e-Resources Module-X

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Course: B.A. (Hons.) Economics, Sem.-VI Students of S.R.C.C.

BANKING CRISIS IN INDIA

Due to the bank-centric nature of Indian economy, any impairment of banking sector on account of balance sheet problems translates itself into a banking crisis and eventually an economic crisis. This evidently calls for prevention of any banking crisis in India through strict supervision and control whereby the accumulation of Non-Performing Assets (NPAs) is not allowed for in the balance sheets of commercial banks. Given that almost 70% of banking in India still continues to be in the domain of Public Sector Unit (PSU) or government-owned banks, it leads to a peculiar "Principal Agent problem" as the agencies that are supposed to regulate these government-owned banks are themselves appointed by the government. Consequently, banking crisis has become a recurrent phenomenon in the case of Indian economy. But in order to deal with the problem of NPAs, whenever the government goes in for recapitalisation of concerned banks, it not only hinders fiscal prudence but also encourages errant banks not to mend their ways. In view of this, it directly follows that instead of wasting its resources in bearing the fiscal costs of recapitalisation of PSU banks falling into trouble, the government should seriously consider diluting its share below 51% in such entities so that they could directly raise capital from the market.

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India is essentially a bank-centric economy in the sense that banks play a major role in promoting the growth of real sector by mobilising savings of the public in the form of deposits and distributing them as credit to productive deficit spenders so as to facilitate investment in the Indian economy. Due to this dominant role played by commercial banks in the growth process of the economy, any impairment of banking sector in India on account of balance sheet problems soon assumes the form of a banking crisis that hampers economic growth and eventually culminates into an economic crisis.

This evidently calls for preventing the occurrence of any banking crisis in India well in time before it could lead to a crisis situation in the real sector of the economy. However, the fact remains that banking crisis is a *recurrent phenomenon* in the case of Indian economy. For instance, even in the post-reform era, the Indian economy has witnessed two major banking crises *viz.*, the one during 1997-2002 against the backdrop of South-East Asian crisis and the other that started in the aftermath of the U.S. sub-prime lending crisis in 2008 and is yet not over.

It is worth noting that 14 major scheduled commercial banks were nationalised in India way back in 1969 and subsequently 6 more banks were nationalised in 1980. Consequently, despite the coming in of private sector banks in the post-reform era, a substantial portion of commercial banking in India say around 70% till date continues to be in the domain of government-owned entities or Public Sector Unit (PSU) banks. Such banks can never "fail" in the traditional sense of the term since the government has guaranteed to fulfil all their obligations in case, they would come across any possible "liquidity shortage". Thus, instead of illiquidity or insolvency, banking crisis in India typically manifests itself in the form of dubious & doubtful assets accumulating in their balance sheets which in due course takes the form of Non-Performing Assets or NPAs.

Evidently, effectively tackling the problem of NPAs calls for the *recapitalisation* of concerned banks but since there is a predominance of government owned or public sector banks in India, the financial burden of the same typically falls on the government in large part thereby degenerating into a fiscal problem *i.e.*, a problem of public finance. In fact, such a recapitalisation of PSU banks by the government not only goes against *fiscal prudence*, but could also lead to a *moral hazard* problem in as much as it gives no incentive to the errant banks to mend their own ways. In view of this, it becomes all the more desirable to *nip the evil in bud* by not allowing the accumulation of NPAs with banks.

But this is more easily said than done. For, given their ownership structure, the PSU banks are more prone to political influence. Further, prevention of Non-Performing Assets from accumulating with a bank calls for the building up of adequate regulatory capacity along with far-reaching reforms in bank regulation and supervision. Given that the agencies responsible for regulating & supervising banks in India *viz.*, the governor and deputy governors of Reserve Bank of India (RBI) are themselves appointed by the government, it leads to a peculiar “principal-agent problem” in the sense that government appointed agencies are supposed to regulate government-owned banks!

It is for all these reasons that it appears pertinent for government to rethink over maintaining ownership of almost 70% of banking sector in India. In this context, Rajeswari Sengupta and Harsh Vardhan are of the view that government needs to consider whether it is the best use of its resources to bear the fiscal costs of PSU banks whenever they fall into trouble though theoretically, most of these banks can raise capital from the market provided government is ready to dilute its share in them below 51%.