

**Indian economy**

## How India can avoid the emerging market blues

Questions are being asked about the government's commitment to liberalisation



The test is whether Arun Jaitley can take measures that would unshackle Indian industry, boost investment, and raise productivity © Bloomberg

Eswar Prasad OCTOBER 7, 2018

[India](#) is the fastest-growing large economy in the world and has a stable government. Yet it has joined the ranks of [emerging markets](#) that are taking a beating. The [Indian rupee](#) has fallen in value by 15 per cent against the US dollar this year.

The tightening of global financial conditions, in tandem with prospects of further interest rate rises by the US Federal Reserve and a stronger dollar, has increased pressure on countries with current account deficits and high levels of foreign currency debt. While it shares some of these vulnerabilities, India can hardly be counted among countries such as Argentina, Brazil, and Turkey that face tough domestic economic and political circumstances.

But investors apparently see a lot to worry about. Rising world oil prices and strong domestic consumer demand have led to a bigger current account deficit and stoked concerns about rising inflation, larger budget deficits, and further currency depreciation.

Still, there are good reasons not to panic. Against a trade-weighted basket of trading partner currencies, the rupee's decline has been less drastic, only about 8 per cent this year. India has \$400bn in [foreign exchange reserves](#) and inflation remains moderate.

Feedback

Prime minister Narendra Modi's insistence in recent years that the rupee's strength is a reflection of the economy's vigour and the quality of government stewardship has, however, put his administration in a bind.

The Modi government has responded to rupee weakness in the way many emerging markets tend to — with a mix of import restrictions and measures to encourage capital inflows, including making it easier for domestic companies to borrow abroad in hard currencies. These measures hardly inspire confidence and might spook both domestic and foreign investors who see them as substitutes for deeper reforms. Questions are now being asked about whether this government will continue on its path of liberalisation or reverse course when the going gets tough.

Indeed, one reason why India is caught up in the broader emerging market stresses, despite its blazing growth, is the postponement of reforms that could make the economy more productive. It is telling that rupee weakness has not translated into a larger boost to goods exports, reflecting the weak competitiveness of Indian industry.

With national elections looming next year, the prospects of essential but politically difficult reforms are receding amid growing fears that the government might engage in populist measures that expand the budget deficit. Ad hoc measures to open up the capital account are unlikely to bring in foreign capital unless they are part of a commitment to a longer term and durable relaxation of capital flow restrictions.

The Reserve Bank of India has wisely held its fire, recognising that aggressive interest rate rises would be less effective if seen as a panicky move to shore up the currency. The central bank's policy of not forcefully resisting market pressures on the currency, other than to smooth out excessive short-term volatility, has served the institution well in terms of its credibility and effectiveness.

India needs a well-thought-out package of reforms, with a short-term downpayment in the form of specific policy actions. Finance minister [Arun Jaitley](#)'s commitment to maintain fiscal discipline is a good start. But the real test is whether he can also take measures that would unshackle Indian industry, boost investment, and raise productivity. In tandem with such measures, rate rises could help to stave off concerns about inflation and stabilising the rupee.

The period of strong growth combined with calm domestic and external environments might be over. But Mr Modi's government could yet turn a time of stress into an opportunity for India.

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Feedback

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