

Rural Credit in 20th Century India

An Overview of History and Perspectives

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This brief overview of rural credit in 20th century India finds a remarkable continuity in the problems faced by the poor throughout this period. These include dependence on usurious moneylenders and the operation of a deeply exploitative grid of interlocked, imperfect markets. We articulate the theoretical and historical case for nationalisation of banks and provide evidence of its positive impact on rural credit and development. Certain excesses led to reforms unleashed in the 1990s. This did increase bank profitability but at the cost of the poor and of backward regions. While the MFI model of microfinance is unsustainable, the SHG-Bank Linkage approach can make a positive impact on security and empowerment of the disadvantaged. Much more than microfinance is needed to overcome the problems that have persisted over the last 100 years.

Introduction

This brief overview of rural credit in India begins in the 19th and ends in the 21st century but it is primarily concerned with the major episodes of the 20th century. The historical narrative pays close attention in each case to the perspectives that informed changes in policy and also documents the impact of these changes. We begin with a description of rural credit in the late-colonial period. The problems faced by India's villages display a remarkable continuity from this situation throughout the period being studied. Dependence on usurious moneylenders and the operation of a deeply exploitative grid of interlocked, imperfect markets afflicts the rural poor. After a review of the weak performance of cooperative credit institutions in India, we articulate the theoretical case for nationalisation of banks in 1969 and document its positive impact on rural credit and economic development. However, we also suggest that certain excesses in the two decades following nationalisation created a basis for the reforms unleashed in the 1990s. While these reforms have undoubtedly increased bank profitability, their impact on availability of affordable rural credit to the poor and India's backward regions, has been extremely adverse. The moneylenders have made a definite comeback. We appraise the attempt of the microfinance sector to address this crisis through an examination of its two main approaches. We suggest that while the Microfinance Institution (MFI) model is unsustainable and might actually end up worsening the situation for the poor, the Self-Help Group-Bank Linkage (SBL) approach has the potential to make a decisive impact on security

and empowerment of the most disadvantaged in the current context of farmers' suicides. It may also be critical in positively influencing profitability of banks in remote rural areas. Finally, we argue that much more than microfinance is needed to overcome the problems that have persisted over the last 100 years.

Late Colonial Period

Usurious moneylending practices are very well documented in many official reports from the colonial period. Perhaps the most important is the Central Banking Enquiry Committee (CBEC) report (1929) and its associated Provincial reports, of which the Madras Provincial Banking Enquiry Committee (MPBEC) report is regarded as a classic. It explains how the mechanisms of debt typically had a cumulative force:

"Frequently the debt is not repaid in full and a part of the loan persists and becomes a pro-note debt. In the course of time, it may with a lucky year be paid off or it may become a mortgage debt. By the existence of this heavy persisting debt, the creditor takes the bulk of the produce and leaves the ryot unable to repay short-term loans. But equally, the short-term loan has produced long-term debt and there is a vicious circle. The ryot cannot clear his short-term debt because of the mortgage creditor and he cannot cultivate without borrowing because his crop goes largely to the long-term creditor. If he pays his long-term creditor his current debts swell and overwhelm him" (MPBEC Report, 1930, Vol. I, p.77).

Thus, repayment of debts was a major compulsion for farmers to sell their crop and the creditor usually insisted on repayment in the immediate post-harvest period. To do this the debtors were forced to borrow once again. The MPBEC found that repayment of 'prior debts' was by far the single most significant motivation for borrowing in 1929. And one of the most important sources of credit were rich landowners, for whom the mortgage mechanism was an ideal means to get control over larger tracts of land through the vicious cycle of debt. This did not necessitate actual dispossession, especially in periods when the mortgage value of land was lower than its price (ibid, Vol. I., pp.64-65, 78).

Moneylenders' power was reinforced through the grain loans they made to poor proprietors, tenants and labourers.¹ Rates of interest were generally higher for the poorer cultivators, partly because they made greater resort to grain loans but also reflecting their generally more vulnerable position (ibid, Vol. II, p.403). Creditors sought to exploit this

¹ These loans were commonly repayable in kind at harvest. Rates of interest on these loans were generally double of those on loans in cash. While the latter ranged from 12-24%, the former lay between 24-48%. In years of famine, they could go up to even 50-60%.

vulnerability by cheating in various ways for it was they who kept the accounts, if any, did the grain measurements and had a more accurate knowledge of prices. The 1935 Report on Agricultural Indebtedness provides instances of moneylenders who kept accounts but never revealed them to debtors, to whom they never provided receipts either. They recorded higher rates of interest on the pro-notes than they actually charged. The amount repaid was generally not deducted while calculating future interest dues, nor were the principal and interest separately accounted. If repayment was not made in instalments previously agreed to, a higher 'penal' interest was charged.

Another oppressive nexus involved the purchaser of crops, who in several cases was also a moneylender. In such cases, the debtor had to sell his produce at a pre-arranged time, usually the immediately post-harvest period, and at a price which was lowered to take account of the interest on the loan.² Such producers, who lacked the requisite storage and transport facilities to take advantage of price variations, both inter-spatial and inter-temporal, were forced to sell off the ground, as it were, immediately after the harvest.³ Finally, the fact that they had to buy back grain in the peak price period made them even more inextricably trapped in debt for they had to borrow in order to buy.

Tenants, who formed a very significant proportion of the working population in the colonial period, were the worst affected because for them an extra source of exploitation was added -- the rent-relationship. Rent payments were generally fixed for the immediately post-harvest period. This was particularly tough on tenants who paid rents in cash. Tenants were not allowed to lift the crop off the ground until the rent had been paid. Since leases were usually renewed every year, pressure on tenants to pay rent was intense. In case rent was not paid in time, high rates of interest were charged on the unpaid amount. When land was leased following a mortgage, the rent charged was equivalent to the interest (MPBEC Report, 1930, Vol. I, p.47).

The colonial administration was aware of this problem and made several, if somewhat feeble, attempts to grapple with it. The first was the enactment of the Deccan Agricultural Debtors' Relief Act (1879) that authorised courts to stop charging of usurious

² Oral evidence to the MPBEC by a landowner in 1929: "The merchants advance loans on condition that crops grown by the agriculturist should be sold to them wholesale as soon as they are harvested at a price 4 percent less than its market value. If he fails to satisfy this condition, the merchant refuses further advances and enforces the payment of the loan through the Court" (MPBEC Report, 1930, Vol. II, p.403).

interest and sales of land as a result. Similar Land Alienation Acts were passed in Punjab, United Provinces and Central Provinces and Berar (Chandavarkar, 1984, p.799). The late nineteenth century also saw Land Mortgage Banks being set up. Low interest loans were provided after the Land Improvement Loans Act of 1883 (for long-term loans) and the Agriculturists Loan Act of 1884 (for current needs). But these loans remained extremely sparse and ineffective. The success of the co-operative movement in Europe prompted the passage of the Cooperative Credit Societies Act in India in 1904. Real government encouragement of cooperatives started with the more comprehensive Cooperative Societies Act of 1912. After the 1915 Maclagan Committee on Cooperation, provincial cooperative banks were established in almost all major provinces by 1930.⁴ But unlike Europe, cooperatives in India found it very hard to get going. The sharp socio-economic divisions in rural India appeared to overwhelm the very idea of "cooperation". The cooperative credit societies were "run in most cases by rich landlords and moneylenders" (Baker, 1984, p.229). These societies were embroiled in local power politics and were a source of rural patronage and influence. In the words of a witness testifying before the Royal Commission on Agriculture, in these societies "outcaste men will not get a loan unless they promise to sell their labour to the caste man who is a member of the panchayat at a lower rate than he can get in the market" (RCA Report, 1929, Vol.III, p.410). The witness went on to describe his experience at an Annual General Meeting of a cooperative credit society where "the Director sat on one side of the street and the outcaste sat on the other" (loc.cit.). In a study of rural credit in western India (1875-1930), Catanach (1970) finds that cooperatives only became an addition to the dealings of the rural moneylender, not an alternative to him.

The Usurious Loans Act, passed in 1918, sought to apply the *damdupat* principle (interest never exceeding principal) to debts. The CBEC estimated in 1929 that the accumulated burden of inherited rural indebtedness in India was Rs.900 crores. The steep fall in agricultural prices during the Great Depression opened the floodgates of legal suits for attachment of lands of borrowers. The official response was a spate of Debt Conciliation Acts between 1933 and 1936 by the governments of CP and Berar, Punjab, Assam, Bengal and Madras. But in his classic enquiry into rural indebtedness in 1941, BV Narayanswami

³ Rice farmers had to sell paddy rather than rice, prices of which were both lower and more variable than those of the latter (Report on the Marketing of Rice in India and Burma, 1942, especially, pp.151-152).

⁴ Only in UP they were established in 1944.

Naidu concluded, "after existing for about seven years, the Debt Conciliation Boards were abolished as not having been of any considerable practical utility" (Naidu, 1946, p.52). The complicated administrative machinery involved in these Boards and the fact that they had no coercive powers explains their poor performance. The Punjab Regulation of Accounts Act (1930) and the Debtors Protection Acts of 1935 provided for compulsory licensing and registration of moneylenders and proper recording of transactions and accounts. However, these Acts proved "by and large, a dead letter . . . not least because of the understandable reluctance of debtors to bring moneylenders, often their sole source of credit to court" (Chandavarkar, 1984, p.800). Ironically, the Madras Agriculturist Debt Relief Act (1938) suffered for the opposite reason when several powerful creditors petitioned the courts questioning it (Naidu, 1946, pp.52-53).

It is clear that the strength of the debt-mechanisms remained largely unimpaired by the activities of the colonial state.⁵ This is why the statement by one of colonial Punjab's legendary administrator-scholars Malcolm Darling (1925) that "the Indian peasant is born in debt, lives in debt and dies in debt" has become a classic of Indian economic history. This condition resulted from an interlocking of a number of imperfect markets (land, input, output, labour and land-lease markets) with the credit market, which itself was characterised by deep imperfections. The moneylender was not merely a source of credit; he often combined the roles of crop buyer, labour employer and land lessor. "Real" rates of interest were then not just the "rate" charged. They were hidden also in the lower price paid for produce sold, exploitative wage rates and rents charged for land leased. This interlocked grid worked in tandem with the oppressive caste system as a powerful nexus of exploitation, which became the basis for the pauperisation of the peasantry in the colonial period. The balance of power was terribly skewed against the poorer, "lower" caste farmers, who faced a cumulative and cascading spiral of expropriation. In such a situation, productive investments were virtually impossible to visualise for the vast majority of India's peasants. Worse, even basic consumption needs were hard to meet, with an external ecological crisis such as a drought, being enough to tilt the balance and endanger survival itself. Especially when the state provided little or no social security.

⁵ Witnesses giving evidence before MPBEC held this mechanism to be the main force leading to the conversion of landowners into tenants and labourers which they saw as the "order of the day" (MPBEC Report, 1930, Vol. II, pp. 407, 584).

1947-1969: Focus on Cooperatives

The historic All India Rural Credit Survey (AIRCS) carried out in 1954 confirmed that formal credit institutions provided less than 9% of rural credit needs in India (see Table 3 below). Moneylenders, traders and rich landlords accounted for more than 75% of rural credit. Cooperative credit societies had already been in existence for 50 years but their share in rural credit was still less than 5 percent. The 1945 Cooperative Planning Committee had discerned early signs of sickness in India's cooperative movement, finding that a large number of cooperatives were "saddled with the problem of frozen assets, because of heavy overdues in repayment" (GoI, 2005, p.8). Even so, in the 1950s and 1960s, the way forward was seen to lie in cooperative credit societies. These cooperatives were to take the lead in the Integrated Scheme of Rural Credit suggested by the AIRCS. The share of cooperatives in rural credit did rise to cross 20% in 1971. Today, India's cooperative credit structure (CCS), with over 13 crore members (including 6 crore borrowers), constitutes one of the largest rural financial systems in the world. The over 1 lakh Primary Agriculture Credit Societies (PACS) can, in many ways, be regarded as the veritable bedrock of India's rural economy. The CCS has 50 percent more clients than commercial banks and Regional Rural Banks (RRBs) put together. Directly or indirectly, it covers nearly half of India's total population (GoI, 2005, p.15). The CCS services farm input distribution, crop production, processing and marketing as also dairying, weaving and textiles.

However, the CCS has never realised the enormous potential opened up by its vast outreach. According to the Task Force on Revival of Rural Cooperative Credit Institutions, this owes mainly to a "deep impairment of governance" (GoI, 2005, p.18). While they were originally visualised as member-driven, democratic, self-governing, self-reliant institutions, cooperatives have over the years, constantly looked up to the state for several basic functions. The Task Force describes in detail how state governments have become the dominant shareholders, managers, regulators, supervisors and auditors of the CCS. The concept of mutuality (with savings and credit functions going together), that provided strength to cooperatives all over the world, has been missing in India. This "borrower-driven" system is beset with conflict of interest and has led to regulatory arbitrage, recurrent losses, deposit erosion, poor portfolio quality and a loss of competitive edge for the cooperatives (GoI, 2005, Ch.III). Domination by richer elements in the rural elite that

characterised cooperatives in the colonial period continues to be an abiding feature of these institutions even after independence.⁶

1969-1991: Nationalisation of Banks

In 1951, the AIRCS found that the share of banks in rural credit was less than 1 percent.⁷ Even through the 1950s and 1960s, the role of private commercial banks in rural credit remained minimal and indirect. The AIRCS itself had wanted involvement of these banks in agricultural marketing and processing but not directly in farm output. Rural branches of commercial banks were few and far between despite a 1954 RBI directive for them to open at least one branch in unbanked rural and semi-rural areas for every branch opened in previously banked areas (Meyer and Nagarajan, 2000, p.172). The Imperial Bank of India⁸ was nationalised in 1955 and the new State Bank of India⁹ was asked to open 400 branches in semi-urban areas and start agricultural lending, even if at a loss. Even so right up to 1971, the share of banks in rural credit was no more than 2.4 percent and most of these loans were made to plantations. Their main activity was to finance agro-processing firms and purchase of bonds floated by land development banks. Until the end of the 1960s, the overwhelming share in commercial bank credit was that of industry (62 percent) and trade and commerce (26 percent). Within industry, the distribution of credit was skewed in favour of large borrowers (Sen and Vaidya, 1997). It has also been alleged that "advances by private banks were diverted to sister companies of the banks or to companies in which their directors had an interest" (Chandrashekhar and Ray, 2005, p.12).¹⁰ Thus, cooperatives remained dominated by the rural elite and banks continued to have an urban bias throughout the twenty years after independence.

In trying to understand the case for nationalisation, it is useful to remember that government control over banking was the norm in most low-income countries in the four

⁶ We must remember that membership of PACS is restricted to only those who own land. Not only do larger landowners dominate them, the landless poor have no access to PACS.

⁷ Chandavarkar (1984, p.782) suggests that Indian banks in the colonial period ignored rural credit and specialised in short-term credit for trade against conventional collateral.

⁸ Set up in 1921 by merging the Presidency Banks of Bombay, Bengal and Madras

⁹ In 1959, eight major state associated banks were made subsidiaries of the SBI

¹⁰ A similar phenomenon was observed by Keynes in the British context in the 1920s (Keynes, 1927, Vol. II, pp.364-65)

decades after the First World War (Burgess and Pande, 2002, p.3). Similar state-led rural finance programmes spread across the developing world in the post-colonial period. State control over banking to act as an engine of structural change and the attack on poverty was part of the orthodoxy of development economics at that time (Besley, 1995). Even though they lament it, La Porta et al (2002), assemble data on government ownership of banks around the world, which show that such ownership is large and pervasive. In the average country, more than 40 percent of the equity of 10 largest banks remained in government hands even as recently as 1995.¹¹

Theoretical Case in Development Economics

Perhaps the first intellectual case for nationalisation of commercial banks in India was made in a public lecture delivered by KN Raj in 1965 (Raj, 1974). Raj felt "there are important reasons why banking enterprises seeking to maximise their profits would not venture out into areas and sectors of activity to which high priority needs to be attached from a larger social and economic point of view" (Raj, 1974, p.308). Thus, rural credit was not merely a commodity that needed to reach the poor to free them from usurious moneylenders, it could also be seen as a *public good* critical to the development of a backward agrarian economy like India. Especially as Indian agriculture moved decisively into the Green Revolution phase, where private investments by richer farmers needed massive credit support.

Private banks operating in an imperfect credit market would only aggravate already existing imperfections. Keynes and Kalecki had already provided the theoretical foundations of this view in the 1930s. As Kalecki put it, "the most important prerequisite for becoming an entrepreneur is the ownership of capital . . . firms below a certain size have no access whatever to the capital market . . . a state of business democracy where anybody endowed with entrepreneurial ability can obtain capital for starting a business venture is, to put it mildly, unrealistic" (Kalecki, 1954, pp. 91-95). In the *General Theory*, Keynes expresses the problem a little differently. He distinguishes "two types of risk that affect the volume of investment" (Keynes, 1935, p.144). The borrower's risk arises because she is unsure whether her business venture will provide the expected yield. She would want a low rate of interest,

¹¹ Even in the United States, the Community Reinvestment Act, 1977 entails that banks meet credit needs of low-income neighbourhoods (Zinman, 2002).

especially if her venture is a risky one. But the same situation creates the "lender's risk" of default by the borrower (voluntary, what Keynes terms "moral hazard" or involuntary, due to poor returns on investment). This necessitates that the lender charges a rate of interest high enough to induce him to lend. Keynes expresses the resulting social dilemma somewhat poetically: "the hope of a very favourable outcome, which may balance the risk in the mind of the borrower, is not available to solace the lender" (ibid, p.145).

Applying the insights of Keynes and Kalecki to a deeply unequal agrarian economy like India, Raj argues "the very basis of profit-making in banking activity sets limits in underdeveloped economies to the enterprise it can display" (ibid, p.309). There are high information and transaction costs of dealing with many small borrowers that acts as a major disincentive.¹² Also because profitability of banks is greater, the higher "the proportion of their earning assets to the idle cash reserves they have to hold" (ibid, p.309), servicing illiterate customers, who insist on payments in cash on the spot, means higher idle cash reserves of banks and lower profitability. Raj showed that mere legislation and control had not led to an "optimal allocation of investible resources" (ibid, p.307). Nationalisation of large banks was the only forward. Raj was aware that "the bureaucratic element in decision-making may introduce considerable rigidity" but he hastened to add that in "large private banks the element of impersonality, with all the rigidity it introduces, is almost as great as in the case of State-owned banks, except in case of favoured customers known to the bank. . . The larger private banks are no less impervious to the needs of small customers who have no security to offer" (ibid, p.311).

Objectives

14 of India's largest scheduled commercial banks were nationalised in 1969.¹³ The RBI now acquired a more direct and activist role in deciding banking policies. The preamble to the Banking Companies (Acquisition and Transfer of Undertakings) Act, 1969 that empowered the state to nationalise commercial banks, speaks of "a larger social purpose"

¹² More recently, in his many works, Stiglitz has shown that asymmetry of information will induce profit maximising banks to exclude "riskier" borrowers (in our context poor farmers) and practice "credit rationing" (see especially Stiglitz and Weiss, 1981).

¹³ Along with the SBI (and its associates), this meant that 22 of India's largest banks (accounting for 86 percent of deposits) were in the public sector in 1969. After six more banks were nationalised in 1980, the share of public sector banks in deposits rose to 92 percent (Krishnaswamy, Krishnamurthy and Sharma, 1987).

and the need 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".¹⁴

The 1961 Census showed that nearly 50 percent of India's towns and almost none of our villages had bank branches. In 1969 the National Credit Council, set up to guide the branch expansion programme, found that not even 1 percent of India's villages were served by commercial banks. It also noted that while industry accounted for a mere 15% of national income, its share in commercial bank credit was nearly 67%. On the other hand, agriculture that contributed 50% of GDP virtually got nothing from banks.

Nationalisation was aimed at redressing these inequities. The idea was to both reduce the average population served by a bank branch and to reduce disparities in this across states. According to the 1949 Banking Companies Act, banks needed a licence from the RBI if they wanted to open a new branch.¹⁵ This policy was a result of the perceived need to control the mushrooming of banks and widespread bank failures during the war period.¹⁶ Under the Act, the RBI closed down, merged and consolidated many unprofitable banks. As a result, there was a decline in the number of banks from 566 in 1951 to 85 in 1969 (Sen and Vaidya, 1997. p.13). The 1969 law sought to dramatically change course. After nationalisation, branch expansion was deliberately skewed towards previously unbanked or under-banked rural and semi-urban areas.

Reaching out to Unbanked Areas

The RBI created a comprehensive list of unbanked locations in India that it circulated every few years to all banks. In 1970, the RBI formulated its first "socially coercive" licensing criterion based on this data. For every new branch in an already banked area (with one or more branches), each bank would have to open at least 3 branches in unbanked rural or semi-urban areas.¹⁷ The RBI directed that all semi-urban locations would

¹⁴ There was a stated thrust towards reducing income inequalities and the concentration of economic power in a few hands. Prime Minister Indira Gandhi unleashed a package of socialist policy initiatives, including the abolition of privy purses, culminating in the winning Garibi Hatao campaign of the 1971 elections.

¹⁵ The RBI was set up in 1935 and nationalised in 1949

¹⁶ 647 banks failed between 1937 and 1947. RBI intervention brought this down to 242 between 1947 and 1951 (Sen and Vaidya, 1997, p.13). These failures had been prophesied by Keynes many years ago when he was a keen student of Indian currency and finance (Keynes, 1971, pp.159-163).

¹⁷ Only banks that already had 60 percent rural branches could follow a 1:2 ratio.

have to be covered by the end of 1970. In 1977, the RBI further upped the ante -- the banked-unbanked license ratio was raised to 1:4. In 1976 of the Regional Rural Banks (RRBs) were created. The RRB Act states that RRBs were set up to develop the rural economy by providing "credit and other facilities, particularly to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs" (Misra, 2006, p.111).¹⁸

Table 1 records that the RBI policy of "social coercion" through licensing and targets was a success in forcing banks to open branches in hitherto unbanked locations. The number of rural branches of banks (including RRBs)¹⁹ increased from a mere 1443 in 1969 to around 35,000 in the early 1990s. Most of this increase was in unbanked areas. The number of banked locations rose in this period from around a thousand to over 25,000. The share of rural branches went up from 18 to 58 percent during the same period. Between 1961 and 2000, the average population served by a bank branch fell from around 140,000 to just under 15,000. There is strong convergence in this figure across states after 1977 and by 1990 all Indian states were below the national target of 17,000. This reflects the fact that bank building intensity was much greater in states with a higher proportion of rural unbanked locations in 1969. Bank branches in unbanked locations really explode after the 1:4 licensing rule of 1977. That the rule was strictly enforced is clear from the fact that between 1977 and 1990, 80% of all new branches opened were in unbanked locations (Burgess and Pande, 2002).²⁰

Another major impetus to rural credit was provided by the establishment of the National Bank for Agriculture and Rural Development (NABARD) through an Act of Parliament in 1982.²¹ NABARD was set up as an apex Development Bank with a mandate for facilitating credit flow for agriculture, rural industries and all other allied economic

¹⁸ The Narasimham Committee of 1975 saw the RRBs as combining "the local feel and the familiarity with rural problems which the cooperatives possess and the degree of business organization, ability to mobilize deposits, access to central money markets and modernized outlook which the commercial banks have" (Bose, 2005, p.1).

¹⁹ By 2004, there were 196 RRBs with 14,446 branches in 518 districts across the country. RRBs form around 43 per cent of the total rural branches of commercial banks. Rural and semi-urban branches constitute over 97 per cent of RRB branch network. 70 per cent of the loans from RRBs were to "priority" sectors.

²⁰ Greater outreach of the banks has also been seen as a means for the government to mop up the post-Green Revolution liquidity generated in pockets of rural India, especially among rich farmers (Ramachandran and Swaminathan, 2005, p.xxiii). It is no surprise, then, that despite the policy of social coercion and the resultant evening out of distribution of banking across India, the Green Revolution areas remained better serviced even after nationalisation (Chavan, 2005, p.111).

²¹ NABARD superseded the Agricultural Refinance and Development Corporation that had been set up in 1963

activities in rural areas. Over the last 25 years, refinance disbursement by NABARD to commercial banks, state cooperative banks, state cooperative agriculture and rural development banks, RRBs and other eligible financial institutions has aggregated over Rs 8,600 crores.

In order to ensure that rural deposits were not used to just increase urban credit, the RBI directed that each rural and semi-urban bank branch had to maintain a credit-deposit ratio of at least 60%. Table 1 shows that between 1969 and 1987, rural credit as a proportion of total credit outstanding went up from 3 to 15 percent. Rural deposits as a share of total deposits went up from around 6 to over 15 percent. The credit-deposit ratio went up from under 40 percent in 1969 to nearly 70 percent in 1984 and remained over 60 percent until the early 1990s.

Table 1

Growth of Rural Banking in India, 1969-2006								
Year	Number of bank offices		Credit outstanding		Deposits		Credit-deposit ratio (%)	
	Rural	% of total	Rural (Rs crores)	% of total	Rural (Rs crores)	% of total	Rural	All areas
1969	1443	17.6	115	3.3	306	6.3	37.6	71.9
1972	5274	36.0	257	4.6	540	6.5	47.7	67.2
1975	7112	35.5	608	6.0	1171	8.5	51.9	73.5
1978	12534	42.5	1530	8.4	2664	10.1	57.4	69.1
1981	19453	51.2	3600	11.9	5939	13.4	60.6	68.1
1984	25541	52.9	6589	13.5	9603	13.4	68.6	68.3
1987	30585	56.2	11127	15.3	17527	14.7	63.5	61.0
1990	34867	58.2	17352	14.2	28609	15.5	60.7	66.0
1993	35360	56.3	22906	14.1	41410	15.0	55.3	58.9
1996	32981	51.2	29012	11.4	61313	14.4	47.3	59.8
1999	32840	49.3	42091	11.0	102697	14.7	41.0	54.8
2002	32443	47.8	66682	10.2	159423	14.2	41.8	58.4
2005	32082	46.9	109976	9.5	213104	12.2	51.6	64.9
2006	30572	44.5	175816	8.4	226049	10.8	56.3	72.5

Source: RBI: *Banking Services: Basic Statistical Returns*, various issues; *Quarterly Statistics on Deposits and Credit of Scheduled Commercial Banks: March 2006*

Priority Sector Lending

Other than directing credit to hitherto unbanked *geographical* regions, the RBI also sought to influence the *sectoral* orientation of bank lending. In 1972, the definition of certain

"priority" sectors was formalised. These included agriculture and allied activities and small-scale and cottage industries. A target of 33% lending to the priority sector was set in 1975 (to be achieved by March 1979). In 1979, the target was raised to 40% (to be achieved by 1985). In 1980, sub-targets were set: 16% of lending was to go to agriculture and 10% had to be targeted to "weaker sections".²² As Table 2 shows, the share of priority sector advances in total credit of scheduled commercial banks went up from 14% in 1969 to around 40% by the end of the 1980s. The share of agriculture had reached 19% by 1985 and remained around that figure until 1990 (Chavan, 2005, p.118). The number of agricultural loan accounts increased from around 1 million in the early 1970s to nearly 30 million by the early 1990s (Narayana, 2000, p.10). Within agriculture, 42% of the credit went to small and marginal farmers (Burgess and Pande, 2002, p.2).

Table 2

Share of Priority Sector Advances in Total Credit of Scheduled Commercial Banks, 1969-2005	
Year	Share (%)
1969	14.0
1972	21.0
1975	25.0
1978	28.6
1981	35.6
1984	38.1
1987	42.9
1990	40.7
1993	34.4
1996	32.8
1999	35.3
2002	34.8
2005	36.7

Source: RBI: *Banking Services: Basic Statistical Returns*, various issues

Ceiling on Interest Rates

Perhaps the most important measure of social coercion deployed by the RBI was to affix ceilings for every size-class of loans for the various priority sectors. Differential rates of interest were introduced in early 1972. The scheme for providing cheaper credit to weaker sections was started in 1974. For this a ceiling of 4 percent per annum was fixed. Banks had

²² Defined as small farmers holding less than 2 hectares, landless labourers, tenants and borrowers with

to provide 1% of their total loans within the priority sector at this rate. In 1978, the RBI directed commercial banks and RRBs to charge a flat rate of 9% on all priority sector loans, irrespective of size. Down payments were not to be mandatory for small rural borrowers. It was clearly recognised that cost of credit, rather than access, was the key constraint facing the rural poor. After all, the local moneylenders were all over the place but the way they operated created more problems for the vulnerable rural population.

Decline of the Moneylender

Something fairly dramatic happened in the 20 years following bank nationalisation. The share of "exploitative" sources (professional moneylenders, landlords and agriculturist moneylenders) in rural credit fell from an average of over 75% in 1951-1961 to less than 25% in 1991. The share of formal sector lending more than doubled between 1971 and 1991.

Table 3

Share of Rural Household Debt by Source, India, 1951-1991 (%)

Credit Agency	1951	1961	1971	1981	1991
Cooperatives and Commercial Banks	5.7	10.3	24.4	58.6	58.8
Government and other formal sources	3.1	5.5	7.3	4.6	7.5
All Institutional Agencies	8.8	15.8	31.7	63.2	66.3
Professional and Agriculturist Moneylenders	68.6	62.0	36.1	16.1	17.5
Traders		7.2	8.4	3.1	2.2
Landlords		7.6	8.6	4.0	4.0
Relatives & Friends	14.4	6.4	13.1	11.2	4.6
Other sources	8.2	0.8	2.1	2.4	2.3
All Non-Institutional Agencies	91.2	84.0	68.3	36.8	30.6
Source not specified	0.0	0.2	0.0	0.0	3.1
Total	100	100	100	100	100

Note: In 1951, landlords and traders are lumped together within "other sources"

Source: All-India Rural Credit Survey for 1951, All-India Debt and Investment Survey for the other years

Economic Development Impacts

A study of 85 randomly selected districts by Binswanger et al (1993) shows that bank

credit limits of less than Rs.10,000

branch expansion accelerated the pace of private investment in agriculture in the 1970s. A 10% increase in bank branches raised investment in animals and pumpsets by 4-8%. Demand for fertiliser was also found highly correlated with bank expansion. Burgess and Pande (2002) devise an extremely sophisticated econometric model²³ to study the economic impact of this explosive growth in rural banking during the period 1970-1992. They find that bank branch expansion into both banked and unbanked areas has a significant positive impact on the growth of non-agricultural output. They also find that expansion of banking into unbanked locations contributed to the growth of the small business sector. This led to an increase in the share of non-agricultural labour in the total workforce as also a rise in the real wages of agricultural labour. Most significantly they find that expansion of banks into unbanked areas reduces aggregate poverty and the rural-urban poverty difference. It is also found to reduce aggregate inequality in the economy. Burgess and Pande conclude that these results are due precisely to the "social coercive" elements of India's banking experiment -- "namely expansion into unbanked locations and priority sector lending" (Burgess and Pande, 2002, p.17).

IRDP Disaster: The Underbelly of Nationalisation

While the positive social and economic impacts of nationalization are evident, the experiment is also a lesson in the disaster that mindless bureaucratic programmes can become. The Integrated Rural Development Programme (IRDP) is a grim reminder of how mechanically trying to meet targets can so completely undermine the very integrity of a veritable social revolution, that a counter-revolution can be set into motion. Arguably India's worst-ever development programme, the IRDP aimed at providing income-generating assets to the rural poor through the provision of cheap bank credit. Initiated in 1978 as a pilot project, the IRDP was rapidly expanded to cover all rural blocks by 1980. It became the lynchpin of India's anti-poverty effort in the 1980s. It peaked to cover over 4 million households by 1987.

Several independent evaluation studies based on micro-surveys across eleven states showed substantial mis-classification of beneficiaries under the IRDP, with better-off families getting selected (Rath, 1985). Little support was provided for skill formation, access

²³ They take great care to ensure that errors such as those due to autocorrelation and the assumption of stationarity do not arise (Burgess and Pande, 2002, p.7).

to inputs, markets and necessary infrastructure. In the case of cattle loans, for example, a majority of cattle owners reported that they had either sold off the animals bought with the loan or that these animals were dead. Cattle loans were financed without adequate attention to other details of fodder availability, marketing of milk, etc. (Shah *et al*, 1998, p.311). As Dreze (1990) has pointed out, the IRDP promoted a very deep dependence on corrupt government officials at every stage. It was principally an instrument of powerful local bosses to opportunistically distribute their largesse. There was no attempt made to ascertain whether the loan being provided would truly lead to the creation of a viable long-term asset. No attempt was made to work out the necessary forward and backward linkages to ensure that the loan was a success. Little information was collected on the intended beneficiary. In chasing targets of high credit supply, what we may term the "quality of lending" was completely undermined. Working for the poor does not mean indiscriminately thrusting money down their throats. Unfortunately, IRDP did precisely that.

The abiding legacy of the programme for India's poor has been that millions²⁴ have become bank defaulters for no fault of their own. Today, they find it impossible to rejoin the formal credit sector. The IRDP alone accounted for 40 per cent of the losses incurred by commercial banks in rural lending in 1988 (RBI, 1995). The final nail in the coffin was the official loan waiver of 1989, which destroyed whatever semblance of credit discipline there was.²⁵

By the end of the 1980s, great concern began to be expressed about the low capital base, low profitability, high non-performing assets and inefficiency of public sector banks. They were seen as being burdened with huge arrears, since their earnings were invariably lower than their loan losses and transaction costs. They required continual refinancing and recapitalisation by apex institutions. Loan recovery was regarded as an especially serious problem. Loans collected as a percentage of total amount due was between 50-60% throughout the 1980s and early 1990s. Of the 196 RRBs, 173 reported losses in 1993. A 1993 survey of rural households showed that only 12% of borrowers made regular repayments. Of those who took loans for buying assets, 16% never bought the asset, 50% had sold the asset and 27% said that their asset had been stolen or had died (Meyer and

²⁴ Estimated by some to be 40 million (Fisher and Sriram, 2002, p.39)

²⁵ The loan waiver was a horrible compounding of errors. It amounted to destroying the future in trying to salvage the past.

Nagarajan, 2000, pp.179-181). A study in Orissa found that loans were disbursed without assessing the feasibility, viability and entrepreneurial experience of borrowers (Rajasekhar and Vyasalu, 1993). An RBI study of 300 rural financial institutions across the country in 1984-85 found that they were being unable to cover their costs (Satish and Swaminathan, 1988). The study argued that break-even nominal interest rates were 27%, 28% and 34% for commercial banks, cooperatives and RRBs respectively. Low interest rates, high transaction costs and low loan recovery rates were depressing bank profits.

It must also be recognised that the expansion of the formal credit sector, even in the period of social banking, showed a great imbalance, being concentrated in the hands of the rich and the already developed regions. The poor still depended in a big way on the informal sector.²⁶

The Narasimham Committee 1991: Reforms and their Fallout

It is in this backdrop that the RBI set up a *Committee on the Financial System* in 1991 (chaired by M.Narasimham). The Narasimham Committee placed its report centrally within the broader process of "liberalisation" of the Indian economy. It wanted to move towards "a vibrant and competitive financial system to sustain the ongoing reform in the structural aspects of the real economy". It took a clear view against using the credit system for redistributive objectives and argued that "directed credit programmes should be phased out". It wanted the branch licensing policy to be revoked and interest rates to be deregulated. Future branch expansion was to depend on "need, business potential and financial viability of location". In order that banks could compete globally, it wanted major changes in capital adequacy norms and a new institutional structure that was market-driven and based on profitability as the prime criterion. It also wanted a larger role for private Indian and foreign banks.

It can be seen clearly from Table 1 that after peaking to over 35,000 in 1993, the number of rural bank branch offices steadily declined thereafter, coming down to around 30,000 in 2006. The share of these offices in total bank branches peaked in 1990 (58%) and steadily declined thereafter to under 45% in 2006. As we saw above, especially between 1977

and 1990, branch expansion exploded in unbanked regions, while declining in already banked locations. After 1990, exactly the opposite started to happen. Mergers and swapping of rural branches, rather than expansion, became the norm. The number of RRBs that rose to 196 by 1990 had fallen to 104 by 2006 (RBI, 2007). A concerted effort was made to reduce the total number of loan accounts. They came steadily down from the peak figure of 659 lakhs in 1991 to 524 lakhs in 2001, before rising once again. Private banks have increased their share in both credit and deposits from around 4% in each in 1990 to around 18-19% in each in 2005.

The profitability of public sector banks has improved following liberalisation. Total non-performing assets (NPAs) of public sector banks as a proportion of total advances have declined (RBI, 2006, Appendix Table III.26). But the share of rural credit has fallen continuously from the peak of 15.3 percent in 1987 to 8.4 percent in 2006. The share of rural deposits has also fallen steadily from its peak of 15.5 percent in 1990 to 10.8 percent in 2006 (see Table 1). The sharp rise in rural credit in 2004-06 will hopefully lead to a trend reversal in these shares. The rural credit-deposit ratio of commercial banks fell from the peak of nearly 69% in 1984 to just 41% by the end of the 1990s. It has also risen sharply in the last two years. But it remains well below the levels in the 1980s. The incremental credit-deposit ratios have fallen even more sharply -- for rural bank branches from over 60% in the 1980s to under 35% in the 1990s; for semi-urban branches, from nearly 49% in the 1980s to 30% in the 1990s (Shetty, 2005, pp.56-57).

This decline in credit-deposit ratios has also been worst in the already underdeveloped regions (Table 4). The intensity of banking had historically been lowest in these regions but they benefitted greatly from the social banking period of the 1970s and 1980s. However, the post-reform period has once again set them back.

Table 4
Region-wise Changes in Credit-Deposit Ratios, 1981-2001 (%)

Region	1981	1991	2001
Eastern	54	50	37
Central (MP&UP)	47	50	33

²⁶ See Rao (1994), Haque and Verma (1988) and Dandekar and Wadia (1989). Nickel and Khan (1993) show that the rich had cornered major benefits from concessional lending by institutional sources.

North-Eastern	43	50	28
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Source: Shetty (2005, p.58)

Chandrashekhar and Ray (2005, p.19) show that public sector banks have increasingly opted for investment in risk-free returns of government securities, their share in total earning assets rising from 26 to 33 percent during the 1990s. This trend has been reversed in the 21st century.²⁷ But there is no doubt that enforcement of stringent prudential norms, capital adequacy stipulations, setting up of the Board for Financial Supervision (BFS) and pressure to reduce NPAs have made banks so risk-averse that they have reduced their exposure to private loans with even a modest risk of non-recovery (Sarkar and Agarwal, 1996). The rise in interest rates in 2006-07 has been seen as showing "utter disregard for the development needs" of the Indian economy, with "adverse repercussions for medium and small borrowers", while rendering "in a nonchalant manner large proportions of bank credit to cash-rich corporates at below prime lending rates" (EPW Research Foundation, 2007, p.621).

Even in terms of sectoral direction of credit, the trends do not enthuse. The share of agriculture in total bank credit has fallen from 19 percent in 1990 to under 11 percent in March 2005. While Table 2 shows that priority sector lending remained as high as 37% even in 2005, we must also note that the reform period led to a widening of the definition of the priority sector in several ways that dilute the focus on agriculture and the weaker sections (Chandrashekhar and Ray, 2005, pp.20-24). The worst affected have been the poor. Sahu and Rajasekhar (2005, Table 11) show that the share of marginal farmers in disbursement of short and long-term loans by scheduled commercial banks (SCBs) declined by 6 percent between 1991 and 2000. They also show that the share of agricultural loans of less than Rs.25,000 in total SCB credit fell dramatically in the 1990s (ibid, Table 6). As the RBI itself said, "Direct finance to small and marginal farmers (with land holdings up to two hectares) has been slowing down in recent years. The average growth in loans outstanding to marginal farmers has decelerated sharply during the 1990s as compared with the growth recorded in the 1980s" (RBI, 2002, para 3.48). The evidence is summarised in Table 5.

Table 5

Trend Growth Rates of Scheduled Commercial Banks' Direct Finance to Farmers (Short-term and long-term loans) (percent)

²⁷ The average figure for 2001-05 was 30 percent and it fell sharply to 25 percent in 2005-06 (RBI, 2006).

	Up to 2.5 acres		2.5 to 5 acres		Above 5 acres		Total	
	Accounts	Amount	Accounts	Amount	Accounts	Amount	Accounts	Amount
Loans Outstanding								
1980s	8.61	19.33	11.80	21.48	7.41	16.96	9.17	18.39
1990s	-3.69	7.65	-1.58	8.95	-0.92	8.05	-2.27	8.17
Loans Disbursed								
1980s	7.51	18.38	11.45	21.55	7.21	17.51	8.51	18.61
1990s	2.16	11.84	5.72	15.88	8.55	16.31	4.95	15.01

Note: Trend Growth Rates are based on semi-logarithmic functions.

Source: *Report on Currency and Finance 2000-01*, (Table 3.15)

The RBI report goes on to reveal that direct finance to small farmers by banks fell from 15% in the 1980s to 11% in the 1990s. Within this, there is a shift in favour of short-term advances which the report views as "a matter of some concern, as it is likely to further accentuate the declining private sector capital formation in agriculture" (ibid). We know that both per capita foodgrain production and availability in India were lower in 2000-03 than their pre-Green Revolution (1960-63) levels. The decline has been the sharpest in the 1990s. A major reason for the slowdown in agriculture is the precipitous fall in public investment in agriculture (GoI, 2006). The drying up rural credit is one integral element in this larger story.

The single most disturbing feature of the post-reform period is the return of the rural moneylender. A comparison of the share of institutional agencies in outstanding cash debt in 1991 (NSS 48th Round) with that in 2002 (NSS 59th Round) provides telling evidence in this regard (Table 6). In all states, there was a dramatic rise in reliance on formal sources after nationalisation. But this trend was reversed after 1991.

Table 6

Share of Institutional Agencies in Outstanding Cash Debt, Major States and All-India, 1971-2002 (%)

	1971 (NSS 26th round)	1981 (NSS 37th round)	1991 (NSS 48th round)	2002 (NSS 59th round)
Andhra Pradesh	14	41	34	27
Bihar*	11	47	73	37
Gujarat	47	70	75	67
Haryana	26	76	73	50
Karnataka	30	78	78	67
Kerala	44	79	92	81

Madhya Pradesh*	32	66	73	59
Orissa	30	81	80	74
Punjab	36	74	79	56
Rajasthan	9	41	40	34
Tamil Nadu	22	44	58	47
Uttar Pradesh	23	55	69	56
West Bengal	31	66	82	68
All India	29	61	64	57

Source: NSSO (2005b, Report 501, Statement 7, p.27)

Note: 2002 data for Bihar and MP exaggerate the decline after 1991 as they refer to the divided states after separation of Jharkhand and Chhattisgarh, both of which have a comparatively much higher share of institutional agencies.

The NSS 59th Round shows that the poorer you are, the more dependent you would tend to be on exploitative sources of credit, something that was true even in the colonial period (Table 7).

Table 7

Share of Debt Provided by Institutional Sources (%), 2003, All-India

Size Class of Land Possessed (ha)	Share of Debt Provided by Institutional Sources (%)
< 0.01	22.6
0.01-0.40	43.3
0.41-1.00	52.8
1.01-2.00	57.6
2.01-4.00	65.1
4.01-10.00	68.8
>10.00	67.6
All Sizes	57.7

Source: NSSO (2005a, Report 498, Table 3, p.125)

It is clear that in the period of banking reforms, in the relentless pursuit of profits, rural banks have forgotten what their primary mandate was and continues to be. The post-IRDP pendulum has swung too far in the opposite direction. While there is no denying that IRDP represented a mindless, reckless disbursement of funds, the correction has now gone too far. The exploitative sector is back. The wheel has turned full circle over the last 100 years.

The Microfinance Phase

It is into this vacuum created by the withdrawal of the state in rural credit that microfinance has entered. Both NABARD and the RBI define microfinance as the "provision of thrift, credit and other financial services and products of very small amounts to the poor enabling them to raise their income levels and improve living standards" (NABARD, 2000; RBI, 1999). Two broad approaches characterise the microfinance sector in India -- Self-Help Group (SHG)-bank Linkage (SBL) and Micro-Finance Institutions (MFIs). The SBL is the larger model and is unique to India but the internationally more established MFI model is the one that appears to be the increasingly favoured route.²⁸ The SBL approach dates from the NABARD initiated pilot of 500 SHGs in 1992. NABARD has had a key role to play in initiating and nurturing India's unique SBL programme. It was largely responsible for the RBI including Linkage Banking as a mainstream activity of banks under "priority sector" lending in 1996. NABARD's work with its partner NGOs (MYRADA, PRADAN and DHAN) also led to the Government of India accorded "national priority" to the programme through the Union Budget of 1999. By March 2006, over 22 lakh SHGs had been provided with bank loans. They covered over 3 crore households and had disbursed Rs. 11,398 crores to their members (NABARD, 2006).²⁹ In comparison, the loans outstanding of 162 MFIs in India were estimated to be around Rs.1,600 crores in March 2006 (Ghate, 2006).

The microfinance sector is still small in India but is growing at an astonishing rate. While in 2001, the proportion of rural bank credit disbursed through SHGs was less than 1%, this figure had risen to over 6% within the next four years.

Table 8

Size of the SHG Microfinance Sector in India			
Year	Total Rural Credit of Scheduled Commercial Banks (Rs. crores) (1)	Cumulative Credit disbursed through SHGs (Rs. crores) (2)	(2)/(1) %
2001	54431	481	0.88
2002	66682	1026	1.54
2003	77153	2049	2.66
2004	85021	3904	4.59

²⁸ Many commercial banks are also increasingly opting for this route (Hermes and Lensink, 2007).

²⁹ Of course, it must be noted that the SBL programme is very unevenly distributed across India, with over 54 percent of credit linked SHGs and 75 percent of cumulative SHG loans disbursed being in the south. The north and northeast have very low presence of SBL.

2005	109976	6896	6.27
2006	175816	11398	6.48

Source: Ghate (2006) for (2); RBI, *Basic Statistical Returns, 2001-05* and *Quarterly Statistics on Deposits and Credit of Scheduled Commercial Banks: March 2006* for (1)

Microfinance has several strengths. Even during the social banking phase, it is undeniable that bureaucratic functioning and haughty attitude of officials made banks highly unapproachable for the rural poor. Going into a bank branch has always been a forbidding experience for village people, especially women. The requirement of collateral, as also the fact that credit would only be provided for productive purposes, make it harder for the poor to access bank loans. Banks do not provide credit even for health and education that can hardly be described as "consumption". With the advent of reforms access has fallen further. In such a context, microfinance offers a new ray hope for the rural poor. It makes finance accessible and available for consumption needs. Freedom from the need for collateral is the other great attraction of microfinance. These are the common features of the SBL and MFI models. But there are significant differences in the two approaches, which have very serious implications for the poor as also for the banking sector.

SHG-Bank Linkage

The SBL approach involves the formation of self-help groups (mainly of women). These women regularly save money that is placed in a local (generally public sector) bank account. Many studies have shown that creation of a safe avenue for savings (on which interest is earned) is an attractive feature of SHGs, which has led to significant promotion of savings (NABARD, 2002, Hashemi et al, 1996, Rajasekhar, 2000). The SHG has a set of bye-laws devised and agreed by the members themselves. These include rules for monthly savings, lending procedures, periodicity and timing of meetings, penalties for default etc. Meticulous accounts and records are maintained. The SHG itself functions like a small bank. The group lends money to its members. After a certain period (six months to a year) of disciplined functioning, it becomes entitled to a loan from the bank where it has an account.

A number of studies document the positive economic impact of SHGs on indicators such as average value of assets per household, average net income per household, employment and borrowing for income generation activities (Puhazhendi and Satyasai, 2000; Puhazhendi and Badatya, 2002; Harper et al, 1998).³⁰ It has been shown that SHGs help

³⁰ Tankha (2002) provides a good summary of such studies

inculcate the banking habit in rural women (Varman, 2005). The running of an SHG is also a great lesson in governance. It teaches the value of discipline, both procedural and financial. Well-run SHGs are subject to external audits that enforce prudence. It broadens the horizons and expands the capabilities of its members who have to interact with the outside world, including banks, government departments and NGOs. Since most SHGs are women's groups, the potential for women's empowerment is huge. There is overwhelming evidence that women-run SHGs are the best managed with women showing much greater sense of responsibility as also a commitment to human development objectives such as health and education of their families (Pitt and Khandker, 1998). There are reports of SHG office-bearers being elected to panchayats and becoming more effective leaders in panchayat raj institutions.³¹ In a word, it is not merely finance but empowerment that is potentially achieved in good SHGs.³²

The problem with SBL is that it is largely a government "pushed" model and has, therefore, suffered from all the infirmities of any bureaucratic programme, run in a mindless, target-driven sort of way. All manner of government officials have been asked to form SHGs, including anganwadi workers and forest guards. These people have badly failed to do their own jobs properly. To expect them to undertake a task requiring much energy, motivation and creativity is absurd. As a result, the impressive figures of the fast growth of the SBL model hide a lot of poor quality work (Basu and Srivastava, 2005, p.1754). This has had the impact of destroying the credibility of the SBL model in the eyes of key stakeholders, including potential women members, as also bankers.

The other side of the problem is the attitude of bankers towards SHGs -- partly because of bad experiences of poorly run SHGs but also owing to the bureaucratic insensitivity that characterises banking in India (both public and private). Bankers fail to recognise the enormous self-interest banks have in the success of the SBL model -- that there can perhaps be no better path to financial sustainability, which also helps banks fulfill their social responsibility, other than lending to SHGs. Banks can effect huge reductions in the information costs of lending to the poor when they go through SHGs by avoiding the usual adverse selection and moral hazard problems (SPS, 2006). There is much merit in the

³¹ See Fisher and Sriram (2002, p.112) on MYRADA and Vasimalai and Narender (2007) on the work of the DHAN Foundation. Our own field experience corroborates this and also reveals the positive impact of dalit SHG leadership on caste dynamics in acutely caste-divided villages.

³² See especially MYRADA (2002)

criticism that SHGs should not be seen as alternatives to public sector banks (Swaminathan, 2007). It is clear that SHGs can flourish only when linked to these banks. But it also needs to be recognised that these banks will not survive the new competitive environment of the banking industry unless they strengthen their bonds with SHGs and their Federations.

The real power of the SBL model lies in the enormous economies of scale that are created by the power of SHG Federations (each of 150-200 SHGs). For example in bulk purchase of inputs (seeds, fertilisers etc) and marketing of outputs (crops, vegetables, milk, NTFPs etc). They also provide larger loans for housing and health facilities to their members by tying up with large service or loan providers. A variety of insurance services are also made available, including life, health, livestock and weather insurance (Vasimalai and Narender, 2007). A study of four large SHG Federations (including India's oldest one) with a total of over 18,000 members in Andhra Pradesh and Tamil Nadu, shows that Federations help make SHGs financially viable by reducing transaction and promotional costs as also default rates, provide them economies of scale, create value added services and build local human capital (Nair, 2001). It has also been shown how doing business with SHG Federations can help public sector bank branches in remote rural areas become viable entities (SPS, 2006).

A number of studies have tried to assess the impact of microfinance interventions on women's empowerment.³³ While the potential for a positive impact is recognised, it is also clear that a great deal depends on the orientation and capacity of the agency facilitating the formation of groups. Since gender issues touch an epicentre of conflict in society, those engaged in forming women's groups better be prepared, both intellectually and politically, to tackle challenges that lie on this path (Mayoux, 2002). Where groups are mere conduits for the lending and recovery of money (as in MFIs, see below) or when lending is to individuals, empowerment impacts are the least (Kabeer, 2005, p.4713).³⁴

SHGs do involve high transaction costs (Swaminathan, 2007). Armendáriz and Morduch (2000) and Murray and Lynch (2003) argue that SHG group meetings are a costly affair for the poor. There is no question that there is investment of time and money in this process. But if we recognise that "governance" and not just finance is a major "deficit" in

³³ See Kabeer (2005) for the best review of this literature. See also Mayoux (2002). Goetz and Gupta (1996) feel that being held responsible for repayment can become an additional burden on women. Kannabiran's (2005) extremely negative about SHGs' role in women's empowerment needs to be balanced with careful reading of Vasimalai and Narender (2007) and Fernandez (2007).

rural India, then we must view this as an investment in empowerment of women and the poor, which is not too high a price for the state to bear. NABARD's "promotional" costs for SHGs, if well spent, can be an invaluable and reasonable investment for achieving this socially desirable goal. In any case, SHGs need support only for the initial years, after which they become financially self-sustaining entities (SPS, 2006).³⁵

There is some critique of SHGs charging high rates of interest to their members (Chavan and Ramakumar, 2006). But we must remember that SHGs (unlike MFIs) are member-run mini-banks. What they charge is also what they earn. The money remains with them. Of course, as we shall argue, there is a need for interest rate caps in microfinance but it is useful to remember that the money earned on interest by an SHG accrues to itself.

MFIs

The newly emerging (and internationally more established) MFI model is a different ball-game altogether. Here the sponsor is a profit-oriented venture capitalist, who sees the rural credit market as a fresh business opportunity. The MFI apparently brings great professionalism, innovation and technology to its enterprise. It also ventures to provide loans that banks do not. But MFIs form no groups that are engaged in governance functions *a la* SHGs. Even when they operate through NGOs, MFIs are primarily concerned with lending and recovering (mostly every week) what they lend to cohorts of people, at times at very high rates of interest. The recent suicide episode in Andhra Pradesh (see Ghate, 2007) is a grim reminder of the possible extreme consequences of MFI lending. Since profits are the overwhelming consideration for an MFI, there is enormous pressure to lend at all costs ("dumping money on borrowers" as Ghate calls it).³⁶ And concomitantly to recover. Added to this is the requirement of MFIs of a security deposit as cash collateral. As also high rates of interest, inevitable because of high transaction costs and a relatively low scale of operations. Another dubious practice of many MFIs is that they charge borrowers interest on the entire remaining period as well, even if they were to return a loan early. This could

³⁴ On the other hand, success poses its own challenges as evidenced in the attempted political capture of SHG Federations in Tamil Nadu and Andhra Pradesh.

³⁵ The key issue is whether we value sustainability of microfinance over all other considerations. Fernandez (2007) strongly questions this tendency, correctly in our view.

³⁶ A strange repetition of the sorry IRDP episode for completely different reasons (that was the coercion of a mindless bureaucracy, this is the economic coercion of the greed for profits).

become a killing penalty with long remaining periods. There is also a great lack of transparency, especially in "start-up" MFIs, about such practices (Ghate, 2007). Join this to the fact that borrowers are often illiterate people, without adequate information on the terms of the loan, and we get a potentially explosive situation. Which in a vulnerable context such as Andhra (already riddled with suicides) was bound to explode. Finally, the really poor do tend to be implicitly or deliberately excluded as they are unable to bear the pressure of recovery (Ciravegna, 2005; Scully, 2004; Marr, 2004; Simanowitz, 2002)

People are reported to have had to borrow from moneylenders in order to repay MFIs. Other borrowers have "absconded", migrated or at times tragically committed suicide. This is linked to abusive collection practices that MFIs sometimes resort to. "Abusive" is a well-defined technical term with strict usage in the literature (CGAP, 2004). It includes "(i) adjusting overdues against the security deposit, (ii) holding the weekly meeting in front of the defaulter's house, (iii) MFI staff sitting in front of the defaulter's house, (iv) offensive language used by group leaders or staff, (v) putting up a loan overdue notice in front of a defaulter's house" (Ghate, 2006, p.66). Instances are also mentioned of recovery of large individual loans by encashing signed blank cheques, legal action to enforce blank promissory notes and physical force used by group leaders. There is huge pressure on all members because of joint liability. No one gets another loan until all repayments are made.

A major demand of MFIs is that they should be allowed to raise interest rates in an unfettered manner. "No regulation can control supply and price simultaneously. So if more credit has to flow to farmers, the price (interest rate) must be deregulated" (Mahajan, 2004, p.33).³⁷ The enactment of anti-usury laws is said to have led to a reduction in supply of credit and rise in interest rates. Our earlier discussion and data clearly show that this is simply not true. There was a massive expansion in the supply of credit to the poor in the social banking era. And this was at low rates of interest. It is only in the reform era that the supply of institutional credit has contracted and the usurious moneylender has made a comeback.

The suggestion that it is not the price of credit but its supply that is the real problem, appears ludicrous in a socio-historical context where usurious moneylending has been at the heart of relations of power, which made credit easily available to the poor but at a "price"

³⁷ Raj, building on Keynes, had shown forty years ago, that "monetary authorities have always considered it necessary to fix both" (Raj, 1974, p.303). As we see it, there is no way you can increase supply of "genuine credit" (as against money, which becomes vicious debt) to the poor, without lowering its price.

that they could just not afford. However, today there are calls, even in official documents, for the poor to pay if they want to get out of poverty. The RBI's Micro-Credit Special Cell proclaims:

"past experience shows that dollops of sympathy in the form of subsidy and reduced rate of interest have not helped matters much. Micro-credit has to be commercialised where all patrons – Micro Finance providers, intermediaries, NGOs, facilitators and the ultimate clients - must get compensated appropriately... The cell believes that freedom from poverty is not for free. The poor are willing and capable to pay the cost" (RBI, 1999b, p.12, emphasis added).

There are many presumptions implicit in this view that need to be questioned:

1. that social banking was a mistake (ignoring the real achievements of the period listed earlier)
2. that social banking was all about "dollops of sympathy" (overlooking the theoretical basis on which it was grounded and continues to operate in large parts of the world)
3. that all "patrons" need "appropriate compensation" (it is clear that the goal has shifted away from eradication of poverty as a moral obligation of the welfare state towards those in whose name it rules and through whose votes it derives its own legitimacy)
4. that "freedom from poverty" is nigh, now that profit-oriented MFIs are here.

What Microfinance can do and What it cannot

It is the last proposition to which we now turn. It must be understood that microfinance by itself is no magic bullet -- not for poverty eradication, livelihood creation, empowerment of women or the poor. As for MFIs, a paradox militates against their very survival. Given their relatively low scale of operations, the imperative of profits forces MFIs to demand that they be allowed to charge high interest rates. But such rates will only attract those with high-risk (and potentially high return) investments. Safer investors (with lower but more certain returns) will not borrow at such high rates. The consequent danger of default will be much greater for MFIs. Which will negatively impact their profits. And/or create unbearable pressure on borrowers with tragedies like the Andhra suicide as an extreme possibility. As Stiglitz (1993) has shown, market failures are even more pervasive in financial than in other markets. This is the theoretical foundation for the need for intermediation in these markets (Diamond, 1984), because "information provision is a natural monopoly" (Sen and Vaidya, 1997, p.5). A recent international survey of MFIs concludes that "due to the trend of commercialisation of the sector, financial sustainability is

becoming more and more important at the expense of using credit to help overcome poverty" (Hermes and Lensink, 2007). Research also shows that increased competition among MFIs may benefit wealthier borrowers but it lowers welfare levels for the poor (McIntosh et al, 2005). Are MFIs in India not in danger of repeating the 1940s and 1950s story of mushrooming private banks and rampant bank failures?³⁸

It is clear that in India, with one of the largest public sector banking networks in the world, it is best for microfinance to build on the SHG-bank linkage model (Basu and Srivastava, 2005, pp.1752-53). But even the SBL programme has a very specific place that must be clearly delineated -- distress cash requirements, including for food; loans for health-related crises; easing the hold of the moneylender-trader nexus; a secure and attractive avenue for the poor to save and insurance. SHG Federations can be a powerful avenue for macro-economic activities such as purchase of inputs and sale of outputs at scale. They can become a source of long-term, high volume "macro-finance" for activities like low-cost housing. These are new "civic institutions" (Vasimalai and Narender, 2007) or "community-based organisations" (SPS, 2006), involved not just with finance but with human development issues such as education, health, sanitation, child nutrition and drinking water. Running SHGs and SHG Federations can be a unique empowerment experience for women. These Federations are also potentially powerful regional economic entities that generate large-scale demand for a variety of goods and services in rural areas, provided by both private and public players.³⁹

But it must clearly be understood that poverty eradication in India's backward regions is impossible without a critical minimum dose of public investments -- in natural resource regeneration, sustainable agriculture and whole range of nature-based livelihoods as also infrastructure -- that create the enabling environment for private investments to flourish. One of the worst directions the SBL programme has taken is its obsession with the setting up of micro-enterprises, which has often been attempted as mindlessly as the IRDP was. By itself microfinance can achieve little even in this direction. Many allied inputs are required -- forward and backward linkages (input-market support), appropriate skills and

³⁸ Let us also not forget the negative experience of financial liberalisation in the Southern Cone countries in the 1970s and 1980s, that is in sharp contrast to the success achieved by the relatively "repressed" financial markets of Japan, Korea and Taiwan (Sen and Vaidya, 1997).

³⁹ The Kudumbashree programme of the Government of Kerala with its Federations of Community Development Societies throws up many learnings in this regard (www.kudumbashree.org)

technologies as also finance for fixed assets and working capital (Dichter, 2004; Mahajan, 2005). Without working out this entire package, micro-credit can easily become "macro-debt", pushing the poor into traps they find very hard to escape. It is truly ironic that the very same people who sing paeans in favour of globalisation are promoting micro-enterprises as the answer to world poverty. Without waiting to reflect on how they expect these micro-enterprises to withstand the unbearable pressures of global competition.⁴⁰

Conclusion

In the Fifth Henry Simons Lecture delivered at the Law School, University of Chicago, James Tobin (1981 Nobel Laureate in Economics), spoke of "specific egalitarianism," which he defined as "non-market egalitarian distributions of commodities essential to life and citizenship". As Tobin said "In some instances, notably education and medical care, a specific egalitarian distribution today may be essential for improving the distribution of human capital and earning capacity tomorrow" (Tobin, 1970, pp.276-77). In our view, rural credit fits very precisely into Tobin's proposal for "limiting the domain of inequality". For lack of access to rural credit has certainly been one of the factors depressing growth in agriculture in the 1990s, which is today regarded as the main drag on the Indian economy. More importantly, it has snowballed into a veritable agrarian crisis, with thousands of farmers taking their own lives, and many others (in over 25 percent of India's districts) taking to the gun.

In a penetrating analysis of rural finance, Bhaduri (2006) argues that the administrative costs of lending are bound to be high in rural areas. For one, the loan per borrower is typically low. The seasonality of agriculture demands that loans be provided precisely in time. And the sparse distribution of population, especially in dryland tribal areas, raises the cost of servicing, as also monitoring of loans. Moneylenders are able to cut costs partly because they are better informed about their clients. But most importantly since the profitability of lending depends "to a large extent on the vulnerability and weak bargaining position of the borrower, it is likely that the lender would develop a sort of vested interest in

⁴⁰ We may recommend to them a reading of Schumpeter's (1942) "perennial gale of creative destruction", if not Volume III of Marx's *Capital* for an understanding of the process of "concentration and centralisation of capital".

the poverty of the borrower, that is in keeping the latter sufficiently poor to be vulnerable" (Bhaduri, 2006, p.165). Bhaduri explains how private moneylending to the poor turns out to be so profitable, even as public sector banks find the same activity difficult to sustain.⁴¹ The mechanism is precisely the interlocked markets we described in the colonial period. The only collaterals rural borrowers can offer are future labour service, future harvest or the right to use already encumbered land. The lender is in a powerful position to undervalue these not easily marketable collaterals. This transfers the risk of default from the lender to the borrower. Monitoring is no longer an issue as the borrower is far more worried about losing the collateral than the lender is. And there is great incentive for charging usurious rates of interest because default will only mean that the lender grabs the asset offered as collateral. The moneylender could even be said to prefer default to repayment. This is an extraordinarily ingenious but utterly exploitative relationship, which has sustained itself over centuries in India. It is deeply distressing to note that the government is even considering that it could "bring in moneylenders" (Reddy, 2006, p.8) to solve the problem of rural credit. There cannot conceivably be a bigger disaster than that, especially when thousands of farmers are already being driven to suicide.

The life of rural Indians in our period of study has been vulnerable to shock, both ecological and market-induced. This vulnerability has grown in the post-WTO period (see especially, GoI, 2007, Chapter 7). Rural credit is one of the cushions against such shock. Rural incomes being seasonal, credit is needed to smoothen out the asymmetry between the flow of earnings and cyclicity of expenditure. Even sixty years after independence, rural Indians have no guarantee of state provided education and health. The public distribution and social security systems are wrecked by inefficiency and corruption. Social obligations too cast a heavy load on the rural populace. Each of the basic needs of health, education, food and social security, apart from the working capital and long-term investment requirements of rural livelihoods create a major demand for credit. The formal banking system could provide some productive credit requirements but it has suffered greatly from a lack of professionalism and accountability in its functioning. The "consumption" needs of the poor also could not be met by banks system. In its responsiveness to the demands for equity, banks reflect the biases of a deeply divided society. Thus, the usurious moneylender holds

⁴¹ The recent rigorous models of imperfect credit markets and collective poverty traps developed by Banerjee (2001) contain an interesting discussion on similar lines

sway in a context of imperfect and interlocked markets that operate as a strangulating nexus of exploitation. After a brief period of 20 years where the moneylenders beat a tentative retreat, the period of reform after 1990 has brought them back to the fore, especially for the rural poor. It is true that even in the period of social banking, rural elites disproportionately cornered the benefits of formal credit. But instead of addressing this problem, the reform period has only aggravated the inter-regional and inter-class inequities in rural finance.

Seeing unregulated MFIs as a solution can be a potential disaster. It has been rightly argued that "dilution of entry norms for MFIs combined with a weak monitoring infrastructure carries risks of (poor, illiterate) consumers getting ripped off" (Srivastava, 2005, p.3628). There may be some grounds for raising interest rates to promote cost-coverage but they must at all events be kept well below the rates charged by usurious moneylenders. It would not be difficult to calculate breakeven rates and specify these for loan-size and borrower categories for all lenders (whether banks or MFIs).⁴² Those unable to adhere would be automatically eliminated by competition. On the other hand, the programme of linking SHGs with banks holds out great promise in providing needs of the rural poor, in a manner that is financially and socially empowering for them. However, this must not be seen as a stand-alone, magic bullet. To meet the requirements of finance in rural India, what we require is a package of changes that includes:

- (1) massive increase in public investment in natural resource regeneration (especially in rainfed India), ecologically sustainable, low-cost, low-risk agriculture and all forms of rural infrastructure;
- (2) market support for crops grown in rainfed areas, such as cotton, pulses and oilseeds (which have become especially vulnerable in the post-WTO period (see GoI, 2007, Ch.7 for a detailed policy package);
- (3) reforms of public sector banking (including RRBs) aimed at strengthening their capacity to deliver high *quality* credit. This includes debureaucratisation of procedures and personnel and the infusion of professional staff. The latter should be able to guide the provision of rural credit in a manner that makes it truly sustainable in both financial and environmental terms. Here the experience of public sector reforms the world over is especially instructive. There is a greater emphasis now on effectiveness rather than

⁴² Ghate (2006) estimates this to be 21-24%. We strongly endorse the stand of the Union Ministries of Rural Development and Women and Child that the new microfinance bill must include interest rate caps

efficiency, in the narrow neo-classical sense of the term. There is a shift from the obsession with “getting things done cheaply” towards actually “accomplishing one’s goals”. (Drechsler, 2005). When reforms have been guided by narrow considerations of efficiency and profitability, they have invariably gone wrong, especially as far as the social and economically disadvantaged are concerned. In India, reforms have further reduced the human resource capacity of rural banks, while these should actually have been strengthened, with infusion of experts on areas such as agriculture, earthen engineering, irrigation, livestock development, rural enterprises etc. While doing this, social coercion to meet national goals must be retained;

- (4) reforms of the cooperative credit structure on the lines proposed by the Task Force on Revival of Rural Cooperative Credit Institutions in order to make PACS truly democratic, member-driven, professional organisations based on the concept of mutuality;
- (5) strengthening of the SHG-bank linkage programme, with the state (especially NABARD) bearing promotional costs in the initial years. SHG Federations must be facilitated and linked to various apex development agencies so that they become a vehicle of macro-finance, human development and sustainable livelihoods for the rural poor;
- (6) strict public vigilance, including maximum permissible interest rate bands, on the functioning of MFIs, to ensure that they operate on a level playing field, within the same social canvas that animates other players in the sector.

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