Chapter 8

Causality between Credit Deposit Ratio and Credit Share in Major Indian States during 1972 –2008

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ABSTRACT

The Indian economy has undergone different structural shifting in its history of development since 1947. One major break was the liberalization of the economy in the period 1991-92 and the reforms in the banking and financial sectors deserved a special attention in the study. The banking sector reform was done under the intention to make more investible banking funds for real investment to raise credit-deposit ratio along with proper allocation of banking funds to all the states so that share of credit of each state is balanced. Literature shows the falling tendency of credit-deposit ratio in the immediate decade after the reform and the rising tendency of divergence in credit possession among the states. At the same time, the states lacking in credit-deposit ratio are either with higher, lower, or moderate shares of credits. This study, hence, tried to examine the direction of causalities between credit-deposit ratio and credit share for the major 16 states of India. Using the time series econometrics technique, this study found 4 states where the causality works for the entire period and less than half of the state where causality works in either pre-reform or post-reform periods.

BACKGROUND

Indian financial system in its history has experienced different phases of developments ranging from the state control to relatively much market oriented status from the pre-independence to post independence era. During the post-independence era the financial sector has faced the nationalization regime that is the establishment of the state control mechanism and the liberalization regime that is the status of making the economy towards market orientation. The financial system of the country has several wings out of which the com-
mercial banking sector occupies a vast area. Indian financial system, particularly the banking system had experienced a string of crises in terms of bank failures resulting into slow growth of this sector during the pre-independence period. Banking sector reform was done on the expectation of allocation of more commercial banks’ credit in particular relative to their levels of deposits to the existing real sectors vis-à-vis reducing operating costs of banks and statutory reserve and cash reserve ratios. Empirical researches in this area have shown that there are phenomenal growth of levels of credits and deposits of the commercial banks of the major states in India after the reform process initiated compared to the pre-reform phase but the level of credit deposit ratio have unquestionably gone down in the first decade of the reform era and then tend to rise (Das & Maiti, 1998; Misra, 2003; Das & Ray, 2009; and Das, 2011). At the same time, the states are diverging in terms of the credit possession by them after the reform periods. Some states are improving in terms of credit deposit ratio but lacking in credit share out of the total credit and on the other hand some states are improving in credit share also improving in credit deposit ratio.

There are also plenty of literatures related to role of financial development upon economic growth. Its variant which is very popular in the field of research is the economic growth and financial inclusion. This leads to study of causality between financial development and economic growth in different economies. Different research works consider different financial and banking variables as the proxy of financial development like aggregate credit, credit-deposit ratio, credit shares, credit to GDP ratio, etc. The noted studies in this area are Schumpeter (1911), Patrick (1966), Diamond (1984), Greenwood & Jovanovíc (1990), King & Levine (1993), Demetriades & Hussein (1996), Beck et al (2000), Kiran et al (2009), Bhanumurthy & Singh (2009), Kar and Pentecost (2000), Hussain and Chakraborty (2012). There are some studies which point out that financial development has no such role in economic development (Lucas, 1988; Demetriades & Luintel, 1996; Sarkar, 2009).

But it is a matter of debate that an economy with good performance in converting its deposits to credits may or may not perform well in the field of possessing credit out of the total economies. In the other way to state, particularly with reference to the study on Indian states, can a state with dominance in credit delivery out of the total credit of the country can also have efficiency in utilizing its total deposit, or the reverse. That particular issue has been the central part of our study. There is really a scarcity in the literature on that particular issue. Hence, our present study concentrates on the relations between these two banking variables for the Indian states.

**OBJECTIVE OF THE STUDY**

This study tries to examine the direction of causality between credit-deposit ratio and credit share for the major states in India.

**PLAN OF THE STUDY**

This study has been organized in the following manner. Section 4 establishes the data source and methodology. Section 5 highlights the trends of credit-deposit (C/D) ratios and credit shares of the states. Section 6 analyses the causality results for the short runs (both pre and post reforms periods) and long run (for the entire period of study). Section 7 concludes.

**DATA AND METHODOLOGY**

The present study uses the annual data on credit and deposit (both in current values) of the scheduled commercial banks situated in different states published by The Reserve Bank of India. The period of study is 1972-2008 out of which the pre reform phase is 1972-1992 and the post reform