The Economist

India's economy

How India got its funk

India's economy is in its tightest spot since 1991. Now, as then, the answer is to be bold

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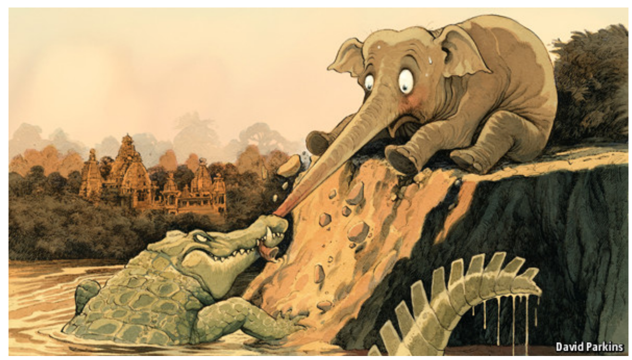

IN MAY America's Federal Reserve hinted that it would soon start to reduce its vast purchases of Treasury bonds. As global investors adjusted to a world without ultra-cheap money, there has been a great sucking of funds from emerging markets. Currencies and shares have tumbled, from Brazil to Indonesia, but one country has been particularly badly hit.

Not so long ago India was celebrated as an economic miracle. In 2008 Manmohan Singh, the prime minister, said growth of 8-9% was India's new cruising speed. He even predicted the end of the "chronic poverty, ignorance and disease, which has been the fate of millions of our countrymen for centuries". Today he admits the outlook is difficult. The rupee has tumbled by 13% in three months. The stockmarket is down by a quarter in dollar terms. Borrowing rates are at levels last seen after Lehman Brothers' demise. Bank shares have sunk.

On August 14th jumpy officials tightened capital controls in an attempt to stop locals taking money out of the country (see article (http://www.economist.com/news/finance-and-economics/21584010-why-india-particularly-vulnerable-turbulence-rattling-emerging)). That scared foreign investors, who worry that India may freeze their funds too. The risk now is of a credit crunch and a self-fulfilling panic that pushes the rupee down much further, fuelling inflation. Policymakers recognise that the country is in its tightest spot since the balance-of-payments crisis of 1991.

How to lose friends and alienate people

India's troubles are caused partly by global forces beyond its control. But they are also the consequence of a deadly complacency that has led the country to miss a great opportunity.

During the 2003-08 boom, when reforms would have been relatively easy to introduce, the government failed to liberalise markets for labour, energy and land. Infrastructure was not improved enough. Graft and red tape got worse.

Private companies have slashed investment. Growth has slowed to 4-5%, half the rate during the boom. Inflation, at 10%, is worse than in any other big economy. Tycoons who used to cheer India's rise as a superpower now warn of civil unrest.

As well as undermining 1.2 billion people's hopes of prosperity, failure to reform dragged down the rupee. Restrictive labour laws and weak infrastructure make it hard for Indian firms to export. Inflation has led people to import gold to protect their savings. Both factors have swollen the current-account deficit, which must be financed by foreign capital. Add in the foreign debt that must be rolled over, and India needs to attract $250 billion in the next year, more than any other vulnerable emerging economy.

A year ago the new finance minister, Palaniappan Chidambaram, tried to kick-start the economy. He has attempted to push key reforms, clear bottlenecks and help foreign investors. But he has lukewarm support within his own party and faces obstructionist opposition. Obstacles to growth, such as fuel shortages for power plants, remain. Foreign firms find nothing has changed. Meanwhile, bad debts have risen at state-run banks: 10-12% of their loans are dud. With an election due by May 2014, some fear that the Congress-led government will now take a more populist tack. A costly plan to subsidise food hints at this.

Stopping the rot

To prevent a slide into crisis, the government needs first to stop making things worse. Those capital controls backfired, yet the urge to tinker runs deep: on August 19th officials slapped duties on televisions lugged in through airports. The authorities must accept that 2013 is not 1991. Then the state nearly bankrupted itself trying to defend a pegged exchange rate. Now the rupee floats, and the state has no foreign debt to speak of. A weaker currency will break some firms with foreign loans, but poses no direct threat to the government's solvency.

And so the Reserve Bank of India must let the rupee find its own level. The currency has not yet wildly overshot estimates of fundamental value. Raghuram Rajan, the central bank's incoming head, should aim to control inflation, not micromanage one of the world's most traded currencies.

Second, the government must get its finances in order. The budget deficit has been as high as 10% of GDP in recent years. This year the government must hold down its deficit (including those of individual states) to 7% of GDP. It is already cutting fuel subsidies, and—

notwithstanding the pressures in the run-up to an election—should do so faster.

This is not enough to fix the government's finances, though. Only 3% of Indians pay income tax, so the government's tax take is puny. A proposed tax on goods and services, known as GST, would drag more of the economy into the net. It is stuck in endless cross-party talks. If the government can rally itself before the election to push for one long-term reform, this is the one it should go for.

Last, the government, with the central bank, should force the zombie public-sector banks to recapitalise. In 2009 America did "stress tests" to repair its banks. India should follow. Injecting funds into banks would widen the deficit, but the surge in confidence would be worth it.

There are glimmers of hope: exports picked up in July, narrowing the trade gap. But India faces a difficult year, with jittery global markets and an election to boot. Even if it scrapes past the election without a full-blown financial crisis, the next government must do much, much more to change India. Over the coming decade tens of millions of young people will have to find jobs where none currently exists. Generating the growth to create them will mean radical deregulation of protected sectors (of which retail is only the most obvious); breaking up state monopolies, from coal to railways; reforming restrictive labour laws; and overhauling India's infrastructure of roads, ports and power.

The calamity of 1991 led to liberalising reforms that ended decades of stagnation and allowed a spurt of fast growth. This latest brush with disaster could produce a positive legacy, too, but only if it persuades voters and the next government of the importance of a new round of reforms that deal with the economy's flaws and unleash its mighty potential.

From the print edition: Leaders