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India must not let slip its moment for reform

By Eswar Prasad

The Indian economy is in the doldrums: industrial output has stalled, inflation remains high, the rupee has plunged to an all-time low and foreign investors are retreating en masse. Is this a temporary rough patch or is the shine coming off?

India, like many other emerging markets, is not immune to global economic turmoil. Yet there is a palpable sense that the economy is losing its direction as political paralysis sets in, stalling reforms that the country desperately needs.

After a few glorious years, when the economy seemed to have switched permanently to a high growth path, the domestic narrative was that India would soon decisively eliminate the growth gap with China. Unfortunately, rather than pushing forward with reforms to cement these gains, a sense of hubris set in.

The main problem is that the government has not created a broad constituency for reforms, as the benefits of growth have been very unevenly distributed. Endemic corruption, which hits the poor hardest and heightens their sense of unfairness, has exacerbated this problem and strengthened the hand of those opposed to reform.

In this context, the recent U-turn on the liberalisation of foreign direct investment in the retail sector takes on considerable significance. While it is easy to blame external forces and speculators for rising commodity and food prices, an underlying problem is that India's food distribution system is highly inefficient, with extensive spoilage and high price mark-ups at different stages.

It is particularly perverse for those opposed to greater competition in the distribution chain to cling to inefficiencies on the pretext of protecting jobs and the poor. The reality is that India's poor suffer the most from high and rising food prices. Moreover, other policies then have to compensate for this. The central bank had little choice but to temper rising food price inflation by tightening monetary policy, hurting growth in the industrial sector. Using monetary policy to deal with the consequences of structural

problems in food supply and distribution ends up costing high-paying jobs and hindering the transformation of India's economy.

The challenge is to ensure that reforms deliver greater benefits to the poor and lower middle class, so they share more in the benefits of India's growth and provide a political base for economic reforms. What should the government do?

First, it should tackle corruption head on. The prime minister is an honourable man, seen to be above reproach. But Manmohan Singh and his government have been playing defence rather than attacking graft. There is an important lesson in the groundswell of support for the anti-corruption activist Anna Hazare. A package of reforms that included a bold strike against corruption would resonate with the public and help build support for other reforms.

Second, the government should improve the social safety net. Replacing food and energy subsidies with cash transfers would staunch corruption that bedevils the delivery of benefits, reduce inefficiencies in these markets and deliver greater benefits directly to the poor.

Third, the government should push ahead with financial sector reforms. India desperately needs a more efficient financial system to channel domestic and foreign capital into productive investment that generates jobs. In this area there has been slow, methodical progress. But a great deal still needs to be done to develop a broader range of financial markets, including corporate bond markets, and free up the banking system from various strictures. Broadening access to the formal financial system so more people can obtain saving, credit and insurance products is also important.

The reform agenda hardly stops there. Restrictive labour market regulations and industrial policies, large government budget deficits and a dysfunctional education system are stifling the intrinsic dynamism of the Indian economy. It is high time for another concerted push on economic reforms – the benefits of those put in place over the last two decades have run their course.

To reinvigorate reforms, the government needs to first focus on measures that spread the benefits of growth more evenly in order to build broader support for the overall agenda. Otherwise, India's shining moment may dim into a dull glow.

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