Unprepared for bad days

India lacks the institutional mechanisms to deal with the death of firms and the failure of banks

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BANK CREDIT TO the industrial sector has started shrinking. Its decline has been a serious cause for concern as credit growth is essential to revive investment. However, the logjam is not a short-term problem. The problem's origins lie in the incomplete reforms of the last 25 years. We hoped for the best and did not prepare for the worst. We failed to prepare for the inevitable business cycle downturns that a market economy witnesses.

The inability of banks to lend to industry appears to have pushed them to lend more to retail consumers. This will, to some extent, help industry which has been operating at below capacity. The phenomenon may be helped further by a rise in the salaries of civil servants, a good monsoon and a pick up in public investment.

In a traditional market economy, one might have thought that a pick up in capacity utilisation will mark the beginning of a self-correcting process of bringing about an upswing in the investment cycle. At this point, when investment in the Indian economy has been declining, this would have helped answer the most difficult policy puzzle faced by the Indian economy. But this may not happen soon enough.

If the decline in bank credit had been only due to a lack of demand for credit, then an increase in capacity utilisation would have eventually pushed industry to further increase capacity and led to an upturn in investment. But if the decline in credit growth is due to high NPAs (non-performing assets) this may not happen. The magnitude of stressed and restructured loans suggest that the latter is a serious issue today.

If the reforms of 1991-1992 had clearly envisaged a move to a market economy that inevitably has booms and busts, the government should have, over the years, systematically put in place institutional mechanisms for dealing with the death of firms, exits, bankruptcy and failure of banks. At the same time, courts and contract enforcement would have been made stronger. Instead, a naive version of a market economy led to an institutional framework suitable for capitalism that only witnesses booms.

An institutional change that should have followed the 1991 reforms should have been setting up of a resolution corporation for banks. In a market economy with booms and busts, banks should be allowed to be set up and to fail. Today, we cannot shut down banks because there is no proper system to shut them down. Weak loss-making banks continue to need more capital. We forcibly merge them into healthier banks, making them weak as well.

Now that we have been stuck in a logjam for a few years we are setting up an institutional mechanism to deal with bankruptcy and bank failures. However, it will be a few years before we can build these properly. Unfortunately, this means that the present situation will not be resolved quickly.

A critical reform that should have followed the liberalisation of industry should have been the development of a competitive private banking sector. Our phase of planned industrial growth was over. Why should the government have had a role in deciding which sector and which borrower gets how much credit? Surely, if the government had to genuinely allow industry to grow, it should not have been deciding who gets the money to grow and who does not. But this was not the case. On the one hand, the government continued to own banks; on the other it continued giving directions to all banks, public and private, about which sectors to lend and which were priority sectors.

Instead of moving to a largely private banking system, bank licensing policy seems to have been dominated by a reluctance to allow the share of private banking to increase beyond about a quarter of the banking system. There was an inconsistency between the vision of market-led industrial growth and government controlled resource allocation.

Similarly, banking regulation needed to move away from central planning mechanisms to one more appropriate for a market economy. It should have undergone a philosophical change, moving away from directing banks to invest in certain sectors to regulating and monitoring the risks banks take in the business of banking. Reducing this risk would have prepared the banking system better for the bust. Instead, banks piled on a lot of risk in the boom years. Many of those projects went bad in recent years. The banking regulator has tried to come up with an alphabet soup of schemes like the CDR, SDR and S4A. None of them has been able to solve the problems created by inappropriate regulation in the first place.

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What is the way forward? In a privately owned banking system, banks do the business of banking to make profits; they retain earnings and they expand their equity capital and grow their balance sheets. If they make losses and are unable to generate adequate profits and retain capital, they are shut down or taken over by banks who have the capital. In a government owned banking system banks cannot be shut down. The only way out seems to be "recapitalisation", or putting tax payer money into making up for the losses or loans not returned. The situation is fraught with problems. Banks are not willing to either recognise bad loans or sell off weak assets at losses. The regulator is willing to give leeway knowing that government has limited money to recapitalise loss making public sector banks. If banks are forced to recognise losses and government cannot put money in, credit would only decline further.

As long as the economy was small and business cycles were mild, we somehow managed. However, after 2000 we saw a doubling of GDP, very high growth, and then a sharp downswing of the business cycle after 2008. The antiquated pre-market institutional framework is not able to provide the mechanisms the economy needs to get out of the logjam. Policymakers have been looking for short-term answers. This is the danger of looking for fixes when something is broken. The approach of "don't fix it because it ain't broke" towards India's banking sector must be fundamentally re-examined.

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