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Close-Up Report

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Gridlock:
The Real Risk to India's Economic Future
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Introduction

Writing on the global economic outlook in January this year, I made the point that the rapid and simultaneous rise of the emerging markets we had seen for over a decade is now history. How emerging markets will "emerge" in the future will depend on how hard and how well they work. While getting rich is very hard work, the challenges facing each emerging market are also different and so they will need to work more smartly as well. There will be winners and losers; some will get things right and continue to rise, but there will be no more "rising water lifting all boats" type of growth, as in the previous decade (see GEMS Bellwether Report, January 2013. The Future of Growth: The New Global Dynamics of Prosperity.) This has indeed happened.

But the recent slowdown in growth among emerging markets has also sent many investors running for cover and prompting others to predict a wholesale demise of emerging markets. Comparisons are repeatedly made with the 1997/98 Asian financial crisis, as if emerging markets in Asia and elsewhere are about to collapse. Such views are completely wrong.

The fundamentals today are totally different from 1997/98, regardless of how they are measured. It is true that emerging markets worldwide are under pressure from capital outflow, in part prompted by signals from the US Federal Reserve that it will begin to scale back its open-ended purchases of long-term assets, the operation known as quantitative easing. But the recent sell-offs of emerging markets' currencies, bonds and equities are also driven by some very ordinary cyclical dynamics.

The fact is that capital inflows to emerging markets surged in the decade of 2000s, and after a brief lull during the 2008/09 global financial crisis, rebounded strongly in 2009 and 2010. Worries over a total collapse in the Eurozone in 2011 again halted the inflow, which then rebounded in 2012 when the Eurozone appeared to have stabilized. In this last period, portfolio bond flows, which are the most sensitive to sudden shifts in investor sentiments, also accounted for the lion's share of total inflow.

> "How emerging markets will "emerge" in the future will depend on how hard and how well they work."

In the cyclical dynamics of global capital flows, the key variables of real growth differentials, interest-rate differentials, shifts in terms of trade, movements in real exchange rates and global risk aversion are closely intertwined. For example, an increase in real output combined with a relative rise in the price of exports tend to generate momentum for faster real exchange rate appreciation.[1] Rising exchange rates, under conditions of a bullish outlook, could encourage more capital inflows, which in turn drive up exchange rates further. This self-reinforcing process of exchange rate appreciation was indeed observed in many commodities exporting emerging markets in the previous decade. For many other emerging markets, faster growth and higher interest rates relative to the developed economies in the past also meant a strong attraction to capital inflows, and the enthusiasm for emerging markets was dampened only periodically during brief episodes of global risk aversion as in 2011 when the Eurozone crisis turned seriously nasty.

Capital inflows reflect foreign investors' enthusiasm for the

1 This is known as the Balassa-Samuelson effect familiar to university economics students.

country in question, especially in terms of its future prospects. Put bluntly, foreign investors' bottom line is that they should be able to take more out of the country sometime in the future than what they are putting in today. They get enthusiastic about a country when they see prospects that would make this possible. And their enthusiasm wanes when they see such prospects dimming. In other words, there is a self-limiting mechanism built into the cycles of capital flows. Rising capital inflows cannot continue indefinitely; they accelerate, then slow, then either stabilize or reverse direction. In general they show pronounced reversion to the mean. Depending on circumstances, when capital flows reverse, they could either slowdown gradually or crash spectacularly.

The panic reactions to slowing growth in emerging markets today are largely a consequence of investors' over-enthusiasm in the past. This should come as no surprise as it is in the very nature of the cyclical dynamic. It does not help that many investors are also waking up to the fact that a great deal of the observed growth in many emerging markets (commodity exporters especially) did not come from real expansion of economic output, but only as a result of faster domestic inflation (compared with the US and Western Europe), increases in export prices (in US dollar terms) and exchange rate appreciation, as per the Balassa-Samuelson effect.

The panic is subsiding, however. This is because the economic fundamentals in many emerging markets, in Asia in particular, are so different from those of pre-1997/98 crisis for anyone who cares to take a closer look. Virtually all have much stronger foreign currency reserves, lower current account deficits and lower short-term external debts[2] . Importantly, most currencies in emerging markets today are no longer pegged to the US dollar and their ability to adjust according to market forces eliminates a major risk. For example, before the 1997/98 Asian crisis, the Thai baht, the Malaysian ringgit, and Indonesian rupiah were pegged to the US dollar. Given their high exposure to foreign short-term debts relative to the size of their foreign reserve at that time, this was a serious vulnerability. In contrast, the floating foreign exchange regime that is more prevalent among emerging markets today provides an automatic stabilization mechanism.

Thus, the over-reaction to the slowdown in growth in emerging markets generally (and to those in Asia in particular) reflects a disconnect between sentiments and fundamentals. In fact, over the longer term, reducing some of the very frothy excess liquidity in emerging markets is a good thing. It is part of the much needed global rebalancing. And as difficult as it is to see now for emerging markets that are facing upward pressure on interest rates and downward pressure on exchange rates, exiting the world of zero interest rates and super-abundant capital inflows is a prerequisite for achieving better quality and more sustainable growth in the coming years.

What about India?

India: 1991 Revisited?

The gradual retreat of the Indian economy in the recent past turned into a route when the rupee dropped to record lows against the US dollar recently, down by some 18% between April and August this year alone. Just as it became voguish to compare emerging markets in Southeast Asia with their situation just before the 1997/98 crisis, many are pondering if India is repeating a similar descent that led to its 1991 balance-of-payments crisis. And just as it is wrong to compare Asia now with 1997/98, it is a mistake

2 Indonesia and India stand out as their current account deficits are not only bigger, but also more structurally entrenched.

to try to understand what is happening in India today in terms of what led to the 1991 crisis. Such a comparison is not only wrong, but it also misleads. It distracts us from focusing on the real crisis that is brewing in India today.

To begin with, India's economic fundamentals are vastly different from its pre-1991 days. Superficially there are resemblances between the two periods: a sharp widening of the current account deficit, high short-term debt, increased political uncertainty and worsening fiscal deficit. But a closer look reveals important differences which are summarized in Table 1. Fiscal deficit as a percentage of GDP is actually lower in 2013 than 1991, even though the current account deficit is slightly higher. But the service sector, which is less volatile than industrial production and agriculture, now accounts for a significantly high share of GDP; and so are exports. Most significantly, the short term debt to reserve ratio is dramatically lower.

Among the short-term external debts of US$172 billion estimated as of March 2013, some US$87 billion is related to short-term trade credits, while US$50 billion is Non-Resident Indian deposits, which are known to be very stable, and only US$5 billion is sovereign debt. While it is reasonable to expect that there will be some pressure on the US$30 billion of long-term overseas corporate borrowing coming up for redemption in fiscal year 2014, the overall situation is very manageable, even if some of the foreign debts are not hedged.

In 1991 India was very much a closed economy. Today, remittances and software exports fund over half of India's trade deficit. In 1991 India's capital inflow was dependent primarily on debts. Today the economy is much more open to capital inflows of all kinds. For instance, inflows that are considered stable such as remittances, foreign direct investment, deposits by Non-Resident Indians, and incomes from service sector exports today account for almost 85% of total inflow, versus 55% in 1991. Foreign reserves today can cover about seven months of imports, compared with about one month in 1991 (which was what triggered the crisis). The total reserve of US$270 billion is higher than the total foreign short-term debts of US$172 billion.

So India is not facing another 1991 crisis. Focusing on comparisons with 1991 would distract us from seeing the real risk to India's economic future: a state of gridlock that is paralyzing the Indian economy. Take inflation as an example, which is a serious concern whether measured from the perspective of the producer or the

Table 1: Comparisons between 1991 and 2013

	FY 1991	FY 2013 (e)
Fiscal Deficit as % of GDP	9.2%	7.3%
Current Account Deficit as % of GDP	3.8%	4.6%
Services as % of GDP	50.0%	66.0%
Exports as % of GDP	5.7%	16.7%
Short Term Debts to Reserve Ratio	277%	62%

(CEIC)

consumer. Stubbornly high inflation has become chronic, which is a direct consequence of persistent supply side constraints due to poor infrastructure and insufficient investment in industrial capacity in the right sector and in the right place; the government's appalling inability to increase power generation being a case in point. It is also a direct consequence of persistent excess demand because of increasingly prevalent subsidized consumption funded by government deficits. It is not just the poor who are now getting used to and expect more government handouts; the general public is also addicted to free lunch of one kind of another. So the problem of persistent inflation is no longer just a monetary phenomenon, but is deeply embedded into the fabric of India's political economy; and is a particular manifestation of the gridlock[3] . But the state of gridlock in India goes far beyond persistent inflation.

Gridlock: India's Real Risk

It now seems an age ago when the Congress-led coalition returned to power with a massive victory in 2009. It then had the mandate and the ability to push for deeper economic reforms. But it felt it didn't need to, since India was, like many other emerging markets, awash with liquidity and growth was accelerating. And senior members of the Congress party, led by Sonia Gandhi as the party president, concluded that they won the election because they did better than their rival the Bharatiya Janata Party (BJP) in distributing government largesse and offering subsidies and handouts, all done under the unassailable "pro-poor" policy stance.

> "As growth receded, all sorts of problems started to show."

The result was a grievously missed opportunity. With growth at record high, deeper reforms and market liberalization would have been easier to introduce as well as securing parliamentary approval, had they been the government's real policy priorities. In spite of strong growth, there were urgent needs to liberalize the markets for labor, energy, and land; and for fast tracking investment to improve infrastructure. Indeed these needs remain and are more urgent now than before. But clearly these are not government's priorities. Instead, politicians and senior bureaucrats basked in the glory of strong growth, taking credit for it whether justified or not. Their trade-mark arrogance turned to pomposity, collusions with corrupt businesses grew worse and the red tape got thicker and tighter.

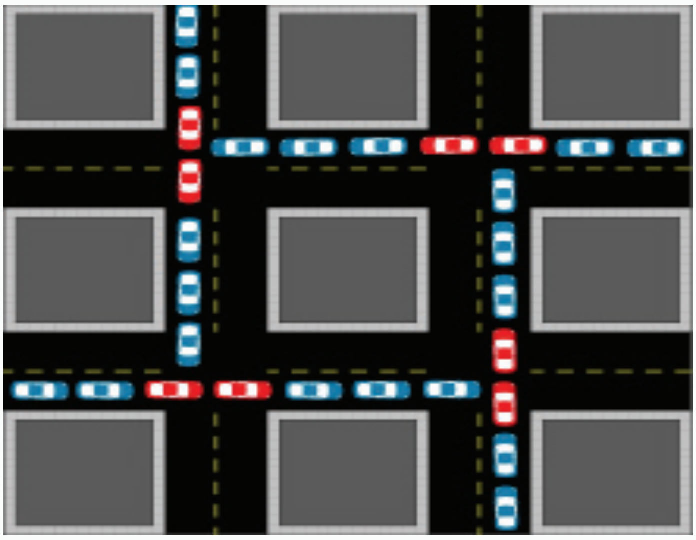
As growth receded, however, all sorts of problems started to show, much like an outgoing tide exposing ugly debris littering the beach. It turns out strong economic numbers had not come with inclusive growth, and there is a palpable groundswell of public anger, often vented against the few corrupt politicians, bureaucrats, and businessmen clumsy enough to get caught red-handed. Unfortunately, public anger was also directed against the government's few, and timid, attempts at market liberalization, such as in the retail sector. The government quickly retreated, and the political class has since simply avoided tough choices.

India, being a vibrant and chaotic democracy, has a dynamic civil society, and a noisy and independent media. A plethora of NGOs took up a multitude of causes on behalf of victims of unbridled development and corrupt collusions

3 In this context, while the appointment of Raghuram Rajan as governor of the Reserve Bank of India is an excellent move, neither Rajan nor the RBI will be able to do much to alter the current state of India's political economy. There is no question that Rajan is capable, understands what is holding back the Indian economy, and has all the right intellectual credentials and stamps of authority to lead from the front. He will try to advance the internationalization of the rupee, to liberalize the banking sector and increase competition, and support bold innovations in the financial market. But there is only so much he could do at the RBI since the state of gridlock in India encompasses electoral and even dynastic politics, the civil society and the judiciary.

between businesses, politicians, and the bureaucracy, real or imagined. For many activists drawn from the urban middle class, the courts become the avenue of choice for seeking justice. At the level of the High Courts, many judges are also sympathetic and eager to hear such cases. This in turn allows the media to keep alive in public a running tally of alleged wrong doings of the political class, the bureaucracy, and the rise of India to greedy profit-seeking operators who trample the public interests in their unscrupulous money-grab. Understandably, many business leaders prefer a lower profile and others are cowed into silence. This is most unfortunate as the silencing of the business sector deprives India, at this critical juncture, of an important counter-balance to its lingering attachment to socialism in the public discourse. risking more investment in the domestic economy either, especially in light of an increasingly hostile public and rising political uncertainty. Thus, there is a spreading paralysis in terms of reforms and investment. A more interventionist court further intimidates everyone, tilting the balance toward inaction, rather than action. The end result is a state of gridlock.

Chart 1: An Illustration of Traffic Gridlock



big businesses; portraying them invariably as corrupt, venal and inefficient.

The fall from grace in the public perception of the business sector was especially dramatic. Overnight, they went from world-beating champions who symbolized

As a result, the bureaucracy now sees absolutely no upside in sticking its head out to make any hard decisions and to risk offending various interest groups. The business sector itself, already hurting from a combination of slower growth, a weaker rupee and higher cost of funds, sees no upside in

The term gridlock was first introduced to explain a particular phenomenon of traffic jam, as illustrated in Chart 1. Traffic is jammed up because of the vehicles blocking the four intersections. No one could move because the "offending" vehicles (shown in red) themselves cannot move. This is an apt analogy for India today as the four intersections conveniently represent the four key sets of actors in India's political economy: the political class focusing on the short-term and for their re-election, the bureaucracy retreating inside its hard shell of inaction and recalcitrance, the judiciary becoming more interventionist and the business sector, sapped of its animal spirits. Being stuck where they are, they also prevent the others from moving. The entire society is stuck, stifling all reform initiatives. The analogy is even more apt when we think about the hundreds of vehicles in a gridlocked traffic jam, all with their engines running and making a lot of noise and pumping out exhaust fume, but not going anywhere.

There is another characteristic of a gridlock that applies to today's India: in a strange way, a gridlock is a system in equilibrium in the short term. Because no one is moving, everyone is resigned to being stuck (it would be pandemonium if the traffic suddenly opens for just one vehicle to pass through). Of course, this short-term equilibrium does not lead to a solution to the gridlock. If the gridlock persists, the system will eventually break down. In a traffic jam situation, some vehicles may run out of fuel, some drivers may abandon their cars and walk away and a few may even try to push their way through by driving on the pedestrian sidewalk, etc. So the short-term equilibrium of a gridlock is illusory, it is actually a prelude to complete chaos and disaster. At risk of pushing the analogy too far, it appears that this is where India is at now, a period of illusory equilibrium induced by gridlock, which allows all the key actors to make lots of noises without actually risking anything or trying to accomplish anything. Meantime, the longer the gridlock continues, the more trouble is stored up for later on.

> "[Gridlock] is an apt analogy for India today ... the entire society is stuck, stifling all reform initiatives."

This state of affairs is best illustrated by the two major pieces of legislation that the Indian government and the parliament managed to pass recently. The first is the Food Security Bill (FSB), and the second is the Land Acquisition, Rehabilitation and Resettlement Bill (LRRB). They are the products of the gridlock in India's political economy, because they both allow politicians to grand stand and take the moral high ground while avoiding hard decisions on market liberalization and reform. These Bills allow the political class to pretend to be doing something important without fighting a real battle; they aim to please everyone and offend no one (at least no one really important as far as their re-election is concerned), while leaving the mess created by the Bills for someone else to clean up later.

The FSB is supposed to guarantee minimum quantities of food (cereal grains such as rice and wheat) at subsidized prices to about 800 million Indians. The scope of the FSB is in itself astounding – 800 million people are about two-thirds of the population of India. Subsidized food for two-thirds of the population? But this is precisely the only kind of policy that can be produced when the political economy is in gridlock. It allows the government to burnish its image as a defender of the people (it can now claim to have acted to provide the Indian people with a constitutional right to food); it neuters political opposition (no Indian politician would commit political suicide by denying food security to 800 million Indians) and it does not tangibly hurt any powerful interest groups, at least not right away[4]. It does nothing to progress economic reform, of course. In fact, it is storing up massive troubles for the future, the least of which is to worsen the already terrible state of the government's fiscal position.

The absurdity as well as vacuity of the FSB is laid bare when you understand that the Indian government is already intervening extensively in the food grain market in the rural sector. The Public Distribution System, which is run by the state governments, has the mandate for procuring cereals, oil and fuel for sale to poor households at subsidized prices. In procuring these stables, the state governments are the sole buyer in rice and wheat, which allow them to effectively control and set the purchase price of the cereal trade in India. Farmers are not allowed, for example, to independently sell their grains overseas even if the international prices are higher than domestic prices. It is widely believed that the Public Distribution System is very inefficient, wasteful and riddled with "leakages". Because of the purchase prices are increased each year based on recommendations of the Commission for Agricultural Costs and Prices for the obvious reason of political expediency (the farmers are a major "vote bank") food prices then rise for everyone who is not on the Public Distribution System. Meantime, due to a very inefficient distribution system (apart from corruption), the state of India is sitting on an ever growing stockpile of food grains each year, most of it poorly stored, easily spoiled and pilfered, and steadily eaten by rodents.

The FSB essentially seeks to extend this dysfunctional system to make it even bigger. But who could argue against standing up for the every Indian's right for food security? And not many people seem to be asking what the Bill will cost the government. And the government's stance is that it is not a question of cost, but a question of whether the government has the will to find the resources to ensure that 800 million Indians are properly fed (so said Sonia Gandhi in her speech to the parliament in urging members to support the Bill). A few intrepid souls did try to work out what it may mean in fiscal terms,[5] but their voices are no match for the thundering political rhetoric. While cost is a serious issue, it probably fades in significance in terms of long term damage to the economy when compared with the effects of market distortion. With the passing of the FSB, the cereal and food grain markets in India are effectively state-run. Prices are no longer able to function as critical signals that mediate demand and supply; and by extension, for allocation of investment in India's rural sector. The FSB could potential shackle an important segment of the India's agriculture to long term stagnation.

Hot on the heels of the FSB came the LRRB. The opposition BJP supported the Bill, just as they did for the FSB, enabling them to become Acts of Parliament. Just like the FSB, the LRRB has staked out a position that is unassailable in India's gridlocked situation today. It makes sure that it has something for everyone that matters: it aims to cater to every potential interested party that may be affected by land acquisition, except for one of the most important actors, the business sector. But the business sector is thoroughly cowed, and does not really count for re-election purposes. The result is a Bill that will prove to be extremely costly and counter-productive for India. Instead of fast tracking infrastructure development, it will further retard it. It is symptomatic of India's gridlock.

4 One does not have to be a cynic to appreciate that the FSB would be used to support Congress's bid to be re-elected in 2014. The government strategically waived loans owed by farmers to state-owned banks in 2008, which helped securing farmers' vote in the 2009 election. They are clearly preparing to repeat the success for 2014.

5 For example, Surjit Bhalla, a Delhi-based independent economist, came up with a figure of 3% GDP per year. For example, Surjit Bhalla, a Delhi-based independent economist, came up with a figure of 3% GDP per year.

The LRRB makes land acquisition extremely difficult, time-consuming, and uncertain for infrastructure development, be it a public or private project. It is actually worse for private sector projects; it has special provisions on rehabilitation and resettlement that apply only to private sector development that exceed acquisition of 50 acres of urban land, and 100 acres of rural land. And, under certain conditions, these provisions can be applied retrospectively. The LRRB also prescribes how compensations are to be estimated, using multiples of estimates – supposedly at "market value" -- of the land to be acquired in the absence of actual market transactions that can substantiate such estimates. There are also extensive provisions for the bureaucracy to demand impact assessments, involving multiple ministries and agencies, which is a perfect set-up for entangled red tape, delay, and bribery.

"The conditions that created the current state of gridlock may not change substantially"

More seriously, the LRRB provides for ample opportunity for legal challenges to any proposed land acquisition. This is, of course, meant to satisfy a wide array of interest groups from activist NGOs to tribal communities, to reassure them that their interests are well looked after (again, with the notable exception of the business sector). But this is also playing with fire given the speed (i.e. the lack of) at which India's judiciary moves. India's has 13 judges per one million of population, versus 50 in OECD countries and around 35 to 40 in emerging markets. At the Supreme Court, there were 58,519 cases pending in 2011, and it increased to 66,569 cases pending in 2013.[6] Making the outrageously optimistic assumption that it takes one Supreme Court judge only one day to adjudicate on one case, and assuming each judge works 200 days per year, it will take 12 years for the Supreme Court to clear its backlog, assuming no new cases being added. And it is to this system that the LRRB resorts for "facilitating" land acquisition.

To repeat, the LRRB is set to make land acquisition difficult, costly, time-consuming and riddled with uncertainty. It is introduced at a juncture where the business sector's animal spirits are sapped, and the economic ills stemming from India's widening infrastructure deficit are worsening. It will make India's infrastructure worse, not better, in spite of its grandiose claim of serving the national interests. Together with the FSB, it has the effect of seriously eroding India's long term growth potential. Sadly, they are also the products of the gridlock in India's political economy, which is the real risk to India's economic future.

With the national election looming in 2014, could the gridlock be eliminated after the election? I claim no expertise in predicting India's electoral outcome. Simply based on what happened in the various state and local elections over the past two years, it seems unlikely that the 2014 election will bring about a strong new government with a convincing majority. Thus, the conditions that created the current state of gridlock may not change substantially if the 2014 election produces another coalition government with an equally fractured parliament.

6 Data came from Pranav Garimella, "How a third of India's judiciary just does not exist", September 5, 2013; in the Online Journal India Spend.

That being said, the upside is that the gridlock does not suggest permanent damage to the roads and the vehicles, not yet. All it takes is for the traffic police to arrive and take charge decisively for the traffic to flow again. It is a very different matter entirely should the gridlock persist for another two years. Then, the damage to India's fiscal account, its investment climate and productivity may well become deeply embedded and difficult to remedy, with dire consequences for India's long term economic outlook.

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