In search of the elusive stability

The govt must contain fiscal deficit to create borrowing space for the private sector

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The financial stability report brought out by the Reserve Bank of India shows some marginal improvement in the balance-sheet position of companies, but the situation in regards to the balance-sheets of the scheduled commercial banks, particularly those of the public sector banks, is alarming. Although some of the deterioration reported in the financial stability report is due to the stricter norms adopted in the asset quality review (AQR) mandated by RBI, the picture is worrisome as it shows that public sector banks, in satisfying large borrowers, have thrown caution to the wind. This underlines poor application of the appraisal process, politicisation and cronyism and perverse structure of incentives and accountability in public sector banks. The adverse consequences of these are not on those who lent the money to unworthy customers or the borrowers who do not consider that is is their obligation to repay borrowed funds, but on those who have put their hard earned savings in these banks and to the extent these are capitalised by the consolidated fund—on the taxpayers of the country.

Of the many important contributions of RBI Governor Raghuram Rajan, two stand out as they directly impact the lives of people. The first is the focus on consumer price index for inflation-targeting and the second is enforcing the asset quality review (AQR) to clean up the balance-sheets of banks. The first is important because, consumer price inflation hurts the common man and particularly the poor. Targeting wholesale prices is meaningless because many of the prices are internationally given and the weights used have no relevance to the pattern of consumption. Some have argued that monetary policy is not an effective instrument to combat food inflation. True, but that misses the larger point. Other policy measures, in particular, supply management of scarcity have to supplement monetary policy. Rate increases compress aggregate demand and if food prices do not decline, non-food prices that are flexible will. Thus, the counterfactual is that, in the absence of effective monetary policy to contain aggregate demand, we end up with both food and non-food inflation. If however, monetary policy is combined with effective supply management, both food and non-food prices will be impacted.

Those who argue for lowering interest rates do not look at the available supply of savings. The only sector that has a saving-investment balance is the household sector and only its financial saving is available borrowing. It must also be noted that the first claim on household sector's financial saving is from the public sector borrowing requirements (PSBR) which includes the fiscal deficit of the Union and the States (close to 6.5% of GDP), borrowing through special purpose vehicles and agencies such as Railways, Nabard, National Highway Authority of India (NHAI) and public sector enterprises. These are close to 9-10% of the GDP. Against this, the financial saving of the household sector is less than 8% of GDP. This implies that and in addition to the financial savings available, public sector borrowings claim a good proportion of foreign investment inflows leaving hardly any borrowing space for the private sector. It should be noted that when the 12th Finance Commission set 6% of GDP as the fiscal deficit target, assuming that the financial saving of the household sector is 10% and external flows is 1.5%—which would cater to the demand of the public enterprises—the private sector would have been left with the a borrowing space of 4%. RBI, by not yielding to the pressure to reduce interest rates, has helped ease inflationary pressures and it is for the government to create borrowing space for the private sector by containing the fiscal deficit and work on supply management to augment supply of essential items.

The focus on cleaning up of PSBs' balance sheets through a comprehensive AQR comes a moment not too soon. When banks lend money to crony borrowers and brush bad loans under the carpet, it is household savings that are insecure

The second most important contribution is in forcing scheduled commercial banks to clean up their balance-sheets. The 36 Scheduled Commercial Banks accounted for 93% of gross advances. Consequent to the AQR, the gross non-performing advances (GNPA) increased from 5.1% in September 2015 to 7.6% in March 2016 and the increase in net non-performing advances (NNPA) as a ratio of net advances was from 2.8% to 4.6% during the corresponding period. Much of this was due to the increase at public sector banks. Their NNPAs increased from 3.6% to 6.1% during the period. It is not clear how much of this is due to deterioration in the six months and how much is due to the AQR. In fact, the macro stress-tests done by RBI shows that GNPA may rise from 7.6% in March 2016 to 8.5% in March 2017 and, if the scenarios deteriorate further, it might further increase to 9.3% by March 2017. The GNPAs of the PSBs may go up from 9.6% in March, 2016 to 10.1% by March 2017 and, under a severe stress scenario, it might even reach 11% by March 2017. This could result in the PSBs recording the lowest capital-to-risk weighted assets ratio (CRAR) of 10.3 March 2017 as against 11.6% in March 2016.

The important point to note is that it is the large borrowers that account for the bulk of the NPAs. In March 2016, large borrowers (defined as those with more than ₹5 crore in loans) accounted for 58% of the total advances of SCBs, but their share in GNPAs was 86.4%. The GNPAs actually increased from 83.4% in September 2015. In fact, the GNPA of large borrowers increased sharply from 7% in September 2015 to 10.6% in March 2016. The top 100 borrowers in terms of funded amounts accounted for 27.9% of credit of all large borrowers and 16.2% of all credit of SCBs. Their share in GNPAs of all large borrowers increased from 3.4% in September 2015 to 22.3% in March 2016.

The focus on cleaning up of the balance-sheets through a comprehensive AQR comes not a moment too soon. Banks operate on other people's money as people put their hard-earned savings in them. When the banks lend money to crony borrowers and, as a practice, when they brush the bad loans under the carpet, it is the savings of these unsuspecting people that is insecure and as the public sector banks get government protection, the taxpayer is made to pay for their imprudence. Indeed, drastic surgery was the need of the hour and we should thank the Governor for this.

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