Is a South Asian miracle just over the horizon?

India's Modi Wave

BY DANIEL TWINING

India's election has produced a decisive majority for the Bharatiya Janata Party. Incoming Prime Minister Narendra Modi promises to reinvigorate an economy whose annual growth rates have halved from near double-digit rates in recent years. He has pledged to tackle endemic corruption and create a slimmed-down, more effective state through what he calls "maximum governance, minimal government." A 30 percent surge in India's stock market attests to the combination of hope and faith business has in the new government. Modi cites his record governing the state of Gujarat as an example of the pro-growth management experience he brings to New Delhi. Gujarat has grown faster than China for two decades, produces a quarter of India's exports, and attracts about 20 percent of India's oreign direct investment. India is now in the hands of a prime minister who has managed the economy of its most industrialized and globalized state. The world has high stakes in an Indian resurgence that turns it into an engine of global growth.

Restoring economic vigor through good governance and decisive reform is the clear mandate of the new government. Economic growth has plummeted to below 5 percent. Annual inflation is in the range of 10 percent and the government's inherited fiscal situation is precarious. As many as 800 million Indian citizens live on less than $2 a day. In the heady days of

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Indian Prime Minister **Narendra Modi** *(center right) after being sworn in by President* **Pranab Mukherjee** *(center left) on May 26, 2014.*

the 2000s when its go-go economy was surging ahead at Chinese-style rates of nearly 10 percent—including a few quarters in which India actually grew faster than China—many Indians internalized the notion that their country was destined for economic and geopolitical greatness. They feel like the outgoing Congress Party government let them down, and have turned to a leader with a demonstrated record of economic competence.

This election may prove a turning point in India's political history. *Indian Express* editor Shekhar Gupta describes the journey of the Indian voter since 1947 in three stages: from gratitude to the Congress Party for delivering India's independence, to grievance as a result of underdevelopment and stifled opportunity, to aspiration for a better future under conditions of dynamic economic growth. Modi's ascension represents the victory of the aspirational group, now comprising hundreds of millions of Indians and growing every day. Rajiv Kumar of the Center for Policy Research argues convincingly that this group seeking greater economic opportunity has replaced the "petitioning" one seeking government handouts as the prime force in Indian electoral politics.

Indeed, judging by an election result that has delivered a stronger mandate for one party than at any time since 1984—and punished the Congress Party's economic underperformance with its lowest vote tally ever—several decades of rapid economic growth appear to have created a more unitary Indian electorate. Their aspirations for a middle-class future cut across lines of caste, class, region, religion, and the rural-urban divide. This emergent urban and suburban, youthful, middle-class India—the India of 900 million mobile connections—is displacing the old rural peasantry as the decisive demographic. This massive constituency voted overwhelmingly for the change Modi promised. They have extraordinarily high expectations for his government.

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The good news is that the drivers of India's long-term growth trajectory remain intact. Despite the slowdown of the past few years, India's economy has expanded by roughly 8 percent annually for the past decade despite the failure to move forward with major new rounds of liberalization following the first wave of economic opening of the early 1990s. If "India grows at night" while the government sleeps, in the words of former executive Gurcharan Das, it promises to grow even faster during the day with better governance, improved infrastructure, and a rollback of hapless state intervention in the economy.

How can Modi fulfill his electoral mandate to reignite economic growth? In particular, his administration could loosen employment restrictions that make it nearly impossible to fire workers (thereby suppressing hiring), revive hundreds of major investment projects that are pending but stalled by government bureaucracy, ease land acquisition rules that prevent companies from securing clean title to build factories and associated infrastructure, roll back budget-busting subsidies whose welfare effects are questionable if not downright regressive, enact a national goods-and-services tax to replace a helter-skelter mix of state tax regimes that reduce predictability and create added red tape for businesses, secure a long-term contract for U.S. liquefied natural gas deliveries and enact clean implementing legislation for the 2008 U.S.-India civilian nuclear deal to ease India's acute energy bottlenecks, and ease foreign investment in a range of sectors, from multi-brand retail to insurance, where it is arbitrarily restricted for reasons having more to do with politics than economic good sense.

Restoring growth from its current 4.5 percent to levels approaching double digits is essential—not only to chip away at India's underdevelopment but to prevent the country's demographic boon from turning into a debacle. On the plus side, India has the world's youngest population and largest workforce—and this will remain true for decades as other major economies in both the developed and developing world succumb to rapid population aging. Experts calculate that India's "demographic dividend" could be worth as much as 2 percentage points of additional GDP growth per annum. However, to realize these gains, the country needs to create as many as ten million jobs annually to employ all those new workers entering the labor market. Economists calculate that every percentage point increase in GDP growth from current levels creates about 1.5 million jobs. Ramping up real annualized GDP growth to 8 percent would, with compounded returns, create the necessary jobs to employ India's growing workforce—even as implementation of structural reforms would boost productivity by reducing underemployment and moving more Indians from the informal sector of the economy (where most of them work today) into the formal one.

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This is the essential challenge Narendra Modi confronts. His administration's ability to meet it will have implications not only for India's rise in the world, but for its internal social cohesion. On the plus side, he has the most significant electoral mandate from the Indian voter in decades. However, he confronts one of the world's most obstreperous bureaucracies, some of the world's most pervasive official corruption, and the strongmen (and occasional women) who govern India's nearly thirty states as regional potentates with democratic mandates of their own. Modi also confronts the challenge that the BJP's strong majority in the lower house of the Indian parliament is not matched by his National Democratic Alliance's representation in the upper house, where Congress and regional party leaders remain powerful. Modi will find that the personalized nature of decision-making he was able to employ as chief minister of Gujarat will be harder to execute when ruling from the center, given India's powerful system of checks and balances at the national level as well as likely opposition from key stakeholders in the bureaucracy, the parliament, and the states.

RAKESH KRISHNA KUMAR

Rush hour for commuters at Borivali station in Mumbai. India offers rich opportunities for building infrastructure, manufacturing, and retail facilities, and other basics of a modern consumer economy.

India's economic potential is enormous. In purchasing power parity terms, it has already surpassed Japan to become the world's third-largest economy. India is expected to achieve the same status at market exchange rates in the 2020s from a base of nearly $2 trillion today. The market capitalization of its stock market, at nearly $1.5 trillion, has just pushed it into the world's top ten. India will soon have the world's largest population of prime workers: two-thirds of its citizens are under thirty-six and half are under twenty-five, in contrast with China's rapidly aging society, where worker numbers have already peaked and the future dependency ratio is set to spike alarmingly. The U.S. National Intelligence Council predicts that India will be the lead driver of middle-class growth by 2030 and could even emerge as the world's largest economy by the end of the century. The Organization for Economic Cooperation and Development forecasts that India could comprise nearly 20 percent of global GDP by 2060. The scale of the Indian marketplace, which will ultimately boast the world's largest number of consumers, means that every serious multinational corporation will need to have the kind of presence in the country which they have in China today, and every serious economy will find that India becomes one of its largest trade and investment destinations.

In recent years, outbound investment from India has exceeded inbound investment. This is striking in light of India's high level of underdevelopment—capital should not be flooding out but flooding into the country, in light of the rich opportunities for building infrastructure, manufacturing, and retail facilities, and other basics of a modern consumer economy. Instead, not only foreign but even Indian business leaders have been so stymied by India's restrictions on investment, land acquisition, and employment (including the essential impossibility of firing workers without government permission) that they have been investing heavily in developed markets in Europe, the United States, and developed Asia. As a result of the outgoing government's failure to pursue necessary reforms and India's dramatic growth slowdown over the past few years, political frictions between India and its major trading partners have mounted. In the U.S. Congress, for example, business-oriented policymakers once bullish on the Indian market have pushed for investigations into Indian trade barriers and investment restrictions.

According to economist Angus Maddison, the Indian economy was the world's largest in the early seventeenth century, comprising some 25 percent of global GDP. The extent of India's early, and extensive, trading relationships can be seen in the deep Indian cultural influence evident today from Oman and Dubai to Zanzibar and Madagascar across to Singapore, Malaysia, Indonesia, and what was once called Indochina. It would seem only natural in the modern era of globalization for a resurgent India to deepen those formative trading networks that spanned the Persian Gulf to the Straits of Malacca, as well as to intensify linkages with the fast-growing Chinese economy on its northern border and deepen trade and technology flows with the developed economies of Japan, Europe, and America. A review of India's major trade and investment relationships highlights the stakes for major global economies of a return to growth in the Indian market.

Perhaps the primary East Asian stakeholder in India's return to rapid development is Japan, whose corporate leaders have long understood India's economic potential as a "second China" (without the political risks inherent in China's anti-Japanese nationalism), and whose prime minister understands its potential role in supporting Japan's economic renewal. Japan is investing $10 billion in the Delhi-Mumbai industrial corridor—when it was announced, the single largest foreign direct investment in India—as the centerpiece of a plan to drive India's infrastructural and manufacturing growth from their currently low baselines. Japan is the fourth-largest direct investor in India and has accounted for close to 10 percent of FDI flows into India since 2000. Surveys conducted by the Japan Bank for International Cooperation show that Japanese companies rank India as the most important long-term potential market for Japanese overseas investment. Bilateral trade is valued at some $20 billion annually and was growing 30 percent to 40 percent annually through 2012, when India's growth slowdown had an impact.

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China-India trade relations are more complicated. Trade totaled nearly $70 billion in 2012. China is India's single largest trading partner in goods (the United States is India's largest trading partner in goods and services combined). However, the composition of Indian exports to China is almost entirely raw materials, whereas Chinese exports to India consist mainly of cheap manufactured goods. This creates an imbalance that fuels political controversy within India as an element of growing security competition with China, exacerbated by nationalist rivalry between Asia's preeminent civilization-states. India has raised steep barriers to Chinese direct investment in sensitive sectors such as telecommunications, again because of a perceived threat from a less-than-transparent China. Indians have protested at the importation of Chinese workers, rather than the hiring of Indian ones, for Chinese infrastructure projects in India. For all these reasons, Sino-Indian trade has been more a source of rivalry than reassurance. At the same time, Modi visited China four times when he was chief minister of Gujarat to gin up business and, as prime minister, is expected to expand economic ties with China even as their security competition intensifies.

ASEAN and its 600 million consumers boasted total trade with India of $80 billion in 2012, a figure which should soon pass the $100 billion mark, putting Southeast Asia collectively near the top of India's major trading relationships. Even more important than trade has been Southeast Asia's role as an Indian investment hub. Indian companies form the largest foreign business community in Singapore, where some 5,000 Indian corporations have operations. This is partly a function of Singapore's status as a gateway to Southeast Asia and partly the result of red tape at home that has led Indian businesses to identify greater opportunities abroad. Modi is expected to deepen India's "Look East" engagement with Southeast Asia in both commerce and security.

The European Union is India's largest trading partner and, for India, a valuable source of technology, defense hardware, and manufactured goods. A French company's pending contract for the sale of $10 billion worth of combat aircraft to India is one example of the economic prizes that await Europeans doing business in India. New Delhi and Brussels have been in negotiations since 2007 for an India-EU free trade agreement. European officials hope that Prime Minister Modi can restore momentum to these negotiations, which will become easier if a new round of liberalization in India reduces the number of domestic sectors shielded from foreign investment and walled off by high tariffs. The value of EU-India trade grew from €29 billion in 2003 to €73 billion in 2013, while EU investment stock in India is approaching €50 billion. Strikingly, India has become a prime source of foreign direct investment in

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Europe, epitomized by Indian ownership of companies like Jaguar/Land Rover in the UK.

The United States is India's top national trading partner measured in trade in goods and services. Since 2001, U.S.-India trade has doubled every five years and is approaching the $100 billion mark. This represents progress. But it remains a relatively low: the bilateral economic relationship is far below scale given the size of U.S. and Indian markets, their deep people-to-people networks, and India's desperate need for the kinds of capital, technology, energy supply, and services the United States is in a singular position to offer. U.S. trade with India amounts to only one-seventh of U.S. trade with China, despite the fact that one country is a strategic partner and the other a strategic competitor.

Regrettably, the biggest trade initiatives of the Obama administration—KORUS, the Trans-Pacific Partnership, and the Transatlantic Trade and Investment Partnership—do not include India. Nor does APEC, the primary existing framework for Asia-Pacific trade liberalization. The United States and India have not even agreed on a basic Bilateral Investment Treaty. The respective comparative advantages of the U.S. and Indian economies are highly complementary. Knitting them together through greater interdependencies in trade, investment, and knowledge workers (Indians currently hold about two-thirds of the very limited supply of H1-B visas for high-tech immigrant workers in the United States) could reap extraordinary dividends for both countries, particularly in the context of a U.S. economic recovery and a strong reformist government in New Delhi.

India enjoyed economic growth rates near 10 percent for almost a decade before its recent slowdown. Prime Minister Modi hopes to ramp growth back up as a way of tackling India's development and security challenges. This is not an unreasonable proposition: until recently China grew at this pace for several decades, as did Japan, South Korea, and other Asian Tiger economies. There is no cultural reason India cannot deliver a "South Asian miracle" to accompany the "East Asian miracle" that has transformed the Pacific Rim. ◆