Agrarian Studies 2

Financial Liberalization and Rural Credit in India

Edited by V K Ramachandran and Madhura Swaminathan

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Introduction

V.K. Ramachandran and Madhura Swaminathan

Credit and Rural Economy

Financial liberalization after 1991 decimated the formal system of institutional credit in rural India. It represented a clear and explicit reversal of the policy of social and development banking, such as it was, and contributed in no small way to the extreme deprivation and distress of which the rural poor have been victims over the last decade. The papers in this volume, theoretical and empirical, examine the impact of changes in banking policy and structure on the rural economy, and on the rural poor in particular.[1]

Financial liberalization is a crucial component of the programmes of economic reform that are being imposed on the people of less developed countries. The demand that financial markets be liberalized quickly is high on the agenda of imperialism; in India, as well, advocates of economic 'reform' see financial liberalization as being at the core of structural adjustment. There are many components of the package of reforms associated with financial liberalization in India. Chandrasekhar and Ghosh (2002) classify these policies of financial liberalization into three types: first, policies to curtail government intervention in the allocation of credit; second, policies to dismantle the public sector and foster private banking; and third, policies to lower capital controls on the Indian banking system.

It is well known that the burden of indebtedness in rural India is very great, and that, despite major structural changes in credit institutions and forms of rural credit in the post-independence period, the exploitation of the rural masses in the credit market is one of the most pervasive and persistent features of rural life in India. Rural households need credit for a variety of reasons. They need credit to meet short-term requirements of working capital, and for long-term investment in agriculture and other income-bearing activities. Agricultural and non-agricultural activities in rural areas, typically, are seasonal, and households need credit to smoothen out seasonal fluctuations in earnings and expenditure. Rural households, particularly those vulnerable to what appear to others to be minor shocks with respect to income and expenditure, need credit as an insurance against risk. In a society that has no law of free, compulsory and universal school education, no arrangements for free and universal preventive and curative health care, a weak system for the public distribution of food, and very few general social security programmes, rural households need credit for different types of consumption. These include expenditure on food, housing, health and education. Another important purpose of borrowing, in the Indian context, is to meet expenses on a variety of social obligations and rituals.

If these credit needs of the poor are to be met, rural households need access to credit institutions that provide them a range of financial services, provide credit at reasonable rates of interest, and provide loans that are unencumbered by extra-economic provisions and obligations.

Historically, there have been four major problems with respect to the supply of credit to the Indian countryside. First, the supply of formal sector credit to the countryside as a whole has been inadequate.[2] Second, rural credit markets themselves have been very imperfect and fragmented. Third, as the foregoing suggests, the distribution of formal sector credit has been unequal, particularly with respect to region and class, caste and gender in the countryside. Formal sector credit needs specially to reach backward areas, income-poor households, people of the oppressed castes and tribes, and women. Fourth, the major source of credit to rural households, particularly income-poor working households, has been the informal sector. Informal sector loans, typically, are advanced at very high rates of interest. Further, the terms and conditions attached to these loans have given rise to an elaborate structure of coercion – economic and extra-economic – in the countryside.

That these constitute what may be called the 'problem of rural credit' has been well recognized; recognized, in fact, in official evaluations and scholarship since the end of the nineteenth century. Given the issues involved, the declared objectives of public policy with regard to rural credit in the post-independence period were, in the words of a former Governor of the Reserve Bank of India, 'to ensure that sufficient and timely credit, at reasonable rates of interest, is made available to as large a segment of the rural population as possible' (Rangarajan 1996: 288). The policy instruments to achieve these objectives were to be: first, extension of the geographical and functional reach of the formal sector; second, directed lending; and third, concessional or subsidized credit (ibid.). Public policy was thus aimed not only at meeting rural credit needs, but also at pushing out the informal sector and the exploitation to which it subjected borrowers. Rural credit policy in India envisaged the provision of a range of credit services, including long-term and short-term credit and large-scale and small-scale loans to rural households.

Banking Policy in Rural India: 1969 to the Present

The period from 1969 to the present can be characterized as representing, broadly speaking, three phases in banking policy vis-à-vis the Indian countryside.[3] The first was the period following the nationalization of India's fourteen major commercial banks in 1969. This was also the early phase of the 'green revolution' in rural India, and one of the objectives of the nationalization of banks was for the state to gain access to new liquidity, particularly among rich farmers, in the countryside. The declared objectives of the new policy with respect to rural banking – what came to be known as 'social and development banking' – were: (i) to provide banking services in previously unbanked or under-banked rural areas; (ii) to provide substantial credit to specific activities, including agriculture and cottage industries; (iii) to provide credit to certain disadvantaged groups, such as, for example, Dalit and scheduled tribe households.[4]

The introduction of social and development banking policy entailed a radical shift from prevalent practice in respect of the objectives and functioning of commercial banks. An important feature of this policy was that it recast completely the role of commercial banks in rural banking. Prior to 1969, the countryside was not considered to be a problem of commercial banks.[5] It was only after 1969 that a multi-institutional approach to credit provision in the rural areas became policy, with commercial banks, regional rural banks and cooperative institutions establishing wide geographical and functional reach in the countryside.

The Reserve Bank of India (RBI) issued specific directives with respect to social and development banking. These included setting targets for the expansion of rural branches, imposing ceilings on interest rates and setting guidelines for the sectoral allocation of credit. Rural credit was an important component of the 'green revolution' package, and the first post-nationalization phase of expansion in rural banking saw a substantial growth in credit advances for agriculture. Specifically, a target of 40 per cent of advances for the 'priority sectors', namely, agriculture and allied activities, and small-scale and cottage industries, was set for commercial banks. Advances to the countryside increased substantially, although they were, as was the green revolution itself, biased in respect of regions, crops and classes.[6] The two main crops that gained from the green revolution, as is well recognized, were wheat and rice, and the application of the new technologies was primarily in the irrigated areas of the northwest and south of India, with the benefits concentrated among the richer classes of cultivators.

In 1975 the government established, by ordinance and then legislation, a new network of rural financial institutions called regional rural banks, which were promoted by the Government of India, state governments and commercial banks. These were created on the basis of recommendations by a working group on commercial credit, also called the Narasimham Committee, and were intended to 'combine the cooperatives' local feel and familiarity with the business acumen of commercial banks' (Jagan Mohan 2004: 22).[7] The number of such banks expanded rapidly, and covered 476 districts by 1987 (ibid.).

The second phase, which began in the late 1970s and early 1980s, was a period when the rhetoric of land reform was finally discarded by the ruling classes themselves, and when the major instruments of official anti-poverty policy were programmes for the creation of employment. Two strategies for employment generation were envisaged, namely, wage employment through state-sponsored rural employment schemes and self-employment by means of loans-cum-subsidy schemes targeted at the rural poor. Thus began a period of directed credit, during which credit was directed towards 'the weaker sections'. The most important new scheme of this phase was, of course, the Integrated Rural Development Programme, or IRDP, a scheme for the creation of productive income-bearing assets among the poor through the allocation of subsidized credit. The IRDP was initiated in 1978–79 as a pilot project and extended to all rural blocks of the country in 1980. There is much writing on the failure of the IRDP to create long-term income-bearing assets in the hands of asset-poor rural households.[8] Among the many reasons for this failure were the absence of agrarian reform and decentralized institutions of democratic government, the inadequacy of public infrastructure and public provisioning of support services, and the persistence of employment insecurity and poverty in rural society. Nevertheless, the IRDP strategy did lead to a significant transfer of funds to the rural poor.

The second phase also involved an expansion and consolidation of the institutional infrastructure of rural banking. 'Even ardent critics of India's growth strategy', wrote a noted scholar of India's banking system, 'would admit that what the country achieved in the area of financial sector development before the present reform process began, particularly after bank nationalization, was unparalleled in financial history' (Shetty 1997: 253). After bank nationalization, as Shetty points out, there was 'an unprecedented growth of commercial banking in terms of both geographical spread and functional reach' (ibid.).

The third and current phase, which began in 1991, is that of liberalization. The policy objectives of this phase are encapsulated in the *Report of the Committee on the Financial System*, a Committee that was chaired, ironically, by the same person who recommended the establishment of regional rural banks, M. Narasimham (RBI 1991). In its very first paragraph, the *Report* calls for 'a vibrant and competitive financial system . . . to sustain the ongoing reform in the structural aspects of the real economy'. The Committee said that redistributive objectives 'should use the instrumentality of the fiscal rather than the credit system' and, accordingly, that 'directed credit programmes should be phased out'. It also recommended that interest rates be deregulated, that capital adequacy norms be changed (to 'compete with banks globally'), that branch licensing policy be revoked, that a new institutional structure which is 'market-driven and based on profitability' be created, and that the part played by private Indian and foreign banks be enlarged.

Let us make it clear that, before the 1990s, the Indian banking system was open to much criticism, particularly of its bureaucratic failures, its insensitivity to the social and economic contexts in which it functioned, and class and regional inequalities in lending patterns. The reforms proposed in 1991, however, were not attempts to bring rural banking closer to the poor, but to cut it back altogether, and to throw the entire structure of social and development banking overboard.[9]

Theoretical Issues

The first set of papers in this volume deals with the theoretical underpinnings of current policy. The core of financial liberalization, according to Prabhat Patnaik, comprises three components: opening up to international financial flows, the removal of controls on domestic banking institutions and autonomy for the central bank. In his carefully argued paper, Patnaik establishes that real interest rates tend to rise in a third world country in a regime of free inflows. He goes on to argue that in a liberalized regime, banks tend to be unwilling to lend to the agricultural sector. On both counts, then, the rural economy is adversely affected in terms of access to financial resources.

In the second paper in this volume, C.P. Chandrasekhar and Sujit Kumar Ray provide a detailed account of the components of financial liberalization in India. The stated objectives of the new policies are to increase the 'efficiency' and profitability of banks. The paper shows that, while the profitability of public sector banks has risen, some of this improvement comes from the infusion of new capital from the Government of India, not just as a result of new policies. The priority sector has been a target and has been blamed for the poor performance of banks. Even in 2003, however, the share of the priority sector in non-performing assets was lower than that of the non-priority sector in non-performing assets. Nevertheless, the new policies have cut back priority sector advances. Stricter prudential regulations, for example, have made banks more risk-averse, a fact reflected in a big rise in bank investments in risk-free government securities at the expense of direct loans and advances. Further, there is a shift among banks from direct priority sector lending to indirect lending (such as by purchase of specialized bonds or investment in the Rural Infrastructure Development Fund, or RIDF). Thus, Chandrasekhar and Ray argue (as does Amiya Kumar Bagchi, in this volume), banks are failing in their principal task of intermediation in rural areas.

A key contribution of this paper is to demonstrate the damage that is being inflicted by the new policies on the structure of development banking in India. Reform measures and the subsequent changes in institutions in recent years (such as the privatization of development finance institutions like ICICI) have increased the fragility of the financial sector. The rising exposure of banks to stockmarkets and the volatility of stockmarkets, and the associated rise in the probability of bank failures, are an illustration of this problem. The authors argue that the RBI has now recognized the problem but only in respect of cooperative banks.

Amiya Kumar Bagchi's paper focuses on the introduction of financial 'innovations' in rural areas following the decline of rural credit in the 1990s, or, what he terms, 'dis-intermediation' for the agricultural sector. Specifically, he analyses the introduction of futures and forward markets in major agricultural commodities, as well as trading in derivatives. As he points out, forward markets for selected agricultural commodities existed even in the 1860s and so these can hardly be called 'innovations'. Nevertheless, it is important to question the basic assumptions underlying these so-called innovations and to examine their effects on different sections of society. Bagchi shows that the new policies not only increase concentration in assets, but also expose the least endowed – small and marginal farmers – to the greatest risk. With the introduction of forward markets, he argues, cultivators 'will lose control over sales of their products' and the gains will accrue to 'large traders with deep pockets'. Further, the burden of adjustment during a downward spiral in the speculative cycle will fall on the small cultivator.

Record of Progress of Rural Banking

Policies of the current phase of financial liberalization have had an immediate, direct and dramatic effect on rural credit. There has been a contraction in rural banking in general, and in priority sector lending and preferential lending to the poor in particular (Ramachandran and Swaminathan 2002; Shetty, this volume; Chavan, this volume).

Let us consider a few indicators. Table 1 documents the growth of bank offices, deposits and gross bank credit in rural areas, as well as the share of rural areas in the all-India total, from December 1969 to March 2002, for all scheduled commercial banks. The impact of bank nationalization on the growth of scheduled commercial banks in rural areas is clear. The share of rural bank offices in total bank offices jumped from 17.6 per cent in 1969 to 36 per cent in 1972. The share then rose steadily and attained a peak of 58.2 per cent in March 1990. From then onwards, there was a gradual decline in the share of rural bank offices, and it fell below 50 per cent in 1998 and thereafter. In fact, there was an absolute contraction in the number of bank offices in the 1990s: 2,723 rural bank offices were closed between March 1994 and March 2000.

S.L. Shetty's paper in this volume discusses the narrowing of the branch network in rural areas after the onset of financial liberalization. Such an 'institutional vacuum', he argues, is likely to affect outcomes of future policies in rural areas, even the new policy for provision of credit through self-help groups.

Official banking statistics do not, unfortunately, give us information on the volume of advances in a specific year. The basic source of data on banking is the RBI's annual *Banking Statistics*. In this document data are provided on 'credit outstanding', which is the total amount advanced, including all outstanding loans and non-performing assets, on 31 March of the reference year. Data under the head 'credit sanctioned' do not represent the volume advanced in a single year either; in fact, at the all-India level, the figures for 'credit outstanding', 'credit sanctioned' and 'credit utilized' are equal. The consequence of this method of collection and presentation of data is that there are no data at all on loan advances by banks each year, that is, on the *flow* of credit. The data on the *stock* of credit show a marked deceleration in credit provision to the countryside since 1991; had we data on the actual amount disbursed each year, we would have a

TABLE 1 *Number of offices, aggregate deposits and gross credit outstanding, all scheduled commercial banks, India, 1969 to 2002* (amount in Rs lakh)

Year	*Number of bank offices*		*Credit outstanding*		*Deposits*		*Credit–deposit ratio (%)*	
	rural (number)	*% to total*	*rural (in Rs 10 million)*	*% to total*	*rural (in Rs 10 million)*	*% to total*	*rural*	*all areas*
1969	1443	17.6	115	3.3	306	6.3	37.6	71.9
1970			193	4.5	400	7.3	48.3	78.1
1971			159	3.1	378	5.2	42.1	69.7
1972	5274	36.0	257	4.6	540	6.5	47.7	67.2
1973	6024	36.5	379	5.3	741	7.4	51.1	70.3
1974	6447	35.9	483	5.9	923	8.0	52.3	71.0
1975	7112	35.5	608	6.0	1171	8.5	51.9	73.5
1976	8588	36.6	870	6.4	1539	8.7	56.5	77.0
1977	10856	40.3	1105	7.2	2010	9.4	55.0	71.7
1978	12534	42.5	1530	8.4	2664	10.1	57.4	69.1
1979	14171	44.0	2003	9.3	3559	11.4	56.3	68.9
1980	16111	46.9	2643	10.7	4644	12.6	56.9	66.9
1981	19453	51.2	3600	11.9	5939	13.4	60.6	68.1
1982	21626	53.0	4473	12.5	7414	14.2	60.3	68.2
1983	23782	52.4	5576	13.6	8828	14.4	63.2	67.0
1984	25541	52.9	6589	13.5	9603	13.4	68.6	68.3
1985	29408	54.6	7489	14.1	11722	13.6	63.9	61.9
1986	29700	55.7	9387	14.5	14375	14.0	65.3	63.0
1987	30585	56.2	11127	15.3	17527	14.7	63.5	61.0
1988	31641	56.2	13452	15.3	20907	14.7	64.3	61.9
1989	33572	57.3	15546	14.8	24383	15.0	63.8	64.7
1990	34867	58.2	17352	14.2	28609	15.5	60.7	66.0
1991	35134	56.9	1859897	15.0	3100980	15.5	60.0	61.9
1992	35254	56.8	2069226	15.1	3574971	15.1	57.9	57.7
1993	35360	56.3	2290640	14.1	4140973	15.0	55.3	58.9
1994	35396	55.9	2467035	14.0	4933114	15.2	50.0	54.3
1995	33017	51.7	2517431	11.9	5181962	13.7	48.6	55.6
1996	32981	51.2	2901237	11.4	6131317	14.4	47.3	59.8
1997	32909	50.5	3252522	11.4	7376970	14.7	44.1	56.8
1998	32854	49.9	3759808	11.4	8670641	14.5	43.4	55.3
1999	32840	49.3	4209081	11.0	10269707	14.7	41.0	54.8
2000	32673	48.7	4875339	10.6	12053919	14.7	40.4	56.0
2001	32640	48.3	5443125	10.1	13943136	14.7	39.0	56.7
2002	32443	47.8	6668190	10.2	15942346	14.2	41.8	58.4

Note: Data refer to December each year till 1989, and to March thereafter.
Source: Shetty (1997) for 1969 to 1990, and RBI, *Banking Statistics: Basic Statistical Returns*, different issues, thereafter.

clearer picture of the collapse in rural banking in the period of liberalization.

The period after nationalization was characterized by an expansion of bank credit to rural areas: the credit outstanding from rural branches tripled in the 1970s and continued to rise in the 1980s. After 1988, however, the credit outstanding from rural branches as a proportion of total credit outstanding declined, from around 15 per cent in 1987 and 1988 to 11 per cent in March 1999 and 10.2 per cent in March 2002. Turning to deposit mobilization, rural deposits grew rapidly after nationalization: their share of aggregate deposits doubled in the 1970s, from 6.5 per cent in 1972 to 12.6 per cent in 1980, and continued to grow, although at a slower pace, in the 1980s. Once again, the peak was reached in 1990–91, when rural deposits accounted for 15.5 per cent of aggregate deposits. The pace of deposit mobilization in rural areas fell in the 1990s.

Given the pattern of growth of aggregate deposits and gross bank credit, it is no surprise that the credit–deposit ratio in rural areas rose after 1969. The ratio peaked at 68.6 per cent in 1984 and remained above 60 per cent until 1991. In the 1990s, the credit–deposit ratio fell sharply.

The paper by S.L. Shetty has a detailed analysis of changes in the credit–deposit ratio for different areas (rural, semi-urban, urban and metropolitan), as well as for different states. It is worth pointing out that credit–deposit ratios have fallen since the beginning of the 1990s, both in terms of the amount sanctioned and amount utilized. An important contribution of this paper is that it brings together rich empirical evidence to show the substantial shortfall in the supply of credit to rural areas relative to the demand for credit.

One of the objectives of banking policy after nationalization was to expand the flow of credit to agriculture and small industries, or what were termed 'priority sectors'. As Table 2 shows, the share of priority sectors in the total credit outstanding of scheduled commercial banks rose from 14 per cent in 1969 to 21 per cent in 1972, and then went up to 33 per cent in 1980. The RBI set a target of 40 per cent for priority sector lending and, by the mid-1980s, this target was met. From 1985 to 1990, in fact, the target was over-achieved; that is, more than 40 per cent of total credit outstanding went to the priority sectors. From 1991 to 1996, the share of priority sector credit fell, in line with the recommendations of the Narasimham Committee. At first glance, the direction in priority sector lending appears to have been reversed over the last five years. This is, however, a reversal by redefinition: 'priority sector' lending now includes advances to newly created infrastructure funds, to non-banking finance companies for on-lending to very small units and to the food processing industry. Loans to multinationals like Pepsi, Kelloggs, Hindustan Lever and ConAgra now count as priority sector advances.[10] More recently, loans to cold storage units, irrespective of location, have been included in the priority sector.[11]

Chandrasekhar and Ray point to the growing presence of foreign banks in India, their direct and indirect presence through the purchase of shares in existing private banks. This expansion is not good news for the priority sector. When data for scheduled commercial banks are disaggregated by type of bank

TABLE 2 *Share of priority sector in gross credit outstanding of all scheduled commercial banks, India, 1969 to 1999* (per cent)

Year	*Share of priority sector advances in total credit*	*Year*	*Share of priority sector advances in total credit*
1969	14.0	1986	41.0
1970	–	1987	42.9
1971	–	1988	43.8
1972	21.0	1989	42.6
1973	23.1	1990	40.7
1974	24.2	1991	37.7
1975	25.0	1992	37.1
1976	24.5	1993	34.4
1977	25.9	1994	36.5
1978	28.6	1995	33.7
1979	30.9	1996	32.8
1980	33.0	1997	34.8
1981	35.6	1998	34.6
1982	36.4	1999	35.3
1983	36.1	2000	34.3
1984	38.1	2001	34.4
1985	39.9		

Source: RBI, *Banking Statistics: Basic Statistical Returns*, different issues.

(public sector banks, regional rural banks, private banks and foreign banks), we find that foreign banks did not lend to rural areas or agriculture.[12]

The paper by Pallavi Chavan examines the growth of rural banking across regions over the period 1975–2002. It documents the gains made by the historically underprivileged regions of east, northeast and central India during the period of social and development banking. These gains were reversed in the 1990s: cutbacks in rural bank branches and in rural credit–deposit ratios were steepest in the eastern and northeastern states. Policies of financial liberalization have unmistakably worsened regional inequalities in rural banking in India.

As already mentioned, one of our central concerns is the 'credit starvation' (the term is S.L. Shetty's) of the rural economy, which resulted in shortages of credit for all purposes, including for productive investment in agricultural and non-agricultural activity. If we examine the term loans issued by scheduled commercial banks to agriculture between 1980–81 and 1997–98 (Ramachandran and Swaminathan 2002, Table 3), then we observe that, in real terms, credit outstanding rose from 1983–84 to 1990–91 but fell in the first four years after 1991 (although there was some recovery from 1995–96 onwards). It is instructive here to look at the distribution of total agricultural advances to cultivators by size-classes of land-holdings. The smallest cultivators, that is, those with land-holdings of less than 2.5 acres or marginal cultivators, were the worst affected by the post-1991 decline in credit to agriculture. Agricultural credit outstanding to marginal cultivators accounted for 30 per cent of total agricultural credit outstanding from commercial banks in 1990–91; its share fell to 23.8 per cent in 1999–2000 (Chavan, this volume, Table 10). At the same time, the share of credit outstanding to 'small cultivators' (with between 2.5 and 5 acres) stagnated while that to large cultivators rose. Another indicator of the decline in credit to relatively poor rural households is the fact that the number of 'small borrowal accounts' (or accounts with a credit limit of Rs 25,000) fell in the 1990s (Chandrasekhar and Ray, this volume).[13]

The IRDP was a major component of the credit-led poverty alleviation strategy of the 1980s. The number of families assisted annually with IRDP loans rose from 2.7 million in 1980–81 to 4 million in 1984 and 4.2 million in 1987 (Ramachandran and Swaminathan 2002). Although the programme slackened after that, the number of beneficiaries in 1990–91 remained above the level of the early 1980s. After 1991, there was a steep decline in the number of IRDP beneficiaries: only 1.3 million families were assisted in 1998. If we index the number of families assisted in 1982 at 100, the number assisted in 1998 was a mere 37. The term credit disbursed by banks under IRDP followed a similar trajectory. With 1982 indexed at 100, total term credit mobilized for IRDP peaked at 113 in 1987 and went down to 52 in 1998 (ibid.). Pallavi Chavan's paper provides a detailed analysis of the patterns of advances to agriculture and to the rural poor at the state level.

Regional rural banks

Regional rural banks, as we have noted, were created in the 1970s exclusively to serve the credit needs of rural India, and specifically those individuals, social groups and regions most excluded by the formal system of credit. For all their weaknesses, these banks passed an important international test. A cross-country study of rural credit institutions threw up the important finding that, in the period 1988–92, of all the institutions studied, regional rural banks in India incurred the lowest costs of administration: 8.1 per cent of the total portfolio.[14]

An important feature of banking reforms has been to alter the equation between different sectors of banking; in this case, to make the norms governing regional rural banks indistinguishable from those governing commercial banks, thus undermining the capacity of the former to serve the special needs of the rural economy and the rural poor.[15]

There has been a ban on recruitment to the staff of regional rural banks since 1992 (Jagan Mohan 2004). At every discussion or seminar on problems of rural credit that we have attended in the recent past, bank officials speak of the impact on rural credit of the greying of bank personnel and the thinning of their ranks. Field officers of regional rural banks in the 1970s and 1980s were relatively young and capable of spending substantial periods of time in the villages served by their branches. These banks have also suffered because they are no longer permitted to recruit agricultural science and engineering graduates for specialized lending (see Shetty, this volume; Jagan Mohan 2004). Liberalization has had the effect of crippling regional rural banks, rendering them incapable of fulfilling their original mandate.

Cooperative credit institutions

Until 1969, no serious role was envisaged for scheduled commercial banks in agriculture and rural development. Abhijit Sen's analysis of the place and role of cooperative institutions in rural credit and banking points out that cooperatives were the oldest source of formal sector credit in India, that they were 'virtually the only source' of formal sector credit in rural India before 1969, and that, with their 'vast network and coverage', they continue to cover more people from among the rural poor than any other formal sector credit institution.

The problems of cooperatives as lending institutions have accumulated over the years, and new problems have arisen after liberalization. After liberalization, cooperatives have increasingly been expected to conform to the norms expected of market-driven commercial bank branches. Further, as Abhijit Sen shows, the fortunes of cooperative bank federations are linked directly with those of state finances, and the general crisis of state government finances has hit efforts to revive and rejuvenate cooperatives hard.

There is much diversity in the performance of cooperative credit institutions across states and regions within states. There is also diversity between states and regions in the historical record of cooperative credit, in the functions that cooperative credit institutions typically undertake and the services they provide, in the types of crop cultivation and non-farm activity in which they specialize, in the classes of cultivators that they are seen to represent, and in the character and degree of the spirit of cooperation that drives them. The two case studies of cooperative credit institutions in this book happen both to be in areas (Kannur district in Kerala and Bankura district in West Bengal) where the kisan movement is active and is, indeed, the moving spirit behind the credit institution. Each, however, has problems and characteristics specific to the region in which it is located. Abhijit Sen's analysis indicates that, as there is diversity in the performance of cooperative credit institutions, so also is there diversity in the impact that policies of financial liberalization have had on them. This is an area open for much useful empirical research.

Miracle Cure: Micro-Credit and Self-Help Groups

It is clear from the preceding sections that neoliberal banking reform amounts, in theory and practice, to a reversal of the public policy objectives of extending the reach of rural credit, providing cheap and timely credit to rural households (particularly economically vulnerable households), overcoming historical problems of imperfect and fragmented rural credit markets, and displacing the informal sector from its powerful position in rural credit markets. As we have seen, there was a large-scale retreat by the formal sector from the Indian countryside in the post-1991 period. From official policy statements, it appears that the government envisages only one major policy instrument to fill the gap left by the formal credit sector in the countryside: the establishment of micro-credit projects in rural India.[16]

The micro-credit approach is viewed as being able to rectify the major weaknesses of the banking system itself, most notably the 'twin problems of non-viability and poor recovery performance' of existing rural credit institutions (Rangarajan 1996: 68). Micro-credit is the favoured alternative to the present system because: first, it is assumed that the transactions costs of banks and other financial institutions can be lowered significantly if these costs are passed on to NGOs or self-help groups; and second, NGOs are expected to perform better than formal sector credit institutions in respect of the recovery of loans.[17]

The terms micro-credit and micro-finance have risen spectacularly to fame in the development profession and in development literature in the last decade and a half. The Declaration of the World Bank-sponsored Micro-Credit Summit held in Washington, D.C. in 1997 defined micro-credit programmes as those 'extending small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families'. In India, the Task Force on Supportive and Regulatory Framework for Micro-Finance in India defined micro-finance as the 'provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban or urban areas enabling them to raise their income levels and improve living standards' (NABARD 2000). The Reserve Bank of India uses the same definition (RBI 1999a).

While micro-credit loans are generally advanced for self-employment projects, they are sometimes advanced for consumption as well. Nevertheless, the advocates of micro-credit do consider it necessary for micro-credit institutions to get borrowers to make the transition from consumption loans to production loans (or loans for income-bearing projects) (Rangarajan 1997: 71). The characteristic features of micro-credit operations are small loans to poor households in rural and urban areas for income generation through self-employment. Micro-credit institutions may also provide facilities for savings and other financial services. Micro-credit, as discussed in the international literature, is associated with the following recurring empirical features:

- very small loans
- no collateral
- borrowers from among the rural and urban poor
- loans for income generation through market-based self-employment
- the formation of borrower groups
- privatization, generally through the mechanism of NGO control over disbursement and determination of the terms and conditions attached to each loan.

In an earlier paper, we reviewed the two claims in support of NGO-controlled micro-credit, that is, lower transactions costs and a better repayment record than that of formal sector financial institutions (Ramachandran and

Swaminathan 2002). The international evidence on administrative costs of NGOs shows that these costs were high (and administrative costs are, of course, the major component of total transactions costs) and relatively higher than those of commercial banks.[18] NGOs cannot match the economies of scale of a comprehensive system of banking (in the case of India, perhaps the best network of rural banks in the less developed world). Secondly, the costs of administration of NGO-controlled micro-credit have actually risen when NGO activity is scaled up.[19] Thirdly, repayment rates in NGO-controlled micro-credit projects are related directly to the level of administrative costs and mobilization efforts.[20]

High-cost NGO operations are financed either by donor funds or by raising interest rates to levels higher than those offered by the banking system, or by doing both.[21] It is acknowledged widely that interest rates charged by micro-credit organizations are higher than the corresponding rates charged by commercial banks or other financial institutions.[22] Thus we argued that the transfer of the task of serving the credit needs of rural borrowers from the banking system to NGO-controlled micro-credit projects does not *reduce* transactions costs but, in effect, *transfers* transactions costs – *higher* transactions costs – to donors as well as to borrowers.

Reviewing interest rates on micro-credit loans, the paper by R. Ramakumar and Pallavi Chavan observes that annual rates ranged from 24 to 36 per cent on bank-linked schemes refinanced by the National Bank for Agriculture and Rural Development (NABARD). Some studies, however, found rates of interest that were even higher, and as much as 60 per cent per annum. To sum up, interest rates for micro-credit loans are undoubtedly higher than those charged by the banking sector for agricultural loans, and the interest rate spread is also larger.

The other salient feature of micro-credit, high repayment, is not a costless achievement. First, a system based on the quick repayment of very small loans does not allow for funds to go into income-bearing activities that have a gestation period of any significance. Only projects with very quick rates of return and high rates of return relative to the tiny investment can meet existing repayment schedules. This pattern of repayment can put the poorest out of the pale of micro-credit, since the ability to pay the first few instalments depends on the initial resource base of the borrower. Second, high repayment is dependent on high transactions costs. As already mentioned, NGOs invest heavily in supervising, monitoring and enforcing loan repayments. When the activities of NGO-controlled micro-credit projects are scaled up, the relative burden of administrative costs tends to increase. An evaluation of SEWA Bank, a bank set up by the Self Employed Women's Association (SEWA), showed that the proportion of overdues to total advances was actually marginally higher than the corresponding ratio for public sector banks. Scaling up NGO-controlled micro-credit, it appears, can generate problems similar to those faced by traditional banking institutions. The corrective measures being taken by SEWA Bank to address the problem of overdue loans involve greater supervision and monitoring (Ghosh 2001). In short, higher and better repayment requires more staff and closer monitoring, or higher transactions costs.

In India, NGO-controlled micro-credit is not yet as widespread and does not represent as general a policy towards rural credit as it is and does, for instance, in Bangladesh. Nevertheless, the scale of bank finance through self-help groups has expanded rapidly in the last few years, and is even considered 'the largest and fastest growing example of micro finance in the world' (RBI 2004a). Witness the proliferation of self-help groups: from less than 10,000 in 1996–97, the number of self-help groups with bank finance has grown to 10 lakhs in 2004. And the total bank lending to self-help groups has crossed Rs 3,500 crore (ibid.). NABARD has set a goal of creating 1 million self-help groups by 2007–08 in order to reach around 40 million persons.

In this volume, we have a case study, conducted by Smriti Rao, of the costs and benefits of participation in women's self-help groups in Andhra Pradesh. Andhra Pradesh has been something of a leader in establishing self-help groups: by 2002, over 50 per cent of the self-help groups in the country (and 20 per cent of all self-helf groups in the world) were in Andhra Pradesh. Despite their growth in numbers – with over 3 lakh self-help groups by 2002 – only 0.6 per cent of the total bank credit in Andhra Pradesh was channelled to these groups in 2002.

Drawing on detailed interviews with women from different self-help groups in two villages of the Telangana region, Rao describes various features of these groups in practice, among them the exclusion of the poorest, and the perpetuation of existing class and caste hierarchies. Her paper also shows that the state government allocated very little by way of funds and manpower to monitoring self-help groups. Transactions costs were inevitably borne by NGOs or members of groups themselves, including income-poor women. From these village studies, it emerges that micro-credit advances were small, short-term and high-cost. Interest rates on these loans were typically 30 per cent per annum, as compared to 36 per cent on loans from informal lenders. Rao writes that, in her study villages, the benefits of participation were 'limited to small, expensive and short-term consumption loans'. Rao's study also shows that self-help groups in her study villages tend to reinforce the separateness of social groups along traditional lines.

There is, as yet, no large-scale evaluation of micro-credit institutions and finance as an alternative mechanism for meeting credit and banking needs in rural India. This is an important area for further research. The conclusions of the case study by Smriti Rao, however, are salutary, for they indicate the shortcomings of relying solely on micro-credit to alleviate poverty and empower women.

We have shown that, despite assertions to the contrary, NGO-controlled micro-credit organizations do not incur lower transactions costs than banks (they are able to transfer these costs to others). Banks have many advantages over private micro-credit organizations as providers of small-scale loans. They have advantages of scale; the banking system in India has a reach and spread that

NGO-controlled micro-credit cannot begin to match; banks can cross-subsidize loans; banks are better placed to provide specialized training to their employees in development banking; banks are better placed to coordinate banking activity with development administrations, local governments and self-help groups; and banks are better able than private micro-credit organizations to offer a wide range of financial services to borrowers. For the state to withdraw from the field and hand over small-scale credit to NGO-controlled micro-credit organizations is, in effect, to undermine and weaken a major national asset, the widespread rural banking system.

Village Studies

Case studies based on primary data help identify the impact of changes in financial policy and banking structure on patterns of indebtedness among rural households. This volume has five papers, each reporting the findings of detailed village surveys on rural credit in the contemporary period. The studies cover Baghra and Udaipur villages of Giridih district in Jharkhand (V.K. Ramachandran and V. Surjit), Panahar and Muidara villages of Bankura district in West Bengal (Vikas Rawal), Morazha village of Kannur district in Kerala (R. Ramakumar), Gokilapuram of Theni district in Tamil Nadu (V.K. Ramachandran and Madhura Swaminathan), and Dhamar of Rohtak district and Birdhana of Fatehabad district in Haryana (Vikas Rawal and Keya Mukherjee).

Gokilapuram village in southwest Tamil Nadu is a highly irrigated, agriculturally advanced and commercialized village. The high development of productive forces is combined with a very unequal distribution of resources: a large proportion of households are landless, while a small minority control the major share of land and other assets. The availability of data from two census-type surveys of Gokilapuram, the first conducted in 1977 and the second in 1999, with smaller surveys in the interim, particularly in 1985, allows for a discussion of changes over a relatively long period of time.

Resurvey data are also available for the two villages in West Bengal. Vikas Rawal first studied the villages of Panahar and Muidara in 1995–96 and restudied them in 2002. After land reform in the 1970s and 1980s, there were major changes in these two villages. Irrigated area, agricultural output and yields surged. As in other parts of West Bengal, agrarian structure in Panahar and Muidara is dominated by small-holders.

In neighbouring Jharkhand, V. Surjit and V.K. Ramachandran conducted surveys of rural credit in the villages of Baghra and Udaipur in 2003. These villages are not only less developed in terms of agricultural production than Panahar and Muidara, but also poorer in terms of general infrastructure and resources. Udaipur village, whose population was almost entirely adivasi, had fewer landless households and less inequality in the distribution of land than Baghra, a multi-caste village.

Vikas Rawal and Keya Mukherjee present some features of credit among landless labour households in two villages of Haryana. In Dhamar village, their survey, which was conducted in 2002, covered 163 landless manual labour households. In Birdhana, a larger multi-caste village, their survey covered 282 households (this included households living in the village settlements and those that lived on the fields) and was conducted in June 2003.

The last case study is from northern Kerala. R. Ramakumar conducted a survey in 2001 of all landless households whose members participated in agricultural work in Morazha village. Morazha belongs to a region that was characterized by widespread and acute indebtedness among the peasantry during the British period. It is also a region where there were major struggles against British rule and against landlordism, and where the cooperative movement took strong roots.

The village studies present some striking observations with respect to rural credit in the liberalization phase. First, all the village studies report high levels of indebtedness: 64 per cent of households in Morazha were indebted, the corresponding proportions were 66 per cent in Gokilapuram, 72 per cent in Baghra, 75 per cent in Dhamar, and 83 per cent in Panahar and Muidara.

Second, with one exception, the village data combined with information on the banking sector indicate that the share of formal sources of credit, that is, commercial banks, regional rural banks and cooperatives, is extremely low. In Baghra village, for example, only 28 per cent of total credit was from the formal sector. In Panahar and Muidara, the formal sector accounted for 24 per cent of credit among all village households in 1995–96, but its share was nil among landless households. In Gokilapuram, formal sources of credit accounted for 14 per cent of loans taken and 40 per cent of the principal borrowed by all village households. Class further differentiates access to credit. Among landless hired labour households in Gokilapuram, the formal sector accounted for only 22 per cent of total principal borrowed. Surprisingly, in the relatively advanced agricultural state of Haryana, landless labour households continued to depend on informal sources of credit. Of total credit outstanding among landless households, formal sources accounted for 12 per cent in Dhamar and 8 per cent among manual labour households living in fields in Birdhana. In Udaipur village, somewhat paradoxically, it was observed that the formal sector accounted for 80 per cent of total principal borrowed. Given the limited scale of borrowing, this observation may be explained by the poverty of the village and the absence of informal lenders.

The exception is the village of Morazha, where the cooperative movement is well established, and where cooperative banks and societies are almost the sole source of credit for rural households. In 2001, 98 per cent of the principal borrowed by landless households was from cooperatives. Even here, though, cooperatives mainly met the needs of consumption credit and the issue of credit to landless households for productive purposes remained neglected.

A most striking feature of the village data from Jharkhand was that the people at large had no access to the formal sector of credit. In Baghra, only seven households received any formal sector credit at all in the five years prior to the survey. In each of the two study villages, only one household received any formal sector credit in the year preceding the survey. The formal sector had virtually washed its hands of any responsibility to the villages.

Third, the two studies that capture changes over time show a clear decline in access to formal sources of credit, particularly credit from scheduled commercial banks, in recent years. In Panahar and Muidara, the share of the formal sector in total debt fell from 24 per cent in 1995–96 to 7 per cent in 2001–02. In Gokilapuram, the share of the formal sector in the total principal borrowed by landless households fell from 80 per cent to 17 per cent between 1985 and 1999. It is worth noting that, among landless labour households in Gokilapuram, the share of principal borrowed for productive purposes fell from 44 per cent in 1985 to 14 per cent in 1999. Borrowing for consumption purposes dominated the loan portfolio of almost all classes of households.

In the study villages in West Bengal and Tamil Nadu, informal lenders are thriving and in fact gained ground after 1991 as a result of the withdrawal of the banking sector from rural areas. The village studies also indicate the gross inadequacy of credit, especially for crop cultivation and other productive activities. The growing and unmet demand for credit, both for direct production and for demands of health, education and other needs, is resulting in what S.L. Shetty terms 'credit starvation' among rural households.

This picture is confirmed by the latest report of the Rural Labour Enquiry, which shows the weakening of banks as well as the consolidation of moneylenders in rural areas. In 1983, the formal sector, comprising government, cooperatives and banks, accounted for 44 per cent of the debt of agricultural labour households. This share fell to 36 per cent in 1993 and further to 31 per cent in 1999–2000 (GoI 2004). Over the same period, 1983 to 1999–2000, the share of moneylenders in the total debt incurred by agricultural labour households went up from 18.6 per cent to 34 per cent. During the period when the share of formal credit in total debt of rural households fell, the share of debt taken for productive purposes also fell sharply, from 41 per cent in 1983 to 21.5 per cent in 1999–2000 (ibid.).

Despite over three decades of systematic expansion of the banking infrastructure in the country, the village studies indicate that informal sources of credit – including usurious moneylenders – remain important, and often dominant and growing, sources of credit for rural households.

In Panahar and Muidara, trader–moneylenders have come to dominate the informal credit market. In 1995–96, 32 per cent of the total principal borrowed by the surveyed households was from traders. Moneylenders accounted for 17 per cent of the total principal borrowed by households. In 2001–02, of the total principal borrowed by surveyed households, 50 per cent was advanced by agricultural traders and another 31 per cent was advanced by urban businessmen.

In Gokilapuram, in 1977, of the total principal borrowed by landless labour households, 27 per cent was advanced by moneylenders and 23 per cent by landowners. By 1999, the share of landowners had fallen to 2.4 per cent while moneylenders accounted for 42 per cent. A major finding of this study is the phenomenal rise in the number of moneylenders, full-time and part-time, village-based and town-based, operating in the area. In Baghra village, too, among informal lenders, moneylenders dominated, accounting for 64 per cent of the total principal borrowed by households. The corresponding proportion in Udaipur was 46 per cent.

Landowner–employers were the dominant sources of credit for landless workers in Haryana. In Dhamar village, nearly 49 per cent of the total principal borrowed by landless households came from their agricultural employers.

The rates of interest on loans from the informal sector, particularly from moneylenders, remain very high. In Panahar and Muidara, where traders were the major source of credit, explicit interest rates were not easy to unearth or compute, though rates between 36 and 120 per cent per annum were reported. In Baghra, the modal interest rate range was 48–60 per cent per annum. In Gokilapuram, the modal interest rate range was 60–120 per cent for landless households and 36–48 per cent for all households. Among landless labour households in Gokilapuram, the share of principal borrowed at rates higher than 36 per cent per annum doubled between 1977 and 1999. In Dhamar, the modal rate of interest charged by employer–lenders was 36 per cent per annum.

A distinctive feature of the Haryana villages was that the dependence of landless manual worker households on their employers for credit, together with conditions of severe unemployment, forced workers to enter into unfree labour relationships with their creditor–employers. It is particularly noteworthy that unfree labour relationships in these villages coexisted with significant technological advance and commercialization in agriculture. The study found that, while unfreedom was widespread, there were considerable variations in its specific forms. The nature of unfreedom was closely linked to the high degree of concentration of ownership of land-holdings in these villages. Casual workers were subject to various kinds of coercion by employer–creditors, and had also to perform various kinds of labour services. *Siri* workers in Dhamar village worked under conditions that were akin to bondage. They were not allowed to work for employers other than their creditors and restrictions were often imposed even on their physical mobility. In short, the study found that the dependence of manual worker households on employers for credit was an important factor in sustaining unfree conditions of employment.

Institutional Credit for Rural India

In April–May 2004, the Indian electorate delivered a dramatic judgement on economic policy. Thirteen years of neoliberal economic policy (further intensified in the last five to six years) had taken their toll, and there is general agreement among serious political observers that the election results represented widespread protest, rural and urban, against the collapse of livelihoods among the mass of the people. If policy is to repair the damage done to the rural economy, India needs large-scale public investment in the countryside. The link between rural distress and the near-collapse of the formal sector of banking is well recognized, and it is no surprise that one of the promises of the new government was that it would double the flow of rural credit in three years.

The purpose of this essay is not to evaluate the rural credit policy of the United Progressive Alliance government.[23] Nevertheless, it is clear that if any government is seriously to address the crisis in rural banking, it must reaffirm the commitment of the state to the policy of social and development banking, and reaffirm the part played by the credit system in redistribution and poverty alleviation. Commercial banks, regional rural banks and cooperatives must lead rural credit revival, which is too serious and large-scale a task to be left merely to self-help groups or NGO-controlled, private sector micro-credit organizations. The geographical and functional reach of public sector banking must be restored and extended, differential interest policies reinstated, and special loans-cum-subsidy schemes reintroduced on a large scale, for all landless and poor and middle peasant households, scheduled caste and tribe households, and other vulnerable sections of the rural population. Priority sector norms must be enforced, and, instead of an alternative such as investment in RIDF bonds, penalties must be imposed on any failure of banks to meet these public interest targets.

If financial liberalization had the effect of damaging the system of formal credit severely, our case studies show that changes in national banking policy have had a rapid, drastic and potentially disastrous effect on the debt portfolios of the income-poor. In general, as formal sector credit withdrew, the informal sector rushed in to occupy the space that it had vacated.[24] Although it is clear that chronic indebtedness among the rural poor is a problem that cannot be solved by banking policy alone, and that the abolition of usury requires agrarian reform, a decisive change in banking policy is nevertheless essential for the very survival of the working people in rural India.

Notes

1 We are grateful to the *Journal of Agrarian Change* and T.J. Byres for permission to use material from our paper, 'Rural Banking and Landless Labour Households, Institutional Reform and Rural Credit Markets in India', *Journal of Agrarian Change*, 2, 4 (October 2002), in this introductory essay.

2 The formal sector of rural credit is the sector in which loan transactions are regulated by legislation and other public policy requirements. The institutions in this sector include commercial banks, regional rural banks, cooperative banks and credit societies, and other registered financial institutions. The informal sector of credit is not regulated by the public authority, and the terms and conditions attached to each loan are personalized, and therefore vary according to the bargaining power of borrowers and lenders in each case.

3 For a more detailed discussion, see Ramachandran and Swaminathan (2002).

4 Wiggins and Rajendran (1987).

5 See Pallavi Chavan, this volume, and Shivamaggi (1986), cited by her.

6 On the unequal impact of the green revolution and the 'region-wise, crop-wise and class-wise concentration of production' as a result of the green revolution, see Prabhat Patnaik (1975). See also Griffin (1975), Bhalla and Chadha (1990), Bharadwaj (1990), Dhanagare (1990).

[7] For a detailed review of the establishment of regional rural banks and their performance before and after liberalization, see Jagan Mohan (2004).

[8] The problems with the IRDP included misidentification of beneficiaries, high initial costs involved in the acquisition of the loan to the borrower, small loan size leading to purchases of relatively low-quality assets or small changes in working capital. Consequently, the programme failed to generate sustained long-term improvements in incomes. On the failures of the IRDP, see MIDS (1980), Osmani (1990), Dreze (1990), Swaminathan (1990).

[9] For a discussion, see Shetty (1997).

[10] Report of the Finance Minister's budget speech (*Business Standard*, 1 March 1999).

[11] RBI (2004b).

[12] See also Narayana (2000, Table 10). Further, foreign banks failed to meet their priority sector targets, even though these targets are lower than for other banks, through the 1980s (Ramachandran and Swaminathan 1992).

[13] In 1999, the credit limit was raised to Rs 200,000 (see Chavan 2001).

[14] Hulme and Mosley (1996), cited in Chavan and Ramakumar (2002).

[15] For a discussion of this important issue, see Jagan Mohan (2004).

[16] Y.C. Nanda, General Manager of the National Bank for Agriculture and Rural Deveopment (NABARD), states that 'the SHG–Bank linkage approach is the core strategy that could be used by the banking system in India for increasing its outreach to the poor' (Siebel and Dave 2002).

[17] Transactions costs include the costs of information collection, of screening of borrowers and of projects (by means of project evaluation), of monitoring and supervision, of coordination, and, finally, of the enforcement of contracts and collection of dues.

[18] As mentioned earlier, the cross-country study of rural credit institutions by Hulme and Mosley showed that, of all the institutions studied, regional rural banks in India incurred the lowest administrative costs (Hulme and Mosley 1996, cited in Chavan and Ramakumar 2002).

[19] As the Grameen Bank expanded its activities, administrative costs rose from 8.6 per cent of liabilities in 1988 to 18.1 per cent of liabilities in 1992 (Hossain 1988, cited in Chavan and Ramakumar 2002).

[20] Organizations such as the Grameen Bank need large numbers of employees for regular monitoring and assessment, to conduct weekly visits and meetings, and to collect dues (Hossain 1993). See, also, Rahman (1999) and Bhat and Tang (1998), cited in Chavan and Ramakumar (2002). See Kelkar, Nathan and Jahan (2004) on the high cost of NGO credit in Bangladesh.

[21] On the dependence of Grameen Bank on donor funds, see Hossain (1993).

[22] In fact, some scholars argue that, in the era of financial liberalization, NGOs too are 'free to charge whatever interest rates they wish in order to cover the (at present very considerable) costs of institution building, supervision, experimentation and insurance' (Mosley 1999: 377).

[23] For a useful discussion of rural banking policy in the first few months of the UPA government, see Rawal (2004).

[24] The most prominent exception in our case studies is one that proves the rule, a village where a cooperative institution that is closely linked with the peasant movement provides consumption loans to the working people.

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