

## India

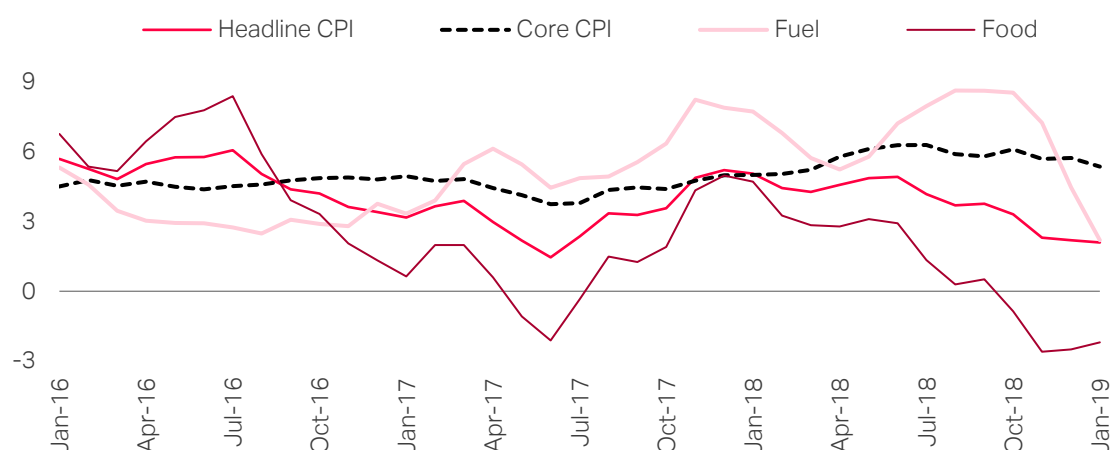
# RBI CREDIBILITY AT STAKE

Shumita Deveshwar

The Reserve Bank of India's approval this week of an interim dividend to the government from its surplus reserves is yet another example of the central bank conforming to the government's wishes under the leadership of Governor Shaktikanta Das. While investors cheered the RBI's softer monetary policy stance earlier this month, former RBI heads continue to warn against the government's short-term bias and emphasize the need for RBI independence.

- Most policies that led to the spat between the RBI and the government spat have now been reversed
- The growth focus has translated into easier banking and regulatory norms
- A softer monetary policy puts the RBI's hard-fought credibility at stake
- Outflows due to political uncertainty and global headwinds will prove tough for a less credible RBI to counter
- Loose fiscal and monetary policies put long-term macroeconomic stability at risk

## Components of CPI inflation (% yoy)



Sources: Central Statistics Office, TS Lombard.

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## A reversal of policies

**By approving the Rs280bn interim dividend on 18 February, the RBI board has now reversed almost all the policies that had become a bone of contention** between the government and the central bank. A glance at the proceedings of the 19 November board meeting – the last one before the shock resignation of former RBI chief Urjit Patel – shows that the key outstanding issues under discussion were the RBI's capital management policy or, in other words, the size of surplus reserves the central bank needs to hold, the restructuring of stressed assets of small and medium-sized firms and the health of banks under the Prompt Corrective Action (PCA) framework, which imposed lending restrictions on weak state-run banks.

**Most of those issues have now been resolved in accordance with the wishes of the government** and following the appointment of former Finance Ministry bureaucrat Shaktikanta Das as RBI Governor in mid-December (see table of policy changes below). As we highlighted in our 10 December 2018 report [Hit to central bank credibility](#), the government has pushed ahead with the use of the RBI's reserves for its fiscal needs and has eased financial norms in an effort to jumpstart economic growth.

### Policy changes under Governor Das, January-February 2019

Policy change	Date	What it entails
Interim dividend to the government	18 Feb	Transfer of a record sum of RBI surplus reserves to the government, which amounts to monetization of the government's fiscal needs
Repo rate cut	7 Feb	Softer monetary policy as the RBI switches to tracking headline CPI instead of core inflation
Banks' exit from the PCA framework	31 Jan	An apparent fast-tracking of the process of lifting lending restrictions on state-run banks and the dilution of requirements for exit from the PCA
One-time restructuring of loans to small businesses	1 Jan	A reversal of the RBI policy of not allowing the restructuring of advances ("ever-greening"), which was a key factor in the high level of banks' NPAs

Source: TS Lombard.

**In our view, investors are underestimating this shift in the RBI's thinking, which comes at a precarious time:** the economy is just recovering but political uncertainty is rising ahead of the April-May national elections. A softer monetary policy amid the government's loosening of the purse strings puts the RBI's hard-fought credibility at risk, especially as the decline in inflation is mainly due to a fall in frequently volatile food and fuel prices while core inflation has remained elevated. Moreover, domestic political uncertainty is growing ahead of Prime Minister Narendra Modi's re-election bid in the April-May national polls; and as my colleague Amitabh Dubey wrote in his 18 February 2019 report [The return of coalition politics](#), the most likely outcome of the

election is a broad coalition government with regional parties. Even though we do not expect a major departure to economic policy under such a scenario, investors will likely be spooked in the short term. A resurgence in global oil prices would lead to both a spike in inflation and a depreciation in the currency.

**If either of those risks materialized, thereby causing an outflow of funds, a less credible RBI would find it hard to counter the stress in market sentiment.** That, in turn, would lead to short-term market volatility. Over the longer term, too, the risk of macroeconomic instability will increase amid a more benign monetary policy and looser fiscal policies as political parties engage in competitive populism to compensate for disappointing economic growth. The RBI under its new leadership has clearly signalled a shift in focus towards growth, and its easier norms with regard to the banking and broader financial sector mean that structural reforms will proceed at a glacial pace.

## Past RBI Governors are worried

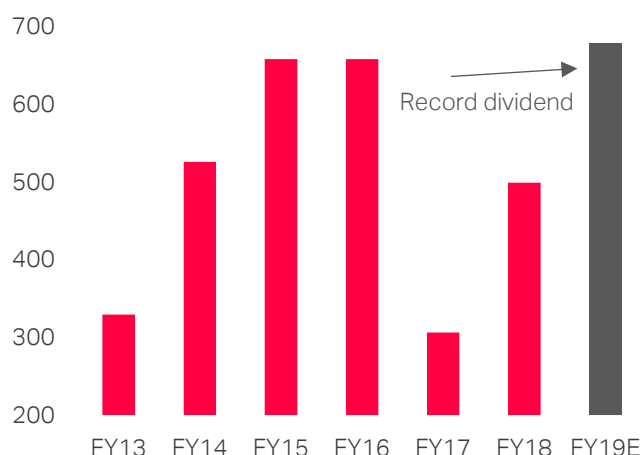
**The latest word of caution against the RBI's change of policies came from former RBI Governor YV Reddy, a day after the central bank had announced a softer monetary policy.** A couple of weeks earlier, at the end of January, another former Governor, Raghuram Rajan, said in a media interview that there should be checks and balances "so the whim of somebody in power cannot prevail". He was responding to a question about tensions between the government and the RBI.

These statements come in the wake of Patel's resignation as well as the [controversial speech](#) by Deputy RBI Governor Viral Acharya in October 2018 that brought the spat between the government and the central bank out in the open. Addressing an academic institution on 8 February 2019, Reddy said that the "unprecedented" practice of issuing an interim dividend suggests that the "immediate fiscal needs [of the government] seem to take precedence over a renewed assessment of the capital needs" of the RBI.

**The interim dividend was cleared ahead of the recommendations of an expert panel that was chaired by former RBI Governor Bimal Jalan** and had been formed by the RBI Board to examine the central bank's economic capital framework. The panel is due to provide its assessment by the end of March. However, the government included the interim dividend in its accounting when it presented the budget for FY20 on 1 February. Economic Affairs Secretary Subhash Chandra Garg said at the time that the government had asked for Rs280bn from the RBI in the form of the interim dividend. The government will use the funds from the RBI to help meet its FY19 fiscal deficit target of 3.4% of GDP, which was revised up from the previous estimate of 3.3%. (As we pointed out in our 4 February 2019 report [Budget in Charts: Populism wins over fiscal discipline](#), the actual budget gap is probably wider owing to the use of creative accounting.

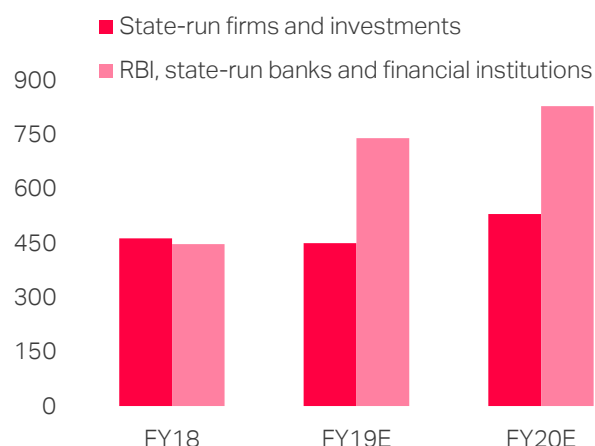
**The total RBI dividend for FY19 will be its highest ever, but the main concern is about the bank's independence and its hard-fought credibility as an inflation-fighter.** Reddy said that although the government ultimately has a right over the RBI's reserves, "the way it exercises [its claim] gives signals to the market and influences public opinion". The government is no doubt trying to boost its finances via alternate routes as tax revenue collection has fallen short at a time when political pressure to increase spending has increased. The chart on the right immediately below shows how the government is also raising funds from other state-run companies in order to help finance the budget.

### RBI dividend to the government (Rs bn)



Sources: Budget documents, RBI.

### Budgeted dividends (Rs bn)



Source: Budget documents.

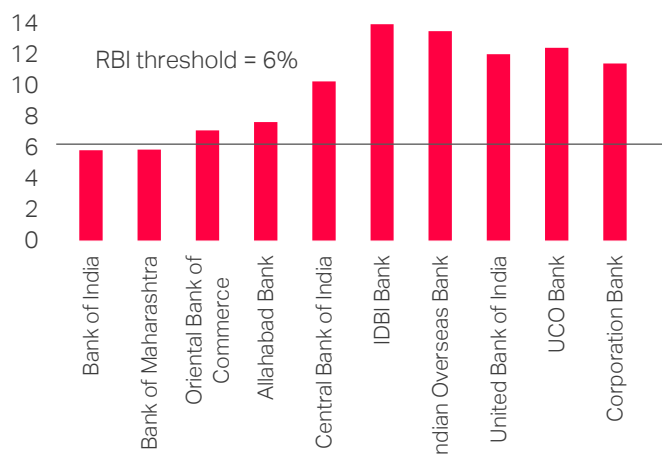
**In the context of the government's demands for a relaxation in PCA norms, Reddy also warned against the dilution of both the autonomy and the accountability of the RBI.** He said that the government was biased in favour of the banks that it owned even though the RBI was the "agent of government" and, as such, was "fully equipped" to take a view on the matter. Over the past few years, the RBI had enforced PCA for 11 state-run banks, barring them from issuing large loans or expanding their operations and putting their financial performance under close scrutiny. In its annual report on India's banking sector published on 28 December 2018, the RBI had said that relaxing regulatory norms "before the structural reforms fully set in" and prior to conclusive evidence on sustained improvement in default rates "could be detrimental to the interests of the economy".

## Easier regulatory norms

**However, just one month or so later – on 31 January – three state-run banks exited the PCA after the RBI had removed the return on assets requirement.** Under that requirement, banks must have had a positive RoA for the preceding two years. To be sure, two of the three banks – Bank of India and Bank of Maharashtra – met the other requirements of the minimum regulatory capital, net NPA and leverage ratios to exit the PCA, helped by the government's recapitalization of the banks. The net NPA ratio of the third, the Oriental Bank of Commerce, was 7.15% in Q3/FY19 – higher than the threshold of 6%. However, the RBI said that the government's December 2018 infusion of capital has since led to a lower net NPA ratio.

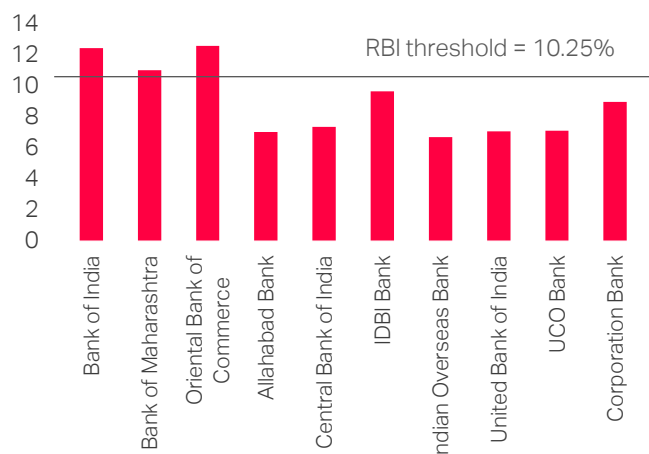
**The RoA for all three banks continues to be negative,** and questions remain about whether these banks can stop making losses or whether continued losses will erode the fresh equity capital that the government has just pumped in. Most other banks still under the PCA appear to be well beyond the maximum NPA and the minimum capital threshold levels, as the charts immediately below illustrate.

### Net NPA ratio (%)



Sources: RBI, media reports.

### Common equity tier 1 ratio (%)

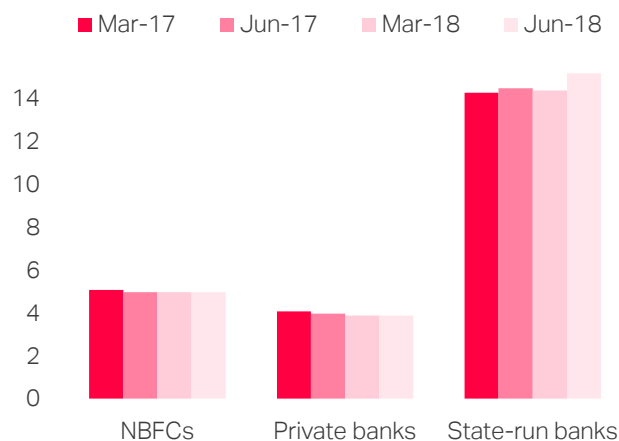


Sources: RBI, media reports.

**The central bank is easing other regulatory norms as well, ranging from extending the Basel III capital adequacy requirement for banks by a year** (which it did prior to Das' appointment) to reducing risk weights for bank lending to non-banking financial companies (NBFCs). Reddy issued a word of caution on both fronts, saying that India probably needs more stringent Basel III norms than the global standard because the realizable value of assets in India is generally far less than the declared value due to higher transaction costs and lower liquidity, especially with regard to real estate assets. With regard to NBFCs, he said that the problems with the shadow bank Infrastructure Leasing & Financial Services (IL&FS) are not related to liquidity but insolvency; that implies that the responsibility for the crisis at the shadow bank lies with the government, not the RBI. Given that both state-run Life Insurance Corp. and State Bank of India are large stakeholders in IL&FS, the central bank should be concerned about the risk assessment capabilities of these important public-sector firms, he said.

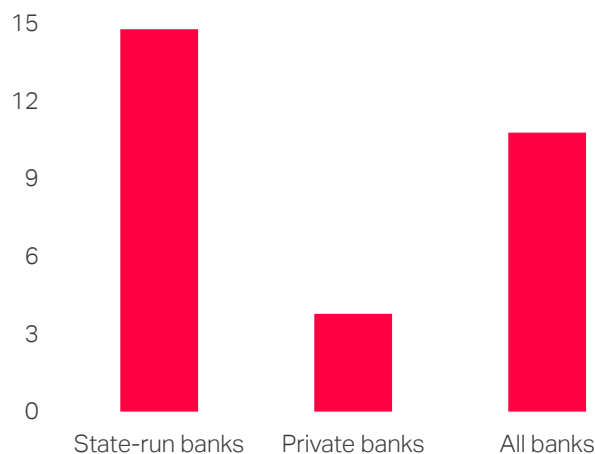
**One of the first steps that the RBI's Das took after taking office was to allow banks to restructure loans of up to Rs25 million for small businesses** despite concerns about credit discipline in the banking system due to the large NPAs and farm loan waivers.

### NPAs emanating from MSMEs (%)



Sources: TransUnion CIBIL, RBI.

### Gross NPA ratio (%)



Source: RBI.

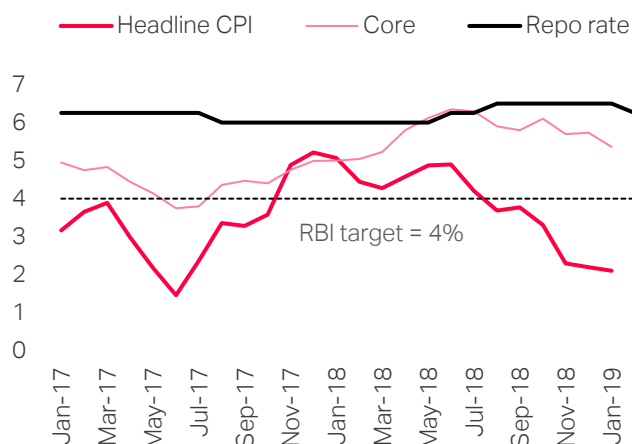
As we pointed out in our 18 January 2019 report [Growth path is not sustainable](#), the RBI's half-yearly Financial Stability Report, which was released just before the policy change, noted that poorly performing state-run banks have the largest share of loans turned bad in the micro, small and medium-sized enterprises (MSME) sector. State-run banks account for 70% of India's banking assets; and as the chart on the right above shows, they also have a far higher gross NPA ratio than their private counterparts.

**Larger companies have demanded that the scheme should be extended to them as well, allowing banks to revise the tenor and interest rate of their loans** without designating them as NPAs. So far the RBI has not blinked on that front, and Governor Das said earlier in February that there was currently no proposal to modify the RBI's so-called "February 12 circular", which has been a key source of conflict between the government and the central bank. The circular was issued a year ago under Patel's governorship to force banks to classify loans as stressed even if borrowers had defaulted by only one day. Companies were compelled to declare bankruptcy, but the proceedings at the insolvency courts have been painstakingly slow and have constrained the private investment recovery. The level of bad loans in India's banking sector is projected to decline to 10.3% by March 2019 compared with 10.8% in September 2018. But as Das commented, they remain too "high for comfort".

## Softer monetary policy

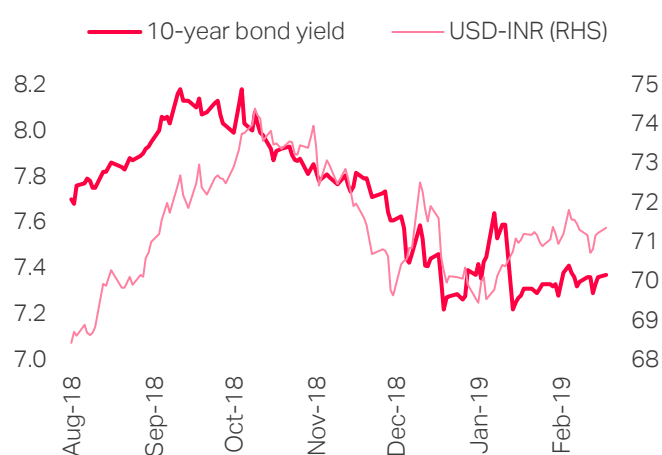
**Monetary policy is easing, too, under Das' leadership: the RBI surprised many in the market with its 25bps repo rate cut to 6.25% on 7 February.** Although the latest CPI inflation number showed a further easing in prices and thus validated the rate cut decision, it came just days after the government missed its fiscal deficit target for the second year in a row. More worryingly, the consolidated fiscal deficit of the centre and the states remains large. Because monetary policy stance is changing from calibrated tightening in December to neutral in February and the tone of policymakers is dovish, investors now expect further rate cuts.

**CPI inflation vs repo rate (%)**



Sources: CSO, TS Lombard.

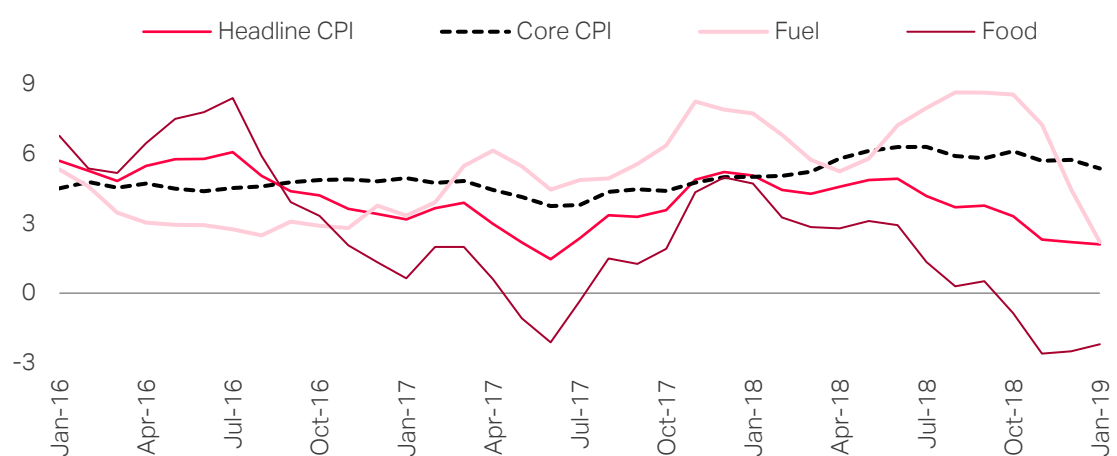
**Benchmark bond yield vs currency**



Source: Bloomberg.

**We remain sceptical on whether inflation is sustainably under control as core inflation has remained relatively sticky and elevated.** The government's policies aimed at stimulating growth in the short-term could possibly result in higher core inflation going forward. As the chart below shows, the drop in the headline CPI number is basically due to the decline in food prices as well as fuel prices that tend to be very volatile. This has helped ease inflation expectations as well as food – with a weightage in the CPI of 45% – accounts for the largest proportion of the Indian consumer's basket.

### Components of CPI inflation (% yoy)



Sources: CSO, TS Lombard.

**The RBI's Monetary Policy Committee under the previous two governors appeared to be targeting core inflation without explicitly stating so** given the lack of monetary policy transmission on food and fuel prices. Following the 7 February monetary policy announcement, Governor Das said that the law mandates that the RBI look at the headline number (which at 2.1% currently is far lower than the 4% headline CPI target). He said that the RBI's estimate of inflation rising to 3.9% by 3Q/FY20 takes into account core inflation. At the same time Deputy Governor Acharya acknowledged that real interest rates "are more closely related theoretically to core inflation".

## Conclusion

**Indian policymakers are worried about how to hasten the speed of economic recovery.**

While governments at both the central and state levels are increasing the fiscal stimulus via populist spending, the RBI for its part is easing monetary and financial regulatory policies.

**The RBI's approach now indicates that there will be further monetary policy easing ahead,** and we believe there is a high possibility of another 25 bps rate cut at the next review in April. We believe that looser fiscal and monetary policies could lead to a price spiral because we doubt that the fight against inflation has been sustainably won. Food prices are unusually low owing to distress in the rural economy and core inflation has remained largely elevated. With the government ramping up populist spending, especially in rural areas, we believe that broader inflationary pressures will resurface as growth starts to pick up.

**A sustainable rise in GDP growth, however, looks unlikely as private investment continues to be sluggish.** The RBI noted in its 7 February monetary policy statement that the recovery in investment activity was mainly due to public spending on infrastructure. But looser fiscal and monetary policies create the conditions for a possible hard landing after the elections if the new government decides to be more serious about undertaking fiscal consolidation. This is a less likely scenario than the increasing inflationary pressures due to political compulsions, especially in the event of a broader coalition government.

**Meanwhile, credit discipline continues to be a concern.** The RBI's step to allow small businesses to restructure their loans is reported to have few takers, but it signals that the government and the central bank will indeed blink in the face of political pressures. Similarly, a softening in the PCA norms for the state-run banks indicates that the government is losing its nerve with regard to tough reforms. Finance Minister Arun Jaitley said after the RBI board meeting this week that India needs fewer and larger banks, and he referred to the merger of State Bank of India and its subsidiaries in 2017 as well as the merger of two smaller public-sector banks with Bank of Baroda currently under way. However, the progress of bank reform continues to be slow and we doubt whether these banks can change structurally. In fact, it is more likely that they will remain dependent on the government to continue bailing them out.

**Key central bank decisions following the appointment of Das as RBI chief are in accordance with what the government and the RBI board wanted.** These policy changes have taken place within just three months of the controversial 19 November RBI board meeting, which showed a flare-up in tensions between the government and the central bank and finally led to Governor Patel taking the unusual step of resigning from his post. Investors should pay heed to the caution being sounded by former central bankers such as Reddy and Rajan, who are clearly worried about the changes taking place at the RBI. As Reddy said in his 8 February speech: "The issues relating to capital framework, the regulatory relaxations and the role and composition of Board, will have a lasting impact on [the] RBI."

## Authors



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