Opinion

THURSDAY, AUGUST 15, 2019

A WILD TURN

CPI(M) leader, Sitaram Yechury

"The fun and frolic in Corbett will not provide the solution to this grave economic crisis, created by the government since 2014. We have not heard any coherent plan from the govt"

Climate change denial on floods won't help

Incontrovertible proof exists linking Kerala-Karnataka-Maharashtra floods to climate change effects

THE FLOODS IN Kerala, Karnataka and Maharashtra were, without doubt, aggravated by short-sighted development that ignored the consequence of exploiting the Western Ghats in the manner this has happened and the poor urban planning that followed. But, saying that the floods have nothing to do with climate change, as environment minister Prakash Javadekar has done, is nothing short of climate denialism. In fact, it flies in the face of research on climate change impact on rainfall in the region.

Twenty-one of the 27 studies published in the 6th edition of the *Explaining Extreme Events from a Climate Perspective*—a special edition of the *Bulletin* of the American Meteorological Society—that was published in December 2017 state that extreme weather events have strong links to long-term anthropogenic climate change. The devastating floods in Uttarakhand (2013), Kashmir (2014), Gujarat (2017), Kerala (2018), and in Maharashtra, Kerala and Karnataka this year would all qualify as extreme weather events. In fact, the rainfall recorded on August 13 in Kerala was 70% above the normal, and that in Karnataka and Maharashtra, over June 1-August 16, was 20% and 31% above normal. But, more importantly, the precipitation in Kerala over August 8-14 was a whopping 387% above the normal while in Karnataka, it was 176% above the normal for that period. This clearly shows these states that are seeing some of the worst floods in their respective histories have been brought to their knees by cloudbursts. Now, research published in the Indian Meteorological Society's journal, *Vayu Mandal*, analysed rainfall data from 1871 to 2011 to find that the contribution of the southwest monsoon in the rainfall that Kerala receives has declined but there is a trend of increased pre- and post-monsoon rainfall in the recent decades.

The fact is climate change is making extreme and erratic monsoon the new normal for India. Flood-drought cycles are becoming common. Between June 1 and August 14, 25 districts in the country had large deficit of rainfall over the normal for that period while 237 recorded deficit. On the other hand, 38 recorded a large excess over the period compared to the normal while 100 experienced rainfall in excess, as per India Meteorological Department's classification. This, and excessive rainfall in an area over a short period are clearly signs of climate-change impact on the southwest monsoons. A committee of experts that studied the heavy floods in Gujarat in 2017 found that the Dhanera region in the state had received twice the seasonal normal in just two days. Vimal Mishra, of IIT Gandhinagar, had found that such extremes are expected to increase, and one-to-five day extreme rains—at levels found once in a half-millenium—can increase by 20-30% if global warming continues as usual. Inadequate storage and drainage in cities and assault on flood plains exacerbate the effects of a deluge occurring due to climate change. As *The Economic Times* reports, The Council on Energy, Environment and Water estimates that if emissions continue to be high, the probability of once-in-a-century flood for a city like Kolkata would increase by 1,000 times by 2050. IMD data shows that between 1951 and 2010, the annual and seasonal mean temperatures in the all six of the states of the Western Ghats—Maharashtra, Goa, Karnataka, Tamil Nadu and Kerala—had increased significantly, and all these states have ignored the recommendations of the Madhav Gadgil committee on the conservation of the Ghats.

As per a 2017 study, India had the second-largest number of deaths linked to extreme weather events—floods, heatwaves, etc. A paper published in *Nature Climate Change* estimates upto 60,000 extra deaths annually by 2030—and 260,000 by 2100—if climate change continues unabated. South Asia will be the worst hit region by the end of the century. Ostrich-like evasion on climate change—worse, climate change denialism—is not going to help. The government, and the green ministry, must get its act together if mitigation steps are to be taken with an eye on avoiding the disasters that are becoming increasingly frequent in these states.

Reverse insurance model

Use trusts/pools for agriculture, insurance for health

WHILE THE CENTRE is reportedly planning to tweak the norms of Pradhan Mantri Fasal Bima Yojana (PMFBY), to make crop insurance voluntary for farmers, it needs to relook the entire insurance model for both PMFBY as well as its flagship health insurance scheme Ayushman Bharat. Indeed, the model needs to be flipped; farm insurance should be based on a trust model or risk-pools, while Ayushman Bharat should be based on pure insurance instead of the trust model that several states are using right now. The reason for this is simple; there are fewer chances of fraud in farm insurance, so the insurance firm can be eliminated whereas, given the high level of fraud in medical insurance, the insurance company is critical in that case.

In the case of farm insurance, no single farmer can claim crop failure, it has to be a village, a district or a state where there has been crop failure due to flooding, drought etc; and with satellite imagery or drone, the extent of disaster can be immediately cross-checked. So, if there is a pool of insurance premium—from the centre, states and farmers—and this is kept in a trust, if the damages for a year are less than the premium, the balance can remain in the fund for use in the next year. In the two financial years—2016-17 and 2017-18—the gross premium collected was ₹48,267 crore and the payout was ₹39,789 crore. Also, it is not as if, once the premium is paid, the central/state governments have no more risk. As per the contract, to keep premiums affordable, if the losses in a year exceed a certain level, the difference is to be made good by the government anyway; if gains are above a certain level, these get ploughed back to the government. Having a trust or an insurance pool, without the insurance company, is then a less-costly model as it eliminates the profits of insurance firms.

In the case of health insurance, as was evident in Rajasthan's Bhamashah model, the risk of fraud is quite large; in this case, the fraud was so widespread the PSU insurance firm even walked out of the project. While the insurance company was catching the fraud, the state government was delaying de-empanelling the hospitals doing the fraud; also, the state government didn't make use of Aadhaar biometrics mandatory, nor time-stamped pictures of people being hospitalised/discharged. Ideally, all states enrolled in Ayushman Bharat should stop the trust model and move to insurance firms that are suitably empowered if fraud has to stop. Over time, if things go to plan, the Health Stack which will have digitised records of everyone's treatment can serve as a check, especially if data analytics and artificial intelligence is used to mine the data for frauds, but for now it is clear a good insurance model is critical.

CaughtBEHIND

BCCI finally submits to NADA dope-testing for cricketers after discrepancies in its preferred protocol surfaced

AFTER ITS DECADE-long deadlock with the National Anti-Doping Agency (NADA), the Board of Control for Cricket in India (BCCI) agreed, last Friday, to come under the it's ambit. The agreement was reached after the Union sports ministry based granting of No Objection Certificates for visas to visiting teams on the precondition that BCCI follow laws applied to the country's other athletes, including those against doping. BCCI has, however, requested for some 'premium services' citing concerns over the quality and efficiency of NADA's testing.

Making cricketers subject to out-of-competition testing and target testing will usher in equality in Indian sports. As per the World Anti Doping Agency's (WADA) norms, all athletes competing in a country are to be tested by that country's anti-doping agency. Indian cricket remained out of NADA's reach, being guided, instead, by BCCI's rules adopted in 2009. Testing of sample was outsourced and the results were handled by BCCI. This came under fire recently, when incriminating transgressions were discovered in the handling of a doping case against Indian batsman, Prithvi Shaw. NADA's scrutiny is welcome, especially since now, ICC can lobby for cricket's inclusion in the Olympics—so far, India was the only ICC member that didn't abide by WADA regulations and this is a key reason for the sport not making it to the Olympics.

RIVER RIGHTS

GIVING LEGAL RIGHTS TO INDIAN WATER BODIES IS A GREAT LEAP FORWARD IN THE PREVENTION AND REDUCTION OF WATER POLLUTION, AND OPENS UP A NEW ERA FOR ENVIRONMENTAL JUSTICE

Ripples of change

BIBEK DEBROY

Chairman PMEAC

Views are personal

AT THE TIME of taking a bath, many people still recite a *shloka*. Without using diacritical marks, rendering a *shloka* in Roman is difficult. Nevertheless—*gange cha yamune chaiva godavari sarasvati narmade sindhu kaveri jale asmin sannidhim kuru*. "O Ganga, Yamuna, Godavari, Sarasvati, Narmada, Sindhu, Kaveri! Please be present in this water." Eric Newby's "Slowly Down the Ganges" also quotes this, with the comment, "Prayer to the Seven Sacred Rivers recited by every devout Hindu at the time of taking his bath". There are many more than seven rivers in India. How many? Since there is no proper definition of a river, it is impossible to answer this question. One way to list is in terms of river basins, so that the main river and its tributaries are both included. For Himalayan rivers, one will then list Indus basin, Ganga basin, Brahmaputra basin, Barak basin and so on. Similarly, in the south, one will list basins of rivers flowing east (Godavari, Krishna, Kaveri, Mahanadi) and those flowing west (Narmada, Tapti). This still leaves some loose ends, minor rivers along the coast and rivers that don't drain into oceans. Depending on what is included, there can be more than 100 river basins and more than 600 rivers in the listing.

Rivers now have legal rights. In a way, it started with some rivers in Victoria. Then, in 2017, we had the Whanganui river in New Zealand and Ganga and Yamuna. Because of news reports, most people know what the Uttarakhand High Court said in March 2017, though there is now a stay because of an appeal before the Supreme Court. "All the Hindus have deep Astha in rivers Ganga and Yamuna, and they collectively connect with these rivers...Accordingly, while exercising the *parens patrie* jurisdiction, the Rivers Ganga and Yamuna, all their tributaries, streams, every natural water flowing with flow continuously or intermittently of these rivers, are declared as juristic/legal persons/living entities having the status of a legal person with all corresponding rights, duties and liabilities of a living person in order to preserve and conserve river Ganga and Yamuna. The Director NAMAMI Gange, the Chief Secretary of the State of Uttarakhand and the Advocate General of the State of Uttarakhand are hereby declared persons in loco parentis as the human face to protect, conserve and preserve Rivers Ganga and Yamuna and their tributaries. These Officers are bound to uphold the status of Rivers Ganges and Yamuna and also to promote the health and well-being of these rivers." Ganga and Yamuna obtained legal rights, but as minors. They needed guardians. Granting legal rights to rivers (and water bodies) opens up a new area of environmental jurisprudence.

Why did Ganga and Yamuna need legal rights? The core issue is pollution. Central Pollution Control Board (CPCB) brings out reports on water quality in our rivers. Strictly speaking, these are measures of water quality along stretches of rivers. There is actually a hierarchy of pollution, based on levels of biochemical oxygen demand (BOD). One can legitimately argue BOD is at best a partial indicator. There are other measures of a river's well-being. If BOD values exceed 8 milligrams per litre, the river will be regarded as severely polluted. Between Wazirabad and Okhla, Yamuna has a BOD level of 32, 55 and 70, at three different places. Between Kala Amb and Narayan Garh, Markanda river in Haryana has a BOD value of 590. Lists float around of most polluted rivers in the world. Ganga and Yamuna will invariably figure in these lists. Without contesting pollution in Ganga and Yamuna, one should be sceptical of lists and rankings, both because of data problems (there are good data only for OECD) and because of the way numbers are used. Similarly, there are also lists of most polluted rivers in India and these lists will typically include Ganga, Yamuna, Sabarmati, Oshiwara and Damodar. More often than not, these lists are based on CPCB findings and therefore mean stretches of rivers, not entire rivers. Somewhat more rarely, there are also lists of cleanest rivers in the world and cleanest rivers in India. For instance, stretches of Chambal, Narmada, Brahmaputra, Umngot, Teesta and Tuipui are remarkably clean.

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Ill-being of rivers is primarily due to raw sewage and industrial waste. Neither problem is new. In Britain, a Royal Commission on Sewage Disposal was established in 1898. Between 1901 and 1915, this produced ten reports. For decades, these reports were used to frame policy in Britain. People may know of this Royal Commission. I suspect not too many have heard of Kashi Ganga Prasadini Sabha, established by concerned citizens of Varanasi in 1886. The Sabha's objective was to introduce drainage and clean up the river. The Royal Commission and Namami Gange are primarily about what government does. (Namami Gange does have a public awareness component.) The Sabha was about what citizens did and in addition to the government bit, the citizen bit is also needed. Today, Thames is listed among the world's cleanest rivers. "The appearance and the smell of the water forced themselves at once upon my attention. The whole of the river was an opaque, pale brown fluid." This is from a letter Michael Faraday wrote to "*The Times*". The year was 1855. But more than one hundred years later, in 1957, Natural History Museum declared Thames biologically dead. The story of rebirth dates to late 1960-s, not earlier. Similar to the Rhine timeline.

The currency manipulation game

Fears of currency wars (or competitive depreciation) have always gone hand in hand with the desire to avoid trade wars. Both concerns are rooted in the "beggar-thy-neighbour" policies

JEFFREY FRANKEL

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THE TRADE WAR between the United States and China is heating up again, with US President Donald Trump abruptly announcing plans to impose a 10% tariff on the $300 billion worth of imports from China that he had so far left untouched. The Chinese authorities then allowed their currency, the renminbi, to fall below the symbolic threshold of CN¥7 per US dollar. The Trump administration promptly responded by naming China a "currency manipulator"—the first time the US had done that to any country in 25 years. Pundits declared a currency war, and investors immediately sent global stock markets lower.

The US assertion that the recent depreciation of the renminbi amounts to currency manipulation is not true. It would be more correct to say that the Chinese authorities gave in to market pressure—the immediate source of which was none other than Trump's announcement of the new tariffs.

Economic theory says that tariffs do not improve a country's trade balance in the way their proponents think they do. When an exchange rate is market-determined, it automatically moves to offset the tariff. Intuitively, if tariffs discourage American consumers from buying imported Chinese goods, then demand for renminbi weakens, and the currency's price falls.

The task of evaluating whether America's trading partners manipulate their currencies lies with the US Treasury Department, which uses three criteria. Two of the three coincide with internationally agreed yardsticks for manipulation under the Articles of Agreement of the International Monetary Fund: persistent one-sided intervention by the country to push down the value of its currency, and a large current-account surplus. Neither of these apply to China today. Since the US Congress assigned this task to the Treasury in 1988, the Department has fulfilled its mandate professionally, regardless of who was in the White House. The sudden decision to label China a currency manipulator, despite it not meeting the criteria, is yet another case of Trump heedlessly running roughshod over established norms, professional expertise, the long-term credibility of US institutions, and even the plain meaning of the law.

To be sure, there was a time when China did act to keep the renminbi substantially undervalued. From 2004 to mid-2014, and particularly in 2004-08, the Chinese authorities intervened heavily to slow down the currency's market-driven appreciation. Over this ten-year period, however, the renminbi still appreciated by 30% against the dollar, peaking in 2014.

Then, the wind changed, and market sentiment turned against the renminbi. For the past five years, contrary to what Trump and some other US politicians often claim, the Chinese authorities have intervened to slow down the depreciation of the currency. In 2015 and 2016, the People's Bank of China spent $1 trillion in foreign-exchange reserves (out of a total of $4 trillion) in an effort to prop up the exchange rate—by far the largest intervention in history to support the value of a currency.

The Chinese authorities' recent decision to let the renminbi break the CN¥7 barrier may well have been a deliberate response to Trump's latest tariff offensive. At the same time, however, China remains concerned that its currency might slide too far too fast and destabilise financial markets.

Trump, meanwhile, is a master at accusing others of transgressions that he himself has committed or is considering. While accusing China of currency manipulation, he wants to do the same with the dollar. Not content with publicly pressuring the US Federal Reserve to cut interest rates, Trump has explicitly attempted to talk down the currency. Clearly, he sees the world as a game of competitive depreciation.

The Trump administration has even considered the possibility of intervening directly in the foreign-exchange market to weaken the dollar. ("I could do that in two seconds if I wanted," Trump said on July 26.)

Yet such a move seems unlikely. The last US effort to depreciate the dollar against other currencies, the 1985 Plaza Accord, worked only because it was part of a coordinated G7 initiative to correct an acknowledged exchange-rate misalignment.

If America were now to engage in a pure currency war against China, it would find itself outmatched, because the US Treasury has only a fraction of the firepower available to the Chinese authorities for foreign-exchange intervention. Furthermore, no matter how crazy US policy gets, investors continue to respond to any uptick in global uncertainty by piling into dollars, the world's number-one safe-haven currency. Paradoxically, therefore, Trumpian volatility can send the dollar up rather than down.

More generally, major governments have so far abided by a 2013 agreement to refrain from competitive depreciation, in the core sense of explicitly talking down currencies or intervening in foreign-exchange markets. But, if currency wars are defined much more broadly to include central banks' decisions to ease monetary policy with the side effect of depreciating their currencies, then the windmills at which Trump is quixotically tilting may not be wholly imaginary. For example, the Bank of England responded to the Brexit referendum with monetary stimulus that depreciated the pound. More recently, the European Central Bank signaled a further easing of monetary policy in response to slower eurozone growth.

Fears of currency wars (or competitive depreciation) have always gone hand in hand with the desire to avoid trade wars. Both concerns are rooted in the "beggar-thy-neighbour" policies of the Great Depression, when countries tried to gain a competitive advantage vis-à-vis their trading partners in a collectively futile exercise.

In truth, however, currency wars are less damaging than trade wars. Whereas a currency war is likely to result in looser global monetary policy, an all-out trade war could derail the global economy and financial markets.

The real significance of the US decision to label China a currency manipulator, therefore, is that it represents a further escalation of the two countries' avoidable trade war. And, sadly, Fed interest-rate cuts may give US politicians the impression that monetary policy can repair the damage caused by their own trade-policy mistakes.

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LETTERS TO THE EDITOR

I-day reflections

It must be conceded that even after 72 years of self-rule we could not erase the dubious distinction of having the largest concentration of impoverished people on earth. While *Shining India* enjoys a measure of prosperity on account of lop-sided economic growth, the *Suffering India* still struggles to cope with dehumanising poverty. With little or no income, many people still cannot even afford basic necessities such as food and clothing. As for the fabric of society, the traditions and values we have inherited from the freedom movement are now under serious strain. The rise of Hindu Right is hastening a retreat from secularism. Hindu nationalism repudiates a pluralist approach to politics and corrodes our pluralist democracy. You can imagine the harm to the country when an ideology hostile to religious diversity becomes the ruling ideology in a multi-religious country! The ruling dispensation's intolerance of dissent is not good for a healthy democracy. In today's India criticism of the government makes one an anti-national! Citing 'national interest' and 'national security' to justify or rationalise violations of constitutionally guaranteed rights and freedoms is not worthy of a free nation. For all the rhetoric of patriotism, the notion of human equality still eludes our hierarchically-organised society. Caste consciousness is still very much there. A high-caste Hindu and a Dalit do not enjoy the same social status. Nor is the value of their lives the same. Nobody seriously seeks to de-sanctify caste. Still the lower castes support the BJP in increasing numbers, thereby lending strength to the saffron party to deny religious minorities their space and rights. Why should any non-Hindu chant '*Jai Shri Ram*' to qualify to be an Indian? For 'independence' to be meaningful in its truest sense in the Indian context, three things should happen; poverty mitigation, India's continued existence as a secular democracy and the annihilation of caste.

— G David Milton, Maruthancode

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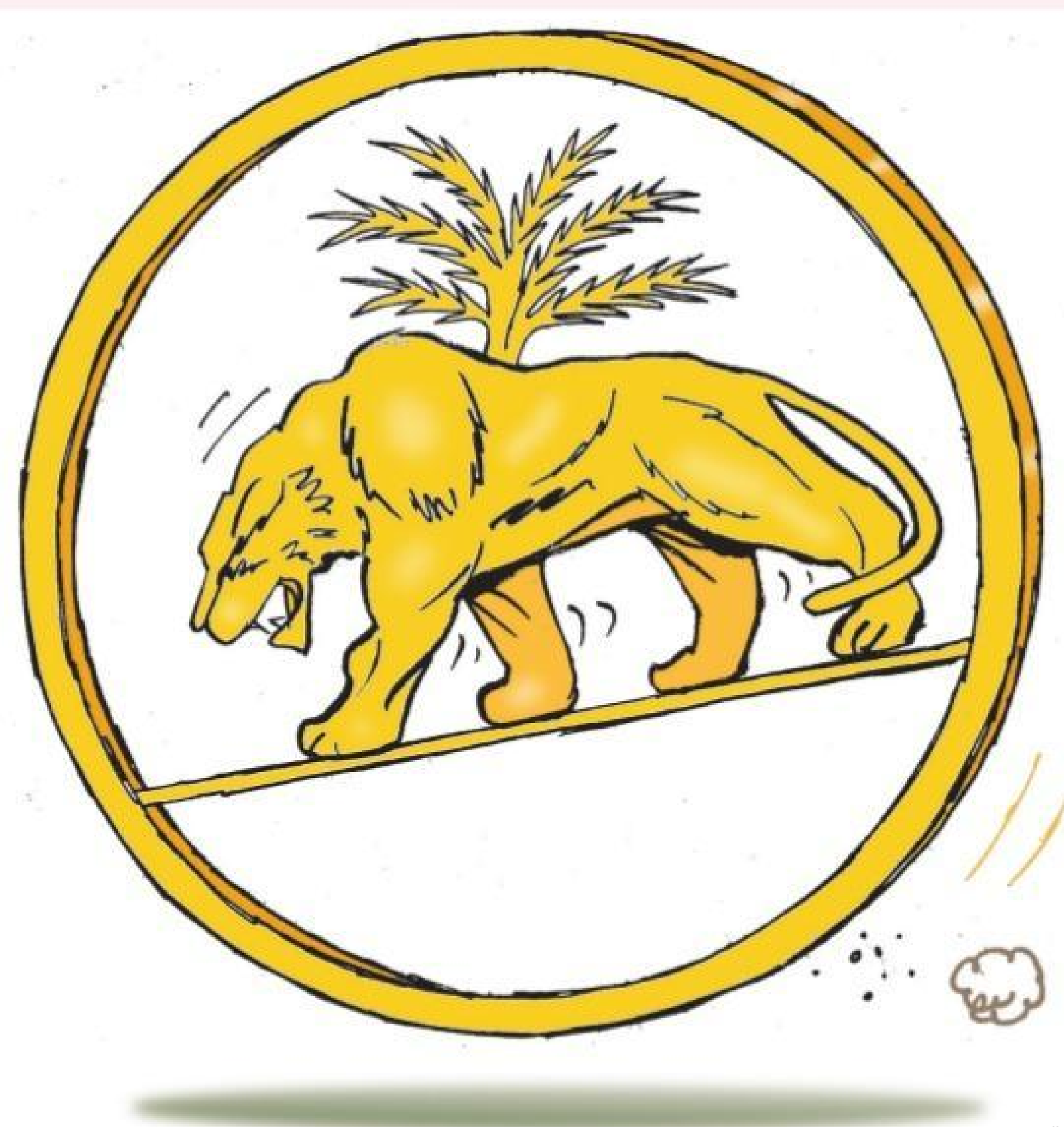

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GROWTH PRESCRIPTIONS

RBI initiatives can reverse slowdown in growth

The central bank's current monetary policy, having evolved from focusing solely on controlling inflation and emphasising independence, is aimed at supporting economic growth

IN AN INTERVIEW reported on July 22, 2019, Governor Shaktikanta Das was quoted as saying that the Reserve Bank of India (RBI) was doing everything at its disposal to be in sync with the government's efforts to accelerate economic expansion, be it interest rate cuts, ensuring sufficient liquidity or enabling more bank lending.

From the time of Das's appointment as Governor, RBI in December 2018, there has been a noticeable change in RBI philosophy. Under the leadership of the two immediately previous governors, RBI had an unwavering focus only on controlling inflation, and emphasising its independence; it ignored other government objectives, such as increasing economic growth or employment.

The objective of the Bank of England's monetary policy is to deliver price stability and, subject to that, to support the government's economic objectives, including those for growth and employment. The US Congress established the objectives for monetary policy by statute, the Federal Reserve Act, not leaving it to the independent thinking of the Fed—maximum employment, stable prices, and moderate long-term interest rates. The Law of the People's Bank of China explicitly stipulates that the ultimate goal of China's monetary policy is to maintain currency stability, and thereby facilitate economic growth—clearly, economic growth is the ultimate objective. The evolution of RBI's monetary policy objective from solely controlling inflation to supporting the government's objective of economic expansion is a refreshing and much-needed change.

RBI has sought to lower interest rates, but seems frustrated that there is a long lag between the time it lowers its repo rate—the rate at which banks can borrow from RBI in case of shortage of funds—and when the banks lower their lending rates. To speed up transmission, RBI should dramatically decrease the reverse repo rate—the rate earned by banks on deposits with RBI—so as to discourage banks from lazy banking. Public Sector Banks (PSBs) are blessed with huge inflows into savings and current accounts, notwithstanding their financial performance because of the customer perception of safety and trust that the Government of India is behind these PSBs; they get a decent return (5.15% even after the reduction on August 7) on such inflows without taking any risk by merely depositing them with RBI. Indeed, the reverse repo amounts totalled over ₹2 lakh crore at the end of the first week of August, up from ₹1 lakh crore in mid-July. This has occurred at a time when MSMEs, NBFCs, and potential borrowers are complaining of lack of availability of finance.

Since RBI has expressed its intention to enable more bank lending, reducing the reverse repo rate to a level where it is no longer attractive for banks to put deposits with RBI is a desirable and necessary step. One-third of sovereign bonds globally carry a negative rate of return, i.e., investors will get back less than what they paid at the time of issue, paying a price for safekeeping of their funds. Banks must likewise pay a price if they want the safety of deploying funds with RBI; otherwise, the banks must play their role as intermediaries between savers and borrowers, and seek out borrowers. The private sector banks have shown that there is no dearth of such customers at this time. If the reduction in repo rates leads to a reduction in deposit rates, it is only fair given the low-inflation scenario prevailing currently; the government must then act with alacrity to reduce administered interest rates, such as the unconscionable tax-free rate of return on provident funds and small deposit schemes.

The US Fed, Bank of England, Bank of Japan have been forward-looking in employing the tools of monetary policy at their disposal. In developing its monetary policy, Bank of Japan employs the Tankan survey, a quarterly poll of thousands of companies that have linkages with economic conditions. The companies are asked about current trends and conditions in the business place and their respective industries as well as their expected business activities for the next quarter and year. For example, firms are asked about domestic demand and supply, inventory levels, projections for inflation, and the number of new graduates they hired in the last year. A rear-view mirror of "hard data", which comes with a lag, results in dated inputs for monetary policy decisions. RBI must develop an efficient system of assessing every quarter forward-looking economic sentiments of rural and urban consumers and businesses as inputs for its monetary initiatives.

In the developed world, monetary policy is proactive and fiscal policy lags in response to developing economic situations. In India, monetary policy has hitherto been reactive while fiscal initiatives are more proactive—for instance, RBI, in its Monthly Monetary Policy Statement 2015-16, dated August 4, 2015, acknowledged the "Government's current proactive supply management to contain shocks to food prices, especially of vegetables, alongside its decision to keep increases in minimum support prices moderate"; the central government is trying to pace out capital expenditure evenly over the fiscal year instead of having it bunched towards the end, as was the practice in earlier times. Where the central government has miserably failed is in its own objective of ease of doing business, and in gross inefficiency in administration—witness the initiatives of the Ministry of Corporate Affairs, such as striking off companies which only hurts lakhs of innocent employees, directors and creditors while protecting the crooked cronies from tax claims, the poor implementation of the GST and the IBC, the tax initiatives introduced without homework, such as the tax on FPIs. If the central government wishes to slow down the slide in the economy and improve the growth rate, it must recognise that the enemy is within—and it is the bureaucracy.

RBI can also play its part in ease of doing business—for instance, avoiding classifying bank accounts as "dormant or inactive", which entails hassles for small depositors, avoiding paperwork for foreign receipts and payments, which even exporters have to comply with, removing the requirement of filling a KYC repeatedly for a bank customer transferring amounts to mutual funds or opening broker accounts or demat accounts, encouraging speedier adoption of technology to serve customers better.

> Too much was being made of the "independence" of RBI in the recent past. No one ever advocated reducing RBI's role in controlling money supply.

Too much was being made of the "independence" of RBI in the recent past. No one ever advocated reducing RBI's role in controlling money supply. Monetary policy objectives must be dovetailed with fiscal policy objectives, and Governor Shaktikanta Das' endorsement of this is a refreshing recent change at RBI. Along with economic growth, RBI may explicitly aim to facilitate employment, and less-explicitly, to prevent currency volatility; work with SEBI and others to facilitate foreign inflows to augment foreign exchange reserves, and to reduce the onerous form-filling requirements, thereby facilitating the less-privileged to put financial savings into financial instruments rather than land or gold; develop a framework in association with SEBI and the government for managing the possible systemic risk from large finance companies and from debt mutual funds, which do not enjoy lender-of-the-last-resort support or an inter-institutional market like the inter-bank market.

COMMODITY MARKETS

'PAC'king quite a few benefits

KUSHANKUR DEY
Professor of Finance, IIM Bodh Gaya

Product Advisory Committee will deepen benefits of derivative markets

SETTING UP AN independent Product Advisory Committee (PAC) to deepen the benefits of commodity derivative markets to commodity value chain actors is a timely move by Sebi. It will address issues in the contract design of commodities and cater to needs of physical market participants. Based on Commodity Derivatives Advisory Committee's (CADC) advice, Sebi has directed each recognised exchange, including stock and commodity, to "constitute a PAC for each group/complex of commodities having common stakeholders/value chain participants, on which derivatives are traded or being proposed to be traded". This requires PAC to:

- work on contract design for new commodities, explore a right mix of liquid and hedge contracts, review design of existing contracts, and ensure these are as per industry's needs;
- work on aligning quality/grade and quantity specifications of the product with spot/physical ready-cash markets;
- provide a choice-set of basis variety, propose additional delivery centres which are exchange-accredited warehouses, and review existing delivery centres;
- review performance of existing contracts on various explicit and broad-based parameters;
- discuss the state of markets for the commodity during meetings or at least twice a year

But, how will PAC extend benefits of futures to the value chain stakeholders? Will it effectively assess the state of the market for commodities under the chairmanship of independent advisor—devoid of any principal and agent dichotomy?

Performance review of existing futures/options contracts, changing the contract design, and exploration of opportunities for new contract could be an up-hill task.

Fundamental factors of commodities should be studied by assessing the local demand and supply. Stock-to-use ratio is essential from liquidity viewpoint of futures/options contract. In the case of *guar gum*, a derivative of *guar* seed, the stock-to-use ratio of the seed determines the liquidity position, price and spread of gum contracts. Also, convenience yield benefits to commodity-holder should be appraised before PAC decides frequency of contract, delivery and stack and roll hedging.

Identifying close substitutes or rival contracts can help explore avenues for inter- or intra-commodity spread and/or calendar spread. Selection of basis variety and tenderable varieties for futures/options contract, too, is important, to encourage and sustain participation of physical market actors.

Delivery schedule should mirror the agricultural cycle of the produce while spot price could be depressed. So, in presence of liquid and efficiency futures/option, producers can offload risk, to secure income and stimulate investment in agriculture.

Market micro-structure parameters—bid-ask spread, margining, contract size, contract duration, price band, etc—are critical to assess performance of futures/options contract. A research body aligned with PAC should review historical and stochastic performance of competing/completing contracts.

PAC's expected role, is at both at the micro and meso-levels. At the micro-level, PAC can observe heterogeneity in participation between physical and derivative market actors, helping exchanges and regulators take measures to bring parity in trade and maintain a healthy hedger-to-speculator ratio. At the meso level, it can help internalise the altruistic benefits of commodity derivative markets among market participants. The advisory body can contribute to the commodity/stock exchange utility and management in reliable price discovery, price dissemination, and effective hedging against basis risk. PAC, in its review meeting, should disclose speculator-to-hedger ratio, to help discover optimal number of derivative contracts (liquid) for each group of commodities and rationalise transaction fees.

The membership criteria and margining system for FPOs should be revised in view of financialisation of commodities. PAC and Regulatory Oversight Committee, in consultation with CADC, should enable trading, settlement, and delivery. Exchange of futures for physicals/alternate settlement mechanism should be promoted along with early pay-in facility.

PAC should facilitate index trading to access annualised average yield and volatility from the disclosure of commodity exchanges. In FY19, the average yield at N-Krishi of NCDEX and MCX-Comdex was 6.6% and 12.5%, respectively, while their volatilities varied from 19% to 37.4%. It should adopt good governance practices from international exchanges and regulators. The committee's right intention, autonomy, directed effort in facilitating and designing broad-based contracts can help accommodate a diverse group of commodity stakeholders—from producers and processors to traders.

CENTRAL BANK ALCHEMY

Converting reserves into money

Financing budget expenditure through RBI surpluses is novel financial engineering

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THE FOCUS OF attention is once again on the Jalan Committee as it is to be seen how much money can possibly be transferred to the government and the modalities of the same. This addresses the issue of utilisation of RBI's excess reserves, which have not been touched so far on the balance sheet side though surpluses generated on account of income and expenditure are transferred almost fully to the government. The other issue is how balance sheet entries will be drawn up to accommodate such drawls.

RBI has a balance sheet size of ₹36.3 lakh crore. The liabilities include a large part of issued currency, which, as of June 2018, was ₹19.2 lakh crore. Another part, of around ₹6.5 lakh crore, is deposits kept with RBI, of which ₹5 lakh crore is under CRR stipulation. These two components are tangible. The 'other liabilities' constitute the second largest part of the balance sheet at ₹10.4 lakh crore, and is the Committee's target.

Within this category, there are four significant components: contingency fund (₹2.3 lakh crore), asset development fund (₹0.22 lakh crore), investment revaluation (₹0.13 lakh crore), and currency and gold revaluation reserve (₹6.91 lakh crore). It looks likely that the contingency fund and currency revaluation funds will be the ones targeted for transfer to the government.

The contingency fund has remained virtually unchanged in the last five years at ₹2.2-2.3 lakh crore and is supposed to be used in case of revaluation of securities held by RBI. With yields coming down, the value of securities would go up and so would these funds, becoming one potential source of funds. The other is currency revaluation—quite high at ₹6.91 lakh crore. If the rupee declines, the fixed set of dollars would be valued higher in rupee terms on the assets side, increasing the reserves on the liabilities side. However, if the rupee appreciates, as is the case today, the reverse would occur and the rupee value of reserves will come down.

Hence, one is really looking at these ₹10 lakh crore of reserves, a part of which can be potentially monetised by RBI and passed on to the government. Since this is legally permitted, there can be no questions in this regard. Some of the questions that the Committee will address are the following.

First, what is the quantum of reserves that can be monetised and drawn out of the balance sheet? Is the contingency fund adequate or too high. However, if we go back another five years, a level of ₹1.5 lakh crore was also witnessed in 2009. Therefore, depending on how far back the Committee looks, there is still potential to draw down this reserve on the grounds that one could manage with a lower amount, as there has not been an instance when the level dipped sharply. Prima facie, keeping a limit of ₹2 lakh crore could be a safe level that releases ₹0.3 lakh crore.

The currency revaluation reserve has been more volatile—₹5.3-6.9 lakh crore in the last five years, with the lower end being reached in 2017 and a low of ₹1.2 lakh crore in 2010. Here, the Committee can think of lowering the reserves by a considerable amount—by, say, around ₹1.5-2 lakh crore—and keeping 15 lakh crore as the floor. Overall, around ₹2-2.2 lakh crore can be drawn from these two reserves.

The second question which follows is that if reserves were to be lowered, how would adjustment be made to the assets side of the balance sheet? If the liabilities get reduced by, say, ₹2 lakh crore, the assets, too, should be lowered. This will be interesting, because if the currency revaluation reserve is reduced, it means that some part of the forex should drop out of the system. RBI has been buying forex from banks to supply liquidity and, hence, any drawdown of forex will mean selling the same to banks, which will create a liquidity problem. Therefore, it is more likely that the dollars have to be kept in a separate suspense account to balance the accounts. Even if the contingency reserve is reduced, it could mean lowering the stock of GSecs (through OMOs), which will impact liquidity in the system as well as GSec yields. This, too, may have to be held in a different account, much like the MSS bonds. The Committee's call on this aspect is something that will be awaited.

The third question is whether the transfer will be done in one stroke or over a period of time. The indication is that it will be done over a period of three to five years, which, being more manageable, has the advantage of reducing market volatility. A one-shot transfer can mean a major shock for the financial market because if ₹2 lakh crore is taken out from, say, the currency revaluation account, the shock for the forex market can be a matter of conjecture. Alternatively, if the contingency fund is being lowered, a call has to be taken on RBI's GSec holdings, which can create disturbances in bond yields. This is something RBI has to consider finally.

Fourth, would the transfer of funds would be conditional or not? Economists would argue that if the RBI reserves are used for financing the budget and are treated as a revenue/capital receipt, depending on how the Committee sees it, it would resemble the disinvestment receipts that are used for general expenses. On the other hand, if they are earmarked for, say, bank capitalisation or specific infra projects, it would be targeted and easier to accept. Unlike disinvestment, which can spread over decades as the government can potentially sell stake in various entities, in this case, it would be almost limited by the target amount decided by the Committee. This is so because the recent experience has been that all RBI annual surpluses are transferred to the government as non-tax revenue. Hence, scope of these reserves increasing may be limited. This will subsume the concept of a macro norm being applied on the desirability of reserves and surpluses in relation to the balance sheet size, which can be 15% or 20%.

Using RBI surplus reserves for financing the budget expenditure is definitely novel—more akin to recap bonds that finances expenses through a different financial engineering. With fiscal pressures mounting, it is natural that new sources of finance are explored as traction in tax revenue is always uncertain. Sale of assets, like land or property, can be the next frontier, and the Railways could open up space for discussion.