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# 1

## India, Japan and Asia

*Jagdish Bhagwati*

When I had to write a Preface for the Japanese edition of one of my books, I wrote that there were three countries for which I had an attachment: India where I come from, the United States which I now live in, and Japan.

I became interested in Japan when I was appointed Secretary, in 1962, to the Indian Wise Men Committee on Indo-Japanese Collaboration and went to Japan for a month where I interacted with Saburo Okita, a distinguished and cosmopolitan bureaucrat, who was my counterpart as Secretary to the Japanese Wise-Men Committee. I was taken to Kyoto, Nara, Osaka and other cities, slept on *tatamis* at Japanese Inns, saw Noh and Kabuki plays, and began reading Japanese literature, seeing Japanese films and studying Japanese transition to economic prowess.

When Japan-bashing began in the United States in the 1980s, my bonding with Japan, and my knowledge of Japanese culture and economics intensified yet further. By then I had joined the Economics Department at MIT as a Professor of Economics in 1968, where I became the principal defender of Japan against the indiscriminate attacks on her as an 'unfair trader', excluding imports and dumping exports.

But I offer this contribution, not as a scholar of US–Japan economic interaction, but rather in a reversion to the earlier phase of my life as a long-standing scholar of the economies of India and Japan, putting the current situation and the future prospects of the interaction between the two great countries in the wider context of Asia.

## India's growth: past, present and future

Let me first begin with India's growth performance. Why emphasize growth? As many of you may be aware, my view has been that, given India's considerable poverty, growth is essential to reduce poverty. Whereas the left-radicals contemptuously refer to growth as a passive, conservative 'trickle-down' strategy, suggesting that we are all enjoying a banquet and a few crumbs fall into the hands and mouths of the impoverished serfs huddled below the table, I have always argued (since the early 1960s when I was working on the problem of poverty reduction in the Indian Planning Commission) that growth is a radical and activist 'pull-up' strategy where considerable state effort is put into accelerating the growth rate so that poverty can be impacted.

Growth reduces poverty directly, by creating jobs which the poor can access; it also reduces it indirectly because it adds to the budgetary revenues that can then be spent on health, education and other social spending which can improve the living standards of the poor. As the current Indian Prime Minister Manmohan Singh has also emphasized, it is all very well to ask for more social spending for the poor but, without growth, that demand can be made but it is almost impossible to respond to.

The problem in India was not with its growth-to-reduce-poverty strategy. The problem was with the fact that the economic policies pursued did not produce the growth in the first place! India, for a variety of reasons which I have explored in my book, *India in Transition* (Clarendon Press: Oxford, 1993, chapter 1), adopted a policy framework that *undermined* growth. These policies mainly included:

- a shift to autarky so that India's share of world exports fell, as did the share of trade in her national income, when many other nations improved their export performance;
- a Kafkaesque expansion of import, production and investment controls *via* a restrictive licensing system known then as 'permit *Raj*', so that competition and innovation were stifled;
- an enormous expansion of the public sector into areas well-beyond utilities and 'natural monopolies', into several industries, with huge losses that added to macroeconomic fiscal imbalances and to industrial efficiency also, because many of the public-sector enterprises produced intermediates (such as steel) which entered other industries and affected their operations adversely in turn; and

- a jaundiced view of inward flow of direct equity investment, and attendant restrictions on it, so much so that when the 1991 shift to reforms began, the annual equity investment inflow was less than \$100 million, believe it or not!<sup>1</sup>

The result during almost a quarter of a century was an economic *debacle* (while the Far Eastern economies, which had diametrically different policies, registered an economic *miracle*) of abysmal growth rates, fluctuating around an average of 3.5 per cent annually. Given the population growth rate around 2 per cent that left an increase of per capita income of 1.5 per cent annually. It takes only commonsense, not economic sophistication, to see that in such a stagnant economy, poverty will not diminish either; and it did not. Ironically, Indian economists such as Professor Amartya Sen persisted in defending, implicitly or explicitly, these outrageously counterproductive policies, catering to pseudo-left forces, and wound up increasing Indian poverty and then presenting themselves to the ignorant public as the champions of the poor whose numbers they had themselves multiplied!

Starting with some reforms in the 1980s, but principally with the acceleration of these reforms initiated in 1991, the Indian economy has moved into higher gears, raising the average growth rate to almost 6–6.5 per cent. With this, poverty has declined, both in rural and in urban sectors. The only debate in India now is on how much poverty has declined, not *regarding* whether it has.

But if India is no longer a basket case and nearly twenty years of high growth, as also the astonishing success of its IT industry, have turned the country's image around, one cannot extrapolate this into a forecast of continuing acceleration of India's performance. Four comments, all rather sobering about India's prospects, are in order.

First, while India has removed licensing and has reduced its trade barriers from an average of nearly 75 per cent applied tariff on manufactured goods down to nearly 15 per cent today, its ability to remove the restrictions on foreign equity investment has been handicapped by continuing bureaucratic hassles. At the same time, India has become stuck with its public sector enterprises as efforts at privatization have been checkmated by the right-wing forces in the BJP (the Bharatiya Janata Party), which lost the last elections but was in power till then and the left-wing coalition partners of the Congress Party (which won the last election but has a coalition with the Communist parties). The

Congress Party is also unable to move forward on much-needed labour reforms which make even the absurdly inefficient French and German labour market practices look good by contrast! This illustrates the point that, while democracies can do well on development,<sup>2</sup> they are unable to change course with ease (whereas dictatorships like in China can, relatively speaking, as witnessed by China's more drastic reforms under Deng) because the old mix of institutions and 'interests' (i.e. vested interests or lobbies), that have grown up around the 'old model' which one is trying to discard, proposes and poses serious political difficulties in making the transition to a 'new model'.

Third, the infrastructure problems which India faces are quite enormous. It is still an open question whether, given the general prevalence of near-xenophobic views about foreign investment, India can make a substantial inroad into this bottleneck to raising its growth rate still further beyond 6.5 per cent annually on a sustained basis. Note that China does not face this problem.

Finally, the opposition to further reform comes from within the Congress Party itself. 1991 saw a displacement of socialist sentiments and of the proponents of the mix of policies. But now, on the false assumption (as I will presently argue) that it was the BJP reforms – which in fact were simply carrying forward those initiated in 1991 by the Congress Party itself – that drove the BJP defeat, the discarded socialists of the Congress Party have now flocked around the powerful Congress leader, Sonia Gandhi. This has a parallel to the Bush 43 administration bringing into its fold the dissatisfied conservative hawks from the Bush 41 administration: Cheney *et al.* These socialist hawks are allying themselves with the coalition partners outside the Congress Party, the Communists, to stall further reforms. Why are they powerful enough to stall further reforms?

They have come back from the cold because the assumption which the Congress leadership around Sonia Gandhi has bought into is that it was the 'neoliberal' reforms that led to a neglect of the poor in the rural areas and therefore we need to reject the emphasis on these reforms and do rural development. I do not buy into this thesis at all. Nearly all incumbent governments at the State level, whether BJP or Congress, lost. In short, the incumbents were being thrown out, whether they had been introducing modern reforms or not. My hypothesis, which I advanced (with Professor Panagariya) in an article in the *Wall Street Journal* within days of the election results, in response

to anti-reforms claims of novelists such as Salman Rushdie and Arundhati Roy, who in my view were continuing to write fiction when commenting on election results, was that the results reflected instead the success of the reforms in reducing poverty. As long as the economy grew poorly before the reforms were introduced, poverty was barely reduced. So, there was what I called a 'non-revolution of falling expectations': the poor felt dispirited and said to themselves: that is the way it is. But once the reforms began to deliver results, we had the 'revolution of perceived possibilities', or the 'revolution of rising expectations': the poor saw that they could improve their lot and now wanted more. Oliver Twist also wanted more but had to settle for less. But the poor with votes could ask for more and turn out the incumbents as they asked for more.

There is nothing wrong with shifting the state's attention to the rural sector. But if this is done, as the people around Sonia Gandhi are doing, by floating expensive 'employment guarantee schemes' which are soaking up huge sums of money, many susceptible to stereotypical diversion into corruption – more so than in the case of output-enhancing infrastructure projects where at least there is visible output to check against, whereas employment enhancing schemes can be judged only by expenditure and apparent employment – then there is likely to be a considerable damage done by diversion of funds from more productive rural uses. The tendency of the Indian political scene to revert back to pseudo-socialist chatter and policies that can harm the economy is disturbing; and only time will determine whether the sensible pro-reform views of the Prime Minister and his allies such as the Finance Minister or the revived anti-reform proclivities of the erstwhile defunct socialists will prevail.

## **India and China**

The question arises, and is relevant to what I discuss later below, as to whether India will ever catch up with China. Both were sleeping giants who were expected at the beginning of the postwar period to awaken and become great players. As it happened, they both fell into counterproductive policies, among them a shared refusal to take advantage of the opportunities offered by globalization. China did this for political reasons – communist regimes such as the Soviet Union and Maoist China turned away from integrating themselves into the world

economy, the way North Korea has done for decades. On the other hand, India did so because of bad choices in economic policy (as discussed above). In the meantime, it was the Far Eastern Four instead who, by shifting to outward orientation from the late 1950s, turned into the new and lean giants; turning into economic miracles indeed.

Finally, almost four decades late, India and China have woken up. But except for Thomas Friedman, few expect India to get close in performance to China soon: it is China that sends shock waves everywhere. Consider Lee Kuan Yew's remarks in New Delhi this summer:

In the decade from 1994 to 2004, India's GDP grew two-fold from US\$ 310 billion to US\$ 661 billion. But during the same period, China's GDP grew three-fold from US\$ 542 billion to US\$ 1,649 billion. In 1984, India's GDP was about 30% smaller than China's. A decade later, it was more than 40% smaller and by 2004 it was about 60% smaller.

But what is the prognosis for the medium and long run? China does not have the rule of law; India has. The authoritarian structure of China carries its own costs. I recall my wife, Professor Padma Desai, talking on a Panel on India and China when both Mao and Chou En Lai were alive. Asked what would be China's trajectory on economic and political development, she said: it depends on whether Mao or Chou En Lai dies first. The Chinese system is top heavy, non-transparent and hence fragile and volatile; India's is at an advantage on these fronts.

Then again, will China really be able to hack it in an IT-intensive world when it is constantly worried about how information technology in the hands of its people may be subversive? India is a democracy and her IT sector has worked wonders. But China has fallen behind. The reason is that the PC and the CP (the Communist Party) are basically incompatible. Again, authoritarian structures can become very expensive except in cases where basically sound decisions are taken, as in China with her reforms during the 1980s. But all is not rosy there either. China's savings rate is estimated today as close to 50 per cent: a number which seems absurdly large and hence unreliable. But that the number is larger than India's 25 per cent or thereabouts. But China's growth rate is not commensurately large. So, presumably India uses resources-cum-investments more efficiently than China.

Finally, as China's middle class grows dramatically, it is likely to become restless for political liberty, in a classic fashion. How will the

political dictatorship react to it? Will it try to repress these demands, leading to Falun Gong type of problems and disruption of the state? Or will the process be smooth and evolutionary, with the Communist Party accommodating gradually to the political demands for more democracy? We cannot know; but there is as much likelihood of China's miracle collapsing as of its continuing.

All this makes many observers today feel that India, while now behind China on the escalator, should get ahead in the longer run. But that the two powers are here to stay, and to become with Japan the three major giants in the Asian region is a moral certainty. What does this imply?

### **India, China and Japan: major Asian powers**

Clearly, the postwar expectation that Japan would be the most important player in Asia, with Asia and especially ASEAN countries as part of its 'co-prosperity' sphere (of influence and responsibility), has to be modified to include India and China in the equation. Asia now is getting its **Big Three**.

From an ASEAN perspective, this is all to the good. Only one hegemon in your front yard is always anxiety-creating. An oligopoly of hegemonies helps: each competes with the others for influence, replacing the itch to dominate and intimidate with the itch to please and seduce. The biggest hegemon of all, the United States, which is concerned about the rise of China for many reasons, would like to use Japan and the new India to act as a counterweight to China, to see these two enormous Asian tigers, one old and the other new, 'contain' China. Evidently neither India nor Japan wants to play, nor be seen as playing, that kind of role. Both countries have to live with China; it is surely not in their national interest to get into an adversarial position *vis-à-vis* China.

### **India and Japan: 'natural allies'**

But India and Japan will surely act, without much fuss, as such counterweights to China. After all, the two nations have been Asia's most important democracies since the end of the Second World War. Among the developing countries, India is unique: where nearly all newly independent and other developing countries at some stage abandoned

democracy, India remained wedded to it. Now that many of these countries have come to be democracies one might also think that India's democracy would be less valued. But it is more so, for India is regarded as having been the precursor of this new trend. And her ability to function as a democracy despite her many religions, languages and ethnicities is regarded as a triumph. By contrast, China's authoritarianism seems like an anachronism; and her human-rights abuses as much as her lack of democracy reduce her appeal.

Their democracies make India and Japan 'natural allies'. So does their ambition now to get permanent Security Council seats: they plus Germany and Brazil have joined hands in this quest. The fact that China is lukewarm, at best, in her support for this move is yet another reason why India and Japan get closer politically.

But, aside from the political factors, there also are economic reasons for a growing closeness between India and Japan. As China has become more unruly in her Japan-bashing, claiming that Japan does not repent enough for her Second World War atrocities and protesting against Japan with riots, it is clear that Japan would have a legitimate interest in diversifying away from excessive dependence on China as a location for her corporations.

Evidently, India offers a better destination for such overseas manufacture by Japanese firms. Unlike China, and indeed much of Asia, India has no unpleasant memories of the Japanese during the Second World War: there is no such memory because there is almost nothing to remember! The Japanese eastward march got bogged down in the jungles of Burma for the most part; and except for the north-eastern border India was not a witness to Japanese invasion. So there is no resentment such as in China where the memory of the war is intolerable and Japan is barely tolerated. India therefore is not merely a 'naturally' but also a 'natural' location for Japanese firms in seeking labour-abundant locations for parts of their manufacture.

Indeed, this should have happened on a larger scale, much earlier. But the fault lay in India's dirigiste state, with masses of restrictions. Today, however, growing reforms have changed that situation. Not enough, as I said earlier, on the foreign-investment front. But the left-wing opposition to such investment can be more readily surmounted for Japanese firms, in bilateral initiatives, than for Western firms which come from 'imperialist' countries. As it happens, the Prime Minister Manmohan Singh succeeded me as the Secretary to the Indian Wise

Men's Committee. The time has come for a major breakthrough of economic relations between the two countries.

## **Bilateral trade agreements in Asia: India, China and Japan**

How does the prospect look then for Asian trade liberalization, as part of Asian economic integration? And what is India's and Japan's role in it? A few points can be made:

- 1 *Why Preferential Trade Agreements (PTAs) are bad news:* Asia long held out against bilateral free trade agreements which are now called what they really are: Preferential Trade Agreements. But it has now joined in the '*Great PTA Rush*'. Why are these PTAs a curse? Let me explain.

First, note that PTAs liberalize trade for the member countries and therefore that part is a freeing of trade. But they also increase, for any given external tariffs, the handicap suffered by non-members in the members' markets. These then are tantamount to increasing protection against non-members. So, PTAs are two-faced: they free trade for members and they increase protection against non-members. So, as Jacob Viner (1950) pointed out in a seminal contribution in the 1950s, PTAs are different from non-discriminatory, non-preferential freeing of trade.

They therefore can divert trade from efficient non-members with low costs of production and can harm those joining such a union (by increasing the cost of their imports), non-members (whose exports are diverted) and world efficiency (by shifting production from lower-cost non-members to higher-cost members). There is plenty of evidence of such trade diversion from specific PTAs.

Second, and far more important, when PTAs multiply, there is a 'systemic' problem: they badly bust up the multilateral system represented by MFN treatment for all members of the GATT, now the WTO. When you have nearly 300 such PTAs today, and they are increasing by the week, most-favoured-nation (MFN) tariffs become terribly emasculated: they matter less and less. Tariffs depend on where a product comes from: for example a country has 12 PTAs and therefore, for any product, there are likely to be 12 different tariff rates at any point of time, depending on the trajectory of each PTA. Then again, if a different tariff applies to a product from a particular preferred source, then the product must be determined

to have originated from that source: so we have rules of origin. So, we also have countless and occasionally sector-wise-differentiated rules of origin that are basically arbitrary. So, between different tariff rates and different rules of origin, you have chaos in the tariff structure. This is what I have called the 'spaghetti bowl' problem.

The MFN principle, so central to the trading system we built after the War, has now been decimated.

Third, the hegemonic powers, the EU and the USA, have used the PTAs with small countries to establish templates on non-trade issues such as labour standards, environmental rules, capital flow controls and so on which are not in the WTO, while also demanding WTO+ (i.e. WTO plus) obligations on issues such as intellectual property protection where the issues are in the WTO already. The trade game is converted, through tough negotiations with small countries, by dangling preferential market access before them, into a non-trade game. It is notable that the PTAs among the developing countries by themselves typically do not have such non-trade issues included in their agreements. The big developing countries such as Brazil and India have rejected these nefarious tactics and the intended intrusion of these non-trade issues so far at the WTO. It is notable also that the PTAs planned by Japan and China do not, to my knowledge, include these extraneous, non-trade issues.

- 2 *Asian PTAs*: The EU started doing PTAs; then the USA, instead of objecting to them – it had the necessary power to do so at the GATT – joined in with enthusiasm, the main culprits being Secretary Jim Baker and his Deputy Robert Zoellick. As US Trade Representative, Zoellick did his best to proliferate them further, claiming mistakenly that PTAs were good for the multilateral trading system as they would prod the world into multilateral trade negotiations.

And now, quite predictably, Asia has joined the process, with China and Japan taking major initiatives with them and India also beginning to consider them actively. For Japan this is a major departure, as it is for the ASEAN countries of APEC, because at the APEC they had all agreed on maintaining MFN and concerted MFN liberalization rather than turning the APEC countries into a Preferential Trading Bloc under Article 24 of the GATT. This is partly a matter of 'monkey see, monkey do'; but it is also an instance of 'reactive PTA formation', where Asia excludes market access from

its groupings the way the US PTAs, and the proposed Free Trade Area of the Americas will exclude Asia and others. The fault lies with the USA and its mindless and intellectually defective leadership, not with Japan, China and now India.

- 3 *Importance of Doha Round and multilateral reduction of trade barriers:* The proliferation of PTAs in the Asian region is not an ideal way to liberalize trade, for the many reasons I have stated above. In particular, China, which is technically a developing country, needs to remember that it needs nonetheless to subject its own PTAs with other developing countries to the discipline of Article 24, instead of using the much weaker and self-destructive route offered by the Enabling Clause to PTAs exclusively among the developing countries.

But the surest way to eliminate some of the deleterious trade consequences of PTA proliferation is to push hard to make the Doha Round a success. As the poorest countries who enjoy preferences now finally understand, MFN trade liberalization reduces the effectiveness of preferences; the preferences are relative to the MFN tariff so that a zero MFN tariff means zero *de facto* preference. So, the only effective way of killing preferences is to kill the MFN tariff: a ratio can be affected by working on the numerator or the denominator. So, the ultimate contribution that Asia can make to undo the damage that Zoellick and the Europeans have wreaked on the world trading system through bilateral PTAs is to provide the leadership to reduce MFN tariffs further by making the Doha Round a success.

## Notes

- 1 The diagnosis of these policies, and their adverse implications for Indian economic performance, was made in *India: Planning for Industrialization* (Oxford University Press, 1968) that Professor Padma Desai and I wrote several years before the reforms started in India.
- 2 See the extended analysis I have offered in my Rajiv Gandhi Golden Jubilee Memorial Lecture, 22 October 1994 in New Delhi, titled 'Democracy and Development: New Thinking on an Old Question', reprinted as chapter 40 in my collected essays, *A Stream of Windows* (Cambridge, Mass., MIT Press, 1998). Senior Minister Lee Kuan Yew of Singapore, the architect of Singapore's miracle, also addresses this question with insight in a splendid Nehru Memorial Lecture that he gave this year in New Delhi.

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Notes: f = figure; n = note; t = table; **bold** = extended discussion or heading emphasized in main text; 91[-]93 = proceed direct from page 91 to page 93.

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