Essays on Fiscal and Banking Risks

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Abstract

The risks associated with managing fiscal targets and bank intermediation activities have largely been studied through the lens of their respective financial statements. However, risks emanating from activities beyond their financial statements have the potential to create contingent risks, and the evaluation of those risks is the motivation behind the thesis. Thus, transparent information dissemination in macroeconomic risk management is of paramount importance, especially in promoting trust in institutions. On the one hand, fiscal transparency links fiscal discipline and good governance to improved economic performance at the cost of political risks from unsustainable policies. On the other hand, banking transparency is critical for banking supervision and market discipline, especially when banks have resorted to diversification in their traditional activities related to lending and borrowing. Under this broad context, this thesis uses four independent studies to evaluate why and how banks, state-owned enterprises, and the government in India have often been compelled to undertake these off-budget or off-balance sheet risks and the potential relation of these risks with the broader public finances of the country.

The first chapter explains the role of efficiency in understanding how off-balance sheet diversification in Indian banks affects banking stability. The importance of the study lies in the fact that the concentration of off-balance sheet activities has outweighed the total

-linear dynamic threshold approach to estimate the optimal level of efficiency below which diversification between balance sheet activities and off-balance sheet activities, and within the instruments of off-balance sheet

activities, may not be recommended. This is primarily related to the complexity of the off-balance sheet instruments, for which not all banks have the wherewithal. The study goes on to argue that while there is a tendency among banks to herd on off-balance sheet activities, it may prove to be a risky proposition. However, in times of an economic crisis, herding on off-balance sheet instruments provides beneficial results for the banks.

Our next point of focus lies in not just recognizing the sources of the off-budget fiscal risks associated with the government but also understanding when the government might resort to these instruments. The second chapter makes an attempt to collate and identify both off budget and contingent risks of the government and

fiscal position must be assessed beyond what appears on the annual financial statements, popularly called the budget of the country. In addition, the sustainability of the risks is assessed through an understanding of the net worth of the public sector and whether it has the capability to manage the fiscal risks resulting from off budget liabilities. In this descriptive chapter, the larger argument is made through the political economy lens, wherein the government is driven towards fiscal opacity to avoid political turmoil and a policy myopia that overrides policy consistency.

The third chapter in the study uses the debt-deficit stock flow reconciliation as an indicative proxy for implicit fiscal opacity. The study argues that off-budget exposure, which poses sizeable fiscal risks as and when they materialize, is an off-shoot of the on-budget constraints that governments either inherit or get involved in. These not only include procedural or rule-driven inefficiencies but also combine asymm

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in revenues generated from disinvestment after 2016, a closer look at the modes points out that there is a need to distinguish between notional and actual disinvestment. By notional disinvestment, we recognize the particular modes of disinvestment used and accounted for, even though they were mere transfer of ownership from one government body to the other. The study incorporates the effect of the soft budget constraint that state owned enterprises enjoy which might have been used to identify the firms for notional disinvestment, especially after 2016, when large scale restructuring of public sector enterprises was undertaken. To understand the effect of restructuring further, the liquidity and leverage position of the public sector enterprises was checked and compared between firms which were enjoying softer budget constraint and the ones which had a harder budget constraint. Using the difference in difference model, our results illustrate that firms that were enjoying soft budget constraints held on to thei