

The Evergrande crisis illustrates real, financial impact of NPAs

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Representative image

In China, the Evergrande crisis, and in India, the proposal to set up a ‘bad bank’, the National Asset Reconstruction Company Limited (NACRL), are essentially different facets of the same issue – non-performing assets (NPAs) – the former a stark example of the borrower’s predicament and the latter, the search for a possible solution by the lenders of money, most significantly banks. While discussions continue on the finer details of the Evergrande episode and NACRL proposal, it is useful to take a broad and long view of the NPA issue.

Banks, as we know, are institutions that exchange financial assets (loans) for financial liabilities (deposit accounts). These financial liabilities or deposits are then used by entities, households and businesses, for investment. Businesses also borrow money from non-bank financial intermediaries (NBFIs), which channel the savings of households and businesses into investment. To economists, investment refers to the purchase of physical assets or ‘real’ goods, typically plant, equipment, house property, and so on.

These investments are used for the production of goods and services that when sold, yield returns, a portion of which can then be used to service the loan from the bank or NBFI (interest payments) as well as repay the principal amount when due. The problem with investment is that it is made on the basis of *expected* sales and *expected* profit. Given that we live in an uncertain world, forecasts can go wrong so that the investment turns out ‘bad’ resulting in bankruptcy of the borrower and simultaneously, the accumulation of NPAs or bad loans on the balance sheet of the bank or NBFI.

Investment spending or capital formation by businesses is vital for an economy’s growth over a period of time as it raises productivity or output per worker. However, in a world of finite real resources, investment in capital goods have an opportunity cost, i.e., they could have been utilized either for present consumption and/or used for alternative investments which may have more effectively served their purpose. Failed investments usually have both, a fixed as well as a sunk (real) asset component. Fixed assets are recoverable and can be salvaged for productive reuse.

It is this fixed asset component that a 'bad bank' like NARCL attempts to salvage. On the other hand, sunk assets are irrecoverable, which must then, based on pure economic logic, be treated as 'spilt milk' or 'bygones.' As the popular adages go, 'don't cry over spilt milk' and 'let bygones be bygones.' Trying to salvage sunk assets will result in further utilization of real resources that could have been put to better use instead, effectively and efficiently. Optimizing the outcome is therefore the task facing asset reconstruction companies.

While the 'real' assets of bad investments are sunk and must be treated as such, it is the financial implications of such investments – fixed and sunk costs – that eventually hog the limelight. As the crisis begins, attention is focused on the borrower. Investments in physical assets are unable to yield adequate returns making interest and loan repayments difficult. A liquidity problem arises. The business will try to access cash by selling bonds, perhaps at deep discounts, or restructure existing debt to stave off a crisis.

This is the stage at which Evergrande is presently in. While the immediate crisis may be averted, it is unlikely that it will vanish completely as long as real investments fail to yield returns. If that were to indeed happen, then when the value of those assets falls by an amount exceeding its capital, the business is bankrupt. The physical assets may be salvaged and sold to pay off some claims of the creditors to whatever extent possible. Nonetheless, some of the physical assets will invariably end up as sunk assets. Equity shareholders and unpaid creditors must bear the brunt of this loss.

On the creditors' side, the repercussions play out for longer, with broader implications. It is unreasonable to expect that the entire amount of NPAs on the balance sheet of a bank or financial institution would turn out to be fixed rather than sunk costs, the latter akin to 'loss assets' defined by the Reserve Bank of India.

While economists believe that the real resources lost (sunk) must be ignored in decisions relating to the future, a problem arises in dealing with the sunk costs *financially* because they have to be written off the balance sheet of the creditors, including banks and NBFIs. It is this process which gets complicated. The simplest step would be to write off the NPAs from the capital of the bank.

However, this could impact capital adequacy norms (like those under Basel III) that affect future lending by the bank, which can result in adverse consequences for economic growth. The outcome could be worse if the contagion from bank bankruptcies were allowed to spread, putting the entire financial system in crisis. Bank bail-ins have also been proposed: The Financial Regulation and Deposit Insurance (FRDI) bill if passed would have enabled banks to write-off NPAs against deposits.

This could, however, have led to widespread panic amongst the public. In the case of NBFIs, depositors who have lent money to it will find their capital eroded. Banks, which may have lent money to NBFIs, will also face a similar predicament as banks that have lent directly to businesses.

When the amount of NPAs is large and the problem is at a national or even global level – a 'too big to fail' situation – the only entity that can afford to take the NPAs on to its balance sheet is the state or an institution set-up by the state. In the case of the latter, the NPAs or sunk costs will ultimately have to be written off the designated institution's balance sheet, possibly leaving it with a negative net worth. The losses would then impact the provider of capital to this institution, say, for example, banks or NBFIs. If this is to be avoided, the NPAs would ultimately have to be passed on to the central bank.

The question arises as to what if the NPAs are large enough to turn the net worth of the central bank negative? This opens up a Pandora's box of questions on the feasibility of central banks having

negative net worth. Although there is consensus that such a situation does not matter to monetary policy operations, it may affect 'central bank independence'. This is a contentious issue and heterodox economists have often questioned whether this independence was contrived as an instrument introduced à la the Washington Consensus to tame governments from expanding their role in the economy.

Finally, if the government were to restore the central bank with adequate capital, then this would be possible by a corresponding issue of bonds by the government and held by the central bank. Capital infusion by the government cannot be made to the central bank for 'cash' as 'cash' is the financial liability of the central bank itself. When everything is netted, the result of these operations would be new bond issuance by the government, and therefore, new public debt, but no change in its net worth as it acquires capital in the central bank.

Questions over moral hazard, corruption, wilful defaulters, whether or not governments want to discipline profligate corporate enterprises or private enterprises challenging state power (as may be the case with Evergrande) make the NPA issue more complex. Nonetheless, it must be understood that while a decision on dealing with real sunk assets is straightforward, the financial ramifications can reverberate through the economy.

Banks and/or NBFIs, if they were to absorb the loss, will find their net worth eroded, which may in turn affect investment and consequently, economic growth. Ultimately, the only entity that can afford to absorb the financial sunk cost of a significant magnitude is the government and the central bank – the state – as it is the creator of its own sovereign currency.

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Views are personal and do not represent the stand of this publication.

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