Business Standard

Subir Gokarn: Can our banks finance the economic recovery?

The banking system's capacity to finance the ongoing recovery may become a constraint

Subir Gokarn November 16, 2014 Last Updated at 21:50 IST

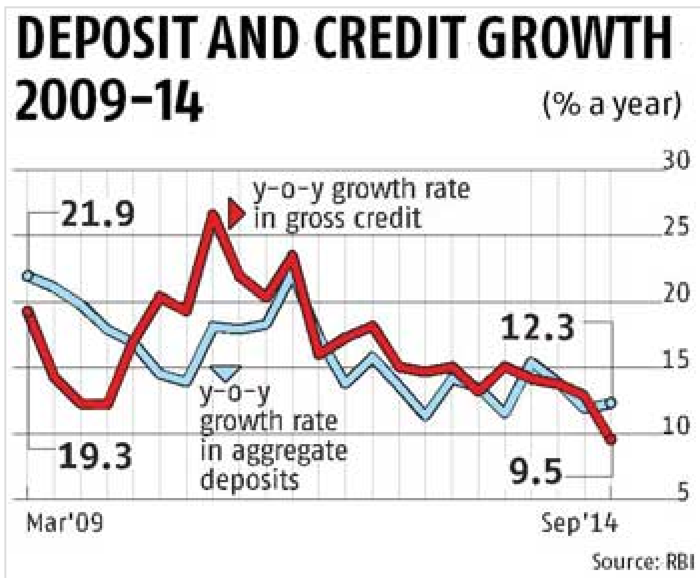
There is little question now that the Indian economy is steadily climbing up from the bottom. Even though the industrial growth numbers are still quite low, the fact is that they are rising. Key sectors like basic metals and automobiles have been growing steadily over the past few months. Most importantly, the dramatic decline in oil prices over the past couple of months has completely re-written the macroeconomic script. The three major stress points - inflation, the current-account deficit and the fiscal deficit - will ease off significantly over the next few months if oil prices remain at the level that they are now. Lower oil prices will, of course, help revive global growth as well.

Overall, the Indian economy is now seeing the emergence of positive drivers last seen during the early 2000s. This raises the question as to whether it will repeat its growth performance during the 2003-08 period. The answer to this has two parts. One part, from the structural perspective, is that it depends on whether there are appropriate policy responses to the major structural barriers to accelerating growth. The other, which is what I want to write about in this column, is whether there are potential constraints to even the cyclical recovery that is now in progress.

To my mind, the key short-term constraint is finance. Specifically, it is the limit on the capacity of the banking system to accelerate provision of credit to businesses, who will need more funds to support growth. Even if all the other conditions are favourable to a recovery, the lack of availability of credit can clearly weaken or hinder it.

Why should we worry about the banks' capacity to lend at this time? To provide a context for this question, the accompanying graph plots the growth rates of aggregate deposits and gross credit raised and provided by all scheduled commercial banks over the past five years. There are three distinct phases: a credit boom in the early part of the period, when credit accelerated far ahead of deposit mobilisation; a middle phase, when both were growing at comparable rates, but steadily slowing; and, finally, in the last few months, some acceleration in deposit growth, but a relatively sharp decline in credit growth. In the quarter ended September 2014, credit grew by 9.5 per cent, the lowest rate in the entire five-year period.

One could argue that this is in itself a cyclical pattern; credit is slowing because demand for it was sluggish. This would imply that, as demand for credit picked up, so would supply. Ergo, no cause for concern on this front. However, in my view, this argument misses a very significant development in the banking system over the past few years - the rising burden of non-performing



assets (NPAs). For the banking system as a whole, gross NPAs as a percentage of total advances went up from 2.4 per cent in 2008 to 3.4 per cent in 2013. For public sector banks, this ratio increased from 2.3 per cent to 3.8 per cent over this period. Here again, the argument could be made that this is a cyclical pattern and will reverse as growth picks up. But there is another factor at work here.

During this period, banks were lending aggressively to infrastructure projects, which reflected the great hopes placed on the public-private-partnership model. As these hopes were increasingly dashed by the realities of projects delayed by policy uncertainties, clearances and approvals, and various other barriers to timely execution, they put promoter companies in financial distress and banks that had lent to them in a situation of mounting NPAs. Unlike the traditional business cycle pattern of NPAs, these are structural and will not self-correct with a growth recovery. In short, the banking system is entering the economic recovery phase with an asset-quality problem that will not sort itself out.

When banks have an NPA burden, an increasing share of their profits needs to be dedicated to provisioning. Managements come under pressure and, consequently, become more and more averse to taking on additional risks. Even public sector banks that are listed are constrained by this, because the analyst and investor communities are so focused on asset quality. These pressures induce bank managements to look for the safest possible ways to deploy their funds.

In the Indian context, traditional commercial lending is not on the top of the list. Pride of place goes to lending to the government. Government securities are the one risk-free asset class that is available in plenty. Returns are attractive, and under the statutory liquidity ratio (SLR) provisions, holdings up to 22.5 per cent of banks' liabilities are exempt from mark-to-market requirements, insulating the banks' balance sheets from interest rate risk.

The pattern of deposit and credit growth that the graph shows for the last quarter suggests that banks are deploying incremental deposits into buying government securities. This also explains why the yield curve has been inverted over the past quarter; the yield on 10-year government securities, which is the most liquid tenor, has been consistently below the overnight repo rate. This combination of outcomes is what leads to my basic concern; even if the economy shows signs of recovery, the structural nature of banks' NPAs will constrain their willingness to provide credit to businesses, which will need it to sustain the recovery.

Policy responses can certainly be visualised. In the immediate term, the system's lending capacity can be enhanced by capital infusions into the public sector banks. Of course, this has long-term fiscal and governance implications, which need to be considered when the allocations are made, but there will be tangible short-term benefits. Importantly, to push the enhanced capital into financing business instead of buying more government securities, the mark-to-market exemption needs to be sharply reduced.

From a somewhat longer-term perspective, the chronic burden of infrastructure NPAs needs to be taken off the banks' balance sheets. In an earlier column, I had argued for a National Investment Fund model to transfer these assets from the banks to a government-funded entity. Whether through this or any other model, it is imperative that bank balance sheets be restored to a state in which they can meet the normal business needs of their conventional borrowers.

Data used for the graph and cited elsewhere in the column were obtained from various publications of the RBI
The writer is director of research, Brookings India, and former deputy governor, RBI. These views are his own