The Liquidity Conundrum*

C.P. Chandrasekhar

A common refrain in assessments of India's current economic predicament is that the economy is performing below potential because of a lack of 'liquidity'. Often, this is merely a means of stating that an inadequacy of credit flow is choking up demand, operations and investment in the real economy. Influenced by such a reading of the current economic situation, the government's crisis response has focused on measures that could enhance financial flows, spur credit growth, and ensure that all agents, large and small, are serviced. In the most recent of such initiatives, Finance Minister Nirmala Sitharaman said that it has directed banks to approach medium and small enterprises with outstanding payments due to them and offer them the facility of bill discounting, so that "MSMEs have sufficient liquidity ahead of Diwali".

On the surface, the evidence seems to support this assessment that growth is being held back because of a constraint from the supply side, in the form of a shortage of finance. Data from the Reserve Bank of India on flow of funds to the commercial sector indicates that total flow during April to mid-September 2019 was at Rs. 90,995 crore just equal to an eighth (12.4 per cent) of what it was in the corresponding period of the previous year. That is, the finance flowing to business from bank and non-bank sources has fallen considerably in recent months, when compared with its normal, long period trend.

When the flow of finance shrinks so drastically, it affects the real economy in multiple ways. It constrains the operations of enterprises and farmers by depriving them of easy access to the working capital they need. These entities borrow to finance their expenses incurred in the course of production of goods and services, and therefore prior to realising the value of the latter when sold in the market. If the volume of such financing shrinks, production is adversely affected. Reduced credit flow also restricts demand that is effective only when the desire to buy or invest can be backed with credit. There are areas of the economy, such as the automobile industry or the housing sector, where demand is substantially driven by credit. A credit crunch limits such demand, as it is visibly doing currently, and holds back production. Finally, a lack of access to finance from bank and non-bank sources adversely affects new investment, which besides creating capacity for future production, directly or indirectly (through the employment it generates) spurs demand and growth. When investment falls, so does growth.

The squeeze on financial flows seems quite generalised, even if uneven in its impact. Net non-food credit provided by the banking system fell by Rs. 93,668 crores over April to mid-September 2019, whereas it had risen by Rs. 1,65,187 crore in the corresponding period of the previous year. Investments by banks in instruments other than safe securities that qualify for inclusion in the computation of statutory liquidity ratio (SLR) requirements have also fallen by Rs. 35,072 crores in the recent period as compared with a growth of Rs. 19,896 crore in the previous year. Clearly, saddled with large non-performing assets that they have not been able to get of their books, banks have turned cautious. Having suffered losses and required to provide for those losses and restore their base capital, they are holding back on new lending. They are reluctant to take on any risk of further losses and prefer safer investments. As ecidence of the latter, holdings of SLR securities was in excess of the SLR requirement of 18.75 per cent of net demand and time liabilities of the commercial banks to the tune of 6.9 percentage points on August 30, 2019.

With banks turning cautious, non-bank financial companies (NBFCs) that rely on the banking system for a chunk of their capital, have been stressed because they are unable to roll over the credit that finances a substantial proportion of their business. This has not only driven entities such as IL&FS and Dewan Housing Finance Limited to bankruptcy, but has severely curtailed NBFC lending. Funds that flowed from the NBFCs to the commercial sector, that stood at Rs 41,200 crore during April to mid-September 2018, shrank by Rs. 1,25,600 crore over the same period in 2019. Short term resources mobilised by non-bank entities fell from Rs. 2,53,669 crore to Rs. 19,118 crore in these two periods. Flow of net credit from housing finance companies moved from a positive Rs. 52,181 crore to a negative Rs. 6,003 crore. Finally, support from four All India Financial Institutions slipped from Rs. 40,032 crore to a negative Rs. 4,774 crore. In sum, resource flows from outside the banking sector in the country have been severely curtailed in recent months.

This severe squeeze on flow of funds from banks and non-banks to the commercial sector seems to have been only partly compensated by increased access to other domestic sources. In the months between April and August 2019, resources mobilised through public issues by non-financial entities amounted to Rs. 58,326 crore (as compared with just Rs. 6,253 crore in the previous year); and that through private placement of equity and bonds to Rs. 62,495 core (Rs. 47,379 crore). These increases were, however, small recompense, with the flow from all domestic sources falling sharply from Rs. 4,44,696 crore in 2018 to just Rs. 13,562 in 2019. Moreover, sources like public issues of shares and private placements of debt and equity are open only to larger and more successful businesses in the current environment. In fact, private placement of bonds are possible only if those bond issues are highly rated, foreclosing that option to companies, big and small, in need of funds because of strained circumstances. Money was clearly not flowing to where it was needed most. This is the crisis that the so-called liquidity crunch is precipitating.

There is also another cause for concern in the current financing environment. Big and successful firms have not only faced no difficulty in accessing domestic financial markets, but have mobilised significant sums from foreign markets as well. Net external commercial borrowing (ECB) that had fallen by Rs. 653 crore during April to mid-September 2018, rose by Rs. 54,073 crore in the corresponding period of 2019. The total stock of external commercial borrowing rose 11 per cent from $193.4 billion to $214.1 billion over the year ended June 2019. This rise was fuelled by two factors. One was the much lower rates of interest prevailing in international markets. The other was the easing of restrictions on ECB by the Reserve Bank of India. Earlier, external commercial borrowing, was restricted to manufacturing companies, special economic zone units, software companies, non-banking financial companies, and other similar entities. Service companies and trading entities could not access funds through the ECB route. In the revised framework, all entities that are eligible to receive foreign direct investments and other specified entities like port trusts, units in an SEZ and startups, among others, can opt for the ECB route. Moreover, while earlier borrowing had to be from a restricted set of sources such as international banks, multilateral financial institutions, and direct and indirect equity holders, now any entity that is a member of the Financial Action Task Force and International Organization of Securities Commissions, including private equity firms and venture capital funds, besides individuals, can be tapped for resources. This liberalisation of ECB rules has clearly contributed to the increased reliance on borrowing from abroad.

External borrowing is risky because of the likelihood of rupee depreciation, which would raise the rupee costs of servicing external debt, unless hedged or insured against such an eventuality. However, hedging involves a cost. The evidence suggests that Indian corporates have sought to save on the costs of hedging on the grounds that the rupee would remain relatively stable or even appreciate given foreign investor interest in the country. This tendency has been strengthened by Reserve Bank of India policy. The RBI, with the aim of easing access to foreign funds, reduced in November 2018 the mandatory hedge coverage to 70 per cent of the foreign exchange payment commitment, from 100 per cent. Also, besides reducing the minimum tenure for borrowing through the ECB route to three years from five years, it cut the tenure required for exemption from mandatory hedging to five years from 10 years. This would only reduce the volume of hedged external debt and increase risk. The borrower bears risk inasmuch as currency depreciation can inflate debt servicing costs and lead to losses and even bankruptcy. The country is burdened because any default on foreign loans can affect investor sentiment, trigger capital outflow and weaken the currency even more. That would aggravate the problem.

Given these features of resource flows to the commercial sector, sole focus on the liquidity crunch tends to divert attention from other troubling developments. The first of these is that the liquidity squeeze is the result of past lending by commercial banks going bad. This is not just because of fraud or corrupt practices, but because investment decisions driven by the euphoria surrounding neoliberal reform proved to be wrong. The large non-performing assets that led to, curtailed bank lending, which in turn had ripple effects on the non-bank financial sector. The second is that the real problem currently is not a generalised credit squeeze but one that affects certain borrowers varying from middle class households to small and medium enterprises and larger firms faced with difficult external conditions. Their inability to borrow slows growth. Finally, inequality in access to credit is worsened by the fact that successful firms are in a position to borrow in international markets. But the lure of low interest rates often results in such borrowing being inadequately hedged against currency risk resulting in fragility, the effects of which spill over into the rest of the system.

The problem is systemic, and minor measures to increase credit flow may not be the solution.

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