

## Rising prices block path to big numbers

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Early in September, the Indian government named Duwuri Subbarao as the new governor of the country's central bank. He has quite a task on his hands.

Gone are the immediate hopes that India was on the verge of sustaining 10 per cent growth rates, with inflation under control. Instead the question is whether India's rampant inflation can be tamed - and what effect a fall in inflation would have on the wider economy.

With global food prices soaring and food accounting for 47 per cent of its consumer price index, India's weekly measure of inflation has rocketed from below its "tolerance level" of 5 per cent early this year to finish August at 12.1 per cent, having peaked earlier in August at a 16-year high of 12.6 per cent.

Rising inflation has caused great difficulties for Manmohan Singh, India's prime minister, who must call an election before May 2009. An inflation-linked squeeze on the incomes of the rural poor is bound to be a vital issue in that election. But inflation's normal cure - a period of slower growth - is almost as bad.

The appointment of Mr Subbarao, a 59-year-old top bureaucrat from the finance ministry, to replace Yaga Venugopal Reddy, who was often seen to be at loggerheads with the populist policies pursued by the finance ministry, suggested that the government might want to ease policies that were causing India's economy to hit its slowest growth rate in three years.

But the initial statements from Mr Subbarao suggest he will be cautious about declaring that the worst of India's inflation problem is over.

Shortly after assuming office, he said: "We are seeing some moderation, although I am not sure that we can see a discernable trend."

The rise in prices, consequent rise in interest rates to a seven-year high of 9 per cent, and squeeze on incomes has taken its toll on economic expansion. Growth slowed to 7.9 per cent in the second quarter of the year and the prime minister's Economic Advisory Council forecast a further drift downwards with growth over the whole of the fiscal year of 7.7 per cent, compared with 9 per cent in 2007.

High energy prices and rising government spending have also put a dent in government finances and the country's trade position, leading some economists to start talking about a "twin deficit" problem.

The council described the slowdown as "modest" and, in a recent report, blamed the downturn on "a further deterioration of global conditions with its attendant impact on India, be it in the sphere of oil prices or capital markets".

It did not expect an improvement until 2009 at the earliest.

But in recent weeks there have been improved news on output. Industrial production in July rebounded to an annual growth of 7.1 per cent compared with 5.4 per cent in June.

The fall in oil prices and a better outlook for agricultural commodity prices will ease the squeeze on companies and consumers, and reduce the chances of another rise in interest rates.

Sonal Varma, of Lehman Brothers, said: "We expect easing oil prices to help gradually fade the twin-deficit concern and improve fundamentals by around mid-2009, helping to ensure that the economy subsequently

rebounds."

If commodity prices ease, India will have a chance to resume its longer-term ambitions of raising sustainable growth rate to the levels China has consistently achieved - about 10 per cent. Such rates are needed if the country is to make better progress in reducing poverty.

Bureaucracy, weak infrastructure, underdeveloped financial services and a inflexible labour market are some of the biggest hurdles to a faster growth rate.

The International Finance Corporation, the World Bank arm that lends to the private sector, says India's bureaucracy is one of the main factors in the size of its informal sector, its level of unemployment and slower-than-possible growth.

Meanwhile Professor Raghuram Rajan of Chicago University, a former chief economist of the International Monetary Fund, and Professor Eswar Prasad of Cornell University say high growth targets are being missed because of a financial system [that] is "not providing adequate services to the majority of domestic retail customers, small and medium-sized enterprises, or large corporations".

Commenting on a report to government on the banking sector, they say government ownership of 70 per cent of the sector has stunted financial development that has "the potential to generate millions of much-needed jobs and, more important, have an enormous multiplier effect on economic growth".

Such barriers ensure that, though India's performance has improved greatly in the past three years, the country still lags China in economic dynamism by a considerable margin. A continuing programme of incremental reforms is needed to ensure that a vibrant economy reaches as many people as possible.

If the country can ride out the current storm, however, the idea that it can aspire to 10 per cent plus growth rates again might become credible.

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