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India's Balanced Growth

Instead of fretting about trade deficits, India should open up more to foreign direct investment.

Late last year, New Delhi reported that its economy clocked 8.9% year-on-year growth in the July-September quarter, further closing the growth gap with China. And as the economics textbooks predict for a country growing this quickly, India is importing capital goods, as its investment cycle picks up again, and consumer goods, as a population with rising incomes aspires to a higher standard of living. Capital is flowing in to fuel growth and a trade deficit.

Yet this is hardly the norm among the fast-growing tiger economies of East Asia, which grow by running trade surpluses and accumulating massive foreign exchange reserves. So established has this model become that India looks like an outlier.

It is cause for celebration that India is bucking the trend. Unlike other countries in Asia that grew by subsidizing their export sectors, India is letting the benefits of free trade accrue to its entire population. The economy's main engine is a stable mix of domestic-oriented investment and demand, and its companies face the rigors of competition. This reduces the risk of malinvestment and balance-sheet recessions.

However, some observers are now sounding the alarm about balance of payments data released by the Reserve Bank of India last Friday, which show the current account deficit widening to $15.8 billion for the July-September quarter, from $12.1 billion in the previous quarter. Does this mean India is going off the rails?

The short answer is, not necessarily. The real worry, though, is that New Delhi still hasn't implemented necessary reforms so it can absorb foreign investment and continue growing at a fast and sustainable pace.

Associated Press

India's Reserve Bank governor D.Subbarao

This isn't the first time there is alarm over India's current account deficit. Since it caught the 8%-plus growth train last decade, Indian policy makers have continually fretted about what sort of investment is financing imports. Much like now, from 2006 to mid-2008 low interest rates in the West drove institutional investors to seek higher returns in emerging markets; the flood of capital into India's stock market was contributing to overheating, at least until the post-Lehman shock sent the money flows into reverse for a couple of years.

The Reserve Bank of India is worried that these flows might again prove destabilizing. For instance, in July-September 2010, flows into Indian stocks and bonds made up 88% of foreign investment inflows that totalled $21.7 billion. The central bank considers these flows "volatile." The more stable foreign direct investment trickled in at $2.5 billion, a far cry from, say, the $10 billion in FDI India absorbed in the April-June quarter of 2008. So, in a financial stability report published last week, the RBI marked the current account deficit as a downside risk to the Indian economy.

We're sympathetic to the concern that easy money in the U.S. is causing problems for developing countries like India. But we're not sympathetic to the kind of steps the RBI took in 2007 to "manage" India's capital account: Greater limits on foreign borrowings and more scrutiny on foreign investors, besides stalling on the introduction of new financial products.

To RBI's credit this time, despite last year's episode of "currency wars," it resisted putting new capital controls in place and intervening in foreign exchange markets to weaken the rupee. In fact, it has gradually proceeded with capital account liberalization in the past year: Last September's relaxation of the foreign investment limit in bonds is one encouraging sign.

When it comes to the RBI's lament over the composition of capital account inflows, it's worth noting that New Delhi's own policies skew that composition. As Cornell economist Eswar Prasad explains nearby, investment tends to flow into Indian stocks because that market offers transparent regulation and minimal restrictions. Managers of multinational companies will tell you that's not true for foreign direct investment; each sector from power plants to shopping malls comes with its own labyrinthine set of regulations, on top of general limits on FDI.

Since Prime Minister Manmohan Singh's government was returned to power in mid-2009, it hasn't relaxed any more FDI caps. Wal-mart still can't enter India's retail market because no FDI is allowed in multi-brand retail; the 26% cap in insurance means no global insurance major can enter as a majority owner. What's worse, the government's environmental activism has made FDI more uncertain. For example, Korean steel giant Posco has been nervously awaiting New Delhi's sanction for a $12 billion project in the eastern state of Orissa. Though a government panel on Monday gave Posco its clearance, the project needs final political approval. This explains why FDI into India is now slowing down.

India has the potential to establish a new model for more sustainable and balanced growth in competition with the East Asian export-led model. But if it fails to undertake reforms to make it a more attractive destination of foreign capital, it will cap its own growth potential. New Delhi deserves praise for remaining more open to portfolio investment than other Asian nations, but going to the other extreme of hampering FDI is inconsistent with its laudable record of balanced growth.

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