PSU banks: maximum government, minimum governance

The PNB fraud has turned into a public sector versus private sector debate. A few weeks ago, a public sector bank chairman made a forceful point: it is private companies that have defrauded the banks, it is the private sector who are the “wilful defaulters”. That doesn’t speak very highly of governance standards in the private sector. Others have pointed to the Barings debacle, where a rogue trader brought down the bank, and to the financial crisis, brought about entirely by private sector banks. A group of 60 economists have cautioned against using the scam as a pretext for privatizing banks. Since the government in any case has to bail out a failing bank, even a private sector one, why privatize the profits if the losses have to be socialized, so goes the argument.

The bank chairman makes a valid point. Banks may be in the public sector, but they lend mostly to the private sector and most of their funds go to large companies. The PSU banks are no bastions of socialism—on the contrary, they serve the private sector and help the development of capitalism in the country. Where’s the contradiction between public sector banks and the private sector then?

After Independence, the nascent Indian private sector needed the crutches of the state to survive and grow. The Bombay Plan, drawn up by Indian industrialists, wanted a strong government role in the economy to support the private sector.

Bank nationalization was instrumental in expanding the footprint of Indian capital to the hinterland, mobilizing savings for industry and infrastructure and creating a large middle class through its lending to small enterprises and big farmers. Indeed, it provided the economic base for the ascent to power of the middle castes. To be sure, it also did some lending to the poorer sections, but that was merely a useful safety valve against rural discontent.

In short, the public sector in a developing country is a tool to help develop capitalism. One very interesting view was that of Amadeo Bordiga, one of the founders of the Communist Party of Italy, who viewed the Soviet Union as a society in transition to capitalism. Later events, well after his death, proved him absolutely right.

But there’s hardly any doubt, after the unearthing of massive amounts of hidden bad debts and the latest scams in nationalized banks, that something has gone very wrong in their working. After all, they have no shortage of skewed incentives. While some of the private banks, too, have seen high bad debts, they pale in comparison to the NPAs of public sector banks. The question we need to ask is: is state ownership of banks still needed for supporting the Indian economy?

In a paper, *Government Guarantees and Bank Vulnerability during a Crisis: Evidence from an Emerging Market* authors Viral Acharya, currently deputy governor at the Reserve Bank of India (RBI) and Nirupama Kulkarni studied the performance of Indian banks during the financial crisis of 2007-09. They found, strangely enough, that the more vulnerable PSU banks performed the best during the crisis.

The authors wrote, “We attribute this to the presence of government guarantees which enabled more vulnerable state-owned banks to grow their deposit base by increasing their deposit rates. While they also increased loan advances, they did so at cheaper rates and especially to politically important sectors. Ex-post, these loan advances have been associated with greater non-performance and restructuring of assets, thus sowing the seeds of an economic slowdown in investments in India.” Simply put, they attribute the subsequent investment slowdown to the actions of the more vulnerable PSU banks.

Indian capitalism is now strong enough to do without PSU banks. They have outlived their purpose. These banks have become the weak underbelly of Indian banking, a risk to the entire system. Thanks to technology, the cost of financial inclusion has come down drastically and a host of small banks, payment banks and companies, telecom companies and micro-finance institutions can easily do the job. The RBI can ensure that private sector banks fulfil any targets seen to be socially desirable.

That means financial inclusion is not the problem. The real reason for the political resistance to bank privatization lies not in the state-owned banks funding social programmes, but in their being an inexhaustible source of patronage and crony capitalism.

The PNB fraud provides an opening for the Modi government to walk the talk on its “minimum government, maximum governance” promise. Will it seize the opportunity?

Manas Chakravarty looks at trends and issues in the financial markets.

Respond to this column at manas.c@livemint.com

END