

A new impossible trinity?

In the early 1960s, Nobel Laureate Robert Mundell propounded the thesis that liberal capital movement, an independent monetary policy and managed exchange rates form an impossible trinity, and policymakers need to give up one of the three. Do bad debts of the banking system, monetary/fiscal constraints and Basle III capital ratios which envisage bail-in of bank creditors, form a new impossible trinity? Banking system's bad debts are becoming a matter of concern not only in India (the recent Financial Stability Report of the Reserve Bank discusses the issue at length), but also in the euro zone; Ireland and Spain a few years back, and Italy and Greece now. The two Anglo-Saxon economies had their own banking crises not too far back, and one of the fallouts has been the higher, risk-based capital charges for the global banking system (Basle III). Many European banks including in Germany are having problems in meeting the capital ratios. One reason is the ultra-low, indeed negative, interest rate regime followed by the European Central Bank for the last several years, which squeezes the net interest income, the principle source of earning for most banks: ECB's current rate on short term bank surplus funds placed with it is a negative 0.4%! And capital constraints inhibit an increase in lending which is so essential for growth to pick up: the inflation target of the ECB remains elusive despite years of ultra-loose monetary policy.

Before looking at the situation in India, it may be useful to look at the current problems, particularly in Greece and Italy, as this may help in forming a better perspective on the issues involved: as the old saying goes, it is much cheaper to learn from others' experiences than from your own. Greece's GDP has dropped 30% since the crisis of 2010 and the fiscal austerity program imposed on it by its creditors. With falling incomes, mortgage loans are not being serviced and many small businesses have had to close down. Nor is large industry immune: recently one of the largest Greek businesses collapsed, and the promoter committed suicide. Greece has a bank rescue fund but recently three of its top executives were forced to resign under pressure from international creditors. The government has no money to bail out the banking system – and the 'bail-in' of creditors, mainly depositors, is not a politically feasible proposition.

Italy's problems are not much simpler, after a three year recession. Given bad debts amounting to 20% of GDP, while on the one hand Italian banks need additional capital, on the other, for the very same reason, private investors are not willing to subscribe. (The shares of Italy's largest bank are quoted at 25% of book value!) There are also major constraints on public funds being used to recapitalise the banking system as the Prime Minister would like to. For one thing, the banking regulations in the euro zone inhibit this; again, funding from fiscal resources would mean that Italian government would cross the '*Laxman Rekha*' of the limit on fiscal deficit. The overall dimensions of the problem have become so large that they are beginning to have political repercussions. In recent polls, Italy's extreme right wing party is ahead of the ruling centre-left coalition, after two holders of a compulsorily convertible ('CoCo') bond of one of the smaller banks was so converted, and they committed suicide: they probably had invested all their savings in the bond.

In some ways, there is a parallel between the constraints on public sector bank recapitalisation in India, and in Italy. Our growth is much higher, but the Reserve Bank is not very happy about its capital being used to capitalise the public sector banks either directly or through a dividend to the Government; a bank holding company with a significant government shareholding supported by outside investors is another idea that has been talked about, but has its own problems and limitations. And, Delhi has tied its own hands by the fiscal deficit target. While ultra-low/negative interest rates is not a problem for Indian banks, as it is for their European counterparts, are they so high, at least in real terms, as to make debt servicing a major problem for the corporate sector? But more on this in the next article.

The whole situation reminds me of an old Marathi saying which voices a child's dilemma: '*My mother is unable to feed me and my father does not allow me to beg*'. What should he do?

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