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Rural Credit: A Historical Overview and Contemporary Views in India

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Abstract

The issues experienced by the poor during this period are remarkably consistent, as this quick survey of rural finance in 20th-century India reveals. They include reliance on predatory lenders and the operation of an intricate web of exploitative, unreliable markets. We lay forth the theoretical and historical justification for nationalizing banks and show how it would benefit rural finance and development. Reforms were enacted in the 1990s as a result of some excesses. This did boost bank profits but at the expense of underdeveloped and impoverished areas. While the MFI lending model is unsustainable, the SHG-Bank Linkage strategy can improve security and empower the underprivileged. The issues that have persisted for the past 100 years require much more than microfinance.

Introduction

This succinct history of rural credit in India spans the 19th and 20th centuries, but the 20th century's most significant events are the focus of this summary. In each instance, the historical narrative pays particular attention to the viewpoints that influenced policy changes and also records the effects of those changes. We start by giving an overview of rural finance during the late colonial era. Over the course of the study period, the issues experienced by India's villages show a striking consistency from this position. The rural poor suffer from dependence on usurious moneylenders and the operation of a highly exploitative network of interconnected, flawed markets. After examining the subpar performance of cooperative credit institutions in India, we present the theoretical justification for the 1969 nationalization of banks and show how it benefited rural credit and economic growth. We do, however, propose that some excesses in the two decades that followed nationalization served as a springboard for the changes that erupted in the 1990s. While there is no doubt that these changes have enhanced bank profitability, they have had a very negative impact on the poor and India's underdeveloped regions' access to affordable rural lending. The moneylenders have unquestionably returned. By a review of its two primary strategies, we evaluate the microfinance industry's efforts to combat this challenge. We contend that the Self-Help Group-Bank Linkage (SBL) strategy has the potential to significantly improve the security and empowerment of the most vulnerable in the current context of farmer suicides, in contrast to the Microfinance Institution (MFI) model, which is unsustainable and may even worsen the situation for the poor. Also, it might play a significant role in enhancing the profitability of banks in isolated rural areas.

Several official records from the colonial era contain extensive documentation of extortionate moneylending practices. The Central Banking Enquiry Committee (CBEC) Report (1929) and its attendant provincial reports, including the Madras Provincial Banking Report, are perhaps the most significant.

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Classic status is accorded to the MPBEC report. It explains how debt usually exerts a cumulative force: A portion of the loan frequently does not be repaid in full, so it becomes a pro-note. It might eventually be paid off within a fortuitous year or it might turn into a mortgage obligation. The creditor takes the majority of the product as a result of this significant, ongoing debt, leaving the ryot unable to pay back short-term loans. Short-term borrowing has also led to long-term debt, creating a vicious cycle. The mortgage creditor prevents the ryot from paying off his short-term debt, and because a big portion of his produce is sent to the long-term creditor, he is unable to farm without taking out loans.

Less than 9% of India's rural credit needs were met by formal credit institutions, according to the historic All India Rural Credit Study (AIRCS) conducted in 1954. More than 75% of the credit in rural areas was provided by moneylenders, traders, and wealthy landowners. Although having been around for 50 years, cooperative credit societies still accounted for less than 5% of rural loans. The cooperative movement in India was showing early signs of illness, according to the Cooperative Planning Committee in 1945, which discovered that many cooperatives were "saddled with the problem of frozen assets, due to heavy arrears in repayment". But, throughout the 1950s and 1960s, cooperative credit societies were considered as the way ahead. The Integrated System of Rural Credit put forth by the AIRCS was to be led by these cooperatives. In 1971, cooperatives' percentage of rural loans did increase to exceed 20%. One of the biggest rural financial institutions in the world today is India's cooperative credit structure (CCS), with over 13 crore members (including 6 crore borrowers). The more than 1 lakh Primary Agricultural Credit Societies (PACS) can be seen as the true foundation of India's rural economy in many aspects. Comparing commercial banks and Regional Rural Banks (RRBs), the CCS has 50% more customers. It affects approximately half of India's population directly or indirectly. The CCS provides services for dairying, weaving, textiles, crop cultivation, processing, and marketing. The CCS, however, has never fully realized the great potential made possible by its extensive reach. The Task Force for the Restoration of Rural Cooperative Credit Institutions claims that the "severe degradation of governance" is mostly to blame for this. Although cooperatives were initially intended to be member-driven, democratic, self-governing, and self-sufficient organizations, they have consistently looked upon the government for several essential services over the years. The Task Force goes into great depth to explain how state governments have taken over as the CCS's primary owners, managers, regulators, supervisors, and auditors. In India, there has been a lack of the mutuality concept, which gave cooperatives around the world their power by combining the functions of credit and savings. Due to regulatory arbitrage, recurring losses, deposit erosion, low portfolio quality, and a loss of competitive edge for the cooperatives, this "borrower-driven" structure is fraught with conflicts of interest (GoI, 2005). Even after independence, cooperatives have retained the dominant role of wealthier members of the rural elite that characterized these institutions during the colonial era.

The AIRCS discovered in 1951 that banks' participation in rural loans was less than 1%. 7 Private commercial banks continued to have a negligible and indirect influence on rural finance even into the 1950s and 1960s. Although not directly in farm output, the AIRCS itself desired the involvement of these banks in agricultural marketing and processing. Notwithstanding a 1954 RBI order requiring them to open at least one branch in unbanked rural and semi-rural areas for every branch opened in previously banked areas, commercial banks' rural branches were few and far between (Meyer and Nagarajan, 2000, p. 172). In 1955, the Imperial Bank of India8 was nationalized, and the newly formed State Bank of India9 was tasked with starting agricultural lending and opening 400 branches in semi-urban areas, even if it meant making a loss. Yet, until 1971, banks only made up 2.4% of the rural credit market, and the majority of

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these loans went to plantations. Their primary function was to invest in bonds floated by land development banks and finance agro-processing businesses. Industry and trade and commerce accounted for the vast majority of commercial bank lending through the end of the 1960s (62% each) (26 percent). The allocation of loans within the industry was biased in favor of big borrowers (Sen and Vaidya, 1997). Moreover, "advances by private banks were routed to sister companies of the banks or to companies in which their directors had a stake" (Chandrashekhar and Ray, 2005, p. 12). 10 In the twenty years following independence, cooperatives continued to be dominated by the rural elite, and banks maintained an urban bias. It is helpful to keep in mind that government control over banks was the norm in the majority of low-income nations in the four 6 We must keep in mind that only people who own land are eligible to join PACS. In addition to being dominated by larger landowners, the landless poor have no access to PACS. 7 According to Chandavarkar (1984, p. 782) Indian banks throughout the colonial era specialized in short-term credit for trade against conventional collateral and disregarded rural credit. 8 created in 1921 by combining the Bombay, Bengal, and Madras Presidency Banks 9 Eight significant state-affiliated banks became SBI subsidiaries in 1959. 10 Eighty years after the First World War, Keynes noted a similar phenomenon in the British setting in the 1920s (Keynes, 1927, Vol. II, pp. 366-45). (Burgess and Pande, 2002, p. 3). In the post-Cold War era, comparable state-led rural financing initiatives proliferated throughout development.

Reforms and their Consequences In 1991, the RBI established a Committee on the Financial System in response to this situation (chaired by M. Narasimham). The Narasimham Committee positioned their report at the center of the larger "liberalization" of the Indian economy process. A "vibrant and competitive financial system to maintain the ongoing transformation in the structural dimensions of the real economy" was what it sought to achieve. It suggested that "directed credit programs should be phased down" and opposed using the credit system for redistributive goals. It called for the deregulation of interest rates as well as the cancellation of the branch licensing regime. Future branch expansion was to be based on "need, business potential, and the location's financial sustainability". Banks desired significant modifications to capital adequacy standards as well as a new institutional framework that was driven by the market and centered on profitability as the primary criterion to be competitive on a global scale. Additionally, it wanted commercial banks from India and beyond to play a bigger role. Table 1 makes it obvious that the number of rural bank branch offices fell progressively after reaching a peak of over 35,000 in 1993, falling to about 30,000 in 2006. The proportion of these offices in all bank branches reached its high in 1990 (58%) before steadily declining and falling to about 45% in 2006. Branch expansion exploded in unbanked regions between 1977 and 1990, as we see above, whereas it decreased in areas that were already served by banks. The precise opposite began to occur after 1990. Instead of expanding, rural branch mergers and swaps became the norm. When compared to 1990, when there were 196 RRBs, there were just 104 in 2006. (RBI, 2007). There was a focused effort to lower the overall number of loan accounts. From a peak of 659 lakhs in 1991 to 524 lakhs in 2001, they gradually decreased before increasing again. From 4% of credit and deposits in 1990 to 18% to 19% of credit and deposits in 2005, private banks have increased their market share. After liberalization, public sector banks are becoming more profitable. The public sector banks' overall non-performing assets (NPAs) as a percentage of total advances have decreased (RBI, 2006, Appendix Table III.26). Nonetheless, the proportion of rural loans has steadily decreased from a peak of 15.3%% in 1987 to 8.4%% in 2006. Moreover, the percentage of rural deposits has consistently decreased from a peak of 15.5% in 1990 to 10.8% in 2006. (see Table 1). Perhaps, a trend reversal in these proportions will result from the large increase in rural loans from 2004 to 2006. By the end of the 1990s, the commercial banks' rural credit-deposit ratio had dropped from its peak of about 69% in 1984 to barely 41%. In the past two years, it has also increased significantly. Yet, it is still far below the 1980s levels. The incremental credit-deposit ratios have decreased even more dramatically, going from over 60% in the 1980s to under 35% in the 1990s for rural bank branches and about 49% in the 1980s to 30% in the 1990s for semi-urban branches (Shetty, 2005, pp.56-57). The regions that are already developing slowly have likewise seen the greatest fall in credit-deposit ratios. These areas had historically had the lowest levels of banking activity, but they benefited enormously from the social banking era in the 1970s and 1980s. Yet, they have experienced another setback since the reform period.

Microfinance has stepped into the void left by the state's exit from the rural credit market. Microfinance is described as "providing thrift, credit, and other financial services and products in very modest sums to the poor, so enabling them to enhance their income levels and improve their living standards" by both NABARD and the RBI (NABARD, 2000; RBI, 1999). Self-help groups (SHG), bank linkage (SBL), and microfinance institutions (MFI) are the two major techniques that define the microfinance business in India (MFIs). The SBL is the bigger model and is exclusive to India, while the MFI variant is the one that seems to be becoming more and more popular abroad. 28 The NABARD-initiated pilot of 500 SHGs in 1992 is where the SBL methodology first emerged. NABARD played a significant part in developing India's distinctive SBL program. It played a significant role in the RBI's 1996 decision to classify linkage banking as a common practice among banks under "priority sector" lending. Because of the collaboration between NABARD and its partner Organizations (MYRADA, PRADAN, and DHAN), the program was given "national priority" by the Indian government in the 1999 Union Budget. More than 22 lakh SHGs had received bank loans by March 2006. They had given their members 11,398 crores of rupees and covered over 3 crore homes. in 2006 (NABARD). 29 In March 2006, it was projected that 162 MFIs in India had loans due totaling about Rs. 1,600 crores (Ghate, 2006). In India, the microfinance industry is still very tiny but is expanding incredibly quickly. Throughout the following four years, the percentage of rural bank credit that was disbursed through SHGs increased from less than 1% in 2001 to over 6%. Size of the SHG Microfinance Sector in India, Year Total Rural Credit of Scheduled Commercial Banks (in crores of rupees): (1) Cumulative Credit Disbursed through SHGs (in crores of rupees): (2) (2)/(1)% 2001: 54431: 481: 0.88: 2002: 66682: 1026 1.54 2003 77153 2049 2.66 2004 85021 3904 4.59 28 Also, more and more commercial banks are choosing this course of action (Hermes and Lensink, 2007). 29, The SBL program is quite unevenly distributed across India, it should be underlined. with the south accounting for over 54% of credit-linked SHGs and 75% of all SHG loans disbursed. There are hardly any people living in the north and northeast. of SBL. 23 2005 109976 6896 6.27 2006 175816 11398 6.48 Ghate (2006) for (2); Basic Statistical Returns, 2001–2005, and Quarterly Statistics on Deposits and Credit of Specified Commercial Banks, RBI: Microfinance in March 2006 has several advantages. Bureaucratic procedures and the arrogant demeanor of officials rendered banks extremely unapproachable for the rural poor even throughout the social banking phase. The experience of entering a bank branch has always been intimidating for villagers, especially for women. The need for collateral and the restriction on using credit other than for legitimate business endeavors make it more difficult for the underprivileged to get bank loans. Even for health and education, which barely qualify as "consumption," banks do not offer loans. Reforms have caused access to decrease even more.

Conclusion

James Tobin, the 1981 Nobel Prize in Economics, discussed "particular egalitarianism," which he defined as "non-market equitable distributions of goods fundamental to life and citizenship," at the Fifth Henry Simons Lecture given at the Law School, University of Chicago. A specific equitable distribution today may be necessary for increasing the distribution of human capital and earning potential tomorrow, as Tobin put it: "In some circumstances, particularly in education and medical care" (Tobin, 1970, pp. 276–77). The lack of access to rural credit, in our opinion, perfectly falls into Tobin's idea of "limiting the realm of disparity." Agriculture, which is now seen as the biggest drag on the Indian economy, saw slow growth in the 1990s due to several issues, one of which was undoubtedly rural finance. More importantly, it has turned into a true agrarian crisis as thousands of farmers have committed suicide and many others have turned to violence (in more than 25% of India's districts). Bhaduri (2006) contends that the administrative expenses of lending are inescapably high in rural areas in his insightful examination of rural finance. One is that loans are typically small per borrower. Agriculture is a seasonal industry, thus loans must be disbursed precisely on time. Also, the expense of servicing and monitoring loans is increased by the sparse population distribution, particularly in dryland tribal communities. Moneylenders can reduce costs in part because they know more about their customers. Perhaps most significantly, since the success of lending depends on "It is conceivable that the lender would form a type of vested interest in the borrower because of their weakness and weak negotiating position. For a better understanding of the process of "concentration and centralization of capital," we might suggest to them reading Schumpeter's (1942) "perennial gale of creative destruction," if not Volume III of Marx's Capital. the borrower's poverty, that is, in keeping the latter sufficiently poor to be vulnerable " (Bhaduri, 2006, p. 165). Bhaduri highlights the potential risks of private lending. Even though public sector banks discover the same thing, the impoverished turn out to be very profitable. tough to maintain activity. 41 We described the linked marketplaces as the mechanism during the colonial era. Rural borrowers can only pledge future labor services, a future crop, or the right to use already-encumbered land as collateral. The lender has the power to undervalue these difficult-to-market collaterals. As a result, the borrower assumes the lender's default risk.

Monitoring is no longer a problem because the borrower is more concerned than the lender is about losing the collateral. Additionally, there is strong motivation to charge usurious interest rates because failure to pay will merely result in the lender seizing the collateralized asset. It could even be stated that the lender prefers to default on repayment. This partnership, which has persisted for millennia in India, is incredibly clever but exploitative. We need a set of changes to meet the needs of finance in rural India, including (1) a massive increase in public investment in ecologically sustainable, low-cost, low-risk agriculture, and all forms of rural infrastructure; (2) market support for crops grown in rainfed areas, like cotton, pulses, and oilseeds, which have grown particularly vulnerable in the post-WTO period (see GoI, 2007, C); and (3) a shift in the way that rural areas are financed. This entails the professionalization of staff and the debureaucratization of processes and personnel. Debureaucratization of processes, debureaucratization of staff, and debureaucracy as a whole are all included in this. The latter should be able to direct rural credit provision in a way that makes it truly sustainable in terms of both finances and the environment. The global public sector reform experience is particularly enlightening in this regard. Nowadays, efficacy is prioritized over efficiency by more than 42 This is estimated to be 21-24% by Ghate (2006). We wholeheartedly support the position taken by the Union Ministries of Rural Development and Women and Child Affairs, according to which the new microfinance bill must include interest rate limitations of 33 percent efficiency, used in the strictest sense of the term in neoclassical theory. There is a change from the focus on "getting things done cheaply" to genuinely "accomplishing one's aims". (2004) Drechsler. Reforms that have been driven solely by concerns for efficiency and profitability have always backfired, especially when it comes to the socially and economically disadvantaged. While rural banks in India could have been strengthened with the addition of professionals in fields like agriculture, earthen engineering, irrigation, livestock development, rural enterprises, etc., reforms have further weakened their human resource capacity. Social pressure to achieve national objectives must be maintained while accomplishing this. To make PACS truly democratic, member-driven, and professional organizations based on the concept of mutuality, reforms to the cooperative credit structure along the lines suggested by the Task Force on the Revival of Rural Cooperative Credit Institutions are necessary. Additionally, the SHG-bank linkage program is strengthened, with the state (especially NABARD) bearing promotional costs in the early years. (6) Strict public scrutiny of the operation of MFIs, including maximum permissible interest rate bands, to ensure that they operate on an even playing field, within the same social framework that motivates other players in the sector. SHG Federations must be facilitated and connected to various apex development agencies. This will enable them to become a vehicle of macro-finance, human development, and sustainable livelihoods for the rural poor.

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