Y V Reddy: Rural credit - status and agenda

Speech by Dr Y V Reddy, Governor of the Reserve Bank of India, at the Administrative Staff College of India, Hyderabad, 16 November 2004.

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Distinguished participants and guests,

It is privilege to be associated with the International Seminar in Honour of Professor CH. Hanumantha Rao. His valuable contributions as a member of the Board of Directors of RBI, my professional association with him for about three decades being a fellow Osmanian, and above all, my personal regard for him, make the participation in the inaugural session today a source of pride and pleasure for me.

There is a wide-range of subjects being considered by a galaxy of eminent scholars and policy-makers, but I will confine my comments in the inaugural address to rural credit. The subject has always been at the core of RBI's activities. Telugus' seem to have been playing a special role in the design and implementation of rural credit policies in India. The monumental work of All-India Rural Credit Survey of 1951-52 was the contribution of a Committee in which half the membership was Telugus. Rural Electrification Corporation and NABARD have been led by Telugus and had Telugus as Chairmen, for a large part. I cannot recall any economist who could equal Professor CH. Hanumantha Rao in research, publication and policy involvement in the field of rural credit. In the context of economic reforms, Professor Rao has published two papers which constitute a treasure trove for all those interested in rural credit. The first titled `Policy Issues Relating to Irrigation and Rural Credit in India' (1993) makes a comprehensive analysis of problems, prospects and tasks. The second, titled "Reform Agenda for Agriculture" (2003) proposes specific credit reforms in the light of experience gained and makes a strong pitch for "a major change in the mindset." But being Telugus, we are individualistic and tend to differ - sometimes politely. Let me illustrate: Shri M. Narasimham Garu, the Bhishma-Pitamaha of the Financial Sector Reforms in India (1991) recommended redefining of and reduction in priority-sector lending, describing some of it as "behest lending". Professor Rao promptly disagreed (1993) with him on redefining priority sector lending though there was agreement between the two on phasing out of concessional rates of interest. Before proceeding further, it is appropriate to co-opt Shri Montek Singh Ahluwalia as a Telugu or an Andhraite since he lived in Hyderabad and had his schooling - perhaps the secret of the solid foundation for scholarship.

There are several concerns in relation to rural credit which are generally expressed in terms of inadequacy, constraints on timely availability, high cost, neglect of small and marginal farmers, low credit-deposit ratios in several States and continued presence of informal markets. It is held that while the commercial banks are more focused in improving efficiency and profitability, they have tended to give comparatively less priority to rural credit. Regional Rural Banks (RRBs) and Co-operatives appear to face serious problems of governance as well as operational efficiency. It is argued that most part of the Co-operative Credit structure is multi-layered, under capitalized, over-staffed and under-skilled, often with mounting non-performing assets while in a few cases resulting in erosion of public deposits as well. Many of the RRBs also appear to share most of these problems, though there are some vibrant and viable institutions in this category. These problems relating to rural credit have been well documented and several policy-approaches were made to remedy the situation. However, there is some element of dissatisfaction that overall situation in regard to rural credit is not improving to the desired level inspite of such a series of actions. It is a matter of concern that cognizable success is eluding the policy-makers, at a time when increasing commercialization warrants a big thrust in institutional credit to agriculture. There is thus a discernible widespread intellectual recognition that while immediate measures are undertaken to increase the flow of credit to agriculture, there is a need to review the policy of rural credit in a comprehensive and thorough manner.

The current strategy adopted by RBI to increase the flow of credit may be summarized as follows. First, the coverage of rural credit is extended to include facilities such as storage as well as credit through NBFCs. Second, procedural and transactional bottlenecks are sought to be removed, including elimination of Service Area Approach, reducing margins, redefining overdues to coincide with crop-cycles, new debt restructuring policies, one-time settlement and relief measures for farmers indebted to non-institutional lenders. Third, Kisan Card Scheme is being improved and widened in its coverage while some banks are popularizing General Credit Cards (GCCs) which is in the nature of clean overdraft for multipurpose use, including consumption. Fourth, public and private sector banks are being encouraged to enhance credit-delivery while strengthening disincentives for shortfall in priority sector lending. Fifth, the banks are urged to price the credit to farmers based on actual assessment of individual risk rather than on a flat rate depending on category of borrower or end-use while ensuring that interest-rates charged are justifiable as well as reasonable. In brief, the thrust is on enhancing credit-delivery in a regime of reasonable credit-prices within the existing legal and institutional constraints and to this limited extent there has been " a major change in the mindset", that Professor Rao desired.

In this background, the agenda for future consists of five parts. First, there is a need for legal and institutional changes relating to governance, regulation and functioning of rural cooperative structure and Regional Rural Banks who have to be critical instruments for rural credit in future. In this regard, it is useful to note the nature of competition and accountability to shareholders governing the functioning of commercial banks which would make their foray into rural credit predominantly subject to commercial considerations. The changes warranted in cooperatives as well as RRBs involve deep commitment of state-governments and have significant bearing on political economy. Thus, the current thrust to improve credit-delivery may soon face limits unless the legal and institutional changes are agreed upon and acted upon in good faith in a timely fashion. It is the fervent hope of RBI that a consensus will develop soon on these fundamental changes that are essential for achieving the broad policy objectives.

Second, there are overhang problems of non-performing loans and erosion of deposits in both cooperatives and RRBs. There is some assessment of magnitudes of losses and capital needs in RRBs while in the case of cooperatives the data are not yet firm. It may not be appropriate to continue to permit institutions that are not solvent to seek and accept public deposits and hence RBI favours early restructuring and recapitalisation. There is an inevitable fiscal impact of any scheme of recapitalisation which has to be transparent and has to bear all the costs of overhang issues as well as capital adequacy to assure continued solvency and safety of public deposits in future. Such a one-time fiscal support is justifiable, urgent and essential for several reasons, including that "There Is No Alternative" and delayed response could end up being more expensive. The current acceleration in credit-delivery can be sustained in the medium term, if such fiscal support from States and Centre is firmly put in place soon to revive or reorganize rural cooperative structure and RRBs.

Third, there is a need to foster credit culture to make enhanced rural credit a lasting phenomenon. A benign credit-culture is one which encourages appropriate credit price, credit-delivery under transparent conditions of lenders' as well as borrowers' liabilities and incentives for repayment rather than default. Measures that counter such a benign credit culture are often well-intended, but as the experience so far has shown they tend to be seriously counter productive. There is a need for a consensus in this regard, so that, rural credit system in India is compatible with our goals of higher growth and better equity. In this regard, it is necessary to recognise that expansion of credit in some of the States which have low credit-deposit ratio depends on conducive credit culture capturing factors relating to governance and commercial viability.

Fourth, on the critical issue of risk-mitigation, it is held that experiments with crop or credit-insurance in India have not been very satisfactory so far. In fact, many farmers argue that where compulsory insurance is resorted to, it increases the burden of borrowing from institutional sources and once the transaction costs are added, the overall costs exceed the Prime Lending Rates significantly. There are several risks that a farmer faces, and of these future price and monsoon conditions are most severe and almost entirely beyond the control of the farmer. While Minimum Support Price is a mechanism that has served us well, its cost-effectiveness is subject to debate and in any case the coverage is limited to cereals like rice and wheat and in some areas cotton. The farmer faces the risks of monsoon conditions and usually the adverse climatic conditions are widespread in a geographical area, with the result severe limits are set on private-insurance. Prof. CH. Hanumantha Rao flagged the issue of strategy to reduce risks as one of the four major areas of long-term planning (in 1993) but they covered only water conservation, venture capital and insurance promotion, where viable. Perhaps, it is necessary to recognize that if some elements of insurance are abinitio not viable, extending credit becomes more risky and hence constrained.

Finally, in the light of the above, there is merit in considering a comprehensive public policy on risk-management in Agriculture, as not only a means of relief for distressed farmers but as an ingredient for more efficient commercialized agriculture. The components of such a policy have to be worked out in detail, but illustratively, the public-policy could consider some of the elements described here. First, establishing a well articulated, objective and independent assessment of impact of adverse monsoon conditions and appropriate relief to farmers on an assured basis. Second, facilitating farmers to assure themselves of a price for all their products before harvesting, or even sowing the seed, through a well regulated network of Forward, Futures and Options markets. Third, establishing and implementing liability of suppliers for any shortfall in quality or assured supply in vital inputs such as seeds, pesticides, power and water. Fourth, gradually eliminating and replacing price-subsidies with outlays on risk mitigation for farmers in the broadest sense and Fifth, positioning flexibility in extending rural credit within a broad framework of such a comprehensive public policy on risk-management in Agriculture.

Let me conclude by thanking Dr. S.K. Rao and Dr. MahendraDev for inviting me to join this intellectual feast. I have great pleasure in inaugurating the seminar and look forward to hearing the luminaries like Dr. Arjun Sengupta, Dr. Yogender Alagh and Dr. R. Radhakrishna.

Thank you.