Turbulence — Risk and Resilience: Built in Peacetime

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Transcript

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Abstract

Crises are not rare events. By Ajay Shah's reckoning, something like five financial crises happen somewhere in the world every year, most of which never make headlines. What determines whether a country survives one intact is not luck but preparation done long before the crisis arrives. In this conversation with Anupam Manur, Shah argues that the instinct to reach for protectionism, currency controls, and trade barriers the moment danger appears gets resilience backwards. Real resilience comes from flexible prices, institutions strong enough to resist bad ideas when everyone is frightened, and financial strength built up during calm times.

Shah traces the current "age of chaos" to three structural breaks: the rise of China as a systemically important non-market economy, the arrival of social media which undid a century-old political settlement around inequality and elite leadership, and the loss of American leadership under Donald Trump, which had previously held together everything from freedom-of-navigation shipping lanes to global environmental agreements. He works through what resilience means in practice, from the primary deficit and fiscal strategic depth to labor market flexibility and exchange rate adjustment, using examples ranging from the UTI bailout to Modi's caution during COVID to Britain's wartime borrowing history. He then turns to China specifically, laying out a categorized framework for when protectionism is justified and when it is not, before widening the lens to global risks over the next decade and what India's own reform process is missing.

The conversation moves from the abstract architecture of global crises down to the granular mechanics of Indian public finance and back up to geopolitical scenarios, all anchored in Shah's central argument: resilience is built in peacetime, not manufactured in a crisis.

Supplementary Resources

- **Ajay Shah On 4 Pillars Of Industrial Policy, And Why They're All Bad** by Rahul Ahluwalia and Ajay Shah (Podcast) [1]

- **Caste, Class, and Power: Changing Patterns of Stratification in a Tanjore Village** by André Béteille (Book) [2]
- **Who lends to the Indian state?** by Aneesha Chitgupi, Ajay Shah, Manish K. Singh, Susan Thomas and Harsh Vardhan (Working paper) [3]
- **The Dark Psychology of Social Networks: Why It Feels Like Everything Is Going Haywire** by Jonathan Haidt and Tobias Rose-Stockwell (Article) [4]
- **Why the Past 10 Years of American Life Have Been Uniquely Stupid: It's Not Just a Phase** by Jonathan Haidt (Article) [5]
- **The Anxious Generation: How the Great Rewiring of Childhood Is Causing an Epidemic of Mental Illness** by Jonathan Haidt (Book) [6]
- **In Service of the Republic: The art and science of economic policy** by Vijay Kelkar and Ajay Shah (Book) [7]
- **Increasing returns, monopolistic competition, and international trade** by Paul R. Krugman (Journal article) [8]
- **Social Theory and Social Structure** by Robert K. Merton (Book) [9]
- **The case for trade barriers against Chinese imports** by Ila Patnaik and Ajay Shah (Article) [10]
- **A narrow path for India and China: de-risking engagement for a cautious peace** by Ajit Ranade, Nitin Pai and Ajay Shah (Blog post) [11]
- **How American Politics Went Insane** by Jonathan Rauch (Article) [12]
- **The Constitution of Knowledge: A Defense of Truth** by Jonathan Rauch (Book) [13]
- **The China Model is Broken** by Ajay Shah and Amit Varma (Podcast) [14]
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- **Financial Crises: Why They Happen, How They Unfold, What to Do** by Ajay Shah and Amit Varma (Podcast) [21]
- **Automatic stabilisation of the macroeconomy** by Ajay Shah (Article) [22]
- **Gains from the UK FTA** by Ajay Shah (Article) [23]
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Introduction to Turbulence series

[00:00:08] Anupam Manur: Welcome to Turbulence, a special series on global finance and geo-economics in an age of disruption from All Things Policy, Takshashila's daily public policy podcast. I'm Anupam Manur.

[00:00:20] Anupam Manur: Sooner or later, every country gets hit. A war, a pandemic, a shipping lane that closes, or a bank that goes down. And the instinct for most governments when the world turns dangerous is to reach for protection. Make it at home, hold the currency steady, and erect trade barriers.

[00:00:40] Anupam Manur: Ajay Shah, my guest today, thinks that this instinct gets resilience almost exactly backwards. What lets a country absorb a blow, he argues, is a set of far less glamorous things. Prices that are allowed to move, institutions that can refuse a bad idea at the moment everyone is frightened, and of course, money in the bank. None of which can be assembled once a crisis has arrived at your shores.

[00:01:05] Anupam Manur: So, when the next crisis comes, and it will, what will India have to absorb it with? Ajay Shah is one of India's most consequential economists. He has worked inside the Ministry of Finance, spent years at NIPFP, and is a co-founder of the XKDR Forum in Mumbai. With Vijay Kelkar, he wrote In Service of the Republic, perhaps the most serious book we have on how the Indian state actually works.

[00:01:05] Anupam Manur: He's also that rare economist who will travel from the primary deficit to military drones to the future of the rupee inside a single answer, which is precisely what this conversation demanded.

[00:01:43] Anupam Manur: Turbulence, Global finance and geo-economics in an age of disruption is a special series of Takshashila's All Things Policy podcast. This series is made possible by the generous support of Zerodha.

[00:01:58] Anupam Manur: Somewhere in the world, as you're still listening to this, a financial crisis is perhaps underway. By Ajay Shah's reckoning, there are something like five of them every year. It could be a banking crisis, somewhere seizing up, a currency breaking. It could be a government discovering that it can no longer roll over its debt.

[00:01:58] Anupam Manur: Maybe five a year, maybe less, but some of them we would never even hear about.

Financial crises and the road from 2008

[00:02:21] Anupam Manur: But all of this tells us something kind of interesting. The idea that crisis, you don't know when a crisis can arise, and you don't know when it lands and how it lands and then how do we get out of it. In 1929, a crash happened in a stock exchange. We all know about this.

[00:02:21] Anupam Manur: This became the Great Depression. It took roughly a third of the American banking system along with it, and arguably ran a direct line to the Second World War.

[00:02:47] Anupam Manur: I am more interested, and I've been thinking a lot about this, in how 2008 seems to be the pivotal year in recent memory of how a single particular crisis led to a spate of events after that. You had the Eurozone crisis, you had Brexit, you had Trump and a whole bunch of right-wing authoritarian leaders rising to ascendancy. Covid, of course, hit in between, but then you had Trump version two.

[00:03:13] Anupam Manur: All of this, Ajay, and you can correct me if I'm wrong, but all of this somehow leads back to 2008 as the single differentiator in recent history. The difference between all of this is that the outcomes are not always the same. You can have a crisis, you can have different outcomes. And some of that could be perhaps on the absorptive capacity of different states and even the global system.

[00:03:36] Anupam Manur: So Ajay, we're going to be talking about all of this and more. I'm going to start with just that question that I asked recently, which is, if crises are so similar and they keep happening so frequently, what makes the outcome so wildly different? Or are they even different? You can correct me on that as well.

[00:03:55] Ajay Shah: Yeah, I mean, I could go into a categorization of financial crisis, but that's not really interesting and relevant. Equally, there are other kinds of things. Look at the blockage of the Persian Gulf. Never in our memory did we have that kind of event earlier, and here we are posing something new.

[00:03:55] Ajay Shah: So, I think there is a wide variety of things that happen.

[00:04:17] Ajay Shah: In terms of how the world has become more messy, sometimes it is called the age of chaos. Sometimes it is called the age of polycrisis where things have become much more difficult. I think it's important to understand some big things that led us here, just so that we can understand this world better.

Three fractures: China, social media, and lost US leadership

[00:04:37] Ajay Shah: So, after the fall of the USSR in 1989, everybody was far more optimistic that now we have finished with the Cold War, we have finished with the ideological battles around liberal democracy and free markets. And the world will find its feet and everything will become hunky dory. And in a way it did, for many, many years, things worked great. And then they didn't quite work so great.

[00:05:03] Ajay Shah: So, what changed? What are the big factors at work? In my mind, there are basically two stories going on. The first is the story of China.

[00:05:03] Ajay Shah: China built a certain kind of economy. It's a state-controlled, industrial policy directed economy, where there are things that just don't sit well with any conception of a globalized market economy.

[00:05:31] Ajay Shah: And China is a systemically big actor. So this combination of non-market practices in the hands of a systemically big actor turned into a big mess, and it created a global crisis where in many, many countries, it undermined the interest of participation and the political support for the globalization project itself.

[00:05:57] Ajay Shah: That was something very new. Nobody had imagined it. Today, something like 30% of global manufacturing happens in China. This is really huge and new.

[00:05:57] Ajay Shah: The only previous episode of so much manufacturing being concentrated in one country that we know from before is the United States, where at the end of the Second World War, something like 40% of world GDP was in the United States. Other than that, we've really not seen a situation like this.

[00:06:24] Ajay Shah: And we've never seen an important country like this be a fundamentally non-market actor engaged in industrial policy, engaged in subsidies. When Paul Krugman wrote theoretical papers around new trade theory, they were considered just theoretical papers. The idea that there can be a country where there is one government and the government subsidizes an industry, that industry has increasing returns to scale, it kills off all global rivals, and then it starts recouping the profits.

[00:06:52] Ajay Shah: That whole thought process did not exist in the world until we got to China. So this is the first big new thing. It's a large non-market actor. It's a systemically important non-market actor.

[00:06:52] Ajay Shah: This is new. We were not ready for this. We don't know what to do about it. I have some opinions, but I put it up as a fundamental break compared to the world we knew before.

[00:07:17] Ajay Shah: The second fundamental break we found in the world was, in my opinion, the rise of social media. Social media is the turning point. It's about 2010 or so where adoption rates of social media became really large all over the world. And social media fundamentally changed the nature of society.

[00:07:17] Ajay Shah: We got more polarization. We got more anger. We got more ability for bad actors to run propaganda campaigns.

[00:07:48] Ajay Shah: It could be an IT cell, it could be Vladimir Putin's Internet Research Agency, it could be anybody. There's a long list of bad actors who run propaganda campaigns, but it's a whole new phenomenon where, in the trusted environment of your home, quietly you are sitting down and toxic messages are being beamed into your skull. It was a whole new phenomenon which had never happened before.

[00:08:11] **Ajay Shah:** I also think a lot about how social media fundamentally messed with the structure of society and the nature of the role of the elite and of Sanskritization. So let me put this up step by step. At first, we had an elite-dominated world, and that worked reasonably well. In the jargon of political science, we should use the word political settlement.

[00:08:11] **Ajay Shah:** There was a political settlement where, of course, there was inequality. Inequality has been a fact of nature.

[00:08:42] **Ajay Shah:** Power and wealth were highly unequally distributed, and things worked out reasonably okay. And there was an intellectual elite, there was a cultural elite. The great sociologists, M. N.

[00:08:42] **Ajay Shah:** Srinivas and André Béteille, the two best thinkers on sociology in India, have shown us how poor people look up to the elite, and they form culture and values and preferences based on elite behavior.

[00:09:13] **Ajay Shah:** So, when the Indian elite walked out of the caste system and started doing inter-caste marriages and inter-religious marriages, then that was the most powerful force of modernization that you could get, because of Sanskritization. And Sanskritization is about others looking up to an elite. This whole thing was broken down by social media in two directions. One was that when rich people posted photographs of their vacation on an island in Greece, it just created more envy than ever before.

[00:09:47] **Ajay Shah:** So earlier, there was always inequality, but the inequality took place behind a high wall, and it was easier to be Gandhian about it. Mothers could bring up their children saying, you care about yourself, you don't look at other people. Envy is not a good value. It is one of the seven deadly sins.

[00:09:47] **Ajay Shah:** You focus on yourself. Whereas when the carefully curated best parts of my life are thrust into your feed, then it becomes harder to be kind and comfortable.

[00:10:17] Ajay Shah: Note, this is an entirely unrealistic picture of the world. These are carefully curated vignettes of the best parts of each person's life put up on social media. But it changed the nature of the world. Envy, and it undermined the old political settlement where humankind had learned how to digest inequality and live with it and get along and make progress.

[00:10:17] Ajay Shah: And we've had very high inequality all through the period after the Renaissance.

[00:10:43] Ajay Shah: All human progress came out of those environments of high inequality. By and large, the social justice people, the Marxism, was kept under check. These were relatively soft voices in the body politic, and the world had built a stable political settlement. That broke down when social media came along, and the envy became much bigger, and then the Marxism, the hatred, the anger, the social justice, all that came to the fore much more prominently.

[00:11:14] Ajay Shah: The second thing that came with social media was that we lost the Sanskritization, because people spend more time looking at their peers and looking at idiot things called influencers. So, you really stopped looking up to the world. And I saw a cartoon a long time ago where in the 50s, a small child in America says that when I grow up, I want to be an astronaut. And today, the small child says that when I grow up, I want to be on America's Got Talent, or I want to be an influencer or something like that.

[00:11:46] Ajay Shah: Just the concept of looking up to your betters and elders has broken down. And people are comfortable looking at each other and doing TikTok gags on each other. And then you really don't get the better angels of our nature reshaping the environment in a bigger way. So, I feel these factors came together and really messed with politics, messed with liberal democracies in a fundamental way.

[00:12:16] Anupam Manur: Perfect. I already have so many threads that I can pull upon. I'll save China for later. And I really didn't think we'd be talking about social media in the turbulence series.

[00:12:16] Anupam Manur: But...

[00:12:27] Ajay Shah: Can I just finish one other point, then I want to put up number three.

[00:12:29] **Anupam Manur:** Yes.

[00:12:30] **Ajay Shah:** So I want to say three big things in the world have changed. I said two. I want to say three big things in the world have changed. The first was the rise of a non-market actor, China.

[00:12:30] **Ajay Shah:** The second was the breakdown of the old political settlement. We had an old political settlement for a hundred years. We fought off the social justice crowd. We fought off the Marxism in the 20th century.

[00:12:30] **Ajay Shah:** Remember, the word Nazi stands for nationalist socialist. It is the same rubbish all over again.

[00:12:56] **Ajay Shah:** We fought off the Nazis. We fought off the Marxists. We found the middle road. The center did hold.

[00:12:56] **Ajay Shah:** Everybody should go read the poem. And suddenly, it seems like we lost all that. That I blame social media. I think of social media as a critical causal factor that disrupted the world in all the ways that I just described.

[00:13:16] **Ajay Shah:** And the third factor is the social media-led return of social justice, of nationalism, of hatred, of polarization, that got us back to Donald Trump. And Donald Trump took America out of the global system. Now, America is an essential power. America was an essential power.

[00:13:16] **Ajay Shah:** America is an essential power. America led the globe. America protected the sea lanes.

[00:13:42] **Ajay Shah:** United States Navy ran freedom of navigation cruises which ensured that sea lanes stayed open. We in India were the great beneficiaries, because first the British and then the Americans kept the Red Sea open, and then we got the beauty of the Suez Canal working in our favor. The entire global system was based on American leadership. As an example, I want you to look back at a story called the ozone layer.

[00:14:09] **Ajay Shah:** You will remember that Freon in refrigeration leads to leakages into the atmosphere, which were breaking down the ozone layer.

[00:14:19] Anupam Manur: CFCs, right? Chloro—

[00:14:19] Ajay Shah: Chlorofluorocarbons, out of which the most famous is Freon. And the West led an agreement where all the countries, including India, agreed to shut down their CFC production. And the ozone layer problem was solved. And that's the power of what American leadership could do.

[00:14:19] Ajay Shah: And we have not been able to do that with climate change, because we lost that American leadership.

[00:14:44] Ajay Shah: So, in the hands of Trump, we lost America. So, in a way, we are in a very bad world. You have a war in Ukraine, you have a war in Iran, all these things would not have happened in the old America. And this is very, very costly for the whole world.

[00:14:44] Ajay Shah: So, if I had to think about this age of chaos, this polycrisis, and think of the fundamental causal factors, I would say these three things.

[00:15:08] Ajay Shah: A non-market economy, China, became big — that is bad for the world. It is a bloody mess. We should not have large non-market economies. You can be North Korea, you can be a dinky non-market economy, it's irrelevant.

[00:15:08] Ajay Shah: But large non-market economies are dangerous and bad for the world. The second was the rise of social media, which undermined the political settlement, which brought the old problems of Marxism and nationalism and social justice back to the fore. And the third is we lost America.

[00:15:39] Ajay Shah: America was the essential power that held up the old world from 1945 to 2016.

[00:15:46] Anupam Manur: Yeah, brilliant. I mean, the third point that you mentioned was where I was going with this. My forming hypothesis as I'm just listening to you is that the second and third are interrelated, right? Which is that we know that social media can amplify a political crisis, but does it also amplify a financial crisis?

[00:15:46] Anupam Manur: How does it play out in the economy?

Social media, populism, and bailout politics

[00:16:11] **Anupam Manur:** Would Trump be doing all of these tariff policies if we were not living in the age of social media? Does the social media-led polarization naturally lead to populist measures, populist policy, which in turn has its own set of repercussions? You did mention what even populism means, which is the actual fight against the elite. So has social media triggered that, and does that play out not just in the politics, which I think is reasonably well understood, but also in the economy and finance?

[00:16:58] **Ajay Shah:** I agree with you. This is an important issue. Consider what happens in any financial crisis. There are some large important firms and markets that are going to go down.

[00:16:58] **Ajay Shah:** And you could say that the government should do absolutely nothing and let those organizations and our market systems blow up. That's pretty expensive.

[00:17:20] **Ajay Shah:** So, for example, we saw in the Great Depression, a third of the American banking system went under, and that was very, very costly for society. Now, it is cost-efficient for the people when public money is used to rescue some financial firms and some financial markets. It's not always true — I think the death of some firms is very important, otherwise it creates moral hazard.

[00:17:48] **Ajay Shah:** But it is cost-efficient for society when some public money is used in some ways. So I want to give you an example. I was a very big critic of government money being used to bail out UTI. I did a public debate against M.

[00:17:48] **Ajay Shah:** Damodaran, who was the leader brought in to deal with the mess, to deal with the crisis. There was a big public meeting in Bombay with 500 people. And I said, what's wrong with UTI going down? UTI should burn.

[00:17:48] **Ajay Shah:** There's nothing wrong with the closure of UTI.

[00:18:20] Ajay Shah: Damodaran said that I was not being correct. He said that this is actually a temporary problem, and in time it will work out, and if the government will give a helping hand to overcome this mess, net-net the cost to the taxpayer will be zero, and there will be many people in the country who will actually be better off by doing that. And oddly enough, shortly after that, I got appointed into the Ministry of Finance to work on the UTI crisis. And we did work out a burden-sharing formula where some costs were imposed on the investors in UTI, and some costs were borne by the government.

[00:18:20] Ajay Shah: So it was not pure moral hazard — some costs were imposed upon the investors in UTI, but some costs were borne by the taxpayer.

[00:19:10] Ajay Shah: And I was a grumbling skeptic. I was age 35, and you have romantic views at age 35. I was a big critic of that work that I was a part of — in all the meetings I tried to bargain public money down. My bias was, let's not put in public money, people should suffer.

[00:19:10] Ajay Shah: The investors in UTI will think twice tomorrow when they lend their money to a government organization, was my hope, was my dream.

[00:19:39] Ajay Shah: Many, many years later, when you do the balance sheet correctly, M. Damodaran was right and I was wrong. On a mark-to-market basis, the government made a profit out of its intervention in UTI. Okay.

[00:19:39] Ajay Shah: So, this is an important lesson that needs to also be on the table — that net-net, the United States federal government did great in its interventions into the 2008 crisis.

[00:20:02] Ajay Shah: But the headlines looked toxic, that 500 billion dollars went to the fat cats. And the Marxists, the Nazis, the social justice crowd got to jump on that and say, see, these rich people, they have yachts, they own an island, and public money is being used to give them money, while the government says at the same time, we don't have money to give pensions to old people.

[00:20:28] Ajay Shah: So this is toxic messaging, which went wide on social media at the time. So yes, I agree with you that a financial crisis is a particularly unpleasant combination that is hard to explain. I'm narrating to you my story — I was far more hawkish. Today I'm relatively supportive that, to protect the financial system, to stabilize the economy, overall net-net the cost-benefit just works out.

[00:20:58] Ajay Shah: It is good to use some taxpayer money with care, with caution, not to bail people out extremely, but modest uses of the Ministry of Finance purse in coping with some financial crisis has its benefits. I'm not puritanical about it. You should impose some costs on private people also, so as to contain the moral hazard. You should not protect people completely.

[00:21:22] Ajay Shah: But when you do this, it is an intense communication challenge. How do you explain it in the age of social media is a huge problem, because this can very readily turn into anti-elite rhetoric and undermine the political settlement and create problems for the country. It can fuel support for the two extremes, the left extreme and the right extreme — the two kinds of crazies in the world both develop greater popularity.

[00:21:49] Ajay Shah: And then, on top of that, in America, just our bad luck that Obama was the president, and that fueled white racism. So the hatred of some white people against a half-black president fueled the right-wing anger in America, and these things came together and gave us Donald Trump.

[00:22:10] Anupam Manur: Yeah, that's the entire arc, and I think we can see much more of that in every single episode. Just to close the bracket on this, today you have Trump announcing tariffs which are very popular with American voters. And just taking from your hypothesis, I would imagine that a lot of this is also done for that signaling — it's done for show. And I think that is where social media plays a much bigger role than it would have earlier.

[00:22:41] Ajay Shah: So, I do want to say that, in the narrow story you said, normally protectionism is always popular amongst dumb people. 99% of the people don't understand economics. And when a government stands up and says, how can I let our workers go out of a job? How can I allow foreigners to compete with Indian tomatoes?

[00:22:41] Ajay Shah: It's always popular.

[00:23:04] Ajay Shah: Remarkably enough, in the polling, the support for Trump on trade policy is not good. So even in the right-wing mob's ability to carry messaging through social media into American voters, the support for Trump on a whole bunch of issues has declined dramatically. The support for Trump on trade is down to a core Republican base of maybe 25 to 30% of the population. It is not something that has worked out too well for him in terms of politics, which I think is a reassuring sign — that even in the modern social media age, he has not been able to get through to more than 25, 30% of American voters.

Three pillars of national resilience

[00:23:49] Anupam Manur: Okay. So, I'm going to come to the heart of the episode. I want to get into slightly categorization territory, or even explanatory territory, which is: when we're talking about resilience, Ajay, I want you to give a fair idea to our listeners of what resilience looks like. We spoke about shock absorbers.

[00:23:49] Anupam Manur: You have a crisis that hits, and obviously different states and different systems have different capacities to absorb that shock.

[00:24:20] Anupam Manur: But the fragility underneath is what really determines that. So, just by your previous writing and by other things that you've done, you've got price flexibility, institutional redundancy, and diversification. These are the three kind of bedrock. But let's take the Indian context, or Hormuz, and say, how does this play out?

[00:24:20] Anupam Manur: What are the actual mechanisms by which these play out?

[00:24:47] Ajay Shah: So I would put up three categories of sources of resilience. I'm making this up right now as we speak. I would put it up as factor market flexibility.

[00:25:00] Anupam Manur: Okay.

[00:25:01] Ajay Shah: The working of prices and labor and so on. Then, the second thing that I would put up is the ability of the institutional apparatus to resist all the short-term populist measures that will inevitably be proposed. So that's more of a mental, intellectual resilience, and the strength of the political system in coping with bad situations.

[00:25:34] Ajay Shah: So I always say you should be terrified in a crisis, because the worst ideas will come to the fore. And the third I would put up is just sheer financial strength. So let's go into each of these. I'm just putting up a classification scheme — factor markets; second is the resilience of the mind when faced with the toxic ideas that come up in a bad environment; and the third is financial strength.

[00:25:59] Ajay Shah: So let's start with the first. Factor price flexibility. What you want is market-based adjustments. Shocks are real.

[00:25:59] Ajay Shah: Human beings like to cling to yesterday. Human beings like that my day today should be the same as what it was yesterday. I had some work, I had some income, I had some job, I had some payment for my petrol. Humans want fixity.

[00:25:59] Ajay Shah: But the world changes. And a good country is one where things fluctuate.

[00:26:30] Ajay Shah: The exchange rate is the most important price of all. It is the shock absorber of the economy. So, when the war in Iran began, in my mind it was crystal clear that there are two tests we need — for petroleum product prices in India to go up, so as to generate demand-side adjustments in India, it should be expensive. If the world price of petrol goes up, then the domestic price of petroleum products should go up.

[00:26:30] Ajay Shah: The second is the exchange rate — if it's an adverse shock to India in so many ways, then the INR should depreciate.

[00:27:02] Ajay Shah: That's a shock absorber, because then Indian exports become more competitive and imports become more expensive. That's the market-based adjustment, the price adjustment. Similarly, the adjustment of factor markets more generally — here, by and large, India does well, because the bulk of the labor market is not in the formal sector. The bulk of the Indian labor market is in the informal sector, where there is price flexibility, there is hire and fire.

[00:27:28] Ajay Shah: By the way, I remember in 2008, when the crisis came, there were many IT companies in India where management had open, comfortable discussions with workers. And there was a candid conversation that we could either sack people or cut wages. And many companies chose to cut wages, and it was a very healthy response. In economics textbooks, we are told that there is a Keynesian rigidity, which is wage rigidity.

[00:27:28] Ajay Shah: But in India, it was actually possible to cut wages when faced with a crisis, and that's a very healthy response.

[00:28:05] Ajay Shah: That's the way good organizations should be. It's the way good countries should be. So I give India high marks on labor market flexibility, because the bulk of the labor is in the informal sector. The formal sector is a bloody mess — the structures, the concepts of labor law are reasonably harmful, and that interferes with Indian economic growth.

[00:28:05] Ajay Shah: But when it comes to flexibility, we are doing relatively okay.

[00:28:32] Ajay Shah: India is also a country where, unlike China, there are no barriers to migration. So people move around the country. When there was a disaster in Covid, people went back home to their village. These are equilibrating responses, and it's good for the resilience of the overall society.

[00:28:32] Ajay Shah: This is my pillar one — price flexibility, factor market flexibility.

[00:28:53] Ajay Shah: Then part two — there's a lot of traction in India that India will only reform in a crisis. Rahm Emanuel, the amazing American politician, has a beautiful line. He says, a crisis is a terrible thing to waste. He's riffing on the American line, a mind is a terrible thing to waste.

[00:28:53] Ajay Shah: So he made it, a crisis is a terrible thing to waste. And I actually see the world very differently, particularly in an Indian setting — when institutions are weak, a crisis is a terrible thing.

[00:29:27] Ajay Shah: Mistakes are held back by checks and balances. What we want is a political system that imposes checks and balances. In a crisis, the checks and balances tend to peel away. So, you think of checks and balances of politics, of what politicians think, of what parliamentarians and legislators think, of the willingness of the courts to intervene, of the media, of the researchers, of the intellectuals — all these checks and balances tend to get suspended in a crisis.

[00:29:27] Ajay Shah: In a crisis, we all become tribalistic. We want a big man or some big woman to tell us what to do and take leadership, take control of the situation. This is a primeval response of humans. And the removal of the checks and balances leads to terrible things, over and over in world history.

[00:29:27] Ajay Shah: The Reichstag fire was a crisis that was used by Hitler to suspend the constitution and consolidate power and put his enemies into concentration camps. Again and again in history, you see that the worst things are done in a crisis. So I would not wish a crisis upon my worst enemies.

[00:30:33] Ajay Shah: I totally disagree. This is Indian middle-class drawing room chatter. It is a lack of knowledge of politics in India, where people want a strong leader, where people shake their heads and say India will only reform in a crisis. We've got to figure out how to reform every day so that we get checks and balances.

[00:30:33] Ajay Shah: We got lucky with Narasimha Rao and Manmohan Singh and Ashok Desai.

[00:30:59] Ajay Shah: You should not feel confident that a crisis will generate good outcomes. A crisis can generate terrible outcomes. And we have seen very toxic things being done around crises. We have seen crises turning into very bad events for the country.

[00:30:59] Ajay Shah: So, I just want to put this up as a basic piece of political science knowledge — that a society works better when there are more checks and balances, not less. When you want more restraints upon the executive.

[00:31:26] Ajay Shah: Where the Prime Minister should have the least possible power, that's where a country works best. Where strong leaders are seen as a problem and not as something desirable.

[00:31:38] Ajay Shah: Okay, so this is my pillar two, which is checks and balances and the dangers of bad ideas coming up. So, in every crisis, there will be at least five left economists who will say, now we need higher customs tariffs. Protectionism comes back, industrial policy comes back. Every low-knowledge person will reach for industrial policy, saying, see, Obama protected General Motors in 2008 — this proves that in a crisis, government should do this, government should do that.

[00:32:06] Ajay Shah: And for my pet industry, my favorite industry, I need fifty thousand crore to come from the government. So, you have to continuously circulate the bad ideas of the country into the public square. And we need enough tireless think-tankers, like people in Takshashila, to not get tired, to not get bored, and keep shooting down bad ideas. It's a very important function.

[00:32:35] Ajay Shah: I tend to prize novelty, and I try to write a new thing every day. But I recognize that many, many times you just have to write the old things over and over. It isn't done just because it's been written twenty years ago.

[00:32:50] Anupam Manur: Ajay, I have thirteen different op-eds just condemning price controls. That's just a staple. I can publish one in the middle of the night at 2 a.m., it comes out automatically, but yes.

[00:33:01] Ajay Shah: And even more so. We need more people who will do this housekeeping work of policing the public sphere. And particularly in India, where there are perfectly articulate English speakers who really have abysmal knowledge of politics and economics, it's doubly dangerous, because it is so easy to go into industrial policy, great leader, government monopoly, government should do this, we need a sovereign LLM — this kind of nonsense just takes off very readily in the latent Indian socialism.

[00:33:31] Ajay Shah: We have not yet exorcised the ghost of Nehru and Mahalanobis, and it keeps coming back in one form after another. So this was claim two. And my claim three for what generates resilience is financial strength. Vijay Kelkar used to always say the time to fix the roof is when the sun is shining.

[00:33:31] Ajay Shah: In good times, we as a society — which includes individuals and corporations and the financial system and government — all four need to run a tight ship.

[00:34:04] Ajay Shah: We should have high savings rates. We should build asset balances. We should not have too much leverage, not in the wrong places. We should not have important financial firms which are frankly a pack of cards where one small wind will blow them off.

[00:34:04] Ajay Shah: And most importantly, we need a government that is fiscally prudent, that is fiscally safe.

[00:34:28] Ajay Shah: And India is in very bad shape on the last one. Here's my quick summary of what constitutes fiscal prudence. There is a beautiful number that is called the primary deficit. I don't want to belabor the technical issues, but I want all our listeners to be able to focus in any budget statement on the primary deficit.

[00:34:28] Ajay Shah: It is the most interesting, most important measure that should be used as an operational check for how public finance is faring.

[00:34:58] Ajay Shah: For eight out of ten years, the primary deficit should be a surplus. It can be a small surplus — it can be 0.2% of GDP. You don't need big surpluses. But for eight out of ten years, there should be a small primary surplus.

[00:34:58] Ajay Shah: That constitutes healthy public finance. In India, we have unhealthy public finance, because if you take a ten-year average of the primary deficit, it is probably about 2.5%. So, we are probably 2.7% away from where we need to be.

[00:35:28] Ajay Shah: We need an adjustment of, you know, 2.5 to 3% of GDP to get to the safe zone. And what are the symptoms of this? What we see is, year after year, the Indian debt-to-GDP only goes up, it doesn't go down. I will always warn everybody — are you really sure you measure the Indian GDP correctly?

[00:35:28] Ajay Shah: Maybe if the Indian GDP is overestimated, then the debt-to-GDP is worse than we think. Maybe it's not 90%, maybe it's 100%, maybe it's 110%.

[00:35:53] Ajay Shah: And that would be far more scary. And we have the bulk of the government's money going away into contracted things like interest payments. All these are symptoms of a lack of financial strength. So, financial strength is not "I am a poor country, so we are weak." Financial strength is the government should live within its means, poor people should live within their means, the small firms of a small country should live within their means, the financial system should be robust.

[00:36:25] Ajay Shah: None of this is excusable because we are a poor country. In a poor country, it is possible to be financially prudent.

[00:36:33] Anupam Manur: Yeah. So, just for the listeners, I'm going to explain — primary deficit is basically your deficit minus interest payments. And in India, that's quite large. Of course, I don't think India is anywhere close to breaking the Domar debt condition, where your nominal GDP growth rate is not sufficient to pay off your interest payments.

[00:36:33] Anupam Manur: But it is worrisome. It's big. It's not really going down.

[00:36:57] Anupam Manur: But on the second part — yeah, maybe GDP overestimation, you do have fiscal deficit underestimation. Some of it has been consolidated, you think, in the recent past, but there's still a lot...

[00:37:11] Ajay Shah: I want to sell this to you. Not as a debt sustainability test, as we do it in economic theory. I want to sell this to you at a bigger level. I want to bring up the word strategic depth.

Strategic depth and India's fiscal weakness

[00:37:24] Anupam Manur: Okay.

[00:37:24] Ajay Shah: What we should be after is strategic depth. Shit happens. And for bad events, we need fiscal space. A bad event can be a war, a bad event can be a pandemic — COVID.

[00:37:24] Ajay Shah: A bad event can be the closure of the Persian Gulf. A bad event is coming in terms of the catastrophes and natural disasters associated with climate change.

[00:37:50] Ajay Shah: When the seas rise, a third of Bangladesh will get flooded. There's going to be a refugee crisis in India and so on. So, I'm not narrowly saying that you need to always pay down your debt — yes, you do — but a country that is able to keep its public finance in balance and not build up large subsidy systems, like we in India are, is a country where the state has strategic depth. So here, I'm going to distinguish between the people and the state.

[00:38:19] Ajay Shah: The state is our agent. If the state runs a tight ship fiscally, then the state will have the ability to mount a response. So I want to take you back to the pandemic. The pandemic was a catastrophe, it was absolutely horrible for a lot of people in India.

[00:38:19] Ajay Shah: Their incomes went to zero. It was an unbelievable disaster. I don't want to dilute that — there was an extreme economic catastrophe when the extreme lockdown came.

[00:38:45] Ajay Shah: We can debate whether alternative measures could have been used, but there was an economic catastrophe. Now, many people looked at other countries, most notably the United States, and saw the very large fiscal responses of the United States government. And they wondered, we're India, could we do the same, should we do the same? I was not in the room, but I have heard secondhand stories about how Mr.

[00:38:45] Ajay Shah: Modi responded to these kinds of calls.

[00:39:12] Ajay Shah: And Mr. Modi said two things. The first is that, okay, you want to do a big fiscal stimulus right now — persuade me that you will not need a big fiscal stimulus next year. Who is to know how long the pandemic will last?

[00:39:12] Ajay Shah: Who is to know when this monster will turn? None of us anticipated the second wave. Who is to know when things get better? Is it better to keep your powder dry, or is it better to spend now?

[00:39:40] Ajay Shah: And, you know, I say, wow, that was a wise proposition. And part two, Mr. Modi is instinctively careful about public finance, and I say, yeah, that's a good way to be. But I disagree with his level of instinct, because his level of instinct is still 2.5 to 3 percentage points of GDP away from where the deficit ought to be, year after year.

[00:39:40] Ajay Shah: With his conservatism, we are 2.5 to 3 away from where we ought to be.

[00:40:07] Ajay Shah: So, I think that having strategic depth is a great thing. The United States was able to really materially improve the lives of its people by launching a large-scale response to COVID in a way that was not available to the Indian state. Mr. Modi was correct that, in the Indian environment, it made no sense to try to be like the United States.

[00:40:07] Ajay Shah: Why? You must go down and ask why.

[00:40:34] Ajay Shah: Not because we are a poor country — because we're a country where public finance has not been managed well, because the financial system doesn't have the depth, our financial repression system... we don't have voluntary lenders to the government, money is coerced out of the financial system to give it to the government. All those root causes are the reason why we don't have strategic depth. So, I want to use the word strategic depth.

[00:40:34] Ajay Shah: It's a good organizing principle when we think of crisis.

[00:41:00] Ajay Shah: It includes war, it includes a financial crisis, it includes a pandemic. It includes shit happening in an unpredictable way. None of us even have the taxonomy of what future crises will look like. But then I would be much happier if we in India, on the public policy side, would basically go after two big elements of the agenda — get the debt-to-GDP down to 50% of GDP with correct measurement of GDP, and get all the borrowing of the government from voluntary lenders.

[00:41:29] Ajay Shah: There should be no financial repression system. At present, 95% of the borrowing of the Indian state is coerced out of various kinds of financial firms. This is taxation, it is not honest borrowing. And again, it's penny wise, pound foolish.

[00:41:29] Ajay Shah: It is short-termist. Again, think of the word strategic depth. Think of the UK in the First World War and the Second World War. The UK government went to the bond market and said, "Guys, will you lend to me?"

[00:41:55] Ajay Shah: The bond market said, "Sure, you give me a higher interest rate, I will lend to you." And the UK government was able to borrow like 150% of GDP to fight the First World War, and 200% of GDP to fight the Second World War. Please note these numbers — 150% of GDP, 200% of GDP. That's what makes a great country. In India, there would be no discussion beyond 3% of GDP.

[00:42:21] Anupam Manur: Yeah. And that is only possible because, during normal times, they kept their purses clean. If you keep overspending during normal times, you lose the trust of the lenders, you lose the trust of even ordinary citizens, and then you also have to get it through financial repression, through the banking channels, a whole bunch of things which will...

[00:42:41] Ajay Shah: So I want to use the British story — what I've said is old British public finance prudence, that don't borrow to pay interest, that's not acceptable. Fair and square, you should run a small primary surplus every year. So when you look at the long time series of the British debt-to-GDP, you see a huge surge only for wars. There was the Napoleonic War, there was a huge surge in debt.

[00:42:41] Ajay Shah: You start paying that down.

[00:43:08] Ajay Shah: So, 1815, the Battle of Waterloo — after that you start paying that down. Then in the Crimean War, you get a small surge, 40% of GDP was borrowed to pay for the Crimean War, and then you start paying it down. Then for the First World War, they borrowed 150% of GDP. They started paying that down.

[00:43:08] Ajay Shah: Then for the Second World War, they borrowed 200% of GDP, and by the late 80s, it was all paid down.

[00:43:32] Ajay Shah: It is only in British socialism and the welfare state that you lose this kind of clarity.

[00:43:38] Anupam Manur: Right. Ajay, you were talking about strategic debt and shock absorbers.

Supply chain resilience and post-1989 globalization

[00:43:42] Ajay Shah: Strategic depth, yeah.

[00:43:43] Anupam Manur: And shock absorbers. So I want to go from there to strategic thinking and planning and depth, both at the national level and at the firm level. For firms, of course, globalization looked very pretty from, let's say, 1989 to 2008, where supply chains were very predictable, you could get whatever, and so it was all efficiency-based. We know that the trade-off between resilience and efficiency exists.

[00:44:15] Anupam Manur: And at some point you have to deal with this. So was that a strategic failure — that firms overthought the efficiency part, didn't really build other alternatives in terms of their supply chains, and if they were caught out, let's say when Trump came about in either 2016 or later — is that just the price they have to pay for lack of strategic thinking? Or is there something else to the story?

[00:44:42] Anupam Manur: And the second part is on the national level, especially for a country like India — I had written, from 2013, 2014 onwards, that we have to build a strategic petroleum reserve, strategic LPG reserves, and so on. And all of that makes sense now when the crisis has hit. But back then, many people would argue that it was a wasteful use of resources when you already have competing users for that, right?

[00:45:11] Anupam Manur: And it could be many, many such things — it could be the stockpiling of vaccines, it could be stockpiling of something else. But that strategic argument — how do you square off the two?

[00:45:21] Ajay Shah: I want to say two or three things. The first is that hindsight is 20/20. If you and I were in the euphoria of the fall of the USSR, what would we have said? We would have said we are done.

[00:45:21] Ajay Shah: Now liberal democracy and free markets are going to reshape the world, as they did for a long, long time. If you look back until Tiananmen Square, when the Chinese government decided to kill five thousand of its own people, there was even a good chance that communism was going to collapse in China as well.

[00:45:55] Ajay Shah: So, we were in full euphoria that this world was getting better. And it made sense to optimize for that world. And then the world changed. I put up the date as 2016 — when Donald Trump came to power, the world changed.

[00:45:55] Ajay Shah: And by 2018, you get the effects, which is the China tariffs. So the first deglobalization of the world began in 2018. And my mental model is we had a great run from 1989 till 2016.

[00:46:27] Anupam Manur: Okay.

[00:46:27] Ajay Shah: That's my dating of the happy period, the happy days, as some German submariners would say. So now the world has changed, our trade-offs have changed. So what would you do in the world of business? You hinted at supply chain resilience — that if you have only one supplier located in China, you're making a mistake.

[00:46:27] Ajay Shah: You need three suppliers in three different countries. That kind of thing is very much a good idea, and it will come at a cost.

[00:46:55] Ajay Shah: And every company needs to re-evaluate the bias-variance trade-off of its supply chain, the mean-variance trade-off of its supply chain. And it will make sense to favor more resilience. That's a good thing. So, I'm sure every business person is doing this.

[00:46:55] Ajay Shah: It took a while for people to blink their eyes and realize how amazing the world was after the fall of the USSR. Business people don't think enough about politics. We had all normalized the existence of the USSR, that there will always be this baleful glare.

[00:47:27] Ajay Shah: And so when the USSR collapsed, most business people didn't understand how profoundly the world had changed. It took strategic thinking to understand that, wow, now we are in a different place and we can build differently, we can do differently. So it took strategic thinking at that time to predict, in 1989, that now India will have to change. In hindsight, it's 20/20 that Narasimha Rao and Manmohan Singh would take India out of the Soviet camp, would take India out of socialism, and start becoming more globalized, would connect India into globalization, would cut tariffs, would remove capital controls.

[00:48:07] Ajay Shah: But the really clever people are those who understood that in 1989. And I want to say, for me personally, it was a hope that now we'll be able to go back and say to social justice people in India, look how badly the USSR worked out, and don't you think we should be a little more capitalist? It was a hope, it was not a certainty — I was not sure it was going to work, but I thought that yeah, now the balance of the argument will tilt, and now India will become better, because many of the social justice people who would hold up the USSR as a credible alternative for how to organize a society would realize that it was actually hollow inside.

[00:48:46] Ajay Shah: Like the way today we get China boosters. The China boosters are people who are not deeply understanding the horror of an authoritarian country and the failures that are hidden inside a propaganda machine. So, we didn't get bad news stories out of the USSR. We only got good news stories out of the USSR.

[00:48:46] Ajay Shah: So we all overestimated the USSR. So it is with China. If you're a Chinese-language-speaking foreign scholar, if you are an unbiased estimator, you won't get visas to travel to China.

[00:49:13] Ajay Shah: So, there is a systematic bias — the Chinese-language-speaking scholars who get permission to travel to China are the ones who are more pro-China, who are more optimistic about China, who put more gloss on China. And so, systematically, our picture of China is biased in favor of greater optimism about China. So that same sort of thing was happening there also. And I think that the world has changed, and our job — yours and mine, and all of us in our research community, we the thinkers — is to be the leaders in understanding this world.

[00:49:48] Ajay Shah: And then practical people will be able to slowly get that knowledge diffused out of us. Now the world has changed. So my summary of the world today is, we've lost the United States for leadership on security arrangements. So there will be more wars and more violence and more deaths and more killings, because various random tin-pot actors will do more strange things.

[00:49:48] Ajay Shah: If you think Doklam and Galwan was bad, it's just the beginning, because the checks and balances against China have diminished.

[00:50:17] Ajay Shah: So this is a more messy world in terms of physical security and violence and military affairs and conflicts. War in Iran, war in Ukraine is only the beginning. The second is that the international trade system that was organized around American leadership, where there would be agreements on problems like the ozone layer — that is gone. Now it is sort of each man for himself, and now each country has to dig into its shoes and find sanity and talent and capability.

[00:50:52] Ajay Shah: Now there's a greater risk of countries becoming stupid. So, for example, for India — I would claim that there is merit in a high amount of protectionism in certain fields against China. For the rest, it remains the case for India that we should do free trade. We should just open up everything to globalization, to all the rich countries, including America.

[00:50:52] Ajay Shah: America will be stupid, but that hasn't changed the benefits to India.

[00:51:19] Ajay Shah: So even if Americans do stupid things against us, there is no benefit for us to do stupid things against American imports. And for the rest, there are plenty of OECD countries. The West is full of countries who do normal, sane, old-style things, and we should engage with them more. We are very pleased about the British free trade agreement or the European Union free trade agreement — they are pieces of progress by Indian standards, but they are not actually free trade agreements by global standards.

[00:51:49] Ajay Shah: They are not deep trade agreements. They are riddled with limitations to free trade. And so we, as a country, have to find the intellectual consensus and the intellectual power to understand this difficult landscape and learn what is optimal for us in India in this difficult world.

[00:52:07] Anupam Manur: And it's even more difficult now than ever before, because even when the world was at its peakglobalization, the argument for a free trade system within India was always going to be difficult. Now critics can just point to the United States and say, if they're being so protectionist, why shouldn't we? So the challenge of this is just so much bigger.

Categorizing China risk: defense, vulnerabilities, and industrial policy

[00:52:32] Anupam Manur: But I want to come to China, because you did mention China. There are so many different threads I can pick on, but I want to go to China. I don't want you to repeat either your particular column with Ila Patnaik — "China is a market failure, therefore we need trade barriers" — nor do I want to replicate the episode you did with Deepak on Deepak Disagrees, because that goes into some of these things in detail.

[00:52:59] Anupam Manur: So, let's try not to replicate that. But I have just one or two questions further to that. For listeners, I would deeply suggest that you go back and read that piece and listen to that episode. One thing that I personally took away, Ajay, is that in all of this, we can't be ideologues saying, okay, free trade always good, or trade barriers always bad.

[00:52:59] Anupam Manur: I think you came across as, and if I may say this, surprisingly, a very practical — you need to go by the merits of the situation type. And with China especially, I think that is the problem.

[00:53:34] Anupam Manur: So, there is obviously a lot of — China can be a market failure for a whole bunch of things, whether it's IP theft and cybercrime, you have the entire thing about heavy state subsidies — but I think the core idea is that there is an irreversibility, that manufacturing knowledge can get lost with China acting the way it does, and then it might take more than a generation to rebuild. With all of this, we say that you need some form of trade barriers.

[00:54:02] Anupam Manur: It need not be tariffs, but some form of trade barriers. Do you want to add just two lines to that before I get to my questioning part?

[00:54:09] Ajay Shah: I agree with everything you said. If you wish, I can do my summary statement of the elements of logic. And you said I sound very practical — basically, I believe in first-principles thinking, that there is never a sweeping ideological answer. You've got to look at each situation, look at the evidence, and do first-principles thinking.

[00:54:09] Ajay Shah: And then the answers will often fall into various camps, but I'm not in the business of being in any camp.

[00:54:33] Anupam Manur: Yeah, yeah. No, please do, if you could just untangle the logic of the entire thing.

[00:54:38] Ajay Shah: There is a list of considerations, categories of considerations. So we will start. Consider defense technology. If there's going to be a military drone in India, then it cannot have a single part originating in China — for both supply chain resilience and also backdoors and kill switches.

[00:54:38] Ajay Shah: Any electronics that is made in China comes with a credible threat of a kill switch or information leakage. And that is completely unacceptable. Pakistan is a partly less important actor for India today.

[00:55:11] Ajay Shah: Our dominant military threat is China. And partly, Pakistan is fully woven into the Chinese system, as we saw in Operation Sindoor, where their equipment is all Chinese. And so, if I were China, I would want to infiltrate motors into Indian drones with a secret kill switch, and then I would want to test, under battlefield conditions, does this work, for the Pakistani military. So in an Ops Sindoor-type situation, this is a very valuable testing ground, where the Chinese have openly been going and saying to the world, look at how well our equipment worked against Rafale in Operation Sindoor.

[00:55:50] Ajay Shah: So this is case one — if we're going to do something military, it has to be absolutely immune to anything coming from China, for reasons of supply chain resilience and for reasons of kill switch and data leakage. Just last week, there was information that there was one particular camera that was used on a British naval boat, and researchers found that it was sending data back to China. And there was a huge furor about how could we trust a single drop of military equipment to come from China?

[00:56:22] Ajay Shah: And that, by the way, does not imply that we have to do self-reliance. You've heard me take the maximally hawkish stand here, of zero China — you must have zero China in the Indian military. That's a maximalist position. But then you have to ask yourself, how can I get that at minimum cost?

[00:56:22] Ajay Shah: And the answer is, embrace the West. The Europeans have the same objective, the Americans have the same objective, the South Koreans have the same objective, the Japanese have the same objective, the Taiwanese have the same objective.

[00:56:52] Ajay Shah: The Australians have the same objective. All Western countries have the same objective. So, we just need to deeply embrace Western tech. And anyway, we are miles behind.

[00:56:52] Ajay Shah: So today's state of the art of conventional war is happening in Ukraine. Ukraine has the number one knowledge. All the Western companies working in Ukraine have that knowledge, and we've got to go get that knowledge. So the puzzle for Indian foreign policy is how to create conditions for deep Indian collaboration into the R&D and also the manufacturing.

[00:57:20] Ajay Shah: In this manufacturing problem, I wish to say there is actually a very important asset that India brings to the table, which is cheap manufacturing for the ridiculous volumes that are required in global war. So, who would have imagined that the consumption of drones is ten thousand to fifty thousand drones per day. They are like artillery shells, they're now consumable. So you need very high volumes.

[00:57:20] Ajay Shah: India is potentially a very good manufacturing giant to bring into this problem. With low-cost labor, you could do manufacturing in India.

[00:57:52] Ajay Shah: If Hyundai makes cars in India, then Hyundai could make unmanned ground vehicles in India. And so there is something useful to be done in India in these global partnerships. By the way, South Korea, Poland, Ukraine is a very important defense collaboration that is now shaping up. And I would say India should be a fourth country in that offering of low-cost manufacturing.

[00:57:52] Ajay Shah: The second amazing thing India brings to the table is geographical remoteness. Every factory in South Korea or Ukraine or Poland is within striking range of China, North Korea, and Russia.

[00:58:30] Ajay Shah: The beauty of South India is that it's reasonably far away. So it's harder for a missile to get there. There would be more early warning for air defense. So you would set up a ring of radars at the Vindhyas, and you would get enough time to protect facilities in the southern cone.

[00:58:30] Ajay Shah: So from all these points of view, India has some good things to offer. And now it is the art of foreign policy — what dealmaking would we do? You know me, I always criticize strategic autonomy.

[00:58:56] Ajay Shah: Strategic autonomy is the idea that I will not make deals. Then you should not say that you're doing foreign policy, or just doing speeches in the United Nations. Foreign policy is the business of making deals. I give something, you give something, we come together, we make progress for both of us.

[00:58:56] Ajay Shah: So if the Indian state will go ask South Korea, we want ABCD from you in the space of defense, and the South Koreans will say, we want XYZ with you in agriculture policy, and we should be willing to negotiate.

[00:59:24] Ajay Shah: We should be willing to make deals that further Indian interests. It's Indian interests that are important. And interests are not always served by autonomy. So this is category one, which is military tech.

[00:59:24] Ajay Shah: We very much need AI chips which are fully immune to China. And there's no hope in hell of any semiconductors happening in India. Sorry, Pranay. I respect and admire all the software engineers in Bangalore doing this stuff, but a full-stack semiconductor ecosystem in India — it's not going to happen for fifty years.

[00:59:54] Ajay Shah: And so we need the sourcing — where are those AI chips going to come from? Five-dollar AI chips are required.

[01:00:00] Ajay Shah: to sit on a hundred-dollar drone.

[01:00:03] Ajay Shah: And we will not get this in India, but there are people elsewhere in the world doing this, and we should partner with them. Category two are domestic strategic vulnerabilities. So we don't want Huawei switches inside any Indian telecom switch. Nitin Pai, Ajit Ranade, and I wrote an article on the LEAP blog where we argue that we should welcome Chinese involvement and investment in India into all the dumb things.

[01:00:26] Ajay Shah: So you build a highway, then it should be fully possible for the Chinese to own the highway. But if there's any electronics on the highway, it should be owned by somebody else. So we should not give the Chinese any surveillance capabilities to operate in India.

[01:00:40] Ajay Shah: So, like that — think in a logical way about what are physical assets, what are arm's-length financial investments. So if the Chinese will be a financial investor in JPT, we should be fine, because you're just a shareholder. You get an annual report, you get to vote like anybody else, it doesn't give you any special access to either information or control. We should be fine with that.

[01:01:04] Ajay Shah: So this is category two — the vulnerability of Indian systems against Chinese threats. It also means hardening Indian systems. I've been in the Ministry of Finance, where budgets were made without backups. I'm not kidding — there were no computers in the Ministry of Finance which had a backup in my time.

[01:01:24] Ajay Shah: So if you got a virus into the Ministry of Finance on the right dates, then the budget would have to be cancelled. And I'm very nervous about Chinese infiltration. So, getting data from AIIMS is a triumph for a Russian or Chinese attacker, because they're getting detailed health records about all Indian civil servants and politicians. It's an absolutely amazing achievement for them in terms of building their intelligence dossiers on important people in India.

[01:01:53] Ajay Shah: But it is our job to harden AIIMS, we have to harden the power system, we have to harden critical facilities like NSE and BSE, and so on. So this is category two — harden the mainland in ways that make sure that Russian and Chinese attacks against India don't happen.

[01:02:12] Ajay Shah: So this is category two. Then comes category three. This is industrial policy, which is very, very difficult — what are the industries where, in India, there is the Paul Krugman new trade theory critique, where realistically, genuinely, there is a plausible, globalized Indian industry that is able to pass the market test and export to the world.

[01:02:37] Ajay Shah: But it gets damaged by the craziness of Chinese government subsidies to exporters. And automobile components comes to my mind — this is a place where India has passed the market test. We're not making this up. This is not like some semiconductor fantasy.

[01:02:37] Ajay Shah: This is proven — pure private Indian automobile component companies became globally competitive, and they've proved their worth by exporting.

[01:03:01] Ajay Shah: And then when you have this current crisis of the last ten years of dumping by the Chinese, then it is really something to worry about, and there is a case for protectionism, at least to keep up that industry for some years, until China implodes. So again, you have to play the waiting game. You had to wait out the implosion of the USSR.

[01:03:23] Ajay Shah: You had to be able to look beyond the one-sided information that crept out of the USSR. Like that, we have to be able to look beyond the one-sided information that comes out of China, wait it out, and then the world will become a more normal place. But for right now, it helps that all the advanced economies of the world are putting up trade barriers against China.

[01:03:45] Ajay Shah: Then you get to category four, where really there is nothing much going on in India, or maybe there will not be much going on in India, and should you just accept a whole bunch of subsidized Chinese imports, because we're not really meaningfully producing in India. The things that come to my mind are solar panels and lithium-ion batteries.

[01:04:06] Ajay Shah: Now there you have to ask the question — will the Chinese switch off supply to India as a strategic threat? In solar panels, it's not that big a problem. It just means you won't build any new solar photovoltaic generation plants using Chinese panels. You start buying panels from everywhere else in the world.

[01:04:06] Ajay Shah: I don't see that as a showstopper.

[01:04:28] Ajay Shah: In the case of lithium-ion batteries, imagine an entire Indian automobile sector where every day cars and two-wheelers and trucks and ships are being shipped using lithium-ion batteries. Then if the Chinese throw a switch and cut off lithium-ion battery sales to India, does it mean an entire industry employing millions of people suddenly stops working?

[01:04:51] Ajay Shah: That is a threat. And we need to think about appropriate responses, and right now I don't want to belabor what that ideal response will be. It can be a strategic reserve, etc. But these are four categories that I would put up.

[01:04:51] Ajay Shah: Finally, on your comment about the strategic petroleum reserve, I want to hold up gas as a success story. We had no meaningful gas reserve.

[01:05:12] Ajay Shah: The way the world works is that when the world price of gas goes up, the highest bidder buys up the scarce LNG tankers of the world.

[01:05:21] Ajay Shah: That's all there is. So you get power cuts in Bangladesh, because they do not have the money to buy LNG tankers. And we in India are able to buy LNG tankers, because we are rich enough to pay for it.

[01:05:35] Ajay Shah: Because India has a tiny elite which does software exports, and Bangladesh does garment exports, India had the money, the hard currency, through which, when the price of gas doubled and tripled, Indian buyers, both private and public, were able to go around the world and afford to buy up the tankers. And tankers did not go to Pakistan and Bangladesh, South Asian countries who did not have that Indian-style extreme elite capability.

[01:06:05] Ajay Shah: And were not exporting software. So please see the connections between inequality and success. It is Indian inequality which gave us a tiny cadre of brilliant people who are software engineers, who generated the exports, and with those export proceeds, we got the resilience.

[01:06:24] Ajay Shah: So I want to be careful about the word "strategic reserves." Anything that can be bought in the world market at two times, three times the price — really, your best strategic protection is just money. Be rich. Have a strategic reserve of money. And then, again, it comes back to all the fiscal stuff.

[01:06:24] Ajay Shah: The government should not be broke, so that in a time of crisis the government is able to put money on the table.

[01:06:45] Ajay Shah: The rupee should not be trembling, struggling with some artificial fifty-billion-dollar FCNR(B) borrowing to prop up the rupee. The rupee should be a boisterous free-market exchange rate, where there are no difficulties. It is 120 to the dollar and we are not crying about it — then you've got a safe, stable country.

Can India afford to wait out China's decline

[01:07:04] Anupam Manur: Yeah, yeah. I mean, yeah, I think strategic reserves of money is the best bet. Just a slight — I don't know — question on the China bit again. A lot of what you said, I agree on the defense front, of course it makes complete sense.

[01:07:04] Anupam Manur: But just two or three questions on that. One, can we afford to wait for the implosion of China? Is a lot of damage not already done by then, as I think you've mentioned — a lot of the tacit knowledge of manufacturing could be lost.

[01:07:35] Anupam Manur: And then you have to rebuild that by the time China implodes. Macroeconomists have been predicting the downfall of China since even the 2000s, and that's a crisis that's not come, or has been managed when it has come. So, how long can we afford to wait?

[01:07:53] Anupam Manur: And on the Indian front, some of the things that you state, Ajay, require a high degree of state capacity to have that discretionary ability to say, okay, this is a particular sector that needs protection in some sense against China, this is a sector where we probably need to do industrial policy.

[01:08:15] Anupam Manur: This is a sector where we can allow Chinese investment, and this is a sector where we don't allow Chinese investment. Given India's broad record in this, where we like to do blanket bans, where we like to do — do we have that state capacity, and where can this go wrong?

[01:08:32] Ajay Shah: These are very fair questions. Let me go bit by bit. First, no — I claim that I was a China hawk that came out right. From Deng Xiaoping 1978 till Xi Jinping 2012 is indeed a shining Chinese success story.

[01:08:32] Ajay Shah: They were doing well. And I was happy, I was waiting and hoping for China to become a normal, healthy, successful country like all others.

[01:08:58] Ajay Shah: And so I thought, okay, they're on a march to freedom — more and more economic freedom, more and more political freedom, they're becoming a better country. We're willing to ignore the murders of people that happened at Tiananmen Square. For the rest, China was making progress. But with the benefit of hindsight, we know that when you don't have constitutional systems, when you don't have checks and balances, when you don't have dispersion of power, it's all vulnerable, and then you can get to bad luck.

[01:09:30] Ajay Shah: And they got their bad luck in the form of Xi Jinping. So in 2012, they got their strongman. So the very concepts of Deng Xiaoping — of dispersing power, of a two-term limit, of limiting the power of the great leader — all those things were destroyed by Xi Jinping. Like other populists, Xi Jinping ran an anti-corruption campaign.

[01:09:53] Ajay Shah: So everybody should be skeptical whenever you hear an Anna Hazare say "anti-corruption." These are just excuses used to put the knife into your political foes and to whip up anti-elite sentiment. Xi Jinping is precisely that — a bit of a villager, not very literate, has not read books, has not traveled the world. He's that kind of strongman.

[01:10:18] Ajay Shah: And he used the anti-corruption campaign to harm the elite and to consolidate power. And that is where China's decline began. So even in Chinese GDP data, you see a decline in Chinese GDP growth. And I say "even in," because, you know, Chinese GDP data is even more untrustworthy than Indian GDP data.

[01:10:18] Ajay Shah: And if you look at twenty other measures, China has done very badly.

[01:10:40] Ajay Shah: But then you have to see the full moving pieces — when the Chinese catastrophes of industrial policy started blowing up, they have a demand problem. Industrial policy has failed and failed and failed in China, field after field — real estate, for example. In field after field, the Chinese state chooses a champion, saying, now we are going to do electric vehicles, and they create ridiculous levels of oversupply, as only a communist country can do.

[01:11:10] Ajay Shah: And there is no local demand for those vehicles. There is no global demand for those vehicles. Hundreds of thousands of vehicles are piling up in warehouses, and nobody wants to buy them. So this is a failure of industrial policy.

[01:11:10] Ajay Shah: It is a lack of market principles. Those companies don't generate ROE. The Chinese stock market is resiliently stuck, because the Chinese industrial policy system is not a normal, healthy capitalism, and it does not work — it cannot work, because it is not a market economy.

[01:11:35] Ajay Shah: There is only one answer, which is to build and run the checks and balances of firms — private ownership, stock market — as we do in India, as the whole world does. So I don't think we are holding our breath waiting for China to fail. We are at the hardest stage for third parties, because China is now at its biggest.

[01:11:59] Ajay Shah: A systemically important country. And their local economy is in disarray. So the pressure is on exports — they are an overproduction system. By design, the Communist Party engineers one piece of overproduction after another based on state leadership.

[01:11:59] Ajay Shah: The government decides that now we're going to overproduce X, and they get ridiculous overproduction of that.

[01:12:22] Ajay Shah: So we are at the world's peak-China moment, where there's the largest China economy and the maximal need to dump goods abroad, where the companies in China are based on various kinds of subsidies — ranging from AI models to electric vehicles, it's the same story, where there is a dumping going on which is not financially sound in any remote sense.

[01:12:44] Ajay Shah: But it's state-driven, it's industrial-policy-driven. So what is to be done? As you said, should we wait for this period to subside, or should we allow it to flood into our country with benefits and costs? I think that in some sectors — remember, I said there are places where there is no meaningful Indian production capability.

[01:12:44] Ajay Shah: For example, in LLMs, there is no meaningful Indian production capability.

[01:13:08] Ajay Shah: We should worry about the strategic damage that Chinese LLMs can do to India. I'm sure their processing is jaundiced in various ways. I think a DRDO head recently said, how can I trust a Chinese model inside my drone? That's correct.

[01:13:08] Ajay Shah: You can't put those things into many applications. It is entirely possible for a Chinese model to praise the killings at Tiananmen Square.

[01:13:35] Ajay Shah: And so we've got to be cautious about the use of Chinese models. But for the rest — other sectors in India where India is really absent — then getting a flood of cheap things is not a bad thing. So that's the industrial policy judgment, and I'll come back to your state capability question in a moment.

[01:13:51] Ajay Shah: The good news is, trade barriers against China are hardly unique to India. All countries are doing them. So effectively, China is being isolated from the world trading system. So, I think we should think of a world which is doing reasonable free trade with each other.

[01:13:51] Ajay Shah: And we need to do more of that. As I said, we need not a free trade agreement with the UK or the EU that is good by Indian standards.

[01:14:17] Ajay Shah: We need a free trade agreement with the UK and the EU which is a normal trade agreement by their standards. They are vastly ahead of us in their concepts of globalization. So there's plenty to do. There's a very large world economy — India is a small country.

[01:14:17] Ajay Shah: There's a very large world economy to play in. As long as you wall off China in some sectors, then Indian firms get the opportunity of playing the Indian market, but more important, get the opportunity of playing in all these rich countries who are facing these same battles, and they are throwing up barriers against China with greater state capability compared to us.

[01:14:51] Ajay Shah: So I don't think you should accept the inevitability that China will keep on doing this forever. In fact, there is a dynamic in motion. The dynamic is that Xi Jinping put an end to the normal, successful evolution of China towards a better country in terms of more economic freedom, more political freedom. He reversed China's improvements in V-Dem and in the Freedom House Index.

[01:15:17] Ajay Shah: He reversed Chinese GDP growth. Even Chinese data shows slower GDP growth in China today. And if you go to other data sources, it's much worse. And the China model is not working, and you are not a hopeless, silly person waiting for them to change more in the future.

[01:15:17] Ajay Shah: And there's plenty to do.

[01:15:37] Ajay Shah: So it's not like we are losing something fundamental when we wall off China in some segments of the economy. And I did say there are some sectors — you know, like should you have a flood of Chinese lithium-ion batteries coming into India? By the way, I just want to say, my wonderful researcher friends and collaborators and co-authors, Nikit Abhyankar and Amol Phadke of UC Berkeley, and Gautam Bambawale, former Indian ambassador to China, and Ashwin Gambhir and Shantanu Dixit of Prayas, and I, are building a paper on this very subject right now.

[01:16:19] Ajay Shah: On how to find that balance of benefiting from cheap Chinese lithium-ion batteries, but recognizing the adverse consequences of a kill switch controlled in China, and finding responses whereby we can do better in pursuing our own self-interest. So I don't want to say it's black and white. It's tough, but we should try.

[01:16:39] Ajay Shah: Finally, I come to the state capability question. When Ila and I wrote that article, we sort of closed our eyes and thought to ourselves that, when we were the macro-finance group at NIPFP and we were working closely with the Department of Economic Affairs, Ministry of Finance, we were de facto an advisory group working closely with the Ministry of Finance.

[01:17:05] Ajay Shah: Would we have been able to work with the MOF of that age, with the intellectual and bureaucratic culture of that age, where Manmohan Singh was Prime Minister, and Rangarajan was the chairman of the Economic Advisory Council to the Prime Minister, and we had a variety of people in the bureaucracy where Montek Ahluwalia was deputy chairman, and so on.

[01:17:29] Ajay Shah: In that environment, could we have been part of a meaningful, useful Indian process of understanding these questions, and 60% of the time come out correct on that industrial-policy-sounding thing? I think the answer is yes. I think we would have. In that age, we could have, we would have.

[01:17:29] Ajay Shah: We wouldn't have been 100% right, we would have been 60% right.

[01:17:55] Ajay Shah: So I recognize that this is a very different India — state capability has declined greatly. So today you would not be able to do it. Today, we should be very, very skeptical about anything sounding like industrial policy in India. Today's Indian state is not a useful player in the Indian economy, and consulting firms that work with the Indian government don't have the opportunity to solve the basic problems of the Indian state.

[01:18:21] Ajay Shah: But I think of this at a deeper level — can we, should we, recreate the political settlement, the intellectual climate, the thinking power in Indian society? I think the answer is yes. So I think both statements are true — that in the short term, we can't, but can we go back to a better India in terms of the thinkers, in terms of the intellectual culture, in terms of the role for knowledge and intellectualism in the Indian state?

[01:18:46] Ajay Shah: In the quality of bureaucracy, and the quality of external people working with teams inside government. In terms of having external people who are upstream of the policy process and not consultants helping the government write English to support the decisions of the government — can there be a movement in these directions? I think the answer is yes.

[01:19:06] Ajay Shah: And so I think all of us should put this picture together — short term, long term — what could you do today, what kind of capabilities should we be building for the future?

[01:19:17] Ajay Shah: A short-termist view that we should be prioritizing the questions and activities that today's civil servants are asking for is a bit self-defeating, because the Indian state has had a remarkable decline in state capability, and the ability of internal people and systems and procedures to come up with good ideas is very limited. And so, helping officials and politicians implement their policy agenda is not very useful.

[01:19:45] Anupam Manur: Yeah. I have just a small follow-up on this, and you can be very brief about it — can we make a case, and I don't like the question myself, but can we make a case where, does India really have an obligation to contribute to the global, Western, relatively free-market view of China? Or can we play our own game, in the sense that if their manufacturing bases are being affected by Chinese overcapacity and dumping, and therefore they're putting up a lot of export controls, which in turn will in some way impact or contribute to China's implosion.

[01:20:25] Anupam Manur: Should India also play that same game, or can we be a little bit more self-interested and dishonest about it all, saying, okay, you make China's implosion possible, but in the meantime, I will try to maximize my self-interest, and if I can get cheap — let's say, again, not the electronics, surveillance, etc. — but if I can get cheap Chinese goods on a whole variety of other things, I'm just going to go open up on those things.

[01:20:48] Ajay Shah: In some respects, we undoubtedly should. Remember I said that there are places where there is no meaningful Indian firm — in India we should just open the floodgates. We should take cheap Chinese goods. I have no hangups about that.

[01:20:48] Ajay Shah: It's only where there is a plausible, meaningful Indian industry, or there are strategic threats, that we need protectionism against China. So I don't have a problem with a wide variety of cheap things coming from China.

[01:21:14] Ajay Shah: In terms of collaboration with the West — one level is to say, of course, only Indian interests matter. Of course, only Indian interests matter. I will not move even one micron away from that statement. We are here to maximize for India.

[01:21:14] Ajay Shah: But you can be naive and transactional about it, or you can be more strategic about it. That's a trade-off — if we have any kind of understanding of Japan, then we will play for fifty years.

[01:21:45] Ajay Shah: And then we will become more strategic. And then there will be a lot of give and take. And we will respect Japanese concerns. We will collaborate with Japan on many of their priorities, so that in exchange, they will respect our concerns and they will collaborate with us on many of our priorities over the next fifty years.

[01:21:45] Ajay Shah: We will modify many elements of domestic policy in ways that suit Japanese interests, as they will modify many elements of their policies in ways that suit our interests.

[01:22:15] Ajay Shah: And everything I have just said is a negation of one intellectual failure of Indian foreign policy, which is called strategic autonomy.

Emerging global risks: AI and geopolitical flashpoints

[01:22:25] Anupam Manur: Yeah. Okay. I'm very conscious of the time, Ajay, so I'm going to be populist myself, and I'm going to end with two really broad questions, and we'll take them one by one. You can be as brief or as elaborate as you wish.

[01:22:25] Anupam Manur: And these are probably questions that you might not like, because they're not very specific, but they are broad questions.

[01:22:45] Anupam Manur: In terms of global risks, because that is what this episode is on — we know there is global risk in terms of, we spoke about political polarization, breakdown of trade, and many of the episodes have spoken about that. We've spoken about increasing use of sanctions and money, etc., in other episodes. In this one, we spoke about China.

[01:23:07] Anupam Manur: One thing we've not spoken about explicitly, and we don't necessarily need to go into it, is climate change. But is there anything else I'm missing in terms of — it might not be fifty years down the line, but in the next ten years, what are the kinds of risks that we should look out for at a global level? Is AI — I mean, we know there is sovereign AI, that part — but will the way that you mentioned social media changing the social fabric of the world, can AI do something like that?

[01:23:37] Anupam Manur: I don't want to get into the cheap part, the easy part about whether AI will steal our jobs, but is there almost an epistemological threat that AI can pose? Can that change the world order, and is there something else I'm missing out on?

[01:23:52] Ajay Shah: I'm sixty years old. I'm a white-haired Unix hippie. So I'm cautious about my opinions on these matters. I'm very nervous about the harm that AI is doing to the growth of young people.

[01:23:52] Ajay Shah: Done right, AI is a phenomenal partner to our knowledge building and our education. I hope you are using AI every day. I use AI twenty-five times every day.

[01:24:15] Ajay Shah: It's a very powerful partner to my learning process. I love it, and I'm thrilled by it. But I'm very worried about young people — that when you don't sweat and do the hard work yourself, then you don't get the knowledge. And there are too many institutional settings where there are things like homework and exams which are being spoiled by AI.

[01:24:37] Ajay Shah: And too many people are taking the shortcuts, and they're not getting the knowledge. So in an ideal world, a child was brought up dreaming of ideas, dreaming of knowledge, with the intrinsic motivation to acquire knowledge. Those kinds of children will triumph, because AI will support their thirst for knowledge.

[01:24:55] Ajay Shah: But the children who were brought up transactional, to win exams, to win homework assignments — I worry about them. The people who do work in the office trying to get ahead and get a promotion will use the AI and get their damn promotion, but in the process they'll not get the knowledge. So this is just me, a sixty-year-old white-haired Unix hippie ranting. I'm sure the world will work out a bit better than what I am depicting, but this is my concern.

[01:25:20] Ajay Shah: I have always watched and waited with pleasure and hope at the next generation. I'm proud of the younger people coming up in India. I love the next generation of intellectuals coming up in India, the thinkers coming up in India. All my life I've invested in the people behind me.

[01:25:20] Ajay Shah: You know many elements of what I have done. I just love it — I think of myself as a product of my age. I was born in 1966. It was a very shitty India.

[01:25:50] Ajay Shah: And things have gotten better. So the children of liberalization should just be so great. They should be so much better. It's just my one fear, my one concern — will people cut corners on doing math problems when the AI can do the problem for you?

[01:26:05] Anupam Manur: Yeah, yeah. And, I somehow think that we are in that kind of golden generation where we've built the hard knowledge ourselves, and now we can use AI to really amplify all our outputs, our learnings, and so on. But yeah, there's an epistemological thing. Any other big global risk I'm leaving out?

[01:26:26] Ajay Shah: That's all. You could think of geopolitics and strategy. I think everybody understands the list of phenomena and scenarios we are thinking about. We're thinking about Russian escalation into Western Europe.

[01:26:26] Ajay Shah: We're thinking of a collapse of the Putin regime, we're thinking of loose nukes. We're thinking of a next 1989, where Russia breaks into twenty countries.

[01:26:48] Ajay Shah: A Chinese land grab into Russia, of Vladivostok going back to China. We're thinking about a North Korean attack against South Korea and Japan. We're thinking of the implosion in China. I worry a lot about Israel.

[01:26:48] Ajay Shah: Israel is a great country, is a wonderful partner to India, is a very important part of the Middle East.

[01:27:12] Ajay Shah: A key part of stability in the Middle East has been the fact that Israel is, and has been, the dominant military power of the Middle East. But will Israel be able to maintain its position and its greatness? And to what extent is Netanyahu a right-wing nationalist who is damaging the idea of Israel?

[01:27:32] Ajay Shah: So this is just conventional thinking, all around the world. And each of these fault lines can blow up and turn into a mess.

Why Indian reform stalls and what's needed to fix it

[01:27:41] Anupam Manur: Yeah, yeah. Final question, I promise, which is on India. I want to close on the India note. Crisis will not automatically produce reform — I think we've kind of understood that.

[01:27:41] Anupam Manur: Let's take the standard Kingdon schema — you've got the problem, you've got the policy, you've got the politics.

[01:28:00] Anupam Manur: There have been multiple situations in which you've had a problem, you've even had some kind of political alignment, but is it your argument that the policies have not been built during peacetime, and therefore we are not able to produce the reform, or we are not able to bring in the good ideas?

[01:28:20] Anupam Manur: Ajay, I've been thinking about this quite a bit. There are so many problems to which I think the solutions exist. It's not new. In one set, for example, the politics failed us — think about agriculture reforms, the politics failed us.

[01:28:20] Anupam Manur: We had a solution — I think those were the farm laws — we can debate plus or minus two percentage points, you could do more, but by and large they were liberalizing reforms.

[01:28:45] Anupam Manur: But on other bits, reform has been so painfully slow, and we don't need to rethink how to get it done — it could be labor, it could be, we still don't have land reforms, structural issues, some parts of finance, you've worked so much on some of the ideas, the bankruptcy law that came in has now, I think, receded in terms of its effectiveness.

[01:29:05] Anupam Manur: I'm saying that there are certain things, for sure, that we need to build newer policy solutions during peacetime, but there are other things where the solution clearly exists, perhaps — or I don't know if I'm overstating it — but yet, even when the crisis was presented, we didn't move on that. During COVID, that could have been a wonderful opportunity to get through some of the labor law reforms.

[01:29:28] Anupam Manur: Yes, we just codified it, we redrafted it, we now have it in four codes, but I don't think it's dramatically changed the way we do business in India in terms of labor. And so on and so forth. So I don't want to belabor that, but I think you get my bit.

[01:29:42] Ajay Shah: Let me put it up in a couple of points. First, as I already said, progress seldom comes from the leadership of today's politicians and today's civil servants. You just got to write it down — if you went to Ministry of Commerce people and spoke about trade policy in the late eighties and early nineties, they would have probably said things like "single window." Single window is the imagination of a bureaucrat. That's all.

[01:29:42] Ajay Shah: And nothing interesting gets done in a single window. The point is to tear down the interference by the Indian state into society. That will never be hatched by the present serving civil servants and politicians.

[01:30:00] Ajay Shah: Those knowledge bases and that consensus need to be created outside, in society. And when we go back to think about all the areas of progress where India moved, it came out of that sort of long-term journey, where many, many people in India moved positions, and the nature of the popularity and support gradient faced by a prime minister or finance minister changed.

[01:30:18] Ajay Shah: When a finance minister would get criticized for doing inflation targeting, you will not get inflation targeting. Then the world changed — finance ministers started getting praised for doing inflation targeting, then we got inflation targeting. RBI governor, RBI deputy governor did not originate inflation targeting. So if you go meet an RBI governor and say, "Sir, can I help you on some reforms?" — they're not going to come up with anything meaningful.

[01:30:44] Ajay Shah: So the important progress is hatched outside. That's my first idea. My second idea is that, if we had to do a one-slogan, bumper-sticker version — I think, Anupam, we should make a Takshashila t-shirt out of this — if we had to make a slogan for what is wrong with India, it is: too much central planning and too little rule of law.

[01:31:03] Ajay Shah: That's at heart. There's way too much government control, and there is not enough rule of law. There's just way too much executive discretion. There is just random, arbitrary power placed in the hands of too many civil servants.

[01:31:16] Ajay Shah: Now, the full knowledge set of how to take this diagnosis and turn it into state capability is actually not widely known in India. There are, it's a very limited set of documents, of people who know how to take this as an organizing principle and say, recreate the Competition Commission of India, or recreate TRAI.

[01:31:42] Ajay Shah: So imagine if I put up this problem to you — what is wrong with TRAI is too much central planning, too much industrial policy, and too little rule of law. What would you do differently? I think that's not a ready knowledge set that we have today. What would be the nature of the laws, what would be the nature of the organization design?

[01:32:00] Ajay Shah: How would we create the checks and balances? How would we come up with a new-age TRAI which would actually be far more respectful, which would stubbornly refuse to do industrial policy, which would not make decisions where it picks winners — this is a good technology, that is a bad technology — and where there would be rule-of-law procedures when the coercive power of the state impacts private people.

[01:32:23] Ajay Shah: Or take taxes — do we in India today have those high-quality masterpiece documents of clean tax policy, the economic principles, the draft laws, and then the checks and balances, the rule of law for how tax administration would work? I think this is still ideas and arguments floating at a high level, in the hands of a few people.

[01:32:48] Ajay Shah: It'll become mainstream, and then it will go to the state. So you and I are at ground zero. It is we, the thinkers, it is we, the research organizations, who have to take these programs seriously. So there again, I want to go back and complain about 1991 to 2011.

[01:32:48] Ajay Shah: We economists played a critical role from 1991 to 2011. Great — I'm proud of all the contributions of the economists.

[01:33:14] Ajay Shah: But we economists did not have knowledge of implementation. How do you build a government organization which will actually do free trade? We didn't have that knowledge. So the economists totally messed up on all the areas that they touched.

[01:33:14] Ajay Shah: They did some sloganeering and some high-level talk.

[01:33:34] Ajay Shah: But they didn't actually contribute to writing good laws. So, for example, famously, Indira Gandhi's FERA, which criminalized cross-border activities, was amended in 1999 to make FEMA. And the economists were very proud that, see, we are liberalizing, we are opening up to the world. Well, dude, go read the law carefully.

[01:33:34] Ajay Shah: FEMA is just the same as FERA with the criminal aspects removed. You don't go to jail — for the rest, FEMA at the beginning was exactly the same as FERA.

[01:34:03] Ajay Shah: And in 2015, the criminal penalties are back. Now this full knowledge set — do we want capital controls? If we want some capital controls, how would we do it without central planning? Currently we do industrial policy — the Reserve Bank says, in this way I will allow capital, in this way I will not.

[01:34:03] Ajay Shah: But how is a government to have intricate knowledge about finance?

[01:34:27] Ajay Shah: That's an unreasonable ask. It's as silly as a Ministry of Industry saying lithium-ion battery is bad, sodium-ion battery is good. How is an official to ever know that this kind of hedged government bond is okay, this kind of unhedged corporate bond is not okay? RBI says foreigners cannot buy this kind of bond, but they can buy that kind of bond.

[01:34:48] Ajay Shah: And I just have to shake my head and say, how do you know? It is the conceit of socialism, where officials pretend that they know what is correct for the country. So when you take "too much central planning, not much rule of law" as the organizing principle of what is wrong in India, then I think we, in the research organizations, are the choke point.

[01:35:10] Ajay Shah: We don't have the knowledge, the documents, the planning, the preparation, the community building, the persuasion, the creation of human capital, the creation of hundreds of people through which these things will get solved.

[01:35:25] Anupam Manur: I think that lays out a very good, I suppose, charter for us to follow now — a mandate for us to follow. Thanks for that. Thank you so much, Ajay, for joining me in this episode. And because you've been so generous with your time, I really appreciate it.

[01:35:25] Anupam Manur: Thank you so much.

[01:35:41] Ajay Shah: Thank you, Anupam. Always happy to do things.

[01:35:43] Anupam Manur: Bye-bye.

[01:35:45] Anupam Manur: We hope you enjoyed that conversation. If you're interested in public policy, AI, geopolitics, or defense, do check out the courses offered by the Takshashila Institution. And for more conversations like this one, stay tuned for the next episode of Turbulence: Global Finance and Geo-economics in an Age of Disruption, a special series of the All Things Policy podcast, supported by Zerodha.

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