CHAPTER IV
THEORY AND PRACTICE OF SOCIAL BANKING

The lack of a comprehensive theory and sound analytical framework has no doubt been a constraint for scholars engaged in empirical research on social banking in developing countries. Conceptually, social banking is related to the nature, use of credit and the role of credit institutions in promoting economic development. There have been, however, studies on social banking and empirical models which attempted to evaluate credit institutions and their lending activities with the achievement of social goals. This was indeed recognising the principle that any institution in use of a society, while benefiting from the transactions in society, do have a return obligation to the society. This section critically reviews the existing literature on social banking and its practice in developing countries.

4.1 AN HISTORICAL PERSPECTIVE

In pre-industrial economies, finance was largely concerned with the development of a medium of exchange. Barter was cumbersome; transaction costs were high; and the absence of a medium of exchange was a constraint to market expansion and specialisation. Early banking functions started in ancient Babylon with the temple treasury being the bank. With the growth and expansion of trade, banks emerged as an institution for financing trade and also in facilitating the settlement of debts.

The origin of commercial banking dates back to the Renaissance period when businessmen and bankers of Northern Italy’s cities of Genoa, Florence and Venice developed the fundamental practices of modern finance, which included trade
credit. The earliest banking institution to have emerged in the process of global economic development was the commercial bank. Schumpeter\textsuperscript{88} (1934) regarded banking and entrepreneur as two key agents involved in the process of economic development, and concurred with the views of Gerschenkron that the more backward a country, greater would be the need for banks to provide both capital and entrepreneur.

In a large number of countries, the development of commercial banking had been closely interwoven with the problems of public finance. During the nineteenth century, banks in Europe (Austria, Italy and Spain) focused their attention on financing government deficits, which incidentally continued to be pursued by a number of state owned banks in developing countries. In Japan, major legal and regulatory reforms in banking were implemented after the Meiji Restoration in 1868 in order to modernise and industrialise the Japanese economy.

In India, indigenous banking was in the form of rural money lending, with certain individuals using their private funds for this purpose. The vedic scriptures name the Vaishyas as the main bankers. The earliest form of bill of exchange, which incidentally continues to be discounted today, is called 'Hundi'. In the beginning of the 19th century, three Presidency Banks were created under a charter viz., The Bank of Bengal (1806), The Bank of Bombay (1840), and the Bank of Madras (1843). However, the earliest Indian Bank to have been established was the Bank of Hindostan in 1770. Private banking companies, which started around 1900 with the Swadeshi Movement, grew substantially and by 1913 there were 41 private banks.

McLeod's\textsuperscript{89} writings revealed that the Scottish banks had pioneered the use of cash credit as an impetus to agricultural development. His work did substantially contribute to the understanding of contemporary social banking. Firstly, he introduced the concept of finance capital or funds, which he defined as cash plus credit or purchasing power. Secondly, he lucidly explained the dynamic role of credit in economic development. He classified capital as 'fixed' and 'circulating' or 'floating capital'. The former was retained by the capitalist, while the latter was loaned to other investors. Further, he stated that credit was purchasing power which an individual or a nation had, over and above money. Moreover, 'debt' was not money owned by the debtor, but rather a personal obligation to pay money. Hence, the word 'debt' meant, the creditor's right of action as well as the debtor's duty to pay. An entrepreneur not only accumulated money in the course of his business, but also acquired skill and ability to earn profits in the future. This enabled him to buy goods, by giving in exchange for them a promise to pay, or a right to demand money at a later time from his anticipated future earnings.

On the dynamic role of credit, McLeod\textsuperscript{90} made a distinction between a real bill and an accommodation bill. The former represented the 'past' and the latter the 'future' transactions. If, as in the case of a "real bill," goods had been purchased to honour the bill, then for an "accommodation bill" the goods had to be purchased on a future date. Thus, there is an element of credibility attached to accommodation bills. Economic development in post-war Scotland had been mainly


\textsuperscript{90} Mcleod, op. cit. 1902, pp. 346 - 349.
through the use of accommodation paper, wherein the investor's latent potential had been gainfully exploited by providing them cash credit, to be later realised from the anticipated income earnings.

Schumpeter\(^{91}\) (1934) also conceptualised credit as essentially a means of purchasing power for the purpose of transferring it to the entrepreneurs, which would in turn give them access to the social stream of goods and services. What emanated from the above discussion is that cash credit could be given to an individual on the basis of his earning potential and personal character.

From the above review, it is obvious that commercial banks existed not only for commercial purposes, but that they had to and did participate in pursuing the social goals of the society. Social banking aims towards providing the bankable poor access to credit. Hence, social banks are intermediaries that bring together profit motivated suppliers of credit and the potentially viable users of credit, who normally cannot obtain collateralised loans. In modern times, bank credit when used rightly, has generated income and wealth, and on the contrary, when misused, has lead to debt burdens and bankruptcies.

4.2 MODELS OF SOCIAL BANKING

A) Views of the New Institutional School of Economics

The New Institutional School model of economic development combines theory and institutions in the study of economics in an attempt to relate economic

efficiency with welfare. In Walrasian neo-classical economics, institutions were treated as exogenous and given, transaction costs are assumed to be negligible and the separability of equity and efficiency was deemed to be an accepted proposition. The lack of credit was not a concern, since demand equaled supply at equilibrium price.

However, in recent years, alternative endogenous theories of institutions have been developed. The explicit or implicit assumption of given institution was unrealistic and limiting in the context of economic development. Institutions underwent substantial change, which in essence was a necessary concomitant of economic growth. As characterised by Uphoff\textsuperscript{92} "Institutions are complexes of norms of behaviour that persist over time by serving collectively valued purposes". Models of credit market and the banking firm that have brought to light the non-price rationing of credit demand are given below.

B) Credit Rationing Models

Stiglitz and Weiss\textsuperscript{93} (1981) viewed that credit rationing occurred when a subset of firms seeking credit at the ongoing rate were not granted such loans, inspite of the fact that their objective characteristics were identical, or nearly so, to those firms receiving credit. Simply put, it was the denial of additional credit by the bank to a borrower at any price. Credit rationing occurred at the long-run equilibrium interest rate (i.e. equilibrium rationing) or in the transitory period between such equilibrium


(i.e. dynamic rationing). Credit rationing models have taken the following three approaches:

1) Rationing tied to the relationship between banks and their customers.

2) Rationing tied to transaction costs.

3) Rationing tied to asymmetric information.

1) Rationing tied to the relationship between banks and their customers.

In the first approach, Hodgman94 (1960) argued that because of the intertemporal and cross product relationship between the bank and the customer, preferential treatment was given to prime customers in times of a credit squeeze. This was the consequence of non-price market mechanism for credit demand wherein the formal lenders often rationed credit to small borrowers in order to reduce their transaction costs. Banks tended to behave as a multi-period profit maximisers by favouring their best customers.

2) Rationing tied to transaction costs.

The transaction cost school that emerged from Coase's95 paper (1960) affirmed that institutions were transaction and information costs minimising arrangements. In this second approach, the banks' offer curve for credit to any specific customer or customer groups has been defined by the standard profit

maximising criteria. A study by Jaffee and Modigliani\textsuperscript{96} (1969) has shown, that if the bank was forced to charge a non-homogenous set of customers the same interest rate, then credit rationing would result. This was because, within the set of non-homogenous borrowers, the bank charge a rate that lies between the lowest and the highest rates applicable to members of the group. For the subset of loans, that should have been charged a higher rate than the optimal rate for the class, quantity rationing results. The least risky in the group and the riskless customers, on the other hand, are never rationed.

3) Rationing tied to asymmetric information

The third approach explained that the expected value pricing of loan rates-assuming a single rate for all loans - hid two different types of borrowers viz., honest and dishonest borrowers. By restricting the percentage of an investment project that is financed by the bank, the lender attracts more honest borrowers and a smaller loan loss experience. The imperfect information theory of institution, associated with the works of Akerlof\textsuperscript{97} (1984), Stiglitz\textsuperscript{98} (1986) and others, was closely related to the transaction costs theory, since information costs constitute an important part of transaction costs. In mainstream neo-classical theory, market acted to supply unbiased information at the lowest possible costs to all participants. However, empirical evidences showed that in developing countries, where


asymmetries of information are present between parties to a contract, the problems of 'adverse selection' and 'moral hazard' have been found to be in existence. As the interest rate charged to borrowers increased, the percentage of low quality loans might also increase, and therefore, the willingness to pay higher interest rate is a screening device for identifying high risk borrowers.

Dow and Saville 99 (1988) had argued that banks were risk averse and operated in an uncertain world in which it was impossible to know what interest rate would adequately compensate for risk. Hence, they used quantitative limits on individual borrowers to reduce exposure, resulting in the segregation of unsatisfied borrowers. Thus, in the above models, social banking was practised by credit rationing and charging differential interest rates.

C) Empirical Models

Adam Smith, through his writings had emphasised on the real bill doctrine as a guide to portfolio management in banks. The orthodox English portfolio model relied on the self liquidating theory of bank credit, wherein the short term credit needs, that were made available by large joint stock banks, were fully secured. This orthodox doctrine and the ensuing model were fore-runners to the cash flow based form of bank lending.

Commercial banks in Japan, Germany and France operated as 'universal banks' engaging in both commercial and investment banking. Although universal banking first appeared in Belgium and France, it proved to be more successful in

Germany and Switzerland. In these countries, the leading commercial banks developed close links with industry and trade and played a crucial role in raising long and medium term finance. In several other continental European countries as well as Japan, the banking sector had become an important source of finance for industry. The benefits and success of universal banking had also motivated banks in developing countries to adopt the universal banking model [Khatkhate and Riechel100; Hugh Patrick101].

Unit banks in the United States represent a mix of 'universal' and 'specialised' forms of banking and operate both on the strength of the principles of self-liquidation and anticipated income. In the early fifties, the Bank of America, then called as the 'little fellows bank', practised retail banking, particularly in financing agriculture, which until that time was not regarded as a viable business. The bank provided small sized loans to investors for productive use.

In Germany, the Raiffeisen rural credit union model had been developed on the premise that the poor can be helped through voluntary group action. One of the oldest financial innovations known generically as the Rotating Savings and Credit Association - ROSCA'S - emerged as informal lenders aimed towards reducing transacation costs and formalising mutual obligations. Commercial banks in England, America, Japan and in European countries started lending to industry and


trade; extended slowly to agriculture and finally began to help the poor people and thus the practice of social banking slowly developed.

The most successful and contemporary development model of a social bank is the Grameen Bank of Bangladesh. Started in 1976 as a research project designed by Prof. Muhammad Yunus, it has today created for itself a niche in rural financing. The Grameen Bank concept implied generating self-employment for the poor through credit without collateral. According to Hussain, strong management system, decentralisation of power and responsibilities and intensive training of bank workers were factors attributed to the success of Grameen Bank. The other successful Asian models that could be cited are the Bank for Agriculture and Agricultural Cooperatives (BAAC) founded in Thailand in 1966, the Badan Kredit Kecamatan (BKK) operating in Central Java since 1972, Bank Rakyst Indonesia Unit Deas (BUD) functioning in Indonesia since 1983, the Rashtriya Baniya Bank of Nepal, and Bank Pertanian Malaysia (BPM), which incidentally had, from the brink of a financial collapse, emerged as a commercially viable rural lending institution. A common thread that runs through all these model banks is, that they have either relied on the existing social structure, or have formed social and peer groups to ensure that borrowers are selected appropriately and repayments are made on time. Thus, the scope of commercial banking was widened from a traditionally rent-seeking form of economic activity to an institution with societal obligations to fulfill.

4.3. SOCIAL BANKING THROUGH STATE INTERVENTION

The above discussion had shown how the commercial banks developed into institutions with societal obligations. Another development was social banking through state intervention. Adam Smith \textsuperscript{103} 1776, had already advocated the role of State in maintaining public institution for eliminating rent seeking in the private sector. In the words of Adam Smith "Banks have contributed a good deal in the expansion of trading activities". The neo-classical economists disputed this view and instead attributed rent seeking to state intervention in markets. However, Bhagwati \textsuperscript{104} (1982), by applying the theory of the second best, had shown that in a situation, where there are already rent seeking activities, the creation of additional rent seeking opportunities through state intervention can be productive. Gerschenkron \textsuperscript{105} (1962) considered state participation in financial markets as crucial and essential in the formative stages of economic development.

Imperfections such as asymmetric information in credit markets of developing countries also compelled the state to intervene inorder to provide access to affordable credit to viable entrepreneurs, according to Stiglitz and Weiss \textsuperscript{106} (1992).

\begin{enumerate}
\item Adam Smith, \textit{The Wealth of Nations}, 1776, p. 281.
\item A. Gerschenkron, op. cit., 1962, pp. 19-20.
\end{enumerate}
Greenwald and Stiglitz\textsuperscript{107} (1986) and Stiglitz\textsuperscript{108} (1989) had argued in their papers that market forces by themselves might not suffice to ensure the success of the development process, since market allocations with imperfect information were in general Pareto inefficient. Farrell\textsuperscript{109} (1987) had shown that with imperfect information, even bilateral relationships might not be efficient on account of complexity of private bargaining. Hence, the state needed to intervene to correct the distortions caused by the free play of market forces (Stree ten\textsuperscript{110} -1993). The infant-industry argument was also given in support of state intervention in financial markets (Yaron\textsuperscript{111} - 1992). Cope stake\textsuperscript{112} (1988) justified state intervention in financial markets on political and moral grounds, provided it achieved a significant improvement in income distribution and equity, even at the cost of a decrease in market efficiency or growth rates. However, this view was untenable in so far as the developmental role of the state was focused upon.

Government ownership of bank was yet another form of intervention in credit markets of developing countries. The case for bank nationalisation goes back to the writings of Marx and Friedrich Engels, both of whom had advocated the


\textsuperscript{110} Paul Streeter, "Markets and States Against Minimalism", \textit{World Development}, Vol. 21, No.8, August 1993, pp. 1281-1298.


\textsuperscript{112} J. Cope stake, op cit., 1988, p. 152.
centralisation of credit in the hands of the state, through a simple National Bank with exclusive monopoly\textsuperscript{113}. Lenin was also a keen supporter of bank nationalisation and monopolisation. He had envisaged that the banking system would become the backbone of the socialist states administrative apparatus\textsuperscript{114}. Cameron\textsuperscript{115} (1972) pointed out that where banks were established by and for large business houses, the institutional credit needs of the small traders and businesses were neglected.

Monopoly power had been one of the notable features of banking systems that motivated bank nationalisation in East Europe, parts of Western Europe and in many developing countries of Asia, Africa and Latin America. Post-war financial development in developing countries had witnessed a strong tendency towards increased government intervention through ownership of financial institutions, particularly the banking industry. In post-war Japan, Government abandoned its competitive market oriented philosophy, liquidated a number of banks and introduced a controlled interest rate policy, together with substantial allocation of directed credit. In the context of Japan's financial development, Government policy has had considerable influence over the structure of the financial system.

As experienced in a large number of developing and least developed countries, the weaker sections of the society were generally deprived of

\textsuperscript{113} T. M. Podolski, \textit{Socialist Banking and Monetary Control: The Experience of Poland}, Cambridge University Press, 1973

\textsuperscript{114} George Gary, \textit{Money, Banking and Credit in Eastern Europe}, Federal Reserve Bank of New York, 1968.

\textsuperscript{115} Cameron, Rondo, (ed), op. cit. 1972, pp. 20-21.
institutional credit as they were not able to provide tangible assets as collateral. The state intervened to remove this anomaly through its directed credit programmes. Besides, discrepancy between private and social costs and benefits, the highly skewed distribution of wealth and incomes, as well as the dichotomous financial market justified state intervention on equity consideration. The World Bank, hitherto a free-market votary, in its 1989 World Development Report\(^{116}\), did also advocate an interventionist approach through state participation.

Government intervention and regulations on the functioning of banks are basically with the objective of protecting the depositors and for maintaining the stability and solvency of the payment system. However, in many developing countries, bank regulations were introduced for the purpose of allocating credit on the lines of planning priorities. Moreover, state intervention also helped in disseminating knowhow and bringing innovation in credit markets.

Summarising the above discussion on the theoretical and empirical frameworks, it can be concluded that social banking, as an economic activity, is essentially a means for creating purchasing power in the hands of the less privileged borrowers to enable them acquire and possess sustainable income generating assets. This idea was developed slowly by the banking institutions themselves and in recent years, state has intervened to urge the banks to provide credit facilities to the poor, without insisting on collateral.

4.4. SOCIAL BANKING: THE INDIAN EXPERIENCE

In the early stages of development, the concentration of banking in India was more to finance trade, particularly internal trade, rather than to industry and agriculture. As early as 1954, it had been envisaged that the focus of banking development in the future would rest on the premise of sounder banking principles and traditions. Extension of banking and credit facilities and better coordination of the unorganised and organised sectors of the money and capital markets were also spelt out117. During the pre-independence days, Government taccavi loans were given to cultivators to meet exigencies arising out of crop failure, famine etc. The Cooperative Societies Act 1904 was also adopted to institutionalise rural credit and ensure its equitable distribution.

The advent of social banking in India can be traced to the setting up of the National Credit Council in 1967 for the purpose of acquiring social control over commercial banks. The Council was created to periodically assess the demand for bank credit and issue guidelines to banks on credit deployment to priority sectors.

To further facilitate directed lending, the Banking Regulation Act of 1949 was amended by the Parliament to enable the Reserve Bank of India (R.B.I.) to regulate the flow and direction of bank credit. Legal and practical difficulties, however, prevented the RBI from exercising its enhanced powers, and so ultimately the Government of India embarked on a programme of nationalising its major commercial banks in July 1969 and later again in 1980.

At the time of nationalisation, it was argued that social control will enable the Government to achieve various social goals in an efficient manner. In the words of the then Prime Minister late Mrs. Indira Gandhi:

"Our sole consideration in extending social control over commercial banks has been to accelerate development and thus make a significant impact on the problems of poverty and unemployment and to bring about progressive reduction in regional disparities" (The Banker, July 1969).

The aforementioned goals, therefore, relied upon the organised rural financial markets in India to accelerate economic growth with equity, which would entail that the institutions should not only maximise market efficiency and growth rates but also welfare of the people.

The genesis of the concept of priority sector finds its root in the report of the study group of the National Credit Council headed by Prof. D. R. Gadgil in 1968. The process of lending to the priority sectors became operational soon after the nationalisation of 14 major commercial banks in 1969. Although it was in pursuance of the objectives of Social Control, it was nonetheless made mandatory for the public sector banks to set apart 40 percent of their loanable funds towards the credit requirements of certain identified sectors and vulnerable sections of the community.

The introduction of the Lead Bank Scheme in 1969 was another innovative measure whereby major commercial banks were allotted specific districts where they were expected to act as pace setters for providing integrated banking facilities.
The Lead Bank had also the responsibility of co-ordinating the activities of different credit institutions and local development agencies, and for drawing up annual action plans for being implemented by each credit institution. The number of districts covered by the Lead Bank Scheme increased to 493 by the end of March 1994, as compared to 483 a year earlier.

To speed up the flow of institutional credit to the weaker sections of the rural community, the Regional Rural Banks (RRBs) were set up in October 1975 co-sponsored by Central Government, State Governments and sponsoring Commercial Banks. These institutions were established with the intention of combining the advantages of local aspirations and knowledge of the co-operative institutions and modern banking practices of commercial banks. It was with the hope that these banks would be low cost institutions supplementing other credit agencies in the field of rural financing.

Making a scathing criticism on the operational efficiency of the rural credit agencies, the National Commission on Agriculture\textsuperscript{118} in its report submitted in 1976 pleaded for extending credit facilities to the small and marginal farmers on grounds of equity and optimum use of manpower and land. To facilitate the conversion of credit into inputs and services, a number of Farmers Service Societies were created.

A landmark in the progress of rural credit institutions had been the establishment of NABARD (National Bank for Agriculture and Rural

Development) in the year 1982 on the recommendation of the CRAFICARD Committee. This institution is today the apex bank for agriculture and rural development. The Vikas Volunteer Vahini (VVV), a programme of NABARD, introduced in November 1982 in selected areas, encompassed successful borrowers with a good repayment record who adhered to the principle of timely repayment of loan. It was stressed that repayment ethics was an integral part of the principles of development through credit disseminated through the programme.

In recent times, in the sphere of rural development, the commercial banks have adopted the Service Area Approach (SAA) under which a cluster of 20-25 villages are allotted to each rural and semi-urban branches. The policy initiative which was introduced in 1989, aimed at improving the credit delivery system and thus made bank branches effective instruments of rural development.

For improving access of rural poor to bank credit, NABARD launched a pilot project, under which 500 Self Help Groups (SHGs) were envisaged to be linked to the banks. The RBI had instructed all the scheduled commercial banks to take necessary action with a view to successfully implement the innovative method of reaching out to the poor. MYRADA [Mysore Resettlement and Development Agencies], a non-government organisation, has with the support of NABARD, played a leading role in organising the Credit Management Groups (CMGs) in the States of Karnataka, Andhra Pradesh and Tamil Nadu. Hereafter, credit planning would be from the grass-roots and aligned with the programme of the development agencies.
In the context of rural institutional credit, the Reserve Bank of India had, since independence, constituted a number of committees to study the structure and functioning of formal credit institutions in India.

In 1954, RBI instituted the Gorwala Committee119 to examine the rural credit system. It was set up in the light of the major developmental issue of that time which pertained to the supply of institutional credit, for raising the productivity of the agricultural sector. The report made far reaching recommendations with regard to credit structure, which later gave a new lease of life to co-operative institutions.

The Venkatappiah Committee120 appointed in 1969 looked into the issue relating to the credit needs of the agricultural sector, which had by then been experiencing technological transformation. Besides, the distributional inequality emerging from a stagnant economy of mid-sixties had also been focused upon. The Committee also examined the percolation of the benefits of economic growth and suggested specialised agencies to deal with the credit problems of potentially viable small and marginal farmers. The committee observed that if the fruits of development continued to be denied to a large section of the community, while prosperity accrued to some, the resulting social and economic tension would frustrate the national efforts to step up agricultural production.

The CAFICARD committee\textsuperscript{121} chaired by B. Sivaraman studied the rural credit system in the background of the 'Garibi Hatao' - a political slogan for poverty removal - programme launched in the seventies. It explored the prospects of how credit could be used as an instrument for bringing about a sustained improvement in the levels of living of the weaker sections of the rural society. As mentioned earlier, a fallout of this report has been the formation of NABARD as the apex institution for rural and agricultural development.

At the insistence of the World Bank, the Khusro Committee (1989) was set up to review the agricultural credit system in India. This Committee observed that in the face of the emerging agricultural technologies, and the secular shifts in the agricultural sub-sectors in favour of commercially oriented agriculture, the agricultural credit system would have to atune itself to the changes and its related problems. The report further stated that in a poverty ridden economy, financial institutions had a responsibility towards the weaker sections\textsuperscript{122}. Nonetheless, it was essential to recognise the limitations of credit as the principal instrument of poverty alleviation. It would, therefore, be necessary to have prudent norms for the selection of beneficiaries so as to avoid leakages, besides ensuring transparency of concessions and subsidies for understanding the lender-borrower relationship. The committee did envisage that a smaller social segment would operate in a socially tempered market system alongside a larger commercial segment responding to market forces.

\textsuperscript{121} RBI, \textit{Report of the Committee to Review Arrangements for Institutional Credit for Agricultural and Rural Development}, Bombay, 1981.

\textsuperscript{122} RBI, op. cit., 1989, pp. 705-718.
As a sequel to economic reforms and structural adjustment programme, the Narasimham Committee was appointed in August 1991. It was constituted at a time when commercial banks had developed certain rigidities and weaknesses, which threatened the viability of the Indian commercial banking system\textsuperscript{123}. The economic reforms along with trade and industrial policy liberalisation necessitated financial sector reforms in order to enhance the efficiency of financial intermediaries. The Committee essentially stressed upon the need for strengthening the rural banking system, and at the same time cautioned that the viability of the rural financial institutions would have to be maintained by restricting the flow of directed subsidised credit only to the weaker sections of the community.

Thus "Social Banking" in India has travelled very far from the "taccavi loans" granted during the British rule. Banking institution in India today has become socially conscious as well as, poor and weaker sections friendly. Probably, "Social Banking" in India is one of the best system in the world. Banks and other financial institutions have been statutorily required to keep a certain percentage of their disposable credit, for concessional lending to agriculture, the poor and weaker sections of the society.

4.5. A CRITIQUE OF SOCIAL BANKING

Normally, the financial system form the hub of the capitalist economy. Though Karl Marx recognised the importance of the financial system in the process of capitalist economic development, Keynes had become wary of the potential

\textsuperscript{123} RBL, op. cit., 1991, pp. 41-44.
damage that could be wrought by financial systems in capitalist economies. Most criticisms of social banking, revolve around issues on subsidised credit and the administered interest rate structure, government intervention through ownership and regulations, selective or directed credit policies and last but not the least, lack of market competition.

1. Subsidised Credit and the Administered Interest Rate Structure

The writings of Marx, Keynes, Tobin and Friedman have influenced monetary and financial policies pursued in many countries throughout the world. In particular, the objective of low or subsidised interest rates has been avidly followed in most industrialised and developing countries and in fact, Keynes’s liquidity trap did set a floor to the nominal rate of interest. There have been well-known political and religious objections to high, usurious or even non-zero interest rates. Neostructuralist led by Lance Taylor (1983) argued that raising interest rate increased inflation in the short-run through a cost push effect, and concurrently lowered the rate of economic growth by reducing the supply of credit in real terms.

Contrary to the above mentioned view, the financial repression school of Mckinnon and Shaw challenged the case for low controlled interest rates and financial repression. They advocated financial liberalisation and development as growth enhancing economic policies. In Mckinnon’s model, real money balances


were complements to, rather than substitutes for, tangible investments. Mckinnon\textsuperscript{126} (1973) argued that financial repression fostered dualism in developing economies. Traditional techniques with low productivities were found to operate alongside modern techniques with high productivities. Traditional techniques generated low incomes, while modern techniques produced high incomes. Shaw\textsuperscript{127} (1973) stated that low interest rates were the cause for market fragmentation, and repressive financial policies gravely retarded economic development.

The emphasis on credit as a development strategy is based on an argument given by T. Patrick\textsuperscript{128} (1966) that "Supply leading" finance stimulate growth by creating financial institutions in advance of the demand for their services. Patrick hypothesised that financial services, that could have a greater developmental impact, were relatively inexpensive to provide.

Subsidised credit, a politically sensitive issue, which had been thrown open to academic polemics, was generally considered as a panacea for poverty alleviation in the developing economies of the world. Opinions have differed on this issue and a group of economists\textsuperscript{129} strongly disputed the efficacy of subsidised credit. Critics

\begin{itemize}
\item 129. Mostly drawn from the World Bank and The Department of Agricultural Economics and Rural Sociology, The Ohio State University.
\end{itemize}
point out that a large component of concessional loans were invariably used for unproductive purposes.

Conceptually, interest rates are the price of the future in terms of the present, and when interest rates failed to perform their role as allocators of scarce capital resources, the available resources tended to be mis-allocated. Moreover, if interest rates were held below equilibrium levels, it could lead to a variety of undesirable results, such as reduction in savings, slower capital formation and inefficiency in investment. Further, subsidised credit did not cover the cost and risk associated with the administration of credit.

Contrary to the equity and income distribution goals envisaged by the proponents of concessional credit, it was rather observed that low interest rates (i.e. below market rate) had transferred substantial income subsidy to the relatively richer beneficiaries of institutional credit. This appropriation of credit due to political influence tended to widen the income gap between the rural rich and the poor peasants.\(^\text{130}\). Gonzalez-Vega\(^\text{131}\) (1981) also stressed that subsidised interest rate policies had a very adverse effect on resource allocation and on income distribution. Interest rate ceiling reduced small producer's access to credit and instead subsidised a few large producers. Further, with controlled interest rates, lenders resorted to implicit price setting that involved differential treatment to loan applicants in terms of loan allocation, disbursement, monitoring and supervision.


This implicit price setting procedure enabled the lenders to exclude or ration unwanted clients. Gonzalez-Vega concluded that real rates of interest should be generally positive, if the goals of efficiency and equity were to be realised.

A study on the efficacy of subsidised lending by Adams and Vogel\textsuperscript{132} (1986) affirmed that low equilibrium rates of interest coupled with targeted lending had substantially weakened the capital base of financial institutions in less developed countries. Extensive loan targeting not only increased the per unit cost of lending, but also created instability in the financial market.

The issue of subsidised credit was also crucial for the Indian financial institutions whose growth has outpaced economic development. Sukhmoy Chakravarty\textsuperscript{133} (1987) in his analysis of the Indian development planning strategies stated that equity goals could be better achieved through budgetary means rather than through subsidised banking. The application of any rigid mechanical rule such as targeted lending would be detrimental to social banking. Ranade\textsuperscript{134} (1984) mentioned that subsidised interest rates were neither conducive for development of the weaker sections nor for the priority sector. He opined that credit as a re-distributive mechanism could achieve validity only if its allocation to the weaker sections is accompanied by increases in their productivity levels and


income. Datey\textsuperscript{135} (1978) confirmed that subsidies for agricultural credit had not resulted in any significant increase in productivity. Dandekar\textsuperscript{136} (1988) had pointed out that rigidly administered interest rates adversely affected both mobilisation of deposits from farmers and recovery of loans disbursed to them. The existing interest spread was not adequate to cover the transaction costs as well as credit risk. A phenomenon widely observed consequent to the availability of subsidised credit, was the diversion of borrowed funds for purposes other than for what they have been availed for\textsuperscript{137}. Hence, fungibility of credit was largely attributable to the low cost of borrowing and to credit being targeted and rationed.

Bottomley and Nudds\textsuperscript{138} (1969) from their analysis of credit supply in underdeveloped rural areas pointed to the fact that there was an inverse correlation between returns on loan investments and interest changes, and directly to the cost of servicing the loan. Hence, banks must increase the size of their productive loanable funds. Anyatonwu\textsuperscript{139} (1983) analysed the relationship between economic development of Nigeria and commercial bank expansion and found that in rural

\begin{itemize}
\item \textsuperscript{135} C.D. Datey, "The Financial Cost of Agricultural Credit: A Case Study of Indian Experience". \textit{Staff Working Paper} No. 296, World Bank, Washington, D.C., October 1978.
\item \textsuperscript{138} A. Bottomley, and D. Nudds, "A Window Cruise Theory of Credit Supply in Underdeveloped Rural Areas", \textit{The Manchester School of Economics and Social Studies}, Vol. 37, No. 2, 1969, pp. 131-140.
\end{itemize}
areas, availability of credit influenced the demand for money function, rather than the cost of credit, both in the organised and unorganised money markets.

Ladman and Adams\textsuperscript{140}, (1978) revealed in their findings that the sheer fact of a large number of farmers borrowing from informal market lenders at high interest rates would suggest that the credit demand schedule for farmers was relatively inelastic. Suffice it to say that, the quantity of credit demanded by individual farmers would not decline substantially if the interest rates were high. Bandyopadhyay\textsuperscript{141} (1984) while discussing about the high rates of interest in unorganised credit markets made an incisive remark that even if the real costs of lending were high, the extension of cheap credit by the institutions would not effectively reduce the rural market rates of interest.

While delivering the 1993 Sir Purshotamdas Thakurdas Memorial Lecture, the former Governor of the Reserve Bank of India and Director of London School of Economics, I.G. Patel\textsuperscript{142}, remarked that the major advantage of phasing out concessional loans would be greater availability of credit and a renewed interest in the productivity of the investment financed. The lending institutions considered concessional loans as gifts to be grudgingly given away, at times for a consideration. This gratuitous act occasionally warranted the borrowers to wilfully


\textsuperscript{141} A.K. Bandyopadhyay, \textit{Economics of Agricultural Credit : With Special Reference to Small Farmers in West Bengal}, Agricole Publishing Academy, New-Delhi, 1984.

default repayments. A nagging danger that goes along with subsidised lending was that credit was also treated as a political right in sharing the scarce financial resources, being shorn of any reciprocal obligations for repayment of loans.

An unavoidable consequence of subsidised lending was the inevitable increase in the demand for institutional loans which inadvertently distorted the loan market structure and eventually led to rationing of credit. Inadequate loans from formal lenders would compel borrowers to avail of loans at usurious rates from informal lenders. To conclude, interest rates below the opportunity cost of capital could seriously limit the contribution of financial markets to the cause of economic development. It was therefore the adequacy of credit and timeliness that were more crucial to the borrower than its subsidised cost.

4.6 GOVERNMENT INTERVENTION THROUGH CENTRAL BANK'S SELECTIVE CREDIT POLICIES AND ITS IMPACT ON THE COST OF CREDIT.

Governments intervened in the financial sectors of developing countries to influence the allocation of credit with a view to accelerate economic development. Intervention was predominantly of the nature of targeted lending and credit ceiling, along with credit guarantees, administered interest rates, refinance schemes and subsidies. Selective credit policies aimed at channelising investible funds through a non-price rationing system to such priority investment projects that the state believed might not be undertaken at higher interest rates. The previous section has highlighted the major flaws and deficiencies that were explicitly or implicitly
intertwined with subsidised credit. Nonetheless, it was equally pertinent to examine the inherent dangers of direct government intervention in the banking sector and the defects in central bank's selective credit policies.

That aggressive pursuit of selective credit policies or credit planning has given rise to extensive financial layering, is evident from the multi-stage and multi-agency approach to lending followed by a large number of public sector-financial institutions in India, Indonesia, Korea, Philippines and many African countries. Virmani\textsuperscript{143} (1982) pointed out that mandatory lending, as part of selective credit policy, induced high loan arrears. Analysing and commenting on the Indian financial system, Felipe\textsuperscript{144} (1985) stated that it was the excessive government intervention in the functioning of formal credit institutions which was responsible for the structural weaknesses in the banking system. He further added that implementing selective credit policies did involve substantial administrative costs to the bank. Cost of financial intermediation referred to the spread between the gross cost of borrowing and the net returns to lending. There are three major components of transaction costs:-

1. Explicit or resource cost attached to labour, capital and maintenance;

2. Cost of lending, which included processing, disbursement, monitoring, loan recovery, assessment of collateral and documentation; and

3. Implicit or risk cost associated with loan default.


Non-price competition under directed lending was said to incur higher resource cost, and transaction costs (explicit or implicit) acted as price signal in loan transactions. Further, the cost of obtaining a loan would also depend upon the administrative structure, as well as procedures and norms followed by the formal lending institutions\textsuperscript{145}.

Empirical studies did indicate that there was a regressive distribution effect i.e. smaller loans bearing high costs vis a vis large loans entailing the lowest transaction costs. This was primarily due to an increase in marginal cost, which rose less than proportionate to the increase in loan size. This phenomenon had been endorsed by Ahmed\textsuperscript{146} (1989) for commercial banks functioning in rural Bangladesh. While comparing transaction costs of borrowing from both formal and informal sources, he found that transaction costs of loans for formal lenders were higher than those of loans from informal lenders. Moreover, transaction costs per unit of loan decreased with loan size and was relatively faster for formal loans. Thus, the effective cost for small loans from formal lenders was higher than that for large loans, and hence, large borrowers benefited from the subsidy in formal credit markets. Gonzalez-Vega\textsuperscript{147} (1983) developed a model to show how concessional interest rates on loans discouraged formal lenders from lending to the


\textsuperscript{147} C. Gonzalez-Vega, Arguments for Interest Rate Reform, In J.D. Von Pischke et al (eds), \textit{Rural Financial Markets in Developing Countries}, EDI Series of World Bank, The Johns Hopkins University Press, 1983.
rural poor, especially when lenders incurred relatively high transaction costs of lending in rural areas.

Adams and Nehman\textsuperscript{148} (1979) have stated that excessive total costs of borrowing from formal institutions, due to high borrower’s transaction costs, discouraged many rural borrowers in developing countries from using formal sources of credit. Ladman\textsuperscript{149} (1984) corroborated this finding by developing a model to explain that borrower transaction costs resulted chiefly from the rationing mechanism adopted by formal lenders who were confronted with high transaction costs. The formal lenders were unable to recover these costs due to policy constraint set by the Central Bank in the form of fixed concessional lending rates.

Timberg and Aiyar\textsuperscript{150} (1984) estimated the transaction costs of financial intermediation and found the cost to be lower in informal markets. They further apprehended that high transaction costs coupled with targeted lending to selected formal borrowers, would eventually cause a net decrease in available funds and thereby decelerate economic activities. Preemption of loanable funds by the priority sectors did have a debilitating effect on the non-priority sectors in India. In this


context Bharadwaj\textsuperscript{151} (1979) had referred to the speculative trading activities in agricultural commodities by traders who had easy access to institutional credit.

Bishnoi\textsuperscript{152} (1991), on examining the impact of priority sector credit on public sector bank's profitability remarked that poor recovery and concessional interest rate factors had adversely affected the profitability of banks. He empirically proved that administrative costs and risk of delivering priority sector credit were higher than those for commercial credit and did weaken the viability of priority sector lendings. He suggested that there needed to be some trade-off between social and commercial considerations of priority sector credit to ensure the efficient functioning of public sector banks.

From previous studies on banking and development, the findings of Khatkhate and Villanueva\textsuperscript{153} (1978) and observations of Lanyi and Saraconglu\textsuperscript{154} (1983) did emphatically stress on the negative effects of selective credit policies on the productivity of investment. An empirical study by Ketkar\textsuperscript{155} (1993) also indicated that although the bank nationalisation policy in India had been successful

\textsuperscript{151} Krishna Bharadwaj, "Towards a Macroeconomic Framework for a Developing Economy: The Indian Case", Manchester School of Economic and Social Studies, Vol. 47, No. 3, September 1979, pp. 270-302.


in raising saving and investment levels, it had rather failed to fulfil the social objectives of priority sector lending. In short, selective credit policies tended to reduce, rather than increase, the efficiency of resource allocation by banking financial intermediaries. Credit ceiling reduced efficiency in two ways:

1. It imposed an uneven rationing criterion because of the customer-market nature of bank credit; and

2. It reduced efficiency by destroying competition for deposits.

On examining the working of financial markets in developing countries, Cho (1985), found that deposit and loan rate ceilings worsened the distribution of income. Besides, most of the economic rent went to large borrowers rather than to small savers/lenders, when deposit and loan rates were held well below their market equilibrium. Further, income distribution was found to be worse where the borrowing firms were predominantly family owned companies. Capital intensive production methods invariably reduced the demand for labour. Hence, in practice, bank loans tended to remain confined to a small number of large and well established clients, and this concentration of bank credit reduced economic efficiency of banks. It could be said that criticism of banking systems in developing countries sprang from the evident lack of competition. As a sequel to this, Indonesia and Korea abolished credit controls on individual banks in the early 1980’s, in order to improve the efficiency of financial intermediation.

In his contribution to the debate over bank nationalisation in Britain, James Robertson\textsuperscript{157} (1974) asserted that government regulation and sanction had been responsible for uncompetitive and unresponsive banking. Dimitrijevic and Macesich\textsuperscript{158} (1973) concluded from their study that in Yugoslavia the principal deficiencies in the financial institutions came from their administrative character and strong government influence. And finally, to conclude this discussion, Wiggins and Rogaly\textsuperscript{159} (1989), commenting on the functioning of commercial banks in India, stated that organisationally, banks were bureaucratic and hierarchically structured, and power was exercised in line with established written procedures. Formality, professionalism and paper records were hallmarks of Indian banking.

In the light of the above criticism, it is suggested that the goals of social banking could be more effectively achieved by the banking institution operating in tune with market forces, rather than being guided solely through state intervention. But at the same time, it is also prudent to keep in mind the fact that in contemporary developing societies, the state and market are two extremely influential social institutions, and as rightly remarked by Kurien\textsuperscript{160} "both have

\textsuperscript{157} James Robertson, "The Argument Continues......", Banker’s Magazine, February 1974, pp. 35-36


\textsuperscript{160} C.T. Kurien, Growth and Justice: Aspects of India’s Development Experience, Oxford University Press, Madras, 1992, p. 246.
profound influences on economic processes, and their roles in economic processes cannot be sharply differentiated".

This being so, it could be construed that if the state functioned in collaboration with other social institutions, it could effectively influence and guide market forces to achieve "social equity" along with "economic efficiency".