Bank recapitalisation: slow-mo replay

Like all things Indian, there are multiple ways of viewing Union finance minister Arun Jaitley's comprehensive presentation on the Indian economy and the package of measures formulated to provide some momentum to a decelerating economy.

One is to view government as profligate: throwing caution to the winds, raiding the exchequer and reaping subsequent political dividends. With state assembly elections due in Gujarat and Himachal Pradesh, this package seems custom-built to address concerns over slowing growth, rising unemployment and the severe economic dislocation which followed demonetisation and implementation of the goods and services tax.

Some may even view this development as a snub to the reconstituted Prime Minister's Economic Advisory Council (EAC). Convened to suggest measures to revive the economy, the council rebuffed calls for a fiscal stimulus programme during its maiden 11 October meeting. EAC chairman Bibek Debroy ostensibly acknowledged, during his post-meeting press briefing, that there was indeed an economic slowdown but, puzzlingly, declined to publicly list the reasons. The new package can thus be seen as realpolitik trumping good economic sense.

Viewed through a different lens, the package can be seen as an attempt to generate temporary feel-good with all the right ingredients thrown in—large numbers, a dizzying number of projects, heady growth estimates. This scepticism is fuelled by the government's predilection for grandiose policy announcements without adequate preparation or execution. What further bolsters the cynicism is the inordinate rush to announce schemes without fleshing out details: for example, the Rs2.1 trillion bank recapitalisation plan lacks all the relevant details. There is another reinforcing factor: the government has front-ended announcements of funds injection, but all mentions of painful restructuring, if any, have been kept for later.

There is another nuanced view. Keeping the political compulsion as a constant, since the impact of the economic distress on impending elections cannot be ruled out, Jaitley's package tries to walk a fine line by providing an economic stimulus while also heeding fiscal concerns. While this assessment does seem closer to reality, implementing it is unlikely to be easy. For example, it will be difficult for the government to undertake all the listed infrastructure projects without any budgetary support, given the private sector's current inability to pitch in with capital.

Many observers and analysts have inveighed against the recapitalisation programme even though the final design is yet to be revealed. They see it as rewarding banks with a free get-out-of-jail card without any corrective measures to avoid repeating past mistakes. There's also the moral hazard question: recapitalisation studies conducted globally have shown that banks receiving fresh government capital tend to exhibit increased risk-taking activity compared with banks deprived of capital infusion. There are other studies which show that recapitalisation stimulates the credit cycle for only larger banks and existing borrowers. This then contradicts the government's assertion that recapitalisation will lead to increased credit availability for the micro-, small- and medium-enterprise segment.

While these are legitimate concerns, the recapitalisation programme seemed like a fait accompli, especially since banks were caught in a vicious cycle, leading to a credit impasse which exacerbated the economic distress. As the largest shareholder, it was incumbent on the government to recapitalize banks to kick-start the credit cycle and growth process. Banks could have raised fresh capital from the market by diluting the government's stake, but their contaminated books made that impossible.

Ideally, recapitalisation and restructuring should go together. The government's current plan incorporates one without the other or, at best, inserts a time lag between the two actions. Many commentators have been clamouring for an accompanying restructuring programme. One suggestion is to reduce the government's stake in public sector banks, which, then, one naïvely assumes will provide banks with operational autonomy. Will, say, a 30% or 40% stake prevent ministers and government officials from calling up a bank's chief executive and influencing credit decisions? Government intervenes in a bank's credit operations in many other ways.

The Banking Regulation Act mandates that a bank's board, apart from the executive directors and the regular government nominee (usually a conscientious bureaucrat), should also include professionals with knowledge of accountancy, agriculture and rural economy, cooperatives, small-scale industry, among others. Governments often exploit this section to appoint party loyalists and sympathizers under one category or another since the eligibility criteria is not rigid. These nominees then enjoy unofficial government imprimatur to intermediate between the bank and Big Business. This gap must be plugged.

The other demand is for complete privatization but, realistically speaking, the political economy will not allow that. And, even if that goes through, it is not fool-proof because some of the largest private banks are also struggling with mountains of bad loans featuring the usual suspects: large corporations. A sustainable, long-term solution must therefore include punitive measures for all wilful defaulters, especially majority shareholders, and not just politically convenient soft targets.

Rajrishi Singhal is a consultant and former editor of a leading business newspaper. His Twitter handle is @rajrishisinghal.Comments are welcome at views@livemint.com

END