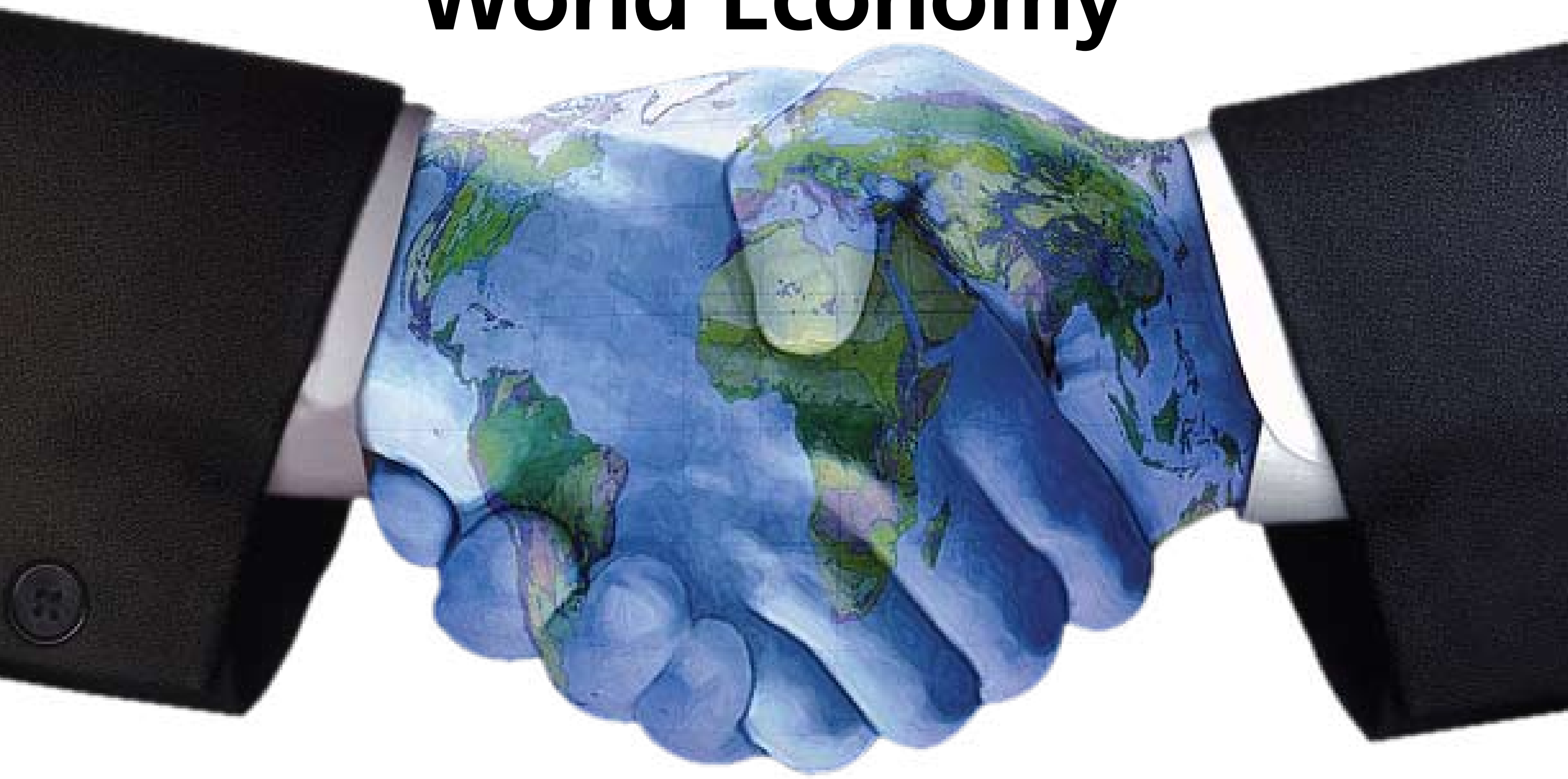
Preparing for the Next Stage of Growth – Deepening India's Integration in the World Economy



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"A society, if it is to be both stable and progressive, must have a certain more or less fixed foundation of principles as well as a dynamic outlook"

– Jawaharlal Nehru

"Indians won their economic independence only after 1991"

– Gurcharan Das

India's economy has done remarkably well. The policy cocktail that has brought India's economic take-off was a complementary one of liberalization and privatization of economic activities domestically, and opening up to commerce and investment internationally. This policy must continue.

2009, an election year in India, offers a much more gloomy outlook. The global economy is in crisis. India is hit by the downturn as well. Economic growth forecasts were revised downwards by the International Monetary Fund to 5.1%. These are lower than for China (6.7%). In a country where mass squalor is still a stark reality, a slowdown of growth is not a good news.

Such a recession also comes at a moment when scepticism against liberalisation and globalisation has risen in India, as elsewhere. Current protectionist temptations must be resisted.

What is more, after several years of complacency, the country will need to find its way back to structural reforms and continue to deepen its integration with the global economy.

Realising its previous autarkic policies were a failure, India embraced the world. But, as the current crisis shows, this has also exposed the country, like all others, to the turbulences in the global economy. Yet this does not mean India should retreat. On the contrary, having high stakes in an open economic system, India will need to improve its leadership credentials and show the way forward. This could start in the World Trade Organization, where India has gained an unprecedented clout in the last years.

Globalising: the Recipe for India's Recent Economic Success

Since 1991, the year a balance of payment crisis forced the government to change economic policies radically, India got rid of most aspects of its mind-boggling "licence raj" that stifled business and economic growth. While reforming its economy from within, it opened it up to the outside world, cutting tariffs and eliminating many border measures such as import bans, licensing requirements, and quotas. India's economic growth rate was a high 6.3% per annum between 1988 and 2006. In 2007, according to the IMF, growth was close to Chinese levels with 9.3%. Even in the crisis year 2008, India managed a very respectable 7.3%.

Poverty levels have fallen significantly. They were as high as two-fifths of the population in the late 1980s and are now around one quarter. This is one of the most rapid paces of poverty reduction in recent history. Starting from a quasi-total isolation from the international economy, India has now achieved a respectable level of international trade and investment activity. Growth of goods exports between 2000 and 2007 averaged 14% per year, with a peak at 19% in 2006. Services export growth was 17% per annum on average between 2000 and 2007, with a record 25% in 2006. India accounts already for 2.7% of world exports of services and is the fifth services exporting economy in the world. FDI levels have risen dramatically, reaching a peak in 2007 with USD 23 billion.

Quite predictably, given the size of its population and economy, India's visibility on the global stage has risen with its economic growth. In the economic sphere, this has been symbolized by the rise of the modern and dynamic Indian multinational in steel, automobile, extractive industries, IT and business services, and pharmaceuticals. These, having gone on a global direct investment spree, spent US 13.7 billion alone in 2007, according to UNCTAD. India's national pride and new standing were boosted with some symbolic acquisitions, such as Tata's purchase of British industrial jewel Jaguar. India is indeed now the United Kingdom's premier foreign investor, in an ironic twist of history. The innovative capacity of India's companies was also reflected in the launch of the "Nano" car in 2008. The choice of economic interdependence with the outside world has fed India's new-found economic "independence" as Das, one of India's key businessmen put it.

In international economic policy-making, a highly politicized area, where rich-and-poor country divisions have run deep and where ideological battles have been raging since the end of the colonial era, India is also gaining more clout. This is in particular the case in the World Trade Organization. India's charismatic commerce minister Kamal Nath is often said to have the key to the conclusion of the now eight-year-old multilateral Doha Round of trade liberalisation negotiations. Posing as champion of India's and the world's poor, Nath has denounced with all his talent for catchy phrases rich countries' protectionist policies in agriculture, services and labour-intensive manufacturing. Exposing those countries' hypocrisies he has refused to give in to their demands to open India's manufacturing and agricultural sector. Last summer at a meeting of WTO ministers in Geneva aimed at concluding the trade talks, India, in alliance with China, has refused to accept a certain number of disciplines demanded by its partners on a so-called "special safeguard mechanism" (SSM) to protect national agricultural sectors in case of sudden surges of imports. The tactic was justified on the grounds that unless free reign be given to protection in case of sudden import rises, poor farmers in developing countries would be savagely displaced. The SSM issue ultimately led to the collapse of the negotiations last summer. The latter haven't seriously been revived since.

India can now afford to defy the world's biggest trading partners, and contribute to bringing global talks to a halt on such an ultimately minor issue. Along with Brazil, and, increasingly, China, India is now part of the core group of WTO members

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including the United States and the European Union, who make, or rather, break, multilateral liberalisation deals.

Much More Reform is Needed to Create a Modern Indian Economy

India's spectacular awakening and economic rise in the last two decades in fact masks many a weakness. India has by far not met its developmental challenges. Despite the glamour and politically popular postures of a flamboyant Commerce Minister, India's external trade policies pursue an outdated agenda which mirrors India's lop-sided development process. The latter favours high-end services and capital intensive industries, but it neglects a few basics, such as agricultural modernization, massive job creation, and domestic consumption, to which we now come.

India is still largely a backward agrarian economy. Economic history teaches that an economic take-off implying sustained improvement in per capita income levels is preceded or accompanied by a revolution in agricultural production methods. This has not seriously happened in India yet. In China, the farm sector's share of overall employment came down to 32% in 2004, from 69% in 1978. In comparison, in India today, sixty percent of its workforce is active in a highly unproductive agricultural sector that only contributes to 21% of gross domestic product. Per capita incomes in both countries also vary: GNI per capita in India is 950 USD, while China's is already double that level at 2010 USD, according to World Bank data. The great majority of rural workers work in the informal sector or make a living out of subsistence agriculture; they very often have no property nor land or tenancy titles. Just about everything in India's agricultural sector would need to be reformed: more secure property rights and tenancy arrangements need to be introduced that guarantee returns on individual efforts and offer collateral for credit. India needs to eliminate an onerous and inefficient input subsidies system that benefits large producers and crowds out more productive investment. India's public procurement system aimed at building food reserves, in fact needs to be scaled down. Combined with India's state-managed marketing mechanism, the latter contributes to keeping prices unduly high and food off the shop shelves and market stalls for scores of poor rural and urban Indians. The system ultimately benefits middle and large producers not the large mass of landless or title-less farmers. The system also stifles rationalization and modernization of production methods.

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Despite economic growth, India has also not yet managed to put its rural masses to work in factories. India will need to adopt large-scale manufacturing of labour-intensive goods. Today, India is still suffering from its decade-long insistence on capital-intensive manufacturing such as steel, or pharmaceuticals, among others, which does not create jobs for the masses. In short, despite having opened up to the world economy, India has not yet been able to exploit its comparative advantage in labour-intensive manufacturing. This failure can largely be attributed to India's highly restrictive labour laws resembling many a crisis-ridden Western European model. These protect jobs unduly, and ultimately deter hiring. They do not provide the flexibility to build economies of scale necessary for the development of efficient companies operating in global apparel or electronics networks. India cannot count on its much-vaunted IT sector to do the job. The latter creates employment for a small skilled elite which receives an extra reward in a country where skills are scarce. Under such circumstances popular perceptions that India's recent growth has not benefited the poor are not surprising.

A modern financial system will be crucial to achieve the next step of India's economic development. But India's financial sector is not up to the task. As India becomes richer, it will require more effective financial intermediation to channel savings more efficiently into productive investments in the economy and provide better and more sophisticated services to its population, ranging from pension products to credit for small business creation in services or industry. Banking, securities and insurance will need substantial upgrading. Modern infrastructure financing in public-private partnerships also requires flexible and sophisticated financial products that need to be offered on a much grander scale in India. However, India's financial sector remains dominated by large inefficient state-owned banks that do not respond to contemporary needs. These banks make up about three quarters of India's banking sector, and tend to be incentivised to invest in government bonds in priority over other productive activities. These banks will need to be privatized. Indeed, their performance is much lower than private sector banks, even in providing credit to poorer sections of India's economy. India also still imposes too many restrictions on the use of sophisticated financial products such as derivatives. These must go.

A recent study led under the auspices of the International Monetary Fund[1], which examined under which circumstances growth in individual Indian states led to significant outcomes in lifting the poor out of their condition. Four main factors were considered the most effective in achieving this goal. First, the level of financial development stands out as a major factor. The better access to credit is organized, the more poor sections of the economy benefit. Second, more flexible labour markets were identified as being conducive to poverty reduction, since these favour remunerative employment. The third venue for significant uplifting of the poor is higher levels of education. The fourth is better infrastructure. Such a study reinforces the case made above, that India will need a "big push" in market-friendly reforms that provide credit, jobs and opportunities on a massive scale, backed of course by human capital (education and health) and infrastructural development.

India Needs to Change Its Strategy in the WTO

New reforms need to be complemented by equivalent external liberalization.

The truth is that India remains among the most protected emerging economies in the world. Although it has substantially reduced its applied tariffs, its average of 14.5 % remains high by international standards, even though average rates in manufacturing are at 11.5 %. Furthermore, India has not bound its tariffs at those levels. Binding is a technique in the WTO by which countries commit never again to raise tariffs above a given level. India's policies here mean that there is a risk of a reversal of policies, which maintains an uncertain trading environment. Uncertainty is a major deterrent for business and for investors.

India's agricultural protectionism has nothing to envy Europe's or Japan's. It is a drag on the much-needed modernization of India's agricultural sector, since it shields the Indian producers from international competition and maintains the status quo, while rich country protectionism is an expensive and wasteful luxury that came after the agricultural and industrial revolution had occurred. India's average applied tariff in agriculture is 34.4 %, with peaks running above 100 %. India has even increased agricultural protection over the last years. India has bound tariffs in the WTO at an average of 114.2 %, which means there is still much more room for erratic tariff rises in agricultural products. In a time of economic crisis, such rises are more likely to occur. As non fuel commodity prices are projected to fall by 29.1 % according to recent IMF estimates, Indian producers might well be tempted to ask for more protection to prop up prices. Soya oil imports have already been subject to higher tariffs.

India's protectionism is also reflected in the fact that it is one of the most active users of antidumping measures in the world. Add on top of it, India's often inefficient and corrupt bureaucracy, as well as its complex web of regulations, then trading with India becomes an extremely difficult task. The World Economic Forum's 2008 Global Enabling Trade Report ranks India 71st out of 118 in its overall trading environment. The ease of access to its market is ranked an appalling 105th, and tariff and non-tariff restrictions on trade are ranked 112th. Import protectionism has an inherently deterring effect on a country's exports. This contributes to explaining why India still only represents one percent of world exports in goods, in contrast to China's 8.7 %. And if it can be proud of its performance in the services sector, its 2.7 % of world export share must be compared with China's 3.7 %.

> The WEF's 2008 Global Enabling Trade Report ranks India 71st out of 118 in its overall trading environment

In this context, India should progressively reduce tariffs and ideally move towards duty-free trade, in particular in manufacturing, if it wishes to boost labour-intensive manufacturing, create jobs, and improve the welfare of its consumers. Liberalization of agricultural imports will be crucial to boost the competitiveness of India's agricultural sector. Reduction of administrative barriers to trade will entail significant streamlining of its bureaucracies. India's liberalization measures must be bound in the World Trade Organization. India's government has signed or is negotiating bilateral free trade agreements with countries in its neighbourhood, and in Asia. But except in the case of its agreement with Singapore, India's free trade agreements can be easily dismissed as bogus. They hardly open India's markets further, in particular not where it is most needed such as agriculture, let alone services. India and its main trading partner, the European Union, have plans to sign a comprehensive free trade agreement. But how will they ever be able to reach an agreement that makes sense if they can't agree on the basics in the WTO? Clearly, for India, opening up needs to start at home.

India's FDI regime will require further opening as well. Energy, public utilities, retailing, and public transport should be opened further, with clear, simple, transparent rules. The crucial reforms in the financial sector sketched in this article will need to be backed by a bold opening up to foreign competition. This would not mean that financial regulation or supervision should be relaxed. The aim is rather to have more actors in the financial scene competing for India's customers and thus offering them the diversified modern services they now require. Existing caps on foreign investment in banks and financial institutions (generally limited to 26 % of foreign ownership) need to be removed. Obstacles to the organic growth of foreign banks – such as restrictions on branching – must be reduced as well. Reforming India's financial sector is a necessary complement to an export-oriented manufacturing growth strategy. China is now paying the price of neglecting its domestic consumers and the growth of a job-providing services sector. A sophisticated financial sector is at the heart of such a consumer-oriented growth. India should avoid making the same mistake as China. As highlighted above, India is now a very powerful member of the WTO. As Doha stalls and the G-20 group of leading economies to which India belongs last November pledged to keep their economies open and finalize the Doha Round, India is in the limelight to show it means business and is capable of the vision its leadership claims would require. India should not wait for others to act. The policies of its commerce ministry at international level have an old-fashioned whiff of "third-worldist" defence of the cause of the poor and wretched. As this article has demonstrated, however, India's protectionism, in particular in the agricultural sector, is in fact what Amartya Sen termed "friendly fire". It is one of "the very institutions that were created to overcome disparities and barriers" that "have tended to act as reactionary influences in reinforcing inequity."[2] India's protectionism is not only inequitable, but also simply inefficient.

India as many other countries, is currently tempted by protectionism. The recent Indian ban on imports of Chinese toys, and the imposition of a countervailing duty on steel imports from China are such a manifestation. This is crowd-pleasing and interest-group-coddling policy. But it is counterproductive.

In the current climate of economic gloom and scepticism towards global capitalism, to recommend liberalization is certainly not popular. Yet protectionist subsidies-heavy domestic policies looming across the globe risk only prolonging the global downturn and transform it into a long and entrenched depression. India in particular has a major stake in having access to foreign markets and in increasing productivity at home if it wants to continue on its road to sustained economic development.

It is time now for India, graced by the solidity of its civilization and democratic institutions, to embrace the 21st Century with the "dynamic outlook" called for by its first Prime Minister. We now know that it is not the state-led planning he had in mind that does the job of nurturing such an outlook, but opening up to the world economy. By engaging constructively in the WTO, India would also demonstrate it is capable of the kind of vision one would be pleased to see in dynamic new leader in the international arena. IER

Endnotes

1 Petia Topalova (2008), India: Is the Rising Tide Lifting All Boats? IMF Working Paper WP/08/54

2 In Amartya Sen (2005), "The Argumentative Indian. Writings on Indian History, Culture and Identity", p.218

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