Thursday May 1st

Maybe the Whole World is Developing
After all: India

- We have seen that India is an example of a country that was deindustrialized as a result of the 19th century industrial revolution and associated agglomeration economies (it had a significant textile industry prior to the emergence and dominance of Lancashire), together with the power imbalance that developed vis-à-vis the West.
- The evidence suggests that the gap in living standards between India and Europe wideneed swignificant relative to the 18th century norm in a clear example of divergence.

- Agglomeration economies and the transportation and information technologies of the time – plus India's lack of policy autonomy – thus go a long way toward explaining this divergence – toward explaining how it was that Lancashire deindustrialized India.
- Yet there was very considerable scope for growth.
  - Hindu and Muhgal India had banks that provided credit for trade and other activities.
  - There was a monetized economy, based on silver.
  - There was an active class of traders.
  - There was a shipbuilding, and exports were carried long distances.
- The mystery, then, is why divergence did not give way to convergence after independence.
  - Indeed, "In 1950 if someone had been asked to predict the Third World country most likely to embark on an industrial revolution and with the best prospects of fostering modern economic growth…the unanimous choice would have been India." (Deepak Lal, 1988).

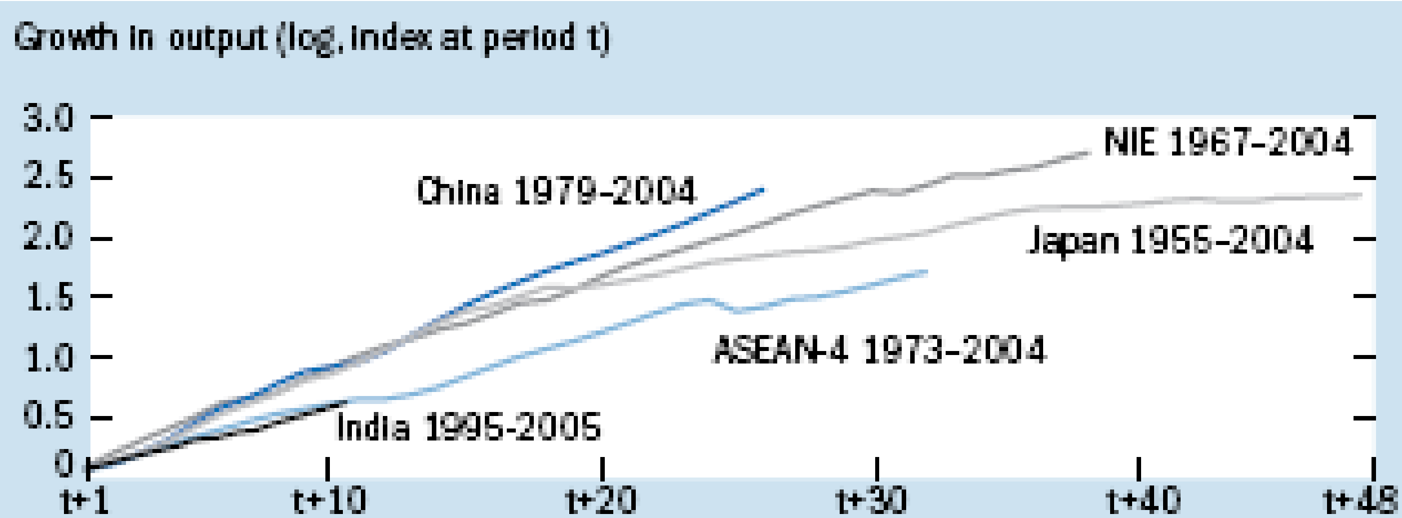
Until recent decades, there was in fact little sign of convergence

- Until the 1980s or 1990s (dates vary depending on who is writing), growth was disappointing.
  - Per capita income growth from the 1950s through the 1980s was barely 1.5 per cent p.a., which hardly made a dent in poverty.
  - In the period 1960-80, India's per capita growth rate was lower than that of the industrial countries, East Asia, China, the Middle East, and even than Latin America.
  - Of the major regions, only Africa did worse.

- There seemed to be a ceiling on feasible growth – Indian economists referred pessimistically to the "*Hindu rate of growth*."
- The economy, Greg Clark would say, seemed to be locked into a Malthusian trap.

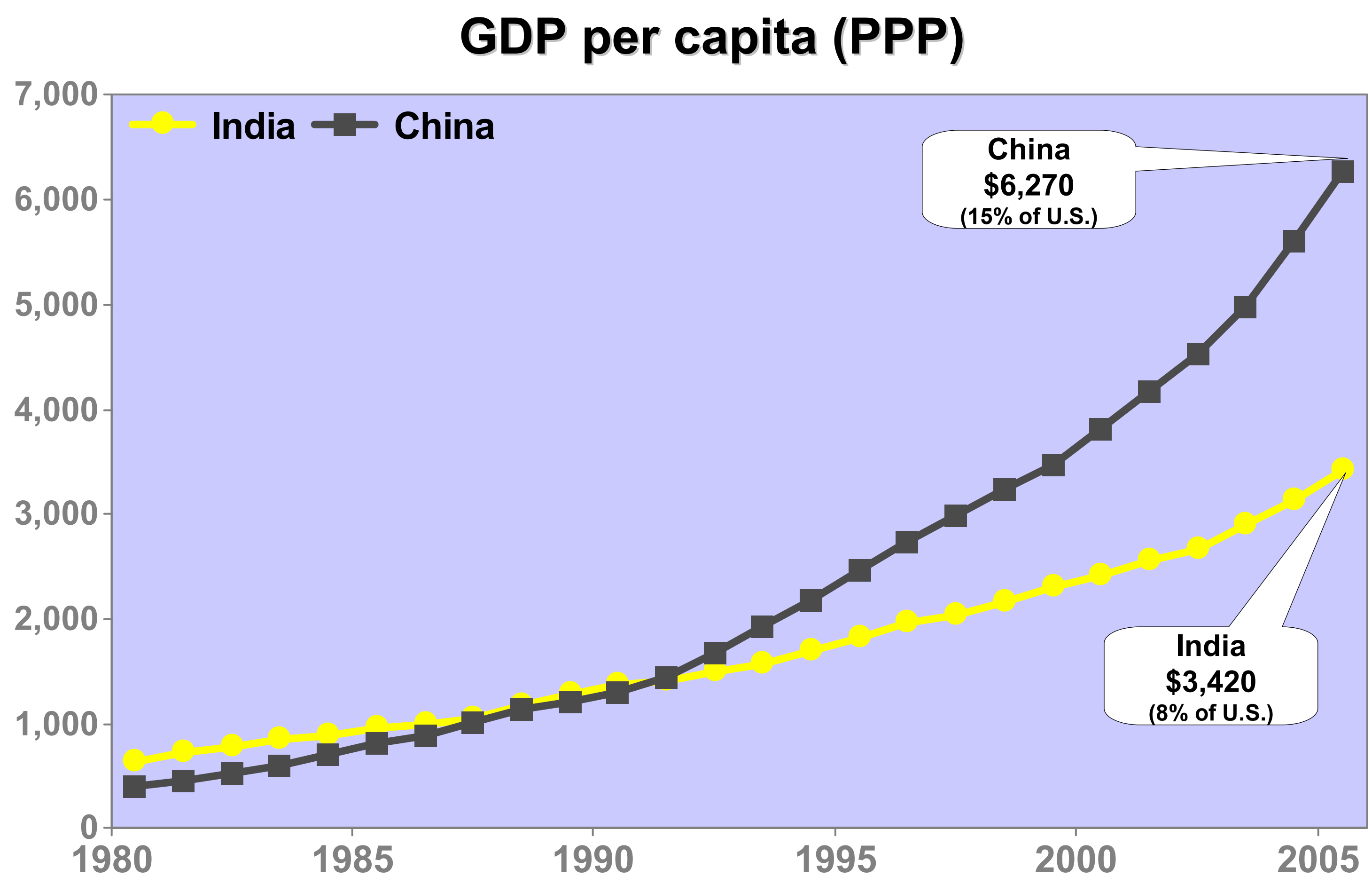
- But then suddenly, sometime after 1980 or maybe 1990, growth in per capita incomes accelerated from a disappointing 1 ½ % p.a. 1950-80 to 4-5%.
- In the last few years, growth has accelerated further: aggregate GDP growth is currently running at 9%.
- India is now widely regarded as a growth miracle.
  - So much for the “Hindu rate of growth…”

But while India is doing much better, it continues to lag behind China



Sources: IMF, *World Economic Outlook, April 2007*, and IMF staff estimates.
NIE = Newly industrializing economies. ASEAN-4 = Indonesia, Malaysia, Singapore, Thailand.

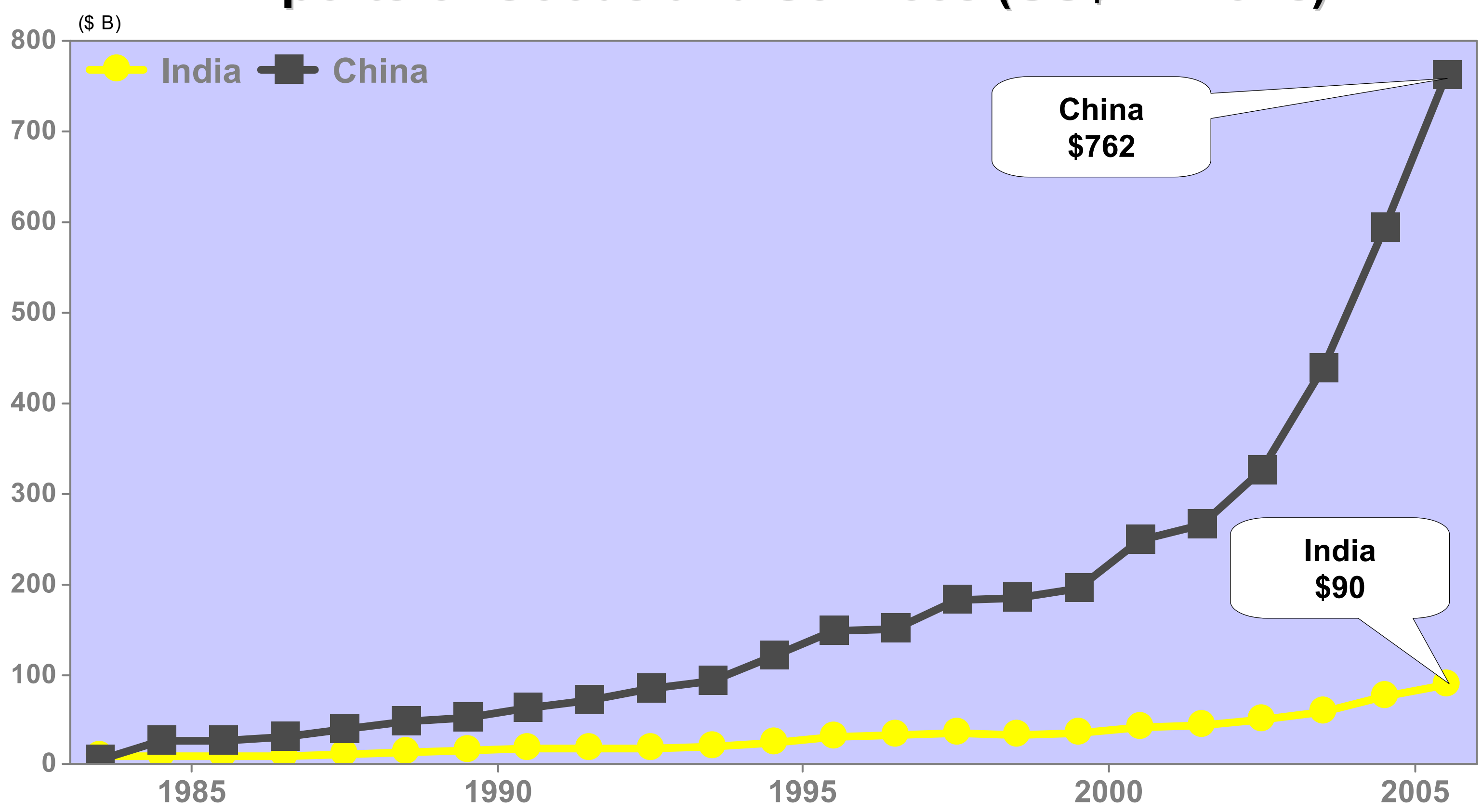
Per Capita Income: China and India



Source: EIU

Export Performance: China and India

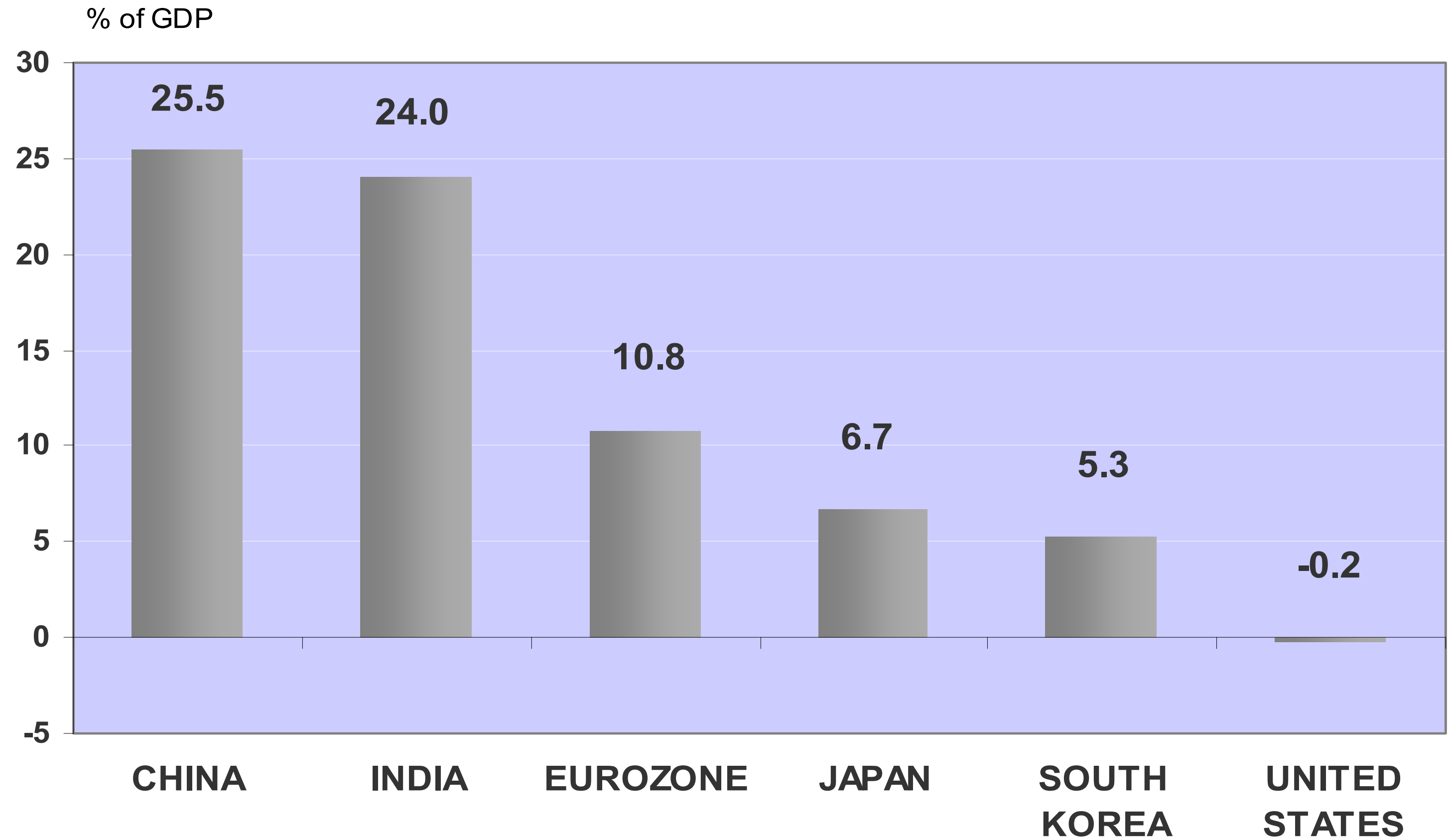
Exports of Goods and Services (US$ Billions)



Source: EIU

Household Savings Rate Comparison

Household Savings: 2005 (% of disposable household income)



Source: OECD, China and India CEIC data 2004

All this raises questions for us

- Why was so little progress in economic growth prior to 1980/1990?
- Why did the situation then change so dramatically?
- Is the fact that India continues to lag behind China simply a reflection of the fact that reform got underway somewhat earlier in China (the “just give it time” interpretation)?
- Or are there continuing structural problems in India that make for slower productivity growth, lower savings rates, and inferior growth prospects going forward, compared to China?
- Or, to the contrary, do India’s position in the service sector, its demographic profile, the fact that it is a political democracy give it advantages going forward?

Why so little progress prior to 1980? We discussed this earlier…

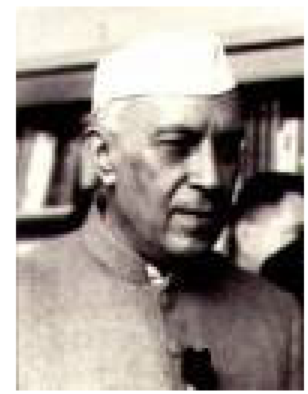
- Recall the argument that Europe's state system, grounded in its geography, provided just the right mix of competition and cooperation.
- Competition disciplined policy: it required the state to foster a stable economic environment or risk losing its valued workers and entrepreneurs to its neighbors.
- But these states were also able to cooperate in extremis (for example, to fend off external threats from, inter alia, the Ottoman Empire).
- In India, in contrast, the various nuclear areas, featuring relatively dense settlement and a cohesive state, neither competed nor cooperated effectively with one another.
- A paucity of navigable rivers, compared to both Europe and China, made internal communications exceptionally difficult.
- These nuclear areas were separated by wide belts of desert, hills or jungle.
- These areas were impossible to subdue – they were characterized by the absence of a state.
- So the different nuclear areas were isolated.
- They didn't have to compete for skilled workers.

- The result was undisciplined government heavy on conspicuous consumption.
- There was no written legal code, no system of contract enforcement.
- Little was spent on providing productive infrastructure.
- These nucleated states were unable to cooperate in resisting outside threats such as the Mughals and the British. Policy autonomy, which we have argued is needed to promote economic development, was a casualty.
- And then there was the burden of the caste system, with its endless restrictions on economic activity and mobility, which we discussed before.

This situation of course changed in the 20th century

- But India's nucleated polity was forceably integrated from the late 19th century first by British colonial rule and then by technology (railways, roads, airplanes).
- After independence, there was healthy competition among Indian states (like competition between US states) under the umbrella of a democratically-elected central government.

- The question is why India’s first generation of post-independence leaders, like Jawaharlal Nehru, did not jettison this burdensome legacy.
- They did abolish the caste system (although old prejudices lingered).
- But they did not abolish the legacy of intrusive, hyper-regulation of the economy by government – this being the burden that most economists feel held back progress in the early post-independence decades.



To the contrary, government intervention in the economy became very pervasive

- Government sought to promote the growth of heavy industry in the Soviet mold (iron and steel, defense industries, etc. – the security situation following partition clearly being part of the motivation).
- A series of five year plans were developed to direct resources toward heavy industry. The financial system was repressed and heavy regulation was used to implement the plan.
- The government built advanced institutions of higher learning (on the model of MIT) to provide the technically skilled workers needed to support these activities (where it could, arguably, have better used some of those resources to invest more in primary and secondary education).
- The government also sought to protect small firms, whose owners and workers were politically consequential, with “reservations” (reserving certain industries for small firms, either partially or entirely – and barring large firms from entering and competing) and restrictions on layoffs for employees (see above).
- To make all this work, the government was forced to limit foreign competition.

Side effects of these policies and plans were not positive

- Critics referred to this intrusive system of reservations and central planning as "*the license raj*."
  - Licenses for investment and imports were vetted one by one by undertrained bureaucrats. Delays were endless. Costs were enormous. Opportunities for corruption were extensive.
    - As late as 1990 permission was required for all investment outside of 18 narrowly defined industries (where investment was unrestricted, because these were viewed as priority industries).
  - Inward *foreign direct investment* (FDI) was restricted.
  - Banks were used to advance the government's industrial policy. They were required to keep half their deposits as reserves and turn these over to the authorities, which used them to stimulate the development of particular industries.
  - Restrictions were placed on firing workers for all firms with more than 100 employees.
  - Reservations for small firms confused labor-intensity with scale. Big firms can adopt labor intensive technologies too, and often at lower cost (by exploiting scale economies).
- One can imagine how this didn't make for a very flexible, efficient or innovative economy.

Understanding these policies requires understanding history

- Hostility to FDI (by multinationals in particular) reflected early experience with East Asia Company, which led to direct British colonial domination from the 1820s. Another example of very strong path dependence!
- More generally, Indian leaders were suspicious of openness: they looked back at the 19th century and saw that trade had deindustrialized the country. Nehru referred to trade as “a whirlpool of economic imperialism.”
- Independence came at a time when memories of the Great Depression were fresh and import substitution was widespread.
- Indian leaders were impressed by the Soviet Union’s success at transforming itself from an agricultural to an industrial economy in a generation and at its success by growing via resource mobilization. They also saw China, next door, attempting a great leap forward on the basis of planning.
- During WWII, the British had put in place an elaborate administrative mechanism to allocate scarce commodities (like cloth, grain and sugar), on which Indian planners could now build.

- All this resulted in a very heavily regulated economy largely closed to transactions with the rest of the world.

As a result, India did not share in the postwar growth miracle

- Between 1950 and 1974, trade grew by less than 3% a year, while world trade was growing by more than 8%.
- The export/GDP ratio fell from 7.5% to 4% over this quarter century, a period when those of virtually all other countries were rising.
- Gross investment rates were below 15 per cent and falling from the late 1960s.
- Inward FDI was nil.

Of course, in a democratic polity a government that fails to deliver the economic goods eventually gets replaced. This knowledge causes even long-lived governments to change course.

- This led to the reforms of the early1990s (triggered by a major debt crisis), which included:
  1. Poverty eradication was seen as the overarching objective of policy in India, and poverty eradication and growth were seen as potentially at odds. (Growth was never seen as having an intrinsic value in and of itself.)
  2. Dismantling import controls and lowing tariffs.
  3. Unifying and devaluing the currency; moving then to a managed float.
  4. Making the rupee convertible for current account transactions (in 1994).
  5. Abolishing licensing requirements on investment
  6. Lowering tax rates.
  7. Eliminating private sector monopolies.
  8. Reforming banking system (encouraging private banks, commercializing public banks, strengthening prudential supervision and regulation).
  9. Reducing financial vulnerabilities (like the share of short term debt in total debt)
  10. Developing financial markets (allowing firms to issue bonds, domestic securities, and ADRs).

Results

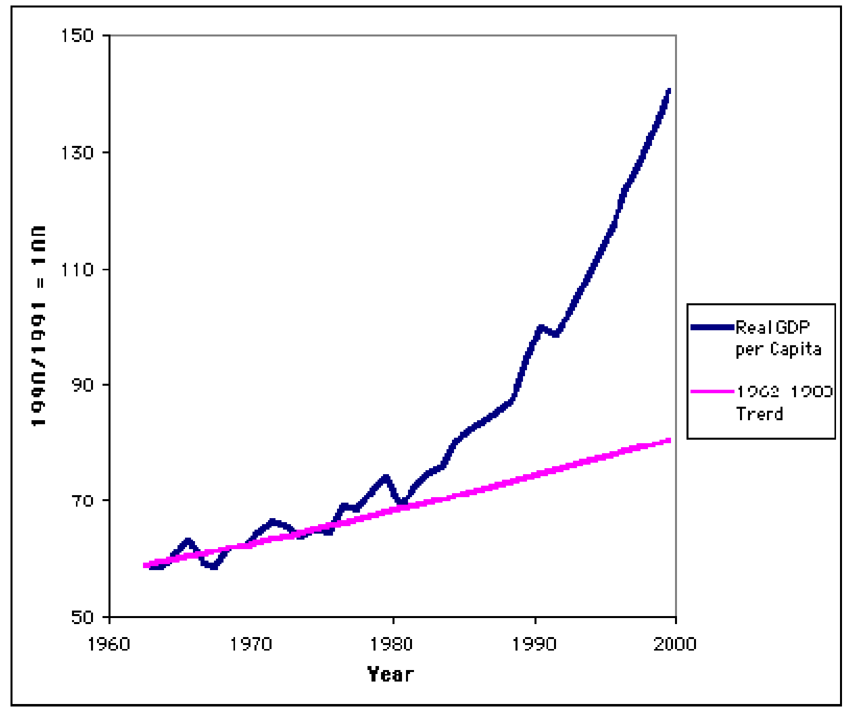
- Growth accelerated -- not to Chinese levels but at least relative to earlier Indian levels (from 2% per annum to 5-6% per annum, as noted earlier).
- There was a one-fifth decline in rates of both rural and urban poverty in the 1990s.

Then came the ICT revolution, the advent of cheap broadband due to the bubble, and large-scale outsourcing.

- New information and communications technologies enabled the production to be further fragmented, undermining the first world's advantages from agglomeration economies.
- A literate population, much of which spoke English, was a strong advantage here.
- So was an education system that focused on high-quality engineering-related skills
- A more investment-friend environment (ease of entry, low tax rates) facilitated efforts to capitalize on this advantage.
- In part reflecting the success of this sector, growth accelerated further, to 7-8 per cent in 2004-5 and 9+ per cent in 2006-7.

Or so goes the conventional account

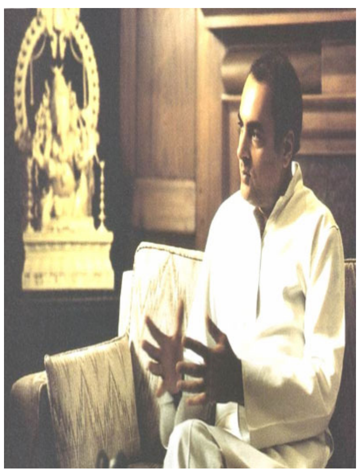
- In reality, the story is more complex.
- Actually, the acceleration of growth appears to have begun earlier, well before 1991.



The growth acceleration appears to begin in the 1980s, not the 1990s when reforms supposed commenced

Period	1950-1980	1980-1990	1990-2000
GDP growth	3.7	5.9	6.2
Per capita growth	1.5	3.8	4.5

Maybe reform still mattered, but it began earlier.



- Indira Ghandi returned to power (after 3 years in opposition) in 1980.
  - She adopted a more sympathetic attitude toward business (letting them know that arbitrary tax increases and nationalizations would be no more). Little deregulation yet, few reductions to entry barriers yet, but a more favorable environment for incumbent firms.
- Rajiv Ghandi then took power in 1984 with a big parliamentary majority (following his mother's assassination).
  - He was a new politician with new advisors.
  - He saw Japan rather than the Soviet Union as the relevant development model.
  - He implemented a modest degree of industrial regulation, import opening, capital account liberalization (something that turned out to be a two-edged sword), and tax system rationalization.

- As in China, this seems to be evidence that it is possible to unleash modern economic growth without adopting the entire Washington Consensus recipe all at once.
- In India, modest reforms convinced the public and politicians of the advantages of further reform. They allowed them to learn gradually about those advantages.
- Thus, Indira Ghandi’s pro-business policies encouraged investment by incumbent firms, which strengthened their support for yet additional reform under her son.
- There was then further reform starting in 1991 – with impetus from the financial crisis in 1990, growing evidence that liberalization was stimulating growth in China, and the collapse of the Soviet Union (which reinforced the conviction of India’s new generation of leaders of the efficacy of moving away from the old model of Soviet-style planning).

So why isn't India closing the gap vis-a-vis China?

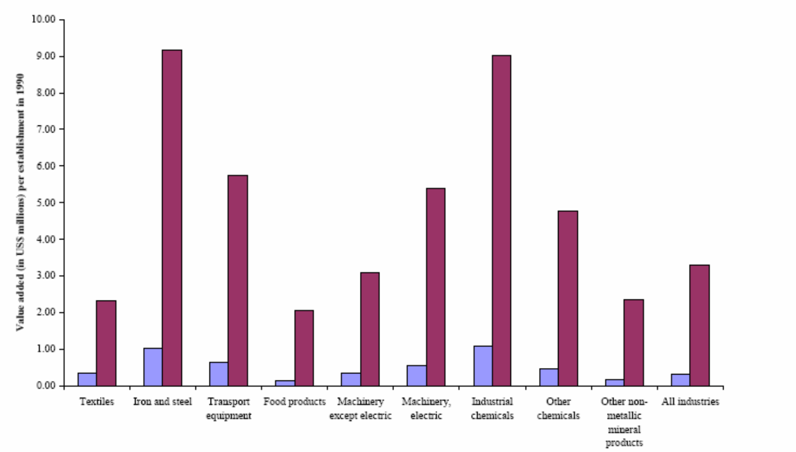
So why isn't India closing the gap vis-a-vis China?

- One answer is that this is simply an unreasonably high standard. 8-9% growth is not so bad…
- Another answer is that removing earlier distortionary policies (and reversing their legacies) is easier said than done. To whit:
  - Even today, China's trade in goods is 50% of GDP, but India's is only 20%.
  - China's tariff in 2001 was down to 13%, while India's was still 28%.
  - Inward FDI is 12% of capital formation in China, as opposed to 4% in India.
  - Large budget imbalances that helped precipitate 1991 crisis have not been cut (consolidated deficit is still running at 10% of GDP).
  - Gov has repeatedly ignored recommendations that it simplify the tax system.
  - Its spending on distorting and inefficient subsidies (mainly to low productivity agriculture) have been rising, not falling.
  - India does much better at providing highly advanced education for the elite than at providing basic education for the masses. Illiteracy rate circa 2000 was still 34% in India, versus 6% in China.
  - Legacy of earlier distorting policies is still evident in obstacles to doing business (*reservations for small firms* (barring large firms from certain industries, either partially or entirely), difficulty of separating redundant workers and hence costs of ramping up).
  - Law laws remain draconian, making it difficult for firms to adjustment employment.

Moreover, the history of earlier policies still cast a long shadow

- India's industry remains unusually capital intensive for a developing country. This is peculiar for a country that is so abundant in labor (it can only be understood as a legacy of history).
- There are lots of corner workshops and stores, but manufacturing firms are unusually large (and often slow-footed) for a country at India's stage of development (again, this is presumably a legacy of history).

Chart 1. Average Firm Size in India and Comparator Countries in 1990



Regulatory burden remains heavy

- Consider the number of days required (China versus India) to:
  - Start a business (45 in China vs. 90 in India)
  - Enforce a contract (245 vs. 420)
  - Register a property (30 vs. 60)
  - Restructure an insolvent enterprise (25 vs. 125)
- So the “license Raj” lives on
  - Constituencies develop for distorting policies
  - Again, history casts a long shadow.

And the high-tech industry is too small to make much of a difference

- Software, call centers and high-tech generally are seen as a way for India to sustain growth and lift the masses out of poverty.
- But employment in IT employment requires a college education, and only 6% of Indians have this. Is this a solution to the mass poverty problem?

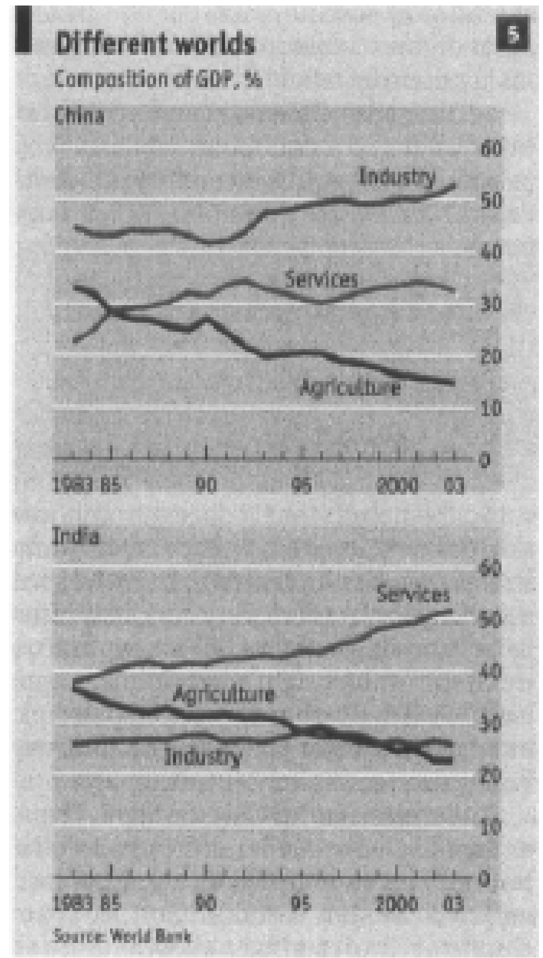
If high tech isn't the solution, what is?

- Moving the masses into better paid jobs requires moving them into manufacturing, as in China.
  - Education helps here as well, but you don't need to have completed university in order to be a productive worker in an assembly factory.

Then if high tech isn’t the solution, what is?

- Relative to China, the expansion of manufacturing output and employment in India continues to lag.
  - Share of manufacturing in GDP has remained stagnant since the early 1990s at 17% (where it has risen to 41% in China). Answer: manufacturing.

- Bottom panel shows that India has compensated for this in some part by expanding employment in services – but only part.



The problem is barriers to faster expansion of industry (these will be familiar at this point in the lecture)

- Reservations for small firms.
- Hiring/firing restrictions.
  - In principle, firms with >100 blue collar workers cannot terminate them under any circumstances.
- Large fiscal deficits absorb resources needed for investment.
- Inadequacies of infrastructure.
  - In absolute terms, China is spending 8 times as much on infrastructure.
- Underinvestment in education.
  - Illiteracy rate remains 35%, compared to just 6% in China, as noted earlier.
  - Only 50% of children complete all 5 years of primary school, compared to 98% in China.

Two final factors arguably also work in India's favor (compared to China)

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- **Demography**
  - In much of Asia, share of working-age population will peak around 2010. In China it will peak around 2015. But in India it will keep rising until 2025 or so.
  - This implies rising savings rates (according to the life-cycle model).
  - In turn this should support higher investment rates.

Two final factors arguably work in India's favor (compared to China)

- **Democracy**
  - India is a stable multiparty democracy. China, on the other hand, is an autocratic one-party state.
  - I have suggested that democracy and separation of powers is not always and everywhere necessary for the adoption of growth-supporting public policies. China is an illustration that even a government with unchecked power can opt for such policies. But it can also opt for the opposite, and there can exist no corrective mechanism.
    - No way of "throwing the bums out," as we say in American electoral politics.
    - Recall how the Ming Dynasty opted to close China to foreign trade, and there was no mechanism for correcting this mistake, which had long-lived consequences.
    - Thus, democracy could be an advantage for India.

Implications for the future

- Development policy needs to be built on two legs: industry and IT-enabled services.
  - Expanding IT means improving infrastructure and delivery of education (relaxing virtual ban on private universities).
  - Expanding industry requires lowering tax rates, streamlining regulation, improving infrastructure.
- But would this be enough? Could India expect growth “China style” to follow?
- Growth Chinese-style requires high savings and investment rates. India has the demographic preconditions for this. Does it also have the requisite policy environment? Will democratic politics be a stabilizing or destabilizing factor?