Economic strategy: Chinese road to nowhere

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India's remarkable economic performance during this decade has put it alongside China at the centre of the world economic stage. Strong growth has been accompanied by rising integration into global trade and finance.

The time is ripe for India to take on a leadership role to match its growing economic clout. How it goes about this will have big repercussions for its growth trajectory and also for the world at large.

The recent economic success has generated a new-found confidence among Indian industrialists and consumers, some hubris among policymakers, and some angst among reactionaries who would prefer the country strive towards the Gandhian ideal of national self-sufficiency. The interplay among these groups creates interesting dynamics in how India connects with the world at large.

Moreover, recent economic success has complicated the conduct of macro-economic policies.

For instance, the money pouring in from foreign investors has stimulated a rapid appreciation of the exchange rate – hurting external competitiveness – and helped fuel a stock market boom approaching bubble-like territory.

Will India respond to such challenges by turning inward or sharpening its engagement with the world? A big risk is that India will imbibe the wrong lessons from world economic developments and, in particular, from the growth path chosen by China.

Comparisons with China are all the rage in India. A popular storyline is that China has got away with maintaining tight capital controls, keeping its exchange rate undervalued, and boosting exports.

Is it not unfair then for India to shoulder the burden of playing by the rules?

Commentators in India tend to focus on the bottom line – China's impressive GDP growth – rather than the reality of an investment-led growth pattern and its costly side-effects.

These include environmental degradation, the waste of resources through reckless investment, and the costs of limiting competition and keeping the banking system under state control.

Furthermore, Chinese capital controls are in practice increasingly leaky, enervating the independence and effectiveness of monetary policy. This has led to rising inflation and an equity market bubble that could end messily.

China's exchange rate policy does create a challenge for India. But for India to tie up its macroeconomic policy in knots to emulate the Chinese makes no sense. India has come too far along the path of opening its capital account and reducing financial repression to turn back.

The broader context is that India has attained robust growth in tandem with moderate inflation, suggesting that, for all of their presumed flaws, macroeconomic policies are getting something right.

The fact that India seems to have dodged the subprime crisis has generated further complacency among policymakers. This is dangerous.

It would be folly to conclude from the subprime episode that regulation of Indian banks is in good shape and the financial system works well. Many challenges remain – public-sector banks are saddled with multiple inefficiencies, the corporate debt market is non-existent, and much of rural India has no access to formal financial intermediation.

While the solutions must come from within, foreign investors could play a useful role in domestic reforms. For instance, allowing them to participate in the government debt market could add to its depth.

And in dealing with many of the major domestic challenges – building up the physical infrastructure, upgrading the educational system – foreign funding and participation could play a useful role.

But the domestic polity has thrown up roadblocks to opening up the economy further. Consequently, even in areas where India has begun to assert itself on the global stage, this leadership has sometimes taken on an obstructionist tint.

Reciprocity has become the watchword in many aspects of trade and financial integration.

Take the example of banking. Indian bankers rightly complain that the US severely restricts Indian (and other foreign) banks from setting up operations, while India allows US banks to operate relatively freely.

But allowing foreign banks promotes competition, improves services, and is good for the consumer, no matter what the US does. The same is true for trade and environmental policies.

India is right to insist on fairness, but shooting itself in the foot when other countries do not co-operate is no solution, though it may be nice for national pride.

It would be better to claim the moral high ground by doing the right thing and shaming the west, including the US, into following India's example.

Should fairness and reciprocity be thrown to the wind? Will the rest of the world simply run roughshod over India if it unilaterally "disarms"?

Unilateral disarmament is not always a good idea. It may not be desirable when the game is truly zero sum, such as in negotiations about relative voting rights at the IMF and World Bank. But too many policies are approached as zero sum games when they are not.

It is time for India to assume a world leadership role on economic issues. The US accedes to this role on account of its economic and military might. China is using its economic resources to build its influence in the Asian region and beyond.

India can really shine by displaying moral leadership, rather than leading by obstruction. What a fine legacy this would be for the land of Gandhi.

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