

Opinion

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INDIA'S WATER CRISIS

Public Health Minister, Madhya Pradesh, Sukhdev Panse

With 1,544 cubic meters per capita availability, India is already a water-stressed country and is moving towards becoming water-scarce

Not just an FM, Jaitley's counsel will be missed

The economic trough makes his successor's job that much tougher, though the final decisions are always those of the PM

GIVEN THE ADDITIONAL complications with his health in recent months, and his fairly long absences from work even before that, it was always clear Arun Jaitley wouldn't be able to do full justice to the job were he to be appointed finance minister the second time around; to that extent, Jaitley has done the honourable thing by opting out. While a finance minister's job is among the most demanding ones in any government, Jaitley has always been much more than just an FM. He doubled up as defence minister for a long time, a period in which he cleared proposals running into tens of thousand crore rupees for potential manufacturing as part of the Make-in-India programme.

He was clearly the government's go-to person for all matters judicial and played a key role in the National Judicial Appointments Commission (NJAC) Bill—to propose an alternative to the collegium appointing/promoting judges—that was finally struck down by the Supreme Court. And, as FM, he was central to most government decisions, such as the one to open up the coal sector to private players or even keeping the names of donors to political parties secret provided the payments were made by cheque. His great interpersonal skills, fine judicial mind and the image of not being a hardliner made him the ideal spokesperson for the government on most critical issues. And while Jaitley is unfairly blamed for GST being too complex with too many tax rates—what could he do when the states didn't agree?—it was primarily his persuasion that ensured the number of items in the higher brackets has constantly been pruned; though the composition of the GST Council allows for a vote, Jaitley chose persuasion and has, till date, never used the vote for any decision. When the UPA left him to deal with the tricky issue of the retrospective tax, he came up with a judicial solution that ensured the government was not accused of favouring anyone; he said that while the government would not use the law, he would accept all judicial—and arbitral—decisions on the existing cases.

If Jaitley had a weakness as an FM, it was giving his officers too much leeway; as a result, he was unable to get them to reduce pending tax litigation as fast as he would have liked, and even allowed them to convince him to levy MAT on FII investments; it was only when FIIs began withdrawing their money that Jaitley set up a panel under Justice AP Shah who recommended scrapping the levy. Despite Jaitley's promise on being fair to victims of the retrospective tax, the tax bureaucracy confiscated Cairn Energy's shares and dividends and, till now, kept arguing retrospective tax cases couldn't be arbitrated. It also ensured the promise of a 25% corporate tax was never implemented for large firms, and the much-needed direct tax code which would reform the tax system was also delayed; as a result, it was left to Piyush Goyal to deliver relief to over 3 crore taxpayers by effectively doubling the income tax exemption limit to ₹5 lakh.

While Jaitley's successor will have to make a recalcitrant tax bureaucracy deliver and persuade state finance ministers to reduce the number of GST rates—only then does GST get really effective—rising oil prices will pose an additional challenge; Jaitley was able to help finance fairly high government capex on roads and railways through the bonanza got from the collapse in crude prices. To the extent the demonetisation bonanza seems to have exhausted itself, the next finance minister will have to rely on a combination of tax reforms and data mining to get a bump in collections. Jaitley was also blamed for forcing PSUs to take over other PSUs, but not going ahead with privatisation—including that of banks—was always the prime minister's call. The next FM can only be as effective as the PM allows him to be.

Getting drought-ready

India must add storage capacity, focus on crop-suitability

MORE THAN 40% of India faces drought this year—with half of this area set to experience severe to exceptional drought—as per a Business Standard analysis of the IIT Gandhinagar's Drought Early Warning System. The pre-monsoon rains have fallen short of usual by 23%—the worst deficit in six years. As of May 25, nearly 6% of India's land area was in the exceptionally dry category, seven times the area that was classified as such the same time last year. A little over 16% of the country's area was in the extremely and exceptionally dry categories, nearly four times that last year. India's future in the face of the unfolding climate crisis, as a 2013 World Bank study shows, is quite precarious. Since the 1950s, there has been a decline in monsoon rainfall, while the frequency of heavy rainfall events has also increased. Against such a backdrop, it is alarming that 60% of India's districts are not drought-ready, as per a 2018 paper by researchers at two IITs, Indore and Gandhinagar—only 241 of India's 634 districts are drought-resilient. Inter- and intra-state water disparity is a powder keg waiting to be lit as access to water dwindles in the coming years.

The factors that affect India's water-security are numerous, thus, there are multiple prescriptions for developing drought readiness. To start with, the country needs to urgently add reservoir capacity—while it receives an annual precipitation of about 4,000 billion cubic metre (bcm), the country makes a heavy discount for evaporation, of 2,131 bcm. Of the remaining 1,869 bcm, the water eventually available for utilisation is 1,123 bcm—the government says “various constraints” don't allow full usage. Now, against the evaporation and “constraints” losses of close to 2,900 bcm, the reservoir storage capacity in the country is a mere 257 bcm. Some of the constraints might be topographical or otherwise insurmountable, but surely India could do a lot better here? Just 34% of India's cultivated area has access to irrigation; this means the rain-fed majority is highly dependent on groundwater. But, there too, vulnerability is increasing because of the rapid depletion of groundwater—even without climate change, 15% of India's groundwater resources are over-exploited. Part of the problem is the large subsidies given by states to the farm sector for power—which enables indiscriminate groundwater pumping—and fertiliser, the excessive application of which changes the soil's water requirement. Thankfully, states like Punjab are beginning to wean farmers away from this. But, at the crux of this is farmers sowing crops ill-suited to a region's soil type and water availability—a water-deficient Maharashtra dedicating two-thirds of its irrigation water to sugarcane, grown on just 4% of the state's cultivated area, or a Punjab growing most of India's rice for exports when West Bengal has an economic water productivity for the crop that is 2.5 times higher. India's water-stressed future looks much worse if it does nothing resolve these issues.

Antibiotic FLOW

A new study shows the drastic levels of antibiotic contamination in rivers worldwide

A STUDY BY researchers at University of York highlights the rising antibiotic contamination of rivers. The research was carried out in 72 countries, to monitor the presence of 14 commonly used antibiotics, and found the presence of antibiotics at large levels in 65% of the sites. Ciprofloxacin, used for treating multiple infections, exceeded safe levels most frequently. The study highlights that, of 111 sites that had unsafe contamination, most were in Asia and Africa.

In India, a study by researchers from Banaras Hindu University showed high levels of antibiotic contamination of the Ganga. In a country that faces a high anti-microbial resistance (AMR) risk because of rampant antibiotic abuse, such contamination points at systemic deficiencies in treating waste-water and solid waste, thereby, revealing a failure of sanitation and waste disposal policies. In the case of the Ganga, for instance, faecal bacteria levels were found to be above the acceptable cap at 48 out of 61 monitoring stations—this, after the government claimed that 4,465 villages along the Ganga were now open-defecation free. Against a 3,730 million litres/day target for development of sewage treatment capacity—the volume of sewage dumped in to the Ganga—the existing capacity is of just 2,350 MLD. Also, an estimated 11,729 tonnes per day of municipal solid waste is generated by the 97 towns along the river, while the existing processing capacity is of just 3,786 tonnes, and a further capacity of just 3,058 tonnes has been approved so far. Against the nearly 5,000 km of sewage network that is targeted to be developed in cities abutting the Ganga, just over 2,600 km exists. All this means, even as India celebrates the Swachh Bharat Mission's incredible toilet-coverage success, our rivers are falling prey to inadequate sewage coverage and waste processing, leading to antibiotic contamination.

SLUGGISH GROWTH

DEMAND SLOWDOWN LIKELY TO RESULT IN LOW Q4 FY19 GDP GROWTH, SIGNS OF STRUCTURAL WEAKNESS WARRANT A COORDINATED POLICY RESPONSE

GDP slowdown: A structural problem?

ANYBODY WILL TELL you that forecasting economic activity in India is a fraught and perilous exercise; difficult for the official system, but really parlous for outside analysts with much more limited access to official data. So here goes, more in the form of revisiting trends of various components of GDP rather than actual forecasts, and trying to connect disparate dots.

The latest FY19 GDP update is Provisional Estimates (PE). The first Advance Estimates (IAE), released in January 2019, pegged growth at 7.2%, and then this was revised down just before the interim Budget to 7%. The corresponding growth rates for Gross Value Added (which is the actual measure for economic activity) were 7% and 6.8%, respectively.

Based on the current high frequency data, Q4 FY19 numbers are likely to be weak. We forecast a 6.1% GDP and 5.9% GVA Q4 growth, bringing the FY19 GDP growth lower to 6.8-6.9%. Of course, this is subject to revisions of growth rates of earlier FY19 quarters.

The downward revision is emanating largely from agriculture, and more modestly, from industrial activity, offsetting a slight rise in services GDP (see accompanied graphic). Our forecast is of a flat agricultural output and about a 6% growth in industrial activity (more on this later)—the combined

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effect of growth and weights in the GDP as the contributions of the respective segments to overall GDP.

A drop in both cereals and horticulture is contributing to the agri slowdown. We await the results of the 3rd update of the 2019 rabi (winter) crop harvest, which, reports indicate, has been late to arrive in markets.

Industrial activity growth is expected to have held up in Q4 (at 5.6%) despite a sharp drop in the Q4 IIP growth to 0.5% from 4.7% over Q1-Q3. The reason is that GVA measure of output combines IIP with the P&L results of manufacturing companies that declare results. We proxy “value added” of a company's sales as the sum of its PBDIT and employee costs. A sample of 824 manufacturing companies shows 11% growth in net sales in Q4, only a moderate slowdown from 13.2% in Q3 (and 13.8% in Q4 FY18). Within the industry complex, the largest component is manufacturing, and relative growths in the IIP manufacturing vs sales of manufacturing companies is shown

in the accompanying graphic.

Similarly, among the trends in (and our forecasts of) the various components of services GDP the one which stands out is growth in Public Admin, almost half of which is government services [see accompanied graphic]. This estimate has the potential of going wrong, but we have based this on a reported 30% in central government spends in Jan-Feb '19. We expect March spending to have curtailed, post start of election model code (and seemingly validated by high government balances with RBI). If spends are lower, GDP growth will correspondingly fall, maybe to 6.8% for FY19. The other uncertain segment is Trade, Hotels, etc., post the introduction of GST; our understanding of the proxies used for this is still quite inadequate.

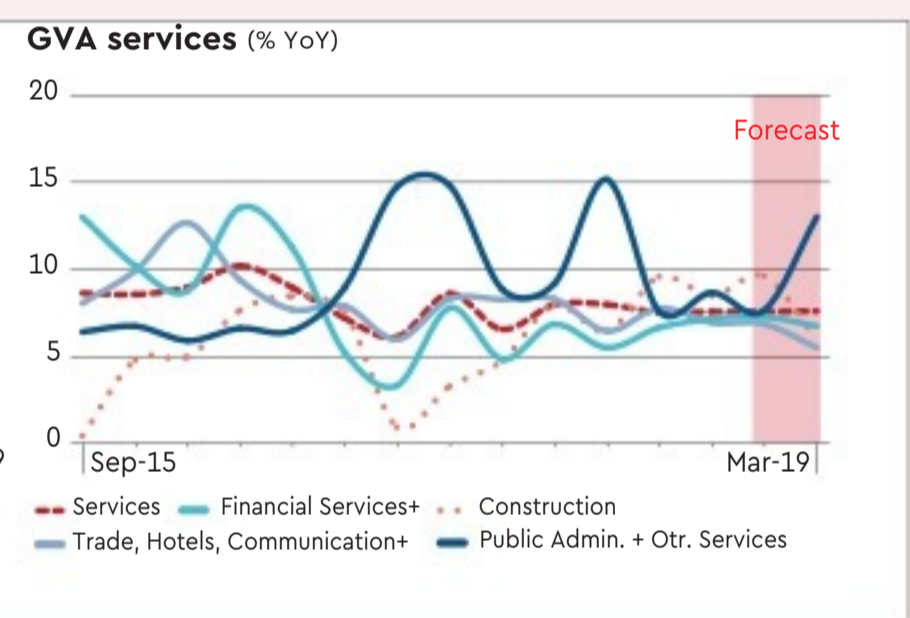
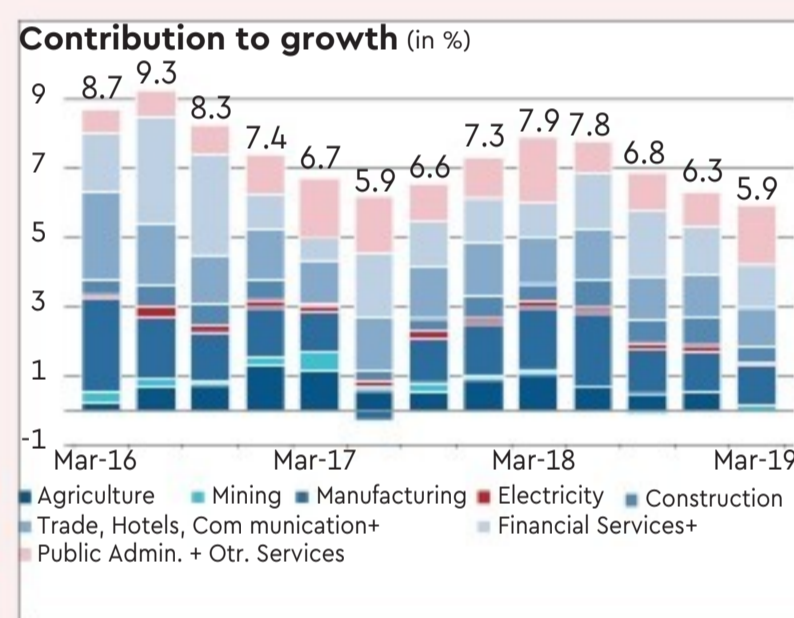
The concern is that within our sample of sales results of about 1,000 non-financial, oil and trading companies, a large quantum of the already slower growth is contributed by the top 100 companies (by sales).

While this skew towards the larger companies is usually the case, the contribution of these subsets of companies in Q4 has been inordinately high, and has been higher in H2 FY19 than normal. The focus of a policy stimulus has to be, hence, on the smaller companies.

A word on the GDP deflators used for transforming nominal sales growth into real inflation-adjusted growth—these deflators are constructed from CPI and WPI inflation indexes. The occasional large divergences of these metrics distort real GDP growth (as can be seen in the divergences in GDP and GVA deflators in previous years), but these deflators have converged very close in FY19. The implication is that the slowdown is quite real.

The question for a policy response, then, is how much of this slowdown is a transient, pre-election phenomenon, and how much is structural. Unfortunately, the credit squeeze in some segments of financial intermediaries seems to have exacerbated a slowing demand, which in turn seems to have led a seeming lack of confidence in expanding capacity. Facilitating a reduction in borrowing costs will certainly help, but this has to be part of a set of coordinated stimulus response.

With contributions from Vikram Chhabra



Support new exporters to shun China

Without infrastructure spending and multilateral trade deals that account for China's rise, the U.S. will find itself isolated from allies

CONOR SEN

Bloomberg



IN A TRADE WAR, one country's strength is the other country's weakness. The U.S. imports far more from China than China imports from the U.S., which means that if the two countries were to sever all ties, China would need to find vast new markets in which to sell goods. The U.S. would have to find new places from which to import goods, which sounds easier but is no small feat.

There are lots of countries in the world that can offer cheap labor, but they don't have the infrastructure to produce and move goods. And while the ability to produce infrastructure is a strength for China, it has not recently been so for the U.S. If the Trump administration truly wants the U.S. to become less dependent on trade with China, America may need to get into the infrastructure business in a serious way, perhaps with a program similar to China's Belt and Road Initiative.

Vietnam is frequently mentioned as a country to which multinational companies can shift production because its labor is cheaper than China's, it's in close proximity to China, and it's already a country from which the U.S. is increasingly importing goods. As recently as 20 years ago, the U.S. was importing less than a billion dollars a year of goods from Vietnam, whereas in the most recent 12 months the U.S. imported over \$53 billion in goods from the country. The increase in tariffs on imported Chinese goods has had a noticeable impact on the growth in imports from China and Vietnam.

But that shift in production to Vietnam is not without its challenges.

Exporting countries need robust infrastructure to move goods around—roads, rail, power generation, ports. And countries like Vietnam are already struggling to keep up even at their current rates of output. To put things in perspective, over the past year the U.S. imported almost 10 times the dollar amount of goods from China as it did from Vietnam. Shifting that production from China to countries like Vietnam, Thailand, Indonesia or Mexico can't be done without significant investments in infrastructure.

China understands that. Part of its vast international project known as the Belt and Road Initiative has been intended to create more interconnected trading ties to China around the world. If we're really shifting to an era in which countries find themselves deciding between a China-centric economy and an America-centric one, then the U.S. may find itself needing to make infrastructure investments around the world as well to keep countries in its sphere of influence.

The main hurdle to do this is likely to be political rather than economic. Ever since the 2008 financial crisis, Washington has found itself increasingly unable to govern, with Congress brought to a halt by gridlock, divided government, and the legislative filibuster in the Senate. This inability to

government must show part of why China finds more to like in its own system of governance than America's.

If “winning” is a function of the size of a country's economy, trading ties to other countries, and technological prowess, then Congress needs to engineer some combination of faster economic growth, more immigration, infrastructure growth, trade deals with other countries, and faster technological progress, perhaps in part by spending more on government research.

An inability to do this would be damaging on multiple levels. First, without infrastructure spending and multilateral trade deals that account for China's rise, the U.S. will find itself isolated from allies and stuck in its reliance on imports from China. Second, it would mean slower economic growth and less technological innovation, allowing China to catch

up with the U.S. in both departments. And third, if Washington continues to be unable to govern, why would any other country look to America as a national model worth emulating and a trading partner to rely on? If America wants to pursue a different course in its relationship with China, someone somehow is going to have to make America govern again.

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LETTERS TO THE EDITOR

Disputed rivers

The Cauvery Water Management Authority (CWMA) directing Karnataka to release 9.19 tmcft of water to Tamil Nadu has infuriated farmers in the Cauvery basin and rightly so. The plummeting water level in the Krishna Raja Sagar dam across the Cauvery in Mandya district and the monsoons playing truant is a matter of concern. However, the farmers can take solace on the ground that water is to be released based on the inflow into the reservoirs. Another consolation is that the Karnataka government has decided to seek legal opinion before taking any decision.

— N J Ravi Chander, Kalyannagar

Tadvi's Case

The suicide of Payal Tadvi, a young woman doctor from Scheduled Tribes community, working in BYL Nair hospital at Mumbai, allegedly after facing persistent caste-based discrimination from her senior doctors is nothing, but a grim pointer to the entrenched caste system, and the miles we need to go, to banish the abominable and discriminatory practices on the ground. Caste-based discrimination is an ubiquitous phenomenon which afflicts every major institutions of the country. Our educational institutions which are expected to preach and practice liberal and egalitarian values—in consonance with our principles enshrined in our constitution—have not yet been free from caste-based discrimination. This attitude within institutions is not only saddening, but also a clear demonstration of the failure of independent India to keep the evils of casteism at bay in its places of higher learning

— M Jeyaram, Sholavandan

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ILLUSTRATION: ROHINIT PHORE

WHAT DID WE LEARN from the victory of the ruling coalition? We already knew that Narendra Modi is a charismatic and effective campaigner, and that the Bharatiya Janata Party (BJP) is well-organised and influential communicators. What we learned from the stronger than (mostly) predicted triumph was that voters were susceptible to the kind of appeal that the ruling party and its leader, in particular, offered. This was an assertive nationalism, firmly grounded in religious identity.

Certainly, elements in Pakistan attack into this narrative—without the attack in February, the margin of victory might have been smaller. But the result also suggests that, even without the specific national security angle, a campaign of emphasising threats from outsiders, whether hostile neighbouring governments or hapless illegal immigrants, would have paid dividends.

The core message of the BJP has been sinking into Indian minds, becoming normalised and familiar. A party that had never captured much more than a third of national parliamentary seats before 2014 is now, by far, the single most dominant force in Indian politics, with a robust new presence in the nation's East and (partly) its South.

The substance and style of the campaign also taught us something about what many Indian voters value in a leader. Modi has effectively created himself as a “man of the people,” though with clear signals that he is also special (the many doubles, the ubiquitous images, the various symbolic actions and markers of holiness). In a sense, he is—someone from an urban working class background, not a descendant of a wealthy dynasty. Jawaharlal Nehru acquired the common touch by his participation in the freedom struggle, though he remained an aristocrat at heart, but each succeeding generation has moved further away from that legitimacy. Rahul Gandhi was figuratively left in the dust in the parliamentary with Modi, even losing his family seat in a former family stronghold. As many have noted, Modi is a new kind of leader for India.

We also learned that many Indian voters are willing, at least temporarily, to put aside concerns about their material well-being, in order to follow more



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What did we learn from the elections?

We learned that many Indian voters are willing, at least temporarily, to put aside concerns about their material well-being, in order to follow more elemental desires for security and feelings of belonging. But we did not learn how serious the ruling party is about economic progress, nor do we know how opposition parties will respond to the new state of affairs

elemental desires for security and feelings of belonging. To the extent that these feelings are fulfilled by denigrating others, this is a dangerous situation, not just for the victims of this exclusion, but ultimately also for the victors. This kind of division, not just for the victims of this exclusion, but ultimately also for the victors. This kind of division, not just for the victims of this exclusion, but ultimately also for the victors. This kind of division, not just for the victims of this exclusion, but ultimately also for the victors.

There are many lessons of the election, and many causes for concern. But there are also uncertainties, and India's future is not determined by the results of this one

India's existence, but the vote in this election suggests an unwelcome resurgence of acceptance of that state of affairs.

What we did not learn from the election is how these factors will play out over the next five years. It is certainly possible for an autocratic ruler to erode institutions that support democracy, through various checks and balances, especially if enough citizens acquiesce or are apathetic. Some observers have noted the tendency of the last government to act in ways that diminish institutional autonomy and

integrity. If that impulse continues, then this election may mark a permanent shift in India's polity.

We also did not learn how serious the ruling party is about economic progress. At times, there have been positive signs, including a continuation of reforms started under previous governments, as well as striking new initiatives such as a focus on toilets and sanitation. However, in many ways, the previous government continued the worst habits of all its predecessors: overcentralising, emphasising symbolism rather than effective implementation, and not drawing on a broad enough range of expertise. Centralisation and personalisation of power and decision-making are unlikely to lead to economic policies that support economic progress at the rate India needs, and is probably capable of.

We also do not know how opposition parties will respond to the new state of affairs. It is plausible that the national government's relative failure on the economic front contributed to the wins for the opposition in recent state assembly elections in the Hindi heartland. In the campaign not one opposition party seemed to offer a message of a pathway to economic betterment that could be an alternative to the nationalist war cry. Nor did they articulate a compelling alternative ideal of what India is as a nation. Perhaps nothing would have worked in this campaign, but the lack of vision is worrisome. “*Bijli, sadak, paani*” is not passé, but needs to be extended to “*hawa*” and “*zameen*,” as environmental degradation starts to erode the quality of life and even livelihoods. The Congress party has a complementary problem as well—its lack of any compelling vision of how to drive improved material well-being for the masses is connected to its being run as a family business, with weak organisational structure and no room for new ideas. We do not know if it can learn any lessons from two successive drubbings, and implement the changes it needs to stay politically relevant.

There are many lessons of the momentous election that has taken place in India, and many causes for concern. But there are also many uncertainties, and India's future is not completely determined by the results of this one election. The next few months may provide clarity: whether that is positive or negative has to be seen.

Promising ‘new’ joint secretaries

RC ACHARYA

The author is former member, Railway Board



Hopefully, they would be fired up enough to work with the zeal of a *karma yogi*

REALISING THAT ‘DOMAIN EXPERTISE’ was missing in his thrust to speed up reforms and ensure better delivery of his varied programmes, Prime Minister Narendra Modi belatedly decided last year to induct experts in a number of ministries at the joint secretary (JS) level.

Considered a key cog in the successful implementation of a policy decision in any ministry, currently personnel managing the posts of JS seldom have domain expertise, understanding of the issues involved, or any hands-on experience. His or her knowledge is mostly of the armchair variety, being what could be gleaned from the office records. In June 2018, the UPSC set about inviting applications for the post of JS in 10 designated ministries, which saw a flood of nearly 6,000 applications. The shortlisted candidates were subject to an interview and the final list issued on April 12, 2019, a full nine months after the posts were advertised.

Persons selected include Kakoli Ghosh for the ministry of agriculture and farmers' welfare; Amber Dubey for the ministry of civil aviation; Arun Goel for the ministry of commerce; Rajeev Saxena for the Department of Economic Affairs; Sujit Kumar Bajpayee for the ministry of environment, forest and climate change; Saurabh Mishra for the Department of Financial Services; Dinesh Dayanand Jagdale for the ministry of new and renewable energy; Himanshu Prasad Singh for the ministry of road transport and highways; and Bhushan Kumar for the ministry of shipping. Only time will tell how effective will they be and how long would they last trying to cut the red tape strung across by the entrenched army of directors, section officers, and achieve a fairly good job by selecting persons who have excellent domain expertise and proven expertise in their chosen field. For instance, Dubey, selected for the ministry of civil aviation, is not only a partner at KPMG in India, but also heads the Aerospace and Defense vertical at the firm. He, along with his team, has been engaged with the ministry of civil aviation, AERA, AAI and has worked closely in drafting of the National Civil Aviation Policy 2016, as well as policy framework for the Regional Connectivity Scheme (RCS).

Similarly, Saxena, in the Department of Economic Affairs, is director, Economic and Infrastructure, SAARC Development Fund (SDF). With over 22 years of relevant work experience, he comes with strong skills in credit and risk management. Working with the Standard Chartered, he had managed to steer Japanese and Korean investments into the Dedicated Freight Corridor and Delhi Mumbai Industrial Corridor. Earlier working in IDBI Bank, he advised PSEs and government bodies and was instrumental in designing and implementing IT-enabled solutions for the MGNREGA.

Here, it is interesting to note the way experts got inducted by the US government when they set up a separate department under the Department of Energy for developing alternative sources of energy. Modelled on the Defense Advanced Research Projects Agency (DARPA) but focused on the development of transformational energy technologies, Advanced Research Projects Agency-Energy (ARPA-E) was recommended to Congress in 2005 by the National Academies. A statutory authority, its director is appointed by the President, with the advice and consent of the Senate. The director can appoint up to 120 experts and shall have the authority to make appointments of scientific, engineering and professional personnel without regard to civil service laws!

In a true story, the person-in-charge for inducting experts set about acquiring talent not by placing advertisements in newspapers, but seeking them in places such as conference on energy matters. On one such occasion, he was able to discover a Mr X who fitted his bill of requirements, was invited over for a detailed interview, and being found satisfactory, handed over an appointment letter the same day.

Hopefully, the experts selected by the UPSC would be fired up enough to work with the zeal of a true ‘*karma yogi*’ even if their pay takes a hit, find navigating the bureaucratic jungle frustrating, and are often driven up the wall.

Only time will tell how effective will they be and how long would they last trying to cut the red tape

NBFCs

SINCE SEPTEMBER 2018, the cost of raising resources by non-bank financial companies (NBFCs) has gone up significantly, mainly due to spillover effects of repayment default by the Infrastructure Leasing & Financial Services (IL&FS) and its subsidiaries. The yield spread of commercial papers (CPs) and debentures issued by NBFCs has widened considerably over the risk-free rates of corresponding maturities, except some softening of these rates during recent months. Following increase in the credit risk, banks are reluctant to renew their lending to NBFCs.

Let us understand the underlying reasons for NBFCs facing a sudden liquidity problem? The average credit growth of NBFCs was more than double compared to the non-food credit growth of scheduled commercial banks during the last five years. As banks were under the asset quality review (AQR), NBFCs got an opportunity to do brisk lending business, borrowing partly from banks and partly from the market, either directly or through issuance of CPs/debt instruments. Sitting on excess cash, particularly after demonetisation, mutual funds (MFs) were also lending liberally to NBFCs, mainly through market-based instruments. In the second half of 2018, MFs faced redemption pressures following portfolio outflows from India and, therefore, could not sustain their lending to NBFCs.

NBFCs demand a special liquidity window from the Reserve Bank of India (RBI) to manage their liquidity problem.

Facing regulatory headwinds?

RBI may tighten NBFC regulations to the extent large NBFCs carry the seeds of financial instability

BARENDRA KUMAR BHOI

Visiting fellow, IGIDR, and former principal adviser, MPD, RBI

Now, should RBI open a special liquidity window for NBFCs? After the global financial crisis in September 2008 and also during the taper tantrum in July 2013, RBI had introduced a temporary liquidity window for MFs to tide over acute redemption pressures. During mid-July to October 2013, commercial banks were allowed to borrow up to ₹25,000 crore from RBI at a penal rate of 10.25%, which was well above the bank rate, for on-lending to MFs. There was no direct lending by RBI to MFs. In addition, MFs hardly availed this facility as the lending to them through banks was not cost-effective.

RBI feels that there is no shortage of liquidity at the system level and, therefore, opening a special window for NBFCs

does not arise. As the repo rate has been cut twice and the liquidity condition has improved significantly in 2019, money market rates have softened, which might have benefited NBFCs as well. Commercial banks, maintaining NBFC accounts, may possibly provide limited short-term liquidity to NBFCs as per needs at their own risk, provided NBFCs have high quality collaterals.

Unless there is an exceptional circumstance, there is no case for opening a special liquidity window for NBFCs. Even if a special window is opened for NBFCs, it may not be attractive as the penal rate may be higher than the CP rate or yield on corporate debt. Moreover, this may create distortion in the money market if the RBI penal rate is not aligned to the CP rate



or yield on corporate debt of similar maturities. There is a growing perception that only a handful of NBFCs face liquidity problem due to weaknesses in their balance sheets arising from imprudent lending. In the absence of AQR, it is not clear whether such NBFCs face temporary liquidity problem or insolvency problem?

There is a thin line of difference between the problem of illiquidity and insolvency. A potentially insolvent NBFC may face liquidity problem to begin with. This needs to be studied through AQR of NBFCs, which is overdue. As far as IL&FS is concerned, it looks more like an insolvency problem (involving close to ₹1 trillion) than a liquidity problem. Due to spillover effect from IL&FS, the possibility of other NBFCs facing temporary liq-

NBFCs have acquired a sizeable proportion of the financial sector; they can cause financial instability if they do not change their business model well in time.

NBFCs face stringent regulatory headwinds, going forward. RBI may tighten NBFC regulations to the extent large NBFCs carry the seeds of financial instability. It has already asked large NBFCs to appoint a Chief Risk Officer as a preventive measure. On May 24, 2019, RBI has come out with a draft circular on liquidity-risk management framework for NBFCs for public comments. Proposals include, inter alia, introduction of the liquidity coverage ratio (holding of high-quality liquid assets like G-Secs), disclosure of compliance concentration, Board-approved comprehensive risk-mitigation policies, etc.

There is no specific mention about AQR for NBFCs other than broad ALM guidelines. The liquidity coverage ratio is proposed to be fully operational over a period of four years starting April 2020, which can be shortened appropriately to, say, 2-3 years. Measures proposed in the draft circular look more like a health advice to NBFCs and their Boards, rather than specific targets, except the liquidity coverage ratio, to be achieved in a time-bound manner. The whole gamut of prudential regulations relating to NBFCs needs to be revisited, including AQR, provisioning/capital adequacy, besides supervisory review of ALM. Alternatively, NBFCs, more interested to have access to public deposit, may be converted into banks and adhere to banking regulations.