

Reducing Rural Poverty

And Accelerating India's Economic Growth

by Imon Ghosh

Can India's rural economy be an engine for growth ?

Mahatma Gandhi once observed that "India lives in her villages." Forty-five years after Independence, approximately *seven* out of ten Indians still do ...

This paper looks at new ways of ***encouraging rural enterprise*** by reducing the exorbitant interest rates that India's rural population currently pay. Dr. Mohammed Yunus, founder of Bangladesh's Grameen Bank, puts the importance of achieving this in perspective when he states that "Access to inexpensive credit is a fundamental human right."

The modern banking system has failed to deliver inexpensive credit to India's 580,000 villages - despite several expensive attempts to do so. ***Do we need to rethink the appropriate institutional structure for rural banking in India ?*** Some suggestions for achieving this are offered here. Prof. Michael Todaro observes in his landmark text on ***Development Economics*** that the problems of widespread poverty, growing inequality, rapid population growth and rising unemployment all find their origins in the stagnation of economic life in rural areas. There can be no national development without rural development.

The Directive Principles of the Indian Constitution lay down that the State shall direct its policy towards securing for all Indian citizens, men and women equally, the right to an adequate means of livelihood.

Economically empowering India's rural population through access to inexpensive credit would help the government of India to discharge its constitutional obligation to 700 million people living in rural India ... besides significantly accelerating India's economic growth !

Surprising strengths

The economic prospects for rural development are far from bleak (indeed, they show an astonishing robustness), as can be seen from the following facts:

In comparison to heavy industry in India, which employs a mere 3 million workers, small scale and cottage industries (despite their comparatively restricted access to credit) employ 30 million people.

While capital-output ratios have been steadily deteriorating since independence in the heavier capital intensive industries, they look a lot healthier in small and cottage industries.

As Prof. P.C. Mahalanobis (considered to be the architect of India's heavy industry growth strategy) himself noted, "In view of the meagerness of capital resources there is no possibility, in the short run, for creating much employment through the factory industries. Now consider the household or cottage industries. They require very little capital. About six or seven hundred rupees would get an artisan family started. With any given investment, employment possibilities would be ten or fifteen or even twenty times greater in comparison with corresponding factory industries."

Reducing regional disparities and ensuring distributive justice

Heavy industry usually needs to be located in urban areas. Small scale and cottage industries, on the other hand, can be located almost anywhere throughout the country, and facilitate the dispersion of economic wealth rather than its concentration.

Achieving self-sufficiency

Many small scale and cottage industries don't even require access to electricity, the scarcity of which is a major bottleneck for industrial output.

Wide range of output

Modern small-scale industries produce a wide range of goods from comparatively simple items to sophisticated products such as television sets electronic control systems etc.

Among traditional village industries, handicrafts possess the highest labour productivity, besides making a significant contribution to earning foreign exchange for the country.

Mobilizing untapped resources

The Industrial Policy Resolution of 1956 specifically notes, while emphasizing the role of cottage and small scale industries, that: "They provide immediate large-scale employment; they offer a method of ensuring a more equitable distribution of the national income and they facilitate an effective mobilization of resources of capital and skill which might otherwise remain unutilized."

Stemming rural-urban migration

The Industrial Policy Resolution of 1956 further notes that "Some of the problems that unplanned urbanisation tends to create will be avoided by the establishment of small centres of industrial production all over the country." The Lewis-Fei-Ranis model offers us the insight that urban wages would have to be at least 30 per cent higher than the average rural income to induce workers to migrate from their home areas. At this urban wage level, the supply of rural labour is considered to be perfectly elastic. The Todaro migration model, however, postulates that migration proceeds in response to urban-rural differences in *expected* rather than actual earnings.

Efficient credit delivery system needed

However, the rural economy's development potential - and with it, the growth prospects of the entire Indian economy - are not going to be

achieved without the availability of (a) *affordable credit*, (b) in *adequate quantities* (c) at the *right time*.

In its final report (March, 1981), the RBI's Committee for Reviewing Arrangements for Financing Institutional Credit for Agriculture and Rural Development (CRAFICARD) notes that the concept of an integrated approach to rural development and its proper implementation requires the existence of an efficient credit delivery system at the ground level.

But how does one go about creating an efficient credit delivery system that offers affordable credit, in adequate quantities, at the right time, in India's 580,000 villages ?

Rethinking the appropriate institutional structure for rural banking

It is known that the organisation and structure of commercial banks are not identical in all countries.

The differences are dictated by a number of local factors like geographical spread, political factors, economic conditions and traditions, not to mention population density and dispersion.

Although the branch-banking structure that we adopted from Britain's banking tradition has served India's urban centres well, all attempts to extend this institutional structure to India's rural areas have resulted in inadequate coverage, and frequently proved to be expensive failures.

The most recent example is the Regional Rural Banks (RRBs), created in 1975 with the worthy aim of providing credit to small and marginal farmers, agricultural labourers, artisans and small entrepreneurs in order to develop agriculture, trade, industry and other productive activities in rural areas. According to Mr. K.S.V. Krishnamachari, Dy. General Manager of the RRBs Dept. of the State Bank of India, the future of the RRBs in their present form is at stake and recent press reports indicate that the Government of India is seriously considering a proposal to set up a 'National Rural Bank' amalgamating the existing 196 RRBs in the country. (Whether *centralizing* the rural credit function will facilitate the timely delivery of adequate amounts of credit at affordable rates of interest to 580,000 villages

without an efficient credit delivery system at the ground level is an issue that needs to be addressed.)

It is estimated that the RRBs in their present set-up incur losses of about Rs. 5,000,000/- per day - despite their lower costs of operation (... the RRBs, however, have some commendable achievements to their credit, such as opening branches at unbanked/underbanked rural centres - albeit with very limited coverage).

Unit banking superior to branch banking for delivering rural credit

The earliest form of commercial banking was necessarily unit banking which simply means that the entire banking operations were conducted from a single office.

Unit banking has already proven its effectiveness for providing an efficient credit delivery system under conditions similar in several important respects to those prevailing in rural India today:

Until recently, large areas of the U.S.A. were underpopulated. The considerable distances between population centres, the difficulties in travel and communication, and the agrarian nature of the economy all fostered the development of unit banks that were locally organised, owned and operated. Unit banks financed the development of the U.S. economy, and are still prevalent there to this day. They offer many of the advantages of branch banking like providing remittance facilities through a system of 'correspondent banks', not dissimilar to our own 'lead banks'.

Although unit banks today are able to offer the same range of financial services that branch banks provide, they tend to be closer to the communities they serve, and understand their needs better.

Another advantage of the unit banking system - not insignificant from the perspective of a Central Bank and 'lender of last resort', is that the 'domino effect' of an individual bank's failure is limited in comparison to that within a branch banking system.

A case study of a Unit Bank that has served a village for 50 years

In the midst of writing this paper, I was fortunate to come across an actual case study of a Unit Bank that has served a village in Kerala for the past 50 years (the bank was established in 1943), and have an opportunity to interview its founder:

Early in the 1940s, a young man in Keecheri village (Ernakulam district, Kerala) pawned a gold ring with a rich landlord. When he returned to redeem it a year later, he was informed that it had already been sold. His outraged friends decided to establish a bank, and offer the villagers an alternative source of funds to compete with the rich landlord.

That's how the Keecheri Welfare Bank came into existence in 1943, with 7 friends contributing Rs. 10/- each as seed capital.

Deposits grew to Rs. 2,000/- by the end of the year. Today, 50 years later, deposits have multiplied 500 times, in nominal terms, and currently stand at Rs. 1,000,000/-.

The Keecheri Welfare Bank encouraged thrift (with its Monthly Savings Deposit Scheme attracting Rs.10/- Rs. 15/- and more) and introduced the banking habit among the villagers at Keecheri, who appreciated the fact that they didn't have to walk 9 Kms., often several times, to transact a piece of business at a scheduled or nationalized bank - often undergoing considerable inconvenience, formalities and delays.

Unlike their urban counterparts, the villagers at Keecheri enjoy rapid loan sanctions and disbursals: The average time taken to approve a loan is half an hour, instead of the weeks and months taken at urban branch banks ... Over the years, the Keecheri Welfare Bank has helped set up numerous small production units (like poultry farms, or financing a pair of bullocks) besides providing adequate credit at reasonable rates of interest without delay to villagers for agriculture, small trading etc. and offering overdraft facilities enjoyed only by current account holders in larger banks !

The bank has even advanced personal loans without collateral security to assetless workers, on provision of 2 surities (not unlike the Grameen Bank's

innovation in Bangladesh), since everyone in the village knows everyone else - and creditworthiness is easy to assess - something a larger urban branch bank would never do.

Although the Keecheri Welfare Bank used to issue chequebooks to villagers during the early years, the Kerala Moneylenders Act of 1956 cut short this, and other, innovations. Forbidden from using the word "Bank" in their title, an association of rural banks in a similar predicament pooled their resources and consulted a lawyer. On his advice, the Keecheri Welfare Bank became the Keecheri Welfare Bankers.

It could be postulated that Kerala would have been a more prosperous state, with a better manufacturing base, if the Kerala Moneylenders Act, 1956, hadn't come into force.

Unlike co-operative banks (... who nonetheless have a very important role to play) that only lend limited quantities of money, for restricted purposes, to a limited membership - sometimes after much politicking, the Keecheri Welfare Bankers are more liberal in their lending policies and list of beneficiaries.

The spread between interest offered on deposits and interest charged on loans is 6%, covering both administrative expenses (3 or 4 employees, earning Rs. 1,000/- a month, living in the village, and having other agricultural interests) and profits/salaries for the partners. Except, instead of 'spread', the quaint phrase 'stationery charges' is used.

The Keecheri Welfare Bankers maintain accounts with the Canara Bank (Mulanthuruthi Branch), South Indian Bank (Kanjiramattam), Federal Bank (Mulanthuruthi) and the State Bank of Travancore (Mulanthuruthi) who act as "Correspondent Banks" for this rural unit bank.

How does one establish Unit Banks in 580,000 Indian villages ?

The answer is that 'unit banks' already exist in every Indian village, and the RBI doesn't have to spend a single rupee in capital outlays for establishing them ...

India's ancient tradition of indigenous banking

It is known that the writings of Manu dating back five thousand years contained references to banks in India, as did the writings of Kautilya. India's indigenous bankers have a presence in every Indian village, and supported a thriving rural economy prior to colonial rule and the onslaught of the industrial revolution which devastated India's rural economy and marginalized the majority of India's people. The Industrial Commission Report (1918) notes that "At a time when the West of Europe, the birth place of the modern industrial system, was inhabited by uncivilized tribes, India was famous for the wealth of her rulers and for the high artistic skill of her craftsmen."

Having survived the vagaries of time - famines and floods, colonial policies, and more recent attempts by the organized financial sector to marginalize them - India's indigenous bankers continue to occupy a prominent position in India's financial markets. According to the Shroff Committee on Finance for the Private Sector, between 75 and 90 per cent of the total internal trade of the country is being financed by India's indigenous bankers.

The Banking Commission (1972) recognized that the indigenous bankers play a useful role in as much as they make credit available to those sectors (small-scale business units and the retail trade) which are productive but which are generally not assisted by commercial banks either on grounds of cost or the risk involved. The Commission noted that the indigenous banker's methods of operation are both expeditious and flexible ...

Integration of India's financial markets essential for effective monetary policy

Despite the predominant role played by the indigenous bankers in India's economic life, they have always remained outside the pale of organised banking, and ***beyond the influence of the Reserve Bank of India.***

Yet an ***integrated financial market*** that responds to the guidance and leadership of the Reserve Bank of India is an ***essential prerequisite for an effective monetary policy.***

As early as 1931, the Central Banking Enquiry Committee emphasized the necessity of unifying the two sectors of the Indian money market, and recommended the linking of the indigenous bankers with the Reserve Bank of India, after the Reserve Bank was established.

Shabby treatment, limited influence

Having (... with one interesting exception) been treated with undeserved contempt by the modern, largely westernized financial sector led by the RBI, it's hardly surprising that the Reserve Bank's influence with India's indigenous bankers has regrettably been limited.

The key to reversing this unhappy situation lies in cultivating and demonstrating greater respect for the rich heritage, and continuing contribution, of India's traditional financial sector.

Wooing India's indigenous bankers

A review of the interactions that the RBI has had with India's indigenous bankers would be in order:

Since 1935, when the RBI was established, several attempts have been made by the Reserve Bank to bring the indigenous bankers under its orbit of influence.

The Reserve Bank issued a draft scheme for establishing direct links with India's indigenous bankers. In it, the Reserve Bank suggested that the indigenous bankers should give up their trading and commission business, switch over to a western system of accounting, develop the deposit side of banking activities, have their accounts audited by certified accountants and submit to the Reserve Bank a periodical statement of their affairs. In addition, the Reserve Bank wanted the ambiguous character of the hundi to cease and insisted that it should become a negotiable instrument always representing a trade transaction. The RBI also wanted the larger of the indigenous banks to play the role of discount houses (buying and selling bills of exchange, etc.) as in London.

In return for trading away 5,000 years of tradition, and the acceptance of a few humiliating controls, the Reserve Bank promised to provide the indigenous banks all the privileges enjoyed by the scheduled banks !

The suitor is sent packing

The indigenous bankers, with their age-old traditions of independence, declined to accept the restrictions as well as the compensating benefits of securing accommodation from the Reserve Bank on favourable terms.

They disagreed with the suggestions regarding accepting deposits and giving wide publicity to their accounts and their state of affairs.

The indigenous banks were unwilling to give up their trading and commission business, and confine themselves to banking alone. They did not believe that the privileges offered by the Reserve Bank were adequate enough to compensate for the loss of their non-banking business. As a result, the scheme proposed by the Reserve Bank to bring the indigenous bankers under its direct influence regrettably fell through.

The Banking Commission (1972) added a few twists of its own. It declared that indigenous bankers should preferably be members of an association; have minimum prescribed capital requirements of at least Rs. 100,000/-. A summary statement of the volume and nature of business should be furnished annually by each indigenous banker to the Reserve Bank of India.

It's interesting to observe that the Banking Commission has repeated all the suggestions that have been made since 1935 for linking indigenous bankers with the organised banking system. However, the Commission appears to have forgotten the simple fact that the indigenous bankers have been unwilling all these years to accept the terms the Reserve Bank has chosen to offer.

The Imperial Bank succeeded where others failed

An important lesson can be learnt from the State Bank of India's predecessor, the Imperial Bank of India, which achieved a measure of

influence in the early years of this century with the indigenous bankers (even influencing the interest rates they charged) which had never been achieved before, and hasn't been achieved since. The Imperial Bank of India achieved its unprecedented influence simply by respecting the indigenous bankers age-old ways of doing business, and offering them rediscount facilities without cumbersome conditionalities.

Extending the Reserve Bank of India's influence in India's traditional financial markets

Drawing upon the lessons of the past, and the need to integrate India's financial markets as a prerequisite for implementing an effective monetary policy, the Reserve Bank can extend its influence with India's indigenous bankers by demonstrating a genuine respect for their traditional and time-tested ways of conducting business (... we can take justifiable pride in the fact that India had evolved a sophisticated financial system many millennia before much of the rest of the world) while offering them a package of benefits they can't refuse in return for a measure of influence in their lending policies, and determination of interest rates.

In formulating (or rather, reformulating) a scheme to integrate India's financial markets, and give the RBI the leadership role it ought rightfully to occupy, it may be helpful to keep in mind that:

No voluntary exchange ever takes place unless the parties involved in the exchange benefit from it (the RBI's prior experience with India's indigenous bankers certainly shows this to be true).

A refinance facility without cumbersome strings attached is likely to be appreciated by India's indigenous bankers, particularly during the busy agricultural season between November and June (as the experience of the Imperial Bank of India, and the measure of influence it was able to exercise with India's traditional financial markets, demonstrates).

A villager in need of a loan can go to village moneylenders (still the most prevalent source of rural credit in most Indian villages), traders and commission agents (who supply funds to farmers for productive purposes much before crops mature. Unfortunately, they often force farmers to sell

their produce at low prices and charge a large commission for themselves), relatives (these loans are generally contracted in an informal manner; they carry low or no interest and are returned soon after the harvest. However, with the increasing needs of modern agriculture, the farmer cannot depend upon this source to any large extent). Landlords (small farmers and tenants often depend for their financial requirements upon landlords - who have occasionally been known to turn landless labourers into bonded slaves ... befitting their role as a colonial vestige created to facilitate the collection of land revenues).

Among the institutional sources of credit, villagers can turn to Co-operative Credit Societies (encouraged by the RBI and the Govt. of India, co-operative societies have made spectacular progress, particularly in Tamil Nadu, Andhra Pradesh, Karnataka, Punjab and Himachal Pradesh. But as Ruddar Datt and K.P.M. Sundharam note in their text on the 'Indian Economy', "In many places, the working of the co-operatives have been hopelessly wrecked by unscrupulous and dishonest farmers, thus denying the benefits of co-operation to really needy farmers."), Land Development Banks (although they offer inexpensive credit with repayments spread over 15 or 20 years, the relatively insignificant amounts loaned by the Land Development Banks every year haven't been able to address the problem of rural credit in a serious way. Nearly 70% of the land development banks are located in the three South Indian States of Tamil Nadu, Andhra Pradesh and Karnataka. And as they lend against the security of land, the larger landlords rather than the small peasant farmers have been beneficiaries.)

Commercial Banks (due to the uncertain character of Indian agriculture, lack of proper accounting of agricultural transactions, small amount of individual loans, inadequate security for loans, and difficulty of collection from farmers, commercial banks in India have largely confined their operations to urban areas, even after nationalization), and the Government (a source of rural finance for short as well as long periods, Government loans to farmers, or 'taccavi loans', are generally given in times of emergency or distress, such as famine, flood etc. The rate of interest is low - about 6% - and the mode of repayment very convenient - in installments paid along with land tax. Although popular because of their low rate of interest, taccavi loans have not assumed any significance because farmers find it difficult and time-consuming to get these loans).

Although institutional credit is inexpensive, it is seldom disbursed in a

timely manner, or in adequate quantities.

Village moneylenders, on the other hand, freely supply both short and long-term loans in adequate quantities without undue delay, which largely accounts for their continuing preponderance in rural areas. Their business methods are simple and flexible, in contrast to the cumbersome procedures associated with institutional finance.

The major drawback with village moneylenders is that the rates of interest they charge, particularly during the busy agricultural season, tends to be exorbitant (usually in excess of 24%).

It could be argued that a modern urban branch bank transported into a rural area, and left to its own devices without any refinance facilities, would be forced to charge interest rates similar (or possibly higher, on account of their larger overheads) to those levied by the village moneylender. Unlike the village moneylender, however, our urban branch bank's prospects for survival over the long run in a rural area are quite dim ...

The solution for integrating India's financial markets, extending the RBI's influence with the indigenous bankers, and creating an efficient credit delivery system at the ground level (without large capital outlays) that offers affordable credit, in adequate quantities, at the right time, in India's 580,000 villages therefore appears to lie in ...

- Offering village moneylenders (however distasteful this idea may seem at first sight) and other indigenous bankers refinance facilities. This would be especially valuable during the busy agricultural season. Refinance facilities would lower the interest rates the indigenous bankers need to charge on loans in order to remain viable.
- Respecting the time-tested methods of doing business preferred by the indigenous bankers to the greatest degree possible, while setting the norms necessary for participation in the scheme to ensure the RBI's own influence and leadership over India's integrated financial markets.
- Treating each village moneylender/indigenous bank as a unit bank, but permitting them the freedom to establish branches without hindrance where they find it economically viable to do so.

- Ensuring that participation in the scheme is voluntary, and permitting more than one moneylender/indigenous banker per village to participate to encourage competition, and discourage monopoly.
- Conducting in-depth studies relating to village credit institutions and how well they fulfill the integrated credit requirements of all segments of the village community, in particular the poorest of the poor, and asset-less workers, who need to be drawn into the economic mainstream (and whose skills and talents are needed for rural - and national -development).

A study of how the U.S. Federal Reserve System influences the lending policies and interest rates of the United States' numerous unit banks would also go a long way in facilitating the RBI's influence in India's traditional financial markets.

With economic growth assuming a new urgency since independence, the range of functions of the Reserve Bank has been steadily widened to include a variety of developmental and promotional functions that at one time were regarded as being outside the normal scope of central banking. According to De Kock, "A true Central Bank should always be ready to perform any functions ... if the conditions and circumstances in its area of operation render it necessary or desirable. The guiding principle for a Central Bank, whatever function it performs at any particular moment, is that it should act only in the public interest and without regard to profit as a primary consideration."

An interdisciplinary approach necessary for success

The RBI's initiatives in promoting rural development are more likely to succeed if the social dynamics that influence the utilization of credit are taken into account.

Social mores that encourage unproductive expenditures like excessively extravagant weddings (and equally extravagant litigation etc.) need to be addressed, perhaps through the village panchayat institutions that are currently being rebuilt and strengthened.

Other issues that can facilitate or hinder rural development like caste-based loyalties that influence the dispersion of rural credit need to be taken into account.

It may be possible to enhance the status of women in rural areas (... and even reduce the population growth rate) through the creation of exclusive credit channels for women, enabling them to establish their own cottage or small scale enterprises. The record appears to show that women `husband' financial resources better than men, since they are more sensitive to the requirements of their families, and less likely to blow up the money on booze ...

Mahatma Gandhi's vision for rural India

The modern concept of development, which encompasses the core values of ***life-sustenance*** (the ability to provide basic human needs), ***self-esteem*** (a sense of self-worth, and pride in one's culture/way of life) and ***freedom from servitude*** (of not being used as a tool by others for their own ends) is in surprising consonance with Mahatma Gandhi's own model for development.

Mahatma Gandhi sought to reverse the continuing decline of India's rural economy and attain maximum self-sufficiency in our village communities. The `Gandhian model of growth' emphasized simplicity, non-violence, sanctity of labour and human values. A basic objective was to raise the material as well as the cultural level of the Indian masses to a basic standard of life within a period of 10 years.

Perhaps its time we ***finally*** actualized the noble vision the Father of our Nation had for India !

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