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India: Big bang, or parting shot?

By Victor Mallet

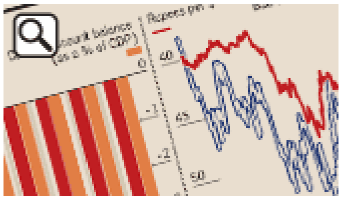
Manmohan Singh has rediscovered his zeal for reform but faces a test of strength

Market forces: small traders, such as these vendors in Uttar Pradesh, dominate the Indian retail sector. Many fear that plans to welcome foreign investors into the country will damage their businesses

Two weeks ago, frustrated business leaders and foreign investors had all but abandoned hope of any significant economic progress for India under Manmohan Singh, the supposedly reformist prime minister in power for the past eight years.

Mr Singh, who turns 80 today, surprised them all. With the tacit backing of Sonia Gandhi, powerful leader of the Congress party, the coalition government has since September 14 unleashed a barrage of economic reforms described as a big bang by Indian commentators.

First, the cabinet braved public anger with a sharp reduction in subsidies for diesel and cooking gas, pushing up the cost of diesel at the pump by about 14 per cent to curb a growing budget deficit. The following day, Mr Singh's government allowed foreign investors to build supermarkets and department stores and buy into



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local airlines, and announced the sale of shares in state companies in a relaunched privatisation programme.

Hardly a day now passes without some new initiative to promote investment and boost economic growth. On Monday – less than two months after an electricity grid failure that left 600m Indians without power in history's biggest power cut – the government unveiled a scheme to restructure over $35bn in debt owed by lossmaking state electricity distribution companies. These will now be pressed to take the politically unpopular step of raising prices.

Markets reacted quickly. The rupee, after a steep decline this year, has recovered some lost ground. Foreign investors have welcomed Mr Singh's rediscovered enthusiasm for reform, while Indian business leaders are euphoric. "From a famine of policy action we've moved to a feast," tweeted Anand Mahindra, the industrialist, after the first two days of announcements. "The government's got back its gumption! We cheer and urge that they stay the course."

Yet the reforms are not without risks for Mr Singh's government and for the investors who theoretically stand to benefit. The flurry of measures to bring order to the public finances and liberalise the economy has destabilised the Congress-led coalition, thereby increasing the chances of an early election in the world's largest democracy – and raising the possibility of a less business-friendly government in the future.

A general election is not due until the first half of 2014, but Mamata Banerjee, the populist chief minister of West Bengal and head of the Trinamool Congress party, has withdrawn her ministers and 19 members of parliament from the coalition in protest at Mr Singh's "anti-people" reforms, leaving him short of a guaranteed majority.

So why did Mr Singh, after years of inaction, take such risks so late in his second term as prime minister? The answer, according to senior Indian officials, is that he felt he had no choice. He believed that his own legacy to India – the modernisation and economic expansion bequeathed when as finance minister in the 1990s he dismantled the corrupt "licence Raj" – was in grave danger of being lost.

Retail: Mom and pop's gloomy prospects

It is mid-afternoon and Simrat Kaur, a 25-year-old housewife in New Delhi's middle-class Kirti Nagar neighbourhood, is pushing a trolley through the well-stocked aisles of the local Easy Day store, part of a retail chain owned by India's Bharti

Mr Singh, an economist who speaks so softly he can be hard to hear, repeatedly alluded to this legacy himself on television last Friday night in what was, for him, a passionate speech to the nation. He defended the economic rationale of the two most controversial decisions – to raise fuel prices and allow foreign retailers such as Walmart to own majority stakes in supermarkets and department stores – and said urgent action was needed so as not to deter investors and increase unemployment.

group and operated with Walmart of the US.

"Find a lower price, and we will match it," the signs say. As Bollywood songs boom over the sound system, a male voice declares: "More music and more fun at Easy Day."

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"The last time we faced this problem was in 1991. Nobody was willing to lend us even small amounts of money then," Mr Singh said. "We came out of that crisis by taking strong, resolute steps. You can see the positive results of those steps. We are not in that situation today, but we must act before people lose confidence in our economy."

Among the early signs that Mr Singh and Ms Gandhi were preparing to take action were the decisions last month to move the energetic Palaniappan Chidambaram back to the finance ministry, and to name Raghuram Rajan, the former chief economist of the International Monetary Fund and an outspoken critic of Indian corruption and bureaucracy, as the government's senior economic adviser.

Foreign investors, Indian business groups and international economists and analysts had publicly expressed concern about the economy's downward path. In private, senior members of the government and the bureaucracy were equally worried. They said the coalition, and even the Congress party itself, was divided between old-fashioned leftists and those who favoured economic liberalisation and competition of the sort that had brought success to Indian mobile telephony and domestic aviation.

It was "politically convenient" to blame the sluggish world economy for India's troubles, a senior financial official noted in August. But the real problems were lack of reform, a failure to invest in power and transport infrastructure, corruption scams, the fractious federalism of the Indian political system and a divided cabinet – in short, a "combination of economic and governance failures, largely domestic and self-inflicted".

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Particularly disturbing for the government was the sharp slowdown in economic growth – the year-on-year increase in gross domestic product dropped to 5.3 per cent in the first three months of this calendar year, compared with 9.2 per cent a year earlier and has since recovered to 5.5 per cent.

Then there is the fiscal deficit. With the rupee declining and world oil prices having risen, the government's fuel subsidy bill was set to exceed $35bn in the current financial year, contributing to a total public sector deficit of more than 8 per cent of GDP. Even after the latest price increases, Mr Singh told Indians in his speech, the government was spending more on fuel subsidies than on health and education combined.

Probably the last straw for Mr Singh was the threat that credit rating agencies would downgrade India's sovereign debt to "junk", or non-investment grade, over the country's inability to tackle its economic woes.

“We could tip if we’re not careful into something more dramatic, so there’s a sense of urgency,” said another senior official in New Delhi who favours reform. “What’s creating the space for doing these things is a growing sense of crisis.”

The government’s determination to take unpopular decisions less than two years before a general election suggests that India’s economic fortunes could indeed be at a turning point as significant as the 1991 reforms. But there are two important caveats voiced by business leaders and analysts.

First, the reforms unveiled so far must be entrenched before Mr Singh can claim victory. It was only last year that he hurriedly reversed an earlier opening of the mass retail trade to foreign direct investment following protests from politicians and shopkeepers. Indian bureaucrats, furthermore, are exceptionally slow to provide environmental and other permits required for such investments.

“Just announcing ‘Let’s have FDI’, let’s have investment’ is not going to be enough,” says Sidharth Birla, chairman of Xpro India, a plastics producer, and vice-president of the Federation of Indian Chambers of Commerce and Industry. “Unless we have good procedures, the investments are not just going to flow in, they are not going to be implemented or produce the desired results.”

The second issue is that the latest reforms amount to only a fraction of what local and foreign investors insist they need to ensure robust economic growth. They say piecemeal concessions to foreign capital are hedged with onerous conditions – on sourcing goods from small Indian suppliers, for example – and need to be followed with broader reforms to facilitate land acquisition, improve infrastructure and simplify the tax system.

“We say, ‘You’ve made a beginning by making these announcements. It’s a signal. But it’s not enough. If you’ve started the cycle, then please go ahead with many other things that are needed’,” says Mr Birla.

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A bruising political battle, or series of battles, lies ahead for Mr Singh. In his address to the nation, he tried to appeal over the heads of squabbling politicians to India’s 1.2bn people, but it is hard for the studious prime minister to compete with the charismatic rivals he accused of “spreading fear and false information”.

Subsidies and foreign retailing are the two most contested battlegrounds. The traditional Indian left, within the Congress party and outside it, reflexively supports state spending and opposes capitalism. The Hindu nationalist Bharatiya Janata party, the main opposition, is beholden to some 50m small shopkeepers and has therefore found itself in an opportunistic and temporary alliance with the secular left against Mr Singh – even though BJP leaders pushed through their own reforms when they were in power a decade ago.

And the increasingly influential regional politicians from states such as Uttar Pradesh and West Bengal are already in pre-election mode, contemplating their chances of joining a coalition led by Congress or the BJP, or of joining a left-leaning “third front” government.

The language used to attract India’s often poorly educated voters is far from subtle. While every politician professes to be working for *aam aadmi* – the common man – and Mr Singh talks of the benefits to farmers and consumers of efficient shops and supply chains and sound fiscal policies, his opponents sometimes resort to xenophobia and overblown rhetoric.

Sitaram Yechury, leader of the Communist Party of India (Marxist), accused Mr Singh of worshipping the US. “Congress wants Indians to be slaves, and foreigners to be our masters,” he told a protest meeting of small traders last week.

Like the politicians, investors from India and abroad – including Walmart, which wants to identify sites for retail outlets within 18 months – are now bracing themselves for months of haggling and confusion. Years may pass before they can look back and say for certain whether 2012 was as important for the Indian economy as 1991.

“These measures don’t fully resolve either policy or political uncertainty,” says Eswar Prasad, economics professor at Cornell University, commenting on the reforms that were announced over the past two weeks. “But they are an important step in reorienting India’s policies in the right direction.

“The Manmohan Singh government has drawn a line in the sand. It may end up with the government losing power and having to call elections in the next few months,” Mr Prasad concludes.

“But at least it’s been made clear that this is a government that will go down fighting. At least there’s a prospect of reform.”