Chapter 13
Analysis of fluctuations in Credit-Deposit Ratio of Indian States:
From Pre-Globalization to Post-Financial Crisis Phase

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ABSTRACT

Under the backdrop of the liberalization and globalization policies undertaken by the Indian government and the outbreak of the global financial crisis, the present chapter tries to study the trends, fluctuations, and ranking of the credit-deposit ratio of the Indian states for the period 1972-2015 comprising pre-globalization to post-financial crisis phase. Applying descriptive statistics, product moment and rank correlation coefficients, and student's "t" test and "F" tests, the results show that there are significant increases in the credit-deposit ratios of most of the states during the phase of financial as well as post-financial crisis phase compared to pre-globalization and post-globalization periods, but there were significant fluctuations in credit-deposit ratio in the financial crisis and post-financial crisis phases. Further, the rank correlation results show that the states maintained almost similar ranks in their credit-deposit ratios for the phases of pre-globalization, post-globalization, pre-financial crisis, and post-financial crisis. The study, thus, suggests that the Indian banking sector has not been affected adversely.

INTRODUCTION

There are historical debates between the supply side economists, the classical school and its followers, and the demand side economists, the modern schools led by J. Schumpeter and later, J. M. Keynes, regarding the necessity of the financial sector in economic developments of an economy. Adam Smith

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did not consider that the financial sectors had any sort of influence upon the production activities and so growth of a nation. Smith, in his famous book, "Wealth of Nations" pointed out that the farmers, producers and the businessmen are the important agents of economic growth. It was the business enterprise, competition and free trade that would lead the farmers, producers and the businessmen to expand market size and which, in turn, made the economic development inter-related. Schumpeter (1911), on the other hand, postulated the counter argument. According to him, society progresses through the trade cycle in a dynamic and discontinuous process. In order to break the circular flow, the innovative entrepreneur's business activities are to be financed by expansion of bank credit. Schumpeter calls it as 'creative destruction'-a process by which invention and innovation replace old production methods with the help of the financial intermediaries. Therefore, bank credit should have some impact on the performances of the real sector of the economy. Patrick (1966) is probably the first to define clearly the inter-relationships between bank credit and growth of output, especially for the undeveloped countries. According to him, there are two ways of explaining the inter-linkages between the bank credit and growth of domestic output. One of the ways, as he pointed out, is the Supply Leading Approach (SLA) and the other is the Demand Following Approach (DFA). Later there are a series of research articles that deal with the impact of financial sector in general and the banking sector in particular on the economic growth of a country. Some studies have shown that growth of the financial sector has a positive influence on the economic growth of an economy (Diamond, 1984; Greenwood & Jovanovich, 1990; King & Levine, 1993; Demetriades & Hussein, 1996; Jayaratne & Strahan, 1996; Beck et al, 2000). The study of Bhanumurthy and Singh (2009) has shown that the high growth of Indian GDP in the recent past has been, among others, due to financial inclusion. They have shown that branch expansion is not the proper indicator of financial development. In contrary, the proper financial indicator is credit-deposit ratio. They observed that there has been co integrated relation between credit-deposit ratio and State Domestic Product ratio.

There are some studies that are skeptical about the positive association between these two components. Lucas (1988) did not found any association between economic growth and finance and he termed the relationship between finance and economic development as 'over-stressed'. Other related studies in this regard are Demetriades & Luintel (1996) and Sarkar (2009).

The Indian financial sector has had a tartan history. The story of the post-independent Indian financial sector can be described in terms of three distinct phases—the first phase spanning over the 1950s and 1960s demonstrated some elements of instability associated with laissez faire system but underdeveloped banking; the second phase covering the 1970s and 1980s began the process of financial development across the country under government control and management but that was escorted by a degree of financial repression; and the third phase since the 1990s has been characterized by gradual and calibrated financial deepening and liberalization or globalization (in the study the term liberalization and globalization will be used interchangeably). Within these junctures, the Indian economy experienced a deep crisis during the early nineties. There was a sharp decline in the country's foreign exchange reserves that was hovering around only $ 1 billion. Inflation rate was at its peak level of around 17 per cent. Fiscal deficits mounted to high levels at around 10 per cent of GDP and the current account deficits was about 3 per cent of GDP creating an unfavourable balance of payment situation. The overall growth of the real sector was at unsatisfactory level. To tackle the crisis, the government of India launched the policy of major economic reforms in 1991 involving both macroeconomic stabilization and structural adjustment programmes. One of the major areas of such reform programmes was the financial sector reform that was formulated by Narasimham Committee to examine all aspects relating to the structure, organization and functions of the financial system. Out of the entire financial system the banking industry has been