Raghuram Rajan and Rohit Lamba

India's Untraveled Path to Prosperity

On Thursday, May 23, Raghuram Rajan and Rohit Lamba joined Markus' Academy for a conversation on their new book "Breaking the Mold: India's Untraveled Path to Prosperity."

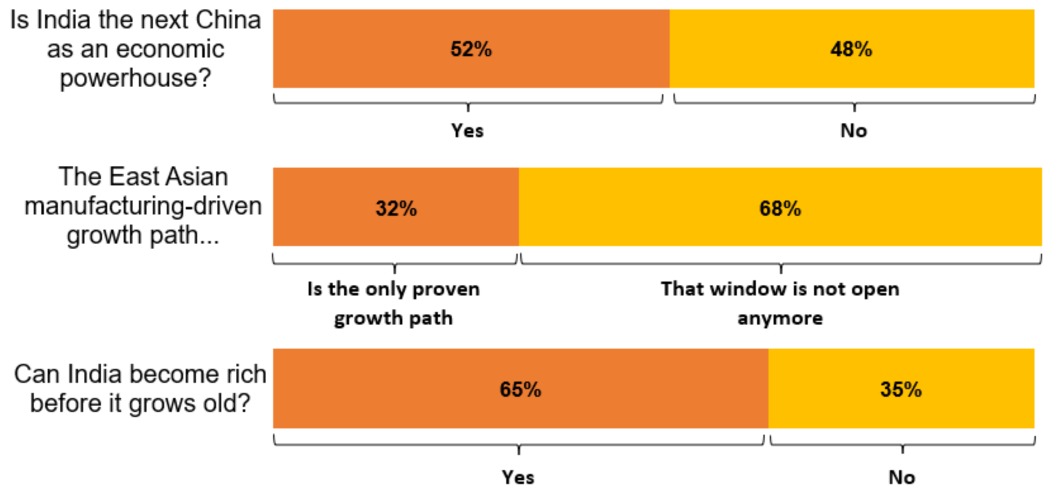
Raghuram Rajan is the Katherine Dusak Miller Distinguished Service Professor of Finance at Chicago Booth. He was the 23rd Governor of the Reserve Bank of India between September 2013 and September 2016. Between 2003 and 2006, Dr. Rajan was the Chief Economist and Director of Research at the International Monetary Fund.

Rohit Lamba is a Visiting Assistant Professor of Economics at New York University, Abu Dhabi and starting Summer 2024 an Assistant Professor of Economics at Cornell University.

A few highlights from the discussion.

- **A summary in three bullets**
    - The book's conceptual point is that, with China having driven rents down from low-skilled manufacturing, and with rise in automation and near and re-shoring of supply chains, how can countries with a demographic dividend grow? How should we think about structural transformation after the global industrialization?
    - There is a new pathway for growth for India based on services, both direct and those embedded in manufacturing, as the leading export sector. Rather than pursuing industrial policy, India should focus on fixing its deficiencies, prioritizing human capital in addition to the physical capital. This includes investing in education and healthcare, fostering innovation and creativity in high value-added sectors, and doubling down on democracy and rule of law.
    - India currently has a severe jobs problem. Promoting job creation is important because it will allow India to leverage its demographic dividend. The key question is: will India grow old before it grows rich?

- **[0:00] Markus' introduction and poll questions**
    - In contrast with strategies of import substitution, the export-led growth model worked. It could be scaled up for the global market, and due to the low wages it offered it led to large foreign direct investment which brought additional benefits from technological transfers.
    - The model works well for manufactured goods, but does it work for services? Can developing economies leapfrog directly to being focused on the service sector? Perhaps this may only benefit the well educated population.



- [6:47] **The old pathway to growth and India's job problem**
    - India's growth does not just matter because of the country's large population. If the old pathways for growth are now unavailable, it matters if India is able to chart new ones. Is there a path that is more about exporting services than about exporting produced goods?
    - The standard development route was to start with agricultural reforms and invest the surpluses in other industries, to then use low-skilled manufacturing for exports at scale and eventually move up the value chain. Low cost labor was crucial to offset other disadvantages (like in infrastructure or bureaucracy), while the initial reinvestment of profits into capital goods complemented labor. To move up the value chain, investing was subsequently geared towards human capital.
    - Three aspects made this model particularly successful in China. The first was a good education system early on (as Yasehng Huang has emphasized). It led to a skilled workforce which in turn enabled the expansion of local enterprises. In contrast, India never attained China's level of education, even though it liberalized only 10 years later.
    - The second was the decentralization of government (as Chang-Tai Hsieh has emphasized), which provided incentives for local politicians to promote growth. Local governments' ability to not just formulate rules, but also break them, led to a competitive cronyism across municipalities, which brought certain amounts of efficiency. In contrast India is much more centralized: the state of Uttar Pradesh has 240 million people and is governed primarily from the capital Lucknow.
    - The third was that China suppressed market forces to promote growth: it kept wages from growing with productivity to allow for more profits to be reinvested, forced interest rates on savings to be abysmally low to ensure cheap funding for companies, and made it easy for the government to acquire land and allocate it to companies. All of these are harder to achieve in India, where unions are strong and many veto powers exist in building infrastructure at speed and scale..

  - In the recent past India has performed better in services, accounting for 5% of the total global trade in services, compared to just 2% in manufacturing. Since the 1980s, the share of manufacturing employment has remained stagnant. In contrast, services employment expanded up until 2019, drawing workers from agriculture.
  - Regardless, India has a problem with jobs. Unemployment and underemployment is high, even while labor force participation is low (for women alarmingly so). Since 2019 the trend in service employment has reversed, with the share of agricultural jobs increasing and enormous numbers applying for government jobs. We are also seeing a decline in labor intensive manufacturing.
  - Last year there were 1.2 million applicants for 6 thousand low-level government clerk positions in Madhya Pradesh. Of these, 100 thousand had an MBA, 80 thousand were engineers, and 1 thousand had a PhDs. It is clear then that there are not many private sector jobs, but also that the degrees are not good.
  - Promoting job creation is important because it will allow for leveraging India's demographic dividends. More people are entering the labor force than leaving it, and the dependency ratio is falling. The key question is: will India grow old before it grows rich?
  - People point out that India is growing at 6%, but what did other countries grow at when they had their demographic dividend? At their respective moment China was growing at 13-14%.

- [19:46] **The new pathway**
  - Which way should India go? One option is to turn back the clock to hop on the low-skilled manufacturing bus, and start again with a more authoritarian government.
  - However we are seeing a backlash against globalization, with increasing amounts of nearshoring and on-shoring. Is there even a place for such a large country to grow through manufacturing when there is not much room for adding to the mass of manufacturing consumption?
  - Hoping on the manufacturing bus would not entail simply competing with the US like before, but competing with Indonesia, Mexico, Vietnam, China, and automation. As a result this strategy will yield much less returns.
  - The book's conceptual point is that, with China having driven rents down from low skilled manufacturing, how can countries with a demographic dividend grow? How should we think about structural transformation after the global industrialization?
  - Richard Baldwin has coined the idea of the smile curve, which plots the value added along different stages in the value chain. Value added is high in R&D, low in production, and high again in a technology's allied services (like marketing or making apps for phones).
  - There is an opportunity in that the delivery of services is no longer fixed in time and space. One can offer them both domestically and abroad.

- India for example has done a great job at attracting Global Capabilities Centers (40% of the world's total). Although they are linked to manufacturing they do not directly focus on it, instead focusing on performing strategic functions that are embedded in products. Foreign banks set them up to develop risk management models and legal advice they use in their own markets, while foreign tech and chip design firms have set them up to develop new products.
- Ultimately, the focus should not be on choosing strictly between manufacturing and services, but on prioritizing human capital over physical capital. Rather than wasting money on industrial policy, which India does not do well, it should focus on investing in education and healthcare and on fostering innovation and creativity in high value-added sectors. Promoting growth is about fixing India's deficiencies, not about subsidies.
- India should compete globally for higher end jobs which require more human capital. This will then create more service jobs to increase the consumption of these workers.
- In contrast with recent developments, India should decentralize governance, not just to improve rulemaking but also to improve the provision of healthcare and education at every level. Politicians have better incentives to improve services when the government is decentralized.
- India may have democratized too early, but at this stage, democracy will be helpful to know when things are going off track, to ensure the provision of services, and to promote creativity and innovation.
- Crucially, democracy will be helpful to promote data-intensive services, as other countries will trust India's exports more (we are seeing the troubles with TikTok or Huawei).

- [46:44] **Q&A**
  - Is the service sector more under threat by AI than the manufacturing sector is under threat by automation? We don't know, that is why we should be hesitant about industrial policy. Creative work will be in part be displaced by AI, but in part it will also be enhanced by it.
  - That is why we should put more weight on skilling and a flexible education. We don't know what sorts of jobs and tasks will be created, so education should be about teaching workers how to learn. Given how many young people leave India to study, one can see promoting education as an import substitution strategy that leads to large positive externalities.
  - India has been effective at building infrastructure in the last 10 years. The binding constraint is the human capital. In the short term India can promote apprenticeships or for example formally train rural quasi-doctors ("barefoot doctors"). In the medium term it can strengthen the links between vocational institutions and manufacturers. In the long term it can continue to build elite research and educational institutions, for example by bringing back the academic diaspora.

- India will be well placed if it doubles down on democracy and rule of law. Investing in legal infrastructure and strengthening intellectual property and data privacy laws will promote the establishment of more data capabilities centers.
- The book offers a plausible model to modify the standard structural transformation route and develop comparative advantages in services (tradable and non-tradable, direct and those embedded in a manufacturing).
- Two aspects have changed: the tradability of services, and improvements in education. Adding the two together offer a new path for growth. It is almost inevitable that African countries will also have to focus on these services rather than low skill manufacturing.
- Is the service-led export model also vulnerable to tariffs? Less so, in part because the largest exporter of services is the US, so it is not in its interests to begin trade disputes. Additionally, it is harder to stop trade in services when they are virtual, as it is difficult to precisely determine where they were produced.

Timestamps:
[0:00] Markus' introduction and poll questions
[6:47] The old pathway to growth and India's job problem
[19:46] The new pathway
[46:44] Q&A