India fever is spreading in the world’s investment community. 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 amid all the hoopla, it is well worth asking whether India is really ready to play a central role in the global economy. Instead of going through the familiar litany of strengths and weaknesses, it would be useful to pose the question in a different way: does India have the mind-set it needs to be a player in a globally integrated economy?

Mind-set is a difficult concept, and even more so when we speak of a nation’s mind-set. But it does seem that there are times when a nation feels confident that it can take on the world, meet any challenge, and achieve any dream. If properly channeled, this spirit can be an enormous aid to growth. In fact, some sociologists argue that such a spirit, a national atma vishwas, so to speak, has been critical to the kind of explosive growth seen in Japan in the 1950s and 1960s, in South Korea in the 1970s, and in China today. It is the spirit that transformed South Korea from a

---

1 Hindi for “self-confidence.”
country with a per-capita income on par with India’s into a member of the Organisation for Economic Co-operation and Development (OECD) in just four decades, that built a sleek futuristic city in the Pudong district of Shanghai in what was largely farmland just a decade ago, and that is currently responsible for the development of the world standard, on-time New Delhi Metro. It is the spirit that asks “why not?” instead of “why?”

One reason such a mind-set 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, they become less tolerant of impediments and more willing to sacrifice their present happiness for the opportunities that they can see are being created for their children.

This mind-set can be important today for another reason as well: 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 competitors no matter where they originated. Such confidence will be necessary if India is to become a hub for the global economy. Clearly, some segments of Indian society possess this mind-set. But does India have it as a nation and, if not, what must India do to get it?

In some ways, India is well prepared to be a global hub. It has a multi-cultural, multi-ethnic society with a vibrant democracy and a free press that readily exposes its shortcomings. The country’s highest elected office is open to anyone who consciously opts for Indian citizenship, not just to those who are born into it. All this reflects a willingness to assimilate and to work with foreign influences in the broadest sense of the term.

Some of India’s corporations also demonstrate this willingness. The global expansion of the Tata Group reflects the emergence of Indian multinationals. But it isn’t just large corporations that are spanning
borders—technology has made it possible for small firms to do so as well. HeyMath! is a Chennai company that provides assistance with mathematics homework to students and lesson plans to teachers over the Internet. Schools in Singapore were the company’s initial target market, but after successfully developing and selling its product there the company is now expanding elsewhere, including India. HeyMath! is small but truly multinational, with consultants from Cambridge University and IIT Madras, managers born in India but trained in the West, employees from Chennai, a knowledge base informed by the math curriculums of a number of countries, and customers around the world.

Despite these examples, as an economy India is still not as open to foreign goods and services, labor, or knowledge as it should be. On the International Monetary Fund’s trade restrictiveness index, India has a score of 8 out of 10, which places it among the most restrictive countries; in 2004, it accounted for 1.62 percent of the global GDP but for only 1.07 percent of world trade. Moreover, India holds the dubious distinction of having instigated the largest number of antidumping cases under the World Trade Organization from 1995 to 2004.

India’s capital account is still relatively closed. The country restricts foreign entry and participation in various areas of the economy—even those that have few implications for national defense. And it is extremely wary of advice from foreigners.

Why is India so closed? The facile explanation is that Indians still remember the colonial experience; indeed, some see the process of opening up as a new colonialism by foreign multinationals assisted by a fifth column of neoliberal Indian economists. Yet there is a big difference between a monopolist colonial power and multinational companies: competition, which keeps any single multinational from getting overly powerful, either economically or politically. Although I do not want to imply that, individually, the multinationals have all been without blemish, there is no credible evidence

---

3 This estimate is based on the International Monetary Fund’s World Economic Outlook, April 2005, with data for 178 countries.
4 Of the total number of cases initiated by the reporting countries during that period—2,646—India initiated 15.1 percent (400), well ahead of the United States (354 cases) and the European Union (303 cases).
that they have conspired to exploit India or misbehaved any more than their similarly placed Indian counterparts have. And in that most revealing of markets—the Indian marriage market—a job in a multinational has always been seen as a plus, almost on par with a place in the elite Indian Administrative Services. This would not be true if multinationals were suspected of dark and dire deeds.

My sense is that India’s failure to open its economy reflects fears other than a dislike or mistrust of foreigners. This is, in some ways, good news, since it would be far harder for India to become a hub of globalization if the country were intrinsically xenophobic. But what else could explain how closed India remains?

One explanation is the lack of confidence among India’s entrepreneurs. Until recently, shielded by protection against domestic and foreign entry, they felt that they simply couldn’t compete against foreign companies. Protection not only renders its beneficiaries lazy and inefficient but also gives them less incentive to rectify the system’s distortions and inefficiencies. Because the costs could be passed on to consumers, India’s corporations couldn’t have cared less that finance was so costly during the License Permit Raj—the highly bureaucratic government system of allotting permits for business undertakings. But when the talk turned to liberalization, the same companies argued that they couldn’t compete against foreigners with access to much cheaper finance. And Indians are not unique in making such complaints. An analysis of attitudes around the world toward competition shows that entrepreneurs are far more likely to oppose liberalization when the financial system is relatively underdeveloped.

Two things have been particularly important, I believe, in helping Indians break out of this vicious cycle in which a lack of competition has bred corporate indifference to the efficient provision of factors of production, such as power and finance, while the resulting inefficiency in turn has reinforced resistance to liberalization. First, software companies such as Infosys, Tata Consultancy Services, and Wipro Technologies showed that Indian firms could 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 to other parts of the economy. Indian companies, when challenged to improve their productivity, found that despite the
inefficiencies of the system, India had unique sources of comparative advantage, even in manufacturing. A few years ago, Indians feared that Chinese imports would swamp the motorcycle market. Today, Bajaj Auto sells more than 1,000,000 motorcycles annually and expects to export 160,000 this year. India’s corporations have come a long way, and many are ready to make India a hub of globalization.

If so, what keeps India relatively closed? One factor is the country’s politicians, aided and abetted by the bureaucrats. Foreigners not only are much harder to control than locals are but also don’t vote, so they are an appealing lot to discriminate against. But India isn’t special in this regard: Nordic politicians resist the takeover of the region’s banks by other European banks, French politicians try to create national champions, and US politicians complain about global outsourcing. Politicians the world over, with a few notable exceptions, find it convenient to rail against openness.

But politicians don’t act in a vacuum; they are particularly effective when they cater to strong constituencies. With large corporations becoming more open minded, so to speak, 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. Of the countries included in the World Values Survey, India and China are among the most favorable toward competition.5

But averages conceal some important patterns. Across countries, and correcting for other factors, richer people are typically more strongly for competition. In India, however, they are not. Indian farmers and agricultural workers, especially those who are not owners, are yet another powerful political constituency against competition. Finally, though in most countries older people are much more favorable than the young are to competition—a contrast calling to mind Churchill’s famous remark that “If you are not a liberal at 20, you have no heart; if you are not a conservative at 40, you have no head”—older people in India tend to be against it. This probably reflects the strength of India’s socialist past rather than a lack of gray cells among the elderly. In addition, the fact that many of India’s politicians are rich, from rural backgrounds, and relatively old makes these constituencies particularly influential.

But even here there is reason for hope. First, more and more of India’s young reach working and voting age unencumbered by the baggage of the

5 The survey, a global investigation of sociocultural and political change, is conducted by a network of social scientists at leading universities around the world.
past, and they are sending their kind into Parliament. Perhaps of greater importance, education and, more generally, the spread of skills tend to make people tolerant of competition: human capital gives them a chance in a competitive world, and India is no exception. So a second reason to hope that attitudes will change is the likelihood that as the population becomes better educated and skilled, India will be more tolerant of competition in general and of openness in particular.

An enlightened government can follow policies for openness and liberalization that encourage and assist the constituencies. The more prepared people are to face competition, the more tolerant of it they will be. Therefore, three key steps are, first, expanding access to and improving the quality of education; second, improving access to finance; and, third, promoting ownership and building infrastructure in rural areas. It is heartening that the Indian government sees these three things as priorities, but it should resist the temptation to use discredited methods, such as pouring money into education without tackling difficult issues (such as teacher incentives and parental involvement) or mandating wider lending by public-sector banks without improving their incentives and systems for evaluating credit and recovering loans. The government could be particularly helpful if it took on an enabling role—setting standards and providing an adequate supervisory, legal, and regulatory infrastructure—while encouraging the competitive provision of financial and educational services by the private sector.

As the constituencies for competition grow, tariffs not only will fall naturally but also won’t be replaced by hidden nontariff barriers. This isn’t to say that direct policy changes will have no role. For many reforms, a key step is reducing the country’s large fiscal deficit. If India is to be a global center in financial services, for example, it must ensure capital account convertibility: the freedom to change local financial assets into foreign financial assets, and vice versa, at market rates of exchange. But the country cannot open the capital account without risk until the deficit is contained—the government has come to rely on a captive domestic financial market to finance it, and the risk of crisis would rise considerably if domestic investors were allowed to invest abroad before it was curbed. Many other policies, such as reorienting bank credit away from the government and toward the private sector and developing effective monetary-policy tools, also hinge on containing the deficit, so the importance of doing so cannot be overemphasized.

Competition will mean greater volatility. The best way to prepare people for volatility is to let them experience it incrementally. At present, however,
the government is the insurer of first rather than last resort, as shown by
the rush to fix prices that move up rapidly, to shore up interest rates that
fall “too far,” to rescue nonviable companies with special “technology-
enhancement” funds, and to bail out failing banks by merging them with
healthy ones. And all too often, it is the vocal and the politically well
connected rather than the truly needy who get the manna from government.

A better form of insurance is flexibility, which India must build into the
economy so that it can react quickly to inevitable change. The country has
too much preservation and too little creation or destruction. Interestingly,
studies show that the way to create more new companies is to make
it easier for them to enter and leave a business (or to go out of business
entirely). This means reducing the many petty bureaucratic barriers to entry
as well as enacting 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.
India should make it easier for workers to learn new skills, so it is
all the more important to invest in education. But the country needs to find
better ways to assist those who cannot adapt, 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 individual workers to shield them
from business cycle fluctuations. In doing so, India should learn from
the experience of other countries to avoid killing incentives for work or
expanding programs beyond the ability to pay for them.

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

Thus far, I have discussed what it will take for India to be more welcoming
toward foreign businesses. But the government also needs to think about
what will make foreign businesses more interested in India. Here again,
the short-term approach would be to ply them with tax breaks and financial
guarantees. These not only are addictive but also tend to discriminate
against domestic companies, which then have perverse incentives to take
capital abroad, have it ritually cleansed and certified as foreign, and then
bring it back home to take advantage of the breaks.
A better way to draw in foreign investors would be to treat them as domestic ones are treated and to deal with all of the domestic investors’ concerns. Foremost among them is policy uncertainty. All too often in the past, policies have been hatched by theorizing bureaucrats removed from the polluting influences of business reality. When a policy, with all its clauses and subclauses, is rolled out nationwide after much discussion within this small and out-of-touch elite, it quickly fails the market test. And because little effort has been made to build a consensus among business groups or political parties, there is immediate uncertainty about when and how much the policy will change.

Fortunately, the authorities are encouraging more open debate about policies before implementing them. It would also help to experiment with different approaches on a small scale to see what works or to avoid setting policies in stone before an initial rollout phase, when they can still be changed. Clearly, it will be less necessary to change policies that specify general principles rather than attempt to micromanage implementation.

Foreign investors also value transparency in decision making—more so than large domestic investors do, because foreigners are less familiar with the corridors of power. Not everything can, or even should, 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 should be given more independence; a first step would be to staff them with attractively remunerated professionals rather than bureaucrats of proven loyalty.

And don’t forget that most countries have their most significant business relationships with their neighbors. Given the size and strength of India, it can afford to take the extra step to quell regional tensions. The government’s immediate offer of help to the country’s neighbors and its coordination of regional relief efforts in the aftermath of the Indian Ocean tsunami are a silver lining in a heartrending tragedy. More proactive attitudes will help to draw in not just neighbors but also the larger world community.

To conclude, the stars are well aligned for India to become a hub of globalization, but the country is still some distance from that goal. The vote of confidence that foreign investors are giving India should not
induce complacency; they are betting on the potential, not the reality. It is up to India to realize that potential. The country could well become a global financial center, for example: it is in the perfect time zone and has the necessary information technology, communications, and financial skills. All that is missing is a more sound regulatory environment and the conditions needed for introducing capital account convertibility. The country could also become a center for higher education: it has the core human capital, both in India and dispersed around the world, and a history of tolerance for ideas. All that is needed 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, health care—I could go on, but the point should be clear. India’s future is in Indian hands and will be what Indians make of it.

This article is adapted from a speech, “India—A hub for globalization,” given by the author on January 7, 2005, at the Pravasi Bharati Divas Conference, in New Delhi. The views expressed in the article are his own and are not meant to represent those of the International Monetary Fund, its board, its staff, or its member countries.

Raghuram Rajan is the economic counselor and the director of the research department at the International Monetary Fund.

Copyright © 2005 McKinsey & Company. All rights reserved.

E-mail this article to a colleague
www.mckinseyquarterly.com/links/18850