'India Rising' and the Mixed Blessings of Globalisation

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Abstract

India has been a major beneficiary of economic globalisation. Yet, integration into the global economy has also made India vulnerable to the unpredictable swings in market sentiment. Nevertheless, the ultimate effects of cross-border economic forces also depend on the robustness of domestic policies. Potential vulnerabilities such as disruption in trade or financial flows can be mitigated by sound macro-economic policies. Although 'licence raj' and 'export pessimism' is now a thing of the past, India's quasi-protectionist policies, coupled with the failure to deepen its integration into the global economy, have made the economy increasingly vulnerable to external forces—as seen when the United States Federal Reserve announced its decision to unwind its stimulus programme in mid-2013, resulting in deep sell-offs in emerging economies, especially India's currency, bond and equity markets.

Keywords

Indian economy, globalisation, quantitative easing, India rising, liberalisation

Introduction

The Indian economy's decade-long sustained high growth rates (only second to China), its remarkable resilience during the global financial crisis, the rapid proliferation of home-grown millionaires and billionaires, significant foreign acquisitions by Indian companies and growing affluence of the nation's middle class led many observers to conclude that an Indian miracle was already on hand. Even India's sober and ever-cautious Ministry of Finance succumbed to the hubris by departing from its usually taciturn statements by issuing (in March 2010) a report boldly stating that India was now in position to overtake China to become the world's fastest-growing economy within four years. Arguably, the triumphal mood emanating from New Delhi was so infectious that during his maiden visit to India in November 2010, President Barack Obama, in his speech to the joined session of the Parliament, stated that 'India was not simply emerging but had already emerged'. Indians basked in the glow of this rather unexpected attention and adulation—and above all, respect—that the country has long craved for. The new upbeat slogan, 'India Rising', neatly captured the national mood of growing self-confidence and 'can-do' attitude. India's dramatic rise was welcomed as its conspicuously free-market, democratic–capitalist growth model is seen as a viable alternative to the statist authoritarian–capitalist model exemplified by China. In fact, the United States even began to take seriously the proposition that India was essential to balancing

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China's rising power and geostrategic and hegemonic aspirations in the Asian region—so much so that President Obama, during his India trip, pledged to support New Delhi's quest for a permanent seat on a reformed United Nations Security Council.

However, in 2013, gnawing concerns about India's ability to live up to the billing quickly gave way to pessimism and grave doubts. The year turned out to be *annus horribilis* when nothing seemed to go right. Indeed, 2013 began rather ominously with a sharp slowdown in the nation's economic activity. The downward spiral only picked up speed with growth dropping by half from the previous year to about 4.4 per cent for 2013. Between June and August, the national currency, the rupee, experienced a literal free fall (declining by approximately 20 per cent), breaching the psychological barrier of ₹ 60/US$ in early July and reaching an all-time low of ₹ 68.4/US$ on 28 August.[1] This gave the rupee the dubious distinction of being Asia's worst-performing currency in 2013. Although the depreciation of the rupee was also due to declining exports because of an overall slowdown of growth in the world economy, the rather sharp and abrupt depreciation both surprised and alarmed the markets.[2] The weak rupee quickly translated into higher prices (in fact, inflationary prices for both imported as well as basic staples such as onions serve as a bellwether for very bad news for the incumbent government), and the current account and fiscal deficits reached unsustainable levels.

Yet, in the face of these mounting challenges, the country's political establishment, in particular the administration of Prime Minister Manmohan Singh, seemed paralysed.[3] Besieged with problems of rampant corruption in its ranks, debilitating political acrimony and gridlock and rising public frustration and anger, India seemed be to running on autopilot with no one in charge. Not surprisingly, a growing number of observers, including media editorials, began to write-off India—dismissing its 'emergence' as premature and shortsighted, and India still as the proverbial 'country of the future and always will be'.

What explains the abrupt slowdown of the hitherto booming Indian economy? Is, as often claimed, globalisation to blame? Certainly, in this era of globalisation, no country is entirely immune from forces emanating beyond its borders, and as the following pages illustrate, the Indian economy's particular integration into the global economic system creates unique challenges. Nevertheless, it will be argued that India's economic woes are symptomatic of broader structural imbalances in the country's economy—woes which have been further exacerbated because of political dysfunction, in particular vacillation and backtracking on market-friendly reforms, including the failure to implement the necessary reforms to deepen and strengthen India's integration into the global economy. Arguably, a period of sustained growth coupled with a positive macroeconomic environment fostered complacency and hubris resulting in the belief that high economic growth was the norm and could be achieved with ad hoc and piecemeal measures—that is, without completing the unfinished reform agenda. The failure to correct the domestic structural problems to reduce distortions and enhance competitiveness and efficiency has made the Indian economy extremely vulnerable to swings in investor sentiments—both domestic and external. Can these problems be corrected to enable India to get back on the path of sustained high growth? The answer is an unambiguous 'yes', provided India implements the long-neglected, 'second-generation' reforms that further deepen the country's integration into the global economy and fully maximise its advantages.

India's Globalisation's Scorecard

It is important to reiterate that globalisation has been good for India. Indeed, the Republic of India, like its northern neighbour, the People's Republic of China (PRC), is the poster child of globalisation.

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Table 1. GDP Per Capita (in current US$)

Country	2008	2009	2010	2011	2012
China	3,414	3,749	4,448	5,442	6,188
India	1,042	1,147	1,419	1,534	1,489

Source: World Bank, 2013c.

Table 2. Number of People Living on Less than $1.25 per Day (at 2005 PPP prices)

	% of Population		Number (Millions)	
	1990	2008	1990	2008
China	60	13	683	173
India	47	33	433	395
Rest of Asia	58	31	427	287

Source: World Bank, cited in Balakrishnan et al. (2013, 4).

Home to some 2.5 billion people or two-fifths of humanity, both countries are among the world's fastest-growing economies. Both countries' integration into the global economy (for China, since 1978; and India, since 1991) has been central to their impressive economic renaissance. Over the past three decades, the Chinese economy has grown at the extraordinary rate of just over 10 per cent, while the Indian economy has expanded at an average annual rate of around 6.4 per cent—a far cry from the anaemic 3.5 per cent 'Hindu rate of growth' that characterised the economy during the period 1950–1980. During 2002–2011, India's growth rate averaged 7.7 per cent, and during 2005–2008, the average growth rate was an impressive 9.5 per cent. Indeed, even in the midst of the global financial crisis, both economies experienced only a modest slowdown and not the meltdown experienced by the United States, the Eurozone and other advanced economies.[4]

In both countries, high and sustained economic growth has translated into significant increases in per capita gross domestic product (GDP). For India, in 1978, its per capita GDP (in purchasing power parity [PPP] terms) was $1,255. It increased to $2,732 in 2003, to $3,452 in 2005 and to $3,900 in 2012. In China, GDP growth skyrocketed from $1,071 in 1978, $4,726 in 2003, $6,757 in 2005 to $8,500 in 2012.[5] Table 2 confirms that such sustained and high growth rates have translated into poverty reduction and improvements in living standards in both countries, albeit the sharp rise in per capita income in China explains the phenomenal reduction in poverty in that country compared to the decidedly modest poverty reduction in India.[6] It is important to reiterate that globalisation has been good for India (Tables 1 and 2).

The Indian Road to Globalisation

Both India and China's continental size, huge markets, rich resource base and human capital give them a comparative advantage in this age of globalisation. If China has benefited from globalisation because it provides its 'hardware' and serves as the 'world's factory', then India's advantage is that it provides the

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'software' and related services. By riding the revolution in information technology (IT), India has been able to fortuitously overcome the once-insurmountable constraints of geography and time. The global expansion of high-speed Internet and related telecommunications networks have rendered 'geography irrelevant' by creating linkages between countries and businesses that simply did not exist before. This has allowed Indian entrepreneurs and the country's large pool of skilled and relatively inexpensive English-speaking 'techies' to cash in on the IT revolution. In a relatively short space of time, India has become the location of choice for all sorts of IT-related activities, best symbolised in 'Electronics City', that is, Bangalore's main 'tech hub', where everything from advanced software production and programming, data processing, network management and systems integration, multimedia, to business outsourcing and call centre processing is performed.

Yet, overconcentration or comparative advantage, mostly in the knowledge-intensive services sector, has come with costs. Unlike China's broad-based integration into the global economy, India's narrow and highly specialised comparative advantage in the skill-intensive technology sector rewards the 'skill premium'—or individuals—with advanced technical skills and education. It is important to reiterate that the labour-intensive service sectors such as tourism, hospitality and retail trade can only create so many jobs, and unlike labour-intensive manufacturing, these sectors can only absorb relatively small numbers of low-skilled labour moving out of the countryside. India's failure to create a wide range of manufacturing jobs which, historically, have served as a ladder out of poverty for many countries, including China, remains a huge developmental challenge. Unlike China's large and diverse labour-intensive manufacturing sector which has absorbed millions of workers, India's narrow dependence on highly specialised and cloistered service sectors, like IT, relies on a relatively small number of highly educated and skilled workers—excluding the vast majority of the estimated 10–12 million young people who enter the labour market each year. The absence of a dynamic industrial and manufacturing sector has meant that the scope for mobility of low-skilled labour out of the agricultural sector has been limited. Not surprisingly, according to the most recent available official data on labour force (the 68th Round of the National Sample Survey on Employment and Unemployment in India), India's total workforce numbered 473 million in 2012. A whopping 70 per cent was classified as 'rural', with 49 per cent of this workforce employed directly in the 'primary sector' (read agriculture) and the rest in rural activities such as construction or as casual labour.

Table 3 vividly shows the small role of manufacturing in the economy when compared to other players.

Table 3. Per Cent Share of Manufacturing Value (added in GDP 2000 and 2005)

	GDP Share (2000)	GDP Share (2005)
India	**14.3**	**14.1**
China	32.1	34.1
Malaysia	32.6	32.2
Thailand	33.6	36.1
Vietnam	18.6	22.5
Industrialised Economies	17.6	16.8
Developing Economies	20.5	21.7

Source: Zagha (2013, 139).

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Zagha (2013, 144) notes that:

> one of the distinctive features of India's manufacturing is its 'missing middle.' That is, the size distribution of firms is U-shaped rather than the inverted U observed in most countries. The implication is that India has large numbers of small firms, mostly in the informal sector, and large firms. But medium-scale businesses, which in other developing nations account for the bulk of employment, are missing…The relative dearth of mid-sized businesses has much to do with India's failure to develop an export-oriented low-skill-intensive manufacturing sector able to provide more employment and pull the economy ahead.

Indeed, the most dominant characteristic of India's manufacturing sector is the extraordinarily small scale of establishments. With about 87 per cent of manufacturing employment in microenterprises of less than 10 employees, small-scale industry reservations' continue to pre-empt the adoption of the optimal scale of production.[7] Specifically, the Indian government not only puts restrictions on private enterprise through licensing laws, directed credit, preferences for small-scale industry and anti-monopoly regulations, but also through stringent labour laws. India's labour laws make it very costly to reduce workers in enterprises of more than 100 workers.[8] According to a recent McKinsey Global Institute (2014, 15) report, 'At least 43 national laws—and many more state laws—create rigid operating conditions and discourage growth in labour-intensive industries'. The result of this policy is that formal sector firms (those that are registered and that pay their taxes) loathe taking on new employment. Cumulatively, these restrictions have not only severely restricted export competitiveness but also job creation by forcing businesses to create more capital-intensive manufacturing jobs, rather than what India needs—more labour-intensive manufacturing jobs. For example, the production of goods such as garments, toys, shoes, leather and textile products continues to be reserved for the small-scale producers, although large firms have potential comparative advantage. This clearly puts domestic producers at a disadvantage while competing against foreign producers who have no scale restrictions.[9] According to the World Bank's authoritative, *Doing Business 2009*, enforcing a business contract in India is estimated to take an average of 1,420 days. As Subramanian (2013, A19) has noted:

> India's panoply of regulations, including inflexible labor laws, discourages companies from expanding. As they grow, large Indian businesses prefer to substitute machines for unskilled labor. During China's three-decade boom (1978–2010), manufacturing accounted for about 34 percent of China's economy. In India, this number peaked at 17 percent in 1995 and is now around 14 percent.

Unlike China, which has invested much resource in building a world-class infrastructure, India's infrastructure is decrepit, inefficient and literally overwhelmed. Inadequate and inchoate road and rail networks, crippling electric power deficit and overcrowded ports and airports where erratic service and long delays are a norm are a drag on economic growth. Because poor infrastructure increases costs, manufacturing industries will continue to be uncompetitive in India (even if labour laws are reformed), unless the country's infrastructure improves. Similarly, infrastructural bottlenecks have gravely hampered industrial expansion. For example, the pervasive delays in ports and roads relative to India's competitors have forced industries to shift operations to other countries. The World Bank (2013a, 2013b) estimates that it takes about 17 days to export from India compared to five from Singapore and other Southeast Asian countries. Specifically, the cost of a container shipped from India was $945, compared

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with $456 from Singapore. Exacerbating this is the lack of reliable electricity supply. Persistent power shortages have translated into costly disruptions to production, and although key stakeholders agree that chronic electricity shortage is the country's greatest infrastructure deficit, little has be done to alleviate this problem. Overall, burdened with chronically poor infrastructure, excessive regulations and red tape (which add to the production and transportation costs), the manufacturing sector remains uncompetitive and inefficient, and not commensurate with India's overall economic weight.

Complacency, Policy Paralysis and Mercantilism

In India, where 'there is strong consensus for weak reforms', complacency and 'kicking the can down the road' has become a perennial habit. Although India's annual growth slipped to under 4.5 per cent in 2013 (while China notched a 7.8 per cent growth), it was still impressive when compared to the 1.7 per cent for the United States, 2 per cent for Japan and –0.6 per cent for the Eurozone (International monetary Fund [IMF] 2013). Arguably, finding solace in these numbers, Indian policymakers remained adamant—claiming not very persuasively—that the 'dip' was due to external factors such as the sharp hike in oil prices,[10] a poor monsoon, including the prime minister's own assessment that India's economic problems was due to 'markets overshooting' and that growth will return as India's 'economic fundamentals' are sound.[11] Unfortunately, this was only partly true. Instead, during Singh's second term, political gridlock, expediency and vacillation have taken its toll as reforms that would have made the economy more resilient to external shocks have languished. Indeed, urgent financial sector and structural reform measures, which includes everything from removing infrastructural bottlenecks, streamlining regulatory and bureaucratic red tape to better utilising the country's vast untapped human capital, have been tabled with much fanfare in the Parliament, only to be infuriatingly pushed from one session to another.

Rather, what has been implemented have been a panoply of very costly populist welfare and redistributive programmes—whose effectiveness is very much in doubt, but which have added to the government's burgeoning fiscal deficits. The government's recently announced massive 'food security programme' is a case in point. Facing increasingly frustrated voters angry at the rapidly rising food prices and growing shortages of basic essentials, the incumbent government announced a politically expedient (but economically imprudent) programme to distribute an estimated 62 million metric tons of cereals (rice and wheat) to the 'poor'. Costing the exchequer an estimated $20 billion every year (at a time when the government's fiscal deficit is already at an unsustainable 9 per cent of GDP), the programme inevitably has triggered inflationary pressures with huge adverse consequences for the very groups the programme is ostensibly designed to help. The irony is that India already has a massive food distribution system in place. However, like the proverbial 'leaky bucket' it is often described as, it is hugely wasteful and inefficient, 'spilling' over 70 per cent of the goods before it even reaches the intended beneficiaries. It should be noted that India's massively subsidised 'food security programme' goes against World Trade Organization (WTO) rules on food subsidies. Indeed, at the last WTO meeting in Bali (in December 2013), India was prepared to scuttle an WTO agreement if it was denied the right to subsidise and stockpile foodgrains like rice and wheat under its National Food Security Act. The United States initially opposed New Delhi's demands, but later relented as failure to reach agreement would

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have further damaged the credibility of the WTO—albeit the Bali meeting was only about reaching agreement on the narrow 'trade facilitation' part of the broader Doha Round trade agenda which has been stalled since 2001.

The failure to deepen India's integration into the global economy has also negatively impacted India–US economic ties. Although trade and financial linkages between the two countries have steadily grown over the past three decades (with the two-way trade totalling roughly $62.9 billion in 2012 and the US foreign direct investment [FDI] increasing from a meagre $200 million to $6 billion in the past decade), it is far less than should be between the world's largest and third-largest economy.[12] Not only is India the United States thirteenth-largest trading partner but also India–US trade is just an eighth of China–US trade. In fact, even Taiwan and South Korea trade more with the United States than India (Wills 2013). The miniscule size of India–US trade is not only due to India's sluggish manufacturing and narrow export base, but also because New Delhi has hampered the deepening of economic ties by creating roadblocks with complex (and contradictory) regulations and rules that business find infuriating and costly (both in time and energy) to navigate. This problem, or what Subramanian has aptly termed 'protectionism through localisation', long known by markets, has been recently confirmed by a recent World Bank index which ranks India 134 out of 189 countries for 'the ease of doing business'.[13]

Even the landmark Indo-US Civil Nuclear Agreement signed in 2008, which was supposed to generate billions of dollars in business for both US companies and their domestic suppliers, has to date, failed to yield anything tangible except protracted disagreements over which partner would be liable in the event of a nuclear accident. Similarly, disappointment with the long-awaited decision to open India's estimated $500 billion retail market to foreign companies such as Wal-Mart and IKEA will only further limit New Delhi's ability to attract much-needed FDI, not to mention deny consumers benefit from these deep-discount stores in the form of wider selection and cheaper prices.[14] Worse still, the relative ease with which the populist Aam Aadmi Party (AAP or common man's party), which won an unprecedented election victory in Delhi in November 2013, has punitively reversed the decision of the previous government to disallow Wal-Mart and other global retail chains to open stores in India's capital city sends the wrong message at the very time when India needs to attract billions of dollars in FDI to modernise its infrastructure and industries, especially the manufacturing sector.[15]

Concern that India was again becoming protectionist and erecting barriers to trade and investment against the US businesses led House Ways and Means Trade Subcommittee Chair, Devin Nunes (on 13 March 2013), to warn:

> I am concerned that India has launched a series of alarming policies that harm U.S. job creators and are counterproductive. I intend to push India to remove barriers that prevent U.S. companies, farmers, ranchers, and workers from competing on a level playing field and selling their world-class products and services to India's 1.2 billion consumers.[16]

Similarly, the Indian government's 'compulsory licensing' rules regarding foreign firms' intellectual property rights, specifically pharmaceutical patents, recently forced leading American industry associations to form a new organisation: the Alliance for Fair Trade with India (AFTI). Led by the US Chamber of Commerce, the National Association of Manufacturers and several other industry groups, the AFTI has directly appealed to President Obama and the Congress to take immediate and 'purposeful' action against New Delhi's inhospitable 'mercantilist behaviour'. Incensed by what it sees as New Delhi's

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cavalier disregard for international rules and gross violation of the pharmaceutical industry's patent rights—namely, the February 2013 decision by India's Patent Office to revoke Pfizer's patent for the cancer drug, Sutent, by granting a domestic manufacturer, Cipla, the right to produce a low-cost generic; the March 2012 action by the Indian government to grant a 'compulsory licence' to a local company to manufacture a generic version of Bayer's Nexavar (a cancer drug), on the grounds that Nexavar was too expensive for Indian patients and the Indian Supreme Court's decision to deny patent to Novartis (for the drug Glivec to treat leukaemia), despite the fact that its patent is recognised in more than 40 countries—the AFTI sent an open letter (on 6 June 2013) to the president and Congress. The AFTI charged that India has 'systematically discriminated against a wide range of U.S. innovative products', 'has repeatedly ignored internationally recognized rights—imposing arbitrary marketing restrictions on medical devices and denying, breaking or revoking patents for nearly a dozen lifesaving medications' and that India's decision to 'undermine internationally recognised intellectual property standards is…designed to benefit India's business and industrial community at the expense of American jobs' (Minter 2013).

Similarly, India's intrusive local content requirements, which mandate foreign companies to buy local content, led Washington (in February 2013) to approach the WTO for dispute consultations concerning the 'domestic content' requirement of India solar programme. The US correctly argued that by requiring all companies producing solar energy-related products to use locally manufactured solar cells (with New Delhi offering special subsidies), India was in violation of WTO rules which require members to treat both foreign and domestic producers and goods on an equal footing.[17] On top of these, putting in place barriers to local market access via high tariffs and inconsistent tax requirements, limits on FDI via foreign equity caps, and restrictions on investment in banking, financial services, retail and telecommunications have served to only hamper the expansion of trade and investment in India.[18] Clearly, New Delhi's actions have not gone unnoticed. In June 2013, more than 170 members of Congress wrote to President Obama to express their concern regarding 'India's failure to protect intellectual property adequately and its attempts to implement local content requirements in technology purchases' (Dhume et al. 2013), and in August 2013, the Senate Committee on Finance and the House Committee on Ways and Means requested the US International Trade Commission (USITC) to launch an investigation on how Indian policies discriminate against the US trade and investment.[19] Signalling that Washington's patience is running out, on 10 February 2014, US Trade Representative, Michael Froman, announced that the Obama administration planned to take New Delhi to the WTO regarding India's 'discriminatory' domestic content requirements on solar energy products. This marked the second time in less than a year where Washington has taken New Delhi to the WTO—the latest step potentially setting the stage for possible US sanctions if the dispute fails to be resolved by the WTO.[20]

Arguably, procrastination and playing hardball with the world's largest economy in earlier times would have had modest economic consequences for New Delhi. However, in an increasingly globalised economy, it has only served to further undermine India's export growth at the cost of a more competitive, efficient and productive manufacturing sector and badly needed job growth. Moreover, economic globalisation is not a seamless linear process. Besides trade, a more volatile, fickle and unpredictable aspect of globalisation is 'financial globalisation', or what has been termed 'financialisation'. Countries, in particular emerging economies, must constantly adjust to it, or get rolled over in the process. India has chosen to more deeply integrate in financial globalisation, but its failure to adjust to the ever-changing demands of 'financialisation' has also made the Indian economy particularly vulnerable to the often

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unpredictable and volatile shifts in the global market sentiments—a reality vividly (and painfully) demonstrated by the US Federal Reserve's decision to 'unwind' its accommodative monetary policies in mid-2013.

India's Vulnerability to Financial Globalisation

In the United States, since November 2008, the Federal Open Market Committee (FOMC) has been using bond purchases to reduce long-term interest rates to promote economic activity to support domestic employment growth and revive America's stagnant housing markets. The FOMC has varied these very large-scale asset purchases, referred to as 'quantitative easing' (QE), based on its assessment of the United States' overall economic performance. In QE3 (announced first on 13 September and again on 12 December 2012), the Federal Reserve (or Fed) committed itself to monthly purchases of $85 billion in bonds.[21] However, in May 2013, when Federal Reserve Chair, Ben Bernanke, during his testimony to Congress, raised the possibility of 'tapering' or unwinding securities purchases from its current $85 billion a month, it had an immediate negative impact on several emerging country bond and currency markets, besides abruptly reversing credit flows to emerging economies with troubling debt loads—most notably, India.

No doubt, the Fed by printing trillions of dollars had kept the US interest rates near zero, besides boosting asset prices around the world (especially in emerging markets like India), forcing investors to turn to emerging markets for higher yields.[22] In turn, emerging market economies like India (and also Brazil, Indonesia and Turkey) welcomed the new inflow of liquidity, not only for investment but also to finance an excess of consumption. In the case of India, this trend is reflected in the total government expenditures—which increased by an average of 15 per cent each year between 2009 and 2013. Now burdened with large current account deficits and debt, economies such as India lay exposed and vulnerable, especially if foreign investors perceived any signs of weakness (real or imagined) such as slowdown in economic growth and risk of currency depreciation or default. Given that the US dollar plays such an important role in the global economy, even modest changes in the US monetary policy can have (sometimes significant) impact on global capital inflows and outflows.[23] In turn, the resulting exchange rate movements against the dollar can have very large and rapid effects on the level of inflation and exports, especially in emerging economies. Indeed, the reverberations stemming from the Fed's policy intention was felt far and wide, especially in emerging market economies currency markets as investors sold or 'unloaded' emerging market bonds and currencies. The rupee (unlike the Indonesian rupiah or the Brazilian real) experienced a significant correction, or more appropriately, a meltdown.

The Feds action led to howls of indignation from emerging markets. As Rodrik and Subramanian (2014) aptly note:

> From Istanbul to Brasilia to Mumbai comes a crescendo of complaints about dollar imperialism. Heads of state and central bank governors allege that the policies of central banks in industrial countries, especially the US Federal Reserve, pursued in self-interest, are wreaking havoc in emerging-market economies. This allegation is mostly unfair. Emerging markets aren't hapless and undeserved victims; for the most part they are simply reaping what they sowed.

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It is important to keep in mind that a large body of research confirms that the key determinants of capital flows to emerging economies are real growth rate differentials and interest rate differentials, including investor sentiments. Countries with high growth rates and those offering high interest rates (as least, relative to those in advanced economies) tend to encourage capital flows, especially portfolio flows seeking quick returns.

As India's growth rate faltered and then began a steady dip, foreign investors began to pay greater attention to the so-called 'fundamentals' of the Indian economy. Clearly worried about India's perennially stalled economic reforms and unsustainable fiscal and current account deficits, the footloose investors began to pull out their funds from India's equity, bond and currency markets. It was this investor wariness about the Indian economy, in particular concerns about the economy's structural flaws and the growing debt load, which explains the large and rapid capital outflows. Specifically, in March 2013, India's external debt stood at US$ 390 billion or an increase of US$ 44.6 billion, or 12.9 per cent, over the level at end March 2012. More troubling for investors was the increase in the overall debt, primarily due to rise in short-term trade credit—with the ratio of short-term debt to foreign exchange reserves rising to 33.1 per cent by March 2013 from 26.6 per cent in March 2012—and the debt denominated in US dollar's jumping to 57.2 per cent of the total external debt (Reserve Bank of India 2013; also, see Government of India 2012). India's excessive dependence on short-term portfolio capital (which is intrinsically more volatile than FDI), the absence of a vibrant and competitive export sector, in particular manufacturing sector, to earn foreign exchange to service its obligations and growing dependence on imported energy stood as big red flags. With India's imports increasing, and in order to make up for the shortfall (or trade deficit), New Delhi both borrowed excessively as well as encouraged short-term portfolio investments—ostensibly to shore up its own foreign currency reserves. However, the Fed's announcement and the potentially tighter credit in the US and other advanced economies triggered a sudden outflow of liquidity. Chastened footloose investors asked, among other things, how is New Delhi going to finance its imports and deficits? Their concerns only speeded their exit from the Indian market. India's currency and capital account were adversely affected by the large outflow of portfolio investment (estimated at $15 billion during June–August), vividly reflected in the plummeting rupee.

Like Brazil and Indonesia, both of which raised interest rates to prop up their currencies, India's central bank, the Reserve Bank of India (RBI), also increased the bank rate to 10.25 per cent (that is, the interest rate at which it lends money to other banks), placed a cap on amount on which banks could borrow or lend under its daily liquidity window, announced sale of government securities through an open market operation and imposed a 10 per cent duty on gold imports.[24] However, these actions failed to bring much respite. To the contrary, put in an unenviable position, the RBI's policy decisions became contradictory, if not harmful. For example, the RBI's decision to reduce the amount of money Indian businesses and residents could send abroad had the unintended impact of spooking foreign investors further, who became concerned that similar restrictions would be imposed on them. This served to only trigger a further sell-off in the Indian financial markets. As capital outflows continued unabated, the depreciation of the rupee increased inflationary pressure, eventually forcing the RBI to raise interest rates. India's experience vividly highlights that in this era of globalisation, countries with large current account deficits (such as India) are particularly vulnerable to shifts in investor sentiment.[25] In this case, an announcement by the US Federal Reserve that it planned to 'taper' its loose monetary policy had far-reaching consequence as capital outflew from emerging markets on expectations of better greater stability and returns in advanced economies.

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In a rapidly globalising world, cross-border economic and financial shocks and spillovers are a fact of life. The Indian case also underscores that in such a fast-evolving global economy, emerging economies, especially those with glaring structural problems like India, will continue to have diminishing options unless they implement the necessary reforms. For example, the RBI correctly reasoned that if it allowed the rupee to weaken, it would not only push up the cost of imports but also further widen the current account deficit and exacerbate the already high consumer price inflation. Although a cheaper currency could help boost exports and help narrow the current account deficit, unfortunately, India with its weak exports could hardly take advantage of this opportunity. On the other hand, further tightening liquidity carried its own risks by undermining India's already weak and sagging growth, besides worsening the financial conditions for corporates and banks by exacerbating their debt woes. Since growing numbers of private businesses in India have large outstanding foreign debts, their ability to service their debt was made more difficult by the depreciated rupee exchange rate.

Indeed, the rupee's fast depreciation had an immediate negative impact. The rapid erosion in purchasing power meant that everything that India imported (which is a lot) suddenly became a lot more expensive. If India's estimated 300 million-strong middle class who have increasingly acquired a taste for Western consumer lifestyle, including annual vacations, saw their purchasing ability shrink, the vast majority of the populace found it exceedingly difficult to afford basic staples. However, as noted, the import that took a big chunk of change was the escalating cost of energy. India's heavy dependence on imported fuel (which can only be purchased in dollar-denominated prices) took a big toll. As the rupee plunged in value against the dollar, the fuel import bill surged. What is the government to do? It can either raise fuel prices or subsidise the cost to consumers. The first option is politically risky (especially close to national elections) as raising fuel prices negatively impacts everyone—although it disproportionately impacts the poor who, in India, go to the polls and vote. The second option or expansion of subsidies means a further widening of the already high fiscal deficit. With the national election campaign already ramping up, legislators quickly opted for greater subsidies and other populist measures which are, to say the least, politically expedient, but fiscally irresponsible.

India as well as other emerging economies must have heaved a big sigh of relief when, in September 2013, the Federal Reserve announced its decision not to reduce its monetary stimulus after all. However, on 18 December, the Federal Reserve announced that it would 'scale-down' its bond purchase programme from January 2014 when it will buy $75 billion worth of bonds each month (down from $85 billion a month). The miniscule reduction will not have much impact on India and other emerging economies. Nevertheless, this respite provides a 'breathing space' for New Delhi and others to put in place the needed reforms. The damage caused by the Federal Reserve's earlier decision is a cautious reminder of the costs when policymakers become too complacent and fail to put in place the needed measures to make the economy more resilient to domestic and external shocks.

Conclusion

At the time of writing this article (mid-March 2014), the Indian economy had stabilised, in part, due to the RBI's contingent actions to support budgetary austerity—which, luckily, have worked in calming the markets. In particular, raising the policy rate to 8 per cent and maintaining a tight stance to counter rising

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consumer inflation, including measures to cut spending to reduce the budget deficit from 5.8 per cent of GDP in 2011–2012 to 4.7 per cent in 2013–2014 and 4.5 per cent in 2014–2015, helped to boost confidence. This confidence was further reinforced by recovery in the agricultural sector (due to the good monsoons) and in export growth—which to the markets signalled the potential for real GDP growth in 2014. Yet, the Indian economy remains vulnerable not only to the whims of external market forces but also domestically, as policymakers have narrowing policy options, especially in regards to more stimulus spending. As the low-hanging fruit of the first generation of reforms have now been picked, it is essential that the long-delayed second-generation structural reforms, including financial sector liberalisation, labour market reforms, tax reforms, opening the economy to foreign investments, among others, are expeditiously implemented to bring regulatory coherence and reinvigorate the economy into a sustainable growth trajectory, in particular more resilient to swings in investor preferences. In the past, it was grave difficulties that prompted India's policymakers to act. Hopefully, the current difficulties will also force the various stakeholders to work together to put in place the much-needed corrective measures so that India can live up to the mantra of 'India Rising'.

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I would like to thank the editor and an anonymous reviewer for their useful comments which helped improve this article. The remaining errors are mine.

Notes

1. In early 2011, the rupee traded at ₹ 45 to the dollar.
2. India was not the only country which experienced a sharp decline in exports. Other than China, most emerging market economies were also adversely impacted by the economic slowdown (and hence, reduction in imports) in the advanced economies.
3. Singh represents the Indian National Congress (commonly known as the Congress) which is one of the two major political parties in India; the other one is Bharatiya Janata Party (BJP). In the general elections held in 2009), the Congress emerged as the single-largest party in the Lok Sabha, winning 206 seats in the 543-member house. By forming a coalition of several other political parties under the umbrella called the United Progressive Alliance (UPA), the Congress was able to gain a majority and form the government.
4. In the case of India, growth dropped to around 6.7 per cent during the height of crisis in 2008–2009, but picked up quickly, averaging 9.0 per cent during 2009–2010. For a comprehensive overview, see Sharma (2013).
5. The GDP represents the size of a country's economy and PPP GDP is GDP converted to US dollars using PPP rates. The PPP is more useful when comparing broad differences in the living standards between countries because it factors the relative cost of living and the inflation rates, rather than relying exclusively on exchange rates.
6. For contrasting explanations regarding India's failure to reduce poverty like China, see Bhagwati and Panagariya (2013) and Dreze and Sen (2013).
7. For a good overview, see Sharma (2009).
8. The Industrial Disputes Act of 1947 requires 'large-scale enterprises' to obtain state government approval before firing or laying-off workers. 'Large scale' used to refer to firms with over 300 employees. An amendment to the Act in 1976 made it compulsory for firms with 300 or more workers to seek permission from the government before dismissing workers. In 1982, the ceiling for seeking prior government permission was reduced to 100 workers.
9. For a good overview, see Panagariya (2008).

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10. In fact, in 2013, there was no sharp rise in the price of oil as prices ranged from $105 to $114. However, India's oil consumption and government subsidies has increased (I thank the anonymous reviewer for alerting me to this). It is useful to note that although the Indian government imports oil at market prices, it, nevertheless, puts a ceiling on the domestic retail price by paying the oil companies the difference. Suffice it to note this expenditure has greatly increased.
11. Clearly, Prime Minister Singh, a distinguished economist, was making a political statement when he claimed that India's economic fundamentals were 'sound'. In fact, when the IMF, in its quarterly *World Economic Outlook*, projected India's growth in 2013 to be at 3.75 per cent, India's Finance Minister, Palaniappan Chidambaram, who was boldly claiming that India would grow by 5–5.5 per cent, took umbrage and dismissed the IMF's claims.
12. In 2012, India's $4.7 trillion economy (in purchasing power terms) became the third largest in the world after it surpassed Japan. The largest is the United States, followed by China (Subramanian 2013).
13. The World Bank data is based on the period 2009–2013 (see Word Bank 2013).
14. A large percentage of India's fresh food produce rots away because of poor transport and rat-infested storage facilities. Foreign super stores such as Wal-Mart, by providing good storage, would have helped to reduce waste and thereby price.
15. Unable to arrive at a consensus on how best to open India's huge retail market, New Delhi finally passed the buck to India's 28 state governments and union territories by giving them the power to either allow or prohibit FDI up to 51 per cent in multi-brand retail stores. Moreover, foreign retailers are required to get 30 per cent of their sourcing from small and mid-size domestic enterprises. The previous Congress-led government in New Delhi was among the first to give permission to foreign retailers to set up shop in its territory. However, the AAP, which sees the world as characterized by a Manichean struggle between the good (Indian) and the bad (foreign), overturned this.
16. Retrieved from http://www.waysandmeans.house.gov/
17. India has not only argued that its solar energy policies are legal because WTO 'government procurement rules' permit countries to exempt certain projects from 'non-discrimination obligations', it has also accused Washington of hypocrisy claiming that the United States continues to provide numerous 'incentives' and 'subsidies' to its domestic companies involved in green technology.
18. Indians rightly complain about the restrictive US immigration policy regarding high-skilled workers. No doubt, both sides will benefit from a more accommodative H-1B visa programme.
19. The USITC is an independent and non-partisan federal agency whose major task is to engage in fact finding. The USITC is tasked to enumerate all the restrictive trade and investment policies that the Indian government maintains or has recently erected, including its impact on the US economy. The USITC report will be available by 30 November 2014.
20. Under WTO rules, member states have 60 days to reach a resolution. However, if no resolution is reached, the United States, in this case, can request the WTO to establish an independent panel to determine whether India has violated WTO trade rules.
21. The September 2012 programme involved purchasing $40 billion in mortgage-backed securities (MBS) every month. It was expanded in December 2012 to include $45 billion in monthly Treasury security purchases.
22. However, China's robust current account surplus and huge foreign exchange reserves made the economy better weather the announcement.
23. Specifically, with the US dollar functioning as the global reserve currency, it means that shifts in the dollar's value directly affect expectations for borrowing costs globally. Thus, any rise in the US interest rates means higher borrowing costs elsewhere in the world.
24. As Subramanian (2013a) aptly notes, 'to hedge against inflation and general uncertainty, consumers have furiously acquired gold, rendering the country reliant on foreign capital to finance its trade deficit'. Similarly,

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a recent IMF study notes that 'of the several reasons cited for the increased demand for gold, there is strong evidence that gold is increasingly being used as a hedge against inflation. Gold imports are highly correlated with households' inflation expectations' (IMF 2014, 6).

25. India's current account deficit (or excess of imports over exports and remittances) in 2012–2013 was 4.8 per cent of GDP, or $87.8 billion. This is more than double the 2.5 per cent the RBI considers sustainable.

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