Usha Thorat: Inclusive growth – the role of banks in emerging economies

Text of the “Independence Commemoration Lecture, 2008” by Ms Usha Thorat, Deputy Governor of the Reserve Bank of India, at the Central Bank of Sri Lanka, Colombo, 28 February 2008.

Assistance of C.S. Murthy, G. Srinivasan, Asha P. Kannan and Sundaram Shankar in preparing this speech is gratefully acknowledged.

*   *   *

Ladies and Gentlemen,

I am delighted to be here in Colombo and honoured by the invitation of the Central Bank of Sri Lanka to deliver this year’s “Independence Commemoration Lecture”. It is my proud privilege to join the illustrious list of previous speakers, who have added laurels to this prestigious lecture series. Today, I would like to share with you India’s experiences on “Inclusive Growth” – a topic which is both current and close to the hearts of public policymakers and central bankers of emerging economies.

Having chosen my topic, I am faced with the, not so unusual, speaker’s dilemma as to from where I should begin. And I thought it is best to begin at the very beginning – some three millennia ago. Yes, some three millennia ago!! I refer to the “Shanti Mantra” – a peace hymn – from the “Kato Upanishad” of the Hindu scriptures which runs like this:

"Om Sahana Vavatu Sahanau Bhunaktu, Saha Viryam Karawavahai, Tejasvinavaditamastu, Ma Vidvishavahai, Om Shanti hi Shanti hi Shanti hi"

and translates to:

"Together may we be protected, together may we be nourished, together may we work with great energy, may our journey together be brilliant and effective, may there be no bad feelings between us, Peace, Peace, Peace"

Indeed, the significance and importance of the “inclusive” concept has been well recognised millennia ago.

Coming to current times, there is growing realisation that while the “trickle down” effect of economic growth no doubt works, it takes too long a time and hence there is a need to focus on inclusive growth. "Inclusive growth", is a little more than just the benefits of growth being distributed equitably and evenly; it is the participation of all sections and regions of society in the growth story and their reaping the benefits of growth.

I. Why inclusive growth?

While it is quite evident that inclusive growth is imperative for achieving the equity objective, what is, perhaps, not so obvious is, why inclusive growth is now considered essential even to sustain the growth momentum.

First, in many of the emerging market economies, the major chunk of population is based in rural areas. Significant increase in demand for manufacturing and services sectors has to come from the rural population. The average monthly per capita consumption expenditure (MPCE) in urban areas in India is almost double that of rural areas. In some States, the disparities are even more glaring. Therefore, it is important to ensure that growth takes place in agriculture, allied sectors as also in secondary and services sectors in rural areas, and amongst urban poor to provide a growing market for the goods and services produced by the expanding corporate sector.

Second, from supply-side management, growth in agriculture is necessary in order to keep manufacturing prices under check, provide food security and keep inflation under control.

Price stability is not merely important as an anti poverty measure but also as an instrument to ensure stable and sustained growth.

Third, higher growth in agriculture and rural areas coupled with demographic dividend (*i.e.* growing proportion of population in the working age group of 15-65) will lead to a rise in the savings level for financing the increasing level of investments necessary to sustain the overall growth momentum.

Fourth, the limitations on increasing production and productivity in agriculture are driving migration to urban areas leading to population pressure in urban areas and increase in urban poor. Infrastructure in urban areas needs considerable investment to handle the migration – this requires significant investment in housing, water, sanitation, lighting and power, waste management, education, health facilities, and other infrastructure. Hence, urban development policies have to focus on inclusive investment to deal with the huge armies of low-income population likely to move into these areas.

Fifth, since in many countries such as India, the growth process is knowledge-based and services-led, the requirement of skilled labour is quite substantial in comparison to the present availability. In order to ensure adequate supply of skilled labour force, huge social sector investment is required covering the vast majority of people who may not be able to afford such education and skill development.

Sixth, whenever we talk of the majority population living in rural areas, it is often identified with the agriculture sector. However, it is the unorganised non-farm sector that is increasingly absorbing most of the labour force. This sector has huge potential for growth once there is sufficient investment in infrastructure ensuring linkage to markets and easier access to assets and skills. Infusion of appropriate technology, skills, and easier access to credit, especially start-up capital, apart from facilitating market development, can make this segment an expanding base for self-sustaining employment and wealth generation and also foster a culture of creative and competitive industry. Entrepreneurial development has to be encouraged by having an enabling competitive environment and easy availability of finance for newer projects and enterprises. In Prof. C. K. Prahalad's words, *“If we stop thinking of the poor as victims or as a burden, and start recognising them as resilient and creative entrepreneurs and value conscious consumers, a whole world of opportunity will open up.”*[1]

Thus, there are several factors to be considered for inclusive growth. Uppermost among these, is the need for raising the allocative efficiency of investment and resource use across different sectors of economy – this can be met by addressing two basic supply-side issues viz. (i) effective credit delivery system to facilitate productive investment in employment impacting sectors especially, agriculture, micro, small and medium enterprises and (ii) large scale investment in infrastructural facilities like irrigation, roads, railways, communication, ports, power, rural/urban reconstruction and in social infrastructure such as health care, education and sanitation.

II. Financial Inclusion for inclusive growth

The challenges of achieving more inclusive growth can be met by policies that encourage easier and affordable access to financial services. Both theoretical and empirical researches highlight the role of financial development in facilitating economic development (Rajan and Zingales, 2004).[2] At the cross-country level, evidence indicates that various measures of financial development are positively related to economic growth (King and Levine, 1993[3];

---

1 Prahlad, C K 'The Fortune at the Bottom of the Pyramid - Eradicating Poverty Through Profits', Pearson Publication, 2005.

2 Rajan, R.G. and L. Zingales (2003), 'Saving Capitalism from Capitalists', Crown Business, New York.

3 King, Robert. G. and R. Levine (1993), 'Finance and Growth: Schumpeter Might Be Right', The Quarterly Journal of Economics, August, 717-737.

Levine and Zervos, 1998).[4] Even the recent endogenous growth literature, building on "learning by doing" processes, assigns a special role to finance (Aghion and Hewitt, 1998 and 2005).[5]

While in developed countries, the formal financial sector comprising mainly the banking system serves most of the population, in developing countries, a large segment of the society, mainly the low-income group, has little access to financial services, either formal or semi formal. As a result, many people have to necessarily depend either on their own sources or informal sources of finance, which are generally at high cost. Most of the population in developed countries (99 per cent in Denmark, 96 per cent in Germany, 91 per cent in the USA and 96 per cent in France) have bank accounts (Peachy and Roe, 2004).[6] However, formal financial sectors in most developing countries serve relatively a small segment, often no more than 20-30 per cent of the population, the vast majority of who are low income households in rural areas (ADB, 2007).[7] Owing to several factors such as the sharp increase in urbanisation, rural to urban migration as also the increase in urban poverty, the share of poor and the low-income households not having any access to finance in the urban areas is also increasing in several countries.

Recent data shows that countries with large proportion of population excluded from the formal financial system also show higher poverty ratios and higher inequality.

Financial Inclusion and Development Indicator

Country	Composite Index of Financial Inclusion (per cent of population with access to financial services)	Poverty (per cent of population below poverty line)	Unemployment during 2000-04 (per cent)	Gini Index
1	2	3	4	5
India	48	28.6 (1999-00)	4.3	32.5 (1999-00)
Bangladesh	32	49.8 (2000)	3.3	31.8 (2000)
Brazil	43	22.0 (1998)	9.7	58.0(2003)
China	42	4.6 (1998)	4.0	44.7 (2001)
Indonesia	40	27.1 (1999)	9.9	34.3 (2002)
Korean Republic	63	..	3.5	31.6 (1998)
Malaysia	60	15.5 (1989)	3.5	49.2 (1997)
Philippines	26	36.8 (1997)	9.8	46.1 (2000)
Sri Lanka	59	25.0 (1995-96)	9.0	33.2 (1999-00)
Thailand	59	13.1 (1992)	1.5	42.0 (2002)

Source: World Bank (2006)[8] and (2008)[9].

4 Levine, R. and S. Zervous (1998), 'Stock Markets, Banks and Economic Growth', American Economic Review, Vol.88, pp 537-58.

5 Aghion, P., and P. Howitt (1998), 'Endogenous Growth Theory', MIT Press. Aghion, P., and P. Howitt (2005), 'Appropriate Growth Policy: A Unifying Framework', The 2005 Joseph Schumpeter Lecture, European Economic Association, Amsterdam.

6 Peachy, S. and A. Roe (2004), 'Access to Finance - What Does it Mean and How Do Savings Bank Foster Access? Brussels: World Savings Bank Institute.

7 ADB, (2007)'Low-Income Households' Access to Financial Services', International Experience, Measures for Improvement and the Future; Asian Development Bank.

8 World Bank (2006), World Development Indicators, Washington.

9 World Bank (2008), Finance for All - Policies and Pitfalls in Expanding Access; Washington.

III. Inclusive growth in India

From an annual average growth rate of 3.5 per cent during 1950 to 1980, the growth rate of the Indian economy accelerated to around 6.0 per cent in the 1980s and 1990s. In the last four years (2003-04 to 2006-07), the Indian economy grew by 8.8 per cent. In 2005-06 and 2006-07, the Indian economy grew at a higher rate of 9.4 and 9.6 per cent, respectively. Reflecting the high economic growth and a moderation in population growth rate, the per capita income of the country also increased substantially in the recent years. An important characteristic of the high growth phase in recent years is its resilience to shocks. The Indian economy, for instance, successfully avoided any adverse contagion impact of the East Asian crisis, sanctions like situation post-Pokhran nuclear test, and border conflict with a neighbouring country during May-June 1999.

Despite the impressive numbers, growth has failed to be sufficiently inclusive, particularly after the mid-1990s. Agricultural sector which provides employment to around 60 per cent of the population lost its growth momentum from that point, though there has been a reversal of this trend since 2005-06. The percentage of India's population below the poverty line has declined from 36 per cent in 1993-94 to 26 per cent in 1999-2000. The approach paper to the Eleventh Plan indicated that the absolute number of poor is estimated to be approximately 300 million in 2004-05.

Concerns about financial exclusion, especially in rural areas have surfaced in India in recent years following the results of the NSSO's All-India Debt and Investment Survey (AIDIS), 2002. According to the Survey results, though the share of non-institutional sources of credit for the cultivator households had declined from 92.7 per cent in 1951 to 30.6 per cent in 1991, it had increased to 38.9 per cent in 2002 mainly due to increase in moneylenders' share. Simultaneously, the share of institutional sources such as commercial banks, co-operative societies, *etc*. increased from 7.3 per cent in 1951 to 66.3 per cent in 1991, before declining to 61.1 per cent in 2002. While data later than 2002 are not available in this regard, it is expected that the doubling of agriculture credit and other measures since 2004 would have led to some improvement in the share of institutional sources.

IV. Financial sector policy and regulatory framework in India for inclusive growth

The financial sector in India has been primarily dominated by the banking system. Scheduled commercial banks (SCBs) occupy a predominant position in the financial system, accounting for around three-fourths of the total assets. As at end-March 2007, the public sector banks (PSBs) accounted for 70 per cent of the total assets of SCBs. Foreign banks operating in India accounted for about 8 per cent of the assets of SCBs. The RRBs and the co-operative banks, with two broad segments of urban and rural co-operative banks also form an integral part of the Indian financial system.

Broadly speaking, one can observe two distinct phases in the developments relating to public policy objectives underlying banking policy. The first phase viz. the two decades since 1970 represented the period of State control over the banking system, pre-emption of the major part of bank resources by the public sector and directed lending with administered interest rates. During this period, the nationalisation of major banks in 1969 saw banking policy giving a thrust to branch expansion in the rural and semi urban areas and stepping up of lending to the so called priority sectors viz. agriculture, small scale industry, self employed and small business sectors and weaker sections within these sectors. As a result, the branches of scheduled commercial banks increased from 8,262 in June 1969 to 69,471 in March 2006. The average population per branch office decreased significantly from 64,000 to 16,000 during the above period, with the share of rural branches increasing from 22.2 per cent in June 1969 to a little over 51 per cent in March 1998. Lending to the priority sectors was increased to the mandated target of 40 per cent. Specialised Regional Rural Banks were set up in 1975, especially in backward and tribal districts to cater to the needs of the weaker sections amongst farmers and non-farm small businesses entrepreneurs. National Bank for

Agriculture and Rural Development (NABARD) largely provided concessional refinance for lending done by the rural cooperative credit structure. The second phase after the early 1990s, represents the period of financial sector reform, higher allocation of credit to the private sector, lower pre-emption by the government sector, moving away from administered interest rates to market determined rates even for government borrowing, introduction of international best practices and regulatory policies for strengthening the financial sector, increased competitiveness with entry of new private sector banks and more foreign banks, and allowing private shareholding in public sector banks. Listing of public sector banks on the stock exchanges made them consciously focus on bottom line, control NPAs, make investments in technology and skills and bring about other efficiencies. This period also saw consolidation of banking system in terms of branches. Although priority sector lending norms continued, the definitions became progressively wider with several sectors and activities getting included. In a sense, this period demonstrated the recognition that inclusive banking cannot be at the cost of weakening financial institutions and that policies for inclusive banking have to go hand in hand with encouraging strong and efficient financial institutions. The thrust of inclusive financing for the poor in this phase was mainly through government sponsored credit-cum-subsidy programmes. The recovery performance in these schemes was not encouraging and their success in achieving desired outcomes was also tepid.

A notable development in the second phase of inclusive banking was the launching of the SHG Bank Linkage programme by NABARD in 1992. The programme gained momentum when Reserve Bank allowed banks to open savings accounts for SHGs despite their not having any legal form. The group leaders operate the SHG accounts. SHGs facilitate collective decision – making and provide “door step” banking to the poor. The banks, as wholesalers of credit, provide the resources, while the NGOs are the agencies that organise the poor, build their capacities and facilitate the process of empowering them. Interest rates on loans granted by banks to SHGs are deregulated. Loans to SHGs of individual farmers are treated as direct agricultural finance, provided the details of such loans are maintained by the bank/SHG. As at March 31, 2007, over 2.9 million SHGs have been linked to banks involving a total credit flow of over Rs.180 billion.

The other strategic move in this phase was the creation of Rural Infrastructure Development Fund (RIDF) in NABARD, into which public sector banks were required to make deposits towards part of the shortfall in their priority sector lending. The Fund is utilised to make loans to State Governments for creation of rural infrastructure. A similar fund was set up in Small Industries Development Bank of India (SIDBI) out of shortfall in meeting priority sector lending targets by foreign banks.

V. Recent strategies for inclusive banking

As the economy began to grow at higher rates, the regional and societal disparities called for new strategies to ensure that the banking system met the requirements of inclusive growth. Such strategies needed to be fashioned in a manner that they did not undermine the stability and efficiency of the financial system. Accordingly, over the last four years or so, several measures have been taken by the Reserve Bank and Government of India to ensure better banking penetration and outreach, particularly that the credit needs of agriculture and small enterprises are met while allowing sufficient flexibility to each bank to evolve its own policies and strategies for the purpose. We shall now discuss some of these initiatives.

Specific focus on financial inclusion commenced in November 2005, when Reserve Bank advised banks to make available a basic banking “no-frills” account with low or “nil” minimum balance as well as charges, with a view to expanding the outreach of such accounts. In such accounts, banks are required to make available all printed material used by retail customers in the regional language concerned. In order to ensure that persons belonging to low income groups, both in the urban and rural areas do not encounter difficulties in opening bank accounts, the know your customer (KYC) procedure for opening accounts has been simplified. Besides the Kisan Credit Cards (KCCs), banks have been asked to consider introduction of a General purpose Credit Card (GCC) facility up to Rs.25000 at their rural and semi urban braches. This facility is in the nature of revolving credit, which entitles the holder to withdraw up to the limit sanctioned. Based on assessment of household cash flows, limits are sanctioned without insistence on security or purpose. Interest rate on the facility is completely deregulated. Fifty per cent of GCC loans can be treated as priority sector lending.

Financial inclusion is intended to connect people to banks with consequential benefits. A decentralised strategy has been adopted for ensuring financial inclusion. The SLBC identifies one district for 100 per cent financial inclusion. So far, SLBCs have reported having achieved 100 per cent financial inclusion in 68 out of 611 districts in the country. 12 million "No frills" accounts have been opened so far, with 11 million of them having been opened by public sector banks. An external evaluation of the progress made in these districts is being undertaken to draw lessons for further action in this regard.

Recognising that the Regional Rural Banks (RRBs) with their dominant presence in backward and tribal areas can become powerful instruments of financial inclusion, measures have been taken to strengthen them through consolidation of the 196 banks into 92 banks, making sponsor banks responsible for their performance, liberalising branch licensing in their area of operation, recapitalising RRBs having negative net worth and providing them with facilities to upgrade their staff skills. Working groups have been set up to explore how these banks could be supported to bring in core banking solutions and adopt ICT solutions for financial inclusion.

A growing component of inclusive banking is the lending by MFIs that are societies, trusts, cooperatives or "not for profit" companies or non-banking financial companies registered with the RBI. This sector currently covers 8.32 million borrowers (Sa-Dhan Report 2007). The NBFC segment within this sector accounts for 42.8 per cent of the borrowers and is the fastest growing segment. Interest rates on lending to MFIs/NBFCs are completely deregulated; bank lending to such entities for micro finance is treated as priority sector lending. Private sector and foreign banks are observed to be actively supporting this sector, which is also attracting private equity funding and philanthropy funding from outside the country.

In order to step up lending to agriculture, in 2004-05, Government of India launched a special programme monitored by NABARD for doubling of agricultural credit, and providing relief to distressed farmers through rescheduling and settlement schemes. A programme of interest rate subvention of 2 per cent on crop loans to farmers was also introduced and this scheme, which is being operated for the last three years, is still in force. In 31 districts identified as distressed, a special package was put in place for interest waiver and rescheduling of principal over a long period to minimise debt burden, together with provision of fresh loans to distressed farmers. Government of India and respective State Governments share the burden of write off. Some State Governments have, on their own, introduced farmers' debt relief programmes.

Government of India has introduced a comprehensive recapitalisation and reform package for the rural cooperative credit structure, both short term and long term, as this sector was plagued by overdues and accumulated losses resulting in choking of credit flow. The reform package has financial governance and regulatory components to ensure that the sector once strengthened is self-sustaining. The programme is currently under implementation. Measures are also being taken by the Government to revamp crop insurance and also introduce weather insurance.

Reserve Bank has modified the prudential accounting norms for classification of asset quality with respect to agricultural loans, keeping in mind the seasonality of crops and cash flows. Standing instructions are in place for rescheduling loans in areas affected by natural calamities and disasters. In order to enable small farmers with loans up to Rs.25000 to re-enter the credit system, banks have been advised to introduce a simplified one-time settlement scheme for such loans. In order to help distressed farmers who have defaulted on loans due to natural calamities, or for reasons beyond their control, banks have been permitted to offer one time settlement under a Board approved policy. Both in rural and urban areas, the poorer sections of the society commonly avail of loans against gold and silver ornaments. These loans entail relatively low risk as they are extended with adequate margins and the collateral (gold or silver) is easily marketable, particularly where the size of the loan is small. Therefore, the risk weight on such loans up to Rs.100000 has been reduced to 50 per cent from the level of 125 per cent for all categories of banks.

Similar measures have been taken to step up credit to the micro, small and medium enterprises (MSME) sector. The Government operates a credit guarantee scheme through SIDBI for providing credit guarantee to banks for their loans to MSME so that they can give such loans based on the viability of the project and not insist on collateral. The guarantee premium has been reduced and coverage increased for smaller loans and backward areas. Credit rating by SIDBI at concessional rates and the putting in place of a comprehensive credit information system for this sector will go a long way in better credit allocation and pricing. Reserve Bank has issued detailed guidelines for debt restructuring for this sector. In view of the importance of creation of employment opportunities in rural areas, especially with a focus on women and weaker sections of the society, Reserve Bank's guidelines stipulate that 60 per cent of total advances to the small enterprises sector should go to micro enterprises.

In 2002, there were more than 2000 small urban cooperative banks in the country providing banking services to local communities. Many of these banks were weak and public confidence in the system had got eroded. Over the recent period, recognising the important role that these banks can play in financial inclusion, a regulatory and supervisory framework has been put in place to weed out the non viable banks in a non disruptive manner through a consultative process with the registrar of cooperative societies and sector representatives. This strategy has paid huge dividends and confidence has slowly come back to the sector.

Over the years, concentration of bank branches in metropolitan areas became a concern. To mitigate this problem, since 2006, the Reserve Bank approves opening of new branches for any bank only on the condition that at least half of such new branches are opened in under-banked areas as notified by it. Banks too have found that the branches in semi-urban and rural areas are commercially viable.

In January 2006, the Reserve Bank permitted banks to utilise the services of non-governmental organisations (NGOs/SHGs), micro-finance institutions 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 population, thus addressing the last mile problem. Banks are also entering into agreements with Indian Postal Authorities for using the enormous network of post offices as business correspondents for increasing their outreach and leveraging the postman's intimate knowledge of the local population and trust reposed in him.

The Reserve Bank of India has been encouraging the use of Information Communication Technology (ICT) solutions by banks for enhancing their outreach with the help of their Business Correspondents. The BCs carry hand held devices, which are essentially smart card readers. The information captured is transmitted to a central server where the accounts are maintained. These devices are used for making payments to rural customers and receiving cash from them at their doorsteps. Mobile phones have also been developed to serve as card readers. Account holders are issued smart cards, which have their photographs and finger impressions. Pilot studies have clearly shown that the technology is practical and robust, besides being affordable. Scaling up is, at present, the challenge, and some States like Andhra Pradesh are keen that all Government payments should be routed through these accounts to ensure transparency and efficiency in such payments, apart from providing a huge opportunity for ensuring financial inclusion.

In the Union Budget 2007-08, the Government announced the creation of two funds – Financial Inclusion Fund and Financial Inclusion Technology Development Fund – for meeting the costs of development, and promotional and technology interventions as recommended by the Rangarajan Committee.[10]

Recognising that lack of awareness is a major factor for financial exclusion, the Reserve Bank is taking a number of measures for increasing financial literacy and credit counselling. A multilingual website in 13 Indian languages on all matters concerning banking and the common person has been launched by the Reserve Bank on June 18, 2007. Comic type books introducing banking to school children have already been put on the website. Financial literacy programmes are being launched in each State with the active involvement of the State government and the SLBC.

Credit counselling services in addition to financial literacy and financial education are being perceived as important tools to enable people to overcome the problem of indebtedness and seek re-access to banking system. Each SLBC convenor has been asked to set up a financial literacy-cum-credit counselling centre in one district as a pilot, and extend it to all other districts in due course.

Easy availability of up to date credit records would go a long way in helping small borrowers to access credit and get better pricing. As a step in this direction, the Credit information Companies Act has been enacted. Comprehensive records take time to get established and it is hoped that this activity will gain momentum once the rules are notified and such companies are licensed.

In the context of the finding that the share of moneylenders in total dues of rural households had increased, the Reserve Bank constituted, in 2006, a Technical Group consisting of senior Reserve Bank Officers and Secretaries from select State Governments to review the efficacy of the existing legislative framework which governs money lending, as also the enforcement machinery in different States. A model draft of legislation on money lending has been prepared by the Group for consideration and adoption by the State Governments for improving the legal and enforcement framework for protecting the interest of rural households. The model legislation provides for a hassle free procedure for compulsory registration with State Governments. The Group has also proposed establishing a link between the formal and informal credit providers, to be called “Accredited Loan Providers" for use as an additional credit delivery channel. The report has been sent to the State governments for their consideration.

VI. Some learning points

First – Is providing affordable financial services to the excluded regions and sections of society a risk to the bottom lines of banks? In other words, does the public policy objective of financial inclusion conflict with commercial objectives? Banks are special and the banking licence, which enables banks to be highly leveraged institutions, casts responsibilities on them to make available basic banking services to all. At the same time sustained growth of their balance sheets would imply that they penetrate remote and hitherto un-reached segments of population requiring investments in technology and skills for scaling-up. In one sense, it seems to be a time horizon issue as, such investments – if made early enough and market share enhanced – can actually help the bottom line. This would then represent a win-win situation for the financial system and society. At the same time in the effort to enhance

[10] Rangarajan, C. (2008), Report of the Committee on Financial Inclusion (Final), January.

scale and profits, there could be a risk of predatory and irresponsible lending as the sub prime crisis shows. The use of local community based organisations and social capital such as SHGs in low-income communities is a way of handling this challenge. It also points out to the fact that interest rates, while covering cost and risk should not be so high so as to add to the risk of default because of high burden. There is thus the need to ensure a fair balance between sustainability of operations through coverage of costs, and interest burden on the borrower. Irresponsible lending also highlights the issue of recovery practices, use of agents and the need to be sensitive to the needs of the poor, as in majority of cases there is no intent to default. In this context, the need for affordable health, accident and life insurance as part of a slew of products for financial inclusion, in addition to financial education and credit counselling, cannot be overstated.

This brings me to the second lesson viz. the issue of subsidised credit; in this context, I would like to quote from a recent speech by Governor Dr. Y.V.Reddy[11]:

"Interest rates have been deregulated to a significant degree not only to aid movement of monetary policy to the use of more effective indirect instruments, but also because administered interest rate regime proved to be inefficient and costly, without necessarily ensuring flow of credit to the needy. The RBI's recommended approach, however, does not preclude subsidisation by the Government but it disfavours excessive use of banking system to cross subsidise, especially if it were to favour non-poor. RBI favours a financial system that provides incentives to encourage flow of credit at justifiable terms and conditions and for purposes that ensure servicing of interest and principal, i.e., bankability of schemes. There has been broad agreement between the Government and the RBI on the above approach, and accordingly, subsidies on interest rates through the banking system to small farmers and small exporters are currently provided for a limited period. There are several Government-sponsored programmes intended for the vulnerable sections and these are small-sized loans for which Government provides subsidy, particularly for employment generation. Thus, the financial sector, in particular the banking system, is utilised as a conduit by the Government's fiscal policy, to subsidise select activities or vulnerable sections, and RBI plays a supporting role in enabling such measures while emphasising the longer term goals of a conducive credit culture. The overall objective remains growth with stability, but with elements of selective fiscal support for ensuring inclusive and equitable growth. Currently, the aggregate annual fiscal burden of subsidisation on account of the above measures, through the financial sector, is estimated to be about a quarter per cent of GDP."

The third important lesson from the Indian experience is the value of having multiple channels of credit, given the scale and diversity of the country. Thus, direct lending by banks, use of SHGs and MFIs for indirect lending, use of post offices, local organisations and cooperatives as agents, focus on RRBs, the revamp of the cooperative credit structure, both urban and rural, NBFCs purveying micro-finance and even the possible use of accredited loan providers under money lending legislation – all these reflect this approach.

Fourth, inclusive growth needs financial institutions to be strong and efficient. The experience with cooperative banks under dual regulation, and deposit taking NBFCs with poor governance, points out the challenges in ensuring effective regulation and supervision of entities allowed to access public deposits. While aligning regulation with international best practices, a more relaxed approach is adopted in India for smaller units such as regional rural banks and small urban cooperative banks operating within a district, without compromising on solvency and liquidity principles.

Fifth, the outcomes of various programmes and policy measures get greatly enhanced if there is good understanding and coordination between the government machinery

[11] Dr. Reddy, Y.V (2007), Speech on 'Financial Sector Policies for growth and employment' delivered at Bali, Indonesia on November 8, 2007.

responsible for development and the banks operating in the area. While the Government functionaries have to appreciate that banks have a responsibility to their depositors as much as to their borrowers, if not more, it is equally important for banks to strengthen their functioning at the local level for meeting developmental objectives of the Government. The various fora under the Lead Bank Scheme have been very useful in sorting out mutual coordination issues. RBI plays a catalytic, as well as a coordinating role, in these initiatives for enhancing co-operation between the States and the banking system. Where the State Governments play a pro-active role in updating and computerising land records, routing of government payments through the bank accounts, supporting IT based solutions for maintaining and operating bank accounts, and providing extension services to farmers and small businesses, the results, indeed, can be dramatic.

Sixth, in agriculture, minimising yield risk and price risk can bring down credit risk and lower the cost of providing credit. This is an area where banks have also taken initiative of setting up rural training centres for small enterprises, farmers clubs, knowledge centres and credit counselling centres. NABARD and SIDBI, the two development financial institutions, are also engaged in providing such credit plus services. Efforts in this area need to be scaled up further.

Seventh, given the rapid urbanisation, the needs of urban poor have to get a separate focus. Significant investments will be required in housing, water and sanitation, lighting and power, waste management, education and health facilities, and other required infrastructure in urban areas – the banking system can play a very important role in this. A High Level Committee recently set up by RBI to review the Lead Bank Scheme is examining how focussed attention can be paid to the urban areas especially big cities for more inclusive banking.

Finally, other elements of financial services like insurance and affordable remittances are also necessary for achieving the objective of inclusive growth – These are areas in which much more needs to be done.

To conclude, ensuring that the financial system plays its due role in promoting inclusive growth is one of the biggest challenges facing the emerging economies, especially as the banking system in many countries is in private hands. However, if all stakeholders realise that "inclusive banking" is good business, then regulatory and policy frameworks that promote accessibility, and responsible banking can definitely lead to the desired outcomes.

Thank you.