Political Economy of Directed Credit

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Introduction

Imagine you are a bank manager and you have to decide to whom you will lend money. One prospect is an industrial company and the other is a farmer. As someone who wants the largest possible profits, you will look at each person's credit worthiness and the interest rate and decide based primarily on these two factors. If the farmer is a riskier borrower but is willing to pay a high enough rate of interest to compensate for this risk, then you may very well decide to lend to the farmer. The same is true for the industrialist. In this stylised example, whoever values the loan more will receive it so the borrower is better off because he is willing to pay more later for money now, and the lender is better off because he is earning the highest possible profit. And the person who did not receive the loan is free to go to a competing banker and borrow money from there or to forgo the loan altogether.

The point of this example is to show that markets, in theory, work for borrowing just as they do for any other good or service. India's financial policies since 1967, however, have been based on the premise that markets do not work in the national interest when it comes to banking and that the government is needed to set interest rates and tell banks to whom they must lend. Lending decisions are taken out of the realm of profit maximisation or economic concerns and placed into the realm of politics.

To be fair, a possibly valid criticism of the above example is that markets may work on the small scale, but for a nation as large and complex as India, markets need government guidance to function correctly. After all, what is true for the whole is not always true for its constituent parts. There are also normative concerns that lending based purely on profit will lead to inequality. My purpose in this paper is to show that these considerations cannot justify the Reserve Bank of India's policy of "directed credit." That is, forcing banks to lend to certain "priority sectors" has caused harm to the Indian economy and that the more recent reforms by the RBI have made directed credit an arbitrary and useless policy.

Why Directed Credit?

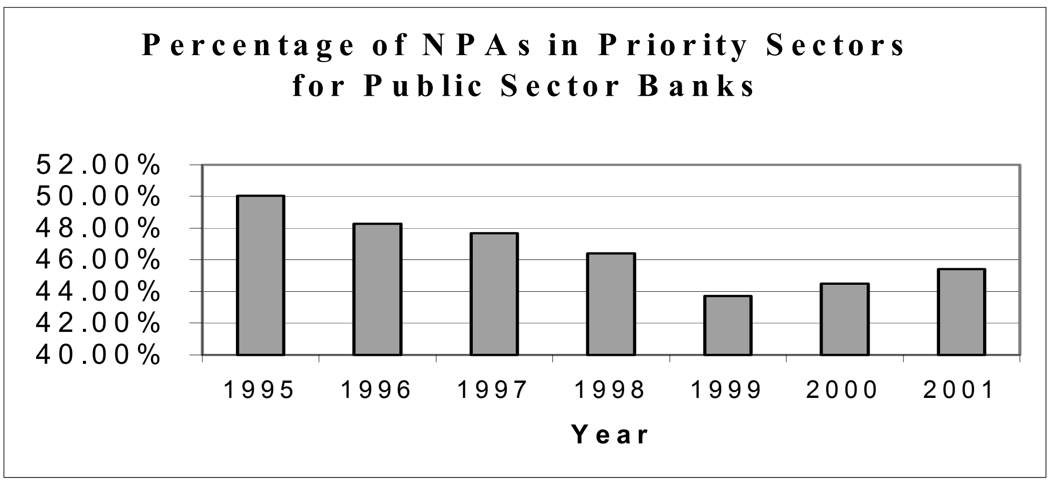
The primary role of the banking sector in a free market economy is to channel savings to investment. Banks are an intermediary that borrow money from account-holders and lends money to others. The ability to borrow money in an economy is crucial for making long-term investments. Without a robust, efficient banking system, investment will be inadequate and inefficient. This, in turn, will tend to lead to low productivity and low economic growth. The Government of India has a history of restricting the ability of banks to accurately judge risk and return on loans and make decisions on loans based on profitability. As in many other areas, the

Government of India justified its intervention in the banking arena by claiming that as a developing economy, a free-market system would not provide adequate funds for investment and so government was required to develop a strong industrial sector. According to C Rangarajan, the free-market was seen by the government as unable "to optimally allocate resources over time, that is, for investment because of the 'myopic' nature of markets." Therefore, the government forced all public banks to allocate a certain percentage of their total credit for certain important sectors of the economy that the government felt were disadvantaged by the banking system.

History

Directed credit has its origins in the "social control" policy of the government in 1967. At this time, many felt that banks were too closely tied to industry and were unfairly disregarding agriculture and other essential sectors of the economy (Patel, pp 126). Since the market was not providing what many in the government thought was essential this seemed to justify government intervention in lending markets. Social control involved pressuring banks to allocate credit to certain strategic sectors. However, this policy is widely viewed as ineffective and one of the motivations behind the bank nationalisation of 1969 was its ineffectiveness. After 1969, the government mandated that 33% of all credit extended by banks be reserved to strategic sectors of the economy. Later, this ratio was increased to 40%, which is also the current ratio (Joshi, pp 113). Directed credit continued virtually unchanged through the 1991 liberalisation and is still in place today. However, in 1998-1999, the RBI made a series of changes in what it defines to be a priority sector.

The first policy change that was made was the inclusion of software firms with a credit limit of less than Rs 1 crore in the priority sector. Other changes to the list of industries that came under the scope of the priority sector during this time include food processing, venture capital, and high-cost housing construction and repair. Although these decisions may seem arbitrary, they broaden the choices that banks have available to them. And since banks have more choices in whom they lend to, economic theory tells us that banks will have less NPAs (Non Performing Assets) and greater profits.

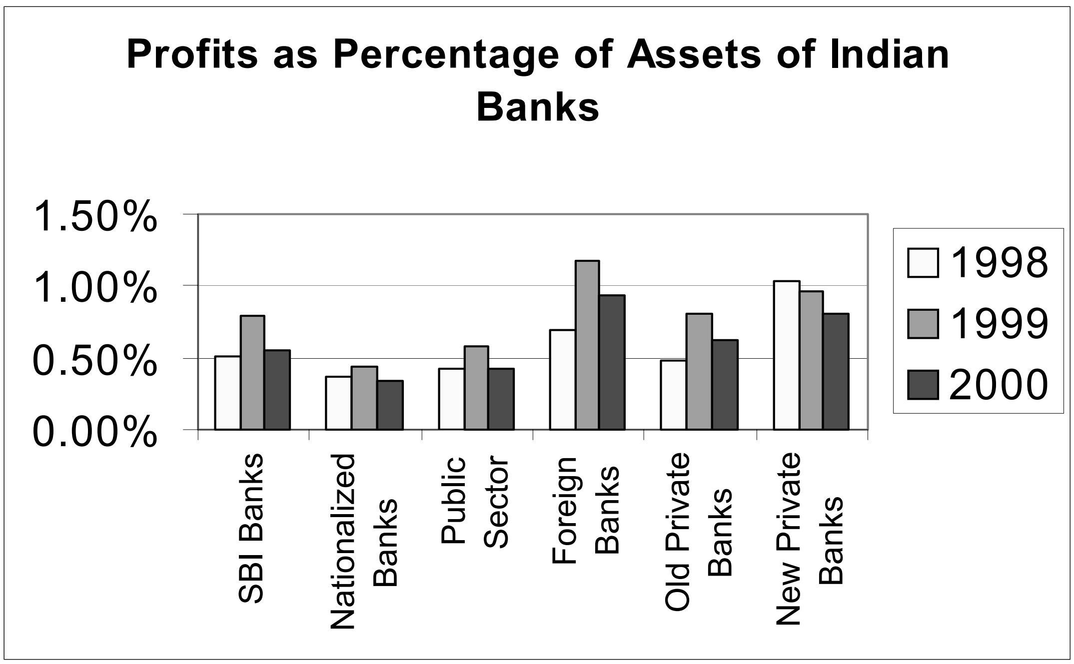


Evaluating Directed Credit: What About the Banks?

Since bank nationalisation in 1969, banks have performed very poorly from an economic point of view. According to S L Rao, "the country's banking system became a playground for political interference with loan 'melas' and loan write offs, and consequent decline in the quality of assets of the banks and financial institutions (Rao, p 80)." In the year 1993/1994, non-performing assets comprised 22% of banks' loan portfolios (Rangarajan, p 114). And in 1995, 50% of all NPAs were invested in priority sectors, while banks were only required to lend 40% of available funds to priority sectors. Since the government was creating artificial distortions in the market for loanable funds, economic theory tells us that this will lead to inefficient investment. In fact, this is exactly what we observe. For the Indian economy as a whole, the average rate of return on assets in the period 1985-1990 was a paltry 15%, which is quite poor by international standards. As banks are the primary vehicle for providing investment funds, we can certainly expect that a bank concerned with its own financial performance would decrease the number of non-performing assets and thus enhance the productivity of assets.

NPA of Scheduled Commercial Banks (Rs Crores)						
	Non-Performing Assets			Percentage of Total Assets		
Gross	1998	1999	2000	1998	1999	2000
Public	51,710	53,033	54,733	6.7%	5.9%	5.3%
Private	4,655	4,761	6,039	4.5%	3.6%	3.7%
Foreign	2,357	2,614	3,071	3.1%	3.2%	3.0%
SCB	58,722	60,408	63,833	6.2%	5.5%	4.9%
Net	1998	1999	2000	1998	1999	2000
Public	24,211	26,187	27,969	3.1%	2.9%	2.7%
Private	2,943	3,031	3,699	2.8%	2.3%	2.3%
Foreign	866	855	800	1.1%	1.0%	0.8%
SCB	28,020	30,073	32,468	2.9%	2.7%	2.5%

Source: Indian Economic Survey. 2001-2002. pp 78.



Sources: Indian Economic Survey, 2001-2002, p 77 and Indian Economic Survey, 2000-2001, p 62.

The preceding table demonstrates two important facts: domestic banks have a higher proportion of their assets in NPAs than foreign banks and the ratio of NPAs to total assets has been declining from 1998-1999 to 2000-2001. One possible reason for the lower proportion of NPAs for foreign banks is the less stringent lending requirements imposed on foreign banks. NPAs as a percentage of total assets has decreased across all banks for the two years following RBI's directed credit reform.

Unfortunately, since the directed credit reforms were enacted less than four years ago as of mid-2002, there is insufficient data to demonstrate in a statistically rigorous manner that RBI's reforms have led to less non-performing assets and greater bank profitability. However, the harm that directed credit did in the past is relatively clear and uncontroversial. The data show some signs that NPAs as a proportion of total assets are decreasing and that the percentage of NPAs in the priority sector is decreasing, but more time is needed to infer a clear, causal relationship.

The government's policy of directed credit resulted in less monitoring of repayment and loan risk on the part of Indian banks (Rangarajan, pp 113). Also, the lack of autonomy of public sector banks is often blamed for the lower profitability of these institutions. We can conclude that the high degree of non-performing assets and low productivity of capital that we observed in the Indian economy in the late 80s and early 90s was caused in part by directed credit.

Conclusion

There are three main arguments that one can make in favour of directed credit: irrationality of banks or lack of information, the externality or economic development argument, and the equity argument. The first argument can be dismissed summarily; all available data show that the sectors to which banks are forced to lend are less credit-worthy than non-priority sectors. The government, by imposing directed credit policies, is not trying to improve the efficiency of banking. SB Gupta, referring to the Narasimham Committee Report, set up by the government to examine the banking system in India, writes, "[directed credit] has been at the cost of the quality of loan portfolios of banks, the growth of overdues and consequent erosion of profitability of banks (Gupta, pp 429)."

The second argument is that the priority sectors have external benefits to the economy as a whole and that even though it may not be profitable to lend to these sectors, it benefits the economy as a whole. This argument parallels the argument in favour of industrial policy or any other active government planning. However, a quick glance at the list of the businesses that fall into the priority sector shows that, although this argument may work in the theoretical case, for India, directed credit is primarily for disadvantaged sectors of the economy, with the exception of venture capital and software. As far as agriculture is concerned, it is difficult to believe that with subsidies, minimum prices, and other interventions in agriculture markets, that directed credit is also necessary to keep agriculture a viable business. As practised in India, directed credit has no economic justification whatsoever.

So that leaves us with the equity argument and a much larger problem than anything economics alone can deal with. However, even if one believes that there is a trade-off between equity and efficiency—a trade-off between some people being rich and others being poor and everyone being moderately well-off—it is equally clear that directed credit is a poor way to achieve greater equality in India. It may be politically popular to benefit the poor at the expense of banks, but directed credit diverts loans away from perfectly viable businesses and instead channels credit to wasteful and inefficient uses.

So if directed credit is such a bad idea, one may ask, why does it exist and why do so many people in the government support it? One answer is that directed credit, as mentioned before, is politically popular because it hurts the banks primarily in order to benefit the poor. It is an indirect subsidy so the cost is largely hidden from the public even though the actual economic cost is much higher than the cost of a direct subsidy. Also, since India has a history of socialist economic policies, claims to the effect that banks will not serve the national interest if left to their own devices have much credence.

Although it is clear that the original intention of the policy of directed credit was to achieve greater economic equality, the inclusion of the software industry, venture capital firms, and high-cost housing shows that the current reason for directed credit is quite muddled. The priority sector has been defined so broadly that, although the harm done by directed credit has been reduced, there appears to be little consistency in what is or is not considered a priority sector.

Appendix

Current Directed Credit Policy

Agriculture is allocated 18% of all loans and "weaker sections" are allocated 10%. Priority sectors are comprised of agriculture, small-scale industries, small business, housing, education, venture capital, software, and credit to caste or tribal organisations or individuals from scheduled castes or tribes (Priority Lending FAQ).

Additionally, priority sector lending requirements are imposed on foreign banks. Foreign banks must make 32% of total credit available to priority sectors of which 10% must go to small-scale industries and 12% to exporters with no targets for agriculture or weaker sections.

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