Singh's big chance to unchain the Indian economy

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Published: August 9 2009 19:32 | Last updated: August 9 2009 19:32

Prime minister **Manmohan Singh**'s government has been blowing hot and cold on economic reforms. The present political and economic circumstances in India – a stable political coalition and a rebound from the global recession – give Mr Singh a chance to deliver real reforms, which are crucial for sustained growth that does not leave behind much of the population. Marginalism on reforms now would be a colossal wasted opportunity.

Why bother with reforms? After all, India's economy has weathered the global financial crisis quite well. This is testimony to the country's tremendous potential – exemplified by a young labour force, a dynamic entrepreneurial class and an improving financial system. But India will always punch well below its weight if it does not remove barriers that keep it from fully tapping that potential.

The list of needed reforms is long. India's labour laws, which constrain large enterprises in particular, have hurt productivity growth. Shackles on the educational system are keeping India from reaping the full benefits of its young workforce. The dilapidated physical infrastructure is hurting growth in all sectors.

Above all, financial sector reforms will determine the pace and quality of India's growth. Loss of momentum in this area could be very costly, for finance is the thread that runs through all other reforms and will determine their ultimate impact.

The reform agenda is about the basics of financial development rather than sophisticated innovations. It is tempting to draw the lesson from the global financial crisis that a closeted economy with a state-dominated banking system is the best and safest option for India. But the financial system should be evaluated against a broader set of criteria.

The basic purpose of a financial system is to channel domestic savings and foreign capital into productive investment. On this criterion, which is how the financial system can contribute to growth, there is a long way to go. Indian banks may have held up well during the crisis but that does not make them efficient intermediaries that are channelling credit to its most productive uses. Many sectors of the economy, especially small and medium-sized enterprises, are still starved of credit.

The banks should be freed of their role as instruments of social policy through government-directed lending programmes. This would allow them to channel credit to enterprises that could effectively convert financial capital into productive physical capital and generate desperately needed job growth. "Priority sectors" identified by the government, including agriculture, should get direct budget financing rather than subsidies through the financial system. A dose of private ownership would force public banks to become more efficient, especially some of the smaller ones that are unviable in their present form.

The opening up of corporate bond markets is also a priority to give firms an alternative way of raising finance, especially for long-term projects such as infrastructure investment.

While the crisis shows that weakly regulated exotic derivatives can wreak havoc, not all derivatives should be tarred with the same brush. Indeed, India has made progress on basic derivatives that enterprises use to hedge against various types of risk. For example, there is a huge demand from exporting and importing firms for derivatives to hedge currency risk and that market has flourished. Opening these markets to more participants, including foreign investors, and improving trading systems would make them more robust.

India's strong growth over the past decade has reduced poverty but much of the population remains at the margins of subsistence. A better-functioning and broader financial system would help entrepreneurs to generate jobs. Wider access to banking products would help households save more efficiently and build up a buffer for a rainy day. The government has made it easier for banks to set up cashpoints but a lot more could be done to push forward initiatives such as mobile banking using cell phones and provision of basic banking services through retail outlets.

Mr Singh should seize this chance to rejuvenate the process of financial development and reforms. His legacy, and India's future path to sustained and inclusive growth, depends on it.

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