

● DOMESTIC BOTTLENECKS

ALL FACTORS CONSIDERED, RBI SHOULD HOLD ITS POLICY RATE, IF NOT RAISE IT BY 25 BPS. A RATE CUT NOW WON'T DO MUCH SINCE BANKS WILL LIKELY BE UNWILLING TO LEND GIVEN NPA BURDEN

Need cautious monetary & fiscal policies

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THE ESTIMATES OF GDP and GVA growth for the first quarter of 2018-19 at 8.2% and 8%, respectively, have raised hopes of economic revival. The growth rate is significantly higher than the 5.6% in both GDP and GVA recorded in the corresponding quarter last year and the 7.7% in GDP and 7.6% in GVA recorded in the previous quarter. However, as pointed out in my last column, much of the growth acceleration is due to the base effect and it would be too optimistic to expect a higher than 7.5% estimated by RBI for the whole year. The growth in manufacturing and construction seems to have gathered steam after weathering the disruptions caused by demonetisation and GST, though sectors like trade, transport and real estate services are yet to recover fully.

There are a number of constraints on sustaining high growth. Firstly, the international environment for emerging economies is no longer accommodative. Besides high crude oil prices, the protectionist trade environment and a return to the high interest regime by advanced countries will continue to put pressure on the current account deficit, exchange rates and domestic prices. Secondly, the aggregate fiscal deficit of the Central and state governments is far from being comfortable. Although the household sector's gross financial savings increased to 11% of GDP in 2017-18, the net financial savings is just 7.1% as indicated in RBI's annual report and this constrains the borrowing space for the private sector. Finally, the insolvency and bankruptcy reform, important as it is, is still a work in progress. Making provisions for bad debt will continue to erode the profitability of commercial banks.

In this environment, it is imperative for both RBI and the ministry of finance to follow cautious monetary and fiscal policies. The return to a tighter monetary policy, synchronised by both the US Fed and the European Central Bank, will have an adverse

impact on fund flows to emerging markets. Despite assurances by the Open Market Committee of the US Fed to hold the rate unchanged at a range of 1.75% to 2%, there is an expectation of three more rate hikes during the year with the US economy currently having the lowest unemployment rate, at 3.9%, in recent years. The strong protectionist sentiments, with the US and China engaged in tariff wars, do not help matters.

Unfortunately, the domestic situation continues to be challenging. The election year will perhaps see more loan waivers and pay revisions, putting pressure on both fiscal deficit and capital expenditures. The Union budget has virtually positioned a pause in projecting the targeted fiscal deficit of 3.3% for 2018-19. Of course, it is comforting to note the statement of the finance minister to not allow further slippage this year. Unfortunately, the revenue collections at the central level in the first quarter, too, have fallen short of expectations. Nor does the adjustment seem convincing when the government resorts to the practice of one public sector enterprise buying another to meet the disinvestment target.

The situation on state finances looks fragile. On the face of it, higher capital expenditures, a marginal revenue surplus of 0.2% and a lower fiscal deficit of 2.6%, budgeted for 2018-19, look optimistic. However, the revised fiscal deficit estimate of 3.1% in

2017-18 and the budget estimate of 2.6% for 2018-19 are likely to see a sharp upward revision in the election year. In fact, there has been a sharp increase in the fiscal deficits of the states in recent years from an average of 2.1% of GDP during 2006-11 to 2.4% in 2014-15, and further to 3.5%

in 2016-17. In fact, loan waivers in Karnataka are expected to cost an additional ₹40,000 crore. Kerala has seen unprecedented devastation and will require substantial spending for rebuilding its basic infrastructure. Andhra Pradesh has an ambitious plan of building its new capital. A number of states will revise the pay scales of their employees. The year

is also likely to see the full interest burden of the taking over of liabilities of DISCOMS under UDAY. The situation does not look very optimistic on the fiscal front.

The biggest risk continues to be the twin balance sheet problem. The woes of the banking sector do not seem to be ending any time soon. RBI's *Financial Stability Report*, released in June, highlights that the gross non-performing assets (GNPA) of scheduled commercial banks (SCBs) increased from 10.4% in September 2017 to 11.6% in March, 2018. The deterioration with regards to public sector banks is even sharper, from 13.7% to 15.6%. The capital to risk weighted assets ratio (CRAR) for all SCBs remained constant at 13.8% but in public sector banks, it declined from

12% to 11.7%. In fact, all the PSBs, barring two, made losses in 2017-18 and the combined loss in 2017-18 is estimated at ₹851.66 billion, which is more than the profits made by all in the last five years. The stress tests show that, even in the base line scenario under constant macroeconomic conditions, the GNPA of SCBs are set to increase from 11.6% in March 2018 to 12.2% in March 2019. The deterioration of GNPA in PSBs, under the base-line scenario, is from 15.6% to 17.3%.

While the enactment of the insolvency and bankruptcy code (IBC) has been a major reform, its implementation is still a work in progress. Bhushan Steel is the only big case that has been resolved under the IBC. Unlike steel, sectors like power are not likely to see much of a demand revival and are not going to be easily resolved. The committee of lenders may not agree to big haircuts in the environment where the senior past and present executives of the banks have been put in the dock. Not surprisingly, the 180 days deadline given by the RBI circular could not be adhered to and the matter was taken to the Allahabad High Court. RBI has done well to stick to the deadline so that the resolutions are done with a sense of seriousness and urgency. It is important that the time set for the resolution process must be adhered to and relaxations on this will take away the urgency and seriousness of the matter.

RBI will have to calibrate monetary policy in this difficult domestic and international environment. Perhaps, the focus will have to be on freeing up the banking system from the burden of bad balance sheets to revive the investment climate. Reducing interest rates at this juncture may not help matters much as the commercial banks in general, and public sector banks in particular, may not be willing to lend until the bad loan situation is substantially resolved. Considering the difficult external environment and the falling exchange rate and the Fed increasing its rate, it seems feasible to hold the rate, if not raise it by 25 bps, for the moment.

The deterioration of GNPA and CRAR in PSBs, under the baseline scenario, is from 15.6% to 17.3% and 12% to 11.7% respectively

