CHAPTER 16

PART-I

FROM IMPORT SUBSTITUTION TO STRATEGIC RESILIENCE AND STRATEGIC INDISPENSABILITY

India enters the second half of the 2020s with stronger macroeconomic fundamentals than most major economies. Growth has been resilient, financial stability has been preserved, and policy autonomy has been retained despite repeated global shocks. These achievements matter. At the same time, the nature of India's development challenge is now changing. In a world characterised by geopolitical fragmentation, strategic trade, volatile capital flows, and rapid technological disruption, the central constraint is no longer macroeconomic management alone. It is the depth and quality of state capacity.

The chapter is structured in two parts. ***Part I*** *situates India's development prospects within a changing global environment and argues that future economic strength will be determined not only by how fast India grows, but also by whether growth builds durable, productive capabilities, reduces external vulnerability, and embeds India more deeply into global economic systems. The chapter frames this transition as a movement from strategic resilience - the ability to absorb shocks and preserve stability towards strategic indispensability - the ability to become a source of reliability, capability, and value for others. Manufacturing, exports, disciplined indigenisation, and participation in global value chains are treated not only as economic objectives but as institutional stress tests that reveal whether the State can support learning, coordination, and execution at scale.*

Part II *turns the lens from external challenge to internal change and argues that India's overarching priority is an institutional incentive structure that encourages action, experimentation, and learning under uncertainty. State capacity is examined not as a single reform agenda, but as a composite outcome shaped by how decisions are taken, how risk and failure are processed, how administration is organised around outcomes, how regulation is designed and delivered, and how incentives shape the behaviour of officials, firms, and citizens. Bureaucratic risk aversion, fragmented accountability, and proceduralism weaken the State's ability to act decisively and adaptively. At the same time, the chapter emphasises that capacity is co-produced: firms and citizens shape whether the State is pushed toward capability or pulled into discretion and enforcement.*

The chapter also examines the ongoing compliance-reduction and deregulation initiative as a practical illustration of state capacity in action. Deregulation is treated not as regulatory withdrawal, but as institutional reorientation, shifting administrative effort from low-value policing toward coordination, facilitation, and problem-solving. In doing so, it demonstrates how disciplined friction removal can strengthen the State.

Taken together, the two parts advance a unified argument: India's ability to convert current macroeconomic strength into long-term strategic leverage will depend on whether the state can act under uncertainty, learn from implementation, coordinate across systems, and sustain discipline over time. State capacity, in this sense, is the economic infrastructure on which strategic resilience is built, and the pathway through which strategic indispensability becomes possible.

सुखस्य मूलं धर्मः ।
धर्मस्य मूलं अर्थः ।
अर्थस्य मूलं राज्यः ॥

The foundation of well-being is dharma.
The foundation of dharma is economic strength.
And the foundation of economic strength is the state.

–Chanakya Sutras

We have done well

16.1. Following the COVID-19 pandemic, the Indian economy has performed exceptionally well. India's growth rates are the envy of the world. The growth rate looks set to continue in the coming financial year. India's potential growth may have shifted higher towards 7.0%. The banking system is in good health. Credit intermediation remains healthy. The private sector is doing well and is investing, but can do more. Capital formation as a percentage of GDP is above 30%. The current account deficit is comfortably low. Foreign exchange reserves are ample. External remittances are strong. The agricultural sector is doing well. Monsoons have been good, and a good Rabi crop is expected. Rural sentiment is buoyant, with positive real wage growth in rural areas and rising rural consumption. Urban consumption, in comparison, is relatively more cautious, although the evidence is anecdotal. Contrasting evidence that paints a different and more optimistic picture is also available, especially since fiscal transfers to households by states have become sizable.

16.2. The government, on its part, has continued with public investment in infrastructure and incentivised states to do the same, offering 50-year interest-free loans. Furthermore, the government has undertaken significant structural reforms. Four labour codes, which provide flexibility to employers and fair treatment to workers, were notified in November 2025. The government has suspended many Quality Control Orders that, on balance, proved counterproductive for the economy, as they extended protection to large companies at the expense of downstream producers without corresponding obligations on the part of those protected.

16.3. In February 2025, the government offered significant relief to households by raising the minimum tax threshold to 12 lakhs for individuals. A family of two income earners would not have had to pay tax on an annual income of up to around Rs. 26.7 lakhs. Together with extremely low food price inflation over the past year, this has left considerable disposable income in the hands of households. In September, the government implemented a far-reaching reform of the Goods and Services Tax, reducing the number of slabs to two and shifting many items to the lower slab. That further boosted household purchasing power and lowered inflation. The government simplified the income-tax provisions and the language. It opened up the insurance sector and nuclear power generation to foreign investors and the private sector, respectively, as announced in the February 2025 budget.

16. 4. Apart from these reform initiatives, the government has been systematically strengthening national resilience by investing in achieving self-sufficiency in critical minerals and semiconductors, as well as supporting the shipbuilding industry through sustained and persistent efforts. These are covered in greater detail in Chapters 8, 9 and 10, respectively.

16.5. More importantly, following the surprise of the reciprocal tariffs and penal tariffs imposed by the U.S. government on India in April and August, respectively, the Indian government intensified negotiations with other countries to open more markets for Indian exporters. The government also passed a relief package for exporters and announced a five-year export promotion package to support expansion into new geographies.

16.6. As a result of the government's systematic and laser-focused efforts, the economy is well-positioned to continue growing. That prospects look good amid pervasive global uncertainty is all the more creditable.

Not so sure about the world

16.7. Global uncertainties are not only pervasive but also deeply structural. For better or worse, the global order that had prevailed for five and a half decades since the War

ended began to unravel in the new millennium. The first warning came with the end of the TMT (Telecommunication, Media and Technology) and Internet bubble in the early 2000s. China entered the World Trade Organisation in 2001 and, over the next two decades, proceeded to become a global manufacturing and export powerhouse, upsetting manufacturing and investment across developed and developing nations. Then came the big one – the global financial crisis of 2008. It almost caused a collapse of the financial sector in America and significantly dented the world's confidence in the U.S. dollar and the American model of post-industrial financialisation-led growth, pursued since the 1980s.

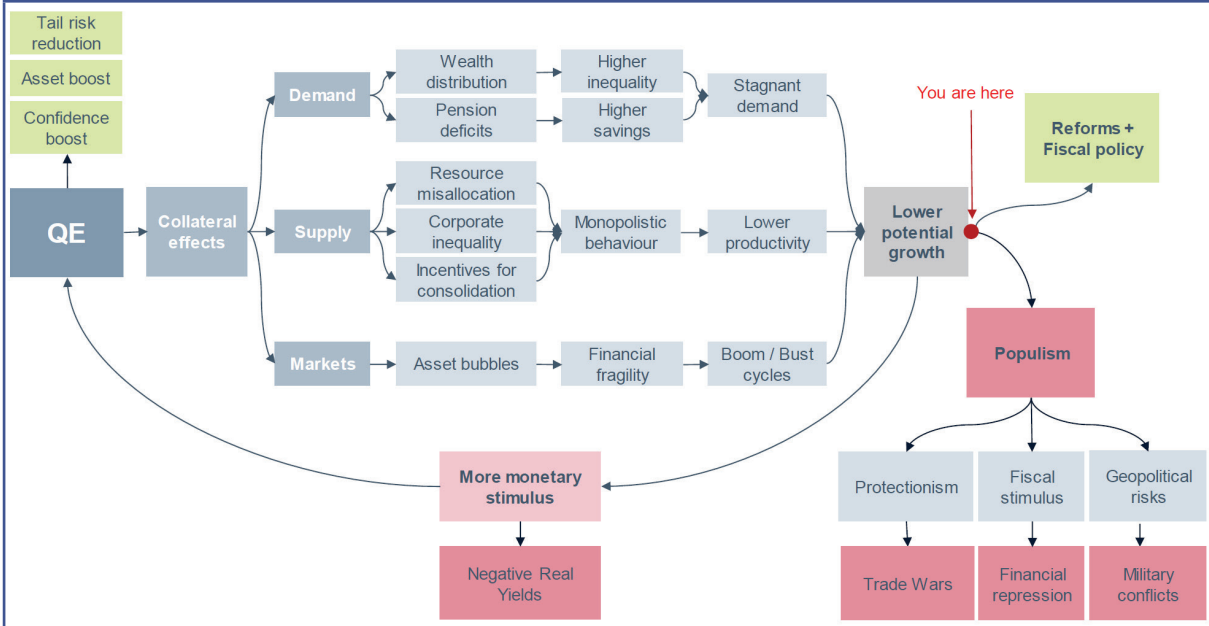
16.8. The response of policymakers in the developed world was to use short-run monetary policy tools as the stabiliser of aggregate demand for a long period. Policy rates were lowered to zero, and long-term rates were kept lower through the active purchase of government bonds by central banks. These actions further financialised their economies and made manufacturing-centric communities vulnerable to social and economic disruption.

16.9. The onset of COVID-19 in 2020 and the disruption it caused further aggravated economic and social problems across the world. Globally, public sector debt has increased significantly due to policy actions taken to address the pandemic. The rise of China as a manufacturing export powerhouse, rising debt, growing middle-class disaffection, and declining growth have brought about political changes across the Western world, upending the international economic order that has prevailed since the 1980s.

16.10. Presciently, in February 2020, shortly after the COVID-19 pandemic broke out, fund manager Alberto Gallo warned that the extraordinary monetary easing that followed the 2008 Global Financial Crisis — and the even more aggressive response to the pandemic — risked locking advanced economies into a prolonged phase of ultra-loose monetary conditions. After a decade of quantitative easing and steadily declining nominal and real interest rates, monetary policy, he argued, was losing traction in stimulating productive investment, with liquidity instead flowing into interest-rate-sensitive and safe-haven assets, inflating asset prices and compressing real yields — a dynamic he termed the “QE Infinity Trap”, in which economies become dependent on sustained accommodation merely to preserve activity. Several elements of this prognosis are now visible: financial repression and negative real yields have unfolded in much of the developed world, while geopolitical tensions, trade frictions and conflict have contributed to a more uncertain and fragile global environment. With that, the world has entered a period of uncertainty, unpredictability and danger. The new administration in the United States is also re-evaluating its approach to alliances and relationships and is busy reconfiguring them. Trade has become a matter of bilateral

agreements rather than multilateral arrangements. Countries are pursuing beggar-thy-neighbour trade policies, and export licensing is now more the norm than the exception.

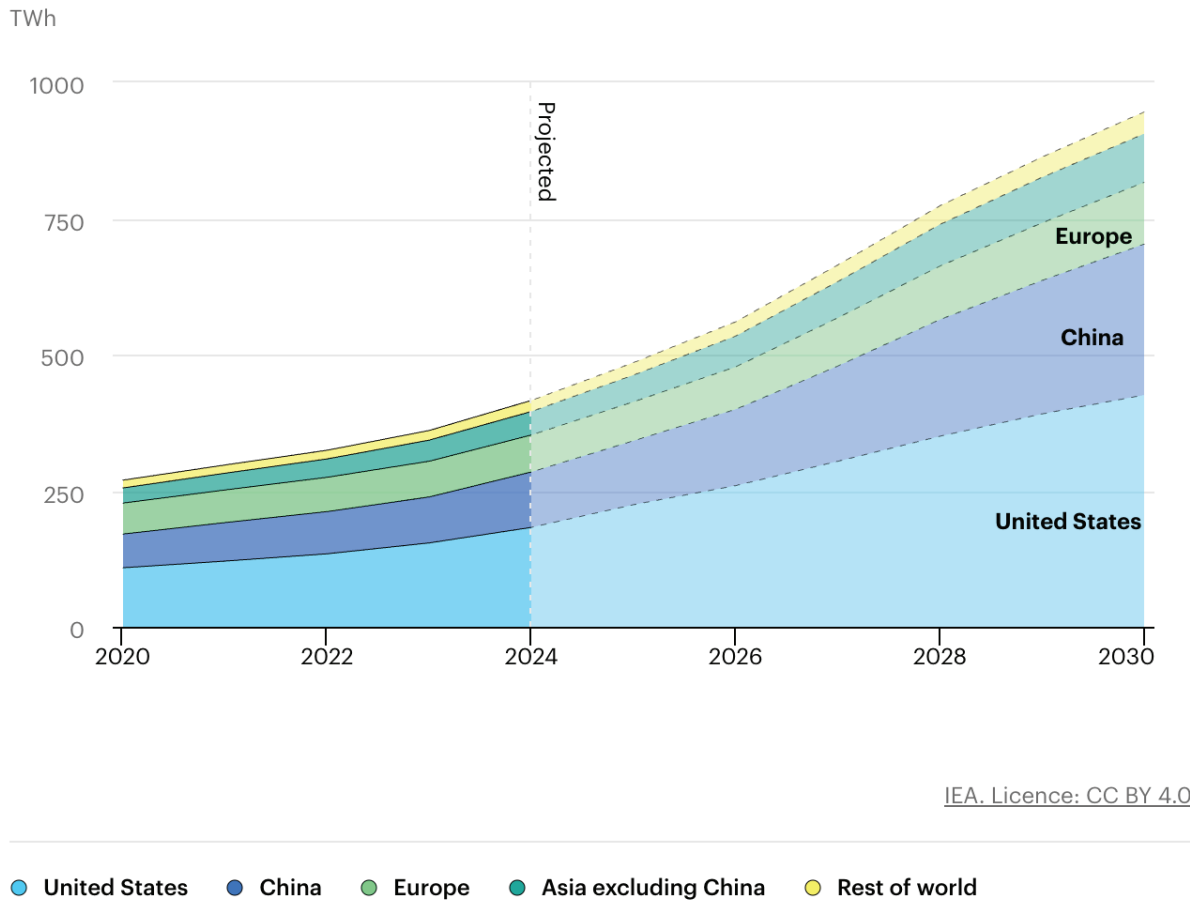
Chart XVI.1: The QE Infinity Trap



Source: Alberto Gallo. Algebris Investments. February 2020.

16.11. In the meantime, more than two decades after the end of the first technology bubble, America and some parts of the world are betting heavily on a boom in Artificial Intelligence (AI), reshaping how we work, how we secure ourselves and how we learn and teach. Where techno-optimism leads, financial engineering follows. In this instance, history may be repeating itself rather than just rhyming. For the time being, the development of AI has proceeded along resource-intensive lines. This intensification of energy demand is reflected in the sharp projected rise in electricity consumption by data centres across major regions (Chart XVI.2). Grids have become unstable, power supply is disrupted, and energy costs have risen, compounded by the push towards intermittent power sources like solar and wind. Frugal AI may be possible, but it is not yet on the horizon, nor is it yet on a commercial or global scale. The US federal government has prevented states from regulating AI.

Chart XVI.2: Projected rise in electricity consumption by data centres



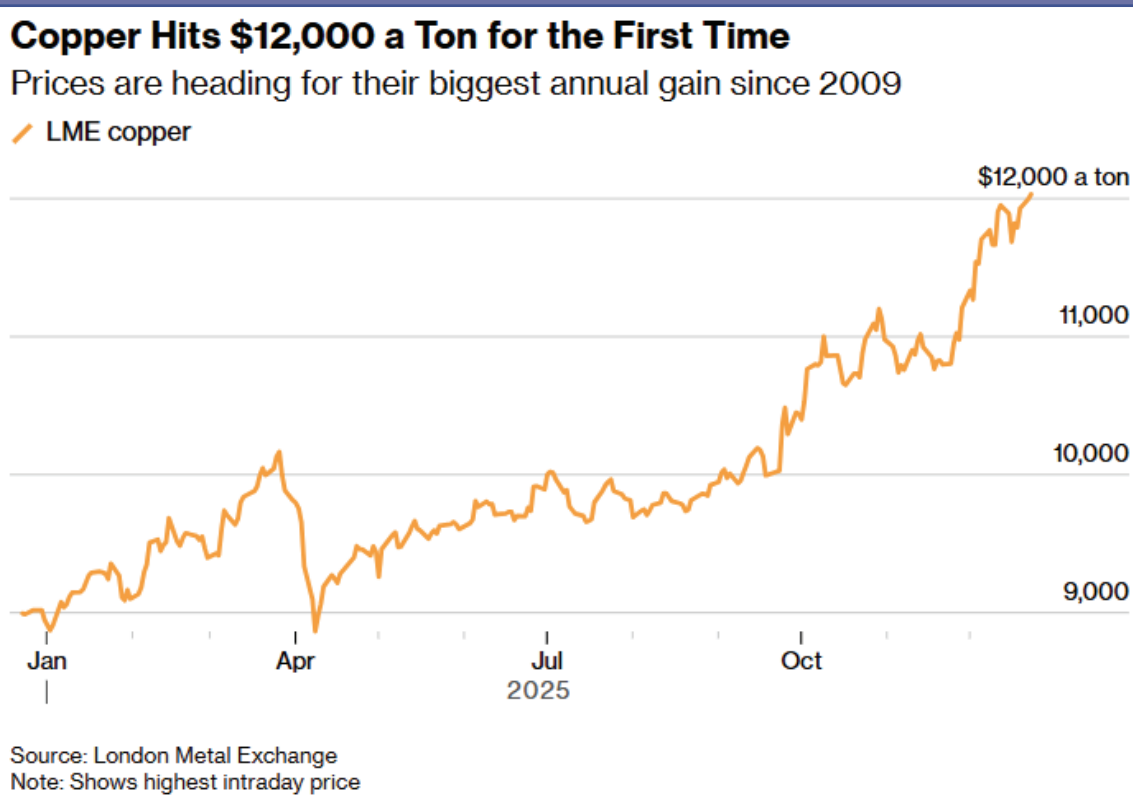
Source: IEA[1]

Narrower and narrowing alliances

16.12. The surge in power demand has led to a corresponding increase in demand for copper. Copper prices have surged nearly a fifth in 2025 (Chart XVI.3), even as yields have fallen. Not just critical minerals and rare earths, but even basic metals will face supply constraints as demand surges and supply tightens due to both natural and nationalistic reasons.

1 International Energy Agency (IEA), Data centre electricity consumption by region, base case (2020–2030). https://tinyurl.com/4fc63kk5

Chart XVI.3: Copper prices reach historic highs amid surging demand



Source: Bloomberg[2]

16.13. Stating that the 20th century ran on oil and steel and that the 21st would run on 'compute' (short-hand for computing power or Graphic Processing Units (GPU)) and the minerals that feed it, America announced a Pax Silica Declaration[3] with a few like-minded countries, aimed at building the AI ecosystem of tomorrow, from energy and critical minerals to high-end manufacturing and models.

16.14. In the meantime, the United States passed the GENIUS Act (Guiding and Establishing National Innovation for U.S. Stablecoins Act) in July 2025, which would take effect from January 2027 or 120 days after the implementation regulations are issued, whichever is earlier.[4] Regulated private sector institutions can issue US dollar-backed stablecoins. Depending on its success, it carries the potential to disrupt capital flows to emerging and developing economies.

16.15. India has managed its external accounts prudently in the last decade. Foreign exchange reserves have risen, external debt remains manageable, and crisis episodes have been navigated without systemic collapse. These achievements reflect sound

2 Mark Burton and James Attwood. Bloomberg. 23 December 2025. https://tinyurl.com/375y6tv4

3 U.S. Department of State. Pax Silica Summit. December 11, 2025. https://www.state.gov/releases/2025/12/pax-silica-initiative/

4 United States House Committee on Financial Services. July 2025. Guiding and Establishing National Innovation for U.S. Stablecoins Act (GENIUS Act): Section-by-Section Summary. https://tinyurl.com/2x9az5bm

macroeconomic management. Yet the source of stability matters. Much of India's external financing has come through portfolio flows, debt inflows, and episodic surges of foreign investment. These flows are valuable, but they are conditional and reversible. They respond not only to domestic fundamentals, but to global liquidity cycles, risk sentiment, and geopolitical developments beyond India's control. Currencies backed primarily by capital inflows behave differently under stress than currencies backed by persistent export surpluses. In moments of global risk aversion, capital retrenches. Exchange rates adjust, sometimes abruptly. Central banks can help smooth volatility, but they cannot permanently offset structural imbalances through reserve accumulation or interest rate adjustments. This is the hard constraint confronting India's macroeconomic aspirations, and India has already felt its impact this year.

16.16. High market valuations and questions over the long-term trajectory of Indo-American relations, stemming from America's imposition of high tariffs on India and its establishment of warm relations with Pakistan, prompted portfolio investors to take profits and wait on the sidelines. While foreign direct investment inflows have improved, they have not been enough to offset the large portfolio outflows. Further, Indian companies have also been required to invest in other countries due to rising trade restrictions. One has to produce locally to be able to sell locally. With India running an overall trade deficit because the surplus in the services trade does not offset the deficit in the goods trade, and with remittances and net invisibles also insufficient, India relies on global capital flows to finance its imports. When that fails to materialise to the extent needed, the currency is vulnerable to depreciation.

Deepening uncertainties lie ahead

16.17. As 2025 drew to a close, China made a significant announcement regarding Hainan Island. The Hainan Free Trade Port (FTP) is China's bold experiment to open its economy more extensively than anywhere else on the mainland. Instead of being just a city or a small zone, the whole island province of Hainan has been turned into a special trade and business area with very relaxed rules on trade, customs, taxes, investment, and visas.

16.18. In simple terms, tariffs on most imports are removed, allowing goods from abroad to enter the island without customs duties. The island operates a special customs system separate from mainland China. Goods made in Hainan that add real value (e.g., with at least 30% local processing) can be sold throughout the rest of China without additional tariffs if they meet rules designed to encourage genuine production, rather than just re-export. Within the island, goods, people, capital and services flow freely with minimal friction. This officially began on December 18, 2025, when Hainan's full-island customs operations commenced, marking it as a functioning free trade port.

16.19. For India, Hainan's Free Trade Port is best understood not as a single disruptive shock but as a gradual structural development that subtly changes the economics of trade, logistics and investment in China's near neighbourhood. In practical terms, it creates a large, low-tariff, services-heavy economic space in the northern reaches of the Indian Ocean and the South China Sea, which could, over time, influence patterns of supply-chain routing, tourism flows, and corporate investment decisions in Asia.

16.20. The significance of this development, however, lies not only in the competition it creates for investment, but in the way it unfolds within a global setting that is becoming more unsettled, where decisions about production, capital and supply chains are increasingly entangled with a broader sense of fragility in the world economy.

16.21. As we write this chapter[5], despite the initial impression that the world economy has weathered the 2025 shocks better than feared, the situation remains fragile. The window for 'Business As Usual' (BAU) or 'muddling through' may be closing with respect to the economy, politics and financial markets. Chances of a moderate to significant disruption or a major rupture in world affairs exceed the chances of a 'BAU' scenario. As a country dependent on global capital flows, India has to plan for liquidity and external capital buffers in the coming year. Capital flight, including with the advent of U.S. stablecoins, is another risk to watch out for. India will remain better placed than most in its ability to maintain a decent growth rate, but its resilience will be tested as strategic vulnerabilities persist due to external dependence for capital, energy and other critical inputs, such as fertilisers.

16.22. Looking further ahead, India will have to be prepared for a prolonged period of geopolitical uncertainties and conflicts, as well as the consequent disruptions in developed societies. It is quite possible that the period between now and 2045 might resemble the interwar years of the twentieth century. Of course, numerous innovations occurred during the 1930s, amidst the Great Depression and the onset of war.[6] The war itself contributed to the growth of industrial capacity that later served the global economy well. But to survive such a turbulent period and to turn necessities into innovations requires not a defensive but a proactive or offensive policy framework. Indeed, the contours of a more uncertain and strategically contested world are already visible in the international economic environment confronting India today.

16.23. The global economic environment confronting India today is materially different from that of the previous phase of globalisation. Assumptions that shaped much of the post-Cold War period, such as open trade, predictable rules, stable capital flows, and relatively apolitical interdependence, hold less firmly today. Trade, technology, finance,

5 We were writing this on the 3rd January 2026 when the United States announced a successful regime change in Venezuela

6 See Morgan Housel: https://collabfund.com/blog/careful-what-you-wish-for/, April 2017.

and supply chains are increasingly shaped by strategic considerations. In this setting, outcomes depend not only on macroeconomic stability or factor accumulation, but on institutional and strategic capacity.

16.24. Institutional and strategic capabilities take time to build. They require patient institution-building, firms that compete rather than rely on shelter, and citizens who internalise rules rather than treat them as negotiable. Capability-building also involves trade-offs between speed and patience, protection and competition, and autonomy and integration that cannot be avoided but only managed.

16.25. This reflects a deeper change in how major manufacturing powers now view trade itself[7]. China, in particular, increasingly treats trade not as a reciprocal exchange between interdependent economies, but as a transitional phase in a longer strategy of production dominance, seeking to sell to the world while steadily reducing its own dependence on external suppliers. In such a setting, openness becomes asymmetric, where some countries remain exposed to external markets and inputs, while others retain the ability to restrict access with limited self-inflicted cost.

16.26. In a world where economic relationships are increasingly strategic and contested, the ability to learn selectively becomes a core element of statecraft. The epic *Ramayana* provides a valuable metaphor for strategic learning in complex and contested environments. In the *Yuddha Kāṇḍa*, the moment of *Ravana's* defeat becomes a lesson in discernment, as Lord *Rama* reflects that insight may be drawn even from adversaries, without inheriting their values or methods. The teaching is subtle yet powerful: learning is compatible with autonomy. In today's fragmented global economy, the capacity to learn without dependence becomes an essential strategic skill.

Swadeshi is inevitable and necessary

16.27. The strategic context has shifted in ways that materially alter the calculus of openness. Export controls, technology denial regimes, carbon border mechanisms, and industrial policy in the West and East alike signal the end of naïve globalisation. We operate in an environment where access to inputs, technologies, and markets cannot be assumed to be frictionless or permanent. In such circumstances, *Swadeshi* becomes a defensive as well as offensive policy lever: a means to ensure continuity of production in the face of external shocks, and a pathway to build enduring national capabilities that reinforce economic sovereignty. The policy question is no longer whether the state should encourage *Swadeshi*, but how it should do so without undermining efficiency, innovation, or global integration.

7 Robin Harding. Financial Times. 26 November 2025. China is making trade impossible. https://tinyurl.com/ykhfyhbn

16.28. Not all import substitution is desirable, and not all forms of protection support long-term competitiveness. The most persistent objection to *Swadeshi*-oriented policies is not ideological but empirical. India's own history, like that of many developing countries, offers ample examples where protection bred complacency, entrenched inefficiency, and insulated firms from global competition. *Swadeshi* is a disciplined strategy rather than a blanket doctrine.

16.29. Import substitution is justified when domestic production is already feasible at reasonable cost but is impeded by non-economic factors such as coordination failures or legacy regulatory burdens, when temporary and explicitly time-bound protection can facilitate learning, scale-building, and productivity gains, when the protected industry is subject to export discipline and measurable performance benchmarks, and when the good concerned is strategically critical even if cost disadvantages persist. These conditions differentiate intelligent import substitution (conditional protection) from indiscriminate sheltering of domestic incumbents.

16.30. The converse also holds: permanent protection is inappropriate in sectors where India is already cost-competitive, where exports are being undertaken at scale, where products serve as general-purpose intermediates across supply chains, or where inputs are critical for labour-intensive industries. In such cases, protection risks raising economy-wide costs, dampening competitiveness, and weakening export potential. Similarly, we must caution against protection that shields poor-quality producers, entrenches incumbency through inverted duty structures, or severs the link between support and innovation, learning, and global integration. The lesson is that protection without productivity-enhancing investment, capability upgrading, and export orientation creates fragility rather than strength.

16.31. A disciplined approach to indigenisation requires clarity on when intervention builds long-run capability and when it merely preserves inefficiency. A simple decision framework for indigenisation and protection in a fragmented global economy is presented below. The objective is not to justify intervention in general, but to discipline it. The framework proceeds by identifying where intervention may be warranted, clarifying where it should be avoided, and embedding discipline through sequencing, conditionality, and export exposure.

16.32. In practice, the application of this framework yields differentiated priorities. Some inputs are systemically critical and warrant early attention due to concentrated global supply or strategic exposure. Others are economically viable candidates for domestic capability building, where scale, learning, and export orientation can deliver competitiveness over time. A third category comprises goods for which import dependence does not translate into vulnerability, and where domestic substitution may raise costs without enhancing resilience. The tiered framework below formalises this differentiation (Chart XVI.4).

Tier I: Critical vulnerabilities with high strategic urgency

16.33. This tier includes goods, components, and technologies where denial of access would impose immediate and asymmetric national costs, and where global supply is highly concentrated. Typical examples include defence-critical systems, core infrastructure inputs, energy security components, public health essentials, and foundational industrial technologies.

16.34. For Tier I items, the objective is assured availability under stress, not short-term efficiency. Domestic production may be justified, even if it is initially costly. However, support must remain disciplined. The goal is to establish minimum assured domestic capacity within a defined timeframe, not permanent protection.

Tier II: Economically feasible capabilities with strategic payoffs

16.35. This tier comprises goods where domestic production is economically feasible at reasonable cost, but imports persist due to coordination failures, historical path dependence, early scale disadvantages, or entrenched procurement and contracting practices rather than genuine comparative disadvantage.

16.36. Indigenisation in this tier is primarily justified on economic grounds, with strategic benefits serving as a complement. The objective is not protection for its own sake, but rather accelerated capability formation through scale, learning by doing, and integration into global value chains. Temporary and targeted support can help firms overcome early barriers, but must be explicitly time-bound, performance-linked, and conditional on productivity improvement, cost convergence, and export readiness. In practice, this tier could include manufacturing activities characterised by modular production, scope for scale economies, and exposure to competitive export markets.

16.37. Without export exposure and credible exit, intervention in this tier may risk entrenching inefficiency rather than building capability.

Tier III: Low strategic urgency or high-cost substitution

16.38. This tier includes goods for which import dependence does not create systemic vulnerability, where global supply is diversified, or where domestic substitution would impose high economy-wide costs relative to the strategic benefits.

16.39. For these items, indigenisation may be unwarranted. Risk may be better managed through diversified sourcing, inventory buffers, or contractual safeguards rather than domestic production. Attempting to indigenise such inputs risks raising downstream costs, weakening export competitiveness, and converting resilience policy into implicit taxation of the manufacturing ecosystem. In such cases, restraint itself is a form of strategic discipline.

16.40. These tiers are not static. Items may move across tiers as technologies mature, costs decline, or geopolitical conditions change. What matters is that indigenisation proceeds sequentially rather than simultaneously, with policy effort concentrated where strategic returns are highest. Where feasible, indigenisation should culminate in export capability, which is the distinguishing feature of intelligent import substitution.

Chart XVI.4 From Import Substitution to Strategic Resilience: A Tiered Framework for Strategic Indigenisation

Indigenisation – High Urgency Sectors		
HIGH URGENCY Macro/Security exposure is significant	***HIGH FEASIBILITY Near-term capability build is realistic*** **TIER 1 (NON-NEGOTIABLE)** • ***Objective***: Rapid domestic scale-up • ***Policy stance***: Demand assurance, procurement alignment, standards, time-bound support • ***Products:*** Oils & pulses, Fertiliser inputs, APIs, Power electronics, Industrial chemicals, Telecom equipment	***LOW-MEDIUM FEASIBILITY Requires phased, long-horizon effort*** **TIER 1 (STRATEGIC CORE)** • ***Objective***: Vulnerability reduction, not full substitution • ***Policy stance***: Diversification, partnerships, selective reshoring, learning curves • ***Products***: Magnets, Battery cells & cathodes, Solar wafers & cells
Indigenisation — Developmental / Capability-Build Sectors		
LOW-MEDIUM URGENCY Exposure manageable; development goals dominate	***HIGH FEASIBILITY Near-term capability build is realistic*** **TIER 2 (SELECTIVE DEEPENING)** • ***Objective:*** Competitiveness upgrading • ***Policy stance:*** Gradual localisation, clusters, exports, firm learning • ***Products:*** Cranes, Industrial machinery, EV drivetrains, Medical devices (non-critical)	***LOW-MEDIUM FEASIBILITY Requires phased, long-horizon effort*** **TIER 2/3 (LONG-HORIZON CAPABILITY)** • ***Objective***: Ecosystem and talent formation • ***Policy*** : Co-engineering, test-beds, procurement-linked learning, no near-term localisation mandate • ***Products***: TBMS, Rail signalling, Defence electronics, Electrolysers

A new National Input Cost Reduction Strategy: competitiveness as infrastructure

16.41. For export discipline to work in India's favour, competitiveness must be achievable and affordable. Resilience strategies can fail if they raise costs across the economy. A repeated lesson from successful industrialisers is that protecting final goods while leaving input costs high makes it harder to scale production and compete internationally. Affordable and reliable inputs are foundational to competitiveness. For India, if indigenisation is to strengthen resilience without eroding exports, it must be paired with systematic input-cost reduction. This is the rationale for a National Input Cost Reduction Strategy.

16.42. Input costs of raw materials, intermediates, energy, logistics, and compliance shape competitiveness across sectors. Unlike final-goods protection, which benefits a narrow set of producers, elevated input costs impose diffuse and persistent penalties on downstream manufacturing, exports, and employment. Thin margins in export-oriented manufacturing, high sensitivity among MSMEs, and weaker incentives to invest in upgrading make this constraint binding. In this sense, input costs function like infrastructure, as they may raise transaction costs across the economy.

16.43. Tariff inversion illustrates the problem. Higher duties on intermediates than on finished goods penalise downstream producers and encourage assembly-oriented imports rather than deeper domestic value addition. This erodes competitiveness, discourages exports, and increases reliance on protection for final goods. Correcting such distortions is not a marginal trade adjustment, but a structural reform with economy-wide implications.

16.44. The core logic of an input-cost strategy is rule-based rather than sector-specific. Inputs widely used across sectors should not be treated as revenue sources or protection instruments once domestic capacity exists. Protecting such inputs may benefit a small number of producers, but it raises costs for many downstream users, weakening competitiveness and job creation. Lowering input costs strengthens multiple value chains simultaneously.

16.45. A structured, rule-based distortion audit can guide reform, avoiding ad hoc adjustments, by asking whether an input is widely used, whether domestic capacity exists, whether protection materially raises downstream costs, and whether continued support serves a strategic purpose or merely entrenched interests. Inputs imposing high economy-wide costs without clear justification become candidates for rationalisation.

16.46. Indigenisation and input-cost reduction can coexist when their scope is clear. Targeted support for critical components can coexist with competitive pressure on

general-purpose inputs once the capability exists. This prevents indigenisation from becoming across-the-board protection.

16.47. Such reforms are, of course, difficult because benefits are dispersed, while resistance is concentrated. Sustaining reform requires a clear articulation of economy-wide gains and rule-based processes that limit discretion and capture. Lower input costs enhance export competitiveness, facilitate global value chain integration, increase employment, and stimulate incentives to invest in upgrading. Treated strategically, they allow manufacturing and exports to reinforce each other, strengthening both resilience and external stability.

16.48. Reducing input costs is a necessary foundation for competitiveness, but it is not sufficient for capability building. Lower costs remove system-wide handicaps, but they do not by themselves create discipline, learning, or scale. Once the economy becomes cost-competitive, the binding constraint shifts from prices to performance, in the form of reliability, process control, quality, and coordination across institutions. It is at this stage that advanced manufacturing becomes decisive. Advanced manufacturing exposes weaknesses that sheltered activities can absorb for long periods. It tests infrastructure, logistics, regulation, skills, and enforcement simultaneously, and it does so under external benchmarks that cannot be negotiated away. In this sense, input-cost reduction prepares the ground, but advanced manufacturing is where capability is actually built and revealed.

Advanced manufacturing as a disciplining system: why manufacturing shapes institutions

16.49. Advanced manufacturing matters not only because it expands output and exports, but because it exposes weaknesses that sheltered activities can carry for a long time. When production is process-driven, scale-intensive, and benchmarked against global standards, small frictions compound into failures in cost, quality, and reliability. That is why advanced manufacturing becomes a stress test for the state and for firms. It forces predictable rules, reliable infrastructure, faster logistics, enforceable contracts, and institutional follow-through. Cost control, operational reliability, and continuous improvement become conditions for survival, not optional aspirations. Adjustment can be uncomfortable, but it is also transformative.

16.50. Unlike activities that can operate in enclaves, manufacturing is embedded in supply chains and factor markets. It depends on ports, power quality, transport reliability, standards and certification, dispute resolution, and predictable administration. When these are weak, the penalty is immediate and externally visible. In that sense, manufacturing does not merely benefit from state capacity; it also actively calls it forth by making governance failures costly to conceal.

16.51. In sheltered activities and protected sectors, firms can survive by substituting access for efficiency. Regulatory discretion, administrative mediation, or protection can sustain profitability even when productivity lags. However, in advanced manufacturing, survival depends entirely on execution, not negotiation, and that pressure reshapes firms, institutions, and incentives.

Learning, scale, and the discipline of competition

16.52. Manufacturing capability is accumulated, not declared. Early stages are often inefficient, and learning occurs through repeated process improvement, supplier development, and incremental upgrading. But learning becomes a capability only when paired with discipline. Support that is unconditional and permanent becomes shelter. Support that is time-bound and performance-linked can enable learning while still fostering competitiveness, especially through export exposure.

16.53. India's experience also highlights a contrast with services-led growth. Services exporters can often operate through specialised infrastructure, regulatory carve-outs, or organisational separation from domestic supply chains. As a result, services can thrive even when broader transaction costs remain high. Manufacturing, by contrast, engages multiple factor markets and public systems simultaneously. Weaknesses in logistics, standards enforcement, or coordination are quickly and visibly apparent.

Why East Asia Matters (and Why It Is Often Misread)

16.54. Any discussion of *Swadeshi*, import substitution, or industrial policy inevitably turns to East Asia. Japan, South Korea, Taiwan, Singapore, China, and, more recently, Vietnam are routinely cited as success stories. Yet the lessons drawn from these experiences are often superficial or selective. Some observers focus narrowly on protection, while others emphasise export orientation or macroeconomic stability. Both miss the deeper institutional logic that made these strategies work. The central lesson from East Asia is not that the state intervened, but how it intervened—and, equally importantly, how it exited. These economies did not succeed because they avoided mistakes; rather, they succeeded because their systems were designed to learn from mistakes and to reallocate resources when bets failed. This required a level of bureaucratic autonomy, political backing, and performance discipline that many countries found difficult to sustain.

16.55. For India, the relevance of East Asia lies in understanding the architecture of state capacity that underpinned its industrialisation. Without that architecture, similar-looking policies can produce radically different outcomes.

Box XVI.1: East Asia – Architecture of State Capacity

Japan: Bureaucratic Authority Anchored in Outcomes

Japan's post-war industrialisation is often associated with its powerful economic bureaucracy, particularly the Ministry of International Trade and Industry (MITI). What is less frequently appreciated is the incentive structure under which Japanese bureaucrats operated.

Officials enjoyed long tenures within ministries, deep sectoral specialisation, and significant discretion in policy design. Crucially, their careers were not derailed by individual project failures, provided those projects were aligned with national objectives and implemented in good faith. This reduced the fear of experimentation and encouraged calculated risk-taking.

At the same time, support to firms was never unconditional. Subsidies, credit access, and protection were tied to performance metrics, including export growth, technological upgrading, and scale. When firms failed to meet expectations, support was withdrawn, even if this entailed short-term disruption.

The Japanese model combined bureaucratic empowerment with accountability for outcomes, not processes. It also relied on dense information flows between the state and industry, allowing policymakers to update strategies based on real-world feedback rather than static plans.

South Korea: Failure Tolerance with Ruthless Exit

South Korea's experience offers perhaps the starkest illustration of disciplined industrial policy. The Korean state actively promoted national champions, provided directed credit, and protected domestic markets in the early stages. Yet this support came with explicit expectations and severe consequences for non-performance.

Bureaucrats frequently rotated between government and industry, ensuring a practical understanding of production constraints and global competition. Failure, when aligned with national goals, did not end careers. What was not tolerated was persistent underperformance.

The state withdrew support when firms failed to meet export targets or achieve technological upgrading. Several chaebol collapsed or were restructured under pressure from the state. The political economy of this system was harsh, but it prevented the accumulation of "zombie" firms living off protection.

For India, the Korean lesson is that discipline must be visible, predictable, and enforced, even when it is politically inconvenient.

Singapore: Speed, Regulatory Flexibility, and Credibility

Singapore represents a contrasting but complementary model. Lacking a large domestic market, it focused on becoming indispensable within global value chains through reliability, speed, and regulatory credibility.

Regulatory agencies were empowered to waive or adapt rules temporarily to facilitate investment and innovation. Speed of execution was valued over formal perfection.

Importantly, this flexibility was accompanied by strict enforcement once standards were set, preserving trust and predictability.

Singapore's experience highlights a dimension often neglected in Indian debates: regulatory friction is itself a competitiveness variable. Even well-designed industrial policies can fail if approvals, clearances, and dispute resolution are slow or uncertain.

Vietnam: Relentless Cost Reduction and Institutional Learning

Vietnam's recent manufacturing success underscores the importance of continuous cost reduction and institutional adaptation. Rather than relying heavily on protection, Vietnam focused on reducing regulatory and transaction costs, reportedly by as much as 20 per cent in certain periods.

This approach made Vietnam an attractive destination for global supply chains seeking diversification. While its domestic technological base remains limited, its integration into global manufacturing networks has accelerated learning and capability formation.

The lesson here is not that protection is unnecessary, but that competitiveness is multi-dimensional. Cost structures, regulatory efficiency, and labour productivity matter as much as tariff policy.

The Common Thread: The Entrepreneurial State

16.56. Despite their differences, East Asian experiences share a common institutional logic, i.e., the presence of an entrepreneurial state. This does not mean a state that replaces markets, but one that is willing to experiment, take calculated risks, absorb failures, and dynamically reallocate support. This approach becomes especially critical in an environment where policy is made under uncertainty, outcomes cannot be known in advance, and mistakes cannot always be reversed without cost.

16.57. Three features stand out:

i. Outcome-oriented bureaucracy: Officials are evaluated on results, not rule-following.
ii. Failure tolerance with learning: Errors are acceptable; stagnation is not.
iii. Credible withdrawal of support: Exit is as important as entry.

16.58. These features are conspicuously absent in systems where industrial policy has failed. Where bureaucracy is punished for honest failure, risk aversion dominates. Where support cannot be withdrawn, inefficiency is entrenched. In such systems, institutions respond to uncertainty not by learning and adapting, but by avoiding action altogether, weakening state capacity over time.

16.59. The East Asian experience does not offer a ready-made template for India. But it does offer a clear message that industrial policy has a far better chance of success with institutional reform.

From *Swadeshi* to Strategic Resilience to Strategic Indispensability

16.60. India's policy challenge does not stop with institutional reform for achieving import substitution or *Swadeshi*, or domestic industrial policy, and doing it intelligently

in terms of making the industry meet world standards. India also needs to build domestic capacity in areas that would make it strategically resilient. Strategic resilience is about building buffers and strengths to withstand external shocks. It means investment in national strength. Intelligent Import Substitution is the first step in investing in national strength. 'Investment in national strength' takes us to the next stage of 'strategic resilience' and then to the final stage of 'strategic indispensability.' Table XVI.1 formalises this distinction by placing import substitution, strategic resilience, and strategic indispensability side by side in terms of their core purpose.

Table XVI.1: Proposed Conceptual Definitions

Concept	Definition	Core Objective
Import Substitution	An economic strategy that promotes domestic production of goods that were previously imported.	To reduce import dependence by producing domestically what was earlier imported.
Strategic Resilience	A broader capability of an economy or system to withstand external shocks, including geopolitical, economic, technological, or environmental, and continue functioning.	To ensure continuity, adaptability, and security of critical supply chains and capacities under stress.
Strategic Indispensability	Integration of the economy with global systems in a way that makes an economy fundamentally important to the global system and gets others interested and invested in its continued functioning.	To take on global leadership and enable leverage in geopolitical negotiations and conflicts

16.61. Table XVI.2 highlights how this transition alters the economic focus, time horizon, and geographic logic of policy. Table XVI.3 complements this by summarising how underlying assumptions, policy instruments, and risk orientation evolve across these stages.

Table XVI.2. From Import Substitution to Strategic Indispensability: A Comparative Perspective

Dimension	Import Substitution	Strategic Resilience	Strategic Indispensability
Economic Focus	Mainly sectoral (manufacturing, consumer goods, intermediate goods).	Systemic (spans energy, food, data, health, defence, infrastructure, and technology).	Global-embedding national industries and technologies as indispensable nodes in global networks.

Dimension	Import Substitution	Strategic Resilience	Strategic Indispensability
Time Horizon	Short-to-medium term industrial policy tool.	Medium-to-long term national capability framework.	Long-term structural positioning in global value chains and institutions.
Geographic Logic	**Produce at home:** focus on domestic value addition.	**Diversify and secure:** mix of domestic, allied, and friendly sources.	**Shape and anchor:** build and control critical global interdependencies.

Table XVI.3. Policy Logic and Risk Orientation across Import Substitution, Strategic Resilience and Strategic Indispensability

	Import Substitution	Strategic Resilience	Strategic Indispensability
Underlying Assumption	Domestic capacity can replace imports effectively.	Global interdependence will persist; risk management through redundancy and diversification is essential.	Global interdependence can be shaped; national power lies in being a node that others cannot bypass.
Policy Tools	Tariffs, local content mandates, subsidies, protective measures.	Supply chain mapping, redundancy planning, friend-shoring, stockpiling, dual sourcing, R&D security.	Building horizontal and ecosystem efficiencies to enhance competitiveness, aim for global dominance
Risk Focus	Trade deficit, industrial underdevelopment.	Systemic vulnerabilities, including energy shocks, pandemics, cyberattacks, and geopolitical coercion.	Global influence or relevance, over-exposure to external rule-making or technology ecosystems

16.62. India's challenge is that the three stages of Aatmanirbharta that will bring us closer to the goal of *Viksit Bharat* are telescoped into each other due to the rapidity of the flux the world is experiencing. A famous quote, "*There are decades where nothing happens; and there are weeks where decades happen*," is attributed to Vladimir Ilyich Lenin. We are in a period where decades seem to happen in weeks. Interestingly, Russia is playing an instrumental role in the current episode.

16.63. Therefore, India must pursue its near, medium and long-term policy priorities of import substitution, strategic resilience, and strategic indispensability simultaneously. There is no time to waste. It is like running a marathon and a sprint at the same time, or having to run a marathon like a sprint!

16.64. *Aatmanirbhar Bharat* is often discussed as a defensive response to supply chain disruptions, geopolitical tensions, or economic coercion. While resilience is a necessary objective, it is not a sufficient one in itself. A nation that merely absorbs shocks remains reactive. A nation that shapes outcomes becomes influential. This is a higher bar than self-sufficiency and a more demanding aspiration than resilience.

This distinction between resilience and influence is also reflected in external comparative assessments of economic power in Asia, discussed in Box XVI.2.

Box XVI.2: From Resilience to Influence - India's Power Gap in Asia

Recent external assessments reinforce the distinction between resilience and influence. The Lowy Institute's Asia Power Index (2025)[8] provides a useful lens in this regard.

The Index distinguishes between resources (what countries possess) and influence (how effectively those resources are translated into regional outcomes). It also introduces the concept of a Power Gap, which measures the divergence between a country's expected influence based on its resources and its realised influence.

India's profile in the Index is instructive. India has now reached major power status in Asia, and its overall power continues to grow steadily. For the first time since the Index was launched in 2018, India's ranking on economic relationships has improved. Notably, India has overtaken China as the leading destination for inward investment in Asia, after the United States, measured on a ten-year cumulative basis. This reflects both the geopolitical diversification of supply chains and India's growing attractiveness as an investment destination.

At the same time, the Index highlights persistent gaps. India ranks 3rd in overall power, but 10th in economic relationships, and records a negative Power Gap (–4.0), indicating that India is not yet translating its resources into external economic influence.

The picture that emerges is mixed but revealing. India has demonstrated strong resilience and absorptive capacity in the face of global shocks. The next phase of its development challenge is different: to move from being primarily a recipient of stability to becoming a source of stability and opportunity for others.

This transition from resilience to interdependence is central to India's journey towards *Viksit Bharat*. It underscores that competitiveness, export capability, and deep integration into regional and global production networks are essential instruments of influence in a fragmented world.

16.65. The highest form of economic power is influence exercised without coercion, when others align with our interests because it is in their interest to do so. Strategic indispensability delivers precisely this form of power. With strategic indispensability comes global influence. When global firms rely on Indian production, when supply

8 Lowy Institute. Asia Power Index. 2025 Edition. https://power.lowyinstitute.org/power-gap/

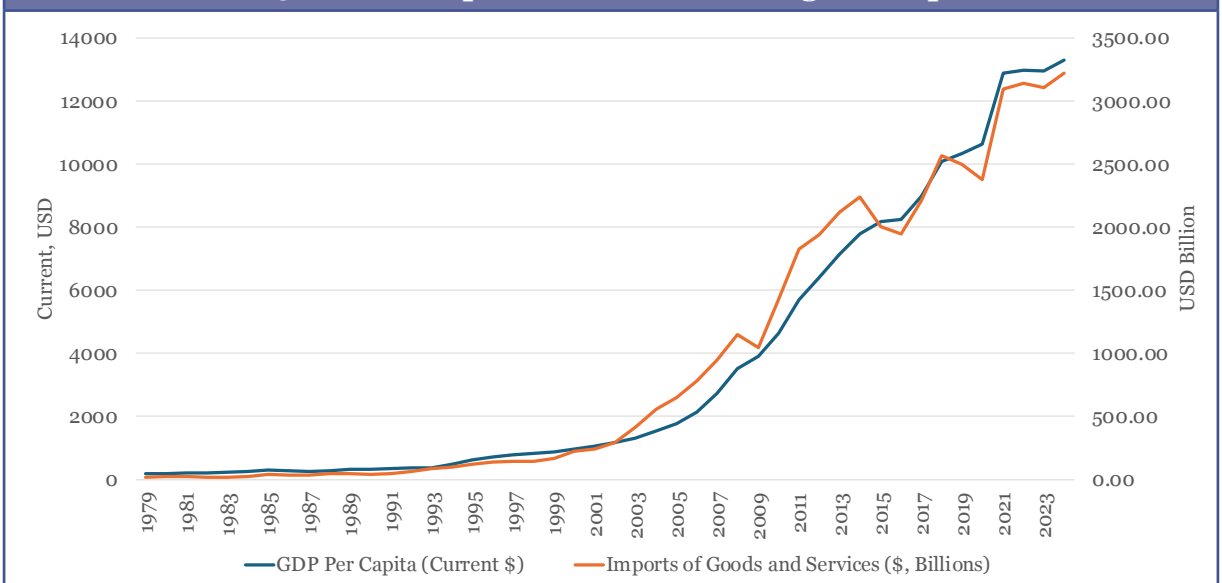
chains cannot be easily reconfigured without India, and when Indian exports are trusted by default, the country's voice carries weight beyond its borders. This is the promise of *Aatmanirbhar Bharat* grounded in strategy.

16.66. In simple terms, when the world moves from 'thinking about buying Indian' to 'buying Indian without thinking', India will have attained strategic indispensability. The Prime Minister threw down the gauntlet to the industry in his address to the nation on Independence Day, when he said that *Swadeshi* meant producing goods of the highest quality at the lowest possible price, so that people would be automatically drawn to buying Indian.

Manufacturing, Export capability, and currency strength

16.67. *Swadeshi* must not be judged solely by import reduction, but by the creation of export capability. Creating capability is both urgent and important in a world where capital flows are increasingly shaped by shifting geopolitical alignments and national interests rather than neutral market forces. As India's economy grows, its imports are expected to rise. This is evidenced in the history of economic development over the last two centuries, and is therefore not a policy failure. In reality, import growth is inevitable and even desirable as incomes rise and economies diversify. Chart XVI.5 illustrates this pattern by showing that China's imports rose as its per-capita income increased, even as China became a top global producer of goods ranging from steel and cement to fertilisers, cars, and drones.

Chart XVI.5 China's Import Growth and Rising Per-Capita Income



Source: World Bank Data

16.68. In India's case, such inevitable import growth also brings currency vulnerability into sharper focus. As a rising economic power, it is reasonable for India to aspire to

a strong and stable currency. Currency strength is often associated with advanced economies. However, the notion of a "hard currency" is frequently misunderstood as being driven only by monetary orthodoxy or central bank credibility. While these are necessary conditions, they are not sufficient.

16.69. The exchange rate is best understood as a signal rather than a policy objective. It reflects a combination of trade balances, capital flows, risk perceptions, and geopolitics. Hard-currency behaviour emerges when markets believe that a country can earn foreign exchange reliably through trade, that external liabilities are matched by productive external assets, that the economy can withstand shocks without emergency financing, and that currency depreciation is not the primary adjustment mechanism.

16.70. Historically, currencies that exhibit such behaviour, including those of Germany, Japan, Switzerland, and later East Asian industrialisers, have rested on their export capabilities rather than dependence on capital inflows. Monetary discipline reinforced this foundation; it did not create it. Capital inflows can support growth, but they are reversible. Export earnings, by contrast, are earned repeatedly through competitiveness rather than confidence alone. India's currency, by contrast, remains structurally soft. This is not a failure of policy, but a reflection of underlying trade dynamics. As long as economic growth mechanically widens the trade deficit, the exchange rate must continue to act as a buffer against external pressure.

16.71. Currency depreciation will therefore remain the primary adjustment mechanism unless export capabilities are developed rapidly. The export capability envisaged here primarily refers to manufacturing exports, not service exports, in which India has achieved remarkable success. India's performance in IT, business services, and professional services has been extraordinary. These exports have generated foreign exchange, supported growth, and deepened global integration. However, services exports face intrinsic limitations. They are less employment-intensive at scale, generate fewer backward linkages, rely heavily on open digital regimes, and do not anchor physical supply chains. They are necessary, but insufficient to counterbalance the import intensity of industrialisation. Manufacturing exports, by contrast, create supplier ecosystems, absorb large workforces, and generate durable trade surpluses when scaled. They remain the only proven route through which late-industrialising economies have achieved lasting external strength.

Route to Strategic Indispensability runs through Global Value Chains

16.72. Manufacturing export capability does not emerge overnight. Its foundations are scale, reliability, and integration built over time through disciplined capability building. Integration refers to embedding Indian firms into global value chains as well as embedding global production systems within India.

16.73. Global trade is increasingly concentrated around a relatively small set of multinational production networks. This reinforces the importance of attracting such firms to India, not merely as sources of capital, but as anchors of export capability and currency strength.

16.74. Foreign Direct Investment is not a homogeneous category. The identity of investors matters as much as the volume of investment. A small number of global brands, particularly in electronics, machinery, apparel, automotive, and consumer goods, account for a disproportionate share of world trade.

16.75. Evidence from global trade data suggests that nearly half of the developed world's imports from China originate from the supply chains of roughly fifty multinational brands. These firms do not merely assemble products. They orchestrate ecosystems comprising supplier networks, logistics platforms, quality systems, and continuous design feedback loops that shape entire industries.

16.76. For India, attracting such firms is not about prestige. It is about accelerating ecosystem formation. When a global brand commits at scale, suppliers follow, skills deepen, standards rise, and exports become endogenous rather than policy-driven. This represents the fastest route from *Swadeshi* as capability-building to *Swadeshi* as strategic indispensability.

The Role of the State

16.77. The state's role in this vision is demanding. It must be firm in enforcing discipline, flexible in adapting rules, and fair in allocating support. Firmness ensures that protection does not become entitlement. Flexibility allows policy to respond to feedback rather than assumptions. Fairness preserves legitimacy and prevents capture. Balancing these attributes is difficult, but not optional. States that fail on any one dimension either stifle initiative, entrench inefficiency, or provoke backlash.

16.78. India's diversity and federal structure are often cited as constraints on its development. In reality, they can be sources of strength. Different states possess different endowments, geographic, demographic, and institutional, and can specialise accordingly. A national *Swadeshi* strategy should enable competition among states, reward outcomes, and disseminate best practices. The government's task is to set direction, remove frictions, and provide credibility.

16.79. The journey from resilience to indispensability can be but need not be long. It requires patience, discipline, and institutional courage. But it is neither unprecedented nor unattainable. India has the scale, the talent, and the democratic legitimacy to attempt it. What remains is alignment between intent and execution, between policy

and institutions, between short-term pressures and long-term goals. If that alignment is achieved, *Aatmanirbhar Bharat* will be remembered as a doctrine of confident integration in a fractured world. To achieve the right alignment, we must reimagine the state. That is what we turn to in Part II of the Chapter.

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