Chart VI.2 : Sectoral Deployment of Bank Credit
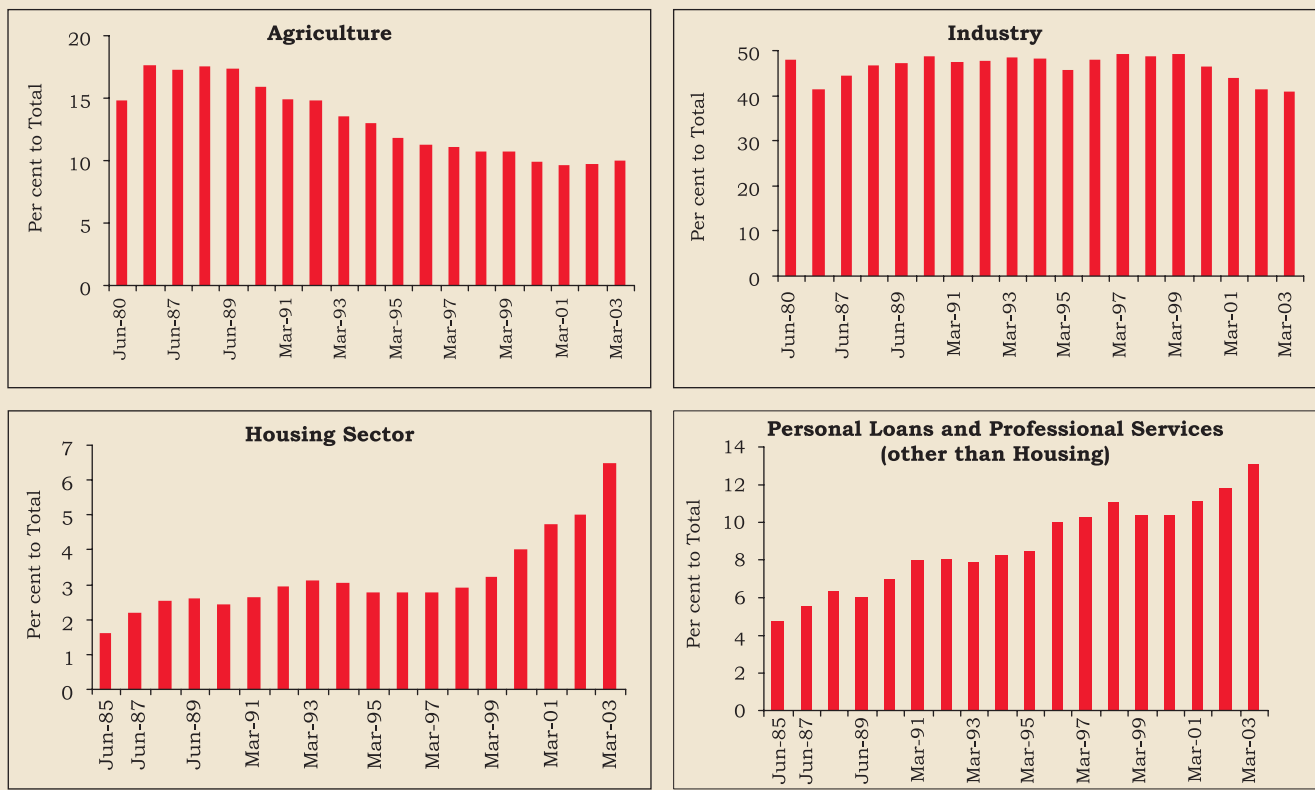

Note : Data are based on outstanding credit of scheduled commercial banks.

last 3-4 years to improve the flow of credit to agricultural sector have been successful. The existing agricultural credit system is geared to the needs of foodgrains production. Despite the fall in the share of the foodgrains production, it is all the more creditable that the ratio of agricultural credit to agricultural GDP has not fallen. Long-term credit as a share of private investment has also been rising in the late 1990s (Mohan, 2004d).

Table 6.8: Credit to Various Sectors of the Economy from Scheduled Commercial Banks

(per cent to GDP)

Item	June 1980	June 1985	March 1990	March 1995	March 2000	March 2001	March 2002	March 2003
1	2	3	4	5	6	7	8	9
Per cent to Overall GDP								
Agricultural Credit	2.6	3.6	3.4	2.5	2.4	2.5	2.8	3.1
Direct	2.0	3.0	3.0	2.1	2.0	2.1	2.1	2.4
	(5.3)	(5.6)	(5.7)	(4.0)	(3.2)	(3.3)	(3.4)	..
Indirect	0.6	0.6	0.5	0.3	0.4	0.4	0.7	0.7
Industry	8.5	8.4	10.5	9.5	11.0	11.3	11.9	12.5
Per cent to Respective Sectoral GDP								
Agricultural Credit	7.8	11.3	12.1	8.9	9.9	11.0	12.3	14.9
Direct	6.0	9.4	10.5	7.7	8.3	9.3	9.1	11.6
	(15.9)	(17.5)	(20.2)	(14.6)	(13.6)	(14.9)	(15.1)	..
Indirect	1.8	1.9	1.6	1.3	1.5	1.8	3.2	3.3
Industry	45.2	43.6	52.4	47.7	61.0	60.6	65.8	67.3

.. Not Available.

Note : Data in brackets are total direct credit to agricultural sector from the banking system inclusive of cooperatives.

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6.43 The preceding analysis is based on credit extended by scheduled commercial banks (SCBs). Apart from SCBs, cooperative institutions have also been a key source of credit to this sector. Total outstanding direct credit to the agriculture sector (as a proportion to its sectoral GDP) at end-March 2002 was lower than that of the early 1990s, although the declining trend was reversed in 2001. The share of cooperatives in total outstanding direct credit to the agricultural sector was around a third in 2002 (Chart VI.3).

6.44 Fifth, credit to industry – both in terms of overall GDP as well as its sectoral GDP – has generally maintained an upward trend. This is in contrast to the earlier noted fall in the share of industrial credit to overall credit. Furthermore, credit to SSI sector also exhibits an increasing trend, contrary to popular perception. Thus, notwithstanding the pressure on banks on prudential and NPA grounds, the small-scale sector does not seem to be credit-starved although there might be pockets of SMEs that face constraints of longer-term finance (Mohan, 2004a). With credit to agriculture as well as industrial sector – as proportion to GDP - exhibiting an increase, the flow of credit to the services sector has concomitantly tended to fall as a proportion of GDP. Although the proportion of bank credit going to the services sector has increased since the 1980s (from about 24 per cent in 1980 to about 31 per cent by 1990 and further to about 37 per cent by March 2003) (Table 6.7), it has not kept pace with the increase in the share of the services in economic activity. This is largely a legacy of nurturing the growth of basic and

heavy industries as also directing credit to the priority sector (including agriculture). Lending to services has not been favoured by traditional banking practices followed in India such as collateral-based financing, emphasis on securitised instruments, limited appetite for risks inherent in financing services and lack of standardisation and customisation of financial products (Mohan, 2004b). The issue of credit flow to the services sector assumes even greater importance with the growing role of the information technology sector in the economy. In the absence of collateral, a key issue is whether banks are in an advantageous position compared to other financiers with respect to access to information. The ability to assess such information crucially depends on the origin of information asymmetries and uncertainties. While banks may have superior information regarding conditions in local markets, they may lack the necessary technical expertise to evaluate such projects. This, therefore, necessitates development of specialisation skills by banks to finance such evolving sectors but, in view of their risky nature, supported by recourse to subordinated debt and appropriate credit transfer risk tools (BIS, 2002).

6.45 Sixth, the industrial sector depends upon its credit needs not only on banks but also on alternative sources such as Development Finance Institutions (DFIs) and capital markets. While banks provide short-term needs of corporates, long-term needs have been met largely by the DFIs. In the context of the dwindling role of DFIs, an analysis of the combined flow of credit from these major sources is crucial. During the latter half of the 1990s, funds available from DFIs almost halved and there was an even sharper decline in funds from capital markets (Table 6.9). A number of factors on both the demand and supply side explain this (Mohan, 2004a):

- The decline in funds from DFIs reflected in part the drying-up of their sources of low cost finance. The Indian experience with DFIs has not been unique.

Chart VI.3 : Share of Cooperatives in Outstanding Direct Agricultural Credit

Table 6.9: Major Sources of Industrial Finance

(Per cent to GDP)

Period	Bank Credit	Non-SLR Investments	DFIs	Capital Market	Total
1	2	3	4	5	6
1970s	1.8		0.3	0.1	2.2
1980s	2.7		0.7	0.6	4.0
1990s	2.6		1.0	1.2	4.8
1992-93 to 1996-97	2.9		1.0	1.9	5.8
1997-98 to 2001-02	2.7	0.7	0.6	0.2	4.2

Source : Mohan (2004a).
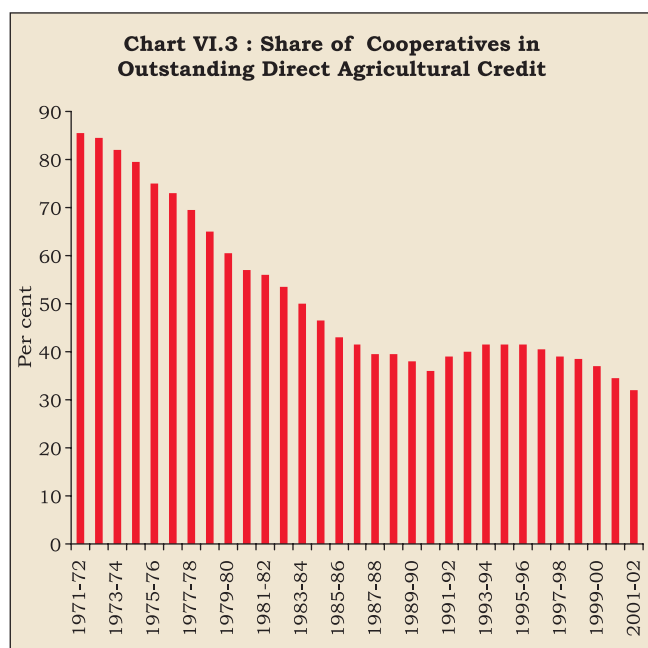
Most DFIs in other countries are also beset with the problems of high and growing NPAs reflecting poor cost-benefit evaluations of projects and wide spread mismatches between their assets and liabilities, especially as raising long-term resources becomes difficult with the withdrawal of state support. Many economies have now begun to restructure their DFIs. In many cases, DFIs are now expanding their areas of operations in banking, para-banking and investments. In consonance with the international experience, efforts are underway to restructure FIs in India.

- As regards capital markets, the decline of funds can be attributed to the exuberant investment activity in the mid-1990s, which led to the creation of overcapacity including some uncompetitive overcapacity. The concomitant erosion of profits explains the poor performance of the stock market in the late 1990s and earlier part of the current decade.

- Another reason for lower recourse to funds from DFIs could be the increase in the internal sources of funds. Internal sources increased from 34 per cent during the first half of the 1980s to 43 per cent in the recent period. The question, however, remains as to whether this reflects the effect of substitution of internal sources for external sources or the scale effect of an external constraint. The decline in debt-equity ratio, as a result of corporate restructuring, could also have led to a lower recourse to DFIs.

6.46   In the context of the waning of the DFIs, a key issue is: whether banks can fund long-term needs of corporates. Two factors curtail the flexibility of the banks to meet the long-term fund requirements. First, deposit liabilities of banks are of relatively shorter maturity. About four-fifths of bank deposits are of a tenor of less than five years. In view of this, long-term lending could induce the problem of asset-liability mismatches. Second, banks already hold large volumes of government paper, usually of long tenors. This further reduces the scope available to banks to fund long-term financing needs. The envisaged reduction in fiscal deficit under the Fiscal Responsibility and Budget Management (FRBM) Act, 2003 is expected to provide banks greater flexibility to lend to the corporate sector. Banks may also need to raise long-term matching liabilities through issues of bonds to fund the infrastructural projects. At the same time, there is a need to develop the corporate bond market in the country. The lack of good quality issuers, institutional investors and supporting infrastructure continue to constrain the development of corporate bond markets. Although several pre-conditions for the evolution of a successful corporate debt market such as well-functioning government securities and money markets to price paper, regulatory and legal framework, an efficient clearing and settlement system and a credible credit rating system - are now in place, there is a need to enhance public disclosure and put in place effective bankruptcy laws. Finally, the possibility of equity markets emerging as a substantial source of project finance hinges upon the expansion of the mutual fund industry and channelling of a part of contractual savings to equity markets.

Bank Credit to Government

6.47   The banking system is a source for funds for not only the private sector but also for the government sector. In India, with progressive widening of fiscal deficits from 1960s onwards, the burden of financing has been borne by the Reserve Bank and the banking system. As the Reserve Bank financing beyond a limit is inflationary, the increase in the Reserve Bank support to the Central Government was accompanied by an increase in cash reserve requirements (CRR). As regards the support of the banking system to the Government's borrowing programme, it took the form of a progressive increase in the SLR. Although interest rates on Government securities - initially kept artificially low to contain the interest cost of public debt - were steadily raised to enhance their attractiveness to the market, it got increasingly difficult to get voluntary subscriptions even at higher rates of return. The SLR, therefore, was raised to 38.5 per cent by the early 1990s and coupled with the increase in the CRR, statutory pre-emptions exceeded 60 per cent of total resources. This curtailed banks' lendable resources significantly and, as noted above, credit to the commercial sector (as a proportion to GDP) showed a near stagnation during the 1980s and 1990s. As a proportion to their deposits, bank credit to the commercial sector exhibited a sharp decline during the 1970s. The declining trend continued during the 1980s, *albeit* at a moderate pace (Chart VI.4). Non-food credit by scheduled commercial banks was as high as 76 per cent of their deposits in March 1971; the ratio fell to 60 per cent by March 1990.

6.48   As a part of the reform process, the statutory pre-emptions were cut and, at present, these are just half of their early 1990s level (Chart VI.5). The SLR, in particular, was reduced from 38.5 per cent to 25 per cent by 1997. This reduction in SLR was expected to reduce banks' holdings of the Government paper and correspondingly lead to a higher flow of credit to the private sector. Notwithstanding the flexibility provided by the new regime, the holdings of the banks in the Government securities remain significantly higher than

Chart VI.4 : Scheduled Commercial Banks Credit and Investment

Chart VI.5 : Statutory Pre-emptions
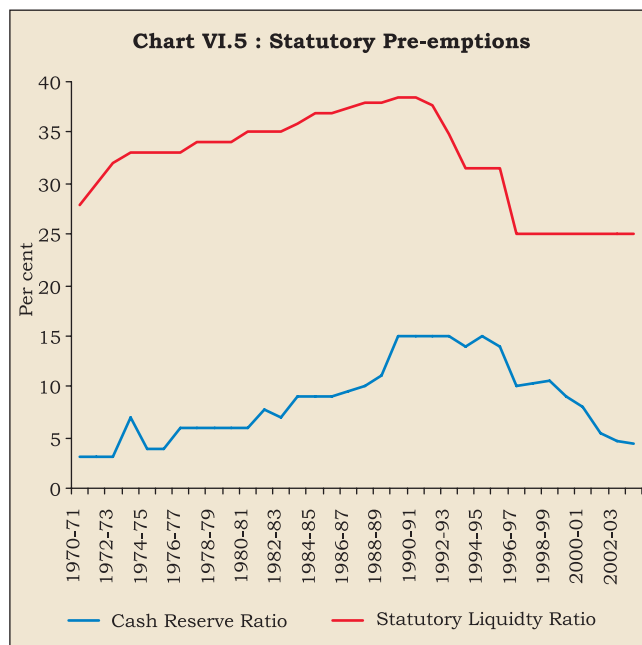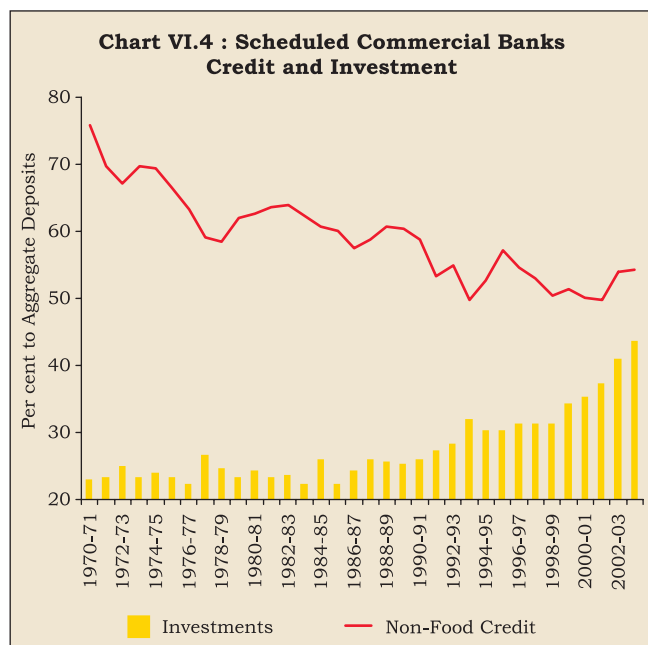
the requirements and, in fact, tended to increase over time. By early October 2004, scheduled commercial banks' holdings of SLR securities amounted to around 40 per cent of their net demand and time liabilities (NDTL) as compared with the required 25 per cent.

6.49   A cross-country analysis shows that lending by banks in India to the Government (as per cent to GDP) is comparable to many developing economies but higher than some of the East Asian economies (Table 6.10). Illustratively, during 2001-03, bank

Table 6.10: Domestic Credit to the Government by the Banking Sector

(Per cent to GDP)

Country/Region	1970s	1981-85	1986-90	1991-95	1996-00	2001-03
1	2	3	4	5	6	7
Argentina	8.5	15.4	24.3	7.8	9.2	34.5
Australia	15.1	11.8	9.7	8.9	6.5	4.2
Brazil	1.6	6.2	60.2 @	38.3	15.7	26.5
Chile	26.6	16.9	33.7	11.8	7.3	9.2
China	-6.6	0.0	1.6	3.1	6.1	24.7
Germany	6.4	14.8	14.3	19.1	27.5	26.0
India	**13.7**	**19.4**	**23.7**	**23.0**	**22.5**	**26.7**
Indonesia	..	-1.4	-0.8	-0.3	18.6	36.8
Japan	38.1	66.3	68.9	71.5	106.9	133.4
Korea, Rep.	3.9	5.8	2.1	0.7	1.9	1.7
Mexico	18.5	37.7	32.4	11.7	14.1	18.9
Philippines	9.0	15.2	6.5	12.5	21.8	24.0
Poland	..	1.5	1.5	15.6	9.7	7.7
Russian Federation	..	..	..	16.6	19.8	8.3
South Africa	23.4	21.9	19.0	20.4	20.4	12.9
United Kingdom	17.1	8.3	-1.7	5.1	3.9	2.1
United States	22.0	23.9	26.9	31.4	25.3	19.2
Memo:						
East Asia and Pacific	-4.7	4.8	4.8	2.8	7.9	23.4
World	17.8	24.1	27.5	30.5	32.4	27.4

..   Not Available
@   Data pertain to 1988-90.
Note   : Domestic Credit to the government sector in this Table is computed as total domestic credit less credit to the private sector.
Source : 1. World Development Indicators Online, World Bank (2004).
           2. Reserve Bank of India.

credit to Government in India was almost 27 per cent of GDP, significantly higher than that of two per cent in Korea. This is in sharp contrast to the earlier noted trend in regard to credit extended to the private sector where the ratios for these economies vastly exceed that of India.

6.50   A number of factors explain the banks' preference for holding excess Government securities. First, demand for private credit moderated following the slowdown of the Indian economy from 1997-98 onwards. Available empirical evidence suggests that there is a co-movement between output and credit demand (Chart VI.6). Downward rigidity in the lending rates of the banks could also have reduced demand for bank credit. Econometric analysis suggests that real non-food credit is positively related to output and negatively related to interest rates. Estimated elasticity of real non-food credit of 1.6 suggests that demand for real non-food credit increases more than the increase in output (Box VI.4).

6.51   Second, capital flows from abroad have been quite strong since 1993-94 (see Chapter IV). This increased the availability of funds with the banks and, in view of weak credit demand, banks preferred to invest these surplus funds in Government securities. Third, a key factor appears to be the fiscal deficit of the Government which has continued to remain high. Market borrowing requirements of the Government sector have, therefore, been increasing. Weak credit demand coupled with increased funds due to capital inflows enabled banks to invest in the Government paper. Otherwise, the pressure to finance the fisc

Chart VI.6 : Output and Credit

could have reverted to the Reserve Bank or alternatively, it could have led to pressures on interest rates.

6.52   Fourth, the preference of the banks for investment in Government securities was also influenced by the phased tightening of prudential norms on capital adequacy, asset classification and income recognition to international standards. These prudential guidelines could have increased risk aversion on the part of the banks to private sector lending, since the credit risk-free Government paper requires zero provisioning. Thus, capital adequacy requirements of banks increases substantially while extending credit to the private sector but no such addition is required while investing in Government paper. Fifth, in an environment of softening interest rates, which prevailed for an extended period of time – from around 1998 onwards till early-2004 – investment in Government securities also turned out to be relatively attractive. In fact, the treasury operations of banks have been a significant source of their profitability in the past few years. These profits strengthened banks' balance sheets and enabled them to provide resources for NPA provisioning. Finally, another reason of risk aversion to lending to the private sector could be that the loan officers worry about the possibility of being falsely accused of corruption. Banerjee, Cole and Dufflo (2003) find some empirical support in favour of this proposition.

6.53   The banks' preference for gilts had a few benefits. First, as noted above, in the past couple of years, it boosted banks' profitability and balance sheets. Second, excessive lending in times of poor growth could have generated problems of adverse selection. At the same time, large investments in gilts raise a number of concerns. First, it reflects dissipation of banking knowledge capital with regard to credit appraisals and runs a danger of the link between liquidity, credit, money and economic activity being severed in the long-run (Mohan, 2003a). Second, in view of the excess investments, the burden of funding the borrowings could revert to the Reserve Bank which makes monetary management difficult. Finally, investment in Government securities are subject to market risks arising from fluctuations in market rates of interest. With the upturn of the interest rate cycle, there could be an adverse impact on banks' profitability. In this context, it is relevant to observe that the Reserve Bank had advised banks to build-up Investment Fluctuation Reserves (IFR) to meet such eventualities.
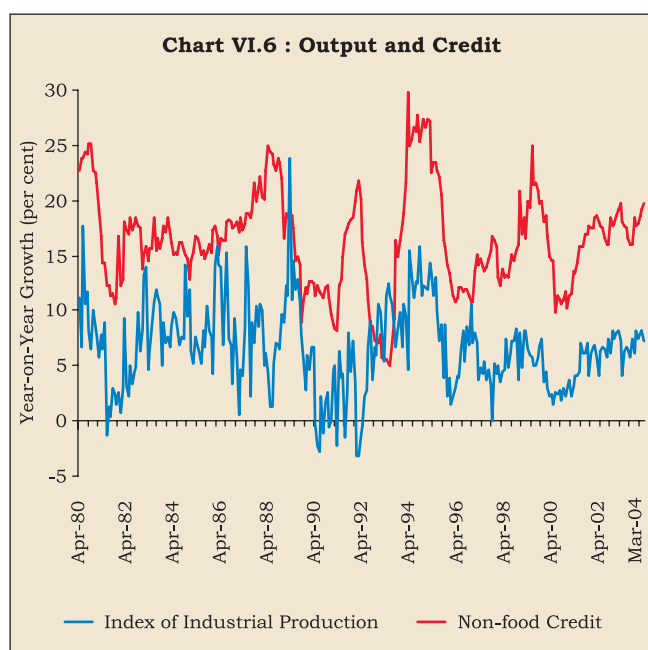
Box VI.4

Determinants of Bank Credit

Bank credit is an important source of working capital for corporates and timely availability of credit contributes to economic activity. Supply of bank credit depends, *inter alia*, upon availability of funds with the banks, the rate at which they lend and returns on alternative instruments of investment (such as Government securities, commercial paper and equity markets). Although supply of credit is important, actual utilisation of credit would depend upon its demand. With growing financial liberalisation, the available pool of resources has expanded to include not only bank credit but also external resources such as external commercial borrowings, foreign currency convertible bonds and equity funds through depository receipts. Thus, due to a variety of reasons there can be a switch from a regime of credit rationing to a situation of demand constraint in the loan market (Rakshit, 1994).

For India, evidence suggests that there exists a bi-directional causality between output and credit, *i.e.*, changes in credit lead to changes in output and *vice versa* (RBI, 2003). In contrast to these aggregate data, Misra (2003) undertook a state-wise analysis of relationship between credit and output. For most of the states, he found evidence in favour of a uni-directional causation from output to credit. His results suggest that credit flow to various states is guided by the absorptive capacity of the states. Lack of credit off-take, in this view, should not be seen as a problem in itself but should be seen in conjunction with growth prospects of the concerned states. According to estimates contained in RBI (2003), demand for credit is positively influenced by lagged as well as contemporaneous output while interest rates depress credit demand. Supply of credit was found to have a positive relationship with lending rates, banks' free reserves and equity prices. Rath and Bose (2004) estimate demand and supply for credit in a vector error correction framework and find that output is a key determinant of credit demand while availability of funds with banks determines the supply of loans by banks. Industry-wise estimates of credit elasticities show that these vary across industries. Credit elasticity is relatively low for industries such as food products and cotton textiles and high for industries like engineering (RBI, 2002). With the changing composition of industrial output over time, overall credit demand elasticity may undergo change.

This Box attempts to re-examine the behaviour of credit and its determinants in India. First, hypothesis of a bi-directional causality between output and credit cannot be rejected[1]. Second, in order to understand the determinants of demand for credit, the relationship between credit, output and interest rates is examined in an autoregressive distributed lag (ARDL) model of order (1,0,0)[2]. Results indicate that credit demand increases by 1.6 per cent for every one per cent increase in real GDP. Third, the negative influence of lending rates on credit demand is statistically significant, although the effect is small. Estimates suggest that a reduction of 10 percentage points in the lending rate would increase credit demand by around one per cent.

Although long-run relationship between these three variables is confirmed, it is also interesting to examine the short-run dynamics as there have been periods such as 1997-98 when credit continued to expand even as activity was sluggish. This could occur if, in the face of weak demand conditions, inventory builds-up and this increases firms demand for short-term credit. As firms adjust over time to reduced demand, they curtail production and run down the inventories and, in turn, this will reduce credit demand (Mukhopadhyaya, 1998). The dynamics of this adjustment process can be examined through estimation of an error correction model[3]. The results show that the error correction term is statistically significant. The coefficient estimate of 0.21 of the error correction term indicates that the adjustment process is relatively fast and one-fifth of the deviation from the equilibrium is corrected every year. Thus, periods when credit and output do not show a co-movement are short-lived and, over time, the positive co-movement is restored.

Estimates of credit elasticities attempted here have covered the period 1975-2003 – a period involving a regime shift from a credit-regulated economy where interest rates did not play an equilibrating role between demand and supply to a regime where credit supply and demand both depend upon market forces. Against this backdrop, the empirical evidence and the estimated elasticities should be treated as indicative.

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[1] Granger causality tests indicate a bi-directional causality between output (proxied by index of industrial production) (IIP) and real non-food credit (RNFC). Real non-food credit is nominal non-food credit of scheduled commercial banks deflated by wholesale price index. In a bivariate VAR of IIP and RNFC (with both variables in first-difference of logs) over the period April 1994 to March 2004, the null hypothesis of Granger non-causality of IIP can be rejected at p-value of 0.00 (with chi-square of 67.8). Similarly, the null hypothesis of Granger non-causality of RNFC can be rejected at p-value of 0.01 (with chi-square of 26.9). The VAR was estimated with 13 lags, with lag selection based on Schwarz Bayesian Information Criterion (SBIC).

[2] Using annual data from 1975-76 to 2002-03, the estimated long-run relationship is as follows:

$LRNFC = -12.4 + 1.60 \ LGDPR - 0.11 \ AVGRATE$,
$\qquad\quad (10.0) \quad (14.7) \qquad\quad (2.0)$

where, LRNFC, LGDPR and AVGRATE denote (log of) real non-food credit, (log of) real GDP and weighted average lending rate of scheduled commercial banks, respectively.

[3] $DLRNFC = -2.6 + 0.33 \ DLGDPR - 0.02 \ DAVGRATE - 0.21 \ ECM_{t-1}$
$\qquad\qquad (3.2) \quad (3.1) \qquad\quad (2.8) \qquad\qquad (3.0)$

$\bar{R}^2 = 0.42 \qquad\qquad\qquad\qquad DW = 2.2$

Prefix D indicates variables are in first-difference form while ECM stands for error correction term.

6.54 On the positive side, the pick-up in investment activity in the economy from the second half of 2003 onwards has led to a strong credit demand from the private sector. Correspondingly, investments of the banking system in Government securities have recorded a significant deceleration (see Chapter II). The enactment of the Fiscal Responsibility and Budget Management Act, 2003 with its envisaged reduction in fiscal deficits will help to reduce banks' investment in gilts and, correspondingly, this is expected to enhance the credit flow to the private sector.

III. CONCLUDING OBSERVATIONS

6.55 This Chapter addressed issues related to the role of finance in growth. Empirical evidence confirms a positive relationship between finance and growth, notwithstanding the debate on the causality. In developing economies like India, with bank-based financial system, bank credit plays a critical role in the growth process. At the same time, the banking system has the responsibility of not only financing the credit requirements of the private sector, it is also often required to finance the fiscal authority.

6.56 In recent decades, there has been a renewed interest in the role of bank credit in economy activity. This is essentially for two reasons. First, it is believed that monetary policy impulses affect economic activity not only through the interest rate channel but also through the credit channel. The credit channel, especially in view of balance sheet effects, through the financial accelerator mechanism augments the conventional interest rate channel of monetary transmission. The second reason for interest in credit aggregates emerges from the view that excessive increases in credit are a precursor to a probable future financial instability. Monitoring of credit behaviour may thus be a reliable leading indicator for monetary and financial stability.

6.57 In India, the banking system has been financing both the Government and the private sector. With the initiation of structural reforms in the early 1990s, the focus has shifted from micro-regulation of credit to macro-management. Interest rates on loans have been deregulated, except for small loans (loans up to Rs. 2 lakh). Banks have been provided the flexibility to lend to various sectors of the economy, based on their risk-return assessment. While the requirement of priority sector lending has been retained at 40 per cent of bank credit, the categories of advances eligible for priority sector have been expanded to provide banks increased opportunities

to lend to these sectors. In the recent years, the efforts of the Reserve Bank have mainly concentrated on improving the credit delivery mechanism. The policy endeavour has been to reduce various information and transaction costs associated with lending so that increased flow of credit takes place at reasonable rate of interest.

6.58 Analysis presented in this Chapter indicates that these efforts to improve credit delivery have had a positive effect. There is evidence that credit flow to the agricultural sector has recovered significantly in the last 3-4 years. The declining trend in the share of agricultural credit to total bank credit as well as its share to overall GDP has been reversed since 2000. Credit to agriculture in relation to its sectoral GDP - a more relevant metric – maintained its upward trend. This is remarkable since the share of foodgrains in total agricultural output has been declining. It is critical that the flow of credit to agriculture is maintained. In order to sustain the flow of credit to the agricultural sector, there is a need for legal and institutional changes relating to governance, regulation and functioning of rural cooperative structure and Regional Rural Banks(RRBs). The changes warranted in cooperatives as well as RRBs involve deep commitment of state-governments and have significant bearing on political economy. Second, in view of overhang problems of non-performing loans and erosion of deposits in both cooperatives and the RRBs, restructuring and recapitalisation by the Government becomes important. The current acceleration in credit-delivery can be sustained in the medium term, if such fiscal support from States and Centre is firmly put in place soon to revive or reorganise rural cooperative structure and the RRBs. Third, there is a need to foster an appropriate credit culture to make enhanced rural credit a lasting phenomenon. Fourth, a comprehensive public policy on risk-management in agriculture is required as not only a means of relief for distressed farmers but as an ingredient for more efficient commercialised agriculture (Reddy, 2004b). Furthermore, banks in India - so far geared to financing of traditional crops like cereals - will have to be prepared to meet the changing requirements of commercialising agriculture.

6.59 Credit flow to industrial sector by banks has also been maintained. However, in the context of the waning of the DFIs, the issue of meeting long-term funding needs of corporates has attracted attention. The ability of commercial banks to meet the long-term fund requirements is hampered by the relatively shorter maturity of their deposits. The limited flexibility

available to banks is further compounded by the fact that banks are already holding large volumes of Government paper, usually of long tenors. This stresses the need to develop an active corporate bond market in the country. Although several pre-conditions for the evolution of a successful corporate debt market are now in place, other requirements such as enhanced public disclosure and effective bankruptcy laws are still awaited. Funding from equity markets hinges upon the expansion of the mutual fund industry and channelling of a part of contractual savings to equity markets.

6.60   The increase in disbursement of housing finance is heartening as housing construction has strong backward and forward linkages. This large increase in housing loans to potential home-seekers in India is fundamentally different from the speculative activity in real estate in other countries. Although the housing sector provides a relatively safe destination for bank credit on account of relatively low default rates, banks need to be on alert against an unbridled growth of housing finance and should take due precaution in the matter of interest rates, margin, reset period and documentation.

6.61   Given the growth and employment potential of small-scale units, there is a need to increase credit availability to this sector at reasonable costs. Banking institutions must improve their credit assessment capabilities with regard to small-scale enterprises so that they can distinguish adequately between good and bad credit. Small-scale must not be equated with high risk. If the interest rates charged to SSIs are much higher than normal good credit risk to large-sized industries, there is an implicit adverse selection in the credit appraisal process. Thus, there is a need for realignment of interest rates among various segments of the financial market. As the financial market develops, ideally the interest rates on all types of debt instruments, both in the Government and private sectors, and in the credit market should align in a relatively narrow band, reflecting realistic risk premia (Mohan, 2002b).

6.62   The flow of credit to the various sectors of the economy could be increased further if banks can contain their operating costs and improve the loan recovery. Operating costs of banks in India remain higher than major economies (Reddy, 2004a). Recovery management is a key to the stability of the banking sector. Indian banks have done a remarkable job in containment of non-performing loans considering the overhang issues and overall difficult environment. These efforts need to be pursued further. This will help banks to reduce their lending rates which will provide a further impetus to investment demand in the economy.

6.63   The structural reforms during the 1990s, *inter alia,* attempted to enhance the credit flow to the private sector through reductions in statutory pre-emptions. However, despite this reduction, banks continue to prefer to invest in government securities for a variety of reasons like weak demand, excess capital flows and risk aversion. The banks' preference for gilts runs a danger of the link between liquidity, credit, money and economic activity being severed in the long-run. Furthermore, with the upturn of the interest rate cycle, there could be an adverse impact on banks' profitability. Fiscal consolidation as envisaged in the Fiscal Responsibility and Budget Management Act is expected to reduce the Government's draft on the banking system. A reduction in banks' holding of long-term Government securities will permit greater flexibility in providing long-term loans for infrastructure projects and this will, therefore, help to bridge the gap created by the DFIs. Overall, lower Government borrowings are expected to increase the flow of credit to the commercial sector with beneficial effects on investment demand, output and employment in the economy.