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## Strategic Implications of the Global Economic Crisis for India[1]

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### Executive Summary

This paper argues that India's recent growth acceleration has only partially been hurt by the global economic slowdown. For this reason, and given the return of the Manmohan Singh government to power, India is expected to pursue policies that will restore the growth momentum. India will have to undertake governance reform at home and ensure a supportive external environment to sustain its rise as a 'free market democracy'.

India's reintegration into the world economy, with higher trade/gross domestic product (GDP) ratio and increased dependence on external capital flows, has made her more vulnerable to global crises, but the pursuit of gradual reform and prudent regulations have minimised the negative impact of both the Asian and, more recently, the 'Trans-Atlantic' financial crises. From a strategic policy perspective, India can claim that her model of "gradual" and "graduated" economic liberalisation, and of risk averse prudential regulation in the banking and financial sector have helped limit her exposure to the 'Great Recession'. India's major economic vulnerabilities remain internal, with weak public finances and inadequate investment in social and economic infrastructure.

If India can return to the more recent high growth trajectory of eight to nine percent annual economic growth and sustain it over a decade, it will be on course to emerge as a great Asian power. The challenge before India in the next half a decade is to regain this momentum at a time when the global economy is likely to be less hospitable than it has been over the past five years. In this sense, the global economic slowdown has imposed new constraints on India's economic rise. However, these are not insurmountable obstacles, given the high domestic savings, investment ratios and the potential of the home market for sustaining high growth.

It is clear that the second Singh government will keep its focus on sustaining high rates of investment and economic growth. This is in keeping with Prime Minister Singh's vision of

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defining India's rise in terms of her economic performance. The global economic slowdown has only underlined the importance of India's economic performance for her global standing. The '10-point' Charter of the new government balances the considerations of equity with those of efficiency. As a 'free market democracy', Indian public policy will have to pay equal attention to both considerations.

An economically stronger India has felt encouraged to pursue a policy of 'asymmetric' or non-reciprocal economic liberalisation towards less developed countries, including those in her neighbourhood. Any deceleration in growth and consequent fiscal pressures would impose constraints on such non-reciprocal trade liberalisation and foreign aid.

One geopolitical consequence of the global financial crisis has been the coming together of the United States and China. Some analysts talk of a United States-China 'G-2' condominium. This could have implications for their respective strategies in South Asia and their individual and joint approaches to geopolitical and security issues in the region. China's rise should not be viewed in purely geopolitical or economic terms but also in terms of the implications it has for the future of liberal and plural democracy in the developing world.

The global economic downturn offers an opportunity for the world's largest democracies and market economies to work together to strengthen the foundations of open societies and open economies, by creating a global order that is supportive of India's developmental aspirations. If the Barack Obama Administration builds on the foundations laid by the Bill Clinton and George W. Bush Administrations to build a strategic partnership with India, the United States could play the same role in India's rise as it did in the post-war reconstruction of Japan and Western Europe, on the one hand, and the rise of the East and Southeast Asian economies, including China.

India requires governance reforms, increased investment in social and economic infrastructure, and a more stable regional political environment to be able to sustain recent rates of economic growth. The policy framework set out in the address of the President to the Parliament in June 2009 and the Indian Finance Minister's Budget Speech in July 2009 define the framework in which India seeks to regain the growth momentum.

**Section 1: Global Reintegration of a Re-emerging Economy**

Wall Street investors have for long viewed India an ‘emerging market’. India’s strategists prefer to see it as a ‘re-emerging economy’. India’s economists view her policies of trade and investment liberalisation as a process of ‘reintegrating’ India into the world economy.[3] This ‘reintegration’ began in the wake of a balance of payments crisis in 1990-91, and was influenced by the dynamics of the collapse of the Soviet Union and the end of the Cold War.[4] Commending his ‘new economic policies’ to the Indian Parliament in July 1991 India’s Finance Minister of the day, Dr Manmohan Singh, claimed:

> This budget constitutes a vital component of a comprehensive vision, a well thought out strategy and an effective action programme designed to get India moving once again…Victor Hugo had once said ‘no power on Earth can stop an idea whose time has come’. I suggest to this August House that the emergence of India as a major economic power in the world happens to be one such idea.[5]

The fiscal, investment, trade, industrial, financial and banking sector reforms that India has since undertaken have helped her weather the consequences of the ‘Asian financial crisis’ in the late 1990s, the economic sanctions imposed on India after her nuclear tests of 1998, the ‘Trans-Atlantic financial crisis’ of 2008 and the consequent global economic slowdown. Consequently, India’s economic growth rate did not decline as sharply as that of the East and Southeast Asian economies in the late 1990s. (Chart 1)

In 2009, India is a more open and globalised economy, but still much less export-dependent than East Asian and Southeast Asian economies. Hence, while it is unlikely to be as badly hurt as the latter have been, it would be hurt more than in the past by a global slowdown.

The Indian economy is on a long-term path of accelerating economic growth. Maddison’s Organisation for Economic Co-operation and Development (OECD)-funded study of historical trends in the national income of major world economies shows that at the beginning of the 18th century Europe, China and India had more or less equal shares of the world’s GDP and the two Asian economies have been recovering their lost space, albeit at a different pace, over the past half century.[6] (Chart 2) The Indian economy has grown at an annual average of 3.5 percent between 1950 and 1980, close to six percent between 1980 and 2004, and close to nine percent since 2004. (Chart 3)

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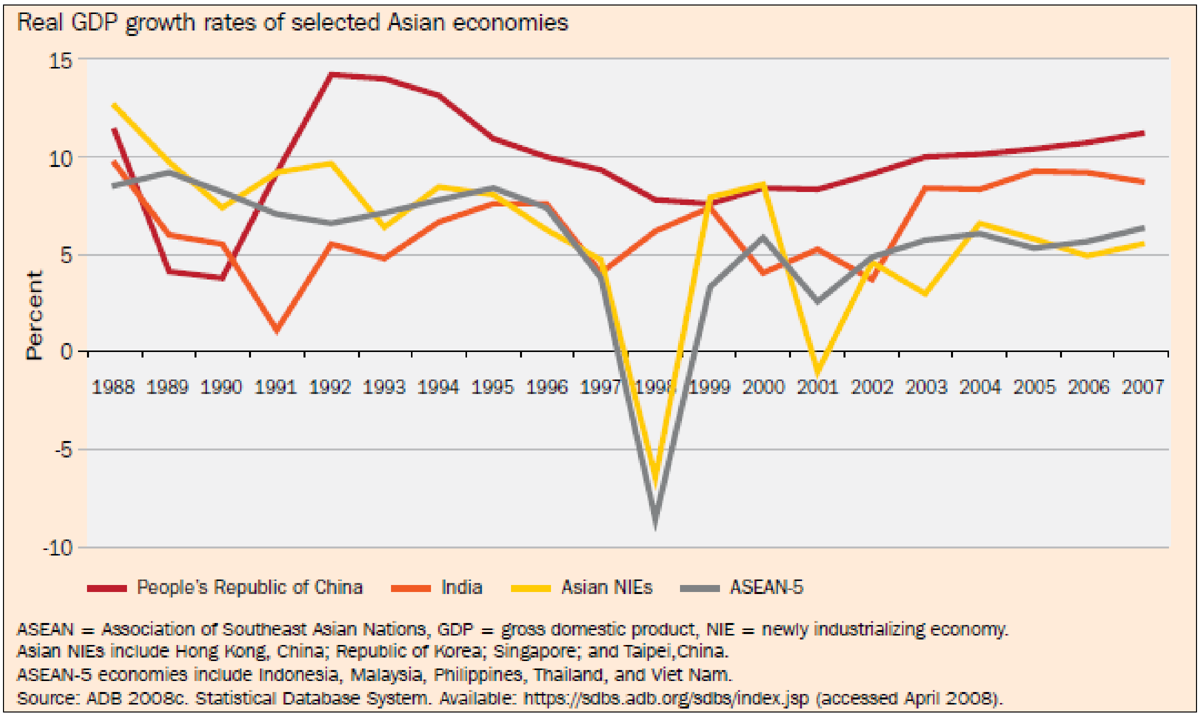
3 T. N. Srinivasan and Suresh D. Tendulkar, *Reintegrating India with the World Economy*, Oxford University Press, New Delhi, 2003.

4 For a strategic perspective on India’s economic reforms see Sanjaya Baru, *The Strategic Consequences of India’s Economic Performance*, Academic (Delhi, 2006)/Routledge (New York, 2007)/Citic Press (Beijing, 2008).

5 Manmohan Singh, Union Budget Speech, Lok Sabha, New Delhi, 24 July 1991. Available at: http://finmin.nic.in/the_ministry/dept_eco_affairs/dea.html.

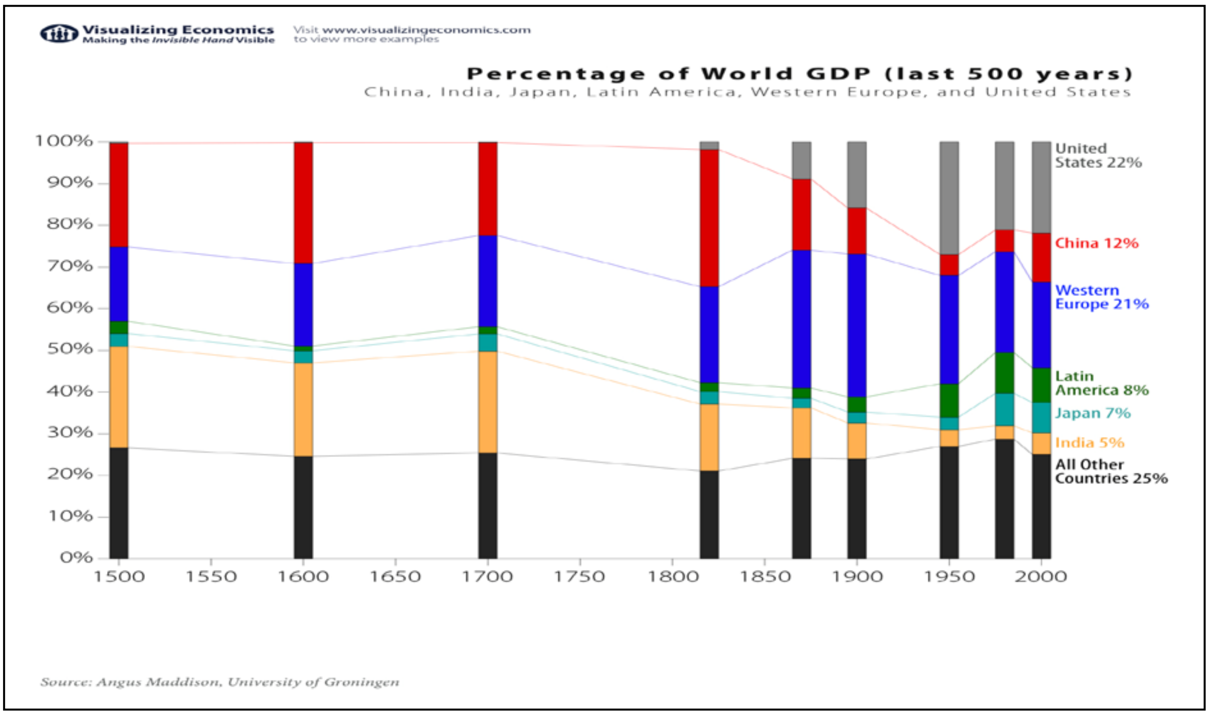
6 Angus Maddison, *The World Economy: A Millennial Perspective*, OECD, Paris, 2001.

**Chart 1: Impact of Asian Financial Crisis on India's Real GDP Growth**



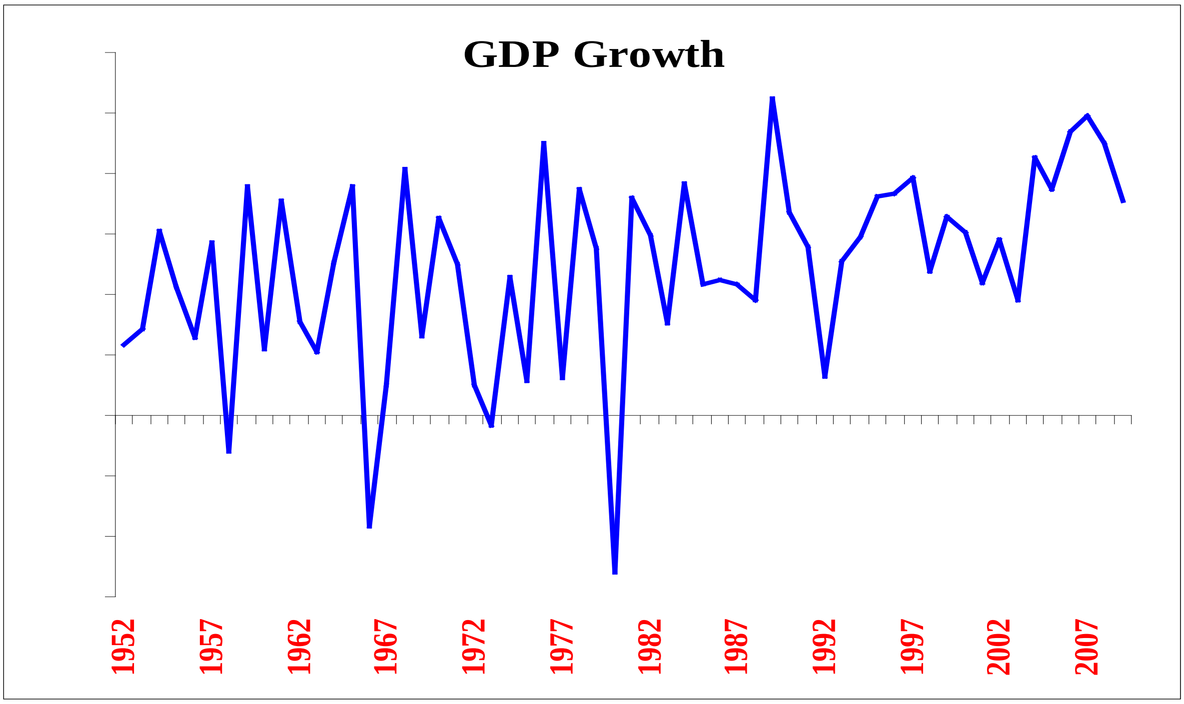

Source: Asian Development Bank, Emerging Asian Regionalism: A Partnership for Shared Prosperity, 2008. (Figure 2.4, p. 36) Available at: http://www.adb.org/Documents/Books/Emerging-Asian- Regionalism/ chapter02.pdf.

**Chart 2: Historical Trends in Distribution of World Income**




Source: Maddison, 2001. Available at http://www.visualizingeconomics.com/category/angusmaddison/

**Chart 3: Trends in GDP Growth: 1952-2009**




Source: Economic Advisory Council to Prime Minister, Government of India, March 2009.

India's more recent growth acceleration, since the early 1990s, has followed a shift in the macroeconomic policy framework, with greater external and internal economic liberalisation. India's economic rise as a 'free market democracy' and her reintegration into the global economy, creating new relationships of inter-dependence both globally and regionally, have shaped her strategic and foreign policies.[7]

**Policy Impact of the Triple Crises of the 1990s**

India's management of the 'triple crises' – fiscal, balance of payments and financial crises – experienced sequentially between the late-1980s and the mid-1990s, set the stage for India's response to the Asian and, more recently, the 'Trans-Atlantic' financial crises.

**First** came the 'fiscal crises' of the 1990s. Responding to an unsustainable rise in budgetary and fiscal deficits, India adopted a fiscal stabilisation programme, subsequently enacting a Fiscal Responsibility and Budget Management Act, thus ensuring a reduction in revenue and fiscal deficits. However, the recent fiscal stimulus packages put in place in response to the current slowdown have forced the government to breach the provisions of the Fiscal Responsibility and Budget Management Act.

**Second** came an external payments crisis in 1991. India has since undertaken transformative changes in her trade, tariff and foreign investment policies. These have helped improve India's external economic profile, including a reduction in external debt to GDP ratios, an increase in trade/GDP and foreign investment/GDP ratios, and, most importantly, enabled India to accumulate foreign currency reserves. India's increased openness to global trade and capital flows has, however, increased her vulnerability to global crises and recession.

[7] Baru, 2006.

**Third** came the financial sector crisis of the early 1990s, which included a stock market crash and problems in the banking sector. India has since undertaken comprehensive financial sector reforms, put in place a world class regulatory and supervisory system for the equities market and the financial and banking sectors, recapitalised banks and improved their asset position.

While undertaking these internal reforms, India opted for gradualism in external sector liberalisation, adopting full currency convertibility only on the current account and eschewing it on the capital account. This defined the context for India's exposure and response to the Asian and Trans-Atlantic financial crises.

The cumulative impact of the reforms undertaken since 1991 has been to make the Indian economy more resilient to external shocks, even as it has become more open to external flows, enabling India to sustain an acceleration of its economic growth within a more open economy framework.

India's low inflation tolerance (the average rate of inflation for 50 years, 1950-2000, has been around eight percent) has meant that fiscal and monetary policies have been largely conservative, with brief episodes of high inflation and fiscal laxity. It was the easing up of this fiscal conservatism that contributed to the 1990 crisis. Although India returned to a more conservative approach in fiscal policy, the current crisis has forced the government to adopt a liberal fiscal stance.[8]

In his authoritative review of India's new economic policies Panagariya concludes, "India has had a history of maintaining a relatively stable macroeconomic environment…",[9] and says of India's external sector management in recent years, "The judicious handling of the monetary and exchange rate policies must be largely credited with price stability in the domestic market and a broadly competitive exchange rate that facilitated a healthy growth of international trade".[10] In short, India's experience with handling the triple economic crises it confronted in the early 1990s has helped put in place a regime of policies that have contributed to an acceleration of economic growth and a strengthening of the Indian economy. This has helped India deal with the current slowdown with a greater degree of confidence.

### Closing the Two Gaps

In the past India's growth process has been constrained by what economists referred to as the 'two gaps' – a domestic savings gap and an external financing gap. Rising domestic savings and increased inflow of foreign capital have helped bridge both gaps, contributing to higher growth. For a long time India's savings rate was below 20 percent, even as East and Southeast Asian economies saw their savings rates exceed 30 percent. In the 1990s, India caught up and its more recent growth acceleration has been facilitated by a sharp rise in savings and investment rates. (Table 1)

Traditionally India has bridged the 'external gap' through foreign aid and concessional debt. However, after 1991 India reduced its dependence on aid and debt flows, and has allowed private capital flows to bridge the gap. The share of foreign investment in India's GDP has

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[8] See Vijay Joshi and IMD Little, India: Macroeconomics and Political Economy, 1964-1991, Oxford University Press, New Delhi, 1994.

[9] Arvind Panagariya, India: The Emerging Giant, Oxford University Press, New Delhi, 2008. pp. xxiv.

[10] Panagariya 2008, p. 207.

gone up (Tables 2 and 3) and foreign capital inflows have increased on account of higher remittances from overseas Indians.

**Table 1: Growth Rate of GDP & Investment & Savings Rates**

| Financial Year | GDP Growth percent | Investment/GDP percent | Savings/GDP percent |
|---|---|---|---|
| 2000-01 | 4.4 | 24.3 | 23.7 |
| 2001-02 | 5.8 | 22.8 | 23.5 |
| 2002-03 | 3.8 | 25.2 | 26.3 |
| 2003-04 | 8.5 | 28.2 | 29.8 |
| 2004-05 | 7.5 | 32.2 | 31.7 |
| 2005-06 | 9.5 | 35.5 | 34.3 |
| 2006-07 | 9.7 | 35.9 | 35.6 |
| 2007-08 QE | 9.0 | 37.4 | 37.8 |
| 2008-09 AE | 7.1 | 35.5 | 35.9 |

Note: QE = quick estimate; AE = advance estimate
Source: Prime Minister's Economic Advisory Council, Government of India, 2009.

**Table 2: External Economy Indicators**

| Year | Foreign Investment/GDP ( percent) | Foreign Investment/ Exports ( percent) | Import Cover of Foreign Exchange Reserves (Months) |
|---|---|---|---|
| 1990-91 | 0.0 | 0.6 | 2.5 |
| 1995-96 | 1.4 | 14.9 | 6.0 |
| 2000-01 | 1.5 | 14.9 | 8.8 |
| 2005-06 | 2.6 | 20.3 | 11.6 |
| 2007-08 | 5.2 | 38.8 | 15.0 |

Source: Reserve Bank of India Database.

Following the Asian Financial Crisis and, more importantly, after facing economic sanctions in the wake of the 1998 nuclear tests, imposed among others by the United States and Japan, India chose to accumulate foreign exchange reserves as a hedge against risk of currency shortage. This explains the sustained rise in foreign currency assets since 2000. (Table 3)

**Table 3: Foreign Investment & Income Flows into India**

| Year | Foreign Direct Investment (US$ Mn) | Portfolio Investment (US$ Mn) | Total Foreign Investment (US$ Mn) | Net Private Income Transfers (US$ Bn) | Foreign Currency Assets (US$ Bn) |
|---|---|---|---|---|---|
| 1990-91 | 97 | 6 | 103 | 2.07 | 2.24 |
| 1995-96 | 2144 | 2748 | 4892 | 8.51 | 20.81 |
| 2000-01 | 4029 | 2760 | 6789 | 12.85 | 39.55 |
| 2005-06 | 8961 | 12492 | 21453 | 24.46 | 145.11 |
| 2007-08P | 32435 | 29395 | 61830 | 40.78 | 299.23 |

Note: P = Provisional
Source: Reserve Bank of India Database.

**Table 4: Trends in External Debt Indicators**

| Financial Year | Debt Stock-GDP Ratio | Debt-Service Ratio | Short-term Debt to Total Debt Ratio |
|---|---|---|---|
| 1990-91 | 28.7 | 35.3 | 10.3 |
| 1995-96 | 27.1 | 24.3 | 5.2 |
| 1999-00 | 22.0 | 16.0 | 4.1 |
| 2005-06 | 17.2 | 9.9 | 14.1 |
| 2007-08 | 18.8 | 5.4 | 20.0 |

Source: Reserve Bank of India Database at www.rbi.org.in.

The share of external trade in India's national income has doubled since 1991. (Table 5) India's trade/GDP ratio, at over 33 percent, is higher than that of the United States (around 25 percent). While increased trade dependence has made India more vulnerable to external shocks, her relatively low export dependence compared to other newly industrialising economies in Asia (China's trade/GDP ratio is close to 80 percent) has helped to limit the negative impact of a global slowdown.

**Table 5: Trends in Trade/GDP ratio**

| Year | Exports/GDP | Imports/GDP | X+M/GDP |
|---|---|---|---|
| 1980-81 | 6.2 | 9.8 | 16.0 |
| 1985-86 | 5.6 | 8.5 | 14.1 |
| 1990-91 | 7.3 | 9.9 | 17.2 |
| 1995-96 | 11.2 | 14.5 | 25.7 |
| 2000-01 | 13.0 | 14.7 | 27.7 |
| 2007-08 | 13.5 | 21.2 | 34.7 |

Source: Economic Survey, Ministry of Finance, Government of India, (various Issues).

The policy of ensuring reduced dependence on external debt flows has, therefore, been accompanied by a policy of increased openness to investment and income inflows. (Table 4) In response to the current global slowdown, India has further liberalised her foreign investment rules to attract increased capital flows. Inward remittances of income earned by Indian workers abroad, especially in the Persian Gulf region, have increased in importance as a source of foreign currency earnings for India. Nearly 3.5 million Indians work in the member-countries of the Gulf Cooperation Council. They send home monthly remittances which constitute a bulk of the US$40 billion that India received in 2007-08, and the US$55 billion it is estimated to receive in 2008-09. (Table 6)

The slowdown of economic activity in the Middle East could result in a decline in such repatriated incomes. This is an important concern for India's balance of payments management. India is also concerned about a decline in the number of H1-B visa holders in the United States, since many of them would also be repatriating some part of their income to families based in India. The downside of the high profile skilled manpower and services exports from India is increased exposure to the risk of a global slowdown in demand.

**Table 6: India's Balance of Payments**

| | | | | | | | *Unit:* US$ billion |
|---|---|---|---|---|---|---|---|
| | **2004/05 R** | **2005/06 PR** | **2006/07 (P)** | **2007/08 (P)** | **2008/09** | | |
| | | | | | **H1** | **H2** | **Year** |
| Merchandise Exports | 85.2 | 105.2 | 127.1 | 158.5 | 96.7 | 86.1 | 182.9 |
| Merchandise Imports | 118.9 | 157.0 | 192.0 | 248.5 | 165.9 | 137.7 | 303.6 |
| Merchandise Trade Balance | –33.7 | –51.8 | –64.9 | –90.1 | –69.2 | –51.6 | –120.7 |
| | –4.8% | –6.4% | –7.1% | –7.7% | –11.5% | –8.6% | –10.1% |
| Net Invisibles | 31.2 | 42.7 | 55.3 | 72.7 | 46.9 | 51.1 | 97.9 |
| o/w Software & BPO | 14.7 | 24.6 | 31.2 | 37.0 | 22.2 | 25.0 | 47.2 |
| Private Remittances | 20.5 | 24.1 | 27.9 | 40.8 | 25.8 | 29.5 | 55.3 |
| Investment Income | –4.1 | –4.9 | –6.0 | –5.2 | –1.6 | –4.5 | –6.1 |
| **Current Account Balance** | **–2.5** | **–9.2** | **–9.6** | **–17.40** | **–22.3** | **–0.5** | **–22.9** |
| | ***–0.4%*** | ***–1.1%*** | ***–1.0%*** | ***–1.5%*** | ***–3.7%*** | ***–0.1%*** | ***–1.9%*** |
| | | | | | | | |
| Foreign Investment | 13.0 | 17.2 | 15.5 | 44.8 | 9.0 | 2.7 | 11.8 |
| o/w FDI (net) | 3.7 | 4.7 | 8.5 | 15.5 | 14.6 | 3.0 | 17.6 |
| Portfolio capital | 9.3 | 12.5 | 7.1 | 29.3 | –5.5 | –0.3 | –5.8 |
| Loans | 10.9 | 6.1 | 24.5 | 42.0 | 7.3 | –14.3 | –6.9 |
| Banking capital | 3.9 | 1.4 | 1.9 | 11.8 | 4.8 | –0.4 | 4.4 |
| **Capital Account Balance** | **28** | **23.4** | **45.8** | **108.0** | **19.9** | **–9.9** | **10.0** |
| | ***4.0%*** | ***2.9%*** | ***5.0%*** | ***9.2%*** | ***–3.3%*** | ***–1.7%*** | ***0.7%*** |
| Errors & Omissions | 0.6 | 0.8 | 0.6 | 1.5 | –0.1 | 0.0 | –0.1 |
| **Accretion to Reserves** | **26.2** | **15.1** | **36.6** | **92.2** | **–2.5** | **–10.5** | **–13.0** |
| | ***3.7%*** | ***1.9%*** | ***4.0%*** | ***7.9%*** | ***–0.4%*** | ***–1.7%*** | ***–1.1%*** |

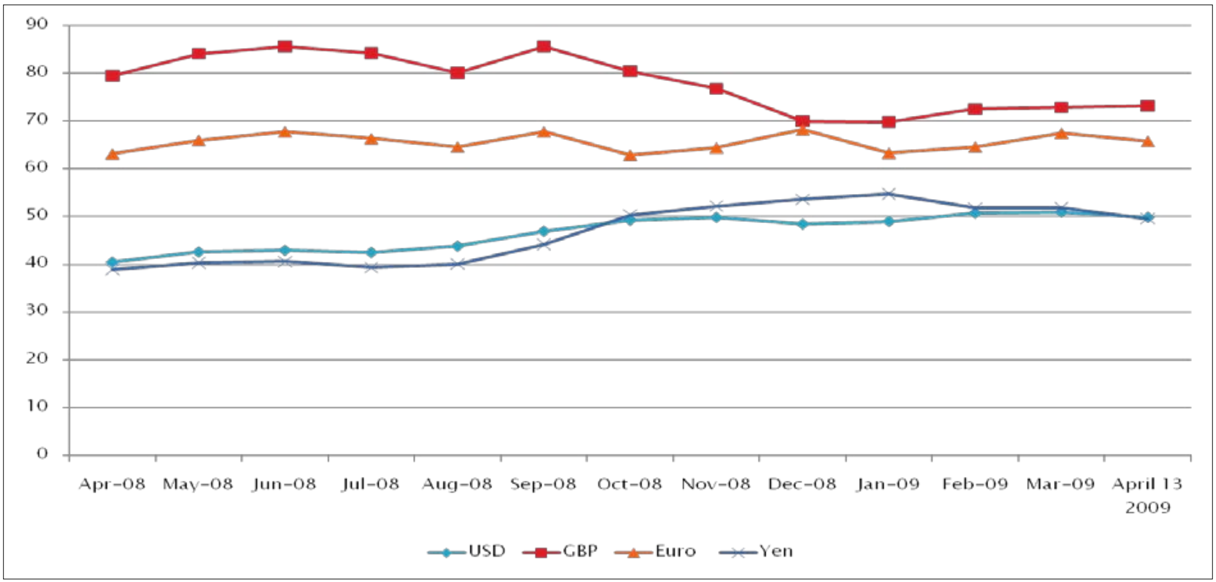
Note: BPO = business process outsourcing. P = Provisional. Figures in italics denote percentage of GDP.
Source: Review of the Economy, 2008-09. Economic Advisory Council to Prime Minister, Government of India, March 2009.

Increased openness and external integration have made the Indian economy more efficient, increasing India's share in world trade from 0.5 percent in 1991 to over 1.0 percent by 2008. India has also been able to draw on foreign savings. However, for these very reasons, the current global slowdown could be expected to have a higher negative impact on India's economic growth compared to the Asian crisis of 1997-98 or earlier episodes of global recession. Already India's trade deficit and current account deficit have gone up, and India has had to draw down its foreign exchange reserves defending the rupee, which has depreciated against the dollar by close to 30 percent in the past year, with a sharp fall in February 2009.

From a national security perspective, it is relevant to note that India's policy of external economic liberalisation after 1991 has focused on increasing non-debt inflows, including foreign equity and inward private remittances. India has never pursued a mercantilist trade policy. Rather, it has always run a trade deficit that has been financed by inflows on the capital account. These inflows have contributed to an accumulation of foreign currency reserves.

Popular resistance to approaching the International Monetary Fund (IMF), as in much of the developing world, has encouraged India to shift its source of external financing away from debt and aid flows, including multilateral and bilateral aid and official development assistance, to increased trade and private equity flows.

**Chart 5: Nominal Exchange Rate of Indian Rupee**




Source: Reserve Bank of India Bulletin, ( various issues).

## Banking and Finance

The 'third' dimension of India's reform and stabilisation programme has been the reform of the financial and banking sector. A stock market 'scam' in the early 1990s, that brought issues of banking supervision and use of bank funds in the equities market into focus, kick-started the first phase of banking and equities market reform. The Asian financial crisis and the government's decision to prepare a roadmap for capital account convertibility defined the second phase of banking and financial sector reform in the late 1990s. A third wave of financial sector reform was initiated by the bursting of the dotcom bubble and its impact on the Indian stock market.

India's decision to attract foreign currency inflows through the capital market by opening up the stock market to foreign institutional investors also forced the authorities to undertake institutional reform. Consequently, India put in place a more efficient and transparent regulatory system for the equities market and the banking and financial sectors.[11] The relatively high standards of governance and institutional credibility of the Reserve Bank of India (RBI) and the Securities and Exchange Board of India have also been effective.

It has been widely commented that India's banking sector has not been impacted by the banking and financial sector crises of 2008 which preceded the global slowdown.[12] RBI Governor, D. Subba Rao has claimed that, "The Indian banking system has had no direct exposure to the sub-prime mortgage assets or to the failed institutions. It has very limited off-

[11] See Y. V. Reddy, 'Monetary and Financial Sector Reforms in India: A Practitioner's Perspective', in Kaushik Basu (Ed.) *India's Emerging Economy*, Oxford University Press, 2004.

[12] Rakesh Mohan, 'Global Financial Crisis and Key Risks: Impact on India and Asia', Remarks prepared for IMF-FSF High-Level Meeting on the Recent Financial Turmoil and Policy Responses at Washington D.C., 9 October 2008. Available at www.rbi.org.in.

balance sheet activities or securitised assets."[13] The RBI has been credited with taking pre-emptive action that has minimised the vulnerability of Indian banks to the ripple effects of the United States sub-prime crisis and the crisis in the equities market. In fact, in an early public statement on this, former RBI Governor, Y. V. Reddy claimed:

> Financial stability in India has been achieved through perseverance of prudential policies which prevent institutions from excessive risk taking, and financial markets from becoming extremely volatile and turbulent. As a result, while there are orderly conditions in financial markets, the financial institutions, especially banks, reflect strength and resilience. While supervision is exercised by a quasi-independent Board carved out of the RBI Board, the interface between regulation and supervision is close in respect of banks and financial institutions, and on market regulation, a close coordination with other regulators exists.[14]

The RBI also took counter-cyclical and precautionary measures to limit the exposure of banks to high risk lending, especially in real estate and housing. According to Reddy:

> In the year 2000 the RBI conducted a stress test of the banks' investment portfolio in an increasing interest rate scenario, when the general trend then was decreasing interest rates. At that time, banks in India were maintaining a surrogate capital charge for market risk, which was at a variance from the Basel norms.
>
> On the basis of the findings, in order to equip the banking system to be better positioned to meet the adverse impact of interest rate risk, banks were advised in January 2002 to build up an Investment Fluctuation Reserve (IFR) within a period of five years. The prudential target for the IFR was five percent of their investments in 'Held for Trading' (HFT) and 'Available for Sale' (AFS) categories. Banks were encouraged to build up a higher percentage of IFR up to 10 percent of their AFS and HFT investments. This counter-cyclical prudential requirement enabled banks to absorb some of the adverse impact when interest rates began moving in the opposite direction in late 2004. Banks have been maintaining capital charge for market risk as envisaged under the Basel norms since end-March 2006.[15]

## Fiscal Policy

Higher economic growth has enabled India to reduce its budgetary and fiscal deficits over the past decade. This has also created the fiscal space for increased public investment in infrastructure development, defence modernisation and the development of strategic capabilities, including maritime. The current slowdown will undoubtedly exert a fiscal pressure on such strategic investments. The government has pursued a counter-cyclical fiscal

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[13] D. Subba Rao, 'Impact of the Global Financial Crisis on India: Collateral Damage and Response', Speech delivered at the Symposium on "The Global Economic Crisis and Challenges for the Asian Economy in a Changing World" Institute for International Monetary Affairs, Tokyo, 18 February 2009. Available at: www.rbi.org.in.

[14] Y. V. Reddy, *Global Financial Turbulence and Financial Sector in India: A Practitioner's Perspective***,** Reserve Bank of India, July 2008. Available at: http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/85529.pdf.

[15] Ibid.

policy and provided a fiscal stimulus, variously estimated to be between three and four percent of GDP during 2008-09. However, a large part of such spending would naturally go into counter-cyclical safety nets and employment generation programmes. This would reduce the funds available for defence and strategic modernisation.

The Indian government can view some of the defence spending as part of the fiscal stimulus. However, given the high import intensity of defence spending in India, and the capital intensive nature of defence modernisation, there are limits to how much defence spending can be a counter-cyclical activity.

To sum up, while India's reintegration into the world economy in the 1990s has made her more vulnerable to global crises, her pursuit of gradual reform and prudent regulation seem to have helped her minimise the negative impact of the Trans-Atlantic financial crisis and the global economic slowdown. From a strategic policy perspective, therefore, India can claim that her model of "gradual" and "graduated" economic liberalisation, and of risk averse prudential regulation in the banking and financial sector have helped limit her exposure to the Asian and Trans-Atlantic financial crises and the subsequent global economic slowdown.

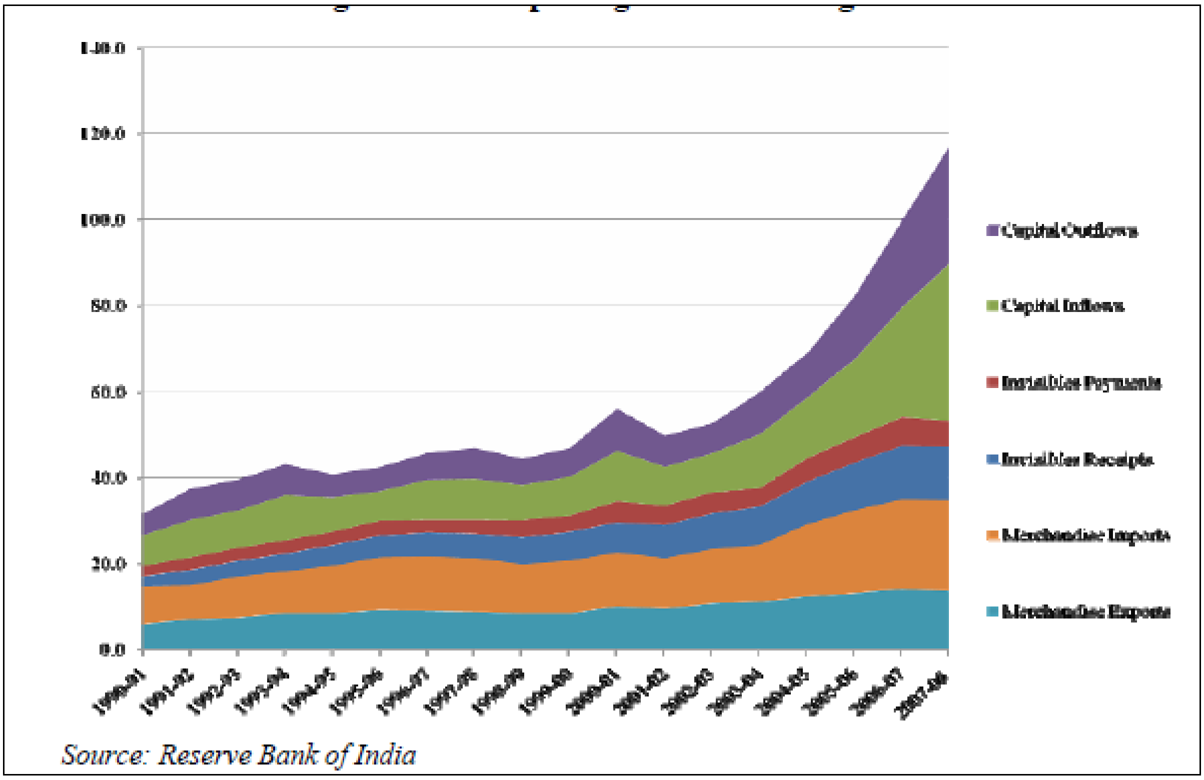
While India still lags behind China, in terms of her share of world trade and capital flows, as well as her share of global currency reserves, her strategy of gradual reintegration into the world economy has yielded strategic dividends. India has been able to increase its share of world income, trade and capital flows, emerging as a participant at the "G-7 plus" forums, along with China, Brazil and South Africa, and a member of the G-20 Summit. India has also increased its economic linkages with East and Southeast Asia, and is a founder-member of the East Asian Summit. Finally, the improved economic performance has enabled India to find resources for defence modernisation and to upgrade her maritime and strategic capabilities. Slower growth will exert a fiscal pressure that would adversely affect investments in these areas.

**Section 2: India and the Global Slowdown – New Vulnerabilities**

In underscoring the new 'post-reform' resilience of the economy, we do take account of new vulnerabilities that could hurt the growth process. The first is the higher trade/GDP ratio and the consequent increased dependence on the global market in both goods and services. The second is the increased importance of foreign capital inflows – portfolio, direct investment, external commercial borrowing (ECB) of Indian private corporate sector and private remittances by overseas Indians. While India's recent growth acceleration benefited from this external connectivity, the global crisis would hurt economic growth in the near term on account of the importance of these linkages.[16] (Chart 4)

[16] Rajiv Kumar, Mathew Joseph, Dony Alex, Pankaj Vashisht, Debosree Banerjee, Indian Economic Outlook, 2008-09 and 2009-10, ICRIER Working Paper No. 234. March 2009. Available at: www.icrier.res.in

**Chart 4: India Increasing Global Linkages**




Source: Kumar, et al (ICRIER, 2009).

In a candid rejection of the so-called “decoupling thesis”, namely that higher growth based on domestic savings and investment, and the greater reliance on domestic demand has ‘decoupled’ the Indian economy from the global economy, RBI Governor Rao told the Confederation of Indian Industry, “The reason India has been hit by the crisis, despite mitigating factors, is clearly India’s rapid and growing integration into the global economy. The contagion of the crisis has spread to India through all the channels – the financial channel, the real channel, and importantly, as happens in all financial crises, the confidence channel”.[17]

Both public and private sector companies in India have become more dependent on the capital market for securing equity and debt finance, and India’s equity market is fully integrated with global markets although the debt market is not. Indian companies are estimated to have raised US$41 billion (net of repayment) as overseas debt through external commercial borrowing and fully convertible commercial debentures.[18] Even in the period October to December 2008 Indian companies were able to raise a total of US$4.5 billion from global debt markets. But these flows are expected to weaken, given the increased risk aversion in global markets. The decline in global merchandise trade has also slowed down the growth of India’s exports, and for the first time in seven years export growth has been negative in the first quarter of 2009.

Apart from these macro linkages and the overall increase in the trade/GDP ratio, the changes in the geographical pattern of trade also points to an increased vulnerability to a slowdown.

[17] D. Subba Rao, Governor, Reserve Bank of India, “India – Managing the Impact of the Global Financial Crisis”, 29 March 2009. Available at: http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=413.

[18] *Money & Finance*, ICRA Bulletin, March 2009. New Delhi. 2009.

The depreciation of the Rupee is a reflection of these external vulnerabilities. India has had to draw down its foreign exchange reserves through the last quarter of 2008 and the first quarter of 2009 largely in defence of the Rupee. While India's reserves are denominated in a basket of currencies, the United States dollar is the principle foreign currency in which India's external transactions are denominated. The United States and the European Union still account for over a third of India's exports, but Asia's share has increased in recent years. The shares of Japan and Russia have gone down, but those of China, South Korea and the Association of Southeast Asian Nations (ASEAN) economies have increased. (Table 7) Each of these economies has experienced a slowdown in growth and a consequent decline in trade.

**Table 7: Geographical Direction of India's Exports**

| **Region** | **1960-61** | **1970-71** | **1980-81** | **1990-91** | **2000-01** | **2006-07** |
|---|---|---|---|---|---|---|
| European Union | 36.2 | 18.4 | 21.6 | 27.5 | 22.7 | **21.3** |
| United States | 16.0 | 13.5 | 11.1 | 14.7 | 20.9 | **14.0** |
| Africa | 6.3 | 8.4 | 5.2 | 2.1 | 3.2 | **6.7** |
| L America | 1.6 | 0.7 | 0.5 | 0.4 | 2.1 | **3.4** |
| USSR | 4.5 | 13.7 | 18.3 | 16.1 | 2.0 | **1.0** |
| - Russia | | | | | | **0.7** |
| **Asia (non-oil)** | **6.9** | **10.8** | **13.4** | **14.3** | **21.4** | **31.6** |
| **Asia (incl oil)** | | | | | | **49.8** |
| OPEC | 4.1 | 6.4 | 11.1 | 5.6 | 10.9 | **-** |
| Japan | 5.5 | 13.3 | 8.9 | 9.3 | 4.9 | **2.2** |
| ASEAN | | | | 3.0 | 7.5 | **10.0** |
| China | | | | | 1.0 | **6.1** |
| South Asia | | | | | | **5.1** |

Source: Economic Survey, Ministry of Finance, Government of India, various issues.

Tables 5 & 7 refer to merchandise exports. The growth of inward remittances from expatriate Indian workers, especially in the Persian Gulf region, and earnings from information technology and software services exports have increased the importance of services exports to India's balance of payments management. While low-skilled manpower exports are mainly to the OPEC member countries of the Persian Gulf and Middle East, high skilled services exports are mainly to the United States and other OECD economies. In 2008-09, inward remittances amounted to US$55 billion, while export earnings from information technology and business process outsourcing business were estimated to be US$47 billion.

The information technology, information technology services and business process outsourcing industry is now estimated to account for almost six percent of India's GDP. Two-thirds of the US$72 billion business is accounted for by exports, mainly to Trans-Atlantic economies. While spokespersons of the National Association of Software and Service Companies (NASSCOM) have expressed optimism that their exports would not be hurt if developed economies do not resort to protectionist measures, since firms in OECD economies would increase their demand for lower cost Indian software services in a downturn, NASSCOM has forecast a reduction in export earnings in 2009-10.[19] Growth in information technology-enabled services exports is expected to be around 15 percent in 2009-10, compared to annual growth rates of around 25 percent in recent years.

[19] Report on Information Technology Software and Services – Performance and Prospects, 2009. National Association of Software Services Companies. Available at: www.nasscom.in & http://www.nasscom.in/upload/60387/Key_Highlights.pdf.

Speaking at the London Summit of the G-20, Prime Minister Singh summed up the official thinking in India on the impact of the Trans-Atlantic financial crisis and the global economic slowdown in these words:

> We in India have been fortunate in having weathered the global downturn better than many others. Our growth rate, which was close to 9 percent in the previous 5 years, will fall below 7 percent in 2008-09. Like other countries, we have made aggressive use of both monetary and fiscal policy, with a total fiscal stimulus or expansion of the fiscal deficit above the planned level of almost 4 percentage points of GDP in 2008-09. We hope to be able to achieve a similar growth rate in 2009-10, with continuing reliance on monetary and fiscal policy. We recognise the importance of fiscal sustainability and it is our firm intention to return to a fiscally sustainable path after 2010. The additional fiscal stimulus we have undertaken will raise our debt to GDP ratio by a few percentage points above what it would otherwise have been, but this is relatively modest compared to what would have happened had our banks suffered a financial crisis. Effective regulation of the banking system has gained us much more than any additional strain imposed by temporary fiscal expansion. Besides, since most of the fiscal stimulus will be directed to increased investment in infrastructure, it will in the medium term contribute to growth and thus help reduce the debt ratio automatically. Expansionary policy at home in an environment where exports are weak and private capital flows have dried up would normally lead to pressure on the balance of payments. In our case this has been partly offset by the fall in oil prices, but even so, India's current account deficit in 2009-10, is likely to be about 1.4 percent of GDP. We expect to be able to finance this without difficulty and in any case our strong foreign exchange reserves position enables us to cope with any shortfall in capital flows we may experience.[20]

This sense of optimism is based on India's growth experience in the past decade. In the period 2002-08 the global economic environment was benign for India. By 2003 the Governor of India's central bank, Bimal Jalan, was declaring that "there is no longer any external constraint on growth".[21] This marked a turning point in Indian thinking about globalisation and external dependence. Jalan's view was shared by Singh who often spoke of how India had overcome external constraints on growth and that the remaining constraints are essentially domestic.[22] Singh saw this as symbolising the success of India's economic openness and globalisation. Even as recently as in March 2007, he told *The Economist Roundtable*:

> An important strength of the Indian economy today is that we no longer face any insurmountable external constraint on growth. The global environment,

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[20] Manmohan Singh, Statement at G-20 Summit, London 2 April 2009. Available at: http://www.pmindia.nic.in/lspeech.asp?id=784.

[21] Interview with RBI Governor Bimal Jalan, The Financial Express, Mumbai, 18 August 2003. Available at: http://www.financialexpress.com/news/there-is-no-longer-an-external-constraint-to-growth/90535/0.

[22] "I have often said that there are no external constraints to our growth. The world wants India to do well. The global community will be happy to see us participate more actively in the global exchange of goods, services, ideas and people. If at all there is a constraint, it is at home. The constraint of illiteracy, ill-health, low incomes, poverty, poor infrastructure; in short, the constraint of inadequate investment in people and in their capabilities." Prime Minister Manmohan Singh, India International Trade Fair, New Delhi, 14 November 2005. Available at: http://pmindia.nic.in/speech/content.asp?id=220.

> both political and economic, is largely benign from our point of view. There are, of course, issues and trends that cause concern but these are generally applicable to most countries. For example, we are all concerned with high energy prices and uncertainty in the oil-producing regions of the world. We are all equally concerned about terrorism and threats to global peace and stability. Finally, we are all equally concerned about global warming and climate change. We are also concerned about the growth of protectionism in major developed countries. But these are global challenges and merit a global response.[23]

While this optimism about future growth prospects has been dented by recent events, there is as yet no anti-globalisation or protectionist sentiment in India. However, such protectionism in the OECD economies and the pursuit of 'beggar-my-neighbour' policies by its economic partners may make India less sanguine about globalisation, given the new external vulnerabilities.[24]

**Section 3: Globalisation and Geopolitics**

India's economic rise and the success of its gradual outward-orientation have brought economics to the centre of its strategic thinking, influencing India's grand strategy. In the early years after its independence, India did see its economic rise as key to its re-emergence as a great power.[25] However, the Cold War interregnum, and India's relatively unimpressive economic performance during that period, saw high politics displace economics in the conceptualisation of India's grand strategy. Bringing the economy to the centre of India's strategic *weltanschauung,* Prime Minister Singh told a Commanders Conference in 2005:

> Our strategy has to be based on three broad pillars. **First**, to strengthen ourselves economically and technologically; **second**, to acquire adequate defence capability to counter and rebut threats to our security, and **third**, to seek partnerships both on the strategic front and on the economic and technological front to widen our policy and developmental options…

In the *Arthashastra*, Kautilya wrote that a healthy economy is a sound foundation for well-funded armed forces. "From the strength of the treasury", he said, "the army is born'. But it is not only for fiscal reasons that the health of our economy is important for our national security. A healthy, growing and stable economy in itself enhances security. New notions of "Comprehensive National Power" give high weightage to economic, social, scientific, technological, educational and cultural aspects of power. Military strength alone no longer guarantees a nation's security. Knowledge power and economic capabilities are equally important."[26]

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[23] Available at: http://pmindia.nic.in/speech/content.asp?id=510.

[24] It is significant that the election manifestos of all the major mainstream political parties in the 2009 elections to the Indian Parliament do not adopt a protectionist stance. In fact the global crisis and slowdown has not encouraged a protectionist sentiment at home, even though there is increased awareness of and concern with China's rising global profile.

[25] In his first major foreign policy speech to the Indian Constituent Assembly, in December 1947, India's first Prime Minister Jawaharlal Nehru said, "Talking about foreign policies, the House must remember that these are not just empty struggles on a chess board. Behind them lie all manner of things. Ultimately, foreign policy is the outcome of economic policy." See Baru (2006), Chapter 2, p. 58.

[26] Manmohan Singh, Address to Combined Commanders Conference, New Delhi, 20 October 2005. Available at: http://www.pmindia.nic.in/speeches.htm.

This view of India's grand strategy firmly embeds it on the foundations of her economic performance. It is only as a 'growing and globalising economy' that India can be a 'rising power'. Hence, safeguarding the environment for economic growth, albeit as a "free market democracy", is critical to India's re-emergence as a 'great power'.[27] China's rise as a 'socialist market economy', globally and regionally integrated with major industrial and newly industrialising economies, has only added urgency to India's efforts to boost domestic economic growth and build economic bridges with the rest of the world.

Improved economic performance has also enabled India to become more globally and regionally integrated with her Asian neighbours. In the 1990s India had launched a "Look East Policy" aimed at closer economic integration with East and Southeast Asia. A decade later India felt confident enough to seek a Free Trade Agreement (FTA) with ASEAN. This was preceded by an India-Sri Lanka Free Trade Agreement and the launch of negotiations for a South Asian Free Trade Agreement. India launched a series of FTA negotiations with her other Asian neighbours. (Table 8)

**Table 8: Preferential, Free and Regional Trade Agreements & Comprehensive Economic Cooperation/Partnership Agreements being pursued by India**

| | |
|---|---|
| Mauritius CEPA * | SAARC – FTA*/CECA |
| South Africa Customs Union - PTA | Gulf Coop Council – FTA |
| Africa – PTA/CECA | New Zealand – FTA |
| Australia – FTA | Japan – CEPA |
| Chile – PTA | Israel – FTA |
| South Korea – CEC/PA | BIMSTEC – FTA |
| India, Brazil S Africa – CECA | Mercosur – PTA |
| South Korea – CEPA | ASEAN – FTA/CECA |
| Singapore – FTA*/CECA | Sri Lanka – FTA*/CECA |
| China – FTA | Russia – CECA |
| Malaysia – CECA | European Union – FTA |
| Egypt – PTA | Thailand – FTA |

Note: FTA = Free Trade Agreement; PTA = Preferential Trade Agreement; CECA = Comprehensive Economic Cooperation Agreement; CEPA = Comprehensive Economic Partnership Agreement.
* indicates concluded.
Source: Ministry of Commerce, Government of India, 2008.

The geopolitical dimension to these trade agreements is obvious. Nevertheless, in defending the India-ASEAN FTA against domestic criticism that it may hurt Indian farmers, Prime Minister Singh pointedly drew attention to its geopolitical dimension. Writing to Congress President Sonia Gandhi on the merits of the India-ASEAN FTA, Dr Singh said, "Our approach to regional trade agreements in general and FTAs, in particular, has been evolved after careful consideration of our geopolitical as well as economic interests. Although India has a large domestic market, its experience with earlier relatively insular policies, as also the

[27] In an official banquet speech on his visit to Tokyo, Prime Minister Manmohan Singh told his Japanese hosts: "India and Japan share a proud civilisational heritage and a common Asian identity. Our two nations have converging long-term political, economic and strategic interests. We have a common commitment to democracy, human rights, the rule of law and a free market economy. India and Japan are thus natural partners with a mutual stake in each other's progress and prosperity." 15 December 2006. Available at: http://pmindia.nic.in/visits/content.asp?id=149.

global experience in this regard, clearly bring out the growth potential of trade and economic cooperation with the global economy."[28]

Even the India-Sri Lanka FTA was sealed at the highest political level in the face of opposition from farm and business lobbies. Such opposition was muted in the past since the Indian economy has been performing well. Any economic slowdown can intensify such opposition to external liberalisation, with consequent geopolitical implications in an increasingly integrated economic region.[29]

The strategic significance of being actively engaged in the processes of Asian economic integration cannot be over-emphasised. India's improved economic performance since 1990, and especially since 2003, helped ensure that the imperatives of globalisation worked in tandem with the logic of geopolitics. As a 'rising power' India felt more confident dealing with a 'rising China' and was able to mentally 'de-hyphenate' itself from slow-growing Pakistan. It also felt encouraged to participate more actively in the processes of East and Southeast Asian regionalism. India's membership of the ASEAN Regional Forum was a stepping stone to closer strategic engagement with the region. Closer economic relations with countries of the region have enabled India to participate in the East Asia Summit and regional community building efforts.

China's rise and globalisation has encouraged India's own policy transition. China has emerged as a key economic partner for most Asian economies, including Japan and South Korea. It has overtaken India as an economic partner of South and Central Asian economies as well, and is well on its way to emerging as a major economic partner for Africa. While India's share of global trade, merchandise and services has doubled in the past decade, it still lags way behind China's. In 2007, India's share of world merchandise trade was about 1.2 percent and 2.5 percent for commercial services. For China, these were eight percent and 3.5 percent respectively. However, India's lower level of global integration has in fact made it less vulnerable to the global downturn than China.

Hence, there are two ways of viewing the implications of globalisation for national power. On the one hand, it creates new relationships of global interdependence that add to a country's global influence and power; on the other hand, this also creates new vulnerabilities that less globally-integrated economies do not face. For India, sustaining her recent growth acceleration and increasing the competitiveness of the Indian economy remain vital strategic objectives, but the gradualism of India's globalisation has yielded dividends in dealing with a global economic downturn. Given that India's growth acceleration has also helped alter her global and regional profile, sustaining this process is vital to its grand strategy.

**The Re-hyphenation with Pakistan**

In the past decade an important perceptional gain for India in strategic terms was its 'de-hyphenation' from Pakistan and a new 're-hyphenation' with China in the popular and intellectual imagination, especially in the West. Rather than view India only as a 'South

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[28] See Sanjaya Baru, 'India and the World: Economics and Politics of the Manmohan Singh Doctrine in Foreign Policy', Working Paper No. 53, Institute of South Asian Studies, Singapore, November 2008. Available at: http://www.isasnus.org/events/workingpapers/52.pdf.

[29] This has already delayed finalization of the India-ASEAN FTA, although the official reason given is that the Summit meeting has been postponed due to the situation in Thailand and that India is now into election season. It is possible that the global slowdown may have encouraged both sides to go slow on the FTA.

Asian' economy, western investors and analysts began viewing her in the context of Asia's rise. In recent years the idea of '*Chindia*' – a joint assessment of the rise of China and India – had gained currency.[30] This new 'hyphenation' with China and 'de-hyphenation' with Pakistan was firmly embedded in the relative economic performance of each of the three countries. The period since 1991 has been a turning point for India in terms of global appreciation of her economic prospects relative to China, Pakistan, Southeast and other South Asian economies.

Until the 1980s, Pakistan had a relatively superior record in economic performance compared to India. This shaped her self-image as well. However, the 1990s saw India not only overtaking, but also breaking ranks. Changing economic performance has had its impact on changing strategic perceptions about the two neighbours, both within the region and outside. (Table 9)

**Table 9: Average Real GDP Growth**

| Period | Pakistan | India |
|---|---|---|
| 1954-1958 | 2.01 | |
| 1953-1960 | 3.80 | 3.7 |
| 1959-1971 | 3.90 | |
| 1961-1970 | 3.35 | 3.3 |
| 1971-1980 | 4.81 | 3.5 |
| 1981-1990 | 6.19 | 5.4 |
| 1991-2000 | 3.96 | 6.2 |
| 2000-2005 | 4.98 | 7.0 |

Sources: 1. Arslan Razmi, *Analyzing Pakistan's Economic Prospects in an Increasingly Integrated World: External Constraints on Sustainable Growth*, ISAS Working Paper, March 2007. Available at http://www.isasnus.org/2007MaySymposium/Panel percent20Three percent20-percent20Presentation percent 20Paper percent20- percent20Dr percent20Arslan percent20Razmi.pdf.
2. Economic Survey, Ministry of Finance, Government of India, various Issues.

The overall deceleration in Pakistan's growth comes through even more sharply when we compare per capita income growth. Pakistan's higher population growth rate and the deceleration of India's population growth have widened per capita income disparity between the two South Asian neighbours.

**Table 10: Growth Rate of Per Capita National Income (Percentage/Year)**

| Country/ Period | 1975-90 | 1990-2003 |
|---|---|---|
| **India** | 2.8 | 3.8 |
| **Pakistan** | 3.4 | 1.4 |

Source: Sadiq Ahmed, Explaining South Asia's Development Success, World Bank, 2006.

[30] The word 'Chindia' received 177,000 hits on Google. A selection of 'Chindia' books includes Jairam Ramesh. *Making Sense of Chindia: Reflections on China and India*. New Delhi, India Research Press, 2005. Jagdish N. Sheth, *Chindia Rising*. New Delhi, McGraw Hill India, 2007. Robyn Meredith, *The Elephant and the Dragon: The Rise of India and China and What it Means for All of Us,* W.W. Norton & Company, New York, 2008. Alan Winters and Shahid Yusuf (Edited), *Dancing with Giants: China, India, and the Global Economy*, World Bank, 2007. Pete Engardio (Edited), *Chindia: How China and India Are Revolutionizing Global Business*, McGraw Hill, New York, 2006. David Smith, *The Dragon and the Elephant: China, India and the New World Order*, Profile Books, London, 2007. Bill Emmott, Rivals: How the Power Struggle Between China, India and Japan Will Shape Our Next Decade, Harcourt, London, 2008.

In more recent years Pakistan has been able to improve its economic performance due to a huge infusion of aid from the United States and multilateral financial institutions. However, the overall deterioration in Pakistan's security environment has meant that this marginal improvement in her economic performance has not yet altered the changed perceptions of the economic weight and performance of India and Pakistan. This could well be one reason why *jehadi* terrorists with links to Pakistan have specifically targeted important economic centres in India like Mumbai, Delhi, Hyderabad and Bangalore.[31]

India's superior economic performance in the 1990s had the effect of subduing Pakistani bravado on the one hand, and encouraged India to adopt a more accommodative stance towards Pakistan, and its other South Asian neighbours. This is reflected in India's policy of "asymmetric liberalisation" within the South Asian Association for Regional Cooperation (SAARC) region. At the Dhaka, Delhi and Colombo SAARC Summits, India proposed a series of initiatives to boost regional economic cooperation.[32] An economically stronger and stable India has felt encouraged to pursue a policy of 'asymmetric' or non-reciprocal liberalisation in South Asia, offering duty-free access to less developed countries. This policy would also be reassessed as a consequence of the economic slowdown. On the other hand, if Pakistan feels emboldened by the renewed injection of economic and military assistance and aid from the West, it may spur new adventurism within the military leadership. Any slowing down of the Indian economy would only encourage such adventurist elements in Pakistan.

Pakistan is the source of India's biggest security problem – *jehadi* terrorism. However, India faces a strategic dilemma. It is in India's interests that Pakistan should stabilise as a nation, a society and an economy. It is in India's interest that Pakistan's economy should do well, that a moderate and peace-loving middle class and business class gains ascendance and democratic institutions take root. However, if improved economic performance, aided by United States assistance, emboldens Pakistan to return to adventurist tactics vis-à-vis India, the security environment in the region would only deteriorate. The impact of the slowdown on the United States economy and politics, and the challenge of the United States budget management could also shape the United States' response to the challenge of terrorism in South Asia. If domestic economic and political pressures encourage the United States Administration to pursue a so-called 'AfPak' strategy that is not in line with Indian security perceptions, India would be constrained to develop its own response to the threat of regional instability. How United States policy responds to the global economic crisis and influences its policy on *jehadi* terrorism in South Asia would, therefore, have a direct bearing on India's strategic environment.

**India and the Least Developed Countries**

India's growth acceleration since 2003 has also enabled it to adopt a more liberal stance towards other Least Developed Countries (LDCs) in Asia and Africa. The policy of non-

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[31] Speaking in Parliament on the 26 November 2008 terrorist attacks in Mumbai, Prime Minister Manmohan Singh drew pointed attention to the targeting of India's economy: "As far as Mumbai is concerned, it was a very calculated and sinister attack, intended to cause widespread terror and damage to the image of India. The forces behind these attacks wanted to destabilize our secular polity, create communal discord and undermine our country's economic and social progress." Lok Sabha, 11 December 2008. Available at: http://www.pmindia.nic.in/speeches.htm.

[32] See Sanjaya Baru, *India and the World: Economics and Politics of 'The Manmohan Singh Doctrine' in Foreign Policy*, ISAS Working Paper No. 53, November 2008. Available at: http://www.isasnus.org/events/workingpapers/52.pdf.

reciprocal trade liberalisation involving duty-free access was extended to all African LDCs at the India-Africa Summit in New Delhi in April 2008, and to the so-called 'CMLV' countries in Southeast Asia (Cambodia, Myanmar, Laos and Vietnam). There are clearly two distinct strands of Indian strategic policy defining these initiatives. On the one hand, India's traditional policy of building bridges with other developing countries and promoting South-South cooperation; on the other hand, the need to keep pace with China in providing aid and assistance to other developing countries, especially the LDCs.

Liberal unilateral trade concessions, even if to the LDCs, would come under attack from producers' lobbies and politicians in a slow-growing India. For example, India's trade concessions to Vietnam, a friendly country, in commodities such as coffee have already come in for sharp attack from even the Communist Party-led state government of Kerala, where coffee growers have political clout. Apart from unilateral trade concessions, India has also stepped up aid and technical assistance to other developing countries. The Indian external aid budget has increased substantially in recent years, with a significant share of it going to Afghanistan and Bhutan.[33] (Table 11)

**Table 11: Budget Allocations for External Aid Financing (In Indian Rupees)**

| | 2008-09 | 1998-99 |
|---|---|---|
| Foreign grants | 1,92,643 | 5,604 |
| Foreign loans | 1,386 | 2,730 |
| Total grants and loans | 20,64,950 | 8,334 |
| Of which MEA budget for, ITEC | 650 | |
| Africa | 800 | 110 |
| Afghanistan | 4,450 | |
| Bhutan | 8,184 | 4,500 |
| Nepal | 1,400 | 700 |
| Myanmar | 560 | 510 |
| Contributions to IOs | 3,531 | 1,621 |
| Allocations to IFIs | 171 | – |
| Of which, AfDB | 144 | |
| Exim Bank interest equalisation subsidy | 2,320 | |
| Total estimated foreign aid | 2,66,712 | 9,955 |
| Exim Bank loans and guarantees | 3,50,039 | 21,013 |

Source: Chanana (2009).

While strategic interests in South Asia and traditional commitment to South-South cooperation drive India's aid budget, competition for influence with China, both within South Asia and in the developing world as a whole, is also a major driver. India's growth acceleration in the past decade has enabled it to find the resources for such aid. Any

[33] See Dweep Chanana, "India as an Emerging Donor", Economic and Political Weekly, 21 March 2009. Available at: http://www.epw.in/uploads/articles/13314.pdf.

deceleration in growth and consequent fiscal pressures would impose constraints. This would most certainly be an adverse strategic consequence of the extant economic slowdown.

**Section 4: The Global Slowdown and the United States-China-India Triangle**

Faced with an economic deceleration, India's priority would be to regain the growth momentum of the past decade. India's higher economic growth in the past decade has contributed to increased economic interaction between India and the Major Powers, including China. This has yielded important strategic dividends for India, like its participation in the G-8 Summits and its membership of the G-20 Summits.

At a bilateral level, India's economic rise has shaped its relationship with the United States and China. It is an appreciation of the strategic importance of sustained growth of a free market democracy in the developing world, and the assurance of energy security for it that helped define an improvement in India-United States relations in recent years, especially during the Bush Administration. The United States came to appreciate that India's economic success within the framework of a secular and plural democracy is of strategic importance to all open societies and open economies.

Condoleezza Rice, then-United States Secretary of State, best articulated this view when she wrote, "India stands on the front lines of globalisation. This democratic nation promises to become a global power and an ally in shaping an international order rooted in freedom and the rule of law... the United States has a vital stake in India's rise to global power and prosperity, and relations between the two countries have never been stronger or broader. It will take continued work, but this is a dramatic breakthrough for both our strategic interests and our values."[34]

President Obama's first important statement on United States-India relations, conveyed through a letter written when he was still a candidate in the presidential elections, to Prime Minister Singh, adopted a forward-looking and supportive position on United States-India relations, underscoring the importance of India's democratic development. Obama said, "I would like to see United States-India relations grow across the board to reflect our shared interests, shared values, shared sense of threats and ever-burgeoning ties between our two economies and societies…Imagine our two democracies in action: Indian laboratories and industry collaborating with American laboratories and industry to discover innovative solutions to today's energy problems. That is the kind of new partnership I would like to build with India as President."[35]

However, the Obama Administration has so far not shown strong and visible commitment to this vision of United States-India relations.[36] It is instructive to remember that the September

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[34] Condoleezza Rice, "Rethinking the National Interest: American Realism for a New World, *Foreign Affairs*, July-August 2008. Available at: http://www.foreignaffairs.com/articles/64445/condoleezza-rice/rethinking-the-national-interest?page=show.
Also see Ashley Tellis, "Indo-US Relations Headed for a Grand Transformation?", *YaleGlobal Online*, July 2005, Available at: http://yaleglobal.yale.edu/display.article?id=5999.

[35] Barack Obama, "Letter to Prime Minister Manmohan Singh," 23 September 2008, available at http://en.wikisource.org/wiki/Barack_Obama's_Letter_to_Prime_Minister_Manmohan_Singh.

[36] An official of the Obama Administration, Deputy Secretary of State James Steinberg, underscored 'continuity' in the United States policy towards India from the Clinton Presidency through the Bush Administration and endorsed the importance of the bilateral relationship. Available at: http://www.state.gov/s/d/2009/ 120856.htm.

letter was written when the financial crisis was just unfolding and few had foreseen the depths of the impending global economic downturn. In the months following this statement, not only has the economic crisis become worse but the situation in Afghanistan and Pakistan has sharply deteriorated.

In dealing with the economic crisis the United States has moved closer to China, while in dealing with terrorism it has become more dependent on Pakistan.[37] It is, therefore, possible that these remarks do not any longer fully reflect the world view of President Obama. The United States continues to share common interests with India. The United States and India have a shared stake in reducing their dependence on imported petroleum and natural gas, and in the development of nuclear and non-conventional energy. Given India's low per capita domestic availability of energy and other natural resources, ensuring access to these resources is vital to India's development process and national security.

The global economic downturn offers an opportunity for the world's largest democracies and market economies to work together to strength the foundations of open societies and open economies, by creating a global order that is supportive of India's developmental aspirations. If the Obama Administration builds on the foundations laid by the Clinton and Bush Administrations to build a strategic partnership with India, the United States could play the same role in India's rise as it did in the post-war reconstruction of Japan and Western Europe, on the one hand, and the rise of the 'East Asian Tigers' and China, on the other.

The United States offered such a 'benign' economic environment for the reconstruction of post-war Western Europe and East Asia. Post-war Germany, Japan and South Korea owe their economic rise to supportive United States policies. Even the so-called 'Asian Tigers' – Hong Kong, Taiwan and Singapore – benefited from helpful United States economic and security policies. The United States economic support also helped many of the 'economies in transition' in Eastern Europe. Indeed, in the past two decades United States policies have facilitated the rise of China. The United States investments in China, access to United States markets for China's exports, United States support for China's membership of the World Trade Organisation have all played an important role, apart from China's own domestic policies, in boosting China's economic performance.

How open the United States remains towards India, keeping her markets open, being liberal with H1-B visas, being supportive in multilateral economic institutions, will have a bearing on India's growth process. The United States-India Chief Executive Officers (CEO) Forum was launched in July 2005 precisely with the intention of strengthening economic relations between the two countries. Just as many in Europe and Asia saw the United States as a partner in their progress, India too must have the opportunities that enable her to view the United States as such.

The impact of the slowdown on the United States economy and politics, and the challenge of the United States budget management could also shape the United States response to the challenge of terrorism in South Asia. If domestic economic and political pressures encourage the United States Administration to pursue a so-called 'AfPak' strategy that is not in line with

[37] Indeed, the United States frustration with Pakistan may even encourage it to look to China for help. See for example the report by Paul Richter, "U.S. appeals to China to help stabilize Pakistan", *Los Angeles Times*, 24 May 2009. Available at: http://www.latimes.com/news/nationworld/nation/la-fg-us-china-pakistan25-2009may 25,0,6047766.story.

Indian security perceptions, India would be constrained to develop its own response to the threat of regional instability.

On the other hand, if Pakistan feels emboldened by the renewed injection of economic and military assistance and aid from the West it may spur new adventurism within the military leadership. Any slowing down of the Indian economy would only encourage such adventurist elements in Pakistan. As mentioned earlier, Pakistan is the source of India's biggest security problem – *jehadi* terrorism.

How the United States policy responds to the global economic crisis and influences its policy on *jehadi* terrorism in South Asia would, therefore, have a direct bearing on India's strategic environment. A greater degree of convergence on strategic options in the region between the United States and India would be helpful for the bilateral relationship, for regional stability and would shape the strategic environment for India's and the region's economic development.

The Obama Administration's outreach to China, on the one hand, and its so-called 'AfPak' strategy in South Asia, on the other, has not been viewed favourably by some influential commentators in India.[38] It would appear as if the Obama Administration was groping for a new policy framework for South Asia, in particular, and Asia, in general. It may have no option other than staying the course set by Presidents Clinton and Bush.

The recent statement of Secretary of State Hillary Clinton points in that direction.[39] Defining the 'four platforms of cooperation' between India and the United States as "global security, human development, economic activity, science and technology", Secretary Clinton declared, "I think our successes and our futures are intertwined. Obviously, we want India to do well on its own for its own sake, but we also have a stake in that outcome, because we want India to succeed as a model of democratic development. We want India to succeed as an anchor for regional and global security. And we want India to succeed so that the world's two largest democracies can work together as strong partners."

The United States strategy in Asia will also shape the strategic environment within which India is trying to improve its economic prospects. Stabilising the economy is also vital for India to deal with the instability of its neighbourhood. Apart from Pakistan, Sri Lanka too is in turmoil and both Nepal and Bangladesh remain potentially unstable polities. In each of these countries we see China's growing influence and interest. China has also arrived in the Indian Ocean with its naval fleet and is once again flexing its muscles on the status of Arunachal Pradesh. Its influence is growing in Pakistan, Nepal, Sri Lanka, Myanmar and Bangladesh. Chinese leaders have visited the Indian Ocean islands of Seychelles and Mauritius, and China is probing the newly democratic Bhutan.

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[38] The Obama administration's 'AfPak' strategy has come in for critical comments in India and experts are already expressing doubts about the durability of the 'strategic partnership' that President Bush and Prime Minister Singh sought. See, for example, comment by former Indian foreign secretary Kanwal Sibal, "Promise of Indo-US Ties Diluted by Obama," *Mail Today*, 21 April 2009.

[39] Remarks at U.S.-India Business Council's 34th Anniversary "Synergies Summit" by United States Secretary of State Hillary Clinton. U.S. Chamber of Commerce, Washington, D.C., 17 June 2009. Available at: http://www.state.gov/secretary/rm/2009a/06/125033.htm.

Against the background of a rising China that is increasingly influential in her troubled neighbourhood India cannot afford to see a weakening of its own growth process that underpins her strategic capabilities.

The bigger challenge for India, however, is to ensure that the current global economic slowdown does not constrain it from catching up with China. Without doubt the rise of China is India's main long term strategic challenge. Already China's influence in Asia is rising. China had long overtaken India as the main business partner of many South Asian economies, not to mention East and Southeast Asia.[40] China has also emerged as a major source of external financial support through its contribution to the Chiang Mai Initiative and direct financial assistance to various countries.[41]

The two Asian giants are already engaged in a race for resources and markets in Asia and Africa, with China far ahead of India. A deceleration in China's growth could blunt the edge of this competition. But it will not go away. Rather, it is likely to accentuate as India catches up in the growth race. As a consequence of the current global slowdown, we can conjecture three alternative scenarios of regional growth.

First, India is able to recover more easily than China, due to its lower dependence on global markets and lower exposure to the United States economy; second, India is unable to regain its growth momentum, while China is; and third, no relative change in the status of India and China in the world economy.

How the global slowdown impacts this bilateral relationship will shape the overall strategy of both the Asian powers. It will also impact on their relations with other Asian economies as well as Western powers. It will shape the process of institution-building in Asia, and the structure of regional economic and security architecture. The resolution of the problem of the savings-consumption imbalance between China and the United States will have a profound impact on the emerging global strategic balance. A United States-China 'condominium' could alter India's strategic environment and options.

The idea of such a condominium was first proposed by Fred Bergsten, who called for a United States-China 'G-2' working together to deal with the challenge of global imbalances and other issues like climate change and the completion of Doha Round negotiations.[42] The idea of '*Chimerica*' captured popular imagination in the Western media on the eve of the London Summit of the G-20, but Chinese commentators have so far reacted cautiously.[43]

A United States-China condominium could go beyond the management of global imbalances and crises. If it encapsulates multilateral trade negotiations and discussions on global

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40 See Baru (2006), Chapter 38.

41 See C Randall Henning, "The Future of the Chiang Mai Initiative: An Asian Monetary Fund?" Available at: http://www.iie.com/publications/pb/pb09-5.pdf.

42 Fred C Bergsten, "A Partnership of Equals: How Washington Should Respond to China's Economic Challenge, Foreign Affairs, July-August 2008. Available at: http://www.foreignaffairs.com/articles/64448/c-fred-bergsten/a-partnership-of-equals.

43 The phrase '*Chimerica'* was first popularized by Niall Ferguson and Moritz Schularick, "Chimerica and global asset markets", *International Finance*, 10. 3 (winter 2007). Pp. 215-239. However, Ferguson has himself since expressed skepticism about the idea. "The End of Chimerica", *StandPoint*, Available at: http://www.standpointmag.co.uk/node/399/full.
Also see Elizabeth C Economy and Adam Segal, "The G-2 Mirage", Foreign Affairs, May-June 2009, Available at: http://www.foreignaffairs.com/issues/2009/88/3.

warming and climate change, it would have an even greater impact on India's strategic environment. India seeks a benign global environment for trade and investment that will enable it to sustain higher rates of economic growth.

The United States offered such a 'benign' economic environment for the reconstruction of post-war Western Europe and East Asia. Its policies also facilitated the rise of China. How open the United States remains towards India, keeping its markets open, being liberal with H1-B visas, being supportive in multilateral economic institutions, will have a bearing on India's growth process.

India's strategic perspective on trade and climate change negotiations has been defined in the framework of economic development, employment generation and poverty eradication. So far India and China have been able to work together on these issues. If China breaks ranks and arrives at an understanding with the United States that does not meet India's needs, India would have no option but to join ranks with other developing countries and other powers to secure its own interests. Here too the United States could adopt a supportive stance towards India or adopt postures that would revive old North-South divisions on global economic issues.

The global economic slowdown has increased the salience of trade and climate change negotiations since the outcomes of these negotiations will shape the overall environment for India's economic development. India has often been portrayed as a 'spoiler' both in the Doha Round and in the climate change negotiations. This is not true. India has a 'strategic stake' in multilateralism on both counts. However, its priority lies in defending the environment for economic growth and poverty eradication. Without a 'development' dimension to the trade and climate change negotiations, India would be hard put to join a multilateral agreement.

A United States-China condominium, with its attendant implications for relations with Pakistan, would force India to rethink its own strategy of global engagement. It would certainly strengthen anti-United States and anti-China sentiment in India. It would encourage India to return to its leadership role in the developing world, imparting new momentum to the India-Brazil-South Africa (IBSA) forum and to its relations with other powers like Russia, European Union and Japan. Indeed, if the G-20 gets reduced to a G-2, then IBSA could become the core of a new G-77, the developing country forum. It remains to be seen if China would risk yielding the leadership space in the developing world to India.

The management of the global economic crisis has forced the pace of events with respect to the reform of institutions of global economic governance. The G-7 has realised the need to bring China, India and other major developing economies into the institutions of global governance like the IMF and the Financial Stability Board. For India the challenge would be to ensure that China does not once again steal a march over it, as it did in the creation of the United Nations Security Council, in the anticipated reform of global institutions and the creation of new regional institutions.

Finally, India would want to see how the changing relationship between the United States and China would shape global negotiations on trade, finance and climate change, and impact on dealing with the challenges of food and energy security. The United States and India have a shared stake in reducing their dependence on imported petroleum and natural gas, and in the development of nuclear and non-conventional energy. Given India's low per capita domestic availability of energy and other natural resources, ensuring access to these resources is vital to India's development process and national security.

State versus Market

The global economic crisis has reopened a debate that many thought was buried by the debris of the collapse of the Soviet Union and the end of the Cold War – about 'State versus Market' and the pros and cons of a free market democracy.[44] The debate is significant for the future of policy in developing country democracies around the world, as China's success increases the appeal of its model of single party-based Statist rule. India's world view, of the importance of a developing country becoming economically better off within the framework of a democracy, is losing salience as that of China's 'socialist market economy' gains ground.

The issue at stake is not the extent of government intervention in markets and State support for private enterprise, since most economies are 'mixed economies' anyway. The issue is the political basis of governance. Has democracy been devalued by the economic crisis? India, like the United States, has a strategic stake in ensuring that democratic institutions are not so delegitimised.

How nations and peoples respond to the current global economic crisis will determine the ideological and political foundations of the world order in the 21st century. Many in East Asia are already suggesting that China's model of the 'development state', based on benign authoritarianism, is more relevant to developing countries than Western models of multi-party democracy that are handicapped by internal political dissent. Claims are being made that a "Beijing Consensus" on economic policy is replacing the disgraced "Washington Consensus" (a phrase used to describe policies that defined the IMF conditionality in the past two decades).[45]

There was much that was wrong with the policies of the so-called 'Washington Consensus'. But the answer for a democracy like India cannot be the economics of a 'Beijing Consensus'. India has a strategic stake in the success of its model of a liberal democracy and a mixed economy – a 'New Delhi Consensus', if you like. The Great Depression of the 1930s gave rise to non-democratic political movements in the wake of popular resentment against the failure of democratic governments to deal with the challenge of an economic downturn. The United States and India have the opportunity to work together in ensuring that the current recession does not encourage non-democratic political movements and systems. Rather, as mentioned earlier, the global economic downturn offers an opportunity for the world's largest democracies and market economies to work together to strengthen the foundations of open societies and open economies, by creating a global order that is supportive of India's developmental aspirations and the ambitions of all developing country democracies, like Brazil, Indonesia and South Africa.

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44 Ian Bremmer, "State Capitalism Comes of Age: The End of the Free Market?", Foreign Affairs, May-June 2009. Available at: http://www.foreignaffairs.com/articles/64948/ian-bremmer/state-capitalism-comes-of-age.

45 "It is very possible that the Beijing Consensus can replace the Washington Consensus," said Cui Zhiyuan, a professor of public policy at Tsinghua University who edited a recent book on the subject. "Since the crisis, the world doesn't have as much confidence in the U.S. economic model as before." Ariana Eunjung Cha, "China Uses Global Crisis to Assert Its Influence: Along With Aid to Other Nations, Beijing Offers Up Criticism of the West", The Washington Post, 23 April 2009. Available at: http://www.washingtonpost.com/wp-dyn/content/article/2009/04/22/AR2009042203823.html?wpisrc=newsletter.

**Conclusion**

India's reintegration into the world economy, with a higher trade/GDP ratio and increased dependence on external capital flows, has made it more vulnerable to global crises, but the pursuit of gradual reform and prudent regulation have minimised the negative impact of both the Asian and, more recently, the 'Trans-Atlantic' financial crises. From a strategic policy perspective, India can claim that her model of "gradual" and "graduated" economic liberalisation, and of risk averse prudential regulation in the banking and financial sector have helped limit her exposure to the 'Great Recession'. India's major economic vulnerabilities remain internal, with weak public finances and inadequate investment in social and economic infrastructure.

If India can return to the more recent high growth trajectory of eight to nine percent annual economic growth and sustain it over a decade, it will be on course to emerge as a great Asian power. The challenge before India in the next half a decade is to regain this momentum at a time when the global economy is likely to be less hospitable than it has been over the past half decade. In this sense, the global economic slowdown has imposed new constraints on India's economic rise. However, these are not insurmountable obstacles given the high domestic savings and investment ratios and the potential of the home market for sustaining high growth.

It is clear that the second Singh government will keep its focus on sustaining high rates of investment and economic growth. This is in keeping with Prime Minister Manmohan Singh's vision of defining India's rise in terms of its economic performance. The global economic slowdown has only underlined the importance of India's economic performance for its global standing. The '10-point' Charter of the new government balances considerations of equity with those of efficiency. As a 'free market democracy', Indian public policy will have to pay equal attention to both considerations.

An economically stronger India has felt encouraged to pursue a policy of 'asymmetric' or non-reciprocal economic liberalisation towards less developed countries, including those in its neighbourhood. Any deceleration in growth and consequent fiscal pressures would impose constraints on such non-reciprocal trade liberalisation and foreign aid.

One geopolitical consequence of the global financial crisis has been the coming together of the United States and China. Some analysts talk of a United States-China 'G-2' condominium. This could have implications for their respective strategies in South Asia and their individual and joint approach to geopolitical and security issues in the region. China's rise should not be viewed in purely geopolitical or economic terms, but also in terms of the implications it has for the future of liberal and plural democracy in the developing world.

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