Opinion

WEDNESDAY, JULY 3, 2019

ON ECONOMIC GROWTH

Finance minister of India, Nirmala Sitharaman

Economic growth is high on the agenda of the Government. Various reforms are being undertaken by the Government in many spheres to improve GDP growth

Air India can't be sold, so best to shut it

If even a Jet Airways is having a problem finding buyers, how is Air India going to do this? Don't waste taxpayer money

IT IS NOT clear what the government hoped to achieve when it chose to issue a correction after civil aviation minister Hardeep Singh Puri told Parliament that the plan to sell Air India (AI) had been shelved due to high oil prices and a volatile rupee. After Puri's statement, his own ministry issued a clarification saying the process of privatisation was still on and that Puri's statement actually referred to an analysis that was done last year. In other words, the government would have us believe that it is just a matter of time before a buyer is found for AI. While such a move may boost market sentiment—it suggests the government's zeal for tough reforms is very much there—this is difficult to believe since even a Jet Airways is finding it difficult to find a buyer; how will AI, whose balance sheeet is so much more compromised, and which has a lot more people who are so heavily unionised they even fight over who should fly which type of plane? And, what does it say about the government's attempt to clean up AI that, as per Puri's statement, AI's net debt rose to ₹58,352 crore at the end of March 2019, rising from about ₹55,000 crore in FY18; and in a year when Jet Airways cancelled so many flights in the run-up to shutting down, AI made losses of ₹7,365 crore, up 38% from FY18's ₹5,337 crore.

Some part of the problem will get addressed by the government hiving off AI's debt into another company and using the sale of some of its assets to partially pay for this. But it is not clear when this haemorrhaging is going to stop since, while Air India is a full-service airline—although nowhere as classy as Kingfisher or Jet—its fare realisation is lower than even IndiGo's. Fixing this means the government has to get rid of AI's excess manpower by compulsorily retiring them, not by asking the potential buyer to do so. Indeed, apart from not taking over all of AI's debt and retaining a stake in the airline—which really spooked buyers since no one wants the government as a partner—the biggest mistake the government made the last time around was to not deal with the labour issue. Theoretically, the new buyer could get rid of excess staff after a year, but this requires government permission, so who would be so foolhardy as to take on this risk? More so, since the entry barriers to setting up a world-class airline are so low now that the aircraft can be leased and rentals paid out of operational revenues?

If the government is at all serious about the privatisation, it needs to retrench AI's staff first; the reason why excess staff was not a problem when airports like the Delhi one were privatised was that buyers were assured that the staffers would return to Airports Authority of India (AAI) if they were not absorbed by the private firms. Indeed, since Air India's losses are going to keep mounting till it sorts out its operations—and it is not clear this can be done in a PSU structure—the government simply has to shut it down; it is unfair to expect taxpayers to fund ₹7,000-8,000 crore annual losses in perpetuity, and they could rise quite quickly as well. Indeed, the same should be done for other white elephants like MTNL and BSNL that continue to bleed the taxpayer; when even professionally-managed companies like Airtel and Vodafone-Idea are having trouble dealing with the RJio onslaught, how will these PSUs that were making losses long before RJio even entered the market?

Action on raters just a start

Have to act on auditors, company boards, RBI/Sebi surveillance...

THOUGH IT TOOK an anonymous whistleblower complaint, and not Sebi initiating adjudication proceedings last December, to get rating agency Icra to send its CEO Naresh Takkar on leave pending an inquiry, the good news is that some sort of action has been taken at long last. The whistleblower had alleged that senior management interfered to ensure good ratings in the case of clients like IL&FS. So, if the inquiry does show this to be true, and Sebi takes action, it won't be a day too soon. As in the case of rating agencies in the west—Moody's owns 52% in Icra—some Indian rating firms too have been suspected of being very liberal with rankings. In the case of IL&FS, for instance, it was amazing that rating firms which gave it a good rating for its ₹75 crore issue as late as August 2018 failed to catch the fact that, while the holding company's profits were ₹584 crore in FY18, the IL&FS Group's losses were ₹1,887 crore; the liabilities of IL&FS at a standalone basis were ₹17,757 crore while those of the group were ₹116,447 crore.

But the problem is not just that of the raters, it is a larger problem of inadequate governance. While the government is trying to blacklist auditors Deloitte and KPMG affiliate BSR & Co, surely both the raters and the auditors would have believed the boards of companies—especially the independent directors—were doing their job to ensure against fraud? In the case of IL&FS, however, while the consolidated debt more than doubled between 2014 and 2018, its risk management committee met just once between 2015 and 2018, in July 2015. LIC owns more than a 25% stake in IL&FS and its managing director Hemant Bhargava chaired the committee. Other members included Maruti Suzuki chairman RC Bhargava and former shipping secretary Michael Pinto, but no action has been taken against any of them. And what kind of surveillance system does India have if neither RBI nor Sebi discovered that the audit committee hadn't met as often as it should have? In the case of IL&FS, as this newspaper has argued, a solid bureaucratic network helped advance the group's prospects, but this has gone unpunished so far.

So if the action against Icra or any of the auditors has to be more than the usual one-off reaction after any major scam, the government needs to act on various fronts. Certainly boards/directors need to be proceeded against, but regulators like Sebi and RBI need to be beefed up considerably, with large investments in their surveillance functions and powers. Sebi has to revive its circular making it mandatory to disclose even one day of default and RBI simply has to make all default data public; how are rating agencies going to predict default if they don't even know when various bank defaults take place? In short, until there is a conscious effort to improve governance standards across the board, penalising one or two credit rating/audit firms won't achieve much.

BuildingRESILIENCE

Every dollar spent on disaster-resilient infrastructure in developing countries will earn $4

A REPORT BY the World Bank and the Global Facility for Disaster Reduction and Recovery says developing low-and middle-income countries like India can save $4.2 trillion by increasing investment in infrastructure assets by 3 percentage points. Despite high investments, the report finds that the quality and adequacy of basic infrastructure services—roads, public transport, power grids, water and sanitation systems—is not up to the mark. For instance, even though research from India shows that incidence of diarrhoea in children decreases by 21% in households with access to piped water, low- and middle-income countries incur a minimum financial cost of $3-$6 billion annually, due to waterborne illnesses and the consequent loss of productive work. Add to this interruptions in water supply, and these costs reach a maximum range of $88-153 billion per year.

While infrastructure services in developing nations already tend to be fragile and prone to failure at a systemic level, the economic impact is exacerbated by natural shocks. The research estimates total annual losses due to damage and disruption of infrastructure assets and services in low- and middle-income countries to be in the range of $391-647 billion, the worst effects of which are borne by the vulnerable and marginalised groups, including the rural and urban poor, and women. Further, it asserts that investments directed towards developing climate-resilient infrastructure would allow such countries to earn $4 for every $1 spent. While resilience may be increased in any number of ways—from digging deeper foundations using alternative material and building flood protection to improving road design and building stronger water treatment plants—it is essential that it is included in the structure of regulation and incentives at the design stage itself. The key to unlocking the economic benefits of resilient infrastructure services lies in spending better, not in pumping more money into inefficient designs.

THE REAL MAINSTREAM

BY HARVESTING RAINWATER AND RECYCLING SEWAGE, MOST INDIAN CITIES CAN MEET THEIR DOMESTIC WATER NEEDS

Reimagining water: A tale of two cities

CHANDRA BHUSHAN

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Views are personal

AS CHENNAI WAS reeling under acute water scarcity and people were fighting over a bucket of water, two water-constrained cities 10,000 km apart were peacefully supplying water to their citizens. I have visited both these cities and seen how a combination of traditional practices and cutting-edge technologies can solve the water crisis in even the most water-scarce areas.

From sewage to drinking water: I heard the term Direct Potable Reuse (DPR) for the first time in August 2018 in Windhoek, capital of Namibia. The term was coined by Namibians to describe the conversion of domestic sewage into drinking water. The city of Windhoek has been treating domestic wastewater for reuse as clean water for more than half a century.

Windhoek is located in one of the driest parts of Africa. In a good year, it gets about 300-400 mm of rain annually. But most of this water evaporates and very little percolates into the ground. So, this city, with a population of over 300,000 people, has to live with a very limited supply of water. The only way they can meet their water requirement is by recycling sewage. They commissioned their first recycling plant in 1968. The older plant was closed and a new, bigger plant, the New Goreangab Reclamation Plant, was commissioned in 2002. This new plant, which I have visited, produces 21,000 m^3 of potable water/day. That is, it supplies 60 litres of water every day to each inhabitant of this desert city. This is sufficient to meet the basic needs of the citizens.

One of the key features of Windhoek is its practise of separating industrial and other toxic wastewater from the domestic wastewater stream. Domestic wastewater is taken through a separate drain and pretreated to obtain a consistent quality. The pretreated waste is then treated through a 10-step treatment plant. The treatment steps are similar to the conventional technologies that we use in our country—coagulation, flocculation, gravity filtration, activated carbon filtration, ultrafiltration, ozonation, disinfection etc. The difference is that while we use three or four steps, the New Goreangab Reclamation Plant uses 10 steps sequenced in such a way that it produces drinking water that meets the Switzerland water quality standard, the most stringent in the world. Since 1968, not a single case of negative health effects has been detected due to the use of recycled water. Amazingly, the cost of treating sewage to reuse it as drinking water is highly affordable. The New Goreangab Reclamation Plant sells water at Namibian $11 per 1000 litres. This is equivalent to 60 paise per litre of clean drinking water.

Make every drop count: Gardens by the Bay is a famous tourist spot in Singapore. It comprises of three beautifully crafted waterfront gardens made on reclaimed land. But many don't know that the water body abutting the gardens is Singapore's largest rainwater reservoir, called Mariana Reservoir. Rainwater falling on one-sixth of the land area of Singapore is collected in this reservoir, and treated and used in homes and factories.

Singapore is a water-scarce city. Apart from the water it imports from Malaysia, its only source of water is rainwater. Still, it provides its citizens with 140 litres of clean water every day by combining traditional practices with modern technologies.

Singapore is the world's foremost city in rainwater harvesting. It gets abundant rainfall, about 2400 mm/year, but has very small landmass to harvest rainwater. It also doesn't have the kind of aquifers that can store rainwater underground. So, it pioneered storm-water harvesting and above-surface storage. Today, two-thirds of Singapore is used as a water catchment, with the rainwater being collected in 17 reservoirs through storm-water drains, canals and rivers.

One of the key features of Singapore is its strict land-use regulations to keep water catchments clean by removing polluting farms and factories near catchments. In addition, it has separate drains for sewerage and storm-water. A combination of clean catchment areas and separate storm-water drains ensures that clean rainwater is collected in the reservoirs.

If Singapore can harvest rainwater, why can't Nagpur, Ranchi or Bhubaneswar? Indian cities should be asked these hard questions

But even this extensive rainwater harvesting is not sufficient to meet Singapore's water requirement, as its industrial and commercial demands far exceed its domestic demand. So, it recycles its sewage and produces NEWater, the brand name for reclaimed water produced by Singapore's Public Utilities Board. Using advanced membrane technologies and UV disinfection, Singapore recycles its sewage into ultra-clean water. This water is supplied mainly to industries and commercial establishments. Currently, 40% of Singapore's water needs are met by NEWater.

Singapore has also set-up desalination plants. Currently, it has three desalination plants that can meet up to 30% of its current water demand. So, a combination of rainwater harvesting, recycling of sewage, imported water and desalination plants makes Singapore a water-surplus city. Today, Singapore calls itself a "Global Hydrohub". It has more than 180 water companies with more than 20 water research centres that are developing cutting-edge technologies in the water sector.

The question we need to ask is that if Singapore, the world's most modern city, can harvest rainwater and recycle sewage, why can't Bengaluru, the hi-tech city of India? In fact, Bengaluru was built by harvesting rainwater in its lakes, ponds and tanks. But, most of these lakes and ponds have vanished or are polluted. But these can be revived. A study recently by TV Ramachandra and his colleagues from the Indian Institute of Science shows that by harvesting rainwater and treating sewage, Bengaluru can easily supply 135 litres of water per day to all its citizens. But will Bengaluru do this? It is most unlikely as the city has decided to commission its ₹5,500 crore Cauvery Water Supply Project, Stage V, to get an additional 775 million litres of water/day from the Cauvery.

But, is it more sustainable and affordable to get water from hundreds of kilometres away, as most Indian cities are planning, or to implement rainwater harvesting and wastewater recycling? If Windhoek and Singapore can convert sewage into potable water, why can't Delhi, Chennai or Bengaluru? If Singapore can harvest rainwater, why can't Nagpur, Ranchi or Bhubaneswar? Indian cities should be asked these hard questions when they come up with multi-crore water supply schemes.

The bottom line is that even the most water-deficient Indian city has more water than Windhoek and all major Indian cities have much larger water catchments than Singapore's. If Windhoek and Singapore can meet their water requirement by adopting traditional rainwater-harvesting practices and using cutting-edge technologies, why can't our cities? I don't see any reason why we can't.

DVR: A difference, not enough change

The acceptance of DVRs by SEBI was supposed to herald a revolution for India's digital companies. But sadly, the regulatory baggage it is saddled with, will hamper the potential of this initiative

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AS A FINANCIAL instrument, shares have two entwined characteristics: one of control and the other of economic benefits. Both these characteristics usually rank parri-passu and any change in one, necessitates a change in the other to maintain that balance. It is the flexibility to cleave these rights that have allowed for unique structures which have unlocked greater shareholder value, the likes of which have never been seen before, like Facebook, Google (now Alphabet), Snapchat and Ali Baba.

The acceptance of differential voting rights (DVRs) by SEBI yesterday was supposed to herald this revolution for India's digital companies. But sadly, the regulatory baggage it is saddled with will hamper the potential of this initiative.

India has had DVRs since 2000 with 5 listed companies, such as Tata Motors, Pantaloons Retail, Jain Irrigation, etc, opting for this. In all these cases, the shares that had differential (inferior) voting rights always had an extra coupon or an economic inducement to compensate for the lack of control, thus respecting the principle stated previously. But all this changed in 2009, with the case of *Anand Pershad Jaiswal and Ors v. Jagatjit Industries Ltd. and Ors*, wherein an issue of DVRs caused someone with a 32% economic interest to wield 62% control of the company. With this case, SEBI acted swiftly and sent a letter to all stock exchanges prohibiting the issuing of DVRs, thus ending India's brief affair with them.

If 2009 saw India shed DVRs, it also saw Facebook embrace it with open arms. The dual-class structure instituted by Facebook in 2009 allowed Mark Zuckerberg, who held 22% of Facebook, to control 57% of the voting rights in the company at the time of IPO. Facebook IPO, in 2012, saw them debut with a peak capitalisation of $104 billion and now has a market cap of $543 billion.

It is important to acknowledge that the reality digital businesses inhabit differs from traditional business or India Inc. Digital businesses and startups chase growth instead of profits initially, and raise multiple rounds of capital to achieve this. As such, the holding of the promoters or founders isn't the 50-60% that promoters of India Inc held in the olden days—they're in the low teens or even single digits. The Flipkart promoters held around 8% of the company together at the point of exit. It is this reality which necessitates DVRs to ensure that promoters of tech companies can still direct the company as per their vision.

It is important to acknowledge that the reality digital businesses inhabit differs from traditional business or India Inc. Digital businesses and startups chase growth instead of profits initially

The best blueprint for DVRs in India would be to follow the US model, wherein liquidity of these DVRs is limited and their economic rights are mitigated in favour of the preferential voting rights that they enjoy. The restrictions on the net-worth of the promoter group, the mandatory sunset clause impede the attractiveness of this. We must acknowledge that Indian tech IPOs have lagged the rest of the world. The last blockbuster tech IPO people can recollect is Mindtree, which has seen itself engulfed by L&T in a hostile takeover. Having DVRs without these restrictions might have prevented this from happening. Even Subroto Bagchi acknowledged this on a panel last Friday, when he said that SEBI's current construct wouldn't have aided their case.

The protections SEBI proposed, such as a fully independent director-led audit committee and the coat-tail provisions, will ensure minority shareholder protection. SEBI has a stellar track-record in this field. In the ease of doing business rankings, India's best showing, at number seven in the world, is in protection of minority shareholder and this is due to the efforts of SEBI. But protection should not stifle innovation, and regulations should not regress progress, but buttress it.

Innovation outstrips regulation, but regulation always outsmarts innovation. Between these lies the entrepreneur, like Icarus, who has to rise while keeping in mind not to get too close to the sun and run the risk of getting burnt.

LETTERS TO THE EDITOR

President's rule in J&K

Extension of President rule for next six months by the Modi government in Jammu & Kashmir is politically motivated as the BJP is afraid of holding the assembly election in the state under the fear of defeat—due to the mess created by the PDP-BJP alliance, resulting in the state becoming backward. There were regular attacks on Indian armed forces from the terrorist groups across the border. The fact of the matter is that when it comes to assembly elections, the centre is hesitant and wants to run the state government without any accountability. The government's zero tolerance policy is not working as the attacks against security forces continues for the last five years. The government is using President's rule as a ploy to run the state from New Delhi and wants to dictate their own terms and conditions rather than giving power to the people.

— Bhagwan Thadani
on e-mail

Arrest of dissent

The West Bengal government has come under a cloud for keeping BJP youth wing leader Priyanka Sharma behind bars despite a Supreme Court order on May 14 to release her immediately on bail. Ms Sharma was arrested and sent in for 14 days of custody for allegedly posting a morphed image of Chief Minister Mamata Banerjee on social media. This is not the first time that the Mamata dispensation is in the news for all the wrong reasons.

— NJ Ravi Chander, Bengaluru

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R.N.I. Reg. No. 6188/61 Printed for the proprietors, The Indian Express (P) Ltd by Vaidehi Chintaman Thakar at The Indian Express (P) Ltd Press, Plot No. EL-208, TTC Industrial Area, Mahape, Navi Mumbai-400 710 and published from Express Towers, Nariman Point, Mumbai-400 021. Editorial & Administrative Offices: Express Towers, Nariman Point, Mumbai-400 021. Phone: 22022627/67440000. Fax: 022-22856323.
Chairman of the Board: Viveck Goenka, Managing Editor: Sunil Jain, Deputy Managing Editor: Shobhana Subramanian* (*Responsible for selection of news under the PRB Act)

ILLUSTRATION: ROHNIT PHORE

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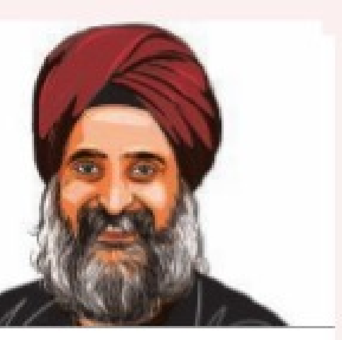

Governance challenges for India

Governance is not well measured by terms such as "minimum government, maximum governance," but by indicators of outcomes and efficiency, and by measures of accountability

FOUR OF THE most important economic challenges for India, as I argued in my last column, are fixing the financial sector, solidifying the tax system, shedding inefficient public enterprises, and reforming the agricultural sector ('*Economic challenges for the new government*', *FE*, June 18; *http://bit.ly/2xc9vDg*). The list of economic challenges does not stop with these four, but it is more important to understand the governance structures that make these and other reform areas challenging, before lengthening to-do lists. Indeed, governance challenges invariably underlie economic challenges.

The slogan of the NDA in the 2014 election campaign, "minimum government, maximum governance," hinted at an overarching idea of reducing unnecessary government interference (presumably including, but not restricted to the economy), while improving the efficiency of what government is actually supposed to do. But that slogan does not provide enough conceptual depth or richness to be a useful guide to action. So how should one think of the underlying governance challenges that India faces?

Governance includes lawmaking, institution building, regulation and administration. All of these are potentially intertwined in designing good policies and in implementing them. For example, inadequate bankruptcy laws, government ownership of banks and non-bank financial companies, and poor regulation all contributed to the bad debt problem in India's financial sector. The laws were recently improved, and the quality of regulation was improving in a parallel and complementary development, but the political compulsions of the ruling party and the overreach of the Supreme Court have both tended to move the situation further away from a speedy and efficient resolution of the problem.

This is India's core governance challenge: a tendency to concentrate power and control at the top, among a small number of loyal politicians and bureaucrats. The economic reform process of the last three decades has been marked by innovations in laws, regulatory institutions, and sources of administrative and policy expertise, all of which have the potential to support a higher growth path for India. But the general trend in the current ruling coalition has been in the direction of reversing these innovations, at least de facto if not by explicit rollbacks. Even robust governance institutions are subject to damage and erosion if a leader is determined, incompetent or malevolent enough: one is seeing this process occurring in the US, where cronyism and corruption are rampant in the Donald Trump administration, expertise is discarded or ignored, and there is pressure on supposedly independent institutions such as the Federal Reserve. One might argue that Trump is a strong leader who knows what he wants and is getting it by imposing his will, but many observers are concerned about the resulting long-run damage to various governance institutions.

India's potential challenges are somewhat different. In particular, its legal and regulatory institutions are not yet robust and efficient enough to support a thriving modern economy. For example, the agriculture sector is one of the areas of the economy that has seen the least progress in changing how productive activities are governed, instead continuing with archaic and severe market restrictions and distortions. Government control of the sector is politically valuable, and it remains to be seen if the new government's stated interest in reform translates into changes that are politically viable. The internal organisation of the judicial system, namely the manner in which legal proceedings are conducted and lawyers and judges are educated, also remains largely unreformed, as does the bureaucracy.

In this situation of limited institutional strength and efficiency, there is a real danger that those areas which have seen progress, such as the functioning of the Reserve Bank of India (RBI), or where there is a strong tradition of competence and trustworthiness, such as the Election Commission of India, will have their quality eroded by a dominant political force at the top of the governance pyramid. The Election Commission is an interesting case, since it has been considered one of India's strongest regulatory institutions, but it came in for criticism in the recent election for evidence of weakening impartiality. Of course, the Election Commission does not regulate economic activity, but if elections are no longer reliably conducted, their role as an accountability mechanism for politicians will erode.

In sum, governance is not well measured by terms such as "maximum," but by indicators of outcomes and efficiency, and by measures of accountability. Cities such as Bengaluru have experimented with citizens' scorecards, and there is much more that can be done in that respect, especially at the level of cities and towns, where the quality of governance affects residents' daily lives most directly. At the national level, the link between efforts and outcomes is more tenuous, and the decisions to be made are more abstract: the benefit of giving RBI the freedom to conduct monetary policy without political interference is not something the average voter will appreciate. Privatised banks that are more efficient, but still incentivised to serve less-well-off rural customers, will be appreciated more directly, but again, the link between the government policy and the benefits to citizens is not transparent. It may be that good governance and its recognition will be something that are best built from the bottom up, in which case the national government's role is to allow and enable subnational governments to flourish. In India's current situation, both vertical and horizontal decentralization of governance are desirable, but achieving either will be a challenge.

BUDGET 2019

Containing the past well

ANITA RASTOGI

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Towards the government's objective to promote ease of doing business in India

WITH REPORTS OF economic slowdown in the last quarter of FY19 gaining ground, the new government would like to leave no stone unturned for providing a boost to economic growth. The upcoming Union Budget, to be presented on July 5, can prove to be a bold step that the government might have in its offing.

Since the Budget would indicate the course the government would adopt over its tenure of five years, an attempt should be made towards containing the indirect tax issues and deliberations that are plaguing the sentiments of business community. Such issues primarily pertain to the ambiguities emanating from indirect tax law (other than GST) and tax department's contentions in respect of pre-GST era indirect tax laws. While the government is busy simplifying near two-year-old GST structure for businesses, delving deep into pre-GST law for raising tax demands not only leads to non-judicious use of the governmental machinery, but also dampens the investment interests of businesses.

Key issues that deserve foreclosure in the Budget are:

1. Clean up the past: The value of designs provided by vehicle manufacturers to component manufacturers be added while paying excise duty. When a vehicle manufacturer or original equipment manufacturer (OEM) gives product specifications (which can be in the form of a design) to a component manufacturer (CM), basis which a component is to be manufactured, the issue that needs to be addressed is whether the value of such product specification/design be included in the value of the component so manufactured in order to determine the excise duty payable thereon.

As a decades-old industry practice, none of the CMs have considered this as an additional consideration for it to be added to the value of the component so manufactured. The reason being that the value of the product specification/design could have only been added if the transaction value of the component was not the sole consideration to determine the value for payment of excise duty. In the instant case, the product specification/design was the condition of contract basis that the component was to be manufactured. Since they do not form part of additional consideration, no excise duty was payable on this.

> For facilitating trade, a Customs Advance Ruling Authority should be made operational at the earliest

Surprisingly, post the introduction of GST, the government has recently issued numerous show-cause notices (SCNs) to various CMs, questioning the non-inclusion of value of product specifications/designs supplied to them by OEMs as an additional consideration in the assessment value of the goods supplied to such OEMs, for the purpose of payment of excise duty.

It is, indeed, important that the government should focus on cleaning up the past rather than digging up new so-called issues which could have been considered in the pre-GST era.

In fact, there is a particular section in the excise Act that empowers the government to issue exemption for the purposes of validating common practices of an industry. It is critical that sooner than later this aspect be looked at, as even in a worst-case scenario if the CM pays additional excise duty, OEMs will not be able to take input tax credit, which otherwise they were eligible under the pre-GST era, and the whole exercise would have been revenue-neutral.

2. Formation of customs advance ruling authority: The establishment of a Customs Advance Ruling Authority is essential for faster decision-making and to reduce the overall time period within which advance ruling can be obtained by the applicant. Although the customs law has been amended to allow its establishment, the constitution of authority is pending and, as a result, applications still need to be filed with the corresponding authority established under the Income-tax Act, 1961. Hence, as a trade-facilitation measure, a Customs Advance Ruling Authority should be constituted and made operational at the earliest.

Providing solutions to problems of aforementioned nature would result in reinstatement of the government's objective to promote ease of doing business in India.

(Rohit Gupta, associate, GST, PwC India, contributed to this article.)

The new international economic order

SHARAD KUMAR

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THE GLOBAL ECONOMIC order of the day resonates a mercurial temperament frequently hitting the headlines, but geopolitics experts very skittishly avoid going to the depths of this debate.

I am reminded of the Cold War—the continued discreet skirmish between the US and USSR; it ended with Glasnost and Perestroika, leading to eventual demise of the USSR. Though slightly hyperbolic, the term resonates again, now involving a superpower of the East.

The US-China trade conflict, which data shows may be hurting US exports more than China, could give a new direction to the emerging patterns in global geopolitics. Trade tensions have reignited commitments made by China towards its Belt and Road Initiative (BRI), which due to cost-related issues was facing bottlenecks in some host countries. Worth $1 trillion, BRI includes various projects and intends to create economic corridors in Asia, Europe and East Africa.

India also shares concern about BRI along with the US, which thinks China may use BRI as a vehicle to extend its military presence in the geographies hitherto not touched upon such as Israel. India may be right that the initiative of creating an analogy of BRI with the Silk Route is a strategic move by China in the guise of economic development. Had it not been so, the Sri Lankan move to handing over Hambantota port to China on a 99-year lease would not have led to an explanation by the Sri Lankan PM about the usage of the port.

The Chinese President has never shied away from showing assertive ambitions. I am reminded of 'Balance of Power'—by David Hume in his *Essay on the Balance of Power*. Though it is difficult to say if the trade war raged by the US is an attempt to balance out the growing economic clout of China, there is a need for new strategic alliances to play down China.

On the economic front, the Asia-Africa Growth Corridor (AAGC) appears to have been thought of as a counter-initiative to balance the ambitious BRI. With almost similar economic objectives as BRI, and with Japan and India leading the way, AAGC looks more conciliatory in nature and more consultative in bringing out ideas and implementing them.

While China has been investing heavily for diplomatic, economic and military gains, India has also gained substantially as far as global opinion is concerned. While staying broadly non-aligned, India has been able to maintain good ties with developed as well as developing nations.

AAGC may turn out as a counter reply to BRI. It would connect Asia with Africa (an untapped market that presents exciting opportunities for trade and business). In the world order of today, the Cold War analogy may not hold true, but, going forward, increase in the share of economic gains, enhancing of trade benefits and grabbing of potential markets would drive the new global economic order.

Taking an interest rate call

Look before you leap

MADAN SABNAVIS

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WITH THE ELECTIONS resulting in a successful return of the NDA government, the focus of attention is now on what will be the stance taken by the MPC? Against the background of not showing a convincing uptick and out of force of habit, there are already calls for reduction of interest rates, with the decibel level being higher for 100-200bps cut. It is, hence, necessary to analyse the pros and cons of reductions in interest rates.

Interest rates have been looked at normally from the corporate lens, and hence the view is these should be lowered to spur investment. Is there a real relationship between the two? Also, as interest rates have a bearing on savings, should this perspective also be looked at? Last, as there tends to be regular comparisons of real interest rates in India with those in the developed world, is there a basis for doing so?

The best indicator of investment is the gross fixed capital formation (GFCF) rate, which is expressed as a percentage of GDP at current prices. The GFCF rate has been declining since 2012-13, from 34.3% to 28.9% in 2018-19. A decline of 5.4 percentage points is significant. During this period, the return on advances for all banks based on RBI data declined from 10.42% in 2011-12 to 8.31% in 2017-18 (the latest year for which data is available)—a decline of 211 points. Therefore, to argue that lowering rates is the panacea for investment can be contested by data.

The disconnection between the two can be explained. First due to over-investment in the pre-2011-12 era following the financial crisis, the stimulus provided on fiscal and monetary sides gave investment a boost. But much of this went into infrastructure, which was afflicted with irregularities in sectors such as coal, iron ore, power, telecom, among others. This led to projects getting stalled, which later got translated into NPAs after some umbrella cover was provided through the CDR route. This led to projects still being in the stalled mode or abandoned. Therefore, private sector interest in investment is limited irrespective of the interest rate regime.

The second reason for low investment is surplus capacity in most industries. Typically, a utilisation rate of around 78-80% is required to push investment. With the rate being stagnant in the 70-73% range on an average, there is limited push here. The latest RBI data shows this has crossed 75%, which is not consistent with the declining IIP rate. Unless this number improves, only then will fresh investment take place.

Now, the way out is really on the demand side for capacity utilisation and on structural issues relating to NPAs and regulation to reignite interest in infrastructure. Under these circumstances, there have been some collateral effects on savings, which have declined during this period.

The ratio of household savings came down from 23.64% in 2011-12 to 17.2% in 2017-18—a fall of 6.4 percentage points. This is significant because bank deposits are today around ₹125 lakh crore, and another ₹12 lakh crore are in debt mutual funds. Lowering of rates affects income received, which, in turn, affects spending power and consumption. The average cost of deposits of banks has come down from 6.28% in 2011-12 to 5.02% in 2017-18—a decline of 126bps. Thus, hasty decisions on interest rates can have a negative impact on savings.

Spread between return on advances & cost of deposits

Year	Household savings rate	Cost of deposits	GFCF	Return on advances
2011-12	23.64	6.28	34.3	10.42
2012-13	22.48	6.57	33.4	10.33
2013-14	20.34	6.39	31.3	9.98
2014-15	19.56	6.35	30.0	9.78
2015-16	17.97	6.09	28.7	9.35
2016-17	17.07	5.61	28.2	8.86
2017-18	17.2	5.02	28.6	8.31

Source: RBI

Real interest rates

Country	Real rate	Country	Real rate
USA	**0.50**	South Africa	**2.25**
Thailand	**0.52**	Malaysia	**2.80**
Philippines	**1.50**	India	**3.08**
Russia	**1.55**	Indonesia	**3.17**
Brazil	**1.56**	Mexico	**3.84**
China	**1.85**	Turkey	**4.50**

Source: Trading Economics
(Policy rate minus CPI inflation latest)

Curiously, the decline in average return on advances of 211bps was higher than that in cost of deposits of 126bps, but savings rate of households fell at a higher rate!

An interesting takeaway from the accompanying table is the spread between return on advances and cost of deposits has come down from a high of 414bps in 2011-12 to around 330bps in 2017-18, and the benefits have been more to the borrowers than the deposit-holding public.

The other issue on real interest rates does raise a fundamental question. Can we really compare the real interest rate in India with that in a western economy? The interest rate is the cost of capital and should reflect the same. This is what theory says. The cost of capital is the result of demand and supply for funds, and if supply is less as revealed by the higher CAD ex post, then it means the economy is capital-scarce. In such a situation, the interest rate level has to be higher than that in other developed economies. Lowering the interest rate to a level that is not supported by the market can lead to distortions.

The table also provides the real interest rates in various countries based on the policy rate adjusted for CPI inflation. As can be seen, the higher ranges of real interest rates are in some of the faster growing economies where there is greater demand for funds. While it can be argued that 3% real interest rate should be 2% or 1.5%, it must be realised that the real rate is looking higher due to low inflation, which is due to supply factors rather than demand. In 2013-14 and 2014-15, CPI inflation was 9.3% and 5.8%, respectively, in which case the real repo rate would have been negative.

The argument on comparing the real repo rate with those in other countries should not be considered in isolation. The low inflation rate that is being witnessed today is due to unusually low farm and fuel prices. The average CPI inflation for industrial workers up to 2017-18 was 8% per annum in the last 10 years, with seven years of above-6% mark. So, rather than looking at current inflation rate for reckoning real rate, an average may be advisable as these rates tend to be quite volatile—at times due to single commodity price effects.

The discussion points to a few conclusions. One, interest rate should be considered looking at both investment and savings, and has to be balanced as it can lead to distortions on the consumption side. Second, lower interest rates are just one factor going into investment decisions, and are not a guarantee for positive response. Third, the global real interest rate comparison misses the point that nations are different, as are their credit markets. Last, even the concept of real rates runs into problems when inflation increases, as the same train of thought can justify significantly higher repo rates when prices of, say, potatoes or onions increases, which can be adverse for future growth.