

June 2, 2009

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India's Virtuous *Cycle*

In recent years, the global view of India has been couched in terms of the daunting China comparison. It wasn't all that long ago—1991, to be precise—when Asia's two giants had similar levels of income per capita. That was then. Now, China's standard of living is more than three times that of India.

The China comparison has been India's wake-up call—a striking example of how economic development can be galvanized by pro-active government policy. It's not that India has floundered. To the contrary, over the 2001-07 timeframe, India's real GDP growth averaged close to 7.5%—an impressive pick-up from the 5.5% pace of the 1990s. Perhaps the most remarkable aspect of this accomplishment was that it occurred despite the government—in the face of stiff political headwinds.

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Those headwinds could now quickly become tailwinds. Courtesy of the stunning victory of the Congress-led UPA in the recently concluded elections, there is a distinct chance that India could now benefit from its own strain of proactive, development-friendly government policies. The same reformers that were so successful in opening up India in the early 1990s were stymied by the politics of coalition management over the past five years. The massive win of the Congress Party all but removes that impediment—hinting

at a new era of reforms that could well unshackle the increasingly robust potential of the Indian economy.

The dirty little secret of the Indian economy is that it has actually been performing much better beneath the surface than the China comparison might otherwise suggest. India has long had a much better *micro* story than China: a large population of world-class companies, outstanding entrepreneurs, a well-educated and IT-competent workforce, relatively sound financial markets and banks, a well-entrenched rule of law, and democracy.

By contrast, India has suffered more from its *macro* deficiencies—especially when compared with China. That's especially been true of saving, foreign direct investment, and infrastructure. Yet in the past 3-4 years, India has made impressive progress on at least two of those counts. Gross domestic saving rates have moved from the low 20s (as a percent of GDP) in the late 1990s to the high 30s in 2007-08. Foreign direct investment accelerated to a \$40 billion annual rate—still short of Chinese style numbers but a four-fold increase from the pace of India's inflows as recently as 2005. Even on the infrastructure front—where development constraints remain quite serious—the GDP share of such investments is up from the rock-bottom levels of the late 1990s.

That points to a virtuous cycle for India—with the self-reinforcing interplay of its micro and macro drivers augmented by pro-active government policy and reforms.

Therein lies India's great potential—an increasingly virtuous cycle brought about the self-reinforcing interplay of its micro and macro drivers that now stands a real chance of being

augmented by pro-active government policy and reforms. The new government needs to seize this moment—moving aggressively on four fronts: public sector deficit reduction, infrastructure support, privatization, and deregulation of pension funds, retail, and banking. These are all tough battles for any politicians to wage. But if the government makes a down-payment on these critical initiatives, the Indian economy is well positioned to benefit for years to come.

With the world having fallen in love with China, the Indian economy now stands a real chance to emerge as Asia's biggest surprise.

The world has fallen in love with the China miracle. India has slipped between the cracks in all this euphoria. Yet China now faces increasingly daunting challenges in coming to grips with long-simmering imbalances of its export- and investment-dominated macro structure. That could be a great opportunity for the “sleeper.” Shifting political winds now give a well-balanced Indian economy a real chance to emerge as Asia's biggest surprise in the years immediately ahead.

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