the cross-country growth experience of 85 countries between 1960 and 1992 and finds that India's growth performance places it squarely in the middle of the group. Thus "India between independence and 1990 was not East Asia as far as economic growth was concerned, to be sure. But it was not Africa either."[26] So whether one thinks that India did badly or not during this period depends in part on which other countries are used as benchmarks and in part on whether one believes that India had the potential to grow much faster than it did.

Despite these qualifications, however, by the 1970s there were clear indications that the Indian model was running into trouble. By this time India's rate of growth had actually dipped *below* the so-called Hindu rate of growth, and the economy's growth performance was starting to lag not just East Asia, but also Latin America and even parts of sub-Saharan Africa.[27] Meanwhile, the success of East Asia had also demonstrated that export-led industrialisation was a feasible development strategy, contrary to the export pessimism of Indian planners.

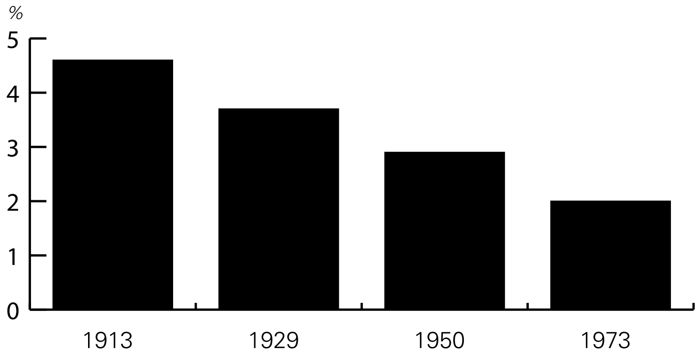
Closing the Indian economy

A central feature of the economic policy regime pursued after independence was a more inward-looking economic stance. Thus when the Second Five Year Plan culminated in a balance of payments crisis in 1957, it triggered the imposition of import controls that would remain in place for the rest of the century.[28] More generally, the decision to look inward reflected a deep-seated conviction that India had little to gain from integration with the global economy: "export pessimism was not just a belief, but almost an ideology among the resident economic elite".[29]

One consequence was that this period marked the gradual withdrawal of India from participation in the international economy. Between 1950 and 1973 world merchandise export volumes grew at an average annual compound rate of almost 8%, while Indian exports grew at 2.5%, implying a sustained fall in market share.[30] India's share of world exports declined from about 1.4% in the 1950s to 0.9% in the 1960s and 0.5% in the 1970s.[31] At the same time, exports as a share of the Indian economy also declined (Figure 1.3).

Figure 1.3

Merchandise exports as share of GDP



Source: Adapted from Maddison (2001)

In large part this decline reflected the deliberate policy choices of the authorities, based in turn upon a self-fulfilling pessimism regarding India's prospects for export-led growth. Since the drive to industrialisation under the FYPs continued to suck in imports (leading to a gap between import and export growth and pressure on India's external accounts) the authorities also resorted to the repeated use of controls and restrictions on trade. These took the form of both higher tariffs and quantitative restrictions, and meant that India's trade regime became increasingly restricted, and increasingly subject to a growing network of administrative and bureaucratic requirements.

The 1980s reform effort

As noted above, by the late 1970s it was increasingly clear that the Indian development model was failing to deliver sufficient growth and that a rethinking of economic policy was called for. This realisation was given added impetus by the two OPEC oil shocks which significantly boosted India's import bill and led to a worsening of India's terms of trade (although these adverse effects were partially offset by the creation of big export markets for Indian agriculture and labour in the Persian Gulf).[32] The scope for reform was also provided by political change:

in the elections that followed the assassination of Indira Gandhi in 1984, Congress secured 77% of seats in the Lok Sabha (the lower house of parliament), with the effective result that the Rajiv Gandhi administration saw India come "as close to an elective dictatorship as it has ever been".[33] With a comfortable majority, the new Gandhi administration was able to introduce reforms without having to worry about parliamentary opposition.

Despite this strong political position, however, the reform process in the 1980s was an extremely cautious one, a kind of 'liberalisation by stealth'.[34] The government's program combined policies aimed at reducing barriers to export, limited industrial deregulation, and some reforms to taxation. Measures taken included a reduction in the share of 'canalized' imports (that is, imports over which the government had monopoly rights), reduced controls on imports of capital goods and components, the removal of price controls in the cement and aluminium industries, and the introduction of several export incentives.[35]

The ultimate effectiveness of the 1980s reform effort remains the subject of debate. On the one hand, the policy shift was associated with a marked improvement in India's growth performance. During the late 1980s India briefly became one of the fastest growing economies in the world, and there was a marked increase in productivity. A study by Ahluwalia looking at trends in TFP in Indian manufacturing between 1960 and 1989 for example, confirms that while TFP stagnated during 1960–80, it improved significantly in the 1980s.[36] Moreover, the 1980s reforms "were important not only because of their … efficiency impact, but also because they gave confidence and credibility to the reformers".[37] Rodrik and Subramanian argue that the 1980s saw a key attitudinal shift in Indian economic policy, with a move to what they describe as a "pro-business orientation", as opposed to the "pro-market" shift that occurred in the subsequent decade.[38] They argue that it was this earlier change which marked the decisive break from India's hitherto disappointing growth performance.

On the other hand, the 1980s reforms were also associated with a move to a more expansionist — and less conservative — macroeconomic policy stance. The latter saw a shift to large fiscal deficits that averaged more than 8% of GDP in the late 1980s.[39] These in turn contributed to a growing domestic debt burden, widening current account deficits, and increases in external borrowing. As a result, the growth benefits of the 1980s were bought at the cost of an unsustainable deterioration in India's macroeconomic position.[40] Moreover, in many ways reform in the 1980s failed to go beyond tinkering at the edges of the existing development model. As Ahluwalia has noted, the policy response was still to seek to liberalise certain aspects of the system, rather than to change the system itself.[41] Systemic change would require a crisis.

The 1990/91 crisis

Growing fiscal and external imbalances and increasing domestic and international indebtedness made the Indian economy increasingly vulnerable to adverse shocks during the late 1980s, and a series of such shocks duly followed. The collapse of the Soviet Union dented Indian trade flows, and the events culminating in the Gulf War in 1991 boosted India's oil import bill while at the same time the forced repatriation of Indian migrant workers from the Gulf reduced inflows of workers' remittances. With inflation on the rise and the economy bedevilled by growing signs of external and internal imbalance, capital flight — much of it in the form of the withdrawal of non-resident Indian deposits — also began to mount, as did speculation of devaluation and default. As reserves began to dwindle, the Indian authorities were forced to turn to the IMF for balance of payments support, entering into a two-year standby agreement with the Fund in November 1991.[42]

A new government came to power in June 1991 with an immediate need to stabilise the economy. At the same time, the 1991 crisis had clearly demonstrated that the existing direction of Indian policy was unsustainable. Moreover, the attractiveness of the old planning model for economic growth had been undermined by the collapse of the Soviet Union and the demonstrated success of China's move towards a more market-friendly policy stance.[43] An alternative approach was clearly needed, and the partial success of the limited 1980s reforms suggested an obvious direction.

The 1990s reform push and beyond: from stabilisation to structural reform

The story of crisis-induced reform is of course a familiar one in developing countries, and in many ways India followed the same path that had been trodden by other countries during the previous decade.[44] This involved combining macroeconomic stabilisation with measures aimed at creating the conditions for sustained growth in the longer term.

Along with stabilisation, the policy prescription followed by India can be broken down into two broad — and mutually supporting — categories: efforts to free up the domestic Indian economy, and efforts to open up that economy to the rest of the world. While the efforts at stabilisation were largely over by 1994, structural reforms have continued to be pursued by subsequent governments — albeit with varying degrees of enthusiasm — for the rest of the decade, and beyond.[45]

Stabilisation

The macroeconomic response to the crisis was in large part "the classic textbook one of expenditure compression through a sharp fiscal correction and expenditure switching through devaluation".[46] Initial government policies combined efforts at fiscal consolidation (the deficit was cut from 8.1 % of GDP in 1990/91 to 5.7 % of GDP in 1992/93) with moves to shift the exchange rate to a sustainable level (the rupee was devalued in 1991, a dual exchange rate announced in early 1993, and a unified and floating exchange rate adopted later that year).

The measures worked largely as intended, producing a marked turnaround in India's external position. Thus the current account deficit was slashed from more than 3 % of GDP in 1990/91 to less than 0.5 % of GDP by 1993/94, while over the same period foreign exchange reserves rose to more than eight months' import cover. At the same time, inflation was brought down from double to single digits.[47]

Liberalising the domestic economy

The series of efforts to liberalise the domestic economy have included moves to reduce government administrative controls on investment and the allocation of resources; measures to increase the share of the economy under private sector management; price deregulation; and moves to reform the financial sector.[48]

At the start of the reform process, India's 'Licence Raj' was imposing significant administrative constraints on the private sector. These included an industrial licensing policy that required firms to secure government permission before carrying out new investments or expanding existing operations above a fairly small scale, policies that reserved particular industries and sectors of the economy for the public sector, and the reservation of a large number of items for production by small scale industry (SSI).[49] There have been significant reforms in many of these areas. Thus in July 1991 industrial licensing for all but 18 industries was abolished, with a further 12 industries dropped from the list in 1998/99.[50] The number of sectors reserved for the public sector has been cut from 18 to three. Progress in terms of reducing the number of industries reserved for SSI production has been slower, but there have also been achievements here, with 14 items removed from the government's reserved list in 2001 and another 50 in 2002, including such potentially important export areas as garments, shoes, toys and auto components.[51]

Price controls have been abolished in key industries including iron and steel, coal, and fertilisers.

The authorities have also moved — somewhat reluctantly — to deal with India's bloated public sector. Here they have been unwilling to pursue the kind of aggressive privatisation strategy that has been followed in several other developing countries. Instead, Indian policymakers have opted for a policy of so-called 'disinvestment', which began with the sale of minority stakes in public sector enterprises, and which focused primarily on raising government revenues. This stance has since been modified, with the then government signalling in 1998 that it would be prepared to reduce its own shareholding to a minority stake, allowing the transfer of management control to private stakeholders, in all but a limited group of strategic areas including defence, atomic energy and railways.[52] Since this announcement there have been several sales under the new arrangements, including of a major petrochemicals unit and India's largest car producer. The outcome of the April 2004 election has raised some doubts over the future of the privatisation process, however. The new government has said that it will not sell off profitable state enterprises, and will close the Ministry for Disinvestment.

Finally, liberalisation of the domestic economy has also been pursued through financial sector reform. Achievements include the removal of controls on interest rates, the abolition of interest rate ceilings, and the elimination of prior central bank approval for major loans.[53] Cuts in the cash reserve ratio and statutory liquidity ratio have also reduced the amount of bank resources pre-empted by the government sector.[54] The supervisory and regulatory framework has been updated and strengthened, with efforts to move India closer to international best practice as set out by the Basle requirements.

Opening up to the international economy

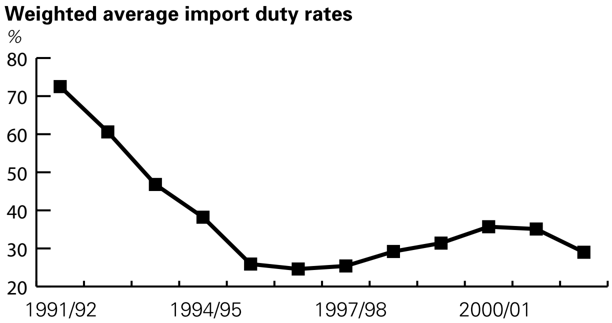
Domestic liberalisation has been accompanied by moves to open India up to the international economy.

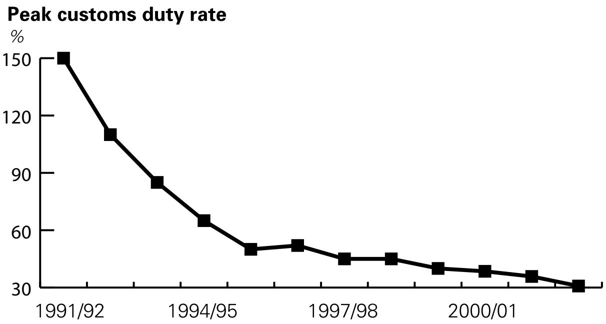
Srinivasan and Tendulkar describe how all export subsidies and most quantitative restrictions (QRs) on intermediate and capital goods were withdrawn in 1991, while the lengthy list of imports subject to QRs was replaced by a shorter (but still substantial) list of mainly consumption goods. As a result, the proportion of QR-protected goods in tradeable GDP fell from 93 % at end of 1980s to 66 % by 1995. India's list of banned or restricted exports was also significantly reduced; taxes on some mineral and agricultural exports were abolished; and with effect from April 2001 the monopoly of government agencies on the majority of so-called 'canalized' imports was ended.[55] QRs on imports of consumer goods and agricultural products were removed in 2001, partly in response to a ruling by the WTO dispute panel brought by the United States.

The reduction in quantitative and other non-tariff barriers to trade has been accompanied by cuts to India's tariff barriers, which at the start of the reform process were among the highest in the world. Reform saw India's maximum tariff rate brought down in steps from 150 % in 1991/92 to just over 30 % by 2002/03. Over the same period, India's average import-weighted tariff was reduced from more than

72 % to 29 % (Figures 1.4 and 1.5). However, the latter reduction has been uneven: the average weighted tariff had fallen to below 25 % in 1996/97, before being hiked back up to over 35 % in 2000/01. Tariff reduction was only resumed in 2002.[56]

Figures 1.4 and 1.5





Source: Adapted from Ahluwalia (2002)

India moved to full current account convertibility and accepted IMF article VIII status in 1994.

The authorities have also introduced several measures aimed explicitly at boosting exports, including schemes allowing exporters to import machinery duty free or at concessional rates in return for export targets, schemes making the import of raw materials, components and parts required for direct use in the export product duty free, and a series of policies aimed first at expanding the scope of existing schemes such as export processing zones, and then the upgrading of the latter to Special Economic Zones.[57]

Table 1.2 India before and after the 1990 reforms

% of GDP unless otherwise stated	1991 crisis	2002/03
Average tariff rate (%)	128	29
Trade (exports plus imports)	17.2	30.5
FDI and portfolio investment	0.0	1.0
Current account balance	-3.1	0.8
Foreign reserves (months' imports)	1.1	9.1
External debt	26.5	19.8
Short-term external debt	4.6	3.0
Inflation (WPI, %)	13.7	3.5

Source: Adapted from Table II.I in Salgado (2003)

Trade liberalisation has been accompanied by moves to liberalise capital flows. Thus in the early 1990s the authorities relaxed controls on foreign direct investment (FDI) and portfolio investment; foreign investment up to a 51% stake was to be approved automatically in most industries, foreign institutional investors were allowed to invest in Indian equity (and subsequently debt) markets, and Indian companies were allowed to issue equity overseas using Global Depository Receipts.[58] Further liberalisation of both types of investment flows were undertaken in the late 1990s, including moves to allow foreign majority ownership in many industries.[59]

Can India's democracy sustain economic reform?

"Every time India goes to the polls it becomes the largest electoral exercise in history."

— Edward Luce, *Financial Times*, 2004[60]

One of the most commonly cited aspects of India's reform process to date has been its cautious, gradualist nature. Not only did Indian reforms get underway later than in many other developing economies (with much of the reform push coming in the 1990s, while reform elsewhere tended to accelerate in the 1980s), but once underway reform has tended to occur at a relatively slow pace. In particular, the speed of Indian reform has often been contrasted unfavourably with the rapid progress made in China, and the relative sluggishness of the Indian effort put down to the adverse consequences of democracy.[61] As an article in the *Financial Times* noted in 2003, "when it comes to China and India … 'practical men' (and women) say the following: China owes its economic success to authoritarianism, whereas India's relative failure can be blamed on democracy".[62] Yet the same article points out that democracy also has an important upside: "since reforms in India involve the painstaking building of consensus, they are likely to stick". India will also not have to confront the future trauma of democratisation that may yet await China.

The political context within which reform has taken place is certainly striking. When India's 675 million registered voters were polled in April 2004 (some 380 million votes were cast), they were participating in India's 14th national election since independence. As Atul Kohli points out, India's democracy has overcome great odds for more than five decades.[63] Widespread poverty and illiteracy and a significant degree of ethnic and religious diversity would all seem to represent significant obstacles to entrenching a democratic system. For example, India now accounts for roughly one-third of the world's poorest people, with more than a quarter of the population living below the poverty line.[64] And of India's more than one billion people, over 80 % are Hindu, 12 % Muslim, and about 2 % each are Christian and Sikh, making India not only the largest Hindu nation in the world, but also the fourth largest Muslim one. Hindi, which is the national language, is the primary tongue of only about 30 % of the population and there are 14 other official language groups (English enjoys associate status).[65] In the previous federal election, "more than half of India voted for regional, language or caste-based parties, making India the most fragmented democracy in the world".[66] The demolition of the Babri mosque in Ayodhya in 1991 and the bloodshed in Gujarat more than a decade later are stark warnings of some of the dangers and divides still facing India.

Moreover, the assassinations of Indira Gandhi (in 1984) and Rajiv Gandhi (in 1991) and the subsequent erosion of the Congress Party's dominance of Indian politics have been followed by a shift towards coalition governments and an increase in government instability. For example, the decades between 1950 and 1990 witnessed just eight general elections, while the single decade that followed brought another five.[67]

Has the survival of India's democracy against all these odds come at the expense of economic reform? Rob Jenkins notes that although the failure to sustain reforms during the 1980s provides support for the thesis that democracies are inherently resistant to change, the relative longevity of the post-1991 reforms together with the way they have been sustained through successive changes of government — both to right and left — is evidence for the competing proposition that open, democratic politics allow governments to sell the benefits of reform in a way that better ensures their sustainability compared to reforms imposed by government diktat.[68]

Ashutosh Varshney has suggested a different explanation, proposing that in many ways reform has not been a dominant concern of Indian voters at all. He distinguishes between "mass politics" and "elite politics", and argues that the Indian voting public has tended to be focused on the former, which covers issues such as religious politics, allowing politicians scope to slip through some economic reforms.[69] As evidence for his case, he points out that in a survey of mass political attitudes conducted in 1996 only 19 % of the electorate reported any knowledge of the economic reforms that started in 1991, while almost three-quarters were aware of the 1992 demolition of the Ayodhya mosque. According to Varshney, economic reforms “were simply a non-issue in the 1996 and 1998 elections”. However, it also follows that those areas where reform is more likely to have moved from elite into mass politics — reforms to labour laws and agriculture — have tended to be avoided by politicians.

On recent evidence, political constraints remain significant. In 2003, for example, plans to introduce a nationwide, harmonised value added tax were shelved in the face of nationwide protests by shop-owners. Similarly, planned cuts to fertiliser subsidies were withdrawn within days of being announced in the February 2003 budget, and telephone price increases were scaled back in May 2003 in the face of other protests.[70] When India’s Supreme Court came down with a ruling in September 2003 that scuppered the government’s plans to privatise two state-owned oil companies, India’s then Minister for Disinvestment, Arun Shourie, mourned that the difference between India and China was that in India “everybody has a veto”.[71]

Reform and the April 2004 elections

The surprise results of 2004’s elections — with the defeat of the BJP-led ruling coalition — have also been taken as evidence that India’s democracy is a significant constraint on economic reform, especially since most observers had expected the economy’s strong showing to deliver a comfortable victory to the ruling NDA coalition.

In the run up to the election, there seemed to be signs that economic reform was starting to have positive political implications, raising the possibility of a virtuous feedback loop between reform and electability. Thus when the NDA won victories in three of India’s largest states in elections held on 1 December 2003 commentators noted that the BJP and its allies had campaigned partly on issues of development and governance, suggesting that those who voted BJP were expressing frustration with their region’s lack of progress in comparison to faster-growing parts of India. India’s then minister for trade and commerce interpreted the victories as a “very strong vote for further economic reform”.[72] Similarly, observers of the 2004 general election campaign noted that "[f]or the first time since independence … economic prosperity has emerged as a key issue in a general election".[73]

The NDA government also announced a series of reforms in the run up to the April 2004 election. Intriguingly, these efforts were seen by critics as a way to buy electoral support, rather than as politically unpopular reform moves.

Other analysts canvassed the possibility that generational change — both in terms of politicians and the electorate — would provide further reinforcement for the reform process. In particular, they wondered whether India's relatively youthful population was becoming more comfortable with a more market-friendly, outward-looking set of policies than past cohorts of voters, providing a growing political constituency for advocates of continued reform.

Yet in the event, the ruling coalition suffered a heavy defeat at the hands of Congress and its left-of-centre allies. Moreover, key leading reformists associated with India's IT revolution such as Chandrababu Naidu (the chief minister of Andhra Pradesh, state capital Hyderabad) and S M Krishna (chief minister of Karnataka, state capital Bangalore) were also turned out by India's voters. Rather than being embraced by the Indian electorate, it appeared that reform had instead received a resounding rejection. Local financial markets initially appeared to make precisely this judgement. After having placed their bets on a win for the NDA, news that India's next prime minister was likely to be Congress's Sonia Gandhi rather than the BJP's Atal Behari Vajpayee triggered a bout of market selling. The Mumbai stock exchange suffered its largest ever fall on 17 May 2004, with the authorities forced to suspend trading to limit the panic.[74]

Market sentiment only recovered with news that the role of prime minister would go not to a member of the Gandhi dynasty, but to Manmohan Singh, a former finance minister and — crucially for market confidence — the architect of India's reform program in the early 1990s. Even after Singh's appointment, markets remained concerned about the ability of the new Congress-led coalition — the United Progressive Alliance (UPA) — to push through difficult economic decisions. At the time of writing, the results gave Congress only 145 seats in India's

545-seat parliament, and the UPA overall just 217 seats, well short of the 272 needed to produce a majority.[75] The government will therefore have to rely on the support of a collection of leftist parties, including the Communist Party of India (Marxist), to govern.

Still, it is worth remembering that minority and coalition governments have been the norm, rather than the exception, during the decade or more of India's reform process. Moreover, the judgement that the election results were a strong vote against reform is probably too gloomy. Indeed, to at least some extent the vote can be interpreted as reflecting the fact that reform in many areas has not gone far enough. Thus several early reviews of the results have focused on the way in which the predominantly rural electorate (an estimated two-thirds of voters live in India's villages) felt that the benefits of reform had largely passed them by.[76] Since voter turnout is reportedly low in the urban middle classes that have been among the big winners from reform to date, it may well have been the *failure* to push reform into India's rural economy, and so deliver more wide-ranging economic benefits to the majority of the (participating) electorate, that was a key explanatory factor behind an anti-incumbency vote.

Finally, despite the many short-term constraints that have been thrown up by the political system, in the long run India's democracy could prove to be a very positive influence on the country's economic prospects. Democracy provides countries with a form of political shock absorber that allows them to deal with economic shocks and crises without requiring the kind of systemic political change that has been seen for example in Indonesia in the aftermath of that country's financial crisis. It also seems to provide more scope for the kind of creativity that fuels modern technological change. India may have paid — and be still paying — some costs in terms of slower progress with reform while developing its democratic institutions, but it may also receive some future dividends from this investment.[77]

Box 1: The tortoise and the hare? India and China

"The Chinese have order, discipline, modern telephones and roads, less poverty and faster economic growth. The Indians have democracy, chaos, lousy phones and roads, move poverty and slower growth."

— David Wessel, *The Asian Wall Street Journal*, 2003[78]

The China benchmark

Throughout this Paper, we will tend to benchmark India's progress across a variety of economic measures and indicators against China (Table 1.3). This shouldn't be a particularly surprising choice. Clearly China is "enormously relevant to India, as the world's only other billion-plus population country".[79] Along with a 2000-kilometre long border in the Himalayas the two countries also share a fair bit of history, including a border war in 1962, the after-effects of which were still being felt as late as 1998.[80] Both countries have also been among the star performers of the global economy in terms of GDP growth in the 1980s and especially in the 1990s, although China's growth rate over the 1990–2001 period outpaced India's by about four percentage points.[81]

The economic comparison is a particularly interesting one because as late as 1980 the two countries looked relatively close in terms of overall GDP (China at $403 billion, India at $433 billion using international (PPP) dollars), while India was ahead in terms of GDP per capita (China $410 and India $630, again using international dollars).[82]

Table 1.3 Two giants compared: India and China in 2002

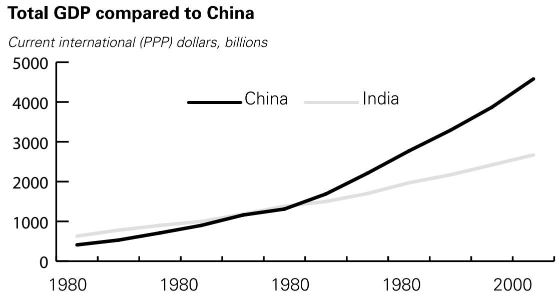
	India	China
Population (billions)	1.05	1.28
% of world total (rank in world)	16.9 (#2)	20.7 (#1)
GDP (billions of current US$)	510	1,266
% of world total (rank in world)	1.6 (#11)	3.9 (#6)
GDP (billions of PPP $)	2,800	5,860
% of world total (rank in world)	5.7 (#4)	12.0 (#2)
Gross national income per capita (US$)	480	940
GDP per capita (PPP $)	2,670	4,580

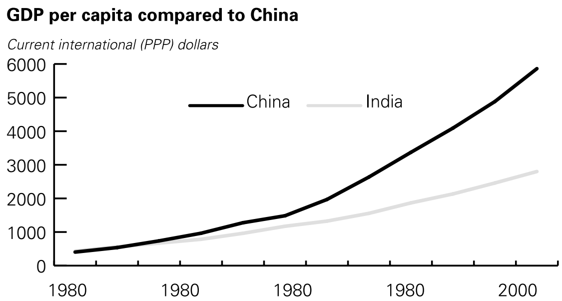
Source: Adapted from World Bank (2003)

In the years since 1980, China has moved sharply ahead of India in terms of both the level of GDP, and in terms of living standards as measured by GDP per capita (Figures 1.6 and 1.7). From rough parity in 1980, China's GDP moved to more than double the size of Indian GDP in 2002, while China's GDP per capita in international dollars moved from just 65 % of India's in 1980 to more than 170 % by 2002. The disparity in performance has prompted Indian economist Pranab Bardhan to note that "the great game of guessing the China–India economic race is, for all practical purposes, over. By most criteria of standard economic measurements of levels of living and their growth, China has clearly won the race."[83]

Indeed, China's relative economic success has arguably been one of the key factors convincing Indian policymakers of the need to embrace reform, and India's strategic rivalry with China is likely to remain an important impetus for further change. Otherwise, New Delhi seemed to face the "economic nightmare of an India of underemployed farm labourers spending their meagre earnings on imported Chinese goods".[84]

Figures 1.6 and 1.7





Source: Adapted from World Bank (2003)

India falls behind

A piece in the *New York Times*, written in 2002, captures the commonly held view (at least until recently) that India was doomed to slide steadily further behind China in economic terms. The author looked at the example of the shoe industry, describing how India's second largest shoe manufacturer would send representatives every two months to Guangdong to purchase Chinese shoemaking machinery and synthetic leather and to visit Chinese factories in order to learn about large-scale, advanced technology and highly organised operations. Yet just two decades before, the shoe industry in both countries had had access to the same competitive advantage of a large, cheap labour force (indeed, Indian workers were better educated). From a similar starting point, Chinese manufacturers had moved to dominate the global market, while the industry in India had been hobbled by local laws limiting expansion (for example in the form of how much land a company can acquire in a city) and infrastructure shortcomings (the author noted that the Indian shoe factory had been running for the previous three days on diesel generators, at more than twice the cost of using electricity from the municipal grid).[85] Recent work carried out by McKinsey has estimated that on average an Indian worker makes just three shoes a day compared with 11 produced by his or her Chinese counterpart, with similar productivity gaps for T-shirts and ceiling fans.[86]

Moreover, India has lost out to China not only in the shoe industry, but also in textiles and other mass-produced manufactured goods where India should have had a similar comparative advantage.[87]

Several arguments have been advanced as to why India's economic performance has fallen behind China's, many of them resting on cultural and political explanations.[88] Bardhan for example reflects somewhat ruefully that "[w]hen I was young we were frequently told that the Chinese were better socialists than us, and now we are told that they are better capitalists".[89] He stresses the superior ability of China to achieve cooperation and coordination, which he explains in part as a function of greater homogeneity, both social (ethnicity, language, religion) and economic (lower inequality in assets and income) and wonders if "that compared to India the Chinese are better capitalists now because they were better socialists before: the egalitarian base has made the shocks of transition to capitalism more bearable".[90] Deepak Lal similarly points to China's ethnic homogeneity as opposed to India's multi-ethnic society and China's history of relative political unity as against India's history of relative political instability.[91]

Another explanation given for China's superior performance is that it benefited from starting reforms earlier, in the 1980s, while India's main reform push only got going in the 1990s. There is almost certainly something to this, but the argument should not be overplayed. Desai for example points out that between 1950 and 1975 India probably enjoyed a better "capitalist infrastructure as well as commercial culture" than China while Pocha notes that China's first stock exchange opened in 1986, 112 years after the Bombay Stock Exchange started to operate.[92]

Scope for catchup … and overtaking?

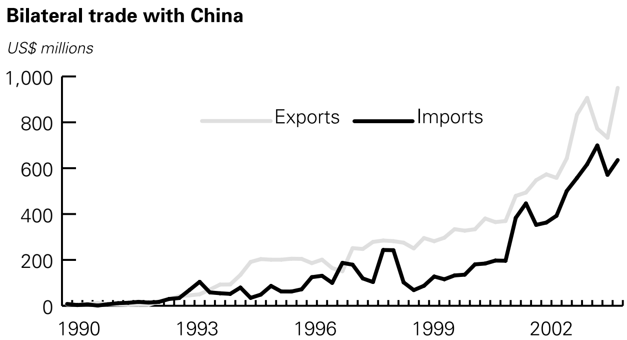
Pessimism regarding India's prospects at the start of the current century has more recently given way to a growing sense of optimism. Thus, in 2003, a lead editorial in the *Financial Times* noted that "After years of being overshadowed by China … India, it is whispered, may at last have what it takes to start catching up with its larger neighbour."[93] Intriguingly, it also noted that "[a]bove all, India's reliance on domestic consumption and its modest dependence on manufactured exports are suddenly fashionable in a world where exporters are facing fierce competition from low-cost Chinese factories".[94]

There are some good reasons to believe that India can close the development gap with China. Srinivasan for example notes that the difference between the two countries' investment rates has been very large, suggesting that the gap in economic performance can largely be explained in terms of relative resource mobilisation, implying that an increase in India's investment rate could produce significant results.[95] Moreover, since India has lagged behind China in terms of integrating with the global economy (as described in Chapter 2), it also has more scope for *future* integration. Others have pointed to what they see as the greater durability of the Indian politico-economic model.[96]

Perhaps more strikingly, in 2003, in a much-cited article in the journal *Foreign Policy*, Yasheng Huang and Tarun Khanna suggested that India's development model could even prove to be *more* successful than China's in the longer term.[97] They argued that while the Chinese approach relied on export-led manufacturing that was in turn largely a creation of FDI, the Indian focus was more on home-grown entrepreneurs, nurturing domestic companies like software firms Infosys and Wipro, and pharmaceutical and biotechnology companies

Ranbaxy and Dr. Reddy's Labs. They point to what they see as other advantages of the Indian model, including more efficient capital markets and a more advanced legal system. As one piece of evidence for the relative success of the Indian approach they cite the fact that in the 2002 Forbes 200 ranking of the world's best small companies, India had 13 firms compared to just four from mainland China.[98] A more sceptical view of the same evidence is taken by Pocha, however, who suggests that India's achievements look less impressive when viewed from the perspective that it took India 112 years to have 13 firms on Forbes' list, against 17 years for China to have four.[99]

Figure 1.8



Source: Adapted from International Monetary Fund (2004)

For all the recent talk about economic competition between them, in practice the two economies should be able to benefit from each other's success. A good example of this prospect is visible in the rapidly growing merchandise trade between the two neighbours, albeit from a very low base. While Indian businesses once feared being swamped by Chinese exports, India is currently running a bilateral trade *surplus* with China and the Chinese market is increasingly seen as an exciting export market opportunity, rather than a threat (Figure 1.8).[100]

Chapter 2
Rejoining the global economy

"The outcome of ten years of reform is that India has opened to the world economy."

— Williamson et al., *From the Hindu rate of growth to the Hindu rate of reform*[101]

"Despite all the talk, we are nowhere even close to being globalized in terms of any commonly used indicator of globalization. In fact, we are still one of the least globalized among major countries – however we look at it."

— Governor Bimal Jalan of the Reserve Bank of India[102]

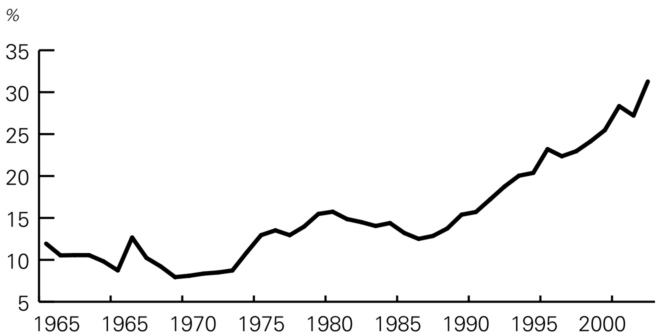
Re-opening the Indian economy?

As noted in Chapter 1, one of the key objectives of the economic reform process that got underway in the 1990s was the reintegration of India into the global economy. And in many ways there is a strong case to be made that "[e]xternal sector reforms have been the most successful of all the reforms that were undertaken in the nineties".[103] This is a judgement shared by India's central bank, the Reserve Bank of India (RBI), which in a recent assessment concluded that structural reforms have been both more widespread and more extensive on the external side than in any other sector.[104] But the process has also been a gradual one, and it remains incomplete.

One standard measure of an economy's openness is the ratio of its trade (the sum of exports and imports) to GDP. A look at the change in this ratio over time provides unambiguous evidence that India has indeed become a much more open economy: the trade share has almost doubled since 1990, rising from 15.7% of GDP in 1990 to 31.3% in 2002 (Figure 2.1).

Figure 2.1

Trade as share of GDP: over time



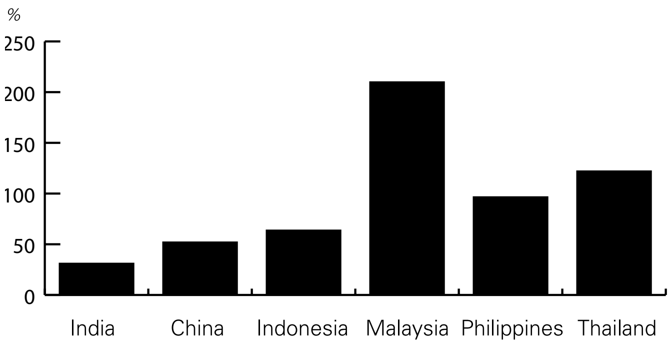
Source: Adapted from World Bank (2003)

However, when the same ratio is used to compare India's openness with China and other East Asian economies, the picture is less favourable.[105]

For example, while India had a ratio of trade to GDP of around 31 % in 2002, in the same year the ratio for China stood at 52 % and for Indonesia at almost 64 % (Figure 2.2). Other East Asian economies had even higher ratios (although the difference in size means that India would always be expected to have a relatively smaller share of trade in GDP than a smaller economy like Malaysia or the Philippines).[106] It is also possible that India's relatively lower openness to trade reflects structural differences within the Indian economy. In particular, the fact that India has a relatively small share of its economy devoted to industry (which tends to be more trade-intensive than agriculture or services) compared to China may be an important explanatory factor, along with India's larger informal service sector.[107]

Figure 2.2

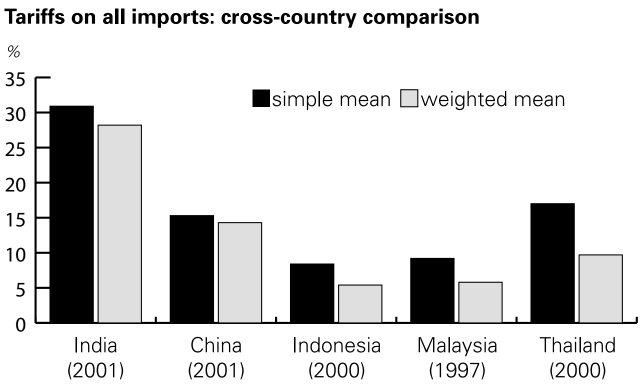
Trade as share of GDP: across countries (2002)



Source: Adapted from World Bank (2003)

A similar message is received by looking at the level of India's barriers to trade. Reform has delivered a significant decline in the level (and dispersion) of Indian tariffs, as well as a fall in non-tariff barriers. So a comparison over time indicates significant progress in opening up. But once again a cross-country comparison indicates that India's relative economic openness is less impressive (Figure 2.3). Using China and other East Asian economies as a comparison reveals that Indian tariff levels are almost double those of China, and close to four times Indonesian and Malaysian levels.[108]

Figure 2.3



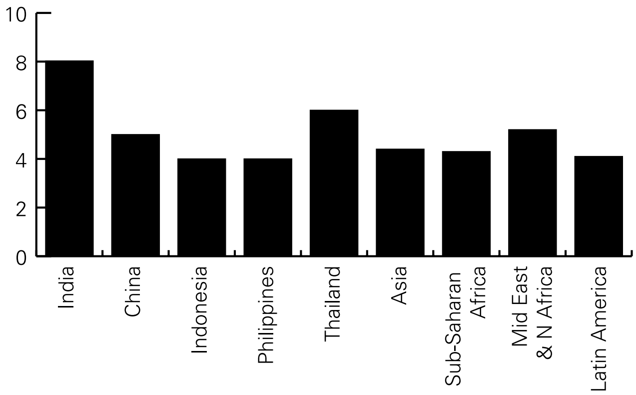
Source: Adapted from Table 4.12 in Reserve Bank of India (2004)

Indeed, Indian tariff rates remain among the highest in the world, as do India's trade barriers more generally. For example, the IMF calculates a "trade restrictiveness index" that ranks economies on a scale of 0 (least restrictive) to 10 (most restrictive). On this measure, India scores a high 8, compared to a score of 5 for China and an average score of a little less than 4 for the Asian region as a whole (Figure 2.4). India's relatively poor showing not only reflects internationally high average tariff rates as described above, but also a high level of tariff dispersion, the presence of various additional duties including countervailing duties, safeguard duties and anti-dumping duties, and the use of non-tariff restrictions including import bans, import restrictions through state trading monopolies, and standards or certification agreements. In recent years, for example, India has vied with the US as the leading user of anti-dumping measures.[109]

Figure 2.4

IMF trade restrictiveness index

0 = least restrictive, 10 = most restrictive



Source: Adapted from Chauffour (2002)

More subjective measures of international economic integration tend to confirm the thesis that India's integration with the global economy is still a partial one. For example, in the latest A T Kearney/*Foreign Policy* globalisation index, which ranks 62 countries for globalisation using economic, personal, technological and political indicators, India is ranked 61st overall, with an economic ranking that is also 61. By way of comparison, while China is only ranked at 57 on the overall index, it comes in at a much higher 37th place when the ranking is conducted in terms of economic indicators alone.[110]

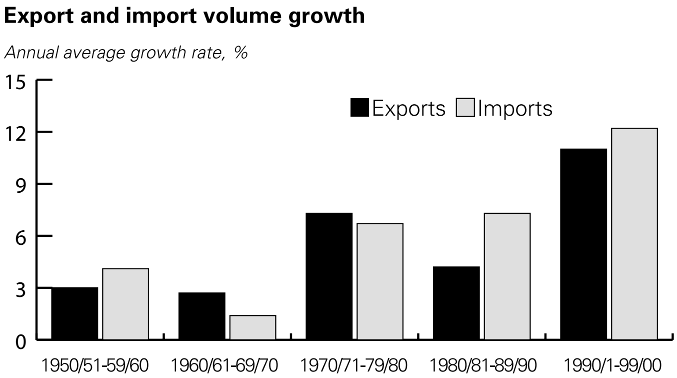
On balance, therefore, the evidence suggests that while reform has made India a much more open economy than it was before, the scope for further progress remains substantial. This message is confirmed by a review of the progress made in opening up flows in goods, services and capital.[111]

Merchandise trade: mixed progress

India's mixed fortunes in terms of its efforts to open up to the international economy are particularly visible in the merchandise trade sector.

The good news is that reform *has* been associated with an increase in the growth of both exports and imports of goods. For example, the annual average rate of export volume growth rose from 4 % in the 1980s to 11 % in the 1990s, while for imports the increase was from 7 % to 12 % (Figure 2.5).[112] Indeed, UNCTAD ranks India among the top 15 economies in the world in terms of export gains made during 1985–2000.[113]

Figure 2.5



Source: Adapted from Table 4.17 in Reserve Bank of India (2004)

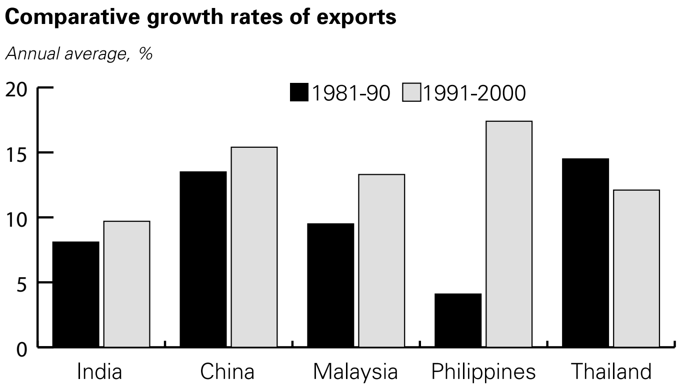
There has also been an increase in growth rates when measured in *value* terms (rupee or US dollar), although the acceleration in export growth in the 1990s relative to the 1980s looks much more modest, with export growth in US dollar terms for example rising from an annual average rate of 8 % in the 1980s compared to a little less than 9 % in the 1990s.

Similarly, India's export growth performance when judged relative to East Asian economies in general, and against China in particular, looks less impressive (Figure 2.6).[114]

Moreover, India's share of world merchandise trade has actually changed only marginally since the reform process began (Figure 2.7). Indeed, by 2002 India's share of world goods trade was still *below* the level it had reached in the 1950s and 1960s. According to the World Trade Organisation (WTO), by 2002 India accounted for just 0.8 % of world merchandise exports and 0.9 % of world merchandise imports, making

India the world's 30th largest exporter and its 24th largest importer.[115]

Figure 2.6



Source: Adapted from Table 7.4 in Reserve Bank of India (2003)

Figure 2.7

Source: Adapted from Table II.2 in World Trade Organisation (2003)

This inability to increase the economy's share of world exports stands in sharp contrast to the Chinese experience. India's share of world trade is more in line with much smaller economies such as the Philippines or

Thailand, which suggests that India is probably 'under-trading' given its size (Figure 2.8).

Figure 2.8

Source: Adapted from Table I.5 in World Trade Organisation (2003)

Support for the 'under-trading' thesis can be found in econometric work carried out by IMF economist Jean-Pierre Chauffour. He uses a statistical model of trade (the so-called gravity model which relates the volume of trade to GDP growth and economic distance) which not only finds that India has under-traded historically, but moreover suggests that "India continued to under-trade during the 1990s". Indeed, the results of the model suggest that the degree of 'under-trading' actually *increased* in the 1990s.[116]

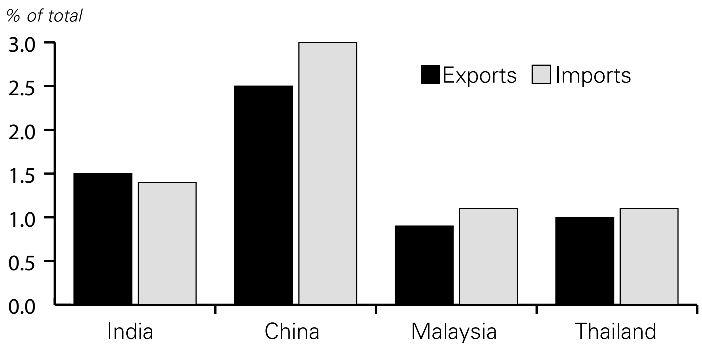
Services and the IT sector: India's success story

India's apparent inability (at least to date) to significantly increase its share of world merchandise trade also stands in marked contrast to the dramatic progress made in terms of service sector exports, and in particular exports related to the information technology (IT) sector, and more recently to so-called business process outsourcing (BPO). As a consequence, the "unique aspect of India's global integration has been the important role played by services exports".[117]

The growth of service exports has significantly outpaced that of goods exports over the last decade, so while India has recorded only a small gain in market share in merchandise trade, its market share of services exports has almost tripled, rising to 1.5 % of world services exports.[118] According to the WTO, India was the 19th largest exporter and importer of commercial services in 2002. The only developing country with bigger services exports than India is now China (Figure 2.9).[119]

Figure 2.9

Share of world commercial services trade, 2002

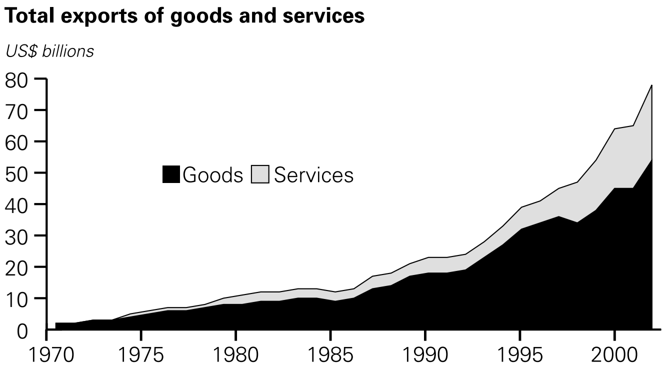


Source: Adapted from Table I.7 in World Trade Organisation (2003)

At the same time, exports of services have become an increasingly large proportion of total Indian exports, with their share rising from just below 20 % in 1990 to more than 30 % in 2002 (Figure 2.10).

While the largest single component of Indian service exports continues to be workers' remittances (India is the largest recipient of workers' remittances in the world), the *growth* of service exports has largely been an IT-story.[120] For example, Salgado calculates that if IT services are excluded from total services exports, then the latter grew only slightly faster than goods exports. Indeed, growth in IT-related services exports accounts for about a 0.5 percentage point of India's total gain in market share in world services trade.[121]

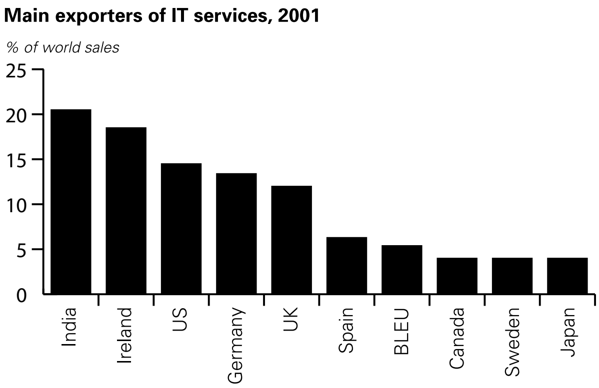
Figure 2.10



Source: Adapted from World Bank (2003)

India has now become a world leader in the export of IT services (including on-site service contracts and off-site software support), placing Indian exporters in direct competition with enterprises in developed economies (Figure 2.11).[122]

Figure 2.11



Source: Adapted from Table 25 in Chauvin and Lemoine (2003)

Although India's share of IT service *exports* is large, the share of the Indian software industry in overall global IT *spending* remains quite small. Even so, the industry has continuously increased its market share, up from around 1.5 % of that market in 2000/01 to an estimated 2.8 % in 2002/03 despite the global downturn in IT spending. To date, this has mainly reflected growing market penetration in the US — which was the destination of around two-thirds of total Indian software exports during 2002/03, with the UK in second place.[123] More than half the US Fortune 500 companies in 2004 are estimated to be outsourcing work to India, where it seems "English is the killer app".[124]

Srinivasan and Tendulkar quote a McKinsey forecast (made in 2001) that India would have an export market of US$25 billion and domestic market of US$21 billion by 2010, and then note that more recent forecasts from the industry association, the National Association of Software and Service Companies are even more dramatic, projecting exports of between US$57 billion and US$65 billion by 2008.[125]

What has been behind India's explosion into the IT-enabled services (IT-ES) and Business processing outsourcing (BPO) markets? Unger wonders whether some form of 'market brahminism' has helped encourage India's new love-affair with the intangibilities of the new economy, and then suggests more prosaically that the fundamental attraction is that India offers "work done to global standards, and often at a faster pace, at Indian costs".[126]

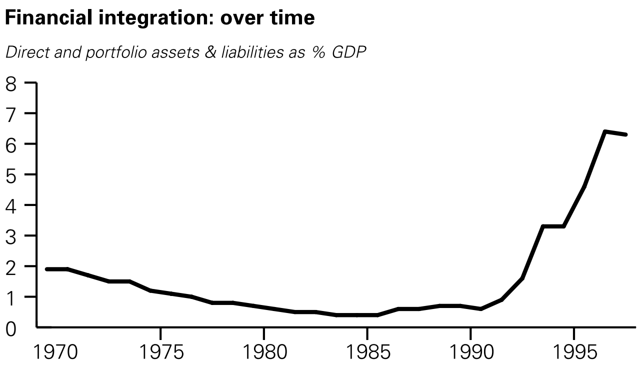
The basic story is that India has been able to combine a telecommunications revolution (which has allowed the delivery of services over long distance at a reasonable cost) with a large supply of English-speaking graduates (more than 250 Indian universities and engineering colleges graduated over 90,000 IT professionals in 2001/02, and more than two million other students graduate annually, many fluent in English) who earn relatively low wages (salaries for Indian IT workers have been about one-tenth to one-half of US levels). In addition, the industry has also been able to leverage the benefits of India's international diaspora (the second largest in the world after China, with over 20 million Indians living overseas, including two and a half million in North America where significant numbers —

more than 200,000 — are IT professionals), and has benefited from favourable treatment by the government (even after the general pace of liberalisation slowed in the mid-1990s, the software industry continued to benefit from sector-specific reforms).[127]

Foreign investment: a gradual opening

The reforms of the 1990s aimed at opening up the Indian economy to international capital flows as well as to trade in goods and services. Once again, there is strong empirical evidence to show that financial integration has increased since the onset of reform. For example, Salgado uses data on external assets and liabilities as a share of GDP to illustrate how financial integration gradually declined between 1970 and 1990 and then bottomed in 1991, before rebounding through the 1990s (Figure 2.12).

Figure 2.12



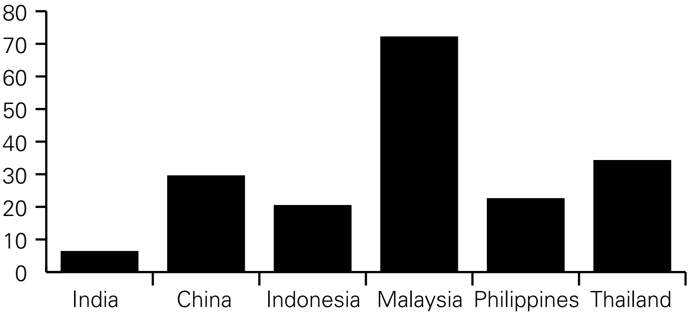
Source: Adapted from Lane and Milesi-Feretti (1999)

However, using the same measure in an international context shows that — as with international trade — India remains significantly less integrated than East Asian economies (Figure 2.13).[128]

Figure 2.13

Financial integration: across countries

Direct and portfolio assets & liabilities as % GDP, 1998



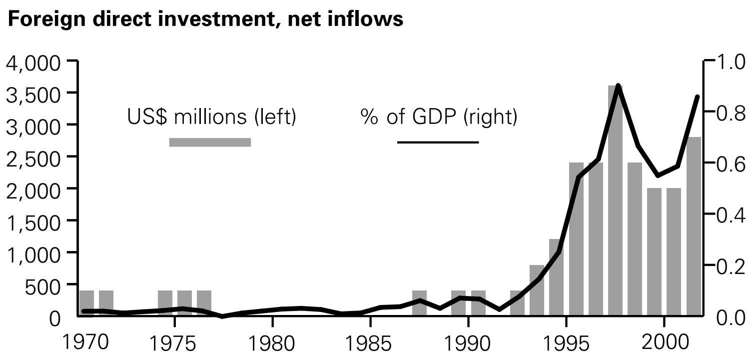
Source: Adapted from Lane and Milesi-Feretti (1999)

In part, this relatively low level of financial openness is the product of deliberate policy. India's opening to foreign capital — with the demonstrated effects of India's own 1991 crisis along with the more recent Asian financial crisis in mind — has been purposefully cautious. The RBI's stated policy stance for example has been to encourage long-term investment flows while discouraging short-term inflows. As a result, "India still retains one of the most closed capital accounts in the world."[129]

Even with this cautious approach, net capital inflows have more than doubled from an average of US$4 billion during the 1980s to an average of about US$9 billion during 1993–2000. At the same time, the proportion of non-debt flows in total inflows has increased from about 5 % in the latter half of the 1980s to about 43 % during the 1990s.[130]

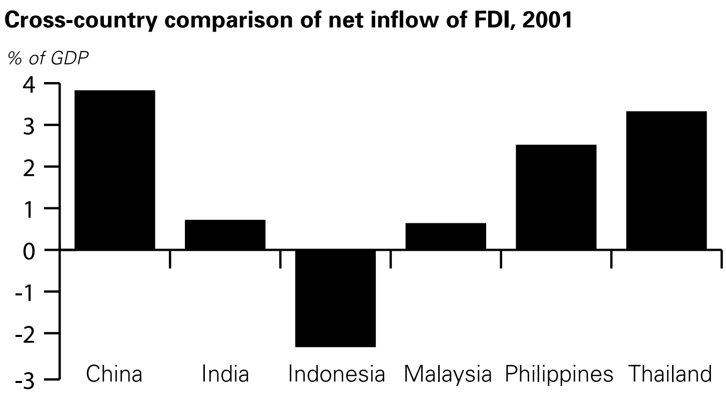
Still, capital flows into India remain small when compared to those received by countries of a similar size. This relative difference in performance is particularly evident in terms of flows of FDI (Figure 2.14). While there has been a marked increase in overall FDI inflows (on World Bank numbers, net FDI inflows to India rose from just US$0.1 billion in 1991 to US$3.5 billion in 2001), in relative terms such inflows remain very modest. For example, in US dollar terms, FDI inflows to China are roughly ten times the magnitude of flows into India.[131] The discrepancy is also evident when FDI is measured in terms of the share of GDP (Figure 2.15). This is despite the fact that on paper at least India looks like a particularly attractive destination for FDI, boasting one of the largest domestic markets in the world along with a generous supply of relatively cheap labour.

Figure 2.14



Source: Adapted from World Bank (2003)

Figure 2.15



Source: Adapted from World Bank (2003)

Another difference from China is that FDI into India has been mainly oriented towards the domestic market.[132] One consequence has been that FDI has been much less important in driving export growth than in China (with the partial exception of the IT sector).[133] Rajan and Sen suggest that because India was a relative latecomer in terms of opening up to the international economy, it missed out in terms of being part of the regional division of labour in manufacturing production chains of parts and components.[134]

India does do relatively better in terms of portfolio investment (although China's share of this global flow is still bigger).[135] India has allowed access to foreign institutional investors since 1993, and portfolio inflows since then have staged a marked increase, running at an average annual rate of US$2.2 billion per year between 1992/93 and 2002/03, with the contribution of foreign institutional investors at around US$1.2 billion. Cumulative investment in India by the latter is estimated by the RBI to be close to US$19 billion and to account for over 10 % of the total market capitalisation of the Indian stock market (in 2002/03).[136]

Limits to international economic integration

The message so far is that India has achieved mixed success in terms of its mission to rejoin the global economy. On the credit side of the balance sheet, there can be little doubt that the degree of international economic integration has increased dramatically relative to that prevailing during India's earlier policy of self-sufficiency. There are also some striking success stories such as India's IT-related service exports. Moreover, Indian policymakers have been able to successfully combine greater international economic integration with a lower level of external vulnerability, as evidenced in a marked improvement in external debt and reserve indicators (Table 2.1). The importance of this particular achievement should not be underestimated.

That said, however, India's progress looks less impressive when it is compared to the economies of East Asia, and in particular to that demonstrated by Asia's other economic giant, China. India's share of world trade remains relatively small for a country of its size, with the performance of merchandise trade failing to demonstrate the same degree of dynamism displayed by the services sector. Inflows of foreign investment remain low relative to other major emerging markets, albeit much higher than in the past.

Table 2.1 External vulnerability indicators

	1990/91	2002/03
Reserve adequacy measures		
Import cover (months)	2.5	13.8
Reserves to total external debt (%)	7.0	72.0
Reserves to short-term external debt (%)	68.3	1,650.9
Debt sustainability measures		
Debt service ratio (%)	35.3	14.7
External debt to GDP (%)	28.7	20.3
Short-term debt as share of total debt (%)	10.2	4.4

Sources: Adapted from Tables 7.6 and 7.16 in Reserve Bank of India (2004)

The reasons for this mixed progress include the relatively gradual pace of economic reform and the continued presence of structural shortcomings, infrastructural bottlenecks and the perverse effect of government legislation. Take the case of India's merchandise trade performance. One major constraint on growth has been the gradual pace of reform. Thus "slow progress in lowering import duties … make India a high-cost producer and therefore less attractive as a base for export production".[137] Moreover, even when Indian exporters have access to duty free imports, they still have to negotiate relatively complex procedures that involve high transactions costs and delays. For example, sample surveys carried out by the Export-Import Bank of India in 1998 and 2003 found that exporters in several key sectors faced particularly high transactions costs in the form of delays in getting refunds or in obtaining licences.[138]

Similarly, a study by the RBI on India's external performance points to some of the adverse consequences of the policy of favouring production by small scale industries (SSIs). As mentioned in Chapter 1, this sector has enjoyed government protection in the form of the reservation of items for production solely by the SSI sector, along with purchase preferences and fiscal incentives. In 1989, 836 items were reserved for exclusive SSI manufacture; by 2003 the list still had 675 items. Exports from the SSI sector account for about 35 % of total exports and nearly 45 % of manufactured exports. The RBI judges that the reservation policy has prevented the expansion of successful SSIs and imposed restrictions on the upgrading of technology. Crucially, the policy has been particularly damaging in areas where India should have had a significant comparative advantage, such as textiles.[139]

A second major constraint on export performance has been infrastructure shortcomings.

Problems with transport and energy for example have increased costs and reduced competitiveness. A recent World Bank/Confederation of Indian Industry (CII) study on the competitiveness of Indian manufacturing found that for physical and financial infrastructure, India's performance lags behind many East Asian and Latin American economies, while the gap between China and India was widening rapidly.[140]

A third constraint relates to the Indian bureaucracy. The same World Bank/CII survey highlights the problems of red tape facing Indian business, noting that the time required to clear customs in India is 50 % longer than in Korea or Thailand, and triple that of many OECD economies.

Many of the same difficulties can also be used to explain the relatively low level of FDI that India has attracted relative to China. For example, Srinivasan argues that India's relative failure to attract more FDI is due to the persistence of onerous regulations along with limitations in physical and legal infrastructure that constrain the economy's absorptive capacity.[141] India's still relatively high level of trade restrictions have probably been an even more important constraint.

Box 2: Regional economic integration: still a long way to go

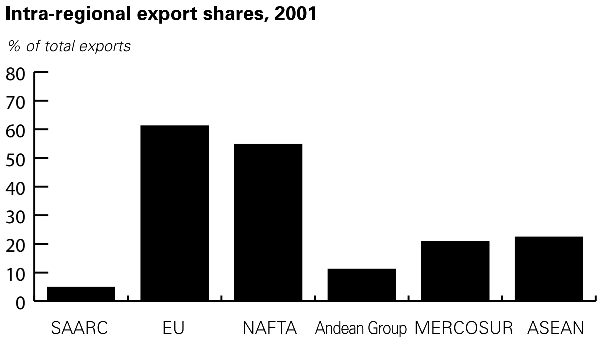
Economic globalisation in practice has tended to have a strong regional aspect, and several commentators have wondered whether India's particular regional environment may have impeded international integration.[142]

India is a member of several regional organisations, including the South Asian Association for Regional Cooperation (SAARC), the Indian Ocean Rim Association for Regional Cooperation (IOR-ARC) and the Bangladesh, India, Myanmar, Sri Lanka, Thailand — Economic Cooperation grouping (BIMST-EC).

Of these, SAARC (which comprises Bhutan, Bangladesh, India, the Maldives, Nepal, Pakistan and Sri Lanka) has probably been the most important in terms of regional trade initiatives. SAARC was created in 1985 and its membership established a South Asian Preferential Trading Arrangement (SAPTA) in 1991. To date, integration remains quite limited, with its relatively under-developed nature visible for example in a low level of intra-regional exports. In 2001 intra-regional exports for SAARC members were less than 5 % of the region's total exports, compared to about 21 % for MERCOSUR, 22 % for ASEAN/ AFTA, 55 % for NAFTA and 61 % for the EU (Figure 2.16).[143]

There is little evidence therefore that SAARC membership has provided much of a spur to trade between India and other regional economies when compared to (say) the boost that NAFTA gave Mexico. This is not particularly surprising; historically, SAARC members (with the exception of Sri Lanka) have been "among the least open of the world's economies".[144] SAARC is also one of the world's poorest regions, and its economic performance has been weak in comparison to a regional grouping like ASEAN (Table 2.2). In addition, the history of tension between India and Pakistan has limited the scope for developing regional economic linkages.[145]

Figure 2.16



Source: Adapted from World Trade Organisation (2003)

More recently, there have been signs that regional integration may have a somewhat brighter future. India concluded a free trade agreement with Sri Lanka in December 1998 and has also signed a bilateral trade agreement with Nepal. Since the Sri Lankan deal went into effect in March 2000, bilateral trade and investment flows have reportedly picked up, and there has also been some increase in trade after the agreement with Nepal was signed.

The prospects for an increase in regional economic integration depend critically on the future of Indo-Pakistan relations (see Box 3). The recent improvement in bilateral relations for example helped contribute to an agreement reached by SAARC on 2 January 2004 on a framework for a regional free trade zone (SAFTA) based around a plan to start cutting tariffs by January 2006 (the agreement had originally been proposed in 1995, with a 2001 deadline, and until recently had gone nowhere). Some estimates suggest that regional trade could grow from its current level of around US$6 billion to US$14 billion under the agreement. However, even if SAFTA proves to be successful in cutting import duties, there remain substantial non-tariff and infrastructure barriers to greater regional trade. For example, in 2003 it took cargo trucks four days to complete the paperwork needed to cross the India–Bangladesh border.[146]

Table 2.2 *SAARC* and *ASEAN* members compared (2002)

	Gross National Income (GNI) US$ billions	GNI per capita US$
SAARC		
Bangladesh	47.0	360
Bhutan	0.5	590
India	514.2	480
Maldives	0.6	2,090
Nepal	5.6	230
Pakistan	58.2	410
Sri Lanka	16.1	840
ASEAN		
Brunei	–	–
Burma/Myanmar	–	–
Cambodia	3.5	280
Indonesia	164.6	710
Lao PDR	1.6	310
Malaysia	88.3	3540
Philippines	82.0	1020
Singapore	85.8	20,690
Thailand	124.3	1,980
Vietnam	35.1	430

Source: Adapted from World Bank (2003)

Box 3: The most dangerous place on earth?

"The most dangerous place in the world today, I think you could argue, is the Indian subcontinent and the line of control in Kashmir."

—US President Bill Clinton, 2000[147]

The future of regional economic integration is closely bound up with the future of India–Pakistan relations. Indeed, with both countries informal members of the nuclear club since publicly testing their nuclear arsenals in 1998, there is much more than economics at stake in the bilateral relationship.[148]

At the centre of the decades old dispute between India and Pakistan is the province of Kashmir, which is currently divided by a 'line of control' that runs along the Himalayas. The two neighbours have fought three wars (in 1947/48, in 1965 and in 1971), not to mention numerous border skirmishes since independence and what was virtually another war in Kashmir in 1999. When terrorists attacked the Indian parliament in December 2001, and India accused Pakistan of involvement, many commentators saw a significant risk of another conflict in 2002, and there even seemed to be some risk that there could be a nuclear exchange.[149]

As well as a heavy toll in terms of the loss of human life (more than 40,000 people are estimated to have died in Kashmir since the insurgency began in 1989), and the frightening possibility of a nuclear confrontation, the political tensions between the two countries has also had significant economic costs. For example, it has been estimated that in the 1990s the Indian army was spending up to US$3.5 million a day attempting to maintain control in Kashmir.[150] Trade relations between the two countries have also been distorted: while official India–Pakistan trade is running at an annual rate of just US$200 million, unofficial trade via cross-border smuggling and transit through third countries such as Dubai and

Singapore is estimated to be closer to US$2 billion.[151] The threat of conflict between the two economies has also likely had a significant impact on India's country risk premium, with implications for the cost and availability of foreign finance. It also seems likely that domestic investment will have been adversely affected by the uncertainty associated with the dangers of a future conflict.

The current moves towards peace began in April 2003 following an approach by India's then Prime Minister Atal Behari Vajpayee. This overture led to a re-opening of transport links and an easing of visa restrictions between the two countries, as well as an agreed ceasefire along the line of control. These confidence building measures were followed by a meeting between the Indian Prime Minister and Pakistan's President Pervez Musharraf in January 2004. The two countries then agreed on a 'road map' for peace talks over Kashmir on 18 February, and also announced separate talks to begin in May on measures to reduce the risks of a nuclear confrontation.[152] The road map was to comprise a series of meetings running from March through August. The meetings were intended to review actions to combat terrorism and promote trade and to deal with the dispute over Kashmir. The process is planned to culminate in an August 2004 summit between the foreign ministers of India and Pakistan.[153] It was given an additional fillip in March 2004 with the first cricket Test series between the countries in 14 years.

Many commentators have pointed to the irony that the best prospects for peace in some time arrived at a time when India was being governed by the Hindu nationalist BJP and Pakistan was under military rule, prompting some to argue that the two leaders were 'indispensable' for the peace process.[154] Does this mean that the process is in jeopardy after the electoral defeat of Vajpayee? The good news is that the incoming UPA government has said that relations with Pakistan will be a top priority, and the parties of the left on which it relies for support are all in favour of peace talks with Pakistan. However, the new government's commitment to the particular details of the Vajpayee-inspired 'road map' to peace has yet to be established.

Chapter 3
Sustaining faster economic growth

"My belief is that India stands on the edge of explosive economic growth."

—Finance Minister Jaswant Singh, 2003[155]

"With the relaxation in the pace of reforms and fiscal discipline, the economy appears to be in danger of relapsing to a lower growth path."

— Srinivasan et al., *Reintegrating India with the world economy*[156]

Targeting faster economic growth

Chapter 1 described how India's move to economic reform and greater integration with the international economy was motivated by a desire to boost economic performance and break out from the so-called 'Hindu rate of growth'.[157] Now, more than a decade into the reform process, sustaining faster economic growth remains a key objective.[158]

Despite the move to a more market-based economy, the framework of Indian economic policy retains an important place for the five year plan (FYP), indicating perhaps some lingering attachment to the planning approach. The latest of these plans, the tenth (which runs from 2002–2007) calls for an annual average GDP growth rate of 8% over its lifetime, as well creating the conditions needed for a further acceleration in India's growth rate over the period of the Eleventh FYP. The ultimate objective is to double India's income per capita over the next ten years.[159] But while the extremely rapid growth rate achieved in the December quarter of 2003 has boosted optimism about India's growth prospects, the Tenth FYP growth targets look very ambitious when set against past experience.

Table 3.1 Growth performance in the Five Year Plans, % pa

	Target	Actual
First Plan (1951–56)	2.1	3.6
Second (1956–61)	4.5	4.2
Third (1961–66)	5.6	2.7
Fourth (1969–74)	5.7	2.1
Fifth (1974–79)	4.4	4.8
Sixth (1980–85)	5.2	5.5
Seventh (1985–90)	5.0	6.0
Eighth (1992–97)	5.6	6.7
Ninth (1997–2002)	6.5	5.4
Tenth (2002–07)	8.0	–

Source: Adapted from Table 2.1 in Government of India (2001)

A review of the previous nine FYPs reveals that the outcome for growth exceeded the official target in five out of nine cases, and that the strongest growth rate yet achieved over the course of any one plan was 6.7% (during the Eighth FYP). Most recently, in the case of the Ninth FYP, growth fell short of the authorities' target by more than a full percentage point (Table 3.1).

Standard economic growth accounting says that an increase in growth can be achieved either by increasing the inputs into the growth process (labour, in the form of a higher workforce, human capital, in the form of a more skilled workforce, and physical capital, in the form of higher investment), or by increasing the efficiency with which a given set of inputs are used (higher productivity), or by a combination of the two.

Table 3.2 Macroeconomic parameters for the Tenth Five Year Plan (2002–2007)

	Ninth Plan (outturn)	Tenth Plan (target)
Domestic savings rate (% GDP)	23.31	26.84
Current account deficit (% GDP)	0.91	1.57
Investment rate (% GDP)	24.23	28.41
ICOR	4.53	3.58
GDP growth rate	5.35	7.93

Source: Adapted from Table 2.7 in Government of India (2001)

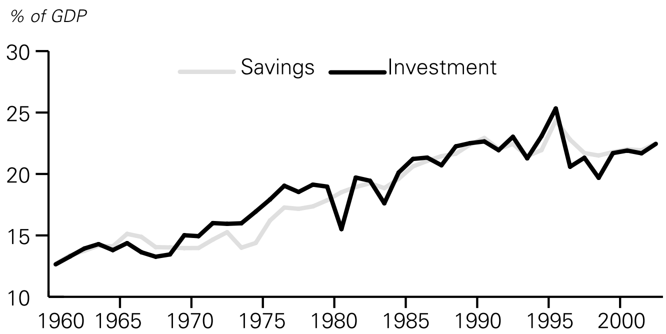
The macroeconomic parameters for the current FYP are set out in Table 3.2. They call for an increase in India's investment rate, and a concomitant increase in the economy's access to domestic (and foreign) savings to finance this. In addition, the plan also calls for a fall in the Incremental Capital Output Ratio (ICOR). The ICOR is the ratio of the investment rate to GDP growth, and is a summary measure of the efficiency of investment. A fall in the ICOR implies an increase in the efficiency with which capital in the economy is being used.[160] In other words, to meet the growth targets of the current FYP, the Indian economy must increase both the inputs into the growth process and the efficiency with which they are used.

Raising saving and investment

A look at the data reveals that, over time, India *has* managed to generate an increase in savings and investment rates (Figure 3.1). However, both gross domestic saving and gross investment as a share of GDP peaked in the mid-1990s, and have since fallen back.

Figure 3.1

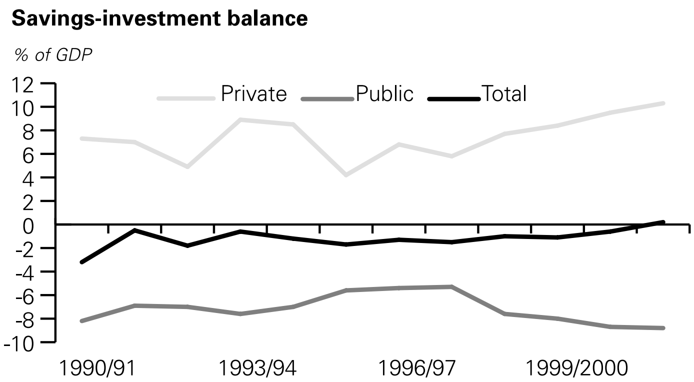
Savings and investment over time



Source: Adapted from World Bank (2003)

Importantly, the improvement in the economy's savings rate is almost wholly a product of an increase in savings by the household sector. In contrast, the rate of public savings has collapsed as India's fiscal stance has succumbed to the "pressure of competitive populism".[161] As a result, while India now runs an overall savings-investment surplus, there has been a steadily widening public sector resource gap that has been financed by tapping the surplus of the private sector, with the latter also reflecting subdued private sector investment (Figure 3.2). This decline in India's overall domestic savings rate in the latter part of the 1990s has served as an important constraint on investment levels, and hence on potential growth.[162]

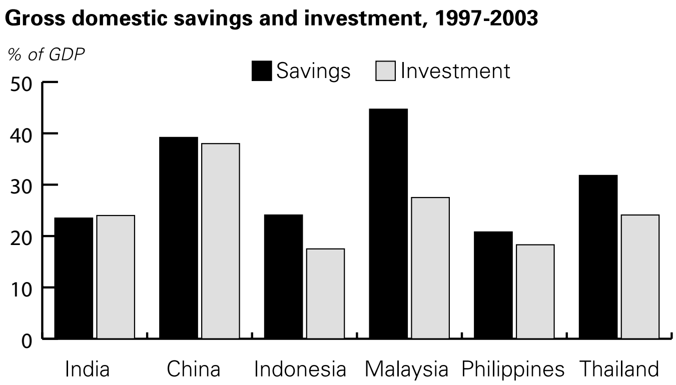
Figure 3.2



Source: Adapted from Table 2.8 in Reserve Bank of India (2004)

Moreover, although India has managed to boost both gross domestic savings and investment over recent decades, it still lags behind China and some of the other East Asian economies in this regard (Figure 3.3). While India's current savings rates compare well to those of other low-income countries, they look relatively low when set against the rates that have been achieved by some fast-growing economies.[163]

Figure 3.3



Source: Adapted from Table 2.6 in Reserve Bank of India (2004)

Raising efficiency

Is there evidence that the reform process to date has succeeded in lowering the ICOR (that is, in boosting efficiency or productivity)? The aggregate picture is somewhat disappointing in terms of India's recent performance. Thus estimates of India's ICOR produced by the central bank find a downward trend (indicating improving efficiency) until 1996/97, but this has been followed by an increase in the ICOR through the latter part of decade.[164] Similarly, Salgado finds that Indian TFP growth was roughly unchanged in the post-crisis 1990s when compared to the 1980s, but that productivity decreased markedly in the late-1990s.[165]

In addition to these macroeconomic or top-down measures of efficiency there have also been a series of studies looking at the productivity performance of India's manufacturing sector. An interesting starting point here is the work by Hulten and Srinivasan, who estimate the rate of TFP growth in the Indian manufacturing industry for the period 1973–1992. They find that the performance of the modern manufacturing sector (the so-called 'registered sector') was *already* not too distant from some of the so-called 'East Asian Tiger' economies even before reform got underway.[166] Topalova looks at the impact of the 1990s trade reforms on productivity of firms in the manufacturing sector.[167] She finds that the trade reforms since 1991 have contributed to an increase in both the level and growth of firm productivity, although the effect is found only for private companies. Unel looks at productivity trends in the (registered) manufacturing sector and compares the post-1980 period to the pre-reform 1959–1979 period and finds that both labour productivity and TFP growth have been 'markedly higher' since 1980, and that labour productivity picked up again after the 1991 reforms.[168] Unel estimates that labour productivity growth in the 1980s and 1990s was up to three times higher than in the preceding two decades.

The RBI has surveyed the evidence on productivity growth in manufacturing, and finds 'near unanimity' in the results, with a decline in TFP growth until 1980, followed by an improvement in the mid-1980s. There remains debate over India's productivity performance over the course of the 1990s, although there appears to be some evidence of a decline in the latter part of the reform period.[169]

Identifying the constraints on growth

So what are the constraints on India's ability to boost savings and investment rates, increase productivity, and hence lift the overall growth rate? Clearly, there are many factors at work, but in this chapter we highlight six important candidates: fiscal fragility, infrastructure bottlenecks, the burden of regulation and bureaucracy, shortcomings in the financial and agricultural sectors and the pressures associated with growing inter- and intra-regional inequality.

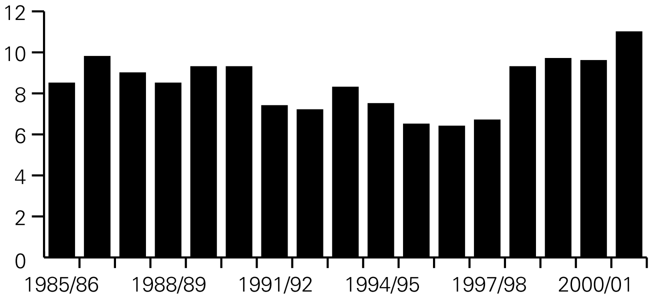
Fiscal fragility

A key constraint on India's ability to raise the domestic savings rate is the large budget deficit (Figure 3.4). India's general government deficit (the combined deficit of the central and state governments) has averaged about 8.5 % of GDP between 1989/90 and 2002/03. In recent years about 60 % of this deficit has been due to shortfalls at the central government level and the remainder due to state government deficits. The general government deficit exceeded 10 % of GDP for the first time in 2001/02, with a revenue deficit (the difference between revenues and current expenditures) of almost 7 % of GDP and a primary (non-interest) deficit approaching 4 % of GDP.[170]

Figure 3.4

General government deficits

% of GDP

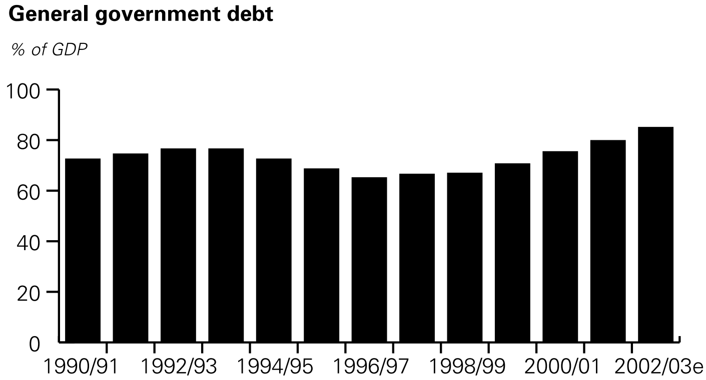


Source: Adapted from Table A9 in World Bank (2003)

These large general government deficits have been financed by borrowing, mainly in the form of long-term, rupee-denominated debt. The result has been a sharp increase in the burden of general government debt, up from 58 % of GDP in 1986 to 85 % of GDP at the end of March 2003 (Figure 3.5). The World Bank estimates that adding in the debt of India's public sector enterprises would boost the ratio to about 95 % of GDP, and including contingent liabilities associated with government guarantees to loss-making public sector enterprises (mainly in the power and irrigation sectors) would push the total to a whopping 112 % of GDP.[171]

The combination of a large public debt stock and sizeable primary deficits means that India's fiscal sustainability is precarious at best, and the failure to deal with fiscal fragility remains a critical shortcoming in the reform effort. Indeed, reviews of the reforms to date are almost uniform in citing the fiscal deficit as a major shortcoming.[172] Both the IMF and the World Bank have also repeatedly stressed that budget deficits are a major threat to India's long run growth prospects.

Figure 3.5



Source: Adapted from Table 11 in World Bank (2003)

Is a fiscal crisis imminent? India's fiscal deficit as a share of GDP is now one of the largest in the world; Ahluwalia has pointed out that India's fiscal and debt indicators are comparable to countries like Argentina, Brazil and Turkey, which have either recently experienced or come close to experiencing severe macroeconomic crises.[173] The good news is that in the short-term the dangers of a crisis are limited by India's healthy external position as highlighted in Chapter 2, along with the continued use of capital controls and the government's control over much of the banking sector. Thus the World Bank notes in a recent report that the strong external position plus a "pliant financial system" means that "India is not vulnerable in the short term to the type of collapse suffered by Russia or Argentina."[174]

The fact that no crisis appears likely in the short-term has even led some to call for continued fiscal stimulus to boost growth. But while a near-term collapse may be unlikely (although the risk is rising over time), the fiscal position is already an important constraint on growth.[175] Higher debt stocks have an adverse impact on India's risk premia and sovereign rating, and hence on the cost of borrowing.[176] In addition, large levels of public sector dissaving are clearly a major obstacle to India increasing its overall domestic savings rate, and therefore to boosting investment. Jha, Chand and Sharma note that India's rising debt servicing commitments are crowding out both capital investment and the provision of public services.[177] Similarly, Salgado estimates that almost 70 % of the slowdown in private investment in the late 1990s was due to deterioration in the composition of public expenditure, and specifically, in the move away from infrastructure investment towards public consumption and non-infrastructure investment as public sector financing constraints started to bite.[178] And the World Bank calculates that since 1986/87 an increase in the central government budget deficit of 1 % of GDP has been associated with a fall in private corporate investment of 1 % of GDP.[179]

Moreover, while a short-term crisis may be unlikely, this is not to say that there is no risk at all. Roubini and Hemming for example have recently argued that India's vulnerability to a so-called 'balance sheet crisis' may be significantly larger than is commonly supposed.[180]

The authorities are aware of the need for action. The recently passed *Fiscal Responsibility and Budget Management Act* calls for a move to a balanced budget by scaling back the deficit by an annual rate of one percentage point of GDP until 2008. But a key question is whether the political will to deliver this program exists, and indeed, whether the political *ability* is present after the recent election. The good news is that the incoming government has already announced that it is committed to targeting a balanced budget by 2009. In practice, the prospects for deficit reduction in the short-term may be limited, however, by the need of the UPA to build cross-party consensus for politically unpalatable measures.

Infrastructure bottlenecks

India's fiscal weakness has also contributed to the economy's 'legendary' infrastructure problems, which are often cited as one of the major constraints to improving the economy's productivity performance.[181] Bajpai for example, stresses that inadequate public investment in the post-reform period has damaged the economy, by leading to "serious under-investment in critical infrastructure sectors such as electric power generation, roads, railways and ports".[182]

Several analysts have argued that initially India was able to boost growth in response to the 1990s reforms *despite* its inadequate infrastructure capacity because of the existence of some slack in the system. But once this spare capacity was exhausted, sustaining growth became more difficult. The RBI for example, has identified infrastructure as a key constraint on the supply response of the Indian economy, emphasising a declining trend in potential output growth for several basic infrastructure sectors including cargo handling and freight loading.[183] Similarly, Jha and Thapa judge that India's ability to supply the infrastructure necessary to sustain growth has been inadequate. They note that for many core economic infrastructure sectors growth has barely improved in the post-reform era and in one case (electricity generation) has deteriorated.[184] Real investment in electricity, gas and water fell to 2.6 % of GDP in the 1990s from 2.9 % of GDP during the preceding decade, with a similar trend for railways, and investment in the infrastructure sector as a whole fell by one percentage point of GDP between the first and second halves of the 1990s.[185]

Perhaps the most binding infrastructure constraint on India's growth prospects has been the energy sector. Persistent power shortages due in part to high transmission and distribution losses, together with voltage and frequency fluctuations are a major constraint on Indian businesses.[186] The World Bank for example estimates that in 2001 Indian electricity power transmission and distribution losses were equivalent to about 27 % of output, compared to just 7 % in China.[187] Survey work by the Bank also finds that some 69 % of Indian manufacturing firms had felt compelled to buy their own power generator, compared to just 30 % in China. And a comparison of India's garment and electronics sectors with those in East Asia suggests that energy costs for Indian firms were double those in Indonesia, the Philippines and Thailand, with adverse consequences for the competitiveness of Indian producers.[188]

After energy, India's transport sector is probably the economy's most cited infrastructural bottleneck. True, on paper, some of India's transport statistics appear impressive. India has the third largest road network in the world while its rail network is by one estimate the world's largest commercial enterprise in terms of employees (more than 1.5 million).[189] Unfortunately, quality is problematic, with India's roads suffering from poor maintenance levels and limited capacity: in

1996 it was estimated (by the Rakesh Mohan Committee) that the drain on the Indian economy due to bad roads could be anywhere between US$2.6 billion and US$6.5 billion per year.[190] On the railways, revenues are largely swallowed by operating costs, and are insufficient to cover maintenance or expansions.[191] Cross-subsidisation and unreliability has helped drive freight traffic off the rails; for example, freight traffic on Indian railways as a percentage of traffic units is just 5 % compared to 79 % in China.[192]

Table 3.3 Basic infrastructure indicators

	India	China
Transport		
Total road network (km)	3,319,644	1,698,012
% of paved roads	45.7	91
Total rail network (km)	62,759	58,656
% electric	22.7	25.3
Communications		
Telephone mainlines (per 1000 people)	40	167
Mobile phones (per 1000 people)	12	161
Personal computers (per 1000 people)	7	28

Source: Adapted from World Bank (2003)

There have also been major problems with India's ports. Historically, the major 11 ports — which between them control 90 % of port throughput — have been run by the central government and been 'hopelessly inefficient' compared to other regional ports like Colombo and Singapore when measured in terms of output per (ship-berth) day or waiting times.[193] As a consequence, in the past cargo has typically been trans-shipped through regional hub ports such as Colombo leading to increased transport costs for Indian firms. A study by the World Bank-CII finds, for example, that the costs associated with shipping a container of textiles to the US are over 20 % higher for India compared to Thailand, and 35 % higher compared to China.[194]

Despite the many problems and shortcomings, however, there is also some good news. For example, the authorities are moving to deal with some of India's transport problems. The government launched the National Highways Development Project to increase carrying capacity, with improvements already delivered for the so-called 'Golden Quadrilateral' (GQ) connecting Chennai, Delhi, Kolkata and Mumbai.[195] The World Bank has estimated that the GQ project alone could deliver total savings to the Indian economy of around US$3.8 billion. Direct benefits should include savings in time and fuel, while there should also be a lift to productivity.[196]

New private sector port facilities have also been introduced through the start of a privatisation process in 1997, and via the mechanism of the provision of 30-year contracts to international port operators. As a result some estimates suggest that the average turnaround time at India's ports has more than halved.[197] Even so, this still lags behind ports in East Asia, and freight payments as a proportion of import value remain well above the world average.[198]

Finally, and after a somewhat shaky start, India's telecommunications sector is now seen as a striking example of the possibilities of reform — and of the opportunities opened up by new technology. The Indian market is currently adding more than two million mobile phones each month as the sector leapfrogs the old technology of fixed lines.

Regulation and bureaucracy

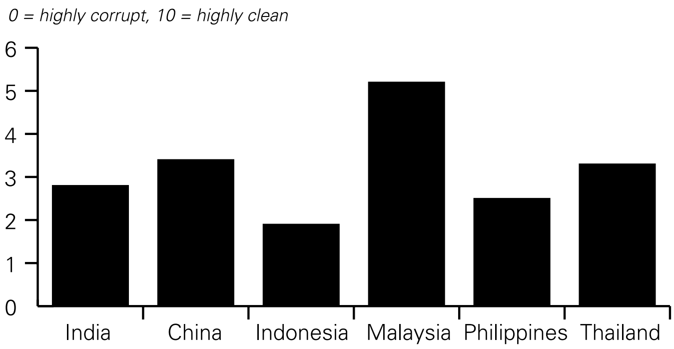
Doing business in India is subject to what has been described as 'institutionalised friction'.[199] This includes the mix of bureaucracy and regulation known as the 'Licence Raj' described in Chapter 1, along with problems of corruption and lack of transparency. Transparency International, for example, ranks India as 83rd out of 133 countries in terms of corruption (China is 66th).

In a recent review, the World Bank concluded that "while the 'License Raj' has been substantially reduced at the center, it still survives at the state level, along with a pervasive 'Inspector Raj'".[200] This represents a significant source of competitive disadvantage for Indian firms.

According to the World Bank's *Doing Business Database*, starting a business in India requires 10 permits compared to six in China, while the median time to complete the process is 90 days in India as compared to 30 in China. Similarly, the Bank's *World Business Environment Survey* found that managers in India spent 16 % of their time in dealing with bureaucracy, compared to 9 % in China.[201]

Figure 3.6

Transparency International Corruption Perception Index



Source: Adapted from http://www.transparency.org/cpi/2003/cpi2003.en.html

Labour market and bankruptcy legislation that limits firms' ability to reallocate capital and labour in response to changing market conditions has also hampered economic efficiency.[202] Labour market legislation such as the *Industrial Disputes Act 1948* was intended to improve employment security, but by imposing significant restrictions on firms' ability to re-allocate labour, the impact has been to reduce the attractiveness of hiring. Similarly, extensive regulations on wages, benefits and employment conditions have increased the relative cost of labour in India's formal (or registered) sector and pushed companies towards more capital intensive production methods and slimmer payrolls.

Procedures for industrial reorganisation including bankruptcy and liquidation are also cumbersome. For example, it has been common for bankruptcy proceedings to last for more than two years, while over

60 % of liquidation cases before India's High Court are estimated to have been in process for more than 10 years.[203]

There are also problems with the use and transfer of land, with some 90 % of land parcels reportedly subject to ownership disputes.[204] Other bureaucratic regulations and regimes, such as the policy of reservation by the SSI sector discussed in the previous chapter, have also created major distortions and inefficiencies in the economy.

Still, once again it's not all bad news. In a review of changing business conditions in India, Naushad Forbes argues that the most striking change for the better has been the growth of competition, with many sectors of the economy seeing new entrants, including overseas firms, competing against incumbents. This has not only led to a big increase in consumer choice, but has meant that "[i]ncreasingly, the criterion for success in more and more industries is to make a product that more people wish to buy more efficiently than others. Through 1991 on the other hand, success for many industrial segments was measured more by the licences that could be captured. In other words, Indian industry is becoming normal."[205]

Financial sector shortcomings

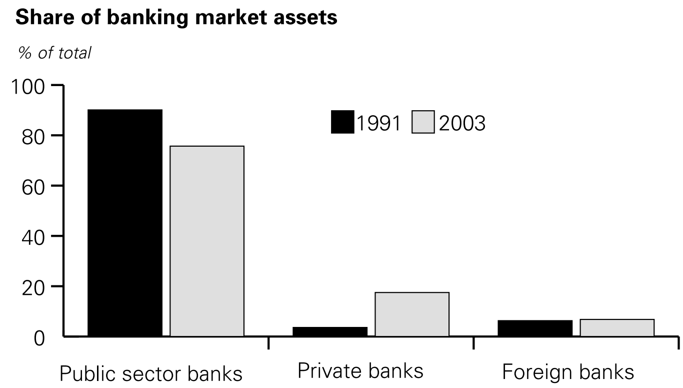
Another area which will have a major impact on India's ability to increase its savings rates, as well as influence the efficiency with which those savings are allocated and used, is the financial sector.

According to the RBI, financial sector reform to date has improved the financial health of the commercial banking sector, delivering gains in terms of asset quality, capital adequacy and profitability.[206] However, India's banking sector is still characterised by high costs and relatively low productivity. Reform has also been less successful in producing improvements in efficiency for other financial intermediaries such as co-operative banks, financial companies and development finance institutions.

There are also concerns about the quality of India's banking sector assets. The RBI has noted that many banks face an overhang of non-performing assets.[207] Official figures put the share of bad loans at around 11 %–12 % of total loans, or about US$20 billion. But estimates by the rating agencies and some consulting firms suggest that the true numbers may be roughly twice as high.[208] Efforts are being made to deal with India's bad loan problem through initiatives such as the creation of debt-management companies like the Asset Reconstruction Company (India), which is owned by a group of India's largest banks and aims either to rehabilitate or sell off assets pledged as security for loans and then distribute the proceeds to investors.[209] Progress in balance sheet reconstruction has been relatively slow, although some argue that India's banking sector problems are not as severe as those witnessed in East Asia because India's 1990s lending boom created 'real' rather than paper assets.[210] There is some evidence for example that on average Indian problem assets may be worth more than those seen in auctions elsewhere in Asia due to the better quality of collateral.

The authorities have also tried to introduce tougher foreclosure laws and improve incentives to increase provisioning for bad loans. In April 2004 the Supreme Court concluded an 18-month hearing by upholding legislation originally passed in 2002 that gives banks the power to seize the assets of defaulting clients. In the past, defaulting borrowers have been able to shelter behind slow-moving civil cases that could take up to 20 years to resolve.[211]

Figure 3.7



Source: Adapted from Table 3.7 in Reserve Bank of India (2004)

The financial sector also continues to see a large public sector influence (Figure 3.7). Cowen for example points out that the commercial banking sector is still dominated by public sector banks, which in 2003 accounted for 76 % of total assets, 74 % of total loans and almost 80 % of all deposits.[212] Public sector banks tend to play a relatively large role in financing the rest of the public sector; government debt (which requires zero risk provisioning) accounts for about 45 % of total bank portfolios in India.[213] Cowen argues that partly as a result, India has failed to get the full benefit of financial sector reform, since private savings are being 'pre-empted' by the public sector to fund the large fiscal deficits described above. As a consequence, while reforms have produced an increase in the *level* of financial intermediation in India, the *efficiency* of that intermediation remains constrained.[214] The Asian Development Bank (ADB) has also warned recently that India could yet face a banking crisis if pre-emptive financial reforms fail to crisis-proof the sector.[215]

Agriculture sector shortcomings

India boasts the world's second largest supply of arable land (after the US) and its largest area of irrigated land.[216] While agriculture's share in total GDP has fallen from more than one third to less than one quarter over the past two decades to 2001, it continues to employ a majority of India's labour force (about 235 million people, or 58 % of the labour force, according to the 2001 census).[217] As such, the performance of the sector clearly has important implications for the economy as a whole. Moreover, given that a majority of India's huge electorate also have ties to the rural economy (about two-thirds of Indian voters live in villages) the relative health of agriculture and the associated rural economy also has a significant influence on the political process at both the state and federal government level, an effect that was visible in the most recent election results. In addition, almost two-thirds of India's poor live in rural areas, and a majority of the rural poor depend on agriculture for employment. Efforts to deal with poverty and related social ills are therefore also closely linked to developments in the sector.

The main focus of agricultural policy in India since independence has been to ensure that growth in the production of foodgrains has kept ahead of population growth.[218] With a huge population heavily dependent on the land, Indian policymakers' initial concern was to ensure security of food supply. Judged on this criterion, agricultural policy has been successful. Indeed, the government's policy of offering steadily increasing minimum support prices for two key foodgrain crops (wheat and rice) succeeded in increasing production to the extent that by the second half of the 1990s official agencies were accumulating burgeoning food stocks.[219] Unfortunately, the growing scale of these stocks has led to a vicious circle, with the overhang of buffer stocks depressing the market price of wheat, which in turn contributed to greater purchases under the government procurement program, and so on. The steady growth in procurement has also pushed up the scale of the subsidy involved, resulting in an increasing fiscal burden that crowds out spending in other key areas.

Despite the impact of these price distortions on the production of foodgrains, some 'worrying longer-term trends' are visible in Indian agriculture. The annual average growth rate of crop production has almost halved (from 3.2% in the 1980s to 1.7% in the 1990s) with the decline due largely to falling yields, in turn a reflection of faltering productivity.[220] The World Bank has also called attention to the fact that agricultural growth rates over the past two decades to 2001/02, have followed a declining trend, citing several recent studies showing declining productivity between the 1980s and 1990s. The Bank worries that these trends call into question the feasibility of sustaining past agricultural growth performance, let alone delivering higher future growth rates. Indeed, it warns that unless the trend to slower agricultural growth is reversed, there will be 'dire consequences' for rural areas and the rural poor in the longer term.[221]

A key problem has been falling public sector investment in areas critical to agricultural growth, including irrigation and drainage, and soil conservation.[222] Public investment in agriculture declined by one-fifth in real terms between 1994/95 and 2001/02, while the share of public expenditure on irrigation and flood control as a proportion of total spending has fallen from 10% during the Sixth FYP to around

6.5 % during the Ninth FYP.[223] Gulati and Bathla have estimated that every 10 % fall in public investment contributes to a 2.4 % drop in agricultural growth.[224] This decline in investment is due in large part to fiscal weakness at the state level, which in turn is partly a product of existing subsidy schemes and poor cost recovery mechanisms.

A related problem is the poor state of rural road networks, where the World Bank reckons about 40 % of rural villages are not connected by all-weather roads to market centres or main road networks. As a result, during monsoon season an estimated 20–30 % of agricultural, horticultural and forest produce is wasted due to an inability to reach markets or processing centres.

In the past, the development of a truly national market for rural produce has also been hampered by the presence of heavy regulation of domestic trading activities for many commodities, including licensing requirements and restrictions on movement and storage. Most of these controls were only lifted in 2002.

Agricultural productivity has also been depressed by the continuing fragmentation of land holdings in the more populous states.[225]

Finally, another major problem facing the sector is increasing natural resource degradation. The government estimated in 1999 that nearly half of India's soil could be categorised as degraded, while other studies suggest well over 50 % of soil has been damaged by factors such as waterlogging and excessive salinity.[226] The Indian government has also warned that water will increasingly become a scarce resource.[227]

Regional inequality and the role of India's states

Sustaining faster growth at the aggregate level will also require an improvement in the economic performance of some of India's state-level polities.

A key facet of India's development experience is the country's federal system, which divides the country into 28 states and seven union territories (Table 3.4). Some of these states have populations and gross state products that are equivalent to countries in size. They have also performed differently under the reform process. Several recent studies have warned that regional disparities are a growing concern, pointing out that while India's overall GDP growth may have been boosted by the reform process, this has also been associated with growing inequalities between states.[228]

Ahluwalia looks at the performance of 14 major states (accounting for more than 90 % of India's total population) in the post-reform period, and compares this with their experience over the previous decade.[229] There is significant variation in the growth performance of states across both periods, but the dispersion of growth rates increases markedly in the post-reform period. This appears to reflect differences at both ends of the spectrum, with an acceleration of growth in the best-performing states (Gujarat, Maharashtra, West Bengal and Tamil Nadu) and a slowdown in laggards such as Bihar, Uttar Pradesh and Orissa.

Bhide and Shand similarly focus on the 14 major states, which they split into high, medium and low performing categories. They find that Karnataka, Maharashtra, Tamil Nadu and Gujarat demonstrated the most growth improvement in the 1990s over the 1980s, while Orissa, Punjab, Uttar Pradesh and Bihar delivered the weakest growth performance.

The message of growing disparities in the growth performance of Indian states has also been highlighted by the World Bank, which finds that India's good aggregate growth performance has masked increasing divergence in per capita incomes and poverty levels between richer and poorer states. After reviewing several studies, the Bank concludes that there is little evidence of any convergence in per capita incomes across states. Rather, richer states appear to be growing faster than poorer ones, and as result, more than 50 % of India's poor are now concentrated in just four states (Bihar, Madhya Pradesh, Orissa, and Uttar Pradesh).[230]

Why the divergence in performance? Bhide and Shand point to geographical factors (noting that their best performing economies are all maritime states, while their poorest performing states are all northern hinterland states) as well as differences in the adequacy of infrastructure and state government debt and deficit levels.[231] Bhattacharya and Sakthivel note that FDI has become increasingly concentrated in four or five of India's more successful states, while Ahluwalia cites work by the World Bank and the CII which finds that

India's investment climate differs widely across states, and that as a result (especially foreign) investment tends to be concentrated in the more investment-friendly states, which are seen as having up to a 30 % cost advantage due to the greater availability of infrastructure and a higher quality of governance.[232]

Table 3.4 India's states and union territories, 2000/01

	Gross State Domestic Product as % of total	Net State Domestic Product per capita as % of all India Net National Product per capita
States		
Andhra Pradesh	7.8	99.1
Arunachal Pradesh	0.1	93.6
Assam	1.8	62.7
Bihar	2.7	30.6
Jharkhand	1.9	54.0
Goa	0.4	290.8
Gujarat	6.7	113.3
Haryana	3.1	138.0
Himachal Pr.	0.8	117.1
Jammu & Kashmir	0.9	76.5
Karnataka	6.0	106.8
Kerala	3.9	116.5
Madhya Pradesh.	4.9	63.8
Chattisgarh	1.6	63.3
Maharashtra	15.2	132.8
Manipur	0.2	76.8
Meghalaya	0.2	87.7
Mizoram	0.1	110.7

Nagaland	0.2	–
Orissa	2.4	55.5
Punjab	3.8	144.3
Rajasthan	4.9	75.2
Sikkim	0.1	93.1
Tamil Nadu	7.9	121.9
Tripura	0.3	91.3
Uttar Pradesh	10.4	55.2
Uttaranchal	–	–
West Bengal	7.9	96.5
Selected union territories		
Andaman & Nicobar islands	0.1	147.0
Chandigarh	0.2	278.3
Delhi	3.3	232.6

Source: Adapted from Central Statistical Office, February 2004

These trends have important implications for India's growth prospects. The World Bank has estimated that if current trends continue, with poorer states growing no faster than 5% pa, then richer states would have to grow at nearly 10% pa on average over the Tenth FYP period just to produce an all-India average growth of 6.5%.[233] On the other hand, one estimate suggests that if best practice in terms of the country's investment climate *was* to be applied across all of India's states, this would boost aggregate GDP growth by about two percentage points.[234]

There is also some risk that growing regional disparities will have political ramifications with adverse consequences for the overall pace of reform. For example the four states which contain the majority of India's poor — Bihar, Madhya Pradesh, Orissa, and Uttar Pradesh — between them account for 170 seats in India's parliament. Congress's largest formal partner in the new UPA government is the Rashtriya Janata Dal, a lower-caste party which governs Bihar and reportedly has little time for economic reform. India's ability to allow some regions to grow much faster than others — the kind of strategy that has been pursued by China — is therefore much more constrained by the political framework.

Finally, as well as concerns about inequalities between states, India's politicians also need to be aware of inequality within states. Thus it is notable that in recent state assembly elections two leading reformists, Chandrababu Naidu and S M Krishna were both defeated. This was despite their success in developing their state capitals as IT hubs. In both cases large rural constituencies apparently felt that they had missed out on the benefits enjoyed by urban voters.[235]

Outlook for sustaining faster growth

Can India sustain a stronger growth performance over the coming years?

The cyclical boost to the economy from a good monsoon means that the near-term outlook is reasonably positive, with growth in 2004 likely to be around the 7% mark, or above. The IMF for example projects Indian GDP growth in 2004 at a fairly healthy 6.8%, although this is forecast to be followed by a dip to 6% in 2005.[236] The ADB is more optimistic, reckoning that growth in 2004 will be around 7.4%, little changed on 2003, and it expects a further acceleration to 7.6% in 2005. The ADB also judges that India's *medium*-term growth outlook is "buoyant" with the economy "on the upswing of a business cycle, which is in turn riding on an accelerating long-term growth path".[237]

But what about India's growth performance beyond the current cycle? There is currently a sense of hope that "India has a chance for a tremendous breakthrough in economic development during the current decade".[238] Optimists point to the growing political consensus about the benefits of reform, the economic dynamism created by a decade of a more open economy, and the benefits of new technology, especially in the IT sector.

This chapter has argued that in practice India's growth prospects will depend in large part on whether the economy can overcome the constraints to growth described above. Not surprisingly, this is also the broad consensus among many India-watchers. They argue that in the absence of further reform the economy is unlikely to be able to sustain growth rates above the 6% achieved over the past decade (1994/95–2004/05). Srinivasan for example worries that without further progress on reform "the economy might be converging to [a] revised 'Hindu rate of growth' of 5%–5.5%".[239] But he also judges that the Tenth Plan's target of average annual growth of 8% per year would be "eminently feasible", provided that the investment climate improved. Similarly, in its latest review of the Indian economy, the World Bank has cautioned that "current policies in India are likely to translate into a continued growth slowdown" with annual GDP growth likely to average only around 5% over the course of the Tenth FYP, while also noting that the "implementation of a comprehensive reform program … would allow India to achieve a growth rate of 8% per annum".[240]

Bhattacharya and Kar provide some quantitative support for this argument. They conduct an economic modelling exercise that generates a range of outcomes including a 'business as usual' forecast, with a growth rate of 6.1% and an optimistic scenario where higher investment rates and/or increased productivity of capital gives growth estimates ranging between 6.8% and 8.1%.[241]

The same sort of message comes from a 2001 study of the Indian economy conducted by the McKinsey Global Institute.[242] This highlighted three main barriers to India's growth: excessive product market regulation (such as the SSI reservation policy), distortions in the market for land, and widespread public sector ownership of business (government controlled entities were estimated to control around 43% of India's capital stock). It calculated that these three barriers constrained GDP growth by more than 4% per year. As a result, McKinsey estimated that removing these barriers would allow India's economy to grow at an annual rate of 10%.

We would agree with the broad thrust of these assessments, with a bias towards the more cautiously optimistic end of the range of growth predictions. Thus the empirical evidence does seem to suggest that the reform process and the associated re-integration of India into the global economy has lifted the economy's potential growth rate, paving the way for a sustained period of faster growth over the past decade (1994–2004). However, whether future growth averages come closer to the 6% rate that has roughly been the recent trend, or closer to the new government's targeted 7-8% (or even above) will depend critically on whether the authorities can overcome the remaining obstacles to growth, including the need to achieve the necessary political consensus. Recent progress with some areas of infrastructure reform, such as the National Highways project, suggests that there is some hope for this, although the political compromises that will be needed to support the new coalition government argue for a cautious assessment.

As noted in Chapter 1, India's 2004 elections delivered a minority government, reliant on the support of a coalition of leftist parties. Concerns about this political shift should not be overdone; recent history indicates that reform can persist through minority governments, and the experience of India's communist state-level government in West Bengal suggests the presence of a degree of pragmatism on the left of the political spectrum. Moreover, both Prime Minister Manmohan Singh and Finance Minister P Chidambaram have extremely impressive reform credentials. After all, the new prime minister is the man widely credited with launching India's drive to liberalisation in the early 1990s. The new government's declared focus on spreading the benefits of reform to rural India through measures such as increased investment in infrastructure and the creation of a national market for agricultural produce are also welcome, and would certainly be good news for India's longer–term growth prospects, provided that they can be delivered without further worsening India's precarious fiscal position.

But if reform overall looks unlikely to go backwards, the prospects for any further acceleration may be problematic. The UPA government's need to win the support of the leftist parties in parliament is evident in the compromises visible in its recently announced "common minimum programme" (a kind of mission statement for the new administration). On the one hand, this targets an annual GDP growth rate of 7–8%, which is to be achieved through fiscal consolidation (a balanced budget by 2009), the introduction of a value added tax, and efforts to triple the annual level of FDI. On the other hand, the programme also says that the new government will not seek to privatise profitable state enterprises and will abolish the Ministry for Disinvestment, will back away from reforms to India's restrictive labour laws, and will review the *Electricity Act 2003* (legislation intended to encourage reform in the power sector).[243] Ultimately, much will depend upon whether the political balance of power allows the new prime minister scope to pursue his reformist instincts.

Still, there are several other — more speculative — reasons to be hopeful about India's growth outlook. First, there is the possibility that the Indian economy is currently passing through a point of inflection, with the cumulative effect of past reforms having passed a threshold which will allow the possibility of a virtuous growth cycle developing. For example, faster economic growth would boost government revenues and help close the fiscal gap, which in turn would free up more resources for growth-enhancing infrastructure investment. Second, India could prove to be a major beneficiary of a 'new economy' style growth dividend. This kind of effect is already visible in the story of India's exports of services, where modern telecommunications equipment is providing a way of leapfrogging over some of the constraints provided by India's 'old economy' infrastructure. Finally, the pressing desire to remain strategically competitive with China is likely to be an important constraint on Indian politicians' willingness to revert to the failed economic models of the past.

Overall the good news for India is that while much remains to be done, this also implies that the potential for significantly faster growth is substantial. India's economic prospects have already improved significantly. Under a reinvigorated reform process, they would be even brighter.

Box 4: India's recent growth experience

As noted in the opening chapter, the years between independence and the first attempts at reform in the 1980s saw economic growth average close to 3.5%. Growth then accelerated during the 1980s, although this increase ultimately proved to be unsustainable, culminating in the 1991 economic crisis. Growth rates during the 1980s were also quite variable, which has been taken as another indicator of the relative fragility of growth during this period. After the crisis, growth rates in the 1990s demonstrated both a lower degree of variability, and a small increase in the average growth rate (Table 3.5).[244]

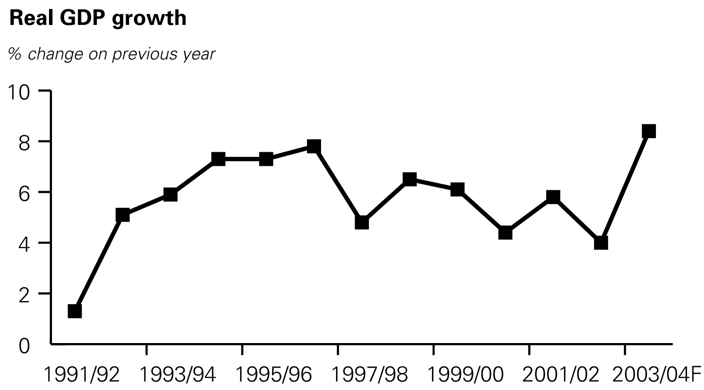
Table 3.5 Average annual growth rates at constant 1993/94 prices (%)

	GDP	GDP per capita
1951–61	3.9	2.0
1961–71	3.8	1.5
1971–81	3.2	0.9
1981–91	5.6	3.5
1991–01	5.7	3.7
Memo:		
1951–74	3.6	1.5
1977–91	5.1	2.9
1992–02	6.1	4.1

Source: Adapted from Table 1 in Panagariya (2003)

India's growth performance relative to the rest of world has also improved over time. In the 1960s India grew at below the average global rate of growth; in the 1970s India's growth rate was roughly in line, and in the 1980s and 1990s India grew at above the average growth of rate of the global economy, although at a pace still below that of East Asia. Finally, by the late 1990s, Indian growth was higher than most other East Asian economies as well, although still lagging behind China.[245]

Figure 3.8



Source: Adapted from Central Statistical Organisation; forecast for 2003/04

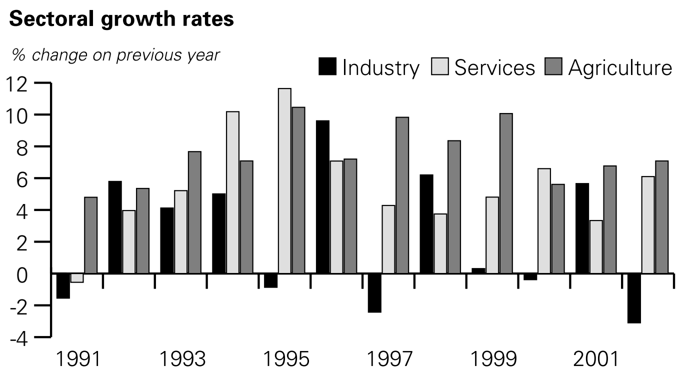
The sustainability of the 1990s growth performance has also been called into question, however. Thus while economic growth appeared relatively strong in the early to mid-1990s, there were clear signs of a slowdown during the latter part of the decade. Moreover, India's growth performance since the start of the current century has been similarly mixed. Real GDP growth has swung from 4.4 % in 2000/01 to 5.8 % in 2001/02 to a disappointing 4 % in 2002/03, before rebounding in 2003/04 (which is expected to see growth exceed 8 % after the strong December 2004 quarter).

Box 5: Why did growth disappoint in the late 1990s?

The slowdown in economic growth that followed the initial reform-induced boost in the mid-1990s was the product of several factors.

First, fluctuations in India's growth rate have continued to reflect the economy's vulnerability to variations in the monsoon. Although the agricultural sector has shrunk to less than one-quarter of total output, it also has large spill-over effects on private consumption due to India's large rural population, making GDP growth a hostage to the climate.[246] Growth in 2002/03 for example was hit by seasonal rainfall falling short of normal volumes by 19 %. This represented the poorest monsoon conditions since 1987/88, with 17 of India's states experiencing moderate to severe drought conditions.[247]

Figure 3.9



Source: Adapted from World Bank (2003)

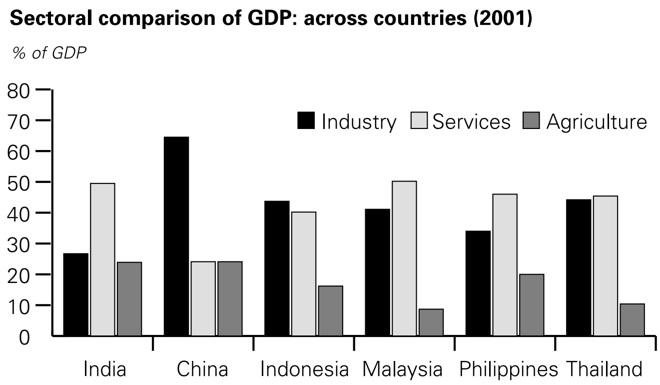
Second, as India's degree of international economic integration has increased, the economy's growth performance has also been increasingly influenced by developments in the global economy, including the adverse impact of the Asian financial crisis on international trade and the imposition of sanctions following the nuclear tests in May 1998.

Third, the slowdown in growth performance in the late 1990s has also been cited as evidence that there were significant problems with the reform process. For example, Acharya argues that while the first half of the 1990s saw strong growth on the back of productivity gains due to deregulation, 1997 marked "the end of the economic party" thanks to a combination of domestic political instability, the start of the Asian financial crisis, and "the petering out of productivity gains from economic reforms, which clearly slowed after 1995".[248] Similarly, Ahluwalia notes that reforms were "not so much gradualist as fitful and opportunistic" and still require the implementation of fiscal consolidation to cement any positive effect on growth.[249] A pessimistic view on the limitations of reform process has been advanced by Aiyar, who suggests that "half-baked reform" mean that "there is no chance at all that India will soon become the next Asian tiger".[250]

Some evidence for the presence of structural limits on growth is provided by Ranil Salgado, who produces estimates of India's potential output over this period.[251] Salgado finds that India's trend growth rate peaked in the mid-1990s at 6.1 %, and then fell to below 6 % — and perhaps to as low as 5 % — in 2001/02. Salgado suggests that this decline in trend growth was due to factors including high real interest rates (due to large fiscal deficits), severe infrastructure bottlenecks, and continuing distortions in industry and agriculture.

Finally, on a sectoral basis the slowdown was particularly significant in the industrial sector of the economy (in contrast, trend growth in the services sector was sustained). The RBI for example has noted that while the industrial sector initially responded to the reforms with high growth rates and an investment boom, the upturn was not sustained, and that in an international context, India's subsequent industrial performance has been lacklustre.[252] The central bank attributes this in part to the changing health of the international economy, but also concedes that slowing reform momentum and structural limitations were also to blame, citing poor infrastructure, high borrowing costs, labour market rigidities and the slow pace of industrial restructuring.

Figure 3.10



Source: Adapted from Table 4.14 in Reserve Bank of India (2004)

In this context, several observers of the Indian economy have worried that the share of manufacturing and industry in GDP has been relatively stagnant, even though there has been structural change within the manufacturing sector, with 'modern' industries (electrical goods) expanding at the expense of 'traditional' ones (textiles). India's experience is this regard differs from most other emerging economies, where manufacturing has typically been the leading sector for economic growth (Figure 3.10).

The sectoral composition of Indian growth has also raised concerns about the economy's ability to create sufficient jobs to employ the growing labour force. Economic growth has had a relatively low employment elasticity in recent years, with the elasticity of employment to GDP following a declining trend since the 1970s.[253] Agriculture in particular has had a zero elasticity of employment between 1993/94 and 1999/00, while manufacturing's recent employment-generating capacity has been constrained by its relatively weak growth performance as well as India's labour laws, leaving the services sector as the main source of new jobs.

Chapter 4
Consequences for the international economy

"India's economy could be larger than all but the US and China in 30 years."

— Wilson et al., *Dreaming with BRICs: the path to 2050*[254]

"After years of wondering what all those fiber-optic cables laid around the earth at massive expense in the late 1990s would ever be good for, we finally have an answer: They're good for enabling call-center workers in Bangalore or Delhi to sound as if they're next door to everyone. Broadband's killer app, it turns out, is India."

— Justin Fox, *Fortune*, 2003[255]

India's growing international presence

We noted in the preface that for much of its post-colonial history, India was an economy that seemed destined never to live up to its full potential. That no longer appears to be the case. The previous chapters have described how the reform process that began in the 1990s has started to liberalise the domestic economy, increase the degree of economic integration with the rest of the world, and shift India onto a higher growth path. Granted, there remain significant obstacles to India being able to attain and then sustain the kind of high growth rates that have been achieved by China over the past two decades (1984–2004). But the *possibility* of such an outcome certainly exists, and even if India's actual progress remains more gradual than that demonstrated by Asia's other economic giant, it will nevertheless be substantial and increasingly apparent over time. It follows that India will almost inevitably play a progressively greater role in the world economy, with the outstanding questions relating not to *whether* this will happen, but rather how quickly.[256] This chapter examines some of the possible consequences of this development for the international economy.

India and global reorientation

The growing economic importance of India is occurring at a time when the global economy already has to accommodate the emergence of China as a great trading power. One consequence of this is that the rise of India is adding further momentum to a shifting distribution of economic weight in the global economy, with the centre of economic power gradually tilting back towards Asia.

According to calculations by the economic historian Angus Maddison, in the early 19th century, China and India between them accounted for almost half of world output. Yet by the time the first age of global capitalism was ended by the outbreak of World War I, the two countries' share of global GDP had fallen to less than one-fifth, and by the early 1970s they accounted for less than one-tenth of global output.[257]

The onset of economic reform in China in the late 1970s and in India in the 1990s has now shifted this trend decline into reverse. The IMF estimates suggest that the share of the two economies in world output in 2004 is likely to have risen to about 19 % using PPP exchange rates, with India on its own accounting for a little less than 6 % of world GDP (Table 4.1).[258]

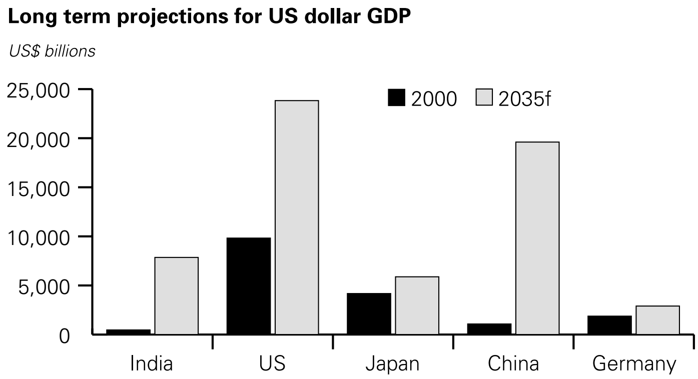
Table 4.1 The world's top 10 economies (measured at PPP exchange rates)

	2004e			1980	
Rank	Country	%	Rank	Country	%
1	US	21.0	1	US	21.6
2	China	13.0	2	Japan	8.0
3	Japan	6.8	3	Germany	6.0
4	India	5.8	4	Russia	4.7
5	Germany	4.4	5	Italy	4.2
6	France	3.1	6	France	4.1
7	UK	3.1	7	UK	3.7
8	Italy	3.0	8	Brazil	3.5
9	Brazil	2.7	9	India	3.3
10	Russia	2.6	10	China	3.2

Source: Adapted from International Monetary Fund (2004)

On current trends, the relative importance of both India and China is set to increase further over the next couple of decades. For example, analysts at Morgan Stanley have estimated that India will become a trillion (US) dollar economy by the end of the current decade.[259] More strikingly, in a report released in 2003, economists from Goldman Sachs predicted that the Indian economy would be larger than Japan's in US dollar terms in 30 years' time, making it the third largest economy in the world, after the US and China (Figure 4.1).[260]

Figure 4.1



Source: Adapted from Wilson and Purushothaman (2003)

Prospects for a greater role in international merchandise trade

Despite India's growing integration with the global economy, Chapter 2 noted that its current share of world goods trade remains quite modest. This is particularly the case given the size of the Indian economy, with the evidence suggesting that even after more than a decade of reform, India continues to under-trade. In 2003 for example, China's *increase* in trade with the rest of the world was roughly double India's *total* trade.[261] Still, while India's relatively small global market share is indicative of some of the structural bottlenecks and barriers to growth discussed in Chapter 3, it also suggests that there exists plenty of scope for India to significantly increase its share of global merchandise trade. For example, Wood and Calandrino use the China comparison to infer that within 20 years further reduction of trade barriers "could cause India's per capita income to double and its exports to quintuple".[262] They also point out that while a five-fold increase in India's exports would see its share of world exports double, it would still leave India with only a relatively modest share of the global market compared to China's *current* presence.

India certainly enjoys several intrinsic advantages that in theory at least could allow it to become a major manufacturing hub in the future.[263] It has a large and relatively low cost labour force that should allow the economy to be competitive in labour-intensive manufacturing along with a relatively strong natural resource base. Indian producers should also be able to benefit from what is set to become one of the world's largest *domestic* markets, with estimates of India's middle class ranging from 200 million to 300 million. Economic historians have long pointed to the importance of a mass market such as that enjoyed by the US in allowing domestic producers to reap significant benefits from economies of scale. In addition, there is also a supply of skilled labour available at internationally competitive wage rates. If India can remove or reduce some of the remaining major economic distortions (still-high rates of protection, infrastructure shortcomings, and policies such as SSI reservation) then the underlying forces of comparative advantage might be able to kick in and deliver a significantly stronger trade performance. According to the RBI, India already has a strong revealed comparative advantage (RCA) in sectors such as iron and steel, chemicals, textiles and clothing.[264] Moreover, reform and increased competition are now having a positive effect in many of these areas. For example, by 2002, modernisation and better management had reportedly made Indian steel the cheapest in the world, contributing to a boom in steel exports.[265]

Again, while the *overall* export performance of India's industrial sector to date may have been disappointing when compared to that of China and other East Asian economies, there are now some areas where India is beginning to make a greater impact. One example is the automobile sector, which has recently seen several major international car companies starting to use India as a platform for export-oriented production.[266] In 2002/03 India became a significant car exporter, selling 215,000 units overseas in the first half of the year, and with export growth running in the double digits.[267] At the time of writing, some analysts, are now forecasting that India could be the next outsourcing success story in the car components sector, although for the moment its industry is still well-behind that of the East Asian economies; India generated US$0.8 billion worth of components exports in 2002/03 compared to US$1.8 billion for Thailand and US$2 billion for China.[268]

Another emerging success story is the pharmaceutical sector, where Indian companies are increasingly seen both as potential partners for Western firms and as prospective competitors.[269] According to *The Economist*, "India's pharmaceutical industry … is a wonder of the third world, making high-quality, low-cost copies of the latest drug innovations."[270] Indian companies are reportedly gaining a growing reputation as inexpensive and reliable suppliers of bulk ingredients for drugs and finished pills, with a competitive advantage derived from labour costs that are as little as one-eighth those in the US in the same sector.[271]

Computer hardware exports also grew sharply in 2000/01 and 2001/02, albeit from a very low base.[272] In the first three quarters of 2002/03 India exported a billion dollars worth of IT hardware, and since then exports have continued to rise at a double-digit rate.[273]

While there are signs that the composition of Indian exports is starting to shift towards some higher-end manufactured products, however, for now the areas in which India has a significant global market share are still concentrated in primary commodities and manufactures based on labour and natural resources. Ten major export items accounted for about 60 % of total exports in 2003/04, with the US as a major market, and East Asian economies the main export competitors (Table 4.2).[274]

As well as making gains in new export sectors, it is also possible that India will make more of an impression in areas where it already has a presence. For example, some analysts suggest that the lapsing of the Agreement on Textiles and Clothing (ATC) at the end of 2004 could create the potential for a surge in Indian exports.[275] At present, India exports about US$15 billion of textiles a year, mainly into the US and EU. In theory, the removal of quotas should allow India to expand this trade, and this prospect is already prompting FDI into India from Singapore and Italy. At the same time, however, India will also have to cope with competition from a China that already exports US$80 billion of textiles and is a much more efficient producer. For example, the restrictions of the SSI policy mean that the largest textile units in India employ some 3,000 staff, compared to enterprises that employ 25,000 in China.[276]

Table 4.2 India's leading merchandise exports, 2002/03

Commodity	Share of exports (%)	Top 3 destinations (%)	Major competitors
Gems and jewellery	16.8	US (36.6), Hong Kong (19.2), Belgium (11.5)	Israel, Belgium, China, Italy, Thailand
Readymade garments	10.2	US (31.3), UK (8.9), Germany (7.7)	China, Korea, Taiwan, Indonesia, Thailand, Malaysia, Bangladesh
Basic chemicals, pharmaceuticals and cosmetics	8.3	US (14.1), Germany (5.6), China (4.4)	China, Brazil
Cotton yarn, fabrics, made-ups etc	6.2	US (18.4), Korea (5.4), UK (4.7)	China, US, Australia, Pakistan, Bangladesh
Petroleum products	4.6	NA	NA

Machinery and instruments	3.5	US (13.9), Germany (7.5), UAE (6.8)	Germany, Japan, Italy, China, Taiwan, Korea
Iron and steel	3.4	China (27.5), US (15.8), UAE (4.9)	Indonesia, Korea, Malaysia
Manufactures of metals	3.3	US (23.6), UAE (10.8), UK (9.9)	Russia, South Africa, Korea
Marine products	2.6	US (27.9), Japan (22.6), China (7.6)	Indonesia, Thailand, Vietnam, Bangladesh
Man-made yarns, fabrics, made-ups etc	2.5	UAE (19.7) Saudi Arabia (5.3), Turkey (5.2)	Korea, China, Mexico, Bangladesh, Pakistan

Source: Adapted from Table 4.22 in Reserve Bank of India (2004)

If India does manage to remove enough of the obstacles to exporting in order to start to approach the kind of export performance demonstrated by the East Asian economies, then that would obviously imply a growing global presence. With India's comparative advantage likely to be in labour-intensive manufactures (along with some of the higher-end sectors discussed above) a key impact of a larger Indian presence in the global market would be further downward pressure on the price of mass-produced manufactures — a sector which has already undergone strong price compression thanks to the rise of Chinese exports. In this respect, therefore, a more merchandise trade-oriented India would be expected to have similar (probably somewhat smaller, but also cumulative) effects on the global economy as the current Chinese impact.[277] This would clearly be good news for global consumers, but less welcome for competing producers in other emerging markets and some developed economies.

Importantly, as well as pumping out more exports, a larger Indian economy will also demand more imports from the rest of the world. As a result, another implication of a faster-growing and more internationally integrated Indian economy will be a shifting pattern of global demand.

One area where this is likely to be particularly apparent for example is global energy demand. According to the US Energy Information Administration, by 2025 India will be the fourth largest energy consumer in the world (it is already number six), with energy consumption between 2001 and 2025 expected to grow at an average annual rate of more than 3 % (second only to China).[278] By 2010 almost three-quarters of India's energy needs will be met by imports, making India an increasingly important player in global energy markets.[279]

Contributing to globalisation of services

Chapter 2 noted that while India's progress to date in increasing its presence in manufactured trade has been relatively modest, its progress in terms of the services sector has been much more dramatic. Indeed, one frequently heard proposition is that the service sector is tailor-made for India. Aiyar for example has argued that India's many structural problems may mean that it is fated never to be a big manufacturing power in the way that China is. But he thinks that this will be offset by the growing tradeability of services, and their rising importance in the global economy. Thus, he suggests, "India will fare much better in a 21st century dominated by services than in the 20th century which was dominated by manufacturing."[280] Similarly, Bajpai argues that the IT revolution has given India a "unique opportunity to leapfrog whole stages of industrial development. Having missed the first two industrial revolutions, [Indians] are eager not to miss the third one."[281]

Intriguingly, in many ways India's current services-based development model does appear to be something quite new. A product of the current age of globalisation, it has seen India become "the first developing nation that used its brainpower, not natural resources or the raw muscle of factory labor, as the catalyst" for economic development.[282]

We have already described how India's success in the services sector is a story of the marriage of technological progress in the telecommunications sector with India's sizeable supply of well-educated, English-speaking and relatively cheap labour. The high quality of Indian tertiary education means that India's stock of human capital already ranks as among the highest in the world and every year India adds another couple of million English-speaking graduates to the labour force.[283] But while most of the excitement to date has centred around India's role in IT-ES and BPO, the range of activities in which India can be competitive is theoretically much wider. In principle "India can export just about any service capable of being carried by fibre-optic cable, from cartoon animation to research and development."[284] Or as economic historian Brad DeLong puts it, India's "development path leads through terrain where computers and telecommunications, fiber-optic cables and microprocessor switches, satellites and packet-switched networks, all make international trade in much of white-collar services … as cheap and as possible as the iron-hulled ocean-going steamship made trade in staple agricultural and industrial commodities in the late nineteenth century".[285]

Critically, the technology side of this equation seems set to continue to boost India's international competitiveness. For example, the capacity of the fibre-optic lines connecting India with the rest of the world is estimated to have increased almost sevenfold between 2001 and 2002, and capacity into India is forecast to more than double *again* by the end of 2004. The existing growth in capacity has already seen the cost of transmitting information between the US and India fall to one-quarter of the level of 2002, and with price falls to Asia still much less than those seen in trans-Atlantic communications markets, experts reckon that there remains scope for significant further cost reductions as new lines to Asia come on stream.[286]

Dealing with the birth pains of a global labour market

The international outsourcing of low skill services jobs has been underway since the 1990s. But as the process accelerates, and as it moves up the value chain (from call centre jobs to computer programming) it is increasingly becoming a hot button political issue. This is not surprising, since it is raising the prospect of a "fundamental restructuring of rich-world economies" in the same way that the globalisation of manufacturing has already revolutionised the global distribution of production.[287]

In particular, by early 2004, growing international competition in the services sector was generating alarm in the US, which by some estimates accounts for more than 70 % of all offshoring business.[288] Magazines like *Fortune* ran articles entitled "Where your job is going: a visit to Bangalore, India" while industry specialists such as Forrester Research forecast that up to 3.3 million US white collar jobs could be lost to outsourcing between 2000 and 2015, including 473,000 IT jobs.[289] Goldman Sachs has estimated that of 200,000 US service sector jobs outsourced in three years to 2003, the majority have gone to India, while Morgan Stanley's chief economist Stephen Roach in early 2004 linked outsourcing to weak job growth in the US and other advanced economies, citing the impact of what he calls "global labor arbitrage" on demand for workers.[290] At the time of writing, stronger US employment readings seemed to have taken some of the heat out of the debate, but outsourcing remained a politically sensitive subject, especially in a US election year.[291]

In theory, the gains arising from outsourcing should be similar to the gains arising from other forms of participation in international trade, providing benefits to both the exporting *and* the importing economies. A numerical example of this argument has been provided in a study produced by the McKinsey Global Institute, which estimates that for each dollar the US spends overseas on offshoring, between US$1.45 and US$1.47 of value is created globally due to a combination of reduced costs, higher revenues, and repatriated profits. Of this total, McKinsey reckons that the importer (the US) captures US$1.12–US$1.14 while the exporter receives on average US$0.33.[292]

More generally, greater specialisation along the lines of comparative advantage should be good for productivity, and for global growth prospects. Catherine Mann at the Institute for International Economics thinks that the globalisation of services will result in a "second wave of innovation and productivity growth" that will have a positive impact on growth and productivity in much the same way as the globalisation of the production of IT hardware did in the 1990s.[293]

While the overall impact of offshoring to India (and other emerging market economies) should be positive for the world economy, however, there is clearly a significant potential for major adjustment costs and strains if the process continues to gather pace, rather than be derailed by a protectionist backlash. Indeed, since services now account for a much bigger share of modern economies than manufacturing, it seems possible that the impact of India's services revolution may be more noticeable than China's manufacturing revolution, at least as far as the advanced economies are concerned.[294] Continued technological advances and cuts in communications costs mean that over time the potential shifts in employment that will be linked to the growing tradeability of services could prove to be "very large indeed".[295] Moreover, much as is happening in the manufacturing sector with the growth of Chinese trade, the combination of the scale of the Indian labour force and the impact of modern technology mean that the adjustment process could prove to be both quicker and larger than past examples of integration into the global economy (such as Japan and South Korea).

Finally, we should stress once again that — as in the case of merchandise trade — the expansion of services trade will of course not all be one-way. To take just one example, economic liberalisation and rising domestic incomes mean that the number of Indian tourists heading abroad is expected to jump to six million in 2004, up by almost one-third over 2003. Overseas Indian tourism is forecast by the World Tourism Organization to grow at least 15% a year from 2004 to 2009. This should be a significant new market for other economies.[296]

Global capital flows and financial market fallout

Another channel through which a more internationally integrated Indian economy will have an impact on the world economy is through its impact on international capital flows. As already noted, India currently receives only a relatively modest amount of FDI and portfolio investment, especially in comparison to China. In 2004, for example, the Institute of International Finance reckons that the Asia-Pacific region will receive about US$108 billion of net private capital inflows.[297] Of this, the vast bulk will consist of FDI (US$61.5 billion) and portfolio investment (US$32.7 billion). China is expected to get about US$53 billion of the net FDI inflows (more than 85 % of total flows into the region) and some US$12 billion of the portfolio inflows (about 37 %). In contrast, while India is forecast to be the second largest recipient of FDI in the region, it is expected to receive just US$4.7 billion, along with US$7 billion of net portfolio investment.[298]

The scale of the Indian economy and its growing importance in the global economy suggests that its share of investment flows is likely to rise substantially over coming years. Even if India does not reach the scale of inflows experienced by China, it will nevertheless become an increasingly attractive destination for overseas investment. In the short-term, this may reduce the supply of capital available for other, relatively less attractive destinations. So those emerging markets that are already worried their supply of foreign capital is being squeezed by China will increasingly have to factor in another major competitor. In the longer term, however, a more successful Indian economy might be expected to become a source of investment into other economies, especially in the surrounding region.

A larger and more internationally integrated Indian economy is also likely to have a greater impact on international financial markets. For example, analysts at Standard Life have estimated that by 2050 India could have become the third largest stock market in the world, accounting for more than 10 % of global equity market capitalisation.[299] The growing importance of emerging markets such as India will have implications for the asset allocation decisions of international investors, with a gradually rising share of international funds likely to be directed towards these new investment opportunities.

Changes in the composition and direction of trade and investment flows are in turn likely to have implications for global currency movements. In the two years before the 2004 election the Indian rupee had been appreciating against the US dollar while declining in overall trade-weighted terms.[300] An India that is involved in a greater share of global trade, and which receives an increasing amount of global capital flows, will likely see a period of real — and possibly nominal — exchange rate appreciation.

Another longer run implication is that investment allocation decisions, currency forecasts and macroeconomic projections will increasingly have to take into account the likely policy decisions of official Indian financial and economic institutions. This rise to global market prominence is already well underway in the case of China, as has been seen in the international debate over China's exchange rate peg to the dollar, and in discussions over the global impact of Beijing's efforts to slow a runaway economy. For now, India is still some way off from justifying this kind of attention.[301] But that will gradually change, and in the future central bank watchers in financial markets will have to add the RBI to their brief.

A regional growth pole?

We noted in Box 2 that economic integration in the South Asian region under the auspices of SAARC has been relatively limited when compared to other regional groupings. However, if the political barriers to closer economic linkages can be overcome, a sustained period of strong growth in India should be good news for neighbouring economies. The steadily rising importance of China as an engine of regional growth in East Asia (and before that the similar role played by Japan) demonstrates the economic dynamism and positive spillovers that can be generated by the economic take-off of a regional giant. At present, India is some distance from providing that kind of lift to its region, not least because of still-problematic political regional relationships. While future prospects will remain hostage to politics, however, they could prove to be much brighter. Indeed, former Prime Minister Atal Behari Vajpayee has talked (admittedly extremely optimistically) about SAARC overseeing an opening up of regional borders, a move to closer economic union, and even the prospect of common currency.[302]

Looking East … to an Asian Economic Community?

Indian policymakers are also looking further afield for market integration. In particular, during the early 1990s Indian policymakers launched a 'Look East' initiative, with a focus on improving economic relations with ASEAN. India became a so-called sectoral dialogue partner of ASEAN in 1992, and a full dialogue partner in 1995. Initially, India's low international economic profile meant that reciprocal interest from ASEAN was limited. That has changed, with the rise of first China and now India leaving South East Asia contemplating a future squeezed between two economic giants.

From an Indian perspective, closer linkages to the ASEAN region are attractive, particularly given the hitherto relatively lacklustre economic performance of its own neighbourhood. From ASEAN's point of view, good relations with both China and India will be crucial to the region's future, while courting both major economies also creates scope for some diplomatic and economic balancing behaviour. An inaugural India–ASEAN summit took place in Cambodia in November 2002, and on 8 October 2003 India signed a framework agreement on comprehensive economic co-operation with ASEAN.[303] This calls for the formation of a free trade area by 2011, and at the preceding second India-ASEAN summit India floated the idea of a broad Asian Economic Community (AEC), which would include ASEAN, China, Korea, Japan and India.[304]

In another facet of the 'Look East' policy, India is also pursuing bilateral trade agreements with several ASEAN economies. Negotiations on an India–Singapore Comprehensive Economic Cooperation Agreement (CECA) were launched on 27 May 2003 in New Delhi, and a ninth round of CECA negotiations were scheduled for May 2004. India has also signed a framework agreement for a bilateral free trade agreement (FTA) with Thailand (on 9 October 2003) which calls for an FTA in services and investment between the two economies in 2006 and in goods in 2010.

Good news for global poverty

According to the World Bank, India is currently home to about one-third of the world's poorest people.[305] So prospects for a stronger and healthier Indian economy should be good news for the future of global poverty. Indeed, there is already evidence that the progress achieved to date has delivered significant improvements in at least some key social indicators, with declines in the incidence of poverty and the infant mortality rate, and increases in life expectancy and literacy (Table 4.3).

Table 4.3 Progress on selected social indicators

	1980s	1990s	2000
Poverty			
Poverty incidence (%)	44.5	36.0	26.1
Education			
Overall literacy rate (%)	44	52	65
Health			
Life expectancy at birth (years)	56	60	61
Infant mortality rate (per 1000 live births)	115	79	68
Prevalence of HIV (million people)	n/a	3.5	4.0

Source: Adapted from Table 1 in World Bank (2003)

However, some of India's progress on social indicators is being partially undermined by the country's worsening AIDS problem. In July 2003 the Indian government estimated that the number of AIDS cases had risen 15 % in 2002, bringing the total number of those infected to 4.6 million, or about 0.5 % of the population. In absolute terms India currently has the second highest number of AIDS cases in the world (after South Africa), and some experts reckon that the official figures significantly underestimate the problem. Indeed, some analysts reportedly fear that India's AIDS epidemic is following the same kind of pattern as that displayed by sub-Saharan Africa in the 1980s, and could prove to be as devastating, with forecasts of up to 25 million Indians infected with the HIV virus by 2010.[306]

Rethinking the architecture of international economic diplomacy

A stronger and more prominent Indian economy will also have implications for the architecture of international economic diplomacy.

An early example of this trend was seen in the current Doha Round of multilateral trade negotiations, and the collapse of the ministerial meeting in Cancún in September 2003. One notable feature of the breakdown in negotiations in Mexico was the important role played in proceedings by a group of developing countries led by China, India, Brazil and South Africa. In a forum that has traditionally been dominated by the developed economies, this new grouping demonstrated that it had an effective veto power over the world trade talks. Arguably, much of the group's clout derived from the presence of China, as the world's newest emerging trading power. But if India does continue to grow its presence in the global marketplace as suggested above, then its weight in future multilateral trade negotiations would also rise.

In fact, India was one of the 23 founding Contracting Parties to the General Agreement on Tariffs and Trade (GATT) concluded in 1947, and India has already often taken a leading role in multilateral trade negotiations in terms of representing less developed countries under the GATT and its successor, the WTO (resting in part on its status as the largest developing country until China joined the WTO).[307] Historically, however, India's stance in the GATT/WTO has tended to be a broadly defensive one with its negotiators focused more on seeking freedom to impose its own defensive measures than on pushing for a more liberal trading system. This has largely continued to be the case even after the shift to unilateral trade liberalisation that took place in the post-reform period.[308]

An Indian economy that is more integrated with the rest of the world could however perhaps begin to play a different role in the WTO. India already has a strong interest in the continued liberalisation of trade in services — particularly in terms of pushing for a liberal agreement on the "movement of natural persons" under the auspices of the General Agreement on Trade in Services (GATS).[309] India also has an interest in pressing for better access to developed country markets in textiles and agriculture.[310] With the world trading system currently in fairly poor health, an India that felt more comfortable about global integration, and which was willing to push for greater multilateral trade liberalisation, could have an important impact. This would especially be the case given India's status as one of world's leading developing countries and its largest democracy — two factors that may give India's voice added (moral) weight.[311]

Several commentators have also noted that the rise of emerging economic powers like China and India is calling into question the relevance of the G-7 grouping as the main informal grouping for managing global economic policy matters.[312] Bergsten for example has argued that the G-7's recent efforts to manage economic adjustment to global economic imbalances have achieved little success because the grouping excludes countries like China, India and Korea whose participation in any adjustment process would be essential. Instead, he argues that the G-20 should "gradually but steadily succeed the G-7 as the informal steering committee for the world economy", given that the declining relative importance of members of the G-7 is being matched by the growing importance of some key members of the G-20.[313] Similarly, Bradford and Linn have argued that ongoing demographic and economic shifts (such as the process of global reorientation discussed above) are working to increase the relative importance of the G-20 as a forum for global economic governance.

We should therefore expect the growing economic weight of China and India to lead to pressure for adjustments in the way the current architecture of international economic diplomacy operates. This will have implications not just for the G-7 and perhaps the G-20, but also for international financial institutions like the IMF and World Bank.

It is also worth noting that India has been embracing globalisation at a time when many commentators have argued that globalisation is in retreat. The world's largest democracy — and soon to be the world's most populous economy — could be a powerful advocate of the benefit of a more open global economy. Perhaps even more importantly, an increasingly successful India would represent a compelling demonstration of the benefits of international economic integration. The importance of India in this regard can be seen in the reaction to the 2004 election results, with the anti-globalisation side of the debate keen to see in them a rejection of the liberal reform agenda.

Becoming a great power?

Finally, an India that demonstrates a growing economic strength, and which plays an increasingly important role in the international economy, is likely also to play a more important role in the world overall. In particular, one might expect there to be a reasonably close relationship between India's growing economic strength and its prospective status as a 'great power'.[314] For example, in his review of India as an emerging power, Cohen acknowledges that India's current demographic and economic size already place it fairly high in terms of international power rankings but goes on to point out that a "growing economy … will add teeth to a foreign policy that has been long on rhetoric but short on resources".[315] Moreover, the changing forces of economic geography mean that India once again has a "central geostrategic position" located between the major energy producers of the Middle East and the dynamic economies of East Asia.[316] Indeed, several analysts believe that India, along with China, will be a central shaper of any future balance of power in Asia.[317]

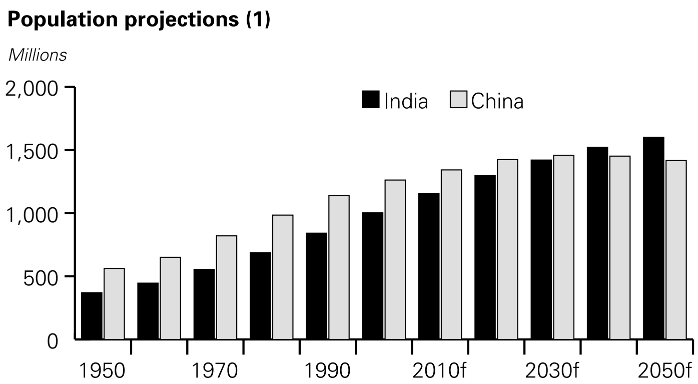
Box 6: Demography as destiny?

"During the present decade, on one estimate India's labour force will expand by 50% more than all of East Asia's (including China's) put together."

— Long, Survey: India[318]

On current trends, India is set to overtake China and become the world's most populous country sometime before 2040, which also means that India is "destined to have the world's largest population of workers and consumers".[319] According to US Bureau of Census projections, India's total population is set to rise from 1.05 billion in 2003 to 1.6 billion in 2050. Over the same period, China's population is projected to rise from 1.3 billion to 1.4 billion. Projections by the United National Population Division tell a similar story, with India's population forecast to reach 1.5 billion by 2050 and China's forecast to reach 1.4 billion.

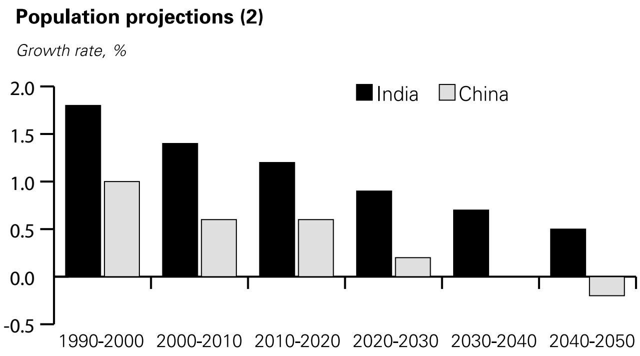
Figure 4.2



Source: Adapted from US Census Bureau at http://www.census.gov/cgi-bin/ipc/idbsum.html (2004)

In terms of growth rates, the Census Bureau expects the rate of increase to slow in both countries, with the average annual growth rate of population in India falling from almost 2 % in the decade of the 1990s to about 0.5 % in the period 2040–2050. China's population is projected to start *shrinking* by the 2040–2050 decade.

Figure 4.3



Source: Adapted from US Census Bureau at http://www.census.gov/cgi-bin/ipc/idbsum (2004)

These different demographic trends are also reflected in shifting age profiles, with China's population ageing more quickly than India's. The Bureau estimates that back in 2000 7 % of India's population was aged 60 or over, compared to 10 % of China's. By 2025 that proportion is forecast to have risen to 12 % in India and 20 % in China. Meanwhile, almost 70 % of India's current billion plus population is under the age of 35 and more than half of all Indians are under 25. This gives India the same kind of demographic bulge of people in the most productive age group that in the past is thought to have contributed to rapid growth in the economies of East Asia (along with a concomitant fall in the dependency ratio). It should also have positive implications for raising India's savings rate. But it also means that India's economy will have to generate enough growth to create an extremely large number of new jobs over the coming decades, or face the prospect of major social strains.

Conclusion

Implications for Australia

"India has in the past been neglected by Australia."

— Defence and Trade Joint Standing Committee
on Foreign Affairs, 1998[320]

India rising

To sum up the argument set out in the previous chapters, the reform process that began in the 1990s is now having a major impact on the Indian economy. International economic integration has increased and prospects for growth have improved. True, there are some important risks to this positive outlook. For example, there remain several significant obstacles to a further acceleration in economic growth, in part because of the as yet incomplete nature of the reform process. India's weak fiscal position continues to give cause for concern. Any renewed deterioration in New Delhi's relations with neighbouring Pakistan would be bad news for India's country risk premium and would almost certainly dent future growth prospects. And the commitment to reform of India's new minority government is yet to be tested. Still, taken overall, India looks set to play a significantly greater role in the global economy over coming years. This will have economic consequences for Australia as India becomes a more important trading partner. There are also likely to be implications for Australia's international economic diplomacy.

Path to a closer bilateral relationship

Reportedly, it has been a rule of thumb among Australian diplomats that every Australian government will 'discover' India at least once in its term of office.[321] A 1994 report noted for example that Australia participated in "waves of 'rediscovery'" of India in the early 1970s and in the mid-1980s as Canberra attempted to move the relationship onto a more solid foundation.[322] But each time, little sustainable progress was made. Thus a 1990 Senate Committee Report on Australia–India relations concluded that even after these previous efforts, bilateral relations remained relatively underdeveloped and there were few signs in the short-term of a significant expansion of bilateral trade.[323]

The relatively limited nature of the relationship before 1990 was partly a function of the Cold War. India's policy of non-alignment and Australia's membership of the US-led Western alliance meant that relations tended to be friendly, but not close.[324] It also reflected India's inward-looking development strategy as described in Chapter 1, which limited the possibilities for any deepening of the commercial relationship.[325] In addition, reasons of geography and economic significance meant that for Australian foreign policymakers South Asia has — not surprisingly — tended to rank behind North East Asia, South East Asia and the South Pacific in relative importance, leaving the region as something of a "poor cousin".[326]

Now, however, the end of the Cold War, India's shift to a more outward-oriented growth model, and the growing economic and strategic importance of India in the world, have all increased the scope for engagement, while also boosting India's relative importance to Australia.

Recognising the change in circumstances, Canberra has made some effort to adjust to this new environment. For example, following one of the recommendations of the 1990 Senate report mentioned above, the Australian government established the Australia–India Council in 1992 as a statutory body aimed at strengthening relations between the two countries. This was followed in 1994 by a visit to Australia by the Indian Vice President, and in the same year the Department of Foreign Affairs and Trade (DFAT) launched a report on trade and investment opportunities for Australia in India. The *Australia–India New Horizons* promotion held in six major Indian cities in late 1996 was a subsequent effort to promote Australian culture, technology and business.[327] The growing importance of India was also recognised in the 1997 foreign and trade policy White Paper, which noted India's growing strategic and economic importance in global and regional affairs, and which stressed that there was "considerable scope" to broaden the relationship bewteen the two countries.[328]

The move towards closer bilateral relations was temporarily derailed in 1998, when international sanctions were imposed following India's decision to conduct a series of nuclear tests at Pokhran. But relations began to improve again with the visit of Australia's Deputy Prime Minister and Minister for Trade to India in February 1999, and full normalisation was signalled by the visit of the Australian Prime Minister in July 2000. In June the following year a visit by the Indian Minister for External Affairs and Defence produced an agreement that both countries would initiate a strategic dialogue at a senior official level, and the first official India–Australia Strategic Dialogue was held in New Delhi in August 2001.[329]

The growing importance of Australia–India ties also received some recognition in the 2003 White Paper on foreign affairs and trade, which noted that India's weight in international affairs was continuing to increase, and that Australian exports to India had achieved double digit annual growth rates over the previous decade. The White Paper emphasised that both governments were committed to developing a "more dynamic and forward-looking approach to the bilateral relationship" building on "democratic and institutional affinities".[330]

An increasingly important trading partner

As India becomes a more significant player in the global economy, it will also become an increasingly important trading partner for Australia.

The bilateral trading relationship goes back to at least the late 19th century, when Australia imported camels from India to serve in the outback, while the first commercial export to India was a shipment of coal in 1801.[331] In the 20th century, trade flows remained relatively small until the 1950s, when there was some expansion in bilateral trade (mainly based around Australian exports of foodstuffs, and then coal, and Australian imports of handicrafts) and India's relative importance as a trading partner for Australia rose to a high in the 1960s at 2.15 % of total Australian exports (in 1967/68) and 1.4 % of imports (in 1963/64).[332] India's share in Australian trade then entered a period of relative decline: by 1989/90 India's share of Australian merchandise exports had fallen to 1.25 % and its share of merchandise imports into Australia to 0.5 % of the total, leaving India as Australia's 24th largest trading partner.

The onset of economic reform in the 1990s has helped reinvigorate trade flows and led to a marked increase in the relative importance of bilateral trade (Figure 5.1). In 1990 Australian exports to India were A$632 million and imports from India were A$279 million. By 2003 Australian exports to India had risen by more than 420 % to A$3.3 billion (3.1 % of total Australian exports), while imports from India had increased by about 250 % to A$0.9 billion (0.8 % of total imports).[333] At the time of writing, India was Australia's 15th largest trading partner and its ninth largest merchandise export market, with Australian exporters having enjoyed average annual growth of more than 12 % in the five years to 2003.[334]

Major Australian exports to India in 2003 included non-monetary gold (A$1,149 million), coal (A$1,054 million), copper ores (A$263 million) and wool (A$160 million). India, in 2003, was Australia's third largest market for coking coal and its fifth largest wool export market. Recent years have also seen substantial increases in Australian exports of so-called elaborately transformed manufactures including mining equipment and electrical machinery.[335]

Australian merchandise imports from India in 2003 included pearls and gems (A$77 million) and textiles (A$51 million).

Figure 5.1

Source: Adapted from ABS Composition of Trade Australia, various years

Looking ahead, India's importance as an export market should continue to expand. A 2001 study by DFAT's *Economic Analytical Unit* reckoned that further liberalisation of the Indian economy would increase opportunities for Australian commodity exports, and for some niche manufactured products. It highlighted prospects for Australian exports of thermal coal (in addition to the already significant coking coal market), and possibly for gas, along with agricultural exports of fruit and vegetables and wheat.[336] In addition, if Indian textile exports do accelerate following the end of the ATC then demand for Australian wool could also see a further increase.

A more internationally competitive Indian economy is also likely to increase its share of Australian imports from their current low level.

A growing role for services trade?

To date, the trading relationship has been concentrated in merchandise trade, where total two-way flows in 2003 were A$4.3 billion. In contrast, total trade in services between the two countries was just A$0.7 billion in the same year (of which almost A$0.5 billion comprised Australian exports, or about 1.5 % of total Australian service exports).[337] Here too, trade flows are likely to expand in the future in line with a growing Indian economy.

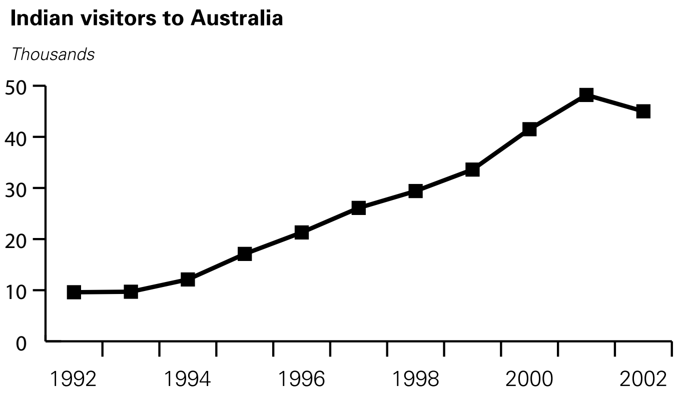
India is already beginning to play an increasingly important role as a consumer of Australian education services (education services are now Australia's sixth largest export, and one of the fastest growing sectors). Indian student enrolments in Australian tertiary education have nearly tripled in the past six years to more than 14,000, and India was, in 2003, the ninth largest source of overseas students to Australia. From an Indian perspective, Australia is the third most popular overseas destination for Indian students.[338]

Tourism remains Australia's largest service export, and the tourism sector is also set to benefit from rising Indian incomes, albeit with the growth coming off a fairly low base. Indian visitors to Australia have increased from less than 10,000 in 1992 to about 45,000 in 2002, and the Australia Tourist Commission forecasts that arrivals from India will have risen to more than 147,000 by 2012 (Figure 5.2).[339]

Other service sectors such as finance, telecommunications, health, environmental services and the media could also seek a share of the Indian market.[340]

On the import side of the equation, Australia is likely to see increased penetration by services imports — particularly IT-Enabled services (IT-ES) and Business process outsourcing (BPO)-related services — as India's international market presence in this sector continues to rise.

Figure 5.2



Source: Adapted from http://www.atc.net.au

To date, India's major export markets for these types of services have been the US and the UK (between them the destination of around three-quarters of all Indian IT service exports). In contrast, Australia's participation in the international outsourcing phenomenon has so far been relatively minor: for example, industry experts Gartner estimate that in 2002 Indian companies' share of Australian spending on application development and systems integration was less than 3 % of the total.[341] However, as an important English-speaking economy, Australia is clearly an obvious market for India, and most of the major Indian IT companies (including HCL, Infosys, Pentasoft, Satyam and Tata) now have representation here. Moreover, if Australia is hoping for an increase in the bilateral trading relationship, it is unrealistic to expect greater access for Australian merchandise and service exporters without a corresponding rise in imports from areas of India's comparative advantage.

This trend will almost certainly be politically controversial, as it has already proved to be in the US. One indication of the sensitivity associated with greater competition from Indian service providers came with the publication of the 2001 report by the *Economic Analytical Unit* that highlighted opportunities for Australian firms to outsource work to the Indian IT sector. The response was a barrage of criticism from some politicians and trade union leaders, with the report described among other things as a "slap in the face" for Australian workers.[342] More recently, an outsourcing push by Telstra — including the news in January 2004 that IBM planned to use an Indian subsidiary to fulfil its Telstra IT contracts — also garnered criticism for "exporting jobs".[343] And in an echo of recent protectionist moves in the US, the Australian Labor Party passed a motion at its annual conference in January 2004 that would ban government departments from allowing IT and call centre functions to be moved overseas.[344]

A demonstrated reluctance to allow Indian service providers to compete in the Australian market would clearly represent an obstacle to any future deepening of the Australia–India economic relationship. Australia could hardly expect to benefit from greater access to a growing Indian market while freezing out competition at home.[345] But if India's expansion into the global services marketplace turns out to be as substantial as the previous chapter suggests, then over time the adjustment strains could potentially be large. This issue could therefore come to represent a significant challenge to policymakers in managing the future bilateral relationship.

Other economic linkages: investment and people

A larger Indian economy is also likely to become a more important destination for Australian investment. Australia is already India's eighth-largest overseas investor, although in absolute terms the value of Australian assets is relatively small. Australian companies were involved in more than 100 joint ventures in India in areas including manufacturing, telecommunications, hotels, minerals processing, food processing, oil and gas, and the automotive sector.[346]

India is also likely to become a more significant investor in Australia. Again, Indian investment in Australia is already increasing. In December 2002, for example, an Indian enterprise reached an agreement with the West Australian government to build the world's largest ammonia plant (valued at over A$600 million), and this followed investment by other Indian companies in copper resources in Western Australia and Tasmania.[347]

People-to-people linkages are already significant, and could also grow in importance. According to the Australian Bureau of Statistics, in 2001 there were more than 156,000 Australians of Indian ancestry, and India is now Australia's second-largest source of skilled migrants after the UK.

Implications for international economic policymaking

Finally, along with consequences for trade and investment flows between the two countries, the economic rise of India is also likely to have significant implications for Australian international economic policy.

This trend is already apparent in terms of international trade policy. We noted in the previous chapter that India — along with several other major developing countries — has played an important role in the Doha Round. Australian trade negotiators will increasingly have to factor in the views of India and other major emerging markets in multilateral trade negotiations. This will also have implications for strategy, including the future role of the Cairns Group. There is a fair degree of overlap between the membership of the group of developing countries that has emerged during the Doha Round and that of the Cairns Group, for example. This suggests that there exists both scope for future cooperation between the two associations, and also possible challenges to the Cairns Group's relative importance. Some commentators have suggested that India should seek to join the Cairns Group in order to press more effectively for agriculture liberalisation, but for now New Delhi's protectionist instincts towards domestic agriculture may rule this out.[348]

A second area where India may be a growing factor in Australian policy relates to New Delhi's 'Look East' policy, and its push for closer relations with ASEAN. The mooted AEC has been proposed as way to 'balance' other regional groupings such as NAFTA and the EU, with the AEC to be based around five blocs of the Asian regional economy - Japan, ASEAN, China, India and Korea (JACIK).[349] While any such arrangement is likely to be some way off (if indeed it *ever* eventuates), it is clearly important for Australia to be prepared to respond to such major potential developments in regional trade arrangements. Moreover, in a world in which the multilateral trading system is under increasing strain, and where the emergence of a multiplicity of regional and bilateral preferential trade arrangements is creating a spaghetti bowl of overlapping trading rules, there is a good case to be made that targeting an Asia-wide arrangement would at least help reduce the distortions involved in narrower trade agreements.

Given Australia's current willingness to participate in bilateral preferential trade agreements (like the ones with Singapore, Thailand and the US), a related issue would be the scope for a similar trade deal with India. Australia is already contemplating an agreement with China, so should we consider a deal with Asia's other economic giant, perhaps as one of the building blocks towards some form of an AEC? Canberra says that it will seek bilateral trade agreements that are "comprehensive in scope and coverage".[350] Setting aside the general debate over the merits of preferential trade agreements, an obvious stumbling block for achieving such a deal with India would be the agricultural sector, which is extremely sensitive for Indian politicians.[351] But a case could be made for the negotiation of some kind of closer economic relations agreement, or even for a deal focusing on the service sector, that would be a way of adding momentum to the bilateral relationship.

Finally, in the previous chapter we outlined the proposition that the shifting balance of economic weight in the world will lead to changes in the structure of international economic policymaking. This process of global reorientation will provide opportunities for Australia to work with India and other Asian economic powers in efforts to increase the region's representation in key international economic bodies like the IMF. Perhaps more intriguingly, we also suggested that there was a good case to be made for considering the G-20 as an alternative to the G-7 as a forum for guiding global economic management. This proposal would have interesting policy implications for Australia, which is also a member of the G-20. The proposition that Australia should work towards promoting a more enhanced role for the G-20 has some attractive features. For example, as well as providing Canberra with the opportunity to align its interests with growing economic powers such as India and China, it would also help secure Australia's place in what would then become a much more important part of the international economic architecture of the new global economy.

Overall, more good news for Australia

The growing economic importance of India is good news for Australia. Historically, Australia's economic prospects have repeatedly benefited from the rise of Asian economic powers, with first Japan and then Korea providing Australia with dynamic export markets that have provided an important stimulus to economic growth. Much the same process is currently underway with the economic rise of China, albeit potentially on a much greater scale.

Looking ahead, the growing economic weight of India in the world should not prove to be an exception to this pattern. There may well be some sensitivities and transition strains associated with India's services-oriented development path however, compared to the merchandise-trade driven models followed in the past by the East Asian economies.

There have been a series of 'good news' stories for Australia from Asia in recent years. These have included the recovery of the region from the 1997/98 financial crisis and the emergence of China as a growing driver of regional and global growth. Even Japan, still Australia's largest merchandise trading partner, is currently enjoying better economic conditions than it has for at least a decade. The birth of another Asian economic giant in the form of the Indian economy should be seen as yet more positive news for Australia's future economic wellbeing.

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[254] Wilson et al., *Dreaming with BRICs: the path to 2050*. p. 4.

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