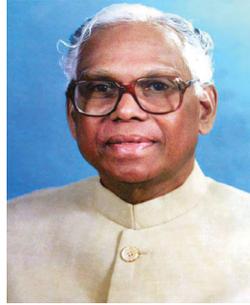


Oration 3: 1996 K.R. Narayanan Oration

Message from the Vice-President
of the Republic of India



I am happy to see that the Australia South Asia Research Centre inaugurated during my official visit to Australia in 1994 has maintained lively and meaningful contacts with the region and continued the intellectual exploration of its developmental problems. The K.R. Narayanan Oration has become an annual event eagerly looked forward to by the academic community.

I am glad to learn that the third lecture in the series is being given by the reputed economist Professor Jagdish Bhagwati. Professor Bhagwati is an economist who has made distinctly original contributions to the study and understanding of contemporary Indian and international economic problems. It is of special importance that he is delivering the lecture in the context of the annual Australian Conference of Economists and as a prelude to the *Australia India — New Horizons* event sponsored by the Government of Australia and scheduled to take place in India later this year. The subject-matter of his lecture: 'India: Retrospect and Prospect' is particularly relevant today when India is entering the fiftieth anniversary of its independence.

Compared to the immense needs of the country and the kind of progress made by the Asian Tigers, India's achievements during the last 50 years might look unspectacular. But the progress made has been steady and all-round, making it possible for the country to move forward rapidly into the future on foundations that are firm and maintaining stability and balance for a vast pluralist society marked by uneven development and baffling social problems.

The most remarkable fact that stands out prominently is that India has developed a democratic system of government that has faced several social, economic, political and security crises during the last five decades, and emerged successful and stronger out of them. In the economic field an achievement of fundamental significance was what has been called the Green Revolution. The magnitude of it can be realised when one recalls the succession of famines that devastated the country before independence and the major famines some of the developing countries had gone through not very long ago. But it has to be recognised that poverty is still with us and that the number of people living below the poverty level is unacceptably high. So is the level of illiteracy in the country. In the world index of human development, India occupies a low position. However, the rise in the average expectation of life from 27 years in 1947 to 60 years today is striking and is the outcome of the slow but steady progress in economic conditions and human development factors. In my state of Kerala, which population-wise is equal to two Australias, the index of human development is more or less the same as that of several advanced developed countries with average expectation of life at 71, literacy level at 100 per cent, infantile mortality rate at 13 per thousand and population growth rate at 1.3 per cent. This is an indication that it might not be impossible for the rest of India also to achieve similar levels of success with proper policies and proper implementation of policies and programs.

The biggest event happening in India since 1991 has been the massive process of economic reforms with liberalisation and restructuring of the economy and its opening up to the rest of the world. Though in the circumstances of India some caution may have to be observed in regard to speed of liberalisation. It has already led to results that are sizeable and significant. In spite of the daunting nature of the tasks facing Indian development, I should venture to be optimistic about the prospects before India. I would personally look forward to Professor Jagdish Bhagwati's analysis and forecasts in regard to this important issue. I am sure that his Lecture would be a stimulating and rewarding intellectual experience.

K.R. Narayanan
New Delhi 1996

India: Retrospect and Prospect

Jagdish Bhagwati

At the outset, I must thank you for the great honour that you have extended to me by inviting me to give the K.R. Narayanan Oration. The honour is twofold.

Vice President Narayanan, whom I have the privilege of knowing well, is a man of great courtesy, charm, acuteness of intellect, and accomplishment. I believe that men and women matter. They defy the tenets of historical determinism, shaping instead of bending to history. They lead themselves, and their nations, to what Prime Minister Jawaharlal Nehru, a great and moving orator, called their 'tryst with destiny'. Dr Narayanan is one of them. But, let me assure the economists assembled here, he is also a man of impeccable taste: he studied economics and even enjoys the dismal science!

And that brings me to the other reason why I am flattered by your invitation today. Australia is in the memories of every Indian of my generation, of course. Many were the days when we ran truant from our school to watch the Indian cricketers locked in combat with the visiting Australians, fascinated in particular by the incredible speed of Lindwall and Miller as they terrified our batsmen: those were the days of exhilarating five-day Test Matches between Cricket *Teams*, not the fast-track deviants now played between *Squads*! And Don Bradman was to us, as to you, a legend.

But as I grew older, and my tastes turned to Economics, and within that to International Economics, I also realised that Australia had produced many of the best international economists in the world: Murray Kemp, Max Corden, Trevor Swan, Ross Garnaut and Heinz Arndt among them.

For me to come to Australia finally is to come therefore, not just to the country of the irresistible koala, of the exotic kangaroo, of genius in cricket and tennis, of *Breaker Morant* and a wonderful cinema, and of a literature crowned by the Nobel Prize, but also to a great scholarly tradition in the subject closest to my heart. But that is not all. Mr Vice-Chancellor, I must add that your world-renowned university has housed many of the splendid economists that Australia has produced: there could then be no better place for me to be giving this Oration than right here!

Indeed, Mr Vice-Chancellor, I would be remiss if, on an occasion that celebrates the growing friendship between our two countries, I did not also recall the fact that I first met Trevor Swan of your university, a venerated figure among Australian and indeed all economists, in India in 1958, I believe. He had come as part of an advisory team of eminent economists that included Ian Little of Oxford and was led by Paul Rosenstein-Rodan of MIT, a great development economist. Swan had come with enthusiasm, eager to put his expert Australian shoulder to the wheel in India's developmental efforts.

Mr Vice-Chancellor, I must entertain you by recalling the contrasting story of the *reluctant* economic adviser that the Nobel laureate, Princeton economist Arthur Lewis regaled his friends with. Once he found himself invited to a fundraising luncheon by the Princeton University President for the Iranian Ambassador in Washington, a man known only to those who read the Style sections of the newspapers because he used the sudden oil wealth of his nation to entertain flamboyantly the likes of Elizabeth Taylor. So, Lewis was minding his manners and quietly getting through the lunch when he was suddenly startled to hear the President promising the Ambassador: 'We would be happy to send Professor Lewis to Iran to help you with planning your development'. As he walked back morose from the luncheon, Lewis ran into the sociologist Marion Levy, a man of some wit, who asked him what the matter was. When Lewis told him, Levy said: 'Arthur, you should have told the President that Professors can be bought, but not sold.'

As it happens, Trevor Swan's early visit to India provides me with the main theme of the Oration today: the reasons why India's monumental developmental efforts went astray and why, for the very same reasons, the current reforms hold great promise. Swan came to India at a time, in the early 1960s, when India's developmental efforts were attracting attention worldwide. And the attention and interest were equally from economists.

To understand this, and also to put the subsequent disenchantment into perspective, let me explain why what we were doing in India through the 1950s was sensible *and* worthy of the huge interest everywhere.

India in the 1950s: On Track, Phase I

At her independence in 1947, India already had a fair degree of industrialisation under her belt. Textiles and steel were among the many industries that had come up exclusively from market forces and with domestic investment, under a colonial government that certainly had not seen itself as a developmental agency and had therefore virtually abstained from ‘infant industry’ protection or promotion. India also enjoyed the presence of an active entrepreneurial class and a modest but definite integration into the world economy. The country was also endowed with a first-rate civil service and administrative structure, world-class leaders and a democratic form of government.

But the poverty was huge, with corresponding standards of living appalling for many, the literacy levels were abysmal even as the higher levels of education were impressive, and the challenge to the new government was clearly immense.

The *key strategy* that defined the resulting developmental effort was the decision to target efforts at accelerating the growth rate. Given the immensity of the poverty, simple redistribution was considered to be both negligible in its immediate impact and of little sustained value. The central anti-poverty strategy had therefore to be the creation of increasing numbers of jobs that would draw ever more of the underemployed and unemployed into gainful employment that would yield them both greater incomes and higher standards of living. Accelerated growth was thus regarded as an instrumental variable, a policy outcome that would in turn reduce poverty, the latter being the true objective of our efforts.

I have often reminded the critics of Indian strategy, who attack it from the perspective of poverty which is juxtaposed against growth, that it is incorrect to think that the Indian planners got it wrong by going for growth rather than attacking poverty: they confuse means with ends. In fact, the phrase ‘minimum income’ and the aim of providing it to India’s poor were very much part of the lexicon and at the heart of our thinking and analysis when I worked in the Indian Planning Commission in the early 1960s.

Equally, the populist notion that pushing growth to kill poverty is a passive and conservative ‘trickle-down’ strategy is wholly obtuse. In the Indian context, it was an active and radical, what I have called ‘pull-up’ strategy. Nor were we unmindful that added policy instruments were necessary to ensure that the growth process would indeed extend to all groups. For instance, just as the United States has a ‘structural’ inner-city problem, we have (among others) a ‘tribal’ problem: each underprivileged group fails to have equal and ready access to the mainstream economy. Nor were social expenditures relegated to oblivion. The first Five-Year Plan itself had addressed this matter, and the Planning Commission had at the time a distinguished social worker, Mrs Durgabai Deshmukh, as a member who formidably minded her portfolio on the social questions.

But substantial and expanding sums could not be spent on the social questions and on the improvement of the ability of the underprivileged to access the growing mainstream economy *unless* you had growth in the first place. Spending on education and on public health, chief among our concerns, could not be expanded or even sustained unless a growing economy produced the added revenues to finance these and other expenditures.

To those who use the cliché of ‘development with a human face’, I respond:

Yes, indeed. But remember that the face cannot exist by itself, except as a mask in a museum, but must be joined to the body; and if the body is emaciated, the face must wither no matter how much we seek to humanise and pretty it up.

So, we return to growth as the centrepiece of the Indian strategy for assaulting poverty and providing minimum incomes to the poor. And we must remember that it was the government’s task to accelerate economic growth. I believe that we could say, in a stylised way but with plausibility, that the central conception underlying India’s growth-accelerating strategy was the devising of a planning framework that would produce the enhanced investment rates. Thus, the objective was to jolt the economy up into a higher-investment mode that would generate, say, a 5 per cent growth rate as against the conventional lower-investment equilibrium with a 2 to 2.5 per cent growth rate.

The planning framework then rested on two legs. First, it sought to make the escalated growth credible to private investors so that they would proceed to invest on an enhanced basis in a self-fulfilling prophecy. Second, it aimed at generating the added savings to finance the investments so induced.

The Five-Year Plan framework was an important aspect of this two-pronged policy. Simply by demonstrating that the government was committed to a higher growth rate, it assured potential investors that demand would grow at higher rates and that the risk of investment would be correspondingly reduced. Besides, at the core of the plan there was commitment to substantial governmental spending, mostly on infrastructure, that added yet greater credibility to the high-growth scenario in what was otherwise an ‘indicative’ plan in terms of its investment profile. Moreover, the commitment to use fiscal policy to raise public savings to levels necessary to finance the projected growth of investment was also a credibility-enhancing factor for bringing about the enhanced investment.

The bulk of the 1950s can then be called the favourable Phase I of Indian developmental effort; and it broadly coincides, in approach, to much of the East Asian experience where, however, the Five-Year Plan framework was not utilised. The governmental intervention, as described, led to an investment boom and hence to an enhanced growth. I may, in fact, recharacterise what happened, in more familiar technical terms, by reference to the Rosenstein-Rodan argument that has now been formalised by Vishny and Shleifer in their fine article in the *Journal of Political Economy* as a case of multiple equilibria.¹ In his classic 1943 *Economic Journal* article,² which is arguably the most beautiful piece of creative writing on development, Rosenstein-Rodan was basically arguing that, for developing countries stuck in a Nash equilibrium with low levels of investment, there existed a superior cooperative equilibrium with higher levels of investment and growth.

The Indian planners, in formulating the first Five-Year Plan (1951–56), were essentially exploiting this insight. This was an indicative plan, without the straitjacket of controls and targeted allocations that would presumably reflect the contours of the superior equilibrium. In fact, it is absurd to

1 Andrei Shleifer and Robert W. Vishny (1988), ‘The Efficiency of Investment in the Presence of Aggregate Demand Spillovers’, *Journal of Political Economy*, 96(6): 1221–31.

2 P.N. Rosenstein-Rodan (1943), ‘Problems of Industrialisation of Eastern and Southern-Eastern Europe’, *The Economic Journal*, 53(210–211): 202–211.

imagine that anyone, either in India or in East Asia, could have worked out such a Rosenstein-Rodan–Vishny–Shleifer equilibrium even if there had been complete information to do so! What did happen instead was that, as I already suggested, the large component of public spending on infrastructure which was built into these indicative programs made the government’s commitment to kicking the system up into some bastardised version of the Rosenstein-Rodan–Vishny–Shleifer equilibrium quite credible to the private sector, triggering the self-fulfilling private sector investment response that lifted the economy into higher investment and growth rates.³

What Went Wrong: Derailing after the 1950s, Phase II

What went wrong with India, and was still not entirely manifest when Swan arrived in India, can be characterised by contrasting India with East Asia once we go beyond the 1950s. In fact, by understanding better why East Asia went ahead to build greater success post-1950s helps us to understand why India went ahead to decline instead in her economic performance: hence, I will focus on East Asia’s success and its causes for now.

Let me begin by observing that, in my judgement, the critical difference was that India turned to the IS (import substitution) strategy and East Asia to the EP (export promotion) strategy. A central implication, which I have not drawn sharply in my earlier writings (which have focused, not on the inducement to invest, but rather on the social returns from investment) is that India, during this Phase II, handicapped the private inducement to invest, while East Asia wound up enhancing it.

3 Dani Rodrik seems to share broadly this view of how private investment rose but seems to err in two ways. He seems to suggest, presumably in sympathy with the Amsden–Wade thinking, that the bureaucrats could figure out the sectoral contours of the superior equilibrium, a presumption that I find ludicrous especially having seen the best bureaucrats in India confess to their inability to choose industrial favourites on any rational grounds. Moreover, he extends the argument well beyond the 1950s whereas, as I argue later in the text, this makes little sense. See Dani Rodrik (1995), ‘Getting Interventions Right: How Over the Home Markets South Korea and Taiwan Grew Rich’ *Economic Policy*, 10(20): 53–107.

India turned inwards, starting with a balance of payments crisis in 1956–57 which precipitated the imposition of exchange controls which then became endemic to the regime, reflecting the currency overvaluation that implies the effective pursuit of an IS strategy. Again, the explicit pursuit of an IS strategy was also desired, reflecting the economic logic of elasticity pessimism that characterised the thinking of India's planners.

The result was that the inducement to invest in the economy was constrained by the growth of demand from the agricultural sector, reflecting in turn the growth of that sector. But agriculture has grown almost nowhere by more than 4 per cent per annum over a sustained period of over a decade, so that the increment at the margin in India's private investment rate was badly constrained by the fact that it was cut off from the elastic world markets and forced to depend on inevitably sluggish domestic agricultural expansion. Thus, it became customary for Indian economists to talk about 'balanced growth' and about the problem of raising the investment rate which, by the mid-1980s, was still in the range of 19–20 per cent.

By contrast, the East Asian investment rate began its take-off to phenomenal levels because East Asia turned to the EP strategy. The elimination of the 'bias against exports', and indeed a net (if mild) excess of the effective exchange rate for exports over the effective exchange rate for imports (signifying the relative profitability of the foreign over the home market), ensured that the world markets were profitable to aim for, assuring in turn that the inducement to invest was no longer constrained by the growth of the domestic market as in the IS strategy. Private domestic savings were either raised to match the increased private investment by policy deliberately encouraging them or by the sheer prospect of higher returns.

This argumentation is not easy to defend once you face up to what my student Don Davis, now at Harvard, has called the 'tyranny of the Stolper-Samuelson': for, when this theorem holds, wages and rentals on capital are inversely related.⁴ When exports are the labour-intensive, the EP strategy may be expected to raise the wage of labour but depress the return to capital, thus depressing, not raising, the inducement to invest. Clearly,

⁴ I am drawing here on the preliminary draft of Don Davis's paper, 'Miracles of Accumulation: Models of Trade and Growth in East Asia' (mimeo), Department of Economics, Harvard University, January 1996.

therefore, the force of Stolper-Samuelson argument must be broken: as indeed it can be by relaxing one or more of the assumptions underlying that theorem.

Thus, Davis suggests that the forces of comparative advantage may be argued to have been sufficiently strong as to make East Asia specialise in the production of the labour-intensive goods. This

decouples factor returns from the factor price frontier for the capital intensive good, leaving wages and rentals dependent only on productivity in the labor intensive good and the price of that good. In moving from autarky to free trade, both factor prices can rise, inducing an accumulation 'miracle'.

Another way out would be to assume productivity differences across countries, as in Ricardian theory. In this case:

if we assume that the relative productivity gap of East Asia relative to the rest of the world is largest in the capital intensive sectors, and that trade serves to close this gap, then it is again possible for both wages and rentals to rise.⁵

While therefore it is possible to formalise the argument I have made that the EP strategy increased the inducement to invest, I must also address Dani Rodrik's recent objection that exports were a relatively small part of the economy at the outset so that EP strategy could not have resulted in any significant impact, and therefore the source of the investment must be found in governmental subventions and interventions whereas the growth of trade is simply a *passive* result of the growth induced by these other factors. This argument is unpersuasive because East Asia would have run into precisely the problem of demand constraint that India was afflicted with if an IS strategy had been followed, with the efficacy of these other policies in generating investment seriously impaired. Moreover, the ultra-EP strategy, with its mild bias in favour of the export market and the policy-backed ethos of getting into world markets, meant that export incentives must have played a major role in influencing investment decisions, not just in the exporting industries, but also in the much larger

5 Ibid., p. 2. Davis proceeds to formalise these ideas in a dynamic framework, more appropriate to the accumulation problem at hand.

range of non-traded but tradeable industries.⁶ In any event, the growth of exports from East Asia was so phenomenal that the share of initial exports in GNP quickly rose to levels that would lay Rodrik's objection to rest, even if it were conceptually correct.

The flip side of the process was, of course, the generation of substantial export earnings that enabled the growing investment to be implemented by *imports of equipment embodying new technical change*.

Now, if the social marginal product (SMP) of this equipment exceeded the cost of its importation, there would be a 'surplus' that would accrue as an income gain to East Asia and would also, as I argue below, boost the growth rate. For this argument to hold, however, the international cost of the newer-vintage equipment must not reflect fully its SMP for East Asia. In a competitive international market for equipment, therefore, I must assume that East Asia was a small player whose higher SMP did not pull up the world price to reflect the higher SMP — i.e. that East Asia could, even without 'piracy' and 'theft' of intellectual property (which was widespread in the region until the new WTO regime), get embodied technology at bargain prices. This seems a reasonable assumption to make, especially when one sees that the world prices of the last-but-one vintage equipment fall drastically due to rapid obsolescence in the presence of quick product innovation: just think of your PCs. (To understand fully the foregoing point, note that an economy in 1970 such as Soviet Russia's which was confined to using its own 1930s-vintage technology in equipment would *not* lose to East Asia which could use a heuristically 20 times more productive 1960s technology if East Asia had to pay a 20 times greater price for it. The surplus arises because East Asia pays, say, only a five times greater price in world markets for equipment that is 20 times more productive in East Asia.)

⁶ Rodrik (op. cit.) also seems to think it pertinent that the export incentive, in the shape of the real exchange rate, did not continue improving. However, it is not necessary for it to be improving continuously for the export incentives to operate. Thus, an excess of the effective exchange rate for exportables over that for importables (as distinct from continuous increase in this difference) will suffice to provide a continuing incentive for the export. Martin Wolf has also critiqued Rodrik's anti-EP-strategy argumentation, as also the Krugman argumentation, in two excellent recent columns in the *Financial Times*, 'The Tyranny of Numbers' and 'A Lesson for the Chinese'.

This argument is illustrated in Figure 1 in a simple diagram, with the SMP curve for increasing imports of the vintage capital equipment for East Asia put against the international cost of importing it, the striped area then representing the surplus that accrues to East Asia.

But there may also be another reservation about this argument's effect on the growth rate, as distinct from its effect on income. It is fair to say that, thanks to the focus on the steady state in Solow-type models, it has now become fashionable to assert that the gains from trade, like any allocative efficiency gains, amount to one-time gains, not affecting the growth rate. This is, however, wrong-headed as a general assertion. Thus, consider the simple Harrod–Domar corn-producing-corn growth model with labour a slack variable. If allocative efficiency regarding land use (say, from one inefficient farm to another efficient farm) leads to a greater return to the total amount of ('invested') corn being put into the ground, the marginal capital-output ratio will fall, *ceteris paribus*, and will lead to a permanently higher growth rate. Similarly, it takes no sweat for a first-rate theorist to construct models where trade in capital goods leads to higher growth rates, without building in externalities, etc. and relying exclusively on the fact that they can be imported more cheaply than constructed under autarky.

Thus, T.N. Srinivasan has extended the Mahalanobis-type putty-clay model to include trade and demonstrated precisely this.⁷ Thus, he assumes (in place of just one capital and one consumer good in the autarkic version) that there are two of each class of goods, with the marginal product of capital constant in each sector as in the Harrod–Domar model. The social utility function and the function that transforms the output of the two investment goods into aggregate investment are Cobb–Douglas. There is no inter-sectoral (i.e. between the consumer goods and the capital goods sectors), as against intra-sectoral (i.e. between the two goods in each sector), mobility of capital: this is the clay assumption.

7 See his comment on 'Two Strategies for Economic Development: Using Ideas and Producing Ideas', by Romer, *Proceedings of the World Bank Annual Conference on Development Economics 1992*, World Bank, Washington DC, 1993. Srinivasan also makes the valid point that the Mahalanobis–Feldman putty-clay models are among the earlier examples of 'endogenous' growth theory since the growth rate is determined by the discretionary policy choice of the share of investment goods being allocated to the capital goods sector. The neglect of the considerable literature on such models by the originators of the current endogenous growth theorists is to be attributed to the fact that these theorists have come to their models from the Solow model and have no acquaintance with the growth models that came up in the context of developmental problems in the 1960s. Of course, most of us are rediscovering great ideas all the time!

Assuming that all four goods are produced under autarky, that free trade is undertaken at fixed terms of trade, and that the share of investment going to augmenting capacity in each of the two sectors is fixed exogenously, Srinivasan then demonstrates plausibly that free trade in consumer goods (but with autarky continuing in investment goods) will raise welfare relative to autarky but not affect the growth rate of income or utility. On the other hand, freeing trade in investment goods will have a positive effect on transitional as well as on long-run (steady state) growth effect, and also a beneficial welfare effect relative to autarky. The vulgar belief that trade gains cannot affect the growth rate is thus easily disposed of.

However, how does one reconcile the ‘surplus’ argument with the findings that TFP growth has been a negligible factor in East Asia? So, is my story plausible but not borne out by the facts, as is often the case with our most interesting theories? I think not.

Thus, consider precisely the case where the imported equipment is 20 times more productive in Period 2 than in Period 1, but its price is only five times as high. If the valuation of this equipment is at domestic (producer) opportunity cost, as it should be, then it will indeed be priced 20 times higher than the older-vintage equipment of Period 1, so the measure of capital contribution at the level of the industry will rise commensurately and I presume that the estimated TFP growth in the industry will be zero: in that case, my thesis about the surplus is totally compatible with measured TFP emerging as negligible. But, of course, if the equipment is priced at its international cost, then I presume that TFP growth will pick up three-fourths of the gain that accrues from the ‘surplus’ of SMP over the international cost. My guess then is that, in East Asia, the former was the case. This might have been, not because the accountants were smart and valued Period 2 equipment at domestic opportunity cost, but because I guess that much of the imported equipment may have gone through importing trading firms which collected the three-fourths premium rather than the producing firms.

The role of literacy and education comes in precisely at the stage of the second step in my story above. For, the productivity or SMP of the imported equipment would be greater with a workforce that was literate and would be further enhanced if many had even secondary education. Thus, as shown in Figure 2, the SMP curve could shift to the right with literacy and education, leading to greater surplus for any given international cost of newer-vintage equipment.

Here I may cite Little,⁸ using the pretext that a lecture justifies the informality of argumentation that a conference paper does not:

It was largely from the experience of conducting this [1975, South Korean] survey, involving visits to the [28 randomly selected] firms ranging from 1.5 to 3.5 hours, that my own impressions of such matters as the acquisition of technology and skills on the part of the labour force ... were formed. I also visited a number of high exporting medium-size labour-intensive firms in Taiwan in 1976 ... Two points are mainly relevant in the present context. First the technology was simple, non-proprietary and easily acquired ... Secondly, both Korean and Taiwan workers were very quick to learn. Employees would usually reach the expected high level of productivity within a few weeks. This would probably not have been the case if the standards of primary education had not been high.

Of course, as these economies grew rapidly, the demand for secondary and higher education in turn would rise and a virtuous circle would follow: primary education would enhance the growth that the EP strategy brought whereas the enhanced growth would demand and lead to a more educated workforce. I see therefore primary education and literacy as playing an enhancing, rather than an initiating, role in the EP-strategy-led East Asian drama.

Thus, my story of East Asia's success, and by contrast that of India's failure, combines in its own way three major elements, in that order: (i) the enhanced inducement to invest due to the EP strategy; (ii) the benefit from the surplus of domestic SMP over international cost of imported newer-vintage capital equipment; and (iii) the raising of this SMP by the presence of a literate workforce. But if the main plot is this, the story has doubtless many sub-plots. I will touch on just one of them, especially as the analysis dates back to the early 1970s and to the NBER project, which I had the pleasure of codirecting with Professor Anne Krueger, yet another of Australia's gifts to Economics.

8 Ian Little (1994), 'Picking Winners: The East Asian Experience', *Social Market Foundation Occasional Paper*, London.

In my synthesis volume⁹ for the NBER Project findings, I had noted that among the advantages of the EP strategy, which the project had found beneficial, one had to count the fact that trade barriers-jumping DFI in the IS countries was likely to be limited for these countries by the size of the domestic market by which it was motivated — there are shades here of the inducement-to-invest argument I have made today, but only in the faintest strokes. Secondly, such DFI as was attracted in the IS countries was also likely to be less productive because it would be going into economic regimes characterised by significant trade distortions that could even generate negative value added at socially relevant world prices — a possibility that was discussed by me (based on an extension to the DFI issue of the contribution by Harry Johnson to the theory of immiserising growth in tariff-distorted economies)¹⁰ and then nailed down in well-known articles into a certainty under certain conditions by Hirofumi Uzawa¹¹ and by Richard Brecher and Carlos Diaz Alejandro¹² independently. I should mention that both these (thoroughly plausible in terms of their economic rationale) hypotheses have been examined, with some success, in cross-country regressions by another former student of mine, V.N. Balasubramanyam at Lancaster University and his co-authors.¹³ So, this element may also be added to the explanation of East Asia's superior performance relative to that of IS-strategy-plagued countries such as India.¹⁴

9 Jagdish N. Bhagwati (1978), *Anatomy of Consequences of Exchange Control Regimes*, NBER, Ballinger, Cambridge, Mass.

10 See Jagdish Bhagwati (1973), 'The Theory of Immiserising Growth: Further Applications', in Michael Connolly and Alexander Swoboda (eds), *International Trade and Money*, Toronto University Press, Toronto.

11 Hirofumi Uzawa (1969), 'Shihon Jiyuka to Kokumin Keizai (Liberalisation of Foreign Investments and the National Economy)', *Economisuto*, 23(December): 105–22.

12 Richard Brecher and Carlos Diaz Alejandro (1977), 'Tariffs, Foreign Capital and Immiserising Growth', *Journal of International Economics*, (4): 317–22.

13 See, in particular, V.N. Balasubramanyam and M.A. Salisu (1991), 'EP, IS and Direct Foreign Investment in LDCs', in A. Koekkoek and L.B.M. Mennes (eds), *International Trade and Global Development: Essays in Honour of Jagdish Bhagwati*, Routledge, London, for the former hypothesis; and V.N. Balasubramanyam, M.A. Salisu and David Sapsford (1996), 'Foreign Direct Investment and Growth in EP and IS countries', *The Economic Journal*, 106(434): 92–105, for an indirect test of the latter hypothesis (explaining growth as the dependent variable).

14 Of course, as Magnus Blomstrom has reminded me, I should also note that there is considerable evidence at the micro-level of beneficial spillover effects from DFI, including from several studies he has undertaken in developing countries. However, reconciling this evidence with the contention that there is little evidence of TFP in the Lau–Young-type studies remains an unresolved issue.

Indeed, the inefficiency of the limited investment that did occur is the other side of India's miseries in the post-1950s Phase II. As India turned inward, the absence of competition and its salutary effects on efficiency were also lost. This loss was further compounded as the original, promotional apparatus established in the Ministry of Industry (the DGTD) turned swiftly into a restrictive agency instead. The government turned from indicative planning to a mechanism for masterminding, with the aid of a stifling licensing system, the production, investment and import decisions in the economy to a degree unimaginable to anyone outside the regime. I am reminded that, eventually when, in the early 1990s just prior to the beginning of the reforms in earnest in 1991 under what we might call Phase III, *The Economist* ran a long piece on India, describing and denouncing its policies, a visiting Russian economist, Maxim Boycko, who then went on to play a major part in the Russian privatisation program of Anatoly Chubais, told me: 'that article could well have been describing the Soviet Union'. We had clearly reproduced beautifully the disadvantages of communism without any of its benefits!

In addition, the early policy adopted in the 1950s itself, under which a growing share of the country's investments would occur in the public sector, spawned inefficient public sector enterprises whose losses would make a significant contribution to a macro-crisis in the 1980s and which, in addition, crippled the efficiency of the private sector as well since the public sector enterprises supplied, or rather failed to adequately and efficiently supply, infrastructure inputs such as electricity and transportation over which they were granted monopoly of production.

So, if I were to summarise briefly the period of three decades between the end of the 1950s and of the 1980s, I would reach the following sobering conclusion:

We had started out in the 1950s with:

- high growth rates
- openness to trade and investment
- a promotional state
- social expenditure awareness
- macrostability
- optimism; and hence
- admiration of the world.

But we ended the 1980s with:

- low growth rates¹⁵
- closure to trade and investment
- a licence-obsessed, restrictive state
- inability to sustain social expenditures
- macroinstability, indeed crisis
- pessimism; and therefore
- marginalisation of India in world affairs.

Why Did the Reforms Happen? The Sources of Phase III

The full story of why the reforms finally began to happen in 1991, under the minority government of Prime Minister Rao, awaits research: we are still too close to it. But I have some candidates that have a bearing on my speculation as to the prospects of India not reversing the existing reforms and of her continuing to undertake further reforms.

First, 1991 saw India perilously close to declaring bankruptcy as the reserves shrank rapidly towards nothing. The macroeconomic crisis, developing steadily as the internal budget deficit got out of hand and reliance on external borrowing became unprecedented, was finally at hand. As many have observed for South America, a macroeconomic crisis, where you rush for the lifeline that the Bretton Woods institutions provides, clears your head as well as the prospect of a hanging. The notion that India, during what I have called Phase II here, had now come to a turning point where it was more readily manifest than ever that her economic policies could not be allowed to continue unchanged. And so the changes, attempted sporadically in the past, would finally begin in earnest.

But then add also the fact that no Bretton Woods support would have been forthcoming without a dose of conditionality pointing in the same direction. The spread of reforms worldwide, before India was getting to

15 The 1980s had higher than the 'Hindu growth rate' of 3 to 3.5 per cent during the preceding two decades but, as has been discussed by many, it was based on excessive internal spending and both internal and external borrowing, and hence was clearly unsustainable. It in fact led directly to the huge external crisis that forced the reforms of Phase III.

them, meant that the IMF–World Bank conditionality could no longer be dismissed as ideological; it had been legitimated as sensible prescription which only reflected what we had all learned in three decades of experience.

But I suspect that it also reflected a sense in the leadership of the Prime Minister and his chosen Finance Minister who would spearhead the reforms that they had here a chance to make history, putting the economy finally on to a path that was bound to work and bring them glory. An India which had played a major role in world affairs in the 1950s was now a marginal player on that very stage, a reflection of her having shot herself in the foot. The historical parallel was with Gorbachev contemplating the decline of the Soviet Union and seeking to seize the moment with *perestroika*: the English Sovietologist has recorded how Gorbachev and Scheverdnadze had discussed that things simply could not go on as they had in the Soviet Union, and that they had to seize the moment.

India's elite, including the bureaucracy, also came to realise that there was a growing dissonance between India's traditional claim to respect and attention and her shrinking ability to command them as her economic policies and failure became more widely known and a subject of derision. I suspect that the worst psychological state to be in is to have a superiority complex and an inferior status!

The Reforms to Date and Prospects

The reforms that have been initiated are many; and they continue to arrive in many little moves, almost continually. But much of importance remains to be done. Should we condemn the reformers for hastening only slowly?

Remember that, to some extent, changing India's uniquely damaging policy framework, nourished over three decades, is a task akin to cleaning up after a typhoon: the task is enormous and cannot be done all at once. It is also hard to double guess politicians beyond a point when, while they move in the right direction, they claim that they must be allowed to traverse the political minefields in a democracy as they, and not we technocrats, see fit as far as speed and strategy are concerned. The last time when technocratic full-speed-ahead advice to a reforming government backfired badly was when shock therapy was prescribed for Russia, with a backlash that gave Russia much political turmoil and little economic progress while returning Jeffrey Sachs unceremoniously to begin a life

again at Harvard. I am reminded of his famous line: 'you cannot cross a chasm in two leaps', to which Padma Desai (I should confess my bias since she is my wife) replied: 'you cannot cross it in one leap either unless you are Indiana Jones; so you drop a bridge instead'.

Yet governments can indeed be too slow for their own, and their societies', good. My judgement is that the initial speed and scope of reforms in India were just about right. India took very definite and substantial steps towards freeing the economy: the industrial licensing system has been virtually dismantled, current account convertibility is virtually in place, and the astringent attitude to direct foreign investment (DFI) which had led to an incredibly low annual inflow of equity capital of just about US\$100 million annually by 1990, has been reversed both in rhetoric and in policy actions.

This early harvest is not yet sumptuous, for these reforms are still to be deepened further. The current account convertibility still goes hand in hand with wholly muddled thinking that permits nearly all consumer goods to be still subjected to strict import controls on the silly ground that we 'do not need such imports'! The DFI policy, while better, is still far from what is necessary to attract substantial inflows: the Enron affair, and now the withdrawal on grounds of inordinate delays in clearance by Amoco from a \$1 billion coal based methane gas project again in energy-starved India, just reported in the *Asian Wall Street Journal* (20–21 September 1996), suggest that much needs to be done, and fairly quickly, if India is to move effectively into its outward orientation mode nearly a quarter century after the East Asian NIE countries did and about a decade after the other ASEAN NECs have done. I am an optimist on this front since I believe that these dramatic instances will, given India's open democratic system, lead to enough pressure from below to weed out the remaining inefficiencies.

The greater difficulties lie, however, in the speed at which important residual reforms can be carried out, now that the Rao government has been replaced by a weak coalition government. The two areas where reforms are necessary and critical, if the outward orientation is to produce growth rates of 9–10 per cent rather than of 6 per cent, are the public sector which cries out to be privatised now and the ability of firms to extract greater efficiency from its labour force, including through changed laws that permit the laying off of workers as necessary, though with appropriate safeguards. In neither area can one expect this coalition government, which

has two Communist cabinet members with trade union backgrounds, to bite the bullet. True, the communists in Bengal have shown flexibility in going out to get DFI and talked the talk of ‘capitalist roaders’. But what you do when the rules are set by the centre which you have no part of, and you must compete for resources in the market place at the state level, is entirely different from what you would do if you are at the centre making the rules.

On the other hand, the new Prime Minister is pragmatic and his personal experience of the Global Age is from the Silicon Valley in Bangalore in his own state of Karnataka: and that gives him an optimistic view of the benefits to India from integrating rapidly into the world economy. And the new Finance Minister is as committed to reforms as the old one; in fact, the two had joined hands in the Rao government as the leading reformers of their time.

So, you can be an optimist or a pessimist as to whether we in India will change from second to third gear in our reforms or whether we will coast along in second gear. Only time will tell.

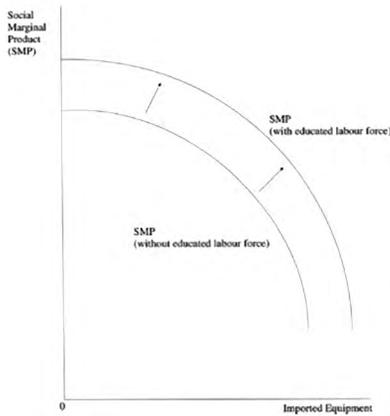


Figure 1

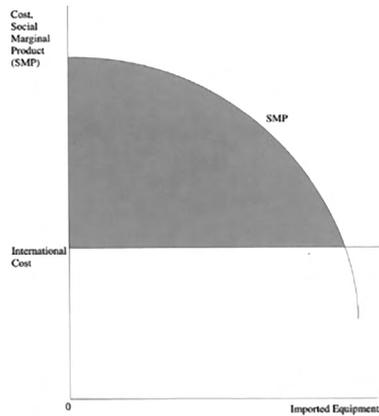


Figure 2

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