The Huge Danger Associated with Privatising Banks*

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There are fundamental objections to the plan of the government to privatise at least some of the public sector banks. They centre around the fact that such a move will change the pattern of deployment of credit, away from productive activities towards speculation, away from peasant agriculture towards big business (with dangerous implications for peasant viability, food security and employment), and away from domestic to global destinations. These objections are well-known and have been much discussed, and their pertinence has been underscored by the fact that Indian public sector banks were completely untouched during the "sub-prime-lending crisis" of 2008; but the government, concerned more with pleasing domestic and foreign big business than with the nation's well-being, predictably ignores them. My purpose here however is not to reiterate these objections; it is to point to another serious danger from privatisation which has been less discussed and which the country can ill-afford to ignore.

During the dirigiste period, bank-loans were used primarily to fulfil short-term credit needs, such as to finance inventory-holding in trading and industrial establishments, while long-term financial needs, for fixed capital formation, were fulfilled through a set of specialised financial institutions that had been set up just for this purpose. These institutions got their funds from government sources, such as the profits of the Reserve Bank of India, and gave loans at low interest rates, lower than the rates that the banks charged, and often even at negative real interest rates (i.e., the nominal rates they charged were lower than the rate of inflation) in order to encourage investment.

With "liberalisation" however this entire arrangement changed. The earlier specialised financial institutions disappeared in their old form, some like IDBI converting themselves to banks. Long-term financial needs of units were now supposed to be met through the capital market, from where also whatever financial institutions existed for giving long-term loans, were to raise their funds. But if an investment project was not profitable enough, or was too risky, then capitalists, instead of approaching the market, started approaching public sector banks even for long-term loans. And the banks have ended up giving large loans, especially for infrastructure projects, with the government pushing them to do so. As a result, the public sector banks, precisely because the government can arm-twist them into giving the loans it wants them to, have developed balance sheets that portend danger.

Banks obtain their resources from the deposits of the public which can be withdrawn by the public at a moment's notice. If a significant part of these resources is used for giving loans for long-term investment, then in effect the banks are "borrowing short to lend long", which exposes them to a potential illiquidity crisis. If many depositors decide suddenly to withdraw their deposits, then the bank collapses; and even if only a few depositors wish to withdraw, and word gets around that the bank may face illiquidity, then there is a run on the bank making it collapse. To prevent such a possibility, banks whose liabilities are short-term, generally hold assets too that are short-term; since short-term assets, by definition, can be liquidated without involving much loss of value, the danger posed to a bank by a sudden withdrawal of deposits is thereby minimised. But if the assets are long-term, then their sudden sale involves a substantial loss, which therefore makes a sudden withdrawal of deposits from the bank much more difficult to negotiate.

The public sector banks have not just given loans for the acquisition of long-term assets; much of the loans they have given are for infrastructure projects, which have a long gestation period, where time and cost-overruns are common, and where profits appear, if at all, only after a long period of time. The fact that a good part of such loans can be counted among the "non-performing assets" of the banks should come as no surprise. But even that part which is not officially counted as NPA, nonetheless falls under the category of "stressed assets". Thus the public sector banks have been pressurised by the government, not just into giving long-term loans but into giving "stressed loans". They are in short sitting on top of a volcano that can erupt at any time.

The reason it has not yet erupted and continues to remain dormant is because these banks are government-owned; the public whose deposits have been used for such financing is not panicky: it has the confidence that if the banks face a crisis, the government that owns them will necessarily come to their rescue. And this confidence is precisely what prevents the banks from facing a crisis.

Everywhere in the world crises of the financial system have arisen when privately owned financial institutions have developed over time an asset-liability mismatch. The East Asian financial crisis towards the end of the last century provides a classic example. Take the case of the South Korean banks. They had attracted foreign currency deposits, and used the proceeds to make loans domestically for long-term investment projects. This meant a double mismatch between their assets and liabilities: first, they were "borrowing short to lend long", i.e. using resources garnered through bank deposits to finance investment projects; and, second, they were borrowing in foreign currency to finance projects that were themselves not foreign exchange-earning. Inevitably, the crisis came, and, when it did, it was particularly severe.

Even the financial crisis in the United States in 2008 was a reflection of such a mismatch. During the Great Depression the Roosevelt administration had passed the Glass-Steagall Act in 1933 that had strictly separated commercial banking from investment banking. Commercial banks, being deposit-financed, were confined to giving short-term loans, while investment banks, not being deposit-financed could engage themselves in giving loans for stock-market activities. This Act was in response to the fact that the Depression had seen a run on banks as they accepted deposits but used their resources on the stock market, a run that had been stemmed only through considerable effort on the part of the US government, including Roosevelt's famous "fire-side chat" broadcasts. Glass-Steagall however was repealed in 1999; and that created the conditions under which the financial system once more faced a severe crisis. To be sure, it was not the only factor behind the crisis; there was a serious underestimation of lending risks across the spectrum, which is why an investment bank like Lehmann Brothers went down. But given this underestimation of risks, the fact that commercial banks too were exposed to the financial crisis was because they had been giving loans against assets that had earlier, i.e., during the dirigiste period, not been part of their usual business.

In India public sector banks too have been exposed to unprecedented risks because of government arm-twisting; they have so far been spared because of the depositors' faith in the public sector. If they are privatised then the volcano on which they are sitting will erupt and the depositors will be hugely and adversely affected. This will not just affect the depositors; it will have a serious and damaging impact on the Indian economy.

It may be thought that the depositors will entertain the belief, even in the event of privatisation, that the government will come to the rescue of the privatised bank just as it would have done if the bank had remained in the public sector; and that this belief itself will prevent any crisis affecting the banks. But this belief has very little justification: the kind of political pressure that can be mounted on the government if it is the direct owner of the bank, will be absent if the bank is privately-owned.

In short, given the asset-liability mismatch of the public sector banks that has been forced on them by the government, its washing its hands off them by privatising them will be an act of utter irresponsibility. It will not only expose the ordinary depositors of the country to the possibility of severe financial loss, but will also eliminate for a long time the public's faith in the banking system, causing a shift in its asset-preference towards currency hoards and away from bank-deposits. This would be a retrograde move that would damage for long the prospects of development.

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