FP
Foreign Policy

India's Unfinished Business

Nobody jokes about the "Hindu rate of growth" anymore. But with hopes for further reform fading in New Delhi, will the Indian economic miracle come to an early end?

BY ARVIND PANAGARIYA | NOVEMBER 4, 2010

When U.S. President Barack Obama arrives in Mumbai Saturday, he'll be landing in what remains one of the poorest countries in the world, with urban slums that stretch for miles and a rural landscape that remains remarkably similar to that in the days of the British Raj. For all you hear about Internet start-ups and high-tech call centers in Bangalore and Chennai, India currently accounts for just **2.25 percent** of the world's GDP and 1.3 percent of its merchandise exports. It ranks 11th worldwide in absolute GDP and **161st** in per capita GDP. Its economy is less than one-tenth the size of America's, but its population is more than three times as large. So why all the hype?

The United States and many other countries are betting on India not because of where it stands today, but where they see it going in the next 15 years. In real dollars, India has grown at an annual rate exceeding 12 percent during the last seven fiscal years. Even going by the conservative assumption that the country will grow 10 percent per year in real dollars over the next 15 years, it will grow from $1.3 trillion in fiscal year 2009-2010 into a $5.5 trillion economy by 2024-2025. Depending on how Japan does during these years, India would then have either the third- or fourth-largest economy in the world.

American perceptions of India are also shaped by the large number of highly successful Indians, the vast majority of them first-generation immigrants. While the presence of Indians in the United States is not new, their phenomenal success is. Over the last 15 years, their influence in the tech and finance industries and higher education has grown as that of no other single immigrant group -- Ajay Bhatt, inventor of the USB port, Vikram Pandit, CEO of Citigroup, and Indra Nooyi, CEO and chairperson of PepsiCo, are today sources inspiration across America. At any given time, there are 100,000 bright Indian students studying at U.S. universities. They promise to be a part of the highly mobile international labor force that will play a decisive role in designing tomorrow's global economy.

A final factor driving American perceptions of India is the resilience of its democracy during the 63 years of its post-independence existence. Its vast size and diversity notwithstanding, India has remained a vibrant democracy with a fiercely independent press and judiciary and growing oversight by NGOs. Its superior economic performance in recent years has also put paid to the notion that democracies are inherently incapable of the kind of miracle-level growth that South Korea and Taiwan achieved in the 1960s and 1970s and China has been clocking over the last three decades. Unlike authoritarian China, which seeks to be a rival power and has adopted an increasingly belligerent posture in the region, Indian democracy promises to be accommodating and friendly.

But none of this will matter if India fails to fulfill its economic promise. As the **recent revelations** about corruption and mismanagement of the Commonwealth Games dramatically showed, India's government still has a long way to go -- the country's phenomenal success over the past two decades has come largely because its politicians and bureaucrats have gotten out of the way. Fortunately, there are four powerful reasons why India will forge ahead, regardless of what happens in New Delhi.
First, except in agriculture, India is now highly open to trade. Trade in nonagricultural goods and services and the flow of portfolio and direct foreign investment are now almost as free in India as in China. Restrictions on outward investment by Indian multinationals

have also been considerably relaxed. The result has been India's rapid integration into the world economy: Trade in goods and services as a proportion of GDP has risen from just 17 percent in 1990-1991 to 53 percent in 2008-2009, and foreign direct investment has risen even faster, from $0.1 billion in 1990-1991 to $64.1 billion in 2009-2010. Not just private Indian companies like Reliance Industries Ltd. and Tata Motors, but also public sector enterprises such as the Steel Authority of India and Bharat Heavy Electricals now compete against the world's best, forcing them to be efficient and productive.

Second, while the Indian government's ability to deliver pales in comparison to that of China, India's dynamic entrepreneurs shine in comparison to their hidebound Chinese counterparts. Even with their hands (and feet) tied by the government's command and control regime, these entrepreneurs founded new business groups such as Reliance, Goenka, and Khaitan and built up existing ones such as Tata and Birla. And as the lifting of the government's heavy hand has freed up the economy's "animal spirits," India's new openness has brought supercompetitive foreign entrepreneurs onto Indian soil. This mix promises to channel savings into highly productive investments.

Third, India's savings rate has **climbed steadily upward**, reaching 33 percent in 2007-2008 from 22.8 percent a decade earlier. Rarely if ever does a country's savings rate collapse quickly after reaching such a high level. So it's a safe bet that savings, and therefore investment, will remain a driver of India's fast growth.
Finally, India has a young population that is growing younger. The dependency ratio, defined as the number of dependents per 100 working people, fell from 66.33 in 1998 to 57.5 in 2008 and is continuing to fall. More importantly, the vast majority of those dependents were below age 15 in 2008. Over the next decade and a half, most of these youth will join the workforce. Labor shortages will not hold India back.

Can India do better? The answer is an emphatic yes. India's economy is still predominantly rural, with more than half of the workforce employed in agriculture, compared with 39.5 percent in China as of **2009**. India's manufacturing sector is another disappointment. In most poor, heavily populated countries that grow rapidly, manufacturing leads the way. For example, the share of manufacturing in South Korea grew from 17.7 to 26.6 percent GDP and 9.4 to 18.6 percent in employment between 1965 and 1975. But in India, manufacturing's share of GDP remained unchanged between 1993-1994 and 2004-2005, while the sector employed only a slightly larger percentage of the Indian workforce. The result: 58.5 percent of Indian workers were still in agriculture in 2004-2005. The dismal growth in manufacturing has also meant poverty in India has declined more slowly than in other fast-growing economies.

It's no mystery why this is the case: India's stringent labor laws, one of which makes it virtually impossible for firms with 100 or more workers to respond to changing market conditions with layoffs, have greatly inhibited the growth of labor-intensive industries like clothing manufacturing. On average, firms in India's apparel sector are much smaller than not just those in China, but also those in Bangladesh and Sri Lanka. Consequently, India exports about as much clothing each year as Bangladesh, which is one-seventh its size in terms of population and one-tenth as much as China.

The list of unfinished reforms in India remains long. The most important ones include cleaning up growth-inhibiting laws relating to land and labor markets, privatizing state-run manufacturing firms and banks, allowing foreign investors to fully enter the retail sector, reforming the higher education system while improving the quality of primary education, overhauling the health sector, eliminating regressive subsidies on food, fertilizer, and electricity, and building major infrastructure, including roads, ports, airports, and electric power generation.

There's a chance that during President Obama's visit the government will announce its intention to open the retail sector to foreign investors. Some partial privatization is also under way. But beyond these measures, critical reforms remain unlikely under the present government, whose left wing opposes free market policies. This means further acceleration of growth is unlikely. The good news, however, is that with considerable external and internal liberalization already in place, significantly increased savings rates, and favorable demographics, India's future looks bright indeed.

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