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THE GOVT AND RBI FACE A TRILEMMA REGARDING PSBS

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What is the trilemma that Patel talks about?

Urjit Patel writes: “The sovereign (government) and the regulator (RBI) face a trilemma: It is clear that it is not possible to: (i) have dominance of government banks (public sector banks) in the banking sector; (ii) retain independent regulation; and (iii) adhere to public debt-gross domestic product (GDP) targets." The government along with RBI cannot hope to achieve all three points at the same time. Only two out of the three can be achieved. Let’s say the government wants the public sector banks (PSBs) to dominate the banking system and at the same time ensure that the public debt doesn’t go up.

What will happen in such a circumstance?

In this scenario, the Reserve Bank will have to compromise on independent regulation. To dominate the banking system, PSBs will have to increase lending at a fast pace. This will lead to accumulation of bad loans or loans that haven’t been repaid for 90 days or more. Given that the recoveries of bad loans are minimal, the government, as the owner, will have to invest more money into the PSBs to keep them going. If the government puts more money into the PSBs, its expenditure will go up. It will have to borrow more money and the public debt to GDP ratio will substantially rise.

How can public debt to GDP ratio be saved from rising?

The central bank will have to dilute some regulations to help the PSBs in not recognizing bad loans. In such a case, the government need not invest in the PSBs immediately. PSBs will have a greater market share and the public debt to GDP ratio will not rise right away. However, the central bank will have to dilute banking regulations.

What is the issue with RBI diluting norms?

When RBI dilutes regulations, banks end up kicking the bad loans can down the road. This postponement leads to a bigger problem, which hits the banks, not immediately, but a few years later. This is precisely how PSBs accumulated peak bad loans of 8.96 trillion, as of March 2018. The government then has to recapitalize the banks in the years to come. In the process, it pushes the public debt to GDP ratio up. This is one situation that the government has been trying hard to avoid.

What is the eventual way out for RBI, govt?

As Patel writes: “The decline in the share of government banks in the banking sector should not be resisted… Current trends broadly suggest that the banking sector is increasingly privatized, by stealth, much like the telecom sector." In the last decade, the share of PSBs in overall lending has dropped sharply from 75.1% to 57.5% at present. As PSBs keep losing share, they will cause fewer headaches for the government and the central bank in the decades to come.

Vivek Kaul is the author of Bad Money.

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