ILLUSTRATION BY AJAY MOHANTY

Dealing with this air pocket

Private persons, domestic and foreign, need to see a capable Indian policy establishment that is able to work with clarity and cohesion

SNAKES & LADDERS

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The financial system has run into a spot of difficulty, with a combination of events in banking, import financing, bond markets, capital flows, etc. This is a time for the Ministry of Finance to devise a strategy in collaboration with all the financial agencies. The markets will be calmed by the sense that a coordinated strategy is in motion, with capable teams executing at all ends.

Many elements of Indian finance are blinking amber. The banking crisis has been slowly getting worse. The Reserve Bank of India's (RBI's) latest changes in regulations — which are on the right track — will further uncover problems that were hidden by the RBI in earlier years. Many banks are working overtime dealing with operational risk and the NPA crisis, which has given a loss of focus on the mundane activities of raising deposits and giving loans.

The goods and services tax (GST) increased working capital requirements for exporters, and these requirements have been hard to fill while the banking system is hamstrung. Importers have been scrambling to respond to the sudden ban on Letters of Undertaking.

There is concern about the scale of issuance of government bonds. Difficulties in debt management have led to fluctuations on the bond market. The long bond rate has risen from 6.5 per cent in mid-June to 7.65 per cent, which will generate marked-to-market losses for banks. We are looking at a difficult March and April on the issues of government borrowing and the bond market.

The Nifty is down 9 per cent from end-January to today. Foreign investors are a bit nervous, watching the difficult questions that are being placed before economic policymakers.

The Ministry of Finance needs to build an internally consistent strategy to address all these problems. If banks are pulling back from lending to firms, many steps need to be taken on other channels of financing that will fill the breach. This calls for liberalising the equity market, the bond market, capital flows, and fintech. The problems of import financing, and the enhanced working capital requirements for exports that were caused by the GST, need commensurate work.

There is concern about the safety and soundness of Indian banks, and public sector banks in particular. The regulatory and enforcement capabilities at the RBI are weak. A public blame game has begun on the failures of bank regulation. The finance minister expressed concerns about the failures of regulation, and the RBI governor said that the regulator lacked adequate powers to regulate public sector banks. While independent scholars should grapple with these issues, it is better, at a time like this, for the Ministry of Finance and RBI to not debate this in public. The ministry and RBI should only speak through a white paper on the road map for RBI reform and public sector bank reform. The markets do not care about the debate, they care about the strategy that is now put into motion.

If I know that your immune system is strong, then I will not attach much importance to the event of your falling sick. I am not too interested in knowing about your illness because I know that your immune system will conquer it. The most important thing is my knowledge of, and trust in, the capability of your immune system. In similar fashion, domestic and foreign persons are not as interested in the details of the problems afflicting the financial system today as they are in the institutional capacity for solutions. In a country with weak institutions, small problems snowball into a big mess, and in a country with strong institutions, a big mess gets amicably resolved.

The thing that the private sector is watching and judging is the economic policy capability. The need of the hour is for the Ministry of Finance to succeed on these problems. Documents should be released for diagnosing problems, designing a workplan, implementing the early steps, and showing the human and institutional capability for the remaining steps. Crises have a way of defusing once the market knows that a sound institutional capability is on track with a sound game plan.

A comparison with the experiences of 2008 and 2013 is instructive. India was one of the worst-hit emerging markets immediately after the Lehman failure. Each crisis is different, and this one had a combination of stress in mutual funds, real estate companies, Indian borrowers in the overseas money market, ICICI Bank, etc. The key factor that led to good outcomes was the capabilities and teamwork between the Ministry of Finance, the RBI, and the Securities and Exchange Board of India (Sebi). The day-to-day actions mattered, but even more, the market was reassured that there was genuine capability and teamwork.

Objectively speaking, the difficulties faced in India in 2013 were smaller than the storm of 2008. What was different were the capabilities and teamwork. We came across there as a jittery government coming out with one new action every day, and lacking an understanding of what we are up against. This converted a small shock into an outsized problem.

A key difference was the approach to the exchange rate. A floating exchange rate is a source of strength while the presence of currency policy destabilises. In 2013, there was a focus on currency policy, while in 2008 there was clarity on the floating exchange rate. In principle, we should be on a better platform today because the RBI has an inflation-targeting objective in the law, but in practice, it has gone back to a tightly managed exchange rate from 2013 onwards. This bodes ill for the coming months.

In the Financial Sector Legislative Reforms Commission design, the institutional machinery for this kind of crisis management is the Financial Stability and Development Council (FSDC), which is chaired by the finance minister. While the FSDC exists on paper, the law that puts the FSDC into motion has not been enacted, it lacks a capable technical secretariat, and it lacks data, which should have been assembled in the Financial Data Management Centre (FDMC). The time to fix the roof is when the sun was shining, and we unfortunately did not use the calm of 2014-18 to set up laws and agencies.

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