

INDIANOMICS

Rural Credit Constraints in India

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As a developing economy, India faces several challenges to its growth, and the analysis of all of these is pertinent, particularly in the current scenario where headwinds from the financial crisis in the developed world have led to a slowdown in the growth rates at home. India being an agrarian country, Rural Finance is of immense importance to the growth story. However, constraints to the provision of the same have led to stagnation in the agricultural growth, especially in the post-reform period.

Issues concerning the availability of credit to the rural poor are limited participation of the poor in the formal sector and considerable inequality in the distribution of formal credit. Credit loans have been predominantly made to wealthier farmers, while the small farmers have been rationed out of the credit market. Historical evidence suggests that repayment of "prior debts" was by far the single most significant motivation for borrowing in the earlier periods. Rates of interest were generally higher for the poorer cultivators, partly because they made greater resort to grain loans and also reflecting their generally more vulnerable position. "Real" rates of interest, historically, have not just been the rate charged but they were also hidden in the lower price paid for the products sold, exploitative wage rates and rents charged for land leased. Although the share of "usurious" sources of rural credit fell

steeply in 1951-1991, the post reform period saw the return of the rural moneylender as one of the primary sources of the same. The share of the marginal farmers in disbursement of short and long term loans by the SCBs has witnessed a steep decline, evidencing the fact that left to itself, the formal sector will exclude the rural sector, particularly the rural poor. The main activity with which commercial bank credit was associated with was financing agro-processing firms and purchase bonds floated by land development banks. This could be attributed to the informational advantage about the rural borrowers that moneylenders have over the formal institutions as well as the lack of availability of collateral with the marginal and small farmers. Given that the interest rates are on a rise, the worst affected have been the rural poor. One also notices informal credit transactions occurring among people of a specific social group or the moneylenders charging differential rates of interests from people belonging to different social and economic backgrounds (segmentation). Formal sources of credit are cheaper across all areas as compared to the informal credit sources, with interest rates charged by private lenders being as high as 300% per annum, despite which the formal sector default rates are comparatively much higher. However, studies suggest lack of participation in the formal credit market on the part of the rural borrowers, which can be traced to the differences in reservation costs of obtaining informal credit vis-à-vis formal credit. India's Co-operative Credit Structure covers directly or indirectly, nearly half of India's total population. However, the concept of mutuality between savings and credit functions has been missing.

There may be several reasons why people borrow from village lenders, despite the fact that they charge exorbitant interest rates.

Due to lack of information about the borrowers as well as the inability to accept collateral in exotic forms, institutional lenders usually discriminate against poor borrowers since their richer counterparts can repay in almost all contingencies, resulting in credit rationing. Poorer borrowers may also be reluctant to borrow from formal sources out of the fear of being cheated or sanctioned in the event of non-repayment. High interest rates may not necessarily be a result of monopoly of the lender over his clientele, instead, the risk of involuntary and strategic default and weak enforcement machinery can drive up the rates to the aforementioned levels.

The figure given below explains credit rationing in the face of possibilities of defaults. L is the loan size and $f(L)$ is the production function describing the value of output for every loan size L . Now, we assume that the farmer can have access to a net profit of A by borrowing elsewhere. Hence, to make the farmer participate at some interest rate i and some loan size L :

$$f(L) - L(1+i) \geq A$$

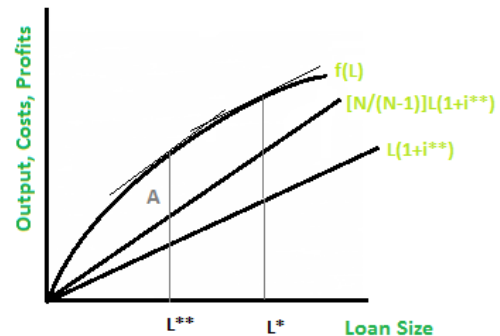
in which case, the optimal loan amount would be L^* . Now, if the farmer's mental horizon is of N dates, he gets $N[f(L) - L(1+i)]$ over the entire N if he doesn't default in any period. If he decides to default, he will get all of $f(L)$. But next period onwards, he will be excluded by the moneylender and would be able to earn only A per period. So for default not to occur:

$$f(L) - \frac{N}{N-1} L(1+i) \geq A$$

The cost line is now modified for the farmer

from to $L(1+i)$ to $\frac{N}{N-1} L(1+i)$. Simple optimization yields the optimal loan size as

L^{**} (such that $L^{**} < L^*$) and the corresponding interest rate as i^{**} .



This fear of default also creates a tendency to ask for collateral, which can take several forms [e.g. Ration cards in Kerala (Kurup, 1976)]. In case the collateral is of a higher value to the lender than the principal itself, the debt contract maybe written in a way so as to induce the borrower to default, which explains extensive landholdings of some landowners in rural India as well as the persistence of bonded labour till date. It is the fear of a default and the unfeasibility of charging a higher interest rate as well as information asymmetries regarding the "good" and the "bad risks" that the equilibrium in the informal market is thrown to 'Credit Rationing', leading to inadequacy of credit.

Interlinkages between credit and other markets is also an important characteristic of rural credit markets in India and are reflected in the coincidence of credit relations with other economic relations viz. trader-cultivator, landlord-tenant etc. The rationale for interlinked markets is lowering of transaction as well as monitoring costs. It becomes even stronger where law or custom restricts certain contractual arrangements. Interlinkage may be used in many cases to counteract the distortion in loan amounts and is often achieved by charging a rate of interest that is not too high or even equivalent to the

formal rate of interest and paying a wage rate or output price that is lower than the market rates.

In order to tackle these constraints, policies should be implemented in the right direction. SHGs should be induced to enter matured levels of enterprise and factor in livelihood diversification in order to ensure that their members are not dependent on informal sources of credit for their financial and non financial needs. There is a scope of increasing credit disbursements on the part of the public lending institutions through policies, innovations and techniques that enable correct identification of viable borrowers. Effective policy interventions in other markets can increase the size of asset holdings with borrowers, thus increasing their access to formal credit sources. As of now, RBI's actions have been effective to a very large extent in purveying credit in the rural sector through regulations pertaining to priority sector lending and opening branches in rural areas. However, Co-operative banks and credit societies as well as RRBs need to shift their focus primarily towards the poorest of the poor rather than just looking broadly at the rural sector. Policies should be initiated in order to incentivise lending to the marginal and small farmers to a greater extent by formal institutions. At the same time, policies like concessional credit rates should be reconsidered since they distort socially optimal loan decisions. Microfinance Institutions developed on the lines of Grameen Bank, which promote group lending can be another possible solution. Credit rationing theory implies that under a policy of no restrictions on interest rates and in a competitive environment, credit will be rationed. Thus any intervention in the market other than to alleviate informational constraints will do more harm than good. A new theory of incentives and monitoring embedded within the actual

operational framework of India's lending institutions might be more appropriate for analysing and designing corrective mechanisms.

References:

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A Tale of Two Transfers

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A transfer payment (or government transfer) is a redistribution of income in the market system. These payments are considered to be exhaustive because they do not directly absorb resources or create output. Examples of certain transfer payments include those for welfare (financial aid), social security, and subsidies given by the government.