Make in India: Yes, but how?

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Narendra Modi articulated the idea of ‘Make in India’ in his first Independence Day speech as prime minister from the ramparts of the Red Fort in Delhi on 15 August 2014. The initiative was launched with much fanfare in late September. It was the focus of attention in the media—editorials, columns, interviews and debates—for a while, but is now on the back burner. There is little follow-up action. Even so, there are three questions worth asking. Why does industrialization matter for India? How is manufacturing doing in the economy? And, if it is not doing well, what is to be done?

At the present stage of development in India, the importance of manufacturing cannot be stressed enough. Indeed, industrialization is an imperative. For one, it is the only path to employment creation. Modest increments in agricultural output are associated with negligible increases in employment. The informal or unorganized services sector is an employer of the last resort, but levels of income are low and quality of jobs is poor. For another, it is a potential source of economic growth, insofar as it can provide employment at higher levels of productivity than in traditional agricultural or informal services sectors, thereby mobilizing our most abundant yet underutilized resource—people—for development. Above all, economic development is not only about economic growth. It is about the capabilities of an economy to organize and transform its productive activities. In practice, this is possible only through industrialization, which leads to the development of a manufacturing sector.

During the past 25 years, alas, India’s progress in terms of industrialization has been most disappointing. This outcome contradicts the claims and expectations of those who argued that economic liberalization would increase efficiency and foster growth of the manufacturing sector. In fact, the story of industrialization since 1991 is somewhat dismal, as compared with our own past performance and the more recent performance of other countries.

The share of the manufacturing sector in total employment in India remained almost unchanged around 11% from 1987-88 until 2004-05 and increased modestly thereafter (*Figure 1*). However, the share of the manufacturing sector in India’s gross domestic product (GDP), which increased slowly from 15.9% in 1987-88 to 17.3% in 1995-96, diminished thereafter to a low of 12.9% in 2013-14 (*Figure 2*). Such a decline in the share of manufacturing in total output, by 4.4 percentage points, a drop of one-fourth the initial level over a period of less than two decades, is a cause for serious concern. Indeed, this might reflect the beginnings of de-industrialization, similar to what was witnessed in Latin America during the 1980s and 1990s.

The contrast with the industrialization experience of four Asian countries, from 1990 to 2010, is striking (*Table 1*). The share of manufacturing value added in GDP in the selected countries was in the range of one-fourth to one-third, as compared with less than one-seventh in India. In these countries, unlike India, this share also increased significantly between 1990 and 2000, although it decreased a little in 2010 in the aftermath of the global financial crisis, but was still roughly double that in India. It is no surprise that China is way ahead of India. So are Malaysia and Thailand. Even Indonesia left India behind.

Obviously, something must be done to revive industrialization in India. The emphasis on manufacturing in India at this juncture represents a cognizance of the problem. But words are not enough. The rhetoric of ‘Make in India’ must be transformed into reality. How can this be done?

Conventional thinking in government, in industry, and among economists, tends to focus on obstacles that are almost folklore: pathetic infrastructure, rigid labour laws, political-cum-legal constraints on land acquisition, and the catch-all ‘difficulties’ of doing business. Resolving these problems is, of course, necessary but cannot be sufficient. Better infrastructure, appropriate labour laws, land for factories, and ‘ease’ of doing business are permissive factors that could allow or enable manufacturing to revive. But these are not causal factors that can make it happen.

The revival of manufacturing and the resumption of industrialization in India require coordinated action that spans monetary policy, exchange rate policy, trade policy, and industrial finance. Monetary policy and exchange rate policy are in the domain of the Reserve Bank of India. Trade policy is in the jurisdiction of the ministry of commerce. And development finance is the jurisdiction of the ministry of finance. These divisions, in terms of primary responsibility, exist everywhere. The difference between success and failure at industrialization lies in the capabilities of the State to coordinate and harmonize these policies across departments and institutions, which are parts of the same

government. Until the government is able to do this, ‘Make in India’ will remain a mere slogan, much like the road to heaven that is paved with good intentions.

Monetary policy is a critical determinant of investment and capacity creation in the manufacturing sector. Manufacturing firms use borrowed capital to finance investment if their expected rates of return are higher than the interest rate payable on such borrowing. Access to credit for manufacturing firms is just as important as the price of credit. In recent years, monetary policy in India has raised interest rates for long-term borrowing by manufacturing firms to the range of 15% per annum, while restricted credit has squeezed availability. Thus, the price of credit has been too high while access to credit has been grossly insufficient. Investment in manufacturing has simply been stifled. It is no surprise that gross fixed capital formation as a proportion of GDP fell from 33.6% in 2011-12 to 28.7% in 2014-15. It is important to recognize that monetary policy is an effective instrument in the pursuit of industrialization objectives.

Exchange rate policy exercises a significant influence on the profitability of manufacturing firms that compete with imports in the domestic market or export to foreign markets. Between April 2014 and March 2015, the rupee depreciated vis-à-vis the US dollar by just 4.5%, whereas the US dollar appreciated far more against the currencies of emerging markets and major industrialized countries: 24% against the euro, 16% against the Japanese yen, and 14% against the British pound. In effect, the rupee appreciated against the national currencies of its major markets and its main competitors. Imports became cheaper than goods produced at home. Exports became less competitive in foreign markets. Insofar as firms in the manufacturing sector mostly produce traded or tradable goods, such an overvalued exchange rate reduces their profitability. It is important to remember that an exchange rate is a price.

Trade policy matters for the manufacturing sector because the pace and nature of import liberalization affects its competitiveness vis-à-vis imports in the home market, just as access to imported inputs affects the competitiveness of its exports in the world market. Manufacturing firms in India have suffered on both counts. The dismantling of quantitative restrictions and the significant reduction in tariffs, which were steps in the right direction, has been too rapid in both consumer goods and capital goods, so that domestic firms have lost markets to imports. Dumping on the part of China exacerbates this problem, but World Trade Organization-admissible anti-dumping actions are seldom invoked. At the same time, despite import liberalization, firms exporting manufactured goods simply do not have the access to imported inputs that is necessary to maintain price and quality competitiveness in world markets. It is important to understand that strategic trade policy can foster industrialization.

Industrial finance provided by development banks performs a crucial role in countries that are late industrializers by meeting the financing needs of manufacturing firms, which are not met by capital markets or commercial banks because, in their calculus, the risk is too great. In India, the contribution of ICICI and IDBI to the financing of industrialization, during the period 1970-2000, was essential, substantial and innovative. Some of it served a strategic purpose in kick-starting manufacturing activities. There were errors but, instead of introducing correctives, the government closed down these development banks, converting them into commercial banks, in the early 2000s. India has much to learn about the continuing importance of finance for investment in manufacturing, from countries such as Brazil, Korea, and China (indeed even Germany and Japan) that have done so much better at industrialization, where development banks have provided industrial finance on a significant scale and continue to do so even now. Indeed, the time has come to establish a National Development Bank that would provide finance to support industrialization in India.

In sum, the revival of industrialization in India, inter alia, requires radical changes in monetary policy, correctives in exchange rate policy, calibration of trade policy, and a rebirth of industrial finance. Strategic coordination of these policies in a long-term perspective, often described as industrial policy, was at the foundations of success in industrialization elsewhere. Without such a coordinated policy-mix, ‘Make in India’ will be no more than a fond hope.

In the past, the wrong kind of government intervention might have hurt the efficiency, if not the pace, of industrialization in India. Since economic liberalization began in 1991, markets have not provided any magic wand to produce desired outcomes. In the future, the absence of the right kind of government support will mean that India remains a laggard and industrialization remains an unfinished journey.

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