India – A Hub for Globalization

Good morning. I thank the organizers for inviting me to speak in such august company and to such a distinguished group. At the outset, let me state that my talk reflect my views as a citizen of India, and is not meant to represent the views of the International Monetary Fund, its board, staff, or its member countries. However, I do represent them all when I express the Fund’s deepest sympathy to the people and governments in this region for the tragic losses suffered on the 26th of December. As the managing director has said, the Fund will provide whatever assistance it can to the affected countries in this difficult time.

The topic for this session, “India- a hub for globalization”, is timely. India fever has caught on in the world’s investment community. Nowadays, the Western press rarely mentions that certified growth miracle, that leviathan of global trade, China, without adding “and India”. In an admittedly unscientific test, a Google search reveals over 10 times more references linking “India” and “China” than “India” and “tiger”, and 100 times more than “India” and “maharaja”. But amidst all the hoopla, it is well worth asking: Is India really ready to play a central role in the global economy? Instead of going through the familiar litany of our strengths and our weaknesses, I thought it would be useful to pose the question in a different way; Does India have the mindset needed for a player in a globally integrated economy?

Mindset is a difficult concept, even more so when we speak of the mindset of a nation. But it does seem that there are times in the life of nations when they feel confident that they can take on the world, that they are capable of meeting any challenge, achieving any dream. If properly channeled, such a spirit can be an enormous aid to growth. In fact, some sociologists argue that such a spirit, a national “atma vishwas” so to speak, is critical to the
kind of explosive growth that we saw in Japan in the 1950s and 1960s, in Korea in the 1970s, and in China today.\footnote{See, for example, \textit{The Spirit of Capitalism} by Liah Greenfeld, Harvard University Press, Cambridge, MA. “Atma vishwas” means self confidence in Hindi.} It is the spirit that moved South Korea from having a per capita income on par with India’s to the ranks of the OECD in just four decades, the spirit that built a sleek futuristic city in Pudong, Shanghai out of an area that was largely farmland just a decade ago, and the spirit that is currently building the New Delhi Metro to world standards and on time. It is the spirit that asks “why not?” instead of “why”.

One reason such a mindset is important is that it creates an intolerance for laziness, for shoddy products, for open corruption, and for the usual excuses – when people have a strong conviction that they can achieve the possibilities of the future, it makes them less tolerant of impediments in their way to it. It also makes generations willing to sacrifice their present, even working themselves to death -- a phenomenon that in Japanese has its own special word, “karoshi” -- for the opportunities they can see they are creating for their children.

There, is however, another reason why such a mindset can be important today. It gives a country the confidence to open itself up to the world, to take advantage of outside opportunities no matter where they arise, to use the cheapest resources no matter where they are produced, to hire the best people no matter where they were born, and to face the fiercest competition no matter what its origin. Such confidence is necessary if India is to become a hub for the global economy. Clearly, some segments of our society possess this mindset, but do we have it as a collective, and if not, what do we need to do?
In some ways India is well prepared to be a hub. We are a multi-cultural, multi-ethnic society with a vibrant democracy and a free press that readily exposes our shortcomings. The highest elected office of the country is open to anyone who consciously opts for Indian citizenship, not just to those who are unthinkingly born into it. All this reflects a willingness to assimilate, and work with, that which is foreign in the broadest sense of the term.

Some of our corporations also demonstrate this. The expansion of the group headed by my co-panelist, Mr Ratan Tata, around the world reflects the emergence of the Indian multinational. But it is not just the large corporations that are spanning borders – technology has made it possible for small firms to do so. Heymath, a firm in Chennai, provides mathematics homework help to students, and lesson plans to teachers, over the net. Its initial target market was schools in Singapore, but after successfully developing and selling its product there, it is now expanding elsewhere, including in India. Though small, the firm is truly multinational, using consultants from Cambridge University and IIT Madras, management born in India but trained in the west, employees from Chennai, a knowledge base informed by math curricula of different countries, and customers from around the world.

Despite these examples, however, as an economy we are still not still as open to foreign goods and services, labor, or knowledge as we should be. On the IMF’s trade restrictiveness index, India has a score of 8, which places it amongst the most restrictive countries. India’s GDP accounted for 1.6 percent of world GDP in 2003 but its trade accounted for only .94 percent of world trade.\(^2\) And it holds the dubious record of instigating the maximum number of anti-dumping cases under the WTO in the period between 1995 and 2002.

\(^2\) Estimate based on 178 countries and World Economic Outlook data for 2003.
India’s capital account is still closed. It still place restrictions on foreign entry and participation in various areas of the economy, even those that have little implication for national defense. And it still is extremely wary of advice that may be associated with a foreign hand.

Why is India so closed? The facile explanation is that we still remember the colonial experience, that some Indians see the process of opening up as a new colonialism, by foreign multinationals, foisted upon them by a fifth column of neo-liberal Indian economists. Yet there is a big difference between a monopolist colonial power and multinationals, and that is competition. Competition keeps any single multinational from getting overly powerful, either economically or politically. There is no credible evidence that foreign firms have conspired together to exploit India, or that they have misbehaved any more than similarly placed Indian firms – though I do not want to imply that individually they have all been without blemish. And in that most revealing of markets, the Indian marriage market, getting a job in a multinational has always been seen as a plus -- almost on par with being in the IAS. This would not have been the case if multinationals were suspected of dark and dire deeds.

My sense is that the reason India has not been open reflects other fears than dislike or mistrust of the foreigner. This is, in some ways, good news for it would be far harder to become a hub for globalization if India were intrinsically xenophobic. But what else could explain how closed India is?

3 From 1995 to 2003, India has initiated 379 cases (15.69%) of a total 2416, well ahead of the U.S, (329 cases -13.6%), or the European Union (274 cases -11.3%).
One explanation is the lack of confidence of our entrepreneurs. Till recently, our entrepreneurs, shielded by protection against domestic and foreign entry, felt they simply could not compete against foreign firms. Protection not only renders the beneficiaries lazy and inefficient, it also gives them less incentive to rectify distortions and inefficiencies in the system. Our corporations could not care less that finance was so costly during the License Permit Raj for the costs could be passed on to consumers. But when talk turned to liberalization, they argued they could not compete against foreigners who had access to much cheaper finance. And they are not unique in such complaints. An analysis of attitudes towards competition across the world shows that entrepreneurs are far more likely to oppose liberalization when their financial system is relatively underdeveloped.

Two factors have been particularly important, I believe, in helping us break out of this vicious cycle where the lack of competition bred corporate indifference towards the efficient provision of factors like power and finance, which in turn reinforced resistance towards liberalization. First, companies like Infosys, TCS, and Wipro showed that it was possible for Indian firms to compete effectively on the world stage and that the profits from doing so were enormous. Second, creeping liberalization, initiated by crisis but then gaining a momentum of its own, forced competition on the rest. When challenged to improve productivity, Indian firms found that despite the inefficiencies of the system, there were unique sources of Indian comparative advantage, even in manufacturing. A few years ago, we feared Chinese imports would swamp the motorcycle market. Today, I see Bajaj Auto sells over a million motorcycles and expects to export 160,000 units this year. Our corporations have come a long way and many are ready to make India a hub for globalization.
If so, what still keeps India a relatively closed economy? One is the politician, aided or abetted by the bureaucrat. Not only are foreigners much harder to control but also they do not vote, so they are an appealing lot to discriminate against. But India is not special in this regard – whether it be Nordic politicians resisting the takeover of their banks by other European banks or French politicians creating national champions or US politicians complaining about outsourcing – politicians the world over, with a few notable exceptions find it convenient to rail against openness.

But politicians do not act in a vacuum. They are particularly effective when they cater to strong constituencies. With large corporations becoming more open-minded, sotospeak, could it be the people who are against competition?

On average, and with the caveat that cross-country comparisons are fraught with difficulty, the answer is no. Amongst all countries surveyed in the World Values Survey, Indians and Chinese are amongst the most pro-competition. But averages conceal some important patterns. Across countries and correcting for other factors, richer people are typically more strongly for competition. In India, they are not. Indian farmers and agricultural workers, especially those who are not owners, tend to be against competition, constituting yet another powerful political constituency against competition in India. Finally, across countries, older people are much more pro-competition than the young, reminiscent of a famous remark by Winston Churchill “If you are not a liberal at 20, you have no heart, if you are not a conservative at 40, you have no head”. Yet in India, older people tend to be against competition, perhaps reflecting the strength of our socialist past rather than their lack of grey cells. In addition, that many of our politicians are rich, from rural backgrounds, and older allows these constituencies to be particularly influential.
But even here there is reason for hope. First, more and more of India’s young are reaching working and voting age, unencumbered with the baggage of the past, and sending more of their kind into parliament. Perhaps more important, education, and more generally, the spread of skills, makes people more tolerant of competition – human capital equips people with a chance in a more competitive world. India is no exception here. So a second reason for hope that people’s attitudes will change is that as the population becomes better educated and more skilled, we will be more tolerant of competition in general, and openness in particular.

Let me now turn to policies with which an enlightened government can enhance the constituencies for openness and liberalization. The point emerging from the above discussion is in many ways obvious: the more prepared people are to face competition, the more tolerant they will be of it.

Three key steps are therefore, first, expanding access to, and improving the quality of, education, second, improving access to finance, and third, creating more ownership and infrastructure in rural areas. It is heartening that the Indian government sees these as priorities, but it should resist the temptation to use tried and discredited methods like simply pouring money into education without tackling difficult issues like teacher incentives and parental involvement, or mandating wider lending by public sector banks without improving incentives and systems for credit evaluation and loan recovery. The government can be particularly valuable if it focuses on an enabling role – setting standards, and ensuring adequate supervisory, legal, and regulatory infrastructure, while also encouraging the competitive private sector provision of these services.
Not only will tariffs naturally be brought down as the constituencies for competition grow, they will not be replaced by hidden non-tariff barriers. This is not to say there is no role for direct policy change. One key step to many reforms is reducing the large fiscal deficit. For example, if India is to be a global center for financial services, it needs capital account convertibility. But it cannot open its capital account without risk until the deficit is contained. Many other policies, such as reorienting bank credit towards the private sector or developing effective monetary policy tools hinge on deficit containment, so its importance cannot be overemphasized.

Competition will mean more volatility. The best way to prepare people for volatility is to let them experience increasing amounts of it. The rush to fix prices that have moved up rapidly, to shore up interest rates that have fallen “too far”, to bail out unviable firms with special “technology enhancement” funds, and to bail out unviable banks by merging them with healthy ones reflects a government that is an insurer of first resort rather than an insurer of last resort. And all too often, it is the vocal and the politically well-connected that get the manna from the government rather than the truly needy.

A better form of insurance is flexibility. We need to build more flexibility into the economy so that it can react to inevitable change quickly. India has too much preservation, and too little creation or destruction. Interestingly, studies show the way to get more creation of new businesses is to allow easier entry as well as easier exit or destruction. This means reducing the many petty bureaucratic barriers to entry, as well as more flexible labor laws, and a better and more rapidly enforced bankruptcy code.

Increased corporate flexibility will inevitably force individuals to bear losses – for example, workers who lose their jobs as the economy changes. We should make it easier for
the worker to be able to learn new skills – all the more important to invest in education. But for those who cannot adapt, we need to find better ways to cushion them, especially because old social support networks like the extended family and the village tend to erode in the modern market economy. As India modernizes, it has to create an explicit safety net, including unemployment insurance, pension schemes, and health care, targeted at the individual worker to shield him or her from business cycle fluctuations. In doing so, it should learn from the experience of other countries on how to avoid killing incentives for work or expanding programs beyond the ability of the country to pay for them.

Finally, people will be far more willing to accept competition if they are given time to adjust and if they are convinced the government will use that time to improve their ability to compete. A time-bound phasing-in of competition and a phasing-out of protections and subsidies may find far greater acceptance than shock treatment.

Thus far, I have spoken about what it will take for India to be more welcoming of foreign business. But we also need to think about what will make foreign business more interested in India. Here again, the short term approach would be to ply them with tax breaks and financial guarantees. Apart from the fact that these are addictive and create a constituency for their continuance, they also tend to discriminate against domestic firms. This then creates perverse incentives for domestic firms to take capital abroad, have it ritually cleansed and certified as “safed poshi”, and then brought back home to avail of the breaks.

A better way to draw in foreign investors is to treat them as one would domestic investors, and deal with all the concerns domestic investors have. Foremost amongst these, in my opinion, is policy uncertainty. All too often in the past, policy has been hatched by theoretical bureaucrats, remote from the polluting influences of business reality. When the
policy with all its clauses and sub-clauses is eventually rolled out nationwide after much
discussion within a small but out-of-touch group, it quickly fails the market test. And because
little consensus on it has been built amongst business groups or political parties, it
immediately creates uncertainty about when it will be changed and by how much.

It is a welcome sign that the authorities are encouraging more open debate about
policies before enacting them. It would also help to experiment with different approaches on
a small scale to see what works, or to have an initial phase during the rollout when changes
will be made, before setting the policy in stone. Clearly, policies that specify general
principles rather than attempt to micromanage will have more success in withstanding
change.

In addition to certainty in policy, foreign investors also value transparency in decision
making, more so than large domestic investors because foreigners are less familiar with the
corridors of power. Everything cannot, and even should not, be laid out in clear rules, but
where discretion is relied upon, the decision making process should be seen as fair.
Regulatory and supervisory bodies need to be given more independence, a first step of which
would be to staff them with attractively remunerated professionals rather than bureaucrats of
proven loyalty.

And one should not forget that for most countries, the most significant business
relationships are with neighbors. Given its size and strength, India can afford the extra step to
quell regional tensions. The government’s immediate offer of help to neighbors and its
coordination of relief efforts in the region in the aftermath of the Indian Ocean disaster are a
silver lining in a heart-rending tragedy. Such an attitude will be helpful, not just in drawing in
neighbors, but also the larger world community.
To conclude then, the stars are well aligned for India to become a hub of globalization, but it is still some distance from that goal. The vote of confidence foreign investors are giving India should not induce any complacency – they are betting on potential, not reality. It is up to India to turn that potential into reality. One could well imagine India could become a global financial center – it is in the perfect time zone and has the necessary IT, communication, and financial skills. All that is missing is a sounder regulatory environment and the necessary conditions for introducing capital account convertibility. It could become a center for higher education – it has the core human capital both in India and dispersed around the world as well as a history of tolerance for ideas. All we need is a more welcoming environment for foreign educational institutions, faculty, and students, as well as a greater tolerance for market clearing fees and salaries. Tourism, healthcare... I could go on but the point should be clear. India’s future is in our hands and it will be what we make of it.