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India in Free Fall

The rupee's plunge is yet another sign that New Delhi's dithering over reform must end.

By ESWAR PRASAD

The falling Indian rupee, which Monday closed at an all-time low relative to the dollar, is a perfect metaphor for the free fall India's economy seems to be in. Growth has slowed to below 7%, and industrial growth has virtually ground to a halt. High oil prices widened the current account deficit, and now finicky global investors are pulling capital out.

Prime Minister Manmohan Singh and his government face a stark choice that they can no longer avoid. They can batten down the hatches and try to get the central bank to intervene in foreign exchange markets to ride out the storm. Or they can heed the real message of the rupee's fall: India's policy making has lost its way. How the government responds will determine whether India's economy gets its shine back or slides into old "Hindu" rates of growth or worse after just a few years of stellar performance.

One problem is New Delhi's undisciplined fiscal policy, which has hurt confidence in both India's ability to weather adverse shocks and its long-term prospects. A high level of public debt—nearly 70% of GDP—and a persistently high budget deficit have pumped up overall demand in the economy. This hamstrings monetary policy, which has to keep tightening, and also contributes to the large current account gap. This leaves the economy vulnerable to shocks such as oil price increases and capital flow reversals.

Populism seems to be an overriding consideration in designing fiscal policy. This year's budget, released in February, lacks any ambition to bring down spending on subsidies and other welfare projects. Markets are concerned that, with national elections due by 2014, next year's budget will be no better. The temptation to lard it with populist measures may be too much to resist.

Finance Minister Pranab Mukherjee is now talking about "austerity," though he's suggested only meager measures. Yet even if he proposes something more drastic—like tax increases in the short term—that's not what India needs.

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New Delhi instead should clearly articulate an ambitious and detailed medium-term deficit reduction plan. This can be supplemented with short-term measures that would at least reorient government expenditures in a better direction. For instance, New Delhi could remove inefficient fuel subsidies, which mostly end up benefiting the middle class, and replace them with direct cash transfers to the poor. Such measures would rebuild some confidence by signaling that the reform momentum is not dead.

Indian Prime Minster Manmohan Singh.

A similarly urgent priority is to resuscitate broader reforms, especially those that make India a more attractive destination for foreign investment. Industry-specific regulation and caps for foreign investors are big deterrents. Rather than undoing these, however, New Delhi proposed policies in its March budget that scared investors even more.

The most worrying is the government's move to retroactively tax mergers or takeovers that involve Indian assets. Many see this tax change as a repudiation of a recent Supreme Court ruling that denied tax authorities the power to extract a $2 billion capital gains tax from British telecom giant Vodafone. Moves like this, whatever their justification, have left international investors with the impression that the rules of the game can be changed whimsically to suit the government's search for revenue.

More generally, New Delhi seems to lack the spine to push through reforms that would have broad benefits. Mr. Singh has done too much backtracking, such as his overnight retreat last year on liberalizing foreign investment in retail.

Policies regarding foreign investors usually whip up jingoistic sentiments in India, but the government hasn't even made repairs to its own systems. Reforms to the public-sector food distribution system, which is characterized by spoilage, inefficiency and corruption, could directly benefit the poor. Unfortunately, the narrative has been seized by those opposed to greater competition in food markets, who argue that it would lead to job losses.

The political constituency for reform is usually hard to find, but Mr. Singh now has the chance to articulate a rationale: that reforms are a must to revive growth and deliver more benefits to the poor. The government has in the past year resorted to half-measures, such as setting up manufacturing zones rather than reforming labor laws and regulations that have hindered the manufacturing sector. But the time has come to put everything on the line.

Of course, to prolong his political life, Mr. Singh could switch to survival mode for the rest of his term, clinging to power while devoting his energy to fending off accusations of graft and mismanagement. This would be a sad legacy for a man who put the country on a high-growth trajectory through reforms he instituted 20 years ago.

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