Opinion

THURSDAY, APRIL 4, 2019

AUTOMOBILE FOCUS

Former Tata Group chairman Ratan Tata

"When I was the chairman of the (Tata) group, I think there was a disproportionate amount of time that I expended in the automobile business because it was at that time the most exciting thing we were doing"

A 50bps rate cut with ample liquidity is needed

Growth is slowing, investment is poor and inflation is well within control; India's real rates are amongst highest globally

WITH FOOD INFLATION gradually reversing from its earlier phase of contraction—from an average of minus 1.5% over the previous three months, this was minus 0.1% in the latest CPI numbers—and core inflation still high at 5.3%, there are many who believe the inflation battle hasn't been won and that RBI needs to remain vigilant. Indeed, policies such as PM Kisan—and the Congress's NYAY, were it to come to power—will all ensure that food inflation starts to pick up. The question, however, is how soon this will happen, and whether inflation will remain under control following this. Right now, most economists seem to be of the view that, in the next one year, inflation will remain below the 4% level the central bank is comfortable with. More so since, GDP growth has already begun to moderate; indeed, as compared to the 7.2% projection in January, the CSO's February projections put it at 7%. Most high-frequency numbers too show a similar slowing—at around 4% for FY19, growth in passenger vehicle sales, for instance, is likely to be the slowest in four years.

Indeed, with not enough jobs being created—or with jobs being created, but offering low salaries, if you go by the latest narrative put out—it is not surprising that consumption growth, which was the single bright spot in terms of growth, has also started slowing. With no signs of private investment picking up, it is likely FY20 will see a sub-7% growth—according to CMIE data, fresh public and private sector investment announcements in the March quarter were 16% lower than those in the December quarter and 46% lower than the year-ago period. In addition to domestic factors, the global situation has only worsened, and even if there is no recession—and there is just a slowing down of global growth—this will only make things worse for India. Indeed, the markets seem to be pricing in a rate cut from the Fed this year, a sign of how fragile growth can be. Apart from what a rate cut can do for the economy, it is worth keeping in mind that India's real rates of interest are amongst the highest in the world and, along with India's high rates of corporate tax, make investment quite unattractive. And, while the impact of bad domestic policies in various sectors is a key reason, this also accounts for why, from a high of 3.4% of GDP in FY09, FDI levels are right now at 2.3% of GDP.

Cutting rates, of course, is of little help if there isn't enough transmission, and that is why ensuring enough liquidity is critical. While RBI's dollar-rupee swap has added to liquidity quite effectively, the fact that the new year has started and government spending will pick up will also help, as will the increased election spending. In which case, it is fair to expect some rate cuts if RBI's monetary policy committee (MPC) goes in for a large enough repo cut later today. While it is not clear whether members of the MPC will be aggressive enough, new Governor Shaktikanta Das has indicated that, as opposed to the central bank focusing primarily on inflation, he would like GDP to be a focus area as well (at least when inflation is under control).

Bridging learning gaps

New study shows mammoth gains from tech-aided learning

OVERCOMING EXTREME DIFFERENCES in learning levels amongst students in the same grade is a key challenge for school education in India. Indeed, as ASER 2018 shows, amongst Class III students in Himachal Pradesh, 2.4% couldn't recognise letters, 10.6% could recognise letters but could not read words, 15.5% could read words but not sentences, 24.1% could read Class I level texts but not higher, and 47.4% could read Standard II level texts. This means the human development potential from the massive jumps in enrollment and narrowing gender gap in classrooms India has seen over the last few decades is being squandered, thanks to policy flaws like the Right to Education (RTE) Act's 'no detention' provision that was scrapped only in January this year and pedagogical shortcomings. The gap between the level of classroom instruction and the individual learning levels of students is a bottomless rabbit-hole—as the curriculum gets more ambitious with each successive grade, those who were already lagging peers fall farther behind. There has been some action from policymakers on "teaching at the right level"—the Delhi government rolled out its Mission Buniyaad last year to ensure basic reading, writing and arithmetic skills amongst Class III-IX students. But, such interventions are cost-and labour-intensive. Beyond this, as the curriculum gets more complex and learning levels more fractionated, such models may not even be viable.

Against such a backdrop, a study by Karthik Muralidharan of the University of California at San Diego, Abhijeet Singh of the Stockholm School of Economics and Alejandro J Ganimian of the NYU Steinhardt School of Culture, Education, and Human Development, shows that greater use of technology in pedagogy could deliver substantial gains. Muralidharan *et al* study the impact of Mindspark, a device- and connectivity-agnostic piece of technology, that was used to assess learning levels of 619 students from low-income households studying in government-funded schools in Delhi, and address deficiencies. Students in the sample were several levels below their respective grade-appropriate levels. They attended after-school Mindspark centres, where they participated in 90-minutes sessions of instruction, six days a week; the session was divided into 45 minutes of individual self-driven learning on the Mindspark platform and 45 minutes of instructional support from a teaching assistant in groups of 12-15 students. Half of them had been selected, via a lottery, to receive vouchers that made attending the module free. The researchers assessed learning learning levels before and after the four-and-a-half months intervention, and estimated that attending the Mindspark centres for 90 days (or 80% attendance for half a school year) could raise math and Hindi scores with standard deviations of 0.6 and 0.39, respectively. The Mindspark software can determine existing learning levels with greater accuracy—perhaps much more so than even a highly-trained teacher—and dynamically personalise the material being delivered in the instruction process to a student's level and rate of progress. Also, it delivered near-uniform gains for students irrespective of household socioeconomic status or gender. The researchers estimate Mindspark delivers comparable gains at a fraction of the costs incurred and time consumed in alternative pedagogical approaches, including extra classes. The study offers a sound policy prescription to governments—Delhi, for instance, that has allocated 26% of its budget to education could jump lightyears ahead if it were to complement its Mission Buniyaad with greater adoption of technology in pedagogy.

Trumping RESEARCH?

Donald Trump's "free speech at universities" push isn't all that it seems

TRUMP IS INFAMOUSLY anti-intellectual—"The experts are terrible (c.2016)". So, there is good reason to fear ulterior motives to Trump's push for "free speech" in American universities. Trump could just use it to arm-twist campuses into fostering his brand of divisive, anti-intellectual politics and generating "research-based" opinion to support his political stands.

What is happening at the US Environmental Protection Agency (EPA) should offer a clue. The deadly effect of vehicular and industrial pollution on human health has been a matter of scientific consensus for over three decades. But, the Clean Air Scientific Advisory Committee (Casac), which advises EPA on air-quality standards, and more particularly its chair, Tony Cox, has called this "unverifiable opinions"—despite the mammoth body of research—as the EPA rushes to revise the national air quality standards. Trump-pick Scott Pruitt, as the EPA administrator, shifted the deadline for the revision from 2022 to 2020, severely straining the normal review process—a scientific advisory committee parallel to Casac has also been dismantled. Now, Casac wants EPA scientists to assess "all relevant studies", including some by Cox, a statistician and a sceptic of the scientific evidence on pollutants' effect on health. Some of Cox's studies were funded by industry groups who stand to be impacted by stricter environmental standards. The "free speech" condition could just become a club to batter universities into giving up research independence, and create more Coxes.

NO PROOF REQUIRED

THE NYAY PROGRAMME OF POVERTY ELIMINATION IS SO FLAWED THAT ITS ADVOCACY BEFORE AN ELECTION IS AKIN TO POLITICAL SUICIDE

NYAY equals *garibi bachao*, not *garibi hatao*

SURJIT S BHALLA

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IT IS NOW official. After the release of the manifesto, the Congress believes that its suggested offering of the Nyuntam Aay Yojana (NYAY) for poverty elimination is a gamechanger, a political winner, and a winner of advanced thinking on the subject. To bolster this claim, and as quoted in *Business Standard* "Consulted big economists, including Rajan: Rahul", Congress president Rahul Gandhi said that the Congress had consulted "all big economists, *without telling anyone*, without giving any speeches". "We were engaged in this work for six months. Take the list of all big economists of the world, we consulted them...Raghuram Rajan..one by one. *The first thing we came to know that there should be a minimum income line. We calculated and the result was that the minimum income line should be ₹12,000 per month* (emphasis added)."

Further, if you look at the hoopla surrounding this master design (names of some leading poverty economists of the world—from Banerjee to Rajan to Picketty—were invoked to show thinking behind the plan), one would infer that this was a major development in thinking. I will show how the minimum income guarantee scheme involves some very confused thinking, and knowledge, about the Indian record of poverty, and its alleviation.

I find it most unusual (but not surprising) for the Congress to *not* claim credit for poverty alleviation (and near elimination according to the existing, too-low official poverty line). For purposes of discussion, let us analyse India's poverty alleviation record till 2011-12 (and 2013-14)—the time-period when UPA was in power. Since this is a record going back the last 70 years, let us give most of the credit (and blame) to the Congress party for all the economic developments that have taken place in India. At the time Indira Gandhi coined the slogan *garibi hatao* in 1971, India was a very, very poor country, with almost 80%-plus of the population absolutely poor, according to the official Tendulkar poverty line. According to this poverty line—approximately a consumption level of ₹850 per person per month (pppm)—and the same as the World Bank poverty line of PPP$1.9 per person per day, poverty in India was only *12%* of the population in 2011-12. This is amongst the best poverty alleviation efforts in the world, and comparable to China which had reduced its absolute poverty rate to *9%* over the same-period. You would think that the Congress would be proudly proclaiming from the roof-tops that it had provided a spectacular reduction in poverty. But you would be wrong—and I would not be ashamed.

What is the poverty line in NYAY, eight years after 2011-12? *The same in real terms as in 2004-5 and 2011-12.* It is ₹1,400 per person, or ₹6,000 per month for a family of 4.3 persons. The approximate absolute poverty level in India in 2019-20 that the Congress wants to eliminate—about 3% of the population. The NYAY programme is *garibi bachao*, not *garibi hatao*.

One of the major consultants to the Congress master plan of poverty alleviation is Thomas Piketty. His analysis (along with co-author Lucas Chancel) claimed, in the latter half of 2017, that Indian income inequality had worsened to beyond Brazilian and South African depths, i.e., was one of the worst in the world—and had deteriorated the most during the UPA period FY05 to FY14. Indeed, their analysis stops around 2015. At the time this analysis was presented, I was the only person who commented, in seminars and articles in *The Financial Express*, that these conclusions were very suspect. At that time, I was a newly appointed member of the Prime Minister's Economic Advisory Council. Not one Congress economist, nor one of the 108 economists busy writing letters and advising the Congress on NYAY, dared to question Piketty. I had said at that time, as I have repeated often times over the last 20 years, India's record of poverty alleviation is among the best. And that income inequality worse than Brazil's was a figment of fertile imaginations. Please recognise that you cannot have both inequality zooming and poverty falling precipitously.

Back to the ill-conceived NYAY. It will retain all existing "merit" subsidies. Food is a very large component of the poor woman's budget (close to 60%). And India has been operating corrupt schemes to "deliver" food to the poor. The corrupt PDS system of foodgrain distribution is supported by a very corrupt MSP system. In the manifesto, the Congress claims that "in the last five years, under the BJP government, the agriculture sector has been driven into deep crisis. Adequate MSP was denied for 4 years" (p.16). In other words—support more PDS, higher MSPs for rich farmers, and NYAY.

> The Congress will succeed in political *hara kiri*—it would upset, and alienate, almost half the population, from the 21st to 65th percentile

Are there better alternatives available? In early January, 2018, Karan Bhasin and I presented a detailed paper on a *targeted basic income* (TBI) for India. A scheme that was not very costly (only ₹2.7 trillion or about 1.6% of FY20 GDP), had the World Bank middle-income poverty line of PPP$3.1 as its basis, and could easily be financed by phasing out corrupt PDS and MSP regimes. The paper is titled *Towards a Targeted Basic Income Policy for India* and can be accessed at *tinyurl.com/yxuxxldh*. There are moral, logical, and economic reasons for helping the bottom third of the population achieving a much higher standard of living. This is very doable, and can easily be financed. Note, a TBI is identical to the much-applauded negative income tax scheme—the only difference being that you need not be in the tax net to receive income support.

Instead of a workable targeted income support system, the confused Congress has offered a poverty alleviation without support scheme—but one without increasing the poverty line! This scheme, as Gandhi's quote mentioned here earlier indicates, is profound, and unique, and never been tried before. "To ensure a life of dignity to all Indians", the Congress proposes to transfer ₹6,000 a month to the bottom 20% of households.

A major aspect of this programme is it has been tried before. In 1795, and it failed miserably. As I state in *The New Wealth of Nations*, (p.151) "The justices of Berkshire, meeting at the Pelikan Inn, in Speenhamland, near Newbury, on May 6, 1795, in a time of great distress, decided that subsidies in aid of wages should be granted in accordance with a scale dependent upon the price of bread, so that a minimum income should be assured to the poor *irrespective of their earnings*. (author's emphasis in italics), (Karl Polanyi, *The Great Transformation*, 1944)." This guarantee of a minimum income proved the undoing of the system. Each person was guaranteed the same level of income; each person ended up with the same level of income, whether they worked or not. Surprise: Nobody worked, and the scheme failed.

The NYAY scheme (sometimes, a scam is a scheme) is additionally politically flawed. It is bound to fail. Worse, because of its format, it is a self-designed political disaster. (As someone said, if you are going to commit suicide, do it at the beginning!) You decide for yourself from the following simple extrapolation of the FY12 NSSO consumption distribution to FY20.

The following per month family income levels are obtained, *after the ₹6,000 NYAY transfer*, for the following percentiles in the distribution (1,5,15,20): ₹11,620, ₹14,860, ₹16,600, ₹16,850. So far so good—everybody in the bottom 20% has ₹6,000 extra consumption (income). Now, I want to report the 30th, 40th, 50th and 65th percentile levels of income: ₹12160, ₹13,580, ₹15,070, ₹14,970, and ₹16,830. Note that the Congress will succeed in political *hara kiri*—it would upset, and alienate, almost half the population, the 21st to 65th percentile.

In order to benefit the poorest 20%. Rahul Gandhi and his world-renowned team of advisers are right—NYAY is unique, never been tried. The reason—no one has (stupidly) dared to adopt it!

FPI inflow outlook positive for H2FY20

This will depend on India-specific fundamental issues, and it is here that the govt and India Inc play a significant role

B PRASANNA

Head, Global Markets Group, ICICI Bank

INDIA'S STORY, OVER the last few years, has been one of hope and despair. The pre-election rally that started in September 2013 was a classic case of hope, and equity markets responded with a 20% return in the run-up to the election. FPIs had participated in the rally (Sept 2013-May 2014) with inflows of approximately $15 bn. The recent surge in FPI flows in March brings to mind the same question: Is this a repeat of the previous election rally, or is it different this time? Predicting FPI flows is tantamount to crystal gazing, but, if one observes historical data, FPI inflows have always been high in an election year—₹65.78 bn in 1999, ₹389.65 bn in 2004, ₹834.23 bn in 2009 and ₹970.54 bn in 2014. India has witnessed positive pre-election FPI inflow in two out of three instances with 2009 period being an outlier. The 2009 period witnessed the great financial crisis that had a huge effect on fund flows. The current pre-election rally has started much later, and has been shallower than the typical past rallies and it will be interesting to look at how these FPIs are expected to behave, given the domestic and global macro backdrop. There has always been an uncertainty discount that was attached to Indian markets by FPIs owing to elections. However, post the surgical strike 2.0, the uncertainty discount seems to have reduced with markets expecting a stable government. This has resulted in a catch-up rally in March 2019.

The sudden change in the mood of the FPIs has taken many market participants by surprise, and they cannot be blamed. Just before the surgical strike 2.0, FPIs had been net sellers to the tune of $4.5 bn till February 2019. The FPIs had reduced their overweight position in India with the weight in the Global Emerging Market (GEM) funds down to 9.4% while that in the Asia ex-Japan at 11.8%, down from the 2015 peak of 13.3% and 14.8%, respectively. This brings us to the issue of continuity of such flows going ahead. FPI flows in FY20 will be a result of an amalgamation of US Federal Reserve policy, global and domestic macro environment, the election outcome and improving corporate earnings driven by improving bank balance sheets. The current Fed chairman, after hiking rates four times in 2018, changed gears sharply and turned "super dovish". Market expectation has also swung from three hikes in 2019 to a pause or even a cut. Fed's change of heart, coupled with global QE and subdued inflation, has kept US 10-year yields under check, resulting in a bull flattening. The US 10-year yield is down from a peak of 3.25% to 2.44%. Lower interest rates are expected to reduce the risk premium and, hence, the cost of equity, and support equity markets, *ceteris paribus*.

The exercise of predicting recessions using the inverted yield curve argument has its own pitfalls although empirical evidence suggests that the US has witnessed recessionary conditions two years after every yield curve inversion. However, this may not pan out this time around, with the US unlikely to slip in to recession just yet and is instead going to face a growth slowdown. The extent of the inversion is important as well as the length of time the inversion sustains. Hence, in this period of bull flattening, equities are likely to remain positive and fund flows are expected to move to relatively higher growth emerging market economies, including India.

The FPI positioning in Indian equity markets is another supportive factor. Excluding the March 2019 inflow number, India on a 12-month trailing basis, has witnessed net outflows. Since 2009, India on 12 month trailing basis, has witnessed outflows only on four occasions (financial crisis, EU financial crisis, yuan devaluation and the recent trade war). This typical FPI capitulation was subsequently followed by a positive inflow. The expectations of the results of the upcoming general election may have provided the basic impetus for inflows. This is also supported by a good combination of improving corporate profitability and expectations of benign nominal interest rate. FPIs have approximately $380 bn of Indian equity assets under custody as of February 2019. Any change in the stance of the GEM Portfolio Managers, who are currently neutral on India, might further drive significant inflows to the Indian market. However, some caveats must be noted, and FPI flows will be front-loaded given the busy calendar in H1FY20. This includes RBI policies, the poll outcome and the full Union budget in June.

After these events, over the rest of the fiscal year, the framework will shift to one of "business as usual", and flows will depend mainly on improvements in corporate profitability, where the consensus is of expected profit growth north of 20%. Any disappointment won't be taken lightly, given that the Indian equity market valuations are relatively at the upper end, with MSCI India trading at 18x 1-year forward earnings. Also, the Indian market is at approximately 40% premium to MSCI Asia ex-Japan, making it one of the most expensive markets in Asia. The other risk is inclusion of China's A-share index in the MSCI indices. Its inclusion means a reduction in India's weight by 20 bps starting from May 2019 to November 2019, resulting in expected outflow of $3.8 bn.

Thus, FPI flows in H2FY20 will depend on India-specific fundamental issues, and it is here that the government and corporates will play a significant role. The new government should introduce a new set of reforms, reduce bottlenecks in the system, continue to help the banking sector clean up balance sheets and improve credit off-take. The steps taken to address agrarian crisis and consumption slowdown should show positive dividends. All these factors should help Indian Inc achieve 20% profit growth and support the current high valuations, thereby supporting the continued FPI interest in Indian equity market.

LETTERS TO THE EDITOR

Cong manifesto is just bad medicine

The Congress party is always high on promise and short on delivery. Congress is trying to reach out to the farming community. A separate kisan budget has been promised. The party has been promising to make failure to pay back farm loans a civil offence. The stigma of criminal offence will go. This is nothing but an encouragement for defaulters. The manifesto also focuses on unemployment. Now, the manifesto promises creation of 34 lakh jobs in public sector. Of this, 4 lakh vacancies are to be filled up in Union government by 2020. If 4 lakh vacancies can be filled, it does not amount to generation of employment. Filling all these vacant posts is very important. But it has been the legacy of every successive government that the posts are not being filled soon after they fall vacant due to resignation, retirement, promotion, dismissal and death. Work in the vacant posts is extracted by placing a person in additional charge of one or more post. How can an employee render quality work when he is compelled to work in more than one post in addition to his own? Single GST rate would weigh the poor and affluent on the same scale. Congress is on its toes to scrap NITI Aayog. By rescinding all the decisions of the Modi government, the party won't be doing any favour to the people. The manifesto promises to dilute AFSPA, abolish sedition and defamation laws. Further, the powers now enjoyed by the Army would be curtailed. If the army's powers are trimmed, the nation will go back to the days when the killing of civilians and army jawans exceeded the number of killings of terrorists. The Congress manifesto is a remedy worse than the disease.

— KV Seetharamaiah, Hassan

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INFLATION EXPECTATIONS

What to expect when you're (not) expecting

The impact of core inflation in shaping inflation expectations is three times that of food. In contrast, gasoline has no economically or statistically significant impact on this. These findings run counter to the conventional wisdom that food and fuel are primary determinants of inflation expectations

WHAT FACTORS influence household inflation expectations in India? Expectation formation is typically a hybrid of rational (forward-looking) and adaptive (backward-looking) impulses. That said, in India's case, several studies find: (1) a meaningful adaptive component and, (2) more importantly, that food and fuel prices are key drivers of household inflation expectations.

The obvious implication is that the sustained disinflation of food over the last few years should have pulled down household inflation expectations, potentially significantly. Lower inflation expectations, in turn, should have a salutary impact on core and headline inflation, through the aforementioned Phillips Curve. So the conditions should be in place for core inflation to soften towards much lower headline inflation. Right?

Not so quick. RBI's household survey of inflation expectations reveals that, contrary to popular perception, inflation expectations have been remarkably, and disconcertingly, sticky. To be sure, expectations saw a sharp downshift in 2014-15, ostensibly responding to headline CPI inflation halving between 2013 and 2015. Since then, however, inflation expectations have been remarkably sticky, despite inflation trending even lower and food inflation, in particular, collapsing in recent years. Yes, much can be made about the fact that 12-month-ahead expectations have softened by 150bps over the last two quarters. But, at 8.5% in December 2018, they are at exactly the same level they were 12 months ago and 24 months ago. Similarly, 3-month-ahead expectations softened last quarter but, as of December 2018, were still higher than both 12 and 24 months ago. This, despite food inflation falling by almost 400bps over the last three years.

What drives inflation expectations?

Why haven't inflation expectations responded to lower food and fuel prices—as is commonly presumed? To investigate this puzzle, we explicitly model household inflation expectations as a function of the different components of inflation—food, fuel and core. This acknowledges both the adaptive nature of expectations as well as tries to ascertain the relative importance of different subcomponents of inflation in influencing expectations—a question of particular salience, given the wide divergence across food and core.

We estimate this equation:

Inflation Expectations = Constant + a(Food) + ß(Core) + d(Fuel) + ?(Gasoline) + e

We alternately use both the 3-month and 12-month-ahead expectations. Food and Core refer to food inflation and core inflation, respectively. Fuel refers to the fuel index in the CPI basket. But because this index does not include gasoline and diesel—which are instead included within services—we separately include a "Gasoline Index", comprising a weighted average of petrol and diesel prices.

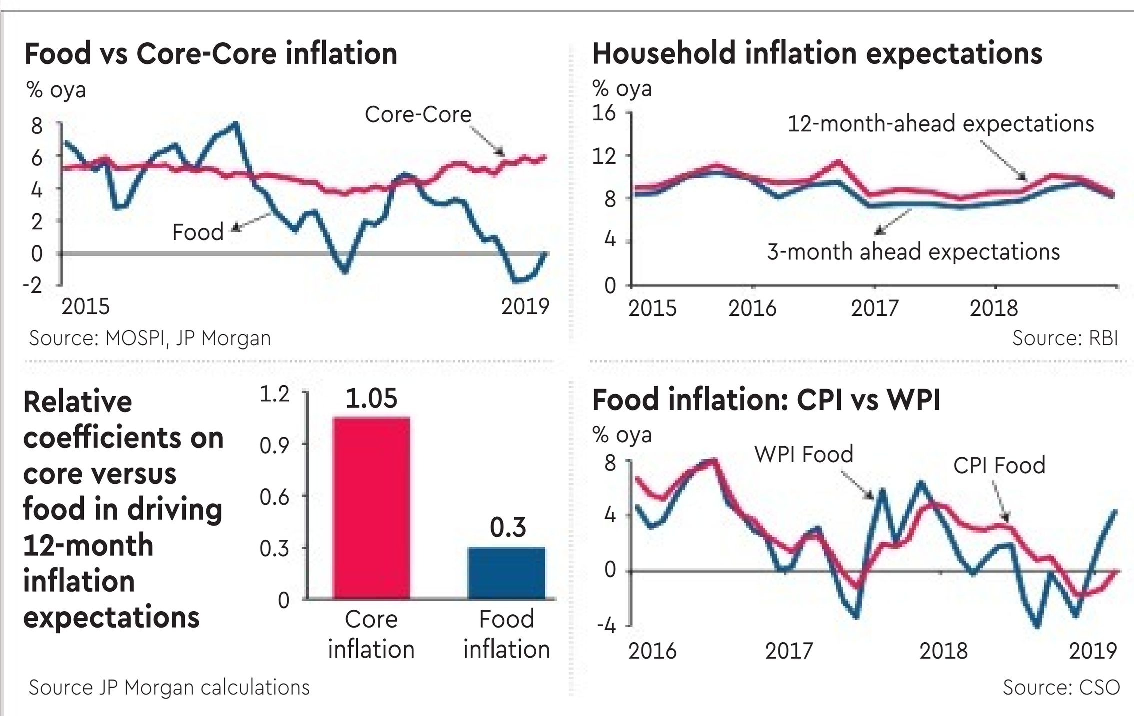
Methodological housekeeping

There are, however, a few methodological issues to contend with. First, running the above regression in year-on-year growth rates creates nonstationarity concerns (since all the variables have a unit root). Therefore, we run the regression in differences, similar to the approach followed by New York Fed.

Second, there is a potential endogeneity issue. We hypothesise that observed inflation impacts inflation expectations (because expectations are adaptive). But, equally, inflation expectations influence inflation (through the postulated Phillips Curve channel). We, therefore, run Granger causality tests and find that observed inflation "Granger-causes" inflation expectations but not the other way around. This finding reinforces the legitimacy of the specification above.

Results: Core inflation matters thrice as much as food!

What do we find? First, contrary to conventional wisdom, core inflation influences household inflation expectations three times as much as food! Second, gasoline inflation has no statistically (or economically) significant impact on expectations. These results are particularly true of the 12-month-ahead expectations, thereby overturning the conventional wisdom that food and fuel are the key determinants of household inflation expectations in India. This result is robust to choice of different control variables in our estimating equation as well as to different time periods (see graphic).



We also get much of the same results using 3-month-ahead expectations, instead of the 12-month-ahead expectations. While the coefficients on food and core are slightly lower, core still matters three times as much as food. That said, core inflation is statistically significant at 12% level, rather than 10% levels when using 12-month-ahead expectations.

Finally, since the household survey is an urban one, we replicate the same results using Urban CPI. Qualitatively, we get the same results when using 12-month-ahead expectations. The coefficient on core is almost three times as much as that on food, though it is significant at a slightly lower level (12% level versus the 10% level in the baseline result, for the combined CPI). The Gasoline Index remains economically and statistically insignificant across all specifications.

One implication of these results is that while food inflation may shape expectations at the 3-month horizon (since the role of core is marginally less statistically-significant at this horizon), it is core inflation that decisively shapes expectations at the 12-month horizon—the horizon that likely matters for central banks given the "long and variable lags" associated with monetary policy. In other words, household inflation expectations are formed much more broadly than commonly presumed.

Our findings can, therefore, help explain why inflation expectations have been so sticky in recent years. Food inflation has fallen by more than 300bps over the last two years which—even by our own results—should have had a depressive impact on expectations. But core inflation has accelerated by about 100bps during that time period, and because the impact of core is three times that of food, our results suggest that accelerating core has largely undone the impact of food, thereby keeping expectations sticky.

A number of implications flow from our findings. First, they help explain why core inflation has been so sticky. The fact that core inflation plays a crucial role in shaping expectations which, in turn, impact the future out-turn of core inflation helps explain the persistence of core.

Second, they help us make sense of our earlier finding—that in recent years it is headline that converges to core and not the other way around. This is because, if headline inflation is ultimately driven by "inflation expectations" and "slack", and (i) slack influences core; and (ii) core influences inflation expectations, it is no wonder that headline eventually converges to core.

Third, the forces that are commonly assumed—that food and fuel will pull down inflation expectations which, in turn, will pull down core—are unlikely to work, given our findings. For core to soften materially, growth will have to slow and output gaps will have to open up.

All this raises the bar for core to soften to headline.

The key is what dynamics could push food towards core inflation? The typical transmission should occur through wages. As output gaps close, wages should start firming up. This should put pressure on food prices through both a cost-push channel (as agricultural wages firm up) and through a demand channel (as higher wages boost demand for food). Are we seeing first signs of that already? Rural wages have stopped decelerating and particularly agricultural wages have begun to tick up. Also, food prices have sequentially increased (on a seasonally-adjusted basis) for three consecutive months, for the first time since the last quarter of 2017. WPI food inflation has accelerated much more sharply. Will CPI prices follow suit?

Economic channels apart, as the last few months have revealed, the political-economy of India is unlikely to tolerate the terms of trade confronting farmers to remain at these depressed levels. One can, therefore, reasonably presume that efforts will be made—whether through cash transfers, minimum income guarantees or opening up exports—by the next government to push up food prices, and thereby alleviate the stress confronting farmers. There are, therefore, both economic and political-economy reasons to expect food inflation to gradually re-accelerate, though this could take a while.

All this suggests we should not take the currently benign inflation trajectory for granted. The current may not be a particularly good predictor of the future.

(Excerpted from JP Morgan Asia Pacific Emerging Markets Research dated April 3, 2019.)

Wage hikes have to be sustainable

ROHIT JHA
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Exorbitant wage hike in Delhi welcome, but can private organisations afford it?

THE DELHI GOVERNMENT had revised minimum wages under the Minimum Wages Act, 1948, from April 1, 2018. Under the revised wages, unskilled workforce in Delhi gets ₹534 per day or ₹13,896 per month, semi-skilled ₹588 per day or ₹15,296 per month, and skilled get ₹648 per day or ₹16,858 per month. Non-matriculates get ₹588 per day or ₹15,296 per month, matriculates but not graduates get ₹648 or ₹16,858 per month, and graduates and above get ₹705 or ₹18,332 per month. This wage hike ranges between 27.16% and 36.78%, from pre-April 1, 2018, levels.

In October 2018, deputy CM Manish Sisodia said the government had effected a historic hike in minimum wages, and labourers in Delhi were being paid the highest amount in the country. However, are private organisations, industries, hospitals in Delhi in a position to take on this exorbitant hike?

To be precise, job opportunities have slowed down and organisations are unable to sustain additional manpower. In such a situation, a massive hike in wages can overburden financial liabilities and cripple day-to-day operations of the already distressed organisations in the national capital. These entities in the national capital employ lakhs of people from across all age-groups.

Another issue that requires a re-look by the Delhi government and policymakers is how relevant is it to formulate a wage hike for workers based on CPI, when salary revisions for central and state government employees are based on WPI?

To provide a better understanding on CPI and WPI and why it might be incorrect on the part of the Delhi government to revise new wages based on CPI, we must take note of what the ex-Governor of RBI, D Subbarao, had said during his stint on WPI and CPI. He had defended WPI usage in the central bank's inflation forecast. He pointed out that "given the limited efficacy of monetary policy to deal with food and fuel inflation, and the limits on using core CPI inflation measures, we have focused our attention on non-food manufactured products inflation, as an indicator of demand-side pressures in the economy."

> Wage hike formulated for workers in Delhi is based on CPI, while govt employees' salary revision is based on WPI

Subbarao had also noted that RBI opted for WPI over CPI as "we do not have a single CPI that is representative of the whole country. Secondly, WPI is available with a shorter lag than CPI. Third, WPI has a broader coverage than CPI in terms of the number of commodities, quotations, inclusion of non-agricultural products and tradable items."

There are numerous other examples that would corroborate the fact that when the central and state governments follow WPI for wage revision, there is no justification for the Delhi government to make an exorbitant wage hike based on CPI.

We must also take into account that there has been a massive flow of population to the national capital, especially the millennials, who are looking for job opportunities. An unintended consequence of the move may be the outflow of industry and capital to Delhi's neighbourhood.

Private organisations alone cannot shoulder the burden of the financial pressure that comes with exorbitant hike in wages; they need to focus on more efficient systems and more efficient workforce to maintain profitability. Employers are under pressure to minimise their manpower to overcome pressure from hiked wages. A holistic view has to be taken into consideration to ensure sustainability of organisations and industries providing employment.

A blow to the IBC process?

The after-effects of April 2 judgment—SC striking down RBI's Feb 12, 2018, circular on resolution of stressed assets—need close monitoring

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FEBRUARY 12, 2018, would go down as a milestone in banking as RBI brought out a circular wherein it came down hard on borrowers who were in default. The one-day rule kicked in, from whereon the two parties had to discuss to restructure, failing which the loan was referred to the IBC after 180 days, which then entered the resolution chain. This has been struck down by the Supreme Court on April 2, after the case was referred to by some of the aggrieved companies, especially in the power, sugar and infrastructure sectors. What does this mean?

It does seem that what was objectionable was that the circular looked at all companies in a similar manner. If a company was having problems because of external conditions, then it could not be bracketed with a wilful defaulter. Hence, if every such default was referred to the IBC, the asset could finally get sold and the promoter could lose the company, which was not fair when there was a genuine problem. The power sector had a grievance that if a generating company could not pay the loan, it was due to problems like the non-availability of coal, absence of PPAs being signed, default on the part of state-run discoms and so on. Therefore, special treatment was required here.

The circular said 'no' and treated all defaulters the same. The implicit logic was that if an exception was made to the power sector, it could be extended to telecom and steel, and so on, and hence one could not draw a line. After all, in the absence of a wilful default that is hard to prove, business failure can always be linked with the environment. This made it contentious.

The fallout of the circular was that as banks started the talks with the customer on day 1, companies were performing better on an incremental basis as the fear of being referred to the IBC made them service their debt on time. But things now get reversed.

First, from what it appears, RBI would have to go back to the circular and work out a fresh resolution mechanism. The February 12 circular had made this generic while it should have been specific according to the interpretation made in the legal fraternity, as was done for the first 12 and 28 cases. Therefore, the gates have to be opened once again and all the avenues that were there, like CDR, S4A, SDR, JLF, etc, could be considered for resurrection.

Second, banks still have the prerogative to take the company to the IBC if a resolution with the borrower is not possible. So, the onus will be on the bank to decide if harsh action can be taken. But for sure when it is not binding, this situation can lead to more litigation where defaulters can appeal to courts when they are pushed to the IBC, and this delays the process.

Third, banks will have an incentive to be liberal with NPAs now and drag things along as they were doing earlier when the IBC did not exist. This will help reduce their NPAs and hence provisioning requirements. In a negative manner, the pressure on the government to recapitalise PSBs will reduce as they will now be more profitable. This was precisely the problem with the CDR structure where the committee of bankers decided to restructure NPAs to avoid the blemish of calling them non-performing. This can happen again.

Fourth, companies will also have the incentive to dodge payments, knowing they cannot be penalised immediately. This was the case earlier and will happen again at the margin. It is hard to identify a wilful defaulter today as this is rarely evident. Macro factors today will always be adverse as commodity prices will be volatile, laws varying, business cycles more common, and geopolitical tensions around the corner. At what stage should the bank pull the trigger?

Clearly, the clock can get turned back. When RBI came out with the AQR, it was hailed as being quite singular, as for the first time a harsh step was taken to clean up the books. Banks scurried to recognise these NPAs and, in the process, a lot of this negative information came out in the open as the strict moralistic code set in. Several bank chiefs were held responsible for the build-up of these assets and were chastised. Now there can be a drift backwards as the compulsions are no longer there.

An interesting complexity that has come up now is how one deals with the past cases? What happens to assets that went to the IBC due to the February 12 circular and were sold as part of the resolution process? What happens to the cases that are in the process of being resolved? Will they be pulled out of the IBC? What is the future of the IBC now, considering that structures were set up starting from the IBBI? The assets already sold that were driven by the February 12 circular could go for appeals. Those that are in the pipeline may stream out of the system. There will hence be a new set of complexity in the system in such cases. Also, now that it is the end of the year, how would banks define their NPAs? How would the divergence issue be treated now that this ruling has come in? All this will have to be answered when preparing the books of banks. For sure, there will be a lot of reconciliation to do.

The after-effects of this judgment need close monitoring because a relapse into the past cannot be ruled out. Rudimentary game theory suggests that when both the parties have an incentive to dodge the system, it becomes an efficient solution. The question is, what does the regulator do now? It has taken a lot of effort to come this far and now with the dilution taking place, the banking system becomes more vulnerable. To top it all, the pre-elections pitch is to make not repaying farm loans only a civil case. Banks have already been told to lend more to SMEs and then restructure those that are not being serviced within a time frame. Top this with loan waivers being announced, which give a reason not to pay up, and we are headed for a very different kind of a loan culture.