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Subir Gokarn: Withstanding the waiver

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The agricultural loan waiver can be an opportunity to turn good politics into good economics.

By far the most prominent issue in the post-Budget discussions that went on through all of last week is the Rs 60,000 crore farm loan waiver, which, ironically, wasn't even a Budget item to begin with. As with many grandiose announcements made in Budget speeches, this amount was not provided for in the Budget numbers and, therefore, strictly speaking, has no impact on the fiscal situation for 2008-09.

In response to the wave of criticism, mostly premised on the moral hazard issue and the impact that the waiver would have on future repayment behaviour, the government has provided an economic rationale for the move by arguing that, since much of this money would not have come in anyway, the waiver provided banks with an opportunity to write off a large number of potentially bad loans and write back the provisions that have already been made against them. Add to this the tax saving from the write-off and you might have a situation in which some banks actually come out ahead!

Even if valid, this represents a rather static view of the situation. The concern is not about the immediate consequences of the waiver on the banking system's finances. It is with what the waiver does to its ability to enforce loan contracts in the future, particularly with farmers who have historically had a good record of compliance and are now induced to believe that defaulting is entirely rational. No, there is no rationale for the waiver other than a purely political one. Once we accept this, it leads us down another line of reasoning, focusing on containment and mitigation.

Presumably, the government believes that, other things remaining equal, the loan waiver will improve its chances of returning to office. Otherwise, the waiver would have been a "scorched earth" measure, leaving the mess in the agricultural finance system for the successor government to deal with, a far-fetched explanation. Assuming that this government accepts it will be in office when it comes time to pick up the tab on the waiver, what should it do to minimise the size of that tab? In other words, whatever we might think of the waiver, it is a fait accompli. The question is now one of restricting its adverse impact on the financial system.

Three categories of mitigating measures need to be brought into play. The first relates to "incentives". How do the banks ensure that farmers who have maintained payment schedules and therefore do not get any benefit from the current waiver continue to behave that way? Declaring defaulters ineligible for future loans would be a market solution, but one that is clearly ruled out by the announcement itself. Notwithstanding this, differentiation can be practised in many ways.

For example, borrowers with good records can be given a small, but visible, discount on their interest rates. The credit limits of farmers who do get the benefit of the waiver could be curtailed by more stringent collateral standards. The bottom line is that a farmer who isn't in distress should be indifferent between defaulting and repaying, based on his calculations of future costs and benefits between now and the time the next waiver can be expected to be given, five years hence. Do the banks have the ability to meaningfully differentiate this way? If so, the ability needs to be enlarged; if not it needs to be created.

The second category of measures can be classified as "insurance". Crop insurance, not a particularly successful venture at the national level, is only one dimension of a comprehensive insurance programme. We need to identify the various risks that are present in any agricultural environment "" production, price and disaster, broadly speaking and sub-categories within each of these. Each one will have one or two approaches, which are efficient in the sense that they can be provided for through a reasonable contribution from the individual, the state government, the central government and even possibly a fourth stakeholder, such as a retail supply chain.

In fact, the reason why the farmer receives such a small fraction of the price that a consumer pays for his product is precisely because of the number of intermediaries in the supply chain, each of whom has a limited capacity to bear risk. Finding more efficient ways to mitigate the overall risk will simultaneously lower the consumer price while enhancing farmer realisations.

One critique of the loan waiver, even from people who seem to support it, is that many of its intended beneficiaries are severely indebted to moneylenders, so their situation is not going to improve at all. In this context, the recommendation of the Radhakrishna Committee on rural indebtedness to set up a moneylender loan redemption fund needs to be seriously considered. A debt swap is certainly superior to a debt waiver, but it will provide an enduring solution only if the new source of debt can effectively meet all the requirements that the old one used to. This is where the third category of mitigating measures comes in. We can broadly describe it as "institutional".

One obvious reason for the persistence of the moneylender even as the banking system has expanded in the rural economy is his far greater flexibility with regard to immediacy, end-use and acceptance of collateral. The total credit requirements of farmers lie far beyond the banking system's capacity with respect to these three critical parameters. Institutional reform, either by creating special vehicles or by re-orienting traditional rural lending practices of the financial system, is a necessary component of a successful debt swap.

Rather than trying to put a "good economics" spin on the waiver, as it is currently doing, the government should accept that it was a political move, which can potentially have serious consequences for the banking system if it is not managed right. Once the issue is framed in this way, the focus can shift away from whether the waiver is a good or a bad thing, which is now a pointless debate anyway, to what is being done to not only contain its immediate impact on the financial sector, but also using it as an opportunity to address some of the enduring problems in agriculture.

In short, good politics will translate into good economics if the political dividend from the waiver is channelised into significant reforms in the agricultural sector. Without this, notwithstanding the intentions behind it, the waiver could well prove to be a "scorched earth" measure.

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