India's struggling banking system controls credit, Indian-style

by Ramtanu Maitra

To further restrict liquidity in the Indian economy, the Reserve Bank of India (RBI), the central banking authority, raised the cash reserve ratio from 10.5% to 11% on July 30. CRR is the cash reserve that each bank must maintain on hand. Less than a month earlier, the CRR was raised from 10% to 10.5%.

This is the first time in the short history of Indian banking that the CRR has been raised twice within the same month. Within the peculiar geometry of India's nationalized banking system, the unprecedented move is a signal of the government's fear of an inflationary surge.

CRR is only one of the restrictions imposed on the commercial banks to control and channel credit—which altogether keep some 50% of bank funds impounded and about 80% dedicated to specific purposes—but it is the one most generally used to control "excess funds" whose inflationary potential is deemed high. In the Indian banking system, it is CRR and not a boost in interest rates, that is relied on to control liquidity.

What really caused the hiking of CRR by one full point during July has not been made public, but two developments stand out. First, deposits rose substantially in the current financial year to July 15. According to one report, the rise in deposits was of the magnitude of about $5.6 billion equivalent, compared to slightly more than half that in the corresponding period of 1987-88. So far, no rational explanation for the rise in bank deposits has been forthcoming.

Second, procurement levels for last winter's wheat crop have been generally low. The government of India impounds cash from the commercial banks to purchase foodgrains from the farmers to maintain a buffer stock for emergencies, on the one hand, and to sell foodgrains through fair price shops at a subsidized price, on the other. The food credit, as it is called, is channeled through the Food Corporation of India and the state government agencies of the FCI, at a rate of 14%, to the tune of about $100 million annually. Although this spring's harvest is estimated to be as high as 47 million tons—a good crop—procurement has remained low. No official explanations have been offered, but the reduced expenditure has undoubtedly increased cash liquidity in the banks.

Evidently, the Reserve Bank of India is not willing to see this surplus liquidity get out into the market at this time, for fear of fueling inflation. Because of the 1987 drought, inflation from fiscal year 1987-88 may turn out to be as high as 10.6%. At the same time, with the likelihood of continuing decline in agricultural credit demand until the October planting-time, administrators calculate that borrowers may not miss the blocked funds in the coming months anyway.

Behind the restrictions

The Reserve bank of India's CRR exercise is characteristic of the operations by which credit is controlled and channeled in the national banking system set up in 1969, when the government of India took over the country's 14 largest private banks. The bold move, vilified in the West, was virtually forced on the Indian government by the irresponsibility of the private banks.

Although 75% of the country's population depended on agriculture in 1969, more that 20 years after independence, there was only a trickle of financing going to the farm sector; the private bankers were hooked on the business houses. The farm sector's share of total credit was as low as 1%! Agriculture was in deep misery, and the government had launched the "Green Revolution" program to boost output—but to function, it would require credit.

The small-scale sector, the next-largest employer in the country, fared little better. In 1969, small-scale industries were getting less than 2% of the total credit allotted. Moreover, the government had embarked on an ambitious nation-building effort in basic industry and infrastructure, and, having been looted by the British colonialists for about 200 years, was facing an acute resource shortage.

To try to deal with this, the government established lending priorities in certain sectors, but the private bankers thumbed their noses at the recommendations and clung to

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their preferred clientele, many of whom had a firm hold on the banks themselves. It was the bankers' negative response to reasoned policy guidelines and the imperatives of the Green Revolution that gave the government the momentum to nationalize, accounting for a total of 91% of total deposits and 84% of advances of commercial banks.

One objective of the bank nationalizations was to ensure that no viable productive endeavor should be allowed to falter for lack of credit. Though a factor of stability and a potent force for positive direction of economic development, the bank nationalization has foundered on the weakness of the banking infrastructure and the economy as a whole.

One of the objectives of the bank nationalizations was to ensure that no viable productive endeavor should be allowed to falter for lack of credit support, regardless of the lack of political clout of the borrower. Thus, the concept of priority sector lending was developed, with agriculture and small industries at the head.

In March 1980, the banks were told to raise the proportion of priority sector advances from about 33% to 40%. In achieving this overall target, the banks were asked to ensure that their direct advances to agriculture should be at least 15% of net bank credit by March 1985, and 16% by March 1987. A tiered interest rate structure—with some 15 different brackets!—was developed to assure credit availability.

Though a factor of stability and a potent force for positive direction of economic development, the bank nationalization has yet to really realize its promise. It has foundered largely on the weakness of the banking infrastructure and the lackluster performance of the economy as a whole. Thousands of branches were opened in rural India, but the distribution of credit to needy farmers has remained slipshod and inadequate. Even today, 19 years after the major banks were nationalized, total bank credit provided to the agricultural sector—which accounts for one-third of the nation's income—is only 17%. Medium and large industries, on the other hand, with a share of 20% of the national income, walk away with 36% of the total credit supplies.

From the commercial banks' point of view, their inability to function effectively is the result of multiple constraints. In the first place, there is little "free energy" in the banks' funds. Besides the now 11% CRR, banks are required to keep another 38% of their funds—the so-called statutory liquidity ratio (SLR)—with the Reserve Bank of India as a means of assisting the government in its borrowing programs. The so-called incremental cash reserve ratio, which involves 10% of the incremental deposits accruing after Nov. 11, 1983, completes the banks' reserve requirements—which together lock up more than 50% of the commercial banks' cash liquidity.

Of the remaining liquidity, the banks are required to lend 40% to the priority sectors, including direct and indirect financing to the farm sector, road and water transporters, retail traders and small businessmen, tribals, scheduled caste, and other weaker sections of the society. The commercial banks are also directed to finance more than 1.2 million "sick industries"—a euphemism for bankrupt companies—which eats up some $4 billion annually. After meeting all these requirements and commitments, the banks are left with about 20% of the total liquidity for lending to various industrial and other borrowers—at rates set by the Reserve Bank of India.

The most prominent casualty in the entire set-up is bank profitability. On a total deposit base of some $8.5 billion, the nationalized banks earned a profit of $240 million last year—a return of less than 0.3% on total working capital.

In part this is due to the interest rate structure. First, the savings deposit rate has been kept attractive to savers, assuring them of staying one step ahead of inflation.

Second, interest rates are set for priority sector beneficiaries at less than the prevailing "free market" rate of 16%. For example, loans to agriculture vary from 10% to 14% depending on the size of the loan. This policy is doubly ineffective, since the rates are actually too high to really benefit the small or marginal farmers who are the main beneficiaries, and too low to allow the banks to break even. And this is not to mention the fact that the government itself force-feeds the banks huge quantities of government securities in exchange for cash at the maximum coupon rate of 11.5%!

Moreover, the inadequate banking structure has taken a heavy toll on banks in the rural areas, because, among other things, they are not equipped to properly assess their borrowers. Studies have shown recently that nearly half of the money lent in rural areas is not paid back. The banks also find it difficult to service hundreds of thousands of small accounts economically.

The commercial banks, for their part, have failed to shake off many inefficiencies and redundancies in their mode of operation. Computerization, for instance, is still being resisted by the unions. E.A.G. Moses, secretary of the National Federation of State Bank Officers, pointed out recently that of the 193 regional and rural banks, at least 50% are running at a loss.