Evolution of Rural Credit Policy

The introductory chapter makes a point that there were major changes in the policies with respect to rural credit over the past few decades. The objective of this chapter is to trace the contours of such policy changes. Before that however, the problems prevalent in rural credit markets that necessitated such policy measures are overviewed. Some of them are supply side constraints, fragmented and imperfect markets, multi-form & high interest rates. Beginning as an overview of the problems affecting rural credit markets, the chapter elaborates into the theoretical models that attempts to work out solutions for the problems. There are numerous theoretical models on rural credit of which the study concentrates on three broad paradigms viz supply leading, neo-classical and information asymmetry. The first two paradigms concentrate on market forces and their action in determining the course of economic progress. The last approach which also happens to be the most recent development, concentrates more on the non-market forces to reason out the issues left unresolved by the previous two models.

The last section of the chapter is focused on the policy evolution in the Indian context and the influence of theoretical paradigms on such policies. The policies were directly influenced by various committees, expert groups constituted from time to time. The reports drawn up by such committees/expert groups themselves were influenced by the larger political economy. During the early years after independence the policy that evolved was one of hesitant intervention of State. Gradually the policy favoured a larger role for state and supply leading approach was embraced in the form of ‘social & development banking’. However the policy environment has changed with the advent of financial liberalisation entailing withdrawal of state.

2.1. Rural Credit and Associated Problems

As has been mentioned earlier, certain problems associated with rural credit makes it far more complicated than the other credit markets. Some of these problems are overviewed in this section.
Inadequate supply of funds: The supply of credit is inadequate in rural areas and multiple evidences support it. Rural borrowers, mostly cultivators, are borrowing from multiple sources from both formal and informal sources. They are borrowing from various formal agencies like commercial banks, co-operatives and other institutions. Simultaneously, they are borrowing from the moneylender, the trader, the merchant, friends and relatives as well. This pattern of borrowing from multiple sources indicates an insufficient supply of credit from any one source. Because of a strong demand that is not completely serviced by the existing supply, there is room for so many agencies and so many individuals that are active lenders at any given point of time and often in the same geographic location. In addition, deposit mobilised by the formal institutions from rural areas is being diverted to lending in the urban areas, which is reflected by the decreasing credit-deposit ratio for rural accounts.

Imperfect Markets: The existence of 'personalized relation' in a loan contract means that the lender's monopoly power arises from the lender's intimate knowledge of the borrower's circumstances. Often this intimate knowledge means that the loan contact is either based on usurious interest rates or exploitative terms and conditions.

Fragmented Markets: Not only is the potential risk of defaults very high on loans in rural markets, but also the collateral provided is of very little or no value in the market. Because of this reason, lenders are ready to lend only to people over whom they exercise some degree of control. This kind of control ensures a lower rate of default. A landlord might be willing to lend only to his tenants, a merchant might be willing to lend only to his regular customers, leading to the creation of 'client islands'; each lender with an exclusive clientele (Basu 1997).

Dominance of informal sector: Informal sector continues to be a major source of credit and terms and conditions for such loans "give rise to an elaborate structure of coercion" (Swaminathan, Madhura and V.K.Ramachandran 2005). According to NSSO (report 501), as late as 2003-04, informal sector accounted for more than 40% of all the loans in rural areas. The informal sector is hardly governed by any laws and is also not subjected

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4 NSSO indebtedness survey
5 Table 3: Credit deposit ratios of scheduled commercial banks
to any regulators. Operating out of the preview of State regulations, these loans are regressive and burdensome. The loans from informal sectors could be procured by pledging a range of assets and services, including land, milch animals, other household goods, labour of self and family members including children. Naturally, this practice increases the vulnerability of the borrower, and more often than not, this vulnerability is exploited by the creditors. Exploitation by moneylenders can range between bonded labour services, including child labour and also land grabbing at the extreme. In fact, agrarian studies by P. Sainath revealed a widely prevalent land grabbing under the guise of money lending (P.Sainath 2005).

Skewed distribution of credit: The distribution of formal credit with respect to region, class, gender and caste has been unequal. Regional imbalance in the distribution of credit is strikingly obvious in India. Not only are the rural branches mobilising more and more deposits but are also increasingly offering more loans in urban areas, which has skewed the credit-deposit ratios in favour of urban areas. Also, women are less likely to have access to credit and financial services. According to Basic Statistical Returns published by the RBI, only about 13.8% of deposits in commercial banks were owned by women in 2005 as against 50.5% for men. The proportion of deposit accounts owned by women is also decreasing since 2000 when it was as high as 16.7%. Similarly, small and large farmers stand a better chance of securing a loan from formal sources than marginal farmers or agriculture labours. Field level studies indicate a strong bias against the landless labour households and that their access to credit from formal sources is very much constrained (Swaminathan and Ramachandran 2005). This asymmetric access to loan in the credit market for different socio-economic groups is mostly due the differences in their entitlement sets. (Basu 1997)

Prevalence of high interest rates: The interest rates are unusually high in rural areas. (Bottomley 1963) Besides, the interest rates can take a wide range of values within the same area. In Philippines, 15% of rice farmers were able to secure loans paying an interest of over 200% per annum, where as about 20% of them paid zero interest for their

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6 Basic Statistical Returns, RBI (Various Issues)
loans (Basu 1997). In India, while the loans from formal sector cost between 9-13% per annum, a similar loan from the informal sector costs over and above 36% per annum. There is also no arbitrage between the sectors given the range of values the interest rate assumes. Therefore, interest rates remain multiform. Taking into account the high risk of default, non-collateralised loan contract (most of the informal sector loans are based on personal knowledge of the borrower without any legal debt contract) and the inadequate supply of formal credit, creates a situation where interest rates are very high.

*Market failure:* Stiglitz (1994) has discussed the problem of market failures in financial markets, which can be extended to the case of rural credit. Market failure is viewed as a serious consequence of ignoring the bottlenecks in procuring perfect information since it involves cost both money-wise and time-wise. Because of these market failures efficiency is undermined. Financial markets rely much more on information than the conventional markets; market failure associated with this market is manifest under multiple guises. They are manifested in the following forms:

**Insufficient supply of Monitoring:** Monitoring is a public good because monitoring of borrowers (which prevents/reduced default) by one lender essentially means a benefit to all lenders. Monitoring is merely collecting information about the activities of the borrowers and it involves costs. So, like any other public good monitoring is undersupplied (Stiglitz 1994).

**Externalities of monitoring, selection and lending:** The process of selecting a borrower, lending and monitoring the borrower involves externalities. The willingness of one lender to lend to any borrower will build up the credit history of that particular borrower. This is a vital piece of information, which will save the potential costs for the second lender. This skews the terms to the disadvantage of the first lender.

**Financial Disruption and Bankruptcy:** Deposit mobilization is an important activity of financial institutions in rural area. Any inappropriate decision by the managers endangering the deposits at the disposal of the banks will lead to the serious liquidity crisis and subsequently to the failure of the bank itself. The failure of one bank may initiate the domino effect and endanger the entire financial system. The absence of insurers and sound enforcement of contracts aggravates the problem. Also, since information is a form of capital, the bankruptcy of financial institutions will lead to the
loss of such capital. Extending this idea to the informal sector, in the presence of fragmented markets, borrowers will be put to hardship in case the lender they have been borrowing from is unable to provide them with the necessary loan. In case the regular lender dies or refused to lend, for reasons other than the borrower's credit worthiness, the borrower will find it difficult to raise a loan elsewhere (Stiglitz 1994).

2.2. Some Theoretical Considerations in the Evolution of Credit Policies

There is many theories on rural credit. Problems like inadequacy of credit, high cost, imperfect and fragmented markets are analysed by theorists in different frameworks. Of these three broad frameworks are overviewed in this study. They are the supply-leading paradigm, neo-classical paradigm and information asymmetry paradigm. The last one highly influenced by the neo-classical paradigm and relies much on non-market forces to explain the anomalies in the functioning for rural credit markets. While supply leading theorists saw credit as one of the productive inputs, they supported the supply of cheap formal credit to overcome many of the typical problems of rural credit markets. On the other hand neo-classicists treated finance as just intermediation, therefore stressing the importance of time over costs and everything else. The paradigms are examined along with studies evaluating them in this section.

2.2.1. Supply-leading Paradigm

The supply leading paradigm is influenced from the school of thought that believes in the role of market forces of demand and supply influencing the rural credit markets. The demand leading approach and supply leading approach are important amongst them. According to demand leading theories, enterprise is followed by the development of financial markets. As the economy grows, the demand for financial products increase which will in turn give rise to financial institutions and assorted financial products including the debt and the equity markets, i.e. the supply of financial products develops as a response to the robust prevailing demand. But in the case of developing countries, the demand for financial products could be slow to develop given the tardy pace of economic growth. Without a strong demand, there will not be enough incentive to supply
financial products. On the other hand, the lack of credit and the subsequent resource crunch could be acting as severe bottlenecks for faster growth of economy. In fact, the inadequate supply and imperfect market meant a constraint in the availability of a productive input. This was the rationale behind the supply leading approach. It was believed that establishment of financial institutions and supplying credit well ahead of demand would stimulate both agricultural and non-agricultural production. An increase in the financial activities was expected to produce ‘substantial effects on pace as well as the direction of development’ (Patrick 1966, Braverman and Guash 1989, Robinson 2001).

All India Rural Credit Survey is credited with highlighting the impact of rural credit on economic development. Not only did the epic work lead to the development of a policy regime that favoured State intervention in the credit markets in rural areas worldwide but also highlighted the menace of informal credit in rural areas (Von Pischke 1980). Money lender the major lender in the class of informal sources, was found to be usurious, manipulative and exploitative, besides having serious limitations in providing adequate volume of credit and a restricted range of financial products. In short, the onus of eliminating various bottlenecks in the supply of credit was on the State, therefore supplying inexpensive and non-exploitative credit was deemed to be the responsibility of the State. The State could disburse subsidised credit either directly through one of its agencies or through private financial institutions. The theory also envisaged a special role for the monetary authority/central bank in developing the supply side of the financial markets. The authority was expected to promote specialised institutions to lend to various categories of borrowers viz small farmers, small and medium entrepreneur etc.

In India, these theoretical developments resulted in the policy of “Social & Development Banking” which essentially meant that, the profitability of the banking operations was secondary with the predetermined primary objective of achieving social justice. As against the neo-classical model, not everyone faced the same rate of interest \( r (1+d) \). It varied from borrower to borrower. Besides the expected marginal productivity of capital was not required to be equal to \( r (1+d) \) – the market determined interest rate adjusted for the risk of default \( d \).
“Social & Development Banking” in the Indian context had the following signature features:

Nationalization of commercial banks: Private ownership of banks posed numerous problems, apart from concentration of operation in urban areas and monopolistic behaviour; they also diverted public funds for their own private use. So nationalization was expected to reduce this anomaly. The preamble to the bank company acquisition act of 1969, (the act that enabled the nationalization of banks) States, “The Banking system touches the lives of millions and has to be inspired by a larger social purpose and has to subserve national priorities and objectives such as rapid growth of agriculture, small industries and exports, raising of employment levels, encouragement of new entrepreneurs and development of backward areas. For this purpose, it is necessary for the government to take direct responsibility for the extension and diversification of banking services and for the working of a substantial part of the banking system.”

Bank Nationalisation was done in various phases. Imperial Bank of India was nationalised and taken over by the RBI in 1955. It was re-christened State Bank of India. In 1959-60 seven banks forming the subsidiaries of the SBI were nationalised. They were State Bank of Mysore, State Bank of Travancore, State Bank of Bikaner and Jaipur, State Bank of Indore, State Bank of Hyderabad, State Bank of Patiala and the State Bank of Saurashtra. In 1969, 14 commercial banks with deposits of over Rs.50 crores were nationalised. They were, Central Bank of India, Bank of Maharashtra, Dena Bank, Punjab National Bank, Syndicate Bank, Canara Bank, Indian Bank, Indian Overseas Bank, Bank of Baroda, Union Bank, Allahabad Bank, United Bank of India, Bank of India and UCO Bank. In the next phase of nationalisation, the government acquired 6 more commercial banks with deposits of over Rs.200 crores. They were Andhra Bank, Vijaya Bank, Corporation Bank, Oriental Bank of Commerce and Punjab and Sindh Bank.

Geographical expansion of formal sector: Geographical expansion proved to be one of the most important tools to overcome supply side constraint of credit in rural areas. This was based on the premise that primary access to credit is determined by the geographical

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7 Quoted from Burges and Pande(2003)
proximity of the lending agency; the closer the lending agency to the borrower, the lesser the cost of borrowing and an improved access to source of credit. However, rural branches with a small non-agricultural portfolio were not as profitable as the high non-agricultural portfolio of urban branches. Therefore, most of the bank branches were concentrated in semi-urban and urban areas before the introduction of statutory requirements in this direction. In India, to induce the banks into opening branches in unbanked areas licensing system was introduced. Accordingly, commercial banks were required to obtain license from the central bank in order to open a new branch. To qualify for applying for such a license, the banks had to open at least four branches in hitherto unbanked region for every branch to be opened in a city/urban area. This license system did have the desired effect in the sense that the number of rural banks increased to over thirty five thousand in 1993.

**Directed lending:** The statutory interference in the allocation of bank credit is referred to as directed lending. This was necessitated by the fact that high risk-low return but vital activities like agriculture and small scale industrial sectors found it difficult to access timely credit on reasonable terms. Besides, developing economies are characterized by resource constraint. Therefore, consumption had to be stemmed in order to increase investments. Directed credit provided the mechanism to thus suppress consumption and redirect scarce resource towards investments. This instrument also provided a mechanism through which projects with high social returns were encouraged, more so projects having positive linkages(forward and backward) vis-à-vis projects with high private returns but low social returns. In the absence of statutory support, such projects would have been crowded out of the markets in favour of projects with high private returns. Also in developing economies, States cannot raise enough revenues to support the capital needs of critical sectors through subsidies. In such situations, subsidised credit line becomes indispensable. Directed lending is represented by the priority sector lending. Initially, priority sector mostly included credit to agriculture, small scale industries, and small businesses. Of late though, priority sector also includes consumer loans like housing loans, loans to big agro-based industries, software companies etc. According to RBI, close to 37% of the total credit were advanced to priority sector during 2004-05.
Table 1: Credit of SCBs to Priority Sector

<table>
<thead>
<tr>
<th>Year</th>
<th>Credit of SCB</th>
<th>Priority sectors</th>
<th>% growth</th>
<th>Percent of total non food credit</th>
</tr>
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<tbody>
<tr>
<td>1969</td>
<td>3599</td>
<td>504</td>
<td>14</td>
<td>15</td>
</tr>
<tr>
<td>1972</td>
<td>5480</td>
<td>1149</td>
<td>21</td>
<td>23.3</td>
</tr>
<tr>
<td>1973</td>
<td>6412</td>
<td>1478</td>
<td>23.1</td>
<td>24.9</td>
</tr>
<tr>
<td>1974</td>
<td>6109</td>
<td>1901</td>
<td>24.2</td>
<td>25.9</td>
</tr>
<tr>
<td>1975</td>
<td>7288</td>
<td>2242</td>
<td>25</td>
<td>27.5</td>
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<td>1976</td>
<td>9072</td>
<td>2815</td>
<td>24.5</td>
<td>30.3</td>
</tr>
<tr>
<td>1977</td>
<td>11613</td>
<td>3488</td>
<td>25.9</td>
<td>31.8</td>
</tr>
<tr>
<td>1978</td>
<td>14094</td>
<td>4491</td>
<td>28.6</td>
<td>34.6</td>
</tr>
<tr>
<td>1979</td>
<td>17621</td>
<td>5906</td>
<td>30.9</td>
<td>36.6</td>
</tr>
<tr>
<td>1980</td>
<td>22068</td>
<td>7278</td>
<td>33</td>
<td>37</td>
</tr>
<tr>
<td>1981</td>
<td>26551</td>
<td>9444</td>
<td>35.6</td>
<td>38.8</td>
</tr>
<tr>
<td>1982</td>
<td>30180</td>
<td>10975</td>
<td>36.4</td>
<td>40.1</td>
</tr>
<tr>
<td>1983</td>
<td>36006</td>
<td>12783</td>
<td>36.1</td>
<td>40.2</td>
</tr>
<tr>
<td>1984</td>
<td>43613</td>
<td>16303</td>
<td>38.1</td>
<td>43.5</td>
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<tr>
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<td>50921</td>
<td>19829</td>
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<td>46.2</td>
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<tr>
<td>1986</td>
<td>57229</td>
<td>22844</td>
<td>41</td>
<td>46.4</td>
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<td>26743</td>
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<tr>
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<td>72436</td>
<td>30693</td>
<td>43.8</td>
<td>45.1</td>
</tr>
<tr>
<td>1989</td>
<td>89080</td>
<td>38086</td>
<td>42.7</td>
<td>43</td>
</tr>
<tr>
<td>1990</td>
<td>105450</td>
<td>41497</td>
<td>40.7</td>
<td>41.5</td>
</tr>
<tr>
<td>1991</td>
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<td>44572</td>
<td>37.7</td>
<td>39.2</td>
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<tr>
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<td>47318</td>
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<td>154838</td>
<td>51739</td>
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<td>36.1</td>
</tr>
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<td>59097</td>
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<td>38.8</td>
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<tr>
<td>1995</td>
<td>211560</td>
<td>69209</td>
<td>33.7</td>
<td>35.8</td>
</tr>
</tbody>
</table>

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In recent years credit off take has increased substantially. Outstanding credit of commercial banks has also seen an increase in the recent years. Apart from the fact that the increased competition and the subsequent easiness with which one can borrow, other factors like consumption of households has also affected this kind of increase in the credit off take. Also with the government announcing tax sops on housing loans, such loans have become very popular. Low inflation and low interest rates, higher disposable incomes and increasing asset price had lead to increase in the volume of outstanding housing loans. Also demand for bank credit both corporate and retail is pro-cyclical; a high growth rate and a buoyant economy during the past few years have also contributed to the phenomena.
Subsidized credit and differential interest rates: Under this regime the interest rates were determined exogenously. This meant that the interest was not expected to be equal to \( r (1+d) \), instead it was expected to be less than the risk adjusted rate of interest \( r^* < r (1+d) \). In India the public sector banks, including the Regional Rural Banks charge differential rates of interest on advances to priority sector and weaker section. Banks were required to disburse at least 10% of the net banking credit to weaker section. The categories classified as weaker sections include small and marginal farmers, agricultural labourers, tenant farmers, share cropper, artisans, village and cottage industries, SGSY, loans to persons belonging to schedule castes and Scheduled Tribes and SHGs. These accounts were required to be charged at Sub-PLR rates, implying subsidisation of credit to the deserving class Therefore, the cost of credit is subsidised for the deserving class. Low interest rates were supposed to boost investments, since interest is the cost of investment, which is therefore negatively related. Another justification was that, the availability of cheaper credit would facilitate the government investment in areas like rural infrastructure and other critical areas.

Multi-agency approach: Apart from all the above solutions, a multi agency approach was also adopted. It was felt that instead of a single agency, various agencies with
different organisational structures would be better to reach out to the rural borrowers. Thus, Regional Rural Banks, Public Sector Banks as well as cooperatives operated simultaneously in any given area. This provision was expected to address the multiplicity of wants of rural borrowers as well as breed competition amongst the banks.

It is because of these measures that banking facilities improved by leaps and bounds during the 1980s till early 1990s. A detailed time series analysis is present in the following chapter. The summary of the analysis is as follows. According to Basic Statistical Returns published by the RBI, there was a rapid expansion of rural banking facilities from just about 1833 branches of scheduled commercial banks in 1969 to about 35389 in 1993. Also the percentage of rural branches in the total branches went up from just about 22.19% to about 57.16% during the same period. Because of the rapid expansion of banking facilities, the population per branch fell from a high of 41000 to 15000 during the period. The ratio of growth in rural branches to growth in population is also positive during the period 1971-81 as well as 1981-91. There was also a massive expansion of deposits during the period. In fact, deposits were just about Rs 4646 crores in 1969 which increased to Rs 274938 crores and has continued to increase even after. Credit has also increased from just about Rs 3599 crores to about Rs 154838 crores during the same period. An increase has been recorded in the real per capita credit as well from just Rs 36.33 in 1969 to about Rs 162.78 in 1993 which has continued to increase albeit slowly. The growth rate of credit in rural areas also accelerated significantly from about 5% in 1972 to about 16.3% in 1989. However, since then the pace has slowed down considerably. The credit deposit ratio also increased in most States during the 1970s and the 1980s. Credit to small borrowal accounts as a proportion of total credit increased from about 9% in 1972 to about 25.4% in 1989. Similarly credit to priority sector as a proportion of total credit also increased from 14% in 1969 to about 43.8% in 1988. Agriculture and trade enjoyed an improved access to formal credit as the proportion of agricultural credit increased from about 9% in 1972 to over 17% in the late 1980s. Credit to trade increased from 14% in 1972 to about over 20% 1986. Therefore during the period the rural credit policy was influenced by supply-leading school of
thought, rural borrowers, critical sectors like agriculture weaker sections and other targeted groups had an improved access to credit.

Other studies also indicate that these policy initiatives did have a positive effect on non-agricultural output and employment. A two stage econometric estimation using a district level time series data by Binswanger and Khandekar (1992) concluded that the expansion of formal credit agencies in rural areas had a substantial positive effect on rural non farm employment and output, and that the ‘availability of better banking facilities appears to have overcome one of the obstacles of locating non farm activities in rural areas.’ Though the study found that in the agriculture sector, output and employment were much less affected by an expansion of formal credit agencies in rural areas, it was found that the consumption of fertilizer along with other capital investments (farm machines, also livestock) had increased with the increasing availability of formal credit. This meant that expanding formal credit in rural areas did have an impact on farm inputs and much less an impact on farm output. The increasing non-farm employment more than made up for the substitution of capital for labour in agriculture and the wages for agriculture workers was also found to increase slightly. On the flip side they noted the failure of the policy to generate viable institutions and the high cost associated with portfolio losses because of poor repayments. However, they conclude with a possibility of the increase in agricultural income benefits exceeding the cost accrued to the government on account of subsidies and portfolio losses.

A more recent and sophisticated study by Burges and Pande (2003) corroborated the findings of Binswanger et al (1992). They conclude that, in the Indian experience, ‘the rural branch expansion managed to make a significant dent on poverty during the 1961-2000 period.’ According to the study, the State led branch expansion proved to be an important means of expanding access to credit and financial services in rural areas. In their econometric exercise they found that the branch expansion explained roughly half of the decline in poverty from 61% in 1967 to about 31% in 2000.
They used a fixed effects regression for their panel data in order to control for omitted variables that differ between cases but are constant over time. They also found key trend reversals in the relationship between rural branch expansion and initial financial intermediation in the year 1977 and 1990. They found the trend breaks for these years to be statistically significant. Besides the observed trend breaks were significant for all the variables that were affected by licensing rule, increasing the credibility of the model. The design of their model is as follows.

$$B_t = a_i + \beta_t + (B_{61} \times [t-61]) \gamma_1 + (B_{61} \times [t-76] \times P_{77}) \gamma_2 +$$

$$+ (B_{61} \times [t-89] \times P_{90}) \gamma_3 + (B_{61} \times P_{77}) \gamma_4 + (B_{61} \times P_{90}) \gamma_5 + \epsilon_t$$

Where,

- $a_i$ captures the State effect
- $\beta_t$ capture the year effects
- $B_t$ the number of branches opened in rural unbanked locations per capita is the social banking measure
- $B_{61}$ the number of bank branches per capital in State $i$ in 1961 is a measure of financial development.

$\gamma_1$ is the first coefficient of interest measuring the relationship between initial financial development and rural branch expansion. ($B_{61} \times P_{77}$) is the interaction dummy capturing the effect of $B$ and another dummy that carries the value of one for the years after 1976.

($B_{61} \times P_{90}$) is the second interaction dummy carrying a value of one for post 1990 years and a post 1989 time trend ($t-89$).

They attribute the access to finance as a crucial factor in poverty alleviation. They also observed that poverty fell more rapidly in States with higher initial financial development before 1977 and after 1990. However, during the period between 1977-90, the trend was reversed and States with underdeveloped financial markets outperformed the States with initially developed financial markets. That meant the ‘rapid expansion of rural bank branches into the more financially backward States during the 1977-90 period affected poverty reduction in these States relative to what was happening in the more financially developed States’. This trend is attributed to the licensing rule. According to which four banks were required to be opened in unbanked areas in order to open one branch in the already banked areas which in most of was cases were profitable urban areas. They also
observed that rural branch affected rural outcomes rather than urban outcomes. The effect of rural branch expansion on economic growth and reduction of poverty is traced out to the substantial increase in secondary and tertiary sector output and employment. The increase in non-agricultural employment (secondary, tertiary sectors viz unregistered and informal manufacturing and services) eventually led to the tightening of the labour market and a rise in wages both agricultural and non agricultural. Thereby, even the agriculture labour registered substantial gains even though they did not direct avail any banking facilities. This finding also address the larger issue of the role of financial markets especially credit in alleviating poverty. This study seems to suggest that the lack of access to credit does have a role in confining the poor in a State of poverty.

Another important finding of this study was the presence of strong evidence against the allegation of elite capture of cheap subsidised State backed credit programmes. The strongest of criticism of supply leading credit policy was the elite capture of credit programmes backed by such policy. Adams et al (1984) have written elaborately on it. The study estimated that a landless household was as likely to get a bank loan as a household with more than 2.5 acres of land. Besides, they also dismissed the allegation of high default amongst the poorer borrowers, the reason being similar rate of default across borrower groups. This they say reflected poor monitoring on the part of the bank. Because of all these evidences, they caution that the withdrawal of the rural branch expansion programme to prove costly in the long run.

Hulme and Mosley evaluated the functioning of Regional Rural Banks in the early 1990s as part of their cross country evaluation of rural credit institutions. Regional Rural Banks as an institution capture the essence of the supply leading theory like no other institution. They found that, “the Regional Rural Banks instrument has been successful in mobilising rural small savings, in bringing down the interest rate charged by money lenders and in raising the incomes of many poor people, some of whom it enabled to enter the capital market for the first time; some of what Regional Rural Banks lose in efficiency, therefore, they may gain in effectiveness.” The Regional Rural Banks loans also carried the lowest interest rates amongst all the institutions evaluated. Besides, it was also found
that 44% of the borrowers belonged to the below poverty line class of population. They also found that average increase in borrower income as a percentage of the control group was about 202% for the entire sample and about 133% for the individuals below poverty line. That is most of the borrowers experienced increase in income as compared to non-borrowers. Regional Rural Banks also had the largest number of borrowers at over 1.2 crores amongst all the institutions studied. The administrative cost of the institution as a percentage of total portfolios was found to be 8.1% which was also the lowest amongst all the institutions studied. On the flip side, Regional Rural Banks had the dubious distinction of having the highest arrears rate of almost 44%. That is 44% of the loans had turned bad (NPA). Because of the high default rates the breakeven interest rate was found to be 45% of which only 8.1% amounted to the administrative costs. The study attributed the high arrears rate in Regional Rural Banks to poor collection methods and lack of repayment incentives. It was also found that there was no significant adoption of ‘new technology’ by the borrowers during the loan period. Though there was a definite increase in the possession of productive assets of borrower vis-à-vis non-borrowing control group.

In short, studies evaluating the effect of supply leading policies are positive about a few issues. However, the policy has not been spared by critics; The main criticisms are discussed in the following section..

2.2.2. Neoclassical Credit Paradigm

The Neo-classical model is actually a heady mixture of Neo-classicism and Neo-liberalism. Neo-classical models were influenced by the Mackinnon-Shaw thesis of the 1970s. They criticised ‘financial repression’ a term used to denote interest rate ceiling, high reserve ratios and directed credit programmes, as the root cause for the poor performance of investment and growth in developing economies. The symptomatic expression of these problems they said were reflected in the severe rationing of credit, low investment and low savings (Dixon 1997, Fry 1997). According to Mackinnon and
Shaw allocation of credit should not be guided by the expected productivity either social or private of the investment projects. Instead it should be guided by transaction costs and perceived risks of default (Fry, Maxwell 1997). For the solution, they prescribed liberalisation of the financial markets, which meant removing interest rate ceilings and elimination of directed credit. The real interest rate was expected to find the equilibrium savings and ensure a steady supply of credit to the markets. Also the increasing availability of credit was in turn expected to fuel investment and kick start the process of development. This thesis indeed moulded the policies of World Bank and IMF who in turn forced many developing countries into adapting this framework, regardless of the possible damages stemming out of this influence was the criticism of supply leading approach.

Firstly, neo-classicists were against the idea of below market rate of interest for select sectors. The repressed interest rates as advocated by the supply leading theorists, they said acts as an incentive for borrowers to undertake riskier projects than they would if the interest rates were market determined. This would in turn lead to misallocation of resources. Further, repressed interest rate excludes the cost of the risk the lender will have to bear given the uncertainty of the borrower's cash flows and subsequent repayments. This will encourage the lenders to "ration credit stringently according to the commercial criteria of creditworthiness, that is, to lend to fewer borrowers than would be willing to pay the rates and to refuse those who are conventionally seen as higher risks" (Von Pischke 1980). So, according to the neo-classicists, the repressed interest rates act much against those who are supposed to benefit from it.

Secondly, they criticised the ceiling on interest rates which meant that the lending institutions when subjected to artificially low rates, could not recover the cost of operation. Besides they are of the opinion that serving rural/targeted population is relatively expensive for the lending institutions given the geographical spread, the small but frequent transactions and the imperative absence of economics of scale which might eventually led to bankruptcy of many rural credit institutions.
Thirdly, according to them, cheap credit programmes had the potential to create inflationary pressures because the cheap credit will increase the purchasing power immediately without increasing the supply of goods and services in the short run. That is low interest rates increased current consumption and to increase the supply of goods and services, additional capacity ought to be created which implies gestation period. The inflationary pressures could be more acute in the case developing economies with supply side constrictions (Penny 1968, Fry 1997).

Fourthly, the Neo-Classicists believed in the saving potential of poor and that most poor, even the poorest has saved in some form or the other, mostly in terms of physical assets and at times in terms of financial assets. However, they believed that a lower interest rates discouraged savings in terms of financial assets. An appropriate interest policy designed to encourage financial savings was seen as an essential precondition to stimulate voluntary savings. A higher interest rate reflecting the commercial costs to the lender was supposed to attract more funds to the lending agencies by the way of more saving deposits.

Fifthly, they also objected to treating moneylenders with a degree of suspicion and the policy regime’s attempt to replace the class of money lenders with formal institutions. They disputed the idea of ‘exploitative’ moneylenders. Since they saw financial markets more as a mechanism of intermediation than a means of production, they believed that moneylender was just doing his duty. They defended moneylender’s higher interest rates as the cost to cover the high risk of default as well as a charge that needs to be paid for his service (Ghatak 1975 Basu, Santonu 1997). They found moneylenders advantageous because moneylenders met all the needs of the farmers, short term, long term, productive as well as consumption loans. Besides, moneylenders were in the possession of information on personal circumstances and local knowledge that he can gather without any cost. This costless information enabled moneylenders to lend to even those who would not be otherwise able to raise a loan in the credit markets. Another advantage of moneylender perceived by the neo-classicists is the flexible hours of working as well as flexible functioning with respect to documentation and paper work. The flexible hours of
operation meant a lower opportunity cost on the part of the borrowers, because they did not have to miss a day's work just to get their loan processed as in the case of formal institutions. They were also of the opinion that administrative costs of the borrowers were low compared to that of the formal institutions because they lent to few clients and they did not have to maintain statutory reserves. Moneylenders also lent consumption loans to cover miscellaneous expenses in the wake of medical emergencies, education, marriage, funeral, child birth and other religious ceremonies.

Finally, they identified 'elite capture' of cheap credit. Because of political pressures the lending agencies had to entertain those with political connection but no serious intentions of repaying the loan. The elite capture meant that the rich were enjoying the benefits of cheap subsidised credit whereas the rationing of credit due to the artificially suppressed interest rate left the poor and needy out of the pool of borrowers. Apart from this kind skewed distribution of credit the politicisation of credit policy, they said, encouraged loan waivers, unrealistic subsidies and favouritism. These loan write-offs not only discouraged the prudent of borrowers from making timely repayments but also jeopardised the health of the financial institution (Ladman and Tinnermeier 1977).

The "Ohio-school" (group of economists from the Ohio University) of thought emerged as a champion of the neo-classical model. Most of their arguments are based on the Neo-classical model. Economists belonging to this school gave major intellectual underpinnings to the subsequent operational practices of World Bank. Not only did they believe in the market forces for the operation of credit markets but also favoured informal credit over the formal agency since the credit design of the former was closer to the neo-classical model than the later. They also found informal credit agencies to be more efficient in terms of operating costs and transaction costs vis-à-vis the formal agencies. Also, they justified the high interest rates charged by the informal agencies as an innovation to adjust for high risk of default. They stressed the role of price in the credit market and assumed that liberalised interest rate was the only answer to a smooth functioning of the credit markets. Therefore they advocated the following:
Everyone face the same interest rate, determined by the supply and demand for credit, adjusted for risk of default, i.e. if there is a $d\%$ risk of default then $r(1+d)$ where $r$ the interest rate is a constant. The interest rate paid to depositors is equal to $r (1+d)$ less the cost of operating the bank. The expected marginal product of capital of the project financed should be equal to the risk adjusted interest rate $r (1+d)$.

The arguments as can be gathered from their writings are as follows:
Informal agencies in developing countries are efficient in meeting the needs of poor in rural areas and that their operating costs are lower than the formal institutions along with being more flexible. The high interest rate they charge is natural given the high risk of default and uncertainty (Ghatak 1975), more so in the absence of collateral. The informal agencies are also quick and provide timely credit to borrowers unlike the formal bureaucratic agencies which generally take a long time to process loan applications. Since the informal financial institutions are not controlled by government, they are more flexible and adjust to the changing market conditions with ease. They are not affected by changing government policies, monetary policy variables etc. Therefore they have much greater flexibility of operation.

Because they do not have to incur costs on the maintenance of idle cash reserves and other statutory reserves that formal institutions are required to maintain, they operate on a lower cost model. However, in the case of formal credit institutions, interest rate cannot be restricted to $r (1+d)$, because the cost of credit will be affected by the statutory reserves (Hulme and Mosley).

They staunchly opposed the idea of targeting loans. They argued that loans should instead flow to efficient projects that can be easily recovered and that targeting encouraged misuse of funds by investing in projects having low returns or projects that are highly risky i.e. in case of targeting, the marginal product of capital will not be equal to $r (1+d)$. Also, they were against the idea of subsidising formal institutions operating in rural area, because subsidies undermined the viability of formal credit institution in the long run. They believed that formal institutions are susceptible to political pressures and that the efficiency of the institution was undermined by politically powerful defaulters, populist loan write offs and encouraged elite capture of subsidised credit. Besides, the
bureaucratic setup was understood to be a big hurdle in improving the access to credit for poor borrowers along with being corrupt.

The neo-classical model is found to be flawed on many counts:
The assumption that the “interest rate paid to depositors is equal to \( r(1+d) \) less the cost of operating costs” is not acceptable; in fact, there will be difference between lending rates and borrowing rates in the same economy owing to the imperfect flow of information in the economy.
The depositor might not know what the creditors are being charged and vice versa. Even if they did, they might not be able to estimate the exact returns they should be expecting on their deposits. Moreover, a divergence between interest rates in the same sub-economy is not uncommon.
Apart from \( d \), the risk of default, there are other factors that determine the interest rates.
This model makes a provision for production cost but ignores transaction costs, like cost of screening the borrowers, cost of writing a debt contract, cost of monitoring the borrowers, cost of enforcing the debt contract, cost of judicial intervention in case of need etc.
According to the neoclassical model, regulated interest rates crowded out small borrowers. However, empirical analysis notes that deregulated interest crowds out the rural credit more severely as has happened in India which is explained in the next chapter.

2.2.3. Neo-liberal reforms in Indian financial markets:

The neo-classical model was the inspiration behind the structural adjustment programme undertaken by the Government of India during early 1990s. Financial liberalisation was an integral part of the programme. Ghosh and Chandrasekhar (2004) call financial liberalisation the cutting edge of the reform programme. Accordingly, the programme had three important components to it. The first is the ‘substantial reduction of government intervention in allocating credit’ (Ghosh and Chandrasekhar 2004). This
effectively meant a reduction in reserve requirements like CRR and SLR. Also, there was a reduction in the directed lending programme whereby target on priority sector lending was lowered. Secondly, there was attempt to bring in more competition in banking sector along with ‘ensuring greater transparency in the operations and accounting practices of financial institutions’ (Ghosh and Chandrasekhar 2004). The third component was the convertibility of currency. There was an increase in the degree of openness in the financial markets wherein residents and non-residents were allowed to invest in assets abroad. Rupee was also liberalised and was floated against a basket of currencies. All these measures affected rural credit, but the strongest impact was felt by the implementation of first measure.

Interest rates were also liberalised because Neo-classicists widely believed that with the market determined interest rates, supply of credit will increase and the interest rates will reduce. The low interest rates were also considered to be causing rationing of credit from formal sector. However, empirical investigations by Kochar (1997) found that the extent of rationing was much less than widely believed.

As a result of reforms, there was a contraction in the number of branches operating in rural areas along with reduction in the lending to critical sectors like agriculture and small scale industries. On the other hand, for another class of population which was mostly urban and salaried, loans were easy and plenty.

Apart from the above mentioned issues, there are other problems as well. These problems arise from the lack of perfect information that is assumed implicitly in the neo-classical model. It includes the adverse selection problem and market failure.

Stiglitz also criticises the stand of neo-classicists on interest rates. In liberalised financial markets, the interest rates are market determined and are generally higher than those repressed by the State. In such a scenario, Stiglitz (1994) and Stiglitz and Weiss (1981) opine that “higher interest rates adversely affect incentives and the mix of applicants, even when these effects are not so strong as to outweigh the direct benefits of higher interest rates” (Stiglitz 1994). A higher interest rate might encourage borrowers to undertake projects that are more risky but with higher payoffs once successful. Therefore,
lowering interest rate could “increase the expected quality of borrowers”, more so, if the State had capabilities to ensure a positive selection. Also, lower interest rate lowers the cost of capital and therefore increases the proportion of loan capital in a project vis-à-vis equity capital. In such a situation, borrowers are expected to be more risk averse and resort to good projects.

Stiglitz argues that repressed interest rates and associated rationing can be used to reward performers and penalise non-performers. In the presence of credit rationing, capital is scarce and the State can award lines of credit to performers, depriving the same to non-performers.

The model also ignores the role of non-price non-market factors, which are proved to cast a strong influence on the behaviour of credit markets and its agents.

2.2.4. Information Asymmetry Paradigm

Recent research has spawned writings on the Information Asymmetry paradigm. This paradigm is highly influenced by the Neo-classical school of thought. The major difference between the two lies in the assumption. This paradigm rejects the inherent neo-classical assumption of availability of perfect information and ‘clear unambiguous and verifiable predictions.’ This paradigm also questions another underlying assumption that ‘all factors are positively priced and fully utilised’ (Greenwald, Stigliz and Weiss). The most important theoretical contribution of this paradigm is its recognition of the role of non-price instruments like private information, joint liability, and peer pressure, as well as non-market institutions like pool of borrowers, ability to enforce social sanctions. They also recognise the importance of non-price instruments like incentives, monitoring, credit design and non-market institutions like pool of borrowers, social sanctions and kinship. It is proved that equilibrium in the presence of asymmetric information could be absent or distorted when present. In these writings, all problems of rural credit are explained by the presence of information asymmetry among various agents of the credit market, including creditors, arbitrageurs and debtors. Much of the literature pertaining to this school can be attributed to Joseph Stiglitz. The basic premise of this paradigm is that the laws of perfect
competition are not applicable to financial markets because of critical absence of perfect and free information. This paradigm offers alternative explanation for the prevailing problems in rural credit markets. As against the neo-classical model which breaks down in the absence of perfect competition, the information asymmetry model explains the inefficiencies and the idiosyncrasies of the financial markets more so the credit markets in less than of perfect competition conditions.

Stiglitz (1994) examines the problems of financial markets from the information asymmetry point of view. Accordingly, information is a public good, characterised like any other public good by non-excludability and non-rivalrous consumption. Non-excludability means that it is either impossible or it is very expensive to exclude any one from possessing information (consumption). Non-rivalrous consumption means the possession of information by one person does not alter the information available for consumption by others. Like all public goods, information is also under supplied in a competitive economy. Therefore, markets that are information intensive like the financial markets are not perfectly competitive.

Stiglitz and Weiss (1981) attribute the constraints in the supply of (rural) credit, to the presence of credit rationing by the lenders, even under equilibrium conditions. Accordingly, lenders are concerned about the interest rate they receive on the loans and the perceived risk of the loan. But the interest rate charged by the lender itself can affect the borrowers in two ways. One is adverse selection, whereby riskier loans are preferred over good loans. The other is the incentive effect whereby the action of the borrower is affected and the borrower is induced to opt for riskier projects because of the interest rate. In order to overcome these problems, borrowers employ various screening devices, important being the interest rate itself. Those who are willing to pay a higher interest rate are perceived as a higher risk than the one who will offer to pay a lower interest rate. Those willing to borrow at a higher interest rate might not be bothered about the interest rates as they might perceive the possibility of repaying to be low. Therefore, lenders perceive the interest rate to be directly proportional to the extent of risk of the loan upto a certain point. The expected returns to the lender, therefore, depend on the interest rate
and decreases with increasing interest rate after a certain point. The interest rate, at which expected returns to the lender is maximised, is the lenders optimal rate. At this rate of interest, the demand overshoots supply, which according to traditional analysis should be subdued once the rate of interest increases. But the lender will not prefer to lend at a higher rate of interest to avoid the above stated problem of adverse selection. Therefore, the situation where demand overshoots supply becomes an equilibrium state and credit rationing prevails in equilibrium state (Greenwald, Stiglitz, and Weiss). Similarly, individuals offering higher collateral are also perceived as riskier, because they are less risk averse. The problem of credit rationing is not solved even in the presence of collateral. Traditionally, a higher collateral requirement should reduce/eliminate excess demand for credit. But, collateral can also be used by the lender as a screening device, and wealthy borrowers who are less risk averse will offer higher collateral for a riskier project thereby endangering the expected profitability of the lender (Stiglitz and Weiss 1981). Therefore credit rationing, where in only a few among many borrowers with similar risk profiles will get loans, will prevail even in equilibrium conditions.

Stiglitz and Weiss (1981) also point out that under equilibrium conditions, interest rates may not be what the market forces determine. Extending the condition described above, under conditions of excess demand over supply, the interest rates should raise upto a point where supply equals demand. But the lenders are aware that higher interest rates might lead them to adverse selection. Since a borrower willing to pay a higher rate of interest is seen as a bad risk, the optimal interest rate might be pegged at a lower rate than risk adjusted interest rate determined by the market unlike hypothesised by the neo-classicalists.

Stiglitz and Hoff (1990) recognise the importance of institutional interventions in credit markets but they did not, however, support the idea of supplying directly subsidised credit to rural areas. But they consider the role the State plays as the insurer of the last resort, whereby the State covers losses incurred by lending institutions in times of crisis. Being the insurer of last resort, the State interfering to ensure that the insured against event does not happen and the State regulating the interest rates so as to keep the bad
risks out of the pool and positively recognising potential good borrowers is considered as an important function of the State. Again as a regulator, if the State chooses interest rate as a screening device, there will be a sub-optimal equilibrium interest rate. They do not consider sub-optimal interest rate as a built-in subsidy; instead they consider it as a screening device (Stiglitz and Hoff 1990).

Stiglitz (1994) also justifies the intervention of State in credit markets because of market failures which will aggravate the situation in the absence of State monitoring. He lists seven market failures which are as follows:

*Insufficient supply of monitoring:* According to Stiglitz monitoring is public good, therefore, it is undersupplied. Any effort by one of the agents to monitor will benefit all the agents, but there is no incentive to undertake monitoring activities. Also, information about the solvency of borrower assumes importance in this context. Availability of any such information will reduce the cost of monitoring. In the absence of such information monitoring will have to be stepped up.

*Externalities of monitoring, selection and lending:* Lenders will always have a choice in selecting borrowers. Borrowers with high probability of repayment are generally chosen over the rest. This process is information incentive and any decision by one lender acts as a clue to other lenders in terms of availability of information.

*Externalities of financial disruption:* Financial disruption due to failure of financial institutions means the loss of valuable capital in the form of information. Also, there will be costs to be incurred in case of bankruptcy. There is also a threat of domino effect that could put the entire financial system in peril. The State can address this problem as the insurer of the last resort.

*Missing and incomplete markets:* There are fundamental problems in the credit markets which are manifested in the form of credit rationing and non-availability of a variety of instruments. This critical problem justifies the intervention of the state.

*Imperfect competition:* Information being a public good is undersupplied. This induces an element of imperfect competition and the inefficiencies associated with it.

*Presence of Pareto Inefficiencies:* Two critical assumptions of Pareto optimal competitive markets are absent in financial markets. They are the assumption of complete markets
and perfect exogenous information. Because of these, credit markets cannot operate like commodity market with the highest bidder getting the pot. The highest bidder in the credit market might be an adverse choice to select; the highest bidder might be the one with the riskiest project, where the payoffs are high only in case of the project becoming a success. This kind of a situation can be avoided if the information about the highest bidder is available in the market. It is in this context that, “there are government interventions that take into account the costs of information and of establishing markets that can make all individuals better off.” (Stiglitz 1994)

Uninformed investors: This is an issue which raises concern about the complexity of existing information which might not help the borrowers much. The information could be so complex that the borrowers might not be able to process it or/and draw proper conclusions from it. Lenders at times obfuscate terms of lending. As it happens, the credit contract runs into pages and the borrowers might be able to go through the fine print. The State can impose regulations that require borrowers to disclose the terms and conditions of the loan completely so that the lenders will not able to take unfair advantage of ignorant borrowers. Further Stiglitz supports the role of the State in terms of creating, regulating financial markets institutions as well as direct intervention. The role of State in the creation of financial market institutions is pertinent in the case of developing economies. The intervention can be direct or indirect in terms of providing conducive regulatory environment for the favoured institution to operate.

The role of State in a financial market is stated succinctly by Stiglitz in these terms, “There is a role for the State in financial markets; it is a role motivated by pervasive market failures.” (Stiglitz 1994) He recognised that, by assuming an active role in the financial markets, the State can enhance the stability of the economy and solvency of financial institutions. However, he does recognise that there are certain limitations on the role of the State just the way there are limitations on the operation of market forces. The role of State he opines should be designed as to overcome such limitations.

It is the influence of such theoretical designs that gave rise to a non-market response to the problems of credit market in the formation of groups and clubbing of a group of
borrowers into a single entity. In the case where debt contracts are not collateralised and credit histories of the borrowers are absent, lending to a group of people acting as each other’s guarantors’ appeared convenient. Besides, the problems of lack of collateral and lack of information is overcome because information about borrowers and their credit history might not be available to lenders but might be known to other borrowers in the group. However, in cases of information asymmetries and lack of ‘observability’ of each other’s effort, such group lending mechanism will be put under serious pressures. In addition, the effect of this kind of non market response is ambiguous as to its effect from the welfare point of view. More so crowding out of market institutions in times of a dysfunctional non market response is a possibility, which is in fact a magnification of existing problems. This is a possibility when groups are dependent on unsustainable grants and the financial institutions are not able to compete in such skewed conditions. Gradually, unsustainable grant dependent groups could crowd out financial institutions from the market, a development which is not welfare increasing either.

Because of the following issues the doctrine of the neo classical paradigm has come under severe attack.

Efficiency of informal financial institutions will be drastically reduced in the rural credit markets because the markets are monopolistic and fragmented with exclusive clientele. There will be a positive externality effect when borrowers promptly repay their loans and build up a credit history for themselves. This credit history is information that will help other institutions in sanctioning loan. When client with solid credit history approach another institution that they have not previously banked with, it is easy for the institution to judge the credit worthiness of the client and approve loans. This cost of information will therefore have a positive externality effect. This makes a case for paying a subsidy equal in value to these externalities.

Infant financial institutions in rural areas of developing countries need to be provided with subsidies because not only are they instrumental in building up financial institutions in rural areas but also because it is very difficult to recover costs and operate at market determined rates. Therefore, opposition of the ‘Ohio School’ to all subsidies appears a bit too overzealous.
Informal financial institutions can never match the size/scale of formal financial institutions.

The summary of all the three paradigms is given in the table below

Table 2: Salient features of the three paradigms of Rural Credit

<table>
<thead>
<tr>
<th>Feature</th>
<th>Social Banking</th>
<th>Neo-Classical Model</th>
<th>Information Asymmetry</th>
</tr>
</thead>
<tbody>
<tr>
<td>Lack of access to credit</td>
<td>Geographical expansion</td>
<td>Decentralised decision making,</td>
<td>Group borrowing with joint liability</td>
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<tr>
<td></td>
<td></td>
<td>flexibility</td>
<td></td>
</tr>
<tr>
<td>Cost of credit</td>
<td>Partly subsidised to reduce the cost of</td>
<td>Market determined. Timely credit</td>
<td>Interest rate covering the risk and</td>
</tr>
<tr>
<td></td>
<td>credit. Cheap credit emphasised.</td>
<td>instead of cheap credit emphasised.</td>
<td>insurance pegged lower than the</td>
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<td></td>
<td></td>
<td></td>
<td>equilibrium rate</td>
</tr>
<tr>
<td>Subsidies</td>
<td>Highly subsidised</td>
<td>No subsidies</td>
<td>State/Institutional support</td>
</tr>
<tr>
<td>Sustainability</td>
<td>Government backed, so no threat to</td>
<td>Sustainability emphasised along</td>
<td>recommended</td>
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<tr>
<td></td>
<td>sustainability</td>
<td>with non intervention of State</td>
<td></td>
</tr>
<tr>
<td>Client targeting</td>
<td>Weaker section given extra attention</td>
<td>No such targeting. Weaker section</td>
<td>Self Selection</td>
</tr>
<tr>
<td></td>
<td>and benefits</td>
<td>will not get extra benefits</td>
<td></td>
</tr>
<tr>
<td>Ownership and motives of agencies</td>
<td>Government owned agencies expected to</td>
<td>Private ownership, profitability</td>
<td>State /Institutional support recognized</td>
</tr>
<tr>
<td></td>
<td>further the policies of the government</td>
<td>is the motive. Informal credit</td>
<td></td>
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<td></td>
<td></td>
<td>encouraged</td>
<td></td>
</tr>
<tr>
<td>Interest rates</td>
<td>Regulated</td>
<td>Market determined</td>
<td>Cost and risk</td>
</tr>
</tbody>
</table>

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2.3. **Rural Credit Policies in India**

The typical problems of rural credit are very much prevalent in India, which have been addressed by various policies. These policies in turn were influenced by different paradigms at different points of time. The interest of State in rural credit systems can be traced back to the 1940s. The policy of the State has been influenced by various committees/expert groups constituted to study issues associated with the rural credit system at periodic intervals. Needless to say, such studies have had major influence on the policies of the State. The studies themselves are influenced by various theoretical paradigms associated with rural credit. Major contours in the evolution of credit policy can be identified as the changing role of Reserve Bank of India, implementation of the recommendation of AIRCS, nationalisation of commercial banks, establishment of Regional Rural Banks and finally the liberalisation of financial sector. Of these only the policy of financial liberalisation is organically different in the sense that the other measures stemmed from the premise that accorded priority to improved access to credit needed expansion of banking system; commercial interests and profitability was therefore low on priority. Under the liberalisation regime, commercial interests and profitability assume prime importance. This section traces the evolution of the policies with regard to rural credit structure and the major influences behind such policy developments.

The initial response of the State towards the rural credit structure can be traced back to the nationalisation of Reserve Bank of India. The Reserve Bank of India started as a privately owned statutory entity in 1935 on the recommendation of the Royal Commission on Indian Currency and Finance set up in 1925. The commission recognised the importance of an agency that can maintain monetary stability in view of growing
The nationalisation of RBI in 1949, envisaged traditional functions for RBI like issue of currency, banker's bank and banker to the government as well as non-traditional functions like development of agricultural credit and rural cooperatives. The RBI took the non-traditional role seriously enough to nurture the cooperative movement as well as extend institutional credit to agriculture in rural India. (ibid, P Satish 2007) It also led to the appointment of the All India Rural Credit Survey Committee in 1951.

The All India Rural Credit Survey was a monumental work in terms of the range of issues addressed and the depth of analysis. The extent of the issues addressed by the committee is captured in the quote,

"Any thesis concerning rural credit in India cannot help being in essence though not in detailed exposition a part of a much larger thesis concerning the economic good of India.... In extent, it is as wide as rural society, which means practically as wide as Indian nation. In content it embraces all economic activities and purposes as they affect rural society, for credit is only a layer of such activities and has organic purpose to have the two fold aspect of achieving wealth and securing its equitable distribution, a programme of rural credit becomes inseparable in its underlying concepts, not only from the end which is economic good but from the means to be employed in the attainment if the end".

The range of recommendations included nationalisation of State Bank of India, creating a favourable co-operative credit structure to the establishment of warehousing board. Major recommendation of the committee which moulded the policy of the State was the establishment of an integrated scheme of rural credit. The impetus was on the creation of a co-operative structure addressing the needs of rural producer and production. The structure not only included the institutions dealing with the credit needs but also that of co-operative economic activity like processing, marketing, storage and warehousing. The committee envisaged a tiered co-operative credit structure, including institutions at state, district and primary levels dealing with short term, medium term and long term credit needs all with the active support of the Government. Rationing of credit was

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recommended by the committee in case of short fall of ‘legitimate credit requirements’ in favour of small and medium cultivators.

However, the committee did not favour direct involvement of the State in providing credit, they opined that,

“A scheme of supervised credit will be completely beyond the government’s administrative and financial resources, besides being likely to defeat its own purpose because of its concentration on instruction and enlightenment, where the real need is promotion and reorganisation of primary economic activity for the benefit of the cultivator”

The committee also recommended the amalgamation of Imperial Bank of India and other major State associated banks to form the State Bank of India. The bank was expected to undertake branch extension to rural areas, the cost incurred in such an operation as well as those incurred on opening and maintaining unremunerative branches were to be met by the creation of a fund which is made up of the dividends earned by the government and RBI on its shares in SBI. The committee was aware of the importance of rural savings and warned against the possibility of diversion of rural savings to fulfil urban credit needs. Having highlighted the usurious behaviour of moneylenders, it was natural that they recommend that money lending legislations be revised and reviewed regularly, and stress on the enforcement of such legislations.

These recommendations resulted in the increased participation of State and Reserve Bank in share capital of co-operatives and the establishment of a co-operative credit structure on the lines suggested by the All India Rural Credit Survey.

On the other hand commercial banks were mostly joint stock companies. Under the colonial administration, these banks were poorly regulated, resulting in frequent bank failures. The banking regulation act of 1949 provided a framework to regulate and supervise the banking system. Despite the act, commercial banks were still deficient on various counts. The important deficiencies included but not limited to, continued neglect of agriculture, rural and small scale borrowers (Ghosh 2005), inequitable credit distribution in favour of large industries and influential borrowers and indirectly financed hoarders who created artificial scarcity. The share of

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9 Report of the committee of direction, All India Rural Credit Survey Vol II General Report, 1954 RBI Bombay pp 564
bank credit to industries increased from 34% in 1951 to 68% by 1968, the share of agriculture remained less than 2% of the total credit. (ibid) In the post-war milieu, the socialist policy regime found it apt to usher in the design of social banking and undertook to nationalise banks in order to ensure adequate supply of cheap formal credit to critical sectors. The preamble to the bank company acquisition act of 1969 captures the spirit of the policy regime succinctly.

"The Banking system touches the lives of millions and has to be inspired by a larger social purpose and has to subserve national priorities and objectives such as rapid growth of agriculture, small industries and exports, raising of employment levels, encouragement of new entrepreneurs and development of backward areas. For this purpose it is necessary for the government to take direct responsibility for the extension and diversification of banking services and for the working of a substantial part of the banking system."

As against the recommendations of the All India Rural Credit Survey committee and subsequently the policy response, which did not favour direct involvement of the government in the credit markets, the exercise of nationalisation justified the direct intervention of the government. The rationale and the justification is summarised by Tandon (1989) as follows.

"Many bank failures and crises over two centuries, and the damage they did under ‘laissez faire’ conditions; the needs of planned growth and equitable distribution of credit, which in privately owned banks was concentrated mainly on the controlling industrial houses and influential borrowers; the needs of growing small scale industry and farming regarding finance, equipment and inputs; from all these there emerged an inexorable demand from banking legislation, some government control and a central banking authority, adding up in the final analysis, to social control and nationalisation."

The exercise of nationalisation was itself a part of a larger design of “Social & Development Banking” which in the Indian context had the following signature features as discussed in the previous section in detail. viz

Nationalization of commercial banks
Geographical expansion of formal sector
Directed lending

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10 Quoted from Burgess and Pande (2003)
Subsidized credit and differential interest rates
Multi-agency approach

During the early seventies it was realised that the nationalisation of banks and the wide spread activities of co-operatives were still insufficient to address the credit needs of the rural poor. While the co-operatives were mostly serving the rural elite, commercial banks were found to be operating mostly in urban areas. (Bose 2005) Another agency exclusively operating in the rural/semi-urban areas, addressing the credit needs of the sector, which otherwise is marginalised by the mainstream commercial banks, was conceived on the recommendation of the Narasimham working group in 1975. The agency was expected to be a high-breed of co-operatives in terms of local feel, familiarity and commercial banks in terms of professionalism and solid resource base. The group did recognise the possibility of such banks suffering from initial losses, but the emphasis was on the rural banks examining ways of “restructuring and reorganising the productive activities of small borrowers so as to bring them to the level of generating surpluses for the purpose of investment”, 12 therefore profitability was not a priority.

Over a period of time many other committees expressed their preference for RRBs as the best institution to serve the credit needs of the rural population. The Dantwala committee 1978 also reaffirmed faith in the advantages of RRBs over the commercial banks and cooperatives in addressing the inadequacies in the rural credit system. The committee recommended earmarking 60% of the advances of RRBs for the benefit of small farmers, rural artisans and rural poor as well as continuation of the concessions for the first five years of operations. To reduce the potential losses the committee also suggested RRB advances to non-target groups as well.

The Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Developments (CRAFICARD 1981) also envisaged a special role for Regional Rural Banks in both rural areas as well as far flung areas like North Eastern states; that they recommended the commercial banks transfer ‘eligible business’ from their rural branches to RRBs if possible as well as special privilege for RRBs to serve larger areas and all categories of borrowers in inaccessible areas. Recognising the possibility of RRBs incurring losses, the committee suggested

12 “Major Recommendations of Various committees/ working groups on RRBs” RBI http://rbidocs.rbi.org.in/rdocs/content/PDFs/78971.pdf
the shareholders make good the losses annually in the same proportion of their shareholdings.\textsuperscript{13} This committee also recommended decentralised functioning of RBI, which led to the creation of a specialised agency to refinance agriculture credit, viz NABARD. (Satish 2007)

Kelkar committee in 1984 identified the problem of unviability in case of small and uneconomic RRBs. They suggested the merger of such RRBs to make them viable. They also suggested recapitalisation and investment in high-yielding government securities to reduce the burden of losses. However, in recognition of the importance of RRBs and their services in rural areas, the report also recommended that the accumulated losses of RRBs be made good in the form of grants by the shareholders in accordance with the shareholding pattern. As a precursor to the policy reversal in favour of liberalisation, the Agricultural Credit Review Committee 1989 (Khusro Committee) took serious note of the problems of RRB including that of declining profitability, high over dues and organisational issues. The committee acknowledged that the high operating costs in handling small loans contributed to the erosion of RRBs margins. Also, because the RRBs were mandated to serve target population they did not have an opportunity to cross-subsidise such high cost loans with loans that could yield higher returns. Along with these problems the committee also recognised the problem of wilful defaults, misuse of loans, lack of follow-up, wrong identification of borrowers and staff agitation as other causes for the poor recoveries in RRBs. The committee also noted that “the objective of serving the weaker sections effectively could be achieved only by self-sustaining credit institutions. RRBs structurally are not the institutions that could fulfil this role... the logic and rationale which justified the setting up of RRBs did no longer exist. The weakness of the RRBs is endemic to the system and non-viability is built into it.” In such a situation, the committee came to the conclusion that the only alternative would be to merger the RRBs with their sponsor banks. However, the recommendation of the committee came a bit too early and the policy makers were unable to accept such drastic change of approach and the report was largely ignored.

Not long after, the Narasimham committee submitted its report which recommended steps towards neo-liberal reforms. The report was a mile stone that brooded reversal of several policies pursued hereto. The committee came down heavily on the pillars of social and development banking like branch licensing, directed credit and regulated interest regime.

\textsuperscript{13} ibid
Also, for the first time since the initiation of social and developmental banking, profitability and commercial interest became issues of importance. To quote from the report of the committee, “in the last two decades, banking and credit policies have been deployed with a re-distributive objective. However, the committee believes that the pursuit of such objectives should is the instrumentality of the fiscal rather than the credit system, accordingly, the committee proposes that the directed credit programmes should be phased out.” The committee also recommended the rollback of branch licensing system so that, “the matter of opening of branches be left to the commercial judgement of the individual banks”. The committee proposed overhauling the existing banking structure to set up a tiered banking structure with a few large banks capable of operating at the international level, 8-10 national banks operating all over the country offering universal banking facilities; local banks operating in specific regions and rural banks (including RRBs) confined largely to rural areas mostly “financing agriculture and allied activities”. The committee however, recognised the edge RRBs had over the other banks in terms of local character. They opined that public sector bank should set up rural banking subsidiaries to take over all its rural branches which are treated on par with RRBs. The committee suggested the 10% target for directed credit in such banks as well. They also proposed that RRBs be allowed to engage in all types of banking business with a continued focus on the target groups. However, noting the serious lack of profitability of RRBs, the committee suggested that the interest rate structure in RRBs to be comparable with those of the commercial banks. They also favoured the option of merger of RRBs with their sponsor banks to improve profitability. The implementation of the committee report did have far reaching consequences as is elaborated in later sections of the study.

Recently the Vyas committee (2004) examined the flow of credit to agriculture and allied activities from the formal banking system. They found out that though there has been an expansion in agriculture credit, the advances fell short of targets because, most of the banks had deposited the amount equivalent to the short fall in their advances to agriculture in the RIDF account with NABARD. The committee sought the attention of policy makers to address this loophole. The report also recognised the poor access to credit, especially in case of small and marginal farmers and weaker section borrowers. The committee stressed on the importance of
providing cheap credit to agriculture and allied activities in order to overcome the problem of access to credit. They suggest that “measures to reduce costs of funds, transaction and risks could lower the cost to borrowers without impairing the viability of RFIs”\textsuperscript{14} As a remedy they suggest reduction in the cost of borrowing, increasing outreach through outsourcing, simple procedures and bridging the information gap. In this regard they also stress the importance of self-help-groups and NGO backed Micro Finance Institutions. On RRBs the committee differed from its predecessors; accordingly, “The RRB mandate has to continue, even as they need to be restructured into viable financial institutions, simultaneously retaining their regional character and rural focus”. The committee acknowledged the strength of RRB because of ‘their strong rural branch infrastructure and rural orientation of their staff’. On the restructuring they suggested a variety of options in the form of mergers and amalgamations. Also, they favoured the merger of all RRBs in the north eastern states into a bank. The recommendations have been positively considered by the government and amalgamation of RRBs is underway in many states.

The latest RBI working group on Regional Rural Banks (Chaired by Sardesai) is of the opinion that, “Regional Rural Banks have played a key role in rural institutional financing in terms of geographical coverage, clientele outreach, business volume as also contribution to development of the rural economy. A remarkable feature of their performance over the past decades has been the massive expansion of their retail network in rural areas.” The working committee also identified factors influencing the performance of Regional Rural Banks. They were as follows:

Areas of operation: Regional Rural Banks were found to be constrained by their limited area of operation, narrow base of business activities. RRBs are mandated to operate only in one district, at the most a few districts. The original intention was to address the local needs, therefore confining operations of the banks to one or few districts only.

Client base: Since customer base is mostly made of small, marginal farmers, agricultural labours etc, there is an inherent limitation to the banks ability to earn higher profits. They cannot be charging a high rate of interest which is profitable with this kind of a customer base.

\textsuperscript{14} Report of the Advisory Committee on Flow of Credit to Agriculture and Related Activities from the Banking System (2004) Reserve Bank of India, Mumbai
Regional Rural Banks have a low capital base which imposes serious limitation on the operations of the banks. The small organisational structure of the banks is also a big handicap.

Large loan delinquencies: Regional Rural Banks have a high rate of loan delinquencies. Many of the Regional Rural Banks are facing accumulated loss because of high delinquencies, high cost of funds and low interest rates.

Cost structure: Regional Rural Banks face high cost of operations because they service a large number of clients borrowing small sums.

Besides, being perceived as a specialised bank the Regional Rural Banks also face problems because of poor financial management. Staff: Poor quality staff coupled with freeze on recruitment of staff had reduced the operational effectiveness of Regional Rural Banks.

Regional Rural Banks are heavily dependent on the Sponsor Banks for financial/business initiatives. There is also an element of competition between the Regional Rural Banks and their own sponsor bank when they both are operating out of the same area.

On the recommendation of various committees like Narasimham, Vyas and Sardesai, RRBs have been permitted to lend to non-target groups population as well. Branch licensing rules have also been relaxed. Subsequently, several RRBs were merged to strengthen the balance sheets as recommended by the above mentioned committees.

The financial liberalisation programmes has a far reaching effect on the Indian rural fabric. Other factors combining with the effects of financial liberalisation precipitated a distress that has lead several thousand farmers to commit suicides. In the wake of increasing burden of debt, along with an increase in the proportion of credit from informal sources and wide spread suicides of farmers an expert group was on Agricultural Indebtedness (Prof Radhakrishna committee) was constituted. The committee submitted its exhaustive report in July 2007. The issues dealt with by the committee are broadly classified into two, one is the increasing indebtedness and the role of formal and informal agencies; the other being a range of issues that causes this sort of indebtedness. The committee’s report recognises that the indebtedness is just a symptom; while the underlying causes include ‘stagnation in agriculture, increasing production and
marketing risks, institutional vacuum and lack of alternative livelihood opportunities’. A gamut of recommendations addressing the symptom included improving credit to agriculture and allied activities in rural areas, ensuring supply of credit even during years affected by natural calamities and reduction of cost of credit. In the context of increasing informalisation of debt, the report opines that there is further scope for institutional agencies to expand their credit base in rural areas. The report emphasises the importance of strengthening the credit delivery mechanism for farm households, including credit for rain fed areas, annual cyclical credit system, formalisation of informal credit, inclusion of groups like small borrowers and other such household who do not have any access to formal credit. The report also calls for a reduction in the transaction cost of loans by establishing mobile banking centres and reducing the costs incurred due to procedural delays, paperwork and repeated trips to the bank offices. Along with these recommendations the report also encourages the integration of micro finance institutions with mainstream banking subjected to the condition that such institutions will charge moderate interest rates and ‘abide by ethical banking practices’. On the lending to agriculture, the report highlights the short fall meeting the target of 18% priority sector lending to agriculture by banks. According to the report, not only should the government ensure that the banks reach this target but also ensure adequate credit flow even during the years when rain fails. In case of crop failures, the group recommends that the loans be rescheduled and fresh loans issued. On the crops failing for two consecutive years, the interest for one year should be waived along with rescheduling the loan. Credit counselling for farmers should be undertaken and the banks should induct qualified personnel to service rural clientele.

Other recommendations refer to the underlying causes, therefore deals with other broader issues. Accordingly, various risk mitigation measures like crop insurance, weather insurance, price risk mitigation, crop surveillance, curbing the influx of spurious inputs & mitigating risks arising from such inputs and strengthening agriculture extension services along with increased investments in agriculture research. The other broader recommendation includes expanding livelihood base and increasing income diversification opportunities in rural areas by promoting non-farm enterprises. Also,
health care costs being one of the most significant causes behind the debt burden in rural areas, the report recommends ameliorated primary health care facilities and health care schemes. Therefore, the policy evolution seems to have come a full circle starting from social and development banking which sought to improve access to formal and subsidised credit of poor population to financial liberalisation which reinstated the focus on profitability and commercial interests. The latest report, i.e. Prof Radhakrishna committee report has shades of social banking and it is an obvious response given the magnitude of crisis currently affecting the rural population.

Thus this chapter was a brief review of the problems typical to rural credit markets and the theoretical responses to such problems. The chapter also reviewed the different theoretical frameworks employed to look at the problem as well as to seek solutions. Supply leading, neo-classical and information asymmetry were some of the frameworks reviewed. Rural credit policies in the Indian context have been tinkered with many times over all these years. The final section of the chapter presented the evolution of rural credit policy in India covering major expert groups/committee reports that influenced the policies. Continuing further, the following chapter presents the effect of the changing rural credit policies and the associated empirical fallout in terms of supply of and demand for rural credit. While the emphasis of the chapter is on the operation of scheduled commercial banks in rural areas, the demand side is evaluated on the basis on data on indebtedness.