With Growth Up and Inflation Down, India May Be Turning a Corner

By Niranjan Rajadhyaksha

September 2013 was a dark time for the Indian economy. The rupee plunged on fears about the US ending quantitative easing. A scandal-plagued government was presiding over a financial mess and banks and private companies were mired in debt. But with the new government of Narendranpa Modi in place, things are looking up, with inflation easing and confidence returning. It is too early to declare victory, writes Niranjan Rajadhyaksha, but optimism has replaced panic.

AFTER BEN BERNANKE first hinted in May 2013 that the United States would soon scale down monetary expansion, India was a sitting duck. The US Fed’s quantitative easing was finally ending, and the rupee fell like a stone in the emerging markets panic that followed. The Indian currency touched a record low against the dollar by the end of September 2013. There were even fears that the country would see a repeat of 1991, when an economic crisis brought India within weeks of a loan default to international creditors.

The rupee rout in those months was fully deserved. Economic imbalances had been allowed to build up by a Manmohan Singh government that was mired in corruption scandals. Inflation was almost in double digits. Public finances were a mess. The record current account deficit was barely being funded by inflows of volatile global capital. It was no surprise that India found itself among what came to be known in global financial markets as the “fragile five” economies. Keeping it company in this brittle club were such paragons of economic virtue as Turkey, South Africa, Brazil and Indonesia.

By now, the memories of those dark weeks have begun to fade. A lot has changed in India since then and for the better (see charts opposite).

- Exhibit One: Inflation is down by more than five percentage points since November 2013.
- Exhibit Two: India seems to be in the early stages of a cyclical recovery.
- Exhibit Three: The current account deficit has come down since the first quarter of 2013.
- Exhibit Four: The public finance mess is being reduced, with lower fiscal deficits.

The financial markets have already taken notice. The major Indian equity market indices have gone up by more than a third since the beginning of 2014 on hopes that a cyclical economic recovery is taking root. Bond yields have come down by around 90 basis points because of retreating inflation. The rupee has been stable despite a global dollar rally that has pushed down several other currencies. The movement in financial prices is a useful indication that the Indian economy is limping back to normal.

TRANSITION TIME
India is perhaps moving toward a sweet spot. The general tenor of research reports by the major investment banks reflects such optimism. Goldman Sachs has said that 2014 will have been a transition year for India. The scare of 2013 is behind it, and stronger economic growth lies ahead. Investment bank Nomura says that India is at a Goldilocks moment; growth is picking up while inflation is coming down. The International Monetary Fund’s October edition of the World Economic Outlook forecasts that the Indian economy will begin to grow faster than the Chinese economy after 2018.

Four factors have worked in India’s favor over the past few quarters.

First, Reserve Bank of India head Raghuram Rajan has made inflation control his main concern ever since he took charge of the central bank in September 2013. Some commentators have compared him to Paul Volcker for his focus on slaying the inflation dragon, though Rajan

The Chart 1 India: Heading Towards a Sweet Spot

Sources: Bloomberg, Reserve Bank of India, IMF
Ahya of Morgan Stanley says that net commodity prices have risen from 1.9 percent to around 12 percent of Indian gross domestic product since fiscal year 2002. Softer commodity prices will help India improve its terms of trade. The impact from lower crude oil prices is particularly significant. Economists at Nomura have estimated that a $10 decline in the global price of a barrel of crude oil helps the Indian economy in several ways: it adds 10 basis point to economic growth, reduces consumer price inflation by 20 basis point, reduces the current account deficit by 50 basis points and leads to a 10 basis point improvement in the fiscal deficit as a percentage of gross domestic product.

Indian policy-makers often make explicit assumptions about global oil prices when they design economic policy. The July budget presented by Finance Minister Arun Jaitley had assumed that global oil prices would be at around $110 a barrel. The baseline inflation forecasts released by the Indian central bank in September were made under the assumption that oil prices would be around $100 a barrel. What has happened since then has been an unexpected gift.

A serious attempt to reduce the economic imbalances that had led to the run on the rupee, a tighter monetary policy by the Indian central bank, the election of a new government with reformist intent and benign commodity prices have all helped India step back from the economic brink in recent quarters. But a lot more needs to be done if the recent gains are not to be frittered away.

The first big issue to watch for is whether the Indian central bank will begin to reduce interest rates in 2015. The second big issue is whether the Modi government indeed pushes ahead with the sort of structural economic reforms that are needed to ensure that the current recovery does not dissipate into thin air. There is a lot on the agenda.

The second big issue is whether the Modi government indeed pushes ahead with the sort of structural economic reforms that are needed to ensure that the current recovery does not dissipate into thin air. There is a lot on the agenda. A national new tax to replace the confusing mess of local taxes has to be cleared by both the federal parliament and the state governments. Labor market regulations have to be simplified so that employers are keener to hire new workers at a time when India needs to create around ten million new jobs a year to absorb its growing working force. A law governing acquisition of land for new industrial projects has to make it easier for companies to buy land while protecting the interests of poor farmers. A new monetary framework that guarantees the Reserve Bank of India operational freedom is in the works while a new fiscal law that restricts government deficits is needed to replace an older one that was dumped after the 2008 crisis. A lot of these pending reforms need careful political deal-making rather than the flourish of an executive order.

What has happened in India over the past 18 months and looks set to happen in the near future can be understood as a movement in three acts. The first act was the stabilization of the economy after the scare it got in the middle of 2013. The second act has been the administrative actions taken by the Modi government in the past six months to get things moving again. The third act will be the important economic reforms that have to be pushed through if India is to have an economy that is dynamic enough to meet the aspirations of its 1.2 billion citizens. The Indian economy is gradually improving, but it still needs to bring down inflation even more, improve its public finances and get private sector investment going. And the key to a sustained economic recovery is a new burst of economic reforms.

This is a time for cautious optimism, rather than either panic or hubris.