The Indian Financial Code

Opposing the Very Purpose of Its Genesis

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"In our seeking for economic and political progress, we all go up – or else we all go down"

– Franklin Roosevelt

Indian Financial Code is an act to regulate the financial sector and to introduce principles for financial regulation and the constitution, objectives, powers and interaction of Financial Agencies and to bring coherence and efficacy in the financial regulatory framework.

Among the various purposes of the formation of IFC Act, the following are the ones needed to understand what was intended by it and what has actually happened:

- The Act lays down mechanisms of independence and accountability, and creates precise objectives, powers and processes for Financial Agencies.
- Reserve Bank of India is incorporated under this Act entrusting it with the role of monetary policy-making, the central bank and the regulation of banking and payment systems

To meet the above objective and also to dispensing with archaic financial laws and modernizing the financial sector, the finance minister announced the formation of Financial Sector Legislative Reforms Commission (FSLRC) during 2011-12 budget speech. FSLRC then got established on 24th March, 2011, chaired by B.N. Srikrishna (a former judge of Supreme Court). The board of members comprised of experts from the fields of finance, law, economics, public finance and so on. From among the many tasks of FSLRC was the one to make recommendations on how financial law should be made that concerns the making of monetary policy. Here FSLRC made recommendations regarding objectives and accountability mechanism for monetary policy making and the composition and power of the monetary policy committee.

Following this, the committee released the approach paper in October 2012 in two volumes. Volume-1 gave the recommendations and volume-2 gave the first IFC draft based on the recommendations in volume-1. This was presented to the government of India on 22nd March, 2013.

The frame work designed by FSLRC came up with two components regarding monetary policy decision making:

1. It gave a strong combination of well-defined objective and the accountability of RBI in its conduct of monetary policy.
2. Recommendations regarding the autonomy of RBI

Following the above recommendations, IFC-1 was drafted which clearly stated RBI's objective was to target inflation while keeping in mind the growth objective. To achieve this target, FSLRC said that the central bank's autonomy will not be compromised and hence, IFC-1 placed an array of powers with the RBI and laid down how who will comprise the Monetary Policy Committee. Following was the institutional design of the Monetary Policy Committee (MPC) as in IFC-1:

- RBI governor as the chairperson of MPC
- Another executive member of the RBI board
- Two members were to be appointed by the central government in consultation with the RBI governor
- Three members were to be appointed solely by the central government

Also, the RBI governor's vote was decisive so the governor enjoyed a veto power and, the central government was provided with reserve power which it could use to override the decision taken by MPC in an extra-ordinary situation.

In this design, if we exclude the governor, the balance of power between the RBI and the central government was thus maintained with three members each (assuming that each of them either supported the RBI or the government). But the governor had the veto power which maintained RBI dominance in MPC and hence RBI's autonomy. This also meant that the onus of achieving the monetary target was largely on RBI's shoulder.

However, even after two years of the birth of IFC-1, no implementation took place as there were issues regarding the transition path to IFC-1, handled by the central government, to be non-transparent. But, suddenly after two years of the release IFC-1 the Ministry of Finance hosted a revised IFC draft called IFC-2 on 23rd July, 2015 on its official website inviting comments on it within two weeks of time.

The modifications in IFC-2 over IFC-1 mainly relate to rule making and operational aspect of capital control, monetary policy framework and the composition of MPC. The question that now arises is why was IFC redrafted and whether the legislative process for implementing the IFC ensures preserving the spirit of recommendations of the FSLRC. To answer these questions we need to look the changes that have been brought about in IFC-2 over the original draft and compare it with the recommendation made by FSLRC as discussed above.

What does IFC-2 say?

Change in the objective

In the new draft of IFC, the objective of inflation targeting has been replaced by a new one according to which growth should be given an equal importance as that given to inflation. Secondly, the inflation target for each year will be determined in terms of the CPI by the central government in consultation with the RBI every three year. Here again arise two questions: one, how can the central government decide the inflation target? Isn't it a part of monetary policy and shouldn't it fall under the purview of the central bank to manage it? Well I think it should! This is because India is unfortunately a vote bank political economy. Achieving a high rate of growth, lowering unemployment rate, taking populist measures such as farm loan waivers in 2008 and bringing out Food Security Bill in 2013 (both in the last year of the rule of the UPA-II government) which are done to widen and deepen the vote bank have unimaginable repercussions on the economy's health. They increase the government's non-plan expenditure heavily and create a need for deficit financing and pressurizing the central bank to finance them, leading to inflation. So, when we know that the government is going to make use of its power to influence monetary policy in its favour that will only aggravate inflation in the country, how can we support this idea of central government setting inflation target?

Also, through inflation targeting, we try to rein and anchor inflation expectations of the masses and so provide stability and certainty to the markets. The inflation objective cannot therefore be a shifting objective or target over a three-year cycle that will introduce unstable inflation expectations.

Change in the composition of MPC

The composition of MPC has also been changed in the favor of the central government. IFC-2 gives the central government the right to appoint 4 out of 7 MPC members and only 3 member of the RBI. The veto power of the RBI governor has also been taken away. This clearly creates an imbalance of power in favor of the government. However, to make it look good and to pacify the situation, a provision of casting vote, to be practice by RBI governor incase in the event of tie in a monetary policy meet, has been made. But who is the government fooling? How can tie take place in a seven member committee unless there is one or more members are absent (which rarely happens). Another pacifier is that the overriding power of the central government (which was to be practiced in extraordinary situations) has also been snatched. But if we see a little deeper into it, is clear that the central government can override RBI in every MPC meeting in the new arrangement! So, why call it a 'Monetary Policy Committee'? It would be better to be named as a 'Fiscal Policy Committee'.

The government, by redrafting IFC, has tried to considerably undermine the autonomy of RBI. This can prove to be very bad for the economy, especially in a political economy. However, the only good thing that the government has done is that it has laid down a trap for itself unknowingly. With MPC having majority of members from the government or appointed by the government, the onus to achieve the monetary target has shifted from RBI's shoulders to the central government's shoulders.

Therefore, reading between the lines, the government has made recommendations only to take away powers from RBI's hands to its own. The government wants control over setting monetary targets so that it can easily and without depending on any other institutions meets its goal of higher GDP growth rate. While for RBI, the major concern is financial stability, i.e., low and stable inflation rate. To achieve this, Mr. Raghuram Rajan has been working hard, avoiding all the pressure from the government and the market to lower the repo rate. He has clearly said that RBI is not a cheerleader that will lower the rates to give boost to positive market sentiments, rather, the decision will depend on strong macroeconomic fundamentals like inflation rate, CPI, IIP, fiscal health, CAD, GDP growth. And the governor has stuck to his words by taking a caliberated approach t lowering the repo rate, sending a very strong signal that its main objective in financial stability but at the same time taking care growth. RBI has been successful so far in doing so. Its target was to bring inflation rate down to 6% by January 2016 however, the rate already hovers at 3.66% (August, 2015) and the pace of disinflation is comfortable. If the power to set monetary target shifts to government's hand, it will definitely succumb to pressure by industrialists of lowering repo rate by 50 bps everytime the market wants. This will happen because the Central government enjoys support form industrialists. But this way of stimulating growth will bad for the long run. Examples are the U.S. and Japan. If the interest rate is continually decreased and the real output doesn't grow at the same pace (which does happen as it takes time to expand production capacity while the pace of decrease in interest rate is increased on market demand), will result in unstable inflation. Plus, a very low interest rate is also not desirable as it puts the economy in liquidity trap and makes interest rate an ineffective monetary policy tool. Therefore, a good balance between interest rate and inflation rate is needed. According to me this is precisely what Mr. Raghuram Rajan has been trying to achieve and is successful so far. RBI rightfully deserves its freedom and to be set up as a truly independent apex institution. So, if IFC has to implemented, it should be the original draft and the revised one should be discarded.

Goods and Services Tax

Goods and Services Tax (GST) is a comprehensive tax levy on manufacturing, selling and consumption of goods and services at a national level under which no particular distinction is made between goods and services for levying of a tax.

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"The difficulty lies not so much in developing new ideas as in escaping from old ones."

– John Maynard Keynes

On a global level GST was launched in 1954, and France became the first country to launch it. Today almost 150 countries have introduced GST in one or another form. In India, its first official mention was in 2009 when a discussion paper was introduced by the previous United Progressive Alliance government. Even though it is been called India's biggest tax reform since 1947, it has not been able to gain a consensus in the parliament. The most prominent hurdle in introducing this new tax structure has been the struggle between the states and the Centre on the loss of revenue. It has taken years to resolve, but even now it is an unfixed issue.

Implementation:

The implementation of GST will help create a common platform and reduce the cascading effect of tax on the cost of goods and services. It will substitute mostly all Indirect taxes levied on goods and services by Central and State Governments of India. It will impact tax structure, tax incidence, tax computation, credit utilization and reporting, leading to a complete overhaul of the current indirect tax system. It will have a far-reaching impact on almost all aspects of business operations in a country, including pricing of products and services, supply chain optimization, IT, accounting and tax compliance systems. Under GST every person is liable to pay tax on his output, and is entitled to get Input Tax Credit (ITC) on the tax paid over its inputs, therefore paying a tax on value addition only such that ultimately the final consumer shall bear the tax. The proposed tax system will subsume a variety of central and state levies such as Central Excise Duty, Service Tax and VAT, thereby simplifying the complicated tax structure and reducing compliance costs.

Dual GST: The unified tax will take the form of a "**dual" GST**, to be levied concurrently by both the Centre and states. The unified tax will comprise of a Central GST (CGST) and a State GST (SGST), which will be legislated, levied and administered by the respective levels of government. The same taxable base will be subject to both GSTs. The words "legislate, levy and administer" are key, since the Centre and the state will legislate the respective GST Acts and both will have power to administer the taxes. It is expected that the base tax rate and other essential features would be common between CGST and SGST. Imports would attract the tax in the same manner as domestic goods and services do. Both CGST and SGST would be levied on the basis of the destination principle i.e., in case of inter-State transaction no tax will be applicable in the originating State and tax will be payable in the State of consumption and since the goods and services produced to consume outside India, it is not consumed in any of the states therefore there will be no taxes on the export items, also this will give a boost to exports of the country. The Central GST and the State GST would be levied simultaneously on every transaction of supply of goods and services except the exempted goods and services, goods which are outside the purview of GST and the transactions which are below the prescribed threshold limits. Further, both would be levied on the same price or value unlike State VAT which is levied on the value of the goods inclusive of CENVAT. While the location of the supplier and the recipient within the country is immaterial for the purpose of CGST, SGST would be chargeable only when the supplier and the recipient are both located within the State. Inter-State supplies within India would attract an Integrated GST (aggregate of CGST and the SGST of the Destination State). The scope of IGST Model is that Centre would levy IGST which would be CGST plus SGST on all inter-State transactions of taxable goods and services. The inter-State seller will pay IGST on value addition after adjusting available credit of IGST, CGST, and SGST on his purchases. The Exporting State will transfer to the Centre the credit of SGST used in payment of IGST. The Importing dealer will claim credit of IGST while discharging his output tax liability in his own State. The Centre will transfer to the importing State the credit of IGST used in payment of SGST.

Two-Rate Structure: It is proposed to be a two-rate structure under GST – a lower rate for necessary items and items of basic importance and a standard rate for goods in general. There will also be a special rate for precious metals and a list of exempted items. GST will not be applied on alcohol and petroleum products, and will remain under the purview of the states, though tobacco products will still be subject to GST, but state governments can levy extra tax percent over and above GST tax rate. In addition to the IGST, in respect of supply of goods, an additional tax of up to 1% has been proposed to be levied by the Centre. The revenue from this tax is to be assigned to the State of Origin of the goods. This tax is proposed to be levied for two years initially or a little longer period if recommended by the GST Council. This additional tax benefit is given to the states to offset the losses incurred by the states in implementing GST.

Effect of GST on the Indian Economy:

GST would be one of the most significant fiscal reforms of independent India. GST is expected to result in major rationalization and simplification of the consumption tax structure at both Centre and State levels. It is expected to replace all indirect taxes, thus avoiding multiple layers of taxation that currently exist in India. The advantages of GST are - wider tax base, necessary for lowering the tax rates and eliminating classification disputes, elimination of multiplicity of taxes and their cascading effects, Rationalization of tax structure and simplification of compliance procedures, harmonization of centre and State tax administrations, which would reduce duplication and compliance costs. Depending on the final GST base rate, there will be a significant redistribution of tax across different goods and services. Goods, currently subject to both Centre and State taxes, should experience a net reduction in tax, with positive impact on consumer demand. Besides simplifying the current system and lowering the costs of doing business, GST will call for a fundamental redesign of supply chains. It will affect how the companies operate their businesses, presenting significant opportunities for long-term revenue and margin improvement. For instance, under the current tax structure, supply chains are invariably designed to minimize the burden of the Central Sales Tax, with distribution centres located in individual States where the consumers are located. They are sub-optimal from a strategic and economic perspective. The elimination of the central sales tax will provide an opportunity to optimize supply chains, enabling companies to re-evaluate existing procurement patterns, and distribution and warehousing arrangements. GST is also expected to result in a reduction in inventory costs. Dealers would be able to claim a credit for the tax paid on their inventories, leading to improved cash flows.

Present Scenario of GST:

The scheme was supposed to be implemented in India from 1st April 2016, however it may get delayed since the NDA government does not have majority in Rajya Sabha. Further, Punjab and Haryana were reluctant to give up purchase tax, Maharashtra was unwilling to give up OCTROI, and all states wanted to keep petroleum and alcohol out of the ambit of GST. Gujarat and Maharashtra want the additional one per cent levy extended beyond the proposed two years, and rose to two per cent. Punjab wants purchase tax outside GST.

Conclusion:

GST would be one of the most significant fiscal reforms of independent India. GST is expected to result in major rationalization and simplification of the consumption tax structure at both Centre and State levels. GST has the power to take the country to next level and increase competitiveness of the companies at the world level. Though a single GST tax structure would have been a lot better but waiting for such a structure for few more decades is non-sensible. Also the conflict between states and centre should be sorted and states should support centre govt. in releasing GST as soon as possible, though now chances of implementing GST by April 2016 looks very bleak.

Devaluation of Yuan

What's behind the China's Yuan devaluation and why Yuan's fall is spooking India?

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Batch: 2015-17

"We are now preparing for the reform of the yuan's exchange rate system. For such reforms to take place, we need good economic conditions." - Wu Yi

The Strong economic growth of China is a result of strong political will and its integration in world trade. China is the world's fastest growing economy with growth rate averaging about 10% for last three decades. China's success can be credited to economic reforms and trade liberalization which was carried out in late 1970s. But something unexpected happened in Jan 2015 China's exports posted a sudden drop which showed slack in global demand abroad and a strong currency which was affecting growth back home. Exports fell 3.3% in January from a year earlier (data from the General Administration of Customs). This was a sharp deterioration from December's 9.7% rise and short of a 4% increase expected by economists polled by The Wall Street Journal. In China the manufacturing sector has come under pressure due to sluggish domestic and global demand.

The Chinese economy is truly slowing. China is on the cusp of a serious, and potentially brutal, slowdown. A sudden drop in exports is just the latest sign of what could be a series of shocks. From weak exports to falling reserves, there are many problems which the Chinese economy is facing but devaluation of currency is not the solution. Chinese currency has roiled the global markets after its sudden move to devalue the currency. Consultancy Firm Fathom believes that China is willing to let Yuan depreciate by as much as 25% over next five years step by step in an attempt to restore export led growth.

Reasons which may have led to a devaluation of Yuan move which roiled global markets:

The First reason may be that the People's Bank of China is keen to show that Yuan as a currency is truly free floating in nature. The main objective of showing currency as free floating is to be a part of basket of currencies used by International monetary Fund to determine the value of member countries and become internal currency of IMF.

This latest move by China could be seen as a way of winning approval of IMF, A decision on Special drawing rights is expected in September 2016. This could open the way for its use as a global reserve Currency

Second, and slightly less reassuring, is the idea that China is trying to buy itself a bit of insurance against a coming Fed rate rise.

The foreign exchange reserves of China are vast which have been dipped to support their currency as pegging Yuan against dollar had become increasingly costly. China believes that there may be a period of financial instability due to monetary tightening so they are trying to weaken the link between Yuan and Dollar.

The third and most alarming argument is that China has resorted to devaluing its currency as a measure to stabilize growth as other measures have failed. Chinese policy makers had been involved in an effort to switch their export based economy in to domestic consumption based model, as the export based economy is reliant on volatile international Demand. At the same time, they are battling to bring more competition and free market approaches to state industries.

They wanted to tackle the problems in stock markets, property and unstainable borrowing. Official figures show GDP growth in line with Beijing's 7% target. With rail freight volumes down 11% on a year ago and electricity production flat, the London-based consultancy Fathom estimates China is really growing at 3.1% a year, not 7%.

From India's Point of view Devaluation of Yuan can lead to "triple whammy" as rupee volatility will increase, exports will come under pressure and there will be dumping of Chinese goods in India.

The fall in Yuan will lead to increase in depreciation, which will lead to increase in demand of dollars which will have an effect of weakening of rupee. If the rupee continues to fall sharply imports will become costlier leading to inflation. This will force the Reserve Bank to hold on to high interest rates, which will hamper the ongoing economic recovery. In normal conditions falling Rupee would have aided domestic exports which have been contracted for seven straight months until June 2015. However there may not be a rise in exports due to global slowdown. The fact which has to be considered is that China and India compete for several export items such as textiles, gems and jewellery etc. which will go against domestic exporters as there is a large overlap between Indian and Chinese markets and also their products. The economic slowdown in China is another negative for Indian exporters as it is among top five countries for India exports.

There's fear that domestic manufacturers will be impacted by devaluation of Yuan which will help the Chinese good and hence will be dumped in the Indian markets. India's exports not only to China but also other countries will get affected due to devaluation of Yuan which increases the competitiveness of Chinese exports. This will lead to higher exports which are from diverse area of manufacturing. We need to ensure that India does not become Dumping ground like it had recently happened for the steel Industry. China produces more steel still than the rest of the world combined, and over four times what the US mustered at its peak in the 1970s Indian industry suffers from relatively high interest rates and logistics cost compared to global players.

In my opinion by delinking its Currency from Dollar, China has given a signal that it is in trouble and there is a need to lift exports as domestic consumption is also limited due to less consumer spending in China. Consumer sending is less due to shockingly low profit margin for most of China's industries, there is a huge overcapacity, of about 30%, across the board in China's industries. That is, on average, the utilization of capacity is only about 70%.In China production of one ton of steel gives a profit of less than one Yuan (some US$ 0.16), and the production of one ton of coal gives a profit that is not enough to buy a bottle of mineral water.