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Economy laid low by governance

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Scams, policy paralysis — and not Europe — have grounded India.

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We are all aware of individual well-being. We are a happier lot when we have opportunities to earn/augment our personal income; are in possession of consumer durables such as a house, cell phone, iPod, digital camera, air conditioner, etc.; have the ability to park our excess income in financial assets such as bank deposits, equities, mutual funds, etc.; and live in a society that is secure, transparent, less corrupt and better governed.

A summation of individual well-being gives us a sense about how an economy is doing. An economy is doing well, if it is doing better in terms of some basic economic indicators such as national income or gross domestic product (GDP), savings, investment, consumption expenditure, foreign direct investment, current account deficit and inflation rate.

So far, India has done pretty well in terms of these basic economic indicators, relative to other emerging or newly industrialised economies, conveniently termed as BRICS economies — Brazil, Russia, India, China and South Africa. If one were to rank the BRICS economies on the basis of these basic economic indicators, then India would be next only to China (*see table*) .

However, things have suddenly changed for worse for India, starting March. At present, everyone is worried about the state of the economy, with Standard and Poor's hinting at downgrading it to junk status from the present BBB-.

There is apprehension about the economy slowing down; there could be fewer opportunities to earn, fewer to spend, weaker demand, and hence lesser incentive to invest. The common man is worried, as low investment (as is evident from the stagnating index of industrial production numbers) leads to an increase in the unemployment rate.

India is at present passing through a period of stagflation, characterised by lower job creation and higher inflation. This prompted the central bank not to cut rates further during its policy meet on June 19.

The Bugs

Why this sudden change of fortunes? Although many will attribute wrong policy signalling and policy paralysis as the main reason, lack of governance leading to corruption is also a factor.

A few events since March have seriously dented India's image as a favourable investment destination. First is the much-talked-about Vodafone case where the Union Government has retrospectively changed the tax laws to penalise the UK-based telephone giant. Second is the cancellation of 2G mobile licences, sending a clear signal to the international business community about uncertain policy environment in India. To top it all are the General Anti-avoidance Rules (GAAR) introduced in the last Budget, spooking foreign investors.

Added to this is policy paralysis, hindering further economic reforms. In the process of bargaining hard for a tax moratorium, the West Bengal Chief Minister, Ms Mamata Banerjee (an important coalition ally), is also making sure that none of the essential reforms — starting with pension, insurance, FDI in multi-brand retail and aviation — is passed without the Centre agreeing to her demand.

Investment deficit

India's budget deficit is also a worry for fund managers. When a part of this budget deficit is on account of non-productive expenditure such as waiving off farm loan, and a part due to scams, the high level of inflation does not come as a surprise. Over the last three years, between March 2009 and March 2012, the consumer price index has increased annually at 11 per cent.

Scams such as 2G, the National Rural Health Mission in Uttar Pradesh, and 'Coalgate' have cost the Government more money than what it spends on the NREGA and food subsidy. The Government has also failed miserably in terms of what it promises, and what it delivers.

The Finance Ministry announced for fiscal 2012 that the budget deficit will be limited to 4.6 per cent. However, this year the budget deficit stood at 5.9 per cent.

In the 2011 Railway Budget, the Railway Ministry announced laying of 1,075 km of new railway lines, and doubling of 867 km of railway lines. A year later, only 180 km of new railway lines were laid, and 249 km of railway lines doubled.

A higher budget deficit than what was originally planned means the Government has been borrowing more from the market. As supply of funds is limited, this additional demand raises interest rate, which is bad news for investment and future job creation.

It also means that to contain the budget deficit the Government may have to increase corporate tax in the future — further undermining

investment sentiment. From the supply side, spending money on infrastructure projects that are not completed implies expenditure without any addition to supply of real deliverables, leading to inflation.

It is not surprising that foreign fund managers are nervous about investing in India. When foreign fund managers withdraw dollars in response to uncertain policy direction and high inflation, the rupee is bound to depreciate. During April-May, foreign fund managers withdrew close to \$400 million, taking down the stock market, along with the rupee.

EUROPE CANARD

The Government is trying to save face by saying that the trade deficit is increasing because of the worsening economic situation in Europe.

Truth is, only around 20 per cent of our total exports are headed to Europe. Since March, the rupee has depreciated not only against the dollar but also against other currencies such as the renminbi, the yen, the Australian dollar, the Canadian dollar and the Singaporean dollar, among others.

This means our exports have gained in terms of price competitiveness and should have been able to lower our trade deficit. However, the fact that the rupee continues to fall tells us the problem is not foreign, but one within our borders.

We can draw little solace from Moody's reaffirming a stable rating for India, unless we fix the bugs.

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