Syllabus subtopic: Indian Economy and issues relating to planning, mobilization of resources, growth, development and employment.

Prelims and Mains focus: about the findings of RBI’s report and challenges mentioned by it in economic revival process

News: The Reserve Bank of India (RBI) on Friday cautioned that the asset quality of scheduled commercial banks (SCB) may worsen next year owing to changes in the macroeconomic scenario.

Financial Stability Report 2019: key findings

- In its latest Financial Stability Report, the central bank also warned that there remains an inherent risk of “froth”—conditions that precede a market bubble—building up in the system due to excess liquidity.
- Citing factors such as an increase in slippages and declining credit growth, the central bank in its biannual commentary said bad loans of SCBs as a percentage of total loans is expected to increase to 9.9% by September 2020 from 9.3% in September 2019.
- This marks a revision of its projection made six months ago, when it had said that the percentage of bad loans was expected to come down by March 2020.
- The RBI has cut policy rates by 135 basis points so far this year. It also warned that multilateral trade and evolving geopolitical uncertainties may continue to have repercussions across financial markets globally.
- The RBI said stress tests done on public sector banks revealed that their gross non-performing asset ratio may rise from 12.7% in September 2019 to 13.2% by September 2020.
- Private sector banks, too, could see an increase in gross NPAs from 3.9% to 4.2% in the period under consideration. These stress tests for credit risk were done to test the resilience of Indian banks against macroeconomic shocks. It encompassed one baseline and two (medium and severe) adverse macroeconomic risk scenarios.
- Among them, three banks may have capital adequacy below the minimum regulatory level of 9% by September 2020, without considering any further planned recapitalization. A severe shock could bring down the capital adequacy of five banks below 9%.
- The performance of public sector banks (PSBs) should be improved and that there was a need to build buffers against “disproportionate operational
risk losses”. Private sector banks, on the other hand, need to focus on aspects of corporate governance.
- India’s financial system remains stable notwithstanding domestic growth.

Challenges mentioned in the report
- The challenge is to ensure transmission of monetary policy impulses to the advantage of real economies and not to aid build-up of froth in financial markets.
- The RBI report said reviving the twin engines of India’s economic growth — private consumption and investment — while being vigilant about developments in global financial markets remain a critical challenge for the central bank.
- It warned against unbridled interest rate cuts, which could cause a “cobra effect”—when a well-intentioned solution ends up worsening the problem.
- The report said aggregate demand slackened in the second quarter of the current financial year, ending March 2020, adding to slowing economic growth.
- While the outlook for capital inflow remains positive, India’s exports could face headwinds in the event of sustained global slowdown, but current account deficit is likely to be under control, reflecting muted energy price outlook.