A Preliminary Report

India's Economic Structure and Financial Architecture:A Growing Mismatch[*]

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I

Introduction: Public Policies As Source of Financial Stress

In recent policy pronouncements on the future of the financial sector in India, a dominant theme advanced by the authorities has been one of gradual harmonisation with the international best practices, in particular standardised approach to credit risk and the basic indicator approach to operational risk under Basel II norms (RBI 2008A:28). In the same vein, proposals have been canvassed for consolidation of banks so as to create some big banks of global standards and removal of voting rights restrictions so as to attract foreign capital into the banking industry. Thus, based on the globalisation goals and the objectives of setting global standards, the priorities and challenges facing the banking industry are conceived in terms of upgrading risk management practices in banks and supervisory processes "for dealing with the stress in the financial system" (*ibid*:27). It is the same policy perspective that has been advanced in the just released *Report on Currency and Finance 2006-08* (August 2008) which is entirely devoted to the subject of "The Banking Sector in India: Emerging Issues and Challenges". Befitting this stance, the Report argues that "supply-driven credit, which is being followed at present in India and several other countries has not been effective" for agriculture and even the SME sector (p.58); therefore, the Report resurrects the philosophy of demand-centric approach for both the sectors - credit based on land as collaterals for agriculture and asset-based financing for the SME sector in India. Such a policy formulation is apparently the final culmination of an incessant drive towards dismantling all aspects of social banking objectives and operations which had served the benefits of the vast informal sectors like

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agriculture and micro and small non-farm enterprises at least for a decade after the bank nationalisation; studies have shown that in the 1980s, substantial redistribution of institutional credit in favour of these sectors had conferred many an economic and social benefit: reduction in dependence on moneylenders and widening the demand base of the economy leading to acceleration in overall economic growth. Now, under the dispensation of global standards, the formal financial institutions find it difficult to reach the assetless poor. It was in this context of the working of the financial markets that are characterised as markedly different from other markets, that Joseph Stiglitz came out clearly to assert that globalisation could have devastating effects on developing countries and especially the poor within those countries (Stiglitz 2002 and 2003).

Thus, in the whole policy discourse now on the expected role of the financial system in India, what is neglected is the imperative of institution-building which is the fountainhead of the supply-leading approach to credit delivery for agriculture, micro and small enterprises and for other informal sectors adopted following bank nationalisation. In fact, it is not realised that a good part of the risk management issues also can be taken care of, if we have a fairly decentralised institutional structure with the spread of branch network in the length and breadth of the country, professionally well-manned, such that 'lenders have sufficient knowledge about borrowers' and information asymmetry giving rise to the issues of moral hazard and adverse selection is avoided.[1]

Bank Consolidation and Global Operations – A Premature Proposition

The use of a weak financial architecture not befitting the country's economic structure is preventing the spread of financial intermediation regionally, functionally and across different size classes of households – which is the substantive theme of this paper; we shall revert to it in the next section. Before doing so, we wish to dilate a while on the priorities of banking sector reform which the authorities have chosen to adopt and which, when implemented, are sure to hurt the interest of broad-based development. First, any

[1] In our perception, the presence of information asymmetry and the issues of *moral hazard* and *adverse selection* are exaggerated insofar as the functioning of commercial and cooperative banks in developing economies are concerned. Unlike in advanced market economies where banks operate as wholesale financial intermediaries, banks in developing countries adopt branch banking combined with relationship banking under which bank managers, if they function professionally, have reasonably good knowledge of the regions and clientele they serve.

forced consolidation of banks is uncalled for. Size of the banks is a function of the size of the economy, its growth and diversification. What has been achieved so far has been commendable. Country experiences have shown in America and elsewhere that there is no immutable relationship between size and operational efficiency; the smaller banks, which specialize in certain areas of business or regions, may have a comparative advantage over larger banks by virtue of their core competence (Report of the Committee on Fuller Account Convertibility July 2006; Chairman: S.S. Tarapore). Also, in a branch banking system, the size has to be measured by the branch network that the banks possess with potential for business growth; by that measurement even small banks in India compare favourably with those in industrialised countries. Secondly, any scope for the Indian banks to operate globally is somewhat premature, for the country does not produce current account surpluses on a large scale. Japan and south-east Asian economics have expanded their global presence precisely as a consequence of their vast foreign exchange surpluses drawn from current account balance and not based on borrowed reserves as India has done. The Indian banks have a pivotal role to play domestically before they can embark on global presence. Third, India has been very liberal in permitting the presence of foreign banks based on any global yardstick. The number of foreign banks operating in India (29 in 2007), their business and the number of branches (272), have all been very liberal (RBI 2008B:384). Fourth, excessive upgradation of risk management practices and supervisory processes in the name of dealing with stress in the system prevent banks from expanding regionally and adopting innovative lending practices for the poorer regions and informal sectors. Finally, above all, stresses and strains in the financial system are inherent in the kind of liberal policies pursued far beyond what many advanced countries adopt. One or two examples should prove this final point.

Unmitigated Secondary Market Operations: A Source of Stress

While studying the growth of the Indian financial system, what stands out is the mindboggling size of turnover in secondary markets in every segment of the system. History has shown that entrepreneurship in this country has strong trading proclivities. Every opportunity is taken for arbitraging and speculation far beyond the genuine

requirements of hedging and far beyond the practices prevalent in the advanced healthy markets (Table 1). Such activities in this country are stimulated by the policies pursued by public authorities. First, in the commodities markets, futures trading may be helpful in some instances, but the way the authorities have permitted futures trading in about 100 commodities with an overwhelming number from the agricultural sector with hardly any distinction in margining for hedging and speculation – a simple process of avoiding gambling type of dealings. Because of the dominance of the speculator-financial interests in futures, genuine price discovery for the farmer is found to be very difficult. Anybody familiar with the current agrarian structure would vouch that not even a miniscule fraction of the farmers can participate in the futures market and enjoy the benefits of hedging and risk management. Because of the limited amounts of physical deliveries, risk management is impossible of achievement.

Secondly, though on the face of it, it appears that the stock market operations in India are more modern and sophisticated which is true, but underneath their operations there are inherent destabilising elements which are officially permitted. Well-meaning experts in the field – Dr. R.H. Patil and Ms. Deena Mehta who headed National Stock Exchange of India (NSE) and Bombay Stock Exchange (BSE), respectively, to name a name a few - have brought out two key lacunae in the derivative segments of the Indian

Table 1: Secondary Market Turnover in Financial and Commodities Markets

(Amount in Rs crore)

	Market segments/Year		2002-03	2003-04	2004-05	2005-06	2006-07	2007-08	2007-08 upto July	2008-09 upto July
1	Government Securities Market		1941673	2639244	2692129	2559260	3578037	5602602	1403062	1671663
			(79.0)	*(95.6)*	*(86.2)*	*(72.5)*	*(86.7)*	*(119.4)*		
2	Forex Market (inclusive of cash, tom, spot and forward)		658035	2318531	4042435	5239674	8023078	12726832	3782519	5360594
			(26.9)	*(84.0)*	*(129.5)*	*(148.4)*	*(194.5)*	*(271.2)*		
3	Total Stock Market Turnover (I+ II)		1374403	3744841	4221952	7209892	10316749	18462682	4467013	5403856
			(56.1)	*(135.7)*	*(135.3)*	*(204.2)*	*(250.1)*	*(393.4)*		
I		Derivatives	442341	2142686	2563165	4824260	7415278	13332787	3232150	3819817
			(18.1)	(77.6)	(82.1)	(136.6)	(179.7)	(284.1)		
II		Cash	932062	1602155	1658787	2385632	2901471	5129895	1234863	1584039
			(38.0)	(58.0)	(53.1)	(67.6)	(70.3)	(109.3)		
4	Commodities Market		66500	129400	571759	2134000	3676335	4065989	1179766	1654443
			(2.7)	*(4.6)*	*(18.3)*	*(60.4)*	*(89.1)*	*(86.6)*		
	GDP at market prices		2449736	2760224	3121414	3531451	4125725	4693602		

Note: (i) Figures in brackets represent percent to GDP at current market prices.
Source : Rakshitra and other Publications of CCIL, Sebi Bulletin and NSE NEWS.

stock market. Both of them have questioned the wisdom of permitting futures trading in individual stocks which now dominate. Emphasizing that equity futures are essentially intended to serve as hedge against unanticipated risks, Patil (2006) argues that "the world over the stock futures are not favoured in view of the risks they pose to the investors as also to the markets ------- Most of the countries that have introduced equity futures have preferred to introduce index futures, and options in index and individual stocks. …… All the major exchanges of the world (in the US or Europe in particular) consider that individual stock futures are not only highly unsafe but also that they do not serve any justifiable purpose". Despite such weighty opinion against stock futures, the same have been permitted in Indian stock exchanges and they now constitute over 53 per cent of the total futures and options market on the NSE, as shown in Table 2.

Table 2: Business Growth of Futures and Options Segment of NSE.

Month/ Year	Index Futures	Stock Futures	Total Futures Trading	Index Options	Stock Options	Total Options Trading	Grand Total	Average Daily Turnover *(Rs. cr.)*
	Turnover	Turnover		Turnover	Turnover		Turnover	
	(Rs. cr.)	*(Rs. cr.)*	*(Rs. cr.)*	*(Rs. cr.)*	*(Rs. cr.)*	*(Rs. cr.)*	*(Rs. cr.)*	
2005-06	1513791	2791721	4305512	338469	180270	518739	4824251	19220
	(31.4)	(57.9)	(89.2)	(7.0)	(3.7)	(10.8)		
2006-07	2539574	3830967	6370541	791906	193795	985701	7356242	29543
	(34.5)	(52.1)	(86.6)	(10.8)	(2.6)	(13.4)		
2007-08	3820667	7548563	11369231	1362111	359137	1721247	13090478	30814
	(29.2)	(57.7)	(86.9)	(10.4)	(2.5)	(13.2)		
2008-09								
Apr-08	280100	336901	617001	133565	15865	149430	766431	38322
	(36.5)	(44.0)	(80.5)	(17.4)	(2.1)	(19.5)		
May-08	267641	380161	647801	129066.5	21040.45	150107	797908	39895
	(33.5)	(47.6)	(81.1)	(16.2)	(2.6)	(18.8)		
8-Jun	377939	375987	753926	308709	21430	330139	1084064	51622
	(47.4)	(47.1)	(94.5)	(38.7)	(2.7)	(41.4)		
8-Jul	395380	382601	777981	357209	24985	382193	1160174	50442
	(49.6)	(48.0)	(97.5)	(44.8)	(3.1)	(47.9)		

Note: Figures in bracket are per cent to total.

Source: www.nseindia.com

Besides, Deena Mehta (2005) has pointedly brought out how in equity derivatives, trades are allowed to be cash settled and not delivery settled.

> "In the absence of physical delivery, the system simply flushes out all trades at the end of the month when the contract expires. There is no logical conclusion to the futures trade. On the last day, cash is exchanged and the one-way traffic of buy does not have any speed-breaker of sale transactions. The continuous balancing of buy and sell does not happen and the populist view gets further propagated as the buyer does not have any obligation to take delivery".

She concludes by asserting thus:

> "The country takes great pride in following international best practices. *In all developed countries, derivative trades are delivery settled.* The danger of a cash-settled system is highlighted above. After the experience of five years in the derivatives market, the regulator must look at the issue on hand objectively. The size of derivatives market being bigger than the cash market, we cannot afford a structurally weak system".

Exotic Derivative Contracts in the Forex Market

The speculative activities prompted by official blessings are not restricted to stock and commodity markets only; there is a third case of the forex market operators enjoying the benefits of officially-aided speculation.

As explained in EPWRF (2008), the genesis of the problem should be traced to two policy developments relevant to the operations of the domestic foreign exchange market. First, the authorities resorted to a major turnabout in their exchange rate policy as a measure of fighting inflation; they allowed the rupee to appreciate from about Rs 44 per dollar in March 2007 to Rs 40 per dollar in May 2007. Just the when the market expectations thus reinforced the prospects of further appreciation, there occurred the second event. The Reserve Bank of India (RBI), in its April 24, 2007 annual policy statement for 2007-08, sought to expand hedging facilities in the foreign exchange market. It said that a range of hedging instruments had been already permitted to market participants including foreign exchange forwards, swaps, and options, but these were

permitted "mainly against crystallised foreign currency exposures". That is, hedging had to be against the underlying exposures based on actuals or past records. But the April 2007 policy expanded the scope of hedging considerably thus: "It is now proposed to expand the range of hedging tools available to the market participants as also *facilitate dynamic hedging* by the *residents"*. Importers and exporters of goods and services were permitted to book contracts on the basis of declaration of an exposure actually in sight or based on past performance, but earlier forward contracts booked in excess of 50 per cent of the eligible limits had to be on deliverable basis; in the April 2007 statement, this limit was raised to 75 per cent and the contracts could be cancelled and rebooked. But, the most damaging aspect of the newly introduced expansion of hedging facilities, as revealed by the recent corporate turmoil, relates to the small and medium enterprises. The April 2007 policy statement said that,

> "In order to enable small and medium enterprises (SMEs) to hedge their foreign exchange exposures, it is proposed to permit them to book forward contracts *without underlying exposures* or *past records of exports and imports*. Such contracts may be booked through authorised dealers with whom the SMEs have credit facilities. The SMEs are also permitted to freely cancel and rebook the contracts" (p.56).

In such a free-for-all policy environment, banks and the corporates, obviously hand-in-glove, have indulged in huge amounts of hedging. The banks appear to have sold contracts to corporates, particularly the SMEs, hardly based on underlying exposures.

While full details of the mark-to-market (MTM) losses are not available, a respected forex dealer, Mr. Jamal Mecklai of Mecklai Financial Services, has placed the MTM losses of banks and the corporate sector in the range of $3 billion to $5 billion (Rs 12,000 crore–Rs 20,000 crore). We have a large list of IT companies, banks and corporates facing huge forex losses. These kinds of liberalisation measures without proper checks and balance have an inherent tendency to create stress in the financial markets. What is more, such speculative activities do not help us to achieve the primary goals of better liquidity and stability in the respective market segments. Let us take the

case of the share market. India's share market is considered as the most volatile amongst the emerging markets, and this volatility has prevented the development of a healthy, stable and dependable primary issue market for the manufacturing and infrastructure sectors.

II

Economic Structure and Financial Exclusion

We shall now revert to the substantive theme of this paper. What is the appropriate financial structure relevant for the emerging economic structure in rural and semi-urban areas in India?

Agricultural Households

(i) Increasing marginalisation and high population pressure on agriculture

As consistent NSSO reports on land (and livestock) holding surveys reveal, the phenomenon of sub-division has resulted in the number of operational holdings steadily rising over the period 1960-61 to 2003, from 51 million to 101 million, but more significantly, the area operated has receded from 133 million hectares to 108 million hectares partly due to the uneconomic nature of tiny holdings.[2] As a result, the average size of operational holdings has dwindled from 2.63 hectares in 1960-61 to only 1.06 hectares in 2003 (Table 3).

Table 3: Certain Key Characteristics of Operational Holdings

	1960-61	1970-71	1981-82	1991-92	2003*
	(17th)	(26th)	(37th)	(48th)	(59th)
1. Number of operational holdings (millions)	50.77	57.07	71.04	93.45	101.27
1.1 percentage increase	-	12.4	24.5	31.5	8.4
2. Area operated (million hectares)	133.48	125.68	118.57	125.10	107.65
3. Average area operated (hectares)	2.63	2.20	1.67	1.34	1.06

*: Estimates for 59th round are based on the holdings reported for the kharif season. Also, 2003 was a drought year.
Source: Source of estimates of 17th, 26th, 37th, 48th and 59th rounds: *NSS Report Nos.144, 215,338,408 and 493*.

[2] As indicated in Table 3 above, the year 2003 was a drought year and hence the decline may have been partly due to that phenomenon. Also, the estimates for 2003 cover only kharif season operations. The NSSO (January 2006, Report No.493) has emphasized that kharif estimates are lower than the total only about 4 per cent in terms of the number of operational holdings and 1 per cent in terms of area.

With the inadequacy of employment opportunities in non-farm sector, the work force dependence on agriculture has remained high. And this has happened when there has occurred a continuous decline in the share of agriculture in the country's gross domestic product (GDP).

Within agriculture, there have been many other adverse consequences. The continued dependence of rising population and labour force on limited and non-expanding land has resulted in a continuous decline in the availability of land per agricultural worker. Apart from the sharp decline in the average size of holding, there is the growing marginalisation. The increases in the number of operational holdings have occurred only under the size class of marginal holdings. In 2003, as per NSSO data, as much as 71 per cent of operational holdings were such marginal holdings of (of below 1 hectare) as against 39.1 per cent in 1960-61 (Table 4).

Table 4: Changes in the Size Distribution of Operational Holdings and Operated Area 1960-61 – 2002-03

Category of Holdings	Percentage of Operational Holdings					Percentage of Operated Area				
	1960-61 (17th)	1970-71 (26th)	1981-82 (37th)	1991-92 (48th)	2003 (59th)	1960-61 (17th)	1970-71 (26th)	1981-82 (37th)	1991-92 (48th)	2003 (59th)
Marginal	39.1	45.8	56.0	62.8	71.0	6.9	9.2	11.5	15.6	22.6
Small	22.6	22.4	19.3	17.8	16.6	12.3	14.8	16.6	18.7	20.9
Semi-Medium	19.8	17.7	14.2	12.0	9.2	20.7	22.6	23.6	24.1	22.5
Medium	14.0	11.1	8.6	6.1	4.3	31.2	30.5	30.1	26.4	22.2
Large	4.5	3.1	1.9	1.3	0.8	29.0	23.0	18.2	15.2	11.8
All Sizes	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NSSO, *Some Aspects of Operational Land Holdings in India*, Various Rounds. Reproduced from Radhakrishna (2007).

In other words, 72 million out of 101 million operational holdings belong to such tiny land cultivation. If the small farmer category is also included, as much as near 80 per cent of cultivator households belong to the small and marginal categories and they possess 43.5 per cent of operated area.

Farmers have thus been facing multiple challenges with what has been described as twin crisis – an agrarian crisis and an agricultural crisis.[3] Amongst the most

[3] Prof. V. M. Rao described so at a seminar organised by the Indira Gandhi Institute of Development Research (IGIDR), Mumbai, in the context of sub-group deliberations for crystallising ideas on *Report of the Expert Group on Agricultural Indebtedness*, Ministry of Finance, Government of India, July 2007 (Chairman: Prof. R. Radhakrishna).

dominating reasons for this crisis, a distinct one has been the weakening of the rural credit structure and the inability of the system to strengthen credit delivery arrangements for the farm community, particularly for small and marginal farmers. As per the evidence provided below, a large number of farm households (about 46 million out of 89 million or 51 per cent) are excluded from the availability of any credit arrangement, let alone institutional finance, because of the weaknesses in the credit delivery mechanism. They need credit for improving productivity of farm operations. Above all, they require credit support for supplementary operations in allied activities; some of them need to migrate to non-farm activities for which they need start-up capital.

Non-farm Sector Households and Enterprises

As per the NSSO 61st Round 2004-05, the estimated number of total workers in the country was about 457 million, of whom 199 million or 43.4 per cent were in the non-farm sector. A few distinct features of non-farm employment are again relevant for the subject of finance. First, the organised employment is hardly rising and as a result, the additional labour force is primarily getting absorbed in the unorganised/informal sectors. Secondly, while employment in the unorganised sector has risen over recent years, it has been generally in the form of low quality employment constrained by low productivity (NCEUS 2007). Thirdly, the proportion of self-employment, both amongst urban males and females, has risen, and such employment obviously requires external finance for running business activities.

As a result of the vast increase in the number of the self-employed, there is a corresponding increase in the number of non-farm enterprises, of which an overwhelming number are of small size. All nation-wide field surveys of informal non-agricultural enterprises, unorganised manufacturing and unorganised service sector enterprises, have revealed that about 98 to 99 per cent are of them having employment size of less than 10 workers each. Concurrently, over 96 per cent of unorganised enterprises have investment in plant and machinery worth less than Rs.1 lakh each.

Taking various reports into account, the National Commission for Enterprises in the Unorganised Sector (NCEUS) has estimated that the number of non-farm enterprises might have increased from 44 million in 1999-2000 to 54 million in 2004-05 and further to 58 million in 2006-07. These enterprises are obviously spread over throughout the length and breadth of the country. The limited availability of external sources of funds for these enterprises is explained in the next section. As in the case of agriculture, there is pre-ponderant financial exclusion of non-farm enterprises by the formal financial institutions.

Financial Exclusion: Farmer Households

As per the 59th NSS Round (January-December 2003) of the National Sample Survey Organisation (NSSO), of total 148 million rural households, 89.35 million (or 60.4 per cent) were farmer households. Of the 89.35 million farm households, 43.42 million (48.6 per cent) were reported to be indebted. That is, 51.4 per cent or about 46 million did not show enjoying any indebtedness (of the value above Rs 300) to any of the credit agencies – institutional or non-institutional.

About 68 per cent of the excluded farmer households belong to the three underdeveloped regions, with the central region accounting for 34.5 per cent, the eastern region 27.6 per cent, and the north-eastern region 6.1 per cent. On the other hand, the three relatively advanced regions have about 10 per cent each of the excluded farm households.

In this respect, what happened after the 1990s has been most distressing and telling. With the easing of directed credit regulations, there has occurred a decline in the share of institutional agencies in the debt outstanding of cultivator households from 66.3 per cent in 1991 to 61.1 per cent in 2002 and a distinct increase in the dependence of cultivators on moneylenders from 17.5 per cent to 26.8 per cent, thus arresting the trend decline from 70 per cent to 17.5 per cent over the decades. This lesson should have a telling influence on the policies to be evolved to help finance the poor and the vulnerable groups.

What is further significant is that there is increase in indebtedness with the size of land holdings and more importantly, the share of institutional agencies in total loans tends to rise much more progressively. In the lowest size groups up to 0.40 hectare (marginal farmers), the shares of institutional agencies have ranged from 23 to 43 per cent, whereas in the large size groups of above 2 hectares, the corresponding shares have been 65 to 69 per cent. *Contrariwise,* in the case of marginal farmers, the shares of non-institutional agencies in total indebtedness have been in the range of 57 to 77 per cent, whereas such shares for large-size groups have been 31 to 35 per cent.

'Financial Exclusion' in the Non-Farm Sector is Equally Disturbing

Evidence of 'financial exclusion' in the non-farm sector is equally glaring.

(i) As per the Third Census of SSI Sector, less than 5 per cent of the small-scale units enjoyed any bank finance; in the case of unregistered units which dominate, it had been just about 3.1. per cent.

(ii) Based on the above data, National Commission for Enterprises in the Unorganised Sector (NCEUS) has made an estimate that only 5.3 per cent out of 58 million units in March 2007 with investment of Rs 25 lakh or less had any institutional credit; about 55 million (about 95 per cent) did not enjoy any such facility;

(iii) The importance of these non-farm informal sector enterprises in the development process is self-evident. If the agricultural sector absorbed 256 million of workers (56.0 per cent), non-agricultural informal enterprises absorbed 139 million or 30.0 per cent of the total. On the other hand, organised sector absorbed 63 million (13.8 per cent), of whom also 28 million were unorganised contract labour.

The Government's Knee-Jerk Response

Against the background of such a crisis situation, there have been distinct signs of social and economic discontent. In response, the government have taken broadly three

important fresh steps essentially to expand the credit delivery arrangements for the informal sectors as well as the poor households. The new steps are: (i) doubling of bank credit disbursed in favour of agriculture and allied activities within a period of three years 2004-05 to 2006-07; (ii) renewed emphasis given to the microfinance (mFI) movement; and (iii) adoption of a policy of 'financial inclusion'.

Table 5: Number of Offices of Scheduled Commercial Banks according to Population Group

Number of Offices														
Year	Rural		Net Increase	Semi-Urban		Net Increase	Urban		Net Increase	Metro-politan		Net Increase	All India	Net Increase
Classification Based on 1991 Census														
Mar-95	33017	*(51.7)*	-2379	13502	*(21.2)*	1461	9575	*(15.0)*	46	7723	*(12.1)*	1331	63817	459
Mar-96	32981	*(51.2)*	-36	13731	*(21.3)*	229	9798	*(15.2)*	223	7946	*(12.3)*	223	64456	639
Mar-97	32909	*(50.5)*	-72	13931	*(21.4)*	200	10061	*(15.5)*	263	8210	*(12.6)*	264	65111	655
Mar-98	32854	*(49.9)*	-55	14174	*(21.5)*	243	10341	*(15.7)*	280	8459	*(12.9)*	249	65828	717
Mar-99	32840	*(49.3)*	-14	14348	*(21.5)*	174	10706	*(16.1)*	365	8783	*(13.2)*	324	66677	849
Mar-00	32673	*(48.7)*	-167	14580	*(21.7)*	232	10851	*(16.2)*	145	8957	*(13.4)*	174	67061	384
Mar-01	32640	*(48.3)*	-33	14700	*(21.8)*	120	11026	*(16.3)*	175	9159	*(13.6)*	202	67525	464
Mar-02	32443	*(47.8)*	-197	14910	*(22.0)*	210	11252	*(16.6)*	226	9292	*(13.7)*	133	67897	372
Mar-03	32283	*(47.4)*	-160	15042	*(22.1)*	132	11423	*(16.8)*	171	9330	*(13.7)*	38	68078	181
Mar-04	32107	*(46.8)*	-176	15252	*(22.2)*	210	11703	*(17.0)*	280	9583	*(14.0)*	253	68645	567
Mar-05	31967	*(45.7)*	-140	15619	*(22.3)*	367	12304	*(17.6)*	601	10079	*(14.4)*	496	69969	1324
Classification Based on 2001 Census														
Mar-06	30610	*(43.2)*	-1357	15471	*(21.9)*	-148	12697	*(17.9)*	393	11998	*(17.0)*	1919	70776	807
Mar-07	30393	*(41.5)*	-217	16352	*(22.3)*	881	13699	*(18.7)*	1002	12755	*(17.4)*	757	73199	2423

Note: Figures in brackets are percentages to All-India

Source: RBI, Banking Statistics: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2007 (Vol.36) and earlier issues

Narrowing of Rural Branch Network

The method of implementing these measures particularly without improving the rural financial infrastructure, has left much to be desired. Data presented in Tables 5 and 6 speak volumes for the disjoint between the credit delivery measures and the further deterioration in the rural branch network. As the RBI gave up the branch licensing policy in 1995 and allowed the banks to consolidate their rural presence by even closing branches of rural centres served by two commercial banks or relocate their loss-making branches at new places even outside the rural areas, the number of rural branches of scheduled commercial banks has been persistently declining since March 1995. The number has declined from 33,017 at the end of March 1995 to 31,967 at the end of March

2005 – a loss of 1056 branches; probably there has been yet another loss of 2,500 rural and semi-urban branches in the next two years on a comparable 1991 census classification basis (Table 5). In the normal course of branch banking to serve the under banked amongst 6 lakh villages, at least another 5,000 to 6,000 rural branches should have been added.

Table 6: Population Group-wise Distribution of Employees of Scheduled Commercial Banks in India

Year	Rural	Per cent to Total	Semi-Urban	Per cent to Total	Urban + Metropolitan	Per cent to Total	Total
Mar-96	196031	*19.2*	227039	*22.3*	595955	*58.5*	1019025
Mar-97	197551	*19.3*	227512	*22.3*	595960	*58.4*	1021023
Mar-98	197531	*19.3*	224635	*21.9*	601805	*58.8*	1023971
Mar-99	195312	*19.2*	223360	*22.0*	598818	*58.9*	1017490
Mar-00	194385	*19.3*	223380	*22.2*	588866	*58.5*	1006631
Mar-01	186471	*20.1*	208392	*22.5*	531655	*57.4*	926518
Mar-02	183027	*20.3*	202833	*22.5*	515428	*57.2*	901288
Mar-03	182686	*20.3*	203013	*22.5*	515450	*57.2*	901149
Mar-04	180869	*20.5*	197950	*22.5*	502903	*57.0*	881722
Mar-05	179423	*19.9*	197587	*21.9*	523423	*58.1*	900433
Mar-06	169088	*18.8*	176104	*19.6*	554932	*61.7*	900124
Mar-07	162870	*18.1*	175066	*19.5*	561471	*62.4*	899407

Classification of population groups for the period March 1996 to March 2005 is Based on 1991Census.
From March 2006 onwards the population groups of centres have been revised based on the 2001 Census.
Source: RBI, Banking Statistics: *Basic Statistical Returns of Scheduled Commercial Banks in India*, March 2007 Vol.36 and earlier issues

More significantly, the number of bank employees posted to rural and semi-urban branches has persistently declined, with the reduction working out to 46,060 between March 1996 and March 2005 or 11 per cent on a comparable basis; there has been a further reduction of about 15,000 in the next two years (Table 6).

Thus, the reduction in the number of rural branches as well as in the bank staff employed in rural and semi-urban areas has hurt the quality of lendings say for the agricultural sector. Detailed analysis of RBI data, suggests that the bulk of the incremental lendings during the three-year period 2004-05 to 2006-07 have been: (a) in the form of indirect credit for input suppliers, etc; (b) credit extended by urban and metropolitan branches; and (c) large size loans with credit limits of Rs. 1 crore and above. As depicted in Tables 7, 8 and 9, the absence of a sound institutional structure

gives rise to distortions in the pattern of lending (see also Ramakumar and Pallavi Chavan 2007). Almost a similar distortion seems to have occurred in SMEs with a preponderant share of bank credit going to medium enterprises and not micro and small enterprises.

Table 7: Direct and Indirect Credit of Scheduled Commercial Banks to Agriculture

(Amount in Rupees, Crore)

		Direct Credit				Indirect Credit			Total Agriculture Credit	
	No. of	Per cent	Amount	Per cent	No. of	Per cent	Amount	Per cent	No. of	Agriculture
Year	Accounts	to Total		to Total	Accounts	To Total		to Total	Accounts	Credit
Mar-01	19564089	98.6	43420	83.9	279200	1.4	8310	16.1	19843289	51730
Mar-02	19740112	97.0	47430	74.1	611072	3.0	16578	25.9	20351184	64009
Mar-03	20195464	96.9	59058	77.8	644970	3.1	16878	22.2	20840434	75935
Mar-04	20719954	97.3	70099	72.8	584214	2.7	26146	27.2	21304168	96245
Mar-05	26010380	97.6	94635	76.1	645928	2.4	29749	23.9	26656308	124385
Mar-06	28418193	97.8	124563	72.1	649920	2.2	48121	27.9	29068113	172684
Mar-07	32482876	97.8	171497	74.5	733691	2.2	58694	25.5	33216567	230191
Incremental Share: March 2004 to March 2007										
	11762922		10139810	75.7	149477	1.3	32548	24.3	11912399	133946

Source: RBI, *Banking Statistics: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2007* (Vol. 36) and earlier issues.

Table 8: Population Group-wise Agriculture Credit of Scheduled Commercial Banks in India

(Amount in Rupees, Lakh)

		Rural+Semi-Urban					**Urban+Metropolitan**					**Total**	
	No. of	Per cent	Amount	y-o-y	Per cent	No. of	Per cent	Amount	y-o-y	Per cent	No. of	Agriculture	y-o-y
Year	Accounts	to Total		growth	to Total	Accounts	to Total		growth	to Total	Accounts	Credit	growth
Mar-04	20173953	94.7	6362353	15.2	66.1	1130215	5.3	3262150	57.5	33.9	21304168	9624503	26.7
Mar-05	25209573	94.6	8622419	35.5	69.3	1446735	5.4	3816069	17.0	30.7	26656308	12438488	29.2
Mar-06	26891025	92.5	10778710	25.0	62.4	2177088	7.5	6489697	70.1	37.6	29068113	17268407	38.8
Mar-07	30677507	92.4	14448085	34.0	62.8	2539060	7.6	8571023	32.1	37.2	33216567	23019108	33.3
Incremental Share: March 2004 to March 2007													
	10503554	88.2	8085732		60.4	1408845	11.8	5308873		39.6	11912399	13394605	

From March 2004 to March 2005 classification of centres is based on 1991 Census data.
From March 2006 classification is based on 2001 Census.

Source: RBI, *Banking Statistics: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2007* (Vol. 36) and earlier issues.

Table 9: Size-Wise Distribution of Direct Agricultural Finance (Scheduled Commercial Banks)

(Amount in Rupees Crore)

A. Details

Size Group	March 2007		March 2004		Incremental Share March-04 to March-07	
	Amount Out-standing	Per cent to Total	Amount Out-standing	Per cent to Total	Amount Out-standing	Per cent to Total
Rs 25,000 & Less	24592	14.3	17640	25.2	6952	6.9
Rs 25,000 & upto Rs 2 lakh	71607	41.8	28521	40.7	43086	42.5
Rs 2 lakh & upto Rs 10 lakh	44636	26.0	15299	21.8	29337	28.9
Rs 10 lakh & upto Rs 1 Crore	8976	5.2	3231	4.6	5745	5.7
Rs 1 Crore & upto Rs 4 Crore	4221	2.5	2663	3.8	1558	1.5
Rs 4 Crore & upto Rs 10 Crore	3761	2.2	1085	1.5	2676	2.6
Above Rs 10 Crore	13705	8.0	1659	2.4	12046	11.9
Total	171497	100.0	70099	100.0	101398	100.0

B. Summary
(As percentage of Total Bank Credit)

Year/Range	Rs 25,000 & Less	Above Rs 25,000 & upto Rs 2 lakh	Rs. 2 lakh and less	Above Rs. 2 lakh
(1)	(2)	(3)	4=(2+3)	(5)
March 2007	14.3	41.8	56.1	43.9
March 2006	18.1	42.7	60.8	39.2
March 2005	22.9	43.8	66.7	33.3
March 2002	34.3	42.7	77.0	23.0
March 1997	53.9	29.4	83.3	16.7
March 1992	61.3	28.4	89.7	10.3

Source: RBI, *Banking Statistics: Basic Statistical Returns of Scheduled Commercial Banks in India, March 2007* (Vol. 36) and earlier issues.

Microfinance: A Useful Innovation But Can Hardly be a Substitute For a Strong Rural Credit Structure

As for microfinance and self-help group (SHG) lending arrangements, they are a useful institutional innovation; they have significant potential to meet the financial needs of the poorer segments of society. But, a detailed study by us of the mFI movement has made us enter some words of caution on the expectations of any large role to be played by the microfinance movement in the rural credit system of the country. First, success stories of mFIs are invariably based on intensely dedicated, selfless and celebrity services of individuals as NGOs. It is in this context that questions are asked whether the institution of NGOs is a free good, liberally available and whether it can be a substitute for public administration and the associated public programmes and policies. Second, NABARD's own experience has shown that over 54 per cent of NGO- supported SHGs

are concentrated in four southern states or over 48 per cent within them in Andhra Pradesh alone. SHG formations in other regions are spreading but gradually; its momentum over these regions is hampered because of the absence of a dedicated NGO movement. Third, women upliftment is an important goal, but the goal of poverty-alleviation has to have a wider coverage. The latest report on progress SHG-Bank linkage for 2006-07 (28.95 lakh SHGs representing Rs 12,366 crore of loans outstanding) states that 90 per cent of the SHGs so linked continue to comprise only of women members, but this has been commended on the ground that as a result, repayment of loans by SHGs to banks has been consistently over 95 per cent. When the micro-finance system is brought into the mainstream, concentration only on women SHGs will not work and formation of SHGs amongst men entrepreneurs is a much arduous task. Fourth, the whole microfinancing programme has been in a nascent stage "and that the results are an initial outcome of a small-scale and nascent programme. Even studies on Bangladesh's Grameen Bank have revealed that low default rates were confined to loans of small size, that the default rates tended to rise with the loan size and with time and repetitive borrowers" (Hossain, 1988). Fifth, the same thing can be said of the impact of high interest rates in micro-credit lendings mediated through NGOs and SHGs. Again, studies on Grameen Bank and other microfinancing schemes have emphasized how high rates of interest, while they are accepted by the poor initially because of their state of helplessness, nevertheless become a burden on their incomes and their future stream of savings (Rahman 1999 and Mosley and Hulme 1998). Finally, studies express similar misgivings regarding the apparent prompt and regular loan repayments by the micro borrowers, but in reality they are known to repay not out of the income stream flowing from assets gained, but through further borrowing from even money lenders (Rahman 1999). In a significant study in northern Bangladesh, Sinha and Matin (1998) reveal that "most of the informal loans repaid with Grameen loans were taken to repay earlier Grameen loans". Among the target group households, 45 per cent of the amount of informal sector loans was utilised for repaying loans taken from micro-credit institutions, including Grameen Bank; for the non-target groups this was 15 per cent (*ibid*). Hence, Rahman (1999) has characterised the micro credit situation as the creation of "debt cycles" for the borrowers. Such are the implications of creating a system of

microfinancing institutions, which are made commercially viable on the strength of higher interest rates charged on the poor than those charged by traditional banking for their normal customers. The RBI has exempted the whole system from interest rate ceilings and it would have significant adverse repercussions on the finances of micro enterprises.

Thus, it is not realised that microfinance movement can at best finance the poorest of the poor and that even for this segment to be catered to, the system of group-based lending through microfinance institutions has also to be an integral part of the formal financial institutions. The requirements of the poor are indeed vast. As against the presently outstanding loan portfolio of Rs 22,300 crore, the estimates quoted by the RBI reveal that the credit support for the poor households could be of the order of Rs 450,000 crore [RBI 2007:156]. Therefore, it is necessary, as has been done by the official agencies, to require formal banking institutions in the country to take an active interest in the mFI movement.

But that is not all; an impression has been given in official discourses that the mFI movement can be a substitute for the larger rural credit structure which is truly unthinkable. There are vast segments of productive enterprises hierarchically above the poverty line and many others in the informal sectors experience has shown that a majority of them also get neglected by the formal financial institutions. Policy planners have no option but to use innovative devices – sticks and incentives – to ensure that the organised banks spread their reach functionally and regionally across the length and breadth of the country. Financial markets by themselves will not achieve this. A theme we have tried to advance in our research studies is that the mFI movement can play a significant role in mitigating the conditions of the poor but it cannot be a substitute for a broader financial system striving to serve the hierarchy of farmers and informal and unorganised non-farm enterprises in the rural areas or otherwise, whose upward mobility in terms of output and investment activities will also benefit the women and other poor household groups that the mFI movement is geared to support. There is a degree of continuum in the economic relationships, say within a village, and the objective of socio-economic empowerment of the poor households in the village would be better served only if all sections of the village

- myriad small and marginal farmers, farm households in general, village artisans, unincorporated enterprises and other household enterprises - partake the benefits of increased institutional credit but such a requirement is unlikely to be served without co-opting the borrowing needs of all small borrowing households as a responsibility of the banking system and not just the NGO-supported and SHG-based micro enterprises. Stiglitz (1993) has provided a strong theoretical rationale, that is, in the form of advocating programmes of directed credit so as to intervene in the way that banks allocate credit. He argued that "without government intervention, banks will not allocate funds to those projects for which the social returns are the highest" (Stiglitz 1993:42). This is what the south-east Asian countries did when they were at India's current stage of development (a per capita income of around $736 as against their current incomes of $2,750 to $16,309). The stage of development thus becomes very crucial for choosing the relevant path of institutional arrangements.

Before concluding this section, one cannot but admire the ability of the capitalist system to coopt innovative ideas to serve its larger purposes. Thus, one senses a larger design of the multilateral agencies and reform enthusiasts in propagating the microfinance movement for the vast numbers of informal sector borrowers so that the formal credit institutions are freed from the burden of financing such borrowers because they represent higher risk, imperfect information and imperfect enforcement paradigm – all associated with market-based and collateral-supported loan arrangements (Hoff and Stiglitz 1990). Thus, the microfinance movement seems to provide a way out for the obvious neglect of informal sector borrowers by the formal financial institutions operating in a liberal and globalised environment with rigorous prudential regulations, but the new movement can give succour only to the poorest of the poor households.

'Financial Inclusion' – A Bureaucratic Response Flawed For Want of Genuine Redistributive Goals

Finally, the system of *financial inclusion* that is being advocated may have the same partial merit as in the case of the mFI movement and the same demerit of not being able to serve the financial requirements of the vast numbers of small and marginal farmers in the agricultural sector, micro and small enterprises in the non-farm sector and

other informal segments in different parts of the country. The opening of 'no-frills' account for everybody appears as an utterly bureaucratic intervention in an essentially development finance area; without the innate involvement of the banking institutions and their personnel, the system is bound to fail. The concept of 'financial inclusion' is also in a wider sense fundamentally flawed because it appears like an escapist strategy to include the poor in credit delivery even as the others can get whatever they desire; it is not an attempt to redistribute the available resources equitably. A concrete experience of 1996-97 when the strategy of 'financial inclusion' was adopted by the RBI is worth citing. In that year, scheduled commercial banks achieved outstanding loans size of Rs.403,534 crore for just three sensitive commodities – an increase of 41 per cent in just one year (Table 10). When commercial banks thus indulge in lending, they do not ask whether the

Table 10: Bank Lending to the Sensitive Sectors

All Scheduled Commercial Banks (Amount in Rupees, Crore)

Sensitive Sectors	2005-06	2006-07	Percentage Variation
1. Capital Market #	22,303	30,637	37.4
	(1.5)	(1.6)	
2. Real Estate @	2,62,054	3,70,690	41.5
	(17.3)	(18.7)	
3. Commodities	1,414	2,207	56.1
	(0.1)	(0.1)	
Total Advances to Sensitive Sector	2,85,771 (18.8)	4,03,534 (20.4)	41.2

: Exposure to capital market is inclusive of both investments and advances.
@: Exposure to real estate sector is inclusive of both direct and indirect lending.
Figures in brackets are percentages to total loans and advances.
Source: RBI (2007): *Report on Trend and Progress of Banking in India*, 2006-07.

sum total of their loans is consistent with macro economic stability. Therein lies the need for a genuinely redistributive policy and not just 'financial inclusion' of everybody. In the absence of such genuine egalitarian policy, the RBI has a knee-jerk reaction to the resulting inflation and all measures are taken to curb it. The resulting increases in interest rates adversely affect the smaller borrowers the most, amongst other things. This is the result of a blind pursuit of a totally market-oriented policy but combine it with some half-hearted policy of 'financial inclusion' to assuage social pressures.

Be that as it may, financial inclusion has been defined as 'delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups who tend to be excluded' (RBI 2008A:194). Towards that end, the RBI has taken a number of measures: 'no-frills' accounts (15.84 million as of March 2008); selection of at least one suitable district in each state/union territory for providing 100 per cent financial inclusion with 'no-frills' account and issue of general credit card (GCC) with complete deregulation of interest rates for this facility; and any overdrafts up to Rs. 25,000 per account granted against 'no-frills' accounts in rural and semi-urban areas as indirect finance for agriculture under the 'priority sector'. It is claimed that as many as 340 districts have been identified for 100 per cent financial inclusion and the target has been achieved in 153 districts in 19 states and six union territories.

The idea is a commendable one but it is too ambitious and bureaucratic, and in the absence of a sound institutional structure, the possibility of it being sustained is indeed remote. The underlying approach adopted by the RBI in this respect is replete with serious constraints against success. For the institutional support, there is an uncanny reluctance to push the financially strong scheduled commercial banks to expand branch network and thus make the necessary institutional infrastructure available for the purpose in different regions of the country. Instead, the emphasis in the *Report of the Committee on Financial Inclusion* (Chairman: C. Rangarajan; January 2008) which has been accepted as part of public policy, is to depend on RRBs and cooperatives to undertake the tasks precisely in the underdeveloped regions where the so-called financial inclusion is a crying need but these institutions are by definition weak and hence such socially-oriented programmes cannot be sustained on an enduring basis. Also, for filling the institutional gap, the RBI has permitted banks to utilise the services of non-governmental organisations (NGOs/SHGs), micro-finance institutions (other than regular NBFCs) and other civil society organisations as intermediaries in providing financial and banking services through the use of business facilitator (BF) and business correspondent (BC) models. The BC model allows banks to do 'cash-in/cash-out' transactions at a location much closer to the rural habitation, thus addressing the last mile problem. Banks are also entering into agreements with India Post for using the vast network of post offices as business correspondents, thereby increasing their outreach and leveraging on the

postman's intimate knowledge of the local population [RBI 2008A:195]. In addition, the use of information technology has been suggested for rendering financial services to the villagers through e-kisoks, mobile vans and such other communication infrastructure. But, experience so far has shown that banks would use the "agency model" rather with great circumspection and it is possible in neighborhood areas where the commercial banks have branch presence; the other areas would get neglected.

In all of these para-banking institutions as agents, there is an underlying belief in the RBI and other official quarters, that as the poor pay usurious rates of interest, that they can afford to pay relatively higher rates of interest than those charged by formal banks. Hence, the overdrafts granted against 'no-frills' accounts have been exempted from any interest rate ceilings. Hence, the RBI has approvingly quoted the following cost structure of mFI borrowings (mFI) (Table 11).

Table 11: Charges of Microfinance Institutions*
(March 2006)

State	Range of Cost to the Borrower (per cent)
Andhra Pradesh	17.0 to 32.5
Karnataka	12.0 to 40.0
Orissa	14.0 to 24.5
Rajasthan	16.0
Uttar Pradesh	13.0 to 26.0

* Charges cover interest rate and other charges such as processing/ administrative charges and upfront levies.
Source**:** CAB. 2007. *Report on Costs and Margin of Micro Finance Institutions*. College of Agricultural Banking (CAB), Reserve Bank of India.

What is more, the RBI has suggested the mainstreaming of the private money lending activities and strengthening of the synergies between the formal and informal segments, ostensibly by eliminating its negative characteristics and usurious rates of interest. There is thus a general surrender to the market forces, particularly when it comes to the financial needs of the poorer segments of society who do not enjoy the benefits of the services of competitive formal financial institutions, are concerned..

Directed Credit Supported by a Strong Rural Credit Structure is the Only Way Out

What is the way out? The solution lies essentially in introducing a model of finance that accommodates the structural characteristics of the Indian economy described above.

The directed credit arrangements have to be done in a holistic manner. The rural financial architecture has to be resurrected. Bank branches have to be strengthened and expanded. Competent and qualified staff have to be posted. Cooperative credit institutions have to be revitalised on the basis of the Vaidyanathan committee recommendations (NABARD 2006). An effective system of monitoring and evaluation of the achievements has to be put in place. Finally, the mFI movement and the new initiatives in the form of 'agency banking' should be very helpful and deserve to be promoted, but they cannot be a substitute for the wholesale rural credit system. The agency model in the form of *business facilitator* and *business correspondent* agencies has been commended to the banks for adoption but a GTZ [Deutsche Gesellschaft fur Technische Zusammenarbeit, German Agency for Technical Co-operation] – NABARD study has revealed that the banks have not shown the necessary enthusiasm in it; there are not enough grassroots level institutions willing to abide by the discipline of a modern bank. In such a scenario, the authorities have no option but to resurrect the whole philosophy of supply leading approach to financial delivery – expanding rural credit structure with scheduled commercial banks with preponderance of financial clout taking the lead and coordinating their efforts with RRBs and cooperatives concurrently with the use of the agency model and enforcing directed credit arrangements. In such a strategy, the mFI movement should constitute an essential and important component; its importance would lie not in the relative size of financial transactions involved but in the number of marginal groups covered; this again would have to be mainly done by the formal financial institutions; quantitatively NGOs will have a minimal role.

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