

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.
- 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.

• It has slowly improved the functioning of its tax system, management of public finances, and monetary policy.

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 \bullet But there are still some serious issues that hamper the sustainable growth. $\mbox{\ensuremath{^{\text{Nn}}}}$

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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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- \bullet Bad loans in the banking sector have been one symptom of this problem.
- E.g. the latest Infrastructure Leasing and Financial Services (<u>IL&FS</u>) crisis, which defaulted on some of its debt obligations.
- \bullet The common factor in these cases is the long-term lending for large projects. $\ensuremath{^{\backslash n}}$
- 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.
- **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.

• In India, there seems to be a common problem of skimming funds (form of

tax evasion), by business borrowers and politicians. \n

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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.
- There is a dire need for a corporate bond market in India that will allow firms to borrow more directly from savers.
- This does not stop at long-term borrowing, but other short-term borrowing can also benefit from new market platforms.
- Regulators As financial markets are broadened and deepened, the demands on regulators increase.
- India's <u>financial system regulatory architecture</u> also needs to be enhanced.
- This involves not just external oversight by financial regulators but also strong corporate governance, with greater disclosure and transparency.
- Auditors and rating agencies also need to step up and do their jobs better.
- The government can facilitate this by raising and enforcing standards for the private sector monitoring institutions.
- 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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