Hard Years Ahead for India’s Ambitious New Prime Minister

Niranjan Rajadhyaksha

Narendra Modi has inherited a country in an economic mess and has limited policy options to deal with them. Clearly defined, though, are the most pressing issues.

Salil Tripathi

On the campaign trail, Modi stuck to domestic issues. As leader, he must now confront foreign policy issues, including terrorism and frictions with India’s near neighbors.
From Landslide to a Hard Climb: India’s New Leader Now Faces Dire Economic Challenges

By Niranjan Rajadhyaksha

Supporters of Narendra Modi, India’s new prime minister, were overjoyed when his Bharatiya Janata Party and its allies triumphed over the ruling Congress Party in the May elections. Capturing the soaring expectations of India’s massive electorate, Modi tweeted: ‘Good days are coming.’

While that may be the case, those days won’t arrive without a lot of hard choices. As Niranjan Rajadhyaksha writes, India’s economy is saddled with daunting problems and limited policy options, a mix that will sorely test Modi’s leadership skills.

MAKE NO MISTAKE: Narendra Modi has inherited an economic mess. The new Indian prime minister was given a stark reminder of the uphill task he faces when the latest official data released in May showed that the economy continued to be sluggish even as inflation remains out of control.

India has been trapped in a mild version of stagflation, with growth trending down and inflation trending up over the past five years.

The memories of the unprecedented boom in the four years leading up to the global financial crisis are fast receding from public memory. The hubristic talk about India becoming the next global economic superpower has thankfully been consumed by a subsequent bonfire of vanities. The wave of popularity that carried Modi to victory has led to an atmosphere of renewed optimism that is not in sync with the harsh economic realities.

Here are the plain facts. The Indian economy grew at 4.7 percent in the fiscal year ended March 2013. This is the first time since the late 1980s that the Indian economy has grown at less than 5 percent for two years in a row. Economic growth is now around four percentage points lower than its peak just before the global financial crisis. The industrial sector has been hit particularly hard. The index of factory output has barely budged over the past three years. The deteriorating financials of Indian companies as well as a logjam of projects have created a growing pile of bad debts in Indian banks. Around a tenth of their total lending portfolio is under stress. A slowing economy usually means that inflation starts falling. India has had no such luck.

The economic slowdown has paradoxically been accompanied by persistently high inflation. Consumer price inflation is around 2.5 percentage points higher than it was in 2007. India has one of the highest inflation rates among the major economies of the world. A large current account deficit that has only recently been brought under control was another sign of large economic imbalances despite the overall loss in growth momentum.

There are no quick fixes available, since India is currently battling a structural slowdown rather than a mere cyclical downturn. An economic turnaround is important not just for the financial markets but also for social stability. India adds around 10 million people to its workforce every year. It needs rapid economic growth to create jobs for these new workers. Modi ran a disciplined election campaign that attacked the incumbent Congress Party government for its economic failures while promising India’s 815 million voters that he would do a better job of meeting their rising aspirations. He will now have to work hard to meet those promises.

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A BOW WITH FEW ARROWS

 Modo has often been compared to Japanese Prime Minister Shinzo Abe in the Indian financial media. A comparison with what has come to be called “Abenomics” is a useful way to highlight the stiff problems that Modi now faces. Abe believes that he needs to fire three arrows to get the Japanese economy moving again: fiscal stimulus, monetary easing and structural reforms. Modi has fewer options because he has inherited a depleted quiver. Consider:

 Fiscal stimulus is risky right now. The fiscal deficit of the central government in New Delhi is now 4.6 percent of gross domestic product (GDP). The combined deficit at all levels of government is 7.3 percent of GDP, or around three times the emerging markets average, according to data from the International Monetary Fund (IMF). Global credit rating agencies have repeatedly warned that India faces the threat of a sovereign downgrade unless it puts its public finances back in order. India has paradoxically been able to reduce its public debt burden despite fiscal profligacy mainly because the government has inflated away the value of its existing debt.

 Monetary easing is not on the cards either. Annual inflation has been running at close to 10 percent over the past three years. Negative interest rates on bank deposits have meant that Indians have pulled money out of the financial sector to buy physical assets such as gold and real estate. The Reserve Bank of India, the country’s central bank, recently committed itself to bringing down inflation to a more tolerable 8 percent by January 2015 and 6 percent by January 2016. The Indian central bank has increased its key repurchase rate by 75 basis points since September 2013.

 Several structural economic reforms are overdue, but they will need complicated political bargaining. The next round of reforms requires the co-operation of regional governments because of the way policy responsibilities are assigned between different levels of government in the Indian federal constitution. For example, a new national tax that is to replace myriad local duties has been held up because regional governments fear a loss of fiscal autonomy. Important factor markets such as land and labor need
to be reformed to promote new investment, but these also require support of regional governments. Modi has said that he will treat the powerful state chief ministers as his extended cabinet to get things moving again.

The upshot: India does not have much room to stimulate demand given its high inflation and fiscal stress. It is anyway not facing a cyclical downturn that can be met with higher public spending or lower interest rates. Here are two indicators to show that there are deeper structural issues that Modi will need to deal with. First, the Reserve Bank of India now says that India’s potential growth rate, or the rate at which it can grow without generating high inflation, is now close to 6 percent, or around 2.5 percentage points below its pre-crisis peak. Second, India has fallen 12 places since 2008, to No. 60, in the annual global competitiveness league tables published by the World Economic Forum.

India finds itself in this trap because of a series of policy mistakes since 2009. The second Manmohan Singh government responded to the global financial crisis of 2008 with a large monetary stimulus followed by a hefty fiscal spurge. This was part of the co-ordinated global policy response that the leaders of the Group of 20 (G-20) nations had agreed upon in the first half of 2009. The stimulus worked initially. The economy bounced back, though inflation also began to accelerate.

The exit from the stimulus program came too late. The Indian government failed to withdraw its fiscal stimulus despite commitments made in parliament to put public finances in order. The Reserve Bank of India also did not respond to rising inflation on time; it stayed behind the curve as policy rates peaked in October 2011, nearly 18 months after the peak in wholesale price inflation (which was the Indian central bank’s preferred inflation tracking measure, until it recently switched to consumer price inflation).

The persistent demand stimulus was accompanied by growing problems on the supply side. A series of corruption scandals over the allocation of telecom spectrums and coal mines to private-sector companies led to the arrest of prominent business executives. Hundreds of projects got tangled in red tape thanks to messy land acquisition and environmental clearance procedures. A bizarre decision to introduce a rule that allows the government to tax companies with retrospective effect upset foreign investors. Business confidence plummeted—and private-sector investment with it. A working paper by IMF economists Rahul Anand and Volodymyr Tulin estimated that policy uncertainty and deteriorating business confidence explains much of the sharp investment slowdown in India.

The macroeconomic policy mix since 2011 fed demand while restricting new supplies. Some of the excess demand spilled over into the external account. India ended up with a record current account deficit that was being funded by volatile capital flows. The emerging markets panic after the first hints in May 2013 that the US Federal Reserve would begin to trim its monthly bond purchases saw fears that India would not find enough global capital to fund its external gap. There was a run on the rupee in July and August. India found itself clubbed with other emerging economies with unsustainable current account deficits. These were what the financial markets called the fragile five—India, Indonesia, Turkey, South Africa and Brazil.

India has done well to get its current account deficit under control since then, partly because of higher taxes on gold imports. The rupee has been stable despite the fact that the US is now well on its way to ending quantitative easing by the end of the year. India now looks far less fragile than it was a year ago, but its growth indicators still paint a sorry picture.

Modi and his finance minister, Arun Jaitley, have a complicated challenge ahead. Here are some policy options that are dominating public discussions in India:

**The most immediate task is to get inflation under control.** Reserve Bank of India Governor Raghuram Rajan has said on several occasions that there is no trade-off between growth and inflation right now: the sacrifice ratio is essentially zero at the current level of...
inflation, which means that reducing inflation will not harm growth. The government and the central bank need to work together to quell excess demand. Food inflation has been a particularly sticky problem. Agricultural economist Ashok Gulati has suggested that the new government should reduce its food mountain by selling between about 15 million and 20 million metric tons of food stocks in the open market in order to reduce the price of cereals such as wheat and rice.

2 Reviving the investment cycle is the key to getting economic growth back on track over the medium term. The economic boom between 2004 and 2008 was based on a splendid increase in private sector investment activity. Lower interest rates will undoubtedly help spur capital formation once inflation is under control, but there are several policy measures that can help in the coming months. Hundreds of large projects are stuck in policy tangles. For example, there are power plants that have been built but cannot operate because they do not have access to fuel such as coal or natural gas. The Modi government has already begun to sort out some of these issues. The broader challenge is to ensure policy stability so that investors face lower regulatory risks when putting money into new projects.

3 Public finances have to be put in order. High fiscal deficits have been inflationary, have led to external vulnerability and have crowded out private investment. India had a national law that restricted fiscal deficits. This law was abandoned to allow the 2009 stimulus package after the global financial crisis. The new government needs to not only chart out a credible plan to bring the fiscal deficit to less than 3 percent of GDP over the next two years, but also move toward getting parliament to approve a new fiscal law that restricts deficits. Meanwhile, there is a strong case for the government to begin shuffling its spending pattern away from current expenditures such as subsidies to asset creation.

4 India must build capacities over the long term to deal with important structural constraints to its continued growth. These include, for example, physical infrastructure, a growing labor force in need of skills, food supply, energy security and environmental sustainability. None of these challenges can be met with quick fixes. Long-term strategic thinking is needed on these questions followed by solutions. Modi is expected to ease some of the immediate constraints on growth through administrative action. He has also indicated that his government will be more serious about economic reforms than its predecessor was, which is all the more strange because Manmohan Singh is an economist who as finance minister first introduced the radical economic reforms of 1991 that set India on the path of faster growth.

It is too early to write India off. Its average annual growth in recent decades has been in excess of 6.5 percent, and there is little reason to believe that it cannot — at the very least — reclaim such momentum. It continues to have a high savings rate, a growing labor force, innovative companies and a democratic political system that has begun to punish economic failure. The two Manmohan Singh governments that ruled India after 2004 behaved as if rapid economic growth could continue without policy reforms; and temporary downturns could be reversed with stimulus packages. The harsh experience of the past three years has been an eye opener for Indian policy-makers. Modi will need to focus on fiscal discipline, higher investment and structural reforms that can build the base for the next round of sustainable economic growth.

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