strategic consequences of India's economic performance

sanjaya baru

Strategic Consequences of India's Economic Performance

...a collection of Baru's journalistic greatest hits... brilliant scene-setting essays analysing the strategic choices that have faced India since it started to open its economy 15 years ago... make it required reading for anyone interested in the interplay between domestic economic strategy and global power politics.

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...stimulating collection...
Baru's book deserves to be prescribed reading for policymakers.

Outlook
NEW DELHI

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essays & columns

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by Sanjaya Baru

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For
Rama and Tanvika

CONTENTS

Foreword

THIS volume of collection of seminar presentations and articles written for journals and newspapers over a period of eight years (1996-2004) is a very timely contribution by Sanjaya Baru to the ongoing debate in the country on the choice of strategy to enhance India's economic growth and development and international security. Today one often hears a demand for the formulation of a consensus on this issue. It is not, however, recognised that this country is in fact having its fourth debate on such a choice. The first one was even before Independence when Gandhiji and Jawaharlal Nehru debated the options for post independence development. While the former pressed for a decentralised rural economy and opposed industrialism (and not industrialisation) the latter was for speedy industrialisation.

The second round came with the setting up of the Planning Commission and India embarking on centralised planning. Nehru explained in his famous essay on the 'Middle Path' the need for India adopting a mixed economy. He was criticised on the one side by the Communists (who then commanded some 11 per cent of votes) for not going far enough on the Socialist path and by the Swatantra Party, on the other side, for going too far! The licence permit quota *raj*, which got entrenched after Nehru, was partly the result of the then prevailing international strategic environment and partly the beginning of organised corruption in our electoral politics and top down control of our political parties.

Then came the third round of debate. Faced with threats of international payments default India launched on economic liberalisation, in 1991. There was no dearth of critics. There were prophets of doom who predicted that the country would be flooded with foreign goods, our country could not face international competition, and it would lead to increased unemployment. None of these forebodings came to be fulfilled. The Indian economic growth accelerated, trade expanded and foreign exchange reserves rose. India got recognition as an IT power. Outsourcing of BPO to this country expanded and increasing number of multinationals started to set up R&D centres in India.

Now there is yet another debate on how India should respond to the US-led global interaction with India. As happened earlier there are those who are for taking advantage of this chance and exploiting it for India's benefit and others who are cautious about venturing on this new path. It is in this context that Sanjaya Baru, a strong protagonist of change, is offering his perspective on the nature of transformation in international economic order, as well as, in the strategic environment. I do not pretend to be unbiased on this issue. I am for India adapting itself to the emerging global balance of power and economic globalisation. Both Baru and myself subscribe to the view propounded by Prime Minister Manmohan Singh that globalisation is irreversible and India has no alternative but to adapt itself to it. Those who are arguing that as a continental sized country India can isolate itself from globalisation should do well to bear in mind the fate of the experiment of building socialism in isolation in continental sized economies such as Soviet Union and China.

The merit of Sanjaya Baru's compilation is in his development of a holistic view of the symbiotic relationship between international economics and international strategic developments. A globalised economy, with this degree of interdependence among nations, and in a balance of power strategic system, has not existed before; at least not in the industrial age. The world did not have nuclear weapons and missiles that deterred outbreak of war among major powers. Nor have we a precedent to a world where knowledge will be the currency of power. The opposition to India's enhancement of its relationship with the US comes largely from people who are risk averse. Sanjaya Baru has done well to highlight in his writings the Chinese example. Mao Tse-tung and his colleagues had far more justification to suspect US bonafides in 1971 than India has in 2005. Yet the Chinese leadership took the risk and did very well.

The Indian political establishment is totally absorbed in domestic politics and does not have much familiarity with international politics and economics. There is no institutionalised long-term strategic assessment, very few think tanks and no university centres for research on foreign policy. The indifference of our legislators to foreign policy and strategic issues is notorious. During the era of Non-alignment we got isolated from international strategic developments. The Non-aligned declarations were a compilation of platitudes and there were very few attempts at analysis of current realities.

In the early years of the Cold War, alliance with the US did not yield very tangible results as was seen in the case of Pakistan, Iran and Turkey. The Indian strategy of autarchic development was justified in those circumstances. But once the rebuilding of Europe and Japan got completed the development of friendly nations was accelerated by strategic considerations by market economies. The East Asian Tigers and China were the principal beneficiaries of this phenomenon. Now the international system has progressed into the new phase of six-nation balance of power, in which, the major nations face no prospect of war but compete peacefully in an evolving rule-bound globalised order.

A correct understanding of this evolution is essential for India to make right policy choices to maximise its advantages. In his Independence Day Address on 15th August, 2005, at New Delhi's Red Fort, Prime Minister Manmohan Singh said: "There comes a time in the history of a nation when it can be said that the time has come to make history. We are today at the threshold of such an era. The world wants us to do well and take our rightful place on the world stage. There are no external constraints on our development. If there are any hurdles they are internal." This compilation is a valuable contribution to promote an understanding of the relevance of overcoming these internal hurdles and its consequence for India's place in the world. For this Dr. Sanjaya Baru deserves our congratulations.

K. Subrahmanyam

New Delhi

K. Subrahmanyam is India's leading defence analyst and former convenor, National Security Advisory Board. He has also been consulting editor of *The Times of India,* and *The Economic Times.*

Acknowledgements

IN writing these essays and columns, in the decade 1994 to 2004, I have incurred several intellectual and personal debts. I must, however, first record my gratitude to the publishers of the various publications from which these essays and columns have been reprinted, for permitting me to include them in this volume. The 'Sources' have been duly acknowledged at the end of this volume.

My most important intellectual debt, in writing on the subjects covered in this book, is to Mr. K. Subrahmanyam, to whom I am also indebted for the valuable *Foreword* he has so graciously written. My second intellectual debt is to Dr. Manmohan Singh, who shaped my thinking on economic policy and globalisation during the 1990s. This book could not have been written but for the paradigmatic change that Dr. Singh helped bring about in India's economic policies and performance. In recent history nothing has defined India's place in the world more importantly than the new profile India's economy has acquired.

I would like to thank my former colleagues at *The Times of India, The Economic Times, The Indian Express* and *The Financial Express* for the stimulating discussions we had on many of these issues. I am also grateful to the faculties of the Research and Information System for Non-Aligned and Other Developing Countries (RIS) and the Indian Council for Research in International Economic Relations (ICRIER); participants at various seminars where some of these papers were presented; and members of the National Security

Advisory Board, where many of my ideas on the economics of national security were shaped, for comments on earlier drafts of some of these essays, and for stimulating many of the ideas contained in the columns published here.

I am grateful to the Prime Minister for permitting me to publish these essays and columns. All these essays were written and published before I joined the Prime Minister's Office. They do not reflect the thinking of the Government of India or the Prime Minister. This book does not contain any information made available to me in my present position. I am grateful to the Kapila family and the editors at Academic Foundation for the high degree of professionalism they brought to bear on the printing and publishing of this volume.

One incurs many debts of gratitude over a period of a decade, but none more important than the debt one owes to our loved ones. I dedicate this book to the two people who gave me their unquestioned love and support and made it possible for me to write these essays and columns—my daughter Tanvika and my wife Rama.

Introduction

WHEN Thomas C. Schelling was awarded the Nobel Prize in economics in 2005, the economics profession had finally come to recognise the value of a strand of economics that still has few practitioners in India. The economics of national security. Schelling's seminal work on the strategy of conflict and the 'nuclear game' took economics beyond the more mundane pre-occupation with the economics of war and national security that grabbed the attention of many Western economists during and after the Second World War. John Maynard Keynes and Nicholas Kaldor, in Britain, and John Kenneth Galbraith and Charles P. Kindleberger, in the United States, were intensely engaged, as professional economists, in studying the financial aspects of war and its economic consequences. Galbraith and Kindleberger were in fact on the staff of the US Office of Strategic Services during the War. Professional economists continue to be hired both by the US Defence and State Departments and by the British Foreign and Commonwealth Office.

Even in China, the collapse of the Soviet Union seemed to encourage greater respect among strategic policy makers for the views of professional economists in shaping strategic and foreign policy choices. It was at a defence establishment think tank that Chinese strategists developed the notion of Comprehensive National Power (CNP), that gave a higher weight to economic and social aspects of national security over the purely military.

Economists have not had the same profile in India's foreign policy and defence establishments, nor in shaping Indian strategic thought. In Government, there has been an institutional disconnect between economic planners and strategic policy makers. Outside Government, a think tank like the Institute of Defence Studies and Analyses has never hired an economist to study the economic and fiscal aspects of defence and national security. Professional economists have rarely considered the economic costs and benefits of India's strategic and foreign policy choices. Thus, a combination of professional disinterest, on the part of economists, and institutional neglect, on the part of Government and think tanks, has contributed to the relative neglect of the economic dimensions of our foreign policy and strategic choices, and the economic consequences of those choices.

My own interest in these issues was not stimulated when I was still a professional economist. It is as a journalist that I came to educate myself on the economic dimensions of India's foreign policy and strategic options. It was in 1995, when I took charge as the Editorial Page Editor of *The Times of India*, that I was called upon to take a view on India's stance on the permanent extension of the Nuclear Non-proliferation Treaty (NPT) and the vote on a Comprehensive Test Ban Treaty (CTBT). I had informed colleagues in the TOI's editorial team to whom I first turned, like senior editors Manoj Joshi, Monu Nalapat and Ramesh Chandran. Soon the editorial team expanded and I had other colleagues like Vidya Subrahmanyam, Shastri Ramachandran and Siddharth Vardarajan joining me. The morning editorial meetings had become seminars on India's nuclear policy with diverse views being expressed. I realised I had to educate myself to be able to guide the raucous debate. I turned to the *Bhishmapithamaha* of Indian strategic policy thinking, K. Subrahmanyam, for guidance!

Subrahmanyam had joined *The Times of India* as its strategic affairs editor. He gave me long tutorials on India's nuclear policy, its history and geography, its economics and politics. I began reading books on foreign affairs and strategic policy and would regularly attend seminars at the Institute of Defence Studies and

Analyses (IDSA) and the India International Centre (IIC). By the time *The Times of India* was required to take a view on India's vote on CTBT, in 1996, I was clear in my mind that we should stand firm against India signing up on CTBT, till the required round of nuclear tests were completed.

My interest in the economics of India's foreign and strategic policy was further stimulated during my stint at the Research and Information System for Non-Aligned and Developing Countries (RIS) and the Indian Council for Research on International Economic Relations (ICRIER). Most of the essays published here were written when I was on the faculty of these two institutions. Some of these essays have come out of working papers I had prepared for the National Security Advisory Board (NSAB), of which I was a member in 1998-2001, and was nominated the convenor of its sub-group on Economic Security.

My first published essay on the economics of Indian foreign policy was, in fact, inspired by an interview that Dr. Manmohan Singh had given to the editors of *World Affairs*, a foreign affairs journal published from New Delhi, for their first issue in early 1997. Looking back at the geopolitical context of the early post-Cold War world in which he had introduced economic reforms in India, Manmohan Singh spoke at length about how China and other Asian economies had used economic openness and links with the West as a strategic instrument of development and foreign policy.

Taking off from these views of Dr. Manmohan Singh, I wrote an essay for *World Affairs* on "The Economics of India's Foreign Policy" (Chapter 2). In writing this essay my thinking was shaped by Jawaharlal Nehru's speech on foreign policy, delivered as early as in December 1947 in the Constituent Assembly (Appendix). I was struck by a statement in Nehru's speech that I felt had acquired a new resonance in the post-Cold War world. Nehru had said, "Talking about foreign policies, the House must remember that these are not just empty struggles on a chess board. Behind them lie all manner of things. Ultimately, foreign policy is the outcome of economic policy."

Surely, I thought, Nehru must have had good economic reasons for his various foreign policy initiatives. The popular myth about our post-Independence foreign policy was that it was based on 'universal principles' and not on 'narrow' national interest. But if economics is the basis, how can one deny the role of self-interest? I came across a fascinating essay by the Polish economist, Michal Kalecki, the co-founder of the Keynesian Revolution in macro-economics, who likened the economics of a 'mixed economy' and the foreign policy of 'non-alignment' to a 'clever calf sucking two cows'! Given Kalecki's impeccable left-wing and anti-imperialist credentials, I figured he was not maligning non-alignment, merely characterising it.

It became clear to me that Manmohan Singh's views, as articulated in the *World Affairs* journal had brought back the relevance of economics into our foreign policy debates. The end of the Cold War after the collapse of the Soviet Union, the growing salience of international trade in international relations, thanks to China's mercantilism and the creation of the World Trade Organization (WTO), and our own increasing economic engagement of our neighbours were all pointers to the renewed relevance of Nehru's dictum on the economics of our foreign policy.

It was, however, the nuclear tests of 1998 that brought out in sharp relief the link between foreign policy and strategic policy options and economic choices. The Pokhran-II nuclear tests in May 1998 sparked a debate among economists and economic journalists on the financial and economic implications of going nuclear and on the cost of sanctions imposed on India by the United States, Japan and some other countries. In an alarmist page one news report *The Economic Times* claimed that Pokhran-II would cost the economy upto $20 billion in terms of sanctions and reduced market access. This claim was very competently challenged by G. Balachandran and T.C.A. Srinivasa Raghavan in a study, *Sanctions: A Indo-US Perspective.*[1] Balachandran and Srinivasa Raghavan showed convincingly that "the sanctions imposed by the US and others,

1. Asian Institute of Transport Development, New Delhi, 1998.

though nationally irksome, are unlikely to have any serious effect on our economic development."

Their view received professional endorsement from a highly regarded American analyst, Fred Bergsten, chairman of the International Institute of Economics, Washington DC, who showed that India's experience with US sanctions was consistent with the global experience, as IIE's extensive research had shown. A country as large as India could not be negatively impacted by sanctions imposed by just one country or a small group of countries. IIE's monumental work on sanctions showed why a large country like India could not be easily disciplined by external sanctions. Visiting India after the Pokhran-II tests, Bergsten told an audience at ICRIER that his own estimate of the net impact of post-May 1998 US sanctions on India would be around US$ 500 million, far from *ET*'s alarmist $20 billion!

While being comforted by this optimistic view, the Government of the day did not want to take chances. It launched several economic initiatives, to mop up dollars, and launched a massive diplomatic offensive, sending teams of Indian analysts and journalists to different countries to explain why India declared itself a nuclear weapons power and why the world should appreciate India's benign intent. I was drafted into this exercise by the IDSA and the IIC and travelled to many capitals with K. Subrahmanyam, N.N. Vohra, Jasjit Singh, Raja Mohan and others to convince the world that a nuclear India is no threat to the rest of the world.

In fact, I argued, a more self-confident and secure India and a stronger Indian economy should be welcomed by the world. Many of my newspaper columns, published in this volume, came out of those travels to distant capitals, ranging from Tokyo and Beijing to Paris and Washington DC. My interest in the economics of India's foreign policy and the strategic implications of India's economic development was stirred by this experience.

It was in early 2002 that I was invited by the Olin Institute of Strategic Studies at Harvard University, Boston, to read a paper at a monthly seminar on Economic Security. I chose to put my random thoughts on the matter, as expressed in a clutch of essays and columns, in a paper that I entitled *Strategic Consequences of India's Economic Performance.* I was delighted by the response I got to this paper from a variety of experts including Henry Kissinger and Martin Feldstein.

The first section of this book also contains an analytical piece I wrote for the *National Security Annual Review* published for the National Security Council Secretariat, on the concept of 'economic security' and a paper that Amit Mitra of the Federation of Indian Chambers of Commerce and Industry (FICCI) invited me to write as a background paper for a FICCI Annual General Meeting that focussed on national security.

The second section of the book contains essays on India and Asia. Here again my interest was first stimulated by a paper I wrote at RIS on India and ASEAN. Extensive travel in East and South-East Asia generated many newspaper columns and an essay that the editor of the Italian journal, *Heartland* asked me to write on the question, that he posed to me, "How Asian is India?" My research on India's trade relations with East and South-East Asian economies at ICRIER yielded a paper on India and China's trade relations with Asian economies. Analysing the so-called 'Asian financial crisis' of 1997 for ICRA's journal *Money & Finance,* I found that what began as a financial crisis became, in some countries, a wider economic crisis and, in some others, evolved into a major political crisis. The strategic consequences for Asia of the economic and financial crisis were all too visible in Indonesia. China's influence increased in the region, while that of the United States had waned.

Spending a summer at the East-West Center, Hawaii, as the First J. Watamull Fellow in 2000, I wrote a paper on the impact of the information technology boom in India on India-US relations. In my essay on India-ASEAN relations I offered the rationale for a 'Bay of Bengal Community', explaining the geo-economic logic of BIMSTEC (Bangladesh, India, Myanmar, Sri Lanka, Thailand Economic Cooperation). India's frustration with SAARC (South Asian Association for Regional Cooperation) made the idea of BIMSTEC popular at that time. However, I viewed BIMSTEC as a bridge to East Asia rather than as a rival to SAARC.

My enthusiasm for regional trade blocs had little to do with the purely economic rationale that trade economists were concerned with. Economists wedded to the idea of free trade viewed regional trade blocs as a diversion from their preferred agenda of unilateral and multilateral trade liberalisation. They viewed regionalism as an escape route from the WTO process. Protectionists, on the other hand, viewed regional trade blocs as the 'back door' of multilateralism. What was politically difficult to accomplish through the WTO, they felt, was being sought to be ensured through regional blocs that appeared politically less threatening. I share the view of those who see regionalism as a stepping stone, a building block, of multilateralism. More importantly, I also viewed regional preferential and free trade agreements as instruments of foreign policy. As trade economist Richard Cooper once put it, "trade policy is foreign policy" and more so with regional trade arrangements. Rather than view trade as a means of creating 'dependencies', *a la* the Latin American school of thought in trade policy, I shared the view that international trade creates relationships of 'mutual inter-dependence'. Consider what China did with the United States? It used trade to lock the US middle class into a mutually beneficial relationship that has acquired a political dimension and has shaped US-China relations over the past decade.

My analysis of the economics of Indian foreign policy and the strategic implications of India's economic development also pointed to the fact that for the first time after Independence, India's superior economic performance was becoming a differentiator as far as India's relations with Pakistan were concerned. I was able to see that Pakistan would pay a bigger economic price for Kargil than India. Pakistan's economy was in a tailspin after 1998 and this was reversed only after 2001, thanks to 9/11. Pakistan had not drawn the appropriate lessons from the collapse of the Soviet Union. The Soviets had armed themselves to their teeth to fight NATO on every possible battlefield. Yet, they lost the Cold War in the market place. The collapse of the Russian economy was a reminder for all nations that attempted to pursue power through the barrel of a gun. India drew the correct lesson and turned its attention inwards in the first half of the 1990s to repair its economy and make it more globally competitive. China's economic success also pointed in this direction. Power in the modern world was based as much on economic competitiveness and political resilience of a country as it was on military capability.

In some ways this debate has not ended. There are still the votaries of military power who see a large military programme in the nuclear field as a necessary requirement of power. There are others who believe that India's influence in world affairs will be shaped as much by its military potential and political profile as by its economic performance. This latter view is what informs China's notion of 'Comprehensive National Power' (CNP), that I have discussed in one essay and a couple of columns.

Apart from the 'hard power' dimensions of India's economic performance and strategic capability, India's emergence as a major power has also been shaped by her 'soft power' capabilities. The growth of India's 'knowledge economy', India's entertainment and news industry and the people-to-people links established by the so-called 'Indian diaspora', the people of Indian origin worldwide, have also shaped our global profile and prospect. Many of my newspaper columns were devoted to these issues and have been published here.

The central argument of this book is captured by the title of a TOI column, published here, "walking on two legs". It is an argument elaborated in Chapter 1, the Harvard lecture. The argument is simple. India is destined to regain its pre-eminent place in the global arena. To do so at a faster pace India must ensure faster paced economic growth, that is more efficient and equitable, and generates the revenues required to sustain a level-headed strategic policy. Equitable growth, within a framework of an open society, will enhance internal security and assure political stability; more efficient growth within a framework of an open economy will boost external security.

In the pre-colonial world, India, China and Europe were the three poles of equal power. European colonisation weakened India and China. The history of the 20th century has been the history of reversing this process. In the 21st century India and China will regain their place in a new 'multipolar', or 'poly-centric' world in which the United States will continue to be the pre-eminent power but will have to accommodate the aspirations of many other nations, including India. For India, the process of recovering the lost space in the global arena will, as it has been for others like China, require economic development and a strengthening of national capabilities. Unless the Indian economy becomes more competitive and is more globally engaged, unless the economic well-being of all Indians is assured, unless the financial health of the Government improves, India will not be able to sustain itself as a major power, nor acquire the other attributes, 'hard' as well as 'soft', of Comprehensive National Power.

Hence, India's rise and re-emergence on the world stage is a function of her economic and strategic capabilities. India's improved economic performance will perforce have strategic consequences. It will enable India to better engage the world economically. It will help build new relationships of economic inter-dependence that can have benign consequences for international relations. It will fiscally empower the Government to invest in strategic capabilities. It will reduce social and economic tensions at home as Government finds resources to invest in social and economic infrastructure. It will enable a more equitable and efficient growth process that will reduce domestic social and political tensions.

The new turn in India's economic policies and performance in the last decade of the 20th century—the success of Indian enterprise in the post-WTO world; the emergence of a confident professional middle-class; a demonstrated nuclear capability; and, the resilience of an open society and an open economy, in the face of multiple and complex challenges—these have all shaped India's response to the tectonic shifts in the global balance of power in the post-Cold War era. These essays and columns, written over a decade and for different audiences, offer a perspective on the economic and strategic dimensions of India's re-emergence on the world stage.

All these essays were written and published before I joined the Prime Minister's Office. They do not reflect the thinking of the

Government of India or the Prime Minister. This book does not contain any information made available to me in my present position.

1 ESSAY

The strategic consequences of India's economic performance

AT a time when the world was still coming to grips with the implications of the end of the Cold War for the global balance of power, for the role and relevance of different nations in the emergent global system, and, before there was as yet any considered appreciation of the impact of the turnaround of the Indian economy on the global and Asian balance of power, one of Harvard's most distinguished strategic thinkers made an interesting forecast about the nature of the post-Cold War international system that resonates to this day among strategic policy analysts in India. Prefacing his study of western diplomacy with a reflection on the 'New World Order', Henry Kissinger (*Diplomacy*, 1994), hypothesised that:

"The international system of the twenty-first century will be marked by a seeming contradiction—on the one hand, fragmentation; on the other, growing globalisation. On the level of the relations among states, the new order will be more like the European State system of the 18th and 19th centuries than the rigid patterns of the cold war. It will contain at least six major powers—the United States, Europe, China, Japan, Russia, and probably India—as well as a multiplicity of medium-sized and smaller countries" (p. 23).

Admittedly, the US remains the dominant military power but it has come to accept the emergence of other centres of economic power. Reiterating his earlier formulation more recently Kissinger (2000) has again spoken of India's 'potential' as a major power underscoring the importance of its economic performance. In 1994 India had neither convincingly demonstrated its ability to generate the kind of economic growth that it did in the period 1992-98, nor had it as yet declared itself a nuclear weapons power. Was Kissinger prescient in 1994 or was he drawing our attention to historical factors and underlying strengths in classifying India as a nation *en route* to 'major power' status? As a student of power and *realpolitik* Kissinger may well have come to understand by then that not only was India capable of sustaining the acceleration of economic growth it had already initiated in the 1980s but that its economic policies would be marked by a greater degree of realism, as in fact was the case by then with respect to its foreign policy, a fact that Kissinger readily acknowledges. However, if Kissinger, like so many other analysts, continues to only see the 'potential' of an as yet unarticulated Indian power, the question is what must India do to translate that potential into reality?

The analysts of power may suggest that notwithstanding India's declared nuclear power status there is still a credibility and a capability gap that has to be bridged before India can truly be viewed as a military and nuclear power with relevance to the world beyond her immediate neighbourhood. Nothing can be more important in bridging this gap between 'potential' and 'reality', between 'promise' and 'performance' than the sustained growth of the Indian economy. Economic development and growth is fundamental to India's re-emergence as a 'Great Power'. If India succeeds in sustaining a high rate of economic growth and can generate the resources needed not only for its defence and security but to invest in human capabilities and well-being and ensure peace and security in its neighbourhood, Kissinger's qualification can finally be dropped.

Emerging perceptions

Whatever western, and in particular American, perceptions of India during the Cold War, by the end of the 20th century two dominant factors seem to have shaped a new thinking about India in the western hemisphere—first, India's economic performance in the last decade of the century and the shift in economic policy and thinking in India; and, second, India's declared nuclear weapons status. Both these elements are factors endogenous to economic and political developments in India to which the US has had to respond. There are two other elements shaping US perceptions about India more recently, which are 'exogenous' to India but have a bearing on India-US relations. These are the rise of *jehadi* terrorism in the Muslim world and China's rising profile within Asia. Together, these factors, namely, India's economic empowerment, her military and technological capability and her role as a liberal and secular democracy in the fight against sectarianism and terrorism will shape the bilateral relationship with the US and the western world in the 21st century and, in turn, this will define American perceptions of India's global role in decades to come.

The challenge for India is to be able to deal with each one of these elements—economic growth and development, national security, *jehadi* terrorism and China's growing power and influence in a manner which will enhance national security and ensure national well-being in the foreseeable future. How India deals with each of these challenges will define the extent and nature of India's power in the 21st century and its national security.

Economic imperative

In a recent classic, the Oxford historian, Neil Ferguson (2001) while rejecting the more simplistic recent theories of the economic foundation of national power, has argued:

"Tolstoy's question was: 'What is the power that *moves* nations?' Substitute the word 'mobilise' and the question is perhaps easier to answer. Clearly, it is something more than purchasing power. Economic resources are important, of course, but they are not the sole determinant of power. A state's means of destruction consist of more than the output of its steel industry. As we have seen, a state can defeat an economically superior foe if it has better strategic, operational and tactical ability. Nor is the effectiveness of military mobilisation sufficient. We also need to take into account a state's financial sophistication: its ability to appropriate resources from taxpayers and to borrow from investors. And in major conflicts a state must also be able to mobilisė civilians optimally. The right balance must be struck between the different sectors of the economy in order to maximise war-making resources without undermining domestic well-being. The quality of bureaucratic organisation in both the state and the private sector can therefore be as important as the quality of military organisation" (p. 418).

Ferguson draws attention to what he regards as the four key institutional pillars of financial strength, constituting the economic 'square of power', namely, a tax-collecting bureaucracy; a representative parliament; a national debt; and a central bank. Admittedly, Ferguson shies away from an economic deterministic theory of state power and says as much:

"No matter how efficient the tax system, no matter how representative the parliament, no matter how liquid the bond market and no matter how well managed the currency, in the end the legitimacy of a state is bound up with such intangibles as tradition (the memory of past benefits), charisma (the appeal of present leaders), popular belief (faith in future rewards, material and spiritual) and propaganda (the state's use of available media to bolster all these). Though Carlyle feared that modernity would turn all human relations into economic relations, the true 'homo economicus'—constantly aiming to maximise his utility with every transaction—remains a rarity, and to most of us rather a monstrous one. Every day, men and women subordinate their economic self-interest to some other motive, be it the urge to play, to idle, to copulate or to wreck" (p. 422).

Thus, states can pursue power and increase their strategic relevance even without the economic wherewithal, but in the long run sustainable power is built on the foundations of sustainable development.

For India, there is no doubt that the first and most important challenge is that of accelerating the rate of economic growth and development. Economic performance and capability certainly constitute the foundation of national security and power even more so for a developing nation like India. It will define the limits to military capability and alter the relationship between India and its neighbourhood, especially its two major adversaries, namely, China and Pakistan. India has the military capability to defend her territorial integrity and security, however, it will have to sustain higher rates of economic growth to be able to alter the strategic balance in Asia, and globally, to her developmental advantage. For this reason, her enemies will act to keep her economically weak. This only underscores the economic imperative and the strategic consequences of sustained economic development.

In his survey of the 'potential and promise' of Indian power, Stephen Cohen (2001) offers a balanced appreciation of both economic and military strengths in the making of a major power, posing the question: "Can India develop the technological, logistic, and military capacity to be more than a south Asian power in years to come?" However, Cohen focuses far too much on India's military, diplomatic and political capabilities, treating economic capability only cursorily. Cohen correctly draws attention to the disjunction between the 'worldview' and 'self-image' of Indian elites, and India's real capabilities. But in defining the latter he shows inadequate appreciation of the centrality of economic performance. A robust performance on the economic front is critical to the full realisation of India's strategic potential and national security.

The economic dimension was introduced more directly into the calculus of evolving strategic power equations in Asia in a RAND study (Yeh and Zycher, 2000) that says that if India can sustain into the period 2000-2015 the economic growth performance it recorded in 1992-1998, then there would be a major reordering of Asian power equations. Following this argument, Ashley Tellis (2001) analysed the many strategic consequences of India's improved economic performance.

"The moral of the story," says Tellis, is that "If India can sustain an average growth rate of even 5.5 per cent or thereabouts for the next two decades or so, it will become a significant actor on the Asian stage. If it can accelerate its growth rates to levels beyond this 5.5 per cent band, then its significance for Asian geopolitics only increases further." Tellis then defines a new marker, "A realisation of a growth rate consistently 7 per cent or higher, an economic performance that inexorably transforms India into a great power, positions it as an effective pole in the Asian geopolitical balance, and compels international attention to itself as a strategic entity with continentwide significance" (p. 240).

These ideas also find reflection in Teresita Schaffer's *Rising India and US Policy Options in Asia* in which the robustness of economic growth and governance are seen as key variables determining the nature of Indian power. Says Schaffer, "The extent of India's rise as an economy and as an international actor will be determined primarily by factors internal to India. Two factors emerged as central drivers in our scenario analysis. The first is economic change, which will profoundly affect the political climate, the leadership contests, and India's international behaviour...The second driver,... is the quality of political leadership,..."

The idea that economic performance and capability is a necessary, though by no means a sufficient, foundation of political and diplomatic influence and military power is now widely acknowledged, more so after the implosion of the Soviet Union under the burden of its economic weightlessness, and the role that rapid economic development has played in China's emergence as a major power.

Having said this, it will be our contention that it is not economic growth in itself that holds the key to India's global profile and power, its strategic role and relevance and its national security, but the nature of that growth process and the manner in which the economic challenges it faces today are addressed. By 'nature' we mean the distributional aspects of growth, the impact of growth on global competitiveness and integration with the global economy and the sectoral composition of that growth, that is the extent of industrialisation, and its fiscal sustainability. This is relevant because India's bigger security challenge, in its journey to major power status, is largely internal both economic and political. The threat to, what more recently has come to be defined as 'homeland security', is posed by social and economic backwardness, the inequalities and the political uncertainty this generates, and the quality of economic development.

India's primary external security challenge, that posed by cross-border terrorism in the north-western region bordering Pakistan, cannot be addressed without dealing with its domestic counterpart which feeds on social and economic backwardness of minorities, and communal and caste tensions. Inegalitarian growth can only feed such threats to national security. Equally, economic backwardness holds the Indian economy back from competing globally and thereby limits the range of her global engagement. Sustained and sustainable economic growth and development are, therefore, the foundation of India's power and security.

I : India's past economic performance and contemporary power

If accelerated economic growth holds the key to realising India's strategic potential, the question arises how has India done and what exactly is the gap between performance and potential.

It is useful to acknowledge at this point that several factors, other than economic growth, contribute to India's self-image as a major power—her civilisational history, her contribution to religion and philosophy, her intellectual, especially scientific and mathematical achievements, her demographic size and composition, her geographical size and location, her military strength and capability. As John Garver (2001) notes in the opening line of his study of the rivalry between India and China "Two of the most brilliant civilisations yet produced by humanity, those of China and India, lie side by side on the continent of Eurasia. The peoples that have produced these civilisations are both rightly proud of their histories and achievements, and determined that their nations will play a major role in the modern world" (p. 3).

A recent statistical enterprise of the Organisation of Economic Cooperation and Development (OECD) captures this notion of historic potential through striking economic numbers. Angus Maddison's (1998) study of China's economic performance has thrown up a set of numbers on world income for the period 1700-1995 that draws attention to India's and China's dominant position in the world economy in the pre-industrial and pre-colonial era, and their more recent journey to regain this lost share. In 1700 China and India accounted for 45.7 per cent of world's national income. (Table 1.1) By the end of the 19th century this share had fallen to 24.2 per cent and by the middle of the 20th century to a lowly 9 per cent. The decline in the share of these two Asian giants in world income was matched by the dramatic increase in the share of the US and subsequently Japan. Europe saw its share increase to a peak of over 40 per cent by the end of the 19th century and a subsequent decline to levels enjoyed before the colonial era. These numbers feed the *hubris* of the Indian strategic and economic policymaking community that India is destined to regain its pre-eminent status as a major actor on the world stage. Equally, they draw attention to the centrality of economic performance in shaping a country's strategic power and relevance.

Table 1.1

Distribution of World Income: 1700-1995

	1700	1820	1890	1952	1978	1995
China	23.1	32.4	13.2	5.2	5.0	10.9
India	22.6	15.7	11.0	3.8	3.4	4.6
Japan	4.5	3.0	2.5	3.4	7.7	8.4
Europe	23.3	26.6	40.3	29.7	27.9	23.8
US	-	1.8	13.8	21.8	21.8	20.9
Russia	3.2	4.8	6.3	9.3	9.2	2.2

Source: Angus Maddison, *Chinese Economic Performance in the Long Run*, OECD, Paris, 1998.

Admittedly, the dramatic story of the second half of the 20th century is China's economic performance, though the jury is still out on the authenticity of the statistical claims. China set itself on a high growth trajectory before India and has succeeded in doubling its share of world income within a span of a quarter century, going up from 5.2 per cent in 1978 to 10.9 per cent in 1995. China's economic growth performance parallels its emergence as a mercantilist trading power, with its share of world trade increasing from around 1 per cent in the late 1970s to 4.5 per cent in 2000. By contrast, India was a slow starter. However, there has been a consistent acceleration in India's economic growth in the 20th century (Table 1.2).

Table 1.2

Macroeconomic Trends in Indian Economy, 1900-2001

	Trend Growth Rates of GDP by Sectors@						
	1900-01 to 1946-47	1950-51 to 1959-60	1960-61 to 1969-70	1970-71 to 1979-80	1980-81 to 1998-90	1990-91 to 1999-00	1997-98 to 2001-02$
Primary	0.46	2.8	1.4	1.8	3.0	2.9	2.1
Secondary	1.82	6.1	5.4	4.7	6.9	7.2	4.5
Tertiary	1.65	4.0	4.5	4.5	6.4	7.7	7.8
Total GDP	1.05	3.7	3.3	3.5	5.4	6.2	5.4
Per Capita	0.22	1.8	1.0	1.2	3.1	4.3	-

Source: S. Sivasubramonian, *The National Income of Indian in the Twentieth Century*, Oxford, 2001.
Notes: Average annual growth rates of GDP based on end values, at 1938-39 prices.
@ At 1948-49 prices.
$ Ninth Five Year Plan, 1997-2002.

What exactly has been India's more recent growth performance and what is the extent of the gap between performance and potential? While India has been slow to start, if a long view is taken of the growth process then we do see a steady acceleration of growth. After recording virtually no growth in the first half of the 20th century, the economy grew at an annual average rate of 3.5 per cent in 1950-80 and 5.4 per cent in 1980-1990 and 6.2 per cent in 1990-2000. In the mid-1990s, 1992-1998 the economy recorded over 7 per cent growth, however in 1998-2002 there has been a marginal deceleration, largely on account of slow industrial growth. This raises some questions about the medium-term growth potential. If the NBAR-CSIS view is accepted, then an average rate of growth of 5.8 per cent, which is the long-term rate registered during

1980-2002, is inadequate to enable India to not only deal with the challenge of development in a poor, populous country but also acquire the diplomatic and military profile of a major power. Indian planners recognise that the elimination of mass poverty and the challenge of human development can only be fully addressed if the economy delivers at least 7 per cent to 8 per cent growth over the next decade. Strategic analysts also believe that such a rate of growth of income is necessary for the government to raise the resources required for the modernisation of the conventional armed forces and the operationalisation of a command and control system relevant to a credible nuclear deterrent.

Notwithstanding these caveats, the acceleration of growth over the past two decades has already had its strategic consequences. If there is further acceleration to a medium-term average of 7 per cent, then there will be further consequences. It is to these issues which we now turn.

II : Strategic consequence of what has been achieved

India's accelerated economic growth and, more importantly, the policy of trade and investment liberalisation has already impacted upon its political and diplomatic relations with nations near and far, ranging from the US and European Union to ASEAN and Taiwan. Nowhere is the impact more dramatic from a strategic perspective than on the relations with her two immediate neighbours and strategic competitors.

India and Pakistan

From the time of partition and independence, India's immediate strategic challenge has been the relationship with Pakistan and, in turn, Pakistan's relationship with the US and China. Pakistan's relatively better economic performance in the period 1950 to 1980 only made matters difficult for India, notwithstanding the fact that Pakistan was defeated in every single battlefield confrontation with India. On its own India could have neutralised the Pakistan challenge, but big power support during the Cold War and the relationship with China helped Pakistan neutralise India's advantages to a considerable extent. While Pakistan's nuclear capability has further reduced the structural imbalance between the two south Asian neighbours, the differential economic performance of the two neighbours has begun to turn the balance once again in India's favour.

Consider the fact that while in 1960-80, Pakistan's GDP growth rate was closer to 6 per cent per annum compared to India's 3.5 per cent, in the 1990s India's growth rate was closer to 6 per cent while Pakistan's had slipped to below 4 per cent per annum. This has had an impact on a variety of economic indicators. For example, India improved its ranking in the Human Development Index (HDI) (compiled annually by the United Nations Development Programme) while Pakistan's ranking has actually slipped. India has moved up in the 1990s from being classified in the 'low HDI' category to the 'medium HDI' category. On another front, India has moved up from being classified as 'moderately indebted country' (external debt classification of the World Bank) to now being regarded a 'low indebted' country. Pakistan, on the other hand, has experienced a deterioration in its external debt profile during the 1990s and has had to seek debt rescheduling after coming close to default.

These and similar divergent economic trends have encouraged strategic analysts to increasingly 'de-hyphenate' the two south Asian neighbours in any strategic assessment of the region. As early as in 1997 an analyst at the National Defense University, Washington DC, (Clawson, 1997) observed:

"The changed GDP ratios (between India and Pakistan) would have military implications. Given that India spends 2.5 per cent of its GDP on its military and that Pakistan's economy is 19 per cent the size of India's, Pakistan would have to spend 13 per cent of GDP to match the Indian military budget in absolute size. In fact, Pakistan cannot afford to spend that much. Pakistan can only afford military spending that is little more than half the size of India's. That is, Pakistan can only afford to dedicate 6.5 per cent of its GDP to the military, because to do more would drain away the resources needed for the investment that sustains future growth. Already, Pakistan faces the same quandary as the former USSR—the military spending necessary to keep pace with the historic foe would drain off so many resources that the economy would fall further behind that of the adversary. The problem will get much worse (when)...Pakistan's GDP slips relative to that of India. As India becomes richer, it will be able to afford to fund its military more generously. The ratio between the Pakistani military budget and that of India could easily become one to three, rather than one to two. At that point, it would become less and less plausible to see Pakistan as in any way comparable in national power to India.

"In short, the gap between Indian and Pakistani economic prospects could lead to a shift in the balance of power in the region. On present trends, India is likely to become the clearly pre-eminent regional power. Indeed, as the difference in economic growth rates becomes clearer, the trends in India's favour will affect perceptions—India will be seen as the power of the future, and that will in turn multiply its power in the present."

Given that economic trends have indeed moved in the expected direction, notwithstanding India's recent growth deceleration, the 'de-hyphenation' of the two south Asian neighbours has already started. This has prompted Tellis to argue that:

"When the economic, political, and strategic fortunes of India and Pakistan are considered synoptically, the opposing trend lines appear in sharp relief. India's grand strategic trajectory appears ascendant, while Pakistan, remaining trapped in the mire of stagnation, appears at risk of collapse. If these trend lines continue, the stage will be set for a consequential geopolitical transformation within south Asia itself. That is, India will steadily acquire the economic, political, and strategic capabilities that set it along the path to great-power status, thus enabling it to break out of the limiting confines of the Indian subcontinent (where it has been since at least 1962) and take its place as one of the major centres of power in Asia writ large" (p. 238).

Even though Pakistan has tried to neutralise the impact of this differential economic performance by, one, going nuclear, and, two, imposing a non-conventional security threat on India, through what has come to be known as 'cross-border' terrorism, in the long run if Pakistan does not reverse the process of economic decline, it will be unable to continue to 'hold India back', one of its most persistently pursued strategic objectives. Indeed, in order to make economics work for it in a positive manner Pakistan will have to seek *modus vivendi* with India and normalise its political relations so that it can turn its attention to economic development.

Their differential economic performance has already impacted upon the economic and business relations between developed industrial economies, including China, and the two south Asian neighbours. Neither the US nor China would like to hurt their business prospects in India. Indeed, China has in the past year delinked its growing business relationship with India from persisting differences on the political and diplomatic front. This partly explains China's equivocal stance on an increasing number of India-Pakistan bilateral disputes like the Kargil War and the campaign against terrorism.

Pakistan will also come under regional pressure from other south Asian countries to cooperate with India when they realise that Pakistan's thwarting of the process of regional economic integration is hurting the region as a whole. India has already delinked the process of regional integration by pursuing bilateral liberal trade agreements with Sri Lanka, Nepal and Bangladesh. India's desire to seek closer economic relations with its eastern neighbours, the members of ASEAN, along with some of the other south Asian countries like Sri Lanka and Bangladesh, will further reduce Pakistan's economic relevance for south Asia. India's Dialogue Partner status in ASEAN, its membership of the ASEAN regional Forum and the India-ASEAN summit scheduled for later this year suggest that ASEAN member countries, including Muslim-majority nations like Indonesia and Malaysia, have decided to place business above politics and religion and pursue closer relations with India. India's 'Look East Policy', its increasing strategic interaction with ASEAN, Australia and Japan and the attempts to create a new regional group around the Bay of Bengal, excluding Pakistan, symbolise a willingness on the part of India's other neighbours to 'de-hyphenate' their relations in south Asia. This proces is largely driven by the emerging economic and business links between India and her wider 'southern Asian' neighbourhood.

India and China

For centuries India and China have been neighbours and at comparable levels of development. China moved ahead of India in the 18th century (Table 1.1), but slid back to level with it by the end of the 19th century. In the period 1950-80 the two economies remained at similar levels of development, even though China had started moving ahead of India by the early 1960s. When China launched the post-Mao modernisation programme it was already ahead of India on most economic and military indicators save one, namely, its extent of integration with the world economy. India and China had comparable levels of share of world trade, around 0.8 per cent each in the 1970s. The period 1980-2000 has made all the difference. China not only sustained a very high rate of growth compared to India during this period, even if China's growth figures are vastly exaggerated, but more to the point China increased its share of world trade four-fold, to around 4.0 per cent by 2000, compared to India's still lowly share of 0.7 per cent.

China's rapid economic growth, its emergence as a major trading nation and the phenomenal increase in foreign direct investment have combined to widen the gap between the strategic power and potential of the two Asian giants. China has used its economic and trading power to build strategic relationships with all major powers and, equally importantly, with each one of her Asian neighbours from the central Asian republics in the west to Japan and Korea in the east and ASEAN in the south. For India to be able to restore the balance within Asia it will not only have to pursue faster economic growth and domestic economic modernisation, but also increase its share of world trade and widen its economic links with the Eurasian landmass as well as with the trans-Atlantic and Asia-Pacific economies.

China has leveraged its economic power in the strategic arena in a variety of ways. At the time of the Asian economic crisis, it played a stabilising role thereby increasing its relevance and role in the region. This has helped impart momentum to projects like an Asian Monetary Fund, and the ASEAN-plus-3 group, which China has pursued. By investing in central Asian oil and gas projects and giving the latter access to the east and South-East Asian markets *via* land-based pipelines through China, its has been able to impact on energy security in the region as well as increase its economic influence in central Asia. Finally, China has emerged as a major market as well as a competitor for all east and South-East Asian economies. In short, it has increased its political influence both in South Asia and South-East Asia by leveraging its economic potential. Indeed, India-China relations have also improved in recent months riding on the back of increased trade and investment flows. China (including Hong Kong) has emerged as India's second largest trade partner next only to the US.

The strategic consequences of the economic competition with China are, therefore, fundamental to India's future role within Asia and the global system. If India can sustain above average growth (over 7 per cent per annum in the next decade) and if China experiences a deceleration of growth, coupled with domestic political uncertainty, the widening gap between the two civilisational neighbours can be reversed to an extent. If not, China will emerge as the pre-eminent Asian power and force India into accepting its strategic leadership even within south Asia. The key to this strategic rivalry will be the relative economic performance of the two countries. The main strategic challenge for India in the medium term is, therefore, its relative economic performance *vis-à-vis* China. Tellis has summed this up admirably:

"They (Indian policy-makers) believe that the best antidote to the persisting competitive, and even threatening, dimensions of Chinese power is the complete and permanent revitalisation of the Indian economy. The pursuit of this objective implies that Indian security managers believe that the best insurance against assertive Chinese power lies not in participating in any evolving anti-China alliance but rather by emerging as a strong and independent power on China's periphery... Within the subcontinental setting, India has focused entirely on economic renewal in order to secure the great power capabilities that eluded it during the cold war" (p. 257).

If India has to realise its power potential, it must address important challenges on the economic front with a direct bearing on her strategic capability. However, successive governments in India, at the centre and in the states, have not been able to devote single-minded attention to economic reforms. Political uncertainty, the vagaries of democratic politics and social tensions have constantly diverted governmental attention away from the economic reform programme. The two areas where the link between economic policy and performance and strategic capability and political influence are most direct are fiscal policy, which limits the economic power of the state, and trade policy, which defines the manner in which a country can utilise its economic power as an instrument of diplomacy, building relationships of inter-dependence between nations and shaping the institutions of multilateralism and the process of globalisation.

III : Economic impediments to national security

If India has to bridge the gap between performance and potential and leverage her economic size for strategic advantage then it must address at least two major economic policy challenges to make economic policy work more effectively to its strategic advantage. We are not considering here the larger challenge of human development and poverty eradication, which are obvious and manifest economic challenges facing India.

The meaningful resolution of these constraints is fundamental to securing strategic capability commensurate with her economic size and civilisational attributes. However, here we consider two limited macroeconomic policy challenges whose resolution is of equal significance to India's strategic capability. The term 'strategic capability' refers to the ability of a nation to deploy its economic, political, intellectual, cultural and military capability in the defence of its national interest and the well-being of its people, and influence the course of events within its strategic environment.

The fiscal empowerment of the state

In Ferguson's model of strategic power, the "square of power" as he dubs it comprises—the tax bureaucracy, the parliament, the national debt and the central bank. It is these four institutions of fiscal empowerment of the state which enable the projection of national power by creating the institutional framework for the mobilisation and deployment of financial resources. In Ferguson's view, "(these) institutions that initially existed to serve the (British) state by financing war also fostered the development of the economy as a whole. Better secondary and higher education, the rule of law (especially with respect to property), the expansion of financial markets and the stabilisation of the credit system: these were vital institutional preconditions for the industrial revolution" (p. 17).

Not surprisingly India inherited these British institutions of war financing and industrial development and managed to put them to good use in the post-independence period. The Indian finance ministry and the central bank by and large pursued a conservative policy of fiscal empowerment that enabled India to avoid many of the fiscal pitfalls of development, like hyperinflation, excessive external debt and exchange rate volatility, that marked the experience of many developing countries. As two distinguished analysts of Indian fiscal policy observed (Joshi and Little, 1994):

"The British created in the Indian Civil Service a small, high-minded, highly elitist bureaucracy with a Gladstonian fiscal outlook; its successor, the Indian Administrative Service, preserved—at least initially—the same traditions... (p. 8). The 'fiscal conservatism' of the civil service manifested itself in a low tolerance for inflation, in the search for exchange rate stability and in a dislike for high budgetary deficits. This paradigm, however, began to shift in the 1970s. Since then India has witnessed a deterioration in its fiscal profile. While this initially contributed to high inflation and high deficits, it finally precipitated a balance of payments crisis in 1990-91, with far-reaching consequences for Indian strategic policy. The

1990s witnessed a gradual improvement in the external profile of the Indian economy. India's current account deficit has been kept within the manageable limit of 1 per cent to 2 per cent of GDP. India's external debt to GDP ratio has declined over the 1990s and the debt service ratio has improved as well" (Table 1.3).

Table 1.3

External Debt Indicators

Year	Debt-Stock GDP Ratio	Debt-Service Ratio	Debt-Exports Ratio	Short-Term Debt/Total Debt	Short-Term Debt/Foreign Currency Reserves
1990-91	28.7	35.3	491.7	10.3	382.3
1995-96	27.1	24.3	295.7	5.2	28.5
1999-00	22.0	16.0	258.6	4.1	11.5

Source: Ministry of Finance, Government of India.

While the external financial profile of the economy has improved, there has been a deterioration of the government's fiscal profile. The tax to GDP ratio has declined from over 11 per cent in the 1980s to around 9 per cent by the end of the 1990s. The combined fiscal deficit of the central and state governments remains at around 10 per cent of GDP after a decade of fiscal correction. The persistence of the fiscal problem prompted the Reserve Bank of India to urge the government to fiscally 'empower' itself through a Fiscal Responsibility Act which seeks to place mandatory legislative curbs on the fiscal and revenue deficits of the central government. From a national security perspective, sound macroeconomic management entails:

- elimination of the revenue deficit, a manageable fiscal deficit, elimination of wasteful subsidies not targeted to the poor;
- low and manageable current account deficit;
- low internal and external debt, low short-term debt in overall external debt;
- profit-generation by public enterprises; privatisation of non-strategic public enterprises;

- self-financing public utilities like power, irrigation, water and public transport; and
- an increase in the tax/GDP ratio to levels reached by rapidly industrialising developing countries of around 15 per cent of GDP from the current low of 9 per cent of GDP.

The medium-term fiscal threats facing the economy arise from an inability to finance essential development expenditure and the inability to ensure a truly efficient financial system. Productive investment is being held back by the inability to reduce unproductive subsidies, mobilise adequate direct tax revenues and generate returns to existing public investment. These systemic weaknesses increase the vulnerability to external economic pressures, especially from multilateral and bilateral aid agencies and donors. In making the transition to 'major power' status India will have to find the resources for national defence and military capacity building. Higher economic growth as well as political and military

Table 1.4

Structure of Central Government Expenditure (percentages)

Item	1980-85	1985-90	1990-95	1995-00	2001-02	2002-03
Non-plan expenditure	59.90	65.52	71.02	75.00	73.00	72.33
Interest payments	13.07	16.52	24.59	30.00	29.00	28.60
Defence	16.72	16.35	14.70	15.00	15.60	15.80
Subsidies	8.35	9.52	9.86	8.50	8.40	9.70
Police	1.24	1.35	1.65	2.00	2.00	2.03
Pensions	1.60	2.04	2.25	3.40	4.00	3.67
Loans and advances to States and Union Territories	2.86	6.03	5.31	6.80	-	-
Grants to states and UT	2.58	2.76	2.52	2.40	4.66	4.67
Other non-plan expenditure	13.48	10.95	10.14	9.00	-	-
Plan expenditure	40.10	34.48	28.98	25.00	27.00	27.67
Total	100	100	100	100	100	100

Source: Economic Survey (various years), Ministry of Finance, Government of India.

strength cannot be achieved without a major programme of fiscal regeneration at both the state and central levels.

In the 1980s growth acceleration was fuelled by fiscal profligacy and imprudence which in turn contributed to the balance of payments crisis in 1990-91. The non-sustainability of such fiscal expansion is demonstrated by the sustained increase in interest payments from 2.2 per cent of GDP in the early 1980s to 4.7 per cent of GDP by the late 1990s. The increasing pre-emption of public finances by non-productive interest payments and subsidies has left little for productive investment, on the one hand, and for defence, on the other. Unless the growth process is fiscally sustainable, India will not be able to translate her economic gains into military and strategic capability.

Fiscal empowerment and public investment

In the current phase of privatisation inadequate attention is being paid to necessary public investment and to making existing public investment more productive. This will remain a challenge even after all public enterprises have been privatised. There are at least two areas in which public investment will remain relevant and important—one, social and economic infrastructure; two, defence and strategic industries (including aerospace, space, shipbuilding and nuclear energy). The central and state governments will have to find the financial resources for increased investment in health, education, urban services and utilities.

There are also important governance issues in each of these areas. Fiscal empowerment is both a function of revenue mobilisation and improved productivity and profitability of public investment. This is a necessary pre-condition of accelerated economic growth of 7.0 per cent and above. The experience of China once again suggests that even as the space for private enterprise and market forces is increased, public investment must not only continue but must become increasingly productive if economic growth is to translate into strategic capability.

Fiscal empowerment and defence spending

India's national security concerns, especially arising out of *jehadi* terrorism, and her long-term nuclear capability building will undoubtedly impose a financial burden on the government. Equally, the acceleration of economic growth will increase concerns about the security of energy supplies. This will also require India to bolster her strategic capability within the Indian Ocean region. India is a modest spender on defence and the 'guns *versus* butter' issue has never been a major point of political contention. A Regional Security Assessment by Jane's Information Group (1997) observed, "India's defence spending remains modest compared to other countries with major security concerns." Through the 1990s India's defex has remained in step with world averages, at around 2.5 per cent of national income, compared to over 5.0 per cent for Pakistan and China. In the last two years, after the Kargil war, there has been a steep increase in defence spending but this remains below the peak of 3.5 per cent of GDP reached in the mid-1980s. India's frontline role in the campaign against terrorism will imply that the government will have to find the resources for defence and national security. The burden of this effort is directly related to economic growth and the fiscal empowerment of the government. The relationship between economic performance and strategic capability is direct in this case.

In a large continental economy like India public investment in strategic industries has economic externalities going beyond power projection. India's investment in defence related industries, as indeed in the case of the US and China, has helped develop domestic technical capabilities with spin off benefits for the civilian sector. The fiscal pressures on the defence budget have in fact meant a reduction in capital expenditure, hurting the development of domestic scientific and technical capabilities, which in turn hurt economic development.

The 'fiscal empowerment' of the state is, therefore, a vital step in the realisation of the economic potential, which in turn will enable India to bridge the gap between her current strategic capability and her potential as a major power.