Opinion **beyondbrics**

India's growth threatened by rising oil prices

Pressure on the budget and currency likely to hamper investment

Indian prime minister Narendra Modi should take advantage of tension between the US and China to promote his 'Made in India' policy to foreign investors © Reuters

Vik Mehrotra of Venus Capital 4 HOURS AGO

India is right to be worried about rising oil prices. Dharmendra Pradhan, oil minister of the world's third-largest energy consumer, has sought assurances from his counterpart in Saudi Arabia that the Opec producers and Russia will ensure ready supply in the face of growing global uncertainty. Unfortunately, the Saudis may have other ideas.

Cheap oil has helped India to boom in recent years. But upward pressure this year on oil prices, which have been bumped yet higher by stalled Venezuelan production and uncertainty over US sanctions on Iran, threatens the country's storied economic miracle with the dual problem of increasing its budget deficit and putting pressure on the rupee.

Even as it scrambles to increase tax collection, Narendra Modi's government looks highly unlikely to meet its deficit target of 2 per cent of gross domestic product this year.

It is a major issue for a country with strategic ambitions to match China's growth. Mr Pradhan is under pressure to reduce the price at the pump for ordinary Indians and will make an announcement soon. But it won't be enough. As Mr Modi looks to his re-election bid next year, the country faces a series of economic headwinds, which could well cause the cherished GDP growth number to fall below that of China.

Credit conditions for private companies, which should be driving India's consumption boom, are dire and getting worse. Bad loans by India's public sector banks have left almost all of them with non-performing assets of 20 to 22 per cent and in desperate need of recapitalisation.

Several chief executives have been asked to resign from public and even private-sector banks. Urjit Patel, the central bank governor, says he cannot control 70 per cent of the banking system. And a high-profile fraud at Punjab National Bank, which has rocked the financial establishment, has made credit officers even more reluctant to lend money.

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So capital formation and expenditure from the private sector is low and the government is trying to fill the gap by spending money. Much of what we are seeing in terms of GDP growth — the most recent figure of 7.4 per cent appears higher than China's at first glance — is being driven by rises in public expenditure rather than growth in the real economy.

Meanwhile, the strong dollar and rising rates in the US have started reversing fund flows to emerging markets, which could badly hit the rupee.

What can be done? Monetary policy is as loose as it can be, so the central bank should be adopting a much more hawkish stance. But it has been struggling to retain its independence, which sets a dangerous precedent. Three of the five members of the monetary policy panel are appointed by the government; if political pressures are allowed to drive their decisions, it could have a serious negative effect on the economy in 2018, particularly as the trade deficit rises and the rupee remains under pressure. Inflation is also bound to increase in the coming months.

Next, there is room for much greater leniency in fiscal policy, which until now has been driven by the government's obsession with increasing tax collection and bringing more people into its scope. A couple of well-pitched tax breaks to small and medium-sized businesses, for example, would help ease some of the financial constraint they are under and allow them to cater more competitively to India's army of price-conscious consumers. That would be a welcome gesture for Indian businesses following Mr Modi's disastrous demonetisation policy, which failed to reduce corruption and sucked liquidity out of the system for the small business sector.

Finally, if the government is serious about competing with China, it should use that country's looming trade war with the US to its advantage. One of the pet projects of Mr Modi's government has been its "Made in India" policy. The tension between the US and China means now is the perfect opportunity to convince Fortune 500 companies to come and base their manufacturing operations in India, which, unlike its competitor, is increasingly showing its values are aligned with the western world.

The old view that China would become more like the west is now long-discredited, and the Indian government should seize the opportunity to advertise itself to the world. Despite the economic headwinds it faces, India's underlying demographic fundamentals remain very strong, with half the population under 25 and eager to enjoy the fruits of economic success.

That success can be Mr Modi's legacy — but he has some work to do to achieve it.

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