

Comment for 01 Buitter-Patel

Abhijit V. Banerjee: The paper argues that while deficits in India are large, at least in the short run the risk of a deficit-induced crisis is minimal. The main reason to worry about deficits is that they crowd out private investment and give the government reason to want the financial sector to remain inefficient, so that there is less competition for the savings. This, in turn, distorts the allocation of savings within the private sector, discourages entry and exit, and reduces the overall growth of the economy.

Buitter and Patel are not optimistic about the current efforts to rein in the deficit. In particular they believe that the recent efforts to bind the hands of the governments, through the Fiscal Responsibility and Budget Management Acts at the center and the Fiscal Responsibility Legislations at the state level, will be renegotiated when the crunch comes, because right now, there is no real constituency for shrinking the deficit nor any mechanism for automatically punishing delinquent governments (as there would be, for example, if most of the debt was foreign currency debt).

They seem less pessimistic about improving the performance of the financial markets. Their recipe is to make the financial markets more competitive by permitting more liberal entry by foreign intermediaries into the Indian market. They note in passing that this would also make it harder for the government to borrow and, interestingly, they see this as a two-edged sword: It would of course cost more for the government to be profligate, which would have salutary effects, but if the deficit remains large, the economy could be more prone to crises.

I tend to broadly agree with their conclusions, with one important exception. Let me start however with a few point of clarification. First, while the Fiscal Responsibility and Budget Management Acts may not in the end bind, they are very important steps toward enhancing the political salience of the deficit. By announcing a target, the government is setting up to fail in public, whereas before it used to fail in private---the press and the opposition can now attack it for renegeing on its explicit promise.

Second, the deficit has remained stubbornly high in the face of improved tax performance by both the state and central governments, which suggests that the real problem is the government's inability to resist populist demands. Hence, while there is a case for further tax effort (one could argue that India is still an undertaxed economy), one worries that any extra tax collection would only feed further profligacy, until the discourse of public expenditures is altered. Here I do not yet sense any progress---I do not hear anybody speaking the language of trade-offs. When a new initiative is proposed, we do not hear the government saying: "That was a bad program, all the money was going to the rich; let us get rid of it and replace it by this other better program." Instead, the program being introduced is always portrayed as a new gift from the ever-generous government, even though additional programs are often funded by quietly diverting money from existing programs.

Third, whatever the history, it is not clear that the banking system today is bailing out the government. In fact the reverse seems true: it is the government that is bailing out the banks--- **the government** could easily lower interest rates further if they wanted. The political economy of this is complex. The problem is that most middle-class people in India like to have their savings in safe assets, and they have historically been able to get decent returns by putting their money in bank deposits. At the same time, the banks could always lend to the government, and the government paid generously. This particular cozy arrangement has been unraveling over the last decade, as the government became more and more interested in reducing its interest costs.

Lowering interest rates further and borrowing less would force the banks to cut the rates they pay on deposits, which will be politically unpopular. Moreover given that the banks still have a large amount of high-interest liabilities on their books (fixed deposits and the like), there is some risk that cutting interest rates further would endanger the stability of some of the weaker banks. One can therefore understand why the government may be reluctant to move faster.

Which brings me to the one place where I disagree with Buitert and Patel. They end their piece with a plea for allowing the entry of foreign players into the banking sector as a way of making the sector more competitive and efficient. We now have a bit of evidence on the impact

of the entry of foreign banks that has already happened. Gormley shows that in the districts in India where foreign banks entered, the probability of getting a loan went up for the 10 percent most profitable firms, but the average firm was actually 7.6 percent less likely to have a long-term loan of any sort.¹ Gormley interprets this as an effect of “cherry-picking” by the foreign banks. The domestic banks, having lost their most profitable clients to the foreign banks, shrank away from risk taking and cut their lending to the more marginal firms.

All the accumulated evidence suggests that smaller firms in India are already underserved by the banking system. Banerjee and Duflo exploit two changes in the definition of the priority sector (it was expanded in 1998 and shrunk in 2000), as a natural experiment on credit access.² The results from both experiments are almost identical. They both suggest that for the firms that get more/less credit in the expansion/contraction (which are medium-sized firms in the organized sector), the marginal product of capital exceeds 80 percent.

The evidence from Gormley suggests that just the fact of entry by foreign banks spoils the climate for the smaller firms. There is reason to suspect that in this respect things would only get worse if, in addition, there were takeovers of domestic banks by foreign banks. The core problem in banking is how to make sure that loan officers are lending responsibly; in smaller banks, the loan officers can be monitored more closely and therefore can be given more discretion. As the bank gets larger and the chain of control becomes longer, more and more rigid lending rules replace discretion. This, as Berger and others show for the United States, means that the smaller and more marginal firms, which are the firms where judgment really plays a role in the lending decisions, tend to get less credit once a small bank is amalgamated with a larger one.³ It seems very likely that something very similar would happen if an Indian bank were taken over by a foreign bank (we already know that the extant foreign banks do not lend to small firms).

This is not to say that no action should be taken to galvanize the Indian banking system. It is indeed true that the structure of growth in Indian banking under nationalization was not aimed at generating competition. Every district was assigned a lead bank, and it was assumed

that the lead bank would dominate lending in that region. Vestiges of this system still persist, and in many districts, it is not uncommon to find that the dominant bank is one of the weaker and less dynamic public banks and that the better public banks hardly have a presence.

The natural solution to this problem is consolidation. The government should force the public sector banks to come together into a small number of much bigger banks, each under the leadership of one of the best public banks. It probably pays to involve some of the best “private” banks in this process as well. This will give each of these new “big” banks access to an established network of branches almost everywhere in the country and the ability to tap into the cheapest sources of savings. This will create a situation where multiple dynamic banks compete for clients in every location.

Consolidation is also an advantage from the point of view of selling off some of these banks to private buyers (or even foreign buyers), since there is less risk that the government will end up holding on to the weakest banks just when competition heats up. This is especially important because, as Buiters and Patel note, everybody in the system assumes that the government is liable if any of the banks collapse.

Even with consolidation, however, this assumption of liability remains a major problem for a government that is thinking of selling off the controlling shares in the banks to the private sector (or foreign private sector). The danger is that the Indian state will continue to be liable after they have sold out, because this is what the public expects. This would mean that the gains from risk taking go to the owners of the bank, but that the government would have to foot the bill in the event of a disaster. Let me end with two suggestions about how to deal with this issue: first, the government should hold on to a significant amount of equity in these banks even after the control rights have been transferred, to make sure that it shares in the gains from increased risk taking. Second, the liability should be structured to make sure that a substantial part of the buyer’s total assets (and not just the assets of the Indian subsidiary of the foreign company), are backing the purchase. What we want to avoid is an Argentina-like situation where the foreign owners of the failed Argentine banks could walk away with their non-Argentine assets intact.

Banerjee, Abhijit, and Esther Duflo. 2004. “Do Firms Want to Borrow More? Testing Credit Constraints Using a Directed Lending Program.” MIT, Department of Economics.

Berger, Allen, N., and others. 2002. “Does Function Follow Organizational Form? Evidence from the Lending Practices of Large and Small Banks.” NBER Working Paper 8752. National Bureau of Economic Research, Cambridge, Mass.

Gormley, Todd. 2005. “Banking Competition in Developing Countries: Does Foreign Bank Entry Improve Credit Access?” MIT, Department of Economics.

¹ Gormley (2005).

² Banerjee and Duflo (2004).

³ Berger and others (2002).