Addressing the Bigger Concerns in Indian Economy

What is the issue?

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A freefall in the rupee or a massive current account deficit would be symptoms of some other underlying serious issues.

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Where should the focus be?

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- Among the sources of economic growth, investment is a fundamental variable.
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- These may include people, knowledge bases, institutional capacity or the obvious physical capital itself.
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- The efficiency of the process of savings generation and channelizing them into productive investment is crucial for sustained economic growth.
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- This is often taken for granted, but focusing on this draws attention to India's biggest economic problem.
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How has India performed in this regard?

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- Since the 1991 reform period, India has made considerable progress in facilitating investment.
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- It has removed unnecessary and inefficient controls on international and

domestic trade and investment.
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- It has slowly improved the functioning of its tax system, management of public finances, and monetary policy.
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- But there are still some serious issues that hamper the sustainable growth.
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What are the persistent problems?

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- **Allocation of capital** - India's biggest economic problem is the inefficient allocation of capital.
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- Bad loans in the banking sector have been one symptom of this problem.
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- E.g. the latest Infrastructure Leasing and Financial Services (IL&FS) crisis, which defaulted on some of its debt obligations.
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- The common factor in these cases is the long-term lending for large projects.
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- These are subject to high risks, because of their scale and their length of gestation.
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- **Banks** - Banks were, in fact, pushed by government in the direction of longer-term loans for fixed capital investment.
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- They were diverted away (at least in relative terms) from working capital and household loans.
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- Worryingly, this happened in banks without the internal expertise required for assessing the most challenging type of lending.
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- **Government** - The Indian government failed to create a regulatory framework.
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- This would have detected the incipient problems in systemically important firms such as IL&FS.
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- **Corporate governance** - Poor corporate governance is a major cause to this whole capital allocation mess.
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- This includes financial intermediaries such as banks and non-bank financial companies and also the firms that do the borrowing.
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- In India, there seems to be a common problem of skimming funds (form of tax evasion), by business borrowers and politicians.
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What could be done?

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- **Markets** - Indian banks should be given more freedom to tap bond markets for funding longer-term loans.
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- This will allow markets to send better price signals about bank portfolios.
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- There is a dire need for a corporate bond market in India that will allow firms to borrow more directly from savers.
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- This does not stop at long-term borrowing, but other short-term borrowing can also benefit from new market platforms.
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- **Regulators** - As financial markets are broadened and deepened, the demands on regulators increase.
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- India's financial system regulatory architecture also needs to be enhanced.
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- This involves not just external oversight by financial regulators but also strong corporate governance, with greater disclosure and transparency.
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- Auditors and rating agencies also need to step up and do their jobs better.
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- The government can facilitate this by raising and enforcing standards for the private sector monitoring institutions.
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- The challenge now is moving beyond improving fiscal policy or monetary policy and addressing the political component too.
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Source: Financial Express

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