Pathfinder Economic Alert

Is India on the verge of a 1991- style crisis?

Imminent crisis?

Some commentators have raised the prospect of India facing a repeat of the balance of payments crisis that shook the country in 1991. Fears have been expressed that after years of 8% - 9% expansion, growth could fall to as low as 3% - it was 4.4% in 2Q 2013. The Indian Rupee depreciated about 18% and there has been an outflow of portfolio capital from stock markets. However, Prime Minister Manmohan Singh, who piloted the reforms of 1991 that placed the economy on a higher growth trajectory, has dismissed fears of a balance of payments crisis.

The budget deficit has risen to 5% of GDP last year (China and Brazil had deficits below 2% of GDP). The current account deficit of the balance of payments has increased to 4.8% of GDP. Despite this, it is very unlikely that India will face a balance of payments crisis similar to that in 1991. India's external debt is only 28% of GDP and external reserves amount to about $275 billion. The downside risks are associated with the possible impact of the US Federal Reserve's tapering policy on global financial markets. The mere talk of a possible reduction of the Fed's QE3 program (liquidity infusion of USD 85 billion per month) has resulted in a market over-reaction which has led to a reversal of capital flows away from emerging markets. Countries with weak macroeconomic fundamentals, including India, have been particularly vulnerable. However, in recent days there has been some correction of the overshooting of the currency depreciation and share market declines, with both the Indian Rupee and the share indices firming up. There is a risk of further disruption when the Fed actually commences its tapering program – some commentators believe it could be as early as this month. The speed with which the Fed undertakes the tapering and the extent of the decline in bond yield differentials will be major determinants of the size of this risk.

Given India's dependence on oil imports from the Middle East, the current uncertainties in that region also pose a downside risk. Despite this, the balance of probability is that India will avoid a crisis. In this short run, its economy will receive a boost from a good Monsoon and exports will benefit from the combination of a depreciated currency and the synchronized upturn in the US, China and Japan, as well as the bottoming-out of the recession in Europe. However, the stalled growth and persistently high inflation cannot be overcome without fiscal consolidation and structural reforms.

The Stalling of Reforms

The Indian authorities have claimed that the country's problems are largely due to external developments. Foreign exchange markets have been accused of overreacting. While the imminent tapering of the Fed's liquidity measures is a factor, the major causes of India's current malaise can be attributed to the stalling of economic reforms. Confidence has also been eroded by what are seen as populist entitlement schemes. The decline in growth resulting from a lack of reforms leads to a reduction in government revenue which, in turn, makes these programs even more difficult to afford.

The high fiscal deficits between 2008 and 2011 have fuelled excess demand. This has stoked inflation and exerted pressure on the balance of payments. This has meant that interest rates have had to be maintained at high levels thereby squeezing growth. This has served to reinforce the negative impact on growth of the stalled structural reforms. The reforms of agriculture and supply chains have been neglected and subsidies have been pumped into rural areas. Consequently, food prices have risen sharply. The manufacturing base has not been strengthened, with industry continuing to be depressed by red tape and graft. New legislation has also made the process of land acquisition and compensation more complicated thereby disincentivizing investment.

The inertia of the government has exerted additional pressure on the Reserve Bank of India (RBI) to balance the twin objectives of growth and stability of prices/balance of payments. This task has been rendered more difficult by the dual nature of the performance of the Indian economy. Rural areas and informal sector firms are doing relatively well. Consumer Price Inflation, which has a heavy food and services weighting, has recorded near double digit increases. At the same time, the industrial and urban economy has slowed down significantly. Prices of manufactured goods have been rising by only 3%. In such a dualised context, the RBI has the unenviable task of setting interest rates for both segments of the two-speed economy. As a result, it has been criticized both for keeping policy too loose and too tight at the same time, depending on which part of the economy the observer is focusing upon. The RBI is compelled to use one instrument for what are, in practice, two economies. The bottom line is that demand management policies alone will not resolve this conundrum. The twin objectives of accelerated growth and price stability can only be achieved through structural reforms.

The Way Ahead

The Indian authorities have undertaken some measures to stabilize the economy in the short term. Fiscal consolidation has seen the deficit decline from 10% of GDP (including the states) to about 7%. The RBI has taken measures to drain liquidity out of markets; give oil exporters access to its dollar reserves; and tighten capital controls on residents. It has also made it easier for banks to borrow abroad. The RBI has sought to smoothen the movement of the Rupee through these measures rather than by raising interest rates at a time when growth is stalling. The new Governor, Raghuram Rajan, has immediately unveiled a number of measures to support the currency and open-up markets.

As mentioned above, the RBI can, at best, stabilize the currency and financial markets. The government has to implement structural reforms to revive the growth momentum. However, it is unlikely that politically difficult and potentially vote-losing action will be taken before the elections next year. The appointment of Raghuram Rajan is timely and welcome. He will be a strong advocate of liberalization and will argue robustly against populism.

In this context, the recent Food Security Act involves a massive expansion of the food subsidy program (US$ 14 billion). It comes on top of the Mahatma Gandhi National Rural Employment Guarantee Program. Some commentators see India's rights-based approach to food security as a populist vote-gaining exercise which is not only unaffordable but is also undermining investor confidence, both local and foreign. However, a strong case can be made in support of India's rights-based approach to food security and employment. It is important to stress that it can only be affordable, if : (1) the growth momentum is revived to swell the government coffers and (2) all subsidies and transfers are much better targeted and leakages minimized. IT can play an important role in this respect. The Aadhaar Scheme to issue biometric identity cards to all of India's 1.2 billion citizens can: (1) improve the effectiveness of targeting; (2) increase transparency; and (3) enhance accountability. The Scheme will be used by the central, state and local government bodies, as well as enterprises, to swiftly confirm an individual's identity for a variety of purposes, including the dispensing of welfare programs.

In summary, India cannot meet the twin objectives of accelerated growth and stability without an ambitious structural reform program. In addition, large projects, such as the Delhi-Mumbai Corridor, road development and other major infrastructure programs should be implemented expeditiously. The sharing of the benefits of growth more widely can be facilitated by improved delivery of spatially blind basic services program.

Implications for Sri Lanka

In recent years, India has been the third-ranked destination for Sri Lankan exports. It has also been ranked number one as the source for imports, tourists and foreign direct investment. With the Indian Rupee depreciating by about 18%, while the local currency has fallen only about 4%, Sri Lankan exports will become less competitive in Indian markets. Conversely, Indian exports to Sri Lanka will become more competitive. In addition, the greater depreciation of the Indian Rupee will make it more expensive for Indian tourists to visit Sri Lanka. It will also disincentivize FDI.

It is also noteworthy that Sri Lanka can draw important lessons from India's policy challenges. These include the need for fiscal consolidation and structural reforms to achieve the twin objectives of growth and stability. The two countries also share the constraints that are being imposed by the timing of the political cycle.

Finally, as pointed out by Charitha Ratwatte (Daily FT 30th July 2012) India's Aadhaar Scheme also provides a model that can help improve the effectiveness of local subsidies and transfers, especially as the national identity card scheme already provides a good information base for launching such a program.

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