

Low Credit-Deposit Ratio and Economic Stability in India

Sukanta Chandra Swain*

While high deposit accretion and low credit offtake leading to surplus liquidity with the banking system in India this fiscal have been the cause of headache for the analysts and experts, this article tries to establish incremental investment by banks mostly in government securities owing to surplus liquidity as a stabilizing mechanism in the present inflationary situation.

The low Credit-Deposit (C-D) ratio in the banking sector in India is now a subject of intense debate. In order to analyze low C-D ratio in Indian inflationary situation, we should have concrete knowledge about it. C-D ratio is the proportion of loan assets created by banks from the deposit received. It is a product of the ratio of number of credit accounts to deposit accounts and the ratio of credit amount per account to deposit amount per account. Fluctuation in C-D ratio has direct bearings on economic stability of the country. While a high C-D ratio could lead to inflationary situation, a low C-D ratio might lead to recession¹. This article makes a modest attempt to examine this issue.

Factors Responsible for Low Credit-Deposit Ratio

Credit-Deposit (C-D) ratio becomes high if credit volume increases, deposit volume remaining constant or if deposit volume comes down, credit volume remaining constant or by both or even if both credit volume or deposit volume increase provided the rate of growth of credit volume is higher than that of deposit volume. The last alternative for C-D ratio to be high is more practicable. In the similar fashion, we can say that C-D ratio, in more practicable way, becomes low if both credit volume and deposits volume increase but the rate of growth of credit volume is less than that of deposit volume. As this article highlights the situation of low C-D ratio in India, which is very well experienced now in banking sector of the country, it is important to focus on the factors responsible for low C-D ratio. Following are some of those important factors:

- Deposit accretions due to more corporate are parking surplus funds with the banks in spite of reduction in deposit rates by most banks.
- Corporate India is yet to start drawing loans from banks in a big way.
- Dismal credit growth due to the lack of credit deployment in industry, trade and finance.
- The current outflows driven by foreign institutional investors and high international oil prices force the domestic refiners to be active in the foreign exchange markets lifting dollar for meeting their payment obligations, resulting more rupee parking in the banks.

* Faculty Member, The Icfai Business School, Mangalore. The author can be reached at sukanta@ibsindia.org

¹ Downturn in a country's economy measured by a decline in aggregate economic activity.

- The low loan recovery rate.
- Low credit-worthiness among entrepreneurs.

Generally, this has been the period² when credit offtake actually begins and in banking sector this period is known as so called busy season. But this year, the season has been less busy than in the past, probably because many industries are playing a waiting game, leading to surplus liquidity with the banks. From this we cannot conclude that there is no demand for loan in the economy. Of course, demand is there but the bankers are seriously looking into the credit worthiness of the borrowers because of a large magnitude of Non-Performing Assets (NPAs)³ with them. Thus, the bankers may prefer surplus liquidity to NPAs. In both the cases, the bankers lose but the loss in surplus liquidity is much less than that in NPAs. In former case, the loss to banks means the amount to be paid to the depositors in the form of interest but in the latter case, the loss to banks means the interest to be collected from the loaned amount (which is generally higher than the interest on deposit amount) and also the principal. That's why, in no way, bankers will give credit without examining the credit-worthiness of the entrepreneurs. Of course, the bankers will not keep the excess reserves with them in idle form. Instead, they will go for other alternatives, which will be discussed in section 4, like investment from which they will at least get something.

How Decelerated is the C-D Ratio in Present Indian Scenario?

What the facts and figures say?

	Outstanding As on Nov. 9, 2007	Growth this Fiscal	YoY* Growth (%)
Aggregate Deposits	29,19,327	3,11,019	26.7
Bank Credit	20,64,180	1,35,267	23.5
* Year-on-Year basis			

Source: RBI Weekly Statistical Supplement

The nominal C-D ratio of India, on the basis of outstanding as on November 9, 2007 as represented in above table, is approximately at 71% (2919327/2064180). On the face of it this ratio appeared comfortable but it is the incremental C-D ratio which is the main point of concern now. The incremental C-D ratio is the ratio of growth of bank credit to growth of aggregate deposits in a fiscal. The Reserve Bank of India's weekly statistical bulletin for reporting week ended November 9, 2007 showed the incremental C-D ratio at only 44% (135267/311019) which is very low as compared to previous fiscals. A year ago it was 84% and two years ago it was nearly 120%. Credit offtake from the beginning of this financial year till November 9 was Rs. 1.35 lakh cr but during the corresponding period last fiscal it was Rs. 1.65 lakh cr.

In order to defend the net interest margins of the banks an unofficial cap was imposed early this financial year by all the public sector banks on rates paid on bulk deposits at 9%. Despite this cap, deposit growth has accelerated to 26.7% on a year-on-year basis. But the bank credit growth on a year-on-year basis is only 23.5%. The shortfall of 3.2% growth in bank credit causes surplus liquidity with the banks. Now the problem for the economy is how to make use of this surplus liquidity, i. e., liquidity management.

² October-December in a year.

³ Assets that are not effectively producing income.

Tools for Liquidity Management

Hike in CRR

When the monetary authority, the RBI, smells the situation of excess liquidity in the economy, it immediately goes for a hike in CRR⁴ as by doing this; the excess liquidity from the market can be removed, leading to cooling of the money supply which is the basic requirement for stabilization. Keeping the present liquidity problem in mind, Y Venugopal Reddy, Governor, RBI, in the Mid-term Review of Annual Policy for the year 2007-08 hiked CRR by 50 basis point from 7% to 7.5% on October 30, 2007. This is aimed to leak out Rs. 16,000 cr from the system effective from November 10, 2007.

This tool for liquidity management was okay from the RBIs point of view as additional liquidity flows were likely to be mopped up through hikes in the CRR. But from the point of view of the commercial bankers, it is a negative approach as there are no interest receipts on CRR balances. Now the bankers will lose for nothing. They will pay interest on deposits but the additional liquidity will be kept in RBI in form of increased CRR for which they will get nothing. So the bankers will also try to discourage the deposits in order to save their cost. If it happens, more money will be transacted in the economy which may insist inflationary situation to aggravate. Thus in such a situation, hike in CRR is a disincentive for deposit accretion in the banking system and imposes a cost. However, if there is high demand for credit in the economy then this tool for liquidity management will be effective because hike in CRR will never be a disincentive for the bankers. The reason is so simple. In such a situation bankers can raise the credit rate⁵ in order to overcome the cost incurred in the form of hiked CRR. But the present situation in Indian economy is quite different, i.e., high liquidity supported by low credit offtake.

Deposit with the RBI

The Reserve Bank of India like other central banks acts as the bankers' bank. Another option before the bankers for liquidity management is to capitalize this specific function of the RBI. As the bankers' bank the RBI accepts deposits from the bankers and sanctions loans. In excess liquidity situation, the bankers can think of this alternative and can park their excess liquidity with the RBI. From the bankers' point of view, this is a safe way to manage the liquidity problem but it is not at all profitable for them as the reverse repo rate⁶ (presently 6%) is less than the deposit rate (9% on bulk deposits given by public sector banks). Thus, the cost of the bankers' will never be recovered if they go for depositing with the RBI. As profit is the only objective of the commercial banks, they will never opt this path so easily.

Investment

Besides these two tools mentioned above, there is another tool for liquidity management, i.e., investment. In order to get rid of liquidity problem, the bankers can think of investment. Investment is of two types—real and financial. In case of real investment, the bankers have to create new capital asset by involving themselves in Direct Production Activities (DPAs), which is in fact out of question for them. The reason is the requirements for this channel: Entrepreneurial ability and risk management which are generally not liked by the bankers. In fact, if they go for real investment, they will invite a set of problems in order to solve a single problem, problem of liquidity. In that set of problems, the problem of risk and entrepreneurial complications will as such be there. But the greatest problem that can be apprehended from this is the missing of the

⁴ This is the amount of money (out of deposits) that the banks have to necessarily park with the RBI.

⁵ Interest charged on the loans.

⁶ The rate at which the RBI absorbs excess cash from banks.

parental activity, i.e., banking. It is because now the bankers' surplus liquidity will no more liquid and if in near future, high credit offtake prevails, which is very well expected, the bankers will not be able to meet the credit demand of the economy. From this we can say—if bankers turned entrepreneurs, on whom the entrepreneurs would bank upon for finance?

Instead, the bankers can think of financial investment in which they will purchase the existing capital asset. Like real investment, the risk is also there but unlike real investment, the problems of entrepreneurial complications and future liquidity requirements are not there in financial investment. Further, the bankers can also minimize the risk by investing tactfully after examining the economic conditions of the investment channels. From all these view points, government securities including Treasury Bills⁷ are the best option for banks.

Treasury Bills are also the favorites as highly liquidity instruments. This bias is also one of the reasons for the pick up in investment deposit ratio as presented in the following Table 2.

What the facts and figures say?

	Outstanding As on Nov. 9, 2007	Growth this Fiscal	YoY Growth(%)
Aggregate Deposits	29,19,327	3,11,019	26.7
Investments	9,48,346	1,57,915	24.8

Source: RBI Weekly Statistical Supplement

The preference for investments has pushed the incremental investment deposit ratio to 51% (157915/311019) this fiscal, which is higher than the incremental credit deposit ratio (44%) of this fiscal, as against only 22% in the last fiscal. Out of the total growth of investments this fiscal, investment in government securities alone was Rs. 1.54 lakh cr. But during the corresponding period of the last fiscal, investment in government securities was only Rs. 43,000 cr. Thus, investments in government securities alone are nearly Rs. 20,000 cr more than bank credit this fiscal. But in last fiscal, the situation was the reverse. Last fiscal credit exceeded investments by about Rs. 1.2 lakh cr.

Despite a low credit offtake, the banks have not lost confidence on the market. They are hopeful that credit offtake would still pick up in the coming weeks. Therefore, they are cautiously putting the money in short-term securities, just in case they have to liquidate it to meet higher demand for loans in the weeks ahead.

C-D Ratio and Economic Stability

As mentioned in introduction, a high C-D ratio could lead to inflation and a low C-D ratio might be resulted in recession. This section tries to justify this. The Indian Government is the largest borrower in the domestic credit market. The government borrows by issuing securities through auctions held by the RBI. Banks lend to the government by investing in these government securities. If the C-D ratio is high in the economy then the bankers will have lesser money with them to invest in government securities. In such a situation, if government needs money to meet its expenditure, it will issue securities but because of lack of money with the banks they can not purchase those. Then the government will have two options — i) It can raise yields on securities to make investment by banks in government securities attractive; or ii) It will force the RBI to take the securities into its books. In first case, as the government securities are now attractive, the banks will either raise the interest on loans in order to lessen the opportunity cost or will go for purchasing government securities instead of sanctioning loans. If they purchase government securities, less money will be available for credit but as the demand for credit is high in the economy, the rate of interest on credit will automatically go up. In fact, yields on government securities serve as a benchmark for interest rates on other debt instruments. A rise in the former,

⁷ A short-term debt obligation backed by the government with a maturity of less than one year.

thus, pushes up interest rates on the latter. As interest rate goes up, producers will be demotivated for production as the cost of capital now is high. That will undermine the supply of goods and services thereby leading inflationary situation in the economy. In second case, the RBI will take the securities and will meet government's money requirements by releasing fresh money. If the money so released is large, too much money will chase too few goods in the economy resulting in inflationary situation. Thus, high C-D ratio is pro-inflationary.

On the other hand, the low C-D ratio may lead to recession. As the corporate and public park more money in the banks instead of opting for investment, it clearly shows that either they perceive the MEC⁸ less than the rate of interest from their deposits because of some bottlenecks in demand side or they apprehend unsafe atmosphere in investment channel. Whatever it may be, more money will come to banks. If the existing corporate and public with surplus income behaves in this way, then the chance for generation of demand for credit from new entrepreneurs will be remote. Accordingly, the credit offtake will be low. In such a situation, to manage the excess liquidity problem, the banks may go for financial investments, particularly investment on government securities, as discussed in previous section, to avoid the problem of risk and future liquidity requirements. As a consequence, the possibility of creating new capital asset will be no more as the entrepreneurs apprehend bottlenecks in the demand side of the economy. That means production will be choked because of deficiency in demand and that situation will lead to recession. However, if there is already inflation in the economy and the credit offtake is getting low, then that will rather be an automatic measure for checking inflation as is going to be explained in the next section.

Low C-D Ratio as an Anti-inflationary Mechanism

Generally, if inflation is there in the economy, the demand for credit should be high as the entrepreneurs prefer to expand the production activities in order to capitalize the excess demand situation. Thus, high credit-deposit ratio is inevitable during inflationary situation. But the present economic scenario of India experiences a different set up: low C-D ratio during inflation. Why so? This set up, what the experts feel, is seasonal only and is due to the perception of many industries that this is not the right time to enter with their capital expansion plans.

During inflation people have more purchasing power (in money terms) because of too much money chases too few goods. In order to check this inflationary pressure, the RBI uses one of its quantitative monetary instruments of credit control, i.e., open market operations and sells government securities in order to suck out some money from the system. But now because of low credit offtake, in order to manage their liquidity problem, the banks are suo motto coming forward to invest in government securities only for their betterment. So what the RBI generally tries to do, the bankers are now fulfilling that on their behalf during inflation. While the former, i.e., the RBFs trial to manage liquidity problem is a deliberate measure the latter, i.e., the step by commercial banks to manage surplus liquidity problem is an automatic measure for suppressing inflationary pressure. The reason is very simple. Due to low credit offtake, investments by banks increase. The increase in investments by banks will lead to drop in yields of government securities. Yields are bound to come down further as there is so much of liquidity with the banks. The increasing investments by banks are a good sign as it is leading to lower monetization of government debt. With lower monetization, money supply will be very much under control and as a result inflation will not be aggravated, rather will be under control. One may apprehend that the increased intervention by the central bank in the forex market and higher capital inflows might stimulate inflation. But in reality, these two factors will not have much of an impact as the banks are investing all the rupees that are being released into the system in government securities instead of lending to corporate.

⁸ Marginal Efficiency of Capital, i.e., the rate of return expected from the amount invested.

The increasing investments by banks are a good sign as they are leading to lower monetization of government debt

Conclusion

As expected by the bankers, the present problem of low credit offtake in monetary system of India is not a permanent one. This is the factor for which they prefer short-dated securities, with a residual tenure of under three years. Of course, the so called busy season in corporate world has been less busy than in the past. So compared to the corporate plans, their implementation will probably be slower this year and the credit offtake would be a little moderated compared to the previous year. But there will definitely be a credit offtake; may not as substantial as the previous years. So far as banks' investment is concerned, the bankers are not at all uncomfortable. In fact, they are very optimistic in their approach. Therefore, in spite of a hike in CRR, some public sector banks are not in favor of hike in their lending rates. However, they will certainly go for cutting down the deposit rates.

Ordinarily it seems, a reduction in lending rates would provide a solution to the surplus liquidity. But in reality, it may not be the fact. It is because the present surplus liquidity in the system is more a case of lack of demand than of oversupply. If the potential demand for credit is less than the actual because of the cost of credit, i.e., existing interest rate on credit, then a reduction in lending rates would create a scope for high credit offtake. But in present situation, there is sluggish demand for credit and for that the corporate prefer parking more money in banks even at very low deposit rates. However, to find the way out for the banks to survive the surplus liquidity problem, along with the alternative tools explained in section 4 for the same, one can reasonably suggest the following. At the macro level, the investment climate, particularly infrastructure-related developments and resurgence of the primary capital markets, has to improve. If it happens, the present day surplus liquidity in the system, which is basically due to lack of demand for credit, can overnight take a turn and the borrowers will run after banks once again for credit. At the micro level, commercial banks are to be little liberal in examining the credit-worthiness of borrowers and have to focus on sectors like middle class in the country which have huge potential for asset creation. So banks should come out with a host of retail loans aimed at the middle class group. Banks also have to look at diversifying their income sources through increased lending to venture capital⁹, especially in the IT sector and also for the emerging e-commerce business. There should also be cooperation from fiscal authority to manage liquidity problem. The budget is to contain such measures aimed at minimizing fiscal deficit to stimulate the investment thereby allowing lesser deposits with the banks. ♦

Reference # 02M-2008-03-06-01

Third Quarter Review of Annual Statement on Monetary Policy for 2007-08

Dr. Y Venugopal Reddy, Governor, Reserve Bank of India presented the Third Quarter Review of Annual Statement on Monetary Policy for the Year 2007-08. The following are the monetary measures:

- Bank rate kept unchanged at 6.0%.
- The reverse repo rate and the repo rate under the LAF are kept unchanged at 6.0% and 7.75%, respectively.
- The Reserve Bank retains the option to conduct overnight or longer term repo/reverse repo under the LAF depending on market conditions and other relevant factors. The Reserve Bank will continue to use this flexibility including the right to accept or reject tender(s) under the LAF, wholly or partially, if deemed fit, so as to make efficient use of the LAF in daily liquidity management.
- CRR kept unchanged at 7.5%.

Source: www.rbi.org.in

⁹ Financing for new businesses.