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THE NEEDLE'S EYE This government's been raising expectations, not the economy

It's the Magical Mystery Tour

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The government's 'Saaf Niyat, Sahi Vikas' (Clean Intent, Right Development) campaign is expectation management in an election year. Nineteen months after demonetisation, we still do not have a final count for the total volume of banned currency notes returned to the nation's banks.

Are we really a less-cash economy now? Authorities had to scramble to plug a cash shortage in March and April just before the Karnataka state election. RBI data show that GoI's drain-the-swamp battle has largely failed. As of March 30, 2018, currency with the public totalled ₹17.599 trillion, higher even than ₹17.013 trillion 10 days before demonetisation.

Cash is Still King

What about credit and debit card usage, which the government was keen to expand? RBI reported 133 million credit card transactions worth ₹451.74 billion in April. This compares with 98 million transactions worth ₹264 billion on Demonetisation Day.

However, we have been withdrawing record volumes of cash. In April, there were 1.09 billion debit card transactions as customers pulled out ₹2.65 trillion in cash from ATMs. This is more than double the 574 million ATM withdrawals worth ₹1.25 trillion on Demonetisation Day. And this, despite the fact that the number of ATMs has risen only marginally since notebandi. As of April, there were 223,359 ATMs, from 219,578 ATMs in October 2016. People still prefer cash purchases, if you go by income-tax raids in May on the country's best-known designers.

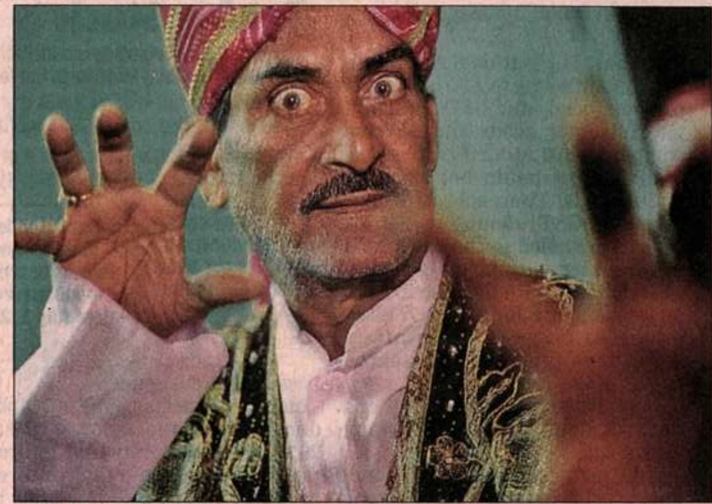
All this cash is presumably being spent, but is it helping the economy? GoI's pledge to trim the fiscal deficit in 2018-19 to 3.3% of GDP from 3.5% last year already seems in jeopardy. Matters will not improve with the Air India sale hitting a brick wall, and the rising tide of bad loans at state-owned banks.

The amber signal is flashing: witness the carnage in the bond market. On June 8, just after RBI raised its benchmark repo rate for the first time since 2014 to 6.25%, the yield on the 10-year sovereign bond (g-sec) rose above 8.0%, the highest in over three years. This was an unprecedented spread between the g-sec yield and the repo rate, and it hurt the banks the most.

The spread is higher now than it was in the 2013 crisis. Banks usually take in short-term deposits and buy g-secs, making profits from arbitrage. But a wide spread of over 170 basis points has pushed down bond prices, and banks are sitting on a growing pile of losses. In response, they are dumping their g-sec stocks.

Over the past few years, as their lending to industry has declined, the banks have loaded up on sovereign debt. But with RBI signalling a rate-hike cycle, the banks are out on a funding limb.

The problem is that GoI wants to sell more short-term debt to fund its budgetary shortfall. The banks don't want to buy more g-secs. So, the price keeps falling at auction. After weeks of no sales, the government is now thinking of cutting back on its short-term debt issuance. In May, RBI itself had to buy up ₹10,000 crore of g-secs to mop up the bonds nobody wanted.



Look into my eyes, look into my eyes, achhe din are here

Foreigners, too, are running for cover. Since January, they have dumped more than $4.5 billion in Indian government bonds. This has further weakened the rupee, worsening pressure on our oil import bill, and will add to the current account deficit.

Liquidate the Dry Assets

The banking crisis is the largest cloud over the Narendra Modi government. A year after RBI sent 12 major bad loan defaulters to the bankruptcy board, only two are more or less on the path to resolution. Nobody is even talking about selling stressed power sector assets. Nobody wants them, but you can't liquidate them.

The bankruptcy law was a good step, but the legal route is taking too long. World Bank's 'ease of doing business' data ranked India the poorest among 13 major economies in resolving insolvencies. It takes an average of 4.3 years in India, versus six months in Japan and a year in the US, and the resolution rate is only 26.4% here.

Acting finance minister Piyush Goyal has now set up a committee to examine if a 'bad bank' is called for and what form it will take. "The traditional Indian way of solving a problem is not to say, 'There are A, B and C options, we choose B'. Indians say, 'We chose A, B and C. We will do all three: none of them will work perfectly but when we add them all up it will work,'" an international economist said.

So, with barely 10 months left for the general election, the risk is if something goes wrong, there could be another 2013-type crisis of economic confidence. GoI is under tremendous pressure to roll back excise on petrol. It is under tremendous pressure to give large increases in procurement prices to angry farmers. And it is going to have to borrow more to fund infrastructure and social spending. That could further destabilise the bond market. There could be a stampede out of g-secs, and out of India. Interest rates could skyrocket.

Or it could all turn out well. If you believe government slogans.

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