Money and Credit

Money as a Medium of Exchange

- **What is money?** Money is anything that is widely accepted as a form of payment for goods and services.
- **Why do we use money?** It simplifies trade and eliminates the need for a "double coincidence of wants" found in barter systems.
  - **Barter System:** Imagine a shoemaker who wants wheat. In a barter system, they'd need to find a wheat farmer who also wants shoes. This is difficult and inefficient.
  - **Money System:** The shoemaker sells shoes for money, then uses that money to buy wheat. No need to find someone with the exact opposite need.

How does money work?

- **Medium of Exchange:** Money acts as an intermediary step in transactions, making trade smoother.
- **Example:** Shoemaker sells shoes for money --> Shoemaker uses money to buy wheat.

Modern Forms of Money

- **Currency:**
  - Notes and coins issued by the government (in India, the Reserve Bank of India).
  - Has no intrinsic value (unlike gold or cattle used in the past).
  - Accepted because the government gives it legal tender status.
- **Demand Deposits:**
  - Money held in bank accounts.
  - Can be withdrawn at any time.
  - Allows for payments by check, further reducing the need for physical cash.
  - Banks play a crucial role in managing these deposits.

Key Points to Remember

- Money makes trade more efficient.
- Modern money is not backed by precious metals; its value comes from government backing and trust.
- Banks are essential for the functioning of modern money systems, especially with demand deposits and checks.

Loan Activities of Banks

- **Deposits:** Banks accept deposits from the public.
- **Reserve:** They keep a small portion (e.g., 15% in India) as cash reserve to handle daily withdrawals.

- **Loans:** The major portion of deposits is used to provide loans to individuals and businesses.
- **Intermediation:** Banks act as intermediaries between depositors (with surplus funds) and borrowers (needing funds).
- **Profit:** Banks earn profit by charging a higher interest rate on loans than they pay on deposits.

Credit: Two Different Situations

- **Credit:** An agreement where a lender provides money, goods, or services in exchange for a promise of future payment.
- **Example 1: Salim (Positive Outcome)**
  - Takes credit for working capital (day-to-day expenses) in his business.
  - Credit helps him complete production and increase earnings.
  - Credit plays a positive role.
- **Example 2: Swapna (Negative Outcome)**
  - Takes credit for crop production.
  - Crop fails, making loan repayment impossible.
  - Forced to sell land to repay the loan, ending up worse off.
  - Illustrates a debt-trap where credit leads to further financial difficulty.

Key Takeaway: Whether credit is beneficial or harmful depends on the risks involved and whether there's support in case of losses.

Terms of Credit

- **Interest Rate:** The rate borrowers pay to lenders for the loan.
- **Collateral:** An asset (land, building, etc.) used as security for the loan. If the loan isn't repaid, the lender can seize the collateral.
- **Terms of Credit:** Include interest rate, collateral, documentation requirements, and repayment mode.
- **Variations:** Terms vary based on the lender, borrower, and loan purpose.

Important Considerations:

- **Risk Assessment:** Borrowers must carefully assess the risks involved before taking credit.
- **Support Systems:** Access to support systems (e.g., crop insurance, government assistance) can help mitigate risks.
- **Responsible Lending:** Lenders should ensure responsible lending practices, considering the borrower's ability to repay.

Formal Sector Credit in India

- **Types of loans:**

- **Formal:** Loans from banks and cooperatives.
  - **Informal:** Loans from moneylenders, traders, employers, relatives, etc.
- **Formal Sector Advantages:**
  - **Supervision:** Reserve Bank of India (RBI) supervises banks and cooperatives.
    - Ensures they maintain adequate cash reserves.
    - Encourages lending to diverse borrowers (small cultivators, small businesses, etc.)
    - Requires regular reporting on lending practices.
  - **Lower Interest Rates:** Generally offer lower interest rates than informal lenders.
- **Informal Sector Disadvantages:**
  - **Lack of Supervision:** No organization monitors their activities.
  - **High Interest Rates:** Often charge very high interest rates.
  - **Unfair Practices:** May use unfair means to recover money.
  - **Debt Trap:** High interest rates can lead to a cycle of increasing debt.

Consequences of High Informal Credit

- **Reduced Income:** Borrowers have less income left after repaying high-interest loans.
- **Debt Trap:** Can lead to a situation where loan repayment becomes impossible.
- **Limited Opportunities:** High cost of borrowing discourages entrepreneurship and investment.

Need for Formal Credit Expansion

- **Higher Incomes:** Access to affordable credit can boost income and economic growth.
- **Diverse Needs:** Enables borrowing for various purposes (agriculture, business, etc.).
- **Crucial for Development:** Cheap credit is essential for overall development.

Credit Access Disparity

- **Unequal Access:** Richer households have greater access to formal credit.
- **Poorer Households Reliance:** Poorer households rely more on expensive informal credit.

Key Takeaways

- Formal credit needs to expand, especially in rural areas.
- Everyone should have access to affordable formal credit.
- Equal distribution of formal credit is crucial to reduce dependence on informal sources.
- Reducing reliance on informal credit can help break the cycle of poverty and promote economic development.

Self-Help Groups for the Poor

- **Challenges faced by the poor in accessing formal credit:**
    - Lack of bank presence in rural areas.
    - Difficulty in meeting bank requirements (documentation, collateral).
    - Dependence on informal sources like moneylenders who charge high interest rates and may use unfair practices.
- **What are Self-Help Groups (SHGs)?**
    - Groups of 15-20 people, usually women from the same neighborhood.
    - Members save regularly (Rs 25 to Rs 100 or more, depending on capacity).
    - Members can take small loans from the group itself at reasonable interest rates.
- **Benefits of SHGs:**
    - **Access to Formal Credit:** After a year or two of regular saving, SHGs become eligible for bank loans.
    - **Overcoming Collateral Barrier:** Banks are more willing to lend to SHGs even without collateral.
    - **Empowerment:**
        - Members make decisions about savings and loan activities.
        - Responsibility for loan repayment lies with the group, promoting accountability.
    - **Social Benefits:** Platform to discuss and address social issues like health, nutrition, and domestic violence.
- **How SHGs work:**
    - **Savings:** Members contribute regularly to a common fund.
    - **Internal Lending:** Members can borrow from the fund for various needs (e.g., working capital, housing, assets).
    - **Bank Loans:** Groups can access larger loans from banks for income-generating activities.
    - **Group Responsibility:** The group is responsible for loan repayment, reducing the risk for banks.

Key Takeaways

- SHGs provide a valuable alternative to informal credit sources for the poor.
- They promote financial inclusion and empower women.
- SHGs contribute to both economic and social development.

Summing Up

- Modern money (currency and deposits) is closely linked to the banking system.
- Credit plays a crucial role in economic activities.
- Access to affordable formal credit is essential for development.
- SHGs are an effective way to provide financial services to the poor and promote inclusive growth.

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