



After Rate Cuts, How Will the RBI Tackle the Uncomfortable Issue of a Bad Bank?

By [T.K. Jayaraman](#) on [13/02/2017](#)

Both the former and current RBI governors are surely acquainted with the Gujarati saying “*kona baapni diwali*”. This cannot be the Centre’s stance when it comes to solving India’s NPA crisis.



The latest monetary policy [decision](#) by Reserve Bank of India (RBI) announced on Feb 8 was highly acclaimed despite initial disappointment from the markets, which wanted a cut by 25 basis points (bps). The central bank's monetary policy committee (MPC) decided unanimously to stick to the policy rate of interest, which stands unchanged at 6.25%.

It is acclaimed because of its continued assertive pose of independence, displayed earlier on December 8, 2016, when it decided to hold on to the 6.25% rate. The decision not to give in to government wishes was indeed a tough decision in the wake of the "tsunami of demonetisation" of November 8, 2016.

The RBI continues to believe that tinkering with the interest rate change will not help changing the course at this stage.

End of the cycle of cutting

The MPC's decision last week is justified by the RBI on the grounds of continuing "uncertain transitory effects of demonetisation" on various factors including impact on price level and the output gap. Specifically, reference was made to upside risks to inflation, such as rising crude prices and exchange rate volatility. Further, the MPC statement indicated a shift in the stance: from "accommodative" to "neutral".

That ends the cycle of cuts, pouring cold water on market expectations. The cycle which began in January 2015 with cuts in steps from 8%, totalling in all 175 bps over the period until October 2016 to 6.25%, and unchanged twice, during last two months is now over.

One cannot expect another cut, as part of a cycle of cuts. The upcoming April MPC decision will be based on a fresh assessment of the situation, which will be a product of domestic and international factors.

The disappointment is not only from the markets, but also from government. The Economic Survey released on January 31 just a day before the budget presented on February 1, dropped gentle "hints" to RBI. It noted inflation according to past trends was benign; and private investment was falling; credit growth was poor; and the budget deficit as percent of GDP has come down from the past high of 4.9% in 2012-13 to 3.9% in 2015-16 and 3.5% in 2016-17 and to 3.2% in the new budget.

It was clear the government wanted an easy money policy from RBI. The RBI answer last week was a firm "No!". So far, so good.

Real test before RBI

The biggest test for RBI is coming up: recapitalisation of banks. With the departure of the former governor Raghuram Rajan, the government would be bringing up the issue afresh.

Non-performing loans are growing. As a proportion of gross advances by banks, it doubled to nearly 9% in June 2016 from 4.6% in March 2015 to June and now the latest news is it has

reached 12%, as revealed by the Economic Survey of January 2017. The Indian Overseas Bank, a leading public sector bank headquartered at Chennai [holds the record](#) with its bad loans at 20% of its total advances.

The Economic Survey suggests setting up a centralised agency, called Public Sector Asset Rehabilitation Agency to absorb the bad debts, to be funded by government bonds and equity contribution from the private sector. The government cannot spare its own limited resources and no private sector would be forthcoming with such resources. So, the government has cast an eye on RBI's excess capital reserves for setting up a "bad bank" that would buy bad debts from troubled banks to clean up their books for new lending and then dispose of the toxic assets of about Rs 6.6 trillion. The bad bank can sell them to asset reconstruction companies at right price or run them until maturity, without looking for buyers.

Rajan, the lone ranger

Until the last moment of his tenure, Rajan was against the idea of bad bank or asset restructuring company. The former RBI governor wanted the banks, which created the bad loans in the first place, to make efforts to recover the dues. He argued that if bad loans are not priced appropriately when transferred to a "bad bank", there would be some new, insurmountable issues. He was confident that much of the assets backing the banks' loans are viable or can be made viable. What was needed was the will to recover.

Rajan knew that most of the bad loans were due to political interference or crony capitalism. The politicians now plead that RBI should help. In the absence of any assurance that it would improve things, such recapitalisation may enable banks simply dole out more loans to undeserving corporate houses, knowing well that erring banks will always be rescued.

That is the familiar moral hazard problem.

Finally, a technical issue

The RBI does not carry out open market operations in its own paper. Just as the US Federal Reserve, it uses government bonds. For mopping up excess liquidity, RBI sells them; for adding to liquidity, it buys bonds. In the process, it builds up reserves by selling bonds; and reduces them, when buying bonds.

In the immediate aftermath of demonetisation, there was a big rise in bank deposits due to the surrender of demonetised high denomination notes. As the deposits were unusually very large they had to be absorbed as anti-inflationary measure without any loss of time. The government, on the recommendation of RBI, raised the ceiling for issue of securities under the Market Stabilisation Scheme (MSS) from Rs. 30,000 to Rs. 6 lakh crore.

These reserves so absorbed through selling securities were primarily for liquidity management purposes. The government has no right to look upon them as reserves for fiscal purposes.

What government can legitimately expect is annual dividend from RBI. RBI's dividend is the surplus income over expenditure at the end of the accounting year: July-June. Surplus income is the difference between the net incomes earned by RBI on government bonds held and net income earned from its open market operations, purchase and sale of government securities and from forward currency operations, and the usual operating expenditures. It is too early to determine what will be the surplus for 2016 June to 2017 July, given the obvious fact that RBI's expenditures now until end of June next year would be higher than in the past. Reduced liabilities do not increase income of RBI or dividend to government.

Central banks under pressure

Way back, soon after World War II, the British Chancellor of the Exchequer Stafford Cripps was reported to have referred to "the mother of all central banks", the Bank of England, as "his bank". That was the time when the Labour Government was short of funds for its welfare handouts.

Professor Maxwell Fry, also from UK and well known for his witty remarks, wrote in 1993 that governments have a tendency to "fiscally abuse" central banks. His widely cited IMF/Working Paper/93/58 is called: The fiscal abuse.

A more colourful Gujarati expression is "Kona Baapni Diwali". It means "having a great time of merrymaking at someone's expense". Former governor Rajan, being a product of Indian Institute of Management in Ahmedabad, Gujarat, should be familiar with this term. Of course, one does not have to translate the term to the present governor.

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