Does Informal Credit Provide Security? Rural Banking Policy in India

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1. Introduction

This paper deals with rural banking and credit policy in contemporary India and with the effect of the current policy of financial liberalization on the credit portfolios of rural workers. It examines, first, the major directions of rural banking and credit policy and indicators of performance of this activity in India since 1969, the year in which 14 major commercial banks were nationalized. Secondly, it attempts to describe and analyse features of indebtedness of rural households, particularly rural worker households, in a south Indian village during different periods of national banking policy. Thirdly, it attempts to evaluate the potential of a new policy alternative microcredit projects controlled by non-government organizations - as a solution for problems of rural indebtedness.

1.1 Problems of rural credit

The burden of indebtedness in rural India is great, and falls mainly on the households of rural working people. The exploitation of this group in the credit market is one of the most pervasive and persistent features of rural life in India, and despite major structural changes in credit institutions and forms of rural credit in the post-Independence period, Darling's statement (1925), that "the Indian peasant is born in debt, lives in debt and dies in debt," still remains true for the great majority of working households in the countryside.

Rural households need credit for a variety of reasons. They need it to meet short-term requirements for working capital and for long-term investment in agriculture and other income-bearing activities. Agricultural and non-agricultural activity in rural areas are typically seasonal, and households need credit to smooth out seasonal fluctuations in earnings and expenditure. Rural households, particularly those vulnerable to what appear to others to be minor shocks with respect to income and expenditure, need credit as an insurance against risk. In a society that has no free, compulsory and universal education or health care, and very few general social security programmes, rural households need credit for different types of consumption. These include expenditure on food, housing, health and education. In the Indian context, another important purpose of borrowing is to meet expenses for a variety of social obligations and rituals.

If these credit needs of the poor are to be met, rural households need access to credit institutions that provide them a range of financial services, provide credit at reasonable rates of interest and provide loans that are unencumbered by extra-economic provisions and obligations.

Historically, there have been four major problems with respect to providing credit to the Indian countryside. First, the supply of formal sector credit to the countryside as a whole has been inadequate.[1] Secondly, rural credit markets in India themselves have been very imperfect and fragmented. Thirdly, as the foregoing suggests, the distribution of formal sector credit has been unequal, particularly with respect to region and class, caste and gender. Fourthly, the major source of credit to rural households, particularly income-poor working households, has been informal sector loans which are usually advanced at very high rates of interest. Further, the terms and conditions attached to these loans have

[1] The formal sector of rural credit is the sector in which loan transactions are regulated by legislation and other public policy requirements. The institutions in this sector include commercial banks, cooperative banks and credit societies, and other registered financial institutions. The informal sector of credit is not regulated by public authorities, and the terms and conditions attached to each loan are personalized, and therefore vary according to the bargaining power of borrowers and lenders in each case.

given rise to an elaborate structure of coercion – economic and extra-economic – in the countryside.

That these factors constitute what may be called the "problem of rural credit" has been well recognized in official evaluations and scholarship since the end of the nineteenth century. Given the issues involved, the declared objectives of public policy with regard to rural credit in the post-Independence period were, in the words of the Governor of the Reserve Bank of India, "to ensure that sufficient and timely credit, at reasonable rates of interest, is made available to as large a segment of the rural population as possible" (Rangarajan, 1996, p. 288). The policy instruments to achieve these objectives were to be, first, the expansion of the institutional structure of formal-sector lending institutions; secondly, directed lending; and thirdly, concessional or subsidized credit (ibid.). Public policy was thus aimed not only at meeting rural credit needs but also at pushing out the informal sector and the exploitation to which it subjected borrowers (Chavan, 2001, pp.5-7 *passim*). Rural credit policy in India envisaged the provision of a range of credit services, including long-term and short-term credit and large-scale and small-scale loans to rural households.

1.2 Three phases of rural banking policy since 1969

The period of our study three phases in banking policy for the Indian countryside. The first was the period following the nationalization of India's 14 major commercial banks in 1969. This was also the early phase of the green revolution in India. During this period, nationalized banks attempted to mop up new rural liquidity. The declared objectives of the new policy, known as "social and development banking", were the following (Wiggins and Rajendran, 1987).

- to provide banking services in previously unbanked or under-banked rural areas;
- to provide substantial credit to specific activities including agriculture and cottage industries; and
- to provide credit to certain disadvantaged groups such as, for example, Dalit households.

The Government of India and the Reserve Bank of India (RBI) issued, from time to time, specific directives regarding "social and development banking".[2] These included setting targets for the expansion of rural branches, imposing ceilings on interest rates, and setting guidelines for the sectoral allocation of credit. Given the new farming practices associated with the green revolution, the first post-nationalization phase of expansion in rural banking saw growth in credit advances for agriculture. Specifically, a target of 40 per cent of advances for the priority sectors, namely agriculture and allied activities, and small-scale and cottage industries, was set for commercial banks. In addition, a decision was taken in 1972 to introduce regional rural banks, institutions that would specialize in social and development banking for rural areas was examined in 1993 by Binswanger, Khandker and Rosenzweig (Narayana, 2000). Advances to the countryside increased substantially, although they were, as was the green revolution itself, biased in respect of regions, crops and classes.

[2] Some of the social objectives of bank nationalization were included in the Bank Nationalization Act, titled formally The Banking Companies (Acquisition and Transfer of Undertakings) Act, 1970). Shetty (1978) notes that the social objectives of bank nationalization were also specified, for example, in Government of India (1969, 1972) and the RBI's Annual Reports and Reports on Currency and Finance. To take some further examples, the directive on Lead Banks was issued in 1969, on Regional Rural Banks in 1975 and on allocating a minimum of 40 per cent of advances to the priority sector in 1979.

In the second phase, which began in the late 1970s and early 1980s, the rhetoric of land reform was finally discarded by the ruling classes themselves, and the two major instruments of official anti-poverty policy were developed: loans-cum-subsidy schemes targeted at the rural poor and state-sponsored rural employment schemes.

Thus began a period of directed credit, during which credit was directed towards the so-called weaker sectors. The most important new scheme of this phase was the Integrated Rural Development Programme (IRDP), a scheme for the creation of productive income-bearing assets among the poor through the allocation of subsidized credit. Initiated as a pilot project in 1978-79, it was extended to all rural blocks of the country in 1980.[3] Much has been written on the failure of IRDP to create long-term income-bearing assets for asset-poor rural households. Among the many reasons for this failure were the absence of agrarian reform and decentralized institutions of democratic government, the inadequacy of public infrastructure and public provisioning of support services and the persistence of employment[4]-insecurity and poverty in rural society. Nevertheless, the IRDP strategy did lead to a significant transfer of funds to the rural poor.

The second phase also involved an expansion and consolidation of the institutional infrastructure for rural banking. "Even ardent critics of India's growth strategy," wrote a noted scholar of India's banking system, "would admit that what the country achieved in the area of financial sector development before the present reform process began, particularly after bank nationalization, was unparalleled in the financial history of any other nation in the world" (Shetty, 1997, p 253). According to Shetty, there was, after bank nationalization, "an unprecedented growth of commercial banking in terms of both geographical spread and functional reach".

The third phase was that of liberalization, particularly after 1991. The policy objectives of this phase were encapsulated in the Report of the Committee on the Financial System chaired by M. Narasimham. In its very first paragraph, the report called for "a vibrant and competitive financial system…to sustain the ongoing reform in the structural aspects of the real economy" (RBI 1991). The Committee said that redistributive objectives "should use the instrumentality of the fiscal rather than the credit system" and accordingly proposed that "directed credit programmes should be phased out." It also recommended that interest rates be deregulated, that capital adequacy norms be changed (to "compete with banks globally"), that branch licensing policy be revoked, that a new institutional structure that is "market driven and based on profitability" be created, and that the part played by private Indian and foreign banks be enlarged. In short, the Narasimham Committee recommended that banking policy be guided more by the market than by regulations set by the public authority.

Let us make it clear that, before the 1990s, the banking system was open to much criticism, including in periodic evaluations by banking commissions particularly of its bureaucratic failures and its insensitivity to the social and economic context in which it functioned. The reforms proposed in 1991, however were not an attempt to bring rural banking closer to the poor, but to throw the entire structure of social and development banking overboard. Shetty shows how the present strategy fails to take account of the structural features of the Indian economy. First, the strategy aims for the "most premature and operationally infeasible goal…of globalization" for the financial sector in India, a goal that has not been set even by industrialized countries. This goal has resulted in the costly and "forced application of capital adequacy and other supervisory norms." Secondly, a

[3] Its forbears were the Small Farmers' Development Agency (SFDA) and the Marginal Farmers' and Agricultural Labourers Agency (MFAL) programmes.

[4] See MIDS (1980), Osmani (1991), Swaminathan (1990a and b), and Dreze (1990).

monetarist approach guides the new policy. This has meant "primacy to the control of money supply" and monetary targeting at the cost of neglecting the "size and distribution of bank credit". Thirdly, the "uncritical acceptance of the free-market philosophy has blinded the government to the needs of a genuine reform of the financial system" (Shetty, 1997, pp.254-263).

The third phase inevitably saw a reduction in rural banking in general and in priority sector lending and preferential lending to the poor in particular. The new policies also contributed to other distortions in the financial system (Shetty, 1997).

2. Record of progress of rural banking

This section documents changes in rural banking at the national level with respect to five indicators: total deposits mobilized and credit advanced in rural areas; the share of priority sectors in total advances; credit advanced to agriculture and allied activities; and the scale of credit disbursed through the IRDP.

2.1 Rural bank offices: deposits and credit

Table 1 documents the growth of bank offices, deposits and gross bank credit in rural areas as well as the share of rural areas in the all India total from December 1969 to March 2000, for all scheduled commercial banks.[5] There are four area categories used by banks: rural areas, semi-urban areas, urban areas and metropolitan areas. The impact of bank nationalization on the growth of scheduled commercial banks in rural areas is clear: the share of rural bank offices in total bank offices jumped from 17.6 per cent in 1969 to 36 per cent in 1972. The share rose steadily thereafter, and attained a peak of 58.2 per cent in March 1990. From 1990 onwards, there was a gradual decline in the share of rural bank offices, and the share fell below 50 per cent in 1998 and thereafter. In fact, the absolute number of bank offices fell in the 1990s: 2,706 rural bank offices were closed between March 1994 and March 2000, most in 1995 and 1996.

The period after nationalization was characterized by an expansion of bank credit to rural areas. The proportion of credit disbursed to rural areas tripled in the 1970s, and continued to rise in the 1980s. After 1988, however, the share of total bank credit that went to rural areas declined, from 15.3 per cent in 1987 and 1988 to 10.6 per cent in March 2000.

Rural deposits also grew rapidly after nationalization; their share of aggregate deposits doubled in the 1970s, from 6.3 per cent in 1969 to 12.6 per cent in 1980 and continued to grow, although at a slower pace, in the 1980s. Once again, the peak was reached in 1990, when rural deposits accounted for 15.5 per cent of aggregate deposits. The pace of deposit mobilization in rural areas fell in the 1990s.

Given the pattern of growth of gross bank credit and aggregate deposits, it is not surprising that the credit-deposit ratio in rural areas rose after 1969. The ratio peaked at 68.6 per cent in 1984 and remained above 60 per cent until 1990. From 1985 to 1988 the share of the rural sector in gross bank credit was higher than its share of total deposits, and in these years, the rural credit-deposit ratio exceeded the all India credit-deposit ratio. In

[5] On the regional pattern of expansion of banking in rural areas, see Narayana (2000).

the 1990s, the credit-deposit ratio fell sharply, coming down almost to the level of 1969.[6] The credit-deposit ratio fell after 1984 at the national level as well. In the metropolitan areas, however, the decline has been reversed significantly in recent years; the data thus reveal a relative shift of credit from rural, semi-urban and urban areas to metropolitan areas.[7]

Table 1. Number of offices, aggregate deposits and gross bank credit of scheduled commercial banks, India, 1969 to 2000

Year	Bank offices		Credit advanced		Deposits		Credit-deposit ratio (%)	
	Rural (number)	% to total	Rural (in Rs 10 million)	% to total	Rural (in Rs 10 million)	% to total	Rural	All areas
1969	1 443	17.6	115	3.3	306	6.3	37.6	71.9
1970			193	4.5	400	7.3	48.3	78.1
1971			159	3.1	378	5.2	42.1	69.7
1972	5 274	36.0	257	4.6	540	6.5	47.7	67.2
1973	6 024	36.5	379	5.3	741	7.4	51.1	70.3
1974	6 447	35.9	483	5.9	923	8.0	52.3	71.0
1975	7 112	35.5	608	6.0	1 171	8.5	51.9	73.5
1976	8 588	36.6	870	6.4	1 539	8.7	56.5	77.0
1977	10 856	40.3	1 105	7.2	2 010	9.4	55.0	71.7
1978	12 534	42.5	1 530	8.4	2 664	10.1	57.4	69.1
1979	14 171	44.0	2 003	9.3	3 559	11.4	56.3	68.9
1980	16 111	46.9	2 643	10.7	4 644	12.6	56.9	66.9
1981	19 453	51.2	3 600	11.9	5 939	13.4	60.6	68.1
1982	21 626	53.0	4 473	12.5	7 414	14.2	60.3	68.2
1983	23 782	52.4	5 576	13.6	8 828	14.4	63.2	67.0
1984	25 541	52.9	6 589	13.5	9 603	13.4	68.6	68.3
1985	29 408	54.6	7 489	14.1	11 722	13.6	63.9	61.9
1986	29 700	55.7	9 387	14.5	14 375	14.0	65.3	63.0
1987	30 585	56.2	11 127	15.3	17 527	14.7	63.5	61.0
1988	31 641	56.2	13452	15.3	20 907	14.7	64.3	61.9
1989	33 572	57.3	15 546	14.8	24 383	15.0	63.8	64.7
1990	34 867	58.2	17 352	14.2	28 609	15.5	60.7	66.0
1991	35 216	58.1	19 688	14.7	33 163	15.1	59.4	60.9
1992	35 218	58.0	20 587	14.5	35 058	15.0	58.7	61.0
1993	35 301	57.6	23 156	14.0	40 672	14.8	56.9	60.5
1994	35 379	57.2	25 074	13.9	47 776	15.0	52.5	56.6
1995	35 008	56.2	28 183	12.7	57 399	15.3	49.1	59.2
1996	33 092	52.7	29 122	11.1	61 106	14.3	47.7	61.9
1997	32 909	50.5	32 525	11.4	73 769	14.7	44.0	56.8
1998	32 854	49.9	37 598	11.4	86 706	14.5	43.4	55.3
1999	32 840	49.2	42 090	11.0	102 697	14.7	40.0	54.8
2000	32 673	48.7	48 753	10.6	120 539	14.7	40.0	56.0

Source: Shetty (1997) for 1969 to 1996 and *Banking Statistics: Basic Statistical Returns*, different issues, for 1997 to 1999, and RBI (2001b).
Note: Data refer to December each year till 1989 and to March thereafter.

6 Interestingly, the credit-deposit ratio for rural Tamil Nadu has generally been higher than the national average. In the late 1980s (from 1988 to 1990 in particular), the rural credit-deposit ratio in Tamil Nadu was greater than one. However, the impact of liberalization has been felt strongly: the credit-deposit ratio fell after 1991 and was down to 0.68 in 1999.

7 See Table 2 in Shetty (1997).

Table 2. Growth rates of rural population, rural bank offices, rural and agricultural credit for scheduled commercial banks, India, 1973 to 1999 (in per cent per annum)

Period	Rural population	Rural bank offices	Credit from rural offices	Rural + semi-urban branches	Credit from rural + semi-urban branches	Credit to agriculture
1973-1981	1.78	15.54	23.46	12.32	16.72	18.76
1981-1991	1.84	7.15	9.97	5.95	7.91	6.64
1991-1999	1.66	-0.86	2.51	0.13	2.88	2.16

Source: Chavan (2001), Table 2.9, p. 40.
Note: Credit figures were deflated with the GDP deflator (base year: 1993-94).

The three phases in banking policy are illustrated in Table 2 by a recent comparative analysis of growth rates of the rural population in India and growth rates of commercial banking (Chavan, 2001). The time-periods chosen were determined by the availability of data. A relatively sharp increase in the number of rural and semi-urban bank offices and in the credit disbursed by them took place in the period 1973 to 1981. This expansion slowed down in the period 1981 to 1991, and declined sharply in the next period, 1991-1999. The same trends were true of total commercial bank credit to agriculture. Table 2 shows that the decline cannot be explained by a decline in the rate of growth of rural population.

2.2 Credit to "priority sectors"

One of the objectives of banking policy after nationalization was to expand the flow of credit to agriculture and small industries, or what were termed "priority sectors". As Table 3 shows, the share of these sectors in the total advances of scheduled commercial banks rose from 14 per cent in 1969 to 21 per cent in 1972 and then went up to 33 per cent in 1980.

The RBI set a target of 40 per cent for priority sector lending and by the mid-1980s this target was met. From 1985 to 1990, in fact, the target was over-achieved, that is, more than 40 per cent of total advances went to those sectors. From 1991 to 1996, the share of priority sector advances fell, in line with the recommendations of the Narasimham Committee. From 1990/91 to 1996/97, loan accounts to agriculture fell by 5 million (Narayana, 2000). While 52 per cent of bank credit in rural areas went towards agriculture in 1985, the proportion fell to 38 per cent in 1998 (Nair, 1999).

At first glance, the direction in priority sector lending appears to have been reversed over the last four years. This is, however, a reversal by redefinition. In the late 1990s, priority sector lending was redefined to include advances to newly-created infrastructure funds, to non-banking finance companies for on-lending to the very snall-scale sector, and to the food processing industry.[8] Loans to Pepsi, Kelloggs, Hindustan Lever and ConAgra now count as priority sector advances, according to the Finance Minister's budget speech in 1999 (*Business Standard*, March 1, 1999). When data for scheduled commercial banks are disaggregated by type of bank (public sector banks, regional rural banks, private banks and foreign banks), we find that there was no lending to rural areas or agriculture from foreign banks (Narayana, 2000, Table 10). Further, foreign banks failed to meet the priority sector targets through the 1980s (although these targets for foreign banks were lower than for other banks in India) (Ramachandran and Swaminathan, 1992).

[8] An examination of the components of priority sector lending shows that the share of lending to agriculture has declined steadily after 1986-87 (*Report on Currency and Finance*).

Table 3. Share of priority sector in total credit disbursed by all scheduled commercial banks, India, 1969 to 1999 (in per cent)

Year	Share of priority sector advances in total credit
1969	14.0
1970	-
1971	-
1972	21.0
1973	23.1
1974	24.2
1975	25.0
1976	24.5
1977	25.9
1978	28.6
1979	30.9
1980	33.0
1981	35.6
1982	36.4
1983	36.1
1984	38.1
1985	39.9
1986	41.0
1987	42.9
1988	43.8
1989	42.6
1990	40.7
1991	37.7
1992	37.1
1993	34.4
1994	36.5
1995	33.7
1996	32.8
1997	34.8
1998	34.6
1999	35.3
2000	36.8

Source: Banking Statistics 1972-1995, Basic Statistical Returns, Banking Statistics Quarterly Handout, June 1999 (RBI, 1999b) and RBI (2001b).

Notes: Figures for 2000 are provisional. See text for recent changes in the definition of "priority sectors".

2.3 Loans to agriculture

The term loans issued by scheduled commercial banks to agriculture between 1980/81 and 1997/98. In real terms, advances rose from 1983/84 to 1990/91, fell in the first four years after 1991, and showed some recovery in 1995/96. It is instructive here to look at the distribution of advances to cultivators by size classes of land holdings. The smallest cultivators i.e., those with land holdings of less than 2.5 acres, were the worst affected by the post-1991 decline in credit to agriculture. The cutback in advances to small cultivators persists: in 1997/98, in real terms, aggregate credit to small cultivators was less than the amount advanced in 1984/85. By contrast, advances to cultivators with more than five acres of land (the largest category) have risen in the last few years and are higher in real terms than before liberalization.

Table 4. Direct institutional credit for agriculture from commercial banks (term loans issued during the year), by size class of household land holding, India, 1980-81 to 1997-98 (in constant 1980-81 prices in Rs. 10 million)

Year	Size class of land holding (in acres)			
	<2.5	2.5-5	>5	All
1980/81	63.2	64.8	369.5	497.4
1981/82	36.8	37.8	131.2	202.9
1982/83	71.1	56.4	218.6	346.1
1983/84	82.4	95.7	323.5	501.6
1984/85	118.4	123.6	409.8	651.8
1985/86	121.7	142.8	398.9	663.3
1986/87	147.5	158.3	486.8	792.6
1987/88	128.9	141.5	464.9	735.3
1988/89	141.9	145.3	472.6	759.7
1989/90	152.1	156.2	496.1	804.4
1990/91	187.1	145.7	496.7	829.4
1991/92	117.0	123.9	429.0	669.9
1992/93	102.8	109.0	421.6	633.4
1993/94	90.2	102.9	360.9	554.0
1994/95	104.8	108.5	468.1	681.4
1995/96	133.9	152.4	544.9	831.4
1996/97	119.9	146.4	599.2	865.5
1997/98	100.2	122.2	497.9	720.2

Source: Report on Currency and Finance, various issues. Notes: Nominal values have been deflated to 1980-81 prices using the GDP deflator. The data refer to July-June for each year.

2.4 Loans under the Integrated Rural Development Programme

Indicators of IRDP, a major component of the credit-led poverty alleviation strategy of the 1980s, are shown in Table 5. First, the number of families assisted annually with IRDP loans rose from 2.7 million in 1980/81 to 3.9 million in 1984/85 and 42 million in 1987/88. Although the programme slackened after that, the number of beneficiaries in 1990/91 remained above the level of the early 1980s. After 1991, there was a steep decline in the number of IRDP beneficiaries; only 1.2 million families were assisted in 1998/99. Indexing the number of families assisted in 1982/83 at 100, means that the number assisted in 1998/99 was a mere 36.7. The term credit disbursed by banks under IRDP followed a similar trajectory. With 1982/83 indexed at 100, total term credit mobilized for IRDP peaked at 113 in 1987/88 and went down to 46 in 1998/99.

To sum up, the period after the nationalization of banks was one of expansion of rural banking, both in terms of deposit mobilization and in terms of credit advances. The spread of banking in rural areas began in the 1970s and was strengthened in the 1980s. The trend was reversed after the introduction of policies of financial liberalization in 1991. This analysis is consistent with S. L. Shetty's observation that "every banking indicator has shown deterioration after the reform process began in 1991-92" (Shetty, 1997, p 265). The extension of private commercial banking in India – including attempts to denationalize banks – is likely to exacerbate this reversal.

Official sources of large-scale data on banking do not touch upon many critical features of the credit system. First, they do not report the total flow of credit to specific sections of rural households, such as the rural poor, the landless, or women within such households. Secondly, they provide no information on the share of the formal and informal sectors in the debt portfolios of rural households. Thirdly, banking statistics tell us nothing about the variety of loan transactions entered into by rural households, the terms of such transactions, and, more generally, the burden of indebtedness on different classes of rural household. Such information can be collected at the village level; village surveys also help provide insights into the local-level socio-economic relations that mediate credit transactions.

Table 5. Number of beneficiaries and credit disbursed under IRDP, 1980/81 to 1998/99

Year	No. of beneficiaries		Amount disbursed by commercial banks, co-operative and regional rural banks	
	(in 100,000s)	Index	(Rs. million, 1980-81 prices)	Index
1980/81	27.27	78.9	2890.50	48.2
1981/82	27.13	78.5	4240.78	70.7
1982/83	34.55	100.0	5998.47	100.0
1983/84	36.82	106.6	6001.11	100.0
1984/85	39.82	115.3	6185.75	103.1
1985/86	30.61	88.6	4889.53	81.5
1986/87	37.47	108.5	6372.36	106.2
1987/88	42.47	122.9	6789.46	113.2
1988/89	37.72	109.2	6581.22	109.7
1989/90	33.51	97.0	6016.69	100.3
1990/91	29.00	83.9	5286.31	88.1
1991/92	25.40	73.5	n.a	n.a
1992/93	20.69	59.9	3702.98	61.7
1993/94	25.38	73.5	4594.46	76.6
1994/95	22.15	64.1	4307.77	71.8
1995/96	20.90	60.5	4667.66	77.8
1996/97	18.89	54.7	5044.65	84.1
1997/98	16.97	49.1	4864.81	81.1
1998/99	12.68	36.7	2761.55	46.0

Source: Report on Trend and Progress of Banking in India 1998-99, 1989-90 and Seventh Five Year Plan 1985-90, vol 2.

Notes: Figures for 1998-99 are provisional (RBI, 1990, 1999c). The year refers to April-March. The amounts have been converted to constant price values using GDP deflators. The GDP deflators for 1997/98 and 1998/99 were estimated based on the projections of the old series of GDP (base year 1980/81) using the growth rates from the new series (base year 1993/94).

3. A profile of indebtedness among landless hired labour households, Gokilapuram village 1977, 1985 and 1999

3.1 Study area and database

Gokilapuram village is in Theni district, in the south-west of the state of Tamil Nadu, in the area known as the Cumbum Valley, a distinct geographical and agroeconomic region within the district. The Valley is shaped like an inverted triangle with a rounded apex, wedged between the Cardamom Hills, whose watershed marks the western and south western wall of the Valley (and the border between Tamil Nadu and Kerala) and the High Wavy and Erasakkanayakanur Hills in the east and south-east. It is an area of much natural beauty and whose specific agroeconomic features include loamy and sandy soils of comparatively high fertility and with assured surface and groundwater irrigation over large parts of the region.

The Valley stands out in Tamil Nadu as a vanguard agrarian region. Paddy and some sugarcane are grown on surface-irrigated land (irrigated by the Periyar system) and coconut, banana, grapes and vegetables are the main crops on groundwater-irrigated land.

The cultivation of these crops is characterized by advanced levels of agricultural techniques by the standards of Tamil Nadu. The agriculture of the Valley draws on a numerically preponderant, largely settled force of hired workers.

This paper reports results from a census-type socio-economic survey of 650 households in Gokilapuram Village in 1999, covering 908 households and compares them with some results from previous surveys, in 1977 and 1985.

3.2 The data set used in this paper

As a proxy for the class of landless households whose income comes mainly from the earnings of its members from hired labour we have separated for this paper two sets of households from the rest. The first set consists of those households that are landless and whose entire income derives from hired labour on agricultural or non-agricultural tasks (we shall call these households "landless labour households with no other sources of income" or "Set 1 households").[9] The second set consists of landless households whose members are hired labourers, but also gain income (however small) from self-employment, salaries or remittances (these households are called "landless labour households with other sources of income" or "Set 2 households"). Incomes in Set 2 other than wages from hired labour generally come from dairying, artisan or service castes' earnings, small salaried jobs (as watchmen or subordinate government employees) and small remittances from the children of the household.

For 1977, we use data for landless households whose major income came from earnings from hired labour in agriculture. This set consists of 257 households; from the sample survey of 1985, we use the category of households with no ownership holdings of land for comparisons with our data for 1999 and 1977 presented a detailed analysis of their socio-economic characteristics (Ramachandran, 1990).

The surveys thus provide data on the level of indebtedness of each household (a measure of the stock of debt) at the time the household was surveyed. Data on loans were collected in similar questionnaires under the following heads: principal, collateral, principal outstanding, rate of interest, interest unpaid, source of loan and purpose of loan. Where individual loans had special terms and conditions attached to them, investigators made separate notes on them. While the three data sets do not represent precisely equivalent categories at the three time periods, they are close enough for comparative use.

3.3 Main results from the field data

As it turned out, the reference period for each survey represented a specific phase of credit policy in the countryside. The first survey was conducted eight years after the nationalization of banks in 1969, and gives us a picture of credit policy during the high tide of the green revolution in the village. The volume of short-term and term-loans coming into the village increased; the flow, however, mainly benefited those who had land on which to introduce the new technology and who were creditworthy, that is, mainly the rural rich (Ramachandran, 1990).

The second survey was conducted at the high point of the implementation of the IRDP in the village. Although coverage of the village poor by the scheme was not complete, loans-cum-subsidies were advanced among the poor on an extensive scale, one that no previous or subsequent credit-based scheme achieved (Swaminathan, 1986;

[9] "Landless" here means with no ownership or operational holdings of land.

Ramachandran, 1990). The third survey was conducted in 1999, eight years after economic policy was explicitly reoriented in the direction of liberalization.

To simplify, the three surveys represent conditions in the village during the green revolution phase (1977), the IRDP phase (1985) and the liberalization phase (1999) of credit policy towards the rural poor.

3.4 Sources of loans

About 68 per cent of landless labour households in 1999 were debtor households (Table 6). This proportion has declined sharply since 1985 (Table 7); the reason for this is the fact that landless worker households no longer have the same access to loans from the formal sector as they did in 1985. The average size of loan among debtor landless hired labour households was Rs 4,556 (Rs 3,494 for Set 1 households and Rs 5,218 for Set 2 households respectively; Table 9).

Table 6. Landless labour households, all households and debtor households, Gokilapuram village, May 1999

Category	All households (number)	Debtor households (number)	(3/2)% (per cent)
Landless hired labour with no other sources of income	233	161	69.1
Landless hired labour with other sources of income	326	221	67.8
All landless hired labour households	559	382	68.3
All village households	908	603	66.4

Source: Survey data, 1999 and Chavan (2001) for last row.

Table 7. Debtor households as proportion of all households in the class, Gokilapuram village, 1977, 1985 and 1999, in per cent

Category and survey year	Proportion
Landless agricultural labour households, 1977	63
Landless households, 1985	83
Landless hired labour with no other sources of income, 1999	69
Landless hired labour with other sources of income, 1999	68
All landless hired labour households, 1999	68

Source: Survey data, 1999, Ramachandran (1990), and Swaminathan (1986).

Tables 8 and 9 shows that of the total number and amount of loans borrowed by debtor landless labour households, only a very small proportion came from the formal sector: 7.7 per cent for the number of loans, 22.4 per cent for the amount. Loans from the formal sector are, of course, typically larger than loans from the informal sector.

Table 8. Number of loans taken, by source of loan, debtor landless hired labour households and all households, Gokilapuram village, May 1999 in number of loans

Category	Source of loan					
	Formal sector		Informal sector		All sources	
	Number	Per cent	Number	Per cent	Number	Per cent
Landless hired labour with no other sources of income	21	5.8	339	94.2	360	100.0
Landless hired labour with other sources of income	51	8.8	527	91.2	578	100.0
All landless hired labour households	72	7.7	866	92.3	938	100.0
All village households	220	14.1	1 335	85.9	1 555	100.0

Source: Survey data, 1999 and Chavan (2001) for last row.

Table 9. Principal borrowed, by source of loan, and average size of loan, debtor landless hired labour households and all households, Gokilapuram village, May 1999 (in rupees)

Category	Source of loan						Average loan size
	Formal sector		Informal sector		All sources		
	Amount	Per cent	Amount	Per cent	Amount	Per cent	
Landless hired labour with no other sources of income	258 000	20.5	999 840	79.5	1 257 840	100.0	3 494
Landless hired labour with other sources of income	697 500	23.1	2 318 280	76.9	3 015 780	100.0	5 218
All landless hired labour households	955 500	22.4	3 318 120	77.6	4 273 620	100.0	4 556
All village households	8 410 000	39.6	12 760 000	60.4	21 170 000	100.0	27 383

Source: Survey data, 1999 and Chavan (2001) for last row.

In respect of outstanding debt, only 11.8 per cent of landless labour households had loans outstanding from the formal sector (Table 10). Scholars have criticized the All India Debt and Investment Surveys, a major source of data on household indebtedness, for underestimating the extent of indebtedness of households, and for overestimating the share of the formal sector in the total principal borrowed by rural households (Chavan, 2001). Nevertheless, it is interesting that even data from another official source, the Rural Labour Enquiry (RLE), indicate that the share of the formal sector in the debt portfolio of rural households has fallen in recent years after rising steadily for over two decades. According to the Rural Labour Enquiry, the amount borrowed from the formal sector as a proportion of all borrowings in the debt portfolios of landless agricultural labour households in Tamil Nadu was 0.4 per cent in 1964/65 and 5 per cent in 1974/75 (Ramachandran, 1990). The proportion rose to 24.2 per cent in 1983/84, rose further to 32.9 per cent in 1987/88, and fell to 23.3 per cent in 1993/94 (RLE, 1990, 1997).

Table 10. Proportion of households with formal sector loans outstanding, Gokilapuram village, May 1999 (in per cent)

Category	Proportion
Landless hired labour with no other sources of income	8.2
Landless hired labour with other sources of income	14.4
All landless hired labour households	11.8

Source: Survey data, 1999.

Our data show that among landless labour households in Gokilapuram, the amount borrowed from the formal sector as a proportion of all borrowings was 17.4 per cent in the green revolution phase, rose steeply to 80 per cent in the IRDP phase, and plummeted by almost 60 percentage points in the liberalization phase (Table 11).

Table 11. Principal borrowed from the formal sector as a proportion of total principal borrowed, Gokilapuram village, 1977, 1985 and 1999 (in per cent)

Category and survey year	Proportion
Landless agricultural labour households, 1977	17.4
Landless households, 1985	80.0
Landless hired labour with no other sources of income, 1999	20.5
Landless hired labour with other sources of income, 1999	23.1
All landless hired labour households, 1999	22.4

Source: Survey data, 1999, Ramachandran (1990) and Swaminathan (1986).

The low share of formal sector loans in the debt portfolios of landless labour households is mirrored in the low share of advances to landless workers by commercial banks. We studied the advances registers of the two main commercial banks (both public sector banks) in Uthamapalayam, the *taluk* centre, in order to derive a summary measure of their advances to the poor. We first looked at the total amount of credit advanced by a bank. We then separated out any advances for which assetless rural workers did not qualify: these included crop loans, terms loans for the development of crop land and plantation land, loans for agricultural machinery that required the hypothecation of land holdings, loans to provide working capital to merchants and loans advanced against the deposit of gold ornaments. The balance of advances – typically, loans for the purchase of milch cattle and draught animals and loans for small-scale self-employment – were loans to which a landless rural labour household had, in theory, access. We then calculated the proportion of such advances to all advances. We visited both banks in mid-July and data refer to total advances as on July 11, 2000 and July 18, 2000. In the branch of the State Bank of India, India's major commercial bank, the advances to which a landless labour family could possibly have had access as a proportion of all advances was a mere 8.4 per cent. In the other bank – the Lead Bank for the district – the proportion was 1.9 per cent.[10]

To summarize, one of the stated objectives of earlier credit policy - whatever its achievements - was to provide preferential access to the poor to credit from the formal sector for production and self-employment. Current policy has reversed that objective. The share of loans from the formal sector in the debt profiles of landless labour households in 1999 was very low and fell steeply between 1985 and 1999. The reversal is clear also from the pattern of advances from local branches of nationalized commercial banks and, in particular, from the minuscule share of total advances to which landless labour households had access.

3.5 Purposes of loans

Data on the purpose for which a household took each loan typically record the proximate reason for taking each loan. Respondent were asked why they took a particular loan, but the replies must be read with care. First, the respondent may have borrowed money for one purpose and used it for quite another. Secondly, the particular purpose stated may be somewhat fortuitous; the respondent may have borrowed money to buy food

[10] The two banks have now been asked to stop all IRDP loans. No credit scheme has taken its place although the managers of both banks told us that they expected to be instructed soon to begin microcredit schemes for groups of rural women.

today because she incurred unexpected medical expenditure yesterday. Bhaduri (1982) examines the fungibility of cash and its implications for separating consumption credit from productive credit.

Table 12. Principal borrowed, by purpose of loan, Gokilapuram village, 1977, 1985 and 1999 (in per cent)

Category and survey year	Purpose of borrowing		
	For agriculture, livestock and other businesses	For consumption	All loans
Landless agricultural labour households, 1977	23.8	76.2	100
Landless households, 1985	44.25	55.75	100
Landless hired labour with no other sources of income, 1999	13.6	86.4	100
Landless hired labour with other sources of income, 1999	26.3	73.7	100
All landless hired labour households, 1999	22.6	77.4	100
All village households, 1999	42.1	57.9	100

Source: Survey data, 1999, Ramachandran (1990) Swaminathan (1986) and Chavan (2001).

The rural poor always need consumption credit, particularly in situations where social security systems are either non-existent or ill-developed: they need credit for food and household subsistence, to meet social and ritual commitments, to pay for educational and medical expenses, to build and repair dwellings and for other purposes. The rural poor also need loans for productive purposes; to finance agriculture, to buy and maintain income-bearing assets, and to finance other small means of employment. The major source of formal-sector loans, commercial banks, do not lend money for other than income-bearing uses. Individual loans from the formal sector are generally larger than loans from the informal sector. Fluctuations in the share of loans borrowed for productive purposes in all loans in the debt portfolios of the poor generally reflect changes in the provision of formal credit to the poor; they do not necessarily reflect changes in the demand for consumption loans.

In Gokilapuram in 1999, the share of loans borrowed by landless labour households for consumption was very high, higher in fact than in previous surveys (Table 12). In 1999, only 22.6 per cent of the principal borrowed by landless hired labour households was taken for directly productive activities (agriculture, livestock and other businesses). The sharp decline between 1985 and 1999 in the share of loans taken for agriculture, livestock and other businesses reflects the reduction in access to formal credit over the period.

3.6 Landless labour households vs. all households

Although data on indebtedness of households other than hired labour households are not yet available, estimates of the indebtedness of *all* village households have been made by Chavan (2000). The proportion of indebted households in the village as a whole (66 per cent) was similar to the proportion of indebted labour households (68 per cent) as shown in Table 6. Similarly, the average size of loan for all households (Rs 27,383) was greater than the average size of loan for labour households by about a factor of 6 (Table 9). This reflects, among other things, the greater access of non-labour households to formal sector credit, since the size of a formal sector loan to landed households is typically much larger than an informal sector loan to a landless household. Table 9 also shows that the share of the formal sector in the total principal borrowed by all households was 40 per cent, while the corresponding share for landless labour households was 22.4 per cent. With respect to the purposes for which loans were taken, 42 per cent of the total principal borrowed by all households in the village were taken for productive purposes; the corresponding share for landless labour households was 23 per cent (Table 12).

3.7 Informalization, rates of interest

The 1990s have not just been a period when the share of informal sector loans in the debt portfolios of the poor increased sharply; they have also been a period over which the process of informalization of the credit market intensified. A formal sector loan is one where the terms and conditions of the loan are regulated by the public authority. An informal loan is subject to no such regulation: it is a personalized transaction, dependent on the specific relation of power between borrower and lender. Over the study period, the personalized nature of transactions in the informal sector intensified.

There are two trends in moneylending as an occupation in the village. First, the number and proportion of persons living off moneylending or whose major occupation is moneylending has expanded. Secondly, moneylending as a part-time occupation or secondary source of income has spread in the village. These trends are supported by the evidence on the composition of lenders within the informal sector.

Table 13 shows the principal borrowed from different informal sector sources as a proportion of the total principal borrowed from the informal sector by landless labour households. The most striking feature of the table is the sharp rise in the share of moneylenders in informal-sector advances, from 27.2 per cent in 1977 to 41.9 per cent in 1999. The traditional dependence of landless labour households on landlords for credit clearly became weaker; the share of landlords in informal sector advances to landless labour households fell from 23.1 per cent in 1977 to 2.4 per cent in 1999. The data also indicate that moneylending as a part-time occupation has spread in the village.

Table 13. Principal borrowed by type of informal lender, debtor landless labour households, Gokilapuram village, 1977 and 1999 (in rupees at current prices and per cent)

Type of lender in the informal sector	1977		1999	
	Amount borrowed (in rupees)	Percentage to total	Amount borrowed (in 000 rupees)	Percentage to total
Moneylenders	21 230	27.2	1 390	41.9
Merchants and millers	13 710	14.9	370	11.1
Landlords	24 970	23.1	80	2.4
Miscellaneous part-time lenders	28 822	31.4	1 480	44.6
Unspecified	3 130	3.4	-	
All lenders in the informal sector	91 862	100.0	3 320	100.0

Source: Survey data and Ramachandran (1990), Table 7.9, p. 156.

New sources of usurious loans have appeared in the village. These are moneylending associations (or *sangams*) whose size varies from about 5 or 6 to 25 subscribers. The members of the group generally belong to the same caste (although in one case the *sangam* consists of workers on grape fields) and each member pays a fixed amount at regular intervals (say once a week) in to a common fund. This fund is then given out as loans, generally at 60 per cent rates of interest per year. The significance of the *sangams* should not, however, be exaggerated. Loans taken from *sangams* constituted about 7 per cent of the total principal borrowed by landless labour households.

The incidence of a type of loan called the *kanthu* loan has increased sharply since the first survey in 1977. As example of a *kanthu* loan, a moneylender gives B a nominal loan of one thousand rupees. It is not actually a loan of Rs 1,000, since B is given only Rs 850. B has to repay the moneylender Rs 100 on an appointed day every week for ten consecutive weeks. The distinctive feature of the *kanthu* loan is that it is time-bound and at the end of the specified time period, the principal *and* interest are repaid. *Kanthu* loans otherwise vary greatly with the amount advanced, the periodicity of repayment and the amount to be repaid each time. Some *kanthu* loans have to be repaid every day; we do not know of any such loan for which the time given for each instalment of repayment was greater than a week.

Every borrower is screened by the lender for his or her creditworthiness and lenders have a sharp-eyed assessment of the borrower's income and wage-earning capacity when they lend money. As a consequence, there has been a proliferation of different types of loans with respect to the terms and conditions attached to each loan. In 1977, a major feature of the labour market in the village was the mediation of the system of wage labour by an elaborate system of labour service; this system had important implications for creditor-borrower relations as well (see Ramachandran, 1990). The system of labour service has now declined. Concurrently, transactions in the informal sector of credit have become more commercialized: a lender lends primarily to gain an income or property through loans, not to be able to extract unpaid labour or to reinforce traditional patron-client relations between himself and the borrower.

A consequence of the commercialization of transactions in the informal sector is that lenders get tougher and tougher with respect to monitoring and enforcing repayment (although physical violence is not a routine method of enforcement). Those who manage *sangams* generally get a person close to the borrower to sign on as a surety and many moneylenders regularly issue promissory notes with each loan. Much time is invested by moneylenders and their henchmen in enforcing repayment (and much scorn poured by them on fellow-lenders who are poor enforcers). In nearby Gudalur (a small town where the major occupation is agriculture), some moneylenders enforce repayment by announcing the names of debtors over loudspeakers fitted on jeeps that are driven through the village; the strategy is that public disgrace (and the fear of public disgrace) will force defaulters back in line. The last resort of many borrowers is flight; those defaulters who flee (individually or with their families) generally go to the industrial town of Tiruppur and its environs in Coimbatore district. They go there to seek work as casual manual workers in wretched working and living conditions rather than having their lives and property uprooted and stripped by their creditors at home.

As already mentioned, agricultural labourers have little - and reduced - access to formal sector loans and the determination of the terms of loans in the informal sector loans have become more individual-specific. These changes have had two consequences on the level of nominal interest rates in the informal sector. First, the general level of interest rates is higher than before and a larger share of loans is borrowed at very high rates of interest. The second consequence is that the interest rates that lenders charge, while being high, vary from household to household, and from individual to individual.

Tables 14 and 15 show that, in 1999, of the total principal borrowed by landless labour households, 64 per cent was borrowed at nominal rates of interest of 36 per cent per year and above. Forty three per cent of the total principal was borrowed at rates of interest of 60 per cent per year and above. If only loans from the informal sector are considered, 56 per cent of the principal borrowed by landless hired labour households was at interest rates of 60 per cent a year or more (Chavan, 2001). As expected, for all village households, a significant share of loans (41.5 per cent) were at low interest rates (1-24 per cent per annum), and only 15 per cent of loans were taken at interest rates of 60 per cent per annum or above. This finding is consistent with the general feature of rural credit reported in Table 4 above that the share of formal credit advanced to households with less than 2.5 acres of land is declining over time. Formal credit typically was disbursed at interest rates that were below 15 per cent per annum.

The share of principal borrowed by landless labour households at rates of interest higher than 36 per cent has doubled between 1977 and 1999 (Table 15) and the share of principal borrowed at rates of interest higher than 60 per cent has risen sharply between 1985 and 1999.[11] It is clear that interest rates in the informal sector rose even during the phase of expansion of subsidized formal credit (1977 to 1985). With the post-1991 withdrawal of the formal sector from lending operations for the rural poor, usury has intensified.[12] In the 1990s, some scholars expected that the formal sector would be a civilising influence on rates of interest in the informal sector of credit (Athreya et. al., 1990), p 269). Their understanding was based on a belief that the formal sector would serve as a countervailing force to the informal sector in the credit market. Events have clearly belied that expectation.

Table 14. Principal borrowed, by size class of rate of interest per year, debtor hired labour households and all households, Gokilapuram, May 1999 (in rupees)

Size class of interest-rate per year	Set 1		Set 2		All landless labour households		All households	
	Principal	% of column	Principal	% of column	Principal	% of column	Principal	% of column
1	2	3	4	5	6	7	8	9
0	63 650	5.2	202 750	7.1	266 400	6.5	620 000	3.0
1<15	71 000	5.8	394 500	13.9	465 500	11.4	4 390 000	21.2
≥15<24	187 500	15.4	313 500	11.0	501 000	12.3	4 190 000	20.3
≥24<36	39 000	3.2	97 500	3.4	136 500	3.4	1 400 000	6.8
≥36<48	253 700	20.8	413 600	14.5	667 300	16.4	4 570 000	22.1
≥48<60	4 000	0.3	182 700	6.4	186 700	4.6	2 070 000	10.0
≥60<120	504 100	41.3	1 025 850	36.0	1 529 950	37.6	2 700 000	13.1
≥120	90 500	7.4	131 100	4.6	221 600	5.4	360 000	1.7
Unspecified	7 000	0.6	86 205	3.0	93 205	2.3	360000	1.8
All	1 220 450	100.0	2 847 705	100.0	5 068 155	100.0	20 660 000	100.0

Source: Survey data, 1999 and Chavan (2001) for last two columns.
Notes: This Table excludes *kanthu* loans and milk-merchants' loans.

Table 15. Share of principal borrowed at rates of interest of 36 per cent and 60 per cent and above, Gokilapuram village, 1977, 1985 and 1999 (in per cent)

Category and survey year	Share at 36 %	Share at 60 %
Landless agricultural labour househdds, 1977	32.3	n.a
Landless households, 1985	50.3	24.0
Landless hired labour with no other sources of income, 1999	69.8	48.7
Landless hired labour with other sources of income, 1999	61.5	40.6
All landless hired labour households, 1999	64.0	43.0

Source: Survey data, 1999, Ramachandran (1990) and Swaminathan (1986).

[11] Ideally, a comparison of interest rates over time should be based on real interest rates. The computation of real interest rates, that is, nominal interest rates adjusted for expected inflation, is a complex task, as the expected rate of inflation will vary with the duration of a loan. To simplify, a common inflation rate could be applied to all loans reported in a given year. However, given the relatively low and stable rates of inflation around our three survey years (4 per cent per annum in 1977-80, 6 per cent per annum in 1983-85 and 5 per cent per annum in 1997-99) nominal rates of interest are not very different from the real rates of interest.

[12] Had the interest rates on *kanthu* loans in Table 14 been included, the average rates of interest on loans would have been still higher. The methodology to merge interest rates on regular loans with the implicit rates of interest attached to *kanthu* loans has yet to be developed.

4. Is NGO-controlled microcredit the alternative?

It is clear from the preceding sections that neo-liberal banking reform amounts, in theory and practice, to a reversal of the public policy objectives of extending the reach of rural credit, providing cheap and timely credit to rural households (particularly economically vulnerable households), overcoming the historical problems of imperfect and fragmented rural credit markets, and displacing the informal sector from its powerful position in rural credit markets. As we have seen, there was a large-scale retreat by the formal sector from the Indian countryside in the post-1991 period. From official policy statements, it appears that the Government envisages only one policy instrument to fill the gap left by the formal credit sector in the countryside: the establishment of microcredit projects in rural India.

4.1 Why microcredit?

In official statements, the move to hand over banking functions in rural areas to NGOs is motivated by weaknesses in the banking system itself, most notably the "twin problems of non-viability and poor recovery performance" of existing rural credit institutions (Rangarajan, 1996, p. 68). The failure of financial institutions to deal with income-poor borrowers in an imaginative and sustainable way and the inaccessibility of these institutions to the poor are stated to be major disadvantages of the existing system. Microcredit institutions are seen as being able to rectify these weaknesses; according to the Governor of the RBI, "the main advantage to the banks of their links with the SHGs [self-help groups] and NGOs is the externalization of a part of the work items of the credit cycle, viz., assessment of credit needs, appraisal, disbursal, supervision and repayment, reduction in the formal paper work involved and a consequent reduction in the transaction costs" (ibid., p. 70).

Thus, microcredit is the favoured alternative to the present system because, first, it is assumed that the transaction costs of banks and other financial institutions can be lowered significantly if these costs are passed on to NGOs or self-help groups,[13] and secondly, because NGOs are expected to perform better than formal sector credit institutions in respect of the recovery of loans.

4.2 Defining microcredit

The terms microcredit and micro-finance have risen spectacularly to fame in the development profession and in development literature in the last decade and a half.

The Declaration of the Micro-Credit Summit held in Washington, D. C. in 1997 defined microcredit programmes as those "extending small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families". The Declaration also stated that, "in most cases, microcredit projects offer a combination of services and resources to their clients in addition to credit for self-employment. These often include savings facilities, training, networking and peer support" (Micro-Credit Summit, 1997). In India, the Task Force on Supportive and Regulatory Framework for Micro-Finance in India (NABARD, 2000) defined micro-finance as the "provision of thrift, credit and other financial services and products of very small amounts

[13] Transactions costs include the costs of information collection, of screening of borrowers, of evaluating projects of monitoring and supervision, of co-ordination and finally, of the enforcement of contracts and collection of dues.

to the poor in rural, semi-urban or urban areas enabling them to raise their income levels and improve living standards." The Reserve Bank of India uses the same definition (RBI 1999a).

While microcredit loans are generally advanced for self-employment projects, they are sometimes advanced for consumption as well. A distinction between consumption and production is, of course, difficult to draw, both on account of the fungibility of cash and because of the organic links between consumption and production. Thus it is not entirely accurate to classify an educational loan or a loan taken to meet medical expenses as purely a consumption loan; medical care and education contribute to productivity as well. Nevertheless, the advocates of microcredit do consider it necessary for microcredit institutions to get borrowers to make the transition from consumption loans to production loans (or loans for income-bearing projects) (Rangarajan, 1997, p. 71).

The characteristic features of microcredit operations, then, are small loans to poor households in rural and urban areas for income generation through self-employment. Microcredit institutions may also provide facilities for savings and other financial services.

Microcredit, as discussed in the international literature, is associated with certain other recurring empirical features.

First, microcredit involves loans without collateral. In the absence of specific policy intervention, landless and asset-poor households are deemed not to be creditworthy by formal sector lending institutions, since they cannot provide collateral that is deemed to be appropriate. In his opening speech at the Micro-Credit Summit, Mohammed Yunus, founder of Grameen Bank, Bangladesh, said that by means of microcredit, "we are celebrating the freeing of credit of the bondage of collateral" (Yunus, 1997).

Secondly, NGO-controlled microcredit loans are generally advanced to individuals who are members of groups. Organizations such as BRAC and Grameen Bank in Bangladesh lend through groups. The NABARD task force identifies three ways of banking with the poor: by means of conventional bank lending, by linking self-help groups with bank lending, and by banks lending to microcredit and micro-finance institutions for on-lending to groups or individuals. The Task Force goes on to say that the second and third methods "are characterized by low transactions costs and high repayments" (NABARD, 2000). The group (or "self-help group") is, in fact, viewed as standing in the place of collateral (Hashemi and Morshed, 1997, p 217). The presence of a group has been called a form of "social collateral" (Johnson and Rogaly 1997). The formation of groups, it is argued, has the double advantage of lowering transactions costs and improving repayment.

Thirdly, and following from the previous paragraph, microcredit is viewed as a way of promoting market-led growth, or, in the words of Mohammed Yunus, of "privatizing the economy" (Yunus 1997). This objective was stated in another way by World Bank President James Wolfensohn in his speech to the Micro-Credit Summit: "Microcredit programmes have brought the vibrancy of the market economy to the poorest villages and peoples of the world" (Micro-Credit Summit, 1997).

Fourthly, this target group are generally only those below a line of absolute poverty as determined by national estimates. Consequently, beneficiaries of microcredit projects constitute a fraction of those in need of credit.

Fifthly, while all definitions concur on microcredit as the provision of "small loans", the scale or "smallness" of loans varies and has to be identified empirically. Loans from the Grameen Bank had an upper limit of 5,000 Taka or around USD 100 (Hossain, 1993). In a sample survey conducted in 1985, however, Hossain found that the loans averaged Tk 3,040 (Tk 3,279 for men and Tk 2,843 for women). The scale is similar in other developing countries; the average loan size was USD 88 in Mexico and USD 157 in Pakistan (Johnson and Rogaly, 1997, pp. 88-89). The NABARD Task Force estimated the credit requirement per family as Rs 6,000 in rural areas and Rs 9,000 in urban areas (respectively USD 128 and 191) but recommended that the average loan given to members of self-help groups (or SHGs) be around Rs. 1,000 (NABARD 2000).[14] The Microcredit Cell of the RBI, however, has proposed a ceiling of Rs 25,000 (around USD 530) for micro-finance, and suggests that the ceiling may be raised, say to Rs 40,000, for borrowers with a track record of regular repayment over two to three years (RBI 1999a).

Finally, while these are the general characteristics of microcredit, a great deal of discussion of the "microcredit alternative" has been on the institutional mechanisms for the delivery of microcredit. A very important component of the argument in favour of a large-scale microcredit effort is that commercial banks cannot and should not directly be responsible for disbursing microcredit loans (because of transactions costs that are allegedly very high and poor recovery). The Microcredit Cell of the RBI, for instance, states clearly that, "NGOs have widespread appeal as micro-finance delivery vehicles" (RBI 1999a). In the Plan of Action of the Microcredit Summit, the responsibility for achieving the goals of the Summit was placed clearly on "the thousands of existing microcredit NGOs, cooperatives, credit unions, grassroots groups, and poverty banks that at present comprise the microcredit movement" (Micro-Credit Summit, 1997). Thus "microcredit" as commonly used means credit provided mainly by the private sector, including NGOs, where the private sector not only controls disbursement but also determines the terms and conditions attached to each loan.

To summarize, microcredit is usually associated with:

- very small loans,
- no collateral,
- borrowers from among the rural and urban poor,
- loans for income-generation through market-based self-employment,
- the formation of borrower groups, and
- privatization, generally through the mechanism of NGO control over disbursement and the determination of the terms and conditions attached to each loan.

In India, as we have noted, microcredit has been described as the way to go with respect to rural banking for the poor. However, NGO-controlled microcredit is not yet as widespread and does not represent as general a policy towards rural credit in India as in Bangladesh, for instance.

4.3 NGO-controlled microcredit: an evaluation

It is clear that, by its very nature, NGO-controlled microcredit does not offer a solution for the problems of rural credit listed in the introductory section of this paper. It is not an instrument for mobilising large-scale funds for scientific and technical change in the countryside, and it does not and cannot supplant the informal sector or overcome the historical imperfections and fragmentation of rural credit markets. NGO-controlled microcredit projects in India cannot hope to achieve the spread and reach of the rural banking system. There are also problems of accountability involved here: NGO-controlled microcredit organizations are not accountable to public scrutiny or to local governments.

[14] The present rate of conversion is approximately USD1=INR47.

Being essentially private, market-oriented organizations, their only formal responsibility is to their donors.

But what of the more limited claim made for NGO-controlled microcredit? Do NGO-controlled microcredit institutions incur lower transactions costs than formal-sector financial institutions and is their record with respect to the repayment of loans superior to that of formal-sector financial institutions? We examine the evidence below.

4.4 Transactions costs

To begin with, it should come as little surprise – despite suggestions to the contrary – that the administrative costs of NGOs (and such costs are, of course, the major component of total transactions costs) are relatively higher than those of commercial banks. NGOs cannot match the economies of scale of a comprehensive system of banking (in the case of India, perhaps the best network of rural banks in the less developed world).

For the period 1988-92, the costs of administration of the Grameen Bank constituted 12.3 per cent of the bank's total portfolio, and the costs of administration of BRAC constituted 40 per cent of its total portfolio (Hulme and Mosley, 1996, cited in Chavan and Ramakumar, 2000). An important finding from the work of Hulme and Mosley is that, in a cross-country study of rural credit institutions, the lowest costs of administration, 8.1 per cent of the total portfolio, were incurred by Regional Rural Banks in India.

Secondly, the costs of administration of NGO-controlled microcredit have actually risen when NGO activity is scaled up. As the Grameen Bank expanded its activities, administrative costs rose from 8.6 per cent of liabilities in 1988 to 18.1 per cent of liabilities in 1992 (Hossain 1988, cited in Chavan and Ramakumar, 2000).

Thirdly, repayment rates in NGO-controlled microcredit projects are related directly to the level of administrative costs and mobilization efforts (Rahman, 1999 and Bhat and Tang, 1998, cited in Chavan and Ramakumar, 2000). Organizations such as the Grameen Bank need large numbers of employees for regular monitoring and assessment, to conduct weekly visits and meetings and to collect dues. Mahabub Hossain notes that, in the case of the Grameen Bank, "the paperwork and the staff time for servicing a given amount of loan are higher than for a normal rural credit programme," and that "the benefits of this intensive credit programme…need to be evaluated against the high costs of operation" (Hossain, 1993, pp. 119-120).

How do NGO-controlled microcredit projects finance their high-cost operations? The evidence on this seems clear. They do so by turning to donors for funds or by raising interest rates to levels higher than those offered by the banking system or by doing both. In his review of the performance of the Grameen Bank in 1984-86, Mahabub Hossain found that although the Annual Reports of the bank reported a small profit, his scrutiny of the account books showed that "the credit operations of the bank involve losses that are compensated for by profits from deposits in other banks of a substantial amount of low-cost funds available from international donors" (Hossain, p. 120). It is acknowledged widely that interest rates charged by microcredit organizations are higher than the corresponding rates charged by commercial banks or other financial institutions. Real interest rates in 1992 varied from 15 per cent per annum in Bangladesh for Grameen Bank to 45 per cent in Bolivia for loans advanced by BancoSol, and 60 per cent in Indonesia for loans advanced by BKK (Hulme and Mosley, 1998, cited in Chavan and Ramakumar, 2000). In Bangladesh, the interest rate charged by Grameen Bank was around 8 percentage points higher than the market rate (Rahman, 1999 cited in Chavan and Ramakumar, 2000).[15] In fact, the literature notes that, in the era of financial liberalization, NGOs too are "free to charge whatever interest rates they wish in order to cover the (at present very considerable) costs of institution building, supervision, experimentation and insurance" (Mosley, 1999, p 377).

Thus the transfer of the task of serving the credit needs of rural borrowers from the banking system to NGO-controlled microcredit projects does not reduce transactions costs but, in effect, transfers transactions costs - higher transactions costs - to donors as well as borrowers.

4.5 Repayments and overdue loans

A record of near 100 per cent repayment is a major success of NGO-controlled microcredit. Repayment rates are reported to be over 95 per cent in many microcredit programmes (Hossain, 1988, Hulme and Mosley, 1998, cited in Chavan and Ramakumar 2000, Johnson and Rogaly, 1997).

This achievement, however, is not costless. A system based on the quick repayment of very small loans does not allow for funds to go into income-bearing activities that have a gestation period of any significance. Only projects with very quick rates of return and high rates of return relative to the tiny investment can meet existing repayment schedules. The first payment on a microcredit loan is generally to be made a very short time after the loan is given. It has been argued that this can put the poorest out of the pale of microcredit, since the ability to pay the first few instalments depends on the initial resource base of the borrower (Zaman, 1997, p. 247).[16]

The repayment record of NGO-controlled microcredit projects slackens as the size of loan rises and as the frequency of borrowing rises. To take the example of the Grameen Bank once again, the default rate was 0.4 per cent among first-time borrowers, 1.2 per cent among second-time borrowers, 6.6 per cent among third-time borrowers and 9.5 per cent among fourth-time borrowers (Hossain, 1988, cited in Chavan and Ramakumar, 2000). Further, when the pressure to repay is as overbearing as it often is, borrowers have to borrow from moneylenders in order to repay NGO-advanced loans (Rahman, 1999, cited in Chavan and Ramakumar, 2000).

High repayment is dependent on high transactions costs. As already mentioned, NGOs invest heavily in supervising, monitoring and enforcing loan repayments. When the activities of NGO-controlled microcredit projects are scaled up, the relative burden of administrative costs tends to increase.

Dealing with overdues: an Indian example.

Adequate data are not available for a comparative study of the problem of overdues in commercial and cooperative banks on the one hand and independent microcredit agencies on the other. Nevertheless, two recent analyses published by the Reserve Bank of India (Ghosh, 2001 and RBI, 2001a) permit some observations on the issue of overdues with particular reference to the performance of one of India's most distinguished microcredit and self-employment organizations, the Self Employed Women's Association (SEWA).

[15] It may, of course, be argued that borrowers have transactions costs in dealing with banks and that these raise the effective rate of interest charged by banks.

[16] For a list of the design features ensuring high repayment, see Hulme and Mosley (1996), cited in Johnson and Rogaly (1997), Table 3.1, page 36.

SEWA, based in Ahmedabad, is an organization of working women, and has long been involved in disbursing microcredit. It has established a bank, the SEWA Bank, which now operates in five districts of Gujarat and advances around 90 million rupees annually. Most of the working capital of the Bank comes from members' savings. A borrower's repayment record is used, in lieu of collateral, to assess her creditworthiness. A recent study of the financial performance of SEWA Bank has found that, at present, "overdues are the major area of concern". In the financial years 1996/97, 1997/98 and 1998/99, Non-Performing Advances (NPAs or overdues) amounted to 28 per cent, 20 per cent and 27 per cent respectively of total loans and advances (Ghosh, 2001,Table 1). For roughly the same period, 1995/96, 1996/97 and 1997/98, the RBI estimates that gross NPAs as a share of the total advances of all public-sector banks together amounted to 17.3 per cent, 18 per cent and 16 per cent (RBI, 2001a). If only Priority Sector advances of public-sector banks are considered, the ratio of NPAs to total advances was 27 per cent, 26 per cent and 23 per cent in each of the three reference years.

The data thus show that the proportion of overdues to total advances of an independent microcredit bank was actually marginally higher than the corresponding ratio for public-sector banks. Scaling-up NGO-controlled microcredit, it appears, can generate problems similar to those faced by traditional banking institutions. The corrective measures being taken by SEWA Bank to address the problem of overdue loans involve greater supervision and monitoring (Ghosh, 2001). For example, daily targets for collection are being set and monitored, leaders from all areas are being called for weekly meetings, a special team of field workers has been created to regularly visit borrowers, and so on (Ghosh, 2001). In short, higher and better repayment requires more staff and closer monitoring. This is as true, of course, for commercial banks as it is for SEWA Bank. In fact, it may well be argued that one reason for the unsatisfactory performance of rural banks in India (both in terms of advances and in terms of recovery) is under-staffing in rural bank branches. In an early assessment of the performance of banks after nationalization, Shetty pointed out that rural and semi-urban bank branches are "generally starved of staff inputs and hence have not fared well in business". For instance, in 1974, rural areas accounted for 36 per cent of bank branches but only 10 per cent of bank employees (Shetty, 1978, p. 1417).

4.6 Small-scale credit and rural banks

As mentioned in an earlier section of this paper, rural credit policy in India needs to offer a range of services and types of loan to rural households. While small-scale, short-term loans – or microcredit – constitute only one among the many services that the public authority should provide, schemes that provide such loans to rural working households do nevertheless serve as a kind of palliative reform in the countryside. For all the weaknesses in its implementation, IRDP played an important role in the 1980s in that it gave new access to millions of rural households to the formal banking system and increased levels of purchasing power in rural India significantly. Small-scale credit schemes have also been the basis for useful and socially progressive experiments in social mobilization.

It is clear that the Indian banking system – cooperative banks and commercial banks – failed on many fronts to fulfil its commitment to the people of rural India in respect of social and development banking. The banking system, we believe, can and must improve its functioning by working with local governments and local voluntary organizations. Some of the transactions costs of loans, costs for banks as well as for borrowers, can be lowered when banks work in an innovative way with *panchayats* and self-help groups.

Small-scale rural credit is indeed necessary, but rural credit policy should build on the strengths of the banking system in this regard. This issue has now been officially recognized in an official report as well. The Expert Committee on Rural Credit set up by

NABARD in its report states that "commercial banks cannot be allowed to withdraw from rural credit" and that cooperative credit institutions need to be strengthened to meet the huge unmet needs of rural credit in India (NABARD, 2001). This paper argues that, despite assertions to the contrary, NGO-controlled microcredit organizations do not incur lower transactions costs than banks (they are able to transfer these costs to others). Banks have many advantages over private microcredit organizations as providers of small-scale loans. They have advantages of scale; the banking system in India has a reach and spread that NGO-controlled microcredit cannot begin to match; banks can cross-subsidize loans; banks are better placed to provide specialized training to their employees in development banking; banks are in a better position to coordinate banking activity with development administrations, local governments and self-help groups; and banks are better able than private microcredit organizations to offer a wide range of financial services to borrowers. For the state to withdraw from the field and hand over small-scale credit to NGO-controlled microcredit organizations is, in effect, to undermine and weaken a major national asset, the widespread rural banking system.

5. Conclusions

Credit policy that attempts to deal with the enormity of the problem of rural indebtedness in India must provide a range of credit services to the countryside, and on a scale that the problem demands. This paper attempted to describe and evaluate rural credit policy in India over the last three decades and to examine its effects on rural workers at the level of a single village.

Three broad phases of banking policy with regard to the Indian countryside can be observed: an early green revolution phase that followed the nationalization of major commercial banks; IRDP phase of credit-based poverty alleviation initiatives; and the most recent phase of liberalization and market-guided banking policy. The first two phases witnessed a significant expansion and consolidation of banking infrastructure in rural areas and, correspondingly, a rise in rural deposit mobilization and advances to rural areas. While the first phase concentrated on the expansion of credit to cultivators, particularly landlords and rich peasants in selected areas, the second phase included credit-based schemes for landless and asset-poor households. The flow of formal sector credit to the rural areas, and specifically to the rural poor, peaked in the late 1980s. The liberalization phase of banking policy has seen a sharp withdrawal of formal banking instruments and credit supply from rural areas.

The village data show that changes in national banking policy have had a rapid, drastic and potentially disastrous effect on the debt portfolios of landless labour households. Rural credit markets in India abhor a vacuum: with the withdrawal of formal sector credit for the village poor, the informal sector has rushed in to fill the space. The village data discussed here refer, to the class of landless labourers. We are thus not in a position to examine the distribution of formal credit in the village as a whole nor can we comment on changes in the distribution across classes after the initiation of financial reforms.

The share of the formal sector in the principal borrowed by landless labour households increased from 17 per cent in the green revolution phase to 80 per cent in the IRDP phase and fell to 22 per cent in the liberalization phase. The share of production and business-related loans in the proximate purposes for which all loans were taken by landless labour households was 23.8 per cent in 1977, rose to 44.2 per cent in 1985 and fell sharply to 22.6 per cent in 1999. The 1999 survey showed new forms of informalization of the credit market, a proliferation of moneylending as a whole-time or part-time occupation, and new trends in the personalization of individual loans. Usury increased over the 22-year period covered by our survey: in 1977, 32.3 per cent of the total principal borrowed by landless labour households was borrowed at nominal rates of interest of 36 per cent and above; the corresponding figures for 1985 and 1999 are 50.3 per cent and 64 per cent. Twenty four per cent of total principal borrowed in the 1985 survey was at rates of interest of 60 per cent and above; the share rose to 43 per cent in 1999.

Every indicator of indebtedness that has been used thus shows that the exploitation of the rural poor in the credit market has intensified in the phase of financial liberalization.

Current policy has, in practice, seen a retreat of formal-sector banking from the countryside. The major policy recommendation designed to fill this gap is the establishment of microcredit projects. The main institutional mechanism envisaged for the disbursal of microcredit are non-government organizations. An NGO typically is expected to disburse loans and collect repayments; crucially, they are also expected to set the terms and conditions attached to each loan they disburse.

Microcredit, by its very nature, cannot attempt to meet the full range of the demand for credit in the countryside. NGO-controlled microcredit is, however, expected to incur lower transactions costs and achieve a better repayment record than the formal banking sector in respect of small-scale, short-term loans. The international evidence, however, does not justify this expectation. There are no indications that the transaction costs of NGO-controlled microcredit are lower than those of rural public-sector banks; on the contrary, the evidence shows that NGO-controlled microcredit are able to transfer their transactions costs - which are generally higher than those incurred by banks - to donors and borrowers. The relatively high rates of repayment achieved by NGO-controlled microcredit is dependent on relatively high transactions costs.

NGO-controlled microcredit projects in India cannot hope to achieve the spread and reach of the rural banking system. There are also problems of accountability involved here: NGO-controlled microcredit organizations are not accountable to public scrutiny or to local governments. Being essentially private, market-oriented organizations, their only formal responsibility is to their donors.

In the first section of this paper, we attempted to show that access to low-interest, timely credit and freedom from extra-economic coercion in the credit market is an essential component of the income and livelihood security and the general freedom of the rural poor. In any enlightened policy of rural credit, there is certainly a place for small-scale, short-term loans, and for a more sensitive approach to rural lending. Banks would do well to work with local governments and self-help groups in this regard. Our view in this paper is that banks have advantages in respect of small-scale rural credit that NGOs lack. The objective of rural credit policy in respect of small-scale loans to the poor in India should be to build on the strengths of the rural banking system, not to undermine or weaken this important national asset.

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