India's Parallel Economies

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India's rapidly changing economy is increasingly on our minds. As I introduce the big picture, it will be evident that what we read about in mainline magazines is part of a bigger story – of India's "parallel" economies in which nearly 750 million of its 1 billion people (many of them concentrated in a few huge states) live in rural poverty with high illiteracy rates alongside a modern urban economy with a growing middle class and a growing number of world class IT software, pharmaceutical and steel firms thrive on India's rich base of technically skilled, English-speaking engineers and university graduates.

My assignment today is to talk about India's demographic, economic and political environment. In short, my focus is on India's economic growth; why is it now one of the world's major emerging economies and will its growth continue? To tackle this subject I use a "sources of growth" framework. What do we need to know about labor, capital and natural resources inputs; about institutions and about the prospects for technological change that in the end determines whether an economy's growth will be sustained in the long term?

First a little history. When British rule ended early in the post-war period the newly-independent Indian government adopted a Soviet- style planned economy. Capitalism was tolerated but government was determined to curb its individualist excesses through oversight and controls. During much of the 1950-1970 period, India's growth strategy was go-it-alone, substituting domestic industrial production for imported goods. The economy muddled along, depending heavily on trade with the Soviet Union and government stimulus to keep growth going as it suffered through a series of droughts and crop failures.

When the Soviet Union collapsed in 1990, India's main export market went with it making it impossible to meet import bills. The country plunged into a balance of payments crisis. Manmohan Singh, the current prime minister, was finance minister at the time. He used the crisis as the rationale for reforms that introduced market forces into the external sector (removing import controls, reducing customs duties and allowing more flexibility in the exchange rate regime. Licensing controls on private investment were abolished, taxes were cut and some public sector monopolies were dismantled). Since then, on a PPP basis, the economy has almost quadrupled in size since (from $1 Tr to $3.8 T in 2005).

But some major challenges persist. One is fiscal deficits. Government borrowing crowds out private sector borrowing and deficits hamstring publicly-funded infrastructure modernization initiatives. India is similar to Canada with a federal structure. India's consists of weak coalitions at the center and strong states, many of which spend more than the revenues they take in.

A second challenge is population growth. If growth continues at 2 percent a year, the 1990 population will double to 1.7 billion people by 2031 (recall that 70 percent+ still live in the countryside; nearly a third still live in absolute poverty).

Nevertheless, the economy has opened up and trade and FDI flows have risen. India shines in services trade and investment but lags in merchandise trade which accounts for only about 20 percent of GDP. Goods exports account for only 9 percent of GDP, a ratio that has grown little in nearly 15 years. Even in markets like the global market for garments where it has comparative advantage market share has changed little over the years—the share was 4 percent in 1980 and 5 percent in 2000. Why the lack of international competitiveness? India's manufacturing existed for many years behind a wall of protectionism that is part of the socialistic legacy of the past. While the "license raj" (bureaucrats controlled licenses to import and export) was largely dismantled in the 1990s, an "inspection raj" persists in many states which continues to erect informal barriers to private businesses.

India’s notable economic and trade success lies in knowledge-based, particularly IT, services exports. Software exports accounted for more than a third of the $20.3 billion earned from services exports in 2001-02, followed by travel and tourism. Services imports are about 80 percent ($16 billion) of its exports; half of these imports are transportation, travel and financial services.

What are some of the reasons for this success?

- English language, common law and the supply of technically trained post-secondary graduates; and
- the perverse impact on entrepreneurs of India’s regulatory thicket. Restrictions protected goods production and trade but encouraged the IT revolution. In the 1970s the hindu nationalist BJP government required foreign multinationals to dilute their equity holdings in their Indian subsidiaries by selling shares to Indian investors. Rather than comply, IT companies like IBM left the country and created a vacuum that Indian firms moved to fill. Some of these firms also entered the IT sector in reaction to India’s restrictive trade regime which made it difficult to import and export hardware. Some persisted and built hardware businesses anyway. Others shifted to software and what goes on inside computers, creating a “virtual” industry that was free of the regulatory and infrastructure obstacles obstructing merchandise trade.

Since trade liberalization began in 1991, the services sector has grown at 9 percent a year accounting for nearly 60 percent of overall economic growth. Services exports grew at over 17 percent annually, mainly supplying business process outsourcing services and IT to offshore customers.[1] NASSCOM (the National Association of Software and Services Companies, the IT industry association), and McKinsey Consulting predict that India’s exports of back office and remote services such as parts procurements for manufacturers will be a $60 billion business by 2010.

[1] Compared to 16 percent growth in China, 7 percent in Canada and 6 percent in the United States.

Yet this dynamic outward-oriented sector has limited linkages with the domestic economy. For example, during the rapid growth in output and exports in the 1990s the sector's share of total employment declined. By recent predictions in 2007-08 India's IT offshoring sector will have a work force of only 1.45-1.55 million people but generate 7 percent of India's GDP. It also faces labor supply constraints: wages and turnover in the engineering talent pool are rising. While India produces hundreds of thousands of engineers annually, graduates from institutions outside the Indian Institutes of Technology lack comparable skills and facility in English.

India's future prospects

India's living standards today in dollar adjusted terms are where China was in 1986 when it was still early in its reform process. Like China, its future economic prospects depend on government's willingness to continue with economic reform.

India's labor force is around 400 million people but only 7 percent of the jobs are in manufacturing.[2] The Tenth Plan (2002-07) calls for the creation of 100 million jobs in the industrial sector in the next decade. Between 75 and 110 million labor force entrants are expected in that period, which means that around 145 million new jobs need to be created just to keep unemployment from rising. If this is the challenge, can India meet it?

Capital and India's financial system

India's financial system is quite good at mobilizing and allocating capital, but savings and investment rates are low. The savings rate, at around 25 percent of GDP, has risen in the past few years but the investment-GDP ratio is around 22 percent, a four point decline since the mid-1990s, partly due to fiscal crowding out. Savings are intermediated by one of the most mature and diversified financial systems in the emerging market economies.

The banking system is sound, perhaps too sound, absorbing resources that could be better

[2] One basis of comparison is China. In 2000, China's labor force numbered nearly 800 million people; urban manufacturing provided one hundred million jobs.

deployed elsewhere in the economy. It is heavily regulated, banks are highly risk-averse and ¾ of total bank assets are held in 27 majority state-owned institutions. The other quarter of bank assets are held by 40 private sector and 33 foreign banks.

The traditional view of the Reserve Bank of India (RBI), the banking regulator, is that banks should assist economic development. Thus governments rely heavily on the banks to buy their bonds issued to finance their deficits (up to 40 percent of the assets of some banks are tied up in government paper). The RBI also presses banks to charge low interest rates on loans to agriculture and small enterprises.

Banking reform is slowly gaining ground as new entrants fan the winds of competition and as the RBI seeks to consolidate the less efficient institutions. Nearly 40 of India's banks are listed on the stock exchanges and 59 are sufficiently transparent that they are publicly ranked and scrutinized by financial analysts. A 2005 Roadmap for foreign banks gives domestic banks until 2009 to shape up before foreign banks are allowed to acquire up to 74 percent ownership of private sector banks.

The insurance sector is no longer a state monopoly but is still heavily regulated. Rules for foreign ownership are less restrictive than for banks giving insurance companies an edge in growing their businesses. Private domestic and foreign financial services firms are slowly gaining market share by providing consumer financing, consumer leasing, investment banking, underwriting, portfolio management, venture capital and foreign exchange advice all through a mixture of both state-owned and private entities.

The *Economist* recently lauded India's capital markets as the jewels of the financial system. They are among the most dynamic in the world: the corporate bond market is extremely lively; more than 5000 companies are listed on the stock exchanges, most of which are now automated.

In short, while the slow liberalization and consolidation of India's banking system is long overdue, its capital markets are well developed, diverse and contribute significantly to long-term growth prospects.

India's labor markets

Low cost labor is abundant. But don't make the mistake of some observers who conflate this abundance into an economic strength. There are distortions on both sides of the labor market. On the supply side is a skills distortion. India's education system produces hundreds of thousands of engineers each year, but its accomplishments in basic education are dismal. In 2000, only 46 percent of India's children had five years of primary education. Female literacy is only 70 percent of male literacy.

On the demand side, there are outdated restrictions imposed to protect labor that make it a fixed rather than variable cost of production. Companies with more than 100 employees must obtain approval from state governments to lay off workers. Other rules restrict certain sectors to inefficient small scale production. Perhaps appropriate to circumstances in the 1930s, these restrictions have the perverse effect of undermining incentives for the private sector to hire new workers and generate new jobs. Most jobs are therefore still in the informal sector.

Despite the ambitious Tenth Plan jobs goal and a clear call for jobs and basic health and education services from the electorate in the May 2004 election, the best the central government has been able to promise is 100 days of paid work a year in a (public sector) job for every low income person who wants one. Even this promise has been watered down in Parliament.

The role of technology

Some of India's basic institutions do encourage innovation and there is a rich entrepreneurial history despite the many bureaucratic obstacles. India also has a growing middle class that often prefers Indian to international brands; sophisticated domestic competition exists in the automotive engineering design, IT software, communications, and in deregulated parts of the financial sector. There is a strong legal framework but there is also a huge backlog of cases before the courts. The post-secondary education system generates the skills on which India's offshoring services revolution has been built. India's venture capital markets make it possible for entrepreneurs to create startups and find financiers who can plan an exit through IPOs in the stock markets

A key criticism of Indian R&D tends to be that Indian firms under-invest in innovation and new technologies, with most of their expenditures aiming to adapt existing technologies and products to the Indian market. As a result of intense lobbying by the auto and pharmaceutical industries, recent tax and patent law revisions are beginning to change that. Indian companies are now beginning to spend on R&D due to recently-introduced tax reductions and accelerated depreciation for R&D equipment purchases.

Political Institutions

India's strengths in finance and its rapid emergence as innovator in IT and commercial services have drawn international attention to it as an emerging economic colossus. These predictions overlook the role of other institutions which "intermediate" the creation and diffusion of new ideas and technologies. While India's is a market economy, there is a striking gloominess among many observers about the slow decline in its democratic institutions and public service. "Attitudes", a code word for corruption and vested interests put sand in the wheels of change and distort economic decision making. One of India's most persistent constraints is the informal self-serving arrangements among politicians and bureaucrats that have grown up in its import-substitution socialist past. Bureaucrats have taken their role in regulating markets so seriously that dislodging them after 50 years is a nearly impossible task. The administrative vacuum left by the British, according to one astute observer, was filled by the *neta babu raj*. *Neta* refers colloquially to politicians and *babu* is the term for bureaucrats. They scratch each other's backs; the civil service, instead of keeping an eye on the national interest in dealing with politicians, has joined hands with them in pursuing their own interests. There are of course significant exceptions, but economic change is obstructed at every turn by deeply vested interests in the status quo.

Change has come about in spite of these problems, in part through evasion of the increasingly dated bureaucratic restrictions, rather than confronting them head on.

A central question about India's future prospects is whether vested interests will permit sufficient reform to sustain long-term growth. Some observers look hopefully at the rising cooperation with China as a new source of dynamism. In April 2005 both country's leaders signed a watershed accord that is spearheading closer cooperation. Prior to the summit a Joint Study Group (2005) published an exhaustive analysis of bilateral trade, FDI and economic cooperation and an examination of a possible bilateral free trade agreement. Trade is growing at double digit rates. Two-way FDI flows are growing.

The best known Chinese investment is telecom equipment manufacturer Hauwei's multi-million dollar investment in a major R&D unit in Bangalore to tap India's talent pool. Another firm, ZTE, has licensed technology to ITI, a government-owned manufacturing firm in India. Most of India's leading IT firms have established R&D centers in China and Indian machine tools manufacturer Bharat Forge has gained control of China's largest forged components unit.

Conclusions

There are good reasons to hope. India's services successes are built on its large pool of post-secondary graduates with technical qualifications and good English language skills, on collaboration with most of the world's leading IT firms, and on government decisions to avoid the restrictions that have hampered traditional industries. India is good at channeling savings to productive uses. Its financial system is vibrant and diverse but the state-owned banks are weighed down with domestic debt and state-ownership continues to dominate the banking system. It has a growing host of dynamic entrepreneurs.

To solve its poverty and unemployment problem, India needs a labor-intensive manufacturing miracle similar to China's. The Commerce Minister aspires to a "techno-manufacturing future", and indeed in the past year the sector expanded at a 10 percent rate. Demand for Indian made mobile phones is exploding. But it won't create the jobs.

To do that India needs to open the economy further to international competition through FDI and trade, and invest in an education system that abolishes illiteracy and supplies low-cost skilled manpower (which should include many young women). To do that, government should withdraw further from ownership and regulation and resolve its budget problems so that it can finance universal basic education and tackle the infrastructure bottlenecks that afflict manufacturing and agriculture exports (India's infrastructure services are 50-100 percent more costly than China's).

It is unrealistic to assume that India will miraculously transform its entire economy in the next decade (but it might!). Vested interests (socialist and communist parities, NGOs AND India's long-established SOEs and private sector manufacturing companies) continue to slow progress. But India's democracy just might prevail. As more people taste the fruits of growth, their demands for better lives could outweigh the interests of the defenders of the status quo.