

The Budget: A few question marks

As expected, the Finance Bill has a clause to amend the RBI Act to formalise CPI-based inflation targeting, and the constitution of a Monetary Policy Committee of six members (half from RBI), with a casting vote for the Governor. One wonders whether this does not vest too much macro-economic policy power in the hands of one individual, particularly when fiscal austerity has become sacrosanct. Can it bias him in favour of high interest rates and an overvalued exchange rate? The latter may mean that the increased domestic demand on which the Finance Minister is banking upon for growth, may only lead to higher imports. The Minister also referred to his success in maintaining the quality of the fiscal deficit even while reducing it; will he also pay some attention to the quality of our record reserves of foreign exchange which he took pride in? Equally importantly, are the monetary and exchange rate policies contributing to the problem of banks' bad debts?

NPAs of public sector banks

The level of non-performing and stressed assets of the public sector banks, which comprise 70% of the industry, has gone up sharply in Q3 results – at a time when GDP growth has been strong, in fact the world's highest amongst major economies. Apart from the alleged corruption and incompetence of public sector bankers, are there any other reasons for the phenomenon? To my mind, if, on the one hand, the RBI and the MoF have pushed the banks to follow more stringent asset quality norms, the other side is whether the price of money and the inefficient governance have not contributed to the deterioration in the quality of the assets. The wholesale price index, more relevant to businesses, has been negative for quite some time now and most borrowers are paying "real", i.e. inflation adjusted, interest rates in double digits. No wonder the percentage of companies with interest coverage ratio of less than one has gone up from something like 17% in Q1 of fiscal 2012-13 to practically double that level in Q3 of the current fiscal year, as per data compiled by Credit Suisse (Mint, February 22). Few businesses earn a return on capital to afford real rates in double digits.

The central bank's argument is that it has done its job by reducing the short term rate but that the banking system's transmission is very poor: but is the liquidity in the system adequate to bring rates down? One indication: the 10-year benchmark yield has hardly

changed over the last one year during which the repo rate dropped by 1%. Globally, central banks' lower interest rate policies have generally been accompanied by pumping liquidity in the market. This does not seem to have happened.

A contributory factor is the exchange rate, which is significantly overvalued, and hurts the tradables sector badly. Given that the domestic prices of most commodities are governed by the global price and the exchange rate, it is no wonder that commodity manufacturers in India (steel, copper, aluminium, etc. etc.) are finding it difficult to compete with imports and incurring losses.

A third factor over which neither the banks nor the borrowers have much control is the inefficiency of governance. When the present government came to power, the Prime Minister promised less government, more governance. But, the number of projects stalled during implementation for land acquisition, umpteen other required approvals, etc. remains very high. And, time and cost overruns can cripple projects under implementation adding to the NPAs. As Dr. E. Sreedharan, widely praised for the way he implemented the Delhi Metro, recently cautioned the authorities about the proposed Nagpur-Mumbai bullet train, each day's delay will increase the project cost by Rs. 50 lacs!

Project finance has always been a riskier business than working capital finance. Looking back at the history of Indian banking over the last 50/60 years, specialised project finance institutions like IFCI and IDBI incurred huge losses; ICICI converted itself into a commercial bank; and IDFC is following suit. Is the share of public sector banks in project/infrastructure finance disproportionately large? One wonders whether an unintended consequence of the recent criticism of public sector banks would be their unwillingness to lend. And surely, this is not going to be helpful to continued growth. As Deepak Parekh said in a speech in Mumbai last month, *"Yes, we need transparency in accounting for NPAs (non-performing assets), but surely the objective of the clean-up is to fix the financial rot, not incapacitate banks."*

A.V.Rajwade (avrajwadegmail.com)