Opinion

FRIDAY, AUGUST 2, 2019

ON FREE POWER IN DELHI

Chief Minister of Delhi, Arvind Kejriwal

"It was a journey and not possible earlier, as power companies' financial state was bad. [Earlier] companies didn't have money to even buy electricity and we had stared at blackouts."

Best to abolish CSR, just add it to the overall tax

Since UPA made CSR a mandatory levy and NDA added penal provisions to this, it is now really a CSR-tax

WHEN NARENDRA MODI first came to power, he mocked the Congress by saying that, while many apprehended that he would reduce funding to the MGNREGA job-guarantee scheme—a flagship UPA program—he was too smart to do this. MGNREGA, Modi said, was a living symbol of the UPA's inability to provide jobs; why would he remove this symbol? That sounded good, but with the NDA also increasing allocations to MGNREGA over the years, it isn't out of place to ask whether the boot is now on the other leg, that the NDA too needs a job-guarantee scheme because it has failed to provide jobs. What is even odder is how the UPA's mandatory CSR-spend has been cemented by the NDA. Till the UPA came to power and made it Compulsory Social Responsibility, Corporate Social Responsibility (CSR) was voluntary in nature, done by corporates who genuinely wanted to help people or by those who wanted to look like responsible citizens; some did it to soften the opposition from local communities to, say, selling their land to them. The UPA, influenced as it was by the NGO lobby, decided to make it mandatory and ruled that 2% of corporate profits had to be invested in CSR. Certain rules were put in place, so investing in an employees' welfare fund, for instance, wouldn't qualify as CSR.

In its wisdom, the Modi government has now added serious penalties for non-compliance apart from deciding that if corporates don't spend this money within three years, it has to be transferred to a fund like the PM's Relief Fund; India Inc has to give reasons for why it never spent the money and its officials could even be fined or imprisoned for not following the law. If this blanket provision wasn't bad enough, the amendments say "the central government may give such general or special directions...as it considers necessary to ensure compliance". While we have to wait for the detailed rules to come out, this does seem like an entry for bureaucrats to decide what will and won't qualify as CSR and, over time, the government can even start deciding what projects will qualify as CSR.

While introducing the amendments in Parliament, finance and corporate affairs minister Nirmala Sitharaman gave it a lofty spin by saying "Gandhiji's trusteeship principle is that legitimate profit-earning cannot be devoid of social responsibility", surely the taxes corporates—and individuals—pay are part of this mandatory social responsibility since a large part of these payments are used to provide facilities for the poor? Indeed, while hard-working corporates and individuals pay taxes, governments continue to fritter this away in many forms, from big leakages in social security programmes to funding massive loss-making PSUs like BSNL and Air India. But, given CSR is no longer voluntary but is completely in the nature of a tax now, with the government deciding the amount of the levy and with penal provisions for not fulfilling the requirements—including, possibly, where and how the money has to be spent—why not just scrap it and replace it with a higher corporate tax; or a cess if the idea is not to share the money with the states. India is now in the august company of countries like Nepal and Mauritius where CSR-spend is mandatory.

Conserving water

Charging for extraction is a good start

THE UNION ENVIRONMENT ministry recommending, for the second time, that users be billed for using groundwater makes a lot of sense. The green ministry has submitted a report to the National Green Tribunal (NGT), outlining a multi-decadal action plan (up to 2070) on regulation of groundwater in the country. The government had notified a similar proposal last year, but the NGT had struck it down and asked it to submit a fresh proposal. As per the current proposal, a water conservation fee (WCF) is to be charged to industrial, residential and farm-based users. The proposal also talks of water credits, earned by users based on water conservation achieved. The Action Plan for the next decade talks of aquifer and recharge area mapping across the country, a sorely neglected area so far, and developing block/village level groundwater management plans, a water security policy and a shift from block-wise groundwater management to aquifer-wise management. A Bureau of Water Use Efficiency is to be created while all groundwater extraction is to be monitored telemetrically with digital flow-meters.

The plan for later decades is to map catchment and protect springs, implement a mega recharge project for water-stressed areas, establish one monitoring stations per 10 sq km, pollutant monitoring remediation of polluted aquifers, development of a groundwater based drought alert system, etc. Groundwater extraction in overexploited, critical and semi-critical areas will only be permitted for drinking water and socially-relevant purposes like building of schools, hospitals, etc. India has just 4% of the world's freshwater reserve and nearly 80% of this is used by agriculture. Given groundwater accounts for watering needs of 65% of the total area under agriculture in the country, charging agriculture, where water as a resource is most abused was the need of the hour. The new proposal will cover nearly 1.5 crore farmers in the country, or a tenth of the overall farmer population. The exact contours of the WCF are not known yet, but the proposal last year outlined it for industrial users; an industry, after obtaining an NOC from the relevant groundwater authority, can pay and extract water.

Groundwater not only contributes to about 85% drinking water supply in rural areas but also accounts for 60% of urban water needs. With 21 cities in the country set to run completely dry in the next few years, the crushing pressure on ground water is already manifest. Of the 6,584 assessment units in the country for groundwater, 1,034 are over-exploited, 253 are termed critical, and 681 semi-critical. Unless a prudent groundwater management system, with charges deterring over-exploitation, and a sound recharge and reuse management structure is adopted, India stares at a parched future, more so with climate change effects playing out the way they are predicted to.

StillTOBACCO

The tobacco industry hopes to fight the anti-smoking campaign with products like vaping. They are as bad

SIGNIFICANT PROGRESS HAS been made in the global—and Indian—fight against tobacco. According to WHO, there are 1.1 billion smokers globally, of which, the recent Global Adult Tobacco Survey indicates, 60% of smokers intend to quit and over 40% had attempted quitting in the 12 months preceding the survey. Also, the WHO has made significant progress in creating awareness about the ills of tobacco as well as in coming up with ways to help people cure their addiction. Today, 2.4 billion people in 23 countries can avail of these services as compared to just 0.4 billion in 2007. The WHO gives credit for this to the efforts of countries like India and Brazil, primarily. Yet, as its *Report on the Global Tobacco Epidemic*, 2019 points out, tobacco firms are trying a new tack, to promote 'healthy' alternatives to cigarettes! These include vapourisers, electronic nicotine delivery systems (ENDS), heated tobacco products (HTPs). However, as the report points out, the bulk of the intoxicants are the same as in cigarettes, so the health impact is not too different. So apart from the older problems of tobacco firms trying to interfere with political and legislative processes in various countries and operating through various front groups, they are now making unproven claims and discrediting proven science; exaggerating the economic importance of the industry is another way to slow government action.

The burden of smoking-related diseases on the economy is huge and required $422 billion in global healthcare spending in 2012. As per the report, reduction in tobacco consumption will result in greater savings for nations—productivity loss because of smoking-related deaths and illnesses, have been estimated to be as high as $1,436 billion. While WHO has its own methods to help people quit smoking, if worldwide risks of tobacco consumption are to be curbed, nations have to take a strict stand against the tobacco industry and its so-called 'alternatives' that create a vicious cycle of addiction, illnesses and deaths.

URBANISE OR PERISH

TO ACHIEVE ITS TARGET OF A $5 TRN ECONOMY BY 2025, INDIA MUST OVERCOME ITS GANDHIAN FIXATION WITH A VILLAGE-BASED SOCIETY AND INVEST IN URBAN INFRA DEVELOPMENT

Urbanisation is key to drive India's growth engines

TV MOHANDAS PAI & NISHA HOLLA

Pai is Chairman, Aarin Capital & Holla is Technology fellow, C-CAMP

Views are personal

DEVELOPMENT AND URBANISATION are two sides of the same coin. No society in recent history remained agrarian while adequately providing for its population. Urbanisation aggregates human activity—aggregation leads to specialisation, specialisation to increased productivity; enabling greater availability of goods, delivery of services, increased wages, and job opportunities. Urban areas are engines of growth in any modern economy.

China is a shining example of how urbanisation drives economic growth. China rapidly urbanised from 26.4% in 1990 to 59.2% today. The impact is evident in China, where the quality of life and life expectancy have improved dramatically. We can also trace the feedforward effect in China's specialised workforce and productivity improvements—making China a Top 2 economy with nominal GDP of $14.1 trillion. In contrast, India is at $2.7 trillion, moving towards the target of $5 trillion by 2025.

The world, on average, is at 55.3% urbanisation, whereas India lags at 34% (see graphic). India has been slow to urbanise because of the fixation on being a village-based society. Most planners still look to Gandhiji's sentiments on this topic—'*The future of India lies in its villages*', he said in 1947. This is no longer true—complexity has increased, people's economic needs and aspirations have grown, and it is impossible to supply adequate resources to India's six lakh villages. Keeping India's population in villages while being unable to meet their economic needs has resulted in high inequity.

Rural employment is mostly in agriculture. 42.7% of India's workforce in 2016-17 was engaged in the agriculture sector, crawling at a 3.4% growth rate and contributing only 17.3% to the GDP (see graphic). Meanwhile, 57.3% of the workforce was engaged in industry and services, growing at 5.5% and 7.6%, respectively. The income differential is very high, the ratio being 1:3:4 for the average wages of dependents on agriculture to industry to services. Left unaddressed, this large group of agricultural dependents will always be condemned to a sub-aspirational existence—with increasing distress and perpetual dependence on subsidies from the government.

Lack of opportunities is also accelerating large-scale internal migration towards India's few urban growth engines—such as Mumbai, Bengaluru, Delhi, Hyderabad, and others. 2011 Census indicates 43,324 uninhabited villages, presumably abandoned due to migration. People are voting for urban areas with their feet while the government sings the same old romanticised song about India in villages.

Large cities are reeling under the strain of overpopulation, with problems like inadequate infrastructure and rocketing living costs. Employment is unable to keep up with the inflow. Due to high costs, it is uncompetitive to set up industries in cities. Without industries to absorb the incoming rural population, they are mostly making low wages as contract labour. Even if they earn higher wages than in their hometowns, they can't keep up with living costs—resulting in a growing urban population with unfavourable living conditions. Moreover, because of the policymakers' fixation on villages, cities aren't allocated enough to develop infrastructure to handle their rapidly expanding populations. A lose-lose situation all around.

A compelling solution to this unstable situation is the systematic shift of people from rural to urban areas. The 2011 census indicates there are 7,933 towns/cities housing 31.16% of the population, with an average population of 47,536. Of these, 465 towns have a population over one lakh and 53 cities, over ten lakh. On subtracting these, the remaining 7,468 towns must have significantly lesser populations than the 47,536 average. The upcoming 2021 census will inform us of the current situation.

Census data must be used to suitably identify 4,000-5,000 smaller towns all over India and develop them to absorb the rural-to-urban shift sustainably. GoI's Smart Cities initiative has identified 100 cities so far, focusing on roads, solar, water, and control centres. While expanding to 5,000 towns, four critical aspects must be incorporated:

1. Infrastructure and connectivity: From the planning stage, it is essential to prioritise providing infrastructure like roads and airport access, internet connectivity, and other amenities. Not only is state-of-the-art infrastructure crucial for quality of life, it also provides the logistical backbone for a productive industrial environment. Moreover, commissioning large-scale infrastructure development will also boost the construction sector—another means of mass employment. We need strategic investments from both the central and state governments in these towns for parallelised infrastructure development.

2. Labour-intensive industry (LII) clusters: Creating many LIIs in and around the 5,000 towns is the best way to provide gainful employment to the transitioning population. By focusing on the right type of industries—garments, fabrication, electronics assembly, automobiles, so on—this move will also boost India's export capabilities. With focused skilling programs, LIIs will offer excellent income opportunities to the incoming population. Even a lower wage than cities will go a long way towards quality of life, especially since living costs are lower in towns. Women, who are not as mobile as men, can also now find employment near their villages and towns, commute and earn a living. Governments, apart from focusing investment here, must also provide incentives for the private sector to create LIIs.

3. New sustainable technologies: While urbanisation improves delivery of services, it poses several challenges like congestion, restricted mobility, high waste production, and pollution. These are solved problems, however, in many parts of the world. India must invest in understanding state-of-the-art technologies and implement them. The newly developed towns will have the advantage of getting sustainable infrastructure—renewables like solar panels and wind turbines, planned tree cover to offset urban spread, water treatment facilities based on phytoremediation and other plant-based technologies, integrated recycling, EV infrastructure, and public transportation with last-mile connectivity—integrated from the planning stage itself. Older cities will need careful planning to incorporate new technologies into unwieldy city plans.

4. Planning for capacity: Indian policymaking has a jaded tradition of planning projects based on latest available data—usually outdated—like the previous census. By the time projects are completed 5-10 years later, they are operationally overloaded. Instead, it is necessary to plan projects for sewage treatment, airports, roads, water supply, and so on with at least a 20-30-year forecast with provisions for future expansion. Again, China paves the way—many major airports have received the go-ahead to build a third runway and increase seating capacity by forecasting the demand to 2030. In parallel, new airports are being commissioned all over the country to provide additional capacity using forecasting beyond 2030.

Rapid urbanisation is essential to sustain India's impressive 10-year growth trajectory and meet PM Modi's 2025 economic target of $5 trillion. The proposed network of small towns and industry clusters can become India's engine of growth and provide jobs at scale, thus improving overall economic prosperity. Sustainable urbanisation can be the force multiplier to mobilise India's potential.

Percentage of urban population in representative regions around the world

Urban population (%)

US	Europe	China	World	Africa	India
82.3	74.5	59.2	55.3	42.5	34.0

Source: World Bank

2016-17 data comparison

% GVA / GVA growth rate / Workforce distribution (%)

	% GVA	GVA growth rate	Workforce distribution	Per-capita GVA (₹)
Agriculture	17.3	3.4	42.7	41,621
Industry	29	5.5	23.8	1,25,231
Services	53.7	7.6	33.5	1,64,569

Source: RBI, MOSPI and World Bank

Achieving investment-led growth

In a world where world trade is undergoing a recession because of protectionist measures, India must look to lower effective corporate tax rates to stimulate the economy

ROHIT CHAWDHRY

Investment professional
rchawdhry@gmail.com
Views are personal

IN A RECENT insightful article in *Business Standard* entitled "The Budget, the Survey and the trilemma" (*https://bit.ly/2Yva1ri*) the author, Sajjid Chinoy, discusses the challenges facing the Indian economy. The author examines the investment led model as the key driver for a sustained 8% growth. Furthermore, he highlights that export growth remains a key determinant of investment rate and cites the 2001-2006 period as an evidence. That is, the causation runs from exports to investments rate. Finally, he concludes by emphasising that the over/undervaluation of real exchange rate is a key determinant for export growth. Hence, rupee depreciation should not be resisted as an under-valued exchange rate implies higher export, which thrusts up investment rate and, hence, overall GDP growth.

Empirically, the argument for an 8% growth, led by an investment growth, remains unquestioned. However, it is the determinant of investment rate which requires further analysis. Examination of two periods for India, 2001 to 2006 and 2012 to 2015, provides some observations. In the first period, exports' y-o-y growth averaged 20% (world exports averaged 25%); investment rate averaged 28%. In the second period, Indian export growth was flat to negative (and so was world export growth) while the investment rate was over 32%. Clearly, exports being a key determinant of investment rate cannot be comprehensively established. So what determines investment rate, then?

A regression between Indian investment rate and real interest rate (independent variable), provides an R2 of over 0.5 with a negative relationship in the period from 2002 to 2018. Admittedly, it is a small sample, but it still provides some insights. Stated differently, higher real interest rate hurts investment rate. A simpler way to explain this is as follows. Low real interest rates make it easier for corporate houses to borrow and invest. Higher investment rate encourages economies of scale, which provides cost advantage. Better cost structure make exports more competitive (along with, if possible, a competitive exchange rate), which is a critical ingredient in achieving high economic growth. Hence, the causation runs from investment rate to exports, and not the other way around. Business confidence is another determinant of investment to GDP ratio.

> **Low real interest rates make it easier for corporate houses to borrow and invest. Higher investment rate encourages economies of scale, which provides cost advantage.**

In a world where world trade is undergoing a recession because of protectionist measures, it is extremely challenging to propel one's exports via old-fashioned mercantilist policies of the eighties and nineties, without inviting higher tariffs on our exports. The way countries are now looking to stimulate their economies and investment rate is via lower effective corporate tax rates coupled with lower interest rates. For example, most major economies have seen a decline in their effective corporate tax rates from 40% in the 1990s to around 27% in 2018. With Indian corporate profits to GDP ratio for Nifty 500 companies having halved from its peak in 2008, it may be time to realign our corporate tax rates with the world, for all firms. Also, with ongoing convergence of Indian inflation with the global levels, Indian real interest rates cannot stay elevated for long, i.e., interest rates have to come down meaningfully, especially in the current deflationary environment. 25% of all global sovereign bonds offering negative yields is a pointer towards deflationary pressures. A combination of both measures—interest rate and tax rate—will likely yield the results for the policy makers.

LETTERS TO THE EDITOR

Tiger conservation

It was heartening to know that the tiger population in India has increased by 33% from 2,226 in 2014 to 2,967 in 2018. We like to believe that the figures are true and not exaggerated to claim credit for tiger conservation. The tiger, included in the 'endangered category' by the IUCN since 2008, and regarded as a keystone and flagship species in the eco-system, has become a symbol for the environmental cause and wildlife conservation. India is home to almost 75% of the world tiger population. This fact puts greater responsibility on us to do all that we can to protect them and increase their number to take the national animal off the list of 'endangered species'. According to the Wildlife Protection Society of India, of the 76 tiger deaths in 2019, 45 were natural mortalities (due to old age and disease) and 31 were poaching cases. Habitat destruction, erosion, fragmentation and mining, quarrying and carving outer areas of tiger reserves for road-building, industrial establishments and tourism recreation centres, interference with their food chain and poaching for body parts, mainly skins and bones must end if the big cats are to survive and prosper. We must win the battle to save tigers. It is an interesting fact that the India abounded with about 40,000 tigers just a century ago. Our ambitious target must be to reach this number, say in a century's time from now.

— David G Milton, Maruthancode

●Write to us at feletters@expressindia.com

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ILLUSTRATION: ROHNIT PHORE

RANVEER NAGAICH & JANAK PRIYANI

Authors are Young Professionals, NITI Aayog. Views are personal

Reviving India's consumption narrative

A holistic approach to credit markets—balancing the credit needs of households, MSMEs, private corporations and, of course, the government—is needed, ensuring that public investment 'crowds in' private investment and consumption, not 'crowds out'

LAST MONTH, THE Monetary Policy Committee of the Reserve Bank of India (RBI) reduced the policy rate by 25 basis points, against the backdrop of a slowdown in global as well as domestic growth. In its monetary policy statement, the central bank mentions that the recent slowdown in the March 2019 quarter is predominantly a consequence of decelerating consumption and export growth in the previous quarter. So, the question needs to be asked: What has been affecting consumer demand?

To understand consumer behaviour better, we have to go back to the basic microeconomic theory. First, we need to understand the difference between the change in quantity demanded versus change in demand. A change in prices leads to adjustments in quantity demanded, not demand. Therefore, in a relatively benign inflation environment, there should be a positive change in quantity demanded, leading to a temporary increase in prices. This, in turn, prompts an increase in quantity supplied, taking us back to our equilibrium price. In essence, this is a movement along the demand/supply curves, rather than shifts.

The factors affecting demand are, however, not necessarily price-sensitive. Income, preferences and confidence in the economy affect demand—resulting in a shift of the demand curve. These factors reflect the consumers' *ability* and *willingness to pay*. An increase in incomes, for example, would raise demand at every price point, not just one. The reverse holds true as well—a decrease in incomes will reduce demand at every price point. The ongoing debate about rural distress in India is essentially about the income effect.

As incomes affect the ability to pay, preferences affect the willingness to pay. For example, even though consumption as a proportion of GDP has stayed at nearly 59% over the past 15 years, the composition has undergone a shift. While food and beverages have seen the most decline as a percentage of GDP, expenditure on recreation, education and cultural services has actually grown the most.

However, in an economy where the current consumption can be financed through credit, willingness and ability to pay also depend heavily on credit availability. Consider automobile sales. A large chunk of these sales are financed through various non-banking financial companies (NBFCs). Retail lending from NBFCs saw a decline of 13% year-on-year in the December 2018 quarter from the growth in lending of 21% year-on-year in the previous quarter. Could this be a possible explanation for the deceleration in the sales of consumer durables?

An argument can be made that there is a large unfulfilled demand in India's credit markets that is holding back consumer demand. For example, vehicle loans extended by commercial banks have been showing signs of deceleration as well. Between calendar years 2015 and 2017, vehicle loans grew at an average rate of 15.8% year-on-year. In 2018, growth in loans decelerated to 9.6% year-on-year, and in 2019 further decelerated to 6.1% (till May 2019). Clearly, access to credit is impeding consumption activity in the economy. The case of consumer durables' loans is even more tricky. According to RBI data, outstanding consumer durable loans as of July 2018 stood at Rs 20,469 crore. And outstanding consumer durable loans as of May 2019 stood at a meagre Rs 6,063 crore, a precipitous fall.

There is evidence that displays a slowdown in consumption growth. Automobile sales are in a slump, and most FMCG companies reported a slowdown in earnings growth in the March quarter. This decline is further reflected in the Index of Industrial Production (IIP) numbers, which show deceleration in both consumer durables' and non-durables' output.

However, there are signs of green shoots. For instance, in the March 2019 quarter, we have seen NBFC retail lending rise by 18.6% year-on-year, compared to a decline of 13% year-on-year in December 2018. Similarly, housing loans continue to grow at a healthy pace, clocking growth of 18.7% year-on-year in May 2019. Accordingly, many analysts see this slowdown as temporary, and expect consumption to drive India's growth story in the future. However, steps must be taken now so as to ensure a smooth growth trajectory for consumption demand, reducing volatility and uncertainty.

With inflation close to the lower bound, an argument can be made for further rate reductions to bring down the real cost of borrowing. A strong policy response to reduce the cost of credit and increase the access to credit for consumers will lead to increased confidence in the economy. As RBI mentions in its statement, it is the sentiment which is weak, but very ironically, it doesn't recognise the major factor affecting it. After the cumulative 50-basis-point cut in the policy rate, there was a 21-basis-point cut in fresh loan rates. In an environment of imperfect monetary transmission, successive rate cuts may be needed to bring down the cost of lending.

Apart from reducing the cost of credit, expanding the availability of credit is of equal, if not greater importance. Consider the following: Domestic credit to the private sector (as a percentage of GDP) in India stands at 49.9% of GDP, whilst that of China stands at 161%. In upper-middle income countries, this number stands at 120.7%. This indicates there is substantial room to expand credit access in India.

> There are signs of green shoots. NBFC retail lending rose 18.6% year-on-year in the March 2019 quarter, and housing loans continue to grow at a healthy pace (grew 18.7% year-on-year in May)

Leveraging technology through fintech firms to expand access to credit provides a crucial avenue. RBI has been working on a regulatory sandbox for fintech firms since the beginning of the fiscal. Efforts should be made to operationalise this sandbox as soon as possible, as India can make significant inroads in this nascent industry. The Boston Consulting Group (BCG) has estimated that the digital lending business in India can exceed $1 trillion by 2023, confirming the enormous potential offered by this sector. Retail lending can get a much-needed fillip, boosting consumption (especially that of durables), whilst the bank clean-up process is on.

While the theory of 'loanable funds' has been subject to intense debate over the past century, it provides an interesting framework to view India's current situation. In this framework, it is our contention that the pool of loanable funds needs to be expanded. The demand for credit is in excess of supply, pushing up the real cost of capital. A holistic approach to credit markets, balancing the credit needs of households, MSMEs, private corporations and, of course, the government is needed, ensuring that public investment 'crowds in' private investment and consumption, not 'crowds out'.

Reducing trade deficit with China

RC ACHARYA

The author is former member, Railway Board

It's not an impossible task, after all

SOON AFTER TAKING power in December 1978, Deng Xiaoping famously stated: "It does not matter which colour is cat as long as it catches mice," and with that private enterprise in China was no longer a dirty word. His perceived catchphrase "To get rich is glorious" unleashed personal entrepreneurship that still drives China's economy. Today, China has spawned a vibrant private sector. India, too, took the inevitable plunge in the early 1990s, but has sadly fallen way behind.

After China joined the WTO, India-China trade has grown exponentially, from $1.49 billion in 2000-01 to $70 billion in 2018-19, with China becoming India's largest trading partner. But this has come at a cost—a yawning trade gap.

While most of its exports to China are goods and raw materials, India imports mainly intermediate and finished goods. In 2016-17, its import mix was 16% capital goods, 21% consumption goods, 63% intermediate goods. Among top exports to China are petroleum products, cotton, organic chemicals, iron ore and plastic raw materials, whereas main commodities being imported are machines for reception, conversion-transmission, bulk drugs and drug intermediates, consumer electronics, and telecom instruments.

Keeping in view huge demand for alternative sources of energy, China has developed massive capacity and occupies a dominant position in manufacture of photosensitive semiconductors and PV cells, capturing 34.3% of world market!

How is it that China is more competitive than India? Is it the one-party system with long-term objectives zealously pursued, or government's policy interventions that ensure factors of production (land, labour, capital) are available to manufacturers at the lowest possible cost, or perhaps both?

Setting aside ideological, political and social differences, China has promoted 'Made in China' with a singular zeal. In 2016, in a survey by Deloitte, CEOs of Fortune 500 companies were asked to rank countries in terms of current and future manufacturing competitiveness, in which China was declared the numero uno. No wonder major MNCs such as Samsung, Toshiba, LG and scores of US MNCs have all set up shop in China. China has also cultivated its large pool of non-resident Chinese, offering them incentives to participate in socio-economic initiatives in mainland China, with a Cabinet-rank minister to look after their affairs. Belatedly, India has also set up a separate ministry to help NRIs contribute to India's economic growth, but needs to play a proactive role.

> Given intensive G2G and B2B talks, and gaining from the fallout of China-US trade war, India should be able to reduce its trade deficit with China

While India's average hourly compensation cost in manufacturing rose from $0.73 to $1.58 in 2012, in China it rose from $0.6 to $3.06. However, Chinese lending rates have remained low—from 3.3% in 2002 to only 4.4% in 2012, whereas India registered a drop from 11.9% to 9.7% for the same period. Cost of land, of course, is another story.

Apparels, electronic goods, telecom, pharma products, oilseeds, gems and jewellery, chemicals, tobacco, plastics, marine products, cotton textiles, synthetics and rayon textiles, and leather are some products that have a bright future.

To feed its billion-plus population, China is a big importer of farm products, reaching almost 10% of global trade. With exports of our agricultural products reaching almost $40 billion, India has a major stake in gaining access, which currently is mired in Chinese regulatory maze. Similarly, India is the world's largest producer of rice, whereas China is the biggest importer of this commodity. And with China importing 3.4 million tonnes of raw sugar per year, which is subject to a quota system providing concessional tariff, India's sugar industry should be able to negotiate a way in. Similarly, export of sesame seeds has not made much headway as Indian export attracts 10% duty, whereas African countries enjoy zero duty and have captured 90% of Chinese market.

A strategy for import substitution and attracting investments in telecom, solar power, bulk drugs and drug intermediaries, auto components, industrial machinery for dairy, agriculture, food processing, textiles, paper, chemicals, etc, and, last but not the least, electric vehicles and lithium-ion batteries needs to be pursued vigorously. Given intensive G2G and B2B negotiations, and gaining from the fallout of the China-US trade war, India should be able to substantially reduce its trade deficit with China in the years to come.

INFLATION TARGETING & RUPEE

A complex relation

RBI should persist with ongoing efforts to unclog the financial system and widen financial access

RAMKISHEN S RAJAN

The author is a professor at the Lee Kuan Yew School of Public Policy, National University of Singapore

IN THE LATEST minutes of the Monetary Policy Committee meeting in June 2019 (*http://bit.ly/335Vaak*), some MPC members made explicit reference to changes in the rupee exchange rate and its consequent impact on imported inflation.

Unlike advanced economies, it is hard to ignore the significant role of exchange rate gyrations when making monetary policy decisions in emerging economies like India. Yet it remains unclear exactly how they impact the economy and what the appropriate policy response should be.

Conventional wisdom suggests that, for any given costs and prices, home currency depreciation could positively impact a country's exports and growth. Insofar as a country has multiple export partners, it is the trade-weighted or effective exchange rate that matters. Of course, the concern is that costs and producer prices could well rise (imported inputs) because of home currency depreciation and, thus, what matters from a price competitiveness perspective is the real and not nominal depreciation. Thus, both inflation and non-inflation targeting central banks in emerging economies constantly have one eye on their real effective exchange rate (REER). RBI is no exception in this regard.

Nominal currency depreciations also raise costs of imported consumer goods, which could directly impact the domestic CPI. For goods that are priced in the producer countries, insofar as a country like India has multiple import partners, once again it is the trade-weighted exchange rate that matters. As the US dollar constitutes less than 10% of India's trade-weighted exchange rate index, it appears, in the first instance, that the rupee-dollar bilateral rate that dominates news and financial markets is grossly misdirected.

Overturning conventional wisdom: In a series of academic papers over the last few years, the International Monetary Fund (IMF) chief economist Gita Gopinath and her co-authors have emphasised the prevalence of dollar invoicing in international trade. They have gone on to show that dollar changes vis-à-vis the home currency (rupee, for instance) are the main drivers of trade prices and quantities, a phenomenon they refer to as the "dominant currency paradigm" (DCP).

The DCP is likely of even more relevance to East Asian countries that are more closely connected than India to global value chains (GVCs), in which dollar trade invoicing is prevalent. However, to the extent that India is a heavy oil importer (80% of its petroleum needs are imported), and oil—like most other commodities—is primarily priced in dollars, India too is not exempt from the DCP.

Also, to the extent that many emerging economies have large external liabilities in dollars, they are likely to be especially sensitive to bilateral dollar changes, as a sharp home currency depreciation to the greenback could impact firms, both by raising the home currency value of external liabilities with negative balance sheet repercussions (if the corresponding assets are predominantly in home currency terms) as well as by reducing their ability to finance dollar debt repayments. The consequence of the home country's depreciation vis-à-vis the dollar appreciation is to curtail international trade and negatively impact economic activity.

Therefore, other things equal, while rupee depreciation against the dollar could improve India's trade balance and provide a degree of economic stimulus, working against this is the negative effect of higher import costs as well as a deterioration in balance sheets and tightening credit conditions due to rising debt service costs. The net effect of such exchange rate movements is, therefore, ambiguous on inflation, trade and overall output.

Conversely, while a depreciating greenback may initially help reduce imported commodity inflation, it could also lead to a build-up of foreign currency debt, hence raising a country's vulnerability over time. Thus, while the exchange rate is certainly important for a country like India, it is unclear what exchange rate to pay closest attention to and in which direction.

Implications for policy: While there is not much a country like India can do to impact dollar invoicing of commodities in the short term, it should aim to reduce its direct vulnerability to exchange rate changes as a step towards enhancing the overall resilience of the economy against external financial shocks. But the recent announcement of a $10 billion sovereign bond issuance seems to be a step in exactly the opposite direction. The government, for its part, should also carefully consider the potential risks of currency exposure in deciding on sovereign bond issuances. If, on balance, the belief is that the benefits of accumulating external foreign currency debt (in terms of lower interest costs and less crowding out of domestic investment domestically) are worth the risks (of depreciation of the rupee vis-à-vis the funding currency and consequent adverse effects), it is advisable to spread the borrowings across a diversified basket of currencies.

Such a diversified basket would make the financial channel of exchange rate changes more dependent on trade-weighted exchange rate changes rather than bilateral ones. While the financial channel would still impact the economy in a different direction from the trade channel (i.e. REER depreciation improves trade balance, but worsens balance sheets), RBI could aim to ensure REER is broadly stable via sterilised FX operations, while the MPC can focus solely on the direct and indirect impacts of interest rate changes on inflation first and foremost, and then output.

While it is paramount RBI maintains public commitment to its inflation target as a means of anchoring inflation expectations, it should also persist with efforts to unclog the financial system and widen financial access to enhance effectiveness of interest rate transmission, while using macroprudential polices to mitigate the build-up of vulnerabilities. In these efforts, one hopes that government actions do not work at cross-purposes with RBI.