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INTEREST RATE POLICY FOR THE RURAL SECTOR

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Interest rate policy for the rural sector is a highly complex and debatable subject. This is because the policy formulation is based not only on economic criteria but also on social and political factors. Often socio-political considerations outweigh economic considerations as a determinant of the policy.

2. There are strong advocates for a high interest rates structure in the rural sector. There are number of arguments put forth by them. First, the interest should be high enough not only to meet the cost of funds and the administrative cost for disbursement and supervision of loans but also to provide adequate cushion for bad debts. The administrative cost is higher in the case of agricultural loans because of the small size of loans per borrower and the additional expenditure involved in training and motivating the farmers for proper use of loans; the risk of default are also higher due to natural calamities, low level of income of the farmers, etc. Second, there will be reluctance on the part of the credit agencies to cater to the rural sector, if the income earned is less attractive than what they can earn by lending to other sectors. This will deprive the rural sector of adequate availability of credit. Third, if a concessional rate of interest is charged for rural credit, there will be a temptation on the part of the borrowers to take credit ostensibly for agricultural purpose but to divert the credit to other purposes. Fourth, if the advance rate remains low, it will not be feasible for the banks to give attractive rate for deposits with the result that the deposit mobilisation will be retarded. Finally, it is argued that the interest rate policy must take care of the continued inflationary pressure on the economy.

3. As opposed to the above, there are also advocates for a cheaper cost of credit in the rural sector, particularly to the rural poor. They emphasise that the rural sector is a

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relatively weaker sector of the economy and hence this sector needs to be sustained and encouraged by credit at a subsidised rate of interest. This argument is further rationalised by saying that there has to be transfer of resources from the urban sector to the rural sector to intensify the efforts for rural development and subsidised credit is one of the means to this end.

4. The above rationalisation for cheap credit to the rural sector often gets decisive political support in a developing economy. The reason is that in a less developed country the agricultural sector dominates the economy and the rural elite wields tremendous political influence. As a result, the concept of concessional credit to the rural sector has a wide political acceptance and, by and large, most of the developing countries adhere to the policy of institutional credit to the rural sector at a subsidised rate of interest.

5. Before I deal with what is considered to be a rational approach towards the interest rate policy for the rural sector, I propose to dispose of a couple of points which are put-forth in favour of a high interest rates structure. One point which is often emphasised is that the interest rates should be so fixed as to take adequate account of the inflationary trends in the economy. In regard to this observation, while I agree that the inflationary trends should be one of the important determinants of the general interest rates structure in the economy, I must confess that it will be awkward and unrealistic to hypothesise that oblivious of the general interest rate policy, only the interest rate policy for the rural sector should be governed by the inflationary trends. I am firm in my conviction that the interest rate policy for the rural sector must be in tune with the general interest rate policy. An interest rate for the rural sector substantially higher than the general interest rates structure in the economy cannot be supported, particularly

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because the rural sector is definitely the weaker sector of the economy.

6. Another argument which is often advanced in favour of a high interest rates structure for the rural sector is that the farmers often borrow at an exorbitantly high rate from the unorganised money market consisting of the money lenders and other non-institutional sources of borrowing. While it is true that exorbitant rates of interest are charged by the money lenders, this does not ipso facto establish a case for a high interest rates structure for the rural economy. This is because the interest rates charged by the money lenders are not based on the ability of the farmers to repay their loans including interest. In the absence of institutional credit at reasonable rates of interest the farmers have to take recourse to borrowing from the money lenders at exorbitant rates of interest to meet their pressing needs but later they come to griefs because of their inability to repay the loans including interest. So, the exorbitant rates charged by the money lenders cannot justify a high interest rates structure for the rural sector.

7. Based on the observations made in the preceding two paragraphs and subject thereto, what I feel is that the interest rates structure for the rural sector should be a synthesis of, on the one hand, the cost of funds, the cost of administration for disbursement and supervision of loans and reasonable margin for bad debts and profits and, on the other, the ability of the borrowers to service the loans. The cost of funds, administrative cost and the risks of default are not difficult to quantify and hence these criteria are amenable to an arithmetical formulation for determination of the interest rates structure. On the other hand, the ability to service the loans on the part of the borrowers would be determined by the incremental income that will accrue to the borrowers from the use of credit. In assessing the

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incremental surplus for servicing the loans, due allowance will have to be made for increasing the standard of living of the borrowers. If the entire amount of the incremental income is absorbed by servicing cost of the loans, the borrowers will derive no benefit from the credit extended to them in improving their standard of living and the credit operation will, therefore, lose its raison detre. From this it follows that the interest rate policy should be so formu-lated as to leave reasonable surplus to the borrowers out of the incremental income to improve their living standard.

8. Considered from the point of view of the ability to service the loans, there does not appear to be any justification for a concessional rate of interest for the relatively affluent borrowers in the rural economy. There may, however, be a case for a subsidy in the case of the rural poor whose income is at subsistence or below subsistence level. If such concession is to be provided in their case, it is important to mention that the burden of such concession should not be thrust upon the credit agencies. The credit agencies must be fully compensated for their cost of funds, administrative cost and risks of default including reasonable profit. For, otherwise it will not be feasible for them to continue their credit operations on a viable basis. Therefore, the cost of whatever subsidy is provided has to be borne either by the Government or the central bank. A concessional credit has also to be very effectively supervised so that this is not misused in any way.

9. I would now solicit the views of this august gathering on this complex problem of the interest rate policy for the rural sector.