STRATEGIC ASIA 2009–10

ECONOMIC MELTDOWN
and Geopolitical Stability

Edited by

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Country Studies

India: Rising Through the Slowdown

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EXECUTIVE SUMMARY

This chapter examines both the impact of the global financial crisis and economic slowdown on India's economy and the consequent geopolitical implications.

MAIN ARGUMENT:
Since the early 1990s India has sought to reenter the global economy through a strategy of gradual and graduated economic liberalization combined with risk-averse prudential regulation in the banking and financial sector. These reforms helped limit India's exposure to the recent financial crises and the subsequent global economic slowdown. With a 7% growth rate likely for 2009, India's major economic vulnerabilities remain internal—weak public finances and inadequate investment in social and economic infrastructure, which are problems that will need to be addressed if India is to continue its rise as a free-market democracy.

POLICY IMPLICATIONS:
- India's improved economic performance in recent years had encouraged the country to become more globally and regionally integrated. This process is unlikely to be reversed by the current global economic slowdown, given the economic and strategic benefits India has derived so far.
- By pursuing policies in Asia that are supportive of India's economic rise, the U.S. will strengthen the foundations of open societies and plural and secular democracies in the developing world.

India: Rising Through the Slowdown

Sanjaya Baru

Though Wall Street investors call India an emerging market, India's economists view the country as a re-emerging and a globally reintegrating economy.[1] 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.[2] These geopolitical developments left their imprint on India's economic choices in the 1990s, and India's consequent economic rise has since shaped the geopolitics of Asia. Commending his new economic policies to the Indian Parliament in July 1991, India's finance minister of the day, Manmohan Singh, drew attention to the likely strategic consequences of India's economic rise when he 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.[3]

India's more recent growth acceleration since the early 1990s has followed a shift in the macroeconomic policy framework, with greater

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The author would like to thank K. Subrahmanyam, Y. Venugopal Reddy, and two anonymous referees for comments on an earlier draft.

[1] T.N. Srinivasan and Suresh D. Tendulkar, *Reintegrating India with the World Economy* (New Delhi: Oxford University Press, 2003).

[2] For a strategic perspective on India's economic reforms, see Sanjaya Baru, *The Strategic Consequences of India's Economic Performance* (New Delhi: Academic Foundation, 2006).

[3] Manmohan Singh, "Budget 1991–92 Speech" (speech delivered at Lok Sabha [House of the People], New Delhi, July 24, 1991), http://indiabudget.nic.in/bspeech/bs199192.pdf.

external and internal economic liberalization. This chapter argues that the fiscal, investment, trade, industrial, financial, and banking sector reforms that India has undertaken since 1991 as part of this re-emergence have helped the country weather the impact of both the Asian financial crisis in the late 1990s and the economic sanctions imposed on India after its nuclear tests of 1998. Yet though the U.S. subprime loan crisis and the "trans-Atlantic" financial crisis of 2008 did not have any impact on the Indian financial and banking sector, the consequent global economic recession has had the effect of slowing down India's growth rate.

Given that India's re-emergence and grand strategy as a rising power have been predicated on economic reintegration into the global economy and the revitalization of the Indian economy, the current "great recession" is bound to have significant strategic and geopolitical implications for India. These will be influenced by the manner in which the United States and China are affected by, and respond to, the crisis. With a new government in office bearing a decisive mandate, New Delhi is expected to settle down to the business of regaining India's growth momentum. India and the United States have the opportunity to be partners in shaping the post-crisis world. How the Obama administration views and accommodates India's rise will in turn shape India's grand strategy and approach to global institutions, regimes, and negotiations.

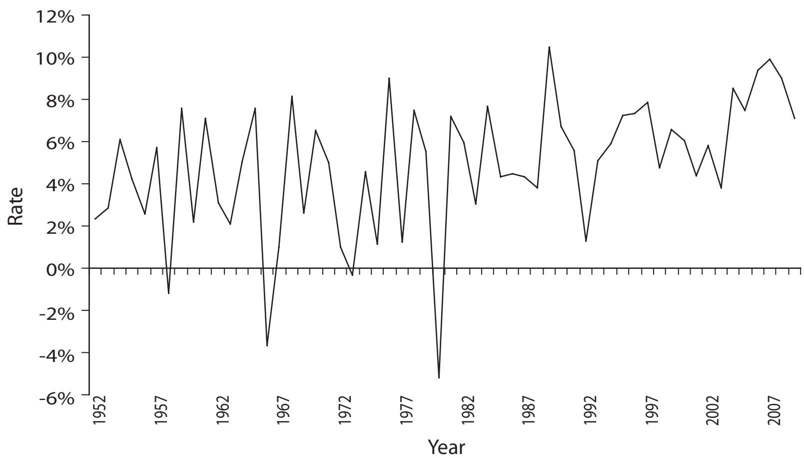
This chapter is organized as follows. The first section delves into the impact that the global financial crisis and resultant economic downturn have had on the Indian economy by first looking at the strong institutions and prudent practices developed during the past fifteen years or more of re-emergence; by second examining the more negative impact that the global economic slump has had on India's economy; and by closing with a discussion of India's likely economic policies moving forward. The second section then turns to the geopolitical implications of these economic impacts, focusing on India's economic rise and grand strategy, India's emerging leadership in South Asia and the developing world, the economic crisis and China's enhanced strategic advantage, and India-U.S. relations and U.S. strategy in Asia. The concluding section sums up the main findings of the chapter.

The Economics of the Economic Crisis

Relative Strengths of a Reintegrating and Re-emerging Economy

The Indian economy has grown at an annual average of 3.5% in 1950–80, close to 6.0% in 1980–2004, and close to 9.0% since 2004 *(*see **Figure 1***)*. India's management of the triple crises—fiscal, balance of payments, and financial—

FIGURE 1 Trends in India's GDP growth, 1952–2009



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

experienced sequentially between the late 1980s and the mid-1990s, set the stage for New Delhi'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 stabilization program and subsequently enacted the Fiscal Responsibility and Budget Management (FRBM) Act, thereby ensuring a reduction in revenue and fiscal deficits. The recent fiscal stimulus packages put in place in response to the current slowdown, however, have forced the government to breach the provisions of the FRBM Act.

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

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 as well as the financial and banking sectors, and recapitalized banks and improved their asset position.

While undertaking these internal reforms, India opted for gradualism in external-sector liberalization by adopting full currency convertibility only on the current account and eschewing it on the capital account. This policy 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. Such an approach has enabled India to sustain an acceleration of economic growth within a more open-economy framework.[4]

India's low inflation tolerance (the average rate of inflation from 1950 to 2000 was around 8.0%) has meant that New Delhi's 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. Though India returned to a more conservative approach in fiscal policy, the current crisis has forced the government to adopt a liberal fiscal stance.[5]

In his authoritative review of India's new economic policies, Arvind Panagariya concludes that "India has had a history of maintaining a relatively stable macroeconomic environment."[6] He further 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."[7]

In short, India's experience with handling the triple economic crises the country confronted in the early 1990s has helped put in place policies that have contributed to an acceleration of economic growth and a strengthening of the economy's ability to deal with external shocks. This has certainly helped India deal with the global economic slowdown with a greater degree of confidence, apart from structural resilience.

Closing the two gaps. In the pre-reform era India's growth process was constrained by what economists referred to as the "two gaps"—a domestic savings gap and an external financing gap. Rising domestic savings and

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[4] For a detailed discussion of the Indian economy's increased resilience to external shocks, see Arvind Panagariya, *India: The Emerging Giant* (New Delhi: Oxford University Press, 2008).

[5] See Vijay Joshi and I.M.D. Little, *India: Macroeconomics and Political Economy, 1964–1991* (New Delhi: Oxford University Press, 1994).

[6] Panagariya, *India: The Emerging Giant*, xxiv.

[7] Ibid., 207.

increased inflow of foreign capital have helped bridge both gaps, thus contributing to higher growth. For a long time India's savings rate was below 20%, even as East and Southeast Asian economies saw their savings rates exceed 30%. In the 1990s, however, the Indian economy caught up. India's more recent growth acceleration has been facilitated by a sharp rise in the savings and investment rates (see **Table 1**).

Traditionally India had bridged the external gap through foreign aid and concessional debt. After 1991, however, India reduced its dependence on aid and debt flows and has since allowed private capital flows to bridge the gap. The share of foreign investment in India's GDP has gone up (see **Table 2** and **Table 3**), and foreign capital inflows have increased on account of higher remittances from overseas Indians.

TABLE 1 Growth rate of GDP, investment, and savings rates

Financial year (FY)	GDP growth (%)	Investment/GDP (%)	Savings/GDP (%)
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

SOURCE: Economic Advisory Council to the Prime Minister, Government of India, 2009.

NOTE: QE indicates data is a quick estimate and AE indicates data is an advance estimate.

TABLE 2 External economic indicators

Year	Foreign investment/GDP (%)	Foreign investment/ exports (%)	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, 2009.

TABLE 3 Foreign investment and income flows into India

Year	Foreign direct investment ($m)	Portfolio investment ($m)	Total foreign investment ($m)	Net private income transfers ($b)	Foreign currency assets ($b)
1990–91	97	6	103	2.1	2.2
1995–96	2,144	2,748	4,892	8.5	20.8
2000–01	4,029	2,760	6,789	12.9	39.6
2005–06	8,961	12,492	21,453	24.5	145.1
2007–08P	32,435	29,395	61,830	40.8	299.2

SOURCE: Reserve Bank of India Database, 2009.

NOTE: P indicates data is provisional.

Following the Asian financial crisis and, more importantly, after facing economic sanctions in the wake of the 1998 nuclear tests—imposed by, among others, 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 (as seen in Table 3).

The share of external trade in India's national income has doubled since 1991 (see **Table 4**). India's trade-GDP ratio (over 33%) is higher than that of the United States (around 25%). Increased trade dependence has made India more vulnerable to external shocks, as can be seen from the recent slide in exports in the face of the global slowdown. India's relatively low export dependence compared to other newly industrializing economies in

Asia (China's trade-GDP ratio is close to 80%) has helped limit the negative impact of a global slowdown.

The policy of ensuring reduced dependence on external debt flows has been accompanied by a policy of increased openness to investment and income inflows (see **Table 5**). In response to the current slowdown India has further liberalized its 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 (GCC). They send home monthly remittances, which constitute a bulk of the $40 billion that India received in 2007–08 and of the $55 billion the country is estimated to receive in 2008–09 (see **Table 6**).

TABLE 4 Trends in trade-GDP ratio

Year	Exports/GDP	Imports/GDP	Exports+imports/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.

TABLE 5 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, 2009.

TABLE 6 India's balance of payments ($b)

	2004–05R	**2005–06R**	**2006–07P**	**2007–08P**	**2008–09**		
					First half	**Second half**	**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 and BPO	14.7	21.6	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	-17.4	-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	28.0	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 and 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%*

SOURCE: "Review of the Economy, 2008–09," Economic Advisory Council to the Prime Minister, Government of India, March 2009.

NOTE: P indicates provisional. R indicates revised. BPO indicates business process outsourcing. Values in italics denote percentage of GDP.

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 Indian H-1B visa holders in the United States, given that many of these workers would also repatriate some part of their income to their families 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.

Increased openness and external integration have made the Indian economy more efficient, increasing the country's share in world trade from 0.5% in 1991 to over 1.5% by 2007, the pre-crisis year.[8] India has also been able to draw on foreign savings. For these very reasons, however, the slowdown could be expected to have a higher negative impact on India's economic growth compared to the Asian financial crisis of 1997–98 or earlier episodes of global recession.

From a national security perspective it is relevant to note that India's policy of external economic liberalization 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. Further, 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.

Banking and finance. Apart from fiscal stabilization and the bridging of the savings and investment gaps, India's reform and stabilization program of the 1990s also focused on financial and banking sector reform.

A stock market scam in the early 1990s, which 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 dot-com bubble and its impact on the Indian stock market.

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[8] "'India's Share in World Trade Goes Up Significantly to Touch 1.5% Share, May Cross 2% by 2009' Says Kamal Nath", Ministry of Commerce, Government of India, Press Release, May 2007, http://commerce.nic.in/pressrelease/pressrelease_detail.asp?id=2052.

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.[9] The relatively high standards of governance and institutional credibility of the Reserve Bank of India (RBI) and the Securities and Exchange Board of India (SEBI) have also helped India deal with the current crisis.

Fiscal policy. Over the past decade, higher economic growth had enabled India to reduce its budgetary and fiscal deficits. This had also created the fiscal space for increased public investment in infrastructure development, defense modernization, and the development of strategic capabilities. The government's welfare and development programs have increased public spending since 2004, contributing to a deterioration in the fiscal situation more recently.[10] Further, in the wake of the economic slowdown, the government has pursued a counter-cyclical fiscal policy and provided a fiscal stimulus, estimated to be approximately 3% of GDP in 2008–09.[11] An immediate impact of the fiscal stimulus response to the slowdown has been that the government will not be able to meet the deficit reduction targets set by the FRBM Act of 2003.[12] Rather than bring the shares of revenue and fiscal deficits in national income down, these deficits are expected to rise in FY 2008–09.

A large part of such spending would naturally go into counter-cyclical safety nets and employment generation programs. This would also have the unintended consequence of reducing funds available for defense and strategic modernization. The Indian government can view some defense spending as part of the fiscal stimulus. Given the high import intensity of defense spending in India, as well as the capital intensive nature of defense modernization, there are limits, however, to the level of defense spending that can be considered a counter-cyclical activity.

Summation. Although India's reintegration into the world economy in the 1990s has made the country more vulnerable to global crises, the

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9 See Y.V. Reddy, "Monetary and Financial Sector Reforms in India: A Practitioner's Perspective," in *India's Emerging Economy: Performance and Prospects in the 1990s and Beyond*, ed. Kaushik Basu (New Delhi: Oxford University Press, 2004).

10 Rajiv Kumar et al., "Indian Economic Outlook: 2008–09 and 2009–10," Indian Council for Research on International Economic Relations, ICRIER Working Paper, no. 234, March 2009, http://www.icrier.org/publication/working_papers_234.html.

11 D. Subbarao, "Fiscal Stimulus at 1.5–3% of GDP: D Subbarao," *CNBC TV18*, http://www.moneycontrol.com/india/news/economy/fiscal-stimulus-at-15-3gdp-d-subbarao/390501/0.

12 "Report of the Task Force on Implementation of the Fiscal Responsibility and Budget Management Act, 2003", Ministry of Finance, Government of India, July 16, 2004, http://finmin.nic.in/downloads/reports/frbm/1.pdf.

pursuit of gradual reform and prudent regulation seem to have helped India minimize the negative impact of the trans-Atlantic financial crisis and the current economic slowdown. From a strategic policy perspective, therefore, India can claim that its model of gradual and graduated economic liberalization and of risk-averse prudential regulation in the banking and financial sector have helped limit exposure to the Asian and trans-Atlantic financial crises and the subsequent global economic slowdown. India's major economic vulnerabilities remain internal, including weak public finances and inadequate investment in social and economic infrastructure.

Not Hurt by a Banking and Financial Crisis, but by Global Recession

It has been widely observed that India's banking sector has not been affected by the banking and financial sector crises in the United States and Europe that preceded the current global slowdown.[13] The governor of the RBI, D. Subbarao, 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-balance sheet activities or securitized assets."[14] RBI has been credited with taking preemptive action that has minimized the vulnerability of Indian banks to the ripple effects of both the U.S. subprime crisis and the crisis in the equities market. In an early public statement former RBI governor Y.V. Reddy claimed that "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."[15]

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. Reddy claims the RBI conducted a stress test of the investment portfolio of banks based on an increasing interest rate scenario, at a

[13] Rakesh Mohan, "Global Financial Crisis and Key Risks: Impact on India and Asia" (remarks prepared for IMF-FSF high-level meeting, Washington, D.C., October 9, 2008), http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/87784.pdf.

[14] Duvvuri Subbarao, "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, February 18, 2009), http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/Speech%20-%20as%20sent-%20Modified%20_4_.pdf.

[15] Y.V. Reddy, "Global Financial Turbulence and Financial Sector in India: A Practitioner's Perspective" (address at the Meeting of the Task Force on Financial Markets Regulation, Manchester, July 1, 2008), http://rbidocs.rbi.org.in/rdocs/Speeches/PDFs/85529.pdf.

time when the general global trend was toward decreasing interest rates. According to Reddy:

> 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 5 per cent 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 per cent 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.[16]

These measures explain India's relative insulation from both the U.S. subprime crisis and the banking and financial market crisis. This does not mean, however, that India has been insulated from the impact of the consequent economic slowdown.

Rejecting the so-called decoupling thesis—namely that growth based on domestic savings and investment and domestic demand has decoupled the Indian economy from dependence on, or exposure to, trans-Atlantic economies—Subbarao 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]

The transmission to the real channel has been mainly on account of a sharp fall in merchandise exports to traditional markets in the first quarter of 2009. Compared to an annual average growth in exports (in U.S. dollars) of about 25% in 2005–08, exports declined by over 25% in the first quarter of 2009 compared to the first quarter of 2008.[18] The financial channel transmission is mainly on account of the increased importance of foreign capital inflows—portfolio, direct investment, and external commercial borrowing (ECB) of the private corporate sector in India and private remittances by overseas Indians. Indian companies had increased their external borrowing in recent years because of interest rate differentials and the easing up of government

[16] Reddy, "Global Financial Turbulence."

[17] Duvvuri Subbarao, "India—Managing the Impact of the Global Financial Crisis" (speech delivered at the Confederation of Indian Industry's National Conference and Annual Session 2009, New Delhi, March 26, 2009), http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=413.

[18] "India's Exports Increase from 63.8 Billion in 2003–04 to $119.3 Billion in 2008–09 Apr.-Nov.– SEZs Generate Employment Year End Review of Department of Commerce," Government of India, Ministry of Commerce and Industry, Press Release, January 2, 2009, http://commerce.nic.in/pressrelease/pressrelease_detail.asp?id=2356.

policy on external borrowing. This had increased the external debt burden of Indian companies. Homeward remittance of savings by Indian workers in the Gulf region is an important source of foreign exchange inflows into India. The global slowdown has contributed to a decline in these inflows. Though India's recent growth acceleration has benefitted from this external connectivity, the global crisis has hurt economic growth in the near term on account of these linkages' importance.[19]

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 (though the debt market is not). Indian companies are estimated to have raised $41 billion (net of repayment) as overseas debt through external commercial borrowing and fully convertible commercial debentures.[20] Even in the period October–December 2008 Indian companies were able to raise a total of $4.5 billion from global debt markets. These flows are expected to weaken, however, given increased risk aversion in global markets.

Apart from these macro linkages and the overall increase in the trade-GDP ratio, the changes in the geographical pattern of trade also point to an increased vulnerability to a slowdown. The depreciation of the rupee is a reflection of these external vulnerabilities. India has had to draw down its foreign exchange reserves defending the rupee, which has depreciated against the dollar by close to 30% in the past year, with a sharp fall in February 2009 (see **Figure 2**).

Whereas India's reserves are denominated in a basket of currencies, the U.S. 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 one-third of India's exports, though Asia's share has increased in recent years. The Japanese and Russian shares have gone down, but those of China, South Korea and ASEAN economies have increased (see **Table 7**). Each of these economies has experienced a slowdown in growth and a consequent decline in trade.

Tables 5 and 7 refer to merchandise exports. The growth of inward remittances from expatriate Indian workers, especially in the Persian Gulf region, and earnings from IT and software services exports have increased the importance of services exports to India's balance of payments management. Though low-skilled manpower exports are mainly to the

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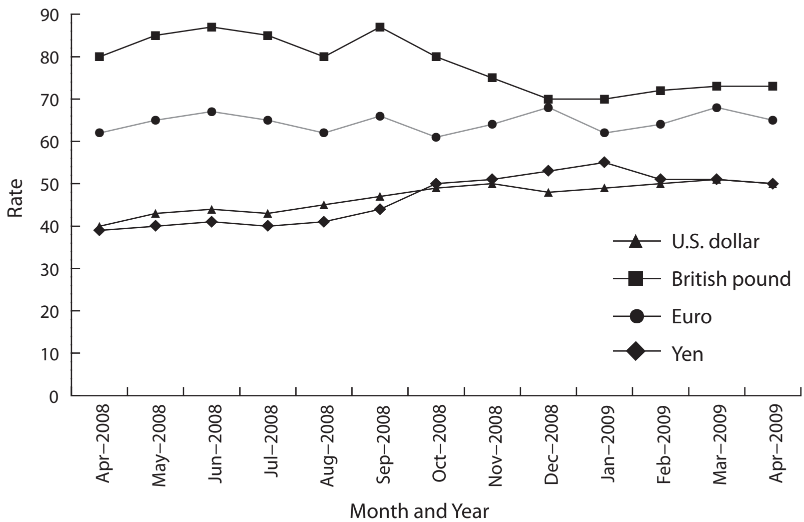
19 Rajiv Kumar, Mathew Joseph, Dony Alex, Pankaj Vashisht, and Debosree Banerjee, "Indian Economic Outlook, 2008–09 and 2009–10," Indian Council for Research on International Economic Relations, Working Paper, no. 234, March 2009, http://www.icrier.org/publication/WorkingPaper234.pdf.

20 "Money & Finance," ICRA Limited, ICRA Bulletin, March 2009.

FIGURE 2 Nominal exchange rate of the Indian rupee



SOURCE: Reserve Bank of India, "Monthly Bulletin," various issues.

TABLE 7 Geographical direction of India's exports

	1960–61	1970–71	1980–81	1990–91	2000–01	2006–07
European Union	36.2	18.4	21.6	27.5	22.7	23.1
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
Latin America	1.6	0.7	0.5	0.4	2.1	3.4
Soviet Union	4.5	13.7	18.3	16.1	2.0	1.0
Russia	NA	NA	NA	–	–	0.7
Asia (non-oil)	6.9	10.8	13.4	14.3	21.4	31.6
Asia (including 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	6.6
South Asia	–	–	–	–	–	5.1

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

OPEC (Organization of the Petroleum Exporting Countries) members in the Persian Gulf and Middle East, high-skilled services exports are mainly to the United States and other OECD (Organisation for Economic Co-operation and Development) economies. In 2008–09, inward remittances amounted to $55 billion, whereas export earnings from IT and business process outsourcing (BPO) were estimated to be $47 billion.

The IT, IT services, and BPO industries are now estimated to account for almost 6.0% of India's GDP. Two-thirds of the $72 billion in business is accounted for by exports, mainly to trans-Atlantic economies. Although spokespersons from the National Association of Software Services Companies (NASSCOM) in India have expressed optimism that exports would not be hurt as long as developed economies do not resort to protectionist measures—given that firms in OECD economies would increase demand for lower cost Indian software services in a downturn—NASSCOM has nonetheless forecast a reduction in export earnings in 2009–10.[21] Growth in IT-enabled services exports is expected to be around 15% in 2009–10, compared to annual growth rates of around 25% in recent years.

For India, the global downturn coincided with a domestic economic slowdown caused partly by a tight monetary policy implemented in the face of public protests over inflation and partly by a diversion of public expenditure from capital investments to consumption expenditure.[22] Though these new vulnerabilities have contributed to a slowdown in growth, India remains sanguine about its growth prospects. Prime Minister Manmohan Singh's upbeat assessment offered to the group of twenty (G-20) summit in London in April 2009 has since been borne out by more recent numbers. Singh had stated:

> We in India have been fortunate in having weathered the global downturn better than many others. Our growth rate, which was close to 9% in the previous 5 years, will fall below 7% 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 recognize 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,

[21] "Key Highlights of Industry Performance," National Association of Software Services Companies (NASSCOM), February 2009, http://www.nasscom.in/upload/60387/Key_Highlights.pdf.

[22] See Mihir Rakshit, "India amidst the Global Crisis," *Economic and Political Weekly* 44, no. 13 (March 28–April 3 2009).

> 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 per cent 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.[23]

Recent macroeconomic data shows that India is likely to see close to 7.0% growth in 2008–09, far above the gloomier IMF forecast of 5.0%.[24] A decisive electoral mandate in favor of the ruling coalition has boosted market sentiment and generated bullish expectations on growth.

Summation. While India's approach of gradual and calibrated external liberalization, especially in the banking and financial sectors, limited exposure to the global slowdown, the country's increased dependence on trade and capital flows in recent years has made it more vulnerable to external shocks. India has been able to weather the storm, however, and is expected to sustain close to 7.0% growth in 2008–09 and 2009–10.

Beyond Crisis—Economic Priorities for a New Government

After five years of a 9.0% annual average economic growth rate, in 2008–09 the Indian economy has slowed down to a growth rate of approximately 7.0% and faces the prospect of another year of slower growth. The challenge before the new government in New Delhi is to sustain domestic investment and consumption demand and accelerate the rate of growth in a fiscally sustainable manner.

Setting out the government's economic agenda, the Indian president Pratibha Devisingh Patil spoke of a ten-point agenda in her inaugural address to the newly elected parliament.[25] These ten priority areas are:

- Internal security and preservation of communal harmony
- A stepping up of economic growth in agriculture, manufacturing, and services

[23] Manmohan Singh (remarks on the occasion of the G-20 meeting, London, April 2, 2009), http://www.pmindia.nic.in/lspeech.asp?id=784.

[24] Surojit Gupta and Rajkumar Ray, "India's Finance Minister Mukherjee Vows to Protect Economy," Reuters, May 23, 2009, http://www.reuters.com/article/worldNews/idUSTRE54M0NA20090523?feedType=RSS&feedName=worldNews.

[25] Pratibha Devisingh Patil (address to parliament, New Delhi, June 4, 2009), http://presidentofindia.nic.in/sp040609.html.

- Consolidation of the existing flagship programs for employment, education, health, rural infrastructure, and urban renewal, and the introduction of new flagship programs for food security and skill development
- Concerted action for the welfare of women, youth, children, backward classes, scheduled castes, scheduled tribes, minorities, the differently-abled, and the elderly, along with strengthened social protection
- Governance reform
- Creation and modernization of infrastructure and capacity addition in key sectors
- Prudent fiscal management
- Energy security and environment protection
- Constructive and creative engagement with the world
- Promotion of a culture of enterprise and innovation[26]

It is clear that the government will keep focusing on economic reform and sustaining high rates of investment and economic growth. This is in keeping with Prime Minister Singh's vision of defining India's rise in terms of the country's economic performance. The slowdown has only underlined the importance of national economic performance for India's global standing. The ten-point charter 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.

The annual budget of the government of India is to be presented to parliament on July 6, 2009. The budget is expected to reveal a new agenda of economic reform aimed at boosting investment, especially in social and economic infrastructure, while improving public finances and addressing equity concerns. FY 2009–10 will be a crucial year for fiscal stabilization and policy reform aimed at reviving the growth momentum.

If India can return to the higher trajectory of 8.0%–9.0% annual economic growth over the next decade, New Delhi will not only overcome the setbacks posed by the current global slowdown but also continue on the path to re-emergence as a great Asian power. The challenge before India in the next five years 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 slowdown has imposed new constraints on India's economic rise. These constraints are not insurmountable obstacles, however,

[26] Patil, June 4, 2009.

given the high domestic savings and investment ratios and the potential of the home market for sustaining high growth.

The Geopolitics of Economic Crisis

India's Economic Rise and Geopolitical Grand Strategy

India's economic rise and the success of its gradual outward-orientation have brought economics to the center of the government's strategic thinking, influencing the country's grand strategy. In the early years after independence New Delhi regarded India's economic rise as key to the country's re-emergence as a great power.[27] The Cold War interregnum, and India's relatively unimpressive economic performance during that period, however, saw high politics displace economics in the conceptualization of India's grand strategy. Returning the economy to the center of India's strategic *weltanschauung,* 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.[28]

This view of India's grand strategy is firmly embedded in the foundations of economic performance. It is only as a growing and globalizing economy that India can be a rising power. Hence, safeguarding the environment for

[27] In his first major foreign policy speech to the Indian Constituent Assembly in December 1947, India's first prime minister Jawaharlal Nehru stated: "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, *The Strategic Consequences*, 58.

[28] Manmohan Singh (address to the Combined Commanders Conference, New Delhi, October 20, 2005), http://pmindia.nic.in/speech/content.asp?id=209.

economic growth, albeit as a free-market democracy, is critical to India.[29] The country's improved economic performance since 1990, for instance, resulted in an important perceptional gain for India in strategic terms. As a rising economic power, India was able to "de-hyphenate" itself from Pakistan, and a new "re-hyphenation" with China was created in the popular and intellectual imagination, especially in the West. Until the 1980s, Pakistan had a relatively superior record in economic performance compared to India, which also shaped India's self-image. Yet the 1990s saw India not only overtaking Pakistan but also breaking ranks. Changing economic performance has had an impact on changing strategic perceptions of the two neighbors, both within and outside the region (see **Table 8**).

The overall deceleration in Pakistan's growth is even more manifest when one compares per capita income growth. Pakistan's higher growth rate in population and the deceleration of India's population growth have combined to widen per capita income disparity between the two South Asian neighbors (**Table 9**).

Rather than view India only as a South Asian economy, Western investors and analysts have begun viewing the country in the context of Asia's rise. In recent years the idea of "Chindia"—the rise of China and India—has gained currency.[30] This new hyphenation with China, and de-hyphenation with Pakistan, is 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 its economic prospects relative to China, Pakistan, Southeast Asia, and other South Asian economies.

The global slowdown and the great recession could have the effect of reversing some of these strategic gains from India's improved economic performance. In order to resolve problems with both China and Pakistan with a greater degree of self-confidence and in an atmosphere of mutual

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29 In an official speech during his visit to Tokyo, 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." Manmohan Singh, "PM's Banquet Speech in Tokyo" (Tokyo, December 15, 2006), http://pmindia.nic.in/visits/content.asp?id=149.

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* (New York: W.W. Norton & Company, 2008); L. Alan Winters and Shahid Yusuf, eds., *Dancing with Giants: China, India, and the Global Economy* (Washington D.C.: World Bank and Institute for Policy Studies, 2007); Pete Engardio, ed., *Chindia: How China and India Are Revolutionizing Global Business* (New York: McGraw Hill, 2006); David Smith, *The Dragon and the Elephant: China, India and the New World Order* (London: Profile Books, 2007); and Bill Emmott, *Rivals: How the Power Struggle between China, India and Japan Will Shape Our Next Decade* (London: Harcourt, 2008).

TABLE 8 Average real GDP growth of Pakistan and India (%)

	Pakistan	India
1954–58	2.0	–
1953–60	3.8	3.7
1959–71	3.9	3.9
1961–70	3.4	3.3
1971–80	4.8	3.5
1981–90	6.2	5.4
1991–2000	3.4	6.2
2000–05	5.0	7.0

SOURCE: Arslan Razmi, "Analyzing Pakistan's Economic Prospects in an Increasingly Integrated World: External Constraints on Sustainable Growth," ISAS, Working Paper, March 2007, http://www.isasnus.org/2007MaySymposium/Panel%20Three%20-%20Presentation%20 Paper%20-%20Dr%20Arslan%20Razmi.pdf; and "Economic Survey," Mininstry of Finance, Government of India, various issues.

TABLE 9 Growth rate of per capita national income

	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.

give-and-take, it is vital that India catch up economically with China and maintain a lead over Pakistan.

India's Emerging Leadership in South Asia and the Developing World

Improved economic performance has also encouraged India to become more actively engaged in the global and regional integration of the country's Asian neighbors. The strategic significance of India's active engagement in the processes of Asian economic integration cannot be overemphasized. Closer economic relations with countries of the region have enabled India to participate in the East Asia Summit and in regional community building efforts. India's superior economic performance in the 1990s had the effect of subduing Pakistani bravado while encouraging New Delhi to adopt a more accommodating stance toward Pakistan and India's other South Asian neighbors.

In the 1990s India 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 and membership in the ASEAN Regional Forum (ARF). This was preceded by an FTA between India and Sri Lanka and the launch of negotiations for a South Asian Free Trade Agreement (SAFTA). India also launched a series of FTA negotiations with the country's other Asian neighbors (see **Table 10**). At the Dhaka, Delhi, and Colombo summits of the South Asian Association for Regional Cooperation (SAARC), India proposed a series of initiatives to boost regional economic cooperation.[31] These included a policy of "asymmetric liberalization" within the SAARC region that offers duty free access to less-developed countries (LDC).

India's growth acceleration since 2003 also enabled the country to build bridges with other developing countries, especially the LDCs in Asia and Africa. The policy of non-reciprocal trade liberalization 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). Building alliances with other middle or emerging powers, such as Brazil and South Africa, is also an important element in India's grand strategy. The Indian external aid budget has increased substantially in recent years, with a significant share of aid going to Afghanistan and Bhutan (see **Table 11**).[32]

These initiatives are shaped both by India's desire to secure permanent membership in the UN Security Council and by the country's strategy to increase its bargaining leverage in global forums like the World Trade Organization (WTO). These initiatives were also driven by the need to keep pace with China in providing aid and assistance to other developing countries, especially LDCs.

India's efforts to take on a leadership role in global and regional economic integration are not without domestic constraints. Liberal unilateral trade concessions, even when to LDCs, came under attack from politicians and lobbyists for producers in slow-growing India. For example, India's trade concessions to Vietnam in commodities such as coffee have been sharply attacked even by the state government of Kerala, which is led by the Communist Party and where coffee growers have political clout. Apart from unilateral trade concessions, India has also increased aid and technical assistance to other developing countries.

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[31] Baru, "India and the World."

[32] See Dweep Chanana, "India as an Emerging Donor," *Economic and Political Weekly* 44, no. 12 (March 21–March 27, 2009), http://www.epw.in/uploads/articles/13314.pdf.

TABLE 10 India's pursuit of trade and comprehensive economic cooperation/partnership agreements

	Agreement
African Union	PTA, CECA
ASEAN	FTA, CECA
Australia	FTA
BIMSTEC	FTA
Chile	PTA
China	FTA
Egypt	PTA
European Union	FTA
India-Brazil-South Africa	CECA
Israel	FTA
Japan	CEPA
Malaysia	CECA
Mauritius	CEPA*
Mercosur	PTA
New Zealand	FTA
Russia	CECA
SAARC	FTA*, CECA
South Africa Customs Union	PTA
South Korea	CEPA
Singapore	FTA*, CECA
Sri Lanka	FTA*, CECA
Thailand	FTA

SOURCE: Ministry of Commerce, Government of India, 2008.

NOTE: FTA = Free Trade Agreement; PTA= Preferential Trade Agreement; CECA = Comprehensive Economic Cooperation Agreement; CEPA = Comprehensive Economic Partnership Agreement. Asterisk indicates agreement concluded.

In defending the India-ASEAN FTA against domestic criticism that it may hurt Indian farmers, Prime Minister Singh pointedly drew attention to the agreement's important geopolitical dimension. Writing to Congress

TABLE 11 Budget allocations for external aid financing (rupees)

Budget allocation	2008–09	1998–09
Foreign grants	192,643	5,604
Foreign loans	1,386	2,730
Total grants and loans	2,064,950	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 international organizations	3,531	1,621
Allocations to international financial institutions	171	–
of which, African Development Bank	144	–
Exim Bank interest equalization subsidy	2,320	–
Total estimated foreign aid	266,712	9,955
Exim Bank loans and guarantees	350,039	21,013

SOURCE: Dweep Chanana, "India as an Emerging Donor," Economic and Political Weekly, March 21, 2009, http://www.epw.in/uploads/articles/13314.pdf.

president Sonia Gandhi on the merits of the India-ASEAN FTA, Singh observed:

> Our approach to regional trade agreements, in general, and FTAs, in particular, has been evolved after careful consideration of our geo-political as well as economic interests. Although India has a large domestic market, our experience with earlier relatively insular policies, as also the global experience in this regard, clearly bring out the growth potential of trade and economic cooperation with the global economy.[33]

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 when the Indian economy was performing well. Any

[33] Sanjaya Baru, "India and the World: Economics and Politics of the Manmohan Singh Doctrine in Foreign Policy," Institute of South Asian Studies, Working Paper, no. 53, November 14, 2008, http://www.isasnus.org/events/workingpapers/52.pdf.

economic slowdown can intensify such opposition to external liberalization, with consequent geopolitical implications in an increasingly integrated economic region.[34]

In sum, an economically stronger and stable India has felt encouraged to pursue a policy of asymmetric or non-reciprocal liberalization in South Asia by offering duty-free access to LDCs. India's growth acceleration in the past decade has also enabled the country to find the resources for such aid both within South Asia and in the developing world as a whole. Although strategic interests in South Asia and traditional commitments to South-South cooperation motivate India's aid budget, competition with China for influence is also a major driver. Any deceleration in growth and consequent fiscal pressures would impose constraints on non-reciprocal trade policies and foreign aid. This would most certainly be an adverse strategic consequence of the extant economic slowdown.

Economic Crisis and China's Enhanced Strategic Advantage

Even prior to the global economic crisis, China held a strategic advantage over India. Although India's share of global trade, merchandise, and services has doubled in the past decade, it still lags far behind China's share. In 2007 India's share of world merchandise exports was around 1.2% while the country's share of commercial services exports was estimated at roughly 2.7%. By contrast, shares for China were 8.9% and 3.7% respectively.[35]

India's lower level of global integration has made the country less vulnerable than China to the economic downturn. Nevertheless, India must still ensure that the slowdown does not constrain efforts to catch 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 has emerged as a key economic partner for most Asian economies, including Japan and South Korea. China has overtaken India as an economic partner of South and Central Asian economies as well and is quickly becoming a major economic partner with Africa. Beijing has also emerged as a major source of external financial aid both through its contribution to the Chiang Mai Initiative and through direct financial assistance to various countries.[36]

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[34] This has already delayed finalization of the India-ASEAN FTA, though the official reasons given for the postponement of the summit meeting are the situation in Thailand and that India was in an election season. It is possible that the global slowdown may have encouraged both sides to proceed more cautiously on the FTA.

[35] "International Trade Statistics 2008," World Trade Organization, 10, 14, http://www.wto.org/english/res_e/statis_e/its2008_e/its2008_e.pdf.

[36] See C. Randall Henning, "The Future of the Chiang Mai Initiative: An Asian Monetary Fund?" Peterson Institute for International Economics, Policy Brief, February 2009, http://www.iie.com/publications/pb/pb09-5.pdf.

The two Asian giants are already engaged in a race for resources and markets in Asia and Africa, with China far ahead of India. Though a deceleration in China's growth could blunt the edge of this competition, it will not go away. Rather, competition between the two countries is likely to accentuate as India catches up in the growth race. Increased U.S. dependence on China since the onset of the financial crisis has actually worked to strengthen China's strategic advantage. China's role in reforming global economic governance structures was also enhanced. Fred Bergsten first proposed the idea of a U.S.-China "condominium," which called for the United States and China to form a group of two (G-2) to work together on dealing with the challenge of global imbalances and other issues such as climate change and the completion of Doha Round negotiations.[37]

The idea of "Chimerica" captured popular imagination in the Western media on the eve of the G-20 London summit, but Chinese commentators have so far reacted cautiously.[38] This is at least partly because China has taken a substantial hit from the trans-Atlantic financial crisis and the great recession: China's overexposure to Western markets and to the U.S. dollar has hurt its economy. This has increased China's economic vulnerability, but it has also made the prospects of a G-2 condominium between the United States and China more attractive.

A U.S.-China condominium could alter India's strategic environment and options.[39] If such a condominium were to go beyond the management of global imbalances and crises and encapsulate multilateral trade negotiations and discussions on global warming and climate change, this partnership would have an even greater impact on India's strategic environment. New Delhi's strategic perspective on trade and climate change negotiations has been defined in the framework of economic development, employment generation, and poverty eradication. India seeks a benign global environment for trade and investment that will enable it to sustain higher rates of economic growth. Thus far India and China have been able to work together on these issues. If China were to break ranks and arrive at an understanding with the United States that does not meet India's needs, India would have no

[37] Fred C. Bergsten, "A Partnership of Equals: How Washington Should Respond to China's Economic Challenge," *Foreign Affairs* 87, no. 4 (July/August 2008): 57–69.

[38] The phrase "Chimerica" was first popularized by Niall Ferguson and Moritz Schularick, "'Chimerica' and the Global Asset Market Boom," *International Finance* 10, no. 3 (Winter 2007): 215–39. Ferguson has since expressed skepticism about the idea, however. See Niall Ferguson, "The End of Chimerica," *StandPoint,* September 2008, http://www.standpointmag.co.uk/node/399/full. See also Elizabeth C. Economy and Adam Segal, "The G-2 Mirage," *Foreign Affairs* 88, no. 3 (May/June 2009): 14–23.

[39] On the U.S.-China-India triangular relationship, see John W. Garver, "The China-India-U.S. Triangle: Strategic Relations in the Post-Cold War Era," *NBR Analysis* 13, no. 5 (October 2002): 5–56, http://www.nbr.org/publications/analysis/pdf/vol13no5.pdf.

option but to join ranks with other developing countries and other powers to secure the country's interests. Here too the United States could either adopt a supportive stance toward India or adopt postures that would revive old North-South divisions on global economic issues.

A U.S.-China condominium could have implications for both countries' respective strategies in South Asia and their individual and joint approaches to geopolitical and security issues in the region. Apart from influencing the course of events in Afghanistan, this partnership could have implications for U.S. policy in Pakistan, Nepal, Myanmar, Sri Lanka, and the Indian Ocean region. This would, of course, alter the strategic environment in Asia and force India to rethink its own strategy of global engagement. A U.S.-China condominium would certainly strengthen anti-U.S. and anti-China sentiments in India. It would also encourage India to reclaim a leadership role in the developing world—imparting new momentum to the India-Brazil-South Africa (IBSA) Forum and to India's relations with other powers, such as Russia, the European Union, and Japan. Indeed, if the G-20 is reduced to a G-2, then IBSA could become the core of a new G-77, the forum of developing countries.

It remains to be seen whether China would risk yielding leadership space in the developing world to India—especially at a time when Beijing is claiming credit for China's model of economic development and political management. Chinese and other Asian scholars have claimed that the financial crisis and the great recession have roots in the United States and the Western model of "finance capitalism," arguing that the so-called Asian model has proved to be more robust.[40]

State and Market

The global economic crisis has also reopened a debate that many thought was buried under the debris of the collapse of the Soviet Union and the end of the Cold War—the debate over state versus market and the pros and cons of being a free-market democracy.[41] The debate is significant for the future of policy in developing-country democracies around the world, as China's success increases the appeal of the single-party model based statist rule. India's view of the importance of a developing country improving

[40] See, for example, Zhou Xiaochuan, "Changing Pro-cyclicality for Financial and Economic Stability," March 26, 2009, http://www.pbc.gov.cn/english//detail.asp?col=6500&ID=182. Zhou states that "facts speak volumes and demonstrate that compared with other major economies, the Chinese government has taken prompt, decisive and effective policy measures, demonstrating its superior system advantage when it comes to making vital policy decisions."

[41] Ian Bremmer, "State Capitalism Comes of Age: The End of the Free Market?" *Foreign Affairs* 88, no. 3 (May/June 2009): 40–55.

economically within the framework of a democracy is losing salience as China's socialist-market economy gains ground.

The issue at stake is not the extent of government intervention in markets or state support for private enterprise. Most economies are mixed in any case. 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 delegitimized.

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 IMF conditionality in the past two decades).[42]

Although much was wrong with the policies of the Washington consensus, 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 mixed economy. 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 great recession does not encourage non-democratic political movements and systems.

The geopolitical consequences of the global economic slowdown are not merely quantitative, i.e., changes in the relative shares of world trade and incomes of various major powers and emerging economies. Indeed, the quantitative shifts may not be very significant and may not alter the relative status of various powers. One must not underestimate, however, the qualitative dimension of the recession in terms of the ideological appeal of China's successful statist model as opposed to India's liberal democratic model of development.

U.S.-India Relations and U.S. Strategies in Asia

An appreciation of the strategic importance of the sustained growth of free-market democracy in the developing world, as well as the assurance of

[42] According to Cui Zhiyuan, a professor of public policy at Tsinghua University, "it is very possible that the Beijing Consensus can replace the Washington Consensus." Cui Zhiyuan, quoted in Ariana Eunjung Cha, "China Uses Global Crisis to Assert Its Influence," *Washington Post*, April 23, 2009, http://www.washingtonpost.com/wp-dyn/content/story/2009/04/23/ST2009042301313.html.

energy security, have helped define an improvement in India-U.S. 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.[43] Condoleezza Rice best articulated this view when she wrote:

> India stands on the front lines of globalization. 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.[44]

Responding to such U.S. support and seeking a long-term U.S. commitment to both democracy and development in India, Singh told the U.S. Congress in July 2005:

> Democracy is one part of our national endeavour. Development is the other. Openness will not gain popular support if an open society is not a prosperous society…There is no other country of a billion people, with our tremendous cultural, linguistic and religious diversity, that has tried to modernise its society and transform its economy within the framework of a functioning democracy. [45]

President Barack Obama's first important statement on U.S.-India relations to Prime Minister Singh—conveyed through a letter written when he was still a candidate in the presidential elections—adopted a forward-looking and supportive position on U.S.-India relations, underscoring the importance of the country's democratic development:

> I would like to see US-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.[46]

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[43] For a survey of India-U.S. relations, see C. Raja Mohan, *Crossing the Rubicon: The Shaping of India's New Foreign Policy* (New York: Palgrave Macmillan, 2004).

[44] Condoleezza Rice, "Rethinking the National Interest: American Realism for a New World," *Foreign Affairs* 87, no.4 (July/August 2008): 2–26. See also Ashley Tellis, "Indo-US Relations Headed for a Grand Transformation?" *YaleGlobal Online*, July 14, 2005, http://yaleglobal.yale.edu/display.article?id=5999.

[45] Manmohan Singh, "PM's Address to the Joint Session of the Congress" (address to the U.S. Congress, Washington, D.C., July 19, 2005), http://pmindia.nic.in/speech/content.asp?id=151.

[46] Barack Obama, "Letter to Prime Minister Manmohan Singh," September 23, 2008, http://en.wikisource.org/wiki/Barack_Obama%27s_Letter_to_Prime_Minister_Manmohan_Singh.

The Obama administration, however, has so far not shown a strong and visible commitment to this vision of U.S.-India relations.[47] It is instructive to remember that the September 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, the economic crisis not only has worsened, but the situation in Afghanistan and Pakistan has also sharply deteriorated.

In dealing with the economic crisis the United States has moved closer to China; in dealing with terrorism Washington has become more dependent on Pakistan.[48] It is, therefore, possible that the above remarks no longer fully reflect Obama's worldview. The United States continues to share common interests with India, however. The two countries, for example, have a shared stake both in reducing dependence on imported petroleum and natural gas and in the development of nuclear and non-conventional energy. Given the low per capita domestic availability of energy and other natural resources in India, ensuring access to these resources is vital to the country'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 strengthen the foundations of open societies and economies by creating a global order that is supportive of India's developmental aspirations. India's rise as an open economy and society would strengthen efforts to build democracy in the developing world. If the Obama administration builds on the foundation laid by the Clinton and Bush administrations for a strategic partnership with India, the United States can play the same role in India's rise as it did in the post–World War II 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 postwar Western Europe and East Asia. Postwar Germany, Japan, and South Korea owe their economic rise to supportive U.S. policies. U.S. economic support also helped many of the economies in transition in Eastern Europe. Even the Asian Tigers—Hong Kong, Taiwan, and Singapore—benefitted from helpful U.S. economic and security policies. In the past two decades U.S. policies have facilitated the rise of China: investments in China, access

[47] An official of the Obama administration, deputy secretary of state James Steinberg, underscored "continuity" in U.S. policy toward India from the Clinton presidency through the Bush administration and endorsed the importance of the bilateral relationship. See James Steinberg, "Remarks on India" (speech at the Brookings Institution, Washington, D.C., March 23, 2009), http://www.state.gov/s/d/2009/120856.htm.

[48] Indeed, U.S. frustration with Pakistan may even encourage Washington 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*, May 24, 2009, http://www.latimes.com/news/nationworld/nation/la-fg-us-china-pakistan25-2009may25,0,6047766.story.

to U.S. markets for Chinese exports, and support for China's membership in the WTO have all played an important role, apart from Beijing's own domestic policies, in boosting China's economic performance.

How open the United States remains toward India—in particular, the openness of U.S. markets, availability of H1-B visas, and support for multilateral economic institutions—will have a bearing on India's growth process. The U.S.-India 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 this relationship with the United States.

The impact of the slowdown on the U.S. economy and politics, and the challenge of U.S. budget management, could also shape Washington's response to the challenge of terrorism in South Asia. If domestic economic and political pressures encourage the Obama administration to pursue a so-called AfPak strategy that is not in line with Indian security perceptions, India would be compelled 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, this may spur new adventurism within the military leadership. Any decline of the Indian economy would only encourage such adventurist elements in Pakistan. Pakistan is the source of India's biggest security problem—jihadi terrorism. India, however, faces a strategic dilemma. It is in India's interest that Pakistan should stabilize as a nation, a society, and an economy. It is also in India's interest that the Pakistani economy should do well, that a moderate and peace-loving middle class and business class gain ascendance, and that democratic institutions take root. Yet if improved economic performance, aided by U.S. assistance, were to embolden Pakistan to return to adventurist tactics vis-à-vis India, the security environment in the region would only deteriorate.

How Washington's policy response to the global economic crisis influences U.S. policy on jihadi terrorism in South Asia will, 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 both for the bilateral relationship and for regional stability, and will shape the strategic environment for the economic development of India and the region.

The Obama administration's outreach to China, on the one hand, and its AfPak strategy in South Asia, on the other, have not been viewed favorably by some influential commentators in India.[49] It would appear that the Obama administration is groping for a new policy framework for South Asia in particular and Asia in general. Obama may have no option other than staying the course set by Presidents Clinton and Bush.

A recent statement by Secretary of State Hillary Clinton points in that direction. Defining the four platforms of cooperation between India and the United States as global security, human development, economic activity, and science and technology, Secretary Clinton declared:

> 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.[50]

Conclusion

India's reintegration into the world economy, with a higher trade-GDP ratio and increased dependence on external capital flows, has made the country more vulnerable to global crises. At the same time, the pursuit of incremental reform and prudent regulation has minimized the negative impact of both the Asian and, more recently, the trans-Atlantic financial crises. From a strategic policy perspective, India can claim that the country's model of gradual and graduated economic liberalization—and of risk-averse regulation in the banking and financial sector—have helped limit the country's exposure to the great recession. Internal weaknesses, such as public finances and inadequate investment in social and economic infrastructure, still remain India's major economic vulnerabilities.

If India can return to the trajectory of 8%–9% annual economic growth and sustain such growth over the next decade, the nation will be on course to emerge as a great Asian power. In the nearer term of the next five years the task before India will be to regain momentum at a time when the global economy is more challenging than it has been over the past half decade. Thus, the current

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49 The Obama administration's AfPak strategy has been criticized in India, with many experts already expressing doubts regarding the durability of the strategic partnership that Bush and Singh sought. See, for example, comments by former Indian foreign secretary Kanwal Sibal, "Promise of Indo-US Ties Diluted by Obama," *Mail Today,* April 21, 2009.

50 Hillary Clinton (remarks at U.S.-India Business Council's 34th Anniversary "Synergies Summit," U.S. Chamber of Commerce, Washington, D.C., June 17, 2009), http://www.state.gov/secretary/rm/2009a/06/125033.htm.

economic slowdown has imposed new constraints on India's economic rise. These constraints, however, are not insurmountable.

It is clear that the second Singh government will remain focused on sustaining high rates of investment and economic growth in keeping with the prime minister's vision of defining India's rise in terms of economic performance. The global economic slowdown has only underlined the importance of India's economic performance for the country's global standing. As a free-market democracy, however, India's public policy will have to pay equal attention to both economic growth and social welfare. The new government's ten-point charter thus balances considerations of equity with those of efficiency.

As it has gained economic strength, India has felt encouraged to pursue a policy of asymmetric economic liberalization toward less-developed countries, including countries in South Asia. Any deceleration in growth, however, and consequent fiscal pressures, will impose constraints on such non-reciprocal trade liberalization and foreign aid. This could potentially slow the growth of India's influence and standing in the global South.

One significant geopolitical consequence of the financial crisis has been the coming together of the United States and China and the possibility of a G-2 condominium. This could have implications for both countries' respective strategies and approaches to geopolitical and security issues in South Asia. Bearing more than purely geopolitical and economic consequences, China's rise also portends important implications for the future of liberal and plural democracy in the developing world.

The current global economic downturn thus 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 also a global order that is supportive of India's developmental aspirations. If, by building on the foundations laid by preceding governments, the Obama administration crafts a strategic partnership with India, the United States could thus play a role in India's ascent similar to its role in the postwar reconstruction of Japan and Western Europe and in the more recent development of the Asian tiger economies.