

RationalExpectations

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Protecting investor interests critical

If as much as a fifth of private investment in infra is stressed, govt must provide a solution; critical for raising investment levels

EVEN AS MOST are hoping there will be a revival in both investment sentiment and GDP growth now that the Narendra Modi government has won such a decisive mandate, how serious the task ahead is will be made clear later today when the GDP numbers for FY19 will be put out. Most expect Q4 GVA growth to be less than 6%; it was last seen at this level in the June 2017 quarter and, if GVA is at this level, this will make it the fourth successive quarter of a fall in growth since the 7.9% number in March 2018. Nor does an early revival look imminent though it is true that activity levels do pick up after an election—according to HSBC Securities chief economist for India Pranjul Bhandari, about 70% of the 40-odd indicators of growth HSBC tracks—like automobile sales and cement/steel production—have weakened over the last three months.

Indeed, while there seems to be small pickup in investment levels—gross fixed capital formation, as a proportion of GDP, rose from 28.9% in Q3FY18 to 29.5% in Q3F19, and data for Q4 will come later today—FDI levels have fallen for the first time since FY13. Equity flows of FDI in FY19 were \$44.4bn as compared to \$44.9bn in FY18. Reviving GDP growth, it is obvious, depends on how quickly investment levels come back.

Given the twin balance sheet crisis, and the fact that several bargain-basement deals are available at the NCLT for businesses that have money, any serious investment revival will take a few years, but that too will require some concerted effort. The latest results for Power Finance Corporation (PFC) provide a good indication of where the problem lies. While only 9% of PFC's ₹314,667 crore loan book is stressed, over 55% of its ₹53,612 crore loans to the private sector are stressed.

So even if the new government is to spell out a new investment plan—for the entire infrastructure sector, not just power—and say, for instance, that it plans to invest X trillion dollars, and half of this is to come from the private sector, do you think the private sector will rush to invest, if a large part of its current investments are stressed? Indeed, while the RBI's latest financial stability report is yet to be released, last year's report points to the fact that slightly over a fifth of all infrastructure loans are stressed; going by the PFC report, chances are the bulk of this relates to private sector investment.

So, one of the first tasks of the government has to be to find a solution to this problem of stressed investments of the private sector; and to then ensure the solution is actually implemented. This is the area where there is the biggest gap in the government's promise and the reality.

In the roads sector, for instance, it was at an *FE Best Banks* event in Mumbai some years ago that then finance minister Arun Jaitley announced, that the government had a new plan to ensure private sector firms got their money that was stuck with various government departments. Since most of these firms were engaged in arbitration with the government, Jaitley said that if the awards went in their favour, 75% of the money would be released immediately. While several construction firms heaved a sigh of relief, since this would ease their cash flows—and even allow them to repay debt on other projects they were working on—it turned out the celebrations were premature. For one, firms had to give a bank guarantee to get even this money due to them despite the fact that the arbitral award had gone in their favour. In some other cases, the money was released to banks to square the debt on the existing projects while the companies needed the money to be able to carry on operations.

In the case of the power sector, for instance, while 52,000MW of assets are deeply stressed, government-owned state electricity boards (SEBs) owe power generators ₹38,000 crore; that is a 60% increase since a year ago. Apart from this, the SEBs are supposed to pay another ₹17,000 crore that are classified as what are called 'regulatory dues'. So if, say, the government raises the royalty on coal, this should normally be paid for by the SEBs, but since it wasn't, the matter went to the regulator which has ruled the SEBs need to pay this. If the government cannot even ensure its own arms pay their dues of over ₹55,000 crore already, investors are right to feel aggrieved when PSU banks try to take over their assets for non-payment of interest and other dues.

It gets worse. With the Uday scheme not really resulting in the massive SEB turnaround that the first Modi government had envisaged—after the huge initial financial savings that resulted from banks being asked to slash their interest rates—a large part of the investment made has been laid to waste. There are a large number of plants that don't have gas, for instance, and around 20,000 MW have no power purchase agreements (PPAs) since the SEBs are too cash-strapped to want to sign long-term agreements. Then power minister, RK Singh had talked of making 24x7 supply of power mandatory—so, SEBs would have to sign PPAs—but this didn't take off; without PPAs, these investments are pretty much dead in the water. And while, during the UPA period, an automatic mechanism was put in place to ensure PSUs got their dues from SEBs—if they didn't pay, RBI deducted the money from the state's bank account—no such mechanism was put in place for private investors.

It is such issues that plague private sector investments that Modi 2.0 needs to resolve if it wishes to win back the trust of investors; not only does this require the right policy, it needs to be ensured that the intent doesn't get lost in the fine print or due to the fact that the policy is never implemented. Investors care about the safety of their investment, not whether India has moved up five or 10 points on some Doing Business ranking.

Costly SILENCE

The Congress keeping away from TV debates will further erode the faith of the masses in the party

THE CONGRESS PULLING out its spokespersons for a month should have the prime-time banshee-anchors of news channels worried—if they don't have the Congress spokesperson to villainize and use as a punching bag, will they now have to report news? The Congress sympathiser is not the same game as a spokesperson, so what is to become of ratings? But, more than the TV anchors, it should be the Congress leaders who should be worried. After the drubbing the Congress received in the Lok Sabha elections, political watchers expected the party to look at radically reinventing itself. Nobody expected it to spiral further into crisis, with party president Rahul Gandhi bent on stepping down, uncertainty over which satrap becomes the uber-chief and whether others would submit and, most importantly, the future of its governments in three key states looking shaky. At a time when the Congress needed to get its act together and signal resolve and cohesion, it has managed to underscore its internal confusion and chaos. Amidst a leadership crisis, with the spokespersons not being part of the decision-making committees of the party, a self-imposed gag order would seem a good idea. But, this is an unusual time in the Congress's history, and choosing silence at this time isn't a sharp strategy.

The Congress's fear of further miscommunication regarding its leadership crisis is real, but so is the need to signal that it is not disintegrating. The party leadership must remember that, though vastly reduced in strength, it remains the principal opposition party in the Lok Sabha, and to abdicate messaging at this juncture will cause further loss of faith in healthy opposition and increase media speculations—especially on the debates they so want to be away from. The Congress clearly needs restructuring and it has to happen transparently. In a democracy, keeping the fourth estate away is not an option.

INDIA'S NPA CYCLE appears relentless. In 2014, bad loans were confined to the nonfinancial corporate sector. But now, the NPA fire seems spreading to micro, small and medium businesses (MSMEs), even drawing some retail loans into its fold. On the lenders side, if it were mostly banks that were overwhelmed with bad loans some years ago, it is the nonbank segment that is dragged in now. A fresh cycle of toxic assets could further pressure the financial system, which is already under tremendous strain.

Observed patterns in the March quarter results (Q4FY19) of banks indicate fresh slippages in new segments, while a few large borrowers added to the existing corpus. According to FE's report (*"NPA crisis: Why loans to MSME, real state, farmers may go bad"* FE, May 27, 2019), 22 of 33 banks declaring results show a sequential increase in NPAs, with a 58% increase in overall provisioning in one quarter! Although this reflects full provisioning for some large legacy bad assets, it also includes contingency provisions for potential slippages from the stressed nonbank segment (NBFCs) that are apprehended. At end-September 2018, 52% of NBFCs' total (non-food) advances were to industry, of which 8% went to MSMEs; 22% of this went to retail loans.

What were MSME and retail asset qualities like in 2018? RBI's *Financial Stability Report* (FSR, December 2018) and *Report on Trends and Progress in Banking in India* (RTPBI, 2018) shed light on this for FY18 and H1:FY19, i.e. up to September 2018. RTPBI (para IV.46, Chart IV.18b) reports deterioration in MSME asset quality across banks and NBFCs in H1:FY19 as gross NPAs (GNPA) increased; the increase was smaller for micro and small industries. GNPA ratio deteriorated to 6.1% for NBFCs in quarter-ended September 2018 (March- 5.8%); the proportion of sub-standard assets rose sharply to 4.8% in six months (March 2018-3.3%) with downgrading of some standard assets (para VI.26, Chart V.1.12).

A better picture of MSME credit quality across financial intermediaries

● BAD LOANS

RECENT DEVELOPMENTS AND DATA INDICATE TOXIC ASSETS RISING IN SMALLER SEGMENTS AS WELL

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Views are personal

is provided by RBI's FSR, December 2018. Observed from TransUnion CIBIL database, this is more granular than supervisory returns because it "...considers an entity's total credit exposure and classifies impaired status based on performance of related accounts...following the 90 days past due norms for impairment across institutions"(Section IV, para 2.5, FSR).

MSME credits, with much larger default transition probability, already embedded a significant default risk in the outstanding portfolio across financial intermediaries, as per March 2018 ratings—public sector banks trailed the rest in both "inherent and realised credit risk". One-fifth of MSME exposure of NBFCs and public sector banks was in the riskiest ratings segment (CMR 7-10). NPAs as percent of relative exposure (loan size ₹10-50 million) increased to 8.7% in H1:FY19 (8.4% in March) for micros; for SMEs, the increase was larger (11.5% from 11.1%). When compared to March 2016—corresponding numbers then were 7.9% and 9.8% respectively for micro and SMEs—the rise is sharper (Para 2.52, FSR). For banks, the NPA rate jumped to 15.2% within a quarter to June 2018 (14.4% in March), remaining static for NBFCs. About 62% and 60% of public and old, private banks' respective exposure to the high-risk, MSME segment is plain working capital and term loan structures; the RBI notes it has previously underlined working capital frauds in public sector banks in general. Against this, 80% of NBFCs exposures (14% acquisition in this segment) are mostly asset-backed loans (e.g. commercial vehicles/equipment and/or auto, gold and mortgage loans).

The distinction between PCA and non-PCA public sector banks on MSME exposure quality (below ₹50 million) is interesting; incremental

exposure of PCA-PSBs rose 166% in one year to FY18 (FY17 - ₹226.8 billion); the RBI warns this "...sharp increase may require examination of possible dilution of credit standards further and additions to supervisory strategy for PCA banks" (FSR, para 2.57). Finally, it is slippages of fresh acquisitions within one financial year that is concerning: for PCA-PSBs, such slippages increased to 4.7% by March 2017 from 2.6% in March 2016; corresponding increase for non-PCA PSBs was as sharp to 1.2% from 0.7%. In March 2018, fresh MSME loans and renewals by PCA-PSBs increased to 2% from 1.4% in March 2017, while similar increase was 2.2 times to 1.25% for other PSBs.

A 2% impairment rate for freshly sanctioned portfolio points to an aggravating situation in MSME loans. Since then, the eruption of the NBFC crisis pushed up funding costs while demand slowed in H2:FY19. That points to increased likelihood of further deterioration in MSME asset quality. For example, MUDRA loans extended under PMMY by banks, NBFCs, MLIs, etc. and grew very rapidly, are reported as a big source—bad loans under MUDRA were reported risen 92% in one year to FY18, followed by 53% surge in the first three quarters of FY19. The RBI was also reported to have expressed its concern to the ministry of finance in this regard in January 2019. Recent reports of a universal debt relief scheme planned for small borrowers (micro enterprises, small farmers, other individuals) may also point to aggravating NPA stress.

How about retail loans? These have been driven mostly by housing and

auto loans, and credit card receivables, grown very fast and supported by government incentives, e.g. Pradhan Mantri Awas Yojana (PMAY), Real Estate (Regulation and Development) Act (RERA), and rationalisation of risk weights and provisioning on standard assets in housing loans of specific individual categories in June 2017. Has the debt stress spread towards the household sector?

The RTPBI reports retail loan defaults at banks remained at a low level; that in agriculture loans worsened as on September 2018. However, RBI's FSR (para 2.12) shows some deterioration in retail asset quality (and agriculture) between September and March 2018 with annualised slippage ratio higher at 2.3% from 2.2% (Chart 2.3a, FSR, December 2018).

What about the quality of NBFCs' retail loan portfolio? 65% of their retail loans are distributed across vehicles (44%) and other loans (21%). A disaggregate profile of retail portfolio of NBFCs is unavailable. But the aggregate asset

quality deterioration and downgraded assets of NBFCs in September 2018 (above) may be an indicator, as might be worsened asset quality of loan companies (these mainly extend loan finance) in H1:FY19. The increase in gross and net NPAs at NBFCs is 2.2 and 2.7 times compared to four years ago (March 2014, FSR, para VI.26, Chart V.1.11). The rapid loan growth at NBFCs is well known. Gross and net NPA ratios of housing finance companies (HFCs), which too grew loan books extraordinarily fast, are rising from FY18 up to by September 2018.

Overall, there are signs the NPA fire may be spreading. Incomes have decelerated since last year; debt-servicing has become costlier. That impacts both MSMEs and individual borrowers, loans to which grew remarkably fast these last few years. Policymakers need to be particularly watchful about this spread as it also shows that indebtedness in the economy is extending beyond large businesses.

LETTERS TO THE EDITOR

On Arun Jaitley's cabinet departure

It is unfortunate that Arun Jaitley, one of the few talented ministers of Modi's outgoing cabinet has called it quits on health grounds. Jaitley had been a gifted troubleshooter to the BJP government, and he was the only person whom Modi trusted most to defend him and his different ministries whenever the opposition raised stinking queries over their functioning. His defence of the draconian demonetisation, GST conundrum and even the murky Rafale deal went a long way to save the face of all concerned particularly Mr Modi. Even when the inexperienced Nirmla Sitharaman faltered to counter the opposition parties' accusations of corruption in the Rafale deal, the role played by Jaitley to place those serious allegations under the carpet was enormous. Though he was not a party to many financial decisions taken by his high commands, resulting in chaos and confusion, Jaitley fought as a true soldier to defend the crown of its folly and save them from ignominy. It is a tragedy that at a time when the services of Jaitley are required most by the new government to set right their past blunders in finance and economic development, he has decided to call it a day. Hope wisdom will prevail on the Prime Minister to appoint someone with a financial background to succeed Jaitley. All lawyers cannot become successful finance heads like Jaitley. However, talent is available from outside as well. — Tharcius S Fernando, Chennai

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Stop blaming the Trade War

Latest demon is the prospect of a recession, which was said to be responsible for sliding stocks. The culprit? You guessed it: the trade war

THE TUSSLE BETWEEN the U.S. and China is being blamed for all manner of economic and financial developments. Some of these are only vaguely related to the tariff spat, or they reflect trends underway before U.S. President Donald Trump ever heard of his Chinese counterpart Xi Jinping. In other areas, like monetary policy, the conflict alters timing, not outcomes.

The latest demon is the prospect of a recession, which was said to be responsible for sliding stocks and diving bond yields Wednesday. The culprit? You guessed it: the trade war. But handicapping a recession has been a favourite game of market commentary every few months for the past two years. America's expansion is almost 10 years old; it's long in the tooth, tariffs or not.

China's economy was already in a long-term slowdown, exacerbated by a crackdown on debt that's been driven by domestic policy choices, not the White House. The country is shifting to an economic model less dependent on exports and cheap low-end manufacturing. By 2016, incomes in China had already reached the level where Japan, South Korea and Taiwan started shifting production abroad decades earlier, according to an International Monetary Fund report. The general vibe at the 31st Singapore Economic Roundtable this week was that discord between Washington and Beijing was amplifying existing phenomena or

underscoring transformations already in train. Rarely was the clash seen as the sole catalyst. (My *Bloomberg Opinion* colleague Tim Culpán recently argued that some firms are using tariffs as a long-sought excuse to reduce their China footprint.)

One place that's shown some trade-war PR wizardry is Vietnam. The country continues to get buzz as the next great U.S. trading partner, having been declared at least a relative winner from the tariff conflict. Exports to the U.S. have increased, but it's hard to determine how much of this reflects the vibrancy of the American economy and how much the ballyhooed upending of the supply chain.

I'm skeptical that many manufacturing operations have shifted outright from China. More likely, as one former Western diplomat in Asia related to me, Vietnamese factories will get extra shifts and possibly some additional capacity. Shutting plants in China and moving all that stuff to Vietnam, purely in response to tariffs, is a big call. To the extent that anyone is doing that, few want to talk about it. Beijing's enmity isn't worth it.

In the arena of central banking, the erosion of investor confidence and risk-off mentality may delay some decisions

to cut interest rates. It won't thwart reductions indefinitely. The same trend toward too-low inflation that preoccupies Western thinking is present in Asia. Two countries where cheaper money looks like a given are South Korea and Indonesia.

In the former, whose economy shrank last quarter and which shows zero upward price pressures, rates should have been cut already. A tumble in the won makes the Bank of Korea more hesitant to proceed, but it's sure to do so before year end. The country's slowdown is too steep to credibly argue otherwise.

Indonesian policy makers have walked back their hawkish language, after following the Federal Reserve higher in 2018. The one hurdle in Bank Indonesia's way is its commitment to stability. In reality, the central bank means the current-account deficit is too great to risk a run on the currency. Officials aren't saying there will be no cuts. The stance has evolved to "cautiously neutral." Most economists see reductions before year-end.

Not even tariffs will prevent that rendezvous with reality.

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DANIEL MOSS

Bloomberg

The general vibe at the 31st Singapore Economic Roundtable this week was that discord between Washington and Beijing was amplifying existing phenomena

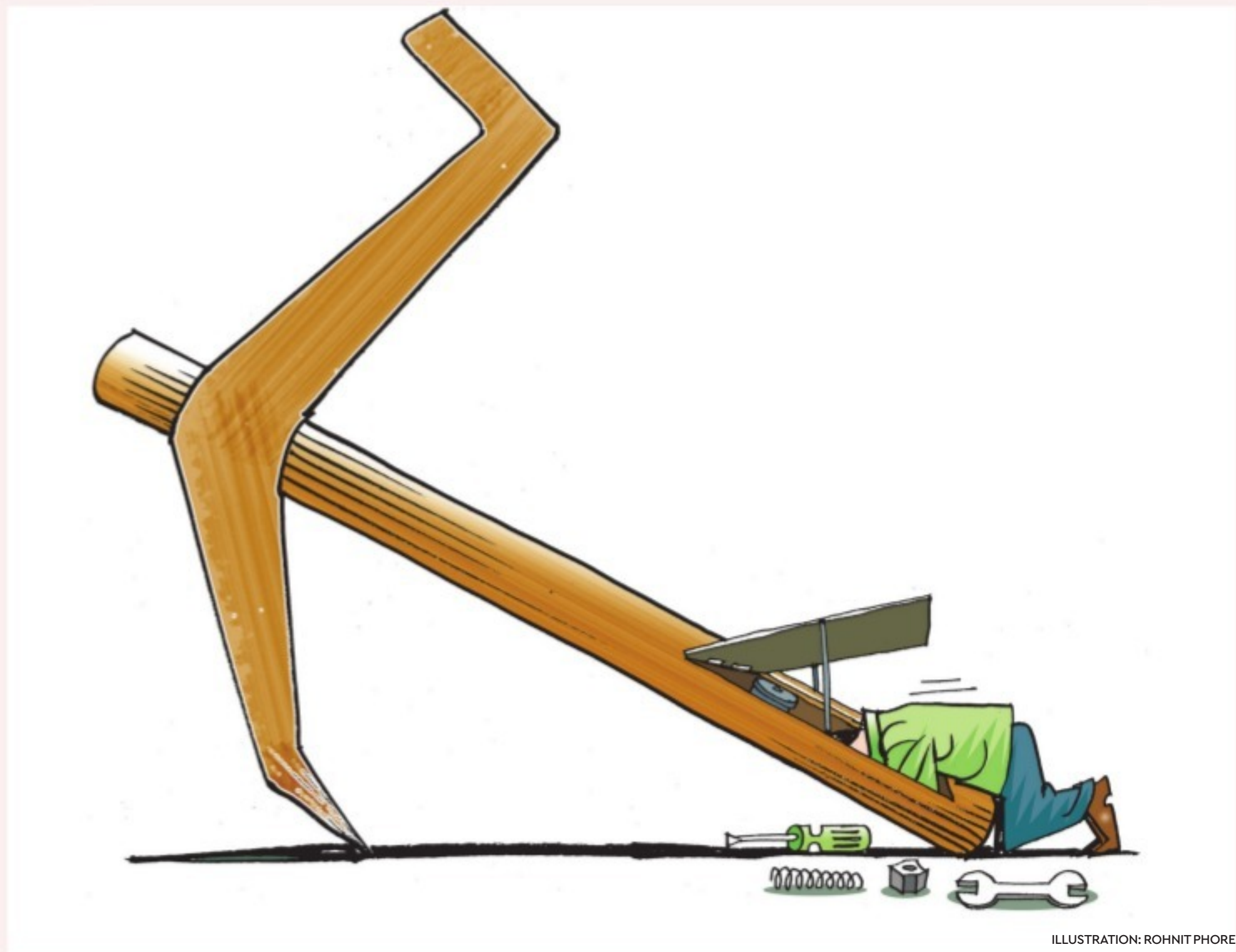


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Indian agriculture calls for big bang reforms

We have to modernise the sector, develop agricultural markets, promote exports of agricultural and processed commodities, consolidate small and marginal farmers, and expand the scope and amount of PM-KISAN

THE NEW NDA GOVERNMENT at the Centre is set to develop its governance agenda for the next five years. During the last five years, the agriculture sector and farmers were at the centre stage. In fact, in the just-concluded general elections, all the political parties raised issues on farmers' conditions and agrarian distress. However, none was able to provide a long-term remedy to overcome the plight of the farming community. At the same time, much was done during the last five years by the NDA-2 government to improve the condition of the agriculture sector and raise farmers' incomes. These steps included programmes and schemes to increase agricultural production, improve sustainability and resilience,

and raise farmers' incomes. The agriculture sector must receive high priority as it contributes to the national food security and provides employment opportunities to more than half of the country's population. One must also keep in mind that incomes in the agriculture sector must increase for the overall growth of the economy, as this increased income creates demand for industrial and services sectors.

Despite the substantially increased investment in agriculture and the launch of several new programmes, there has been a general feeling of farmer distress across the country. The question one must ask is: When and where did things go wrong? It appears that agriculture is excessively supported by the government, and almost everything in this sec-

tor is controlled by the government. For example: (1) growing subsidies in production (fertiliser, power, irrigation, machines, seeds, credit); (2) raising minimum support prices; and (3) increasing farmers' allocation to new schemes such as soil health cards, agricultural insurance, National Food Security Mission, agricultural insurance, etc.

In addition, several research studies reveal that (1) agricultural subsidies are overcrowding investments; (2) incentives continue to traditional crops and production systems (rice and wheat); and (3) there are no incentives to demand-driven agricultural commodities.

The fact is that farmers are not given incentives to produce efficiently, compete in the global markets, and carry out agriculture as agribusiness. Unless the agriculture sector is liberalised and the government control is minimised, it will continue to suffer. The new government may consider the following to improve the agriculture sector and subsequently farmers' welfare:

■ First, modernise the sector: Globally, the next 20 years will witness a remarkable change in agriculture and agricultural practices. The focus will be on increasing production from a declining resource base, especially land and water. Labour will be replaced by machines and drones. Therefore, Indian agriculture must keep pace with the changing scenario and respond to the dwindling resource base, unfolding demand for agricultural commodities at national and global level, and the rising climate change threats.

Modern technologies need to be promoted to make agriculture more efficient, competitive, sustainable, resilient and environment friendly. This will require investment in agricultural research, and in developing linkages between research and industry and service centres for disseminating modern technologies. Equally important is to reform the agricultural research system with more decentralisation to undertake target-oriented research.

■ Second, develop agricultural markets: Volatile prices of agricultural commodities are a major source of agrarian distress. Prices steeply fall immediately after a crop harvest, when a majority of farmers sell their produce. However, consumers continue to pay higher prices. It means that (1) consumers are ready to

pay higher prices, and (2) demand is there to absorb prices. The huge margins between what farmers receive and what consumers pay is due to inefficient, unorganised and fragmented markets of agricultural commodities. Despite the rising agricultural production of almost all commodities, appropriate markets have not been developed at the same pace. In the past, excessive efforts have been made to increase agricultural production (which is good), but without giving due attention to developing new markets. Therefore, developing and liberalising markets should receive high priority as the volume of produce from different parts of the country has increased manifold. The government should gradually withdraw in fixing agricultural prices and their procurement. Instead, the organised private sector must be attracted to develop agricultural markets—let the market decide prices and the government may compensate farmers in case there is a steep fall in prices of key agricultural commodities.

■ Third, promote exports of agricultural and processed commodities: Indian agriculture has already achieved food self-sufficiency, and now it needs to leapfrog from the food security syndrome to market-oriented agriculture. This will require a stable and proactive trade policy. Exports of many agricultural commodities are increasing, but imports are rising faster than exports. India has a huge potential to export several of its agricultural commodities to Africa, Central Asia, South East Asia and West Asia, besides to its neighbouring countries in South Asia. India can take advantage of the ongoing trade war between China and the US to develop its own market. It requires identification of niche commodities to different markets depending upon their taste, preferences and requirements. However, success will depend upon how quality and food safety issues are ensured.

■ Fourth, consolidate small and marginal farmers: Indian agriculture is dominated by small and marginal farmers—more than 86% holdings have land less than two hectares. This group has tiny marketable surplus; they have high transaction costs and low bargaining power. Small and marginal farmers and their produce may be consolidated through (1) incentives to form farmer producer organisations, self-help groups and/or cooperatives; (2) promote contract farming and develop vertical integration; and (3) incentivise states to implement the already developed model land lease Act. There is a misperception that (2) and (3) will lead to corporate farming. What is

wrong if corporate sector brings in new technologies, best practices, more investment, and gives higher returns to farmers? Care may be taken that the corporate sector does not exploit farmers.

■ Fifth, expand the scope and amount of PM-KISAN: In this year's Interim Budget, the government announced an income support scheme to the farmers, called the Pradhan Mantri Kisan Samman Nidhi Yojana (PM-KISAN). Farmers must be supported as a majority of them are small and marginal. It is proposed that the amount of Rs 6,000 per farmer is increased. This can be done by ceasing many of the old and existing schemes that are not making any impact on farmers' welfare and have become redundant with time.

The success of agriculture reforms will depend on a strong political will. The new government may consider constituting an Agricultural Council on the pattern of GST Council for having consensus on issues related to model market Act, model land lease Act, subsidies, investment and strengthening agricultural research and extension.

It is also an opportune time that a new agricultural policy may be drafted to prepare a medium- and long-term roadmap for various reforms in the agriculture sector.

The success of agriculture reforms will depend on a strong political will. The new government may consider constituting an Agricultural Council on the pattern of GST Council for having

The future of retail banking

SUBHASISH ROY

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Banks need to develop more mobile-based applications for retail banking operations

ON ACCOUNT OF ECONOMIC slowdown and policy-level issues, the growth of credit to the corporate sector has declined, whereas credit growth in the retail sector has gone up. As per latest data, credit growth to industry was 4.4% in December 2018; in the same period, credit growth to retail was 17%. It seems the economic slowdown that has affected corporate credit may not hit retail credit. Indian households have borrowed more since the last few years to fund their property, vehicle and credit card purchases. Retail credit, which has shown significant growth in the recent past, is expected to show steady moderate growth. As per CRISIL, the retail segment is expected to grow by 19% in FY20, led by strong consumer demand and higher penetration by banks. Sectors that will drive growth are housing and consumer durables.

A reason for higher growth in retail credit is that delinquency level in retail is low as compared to corporate. This is because in retail the ticket size is very small, and risk is distributed among a large number of borrowers in retail lending. While many banks have shifted their strategy towards retail lending, still a large number of people are out of reach of retail finance. Major challenges for banks are (1) retention of existing customers and (2) acquiring new customers in a cost-effective way. As per a study in the Harvard Business Review, a 5% increase in customer retention can increase profitability by 35% in banking business.

To address these challenges, technology has to play a greater role. Today, a large number of customers prefer digital modes of transaction rather than branch banking. The future of retail banking, therefore, lies in innovative financial technology. Here, new-generation private and foreign banks appear to have taken the lead. Other banks, too, need to move from branch banking to digital banking, and need to launch more digital applications rather than open new branches. This will not only reduce operational costs, but also help banks reach the target customers in a faster and convenient manner.

Going forward, the major demand for retail transactions, including loan products, cash management, wealth management, insurance services, etc., in both urban and metro areas, will mainly come from younger customers. A recent survey revealed that among all modes of banking channels, the new generation prefers smartphones the most. Thus, in order to succeed, banks need to develop more mobile-based applications for various retail banking operations. In addition, artificial intelligence and big data analytics will play a crucial role towards determining the success of retail banking in the future. To capitalise on this area, banks first need to develop a big data warehouse where they capture potential customers' various transaction patterns. Then, based on this data, they have to select their target customer. After customer selection, banks need to develop software applications based on AI and robotics, which can be useful for performing complex tasks relating to transactions such as small value loans, appraisal, KYC-related issues, loan monitoring, etc. Considering that most traditional banks lack expertise in this area, they can collaborate with fintech firms, utilising the latter's innovative ideas and technologies. Such a step can provide a competitive edge to banks to deliver their retail banking products and services through new digital platforms.

While digital banking has its benefits, there are also risks involved, such as cyberfraud and IT-related risks. Banks, thus, need to develop robust risk management tools and techniques. Further, overdependence on innovative technologies may lead to systemic risks across the financial sector, which may affect overall financial stability. To address this issue, we perhaps need a separate regulatory framework and strengthened governance, to ensure integrity of data, algorithms and the stability of the financial system.

Many traditional banks still lack expertise in digital field, and they can collaborate with fintech firms, utilising the latter's innovative tech

TURKEY

THE GLOBALECONOMYIS grappling with risks like trade war, volatile crude oil prices, Brexit, to name a few. Another crisis situation that has been brewing for the last one year is the economic and political turmoil in Turkey, which faced a currency crisis in mid-2018. In a span of a fortnight, the Turkish lira depreciated sharply by 40%. The crisis spread over to other emerging market currencies and stocks. Adverse investor sentiment led to large sell-off from emerging markets. Capital inflows into EM economies fell to \$2.2 billion in August 2018 from \$13.7 billion in July 2018. Currencies like Argentinian peso and South African rand fell by 10% each, while the weakening in the rupee was relatively less in the period under review. The MSCI Emerging Market equity index also fell by 5%, triggered by the Turkish currency crisis.

Cut to May 2019, Turkey witnessed another sharp depreciation of the lira. The currency fell to a 7-month low of 6.2 to a dollar, weakening by over 15% since the beginning of the year. Investor sentiment for the Turkish economy is weak and there is social and political instability. So, what are the lingering risks affecting the Turkish economy?

For more than a decade, Turkey enjoyed the availability of cheap credit and foreign capital that fuelled high economic growth. GDP grew by an average of 5% in the last five years. This led to debt level in the economy

Is another global crisis brewing?

Aggravation of Turkey crisis could impact investor sentiment in EMs

RUTUJA MORANKAR & RAJANI SINHA

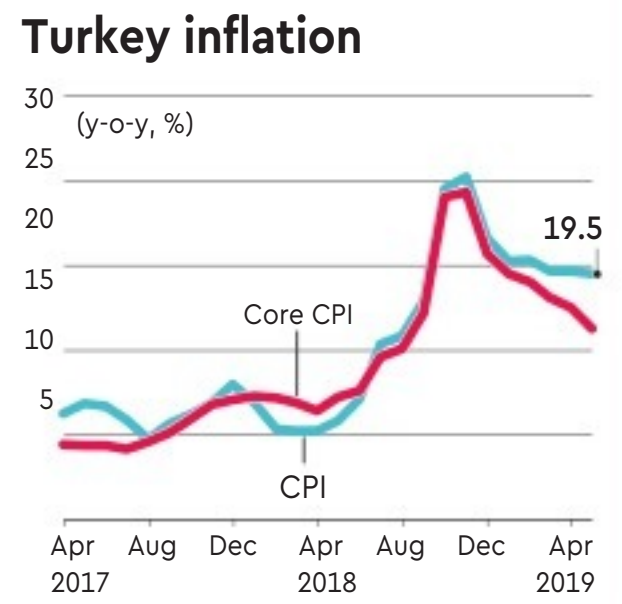
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accelerating. Turkey has an external debt-to-GDP ratio of 53.5%. More worrisome is the short-term debt of \$177 billion, which is maturing in the next 12 months. While debt levels are high, Turkey's forex reserves have been dwindling. Forex reserves at \$60 billion are not enough to support currency in case of further deepening of crisis. The country has forex reserves to short-term debt ratio of 30%, which is quite low. The IMF advises this ratio to be maintained at 100%.

Sharp weakening of the currency as investor sentiments dwindle is pushing up dollar-denominated debt burden. This is adding to the stress on the indebted corporate sector, resulting in rising levels of banks'

non-performing loans. Sharp weakening of the currency has also resulted in higher import prices and double-digit inflation in the economy. Inflation is currently hovering around 20%. In response to rising inflation, the Central Bank (TCMB) tightened the key policy rate to 24% in September 2018 from 8% in May 2018. This has increased borrowing costs sharply, dampening growth.

Turkey entered into recession in Q4CY18 following two consecutive quarters of negative GDP growth. According to the IMF, Turkey will record negative growth of 2.4% on an annual basis in 2019. On the labour market side, the unemployment rate has risen to the highest since 2009, at



14.7%. This raises concerns that it may no longer have sufficient firepower to defend the lira in case of another sharp depreciation.

The US and Turkey are at loggerheads over their Syria policy. Last year, the US-Turkey relationship particularly soured over the detention of a US pastor by Turkey. The US responded by doubling tariffs on imports of steel and aluminium from Turkey. In March 2019, the US announced the removal of the Generalized System of Preferences (GSP) status of Turkey, which could adversely impact exports from Turkey. More recently, Turkey's plan to purchase the Russian missile defence system has miffed the US (as the US claims it to be non-compatible with the

NATO). The US is considering imposing sanctions on Turkey. The US-Turkey relationship will be crucial and an escalation of tensions is likely to weigh on the lira.

The Erdogan government, on the other hand, won a second term in the general elections held last year. However, it recently lost the mayoral election for Istanbul. The decision by the election commission to nullify Istanbul municipal elections and go for re-election in June led to mass protests and social unrest. Investors showed reduced faith in democratic institutions. President Erdogan's party had also lost mayoral election in Ankara and some cities in south Turkey earlier during the year, which high-

lights reducing support for his government. The market is anticipating policy instability and conflict, domestically and in foreign affairs, which could dampen the economy and result in flight of capital.

In an attempt to stabilise the economy, the Turkish finance ministry announced reforms over the next 4-5 years. These include agricultural policy to keep food prices in check. The government is also infusing \$5 bn to recapitalise state banks and taking off some bad loans from the balance sheet of banks. Two special funds are to be created to manage high debts in energy and construction sectors. Bad assets would be reduced through debt-to-equity swaps. There are plans to boost tourism, exports and improve judiciary regulations. Some reforms on pensions and taxes to improve consumption are under way. But these measures have failed to enthrone the investor.

To conclude, high debt is a big risk for Turkey, with low forex reserves and weakening currency. This could lead to downgrade of Turkey's sovereign rating (which is currently B+ stable, four notches below investment grade). Debt default by Turkey would impact European banks, especially Spanish and Italian, due to a high exposure to Turkey debt. Further aggravation of the Turkey crisis could impact the investor sentiment for the EM basket. Resulting capital outflows would severely impact Brazil, South Africa, Argentina and, to some extent, India.