Revisiting Rural Indebtedness*

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If Reserve Bank of India Governor Raghuram Rajan is to be believed, efforts to help Indian farmers by providing them with cheap(er) credit and relieving them of an unsustainable debt burden only harms them in the long run. In his speech delivered at the annual conference of the Indian Economic Association, Rajan is reported to have advanced a number of counterintuitive arguments and raised a number of unusual questions on farm debt.

The first was that when governments in the states or at the centre intervene in periods of distress (resulting from damage due to floods, cyclones or drought, for example) by requiring banks to waive farm debt with promise of official support, they end up restricting credit flow to agriculture. Banks become reluctant to lend to farmers because they fear that those new loans too would be written off. Moreover, as happened with loans that were written off when governments in Telangana and Andhra Pradesh declared loan waivers when cyclone Phailin ravaged the region last year, the promise of official support may not be kept. While the Telengana government did deliver the mandated 25 percent of the loan amount written off by the banks, Andhra Pradesh has thus far not done so. This, in the governor's view, would only increase the reticence of the banks to lend. Clearly in his view, the government cannot influence the behaviour of even banks that are publicly owned, even though it seems to be able to force them to lend huge amounts to privately operated infrastructure projects in areas varying from from power to civil aviation.

Second, there is, according to the governor, reason to believe that when debt waiver schemes are implemented they are afflicted by significant errors of inclusion and exclusion, providing beneifits to those who are not eligible and bypassing some who should be benefited. To illustrate this view, he refers to the CAG report that found that when in 2008 the then UPA government implemented an Agricultural Debt Waiver and Debt Relief Scheme, which provided debt relief to the tune of Rs 52,516 crore, there were several instances when ineligible farmers were given the benefit and eligible ones were ignored. Suggesting that this evidence pointed to the possibility of fraud, the governor has argued against such schemes. The strategy seems to be one of avoiding ithe possibility of fraud, rather than one of detecting and penalising fraud.

Finally, the governor argued that cheap and subsidised credit to the farm sector in the form of short term crop loans rather than long term loans for investment may be diverting credit away from capital formation with attendant adverse consequences for productivity, even while the indebtedness of farmers increases.

The thrust of these arguments seems to be that the policy adopted after bank nationalisation of directing credit to the priority sectors at reasonable interest rates, with 18 per cent of total advances mandated to be provided to the agricultural sector, should be revisited. It may be better to leave it to the banks to decide whether credit should be provided to the agricultural sector, and if so to which activities and at what interest rate. Implicit in that view is the perception that forced lending to agriculture has not only resulted in a sharp expansion of credit to the farm sector, but also in indebtedness of a kind that demands periodic debt waiver and relief schemes at the expense of bank balance sheets and productive investment.

This amounts to turning hitherto received wisdom on its head. The policy of directing credit to agriculture was adopted because evidence on the eve of bank nationalisation pointed to the near complete exclusion of agriculture from bank credit. Despite accounting for as much as a third of GDP and more than two-thirds of total employment in the mid-1960s, agriculture received around 2 per cent of total bank credit advanced. Nationalisation was seen as breaking the control of the business groups over much of the banking system which was seen as explaining this exclusion of agriculture from bank credit flows, which went largely to the corporate sector. It was also seen as creating conditions that ensured that it was not just profit, but the development objectives of the government that were served by the banking system.

The evidence shows that with public ownership, the target of directing 40 per cent of total credit to the priority sectors, and the sub-target of channeling 18 per cent of total credit to agriculture, were soon achieved. The change in ownership had clearly transformed bank behaviour to yield the intended result. Yet, in 1991, the first Narasimham Committee on the Financial System recommended that the directed credit programme should be phased out, the "priority sector" redefined and its share in total credit reduced from 40 per cent to not more than 10 per cent. The justifcation provided was largely that the directed credited programme was adversely affecting the profitability and contributing disproportionately to the non-performing assets of the banking sector.

Even though this recommendation of the Narasimham Committee was not accepted by the Reserve Bank of India and the government, liberalisation of the bank licensing policy after 1991 saw a reduction in the number of rural branches and a decline in the share of commercial banks in outstanding agricultural credit from about 61 per cent of total agricultural credit in 1990-91 to around 26 per cent in 1999-2000. Reform seemed to have encouraged banks to withdraw from the direction pursued till then.

Interestingly, after 2004 the trend changed sharply with the share of commercial banks in agricultural credit rising once again to reach 58 per cent by 2010-11. However as Pallavi Chavan has underlined, there was one major difference in the trends in bank credit to agriculture in the years prior to and after 2004. In the period between 1973-74 and 1997-98, while the ratio of agricultural credit to agricultural GDP rose from around 10 to around 25 per cent, the ratio of capital formation in agriculture to agricultural GDP also rose from around 6. 6 per cent to 8.1 per cent of GDP. While the divergence between the two ratios had increased, the increase in credit was also supporting increased investments in agriculture. However, starting from the end of the 1990s, while the ratio of agricultural credit to agricultural GDP shot up from around 25 to about 73 per cent by 2010-11, the ratio of capital formation in agriculture to agricultural GDP had risen only from around 8 to 17 per cent. This huge increase in divergence implied that far more money was going to non-productive purposes. This was also a period when agricultural GDP was rising at a slow 2.8 per cent per annum. The boom in bank credit to agriculture was contributing only marginally to capital formation and growth.

One reason is because, as suggested by the Narasimham Committee, the notion of priority sector credit was redefined, with new areas such as lending to input providers (such as seed suppliers), warehouses, and micro-finance institutions being treated as "indirect finance" to agriculture. Even though indirect finance to agricullture could only amount to 25 per cent of the agricutural lending sub-target of 18 per cent (0r 4.5

per cent of total advances), any such lending in excess of 4.5 per cent could be included when computing achievement of the 40 per cent aggregate priority sector requirement. This opened a set of relatively lucrative lending avenues that could serve to meet the priority sector lending target. According to Chavan, "the share of indirect credit in total agricultural credit more than doubled from 21.5 per cent in 1991-92 to 48.1 per cent by 2007-08." Thus, if there is any distrotion in the distrubution of agricultural credit, it seems to result from the liberalisation of policy rather than from excessive intervention.

What is also remarkable is that despite the boom in bank credit to agriculture, the access to credit in the rural areas still remains limited. According to the recently released results of the All India Debt and Investment Survey conducted by the National Sample Survey Organisation, as on the 30th of June 2012, there were only 31.4 per cent of households in rural India that were exposed to debt. That was not very much higher than the 26.5 per cent recorded in the previous survey relating to 2002. Moreover, 19 per cent of the rural hoseholds obtained credit from non-institutional sources and only 17 per cent from institutional sources (including banks). Clearly, the perception that rural hosueholds have been forced into excess indebtedness because of availability of cheap bank credit seems to be overstated.

What is more, an analysis of the class-wise distribution of the incidence of indebtedness shows that while incidence varied between 19.7 to 27.5 per cent in the lowest four deciles classified in terms of the size of asset holding, the average debt of each of the households in these deciles varied from just Rs. 40,000 to Rs. 50,000. On the other hand, the incidence of debt in households in the richest decile in terms of assets was 41.3 per cent with the average debt of indebted households placed at Rs. 2.7 lakh. Not surprisingly while the percentage of households indebted to institutional sources was placed at 7.9 and 7.4 per cent respectively in the poorest asset classes, the figure stood at 32.6 for the richest asset class. On the other hand in terms of exposure to non-institutional debt, the figures were 14 and 17 per cent in the poorest asset classes and 15.3 per cent in the richest. Poorer households were being forced to rely disproportionately on non-institutional sources for credit.

In sum, what the evidence seems to suggest is that the problem in rural India is not too much credit to poor households that lead to debt waiver schemes that damage bank balance sheets, but the inadeuqate access to credit from formal sources. If rural credit needs to be revisited it must be to expand credit access rather than to restrict it because of excessive indebtedness. Moreover, it appears that when banks are given greater freedom, they lend far less for capital formation rather than much more. And the size of the loans involved are clearly small change when compared to the loans handed out to those in the corporate sector who are increasingly being seen as wilful defaulters. As the governor has flagged on another occasion, those large wilful defaulters see the restructuring of debt which they have stopped servicing as their right rather than (as ostensibly in the case of debt waiver schemes) a favour from the government or the Reserve Bank of India.

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