Bank Privatization and the Never-finished Neoliberal Agenda*

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The long-standing debate on whether India's public sector banks should be privatized has resurfaced in recent days. Two articles, besides numerous statements from advocates of 'reform', triggered this round of debate—one wittingly and the other, perhaps unwittingly. The contribution that argued for immediate action in the form of privatization, and was presented at the India Policy Forum, was authored by two established and well-known economists (Poonam Gupta and Arvind Panagariya) who have been closely engaged with Indian policy making in senior positions. It makes a case for privatisation of all public banks, except for the State Bank of India, which is expected to take on the developmental responsibilities that private banks are unlikely to shoulder, given the adverse implications for margins and profitability. The other is a research article authored by three officers (Snehal S. Herwadkar, Sonali Goel and Rishuka Bansal) in the Department of Economic and Policy Research of the Reserve Bank of India, published in the RBI Bulletin of August 2022, which was clearly part of the research output of the department, and focused on the performance of public banks in India.

The bank denationalization agenda was revived by the finance minister in her 2021 Budget speech, which announced plans to privatize two public sector banks and a general insurance company. Clearly the India Policy Forum input was not satisfied by the ambition implicit in that promise.

It appears coincidental that the research article from the RBI's offices was published at a time when the debate on privatization was being rekindled. But the article received more attention than research output from the RBI normally gets, because it pointed to the important and even crucial role that the public banking system played in ensuring financial inclusion—by extending the reach of banking; and raising lending to previously neglected regions, sectors and groups. Referring to a core theme in the Gupta and Panagariya article, the RBI researchers argued that while on pure profitability grounds private banks in India appear more efficient than public ones, when financial inclusion indicators are added to the objective function public banks turn out to be more efficient. Moreover, public banks unlike private ones are counter-cyclical in their lending behaviour, playing an important role in times of stress. Underlining this multi-faceted role of public banks, the article called for both caution and gradualism when privatizing public banks, if that was contemplated at all.

Even if not revelatory in terms of the evidence it collated, versions of which have been highlighted by many for quite some time, the contribution from the RBI researchers was significant for having once more underlined the fact that the years since nationalisation of leading banks in India (14 in 1969 and another 6 in 1980) have seen the achievement of the goals, the pursuit of which motivated bank nationalization in the first place. In the years after Independence, till 1969, besides creating one major public sector bank (State Bank of India) with developmental priorities, by nationalizing the Imperial Bank of India, the government directly and through the RBI attempted to cajole and persuade the private banks to expand to underbanked spaces and take on developmental responsibilities by sacrificing a small share of their margins. That effort proved to be a complete failure. The lesson drawn was that yield-seeking privately owned banks, in which equity infusion by the owners was a miniscule proportion of the public savings mobilised as deposits, were unlikely to take on any developmental responsibilities. Even by the mid-1960s, the agricultural sector accounting for a large share of GDP and of employment, received less than 2 per cent of the advances of the scheduled commercial banks. What is more, a significant share of advances of individual banks were being diverted to projects in which the private owners or directors on their boards had an interest. It is this refusal of the private banks to be more inclusive in their operations and support the government's efforts to accelerate development that necessitated nationalization and forced the government to take that route.

When recognizing the success of that policy, the assessment by the RBI researchers was that privatisation or denationalization would result in a setback on the financial inclusion front, and would damage the larger development agenda. Note, the article was not making a case against privatization, but for gradualism in implementation, in keeping with the first step of two-bank privatisation announce earlier by the finance minister. Yet the article was interpreted by many, as pointing to the erroneous nature of the policy direction the NDA government is clearly inclined to take, and that neoliberal reformists have backed.

Given this conflict between what the government is advocating and what the article's argument and conclusions are, the attention the latter received troubled the senior management of the central bank. In an unusual move, the RBI issued a clarification which repeated the caveat that "the views expressed in the article are those of the authors and do not represent the views of the Reserve Bank of India" and went on to quote sentences from the article to establish that even the authors were "of the view that instead of a big bang approach, a gradual approach as announced by the Government would result in better outcomes."

This sensitivity to suggestions that the central bank and the government are not on the same page is partly a reflection of the recognition that the NDA government is keen on completing a process of banking liberalisation heralded by the Narasimhan Committee reports of 1991 and 1998, by privatizing the banks that had been nationalized starting 1969. To give power to that policy inclination, Gupta and Panagariya reiterate most of the arguments that have over time been advanced to denationalize and privatize the public banks. In the process they convert the achievement of many of the objectives of nationalization into evidence of failure. One example is the lower relative profitability of public as compared with private banks. Nationalization was deemed necessary because the single-minded pursuit of profit by private banks precluded creating branches in underbanked areas that would be needed to provide small sized loans to dispersed borrowers like small peasants, who in any case are vulnerable to crop failure. Not only are such branches considered unremunerative, but such lending is not preferred because the higher transaction costs and risks associated with such lending makes it less profitable than commercial lending to businesses or retail lending to middle and upper-middle income borrowers. Yet broad-based and inclusive credit delivery is a must for successful development. Public ownership of banks was seen as a way of ensuring that, and nationalization did indeed deliver.

A second claim is that public ownership leads to distorted lending, with direction of credit to sectors and target populations that are not just less profitable but also more prone to. Targeted lending to priority sectors by banks under public ownership is seen as having resulted in high levels of non-performing assets that eroded the ability of these banks to offer adequate credit to productive sectors. Together with ‘excess’ lending to government, this is seen as having displaced profitable and safer lending to the private sector. What is underplayed in that reasoning is the fact that government policy has in recent years worked to divert public bank credit to the corporate sector with adverse consequences. This included large credit packages for private or joint-sector infrastructure projects from the public banks. Conventionally, banks do not finance such projects because of the large investments required and the lower or absent profitability. Moreover, such investments are relatively illiquid, since finding buyers for securities associated with such projects is not easy. On the other hand, they involve large gestation lags and tend to be riskier. For these reasons, banks that mobilise money from savers interested in instruments characterised by shorter maturities, greater liquidity, and low risk, are averse to lending to such projects given the maturity and liquidity mismatches involved. Thus, specialised development banks were established to finance investments of this kind.

But since after liberalisation the development banks in India faded away, but there was a need for enhanced investments in infrastructure, the government decided to use its ownership of public banks to get them to lend large sums to the corporate sector for infrastructural projects. In time many of these projects performed poorly and despite much help in the form of restructuring of loans on extremely favourable terms defaults could not be avoided leading to a sharp spike in non-performing assets in the banking system. These NPAs were not on account of lending to the priority sector but on account of lending to corporates, in keeping with the needs created by neoliberal reform. Rather than locate the large NPAs of recent years to these liberalisation-linked developments, Gupta and Panagariya attribute it to public ownership to buttress the case for privatisation.

Finally, public ownership of banks is seen as a remanent of the policy of “financial repression”, which controlled interest rates, regulated lending and securities investments, and restricted competition between banks to prevent them from raising deposits rates to attract savers and investing in higher risk projects involving higher returns. This was seen as limiting savings and diverting investment away from the highest yielding projects. However, as revealed by multiple banking crises across the globe since financial deregulation began, especially the global financial crisis in 2008, the case for such deregulation and liberalisation has taken a hit. That has not prevented neoliberal ideologues from advocating such ‘reform’.

These aspects of the role of public banks and the failure or weaknesses of private banks possibly explains the fact that successive governments with a neoliberal agenda have not been able to roll-back nationalization, even though the denationalization and privatization campaign began around thirty years back. That fortuitous ‘failure’ shows that the criticism of public ownership of banking is misplaced, and that policies of liberalisation and deregulation have lost their legitimacy. It is not the officers of the RBI, but those pushing for privatisation who need to be reined in.

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