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BANK AND ITS CRITICS

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

Recreating the classic 'mohalle ki Diwali' on Digital?

Recent weeks have seen a bewildering explosion of commentary on the RBI by a disparate group including named and unnamed government sources, members of policy advisory groups, academics and others. The issues revolve around the capital base, performance and autonomy of the RBI.

Is the RBI's capital base too large? Central banks need to be adequately capitalised in order to perform their core functions which include being the lender of last resort for the banking system. As per the latest available figures, total RBI capital is around 27 per cent of its total assets. This, as some observers have pointed out, is more than in most central banks in the world.

The problem with this conclusion is the composition of the RBI capital base. Only a third of RBI capital is actually contingency funds that can be deployed when needed. The remaining two-thirds of its capital is primarily revaluation funds. This is an accounting entry which rises and falls as the value of the assets of the RBI rises and falls. Thus, over the past quarter, the depreciation of the rupee has led to an increase in the rupee value of RBI dollar assets by almost Rs 1.6 trillion. But this is accounting income, not earned income. If one had reported the RBI balance sheet in dollars, then there would have been no change on either side of the balance sheet at all.

The deployable capital base of the RBI is just about 7 per cent of total assets. This makes the RBI one of the most under-capitalised central banks in the world. Commentators (including the Government of India's Economic Survey of 2016) who focus on the overall rupee size of the RBI capital base as opposed to its deployable capital base are either deliberately misleading or are just dilettante economists. This brings us to the issue of RBI performance. The recent uproar has been over two overlapping concerns — the Prompt Corrective Action (PCA) norms and the liquidity management of the RBI since the IL&FS crisis broke in September 2018.

The PCA norms were introduced as a way of getting scheduled commercial banks to begin a prompt recognition and clean-up of their asset base before they acquired any new risky assets. This came on the back of a continued worsening of the balance sheets of a number of banks, especially public sector banks, with rising non-performing assets (NPAs).

Have the PCA norms worked? A simple examination of credit growth in the Indian economy this year would suggest that the measures most certainly have worked. Credit has been consistently growing at double digit rates since December 2017, including in September 2018 when it grew at 12.4 per cent (yoy). Crucially, this turnaround in credit growth has come after the low single digit rates of the last couple of years. Greater lending is being undertaken by better capitalised banks that have weaker incentives to ever-green their stressed assets. The claim that the PCA norms have failed is thus an argument based not on facts but rather on political expediency and corporate rent-seeking.

Banks are supposed to allocate the saving of households towards borrowers who are able to offer the highest returns at the lowest risk. When banks don't undertake due diligence, taxpayers are left holding the bill while credit gets rationed for everyone. Hence, regulators devise measures to ensure that the lending process does not get compromised. PCA norms are one such measure. Throwing mud at the RBI for forcing under-capitalised banks to stop lending until

they clean up is akin to throwing stones at a rehabilitation centre for forcing an alcoholic to sober up.

The other criticism of the RBI is with regards to its post-IL&FS liquidity management, especially for NBFCs. The available evidence certainly doesn't suggest an ongoing liquidity crisis. NBFCs had typically been funding their investments with debt and bank loans with an increasing reliance on shorter and shorter commercial paper (CP) over the past year.

The first place that a big squeeze in liquidity would show up is in commercial paper rates. After adjusting for the monetary policy tightening cycle, the supposed liquidity crunch in the NBFC segment finds no supporting evidence in the CP rates which have only moved to the extent that the policy rates have moved (with some lag). There is no sustained independent effect of the IL&FS crisis on market rates. Pointing at the fall in new CP issuance in September 2018 is an attempt at drawing systemic conclusions from one data point. CP issues are a volatile series. Their growth rates (yoy) were negative in February, March and April of 2018 as well! There is certainly no evidence of any aggregate liquidity crunch.

This brings us to the question of RBI independence. A sovereign government finances itself from two sources: Taxes on its citizens and printing of money. The taxes go directly to the government while revenues from money printing accrue to the central bank. Governments face various political constraints that may induce them to take actions that create economic uncertainty. One way for citizens to exercise control over the government is to hand over part of the revenues to the central bank and make it institutionally independent of the government. Arguing, as some have, that independence is earned through performance gets this backwards. Central bank performance depends on independence, not the other way around.

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