THE HINDU
Online edition of India's National Newspaper
Tuesday, Jan 25, 2005

Open Page

Consumer credit boom and its pitfalls

YOUR EDITORIAL "Consumer credit: boon or bane?" (*The Hindu,* December 31) was timely. As the Editorial points out, borrowing against future income has become a widespread phenomenon. Both consumers and banks have joined the financing boom with unfettered enthusiasm. The Editorial has raised some important concerns. One is the rising indebtedness of households, hardly a desirable phenomenon for a poor country like ours. The second is a pronounced bias on the part of banks for retail lending. This means a shift away from more traditional industrial lending activities that create productive assets, especially infrastructure, which is vital for a country like ours.

A fundamental principle of economics, which is beyond debate, is that poor countries need to save as much as they can. Such countries also need a well functioning financial system which can channel these savings into meaningful investments to create assets of lasting value. What the consumer financing boom is doing is to decrease, not increase, savings. The boom is also undermining the ability of the financial system to perform its main duty. Savings are simply not being channelled into investments.

All of us have aspirations as consumers. If we are confident about our future earning capabilities, there is nothing wrong in borrowing and buying something which we can consume from a relatively young age. The key assumption here is that our future financial circumstances will be more favourable than the present. If the assumption holds, the loan can be repaid with little difficulty. Unfortunately, this assumption is unrealistic in most cases.

Uncertainty

Many of the people taking loans today are relatively young professionals in sectors which look glamorous today but where there is considerable uncertainty in the medium to long term. Take the software engineers. They work in an industry where much depends on the growth of developed countries. If economic growth stalls in the U.S. or Europe and if the Information Technology (IT) industry slows down as it happened in 2001, IT companies will retrench. Earlier these companies could afford to keep people "on the bench." But now with intensifying competition and thinning margins, there will be no option but to fire surplus engineers.

Similarly, consider the Business Process Outsourcing (BPO) boom. People have already started concluding that India has become the outsourcing hub of the world.

The feeling is that more and more work will be outsourced to India and the boom will never stop. Again, this is a surprisingly simplistic and optimistic assessment. Even if outsourcing picks up momentum in the western countries, all the work may not come to India. And even if the boom continues in India, not all companies will do well. We can expect some industry consolidation to take place. Moreover, as technology becomes more sophisticated, many back end jobs will get automated. In short, there is likely to be rationalisation and job losses.

The bigger concern is the possibility of banks becoming full-fledged consumer financiers as opposed to project lenders. Indeed, terms like Universal Banks are nothing but a euphemism for this phenomenon. In a country like ours, where the capital markets are still very shallow, the primary role of banks is to appraise industrial projects and finance them accordingly. While big companies can raise money from the capital markets, small businesses have no option but to turn to the banks. And these businesses are just not getting the funds they need from banks. No wonder, our small scale sector is failing to take off. The world over, it is small and medium enterprises (SMEs) which drive economic growth.

But let us not blame banks for behaving like this. At the current low level of interest rates, giving consumer loans is more attractive than lending to industrial projects. Interest paid by banks on most deposits is less than 6 per cent and if a consumer loan is given at 8 per cent, the spread is very attractive considering that the risk is diversified across many customers. But lending at even 11-12 per cent to an industrial project is not attractive as the risk is much higher and difficult to quantify.

The larger issues associated with the consumer financing boom also need to be debated thoroughly, especially the priorities of our youngsters on whom the future of our country heavily depends. Youngsters are aspiring for all the goodies of life without realising they have to be earned the hard way. Thus it is common to see MBA students walking into the classroom carrying cell phones but not calculators. These students spend thousands of rupees at weekend get-togethers in swank restaurants. But if professors tell them to buy a couple of good books and read them, there is a lot of resistance. A decade back, people hesitated to get married till they had finished their studies and worked for at least 3-4 years. Today youngsters want to get married even before their studies are over. All this shows that the tendency for early gratification is on the rise.

I am not arguing that people should live like hermits. Indeed, we must enjoy life, for life is short. But we must enjoy life in a meaningful and sustainable way. Till we become a rich developed country, we need to be more circumspect. Living on borrowed money is fine as long as things keep going the way we expect them. But if something goes wrong down the line, it would be a real catastrophe. Major social upheavals would result.

A.V. VEDPURISWAR