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The Impact of National Budget and Monetary Policy on Profitability and Operational Efficiency in Public Sector Banks: An Empirical Analysis

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Abstract

This research paper is a study of the influence of national budgetary steps and monetary policy instruments on the performance of Public Sector Banks (PSBs) in India in terms of profitability and operational efficiency. The study uses a panel dataset of the top ten PSBs from 2013–2023 to estimate the effect of fiscal transfers (such as recapitalization and sectoral spending) and the key monetary variables (such as the repo rate, cash reserve ratio, and inflation) on various bank-level indicators such as Return on Assets (ROA), Return on Equity (ROE), Cost-to-Income Ratio, and Non-Performing Assets (NPAs).

The evidence indicates that PSBs' fiscal interventions, i.e., the capital infusions supplied by the government, have beneficial effects on the profitability as well as asset quality of the banks. By means of fiscal interventions, the capital situation of banks receives a boost, credit management is strengthened, and lending operations, especially, receive a push under economic slump. Conversely, tight money measures such as increase in repo rates and increased cash reserve requirement work in the opposite direction of operational efficiency by increasing the funding cost of banks. Such measures decrease net interest margins, increase the cost-to-income ratio, and can harm overall bank performance. Moderate inflation levels surprisingly have a positive relationship with loan recovery rates and interest spreads.

Briefly, this article highlights the interdependent nature of monetary and fiscal policy and PSB performance and identifies that although government support can be integral in enhancing bank performance, tightening monetary policy can stifle efficiency. The article evokes the necessity for effective policy coordination for maximizing the utilization of fiscal and monetary tools towards enhancing the banking sector.

Keywords: Public Sector Banks, National Budget, Monetary Policy, Profitability, Operational Efficiency, Capital Infusion, Repo Rate, Cash Reserve Ratio, Cost-to-Income Ratio, Non-Performing Assets, Fiscal-Monetary Coordination, Indian Banking Sector

INTRODUCTION

In developing economies such as India, Public Sector Banks (PSBs) are of great importance in the overall functioning of the economy through the dynamics of financial inclusion, credit provisions, and support for government policies. Given their large market share and systemic importance, PSBs are, by their very nature, subject to national budgetary policies as well as monetary policy decisions made by the highest central authorities. In many respects, these policies define how banking-sector performance is judged regarding profitability or operational efficiency and asset quality.

Among the key policy tools through which the government infuses capital, allocates funds for different sectors, and sets fiscal priorities is the National Budget. Thus, capital infusions and policies regarding the recapitalization of PSBs and public investment in infrastructure are important for PSBs. Fiscal allocations from such activities will help PSBs maintain solvency, absorb shocks, and support lending. On the other hand, the operations of PSBs are directly influenced by monetary policy set by the central bank, typically through changes in interest rates (repo rate) and liquidity management tools (cash reserve ratio and statutory liquidity ratio). Changes in interest rates will hit the banks' lending rates, the cost of borrowing, and ultimately the marginal profitability.

Despite the enormous role of PSBs in supporting the nation's economic growth, very few studies have looked into the conjoint effect of fiscal and monetary policies on PSB performance. Existing studies mostly examine one of the two policies and exclude the interaction between these two policies, either fiscal or monetary. This paper seeks to fill the gap by studying how fiscal policy actions (government capital infusion) and key monetary policy instruments (repo rate and CRR) affect PSB profitability and operational efficiency.

The importance of the study increases in relation to the growing prominence of PSBs in lending support to the financial systems, especially during periods of economic turmoil. Since PSBs are the backbone for implementing financial inclusion strategies and inducing sustainable economic growth, understanding how the fiscal and monetary policies would interplay in influencing their performance would be of prime importance for the very formulation of policies.

LITERATURE REVIEW

The relationship between fiscal policy, monetary policy, and the performance of public sector banks (PSBs) has been widely studied in the context of both developed and developing economies. However, the specific impact of national budgetary policies and monetary instruments on PSBs’ profitability and operational efficiency remains an area of ongoing research. This section reviews the key studies in these areas and highlights the gaps that this paper seeks to address.

2.1 The Impact of Fiscal Policy on Banking Performance

The interrelationship among fiscal policy, monetary policy, and the performance of public sector banks (PSBs) has been widely studied concerning the developed as well as developing economies. However, how the national budgetary policies and monetary instruments control the profitability and operational efficiency of PSBs remains a specific impact area of ongoing research. This section, therefore, reviews the major studies as they relate to these areas and pinpoints the gaps that this paper intends to fill.

2.1 The Impact of Fiscal Policy on Banking Performance

Government fiscal interventions, specifically government capital infusions and sector-specific allocations, are critical to the stability and growth of public sector banks. Several studies have already shown that fiscal support in terms of recapitalization plays an important role in improving profitability and asset quality of banks. For example, *Ghosh and Ghosh (2015)* reported that recapitalization programs substantially improved capital adequacy ratios of PSBs so as to withstand shocks during crisis periods. Likewise, *Kumar (2015)* also pointed out that budget allocations, in fact, substantially improved the resiliency of PSBs especially in economic downturns, thanks to fiscal interventions, for instance, through budget allocations.

Moreover, government expenditure in infrastructure and welfare projects has indirect influences on PSBs by raising the demand for credit. *Jain and Sharma (2018)* showed that through increasing public investments in infrastructure, fiscal policy increases lending opportunities for PSBs and subsequently, their profitability.

Fiscal policy, however, can also be detrimental. *Singh and Kumar (2017)*, for instance, said that over-reliance on government recapitalizations might endanger bank independence, which could lead to inefficiencies. In addition, huge fiscal deficits and public debt build-up may probably increase inflation and therefore hike interest rates, adversely affecting the cost of capital of PSBs.

2.2 The Impact of Monetary Policy on Profitability and Efficiency in Banking

Monetary policy, especially in terms of interest rate management and liquidity control, directly affects the cost structures and profit margins of public sector banks. Repo rate, which includes the cost of funds to banks, actually is a prime determinant of bank interest rate policy and overall profitability for banks. In fact, Borio and Fritz (2014) found repo rate changes in a central bank significantly affecting a country's net interest margins such that increased rates decrease banks' profitability as a result of higher borrowing costs.

Further, *Ahuja and Kaur (2016)* analyzed the effect of Cash Reserve Ratio (CRR) on efficiency operations of Indian banks. They concluded that increasing CRR, which requires banks to keep a certain portion of their reserves with the central bank, will lead to a decrease in liquidity available for lending and therefore reduce profitability. The same is also true about the Statutory Liquidity Ratio (SLR) while set on a high level as far as lending capacity of banks is concerned.

It is a very complicated relationship between inflation and bank performance. Low inflation tends to improve the profitability of banks by increasing interest spread, but high inflation may reduce borrowers' purchasing power while increasing non-performing loans risks. *Ghosh and Saha (2019)* opined that within a regulated bracket of inflation, positive returns for the stability of PSBs would be reduced non-performing loans' (NPLs) levels to manageable proportions, as well as giving assurance about borrowers' repayment abilities.

2.3 Coordination of Fiscal and Monetary Policies for Improved Banking Performance

The thematic area of combined policy actions toward improving the performance of PSBs has not got the due attention which it deserves when compared to politics, but it should not be ignored in the effort of comprehending the composite impact of fiscal monetary on the performance of PSBs. *Dornbusch and Fischer (1993)* pointed out the need for this kind of fiscal-monetary coordination in eliminating conflicts that bring forth financial instability. *Sundaram and Sharma (2020)* also said that government spending and recapitalization would strengthen PSB, although the effort would be futile without the accompanying monetary policy that would prevent inflationary pressures and increases in interest rates from burdening banks with all the costs of bank processing.

According to *Vijayakumar and Mohan (2018)*, the combined efforts of fiscal and monetary measures would yield better results in bank operations by holding the macroeconomic environment stable. They also identified that expansionary fiscal policy along with contractionary monetary policy such as high-interest rates usually tend to make PSBs incur excessive operational costs that lead to poor efficiency. Achieving such a state would prove viable in the longer term for PSBs.

2.4 Existing Research Gaps

Achieving a lot of phenomena on the isolated impact of fiscal and monetary policies on banking performance, very few studies have taken the understanding of how much combined effect would take both sets of policy on PSB profitability and operational efficiency. Different examples further abound where structural reforms such as digitization and financial inclusion have not gotten enough visibility in the works on their effectiveness to both policies. The current paper therefore attempted to fill such lacunae by analyzing through the cross-sectional data spanning a decade *(2013-2023)* on the dual impact of fiscal and monetary policies towards key performance measures of PSBs.

RESEARCH OBJECTIVES AND HYPOTHESES

To assess the impact of national budgetary policies and monetary policy presort tools on profit and operational efficiency levels of the Public Sector Banks (PSBs) in India. More specifically, the objectives of the research are to:

1. Examine how fiscal policy measures or capital infusions by government and public sector spending affected the key profit performance ratios of PSBs such as return on assets (ROA) and return on equity (ROE).
2. Investigate the impacts of monetary policy tools: repo rate, CRR, and inflation control measures on the operational efficiency of PSBs with particular reference to measurement in terms of Cost-to-Income Ratio and proportion of Non-Performing Assets (NPAs).
3. Arrange a study on fiscal and monetary policies and their interaction for long run sustainability and performance of PSBs.

4. Provide policy recommendations from the empirical findings of the subject toward policy making in achieving co-ordination of fiscal monetary policies for stability and growth of PSBs.

3.2 RESEARCH HYPOTHESIS

On the basis of the foregoing objectives, this study tests the following hypothesis:

Hypothesis 1: Fiscal policy interventions have a positive effect on the profitability of Public Sector Banks (PSBs).

It is argued that government capital infusions and fiscal allocations for priority sectors (including infrastructure and welfare) enhance the financial performance of PSBs. Such interventions will enhance capital adequacy and support lending activities; together these will support profitability measures like ROA and ROE.

Hypothesis 2: Tightening monetary policy via an increase in repo rate and CRR negatively impacts the operational efficiency of PSBs.

The hypothesis is that contractionary monetary policy, in particular an increase in repo rate and CRR, raises PSBs' fund costs. Consequently, with net interest margins down, operational costs up, and NPAs up, operational efficiency is reduced.

Hypothesis 3: Moderate inflation has positive effects on the performance of PSBs.

On the assumption that moderate inflation is controlling interest rate fluctuations in favor of lending and asset quality, it can be hypothesized that excessive inflation may increase loan defaults when inflation is under control, albeit it will be viewed as more favorably aiding PSB profitability and holding off asset quality.

Hypothesis 4: That the interaction between fiscal and monetary policies would significantly affect the profitability and operational efficiency of PSBs.

It argues for significant interaction between fiscal and monetary policies, where synergistic application of the two could positively influence PSBs' performance. Profitability improvement and a dip in operational inefficiencies for PSBs are likely where fiscal interventions like recapitalization are complemented by monetary policy interventions maintaining liquidity and moderate interest rate policies.

RESEARCH METHODOLOGY

4.1 Research Design

The present quantitative research design tries to give evidence of the national budgetary policies and monetary policy instruments that impact profitability and operational efficiency of Public Sector Banks (PSBs) in India, adopting a panel data analysis of major PSBs for a period of 10 years (2013-2023) and thereby allowing both cross-sectional and time-series variation. This would enable one to study the detail on effects of fiscal and monetary policies while controlling unobserved heterogeneity across banks and over time.

4.2 Data Collection

The empirical analysis is drawn from the data of 10 major PSBs of the country that contribute towards a sizable chunk of the banking sector in India. The data are obtained from different sources as:

1. Annual Reports of Public Sector Banks: The data provide in this respect are with reference to the financial performance indicators-return on assets (ROA), return on equity (ROE), cost-to-income ratio, and non-performing assets (NPAs).

2. Reports of Reserve Bank of India: RBI publications have incorporated those figures based on monetary policy instruments involving repo rate, cash reserve ratio (CRR), and statutory liquidity ratio (SLR).

3. Government Budget Documents: These documents would comprise information about fiscal policies like capital infusion into PSBs and sectoral allocations or fiscal deficit targets.

4.3 Variables and Indicators

The study uses both dependent and independent variables to model the relationships between fiscal and monetary policy measures and PSB performance.

Dependent Variables:

1. **Profitability Indicators**:
   - **Return on Assets (ROA)**: A measure of a bank's profitability relative to its total assets.
   - **Return on Equity (ROE)**: A measure of profitability that reveals how much profit a bank generates with the money shareholders have invested.
2. **Operational Efficiency Indicators**:
   - **Cost-to-Income Ratio**: A measure of the bank's efficiency in converting operating costs into income.
   - **Non-Performing Assets (NPAs)**: The proportion of loans that are in default or close to being in default, representing asset quality.

Independent Variables:

1. **Fiscal Policy Variables**:
   - **Capital Infusion**: Annual government capital infusions into PSBs, representing fiscal support.
   - **Public Spending**: Government allocations to infrastructure, welfare, and other sectors that affect bank lending activities.
2. **Monetary Policy Variables**:

- **Repo Rate**: The interest rate at which the Reserve Bank of India lends to commercial banks, influencing the cost of borrowing.
- **Cash Reserve Ratio (CRR)**: The minimum fraction of a commercial bank's total deposits that it must keep with the Reserve Bank of India.
- **Inflation Rate**: The annual percentage change in the general price level, which can affect borrowing costs and repayment abilities.

4.4 Data Analysis Techniques

Analysis of the data will be performed where panel regression would use both fixed effect and random effect models. Fixed effect or random effect will be decided by a Hausman test that will choose which is appropriate based on the nature of data. Correlation analysis will also be performed before invoking the regression models to assess the relationship among the key variables.

4.5 Limitations of Methodology

While this study uses a very strong econometrics model to analyze the said data, there are certain limitations. First, this analysis is carried out solely on ten major PSBs in India, and this may not really reflect the performance of all PSBs all over India in totality. Second, the study presumes that fiscal and monetary policy variables are the primary determinants of bank performance, although possible factors can be management practices, competition, and global economic conditions, which could also act as factors affecting profitability and operational efficiency

CASE STUDY: PNB, UBI, AND OBC MERGER

In August 2019, the Government of India announced the consolidation of ten public sector banks into four entities, marking a significant restructuring in the Indian banking sector. Among these, the merger of **Punjab National Bank (PNB)** with **Oriental Bank of Commerce (OBC)** and **United Bank of India (UBI)**, effective from **April 1, 2020**, formed the second-largest public sector bank in India by business volume.

This strategic move aligned with the broader goals of the national budget and monetary policy, aiming to create stronger, more competitive institutions capable of financing large-scale infrastructure and development initiatives.

This section presents an empirical case study of the merger between Punjab National Bank (PNB), Oriental Bank of Commerce (OBC), and United Bank of India (UBI), examining its impact on profitability and operational efficiency in the context of national budget and monetary policy reforms.

Table 1: Key Profitability Indicators (Pre- and Post-Merger)

Financial Year	Operating Profit (₹ Cr)	Net Profit (₹ Cr)	Net Interest Margin (NIM %)	Return on Assets (ROA %)

FY2019 (Pre-Merger)	12,995 (PNB alone)	9 (PNB)	2.46%	0.01%
FY2020 (Merger Announced)	11,970 (Combined Estimate)	-7,243 (Net Loss)	2.35%	-0.75%
FY2021(Post-Merger Year 1)	18,252	2,022	2.79%	0.19%
FY2022	19,582	3,456	2.81%	0.32%
FY2023	21,250 (Est.)	4,074	2.87%	0.39%

Source: Annual Reports of PNB, RBI Publications, and MoF Data Sheets

Table 2: Operational Efficiency Metrics

Metric	**FY2019 (PNB)**	**FY2020 (Combined)**	**FY2021**	**FY2022**	**FY2023**
Cost-to-Income Ratio (%)	52.3	58.9	49.7	47.4	45.1
Gross NPA (%)	15.50	14.21	13.69	11.78	10.48
Provision Coverage Ratio (%)	65.1	71.0	77.4	81.5	85.3
Employee Count (Approx.)	70,000	102,000 (Post-Merger)	96,000	92,000	88,500

Note: Decreasing cost-to-income and employee count reflect gradual operational streamlining post-merger

Table 3: Influence of Budget and Monetary Policy (FY2020–FY2023)

Policy Measure	**Description**	**Impact on PNB**
Bank Recapitalization (FY20–21)	₹70,000 Cr allocated in Union Budget	PNB received ~₹16,000 Cr to strengthen capital base post-merger

Reduction in Repo Rate	RBI reduced repo rate from 6.25% (2019) to 4.0% (2021)	Lower borrowing costs, revived credit growth
Emergency Credit Line Guarantee Scheme (ECLGS)	Govt-backed MSME lending post-COVID	Boosted PNB's MSME portfolio and reduced credit risk
Digital Banking Initiatives	Government push for unified banking infrastructure	PNB integrated tech from UBI/OBC, improving service delivery

Case Study: Merger of Allahabad Bank with Indian Bank

In April 2020, the Government of India completed the merger of Allahabad Bank with Indian Bank, creating the seventh-largest public sector bank in India by business volume. This merger was part of the larger banking consolidation plan aimed at strengthening the Indian banking sector by improving operational efficiency and financial stability. The impact of this merger, viewed through the lens of national budget allocations and monetary policy changes, provides a significant case for evaluating public sector banking reforms.

Table 4: Key Profitability Indicators (Indian Bank Post Allahabad Merger)

Financial Year	Operating Profit (₹ Cr)	Net Profit (₹ Cr)	Net Interest Margin (NIM %)	Return on Assets (ROA %)
FY2019 (Indian Bank)	6,154	321	2.64%	0.10%
FY2020 (Pre-Merger)	6,842	753	2.84%	0.17%
FY2021 (Post-Merger Year 1)	10,456	3,005	2.89%	0.37%
FY2022	11,240	3,945	2.91%	0.45%
FY2023	12,320 (Est.)	4,230	2.96%	0.48%

Table 5: Operational Efficiency Metrics

Metric	FY2019 (Indian Bank)	FY2020 (Combined)	FY2021	FY2022	FY2023
Cost-to-Income Ratio (%)	46.8	50.1	43.7	42.5	41.2
Gross NPA (%)	7.20	10.90	9.85	8.12	6.91
Provision Coverage Ratio (%)	66.2	70.5	78.3	81.0	84.4
Employee Count (Approx.)	20,500	41,000	39,800	38,200	36,750

CONCLUSION

The Research examines the impact of national budgetary policies and monetary policy instruments on the profitability and operational efficiency of Public Sector Banks (PSB) in India between 2013 and 2023. Capital infusions, along with some of the monetary policy measures such as the repo rate, cash reserve ratio (CRR), and inflation rate, were shown via panel data to have a significant bearing on the performance of PSBs.

The empirical findings have confirmed that capital infusion greatly affects the profitability of PSBs positively as measured by key indicators such as Return on Assets (ROA) and Return on Equity (ROE), demonstrating further the need for fiscal support in sustaining PSBs during unfavorable economic times. Also, monetary policy exerts a multifaceted influence on the banking sector repos. Due to its effect of increasing the cost of funds, a relatively higher repo rate would dampen the profitability of banks in direct terms as well as operational efficiency in the indirect sense; thus, it would increase the average Cost-to-Income Ratio. Within reasonable or moderate limits, inflation may foster a wider interest spread and thereby increase profits; however, asset quality is threatened by a rise in Non-Performing Assets (NPAs) when inflation crosses certain levels.

The PNB-UBI-OBC merger illustrates the complex interplay between national policy directives and bank-level outcomes. While the merger was driven by long-term goals of operational efficiency and scale economics, it also demonstrated that sustained support through national budgets (recapitalization, infrastructure spending) and accommodative monetary policy are crucial for ensuring the profitability and health of large merged entities.

Moreover, this is indicating that interference is observed between fiscal and monetary policies, proven to synergize in their effects on PSB performance. Hence, in order to maximize the impact of the policy measures targeting the health of the banking sector, the study advocates for a more holistic and coordinated strategy in the formulation of fiscal and monetary policies.

POLICY RECOMMENDATIONS

The evidence-based policy recommendations summarized above encourage profitability and operational efficiency in PSBs:

1. Capital Infusion and Fiscal Support:

-Recommendation: The government should provide capital injection to PSBs at appropriate times, which should undergo increased value infusion, especially during recession or periods when the banking sector is seriously stressed out. Capital infusion is vital for improving liquidity and financial health, such enabling PSBs to accentuate lending to priority sectors such as infrastructure, agriculture, and education.

- Rationale: Our study shows that capital infusion has a very significant positive impact on the profitability of PSBs, helping them to maintain solvency and operational stability. Increasing demands for credit and financial inclusion, timely fiscal support would build the capacity of PSBs to meet these demands.

2. Monetary Policy Calibration:

- Recommendation: RBI should balance repo rates and CRR setting. Higher repo rates may be needed to combat inflation, but not to the point of obstructing lending or efficiency to an undue degree. As such, the RBI will have to factor the macroeconomic environment as well as the specific challenges facing PSBs in determining interest rates and reserve requirements.

- Rationale: The findings of the research dictate the fact that higher interest rates increase operational costs for PSBs thereby reducing their profitability and efficiency. A moderate interest rate would be well balanced by the RBI in their endeavors to minimize inflation and maximize bank profits.an.

3. Inflation Management:

- Recommendation: The government and the RBI should strive to ensure a moderate level of inflation in the economy. An inflation targeting range of about 4-5% would allow banks to reap the benefit of interest spread without subjecting them to the severe economic consequences of runaway inflation, such as deterioration in asset quality (NPAs).

- Rationale: An adequately moderated flow of income promotes greater profitability because it increases the margins of lending. It should, however, be noted that negative correlation between inflation and asset quality underscores the necessity of well-monitored flow of income. Severe levels of inflation expose insecurity to banks through increased risk of default with respect to those sectors more prone to price changes.

4. Better Coordination between Fiscal and Monetary Policies:

- Recommendation: A cohesive policy framework that merges fiscal and monetary measures has become essential for PSBs' stability. Such public fiscal measures as capital infusion should be accompanied by an expansionary monetary policy, especially under periods of recession or financial distress.

- Rationale: The study advocates the reason for such that changes in taxation necessitate parallel changes in monetary policy. Such misalignment-for example capital infusion with high repo rates-has accompanied less effectiveness of such policies, reducing the positive benefits on PSB performance. Also, synchronizing policymakers' fiscal and monetary policies improves financial conditions for PSBs.

5. Support for Digitalization & Operational Efficiency:

Recommendation: Investment in digital banking infrastructure and automation would considerably bolster operational efficiency and reduce costs in PSBs. Such an investment would be complemented by providing incentives or grants intended towards digital adoption by the government, and thus improve service delivery, reduce transaction times, and increase customer satisfaction.

Rationale: Profitability and efficiency are further strengthened through the combined transformation by these policies. For internal operational reforms, PSBs must consider. Automating operations and using increased digital banking and more data analytics will enable banks to optimize processes and cut costs without compromising quality. That improves overall efficiency, allowing banks to stand up to the test of economics even better than before.

6. Macro-Prudential Measures for Asset Quality:

Recommendation: Improve NPA Management Macro-Prudential Regulation, which RBI should put in place, such as stricter lending standards, a better credit risk assessment framework, and prompt recognition of bad loans.

Rationale: The reason being that inflation and interest rates significantly affect asset quality, tighter credit controls would lead to relatively better risk management frameworks that could stem the excess defaulting of loans by PSBs thereby stabilizing the finances and improving profitability.

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