Indian Economy

Serious economic reform is key to unlocking India's potential

Narendra Modi's government can win investor confidence with bold strategies for change

Eswar Prasad

India's goods and services tax ended up as a complicated hodgepodge that Isuffered from uneven implementation © AFP

OCTOBER 16, 2017 by Eswar Prasad

The shine has come off India's growth. Most countries would crave a growth rate as high as 5.7 per cent, but this is a setback for a country that recently boasted of growth rates higher than China's. The slowdown exposes underlying fragilities that no triumphalist talk could conceal. What lessons the government takes from this, and how it responds, will determine the contours of the economy and its growth prospects for a long time.

The call for reforms has not gone unheeded by the government of Narendra Modi. A corporate bankruptcy law was put into effect last year. So was an inflation-targeting framework, giving the central bank a more focused mandate that makes low, stable inflation one of its principal objectives.

Last November, the government unexpectedly withdrew 500 and 1,000-rupee notes. This year, it implemented the goods and services tax, a regime that gets rid of a patchwork of state excise levies.

These reforms have fallen prey to a mix of weak design, poor implementation and inadequate follow-through. The GST ended up as a complicated hodgepodge that suffered from uneven implementation.

Then consider the demonetisation, a well-intended strike against corruption. The chaos it unleashed in a cash-driven economy took too long to quell. Moreover, with no follow-through to change the incentives that foster corruption — especially the intrusive role of the state in most aspects of the economy — the dividends have been paltry.

Nevertheless, Mr Modi still has enormous support. His demonetisation gambit got a remarkable political vindication in March when his party swept to victory in polls in Uttar Pradesh. With a majority in parliament and an economy growing rapidly, this outcome gave the prime minister more wind in his sails.

What has he done with all this momentum? Little of consequence. The economic reform agenda seems to have given way to the social agenda promoted by extremist and nationalistic elements of his political party.

Now, with growth flailing, there is a temptation to use looser fiscal policy to push up economic activity. The government is also subtly increasing pressure on the central bank to cut interest rates.

These measures can help growth. But even the short-term boost will depend on whether they are undertaken in isolation or in tandem with broader reforms. And they are not without risks.

Inflation had come under control sooner than expected but inflationary pressures are once again building up. Getting off the announced public deficit and debt reduction paths could shake investors' confidence, pushing up interest rates and increasing the cost of financing the government's debt.

Such stimulus measures will do little for growth beyond a year or two unless investment picks up. This is the most fragile aspect of India's economic surge in the past two years — private investment growth has been practically nonexistent. Thus, the real question for policymakers is not about how they can boost growth temporarily but how to create the environment to elicit private investment. Without that, durable long-term expansion will remain a mirage.

In addition to a stable macroeconomic environment, including low inflation and low budget deficits, substantive policy reforms are needed to give businesses confidence that India has economic prospects that would justify higher levels of investment.

Some good could come of the growth slowdown if it tamps down the government's triumphalist chatter and forces it to fix the banking system, labour market and infrastructure, along with freeing the economy from state control. This is essential if India is to have a shot at achieving its potential. A panicky response emphasising short-term stimulus will hurt India's economy.

The writer is a professor at Cornell University and senior fellow at the Brookings Institution