

Chapter-3

Money and Credit

- * Double coincidence of wants \Rightarrow It means a situation in which a person desires to sell is exactly what the other wishes to buy.
- * Barter system \Rightarrow Barter system is a system in which goods are directly exchanged without the use of money. Double coincidence of wants is necessary in this system.
- * Money \Rightarrow Money is a system of exchange and it eliminates double coincidence of wants. Since money acts as an intermediate in the exchange process, so it is called as medium of exchange.

Modern forms of money-

\Rightarrow Money acts as a medium of exchange. For the introduction of coins, people used grains and cattles as money. After that, metallic coins were used. Major forms of money are as follows:

1) Currency.

- Modern forms of money include currency - paper notes and coins.

- The modern currency is without any use of its own.
- Although it is accepted as a medium of exchange because the currency is authorised by the government of the country.
- In India, Reserve Bank of India (RBI) issues currency notes on behalf of central govt.
- As per Indian law, ~~no one~~ is allowed to issue currency and also ~~no one~~ can refuse a payment made in Rupees.

* Rupee is widely accepted as medium of exchange.

2) Deposits with Banks.

- People also hold money as deposits with banks.
- People can deposit money in bank by opening a bank account in their name. The banks accept the deposit and also pay an amount as interest on their deposits.
- By this way, ~~people's~~ money become safe and they earn an amount as interest.
- These deposits can be withdrawn by demand, so it is also called demand deposits.

- Demand deposits have an advantage that instead of cash, people can also pay through cheques.

* Cheque \Rightarrow A check 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 issued.

- Cheques directly settle payments without the use of cash.

Loan activities of banks

- Banks keep only a small proportion of their deposits as cash with themselves. In India, banks hold 15% of their deposits as cash.
- Banks use the major portion of the deposits to extend loans for various economic activities.
- Banks mediate between the depositors and the borrowers.
- Banks use to charge high interest on loans and give small interest on deposits. This is the main source of income for the banks.

Two different credit situations

- Credit (loan) refers to an agreement in which the lender supplies the borrower with money, goods or services in return for the promise of future payment.
- In rural areas, the main demand for credit is for crop production which involves costs on seeds, fertilisers, pesticides, water, electricity, etc.
- Farmers usually take crop loans at the beginning of season and repay the loan after harvest.
- Sometimes credit plays a positive role while sometimes it makes the situation worse. This depends on the risk in the situation and whether there is some support in case of loss.

Terms of credit

- Every loan agreement specifies an interest rate and the principal amount, and the lenders may demand collateral against loans.
- * Collateral \Rightarrow It is an asset that the borrower owns and uses this as a guarantee to a lender until the loan is repaid.

Example - Land titles, deposits with banks, etc.

- Interest rate, collateral and documentation requirement, and the mode of repayment together terms of credit.
- Terms of credit may vary depending on the nature of the lender and the borrower.

Formal sector credit in India

- ⇒ The various types of loans can be grouped in two categories: formal sector loans and informal sector loans.
- Formal sector loans include loans from banks and cooperatives.
 - It charges low interest rate and requires documentation and collateral.
 - The Reserve Bank of India supervises the functioning of formal sources of loans.

Role of RBI in formal loans:

- The RBI monitors the banks that they maintain the cash balance.
- RBI also sees that banks give loans to small cultivators, small scale industries, etc.
- Periodically, banks have to submit info. to RBI on how much they are lending, interest rate, etc.

- Informal sectors include moneylenders, traders, employers, friends, relatives, etc.
- There is no organization to supervise the credit activities of lenders in informal sector.
- There is no fixed interest rate, neither it requires any documentation or collateral.
- There is no one to stop people using unfair means to get their money back.
- They charge high interest rate therefore the cost to the borrower is much higher.

Higher cost of borrowing means larger part of the earnings of borrower is used to repay the loans. This is the reason people do not start their enterprise.

- For these reasons, banks and cooperative societies need to lend more. This would lead to higher incomes of the people.

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

Formal and informal credit: Who gets what?

- In urban areas, most people take loans from informal sector because of lack of collateral and documentation.
- On the other hand, rich people take loans from formal sector and pay less interest.
- Due to this, the poor people's condition becomes worse and rich enjoy the low interest rates.

What does this suggest?

- First, the formal sector still meets only about half of the total credit needs of rural people.
- Secondly, while formal sector loans need to expand, it is also necessary that everybody receives these loans.

Self-help groups for the poor-

- ⇒ Self-help groups organise rural poor, especially women, and pool (collect) their savings. A typical SHG has 15-20 members.
- The members can take small loans for different purposes such as for releasing mortgaged lands, for acquiring household assets, etc.
 - SHGs charge a reasonable interest rate.
 - After a year or two, an SHG becomes eligible for taking loans from banks.
 - The loan is taken on the name of SHG and the amount is given to the needy person and if he/she fails to repay the loan, the members of SHG pay instead of that person.
 - SHGs help borrowers to overcome the problem of lack of collateral.
 - The regular meetings of the group help them to discuss about the social issues, such as nutrition, health, domestic violence, etc.