Growth in the Time of a Credit Squeeze*

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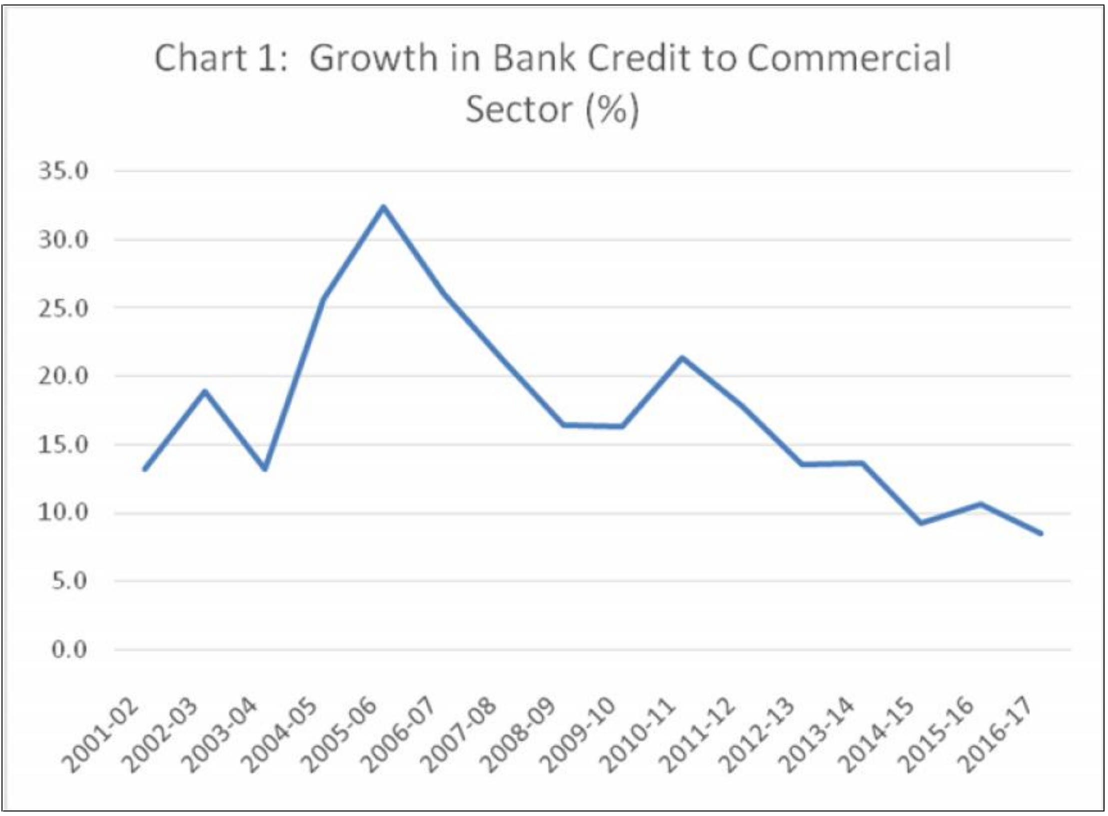
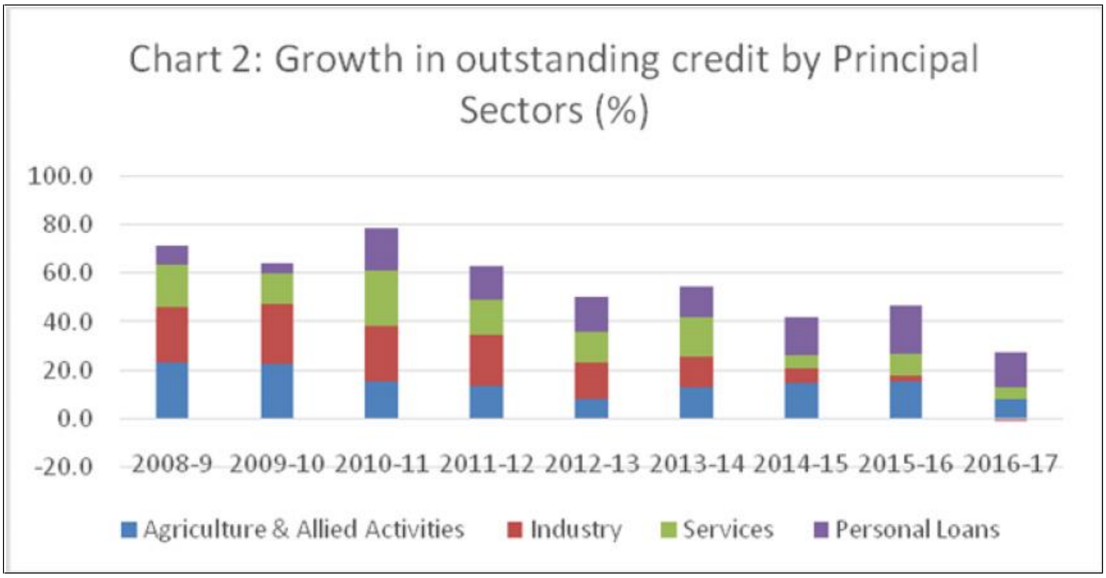
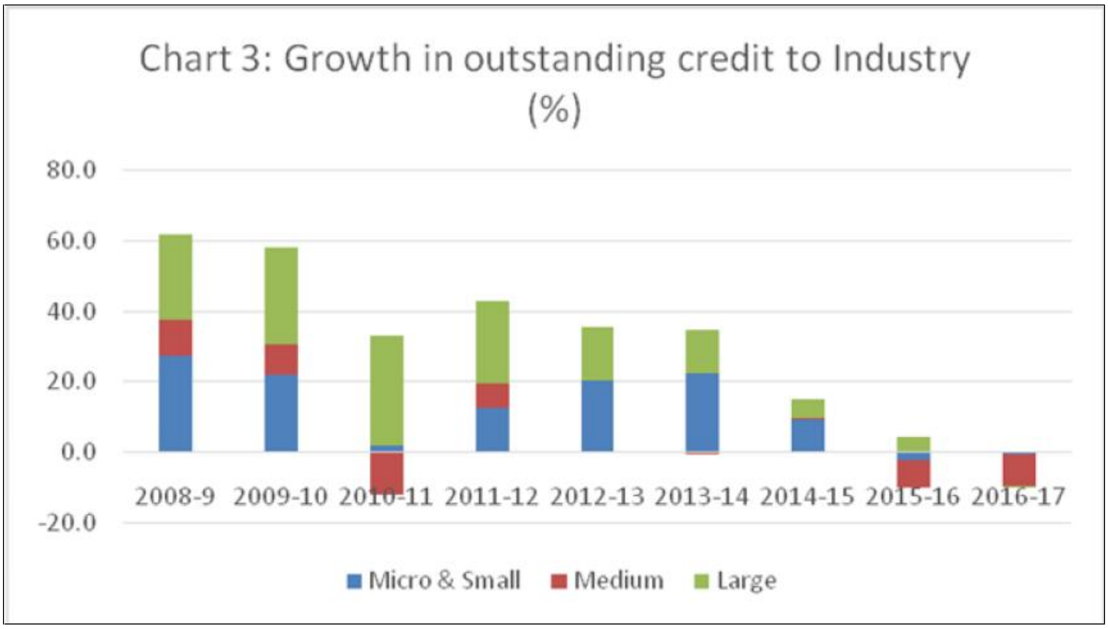
Hit by demonetisation and burdened by non-performing assets (NPAs) Indian banks have slashed lending to the commercial sector during financial year 2016-17. As compared to an average annual growth rate of more than 20 per cent during the first decade of this century, and 10.6 per cent in 2015-16, the rate of growth was down to 8.5 per cent last financial year (Chart 1).



But even this conceals a disturbing trend. Lending to industry has fallen (with a rate of growth of minus one per cent) and that to agriculture decelerated, with the rate of growth falling from 15.3 to 8 per cent. It is only lending to the retail sector (personal loans) that held up, with rates of growth of 19.4 and 14.4 per cent in 2015-16 and 2016-17. (Charts 2 and 3). The sectoral figures for 2015-16 and earlier are based on data from banks accounting for 95 per cent of total lending, whereas that for 2016-17 has been calculated after excluding data for four erstwhile associates of SBI—State Bank of Bikaner & Jaipur, State Bank of Hyderabad, State Bank of Mysore and State Bank of Patiala—since the post-merger data reconciliation exercise is still underway.

While demonetisation, which paralysed normal functioning of the banking system, had a role to play in 2016-17, the deceleration in credit is the result of a longer-term adjustment. As Chart 1 shows, after the credit boom during 2004-05 to 2007-08, when the ratio of commercial bank advances outstanding to GDP soared, the rate of growth of credit initially stabilised and then was in continuous decline from 2010-11; indeed, it more than halved by 2016-17.





The reason for this persistent decline is no doubt the large burden of non-performing assets. Banks that were under pressure to lend because of the expansion of liquidity in the system and consequently of their deposit base, clearly stretched their lending to include borrowers with a higher potential for default. This began to show itself with a lag in the form of rising defaults. Needless to say, this forced banks to be more cautious in their lending, which slowed down credit growth well before the effects of demonetisation were felt.

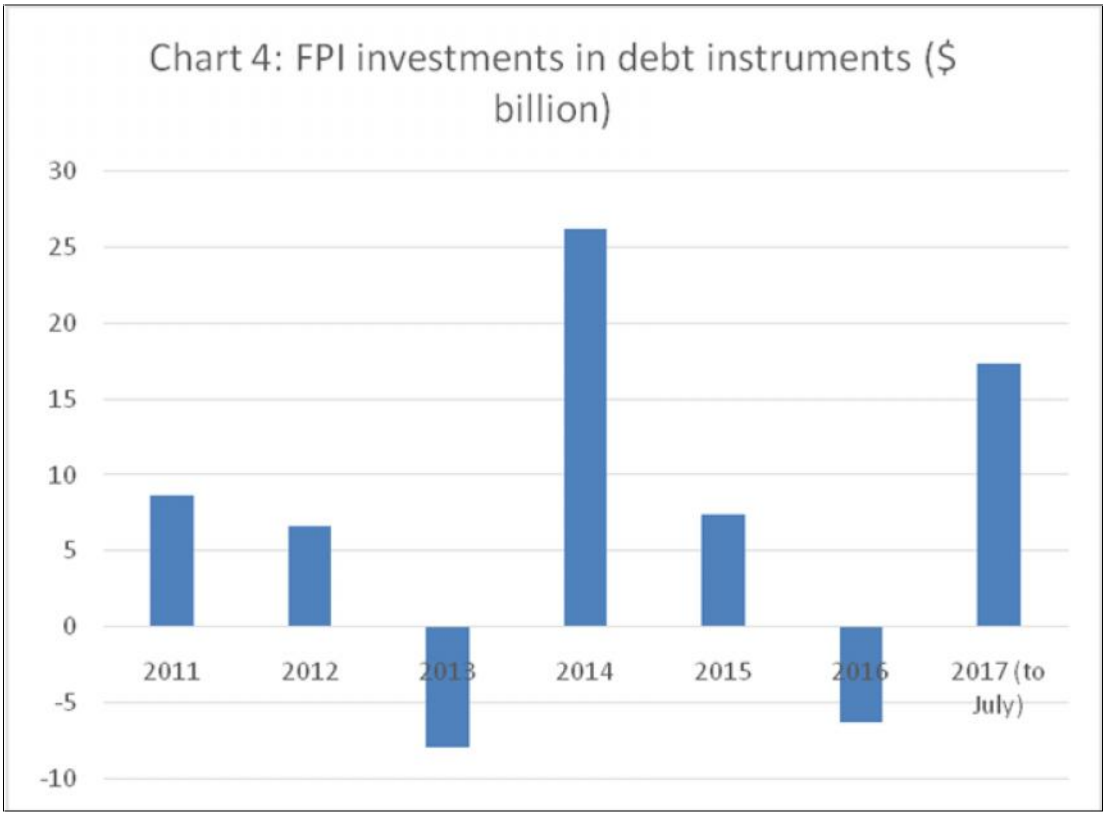
Now, as banks are taking to the courts to try and recover at least some of their money, it is becoming clear that large loans to capital intensive industries accounted for a very high proportion of the NPAs. Twelve large corporate defaulters who have been identified for recovery through liquidation are said to account for a quarter of all non-performing assets. Most of them are borrowers from the industrial sector, engaged in capital intensive businesses financed with large borrowing from the banking system.

This has had three effects on recent bank behaviour. First, lending has been reined in to keep down exposure to new borrowers who may be potential defaulters. Second, lending to industry in particular has been curtailed sharply. And, third, lending to the retail sector, where defaults have been much lower, is being kept at high levels as part of a strategy of making up for the losses arising from provisioning for non-performing assets. As a result, the quantitative adjustment in the volume of lending has been accompanied by a qualitative shift in favour of retail lending.

One collateral damage of these trends in credit provision is that it is not only the sector where defaults predominate, viz. large industry, that is hit by the credit squeeze. The deceleration in lending also affects the agricultural sector, as has been noted above. Within industry, it is the medium sized firms that are affected most, with credit to them having shrunk by 7.8 and 9.1 per cent respectively in 2015-16 and 2016-17.

Moreover, within the large industrial sector, even firms with a reasonable repayment record are facing a tight credit market. It has, however, been argued that with the corporate bond market turning buoyant as a result of investments by foreign portfolio investors (FPIs) and domestic institutional investors, these firms have another option available for financing investment. In the first seven months of 2017, for example, FPI investments in debt instruments were more than $17 billion. In fact, there is a view that the ability to mobilise significant sums at the lower interest rates in bond markets explains the decline in bank loan off take by the private corporate sector. In other words, the decline in bank lending is not much cause for worry.

However, as Chart 4 tracking foreign portfolio investments in debt instrument shows, investor interest in corporate bond markets is not new. These markets have been attracting foreign investors for a few years now. But investor interest in these markets is extremely volatile, and the performance of the market was particularly poor in 2015 and 2016, perhaps influenced by the expectations of an interest rate increase in the US and elsewhere in the developed world.



In sum, the credit squeeze is likely to continue for some time. This renders significant one puzzle raised by these trends, namely the marginal effect of the end of the credit boom on the GDP growth numbers. This is a puzzle because there is reason to believe that credit financed investment and consumption played an important role in raising demand and accelerating growth in India. Given the government's adherence to its fiscal deficit targets, government expenditure has not been a particularly strong stimulus to growth. And exports are just recovering from a long period of decline. So debt financed private expenditure has been crucial for recent growth. However, while credit to finance consumption continues, credit for investment has been substantially curtailed. The 'evidence' that this has not affected growth does strengthen the suspicion that the revised GDP figures may not be telling the true story. Hence, using the GDP growth figures to underplay the significance of the credit slowdown and its consequences, may be using a mirage to camouflage a reality.

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