

6.1 Availability of adequate and timely finance is an important pre-requisite for growth. Monetary policy affects economic activity not only through the conventional interest rate channel but also through supply of bank credit. In most developing economies and in some advanced regions such as Europe, banks have traditionally been the main source of finance for various sectors of the economy. In contrast, in many advanced economies such as the US, market-based finance systems predominate. In either case, adequate and timely provision of finance is necessary to fund investment in the economy. Moreover, a well-developed domestic financial system can help to mobilise domestic savings and channel these funds to local borrowers in local currency, and thereby mitigate the potential for externally induced crises that may arise from various sources such as currency mismatches.

6.2 A particular characteristic of developing economies, often justified by the need to conserve scarce resources for socially productive uses, has been the prevalence of a wide range of credit controls and directed credit programmes often at concessional prices. Such programmes, usually accompanied by extension of the financial system, played an important role in the process of financial deepening in the 1950s and 1960s. At the same time, the resultant segmentation of markets blunted the process of price discovery and limited the allocative efficiency of financial systems. In consonance with the increasing market orientation of monetary policy, most central banks in developing countries have been phasing out direct instruments of monetary control. A key challenge for central banks in emerging market economies (EMEs) is their ability to channel credit to the relatively disadvantaged sections of society.

6.3 Apart from financing growth, variations in bank credit are an important channel of monetary policy transmission mechanism even for central banks that rely on interest rates to convey their policy stance. Modulations in policy interest rates by the central bank influence credit market conditions which reinforce the effects of the traditional interest rate channel of monetary transmission. For the interest rate channel to be effective, however, it is critical that monetary policy signals are transmitted by banks onto their

lending rates. This, in turn, requires banks to be able to assess various risks adequately and incorporate them in their lending rates. While such risk assessment techniques are in place in advanced economies, they remain underdeveloped in many EMEs. Given the large information and transaction costs, banks are not fully able to take into account the risk profile while pricing their loans to various borrowers. For monetary policy signals to work effectively, efforts to reduce information and transaction costs through promotion of agencies such as credit information bureaus assume importance. Better information does not mean that banks will necessarily reduce credit availability for riskier borrowers. Rather, banks can more knowingly choose their risk profiles and price risk accordingly (Greenspan, 2004). While facilitating an efficient allocation of resources, it also enhances the efficacy of monetary policy signals. In other words, improvements in the credit delivery mechanism are necessary for monetary policy signals to have the expected effect on output and prices.

6.4 In India, a key objective of monetary policy since Independence has been the provision of adequate credit to support investment demand in the economy while keeping a vigil on inflation. Given the existence of large fiscal deficits in the past two decades, banks have been required not only to finance the credit requirements of private sector but also that of the Government. Coupled with the administered interest rate mechanism that was in place till the early 1990s, this necessitated regulation of credit by the Reserve Bank to meet the requirements of both the Government and the private sector and those of the underprivileged segments within the private sector. In consonance with the overall reform process, the arrangements in regard to provision of credit have undergone a significant shift from micro-regulation of the 1970s to macro-management during the 1990s. Interest rates have been deregulated while statutory pre-emptions have been almost halved between 1990 and 2004. However, while making this shift from a planned and administered interest rate system to a market-oriented financial system, the importance of credit has not been undermined. A key issue is to maintain balance between deregulation that brings

about medium to long-run efficiency gains on the one hand and the required credit flow to various sectors on the other hand (Reddy, 2004a).

6.5 The actual experience indicates that notwithstanding the deregulation of interest rates and the significant reduction in the statutory pre-emptions during the 1990s, banks continued to show a marked preference for investments in Government securities *vis-à-vis* extending credit to the commercial sector. Thus, policies of liberalisation, deregulation and the enabling environment of comfortable liquidity at a reasonable price have not automatically translated into increased credit flows to various sectors. The banking system continues to charge interest rates to various categories of borrowers by their category *per se* - whether agriculture or small scale industry - consistent with the legacy of the old administered interest rate regime rather than actual assessment of risks for each borrower. Moreover, significant divergence in lending rates between formal and informal markets still exists. Consequently, issues relating to information asymmetries that keep lending rates high for a large category of borrowers/sectors have come to the forefront. The Reserve Bank's endeavour has, therefore, been to reduce transaction and information costs so that adequate credit to such sectors is available at reasonable interest rates.

6.6 Against this backdrop, Section I of this Chapter addresses the role of finance in contributing to investment and growth. The section begins with a brief overview of the theoretical literature and empirical studies on the interlinkages between finance and growth. This is followed by a discussion of the role of bank credit in the conduct of monetary policy. Section II dwells upon the Indian experience in regard to bank credit. Key measures taken by the Reserve Bank to improve the credit delivery mechanism in the country in the recent years are highlighted. Trends in the flow of credit to various sectors of the economy in the post-reforms period are critically examined. With the gradual waning of the development finance institutions, the ability of banks to cater to the needs of long-term finance is assessed. Despite reductions in statutory liquidity ratio (SLR), banks' investment in Government securities remains significantly above the statutory requirements and reasons for this are explored. Concluding observations are presented in Section III.

I. ANALYTICAL ISSUES ON THE ROLE OF CREDIT

6.7 Financial development, *i.e.*, the existence of well-functioning financial institutions and markets,

is believed to contribute to economic growth through a number of channels: (1) acquisition of information on firms; (2) intensity with which creditors exert corporate control; (3) provision of risk-reducing arrangements; (4) pooling of capital and (5) ease of making transactions (Levine, 2004). Financial institutions are better suited than individuals to identify potentially successful projects because these institutions have better information gathering and processing ability and the requisite personnel skills to monitor the efficiency and productivity of projects. By reducing the costs of acquiring and processing information, financial institutions improve resource allocation and encourage the mobilisation of savings to invest in large projects. They also facilitate the pooling and hedging of risks inherent in individual projects and industries. Well-developed financial markets augment liquidity in the economy. Adequate liquidity enhances savings in the economy by reducing liquidity risk of securities holders' by allowing them to sell their securities easily without affecting firms' access to the funds initially invested. By exerting effective corporate governance, financial systems can help to retain domestic savings at home. Thus, well-developed financial markets and institutions can generate growth by increasing the pool of available funds and by reducing the risk and ensuring productive uses of funds mobilised from savers. The endogenous growth literature, building on 'learning by doing' processes, assigns a special role to finance. Finance is seen as a crucial factor of production like knowledge and the influence of institutional arrangements in regard to finance on growth has often been forcefully emphasised. By facilitating borrowing for accumulation of skills, financial systems can promote the accumulation of human capital (Jacoby, 1994).

6.8 Several studies have attempted to examine the relationship between various alternative indices of development (such as, the ratio of consumer credit to GDP, market capitalisation to GDP and bank credit to GDP) and growth rates. Illustratively, using cross section data for 77 countries for the period 1960-1989, King and Levine (1993) found statistically and economically significant positive relationship between the measures of financial development and growth. The measures of financial development used in this study as well as most subsequent studies are, however, quite different from what the theory suggests. Benhabib and Spiegel (2000) found that financial development affects growth both through capital accumulation and productivity increases engendered by knowledge creation.

6.9 The issue of causality between finance and growth, however, remains unsettled. Financial development may promote growth simply because financial systems develop in anticipation of future economic growth. Furthermore, differences in political systems, legal traditions or institutions may be responsible for driving both financial development and economic growth. Rajan and Zingales (1998) attempt an industry-wise analysis to circumvent the issue of causality between finance and growth and find that industries that are relatively more dependent upon external finance grow relatively faster in countries that have well-developed financial systems. Fisman and Love (2003), however, argue that the external dependence measure of Rajan and Zingales (*op cit.*) may be capturing good global growth opportunities rather than the role of finance.

6.10 According to Favara (2003), the relationship between financial development and economic growth is, at best, weak. Moreover, the relationship is non-linear in the sense that finance matters for growth only at intermediate levels of financial development. The effects of financial development are found to differ considerably across countries and display no obvious pattern. In contrast to Favara's (*op cit.*) findings of non-linear effects, Bossone and Lee (2004) find empirical support in favour of 'systemic scale economies' (SSE) hypothesis, *i.e.*, larger, deeper and more efficient systems enable banks to save on the resources needed to manage the higher risks associated with larger production. Small banks in large systems are more cost efficient than small banks in small systems. Banks in small systems are found to over-utilise financial capital and *vice versa*. Finally, Bassone and Lee (*op cit.*) also find that large banks in large systems operate at an approximately optimal capital level.

6.11 In brief, the empirical evidence suggests that there exists a positive correlation between finance and growth. There is also an emerging consensus that the causation runs from finance to growth. Differences in financial development can alter economic growth over long time horizons and, therefore, well-developed financial sector is crucial for all economies. Healthy and competitive financial markets are an extraordinarily effective tool in spreading opportunity and fighting poverty (Rajan and Zingales, 2003).

6.12 In India, the role of finance in promoting growth was recognised early on after Independence. The First Five-Year Plan (1951) observed that central banking would have to take on a direct and

active role in creating the machinery needed for financing developmental activities and ensuring that the finances available flow in the directions intended. With the initiation of the reform process in the early 1990s, although there has been a paradigm shift in the credit allocation process from micro-management to a greater role for market forces in credit allocation, the Reserve Bank continues to pursue with its efforts to improve the credit delivery mechanism in the economy. For India, empirical evidence confirms the positive role of finance on growth (RBI, 2001).

Banks versus Market Based Systems

6.13 Based on the level of sophistication and the type of system, financial systems can be grouped into two categories, *i.e.*, (a) the Anglo-American model of market-based finance where financial markets play an important role and (b) the Continental/Japanese model of bank-based finance, in which savings flow to their productive uses predominantly through financial intermediaries such as banks and other financial institutions. The market-based system is relatively impersonal as the sources of funds are atomistic household savers, directly or indirectly through mutual funds, pension funds or insurance funds. The bank-based systems are more relationship-based, because the lenders are few and large. Generally, bank-based systems often tend to be stronger in countries where governments have taken a direct role in industrial development, such as Germany, in the 19th century, and Japan and India, in the later half of the 20th century. At the same time, a number of EMEs, especially the South Asian tigers, follow a market-based system (Mohan, 2004a).

6.14 The two-way classification of financial systems - market-based *versus* bank-based - is rather restrictive. The composition may not matter since the two systems may be complementary and the key issue is a well-functioning financial system (Huybens and Smith, 1999; Merton and Bodie, 1995). Furthermore, the distinction between the two has blurred in recent years with the institutionalisation of the sources of finance all over the world. The blurring has emanated from the gradual spread of universal banking, spanning the entire range of financial services across commercial banking, insurance and securities (investment as well as underwriting).

6.15 Notwithstanding the debate on market *versus* bank-based systems, banks remain the predominant purveyors of credit in many developing

economies. Even in advanced economies, banks continue to be important, despite the growing importance of market-based systems. Therefore, bank credit is an important source of finance although the role of credit analytics in monetary policy formulation has seen ups and downs over the past five decades. Credit aggregates were a key variable in the conduct of monetary policy during the 1950s and 1960s in a large number of economies, including the advanced economies such as the US. With restrictions on interest rates, a number of industrial economies regulated credit to various sectors of the economy during this period, although the fraction of credit so directed was smaller than that in EMEs (Krueger, 2004). During the 1970s, credit aggregates gave way to monetary aggregates. With the onset of financial innovations, as money demand turned unstable, both money and credit vanished from the scene as targeting variables by the early 1990s (Borio and Lowe, 2004). In the subsequent period, interest in credit behaviour has re-emerged as it is believed that credit conditions play a key role in the monetary transmission mechanism.

6.16 The traditional interest rate channel is based on the assumption of perfect substitution between the different financial assets and neutrality of firms' financial structure. This view – the “money view” - holds that financial intermediaries like banks offer no special services on the asset side and capital structures do not affect any lending/borrowing activity, while on the liability side of their balance sheet the banking system creates money by issuing demand deposits. However, the assumption of perfect substitution between financial assets such as bonds and loans does not hold in the presence of information asymmetries. The ‘credit view’ or ‘lending view’, although not necessarily in conflict with the ‘money view’, stresses imperfect substitution between bank credit and securities and, at least implicitly, between internal and external finance (Bernanke and Blinder, 1988).

6.17 The credit channel of transmission reinforces the effects of the traditional interest rate channel of monetary transmission. According to the credit view, the direct effects of monetary policy on interest rates are amplified by endogenous changes in the external finance premium (EFP). EFP is the difference in cost between funds raised externally (by issuing debt or equity) and funds generated internally (from retained earnings). The size of this EFP reflects imperfections in the credit markets and varies in the same direction as the movement in interest rates. Thus, monetary

tightening increases EFP while easing of monetary policy reduces EFP. Consequently, the impact of a given change in short-term policy interest rates on demand and output is magnified, thereby reinforcing the effects of variations in interest rates *per se* (Bernanke and Gertler, 1995). Thus, credit conditions play an important role in the monetary transmission process.

6.18 Within the credit view, two alternative channels are stressed. The “bank lending” channel holds that a contractionary monetary policy decreases bank reserves, which cannot be offset by the banks (say, by issuing certificates of deposit) thereby reducing bank lending, investment demand and output. The credit view also proposes a “balance sheet” channel of monetary transmission. According to the “balance sheet” channel, a tight monetary policy reduces net worth of the borrowers as well as lenders. The reduction in the net worth of the borrowers, for instance, reduces the collateral available with them which, in turn, increases the EFP. This inhibits investment demand in the economy and the effects may get magnified through a financial accelerator mechanism. The effect may also depend upon the size of the firms and their access to credit markets. Small firms that have relatively poor access to credit markets will be forced to curtail their production relatively more compared to large firms with better access to credit markets. The latter may be in a better position to take recourse to alternative avenues of funds such as commercial paper so as to maintain their production. In brief, relatively more credit-constrained firms will see a larger degree of output contraction in response to monetary tightening.

6.19 The origins of the credit view can be traced to Fisher (1933), who argued that the severity of the economic downturn during the Great Depression resulted from the poor performance of financial markets. The credit view is better able to explain the severity of the Great Depression (Bernanke, 1983; Bernanke and Gertler, *op cit.*). Monetary forces alone were ‘quantitatively insufficient’ to explain the depth of the Depression and its persistence, and that the collapse of the financial system, reflected largely in bank failures and stock market crash worldwide, was an important explanatory factor. The credit channel and the financial accelerator mechanism also explain the severity of the financial crises in the Asian countries (Catao and Rodriguez, 2000). In many instances, credit booms are a precursor to future financial instability (Box VI.1).

Box VI.1

Bank Credit Booms and Financial Instability

The 1990s was a decade of low interest rates and low inflation in many countries. At the same time, the decade witnessed sharp increases in property and securities prices, partly fuelled by accommodative monetary policies. Sharp rises in asset prices are often followed by equally sharp reversals. With increased leverage, sharp reversals in asset prices bring forth a reduction of net worth and the financial accelerator mechanism can reinforce the downswing of economic activity.

The role of credit conditions in the expansion of the 1920s and the slump of the 1930s directs attention to two factors: the structure of domestic financial systems and the interplay of finance and innovation. While financial structure and regulation have featured in the comparative literature on the causes of banking crises in the 1930s (Grossman 1994), the interplay of finance and innovation in stimulating the expansion and setting the stage for the crash has been the subject of less attention. It was precisely the experience of the 1920s and 1930s that provided the backdrop for Schumpeter's characterisation of the cyclical aspect of capitalism as "innovation financed by credit." The experience of the 1990s is reminiscent of the development and effects of credit conditions in the 1920s and the fact that the interaction of credit with innovation may generate business cycles.

Against this backdrop, a view has emerged that central banks should lay more stress on movements in credit. Almost 75 per cent of credit booms in EMEs have been

associated with a banking crisis while 85 per cent of the booms were associated with a currency crisis (IMF, 2004). Amongst the various variables considered individually, credit booms – defined as a situation where credit/GDP ratio is four percentage points above its trend - turn out to be the best predictor of future financial imbalances and dominate other possible variables such as money, asset prices and output gaps. Over 3-5 year horizon, credit booms predict 80 per cent of banking crises, much higher than that of 47 per cent in case of asset price misalignments. If a combination of various variables is considered, then asset price misalignments taken in conjunction with sharp movements in credit aggregates turn out to be the best predictors of future instability (Table 6.1). Thus, central banks should pay particular attention to credit developments since a focus on monetary aggregates alone is an inadequate substitute (Borio and Lowe, *op cit.*).

Credit booms have been often preceded by strong capital flows, but are not found to have a major impact on inflation. This is partly on account of high trade openness. Domestic demand imbalances in an open economy get reflected in widening trade and current account deficits and an appreciating exchange rate. Therefore, price stability does not prevent a credit boom/bust. Notwithstanding this, the case for pre-emptive monetary tightening to stop credit booms and asset price bubbles remains a matter of debate (see Chapter VIII).

6.20 Bank credit, in particular, plays an important role in developing economies. As a matter of fact, some European countries are even now reluctant to

leave credit entirely to market forces (Krueger, *op cit.*). A distinctive characteristic of developing economies, often justified by the need to conserve scarce

Table 6.1: Credit Aggregates and Future Banking Distress

(Probability that indicator(s) predict a future banking crisis)

| Forecast Horizon (years) | Single Indicators | | | | Combined Indicators | | | | |
|--------------------------|-------------------|----------------|-----------------------|----------------|---------------------|------------------------------------------|-----------------------------------|----------------------------------|------------------------------------------------------------|
| | 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| | | Credit Gap [4] | Equity Price Gap [60] | Output Gap [2] | Money Gap [3] | Credit Gap [4] and Equity Price Gap [60] | Credit Gap [4] and Output Gap [2] | Credit Gap [4] and Money Gap [2] | Credit Gap [4], Equity Price Gap [40] and Output Gap [1.5] |
| 3 | | 80 (0.22) | 47 (0.24) | 53 (0.46) | 53 (0.51) | 47 (0.06) | 53 (0.13) | 60 (0.21) | 27 (0.05) |
| 3-5 | | 80 (0.19) | 73 (0.12) | 73 (0.30) | 60 (0.42) | 73 (0.02) | 73 (0.06) | 60 (0.19) | 60 (0.01) |

Note : 1. Credit and money variables are as ratios to GDP. Equity prices are in real terms.
 2. Figures in square brackets [] are the size of the threshold at which the specified indicator provides lead information on a possible future crisis. These thresholds are the gaps of the specified variable (measures as percentage points) from their *ex ante* recursively calculated Hodrick-Prescott trends. Illustratively, the threshold of 4 for credit indicates that when credit/GDP ratio is four percentage points above its trend, the probability of a crisis three years hence is 80 per cent.
 3. Figures in parentheses are noise/signal ratios.

Source : Borio and Lowe (2004).

resources for socially productive uses, has been the prevalence of credit controls and directed credit programmes often at concessional prices. Five main types of interventions have been used: lending requirements and quotas on banks, refinance schemes, loans at preferential interest rates, credit guarantees and lending by development finance institutions. Such programmes played an important role in the process of financial deepening and growth in the 1950s and 1960s in developing economies. Directed credit, for instance, was one of the ingredients that contributed to Korea's strong export growth. At the same time, the resultant segmentation of markets blunted the process of price discovery and limited the allocative efficiency of financial systems. With the increasing market orientation of monetary policy, direct instruments of monetary control are being progressively phased out in many developing countries. The old paradigm of supply-leading subsidised and targeted lending is being gradually replaced by the new demand-leading programme aimed at improving financial market efficiency (Meyer and Nagarajan, 1999) (Table 6.2).

6.21 In brief, empirical evidence shows that finance and growth are positively correlated. Financial development – both bank-based and market-based systems - contributes to growth. Amongst alternative sources of finance, bank credit plays a critical role in economic growth. Although the importance of bank credit in the conduct of monetary policy waned in some advanced economies during the 1970s and 1980s, subsequent developments have led to a renewed focus on the behaviour of credit conditions

and credit aggregates. While credit conditions are believed to reinforce the traditional interest rate mechanism of monetary transmission, sharp increases in credit aggregates are viewed as containing lead information on a possible banking crisis in the future. Developing economies are progressively moving away from micromanagement of credit towards permitting interest rates a greater role in credit allocation.

II. BANK CREDIT: THE INDIAN EXPERIENCE

6.22 Adequate availability of credit to support investment demand in the economy has been an important objective of monetary policy in India. At the same time, monetary policy had to contend with widening fiscal deficits. The higher borrowing requirements of the Centre as well as the State Governments in an environment of administered interest rate mechanism were essentially met through a phased increase in statutory pre-emptions of banks' deposits. Not only were the banks' lendable resources to be shared between the private sector and the government, the social concerns of society had also to be taken into account. This took the shape of directed lending in the form of priority sector lending targets. Thus, by the early 1980s, an elaborate and arduous system of credit planning was in place. With food credit for procurement operations as the first charge on credit demand, credit planning involved sectoral limits for credit deployment. The broad objective of the credit policy was to meet genuine credit needs for productive purposes without stoking inflation expectations. The focus on credit aggregates

Table 6.2: Credit Allocation: Towards a Market-Based System

| Features | Directed Credit Paradigm | Financial Market Paradigm |
|--------------------------------|------------------------------------------------------------------------------------------|-------------------------------------------------------|
| 1 | 2 | 3 |
| Problem definition | Overcome market imperfections | Lower risks and transaction costs |
| Role of financial markets | Promote new technology Stimulate production Implement State plans Help the Poor | Intermediate resources more efficiently |
| View of users | Borrowers as beneficiaries selected by targeting | Borrowers and depositors as clients choosing products |
| Subsidies | Large subsidies through interest rates and loan default Create subsidy dependence | Few subsidies Create independent institutions |
| Sources of funds | Governments and donors | Mostly voluntary deposits |
| Associated information systems | Designed for donors | Designed for management |
| Sustainability | Largely ignored | A major concern |
| Evaluations | Credit impact on beneficiaries | Performance of financial institutions |

Source : Meyer and Nagarajan (1999).

implied a reduced role for the interest rate as the equilibrating mechanism between demand and supply although interest rate was used as an instrument of cross-subsidisation (RBI, 1999). Increasingly, it came to be realised that such a system hindered efficient allocation of resources [Chakravarty Committee (RBI, 1985); Narasimham Committee (RBI, 1991)]. First, a combination of an administered interest rate regime and directed credit controls prevented proper pricing of resources. Second, most financial intermediaries remained confined to markets relating to their area of operations because of balance sheet restrictions, leading to market segmentation. Finally, there was the problem of missing markets, especially at the shorter end, with caps even on the inter-bank rate.

6.23 From the mid-1980s onwards, steps were, therefore, taken to liberalise the credit delivery system but these gathered momentum only in the 1990s. Selective credit controls have been dispensed with and micro-regulation of credit delivery has been discontinued providing greater freedom to both banks and borrowers. Although directed lending in the form of 'priority sector' remains at 40 per cent of total bank lending, banks have been provided greater flexibility in the changed milieu to meet the priority sector requirements. Notably, advances eligible for priority sector lending have been enlarged and interest rates deregulated, thus making the system far more flexible for priority sector lending. Arrangements requiring banks to form consortia for loans beyond specified credit limits were phased out by 1997.

Credit Delivery System

6.24 Consequent upon the deregulation of interest rates and the significant reduction in the statutory pre-emptions, there was an expectation that enhanced credit flow to the needy would be facilitated. In contrast to these expectations, banks continued to show a marked preference for investments in Government securities. Even as the SLR was brought down from 38.5 per cent in 1992 to 25 per cent by 1997, the credit-deposit ratio of scheduled commercial banks did not witness any increase at all. In fact, the ratio at 53.6 per cent at end-March 2000 was lower than that of 54.4 per cent at end-March 1992. As discussed later, a number of factors such as weak demand and risk aversion by banks explain this phenomenon.

6.25 The micro-management of credit through various regulations during the 1970s and 1980s had eroded the risk appraisal techniques of the banks. Notwithstanding the shift in approach from lending based on credit allocation targets and administered

interest rates to a risk-based system of lending and market-determined interest rates, banks continue to charge interest rates to borrowers by their category - whether agriculture or small scale industry - rather than actual assessment of risks for each borrower. Thus, the need for the banks to improve their credit risk assessment skills has gained importance.

6.26 Development of appropriate credit risk assessment techniques is critical also for the efficacy of monetary transmission. With the shift to indirect instruments of monetary management, monetary policy signals are increasingly transmitted through modulations in short-term interest rates. The monetary transmission mechanism is, thus, now crucially dependent on the impact of changes in policy interest rates, such as the Bank Rate or the reverse repo rate, on banks' deposit and lending rates. An improvement in banks' credit risk assessment techniques will help not only to increase the flow of credit to the commercial sector but should also enhance the efficacy of the transmission mechanism in the economy.

6.27 It is against this backdrop that various measures by the Reserve Bank aimed at reducing the information and transaction costs of lending in order to improve the credit delivery mechanism (issues related to interest rate deregulation are covered in Chapter VII). This analytical discussion is followed by an analysis of recent movements in credit availability to various sectors of the economy in order to assess the efficacy of the policy measures. Finally, the section addresses reasons for banks' continued preference for Government securities, well above the statutory requirements.

Credit to Agriculture

6.28 As a key sector of the Indian economy, agriculture receives priority in the credit delivery mechanism. The Reserve Bank of India Act is unusual among central banks to have specific provision for attention to agricultural credit. Notwithstanding the impressive geographical spread and functional reach, the rural financial institutions at the start of the 1990s were found in a poor shape and characterised by several weaknesses such as decline in productivity and efficiency, erosion of repayment ethics and profitability (Mohan, 2004d). Accordingly, during the 1990s, steps were undertaken to strengthen the rural financial institutions through recapitalisation of select regional rural banks, introduction of prudential accounting norms and provisioning requirements for all rural credit agencies.