Signals from the Banking Sector*

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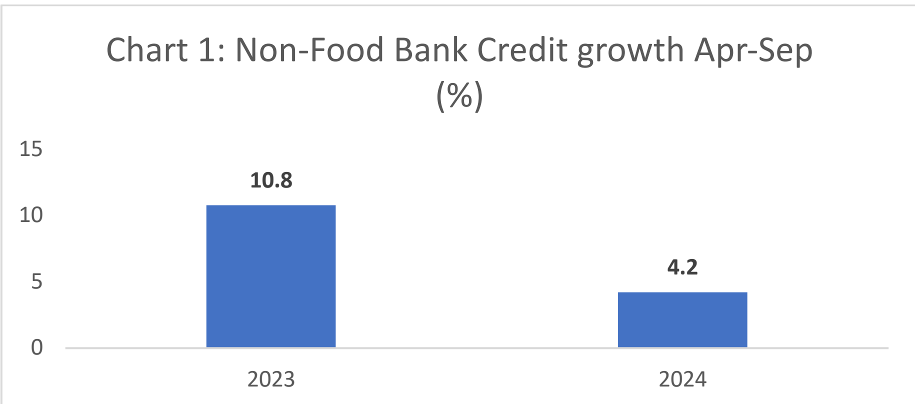
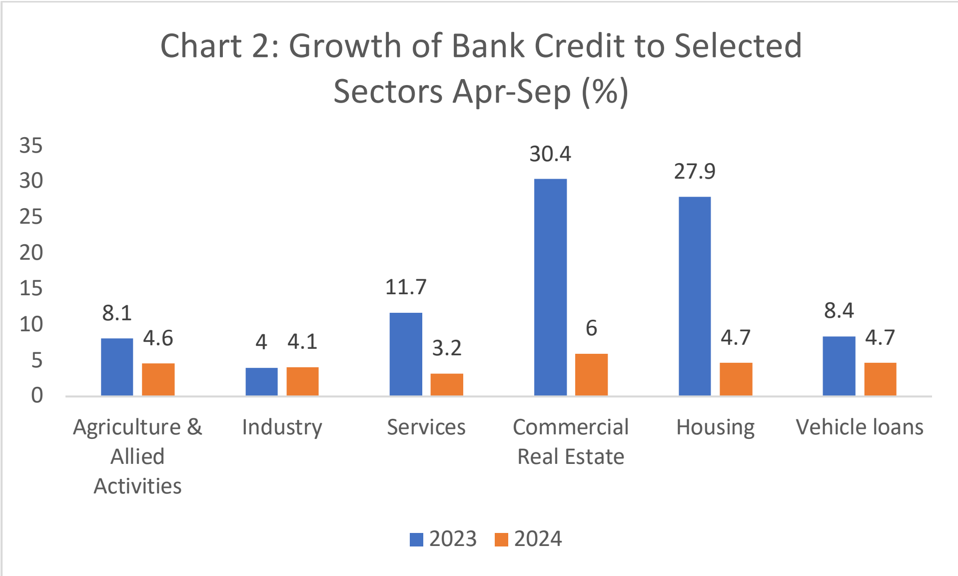
The sense in business circles, that demand is weak and growth is slowing down, was confirmed when GDP figures for the second quarter (July-September) of financial year 2024-25 showed growth at 5.4 per cent. This was well below forecasts of annual GDP growth in the 7 per cent range, and the 8.1 per cent recorded in the corresponding period of the previous year. Following that, several international and domestic institutions have revised downwards their projections for the full financial year. Manufacturing in particular has performed poorly, with annualised growth of 2.2 per cent in the second quarter of 2024-25, as compared with 14.3 per cent in the corresponding months of the previous year. The index of industrial production rose year-on-year by 4 per cent during April to October this year, as compared with 7 per cent in the previous year.

By all accounts, the deceleration of growth is on account of tepid demand. Given the central government's claims that it has been hiking spending, especially its capital expenditure, and the injection of demand into the system because of spending related to consecutive elections, this slowdown is indeed puzzling. The central government's claims ignore the fact that much of enhanced central spending within an overall conservative fiscal framework comes at the expense of the state governments, which are being starved of resources to meet their own development responsibilities to boost the Centre's receipts. Overall expenditure at central and state levels together is by no means buoyant.

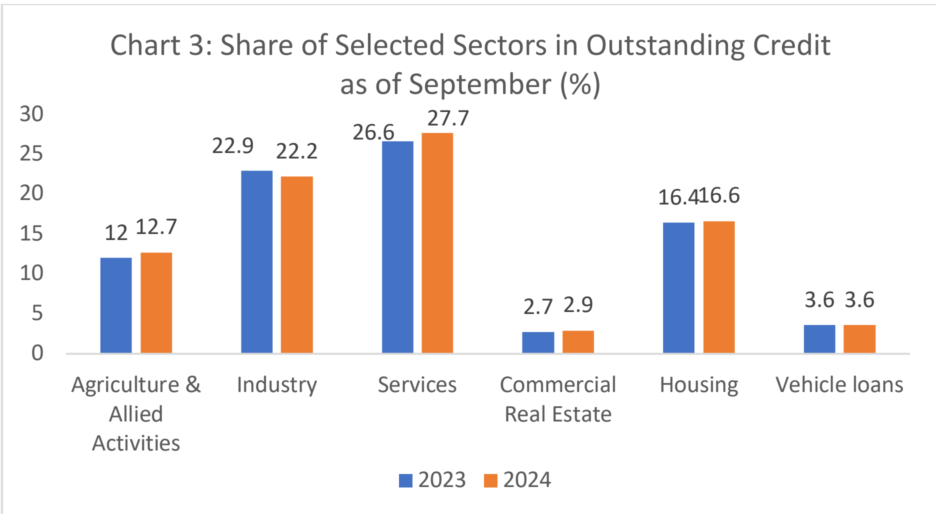
Besides the government's exaggerated claims about its proactive fiscal policy, a substantial part of the explanation for the growth slowdown seems to lie in the deceleration of credit financed spending. As Chart 1 shows, non-food bank credit growth in the period April-September 2024 (at 4.2 per cent) was substantially below the 10.8 per cent registered in the corresponding months of 2023. The deceleration of credit growth was particularly sharp in commercial real estate and personal housing, where debt has played a major role in fuelling spending and demand. The other major area where credit has decelerated has been in vehicle loans, where too demand has been driven by borrowing (Chart 2).



But the problem appears to be more generalized. The shares of major sectors in bank credit outstanding did not register much change in September 2024 compared with a year ago (Chart 3). The deceleration in credit growth seems to have occurred across the board.



Growth in credit, demand and output are of course all mutually related. But ever since there has been a step up in foreign financial flows into Indian markets, the banking system has been awash with liquidity. That put pressure on banks to lend and earn the spread they need to continue in business. With the spike in such financial flows in recent years the pressure has only increased.



Early in the process, that pressure led to substantially enhanced lending to the retail sector and to infrastructure. The latter in fact attracted substantially enhanced lending. But with many projects failing to deliver on their promise, defaults on loans to these sectors rose. When the magnitude of those defaults could not be concealed and were revealed in the ratio of non-performing loans, banks saddled with losses due to provisioning had to be recapitalized by the government or had to recapitalize themselves.

This led to a significant withdrawal of credit to the corporate sector to finance infrastructure projects. But the pressure to keep credit moving did not abate. Since at that time the ratio of non-performing loans in the retail sector (especially lending to finance housing investments and vehicle purchases) was low, banks increased their focus on such lending.

More recently however, there have been indications that retail loans are also vulnerable to default, because the universe of borrowers has been enlarged far too much, bringing in weaker or “subprime” borrowers. Banks that had learnt their lesson at the time of the infrastructural lending crisis and cannot go through another round of large scale recapitalization, seem to be holding back. This seems to explain the generalized retreat from proactive lending, leading to the deceleration in credit growth and the softening of demand.

The problem is that the feedback effects of this process worsen credit growth. As growth slows, so does investment. The absence of demand also reduces the appetite for borrowing. That leads to further slowing of credit growth.

There are two issues these developments raise. The first relates to the factor that can replace credit as a driver of demand and growth. Prior to the embrace of **fiscal conservatism**, proactive state spending played this role, making up for the slack in private demand. That now seems to be off the table for this government. India’s exports are not doing well at all, so there is little by way of an “external stimulus” to growth. Taxing income and wealth of the super-rich to increase public spending can provide an alternative, but there is even less appetite for that. The structural problems that underlay the stagnation of the late-1960s and 1970s seem to be asserting themselves. A revival of growth even in the medium term seems uncertain.

The second issue relates to how the banking system is going to adjust if it cannot sustain its lending boom, even while capital flows in from abroad and swells its deposit base. A partial resolution of this problem seems to come from the retreat of foreign investors from hugely overvalued financial markets. A retreat hastened by interest rate adjustments in the developed countries. The resulting decline in the injection of liquidity into the system would reduce the pressure to increase lending by expanding into riskier areas. But retreat of foreign investrs is leading to a sharp downturn in financial markets. Given the exposure of the liberalized banking system to players in financial markets, the downturn is not all good news for the banks. It could lead to defaults by other players. Uncertainty prevails here as well.

All in all, there seem to be “interesting times” ahead for an economy that is still being presented as that of the world’s fastest growing nation.

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