GUBERNATORIAL AMBITION

Last week I went up to an office in Hornby Road – now predictably and boringly called Mahatma Gandhi Road – and looked out on the Reserve Bank Building. I imagined Urjit Patel sitting in a comfortable armchair on its top floor; then I remembered that Raghuram Rajan's term has not yet ended. I shall miss him for his wit no less than for his economics. My hope is that he will continue to exhibit both and entertain us in some other post. I also hope he will write about what he learnt about the Indian economy, for good economic analysis is scarce in our country.

But now it is time to look forward to Urjit Patel's tenure. He is not a public performer like his predecessor, but he is a solid, reliable economist. The obstacles to achieving something in our government are formidable, and the governor faces frequent sabotage from Delhi if he does not toe its line. Rajan achieved little, but made great headlines on account of the sabotage. While grand fights are always fun for a watcher of public affairs, even a watcher like me would wish that Bombay and Delhi would work together to improve the country's economy. Assuming that he will get more cooperation from Delhi, what are the things he should try to achieve?

The core business of Reserve Bank is monetary policy. A committee chaired by Urjit Patel wrote a very good report on it almost two years ago. The government accepted one of its criticisms, namely that its persistent raising of minimum support prices of foodgrains was an important cause of inflation, and slowed down increments. The committee also described the infirmities of Reserve Bank's primary tool, interest rates, to control inflation. It could have said more frankly that fiscal deficit is a major source of inflationary pressure, and that unless governments reduce it, inflation cannot be controlled by Reserve Bank alone. Much as one may wish, I do not have great hopes of Delhi becoming more responsible, so control of inflation is likely to remain on back burner.

What then can Reserve Bank focus on next? I think it should be more competitive interest rates. As in many things, we have a dual market in loanable funds. There are funds from banks, largely owned by the government. They are an oligopoly, and charge extremely high margins; the difference between the rates they pay depositors and those they charge borrowers is enormous. And there is a cosy relationship between banks and their borrowers. Banks keep lending to their favourite borrowers with little consideration of their quality; this is a major, though not the only factor behind the high bad debts of banks, given the less shocking name of non-performing assets. The government's approach is to legislate measures that would enable banks to appropriate assets of their borrowers. Borrowers are well aware of this possibility, and take timely action to remove the assets from their companies that have borrowed from the banks; so banks get back very little of their bad debts. Is there a better way of resolving this problem?

I think the solution lies in creating public information about the quality of borrowers; and the way to do so is to create a competitive debt market that all potential borrowers can enter. There should be a debt market in every town; it should trade in loans of standard tenures, say a quarter, a year, two years and five years. Any local business with five years' published financial results should be allowed to float debt in the market. The banks should be major participants in the market, selling off the loans they have given and investing in businesses they consider reliable. The market should be equally open to non-bank lenders, whether businesses or individuals. The solidity of the businesses will be reflected in the market rates of interest they will pay. Competition in the debt market will have an additional advantage, that it will put pressure on banks' profits and force them to control costs.

Debt is one type of finance; equity is another. The Indian equity market has been virtually killed by Securities and Exchange Board of India. It allows only the safest companies to raise equity. It judges safety by whether government financial institutions and similar conservative financiers are prepared to buy the shares of a company. As a result, it has made it difficult for enterprise and innovation to get access to the capital market. The consequences are dire. Few Indian companies have done well abroad, whether in terms of trade or investment; the reason is that SEBI has discriminated against risk-taking. It has also squeezed out small companies out of the capital market; so it is difficult for them to grow. India has thousands of small and medium businesses, but few of them become national or international successes. The reason is the negative, bureaucratic approach of SEBI. One consequence of the scarcity of equity is that firms that need equity contract debt instead; debt becomes riskier as a result. One way out, as I suggested above, is to create markets in debt that would reveal the risk attaching to it. Another would be to let banks invest a certain proportion of their assets in equity.

This proportion cannot be high. A third way is to lend to companies on the collateral of their own equity. Its proportion too cannot be high; and the ownership pattern of the company's equity would be relevant to how much can be lent to it. The point is, however, that because of the damage SEBI has done to the equity market, corporate risk spills over into debt, and adds to the risks faced by banks. They face crises related to nonperforming assets once in a decade on the average. Once they are in crisis, the only solution is baleout from the central budget – for government banks at any rate, and they constitute roughly four-fifths of the banking system. In other words, the taxpayer pays the cost of the government's mismanagement of the capital market. The remedy does not lie within the powers of Reserve Bank; but the consequences are borne by the banking system and are therefore very much the concern of Reserve Bank. It is the duty of its governor to press this analysis of Indian financial malaise upon the government, and to persuade it to adopt the structural remedies which require its initiative and assent. Rajan did this to some extent, and without success. Urjit Patel will have to find his own way of doing it. Although the governor lives and works in luxury, his job is not a comfortable one, especially if he chooses to do it seriously. It is the job of a diplomat, nor one of a ruler. The rulers in Delhi generally have a myopic view of the economy, for they have to face elections every five years and cut-throat competition of their fellow politicians in the meanwhile. The governor has to catch their attention and egg them on to make small reforms from time to time. Urjit Patel will need all his skills in doing so – and much luck, which I wish him.

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