DIRECTED CREDIT POLICY IN INDIA

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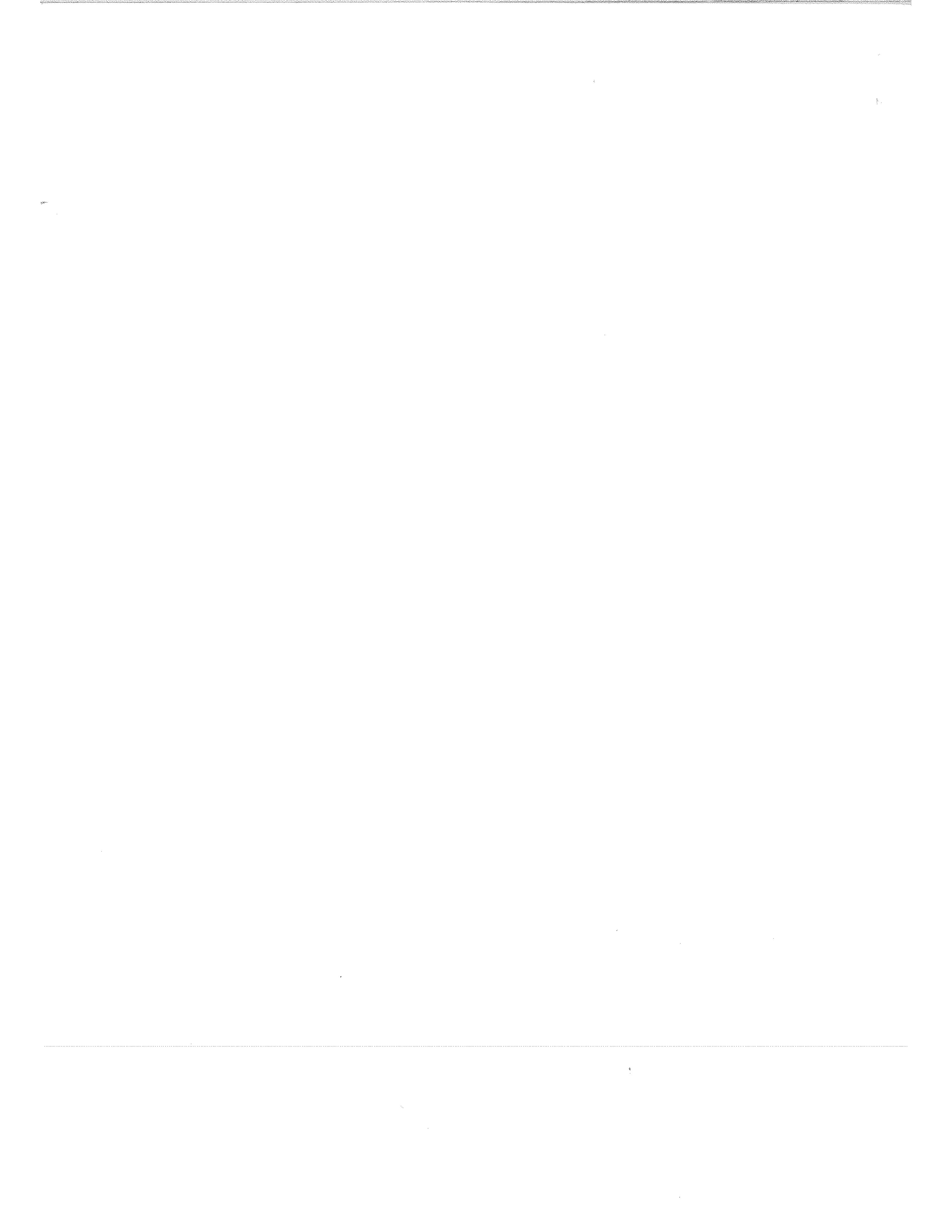

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ABBREVIATIONS USED:

RBI	:	Reserve Bank of India
DFI	:	Development Financial Institution
RRB	:	Regional Rural Bank
CRR	:	Cash Reserve Ratio
NABARD	:	National Bank for Agriculture and Rural Development
ARDC	:	Agricultural Refinance and Development Corporation of India
IDBI	:	Industrial Development Bank of India
IFCI	:	Industrial Finance Corporation of India
ICICI	:	Industrial Credit and Investment Corporation of India
EXIM BANK	:	Export-Import Bank
SIDBI	:	Small Industries Development Bank of India
SFC	:	State Finance Corporation
SIDC	:	State Industrial Development Corporation
UTI	:	Unit Trust of India
LIC	:	Life Insurance Corporation
GIC	:	General Insurance Corporation
SLR	:	Statutory Liquidity Ratio
DRI	:	Differential Rate of Interest Scheme
IRDP	:	Integrated Rural Development Programme
SEEUY	:	Self Employment Scheme for Educated Unemployed Youth
SEPUP	:	Self Employment Programme for Urban Poor
SUME	:	Scheme for Urban Micro Enterprises

1. INTRODUCTION

During the last few decades, India has experienced rapid financial deepening. It now has an impressive financial system which ranks in the top quarters among the financial sectors of most developing countries (See Morris (1985) and World Bank (1990). Not many developing countries have financial systems that can equal India's in size, variety of institutions and the range of instruments.

In line with India's overall development strategy and policy framework, its financial sector has also been perhaps one of the most regulated ones in the world. Its evolution over the years, especially since the late '60s, has taken place in an environment of increasing degree of public ownership and control of financial institutions. Practically most of the financial institutions in India are now government-owned and over three-fourth of financial assets of the organised financial sector flows through public sector financial institutions. The financial sector is steered by the government and the Reserve Bank of India (RBI), the country's central bank, through a set of guidelines, directives, regulations and supervision and management plans.

One of the key policy instruments used to steer the financial sector is the directed credit policy of the government. Allocation of a significant proportion of the financial sector funds is done by government directives at

administered interest rates. Some of the financial institutions are required to lend a certain proportion of their funds to the government and other selected sectors and activities on a priority basis. The role of such directed credit policies in the allocation of funds has perhaps been the most prominent in the case of commercial banks, the most important segement of India's financial sector. At present, banks are subject to both statutory investment requirements and "priority-sector" credit targets. Banks must invest a certain proportion of their deposits in government and government-approved securities at administered interest rates; of the remaining funds, banks are required to lend a targetted amount to selected "priority sectors" at government-fixed interest rates.

These directed credit policies have been in existence for over two decades. The main objectives of this paper are to:

i) trace the evolution and rationale of these directed credit policies,

ii) estimate the broad magnitude of directed credit and the extent of its interest subsidisation.

iii) examine the extent to which these policies have fulfilled their objectives, and

iv) highlight some of the emerging problems in the continuation of directed credit policies.

Section 2 provides an overview of the Indian financial system, evolution of its structure and the trends in its size

over the years. Against this backdrop, Section 3 traces the evolution and the rationale of directed credit policy in India. Section 4 provides an estimate of directed credit in the Indian financial sector; it also addresses the issue of interest subsidisation of directed credit. Section 5 presents an assessment of the effectiveness of directed credit policy in achieving its objectives in selected areas. Finally, Section 6 highlights some of the emerging problems and prospects in the area of directed credit policy. An Annexure deals with the administrative aspects of directed credit policy focussing primarily on the interrelationships between the government, the banks and the beneficiaries of the directed credit policy.

2. THE STRUCTURE AND SIZE OF THE INDIAN FINANCIAL SECTOR

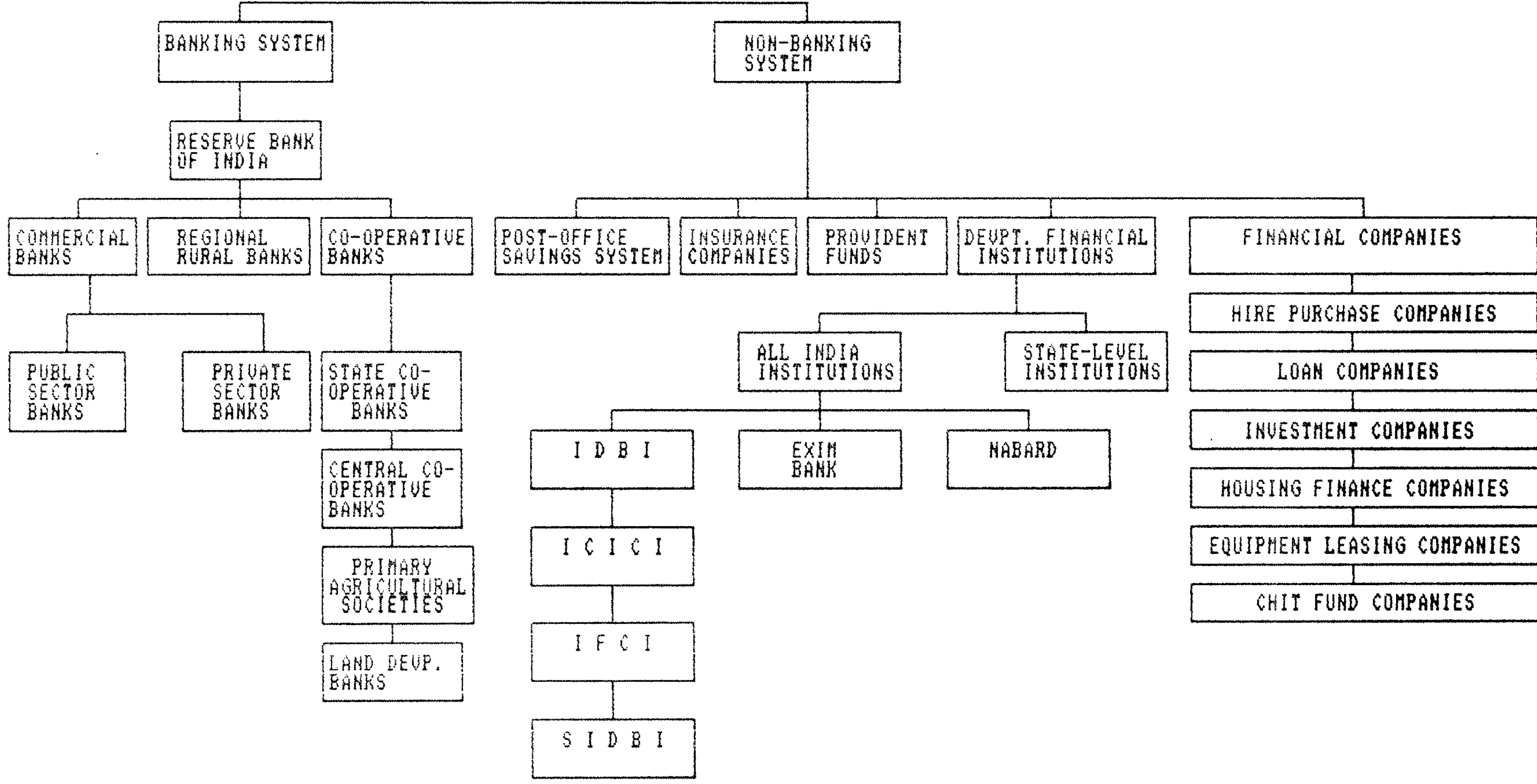
As in most developing countries, the Indian financial sector is characterised by a dual structure: the co-existence of a highly institutionalised formal segment and a less organised informal segment. The financial institutions in the formal segment are fairly well known. Besides the Reserve Bank of India (RBI), which is the central bank of the country, the formal sector consists of a) commercial banks, now largely nationalised, b) co-operative banks/societies, c) term lending financial institutions or development financial institutions (DFIs), d) investment and insurance companies, e) provident funds, f) post office savings system, and g) non-banking financial companies such as loan companies, hire purchase and equipment leasing companies, housing finance companies and mutual funds (See Chart 1). The informal sector largely consists of indigenous-style, traditional money lenders. (For a detailed discription of the financial system, see Bhole (1982), Goldsmith (1983), Morris (1985) and RBI (1985)).

2.1 Institutional Structure of the Financial System:

2.1.1 The Banking System:

Besides the Central bank, the banking system consists of two distinct types of institutions: the commercial banks, including their rural subsidiaries called regional rural banks (RRBs) and the co-operative banks.

CHART – I
INDIAN FORMAL FINANCIAL SECTOR



Reserve Bank of India

RBI is the apex institution in the financial system. As the central bank of the country, RBI formulates and implements monetary and credit policy, functions as the government's and bankers' bank, manages the liquidity reserves and supervises the operations of the credit institutions, manages the exchange value of the rupee and exercises control over balance of payments transactions. In addition to these traditional, regulatory functions, it also undertakes promotional functions aimed at the overall development of the financial system, both by encouraging innovations in existing institutions and by setting up new institutions.

Commercial Banks

Next to RBI, commercial banks are the most important institutions in the banking system. Commercial banking in India has changed substantially over the past 30 years, in terms of its ownership and geographical coverage. In the early '50s, commercial banks were largely privately-owned. But at present, most commercial banks are owned by the government. The major shift in the ownership of commercial banks occured in July 1969, when the government nationalised 14 privately-owned commercial banks, thus bringing about 80% of the commercial bank assets under government ownership. In April 1980 six more commercial banks were nationalised. With

this, over 90% of the commercial banking system is now owned by the government. Before nationalisation of the major commercial banks, banks catered mainly to the needs of the urban population. But since nationalisation, as a deliberate policy, the government has spread banking facilities to the small towns and rural areas. As a result, the geographical coverage of commercial banks has increased by leaps and bounds in the last two decades.

As in most countries, the main source of funds for the commercial banks is deposits from the general public. In addition, they also get refinance facilities from RBI and other financial institutions. Interest rates on bank deposits are administered by the government, although recently some liberalisation has occured on this front. In addition, the allocation of commercial banks' funds is regulated by the government and these regulations have increased over the last two decades.

At present, commercial banks are required to hold about 15% of their funds in cash to fulfill the cash reserve requirement (CRR) - the traditional monetary policy instrument. Commercial banks are statutorily required to invest another about 38% of their funds in government and government-approved securities. Interest rates on these securities are pegged below the market-clearing levels. In addition, 40% of the funds remaining after fulfilling the cash reserve and statutory investment ratios are required to

be lent at somewhat concessional terms to what are called "priority" sectors. These sectors consist of agriculture and allied sectors, small scale industries, and small business ventures done especially by people with very low incomes and assets - generally referred to as weaker sections of the population.

More than 70% of the funds with the commercial banks are thus pre-empted by cash reserve requirements, statutory investments and priority sector credit. Of the remaining funds, banks are expected to meet the credit requirements of exporters at concessional interest rates and the buffer-stocking operations of the government in foodgrains. There are, however, no quantitative targetting of bank credit for exports and buffer-stocking operations. At present, export credit and food credit constitutes about 4% and 1% respectively of the total funds with commercial banks. These then leave less than 25% of the funds with commercial banks for lending at their discretion, mainly for working capital requirements of the medium and large industrial units. The RBI fixes the minimum lending rate on these loans and the banks have to follow certain guidelines on the maximum amount to be lent to any single borrower.

Co-operative Banks

Co-operative banks/credit societies mostly cater to the banking needs of the rural India and as such their presence in urban areas is much less than that of commercial

banks. The co-operative banking system is somewhat pyramedical in its structure with State co-operative banks at the top, district central co-operative banks at the middle and primary agricultural societies and land development banks at the lowest rung. Whereas land development banks mainly extend long term agricultural credit, primary agricultural societies provide short and medium term agricultural credit. Neither the primary agricultural credit societies nor the land development banks mobilise much resource through deposits. The land development banks raise resources mainly by issuing bonds which are held by other financial institutions in the system such as the National Bank for Agricultural and Rural Development (NABARD), the insurance companies and other financial intermediaries. Most of the funds of primary agricultural societies are borrowed from the central and State cooperative banks. Central and State co-operative banks, in turn, mobilise resources partly through accepting deposits from the public and partly through refinance facilities from NABARD.

The primary agricultural credit societies, which constitute the grassroot level institutions in the pyramedical structure of the co-operative banking system, are owned mostly by farmers in that they hold their shares. The organisational structure of these co-operative banks is more democratic than the corporate form of business of commercial banks in that the voting rights of shareholders are not proportional to the shares owned but are equal across

shareholders. The central co-operative banks are owned by the primary co-operative societies and the State co-operative banks, in turn, are owned by the central cooperative banks, although State Governments also contribute to their share capital. The interest rate structure of co-operative banks is administered by NABARD. Co-operative banks have to adhere to cash reserve and statutory investment requirements but at a much lower level than those applicable to commercial banks.

2.1.2 **Non-Banking Financial System:**

The non-banking financial sector in India consists of four broad groups of institutions: development financial institutions, investment and insurance companies, provident funds and financial companies.

Development Financial Institutions

India has a large number of development financial institutions set up by the government and the RBI mainly to provide sectoral finance, mostly to medium and large industry. Most of these financial institutions are owned by either the government or the RBI. (For details see Morris (1985) and IDBI (1991)).

Broadly, these institutions are of two types: all-India institutions promoted by the Central Government and RBI and State-level institutions promoted by State Governments with assistance from the Central Government and RBI. The major all-India institutions are Industrial Development Bank

of India (IDBI, set up in 1964), Industrial Finance Corporation of India (IFCI, set up in 1948), Industrial Credit and Investment Corporation of India (ICICI, set up in 1956) and Small Industries Development Bank of India (SIDBI, set up in 1990). These institutions are specialised in providing long term finance to the industrial sector. To co-ordinate agricultural credit and provide loans and refinance assistance to the agricultural finance institutions, the government had set up Agricultural Refinance and Development Corporation of India (ARDC), now called the National Bank for Agriculture and Rural Development (NABARD). The main sources of funds of these institutions are: loans from Government of India and RBI and floation of bonds/debentures both within the country and outside.

The key DFIs at the State level are State Financial Corporations (SFCs) and State Industrial Development Corporations (SIDCs). Like the all-India institutions, these provide long term finance for industry but confine their operations within their respective States. The main source of funds for these institutions is loans from IDBI. In recent years, this is also supplemented by the floation of bonds and debentures by these institutions.

The interest rates at which the DFIs lend as well as float bonds and debentures have been administered by the government. In recent years, however, the government sets only the floor lending rate (at present 15%) and the DFIs are allowed flexibility to charge higher interest rates on their

loans subject to this floor rate. A major feature of the industrial financing by the DFIs is the consortium approach to lending - i.e, the participation of more than one institution in financing a particular project.

Investment and Insurance Companies

The Unit Trust of India (UTI), which was set up in 1964 as a statutory corporation, is the largest investment institution in India. Its key source of funds is the savings of small investors. These funds are used to provide term loans to industry, underwrite equity and to invest in industrial securities.

The insurance business in India is conducted by two institutions both of which are government-owned - the Life Insurance Corporation of India (LIC) and the General Insurance Corporation (GIC). By law, LIC is required to invest 50% of its funds in government and government-approved securities, the latter mainly consisting of bonds and debentures of DFIs. The remaining funds of LIC are invested mostly in the shares and debentures of the corporate sector. Like LIC, there are statutory restrictions on the use of funds of GIC. It is required by law to invest 35% of its funds in government and government-approved securities.

Provident Funds

These are social security institutions of non-government industrial and other enterprises in the organised sector of

the economy. Until September 1968, most of their funds were required to be invested in government securities. This requirement was reduced to 65% in 1968-69, to 25% in 1975-76 and further to 15% in 1980-81. At present, the remaining 85% of their funds is required to be invested in special deposits of the Government of India at government-fixed interest rate.

Postal Savings System

Like commercial banks, post offices in India accept deposits from the public. But unlike commercial banks, they do not extend credit to the general public. Instead, the entire funds collected by the post office savings system are transferred to the Government of India. A substantial proportion of post office deposits accrue from rural areas. The investments of the general public in the various tax-deductible savings investments (e.g. National Savings Certificate and Public Provident Funds) form another source of funds for the postal savings system.

Financial Companies

These include a host of intermediaries such as loan companies, hire purchase and equipment leasing companies, housing finance companies and mutual funds. The main sources of funds consist of deposits and equity raised from the public. The interest rate and the terms and conditions on which they can raise deposits are regulated by the RBI. At present, they are also required to invest 15% of their funds

either as deposits with commercial banks or as investments in government securities.

2.1.3 Informal Financial Sector:

The informal segment of the Indian financial sector consists of indigenous-style bankers. These are basically non-corporate entities. Acceptance of deposits from the public by unincorporated bodies is tightly regulated by RBI. Therefore, the main source of funds of these entities is their own funds. It is understood that they provide short term finance to individuals and small businesses at an interest rate substantially higher than that ruling in the formal sector.

2.2. The Size of the Financial Sector

Systematic information on the size of the informal financial sector is not available. Estimates made by different authors give too wide a range to be of much use in arriving at an approximate measure of the size of the informal sector. For example, according to one estimate, the informal credit market accounts for upto 30% of all capital in Indian urban markets (Tinberg, 1979). In contrast, Goldsmith attributes a much smaller share to the financial operations of the informal sector. He conjectures that the loans by rural money lenders constituted about 5% of the total assets of the formal financial assets and the advances of urban informal sector less than 5% of the advances of commercial and co-operative banks in the early '70s.

(Goldsmith, 1983). Similarly, another study by Madhur and Nayar estimates that informal sector lending constituted less than 10% of commercial bank credit in the mid '80s (Madhur and Nayar, 1987). In view of this wide range of estimates on the size of the informal sector, we focus only on the trends in the size of the formal financial sector.

At present, the assets of the financial institutions in the formal sector (excluding RBI) is close to 100% of GDP (see Table 1). The banking system accounts for approximately 60% of the assets of the formal sector institutions and clearly the commercial banks dominate the banking system. Over the decades, the ratio of financial sector assets to GDP has increased considerably; from about 20% in 1950-51 to about 45% in 1970-71 and to close to 100% at present. During the last three decades, the share of banks in the financial sector has remained more or less stable between 55% to 60%. The remaining 40% to 45% has been accounted for by non-bank financial institutions. Beginning with the nationalisation of the major commercial banks in late '60s, the share of commercial banks within the banking system has gone up at the cost of co-operative banks. Within the non-bank financial segment, the DFIs account for close to 30% of the financial assets, post office savings system another 25%, Unit Trust of India and insurance companies another 27% and the non-government provident funds about 13% (See Table 2).

The growth in the assets of the financial sector is closely linked to two key developments in the economy: the

Table 1

Financial Assets of Formal Sector Financial Institutions

(Rs. billion)

	1950-51	1960-61	1970-71	1980-81	1990-91
I Banks	12.5 (66.5)	33.4 (55.2)	116.3 (58.8)	620.8 (60.0)	2929.9 (57.8)
1. Commercial Banks	10.8 (57.5)	22.6 (37.4)	68.6 (34.7)	470.7 (45.5)	2226.9 (44.0)
2. Co-operative Banks	1.7 (9.0)	10.8 (17.8)	48.7 (24.6)	150.1 (15.0)	703.0 (13.9)
II Non-Bank Financial Institutions	6.3 (33.5)	27.1 (44.8)	88.4 (44.7)	414.6 (40.0)	2135.0 (42.1)
III Total Formal Financial Sector (I + II)	18.8	60.5	197.6	1035.4	5064.9
IV Assets of Formal Financial Sector as % of GDP at market prices	20.1	37.3	45.8	76.1	95.4

Note: Figures in brackets are percentages to total assets of the formal financial sector

Sources:

i) For the Years 1950-51 to 80-81, RBI, Report of the Committee To Review the Working of the Monetary System, 1985 p.59

ii) For 1990-91, RBI, Trend and Progress of Banking in India, 1990-91, p.141. To make this year's data comparable to the data for other years we have done the following adjustments:
i) RBIs table gives assets of only State Co-operative Banks, but we have included the assets of other co-operative banks based on data given in "Co-operative Movement in India: 1988-89", published by NABARD. For 1990-91, we have projected the assets of co-operative banks by assuming the same annual rate of growth as in 1988-89 over 1987-88.
ii) RBI's data does not include the assets of postal savings system or outstanding small savings; we have added this to the assets of non-bank financial institutions, data obtained from RBI's Report on Currency and Finance, 1990-91.
iii) RBI's data does not include the assets of non-banking financial companies; we have added the deposits of non-bank financial companies (a proxy for their assets) as given in RBIs Survey's of Growth of Deposits with Non-Banking Companies published periodically in RBI Bulletins. For 1990-91 the figures are projected based on previous year's growth rate.
iv) RBI's data does not also include assets of non-government provident funds. We have included outstanding investments of Employees Provident Fund (a proxy for their assets) as given in the Annual Reports of the Employees Provident Fund Organisation.

Table 2

Composition of Non-Bank Financial Sector's Assets

(1990-91)

	Rs. billion	% of total
1. Development Financial Institutions	607.0	28.4
2. Unit Trust of India	231.6	10.8
3. Insurance companies	354.0	16.6
4. Post Office Savings System (outstanding small savings)	529.8	24.8
5. Provident Funds (Social Security)	275.3	12.9
6. Other Financial Intermediaries	137.3	6.5
7. Total (1 through 6)	2135.0	100.0

Note: Other financial intermediaries include non-bank financial companies such as loan companies, hire purchase companies, equipment leasing companies, housing finance companies and mutual funds.

Sources: Same as for Table 1

increase in the domestic savings and the investment rates and the trend increase in the deficits (i.e., the excess of investment over own savings), of the public and the private corporate sectors. (See Table 3). The domestic savings rate which has been in the range of 10 to 13% in the '50s has more or less doubled to about 24% now. The public sector deficit which was in the range of 1 to 3% in the '50s has increased to 8 to 9% in the second half of the '80s. The deficit of the private corporate sector has also shown a similar increase over time. These increased deficits of the public and private corporate sectors has been financed partly by surpluses from the household sector and partly by capital inflows from the rest of the world - both of which required increased financial intermediation and hence the growth of the financial sector. This process was facilitated to a large extent by the promotional role played by the government and the RBI in developing newer institutions and innovative instruments in the financial sector.

2.3 Key Features Of The Structure of the Indian Financial System:

Three key features emerge from the review of the structure of the Indian financial system. First, government-ownership of financial institutions has increased over time and at present the financial sector is predominantly government-owned. More than 90% of commercial banks, most of the DFIs, the entire insurance business, the largest investment institution in the country (the UTI) are all

Table 3

Gross Domestic Investment, Savings and Sectoral Deficits

(As % of GDP at Market Prices)

	1950-51	1955-56	1960-61	1965-66	1970-71	1975-76	1980-81	1985-86	1990-91	1991-92
Gross Domestic Investment	10.2	14.3	15.7	16.8	16.6	18.8	22.7	22.1	26.3	25.5
Gross Domestic Savings	10.4	13.9	12.7	14.5	15.7	19.0	21.2	19.7	23.6	24.3
(a) Public Sector:										
Savings	1.8	1.7	2.6	3.1	2.9	4.2	3.4	3.2	1.1	1.7
Investment	2.8	4.9	7.0	8.5	6.5	9.6	8.7	11.1	10.5	9.5
Deficit	1.8	3.2	4.4	5.4	3.6	5.4	5.3	7.9	9.4	7.8
(b) Private Corporate sector:										
Savings	1.0	1.3	1.7	1.5	1.5	1.3	1.7	2.0	2.7	2.7
Investment	2.3	2.1	3.3	2.7	2.4	2.7	2.5	5.5	4.7	4.2
Deficit	1.3	0.8	1.6	1.2	0.9	1.4	0.8	3.5	2.0	1.5
(c) Household Sector:										
Savings	7.7	11.0	8.4	9.9	11.3	13.4	16.1	14.5	19.8	19.8
Investment	6.0	6.8	5.6	5.8	8.2	8.5	9.7	7.4	11.3	10.3
Deficit	-1.7	-4.2	-2.8	-4.1	-3.1	-4.9	-6.4	-7.1	-8.5	-9.5

Notes: i) Gross domestic investment is not equal to the sum of sectoral investments as the former is adjusted for errors and ommissions.

ii) Sectoral deficits are equal to their investment minus savings.

Source: Central Statistical Organisation, National Accounts Statistics and Quick Estimate of National Income etc., 1991-92

government-owned. In addition, the post office savings system is part of the government's postal department itself. For practical purposes, therefore, almost the entire superstructure of modern financial institutions is being owned by the government. Second, the interest rate structure of financial institutions, irrespective of whether they are government-owned or not, have been administered by the government and the RBI, although recently some simplification and liberalisation of interest rates have taken place. Third, in addition to interest rate regulations, the allocation of funds of many of the institutions have been subject to statutory investment requirements and targetted credit programmes, the commercial banks bearing the brunt of these programmes.

3. DIRECTED CREDIT POLICY: ITS EVOLUTION AND RATIONALE

3.1 What Is Directed Credit ?

In a financial system like India's, where most of the institutions are owned by the government and the interest rate structure is administered by the government, it is somewhat difficult to specify as to what should be included in the concept of directed credit. In a way, the entire credit allocation process in such a financial system could be considered as being 'directed' by the government. However, such a broad interpretation of directed credit policy may be misleading since within the interest rate structure laid down by the government and the RBI, a number of financial institutions, both government-owned and privately-owned, have discretion to decide both the overall allocation and the sectoral composition of their lending. From this point of view, not all credit allocation by the financial institutions should be considered as being directed by the government.

A more practical and tractable definition, therefore, needs to be arrived at for analysing directed credit policy in a meaningful manner. One such concept could be to include only such allocation of funds by the financial institutions for which the government specifies prior targets. In other words, only such allocation of funds by a financial institution should be considered as "directed" if the institution is required to lend a targeted amount of funds to a particular sector/activity. In this definition, directed

credit includes sectoral lending by the financial institutions for which the government fixes lending targets either in terms of an absolute amount or as a proportion of funds with the concerned financial institution. The beneficiaries of such directed credit could be either production sectors of the economy or certain categories of the population.

In the Indian context, directed credit, as defined above, consists of two distinct components: i) statutory investments of various financial institutions in government and government-approved securities and ii) directed credit to private sector in the form of priority sector lending by the commercial banks. Besides the government-fixed targets, a key feature of both these components of directed credit policy is that they are provided at somewhat subsidised interest rates.

3.2 Statutory Investments:

The financial institutions which are required by statute to invest a certain proportion of their funds in government and government-approved securities are the commercial banks, co-operative banks, provident funds, insurance companies and post office savings system. At one end of the spectrum, all the funds accruing to the post office savings system are automatically transferred to the Government of India - a case of 100% directed credit to the government. The case of provident funds is similar, 15% of

their funds are required to be invested in government securities and the remaining 85% in a "special deposit", accruals to which automatically go to the Government of India. Other institutions are required to invest varying proportions of their funds in government and government-approved securities:commercial banks (excluding regional rural banks), 38%; co-operative and regional rural banks, 25%; insurance companies, varying from 35% to 50% (35% for GIC and 50% for LIC).

The origins of statutory investment requirements in government and other similar securities for financial institutions can be traced back to the Banking Regulation Act of 1949. The Act stipulated that all banking companies should maintain a statutory liquidity ratio (SLR i.e., investments in government and government-approved securities and cash in hand as percetage of their total liabilities) of 20%. In 1964, some definitional changes were introduced in SLR and it was also raised to 25%. (See Rao (1980) and RBI (1985). It appears that the basic objective of specifying an SLR was to impose some financial discipline on the financial intermediaries and provide protection to the depositers of funds with them. Maintaining a reasonable proportion of their assets in liquid form rather than as advances provided the financial intermediaries a cushion to cope with sudden withdrawals of deposits. Hence, originally SLR was intended to be a prudential requirement on the banks and other similar institutions.

Over time, however, SLR has been increasingly used as a fiscal instrument to raise resources for financing government expenditure. In the absence of a well developed market for government securities, by raising SLR the government has compelled commercial banks to invest an increasing proportion of their funds in government securities at below-market rates of interest. The SLR for commercial banks which was 25% in 1964 has now increased to about 38% (See Table 4). The statutory investment requirement for other financial institutions also has been maintained at very high levels. In effect, a "captive" market for government and government-approved securities has been promoted over the years. Financing public sector expenditure at below-market interest rates through such a captive market was considered socially desirable on the ground that most public investment programmes carried a social rate of return which was much higher than the private rate of return - the familiar externality argument.

3.3 Directed Credit to Priority Sectors

The concept of priority sector in the Indian banking system can be traced back to the '60s. Right from the early '50s there was a general consensus that institutional finance was not adequately available for certain sectors in the economy, especially agriculture and other non-farm activities in rural India. The All-India Rural Investment Survey conducted in 1951-52 had shown that as much as 91% of rural

Table 4

Changes in Statutory Liquidity Ratio (SLR) for Commercial Banks

1964 (September)	25
1970 (February)	26
(April)	27
(August)	28
1972 (August)	29
(November)	30
1973 (December)	32
1974 (June)	33
1978 (December)	34
1981 (September)	34.5
(October)	35.0
1984 (July)	35.5
(September)	36.0
1985 (June)	36.5
(July)	37.0
1987 (April)	37.5
1988 (January)	38.0
1990 (September)	38.5
1992 (October)	37.8

Sources:

1) For data until, 1985, RBI, Report of the Committee to Review the Working of the Monetary System, 1985, Bombay;

2) For 1985 onwards; RBI, Report on Currency and Finance, (Various Issues)

Notes:

1) Liquid assets which satisfy SLR requirements are excess cash balances with the banks (over and above CRR requirements) and investments in government and government-approved securities. Generally, about 60% of the banks SLR investments have been found to be in government securities.

2) The S.L.R. for the rural subsidiaries of commercial banks, rural regional banks, (whose advances form roughly 2% of the scheduled commercial banks' advances) have remained unchanged at 25%. Similarly, commercial banks are required to hold a lower SLR against the deposits of overseas Indians with them. These minor differences are, however, not going to make much difference to banks' aggregate SLR related investments.

finance was provided by non-institutional sources, mainly traditional money lenders (about 83%) at usurious interest rates; institutional finance accounted for only the remaining 9%. Even a decade later, in 1961, it was found that the share of non-institutional finance was as much as 62%. There was a general consensus then that agricultural and allied sectors which contributed close to 50% of the nation's GDP and which had a great potential for labour-intensive growth should not be made to depend on non-institutional finance but be financed by low-cost institutional sources.

During the '50s and the '60s, government tried to achieve this by promoting the co-operative banks. Co-operative banks were then considered as engines of growth for rural India. Certainly, during the two decades since the early '50s, co-operative credit to the rural economy increased at a fairly impressive rate. But by the second half of the '60s co-operative movement was weakening somewhat with co-operative banks facing problems of inadequate loan recovery and bad debts. Also, the review undertaken by the All India Rural Credit Review Committee in 1969 found that the co-operatives had not measured up to their expectations in mobilising deposits; instead they relied mostly on subsidised borrowed funds from government and other sources. The Review Committee, therefore, felt that the efforts of the co-operatives in providing institutional credit to agriculture and non-farm rural sectors should be supplemented

by other financial institutions. For this, a multi-agency approach to the provision of credit to the rural areas with much larger role for the commercial banks was considered necessary. (See Nair (1991)).

At around the same time, it was generally observed that the commercial banks lent bulk of their funds to trade and industry, particularly to the big established business and industrial houses. As a result, sectors like agriculture and small industries did not receive their due share of bank credit. The government felt that in the larger social interest of the country, the link between a few industrial houses and banks should be broken and credit allocation by the banks must be made to conform to the priorities of the overall development strategy of the country. With this view, the concept of priority sector, which included agriculture, small scale industry and small entrepreneurial ventures, was introduced. In 1967 through a scheme of social control over banks, government attempted to channel a larger proportion of bank funds to these priority sectors.

To implement the scheme of social control over banks, the Government undertook two key measures: one the establishment of the National Credit Council and the other the amendment of the banking laws. The National Credit Council was an advisory body entrusted with the task of making an assessment of the demand for bank credit from various sectors of the economy and determine the priorities for the granting of bank loans. To enable the Reserve Bank

of India enforce the recommendations of the National Credit Council, the banking laws were suitably amended thus giving greater powers to the Reserve Bank to control the functioning of the banking system. In essence, the scheme of social control over banks was an attempt by the Government to regulate commercial banks' lending policy without necessarily owning them.

The scheme of social control over banks was tried for some time, but progress in re-orienting bank credit towards priority sectors was found to be slow. Government, therefore, found it necessary to take direct responsibility for the extension, diversification and working of a substantial part of the banking system. For this, 14 major Indian commercial banks (with deposits above Rs.500 million) were nationalised in July 1969. In 1972, the RBI issued guidelines indicating the specific sectors and activities which should be treated as priority sectors for purposes of bank lending. Sectors such as agriculture, small scale industries, small transport operators, retail trade and small business, professional and self-employed persons were given the status of priority sectors and banks were asked to lend increasingly to these sectors. In the initial years of bank nationalisation, however, there was no particular target fixed on the required volume of lending by banks to these sectors. Banks were only pursuaded to lend a larger proportion of their funds to these priority sectors. But by November, 1974 banks were advised to increase the share of

priority sector credit in total credit to about 33% by March, 1979.

In the late '60s and the early '70s, priority sector lending by the banks was viewed mainly as a tool to facilitate labour-intensive rural growth through credit and technology adoption. But since the early '70s, another dimension got added to priority sector lending programme -- achieving growth with social justice through credit. Adherents of this strategy began to see banks not simply as profit maximers channeling their funds to the most productive sectors of the economy but as under-utilised institutions to be activated for affirmative action, social engineering and redistribution of wealth. Consequently, a whole set of subsidised bank-lending schemes to provide finance to targeted groups of people got superimposed on the already existing sectoral targets. The priority sector lending programme since then increasingly became a matrix scheme: on the one hand, banks were required to lend certain proportion of their funds to priority sectors and within each priority sector to targetted groups of people who were intended to be the beneficiaries of the government-run poverty alleviation and social welfare schemes.

The differential interest rate scheme (DRI) introduced in 1971 was perhaps the first such scheme. Under this scheme, public sector banks were instructed to channel atleast 1% of their total credit into productive ventures for

families with incomes and landholdings below a certain threshold. The interest rate on DRI credit was fixed at 4% and banks were expected to cross-subsidise DRI beneficiaries by charging higher interest rates on other borrowers.

The scheme-based priority sector lending programme of the banks got a further boost by the late '70s when the government started credit-based poverty alleviation and social welfare programmes on a larger scale. The introduction of the poverty-alleviation and social welfare programmes itself reflected a shift in the overall development strategy of the country. By about the mid '70s, there was an increasing consensus in the Government that overall economic growth alone would take an unduly long time to trickle-down to the poorer sections of the population and that there is a need to combat the problem of poverty more directly through the implementation of certain poverty-alleviation programmes. With the introduction of these programmes, banks were asked to finance them on concessional terms under their priority sector lending programme. One of the first and the largest such programmes was the Integrated Rural Development Programme (IRDP).

Since the introduction of the IRDP in 1980, the government has introduced a few more poverty-alleviation and related programmes targetted to benefit the poorer and the weaker sections in the urban areas. (See chart 2). Lending to specific target groups is the key feature of these schemes. The target group is mostly defined by ownership of

CHART 2

POVERTY ALLEVIATION AND RELATED PROGRAMMES
UNDER PRIORITY SECTOR CREDIT PROGRAMME

	DRI (1971)	IRDP (1980)	SEEUY (1983-84)	SEPUP (1986-87)	SUME (1989)
The Scheme	For Weaker Sections of the society engaged in modest production activities	To assist families living below poverty line in rural areas by providing income generating assets to take up self-employment ventures in rural industries, small business & allied agricultural activities	To provide credit facilities to educated unemployed youth for self-employment ventures in industries, services, business and allied agri. activities - Scheme is not applicable at centres having population more than 10 lacs as per 1981 census.	To provide self-employment to the urban poor living in metropolitan/urban/semi-urban centres and in the areas not covered by IRDP	Same as SEPUP
Eligibility	Any person engaged in production activity/business - indigent students - physically handi-capped persons - orphanages - women's homes - SC/ST bene-ficiaries without any land holding - criteria for others land holding should not exceed one acre of irri-gated land or 2.5 acres of dry land.	Small farmers with land-holding upto 5 acres of dry land or 2.5 acres of class I irrigated land	Any person who has passed matriculation or equivalent standard (10 Std.) or III passed youth (for indl./service ventures only) - age group 18 to 35 years	Any person who is a permanent resident for a minimum period of 3 years in metropolitan/urban/ semi-urban centres	Same as SEPUP
Annual Family Income	Not to exceed Rs.7200 in urban, semi-urban metro-politan areas and Rs.6400 in rural areas	Not to exceed Rs.11,000	Not to exceed Rs.10,000	Not to exceed Rs.7200	Not to exceed Rs.11,850

	DRI (1971)	IRDP (1980)	SEEUY (1983-84)	SEPUP (1986-87)	SUME (1989)
Subsidy	---- Nil ----	25% to 50% of loan amount i)Max. Rs.4.000 per family (Drought Prone area project) ii) Max. Rs.3,000 per family (non-DPAP areas) iii) Max. Rs.5000 per family-SC/ST handicapped beneficiaries Provided by the Government	- 25% of the maximum disbursed amount within the loan amount sanctioned - Subsidy provided by Govt. of India	25% of amount disbursed subsidy provided by Govt. of India	Same as SEPUP
Loan Amount	Max. Rs.6,500/- for TL & WC requi-rements - physically handicapped persons can be financed for the purchase of artificial limbs, hearing aids, etc. max.amount Rs.2500 within the overall limit of Rs.6500	Depending upon the project cost of the scheme formulated by Dist. Rural Development agency and the amount of subsidy eligible per family	- Max. loan for industrial ventures Rs.35,000 Services Rs.25000 Business and Allied agricul-tural activities Rs.15,000	Max. Rs.5,000	Max. Rs.7500
Interest Rate at present	4% per annum	Normally between 11.5% to 16.5% per annum	11.5% to 16.5% per annum	11.5% per annum	11.5% p.a.
Repayment	Liberal repayment programme upto 5 years depending upon the income generating capacity of the individual	In suitable instalments over a period of not less than 3 years depen-ding upon the income generating capacity	Only the term loan component is required to be repaid over a period of 3 to 7 years	To be paid in 33 monthly instalments within a period 33 months with a start-up period of 3 months	To be repayed in 3 to 5 years

assets (mainly land); by income level; or membership of a particular social group. Most of these schemes require banks to provide finance to the intended beneficiaries to buy an asset or to start a small business venture. Out of the total amount provided by the banks, a certain percentage is to be treated as grant and the remaining as loan, at government-fixed interest rates. The grant component of the bank finance is reimbursed to the banks by the government. Besides an interest subsidy, therefore, these schemes involve a capital subsidy too.

With the introduction of the various poverty-alleviation and related schemes, the priority sector lending operation now has the dimension of a matrix programme. On the one hand, it is aimed at allocating a certain percentage of funds with the banks to priority sectors like agriculture, small scale industries and small business ventures and on the other within each sector, banks are required to lend to the intended beneficiaries of the various poverty-alleviation and related programmes. (See Chart 3).

Since the introduction of priority sector lending target in 1974, both the targetted share of bank credit to the priority sector and the categories of beneficiaries have increased gradually. In 1983 the proportion of priority sector lending was raised gradually and banks were advised to raise the share of priority sector advances in total bank credit to 40% by March, 1985. By the mid-1980s within the overall target for priority sector lending, banks were also

CHART 3

SECTORAL AND SCHEME-BASED COMPOSITION OF PRIORITY SECTOR CREDIT PROGRAMME

POVERTY ALLEVIATION → AND RELATED SCHEMES / SECTORS ↓	DRI (1971)	IRDP (1980)	SEEUY (1983-84)	SEPUP (1986-87)	SUME (1989)	OTHERS	TOTAL
AGRICULTURE							
SMALL SCALE INDUSTRIES							
TRANSPORT OPERATORS							
RATAIL TRADE							
PROFESSIONAL SERVICES							
OTHERS							
ALL SECTORS							TOTAL PRIORITY SECTOR CREDIT

ABBREVIAIONS :

DRI : Differential Rate of Interest Scheme

IRDP : Integrated Rural Development Programme

SEEUY: Self Employment Scheme for Educated Unemployed Youth

SEPUP: Self Employment Programme for Urban Poor

SUME : Scheme for Urban Micro Enterprises

given sub-targets. They were advised that within the 40% target of priority sector credit, they should ensure that agriculture gets atleast 15% by 1985 and 16% by 1987 and 18% by March, 1990.

3.4 Bank Nationalisation, Directed Credit and Industrial Finance

The nationalisation of banks was a major landmark in the evolution of the Indian financial system. It had important implications for industrial finance in general and the relationship between government, banks and industrial firms in particular. The key objectives of bank nationalisation were two-fold: removal of the control over banks by a few industrial houses (and the consequent concentration of economic power) and the provision of adequate bank credit for agriculture and small scale industry. At around the time of bank nationalisation, the major commercial banks were controlled by big business houses by virture of being the majority shareholders of these banks. The directors of these banks invariably used their position to finance the companies in which they had interests. Quite often, to provide safeguard against the criticism of favouritism, they financed each other's companies on a reciprocal basis. Being owned essentially by big business houses, banks were reluctant to lend to agriculture, small scale industry and similar other needy sectors of the economy.

With the nationalisation of banks, the close nexus between large industrial houses and banks was broken. The management of banks changed hands - from the big business houses to the government. With this, the close consultative relation between banks on the one hand and the large industry on the other also came to an end. Before rationalisation the major commercial banks were merely sister-organisation of one or the other business house. Since nationalisation, the banks and the industrial firms have an arms length relation between them. This is perhaps in contrast to the experiences of Japan and Korea where the government, banks and the large industrial firms worked in close consultation with each other through various deliberation committees, monthly export trade promotion meetings etc.

Nationalisation of banks also had important implications for industrial finance in the country. Subsequent to the nationalisation, the proportion of banks' funds pre-empted through directed credit policy - both through statutory investment requirements and priority sector lending targets - has substantially increased. By the same token, the proportion of banks' funds available for financing the medium and large industrial sector has gone down. This is in contrast to the Japanese and the Korean experience where directed credit was instrumental in making banks lend a larger proportion of their funds to large industrial firms. Thus whereas in Japan and Korea directed credit policy encouraged a larger flow of bank funds to the large industrial firms, in India it generally discouraged it.

Directed credit policy in India has a primarily egalitarian goal - to enhance the access of small scale industry, farmers and other weaker sections of the society to bank credit.

It is possible that in persuing this egalitarian goal, directed credit policy has crowded out the large industrial sector from the financial market. To some extent, therefore, directed credit policy might have limited the pace of industrialisation. Two caveats, however, need to be entered in this context. First and foremost, many of the large industrial firms in the Indian industrial sector belong to the public sector; these are owned by the Government. These firms got liberal finance from the Government Budget. Perhaps this would not have been possible without the transfer of funds from the banks and other financial institutions to the Government through the statutory investment requirements. To that extent, directed credit policy might have, in fact, encouraged the flow of funds to the large enterprises in the public sector. Secondly, even though the Government pre-empted an increasing proportion of bank funds through directed credit policy for non-industrial use, it also continuously promoted several DFIs meant especially to provide industrial finance. Some of the DFIs even got a share of the Government's receipts from statutory investment requirements on banks at a concessional interest rate. All these must have softened the crowding-out effect of directed credit policy on medium and large industrial firms.

4. THE VOLUME OF DIRECTED CREDIT AND ITS SUBSIDISATION

4.1 Statutory Investments:

It is difficult to have a precise estimate of the volume of statutory investments by banks and other financial institutions, especially on a strictly comparable basis over a period of time. This is because the statutory investment requirements for some institutions are specified in terms of their total liabilities, for other institutions as a percentage of their own funds and for some others as a percentage of their incremental funds. Therefore, precise estimate of the denominators of the statutory investment ratios for all the financial institutions are difficult to arive at. Rough estimates of statutory investments could, however, be made by assuming that the denominator of the statutory investment requirements of an institution is approximately equal to its total financial assets. Such an estimate of the statutory investments for selected years is presented in Table 5.

Aggragate statutory investments which was about Rs.72 billion in 1970-71 has increased close to Rs.2000 billion by 1990-91. As a proportion of the aggragate assets of the formal financial sector, statutory investments have more or less remained constant at about 38% during the last two decades. The institution-wise composition of statutory investments has, however, undergone substantial changes during this period. The share of commercial banks in

Table 5

Statutory Investments of Banks and other Financial Institutions

(Rs. billion)

	1965-66	1970-71	1975-76	1980-81	1985-86	1990-91
1. Commercial banks	8.1 (20.6)	17.7 (23.8)	50.7 (31.2)	141.3 (38.1)	359.0 (41.1)	816.5 (41.6)
2. Co-operative banks	5.72 (14.5)	12.2 (16.4)	21.4 (13.2)	37.5 (10.1)	81.8 (9.4)	175.8 (8.9)
3. Life Insurance Corporation (LIC)	5.5 (14.0)	9.8 (13.2)	18.2 (11.2)	34.1 (9.2)	64.7 (7.4)	145.2 (7.4)
4. General Insurance Corporation (GIC)	-	-	-	4.2 (1.1)	10.0 (1.1)	22.3 (1.1)
5. Provident Funds (Non-government)	4.5 (11.5)	12.3 (16.6)	29.6 (18.2)	68.4 (18.5)	134.0 (15.3)	275.3 (14.0)
6. Post Office Savings System	15.5 (39.4)	22.3 (30.0)	42.4 (26.1)	84.9 (22.9)	224.7 (25.7)	529.8 (27.0)
7. Total Statutory Investments (Sum of 1 through 6)	39.3 (100)	74.3 (100)	162.3 (100)	370.5 (100)	874.2 (100)	1964.9 (100)
8. Statutory Investments as % of aggregate assets of the formal financial sector	-	37.6	-	35.8	-	38.8

Notes:

i) Figures in brackets are percentages to the total statutory investments.

ii) Except for commercial banks, statutory investments are worked out as the product of the financial assets of the institution concerned and the statutory investment ratio applicable to that institution, which is 100% for provident funds and the post office savings system, 50% for LIC, 35% for GIC and 25% for co-operative banks.

iii) For commercial banks, it is worked out by applying the SLR on the total demand and time liabilities of scheduled commercial banks. No adjustment is made for the lower SLR applicable to the rural subsidiaries of commercial banks nor for the lower SLR applicable to the overseas Indians' deposits with banks. These would not introduce much error to the estimate since these were negligible magnitudes.

iv) In general, the statutory investments of institutions other than the banks should be considered as a broad approximation since we have expressed statutory investments of these institutions as percentage of their total financial assets. Total financial assets would generally be higher than the total funds with these institutions, to which statutory investment ratio applies in practice.

Source: Worked out from the data in Table 1, 2 and 4

statutory investments has roughly doubled in the last two decades, from about 20% in the late '60s to over 40% in 1990-91. In comparison, the shares of co-operative banks, insurance companies and post office savings system have gone down over the years whereas that of provident funds has fluctuated without a clear trend. These changes in the institution-wise composition of statutory investment is clearly a reflection of the governments policy - increasing the statutory liquidity requirements for commercial banks from about 25% in the late '60s to about 38% now.

4.2. The Volume of Priority Sector Credit by Commercial Banks

Like statutory investments by financial institutions, priority sector credit by commercial banks has increased substantially over time. In absolute magnitude, it has increased from about Rs.5 billion in late '60s to over Rs.460 billion by 1992 (See Table 6). Reflecting the government's policy of directing larger share of bank credit to priority sectors, it has also increased as a percentage of gross bank credit, from about 15% to 20% in the late '60s and early '70s to about 40% now. As a proportion of commercial banks' aggragate assets, priority sector credit has increased from just about 11% before nationalisation of the major commercial banks to more than 20% in recent years. As a ratio of the aggragate assets of the formal financial sector, priority sector credit has increased from about 5% in the early '70s to about 9% now.

The sectoral composition of priority sector credit by commercial banks has also undergone some changes. Until about the mid-70s a little less than 50% of priority sector credit went to small scale industry, another about 36% to agriculture and the remaining 15% to other sectors such as transport operators, retail trade and personal and professional services (See Table 7). Over time, the share of small scale industry has fallen whereas those of agriculture and other priority sectors have increased. The share of small scale industry in priority sector credit now stands at about 40%, that of agriculture another about 40% and that of other sectors 20%. To some extent, the increase in the share of other priority sectors could be attributed to the government's increasing emphasis on promoting government-sponsored self employment schemes both in urban and rural areas in the '80s.

4.3 Interest Subsidy on Directed Credit:

Both statutory investments and priority sector loans are made at somewhat subsidised interest rates. This implies a certain amount of subsidisation of directed credit.

Some measure of the cross-subsidisation of statutory investments by commercial banks can be inferred from Table 8. Three measures of interest subsidy on statutory investments are given in the Table: the difference between the average redemption yield on government securities on the one hand and three proxies for the opportunity cost of funds to the banks

Table 6

Priority Sector Credit by Commercial Banks

	Outstanding Priority Sector Credit			% of aggregate sectors of the formal financial sector
	Rs. billion	% of gross bank credit	% of commercial banks' assets	
June 1969	5.1	14.9	10.5	-
June 1970	8.7	20.6	15.5	-
June 1971	10.3	21.4	15.7	5.2
June 1972	12.1	22.0	16.1	-
April 1974	18.0	23.0	18.5	-
April 1975	21.5	24.5	16.7	-
June 1976	28.2	24.2	16.7	-
June 1977	34.9	25.6	16.9	-
June 1978	43.3	27.2	16.9	-
June 1979	56.8	29.4	18.5	-
March 1980	67.3	31.7	18.1	-
March 1981	85.0	34.3	19.0	8.2
June 1982	106.7	35.9	20.6	-
June 1983	126.4	35.6	20.4	-
June 1984	158.9	37.1	21.6	-
June 1985	192.1	38.1	21.9	-
June 1986	223.0	39.4	21.5	-
June 1987	259.8	40.8	21.2	-
June 1988	298.5	41.6	21.2	-
June 1989	352.9	39.4	21.8	-
June 1990	410.4	38.9	20.9	-
June 1991	435.3	36.3	-	9.2
May 1992	463.7	34.8	-	-

Notes:

i) Bank credit and priority sector credit are for scheduled commercial banks.

ii) For assets, the scheduled commercial banks' assets as on March of the year is used.

Sources:

i) RBI, Trend and Progress of Banking in India (various issues)

ii) Report on Currency and Finance (Various Issues)

iii) H.L. Chandhok and The Policy Group, India Data Base 1990, Vol. II, pp. 870-871

Table 7

Sectoral Composition of Priority Sector Credit by Commercial Banks

(Rs. Billion)

	Agriculture	Small Scale Industries	Others	Total Priority Sector
June 1969	1.88	2.86	0.31	5.05
	(37.2)	(56.6)	(6.2)	
June 1970	3.42	4.14	1.14	8.70
	(39.3)	(47.6)	(13.1)	
June 1971	3.82	5.00	1.44	10.26
	(37.2)	(48.7)	(14.0)	
June 1972	4.39	5.97	1.72	12.08
	(36.3)	(49.4)	(14.2)	
April 1974	5.99	9.27	2.77	18.02
	(33.2)	(51.4)	(15.4)	
April 1975	7.85	10.42	3.22	21.50
	(36.5)	(48.5)	(15.0)	
June 1976	10.92	12.22	5.01	28.15
	(38.8)	(43.4)	(17.8)	
June 1977	13.81	14.60	6.45	34.86
	(39.6)	(41.9)	(18.5)	
June 1978	17.26	17.56	8.52	43.34
	(39.8)	(40.5)	(19.7)	
June 1979	22.88	22.52	11.37	56.77
	(40.3)	(39.7)	(20.0)	
March 1980	27.67	26.35	13.28	67.30
	(41.1)	(39.2)	(19.7)	
March 1981	35.84	32.29	16.91	85.04
	(42.1)	(38.0)	(20.0)	
June 1982	45.94	39.09	21.70	106.73
	(43.0)	(36.6)	(20.3)	
June 1983	53.75	45.84	26.78	126.37
	(42.5)	(36.3)	(21.2)	
June 1984	65.51	57.50	35.93	158.94
	(41.2)	(36.2)	(22.6)	
June 1985	79.78	69.56	42.74	192.08
	(41.5)	(36.2)	(22.2)	
June 1986	93.91	81.01	48.10	223.02
	(42.1)	(36.3)	(21.6)	
June 1987	108.52	95.25	56.03	259.80
	(41.8)	(36.7)	(21.6)	
June 1988	122.85	111.64	63.96	298.45
	(41.2)	(37.4)	(21.4)	
June 1989	141.33	136.77	74.32	352.88
	(40.1)	(38.8)	(21.1)	
June 1990	169.40	156.70	84.20	410.30
	(41.3)	(38.2)	(20.5)	
June 1991	172.00	173.40	89.90	435.30
	(39.5)	(39.8)	(20.7)	
May 1992	186.70	184.80	92.20	463.70
	(40.2)	(39.8)	(20.0)	

Note: Figures in brackets are percentages to total priority sector credit.

Source: RBI, Trend and Progress of Banking in India, (Various Issues)

Table 8

Yield Rate on Govt. Securities vis-a-vis the Deposit and General Lending Rates

(% per annum)

Year	Redemption yield rate on govt. securities	Commercial Banks' fixed deposit rate (1 to 3 years)	SBI advance rate	Prime lending rate of IDBI	(2-1)	(3-1)	(4-1)
	(1)	(2)	(3)	(4)	(5)	(6)	(7)
1960-61	3.76	3.75	4.75	-	-0.01	0.99	-
1965-66	4.98	6.00	7.25	8.50	1.02	2.27	3.52
1970-71	4.60	6.00	7.75	8.50	1.40	3.15	3.90
1975-76	5.79	8.00	14.00	11.00	2.21	8.21	5.21
1980-81	6.36	8.50	16.50	14.00	2.14	10.15	7.64
1985-86	9.03	9.00	16.50	14.00	-0.03	7.47	4.97
1989-90	11.96	10.00	16.50	14.00	-1.96	4.54	2.04
1990-91	12.30	10.00	16.50	14.50	-2.50	4.20	2.20
1991-92 1_/	13.36	11.00	18.25	16.54	-2.36	4.89	3.18
1992-93 2_/ (Latest)	14.26	11.00	17.00	17.00	-3.26	2.74	2.74

Notes: 1_/ Effective Oct. 1991, the deposit rate was raised to 12% and the SBI advance rate to 20%. We have taken simple averages of the pre-revised and revised rates. Also, effective August 16, 1991, the IDBI given the flexibility to charge interest rates subject to a flow rate of 14-15%. Until Nov. 1992, the IDBI operated on a range of rates from 18 to 20%. We have taken the average of 14.5% and 18%, weighted by the number of months for which these rates were applicable.

2_/ The yield rate on government securities is an average for April-August 1992 whereas the other rates are as on June 1993. The IDBI rate as on June 1993 is the minimum of its range 17.0 to 19.0%

Sources: i) Rao, D.C. "The Statutory Liquidity Ratio: Its Role and Some Policy Issues", RBI Bulletin, Nov. 1980, pp 860-870

ii) R.B.I., Report on Currency & Finance (Various Issues)

iii) H.L. Chandhok and the Policy Group, India Data Base, Vol.II, New Delhi, 1990.

- the State Bank of India (SBI) prime lending or the advance rate, the bank deposit rate on one year deposits and the prime lending rate of Industrial Development Bank of India (IDBI), the largest DFI in the country.

The differential between the prime lending rate of banks and the redemption yield on government securities measures the cross-subsidisation of statutory investments by charging higher rates on their organised industrial borrowers; it is now about 3%. This subsidy is borne mainly by the organised industrial sector. A similar measure of cross-subsidisation by the organised industrial sector is given by the differential between the prime lending rate of DFIs (proxied by the IDBI prime lending rate) and the redemption yield on government securities; at present, this differential is also about 3%. In comparison, the differential between the deposit rate and the redemption yield on government securities, the former adjusted for administrative and other costs of banks, gives a measure of the subsidisation of statutory investments by the banks. Assuming that the banks need a spread of about 3% between the deposit and the lending rates to cover administrative and other overhead costs, at present the banks would need to charge a minimum of about 14% on their investment and loan portfolio. The yield rate on government securities at present is about 14%. On this measure, banks are just about breaking-even on their statutory investments. The interest subsidy on statutory investments is, therefore, in the range of 0 to 3%.

Neither of these interest differentials may, however, give a measure of the economic subsidy on statutory investments, i.e., the difference between the undistorted market rate of interest in the economy and the yield rate on government securities. There are reasons to believe that the prime lending rate of both commercial banks and the DFIs may give an overestimation of the market rate. Because of cross-subsidisation of statutory investments, these prime lending rates may have been pushed above the market clearing levels. Therefore, a reduction in the statutory investment requirements and/or a freeing of interest rates on government securities is likely to put a downward pressure on both these prime lending rates. Most likely, the prime lending rate should then settle somewhere between the existing yield rate on government securities, (which is about 14%) and the prime lending rates of about 17%. It is difficult to pinpoint at what level the new prime lending rates would settle, once statutory investment requirements are lowered. Therefore, we can indicate only the broad range of interest subsidy on statutory investments, although 3% is likely to be its upper limit.

Like in the case of statutory investments, it is difficult to arrive at the true economic subsidy to priority sector credit programme. Until recently, the interest rate structure on priority sector credit was so complex that the rate differed depending on the size of the loan, the purpose

of the loan, the economic status of the borrower, the degree of backwardness of the region where the project is located and the particular poverty-alleviation and related programmes under which the beneficiary is covered. In September, 1990 the interest rate structure of commercial banks was both simplified and liberalised. Since then, the lending rate of commercial banks is primarily determined by the size of the loan, with minimal sector-specific, end-use specific and borrower- specific differentiations (See Table 9). At present, only term loans above Rs.25,000 to priority sectors enjoy an interest rate subsidy. Most priority sector loans are charged an interest rate ranging from 12% on small sized loans to over 15% on large sized loans, whereas the corresponding general lending rate to the large and medium industrial sector ranges from 12% to a minimum of 16% . Some of the priority sector borrowers now enjoy an interest subsidy not because of sector-specific rate differentiation but mainly because of the small size of the loans to priority sector borrowers.

Table 10 compares the average size of priority sector loans to that of loans to medium and large industry. In general, the average size of the priority sector loans have been much smaller than the average size of the loan to medium and large industry. For example, in 1990 the average size of a priority sector loan to agriculture was about Rs.6,000, that to small scale industry about Rs.35,000, to small transport operators about Rs.26,000, whereas that to medium and large industry over Rs. 1 million.

Table 9

The Structure of the Lending Rates of Commercial Banks

(% per annum)

	Effective Sept. 1990		Effective Oct. 1991		Effective July 1993	
	General	Priority Sector Term Loans	General	Priority Sector Term Loans	General	Priority Sector Term Loans
I. Rates Related to the Loan size						
Upto Rs.7500	10.0	10.0 (0.0)	11.5	11.5 (0.0))	)	
Rs.7500-Rs.15,000	11.5	11.5 (0.0)	13.0	13.0 (0.0))	12.0	12.0 (0.0)
Rs.15,000-Rs.25,000	12.0	12.0 (0.0)	13.5	13.5 (0.0))	)	
Rs.25,000-Rs.50,000	14.0	13.0 (1.0)	15.5	14.0 (1.5))	16.0	15.0 (1.0)
Rs.50,000-Rs.2,00,000	15.0	14.0 (1.0)	16.5	15.0 (1.5))		
Over Rs.2,00,000	16.0 (minimum)	14.0 (2.0)	20.0 (minimum)	15.0 (4.0) (minimum)	16.0 (minimum)	15.0 (1.0) (minimum)
II. Rates Unrelated to the size of the loan						
1. DRI Advances		4.0		4.0		4.0
2. Preshipment Export Credit upto 180 days		7.5		15.0		13.0
180 days to 270 days		9.5		17.0		15.0
3. Loans against commodities under selective credit control		16.0		20.0		16.0 (minimum)
4. Personal loans, consumer loan and miscellaneous loans	Banks are free to determine the rate of interest					
III State Bank of India (SBI) Advance Rate		16.5		20.0		17.0

Notes: i) Figures in brackets are the difference between the general rate and the priority sector term loan rate in the corresponding loan size category.

ii) SBI advance rate is the prime lending rate of SBI, the largest commercial bank in India, i.e., the rate it charges on borrowers with good credit rating.

Sources: 1) RBI Report on Currency and Finance

2) RBIs Circulars on interest rate structure to Banks

Table 10

Average size of the loan to priority sectors and large industry by scheduled commercial banks

Sector	Average Size of the Loan in Rupees				
	December 1970	December 1975	December 1980	December 1985	March 1990
1. Agriculture (Direct Advances)	2318	2341	3280	4939	5995
2. Small Scale Industry	-	44,909	35,367	47,689	34,364
3. Small Transport Operations	22,283	24,993	22,614	32,603	26,496
4. Medium and Large Industry	-	71,042	516,225	572,884	1031,05

Sources: 1) R.B.I., Report on Currency and Finance (Various Issues)
2) R.B.I. Banking Statistics : Basic Statistical Returns (Various Issues)

Since under the present interest rate structure the rate rises with the size of the loan, the much smaller average size of the loan to priority sector borrowers entitles them to relatively lower rates of interest. For example, most loans to agriculture and small transport operators under priority sector credit programme would be carrying an interest rate of about 12% and that to small scale industry closer to 15%. In comparison, an average sized loan to large and medium industry would be carrying a minimum interest rate of 16%, say about 17% to 18%. Hence, even though sector-specific and end-use specific interest rate differentials have been minimised now, the priority sector borrowers get credit at a somewhat lower rate than the non-priority sector borrowers mostly because of the smaller size of their loans. During the last year, however, these interest differentials across loan sizes and hence the cross-subsidisation of priority sector credit have been reduced.

The lowest interest rate on priority sector loan at present (excluding DRI loans) is 12%; this is a percentage point more than the rate of interest on one year deposits with banks. Certainly, on these loans the banks do not cover the actual cost of funds, including the spread required to cover their administrative and overhead expenses. Banks are subsidising these loans to the extent of atleast 2.0%. On other priority sector loans, however, the average interest rate ranges between 12% and 15%, or, say, an average rate of about 14%, just about enough to yield a spread of 3

percentage points.

Comparing the interest rates on priority sector loans to the prime lending rate of banks gives a much larger estimate of the subsidy. For example, at present, the average interest rate on agricultural loans is about 5 percentage points lower than the banks' prime lending rate (17%-12%) that on other priority sector loans lower by about 3 percentage points (i.e. 17% - 14%). These indicate that in spite of the recent simplification and rationalisation of the interest rate structure, there is substantial cross-subsidisation of priority sector loans by the medium and large industrial sector. Like in the case of statutory investments, this measure of cross-subsidy may be an over-estimate of the economic subsidy on priority sector loans - due to the possibility of the current prime lending rate of banks being higher than the market clearing rate.

In the case of priority sector credit, there is, however, an offsetting factor because of which the above estimate of interest subsidy could be an underestimate: the possible difference in the risk cost between priority sector loans and loans to other sectors. Because of the sharp increase in the overdues of agricultural loans in recent years, there is reason to believe that these loans have higher than average risk costs. Similar is the case with the small scale industrial sector on account of the increasing volume of bank credit tied up in sick units. However, the

problem of overdues is not exclusive to the agricultural sector. Nor is the problem of bank credit to sick units confined to small scale industry alone; the problem, though somewhat of lower gravity is nonetheless present in the case of medium and large industrial units (See Table 11). At present, the ratio of overdues to outstanding loans is about 20% in the case of bank loans to agriculture, the share of bank credit to sick units about 16% in the case of small scale units and about 13% in the case of medium and large industry. If we assume that the ratio of loan default to overdues (or credit to sick units) is more or less the same across sectors, the risk cost of loans to agriculture and small scale industry would be somewhat higher than that of medium and large industry.

Table 11

Trends in Overdues/Bad Debts of Commercial Banks

	Overdues of Priority Sector Agricultural Loans		Bank credit locked up in sick industrial units			
			Small Scale Sector		Medium & Large Industry	
	Rs. billion	% of outstanding loans	Rs. billion	% of outstanding loans	Rs. billion	% of outstanding loans
June 1984	13.19	24.9	7.88	13.7	-	-
June 1985	15.29	20.6	9.55	13.7	-	-
June 1986	17.00	19.2	11.84	14.6	-	-
June 1987	19.17	20.6	15.42	16.2	26.80	12.4
June 1988	22.07	20.6	19.80	17.7	30.26	11.6
June 1989	25.03	19.4	22.43	16.4	42.58	12.7
June 1990	35.44	23.2	26.11	16.7	47.34	12.2
June 1991	33.72	21.3	-	-	-	-

Notes: Data for overdues of agricultural loan for 1985 and 1986 are as on December and the data for sick units for 1989 and 90 are as on September. The data relates to public sector banks only whereas the bank credit locked up in sick industrial units are for all scheduled commercial banks.

Sources: 1) R.B.I., Report on Currency and Finance (Various Issues) and Trend and Progress of Banking in India (Various Issues)

5. EVALUATION OF DIRECTED CREDIT POLICY

How effective has directed credit plicy been in achieving its objectives ? As we have seen in section 3, the original objective of introducing the statutory investment requirements for financial institutions was to impart a certain degree of liquidity to their port-folios. In other words, it was intended to be a prudential requirment. However, over time, government has increasingly used it as a fiscal instrument to raise resources for the public sector. Financing public investment through resource transfers through statutory investment requirements on the financial system at some-what subsidised interest rates was considered socially desirable.

Evaluating the effectiveness of statutory investments of financial institutions would require analysing the benefits and costs of public investment. This is far beyond the scope of the present paper and, therefore, it does not attempt such an evaluation of the statutory investment component of directed credit. However, a limited point that needs to be made here is that since the mid '80s a part of the resources which have been transferred to government through statutory investment requirments have gone to finance government's current expenditures rather than investment expenditures. This has been the result of the government running deficits in its current account ever since fiscal year 1984-85. What is more important, these deficits which measure government's dis-savings have increased sharply both

in absolute amount and in relation to the GDP. (See Table 12). This indicates that since the mid '80s, even the limited objective of effecting resource transfer through statutory requirements to finance public investment has received a set-back. Of late, government has been making efforts to reverse this trend by reducing both the overall fiscal deficit and the deficit on the government's current account. The recently finalised Document on Eighth Five Year Plan proposes to reduce the dis-savings of the government to about 1% of GDP by the terminal year of the Plan i.e. fiscal year 1996-97. (See Government of India (1992)).

5.1 Effectiveness Of Priority Sector Credit Programme: Some Case Studies

As we have seen in Section 3, the original objective of commercial banks' priority sector lending programme was to channel an increasing volume of their funds to agriculture, small scale industry, small business ventures and other weaker sections of the population. No doubt, channeling a certain volume of funds to these activities was only an intermediate objective of the priority sector lending programme, the ultimate objective being to increase investment, output employment and incomes of these targetted sectors/ beneficiaries. There are no macro-level studies of the effectiveness of the priority sector lending programme as a whole. However, there have been studies aimed at evaluationg the effectiveness of institutional finance/bank credit for selected priority sectors/beneficiaries. We

Table 12

Savings of Government Sector

	Rs. billion	% of GDP at market prices
1970-71	8.57	0.85
71-72	8.64	0.84
72-73	8.26	0.81
73-74	11.26	1.07
74-75	17.03	1.59
75-76	24.49	2.10
76-77	27.70	2.33
77-78	28.64	2.25
78-79	32.46	2.41
79-80	33.12	2.60
80-81	25.59	1.90
81-82	37.67	2.36
82-83	28.96	1.63
83-84	12.01	0.58
84-85	- 3.15	-0.14
85-86	- 4.74	-0.18
86-87	-24.00	-0.82
87-88	-53.84	-1.62
88-89	-77.48	-1.96
89-90	-117.66	-2.61
90-91	-146.13	-2.80
91-92	-120.38	-2.00

Note:

Government Sector refers to government administration, but excluding both departmental and non-departmental commercial enterprises.

Source:

Central Statistical Organisation, National Accounts Statistics, (Various Issues) and Quick Estimates of National Income Etc., 1991-92.

summarise the key results of three such case studies: one relating to the effect of institutional finance on investment, output and employment in the rural sector, a second one on a comparaison of capital-labour ratios and the overall efficiency of resource use of small scale industries with those of large industries and the effect of bank finance on the relative efficiency of small scale industries and a third one on the effectiveness of the largest poverty-alleviation programme in India financed by priority sector bank credit, IRDP.

5.1.1 The Effect of Institutional Finance on Rural Economy:

Binswanger and Khandker (1992) analyse the impact of institutional finance on rural investment, output and employment. The basic hypothesis of the study is that in the rural sector where farmers face credit constraint, additional supply of credit can raise input use, investment and hence output - the liquidity effect of credit. In addition to the liquidity effect, in most developing countries where agriculture remains still a risky activity, better credit facilities can help farmers smooth out consumption and thereby increase the willingness of farmers to take risk and make agricultural investment - the consumption effect of credit. Better rural credit should, therefore, help achieve some of the objectives of priority sector credit programme: higher investment, output and employment in the rural sector.

Binswanger and Khandker test this hypothesis using a simultaneous-equation model estimated by using district level time series data. The study covers data for 85 districts of India for the period 1972-73 to 1980-81. The study uses three proxies for institutional rural credit: i) total institutional rural credit which is the sum of rural credit advanced by the commercial banks and the co-operative banks, ii) agricultural credit advanced by the co-operative banks, and iii) the number of rural branches of commercial banks. The key results of the study are presented in Table 13.

Rural credit, irrespective of the proxy used, has a significant effect on both agricultural investment and output. The elasticity of agricultural output with respect to institutional credit ranges from .02 to .06, depending on the proxy used. Institutional credit, however, has a labour-displacing effect in agriculture and hence reduce agricultural employment. The elasticity of agricultural employment with respect to institutional credit ranges from -0.05 to -0.07. In contrast, institutional rural credit has a positive effect on non-agricultural rural employment, the elasticity ranging from .24 to .29. Overall, therefore, it appears that the reduction in agricultural employment is compensated by an increase in rural non-agricultural employment with the result, aggragate rural employment is more or less insensitive to rural institutional credit.

Because of data limitations, the Binswanger-Khandker study does not explicitly estimate the effect of rural credit

Table 13

Effect of Rural Credit on Agriculture and the Rural Economy

Dependent variables	Cooperative credit advanced	Number of commercial bank branches	Overall rural credit advanced
	Independent Variables		
Aggregate crop output	0.063 (2.38)*	0.020 (1.92)*	0.027 (1.37)
Fertilizer demand	0.39 (4.55)*	0.25 (6.69)*	0.305 (6.67)*
Investment in tractors	n.a	0.14 (1.31)	n.a
Investment in pumps	.40 (3.59)*	0.38 (3.61)*	0.461 (3.63)*
Investment in draft animals	0.14 (0.62)	0.71 (1.96)*	0.395 (1.56)
Investment in milk animals	0.58 (4.34)*	0.52 (2.63)*	0.763 (5.09)*
Investment in small stock	0.84 (3.60)*	-0.16 (-0.42)	0.758 (5.09)*
Agricultural employment	-0.07 (2.51)*	-0.07 (-2.69)*	-0.050 (2.07)*
Rural non-agricultural employment	0.06 (1.48)	0.29 (10.94)*	0.242 (5.26)*
Rural wages	0.03 (1.34)	0.06 (2.01)*	0.061 (2.93)*
Total rural employment 1_/	-0.05	-0.01	-0.00
Rural output: assuming non-agricultural output has the same elasticity as non-agricultural employment 2_/	0.06	0.11	0.10

Source: Binswanger and S. Khandkar, (1992), p 27.

Notes:
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i) T statistics are in parenthesis. Asterisk refers to significant level of 10 percent or better on two-tail test.

ii) 1_/ and 2_/ These are computed by us from the sectoral elasticities presented by Binswanger-Khandker. The elasticities of rural employment is weighted average of the elasticity of agricultural employment (weight 83.5%) and the elasticity of non-farm employment (weight 16.5%). These weights are derived from the distribution of rural employment for 1972-73 and 1983-84, from National Sample Survey results. Similarly, the elasticity of aggregate rural output is the weighted average of the elasticity of agricultural output (weight 66%) and the elasticity of non-farm output assumed to be equal to the elasticity of non-farm employment (weight 34%). These weights are from the disribution of net domestic product in rural India for 1970-71 and 1980-81 given by the Central Statistical Organisation.

on non-farm output. However, the non-farm sector uses institutional credit to finance both material inputs and capital. If, as in agriculture, these inputs partly substitute for labour, the effect of credit on output must exceed the effect on employment. The estimate of the elasticity of non-farm employment with respect to credit should, therefore, be the lower-bound for the elasticity of non-farm output with respect to credit; if anything, the non-farm output elasticity to rural credit should exceed .24. Given this, the elasticity of aggregate rural output with respect to rural credit works out to about 0.10. Overall, the Biswanger-Khandker results suggest that institutional credit had a positive effect on rural investment, output and wage whereas it did not have much effect on rural employment.

The benefits of higher agricultural output attributable to institutional credit was found to be roughly equal to the overall cost to the government of providing such credit to the agricultural sector. Biswanger-Khandker assume that the value of the extra agricultural income associated with the extra credit is equal to the additional return to the fixed factors in agriculture that accrue on account of the additional output. The returns to fixed factors is net national product in agriculture less the value of material inputs and employee compensation.

The costs to the government of providing institutional credit to agriculture are taken to be: i) an interest subsidy of 3% per annum on the agricultural loans, ii) the cost of

loan default to the government, assumed to be 10% of the loan, and iii) administrative costs to government of providing agricultural loans, roughly equal to 7% of the loan advanced to the agricultural sector. The benefit-cost ratio so worked out by Binswanger - Khandker was baout 1.13. On the one hand, the 7% transaction cost and the 10% default percentage for agricultural loans assumed in the Binswanger-Khandker study appears to be somewhat on the higher side, leading to an overestimation of the cost of providing rural loans. On the other hand, the non-inclusion of the cost of family labour might have had a downward bias on the cost estimation. Subject to these caveats, it is perhaps appropriate to conclude that the total cost of providing agricultural credit has been more or less equal to, or if anything somewhat lower than, the total benefits.

5.1.2 Priority Sector Credit to Small Scale Industry

One of the key objectives of financing small scale industry through priority sector credit programme has been to promote a labour-intensive industrial growth. The basic premise of this strategy was that capital productivity and labour-capital ratios were higher in small scale units than their large scale counterpart. Quite obviously, promoting small scale industry through subsidised priority sector credit was, therefore, expected to lead to a more labour-intensive industrial growth. It was also expected to reduce the concentration of industrial power among the large

business houses and promote small industrial entrepreneurs in the country.

One way of evaluating the effectiveness of directed credit to small scale industry is to test whether small scale units, in fact, have higher capital productivity and labour-intensity than large scale units. This, would, however be a weak test of the employment-advantage of small scale industry since it ignores the overall efficiency of resource-use by the small scale units. If the higher labour-intensity in small scale units is achieved by adopting inefficient production methods, then the extra employment generated involves a cost to the society in terms of the lost output. The higher this degree of inefficiency, the greater would be the cost of the extra employment generation by the small scale industries. Hence, a more appropriate test would be to compare not only capital productivity and capital-labour ratios of small scale units with their large scale counterpart, but also to compare the overall efficiency of resource use between the sectors. A study by Golder (1988) does these comparisons for the year 1976-77. He compares: i) capital productivity, ii) capital- labour ratios and iii) total factor productivity (a proxy for overall efficiency resource-use) of more than 12,000 small scale units which have been financially assisted by banks with those of the large scale industrial sector. The key results of this study are summarised in Table 14.

Table 14

Indices of Relative Labour, Capital and Total factor Productivity in Small Scale Industries: 1976-77

Industry-Group	Relative Labour Productivity	Relative Capital Productivity		Relative Total Factor Productivity	
		A	B	A	B
(1)	(2)	(3)	(4)	(5)	(6)
Grain mill products	0.390	0.709	0.477	0.514	0.428
Other edible oils & fats (mustard oil, groundnut oil, til oil, etc.)	1.385	1.484	1.172	1.440	1.261
Printing, dyeing & bleaching of cotton textiles	0.760	1.425	0.964	1.044	0.857
Weaving & finishing of cotton textiles in handlooms, other than khadi	0.338	2.131	1.871	0.693	0.659
Weaving & finishing of cotton textiles in powerlooms	0.990	1.707	1.319	1.287	1.137
Spinning, weaving & finishing of other textiles, synthetic fibres, rayons, nylons, etc.	0.596	1.180	1.014	0.864	0.795
Knitting mills	0.762	1.115	1.138	0.963	0.976
All types of textiles, garments (including wearing apparel)	0.602	1.221	1.125	0.837	0.806
Sawing & planing of wood (other than plywood)	0.920	0.909	0.743	0.915	0.840
Wooden & cane boxes, crates, drums, barrels, baskets, etc.	0.249	0.895	0.727	0.482	0.433
Wooden furniture & fixtures	0.710	1.469	1.310	0.944	0.903
Container & boxes of paper & paper boards	0.433	1.072	0.956	0.738	0.690
Printing & publishing of periodicals, books, journals etc.	0.717	0.684	0.632	0.705	0.685
Printing, publishing & allied activities n.e.c.	0.736	0.849	0.798	0.784	0.763
Footwear (excluding repair) except vulcanised or moulded rubber or plastic footwear	0.184	0.605	0.551	0.285	0.276
Plastic products n.e.c. (except house furnishing)	0.378	0.794	0.734	0.610	0.580
Basic industrial organic & inorganic chemicals & gases	0.232	0.997	0.693	0.559	0.449
Paints, varnishes & lacquers	0.318	0.787	0.651	0.587	0.517
Drugs & medicines	0.280	0.739	0.624	0.516	0.464
Perfumes, cosmetics & other toilet preparations	0.170	0.849	0.684	0.516	0.445
Structural clay products	0.224	2.054	1.485	0.549	0.481
Foundries for casting & forging	0.587	1.402	1.347	0.898	0.881
Fabricated metal products	0.576	0.899	0.842	0.723	0.699

Industry-Group	Relative Labour Productivity	Relative Capital Productivity		Relative Total Factor Productivity	
		A	B	A	B
(1)	(2)	(3)	(4)	(5)	(6)
Structured metal products	0.407	1.002	0.972	0.688	0.677
Handtools & general hardware	0.356	0.650	0.634	0.465	0.460
Metal utensils, cutlery & kitchenware	0.447	0.784	0.772	0.621	0.615
Agricultural machinery & equipment & parts	0.217	1.102	0.956	0.557	0.513
Industrial machinery for food & textile industries	0.551	1.140	1.073	0.834	0.806
Industrial machinery for industries other than food & textiles	0.337	2.081	2.050	0.791	0.786
Machine tools, their parts & accessories	0.349	1.141	1.008	0.648	0.608
Electrical industrial machinery & apparatus & parts	0.299	1.410	1.380	0.677	0.670
Electrical apparatus, appliances & their components	0.431	0.883	0.719	0.601	0.547
Radio, television, etc.	0.527	1.178	1.004	0.753	0.701
Motor vehicles & parts	0.301	1.025	0.854	0.572	0.520
Bicycles & cycle rickshaws & parts	0.663	0.929	0.754	0.791	0.709
Medical, surgical & scientific equipment	0.680	1.381	1.228	0.907	0.865
Repair of motor vechicles & motor cycles	0.693	1.056	0.865	0.789	0.742

Source: B. Golder (1988)

Note : i) The indices of relative labour and capital productivities are obtained by dividing labour and capital productivities in small scale units by those in in large scale units. Series A is based on gross invested capital and Series B on net invested capital as measures of capital stock.

ii) The index of relative total factor productivity in small scale units is computed as:

Log E = a Log (LPs/LPe)+ b log (KPs/KPe)

Where:

E = index of relative total factor productivity of small scale units.

a = 1/2 (a + a)

b = 1/2 (b + b)

a + b = 1

with

a and b being the income shares of labour and capital in small scale units, and a and b , the corresponding income shares in large scale units.

It appears that capital productivity is higher in small scale units than in large units: the index of relative capital productivity, i.e. the ratio of capital productivity in small scale units to that in large scale units, is higher than unity in a majority of industry-groups. Also, in almost all cases relative capital productivity exceeds relative labour productivity, i.e., the capital-labour ratio is lower in small scale units than in large scale units. These findings, therefore, suggest that capital productivity and labour-capital ratios are generally higher in small scale units than in large scale units. From this point of view, promotion of small scale units (through priority sector credit and other policies) must have led to a more labour-intensive industrial growth. In fact, both output and employment in the small-scale sector have grown at a faster rate than in the large scale sector during most part of the '80s. However, the extra employment generation through the small scale sector has not been without its costs. This becomes clear if one compares the overall efficiency of resource use, as measured by total factor productivity, between the small scale and large scale units.

In almost all industry-groups, the relative total factor productivity, i.e., the ratio of total factor productivity in small scale units to that of large scale units, is less than unity (See Table 14). This implies that promotion of small scale industries helps to achieve more labour-intensive industrial growth, but this growth is not

always efficient. In other words, industry-groups in which the index of relative total factor productivity of small scale units is close to unity are very few (about 7 in Table 14). What is more important, in these industries there does not seem to be much difference in capital-labour ratios between the small scale and the large scale units. In comparison, in about 11 industry-groups where the capital-labour ratios are substantially lower in small scale units than in large scale units, the index of relative total factor productivity of small scale units is below 0.6. Thus, there appears to be a positive corelation between the index of relative total factor productivity and the relative capital labour-ratios; in Golder's study, this correlation coefficient is close to 0.5.

From these results, it appears that the overall efficiency of resource-use in small scale units is more or less the same as that of large scale units in those industries in which the differences in capital-labour ratios (between small and large units) are also relatively small. Quite obviously, small scale units do not have an advantage in employment generation in these industries. Overall, in industry-groups in which small scale units have a substantial advantage in employment generation (i.e. where capital-labour ratios are lower), they are relatively inefficient; and in industry groups in which they are more or less as efficient as the larger units in overall resource use, they do not have much advantage in employment generation.

To promote efficient labour-intensive industrial growth through small scale industries, therefore, their overall efficiency of resource use itself needs to be improved. It is possible to argue that in an environment characterised by credit rationing, enhanced credit supply to small scale industries through priority sector lending programme might have improved their overall efficiency of resource-use. This, however, is not borne out by Golder's results. Using a multiple regression model of relative total factor productivity of small scale industries, he finds that each of the three proxies for the availability of institutional credit to small scale industires which he uses (namely, i) ratio of short term bank borrowings to inventories, ii) ratio of short-term bank borrowings to total short-term borrowings, and iii) share of credit from banks and financial institutions in total long-term borrowings) had a negative effect on the index of relative total factor productivity of small scale units.

This is somewhat surprising since one would expect that enhanced credit facilities should help small scale units to overcome the problem of insufficient working capital and thereby contribute to a more efficient management of the production process. This result perhaps indicates that providing credit to small scale units at concessional rates have led to an un-economical or excessive use of capital. After comparing the efficiency indicators of small scale units which were financially assisted by financial

institutions with those of non-assisted small scale units, Sandesara also comes to a similar conclusion. The non-assisted units, in general, had lower capital intensity and higher capital productivity and profitability than the units assisted by financial institutions (See Sandesara (1989)). Overall, therefore, the case for the promotion of small scale industries to achieve a more labour-intensive industrial growth (be it through a liberal credit policy or other policy measures) does not seem to be as strong as it is generally made out to be.

5.1.3 **Priority Sector Credit And IRDP**

IRDP is the largest scheme in a series of programmes that have been initiated by the government to alleviate poverty through increased access of the rural poor to institutional credit, mainly priority sector credit by banks. As we have mentioned in Section 3, it provides access to non-collaterised bank credit to the rural poor at subsidised interest rate. Bank credit is also supplemented by government grant. The money that is made available through bank credit and government grant allows the poor rural households to be self-employed by making investments in certain assets. Over a period of time, the net income from the asset (i.e. income minus repayment of the bank loans and interest on it) is expected to help the poor families to improve their living standards. There are a wide range of assets which are eligible to be financed from IRDP loans.

The most common assets generally provided in the IRDP programme are cattle and minor irrigation equipments such as tube wells, pump sets, diesel engines and electric motors. Since the mid '80s, the annual average bank credit extended to IRDP has been in the range of Rs.10-12 billion and the number of beneficiaries in the range of 3 to 4 million.

The success of priority sector credit to finance IRDP should be judged against its three main objectives: i) targetting the benefits of subsidised bank credit and government grant to the eligible households - poor rural households having income below a certain level, ii) a viable investment that provides the poor rural households sustained income from self-employment, and iii) repayment of bank loans by the beneficiaries. A number of studies/surveys have attempted to evaluate the achievements and shortfalls of IRDP (see Pulley, 1989 for a list of references). At the national level, the Ministry of Rural Development, Government of India, has conducted three Concurrent Evaluations of IRDP; the first in 1985-86, the second in 1987 and the third in 1989. These surveys provide valuable information and indicators of the achievements and shortfalls of IRDP. Some of the indicators which can be used to judge the extent to which the programme has succeeded in achieving the three objectives mentioned above are given in Table 15.

Generally, the programme appears to have been quite successful in achieving the first objective i.e. in targetting the benefits to the eligible households. On an

average, only about 10% of the beneficiaries of IRDP were ineligible in terms of the income and other criteria of the programme. Although this does not indicate whether the 90% of the eligible beneficiaries received the full amount of the bank credit or they only got a part of it because of leakages to the middlemen, the programme appears to have been reasonably well targetted.

The initial welfare gains achieved through a good tagetting of IRDP is only a prerequisite for the success of the programme. Over a longer term, the IRDP investments should be viable too. If one accepts the notion that poor households behave rationally, a good indicator of the viability of the IRDP investments is whether the assets that have been acquired under the programme are retained for a reasonable period of time or not. Over a period of time, only viable investments/assets will be retained by the beneficiaries; unviable investments/assets will be liquidated.

On an average, about 70% of the assets acquired under the programme have generally been retained. Although this represents a reasonably high retention-ratio of IRDP assets, how long the assets have been retained is not known. This is because the National Concurrent Evaluation of IRDP is not a panel survey. Since the IRDP started in 1980, the assets which were found to be in tact at later years (for example 1985-86, 1987 and 1989 as given in the Concurrent Evaluation

Reports) would be of different vintage. For example, some of the IRDP assets which were found to be in tact in 1989 could be as old as nine years but some others could be only a month or a few months old. It is, therefore, not possible to infer the average life of the varioues IRDP assets which have been found to be in tact by the Concurrent Evaluation Surveys. In the absence of this, a high retention-ratio of IRDP assets is not a sufficient indicator of the viability of the programme.

A more appropriate test of the viability of IRDP investments requires data based on panel surveys. Pulley, (1989) reports some results from a panel survey conducted on a sample of households in the largest State in India, Uttar Pradesh. According to these results, about 59% of the IRDP assets were found to be in tact for a minimum period of 4 years. Although this percentage is lower than the retention percentage given in the National Concurrent Evaluation Surveys, it still indicates that, over a medium term, a substantial part of the IRDP assets have been retained.

Even a high retention-ratio of IRDP assets over a medium term is only a partial indicator of the economic viability of the IRDP investments. Economic viability requires not only that the IRDP assets are retained for a reasonable number of years but also that the beneficiaries repay the bank credit over these years. The repayment record of the IRDP loans has, however, been poor. On an average, about 60% of the IRDP beneficiaries had overdues to the banks (See Table 15). Hence even though the bank lending for IRDP

is well targetted and a substantial percentage of the assets so financed were retained in the medium term, a very high proportion of the beneficiaries failed to repay the bank loan. Therefore, a much lower percentage of the IRDP investments really met the twin requirements of economic viability: retention of assets as well as the repayment of bank loans. Pulley (1989) reports that only about 44% of IRDP investments in the Uttar Pradesh Panel Sample met this twin criteria - assets in tact for four years as well as absence of overdues to the banks.

Overall, therefore, it appears that the bank financed poverty-alleviation programme, IRDP has had mixed success. The programme's record on targetting and retention of the bank-financed assets have been quite impressive but that on repayment of bank loans by the beneficiaries left much to be desired.

Table 15

Performance Indicators of IRDP

	% Eligible Beneficiaries	% Investments Intact	% Beneficiaries with overdues
Oct-June 1985-86	93	69	58
Jan-Dec 1987	88	72	58
Jan-Dec 1989	84	71	63

Source: Government of India, Department of Rural Development, National Concurrent Evaluation of IRDP, 1985-86, 1987 and 1989.

Perhaps the Indian financial sector has already hit this limit. At present, the prime lending rate of commercial banks and DFIs to industrial sector is upwards of 17%.

Beginning June, 1991, the government has initiated a set of economic reforms with integrating the Indian industry with the rest of the world as one of its objectives. The current high levels of interest rates on the organised industrial sector can act as a major hurdle to this integration process. With such high interest rates on industrial finance, the organised industrial sector would be at a disadvantage in the international markets. Even the benefits of other reform measures such as industrial deregulation, trade liberalisation and relaxation of foreign investment policy would be somewhat reduced, if real interest rates on industrial finance is pushed much beyond, say, 5% to 6%. Moreover, with greater deregulation and the gradual opening up of the economy, private sector and foreign trade will be playing a greater role in the country's industrialisation. This would require larger flow of funds to finance private investment and foreign trade. This cannot be done without a smaller pre-emption of funds by statutory investment requirements and priority sector credit programme. About a year ago, an official Committee on the Financial System has highlighted some of these problems emanating from the large and increasing volume of directed credit and its cross-subsidisation in the Indian financial system (See Government of India, (1991)).

6. DIRECTED CREDIT POLICY: PROBLEMS AND PROSPECTS

6.1 The Emerging Issues:

On a balance of considerations, it appears that directed credit policy in India has had mixed results. It has achieved the objective of chanelling resources to what are considered socially desirable sectors and weaker sections of the population. The increased flow of credit to some of these sectors has also benefitted them in that it generally had positive effects on investment, output, employment and incomes in these sectors. However, these achievements have not been costless.

While solving some of the old problems such as high concentration of credit in large business houses and its inadequate availability to other productive sectors in the economy, directed credit policy has also given rise to new problems. The most important of these problems is the substantial cross-subsidisation of directed credit by the medium and large industrial sector. This applies to both the components of directed credit, namely statutory investments and priority sector credit. But because of its larger volume, the problem of cross-subsidisation is of a much larger magnitude with statutory investments than with priority sector credit. There is a limit to cross-subsidisation of directed credit by the industrial sector. Beyond a certain limit, such cross-subsidisation would lead to unsustainably high interest rates on industrial finance.

commercial banks over the next few years. For substantial progress in this front, the efforts of the Central Government at containing its fiscal deficit will have to be supplemented by similar efforts by the State Governments.

Another aspect which has received increasing attention both by the government and the academia is the subsidised interest rates on statutory investments. The yield rate on government securities has been below the average rate which banks charge on loans to medium and large industry. It is also lower than the prime lending rate of DFIs on long term industrial finance. There is, therefore, significant subsidisation of statutory investments at the cost of a higher rate on the organised industrial sector.

Following the recommendations of the Committee to Review the Working of the Monetary System in 1985, in recent years the government has effected substantial upward adjustments in the rates of interest on government securities. The Committee on the Financial System has recommended further upward adjustments in the rates of interest on government securities. It has also suggested that the government borrowing rates should progressively be market-related and not government-fixed. Once again, progress on this front would depend upon the fiscal consolidation that the government can achieve in the coming years. First, a lower fiscal deficit, and hence lower borrowing requirements of the government, would put a

6.2 **Statutory Investments:**

The Committee on the Financial System has rightly pointed out that the present levels of statutory investment requirements, especially on banks, are too high to limit cross-subsidisation to sustainable levels and to allow banks to operate as commercial entities. The Committee is of the view that the statutory liquidity requirements on commercial banks should be reduced from its present level of about 38% to about 25% over a five-year period. Such a reduction should allow banks to reduce the volume of cross-subsidisation of statutory investments as well as give them more freedom in their portfolio management.

The government has, in principle, accepted the proposal to reduce the statutory liquidity requirements. The extent of reduction would, however, depend upon the containment of the fiscal deficit and hence the borrowing requirements of the government. Starting with 1991-92, the Central Government has already initiated a programme of fiscal adjustment. Under the programme, its fiscal deficit as a ratio of GDP has been brought down from close to 9% in 1990-91 to about 6.5% in 1991-92 and further to about 5% in 1992-93. The government has also expressed its intention to further reduce the fiscal deficit to about 3% to 4% of GDP by the mid '90s (Government of India, (1992)). The proposed fiscal deficit reduction, if achieved, should enable the government to reduce the statutory liquidity requirements on

exclude larger farmers), the tiny segment of the small scale industrial sector (and exclude the larger units), village and cottage industries and other weaker sections.

If the twin recommendations of the Committee on the Financial System - gradual reduction in the statutory investment requirements and the phasing out of the priority sector credit programme - are implemented, the proportion of commercial banks' aggregate funds pre-empted by directed credit would be more than halved over a five year period, from about 58% (i.e., the sum of statutory investment of 38% and the share of priority sector credit in the banks total funds of about 20%) at present to about 25%. The government has not yet announced its decisions on either the extent or the time-phasing of the reductions in the statutory investment requirements and the priority sector credit programme. To some extent, a reduction in the statutory investment requirements gives larger scope for reducing the share of priority sector in aggregate bank credit, without at the same time adversely affecting the flow of bank credit to these sectors.

It is difficult to prescribe as to what should be the order of reduction in the priority sector credit target. The proposal of the Committee on the Financial System to phase out priority sector credit is only one alternative. It is perhaps an extreme step. But given that there is a need to both increase the flow of funds to the organised industrial sector and reduce the burden of cross-subsidisation of

downward pressure on the market rate of interest itself. Secondly, the lower the government's borrowing requirements, the greater would be the manouverability on the part of the government to pay market-related interest rates on its securities.

6.3 **Priority Sector Credit:**

The directed credit programme under the priority sector lending operations of the banks has served a useful purpose in extending the reach of the banking system to cover sectors which were generally neglected in the '50s and the '60s. Yet, along with high levels of statutory investments, the priority sector credit programme has forced banks to hike their lending rates on medium and large industrial sector, thus nullifying some of its beneficial effects. Along with a reduction in the statutory investment requirements, there is, therefore, a need for some rethinking on the priority sector credit programme. Either the coverage of the programme will have to be pruned and/or the extent of cross-subsidisation on priority sector credit reduced.

The Committee on the Financial System has recommended that the priority sector credit programme should be phased out. In the transition, it has suggested that the list of priority sectors should be pruned and the interest concessionality on priority sector credit eliminated. The pruned priority sector, it has proposed, should include only: small and marginal farmers in the agricultural sector (and

credit programme in the near future, although there may be scope for reducing the interest concessionality on agricultural loans.

The very high percentage of overdues of agricultural loans is, however, a cause for concern in continuing the priority sector credit programme for agriculture. The overdues of priority sector agricultural loans by commercial banks has nearly trebled since 1984, from about Rs.13 billion then to about Rs.33 billion now. It now constitutes more than 20% of the outstanding bank loans to agriculture. The high overdues and non-repayment of loans have resulted in high risk cost of lending to agriculture, although the estimates of the risk cost varies widely from 1% to about 8% of the principal amount. (See Katula and Gulati (1992)). Empirical evidence has increasingly highlighted four key factors as the determinants of overdues/non-repayment of agricultural and rural loans: i) the agro-climatic conditions of the region, ii) defective loan policies and procedures by the banks and the government, iii) ad-hoc one-shot waiver of agricultural loans by the government, and iv) highly time consuming procedures involved in loan recovery. (See Nair 1991). The last three of these factors are more or less under the control of the banks and the government.

The whole gamut of factors which are internal to the banking system such as defective loan polcieis and procedures, financing of agricultural projects unsuited to a particular region, fixation of unrealistic repayment

priority sectors on it, reduction in the priority sector credit target may be almost unavoidable. Perhaps one way of effecting this could be by excluding small scale industries from the list of priority sector. There is reasonable empirical evidence to show that the small scale units are relatively inefficient (in overall factor use) in industries in which they have lower capital-labour ratios than the larger units. In industries in which they are more or less as efficient as the larger units, their capital-labour ratios are not significantly lower. Hence, the traditional argument for promoting small scale units for labour-intensive industrial growth appears to have been exaggerated. Therefore, it is time to seriously consider the exclusion of small scale industries from the priority sector credit programme.

Agriculture and allied sectors may have to be in the priority sector credit programme for some time to come for atleast two reasons. First, institutional credit appears to have had positive effects on rural investment and incomes. Overall, the benefits of institutional credit to the agricultural sector has been somewhat higher than its cost. Secondly, the largest poverty-alleviation programme in the country, IRDP, is inextricably linked to agriculture and the rural economy. Notwithstanding the deficiencies of IRDP, it does provide a social safety net to the rural poor. On both these considerations, it does not seem feasible to exclude agriculture and allied sectors from the priority sector

Annexure

Administering Priority Sector Credit Programme

Priority sector credit programme, as we have seen in the earlier section is a fairly complex programme: on the one hand, it is aimed at allocating a certain percentage of the funds with banks to productive sectors such as agriculture, small scale industries and small business enterprises. On the sectoral credit targets, the government has also superimposed a number of schemes aimed at financing poverty-alleviation and other related programmes. In other words, within each of the productive sectors designated as priority sectors, the banks have to finance the various poverty-alleviation and other related programmes.

Administering such a complicated lending programme involves the interaction of three key sets of players: the government, the banks and the beneficiaries of priority sector credit. To a large extent, the success or the failure of the priority sector credit programme depends on how well the three players interact among each other. Three key issues of administering the priority sector lending programme deserves special attention. i) Who selects the specific projects/ beneficaries under the priority sector credit programme and how are these selected; ii) who monitors the implementation of the project/activities under the priority sector credit programme; and iii) who is responsible for monitoring the repayment of priority sector loans and how is the problem of default tackled.

schedules, under or over-financing of projects, can be improved with better technical evaluation of the rural projects by the banks. In recent years, the one-shot waiver of agricultural loans by the government also appears to have contributed to the poor loan repayment. Such policies have a tendency to build expectations of further future loan-waiver schemes and hence to poor repayment of existing loans. Putting an end to such loan-waiver schemes should help improve loan repayment. Finally, at present the legal procedures for loan recovery from defaulting borrowers are highly time consuming. (See Annexure). Setting up of special tribunals for loan recovery, as has been proposed in the 1993-94 Union Budget, could help reduce the legal hurdles at better loan recovery.

6.4 Summing Up:

To sum up, the proportion of banks' funds which is pre-empted by statutory investment requirements and priority sector credit has increased from about 35% before the nationalisation of the major banks in 1969 to about 57% now. Against the background of the recently initiated economic reform measures and the expected increase in the role of private sector and foreign trade in India's industrialisation, there is a need to reverse this trend and make a larger percentage of funds available to the organised industrial sector. Progress on this trend-reversal would crucially depend upon the further fiscal consolidation that the government can achieve in the next few years.

The pre-sanction survey is conducted by the Field Officer attached to the bank's branch. First, the Field officer of the banks concerned has to visit the loan applicant and satisfy himself that the documentation given by the applicant regarding his residential address and asset holding are genuine. He also has to take care to see that the proposed project by the applicant is financially viable. Once he verifies these things, he submits a pre-sanction survey report to the manager of the bank branch. In the case of loans of small amounts the branch manager of the bank is entrusted with the powers to either sanction the loan or reject the application based on the pre-sanction survey submitted to him by his field officer. But in the case of larger loans the branch manager of a bank is required to obtain permission from his higher authorities. On an average, it is understood that it takes about 3 to 6 weeks from the date of application to the date of sanctioning a loan if the loans are sanctioned at the branch managers level and about 12 weeks if the permission from the higher authorities above the branch manager is required.

Unlike in the case of general lending under priority sector credit programme, if the loans are tied to any of the poverty-alleviation programmes, the responsibility of selecting as to who is eligible for the benefit is made by the government at the village and the block levels. As part of the implementation of the poverty-alleviation programmes, the block level staff are required to prepare a list of

A.1 Selection of Projects and Beneficiaries

Overall the responsibility for the selection of projects and beneficiaries lies with the banks and the government. In the case of general lending to the priority sector, the responsibility lies mainly with the banks whereas as in the case of financing poverty alleviation and related programmes, the responsibility lies mainly with the government, particularly at the village and the block levels.

In the case of general lending under the priority sector credit programme, the responsibility of selecting the beneficiaries within the broad sectors designated as priority sectors lies mostly with the banks. A typical loan process for general lending under priority sector credit programme involves three steps: application for the loan, the pre-sanction survey of the project and the beneficiary and the final sanctioning of the loan.

In the first stage, the branch office of a bank receives the application from prospective borrowers giving the purpose for which the loan is sought and the details of the project to be financed. Before the loan application is processed, the banks have to satisfy that the details given by the loan applicant regarding his residential address, and asset holding and the project details are genuine. For this, the branch office of the banks undertake a pre-sanction survey of the beneficairy and the project.

A.3 Loan Recovery and Default

There is an elaborate legal apparatus to enforce repayment of the loans and also to deal with the problems of loan default. Once again, the responsibility for loan recovery and tackling the problem of default lies jointly with the banks and the government. First of all, all the priority sector loans by banks have insurance cover provided by the Deposit Insurance and Credit Guarantee Corporation (DICGC) which is a subsidiary of the Reserve Bank of India. But before the banks can approach the DICGC, they have to make every effort to recover the loan from the borrower. In this task, banks are supposed to be helped by the State governments.

The recovery procedure from a defaulting borrower typically proceeds as follows: once the borrower has defaulted on one of the repayment instalments, the bank sends a request notice to the borrower requesting him to make the repayment. After repeating this for a few times, the bank then approaches the State government to help it in recovering the loan. The State governments have the authority to sell the assets of the defaulting borrower and use the proceeds to make the loan repayment to the bank. This option is very rarely resorted to by the State governments. Instead, they generally pursuade the defaulting borrower to make the repayments. In a number of cases, these efforts by the banks and the State government are inadequate to recover the loan. It is only then that the bank makes an application to the DICGC.

qualified beneficiaries taking into account the income and asset holding of the beneficiaries and submit it to the traditional village assembly for approval. The block officials are also required to assist those investors in choosing viable investments, completing loan applica-tions and submitting them to the banks. As in the case of general priority sector lending, the banks then do the usual pre-sanction survey of the beneficiary before sanctioning the loan.

A.2 Monitoring the Projects

Once the loan is sanctioned, the monitoring the projects financed under the priority sector credit programme is entrusted to the banks. The Field Officer of each bank branch is required to make frequent and regular visits to the beneficiaries/location of the project to see that the loan is being utilised for the purpose for which it was taken and that the project is progressing satisfactorily. Such monitoring of the end-use of the loan forms part of the post-sanction survey conducted by the Field Officer. In most banks, the Field Officer is required to visit the beneficiary/ location of the project once in a month and the manager of the bank branch once in three months. The post-sanction survey by the Field Officer is also supposed to ensure the repayment of the loans according to the repayment schedule fixed at the time of sanctioning the loan.

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In general, banks can recover upto 60% of a bad loan (plus interest) amount from the DICGC, subject to a maximum of Rs. 1 million. The banks generally avoid resorting to the legal process for the loan recovery since the whole process takes too long a time in the Indian Civil Courts. This is perhaps one of the reasons why banks have been bearing the increasing burden of bad debts rather than resort to the legal process for better loan recovery. This is especially important for priority sector lending where banks have insufficient collateral to enforce prompt repayment. Increasingly, the banks view this as a social cost of doing business. However, in recent years the problem of bad debts has increased to such an extent that it is threatening the viability of the priority sector credit programme.

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