Demonetisation doubts

Three questions the government must answer after the RBI revealed the number of demonetised notes that it got back

RAISINA HILL

A K BHATTACHARYA

The Reserve Bank of India (RBI) has ended the suspense over the value of demonetised notes that were returned to it. Of the ₹15.44 lakh crore worth demonetised high-denomination currency notes (₹500 and ₹1,000) in circulation as on November 8, 2016, an estimated ₹15.28 lakh crore have been deposited back with the RBI. This leaves only ₹16,000 crore or a little over one per cent of the demonetised notes that have not surfaced so far.

Three questions arise from this revelation and the associated numbers that the RBI made public in its annual report last week. One, what led to the government grossly overestimating the value of the demonetised currency notes that it thought would not come back to the central bank? Why was the Supreme Court told that almost ₹4-5 lakh crore of the demonetised currency notes would not surface? That view was endorsed also by a senior finance ministry official then.

Of course, the finance ministry has now explained that the figure put out before the apex court represented an opinion. Even if that were an opinion, which indeed it was, there are reasons to believe that the government must immediately examine why and how that estimate was made, prompting its chief law officer to present that view before the apex court.

As early as the first week of December 2016, the RBI had some information that returns of demonetised notes were taking place in huge numbers. On December 10, it had estimated that over 80 per cent of the demonetised notes were already back with the banking system. Just about three weeks were left by which the demonetised notes could have been returned. Shouldn't the government and the central bank have got a sense by then that the estimate of how many high-denomination currency notes would be returned could go wrong?

It is also true that, as the finance minister has argued, the government today is in a better position to identify illicit money from what was returned to the banking system. After the return of the demonetised notes, the government has now assessed that an estimated ₹1.7 lakh crore of deposits could be termed "suspicious". Already, ₹29,200 crore of this has been admitted by the depositors as undisclosed income and more than five million new income-tax returns were also filed this year.

Other numbers that have been revealed in the RBI annual report are worth a closer look. The currency in circulation as per cent of gross domestic product (GDP) has declined. It used to be 12 per cent of GDP before demonetisation and it was down to about 10 per cent by the end of August 2017. Total card transactions, including credit cards, debit cards and prepaid instruments, saw a 68 per cent increase at ₹7.4 lakh crore in 2016-17, compared to ₹4.4 lakh crore in the previous year. The increase in such transactions in 2015-16 was only 33 per cent. The detection of fake currency notes could also be attributed to the demonetisation drive, if one goes by the RBI annual report. The value of detected fake Indian currency notes went up to ₹43.5 crore in 2016-17, compared to ₹29.6 crore in the previous year. The value of fake currency notes detected in 2014-15 was lower at ₹28.7 crore.

But the question that begs to be answered is whether all these gains in terms of widening the tax net, increased digital transactions and detection of higher fake currency notes could have been achieved without the huge disruption and output loss that demonetisation caused to the Indian economy. Was a more sustained and steady campaign better than the shock of demonetisation to achieve all these goals? Now that all the data are becoming available, a more reasoned study on the futility of demonetisation is called for.

Finally, the central bank must explain why it took so long for it to come out with the total number of the demonetised currency notes that were returned to it. Remember that it was a long wait and even now this figure is only an estimate, subject to further correction. The central bank governor was quizzed by parliamentarians to reveal the number of notes returned to it a few months after the last date for submitting the demonetised notes was over. But the governor maintained that the exercise to verify the returned notes was going on and he would reveal the numbers only when the central bank was sure.

Did it take so long because the central bank wanted to recheck all the numbers because of a fear that the value of the returned demonetised notes could have exceeded even the estimated currency in circulation at the time of demonetisation? The nation, for the present, must be relieved that such a fear was unfounded.

CHINESE WHISPERS

Kovind's encore

When Minister of State (independent charge) of Petroleum and Natural Gas Dharmendra Pradhan took oath in Hindi as Cabinet minister, President Ramnath Kovind made him repeat one word to correct his pronunciation. Kovind made Pradhan repeat the word '*sansoochit*', which the minister had initially pronounced it '*samuchit*'. When Kovind was Bihar governor, he had asked Rashtriya Janata Dal chief Lalu Yadav's son Tej Pratap to repeat the oath of office after he misread the Hindi word *apekshit* (expected) during the swearing-in ceremony of ministers.

Mentors absent

Nirmala Sitharaman (*pictured*), elevated as Cabinet minister, and Alphons Kannanthanam, appointed minister of state, took oath in English on Saturday. All others took oath in Hindi. No representative of the Opposition — except leader of the Opposition in Rajya Sabha Ghulam Nabi Azad — was present at the swearing-in ceremony. Kalraj Mishra and Sanjeev Balyan, who resigned as union ministers ahead of the reshuffle, were present at the ceremony. However, Bharatiya Janata Party leaders L K Advani and M M Joshi, who are also part of the party's '*margdarshak mandal*', or mentors' group, were absent.

Trouble on the horizon?

According to an opinion poll, the Congress government in Karnataka may have the upper hand over rival Bharatiya Janata Party (BJP) ahead of Assembly elections in the state next year. But to turn that hope into reality, Chief Minister Siddaramaiah (*pictured*) may have to keep his house in order. As part of the state Cabinet reshuffle, Siddaramaiah added three ministers, but state Congress President G Parameshwara was missing when they were sworn in. He was said to be unhappy with the choices. While Siddaramaiah dismissed this as a non-issue, tongues started wagging that this could escalate into a bigger fight, similar to the one between K S Eshwarappa and B S Yeddyurappa in the BJP.

Slowdown across sectors

The macroeconomy is in trouble, GDP numbers are miserable and note ban has yielded poor results

FRONT RUNNING

DEVANGSHU DATTA

The stock market continues to ignore signs that India Inc and the macroeconomy are in trouble. Gross domestic product (GDP) estimates for Q1, 2017-18, are miserable. The Reserve Bank of India annual report confirms, if any confirmation was required, that demonetisation had poor outcomes. The Q1 corporate results are also poor. There are far more downgrades than upgrades and there isn't a single sector growing at a pace that justifies respective valuations.

Despite all that, money continues to flow into stocks. While domestic institutions bought over ₹16,000 crore in August that was almost balanced by the ₹14,000 crore plus that foreign portfolio investors sold. Retail also continues to push in money and, importantly, that has boosted smaller stocks. The Nifty is up 21 per cent in calendar year 2017.

The GDP growth rate in April-June 2017 dipped to 5.6 per cent year-on-year, the slowest growth since January-March 2013. It's 2.2 per cent lower than April-June 2016. Nominal growth (including inflation) is the lowest in several years at nearly 10 per cent. Government expenditure expanded. Private consumption contributed 4.2 per cent to growth. A lot of the activity appeared to be jewellery-related, which is not reassuring.

Manufacturing was stagnant at 1.2 per cent year-on-year while agriculture grew two per cent. Imports expanded 13.4 per cent, exports grew 1.2 per cent. The investment cycle remains muted, with growth at just 1.6 per cent. Government expenditure led to the fiscal deficit hitting 93 per cent of the 2017-18 Budget annual estimate in the first quarter. It's unlikely that it can be sustained at these levels.

Interestingly, nominal growth in agriculture was lower than inflation-adjusted real growth. Deflation wiped out food prices and this explains massive farmer agitations and low rural consumption. Incidentally, food prices have now started rising due to supply shortages. This is in line with previous experience with the erstwhile Soviet Union's demonetisation in 1991. Farmers didn't have the money to plant at the right time and that means lower harvests. Widespread floods in the east will not help matters.

Another explanation offered for the slowdown, apart from demonetisation's evil legacy, is "destocking" ahead of GST. This is plausible until you notice that inventories shot up by 66 per cent, which is at odds with destocking.

The RBI had transferred a dividend of ₹30,650 crore as surplus to the government. That was ₹34,500 crore less than in 2016-17 — one cost of demonetisation. The delayed annual report of the central bank indicates that over 99 per cent of the banned notes are back in the bank (and there could be more coming back from Nepal). Fake notes were less than 0.001 per cent.

That's a maximum seigniorage write-off of ₹16,000 crore versus a direct cost of ₹8,000 crore spent on the demonetisation by the RBI. This is a far cry from the ₹1.5 trillion of unreturned notes that some eminent economists were confidently expecting. More than 100 deaths in queues and an estimated five million job losses across the informal sector, with the knock-on effect of collapsing consumption seems to be rather a large price to pay.

Some "optimists" took heart from the slowdown, asserting that the RBI will now be forced to cut rates again. The GST seems to have got off to a good start and the market certainly took comfort from excellent initial tax collections. However, we'll have to wait for net numbers after offsets before we can figure out how GST is actually working. Also, industry and services are going through working capital crunches since the tax offset cycle, as predicted, is much too slow.

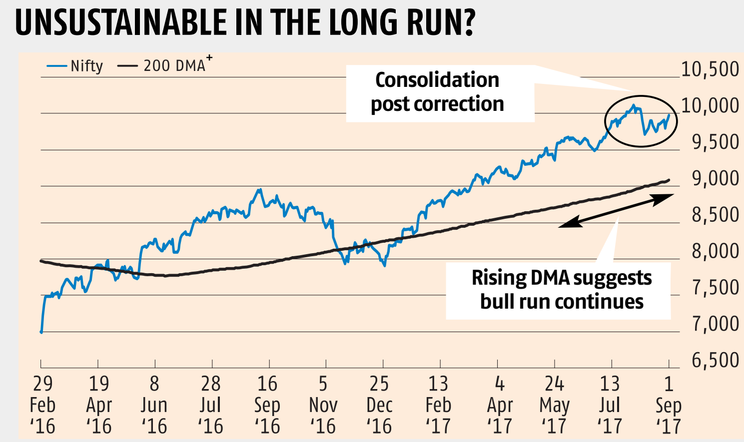
The Nifty 50 saw 29 earnings downgrades and the Nifty 100 saw 62 downgrades. Overall profit growth was flat across the largest businesses. According to Bloomberg, consensus EPS estimates across the entire stock market have been downgraded by about eight per cent. Low double-digit earnings growth is the consensus expectation for the rest of the fiscal. Given valuations running at PE 26-plus, the word "bubble" comes to mind. The manufacturing Purchasing Managers' Index for August does indicate that the industrial sector has started expanding after contraction in July. So, there's some hope.

The confusion continues in Infosys, with another round of insults exchanged. There are rumours that some founders might cash out or reduce their personal exposures by offering stakes in the buyback. This could lead to another crash, post buyback.

Geopolitics did not impinge much on the Indian market last fortnight. There was relief as the Doklam stand-off ended. There are optimistic noises about US tax reforms, though there are doubts about the Trump administration's ability to push those through. The US economy was strong in April-June 2017, with GDP growth at three per cent. The UK continues to negotiate "divorce" from the European Union, where there is also economic expansion.

Technically speaking, the market has recovered from a correction down to 9,700 Nifty. It is consolidating within a narrow range of 9,800-10,000. Typically, such phases of range trading end in either a sharp breakout, or a sharp breakdown, caused by some news trigger.

UNSUSTAINABLE IN THE LONG RUN?



	Value		Equations
	Previous (Aug 18)	Current (Sep 1)	Change %
Nifty value	9,837.4	9,974.4	**1.39**
Index PE	25.1	25.99	3.55
Index dividend yield	0.97	0.93	-4.12
Index Book value	3.46	3.51	1.45
USD INR (RBI reference rate)	64.14	64.02	**0.19**
FII net equity buys/sales (Sep 1) (₹ cr)	-14,293*	**444**	
DII net equity buys/sales (Sep 1) (₹ cr)	16,205.22*	**731.72**	

*Aug 1-31 net equity buys/sales, +200-Day Moving Average
NB FIIs bought net debt of ₹15,249 cr (Aug 1-31) and ₹18,867 cr (Jul 1-31)

BUSINESS LIFE

Travel barriers are the worst of new Cold War

Why is the US squandering its soft-power advantage on a tit-for-tat with Russia?

LEONID BERSHIDSKY

The latest loop in the escalation of US-Russia hostilities is probably the dumbest and the most damaging: The two countries are introducing de facto travel restrictions for each other's citizens, choking off the friendliest, most human channel of communication between them. It's the biggest step back into the Cold War era that the two governments have taken yet.

The State Department has stopped issuing visas in Yekaterinburg, Vladivostok and St Petersburg, a response to Russian demands for drastic cuts in US diplomatic mission based in the country. In 2016, those three posts combined issued 46,243 visas, about a third of the turnover of the US embassy in Moscow, now the only visa-issuing office in Russia. The decision effectively ends all non-essential travel to the US from the Russian hinterland, and even from St Petersburg, the country's second city. Most travellers will end up picking a different destination rather than travel to Moscow for a consular interview.

As if that wasn't enough of a retaliatory move, the US has also ordered Russia to close its San Francisco consulate. The Russian foreign ministry doesn't break out its data in visa statistics, so it's not clear how many of the 56,229 Russian tourist visas issued to Americans in 2015 originated there. But the closure of the office will mean an end to all non-essential travel to Russia for people who live on the West Coast.

I understand the logic of diplomatic tit-for-tat, and it doesn't concern me who started this or whom to blame. One doesn't need to take sides in the old academic argument over whether tourism is an instrument of peace or a beneficiary of peace. It's just plain good sense to see that keeping casual travellers out of a country prevents people from forming an unmediated opinion of it. Stopping Russians who want to see the US from doing it leaves them at the mercy of the Kremlin propaganda machine, which will be happy to tell them its own stories of life in the US. Creating obstacles for Americans to travel to Russia leaves them a choice between the increasingly anti-Russian mainstream press and the export version of the same Kremlin propaganda.

In my travels around the US during the 2016 election campaign, I have met people content with the mainstream narrative of a backward, morally bankrupt, hopelessly corrupt Russian society and the avid watchers of RT, the Russian government-funded TV channel who mistrusted that narrative and admired Russian President Vladimir Putin's ideology and methods. I couldn't convince either side that they'd feel quite differently if they ever visited my homeland.

I have also often met Russians who refused to believe my stories of American complexity.

The mutual misunderstanding isn't as bad yet as it was in the 1980s, when the Soviet Union weakened and the Iron Curtain opened a crack. The Americans I met then were usually shell-shocked by their experience of informal contacts with Russians.

© Bloomberg

Russia and the US are choking off the friendliest, most human channel of communication between them

PHOTO: ISTOCK

LETTERS

More downs than ups

The editorial, "Big bang failure" (September 1), ended with the verdict, "Demonetisation was a blunder, poorly thought through and badly executed."

Demonetisation as a tool to flush out black money was a noble idea, but the execution left a lot to be desired. Before announcing demonetisation, the government should have introduced the ₹2,000 and the new ₹500 notes. ATMs should have been recalibrated in phases to stock the new notes. Once, around 50 per cent of ATMs had been recalibrated, the announcement to withdraw ₹1,000 and old ₹500 notes from circulation could have been made. After the announcement, the rest of the ATMs could have been recalibrated on an urgent basis. This would have eased the pressure on the common man. The ₹200 notes could also have been introduced before demonetisation.

The process for exchange of demonetised currency notes in bank branches was not carried out systematically. Indians' penchant for *juggad* to circumvent a problem should have been envisaged and checkmated in advance. What we saw were frequent changes and new rules being framed almost daily. This added to the confusion.

If a sizeable quantity of new ₹2,000, ₹500 and ₹200 notes were in circulation during demonetisation, frantic attempts to exchange notes at bank branches could have been avoided. Customers could have been asked to deposit their old notes directly into their accounts. This would have negated the nefarious designs of unscrupulous people using "cash coolies" to launder their money.

Due to the need for secrecy, the demonetisation decision seems to have been taken without anticipating the pitfalls. If discreet advance feedback or suggestions had been sought from people with experience in bank branch work, much of the angst among the public and staff of banks could have been quelled.

While demonetisation has not been a big success, it has put the fear of god into cash hoarders. The authorities would be probing ₹1.75 lakh crore of suspicious deposits that flowed into the banking system post demonetisation. A sizeable chunk of this could lead to positive action against the depositors. This could boost tax collections and lead to penal action, which would be a positive result of demonetisation.

K V Premraj Mumbai

No tangible benefits

With reference to the editorial, "Big bang failure", the Reserve Bank of India data proved conclusively that demonetisation, touted as a "shock therapy" and "surgical strike" against black money, did not achieve its objectives. It did not succeed in detecting or flushing out black money and counterfeit notes or in halting the flow of funds to "political and religious radicals".

The data gave economists opposed to the note ban and other critics of the Narendra Modi government vindication for their stance. The fact that 99 per cent of the demonetised high-denomination notes were either deposited or exchanged for new notes in banks put paid to the Prime Minister's desire to give each citizen ₹15 lakh of the confiscated black money and allocate more funds for social welfare schemes from out of a windfall of ₹3-4 lakh crore that was expected from demonetisation.

The note ban did the country a lot of harm and no good — the "surge" in tax compliance reported by the Economic Survey was "normal" and the initial "jump" in digital transactions could have been achieved by less deleterious means. Demonetisation depleted cash flow, paralysed the economy, led to loss of jobs, worsened the plight of farmers and unskilled workers, claimed the lives of more than 100 people and shaved two per cent off the gross domestic product growth rate.

The pain people bore stoically brought them no tangible benefits. Only time will tell if the note ban blunder and the subsequent likely erosion of credibility will harm Modi's chances of winning the 2019 election.

G David Milton Maruthancode

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HAMBONE BY MIKE FLANAGAN

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A vote for competence

Cabinet reshuffle will raise the govt's capability quotient

With a little more than a year and a half to go for the Lok Sabha elections, Prime Minister Narendra Modi on Sunday effected a long-awaited reshuffle of his council of ministers, which was a clear attempt to improve the capability quotient by bringing in new people with proven administrative experience. Of the nine new ministers of state, four were former bureaucrats with distinguished service records. It is also significant that three of them have been given independent charge of important ministries straightaway, indicating Mr Modi's desire to address concerns over talent deficit in his party and an inadequate bench strength to fill in key portfolios. The Prime Minister also rewarded the performance of a few of his ministers and that is why Dharmendra Pradhan, minister for petroleum and gas, as well as Piyush Goyal, power minister, were promoted to Cabinet rank while Nitin Gadkari was given additional responsibilities.

That possibly was also the reason why Suresh Prabhu, outgoing Railways minister, was given the benefit of the doubt even though his tenure was plagued with several safety lapses. His performance as minister for four years under Atal Bihari Vajpayee perhaps weighed in his favour. Mr Prabhu has now been given the crucial charge of commerce and industry and it is hoped that he will bring a more positive approach to trade issues and will be able to use exports as a genuine engine for domestic growth. The biggest surprise, of course, was the elevation of Nirmala Sitharaman as defence minister despite her middling performance as commerce and industry minister. She now becomes part of the Cabinet Committee on Security, along with External Affairs Minister Sushma Swaraj, making it the first time in India's history that two women are on one of the country's top decision-making bodies. Ms Sitharaman takes over at a time of complex challenges for the ministry and given that the defence portfolio involves signing on big purchase bills, it is likely that her integrity was a factor that favoured her selection.

While there is much to admire about these choices, there were some unconvincing factors as well. For instance, it is hard to understand why the vacated portfolios were treated as adjuncts: Skill development has been clubbed with the ministry of petroleum and water resources with road transport and shipping. Strangely, the coal ministry has been grouped with railways, but the mines portfolio has been packaged with the rural development ministry. There are other such adjunct ministries as well: For example, environment. There was a hint of some political compulsions as the PM found it necessary to include people like Anantkumar Hegde, who hails from Karnataka, a state which goes to the polls next year. The five-time Member of Parliament made headlines recently for slapping a doctor and was charged with giving a hate speech in 2016.

Overall, the message is clear: While performance will be rewarded, that alone won't be enough. That six of the nine new ministers are from the Lok Sabha, and only one from the Rajya Sabha, implies that Mr Modi is not encouraging backdoor entry into his council of ministers and is insisting on candidates who can win elections. The reshuffle also shows Mr Modi has a clear eye on the 2019 Lok Sabha elections. New additions to the cabinet include two each from Uttar Pradesh and Bihar — key states that together elect 120 MPs to the Lower House.

Trai's dilemma

Regulator must balance reducing IUCs and mobile industry health

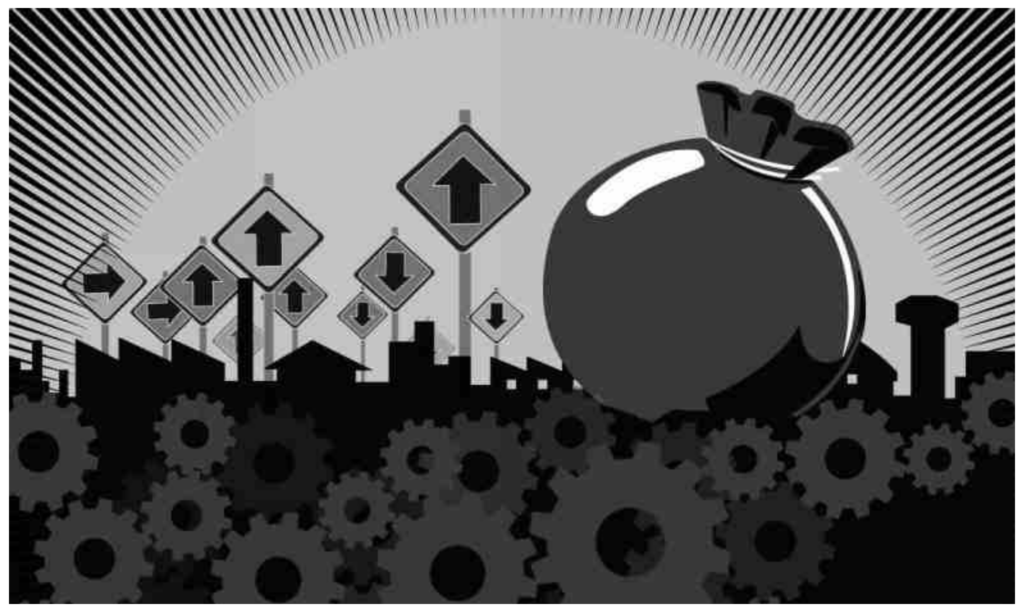
The Telecom Regulatory Authority of India, or Trai, will soon decide on the vexed question of the interconnect user charge, or IUC. The IUC is a payment, per minute of a completed call, from the network where the call originates to the network where the call terminates. The essential idea behind the IUC is that it compensates the company where the call terminates for its investment in last-mile connectivity, since part of the call will naturally be carried over the infrastructure that the call receiver's chosen mobile company has installed. Currently, the IUC is 14 paise a minute; the question is whether, and if so by how much, this should be reduced. Many incumbent companies, including the largest — Airtel, Idea, and Vodafone — have in fact asked for the IUC to be increased, perhaps doubled. Meanwhile, the cash-rich new entrant Reliance Jio, which has shaken up the industry through its various user subsidies, has demanded that the IUC be halved.

There are good reasons, grounded in economic theory, against having the IUC at all. The International Telecommunication Union (ITU), for example, the United Nations agency that deals with telecom-related issues, has generally made the case that a high IUC "can distort competition, become a barrier to new entrants, and be harmful to end users". On the other hand, eliminating it "could lower consumer prices and spur innovation in the entire telecommunication sector". The ITU's point is not difficult to see: High IUCs clearly favour large incumbent mobile companies, which will constantly receive payments from new entrants since their large customer base will receive more calls than the new entrants' smaller customer base. In the last financial year, Airtel, for example, received more than ₹10,000 crore as interconnect charges.

While the economic case for low, or even zero, IUCs is clear, there are other considerations too, mostly dealing with the sustainability and the health of the overall industry. Many incumbent operators are reeling under high spectrum charges, heavy tax bills, or overburdened balance sheets. A policy that appears to favour the cash-rich entrant, Reliance Jio, could further stress the incumbents and lead to a dangerous build-up of market power. The Indian telecom sector presents additional unique challenges, because of the segmentation of the market between urban and rural areas. The chief executive officer of Vodafone has written to Trai, arguing that 15-20 per cent of the company's cellular sites are running at a loss, and without the income from the IUCs, the firm may have to shut down these locations — which are primarily in rural areas.

Thus, Trai will have to perform a delicate balancing act between ensuring the health of the overall network and the competitive nature of the industry, and make space for growth and technological innovation. Policy cannot perpetually favour obsolete 2G circuit-switching technology over cheaper and more efficient 4G mechanisms. But clearly, an immediate change to "bill and keep" a zero IUC will decimate the industry. Thus, Trai should work on creating a glide path to reducing the IUC so that the goal of zero interconnection charges is achieved in time, but market players have adequate time to adjust. Such a policy would not favour one company at the expense of all the others.

ILLUSTRATION BY AJAY MOHANTY



What shapes investment?

Expectations of buoyant growth are related to progress on economic reforms, with strong institutional mechanisms in place

SNAKES & LADDERS

AJAY SHAH

A revival in investment is central to Indian business cycle conditions. How and when will this come about? The phrase 'animal spirits', which is often used about investment, suggests that there is something mysterious or irrational about the mood of the private sector. Investment can, however, be understood through five questions. Firms build new capacity when they are faring well on capacity utilisation, predicated on profitability and access to capital. Layered on this is the degree of optimism about Indian economic reforms and the expected tailwind of macro growth. Finally, there is an assessment about how the policy establishment will deal with situations in the future.

Within GDP, consumption and government are fairly stable. The action over the business cycle is largely in investment and in net exports. The ups and downs of private corporate investment are a big part of the story of India's GDP.

What makes corporations invest? There is of course a major role for the judgment of the key persons in firms. The phrase 'animal spirits' seems to suggest that this is some purely an intuitive decision. While there is a role for feeling, this is layered on top of comprehensible analysis.

The first issue concerns capacity utilisation. If a line or a factory is not fully utilised, the firm has little reason to build new ones. The first priority is to get capacity utilisation up. The related issue is that of profitability. It is not just enough to get high capacity utilisation; this must happen at decent profit margins also.

An economy in a slump is one with poor profit margins and low capacity utilisation. Firms under these conditions will not invest on a large scale. Roughly speaking, in the two years before an upsurge in investment, we will see strong profit margins and high capacity utilisation.

Once a firm achieves good profit margins and attains high capacity utilisation, the question of building new capacity will be discussed. Here, questions of corporate finance will arise. The firm will look at its ability to obtain equity and debt capital and the prices seen on these markets will shape the decision.

Difficulties in financing are never a quantity constraint. Almost any firm can obtain capital if it tries hard. It is a question of price. If the cost of capital is too high, the net present value of the investment is affected. For this reason, managers never discern problems of the financial system. They are used to treating the required rates of return demanded by finance as a given. When a financial system malfunctions, and the manager is asked for an excessively high required rate of return, the manager feels his project is not attractive enough.

In Indian finance, there is an aristocracy of the top 1,000 firms which get the best prices when raising equity and debt capital. They have a financing edge. This translates into more attractive investment opportunities for them in the real sector, and less attractive investment opportunities for all other firms that are not given a friendly financial system.

The cash flows from a new investment project always lie in the future. Every projection about revenues is grounded in a view about the economy. When growth projections are buoyant, that gives a nice tailwind which makes all projects look more promising. In good times, firms are able to add a few percentage points to their top line projection, and all the financial projections then look nicer.

What makes these good times? Expectations of buoyant growth are related to progress on economic reforms. In the early 2000s, private persons saw a government that was building strong teams and executing complex reforms in numerous areas, such as highways, telecom, indirect taxation, equity market, and pensions. Each of these reforms created the confidence of enhanced growth in coming years, which fed back into more buoyant revenue projections by firms.

Going beyond all this is the incomplete contract between the government and firms in terms of action. The world will change, and unexpected situations will present themselves. Private persons form an opinion about how sensibly the government will behave in the future. What will harmful policy decisions be taken? If a difficult situation arises in a firm dealing with a government, what will the mechanisms through which the problems will be solved? Ideally, there should be strong institutional mechanisms in place, so that firms have confidence in institutions without requiring to think about the individual in charge. When institutions are weak, firms obtain short-range comfort if a sound person is seen in charge of a policy institution, but everyone knows that staffing changes will come about and lead to new kinds of uncertainty.

The term 'animal spirits' is often used, and the impression is often given that the investment by firms is an act of faith by their decision makers. While this is true in part, a lot of the investment process can be understood as a systematic set of five steps. (1) Is capacity utilisation strong? (2) Are profit rates attractive? (3) Is equity and debt capital available at attractive rates, so as to make projects viable? (4) Is a strong economic policy team in place, so that high GDP growth is forecast, after which all business endeavours are helped by a tailwind? (5) Are government institutions and personnel in good shape, so that good outcomes can be counted on with policy actions and disputes? Looking back at India's recovery from 2002 to 2004, these five questions worked well in anticipating the turning point.

The rupee value of projects under implementation has barely grown, in nominal terms, from 2011 to 2017. Why did this happen? The answers lie in these five questions. These five tests also help us to recognise conditions, at future dates, when we may expect investment to take off.

The writer is a professor at National Institute of Public Finance and Policy, New Delhi

How opaque MCLR allows looting of borrowers

IRRATIONAL CHOICE

DEBASHIS BASU

In my two previous pieces, I explained how banks are looting home loan borrowers under the benign gaze of the regulator, the Reserve Bank of India (RBI). In this piece I will try to paint how big the loot is, and how flawed the marginal cost of fund-based lending rate (MCLR) structure is. For this piece, I encouraged Shirniwas Marathe, a retired banker who has gone into the depths of the issue of home loans, to do some calculations. He has come up with some stunning numbers to indicate the extent of overcharging going on under the overall floating rate system, even though banks consistently stonewalled Mr Marathe when he tried to get the data through Right to Information applications.

To start with, the entire credit of the banking system is distributed over loans of various tenors and various rates. The MCLR effective date (April 1, 2016) lies in the entire tenure of a loan anywhere from the first year to the 20th year. In other words, a loan taken in August 2015 would be in its first year on the MCLR effective date while a loan taken in December 2006 would be in its 10th year, while a loan taken in October 1995 would be in its 20th year. "The distribution of all these can be assumed to be a 'normal distribution' in statistical terms and theoretically we should take the weighted averages over the duration of loans, over various interest rates and over various tenors," he says.

Based on his assumptions, he believes that a rough estimate of the loss inflicted by the banking system as a whole by denying the MCLR benefits is more than ₹43,000 crore! The calculation is as follows. The floating rate credit is about ₹29,53,106 crore, for 80 per cent of which the banks may not have passed on the benefits to borrowers. Assuming different loan periods (20 to 10 years) and different contracted interest rates (9.75 per cent to 12.75 per cent), the interest benefit denied could be around ₹43,437 crore, he calculates, assuming the post-MCLR interest rate to be 8.75 per cent. Once again, this is only an approximation because we simply don't know the aggregate loan amounts under different tenures and the corresponding original interest rates on which the MCLR benefit is supposed to be given. Mr Marathe has worked out an average figure. We now move to the second part of the problem: The calculation of the interest rate itself. An RBI circular of April 6, 2010, lays down the methodology of calculating the base rate as a summation of the four factors below.

- Cost of deposits/funds: "The cost of deposits/fund varies with the spread of the deposits over components like current account and savings account (CASA), buckets of the term deposits, call money borrowings and other borrowings," explains Mr Marathe. But the RBI does not monitor any of these closely for individual banks, leaving enough scope of manipulation in calculating the cost of deposits.
- Negative cost of carry on CRR and SLR: Banks need to lock up a part of the deposits in the statutory liquidity ratio (SLR) and cash reserve ratio (CRR). The RBI assumes that the combined yield on this is lower than the cost of deposit (negative carry). If so, under the a+b+c+d formula, b should be a negative figure, reducing the base rate. But Mr Marathe argues that the formula specified by the RBI is wrong, and creates a positive, not negative, carry, increasing the base rate.
- Unallocable overhead cost: The components of the unallocable overheads were not clearly defined, leaving enough scope for banks to show a higher figure.
- Average return on net worth: "This is the ratio of net profit to deployable funds expressed as percentage. It is not clear again whether it is the net profit of the last quarter or the weighted average of the profit over the financial year," points out Mr Marathe.

In April 2016, when the benchmark was changed to the MCLR, the components were changed to: Marginal cost of funds; negative cost of carry on the CRR; operating costs; and tenor premium. Clearly, almost all components of the flawed base rate have been carried forward to the MCLR regime for the banks to continue to manipulate the benchmark rate at the expense of borrowers. Note that the negative cost of the SLR and CRR is now only the CRR. This removes the gains from SLR income from the calculation, increasing the cost and allowing banks to push up the MCLR figure even further. Meanwhile, remember that the banks have been charging separately for almost every service they offer and hence there is no operating cost that can be added to the calculation of the MCLR in accordance with the RBI directives and yet the RBI has allowed them the leeway to do exactly that. Will the RBI check what "operating costs" are being loaded into MCLR calculations? The RBI has now decided to set up an internal committee to look into the MCLR. No, there is no talk of fixing responsibility on anyone who has allowed banks to continue to loot us through flawed and opaque benchmark calculations. After all, who expects the regulator to regulate itself? Expect more of this free-for-all for banks to charge you what they want to.

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Conformity in China's schools

BOOK REVIEW

ALAN PAUL

China is such a vast, contradictory land that the most illuminating books often explore it through an intense focus on a single topic: The aviation industry, the one-child policy, the lives of migrant factory workers. Education is a particularly transparent window, as demonstrated by the perceptive *Little Soldiers*, which turns over cultural rocks from bribery to the urban-rural divide while delving into the nation's school system, deeply rooted as it is in both ancient Confucianism and Communist dogma. As Lenora Chu notes, in China, "countless individual decisions, big and small, are made in the name of education."

Anyone will understand the country better after reading this book, the heart of which is Chu's experience of enrolling her three-year-old son in an elite Shanghai preschool. She and her husband, the NPR correspondent Rob Schmitz, work hard to get Rainey admitted, but from his first day they start to have second thoughts. They fear that their son is being brainwashed into being a good little soldier, a loyal Chinese patriot, and are sure that the school employs methods that rankle American sensibilities, including hard-edged coercion; public competition, with posted rankings of everything from height and haemoglobin level to recorder skills, punctuality and politeness; and even threats of calling the police if a child doesn't take a nap.

Their toddler comes home singing songs in praise of Chairman Mao, has a friend attending "early MBA" classes and tells them that his teacher forces him to eat eggs by holding his mouth shut. These warning signs are balanced by his rapidly developing self-sufficiency, sense of discipline, math and Chinese skills. He's also learning to navigate a complex, obstacle-filled world. In China, there is almost always a "work-around" to strict rules, and Rainey starts wordlessly figuring this out, much to Chu's delight.

After immersing herself in the Chinese education structure, the author visits American schools and recognises that while the Chinese system is designed to weed out and filter students, in America the express goal is "No child left behind"

The author befriends two high-achieving Shanghai high school students, one meticulously working the system and the other counting the days until she can abandon it in favour of an American university. Along with an array of international education experts, they serve as insightful commentators as Chu pulls back to examine the broader system, including a more typical Shanghai public school and poor migrant students stumbling toward the zhongkao high school entrance exam, which can determine whether a student will follow an academic or blue-collar path. Chu follows a migrant worker from a rural province who has lived apart from her husband and son for years. Working as a masseuse in Shanghai, she has dedicated her life to improving her child's lot, only to realise that, raised without parental guidance, he lacks the study skills necessary to launch himself onto another track. It is one of several heartbreaking tales the book could have explored more deeply. The overlooked students get less attention than do the strivers in *Little Soldiers*, as in life.

Chu recalls her own teenage rebellion growing up in Texas with Chinese immigrant parents who demanded excellence and expected to largely control her decisions. A Freudian could have a field day with her decision to enrol her own son in the strict Chinese system, but Chu understands that she is striving to replicate her own jumble of Chinese and American education and culture, with the parental and institutional roles reversed. She writes, "It was as if I looked into Teacher Chen's eyes ... and immediately recognised my father's intentions (sometimes misguided but always well-meaning)."

After immersing herself in the Chinese education structure, she visits American schools and quickly recognises that while the Chinese system is designed to weed out and filter students, in America the express goal is "No child left behind." The American schools feel impossibly soft, with an overemphasis on individual desires that allows weaker areas to wither. This is especially so in the teaching of math, with so much focus on applicable knowledge that concepts are taught in a shallow fashion, while Chinese students memorise what they have to, then explore deeper, more complex applications. Chu vividly sketches these differences in terms that will make readers ponder what they actually think about rote memorisation and parents question their preferences for their own children.

LITTLE SOLDIERS
American Boy, a Chinese School, and the Global Race to Achieve
Lenora Chu
Harper/HarperCollins Publishers
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