Demystifying the Hype

Arvind Panagariya

India: The Emerging Giant

Arvind Panagariya has written probably the best all-around, up-to-date, and accessible book on the Indian economy. It is informed by the analytic apparatus of a leading international trade economist, yet it is packed full of useful real-world detail. It has a comprehensive range—but it links the separate elements into a coherent whole. It is a superlative work of applied economics, and it is also sensitive to India's political economy. It has pointed, punchy policy conclusions: Panagariya is not shy about attacking those he thinks have got it wrong on the Indian economy, and he does so with a powerful combination of analytical argument and detailed evidence. Finally, though the book was written before the current global economic crisis, its fundamental conclusions remain as valid as they were before the crisis.

This decade's Goldilocks global economy (which ended in 2007–08) has encouraged “India hype,” and with it a misdiagnosis of India's seemingly successful recent economic performance. India-hype peddlers paint an impossibly glossy picture of the Indian economy. This has very little to do with Indian reality.

One aspect of India hype that has been given a degree of academic respectability by some business school professors and academic economists is the thesis that India is forging a separate successful path to development, in contrast with the traditional comparative-advantage-based development of China and other industrialized Asian economies. At its extreme, this argument holds that India’s growth engines are its high-end service and now manufacturing sectors, with their globalizing, world-beating companies. Dani Rodrik and Arvind Subramanian go one step further: they give some credit to past dirigiste policies for laying the groundwork for recent economic success and downplay the role of the post-1991 market reforms in generating better economic performance.

Panagariya attacks these arguments head-on. He highlights Indira Gandhi’s disastrous economic policies (from the mid-1960s to the early 1980s), which turned India’s back on its comparative advantage in labor-intensive activities and entrenched destructive regulations that are still difficult to dislodge (not least in labor markets). And he gives due credit to pro-market reforms, not just from reform bursts in 1991–93 and 1998–2004, but also in the late 1980s.

Reform gaps

Also threaded through the book is a dissection of India’s growth dynamics and nongrowth statics. The vaunted successes in services based on information technology and in manufacturing niches are welcome. But they are merely a high-wage, capital- or skill-intensive drop in India’s low-wage, unskilled, labor-abundant ocean. India’s growth should be churning in these labor-abundant waters, but it isn’t. Agriculture is stagnant, hobbled not just by very high external protection but even more by draconian domestic restrictions that fragment the internal market. Nontradable service sectors—where potential employment generation is huge—are also crippled by domestic restrictions. Backbone service sectors (such as banking, insurance, and retail) suffer from external protection as well. And—crucially—India’s glaring development gap is in manufacturing, for all sorts of national and state-level policies conspire to stand in the way of labor-intensive industrial production. Panagariya has no doubt that India needs its Industrial Revolution if it is to grow out of poverty. That means putting impoverished people in the countryside into (initially) low-wage work in mass manufacturing. That is what East Asia has done. But not India.

Nevertheless, Panagariya is optimistic about India as an “emerging giant.” He believes that market reforms have forward momentum, that they will widen and deepen, and that Indian economic performance will come closer to its potential, to the benefit of a broader cross section of Indians.

I can’t say I fully share such optimism—for three reasons. First, the end of the Goldilocks global economy has exposed India’s reform deficits and brittle growth foundations. Second, India is now paying the price for a government that since 2004 has not delivered any reforms. Third—and most important—the Indian state, led by its political-bureaucratic elite, remains unreformed. Indeed, state institutions have gotten worse at both the national and state levels. According to Arun Shourie, a former minister and leading Indian commentator, India’s race backward as a state “hollowed out by termites” is not compatible with its race forward led by urban professionals in the private sector; the former will drag the latter backward. That remains to be seen. But the upshot is that much-needed market reforms cannot continue to skirt reform of the state itself. Politically, that is the hardest nut to crack.

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How We Got Here

Mohamed El-Erian

When Markets Collide

Investment Strategies for the Age of Global Economic Change


Timely, informative, and readable, this book combines a multifaceted analysis of structural transformation in the global economy and financial markets with an action plan for market participants, as well as policymakers. The approach reflects the extensive experience of the author, cochairman of PIMCO, which runs the largest bond fund in the world, and formerly president of the Harvard Management Company and a senior official at the IMF.

The book first summarizes elegantly anomalies and puzzles, giving a snapshot of the symptoms of the transformation, including the famous interest rate conundrum: falling long-term interest rates in the United States even as monetary policy was being tightened. It explores these symptoms’ underlying causes—dramatic change in the magnitude and channels of interaction among industrial and emerging market countries, and enormous expansion in the operations of the financial markets. These in turn have a significant bearing on how we should assess market developments, investment decisions, and policy responses.

The author argues convincingly that we should not ignore the anomalies and the information they contain, because they highlight underlying changes in risk and return patterns. The book offers a systematic framework for recognizing and understanding anomalies and turning points, and explains why it is difficult to look for signals within the noise. The author draws on behavioral science disciplines and neuroscience to explain our general inability to internalize rare events, despite their extreme impact. This analysis illustrates well the basis for the Keynesian dictum that “the difficulty lies not so much in developing new ideas as in escaping from old ones.” The book identifies a number of specific steps to separate the signal from the noise.

El-Erian uses this framework to explore the general realignment of the global system: it is no longer enough to assess developments in the major industrial economies; the role of emerging markets is also crucial. Moreover, the fundamentals are affected by unprecedented cross-border capital flows, and proliferation of new products and instruments, new financial market participants, and new pools of capital such as sovereign wealth funds. In short, there are more diversified sources of global activity and a wider array of investable funds. He illustrates actual and prospective changes in the drivers of key variables such as growth, trade, price formation, and capital flows that will affect the approaches taken by market participants.

Disciplining investors

The author considers how market participants should position themselves to benefit from the upside and manage the downside, and how to design an asset allocation plan that is consistent with forward-looking realities but also affords portfolio protection. He takes the reader step by step through a disciplined asset allocation process. He argues that investors have to assume greater responsibility for the management of risk than in the past and discusses the need for frequent monitoring of a portfolio’s sensitivity to key market risk factors. (There is an enjoyable discussion of tail risks and “Pascal’s wager”—the small probability of an event that has enormous consequences—and its implications for buying tail insurance.)

Regarding policy, the author argues that transformations weaken the effectiveness of traditional approaches and instruments, and erode the informational content of traditional indicators. This points to needed changes to traditional approaches. He presents a concrete action plan for multilateral institutions—such as the IMF—that would strengthen their role in a sustainable way.

Given the transformation under way and the uncertainties that “alter in unthinkable ways the configurations of risks and returns,” the book provides a powerful analytical framework for charting a course through the thicket of recent and ongoing developments. The proof of the pudding is that the book came out in early 2008 and its predictions have proven all too true. The author warned of the danger of increasing risk through unprecedented leveraging and deregulation, which in turn reflected the scramble for high returns, and the risk of serious market accidents and dislocations as a result of investors’ and intermediaries’ unsustainable behavior. The speed with which the crisis has deepened and spread, particularly since the Lehman bankruptcy, testifies to the inter-relationships analyzed in this book, as does the recognition that the depth of the global recession will be determined by the extent to which the banking sectors and financial markets stabilize in the near term. The book also clearly anticipated the limitations of policymakers in such an environment and the compounding influence of potential policy mistakes.

In short, the book should be required reading in these unprecedented times to understand where we are, how we got here, and where we might be headed.

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