Demand is affecting credit growth

A constant lament around the state of the economy today is on “low credit growth”. Generally, the twin balance sheet issues are the identified villains. As fresh data on non-performing assets (NPA) keep coming in with numbers worse off at the margin, the noise levels keep getting institutionalized.

The narrative is simple enough—banks are not lending because they don’t have balance sheet capacity to lend (most banks, especially public sector ones, do not have enough capital to write off NPAs and write fresh loans). As a result, credit supply to the larger economy is being crimped, thereby constraining growth. Anaemic growth in non-food bank credit growth (9% in financial year 2016-17, or FY17, in negative territory this fiscal year) is held up as empirical basis of the hypothesis. Weaker-than-expected quarterly gross domestic product (GDP) growth (at 5.7%) provides the ostensibly clinching evidence that weak credit growth is pushing down growth.

Like many popular hypotheses though, this too has a case of missing some really large woods for the trees. First, the popular narrative conflates one source of supply of credit (bank loans) with the overall demand for credit. However, one of the remarkable changes in the Indian financial sector over the last three-four years has been the steady erosion in the importance of banks as financial intermediaries. A host of other credit suppliers—mutual funds, insurance companies, non-banking financial companies (NBFCs)—have taken market share away from traditional banks. These new suppliers of credit are also experimenting heavily with alternative credit instruments (away from loans), like corporate bonds and structured financing instruments. These are often more flexible and cheaper than vanilla bank loans.

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Consolidated credit growth (bank loans, corporate bonds, NBFC loans) has been 13% in FY17, while bank loans alone grew only by 9%. The former represents a more representative estimate of real credit growth in the economy, than bank loans alone. The popular press (and even some of the more informed commentary) tends to focus only on bank credit, missing the real big story on disintermediation of credit. The real growth in credit demand is quite in line with nominal GDP growth and the 70% capacity utilization levels in Indian industry.

Second, the base effect of the Ujwal Discom Assurance Yojana (Uday) bonds. Since March 2016, the adoption of the Uday programme by state governments has transferred a large chunk of bank credit from state electricity distribution companies (discoms) to state government-issued Uday bonds. As the latter don’t get counted as “non-food credit”, growth numbers are automatically depressed going forward. Adjusted for Uday bonds issuance of Rs1.7 trillion in FY17, total credit growth in the year would have been about 11.4%, higher than the headline number of 9% and partially higher than the FY16 number of 11%.

Third, even for bank loans, the issue doesn’t seem to be so much about supply (or the willingness of banks to lend) as it is about finding bankable borrowers to lend to. In the recently released Reserve Bank of India (RBI) data on sectoral deployment of bank credit, banks have registered healthy growth in loans to the personal segment, trade, NBFCs. On the other hand, large swathes of manufacturing industries show barely any growth in bank credit.

There are multiple factors at play here. Highly rated (AAA) borrowers are increasingly finding the corporate bond market a cheaper source for fund-raising, compared to traditional banking channels. On the other side of the spectrum, in the riskier (and stressed) segments of borrowers, bank funding has shrunk—partly on regulatory diktat, and partly on account of the diminishing risk appetite of banks. These borrowers have tapped alternative sources of funding—via structured finance instruments—from NBFCs, private equity and alternative investment funds (AIFs).

Fourth, and somewhat non-linearly related, is the dramatic increase in equity raising by Indian industry over the past two years. Total equity raised via public (and rights) issues has risen by 200% over the last three years. At least part of the fresh equity raised has gone towards replacing debt in the capital structure.

We have a fundamental demand issue today in the economy. Total credit flows into the economy mirror the aggregate demand, and as we have seen above, are not a constraint. We looked at commitments raised by AIFs, a key emerging source of “risk-funding” today. As of FY17, only around 40% of the total funds raised by AIFs (in excess of Rs80,000 crore) have been deployed—thereby illustrating a paucity of deployment opportunities even for risk capital.

Unfortunately, most policy actions are concentrating on supply-side fixes (bank consolidation, NPA resolution, etc.). While these are important and necessary, they won’t help kick-start growth. As seen above, there is enough capital available to fund any amount of bankable projects coming on stream. The real issue is elsewhere—it is around lack of demand (both domestic and exports) for Indian industry. This is resulting in capacity utilization picking up painfully slowly, and constraining fresh investments by industry. Paraphrasing Cassius in Julius Caesar, the fault lies within (the industry), not in our stars (of the banking system).

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