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India Is Still Waiting for Superman

Even if new central banker Raghuram Rajan works miracles with monetary policy, it will take more than one man to fix the economy.

By ESWAR PRASAD

The Indian economy is facing a rout. The latest data, which show growth slowing sharply, and a plunging currency have laid bare the fragility of the economy. Raghuram Rajan, who takes over at the helm of India's central bank this week, is being heralded as the savior the country needs.

However, it will take a lot more than one person, even if he works miracles with monetary policy, to stem the tide. Decisive action is needed on a number of fronts to revive growth and rebuild the confidence of domestic and foreign investors. Monetary policy can play an important role but not if it remains hamstrung by other policies that are working at cross-purposes. The central bank may be forced to raise interest rates further to defend the currency, but that would only hurt the economy if other policies don't take on the burden of supporting growth.

What can Prime Minister Manmohan Singh's government do to help Mr. Rajan manage this balancing act and turn things around? The path is clear. The government needs to use the looming crisis as an opportunity to break the political stalemate that has blocked far-reaching reforms aimed at enhancing productivity and building a stable foundation for growth. At a moment like this, it would be hard for naysayers to argue that reforms are not necessary or that their risks are greater than the potential benefits. But it takes political will to undertake reforms.

The government must use this moment of economic distress to do three things that would stem the rot, put the economy back on track to growth, and rebuild investor confidence.

First, the government needs to lay out a broad reform agenda for getting India back on to a high growth path—including eliminating stifling labor market regulations, freeing up channels for investment in public works, improving the education system, and bringing the budget deficit under control.

Munshi Ahmed/Bloomberg News

The incoming governor of the Reserve Bank of India Raghuram Rajan.

These changes would have both short-term and long-term benefits. For instance, removing onerous regulations that protect unionized workers would increase firms' flexibility in adjusting employment to changing conditions, which would encourage them to employ additional labor and benefit from economies of size. This in turn would boost India's manufacturing sector and increase its ability to take advantage of a falling currency.

While the government certainly needs to prioritize and pick its battles, it needs to signal commitment to a broad range of reforms. The time for half-measures is past.

Second, it is necessary to provide a down payment on these reforms. The government must rebuild momentum on some reforms already under way—including shifting to a cash transfer scheme in place of inefficient subsidies to help the poor, freeing up channels for capital inflows, and promoting further liberalization of the financial system. At this stage, even modest actions in the right direction can speak far louder than words and promises.

Mr. Rajan can help by encouraging entry of new banks into the financial system to promote competition and better service. He can also use his perch to encourage the rapid development of a broader set of financial markets, especially the corporate bond market to more efficiently channel domestic savings into productive long-term investments.

Again, there is a limit to how much the central bank can do if other policies don't play their part. Without disciplined fiscal policy, the central bank will find it much harder to manage inflation and to avoid banks being seen as a source of government debt financing and subject to political interference.

Third, the government should articulate the rationale for a broad package of reforms needed to revive the country's growth and deliver more benefits to the poor and lower middle class.

There is a widely held perception that most of the benefits of growth in recent years have largely gone to the elite, with the nexus between big business and politicians leading to a growing concentration of economic and political power. Meanwhile, rampant corruption and high inflation have hurt the poor, who have seen little trickle-down from India's vaunted growth performance. A bold strike against corruption and steps to provide broader access to the financial system would help spread the benefits of growth more evenly and create a broader political base for reforms.

The Indian economy is at a critical juncture and can no longer count on past reforms to continue pulling the country through in difficult times. Policy choices made in these difficult times will resonate for years to come. The danger now is that, faced with domestic and external peril, Indian officials batten down the hatches and hope the storm will blow over.

The government should re-energize the reform process rather than beating a retreat. That would be the best way to secure long-term growth that would ultimately benefit India's population, including the poor. And that is also the only durable way to bring foreign capital back in and keep domestic investors from bolting with their money.

Mr. Prasad is a professor of economics at Cornell University and a senior fellow at the Brookings Institution.