

Lecture on India, Financial Crisis and Globalization at MSH, Paris (May 7, 2010) by Arup Mitra

(The lecture is based on certain papers and reports listed at the end of the text.)

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A number of studies undertaken in the last few years have noted that India's economic growth accelerated nearly a decade before the economic reforms began in India, i.e. the acceleration in India's economic growth took place around 1980 and not in the 1990s.

- COMPOSITION OF GROWTH:
- Tertiary sector has registered a high growth.
- Within the tertiary sector: two distinct streams can be seen.
- Trade hotel and restaurant account for a large share and also have been growing steadily.
- Transport etc. and Finance etc. are growing rapidly but the base of the finance etc. was small to begin with.

Distribution of GDP

Year	Primary	Secondary	Trade, Hotels, Transport and Communication	Financing, Insurance, Real Estate and Business Services	Public Administration and Defence, and Other Services
1950-51	56.53	13.62	11.30	7.67	10.57
1960-61	52.28	17.02	13.00	7.00	10.31
1970-71	45.95	20.38	14.72	6.82	12.01
1980-81	39.94	22.03	17.44	7.49	13.10
1990-91	34.05	23.24	18.34	10.58	13.78
2000-01	26.18	23.51	22.29	13.04	14.98
2006-07	20.55	24.71	26.81	14.31	13.62

Growth Rate in GDP (% p.a.)

Period	Primary	Secondary	Trade, Hotels, Transport and Communication	Financing, Insurance, Real Estate and Business Services	Public Administration and Defence and Other Services	GDP
1950-51 to 1959-60	2.71	5.97	5.16	3.01	3.45	3.62

1960-61 to 1969- 70	1.62	5.57	4.66	3.06	5.11	3.23
1970-71 to 1979- 80	1.84	4.40	5.26	4.35	3.61	3.39
1980-81 to 1989- 90	3.19	5.42	5.76	8.86	6.05	5.04
1990-91 to 1999- 2000	3.37	6.23	7.96	7.65	6.30	5.87
2000-01 to 2006- 07	2.68	7.58	10.11	7.60	5.32	6.70

Source: Goldar and Mitra (2008)

Rodrik (1997) on Globalisation

- Globalization is a broad concept casually used to describe a variety of phenomena that reflect **increased economic interdependence of countries**.

Such phenomena include

- flows of goods and services across borders,
 - reductions in policy and transport barriers to trade,
 - international capital flows,
 - multinational activity,
 - foreign direct investment,
 - outsourcing,
 - increased exposure to exchange rate volatility,
 - and immigration.
- These movements of goods, services, capital, firms, and people contribute to the spread of technology, knowledge, culture and information across borders.
 - Research on the effects of globalization in economics has concentrated on those aspects of "globalization" that are easier to capture empirically.

Sources of tension

First

- Reduced barriers to trade and investment accentuate the asymmetry between groups that can cross international borders (directly or indirectly, say outsourcing) and those that cannot.
- First category: owners of capital, highly skilled workers, professionals
- Second: unskilled and semi-skilled workers, middle managers
- Workers now have to **pay a larger share of the cost of improvements in work conditions and benefits** (they bear a greater incidence of non-wage costs)
- They have to incur **greater instability in earnings and hours worked** in response to shocks to labour demand or labour productivity (that is volatility and insecurity increase)
- Their **bargaining power erodes**, so they receive lower wages and benefits whenever bargaining is an element in setting the terms of employment.

Second

- Globalisation engenders conflicts within and between nations over domestic norms and the social institutions that embody them.
- (workplace practices, legal rules, social safety nets vary across countries; not technology)

Third:

- Globalisation has made it exceedingly **difficult for governments to provide social insurance.**
- At the moment international economic integration is taking place against the background of **receding governments and diminished social obligations**
- **The welfare state has been under attack**
- **The increasing mobility of capital has rendered an important segment of the tax base footloose**, leaving governments with the unappetizing option of increasing tax rates disproportionately on labour income.
- **Inequality trends which globalisation produced are of primary concern**

Empirical Evidence (we focus on the following two aspects):

- **Trade liberalisation and its impact on Indian industry**
- **Innovation**

India's manufacturing Employment (Goldar, 2009)

- Analysing the impact of trade on manufacturing employment in India, it is found that exports had a favourable effect on industrial employment, but the positive effect of export increase was offset by the negative effect of increases in imports.
- The net effect was marginal.
- The failure of trade to raise industrial employment is traced primarily to the changing product composition of trade and the changing direction of trade.
- Petroleum products have emerged as a major item of India's exports whereas the traditional labour-intensive products have lost their share.
- The analysis reveals an adverse effect of changing factor prices on manufacturing employment.
- One interesting finding of the study is that after a long period of jobless growth, the corporate sector organized manufacturing has achieved in the last four years (2004-05 through 2007-08) a high rate of growth in employment, about 7 per cent per annum on average.

Services (Mitra, 2009)

- The service sector value added in the Indian context has been growing quite rapidly for the last several years.

- Based on the time series macro data, the elasticity of organised service sector employment with respect to value added and exports and imports have been estimated.
- These exercises have been pursued separately for four broad groups of services: trade and hotels, etc, finance and business services, transport, storage and communication and community, social and personal services.
- After controlling for growth it is difficult to identify a positive and significant impact of international trade on employment in the organized service sector.
- In other words, international trade does not seem to be contributing to employment growth in the organized service sector.
- We have also tried to work out the direct and indirect effects of exports and imports on employment after deciphering their effects included in overall growth.
- However, the positive effects are mostly negligible.
- The elasticity of informal to formal sector employment has been calculated and based on these estimates the impact of international trade on the informal services sector employment has been worked out.
- The impact does not seem to be greatly different from what was observed in the case of the organized service sector employment.

- Though Capital Line data are indicative of a high employment growth in the service sector during the period 2005 to 2008, CMI data for around 3000 firms in the service sector do not unravel such a pattern.
- It would be, therefore, misleading to conclude that in the recent past the acceleration in economic growth is able to translate itself into employment growth as well.
- Since some of the firms in the service sector as per the Capital Line data recorded an employment growth in double digit, suggesting possibility of close links between growth and employment, we have tried to assess the effect of international trade on employment in these units.
- However, as per the findings, international trade does not seem to be an important determinant of employment, implying that trade liberalization per se did not reveal any significant contribution to employment growth.

Export Competitiveness of Indian Textile and Garment Industry (Verma, 2002)

- The Indian textile and clothing industry occupies a unique place in the Indian economy.
- It contributes about **4% of GDP and 14%** of industrial output. **Second largest employer after agriculture**, the industry provides direct employment to 35 million people including substantial segments of weaker sections of society.
- With a very **low import-intensity** of about 1.5% only, it is the largest **net foreign exchange earner in India**, earning almost **35% of foreign exchange** (though relative to many other countries India is lagging much behind)

- **Indian textile and clothing sector is predominantly cotton based**, and we may focus mainly on the cotton textile and apparel, and look at the entire value chain from fibre to garment and retail distribution
- USA one of the largest importer of textiles and clothing, importing 21% of world import

India's Competitive Performance in the US

- Of the eight cotton apparels, India's market share in US import **market exceeded (in 2000) 10% in** cotton dresses (336), W&G woven shirts (341), and cotton skirts (342).

Biggest threat is China for woven shirts (341): by reducing the price China is able to capture a large market.

- **India operates in the low value segment in most cotton apparels in the US**
- However, there are three cotton apparels which are not in the low value segment :They are **knit shirts (338) and trousers for M&B (347) and for W&G (348)**.
- Incidentally, US imports of these products is growing fastest among all cotton apparel categories.
- However, India has lost market share in all except 347 during 1995-2000.
- except made-ups like towels, bed-sheets Indian textile export to the US has no future

EU Market for T&C (textile and clothing) Imports

- **India has performed reasonably well in the EU in terms of yarn- both cotton and synthetic- and synthetic table linen.**

- **The losers are bleached fabric made of cotton as well as synthetic fibres/yarns, and knit jerseys/pullovers.**
- The message is quite clear:
- EU is importing less of yarn/fabric from outside, but more of made-ups and garments.
- India should try to take advantage of that.
- **Indian textile and clothing sectors have a tremendous potential, only a portion of which has been exploited due to policy constraints.**

Innovation (Mani, 2009)

- **After globalisation one of the distinguishing aspects of India's growth performance is that its knowledge-intensity has increased**
- **Currently about 14 per cent of overall NDP of the country can be termed as composed of knowledge-intensive production.**

knowledge-intensive industries both in manufacturing and service activities have come up : West thinks that India is undertaking lot of innovative activities

FDI from India has steadily been increasing and over 2007 and 2008 there have been a number of high profile take-over of Western technology-based companies by Indian corporates.

Indicators of innovation

- **a. Improvement in India's rank in the Global Innovation Index (ECONOMIC Intelligence unit)**
- (b. Many instances of innovation in the services sector and especially in health care segment ;
- c. Increase in knowledge-intensity of India's overall output;
- d. Growing FDI from India including some high profile technology based acquisitions abroad by Indian companies;
- e. Competitiveness in high technology areas; and
- f. Increase in the average propensity to adapt)
- **Within the manufacturing sector itself a number of innovations have been reported from the automobile, medical devices industries.**
- **However these propositions have not been subject to any rigorous empirical scrutiny.**
- According to the Economist (2009) the pursuit of technology is a powerful motive for foreign acquisitions. Before Tata Steel's purchase of Corus, the Indian steelmaker did not hold a single American patent.
- **Examining it critically: Increasing foreign acquisitions of technologically speaking active targets have given Indian companies considerable access to technological inputs of the acquired firm without really building it up.**
- **In fact, a whole host of innovation generating**

non-R&D routes is used, (for instance by acquiring machinery, purchasing innovative outputs from outside, training of personnel etc.)

- **even with low levels of R&D investments some of the developing countries are able to continuously improve their respective patenting records.**
 - **overall investments in R&D have actually declined.**
 - Within the industrial sector much of the R&D is performed by private sector enterprises.
 - Currently Indian private sector enterprises spend approximately four times their public sector counterparts.
 - Within the industrial sector about four industries account for a significant share of R&D investments
 - **The pharmaceutical and the automotive industries are the two most important spenders.**
 - Overall research intensity of the country as judged by rates of growth of GERD and GERD to GDP ratio has actually gone down since 1991;
 - **On the whole, for the aggregate economy**
- Within Mfg : pharmaceutical : domestic firms**
- **Within Services: IT: Multinationals**

Financial Crisis

- **Globalisation spreads both prosperity and distress. The contagion works both ways.**
- **India's growth rate in 2008-09 was 6.7 per cent as compared to 9 per cent in the previous year.**
- **Indian banking sector:**
 - **The broad features of the on going banking reforms have been: gradual removal of pre-emptions (reduction in CRR and SLR), deregulation of interest rates, tightening of prudential standards, competition and transparency, improving the quality of supervision, partial removal of selective credit controls, assistance to banks in debt recovery and reforms in money and forex markets.**
 - **To improve the efficiency in the system an element of competition was introduced.**
 - **The International Monetary Fund (IMF) in 2008 surveyed 113 episodes of financial stress in 17 countries.**
 - **Of these, 43 episodes were driven mainly by stress in the banking sector.**
 - **In 17 episodes, stresses arising elsewhere in the financial system had a significant impact on the banking sector.**
 - **Thus, a total of 60 episodes – or a little over half of all the episodes of financial stress – were banking-related.**

- **International crisis**
- **Lehman was, among other things, a prime broker, that is, it provided two-way quotes and funds to its broking clients.**
- **(With interest rates rising and home prices falling, there was a sharp jump in defaults and foreclosures. However, this would have remained as a purely mortgage market crisis but for the fact that these sub-prime mortgages were securitized and packaged into products that were rated as investment grade.)**
- **Its bankruptcy had implications for the market in three ways:**
 - **one, the impact on the credit default swaps (CDS) market;**
 - **two, the liquidation of money market funds due to losses suffered on Lehman debt;**
 - **and three, the consequences for the firm's prime brokerage clients.**
- **An even bigger fallout of the Lehman failure was on the money markets.**
- **The IMF provides an explanation that appears plausible: In a modest US slowdown, emerging markets (and also other economies) are affected mainly through the trade channel.**
- **However, when the US economy runs into serious problems, the asset price channel gets activated.**
- **Financial flows to emerging markets are severely affected and equity prices also tend to become highly correlated with those in the US market.**

- Besides, there is a broader impact through undermining of confidence among consumers and investors.

Many people think that India has not been affected much:

Indian Capital Controls

- India has an elaborate system of capital controls which impede capital mobility and particularly short-term debt.
- the commercial banks are robust and resilient. The single-factor stress tests (undertaken by the CFSA) reveal that the banking system can withstand significant shocks arising from large potential changes in credit quality, interest rate and liquidity conditions.
- Bank balance sheets remain healthy and adequately capitalised. The CRAR of all scheduled commercial banks (SCBs) taken together was 13.0 per cent at end-March 2008, well-above the regulatory requirement of 9 per cent. No SCB has CRAR below 9 per cent.
- Furthermore, in India, complex structures like synthetic securitisation have not been permitted so far.
- Indian capital controls: several rules, restrictions, quantitative controls and outright bans.
- For example restrictions on external commercial borrowing prevent firms from borrowing short term (less than 3 years) in international money markets or to utilise the money borrowed for uses other than those specified such as capital goods imports and infrastructure.

- **The total borrowing by India has a cap and every firm needs approval from RBI for such borrowing. India is one of the more closed economies in the world in terms of de jure controls.**
- **Yet, when the global money market fell into turmoil the Indian money market was affected.**
- **It arose from three channels: *the trade channel, the financial channel and the confidence channel.***
- **a higher level of financial integration impacted on the Indian economy in three related ways: *reducing Indian companies' access to overseas finance, lowering domestic liquidity and causing stock prices to fall.***
- **There is a much broader impact on the Indian economy arising from foreign inflows in *forms such as foreign direct investment (FDI) and foreign institutional investment (FII).***
- **The gap between domestic investment and savings or the current account deficit – of around 1.5% of GDP – in recent years understates the potential impact on the Indian economy of foreign inflows. As Subbarao (2009) points out, capital inflows in 2007-08 amounted to 9% of GDP, vastly in excess of the current account deficit.**
- **In the period 2003-08, the share of investment in India's GDP rose by 11 percentage points. Of this, roughly half was financed by corporate savings but a**

significant portion of the balance came from external sources.

- The fall in domestic stock prices is another aspect of financial integration, reflecting as much the impact of net sales by FIIs.**
- The flight of capital from India as well as the drying up of dollar credit abroad meant that both rupee and dollar liquidity were tightly squeezed.**
- The sharp depreciation of the rupee with respect to the dollar required the RBI to intervene with dollar sales and this also impacted negatively on rupee liquidity.**
- The reversal in capital inflows, which created a credit crunch in domestic markets along with a severe deterioration in export demand, contributed to the decline of gross domestic product by more than 2 percentage points in the fiscal year 2008–2009.**
- The indirect impact on the economy because of the recession abroad is very much there. The decoupling theory does not hold good.**
- The fall in international commodity prices and more particularly crude oil is reducing sharply the import bill from previous estimates.**
- The recession abroad is having an adverse effect on exports of goods and services. There is a sharp deceleration in the rate of growth of exports in 2008-09. The decline in growth rate in exports will affect strongly some sectors where exports constitute a significant proportion of the total production. Some**

examples are textiles, automobile components and gems and jewellery.

- In contrast, to the strong inflow of over \$100 billion in 2007-08, 2008-09 saw a net increase of only \$10 billion in capital flows. The flow of portfolio capital turned negative.**
- Net market borrowings during 2008-09 almost trebled.**

Impact on the real economy

- Reflecting the slowdown in external demand, and the consequences of reversal of capital flows, growth in industrial production decelerated to 2.8 per cent in 2008-09 (April-February) from 8.8 per cent in the corresponding period of 2007-08.**
- On the other hand, services sector activity has held up relatively well in 2008-09 so far (April-December) with growth of 9.7 per cent (10.5 per cent in the corresponding period of 2007-08).**
- Services sector activity was buoyed up by acceleration in “community, social and personal services” on the back of higher government expenditure.**
- Overall, real GDP growth has slowed to 6.9 per cent in the first three quarters of 2008-09 from 9.0 per cent in the corresponding period of 2007-08.**
- On the expenditure side, growth of private final consumption expenditure decelerated to 6.6 per cent from 8.3 per cent.**
- On the other hand, reflecting the fiscal stimuli and other expenditure measures, growth in government final consumption expenditure accelerated to 13.3 per cent from 2.7 per cent.**

One Major Explanation (Patnaik and Shah, 2010)

- **Indian multinationals (financial and non-financial) were using the global money market and were short of dollars on 15 September. They borrowed in India and took capital out of the country.**
- **They had been using the global money market before the crisis, avoiding India's capital controls by locating global money market operations.**
- **When the global money market collapsed after the failure of Lehman, these firms were suddenly short of dollar liquidity.**
- **They borrowed in the rupee money market, converted rupees to USD, to meet obligations abroad.**
- **This suggests an important role for Indian multinationals in India's evolution towards de facto convertibility.**
- **The treasury operations of Indian multinationals (MNCs) is important.**
- **This led to pressure on the currency market. The rupee depreciated sharply. RBI attempted to reduce rupee depreciation by selling dollars.**
- **Ordinarily, we may have expected depreciation of the exchange rate on both the spot and the forward markets.**

- **However, instead of the forward premium going up when there was pressure on the rupee to depreciate, or remaining the same, it crashed sharply.**
- **Some Indian MNCs, who were taking dollars out of India, planned to bring the money back to India in a few weeks. They sold dollars forward and the one month forward premium fell sharply.**
- **MNCs engage in substantial intra-firm trade. These transactions can be used for transfer pricing, so as to recognise profits at low-tax locations, and to move capital across the world in ways that are not permitted by capital controls.**
- **There is a link between the rise of MNCs and issues of misinvoicing as a mechanism for obtaining de facto capital account openness.**
- **This dimension of India's integration with global capital markets gives a new insight into India's de facto capital account convertibility (Patnaik and Shah, 2010).**
- **Present Situation:**
- **Equity values are now at very low levels and many established companies are unable to complete their rights issues even after fixing offer prices below related market quotations at the time of announcement.**

- **Impact on employment through industrial deceleration.**

Impact on poverty

The economic crisis has a significant bearing on the country's poverty scenario. The increased job losses in the manual contract category in the manufacturing sector and continued lay offs in the export sector have forced many to live in penury.

- **Present economic growth 7 per cent (stimulus: printing more money)**
- **The turnaround came in the second quarter of 2009-10 when the economy grew by 7.9 percent year-on-year basis. The CSO estimates that 7.2 percent GDP growth in industrial production increases by 8.2 percent and services sector at 8.7 percent. The rise is very impressive, despite a decline of 0.2 percent in agricultural production caused mainly by sub-normal monsoon climate.**
- **Economic Survey for 2009-10: economic recovery is weak and the high double-digit food inflation in 2009-10 is a matter of great concern.**

ICRIER, Macro Team (2010)

- **In spite of growth recovery per capita consumption growth reflected in the final private consumption shows a downward trend since 2007-08.**
- **The Reserve Bank of India released the data on India's balance of payments for the first three quarters of the financial year 2009-10 on the last day of March 2010.**
- **However, based on data on some major segments available so far, ICRIER has constructed the balance of payments for 2009-10. It indicates that the year has ended with the worst current account deficit ever for India.**
- **The trade deficit deteriorated from 9.8 per cent of GDP in 2008-09 to 10.2 per cent in 2009-10.**
- **This deterioration in trade balance cannot be seen in DGCI&S data, which shows an improvement in trade deficit from US\$ 114.7 billion during April-February 2008-09 to US\$ 95.4 billion in April-February 2009-10.**
- **The level of current account deficit is the highest since independence.**
- **The previous highest at 3.2 per cent of GDP was in 1957-58 followed by 3 per cent of GDP in the year 1990-91.**
- **Unlike the previous high current account deficit situations, last year's deficit had not been alarming.**

- This is so because the net receipt of capital inflows into the country has been much more than the current account deficit at US\$ 65 billion – equivalent to about 5 per cent of GDP.
- As a result, that there had been a reserve build-up of nearly US\$12 billion in 2009-10 in contrast to a reserve draw down of US\$20 billion in 2008-09.
- However, the problem lies in the fact that in the midst of the largest current account deficit, the rupee has been appreciating.

The massive 18% appreciation in the rupee between March 2009 and March 2010 is the largest 12-month gain in history
Shankar Acharya / New Delhi April 22, 2010.

- It is time that the RBI did a rethink on its exchange rate strategy.

What has to be done

- The Government and the Reserve Bank of India took aggressive countercyclical measures, sharply relaxing monetary policy and introducing a fiscal stimulus to boost domestic demand.
- However, policy measures to restore the Indian gross domestic product growth back to its potential rate of 8–9% must focus on addressing the structural constraints that are holding down *private investment demand*.

- **The principal monetary responses since October 2008: reduction in the repo rate from 9% to 5.5% and in the reverse repo rate from 6% to 4%; reduction in the cash reserve ratio from 9% to 5%; and reduction in the statutory liquidity ratio from 25% to 24%.**

Trade possibilities in Health and Education Sector need to be explored in a big way. But that can have adverse effect since the domestic demand is often larger than the supply.

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