GATEWAY HOUSE
INDIAN COUNCIL ON GLOBAL RELATIONS
भारतीय वैश्विक संबंध परिषद्

Policy Perspective No. 4
20 September 2013

Policy Perspective

The domestic dimensions of India's international economic crisis

Summary:

As recently as three years ago, India was being hailed by the international community as an upcoming economic superpower along with China. Now, however, the country finds itself wading through a severe economic slowdown and at the precipice of a potential balance of payment crisis.

The rupee plummeted to historic levels before a recent rally provided momentary relief. The declining foreign exchange reserves have led some experts to compare the situation with India's 1991 crisis; a few even suggested that the country needs to consider seeking International Monetary Fund (IMF) loans. The Indian government's economic mismanagement is largely to blame and there is no substitute for good governance. However, India's business community has abdicated its role of providing the government with an independent opinion and pushing for critical reforms.

Corporate India can play a leading role in pulling the country out of this mire by altering its own approach towards government inaction. This would include reforming Indian chambers of commerce and advocating for key measures such as stimulating domestic investment, better coordination between centre and state, and rethinking India's energy policy. These largely domestic measures will have a wide-ranging impact on India's international economic policy and financial standing.

Dimensions:

1. 'Where else will the money go?': Corporate India and the government grew complacent about the steady inflow of foreign capital. The high growth rates of 7-9% from 2003 until the 2008 crisis deluded the government into believing that an average 9% growth rate, as stated in the 12th Five-Year Plan, can be achieved without internal reforms. The business community borrowed liberally from overseas during this time at low interest rates without commensurate exports, reflecting an overall decline in Indian industry's competitiveness.

2. Influence of U.S. monetary policy: India and many emerging nations protested against the Quantitative Easing (QE) Programme when it was first introduced by the U.S. Federal Reserve in 2008. They feared that it would eventually lead to conditions similar to the Asian financial crisis of 1998. Gradually, the protests subsided as the foreign funds compensated for India's increasing import bills. But these fears were realised when the influence of foreign capital and U.S. monetary policy on India's economy was exposed by the U.S. Fed's announcement of a reversal of their QE programme. The rupee dropped from 56.09 in May 2013 to 68.36 in August 2013 – almost a 25% crash. Currencies from other countries like Turkey, Brazil, Indonesia, and South Africa, with large current account deficits, also lost between 10% and 20% value for similar reasons. The September 18 decision by the U.S. Fed to postpone the reversal is a brief reprieve, but not a long-term solution.

3. Expense over revenue: The passing of the Food Security Bill into law is a populist measure without a clear mechanism to finance it. The estimated cost of Rs. 80,000 crores is around 5% of total expenditure in the annual budget. In addition, increasing international oil prices have required greater subsidies in India's annual budget. The gradual rolling back of fuel subsidies is a welcome measure, but is still not adequate to address the burgeoning fiscal deficit. There is a lot of expectation from the new RBI governor, but the central bank's jurisdiction is limited to monetary policy, banking regulation, and the currency, not fiscal policy managed by the government that is in urgent need for reforms.

Policy Perspectives from Gateway House give an overview of a global issue that has implications for India's policy-making and business community. Each perspective summarises the criticality of the issue, lists the dimensions to be considered for analysis, and outlines how a policy can be designed or executed.

4. Entitlement-driven economy: The employment guarantee law, NREGA, of 2005, the Right to Education Act of 2009, and now the Food Security BILL of 2013, are all indications of a move towards an entitlement-led economy supported by the state. This is a reminder of the Brazilian economy of the 1980s, where increased benefits, the de-linking of contribution and benefits, and the pension programmes were followed by the fiscal crisis in 1985. This social insurance system, once established, was hard to reform until 1995.

5. The IMF option: India's foreign reserves of $275.5 billion, its bilateral currency swap agreement with Japan worth $50 billion, and its multilateral currency swap agreement with BRICS for $100 billion, are sufficient to ensure that going to the IMF is not the first alternative. However, a constructive engagement with the IMF can be a conduit for forcing reforms, by keeping in mind that its accompanying conditions may come at the cost of more equitable growth in the future. Typically, governments are apprehensive of approaching the IMF before elections. However, for India, this hinges heavily on bullish expectations that the Indian economy will be stable for the next nine months.

The way forward:

1. Business activism through reform of chambers of commerce: While specific economic initiatives are important, India's business community must take the responsibility for long-term structural changes. It must realise that the country is not its business protectorate. Businesses, regardless of size, should have a level playing field and they can be assisted by the chambers of commerce. The chambers themselves have to be restructured. They must focus on advising the government on business policy, look beyond the interests of a few powerful members, independently fund their organisations, and support their lobbying with research. In Germany, all companies are required to be members of a specific chamber. However, in India, only around 7,100 companies are members of the Confederationof Indian Industry (CII) out of millions of individual businesses. The CII and Federation of Indian Chambers of Commerce and Industry are not representative of the multi-layered landscape of businesses across the country. This representation can be improved by creating and empowering local district-level chambers that have small and medium businesses as their members.

2. Focus on domestic investment: FDI inflows into India declined from $36.5 billion in 2011-12 to $22.4 billion in 2012-13, reflecting decreased international investor interest in India. However, foreign investment represents less than 5% of total investment in the country. International investors often look at domestic investment as a signal of the economic health of a country and follow the lead of local organisations, which are considered more adept at managing the local environment. Unfortunately, the gross domestic capital formation has dropped from 38% of GDP in 2007 to 35% in 2013, reflecting the declining overall investment in India. While India does require foreign currency investment, the government should focus on stimulating domestic investment first – international investors will then follow.

3.Start with the states: Healthy competition between individual states has resulted in an improving business environment in certain states. But the relationship between the central and state governments has deteriorated to an all-time low. The central government has to work with the states to push for the Goods and Services Tax reform that was to be introduced by 2010. The Empowered Committee of state finance ministers was due to meet on September 19 to discuss this bill, which still contains clauses that are not agreeable to all parties. The ease of doing business across India will play a large role in pulling in investments. The centre may have to make asymmetric concessions to bring the states on board. The lines of communication between the centre and the state have to be re-established to make progress.

4. Rethink energy policy: Energy makes up 75% of India's import bill. Developing on and off-grid solar power through a public-private partnership will be a step in the right direction. In time, this will support local businesses and employment, and reduce the import bill. Decentralised renewable energy may require hardware mass-manufactured at a plant; however in its usage, it lends itself to decentralised entrepreneurship. In parallel, our conventional energy approach should also be rationalised. The reform of India's coal monopoly and increased exploitation of its gas resources will reduce imports of fuel and provide energy for existing power plants, many of which are idling or operating below capacity.

This perspective is based on two meetings hosted recently by Gateway House. The first meeting, 'India: Breakout or Breakdown Nation', was held on 27 August 2013 with Ruchir Sharma, Head of Emerging Markets and Global Macro, Morgan Stanley Investments. The second meeting, 'India's Economic Crisis', was held on 6 September 2013 with Rajiv Kumar, Senior Fellow, Centre for Policy Research, and Suresh Prabhu, former Union Minister of Power, Government of India.

Compiled by Karan Pradhan, Senior Researcher, Gateway House: Indian Council on Global Relations.