Opinion

TUESDAY, SEPTEMBER 10, 2019

100 NOT OUT

Prime Minister of India, Narendra Modi

"Whatever big decisions were taken in the past 100 days, inspiration behind them were 130 crore people of the country... I thank all the parties for the record work done"

Need to relook the current NHAI road-building model

With costs soaring and private sector unable to invest, NHAI took on too much debt and is now near-bankrupt

INDIA'S ROAD-BUILDING programme, which was going places, could be stopped in its tracks. On the one hand, the prime mover—NHAI, or the National Highway Authority of India—is clearly financially stretched. Former chairman Brijeshwar Singh estimated that the contingent liabilities could be more than twice the hard liabilities of ₹1.5 lakh crore. While this observation has been rebutted by the current chairman, it is evident the authority's balance sheet is far from robust. The CAG pointed out the NHAI had failed to set aside the mandatory sum (half-yearly) from its income in a reserve fund. Unless budgetary support to the authority increases substantially, it will become more dependent on costlier market borrowings. As for concessionaires, few today have the financial wherewithal to support projects with an equity contribution; more importantly, they are unwilling to take on project risks. Developers want to work with the BOT-HAM (hybrid annuity model), where the NHAI takes on most of the equity risk, and also shoulders the responsibility of acquiring the land and collecting the toll. The HAM is much like an EPC, with the concessionaire having virtually no skin in the game; the equity contribution is sub-10%. That is one reason why banks are wary of extending loans to these projects.

The government launched the HAM because builders were reluctant to execute the plain-vanilla BOT (build-operate-transfer) projects. Not surprisingly, the share of BOT projects has come down sharply. In FY18, of the overall 7,397 km awarded by the NHAI, around 3,397 km was awarded under HAM, 3,791 km under EPC, and only 209 km under BOT. In FY19, the projects awarded through HAM slowed down to around 880 km of the overall 2,222 km awarded, partly because of delays in getting the right-of-way, but also because financial tie-ups were not easy to come by. The authority now wants to re-focus on the BOT, but concessionaires may hesitate to participate in these projects. For one, their balance sheets remain stressed; most will find it hard to bring in equity capital, and even more will be unable to tie up bank loans. Even if NHAI comes forth to acquire the land—which it should—it is doubtful banks will lend to promoters who are stressed. The appetite for BOT, therefore, could be limited unless the model is tweaked.

One reason for the road-building programme losing steam is that after the revised compensation guidelines of 2013, land prices have soared. In 2017-18, they were ₹3.8 crore per hectare, and moderated to ₹2.5 crore in 2018-19 due to more greenfield related acquisitions. The high land costs have compelled NHAI to borrow more; market borrowings rose to ₹62,000 crore in FY19, taking the debt to an estimated ₹1.8 lakh crore from ₹1.22 lakh crore in 2017-18, and a near-threefold increase over the debt in FY14. While the general elections slowed the pace of awards, the fact is that only 500 km of roads projects were awarded between April and July. That was on the back of a subdued performance in 2018-19, when only 2,222 km were awarded, down from 7,400 km in the previous year. In fact, construction rose just marginally to 3,320 km from 3,071 km in 2017-18. Even if NHAI is able to rustle up the funds, concessionaires will find it hard to do so.

Not just market share

SC ruling in Uber-Meru case has important implications

AS A GENERAL rule, most people believe that if a firm doesn't have much market-power in an industry, it cannot be construed to be indulging in predatory pricing, even if its pricing is way below its costs. Indeed, as a recent case involving cab firms Meru and Uber shows, even the Competition Commission of India (CCI) seems to believe this to be the case. This never really made sense since, even in the case of imports from countries that have little market share, the government is quick to impose anti-dumping duties, which are, in a fundamental sense, the same as action against predatory pricing. In this particular case, Meru approached CCI in 2015, alleging new entrant Uber was indulging in predatory pricing; to support this contention, it gave details of how much Uber was losing—₹204 per trip—and said that its market share was above 50%, as per a market survey report by New Age Tech Sci Research Private Limited. Meru also said that, while Uber began its service, it charged ₹20 per km—most radio cabs charged around ₹23 at that point—but this was dropped to ₹7-12 per km for different categories of services.

CCI, however, rejected Meru's plea for an investigation on various grounds. For one, it contested the New Age Tech study, and said its findings were quite different from a report by 6Wresearch that CCI had been presented with in another case; CCI also said that the relevant market was Delhi, and not the Delhi-NCR that Meru argued was the case; CCI added that there is a vibrant and dynamic radio taxi service market in Delhi, so Uber was not dominant in the relevant market.

This ruling was struck down by the Competition Appellate Tribunal (Compat), and this has just been upheld by the Supreme Court (SC). Compat pulled up CCI for first dismissing the New Age Tech report, and yet, later, combining this with the 6Wresearch report; and if the findings were contradictory, why not get a fresh report done? More important, Compat said that, under competition law, dominance doesn't necessarily have to be related to just market-share in statistical terms. Compat drew CCI's attention to sub-clauses b, c, d, and e of 19(4) of the Competition Act; the "issue of dominance needs to be seen from a perspective that does not limit to the market share of the enterprise alone..." The Compat ruling, and the SC stamp of approval are an important milestone in India's competition law. Indeed, if the market-share criterion was to be rigidly followed, this would have meant CCI would never take action against an RJio—it didn't, as it happens—or a Flipkart/Amazon, just because their initial market-shares were low. Of course, CCI action has to look at other issues as well, like technology and consumer welfare—technology changes market dynamics more than anything else, and lower prices benefit consumers—but recognising that concepts like significant market share are outdated is also important.

FreebieSPEECH

The SC warning the Delhi govt against its plan to give free rides to women on Delhi Metro smacks of judicial overreach

THE SUPREME COURT (SC), on Friday, warned the Arvind Kerjriwal-led Delhi government against its plan of making metro rides free for women, asserting that it was not beyond the powers of the apex court to intervene in case of mismanagement of public money to provide sops and freebies. Justices Arun Mishra and Deepak Gupta, while hearing the matter of the construction of Phase IV of the Delhi Metro, opined that allowing people to travel free would run the Delhi Metro into a loss, and, given the Delhi government's insistence that the Centre must share any further operational losses that DMRC may suffer, the scale of loss of public funds is unjustifiable. The SC may be right about the distortionary effect freebies have, but dictating, or declaring its intent to dictate, to a democratically elected government on how it should spend public funds is, in principle, overreach.

The question is not whether the AAP government is right or wrong in making public transport free for females, or even, for that matter, whether the other sops it plans to roll out, on electricity and water, for instance, are economically-sound decisions. At the heart of the matter is whether the SC is right in interfering in the matters that are exclusively the turf of the legislature. More so, since it has set no precedent in this regard, cautioning against similar channelling of public money to freebies and sops, say, under the National Food Security Act, which gives almost two-thirds of the country's population substantial subsidies. In intervening in matters of governance, the SC is not only reaching beyond its given mandate but also violating the constitutional principle of the unbiased, and independent functioning of the state organ. There are many institutional mechanisms to check for the soundness, or the lack thereof, of a government's spending decisions. The SC should refrain from pronouncing in a manner that tramples on the separation of powers.

STRUCTURAL FAILURES

WITH THIS COLLAPSE, SEVERAL GROWTH NARRATIVES OF THE PAST TURN OUT TO BE MYTHS

Growth distress returns

RENU KOHLI

New Delhi-based macroeconomist
Views are personal

GDP GROWTH PLUMMETING to 5% has triggered another round of downward revisions to FY20 GDP forecasts, closer to 6%, or even lower. The collapse in private consumption has punctured the one leg on which the economy stood. The elephant that was poised to run post-GST has been grounded, pushing the government's $5-trillion economy dream further ahead. The extent of output collapse (three percentage points *vis-a-vis* April-June 2018) has surprised even the government's worst critics, invoking a debate if this is cyclical or structural. Many consider it cyclical, including RBI, which also finds trend growth moderating since 2016-17. Lowered potential output suggests the story lies on the structural side.

Economists are advocating more structural reforms. That is for the future. What about the past? Modi 1.0 government introduced several big and small reforms, especially inflation targeting, IBC, RERA, demonetisation, GST, and improving doing business. Modi 2.0 should be reaping the dividend. Instead, growth faltered. What went wrong?

The inevitable comparison with the 2012 slowdown calls for revisiting growth narratives of the time. It is important to see how these hold out, as they guided Modi 1.0's policy responses.

Policy Paralysis: The outstanding explanation of 2012 slowdown was 'policy paralysis'—government failure in timely project clearances, mostly infrastructure, which stalled due to land acquisition, environment and forest rights issues. Attributed to weak leadership of a coalition government, the recommended solution was reforming governance—strong, decisive leadership could take quicker action. The new government cleared many stalled projects, sparking expectations of imminent investment revival. But, investment never recovered; it is probably more depressed. Private participants remain risk-averse to infrastructure exposure even as public capex is exhausted.

The 'policy paralysis' diagnosis was always overblown, limited, and evaded material issues of private risk-taking and sharing, external demand collapse, and other nuances, which 'decisive leadership' alone couldn't resolve. As early as March 2014 (*bit.ly/2k2CxSO*), we apprehended that these narrow accounts risked skipping policy focus on 'real' productivity-enhancing reforms. Growth costs of overemphasising governance are now apparent.

Growth Domestic demand-driven; External Factors mattered little: External factors were given short shrift. The overwhelming conclusion was India's growth was largely driven by a domestic demand-oriented investment boom; unlike China, and several other emerging markets, India relied less on exports. Growth decomposition, and econometric exercises reaffirmed this, attributing investment shortfall as the major cause. Added to evidence on stalled infrastructure projects, the verdict was that domestic policy uncertainties, not world recession, forced businessmen to abandon ongoing projects; scrap future plans. That India was no exception to a global downturn—prominent economies like Russia, Turkey, Thailand, China and South Africa experienced even sharper slowdowns in 2012-13—was ignored.

This led to subsequent neglect of exports, and trade policy. Exports lost competitiveness not just from rupee appreciation due to illusory external balance improvement but also from failure to recognise the trend fall in world trade volumes, which, ideally, should have urged appropriate structural reforms to gain an extra edge. While our emerging market peers focused upon efficiency-productivity improvements through structural reforms in that period, the underplayed role of external conditions proved costly, with excessive faith on propping up domestic demand, including from strengthening currency.

Structural Reforms: The failure to make India's factor markets, other institutions more flexible, and efficient, to lower trade-production costs in the post-crisis world was also attributed to an inept, coalition government. The new government did try to revise land acquisition rules, but lacked majority in the Upper House, leaving labour market reforms to state governments. But, Modi 1.0 instituted other signal reforms, whose growth outcomes deserve appraisal.

Inflation Targeting intended to resolve India's high-inflation by anchoring expectations, disciplining wage-price spirals to deliver fairer returns to savers, and lower costs for producers. The promise was low and stable inflation would lay the foundation for strong and sustainable growth for many years. Inflation did lower, but growth dropped; higher returns haven't quite excited savers as declining household financial savings testify, while producers and several commentators blame high real interest rates for discouraging investment. Contextually, the IT reform missed reading the secular decline in global inflation, which major central banks have failed to revive. India kept real interest rates astronomically high in this environment, extracting severe output sacrifice.

> The need of the hour is to recoup lost competitiveness, unaddressed since the 1991 reforms

Demonetisation, a 'structural reform' to encourage formalisation, digitisation, and increase public revenues and savings by discouraging cash holdings, eliminating black money proved nothing as such. But, it deserves flagging the economy struggles, today, from a depressed informal sector, as commentators debate about how to address it!

GST, the 'one nation-one tax' ushered in Parliament's central hall in July 2017, estimated GDP gains between 0.9-1.7%, and higher exports in the 3.2-6.3% range. Other benefits were structural improvement in fiscal balances from higher compliance and revenues; positive direct tax collection spillovers from removed distortions; better governance from increased transparency; new job opportunities; decentralisation of production, formalisation, etc. Two years later, none of this is visible: GDP and tax revenue growth have precipitously slowed, and market share gains of organised firms are reported to be tapering off even as transport times are reduced and logistics improved. Did GST follow too close after demonetisation, affecting careful designing and implementation?

Insolvency and Bankruptcy Code provides legal exit and resolution options for failed businesses, imparting certainty. However, its impacts upon existing and potential/new investors need differentiation: IBC increases uncertainty for existing investors, deterring them from further investments seeing the fate of past ones; new investors do have more future certainty, but do not foresee demand. We need to recognise this dynamics to understand that IBC has not yielded any growth benefits.

Banking sector stress was recognised mid-way through Modi 1.0, which responded to NPA recognition, resolution, recapitalisation and reform. The process has been slow, and is still incomplete; recapitalisation has been inadequate as regulatory and growth capital needs are consistently underestimated, and fall short; public banks' reform misses key governance problems. Then, some private banks got similarly sullied. Growth was surely pulled down.

Excess Welfare Spending or Dolenomics: Excessive welfare spending squeezed public capex, worsened expenditure quality, and underpinned the severe resource constraint by 2012. This 'dolenomics' analysis perversely influenced public spending by Modi 1.0: it neither controlled nor reformed revenue expenditure, but rather expanded it, scaling-up capex through large off-budget borrowings. The outcome is counterproductive, as this pattern pushed up private borrowing costs—a serious mistake—creating further resource constraints while the private investment shortfall persists.

The partial growth narratives of the 2012 slowdown led to investing of political capital in inadequate policy actions, missing deep-seated reforms to raise productivity in a stagnant post-crisis world. Potential output is, no doubt, lowered with no fresh capital stock addition for one decade, falling labour force participation and lagging productivity. As growth collapses once more, there is little choice but to take a hard look at what holds India back the most: the high costs of production, and trade transactions. The need of the hour is to recoup its lost competitiveness, unaddressed since the 1991 reforms. There is a majority government in both houses. This political dividend needs harnessing to reform land, labour, markets, and institutions for conversion to a growth-dividend and job-creation.

Keep your eye on the road

Tax cuts for the auto industry may cheer the equity markets, but for bond investors, the govt's share matters as much as the private sector's spending capacity

ANDY MUKHERJEE

Bloomberg

INDIA'S PLUNGING AUTO sales are making investors nervous. Their bigger worry should be the vanishing new roads.

The country's top six automakers reported a 29% decline in August sales. A 45% slump in commercial vehicle sales by Tata Motors Ltd, the No. 1 Indian truck maker, added to the gloom. With GDP growth facing its longest slump since 2012, India is in a quasi-recession, Teresa John, an economist at Nirmal Bang Equities Pvt in Mumbai, said in a report this week.

The bond market seems to agree. A five-year swap, which allows investors to lock in a fixed interest rate by promising to pay a floating overnight rate, has dived to its lowest since the 2008-09 global financial crisis. The swap, a proxy for how traders view short-term rates will behave in the future, is signalling expectations of very deep cuts in the policy rate.

While those cuts would push up bond prices, a 5%-plus drop in the rupee so far this year will undercut the dollar value of capital gains for global investors. New money may be dissuaded by low initial yields plus the risk that the rupee could fall more.

A contrast with Indonesia may be helpful. Like its bigger neighbouring economy, Indonesia, too, is hungry for capital that would create jobs for its teeming youth population.

But while Indonesian government bonds have attracted $8 billion in foreign money this year, net inflows into Indian debt securities have been $4.5 billion. Indonesia's economy will also slow because of the US-China trade war. Still, Jakarta has the fiscal headroom to follow through on its intention of slashing corporate tax rates by 5 percentage points to 20%. If that's not enough to spur business activity, President Joko Widodo can also channel fresh investment into a brand new capital city.

That brings us to Indian prime minister Narendra Modi's pro-growth spending ambitions. A $70 billion plan to build a 35,000-kilometre (22,000-mile) road network is under way. Highways can act as a powerful stimulus by creating new construction jobs, spawning fresh orders for excavators, graders and rollers, and putting spending money in the hands of people whose land is getting acquired.

Trouble is, India doesn't have fiscal resources. Even involving the private sector to share 60% of the cost of new roads—against a guaranteed annuity for 15 years—is getting tricky. After shouldering the burden of the remaining 40% cost, the highway authority's debt has risen to 1.8 trillion rupees from 240 billion rupees five years ago. The agency has to slow down. Realistically, it can award between 3,100 km and 3,500 km annually over the next four years, according to SBICAP Securities, a big drop from the record 7,400 km of contracts it gave out in the year ended in March 2018.

In the absence of more spending in an area with a high fiscal multiplier, deeper interest rate cuts may be needed to arrest plunging GDP growth. That overburdening of monetary policy is something investors will take into account.

More crucially, monetising existing roads could generate the much-needed upfront funds to build more new ones. But a 3-km stretch sold to investors for 30 years garners resources to build only 1 km of new highways. That's partly because the previous government came up with a law to ensure landowners get 34 million rupees per hectare as compensation, versus just 7 million rupees in 2013. All very noble (and extremely populist), but where's this money going? Why can't Modi's all-pervasive goods and services tax pull some of it back for the exchequer to ease the financial constraints on infrastructure?

Investors can keep asking, but a government that has only recently admitted to a widespread slowdown won't accept that its GST is fatally flawed. Some tax cuts for the auto industry may cheer the equity markets. But for bond investors, what matters is not only how much more the private sector can spend out of any tax relief, but also how much less the government will get, and therefore what its borrowing will be.

Let equity markets worry about cars. Bond investors have their eyes on the road.

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LETTERS TO THE EDITOR

Kashmir imbroglio

The Modi government's stand that the abrogation of Article 370 will bring about the integration of Jammu & Kashmir with the rest of India simply does not stand up to ratiocination. The continuing lockdown in the Valley begs the question of whether the government has really done right by J&K's inhabitants. Instead of allowing the indigenous people of the Valley to integrate with those of mainland India organically and of their own free will, the Modi government has hastened to forcibly graft the crown of the sub-continent onto a supranational entity. It is unfair not to let the people of Kashmir have their say. The overwhelming support for the misstep is explicable in terms of the numerical superiority and predominance of Hindus. To put it candidly and concisely, the Kashmir problem still remains vexed, intractable and unresolved because of the religious fault-lines that run deep through the sub-continent. It is a fallacy to say that the Modi government has 'liberated Kashmir from the clutches of Abdullahs and Muftis' or that its assurance of 'development' will win over disaffected and alienated Kashmiris. It is not unpatriotic to take the view that the restoration of Article 370, granting greater autonomy, coupled with measures to fulfil legitimate political aspirations and adherence to secularism in the rest of India are what is needed for the Valley's integration in its true sense.

— G David Milton, Maruthancode

●Write to us at feletters@expressindia.com

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ILLUSTRATION: SHYAM KUMAR PRASAD

SANJEEV NAYYAR

The author is a chartered accountant and founder, eSamskriti.com. Twitter: @NayyarSanjeev

Is the auto slowdown for real?

Governments must stop milking the auto sector unless they wish it goes the telecom way. Neither consumers nor manufacturers want policy uncertainty

NOT A DAY passes without reading how the Indian automotive sector is in the midst of a crisis and its appeals to the government for help. This article takes an integrated view of the issues involved with an intent to provoke thought. The author does not claim to be an auto expert.

Amidst sagging animal spirits, Kia Seltos got 23,000 bookings and MG Hector 21,000 bookings, collecting a booking amount of Rs 57.5 crore and Rs 105 crore, respectively. Buyers aspire, have money, hence booked.

Modi 2.0 started on a wrong note by seeking to fast forward the use of electric vehicles (EVs) without any infrastructure for charging. It created a perception that only sales of EVs would be allowed and internal combustion engine (ICE) would be banned, especially in two-wheelers. Next, the Budget 2019 levied a special additional excise duty and road and infrastructure cess on petrol and diesel of Rs 1 each. An earlier Supreme Court order increased insurance cost by making it mandatory to have long-term third-party insurance, three years for cars and five years for two-wheelers. As if this was not enough, the government increased registration fees. Governments must stop milking the auto sector unless they wish it goes the telecom way. Neither consumers nor manufacturers want policy uncertainty. It affects consumer confidence and future investments.

Another related issue is introduction of Bharat Stage 6 norms in April 2020. As a consumer, why would I buy a BS4 car when April 2020 is just six months away? Since India has a vibrant second-hand car market, the resale value of a BS4 car in, say, 2024 would be much lower than a BS6 one. More about BS6 later.

Also, the popularity of shared mobility or cab services, which contributed to a surge in sales earlier, has begun to hurt. And the cost of owning a car has gone up. A consumer pays EMI (high interest rates), recurring cost of fuel, insurance, registration, maintenance, and hassle of car parking. Cab services reduce your investment and stress. Uday Kotak, the MD of Kotak Mahindra Bank, recently said that consumers prefer car services. It is now considered cool to use cabs, not own a car. Consumer behaviour is changing. As the metro rail coverage increases across India, it might further reduce the demand for cars and two-wheelers.

By nature, Indians are bargain hunters. With the industry clamouring for a GST cut, they are waiting to see if the government succumbs. Modi 2.0 has compounded the problem by taking a piecemeal rather than integrated approach to address the alleged auto industry woes.

Let us look at sales numbers now.

Exports of passenger vehicles (PVs) peaked in 2016-17 (see table), growing by only 9% over a five-year period. India has a long tradition of making commercial vehicles (CVs), yet export numbers are an embarrassment. Three-wheeler exports grew by 39% and those of two-wheelers by 33% over a five-year period. Two-wheeler exports grew at a good 20.3% and 16.5% in 2017-18 and 2018-19, respectively. One does not need to be an IIM graduate to know that exports compel manufacturers to improve quality, technology and reduce per unit indirect cost, amongst others.

Also, over a five-year period, growth in domestic sales volumes was 30% for PVs, 64% for CVs, 32% for three-wheelers and 33% for two-wheelers (see table). PV sales grew at a high of 9.3% in 2016-17, falling to 2.7% in 2018-19. Actually, growth rates in PV sales started falling in 2017-18. The decline in sales could also be because of lack of new products, especially in the affordable segment. When I look at the top-20 cars by sales volume in July 2019, I see the same old models. Where is the motivation to buy!

In a recent interview to ET Now, Prashant Jain, CIO and ED of HDFC AMC, said, "Consumer discretionary spending is slowing down. The real reason for this slowdown is that white-collar wages in the private sector have not done well over the last many years. Actually, in many areas of the economy, they have degrown in real terms. The last few years' growth was sustained by increasing household borrowings and falling savings. Household leverage in India has gone up pretty sharply in the last 5-6 years. We are coming to a stage where we do not have much room to borrow and consume. Going forward, consumption will grow when jobs and wages increase."

CVs grew at 20% in 2017-18 and 18% in 2018-19. If one compares sales of CVs in 2019-20 with the previous two periods, the fall would be sharp on account of a high base.

It can be argued new axle-load norms led to an increase in rated load capacity of trucks, allowing transporters to carry additional weight, and thus reduced demand for CVs. Actually, "The higher limit, i.e. increased load, has in a way legalised overloading and given fleet owners the opportunity to sweat their existing assets more instead of purchasing new trucks." (*http://bit.ly/2lZjiKu*).

Two-wheeler sales grew at 14.8% in 2017-18 as against 6.9% in 2016-17 and 4.9% in 2018-19. Rajiv Bajaj, MD, Bajaj Auto, recently asked, "In terms of motorcycles, I was looking at these numbers, year on year the decline in retail sales is only around 5-7%... if that can be called a crisis, what is it we mean by the normal up and down cycle of a business?"

The above are wholesale numbers, i.e. from companies to wholesalers. Can the Society of Indian Automobile Manufacturers, the industry body, release retail sales for a better evaluation of trends?

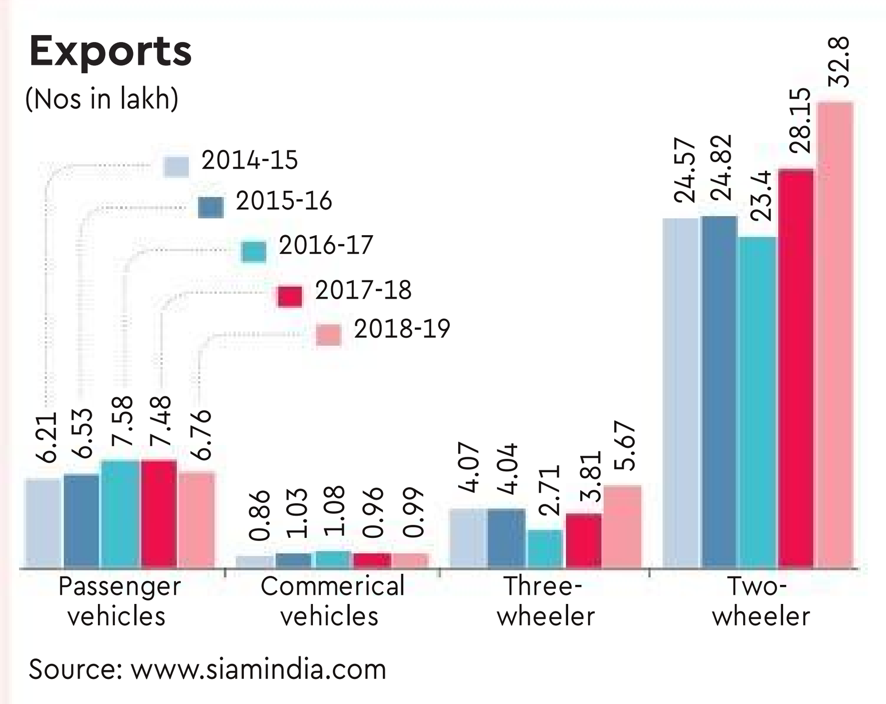
The crisis in the NBFC sector has reduced financing options for consumers. The question is whether over-leveraging by NBFCs should be brought out in the open or brushed under the carpet for fear of hitting growth rates?

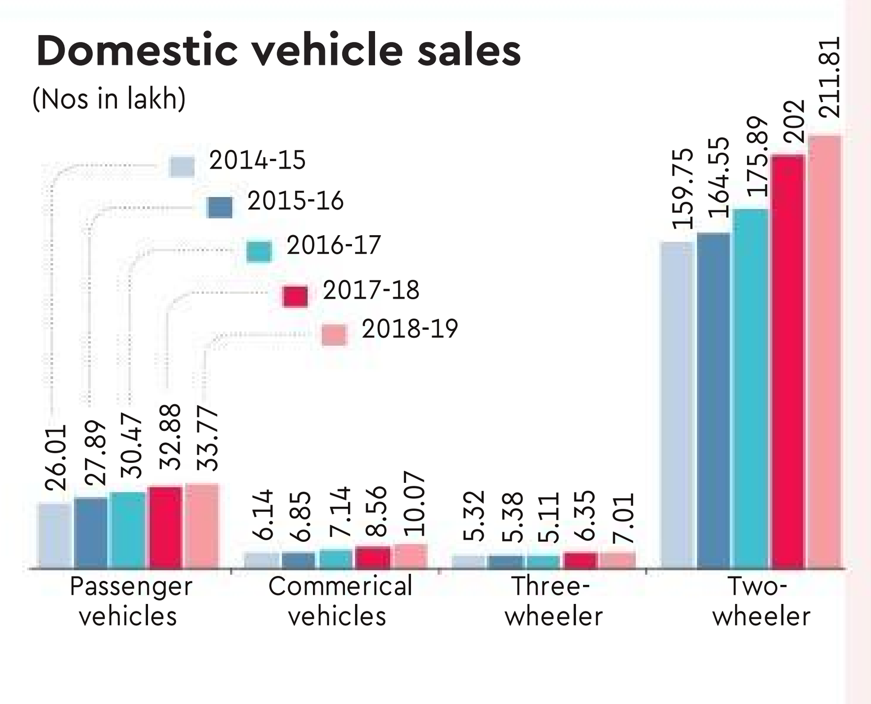
In order to lure consumers, companies have invested in showrooms. These require investments and increase fixed costs. When demand fails to meet expectations, dealers come under pressure. Has the time come to experiment with multi-brand auto showrooms?

Another factor that has received inadequate attention is BS6 norms by April 2020. Are oil marketing companies ready to supply BS6-quality fuel? Since BS6 cars would coexist, would petrol pumps supply a separate fuel for those cars? How would these fuels be priced?

Here is an excerpt from a Team-BHP report 'Busting the myth of BS6 engines in India', "Since there is no clarity yet as to what the final rollout of BS6 norms and fuels would be like (restricted to a few tier-1 cities, or pan-India), we as car buyers and owners can only speculate about the various measures being taken by the government and automobile manufacturers to save money, make more money from customers, and work around the SC orders relating to BS6 rollout."

Change and uncertainty are synonymous. It is imperative for the government and industry to rise above revenue considerations, sales targets and communicate clearly and consistently, failing which the consumer will wait till at least May 2020 to see how things pan out. The Supreme Court should trust these two and refrain from passing orders that will only compound policy uncertainty.





Source: www.siamindia.com

RBI RATE CUTS

Role of external benchmarks

RBI will need to cut less if banks begin with a lower lending rate

HOW WILL THE Reserve Bank of India's introduction of external benchmarks, effective October 1, impact its Monetary Policy Committee's rate policy? We expect it to follow Governor Shaktikanta Das into cutting policy rates by another 'out-of-the-box' 35bps on October 4 and 15bps in December, pause as inflation goes up on base effects, and cut 40bps to 4.5% repo rate by September if US recession risks rise. Our base case has banks pricing fresh retail/SME loans on a spread defined as the difference between the current retail/SME lending rate and the external benchmark. As the external benchmark falls on RBI rate cuts, banks would duly reduce lending rates. Second, what if banks settle at a lower spread/lending rate to begin with? This would obviously reduce the need for deeper RBI rate cuts. Finally, what if banks are split between RBI repo rate and yield benchmarks? They would end up following the benchmark that is rising/falling faster in a rising/falling rate environment.

So, what's changing? Banks currently price their MCLR by the following formula: *MCLR = Marginal cost of funds (deposit rates, borrowing, cost of equity = risk free + mark up) + CRR cost + tenor/credit risk premiums + opex*...(1).

RBI actions enter equation 1 indirectly: (a) deposit rates depend on RBI durable liquidity infusion; (b) borrowing costs on liquidity (repo/reverse repo mode) and RBI repo rates, and (c) cost of equity on RBI rate cut/OMO.

RBI has now mandated that banks should price lending rates on fresh retail/SME loans (about 50% of book) as a spread over external benchmarks like the RBI repo rate, 3m/6m T-Bill or any other benchmark market interest rate published by the Financial Benchmark India Private Ltd (FBIL), by October 1. As floating rate loans are linked to external benchmarks (at 3-month reset), transmission will naturally be direct (for RBI repo rate), or, at least far more rapid (for, say, T-Bills). Banks are free to choose their spread over the benchmark interest rate, subject to the condition that the credit risk premium can change only when the borrower's credit assessment undergoes a substantial change, as agreed upon in the loan contract.

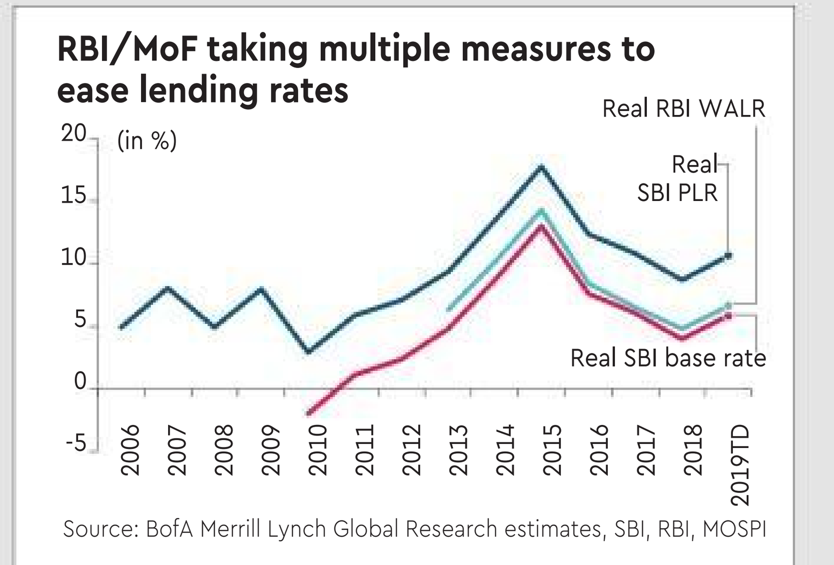
Lending rates headed lower at the margin

Scenario 1. Banks retain current lending rates. Our base case has banks pricing fresh retail/SME loans on a spread defined as the difference between the current retail/SME lending rate and the external benchmark. As the external benchmark falls on RBI rate cuts, banks will duly lower their lending rates. They will likely also cut their deposit rates to protect margins to some extent.

Scenario 2. Banks set lower spread/lending rate. Banks could begin with a lower lending rate if they fix a lower spread. This will obviously reduce the need for RBI to cut rates much further. As real lending rates are still very high, it is unlikely that the RBI rate cutting cycle will immediately ground to a halt (see chart).

Scenario 3. Banks split between RBI repo rate and yields. Banks will likely have to follow the faster falling/rising rate benchmark; for example, if yields fall in expectation of RBI rate cuts, banks will have to cut lending rates to retain customers. What if yields go up on fiscal stimulus fears, even though RBI is cutting rates? Banks priced on yield benchmarks will have to follow banks priced on the RBI repo rate to retain their customers again.

(*Excerpted from the report* 'India Economic Watch. RBI rate cuts: How will external benchmarks affect?' *by BofAML dated September 9, 2019*)



Source: BofA Merrill Lynch Global Research estimates, SBI, RBI, MOSPI

The power vacuum at the WTO

Why free trade belligerents need to be prevailed upon

GARIMA SAHDEV

The author is researcher, international trade and investment law

THE GLOBAL TRADING system is undergoing conflict, chaos. It has remained static in the face of disruptive technologies, automation and shifts in geoeconomics in the last few years. The GATT-based WTO rules are well over 70 years old. Even the newer version of GATT (Uruguay Round, 1986-1994) is decades old, and any attempt to update—through the adoption of a comprehensive Doha Development Agenda (DDA)—has remained inconclusive after 18 years. The challenges faced by the global commercial arbiter run in plenty. To start with, the WTO continues to be at the mercy of Washington.

Despite his earlier disdain for multilateral trade deals and projecting a protectionist stance during the 2016 presidential campaign, Donald Trump appeared to rethink the isolationist approach after the elections. After his initial hawkish stance, Trump erased the fears of the US withdrawing from NAFTA last year. But protectionism is back on the US agenda, with the recent tariff measures against China, India, Canada and the EU. Since July 2018, the US has imposed tariffs on $250 billion worth of Chinese goods including aerospace, auto parts, electronics. China has also retaliated with duties on about $75 billion worth of American products. However, despite a year-long tariff war between the two, China had a record $419 trade goods surplus with the US for the same period (United States Census Bureau).

Beijing's engagement in the global trading system has been questionable. Much has changed since the WTO came into force in 1995. China, a WTO member, has an extraordinary influence in global economics, and is the common aggressor in trade disputes with all major economies. Beijing's predatory trade and IP theft practices, heavy-handed direct government intervention in industrial sector, and its abuse of the "special and differential treatment" clause (Art XVIII, GATT 1947) to subsidise specific export industries and dump its oversupply in other countries is universally agreed upon. In general, the stringent WTO rules squeezed the policy space for developing countries to pursue individual industrial policies—pushing them towards "premature deindustrialisation" (Dani Rodrik). But for Beijing to continue its unrepentant mercantilist policies in open defiance of WTO's free trade rules is evidence that the trade arbiter has failed to enforce its rules.

The American charge against China is fair but doesn't compensate for the general rhetoric of the multilateral trading system. One may recall Washington has exited major multilateral deals like the TPP (now CPTPP) and Paris Climate deal, while renegotiating NAFTA and threatening to pull out of the WTO. It has unilaterally imposed tariffs on steel and aluminium from other countries including India using the Article XXI of GATT. What constitutes "essential/national security" is rather ambiguous and has the potential of weakening the credibility of WTO's Dispute Settlement System. The US also supported Russia's invocation of "essential security" clause in the 2014 blockade on Ukrainian goods headed to Central Asia.

The next challenge facing the WTO is technology disturbing the rules of the game. Digital innovations led by artificial intelligence, blockchain and the internet of things are changing the structure of production and trade. New business models based on these technologies and big data and analytics are breaking up barriers to trade at a time when nations are embracing protectionism. The current set of WTO rules is not well-equipped to deal with modern trade practices.

So, how is India positioned in the global trade mess? One section says that India stands to gain in terms of moving up in the global supply chain if it capitalises on falling investment in China and uses this as an opportunity to give a boost to its merchandise exports. Manufacturing industry in India, which is central to job creation and diversification of economy, has faced the brunt of trade liberalisation post WTO's inception (having jumped from agriculture to services, without going through a robust industrial stage). India's share in global merchandise exports is under 2% despite 70% of its exports coming from this sector. Keeping in line with global protectionist trends (America First, Brexit, tariff wars), India has, in the last two years, increased tariffs on several products—mainly from China and the US, and other non-FTA trade partners, to give an impetus to manufacturing. But the retaliatory measures by India in response to Washington's increase in tariffs on Indian products are likely to bite India back.

Secondly, India is shying away from an indiscriminate signing of FTAs: India is not a part of any mega-FTAs so far and the logjam at RCEP continues. Keeping in view India's obstructionist view, Beijing even proposed an ASEAN+3 Mega FTA sans India, Australia and New Zealand.

India's approach towards trade liberalisation is under attack. Trump's recent barb at India being the "tariff king" is not misplaced as the World Tariff Profiles 2019 show that India's average tariffs at 13.8% are much higher than most major trading economies like China (9.8%) and the US (3.4%). Considering that its burgeoning trade deficit with China is the primary irritant that's holding India back from RCEP, if India were to bring down its tariffs to nil in 90% of the traded goods—as Beijing demands—it is likely to lead to even higher trade deficit with China. As such, intermediate products and raw materials (low-value-added category) constitute India's major exports to China—a matter of concern. With its recent increase in tariff rates on a range of items, it remains unclear if New Delhi has any intent of moving ahead with the Chinese demand under the RCEP, given Beijing's economic hegemony in the region.

The WTO must be saved: With the ongoing stalemate at the WTO and the near-abandonment of the DDA, RTAs—and recently, mega-FTAs—have taken the lead. RTAs are easier to negotiate than the consensus-based WTO. Some of these mega-FTAs have adopted the "non-issues" and "WTO-plus" provisions (on environment, labour, IPR, competition, investment and government procurement) after they had to be dropped from the DDA due to opposition from developing countries—who, on the other hand, are signing their own mega trade deals to foster greater economic integration, further stealing WTO's thunder. While the WTO encourages signing of RTAs to further the goal of economic integration, frequent resort to RTAs bypassing the WTO route has become a vicious practice.

The idea of multilateralism is sold greatly by no other institution as the WTO—founded to instil a confidence in law and institutions. Also, Washington stands accused of returning to unilateralism and its 1930s-styled beggar-thy-neighbour policies. Unilateral imposition of sanctions and high tariffs on Chinese products bypassing the WTO DS mechanism sets a bad precedent and countries like India are following suit—belittling the importance of WTO. A strong WTO is essential to check China's intransigence.

The global financial crisis of 2008 tested the strength of existing international trade governance framework when the WTO acted as a wall against a descent into protectionism during the crisis years. Can it still do it? The answer lies in how firmly member-states come together to reform and save the WTO.