

Make in India, Largely for India

Raghuram Rajan

The danger when we discuss “Make in India” is to assume the export-led growth path that China followed. Slow growing industrial countries are much less likely to absorb a significant additional amount of imports in the foreseeable future. Industrial countries themselves are now adopting capital-intensive flexible manufacturing, dispensing with labor but doing what they outsourced, at cheaper cost made possible by the fact that, for example, United States has very cheap energy today. Besides, when India pushes into manufacturing exports, it will have China, which still has some surplus agricultural labor to draw on, to contend with. Export-led growth will not be as easy as it was for the Asian economies that preceded us.

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Introduction

The world economy is growing very slowly in the last couple of years and the IMF has repeatedly reduced its growth forecasts. In fact, after 6 years of a tepid post-Crisis recovery, the IMF titles its latest World Economic Outlook “Legacies, Clouds and Uncertainties”. The legacies, clouds and uncertainties continue even after 6 years after Financial Crisis. Why is the world finding it so hard to resume the pre- Great Recession growth rates, let alone restore the levels of GDP which would have been achieved if the Great Recession had not happened? Typically, in most recessions, economies go down but come back much faster. However, in this case we see a slow world in terms of levels of GDP as well as growth rates many years from the Great Recession.

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One answer to why the growth is so slow is the overhang of debt; when countries have lots of debt it prevents them from growing fast. Banks can't lend, households find it difficult to borrow and governments can't do Keynesian spending simply because they

don't have the fiscal space. It could be one explanation for why there exists what the IMF Managing Director calls the 'New Mediocre'. The implication here is that growth is unacceptably low relative to potential and more can be done to lift it through a variety of stimulus policies especially given that so many economies are flirting with deflation. So, the conventional policy advice urges yet more innovative monetary interventions with an ever expanding set of acronyms like QE and QQE, as central banks try to inject stimulus. Then just monetary stimulus will not do, there should be a fiscal stimulus too. So, more and more governments are urged to do obvious things like building infrastructure. There are voices saying more than this, for example, structural reforms but they are typically deemed very painful and possibly growth-reducing in the short run. So, the accent is on monetary and fiscal stimulus, and as much of it as possible given the deadening effect of the debt overhang.

If there is one country which has tried this for a long time it is Japan. Japan has been in a quasi-recession for 20 years now, really hasn't got out of the Great Crash of early 1990s and it has done everything that has been suggested. Interest rates have been low for long, quantitative easing and massive debt-financed spending on infrastructure. Japan had very low levels of government debt to GDP. Today, it has the highest net government debt to GDP in the industrial world. Few would argue that despite doing all this Japan is free of its malaise. It is out there, scooting ahead; last two decades have not been good.

Secular Stagnation

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There is now a different narrative of the pre-crisis period from this traditional view i.e. debt overhang to explain why the efforts at stimulating the economy back to the pre-Crisis growth paths have not been successful even six years after the Crisis. A common term, "secular stagnation" used by Larry Summers to describe this followed Alvin Hansen's speech in 1938 in the midst of the Great Depression, when the phenomenon of then slow persistent growth was called secular stagnation. Different economists focus on different versions of secular stagnation. Larry Summers emphasizes the inadequacy of aggregate demand, the Keynesian view, and the fact that interest rate can't be pushed below zero. Therefore we can't give more monetary stimulus than certain level in a period of low inflation. The possibility for financial instability prevents monetary policy from being more active. Coupled with that we don't have tools to stimulate but we also have headwinds to growth, specially ageing populations who want to consume less and the increasing income share of the very rich whose marginal propensity to consume is small. Those are the arguments that are made for very slow growth from the demand side.

Total Factor Productivity

There are others who argue that low growth from the supply side has been

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building for a long time. Prominent among those are Tyler Cowen and Robert Gordon who argue that the post-World War II years (30 years) of growth was extremely strong. This was because growth was helped by reconstruction in Europe, the spread of technologies such as electricity, telephones, and automobiles, rising educational attainments, and higher labor participation rates. Remember that women joined the workforce in a big way post World War II as well as restoration of global trade and increasing investments of capital. Everything was going in the right direction. Interestingly the one thing that was not going in the right direction was total factor productivity which was the highest during 1920-50 when world growth was relatively slow because of headwinds but since then productivity has been falling off. For those who think face book and social media are wonderful new inventions and the world has been more inventive and innovative in this period than ever before, think about the innovations that happened in the early part of the 20th century. There was a transition from horse drawn carriages to motor cars, from gas lit lamps to electricity, from coal filled irons which were heavy and required whole lot of labor for women to electric irons, and from washing clothes at the stream to washing machine. Compare those kinds of changes with twitter, facebook etc. and it can be seen that productivity growth was really quite large at that time. So,

productivity growth has fallen and it is also being held back by headwinds such as plateau in education levels and labor participation rates, as well as a shrinking of labor force in some countries because of population ageing. This is particularly pronounced in Japan and, to some extent, it shows us what the industrial world might look like if all these forces play out, subject to very slow growth. Population ageing contributes to both the demand and supply side reasons for secular stagnation.

There is a tendency to save today because of the belief that our employment prospects and our children's employment prospects are not going to be bright and that the society will not be able to deliver on the social security promises it has made. Therefore, there is a tendency to save; more the saving, today's consumption demand will be lower. One could argue that the West has been heading this way for some time, secular stagnation has been in the works. Once there is secular stagnation happening, there is slow growth and then there are number of concerns. One, of course, is in the time of very high growth (30 glorious fast growth years after World War II) societies made lots of promises in Europe. Post World War II is when England got the pension system and unemployment insurance. In the US, Lyndon Johnson Great Society in the mid-1960s again promised of social security, healthcare.

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Lots of promises were made in the good times. Except just after the good times growth collapsed. There is thus this very volatile combination of lot of promises to deliver and not enough growth. Initially some promises can be delivered without growth, if it is financed by printing money. Economists warn us that this causes inflation.

Promises to Deliver

The first phenomenon of this slow growth was in the 1970s when there were high levels of inflation when governments tried to finance the spending by printing money. It however, didn't work. We had the Volcker disinflation in all parts of the world subsequently. But if the economy can't inflate its way and there is still the need to spend what does one do? The governments issue debt and debt levels started picking up in industrial countries. At some point, even that became difficult. How much debt can be accumulated? Then private debt is encouraged. One would encourage people to borrow and spend, encourage housing loans and so on. There was the third phase which was an explosion of private lending just before the Financial Crisis and that also proved too much. In the US, it was the private debt which was the problem. In Europe, it was public debt especially in the periphery which proved to be the problem. So, this phenomenon of trying to increase growth higher than the potential of the economy eventually came a cropper in the West with Great Financial Crisis. But, post Financial Crisis, the imperative for growth is still there except now there is whole lot of debt also

on the part of these countries. Public debt has increased tremendously, private debt has also increased and there is still the need to try and stimulate the way out of growth. Besides, if it was an emerging market which was in trouble during Great Financial Crisis, the recommendation of the international organizations would be debt reforms. Get your debt straight, create the underlying growth that you need, don't pretend you can spend your way out of trouble. Of course, that is not the advice many industrial countries have taken, they have tried to spend their way out of trouble and got into more trouble.

Technology & Globalization

Further complicating this environment of slow growth is a growing sense amongst the middle class in a number of countries. Overlaying growth is also a differentiation in growth. It is coming because of technology, because of globalization. The routine jobs that used to exist have all gone away. Adding up both sides of the balance sheet is now taken up by computers or by somebody sitting in India. Routine jobs such as assembly line work have also been outsourced. So, a combination of globalization and technology has taken away the routine but reasonably well paying middle class jobs. What are left are the non-routine menial jobs such as flipping hamburgers that is still not automated. Nor is gardening automated. Haircut is still not automated. These are still non-routine and relatively low skilled jobs as well as non-routine high-skilled jobs such as the consultants and lawyers etc. So we have got bifurcation of jobs available, low paying and

very high paying and nothing in the middle. The middle class in a number of industrial countries is desperately anxious, they don't want to slip down but to go up. They realize they haven't had the quality education they need to apply to the Ivy League. Moreover if they apply to the Ivy League, they don't have the money to afford it. So, there is a very great angst in the middle class in Europe about what will happen to them because they want to go up but there is a probability that they will slip down. Given this, populist movements like the Tea Party in the United States or UKIP in the United Kingdom have come up. These are all parties that are playing to the middle class angst. The kind of message they often give is that there is a possibility of a backlash against technology, global finance, and foreign immigration and trade, saying these are the kind of things that hurt and these are the things that have to be kept in check.

So, the bottom line is that there is a very mediocre economic outlook. There are obviously certain things which could pull the world out. Strong US growth could be the locomotive. Low oil prices are net positive for the world in terms of demand because the oil producing countries typically consume less than the oil consuming countries. So, more incomes in India would mean a net positive for world demand.

Given this, economies may well be moving out of this relatively tepid recovery and over time it may be possible to figure out how to harness as well as monetize new technologies. There are

lots of new technologies which can improve productivity considerably. There is a need to figure out how to monetize them, how to make them pay, how to make them part of the economy. Just an example, the kids used to go to movies. Now they spend the same time, entertain on the computer free of charge. From the economy's perspective, the amount they spend on movie tickets doesn't show up as income, while, in fact, they are getting better benefits perhaps by sitting there and playing. So, given that there are real gains to the world economy but they may not be measured as well. Overtime perhaps all those will come in. One of the constants in the age of pessimism when things are going down, jobs are disappearing etc., is that new kinds of jobs emerged that could never be thought of. Today, for example, there is a job in advertising trying to estimate the number of hits a site will have and then sending advertising dollars in that direction. That job didn't exist 10 years ago, it was made possible by Google. The placement of the advertisement when you do a Google search. That is a whole science in its own right. But it is important to plan for a global economy which is not as strong as in the pre-Crisis year and which is also going to be politically more difficult to deal with for a variety of reasons.

If secular stagnation persists, industrial countries will have to figure out how to restructure their promises, whether it is debt, social security, or low taxes, and how to distribute the burden of these slow growing economies amongst people. One example is the city of Detroit in the

United States which has seen a massive erosion of auto worker jobs. It recently filed for bankruptcy but it had to make very tough choices, between servicing its pensioners or its debt, keeping its museums open or its police force intact. How much of it to be actually kept as a city and how much to make in to a green zone of forest? That is the kind of choice they had to make. More such difficult choices may come if this secular stagnation persists.

Export-led Growth

A few more years of slow growth is what India will have to face. What this means is a traditional development path for emerging markets – export-led growth has become significantly more difficult. Over the last 3 decades, every Asian country has developed on the back of its export-led growth. In fact, most recently, Latin America has developed on the back of exporting to China which has exported to industrial countries. Export led growth has been a facet of emerging markets because relying on domestic demand is very difficult due to the temptation to over stimulate. Developing countries when they have to rely on their own demand tends to run excessively large fiscal deficits and have credit booms which turn into credit bust and exces-

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sively high inflation. Those are the problems which always existed in relying only on domestic demand which is why when one exports efficiently that growth becomes very sustainable. That is more difficult today. It also becomes more difficult because of the abundance of liquidity around the world as a result of the ultra-accommodative monetary policies. Any signs of growth can attract foreign capital, and can precipitate a credit and asset price boom and exchange rate overvaluation. It is a concern because eventually when monetary policies in the industrial countries tighten, some of the capital is likely to depart and depart very quickly. If emerging markets are vulnerable at that stage they pay a price. India had a mini episode of this kind last year in summer when there were some hints that money would be withdrawn after the Fed announced that it would taper its quantitative easing. That created a significant amount of market disruption. Having weathered those initial squalls of the “taper tantrums” what should be taken away for stable growth assumes that industrial countries are likely to grow slowly for the next few years.

The rest of the address would focus on four key aspects: first, as importantly announced by the Government, is “Make in India”; There is a need to figure out how to do it better. Second, if the industrial countries are growing relatively slowly, India should also Make for India as opposed to make for rest of the world. India would aim to make for rest of the world but let us realize for most part there would be reliance on domestic demand. Third, there is to ensure transparency and stability of the

economy when the reliance is on domestic demand because the dangers of it running away are extreme. Fourth, work towards a more open and fair global system where the globe has a tendency of shutting down rather than expanding.

Make in India

To achieve this goal, the Government has to implement its ambitious plans on building out infrastructure.

First is 'Make in India'. The Government has announced this and it meant improving the efficiency of producing in India, whether of agricultural commodities, mining, manufacturing, or services. To achieve this goal, the Government has to implement its ambitious plans on building out infrastructure. This includes physically linking every corner of the country to domestic and international markets through roads, railways, ports and airports. What happens when a road gets built into a village? Immediately a variety of new activities come up in that road – horticulture, poultry, dairy farming because they have access to the markets. Once they have some incomes clothing and assorted goods shops begin to come up. The increasing use of powered vehicles is extraordinary. So, activities start exploding once there is physical connectivity. The same can be said about highway connectivity. Second element is ensuring the availability of inputs such as power, minerals and water at competitive prices. Everyone has to be linked electronically and finan-

cially through mobiles, broadband, and intermediaries such as business correspondents. Institutions such as markets, warehouses, regulators, information aggregators and disseminators, etc are required. Finally, there is a need for affordable and safe homes and work places across the country. These are important elements.

A second necessity for increasing productivity in India is to improve human capital requiring healthcare, nutrition and sanitation. Unless the people are healthy and able they can't participate in the modern economy. That has to begin but then more appropriate education and skills that are valued in the labor market and firms have the incentives to invest in workers are required. One of the biggest consequences of labor reforms will be to give firms more incentives to invest in their workers because they intent to retain them longer.

The Government is examining the third aspect which is reducing the cost of doing business in India. The woes of the big business are well known but woes of small entrepreneur are even greater as they confront the myriad, mysterious regulations that govern them and the numerous inspectors who have the power to close them down. The Government needs to do more because the petty bureaucrat, empowered by the kind of regulations is a virtual tyrant. He or she has to become a help to business. As regulators, the costs and benefits of the regulations have to be constantly examined and paired them down periodically so that they are just right.

Finally, access to finance has to be made easier. If we want domestic demand people have to have the ability to borrow and spend not easily but to a reasonable extent.

Some Caveats

There is a danger when we discuss “Make in India” of assuming that it means a focus on manufacturing, an attempt to follow the export-led growth path that China followed. In my opinion, such a specific focus is intended. There is a need to be careful because slow growing industrial countries are much less likely to absorb a significant additional amount of imports in the foreseeable future. Other emerging markets certainly could absorb more. We have to have more and more regional focus. We have to look at Africa. We have to look at East Asia. But, the world as a whole is unlikely to be able to accommodate another export-led China. After all we are China sized, we will be another export-led China if we go that way.

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Second, industrial countries themselves are now adopting capital-intensive flexible manufacturing, dispensing with labor but doing what they outsourced, at cheaper cost made possible by the fact that, for example, United States has very cheap energy today. Any emerging market wanting to export manufacturing goods will have to contend with this new

phenomenon of the industrial countries moving into that area.

Third, when India pushes into manufacturing exports, it will have China, which still has some surplus agricultural labor to draw on, to contend with. Export-led growth will not be as easy as it was for the Asian economies that preceded us and, therefore, we have to be careful about focusing on that.

The aforesaid should not lead to export pessimism here. The country must export. India has been extremely successful at carving out its own areas of comparative advantage, and will continue to do so. Instead, the counsel is against an export-led strategy that involves subsidizing exporters with cheap inputs as well as an undervalued exchange rate, simply because it is unlikely to be effective at this juncture. There has to be a constant attempt to try and do that. That strategy, if tried, probably is going to be far less effective than it was for our Asian counterparts. There is also a need to caution against picking a particular sector such as manufacturing for encouragement, simply because it has worked well for China. India is different, and developing at a different time, and should be agnostic about what will work.

More broadly, such agnosticism means creating an environment where all sorts of enterprises can flourish, and then leaving entrepreneurs, of whom we have plenty, to choose what they want to do. Instead of subsidizing inputs to specific industries because they are deemed important or labor intensive, a strategy that has not really paid

off for us over the years, let us figure out the public goods that each industry needs and strive to provide them. For instance, SMEs might benefit much more from an agency that can certify product quality, or a platform to help them sell receivables, or a state portal that will create marketing web sites for them, than from subsidized credit. The tourist industry will probably benefit much more from the recent announcement of visa on arrival and a strong transportation network than from the tax benefits they usually demand. The caution should be on subsidies and tax benefits and focus on public goods that can be provided for by the Government.

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A second possible misunderstanding is to see “Make in India” as a strategy of import substitution through tariff barriers. This has been tried before and it has not worked because it ended up reducing domestic competition, making producers inefficient, and increasing costs to consumers. Instead, “Make in India” is seen as more openness and creating an environment that makes our firms able to compete with the rest of the world, and encourages foreign producers to come take advantage of our environment to create jobs in India. It is about creating the environment rather than picking specific set of terms.

Make for India

Second aspect is “Make for India” because rest of the world is going to

be less accepting of exports. If external demand growth is likely to be muted, there is need to produce for the internal market. The policy makers must work on creating the strongest sustainable unified market which requires a reduction in the transaction costs of buying and selling throughout the country. Physical infrastructure will certainly help in doing this but the need is also more efficient and competitive intermediaries between the supply chains from producer to the consumer. A well designed GST bill, by reducing state border taxes, will create a truly national market for goods and services, which will be critical for our growth in years to come.

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Domestic demand has to be financed responsibly, as far as possible through domestic savings. Our banking system is undergoing some stress. Our banks have to learn from past mistakes in project evaluation and structuring as they finance the immense needs of the economy. They will also have to improve their efficiency as they compete with new players such as the recently licensed universal banks as well as the payment banks and small finance banks. At the same time, their task should not be made harder by creating impediments in the process of turning around, or recovering stressed assets. The RBI, the Government, as well as the courts have considerable work to do here.

Financial services have to be spread because once they learn how to manage finances and save they can be relied on to borrow responsibly. New institutions and new products to seek out financial savings in every corner of the country will also help halt the erosion in household saving rates and lead to a more stable financing of our investment needs. Given that the income tax benefits for an individual to save have been largely fixed in nominal terms till the recent budget, the real value of the benefits has eroded. We have to find ways to encourage savings once again. One of the least inefficient ways of tax spending is to offer some benefits to saving. One might think of increasing the financial benefits to savings through the tax mechanism.

Third, the domestic demand is very difficult to control. It tends to go overboard. If there has to be a reliance on domestic demand institutions that help us control it have to be improved. Countries typically tend to over stimulate, with large fiscal deficits, large current account deficits, high inflation, credit booms and then only to see growth collapse. To avoid such booms and busts a policy framework is required to avoid asking for multilateral help especially because India doesn't belong to any power blocks. For a stable framework critically important is the fiscal framework.

Fiscal Spending

The Dr. Bimal Jalan Committee's report will provide a game plan for fiscal spending and the government has clearly

indicated its intent to stick to the fiscal consolidation path that has been laid out. All these things are good. Whether more institutions are required to ensure deficits stay within control and the quality of budgets high is something worth debating. A number of countries have independent budget offices/committees that opine on budgets. These offices are especially important in scoring budgetary estimates including unfunded long term liabilities that the industrial countries have shown are so easy to contract in times of growth and so hard to actually deliver.

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On the monetary side, a central bank focused primarily on keeping inflation low and stable will ensure the best conditions for sustainable growth. Of course, we are a central bank in a developing market rather than in an industrial country and it has to be recognized that emerging markets are not as resilient as industrial economies are. So, the path of disinflation cannot be as steep as in an industrial economy because an emerging market is more fragile, and people's buffers and safety nets are thinner. This is why the notion that we would do a Volker style disinflation is rejected. India cannot sustain a Volker like disinflation. In fact a much more sustainable Urjit Patel glide path is what has been done in trying to bring down inflation. Over the next few weeks, the appropriate time line will be discussed with the Government after

2016 as we move to the centre of the inflation band of 2-6%.

Financial Stability

In addition to inflation, we have to pay attention to financial stability. It is a secondary objective but it may become central if the economy enters a low-inflation credit and asset price boom. Financial stability sometimes means regulators, including the central bank, have to go against popular sentiment. The role of regulators is not to boost the Sensex but to ensure that the underlying fundamentals of the economy and its financial system are sound enough for sustainable growth. Any positive consequences to the Sensex are welcome but are only a collateral benefit, not the objective.

Finally, India will, in the foreseeable future, run a current account deficit, which means we will need net foreign financing. The best form of financing is long term equity i.e. Foreign Direct Investment (FDI), and this has the additional benefit of bringing in new technologies and methods. While there is no need to be railroaded into compromising India's interest to attract FDI – for example, the requirements to patent a medicine in India are perfectly reasonable, no matter what the international drug companies say. However, to attract foreign investment policies especially tax policies have to be transparent and any redress is quick. If it comes easier for young Indian companies to do business, it will also help in making it easier for foreign companies to invest for, after all, both are outsiders to the system. Doing good to

the youth of India will effectively create a transparent system which will effectively do the same for foreign investors. We don't have to do special deals; we have to focus on bringing our young companies, young entrepreneurs into the system.

International Framework

As a country that does not belong to any power block and also that does not export vital natural resources but is dependent on substantial commodity imports, India needs an open, competitive and vibrant system of international trade and finance. The energy security of the country, for example, lie not in owning oil assets in remote fragile countries but in ensuring the global oil market works well and is not disrupted. The requirement is of strong independent multilateral institutions that can play the role of impartial arbitrator in facilitating international economic transactions. Equally important are the open global markets because of our dependence, specially for inputs, on them.

Unfortunately, the international monetary system is still dominated by the frameworks put in place in the past by industrial countries, and its governance is still dominated by their citizens. To be fair, it is changing, although relatively slowly. But, there is a more immediate reason for faster change. With slow growth in industrial countries, as well as the need to finance large debt loads, the interest of industrial countries in an open global system cannot be taken for granted. For instance, regulations that have the

appearance of shoring up safety and soundness of the industrial country financial system may have the collateral effect of making it harder for cross border lending into the emerging market or cross border investment into the emerging market. We have to recognize that unintended or intended slow growth may direct industrial country economic policymakers' attention inwards, even while politics turns protectionist. The multilateral governance system, still dominated by industrial countries, may not provide a sufficient defense of openness. It has in the past when the desire for industrial country was to open up the emerging market but now that the boot is on the other foot so to speak, it may not provide the same defense.

Emerging markets may, therefore, have the responsibility of keeping the global economy open. For this, not only the emerging markets have to work on quota and management reforms in the multilateral institutions, but importantly the country would have to work on injecting new agendas, new ideas, and new thinking into the global arena. Typically India has been passive or reactive often reacting to industrial country proposals. There is a need to go back to putting some of our own proposals on the table on development institutions. Our research department in government organizations, universities, our think tanks have to develop ideas that we can feed to India's representatives

in the international arena so India also starts playing a role in determining the international agenda.

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India is more dependent on the global economy than is thought of. That it is growing more slowly, and is more inward looking than in the past means that we have to look to regional and domestic demand for our growth – to make in India primarily for India. May be this has to be done for the next 5 years till the world picks up once again. Domestic-demanded growth is notoriously difficult to manage, and typically leads to excesses. This is why domestic macroeconomic institutions may be strengthened so that sustainable and stable growth can be fostered. At the same time, foreign markets cannot be shrunk further and we have to take up the fight for an open global system. Rather than being reactive, we have to be active in setting the agenda. That requires investment in idea-producing institutions – research departments of official bodies, think tanks including places like FICCI, CII and so on as well as universities. In sum, the diminished expectations in the world at large should not be a reason for India to lower its sights. I completely agree with Dr Manmohan Singh when he expresses the sentiment that the best for India is yet to come.