First, fix the banks

Yashwant Sinha's tough broadside in The Indian Express on September 27 about the economy sliding downwards, immediately drew contrary claims by ministers, Rajya Sabha members, unattributed government sources and the prime minister himself who claimed that some speak well only after spreading pessimism. The facts, however, are undeniable. From a peak of 9.2 per cent in January-March 2016, GDP growth has fallen every successive quarter: First to 7.9 per cent, then 7.5 per cent, followed by demonetisation which reduced it further to 7 per cent in October-December 2016, then 6.1 per cent and finally 5.7 per cent in April-June 2017. Given the significant frictional costs imposed by a badly designed and poorly implemented GST, some expect growth to fall over the next two quarters before the start of a modest uptick.

What, then, is the solution? There is a popularly false one: Pretend to be John Maynard Keynes and argue for big increases in government spending, claiming that the multiplier effect will push growth to a higher trajectory. I reject this not as a fiscal deficit fetishist - which I am not - but because it doesn't address the real question of why growth has fallen.

How do hundreds of thousands of enterprises producing goods or services actually function? When an entrepreneur gets an order, he uses working capital from banks which finances the raw material inventory and work-in-progress. After production, delivery and collection of final payments, he pays interest on that working capital and draws it down with the bank until the next order. If the working capital cycle remains intact and accommodative, businesses are not hit by a squeeze on financing. But with severe constraints on such finance, all businesses are hit, irrespective of how good demand may be.

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Massive tightening of working capital is exactly what has affected the bulk of entrepreneurs across India. Why so? It has entirely to do with the state of the banking system, especially public sector banks (PSBs). These entities, comprising 21 "nationalised banks" and six of the State Bank of India group, account for almost 70 per cent of the assets and liabilities of the system - split 48 per cent among the former and 22 per cent in the latter.

In an exuberant milieu that started with the UPA 1 government and continued until three years after the global financial crisis of 2008, large corporations conceived major projects proposals in capital-intensive sectors such as power, ports, airports, housing and highway construction. Banks were only too keen to lend, often without sufficient evaluation of risks and returns. Things started worsening with the policy paralysis brought about by the spectrum and coal mining scandals. Soon, most projects were getting stuck, especially in power and highways; and banks found their loans going sour. Initially, the extent of non-performing loan assets (NPAs) was kept under wrap by "ever-greening" based on the dictum that rolling loans gather no loss. Soon, the Reserve Bank of India (RBI), started tightening the screws. And the NPAs started tumbled out.

According to the RBI's Statistical Tables Relating to Banks in India 2015-2016, NPAs were 3 per cent of gross advances of all banks in India in 2013. By 2016, they had grown to 9.3 per cent. The increase was much more pronounced for nationalised banks - from 2.9 per cent in 2013 to 13.8 per cent in 2016 - compared to privately-owned banks where the NPAs rose from 2 per cent of gross advances in 2013 to 3.1 per cent in 2016

As of December 2016, gross NPAs for the 27 PSBs were Rs 6,47,800 crore, or 88 per cent of the total NPAs recorded across all banks. This is an underestimate. Even so, it was a 140 per cent increase over two years earlier. For the 10 worst PSBs, gross NPAs averaged 16.4 per cent of gross advances as on December 2016, from 22.4 per cent for the Indian Overseas Bank to 14.1 per cent for the Central Bank of India - in effect, each having thoroughly destroyed its balance

sheet. In fact, for the PSBs as a whole, gross NPAs are now greater than their tier-1 capital (the one that really counts). Thus, the system does not have enough capital to take care of its bad loans.

How have the PSBs behaved in such circumstances? With large losses on account of heavy provisioning and bad loans eroding their balance sheets, they have done what bankers do - curtailed loans and advances. From a growth of around 15 per cent four years ago, PSB advances grew by just 3 per cent in 2015-16.

The fat cats who borrowed heavily to default spectacularly have got away, and now await repurchasing their bankrupt businesses at lower prices; the smaller and medium-sized businesses that dot the countryside have got hammered. These firms, accounting for the bulk of employment in agro-industries, manufacturing and services, are scrounging for working capital, with banks fobbing them off on one pretext or the other.

What's the solution? Here, one must distinguish between the regulator and the majority owner. As the former, the RBI has done the right things: Tightened income recognition and provisioning and forced banks to take the haircuts that they were avoiding. The owner has also done a few right things such as going after major defaulters and initiating better bankruptcy resolution. However, it has failed in one area.

Barring a wee bit allocated in the 2015-16 budget, the government has steered clear of recapitalising the PSBs with the claim that it will cause "moral hazard". Of course it will. But what does one choose: No moral hazard as the banks wither on the vine, or some moral hazard in recapitalising the better PSBs so that these can get back to lending?
It was done before. The NPA crisis in the 1990s was mitigated by a $500 million World Bank loan backed by a corresponding budgetary outlay. This time the cost will be higher and, therefore, one must target the banks carefully. But if we do so, we will strengthen distressed balance sheets and give space to the recapitalised bank to behave as they should - as bankers and not rabbits staring at headlights. Besides, the amounts thus spent can be recouped by putting the requisite number of shares of those banks as public offers. Recapitalisation will raise their enterprise value, which can then be leveraged through selective divestment.

The financing squeeze had played a big role in decelerating growth. Economies grow because banks intermediate. Ruined banks don't intermediate. So, instead of thinking of yet another scheme or two to hit the headlines, may I press upon the finance minister to begin selective PSB recapitalisation? If his house sprung leaks and needed repairs, wouldn't he do it? Aren't the PSBs his houses?

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