Nissay Asset Management Corporation

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Topic Report

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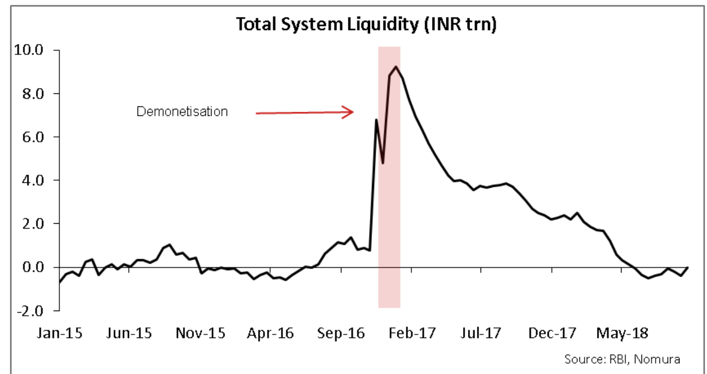
Liquidity crunch overshadow India's growth

◆ Full cycle of demonetisation completed

Demonetisation of two high value currency notes on 8th November 2016 triggered to bring liquidity into the banking system and lower money market rates. The liquidity boost had stayed with the banking sector a year after the event. However, currency in circulation grew gradually and outflow from the banking system put pressure on liquidity. Coupled with this completion of full cycle of demonetisation, global liquidity tightening led by monetary and liquidity tighten in US and severe currency depreciation as a result of a high oil price-led widening of of current account deficit have caused significant tightening in the Indian banking system.



The yield on 10-year government bond climbed to above 8.0% from below 6.5% in the last 12 months.

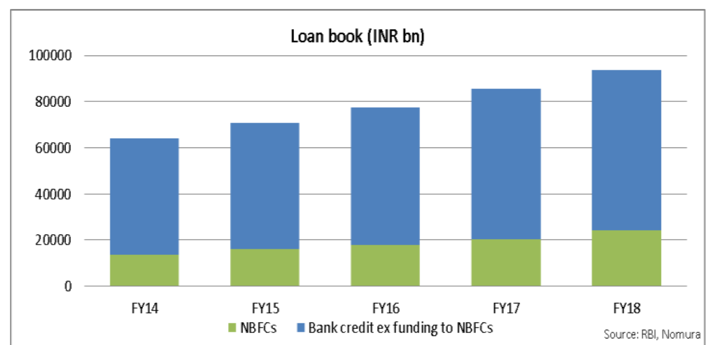
◆ First victim

Infrastructure Leasing and Financial Services (IL&FS), which has around US$12.5bn aggregate debt together with its subsidiaries and had AAA rating until August, has felt the pain from higher interest rates for short-term borrowings as well as a recent drying up of new infrastructure projects in India. Starting in late August, IL&FS has defaulted on several payments on commercial paper and NCD, and sent shock waves through credit markets. Other non-banking financial companies (NBFCs) faced difficulty to raise money even in short term market and refinancing risks increased, as the default of a AAA rated company led to a crisis of confidence among debt investors.

◆ NBFCs played an important role in recent years

NBFCs are becoming increasingly systemically relevant. Sluggish credit growth from deposit collectors, capital-strapped public sector banks, has made space for NBFCs as intermediates. Benign liquidity in the banking system provided cheap funding costs and NBFCs' book had a 17% CAGR in the last 2 years whereas bank credit has grown by a lower 8%. As a result, NBFCs' book increased to as large as 35% of bank credit.

Now that funding condition for NBFCs have tightened and their borrowing costs increased, their loan growth should slowdown.



◆ Growth slowdown inevitable

Given that NBFCs have adequately stocked with capital in aggregate and the government and the Reserve Bank of India have taken action to prevent contagion, NBFCs' stress may not be a systemic risk. However, it is likely to be another headwind for the Indian economy. Because of tight banking system liquidity and heightened risk aversion by investors, NBFCs will likely have to compromise their growth. While banks may partly fill this gap, surplus liquidity is available only with public sector banks which have capital constraints.

◆ **Oil problem back to haunt India**

India's external situation has come under pressure amid a strong recovery of oil prices as well as broader EM risk aversion and Indian Rupee has depreciated by more than 14% against US dollar in 2018. Historically, India has never faced a yearly capital account deficit since 1975 and in most years capital account surplus fully funded the current account deficit. But this time is different. It is expected that India's balance of payments would swing to deficit for fiscal this year which could deplete RBI foreign exchange reserves, hence, could reduce money supply. The RBI faces a policy dilemma between growth and stability.

(Investment Solution)

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