The country’s grand November credit bubble should worry us

A steep rise in personal loans over the festive season, coupled with stagnant credit to industry, portends a surge in defaults

The festival and wedding season is under way in full swing. Optimism is in the air, with the Sensex at an all-time high. Post Joe Biden’s victory in the American presidential election, capital is flowing into India, bolstered by hopes of Pfizer’s vaccine rolling out soon. Finance secretary Ajay Bhushan Pandey in an interview pointed to a rise in goods and services tax receipts in September and October, and e-way bills in October, as indicative of a robust recovery. Many noted economists and columnists have concluded likewise. Since these increases are year-on-year, not monthly or quarterly, they have emphasized that these data do not reflect the immediate bounce-back after the lifting of India’s lockdown, but capture the longer term momentum of the economy. Whether this is sustainable remains to be seen.

Instead of gross domestic product crystal ball gazing, this article highlights a disturbing financial trend. Over the last few years, bank credit to industry has been shrinking, while that to consumers has been growing rapidly. Expansion of personal loans is not problematic per se if job and income growth are robust, enabling them to smoothly pay off their loans, while new loans are incurred.

However, the weakness in bank lending to industry suggests a long-term slowdown in growth, leading to job losses. As a result, consumers without jobs and income will be unable to pay back the huge debts they are now incurring. The huge credit expansion underway in the financial system, from banks to online outlets and beyond, is very lopsided and fundamentally unsustainable.

To support this view, let us scrutinize trends in the sectoral deployment of bank credit, on which the Reserve Bank of India (RBI) puts out very useful data. Total non food credit outstanding was ₹91.173 trillion at the end of September 2020. This comprised four broad categories: Agriculture, industry, services and personal loans. Shares of these in total credit were 13.1%, 32.2%, 27.4% and 27.3%, respectively. It is vital to note that the shares of services and personal loans are above a quarter each, and fairly close to that of industry.

Within industry, there are three sub-categories: first, micro and small firms, then medium, and finally large firms. In the 12 months ended September 2020, credit to industry was flat—actually it fell by a tiny ₹184 crore. Among these sub-categories, credit to micro and small firms and large firms both fell a bit, while it grew 14.5% to medium-sized firms, boosted by finance minister Nirmala Sitharaman's fiscal package.

In sharp contrast to industry, personal loans grew by 9.2%. Despite the decline in many categories of personal loans post covid, the miscellaneous category, of "other personal loans" rose 13.2% over the year and 2.5% in the six months after March. If outstanding personal loans rise, that need not be ominous in itself. On the contrary, it may reflect a dynamic, flexible system that allows its participants to cope with the corona calamity.

To buttress the conclusion that growth in credit has been lopsided, we should pay close attention to the pre-covid data over a longer period. This is because data for the most recent year has been hugely distorted and depressed by the pandemic and various subsequent policies.

In the five-year period ended September 2019, credit to industry grew by a measly 2.0%, while that for personal loans grew by 16.6%. The share of industry in total credit fell from 44.1% to 32.1% while that of personal loans rose from 19.2% to 27.3% over this five-year period.

A critic could argue that the focus on credit to industry is misplaced. If the services sector grows rapidly, and creates jobs and incomes, why be obsessed with physical manufacturing? After all, India's strength is information technology services, just as China's is manufacturing. While this point is valid, within services the sub-category of loans to non-bank financial companies grew by a whopping 30.5% in the year ended September 2019, and by 12.5% by September 2020. The share of this sub-category of non-banking financial company lending (in total non-food credit) rose from 5.2 % in 2014 to 8.3 % in 2020. Arguably, this reflects excessive financialization of the economy, and not healthy growth.

Going beyond bank data, there is a dangerous explosion of credit underway fostered by the digitization of the process of granting credit—as distinct from the mere digitization of payments, such as the use of a debit card to replace cash payments. Card machines in smaller towns are emerging as the new agents for consumer durable loans sold against equated monthly instalments (EMIs) at point-of-sale machines.

Many internet retailers are enticing naïve customers by packaging the price discount they are offering on products as "zero cost EMIs". One may ask, what precisely has RBI done to tackle this credit bubble? What exactly has former deputy governor Viral Acharya, vocal about fiscal dominance and bad public sector banks, written about this personal loan expansion?

Such an explosion of credit pushes policymakers to keep the economy growing very fast to avoid loan defaults, even though the covid or inflation situation may warrant restrictions.

“Buy now, pay later". “Hurry now, worry later". With a grand Diwali credit bubble underway, all one can do is wish the reader and consumer a happy and credit-able Diwali season.

Vivek Moorthy is professor, economics and social sciences, Indian Institute of Management Bangalore