Working Paper

INITIATIVES IN RURAL CREDIT POLICIES UNDER NEW ECONOMIC ENVIRONMENT

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W.P. No.1403
October 1997

WP1403

WP
1997
(1403)

The main objective of the working paper series of the IIMA is to help faculty members to test out their research findings at the pre-publication stage.

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AHMEDABAD - 380 015
INDIA

Initiatives in Rural Credit Policies Under New Economic Environment*

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Ever since the changes in economic environment were introduced in mid-1991, several new initiatives have been taken in rural credit policies. I propose to reflect on them. However, before doing so, I wish to state three points.

Firstly, my coverage of initiatives may not be complete as it is largely based on what media and professional journals have reported. Secondly, following my international collaborative research on rural credit, I propose to reflect on the new initiatives as they relate to the policies for institutional development and interest rates. This is because this broad analytical classification of these policies enables developing operationally meaningful conceptual framework. And thirdly, I find that the new initiatives seem to consist of some that are right, and some others that are not so. This is so for both the broad policy instruments of institutional development and interest rates, and I shall attempt to delineate them in what follows.

Institutional Development (ID)

ID is highly essential for promoting formal rural financial institutions (RFIs) for four broad reasons. One, RFIs can wean away farmers from the money lenders whose operations are characterised by inappropriate services, extortion, and inadequate capital. Two, they can monetize the rural economy which at times have barter transactions whose limitations are well known. Three, formal rural credit system can bridge the gap in lack of simultaneity between income and expenditure that is inherent to agriculture by providing

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* Keynote Address for the Seminar on Agricultural Finance: Problems and Prospects, organized by the Department of Agricultural Economics, Gujarat Agricultural University, Junagadh Campus, Junagadh, Gujarat.

credit and deposit services when there is deficit and surplus, respectively. And four, this system can promote services like complementary new knowledge, working capital credit to acquire new inputs, and term loans for technological transformation of agriculture that entails use of capital that is not always divisible (such as wells, irrigation equipments, land development, tractors, etc.).

All these rationale are relevant even now. They encourage private thrift, investment, employment and output in the rural economy in addition to integrating the huge rural financial market with the rest of the economy.

More so because RFIs have notable accomplishments of their developmental and financial viability goals. Indeed, they have significantly improved their contribution to agricultural growth and to a certain extent, poverty alleviation after the advent of Green Revolution (Desai and Namboodiri 1996a; Desai 1994a; Desai and Mellor 1993; Desai and Namboodiri 1991; Desai, Gupta and Singh 1988; Gadgil 1986; BOI 1977; Jodha 1974; Kurulkar 1983; Mohanasundaram 1993; Rao and Rangaswamy (undated); SBIMR 1987; Banwari Lal 1992; and NABARD 1995). They have demonstrated reasonable efficiency by reaping some scale economies in their costs. For the share of priority sector advances, they have a unit/average profit elasticity of 0.11 to 2.82 per cent at branch level and 1.11 per cent at bank level as against the corresponding elasticities of 0.75 to 2.50 and 0.12 per cent for the share of non-priority sector advances (Desai 1994b; Desai and Namboodiri 1996a and 1996b; and Bhattacharjee 1996).

Considering this as a context, the positive policy initiatives are

1. Infusion of new equity and other resources;

2. Prescription of prudential norms for better accountability;

3. Relocation and/or merger of loss-making branches of the nationalised commercial banks (NCBs), and Regional Rural Banks (RRBs);

4. Memorandum of Understanding (MOUs) and Development Action Plans (DAPs) by RFIs for their better performance, services, and financial viability;

5. Establishing specialised branches like those for hi-tech agriculture by NCBs;

6. Widening the scope of `indirect' agricultural credit to include credit dispension to private agro-marketing and processing as a part of priority sector lending, and loan diversification in general for the rural sector;

7. Permitting RRBs to extend 60 per cent of their new loans to the non-target group (NTG i.e. non-poor), and other banking services, besides investing their surplus funds in UTI, fixed deposits of banks, bonds of development financial institutions and public sector enterprises.

8. Financial and institutional support for NGOs and SHGs that have micro credit dispension through linkage with the formal RFIs; and

9. Opening up the rural credit market for the entry of local private sector banks.

While first two and the last initiatives would strengthen the organisational principles of multi-agency approach and diversified forms of organisation of RFIs, the other initiatives will further develop their vertically integrated organisational structure, density of field-offices, and reach of the clientele with diversified and multiple services.

The three negative initiatives are:

1. RBI discontinuing its contributions to the long-term funds created from its profit and managed by NABARD to refinance agricultural loan portfolio of RFIs;

2. Closing loss-making rural branches of the NCBs and RRBs; and

3. Creation of rural infrastructure development fund (RIDF) with NABARD from the shortfall of NCBs' 18 per cent targeted lending for agriculture.

I shall take up each of these initiatives for a constructive critical analysis. On the positive initiatives, my submission is as follows.

New Equity and Other Resources

Both of these are required because of erosion of capital and reserves that is largely associated with poor loan recovery and recycling, and inappropriate management. All four types of RFIs (namely, three-tiered short-term co-operative credit structure, long-term co-operative credit structure, NCBs and RRBs) have this assistance from the government though NCBs are now also allowed to access the national capital market.

The government support for the formal rural credit system is common all over the world (Desai and Mellor 1993). This may be because of the fact that rural credit market is characterised by unique and more difficult imperfections and externalities. We recommend that those co-operatives and RRBs which have been deprived so far may be given government support. This will make access to rural banking more broad-based, and the institutional and human capital infrastructure created by the past prudent policies better utilised.

But inasmuch as the past experience suggests some lessons for better future rural credit system RFIs may be made more accountable to their clientele. One way by which this could be promoted is to have the customers subscribe to their equity capital. This would also encourage loan discipline among borrowers. This source of fund would also reduce the burden on the exchequer. We further suggest that there should be steep ceiling on individual private ownership of capital to ward off domination by the rich.

Prudential Norms

This is a logical extension of the policy of providing new equity and other resources so that it becomes accountable and more effective. Had the norms of non-performing assets, classification of risky assets, and capital adequacy been adopted in the past, formal rural credit system would have had much more self-esteem and confidence. However, it is better late than never! All the four types of RFIs must be required to adopt these norms in a time-bound framework. But the time frame for the co-operatives and RRBs may be somewhat more flexible as these RFIs unlike NCBs have limited areas of operations with a clientele that is at a lower developmental stage.

Another desirable complementary policy required is to publicly declare moratorium on loan and interest waivers. Any borrowers delinquency associated with natural factors may be assisted by rescheduling loans so that these borrowers become eligible for new loans. A related policy of credit guarantee cover of Deposit Insurance and Credit Guarantee Corporation (DICGC) must be mandatory for all institutions rather than voluntary. And the premium for this coverage may be collected from the borrowers only if they are compensated under this coverage.

Reorganising Loss-making Branches

The proactive feature of this initiative is that it will strengthen institutional infrastructure at the grassroots level. Unless this is realised sustained institutional development so critical to agriculture that is geographically dispersed will remain a distant dream. Only care that is needed is in ensuring the broad participation of the rural clientele in the process of relocation of the branches.

MOUs and DAPs

I see a major paradigm shift in this initiative for institutional development of RFIs. It is mainly in the sense of bottom-up and self-targeting approach to this development based on past and future opportunities. It is also a tool for building self-esteem, accountability, and relevant services for the customers. Both these aspects must be kept in forefront while considering the results achieved for financial viability. Care should also be taken to ensure that the controlling and monitoring authorities at the apex levels do not become bureaucratic about MOUs and DAPs without compromise on the accountability of performance.

Equally important is to decentralise not only action plans but also their implementation so that the location-specific effective services for the clientele are achieved at the grassroots level. In this process NABARD/RBI may also organise their officials as spearhead teams to rejuvenate the field-level institutions. This will be mutually beneficial to all these agencies. And lastly, DAPs must be integrated with the District Development Plans.

Hi-tech Agricultural Branches

With globalization, exports and growth opportunities are perceived for horticulture, floriculture, acquaculture etc.

This perception seems to have encouraged some NCBs to open specialised branches for hi-tech agriculture as these activities may require more sophisticated technology applications. These branches are manned by relevant technical staff to complement the efforts of the operating staff to expand the volume of business that is quality-oriented. All this is interesting as it is more at the initiative of NCBs rather than their controlling authorities, as was often the case in the past. Similar approach is warranted by the NCBs for ensuring that these new opportunities do not get expanded disproportionately as some of them do displace labour.

More importantly, such an initiative is also required for servicing hard-core agriculture as its credit would fructify better only when it is combined with new technology that is both seed and resource-centred (for some options on this see Desai and Namboodiri 1996b; Desai and Namboodiri 1997a).

`Indirect' Agricultural Credit Widened

This innovative credit policy was first introduced in the late 1960s with the advent of Green Revolution and opening up of the input marketing business for the private sector. It is extended to enterprises like farm input dealers, agro-industries corporations, rural electrification corporations, agro-marketing and processing co-operatives etc. that extend support services for agriculture.

Credit extended to even private agro-marketing and processing enterprises is now eligible under `indirect' agricultural credit as a part of priority sector lending. This is a welcome change as it will improve the balance between the forces of demand for these services encouraged through credit to farmers (i.e. `Direct' agricultural credit) and supply of these services associated with this `indirect' agricultural credit. This process will improve agricultural performance in addition to controlling inflationary implications of credit. For these very reasons even the credit extended to farm input

manufacturers may also be considered `indirect' agricultural credit.

Moreover, the priority sector target for agriculture may be raised from the present 18 per cent as these new avenues of `indirect' agricultural credit are large volume business with a consequent reduced availability of credit for the farmers. Such upward revision in priority sector lending requirement would not necessarily affect viability of RFIs adversely as these new avenues are relatively high-interest bearing loans in addition to making both the types of agricultural credit more effective with better recycling of funds.

Before turning to discuss another new initiative, I wish to strongly advocate that there is ample scope to diversify both crop-loans and term-loans at the farmers level to even include credit to meet their (imputed) wage expenses as a part of these loans. This innovation will also indirectly facilitate in meeting the consumption credit requirement to some extent.

RRBs Permission for NTG Loans, other Banking Services and for Investment of Surplus Funds

These banks are now permitted to lend 60 per cent of their new loans to non-target group with the hope that such credit with higher interest rate would facilitate improvement of their viability. The relaxation would also attract better loyalty from the clientele, especially depositors of these banks. But the share of NTG loans may be gradually reduced from 60 to 40 per cent to retain pro-poor image of RRBs that Dantwala Committee had recommended in 1978.

Allowing RRBs to undertake other banking services like issuing demand drafts, bill-discounting, locker facilities etc. will make them more attractive to the customers. It will also enable them to earn some non-interest revenue to improve their viability. This would also be facilitated when they would invest surplus funds in UTI schemes, fixed deposits of

banks, bonds of development financial institutions and public enterprises. But there should be a reasonable ceiling on such investments so that RRBs do not siphon off the local funds from making agricultural and non-farm loans in their areas of operations.

NGOs and SHGs Linkage with RFIs

Making this linkage grow from pilot experiment of NABARD into a regular credit line of RFIs is highly desirable for its own merits. These merits are mainly three-fold. One, it will enlarge the reach/coverage of rural clientele. Two, it will be the reach for those who need credit most and who have shown remarkable loan repayment performance. And three, it will mean lower cost to the RFIs as they will require to serve one group client instead of several individual clients that make up a group in addition to benefiting from NGOs role in making group activity a success. But RFIs should not view this as a substitute for their present modes of reaching the rural clientele. SHGs and NGOs provide at best a complementary mode of reaching the unreached.

Entry of Local Private Rural Banks

This will further strengthen the multi-agency approach and diversified forms of organisation of RFIs by way of providing a choice to the farmers and by increasing the density of field-level institutions. This is a right signal when some private entities have, on their own, shown interest in serving the rural sector.

While relaxation in equity capital requirement to form a bank is a step in the right direction, these banks should also be subjected to same other privileges and restrictions that apply to the existing RFIs. This is to create a level playing field in competition; if left unregulated this can create wastage, and price and non-price wars so typical of credit markets. It is also necessary to protect the interest of multitudes of rural clients that do not typify the urban

groups. For all these reasons operations of all the RFIs including new ones must be part and parcel of Service Area Plans.

My reflections on the three initiatives that are a retrograde are as follows.

1. **RBIs Discontinued Financial Support**

On the recommendation of the All-India Rural Credit Survey Committee, RBI in the late 1950s instituted two funds now called National Rural Credit (Long-term Operations, and Stabilisation) funds from its profit to refinance agricultural credit portfolio of RFIs. This was an unconventional innovation in macro policy for rural credit by international standards; and yet, RBI has discontinued this contribution since 1993.

In a low income country like India the central bank should consider this contribution as a legitimate and desirable avenue of investment of its profit. There are three additional reasons for this: (i) Such a fund encourages RFIs to promote agricultural credit so critically needed to accelerate private investment; (ii) RFIs have an access to this fund only as a refinance facility the need for which may arise from a mismatch in their sources and uses of funds among other factors; and (iii) this fund accounted for barely about 16 per cent of agricultural credit outstanding in 1989-90 suggesting thereby that RFIs have invested more from their resources rather than this refinance facility. All these reasons point to recommend that even NABARD should make contributions from its profit to these funds.

2. **Closing Loss-making Rural Branches**

This is a retrograde step for it reduces the density of field-level offices of RFIs that is already low; it was only 1 for every 1000 hectare of net sown area in the late 1980s as compared to 4 in China. As stated earlier this density is crucial to making rural banking effective

and relevant for its clientele.

Closing any field-level office is a non-option as there are other alternatives to make it viable. This can include relocation, merger and even improvement of the existing unit by making it more effective. Let us not ignore the fact that the rural branches have been highly successful in mobilisation of deposits that are even low-cost in unit terms. Moreover, these deposits have enabled financing the rest of the economy as rural credit-deposit ratio has remained way below 60 to 70 per cent.

3. **Rural Infrastructure Development Fund from NCBs**

What I concur with this initiative is the need for funds for rural infrastructure development. But what I disagree with is to utilise the shortfall in NCBs' targeted lending of 18 per cent in agriculture for this purpose. There are several reasons for this. One, NCBs may perceive it as a medicine that the patient would like the doctor to prescribe! (for a similar view see Rao 1997). Two, agriculturists would be deprived of credit though the government would receive it to fund the rural infrastructure construction. Three, government may become lax in mobilising resources for its legitimate function of this kind. Having said all this is not enough because the issue may be where to get funds for building rural infrastructure.

An obvious option is that the government mobilises new resources including that from disinvestment of PSUs, rationalisation of prices and subsidies, additional taxation including that from agriculture, market borrowings, and even rationalisation of its current expenditure. But, if the issue is the ineffectiveness of the government in implementing rural infrastructure construction then the option is to make it effective or to establish an autonomous Rural Infrastructure Development Authority (RIDA).

Interest Rates

Major initiatives on interest rates policy are threefold. These are:

1. Simplification of interest rates structure for rural credit;

2. Raising of (minimum) interest rates on agricultural credit (initially from 10 to 12 per cent, and then perhaps up to 15 per cent now); and

3. A hotchpotch of fully and partially deregulated interest rates for the four types of RFIs.

While first of these three changes is right, the other two are not. Critical but constructive analysis of these initiatives leads me to conclude that RBI should restore its past leadership role in determining the tiered interest rates with minimum and maximum rates prescribed as guided market policy. This is because credit market dealing as it does in future transactions is inherently imperfect. Credit transaction is different from a transaction in soap or ice cream. The latter transaction gets over between the buyers and sellers at the same time. But the former does not get completed until the entire loan cycle of sanction, monitoring and recovery is not over. And during the intervening period both the lenders and borrowers witness changes which are not perfectly predictable. Under such circumstances the central monetary authority provides a guidance to determining interest rates.

What is advocated is quite common for critical sectors like agriculture, exports, and infrastructure in many countries including those with financial liberalisation (see, for example, Mao and Shive 1995, EPW 1994, and Desai and Mellor 1993). This may be because these sectors encounter more difficult market imperfections and externalities including those due to weather-induced fluctuations.

1. Simplification of Interest Rates Structure for Rural Credit

Prior to new economic environment there were many interest rates that varied broadly with the amount and purpose of loans and farm size. Now they merely vary with the amount of loan and are uniform for all the sectors. The former is a step in the right direction though it needs to be more consistent with the stakes of both borrowers and lenders. Before I elucidate my reservation the latter change may be briefly commented upon.

Policy of uniform interest rates on credit for all the sectors implies that the returns on investment in agriculture, industry, trade, profession etc. are the same. Such a proposition follows from the neo-classicial economics which has a questionable application to (rural) credit market for the reasons stated earlier. But the interest rates for any sector must not be negative in real terms to avoid a subsidy on them. More on this is discussed subsequently. Suffice it to quote Joseph E. Stiglitz, according to whom the rationale for liberalising financial markets is "based on ideological commitment to an idealised conception of markets that is grounded neither in fact nor in economic theory" (Stiglitz 1993).

The new interest rate structure is oversimplified with only three tiers/slabs of amount of loans, namely, up to Rs.25000, Rs.25001 to Rs.200000 and above Rs.200000. Interest rates on these three categories are about 12, 13.5 and 16.5 (prime lending rate) per cent, respectively. Under this new regime both a marginal farmer/tenant would pay about the same interest rate as the large farmer/farm input dealer/small trader selling cosmetic products given that a majority of farmers on an average have a loan that is less than Rs.25000 (**Table-1**).

Another limitation of this new initiative is that the RFIs making these loans would have about the same unit gross margin (i.e. difference between interest rate

on loans and that on deposits/funds) to cover the transaction costs. This is quite contrary to what seemed to have formed the basis for the other two changes in interest rates policy referred to earlier.

Considering both these limitations, it seems reasonable to have four additional tiers, namely, up to Rs.5000, Rs.5001 to 15000, Rs.25001 to 50000, and Rs.50001 to 100000 under the first two categories stated earlier. Interest rates for these additional tiers could, respectively, be 10, 11, 13, and 13.5 per cent, while for Rs.100001 to 200000 it could be 14 per cent.

2. Raising (Minimum) Interest Rates on Agricultural Credit

Between mid-1991 and 1996, (minimum) interest rates on agricultural credit have been raised more than once presumably to improve incentives for the RFIs to make IRDP and other loans more attractive. This consideration has emerged largely from the concern for improving RFI's unit gross margin (i.e. interest spread) (ACRC 1989; GOI undated; Rath 1989; NABARD 1992-93 and 1994; and Adams 1988). It seems to have also been prompted by the widely held belief that there is an interest rate subsidy for agricultural sector (see, for example, World Bank 1973; Von Pischke 1983; Gulati and Sharma 1991; Adams 1988; RBI 1989; GOI undated and 1994-95). I shall first review the former and then the latter.

The concern for improving the unit gross margin has its root in Agricultural Credit Review Committee's (ACRC) analysis of financial viability of RFIs. It is, therefore, appropriate to examine this in some detail.

ACRC defined and measured the financial viability as the difference between unit gross margin and administrative/transaction costs of making a loan of Rs.100. Since this unit net margin was found to be negative for most of the RFIs, ACRC recommended raising of interest rates on agricultural credit. But both the

framework and methodology of ACRC analysis have serious limitations.

One, ACRC's analysis of financial viability is inconsistent with this policy of viability for an institution. What ACRC has studied is a viability of lending and based on that it has concluded that the institution is nonviable. RFIs not only give loans but also borrow, mobilise deposits, collect loans advanced, and provide other services. Many of these operations are joint/complementary.

Two, most administrative costs are common to all these operations. Their allocation to `lending' is thus artificial, arbitrary and fraught with assumptions that can prove misleading.

Three, interest rates on funds ranged from zero per cent on current deposits to 12 per cent on some fixed deposits. Depending on which ones of these are considered and for what loan types, the interest cost would also vary. It seems, the higher of these interest rates and loan duration of five years are considered. But, this is questionable because 63 per cent of `direct' agricultural credit advanced in 1988-89 was for short-term (i.e. upto 12 to 18 months) and another 10 per cent was for medium term (i.e. 1 to 5 years). Even NABARD's recent estimate of interest rate required by RFIs to break-even suffers from these weaknesses, besides being unrealistic in its assumptions of lack of growth in agricultural loans, and absence of scale economies in financial costs.

Four, non-interest revenues are ignored. They can be and are significant for some RFIs. For example, rural branches of NCBs can and do earn commission, exchange etc. Similarly, Primary Agricultural Co-operative Credit Societies (PACS) earn on their sale of inputs and consumer goods.

Five, ACRC's sample of PACS and rural branches of NCBs did not even constitute one per cent of these institutions.

And last but not the least, ACRC found the unit net margin (i.e. average profit) for an institution to be positive for all RFIs (except RRBs for which no result is reported!). This reinforces the first two deficiencies discussed earlier.

Another serious lacuna in the approach discussed above is that it does not distinguish the issue of high costs from rising costs. High costs do not necessarily mean rising average/unit costs. If this cost is rising it implies RFIs have scale diseconomies which is a legitimate cause for concern. This brings us to discuss the evidence on scale economies.

Applying the Theory of Costs to transaction, financial and total costs for each of the four RFIs, it is found that these institutions have either scale economies or constant returns to scale in their transaction costs. Their scale economies in financial costs is constant in nature. But in their total costs they have again either scale economies or constant returns to scale (Desai 1994b; Desai and Namboodiri, 1996a and 1996b; and Bhattacharjee 1996). These findings suggest that RFIs have declining and/or constant nature of their various unit costs. They also imply that these institutions can improve their viability under the existing interest rates and unit gross margin structures. Consequently, cost-based pricing does not require increasing interest rates. Indeed, both lending and deposit rates must be kept constant so that the expansion and diversification in business volume occurs and RFIs can reap full scale economies.

Furthermore, increase in lending rate is unwarranted because demand for rural credit has now become interest elastic (Desai and Mellor 1993; and Desai and Namboodiri 1997b). Under this situation, if lending rate is increased it would reduce the growth in loan demand with consequent decline in business volume and adverse implications for scale economies and viability of RFIs (Desai 1994b). The evidence of scale economies further

suggests that RFIs have low financial viability rather than non-viability. This in turn is due to their low productivity and efficiency. These inefficiencies are largely associated with high loan delinquency, misconceived perception of rural banking being inherently unviable, overbureaucratization, and politization of RFIs.

As regards subsidy element in interest rate on agricultural credit, I first consider how this may be defined. This subsidy exists when the prevailing interest rate is lower than the effective interest rate that the borrower would have paid. In Economics, the latter is the price of credit that would prevail in a perfectly competitive credit market. But such market exists only in the text-books of under-graduate studies. Policy research thus requires defining interest rate subsidy in some other way.

One such approach defines it as the interest rate foregone by the lender in providing agricultural credit. Gulati and Sharma consider this definition. According to them agricultural credit has 4 per cent subsidy since it carried an average interest rate of 12 per cent instead of an alternative 16 per cent on industry and trade credit. But they did not consider the interest rate on export credit which carried an interest rate of 7 to 8 per cent! And secondly, this approach also implicitly assumes perfectly competitive capital market in which (marginal) returns are equal in various sectors like agriculture, industry and trade. But this is questionable, as was argued earlier. So we are back to square one in defining and measuring interest rate subsidy.

It appears that the approach of Neo-finance literature that defines this subsidy could be a reasonably acceptable surrogate. This approach is universally accepted. This may be because allocating transaction costs to credit among other operations including different loan types is almost impossible

because most of these costs are common to the management of sources and uses of funds in any financial institution. Moreover, the measurement of capital itself is an unresolved issue even in the theoretical literature.

Neo-finance literature considers that whenever nominal interest rate on credit is lower than some measure of inflation rate there exists an interest rate subsidy (see, for example, McKinnon 1973 and Shaw 1973). Considering this definition, it is found that on the whole, there has been no interest rate subsidy for agricultural credit in the last 40 years since 1950 except for eight years of exogenous shocks of oil crisis and severe droughts when inflation rate was abnormally high (Desai and Namboodiri 1996a).

To conclude, the evidence of scale economies as well as real interest rate on agricultural credit suggests that the upward revisions in lending rates were not required. The question then arises: Is the new policy justified on the ground of demand price of agricultural loans?

Much of the literature on interest rate on credit does not deal with this consideration. One exception however is emerging. The view that the farmers are continuing to pay astronomically high interest rates to money lenders suggests that they can bear a hike in interest rates of formal lenders. This is not only a perverse case for raising these rates but is based on a logic that is flawed.

Informal lenders' loan services are basically non-comparable to those of formal lenders. The money lenders largely give loans for food consumption, social and religious ceremonies, etc. without much collateral and paper work. Moreover, their loans are typically small and for shorter period. More striking is the fact that some of them even lend in the form of grains etc. and also recover in such forms, besides labour at prices that make effective interest rates even higher than the

nominal rates (see, for example, Bhaduri 1973, Desai 1976, and Reddy 1993). In other words, informal lenders operations are interlinked in credit, land, labour and commodity markets.

Neither the crop loans nor the term loans from RFIs are typically characterised by the features of small size, shorter duration, frequent loan repayment instalments, absence of collateral and paper-work or above all, these interlinkages.

The fact that the rural folks pay high interest rates to informal lenders does not necessarily suggest that their loan demand is insensitive to interest rate. It may as well be elastic; yet, they continue to borrow from the informal lenders because there are no comparable options in the formal segment of the rural credit system. Indeed, elsewhere we have shown that the loans from informal sources are also interest rate elastic (Desai and Mellor 1993). And yet, their share in total rural credit has significantly declined during the last four decades or so with the expansion of the formal credit system.

This expansion has even lowered the interest rates of informal lenders significantly (Desai and Namboodiri 1997b). The decline in interest rates of informal lenders is not unique to India. It is also witnessed by other developing countries with the expansion of their formal credit system (Desai and Mellor 1993, and Wai 1957-58 and 1980).

Yet another argument of Neo-finance literature which recommends raising interest rates for agricultural credit is that the increased rates would discourage more use of scarce capital and by the same token induce larger use of labour that farmers have in ample measure. Even on this count, increased interest rates are unwarranted for three reasons.

One, most forms of capital except harvest combines and weedicides in agriculture are complementary to labour, land and intermediate inputs like HYVs,

fertilisers, cattle feed etc. It is in this respect that agricultural production process is unique and different from the industrial production process.

Two, hence, fixed and working capital (including for family labour) in agriculture are also complementary rather than substitutes. When this complementarity is satisfied the agricultural output response is larger than the sum of effects of each input used individually. This reinforces the rationale for credit for land, labour, intermediate inputs and capital that is complementary to these very resources. It also implies that the farmer-level credit promoted for any one of these alone would fructify much less. And three, the demand for working capital credit in agriculture emerges because consumption (including input use) cycle is more continuous while production cycle matures only at the end of a biological process with consequent seasonality, shorter duration, and smaller magnitude of financial saving. And demand for credit for fixed capital arises due to its lumpy nature and long gestation which ill-matches with the features of rural financial saving just described (Desai and Mellor 1993). Thus, under the Green Revolution type of new technologies most forms of capital are complementary to land, labour, and intermediate inputs rather than perfect substitutes as the neo-classicial economics considers and which seem to underpin the thinking of Neo-finance literature.

Before I turn to discuss the third initiative, it must be stated that the demand for agricultural credit is influenced more by non-price factors like its timely and adequate availability, branch density, access to new technology, and non-lending services of RFIs (see, for example, Desai and Mellor 1993; and Desai and Namboodiri 1997b). Since the new thinking recognises this, its pre-occupation with changing interest rates policy is misplaced.

Hotchpotch of Deregulation of Interest Rates

Co-operatives and RRBs have fully deregulated interest rates. But NCBs have partial deregulation; it is free for deposits of more than one year maturity, and for advances of more than Rs.2 lakh.

Normally deregulation is justified when there is subsidy. But since there was no subsidy it was unwarranted. Furthermore, though initially deregulation did not lead to increases in the interest rates they have significantly increased in recent period. These increases have caused a concern. Hence, in the recent busy season, RBI and GOI pleaded with the bankers to reduce the freed interest rates on loans. Two reasons may have prompted this; one, inflation rate has declined and two, borrowers perceive these rates as too high for making investments. As a result, fortunately, prime lending rates have been reduced by about 1 to 1.5 per cent and the cap on (unit) gross margin of about 4 to 5 per cent is also pleaded. The latter implies a ceiling on lending rates.

But other lending rates have remained unchanged. Consequently, borrowers to whom all these rates are applicable have not gained despite lower inflation rate and their demand being interest sensitive. Such borrowers being placed mainly in rural areas have been by-passed by the RBI and GOI. In other words, the central monetary authority has lost the control over influencing investment of these borrowers who are large in number.

These self-inflicting woes would have highly adverse implications for broad-based (rural) growth and poverty alleviation. Such an impact may even compound under the new regime in which collusion among large borrowers and RFIs may occur. It may even lead to politicisation of interest rates policy or jeopardise RFIs financial viability (Desai and Mellor 1993; and the Economic Times, February 12, 1997). To put it differently, the interest rates deregulation is unlikely to serve the objectives of

various stakeholders better excepting the borrower barons. Considering that it was justified by RBI/NABARD (at least for the co-operatives) for improving viability of RFIs these unintended evils must be overcome. The question is how.

One option is to restore the past policy together with what is recommended in the discussion on the first two initiatives on interest rates. Another option is to fully deregulate interest rates of NCBs so that they have level playing field on this with the co-operatives and RRBs. But the experience of pleading for lowering the prime lending rates cannot be forgotten so early.

I for one would opt for the first alternative for the reasons discussed earlier. Also, it is a better option for it has served reasonably well the past without any interest rate subsidy, and instability in the interest rates in addition to the fact that the problem of viability is more associated with non-price factors. Moreover, steering the realisation of the objectives of all the stakeholders would be relatively easier to implement.

But irrespective of which option is chosen, restraint on increases in interest rates must be exercised because of the evidence of scale economies, positive real interest rates, interest elastic nature of demand for rural credit, and interest inelastic character of supply of rural deposits.

Concluding Observations

Between the institutional development and interest rates policies, new initiatives are far better for the former. Initiatives on institutional development that are in the right direction need to be strengthened by eliminating some of their limiting features. And those that have retrograde process must be turned towards the right direction.

The potential utility of all these initiatives would be realised more if RBI reinstates its past leadership role on interest rates policy together with the simplified structure of these rates that are more in tune with the rural realities.

Table 1
Distribution of Borrowers (%) and Average Amount of Loans (Rs.) by Ownership Holding Size Groups: 1991-92*

Ownership Holdings (Ha.)	PACS			Ownership Holdings (Ha.)	CLDBs		
	% to Total Borrowers	Per Borrower Loans			% to Total Borrowers	Per Borrower Loans	
		Advanced	Outstanding			Advanced	Outstanding
Upto 1	39.81	1939.56	1911.13	Upto 1	55.93	10044.33	9857.96
1 - 2	23.38	3411.58	4689.52	1 - 2	24.86	13013.98	27277.95
2 - 4	17.37	5340.48	7573.08	2 - 4	9.69	27825.89	87194.95
4 - 8	12.47	6739.74	10579.49	4 - 8	5.28	37498.48	131638.19
Above 8	6.97	10141.24	14430.59	Above 8	4.24	42243.78	181175.90
All	100.00	4044.49	5497.45	All	100.00	15319.62	35372.23

Ownership Holdings (Ha.)	PLDBs			Borrower Categories	PACS		
	% to Total Borrowers	Per Borrower Loans			% to Total Borrowers	Per Borrower Loans	
		Advanced	Outstanding			Advanced	Outstanding
Upto 1	28.36	10625.03	52620.14	Tenant cultivators	18.37	1261.80	3625.97
1 - 2	28.62	10205.89	52794.75	Agricultural labourers	34.15	1445.69	1933.26
2 - 4	16.31	15149.55	76927.20	Others	47.48	2082.15	4272.31
4 - 8	14.90	15300.26	66832.79				
Above 8	11.81	17299.91	74856.05				
All	100.00	12727.86	61377.84	All	100.00	1714.15	3354.80

* Latest year for which data in published sources are available.

PACS Primary Agricultural Cooperative Credit Societies
CLDBs Central Cooperative Land Development Banks
PLDBs Primary Cooperative Land Development Banks

Source: Statistical Statements relating to Cooperative Movement in India 1991-92, Part I Credit Societies, NABARD, Mumbai.

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