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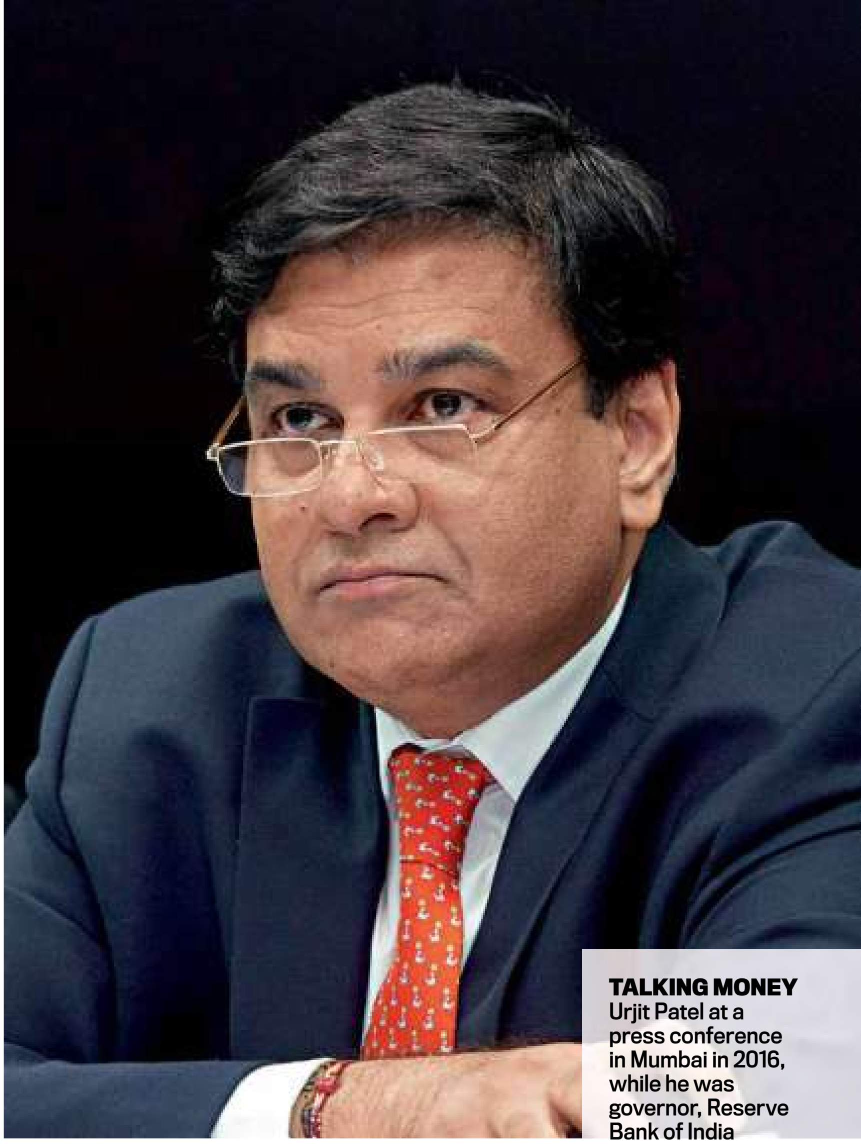
BOOKS | EXTRACT

A HIGH RISK GAME

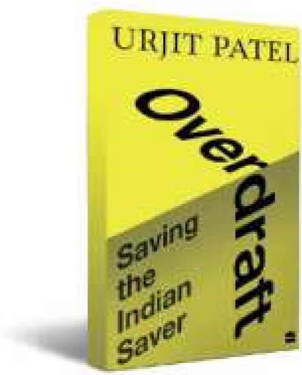
The former RBI governor's new book sidesteps the political quarrels of his tenure to focus on the 'drama of monetary policy'. Exclusive excerpts

By Urjit Patel



TALKING MONEY Urjit Patel at a press conference in Mumbai in 2016, while he was governor, Reserve Bank of India

RACHIT GOSWAMI



OVERDRAFT
Saving the Indian Saver *by Urjit Patel*

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THE CREDIT MARKET IN India is prone to perilous setbacks, with the extant prolonged non-performing asset shock being the latest one. At the heart of the subject is the increasing risk, in effect, due to the failure, over decades, to arrest a creeping banking sector-fiscalisation; ownership of banks as a means for day-to-day macroeconomic management rather than primarily for efficient intermediation between savers and borrowers. Indian finance ministers, somewhat unusually as compared to colleagues elsewhere, declare 'credit budgets' on behalf of banks in the annual finance speech; state chief ministers, for their part, announce quinquennial write-offs; in 2008, in the lead-up to elections in the following year, the Union government did both simultaneously! How we got here feels like a case of an Overton window in India's political economy, where 'gradual shifts over time make [previously] abnormal situations feel normal to anyone watching on'. An inexorable upshot in such cases is that the financial burden on the national balance sheet snowballs and policy contradictions catch up.

A positive outcome of successfully overcoming the current challenge would be a low-hanging opportunity to boost growth by putting moribund capital stock to work. The Indian financial ecosystem has been dominated by the official sector for much of the last half-century. The involvement is manifest through three broad channels: (i) unfettered ownership of numerous intermediaries; (ii) mobilisation of resources; and (iii) policy prescriptions on credit. These encompass marshalling of financial savings and its utilisation for investment and working capital. The government's instrumentality is both direct and through those of the entities it owns, as well as indirect, owing to statutory restrictions and social lending requirements.

Even after three decades of banking sector reforms, including entry of private banks, state-sponsored credit creation retains a majority share. Competition in the system has increased, but the large presence of government institutions in all segments—India and China are outliers amongst large economies in this respect—has meant that they still continue to be, in a manner of speaking, 'Stackelberg leaders'. The public ownership creates an environment where market discipline is perceptibly weak, and where the regulator's remit is circumscribed. Over decades, entities, insurers, financial institutions and non-banking financial companies have been used to support vague (and extraneous) objectives—underwriting the government's disinvestment targets, preserving employment in public enterprises, contributing assistance to states based on the political clout of the representatives, intermittently providing artificial support to stock markets, and occasionally overt lapses in due diligence. ...

As successive governments have found their capacity for further fiscal expansion becoming constrained, it has used the banks that it owns to fire up and pump-prime the economy; hence the term banking sector-fiscalisation. We have been in the realm of political credit cycles for at least the last decade or so:

- Drum-beating higher credit growth to impart stimulus for growth and, concomitantly, job creation. Even as the sector grapples with non-performing assets (NPAs), the government directed its banks in October 2019 to extend credit in 250 districts to boost consumption.
- Farm loan waivers that are redistributive in nature from taxpayers to borrowers.
- Backward-looking prudential norms; inertia in adjusting risk weights on loans by the regulator.

In this scenario, the normal mechanisms that mitigate moral hazard in agency situations are greatly weakened. First, public ownership reduces the (risk-adjusted profit-maximising) incentive for requiring optimal pure risk capital from borrowers—both the absolute levels and the effectiveness of co-financing decline. The use of intermediaries by the government as quasi-fiscal instruments, with diversion of financing for non-commercial purposes, reinforces the decline in the quality of assets. Secondly, the absence of effective and time-bound bankruptcy procedures force intermediaries to roll over existing sub-standard debt or convert them into equity, thereby continually building up the riskiness of their asset portfolio and further diluting the (already weakened) notional leverage norms. Beyond a point, the practice, in effect, morphs into a fraud in some instances, which comes to light years later. Thirdly, a virtual certainty of sustained bailouts by the government replaces a policy of 'constructive ambiguity' with one of 'destructive unambiguity'. Fourthly, there is a higher regulatory forbearance for bank closure, given their public sector ownership. The resulting political economy of financial intermediation with the aforementioned characteristics leads to aggravated moral hazard (AMH). Inevitably, at some point, self-correcting processes—even the modest ones—stall. One can reasonably hypothesise that NPA-induced (financial) shocks have amplified the structural weakness in the Indian economy, with concomitant lengthy growth repercussions.

WITH THEIR CAPACITY FOR FISCAL EXPANSION CONSTRAINED, SUCCESSIVE GOVERNMENTS USED PSU BANKS TO PUMP-PRIME THE ECONOMY

Banking is a business almost wholly conducted with other people's money, mostly those who place their savings as deposits; pure equity of those who own a bank can be even lower than 5.5 per cent of risk-weighted assets. Banking regulation is needed because, inter alia, there are externalities. I have worked in the private sector for almost half of my working life. For the first time, credit-worthy (corporate) borrowers are feeling the effect of NPAs that banks have to sustain on their balance sheets. There are two aspects around this issue:

1. Banks have to hold buffers in the capital structure to bear losses. All borrowers to some extent have to (indirectly) shoulder the 'carry cost' of distressed assets and, increasingly, frauds, through higher margins on their loans.

2. The uncertainty and lags around the resolution/liquidation process has meant that a (recovery) risk premium is added to the borrowing margin of all borrowers, including those who are diligently servicing their debt.

Over the period 2019 up to early 2020, although policy rates were cut by 135 basis points over eleven months, less than one-half have been transmitted for fresh loans. It would seem that downward-sticky deposit rates are interacting with the NPA overhang. Even if deposit rates are relatively rigid, banks could cut lending rates and work with lower net interest margins; however, their ability to do so has been impaired by the provisioning costs that they are incurring.

From 2014 onwards, the regulator, the Reserve Bank of India (RBI), and the government have sought to work towards addressing the scourge of large NPAs—the thrust on transparency meant that the unveiled figure tripled to Rs 10.4 trillion by 2018—in a consistent manner. The overall path can be christened, in short, as the '9R' strategy, implemented in distinct steps. ■