

### **Fiscal Austerity and NPAs**

Earlier this week, the Reserve Bank came out with yet another mechanism to help Sustainable Restructuring of Stressed Assets: this is on top of several earlier initiatives like 5:25 Flexible Restructuring, Strategic Debt Restructuring, the Joint Lenders' Forum, etc. etc. The Corporate Debt Restructuring Scheme goes back 15 years. While all these may help mitigate the problem of non-performing assets (NPAs), are the roots in recent macroeconomic policies?

In an earlier article (The Other Side, March 3, 2016), I had argued that two contributory macroeconomic factors to the sharp increase in the banking system's non-performing assets (NPAs) are monetary:

- ⇒ The extremely high, double digit real interest rates measured in terms of the wholesale price index, currently paid by most business borrowers. No wonder, the interest cover ratio of the Top 10 business houses has dropped from 10.4 in 2007-08 to 3.7 in 2015-16 as per a report in Business Standard on June 13; and
- ⇒ The overvalued rupee, which makes it difficult for businesses in the tradeables sector to compete with imports – or in third markets.

Is the holy cow of rigid limits on the fiscal deficit another contributory factor? In recent decades, fiscal austerity, strict limits on deficits, have led to a number of important sectors of the economy, which earlier used to be financed through budgets – power generation, road construction, ports, etc. –, being transferred to the private sector, and bank financing. These capital-intensive projects have long gestation and payback periods, and often face regulatory, land, or environmental hurdles. These are the sectors to which public sector banks are more exposed, and form a sizeable proportion of their NPAs. Arguably, many such infrastructural projects are not “fair banking risks”.

As for the mechanisms, a cautionary tale from Italy, which also has a huge problem of bad debts is worth narrating. (Incidentally, most banks there are not government owned, nor were those which created the global financial crisis of 2008: clearly privatisation of public sector banks, which some advocate, is not a panacea.) As part of the euro zone, Italy has to observe strict limits on its fiscal deficits. It has around €200 bn of bad debts,

of which €85 bn are still to be provided in the accounts (Financial Times, April 21<sup>st</sup>). A measure of non-performing assets estimates the total at €360bn. Italy therefore created a €5 bn capitalised fund, Atlas, with some equity from the government, but most from banks and other investors; to help resolve the problem – an exact parallel to what we are trying to do with two new agencies, one to contribute equity to “sick” companies, (Stressed Asset Equity Fund) and another to provide soft loans. Atlas has run out of money within months of its creation, helping mitigate only a very small part of the problem. Will our funds fare any better? As it is, public sector banks face a huge shortfall in capital to meet the Basle III standard over the next three years. How much can they contribute to such funds?

One administrative initiative which looks more promising is the effort to reduce the undue influence of the vigilance system on resolution of the problem. This certainly is one area where public sector banks are worse placed than their private sector counterparts who have only internal and external audits. NPAs require prompt decisions – both preventive and curative. The vigilance culture focuses on procedural rather than substantive issues, tempting executives to avoid taking decisions, passing on the buck to the next level – and this surely is not very helpful in resolving the problem.

Coming back to the fiscal austerity, another corollary is that public sector undertakings are being forced to declare higher dividends than they otherwise would have, to reduce the deficit. This obviously affects their investment resources. LIC has become an “investor/lender of last resort” to entities from the National Infrastructure and Investment Fund to Indian Railways to public sector banks’ bonds and equity. But for the pressure from the owner, would LIC have done these investments? In short, adherence to fiscal deficit is increasingly coming at the cost of future investments in the real economy – and increasing NPAs in the financial economy. This surely will affect future growth.

Is there a case for looking at the fiscal deficit, separately for expenditure and investment, the latter being treated differently from the former? The N.K. Singh Committee needs to examine this issue pragmatically and without assuming that all fiscal deficits are evil.

A.V.Rajwade ([avrajwade@gmail.com](mailto:avrajwade@gmail.com))

