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Opinion

THURSDAY, SEPTEMBER 14, 2017

AADHAAR NOT UNCONSTITUTIONAL

Union finance minister Arun Jaitley

"The (Aadhaar) legislation has been passed, and I am sure it will stand the test of constitutionality for the reason that even while upholding the idea of privacy as an important constitutional guarantee, the restraints under Article 21, SC said which, could be imposed, must be by law"

DoCoMo shock for Abe, shows India unreformed

It should have had no problem in exiting TataTele to begin with, and now it faces a ridiculous tax demand

THE TAX DEPARTMENT has just delivered a reality check for all those who thought the foundation-stone-laying for the Mumbai-Ahmedabad bullet train on Thursday—by prime ministers Shinzo Abe and Narendra Modi—represents a new high in Indo-Japanese relations. Apart from the plethora of red tape that dogs many large Japanese investments in India, including the high-profile Delhi Mumbai Industrial Corridor Development Corporation, the taxman slapping a ₹2,500 crore demand on Japanese telco DoCoMo—*Business Standard* has just reported this—shows just how unresponsive and unreformed India's governance system continues to be. The tax demand adds salt to injury and, to that extent, is a signal to all investors to stay out of the country, and we are not even talking of those like Vodafone and Cairn that are victim to Pranab Mukherjee's retrospective tax that even the NDA has not found fit to repeal or find any way to provide succour to affected investors. Much like *Hotel California*, it would appear, you can check out any time you like but you can never leave.

When DoCoMo invested ₹14,500 crore in Tata Teleservices in 2009, it put in a stop-loss through an options clause—in case the JV failed to meet certain performance criterion, Tata agreed it would buy back DoCoMo's equity at half the original value—the exchange risk was DoCoMo's. RBI rules even at that time disallowed options, but firms were allowed to apply for permission. The RBI rule made sense since, while India had ceilings for foreign debt, some firms (in the real estate sector, primarily) were skirting this by disguising their loans as equity—the buyback clause in their contracts built in the interest rate. But with DoCoMo asking for just half its initial investment, and only after certain performance parameters were not met, it clearly didn't fall in this category. Yet, when Tatas applied to RBI to buy out DoCoMo, the government turned it down—RBI passed it on to government because RBI chief was related to a senior Tata official. Later, when Tatas lost the case in London arbitration, the government and RBI argued against the award being enforced. Fortunately, the Delhi High Court took a progressive view and said foreign awards simply had to be enforced, and that is how Tatas paid DoCoMo.

A problem here was the London court awarded damages to DoCoMo for the Tata refusal to honour the contract and the taxman is arguing the damages paid are taxable since they represent an income for DoCoMo—had the payment been made by Tatas according to the original contract, the taxman would have treated is as a capital loss and not taxed it. It is possible the courts will rule in favour of DoCoMo eventually, but surely someone needed to apply their mind and examine the spirit of the contract and therefore the context of the arbitration award? The taxman is probably justified in arguing the damages are an income, but from an investors point of view, whether the Tatas paid damages or honoured their contract is really the same thing since the damages were awarded because the contract was not honoured. If this is the casual attitude towards investors from countries that India considers strategically important, you shudder to think about what happens to ordinary investors—both Cairn and Vodafone, of course, are living testimony to that.

Direct tax reforms, finally?

High time we reduced rates, removed exemptions

WHILE FINANCE MINISTER Arun Jaitley had announced, in his February 2015 budget, that he would reduce corporate tax rates from 30% to 25% in four years, this is far from being done—in this year's budget, taxes have been cut to 25% but only for units that have a revenue of less than ₹50 crore. For Jaitley to be able to do this, he has to reduce the plethora of exemptions given to corporates—only then can taxes be cut without seeing a major loss in revenues. That is why, prime minister Narendra Modi did well to talk last week—at the annual retreat of tax officers, Rajaswa Gyan Sangam—of the need to overhaul the direct taxes framework. Following this, according to a report in *The Times of India*, the government is planning to set up a task force to draft a new law to meet India's needs. While an attempt to write the new direct tax law was made in 2009 when then finance minister P Chidambaram led an exercise to draft Direct Taxes Code (DTC), the legislation could not take the shape of law even after substantial dilutions. It was finally junked by finance minister Arun Jaitley after the NDA came to power.

Some parts of the DTC, like lower corporate taxes and elimination of corporate exemptions, have already been built into the law; others like GAAR have also been made part of the income tax law. Even so, a larger exercise of reducing personal income tax exemptions is also required since this is also a large contributor to poor income tax compliance, especially at the level of those in the ₹10-20 lakh income bracket—if tax moderation is a critical part of GST, it has to be a critical part of direct taxes as well. Indeed, instead of reducing the gap between tax slabs, this year's budget has gone and increased them. While annual incomes between ₹2.5 lakh and ₹5 lakh are taxed at 5%, the tax rate jumps to 20% for the income between ₹5 lakh and ₹10 lakh. If that isn't bad enough, the top tax rate of 30% kicks in at just ₹10 lakh. The DTC, in 2009, had proposed the 30% rate being charged on incomes above ₹25 lakh and the 20% rate to be charged on income between ₹10 lakh and ₹25 lakh, along with the removal of all exemptions and a ₹3 lakh taxable income limit. Similarly, in case of the companies, the DTC had proposed a reduction in the tax rate from 30% to 25% along with the removal of all exemptions. Even if it is not possible to make all these changes next February, a roadmap for the final changes must be announced by the taskforce.

DyNASTY

From Indira Gandhi to Kareena and Ranbir Kapoor, many successful examples Rahul Gandhi could have cited

CONGRESS SCION RAHUL Gandhi's remarks, at Berkeley, on the spread of dynasties across India, and across professions—he himself is a 5th generation politician—may have drawn sarcastic comments about him being a failed dynast, but there is no denying South Asia tends to have more than a smattering of dynasts. Defending his position as a dynast, Gandhi spoke of Akhilesh Yadav and Anurag Thakur as examples of dynasts in politics, Abhishek Bachchan in cinema and Isha and Akash Ambani in business—and, he said, he thought the same was happening at Infosys; something Infosys co-founder Narayana Murthy has always denied. Oddly, Gandhi left out examples of very successful dynasts. In politics, and his own family, both Jawaharlal Nehru and Indira Gandhi were remarkably successful dynasts and, in films, so many generations of the Kapoors ending with Kareena and now Ranbir have been enormously successful dynasts. While it is too early to say if Isha and Akash will be successful industrialists, or Kavin Mittal for that matter, both Mukesh Ambani and Kumaramangalam Birla are examples of very successful dynasts, as was Ratan Tata before he retired.

Gandhi is clearly right in saying what really matters is whether the dynast is capable or not, but what contributed to India's success in the 1990s and the 2000s was the regularity with which many of the names in the Top 20 or Top 30 businesses kept changing—if Ambani/Tata/Birla were a constant, it was because they were continually reinventing themselves. That slowed in the 2010s and, not surprisingly, so did India's growth. The good news is that the new insolvency code will give a fillip to this creative destruction and inefficient and debt-heavy corporates, known more for their ability to corner bank finance, over generations in some cases, will die a quick death—DieNasty!—while the adept and those with new ideas will rise.

BANKING ON DEPOSITS

ALMOST 25% OF DEPOSITS ARE IN SAVINGS ACCOUNTS; A 50 BPS CUT IN RATES WOULD SAVE AROUND ₹12,500 CRORE IF DONE ACROSS ALL BANKS

The impact of lowering savings interest rates

MADAN SABNAVIS

Chief economist, CARE Ratings

Views are personal

AN INTERESTING DEVELOPMENT in the banking sector that has not provoked much discussion is the lowering of savings bank interest rate by 50 bps by a number of banks. It was spearheaded by SBI; and quite expectedly, other banks have followed. Most banks that were offering 4% interest on these deposits would now pay only 3.5%. Those which were offering 5-6% have also brought down their rates by a similar amount. This action was contrary to the action taken by banks in 2011—even while RBI deregulated interest rate on savings deposits in October 2011, the response of some banks was to increase rather than decrease it. In fact, the rate had gone up to 7% for some banks above a minimum threshold of deposit level. Now, for the first time, banks have lowered the rate. Such an act has several interesting implications.

The first is that when one bank does take such action, others follow. There has always been an oligopolistic approach towards interest rates in the country even after deregulation, as all banks normally end up working in unison as the invisible hand guides them. There could be differences in interest rates offered on different tenures of bank deposits, but such decisions are guided more by their respective requirements of funds to match asset tenures. This holds especially for public sector banks (PSBs), where it may be difficult to distinguish the interest rates offered on deposits.

Second, households appear to be very sticky when dealing with banks. When some private banks offered a rate of 200-300 bps higher on savings deposits, there was no migration from the existing banks to those offering higher rates. This means that households are 'lazy' and do not readily react to incentives on the deposits side. A reason could be that there is a long-term association with a bank branch, which makes them reluctant to swap deposits across banks when rates offered are different. In addition, the process of shifting over is cumbersome as it involves opening new accounts with all the compliances in place. Banks are hence able to exploit this frailty of consumer behaviour as individuals are not rational here. Interestingly, for consumer goods, people tend to be very discerning about price, but when it comes to bank deposits, they really do not care much. Even service quality often does not matter, as once any bank becomes a habit, nothing else matters.

Third, banks on the whole can save considerable amount of money by continuously lowering the rate. As almost 25% of deposits are in these accounts, 50 bps cut in rates would save around ₹12,500 crore if done across all banks. If they further reduce rates by another 50bps, then the total savings go up by ₹25,000 crore, which will help to strengthen their profit and loss (P&L) account. As an extension, this can be used for making provisions on NPAs and clean up their balance sheets faster. Customers really don't have a viable choice, or choose not to change over banks, just like they are indifferent when banks charge for virtually every normal banking service like cheque books and ATMs beyond a threshold. Here too, there is little differentiation across banks in terms of price.

Fourth, a logical question to pose to banks is that if, on their own volition, they have successfully lowered the savings bank rate along with other things being constant, they could also do the same on term deposits and not wait for RBI to lower policy rates. As an extension, this can be stretched to the lending side too. It is significant that banks have been lamenting that RBI has been intransigent in its stance on monetary policy and, therefore, as a corollary, are not in a position to lower rates. Industry, too, has been dissatisfied when RBI does not lower interest rates every two months. By unilaterally lowering rates on savings deposits, banks have actually acted independently. This, in a way, is good, as they have taken a decision jointly to go by their instinct, albeit inadvertently.

> **Households appear to be sticky when dealing with banks; they do not always react to incentives on the deposits side. A reason could be long-term association with a bank branch, which makes them reluctant to swap deposits across banks when rates offered are different**

It should be remembered that the repo rate enters the formula for calculating the base rate or the Marginal Cost of funds-based Lending Rate (MCLR) purely on the basis of the quantum borrowed or lent through the repo or reverse repo reservoir—including daily and term instruments—the rate involved for 50 bps is just ₹500 crore, which is minuscule as the total interest income of all banks in 2015-16 was about ₹10 lakh crore. The amount is not really significant and, therefore, logically, banks should be able to take whatever action they feel is appropriate rather than wait for RBI to lower rates.

Fifth, at an ideological level, such decisions also have an impact on the efficacy of monetary policy. As long as banks respond to the repo rate change, which is what RBI calls the transmission mechanism, monetary policy will be effective. If banks continue to act on their own and independent of the RBI policy direction, then monetary policy impact becomes weaker and, at the theoretical limit, will cease to matter (which is unlikely as banks would never exceed the thresholds).

Globally, the rate paid on similar accounts is much lower and would not be more than 20-25% of the fixed deposit rate with a tenure of one year. Based on this norm, the savings bank interest rate could be lowered further, which will be good for banks, though not so good for customers. If a fixed deposit gives a yield of 6.5-7%, then at 3.5% the savings bank rate is still 50% of the former. Individuals would need to consider investing in very short-term liquid options of mutual funds if the amounts are large, as there is significant flexibility here, with withdrawals being possible with a lag of a day. Account holders could also try using the term deposit route with a sweep-in facility to ensure that only a minimum amount is kept in this account and the balance earns a higher rate. Customers have to re-evaluate their options and change their mindsets to optimise their returns.

Interestingly, post office savings accounts offers 4% without any limit and hence could become attractive, provided savers are flexible. In the past, banks have pointed out that they have not been in a position to lower deposit rates as post office savings and small savings offered higher rates. Quite clearly, it appears, they are out of this syndrome.

Crying wolf over EVs

Innovating and promoting electric vehicles today will grow auto-sector jobs; India will not have to depend on imports for sub-systems

ASHOK JHUNJHUNWALA

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THE GOVERNMENT'S INTENT to convert all of India's vehicles to electric has now been known for a year. Several auto-companies have however been in denial mode. A recent tender by a public-sector company to procure some 10,000 electric cars and a programme to launch 50,000 electric 3-wheelers and 10,000 buses have suddenly shaken them. They are crying foul and creating a hysteria that the Electric Vehicles (EVs) will have huge socio-economic costs for the country and will contribute to loss of millions of jobs in India. Let us do some reality check.

The energy efficiency of an internal combustion engine using petrol (or diesel) is between 16-21%; that of electric motors is above 90%. A petrol car has over 2,000 moving parts, whereas EVs have some 25, making it far-more reliable. The prices of batteries are falling rapidly—a 75%-drop in last six years. In the next five-six years, an electric vehicle with acceptable range will cost less than a petrol vehicle, and will have five-six times lower running cost. Sheer economics will make Indians prefer and purchase EVs.

The only problem is that if India waits now, other nations acquire a definite technology-edge and India will end up importing most of the EV sub-systems or pay massive royalties. This will in fact result in the collapse of many auto and auto-parts manufacturers in India, leading to massive job-losses.

If this perilous state is to be avoided, India has to act now and move rapidly to EVs, innovating upon every aspect so as to attain leadership in at least some aspects of technologies involved. It has to start making motors, drives, batteries, battery-cells, chargers and control systems for EVs today. It has to carry out lithium battery recycling and make electric power-steering, brakes, air-conditioners and every subsystem required to further drive efficiencies in entire supply chain for small as well as large electric vehicles. It has to start making electric autos, electric rickshaws, electric load carriers, electric cars and electric buses today, instead of waiting.

India has to innovate to overcome high costs of several EV sub-systems today and optimise the technologies for the higher ambient temperature in our country. It has to optimise the design of these vehicles to give high performance even at the lower average speeds in our congested cities. India has to try out innovative techniques to overcome range anxiety, including battery-swapping and top-up charging and find solutions most suitable for our conditions.

> **India has to try out innovative techniques to overcome range anxiety, including battery-swapping and top-up charging and find solutions most suitable for our conditions**

There has been a significant number of Indian companies, which have taken the initiative and been doing precisely this. They have been working over the last one year, engaging in dialogue with the government and partnering with R&D institutes to take up these challenges. A combination of existing and new industry players are taking up such tasks, confident that as EV replaces IC-engine vehicles in the coming years, the contribution of the auto-industry to India's economy and jobs will not just remain intact, but actually grow.

There are however, other companies, which believe that the coming EV revolution is just a bad dream and will simply disappear. Some of them go out of the way to be critical of the modest efforts made by the government to promote EVs. They believe that technology should be proven and worked out elsewhere in the world and then only India should adopt it; they believe that we should adopt hybrids at present, which were introduced in the world some 20 years ago. After all, they believe that India can only follow and never lead.

They, however, are not aware that a new generation of leadership has emerged in industry, in academia and amongst the youngsters and start-ups, who believe that India can lead; and they are working towards India becoming a fully-EV nation by 2030 and making India a leader in EVs, in spite of all the fears and negativity around. They are the future of India.

LETTERS TO THE EDITOR

Rajan shouldn't be critical

Apropos the the report "Let India grow at 8-10 % for ten years before chest-thumping: Rajan" such comments don't sit well with the status of former RBI Governor Raghuram Rajan. The statement smacks of arrogance and zero humility. Culture and history are different aspects of our country, and they have nothing to do with economics and development. Countries like Greece still cherish their past although their present economy may not be good. No country in the world can boast of seamless growth for years. When such is the case, the Indian growth is laudable. How many countries in the world, excepting perhaps China, could visualise such a growth phenomenon, including the highly developed countries like the US, the UK, France, Japan and Germany. Rajan would do well to prescribe remedial measures and success-models to the government.

— Venkat Eswaran, *via* e-mail

Resisting intolerance

The show of strength by people across the country at the rally and resistance meeting in Bengaluru to protest the killing of journalist Gauri Lankesh is an apt reminder that citizens of the country will not hesitate to stand united in the face of intolerance. It is heartening that several organisations threw their weight behind the rally. The protesters rightly condemned right-wing organisations which celebrated Lankesh's murder and demanded that the government take punitive action.

— NJ Ravi Chander, Bengaluru

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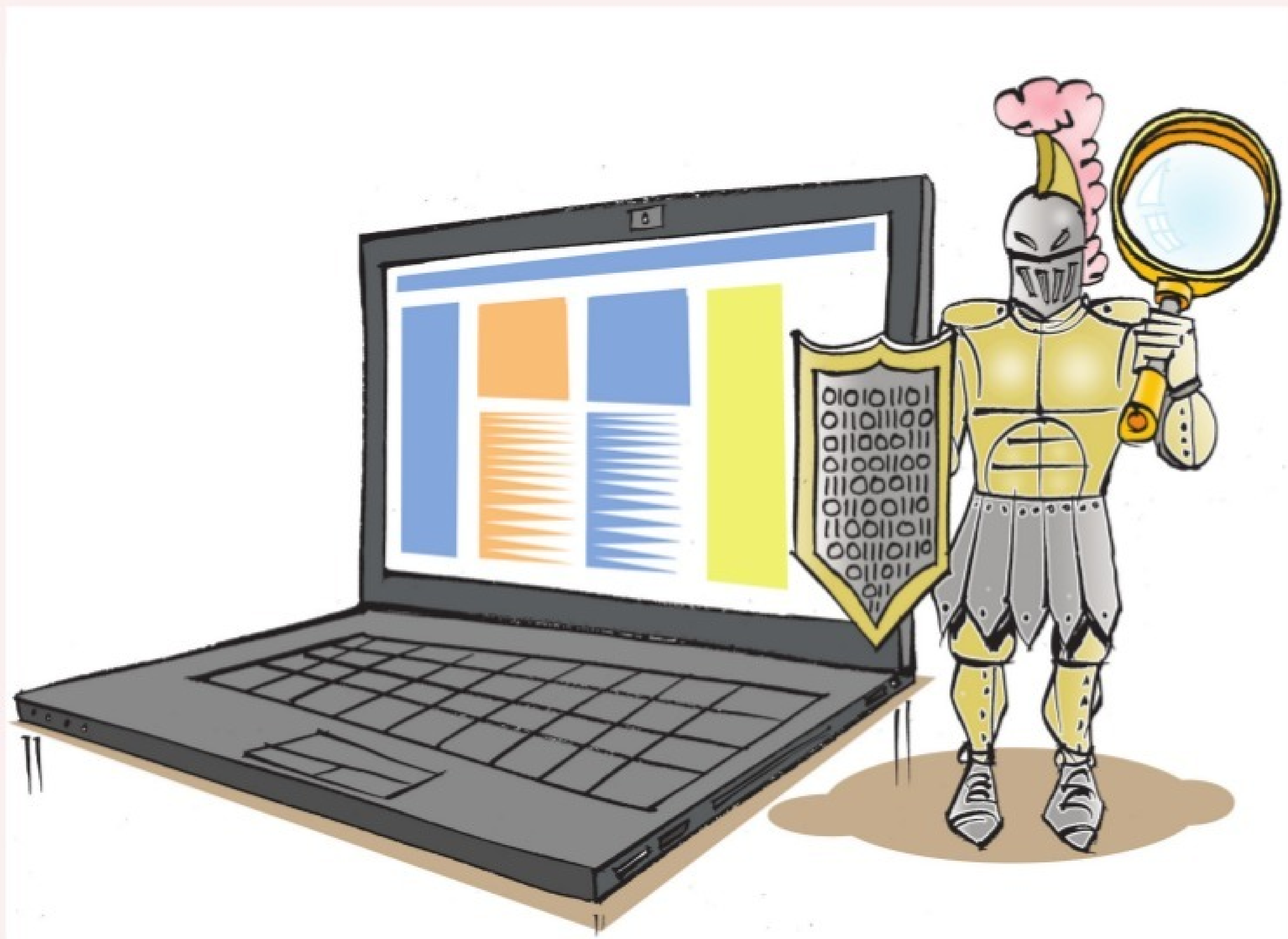

ILLUSTRATION: ROHNIT PHORE

SUSHILA RAVINDRANATH

REGIONAL CAFE: TAMIL NADU

Fighting computer viruses for 25 years

Chennai-based K7 Computing has emerged as one of the leading names globally in cybersecurity. It is among the top three in the country, edging towards number one

K7 COMPUTING IS ONE of the pioneers of the cybersecurity industry in India. Eponymously named after its founder and CEO Kesavardhanan Jayaraman, K7 Computing is celebrating its 25-year journey. The company developed a free tool for the recent WannaCry ransomware attack. It protects over 20 million customers globally—both individual and enterprise users—against threats to their IT environment. It is a market leader in the consumer segment in Japan. It has evolved from an anti-virus company to a provider of total security systems. Today, in the era of the internet, threats can come from anywhere and the customer needs a 360⁰ protection. K7 hopes to provide the same.

K7 is, in many ways, a unique story. It is one of the hidden gems from Chennai, although the founder and the company are well known in the security industry. Kesevan, a high school dropout, is a coding wizard. His school years were unspectacular, but for his love of numbers. Maths was a subject he excelled in. After he completed his 10th standard, he joined a computer training institute paying ₹750, which was a princely sum for his family then. He discovered computers and coding when he was 15, and started writing programs at a speed the class had never seen before. Although he went back to school, he lasted just a year. He was busy mastering all the programming languages of that era.

Assignments came his way and Kesevan started making money. He started working with PhD scholars, chartered accountants and other professionals, learnt their subjects, and delivered programming packages for them. In the 1980s, personal computers entered India, and so did viruses attacking PCs. "When I saw viruses invade computers, my first instinct was to help people. I knew assembly language and DOS, and so it was easy for me to write the codes to kill the virus. I did a lot of free service. I accidentally created 'freeware' in India," says Kesevan.

With India opening up, the PC market picked up. The threat from viruses increased. In 1991, the virus Michelangelo was threatening to wipe out all the information stored on desktops. Kesevan took the plunge into entrepreneurship and set up K7 Computing the same year to offer anti-virus products. Why did he decide to build an anti-virus product when he had so many options with his skills? He says the concept of reverse engineering, which is what anti-virus is all about, challenged him. Those days, people opted for cheap pirated software, but were willing to pay for anti-virus.

Today, K7 would be seen as a typical start-up. It is one of the earliest companies in the country to come up with an IT product. It was bootstrapped and Kesevan did not go for any funding. He thought global and never gave up in spite of the many ups and downs he went through. It was a hand-to-mouth existence in the early days. He would not sell out, although the global leader McAfee came up with an offer in 1999. When he built his first anti-virus programme VX2000 (which he never patented), CyberMedia of the US entered into an MoU with Kesevan. He started acquiring global clients and servicing them. McAfee eventually took over CyberMedia.

By 2001, Kesevan started paying the price of growth not planned carefully. The company lacked marketing skills. It set up offices all over the country, which proved to be unviable. It focused on solutions for the latest virus, but not on the commercial aspects of the business. He was beginning to face major cash flow problems and could not pay salaries on time. Several of his top employees left.

In 2002, there was an unexpected breakthrough. Japanese software publisher SourceNext was looking out for a partner to develop a unified product that could handle security issues relating to a firewall, anti-virus and email. They asked McAfee for a reference and McAfee directed them to K7. The rest is history. "We showed we could do a product from Chennai and launched it in 2003. It proved to be a game-changer for us. We built a small team to focus on Japan. We focused on R&D, quality and speed," says Kesevan. K7 started making money. SourceNext continues to be the market leader in Japan and K7 suite is its largest selling product.

By 2009, the company could move to a swanky office in Chennai's IT Park from a hole in the wall. It started looking at the Indian market, that was much more complex. India continued to prefer privacy to new products. Hardware had not moved up the value chain. "Some professionals found it difficult to work with a school dropout. The software distributors we tied up with acted more like warehouse partners than distribution partners," he says. The revenues remained flat.

From 2012 onwards, Kesevan has started making serious attempts to change his business model. "I realised that if we had to win, we should follow the FMCG model and not treat our products like commodities. We now sell like an MNC sells its toothpaste. K7 has created a strong sales force, hiring people with FMCG background. They personally approach 15,000 outlets. "We are now catering to 6,000 customers every day," Kesevan says. The company is now seriously focusing on B2B market as well.

> K7 Computing follows the FMCG model. It sells anti-virus and similar products like an MNC sells toothpaste. It has created a strong sales force, hiring people with FMCG background. They personally approach 15,000 outlets, and the company now caters to 6,000 customers daily

Technology is in the founder's DNA. K7 has nearly all the international certifications in cybersecurity, numerous awards, and is one of the leading names mentioned in cybersecurity journals. It is among the top three in the country, edging towards number one. All its products are built in Chennai.

Having got his act together (again, without any outside funding), Kesevan is optimistic about the future. "Technology is changing everyday. We anticipated protecting user experience with the internet in 2000 itself. Mobile, IoT, online transactions are all going fast in India. Smartphones are becoming the epicentre of IT. When you lose a phone, you don't just lose a device, you lose your privacy. We will take care of it for you. There is always growth and future in security."

Kesevan says he still has the same passion he started with. "Programming is an art and the product is my child." He is seriously looking at the US market. "Even a 5% market share will be huge for us." Next on the agenda is setting up an academy for cybersecurity.

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DIGITAL PAYMENTS

Paving the way for financial inclusion

BIPIN PREET SINGH

Founder, MobiKwik

India will be a digital superpower within the next decade, leading digital payments revolutions in Asia

IN THE RECENT Mann Ki Baat, a lot of us heard Prime Minister Narendra Modi saying that "The Jan-Dhan revolution is a historic movement to bring the poor, downtrodden and marginalised into the financial mainstream." The mobile revolution and an expanding digital ecosystem have seemingly transformed the financial landscape in the country.

The Jan-Dhan Yojana has brought millions under the formal banking system and, at the same time, fintech companies are further stimulating the financial inclusivity agenda of the government by enabling last-mile distribution and accessibility.

According to NITI Aayog, the volume of all digital transactions increased by about 23 times with 63,80,000 digital transactions for a value of Rs 2,425 crore in March 2017, compared to 2,80,000 digital transactions worth Rs 101 crore till November 2016. This growth symbolises that collaboration of the government and fintech start-up sector can help India move at lightspeed in realising its digital ambitions.

In November 2016, the government took the decision of demonetisation to enable a clean economy, free of black money, and to promote digital payments for better accountability. Private players, such as wallets, worked determinedly in supporting the government and enabling digital payments for use cases, ranging from paying for a local cab, medical supplies, milk or groceries. The envelope moved beyond paying bills and organised retail, to include daily-use cases of masses and obliterating the use of cash. The acceptability of digital payments, led by wallets or the Unified Payments Interface (UPI), has had a remarkable impact on India's digital economy.

Digital payments have also become a user's entry point into the formal financial system. The millennial generation is fuelling this growth, spending an average of 17 hours per week online and 40% of them transact online. The smartphone user base, at present, has touched 300 million in the country, of which over 100 million are active mobile wallet users. A number of telecom companies, including the PSU BSNL, have started to deepen financial inclusion to the vast under-banked masses by fostering associations with new-age wallet companies, and in one stroke more than 100 million customers of BSNL, largely in rural areas, can benefit from digital payments.

> Financial and digital literacy remain a concern in rural areas. Despite the benefits of the digital revolution, the basic understanding of financial services is limited

With digital payments becoming ubiquitous, mobile wallets are deepening financial inclusion by offering micro credits to customers. Within a few years, users would be able to avail of insurance, loans, investment and mutual funds, in addition to executing basic payment functions through their phones.

Financial and digital literacy, however, remains an area of concern, especially in rural areas of the country. Although the digital revolution has brought benefits to millions of Indians, the basic understanding of various financial services is limited across segments of the population. The digital financial literacy training, launched earlier this year, facilitates access to such instruments for one crore rural citizens. In fact, at the 'Champions of Change' meet that was organised recently, entrepreneurs underlined on inclusion of financial literacy as a subject or module in school, college, and skill development institutes for endorsing Digital India.

There is no doubt that India will be a digital superpower within the next decade, leading digital payments revolutions in Asia. The advent of financial literacy and mass disbursement of financial services will ensure that a billion Indians will be able to realise their financial aspirations, removing the under-banked from India's economic phrasebook.

Flexible inflation targeting & the rupee

RBI should ensure that incentives for regulatory arbitrage are minimised

RAMKISHEN S RAJAN

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INFLATION-TARGETING (IT) frameworks have gained widespread popularity among global central banks over the last few decades. According to IMF, as of October 2016, 38 countries had officially adopted an IT framework—10 advanced economies (AEs) and 28 emerging market and developing economies (EMDEs), India being one of them.

India, like most other countries, operates an IT framework flexibly to accommodate other objectives, including growth/unemployment and financial stability. Can a flexible IT regime with a single instrument (usually the interest rate) adequately accommodate multiple objectives?

In principle, the answer is yes for at least two reasons. One, if an IT framework is operated loosely—in the sense of having a wide inflation band (+/- 2% for India), longer-time horizons within which the inflation objective should be hit (effectively three consecutive quarters for India), or more escape clauses (i.e. exceptional circumstances which might preclude inflation objective being met)—this flexibility allows the pursuit of other non-inflation objectives. Nonetheless, too much flexibility could also create confusion and impact communication of the central bank.

Two, at times there could be "divine coincidence" in the sense that a single policy instrument (repo rate for India) could hit multiple objectives simultaneously. For instance, if there is a capital inflow-induced boom in overall growth, leading to inflationary pressures, and asset price surges that could threaten financial stability, then an interest rate hike would be an appropriate policy instrument that could help achieve all three goals of non-inflationary growth and financial stability.

However, what if the objectives are at loggerheads? For instance, the country might experience sluggish growth along with stable inflation but an asset price boom that threatens financial stability? In such an event, interest rate hikes to reign in asset prices would exacerbate the domestic downturn and threaten the macroeconomic outlook.

Thus, absent divine coincidence, we should recall the classic Tinbergen rule which states that there must be at least as many instruments as there are objectives. In an ideal scenario, the so-called assignment problem suggests that, in the event there are primary trade-offs, inflation should be the primary focus of monetary policy. While growth and employment should be the prerogative of fiscal and structural policies, the goal of financial stability can be tackled via macroprudential measures that are designed to limit systemic vulnerabilities by focusing on the entire financial system.

Flexible inflation-targeting and exchange rate flexibility

For EMDEs, there is arguably an additional objective beyond inflation, growth and financial stability, viz. a degree of exchange rate stability. There are two dimensions to exchange rate stability: managing volatility versus preventing misalignment. The former is not controversial and is not inconsistent with an interest rate based IT framework. It is used by both AEs and EMDEs operating an IT regime.

Somewhat more controversial is the idea of dealing with misalignments. Why should countries with an IT framework pay heed to the exchange rate movements? There are two broad concerns in this regard.

One, for EMDEs, the exchange rate is too important for the macroeconomy and the interest rate transmission is not entirely effective for various reasons, including financially impaired banks, underdeveloped financial markets and instruments, and lack of financial inclusion.

Two, there remains an ongoing concern that exchange rate changes/misalignments impact the domestic economy in ways not easily captured in available macroeconomic models. These effects include wealth and balance sheet effects due to US dollar borrowing/foreign exchange exposure, hysteresis or permanent negative effects on exports due to persistent overvaluation, changing extent of and asymmetries of exchange rate pass-through to inflation, and so forth.

In view of the significant but rather complex impacts that exchange rate changes have on the domestic economy on the one hand, as well as the incomplete pass-through of interest rates to the macroeconomy on the other hand, managing the exchange rate is an additional objective that has been pursued by many other East Asian countries that have operated flexible IT frameworks.

Specifically, many of them continue to lean-against-the wind when the exchange rate strays too far from levels that are inconsistent with medium-run fundamentals. The key point to note here is that managing the exchange rate in response to possible sharp deviations from "fair value" does constitute currency undervaluation as long as foreign exchange intervention is done symmetrically. Currency undervaluation can't be a substitute for the government addressing domestic bottlenecks that hinder exports and investments.

Broadening RBI's evolving policy toolkit

In some circumstances—divine coincidence—interest rate as a single instrument can hit multiple objectives. For instance, when there is inflationary pressure and a depreciating currency, one can raise interest rates. But what if there are domestic boom/inflationary concerns and capital inflows-induced appreciation? Should the central bank raise or lower interest rates?

Absent international policy coordination, and if countries decide against countercyclical use of capital controls, EMDEs like India are not helpless. They have at their disposal sterilised foreign exchange intervention with the goal of insulating interest rates from the effects of foreign exchange intervention. While such a form of intervention may not be very effective in AEs, in EMDEs that are often characterised by imperfect asset substitutability and imperfect capital mobility, sterilised intervention remains a viable policy tool.

In general, therefore, RBI, like some of its East Asian counterparts, should focus on flexible, but not "too flexible", IT. It should aggressively use macroprudential regulations but ensure that incentives for, and the ability to undertake, regulatory arbitrage are minimised. RBI should also be willing to undertake sterilised intervention when exchange rate movements appear inconsistent with fundamental changes, though making sure never to regress to exchange rate pegging.

In the final analysis, RBI needs to pay attention to many dimensions of economic performance and financial stability using a broad array of tools but always maintain and communicate the primacy of the inflation target.