

**IMF Working Paper**  
Research Department

**India's Banks: Lending to Productive Firms?**

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Authorized for distribution by Giovanni Dell'Ariccia  
April 2022

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**ABSTRACT:** Capital misallocation is widely thought to be an important factor underpinning productivity and income gaps between advanced and emerging economies. This paper studies how well Indian banks allocate capital across firms with varying levels of productivity. The analysis reveals that the link between productivity and bank credit growth is weaker for firms with significant ties to public sector banks, especially in years when public sector banks represent a large share of new credit. Large flows of credit to unproductive firms represent important missed growth opportunities for more productive firms. These results suggest that measures to improve governance of public sector banks, potentially including privatization, would help reduce capital misallocation.

JEL Classification Numbers:	E44, G21, G38
Keywords:	Productivity, bank lending, allocation of credit
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\* Yang Liu, Armaghan Naveed, and François-Clément Charbonnier provided excellent research assistance.

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