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Are there financial risks to strong growth?

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Since 2003/04, India's GDP growth has been running at about 8% on average per year, a growth rate well above India's long-term trend. Expansion is broad based, with the most noticeable feature being the strong acceleration in industrial production underpinned by stronger domestic and external demand. Growth rates in industry are catching up those in the still buoyant services sector. Services and industry thus form a solid basis for growth over the coming years, to the extent that both sectors reduce the economy's vulnerability to the persistent volatility of farm output.

Takeoff in corporate investment and strong consumer spending are supported by high growth in non-food credit, which the monetary policy tightening underway has not succeeded to curb so far. Favourable medium-term prospects are also attracting foreign private capital but mainly in the form of short-term volatile investments, which make the local stock market becoming relatively more vulnerable to adverse external shocks. The aim of this paper is to determine whether both phenomena (credit growth and capital inflows) bear risks for the short- and medium-term stability of India's financial environment, to the extent of eventually derailing growth.

In what regards the credit issue, our assessment is that strong credit growth is in accordance with India's higher potential growth, even though it has now to moderate in order to preserve sound banks', households' and corporates' balance sheets. As for capital inflows, the authorities keep a gradual approach to fuller capital account convertibility, so that India's transition towards greater exposure to external shocks can go ahead smoothly.

I. Credit expansion supports the rise in India's potential growth

I.1. Underlying structural factors elevating potential growth

Statistical evidence of increasing India's potential growth is given by the trends observed in the capital goods sector, with both production and imports increasing strongly over the past few years. As the share of industry in GDP is relatively narrow (27%) compared with other countries at the same stage of development, India most probably was in a situation of industrial undersupply in the early 2000s in the face of growing internal and external

demand. Stronger domestic demand reflects structural enhancements in private consumption dynamics underpinned by favourable socio-demographic trends (emergence of a middle class, development of consumerism). Stronger Indian exports mainly result from the takeoff of manufactured exports – alongside already performing exports of high value-added services –, as Indian manufacturers have improved their competitiveness after years of restructuring started in the late 1990s. In addition, India is specialised in production segments enjoying strongest growth in world demand (oil products, organic chemicals, electric equipment) which account for an increasing share of Indian exports. Finally, Indian exports have also moved more towards rapidly growing areas including main OPEC member countries and emerging Asia, notably China. In total, stronger internal and external demand has triggered an investment recovery at a moment when enterprises were in better financial health and in a better competitive position.

I.2. Bank credit in a caught-up phase

I.2.1. Bridging the infrastructure gap

In this context, non-food credit to the commercial sector has been growing rapidly since early 2004/05 (33% year-on-year on average) following a powerful acceleration initiated the previous year. Demand for credit has been broad based, stemming from agriculture, industry and also individuals, but the last two categories have been the most dynamic segments. In the period from April to January 2006, demand for credit from the industrial and the individual sectors has continued to strengthen. In this period, almost 26% of incremental non-food credit went to industry, 15% to housing loans, and 11% for agriculture and allied activities. Furthermore, the increase in industrial credit has been mainly on account of infrastructure industries (power, roads, ports and telecommunications) construction and iron steel, which has supported industrial production. The infrastructure sector[1] alone accounted for more than a third of incremental credit to industry. Credit demand from other highly performing sectors of the economy like textiles, gems and jewellery, vehicles, and food processing is also sustained but to a lesser extent than for infrastructure industries.

I.2.2. Consumption trends spurt the rise in personal lending

Besides industrial credit, the share of personal loans in total bank lending has also been growing fast over the past few years, from 11% in 1999/00 to 24% in 2004/05. Housing loans have increased the quickest on average since the late 1990s (44% per year) and mortgages remain by far the largest component of personal lending (half of the total portfolio). A new phenomenon is the sharp rise in consumer loans and credit cards, for which demand has accelerated significantly over the past two years, albeit from a low base. They each still account for a mere 2.5% of the total portfolio of personal loans.

The rise in retail lending reflects the structural increase in consumer spending underway based on the enhancement of the consumption model (emergence of a middle class[2] with the rise in the average income per capita over the last decade, increase in the share of working-age population in the total population, structural fall in interest rates). Higher earnings combined with the rise of consumerism and favourable demographics have created an attractive business climate for banks that have then sought to develop an extensive range of

[1] Infrastructure industries (29% of India's industrial output): electricity, coal, steel, cement, crude petroleum and petroleum products.

[2] Defined by the NCAER as households with an annual income of INR 200,000-1,000,000 (or USD 4,000-23,000). They are estimated to account for about 6% of the Indian total population.

personal credit. This new segment helped mitigating stagnant credit demand from the industrial sector in the second half of the 1990s and the current trend towards disintermediated financing for medium and large Indian enterprises that can raise cheaper money in local capital markets (international markets for largest groups). The government policy promoting housing since the early 2000s has also contributed to reinforce demand for personal loans.

In total, credit growth appears to be in a catching-up phase that helps the economy's elevating its potential. The ratio of domestic credit to GDP is still low (60% of GDP) compared with other emerging countries. Bank credit will continue to expand in the long run, even though the current pace is not sustainable and should moderate in the years ahead. The rapid development of the new segment of retail lending for banks can also pave the way for future crises if regulation is not adequately adapted.

I.3 Potential risks of rapid credit growth on the economy and the banking sector

I.3.1. From the demand side: asset quality

There exists no breakdown showing the origins of bank's non-performing loans (NPLs) by sector. However, despite strong credit growth of the past few years, NPLs in absolute level have continued to decline steadily due to improved recovery (enactment of more effective foreclosure laws). Combined with strong credit expansion, the NPL ratio has been reduced and now reaches relatively low levels. The gross NPL ratio was down from 7.4% in March 2004 to about 4% in March 2006 (net NPL ratio down from 2.9% to 1.5%). Therefore, asset quality of the whole banking system is currently sound.

The largest share of bank credit continues to go to the industrial sector, but this share is in decline relatively to the rise in personal loans. This decline is also in absolute level reflecting increasing disintermediation and market interest rates more competitive than banks' prime lending rates. The risk of asset deterioration attached to corporates in the industrial sector is assumed lower than that attached to personal lending, given the deleveraging process in the manufacturing sector in the late 1990s and improved profitability over the past few years, underpinned by strong domestic and external demand. In contrast, consumer loans and residential mortgages are historically un-penetrated segments for Indian banks, and some small problems have begun to emerge (forged property documents, fake salary certificates), which may affect asset quality of some banks, especially those that have entered this business aggressively without developing adequate risk management systems. However, central bank's regulations have periodically been tightened to temper the banks' enthusiasm (increase in the risk weightings for consumer lending since October 2004). Moreover, retail banking still represents a small share of bank's credit portfolio and only 10% of GDP, which should limit the impact of delinquencies on the banking system and on the whole economy. Nevertheless, although no serious problems are likely to appear in the next few years, the delinquency rate will inevitably rise in the medium term with the continued expansion in personal lending.

I.3.2. From the supply side: stretching domestic liquidity

In the short term, however, strong credit growth already seems to pose a liquidity problem to banks. Indian banks have long been over-liquid in the sense that the ratio of deposits to total domestic credit has remained comfortable at more than 100%. Since the early 2000s, liquidity has shrunk with rapid growth in credit and slowing growth rates of deposits. In June 2006, the liquidity ratio stood at 82% compared with 95% in June 1999. Tensions on

liquidity have intensified last year with slower accumulation of official currency reserves linked to the rapidly widening current account deficit in 2004/05 and 2005/06 and to the bullet repayment of Indian Millennium Deposits (IMD) in December 2005. In an increasingly competitive environment for banks, lower interest rates and the bullish local stock market have also encouraged households to reallocate their deposits in favour of higher-yielding financial investments with non-bank financial institutions (mutual funds in particular). Up until now, banks have been able to finance the sustained credit demand through partial liquidation of their investments in Government and non-SLR securities and raising of capital through equity issuance. In the second half of 2005/06, banks also improved deposit mobilisation by increasing deposit rates by 75-100 basis points across various maturities. In addition, the central bank raised interest rates on non-resident Indian (NRI) deposits, though they account for a smaller share of total deposits than in the past.[3]

However, the most efficient way of improving liquidity conditions remains to curb credit growth through stricter regulations and tighter monetary policy, as it has been the case since October 2004. Simultaneously, however, the Reserve Bank of India (RBI), India's central bank, also wants to preserve growth and avoid reproducing past errors such as the severe policy tightening of the mid-1990s that had had a calamitous impact on domestic demand. The monetary policy tightening underway is thus very gradual (+100bp in total). The latest increase in July 2006 brought the reverse repo rate to 6.0%. Stricter prudential standards have also been introduced (increase in the weighting of high-risk assets[4] in the capital adequacy ratio alongside an increase in their provision rate). Credit growth has not shown any signs yet of deceleration though it has stabilised at a robust pace (the year-on-year increase in the non-food credit has remained stable at roughly 28% since late 2004/05). Continued strong GDP growth in the first half of 2005/06 and the upward trend in global interest rates should ensure that the RBI will continue with progressive tightening.

Stabilised credit growth, slight progress in deposit mobilisation and recovering foreign exchange reserves since late 2005/06 have globally contributed to ease domestic liquidity conditions over the past year. The lagged effects of rising nominal and real interest rates (some banks have already raised their prime lending rates in line with higher short-term policy and market rates) and increasing constraints on banks (persistent gap between deposit growth and credit growth, RBI's measures to control credit growth), should eventually trigger a slowdown in credit expansion in the course of 2007/08.

Nevertheless, domestic liquidity remains a long-term issue, as for the first time in Indian post-independence era the banking sector is likely to face simultaneously strong credit demand from both the private and the public sectors. The boom in industrial activity should continue while public development spending is to increase to overhaul public infrastructure. In this context, eviction effects appear unavoidable in the future to the detriment of economic growth. This problem illustrates that India's banking system is still underdeveloped in terms of total assets given the economy's borrowing requirements, despite the fact that some banks have begun to increase their capital to comply with Basel II.

II. An orderly increase in India's external vulnerability

India's increasing external vulnerability to shocks goes hand in hand with the opening up of the economy to global trade and intensified financial links with the rest of the world. But this increase starts from a low level, has India has accumulated a comfortable stock of

[3] Their outstanding has fallen from 13% of total deposits in 1990/91 to 8% in 2004/05.
[4] Namely commercial and residential property, personal loans and credit cards.

foreign exchange reserves. In addition, external debt is low in absolute level and as a share of GDP. In particular, public external debt is limited and held by residents. Looking ahead, the authorities' commitment to maintain a gradual approach to fuller capital account convertibility should continue to act as a protection against potentially destabilising massive foreign capital inflows.

II.1. The challenge of current account deficit financing

India shows recurrent current account deficits reflecting strong imports of capital goods whereas exports of manufactured goods have only recently started to take off. The trade deficit is only partly compensated for by growing net exports of services notably based on the buoyancy of the IT- and IT-enabled services sector. Recently, the significant rise in the energy bill coupled with accelerating growth in imports of capital and intermediate goods has led to a sharp widening in the current account deficit since 2003/04. Lately, the current account deficit has stabilised but only owing to a move seen as temporary, i.e. the sharp drop in imports of pearls, precious and semi-precious stones because of high global gold prices. Such a large current account deficit is not viewed as a threat as long as it is covered by capital inflows, which is actually the case. Foreign investors have been increasingly attracted by India's favourable medium-term economic prospects.

In the short and medium term, however, two problems may arise. First, the bulk of capital inflows are mainly short-term volatile investments in nature, easily revertible in case of shocks. Second, in the long run the current account deficit is likely to remain large or even to widen further as India's energy dependency is set to continue to increase. India already imports 70% of its oil needs. We look at the first issue more in details.

The jump in the surplus of the balance of capital since 2004/05 primarily reflects massive inflows of foreign portfolio investments in the form of net purchases of Indian stocks, external commercial borrowings (ECBs) – mainly in the form of foreign-currency convertible bonds issued by listed Indian companies[5] –, and short-term loans. However, though growing fast, they still account for a limited share of market capitalisation. The spectacular rise in the Mumbai stock exchange since 2003/04 resulted for the major part from domestic purchases of equities. The local market continues to be dominated by residents, among which an increasing number of households (thanks to tax breaks, financial innovations in savings products)[6], even though the ratio of hot money to foreign currency reserves is high, estimated at about 100%.

The turmoil in emerging financial markets in mid-2005/06 due to global jitters about rising inflationary pressures in the U.S. economy triggered a healthy 20% correction in the Mumbai stock exchange market[7], which was mainly driven by domestic sell-offs. Net foreign sales of Indian stocks totalled only $0.8bn between March and mid-July compared with net purchases of $12.5bn for the whole year 2005/06. This illustrates that, though important in absolute level, foreign portfolio investments are still a small part of market capitalisation, which makes India still moderately dependent on foreign investors' risk appetite. In March

[5] Foreign currency convertible bond (FCCBs) issues involve a financial risk for Indian companies but these are subject to the prudential standards set by the regulatory authorities. These securities give investors the option of converting a corporate bond into shares in the same company before maturity, the conversion price being determined by the share price at the time of the transaction, plus a premium. FCCBs are attractive when stock markets are rising but generate debt in the event of a sharp or lasting decline. However, in the absence of conversion (bear market), Indian companies should not find themselves over-indebted, as they took advantage of restructuring in the late 1990s to reduce debt.

[6] Equities are still underrepresented in Indian investment fund portfolios (less than 5%).

[7] The rise in equity valuations before the May correction was beginning to become unsustainable from a P/E standpoint.

2006, foreign portfolio investments accounted for just 15% of India's market capitalisation versus 11% a year earlier.

In all, India's low external vulnerability lies in its substantial stock of foreign currency reserves[8] and low external debt, even though reserves have become more fungible due to the inflows of short-term foreign portfolio investments. In the long term, however, the capital account should balance out in favour of more stable financing with the slow but structural increase in foreign direct investment (FDI) in line with progressive relaxation of sectoral limits to FDI, even though the rise in FDI also has to result from an improvement in the domestic business climate (heavy bureaucracy, poor quality of basic infrastructures).

II.2. The long road toward full rupee's convertibility

Against this financial backdrop, the Indian authorities are opening the capital account cautiously. Although the rupee has been convertible for trade transactions since 1994, the government is still reluctant for this to happen with financial transactions. The 1997-98 Asian crisis has reinforced this consensus. There are numerous restrictions in both directions and the process of liberalisation is being undertaken step by step. Other prerequisites to a complete opening of the capital account have not yet been met. Firstly, the situation for public finances remains bleak despite the start of a consolidation, and this could discourage foreigners from holding government bonds. Secondly, the banking system is underdeveloped in terms of total assets given the economy's borrowing requirements[9] – even if some banks have opted for capital increases, particularly in light of the Basel II reform – and it will remain protected from foreign competition until 2009. Lastly, the economy is still not sufficiently deregulated and it could be destabilised by a further massive inflows of foreign capital.

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[8] $158bn in July 2006, corresponding to about 12 months of imports of goods and services imports, which is considerable.

[9] The Indian banking sector is still largely dominated by public banks, but it is profitable and suitably capitalised. The Cooke ratio was 12.8% in 2005/06 but it was down for the first time since 2000/01 due to the increase in high-risk assets as a percentage of total capital, as well as the rise in the weighting attached to mortgages. However, the Tier-I capital ratio was 8.5% and some banks have already increased their capital as they switch to the new Basel II standards.