NBFC problem is one of insolvency, not liquidity

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RBI needs to fix the Rs 1 lakh crore liquidity shortage, not worry about augmenting of credit for NBFCs—let banks lend to them

Going by the substantial rollovers and new issuances of commercial paper (CP) by NBFCs, in November so far, there seems to be no crisis.

The government has done well to clarify that it is not pressing RBI for a special line of credit for NBFCs at the next board meeting on December 14. The problem with NBFCs appears to be one of insolvency rather than one of liquidity. In any case, asking RBI to open a special window for NBFCs means asking it to take a credit risk on NBFCs. The issue of an asset-liability mismatch, where there is one, can be resolved by the sale of assets. If these are backed by good collateral, banks will pick them up; moreover, banks can also take direct exposures. Going by the substantial rollovers and new issuances of commercial paper (CP) by NBFCs, in November so far, there seems to be no crisis. This means the stronger NBFCs are able to access loans even if they are paying a little more. Also, mutual funds (MF) aren't seeing the kind of redemptions that were feared post IL&FS and continue to buy commercial papers.

There are also unconfirmed reports the government would like some financial support for stressed real estate companies, again not desirable. If the businesses are insolvent, developers should sell their land or their projects to the highest bidder. Also, banks should not be allowed to restructure loans to builders—something that was done with deleterious consequences after the financial crisis in 2008; it would merely lead to indiscipline all over again.

However, the central bank needs to urgently address the liquidity shortage in the system—currently estimated at close to Rs 1 lakh crore and expected to go up to Rs 2.5 lakh crore in a few months time. To be sure, it has been conducting open market operations(OMO) and these need to be stepped up. Also, economists say instruments like the term repo are helping and could be used more frequently if needed.

While the shortage of liquidity in the first half of the year was exacerbated by RBI's sales of dollars, it is possible these sales would no longer be needed now that the rupee has regained much lost ground and is trading between 71-72 levels to the dollar. Indeed, with oil prices having come off from \$86 per barrel to \$61 per barrel, the current account deficit might come in at closer to 2.2% of GDP in

H2FY19, giving us a BoP surplus. That would make life a lot easier for the central bank, probably allowing it to even buy dollars, rather than sell them, thereby adding to rupee liquidity. Indeed, the appreciating rupee and strong yields could lure foreign portfolio investors back into the bond market where they have been big sellers. There are signs that the correction in the equity markets has triggered some buying by foreign funds. The return of foreign investors into the stock and bond markets will also ease liquidity conditions. The high levels of currency in circulation could persist for some time until the general elections are over in May next year. There are those who have called for a cut in the Cash Reserve Ratio (CRR) but it might be wise to hold on to the ammunition for a real emergency. Even six weeks back it seemed like the money markets would stay tight for a long, long time but the 25% fall in the price of oil has changed all that.

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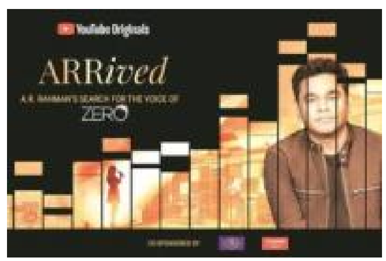

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