MONEY AND CREDIT

CLASS- X

Money

When we turn the pages of history we will find that money was used in various forms at various times. The different materials that were used as currencies, the different goods that were exchanged in trade make a very interesting story.

Today in this modern world newer forms of money are slowly spreading with computerization of the banking system. Money and credit go hand in hand. Credit is a crucial element in economic Life.

The other crucial issue of credit is its availability to all, especially the poor, and on reasonable terms. Without credit a large section of people would be kept out of the development process.

Money as a Medium of Exchange

The use of money spans a very large part of our everyday life. Several transactions involving money are made in any single day.

- Goods are being bought and sold with the use of money.
- Services are being exchanged with money.
- Goods are also bought with a promise to pay money later.
- Money is sometimes paid as advance with the promise of delivery of goods later.

In the olden days, when modern currency was not in vogue, people had to sell and buy each others commodities. This was called the barter system. For instance if a shoe manufacturer wants to buy wheat, he has to find a farmer who wants to buy his shoes in exchange for the wheat. That is, both parties have to agree to sell and buy each others commodities. This is known as double coincidence of wants. In a barter system where goods are directly exchanged without the use of money, double coincidence of wants is an essential feature.

The barter system proved very inconvenient and the need for some form of payment in exchange for ones goods became a necessity. Everyone prefers to receive payments in money (in some form or the other) and then exchange the money for things that they want. For instance, shoe manufacturer will now first exchange shoes that he has produced for money, and then exchange the money for wheat or any other product he wants, instead of going in search of a trader who wants to sell what he wants to buy.

Since money acts as an intermediate in the exchange process, it is called a medium of exchange.

<u>Modern forms of Money</u>

As the need for a medium of exchange became a necessity different materials were used as a medium of exchange. Initially Indians used grains and cattle as money. Before the introduction of coins, a variety of objects was used as money.

Thereafter came the use of metallic coins — gold, silver, copper coins — a phase which continued well into the last century.

As time progressed, trade increased, and a global market was created. With the global market came the need for a more convenient medium of exchange. Thus was born the modern forms of money - paper notes (currency) and coins.

Modern currency is not made of precious metal such as gold, silver and copper. And unlike grain and cattle, they are neither of everyday use.

The modern currency is without any use of its own. Still, it is accepted as a medium of exchange because the currency is authorized by the government of the country.

In India, the Reserve Bank of India issues currency notes on behalf of the central government.

As per Indian law,

- No other individual or organization is allowed to issue currency.
- As also no individual in India can legally refuse a payment made in rupees.
- Hence, the rupee is widely accepted as a medium of exchange.

Deposits with Banks

At a point of time, people need only some currency for their day-to-day needs. So, people deposit the extra money with the banks by opening a bank account in their name. Banks accept the deposits and also pay an interest rate on the deposits. In this way people's money is safe with the banks and it earns an interest.

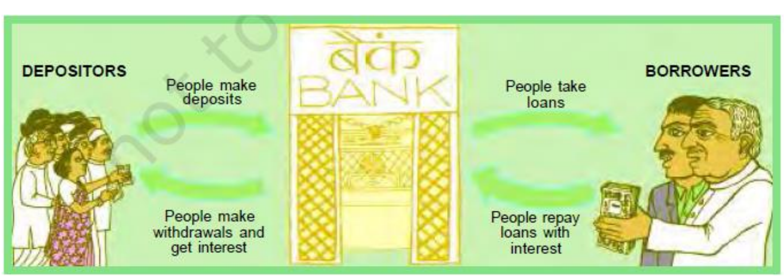
People also have the provision to withdraw the money as and when they require. Since the deposits in the bank accounts can be withdrawn on demand, these deposits are called demand deposits.

Cheques

A deposit in a Bank offers the customer the facility of issuing cheques. A cheque is a paper instructing the bank to pay a specific amount from the person's account to the person in whose name the cheque has been made. The recipient of the cheque can deposit it in his own account in his bank. The money is transferred from one bank account to another bank account in a couple of days. The transaction is complete without any payment of cash. This is a safe mode of transferring money avoiding the possibility of any theft.

Loan Activities of Banks

Let us see what the banks do with the deposits they receive.



1) Banks keep a small proportion of their deposits as cash with themselves to pay the depositors who might come to withdraw money from the bank on any given day.

2) Banks use the major portion of the deposits to extend loans. In this way, banks mediate between those who have surplus funds (the depositors) those who are in need of these funds (the borrowers). Banks charge a higher interest rate on loans than what they offer on deposits. The difference between what is charged from borrowers and what is paid to depositors is their main source of income.

Terms of Credit

Every loan agreement specifies an interest rate which the borrower must pay to the lender along with the repayment of the principal, this is called the terms of credit.

- Collateral.
- Documentation required
- Rate of Interest.
- Mode of repayment.

If the borrower fails to repay the loan, the lender has the right to sell the asset or collateral to obtain payment. Property such as land titles, deposits with banks, livestock are some common examples of collateral used for borrowing.

Let us see the terms of credit for a bank loan taken by Megha:

- Megha has taken a loan of Rs 5 lakhs from the bank to purchase a house.
- The annual interest rate on the loan is 12 per cent.
- The loan is to be repaid in 10 years in monthly installments.
- The bank will be retained as collateral the papers of the new house.
- The papers of the new house will be returned to Megha only, when she repays the entire loan with interest.

Interest rate, collateral and documentation requirement, and the mode of repayment together comprise what is called the terms of credit.

Credit Arrangements

Let us look into three credit arrangements:

Case-I

- A small farmer borrows money from an Agricultural trader.
- The rate of interest is 36 % per annum.
- The trader supplies farm inputs like seeds and fertilizers.
- In addition to the interest and capital the farmer has to sell his crops only to the trader.
- The farmer has to accept the price offered by the trader.

- The trader not only gets a interest for his loan, but also earns a huge profit from selling the crop at a very high price.

Case- II

- A farmer borrows money from a bank
- The rate of interest is 8.5 % per annum.
- The loan can be repaid anytime in the next three years.
- The farmer plans to repay the loan after harvest by selling a part of the crop.
- The farmer will then store the rest of the potatoes in a cold storage and sell it when the price is high.
- The farmer can apply for a fresh loan from the bank against the cold storage receipt. The bank offers this facility to farmers who have taken crop loan from them.

Case- III

- An agricultural labourer borrows money from her employer to meet the expenses for sudden illness in the family.
- The rate of interest is 60 % per annum
- The labourer has to repay her loan by working for the employer.
- The employer does not treat the labourer well.
- Employers are the only source of credit for the landless agricultural labourers.

Loans from Cooperatives

Besides banks, the other major source of cheap credit in rural areas is the cooperative societies (or cooperatives). Members of a cooperative pool their resources for cooperation in certain areas. There are several types of cooperatives, namely:-

- Farmers cooperatives
- Weavers cooperatives
- Industrial workers cooperative

Let us take the example of Krishak Cooperative.

- Krishak cooperatives in village near Sonpur.
- 2300 farmers are members.
- It accepts deposits from farmers.
- By putting deposit as collateral, it takes loan from the bank.
- These funds are used in advancing loans to farmers.
- Once loan is repaid, another lending round begins

Sectors of Credit in India

People obtain loans from various sources. The various types of loans can be conveniently grouped as:-

- Formal Sector Loans
- Informal Sector Loans

The formal sector loans

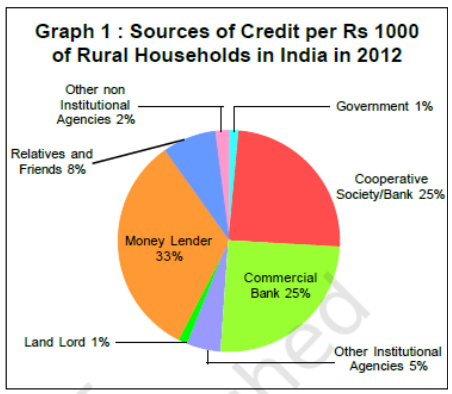
- ✓ Loans from banks
- ✓ Loans from cooperatives.

The informal sector

- ✓ Loans from money lenders
- ✓ Loans from traders

Here is a glance at the distribution of credit source in rural India.

Sources of Credit for rural households in India 2012



Formal Credit Sector

- ➢ The Reserve Bank of India supervises the functioning of formal sources of loans.
- ➢ The banks maintain a minimum cash balance (15%) out of the deposits they receive.
- ➢ The rest of the deposit money is given out as loans.
- ➢ The RBI monitors that the banks actually maintain the cash balance and sees that the banks give loans not just to profit-making businesses and traders but also to small cultivators, small scale industries, to small borrowers etc.
- ➢ Periodically, banks have to submit information to the RBI on how much they are lending, to whom and at what interest rate.

Informal Credit Sector

There is no organization which supervises the credit activities of lenders in the informal sector. They can lend at whatever interest rate they choose. There is no one to stop them from using unfair means to get their money back.

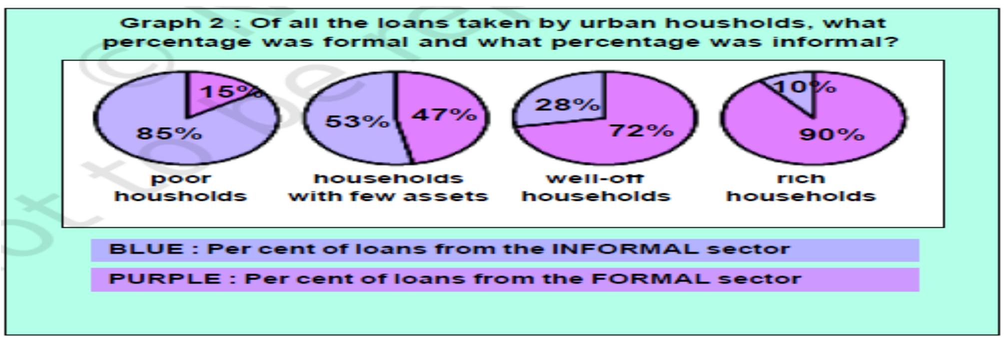
Compared to the formal lenders, most of the informal lenders charge a much higher interest on loans. Thus, the high interest rate of borrowing can mean that the amount to be repaid is greater than the income of the borrower. People who wish to start an enterprise by borrowing may not do so because of the high cost of borrowing.

Banks and cooperative societies need to lend more to the underprivileged so that they could grow crops, do business, set up small-scale industries etc.

Cheap and affordable credit is crucial for the for the country's development.

Comparison between Formal and Informal Credits

Let us look at the tabular column below, to see the percentage of formal and informal credit distribution in urban households.



Here are the deductions from the above findings.

I. The formal sector still meets only about half of the total credit needs of the rural people. The remaining credit needs are met from informal sources.

II. It is the richer households who receive formal credit whereas the poor have to depend on the informal sources.

"It is important that the formal credit is distributed more equally so that the poor can benefit from the cheaper loans. Thus, it is necessary that banks and cooperatives increase their lending particularly in the rural areas, so that the dependence on informal sources of credit reduces."

Self Help Groups

As we have seen, poor households are still dependent on informal sources of credit.

Why is it so?

- Banks are not present everywhere in rural India.
- Even when they are present, getting a loan from a bank is much more difficult than taking a loan from informal sources.
- Bank loans require proper documents and collateral.

- Absence of collateral is one of the major reasons which prevents the poor from getting.
- Bank loans.
- Moneylenders, on the other hand, know the borrowers personally and hence are often willing to give a loan without collateral.

In recent years, people have tried out some newer ways of providing loans to the poor. The idea is to organize rural poor, in particular women, into small Self-Help Groups (SHGs) and pool (collect) their savings.

Let us look at a typical SHG

- A typical SHG has 15-20 members, usually belonging to one neighborhood, who meet and save regularly.
- Saving per member varies from Rs. 25 to Rs. 100 or more.
- Members can take small loans from the group itself to meet their needs.
- The group charges interest on these loans but this is still less than what the moneylender charges.
- After a year or two, if the group is regular in savings, it becomes eligible for availing loan from the bank.
- Loan is sanctioned in the name of the group and is meant to create self-employment opportunities for the members.
- SHGs help borrowers overcome the problem of lack of collateral.
- They can get timely loans.
- SHGs are the building blocks of organization of the rural poor.

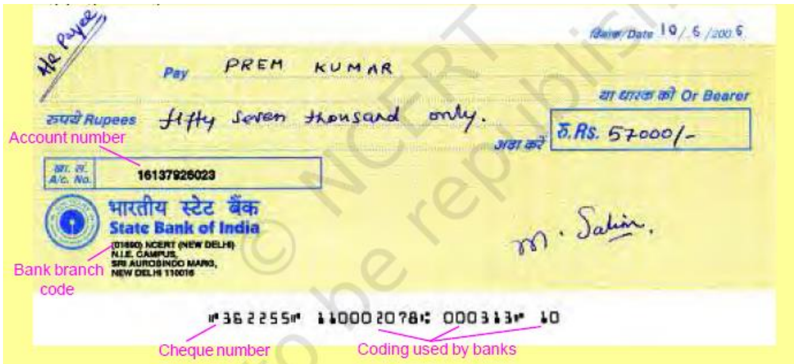
Grameen Bank of Bangladesh

GRAMEEN
Banking for the poor

Grameen Bank of Bangladesh is one of the biggest success stories in reaching the poor to meet their credit needs at reasonable rates. Started in the 1970s as a small project, Grameen Bank now has over 6 million borrowers in about 40,000 villages spread across Bangladesh. Almost all of the borrowers are women and belong to poorest sections of the society. These borrowers have proved that not only are poor women reliable borrowers, but that they can start and run a variety of small income-generating activities successfully.

"If credit can be made available to the poor people on terms and conditions that are appropriate and reasonable these millions of small people with their millions of small pursuits can add up to create the biggest development wonder."

IMPORTANT NUMBERS ON CHEQUE



First six-digit block: It is common wisdom that the first six digits on your cheque are your cheque number. It is important to note the number because if your cheque gets lost or the money has not been credited, you can know the status of the cheque by providing the cheque number.

Magnetic ink character recognition: Magnetic ink character recognition or MICR comprises nine digits, which are further sub-divided as city, bank and branch code. It works the same way as your home or office address, enabling your snail mail to reach you from far-flung places. But unlike your addresses, the banking address is all numerical, where:

1.City code:The first three digits specify the city in which you have a bank account.

2.Bank code: The next three digits of MICR specify your bank in thatparticular city.

3.Branch code: The last three digits of MICR help in figuring out the specific branch of the specific bank.

The nine-digit code is called MICR because it is printed with magnetic ink, which is usually made of iron oxide. Magnetic ink is used so that numbers are readable even if it is stamped over.

4.A/c with RBI: The third numeral block represents your account number maintained by the Reserve Bank of India (RBI). The number helps in cheque processing when it goes to RBI for clearance.

5.Transaction code: The last two digits at the bottom of the cheque help in decoding whether the cheque is current or a saving account cheque. MICR also tells whether the cheque is at par. It helps in processing an intra-city cheque as a local one with a faster turnaround time.

Inward clearing: It is important to be aware of the concept because the type of clearing affects the speed of transaction. Inward clearing is for the bank that issues the cheque.

Outward clearing: Outward clearing is for the bank in whose name the cheque has been issued. The inward and outward clearing bank can be same if the bank that issues and the bank in whose name the cheque has been issued are the same.