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Economic Policy

Policy Paper No. 1

India's Inward (Re)Turn: Is it Warranted? Will it Work?

October 2020

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ABSTRACT

India is turning inward. Domestic demand is assuming primacy over export-orientation and trade restrictions are increasing, reversing a 3-decade trend. This shift is based on three misconceptions, which we dispel: that India's domestic market size is big, India's growth has been based on domestic not export markets, and export prospects are dim because the world is deglobalizing. In fact, India still enjoys large export opportunities, especially in labour-intensive sectors such as clothing and footwear. But exploiting these opportunities requires more openness and more global integration. Abandoning export orientation is thus akin to killing the goose that lays golden eggs. Indeed, given constraints on public, corporate and household balance sheets, abandoning export orientation is akin to killing the only goose that can lay eggs.

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1.Introduction

The Covid pandemic has ravaged the Indian economy. But even as the country remains mired in crisis, discussion is turning to the medium-term and in particular to India's post-pandemic development model. In this paper, we ask what that model should be. Specifically, we ask whether India's orientation should be outward or inward.²

So far, the intellectual and policy consensus seems to favor an inward orientation. This consensus was emerging even before Covid had struck, reflected in increasing calls to *atmanirbharta* or self-reliance.

We challenge this consensus, based on new evidence. We argue that this belief is based on three main myths. The first is that India's domestic market is large and buoyant. In fact, the domestic market is still quite small, and likely to remain small over the medium-term, since domestic demand will be weighed down by heavy debts across the economic horizon—in firms, households, and the government.

The second myth is that India's growth has been driven by domestic demand, not by exports, and definitely not manufacturing exports. Our evidence illustrates the opposite, namely that for three decades a stellar export performance has played a critical role in India's overall growth.

The third myth is that India's exports prospects are dim. We show to the contrary, that India has considerable room to increase exports by increasing its market share. India has been gaining market share for several decades now, even during the difficult global conditions of the past decade. Moreover, India's past under-performance on low-skill exports creates a significant opportunity at a time when China is vacating export space in such products.

Given these conditions, we argue that an inward turn could doom India to a trajectory of mediocrity. A strategy of abandoning exports to focus on the domestic market will give up a valuable—perhaps the most valuable—opportunity for growth. And a strategy of offering protected access to India's market as a way of convincing firms to relocate their global production to India will not work. To the contrary, the big export opportunity for India—low-skill manufacturing—can only be exploited through *less* protection and *more* outward orientation because this industry is import-intensive, as China and the other successful low-skill exporters have shown.

Thus, abandoning export orientation is akin not just to killing the goose that has laid golden eggs. It is akin to killing the *only* goose that can lay eggs.

The paper is organized as follows. Section 2 describes the inward turn. Section 3 discusses and dispels the three myths underlying the inward turn. Section 4 evaluates the inward strategy and Section 5 provides brief concluding observations.

² Development is about a lot more than this question but we chose to focus on one dimension both because it is macro-economically important and because it has become a domain of intellectual and policy contestation. On another important issue, namely fixing the financial system to revive investment, a more detailed diagnosis and prescriptions are in Subramanian and Felman (2019).

2. Has India been turning Inward?

Inward and outward orientation can be assessed on a number of dimensions: macroeconomic, trade, capital flows, people, technology and data. We will restrict ourselves to the first two, where the inward turn is more pronounced. In contrast, since 2014 India has become more open to capital flows, both in the form of foreign direct investment and portfolio flows.³

A. Macro-economic

Inward orientation has become central to India's policy and intellectual discourse (Mehra, 2019). A consensus seems to be emerging that India's growth slowdown pre-Covid owed to weakening domestic demand, especially consumption.⁴ Accordingly, there has been a search for policies to revive demand, with some proposing a redistribution of income, others suggesting agricultural reforms, and still others proposing more public investment (Nagraj, 2020; Chinnoy, 2020; Ghatak et. al., 2020; Kotwal and Sen, 2020).⁵

The focus on domestic demand is not limited to short-term strategies. Many argue that this needs to be the new medium-term growth strategy. In that sense, there is a parallel with—perhaps even mimicry of—discussions in advanced economies that claim there has been secular stagnation, which can only be overcome with forceful demand-side measures such as public investment (Summers, 2016, Krugman, 2013).

The Indian debate seems also to be inspired by a resurgence in academic-cum-policy circles of the notion that in the face of demand constraints to long-run development (emphasis ours), some countries can leverage their size to boost demand and create incentives for faster growth. Most notably, there has been a rehabilitation of the Shliefer et. al. (1989) model which formalized the Big Push intuition of Rosenstein-Rodan from the 1950s.

The clearest exposition is by Goldberg and Reed (2020). As they say, “The main implication of this framework is that a minimum efficient scale – a threshold market size – is required to achieve development (if there is not enough demand, a firm adopting the increasing returns technology will not break even).” Given some positive shock to productivity/income/wealth, countries that are

³ All discretionary scrutiny of FDI was abolished, reflected in the dismantling of the Foreign Investment Promotion Board. In terms of sectoral scope, India is closer to a negative list of impermissible FDI than to a positive list of permissible FDI. Similarly, there has been a consistent opening to foreign equity and bond inflows as well as relaxation of limits on external commercial borrowings (Patel, 2020). The impact of these measures on actual gross capital inflows has been substantial. In the period before 2014, FDI averaged \$27.5 billion and total capital inflows averaged \$80 billion; thereafter FDI jumped to 42.5 billion (55% increase) and total inflows to \$133 billion (66% increase). Two exceptions to the FDI liberalization were in relation to China and to retail, the latter to favour a domestic incumbent against foreign competition from Walmart and Amazon.

⁴ One tension about this view is that it is at complete odds with the official figures which now show steadily rising and robust growth in private consumption until 2018.

⁵ Recent ideas from scholars at Azim Premji University to create urban employment guarantee schemes and from Jean Drèze for low-wage subsidies are extremely important and worthy of consideration. But they should be seen more as strengthening the social safety net and less as policies to sustainably boost growth (Abraham, et. al. 2020; Drèze, 2020). We therefore do not discuss them in this paper.

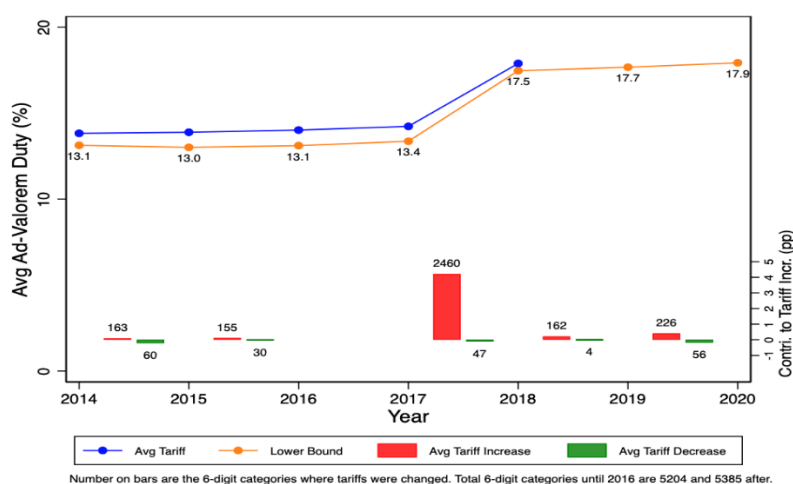
able to ensure that the results are widely shared will ensure greater consumption demand, increasing the likelihood that oligopolistic firms can attain minimum efficient scale.

B.Trade

The inward orientation on trade is discernible in actual policies. Tariffs have been raised, free trade agreements have been put on hold (and a major Asian treaty rejected), and production subsidies have been rolled out.⁶ In magnitude and scope, these steps have been carefully circumscribed. But in spirit and intent, the inward turn marks a major break with the three-decade trend of steady opening since 1991. And of course, this could only be the beginning.

The most important change has been the reversal in tariff policy (Figure 1). Between 1991 and 2014, average MFN tariffs declined from 125 percent to 13 percent (Singh 2017). Since 2014, there have been *about 3,200 tariff increases* at the HS-6 digit level (on most-favored-nation imports), a strikingly large increase.⁷ As a result, the average tariff has increased from 13 percent to nearly 18 percent. The largest increases occurred in 2018 when there were nearly 2,500 tariff increases amounting to nearly 4 percentage points.⁸ We estimate that the tariff increases affected import categories that amount to about \$300 billion or about 70 percent of total imports.⁹

Figure 1. Tariff Changes, Aggregate, 2014-2020



Source: WTO and Ministry of Commerce, Government of India

⁶ A number of China-related actions have also been taken—restricting Chinese foreign direct investment (FDI), excluding Chinese firms from bidding for government contracts, indigenizing military production and reducing military imports, delaying clearing of goods and services coming from China, and banning Chinese technology apps and platforms. This paper will not focus on these trade actions, as they are largely geo-political in intent.

⁷ The HS Classification was revised in 2017. Hence, we cannot fully compare 2017 categories with 2016 categories. Thus, the bar for the tariff changes between 2016 and 2017 is omitted. The 3200 increases in tariffs for HS6 digit lines includes the 24 increases between 2016 and 2017.

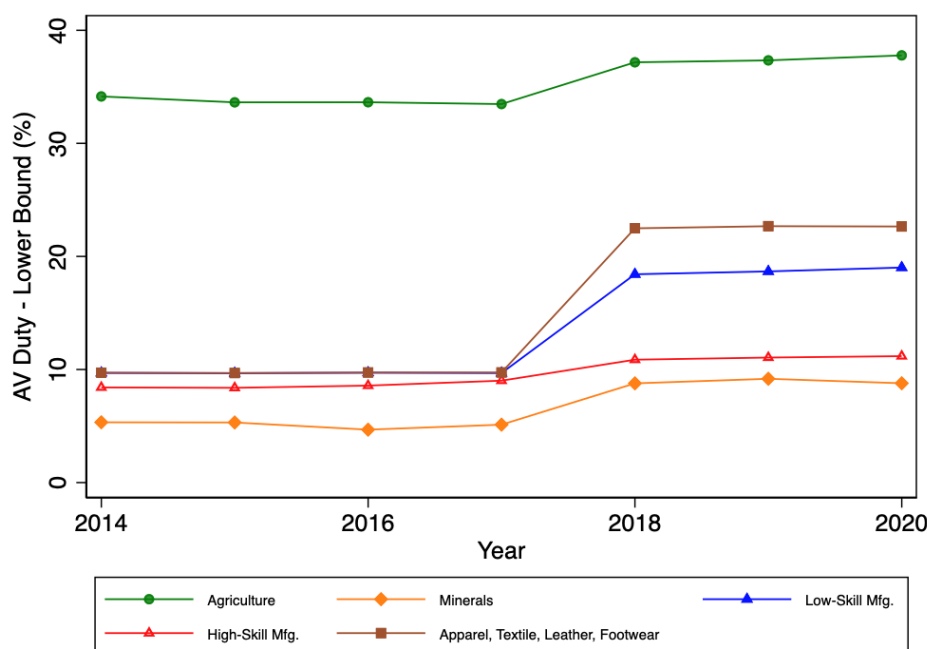
⁸ Kelkar et. al. (2020) cite the Global Trade Alert database to show that India had the highest count of protectionist actions amongst developing countries (Chart 3, <https://www.livemint.com/news/india/india-must-remain-vocal-for-global-11594822682912.html>).

⁹ \$300bn is the total imports in 2017 across all HS-6 categories where tariffs were increased between 2017—2020. Note that we cannot say how much of actual imports were affected because some came under free trade agreements but we discuss this issue below.

Figure 2 shows a sectoral breakdown of the tariff increases. In 2014, India's tariffs were highest in agriculture (about 35 percent) followed by low-skill manufacturing (10 percent) and then high-skill manufacturing (less than 10 percent).¹⁰ Since then, tariffs have been increased. Agricultural tariffs have gone up modestly, by about 3.3 percentage points. The increases on low-skill manufacturing products have been much larger, especially in apparel and footwear where tariffs have gone up by 15 percentage points. Tariffs on assembly of cell phones were increased by 20 percentage points and on electronic products by 3.6 percentage points between 2014 and 2020.¹¹

It is worth noting that tariffs have come down on some products. But even these reductions are a form of protection, since they have mostly been on inputs, which encourages firms to set up plants to assemble products domestically. Not coincidentally, input duties have been reduced on inputs for cell phones and electronic products.

Figure 2. Tariff Changes, Sectoral, 2014-2020



Source: WTO and Ministry of Commerce, Government of India

Of course, these tariff increases will not apply to imports under Free Trade Agreements (FTAs). Even so, they will have significant effects.¹² For one thing, imports under FTAs are not the same as imports from *countries* with FTAs. The reason is that many sensitive goods are excluded from

¹⁰ High and low skill sectors are defined in Chatterjee and Subramanian (2020a). Apparel, textiles, leather and footwear are the large and prominent low-skill sectors.

¹¹ Simple average of MFN duty for HS-2 digit category 85. Cell phones and electronic products are not low-skill intensive products although their final assembly might be.

¹² https://www.business-standard.com/article/economy-policy/duty-free-hits-a-fifth-of-manufacturing-imports-says-wto-report-120071201035_1.html.

these arrangements (Krishna, 2019).¹³ For these items, an increase in MFN duties is an increase in the duties on all imports of the particular item.

Even if the goods in question do enter duty-free under FTA, tariff increases still have deleterious effects. An MFN tariff increase in the presence of FTAs is like a preferential tariff increase on the rest of the world (that is, non-FTA partners). It will lead to increased imports from FTA partners—imports which by definition must be low quality or high cost, since otherwise they would have entered the country before the tariff increase. This trade diversion in favour of FTA partners will raise costs and reduce welfare.

So much for tariffs. What about other trade policies? Progress in regional integration has come to a halt. Between 2004 and 2014, India signed 11 preferential/free trade agreements. But none have been signed thereafter. The major development has been India's decision not to join the Regional Comprehensive Economic Partnership, a pact that covers nearly all Asian countries, including China, Korea, Japan and ASEAN, as well as Australia and New Zealand. Free trade negotiations with the European Union have made little progress.

Most recently, the government has announced a major initiative: production-linked incentives, PLIs. This initiative aims to give production subsidies to companies across a range of sectors: electronics and pharmaceuticals have already been announced; clothing and automotive are expected. To some extent, these subsidies are a replacement for the explicit export subsidies awarded under the MEIS (Merchandise Exports from India Scheme), which had to be eliminated because of their inconsistency with WTO rules. Production subsidies occupy a grey zone of permissibility under WTO rules but in economic impact they serve to reduce imports and/or increase exports.

PLIs have been complemented by a phased ban on military imports with a view to encouraging domestic self-sufficiency in military production in the wake of Chinese aggression in the Himalayas. The ban would cover 101 items of equipment, which roughly involve expenditures of \$10 billion per year (Shukla, 2020).¹⁴

3. Dispelling the myths

Three myths underlie India's inward turn. First, there is a growing belief that India is now so big that domestic opportunities can make up for the loss of opportunities overseas. Second, and partly following from the first myth, many believe that exports in general and exports of manufactures in particular have not been critical to India's overall economic performance. Third, there is the belief that export opportunities are in any case shrinking because the era of globalization is over in the post-Covid world. We present evidence to contest each of these myths.

¹³ For example, motor vehicles, textiles, petroleum products, sugar, wheat, vegetable oil dairy products and other food products were excluded or placed in the sensitive track for delayed liberalization in India's ASEAN FTA. If certain goods are excluded, then the question of trade diversion does not arise and tariff increases will lead to a reduction in imports.

¹⁴ https://www.business-standard.com/article/economy-policy/invoking-self-reliant-india-govt-bans-import-of-101-defence-items-120080900743_1.html.

Myth 1: Growth can be based on the domestic market because it is big

Since 2014, the Prime Minister has spoken often of India's advantageous three Ds: demography, demand and democracy. The invocation of the first two Ds reflects a conviction that India's domestic market size can be the basis for long-run growth.

This is a new idea. Circa 1980, import substitution always came with the caveat that even (or especially) if the strategy worked, it would soon exhaust itself. After all, domestic supply could not expand that much when domestic demand was so small.

Four decades of rapid growth later, there is a belief that India is a now large market, with a middle class endowed with considerable purchasing power. Metrics such as the number of Facebook users or telecommunications subscribers, running into hundreds of millions, occasionally billions, only serve to reinforce this belief.¹⁵

Underlying the India-is-big view are three claims. First, a large domestic market increases the scope for import substitution: when domestic demand is large, it makes sense for firms to set up factories in India, rather than supply from abroad.

Second, it makes sense to use India as a global export base, since the large population means that there is a large labour force that can be tapped. In particular, India's large population, combined with financial assistance (zero input tariffs, production and other subsidies), could lure firms that are now exiting China for geo-political reasons. After all, India is the only other country in the world with a population size comparable to China.

Third, with a large market, India—like the US and China—can create national champions in the new technology and technology-intensive sectors. This can be done through restricting competition, domestic and foreign, as well as through domestic regulatory assistance.

So, how big is India as a market for consumption? The answer is sobering, illustrating how population size can obscure market realities. Table 1 below provides some rough comparisons with China and the rest of the world. It shows that the Indian market is smaller than commonly believed. The “true” market is:

- a fraction of the headline GDP number, somewhere between 15 and 45 percent of GDP
- much smaller than China's, roughly 15-20 percent of China's true market size; and
- a tiny 1½-5 percent of the global market.

¹⁵ A recent exposition of this view is by respected banker and former government-appointed head of the BRICs bank, K.V. Kamath: “India and China have had very different growth paths, he said, adding that the neighbour to the east expanded into exports because they didn't have a big enough domestic market for the goods. India, the world's second-most populous country, will likely focus on the ‘Atmanirabhar Bharat’ plan championed by the government. That, according to Kamath, will benefit India's economy and balance of account.” (<https://www.bloomberquint.com/economy-finance/indian-banking-system-in-a-much-better-place-than-earlier-says-kv-kamath>.)

Several factors explain this result: India has a large population of relatively poor people, who don't consume (much) middle-class goods; while the smaller group of high earners have high saving rates, reducing their consumption.

Table 1. Rough Estimates of “Middle Class” Market Size: India, China and World, 2019

	India		China	
GDP (\$ trn.)	2.9		14.3	
<i>Definition of middle-class</i>	<i>Middle-class 1</i> (cut-off is Rs. 3200 per month or \$5.5 PPP per day)	<i>Middle-class 2</i> (cut-off is Rs. 8550 per month or \$5.5 PPP per day)	<i>Middle-class 1</i> (cut-off is Rs. 3200 per month or \$5.5 PPP per day)	<i>Middle-class 2</i> (cut-off is Rs. 8550 per month or \$5.5 PPP per day)
Population share	Moderate (~15 percent)	Tiny (~1-2 percent)	Large (~75 percent)	Reasonable (~25 percent)
Income share	Large (65-75 percent)	Moderate (~25 percent)	Very large (~90 percent)	Large (~50-60 percent)
Estimated “middle class” market size (\$ trn.)	1-1.3	~0.5	~6.5	3.5-4.5
Memorandum Item World trade (\$ trn.)	~26			

Population share estimates are based on World Bank (2016), Lakner and Milanovic (2016) and PovcalNet; Income share estimates are based on World Inequality Database; market consumption estimates assume savings rate of 40 percent for India and 50 percent for China.

The first row shows the 2019 GDP in dollars for India and China. The obvious point is that India's market size is reasonably big (fifth in the world) but still only one-fifth the size of China's.

But as a gauge of a “middle class” consumer market, overall GDP is misleading. We need to make three adjustments. The first is to realize that there is a large population with limited purchasing power. Data from Lanker and Milanovic (2016) allows us to get a rough estimate of the population share that commands decent purchasing power. We employ two definitions of “middle class”, the population that spends more than:

- \$15 per day per person (roughly Rs. 8550 per month at purchasing power parity, or PPP); or
- \$5.5 per day (roughly Rs. 3200 per month at PPP).¹⁶

The Lakner and Milanovic data suggests that between 1 and 2 percent of Indian population share falls into the former category (in 2011) and about 12-15 percent falls into the latter category. For China, these numbers are substantially bigger.

We next need to ask how much income these populations command. Now, a key point is that we cannot get these numbers from consumption surveys because as documented first by Banerjee and Piketty (2005), consumption surveys do not capture a lot of the top incomes, almost 40 percent of

¹⁶ This corresponds roughly to the median purchasing power estimated in Ghatak et. al. (2020).

the total. So, we turn to the world inequality data base, which provides data (better not perfect) on income shares by population groups. This allows us to approximate the incomes of the “middle class”, according to the two definitions.

Finally, we need to convert middle class incomes into consumption because better-off groups tend to be high savers (Ghatak et. al. 2020), ranging from 35-50 percent for the top three deciles of the population.

Based on all these calculations, we get estimates for market size for India and China. These numbers are by no means definitive, but the broad orders of magnitude are still revealing. They show that—contrary to popular belief—India’s real market size is modest, much smaller than China’s, and substantially smaller than the potential global market which we equate with world trade because that is the potential market that Indian firms and producers can compete for.

Admittedly, these calculations are based on a number of assumptions. But one can make a straightforward cross-check, by examining China’s growth strategy when it was at a similar stage of development as India today. That would be in the early 2000s, when China’s GDP was also around \$3 trillion. And what strategy did China embrace at that point? It considered that its domestic market was too small, and that the real opportunities lay overseas. So, it joined the WTO and embarked on the biggest export binge the world has ever seen.

Myth 2: India’s growth has not been driven by exports and certainly not manufacturing exports

Normally, it is failure that is an intellectual orphan. In contrast, India’s may be making an orphan of spectacular success. In part, this is occurring because this success is not well known. In fact, for the three decades since the early 1990s India has been an exemplar of export-led growth, not only in services but also in manufacturing. Its export growth has been positively East Asian Tiger-esque, which in turn has driven and/or sustained high GDP growth.

Figure 3a. Export growth of Goods and Services 1995-2018

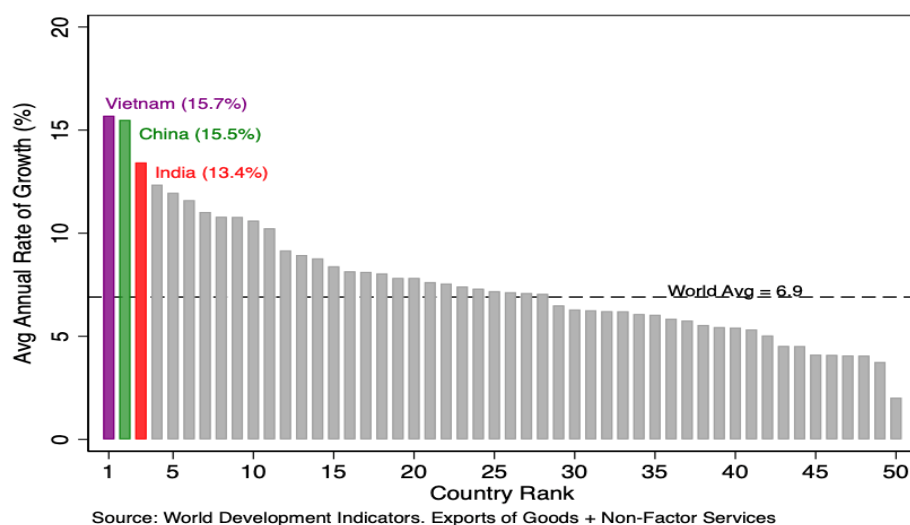
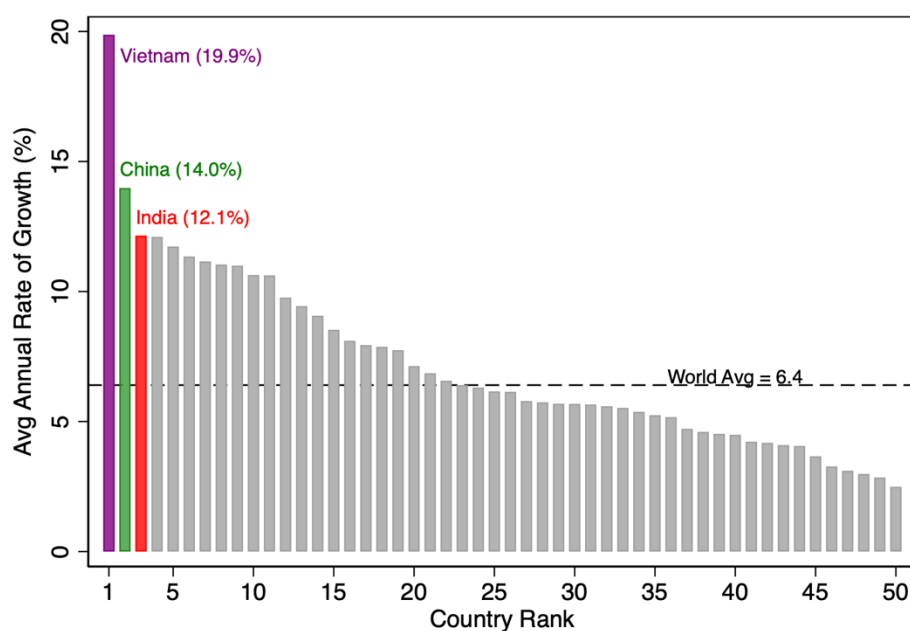


Figure 3b. Exports growth of Manufactured Goods 1995-2018



Source: BACI dataset, CEPII

Source: Chatterjee and Subramanian (2020a)

Between 1995 and 2018, India's overall export growth (in dollars) has averaged 13.4 percent annually, the third best performance in the world amongst the top 50 exporters, nearly twice the world average growth (Figure 3a) and not far behind China's growth of just over 15 percent.

Table 2. Contribution to Growth of “Exogenous” Demand Components

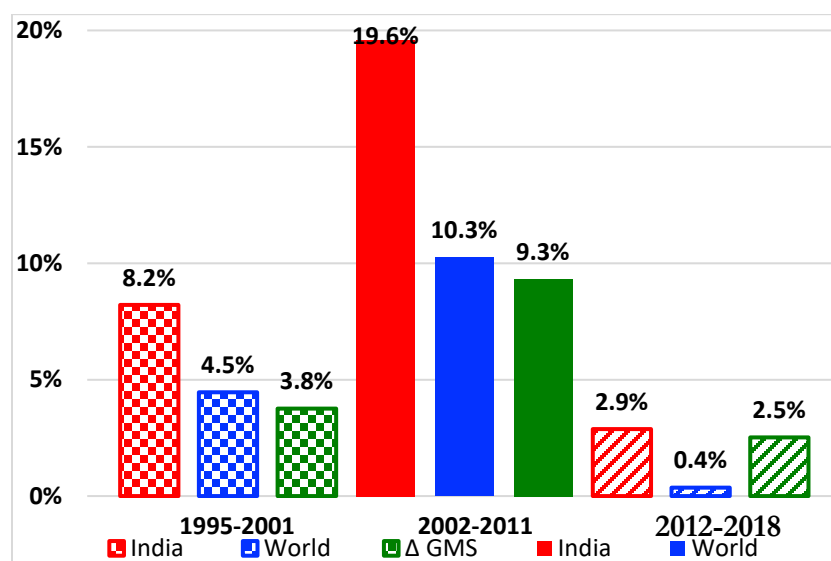
Period	Government consumption	Investment	Exports		Government consumption	Investment	Exports
	percentage points				share of total		
1992-2001	0.77	1.55	0.79		25%	50%	25%
2002-2011	0.90	3.14	1.94		15%	52%	32%
2012-2018	0.66	0.73	0.73		31%	35%	34%

Source: Chatterjee and Subramanian (2002a).

Moreover, this is not just because India is a services export powerhouse but also because it is a successful exporter of manufacturing products. Over the same period, India's manufacturing exports (in dollars)—long considered to be the country's Achilles' Heel—grew on average by 12.1 percent, nearly twice the world average (Figure 3b). This was the third-best performance in the world, surpassed only by China and Vietnam.

These exports have made a substantial contribution to GDP growth. In each of the three decades since the 1990s, exports have accounted for about one-third of “exogenous” aggregate demand (Table 2).¹⁷ Admittedly, India’s export growth has slowed in recent years, as global trade and growth collapsed (Figure 4). Even so, India has continued to gain global market share, suggesting that the domestic productivity performance has remained reasonable. For example, post-2012, world exports were virtually flat and yet India’s exports grew by about 3 percent. This was true in both manufacturing and services. In fact, during this period, India’s manufacturing export growth ranked within the top 10 (amongst the 50 major exporters).

Figure 4. Export Growth Decomposed into World Growth and Excess over World Growth



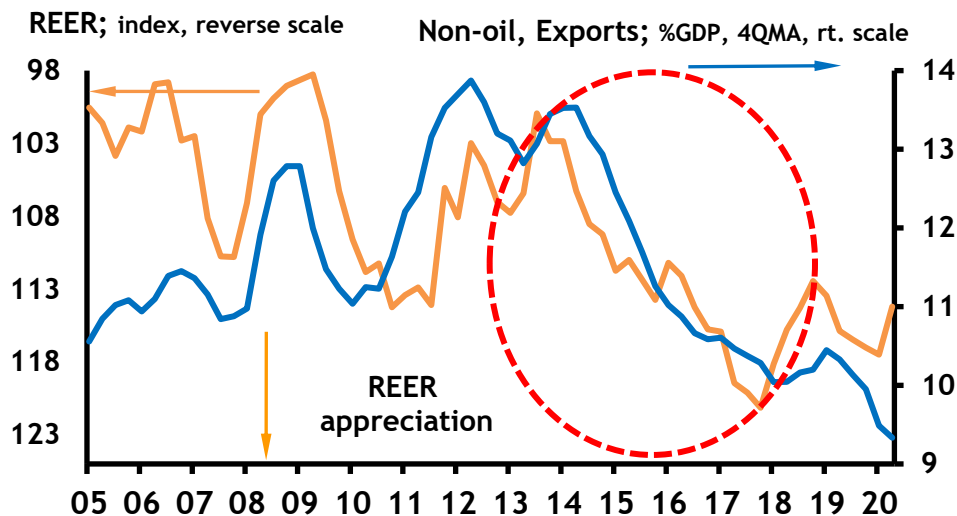
Remarkably, this achievement occurred in the face of several anti-export developments:

- Pre-GFC, pharmaceutical exports performed well based on exports of generics to the US but afterwards their reputational advantage was undermined by the exposure of malfeasance fraud at some Indian pharmaceutical manufacturers.
- Minerals (especially exports of iron ores) did well pre-2014 because of Chinese growth and lax regulatory policy. Once the Supreme Court forced a tightening of regulations, mineral exports declined.
- Social policy—on livestock—also changed post-2014 because of more zealous enforcement of the ban on beef, contributing to the decline in agricultural exports.

¹⁷ We do not include consumption for two reasons: the pragmatic one is that the mismeasurement in GDP affects consumption, especially for the last two decades, and hence misleading for analysis (see Appendix 4 in Chatterjee and Subramanian, 2002a). The more conceptual reason is that consumption is likely to be more endogenous to income than the other demand correlates, although supply factors could be driving all these correlates.

- Perhaps most importantly, the real effective exchange rate appreciated by about 20 percent, worsening non-oil export growth and the non-oil current account balance (Figure 5; Chinnoy and Jain, 2018).¹⁸

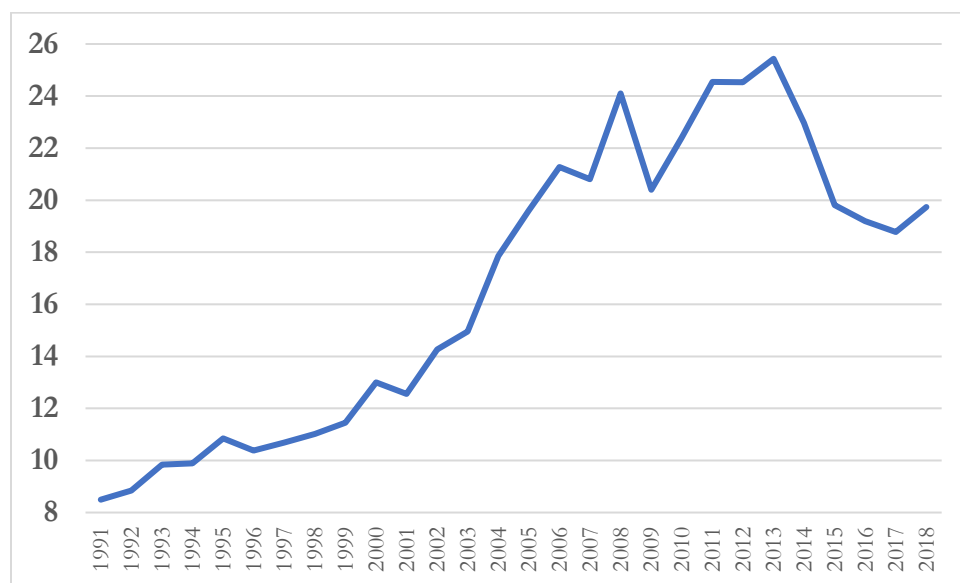
Figure 5. Real Effective Exchange Rate (REER) and Non-Oil Exports, 2005-2020



Source: Chinnoy and Jain, 2018 (updated)

Despite these setbacks, and unfavourable global conditions over the past decade, India's export-GDP ratio remains a substantial 20 percent, more than twice as high as in the early 1990s (Figure 6).

Figure 6: Ratio of Exports of Goods and Services to GDP, 1991-2018 (in percent)



¹⁸ The strong correlation between non-oil exports and the real exchange rate is also true for the non-oil current account balance and the real exchange rate. And, as Figure 5 shows, the correlation holds for earlier periods as well.

This has significant consequences for India's growth outlook. For example, if export growth slows by 5 percentage points, this will shave 1 percent in overall GDP growth.

In other words, abandoning the export (outward orientation) model is akin to killing the goose that lays the golden eggs.

Myth 3: Export-led growth is not possible in the post-Covid world

Some advocates of inward orientation argue that even if India's exports have done well in the past, the future is going to be different. In particular, export growth will inevitably be slow in a post-Covid world. After all, global export growth decelerated from 15 percent to 5 percent after the GFC, and things will surely become worse post-COVID as countries consider the risks arising from dependence on imports, at least for essential commodities such as food and medicines. At the same time, domestic export capability has diminished, as shown by India's inability to take advantage of the big opportunity created by China's vacating of export space over the past decade. Thus, supply and demand considerations support turning inward to find our own market to support our growth.

This pessimism is the modern-day counterpart of the Prebisch-Singer hypothesis and also the pessimism (now forgotten) in the 1980s about whether other countries could imitate the successful export strategy of Japan and then of the East Asian Tigers (Reidel, 1984).

We analyze this new-style export pessimism in three parts, arguing that:

- Deglobalisation is not inevitable; structural changes could actually boost demand for tradable services;
- even if overall global imports of goods grows slowly, India is small enough to gain market share, thereby maintaining high rates of export growth; and
- in particular, there is enormous potential to increase unskilled labor exports, which India is vastly under-exploiting.

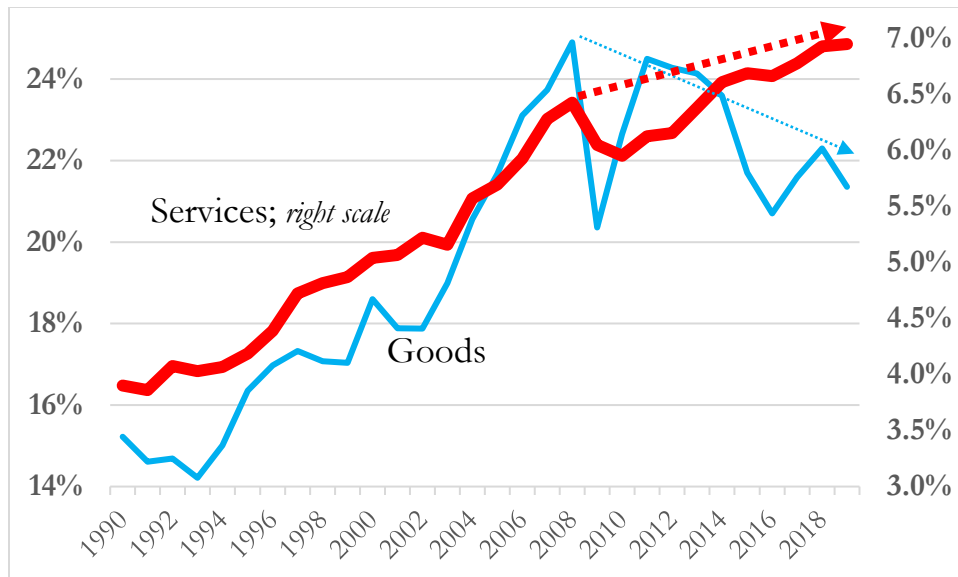
A. India-friendly upside to globalization post-Covid

The reports of globalisation's demise have been greatly exaggerated. It is true that world exports of goods have declined to about 21 percent of world GDP from about 25 percent prior to the GFC (Figure 6). But world exports of *services* have continued to increase, rising to about 7 percent of global GDP from 6.5 percent prior to the GFC. In other words, the globalization of services is continuing.

What are the prospects for services exports post-Covid? Quite possibly, the trend might actually accelerate. After all, the pandemic is encouraging activities that can be done at a distance, as opposed to those that require physical contact. For example, physical shops are being replaced by websites—which could be designed and serviced in India. Similarly, if firms in the West are going to allow employees to work permanently from home, these employees could just as easily—and more cheaply—be located in India.

If there is a renewed impetus to globalize service provision, it would represent—or rather continue to represent—a big opportunity for India. After all, India has a clear revealed comparative advantage in this area: its services exports have grown faster than world exports by an average of 9 percentage points every year, resulting in substantial gains in global market share.

Figure 7. Globalization of Goods and Services, 1990-2019
(share of world exports of goods and services, respectively in global GDP)



India might even benefit from post-Covid trends in the production of goods. The pandemic has highlighted the risks of depending entirely on one country for provisions of key goods; in the future, there will be a concerted effort to diversify the sources of supply. And India could be a major beneficiary of this search for new, low-cost suppliers.

B. Gaining market share even in a deglobalizing world

But even on the assumption that globalization in goods comes to a halt post-Covid, the export outlook would still remain far from bleak—because India could continue to gain market share. Often, this possibility is dismissed, on the grounds that: “yes, Vietnam could do it but India is not Vietnam; it is too big.” But in this argument is not well-founded. In fact, India is not a big exporter on the global scale; its share of global manufacturing exports is only 1.7 percent, marginally less than Vietnam’s at 1.75 percent (Table 3). So on the relevant metric India is *not* big, compared to Vietnam.

So, let’s consider an extreme scenario. Suppose pessimistically that over the next 10 years world real export growth is just 2 percent per year, while India’s export growth is 8 percent. What would this imply for India’s market share? Would this increase be politically feasible?

Table 3. India's Impact on Global Exports and Export-GDP ratio: An Extreme Scenario 1/
(percentage points)

Gain in India's global export market share	1.3
Increase in global export-GDP ratio on account of India's gain 2/	0.3

Source: Authors' calculations.

1/ India's manufacturing exports grow by 8 percent every year and world exports by 2 percent

2/ Assuming global export-GDP ratio in manufacturing of 25 percent.

Under the scenario, India's global market share would increase to a still-modest 3 percent, an increase of merely 1.3 percentage points over a decade (Table 3, first row). Just to place this increase in perspective, over the span of just three years—from 2015 to 2018—China ceded export space of nearly 1 percentage point in low-skill labour exports.

But let's become even more pessimistic and assume that China and other countries don't actually cede any more export space over the next decade. In that case, India's rapid export growth would push up the global export-GDP ratio. If the world's appetite for globalization can be proxied by this indicator, then the estimate in the second row is a rough measure of how much India's performance will then test the world's carrying capacity for globalization. The answer is not much. Even if India's exports grow four times as fast as world exports, India's increased exports will only account for about 0.3 percent of world GDP.

Put another way, rapid Indian export growth would not seriously test the capacity of the global system. This is one of the advantages of past under-performance: the future can be more accommodating to India and less intimidating for the world.

In other words, the global environment is not as forbidding as it appears on first blush. But where is the specific opportunity?

C. India's big unexploited opportunity of unskilled labor exports

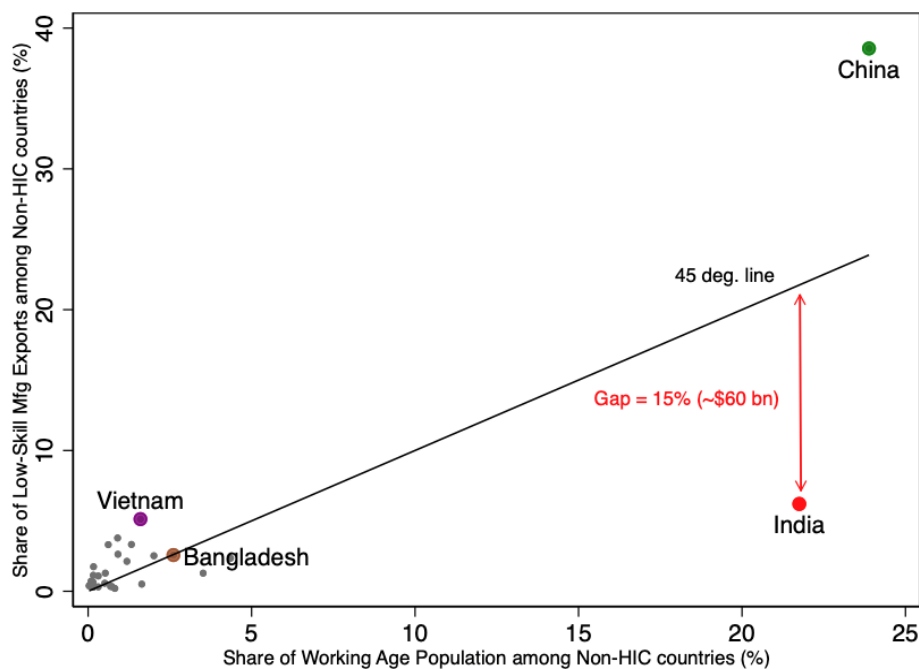
Consider Figure 8 below from Chatterjee and Subramanian (2020a). It shows, on the y-axis, a country's share of global exports of low-skilled exports, and on the x-axis, its share of global unskilled labor force. We expect that countries should line up roughly along the 45-degree line so that outcomes--the share in the unskilled manufacturing exports--is close to endowments, the share in labor force.

The results are striking. China and India are stark outliers but in the opposite direction. India's share of global labor force far exceeds its share of low-skill exports. For China, it is exactly the reverse. India's share of global low-skilled exports is about 15 percentage points less than its share of the labor force. The implication is that India is exporting about \$60 billion of low-skill exports annually less than it should be. Ideally, we should be calculating how much of the underlying production of unskilled activities is falling short because trade theory suggests that endowments should match production not necessarily exports. We don't have cross-country data on production

of unskilled sectors but we do have it for a key sector, textiles and clothing. For this sector, we estimate that India should be producing an extra \$140 billion in these sectors, amounting to about 5 percent of GDP.

There are, of course, two ways to look at this finding. On the one hand, it is an indictment of past performance. On the other, it is also an indicator of potential future opportunity if the underlying problems are addressed.

Figure 8. Labor Endowment and performance in low-skill exports of developing countries in 2018



This is not just a theoretical opportunity. It is a very real one, since China is currently vacating the low-skill export space, creating a large opening for India. Consider Table 3 from Chatterjee and Subramanian (2020b). The table shows that post-GFC, China vacated about \$140 billion in exports in unskilled-labor intensive sectors, including apparel, clothing, leather and footwear. India did not take

Table 4. Major Beneficiaries of China's Loss in Global Market Share 1/

Sector	Chinese Loss in Global Market Share	Top 3 Gainers	Increase in Market Share	India's gain in Global Market Share
Footwear	7.5%	Vietnam	5.9%	0.1%
		Germany	1.4%	
		Belgium	0.7%	
Ceramics	6.0%	Spain	1.2%	1.0%
		Italy	1.1%	
		India	1.0%	
Apparel	5.8%	Vietnam	2.9%	0.2%
		Bangladesh	2.8%	
		Spain	0.7%	
Leather	3.4%	Vietnam	2.5%	0.2%
		Italy	1.6%	
		France	1.5%	
Iron and Steel	2.7%	India	0.4%	0.4%
		Belgium	0.3%	
		Indonesia	0.3%	
Pearls, Gems, etc.	2.3%	India	3.5%	3.5%
		Israel	1.1%	
		United States	1.0%	
Furniture	2.2%	Poland	0.9%	0.1%
		Vietnam	0.8%	
		Czech Republic	0.4%	

1/ China's loss is measured as the difference between the peak market share (post-GFC) and the average of the share in the last three years

advantage of the first China opportunity post-GFC, created by China's organic process of becoming richer and hence less competitive in unskilled labour intensive activities. Now, post-Covid a second opportunity stemming from geo-politics has been created and that is India's big prize waiting to be seized.

A final reason for not succumbing to export pessimism also relates to China. If China as producer can contribute by vacating export space, China as consumer could become a bigger market for low-skill consumer goods. In effect, China would do for poorer countries what the West did for China—providing a ready market for its goods. This, of course, would require China to become more open and less protectionist at least for low-skill goods.

Is there any guarantee that any of these factors will actually lead to export success for India? Of course, not. India will still have to do the hard work of creating the conditions for firms to compete effectively in global markets. But the export opportunities are there.

4. Evaluating the twin prescriptions

Next, consider the twin policy recommendations: domestic demand over exports; and protectionism over freer trade. Before we turn to the Indian situation, it is worth emphasizing the two deeper advantages of export orientation and one piece of historical evidence.

First, foreign demand will always be bigger than domestic demand for any country. Second, there is a fundamental asymmetry in that if domestic producers are competitive internationally, they will be competitive domestically and domestic consumption will also benefit. The reverse is not true: being competitive only domestically is no guarantee of efficiency and low cost. On history, there is no known model of domestic demand or consumption-led growth, anywhere or at any time, that has delivered sustained and high (say 8 plus) rates of economic growth. Some advanced countries (US, for example) did achieve success based on the domestic market but they averaged growth rates of about 3 percent over 100-150 years. No developing country success after World War II with growth rates over 6 percent has been based on domestic demand.

Before we discuss the prescriptions, a clarification on other prescriptions is necessary. Several contributions have been made on the need to revive agriculture (Ghatak, Kotwal and Ramaswamy, 2020; and Kotwal and Sen, 2018), create an urban-type MNREGA (Abraham, et. al. 2020; Drèze, 2020) and create a new social contract (Kapur and Subramanian, 2020). These are all desirable changes that need to be considered.¹⁹ But they are strictly orthogonal to the question of whether India should prioritize domestic demand over exports as a medium-term growth strategy.

A. Killing the goose that lays golden eggs but also killing the only goose that can lay eggs

The advocates of India's inward turn argue that domestic demand can propel rapid growth. Without doubt, there will be some normalization of spending as the lockdowns ease, which will allow a modest recovery. But domestic demand is unlikely to provide much impetus for growth over the medium term, since nearly all public and private sector balance sheets are bleeding. Only growth can rehabilitate balance sheets; stressing balance sheets further cannot realistically revive growth. Consider the key elements:

- Investment will be constrained, because after the long lockdown most firms aren't in any financial position to embark on new projects, while those that are financially strong will find it difficult to secure funding because the banking system is struggling under the weight of large nonperforming assets (Subramanian and Felman, 2019; Patel, 2020). The climate for risk-taking has also been seriously undermined given the concerns about the hyper-activism of India's investigative agencies (the famous 4 Cs: Courts, CBI, CVC and CAG).

20

¹⁹ A different policy implication drawn by Ghatak, Kotwal and Ramaswami (2020) is to bias growth (on the supply side) in favour of those who have greater propensities to consume. An agricultural push, because it raises incomes of those that are relatively poor, potentially increases demand for the kinds of manufacturing goods where scale might matter. But nothing about this argument prevents a push on construction which is highly unskilled labor intensive (see Amirapu and Subramanian, 2015); or even on unskilled labour intensive manufacturing and exports. And nothing about this argument warrants protectionism that would raise costs and incentivize inefficiency.

²⁰ There has been a gradual change in this 4Cs problem. Until recently, the problem was that these investigative institutions were using their institutional independence (in the context of a weak executive) to act as unaccountable vigilantes that exerted a chilling effect on public sector decision-making. Now they have become instruments of the

- Consumption going forward will be limited by the fact that household debt has grown rapidly in the last few years (Chinnoy, 2020). Most importantly, consumption will thus depend on income, not the other way around.
- Government spending will be severely circumscribed over the medium-term. Already this year the pandemic has pushed the overall deficit (centre and states) well into the double-digit range, while propelling debt from about 70 percent of GDP to about 85-90 percent. And while the deficit will surely narrow as the economy recovers, it may not narrow enough to halt the rise in debt.

It is worth considering this point in some detail. India's intellectuals have asked why India can't pursue expansionary fiscal policy when advanced countries are doing so (Blanchard, 2020). The answer is straightforward: because India is in a very different position from advanced countries. In advanced countries, interest rates are essentially zero. But in India interest rates on government securities are around 6 percent, partly because of persistent inflation, partly because India's borrowing is considered risky by investors, reflected in ratings that hover close to sub-investment.

This difference between India and the West matters because the interest rate-growth differential is the key to fiscal sustainability. If interest rates are low, the government debt/GDP ratio is likely to fall, since GDP growth will increase the denominator, while new borrowing will have little impact on interest payments, and hence on deficits and debt. This favorable dynamic will not be operating in India's case, so it needs to be much more careful about borrowing—especially as further increases in its debt ratio could prompt a ratings downgrade, which would further increase interest rates.

Given the poor prospects for domestic demand, the real question not the best way to stimulate the economy. Rather, it is whether India can find a way to export its way out of the pandemic crisis. It is worth pointing out that East Asian countries in the aftermath of the Asian Financial Crisis in the late 1990s confronted a similar situation of weak economy-wide balance sheets. And how did they respond? They doubled down and exported their way out of that crisis.

B. Will protectionism work as an effective export strategy this time?

Some advocates of protectionism argue that their strategy will actually promote exports. In their view, offers of protectionism can lure firms to relocate to India, which they will then use as a production base for their exports.

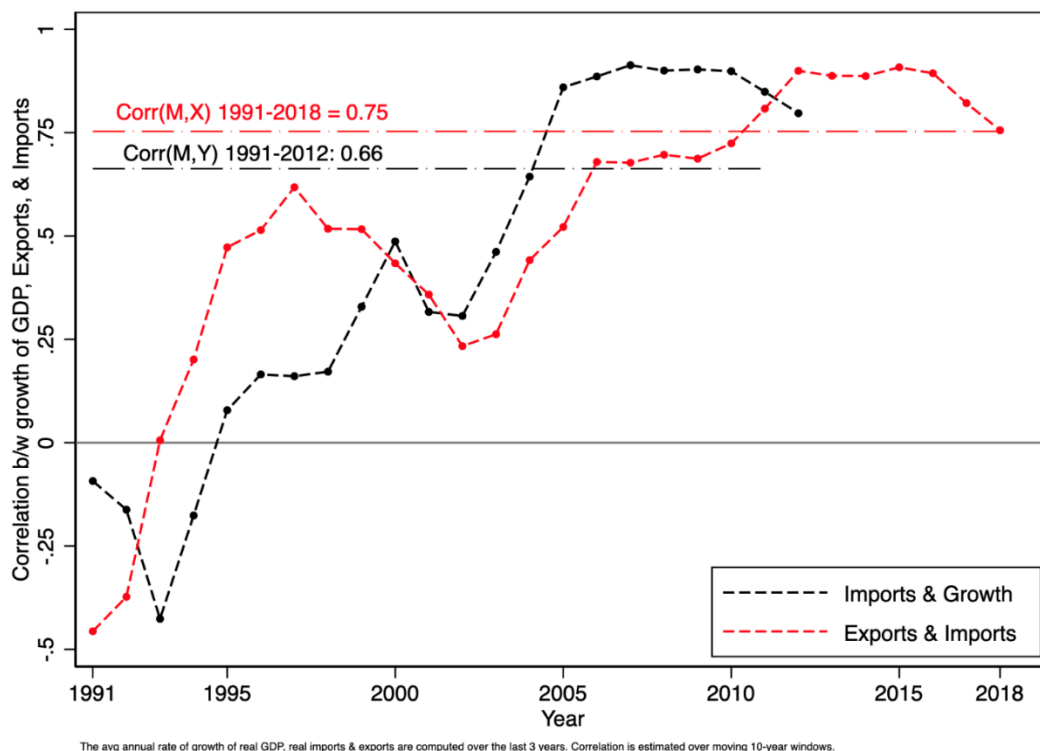
At one level, the strategy seems plausible. But India's history suggests otherwise. Export performance was weak under the protectionist license-quota-raj (Krueger, 1978; Bhagwati and Srinivasan, 1994). But after the economy was liberalized, exports boomed, as we show in Chatterjee and Subramanian (2020a). Real export growth of goods and services averaged close to 11 percent between 1992 and 2019, more than double the 4.5 percent rate recorded between 1952

government and as a result their targets are more politically decided. The recent example of a privatization transaction being re-opened by a state high court against a former minister and critic of the government is a case in point.

and 1991. And overall GDP growth rates were 6.5 percent and 3.5 percent, respectively in these two periods.

The association of India's export boom with liberalization is not just a coincidence. India's exports have required imports to sustain them. Figure 9 shows that exports have been highly correlated with imports (correlation co-efficient of 0.75). Figure 9 also shows that growth has been highly correlated with imports, suggesting that openness is needed for growth.

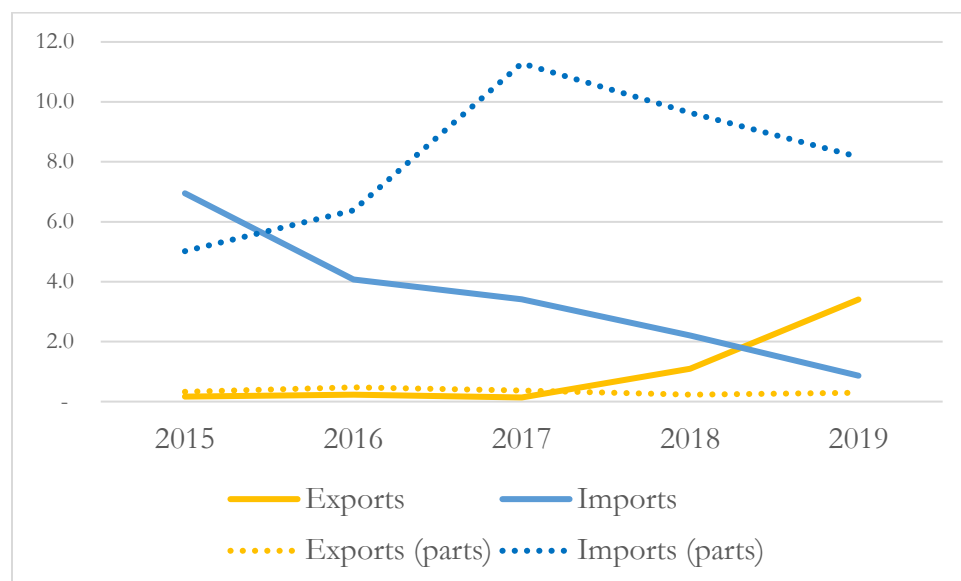
Figure 9. Correlation between India's exports and imports, 1980-2018



Of course, advocates of protectionism argue that this time is different. They point in particular to some encouraging results in the cellphone market. The government has been encouraging domestic assembly of cellphones with the hope that over time, India can become globally competitive not only in the production of cellphones but more importantly in the production of the more technologically sophisticated components. Accordingly, tariffs on cellphones have been increased from zero to 20 percent while tariffs on components have been reduced. In addition, India recently announced a slew of production-linked incentives, leading 22 firms to apply (so far) for the scheme, which will entail some export obligation.

While it is too early to judge the success of these measures, it is useful to look at the early evidence from trade data. The figure below presents data on exports and imports of cellphones (HS 6-digit code 851712) and of components (HS 6-digit code 851770). They show that imports of cellphone

Figure 10. Exports and Imports of Cellphones and Components, 2015-2019 (\$, bn.)



components have doubled from \$5 billion in 2015 to an average of \$10 billion in the last two years, while imports of cellphones have collapsed from nearly \$7 billion to less than a billion in 2019. Therefore, there is some evidence of import substitution. There is also some evidence that exports of cellphones have increased, though exports of parts have not.

It is too early to draw firm conclusions. After all, protectionism raises costs and incentivizes inefficiency. Whether the government has the ability to credibly ensure that firms over time will become efficient and start exporting on a large scale is an open question. And it is not obvious what will happen to production when the incentives end. But even if this experience turns out to be a success, the more important question is whether it can work more broadly.

The problem is that the cellphone market is special, in that India's domestic market for basic cellphones is exceptionally large, giving firms a large incentive to manufacture domestically. But what is true for this sub-sector is not true at an economy-wide level. As noted above, India's domestic market is quite small in a global context. Indeed, even for China whose domestic market is several times larger than India's, foreign demand is twice domestic demand in the IT and electronics sector (OECD, 2015).

More to the point, as noted in Section 3, India's great unexploited export opportunity lies in low skill manufacturing: apparel, clothing, leather, and footwear (Figure 8). This is where China is rapidly ceding space, as Table 4 showed. But boosting these exports cannot be done through protectionism. To the contrary, it requires opening up further, so that India can integrate itself into the global value chains that characterize these industries. In short, it requires doing a China.

Consider clothing and leather. In this section, openness is not a luxury but an existential necessity, since there are so many parts and components which need to come from so many different sources. One rough indicator of the importance of foreign inputs in these sectors is given by the foreign value-added component in exports. India's import share is about 16 percent. In contrast, when

China and Vietnam were starting their export boom in textiles and clothing their foreign shares exceeded 40 percent.²¹ Clearly, then, achieving Chinese and Vietnamese levels of success will require much greater openness.

Table 5. Foreign Value Added in Textiles and Clothing

<i>Country</i>	<i>Percent of Foreign Value Added</i>
China (1995)	>40
Vietnam (2015)	46.1
India (2015)	16.4

Sources: OECD (https://www.oecd.org/sti/ind/tiva/CN_2015_China.pdf) for China; WTO (https://www.wto.org/english/res_e/statis_e/miwi_e/VN_e.pdf) and https://www.wto.org/english/res_e/statis_e/miwi_e/IN_e.pdf) for Vietnam and India, respectively

One can be more specific. In the case of clothing, several market-opening measures will be needed:

- Most important would be to eliminate tariffs on all inputs, especially the long-standing tariff on man-made yarn, since man-made fiber-based exports (not cotton-based apparel) are the most dynamic segment of world exports.
- Free trade agreements would need to be signed with Europe, which still imposes duties on India's clothing exports of close to 10 percent, disadvantaging India relative to Bangladeshi and Vietnamese exports (Economic Survey, 2017). But Europe will only be willing to sign such an agreement if India is willing to open its other markets (for example, automobiles).
- There needs to be a genuine easing of the costs of trading and doing business in India.

5. Concluding observations

India is turning inward: policymakers are focusing on domestic demand, while trade restrictions are increasing, reversing a 3-decade trend. This policy shift is based on a certain diagnosis of the economic situation: that India's domestic market is large and dynamic; that exports have not played much of a role in India's growth; and that in any case export prospects going forward are poor.

The problem is that the diagnosis is wrong: all of these claims are myths. In fact, India's real market size, defined as consumers with a modicum of purchasing power is not big. It is much smaller than the headline GDP number, much smaller than China's, and only a small fraction of the world market. The reason is that India has many poor consumers, while the rich tend to be large savers, limiting their consumption.

²¹ In the case of China, nearly 90 percent of intermediate imports of textiles and clothing are embedded in exports. Today, China's dependence on imports have declined but after it has achieved success. These import dependence numbers are much greater in IT and electronics, suggesting that even in those sectors greater openness will be required.

Partly for this reason, exports have been a crucial component of India's growth story. Since 1991, exports of services and manufacturing have grown rapidly, making India the third-best performer in the entire world.

Similarly, the prognosis that export prospects are dim because the world is deglobalizing is overly pessimistic. To begin with, it is unclear whether the world is really deglobalizing, at least in services. And even if it is, India's export share is so small—even smaller than Vietnam in manufacturing exports—that its exports could grow rapidly by gaining market share. In particular, India has major unexploited opportunities in low-skill manufacturing and services, which it could exploit in the post-Covid environment where firms are looking to exit China and diversify their sources of supply.

In these circumstances, the call to turn inward is highly problematic. Domestic demand-led growth looks like a recipe for mediocre growth given the parlous state of public and financial sector balance sheets: the former will limit government spending and the latter will impede private investment.

Meanwhile, protectionism is unlikely to succeed as an export strategy because exploiting the big opportunities in the key labour-intensive sectors requires more openness and more global integration, as the experience of China and Vietnam have shown.

The conclusion is clear. Resisting the misleading allure of the domestic market, India should zealously boost export performance and deploy all means to achieve that. Pursuing rapid export growth in manufacturing and services should be an obsession with self-evident justification. Abandoning export orientation will amount to killing the goose that lays golden eggs and indeed to killing the only goose laying eggs. Alas, to embrace *atmanirbharta* is to choose to condemn the Indian economy to mediocrity.

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