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BANK FOR THE BUCK

Relevant for: Indian Economy | Topic: Issues relating to Growth & Development - Banking, NPAs and RBI

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The finance minister's announcement last week of the merger of public sector banks, coming in the wake of growth sinking to a six-year low, was meant to be seen as a big bang response to arresting the slowdown. On the contrary, it's a needless distraction.

In the short-term, the mergers will contribute nothing towards engineering a turnaround of the economy. Worse still, the administrative and logistic challenges of mergers will divert the mind space of bank managements away from their most pressing task at the moment — of managing the NPAs and aggressively looking for lending opportunities. Down the line, bank staff will be worrying, notwithstanding the finance minister's assurance, about their jobs and career prospects even as their morale will be sapped by the complexity of coping with a new banking culture and new practices at a time when they should be giving their undivided attention to scouting for borrowers and improving service delivery.

A follow-on question is this: Even if the short-term outcome is not promising, are mergers a net positive in the long term? That is not unambiguously clear. While organic mergers of banks motivated purely by business considerations lead to efficiency gains, whether arranged marriages of the type the government is organising are a good thing remains debatable.

On the positive side, large banks will entail cost advantages by way of economies of scale such as centralised back office processing, elimination of branch overlap, eliminating redundancies in administrative infrastructure, better manpower planning, optimum funds management, and savings in IT and other fixed costs. Large banks will also be able to finance large projects on their own even while staying within the prudential lending norms imposed by the regulator.

On the flip side, the biggest argument against big banks is that they can become too big to fail. The financial sector is all inter-connected and a risk in any part of the system is a risk to the entire system. If a large bank were to fail, it could bring down the whole financial sector with it, as was evident from the near death experience following the collapse of Lehman Brothers in 2008, which triggered the global financial crisis. No country can therefore afford the failure of a big bank. The tacit knowledge that the sovereign will be forced to rescue it encourages irresponsible behaviour by big banks.

One of the important reforms in banking regulation following the crisis was to curb this moral hazard by requiring regulators to identify systemically important financial institutions and subject them to higher capital requirements and more stringent regulation. Indeed, the country's largest bank, State Bank of India, was categorised by the RBI as a systemically important bank whose failure can have big negative externalities. The proposed mergers will increase this "too big to fail risk".

It will be tempting to argue that all our public sector banks (PSBs), big or small, operate in any case under an implicit sovereign guarantee with a built-in moral hazard. There is no additional risk from merging many small banks into fewer large banks. On the other hand, there could be efficiency gains.

This point can be debated but I do not want to get into that. What I want to do instead is to use that to segue to a larger debate which is that as far as PSBs are concerned, the issue is not big or small, but whether or not. Banks were nationalised 50 years ago in a different era, in a different context. In the event, PSBs rendered commendable service to the nation by deepening bank penetration into the hinterland and implementing a variety of anti-poverty programmes. PSB managers, especially at the front end, were entrepreneurial, innovative and committed. There were many factors responsible for India moving from low income to low middle income, and financial intermediation by PSBs has to find a place in that list.

Even as it acknowledges the contribution of PSBs, the government needs to confront a stream of $5 trillion questions. Do we still need PSBs? Isn't the financial sector wide enough and deep enough to take care of financial intermediation without the government at the steering wheel? Aren't there better uses for the government's mind space and its time?

There is wide consensus that today's economic slowdown is due both to cyclical and structural factors. By way of cyclical response, the RBI has cut rates and the government has announced a few measures like frontloading expenditures and slashing some taxes. Perhaps the RBI will ease further and the government will follow on with some more measures. The most these can do is to lift the growth rate to its potential.

But that will hardly make us a $5-trillion economy. We will become a $5-trillion economy not by growing at our current potential growth rate but by raising it. That requires structural reforms. The agenda for structural reforms is now a daily staple of our media discourse and there is no need to rehash that here.

Structural measures will take time to work their way through the system. But even the announcement effect of structural reforms can be stunning. If, for example, the government were to put out a roadmap for giving up its majority stake in PSBs, it will go a long way in shoring up sentiment and getting us off the block to a $5-trillion economy. An idea whose time has come?

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