A new India in a new global economy?

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I would like to begin by thanking the University of Canberra and Dr Weigold for their kind invitation to speak here today.

In this session I want to take a 'big picture' view of India's economic prospects, placing them in a global context, and hopefully setting the scene for some of the more detailed sessions to follow.

The title of my presentation, *A new India in a new global economy?* poses two interlinked questions: are we seeing the emergence of a new India, 'the next economic giant' as suggested in my recent Lowy Institute Paper?[1] And are we operating in a new global economy?

Past experience suggests that economists are well-advised to be cautious when advancing the case for dramatic paradigm changes or regime shifts. Much of the 'New Era' thinking advanced to justify the run-up in IT share prices at the turn of the century looked foolish once the bubble became rubble. And it now appears that some of the clever theories advanced to explain why the US dollar could defy gravity – in the form of a record current account deficit – are headed the same way.

[1] Lowy Institute Paper No.01 *India: the next economic giant.* Available from the Institute's web site, www.lowyinstitute.org

Still, to begin with my conclusions, this morning I want to suggest that we *are* in fact seeing the emergence of a new India – at least in an economic sense – *and* at the same time we are seeing the emergence of a new global economy.

Moreover, these two developments are closely related, with important feedback effects between them.

A new India?

Let's begin with the proposition that we are seeing a new India.

Referring to Brazil, Charles de Gaulle reportedly once said, 'it has enormous potential, and always will'. For much of its post-colonial history, the same dismissive description would seem to have applied equally well to India.

When India gained independence from Britain in August 1947, it did so as an extremely poor country – one of the poorest in the world in fact – and growth in output per head had been especially weak during the closing years of colonial rule.

But against this, the scope for economic catch-up of the form subsequently enjoyed by the 'miracle' economies of East Asia *also* looked respectable: India had several advantages, including a potentially vast domestic market, a reasonably diversified natural resource base, a large supply of labour, a relatively efficient bureaucracy, and

a well-developed financial system that boasted one of the region's oldest and largest stock markets, along with a 20-year old central bank.

Yet economic take-off occurred not in South, but in East Asia. And while it would be unfair to dismiss completely the achievements of Indian economic policy in the decades after independence, it seems fair to say that, at least with the luxury of hindsight, there is a sense of opportunities missed.

Not surprisingly, the dynamism of the East Asian economic model, when set against the measured 3½% per annum pace of the so-called Hindu rate of economic growth, and the bureaucratic inertia of the Licence Raj, led many observers to conclude that the real action in the world economy would always be found elsewhere.

Today, the good news is not only that this perception no longer holds, but that there are reasonable grounds for believing precisely the opposite. That is, there is a good chance that India will be *exactly* where the action is in the world economy in coming years.

This reflects the fact that the impact of well over a decade of economic reforms, beginning at first very tentatively in the 1980s, and then with more confidence and commitment in the years following the 1991 balance of payments crisis and change of government, has been to significantly boost India's growth performance. Granted, perhaps not (yet) to the heady levels displayed by China: but nevertheless, to a still impressive average rate of growth of around 6% per annum over the past two decades. That in turn has been enough to make India one of the fastest growing economies in

the world in recent years. Last year for example, the economy grew at a rate of over 8%, and so far this year, annual growth has been running at over 7%.[2]

Crucially, reform has also encouraged India's re-engagement with the international economy, reversing a decades-long retreat. This of course has been most visible in the case of India's high profile participation in the offshore outsourcing business, but it is apparent across a wide range of indicators, from tariff levels to the ratio of trade to GDP and the scale of capital inflows.[3]

In my view, this faster growing, more internationally integrated economy does justify the description of a 'new India.'

A new global economy?

What about the second proposition – that of a new global economy?

Here I want to focus on four key trends that I think are leading to a fundamental shift in our international economic environment.

The first is the onset of a second age of global capitalism.[4]

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[2] Recent work by Rodrik and Subramanian makes reasonably conservative estimates about productivity growth (growing at 2½%pa in line with historical average), investment (increasing in line with a rise in savings prompted by demographic changes) and the labour force (growing at 1.9%pa in line with population forecasts – about ½pp faster than population growth overall) to give a lower bound estimate for potential growth of a little under 7% for India in the future. Rodrik and Subramanian *Why India can grow at 7 percent a year or more: projections and reflections* IMF Working Paper July 2004.
[3] For an overview see Chapter 2 in *India: the next economic giant*.
[4] The first age is typically dated as the period between 1870 and 1914.

The end of the Cold War, the fall of the Berlin Wall and the subsequent collapse of the Soviet Union brought some 400 million people into the international economy, making it truly *global* for the first time since the First World War.[5] Perhaps even more importantly, the end of the Cold War also secured victory for global capitalism over international socialism in the battle of ideas, with important demonstration effects for economic policy in emerging markets and other developing countries.

The second theme is global reorientation.

By this I mean the geographic redistribution of economic weight in the global economy back towards Asia – from whence it departed during the nineteenth century.

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.[6] This 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. But it has been China's economic take-off that has seen global reorientation really gain traction in recent years.

My third theme is demographic transition.

The world is now in the third and final century of a demographic transition that began around 1800.[7] Before then, births were many, death came early and the world's

[5] See Yergin and Stanislaw *The commanding heights: the battle for the world economy*.
[6] See Angus Maddison *The World economy: a millennial perspective* Paris OECD 2001
[7] See Ronald Lee. *The Demographic Transition: Three Centuries of Fundamental Change*. Journal of Economic Perspectives Vol 17 Number 4 Fall 2003 pp167-190.

population was young. Then, starting in Western Europe, falling mortality rates, followed by declining fertility rates, began to alter dramatically the demographic landscape. The result was a three-stage transition process: stage one brought an increase in population growth; stage two saw that growth then decline, and the third and final stage brings population ageing. Much of the developed world is now in this final stage, with Europe and Japan leading the way.

At the global level, one consequence of this transition is likely to be a greyer world, with the proportion of the world's population aged sixty or above forecast to rise from around one in ten in 2000 to more than one in five by 2050. Another implication is that there will also be a significant shift in the geographic location of the world's working age population.

My fourth and final theme is the impact of the new technological revolution, and the resultant rise in the 'tradeability' of services.

The first age of global capitalism was in part a product of technological innovation: the development of the steamship allowed international trade in basic agricultural and manufactured products, while the (submarine) telegraph cable facilitated international capital flows.[8]

In a similar way, the current age of global capitalism is a product of the information age, with fibre optic cables and commercial satellites taking the place of steamships

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[8] For an elaboration of this argument, see Stephen S. Cohen and J. Bradford DeLong *Our Outsourced Future.* Draft version available at http://www.j-bradford-delong.net/movable_type/2004_archives/000556.html

and telegraph cables. This new wave of innovation has reshaped the international economy by encouraging vertical specialisation in a process that has seen companies locate different stages of production at different geographical locations. This trend is at the heart of China's current economic take-off and in particular the wave of Foreign Direct Investment (FDI) that is now flooding into that country.

However, perhaps even more important in the long run, improved communications technology – greater bandwidth, if you like – is driving offshore outsourcing in the service sector, exposing increasing numbers of white collar jobs to the winds of international competition, and paving the way for truly dramatic shifts in the international division of labour.

A new India in a new global economy

I'd now like to draw the two themes of a new India and a new global economy together, and think a little bit about the interaction between them.

For example, the watershed years that marked the birth of the second age of global capitalism also witnessed a dramatic change in the Indian economy. In June of 1991 – the same year that saw the dissolution of both the Warsaw Pact and the Soviet Union – the Rao government came to power in India, and Manmohan Singh as Finance Minister subsequently launched a series of reforms designed to reintegrate India with the international economy.

Indeed, the collapse of the Soviet system played a direct role in all of this: the loss of a major trading partner (along with the 1991 Gulf War) damaged India's trade and contributed to a balance of payments crisis that helped make the case for reform. At the same time, the Soviet collapse also signalled definitively the failure of the old central planning model that had already been discredited by China's earlier move to the market.

In turn, India's decision at that time to begin opening up to the world paved the way for the entry of (then) about 866 million people into the global market place, of whom 514 million were of working age.[9] Along with the addition of workers from behind the now defunct Iron Curtain, and together with the earlier entry of China into the world economy, this triggered a dramatic increase in the effective global labour force, the consequences of which are playing out today.

The international integration of India therefore is a crucial part of the story of the birth of a new global economy.

Similarly, India is also becoming an increasingly important contributor to – and source of momentum for – the process of global reorientation. Although still behind China in terms of economic weight, India nevertheless accounted for 6% of world GDP last year when output is measured using purchasing power parity (PPP) exchange rates, making it the world's fourth largest economy. If output is measured

[9] The corresponding numbers for 2003 are around 1.1 billion and 664 million, respectively. Data from the World Bank's world development indicators.

using market exchange rates, this share falls, to a bit over 1½%. This still makes India a respectable number 12 in the world GDP league table.[10]

The key point however is that India's share of world output is set to climb over coming decades, both in PPP and in market exchange rate terms. For example, some estimates suggest – not unreasonably in my view – that India could be the world's third largest economy in US dollar terms by 2030 or thereabouts.[11]

India is also a major player in the global demographic transition. The subcontinent is already home to more than one billion people, or about 17% of the world's population, making it the second most populous country in the world after China. According to the UN, on current trends India is set to overtake China to become the world's most populous country – with more than 1.4 billion people – by 2035.[12]

Importantly, the same demographic projections show that India's dependency ratio (that is, the ratio of non-working age to working age population) is set to fall from about 64% in 2000 to 48% by 2030, a drop of 16 percentage points.[13] There is some statistical evidence to suggest that this fall could translate almost one-for-one into a rise in national savings. If so, this would imply a savings rate of around 40%, compared to the current rate of around 24-25% of GDP, providing a major boost to medium-term growth prospects. This would also give India the kind of bulge in

[10] These numbers are taken from the quick reference tables on the World Bank's web site: http://www.worldbank.org/data/quickreference/quickref.html
[11] See Dominic Wilson and Roopa Purushothaman *Dreaming with BRICs: the path to 2050*. Global Economics Paper No.99 Goldman Sachs 2003. The assumptions include a 30-year average growth rate of 5.8%.
[12] Data from the United Nations Population Division web site.
[13] United Nations Population Division web site.

working age population enjoyed by East Asian economies during their periods of economic take-off.[14]

Finally, India is also at the heart of the fourth trend shaping the new global economy – the growing tradeability of services.

One particularly striking feature of the current Indian development model is the central role that has been played by services. During the 1990s the Indian service sector grew at an annual rate of 9%, contributing nearly 60% of overall economic growth. At the same time, services exports grew at over 17% per annum. As a result, India has seen its share of world services exports triple in the space of about a decade.

Moreover, many of these gains have come in so-called new economy sectors like software, where India's share of the global market is around 17%, and where the growth of its exports has been double the world average.[15]

Again, McKinsey estimates that Indian firms now control over half of the global IT and back office outsourcing market.

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[14] One *very* simple framework for thinking about potential growth rates is based on the Incremental Capital Output Ratio (ICOR). The ICOR is the ratio of the investment rate to real GDP, and a crude measure of investment efficiency – the amount of capital required to generate an additional unit of output. An economy's growth rate can be calculated as its savings rate divided by its ICOR. India currently has an ICOR of roughly 4, so with a savings rate of around 24-25% of GDP, this suggests a growth rate of around 6-6½%. An increase in the savings rate to 40% would, all else equal, imply a growth rate closer to 10%. At an annual rate of 6%, output doubles roughly every 12 years. At 10% that 'doubling time' is cut to 7 years.

[15] *Sustaining India's services revolution* World Bank 2004

In other words, Indian firms are now competing successfully in areas once thought to be the preserve of the developed world, while at the same time contributing to a new global reorganisation of international business.

The opportunities – and the challenges – ahead

I'd like to finish by considering some of the opportunities – and the challenges – posed by the emergence of a new India in a new global economy.

At the most basic level, the emergence of India as a new economic giant should mean a higher standard of living for more than one billion people – an improvement that would benefit almost one in five of the world's population. With an estimated one-third of the world's poorest people living on the subcontinent, this would also be good news for global poverty.

Of course, a wealthier and more dynamic India will also mean new and expanding markets for goods and services for the rest of the world, including Australia. Indeed, we can already see this in the data: Australian exports to India have grown by more than 400% over the past decade, and were up more than 80% on a year ago in 2003/04. India is now one of our fastest growing export markets, and our seventh largest one (taking some 4½% of total exports in the previous financial year, or about the same as the UK).

More generally, there will be implications for the pattern of global demand, for the international structure of relative prices, and for the direction of global capital flows.

The redistribution of economic power involved in global reorientation should be good news for an Australian economy that has repeatedly benefited from Asia's economic success stories. It will, however, also have implications for the international economic architecture, not to mention geopolitics, which could pose interesting – and at times difficult – adjustments, at least in the longer term.

India's services based development model – which is starting to see India do for services what China is doing for manufacturing – implies that we are also gradually moving towards something that looks more and more like a global labour market, with all of the opportunities and adjustment strains that this will entail.

Lastly, there will be significant challenges for India itself. Economic reform since that watershed year of 1991 has been successful, but it has also been partial, gradual, and at times faltering. It also continues to be conditioned by the political constraints imposed by India's democracy – a fact brought home once again by the surprise election results earlier this year.

For India to be sure of securing its place as the world economy's next economic giant, reform needs to be sustained. To take just one example, the significant potential benefits that could be reaped by India's coming demographic boost will only be realised if the economy generates enough employment to provide jobs for an expanding workforce. On some estimates, that means creating more than 100 million jobs in the next decade, just to keep the unemployment rate from increasing. That in turn requires policies that deal with a range of issues, including fiscal fragility,

infrastructure bottlenecks, rigid labour laws and bureaucratic inertia. Clearly, this is no easy task, and the recent signals coming from Delhi have been mixed on this point, with the commitment to the Fiscal Responsibility Bill, the move to raise some sectoral caps on FDI and a further shrinking of the small scale industries (SSI) reservation list having to be set against the negative signal from the abolition of the disinvestment ministry and an apparent reluctance to tackle labour laws.

Still, if the policymakers in Delhi can deal with such issues, then India's future should be very bright indeed, allowing India to fulfil its potential as the world economy's next economic giant.