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No sick industrialists

Banks do well to say they can't keep funding losses

While banks have done well to insist, at Monday's meeting on corporate debt restructuring (CDR), that promoters need to bring in more funds and relinquish some control, this is unlikely to work until RBI steps in. Unless RBI steps in and formulates more stringent regulations, the political-bureaucratic class will ensure public sector banks (PSBs) will continue to bail out sick units—remember the old joke about there being lots of sick industry but no sick industrialists? It has to mean something if PSBs have NPA levels that are significantly higher than those of their private sector counterparts—the PSBs' gross NPA ratio increased to 3% as on March 31, 2012, from 2.2% a year ago, while that of private sector banks declined to 1.9% as on March 31, 2012, from 2.3% a year ago. The list of companies that have messed up their businesses and are looking for bailouts is already a long one—Kingfisher, Air India, Bharati Shipyard, Hotel Leela, GTL—and the amounts are only getting bigger. Loans recast by the CDR cell rose nearly 35% to ₹1,50,225 crore by end of March 2012; indeed, the amount sought to be restructured was even higher at ₹2,05,692 crore. While it's true the environment hasn't been easy, most of these companies are in trouble because they mismanaged their affairs. And that's why it's only right that they take a bigger hit than they do now; bankers point out that promoters need to bring in a bigger share of 20-25% of the value that's being lost by banks because of the lower interest rates and the extended tenures. Right now, promoters are bringing in just 15% of the amount and just half of this is coming in upfront.

Some bankers are also looking for greater control over these companies and feel the promoter needs to relinquish some equity stake and allow bankers a few more seats on the board. Others have gone so far as to say that the management needs to be changed before a restructuring package goes through. It is unfortunate the rules aren't tighter and it's also unfortunate that banks have converted a portion of their loans into equity as with Kingfisher or cumulative convertible preference shares as with GTL. Even if RBI is right in its belief that typically 15% of loans recast turn into NPAs, the amount is disconcerting. In the March 2012 quarter, SBI's restructured loans have more than doubled to ₹5,134 crore, on the back of a ₹8,000 crore recast in the December quarter. At PNB, the number was a shocking ₹8,000 crore for the March quarter. SEBs are among the biggest entities in trouble, which is why the public sector banks are more stressed than their private sector peers. The short point is that promoters need to share the pain and pay up once the going gets good.

Don't rush the Lokpal

Issues like autonomy for CBI still need thrashing out

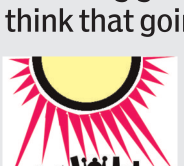
Though the Opposition has gone to town over how the government is not serious about a Lokpal and how it was playing football with it, rushing it through Parliament was always a bad idea, given the serious nature of issues involved—referring it to a Joint Select Committee of Parliament offers the opportunity to mull over complex issues. It must also be emphasised that this committee is truly diversified, accommodating members from the Congress, BJP, BSP, JD-U, NCP, DMK, AIADMK, CPI-M, TMC and SP, as well as an industry expert nominated to the Upper House.

In a fundamental sense, once the government sanction for prosecution of bureaucrats was made easier, or even abolished, the real issue is whether CBI investigation into charges will be an honest one or whether, like so many cases against politicians, it will depend on who is an ally of the party in power. The issue of autonomy of the CBI is a complex one, and many solutions have been offered including having it report to the CVC, but it is clear the civil society solution to simply place it under the Lokpal is fraught with all manner of problems as it creates another power centre that, at the end of the day, is accountable to no one. Though the pressure exerted by Anna Hazare, and the votes to be won by those seen siding with him, is undoubtedly on the minds of legislators, issues such as these need deeper reflection. Indeed, the same applies to the Lokpal/Lokayukta creating a parallel structure of oversight over all layers of government. With the government moving towards more transparent public procurement, Aadhar-based money transfers in place of the current corrupt system of transfers, and auctions to allocate natural resources, it's not immediately clear steps to clean up the system are not already being put in place—in which case, is the Lokpal/Lokayukta the panacea it's touted to be, or will it just complicate governance further?

Apart from the issue of the federal principle of whether the Centre can mandate a Lokayukta at the state level, there is the question of whether reservations should be brought into a constitutional body and the repercussions of this on other wings like the judiciary. These are serious and complex issues that need deliberation—an artificial deadline imposed by civil society cannot be used to rush the debate.

HOUSETHAT

Housing gets a lot more affordable, but you wouldn't think that going by the results of most real estate firms



YOU wouldn't guess it looking at the dismal results of most real estate firms—Unitech just declared a 98% fall in net profits for the quarter—but if data just out from India's top housing finance firm are anything to go by, the underlying has got a lot better. Back in 1995, when the average annual income of HDFC's housing client was ₹1.2 lakh, the average property cost was ₹26 lakh. The average property cost may have gone up to ₹40 lakh since then, but average salary has also climbed to ₹8.3 lakh. The net effect is that, in a happy average as of 2011, you no longer need 22 times your annual income to purchase a home, but a much more affordable 4.6 times. This still isn't as good as the 2.5 number that CNN-Money says applies to US home buyers, but it's certainly getting there—for those that have jobs in the US, and that's a big caveat, things may even have improved a bit more with the correction in house prices.

So why's real estate so down? One, the huge build-up of debt in the boom years was made worse with the slowing economy as real estate firms were left carrying huge inventory. That many real estate firms were aiming at the top end of the market made things worse. According to a Credit Suisse report, gearing for Indian realty firms is, by and large, very high—it was 83 for DLF, 48 for Unitech, 54 for Sobha Developers and 81 for Prestige Estates as compared to 3 for Cheung Kong and 19 for Sun Hung Kai Props in Hong Kong; 20 for CapitaLand and 19 for City Developments in Singapore. If Indian developers learn the right lesson and price their properties right, perhaps the stagnating market will get a leg up.

More grey in white paper

Parts of it contradict one another, and there is a strong line on the role of globalisation in generating black money

On first principles, there is no reason for criticising the white paper on black money for not having thrown up a figure for all and sundry to chew on. The Central Board of Direct Taxes (CBDT) was not tasked to come up with one and it does not have the expertise to develop an estimate, which is essentially an economists' domain.

The Board, in any case, should not have been asked to come up with this report either, as it is neither the policy-making arm of the finance ministry nor in its history has it done any commensurate work on public finance. At times, individually capable officers from the Board have been seconded to committees set up independently by the government on various tax issues. But as finance minister Pranab Mukherjee was in a hurry to show that the ministry was not sleeping on his watch, the paper is now in the public domain.

As a result, you get the distinct feeling after reading the paper that it has not been written by the same team across all sections. The difference makes itself obvious in chapters 1 and 5 that look at the economic rationale for how black money is created and compare those with the rest, which is a breathless recital of the annual report of the Board but with a different set of headings.

One would like to make this difference as the white paper has a very strong line of thought on globalisation, which is hopefully not the settled view of the government. Chapter 4 of the paper clearly asserts that globalisation and economic liberalisation (it mentions both) has led to (an uncomfortable) rise in cross-border transactions. It goes on to say that most of these transactions originate and end at various arms of multi-national corporations. These corporations then misuse transfer pricing provisions to transfer capital from high-tax jurisdictions to low-tax jurisdictions and block tax probes on those as they have more resources than the tax departments of countries like India.

It then says that this is the principle reason for the generation of black money and suggests a five-point line of action to block them. There is only a passing reference to the possibility of black money being generated within the economy through corruption in government schemes (NRHM scam, petrol diversion or 2G scam did not happen).

Also, while chapter 1 and later chapter 5 establish why the breathless estimates of black money by agencies like Global Financial Integrity for India are highly suspect, chapter 4 makes the reverse claim. "In view of the report of GFI relating to mis-pricing, a committee was constituted by the Finance Minister to strengthen the transfer-pricing provisions in the Income Tax Act 1961. Various recommendations made by the committee have been implemented by way of legislative amendments through the Finance Acts 2011 and the Finance Bill 2012", it says.

On the same issues, chapter 5 makes no mention of this line of thought. Instead, it is clear that it is government action including reduction in tax rates, making tax payments easier and reforms in vulnerable sectors along with credible deterrence that are the way forward.

SUBHOMOY BHATTACHARJEE

Asking for more posts is fine, but keep in mind the 16 national agencies tasked with busting black money; CBDT has filed just 1,485 complaints in seven years and has got just 123 convictions

The vulnerable sectors it lists are real estate, bullion trade, financial sector as an involuntary conduit, non-profit sector and allocation of natural resources by governments. A major point of discussion in this context it makes is the role of the cash economy. It rightly points out that there is no bar on anyone holding any pile of cash (imagine Ponty Chadha even if he had a supposed cache) and this means a tax guy can do nothing about them if the person can prove there is a good reason why he held on to the pile. Changes here mean a huge political challenge. If the government was keen to take the war to the opposition camps, this was a powerful line of argument to do so. But then no political party would want this to be investigated. Much better than to blame the black money issue on "dirty foreigners" and get on with life.

So, obviously, there are two significant lines of thoughts that run in the government on black money. This is where the trouble lies. Mukherjee's ministry and by extension the government itself is not clear about the dimension of the problem.

The reforms suggested, such as an upper limit on the use of cash, incentives for use of credit and debit cards, building up of data bank on non-governmental organisations including the cooperative sector, are all political hot potatoes for this government and possibly also for most others. They go against the *aam aadmi* theme zealously pursued by the UPA government so far. There is some more of this, such as the prevention of misuse of corporate structure and, surprisingly, those too are stymied. What it does not mention, however, is that there are 16 national agencies, leaving out the economic offences wing in every state police set-up to bust black money, each armed with a raft of laws. This excludes the two Boards of Direct and Indirect Taxes.

Instead, the paper has become a clever ruse by the CBDT to demand a massive increase in manpower, including a huge retinue abroad. The department has the largest number of vigilance cases lined up among all central government departments. There is definitely a ground for increase in posts but a Board that has filed only 1,485 complaints in seven years and secured conviction in only 123 cases out of those needs to be sent through the wringer first before Parliament sanctions such a mammoth rise in expenditure.

The Parliamentary Standing Committee on Finance has itself pointed out that the Board has issued over 13 crore PAN cards but has just over 3 crore income tax assesses to show for it. There have been several audit reports that have pointed to the serial underestimation of tax cases that run into several thousand crore of rupees.

As was pointed out in the *FE* editorial (*Shady money*, May 22 "*http://goo.gl/dP2eH*"), tracking of black money is a function of an efficient state that doesn't need tax guys to make periodic visits to European countries. But destructive deployment of such a scare to go after trade and industry can be highly counter-productive, as the rupee gyrations are showing up.

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The paradox of forex reserves

Burning through them gives relief from temporary depreciation pressures, but their decline signals loss of strength

The rupee finds itself under pressure again, retracing the gains made earlier this year. Fears arise about further weakening and, understandably, calls go out for the Reserve Bank of India (RBI) to use its reserves to support the value of the rupee. In this environment, RBI must confront the paradox of foreign exchange reserves in deciding how to handle currency policy.

Foreign exchange reserves provide an indispensable signal of strength backing a country's currency. But unlike other expensive deterrent forces a country underwrites for national security, such as the military, foreign exchange reserves are ephemeral, vanishing as they are utilised. Hence, the more a country defends itself with foreign exchange reserves, the weaker its defences appear. Perhaps for this reason, reserves rarely succeed in defending against anything other than temporary depreciation pressures. The frustrating paradox of reserves is their simultaneous necessity and futility.

One of many ways RBI Governor Subbarao has distinguished himself from his predecessors has been his approach to currency management. He has only intervened to dampen market volatility, not to attempt to influence the overall rate. To be fair, pressure on the rupee during YV Reddy's tenure was almost exclusively to strengthen, and the paradox of foreign exchange reserves does not apply to appreciation. Stemming persistent appreciation implies accumulating reserves—easier to manage than spending them—making it much more tempting to oppose the market.

While the advantages may be difficult to appreciate as the market moves, Subbarao's policy of allowing greater rupee flexibility provides many benefits to India. In particular, exchange rate movements act as a valuable macroeconomic adjustment mechanism. Through exports and imports, appreciation helps cool the economy when it overheats, and depreciation boosts the economy when it lags. Exchange rate movement also sends a signal to policymakers about whether macroeconomic management is aiming in the right direction. Further, allowing the currency to move up and down forces the private sector to bear the cost of hedging foreign exchange risk, which discourages unhealthy imbalances in cross-border lending.

When considering using reserves, RBI must also consider future needs. Some worry that Indian reserves already look insufficient to bolster the currency, given that the amount has roughly held steady for the past five years while the economy has continued to grow. Gauging the adequate amount of reserves has become trickier since the global financial crisis.

Previously, economists worried mostly about needing reserves for domestically-generated problems or for contagion from other emerging markets. For those purposes, the best simple benchmark is covering all short-term debt and the current account deficit, representing a full year of external payments coverage. The most current rent debt data for India that includes long-term debt with less than a year to maturity is from June 2011, and measures to encourage NRI deposits will probably have raised short-term debt levels since then. Nonetheless, reserves will likely remain at roughly 40-50% above this benchmark. By this metric, India could burn through almost $100 billion and still appear robust.

RUSSELL GREEN

The experience of the global financial crisis suggests simple benchmarks miss a much more complex reality. Among other aspects, countries compete against each other for investments, so peer behaviour matters. Holding double the benchmark looks great unless everyone else holds triple. In this case, Chinese currency policy that led to $3 trillion in reserves continues to distort markets by setting an unhealthy standard. It is unrealistic and undesirable for India to build such unassailable reserves, yet investors will inevitably compare.

When capital markets fell apart from September 2008 to March 2009, the rupee fell 18% with a modest amount of RBI intervention. That was almost matched by the rupee decline in the final four months of 2011 when there was no comparable external crisis. But economic fundamentals looked much more robust in 2008 than today. Potential GDP growth was assumed to be just below 9%, fiscal and monetary policy had ample room for expansionary policy, and the current account deficit amounted to less than 2% of GDP.

Current rupee weakness largely emanates from home-grown factors that don't appear temporary. That is why the $20 billion of reserves RBI burned through last year accomplished nothing. Given today's economic backdrop, another shock to global financial markets might require much heavier use of India's reserves. With Europe still struggling to contain its crisis, foreign exchange reserves should be used judiciously.

The potential risk of an external shock piling onto domestic problems should instead provoke a more concerted effort to repair the economy. Here RBI is apparently as frustrated by lack of progress as everyone else. Using reserves to prevent further rupee decline would only provide temporary respite to those who are avoiding meaningful reforms. Better to continue RBI's policy of minimising disruptive volatility, but allowing the market's basic message of dissatisfaction with the pace of reform to ring out loud and clear.

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EAVESDROPPER

ROHNIT PHORE

Divine solution

It happens only in India! After failing to convince motorists to slow down on the hairpin curves of the road leading to Shimla, the authorities are said to have come up with a truly *desi* solution. The local and state governments, which had earlier mandated several traffic signs along the winding roads, did not really see much of an effect on the rising accident rates as drivers either did not see them or completely ignored them. In a desperate attempt, authorities started placing small temple shrines at strategic spots that were accident prone. Even though the average Indian has no respect for the traffic rules, he will generally slow down before any place of worship and take a moment to ask for blessings! Predictably, the ploy seems to be working.

LETTERS TO THE EDITOR

Why the DTC?

Recently the finance minister said that the Direct Taxes Code Bill will be introduced in Parliament in the monsoon session. It has been said that the Standing Committee on Finance in Parliament has suggested important proposals like raising tax exemption limits. Lowering the corporate tax rates from 30% to 25% was the main recommendation in the DTC. But the real question is whether the DTC has achieved the purpose for which it was drafted. The main purpose of this Bill was to simplify the complicated and complex sections of the Income-Tax Act, 1961. But it was never made clear which sections of the Income-Tax Act, 1961, were found complicated and complex by the drafters of the DTC and after identification of such sections what new sections have been proposed to replace the complex and complicated sections of the Act? So much has happened with the DTC and its delayed implementation that, in my view, the DTC should be withdrawn completely because it has now become a forced piece of legislation that is being projected as a reform without telling what reform it will bring?

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