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Will roads and banks stimulus revive the economy?

While both are necessary, they are not silver bullets—issues such as resource mobilization for road building and future flow of toxic assets must be addressed

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The slowdown in the economy has led to a fierce debate in the public domain. For some time, the government was in denial mode. However, amid mounting concerns, the Union ministry of finance seems to have recognized that there is a problem. At a press conference in late October, it announced a package of Rs9 trillion, made up of government investment in roads and recapitalization of public sector banks—the largest so far, even if some of it is old wine in new bottles—to revive economic growth.

The essential underlying factor, it should come as no surprise, is politics. There are assembly elections in Gujarat, Himachal Pradesh, Karnataka, Rajasthan, Madhya Pradesh and Chhattisgarh in a 12-month period, followed by the national election, due by April-May 2019. The performance of the economy in the interim will be critical in shaping outcomes.

The government has announced a new umbrella road building programme over the next five years with an expenditure of Rs6.92 trillion for 84,000km of roads. In this, Bharatmala Pariyojana will have an outlay of Rs5.35 trillion for 35,000km of roads to generate 142 million man-days of employment. The remaining 49,000km of roads will be under other current schemes with an expenditure of Rs1.57 trillion. The sources of financing Bharatmala are: Rs2.19 trillion provided by the government from accruals to the Central Road Fund, Rs2.09 trillion raised as debt from the market, and Rs1.07 trillion through private investment in public-private-partnerships. The sources of financing the roads under other schemes are: Rs0.98 trillion from the Central Road Fund and Rs0.59 trillion as budgetary support. Thus, the average annual outlay is projected at Rs1.07 trillion for Bharatmala and Rs0.33 trillion for other roads. It is not clear how much of this is a net addition as a large provision has already been made for roads in the Union budget for 2017-18.

This is, in effect, the equivalent of a fiscal stimulus to build physical infrastructure, which is both necessary and desirable. Building roads would ease supply constraints, provide much-needed connectivity, create employment opportunities, and stimulate growth in the economy through multiplier effects on the demand side. But there is nothing automatic about the process of implementation. Resource mobilization on the scale required may not turn out to be feasible. The utilization of available resources is by no means assured. The gestation lags to completion could be long. Thus, the benefits to the economy might not kick in for some time.

The government has also announced a recapitalization of public sector banks (PSBs) by Rs2.11 trillion over the next two years. This sum is more than one-third the tier I or core capital (equity plus reserves) of PSBs and the equivalent of about 1.25% of gross domestic product (GDP). It is not the first time this has been done in India. There was a recapitalization of PSBs in 1993/94-1994/95 (Rs11,300 crore) and during 2010/11-2013/14 (Rs67,700 crore). The Indradhanush plan announced in August 2015, to be implemented over four years from 2016-2019, pledged Rs70,000 crore of budget support and stipulated that PSBs raise Rs1.1 trillion from the market through equity. The latest package has three components: the government would provide Rs18,000 crore from the budget (since Rs52,000 crore has already been infused under Indradhanush); PSBs would raise Rs58,000 crore from the market through equity (only Rs21,000 crore has been raised so far under Indradhanush), which should not be a problem as the market value of PSB shares rose by Rs1.2 trillion in just one day after the announcement; and the balance of Rs1.35 trillion is to be pumped in though recapitalization bonds.

There is no precise information, yet, about the proposed recapitalization bonds, so it is not possible to answer the most basic questions: Who will issue the bonds? What will be the period of maturity? What will be the interest rate payable? Will these bonds be marketable or non-marketable? How will these bonds be distributed among PSBs? These details will be announced in the next quarter.

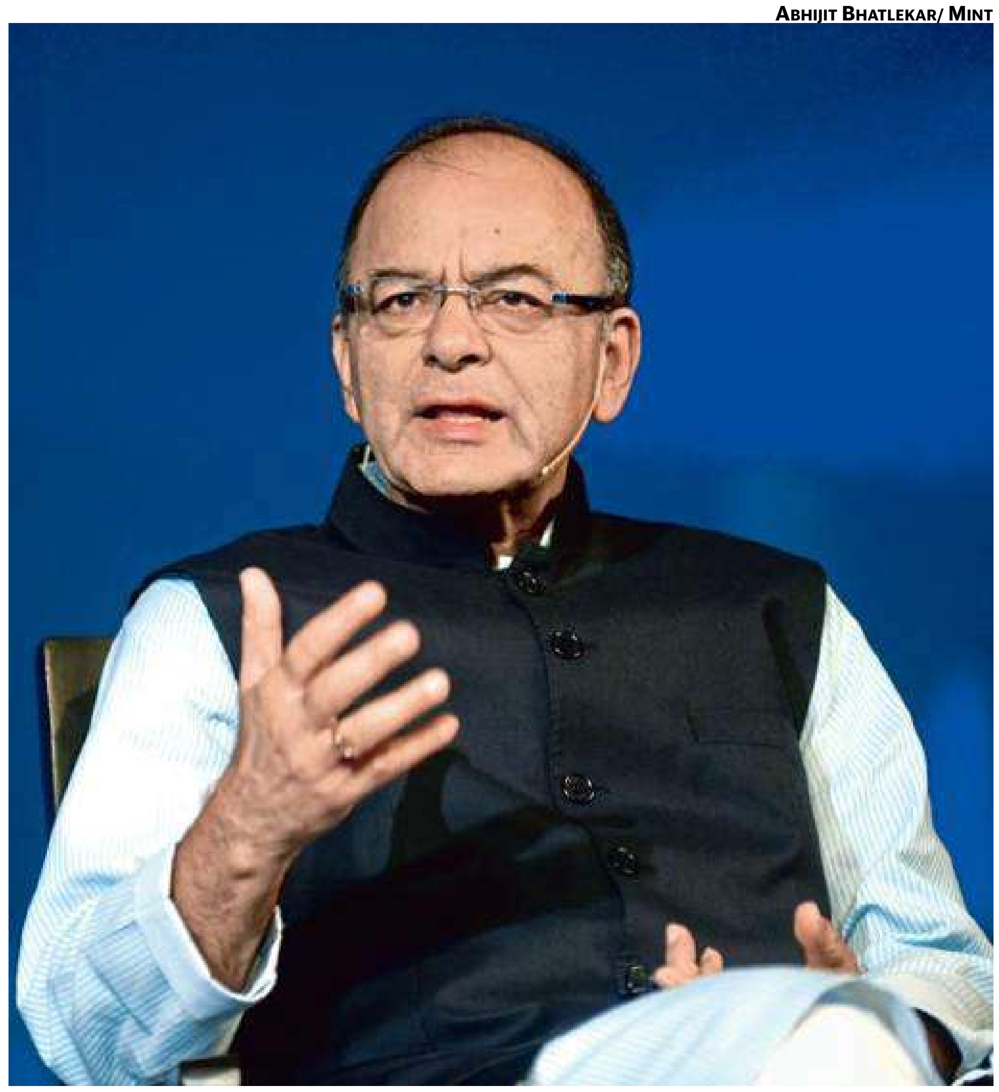
However, the basic modus operandi of such recapitalization bonds is simple. The government, or its designated entity, will issue the bonds. PSBs, flush with cash deposits after demonetization far in excess of their normal deposits, will buy these bonds that would be interest-earning assets for them. The government will use the money so raised to buy shares of PSBs. There will be no cash outflow from the exchequer except for the interest payable on these bonds.

The rationale runs as follows. The infusion of equity capital into PSBs will help these banks to provision for their non-performing assets (NPAs), where borrowers have defaulted on interest or amortization payments that are due, which would eliminate toxic assets and clean up their balance sheets. This should make available capital for growth and revive lending. There is also an implicit hope that such recapitalization would resolve the twin-balance sheet problem (PSBs with bad loans and over-leveraged companies with large unserviceable debts) that the economy is saddled with, at one stroke.

In effect, this bail out for PSBs is driven by two factors. The first is regulatory compulsion, as the tier I or core capital of banks (equity plus reserves) must conform to global standards embodied in Basel III norms by April 2019. The second is economic necessity, as provisioning for NPAs constrains the lending ability of banks, or violates capital adequacy norms, while credit is the lifeblood of a market economy. Thus, the recapitalization decision is a necessity—regulatory and economic—rather than virtue. In terms of the political narrative, however, with elections on the horizon, it is portrayed as a bold decision to revive economic growth.

The situation is not just serious—it is alarming. The latest Financial Stability Report of the Reserve Bank of India (RBI) shows that for PSBs, gross NPAs as a proportion of total assets were 11.4% in March 2017 and would rise to 14.2% in March 2018, as compared with 9.6% and 10.2%, respectively, for all banks. The share of PSBs in total gross NPAs is around three-fourths, so private banks have a similar problem though not as bad. There has been a sharp deterioration in the past five years. For PSBs, net NPAs as a proportion of net worth (equity plus reserves) have jumped from 18% in March 2012 to 76% in June 2017. This proportion is less than 40% in just two PSBs. It is a legacy problem that has compounded over time.

ABHIJIT BHATLEKAR/ MINT



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In absolute terms, gross NPAs of PSBs rose by Rs4.33 trillion from 5.4% (Rs2.78 trillion) in March 2015 to 13.7% (Rs7.33 trillion) in June 2017. This increase was partly a consequence of the far more rigorous asset quality review by RBI. But, over this period, provisioning also rose by Rs3.79 trillion (compared with Rs1.97 trillion in the preceding 10 years). Thus, in principle, a recapitalization of Rs2.11 trillion should suffice.

How will recapitalization bonds affect the fiscal situation? These would not add to the fiscal deficit according to International Monetary Fund norms because government borrowing is offset by buying shares in PSBs. This is just accounting. In real terms, it will add to the overall public sector deficit. The fiscal cost will be the interest payable on these bonds which should be in the range of Rs8,000-9,000 crore per annum. If the return on equity of PSBs (dividends) so acquired by the government is higher than the interest paid, there would be a fiscal benefit. If not, there would be a fiscal strain.

It is not obvious that there would be a commensurate increase in the supply of credit. For one, there will be a time lag, since the details will be announced in the next quarter, while the recapitalization will happen in 2018-19. For another, whether the provisioning creates space for lending depends on the allocation of capital between PSBs. The finance minister says discretion will be used in allocation, but it will need to be discrimination in allocation, based on the past record and future performance of PSBs, rewarding performers and penalizing non-performers.

Even if there is an increase in the supply of credit, recapitalization cannot ensure demand for credit. The demand for credit in the economy is sluggish because investment levels are low, investor confidence is weak, and interest rates are high. This is reflected in the excess statutory liquidity ratio funds with PSBs.

The only certain outcome is that recapitalization will help reduce, and depending on allocation perhaps help eliminate, stocks of toxic assets held by PSBs. However, it can do nothing to stem the flow of toxic assets if the practice of bad loans continues. Indeed, the problem will recur unless there are some fundamental changes. Behest lending prompted by the government must stop. Inept lending and corrupt practices by banks must stop. Governance problems in PSBs, often compounded through flawed appointments of independent directors by the government as a form of patronage for supporters or cronies, must be addressed. PSBs must begin to exercise due diligence in their lending operations. The regulatory failure of RBI, manifest in the current situation where private banks also have serious NPA problems, must be corrected. But old habits die hard. It will take some doing.

Thus, the recapitalization of PSBs by itself, while essential, cannot suffice to revive the economy in time for any electoral dividend. It also carries two dangers. First, any such bail out of banks to eliminate toxic assets from their balance sheets represents what economists describe as "moral hazard", because neither the negligent banker nor the defaulting borrower pays any price for their sins and might therefore repeat their errant behaviour. Second, the burden of costs imposed by such bail outs represents what the financial sector describes as a "haircut", which is seldom borne by the negligent banker or the defaulting borrower, so that it is taxpayers and citizens who take the haircut and pay the price.

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