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Will Modi's arrows hit the mark?

Prime Minister Narendra Modi: his government has renewed optimism for India's recovery.

ALOK SHEEL

A VISIONARY new leader, Narendra Modi, has recently come to power in India. He seeks to realise India's huge growth potential and make it a major global player. This has generated enormous optimism nationally, and internationally, about an Indian resurgence. What challenges must India overcome to achieve this?

At the turn of the 20th century, India was struggling to free itself from colonial rule. A century later, on 4 September 1999, *The Economist* despaired at India's untapped potential, labelling it 'the world's biggest under-achiever'.

Shortly after, India became the second fastest growing major economy in the world. Foreign investments surged. The popular account of India's story was that India was a big and fast-growing economy with a young demographic profile. It had an abundance of cheap labour with huge scope for large productivity shifts. Its entrepreneurs were in the forefront of the IT revolution and in leadership positions in transnational corporations. The only hurdle in the way of India's economic take-off was the lack of structural reform.

But a rising tide lifts all boats. The opening decade of the 21st century was also a period of unprecedented global growth. Be it as it may, India, along with China, also weathered the early blows of the global financial crisis of 2008 reasonably well. As China struggled to rebalance its economy, India's resilience was attributed to its greater reliance on robust domestic demand as its engine of growth. India seemed to have, at last, taken off.

But, beginning in 2011, the Indian economy went into a downward spiral of almost 12 successive quarters of falling growth, including several quarters of below 5 per cent growth. Several near-term indicators—such as industrial production, agriculture, exports and the real estate sector—remain depressed. Uncertainty surrounding US monetary policy threatens the recovery. Inflation and the current account deficit have declined impressively, but this is consistent with both low demand and sound macroeconomic management.

The Modi government has renewed optimism in India's recovery. There is a broad consensus that structural reform should centre on three critical economic policy arrows, and the new government seems intent on pursuing these. The first arrow is agriculture, where major market failures have made consumer price inflation endemic. The second arrow comprises the clutch of reforms to facilitate labour-intensive manufacturing to make the government's 'Make in India' campaign reality. The third arrow is fiscal restructuring to free up taxpayer resources for major investment in physical and social infrastructure.

These policy arrows need to fire from a robust bow of good governance that breaks loose from the extant bureaucratic and political system that has hobbled the delivery of policy in the past. State dominance over economic activity has led to inertia and corruption at each step for decades.

BUT is it possible that India could once again miss the bus? Is India still the world's biggest under-achiever?

The vast potential of India is undeniable. It is often traced back to the time before the Industrial Revolution when India and China were the biggest and most prosperous economies in the world. There were good reasons for this dominance. The Indo-Gangetic floodplain was one of the most fertile and productive in the world. It supported population densities rivalling industrial counties in nineteenth-century England. Seed-yield ratios for major cereals were about 2–3 times those in late medieval Europe. There were two crops year after year without fallowing, compared with every three years under the three-field system in Europe.

These high levels of productivity spawned a sophisticated division of labour. Unsurprisingly, India stood at the centre of the two dominant ancient trade routes—the Silk Road and the Indian Ocean. On the eve of the Industrial Revolution India was the biggest exporter of cotton textiles.

Following the unprecedented and rapid productivity shifts of the Industrial Revolution, India fell far behind Western economies. This led, almost inevitably, to imperial domination.

India nevertheless bounced back to be at the forefront of anti-colonial movements from the late 19th century. When it finally attained independence from foreign rule in 1947, it was one of the most advanced 'developing countries'. The foundations of a modern infrastructure of metalled all-weather roads, canals and railways had been laid and there was a strong indigenous modernising impulse.

But, a growing East Asia left India far behind. In 1980, income per capita in China and India was roughly the same. Today China's is 4–5 times higher. This is perhaps what inspired the damning verdict of *The Economist* and now gives one a sense of déjà vu.

So what can India do to achieve its potential?

Beyond the three major structural reforms there are, arguably, three fundamental factors holding India back. These operate at three interrelated but heuristically distinct planes: economic, cultural, and social.

On the economic plane, the chief constraint is the failure to strike the right balance between the market and the state. There is a close correlation between economic freedom and high median per capita income. The reason for this is startlingly simple: free markets and trade maximise efficiency and productivity growth through the time-tested principle of comparative advantage. The world's fastest growing economies started growing rapidly only after opening up.

Fear of the market has long pervaded economic policy and civil society in India. This fear has tilted the balance between the market and the state sharply towards the latter, undermining economic efficiency and productivity growth. Crony capitalism, or rent seeking, was the direct outcome of this imbalance. Despite significant economic liberalisation since the early 1990s, India remains among the most protectionist, economically unfree and challenging business environments. It is still not clear whether the new administration would open up markets or try and emulate the East Asian statist model of command and control capitalism that may yield spectacular returns over the short run.

THE state no doubt has a critical role to play in regulating markets and providing public goods. Adam Smith noted that participants tend to abuse the market, necessitating state intervention. But there can also be state failures and markets often fail because of excessive state intervention. Agricultural commerce in India that prevents farmers from selling directly in the open market is a case in point. Like all monopolies, state monopolies risk becoming inefficient in the absence of competition, and are also eminently corruptible

But even as the state has overextended itself in market regulation, control and substitution, it has not invested sufficiently in critical physical and social infrastructure, where private enterprise has much less of a role to play. This has constrained productivity and income growth.

While the fear of markets has tended to limit efficiency and productivity gains, India's predominantly inward orientation has constrained competitiveness in a rapidly integrating global economy. India is now an outlier among emerging market economies in running structural current account deficits.

Despite the far-reaching trade reform of the early 1990s, India remains one of the most protectionist of the world's major economies. This inward orientation is difficult to fathom because of India's strategic location between East and West and the global spread of India's entrepreneurial diaspora. Also, whenever India has engaged economically with the world, whether through merchandise trade in pre-modern times or through services trade today, it has consistently been a world leader.

This insularity was best articulated over a thousand years ago by the Arab scholar al-Biruni who suggested that Indians did not feel the need to learn from the rest of the world, or indeed to engage with it intellectually.

This sense of Indian exceptionalism and inward orientation persists to this day, including amongst fringe elements in Modi's own party. While East Asia scours the world to learn and implement global best practices in a bid to catch up rapidly, India seems to think that it is different, has little to learn from the experience of others and must chart its own unique policies. There is, of course, no need to uncritically follow everything Western, but if India is to tap its potential, and not fall behind yet again, it needs to engage more with the outside world—both West and East.

India must also address social inequalities that limit equal access to opportunities.

A GOOD way to underscore the critical importance of social constraints is to ask why the third largest economy in the world—and the world's biggest democracy, comprising about one-sixth of humanity—struggles to win a single gold medal at the Olympic Games. Does this reflect a lack of talent or a lack of opportunity?

The caste system has long been a defining feature of India. It segmented society into communities with limited social contact and gave asymmetric, hierarchical access to opportunities.

Extreme forms of socio-economic disenfranchisement, such as untouchability, have loosened considerably, especially in fast-expanding urban spaces. But the lingering effects of the caste system still segment access to opportunities and undermine the dignity of labour in civil society at every level. It is difficult to explain to Westerners why the lady of the house and the maid cannot sit together at the same table over tea and engage in small talk, woman to woman.

A startling outcome of these lingering effects is India's poor human development indicators. On average, even sub-Saharan Africa does better nowadays. This cannot be attributed to scarcity of resources because the state has pampered a large middle class, at the expense of investment in social infrastructure for those on the margins of society.

Yet it is not the moral argument against inequality—strong as it is—that needs to be underscored, but the economic one. A large chunk of the population is denied opportunities for educational and skills advancement. The full potential of the nation's enormous talent pool cannot be tapped.

India's poor performance in the Olympic Games is only one symptom of its overall underachievement according to global benchmarks. This extends to basic student skills in rural schools, the output from our higher and technical education institutions, research, and various areas of economic activity. India's best talent may be invisible because it is not given an opportunity to develop and achieve.

This is yet another area where the state–market balance has floundered. The state has tried to equalise outcomes through reservations, regulation and poorly targeted redistribution that puts increasing restrictions on the market. Instead the state should put in place the infrastructure to equip every individual to effectively compete and expand incomes under a market framework. The tendency to shift the burden of social protection from state to non-state market participants, such as private corporations (through stringent labour laws) and schools (through a quota system) has resulted in a vicious cycle of decapitalising affected sectors or pushes them towards informality. This depresses investment, productivity and growth, and further constrains tax revenues that could be used to redistribute resources.

FREE markets do not, of course, lead to equality of outcomes. But they also abhor poverty that depresses demand and stifles growth. Public goods and social protection can be provided most effectively when markets grow. But cutting the cake into smaller pieces only equalises misery. In the absence of growth India risks falling into the politically volatile middle-income trap.

The global economy is still recovering from the biggest financial and economic crisis since the Great Depression of the 1930s. The old growth model, based on leveraged consumption in advanced economies, has broken down. A major global rebalancing of demand and structural reforms is required to get growth back on track. A stagnant global economy is an economy in search of new engines of growth.

India could be this new engine of growth. Though the medium-term prospects of a robust global recovery are distinctly downbeat, there is reason for cautious optimism with regard to India in the short term. The two major drivers that recently pushed Indian trend growth from 5.5–6.5 per cent into the 8–9 per cent trajectory are intact. The dependency ratio continues to decline, while the roughly 10 per cent increase in domestic savings, as a share of GDP, is largely intact except for some short-term damage to financial savings.

Unlike other emerging markets that are dependent on external levers to return to high growth, India's economy is balanced. The necessary reforms are mostly domestic, making now the opportune time for an Indian resurgence.

To realise its vast potential, India needs major policy and structural reform over the short- to medium-term. In particular, it needs to fire three arrows—agriculture, labour-intensive manufacturing and fiscal restructuring—from the bow of good governance.

Pulling these three strings is the immediate challenge for the Modi government in New Delhi over the short to medium term.

But if India is to sustain high growth over an extended period, beat the middle-income trap and become a major global player, it also needs to change its mindset. Civil society needs to overcome its fear of markets, engage more fully with the outside world and empower its citizens with equal opportunities. The real wealth of nations lies in their people. EAFQ

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Jokowi's police go unpoliced

JACQUI BAKER

RARELY do the police figure in studies of politics. Of all the institutions of the state, police are the great wallflowers of the political party. They are not known for their great generals or their formidable political veto power. And yet, 100 days into the much-anticipated presidency of Indonesia's Joko Widodo (Jokowi), it has been his failure to manage the complex and nuanced politics of the police that has not only brought about the downfall of Indonesia's highest crimefighter but exposed Jokowi's personal and political weaknesses.

When rumours spread around Jakarta that Jokowi was intent on replacing the National Police Chief, General Sutarman, there was understandably some surprise. After all, Sutarman was a reasonably competent cop, nominated by the last administration and still with a solid six months to his term. But a new administration often requires new leadership and so speculation turned to a handful of names of similarly passable officers who might replace him. In principle, the president, in consultation with the National Police Commission, is free to nominate multiple candidates whose names are then put forward to the House of Representatives to assess. On 9 January 2015, Jokowi followed his predecessor's practice by nominating a single candidate: Budi Gunawan.

That Gunawan would be one of the names in circulation was also no great surprise given his closeness with Megawati Sukarnoputri, Jokowi's political patron and the head of his party, the PDI-P. Gunawan served as adjutant during Megawati's presidency and vice presidency. Within police circles, Gunawan is known as a major broker, able to insert himself in the most powerful and lucrative networks. As assistant to the Deputy for Human Resources under former police chief General Sutanto, Gunawan's personal wealth had inexplicably ballooned.

Later stints as chief of police in Jambi province and then at police headquarters as head of internal affairs further amplified his authority. Although Gunawan had been cast out under Sutarman to the political wilderness of police education, this did not limit his financial prowess. His 2013 personal wealth statement was 21.5 billion rupiah (about US$1.7 million). Such was the extent of Gunawan's wealth, and the speed with which he accumulated it, that Gunawan was repeatedly rumoured to have one of the 'fat police bank accounts' monitored by the Centre for Indonesian Financial Reports and Analysis.

INDONESIAN civil society and intelligentsia reacted to the nomination with shock and outcry. But in the days that followed, Indonesia's Anti-Corruption Commission (KPK)