ECONOMIC REVIEW

DEC: 1983

RURAL BANKS IN SRI LANKA

COMMODITIES SITUATION CHANGES FOR SRI LANKA

(THE CORRECT DIAGRAM)

Our November 1983 issue indicated the situation, with the following caption, but we inadvertently published the wrong diagram, namely that for July and August 1983. What we intended showing was the December 1983 and January 1984 position, as illustrated below:

For nearly nine years the *Economic Review* has reflected the constant fall in real value of earnings from Sri Lanka's major commodity exports. Tea was a prime example and we have occasionally illustrated the situation through this regular monthly diagram from the journal *"South"*. The situation has changed dramatically for Sri Lanka which broke through the trend followed by the other 13 commodities that have been dealt with in this diagram. As seen below, in January 1984, tea surges ahead of its 1975 position, contrary to the trend of all other commodities.

WHAT COMMODITIES CAN BUY

SOUTH INDICES

This table shows the changes in the purchasing power of commodity exports.
Commodity purchasing power is measured in the following terms:

1. how much oil one tonne of each commodity can buy;
2. the volume of debt service payments one tonne of each commodity can cover in US dollars.

1975 — January 1984 — December 1983

Commodity		Oil (barrels) bought by 1 tonne of commodity	US $ debt interest covered by 1 tonne of commodity
Copper	1975	115.40	17800
	January 1984	47.49	14024
	December 1983	48.95	13959
Lead	1975	38.47	5934
	January 1984	13.66	4033
	December 1983	13.83	3945
Tin	1975	640.91	98857
	January 1984	421.44	124459
	December 1983	431.83	123139
Zinc	1975	69.56	10730
	January 1984	32.96	9735
	December 1983	29.40	8383
Cocoa	1975	147.70	23104
	January 1984	93.73	27680
	December 1983	88.38	25202
Coffee	1975	289	44561
	January 1984	105.01	31010
	December 1983	106.56	30385
Cotton	1975	119	18392
	January 1984	57.32	16929
	December 1983	58.51	16684
Aluminium	1975	73	11326
	January 1984	53.50	15799
	December 1983	53.33	15209
Rubber	1975	62	9657
	January 1984	42.35	12505
	December 1983	41.86	11937
Soya bean	1975	19	2866
	January 1984	9.61	2837
	December 1983	9.86	2812
Sugar	1975	41.89	6462
	January 1984	5.28	1560
	December 1983	6.12	1744
Maize	1975	10.61	1749
	January 1984	4.06	1199
	December 1983	4.09	1168
Jute	1975	35	5338
	January 1984	14.05	4150
	December 1983	13.08	3729
Tea	1975	129	19948
	January 1984	149.39	44116
	December 1983	124.35	35458

SOUTH MARCH 1984

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COVER

RURAL CREDIT: THE OLD AND THE NEW

Our cover picture shows customers at a rural bank; with inset a representation of the informal credit supplier - the village boutique - the rural banks helped replace.

Designed by Palitha Kannangara

THE ECONOMIC REVIEW is intended to promote knowledge of and interest in the economy and economic development process by a many sided presentation of views & reportage, facts and debate.

THE ECONOMIC REVIEW is a community service project of the People's Bank. Its contents, however, are the result of editorial considerations only and do not necessarily reflect Bank policies or the official viewpoint. Signed feature articles also are the personal views of the authors and do not represent the institutions to which they are attached. Similar contributions as well as comments and viewpoints are welcome.

THE ECONOMIC REVIEW is published monthly and is available both on subscription and on direct sale.

DIARY OF EVENTS

Dec.

1 The restriction on commercial bank advances imposed by the Central Bank with effect from November 1, 1983 was withdrawn. However, in view of the need for continuing the credit restraint on commercial bank advances, the statutory reserve requirements were raised from 14 percent to 16 percent per annum on demand deposits and from 6 percent to 8 percent per annum on time and savings deposits. In addition for the first time in Sri Lanka, a reserve ratio of 16 percent per annum on unused overdraft balances was imposed with effect from December 16, 1983.

Government decided that no export of fresh nuts should be permitted in December and restrictions on the sale of kurumba should be imposed, in a bid to tackle the problem of high prices of coconuts.

Both inland and foreign postal rates were increased. Some of the major changes are: Inland letters from 50 cts. to 60 cts. per every 30 grammes or part thereof; and Registration fee from Rs. 2/00 to Rs. 4/00; Aerogrammes from Rs. 3/50 to Rs. 5/00.

11 An agreement for the extension of the Voice of America (VOA) Agreement which provides for the updating of the existing Relay Station in Sri Lanka with modern equipment covering a wider area of broadcast in the region, was signed in Colombo.

12 An agreement was signed between the Governments of the United States of America and Sri Lanka providing for a loan of US$ 25.0 million(approximately Rs. 615 million) for the purchase of approximately 150,000 metric tons of wheat under the Financial Year 1984 PL 480 Title I Programme.

Ministers of the Organization of Petroleum Exporting Countries ended a three-day meeting in Geneva, agreeing to keep oil prices and output levels unchanged.

14 A big US Company, Kellwood International, had completed a deal to buy up LMK (Ceylon) Ltd., considered one of the more successful and a pioneer garment industrialist in the Katunayake Investment Promotion Zone (KIPZ), according to a press announcement.

15 A Swedish aid mission which signed a Rs. 1,530 million agreement in Colombo to finance the Kotmale Project expressed its concern about the delays in construction of transmission lines. This delay will cost at least Rs. 25 million a month, the mission told Finance Minister Ronnie de Mel, according to a press report.

19 US Agency for International Development (USAID) has increased its contribution to the H Area of the Mahaweli Project by approximately US$ 25 million from a proposed US $95 million to a projected 120 million, according to a report from New York.

21 Malaysia crude palm oil was traded at a record high price of 1,600 Ringgit per tonne against an average price of about 1,300 Ringgit a tonne earlier in the month. Dealers attributed the surge in the price to the tight supply situation for all vegetable oils in the market.

22 Indian customs have seized Rs. 138.9 million worth of contraband that was being smuggled out of Sri Lanka into India during 1983, India's revenue intelligence chief M.L. Wadhawan has revealed. Smugglers concentrated on electronics, synthetic fabrics, zip fastners and watches. Detections of the contraband flow, including textiles, beedi leaves and opium, moving in the other direction to Sri Lanka was valued at Rs. 6.3 million.

23 The Department of Private Omnibus Services commenced functioning. The main objective of this Department is to ensure better control and administration of private buses. The functions of the Department include the supervision, issue of route permits and operational control of private omnibuses.

24 The Indian Government announced a ban on the export of CTC (cut, tear and curled) teas, until further notice. This step was taken mainly to control the unprecedented rise in prices of tea in the domestic market. This move was expected to have a decidedly favourable impact on prices at the Colombo auctions.

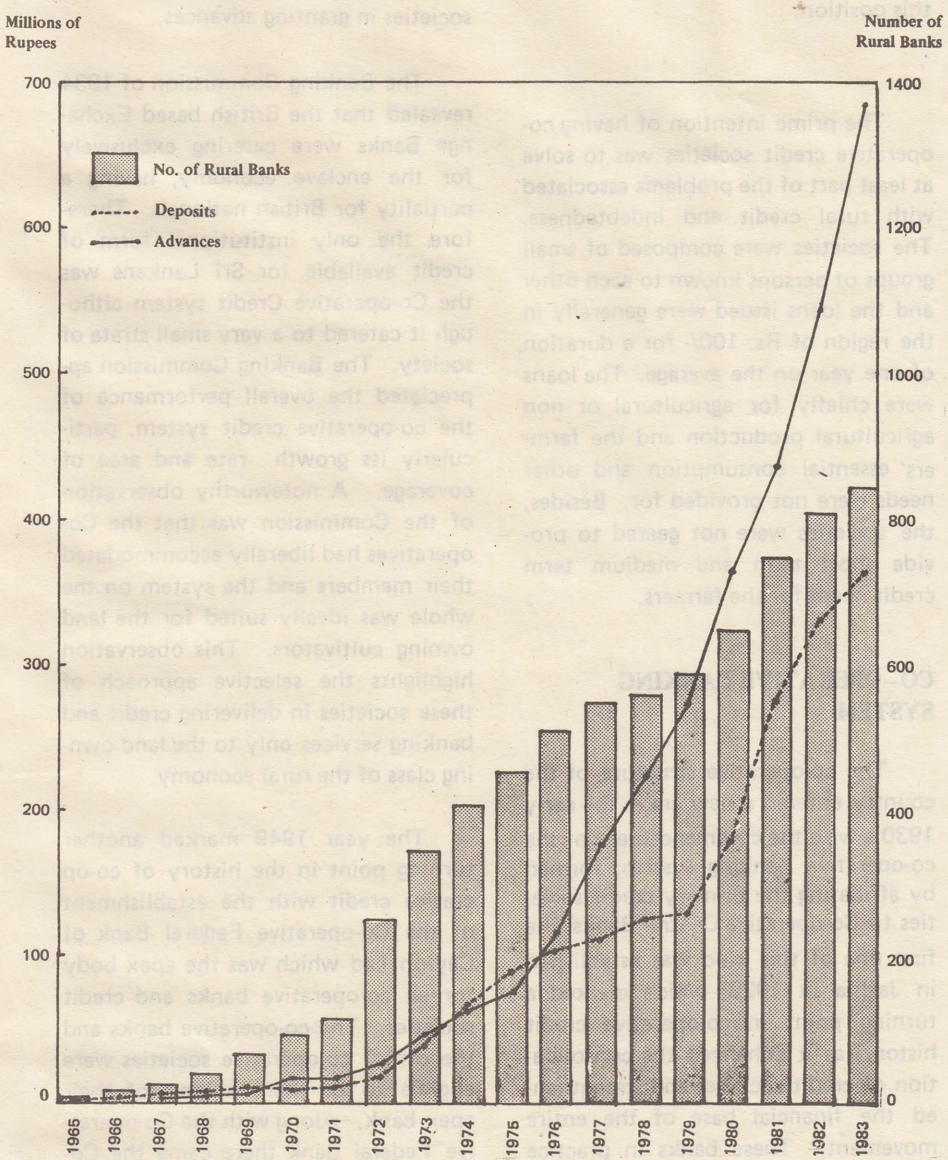
The Ministry of State has decided to limit expatriate salaries in five star and other hotels and has specified a ceiling of Rs. 25,000 monthly (US $ 1,000) on all new contracts, according to press reports.

25 The International Monetary Fund (IMF) mission which was in Sri Lanka at the beginning of December has not been satisfied with Sri Lanka's performance, under the standby agreement which the Government signed with the IMF in August, states a *Sunday Observer* report. Under this agreement Sri Lanka was to get SDR 100 million from the IMF in two tranches. The first tranche of SDR 50 million had been drawn and the second tranche of SDR 50 million will be available to Sri Lanka only if the mission is satisfied that the Sri Lanka Government has fulfilled the performance targets specified in the agreement.

30 Signs of a long awaited upturn in economic activity in the European Community were reported by the delegation of the Commission of the European Communities for South Asia. For the calendar year 1983, the Community's Gross Domestic Product (GDP) is estimated to have risen 0.9 percent in real terms; the rate of inflation declined in all member states, averaging 6.2 percent and the deficit on current account in its balance of payments contracted to 0.1 percent of GDP. The forecast for 1984 was more encouraging, according to the statistical section of the European Commission, which predicted GDP growth of 2 percent, an inflation rate of 5.2 percent; and a marginal surplus (equal to 0.3% of GDP) in the current account.

31 At the end of December 1983 the Wholesale Price Index maintained by the Central Bank of Ceylon had reached 415.1 (for all items) as against 291.5 at the end of December 1982.

GROWTH OF RURAL BANKS AND THEIR DEPOSITS AND ADVANCES



RURAL BANKS

IN SRI LANKA

Rural Banks in Sri Lanka mark their 20th anniversary of operations in March this year. In the last two decades, and especially since the re-organisation of the Co-operative sector in 1972, the Rural Banks have grown rapidly. This special report describes the history of the Rural Banks, their growth, as well as the degree to which they have achieved their stated purpose of mobilising rural resources for development.

CO-OPERATIVE CREDIT BEFORE 1964

The history of co-operative credit societies extends as far back as 1906, in which year the first co-operative credit society was established in Dumbara in the Central province. This was followed by another important step of the colonial government, namely, the appointment of an Agricultural Banking Committee in 1909, which highlighted the gravity of the problem of rural indebtedness in the traditional sector as against the enclave sector of the economy. The committee further advocated the establishment of Co-operative Credit Societies, which would enable the small farmer to borrow at a reasonable rate of interest for his agricultural needs while offering him an inducement to invest money in his lands,in manure,in providing agricultural machinery etc.,all of which could bring the farmer a return more than commensurate with expenditure he incurred. Consequently the Co-operative Societies Ordinance was enacted in 1911, and this is considered the beginning of organised credit for small farmers in the traditional sector of the economy.

The first Co-operative Credit Society, registered under this Ordinance, was an unlimited liability society modelled on Raiffeisan lines where members were individually and jointly liable for the debts of the society.

Credit societies of limited liability and Co-operative Thrift and Savings Societies were two other types of Co-operatives founded in the early period. However, these two types had a considerable urban-middle class bias both in their outlook and formation. Even the credit societies of limited liability were of numerous types although they had a fundamental advantage of having an explicit rural-small farmer orientation.

In later years there was a trend for the co-operative thrift and savings societies of public servants to be transformed into societies of limited liability so that they could expand their loan business by removing the restriction of loans to a percentage of the savings held.

CO-OPERATIVE CREDIT SOCIETIES

In the early decades co-operative credit societies of unlimited liability were the most numerous type and they catered to the rural population. Apart from introducing organised credit for the first time to the farmer, they also signalled the entry of a new institution to encourage thrift and savings at the Village level. Up to that time the only institutions available to the small saver were offices of the Post Office Savings Bank.

In the years following 1930 and upto the 1950s these credit co-operatives continued to increase in number, membership, shares, deposits, resources and assets. It was observed of the credit societies of the unlimited liability type that throughout their active life-span of over forty years they embodied in a very real sense the basic co-operative philosophyofself help and mutual help. It is unrealistic to expect a comprehensive coverage of credit by these societies, based on their own funds, owing to the impoverished nature of the rural economy. Therefore, funds were drawn from external sources, such as the state owned 'Local Loans and Development Fund', to meet short term liquidity problems. It should, however, be noted that the resources of the Co-operative Societies that came in the form of share capital, deposits and resources consistently supported a substantial proportion of their own lendings. The figures on the percentage share capital and member deposits to total loan outstanding between 1953 and 1967 illustrate this position.

The prime intention of having co-operative credit societies was to solve at least part of the problems associated with rural credit and indebtedness. The societies were composed of small groups of persons known to each other and the loans issued were generally in the region of Rs. 100/- for a duration of one year on the average. The loans were chiefly for agricultural or non agricultural production and the farmers' essential consumption and other needs were not provided for. Besides, the societies were not geared to provide short term and medium term credit needs for the farmers.

CO–OPERATIVE BANKING SYSTEM

The co-operative structure of the country entered a new era in the early 1930's with the commencement of the co-operative banking system, formed by affiliating the primary credit societies to Co-operative Central Banks.The first one of this kind was established in Jaffna in 1929; which marked a turning point in co-operative credit history, as it enhanced the consolidation of credit societies and strengthened the financial base of the entire movement. These banks in practice accepted time and savings deposits both from co-operatives and the public although demand deposits were accepted only from the co-operatives. In the meantime their credit lines indicated a conscious bias towards credit societies in granting advances.

The Banking Commission of 1934 revealed that the British based Exchange Banks were catering exclusively for the enclave economy, having a partiality for British nationals. Therefore the only institutional form of credit available for Sri Lankans was the Co-operative Credit system although it catered to a very small strata of society. The Banking Commission appreciated the overall performance of the co-operative credit system, particularly its growth rate and area of coverage. A noteworthy observation of the Commission was that the Co-operatives had liberally accommodated their members and the system on the whole was ideally suited for the land owning cultivators. This observation highlights the selective approach of these societies in delivering credit and banking services only to the land owning class of the rural economy.

The year 1949 marked another turning point in the history of co-operative credit with the establishment of the Co-operative Federal Bank of Ceylon Ltd which was the apex body for all co-operative banks and credit societies. The co-operative banks and the other co-operative societies were eligible to be share holders of their apex bank. Along with the Co-operative Federal Bank there came the Co-operative Agricultural Production and Sales Societies (CAPS) which were basically a state creation rather than a spontaneous co-operative development.

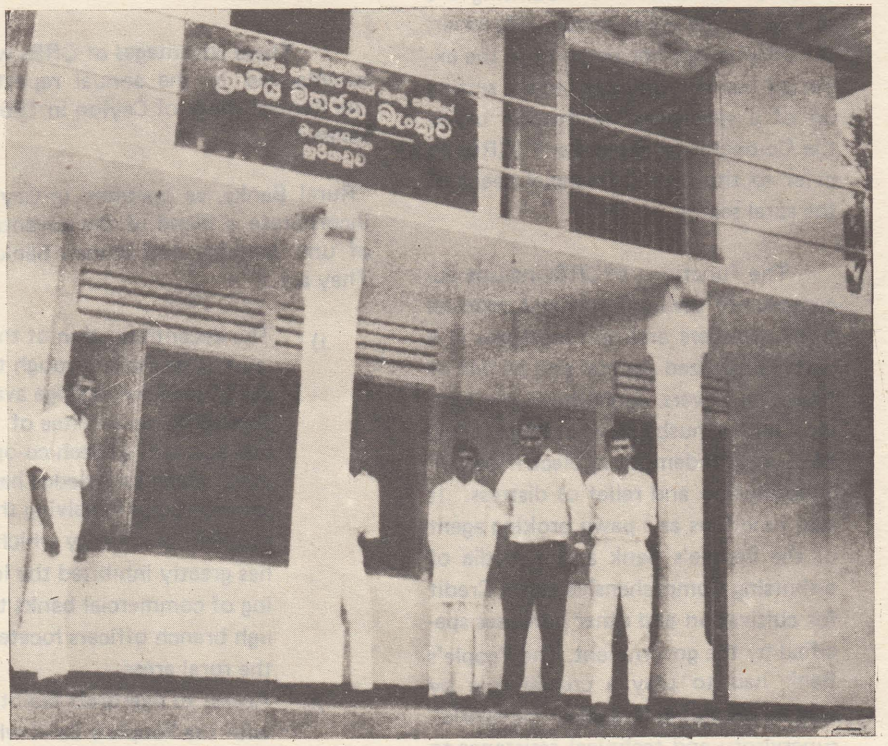
A prime responsibility of this organization was to act as a commission agent of the government for purchase of commodities coming under the guaranteed price scheme (GPS). Besides functioning as marketing agencies these societies were also used by government as a medium for channelling loans to farmers for cultivation. Des-

Years	Total Loans Outstanding Amount Rs. '000	Share Capital (Members Deposits)	Percentage of Share Capital and Members Deposits to Total Loans Outstanding
1953-57	38,250	18,332	47.92
1958-62	50,513	28,864	56.15
1963-67	50,923	30,521	59.93

pite the very ambitious programmes drawn up the CAP Societies too succeeded in reaching only a limited segment of the small farmer population. Another drawback was that the classical co-operative concepts of mutual help and self-reliance were hardly evident in the new CAP Societies.

On the basis of the findings of the survey on 'Rural Indebtedness in Ceylon' 1957, the Co-operative structure was organised by establishing an islandwide network of Multi-Purpose Co-operative Society's (MPCS) with the object of promoting inter alia rural credit on a comprehensive basis. An established view at this time was that the multipurpose form of society where credit, marketing, provision of consumer goods and other services were combined was superior to the single purpose form of co-operative. The scheme was a multi objective one, where the MPCS's were expected to operate as a village bank providing credit, mobilising savings, and playing a catalytic role in stimulating the overall development of the village.

The objectives of the MPCS movement were laudable, although in practice the then-existing co-operative banking structure, representing the apex Co-operative Federal Bank on the one hand and the Provincial and District Co-operative banks on the other, was ill-equipped to meet the increasing financial commitments of the new structure. The self-imposed restriction arising out of the insufficient financial base, and the limits created by the unit banking approach appeared to be counter productive in the context of increasingly high financial requirements. Thus, setting up of a specialized bank possessing the much needed structural strength to supply the co-operative movement with adequate finance and absorb the risks became a dire need in this period. In 1961 the People's Bank was established to fulfill this need and the objectives of this new bank, as spelt out in the People's Bank Act, were as follows "The purpose of the Bank shall be to develop the Co-operative Movement of Ceylon, Rural Banking and Agricultural Credit by furnishing financial and other assistance to co-operative societies, cultivation committees and other persons"



Bank officials at the opening of the first Rural Bank at Manikhinna in the Kandy District, on March 26, 1964.

It was envisaged that it would acquire the necessary structural strength by providing it

(1) Government participation in the share capital
(2) Provision to engage in all aspects of commercial banking
(3) Provision to establish a branch network
(4) Statutory requirement that all co-operatives should bank with the new bank so that the limited resources of the movement could be concentrated in one financial institution.

Accordingly all the 17 Co-operative Provincial and District Banks merged with the newly established People's Bank. Thus capital of the People's Bank was owned equally by the government and the co-operatives.

The People's Bank in a very short period of its operation realized the high cost of extending 'banking and agricultural credit' to remote rural areas particularly where there was limited banking business. The difficulties involved in servicing loans, of a small size to a large number of small farmers on a direct banker-borrower basis, compelled the bank to channel credit through the co-operative network. However, the year 1963 witnessed the introduction of a People's Bank sponsored Extended Credit scheme which provided credit through the multipurpose co-operative network. This network was composed of over 14,858 co-operative societies by the end of 1964, which made it the prime source of institutional credit to the rural sector.

The Extended Rural Credit Scheme, introduced by the People's Bank in 1963, is considered the forerunner of the Co-operative Rural Banks. So much so that the new scheme was intended to be an effective vehicle to eliminate the discrepencies created by the middlemen and money lenders, while at the sametime mobilising the savings in the rural sector. However, the scheme did not perform in the expected manner which led to the setting up of a specialised institution called the Co-operative Rural Bank (CRB) to cater to the overall financial needs of the rural sector.

The functions of CRBs include acceptance of savings and fixed deposits from members and non members in a better organized manner and its line of financing covers agricultural production, animal husbandry, cottage industries, debt redemption, electrification, consumption and relief of distress. It also functions as a pawn broking agent of the People's Bank and a media of disbursing Comprehensive Rural Credit for cultivation and other purposes specified by the government. The People's Bank had to play a crucial role by way of providing financial, managerial, supervisory and technical assistance to enable the rural banks to overcome their shortcomings, and function as viable-self sufficient units. The People's Bank in turn gains knowledge of conditions in the rural areas which helps to build up effective contact with the rural clientale. The functions of CRB may be summarized as follows:

(1) Mobilization of deposits from members and non-members
(2) Provision of loans and other accommodation to members for production and consumption purposes.
(3) Provision of pawn-broking facilities to members and non-members
(4) Provision of money payment and transfer

The CRBs operating in a limited area have the advantage of intimate knowledge of the local individuals. This has significance in a situation where there is difficulty in finding conventional forms of security to satisfy the procedurial needs of the lending institutions, contributing to the perpetuation of poverty and indebtedness.

These advantages of CRBs were summarized in the annual report of the Central Bank of Ceylon in 1965 as follows:

"Rural Banks, as operated in Ceylon, incorporate a blend of the advantages of unit banking and branch banking. They are :

i) The decentralization of the lending decision through the use of local knowledge available to the committee of management of each co-operative. Such knowledge has proved useful in solving the problem of security which has greatly inhibited the lending of commercial banks through branch officers located in the rural areas.
ii) Access to overdraft facilities with the People's Bank which mobilizes resources from surplus areas through the system of branches.
iii) The lower cost of operation made possible by the economies resulting from the minimising of centralised management and also by the local recruitment of staff.

At the time of setting up of the Rural Banks it was clear that the very nature of the rural economy provided the basis for the establishment of banks of this type. The bearing of economy on these was well analysed in a paper by two economists of the Central Bank who showed that the rural economy was almost entirely dependent on agricultural activity and was characterised by income flows only at harvest times while expenditure for production and consumption needed to be fairly continuous and regular. At harvest time the surplus of funds over immediate needs could be mobilised for use in other areas where the production-consumption cycle is at a different stage. Such mobilization of funds and their transmission to deficit areas is of mutual benefit to both savers and borrowers. The link between the rural banks and the People's Bank enables this type of mobilization and transmission of funds. Funds in a rural bank area may also be utilized within the area itself in the deficit sector

However, the mobilization and use of funds within a 'rural bank sector' may be limited by the low level of income in the area. In such circumstances, it is necessary to provide these deficit areas with supplementary resources, mobilized elsewhere in the more developed and prosperous sectors of the economy. Here again, the rural bank's link with the overall resources of the People's Bank provided a means of credit to deficit areas.

The period 1964 to 1972 should be considered largely an experimental phase in the evolution of rural banks. The period after 1972, coinciding with the re-organisation of the Co-operative Societies, saw a period of rapid expansion of the Rural Banks. In the period 1964 to 1972 there were only a few Rural Banks in selected Co-operative Societies. The expansion was then relatively slow, as seen from the following statistics in table 1. An important aspect of lending policy during this period was that loans were restricted to purposes other than paddy production. (Also see figure I).

A period of increased growth emerges after the re-organisation of the Multi Purpose Co-operative Societies in 1972. In this reorganisation, a large number of small and uneconomic Multi Purpose Co-operative Societies were brought together to form larger units. The idea was to reduce the number of societies and increase the standard of management. Each such

THE ROLE OF RURAL BANKS

A characteristic of agricultural activity is the periodic failure of crops. The availability of credit from rural banks at reasonable rates of interest could minimize hardships at such times and redeem farmers from indebtedness caused by such calamities. In fact a significant proportion of the funds lent by rural banks has been for debt redemption. The release of farmers from high-interest lenders could relieve farmers of chronic indebtedness. This often reduces the profitability of agricultural production owing to both, the increase in production costs and reduced prices due, to the commitment of produce to lenders at below market prices.

For several reasons a rural bank is in a better position to perform the lending functions in a rural area than a branch of a commercial bank. A rural bank operates in a limited area and therefore, has the advantages of an intimate knowledge of both local conditions and of persons served by the bank. This is particularly significant in a context where the customarily acceptable forms of security are very limited. The continued insistence on these therefore tends to perpetuate conditions of poverty, the fundamental reason for which is the lack of adequate capital. A greater intimate knowledge of the borrower permits a rural bank to give credit on personal security and on the security of guarantors rather than on real assets or colateral.

A rural bank is much less costly to operate than a branch of a commercial bank. The limited operations in a rural bank area necessitates the provisions of banking facilities at lower costs than those of operating a branch bank. In terms solely of the cost of operating a branch bank, rural bank areas may not be served with any commercial bank branches. A rural bank is often housed in the co-operative society building and engages persons on its staff who are paid lower salaries than regular People's Bank staff members. The choice in these area is between limited banking facilities as provided by rural banks or no facilities at all.

From the point of view of the rural clientele the provision of even limited banking facilities by a local and familiar institution may be preferable to a more imposing but less comprehensible type of institution. The personal acquaintance of bank personnel and the operation of the bank at times convenient to the clientele are advantages of particular significance in a context of non-familiarity with institutional savings and credit organisations.

The scheme of rural banks could be looked upon as a means of extending even limited banking and credit facilities to areas whose conditions do not justify the extention of the branch banking system. It is also a means of combining the advantages of a unit banking system such, as personalised knowledge of the clientele and local conditions, with the advantages of a branch banking system, which enables the transfer of resources between different areas and a greater security and stability of funds.

Source: *The role and performance of Co-operative Rural Banks in Sri Lanka 1964-1976. Sumanaratne Kahagalle and Nimal Sanderatne.*

re-organised large Co-operative Society had a Rural Bank. The number of rural banks rose rapidly as a result. By the end of 1973, there were 341 rural banks corresponding to each of the 341 Multi Purpose Banks which were opened in the sub-branches of the Multi Purpose Co-operative Societies or *Pradeshikas*. This resulted in a further expansion of the number of branches as seen in the following Table 2. The decrease in the number of Rural Banks since 1973 was due to that amalgamation of multi-purpose co-operative societies. As a result of this amalgamation, a number of rural banks were converted into special branches. By 1983 the number of

Table 1
Expansion of Rural Banks
(1964 – 1971)

Year	No. of Rural Banks
1964	3
1965	8
1966	13
1967	27
1968	44
1969	68
1970	70
1971	111

rural banks was over 825; a strong contrast to the 112 branches of 1971, before the re-organisation. Table 2 together with figure I, indicates the relatively slow growth upto 1972 and the uniform rapid expansion thereafter. (Table 2).

After the reorganisation the Rural Banks were re-designated Co-operative Rural Banks. A survey conducted by the People's Bank of Co-operative Societies, in the latter part of 1983, to assess the need for any further expansion of branches has revealed that according to the perception of the Co-operative Societies managements over 80 percent of the need for rural banks has already been met.

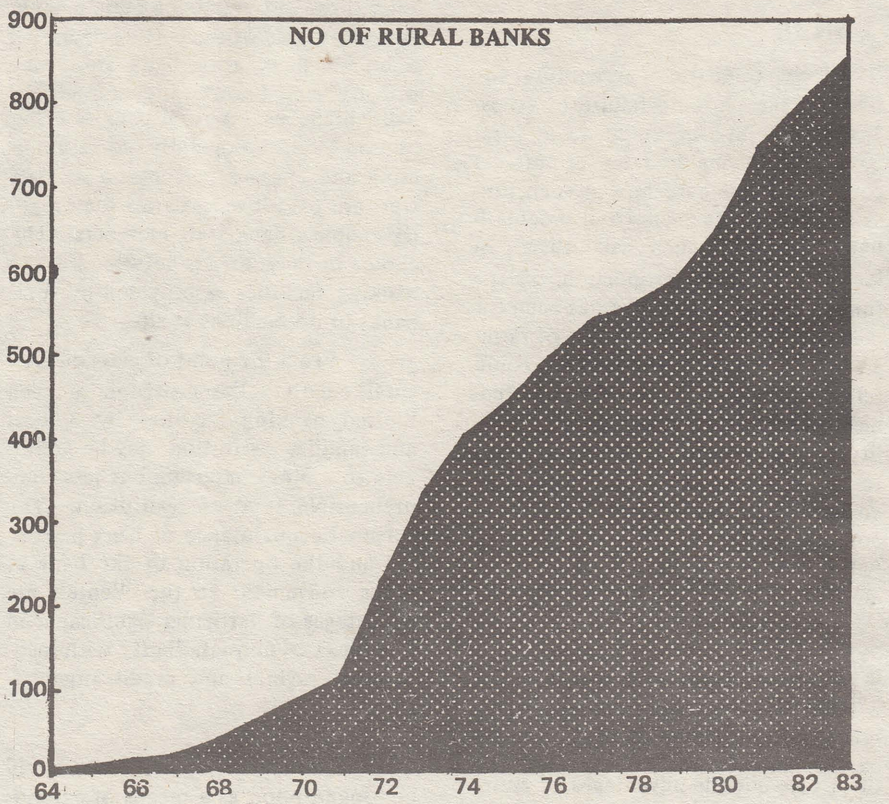
With the increase in the number of branches, there has been a corresponding increase in the number of deposit account holders. A pattern of steady growth from 1964 to 1972 with a rapid growth thereafter, since the re-organisation, is indicated. The growth of deposits also follows the trends described above. Deposits grew at a slow and steady pace upto 1972 when the amount of deposits was Rs. 23 million. However, after 1972 an almost exponential growth is shown in the deposits. In 1976 the deposits stood at Rs. 116 million, in 1980 it was at Rs 334 million. It further increased to Rs. 683 million by the end of 1983.

(See figure on Page 10.)

Table 2
Expansion of Rural Banks
(1972 – 1983)

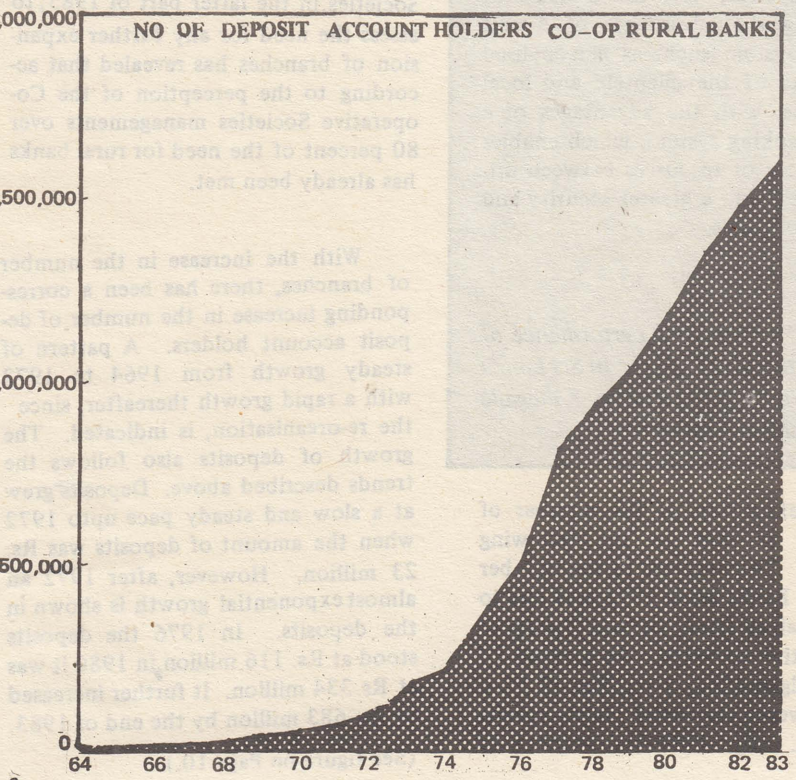
Year	No. of Rural Banks	No. of Special Banks	Total
1972	242	–	242
1973	341		341
1974	332	71	403
1975	338	109	447
1976	345	158	503
1977	285	259	544
1978	284	275	559
1979	284	303	587
1980	284	357	641
1981	284	459	743
1982	286	518	804
1983			840

FIGURE I



Under the rules of the rural banks any member of the public, whether a member of the Multi Purpose Co-operative Society or not, could deposit money in the rural bank. However, they could obtain loans only if they were members. The conditions for membership are liberal. For example, a membership fee of only Rs. 1/- is charged once and for all, a contrast to the situation before the re-organisation, where a membership fee of Rs. 50/- was charged, in effect shutting off large sections of the population. As at 1972 the number of deposit holders stood at 97,000, at 1978 942,000, and in 1983 there were 1,595,000 deposit holders. This dramatically indicates the effectiveness of the reorganisation. (See figure II) A study carried out by the People's in 1978 covering a specific sample, showed that, after 13 years of service, as much as 39 percent of the total membership within the sample area had opened savings accounts in the rural banks which is by no means an insignificant achievement.

Figure II



Those eligible for loans from rural banks are those who are members of the Co-operative Society and those who already have deposit accounts in the rural banks. However, under recent amendments to the rules (in 1983) even non-members with a deposit account with the Bank could withdraw money by pawning articles.

The Recovery Position of Rural Banks in Relation to Short Term Loans by People's Bank Administrative Regions as at 30.9.1983

Region	Short-term Loans	Defaults
Anuradhapura	Rs. 7,835,459/-	Rs. 4,433,050/-
Badulla	Rs.10,410,659/-	Rs. 3,633,162/-
Trincomalee	Rs. 872,907/-	Rs. 208,205/-
Colombo	Rs.11,367,085/-	Rs. 1,822,805/-
Gampha	Rs.19,982,697/-	Rs. 3,847,117/-
Jaffna	Rs. 1,959,939/-	Rs. 769,647/-
Kandy	Rs.11,035,315/-	Rs. 2,727,575/-
Matale	Rs. 3,159,965/-	Rs. 857,400/-
Nuwera Eliya	Rs. 4,699,318/-	Rs. 1,586,638/-
Kurunegala	Rs.23,099,9726-	Rs. 2,024,489/-
Galle	Rs.13,005,097/-	Rs. 1,359,496/-
Matara	Rs. 9,697,467/-	Rs. 950,080/-
Kalutara	Rs. 6,132,248/-	Rs. 1,119,321/-
Kegalle	Rs. 5,998,808/-	Rs. 988,974/-
Ratnapura	Rs. 7,886,241/-	Rs. 1,812,828/-
Total	Rs.137,143,177/-	Rs. 28,140,787/-

Although there has been a dramatic increase in the number of deposit holders since the re-organisation, the same does not seem to have occured as far as loan recipients are concerned. Thus in 1970 the number of persons making use of loan facilities in rural banks stood at 10,000. The corresponding figures for 1972, 1976, 1980, and 1983 are respectively 12,000, 43,000, 59,000, 65,000. This shows a very slow growth in comparison with the growth of the number of branches or with the growth of number of deposit holders. It indicates that the re-organisation has had no effect on the number of loans granted. In contrast to loans, pawn broking activities have increased very significantly in the two years following the re-organisation. In 1972 the number of persons who had pawned articles stood at 61,000 whereas this figure had increased to 235,000 by 1974. Two factors contributed to this increase.

Firstly, the expansion of rural bank branches, and secondly, the higher rate payable for gold which went up from Rs. 250/- to Rs. 500/- per soverign in 1973. However, mid 1970's also saw a rapid rise in prices of gold worldwide but the value of gold was not put up by the rural banks to keep pace with this rise. Consequently, there was a drift away from rural banks to private pawn brokers during this period, as is evidenced by the drop in the number of persons obtaining pawning facilities from 1974 to 1978.

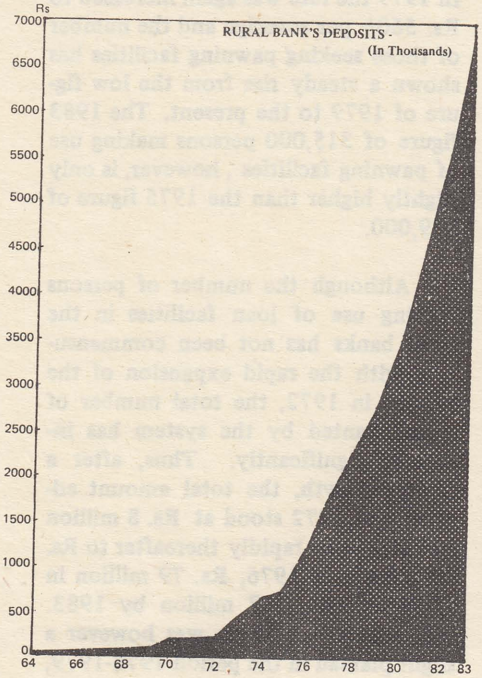
In 1979 the rate was again increased to Rs. 560/- per soverign and the number of those seeking pawning facilities has shown a steady rise from the low figure of 1979 to the present. The 1983 figure of 315,000 persons making use of pawning facilities , however, is only slightly higher than the 1975 figure of 299,000.

Although the number of persons making use of loan facilities in the rural banks has not been commensurate with the rapid expansion of the system in 1972, the total number of loans granted by the system has increased significantly. Thus, after a steady growth, the total amount advanced at 1972 stood at Rs. 8 million and increased rapidly thereafter to Rs. 47 million in 1976, Rs. 79 million in 1980 and Rs. 137 million by 1983. (See figure) There was however a slight plateau in the period 1978-1979, coinciding with the withdrawal of Central Bank's guarantees for such loans.

The statistics indicate that a relatively few people have been making use of loan facilities, while a large number of those eligible have not obtained loans. In other words, the number of advances per person has increased at a faster rate than the number of persons served by the Banks. Detailed follow up studies also indicate other trends in this concentration of loans where there is evidence that sometimes persons close to rural bank decision making have been availing of loans more often than others.

The total volume of pawning advances also shows rapid increase from 1972. In 1970 the total amount of pawning advances which stood at Rs. 2 million and increased to Rs. 54 Million by 1976; they grew very slowly during the period 1976 to 1978 because of low rates paid for gold by the rural banks and increased rapidly after 1978. In 1978, the total amount of advances in pawning stood at Rs. 61 million increasing to Rs. 224 million in 1983. (See figure).

The graph on the growth of deposits and advances in rural banks since its inception also reveals many interesting features. Since of late, the



deposits have been increasing at a more rapid rate than advances. Upto about 1976 the deposits and advances had kept apace, but thereafter the two diverged significantly. The importance of this fact is that savings from the rural sector are not being fed back to the rural sector, but are being channelled elsewhere. The rural banks themselves make their major investments in deposit accounts in the People's Bank and thereafter rural savings find their way into the general financial activities of the People's Bank. The more significant of these activities generally belong to the growth areas of recent times, namely construction, and foreign and internal trade.

Although rural savings are not being mobilised (except in a few cases) within the rural areas themselves. this is not necessarily a bad thing. Most areas can still gain if the benefits from investment of these funds flow back in an indirect way. Rural savings and surpluses from the rural areas have often fed urban development and helped industrialisation in a wide variety of contexts. The industrialisation of the Soviet Union in the 1930's is an example of peasantry contributing to industrialisation.

However if rural savings are being used for activities which, in the long run, are not in the interest of the rural sector and the country, that naturally would be harmful. In a climate where pure market forces prevail, individual rural banks or the People's Bank itself could not be blamed for following strategies which in a sense pump rural savings into other sectors, because it is here that the maximum profits lie. Specially in a climate of competition among banks, profit becomes a priority consideration. Both the People's Bank Act and the by-laws of the Co-operative Department,under which the Rural Banks were formed, implicitly specify that the savings should be channelled to the rural sector itself. The economic climate for such channelling can however be created only by macro-governmental policy measures which will then skew returns of Bank investment towards the rural sector

There are also significant regional variations in utilisation of deposts. The activities of the People's Bank are divided into fifteen regions. The largest amount of deposits from Rural Banks are found in the Gampaha Region (Rs. 133.6 million) with the lowest in Batticaloa Region (Rs. 9.3 million) Similarly the largest advances (Rs. 61.6 million) are found in the Gampaha Region and the lowest in the Jaffna Region. This low figure in Jaffna is explained by the fact that pawning, because of security considerations, has been stopped in rural banks for quite sometime. Gampaha Region has the largest surplus over advances, amounting to Rs. 72 million; whilst Batticaloa Region has the least with advances being higher than deposits. The figure stood at a deficit of Rs. 4.7 million. It should, however, be noted that the quantum of both advances and deposits for Batticaloa Region are much smaller than the more densely populated Gampaha Region. If one were to examine the amount of deposits utilised within the region, we find that Batticaloa Region comes highest with (150 percent) more loans being given out than deposited. On the other-hand, the lowest on this count is Jaffna Region with only 14 percent of that deposited being lent out.

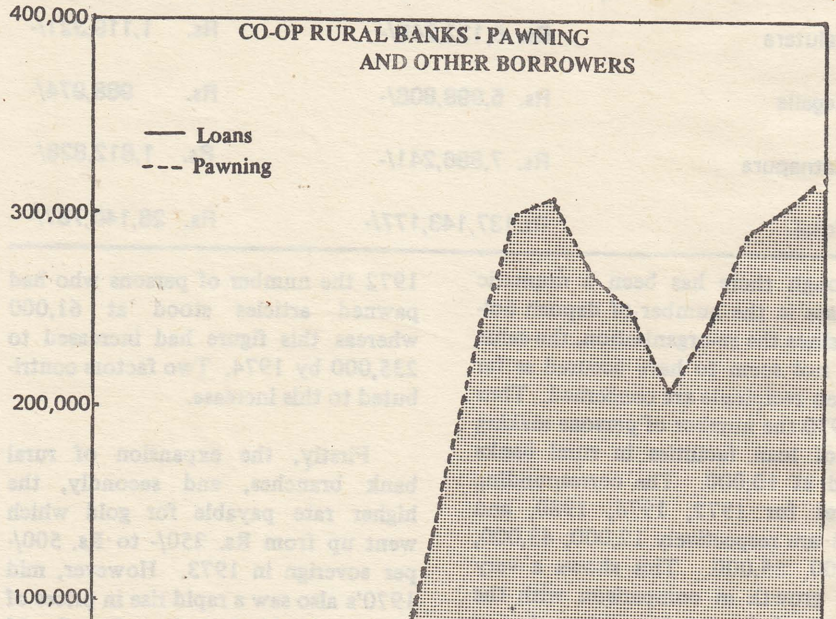
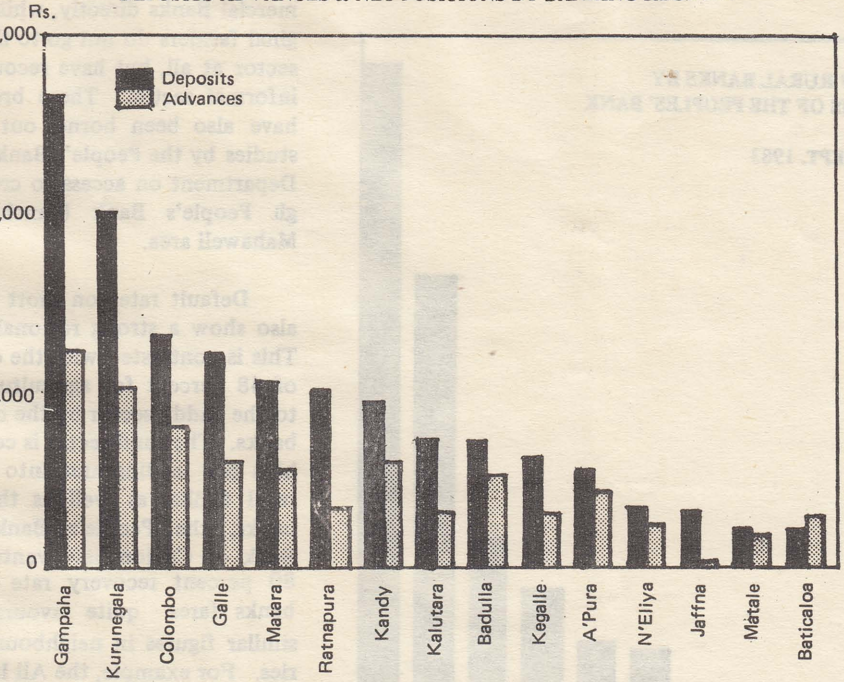


Figure III

DEPOSITS ADVANCES & NET POSITIONS BY BANKING REGIONS



which is about 7 times more than is being deposited in Jaffna Region. It should be noted that the Jaffna Region loan pattern is skewed by the security situation; with pawning being suspended in rural banks. The bar chart on this page illustrates these factors.

However, the concept of a rural to urban pump of financial resources, using only the figures from rural banks would be misleading. The People's Bank and other banks also operate in rural areas. When considering these factors, some of the general observations we have made above may have to be revised; especially as high income farmers tend to deposit more in the People's Bank than in commercial banks. A study by Chandra Fonseka has indicated that although Jaffna scores high on the rural to urban pump in the rural banks, when the People's Bank is included this position was almost reversed. To correct the picture therefore, one has to keep the activities of the commercial banks in mind, which aspect is not being covered in this report. There are no island wide studies which reveal who the major depositors are, and the main loan recipients of the rural banks. A few case studies conducted by the People's Bank, Research Department on certain selected areas however indicate inter-

FIGURE IV

LOANS GRANTED BY THE CO-OP RURAL BANKS - (In Rs. 1000's)

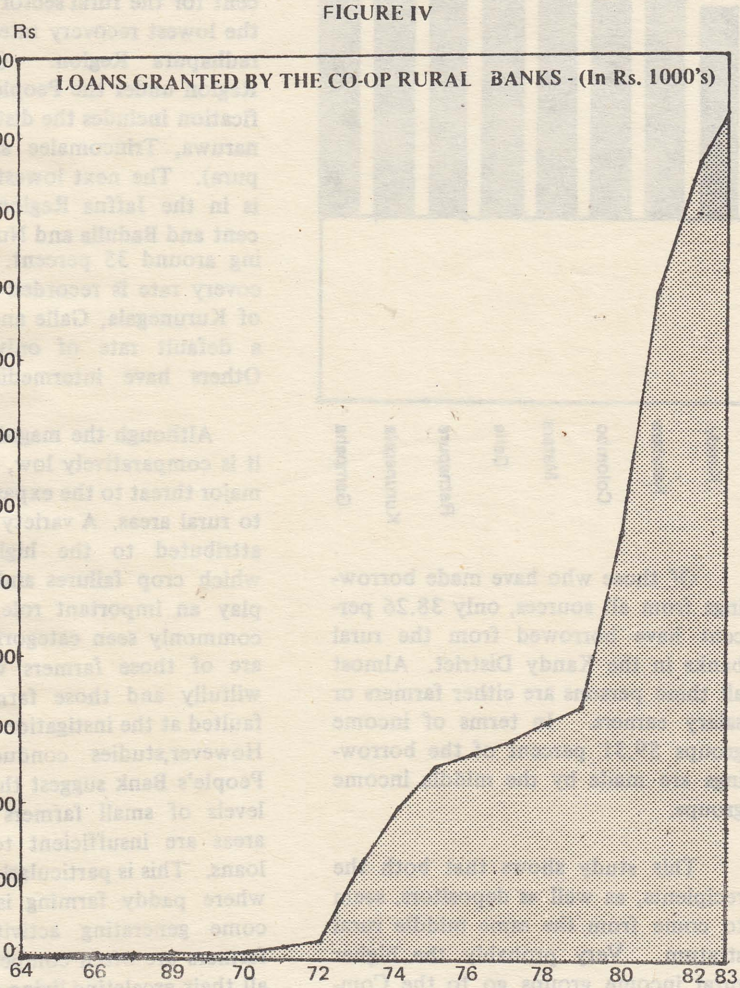
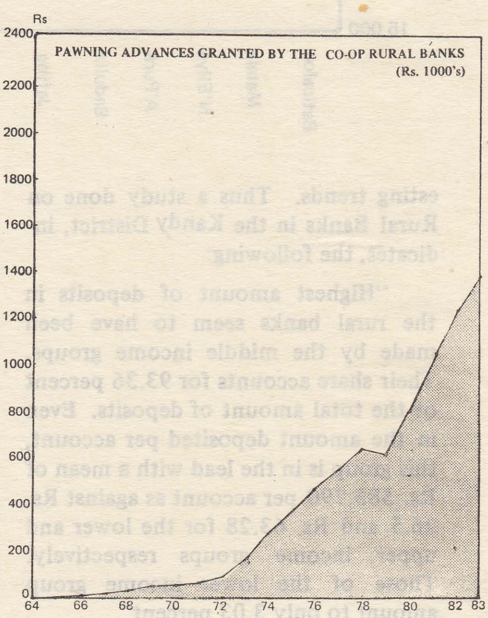
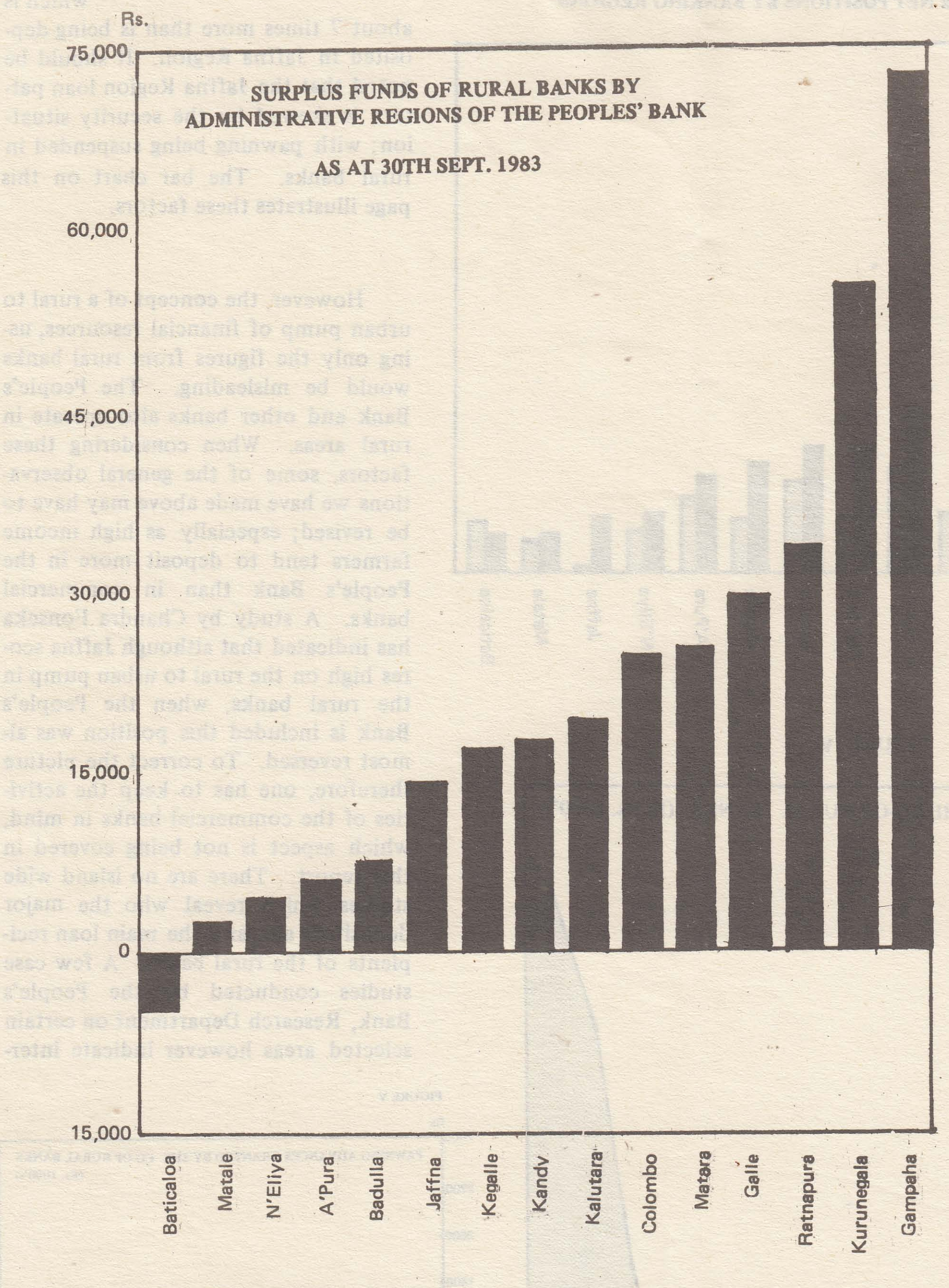


FIGURE V

PAWNING ADVANCES GRANTED BY THE CO-OP RURAL BANKS (Rs. 1000's)





SURPLUS FUNDS OF RURAL BANKS BY ADMINISTRATIVE REGIONS OF THE PEOPLES' BANK

AS AT 30TH SEPT. 1983

esting trends. Thus a study done on Rural Banks in the Kandy District, indicates, the following:

"Highest amount of deposits in the rural banks seem to have been made by the middle income groups. Their share accounts for 93.36 percent of the total amount of deposits. Even in the amount deposited per account, this group is in the lead with a mean of Rs. 583,790 per account as against Rs. 26.5 and Rs. 63.28 for the lower and upper income groups respectively. Those of the lower income group amount to only 3.03 percent".

Of those who have made borrowings from all sources, only 38.26 percent have borrowed from the rural banks in the Kandy District. Almost all these persons are either farmers or salary earners. In terms of income groups 59.31 percent of the borrowings are made by the middle income groups.

This study shows that both the recipients, as well as depositors, seem to come from the same middle rural stratum. Very probably the higher rural income groups go to the Commercial Banks directly, whilst the marginal farmers do not go to the banking sector at all, but have recourse to the informal sector. These broad results have also been borne out in several studies by the People's Bank, Research Department on access to credit through People's Bank branches in the Mahaweli area.

Default rates on short term loans also show a strong regional variation. This is contrasted with the overall rate of 48 percent for agricultural lending to the paddy sector by the commercial banks. The rural sector is considered a high risk lending area into which the rural banks, as well as the national banks, the People's Bank and the Bank of Ceylon have ventured. The 80 percent recovery rate for rural banks fares quite favourably with similar figures in neighbouring countries. For example, the All India recovery rate for agricultural loans is 54 percent for the rural sector. Region wise, the lowest recovery rate is in the Anuradhapura Region. (Anuradhapura Region under the People's Bank classification includes the districts of Polonnaruwa, Trincomalee and Anuradhapura). The next lowest recovery rate is in the Jaffna Region with 39 percent and Badulla and Nuwara Eliya being around 35 percent. The best recovery rate is recorded in the regions of Kurunegala, Galle and Matara with a default rate of only 10 percent. Others have intermediate positions.

Although the magnitude of default is comparatively low, it has posed a major threat to the expansion of credit to rural areas. A variety of reasons are attributed to the high defaults of which crop failures and low incomes play an important role. Two other commonly seen categories of defaults are of those farmers who defaulted wilfully and those farmers who defaulted at the instigation of politicians. However, studies conducted by the People's Bank suggest that the income levels of small farmers in the rural areas are insufficient to repay their loans. This is particularly true in cases where paddy farming is the sole income generating activity; here the farmers are often compelled to match all their escalating living expenses with

Table II

GROWTH OF RURAL BANKS IN SRI LANKA

Year	No. of Rural Banks		DEPOSITS: Savings Deposits	DEPOSITS: Fixed Deposits	DEPOSITS: Total	ADVANCES: Short-term loans	ADVANCES: Pawning	ADVANCES: Total	Differences between deposits and advances
			Rs.	Rs.	Rs.	Rs.	Rs.	Rs.	Rs.
1965		8	491,626	4,734	496,360	914,669	252,596	1,167,295	− 670,935
1966		13	703,011	22,737	725,748	1,326,475	427,129	1,733,586	−1,027,836
1967		27	1,305,846	65,381	1,377,227	2,029,476	633,213	2,662,689	−1,291,462
1968		44	3,110,576	222,614	3,333,196	3,360,731	1,085,613	4,716,344	−1,383,134
1969		89	5,712,893	460,168	6,173,061	3,572,281	1,823,646	7,095,927	− 922,836
1970		90	16,109,287	799,117	16,908,406	7,122,213	1,980,066	9,102,279	+ 7,806,126
1971		111	17,188,297	676,106	17,864,403	7,144,913	2,171,734	9,316,647	+8,547,756
1972		242	22,703,136	617,150	23,320,586	8,226,663	6,958,250	15,184,913	+8,135,673
1973		341	44,281,601	872,935	45,154,536	16,177,708	22,734,438	38,912,146	+8,242,390
1974	R.Bs. 332 S.Bs. 71	403	61,549,118	1,185,243	62,715,361	29,008,262	38,398,508	67,406,770	−4,671,409
1975	R. Bs 338 S.Bs 109	447	72,833,887	1,380,104	74,213,971	37,387,369	49,898,203	87,285,512	−19,071.601
1976	R.Bs. 345 S. BS.158	.50 3	114,495,097	1,793,923	116,289,020	47,624,595	54,167,951	101,792,546	+14,496,474
1977	R.Bs. 285 S.Bs. 259	544	170,514,871	4,947,329	175,460,200	55,034,180	55,849,120	110,883,300	+64,576,900
1978	R.Bs.284 S.Bs. 275	559	209,608,000	12,538,000	222,146,000	63,763,000	61,315,000	125,078,000	+97,068,000
1979	R.Bs. 284 S.Bs. 302	586	250,043,000	20,960,000	271,018,000	62,558,000	66,693,000	129,251,000	+141,767,000
1980	R.Bs. 284 S.Bs. 357	641	309.184,000	59,170,000	368,354,000	79,677,000	97,022,000	176,699,000	+191,655,000
1981	R.Bs.284 S.Bs. 459		356,798,000	77,250,00	434,048,000	100,899,000	170,697,000	271,596,000	+162,452,000
1982			441,997,000	99,486,000	541,483,000	122,470,000	206,807,000	329,271,000	+212,212,000
1983			562,125 367	121,319,323	683,444,690	137,143,117	224,117,890	361,261,009	+322,183,681

a meagre producer margin. In such a situation the farmer tends to give priority to feeding himself and his family members. Therefore, however honest he is he will not be able to settle his loans because he is too poor to meet his obligations.

As revealed by the Bank's study in the Kandy district, "In terms of income groups the repayment rate is most satisfactory in the upper 20 percent income group. While for this group the repayment rate is 80 percent, it is only 50 percent for the lower income group. This finding also collaborates the view that the non repayment of bulk of the rural credit is due to the inability of the farmers to pay."

The findings of this case study on Rural Banks in the Kandy District were applicable to most other areas as well, and still hold. Among the study's conslusions were the observation that the Rural Banks in a developing country like Sri Lanka are closely connected with the process of national development; being primarily concerned with the mobilisation of savings and the provision of credit needed for the development of the rural areas. This study highlighted the scarcity of capital required specifically for development of land and labour resources in the rural areas. A major step to fulfill this need was taken in the 1960's when this programme was begun to mobilise rural savings for the purpose of meeting the capital needs of these areas. It was the recognition of such needs that lead to the setting up of Rural Banks.

Considering the views of all respondents who expressed their opinions on the performance of Rural Banks over this 14 years period, the study concludes that the majority maintained that the Rural Banks had rendered a useful service. This was the general concensus in the first systematic evaluation of the activities of Rural Banks since they were originally set up. More recent views on the Rural Banks and the scheme in general are contained in the following pages

CO-OPERATIVE RURAL BANK CREDIT

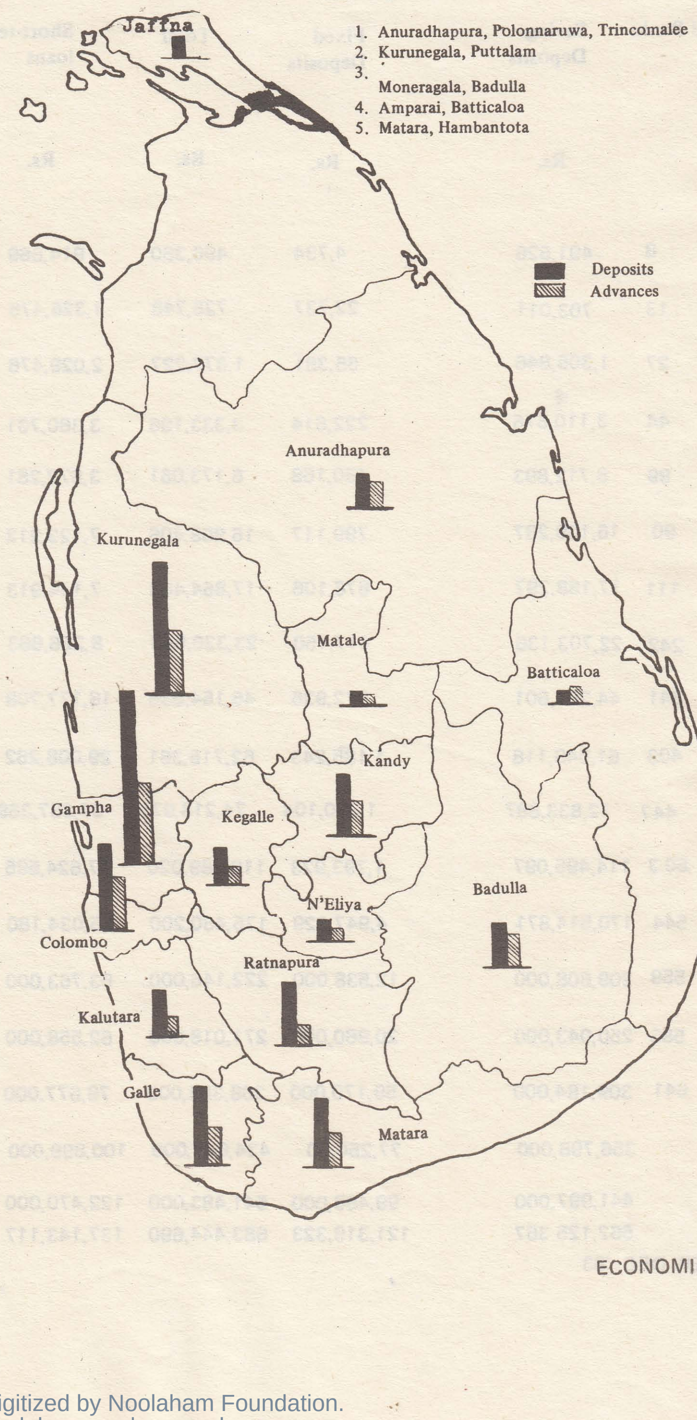
R.M. Abeyratne Banda

There are several Co-operative Rural Bank loan schemes which provide credit facilities to meet the needs of the rural community. In the initial phase of the Rural Banks, namely from 1964 to 1974, credit was approved as and when it was deemed necessary for various purposes. From 1973 a more effective credit scheme, called the Comprehensive Rural Credit Scheme, was introduced. Obtaining loans and advances under this scheme was more convenient for members of rural banks. Members were no longer subject to delays and difficulties they underwent earlier while guarantees

MAP SHOWING DEPOSITS AND ADVANCES BY ADMINISTRATIVE REGIONS OF THE PEOPLE'S BANK

The following schedule gives the districts amalgamated to form administrative regions.

1. Anuradhapura, Polonnaruwa, Trincomalee - Anuradhapura
2. Kurunegala, Puttalam - Kurunegalla
3. Moneragala, Badulla - Badulla
4. Amparai, Batticaloa - Batticaloa
5. Matara, Hambantota - Matara



for credit were also now less demanding. Loans were given for both production and consumption.

As seen in the table below, from 1980 the maximum amount of credit available to a member of the Co-operative Rural Bank was Rs. 15,000/-. This maximum applies to advances for production and construction. The upper limit for loans under personnel guarantee is Rs 5,000/-; while loans to a limit of Rs. 15,000/- were possible by obtaining security of property as a guarantee (Mortgage). Provision has been made in the case of mortgages to secure undivided property as security mainly due to the convenience of obtaining inherited, undivided property which is available in the rural areas.

Loans are issued by the Rural Banks for a number of purposes and may be categorised under;

Production, including Industries, Agriculture, Animal Husbandry, etc.,
Consumption-Long Term (for purchase of items like Sewing Radios, Cycles etc.) and Short Term (for purchase of Food, Clothes etc.)
Also, Construction (houses, factories, stores, etc.); Trade, Debt Redemption; Electrification (houses, factories, etc.) and Emergencies.

Loans for debt redemption are given to redeem mortgaged properties and pawned properties and pawned articles and loans against promissory notes. Consumption loans are given for the purchase of necessities and consumer durables. Assistance for illness and funeral expenses constitute loans in emergencies. Advances for installing electricity were commenced in 1967. Details are given in the table.

Credit has continued to expand over these 20 years with a particularly rapid growth over the last decade. Between the period 1964-67 total short term advances amounted to about Rs. 2 million; and this amount grew approximately by Rs. 1.05 million annually upto 1971. In the year 1973 there was a heavy annual increase in advances and from that year onwards credit has grown by about Rs. 8 million annually till 1979. In 1980 once again there was a heavy increase of almost Rs 17 million and in 1981 an increase of Rs. 21 million. From less than Rs. 1 million in 1965 value of advances rose to over Rs. 37 million in 1975 and Rs. 137 million by 1983.

Maximum Loan Limits per Purpose and Individual and the Maximum period of Repayment 1965 - 1980

Purpose	1965	1968	1973	1980	Maximum Period of Repayment
Production	2,500	5,000	7,500	15,000	1-5 Years
Housing	2,500	5,000	7,500	15,000	3-5 Years
Debt redemption	2,500	5,000	5,000	5,000	5 Years
Consumption	500	500	1,000	5,000	1 Year
Emergencies	200	200	200	500	1 Year
Electrification	-	600	1,000	3,000	5 Years
Trade	-	-	1,000	2,000	-
Maximum loan limit per individual member	3,000	5,000	7,500	15,000	

Source: People's Bank

PEOPLE'S BANK PROPOSALS FOR RELIEF TO DEFAULTED BORROWERS IN THE RURAL FARMING SECTOR

The problem of defaulted borrowers, particularly in the rural farming sector, has engaged serious attention of all authorities concerned. In 1983 the Rural Credit Advisory Board, consisting of representatives of major institutions involved in the area of rural credit, gave close consideration to proposals of People's Bank. According to these proposals existing outstanding past due crop loans could be converted into a financial asset by the Government, in order to strengthen the capital base of the lending institution concerned.

The People's Bank has recognised its statutory obligations to provide credit to the rural sector and also the urgent national economic need to expand the coverage of credit facilities to this sector; while emphasising that financial prudence necessitates a pragmatic approach to the implementation of a scheme for the rehabilitation of past due borrowers. The proposal emphasised that these objectives could be achieved by overcoming identified weaknesses in rural agricultural and ensuring the continued financial viability and strength of the lending institutions.

Among the suggestions for expanding credit immediately to the rural sector without eroding the financial structure of the institution were that the government should offer the People's Bank a long term non-encashable bond upto the value of cultivation loans unrecovered/written-off which have been made out of Bank funds.

The Central Bank to set up a stabilisation Fund to provide for irrevocable balances of future loans to farmers whose defaulted loans have been rescheduled.

The People's Bank in turn would undertake rescheduling of outstanding cultivation loans of farmers cultivating viable units which are capable of producing adequate marketable surpluses to repay these loans. It would also inturn write-off the interest due and reschedule the principal due.

The scheme will be implemented by way of direct advances by the Bank and through credit-worthy Multipurpose Co-operative Societies. The Bank will reserve the right to select Co-operative Societies which could be allowed to undertake this operation. Funds of the Co-operative Development Fund will be used to rehabilitate the Multipurpose Co-operative Societies in order to strengthen them to carry out these responsibilities.

VIEW-POINTS ON RURAL BANKS

AN INTERVIEW WITH THE PEOPLE'S BANK'S FIRST CHAIRMAN, MR. VINCENT SUBASINGHE

Q: The Rural Bank Scheme was your brain-child and these banks were originally set up when you were chairman of the People's Bank. How did you conceive of such a scheme?

A: The People's Bank was established in the year 1961. Its first branch was opened in a section of the YMBA building in Fort, Colombo and gradually more branches were established in various parts of the island. At the end of the first two years there were a total of 20 branches spread throughout the country. At this stage visits to these branches were undertaken by me and some other bank officials to ascertain how effectively these branches were functioning and we had detailed discussions with the officials of the Co-operative Societies during such visits. We were informed that although the Bank served the businessmen and middle class in these areas, the services rendered by it to the rural sector, such as the small scale farmer or persons engaged in animal husbandry, carpentry, the handloom industry and in various domestic industries was at a minimal level. This fact prompted us to consider and conceptualise ways in which we could assist these neglected sectors as well.

An article I read in a journal, when I was a boy, about the "Penny Banks" came to mind. All students of a school were called upon to deposit a penny per week in the Children's Bank in their school. The money thus collected was used to purchase and supply items that were useful to them, such as books and stationery, at wholesale prices from the merchants and these were retailed at a minimum price.

It also reminded me of how, during my young days, the peasants of our village used to deposit sums of money weekly with certain merchants, of the village. This scheme was called the "Box Scheme" or "Chettu System" and even my mother and the domestic aids in our house used to deposit money in this manner. At the end of a year or two years, the merchant repaid the sums collected from each depositor with an additional amount which could be called the interest in today's context.

Another important episode which influenced my conceptualisation of the Rural Bank Scheme was in the year 1952 when I had to pay a visit to Oxford in England with my son, who was taken there for medical attention. During this visit I had the opportunity of meeting certain individuals who had undertaken a consumer business in the city and the district. A prominent feature I observed in their business was the depositing of money by a majority of the members of this society, on a particular day of the week, at their society centre. This activity amounted to a banking function to some degree. This example was adopted by me later when I returned to my village and started the "Oxford Co-operative Society Deposit Scheme among the members of the Sandalankawa Co-operative Society. The rural peasant could come to the Society and deposit a minimum sum of cents 25 or more at a time and the receipt was acknowledged in the form of a label which was pasted onto the pass books they were issued. The total sum collected in this manner exceeded Rs. 8 million. An annual interest of 6 percent was also paid on these deposits. The successful implementation of this scheme was a major factor that influenced my conceptualisation of the Rural Bank Scheme.

Q: Could you now elaborate more on how you endeavoured to implement your new concept through the People's Bank and the action that followed in this connection.

A: Before the commencement of the Rural Bank Scheme here I had the opportunity to visit the Madras region in India, where such a scheme was already in operation. I used this opportunity to observe and examine the activities of some selected Co-operative Rural Banks in this region, through the courtesy of the Registrar of Co-operatives of Madras. On this visit undertaken by me at my own expense, I gathered valuable information and experience about various aspects of the Co-operative Banking sector in Bombay and other places. I also furthered my knowledge in these aspects as a result of some briefing sessions I underwent for a number of days with some key officials of the Reserve Bank of India.After these experiences, steps were taken to send the then General Manager, Mr. Solomons and also Assistant General Manager,Mr.Amerasinghe to these places which I toured in India and they too came back with invaluable experience.Although Mr. Ranjith de Livera could not undertake this tour himself he was well briefed of the developments and was a prime force in the establishment of the Co-operative Primary Banks.

Q: What are your observations about the present condition of the Rural Banking Scheme, and what measures would you recommend to overcome any shortcomings and weaknesses prevailing in the system?

A: Today the rural banks numerically amount to nearly 900 with special branches. At the present trend I expect the number to exceed 1,000 by the end of 1984. If this happens, within a time span of 20 years the number of rural Banks would have exceeded 1,000. My wish is that at the end of the next 20 years of its operation, every Grama Sevaka Division should see see the establishment of a branch of its own. What is clear by this situation is that the Rural Bank scheme has not only lived upto its original expectations, but also has become a most important institution helping the rural sector. I take this opportunity to express my gratitude and thanks to the various Chairmen, Board's of Directors and the officials of the People's Bank who have endeavoured to develop and expand the Rural Bank Scheme which I initiated in order to desseminate its services among the rural community. At the same time I believe though the Rural Bank Scheme has expanded there yet exists a considerable capacity for the expansion of its services. If new schemes could be implemented to utilise the funds deposited at the Rural Bank's through Regional Co-operative Societies, to commence various new industries, small scale business concerns etc. with a view to uplift the rural economy, it would be a great step forward.

AN INTERVIEW WITH THE PEOPLE'S BANK'S PRESENT CHAIRMAN, DR. S. T. G. FERNANDO

Q: Today the Rural Banking Scheme is being expanded despite a number of shortcomings. Could you kindly elaborate how such a situation could prevail, with particular reference to the responsibility of the People's Bank.

A: From the very start there existed a close association between the People's Bank and the Rural Banks. The Rural Banks were established with a view to meet the needs of the rural community. These Rural Banks assist the rural community by way of extending credit facilities for the agricultural and other investment needs and requirements of the sector. The People's Bank provides these credit facilities at very low interest rates. The extension of such credit by us to the Rural Banks and the Co-operative Societies, at very favourable interest rates, has been of tremendous importance of their development.

There is a common belief that the People's Bank invests the money that it earns, through the Rural Banks, in urban areas and thereby the greater benefit of this activity is directed towards the urban community. Although there is a certain truth in this belief to a large extent there seems to be a misconception. The majority of the People's Bank branches are located in rural areas and these are managed by well trained and experienced managers. When a proposal for an investment is brought before them, it is carefully examined by them for its viability in all its aspects. This means that we cannot accept every proposal that comes to us. Thus, there occurs a considerable excess of funds in the Rural Banks, which in a way is a favourable situation. When credit is granted it has to be done adhering to certain accepted norms and principles and not arbitrarily.

There are a number of shortcomings in the Co-operative Societies which can appear in the Rural Banks too; while certain Co-operative Societies are in the red by trying to engage in types of investment which are beyond their capability, some of the officers of these societies are even inclined towards corruption. It is true that the People's Bank has been rather reluctant to invest in such Co-operative Societies. I do not say that all Rural Banks and all Co-operative Societies are in the same position but such a situation prevails in a number of Co-operative Societies.

Q: It is said that the weaknesses of the Co-operative Societies hinder the progress of the Rural Banks. What remedial measures would you suggest the People's Bank should take to avoid such a situation?

A: Well, in a way it is difficult for us to take the total responsibility here. We cannot accept the total responsibility since it is the Central Bank of Ceylon which has greater responsibility. It is required to appoint well trained experienced staff to the Rural Banks which are not in a sound position and this staff has to be adequately remunerated. Also a constant check on their activities is very necessary. An occasional check by an officer from our Bank is totally insufficient. Above all, prior to establishment of rural banks either the Central Bank or the Department of Co-operative Development must look into these Co-operative Societies and should take remedial measures and then we can help them to run smoothly by assisting them with guidance from our officials. We cannot impose conditions on Co-operative Societies which fall within the purview of the Department of Co-operative Development. Our responsibility generally has been activity such as examining whether there is a proper maintenance of books, how they extend credit facilities or advice when a change in the rate of interest occurs. However, the People's Bank cannot closely scrutinise all activities of the Co-operative Societies.

Q: It has been two decades since the Rural Banks were established and there are almost 900 in operation today. If one is to envisage a development of the rural sector through these banks they would have to be highly efficient in future. Could you illustrate the future plans for them?

A: I do not think that it is a healthy practice to open Rural Banks rapidly. Before I was appointed Chairman of the People's Bank nearly 20 to 30 Rural Banks had been established annually. But since my appointment we have changed this system. Opening up Rural Banks without having the necessary trained staff and other facilities is not a prudent practice. If large amounts of advances fall into the category of past dues, what point is there in such an exercise? Therefore establishment of Rural Banks without necessary infrastructure clearly amounts to unproductive activity. Therefore what is required now is to have this staff well trained and effect proper management according to the banking rules and regulations. It is required to effect a change in attitudes of the public about the weaknesses of the Rural Banks and for this, as I said earlier, the proper management of these Rural Banks by trained staff is essential. When shortcomings and weaknesses are spotlighted in the media existing goodwill and public confidence is eroded.

Q: Recently the Hon. Minister of Finance has proposed the setting up of a Regional Rural Banking Scheme under the auspicious of the Central Bank. If such a situation arises would this amount to a threat to the further development of our Rural Banks Scheme?

I also would like to suggest a scheme to establish centres to support and service the newly settled villages under the Mahaweli Programme, and also marketing centres to assist them to market their produce.

Finally, I would extend my blessings for the future of the People's Bank, which has attained a commanding position among the other competing banks in Sri Lanka. It is my belief that if the People's Bank pays more attention than at present to the rural sector it would further enhance the development of this sector in all aspects.

These 3 interviews are translated from the Sinhala original in the Bank House Journal, "Bank and You".

A: Well, if such a scheme is inaugurated by the Central Bank this will be a motivating factor for us to increase the efficiency of our Scheme just as in the case of what had happened with the arrival of foreign banks in Sri Lanka. Therefore, as I stated earlier we have to maintain a favourable image in the eyes of the public. We must reap the maximum benefits from this competition. We have a high degree of self confidence and we will be able to face up to any competition. If these proposed Rural Banks are established we shall endeavour to maintain our Rural Banks in an exemplary condition. If we work hard and efficiently there is no reason to fear any competition. For example, what were the effects on our activities from the competition of the foreign banks? Although this move stirred initial fears we have been doing much better ever since. Therefore, what I can say of the competition from the proposed Rural Banks of the Central Bank is that we shall face upto this task through the internal necessity arising from such a situation.

THE GENERAL MANAGER PEOPLE'S BANK MR. P. B. RATNAYAKE

We have not forgotten the Rural Banks and are always willing to assist them in all their activities to increase their level of efficiency. The popularity of this scheme is amply demonstrated by the vast number of the Rural Bank branches that have been established so far and are to be established in future. Although, unlike at the inception, the direct inspection of these banks from the Head Office has become less practicable, we have continued to carry out this activity through our island-wide network of branches. This is done in three ways. There is a form of control and supervision from the Head Office; and also by the Regional Office and through the Bank branches. Further, we conduct frequent discussions with the officials of the Department of Co-operative Development, and of the National Co-operative Federation, with a view to being constantly alert to the needs and developments of the system.

One may find while a particular Co-operative Society functions at a weaker level, yet the Rural Bank attached to it is strong and therefore there is the ability for this Rural Bank to develop the society with which it is associated. To activate this process smoothly it is essential that we overlook their functioning. It is most heartening to see the majority of Rural Banks and their associated Co-operative Societies function profitably today. As a result of these activities of the Rural Bank's we see a re-awakening trend in the rural sector today and we should endeavour to safeguard this trend in future. The capacity of the Rural Banks to develop economic, social and cultural bases of the rural community is tremendous. I believe if we could bring about this change effectively with the help of our Bank, it would amount to a development of not only a section of the community but of the whole system as well.

REGIONAL RURAL BANKS IN INDIA

The developments in the Co-operative credit structures were not free from distortions. There were constant allegations that the Co-operative credit flowed mainly to large cultivators, irrespective of the different legal and other provisions employed to safeguard the interests of the weaker sections of the society. As usual bulk of the weaknesses lie in the areas of deficient and ineffective lending policies, inadequate and untimely credit, lack of supervision over use of credit and the inability to develop the climate and culture for timely repayment causing heavy overdues. Thus the co-operative credit structure was not adequately equipped with fool-proof systems to ensure social equity aspect of credit. Secondly the increasing defaults, posed another serious question as reregards to the viability of these institutions. Side by side with them came the problems of misappropriation and misuse of loan funds.

A view expressed was that "in the total scheme for bridging the credit gap in the agriculture sector, the major difficulty is that the co-operative banking sector which has a very wide organization at the field level is unable to mobilize deposits",

A system of Regional Rural Banks was established in 1975 to combine the local feel and familiarity with rural problems which co-operatives possess and the degree of business organization ability to mobilize deposits, access to central money markets and a modernize outlook which the commercial banks have..." in the context of the vastness of the country and its rural economy, where bulk of the population are depending on agriculture and allied activity for living, the infrastructure for credit provided by the co-operative banking system side by side with the public sector banks was found to be quite inadequate. Therefore the decision to establish RRBs was taken with a view to supplement the present institutional arrangements for providing rural credit. Thus in India the RRBs emerged not as a competitor to the existing credit institutions but complementary to the massive rural development efforts of the government.

The major objectives of the RRBs according to the RRB act was to development of agriculture, trade commerce, industry and other productive activities in the rural areas, credit and other facilities, particularly to the small entrepreneurs...". The lending activities of the RRBs were restricted to the weaker sections of the rural community and the jurisdiction of each RRB was confined to a specific district or a number of districts. The paid up share capital of a RRB is subscribed by the Central Government, State Government and the sponsor bank in the ratio fo 50:15:35.

The operational guidelines of RRBs are prepared and issued by the Government of India, Reserve Bank of India and the National Bank for Agricultural and Rural Development (NABARD).

The performance of RRBs are given in tables I and II, which indicate a very impressive rate of growth of this scheme in India. The total number of RRBs that stood at 6 by the end of 1975 increased to 60 in 1979 and further 141 towards the end of the first quarter of 1983. The number of branches grew at a much faster rate and by the first quarter of 1983 there were 6458 branches covering 246 dis-

TABLE I
OVERALL PROGRESS OF THE REGIONAL RURAL BANKS
(DECEMBER 1975 – MARCH 1983)

(Rupees in lakhs)

Sl. No.	Performance Indicators	December 1975	December 1979	March 1983
1.	Total number of RRBs	6	60	141
2.	Number of RRBs setup during the year6	6	9	17
3.	Total number of branches	17	2420	6458
4.	Number of branches added furing the year	17	667	267
5.	Average number of branches per RRB	3	40	46
6.	Number of States covered	5	17	22
7.	Number of districts covered	11	121	246
8.	Percentage of (7) to total districts m	3	31	63
9.	Deposits:Accounts			
	a) Overall	N.A.	2580274	8146641
	b) Per RRB	N.A.	43005	57777
	c) Per branch	N.A.	1066	1261
10.	Deposits: Amount			
	a) Overall	20.00	12321.63	50154.37
	b) Per RRB	3.32	205.36	355.70
	c) Per branch	1.17	5.09	7.77
12.	Advances: Amount			
	a) Overall	10.00	16740.85	60284.81
	b) Per RRB	1.71	279.01	427.55
	c) Per branch	0.60	6.92	9.33
13.	Per Account			
	a) Deposits(actual	-	478	615
	b) Advances(actual)	-	1021	1578
14.	Credit-Deposit Ratio	50	136	120

N.A. = Not Available

tricts and 22 states in India. Another notable feature is the impressive growth recorded in the areas of deposits and advances that demonstrate an emergence of a favourable credit deposit rate of 136 in 1979 and 120 in March 1983.

This impressive performance however should not be overestimated, since the RRB scheme was not free of constraints and shortfalls. There are a number of serious constraints which scheme in India. Although the RRB programme receives a considerable subsidy from the state, it also undergoes a severe pressure from the state itself to reach ambitious credit targets based on non objective credit criteria. When proper infra- structure and supporting services are not forthcoming the possibilities to reach full potential benefits get narrowed which ends up in increased credit delinquency. Thus by march 1983, the overdues exceeded 22 per cent of the outstanding credit and there is fear that the future of RRBs will not be different from co-operative banks. The situation was aggravated by the decisions of some state governments to write-off or scale down the co-operative debt, that always adversely affect the overall repayment climate..

Another issue worrying RRBs is the question of the viability of this institution. Though the viability and profitability of RRBs have to be reconciled with the social objectives for the setting up of RRBs it should be noted that no institutional structure will survive if they make continuour losses. Studies conducted by the Reserve Bank of India have shown that on an average, a RRB would require about 6 years time and a network of 70 branches to become viable. It had further noted the necessity of reaching " an outstanding loan business level of Rs. 80 million and also enjoying a margin of 5 per cent between the borrowing and lending rates. However in the light of the increasing deposit rates and establishment of upper limits of lending rates by the National Bank for Agricultural and Rural Developments the possibilities to maintain a 5 percent margin may not be practicable.

Although RRBs are expected to be treated as the development wing of the state, in a number of states these banks had not received the minimum expected patronage. As a result of the lack of minimum basis amenities,shelter and other infra-structure which have to be provided by the state governments the initial enthusiasm of the RRB employees is slowing down. All these problems would suggest that the future of the RRBs depends on the effectiveness of the Union Governments, the STate Governments, the REserve Bank of India and the NABARD in overcoming these constraints that more or less hampers the proper operation of the co-operative banking structure.

HELPING THE RURAL MILLIONS IN SRI LANKA

Warnasena Rasaputra

In this address delivered at the fifth anniversary of the Village Re-awakening Movement, in June 1983, Govenor of the Central Bank, Dr. Warnasena Rasaputra discusses the vast potential within Sri Lanka's rural sector and the need for the development of a strong rural economic structure to attain rapid economic growth and raise the people's living standards. This, he emphasises, requires massive organisation in the nature of development cells in each village or cluster of villages, with assistance from the Centre, the people, banks, government organisations and private organisations.
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A country with twenty five thousand villages must necessarily place emphasis on the development of a strong rural economic structure for the attainment of rapid and sustained high growth in the living standards of the people. Apparently, many traditions are changing but some are deeply rooted in the village society. Monetisation of the economy has given rise to changes in attitudes, relations and objectives. The importance of land, as a measure of wealth predominates. However, due to rapid population growth, its relative importance has declined. Nevertheless it still remains a scarce resource in the rural areas. The parochial attitudes are breaking down with the impact of modernisation and growth. There is generally an inexorable desire to reach high living standards amidst mixed attitudes and aspirations. Any development programme for the rural areas must take into consideration not only the changes that are taking place, but more so the changes that are expected, but have not taken place. The emancipation of the rural people from the existing social enviornment and moving them to a development oriented environment requires the creation of a psychological atmosphere of innovation, expansion and development.

Villagers find it more comfortable to grow within their social system. In ancient times, the people collectively enhanced their development prospects through various schemes to increase agricultural production and provide the necessary infrastructure. The extended family system enabled a large variety of skills to be developed with the minimum of costs. These were further encouraged through royal patronage. Cultural activity was woven around agriculture. Music, songs, dances and drama were more directed towards invoking blessings for a good harvest, or giving thanks to the deities for a bountiful harvest. Thus, the economic,social and cultural life were all well integrated and the working of a self-reliant development scheme was eagerly awaited, keenly assisted, and enthusiastically implemented. But income levels were low. In order to meet the increased demand for goods and services from the West after the rise of capitalism this economic system had to adjust, to changed conditions.

This pattern of development cannot be re-introduced in a changing world. The economic structure has to adjust further. Inadequate changes lead to bottlenecks, and disruption of economic growth, due to disparities. The older people are slow in accepting change but nevertheless, they want to change for the sake of their children. The poor villagers have always sacrificed quite a lot for the sake of their children and they are willing to do so even now. However, they are cut off from the younger generation due to the communication gap or what is better known as the 'generation gap'. In the absence of ameliorating or moderating influence from their own households, the youth become frustrated and restive. Since their contact with the elders outside their households is minimal, they tend to think that the elders are insincere and are more concerned with the maintenance of the status quo. Thus, conflicts arise among those who want slow and gradual change in the context of existing social privileges and those who want quick and rapid changes devoid of privileges.

The rural sector generates the bulk of the national income and in the last decade it had made significant progress. This is evident from several criteria – incomes have increased, unemployment has decreased and housing conditions and other amenities such as access to electricity and pipe-borne water have improved. The average income of the rural person which was only fifty four rupees in 1973 rose to one hundred and seventy two rupees in 1978-79 and to two hundred and sixty rupees at the end of 1981. The average income for the rural family or the household was less than three hundred rupees in 1973. It increased by over four-fold to one thousand seven hundred and sixty three rupees between 1978-79 to 1981-82. Unemployment has decreased substantially since 1973. Rural unemployment which was as high as 25 percent had dropped to 15 percent in 1978-79 while the latest available data indicate that the rural unemployment in 1981-82 decreased to 13 percent.

The availability of amenities in the rural areas has increased steadily. The percentage of households having access to electricity increased from 2.5 percent in 1973 to 6.7 percent in 1978-79 and those having pipe-borne water increased from 4 percent to 6.6 percent. A larger proportion of the rural households have latrines today. Three-fourths of the rural households in 1978-79 had this facility, whereas five years ago this was confined only to little over half of the rural households.

The averages do not speak of the poverty that is in existence; nor does it reflect the infrastructure facilities that have been made available to them. Nearly 40 percent of the rural population live in abject poverty. They receive less than three hundred rupees a month. Nearly half the population have been issued with food stamps. A study made in 1975 on the basis of 1969/70 survey data indicates that 45 percent of the rural population is below the poverty line on the basis of calorie intakes, compared with the desired level.

Poverty in a developed country is measured by the relative position it occupies in the midst of affluence. In developing countries, on the other hand, it is measured by its relative position in the midst of an ocean of poverty with a few scattered islands of affluence. The grim future that lies for the poorest of the poor in such countries as Chad and Mali in Africa or such Asian countries as India and Pakistan, may be very different from what we can see in Sri Lanka. Sri Lankans in relative terms, are better fed, better clothed and better housed. But this should not impart any sense of euphoria, as our comparisions are with our immediate neighbours and with other developing countries. This type of comparison is misleading and would result in erroneous judgements being made for the betterment of the large bulk of the people. All are too keen to raise the lot of the poor and to build up an asset owning democracy by well designed and accepted plans for the development of the country. The gap between the rich and the poor indicates not only the potential but also the size and nature of the problem. In reducing this gap, the world community has to work with speed and efficiently. The fact that Sri Lanka is not in that unhappy position as the neighbouring Asian countries or the African countries should not reduce our enthusiasm to accomplish things fast. We have got to compare ourselves with the average income earners in a developed country. It is with this in mind, that any initiative that has to be sponsored and maintained, should be well-conceived, identified and promoted.

The most important factor in any developmental programme is the need to promote and cultivate economic development as a habit forming activity. Once they have acquired this habit, there will be some automaticity in the approaches made by each individual member of the family, by the families themselves and by the community itself. The attitudes of the people must be so organised to allow them to have a clear idea of the direction in which they could move for the betterment of their living conditions. These may vary from village to village, from place to place and country to country. In Sri Lanka it is not easy to find a cluster of cohesive villages. It is therefore, necessary to consider the village as the unit and bring about structural changes in the village areas. This, when fully supported from the Centre, would result in a lasting and indelible impression on the developmental activities of the country. People cannot take the initiative unless they feel that they can get something out of what they are doing. At least a part of their hopes must be realised by the time they take stock of the situation into which they have been guided and directed.

The most important aspect of the development that is understood by the villagers is the provision of employment and the growth of incomes. Traditional society encouraged underemployment: the unemployed were looked-after by the pooling of family incomes. Even today it has reduced social stress; Undoubtedly, the most pressing problem today to which the policy maker pays the highest attention is the creation of more job opportunities.

The rural sector is agricultural. But low productivity in agriculture has resulted in low demand for its activities. Agriculture and its allied activities such as dairying, fisheries and animal husbandry need to be intensified to provide more income and employment opportunities. Attention given to this sector has not been so far equal to its potential. Rural industrial base remains weak. Rural industries could not grow, not only because of lack of entrepreneurship but also due to lack of proper attitudes apart from credit and other facilities. A large number of people employed in agriculture can be taken away without affecting its productivity. Obviously, industrial growth in rural areas using appropriate technology, could be one way out. Rural industries may not be of the capital intensive type and they can vary from those that use moderately advanced technology to those that use low technology. But adequate work has not been done on the type of technology that is most appropriate for a particular village and to a particular project or product. Regulation of technological changes cannot be regarded as a farsighted policy to protect and enhance employment. That is good enough as a holding operation. Technology has to be developed in such a way, so as to take advantage of its annual growth and its effect on employment, both direct and indirect.

Clearly, the effect of an employment expansion comes through income and substitution effects pertaining to primary, secondary and tertiary sectors. Just as tourism in village areas will create a further demand for transport, trade, storing, packing, repair services, telecommunication training and other allied services, so will any agro-based industry create similar direct effects on employment. Mere emphasis on cottage industry or handicrafts which are based on individual skills, cannot widen the base for employment in the medium term.

Rural development planners run into a dilemma. On the one hand, lack of cohesion among a group of villages makes it difficult to organise clusters of villages large enough to carry out development through recognised instruments and methods. On the other hand, the socio-cultural pattern makes it difficult to isolate individual villages and try to solve problems in isolation. There is a strong lobby to work within the existing social environment so that modern civilisation does not destroy existing social and cultural values. At the same time, the youth are looking forward to using more fashionable methods in agriculture and its allied activities. Though the small man is a producer, consumer and distributor, there are constraints on the successful working of small units. Marketing is important for any sustained growth but due to the low acceptability of the locally produced goods the rural market is unable to expand.

Undoubtedly, at the early stages of development, rural units require protection from severe competition from outside. At the same time, the quality of the product should not inhibit the sale of the products, and reduce its acceptability. Quality control methods need to be enforced with determination and purpose.

The Commercial banks are chosen institutions for rural development. Just as much as they encourage savings, they can encourage investment. Identification of projects, promotion of entrepreneurship and provision of credit can all be done by this one institution. Conservation of the Commercial banks make them reluctant to take undue risks. It is important to provide credit at the appropriate time even if it means the establishment of new agencies and institutions in keeping with the social requirements and with which banks can work directly. Credit available when it is least needed is as good as credit given for consumption purposes.

The banks cannot work alone towards rural development. The multi-agency approach is indespensable. Government departments and private organisations can always give a helping hand and be directly involved. The extension work and the work of various agencies in rural areas have not always received satisfactory reports, mainly because of a lack of commitment to the larger cause of rural development, to promote social justice. There is no need to create too many institutions as it will prove to be counter-productive. What is required is the strengthening of the existing institutions with strict supervision and guidance. The rural participation cannot be replaced, but they require training and expert advice. Just as United Nations' experts are sent out from the headquarters to developing countries to assist them in various disciplines the despatch of experts on various disciplines from the Centre, charged with the exclusive responsibility of developing the area assigned to them, would be desirable..

The rural sector has vast potential but it requires massive organisation in the nature of development cells in each village or cluster of villages, with assistance from the Centre, the people, banks, government organisations and private organisations. The physical resources of each village are to be matched against the finincial resources available, and that can be made available, through the banking system, so that maximum funds go to the priority sectors. To meet the requirements of social justice, employment and income opportunities for the rural poor, and the economically weaker, but viable farmers, need to be significantly increased. With this end in view all agencies must necessarily give their time, effort and attention with the support of resources from the government, private organisations, credit institutions and local resources of the villages themselves.

THE HEALTH BUSINESS

The Pharmaceutical Industry and the Third World

Dieter Brauer

The pharmaceuticals marketed by the multinational corporations do not correspond to the needs of a just health care system adapted to the situation in the Third World;

A significant part of these medicines is either superfluous or irrelevant;

Trade name medicines are often overpriced;

Research on tropical diseases plays only a marginal role for the pharmaceutical industry in the Federal Republic of Germany;

The market power of the international pharmaceutical corporations largely prevents the development of independent local medicine production adapted to local needs. These criticisms have been raised by the Federal Congress of Development Action Groups (BUKO), in which about 180 development action groups in the Federal Republic are united. For some time, BUKO has been carrying out a pharma campaign, partly financed by the Protestant Church, with the aim of informing the public about problems in this area. Now for the first time a public discussion between the pharmaceutical industry and its critics has taken place. The discussion occurred within the framework of a meeting on the topic of "Medicines in the Third World", which was organized by the Protestant Church of Germany.

At the beginning of the meeting, Klaus Wilkens, of the Protestant Church Office in Hannover, cited the reasons why the Church had taken up this controversial topic:

- In many countries of the Third World there is an acute shortage of medicines because of the lack of foreign exchange: - On the other hand, manufacturers have flooded the market with products, marketing is accompanied by aggressive advertizing which gives consumers the illusion that health can be bought with money, and that prevention becomes unnecessary when the "repairshop" is easily at hand.
- At issue are concrete economic interests which, however, collide with the needs of the developing countries. The Church is concerned that economic power is being used to the disadvantage of people in the Third World. There are already examples, as in the case of Bangladesh, where alternative government health care policies have brought strong pressures from the international pharmaceutical industries and their home governments.

WHO Policies

An initiative for a new health care policy oriented towards the needs of the developing countries has come from the World Health Organisation (WHO). At the World Health Assembly of 1975, there was a discussion on a list of "essential drugs", which was to end the confusion resulting from the extremely large number of drugs marketed by the international pharma industry. Halfdan Mahler, Director General of WHO, was given the task of supporting member nations in the drafting or execution of a "national drug policy". National drug research programmes are to be supported and suitable measures for official registration, management and control of drugs are to be introduced. In addition, the WHO is supposed to advise the health authorities in the selection and acquisition of essential drugs at appropriate prices.

As a consequence of this decision, a list of 244 generic drugs was drafted, which was designated by the WHO as the list of "essential drugs" and which was recommended as the basis for drug supplies in individual countries. From the WHO viewpoint, the advantages of this list are as follows:

- A reduction in the number of drugs that have to be bought, stored, analyzed and distributed;
- Improvement in the quality of drug application, administration, information and control:

- incentives for local pharmaceutical industries and;
- assistance for the developing countries in finding solutions to the problems of primary health care.

Since then individual developing countries have attempted to realize national drug policies corresponding to the recommendations of WHO. For example, in June, 1982, the Government of Bangladesh issued exact guidelines for the manufacture, distribution and use of medicines. A basic catalogue of only 150 medicines was regarded as sufficient for the requirements of essential therapies.

1700 drugs were banned because they were regarded as useless, harmful or too expensive. In future, the essential drugs are to be manufactured by local firms while imports from international pharmaceutical corporations are to be restricted to complicated medications.

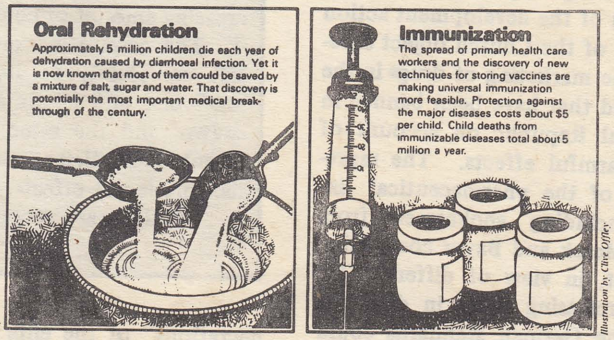
Health for the masses

At the meeting in Bonn, Dr. Reinward Bastian of the German Institute for Medical Mission in Tubingen, explained how a drug policy should be designed to meet the health needs of the broad masses in the developing countries. Dr. Bastian, who has years of practical experience in Tanzania, reported on a project in India which used simple means to achieve an essential improvement in basic health care. In an area in which 6- per cent of all deaths were due to only 8 diseases, considerable success was achieved by the use of only 7 drugs. These were distributed in the villages by health care workers who had undergone only short-term training. In the clinics, doctors have access to about 120 especially priceworthy and dependable drugs. In children, every sixth death was due to diarrhoea, and therefore oral rehydration was regarded as being especially important. This can be achieved by a simple method that does without the use of expensive and in some cases dangerous medicines: The child is given a solution of table salt, dextrose, sodium carbonate and potassium chloride.(see comic above).

The view of the pharmaceutical industry

In the view of the German pharmaceutical industry, some of the problems raised by critics do not really arise. First of all, the industry points out the significance of pharmaceuticals to the national economy. In 1981, total sales of German pharmaceutical companies amounted to more that 16 billion DM. Of this amount,products at a value of about 6.5 billion DM were exported, putting the Federal Republic at the head of world pharmaceuticals exporters. In 1980 about 73,000 people were employed in the industry. About one fourth of the exports go to the developing countries: 18 percent to Asia and 2 per cent to Africa. This makes the Third World an important market for German corporations.

Of course, a restriction of this market to the 244 essential drugs on the WHO list is not seen as very useful by the industry. As Gerd von Breitenbach of the Federation of Pharmaceutical Industries stated in Bonn, it shou-



When confidence in child survival grows people generally begin to have fewer children. In the long run therefore a child health revolution would help to reduce the rate of population growth. In no country has there ever been a significant fall in birth-rates which has not been preceeded by a significant fall in child death rate.

Dr. Bastian made 13 recommendations, based on his experience in India, for improved drug supplies for the Third World (see box on p. 24).Among other things, this list calls for improvements in the storage, distribution and control of medicines, the listing of really essential medicines based on the WHO list of 244 essential drugs; the introduction of generic names of medicines (instead of trade names); and the regulation of prices and advertising.

ld be left to national health authorities what criteria are used to approve drugs. This would necessarily result in different behaviour in different countries. For example, there were,"ethnic differences" in the frequency of certain diseases and, therefore, different needs for certain medicines. One should be careful not to prescribe to the developing countries what drugs they should select for import since this could easily be regarded as "neocolonial" interference. If the developing countries used Western criteria in setting standards for medications, then they should not be criticised for doing so, according to Gerd von Breitenbach. After all, he went on, all of the diseases that exist in the industrial nations are also found in the Third World. Therefore, a complete array of drugs should be available.

Gerd von Breitenbach rejected the banning of trade names and their substitution by generic names. The origins and quality of medicines could then no longer be controlled. Such a measure would provide no incentive for research on new drugs, which at present can cost up to 150 million DM for a single product. Nevertheless, he also announced the willingness of German industry to help the Third World establish their own pharma industries. But the interest , for example in Africa, was not very great in such cooperation ventures.

Controversies in the debate

In the course of the meeting, controversies arose in the debate over a number of individual examples of the activities of German Pharmaceutical corporations in developing countries that were brought up by BUKO. Representatives of the development action groups and of the Church object especially to the marketing of drugs in the Third World that have been banned in the Federal Republic on account of possible harmful effects. The representatives of the pharmaceutical industry, including spokesmen from Hoechst, Merck and Bayer companies, stated that, in view of different criteria for releasing drugs in different nations, the German standards could not be applied world-wide. Rather, "meeting the demands for medicines" takes place "within the framework of the free market order" and is aimed at "legitimate profits".

This point was decisively contradicted. According to Marcel Buhler, author of the book "The Business with Poverty", there can be no talk of a free market in the relationship of a patient to the doctor and to the pharma industry. Patients, especially in developing countries, do not have a free choice. It is not the needs of the broad masses, but the "increased expectations" of the elite which decide which drugs are offered on the market.

Angry reactions came on account of the tactics of industry representatives which avoided making replies to concrete cases of inadmissible advertizing or the export of dangerous drugs to Third World markets.

The statements from industry representatives that these cases must first be carefully examined met with little understanding because most of the cases that were mentioned have been known for a long time and have been documented in publications of BUKO and other action groups around the world.

In any case, the debate brought one concrete result for the meeting: Industry representatives declared their willingness to establish a kind of "clearing house", together with the churches, in order to discuss and clarify the charges involving individual cases. Industry is also prepared, together with churches, to support projects in developing countries aimed at establishing national pharmaceutical industries, especially for the production of simple medicines. This is welcome progress on the part of the industry, especially in contrast to its previous attitude which was to reject out of hand the charges brought by BUKO.

IMPROVED DRUG SUPPLIES TO THE THIRD WORLD

1. Each country should have a good drug distribution system with sufficient storage capacities and transport possibilities. Established procedures for ordering and supervision are indispensible to good supplies. Feedback on inadequate packaging and quality of medicines should lead to improvements.

2. Drug orders of a country should be summarized and put up for international tender. This requires an independent and incorruptable authority. To an increasing degree, the private market should be included in this.
3. There should be representative and independent controls on the quality of medicines.
4. An independent committee of experts (pharmacists, doctors and economic experts) should be available to advise the responsible government authorities.
5. The really essential drugs should be listed. This list must be relatively binding and can be oriented on the list of 244 essential drugs of the WHO.
6. In the course of time the generic names of drugs should be given an increasing amount of consideration.
7. The private market should not be left completely to itself. Irrelevant medicines and elixirs should be withdrawn, and the same holds for non-essential medicines and those with dangerous side-effects.
8. Health care workers, nurses and doctors should receive necessary information on drugs in an objective form.
9. Comprehensive legislation should insure that regulation of patents, of prices and technology transfer, in the middleman's sector too, proceeds according to sensible rules. The state should have effective controls on private and government markets.
10. The distribution of free samples, gifts of all kinds, and other sales incentives must be regulated.
11. National pharma companies should orient their production more and more towards the list of drugs considered as of priority. Every country can begin with the first steps of local production, for example, with packaging oriented to needs and with the tabletizing of the 10 most important medicines.
12. Special care should be given to training and advanced training of pharmaceutical and medical personnel. In the area of health care, what is at issue is the cares and fears, the hopes and disappointments of the patients. Doctors, nurses, and assistants are therefore exposed to special temptations. Therefore good training and the inner steadfastness of health care personnel are of great significance.
13. Traditional healing methods should not be seen as competitors of Western scientific therapies. Traditional healing methods can reduce treatment costs and can increase the chances of a cure in certain diseases.

ESSENTIAL DRUGS ONLY

Dianna Melrose

Along with other UK-based development agencies and health professionals, OXFAM is launching a Rational health campaign calling on manufacturers and the British Government to adopt specific policies listed in a Rational Health Declaration to help the Third World cope with problems of pharmaceutical exploitation. Already this declaration has been signed by leading British pharmacologists, professors and doctors. People seen to be made actively involved in the campaign are forming local health action groups to support rational drug policies and better marketing practices. The following article, looks at the efforts of British groups to help combat the threat of Third World drug abuse.

Thousands of pages of enlightened analysis of Third World drug problems have been written and filed away in cubic metres of reports,. Similarly, countless UN resolutions setting out what needs to be done by governments to resolve the problems have been unanimously adopted by the international community. Meanwhile almost nothing has changed for the Third World poor. Millions are dying of diseases which are preventable or treatable with modern drugs and vaccines. We have had drugs to treat TB since the 1940s. Today, in India alone, an estimated half a million people die each year of TB. How complacent can we afford to be living in a society that has the means to reduce so much suffering, but fails to use it?

Momentum

The momentum for radical change in drug supply and marketing in the Third World is growing rapidly. The international debate has intensified over the past two years since the information of Health Action International (HAI) in May 1981. HAI offers a unique framework for groups and individuals in developed countries to work in partnership with groups in developing countries for the adoption of rational drug policies. Within the last 12 months a succession of books have provided carefully documented and compelling evidence that a drug market system which virtually ignores the existence of over half the world's population cannot be working. It makes neither ethical sense, nor economic sense in any terms except a very short-sighted drive for profit.

Worldwide pressure on public funds, the escalating costs of running health services and the growing strength of the consumer movements are fuelling the pressures of new drug policies. A growing body of professional and consumer opinion would like to see human needs, rather than market opportunity, become the key determinant both of research and development into new drugs and of existing drug production; if no better convergence between human need and profit is found, it is the Third World poor who will continue to pay the heaviest price.

What are the prospects for change? Structurally, the obstacles are significant. Individual manufacturers are caught in the dynamics of a market system which targets only the wealthy minorities in developing countries and ignores the needs of the mass of the people because they lack purchasing power. Leading manufacturers show little enthusiasm to move into the large volume, low-profit margin generics market.

Insight

An insight into their thinking can be gleaned from the confidential Minutes of the October 1982 half - yearly Meeting of the ABPI (Association of British Pharmaceutical Industries) which describes the new policy trend in Third World countries as being "in a direction inimical to our interests."

Why is an attempt to increase the number of drug consumers worldwide (by concentrating limited resources on drugs that are essential) in a potentially vast new market looked at in purely negative terms? Why is there so little discussion on long-term opportunities in the light of opening up new markets?

Opposition from industry is one barrier. Even more critical is lack of political will by some governments. Their lack of commitment to pursuing rational drugs policies is reinforced by the apathy of governments of major drug exporting nations who are concerned about their positive balance of trade in pharmaceuticals to the exclusion of whether the world's poor get access to basic drugs.

What of the dynamics for change? The role of the World Health Organisation (WHO) has been described as that of a catalyst for change in the drugs field, since Dr. Mahler, its Director General, took a pioneering role in decrying the evils of "drugs colonialism." There are encouraging new developments, such as the Welcome Foundation's joint research venture with WHO on onchocerciasis. But, however, valuable the potential of new research into tomorrow's drug for Third World diseases, the fact is that the poor still are not benefiting from yesterday's drugs. The immediate priority has to be a more equitable distribution of these essential drugs at fair prices.

This was the objective underlying the WHO Drugs Action Programme.

Five years into this programme and despite protracted negotiations beteen the International Federation of Pharmaceutical Manufacturers Association (IFPMA) on behalf of the leading manufacturers and WHO -on behalf of the least developed countries - there are no tangible results. The current situation is one of stalemate. The developing countries recently rejected the strings attached to the industry's offer of a "preparedness to negotiate on non-commercial prices" for drugs for the public sector only.

It is questionable whether these time-consuming negotiations offer the best way forward. WHO's technical expertise could be better employed in assisting individual countries to strengthen their buying mechanisms - to buy on their own terms.

The policies pursued by the Sri Lankan State Pharmaceutical Corporation in the early 1970s are just one example of what can be achieved with the political will to break dependence on monopoly suppliers and shop around on the world market. Faced with the opening up of competition, leading manufacturers dropping their prices substantially from one year to another. Beecham, for example, dropped the prices of clocacillin and ampicillin dramatically to 22 and 17 percent respectively of their previous prices.

A further major limitation of the WHO Drug Action Programme is that any negotiations on special prices are limited to the public sector, ignoring the private sector which in many developing countries dwarfs public sector distribution. In Bangladesh, for example, the private sector accounts for 90 percent (by value) of drug distribution. Thus if the needs of the majority of the pupulation are to be served, efforts must be made to increase the availability of low cost generics for private sale. This process may be jeopardized if drugs for the public sector are obtained cheaply with the quid pro quo of leaving a mass of wasteful, inessential products on the private market and pressures against generic prescribing.

No Substitute

If people in the Third World are to get the drugs they need, there is no substitute for political will on the of Third World governments. Thus the most significant recent event in the drugs field is without doubt the new drugs policy introduced in Bangladesh in June 1982. The Government decreed the phased withdrawal of 1,700 inessential, wasteful and unnecessarily harmful drugs from a total of about 4,000 on the local market.

This was the crucial first step towards eliminating wastage to give priority to production of 150 essential drugs. As WHO's Director General pointed out, the policy is very much in line with WHO recommendations. Nonetheless, the policy came under intense fire particularly from foreign manufacturers concerned both at the disruption to their short-term profitability and at the international implications of a move to get rid of inessential but profitable items like cough syrups and multi-vitamin tonics.

The US and the British governments both echoed their manufacturers' misgivings about the wisdom of the policy and its possibility negative impact on future foreign investment in Bangladesh, a country heavily dependent on foreign aid and investment.

The new Bangladesh Drugs Policy was decisive in demonstrating that non-governmental organisations have an impotant role to play in rallying support for rational drugs policies. Member groups of Health Action International, including OXFAM, War on Want, the Voluntary Health Association of India and the International Organisation of Consumer Unions, all rallied to defend the policy. Congratulatory messages arriving in Bangladesh from all over the world helped strengthen the resolve of the Bangladesh Government when it found its policy attacked by powerful opponents.

Support

Particular weight was given to the messages of support received from British pharmacologists and doctors underlining the positive role that British health professionals can play in achieving positive change to benefit the world's poor. Members of Health Action International have been greatly encouraged by what Bangladesh has achieved to date and are resolved to continue to seek international support for the policy and to help with the important public educational work that needs to be done within Bangladesh to publicize the objectives of the policy to doctors, health workers and the general public.

One new development is clear and encouraging: manufacturers are taking the Third World drugs issue a great deal more seriously than they did a few years ago. The IFPMA has drawn up its own international code on marketing practice. This should be seen as a first step towards a much tougher WHO-sponsored Code. Increasingly, national pharmaceutical manufacturers associations are setting up bilateral projects to improve drug supply in some of the world's poorest countries, including Burundi, Gambia and Rwanda to date.

These visible projects are designed for public relations advantage. However, as long as they put essential drugs in the hands of those most in need, it would be unfair to dismiss them as mere PR exercises. Realistically, manufacturers are not going to leap to answer the needs of the world's poor unless they are pushed along that road, by the trade-union movement (which is making very positive noises) by governments of developing and developed countries: and finally and critically by public opinion.

(Courtesy: Development Forum)

THE LOP-SIDED WORLD OF THE DRUG INDUSTRY

Caral Rapoport

The US $ 80 billion pharmaceutical industry is becoming increasingly international in all areas of its business; while the distribution of drugs world wide is getting heavily lop-sided in favour of those countries which can afford to pay for them. International manufacturers showing concern for this situation have proposed that special price concessions be offered to developing countries while adequate drug prices be charged in the industrialised countries to generate funds required for granting the concessions.

As the world's demand for modern hospitals and medical equipment increases, so does its demand for safe, efficacious drugs.

In the last decade or so, the pharmaceutical industry's image as miracle-worker has been somewhat tarnished but the setbacks and controversies have only increased the industry's determination to provide more treatments for more diseases in more parts of the world.

To meet this challenge, the $ 80 billion a year pharmaceutical industry is becoming increasingly international in all areas of its business. Thus, research into new cephalosporins, the broad-spectrum antibiotic used mainly in hospitals, is actively under way in the U.S., Britain and Japan, as well as in Sweden, West Germany and Switzerland.

Anti-cancer research is also a truly global project, with nearly every developed country hoisting a cancer research institute to augment the work done by private researchers.

This expansion in research activity world-wide has led to a record number of licensing and joint-venture deals within the pharmaceutical industry. Last year, for example, nearly 400 companies from 29 different countries agreed to licensing deals for new products – up from just 186 companies in 1981.

Research

The amount of money being ploughed into research is also growing. According to Edinburgh stockbrokers, Wood, Mackenzie, in 1978 drug companies were spending about 10.3 percent of their sales on research and development. Today that figure is close to 12 percent.

Even so, the distribution of drugs world-wide is heavily lop-sided in favour of those countries which can afford to pay for them. According to United Nations statistics, over 80 per cent of the world's drug production is consumed in developed countries and less than 20 percent in developing nations.

In fact, Dr. Haifdan Mahier, director general of the World Health Organisation said last year that the public health services of the 67 poorest developing countries, excluding China, are spending less in total than the rich countries spend on tranquilisers.

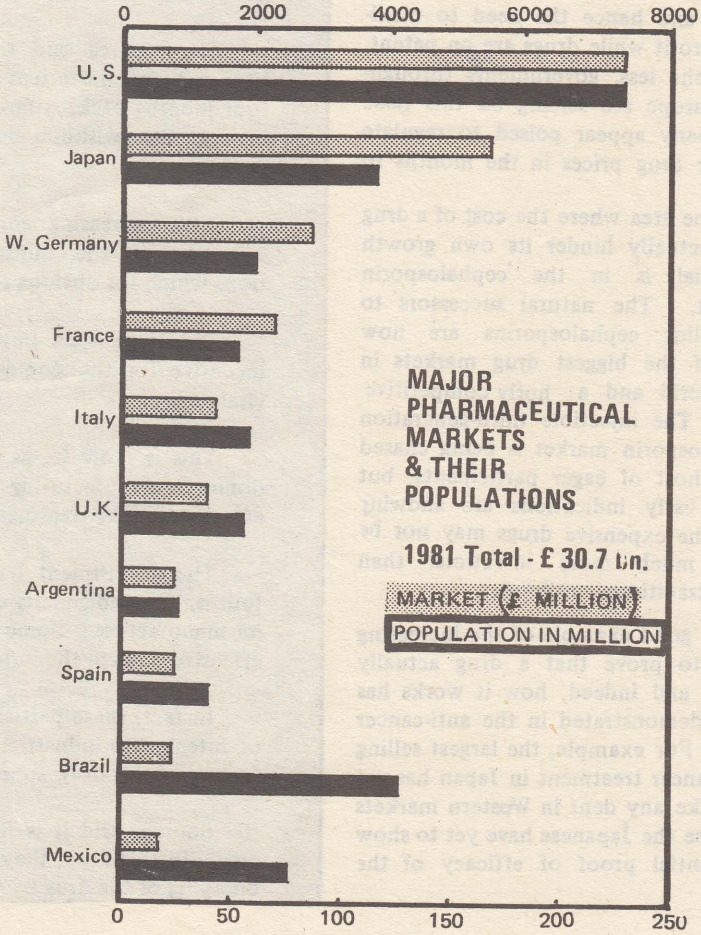
In a recent paper on the European pharmaceutical indsutry, Dr. George Teeling-Smith, director of the UK Office of Health Economics, and Mr. Otto Nowotny argued that three specific actions should be considered by industralised countries in order to change this pattern.

These proposed actions are:

* More research into tropical and other diseases prevalent in developing countries.

* Special price concessions to developing countries in order to make drugs available to as large a segment of the needy population as possible.

* Adequate drug prices in the industrialised countries to generate the funds required by the first two proposals.



The third proposal strikes a sensitive chord with the drug industry and its critics. In the past few years, the drug industry in Europe and the U.S. has come under attack by charities like Oxfam and consumer groups for allegedly charging excessively high prices for its products.

The critics charge that drug companies are quick to bring out similar products in a given therapeutic area without necessarily providing any innovation in treatment. Senator Edward Kennedy of the U.S., described the results as a "race" in which the world has been flooded with a "myriad of competing drug products".

The World Health Organisation in a controversial report published in 1981, stated that just over 200 active substances could adequately cover the health needs of the majority of the world's population. This figure of 200, they stated, compared to the "quite absurd figure" of 30,000 brands in some countries.

In their defence, drug companies point out that long regulatory procedures mean shortened patent life for drugs, and hence the need to maximise profit while drugs are on patent. None the less, governments throughout Europe are seizing on this issue and many appear poised to regulate further drug prices in the months to come.

One area where the cost of a drug may actually hinder its own growth potential is in the cephalosporin market. The natural successors to penicillins cephalosporins are now one of the biggest drug markets in the world and a hotly competitive one. The injectible third-generation cephalosporin market is being chased by a host of eager participants, but some early indications are showing that the expensive drugs may not be very much more infectious than more traditional antibiotics.

A good example of the increasing need to prove that a drug actually works and indeed, how it works has been demonstrated in the anti-cancer area. For example, the largest selling anti-cancer treatment in Japan has yet to make any dent in Western markets because the Japanese have yet to show substantial proof of efficacy of the drug.

MINCs Dumping Rifampicin in India

Rifampicin is a drug vitally required in India both as an anti-tuberculosis bulk drug and as an effective treatment for leprosy.

Indian manufacturers had ideas of producing this drug locally and 4 or 5 indigenous companies obtained official approval to set up projects. Meanwhile, the multinational drug firms operating in India began a price-war and have reduced their prices of Rifampicin about 3 to 4 times. This technique of gaining a foot-hold in an overseas market has had the desired effect of making it uneconomical for local manufacturers to start production, as this report in the Indian daily *"Financial Express"* of December 30th, 1983 indicates.

Multinational drug companies have resorted to dumping Rifampicin, an anti-tuberculosis bulk drug, on the Indian market, taking advantage of the liberal official policy with regard to import of this life saving drug.

According to sources here, the multinational companies are said to be vying with one another to capture the "vast" Indian market for this drug resulting in a virtual "price war" with competing companies cutting back their prices in quick succession.

On the other hand, this has frustrated the attempts of the domestic industry to create new capacities to cater to the growing demand for anti-TB drugs from indigenous sources.

The sources said that this year alone, the multinational companies have reduced the prices of Rifampicin about three to four times. About four months back, Rifampicin was quoted on the Indian market at Rs 4,000 per kg. But, within a short span of time, this was reduced to about Rs 3,000 per kg.

With increasing competition among the supplier companies to gain a foot-hold in the country, some suppliers have in fact offered further reductions which for obvious resons go in favour of the consumers.

The large scale imports at dump prices has proved to be a great disincentive for the domestic licencees to undertake the manufacture of this vital drug.

This is more so, as this vital drug is wholly imported currently with no domestic manufacturing base. Besides, this drug has been found to be equally effective for the treatment of leprosy.

The government had, realising the importance of this drug, permitted four or five indigenous companies, by granting letters of intent, to undertake its manufacture. Some of these manufacturers have not been able to take effective steps in the implementation of their projects.

In fact, these parties have not even sought the conversion of their letters of intent into industrial licences as the entire economies of domestic manufacture of this drug appear to have gone away.

Sources said it is feared that once the indigenous manufacturers come out with this drug, they may not be able to market the same in view of the dumping of the drug by multinationals.

High hopes

High hopes for interferon, the body's own first-line defence against disease, have also been dented because of disappointing results in clinical trials on solid tumour cancers. The proliferation of new cancer treatments remains high, however, because of the continuing spread of the disease world-wide.

Cancer research is also somewhat less affected by side-effect problems, as terminally ill cancer patients are less likely to complain about complications with a new drug if it offers some hope of recovery, In other areas, however, the concern over side-effects has been increasing.

In Britain alone, some five new drugs have been withdrawn or prevented from entering the market because of side-effect problems over the last 12 months. Many European governments are now considering ways to strengthen their monitoring systems for side-effects on new drugs.

For the future, both the consumers and manufacturers are becoming increasingly hopeful about the benefits of genetic engineering for the world's health. Already, deals in the licensing of biotechnology products are proliferating. According to IMS World Pharmaceutical Marketletter, biotechnology agreements involved nearly 20 percent of world-wide licensing agreements in 1981– by 1982, that percentage had shot up to 50 per cent.

Many newly formed biotechnology venture firms have recently signed agreements with large drug companies for the commercialisation of their recombinant DNA products. The most active areas of research are in new means of energy production, genetics and human growth, prevention of disease as opposed to treatment and plant genetics and vaccines.

Researchers forecast that these innovations are still some 10 to 20 years away from chemists' shops. Until that time, the drug industry and its consumers face the challenging task of improving the world's health with the means at hand.

THE FAILURE OF MONETARISM

Nicholas Kaldor

British economist Professor Nicholas Kaldor, also noted both in Sri Lanka and India for his expert advice on taxation, read this paper in the first Chintaman Deshmukh lecture instituted by the Reserve Bank of India in memory of the Reserve Bank of India's first Indian Governor.

In an introductory remark Kaldor says that in discussing monetarism he will be dealing with how the discarded and discredited ideas of 60 years ago became the official policies of the most important central bank of the world, the Federal Reserve System of the United States.

Kaldor also argues that contrary to Friedman's frequent assertions the demand for money as a proportion of incomes (i.e. the reciprocal of the velocity of circulation) is neither "stable" between countries not stable over time, except in some countries.

The American monetarist experiment was a terrible failure. He assetts that the primary function of the Central Bank is to ensure that the expansion of bank credit proceeds fast enough to exploit an economy's true potential for growth, without allowing the economic mechanism from being clogged up through excessive credit creation.

His final conclusion is that bank credit should expand at the right rate, neither more nor less; and this is neither ensured nor prevented by the attempts to control the vagaries of the money supply.

I must not spend any more time on reminiscences as there would be no time left for the intended subject matter of my lecture, of how the discarded and discredited ideas of 60 years ago became the official policies of the most important central bank of the world, the Federal Reserve System of the United States. Fortunately the American Constitution, based on the principles of Montesquieu, provides for the division of powers which ensures at present that while monetary policy conducted by the Federal Reserve and the United States Treasury pulls in one direction, taxation and fiscal policy, as determined by Acts of Congress, pulls in the opposite direction. Hence, in contrast to the prewar situation when the contraction of the US economy created the world dollar shortage, and was the main cause of worldwide deflation, there is no world dollar shortage at present; the United States balance of payments on current account is in the red to the tune of over $ 30 billion which is expected to reach $ 60 or 70 billions by 1986. Together with the disappearance of the petrodollar surplus of the OPEC countries this will greatly ease, if not altogether remove, the balance of payment constraint on the economies of the rest of the world – though given the foolishness of many political leaders of the West, there is no telling what might happen.

I think I had best begin by making my own position clear – I regard 'monetarism' as a terrible curse, a visitation of evil spirits, with particularly unfortunate, one could almost say devastating, effects on my own country, Britain. The biological process of natural selection should make for the development of favourable traits in the human character – and that includes the acceptance of ideas and beliefs that promote progress and the rejection of ideas that have the opposite effect. As we all know this is not, unfortunately, either a smooth or a continuous process – it proceeds by fits and starts. The religion of most societies contains the basic dualism between good and evil spirits, between angles and devils, between the purveyors of good advice and the purveyors of bad advice. The choice between them is often represented as a moral issue whereas it is more truly a matter of flair and intuition which sometimes works and sometimes does not. Decadence, according to Nietzsche, is a state in which the individual intuitively goes for the bad solutions for getting out of difficult situations, and fails to pick out the good ones.

The alarming thing is not that some people should hold crackpot ideas – the alarming thing is when crackpot ideas sweep the board – when they capture the minds of a wide selection of important and influential people. This has been the case with the rapid spread of monetarism among academics, journalists, bankers and politicians in the ten years following the first "oil shock" in 1973. Ultimately the devil fails – at least this has been the case hitherto, otherwise we should not be here. But the cost is sometimes horrendous — whether through wars, revolutions or the misery and agony inflicted by mass unemployment, loss of opportunities, loss of skills or even loss of knowledge and know-how.

> *"..... an essential part of my scheme was a large reduction in the rates of taxation — with a maximum marginal rate of income tax of 45 percent — so that the part of the recommendations confined to the introduction of new taxes was contrary to the 'concept and spirit' of my scheme".*

Function of Central Bank

Perhaps I ought to make explicit the obvious point that the term "monetarism" does not mean "monetary policy", as ordinarily understood. The latter term relates to the policy of policies conducted by the Central Bank. Monetary policy can be of numerous kinds. It could be Keynesian or orthodox, it could also be "monetarist" in the special sense used here, except, as I shall attempt to show, the latter is not likely to be a viable policy in terms of its own objectives. However, as Adam Smith has shown in the Wealth of Nations, banks form a most important institution for economic development, since it is the availability of bank credit which alone makes possible the exploitation of new investment opportunities as they accrue and before the savings generated by the exploitation of the enlarged economic potential come into existence. It is the primary function of the central bank to ensure that the expansion of bank credit proceeds fast enought to exploit an economy's true potential for growth, without allowing the economic mechanism from being clogged up through excessive credit creation. The art of central banking. as Hawtrey explained, was to make sure that the right amount of new credit is generated, neither more nor less.

The rise of the new monetarism is mainly associated with the work of a single pioneer, Milton Friedman, a man of unusual ingenuity and powers of persuasion, but also an impish character of whom one can never be sure whether he is serious or just kidding — how far he is genuinely convinced of the things he says and how far he just enjoys the spectacle of parrying the intellectual blows of his opponents by a rich variety of counterthrusts in unexpected directions — so that he need never acknowledge defeat. The charge of intellectual dishonesty is a serious one and should not be made lightly. However, in connection with Friedman's empirical investigations it has been made more than once, recently and most effectively in a paper by Professor D. F. Hendry (who is professor of econometrics at Oxford) and published by the Bank of England.

Friedman's work as an economist can be mainly characterised as a counter-reformation — the reaction against the new economics of the 1930's and the return to 19th century orthodoxies. This involved both a denial of the theories of imperfect competition which were destructive of the neoclassical Walrasian general equilibirum value theory and of Keyensian macro-economics which replaced the orthodox ideas on money and inflation.

Three assumptions

The more modern monetarism is characterised by three particular assumptions — all of which are part of the credo of the (original) Chicago School.

1. Prices in all markets are completely flexible — they rise in response to excess demand and fall in response to excess supply. Since prices in a perfect market must settle at the point where supply and demand are equal neither commodities nor services can be in a state of "excess supply" more than momentarily. (This comes to the same as the assumption that a market economy, left to itself, is self-regularating — it functions so as to ensure the full and efficient distribution of resources).

> *It is the primary function of the central bank to ensure that the expansion of bank credit proceeds fast enough to exploit an economy's true potential for growth, without allowing the economic mechanism from being clogged up through excessive credit creation.*

2. There are no important differences between a (pure) commodity money economy (where money consists of gold or silver or oxen) and a credit — money economy where money consists of negotiable debt certificates — promises to pay of financial intermediaries which are convertible only in the sense that they can be exchanged into other forms of debt. (A bank cheque can be converted into bank notes; a bank note into other bank notes and so on).

3. Effective control over the "money supply" will have a direct influence on the level of demand, and hence of prices; successful control of the money supply is both a necessary and a sufficient condition for moderating the rate of inflation — and indeed bringing it to an end, if the control is maintained long enough.

All three of these propositions are based on false premises and are the main sources of error in monetarist thinking.

1. The first assumption leads to a failure to recognise the all important difference between a demand inflation and a cost inflation. In the 'Walrasian' model of the economy which is at the bottom of all Friedmanite thinking, a rise in prices can occur only as a result of excess demand in some or all the markets. Costs (or incomes generated in the process of production) in that model of the economy are derived from prices, hence they cannot exert an autonomous influence on prices. In the real world,however,, except in special circumstances where there is an excessive pressure on resources (this generally happens as a result of a major war on its aftermath, but it can also happen as a result of failure of a government to cover an adequate proportion of its expenditure by normal revenues), prices of goods and services rise in consequence of a rise in costs — whether material, fuel, or labour costs —and such cost induced rise in prices tends to generate further price and cost increases even in circumstances in which there is an excess supply both of labour and of productive capacity. Thus the strict monetarist view denies that trade unions can bring about a rise in the prices of the goods which they produce. (This was Mrs. Thatcher's view in the first year of office when she fre-

quently said that all labour can do is to price itself out of the market — it cannot cause inflation. In her second year however she changed her position and admitted that a reduction of price-inflation pre-supposes a reduction in the size of wage settlements).

2. The second assumption carries the implication that money has an 'exogenus' supply schedule in a credit economy, which determines the quantity available independently of the demand for it — it denies the basic difference in casual relationships between a commodity — money system and a credit-money system.

3. The third assumption implies that the quantity of money and the velocity of circulation are mutually invarient, whereas in reality, controls which succeed in reducing the stock of money (or cause it to rise at a lower rate) may be rendered nugatory by a compensating change in the velocity of circulation. Indeed the very distinction between changes in the quantity of money and changes in the velocity of circulation comprises an arbitrary element of definition — what appears as a rise in the velocity of circulation under a narrow definition, may appear as a change in the quality of money, on a broader definition, which includes money substitutes.

Of these assumptions I propose to concentrate on the second, the differences between a commodity-money-economy and a credit-money-economy just because I regard this as the essential element of the problem which has been largely neglected by Keynesian economists and not only by the monetarists.

It is the essence of the quantity theory of money that the supply of money is "exogenous" — that is to say, that it is determined independently of the demand. This will be the case in all circumstances in which the quantity of the money-commodity (strictly speaking this involves a closed economy not trading with the outside world) — the quantity of precious metals — is given. It is also true in case in which money has an independent supply function — i.e. when the quantity of the money commodity can be varied through production, by the changes in supply that can be brought about in this way directly generate incomes, and are closely related to the value of money in terms of goods. (Ricardo assumed for purposes of this theory that gold is produced under conditions of constant cost i.e. that the value of gold in terms of commodities is fully determined by its labour costs relative to that of other commodities). But in the case of paper money or credit money in its numerous forms (bank money) there is no such independent supply function. Credit money cpmes into existence as a result of bank lending and is extinguished through the repayment of bank loans. Hence the 'money supply' can never be in excess of demand in the sense in which the available quantity of gold can be in excess of the amount people wish to hold. At any one time the volume of bank lending and its rate of expansion is limited by the availability of credit-worthy borrowers. When trade prospects are good or when the money value of the borrowers' assets (their collateral) rises as a result of a rise in prices, the demand for bank credit rises but by the same token, the credit worthiness of potential borrowers also improves so that the suplly of credit will expand automatically with the demand.

I found that contrary to Friedman's frequent assertions the demand for money as a proportion of incomes (i.e. the reciprocal of the velocity of circulation) is neither "stable" between countries nor stable over time except in some countries.

In the case of a purely metallic currency, it is possible to suppose that the supply of the money commodity increases relatively to the demand — say, as a result of the discovery of new gold mines or the conquest of a new continent with a great deal of gold like the Spaniards found in America in the 16th Century — in which case the value of gold must fall relative to other commodities in order to find a 'home' for all the fold that seeks a 'home'. A change in the price level — in the value of the money commodity relatively to others thus forms the adjustment mechanism which brings desired money balances (Walras "encaisse desiree") into conformity with actual balances.

Endogenous Money Supply

But there is no analogue to this in the case of credit money. The "supply" of bank money cannot be assumed to vary relatively to demand, the two must always change together. It is impossible to imagine that the prevailing amount of bank money should be in excess of the amount which individuals collectively desire to hold — if there was such an excess, it would be extinguished through the repayment of bank loans.

In other words, in a credit money economy the supply is necessarily endogenous, not exogenous. This proposition is of course in sharp contradiction to the beliefs of the many adherents of the quantity theory of money which think that the exogenity of the money supply in a credit money economy is ensured either through the numerical dependence (or strict proportionality) of bank money to the underlying "real" money (this was Walras' and Marshall's view) — paper money is in strict proportion to gold — or simply through the reserve requirements imposed on commercial banks by the central bank. However there is no such one way causation from the "monetary base" determined by the central bank and the size of the credit pyramid which is built on it. This is partly because the central bank can only determine the total of "base money" issued (including the notes and coins circulating with the public) and not the size of the commercial banks' reserves as such. But it is partly also because 'the central bank's function of "lender of last resort" (which is considered indispensable for maintaining the solvency of the banking system) makes it impossible for the central bank to set rigid limits to the amount of cash which it is willing to put at the disposal of commercial banks through rediscounts. The "discount window" can never be closed.

Keynes unwittingly contributed to Friedman's revival of monetarism by his "liquidity preference" equation, M = L (y, r) where the demand for money was assumed to vary with the rate of interest, whereas the supply of money, M , was taken as an exogenous constant. This formulation puts the whole burden of adjustment to a change in the level of income, Y, on the elasticity of demand for money balances — the elasticity of the liquidity preference function, which meant that variations of economic activity will be correlated with corresponding variations in the velocity of circulation. Starting from these premises. Friedman was justified in thinking that strong empirical evidence concerning the stability of the velocity of circulation — in other words, a strong empirical correlation between M and Y is sufficient to "refute" the Keynesian hypothesis. However it did not occur to him (at least not immediately) that the explanation of his findings may lie somewhere else — in the variability of M with the volume of borrowing which postualtes a high degree of elasticity in the supply of money with respect to the rate of interest (or simply of income) and not (or not necessarily) of the demand for money (at a given level of income). However, once we realise that the supply of money is endogenous (it varies automatically with the demand, at a given rate of interest), "liquidity preference" and the behaviour of the velocity of circulation ceased to be important.

At a later stage, Friedman and his followers investigated the matter and came up with a remarkably ambiguous answer: "the alternatives contrasted are not mutually exclusive. Undoubtedly there can be and are influences running both ways" (i.e. from Y to M as well as from M to Y). He then cites "five kinds of evidence" for the view that the "monthly series is dominated by positive conformity".

I found most of his "evidence" (particularly that of his book, The Monetary History of the Unied States) largely worthless or irrelevant. Moreover, I found that contrary to Friedman's frequent assertions the demand for money as a proportion of incomes (i.e. the reciprocal of the vecolity of circulation) is neither "stable" between countries nor stable over time except in some countries. For example, in Switzerland, Italy and Japan the money supply (on the broad definition M3) has been rising over the last twenty years in relation to incomes, whilst in the US and the UK it has been falling. In 1978 the ratio of M3 (broad money) (as proportion of the GNP) was over three and a half times as large in Switzerland as in the UK. Even on the narrow definition, M1 the money supply in Switzerland was nearly three times as great as in the UK or the US as a proportion of the GNP. Yet no-one would regard Switzerland as an "inflation prone" country (let alone more inflation prone) than the US or the UK.

Money substitutes

The traditional method by which a central bank exerts its regulating function is by setting its own re-discount rate, and keeping the market rates in certain relationship to this through open market operations. Historically, the central bank's policies were mainly motiviated by the desire to protect its own reserves (consisting of gold and reserve currency holdings); it lowered the discount rate in times of rising reserves and vice versa. This policy is perfectly compatible with the "money supply" being a passive element varying automatically with the demand for credit (or the availability of credit-worthy borrowers).

However, in the new monetarist's view all this is wrong. To stabilize the economy and to avoid inflation what is needed first of all is to secure a steady growth in the money supply, not a steady rate of interest. Hence the "new" policy of the Federal Reserve, announced by Mr. Volcker on October 6, 1979, was to secure a slow and steady growth of the monetary aggregates M1 and M2 by varying the reserves available to the banking system through open market operations, irrespective of the movements of the rate of interest. From that day on dramatic changes started to happen which were quite different from those expected. The money supply failed to grow at a smooth and steady rate; its behaviour exhibited a series of wriggles. The rate of interest and the rate of inflation, though both were very high at the start, soared to unprecedented heights in a very short time.

By March 1980 the rate of interest rose to 18.6 percent and the rate of inflation to 15.2 percent, and a little later both were over 20 percent — which had never occurred before in the United States, certainly not in peace-time. And there was a mushroom-like growth in new forms of making payments and new instruments circumventing the Fed's policy through the invention of money substitutes of all kinds, the transfer of business to non-member banks or to branches of foreign banks, and so on. The Fed's reply to this was that its failures were all due to loopholes in the existing system which must be closed. Congress obliged their friends in the Fed very quickly, passing the Monetary Control Act of 1980, supplemented by invoking the International Banking Act and the Credit Control Act. These extended minimum reserve requirements to all deposit-taking institutions, whether or not they were member banks of the Fed, as well as to branches of foreign banks in the US. But none of this helped, as the British Radcliffe Committee foretold would happen twelve years earlier, when it said that the extension and multiplication of controls, through a wider spread of banking regulations would only mean that new forms of financial transactions or intermediaries will appear which will cause the situation continually "to slop from under the grip" of the authorities.

The American monetarist experiment was a terrible failure, as was publicly admitted by Friedman and Meltzer in 1982, though insisting that it was the fault of the authorities in not being able to run a monetarist policy properly — not the fault of basic theory, Short of the old Chicago plan for 100 percent reserves, there was certainly no way in which the authorities could have stopped the banks inducing the public to exchange more of their currency notes for deposits and thereby enlarge the lending power of the banks combined with a repurchase agreement if necessary.

After a year and a half of continued failures and a chaotic volatility of everything — interest rates, exchange rates, inflation rates — the experiment was abandoned and the system returned, in effect, to the traditional policy of regulating interest rates but with a more delfationary stance; partly, I presume, to offset the inflationary force of excessive federal deficits — and cause the rest of the world to suffer (or benefit, as the case may be) from the consequences of an overvalued dollar. As the former German Chancellor Schmidt said the other day, the US government caused real interest rates to rise to higher levels than at any time since the birth of Christ.

Structure of Interest Rates

In retrospect none of this would have happened if the Fed had studied and understood the analysis and prescription of the British Radcliffe Committee in 1958, according to which central banks should not really be concerned with the "supply of money" — it is the structure of interest rates and not the quantity of money "which is the centre-piece of monetary action". However, the committee was also of the view that the structure of interest rates, and particularly the long term interest rates should be set by the central bank in the best interests of long term development and not moved up and down with the changing needs of the short-term situation. But this implies (through the committee refrained from spelling out these consequences explicitly) that for the day-to-day control of the rate of expansion of bank credit, the central bank requires additional instruments such as setting the 'ceilings' for the rate of credit expansion, which is the met-

The Thatcher experiment has left Friedman and the monetarists in an intellectually highly embarassing position.

hod practised by most European central banks (including the Bank of England upto 1931) as well as, I understand, by the Reserve Bank of India.

In Britain, when Mrs. Thatcher came to power in May 1979, her government officially pronounced the formal adoption of the "monetarist creed" with almost the same solemnity as the Emperor Constantine when he embraced Christianity as the state religion. However in the circumstances of British institutions this proved even more difficult than in the United States, as subsequent events have shown. The Bank of England was incapable of fixing the "monetary base" let alone the size of mandatory bank reserves, or to leave interest rates to be freely determined by the market. Instead they fixed a four year target for the growth of the money supply (on its broad definition of M3 including interest-bearing bank deposits) on a gradually shrinking basis: 7 — 11 percent increase in the first year, 6—10 percent in the second year and 4—8 percent in the fourth year; and they relied, for holding the money supply within the target range, on a steadily falling public sector deficit (as a percentage of the national income) and on varying the short term interest rates upwards or downwards according to the moeny supply moved relative to the target. (They were convinced, wrongly, in my view, that the public sector deficit is the major cause of changes in the money supply or that a change in interest rates can affect the money supply otherwise than through consequential changes in the volume of borrowing).

But the whole plan came unstuck in their first year and disastrously so in the second year. The growth in the money supply continually exceeded the target range from the beginning and it rose at an almost unprecedented rate of 22 percent in the second financial year. At the same time the deficit of the public sector exceeded the target by 2 percent of the GDP in 1980—81 and by 1 percent in 1982 — despite repeated cuts in public expenditure and heavy increases in the burden of taxation.

The government has thus singularly failed to carry out its stated objectives in terms of either the growth of the money supply or of the reduction in the burden of taxation or in the public sector deficit. But they have nevertheless succeeded (if "success" is the appropriate term) in creating a deep economic recession — a recession that goes far beyond that experienced by any other Western industrialised country. Manufacturing output fell by 13.5 percent in 1980 — a greater fall than in any year of the great depression of the 1930s. Industrial production in 1983 was 20 percent lower than ten years earlier, whereas in the case of other industrial countries production is considerably higher than ten years ago. There can be little doubt that the unprecedented rise in effective exchange rate of the pound sterling (which reduced industrial competitiveness by some 40 percent in comparison with 1978) must have played a major role in this, causing a large fall in new orders both in the home market and abroad and an exceptionally large reduction in stocks.

The rise in unemployment from 1.2 to 3.2 millions — by 2 millions or 8 percent of the labour force in two years — together with the numerous closures of factories, actual or threatened, has undoubtedly greatly weakened trade union power and thus contributed to a slowing down in the rate of increase in wages in recent settlements. This, however, is clearly a consequence of mass unemployment due to the recession; it cannot be due to anything which has happened, or is happening, on the side of the money supply. The "achievements" on the wage front and in the inflation rate do not provide any support for the validity of "monetarism" — quite the contrary — which does not stop government spokesman from claiming credit for it.

The Thatcher experiment has thus left Friedman and the monetarists in an intellectually highly embarassing position. Friedman has admitted that as far as the United Kingdom is concerned, the money supply is not exogenously determined by the monetary authorities but he attributed this to the "gross incompetence" of the Bank of England. Later he said or implied the same thing about his own country. However, this puts an entirely new complexion on monetarism. It was nowhere stated in the writings of Friedman or any of his followers that the quantity theory of money only holds in countries where the monetary authorities are sufficiently "competent" to regulate the money supply. If the Bank of England is so incompetent that it cannot do so, how can we be sure that the Bank of Chile or of Argentina or Mexico — to take only the highly inflationary countries — is so competent, or rather so competently incompetent, as to make it possible to assert that the inflation of these countries was the consequence of the delibrate action of their central banks in flooding these countries with money ? How indeed can we be sure that any central bank — not excluding even the German Bundes-bank or the Swiss bank — are sufficiently competent to be able to treat their money supplies as exogenously determined ? And what happens if they are not ? Surely we need a theory of money and prices to cover the cases of countries with incompetent central banks, such as Britain and the United States ?

The acceptance of monetarist theories was largely the consequence of the glittering empirical and econometric evidence which Friedman and his followers were able to assemble concerning the close correlation between the changes in the money supply and of the level of money transactions (the money GNP) which Friedman believed was incompatible with, and thus refuted, Keynesian theory. However, he always admitted that this is only true on the supposition that the change in the money supply is the cause of the change in the level of prices (or of total expenditure) and not the other way round. In other words, that the money supply is exogenously determined by the monetary authorities. If it is now conceded that this would not be true in all cases — it would not be true in cases of countries with incompetent monetary authorities like the Fed or the Bank of England — how can we be sure that his findings have any relevance to other countries which may be tempted to control inflation by making the money supply follow an exogenous path of slow growth ? The only remaining example where Friedmanite policies were given a thorough airing is Chile, but it would take me too long to explain why that country, too, must be classed among the incompetents.

In my view the proper test of competence of a central bank is how far it succeeds in ensuring that the banking system grants sufficient credit at the disposal of industry and commerce so that the true economic potential of the economy can be reasonably fully exploited without being over-exploited. In other words, bank credit should expand at the right rate, neither more nor less. This is neither ensured nor prevented by the attempts to control the vagaries of the money supply.

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