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## Turning sour

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INDIA'S coalition government went to outlandish lengths to win a vote of confidence in Parliament on July 22nd, a victory it hopes will prolong its life until early next year. To appease one politician, it even renamed the airport in Lucknow, a state capital, after his father. (The ingrate still voted the other way.) Asked to justify this ploy, India's finance minister dryly remarked, "It will facilitate better take-offs and landings." Now he and his fellow reformers must facilitate a safe landing for India's economy. It too may go the other way.

Until the start of this fiscal year (which began on April 1st), India's economy had its head in the clouds. Having grown by at least 9% a year for three years, it was attracting more overseas capital than it knew what to do with. Foreigners ventured a net \$20 billion on its booming stockmarket last fiscal year; overseas banks lent even more to its mighty companies.

But India's share prices were collapsing and its economy slowing even before July 29th, when the central bank stepped up its campaign against inflation by hiking its benchmark "repo" rate for the third time in less than two months (see chart). Industrial production expanded by only 3.8% in the year to May. The figures for capital goods and infrastructure industries, such as steel, cement and electricity, were particularly dismal for a country that prides itself on having an investment boom.

A big gap has now opened up between the increasingly gloomy views of India's prospects from abroad, and the defiant optimism of its own forecasters. The Centre for Monitoring Indian Economy, in Mumbai, thinks India will still grow by 9.5% this fiscal year. JPMorgan, a foreign bank, foresees growth of just 7%.

The imponderable is the oil price. Though prices have eased on world markets, India still faces an import bill for crude that may reach \$120 billion this fiscal year, compared with \$69 billion the year before. The extra burden is about 4% of GDP—a huge amount. The Congress-led government, which must go to the polls before May, is reluctant to pass on the full cost to voters. When it raised pump prices in June, the opposition described this as an "act of economic terrorism".

But by sparing households, it is jeopardising the public finances. Between them, the fuel subsidy, cheap fertiliser, forgiven farm loans and fatter pay-packets for bureaucrats, could increase the budget deficit to 10% of GDP this fiscal year, if the red ink spilled by state governments is included.

When you combine government largesse with the oil bill, you get an external deficit which could reach 4% of GDP this fiscal year. Narrowing that gap is a matter of urgency. The foreign capital needed to bridge it is now less forthcoming. The threat to India's exchange rate is plain.

It would be too sensational to talk of a run on the rupee. India is not a debtor nation: its foreign assets—including more than \$300 billion of foreign-exchange reserves—outweigh its foreign debts. Moreover, the foreign investors with direct stakes in India's growth will not liquidate their back offices or assembly lines just because of a bit of cyclical gloom.

More fickle, however, are the foreigners who bet large sums on Indian shares when the stockmarket was in full bloom. They are deserting the country, withdrawing \$6.7 billion so far in 2008. The only consolation is that as share prices fall, so does the amount they can repatriate, relieving some of the pressure on the currency.

Two modest reforms, pending in Parliament, might restore some of India's charms to foreigners even before the next election. Both are designed to encourage outside investment in the financial sector. One would raise the cap which limits foreign direct investment in insurance. The other would give foreigners who invest in Indian banks voting rights commensurate with their stakes. But India must learn to cope without an inrush of foreign money. That may entail slower investment and a narrower fiscal gap. In particular, the government, having won its confidence vote and prolonged its life, cannot now afford to wait until after the next election before again raising fuel prices.

Neither epic nor tragedy

Even as they dump shares, India's foreign investors should also take stock. They were wrong to count on a 9-10% rate of growth. Such a rate could be sustained only with a furious pace of economic reform, which India's mutinous democracy cannot provide. Any projection that relies on the wholesale unshackling of the market for labour, land or electricity would therefore be about as useful as the astrological projections that convinced India's opposition leader he would triumph in the no-confidence vote.

But India also benefits from what financial types might call the "democracy put": its politics forestall the worst outcomes, even if they squander the best. India's policymakers only seem able to reform under duress. They accomplish little during good times but have plenty of rabbits left in the hat when darker times loom. For example, India is still a lightly taxed country, and the proposed introduction of a nationwide tax on goods and services could add three percentage points to the taxman's share of GDP. Likewise, the government still owns hundreds of enterprises. It may not have time to flog

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much of this patrimony before it goes to the polls. But it could prepare the ground for a sale soon after.

In the past few years, foreigners have enjoyed reciting the “India story”, the epic tale of a youthful nation throwing off its shackles to fulfil its destiny as an economic superpower. Indians enjoyed telling the story back to them, with justifiable pride and perhaps a little masala (ie, embellishment). That story is not all myth: in the past few years, India’s sustainable rate of growth has increased from less than 6% to somewhere close to 8%. But as recent events show, the India story often resembles a comedy as much as an epic. Its policymakers run around in circles, swapping partners and scandalising onlookers, but with luck pull it together at the end.

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