Ashay Kadam
Goa Institute of Management

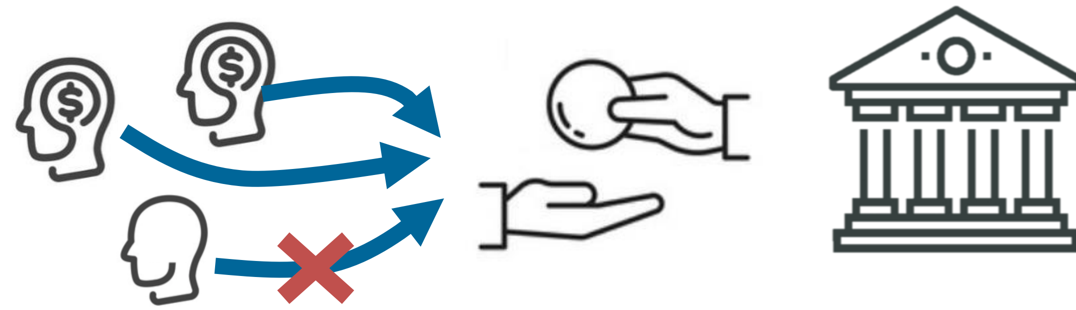
Magdalena Pisa
WHU - Otto Beisheim School of Management

Credit expansion and diligent banks

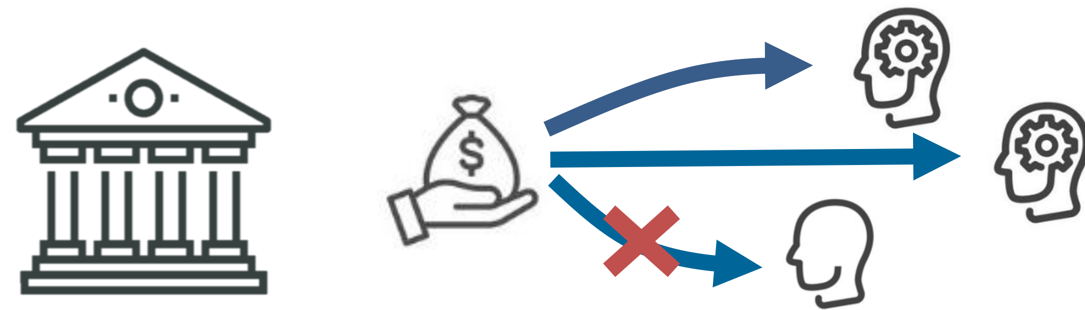
Introduction

Credit expansion has been increasingly credited to contribute to economic growth. Higher economic growth can result from:

1. a **demand-led** credit expansion, in which financially constrained firms demand more finance to unlock their productive projects,



2. or from a **supply-led** credit expansion, in which banks reallocate resources to the more profitable and potentially productive firms.



Recent studies underline the unexploited potential of financially constrained firms (i.e. Ersahin 2020 *RFS*).

→ **This paper shows the banks' role in efficiently reallocating capital in the economy.**

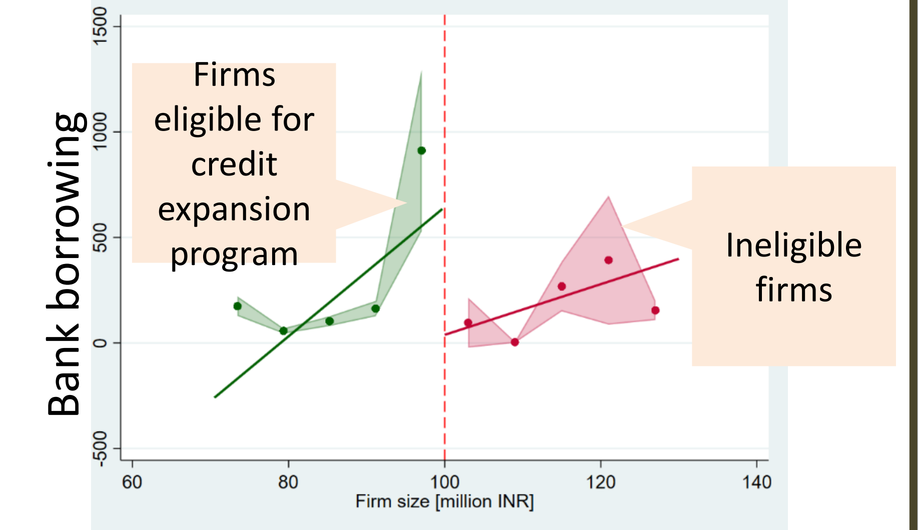
Institutional background

- In 2015 reform of a credit expansion program (PSL program) in India.
- The eligibility cutoff for the program increased from 50 to 100 million INR for manufacturing firms.
- Commercial banks in India are expected to lend 40% of their advances to PSL sector.

Method

- Eligibility for the program depends on firm size
- Firms marginally below the cutoff of 100 million INR are eligible, while firms marginally above are not

→ **Use of RD design**



Results

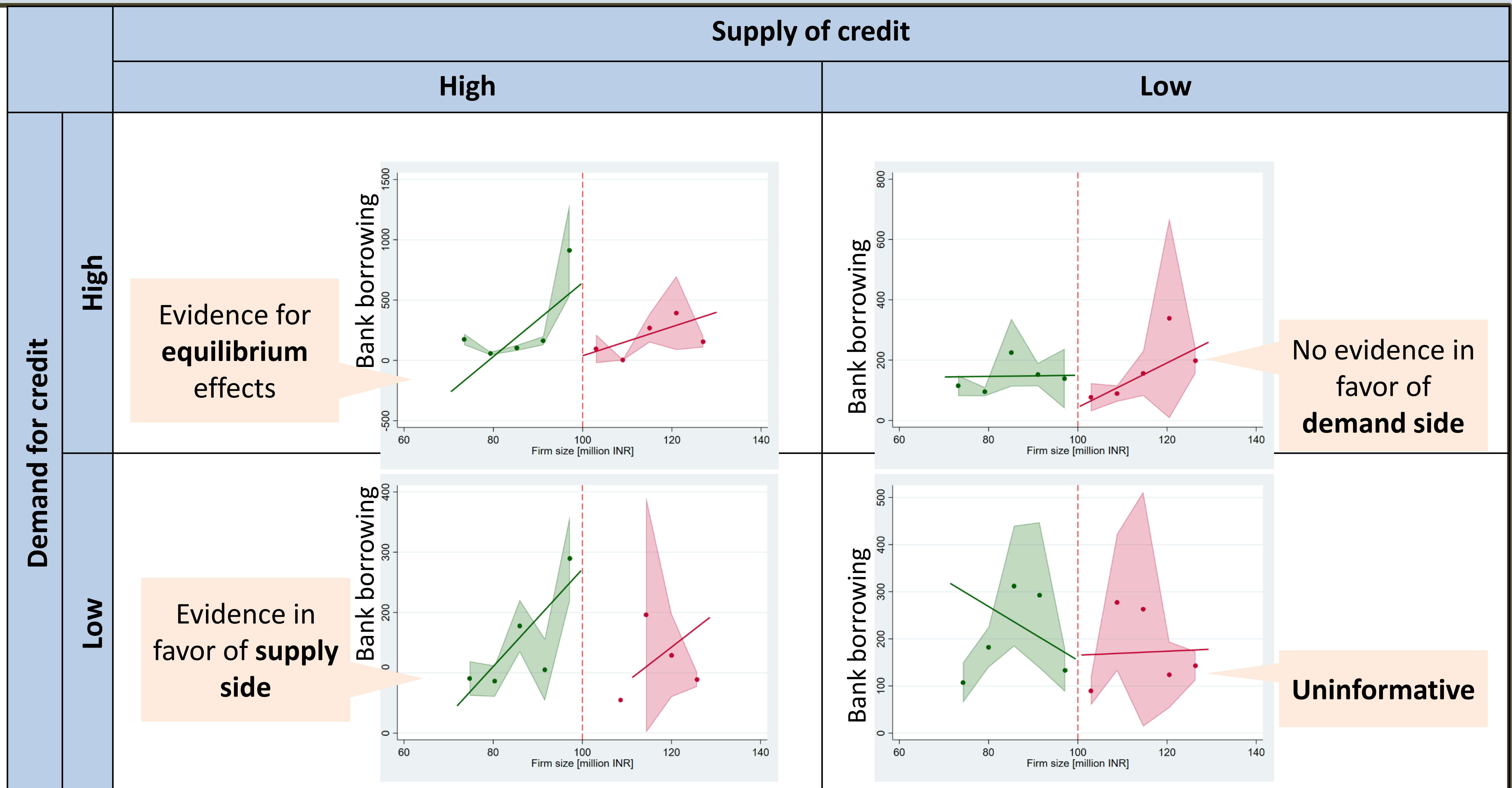
❶ We find evidence of **supply-led** credit expansion.

4 groups of firms:

1. High supply and demand for credit
2. High supply and low demand
3. Low supply and high demand
4. Low supply and demand for credit

Bank borrowing increases for the firms with high supply and low demand but not for the firms with low supply and high demand

→ **Evidence in favor of supply side driving the credit expansion.**



Other results

❷ Banks that lend to a higher share of eligible firms are more sturdy, i.e. have:

- higher Tier 1 capital adequacy ratio, and provisioning coverage ratio
- lower NPA

❸ Industries with higher share of eligible firms perform better, i.e. have:

- lower variance of MPK, and variance of leverage
- higher aggregate sales, aggregate cash profit, and aggregate R&D

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