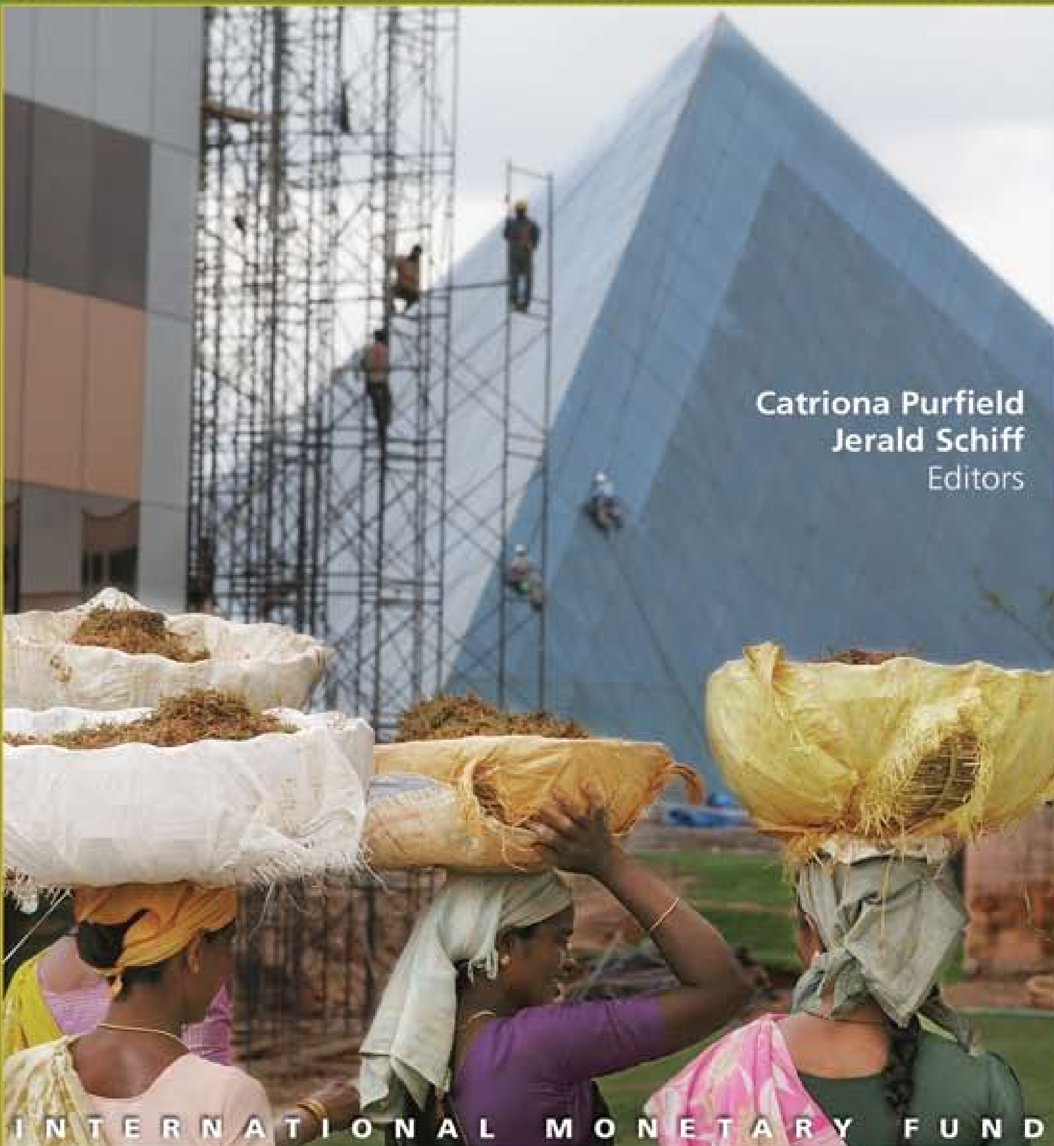
India Goes Global

Its Expanding Role in the World Economy



Catriona Purfield
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Editors

INTERNATIONAL MONETARY FUND

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- In tables, a blank cell indicates "not applicable," ellipsis points (. . .) indicate "not available," and 0 or 0.0 indicates "zero" or "negligible." Minor discrepancies between sums of constituent figures and totals are due to rounding.
- An en dash (–) between years or months (for example, 2005–06 or January–June) indicates the years or months covered, including the beginning and ending years or months; a slash or virgule (/) between years or months (for example, 2005/06) indicates a fiscal or financial year, as does the abbreviation FY (for example, FY2006).
- "Billion" means a thousand million; "trillion" means a thousand billion.
- "Basis points" refer to hundredths of 1 percentage point (for example, 25 basis points are equivalent to ¼ of 1 percentage point).

As used in this publication, the term "country" does not in all cases refer to a territorial entity that is a state as understood by international law and practice. As used here, the term also covers some territorial entities that are not states but for which statistical data are maintained on a separate and independent basis.

Preface

The team at the IMF that has worked on this book has been extremely fortunate to be involved with India precisely as it emerged as a global economic power. In the last several years, India has opened itself to the global economy and become one of the world's fastest growing economies, the leading outsourcing destination, and a favorite of international investors. At the same time, India faces daunting challenges as it seeks to continue to integrate with the world economy, sustain rapid growth, and improve the well-being of all its citizens. The studies in this book document and analyze India's impressive achievements, while examining the important and difficult steps that remain to consolidate and build on these gains. It is our hope that these studies can contribute to the vibrant public debate—both within India and outside—on the direction of economic policy in India.

This book grew out of the IMF staff's ongoing policy dialog with the Indian authorities, in particular at the Ministry of Finance and the Reserve Bank of India. The focus of several chapters was suggested by officials from these agencies, while other chapters benefited from a stimulating exchange of views as well as specific comments and suggestions made by the staff of the Reserve Bank and Ministry of Finance on earlier drafts. The Office of the Executive Director for India at the International Monetary Fund, headed by B.P Misra, has been instrumental in facilitating this dialog while providing helpful input into our work. Wanda Tseng, Deputy Director of the IMF's Asia and Pacific Department, who has led the department's work on India for several years, provided critical intellectual leadership for the project. Rabin Hattari, Yuko Kobayashi, and Nong Jotikasthira provided outstanding research and administrative assistance. Esha Ray provided invaluable support in editing the book and coordinating its production.

Abbreviations

AETR	Average effective tax rate
ASEAN	Association of South East Asian Nations
ATC	Agreement on Textiles and Clothing
BPO	Business process outsourcing
CAR	Capital adequacy ratio
CIT	Corporate income tax
CPI	Consumer price index
CSO	Central Statistical Organisation
CST	Central sales tax
CV	Coefficient of variation
ECB	External commercial borrowing
EPW	*Economic and Political Weekly*
EREER	Equilibrium real effective exchange rate
ETE	Export tax equivalent
EU	European Union
FDI	Foreign direct investment
FICCI	Federation of Indian Chambers of Commerce and Industry
FII	Foreign institutional investor
FIPB	Foreign Investment Promotion Board
FRBMA	Fiscal Responsibility and Budget Management Act
FRL	Fiscal responsibility legislation
G-5	Group of Five
G-7	Group of Seven
GDP	Gross domestic product
GNI	Gross national income
GMM	Generalized method of moments
GSDP	Gross state domestic product
GST	Goods and services tax
GTAP	Global Trade Analysis Project
ICRIER	Indian Council for Research on International Economic Relations
IFS	*International Financial Statistics*
ISP	Internet service provider
IT	Information technology
LIBOR	London interbank offered rate
METR	Marginal effective tax rate

METW	Marginal effective tax wedge
MFA	Multifiber Arrangement
NBFC	Nonbank financial company
NFA	Net foreign assets
NPA	Nonperforming asset
NPL	Nonperforming loan
NSDP	Net state domestic product
NSSO	National Sample Survey Organisation
OECD	Organization for Economic Cooperation and Development
OLS	Ordinary least squares
PIT	Personal income tax
PLR	Prime lending rate
PPP	Purchasing power parity
RBI	Reserve Bank of India
REER	Real effective exchange rate
SME	Small and medium-sized enterprise
T&C	Textiles and clothing
TFC	Twelfth Finance Commission
UN	United Nations
UNCTAD	United Nations Conference on Trade and Development
VAT	Value-added tax
VECM	Vector error correction model
WDI	*World Development Indicators*
WTO	World Trade Organization

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Opening Its Doors: India's Emergence on the Global Stage

JERALD SCHIFF

There can be little doubt that India is an emerging global economic power. India's economic growth has averaged some 8 percent over the past three years, placing it among the world's fastest growing economies. As a result of more than a decade of solid growth, India's share of world output, at purchasing-power-parity-adjusted exchange rates, has increased from 4.3 percent in 1990 to 5.9 percent in 2005. Growth has been robust in the face of shocks, including the Asian crisis of 1997–98, several below-par monsoons, and the recent sharp increases in energy prices. In line with good growth, poverty has declined dramatically, with estimates indicating a drop in the poverty rate from 41 percent in 1992–93 to less than 29 percent in 2000. The reform process that has helped make this possible—and which began in earnest in 1991—has made steady progress despite several changes in political leadership. Looking ahead, it appears that the broad path of reform—although not the pace or details—is firmly established. And success begets success. India is now more than ever a focus for international investors, who are eager to take part in a new India.

India's recent rapid development has gone hand in hand with a marked opening of its economy. Tariffs have come down dramatically in the last decade, while capital account restrictions are being gradually lifted. During 2003/04–2004/05 India's imports (including services) rose by 39 percent a year, twice as fast as in 1990–2002, buoyed by strong investment and consumer demand. Exports grew by 37 percent a year, up from 18 percent growth in 1990–2002, as India benefited from the commodity boom and expanded into engineering goods, pharmaceuticals, and business services. There is also some evidence that India is increasingly tied into regional production processes, with Asia's share in Indian imports rising steadily and with Asia becoming a major destination for India's exports. Intra-industry trade with China, in particular, is rising rapidly helping plug India into global production networks. India is also integrating into global financial systems and has benefited from rapidly rising capital inflows, including into the Indian stock market.

Reflecting these developments, India is playing a more important role in the global economy. A few examples only hint at the changes:

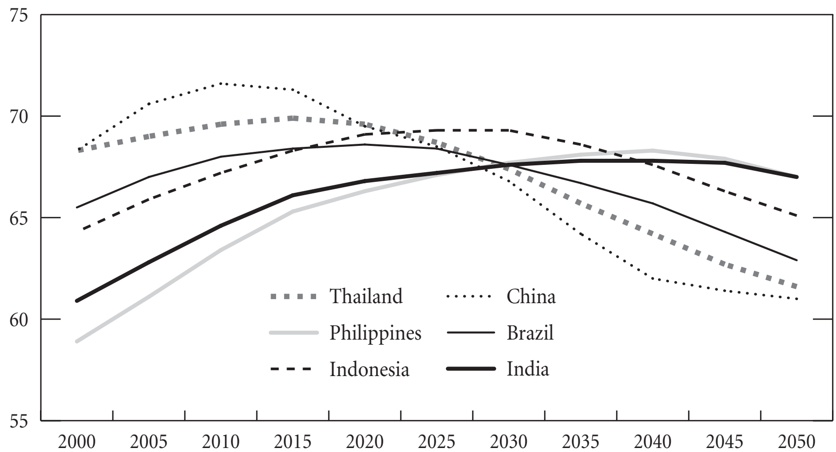
- India contributed nearly one-fifth of Asian domestic demand growth over 2000–05. Looking forward, India is slated to be the second-largest demand driver in the region, after China.
- India accounts for almost one-quarter of the global portfolio flows to emerging market economies, nearly $12 billion in 2005.
- India is the world's leading recipient of remittances, accounting for about 20 percent of global flows.
- India is the world's leading outsourcing destination and is fast emerging as a top 10 tourism destination.
- Indian corporates are emerging as key players in their own right. Reliance owns one of the largest refineries in the world, while Tata Steel is among the most efficient producers in the world. Indian firms, in industries including steel and oil, are looking abroad to acquire assets. And Indian corporates are increasingly carrying out their own research and development. In 2004 alone, Indian pharmaceutical companies filed about 200 patents.

India's demographics underline the potential for an extended period of rapid economic growth. India is an extremely young country, and is one of the few large countries forecast to sustain a growing labor force over the next 40 years (Figure 1.1). Estimates point to between 75 million and 110 million entrants to the labor force over the next decade, with the obvious potential to raise the economic output of the country and underpin India's competitiveness. Also, because working-age people tend to have a higher propensity to save, India should benefit from a favorable saving trend that will help finance investment and fuel rapid growth.

Opportunities, but Challenges as Well

While India is poised for economic takeoff, continuing success is by no means assured. India's development path thus far has been considerably

Figure 1.1. Working Age Population
(In percent of total)



Source: United Nations, Population database.

different from those of Japan, China, Korea, and the other "Asian tigers" in previous decades. And some of these differences present unique challenges to the country as it moves forward.

Growth in India has been led by services rather than manufacturing. While India's role as an information technology (IT) provider has been well documented, and is a major growth engine for the country, more rapid development of the manufacturing sector will be needed to generate the sort of lower-skilled jobs that can serve as a ladder out of poverty for many. The current employment elasticity of growth in India implies that a 5 percent rise in real GDP leads to only a 2½ percent rise in employment, and unless this is raised substantially, the large number of new workers can become a massive problem for India rather than a boon. India has the potential to be a manufacturing giant, but needs to remove the considerable roadblocks that industry still faces—notably poor infrastructure, rigid labor laws, and relatively inhospitable business and regulatory environments. Moreover, the reliance on services growth implies a need for a large pipeline of well-trained engineers and scientists, which may not be forthcoming without significant reform of higher education.

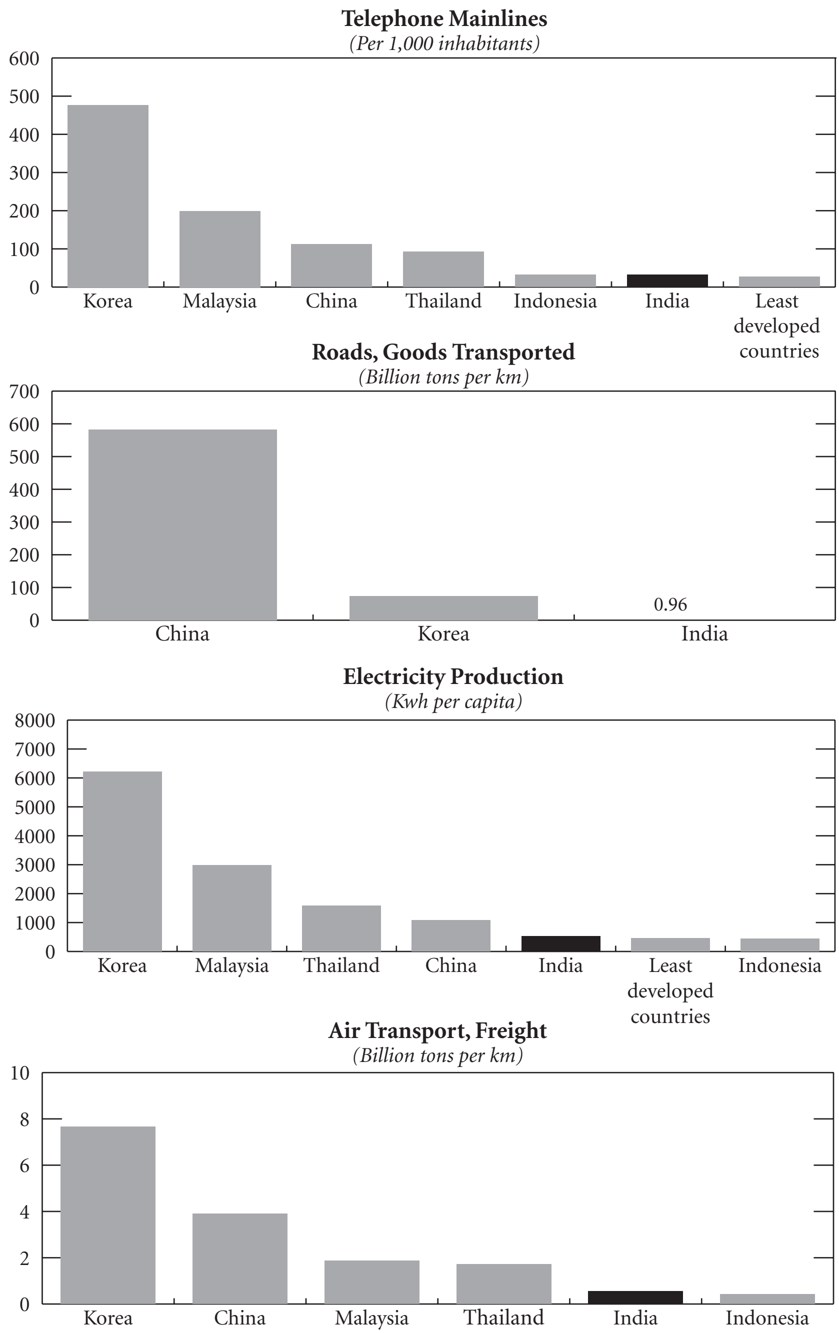
Second, in contrast to most other Asian economies, almost two-thirds of the population still derives its income from agriculture. While this reflects in part the limited supply of manufacturing jobs, high levels of illiteracy and extreme poverty in rural areas also mean that individuals may lack information about employment opportunities or the means to move elsewhere. A large share of the population relies on subsistence agriculture, and farming remains heavily rain-dependent, with irrigation lacking in many areas. The high correlation between agricultural growth and rainfall in India (about 0.65), illustrates the dependence of growth on rainfall. For India to achieve and sustain the sort of high growth it is targeting—in the range of 8–10 percent a year—productivity in agriculture needs to be raised, but agricultural workers also need to be provided with the basic tools and opportunities to move to new jobs in manufacturing.

Third, India's fiscal deficit and debt remain large, constraining its ability to act in key areas. With general government deficits still in excess of 7 percent of GDP and government debt above 85 percent of GDP, the government's ability to meet the many urgent needs of its population—notably in rural and urban infrastructure, education, and health care—will depend on its success in raising additional revenues without choking off economic growth and limiting inefficient and low-priority spending. The infrastructure gap remains large with inadequate roads, ports, airports, and power increasingly constraining India's potential growth (Figure 1.2).

Finally, India remains—despite its ongoing reforms—a relatively closed economy. Even though India has received much attention for its role as an outsourcing destination, trade linkages remain comparatively weak. Trade is low when compared to that of other Asian countries that pursued more export-driven growth strategies. India still only accounted for about 1½ percent of the global trade in goods and services in 2005. Although trade with other emerging countries in Asia has expanded rapidly, India's participation in global production chains, while growing, is in its infancy. While the share of intra-industry trade in East Asia trade rose to 75 percent in 1996–2000 from 42½ percent in 1986–90 (Zebregs, 2004), it only rose to 18 percent from 12 percent between 1992 and 2001 in India (Cerra, Rivera, and Saxena, 2005). As emphasized throughout this volume, the authorities will need to continue to open the economy to take full advantage of globalization and ensure that India reaches its full growth potential.

The Indian authorities are well aware of the challenges they face and are moving to address them. For example, trade tariffs have been coming down for a decade—most recently in the context of the 2006/07 budget—and there are plans to bring these down further to levels of member countries of the Association of South East Asian Nations (ASEAN)—around 8 percent on average—by 2009. India is also active in bilateral and regional trade liberalization, with the South Asia Free Trade Agreement to begin in 2007, and with ongoing discussions with Mercosur, ASEAN, and China, among others. In addition, capital controls on foreign direct investment (FDI) in India and external commercial borrowing by domestic firms are

Figure 1.2. Measures of Infrastructure Access



Source: World Bank, World Development Indicators database.

being eased, while the emergence of world-class Indian corporates is being encouraged by the progressive lifting of controls on outward investments. In addition, India has made improving its infrastructure its top priority. A start has been made in creating the fiscal space for greater public investment, and creating a favorable regulatory environment for private infrastructure investment, but the process has only just begun.

In other areas, progress is proving more difficult. The typical political constellation in India—a coalition government at the center and powerful governments pursuing their own agendas at the state level—has made it particularly difficult to overcome vested interests and introduce difficult structural reforms. For instance, privatization of state-owned commercial enterprises has stalled in recent years, forgoing large potential improvements in productivity. Broad labor reforms have faced strong opposition, limiting employment gains. And the inability to fundamentally reform food, fertilizer, and petroleum subsidies has meant that fiscal space for high-priority spending remains limited and incentives for farmers to diversify production and raise exports are muted.

But why quibble with what, by any measure, has been impressive success in recent years? Well, there are actually several reasons.

- *The consequences for India of a move from good growth to one of very rapid sustained growth is potentially enormous.* At 6 percent annual growth, average incomes will double in about 12 years, while at 10 percent it would take just 7 years. The impact of such a development on the living standards of the average Indian would be dramatic. By 2018, an estimated 191 million people would be pulled out of poverty under the high-growth scenario, nearly double that under the lower-growth outcome, and millions of additional people would be pulled into the burgeoning middle class.
- *It is critical that the current optimism in and about India does not morph into complacency.* It is important to remember that India has experienced previous rounds of rapid growth—the mid-1990s come immediately to mind—which were not sustained. The current economic renaissance is a reflection of 15 years of reforms, and continued strong growth will need to be infused by more such reforms. Macroeconomic sustainability—while not currently a major worry—also remains an issue. A period of robust growth in the 1980s was brought to a halt in large part by high fiscal deficits and macroeconomic imbalances and with fiscal deficits still high, India cannot be considered out of the woods in this regard.
- *Policies need to ensure that reform and growth are politically and socially sustainable.* As the 2003 national elections underscored,

> reforms leading to rapid growth—but which are not seen as promoting equitable sharing of the benefits from that growth—may not receive the public support necessary to ensure their completion. The reform process thus far has not eliminated the sense that there are two Indias. Poverty remains high—almost one-third of Indians live on less than a dollar a day—regional disparities are growing, and the rapidly expanding working population will need jobs. While high-tech centers generate worldwide notice and have contributed to the growth of the middle class, they remain a small enclave. It is critical that poverty reduction, already proceeding at a rapid rate, be accelerated and that poor states and regions be brought on board.

This book, then, appears at an opportune time. Are we seeing the first years of a "Golden Age" for India? Or is this another period of strong, but ultimately unsustainable, growth. Prime Minister Singh put the choice clearly in a speech in 2005, "We must think big and bold. We must move away from the paradigm of incremental growth to a paradigm of exponential growth and growth into uncharted territory." He stressed that success stories from both the public and private sectors should be replicated so that more and more Indian firms can "go global." In this book, we look more closely at that paradigm of exponential growth and at what an India that goes more fully global would like look.

A Global India: The Policy Agenda

Perhaps the best way to begin a discussion of India's economic policies in a new globalized environment is to look at what has worked thus far. In this regard, India's states—with a wide range of demographic characteristics and economic policies and outcomes—can serve as a useful "laboratory." Chapter 2 examines the determinants of the disparate economic outcomes across states, both to draw implications for policy and to assess whether poor states are catching up or being left behind. Among the key findings: the gap between rich and poor states is widening, with richer and faster growing states also more effective at generating jobs and reducing poverty. Much of this difference reflects policy choices. In particular, states that encourage private investment, limit the size of government, and focus on improving institutions see a large payoff.

With India embarked on a seemingly irreversible opening to the global economy, it is presented with important new opportunities. Policies must be directed at ensuring that India—and the broad cross-section of Indian citizens—grasps these opportunities. Chapter 3 focuses on one aspect of this effort to maximize gains from globalization: the nexus between India's increased openness to trade and the opening of its capital account. Trade and capital account liberalization have been gradual processes in India, with beneficial effects on productivity, growth, and inflation. The chapter finds, moreover, that the opening to trade and capital have been mutually reinforcing. For instance, FDI has brought with it imports from the home country as well as technological know-how and an increased capacity to export, while easing restrictions on external borrowing has raised trade by lowering borrowing costs for Indian corporates. Increased trade, in turn, has raised the demand for the hedging opportunities and financial deepening that capital account liberalization can bring. With a good deal still to accomplish to complete India's integration with the world economy, sequencing of remaining steps will need to be closely considered to maximize these synergies.

With lowered barriers to trade, it will be increasingly important that policies aim at enhancing competitiveness. In this context, Chapter 4 looks closely at the state of India's competitiveness, noting that India's export performance has been solid and that India has made significant inroads in gaining market share, both in Asia and in new markets, such as Africa. However, export performance would be greatly enhanced with improved infrastructure, lower tariffs, and a more friendly business environment. An important finding is that the exchange rate is not a bar to competitiveness, with no evidence that the rupee is fundamentally misaligned. Continued exchange rate flexibility would, then, be a key to ensuring that India can continue to enhance its global competitiveness.

Capital account liberalization has allowed India to attract large portfolio flows, but reforms are needed to raise FDI, which remains a disappointment. FDI can bring with it—in addition to increased capital—cutting-edge technology and managerial know-how. But India is not fully reaping these benefits. In 2003, the stock of FDI to India totaled just 5 percent of GDP compared, for example, to 31 percent for Thailand and 35 percent for China. But the most striking fact is that, at the same time that FDI lags, surveys consistently point to India as one of the top two or three destinations for FDI in the coming years. So, the opportunity is there for the taking. In this context, Chapter 5 examines the reasons behind India's relatively poor performance in attracting FDI. The analysis suggests that while sectoral restrictions on FDI have played some role, India's FDI regime is not overly restrictive by international standards. Rather, what is mainly holding back FDI is broader difficulties of doing business. A few statistics serve to define the problem: to start a business in Korea takes 22 days and in China 41. But in India, it takes 89 days. And enforcing a contract takes 425 days in India, more than five times longer than Korea and nearly double that in China. Addressing such bottlenecks—along with closing India's infrastructure gap—should make India one of the primary FDI destinations in the world in the coming years.

In opening itself to the global economy, a healthy and vibrant financial sector is becoming a pillar of India's development. Recent growth in India has been accompanied by increased lending and, while rapid credit growth poses some potential risks, the financial sector has become increasingly healthy. With this sound base, the authorities are now looking for ways to continue to deepen financial intermediation. Chapter 6 addresses these issues, examining how India can develop a world-class financial sector. The chapter notes that, despite recent rapid growth, the credit-to-GDP ratio and the public's access to banking services remain low and the banking system is dominated by less efficient public sector banks. Development could be spurred by allowing more private ownership in the banking system—domestic as well as foreign—eliminating structural constraints to lending to small enterprises and agriculture, and continuing to strengthen prudential oversight.

Fiscal reform—a long-standing concern—becomes all the more important in a global India. Despite recent progress, India's high fiscal deficits and heavy debt burden remain a barrier to more rapid sustained growth. Tax and expenditure reform will be needed to create space for infrastructure investment and social spending, and facilitate private investment. It is estimated that infrastructure spending needs to rise by some 3 percent of GDP a year for India to maintain its current growth performance. Also, the government aims to double spending on health and education over the medium term, a potential rise of another 3–4 percent of GDP. Moreover, with private investment on the rise, crowding out is increasingly a concern, as corporate and small business borrowers come face-to-face with the government's still large financing needs.

As discussed in Chapter 7, India's federal system has tended to complicate efforts at fiscal adjustment. India's states undertake more than half of general government expenditure and account for roughly half of the general government deficit that stands—even after several years of adjustment—in excess of 7 percent of GDP. Moreover, India's states have been more reliant on resources transferred from the center and have faced less stringent borrowing constraints than state-level governments in many other countries, contributing to fiscal indiscipline. With the 2005/06 budget, the central government has sought to address these issues. As the chapter points out, the reforms—including harder budget constraints on states and more conditionality on transfers—move in the right direction. But more needs to be done—a number of states will likely remain in a vulnerable position for some time to come, making it difficult for them to meet their objectives for higher spending on infrastructure, health care, and education.

As the government's overall spending needs are unlikely to decline for some time, tax reform, examined in Chapters 8 and 9, will be a key to addressing fiscal issues. Chapter 8 finds that, while India's tax collections are broadly in line with countries at a similar stage of development, they lag well behind those of more advanced emerging market economies. The chapter lays out a strategy for reform that could generate revenues equal to about 4 percentage points of GDP, solely via base broadening. Chapter 9 analyzes the scope for such base broadening to stimulate growth by generating efficiency gains in investment. Combined, the two chapters deliver the message that fiscal adjustment in India can, if done right, be very much pro-growth and pro-poor.

Cases in Point: Services and Textiles

India's booming services sector provides eloquent testimony to its ability to thrive with globalization. Chapter 10 examines the rapid growth in services, finding that liberalization has been a driving factor behind this growth. The ability of India to compete on the global stage is amply illustrated by the boom in IT. While a rising home-grown demand is playing some role in the IT sector's growth, the story is overwhelmingly one of India competing—and winning—in the globalized economy. The exports of the Indian IT sector grew by an estimated 32 percent in 2005/06 following similar robust growth the previous year. With Indian firms exporting services ranging from call centers to medical diagnostics to tutoring of American high school students, India's position of world leadership in IT is well known. And the IT success story is largely one of private sector initiative, with the government stepping back and focusing on providing an enabling environment.

If the growth of the IT sector underlines India's potential, the experience of the textile industry also points to the unfinished nature of the reform process. Chapter 11 examines the likely impact of the recent lifting of quotas on textiles and clothing, which provides an excellent example of the opportunities and challenges facing India. India has a centuries-old tradition of producing textiles admired around the world. Also, Indian exports were constrained by quotas before 2005, pointing to the potential for large gains with their elimination. However, performance in the textile industry in the past year has been decidedly mixed—India has gained market share, in particular in the key U.S. market, but has done so to a much lesser degree than China. And even these gains may be at risk once China's voluntary quota agreements with the United States and the European Union lapse. As the chapter makes clear, both improved infrastructure and removal of a number of structural barriers—including rigid labor laws—will be needed for India to repeat the success it has achieved in services.

Epilogue: An Engine for Global Growth?

With India seeking to strengthen global linkages, it should begin playing a significantly bigger role in the world economy. India's role as an engine for global growth has been limited by the still relatively closed nature of its economy. Even so, given its sheer size, a sustained takeoff in India can have a substantial impact in Asia and the rest of the world. More to the point, over the next five years, Indian exports are expected to more than double while imports will nearly triple. Moreover, with a rising working-age population over the next 40 years, long-term growth prospects should receive a further boost. Should India succeed as expected, new and improved Indian firms as well as a huge new middle class of several hundred million consumers will be unleashed on the global economy, with a major impact on world trade, prices, and growth. As India's manufacturing sector and exports become more competitive, it will present a major challenge for its neighbors. But a prosperous and outward-looking India would present even more opportunities for Asia and the world.

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