

*State of the World Economy, 2011-2012:*

# Whither or Wither?

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On November 18, 2010, the U.S.-Korea Institute at SAIS and the Korea Institute of Finance, sponsored by the Asian Studies Program at SAIS and the *JoongAng Ilbo*, hosted the one-day conference, "State of the World Economy, 2011-2012: Whither or Wither?" at the Paul H. Nitze School of Advanced International Studies (SAIS) in Washington, D.C.

This volume contains the speeches and papers that were presented that day and subsequently further refined by the authors to reflect discussions during the conference.



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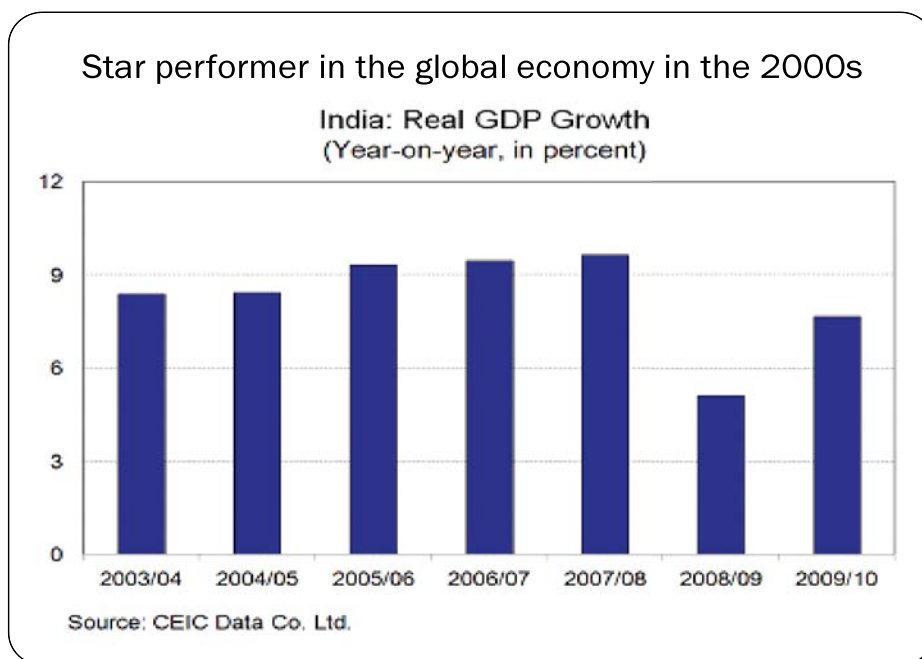
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## *India as a Locomotive for the World Economy*

Kalpana Kochhar\*  
World Bank

Globalization has transformed India into a world economic power. The reforms that began in the early 1990s, which deregulated business and finance and lowered barriers to international trade and capital, resulted in an acceleration of economic growth to among the fastest rates in the world. Thanks to this rapid growth, India now ranks among an exclusive club of trillion-dollar economies. In purchasing power terms, India is now the globe's fourth-largest economy.

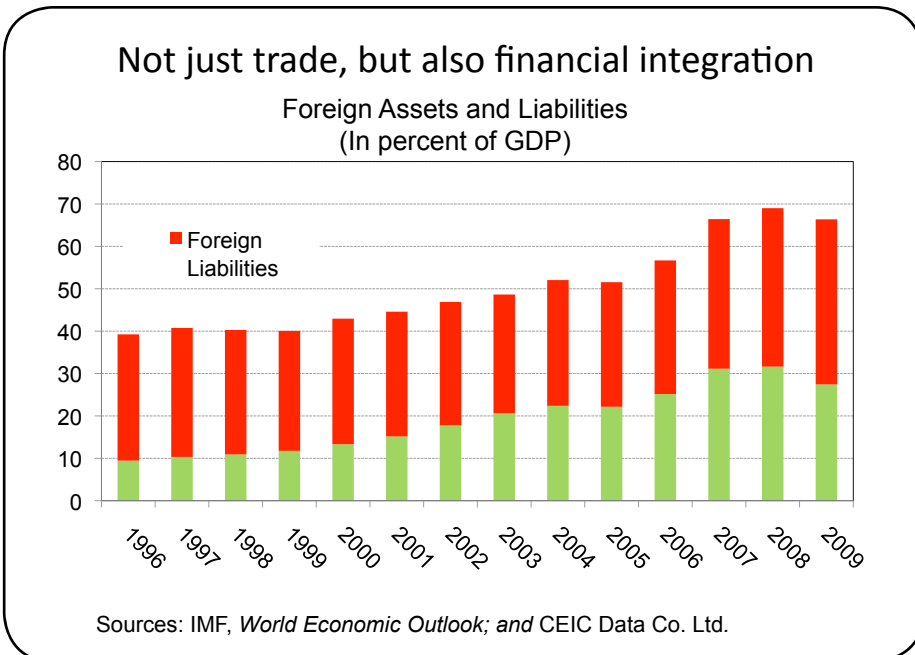
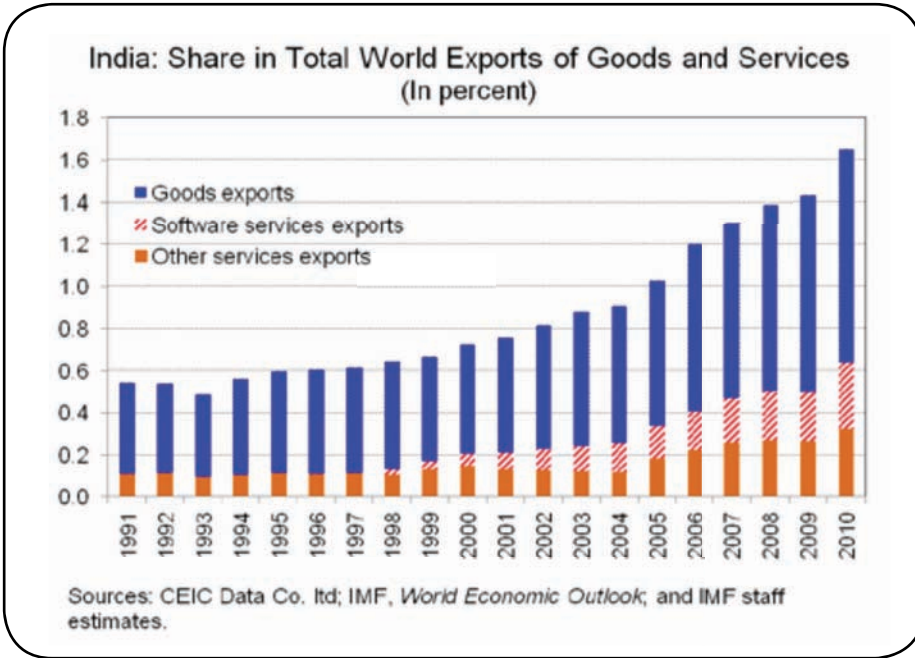


This paper deals with four issues. First, it documents the emergence of India as a globally integrated economy. Next, it discusses some key characteristics of India's growth. It then outlines the impact of the global financial crisis on India and India's policy responses, which drove its rapid recovery. And finally, it presents a brief discussion of India's medium-term growth prospects and the potential for it to be a locomotive for the global economy.

\* Kalpana Kochhar is currently the Chief Economist for the South Asia region at the World Bank.

## A Globally Integrated Economy

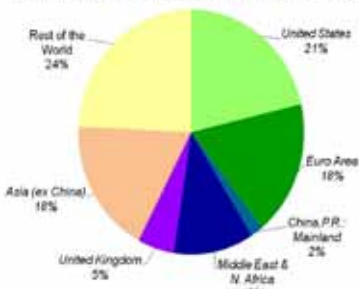
India has integrated rapidly into global markets for goods, services, and capital. The figures below illustrate the rapid increase in India's share of total world exports and its growing integration with global capital markets.



Another part of the Indian export story has to do with the diversification of products and markets and the active shift towards the east in India's export destinations.

## Exports go eastwards

India: Exports to the World by Partner Country, 2000



Sources: IMF, Direction of Trade Database; and IMF staff estimates.

India: Exports to the World by Partner Country, 2009



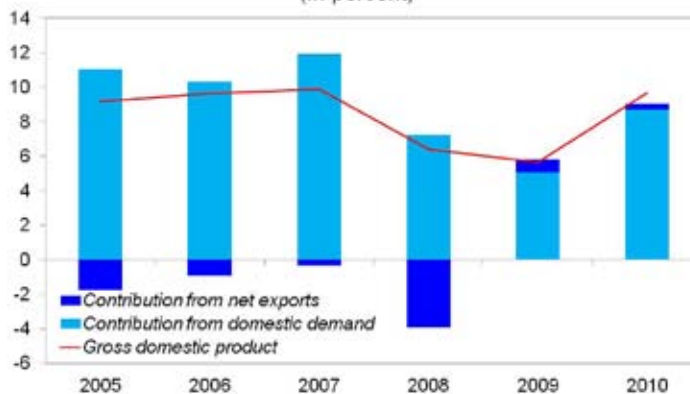
Sources: IMF, Direction of Trade Database; and IMF staff estimates.

## A Story of Twin-Engined, Balanced Growth

An important characteristic of India's growth is that it is "twin engaged," fueled both by exports and external demand as well as by domestic demand.

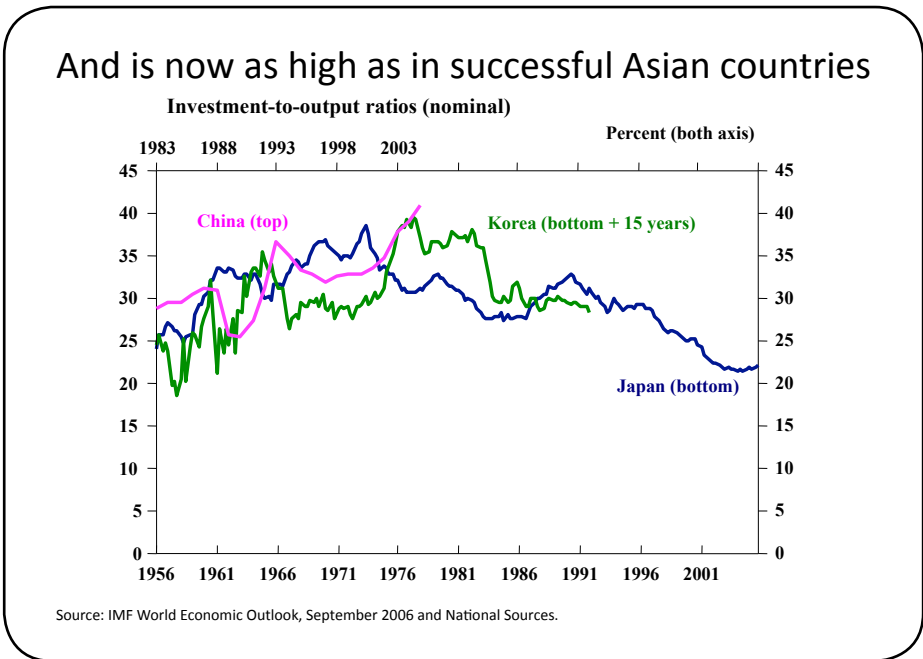
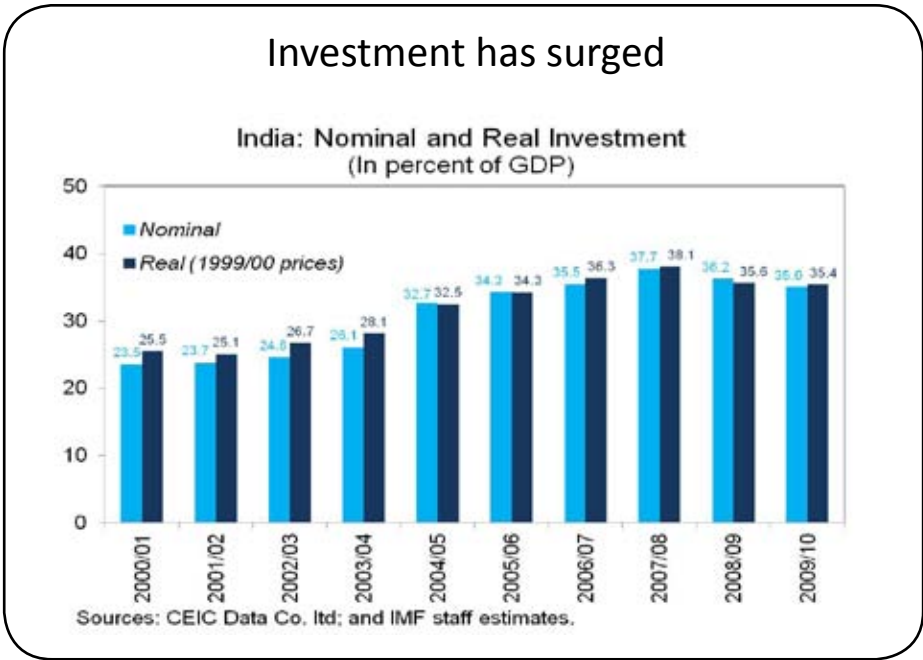
## Twin engaged growth?

India: Contribution to Real GDP Growth (In percent)



Sources: IMF, World Economic Outlook; and IMF staff estimates.

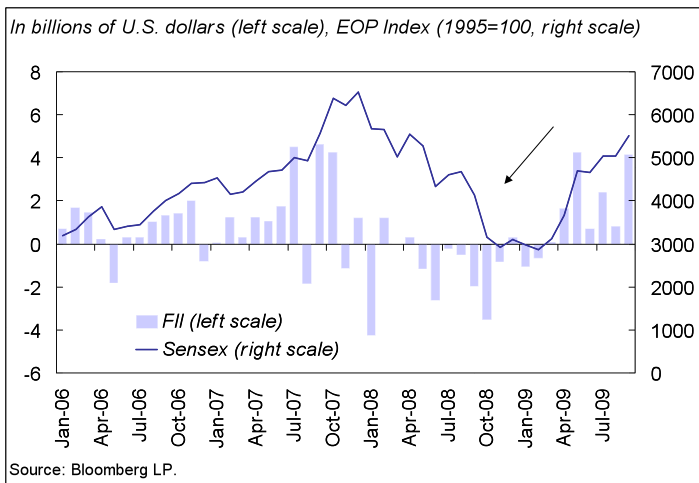
Indeed, the growth takeoff has been mirrored in a sharp increase in investment, which is now in the range of the peaks achieved in the successful East Asian countries during their growth takeoffs.



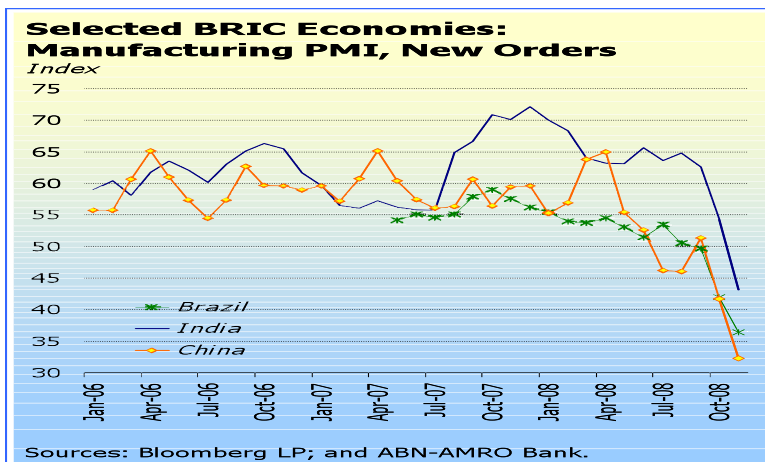
## Impact of the Crisis and Recovery from the Crisis

Given its integration with the global economy, it should not be a surprise that India was not spared the impact of the crisis in 2008. Foreign institutional investor inflows plummeted as foreigners retreated, in large part to cover losses in other markets, and the stock market fell sharply. Not unlike its emerging-market counterparts, India was affected through the trade channel too, with new orders collapsing sharply.

### Financial turmoil hits India...

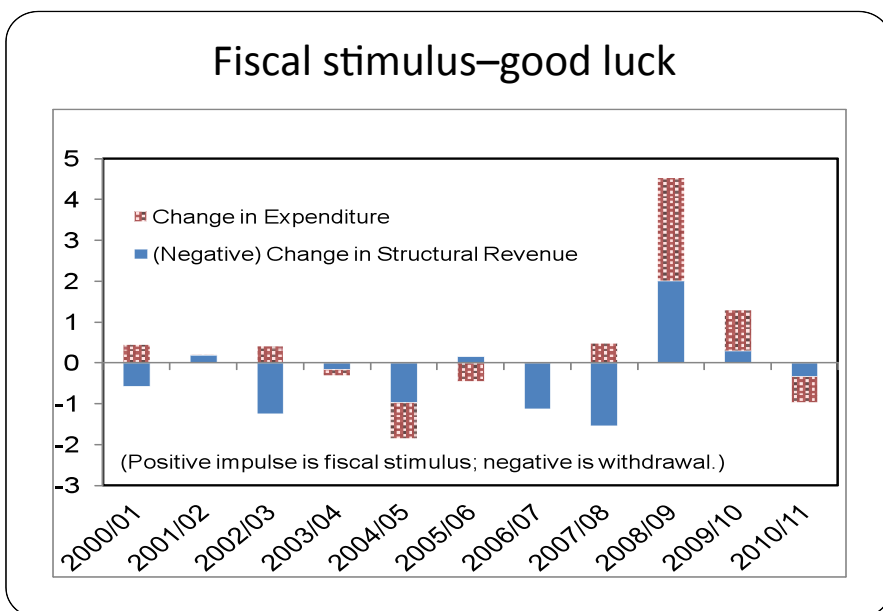


### India affected by the trade channel too





The authorities' response to the crisis was swift and appropriate. The RBI took immediate steps to pump liquidity into the banking system, cutting interest rates and lowering the cash reserve and statutory liquidity ratios. In an effort to counteract the "sudden stop" in capital inflows, the RBI also raised interest rates on deposits by nonresident Indians in India and eased controls on capital inflows. Steps were taken to enhance coordination among regulators of different parts of the financial system to provide early warnings of distress in the sector. And the election-related pump priming announced in February 2008 and implemented starting April 2008, along with additional fiscal stimulus measures implemented after the crisis, served to provide important support to domestic demand in the immediate aftermath of the crisis.

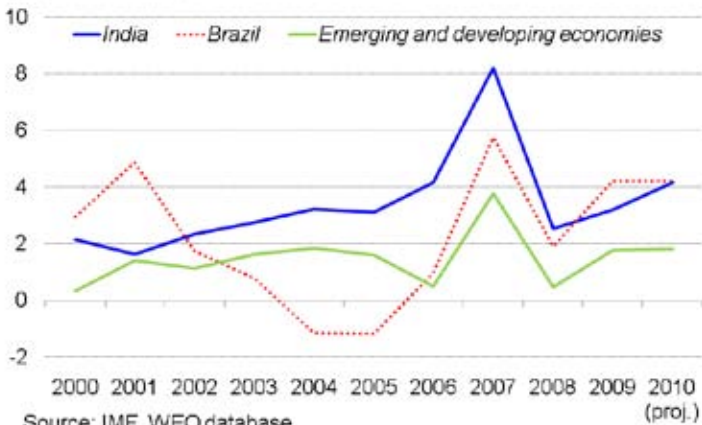


A final important point is that the authorities were pragmatic in the management of the exchange rate. They recognized the futility of fighting what had turned into a global flight home and let the rupee depreciate with the capital outflows.

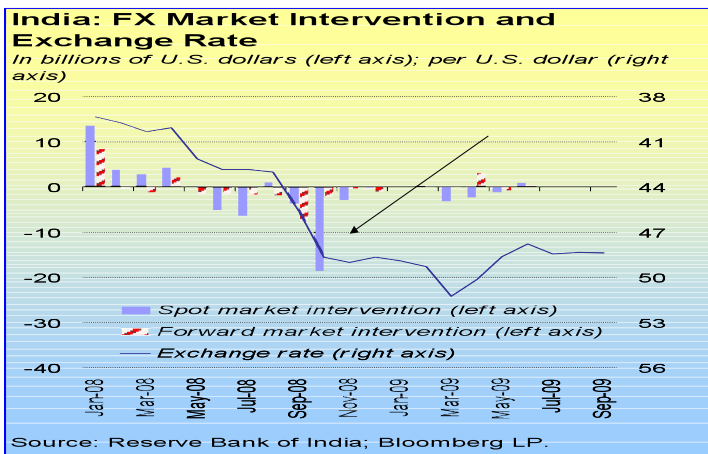
## Big swings in capital flows...

### Net Capital Inflows

(In percent of GDP)

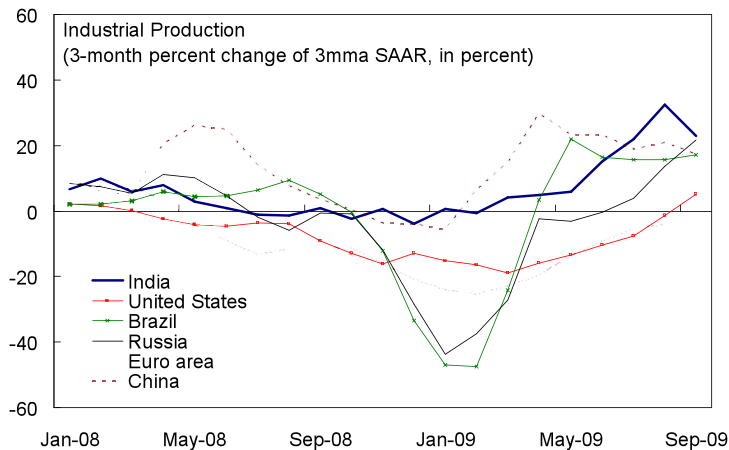


## Pragmatic exchange rate management...



As a result of the policy response and the underlying characteristics of India's growth, the economy experienced only a shallow downturn followed by a brisk recovery.

## Resilient India—shallow downturn, early recovery



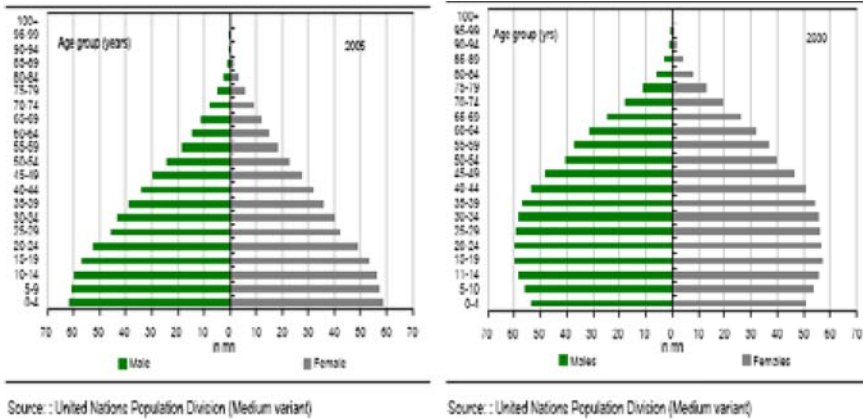
### What Does the Future Hold for India and India's Role in the Global Economy?

The most positive trend facing India is its demographic composition. In 2020, the median age in India will be 28 years compared with 49 in Japan, 37 in China, and 45 in Western Europe. India will be home to a large number of working-age people, and judging by past experiences in other countries that have experienced similar demographic changes, there is considerable scope to reap a sizable demographic dividend—that is, a sustained increase in growth along with changes in the age structure of the population towards the working age.

However, the achievement of this demographic dividend is by no means a foregone conclusion. India faces major challenges in overcoming constraints to growth to put itself in a position to reap the demographic dividend. The most pressing challenge is the one posed by the major gaps in physical infrastructure. Why do infrastructure gaps matter? They matter because they are a deterrent to the development of industry—which has the greatest potential to absorb the expected increases in the labor force. Infrastructure quantity and quality also matter for inclusive growth, as corroborated by empirical studies using data from Indian states.

The authorities in India have recognized this fact and have given infrastructure investment their highest priority. They aim to virtually double infrastructure investment over the next five years to close to 9% of GDP, implying a total investment in infrastructure of around \$1 trillion. This is an important first step, but many challenges remain in implementing this plan. Foremost amongst these are those related to financing the massive planned investment. India has a high level of private savings, and the demographic trends will certainly help sustain these trends.

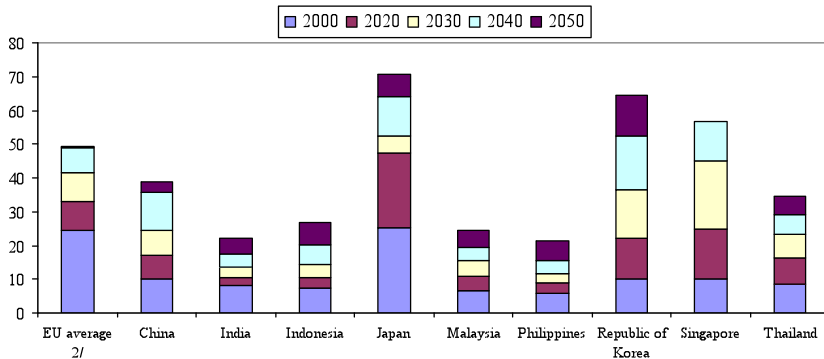
## Favorable demographic transition underway

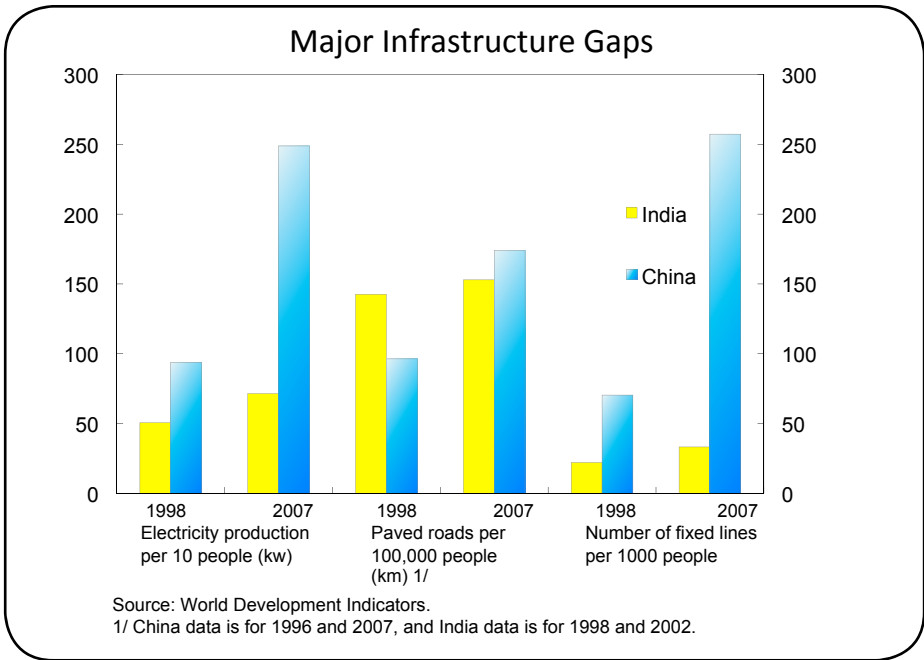


## And will continue for at least 4 more decades

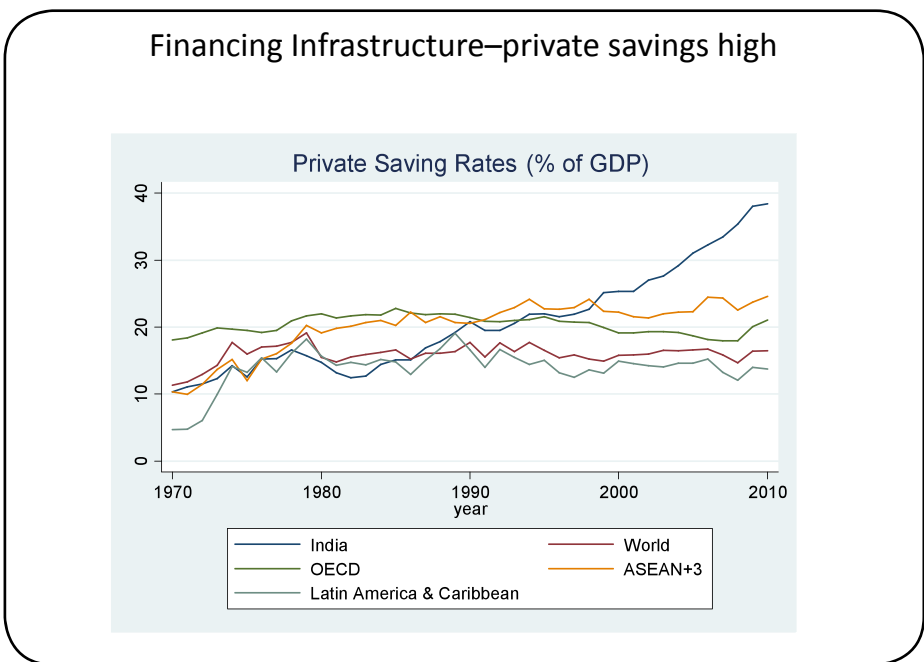
Chart 1

Old Age Dependency Rate in Asia, 2000-2050 1/

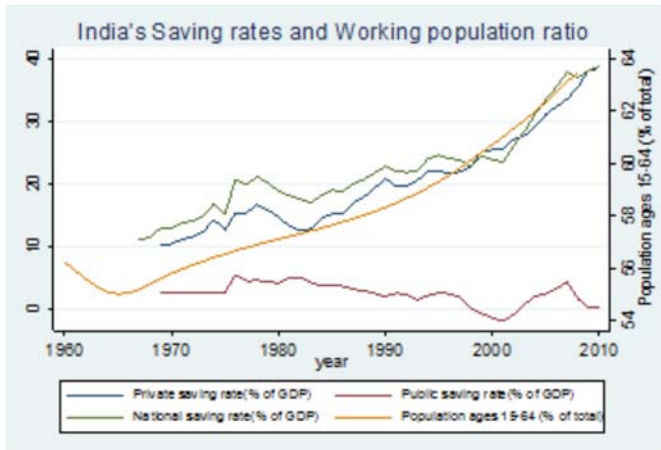




But the persistently high fiscal deficits have preempted these savings, leaving little room for private investment in infrastructure. Strong efforts to reduce the fiscal deficit are urgently needed. Much recent progress has been made in raising the revenue/GDP ratio, and although more can be done here, reforms of expenditures are lagging. There is therefore an urgent need to reform wasteful and unproductive subsidies that do not benefit those that need it and where the design of the schemes has outlived its usefulness as India gets closer to middle-income status.

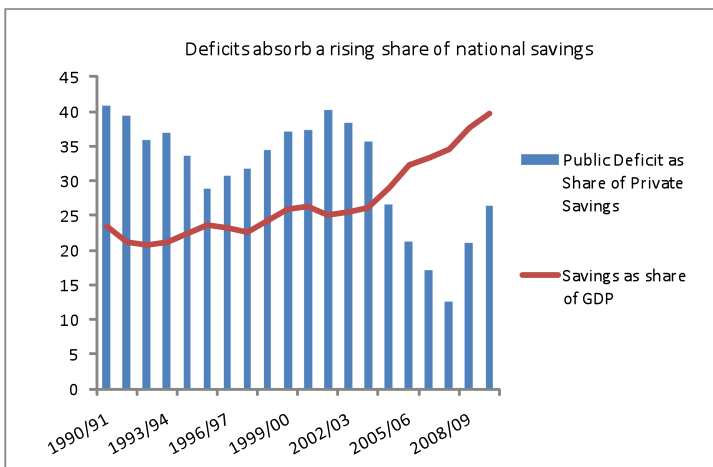


## And will likely continue to rise with demographics



In addition, India needs broader sources of finance. The ingredients for developing India's domestic financial and capital markets are well known, as laid out in a series of expert reports over the past several years. A key ingredient is developing the domestic institutional investor base: pension and insurance funds. And better-developed financial markets are also needed to intermediate flows from abroad.

## But they are preempted to finance the large fiscal deficits



## **Conclusion**

India's favorable demographics, the fact that growth is balanced between external and domestic sources and the diversified export market base are all positives for sustained medium-term growth. But by themselves, they are not enough. Efforts need to be made to rapidly build up infrastructure without building up risks to the economy, so that growth can be truly inclusive and India can fully reap the massive demographic dividend that is potentially embodied in its swelling labor force.

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