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The Indian Economy: Growth, Challenges, and Regional Cooperation

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[Main Points]

- Despite a temporary slowdown precipitated by the global financial and economic crisis, the Indian economy has continued to grow at a healthy rate. To maintain high-paced growth in the years ahead, India will need to address a number of issues, most notably, poverty (which remains widespread despite improvements), unemployment, lagging infrastructure development, and the need for ongoing economic reforms.
- In a climate of rapid globalization, India's information technology industry has grown dramatically. Indian IT companies have posted impressive sales figures thanks in large part to work outsourced by US businesses. The auto industry has also enjoyed rapid growth in sales and increased competitiveness. The Nano, the super-economy car developed by Tata Motors, is evidence of a high level of technical expertise among India's engineers.
- Removing obstacles to growth to ensure that the economy continues expanding will require independent effort on India's part, but efficient and effective use of assistance from overseas is also important. Recognizing India's potential for the future, Japan should take the initiative in offering such support, focusing on human resource development. From the standpoint of bilateral relations, student exchange is one of the most vital areas of cooperation.
- Japan, which faces the strong possibility of labor shortages over the middle and long term, should make use of India's talented human resources, particularly in the IT industry. To attract talent from India and other countries, Japanese businesses must create a welcoming environment by clearly explaining the nature of the work and the conditions of employment, as well as the potential for promotion and career advancement.

1 A Rising Profile in Asia and the World Issues

Like China, India has been drawing global attention by virtue of a huge population combined with strong and steady economic growth. Both countries suffered temporary slowdowns as a result of the global financial and economic crisis that followed the “Lehman shock” of September 2008, but both began to rebound in 2009. This rapid recovery at a time when the advanced industrial economies of the West and Japan have yet to turn the corner has fostered the view that China and India are poised to become major engines of global economic growth.

An earlier impetus for the surge of interest in the Indian economy was an October 2003 report by Goldman Sachs on the emerging economies of Brazil, Russia, India, and China, the so-called BRICs. Assessing the role of these countries in the global economy through 2050, the report concluded that their importance would increase dramatically and forecast especially rapid growth for India and China. It predicted that India would overtake Italy, France, and Germany in gross domestic product between 2015 and 2025 and would surpass Japan to become the world’s third-largest economy (behind the United States and China) by 2032.

The World Bank spotlighted India and China as well in a 2006 report that compared the two economies in terms of existing conditions and potential problems (World Bank 2006) and forecast economic growth between 2005 and 2020. Although the World Bank’s predictions are more conservative than Goldman Sachs’s, they still anticipate growth rates well above those of other major countries.

In Japan, a rising interest in the Indian economy is suggested by the large number of books on the subject appearing in recent years, including those by Hisaya Oda (2009) and Kohei Shiino (2009). Among Japanese businesses, interest can be gauged by the level of direct investment in India, which expanded more than 10-fold between 2006 and 2008 (JETRO 2009).

The increased attention the Indian economy is attracting both in Japan and around the globe stems from a growing realization of the profound impact this economy could have on Japan and the world as it continues to expand. India’s economic growth affects other countries in a variety of ways. For example, while a growing Indian economy offers new opportunities for export and direct investment, India’s own export of increasingly competitive goods and services puts competitive pressure on industries in other countries. The actual impact, of course, is far more complex, but the bottom line is that the Indian economy has become a force to be reckoned with.

With these circumstances in mind, in 2009 the Asia Project undertook to analyze the current state of the Indian economy and examine its potential for the future.

This study went beyond conventional macroeconomic analysis, taking into account semi-macro and industry-specific trends together with politics and foreign policy in an effort to elucidate India's place in a world of accelerating regional integration and cooperation.

The results of the analysis show how policies for market opening and domestic deregulation adopted in 1991 and thereafter played a crucial role in the country's rapid economic growth by permitting India to seize the opportunities presented by advancing globalization and the rise of the IT industry, which has benefited the most from globalization. In terms of future trends, our analysis identified a number of factors conducive to continued growth, including a high rate of savings and investment, a relatively youthful population, and an expanding middle class. At the same time, it revealed a variety of factors that could inhibit growth, namely, problems relating to the fiscal deficit, poverty, unemployment, education and health care, infrastructure, energy and the environment, and agriculture. While India's own efforts will be critical to resolving or mitigating these problems, the effective use of assistance from overseas is another important ingredient. An Indian economy that realizes its potential could bring economic growth and social and political stability to Japan and other countries in East Asia and, by extension, to the entire world. That is why Japan needs to strengthen ties with India through such means as people-to-people exchange and the conclusion of a free trade agreement. After summarizing the report's findings chapter by chapter in section 2, I conclude in section 3 by proposing several steps by which the Japanese government and Japanese business can strengthen relations with India. It is my hope that the results of this study can contribute something of value to the government's international trade and economic cooperation policies, including official development assistance, as well as to the investment and trade strategies of Japanese corporations.

2 Chapter Summaries

2.1 Overview of the Indian Economy and Challenges for Further Growth

After years of inconsistent economic performance resulting in part from such noneconomic factors as natural disasters and war with Pakistan, India has been on a continuous growth trajectory since 1991. Since 2000 the Indian economy has performed particularly well, growing at the high average annual rate of 7.2%. Among the factors that helped bring about this rapid growth, special attention must be given to the deregulatory and market-opening reforms launched in 1991 under then–Finance Minister Manmohan Singh (now prime minister). Singh's economic reforms linked foreign and domestic investment directly to production. Rising corporate income and retained earnings gave companies the financial wherewithal to invest in the production of such desirable products as passenger cars, motorbikes, household appliances, and cell phones, which, aided by the spread of information and communications media, spurred rising consumption. Competition led to better product quality and service and lower prices, completing the virtuous circle. Amidst these positive developments, the Indian economy was hit by falling exports and tightened bank lending as a result of the global financial and economic crisis that struck in 2008. By the middle of 2009, however, growth in mining and manufacturing output had resumed, and the stock market was recovering as well. However, the economy has yet to recapture the high growth rates sustained earlier in the century.

India has gained the world's admiration by maintaining higher growth rates than the majority of countries in the midst of the global economic and financial crisis. However, it needs to overcome numerous challenges if it wants to resume the rapid growth trajectory of the precrisis years and continue along the path of stable development. The most serious problems it faces are those relating to the fiscal deficit, poverty, unemployment, education and health care, infrastructure, energy and the environment, and agriculture. The nation's high savings and investment rate, on the other hand, is a factor working in favor of future growth.

Some of the challenges to growth listed above could turn into positives if appropriately addressed. Since a high proportion of India's population of more than 1.1 billion falls into the 25-and-younger age group, the labor force can be expected to continue expanding. Providing a good education, vocational training, and job opportunities for this huge working population could contribute substantially to economic growth. If employment opportunities are not created, on the other hand, unemployment will rise, fostering social and political unrest. Agriculture currently suffers from a shortage of capital and low productivity, but with such natural advantages as a total cultivated acreage second only to the United States, this sector has real potential for growth if handled correctly. Economic reforms will have to play an important role in meeting the challenges outlined above, but in the largest democracy in the world—with more than 700 million voters—politics can raise obstacles to economic reform.

T As Japan eyes opportunities for business expansion in India, it needs to be proactive in promoting cooperation on such matters as the environment, infrastructure development, and economic reform—not only at the bilateral level but also through such multilateral frameworks as ASEAN plus Six (the Association of Southeast Asian Nations plus Australia, China, India, Japan, New Zealand, and South Korea) and the Group of Twenty. Needless to say, an understanding of India's complex political and social circumstances will be essential in addressing these challenges.

2.2 Potential and Risk in the Indian Mega Market

As one of the four BRICs, India is already an economic behemoth—the world's fourth largest economy by purchasing power parity. As of fiscal 2008 (April 2008–March 2009), it had a population of more than 1.15 billion and a GDP of $1.156 trillion.

Since the Lehman shock of 2008, most of the world's industrial and emerging economies have been mired in negative or low growth. Although the worldwide recession had a major impact on India's export industries, making an economic slowdown inevitable, the Indian economy has continued to expand at a rate of more than 6%. In addition to the nation's growing middle class, a "developing middle class" has emerged as a new group of spenders, further expanding the market for consumer goods and playing an important part in sustaining economic growth

India's middle class has expanded at a breathtaking pace since the beginning of the twenty-first century. Between fiscal 2001 and fiscal 2009, it grew at an average rate of 12.9% a year, while the percentage of households classified as middle class rose from 5.7% to 12.8%. During the same period, the number of impoverished Indians fell by 1.8% a year on average, and the ratio of impoverished households dropped from 71.9% to 51.5%. The developing middle class also grew, if somewhat less quickly, expanding at an average annual rate of 7.9% and swelling from 21.9% to 33.9% of all households. The fastest-growing economic stratum, incidentally, has been the upper class, which has expanded at an average rate of 22.3% and increased its share from 0.4% to 1.7% of all households.

The key role India's rising middle class has played in expanding domestic markets is obvious, but two new trends are associated with the growth of India's domestic market. The first is the rise not only of a narrowly defined middle class but also of the so-called developing middle class as an important new group of spenders thanks to the adoption of low-cost business models, leading to continued expansion of the domestic market. Application of the low-cost model can be seen in a wide range of consumer products, from such daily commodities as shampoo and soft drinks—known as fast-moving consumer goods (FMCGs; see Chapter 6)—to Tata Motors' 100,000-rupee automobile, the Nano (see Chapter 5). The second trend is the relatively wide distribution of this buying power, which is appearing in rural towns and villages as well as the big cities.

The expansion of the domestic consumer market thanks to the growth of the middle class and the developing middle class has the potential to sustain steady economic growth independent of overseas markets. However, if the problems alluded to in the previous section are not solved or mitigated, the nation could find itself in a vicious circle of poverty, as economic growth slows and the middle and developing middle classes sink back into poverty, blunting economic growth even further. To avert such a scenario, India needs to make the most of cooperation from overseas to solve the problems it is facing.

2.3 The Globalization of India

Globalization is overtaking the Indian economy thanks to the rapid growth of foreign trade and direct investment. Between fiscal 2000 and 2008, India's annual exports and imports of goods increased by 4.1 times and 5.8 times, respectively, while foreign direct investment in India rose seven-fold. When it comes to goods, India imports more than it exports, but in services it is running a surplus, evidence of Indian industry's growing competitiveness in this sector. Exports of software services have grown especially rapidly and now occupy a large share of total exports in services. In recent years trade with East Asian countries, China in particular, has increased dramatically as a percentage of India's total trade volume. A notable feature of foreign direct investment by Indian businesses is the prominent role of mergers and acquisitions.

Underlying this rapid growth in trade and direct investment are the economic liberalization policies adopted since 1991. In respect to trade, these reforms used tariff reduction and other measures to open up the market to imports and instituted various tax breaks for export businesses and special economic zones to promote exports. In respect to direct investment, looser restrictions and preferential tax treatment favoring particular countries contributed to the growth of foreign direct investment in India. Meanwhile, the deep pockets of Indian corporations and the extensive network of "nonresident Indians" living overseas played the key role in the growth of outward direct investment.

Like other countries, India responded to the financial and economic crisis by implementing numerous restrictions on imports with the goal of protecting domestic industry, but it has since lifted some of these restrictions. The result at this time is a lack of coherence in India's trade policy. It is hoped that the remaining trade barriers will be removed as the economy continues to recover, but to prevent the adoption of similar restrictions in the future, it is important to reach an accord in the current Doha round of world trade negotiations as soon as possible.

Even while adopting protectionist measures in response to the global recession, the second cabinet of India's ruling coalition, the United Progressive Alliance (inaugurated in June 2009), has been pursuing trade liberalization through free trade agreements with ASEAN, South Korea, and other East Asian nations. Although the FTAs the Indian government has entered into are fairly limited in their scope, they still represent substantial progress toward liberalization when compared with the current level of protection, and businesses around the world, Japanese corporations included, are optimistic that they will open the way for new business opportunities. The future opportunities India offers to Japanese business, as a manufacturing base and as a market, will depend in large measure on Japanese corporations' ability to take advantage of these FTA frameworks. The general outlines of the FTA currently being negotiated by the Japanese and Indian governments can probably be inferred from the agreement between India and South Korean scheduled to go into effect on January 1, 2010. This pact establishes a schedule for gradual reduction of tariffs on goods and provides for limited liberalization of trade in services and investment. For Tokyo, a key focus of negotiation will be getting India to agree to liberalization in more advanced industries than those covered by the pact with South Korea.

2.4 The IT Industry—Leveraging India's Talent

As globalization gained momentum in the 1990s, the IT industry experienced dramatic growth. The rise of India's IT industry can be traced back to the 1970s, when US computer manufacturers asked their Indian affiliates and partners to send Indian engineers to the United States to work as programmers. With a boost from the deregulation and preferential policies of the 1980s and an even bigger boost from the globalization and IT revolution of the 1990s, software exports expanded rapidly, and soon a competitive IT industry had emerged in India.

During the 1990s India's IT industry grew 50%. In fiscal 2008, the industry recorded net sales totaling $64 billion, a full 5.8% of the nation's GDP. As of fiscal 2007, India's share of the global IT market amounted to only 4%, but in the area of global outsourcing it has assumed a leading role, with 62%–66% of the world market in IT services and engineering services and 38%–42% in business-process outsourcing. The growing tendency in recent years for multinational IT corporations to locate key research and development facilities in India testifies to the nation's growing importance in this field.

The rapid growth of India's IT industry would not have been possible were it not for the large number of science and engineering graduates that the country's institutions of higher education have trained in such IT-related fields as computer science, electronics, and communications. Yet despite all the IT experts India turns out, it is not keeping up with demand from a long-term perspective, and the supply is tightening. As a result, some of India's biggest IT companies have begun moving their operations to places like China, attracted by those countries' human resources as well as their markets.

As a highly productive, fast-growing sector, as well as an important source of foreign currency, India’s IT industry occupies the central role in the nation’s services-powered economic development and constitutes a key engine of economic growth.

Despite Japan’s much-lamented shortage of IT personnel, Japanese business has approached global outsourcing warily. When Japanese companies do outsource, they are apt to choose China over India, in direct contrast to US businesses. Several factors have deterred Japanese companies from outsourcing more work to India. These are (1) the Japanese-English language barrier; (2) the small population of Indian nationals in Japan who could serve as bridges between the two countries, especially in comparison with those in the United States; (3) the inherent difficulty of outsourcing work from Japanese companies, where job duties tend to be amorphous, impeding the breakdown of operations into work modules; (4) a shortage of personnel with international business skills; (5) a deep-rooted preference for doing things in-house.

To lay the groundwork for greater cooperation between Japan and India in the IT field, the Japanese government should step up people-to-people exchange in higher education by providing a variety of scholarships for Indian exchange students and issuing work visas to ensure that the exchange students can remain in Japan after graduating. Japanese businesses, meanwhile, need to respond adequately to globalization, such as by clarifying job descriptions and requirements, putting employees with international business skills in key posts, and freeing themselves from the “not invented here” resistance to outside resources.

2.5 Automobiles

India’s automobile industry has been expanding since 2003. Production and sales of passenger and commercial vehicles alike began to rise in 2003, and although the industry’s growth stalled temporarily in the wake of the financial crisis of 2008, it has since resumed at an accelerated rate. That said, the 2.42 million commercial and passenger vehicles India produced and sold in 2008 come nowhere near China’s 9.34 million. India’s auto industry also differs from China’s in its relatively large ratio of passenger cars to total production and sales. Cuts in excise taxes and falling interest rates for auto loans have played an important role in spurring sales of passenger cars in recent years.

The most widely covered news in India’s auto industry in recent months was the debut of the Nano, produced by Tata Motors. The Nano is a four-door hatchback compact that seats four comfortably, although its 624-cc engine is a bit smaller that of a Japanese minicar. From an environmental standpoint, it meets Euro 4 emissions standards, and it is said to comply with all major national safety standards, yet its starting price is a mere 100,000 rupees (about US $2,200 at December 2009 exchange rates). This amounts to about half the price of the Multi 800, previously the cheapest car on the Indian market.

To bring Chairman Ratan Tata's concept of "the people's car" to fruition, the company completely redesigned the auto-making process, integrating every phase from planning, development, and design to parts supply, factory production, sales, and service. By cutting everything superfluous, not only in the automobile itself but in the entire development process, they were able to develop their own super-economy model. The technological confidence and creativity embodied in the development of the Nano is something that the Chinese auto industry has yet to attain.

The government of India has nurtured the nation's auto industry with an industrial policy that intervenes in foreign investment, trade, and technology. The reason given for these policies is that the auto industry as a whole, including parts as well as finished vehicles, supports a large number of jobs and plays an important role in helping to absorb India's labor surplus. In 2006, the government drew up a 10-year plan for development of the auto industry. The plan calls for development of industrial infrastructure and R&D facilities, as well as reform of India's labor laws, with the goal of boosting the auto industry's share of India's GDP from 5% to 10% by 2016.

A challenge to the continued development of the industry will be the ability of companies lacking experience in mass production to meet demands for high quality, low cost, and reliable delivery, along with high safety and environmental standards. However, given the numbers and skills of India's engineers—as attested by the success of the nation's IT industry—and given Indian manufacturers' increasing contact with technologically experienced foreign companies as a result of expanding direct investment, there is good reason to believe that the industry will overcome these hurdles.

2.6 Fast-Moving Consumer Goods

Production and consumption of fast-moving consumer goods—such common everyday commodities as shampoo and soft drinks—are on the rise in India, and the expansion of the FMCG industry is expected to continue. Rising living standards ushered in by economic growth in a population of more than 1.1 billion is powering the growth of the FMCG market and industry. The key to further growth in the years ahead will be the penetration of such products into India's rural areas.

India's FMCG industry is smaller in scale than its information, textile, or auto industries but larger than the pharmaceutical industry, which has attracted much attention of late. In addition, because FMCGs are integral to daily life, the market is less likely to suffer even if the economy as a whole were to slow down in response to the current global recession.

Traditional “mom and pop” stores remain the predominant sales channel for FMCGs, but modern large-scale retail chains, including foreign-based as well as domestic businesses, have been spreading at a rapid pace, and this trend is expected to continue. Any Japanese corporations hoping to enter this market, however, should be aware that the foreign-based retailers are not newcomers but companies that established a presence before or immediately after World War II and have gradually penetrated the market over the years. At the same time, brand is playing an ever more important role in this market, and enhancement of brand value is sure to become an important issue in the manufacture of FMCGs.

It is only relatively recently that Japanese corporations have begun penetrating India’s FMCG market, and it seems fair to assume that this trend has just begun. At this point the focus is on baby products, sanitary products, and fermented milk drinks. To successfully expand in India’s growing FMCG market, Japanese corporations will need to take advantage of the modern retail business model in India’s urban centers. The modern retail business model appeals to Japanese businesses because it allows them to practice the quality- and service-oriented style of manufacturing and sales at which they excel, while offering the potential for large sales volumes.

Among the various challenges that must be addressed to promote economic linkages between Japan and India and greater market penetration by Japanese companies, the following four are particularly important: (1) improved trademark and patent protection, (2) reform of labor laws, (3) infrastructure development, and (4) institution of a goods and services tax.

2.7 India’s Financial and Capital Markets

India is unusual among developing nations for the relatively large role its financial sector plays in the national economy. Within the financial sector, the stock market has expanded at a particularly rapid pace in recent years. While the global economic recession has depressed stock prices in Japan, the United States, and many other nations, India’s stock market has soared since bottoming out in February 2009. This trend has been driven by vigorous demand for capital attending India’s strong economic growth, which in turn has fostered bullish sentiment among stock market investors. India’s derivatives market is still young, but it has developed quickly in recent years to become one of the most actively traded derivatives markets in the world.

India's bond market is dominated by government instruments, as the corporate bond market remains underdeveloped. The securitization market is also underdeveloped. Indian companies still raise most of their capital from bank loans, but the securitization market can be expected to play an increasingly important role as time goes on.

One factor that has profoundly affected trends in India's financial and capital markets in recent years is the dramatic increase in cross-border capital flows in the form of portfolio investment and direct investment from overseas. However, there is still considerable room for liberalization in this area, as the government continues to impose a variety of restrictions on foreign investors with regard to where and how much they can invest. In recent years mergers and acquisitions have played an increasingly conspicuous role in cross-border capital flows, both in foreign corporations' expanding India operations and in Indian corporations' expansion overseas.

In India's securities market, mutual funds have been growing rapidly, a trend powered by rising household financial assets. That said, a mere 6% of household financial assets are now invested in stocks and mutual funds, while more than half are in the form of bank deposits. This low level of private investment compared with other countries suggests a large potential for future growth in the market.

An essential prerequisite for development of financial and capital markets is strong governance by the companies seeking to raise capital, and unfortunately governance has long been considered the weak point of India's corporate culture. Many Indian companies remain in the control of their founder-owners and their families, and minority shareholders have suffered losses as a result of insider trading and other illicit practices. Steps have been taken to strengthen corporate governance, but more needs to be done.

In response to the growth of the Indian economy and of its financial and capital markets, Japanese financial institutions have been stepping up their efforts in that direction, but foreign financial institutions still face obstacles to doing business in India. Particularly problematic are (1) restrictions on investment in the Indian securities market, (2) restrictions on foreign ownership, and (3) corporate governance and problems enforcing compliance with existing laws. These problems must be appropriately addressed to facilitate further development of India's financial and capital markets.

2.8 Shifting Political Currentsl

Since the 1990s, domestic politics and foreign policy in India have revealed conflicting trends, at once accepting and resisting the trend toward globalization.

Globalization means the adoption of free-market policies, but in India's case the trend has been to pursue such policies within the limits imposed by popular sovereignty.

This tendency is particularly obvious when it comes to the establishment of special economic zones. Such zones benefit the economy greatly by encouraging the influx of foreign capital, promoting exports, and creating jobs. But when the large expanse of land needed for an SEZ is farmland, the government often faces fierce opposition from farmers. When this happens, the SEZ becomes a highly charged political issue, and the government finds it difficult to forcibly appropriate the land.

Since the 1990s, India has become accustomed to coalition government, and political stability has been maintained. Since 2004, the coalition government has been headed by Indian National Congress politician Manmohan Singh, who instituted free-market reforms while serving as finance minister under the INC-led government in the first half of the 1990s. India's political stability henceforth will most likely hinge on the success of the Singh administration's efforts to close the gap between rich and poor, the biggest domestic issue the government is grappling with today. The gap between the rural and urban areas in particular has become too glaring to leave unaddressed. The government faces a mounting array of problems in this regard, including low income and low employment, as well as inadequate education, health and hygiene, and infrastructure. Poverty and the gap between rich and poor are key factors fueling extremism within India's Muslim and tribal population.

During the Cold War years, through the 1980s, India's foreign policy assumed a global stance, but it rarely demonstrated its commitment when economics was at stake. In the wake of the Cold War, the Indian government has had no choice but to grapple with such global issues as the world economy and global warming. In the realm of foreign policy and security, it finds itself obliged to take into account three perspectives, the global, the regional (South Asia and the surrounding area), and the local (India). To advance the national interest in such a climate, India is riding the tide of globalization while pursuing an omnidirectional foreign policy. Its orientation, however, is clearly toward the world's superpowers.

In its foreign policy, New Delhi's major concern is balancing the dynamics of the three-way relationship among India, China, and the United States—a four-way relationship if one includes Pakistan. India's dealings with such states and entities as Japan, Russia, the Shanghai Cooperation Organization, and the European Union are predicated on their relationship to that triangle. From a medium-range perspective, we can anticipate that India's presence will spill out of South Asia and into Southeast Asia. Over the long term, a permanent seat on the United Nations Security Council is a possibility, and in that case, India's influence would extend beyond Southeast Asia to the entire Asia-Pacific region.

Relations between Japan and India are probably the strongest they have been in the last 60 years. At present good relations with Japan are important to India because the two countries face a common rival, but at this point it is questionable whether India will maintain a strategic emphasis on ties with Japan in the future. Japan needs to place this bilateral relationship on a firmer footing, especially given the specter of a weaker Japan-US alliance and changes in the role of the US-China relationship in international politics. Japan also needs to take action now, while a power equilibrium exists between the region's major powers, to build an East Asian community or a similar multilateral regional mechanism.

2.9 SAARC—Outlook for Economic Regionalism and Indian-Pakistani Cooperation on

The South Asian Association for Regional Cooperation was established on December 8, 1985, with the purpose of facilitating cooperation at the regional level to address the problems of poverty, underdevelopment, and low productivity and accelerate the process of economic and social development. SAARC's eight member countries—Afghanistan, Bangladesh, Bhutan, India, the Maldives, Nepal, Pakistan, and Sri Lanka—have a combined population of 1.49 billion as of 2005, making this the largest organization for regional cooperation in the world in terms of population. However, the power and resources of this region are heavily concentrated in India and Pakistan, which together account for 80% of the eight member nations' total GDP and 85% of their population. Moreover, India's population and GDP are both approximately seven times larger than Pakistan's, further accentuating SAARC's unbalanced makeup when compared with organizations like the European Union or ASEAN. The lopsided nature of the region's economic relationships is reflected in its patterns of trade and investment as well: India and Pakistan account for the bulk of trade and investment in the other six member states, but India and Pakistan themselves depend heavily on Europe, the United States, and other economies outside the region. It should also be noted that overall trade and investment levels among the SAARC nations are quite low compared with those of Southeast Asia and other developing regions.

Owing to the conflict between India and Pakistan, SAARC was able to claim little substantial progress for the first two decades of its existence, notwithstanding the conclusion of the SAARC Preferential Trading Arrangement—forerunner of the South Asian Free Trade Agreement—which came into force in 1995. However, when relations between India and Pakistan began to thaw, the situation changed dramatically, and the organization began taking concrete steps to advance its agenda. In 2005 SAARC granted membership to Afghanistan, which was struggling to rebuild from its civil war, and reached an agreement to establish a regional poverty alleviation fund, and in January 2006 the South Asian Free Trade Agreement came into effect. To this point SAARC has extended observer status to seven countries and regions: Japan, China, South Korea, the United States, the EU, Iran, and Mauritius. The organization has shifted its orientation decisively, from ideologically focused “solidarity” to pursuit of practical benefits through regional cooperation, and while problems persist between India and Pakistan, there is reason to hope that SAARC will make steady progress toward development henceforth with the support of the observer states and other countries around the world.

While India’s rapid growth and economic opening (as demonstrated by the implementation of SAFTA) have resulted in an expansion of trade within the SAARC region, the overall volume of trade remains low. Considered in terms of trade structure, the potential for expansion of intraregional trade is high, but lingering trade restrictions and underdeveloped infrastructure are preventing that potential from being realized. There is reason to hope that full-fledged enforcement of SAFTA will spur further growth not only in trade but in investment as well. For Japanese business, which can no longer hope for dramatic growth in the East Asian and Southeast Asian markets, South Asia’s markets exert a strong appeal despite the potential difficulties of doing business in the region. Recognizing the promise of SAARC, China and the United States are already seeking active involvement in the region. Japan needs to step up its level of assistance and cooperation in South Asia unless it wants to be left at the starting post.

2.10 Relations with Japan—Expanding Bilateral Cooperation

Over the past few years, economic relations between Japan and India have expanded dramatically, largely as a result of increased direct investment and trade fueled by India’s rapid economic growth. Direct investment in India has risen precipitously since the second half of 2000, and from 2006 to 2007 it tripled in a single year. Investment in the auto industry has been brisk for some time, but recent years have seen an increase in large-scale investment in such fields as pharmaceuticals and telecommunications. The truth is that Japanese business now regards India as one of its most important destinations over the medium to long term, ranking alongside China. Trade between India and Japan has also grown rapidly, but because India’s overall trade volume has grown even faster, Japan’s importance as a trade partner has diminished. To further expand economic ties between Japan and India, it will be important to reach an early agreement on a Japan-India FTA, which promises to remove mutual trade and investment barriers, and transform the Comprehensive Economic Partnership in East Asia from a concept into a reality. Another way to expand bilateral economic ties is for Japanese business to amass a record of successful undertakings in India. To this end, Japanese companies should take note of this report's recommendations relating to top-down decision making, large initial investments, marketing, production control and technical transfer, and human resource strategies

The Delhi-Mumbai Industrial Corridor and the Delhi-Mumbai Dedicated Freight Corridor, a railway to run through the center of that zone, constitute the biggest new initiative in Japan-India economic cooperation. The DMIC is an ambitious plan to develop a 1,483-kilometer corridor between Delhi and Mumbai into an industrial zone comparable to the Taiheiyo Belt between Tokyo and Osaka. The governments and business communities of both countries have high hopes for the project, but a number of conditions must be met in order for the DMIC to proceed according to plan. These include sufficient investment by Japan, the Indian government's guarantee of a loan from the Japan Bank for International Cooperation to finance preliminary studies, and resolution of local issues regarding the siting of industrial parks and development of infrastructure in the six states affected.

Environmental issues present a tough challenge that must be met in order to achieve sustainable economic development. Given the huge scale of the Indian economy today and its expected growth in the years ahead, it is clear that India has an important role to play in protecting the global environment. The Japanese government is contributing to this effort through ODA projects in the area of energy conservation. Business also has a major environmental role to play in India, but while a few Japanese companies are active in this area, European and US business have taken the lead overall. As Japanese companies are highly competitive in the environmental field, it is to be hoped that they will step up their activity in the environmental business sector.

People-to-people exchange has a key role to play in strengthening economic ties, but such exchange between Japan and India remains woefully inadequate. Stepping up student exchange could be a vital key to achieving closer economic ties in the future. In fiscal 2008, only 544 Indian students were studying in Japan. This figure scarcely bears comparison with the number of exchange students from China (72,766), but it also falls short of the numbers from Nepal (1,476) and Sri Lanka (1,097), countries with much smaller populations. The biggest reason few Indians come to study in Japan is the language barrier, but another is the difficulty of finding employment in Japan. The number of Indian exchange students could be expected to rise if Japanese and Indian universities were to expand cooperative ties and if Japanese companies made an effort to hire more Indian exchange students.

3 Recommendations

India has recorded strong economic growth ever since the economic reforms of

1991, growth that accelerated even further around the middle of the last decade. The economy slowed briefly under the impact of the global financial and economic crisis that started in the United States in 2008, but it began to recover again during 2009. Economic growth is expected to continue in the future, but the nation is facing a wide range of challenges in terms of infrastructure, human resource development, job creation, growth in the farm sector, and ongoing economic reform. If these issues are not resolved or alleviated, it will be difficult for the economy to realize its growth potential, and India will be unable to achieve the kind of rapid growth the world is anticipating. The Japanese economy stands to benefit substantially from the robust growth of the Indian economy, since it promises greater export and direct investment opportunities for Japanese business and greater social and political stability for East Asia. With this in mind, we have compiled a number of recommendations that Japanese government and business would do well to consider when doing business with India.

The Japanese government, to begin with, must actively assist India in meeting such key challenges to economic development as infrastructure and human resources. In the process, it needs, at a minimum, to keep the following two basic recommendations in mind. The first is to make use of multilateral frameworks as much as possible instead of acting alone. The second is to cooperate with the private sector.

India's economic development is being aided not only by the Japanese government but by a wide variety of bodies, including other national governments, international organizations, and nongovernmental organizations. In many cases their activities overlap, and this can compromise the efficiency of aid programs, so that they fail to yield the anticipated benefits. To avoid such situations, the Japanese government should collaborate with other organizations that are providing aid in the same area. In such cases it is obviously vital to build an understanding with the Indian government, but it is also important that Japan take a leadership role to insure that the projects are implemented in line with its own ideas and intentions.

With the rapid acceleration in cross-border economic activity, we are seeing a growing number of situations in which infrastructure development requires the cooperation and collaboration of neighboring countries. To give an example in the area of transport infrastructure, roads and railways to quickly link India to the countries of Southeast Asia can make a huge contribution to the economic development of all the nations involved. Development of this type of infrastructure must be approached from a regional rather than a national perspective. It would be inefficient for Japan to work alone on projects that span national borders in the region. It is important that they be carried out in cooperation with such institutions as the Asian Development Bank and the Economic Research Institute for ASEAN and East Asia (ERIA).

While I have stressed the importance of making use of multilateral frameworks when providing infrastructure assistance, there are types of aid that Japan should carry out independently. Typical of these is human resource development. Of course, support for general educational efforts, such as primary and secondary schooling, can be provided within multilateral frameworks, but when training Indian IT personnel to work in Japan, for example, a bilateral Japanese-Indian program is bound to be more effective, and it makes more sense. While Japan has a shortage of IT workers, India has an abundance of talent in the field. Japan should offer assistance to provide these Indian IT engineers with the language and other skills they need to operate in the Japanese business environment.

Cooperation with the private sector is also important when providing development assistance to India. Consider an infrastructure project like large-scale railway construction. Projects of this nature have a strong public element, and in many cases private corporations would find it economically unfeasible to implement them alone. In such cases government involvement is justified. However, in many cases a strictly government-run project will suffer from inadequate funding and inefficient operation. For this reason it is preferable to forge public-private partnerships that make use of the private sector’s financial and human resources and know-how.

Economic exchange between Japan and India in the form of trade, investment, and people is beneficial to the economic growth of both nations. Yet such exchange is currently impeded by barriers of various sorts, including tariffs that discourage trade, legal restrictions on foreign investment, and a variety of regulations limiting the movement of personnel. To eliminate or lower such barriers so that both nations can enjoy the full benefits of economic exchange, we need to bring the current negotiations for a Japan-India economic partnership agreement to a rapid conclusion and implement the agreement as soon as possible. It is also important to pursue broader regional cooperation within the ASEAN+6 framework, including the proposed CEPEA, which would include the ASEAN+6 nations. It is to be hoped that Japan and India will cooperate and contribute actively to the creation of the CEPEA.

The paltry level of student exchange between Japan and India poses a problem for our bilateral relationship. Exchange students bring nations closer together, not only economically but in social terms and other respects as well. If an Indian student finds employment in a Japanese firm upon graduation, it becomes much more likely that that company will forge ties with Indian businesses. Indeed, a major factor behind the close relationship that developed between India and the United States in the IT industry was the large number of Indian students who had studied in the United States. The Japanese government should be proactive in instituting and implementing programs to bring able Indian students to Japan on scholarships.

In terms of recommendations to private business, I have already touched on the role of business in the context of joint public-private projects. Here I would like to raise some considerations for private corporations with respect to their own business activity. Needless to say, one important step our businesses need to take is to actively engage Indian employees. When attempting to bring in human resources from other countries, Japanese businesses must create a welcoming work environment by clearly explaining the nature of the work and the conditions of employment, as well as the potential for promotion and career advancement. In addition, both Japanese and Indian firms stand to benefit from collaborative research.

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