Bank Ownership and the Effects of Financial Liberalization: Evidence from India (by Gupta, Kochhar and Panth)

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Introduction

- Does financial sector reforms ("liberalization") affect the deepening of lending to the private sector?

- Various reforms:
  - Entry of private and foreign banks into state-owned banking sector
  - Liberalization of interest rate controls
  - <u>Reductions in cash reserve and statutory liquidity ratios (CRR, SLR)</u>
  - Inter-bank markets, repo and reverse repos, etc.

Introduction (cont'd)

- Seems like a reasonable question to ask
- Traditionally, CRR and SLR's have been thought to be binding constraints
- If so, their relaxation should lower banking sector's choice of cash and liquidity holdings, in turn, private sector lending
- Somewhat surprisingly, this does not seem to be the case, in bank-level data during 1991-2007,

Conclusions drawn

- Liberalization need not necessarily produce expected gains for the economy
- It depends in this particular case on the ownership structure of the banking sector, public vs private
- “Political” reasons for public-sector banks not increasing their lending in spite of flexibility to do so

Some Issues

- Level of lending or its efficiency?
  - Allocation of credit may be more important than its level
  - Worth checking if this changed or not
  - In any case, it is fair to say that the priors were liquidity constraints were binding and level of lending should have gone up following liberalization of CRR and SLR ratios
- What else happened at time of liberalization?
  - Liberalization coincident with economic growth
    - Booming stock markets provided funding rather than bank

Some Issues (cont'd)

- Public sector banks are "lazy" – but why?
  - Poor governance: automatic stabilizer in the form of government recapitalization discourages effort
  - Theoretically, excessive risk-taking also possible (even under liberalization, but especially with government guarantees)
  - Is the regulator/supervisor too conservative and banks too meek?
- Conjecture 1: Is the binding constraint priority lending norms rather than CRR and SLR ratios?
  - Perhaps CRR and SLR have been high as banks have been rather risky

The result I liked the most…

- Lending by banks (esp. public sector banks) is weakest when government deficits and indebtedness are high
  - Is the government borrowing "crowding out" private sector?
  - Public-sector banks are a convenient mechanism to raise insured deposits and fund government spending
    - May be benign, could be wasteful
    - Examples: Fannie-Freddie and US home ownership subsidy
  - Government bonds become riskier when fiscal situation tightens…

Conclusion.

- Nice paper.
- Surprising finding.
- Should attempt to “nail down” the exact reason driving the finding and check its robustness.
- We might be able to learn about the costs of perpetual footprint of the government in financial/banking sectors, especially when there is fiscal stress (which may itself be endogenous