A big bang bailout

The recapitalisation of public sector banks, announced by Finance Minister Arun Jaitley, has been touted as yet another big bang reform by the Central government. It is hoped that this reform will push nationalised banks to lend more actively in the coming months and bring about a quicker recovery of the economy by boosting private investment. What has been swept under the carpet, however, is the fact that recapitalisation is just a euphemism to describe what is essentially a bailout of banks using taxpayer money. Also, amidst all the fanfare and excitement about the massive 2.11 lakh crore bailout, the fact that banks are in the current mess mainly because of their mismanagement for political reasons has been ignored.

Many who have justified the throwing of good money after bad have done so, however, with an important caveat. They have argued that the bailout should be accompanied by governance reforms that will safeguard the balance sheets of public sector banks from the ill-effects of populism in the future. While this sounds good in theory, it does not work as well in reality. Nationalised banks, which are supposed to be run for the benefit of the public, are in effect managed by bureaucrats who are accountable only to the political party that is in power. So, it is no surprise that these banks often end money to fund populist and crony pet projects of politicians who care more about the next election than the long-run health of banks. Eventually, when the banks end up with huge bad loans on their books, more reasons are given to bail them out of trouble, and the cycle continues.

This is in contrast to private banks where owners, who have invested their own money and stand to lose it all in case of mismanagement, have a strong economic incentive keep a tab on managers who run their business. Such oversight, of course, is never perfect but is still superior to the almost complete negligence and gross mismanagement of books in the case of public sector banks. It may be true that private banks have not been immune to the problem of bad loans, which is a part and parcel of lending aggressively under a fractional reserve banking system. Yet, in the case of public sector banks, the implicit guarantee of their books by the government only worsens this cyclical problem by adding to it the risk of moral hazard. As nationalised banks are allowed to tap into taxpayer money whenever they are in deep financial trouble, they have very little reason to be careful while lending and more reason to take huge risks with their balance sheets. Incidentally, the same happens whenever the government protects private sector banks from the negative consequences of their actions.

The only way to build a healthy and competitive banking system is to reform bank ownership and force banks to take responsibility for their actions. India is nowhere close to enacting such real big bang reforms.

The jurisdiction of our high courts has been subject to relentless attack

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