Raghuram Rajan: Filtering out the real India

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Indian cricket fans are manic-depressive in their treatment of their favorite teams. They elevate players to god-like status when their team performs well, ignoring obvious weaknesses; but when it loses, as any team must, the fall is equally steep and every weakness is dissected. In fact, the team is never as good as fans make it out to be when it wins, nor as bad as it is made out to be when it loses. Its weaknesses existed in victory, too, but were overlooked.

Such bipolar behavior seems to apply to assessments of India’s economy as well, with foreign analysts joining Indians in similar swings between over-exuberance and self-flagellation. A few years ago, India could do no wrong. Commentators talked of “Chindia”, elevating India’s performance to that of its northern neighbor. Today, India can do no right.

India does have its problems. Annual GDP growth slowed significantly in the last quarter to 4.4%, inflation is high, and the current-account and budget deficits last year were too large. Every commentator today highlights India’s poor infrastructure, excessive regulation, small manufacturing sector, and a workforce with inadequate education and skills.

These are indeed deficiencies, and they must be fixed if India is to grow strongly and stably. But the same deficiencies existed when India was growing fast. To understand what needs to be done in the short run, we must understand what dampened the Indian success story.

In part, India’s slowdown paradoxically reflects the substantial fiscal and monetary stimulus that its policymakers, like those in all major emerging markets, injected into its economy in the aftermath of the 2008 financial crisis. The resulting growth spurt led to inflation, especially because the world did not slide into a second Great Depression, as was originally feared. So monetary policy has had to be tight, with high interest rates contributing to slowing investment and consumption.

Moreover, India’s institutions for acquiring land, allocating natural resources, and granting clearances were overwhelmed during the period of strong growth. Strong growth increased the scarcity and value of resources such as land or mineral wealth. To the extent that these were cheap in the past, there was little reward to misallocating them. Growth, however, increased the rents to corruption.

Similarly, industrial development led to growing encroachment on farmland and forests and the displacement of farmers and tribals. India is a developing country with a civil society possessed of first world sensibilities. Protests organized by politicians and activists led to new environmental laws and land acquisition laws that aim to make development sustainable. Over time, India will learn to streamline the new laws to make them more functional, but in the short run a side effect has been more bureaucratic impediments to investment. So growth, as well as the reaction to that unbridled growth, created a greater possibility of corruption.

Fortunately, a vibrant democracy like India has its own checks and balances. India’s investigative agencies, judiciary, and press started examining allegations of large-scale corruption. The unfortunate side effect as the clean-up proceeded was that bureaucratic decision-making became more risk averse, and many large projects came to a grinding halt.

Only now, as the government creates new institutions to accelerate decision-making and implement transparent processes, are these projects being cleared to proceed. Once restarted, it will take time for these projects to be completed, at which point output growth will increase significantly.

The combination of excessive (with the benefit of hindsight) post-crisis stimulus and stalling large projects had other consequences such as high internal and external deficits. The post-crisis fiscal-stimulus packages sent the government budget deficit soaring from what had been a very responsible level in 2007–2008 of around 2.5 percent to over 6 percent. Similarly, as large mining projects stalled, India had to resort to higher imports of coal and scrap iron, while its exports of iron ore dwindled.

An increase in gold imports placed further pressure on the current-account balance. Newly rich consumers in rural areas increasingly put their savings in gold, a familiar store of value, while wealthy urban consumers, worried about inflation, also turned to buying gold. Ironically, had they bought Apple shares, rather than a commodity (no matter how fungible, liquid, and investible it is), their purchases would have been treated as a foreign investment rather than as adding to the external deficit.

For the most part, India's current growth slowdown and its fiscal and current-account deficits are not structural problems. They are all fixable by means of modest reforms. This is not to say that ambitious reform is not good, or is not warranted to sustain growth for the next decade. But India does not need to become a manufacturing giant overnight to fix its current problems.

The immediate tasks are more mundane, but also more feasible one: clearing projects, reducing poorly targeted subsidies, and finding more ways to narrow the current-account deficit and ease its financing. Over the last year, the government has been pursuing this agenda, which is already showing some early results. For example, the external deficit is narrowing sharply on the back of higher exports and lower imports. The government and the Reserve Bank said it would $ 70 billion this fiscal year, down from $ 88 billion last fiscal year, but recent data suggests it could be lower still.

This leads me to another point. Because analysts keep looking for major structural reforms to fix the deeper economic challenges, they ignore smaller steps or dismiss them as "band aids". But strategically placed small steps – strategic incrementalism for want of a better term – taken together can deal with the immediate problems, thus buying time and economic and political space for the major structural reforms.

Put differently, when the Indian authorities said they would bring the fiscal deficit below 5.3% last year, no one believed them. The final outturn was 4.9%. Similarly, while we project the CAD to come down to 3.7% this year, I think we could be pleasantly surprised. Not all the actions we have taken are pretty, and not all are sustainable, but they have done the job.

Indeed, despite its shortcomings, India's GDP will probably grow by 5–5.5% this year – not great, but certainly not bad for what is likely to be a low point in economic performance. The monsoon has been good and will spur consumption, especially in rural areas, which are already growing strongly, owing to improvements in road transport and communications connectivity.

The banking sector has undoubtedly experienced an increase in bad loans, often owing to investment projects that are not unviable but only delayed. As these projects come onstream, they will generate the revenue needed to repay loans. India's banks have the capital to absorb losses in the meantime.

Likewise, India's finances are stronger than in the typical emerging-market country, let alone an emerging-market country in crisis. India's overall public debt/GDP ratio has been on a declining trend, from 73.2% in 2006–07 to 66% in 2012–13 (and the central government's debt/GDP ratio is only 46%). Moreover, the debt is denominated in rupees and has an average maturity of more than nine years.

India's external debt burden is even more favorable, at only 21.2% of GDP (much of it owed by the private sector), while short-term external debt is only 5.2% of GDP. India's foreign-exchange reserves stand at $278 billion (about 15% of GDP), enough to finance the entire current-account deficit for several years. Even if you count all of trade credit as well as maturing deposits held by overseas Indians as short term debt, India's reserves can pay them all down and still have money left over.

That said, India can do better – much better. The path to a more open, competitive, efficient, and humane economy will surely be bumpy in the years to come. But, in the short term, there is much low-hanging fruit to be plucked.

For instance, we are committed to developing our financial system, and carefully expanding access to finance can be a source of tremendous growth in the years to come. We are also embarked on large infrastructure projects. For example, the Delhi Mumbai Industrial Corridor, a project with Japanese collaboration entailing over $ 90 billion in investment, will link Delhi to Mumbai's ports, covering an overall length of 1483 km and passing through six States. This project will have nine mega industrial zones of about 200–250 sq. km., high speed freight lines, three ports, six airports, a six-lane intersection-free expressway connecting the country's political and financial capitals, and a 4000 MW power plant. We have already seen a significant boost to economic activity as India built out the Golden Quadrilateral highway system, the boost from the Delhi Mumbai Industrial Corridor can only be imagined. The best of India is yet to come.

Back to the cricketing analogy, India is an open argumentative society. But we are prone to mood swings, perhaps more so than other societies, perhaps in part driven by our excitable competitive and very young press. Stripping out both the euphoria and the despair from what is said about India – and from what we Indians say about ourselves – will probably bring us closer to the truth.