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Should we recapitalise the banks?

Our priority should be to address the policy failures that gave our banking crisis, not to paper over the problem with taxpayer money

As the banking crisis unfolds, banks will be short of equity capital. There will be calls for taxpayers to invest in private or public banks. The exchequer is unable to absorb such a shock, and it is a bad use of money. We have the luxury of time, and the opportunity to address this at the root cause.

Banks in India have a leverage of 20 times. That is, they use ₹5 of equity capital and ₹95 of deposits to create a pool of ₹100, which is then invested in various assets. A loss of over ₹5 gives a bankrupt bank. If we estimate that NPA recoveries average 20 per cent, a bank is bust when its true NPAs are 6 per cent of the total assets.

Many banks in India are in this state. There will be a clamour to use taxpayer money to give new equity capital to these failed banks. Is this a good use of fiscal resources?

Public finance is not ready for this shock. Nobody knows how much money is required, but estimates range from 4 per cent to 10 per cent of GDP. Medium-term fiscal planning has not geared up for this in the last few years. Given the infirmities of how the government borrows in India, it is hard to greatly increase borrowing *(https://goo.gl/eYwNF6)*. We are some years away from setting up the Public Debt Management Agency (PDMA), scaling back financial repression, and setting up a modern borrowing arrangement. In the short term, a large jump in the deficit is not a choice for policymakers.

SNAKES & LADDERS

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Even if this were feasible, is it advisable? The Marginal Cost of Public Funds in India is roughly 3 *(https://goo.gl/JdKvi6)*, which means that the cost to society of ₹1 of government expenditure is roughly ₹3. Should we impose a cost of ₹30 trillion (₹1 trillion = ₹1 lakh crore) upon society in order to give ₹10 trillion to banks? This seems like a poor use of money. For a sense of scale, the first three phases of the Delhi Metro added up to an expenditure of ₹0.7 trillion.

It is argued that a large banking system is integral to prosperity and we should just hold our nose and write these cheques. This position is questionable at several levels.

Imagine a country where the state capacity for air traffic control was lacking, so that planes regularly crashed. Would we insist that air travel is integral to modernity, buy a new plane after every crash, and start over each time? No. We would say that air traffic control is essential, and clean up the state capacity before the planes start flying. In similar fashion, our priority should be to address the policy failures that gave our banking crisis, not to paper over the problem with taxpayer money.

We are lucky to have a small banking system. Non-food lending by all banks is ₹76 trillion. Compared with this, the equity capital — in only the top 2,429 companies — is ₹127 trillion. In countries like Japan and China, a banking crisis is a more intractable problem, as bank credit is a dominant player. India is a market-dominated financial system, and that gives us the room to manoeuvre.

In the long Indian historical experience, a healthy rate of growth of non-food credit has been 11 per cent in real terms. At the inflation target of 4 per cent, this translates into a required nominal increase of 15 per cent per year of non-food credit. If we put banking in the ICU, we would get growth of roughly 0 per cent nominal in non-food credit. This is a shortfall of ₹1.15 trillion per year of capital going into the economy. Are there levers through which this shortfall can be made up?

There are ample opportunities for policymakers to get more capital moving through non-bank finance. This includes building the equity market, building the bond market, liberalising market-based capital flows, liberalising NBFCs (non-bank finance companies), and creating the space for the 'fintech' revolution with new technology-intensive players in finance. It is not difficult to find the reforms which will generate additional ₹1.15 trillion per year flowing through these channels, and thus offset the stagnation of bank credit while banking is in the ICU.

India is a market-dominated financial system, and the gap in bank credit growth is not an alarming one. We can survive 0 per cent growth in bank credit by pushing five levers of policy that yield an additional ₹1.15 trillion per year of capital for the economy. The banking crisis is a problem, but it will need not overwhelm the macroeconomic situation.

With this fear out of the way, now let us think about what to do with the patient once he is in the ICU. Look back at our success stories.

We had a problem in UTI in 2001. What did the Ministry of Finance do? Half (but not all) the cost was borne by the taxpayer; the UTI Act was repealed; the viable part of UTI was privatised and placed under Sebi regulation; Sebi regulations were strengthened to put an end to the things that the old UTI was doing wrong. There has been no mutual fund crisis after 2001.

We had a problem in stock exchanges in 2001. What did the Ministry of Finance do? The old *badla* trading was shut down; it was replaced by derivatives trading, which required an amendment to the Securities Contract (Regulation) Act; the BSE was demutualised so as to achieve a three-way separation between shareholders, managers, and trading members of stock exchanges. There has been no stock market crisis since 2001.

We did not merely use taxpayer money and get back to business as usual; we solved the problem at the root cause. This scale of work is required at the Ministry of Finance. When trillions of rupees are lost, there needs to be a reckoning. What went wrong? How do we make sure this never happens again?

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