

India's looming financial crisis

The Hindu

Paper - III
(Economy)

Rapid credit growth is akin to a siren song. It lures economies with the promise of prosperity only to lead them into crises. Each financial boom is framed as a story of financial innovation and good times. But each new story is just whipped-up frenzy, it is, in economist Robert Shiller's words, "irrational exuberance". As the economists Carmen Reinhart and Kenneth Rogoff explained in their celebrated history of financial folly, governments and market participants dismiss previous crises that followed credit booms by invoking the mantra "this time is different".

There is a rapid growth in lending in India is leading to financial instability. This process gives us a warning that excessive borrowing, particularly by households, is creating a risky economic situation that could lead to a financial crisis similar to those experienced in other countries.

What is the current state of credit growth in India?

India is experiencing rapid credit growth, particularly in the household sector, which is rising at an annual rate of 25% to 30%.

In 2023, the International Monetary Fund (IMF) praised India's financial sector for robust bank lending and low non-performing assets.

A review by the National Council of Applied Economic Research in March 2024 noted a 20% increase in bank lending from the previous year, with a significant rise in personal loans. The surge in lending is primarily directed towards consumer spending rather than productive investments, contributing to economic vulnerabilities.

What are the risks associated with this rapid credit expansion?

Financial Instability: Rapid credit growth historically leads to financial crises. Previous booms ended when new loans couldn't cover old debts.

Unsecured Borrowing: Almost a quarter of household loans are unsecured, increasing financial system stress. Credit card debt surged from 20 million cards in 2011 to 100 million in 2024.

Economic Contraction: High debt burdens reduce household spending, leading to economic slowdown. Indian households' debt-service-to-income ratio is 12%, one of the highest globally.

Inefficient Lending: Financial institutions focus on consumer loans instead of productive investments. This can lead to economic downturns when consumer spending slows.

Job Shortage: The ongoing job crisis will worsen, pushing more people back to agriculture, reflecting deeper economic regression and increasing inequality.

What should be done?

1. **Improve financial regulation:** Strengthening oversight is necessary to prevent rogue behavior among financial institutions. The rise in unsecured loans, approaching a quarter of household loans, indicates a poorly regulated financial sector. Fintech companies have led the charge in offering high-interest loans to households, contributing to financial stress.

Weaken the rupee: A weaker exchange rate can boost exports, helping to cushion the economic downturn. Historical data shows that rapid credit growth and an overvalued exchange rate are a lethal combination.

Focus on job creation: Address the deep-rooted jobs deficit to ensure sustainable economic growth. Current policies have led to more workers returning to agriculture, highlighting the urgent need for job-rich growth.

Expected Question for Prelims

- Que.** Consider the following statements with reference to India's credit growth:
1. Credit growth in the household sector in India is increasing at an annual rate of 25% to 30%.
 2. According to recently published data, an increase of 20% was seen in bank lending as compared to last year.
- Which of the statements given above is/are correct?
- (a) Only 1 (b) Only 2
(c) Both 1 and 2 (d) Neither 1 nor 2

Answer : C

Mains Expected Question & Format

Que.: Discuss the current status of credit growth in India and also mention the risks associated with it.

Answer's Approach:

- ❖ In the first part of the answer, discuss the current situation of credit growth in India.
- ❖ In the second part mention the risks associated with current loan growth.
- ❖ Finally give a conclusion giving suggestions.

Note: - The question of the main examination given for practice is designed keeping in mind the upcoming UPSC mains examination. Therefore, to get an answer to this question, you can take the help of this source as well as other sources related to this topic.