



A STUDY OF ECONOMIC POLICY UNCERTAINTY AND BANK CREDIT IN INDIA

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ABSTRACT

The research paper aims to examine the impact of economic policy uncertainty on the banking sector variables in India. The BBD-EPU index for India is used to assess the impact of economic policy uncertainty (EPU) on banking variables: bank credit, bank deposit, bank capital, borrowings, investment, and leverage. The impulse response function (using Eviews) is used to examine the impact of EPU on these variables. The study concludes that the economic policy uncertainty negatively affects the bank credit suggesting possible slowdown in bank credit due to increase in the economic policy uncertainty. Further, the economic policy uncertainty has positive impact on bank deposit, suggesting that the depositors may prefer safety of their money in the time of heightened economic policy uncertainty. The economic policy uncertainty also has the positive impact on bank's leverage and bank capital. The results suggest that positive impact on bank's leverage is possibly due to surge in deposits in banks and increase in bank capital is due to the fact that banks may prefer to be well capitalized in the time of heightened policy uncertainty.

Keywords: Bank Credit, Bank Deposits, Borrowings, Capital, Economic Policy Uncertainty, Impulse Response Function.

1.Introduction

The unprecedented situation of COVID 19 has hit the entire world. Due to this situation, the global economy has come to a standstill. The entire global economy is expected to shrink by 5.2 % this year as forecasted by the World Bank. The Indian economy also contracted by 23.9 % in Q1 of 2020-2021. This has led to increasing in uncertainties with respect to current and future economic outlook. The rise in uncertainty is reflected in BBD-EPU Index developed by Baker, Bloom, and Davis (2016). Baker, Bloom and Davis (2016) has developed an index based on newspaper methodology. This index measures the economic policy uncertainty. The economic policy uncertainty is the economic risk related to undefined government policies and regulatory framework. The increase in

economic policy uncertainty is an indicator of week current and future economic conditions. Economic agents like companies and individuals show conservative behaviour due to rise in economic policy uncertainty. The companies become reluctant to go ahead with their capital expenditure projects and slows down their investment in different projects due to rise in economic policy uncertainty. This approach of companies leads to reduction in investment in economy, which has a detrimental effect on economic growth. Also, individuals which are the consumers in the economy delays spending on different products due to rise in economic policy uncertainty. They tend to save more and delays spending due to the rise in economic policy uncertainty. The

inactions of economic agents push the economy into crisis. Here, the banks are expected to play a very important role in helping the economy to come out from this trouble by granting bank loans and advances, which in turn increase the investment and spending in the economy. Thus, it becomes imperative to understand the impact of economic policy uncertainty on banking variables. This research paper will add to the existing body of literature by studying the effect of economic policy uncertainty on banking variables. There are very few research papers available which have studied the impact of economic policy uncertainty on banks. In India, there is a dearth of research papers which has studied the impact of economic policy uncertainty on Indian banking variables. This research paper attempts to examine the effect of economic policy uncertainty in India on various banking variables like bank credit, bank deposit, bank capital, bank investments using impulse response function using the VAR model. Further, the paper is divided into the following sections: section 2 delineates review of literature; section 3 presents the research methodology, section 4 discusses the conclusion, limitations, and future scope of study.

2.Review of Literature

The economic policy uncertainty is defined as the economic risk associated with the rise in uncertainty due to undefined future government policies and regulatory framework (Thaqeb and Algharabali, 2019). Baker, Bloom, and Davis (2016) have developed an index using news-based

methodology which measures the economic policy uncertainty of countries. This index is known as BBD-EPU index. The BBD-EPU index is widely used in various research papers to understand the impact of economic policy uncertainty on macroeconomic and banking variables.

The previous researches have confirmed that rise in economic policy uncertainty has restrained bank lending, which was the reason for a crisis like Great Depression to get prolonged (Aron et al., 2012; Borda et al., 2016). The policy uncertainty significantly slows down the bank credit in the USA (Borda et al., 2016). The innovation in economic policy uncertainty significantly affects the GDP and bank loans. Borda et al. (2016) has further suggested that the economic policy uncertainty has a negative effect on loan growth in large-size banks in the USA. Further, the negative effect of economic policy uncertainty is smaller in not only highly capitalized bank, but also in banks with more cash assets. However, there is no significant correlation found between economic policy uncertainty and different level of securities holding. The economic policy uncertainty has a negative effect on bank lending which in turn negatively affects the economic activity. Further, Berger and Barwman (2013) have suggested that bank capital helps banks to perform well during crises. Also, economic policy uncertainty is found to be positively correlated to the bank capital ratio (Tran, 2020).

According to Acharya and Naqvi (2012), due to increase in macroeconomic risk, investors hold more bank deposit. Banks are flush with liquidity which leads to increase in credit risk and asset price bubbles. There are few research papers which confirm that the rise in economic policy uncertainty leads to increase in bank deposits, as individuals intend to save more money to rise in uncertainty instead of spending it in the economy (Baber et al., 2006; Gatev and Strahan, 2006). Depositors seek safe heaven and tend to deposit more money in the bank (Berger et al., 2017).

Further, Waisman et al. (2015) suggested that increase in political uncertainty in the economy increases the cost of corporate debt financing. Also, Schwarz and Dalmacio (2020) have suggested that increase in economic policy uncertainty increases in corporate leverage. In India, Priyaranjan and Pratap (2020) confirm the strong procyclical nature of uncertainty. They suggested that rise in uncertainty in Indian economy lowers consumption, spending, investment, and bank credit. The increase in economic policy uncertainty in India has negative impact on bank credit.

3. Research Methodology

3.1 Research Objective

The objective of this research paper is to study the impact of economic policy uncertainty on banking variables like bank credit, investments, deposits, borrowings, capital, and leverage in India.

3.2 Research Method

To study the impact of economic policy uncertainty on banking variables, the study used impulse response function reported in VAR models. The statistical software EViews is used to analyse results produced by the impulse response function. In this study, the impulse response function shows how banking variables respond to one standard deviation shock in economic policy uncertainty. The data series are made stationary using augmented dickey fuller test in unit root test.

3.3 Data

To examine the effect of economic policy uncertainty, the data of policy uncertainty was taken from the policy uncertainty index developed by Baker, Bloom, and Davis sourced from www.policyuncertainty.com. The other data comprise bank credit, deposits, bank borrowings, bank capital, and leverage. The data is taken from the RBI publication. The period of data is October 2016 to March 2020. The percentage change of each variable is calculated on monthly basis. Thus, there are 42 observations used for each variable in the study.

3.4 Models

In model 1, the paper investigates the impact of economic policy uncertainty on bank credit and investments. The economic policy uncertainty is expected to have a negative effect on bank credit (Borda et al. 2016). In model 2, the paper investigates the impact of economic policy uncertainty on Bank deposits, borrowings, and capital.

The economic policy uncertainty is expected to have a positive effect on bank deposits (Beber et al. 2006; Gatev and Strahan, 2006). In model 3, the paper investigates the impact of economic policy uncertainty on leverage and capital. The leverage is expected to increase due to increase in economic policy uncertainty (Schwarz and Dalmacio, 2020). The economic policy uncertainty is expected to have a positive effect on bank capital (Tran, 2020).

4. Results

The results of the Impulse response function are discussed as follow:

Figure-1 shows the impulse response function of economic policy uncertainty, bank credit, and investments. The figure delineates the response of bank credit and investment to a one standard deviation shock to economic policy uncertainty. A one standard deviation shock to economic policy uncertainty causes a maximum negative impact on bank credit in month 3. The results are in line with the results of previous studies (Borda et al. 2016). The effect on bank credit of a shock of policy uncertainty gradually spread out after five months. Further, one standard deviation shock in economic policy uncertainty causes an instantaneous decline in investment from month 1 to month 2. Thus, it has the maximum negative effect in month 2. However, the response gradually increased in month 3 and gradually spread out after four months.

Figure-2 shows the impulse response function of economic policy uncertainty, bank deposit, borrowings, and capital. The figure delineates the response of bank deposits, borrowings, and capital to a one standard deviation shock to economic policy uncertainty. A one standard deviation shock to economic policy uncertainty causes a maximum positive impact on bank deposits in month 4. The response of bank deposits although comes with delay and it gradually disappeared after six months. The results are in line with the results of previous studies conducted by Beber et al. 2006; Gatev and Strahan, 2006. Further, one standard deviation shock in economic policy uncertainty causes a negative effect on borrowings in month 3. The response then become positive in month 4 and gradually dissipates after that. Further, one standard deviation shock to economic policy uncertainty causes the asymmetric effect in the response of capital from month 1 to month 4, but the response remained mostly in the negative zone till month 4 before getting disappeared after 5 months.

Figure-3 shows the impulse response function of economic policy uncertainty, leverage, and bank capital. The figure delineates the response of leverage and capital to a one standard deviation shock to economic policy uncertainty. A one standard deviation shock to economic policy uncertainty causes an asymmetric impact on leverage. The response shows a negative effect in month 3 and month 5; whereas it shows the maximum positive effect in month 4. The positive effect on

leverage is in line with the result of a previous study conducted by Schwarz and Dalmacio (2020). The response gradually dissipates after month 6. Further, one standard deviation shock to economic policy uncertainty causes a maximum positive effect on capital in month 2. The response wanes after month 4. The result is in line with the result of the previous study (Tran, 2020).

5. Conclusion, limitation, and future scope of the study

The research paper studied the impact of economic policy uncertainty on banking variables such as bank credit, deposits, borrowings, bank capital, and leverage. The study used the impulse response function and found that the economic policy uncertainty negatively affects the bank credit. Due to the rise in policy uncertainty in the economy, banks may turn cautious and grants less credit to the industry. Further, the firm may delay investments in the economy due to rise in uncertainties, leading to low credit requirements. Thus, increase in economic policy uncertainties slows down the bank credit, possibly affecting both the supply and demand side. The results further suggest that economic policy uncertainty positively affects bank deposits. The increase in bank deposit is attributed to the fact that the increase in economic policy uncertainty may compel investors to seek safe heaven like bank deposit. However, the bank's borrowings seem to decrease first in response to economic policy uncertainty, which could be a sign that banks wanted to reduce their

debt due to the rise in economic policy uncertainty. Thus, the increase in leverage of the bank in these economic policy uncertainties may be due to the increase in deposits in banks but not due to borrowings. The previous studies found that the highly capitalized banks have less impact of these economic policy uncertainties. The increase in bank capital in response to increase economic policy uncertainty may be an indication that banks are preparing themselves to face these uncertainties. The limitation of this study is that it is difficult to study long term effect of economic policy uncertainty using monthly data. Yet, the scope of this research can be expanded by using the long-term data series of all variables in studying the long-term effects of economic policy uncertainty on banking variables in India

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Figure-3 Impulse response function: Economic Policy Uncertainty (EPU), Leverage, and Capital.

Response to Cholesky One S.D. (d.f. adjusted) Innovations ± 2 S.E.

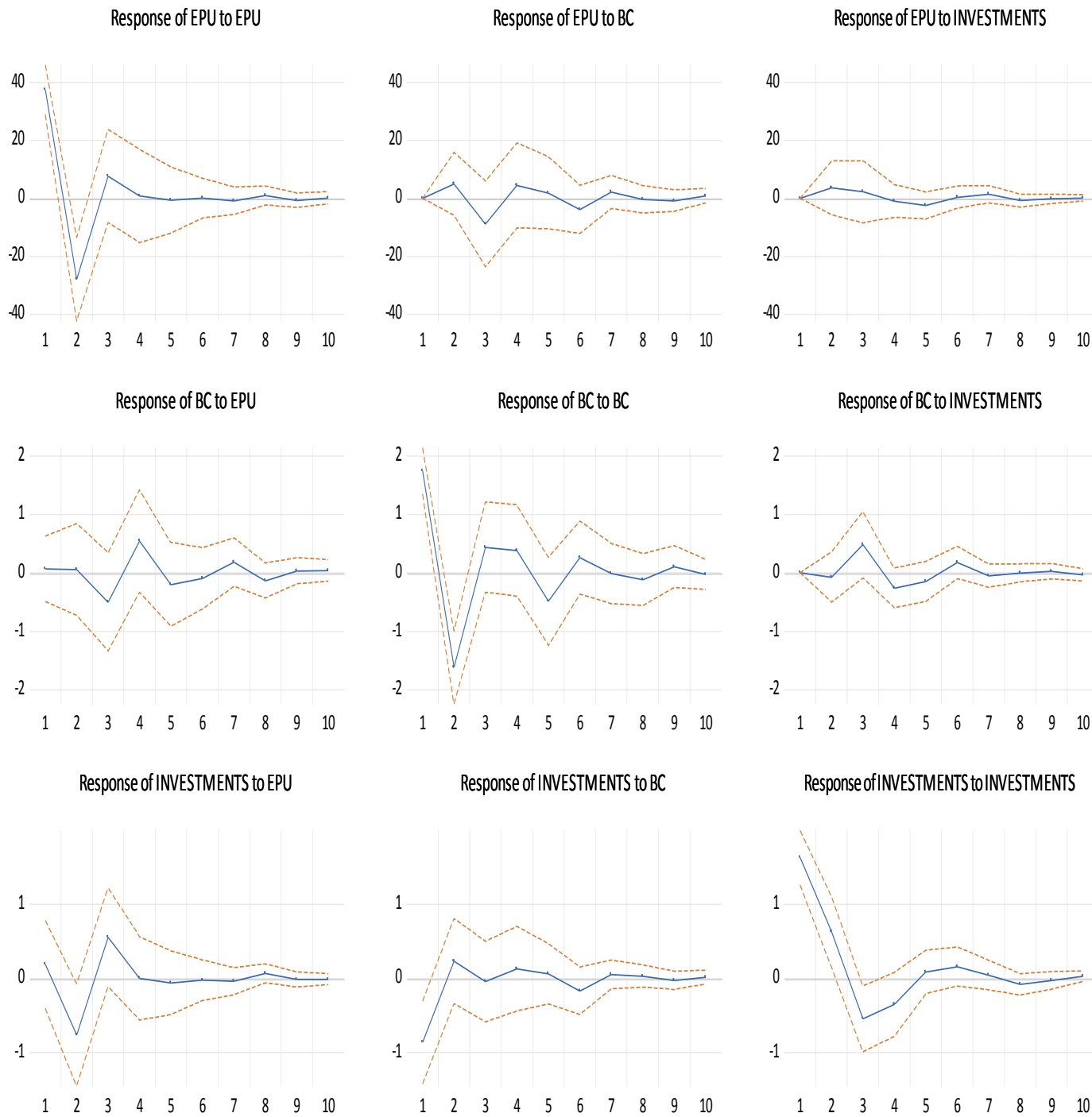


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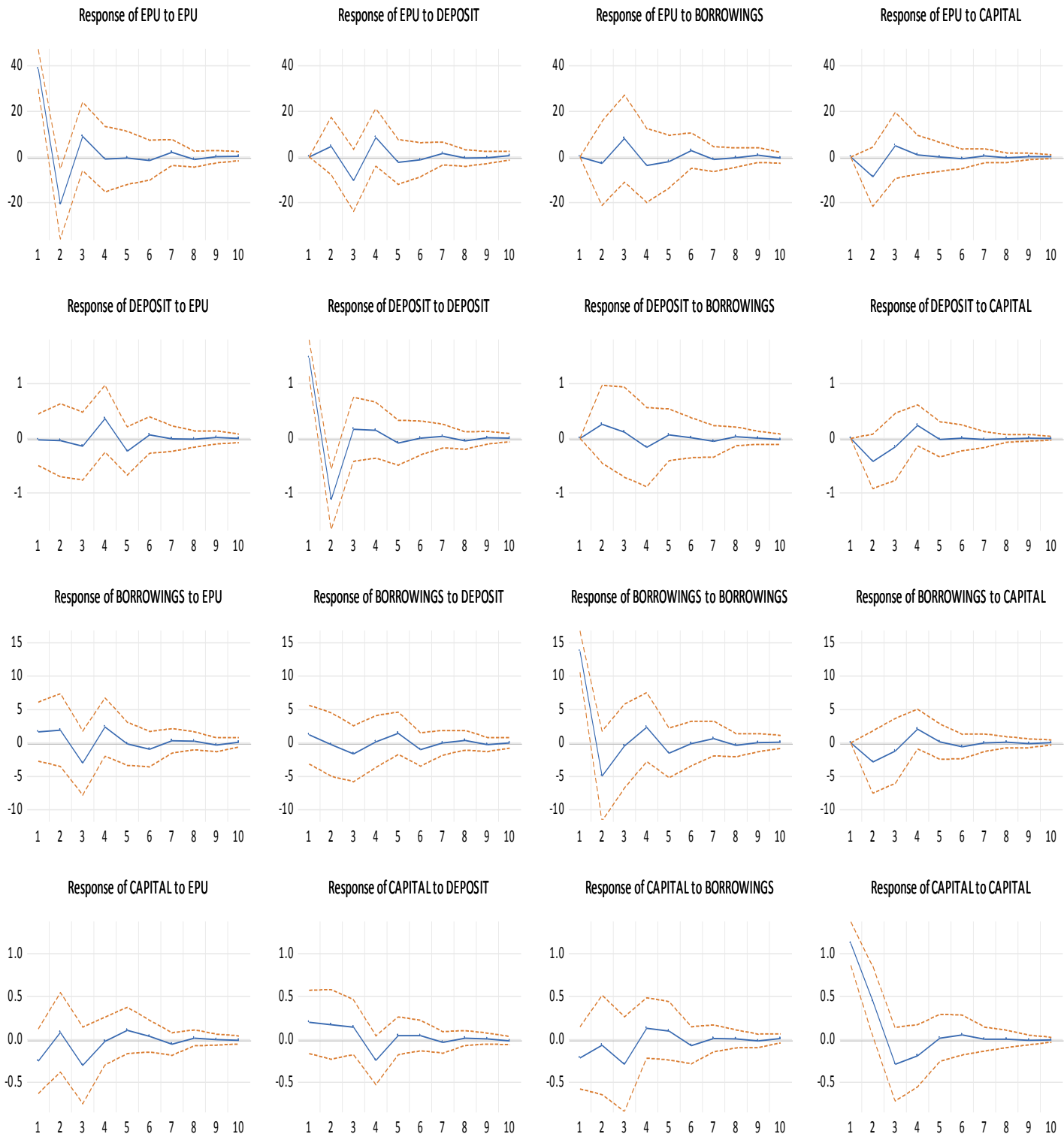


Fig-2 Impulse response function: Economic Policy Uncertainty (EPU), Bank deposits (Deposit), Borrowings and Capital.

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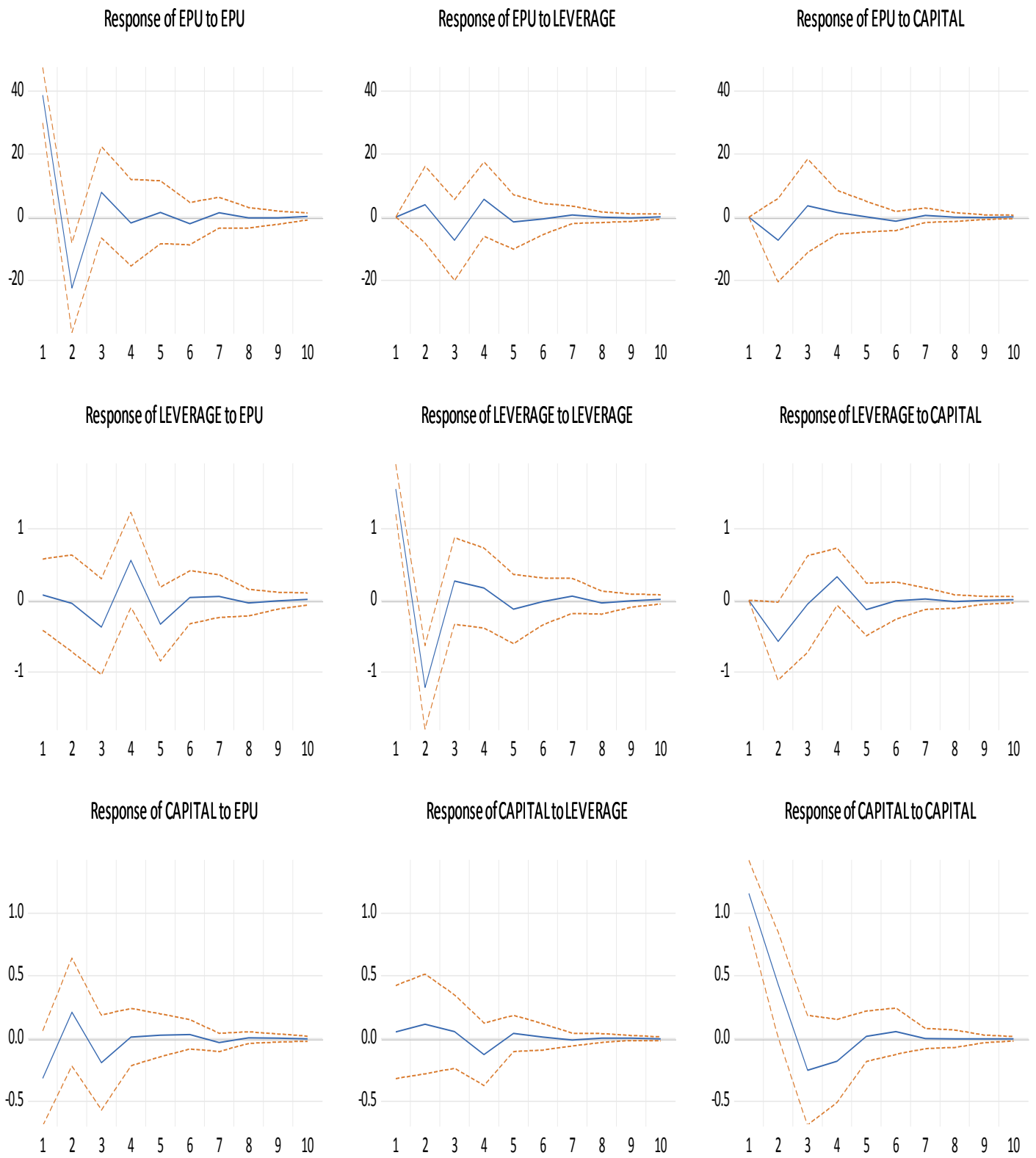


Fig-3 Impulse response function: Economic Policy Uncertainty (EPU), Leverage, and Capital.