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March 2008

India: The Emerging Giant

Reviewed by Greg Rushford

For nearly four decades there have been only a handful of serious scholarly studies of what makes the economy of the world's second most populous country tick. And no wonder, since there wasn't much ticking going on. Despite promises of reasonably enlightened economic leadership after its 1947 independence from British rule, by the 1960s India had become one of the world's worst economic performers—an infuriatingly inward-looking, impoverished, protectionist basket case. After such leading economic theorists as Jagdish Bhagwati warned in the early 1970s that India's economy was headed south, there really wasn't much more to add.

Now an economy that stagnated for a generation has been taking off, growing more than 8.5% annually. In a book as impressive as the economy it describes, Columbia University economist Arvind Panagariya—fittingly, the holder of the Jagdish Bhagwati chair at Columbia's School of International and Public Affairs—has the story.

Since the reform process got underway in the early 1990s, India has been on the move. Such formerly closed major sectors including banking, telecommunications, pharmaceuticals and airlines have been liberalized, and average industrial tariffs, once as high as 340%, have fallen to around 10%. The reforms, particularly those directed at embracing international trade, have paid off in real growth.

In 1990, India's merchandise exports were \$18.1 billion, a number that wouldn't double for 10 years. But such exports have doubled again in just the past three years, to \$102.7 billion. India's service-sector exports, just short of \$30 billion three years ago, have shot up to more than \$60 billion. Overall, trade now amounts to more than 43% of the Indian GDP. And while the exact numbers are subject to debate, there is no doubt that hundreds of millions of Indians have been pulled out of poverty. The professor finds much to applaud.

Mr. Panagariya, however, is hardly a cheerleader. While he believes that India's impressive growth is likely to be sustainable, as long as reforms continue, he scoffs at fashionable predictions that India will pass China in the coming half century. "Such long-term predictions have no more validity than astrological predictions," he quips. The economist has the numbers to show that India still has a long way to go: India's share of world merchandise exports has doubled since 1990, but is still only about 1%. By contrast, China's share of global merchandise exports rose to 6.5% by 2004 from 2.8% in 1984. And while India's exports of goods and services are now in the 20-plus percent range of its economy, China's trade in goods and services shot up to 65% of its GDP in 2004 from 20%. And since 1990, India's share of manufacturing to its total economic output has "stagnated at 17 percent." In sum, to overtake China in 30 years, Mr. Panagariya figures, India would have to sustain its present growth, while China's own presently double-digit growth would have to fall to about 5%. The most sobering calculation is that despite the great strides in reducing poverty, perhaps 300 million of India's 1.1 billion people still subsist on some \$1 per day.

Beyond competition with China, Mr. Panagariya analyzes just about every economic issue that India faces, from macroeconomic topics including capital markets and trade in derivatives and bonds, to the performance of specific sectors like agriculture, banking, insurance, infrastructure, water supply, electricity and education. But for general readers, perhaps the most interesting parts of this book would involve the classical "political economy" questions. How did India dig itself into such an economic hole and what remains to be done?

Mr. Panagariya explains the first part of the question by focusing on what happened after Indira Gandhi became prime minister in 1966, a position she held (excepting the three years between 1977 and 1980) until she was



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assassinated in 1984. By the time Mrs. Gandhi took office, evolving Asian tigers like South Korea were already looking outward. But India remained insular, evidenced by the combination of high tariffs, quotas, price controls and the infamous License Raj system of bureaucratic control that discouraged both imports and productive investments. "Socialism with a vengeance," Mr. Panagariya sums up this period. Under Mrs. Gandhi's leadership, India's economy became strangled in red tape and protectionism. The licensing regime was further tightened, while she nationalized banks, insurance firms, the coal and oil industries, and discouraged foreign investment and international trade.

While such ideas certainly appear, well, less than bright, Mr. Panagariya is more interested in explanations than condemnations. For instance, he observes that in regard to bank nationalizations, "it was widely believed that commercial banks effectively excluded farmers and small entrepreneurs from their lending operations, and that the government needed to do something to improve the access of these groups to credit."

Meanwhile, as if India wasn't already doing enough to cripple its growth, there were external shocks: wars with Pakistan in 1965 and 1971, a 1962 war with China, consecutive droughts from 1971-73 and also the oil-price shock in October 1973.

Since 1991 India has gotten back on track, increasingly embracing globalization by lowering tariffs, removing import licensing, welcoming foreign investment and otherwise encouraging more Indian industries to compete in global markets. To cite just one example of how fast India can grow given the right policies, Mr. Panagariya references the opening of airlines to market forces, mainly in this decade. Domestic airline passengers numbered 8.1 million in 1991 and increased to 13.3 million in 2000; by 2005 passenger numbers had shot up to 22.7 million.

Still, Mr. Panagariya rightly points out that much more needs to be done. India's ports remain clogged. Roads, particularly in poor rural areas, remain inadequate. Tariffs and subsidies, especially in the notoriously weak agriculture sector, are still too high. Thanks to nightmarish labor laws that kill entrepreneurial activity, rent control and restrictions on land use, urban infrastructure reform appears "intractable."

Despite the daunting challenges, Mr. Panagariya has reason to be optimistic. Indian elites who once refused to heed the warnings of his mentor Mr. Bhagwati are now paying attention. It is now "unthinkable" that the days of the License Raj will return. Add India to China and the other Asian tigers that have become worthy of the attention of world-class economists like Mr. Panagariya.

Mr. Rushford is editor of the Rushford Report, an online journal that specializes in trade politics and diplomacy.

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