WHAT FORM OF FINANCIAL DEVELOPMENT WORKS BEST FOR POOR IN RURAL INDIA?

Atul Mehta[1], Joysankar Bhattacharya[2]
Correspondence: Atul Mehta, Fellow Programme in Management (Economics Area), Indian Institute of Management Indore - 453556 (M.P.) – INDIA. Cell: +91-97133-95666. Email: f11atulm@iimidr.ac.in;

Abstract

This paper examines the direct (microcredit), medium-direct (bank credit), and indirect (through economic growth) effect of financial sector development (FSD) on rural poor in India using state-wise annual data from 1999-00 to 2011-12 (for the years 1999-00, 2004-05, 2009-10, and 2011-12). A dynamic panel data analysis for a sample of 15 major Indian states using the generalized method of moments estimators provides an empirical evidence for the direct (microcredit), medium-direct (bank credit), and indirect (economic growth) effect of FSD on rural poor. The paper proposes that formal financial services by banks are primarily availed by non-poor and urban population and hence acts as a medium-direct channel whereas the semi-formal financial services by microfinance institutions specifically target the rural poor and act as a direct channel to affect the poor. It is the first ever study to use state-wise data on microcredit disbursed under Self-help Group Bank Linkage Programme to assess the direct impact of FSD on rural poor. Our findings suggest that the reduction in poverty seems to be not fully converting into reduction in income inequality between the richest and the poorest 20 percent. While bank credit disproportionately increases the income of the bottom 20 percent and reduces income inequality, microcredit with high chances of doing so, fails. The poorest seem to be the hardest hit victim of access to finance channel with both the channels increasing the income inequality among the poor. The study questions the social banking initiatives of the government in rural areas where more than 80 percent of the poor reside. There is a need for restructuring financial inclusion programmes with a shift in their focus on rural areas and an improved mechanism to target the poor.

Keywords: Financial sector development; Poverty; Inequality; Microcredit; SBLP

JEL classification: G21, O16, O18

---

[1] Fellow Programme in Management (Economics Area), Indian Institute of Management Indore - INDIA
[2] Assistant Professor (Economics Area), Indian Institute of Management Indore - INDIA