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Forex boost to India's infrastructure

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India's ruling coalition of the United Progressive Alliance (UPA) recently announced its desire to use US$10 billion of the country's $119.3 billion in foreign exchange reserves to accelerate investment in the infrastructure sector.

Every government tries to distinguish itself by implementing a few big ideas that make a profound impact on people's lives. The UPA government has just got a whiff of a mega project, which, if executed well, could catapult India to sustained 8% growth. Prime Minister Manmohan Singh is keen on using part of the massive forex reserves to drive big infrastructure projects in roads, ports, high-speed railways and the power sector. What's more, the UPA's most important but troublesome partner - the left - is also game. In fact, the left has been strongly pushing for this Keynesian exercise to boost employment and growth.

With India's forex reserves expanding by the day, this makes immense sense. When the Reserve Bank of India (RBI) builds up forex reserves by buying US bonds, poor India is actually lending the rich US money at very low interest rates. This is perverse. If India can increase its investment rate to, say 30% of GDP, it would soak up all domestic savings as well as remittances from abroad, foreign direct investment, foreign portfolio investment and foreign aid. Assuming an ICOR (incremental capital output ratio) of 3.7, this is likely to translate into a growth rate of more than 8%.

The inflow of dollars from abroad plugs the savings-investment gap as well as the current account deficit. This model was followed by countries like Japan, the Asian Tigers and other Southeast Asian countries. The Asian Tigers in their heyday invested 40% of GDP, so does China today. In contrast, investment in India peaked at 26.9% in 1995-96, drifted down to 22.6% in 1998-99 and then rose marginally to 23.3% in 2002-03.

The UPA government proposes to create special purpose vehicles (SPVs) that can operate in a public-private partnership framework. The SPVs will be given rupee funds by the central bank - the RBI - at a concession interest rate. It will virtually be like deficit financing or printing currency as it used to be done in the past. The SPVs will use their rupee resources to buy up dollars from the RBI to fund their imports. Thus the rupees released by the RBI will be bought back by releasing dollars. The key to the entire exercise is that it must be inflation-neutral and must not lead to any excessive growth in the local money supply resulting in general price rises.

The other obvious advantage of adopting this instrument is that it will avoid the crowding out of private investment. Had the government borrowed from the market to fund such massive investments, it would eat into bank funds that would normally be accessed by the private sector. This would generally result in the cost of funds in the economy going up.

In any economic comparison between the emerging Asian superpowers of India and China, the most easily identifiable fault with India is its comparatively poor quality of physical infrastructure. In roads, rail, ports, power and water, India lags miles behind China. The reason: It just does not spend enough on them. According to a Morgan Stanley research, China spent $260 billion - or 20% of its GDP - on power, construction, transportation, telecommunication and real estate in 2002. India spent just $31 billion, or 6% of its GDP.

Also, the cost of most infrastructure services in India runs about 50-100% higher than China. The

electricity sector, for example, is India's biggest infrastructure bottleneck, with daily supply cuts in all but a few cities. The result is an annual growth rate of around 6%, which, while respectable enough in most circumstances, is at least a couple of percentage points below its true potential. According to Morgan Stanley, freight as a percentage of total import value is about 11% in India, compared with a 6% global average and 5% for developed countries. There is also a higher lead time for trade: six to 12 weeks for India's trade with the US, compared with China's two to three weeks.

A World Bank report issued almost three years ago said, "The shortage of power is estimated at about 10% of the total electrical energy and roughly 20% of peak capacity requirement." Fifty years after independence, many rural areas in India still have no electricity. Even measured against neighboring countries, India's per capita electricity consumption is very low - 270 kilowatt hours/year as compared to 300 for Pakistan and 480 for China.

Thus any stress on investment in infrastructure is most welcome. However, that is not problem-free either. It means expanding the fiscal deficit by 2-3% of GDP. Can India spend its way out of the muddle? Will this extra public investment generate enough extra growth to ultimately pay for the additional borrowing required? Experience does not say so. The link between public investment and GDP growth is not automatic. Higher levels of public investment in the past did not generate growth any faster than today's. High-quality public investment is unquestionably a spur, but India has a long history of poor-quality public investment.

Then the question is, where lies the problem? Is India's infrastructure development caused by the lack of financing or an inadequate business climate? The rise in our forex reserves is actually a symptom of our inability to create a climate for large-scale investment. To fill that gap would require far more than additional public investment.

Since practically everything can be imported freely, the projects should be able to import whatever technology or equipment they need without any hassle. At the macro level, with domestic savings falling short of domestic investments, a deficit on the current account will result and the reserves will drop. Starting with that objective puts the cart before the horse. The risk in such an approach is that the objective will be to somehow using up $10 billion, the imports will take place, and the projects will remain incomplete. As it is, India has any number of projects in the infrastructure sector lying incomplete for want of resources. In successive budgets, one finance minister after another has allocated resources for the completion of such projects, with little result.

Incomplete projects only add to the fiscal burdens and do not create either jobs or help growth. It is estimated that the government loses at least Rs410 billion (US$9 billion) due to delays in more than 300 projects, all above Rs200 million. One can only imagine the total cost of delay if all central and state government projects are put together. According to some estimates, projects into which Rs1,000 billion has already been sunk remain unfinished. A substantial part of this investment will be lost forever and the remaining will see time and cost overruns that will mostly render them unviable.

Let's take the case of Mumbai Trans Harbor Link. It is a 22 kilometer, $600 million bridge designed to deliver an expressway connection between the commercial hub of Mumbai and its new port at Navi (New) Mumbai. The project has been on the drawing board for 20 years. In 2001, it was announced that the project would be taken up on a priority basis. But the global invitation for tender pre-qualification has started only recently. The bridge will take four years to build (assuming no unforeseen time over-run, though cost over-run is a certainty) - consigning traffic from the new port to a tedious journey across crowded roads till it is done.

Ensuring transparency and proper project management will help improve accountability and ensure timely implementation of work and will have a crucial multiplier effect on the whole economy. Since 1991, India has had a policy of attracting private investment into infrastructure. While some progress has been made, it's nothing compared to what India needs. If the private sector is to play a big role in meeting its infrastructure demands, then India needs sectoral policies and a regulatory framework conducive for private investment.

Some examples will bring the real problem to the fore.

Ever since the liberalization policy was launched in 1991, the power sector has been systematically starved of funds. Not only has the private sector failed to contribute to production capacity in any significant way, but investment in transmission and maintenance of existing plants has seen catastrophic declines. As a result, even when new plants are commissioned, the problem of poor transmission networks remains. Even the so-called reform in the power sector (the Electricity Act, 2003) has many loose ends that inhibit private sector initiative.

One area where the neglect of infrastructure over the decades is most apparent is in the nation's road network. Only 2% of Indian roads are four-lane, 34% are two-lane, and 64% are single-lane. Nearly 50% of Indian villages are yet to be connected by all-weather roads. The progress of the much-vaunted Golden Quadrilateral project in India (which was started to link the four metros of Delhi, Mumbai, Chennai and Kolkata with expressways) is a clear pointer to institutional failure.

A similar weakness is all too visible in the Indian port system. Decrepit and bogged down by lack of modernization, Indian ports are a nightmare to importers. The old state-run Mumbai port is a classic example: it suffers from inefficiency, poor draught, low productivity, high costs and long vessel turnaround times. Mumbai's inadequacies have benefited Colombo in Sri Lanka, which enjoys growing container volumes.

Efforts to develop India's ports have all too often been stymied by the creaking bureaucracy. Bureaucratic problems encountered in the private tendering processes at Mundra in northwestern India and in the conversion of two break bulk berths to a new container terminal at Nava Sheva under the Jawaharlal Nehru Port Trust have slowed down the development of ports in India.

Overall, as industrial development came to be divorced from efficiency and productivity over the years, India's ability to compete globally was seriously compromised. In contrast, during the same period, Chinese manufacturers became increasingly competitive. And, infrastructure made all the difference. The issue is, unlike China, where new highways, bridges and ports can be fast-tracked on central government orders, India must go through a time-consuming consensus-building process among various political constituents. Then there are bureaucratic delays, corruption and politician-criminal nexus - all of which act as a hindrance.

A recent World Bank report states that in India it takes 89 days to start a business (with 11 separate procedures), 425 days to enforce contracts (40 procedures), 67 days to register property (six procedures) and 10 years to resolve insolvency. In comparison, the respective figures are 41 days, 241 days, 32 days and 2.4 years for China. This calculation of course does not take into account the time required to collect information about registration procedures. The number of procedures does involve transaction costs, but ultimately, it is the time taken that matters. Among a set of nine developing country counterparts, India pretty much figures at the bottom of the heap as far as various investment climate indicators are considered.

An investor aiming to invest in India faces a variety of uncertainties in carrying out a project appraisal. The costs of inputs such as labor, capital and land should be relatively easy to calculate, but the total cost of doing business also includes transaction costs, many of which are hidden and intangible. They depend on institutions too. Good institutions, from an investor's perspective, should minimize the hidden, human-made costs of doing business. High transaction costs deter domestic as well as foreign private investment.

Unfortunately, in India, institutions have, more often than not, acted as a hindrance rather than a catalyst. Thus mere announcement of using forex reserves for infrastructure development without making a strong statement of carrying out the required institutional reform will hardly work.

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