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Economic Bulletin
January 2005

Volume III, Number 1

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India Resident Mission

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India: Key Economic Indicators

Variables	Unit	Reporting Date	Current	Percentage Change ¹
GDP at Factor Cost (1993-94 prices)	Rs. Billion	April-September 2004	6,994	7.0
● GDP in Agriculture	Rs. Billion	April-September 2004	1,321	1.5
● GDP in Industry	Rs. Billion	April-September 2004	1,971	7.5
● GDP in Services	Rs. Billion	April-September 2004	3,702	8.8
Industrial Production – General (1993-94=100)	Index	April-December 2004	199.4	8.4
Industrial Production – Manufacturing (1993-94=100)	Index	April-December 2004	208.5	9.0
Wholesale Price – All Commodities (1993-94=100)	Index	April-December 2004	186.7	6.9
● Primary Articles	Index	April-December 2004	189.5	4.5
● Manufactured Articles	Index	April-December 2004	165.6	6.7
Consumer Price (Industrial Worker) (1982-83=100)	Index	April-December 2004	517.6	3.7
Broad Money (M3)	Rs. Billion	24 December 2004	21,515	13.1
RBI's Credit to Commercial Sector	Rs. Billion	24 December 2004	18.9	-9.2
RBI's Credit to General Government	Rs. Billion	24 December 2004	47.7	-90.6
Consolidated Fiscal Deficit / GDP	Per cent	FY2003	9.4	-
Domestic Public Debt	Rs. Billion	FY2003	21,252	13.6
Exports	\$ Billion	April-September 2004	34.5	23.2
Imports	\$ Billion	April-September 2004	51.9	39.0
Trade Balance / GDP	Per cent	April-September 2004	-5.5	-
Current Account Balance / GDP	Per cent	April-September 2004	-1.0	-
International Reserves	\$ Billion	31 December 2004	125.2	27.9
External Debt	\$ Billion	end-September 2004	113.6	0.8
External Debt to GDP Ratio	Per cent	end-March 2004	17.6	-
Debt Service Ratio	Per cent	end-March 2004	18.3	-
Foreign Exchange Rate, Spot	(Rs./\$)	31 December 2004	43.6	-4.5
Nominal Effective Exchange Rate (1985 =100)	Index	April-November 2004	35.6	-0.4
Real Effective Exchange Rate (1985=100)	Index	April-November 2004	76.5	0.3

¹Percentage change over the corresponding reporting date a year ago.

Contents

I.	The Tsunami Disaster and its Impact	1
II.	Growth Performance	2
III.	Sectoral Performance	4
IV.	National Rural Employment Guarantee Bill	6
V.	Fiscal Developments	7
VI.	Inflation, Money and Financial Market Developments	9
VII.	Balance of Payments and Foreign Exchange Reserves	11
VIII.	Near-Term Outlook	12
	<i>Special Features</i>	17-32
●	Ethics and Development – Dr. Sudipto Mundle, India Chief Economist, Asian Development Bank, India Resident Mission, New Delhi	
●	The World Economy: From Uni-polar to Tri-polar – Dr. Arvind Virmani, Director and Chief Executive, Indian Council for Research on International Economic Relations, New Delhi	

I. The Tsunami Disaster and its Impact

1. For the first time in half a century, India experienced the devastating effects of a tsunami, caused by a series of earthquakes in the Bay of Bengal¹. The first earthquake off the west coast of Sumatra Islands (Indonesia) was at 6.29 a.m. (Indian Standard Time) on 26 December 2004 (magnitude and intensity 9 USGS), followed by one off the coast of Great Nicobar Islands (7.3 USGS) some three hours later. The massive earthquake in Sumatra set off giant tsunami tidal waves, which hit the southern, eastern and southwestern coastal areas of India, where people were totally unprepared to deal with an unexpected and unfamiliar disaster of this magnitude. India is not a member state of the International Coordinated Group for the Tsunami Warning System and had no access to prior warning about the impending disaster. There has been extensive loss of life, especially among fisherfolk in the southeastern coastal areas of the country, currently estimated at around 10,749 deaths (as on 20 January 2005). About 5,640 persons are still missing and there is no reliable estimate of the total number of persons injured and displaced by the disaster. There has also been extensive damage to private homes, fishing boats and nets, public property (infrastructure), and farmlands (due to flooding by sea water).

2. The worst affected state in India is Tamil Nadu, although other states viz. Kerala, Pondicherry, Andhra Pradesh have also been affected. The Andaman and Nicobar Islands (A&N), that are nearest to the epicenter of the earthquake, have also been severely affected. The tsunami affected 2,260 km of the mainland coastline besides the entire A&N Islands. While the detailed damage assessment for the remote A&N islands is still being finalized, for the mainland states it has been reported that national highways, state/district highways, bridges and culverts, and a huge number of private homes and government buildings have been damaged, as well as several small fishing ports. Total reconstruction cost for the mainland is estimated to be \$1.56 billion as of 20 January 2005, while that for A&N islands is still being assessed.

¹ The last time a Tsunami hit the coast of India was in 1945. The other Asian countries affected are Indonesia, Maldives, Myanmar, Sri Lanka and Thailand. Several countries in East Africa have also been affected.

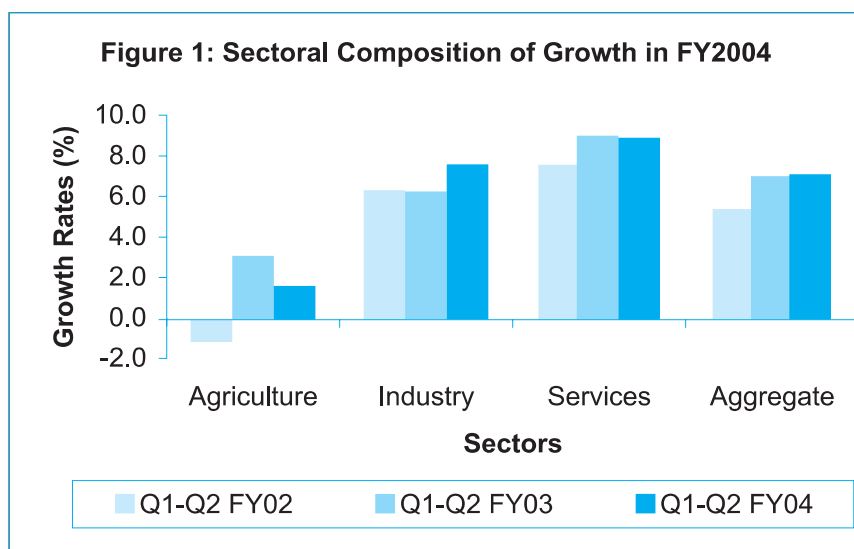
3. Coastal fisheries and agriculture are the worst affected economic activities. The tidal waves penetrated 300 m to 3 km into the mainland, and affected agriculture by damaging cropped area of around 11, 827 ha. Agriculture has suffered due to leveling of fields, destruction of irrigation, loss of land due to massive erosion and deposition of non-fertile sediments. A large number of fishing boats of different sizes have been lost or destroyed. Fishing ports and landing centers have also suffered heavy damage. Though tourism has been temporarily disrupted in coastal areas, the tsunami is not expected to have any major long-term impact on tourism. Moreover, the impact of the tsunami on manufacturing and services has been limited, and the adverse impact on fisheries and agriculture is localized. As such, while the local economic impact is severe, the level of national economic activity has not been significantly affected. The main economic impact of the tsunami at the national level is the burden of additional public expenditure on relief, rehabilitation and reconstruction, and its adverse effect on efforts to contain India's large fiscal deficit.

4. The Government of India (GoI) has set up a National Crises Management Committee chaired by the Cabinet Secretary, the senior most Government official, to co-ordinate relief and rehabilitation measures for the affected people with the help of the defence forces. At the ground level, relief operations are being led by the local district administration officers, supported by the defence forces as well as NGOs. The key immediate priorities, following the disaster, were disposal of dead bodies, prevention of epidemics, and provision of fresh drinking water, oral re-hydration kits, food, medicines, plastic sheets for shelter and clothes for the displaced persons. The focus is now shifting to rehabilitation and reconstruction activities, including resettlement and restoration of livelihoods.

II. Growth Performance

5. GDP growth has been robust during the first two quarters of FY2004² at 7.0% (Figure 1). This follows an annual growth of 8.5% in FY2003. This strong performance

² Year ending 31 March 2005.



Source: Compiled from www.mospiniic.in/stat_pr.htm

has been led by broad-based growth in both industry and services. In the July 2004 issue of this bulletin, ADB had forecast an annual growth of 5.4% to 7.1%, with a best estimate of 6.5% in FY2004. This forecast is being maintained and has been supported by projections of other agencies that are converging around this figure (Table 1) despite the adverse effects of a slowdown in agricultural growth, the high price of oil, and the re-emergence of a current account deficit. The negative growth impact of these factors is being offset by an increase in the rate of investment.

Table 1: Projections of Overall Growth (%)

Agency	FY2004
ADB	6.5
Government of India	6.9
Reserve Bank of India	6.0-6.5
International Monetary Fund (IMF)*	6.4
Economic Intelligence Unit (EIU)	6.9
National Council of Applied Economic Research (NCAER)	6.6
Centre for Development Economics-Delhi School of Economics (CDE-DSE)	6.6
Investment Information and Credit Rating Agency (ICRA)	6.5-6.7
Credit Rating Information Services of India Limited (CRISIL)	5.5-6.0
Centre for Monitoring Indian Economy (CMIE)	6.2
Consensus Forecast	6.4-6.5

* The projections are for the calendar year.

III. Sectoral Performance

6. Agricultural growth was negative in the second quarter (July-September) of FY2004 and only 1.5% during April-September 2004, a sharp decline from the 9.1% growth recorded during FY2003.³ This decline is attributed to the 13% shortfall in monsoon rainfall, that also had a highly skewed geographical distribution. The post-monsoon precipitation was also 11% below normal with 18 out of 36 meteorological subdivisions receiving deficient or scanty rainfall. As a result, the 2004 *kharif* (summer) foodgrain production is estimated at 102.94 million tons as compared to 112.05 million tons in 2003. The area sown for most *rabi* (winter) crops such as wheat, rice, pulses and most oilseeds has also declined compared to 2003, hence the winter harvest is also expected to be lower. For the year as a whole, total agricultural production could, at best, grow marginally at 0.6%.

7. Industrial growth accelerated in the second quarter of FY2004, pulling up the growth rate to 7.5% for the period April-September 2004 as compared to 6.2% during the corresponding period in FY2003. Monthly data for October-December 2004 show that industrial growth remains high at 8.6%. In the manufacturing sector, consumer durables and capital goods production are growing at over 13% and 14% respectively during this quarter. Growth of production in individual product groups is shown in Table 2. Such broad-based manufacturing growth was supported by strong growth in key infrastructure industries such as energy and cement. Buoyant industrial growth reflects a pick up in investment and consumption demand. The strengthening of business confidence⁴ and other leading indicators such as growth of non-food credit, especially housing credit, suggest that this high industrial growth will be sustained in the months ahead.

8. However, there are risk factors that need to be watched carefully. The textiles and garments sector needs to improve its productive efficiency in order to remain competitive

³ The agricultural year in India runs from July to June, and is thus different from the financial year.

⁴ NCAER (2005).

Table 2: Sectoral Performance: Manufacturing (% growth)

Increasing Output				Declining Output			
Sector	2002-03	2003-04	2004-05@	Sector	2002-03	2003-04	2004-05@
Machinery (except Transport Equipment)	1.8	15.2	21.9	Wood & Wood Products	- 17.8	6.8	- 10.4
Other Industries	- 0.5	6.5	19.4	Jute and Mesta	8.4	- 4.2	- 1.3
Chemicals & Allied Products	4.0	8.2	15.7	Food Products	10.7	- 0.2	- 1.1
Textile Products	15.6	- 3.8	14.8				
Beverage, Tobacco etc.	27.3	9.4	8.8				
Cotton Textiles	- 2.4	- 3.3	8.3				
Metal Products	6.4	3.4	6.7				
Paper & Paper Products	5.6	15.9	6.3				
Man-made Fibers etc.	3.8	6.2	4.4				
Basic Metal	9.2	9.1	3.8				
Transport Equipments	14.9	17.0	3.2				
Leather Manufactures	- 2.9	- 4.3	2.7				
Non-metallic Mineral Products	5.0	3.7	1.9				
Rubber, Plastic etc.	4.9	4.5	1.9				
Overall Manufacturing	6.0	7.2	9.0				

Note: @ April-December 2004-05

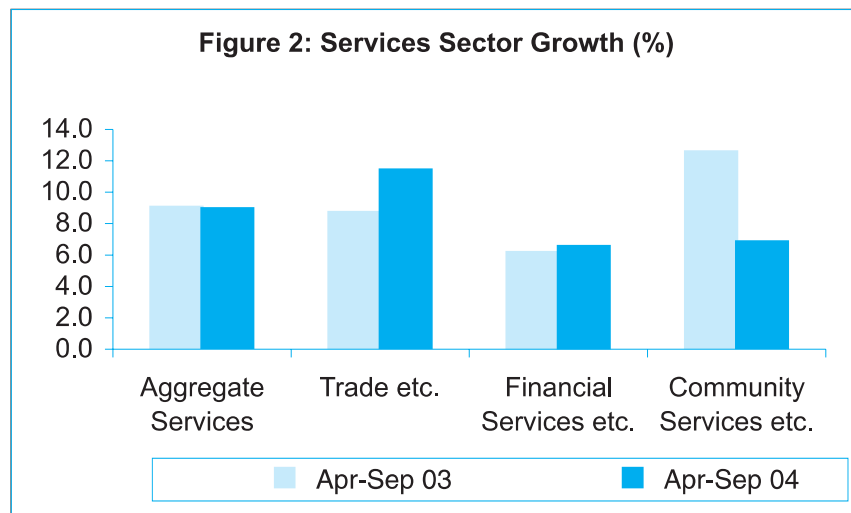
Source: Compiled from www.mospi.nic.in/stat_pr.htm

in the post-Multi-Fibre Agreement (MFA) regime. The gains from MFA phase-out will accrue to India only if there are improvements in productivity, reduction in unit costs, diversification to more value-added products, and consolidation of scale economies.⁵ Similarly, growth of chemicals, in particular pharmaceuticals, will face the challenge of a new patent regime following the third amendment of the Patents Act 1970. This amendment, which is designed to comply with India's commitments under the TRIPS Agreement in WTO, marks a departure from the past regime of granting only process patents. The new amendment allows for introduction of product patents and exclusive marketing rights under certain conditions in the area of chemicals, including agricultural

⁵ See Hashim (2005).

chemicals and pharmaceuticals, and food. Certain features of the recent amendment have generated controversy. It has been claimed that the new amendment restricts affordable access to some essential drugs.⁶

9. The services sector continued to grow at a high rate of 8.8% during the first two quarters of FY2004. Within the sector, growth of ‘trade, hotels/restaurants, and transport and communication’ has accelerated to 11.3% during April-September 2004 as compared to 8.6% in the corresponding period in FY2003 (Figure 2). Telecommunications and trading and transport services have grown at particularly high rates during this period. ‘Financial and business services, and real estate’ and ‘community, social and personal services’ have also registered high growth mainly because of a buoyant capital market, continuing growth in exports of IT-enabled services, and a boom in the real estate market.



Source: Compiled from www.mospi.nic.in/stat_pr.htm

IV. National Rural Employment Guarantee Bill

10. Despite the high rates of GDP growth, employment growth remains tardy. The latest available data show that employment growth in agriculture and allied activities

⁶ See Dhar and Rao (2004).

has been flat. The situation worsens in years of weak monsoons and crop failure. In a bid to address this challenge of 'jobless growth', the federal Government has introduced the National Rural Employment Guarantee (NREG) Bill 2004, in Parliament. This Bill seeks to implement an Employment Guarantee Scheme in 150 of the most backward districts of the country in the first phase, and then extend the coverage in stages to the entire country within five years. If enacted, the new law will make it mandatory to provide 100 days of employment in a year to at least one member of each rural household, and thus provide the rural poor with an effective safety net. The NREG Bill has triggered a vigorous debate.⁷ Critics have pointed out that the listing of schemes in the appendix rather than in the main body of the proposed law leaves room for discretionary interventions by Governments. Such programs have also been criticized because of large leakages and poor delivery systems. Furthermore, the administrative feasibility of providing mandatory employment has been questioned. It has been suggested that the existing employment generation schemes, with self selection by genuine beneficiaries, may be better. The beneficial effects of such self-selecting schemes are evident in Maharashtra, and were seen in Rajasthan and Gujarat during the droughts of 1987-88. The other important benefits of such programs include an expected reduction in rural-urban migration, empowerment of women, creation of useful assets in rural areas, and changes in the power equations in rural society that foster a more equitable social order.

V. Fiscal Developments

11. On the fiscal front, the consolidated fiscal deficit of the federal and the state Governments as a percentage of GDP improved marginally to 9.4% in FY2003 from 9.5% in FY2002. This was largely on account of the improvements in fiscal indicators of the federal Government. However, fiscal performance of the federal Government during April-November 2004 is weaker than in the corresponding period in FY2003.

⁷ For different views, see the articles by Acharya (2004), Ganesh-Kumar, Mishra and Panda (2004), Dreze (2004), Srinivasan (2005), Bhaduri (2005), Patnaik (2005), Basu (2005), and Papola (2005).

The fiscal deficit of the federal government already amounted to 68% of the annual budget estimate by November 2004 as against only 46% during the corresponding period in FY2003 (Table 3). This is primarily attributed to poor revenue realization. Tax and non-tax revenue collection has been low as compared to the budget estimate. The growth of net tax revenue is only 18.5% against 25% assumed in the budget, mainly on account of post-budget duty concessions on various imports. In particular, the federal government reduced the duties on crude and petroleum twice to soften the impact of rising international oil prices.

Table 3: Federal Fiscal Indicators

(Rs billion)

	Apr-Nov 2003 (1)	FY2003 (BE) (2)	(1) as % of (2) (3)	Apr-Nov 2004 (4)	FY2004 (BE) (5)	(4) as % of (5) (6)
Total Receipts	1864	2852	65.4	1937	3404	56.9
<i>of which</i>						
Tax Revenue (net)	900	1842	48.9	1067	2339	45.6
Non-tax Revenue	471	698	67.5	424	754	56.2
Total Expenditure	2800	4388	63.8	2644	4778	55.3
Fiscal Deficit	707	1536	46.0	937	1374	68.2

12. Finances of the states deteriorated further in FY2003 as compared to FY2002. Gross fiscal deficit as a percentage of GDP for all the states increased from 4.1% in FY2002 to 5.1% in FY2003. The expenditure on post-tsunami rehabilitation and reconstruction and the additional expenditure on the employment guarantee scheme will have an adverse impact on the consolidated fiscal situation. The consolidated gross fiscal deficit of the federal and state Governments is likely to remain at 9.1% of GDP in FY2004. The Twelfth Finance Commission (TFC) mandated to make proposals on federal fiscal assistance to states has already submitted its report, which will be presented in Parliament during the forthcoming budget session in February 2005. It is expected that when the TFC awards are made, there will be some relief for states' finances on account of an increase in the states' share of central taxes, a lower debt servicing burden

owing to rescheduling of debt repayments to the federal government by the states, and provision of all future assistance from the federal Government to the states in the form of grants, not loans. The Finance Minister is also expected to introduce a major fiscal reform initiative during the budget session.

VI. Inflation, Money and Financial Market Developments

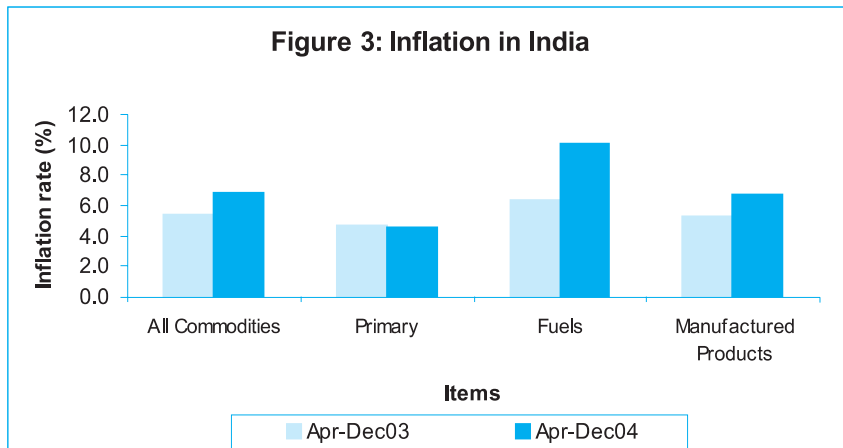
13. Money supply (M3) growth has started declining in recent months. M3 growth was 13.1% as on 24 December 2004, which is lower than the monetary policy target of 14% for the year as a whole.⁸ However, there has been a significant growth in bank credit to the commercial sector during the year, which is well dispersed across subsectors.⁹ Growth of reserve money continued to remain high at above 17% during this period. This is mainly on account of the large inflow of foreign capital and continued buying of dollars by the Reserve Bank of India (RBI) to prevent appreciation of the rupee. Despite a 20% growth in the foreign exchange assets of RBI and a consequent expansion of the monetary base, the excess liquidity scenario had reversed as a consequence of the sharp increase in demand for non-food credit, along with an increase in the cash reserve ratio and sterilization by the central bank through the Market Stabilization Scheme.¹⁰ However, the liquidity position has eased in January 2005.

14. Inflation, measured in terms of the Wholesale Price Index, was high at 7.2% during the third quarter of FY2004, mainly on account of the high price of oil and rising prices of iron and steel. However, the rise in prices has moderated since December 2004. For the whole period April-December 2004, the average inflation rate was 6.9% (Figure 3). Given that there are significant unutilized capacities in some sectors, demand driven inflation is not a concern at present. Inflation based on the Consumer Price Index for Industrial Workers has been even lower at 3.7% during April-December 2004.

⁸ Mid-term Review of the Annual Policy Statement 2004-05 of Reserve Bank of India, October 2004.

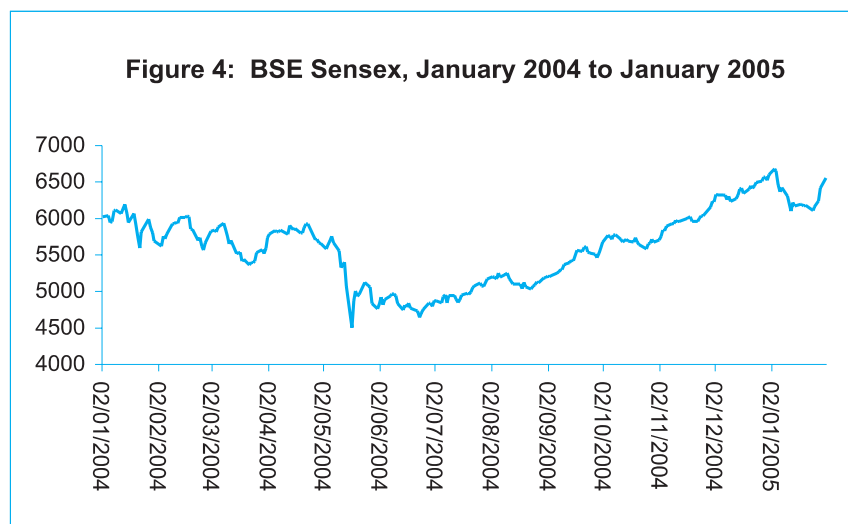
⁹ Reddy (2005).

¹⁰ For a detailed discussion on the altered liquidity scenario, see the previous issue of this bulletin (ADB India Economic Bulletin. October 2004: 6-7).



Source: Compiled from www.eaindustry.nic.in

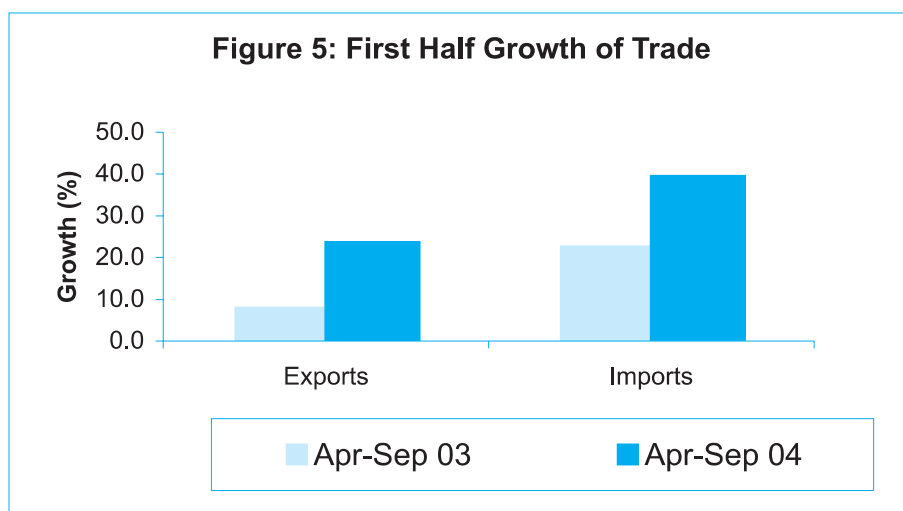
15. Bullish expectations, driven by buoyant growth, are reflected in the recent boom in stock prices. After declining quite sharply during April-May 2004 in the run up to elections and the formation of the new coalition government, the market has recovered phenomenally to reach record levels of market capitalization. The Sensex market index has crossed the 6000 mark, which is about 20% above the 5000 mark at which it was hovering in November 2004 (Figure 4). The volatility of the index during December 2004 reflects fluctuations in portfolio investments by Foreign Institutional Investors (FIIs), primarily on account of expectations of an increase in the US Fed rate.



Source: Compiled from www.bseindia.com

VII. Balance of Payments and Foreign Exchange Reserves

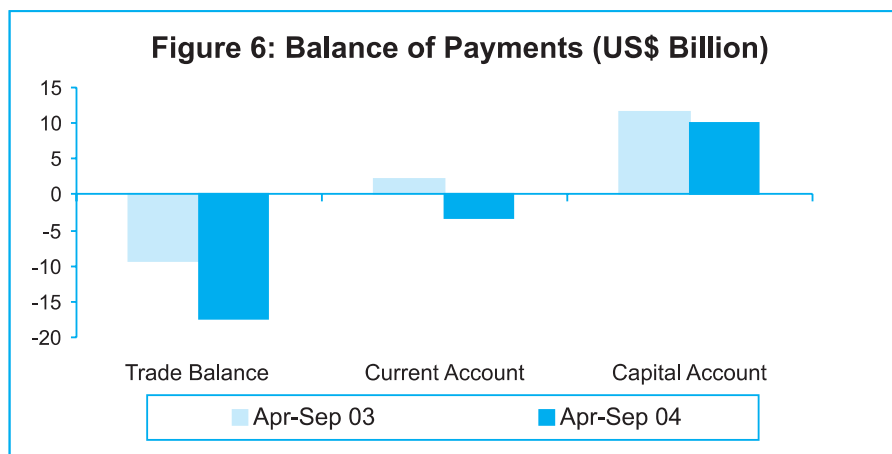
16. External sector performance has also been robust in FY2004. Merchandise exports grew at 23.2%, while imports grew by 39.0% at the end of the second quarter of FY2004 (Figure 5). With imports growing faster than exports during the period, the merchandise trade deficit has increased. The current account has also gone into a deficit of \$3.3 billion after having remained surplus since the third quarter of FY2000. This is partly offsetting and dampening the growth impact of a rising investment rate. High import growth is mainly on account of high oil prices and strong domestic absorption. Accelerating growth of merchandise exports, despite exchange rate appreciation, reflects strong growth of world demand, especially in developing Asia including the People's Republic of China (PRC). India has been moving towards greater integration with the ASEAN+3 countries, which now account for about 23% of India's total trade. The commodity composition of India's merchandise exports is well diversified as compared to its imports, which largely comprises bulk items. The high growth of textiles and garments exports in recent years shows the competitive strength of these products in the international market; and, it is generally believed that India will benefit from the expiry of MFA with effect from 1 January 2005. However, it is



Source: Compiled from www.rbi.org.in

rather early to assess these potential gains, and textiles sector performance needs to be monitored closely.

17. On the capital account, the country received a net capital inflow of \$10.1 billion during April-September 2004 (Figure 6), though net FDI is only around \$2.0 billion. The surplus on the capital account is mainly on account of commercial borrowing and short-term loans, and other capital inflows. Data on foreign capital flows up to December 2004 show an upsurge in foreign institutional investment inflows during the third quarter, raising foreign exchange reserves to \$125.2 billion. The accumulation of large reserves, along with the weakening of the US dollar against major international currencies, has led to an appreciation of the rupee-dollar exchange rate by 1.8% during April-December 2004.



Source: Compiled from www.rbi.org.in

VIII. Near-Term Outlook

18. GDP is expected to grow at 6.9% in FY2005, up from 6.5% in FY2004 (Table 4). Agriculture is projected to grow at a high rate of 4.4%. Despite an expected downturn in the industrial business cycle, industry is projected to grow at 6.7%. Services sector growth is projected at 7.7%. In FY2006, GDP growth is likely to decline to 6.1%, mainly on account of an expected cyclical decline in the growth of industry and services to 5.2% and 7.3% respectively.

Table 4: Major Economic Indicators, FY2004-FY2006

	2004	2005	2006
Real GDP Growth	6.5 ^a	6.9	6.1
Inflation	6.0 ^b	4.2	3.0
Gross Domestic Investment/GDP	26.5	26.5	26.5
Money Supply (M3) Growth	14.8 ^d	14.5	12.5
Consolidated Fiscal Balance ^e / GDP	-9.1 ^c	-8.8	-8.5
Export Growth	23.2 ^f	14.1	13.8
Import Growth	39.0 ^f	19.7	15.4
Current Account/ GDP	-1.0 ^{f,c}	-1.0	-1.5
External Debt/GDP	19.0 ^c	19.5	20.0

Note: ^a: ADB-INRM Projection. Official growth projection of RBI is 6-6.5%, and that of Government of India is 6.9%.

^b: ADB-INRM Projection. Official inflation projection of RBI is 6.5%.

^c: Estimated.

^d: April-November 2004.

^e: This includes the combined fiscal deficit of the federal and all state Governments.

^f: April-September 2004

19. Inflation is forecast to decline to 4.2% in FY2005, down from 6.0% in FY2004. It is expected to decline further to around 3.0% in FY2006. The moderation of inflation will be largely on account of the expected stability in prices of fuels etc. as well as manufactured goods through FY2005 and FY2006. The downside risks that could undermine the growth and inflation projections include a weak monsoon, a sharp increase in oil prices, inadequate fiscal consolidation, and hardening of domestic interest rates following tightening of money supply growth. The expected increase in the U.S. Fed rate could lead to a decline in the capital account surplus.

20. Despite the significant contribution of consumption demand, growth in investment – especially in infrastructure – holds the key to sustaining high growth over the long run. The investment rate has already increased to 26.3% in FY2003 and is expected to remain at 26.5% of GDP in FY2004. However, the current rate of infrastructure investment at 3.5% of GDP is way below the required rate of 8.0% estimated by the Expert Group on the Commercialization of Infrastructure Projects (chaired by Dr. Rakesh Mohan). The current rates of both private and public infrastructure investments have been well below target. The key problem in attracting adequate private capital in infrastructure is the lack of appropriate risk allocation between creditors and investors. One such risk originates from the fact that lenders are paid only from the cash flow

generated by an infrastructure project, and they have limited options if investments fail to provide the expected returns because of a shift in policy parameters. Moreover, infrastructure projects have long gestation periods and there is usually a maturity mismatch between loans and returns. Developing a domestic market for long-term securities is therefore critical for infrastructure financing. ADB's recent issue of domestic currency long-term bonds to extend the yield curve is an important step in this direction.

21. The key factor constraining higher public investment in infrastructure is the large consolidated fiscal deficit of the federal and state Governments.¹¹ Despite the weak performance of tax revenue in recent months, the federal Government will attempt to meet its FRBM targets through sale of public enterprise equity in FY2004. Strong fiscal reform measures are also expected in the forthcoming budget, which will help contain the federal fiscal deficit in line with FRBM targets. Enhanced awards of federal transfers to the states is also expected in the forthcoming budget, based on the report of the Twelfth Finance Commission. This will help the state Governments contain the observed deterioration in their own finances. Despite these factors, the deficit is expected to remain high in FY2005 and FY2006 (Table 4). Fiscal pressures have also been compounded by the additional expenditure to be incurred for tsunami damage-related rehabilitation and reconstruction activities. Thus, the Government will have to continue borrowing funds to finance current expenditure within the limits set by the FRBM Act, and this will constrain its capacity to invest in infrastructure.

22. The external sector is expected to remain buoyant. Growth of merchandise exports is forecast at 14.1% in FY2005 and around 13.8% in FY2006. The projected large increase in merchandise exports, despite anticipated appreciation in the real exchange rate, is largely on account of the projected high growth in world trade. Strong growth in East Asian countries in FY2005, especially the People's Republic of China (PRC),

¹¹ On the role of the Government in an ethical concept of development, see the Special Feature by Sudipto Mundle in this issue.

will provide a stimulus to India's merchandise exports in FY2005.¹² However, the anticipated slowdown of PRC in FY2006 is likely to moderate India's merchandise export growth in that year. The end of the MFA from 1 January 2005 will have a large impact on India's textiles and garments exports, which account for 20% of total exports. India's textiles export composition is well diversified, and it has a competitive edge in products ranging from cotton textile products, yarns and fabrics to knitted wears. However, as mentioned above, the gains from MFA phase-out, will accrue to India only if there are substantial improvements in efficiency, and consolidation of scale economies. Also, to remain competitive, Indian textiles and apparel firms need to be a part of the global value chain, and reposition themselves accordingly.

23. Merchandise imports are projected to grow at 19.7% in FY2005, down from around 39% in FY2004, mainly on account of the expected stability of oil prices. They will decline further to 15.4% in FY2006 because of the expected downturn in GDP growth and an expected decline in oil prices. With import growth exceeding growth of exports during these years, the trade deficit is expected to remain high. As a result, the current account will also remain in deficit despite a positive invisibles balance. This will partly offset the surplus on the capital account. Moreover, with the expected hardening of the US interest rates over the next two years, there may be a significant reduction in net portfolio investments, which will lower the capital account surplus. Hence, the rapid accumulation of foreign exchange reserves observed since 2001 is likely to moderate over the medium term.

¹² For a discussion on the emergence of India and PRC as two poles in a tri-polar world, see the Special Feature by Arvind Virmani in this issue.

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Special Feature

Ethics and Development

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Ethics and Development¹

Sudipto Mundle

I. The Ethical Critique and Changing Concept of Development

The manner in which the concept of ‘development’ has evolved during the past century, thanks mainly to a sustained ethical critique of a narrow ‘industrialisation and growth’ centered concept of development, represents what Thomas Kuhn described as a *paradigmatic shift* in his famous work, *The Structure of Scientific Revolutions* (Kuhn, 1962). Franz Fanon in Africa, Raul Prebisch in Latin America, Gunnar Myrdal in Europe and Denis Goulet in North America are only a few of the better known critics of the orthodox concept of development from across the world². Development orthodoxy has also been persistently resisted on the ground through hundreds of activist movements, such as the Chipko Andolan and the Narmada movement to cite only two examples in India. But perhaps the most powerful and influential critique of development orthodoxy, straddling the worlds of both theory and practice, has come from Mahatma Gandhi.

In his classic treatise *Hind Swaraj*, originally published in Gujarati in 1909 and translated into English in 1910, Gandhi rejected the technology of modern large scale production, competition and materialism – the endless desire for greater material wealth, as the very anti-thesis of a genuine humane civilization (Gandhi 1910). As we know, the production of ever greater material wealth, based on the application of modern large scale production technology, and the organizing principle of competition are in fact the constituent core elements of the orthodox concept of development as industrialization and growth. Instead of these elements he proposed an alternative ‘good way of life’ in which individuals curb the desire for greater material consumption beyond their basic needs, the use of ‘ethical’ science and technology in harmony with nature and better suited to human needs on a

¹ This paper will be delivered as an address at the Roundtable on Ethics and Development, India International Centre, New Delhi on 15 February 2005. The paper draws on an earlier keynote address delivered in 2001 (Mundle 2001). The views expressed in the paper are my personal views and are not necessarily shared by the Asian Development Bank. In the preparation of the paper, I have greatly benefited from the help and advice of Shomit Chakravarti, Kaveri Kumar and Dilip Simeon.

² For a succinct review of the literature on ethics of development see Crocker (2003).

limited human scale, and cooperation rather than competition among human beings as the organizing principle of society. A 'way of life' that is ethical and seeks to harmonize with nature instead of seeking to control it³.

Gandhi was of course a devout Hindu and, according to some readings of Gandhi, placed himself within a pantheistic tradition that is central to Hindu culture (Hardiman 2003). However, over time his *Hind Swaraj* came to be adopted as a manifesto for a wide variety of groups and communities, ranging from the critics of capitalism to Christian pacifists and ecologists. Moreover, Schumacher, undoubtedly the world's most influential Gandhian economist in our times, propounded what he described as Buddhist economics in his famous treatise, '*Small is Beautiful*', but insisted that 'the teachings of Christianity, Islam, or Judaism could have served just as well, or any of the other great Eastern traditions, as the ethical foundation of his economics (Schumacher 1973). In other words the Gandhian critique of development orthodoxy is embedded in religion, and at the same time it is completely secular in that it is not rooted in any particular religion.

The dialectical process through which this ethical critique of development orthodoxy led to a paradigmatic shift of the concept of development is a fascinating story. On the one hand Gandhi himself, never a dogmatist, came to accept in his later life that many modern technological innovations and institutions such as the railways, large scale factory production or the courts of law could not simply be wished away. He accepted that the new technologies and institutions would have to be used because of the way the world had evolved, but insisted that this be done without subordination of human beings to the machine. There is a neo-Gandhian school within the contemporary Gandhian movement which pursues this line of thought.

On the other hand this external 'ethical' critique also led to growing discomfort with the actual social and environmental outcomes of development from within the dominant development paradigm, and the gradual emergence of an internal critique leading to its eventual transformation. The central concern of this internal critique was that in their pre-occupation with accelerating and expanding material production, i.e. high GDP growth,

³ On Gandhian economic thought see, among others, the collection of papers in Biswas (1969) and Dasgupta (1996).

development theorists and practitioners had lost sight of the impact of this growth-centric concept of development on the quality of human life. Starting with the ‘basic needs’ approach of Paul Streeten and his associates (Streeten et al.1981), and the concept of ‘human development’, this movement led to UNDP’s new measure of development outcomes in terms of human well being, the Human Development Index, and finally the Millenium Development Goals (MDGs), that are firmly embedded in human development outcomes⁴. The international development community has now adopted specific and measurable MDG performance targets to be accomplished by 2015. The broadening of the goals of development from mere GDP growth to this wider range of Millenium Development Goals is what I call a paradigmatic shift in the concept of development.

II. Development as Freedom

Underlying this paradigmatic shift is of course Amartya Sen’s seminal work on the concept of ‘development as freedom’, a deeply ethical conception of development which brings the human being back into the center-stage of development (Sen 1999). In fact Sen himself, along with Sudhir Anand and others, led the technical work on the UNDP’s Human Development Index (Anand and Sen 1994). The traditional concept of development as the exclusive pursuit of high growth is a vision of the development process as a forced march to reach an urgent destination, not unlike a military campaign. It is a vision we have inherited from the experience of forced industrialization in the Soviet Union, a strategy which was subsequently emulated by many newly independent developing countries after the Second World War. The concept is also not much different in the market economies, which are equally preoccupied with growth, though the underlying institutional framework is quite different. However, there is also an alternative vision of development as a more friendly process where improvements in material life come along with political liberties, the spread of voluntary exchange in free markets, social development, the building of social safety nets, and so on. This is a vision going back to Adam Smith, and it is the vision which Sen adopts.

Starting from this perspective, he defines development as a state of freedom for people to live their lives as they want. This generic concept is then fleshed out by examples, which

⁴ For Human Development Index rankings of countries and the Millennium Development Goals, see UNDP (2003).

include freedom from such deprivations as starvation, under-nourishment, escapable morbidity or premature mortality. The examples also include literacy and numeracy, political freedom, and free speech among other things. The list is illustrative not exhaustive. It is important to emphasize that in this view, freedom is both *constitutive* and *instrumental* in development. That is to say, it is both the *end* as well as the *means* of development. To illustrate, freedom from illiteracy is an end in itself, a *constitutive component* of development, a goal of the development process. At the same time, literacy and numeracy add to the skills of workers, raise productivity, raise income, and hence facilitate the freedom from hunger and want. Literacy also promotes the circulation of news, views, and ideas, thereby facilitating political freedom. In these roles freedom from illiteracy is *instrumental* in facilitating development.

Sen (1999) defines a typology of five different types of *instrumental freedoms*:

- (i) **Political Freedom:** opportunities people have to determine who should govern, and on what principles; the right to scrutinize and criticize authority, free speech and an uncensored press.
- (ii) **Economic Facility:** opportunities individuals enjoy to use economic resources for consumption, production, or exchange. The economic entitlements of a person depend on the resources owned or available, the condition of the market, as well as the distribution of available resources.
- (iii) **Social Opportunities:** the available social arrangements for education, health care, etc. that enhance the freedom to live a better and healthier life.
- (iv) **Transparency Guarantees:** the freedom to deal with one another under guarantees of disclosure and lucidity. These guarantees have a clear instrumental role in preventing corruption and curbing financial irresponsibility.
- (v) **Protective Security:** the provision of a social safety net to protect the affected population from being reduced to abject misery in times of national disasters, economic downturns and increase in unemployment.

This alternative perspective of development as freedom is not altogether alien to economic growth, or the accumulation of physical and human capital. On the contrary, these processes

expand a range of *instrumental* freedoms, thereby contributing to development as freedom. However, the new concept goes much beyond the traditional development variables in its reach and coverage. It therefore demands a much broader evaluative framework of development than the traditional pre-occupation with growth of per capita income alone. Is this extension of the evaluative framework inessential, or in some sense less important than per capita income growth? The question is not trivial. Based on an alleged conflict between the requirements of food and freedom; diverse societies in Asia and elsewhere have in different periods suppressed various freedoms, prioritizing bread first and freedom afterwards. After all you can't eat freedom. However, the choice is not obvious. Much depends on the nature and degree of unfreedom that is in question.

While researching a system of debt bonded labour in a remote corner of the state of Bihar some 25 years ago, I stumbled on a surprising discovery. Because of the assured work that comes with their debt bonds, bonded laborers often earn more over the agricultural season than their counterparts among free laborers, who are more frequently unemployed. But this 'reward' comes with great loss of freedom, and condemns the poor worker to a life of semi-slavery. Such labor tying is often linked to small loans, real or fictitious, passed on for several generations of bonded laborers (Mundle 1979). However, the brute power of the landlord employers and their capacity to wield terror in their localities prevents the bonded laborers from breaking away. They are beyond the reach of the law, which has long ago declared such tying of labor to be illegal. In a well known study of the slave laborer system published in the United States around the same time, Fogel and Engerman arrived at a remarkably similar finding, namely that the pecuniary income of the slaves compared quite favorably with the incomes of free agricultural laborers (Fogel and Engerman 1974). Yet, once these slaves were freed, planters found it difficult to reconstitute work gangs of free laborers even at wages that were often double the imputed incomes of the slaves. Clearly, in both cases the lack of freedom was the dominant and most urgent existential reality of the workers. However, an assessment of development based on income alone would completely miss this dominant reality of unfreedom, which is fairly typical of precapitalist agriculture in developing countries.

Thus the perspective of development as freedom leads us directly to a reconsideration of

the concept of poverty. Conventionally, measures of the incidence, depth and intensity of poverty are based on some minimum income or expenditure norm, usually linked to a calorie intake requirement, called the poverty line. However, this income based measure of poverty may fail to capture other dimensions of poverty, linked to varieties of unfreedom that I have mentioned earlier. In line with the extension of the traditional per capita income concept of development to an alternative concept of development as expanding freedoms, the traditional concept of income poverty also needs to be supplemented by a concept of human poverty which is sensitive to such unfreedoms as undernourishment, morbidity and premature mortality, illiteracy, and the lack of political freedom and freedom of expression.

III. Development Theory and Development Practice

We now have an ethical concept of development which brings the human being and the range of human freedoms back to the center of the development discourse, but do we have a strategy or an approach that can translate this theoretical concept into actual outcomes in the real world? Once again it is necessary to turn to Gandhi, and his ‘constructive program’. Through this program the Gandhian movement sought to inculcate Gandhian civilizational values such as *swadeshi*, or self reliance in production, *sarvodaya*, or commitment to public welfare, and *aparigraha* or non-possessiveness. These values were sought to be disseminated through educational programs and cultural and social work, including campaigns for communal harmony and the eradication of untouchability. In early history the Hindu way of life had spread through southeast Asia, via Thailand and Cambodia, all the way to the Champa kingdom on the shores of the Pacific in Viet Nam, and even further to Bali in Indonesia. This had happened not through either conquest or proselitisation but demonstration and emulation, a kind of osmosis. Gandhi may well have expected the same outcome from his ‘constructive program’. Even today there are thousands of Gandhian institutions, ashrams and schools, dispersed across the country, that seek to promote the Gandhian way of life mainly by example. There are also thousands of other voluntary organizations which may not be technically Gandhian institutions but in fact seek to promote a very similar ethical path of development. Collectively, these thousands of grass root organizations constitute an awesome accumulation of social capital.

Yet, it would be difficult to argue that they have successfully re-aligned India's development path with the conceptual paradigm of 'development as freedom' embodied in the Millennium Development Goals. Actual development proceeds, in the main, along the orthodox and narrower growth-centric path of development, led by the state and the market. Despite this orthodox pursuit of development as growth, India has registered significant improvement in most human development indicators, having started from a rather low base. Nevertheless, there is a dichotomy between the theory and practice of development. And it is important to ask why, if we are to seek a better balance going forward.

Is it that voluntary organizations as institutional instruments are ill equipped to implement the paradigm of development as freedom? Or have they simply been crowded out by the more aggressive institutions of state and market? Or is it that civil society has preferred and consciously chosen the narrower, materialistic and growth-centric paradigm of development? These are difficult questions, and I do not pretend to have all the answers.

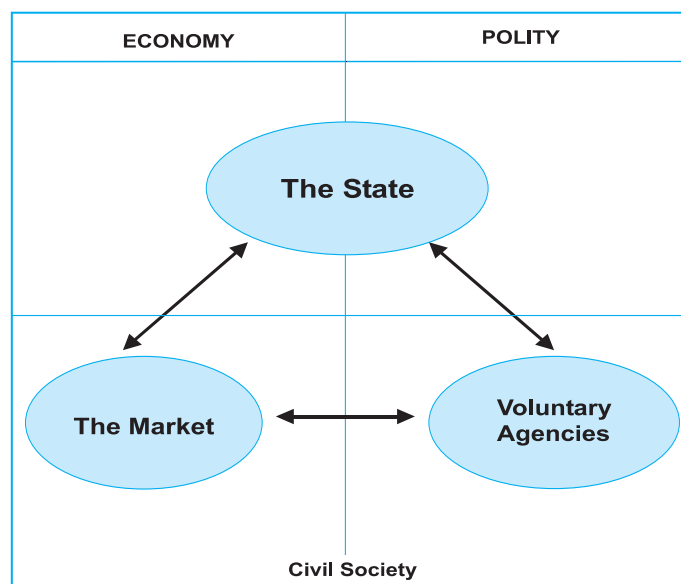
IV. State Power and the Countervailing Power of Civil Society

However, I would like to refer briefly to the role of the state. In recent years there has been much discussion about rolling back the reach of the state, or at least its executive arm – the government, not so much in relation to the space of voluntary organizations in civil society but vis-à-vis the market. Dirigism, it is argued, has led to widespread economic inefficiency and corruption, and held India back from its potential economic performance. There is much truth in the argument, in my view, and this of course is the basis of the pro-market reforms that have been implemented since 1991.

However, there is a point beyond which further reduction of the role of government can become quite counter-productive. Imagine a situation in which the Government suddenly stopped building roads, rail roads and irrigation systems, stopped managing the cities and towns, stopped providing basic education and primary health care services, stopped maintaining law and order, not to mention national security, stopped protecting the environment, and so on. It is nobody's case that these public or quasi-public goods and services are provided effectively today. But it is not difficult to see the anarchy and chaos that could arise if the government were to altogether withdraw from all its essential functions.

The thousands of voluntary organizations that I mentioned earlier and private entrepreneurs, all put together, could not possibly substitute for a missing state. There is, therefore, a core of public services and public goods, which the state must provide and coordinate⁵. And it is difficult to think of administrative models that can provide such coordination without control. This leads immediately to the familiar problem of regulatory capture. Those with an initial endowment of political or economic power can potentially capture this instrument of control and deploy it for further accumulation and centralization of power, with all its attendant consequences ranging from inefficiency and poor public services to rent seeking and corruption.

Figure 1



Is there a way forward in containing this concentration of state power beyond mere exhortations for good governance? Strategically, we may have to part ways here with the Gandhian aversion to competition, promote competition within the state, and at the same time mobilize the countervailing powers of civil society, the market and the social capital

⁵ On this class of issues see Mundle (2001).

of thousands of voluntary organizations, to contain the accumulation of state power⁶. In other words, we need a proper balance of power between the state, the market, and the voluntary organizations of civil society as the three fundamental pillars of a robust democracy (Figure 1). Finally, it has to be said that there is perhaps nothing more important for the preservation and nurturing of such a robust democracy than a free and vibrant media and universal basic education.⁷

⁶ On the effective mobilization of social capital in a Western cultural context see Fukuyama (1999).

⁷ For a compelling discussion of these questions see Sen (1999) and also Sen (2005).

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Special Feature

The World Economy: From Uni-polar to Tri-polar*

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Among other important committees Dr. Virmani has chaired the Working Group on Public Debt Management and Inter-ministerial Group on Customs Duty Reform, and was member-secretary of the Steering Group on Foreign Investment. He has also been Director of Punjab National Bank and Allahabad Bank and a Trustee of the Unit Trust of India (UTI).

*In view of the topical interest of this article to many of our readers, this article is being reproduced from Dr. Arvind Virmani's "Recent Notes and Article" at ICRIER website: <http://www.icrier.org/avnotes.html> or <http://www.icrier.org/BS05sizev.pdf>. An earlier version of this article appeared in *Business Standard* on 21 January, 2005. The views expressed here are the author's own.

The World Economy: From Uni-Polar to Tri-Polar

Arvind Virmani

Introduction

For over a century the USA has been the largest economy in the World. Major shifts have however been under way since then. During the last 30 years the weight of the world economy has shifted from the USA and the rich countries of Europe to China and India. These trends will continue in the 21st century, bringing about a historic transformation of the World economy. The Global economy will change from a unipolar to a bi-polar one with the emergence of China. This will be followed a decade and a half later by the emergence of India, converting the World economy into a tri-polar one.

The rich countries of Europe have seen the greatest decline in global GDP share by 4.9% points, followed by USA and Japan with a decline of about 1% points each. Within Asia the declining global share of Japan since 1990 has been more than made up by the rising share of China and India. During the seventies and eighties ASEAN countries and during the eighties South Korea along with China and India contributed to the rising share of Asia in world GDP. Between 1975 and 2002 Japan's share of world GDP fell by 1% point while that of South Korea, ASEAN, India and China rose by 1%, 1.2%, 2.2% and 9.2% respectively. Thus India's gains since 1980 have been much larger than ASEAN and South Korea but much less than those of China¹.

Uni-polar Global Economy: 2002

At the start of the new millennium the ranking of the 10 largest economies in terms of size is shown in Table 1. USA, the largest economy, is almost 2 times the size of the next largest economy, China, and about 3 times the third largest economy, Japan. Thus the size of the

¹ A. Virmani, 2004. 'Economic Performance, Power Potential and Global Governance: Towards a New International Order'. ICRIER Working Paper No: 150. New Delhi: Indian Council for Research on International Economic Relations. December.

US economy is larger than the next 2 economies combined, revealing clearly the uni-polar nature of the Global economy. The fourth largest economy, India, is a little over one-quarter the size of the US economy. The next 5 positions are taken by the big 4 of Europe: Germany, UK, France and Italy. Brazil and Russia bring up the rear with their joint size less than that of India. In turn the size of these 3 economies together is less than that of China.

Table 1: World Share of GDP at Purchasing Power Parity

Country	Current			Projected (2002 prices)				2035: Tripolar	
	2002: Uni polar (Int\$bi)	Share	Rank	2015: Bipolar Share	Rank	2025 Share	Rank	Share	Rank
China	5861	12.1%	2	19.5%	1	25.2%	1	30.0%	1
USA	10308	21.3%	1	19.5%	2	17.8%	2	16.0%	2
India	2800	5.8%	4	8.2%	3	11.2%	3	14.3%	3
Japan	3425	7.1%	3	6.2%	4	5.5%	4	4.8%	4
Germany	2236	4.6%	5	3.5%	5	3.0%	5	2.6%	5
France	1601	3.3%	6	2.7%	6	2.4%	7	2.1%	8
UK	1549	3.2%	7	2.7%	7	2.3%	8	2.0%	9
Russia	1186	2.4%	10	2.6%	8	2.6%	6	2.5%	6
Italy	1525	3.1%	8	2.5%	9	2.0%	9	1.6%	11
Brazil	1355	2.8%	9	2.2%	10	1.9%	12	1.6%	12

Source: A. Virmani. “Economic Performance, Power Potential and Global Governance: Towards a New International Order.” *ICRIER Working Paper No. 150*, December 2004.

Bi-pole China

Within 10 years the global economy will be transformed from a uni-polar to a bipolar one. China is projected by us to become the largest economy in the world within 15 years. Though India like the rest of the world has been falling behind China, its share of World GDP will continue to grow. Before the end of the current decade India’s economy will become larger than that of Japan, thus taking it to third place behind USA and China.

We measure the incremental impact of an economy on the rest of the world through trade and financial flow, by change in GDP at current exchange rate. By the end of the decade, China will become a larger driver of global growth than the European Union’s six largest economies. Similarly India will be a larger growth driver than UK, the most significant growth pole in the EU. At this time the combined impact of the 3 Asian giants (including

Japan) will exceed that of the USA. The global impact of other emerging economies is relatively small. In 2015, Canada and Russia are ranked 11 and 12 in terms of impact, which is less than a third of that of India at that time. The South Korean economy in contrast comes in at seventh rank with an impact that is half that of India's. Brazil's impact is projected to be much lower than that of Mexico.

India: 3rd Pole and Growth Driver

As the share of the USA in World GDP falls (from 21% to 18%) and that of India rises (from 6% to 11% in 2025), the latter emerges as third pole in the Global economy. By 2025 the Indian economy is projected to be about 60% the size of the US economy. The transformation into tri-polar economy will be completed by 2035 with the Indian economy only a little smaller than the US economy but larger than that of Western Europe.

China's economy is projected to become 50% larger than the US economy by 2025 and almost double that of the USA by 2035. At this point China's share of the World economy will be equal to the share of the US and Indian economies taken together. All the other countries that are either currently members of the Security Council or aspire to become so will therefore have relatively small shares. Japan the largest among them will have a share of about 5% while the others (including Russia) will each have 2.5% (Table 1).

This scenario assumes that China will be able to sustain the 'FDI-Export' cum 'zero capital cost' model of fast growth. The 'FDI-Export' model transformed ASEAN countries into "miracle" growth economies, but the Asian crises showed that it is heavily dependent on creating and sustaining optimistic expectations. China's risk is heightened by it combining with 'zero capital cost' to producers of inputs (including infrastructure) that bury inefficiencies in the government banking system (implicit fiscal subsidies). It is however hard to predict what kind of exogenous shock will knock such an economy off the high growth knife-edge path to more normal sustainable growth rates.

By around 2025, China's impact (in terms of GDP at prevailing exchange rates) on World growth is likely to be larger than that of the USA and India's impact larger than that of

Japan. By 2035 India is likely to be a larger growth driver than the 6 largest countries in EU, though its impact will be a little over half that of the USA. China's impact will, however be about 40% more than that of the USA.

Conclusion

The projected changes in the relative size of economies will have profound implications for global governance, the global balance of power and the stability of Asia. This phenomenal change in relative power poses a major challenge to the economies of Europe, North America, and Asia that very few seem to fully understand or appreciate.