

Macroeconomic Policy and Structural Reform The Indian Case

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The Global Economy and India

In their introductory chapter, Kemal Derviş and Homi Kharas discuss the limited political and policy space available to the advanced countries in dealing with continued sluggishness in the global recovery. As Martin Wolf has observed, in many ways it is incorrect even to talk of a double-dip recession for the U.S. or Europe. While the mix between overstretched households, undercapitalized banks and over-indebted sovereigns differs across countries, slow growth is both a consequence and a cause of the attempts to repair balance sheets in each sector. The synchronization of these stresses across the major advanced countries has further retarded the global recovery, in a way that was last seen in the 1930s. Even the crisis of the euro can be seen as a manifestation of the relentless interconnection between the overextension of bank credit (in this case to sovereigns), the bursting of a valuation bubble, and the resulting effects on economic growth and bank solvency.

The only silver lining is that corporate balance sheets remain robust in most advanced countries, although weak prospective demand inhibits fixed investment domestically. The ensuing diversion of investment to faster-growing emerging markets by advanced country multinational corporations, while supporting global growth, has become a divisive and controversial issue in home countries, notably the United States. And if history teaches us that balance sheet recessions linger on for a long time, the experience of the U.S. in the late 1930s and Japan in the 1990s also teaches us that intense political and market pressures for fiscal consolidation build up even when demand is weak. It can be persuasively argued that premature fiscal tightening in both those cases

aborted a nascent recovery. Indeed, for a given current account deficit, attempts to increase savings by households (and, as appropriate, to boost net worth by financial institutions) implies an offsetting deterioration in the net worth of the public sector. With monetary policy constrained, there are concerns today that simultaneous fiscal tightening in the United States, United Kingdom, Japan and Europe, although justified from a medium-run fiscal sustainability perspective, may be too harsh in the current environment of weak global demand.

Given these pressures in the major advanced economies, the rapid recovery and strong growth in the major developing countries have been a few bright spots in an otherwise gloomy global economy. Given the size of its economy, the contribution of China to global growth has been overwhelming. Its policy choices attract the most attention and rightly so. Despite the common practice of bracketing China and India together, the much smaller scale of the Indian economy (about one-third the size of China's) and the somewhat lower trade openness of India both imply that the significance of India to the global economy is much less than that of China. Nonetheless, India does currently add to aggregate global demand by running a significant current account deficit. More importantly, both for India's standing in the G-20 and for investment expectations globally, belief in India's longer-term growth prospects has provided a source of comfort. According to press reports, India is one of the "systemically important" G-20 countries being subjected to peer review under the Mutual Assessment Process (MAP) agreed to by the G-20 at Pittsburgh. Together with Canada, India is a co-chair of the so-called Framework Working Group set up at that meeting.

In this essay, I reflect on the dilemmas and tensions facing the Indian authorities as they prepare for the G-20 Summit in Cannes. I see these in many ways as analogous to those facing the advanced countries. I believe the situation is analogous for at least three reasons. First, for India too, a financially sustainable growth path requires a judicious mixture of demand management and structural or supply-side measures. Second, the parlous state of the global economy creates a confusing and difficult decision-making environment for the authorities. This makes it hard both to define the nature of the problem as well as to create a domestic consensus for the kinds of reforms that might be required. Third, the global financial crisis has sharpened the need for politically inconvenient decisions.

Indian Commercial Banking

A useful point of entry into some of these complexities was a recent decision by Moody's Investor Services to downgrade the so-called "standalone" rating of the country's largest commercial bank, the State Bank of India (SBI)¹, which the government is the majority shareholder. Such "standalone" assessments are separate from, but provide the basis for ratings of specific debt obligations issued by the institution concerned. In the case of SBI, the "standalone" rating (also referred to as the financial strength rating) was downgraded to D+ from C-, equivalent to a so-called Baseline Credit Assessment for the institution of Baa3. Consequently SBI, despite the support of the full faith and credit of the Indian government, is judged a weaker credit than its major private sector peers. SBI's current Tier I capital ratio is at 7.6 percent and is currently below the 8 percent that the government of India has committed to maintaining for public sector banks and well below that of the private sector banks listed above.²

SBI is the largest of the so-called "public sector scheduled commercial banks". It is India's oldest bank and, as the Imperial Bank of India, performed quasi-central bank functions until the Reserve Bank of India was set up in 1935. The government, acting through the Reserve Bank of India, became

the majority shareholder soon after India's independence in 1947 in order to provide direct policy guidance to the bank. SBI, together with its affiliates remained the only publicly-owned banks until Indira Gandhi nationalized the 20 largest privately-owned banks between 1969 and 1980 in order to pursue her socialist agenda. Following liberalization in 1991, a handful of new privately-owned banks were licensed and one of them has grown to be the second largest bank by assets in India. However, publicly-owned banks still account for about 70 percent of the banking business in India. Even after nationalization, SBI retained a substantial number of shareholders and has been a pillar of the portfolio of foreign institutional investors (FIIs), subject to an overall foreign ownership cap. There are a number of foreign banks in India who are important in foreign exchange and corporate business, but whose branch expansion has been tightly controlled.

In justifying its downgrade, Moody's observed that notwithstanding their expectations that SBI's capital ratios will soon be restored, "SBI's efforts to secure this capital for the better part of the year demonstrates the bank's limited ability to manage its capital". This refers to the reality that, for the government to maintain its majority stake, it has to subscribe *pari passu* with other shareholders and finds it inconvenient to do so given its announced path of fiscal adjustment and the impact of a slowing domestic economy. Moody's argues given "that a bank's ability to freely access the capital markets is an important rating criterion globally", a downgrade in the financial strength rating is justified. Looking ahead, Moody's believes that SBI will find itself capital constrained again in a relatively short period of time.

It goes without saying that the ratings agencies have not covered themselves with glory during the recent global financial crisis. They were deeply complicit in providing the highest credit ratings to synthetic instruments put together by clever investment bankers and their business models are shot through with conflicts of interest. At the same time, it is important to try to understand carefully

what signals this rating downgrade conveys in the present global environment, not just in the case of SBI but for the structure of the Indian banking system more broadly.

Fiscal Flexibility and Public Ownership

In exploring these wider ramifications, I would like to acknowledge the work of Viral Acharya of the Stern School of Business at New York University. Professor Acharya has been engaged in two parallel programs of work over the past year: one examining the evolution of regulatory reform in the advanced countries in response to the financial crisis; and the second examining market and regulatory responses to the crisis in the Indian banking system. His work is helpful in drawing parallels between the circumstances of the advanced countries and the case of India. These two streams of thinking have come together in a draft paper prepared for the International Growth Centre, which will soon be published by the centre.³ The paper examines the mechanisms by which the global financial crisis spread in the advanced countries, the appropriateness of the regulatory response as represented by the revision of the Basel III rules for regulatory capital and leverage for banks, and by the Dodd-Frank Act in the United States. While the paper has been designed primarily to be of interest to financial sector regulators, there are some important messages for a wider audience.

One key message from both the work on the U.S. and Europe for India is that there are significant, empirically substantiated links between government deposit guarantees and what finance professionals call “moral hazard”: the propensity of institutions which enjoy government indemnity to take risky bets in the expectation of a bailout. In the United States, elaborate regulatory machinery was set up in the 1930s to prevent commercial banks from gambling with insured deposits. The erosion of these boundaries in the mid-1990s is one widely cited explanation for the buildup of leverage that took place thereafter. The U.K. proposal to ring-fence the guaranteed activities of commercial banks and the so-called Volcker rule in the United

States are examples of initiatives designed to once again separate the protected and speculative aspects of banking.

What is the relevance of any of this for India? Acharya draws two implications, both of which I agree with. The first is that the natural tendency of a government-guaranteed institution will be to take on risky behavior and strong supervision is needed to counteract these tendencies. Here we have to deal with the ambiguity of the Indian deposit insurance system. In principle, a government guarantee of deposits is limited to small value deposits, supported by an insurance premium, and the same regime applies to both the public and private sector. In practice, it is widely assumed that the government will stand by all depositors in public sector banks, while its *de facto* stance where private sector banks are concerned has not been tested.

Given that 70 percent of banking assets enjoy *de facto* deposit guarantees, the government’s response has been twofold: intensive supervision and strong asset controls (primarily in the form of obligatory holdings of “riskless” government debt under the so-called Statutory Liquidity Ratio or SLR). While these strictures apply to all banks, on the basis of market reactions at the time of the Lehman crisis, Acharya argues that the private banks have so far been disadvantaged by the perceived superior safety of public sector bank liabilities.

However, it is Acharya’s second point based on the U.S. experience with the so-called government-sponsored enterprises (GSEs) such as Fannie Mae and Freddie Mac that is even more important in the Indian context. He argues that sooner or later the contingent liabilities represented by guaranteed deposits do get called and the country’s fiscal position needs to be strong enough to absorb these liabilities.

Moody’s rating action accordingly draws notice to two inconvenient truths about India’s current banking system. The first is that the largest public sector bank lacks the capital it needs to support the credit growth that the economy requires. Second,

the government is poorly placed to provide the additional capital needed or indeed to make good on the implicit guarantee offered to all depositors. The problem is now being aggravated by stubborn inflation that has required considerable monetary tightening, which is predictably putting stress on corporate balance sheets and hence the quality of bank assets, and by the overall reappraisal of the safety of sovereign debt that the European crisis has provoked. As Acharya argues:

“While the Reserve Bank of India has historically done a prudent job of containing the banking sector’s potential excesses, and the well-developed equity market counter-balances to some extent the lack of thriving fixed-income markets, it is clear nevertheless that there is a great deal of ‘fat’ in the government’s fiscal condition. There are excessive subsidies to farming and fuel, there are explicit and implicit government guarantees to state-owned banks, and a number of state-owned enterprises and sectors are poorly run and managed. A tidying up of the government balance-sheet on pretty much all of its dimensions may be India’s best preparation for any risks that it is exposed to, internally or externally”.

For India too then the continuation of the global crisis is likely to force fiscal adjustment to reassure the markets even as monetary tightening addresses stagflation. Ultimately, the government may be faced with the choice of allowing the public sector banks to shrink as a share of the banking system or to give up majority government control.

References

Acharya, Viral. 2012 forthcoming. “The Dodd-Frank Act and Basel III: Intentions, Unintended Consequences, Transition Risks and Lessons for India”. *International Growth Centre*, London and New Delhi.

Endnotes

¹ I served as an independent elected director (shareholders’ representative) on the central board of the SBI between 2002 and 2008.

² Tier I capital represents the highest quality equity and reserves available to a bank to absorb losses on its asset portfolio, resulting from changes in market valuations, credit losses, or operational causes such as fraud or technology failures.

³ Acharya (2012 forthcoming).