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India: the next economic giant
A think tank perspective

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India arrives in the *economic* headlines

Recent focus on India becoming more important player in global economy.
Two frequently cited examples:

1. **Dominic Wilson and Roopa Purushothaman *Dreaming with BRICs: the path to 2050* Goldman Sachs Global Economic Paper No.99**

   In 30 years time the Indian economy projected to be world's third largest in US dollar terms (behind US and China).

2. **Yasheng Huang and Tarun Khanna *Can India overtake China?* Foreign Policy July / August 2003**

   India's development model (home-grown entrepreneurs, more efficient capital markets & legal framework) better in long run than China's (FDI, export-led manufacturing).

India is the world's seventh largest economy in terms of total land area, & its second in terms of population. In economic terms, India's economy in 2003 was either the world's 12th largest (with output measured using market exchange rates) or its 4th largest (output measured using purchasing power parity exchange rates). Yet relative to its size, India's impact on the global economy has been relatively modest. Charles De Gaulle reportedly once said of Brazil – damning with faint praise – 'it has enormous potential and always will'. For much of its post-colonial history, it seemed the same description would apply to India, with all the action in the world economy to be found elsewhere. When India made the headlines, it tended not to be in the economic press, but to be about political, social, religious or cultural matters.

Yet in recent years that perception has changed, with a growing number of observers arguing that India's economic potential is finally starting to be realised. As an example of this, two papers released in 2003 seem to have created a lot of public attention. A research report by Goldman Sachs carried out a fairly straightforward growth projection exercise to suggest that India could become the world's third largest economy in US dollar terms by 2050. And an article in Foreign Policy magazine argued that – over the longer term at least – India's particular development model might prove to be even more successful than that of China's. A striking claim at a time when the world economy was struggling to deal with the impact of an emerging Chinese economic powerhouse.

So why the new interest in India's economy? Likely reasons include:

1. An improved growth performance. After years of the disappointing so-called 'Hindu rate of growth' – GDP growth of around 3½% - India became one of world's fastest growing economies over 1991-2003 period (average annual real GDP growth just shy of 6%). In particular, during FY2003/04, when the economy was boosted by an unusually good monsoon, & with positive base-year effect, India turned in series of impressive quarterly growth numbers, with output expanding at annual rate of over 10% in last quarter of 2003. In FY2003/04 the economy grew by 8.2%, after growing by just 4% (partly due to poor monsoon) in 2002/03. Other macroeconomic & country risk indicators (reserves, inflation, interest rates) have also improved, contributing to . . .

2. Stronger credit ratings. As reward for stronger economic performance, the major rating agencies have given India better sovereign risk ratings. Most striking of these in terms of attracting investor attention was Moody's decision to upgrade India to investment grade (Baa3) in January 2004. S&P placed its India rating (BB) on positive outlook in August 2004.

3. 'Head turning' effect of offshore outsourcing business. The international outsourcing of white collar jobs, and India's increasing role in that process gathered a lot of attention in 2003 and 2004 (linked to US electoral cycle), with pundits wondering whether 'India would be to services what China was to manufacturing'.

Contd . . .

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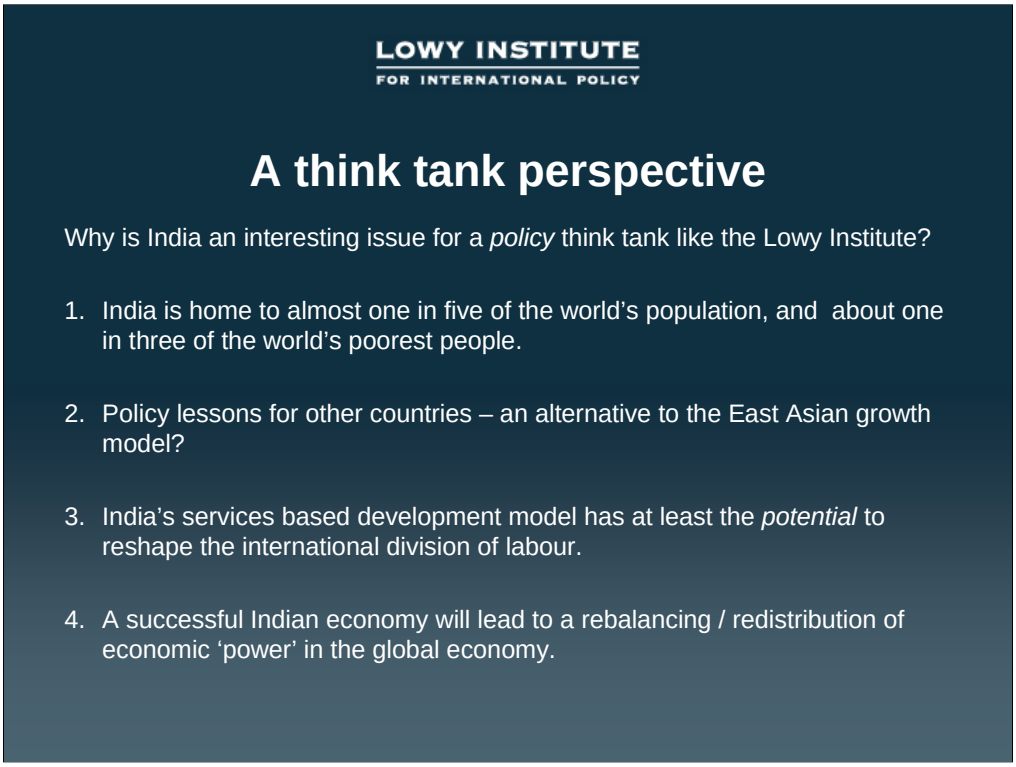
Two giants : India & China in 2003

	India	China
GDP (Market Exchange Rates, US$ b)	598.9	1, 409.8
Rank in world economy	12	7
Share of world GDP (%)	1.6	3.9
GDP (PPP rates, $ b)	3,096.2	6,435.8
Rank in world economy	4	2
Share of world GDP (%)	6.0	12.4
Population (billions)	1.06	1.28
Rank in world economy	2	1
Share of world population (%)	17.0	20.5
Real GDP growth 1991-2003 (% pa)	5.8	9.7

4. Improved relations with Pakistan. Growing optimism about India's place in the international economy also reflected perceived progress in often fraught relationship with Pakistan. As recently as 2002 the two countries appeared on the brink of conflict; by 2004 the first formal peace negotiations in two years were underway. Implication is fall in country risk premium – potentially big effects if sustained, if buy modern macro-models?

5. The China comparison. Suspect that at least some of the interest in India has been sparked by China's increasingly visible role in the global economy. The two billion-people-plus economies are in some ways natural comparators, so the 'China story' may well have encouraged more focus on the 'India story.'

Some interesting comparative dynamics here: in 1980 the two economies looked reasonably close in size (GDP of around PPP$400 billion, with India slightly larger), & similar per capita GDP, (with India at PPP$630 against China PPP$410). Subsequent history seen China emerge as convincing 'winner' in the development race (see table). Also, likely that China's success a spur for India's change in policy/direction – one newspaper story canvassed an Indian 'nightmare' of underemployed farm labourers spending scanty incomes on Chinese imports . . .



Why is this of interest to a policy think tank like the Lowy Institute?

1. India is home to almost one in five of the world's population, & about one in three of the world's poorest people. If we're interested in the future of the planet, & in the welfare of its people, we almost have to be interested in India by definition.

2. India's development successes & failures could have important policy lessons for other countries. In particular, when rise of China may be crowding space for export-oriented growth (note this is a controversial claim), possible that India might offer alternative development path.

3. India's services based development model – which implies increased tradeability of service sector jobs – could have major implications for international division of labour, & hence for structure of employment in developed economies.

4. A larger Indian economy will contribute to 'global reorientation' – shift in the geographic distribution of economic power back towards Asia. Possibly major implications for international economic (and political?) institutions. e.g. G20 v G7

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Some interesting issues . . .

1. (Why) did India miss out on an 'economic miracle' like that of East Asia?
2. When and why did India's growth performance shift?
3. Is there a democratic constraint on growth? Is that changing?
4. How fast can India grow?
5. What are the implications of India's services-based development model?
6. What will a more successful India mean for the world economy?

These themes suggest a long list of policy relevant questions. A (non-exhaustive) sample is given here.

Note question 1 is sort of two questions, one imbedded in another . . .

Very difficult (impossible?) to provide complete answers to all of these questions given current state of knowledge/future uncertainties. Rather aim is to sketch out some hopefully interesting issues & try to provide some framework/context and maybe tentative conclusions.

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A fundamental question . . .

Cast light on the central questions of economic growth and development?

'Is there some action a government of India could take that would lead the Indian economy to grow like Indonesia's or Egypt's? If so, what exactly? If not, what is it about the "nature of India" that makes it so? The consequences for human welfare involved in questions like these are simply staggering: once one starts to think about them, it is hard to think about anything else.' Robert Lucas, "On the Mechanics of Economic Development," Journal of Monetary Economics (1988)*

* Note the date: presumably the country selection would differ today . . .

Robert Lucas (winner of Nobel Prize for economics in 1995) musing on the importance of understanding economic growth.

One simple way to think about prospects for economic growth is idea of catch up. An economy's distance from 'frontier' (best practice in terms of technology/productivity etc – the US economy today) gives potential for catch-up growth, while 'absorptive capacity' is some measure of its ability to actually exploit this potential by importing necessary techniques/technology etc. (Just 'being poor' isn't enough.)

India ended colonial period in 1947 as one of world's poorest countries, & after period of sluggish economic growth in closing years of British rule. Yet prospects for 'catch-up' not too bad? E.g. potentially large domestic market, relatively diversified natural resource base, fairly large supply of unskilled and skilled labour; history of entrepreneurship; functioning bureaucracy; tradition of industrial development; 20-yr old central bank & Asia's oldest stock market.

Problem India's development path? Drew inspiration from state control during war period & apparent successes of Soviet planning to produce program of state-led industrialisation & administrative requirements – latter the Permit Raj. And a (self-fulfilling) pessimism about prospects offered by international economy. Self-reinforcing rent-seeking/distortions e.g. industrialisation drive - high imports – BoP probs – controls – weaker exports – more BoP probs – more controls etc.

But how bad *was* policy? Choice of benchmark: De Long – if look at total international performance, not bad, merely unexceptional (not a miracle economy like East Asia, but not Africa). Yet performance worsening by 1970s even compared to other emerging markets.

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Why & when did things change?

1. The conventional story:

- 1991 BoP crisis / collapse of Soviet Union / China effect
- Move to more open economy
- Greater reliance on market signals

2. The Rodrik /Subramanian story

- Structural break in growth performance in 1980s, not 1990s
- Move to 'pro-business', not 'pro-market' environment

Conventional story

By late 1980s growing fiscal & external imbalances & increasing indebtedness leading to increased vulnerability to shocks. Collapse of Soviet Union hit trade flows, dented faith in central planning, Gulf War boosted oil import bill & cut remittances; looming BoP crisis pushed India into IMF support in November 1991. Under Finance Minister Manmohan Singh, India enacted first stabilisation policy, then moved to liberalise economy, with (i) efforts to make economy more open to international economy and (ii) more sensitive to market signals. Result was improvement in economic indicators and growth performance as India integrated with global economy and became more 'market friendly'.

'Rodrik / Subramanian story*

Look at the data (Rodrik, also De Long) shows that structural break in GDP growth performance came in 1980s, not 1990s (& some support on more micro level productivity indicators). Dani Rodrik argues key change was under Rajiv Gandhi with move to a 'pro-business' (as opposed to later, pro-market) stance – efforts to reduce controls on industry, exports etc.

Which story is closer to truth clearly important to policy debate. But fact that 1980s reforms were derailed by expansionary fiscal policy and led to BoP crisis has undermined attractiveness of alternative story for many.

* Dani Rodrik and Arvind Subramanian *From 'Hindu Growth' to productivity surge: the mystery of the Indian growth transition.* IMF Working Paper 2004

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A political constraint on growth (i)?

‘ . . .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.’ Financial Times September 2003

‘The Chinese have order, discipline, modern telephones and roads, less poverty and faster economic growth. The Indians have democracy, chaos, lousy phones and roads, more poverty and slower growth.’ Asian Wall Street Journal July 2003

The FT quote goes on to note that Indian democracy also has an important upside – consensus makes reform more likely to stick.

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A political constraint on growth (ii)?

- Impressive electoral dynamics (675 million registered voters at April 2004 elections, some 380 million votes cast) – asset or liability?
- Interpreting the 2004 'surprise' election results.
- Democracy as a form of shock absorber?

One of most commonly cited features of Indian reform process been cautious/gradual nature – reforms started later in India than in many other developing economies, and once underway proceeded at relatively slow pace. Democracy gets the 'blame'. Whether this interpretation is fair is obviously important for understanding development/growth.

Before April 2004 elections, belief was that this political constraint had been relaxed; arguments included generational change & an appreciation of the fruits of reform. But then the 'surprise' result, with Congress victory, led to a return of the 'political constraint' thesis.

Hence interpreting the result important: a rejection of reform? Or a demand that reform be extended to deliver benefits to those missing out (e.g. rural India accounts for an estimated two-thirds of voters) ? Looking at Congress policy rhetoric *post* election, the 2nd interpretation seemed to be the one they favoured.

Finally, while may be short-term 'costs' of democracy ('everybody has a veto' – Arun Shourie, former Minister for Disinvestment), are there long-term benefits, such as ability to deal with economic shocks and crisis within prevailing political system (contrast say with Soeharto's Indonesia)? And more scope for kind of creativity that fuels modern technological change?

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How fast can India grow?

Two (very) simple frameworks:

1. ICOR (Incremental Capital Output ratio)

Growth = Savings rate / ICOR

Savings rate 24-25% of GDP, ICOR 4, implies growth rate of 6-6.5%

2. Growth accounting (e.g. Rodrik & Subramanian)

Growth = (capital share * investment) + (labour share * growth in work force) + TFP growth

Capital share =0.35, TFP 2.5%pa, investment 8.3%pa, workforce 1.9%pa gives growth rate of 6.7%pa

Growth rate matters – at a 6%pa average GDP growth rate, doubling time for real output is roughly every 12 years. At an 8% rate, takes nine years; at 10% takes seven years. Goldman Sachs BRICs report assumes a 30-year average real GDP growth rate for India of 5.8%, for example.

1. ICOR model

ICOR is calculated by dividing the investment rate for a given period by real GDP growth over the same period. Crude measure of efficiency = amount of capital required to generate an additional unit of output (lower ICOR means more efficient). Simple framework: growth = an economy's savings rate, divided by its ICOR. India savings rate around 24-25% of GDP, ICOR of roughly 4. Growth rate of 6-6½% - not much better than recent past performance. Can increase savings (fiscal reform, foreign savings?) and/or lower ICOR. NB. Problems with framework (relationship may be non-linear, ICOR not constant): no more than rough rule of thumb.

2. Growth accounting (Rodrik & Subramanian calculations)

Growth in output equals growth in inputs of capital, labour and growth in their productivity (TFP). Assume TFP growth same as past 2 decade average (conservative), working age population grows at 1.9%pa (while pop growth about 1.4%pa), & investment boosted by demographic-driven rise in savings rate as dependency ratio falls 14pp between 2000 and 2025 – 1:1 gain?

*Dani Rodrik and Arvind Subramanian *Why Indian can grow at 7 percent a year or more: projections and reflections.* IMF Working Paper 2004

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Services based development model

- Striking feature of Indian development - role played by services.
- Way of leapfrogging India's infrastructure shortcomings?
- Enough jobs / growth generated by services vs. low wage, low skill manufacturing?
- Reaction in rest of world – another shock to international division of labour.

Central role played by services in Indian growth story. During 1990s service sector grew at annual rate of 9%, contributing nearly 60% of overall economic growth. Services exports grew at over 17%pa. India has seen its share of world services exports triple in about a decade. Gains in so-called new economy sectors like software, where India's share of the global market is around 17%, & where growth of exports double world average. McKinsey estimates Indian firms now control over half global IT & back office outsourcing market.

Attraction of services based model is New Economy can leapfrog India's hitherto poor physical infrastructure – a major constraint on manufacturing. India's infrastructure spend fraction of China's (2002: US$31b v US$260b but real estate distortion): power sector major bottleneck, transport also. Claim that India uniquely suited to a 21st century economy driven by services, after having missed out on Manufacturing Revolution that powered much of 20th century growth?

Counter argument services sector remains enclave, employing only small fraction of India's workforce, & that real development still needs old manufacturing model. Yet to date estimates of employment elasticity of manufacturing low (0.26 over 93/94-99/00) compared to say business services/real estate/finance (0.73) – partly reflecting bias to capital: in labour-rich economy, a sign of (policy) distortion?

India does for services what China is doing for manufacturing? Mini-furore over offshore outsourcing, now faded. But reasons to think will come back: share of services in output, wage differentials, technology changes lead to growing importance . . . Economic theory tells us more winners than losers, but who are they? Capital v labour in developed world? Protectionism?

Shifts in international division of labour just one facet of more general process of global reorientation: At the start of the nineteenth century almost 60% of world output originated in Asia. Yet by 1950 the region's share had declined to less than a fifth. Process of declining relative economic power was halted, and then moved into reverse with the post-war rise of Japan and the subsequent spread of economic growth to Northeast and then Southeast Asia. China's economic take-off has seen global reorientation really gain traction in recent years. And if the projections about India's growth prospects are right, then will add further momentum.

Rise of India / China leads to shifts in relative prices, relative returns to capital & labour (think of as shock to global labour supply?), shifts in direction of capital flows (more capital or more competition for same flows?), shifts in comparative advantage (SE Asia back to commodity exporters?).

Calls for changes to global economic architecture – e.g. replace G7 with G20? Watch what's happening in WTO; IMF/ World Bank reforms? Not just economic institutions – what about the UN?