

## Rural Credit

*Robini Pande*

In 2000, over seventy percent of India's population, and roughly three quarters of its poor, lived in rural areas. The main livelihood in rural India remains agriculture, an activity characterized by significant time-lags in production and a high degree of sensitivity to weather conditions. These features of agricultural production make access to financial instruments critical to a rural household's ability to smooth income shocks and make long-term productive investments. However, as is well known lenders' inability to perfectly identify the credit-worthiness of potential borrowers and the cost of enforcing repayment places severe restrictions on rural households' access to credit. These problems are potentially more severe for the rural poor who are less able to reduce lender risk by providing collateral. This also has implications for the geographical distribution of formal credit lenders. Anticipating insufficient profits, lenders such as commercial banks, may choose not to set up branches in relatively poor rural areas. This, in turn, by giving lenders in the informal sector monopoly power may further raise the interest rates faced by the rural poor and restrict their access to affordable credit. Banerjee (2004) provides evidence that informal interest rates in India are high and exhibit significant variation.

A belief that the welfare costs of exclusion from the banking sector, especially for the rural poor, are high has led to widespread government intervention in the banking sector of low income countries. Examples of such interventions range from interest rate ceilings on lending to the poor to State-led branch expansion in rural areas. India was home to some of the largest policy interventions aimed at providing banking for the poor. The motivation for the Indian interventions can be traced to the All-India Credit Survey Report (1954). This report showed that four years after independence, the informal credit sector accounted for the bulk of rural lending, with moneylenders contributing close to 70 percent of the total. The average annual interest rate on these loans exceeded 20 percent. In contrast, less than one percent of the borrowing was accounted for by commercial banks. Commercial banks remained confined to urban areas and geared towards the financing of trade and commerce activities. The survey data also showed a strong positive relationship between asset ownership and borrowing. The Report concluded that financial backwardness was a root cause of rural poverty, and that commercial banks needed to be harnessed to enhance formal credit in rural areas — both to enable poor, rural households to adopt new technologies and production processes, and to displace 'evil' moneylenders who exploited their monopoly power to charge high rates of interest.

The conclusions of this Report have guided Indian government's policy towards rural credit markets. By 1991, according to the All India debt and investment survey, the share of moneylenders in total credit had reduced to 15 percent, and the share of commercial banks soared to 29 percent. Equally striking is the fact that by 1991 the probability of having a rural household having a formal loan was only weakly correlated with the amount of land it owned. At the same time, the total number of locations with at least one bank branch had increased from under 2,000 in 1951 to over 30,000. By the year 2000, the Indian rural banking sector accounted for the rupee equivalent of 26,768 million dollars as deposits and 10,834 million dollars as loans outstanding. In terms of population reached, the rural sector accounted for 125 million savings accounts and 25 million borrowing accounts.

A proximate reason for these changes in borrowing practices was the fact that the Indian government, and Central Bank followed an aggressive policy of state intervention in rural credit markets, often described as 'social banking'. The policy instruments to achieve these objectives included the expansion of the institutional structure of formal-sector lending institutions; secondly, directed lending; and thirdly, concessional or subsidized credit.

In 1969 the fourteen largest Indian commercial banks were nationalized, at which point they came under the direct control of the Indian central bank and were formally incorporated into the planning architecture of the country. Bank nationalization was intended to allow the state to target financial backwardness as a means of promoting social objectives. A central aim was to reduce and equalize the average population per bank branch across Indian states. To achieve this the Indian central bank adopted an area approach whereby unbanked locations — census locations with no prior presence of commercial banks — were targeted. The Indian central bank, however, still needed to coerce commercial banks to expand into unbanked, rural locations. In particular, in states where unbanked locations were remote and/or unprofitable. Under the Banking Regulation Act of 1949 commercial banks have to obtain a license from the central bank in order to open a new branch. On January 1, 1977 the Indian central bank announced that to qualify to open a branch in an already banked location a commercial bank must open four in unbanked locations. This licensing rule was frozen in 1990 when India began liberalizing the economy, and was formally repealed in 1991. At this point it was deemed that future branch expansion should depend on “need, business potential and financial viability of location”.

A second feature of the Indian social banking program was an emphasis on directed bank lending towards sectors deemed as priority sectors (these included agriculture and small scale industries), and within these sectors to individuals belonging to weaker sections of society. The latter included members of the historically disadvantaged scheduled castes and scheduled tribes. In 1980 the Indian central bank formalized its directed lending policy by requiring that, by 1985, 40 percent of all bank lending go to priority sectors. Moreover, 25 percent of this lending must go to individuals belonging to the weaker sections. While these targets remain to date, bank compliance with these targets sharply reduced after financial liberalization.

The success of the Indian social banking program in expanding the presence of commercial banks in rural India is incontrovertible. Much more debated, is the question of whether commercial banks in rural India affected the extent and type of economic activity in rural areas, and whether they affected poverty and inequality. The extent to which credit disbursements by the banking sector were based on need rather than political power is also debated. Finally, the extent to which any economic gains were due to productive investments associated with credit provision, rather than simply attributable to the redistribution of resources through the banking sector remains unclear.

Burgess and Pande (2005) use panel data for Indian states, 1961-2000 to examine whether the bank branch expansion program affected state output and poverty outcomes. The typical problem with examining this relationship is the fact that banks are prone to open more branches in richer states. Not accounting for this fact can lead to biased estimates of the relationship between branch expansion and economic outcomes. Burgess and Pande address this problem by exploiting the fact that between 1977 and 1990 more bank branches were opened in financially less developed states. The opposite was true outside this period. This change in the trend relationship between a state’s financial development and branch openings allows them to isolate the policy-driven part of branch expansion and to use that to examine how this expansion affected the Indian economy. They show that branch expansion was associated with an increase in the shares of rural credit and savings. In keeping with earlier studies, they also find that the branch expansion increased non-agricultural, but not agricultural, output. In companion work, Burgess, Pande and Wong (2005) used household data from the National Sample Survey to show that the simultaneous enforcement of directed bank lending requirements was associated with increased bank borrowing among the poor, in particular low caste and tribal groups.

On the flip side, it is also true that commercial banking in rural India remained unprofitable. The average default rate for commercial banks during the 1980s stood at 42 percent (as a share of all

loans due for repayment). Default rates were very similar across types of borrower — a finding consistent with poor monitoring of borrowers at all levels, and the fact that large scale loan defaults were very often politically condoned. ref cole

In the end, it was the relative unprofitability of rural banking which led to the demise of social banking in India. In 1991, at the outset of liberalization of the Indian economy, the Report of the Committee on the Financial System stated that redistributive objectives “should use the instrumentality of the fiscal rather than the credit system” and that directed credit programmes be phased out and that branch licensing policy be revoked. As a result post-1991 rural branch expansion has been limited and multiple studies suggest that access of the rural poor to the banking sector reduced. The share of rural banks in total banks has fallen from 58 percent in 1990 to under 50 percent by 2000 and the share of total bank credit that went to rural areas declined, from 15.3 per cent in 1988 to 10.6 per cent in 2000. The policy recommendation is that this reduction in formal sector lending be filled by micro-credit institutions. Despite impressive advances by the Indian micro-credit sector it is still unclear whether they will be able to achieve a mobilization of rural savings and a credit outreach which equalled the achievements of the Indian social banking experiment in the 1970s and 1980s.

## References

Banerjee, Abhijit, [2004], "Contracting Constraints, Credit Markets and Economic Development" in M.Dewatripont, L.Hansen and S.Turnovsky, eds. *Advances in Economics and Econometrics: Theory and Applications*, Cambridge University Press.

Burgess, R. and R. Pande (2005), "Can Rural Banks Reduce Poverty? Evidence from the Indian Social Banking Experiment", with R.Burgess, *American Economic Review*, Vol. 95 (3), pp. 780-795.

Burgess, R., R. Pande and .Wong (2005) "Banking for the Poor: Evidence from India" *Journal of the European Economics Association Papers and Proceedings*, Vol. 3 (2-3), pp 268-278 April-May.

Government of India [1991], "Report of the Committee on the Financial Sector" chairman M. Narsimhan, Ministry of Finance, Delhi .

Reserve Bank of India, [1954], 'All-India rural credit survey: report', Report of the Committee of Direction of the All India Rural Credit Survey, Mumbai.

.