**India’s looming financial crisis**

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”.

A lofty and dangerous narrative

India is in the midst of similar folly, driven by policymakers wedded to an unhinged hype about the country’s performance and prospects. The ‘this-time-is-different’ theme touts India’s digital infrastructure as the catalyst for financial innovation and inclusion, promising growth and equality. Ironically, this lofty narrative has enabled a poorly regulated financial sector and consumers living beyond their means to generate a lending surge.

Both international and domestic analysts are applauding this surge. In December 2023, the Board of Directors of the International Monetary Fund (IMF) praised the performance of the Indian financial sector, citing robust growth in bank lending and low levels of non-performing assets. Similarly, the March 2024 review of National Council of Applied Economic Research cheered a 20% increase in bank lending over the previous year, interpreting the particularly large increase in “personal loans” — while lending to industry struggled — as signalling bright prospects.

This celebration of credit growth deflects attention from the deep-rooted jobs’ and human capital deficit; and it extends the hype into dangerous territory. The truth is that when lending expands, the financial sector looks in good health as new loans pay off old ones. But the house of cards collapses when lending slows and options for more loans to repay earlier obligations get shut. The IMF knows this history well: heavily indebted households and businesses sharply reduce spending to repay their debt, causing an economic crunch.

This distressing script is set to repeat for India especially because of the feverish expansion of households lending at between 25% and 30% a year. As financial intermediaries have pushed their loans, many lower- and middle-income households have viewed the funds as easy cash to make ends meet or to buy homes, gadgets and cars, pay for education, and indulge in ‘lifestyle’ spending, including vacations and elective medical procedures.

A household debt boom is a quintessentially “bad” boom. It does not add to productive capacity but, instead, bids up domestic prices, making the country less competitive. As economists Atif Mian and Amir Sufi report: the higher the household debt burden, the steeper the crash that follows. Add to the bad credit boom a stock market rising unmoored from weak corporate investment and anaemic consumer spending, an overvalued exchange rate, and a tendency for Indian authorities to talk up dodgy data, and India presents a textbook example of the key elements that signal a looming financial crisis. The financial crisis will cause not just economic pain but will also degrade the economy’s long-term well-being.

While the two terms of the Modi government have brought us to this moment, three decades of economic and financial policy are culpable. Unable to generate job-rich manufacturing growth, successive policymakers have pushed the financial services industry to raise headline GDP growth rates: in the last decade, the financial sector has contributed over a quarter of GDP growth.

A chaotic financial services industry

Making matters worse, Indian-style liberalisation has promoted a large and chaotic financial services industry. At the top are 30-odd large providers — scheduled commercial banks and major non-banking financial institutions (NBFCs), all with a history of rogue behaviour. Alongside, thousands of smaller players, including fly-by-night NBFCs and new fintechs operate in dubious ways.

The problem is simple. There are too many financial services’ providers with too few options to lend for productivity-enhancement projects. Indeed, over time, lending opportunities have narrowed as the Indian corporate sector has reduced its investment-GDP ratio and borrowing pace. Financial institutions have, therefore, been under great pressure to generate profits.

From the start of economic liberalisation in 1991, the search for easy profits spawned scams. But especially after COVID-19, financial services providers redirected lending toward households eager to borrow in lieu of stagnant incomes. The newly emergent fintechs led this charge by offering loans to desperate households at extortionary interest rates. A new set of scammers preyed on the gullible. Yet, some borrowers became addicted to such loans.

Today, a dangerously growing share (approaching a quarter) of household loans is “unsecured,” backed by no collateral. The poster child for unsecured consumer borrowing is credit card debt. In January 2024, Indians owned almost 100 million credit cards, up from 20 million in 2011. While the cards bring convenience, aggressively peddling them to low-creditworthy individuals builds up stress for both borrowers and the financial system. As the Reserve Bank puts it, explosive credit card growth has attracted “below-prime” or riskier borrowers.

Twenty-five-year-old Rohan (not his real name) is an example. He used his card to buy a TV, a laptop, and a smartphone. Drawn by rewards, cashbacks, and “no-interest EMIs” (which bundle interest costs into the purchase price and upfront fees), he quickly fell behind on payments and soon was neck-deep in debt.

Eventually, he took a cheaper loan to pay off his credit card dues. Multiply the Rohans manifold and you have a macroeconomic threat point.

Indian household debt, at 40% of GDP, is low by international standards, but household debt-service-to-income ratio, at 12%, is among the highest in the world because of high interest rates and predominantly short duration loans. Indeed, the Indian household debt-service ratio is alarmingly similar to that in the United States and Spain just before their 2008 financial crises, when high household debt-service burdens precipitated major economic downturns.

The economist Rudi Dornbusch’s warning applies to India: “The crisis takes a much longer time in coming than you think, and then it happens faster than you would have thought.”

The source of the impending crisis lies in a paradox: despite buoyant credit growth, household consumption is increasing at an excruciatingly slow pace. Households are struggling; their savings rates have declined and they are boosting meagre consumption by borrowing money. Soon, it will no longer be possible to repay old loans with new ones and consumption could even contract. The crisis will come initially through such macroeconomic contraction; defaults on loans will follow. The initial defaults will topple more dominoes, a consequence of the interconnected nature of banks, NBFCs, and fintechs. Cascading defaults will induce more economic contraction and financial sector distress.

A solution

The 2024 general election results might diffuse the India hype, but a sudden stop in credit could trigger a crisis. Preventing the crisis requires surgically downsizing the financial services industry to better match lending capacity and productive borrowing needs, and weakening the rupee to help expand exports and cushion the downturn when it comes. History makes clear that rapid credit growth and an overvalued exchange rate are a lethal combination.

But policy change is unlikely. In opposition to Joan Robinson’s dictum that finance must follow growth, Indian policymakers have committed themselves to the notion that finance will spur growth and help overcome the country’s severe developmental handicaps in human capital and other public goods. Policymakers are also committed to a strong exchange rate as a metric of the nation’s virility. Meanwhile, as the risks of a financial crisis grow, an acute job shortage persists, reflected most poignantly in a catastrophic regression of the workforce back to agriculture.

India’s heavily credit-reliant economic strategy is akin to a car speeding toward a cliff’s edge without brakes. Sadly, the nation’s financial and policy elite has adopted a see-no-evil attitude. After all, the weak and vulnerable will bear the burden of the crisis, as the dire employment situation becomes worse — and stark inequalities become starker.