

Chapter 3 – Money and Credit

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Question 1:

In situations with high risks, credit might create further problems for the borrower. Explain.

Answer:

In situations with high risks, credit might create further problems for the borrower. This is also known as a debt-trap. Taking credit involves an interest rate on the loan and if this is not paid back, then the borrower is forced to give up his collateral or asset used as the guarantee, to the lender. Thus, in situations with high risks, if the risks affect a borrower badly, then he ends up losing more than he would have without the loan.

Question 2:

How does money solve the problem of double coincidence of wants? Explain with an example of your own.

Answer:

Money solves the problem of double coincidence of wants by acting as a medium of exchange. Double coincidence of wants implies a situation where two parties agree to sell and buy each other's commodities., i.e., what one party desires to sell is exactly what the other party wishes to buy. Money does away with this tedious and complex situation by acting as a medium of exchange that can be used for one and all commodities. For example, if an ice-cream vendor wants a bicycle but the bicycle manufacturer wants clothes, and not ice-creams, then the vendor can use money to obtain a bicycle. He does need to adhere to the bicycle man's needs because money acts as the common medium of exchange. Similarly, the bicycle manufacturer can then use the money to buy clothes.

Question 3:

How do banks mediate between those who have surplus money and those who need money?

Answer:

A bank mediates between those who have surplus money and those who need money by allowing both to open accounts with it. Banks only keep about 15% of cash reserves to provide to people who come to withdraw money on a daily basis. Those with surplus money are encouraged to invest with the bank and are paid a certain rate of interest for the same. Those who need loans are required to pay an interest on their loans. The difference between payment to lenders and receipt

from borrowers comprises the bank's earnings. Thus, the bank acts as a beneficiary for those with surplus money as well as those who need money.

Question 4:

Look at a 10 rupee note. What is written on top? Can you explain this statement?

Answer:

A ten rupee note has "Reserve Bank of India" written at the top, along with a statement "guaranteed by the central government", following it. It is a promissory note and can only be issued by the Reserve Bank of India which supervises all money-related functions in the formal sector, in India. The statement on the ten rupee bank note relates to this idea that the RBI is the central organ in the working of money-related activities.

Question 5:

Why do we need to expand formal sources of credit in India?

Answer:

We need to expand formal sources of credit in India for two main reasons. Firstly, to reduce dependence on informal sources of credit because the latter charge high interest rates and do not benefit the borrower much. Secondly, they will be able to provide loans to a larger group of people who trust government sanctioning more than a private loaning system.

Question 6:

What is the basic idea behind the SHGs for the poor? Explain in your own words.

Answer:

The basic idea behind the SHGs for the poor is to provide them with a vista for self-help in financial areas. A self-help group is a small group comprising people in the rural areas who collect their savings, and loan these out to members on an interest rate lower than that charged by the informal sector. If the SHG functions well for over a year, then it becomes eligible for loans from banks. Such loans are then used for creating self-employment opportunities for the poor. Thus, they become economically upgraded, and are not dependent on moneylenders anymore.

Question 7:

What are the reasons why the banks might not be willing to lend to certain borrowers?

Answer:

Banks might not be willing to lend to people who cannot provide collateral, who do not have steady earnings or jobs, and who have a history of non-repayment of

loans. In such cases, banks do not have a guarantee as to whether or not the loans will be repaid by the persons concerned. It has to be understood that banks only mediate between those who have surplus money and those who need money. Banks in fact borrow the money deposited with them, and lend it out to persons requiring money. They would thus be unwilling to advance the money to individuals from whom repayment is uncertain.

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Question 8:

In what ways does the Reserve Bank of India supervise the functioning of banks? Why is this necessary?

Answer:

The Reserve Bank of India monitors the amount of money that banks loan out, and also the amount of cash balance maintained by them. It also ensures that banks give out loans not just to profiteering businesses but also to small cultivators, small scale industries and small borrowers. Periodically, banks are supposed to submit information to the RBI on the amounts lent, to whom and at what rates of interest.

This monitoring is necessary to ensure that equality is preserved in the financial sector, and that small industries are also given an outlet to grow. This is also done to make sure that banks do not loan out more money than they are supposed to, as this can lead to situations like the Great Depression of the 1930s in the USA, which greatly affected the world economy as well.

Question 9:

Analyse the role of credit for development.

Answer:

Credit plays a crucial role in a country's development. By sanctioning loans to developing industries and trade, banks provide them with the necessary aid for improvement. This leads to increased production, employment and profits. However, caution must be exercised in the case of high risks so that losses do not occur. This advantage of loans also needs to be manipulated and kept under an administrative hold because loans from the informal sector include high interest rates that may be more harmful than good. For this reason, it is important that the formal sector gives out more loans so that borrowers are not duped by moneylenders, and can ultimately contribute to national development.

Question 10:

Manav needs a loan to set up a small business. On what basis will Manav decide whether to borrow from the bank or the moneylender? Discuss.

Answer:

Manav needs a loan to set up a small business. Manav will decide on whether to borrow from the bank or the moneylender on the basis of various factors. Firstly, he must have a collateral or asset which can guarantee his loan. If he lacks such an asset, Manav cannot get a loan from a bank. In this scenario, he will have to go to a moneylender, even though the latter charges a higher interest rate. Secondly, if Manav is not aware of the banes of borrowing from the informal sector, he might not even consider taking a bank loan. Thirdly, if there are no banks in or near his area of residence or work, then Manav will borrow from a moneylender.

Question 11:

In India, about 80 per cent of farmers are small farmers, who need credit for cultivation.

- (a) Why might banks be unwilling to lend to small farmers?
- (b) What are the other sources from which the small farmers can borrow?
- (c) Explain with an example how the terms of credit can be unfavourable for the small farmer.
- (d) Suggest some ways by which small farmers can get cheap credit.

Answer:

- (a) Banks might be unwilling to lend to small farmers for lack of a collateral or asset on the part of the farmers.
- (b) The other sources from which the small farmers can borrow are moneylenders, relatives or friends, self-help groups and cooperative banks.
- (c) The terms of credit can be unfavourable for the small farmer if he has a bad crop, and is forced to either surrender his collateral (if he borrowed from a bank) or sell off a part of his land (if he borrowed from the informal sector), in order to repay his loan.
- (d) Self-help groups and cooperative banks do not require a collateral as a guarantee; hence, they can provide cheap credit to the small farmers.

Question 12:

Fill in the blanks:

- (i) Majority of the credit needs of the _____ households are met from informal sources.

- (ii) _____ costs of borrowing increase the debt-burden.
- (iii) _____ issues currency notes on behalf of the Central Government.
- (iv) Banks charge a higher interest rate on loans than what they offer on _____.
- (v) _____ is an asset that the borrower owns and uses as a guarantee until the loan is repaid to the lender.

Answer:

- (i) Majority of the credit needs of the poor households are met from informal sources.
- (ii) High costs of borrowing increase the debt-burden.
- (iii) Reserve Bank of India issues currency notes on behalf of the Central Government.
- (iv) Banks charge a higher interest rate on loans than what they offer on deposits.
- (v) Collateral is an asset that the borrower owns and uses as a guarantee until the loan is repaid to the lender.

Question 13:

Choose the most appropriate answer.

- (i) In a SHG most of the decisions regarding savings and loan activities are taken by
 - (a) Bank.
 - (b) Members.
 - (c) Non-government organisation.
- (ii) Formal sources of credit does not include
 - (a) Banks.
 - (b) Cooperatives.
 - (c) Employers.

Answer:

- (i) (b)
- (ii) (c)

Question 1:

The following table shows people in a variety of occupations in urban areas. What are the purposes for which the following people might need loans? Fill in the column.

Occupations	Reason for needing a Loan
Construction worker	—
Graduate student who is computer literate	—
A person employed in government service	—
Migrant labourer in Delhi	—
Household maid	—
Small trader	—
Autorickshaw driver	—
A worker whose factory has closed down	—

Next, classify the people into two groups based on whom you think might get a bank loan and those who might not. What is the criterion that you have used for classification?

Answer:

Occupations	Reason for needing a Loan
Construction worker	To meet living expenses
Graduate student who is computer literate	To pursue higher education
A person employed in government service	For an offspring's wedding
Migrant labourer in Delhi	To buy a house
Household maid	To meet living expenses
Small trader	To buy new machinery
Autorickshaw driver	To buy an autorickshaw

A worker whose factory has closed down	To meet living expenditure while still unemployed
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Those who might get a bank loan	Those who might not get a bank loan
Graduate student	Construction worker
A person employed in government service	Migrant labourer in Delhi
Small trader	Household maid
Autorickshaw driver	A worker whose factory has closed down

The criterion I have used for the aforementioned classification is firstly, whether the borrower has the potential to repay the loan or not. Those with job security will certainly get a loan because they have the capability to give repayment instalments. The second basis of classification is whether the borrower has a collateral or not, on which to guarantee his/her loan. These two are the basic prerequisites for getting a loan from a bank.