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Tracking Financial Inclusion: Rural and Marginalised Perspectives in India

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Abstract

The significance of an inclusive financial system cannot be overstated, particularly in fostering financial development. Recognizing the crucial role of finance in overall development, ensuring universal access becomes imperative. This paper undertakes an assessment of the temporal trajectory of financial inclusion in India, spanning from the 1970s to the present era. The objective is to elucidate the evolution of financial inclusion within the Indian economy, eschewing a comparative analysis with global counterparts. To gauge the extent of financial inclusiveness, metrics such as banking, deposit, and credit penetration serve as the overarching parameters. Through an endogenous determination process employing Principal Component Analysis, the weights assigned to these metrics are derived. The resultant index offers a straightforward and easily computable measure of financial inclusiveness.

Introduction

In scholarly discourse, the intricate relationship between financial development and economic growth has been extensively explored and debated. While conventional economic wisdom posits that a robust financial system is a catalyst for economic prosperity, recent scholarship underscores the imperative of ensuring the inclusivity of financial systems (Gurley and Shaw, 1960). In the Indian context, the watershed moment of 1992 heralded a transformative era of financial liberalization.

This policy shift unleashed a tide of financial development, facilitated by the relaxation of regulatory constraints governing institutional expansion and branch networks, particularly in rural areas (Williamson and Mahar, 1998). Consequently, the pre and post-liberalization epochs offer a fertile ground for evaluating the inclusiveness of India's financial development trajectory, especially when juxtaposed with recent policy interventions and regulatory frameworks.

Amidst the burgeoning landscape of financial institutions and liberalization, it becomes imperative to delve deeper into the inclusivity quotient of the resulting financial development. Inclusive financial systems are heralded for their welfare-enhancing attributes, providing a secure and accessible platform for all segments of society to avail themselves of a myriad of financial products and services (Sarma, 2008).

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Central to this discourse is an exploration of the multifaceted repercussions of financial exclusion. The notion of "financial exclusion" gained traction in 1993, primarily driven by concerns over limited access to banking services due to closures and geographical constraints (Leyshon and Thrift, 1993). Individuals grappling with financial exclusion often find themselves marginalized, wrestling with restricted access to mainstream financial services, which, in turn, exacerbates their financial vulnerabilities (Sinclair, 2001).

Moreover, financial exclusion is intricately intertwined with social exclusion, engendering a complex interplay between economic and social dimensions (Beatriz et al., 2018). Recognizing the multidimensional nature of financial inclusion, regulatory bodies such as the Reserve Bank of India (RBI, 2015) and various committees have endeavored to define it as ensuring access to a comprehensive suite of financial services for vulnerable groups at affordable costs. The Rangarajan Committee (2008) further refines this definition, emphasizing the importance of timely and adequate credit provision to vulnerable groups. Similarly, the RaghuramRajan Committee (2007) expands the scope of financial inclusion to encompass universal access to a wide range of financial services, including banking, insurance, and equity products.

However, existing definitions of financial inclusion primarily focus on access and inputs, neglecting usage and outcomes, and fail to adequately address the diverse needs of firms within the financial ecosystem. Consequently, there exists a pressing need for a comprehensive evaluation mechanism to measure the extent of financial inclusion in the economy over time.

Such a mechanism should not only assess access and inputs but also consider the suitability of financial products and services and their impact on end-users. By addressing these shortcomings, policymakers and stakeholders can gain a more nuanced understanding of financial inclusion dynamics and formulate targeted interventions to enhance inclusivity in the financial landscape.

Furthermore, this paper aims to contribute to the discourse on financial inclusion by proposing a novel index that incorporates usage and outcome-based indicators, thereby providing a more holistic assessment of inclusivity. Drawing on original research findings and empirical data, we seek to offer insights into the efficacy of current measures and identify areas for further intervention. Through our comprehensive approach and robust methodology, we aim to advance the understanding of financial inclusion dynamics in the Indian context and contribute meaningfully to efforts aimed at fostering a more inclusive financial landscape.

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Literature Review

India's history of financial inclusion

Financial inclusion in India traces back to significant milestones in its economic history, notably the nationalization of life insurance companies in 1956, followed by the nationalization of banks in 1969 and 1980. To comprehensively understand the evolution of financial inclusion, we delineate it into three distinct phases and scrutinize each phase in detail.

In the initial phase, spanning from the 1950s to the nationalization of commercial banks, the focus of commercial banks primarily centered on the private corporate sector. Although cooperative banks were established for agricultural financing, they remained in a nascent stage, with commercial banks exhibiting reluctance to finance agriculture and allied sectors (Rao, 2007).

The second phase, spanning from 1969 to the period preceding liberalization in 1991, witnessed a paradigm shift with the advent of social objectives in banking. The concept of the "weaker section" gained prominence, leading to mandatory priority sector lending, constituting 40% of aggregate bank advances. The establishment of the Lead Bank scheme in 1969 further underscored efforts towards inclusive banking, with designated banks tasked with coordinating credit activities within their respective districts (Das, 2002).

Commercial banks emerged as primary providers of funds to the priority sector, particularly in agriculture and allied activities. Additionally, the creation of Regional Rural Banks aimed to bolster rural credit accessibility, particularly for small and marginal farmers.

The third phase, spanning from post-liberalization in 1991 to 2005, witnessed a shift towards financial institution reforms, emphasizing efficiency and profitability. Banks gravitated towards risk-averse strategies, heavily investing in government securities and displaying caution in lending to the priority sector. Consequently, there was a gradual decline in credit to the priority sector over time (Rao, 2007).

This period also saw the emergence of Micro Finance Institutions (MFIs) and initiatives such as Self Help Groups (SHGs) and Kisan Credit Cards to augment credit support for farmers. Statutory liquidity ratio (SLR) and Cash Reserve Ratio (CRR) witnessed a gradual decline to alleviate loan requirements. The fourth phase, commencing from 2005 onwards, witnessed a renewed focus on commercial banks as key drivers of financial inclusion. Financial inclusion gained policy impetus from the RBI, emphasizing the importance of opening bank accounts. The proliferation of private MFIs raised concerns over high-interest rates, prompting regulatory intervention by the RBI.

The launch of the PradhanMantri Jan-DhanYojana in 2014 marked a significant milestone, aiming to provide at least one bank account per household. Subsequently, initiatives such as the National Strategy for Financial Inclusion 2019-24 and the Jan DhanAadhaar Mobile (JAM) trinity further underscored the government's commitment to enhancing financial inclusion (Varghese et al., 2018).

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Literature on Indexing

Financial inclusion indexing has emerged as a crucial tool in assessing the extent and dynamics of financial inclusion within economies. Scholars and policymakers alike have employed various methodologies and frameworks to construct indices that capture the multifaceted nature of financial inclusion.

Sarma (2004) is renowned for her pioneering work on financial inclusion indices, emphasizing dimensions such as banking penetration, availability of bank branches/ATMs per 100 adults, and usage metrics like deposit and credit as a percentage of GDP. This multidimensional approach provides a holistic measure of financial inclusion, offering insights into both access and usage aspects.

In addition to Sarma's work, researchers like Kumar and Mishra (2000) have contributed to the literature by constructing indices that capture regional disparities in financial inclusion. By incorporating demand and supply factors, these indices shed light on variations in financial access across different states and regions within a country.

Gupta et al. (2012) further expanded on this framework by integrating additional dimensions into their index, enhancing its comprehensibility and granularity. This approach enables a more nuanced understanding of the factors driving financial inclusion dynamics, facilitating targeted policy interventions.

International initiatives, such as the Global Findex Core Indicators, have provided valuable insights into financial inclusion progress on a global scale (Kunt et al., 2017). By utilizing indicators such as bank account ownership, savings, borrowing, and insurance, these indices offer a comprehensive assessment of financial inclusion efforts and outcomes across countries.

Region-specific indices, such as CRISIL Inclusix, have focused on relative inclusion metrics tailored to specific geographical contexts (CRISIL, 2015). By incorporating various financial services into a single metric, these indices provide a nuanced understanding of outreach and accessibility at different levels, from districts to national levels.

Despite the progress made in financial inclusion indexing, there remain challenges and limitations that need to be addressed. Methodological issues, data constraints, and the evolving nature of financial markets pose challenges in constructing comprehensive and reliable indices. Moreover, the effectiveness of policy interventions and their impact on financial inclusion outcomes require further scrutiny and evaluation.

Moving forward, there is a need for continued research and innovation in financial inclusion indexing to develop robust frameworks that can accurately capture the complex dynamics of financial inclusion. By leveraging advances in data analytics, technology, and interdisciplinary collaboration, researchers and policymakers can enhance our understanding of financial inclusion and devise effective strategies to promote inclusive and sustainable economic growth.

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Objective and Methodology

The study aims to evaluate the trend of financial inclusion in India from the pre-liberalization era of the 1970s to the present day. By examining the evolution of financial inclusion over this period, the study seeks to provide insights into the progress made by the Indian economy in fostering inclusive financial access. Furthermore, the study aims to critically evaluate the effectiveness of policy measures adopted during this period to promote financial inclusion. It is important to note that the objective of the study is to observe the overall trend of financial inclusion at the national level, rather than conducting a comparative analysis among states or across countries.Thus, the study aims to create a multi-dimensional index, which comprehensively evaluate the temporal progress of financial inclusion in India.

The description of the policy variables used in the index construction are presented below:-
The present study does a time series analysis using data from Basic Statistical Returns, RBI from 1972 till 2018 and constructs index using five parameters which are as follows:
First is the Banking Penetration which is catered by the rural branches to total bank branches in all Scheduled Commercial Banks and is denoted by RBR.
Second is Deposit Penetration which is included in the form of rural deposits to total deposits made in all Scheduled commercial banks and is denoted by RRB.
Third is Credit penetration using three sub parameters which are :-

RRC = Rural credit to total credit dispersed by all Scheduled Commercial Banks

LLAR = Number of accounts where up toRs 25000 amount of credit is provided.

CDR = Credit to Deposit ratio in rural areas

Thus, the parameters chosen focuses on rural areas to get a clear picture of inclusion in true sense.

After selecting the parameters, the next step is to normalize the parameters because they have different units and cannot be aggregated directly to arrive at a composite index. Every parameter is first normalised using the Min-Max method of normalisation.
As the normalised parameter indices are free of units and dimensions, and are easily aggregated. This approach is similar to the one used by United Nations Development Programme (UNDP) for computation of well-known development indices such as the Human Development Index.

After this the principal component analysis is used to construct the index. The composition can be expressed as:
$FII = w_1 RDR + w_2 RBR + w_3 RCR + w_4 LLAR + w_5 CDR$

Where the weights “w” is obtained from the principal component analysis.
Thus, the weights of each component is given by the eigenvector of the selected principal component

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Principal components/correlation                  Number of obs    =        47
                                                  Number of comp.  =         5
                                                  Trace            =         5
    Rotation: (unrotated = principal)             Rho              =    1.0000
```

Component	Eigenvalue	Difference	Proportion	Cumulative
Comp1	3.59418	2.51811	0.7188	0.7188
Comp2	1.07606	.82771	0.2152	0.9340
Comp3	.248354	.18068	0.0497	0.9837
Comp4	.0676746	.0539453	0.0135	0.9973
Comp5	.0137293	.	0.0027	1.0000

Taking the first principal component which accounts for 71% of the total variance in the five policy variables

Variables	PCA-I
RDR	0.508
RCR	0.5029
RBR	0.5116
LLAR	0.4735
CDR	-0.0477

Now substituting the respective Eigen values for Wi in the equation we get:

FII = 0.508 RDR + 0.5029 RCR + 0.5116 RBR + 0.4735 LLAR + (-0.0477) CDR

Here the values for RDR, RCR, RBR, LLAR and CDR are multiplied by their respective weights and financial inclusion index for each year is derived by summing the calculated values for all the five parameters.

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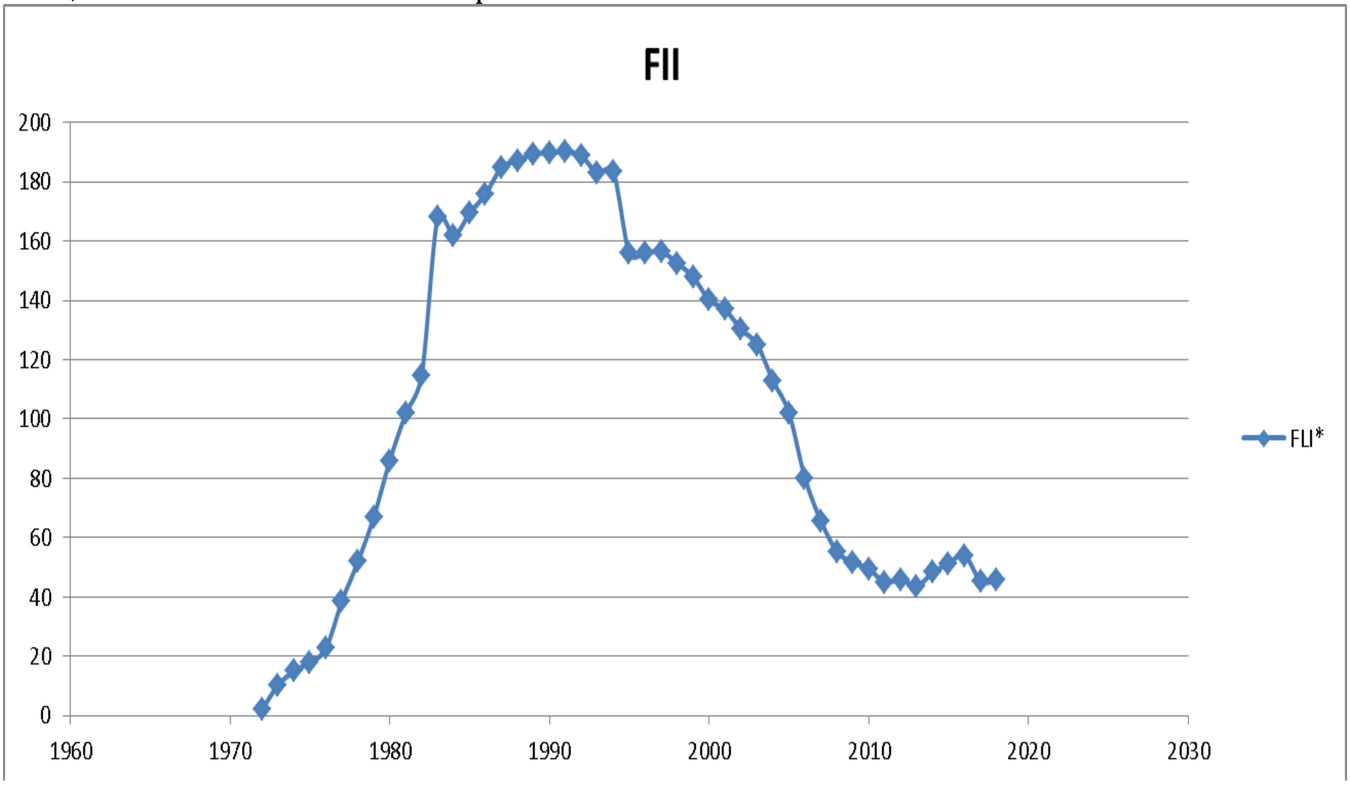
Results:

Thus, the financial inclusion index plotted over time comes like this



The FII trend shows a positive and rampant upward movement from 1970s to 1990s then a gradual horizontal movement during the 1990s and then a slow decline happens in early 2000s and finally reaching quite low levels post 2010 onwards in comparison to the level reached in the pre-liberalization time period.

Such a trendline indicates that for the low-income marginalised sections and rural groups in particular have felt a setback post mid 1980s. With the onset of liberalisation measures the inclusivity of rural areas and low income groups have seen a setback. However the trendline is completely different if we talk about the overall inclusion in the economy.

If we plot the same financial inclusion index by taking the all India parameters for branching, deposit and credit penetration instead of the specific rural India figures as done earlier, then the plot has a throughout upward movement as seen below:

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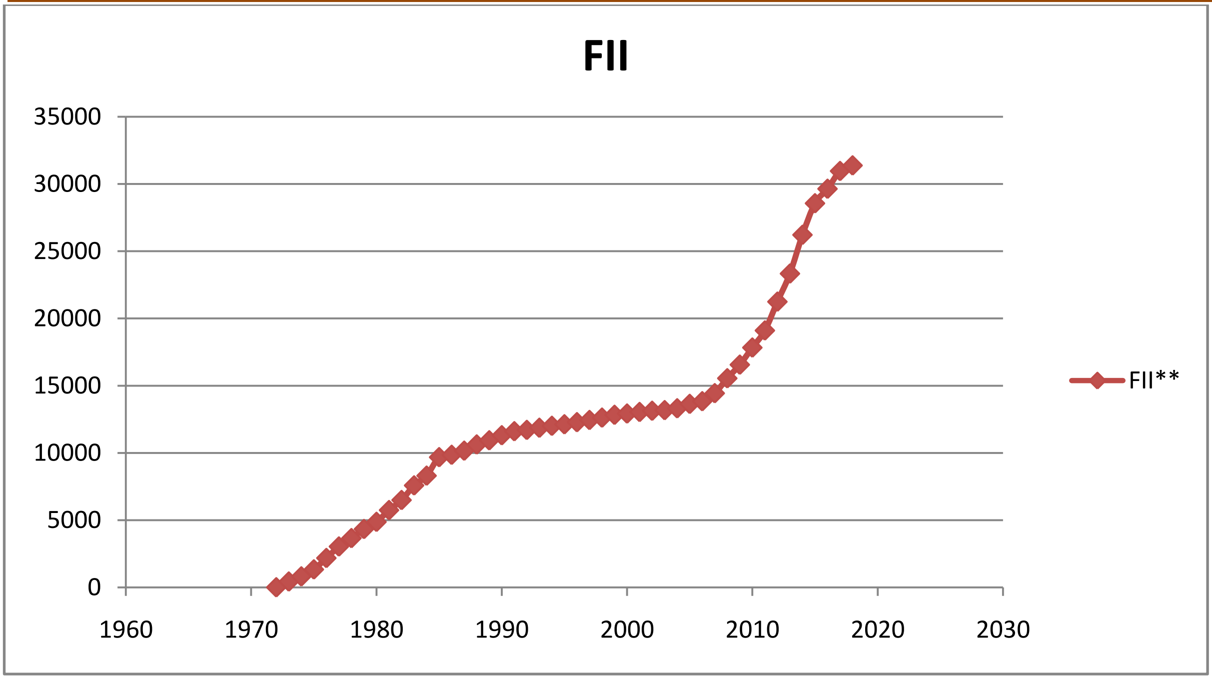

This trendline isn't different from what we have known before that slowly and steadily the Indian economy is getting more and more inclusive. However this paper has brought to light that if we just twist the parameters a little and try to capture the true inclusiveness among the rural and low-income marginalisation then the picture is bleak.

Clearly the changes in the policies like reducing priority sector lending and othermeasures adopted in the pre liberalisation measures were very different from post liberalisation and it drastically changed post 2005 onwards as discussed extensively in the literature review. Over time the focus have shiftedtowards the urban areas so much that the overall trend looks optimistic and makes policy makers contended by simply ignoring the details aboutthe other marginalised groups.

Conclusion:

In conclusion, the analysis of the Financial Inclusion Index (FII) trend illuminates a complex and nuanced narrative of India's journey towards inclusive economic development. The observed pattern of progression and regression over the study period, spanning from the 1970s to the present day, underscores the dynamic interplay of economic policies, institutional reforms, and socio-economic factors shaping the landscape of financial inclusion in the country.

From the outset, the upward trajectory of the FII trend from the 1970s to the 1990s reflects commendable efforts to expand access to banking services and credit facilities, particularly aimed at empowering marginalized and underserved communities. The introduction of cooperative banks, the lead bank scheme, and other targeted initiatives during this period laid

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a strong foundation for inclusive growth, driving positive outcomes in financial access and usage.

However, the subsequent decades witnessed a shifting tide, marked by a plateauing and eventual decline in financial inclusion levels. The liberalization measures of the 1990s, while fostering economic growth and market dynamism, also introduced new challenges and vulnerabilities, particularly for rural areas and low-income groups. The decline in financial inclusion post-2010, especially when contrasted with pre-liberalization levels, raises concerns about the widening gap in access to financial services and opportunities.

Amidst these challenges, it is important to recognize that the overall trend of financial inclusion in the economy portrays a more optimistic picture. The consistent upward trajectory observed when considering broader parameters encompassing all of India reflects the cumulative impact of policy initiatives, technological advancements, and regulatory reforms aimed at fostering a more inclusive financial ecosystem.

Nevertheless, the disparities and setbacks observed among rural and low-income populations underscore the urgency of targeted interventions and inclusive policy measures. Addressing the structural barriers to financial access, enhancing financial literacy and awareness, and fostering innovation in financial service delivery are critical priorities for ensuring equitable and sustainable economic growth.

In this context, the findings of this study emphasize the importance of continued monitoring, evaluation, and adaptation of financial inclusion strategies. By leveraging data-driven insights, evidence-based policymaking, and collaborative partnerships, India can navigate the complexities of financial inclusion and chart a course towards a more inclusive and resilient economic future for all its citizens.

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