CHAPTER - 30

MONEY AND CREDIT

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We learn about the following in this chapter,

- Importance, evolution and functions of money.
- Indigenous bankers and types of credit.
- Evolution of banks and their types.
- Introduction of different types of bank deposits.
- Establishment and functions of Central Bank of India.

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Money is fundamental discovery. It has eased the day to day transactions, valuing goods and services and has allowed us to store the wealth and trade in future.

Money buys goods and services. It is generally accepted as means of payment, measure and store of value. According to Robertson 'Money is anything which is widely accepted in payment for goods or in discharge of other business obligations".

The word Money is derived from Roman word 'Moneta Juno'. The Indian rupee is derived from Sanskrit word Rupya which means silver coin.

Evolution of Money : Today we use paper notes, coins as money. But the evolution of this stage has not happened overnight. It took thousands of years to reach such a stage. There are many stages of evolution of money. The earliest and primitive stage is Barter system. Now let us discuss the different stages of evolution of money.

Barter system : In the primitive stage, man exchanged goods for goods without the use of money. Barter was extremely difficult method of trade involving lots of time and energy. For example if A had cow and wanted Sheep in exchange A had to search an individual who not only had a sheep, but also who needed cow in exchange. If finally, A comes across one such individual then the question is how many sheep are equivalent to one cow? Hence Barter system had many deficiencies like lack of double coincidence of wants, common measure of value, indivisibility of commodities, difficulties of storing wealth. The next stage of evolution was commodity money.

Commodity money : A commodity with a prescribed size and weight was adopted as money and everything else was measured in terms of the standard commodity. Different commodities were regarded as commodity money at different economies. For example; cattle in Greece, Sheep in Rome, teeth in China.

The introduction of money as unit of account didn't solve all the difficulties of barter. The next stage of development is metallic money.

Metallic money : The precious metals especially Gold, Silver, Bronze were used for metallic money. The standard weight and fineness of metal especially gold and silver with a seal on it became medium of exchange. They were of different denomination easily divisible, portable and were convenient in making payments. The next stage of development in the money is paper money.

We already know different types of coins used by different kings in history.

Metallic money

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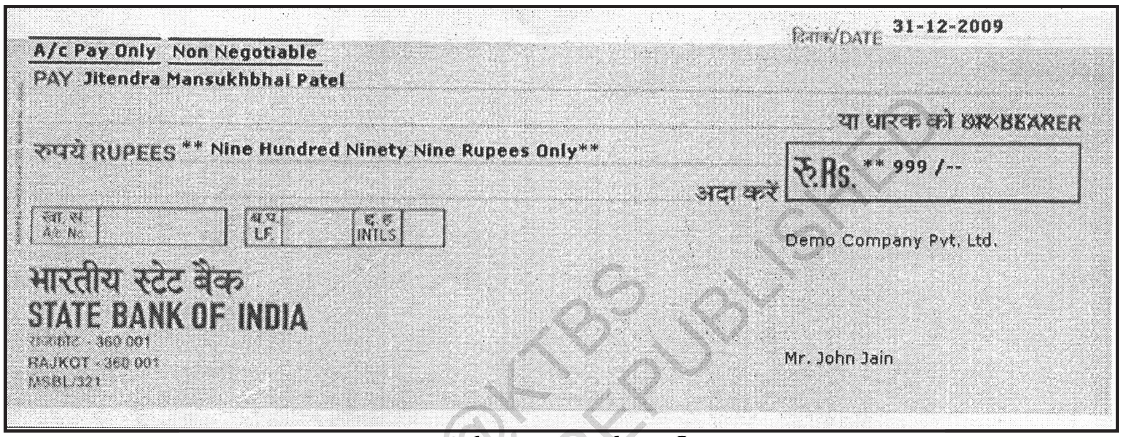
Paper money : The metallic money was unsafe to carry from one place to another. Hence traders began to carry the written documents issued by known financers as evidence of the quantity of money at their command. The written documents were not actual money, but accepted as they were readily exchanged for money on demand. People gradually became accustomed to bank notes and they were not used merely as substitutes, but as actual money. This happened as the respective governments of the economy gave the monopoly of note issue to their central banks. It became legal tender.

Paper money

No individual can refuse the legal tender in the transaction in the respective country. In India it is rupee, similarly in USA - dollar, UK-Pound, Germany - mark, Japan -Yen, China-Yuan, etc

Bank money : As trade and commerce flourished bank money came into existence. Cheques, drafts, credit and debit cards etc are some of the examples. The money can be transferred from deposit to deposit or from deposit to cash with the help of cheques. Cheques are used for transactions of goods and services.



Cheque leaf

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Credit card and Debit card : Credit card enables the holder to buy goods and services on credit at specified suppliers. Credit card is swiped on the electronic machine and the payment will be made to seller account from the buyer credit account. The debit card also works in a similar fashion, but in the debit card the money will be deducted from the buyer's savings account.

Debit card

Functions of money : Functions of money are classified into

1) Primary functions
2) Secondary functions
3) Contingent functions

1) **Primary functions :** They are :

a) **Medium of exchange or means of payment :** Money is used to buy the goods and services. It is obtained by selling the commodities in the market and the goods and services are purchased from market using the money.

b) **Measure of Value :** All the values are expressed in terms of money it is easier to determine the rate of exchange between various type of goods and services.

2) **Secondary functions :** The three important secondary functions are :

a) **Standard of deffered payments :** Money helps the future payments too. A borrower borrowing today places himself under an obligation to pay a specified sum of money on some specified future date. Simillarly, a person buys on time agrees to pay a stated amount of money on a specified future date.

b) **Store of value or store of purchasing power :** The introduction of money has helped to save it for future as it is not perishable.

c) **Transfer of value or transfer of purchasing power :** The introduction of money has made the exchange of goods to distant places as well as abroad possible. It was therefore felt necessary to transfer purchasing power from one place to another. Borrowing and lending takes place in terms of money.

3) **Contingent Functions :** In addition to primary and secondary functions, money also performs certain contingent functions. They are

a) Basis of Credit : Money forms the basis of credit. The cheque system has further allowed the credit creation by banks.

b) Increase productivity of capital : Money in form of capital is put to several uses. The Liquidity feature of money has helped the capital to be transferred from the less productive to more productive uses.

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Types of Credit

Credit 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 India, we have two different forms of credit namely formal credit sector and informal credit Sector.

1) Informal Credit Sector : The system of informal credit by indigenous banking dates back to ancient time in India. The informal credit Sector includes the indigenous bankers who are called as Shroffs, Mahajans, Shets, Sahukars, Chettis. They are basically the money lenders.

Until the middle of the nineteenth century indigenous banks were the central part of the financial system in India. The advent of the European bankers disturbed the monopoly of these indigenous bankers, as they enjoyed government patronage in India. But despite this the money lenders were playing the major role in the credit system. Post independence, Government of India took series of initiatives to free the credit system free form the clutches of money lenders. Government nationalized 14 commercial banks in 1969, 6 in 1980, established Regional Rural Banks exclusively for rural India credit needs. But unfortunately money lenders still cater to sizeable share in rural credit.

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2) Formal Credit : The formal credit sector is distributed by banks and cooperatives. They do not charge the exorbitant interest rates. Their intention is not just earning profits, but also has the social responsibility which is regulated and supervised by the Reserve Bank of India.

Banks and Deposits : Banks play a vital role in the process of economic development. There is no unamity in the derivation of the term banks. Few believe the English term bank is derived from Italian word **'Banco'** which means a **Bench**. For others it is derived from German word 'Banck' which means joint stock fund or a common fund.

The Indian Banking Regulation Act of 1949 defined the term "Banking Company" as "any company which transacts the business of banking in India", and the term "banking" as "accepting, for the purpose of lending or investment, of deposits of money from the public, repayable on demand or otherwise withdrawable by cheque, draft, order or otherwise".

Importance of banks : Banks play very significant role in economic development. Bank mobilizes the savings of the public by offering attractive interest rates and help in the process of capital formation. Banks provide the convenient way of payment though the cheque system. Banks give higher rates of interest on fixed deposits. Banks give loans to the borrowers at the prevailing market rate of interest. They help in the development of agriculture industry and services, banks also discounts the bills of exchange. They also offer demand drafts, credit cards, debit cards. The banks also invest the funds on securities. The bank play the major role in the credit creation.

Types of Banks : There are many types of Banks; each type usually specializes in a particular kind of business.

1. **Industrial Banks :** Industrial banks cater to both short-term and long-term loans for industries. The Industrial banks lend money for long periods and provide fixed capital to industrial concerns. For Example :- Industrial Finance Corporation, Industrial credit and Investment Corporation, Industrial Development Bank of India, and various State Finance Corporations.
2. **Exchange Banks :** These banks finance the foreign trade of a country and deal in foreign currency. The main credit instrument here is the bill of exchange and their main function is to discount, accept and collect foreign bills of exchange. They also carry on ordinary banking business but their share is less.
3. **Savings Banks :** These banks encourage saving habit even among with less income. They are concerned with mobilization of small savings of the individuals. They are found in American and European countries. In India savings bank business is performed by post offices and commercial banks.
4. **Co-Operative Banks :** Co-operative banks run on the principle of co-operation. They are registered under the Co-Operative Societies' Act. They confine their activities to members only. They accept deposits from them and advance loans to them at reasonable rates.
5. **Land Mortgage Banks :** They are also co-operative banks. They give long-term loans to agriculturists to carry out permanent

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improvements on land, such as drainage, irrigation, farm buildings and so on. They are also called as Land Development Banks.

Deposits of commercial banks : Collecting deposits are the important and princial function of commercial banks. The main type of deposits the commercial banks collect are current accounts, savings account deposit, Fixed or term deposits.

Current account deposits : Current accounts are generally opened by business firms, traders and public authorities. They are opened for the convenience of making payments by cheques rather than earning interest. The current accounts help in frequent banking transactions as they are repayable on demand.

Saving Deposits : Saving deposits are opened by customers to save the part of their current income. The customers can withdraw their money from their accounts when they require it. The bank also gives a small amount of interest to the money in the saving deposits.

Fixed deposits : Fixed accounts are meant for investors who want their principle to be safe and yield them fixed yields. The fixed deposits are also called as Term deposit as, normally, they are fixed for specified period.

Reserve Bank of India

Reserve bank of India is the central bank of India. It was established on 1st April 1935, formally it was started as a share holder's bank. RBI was nationalized on 1st January 1949, since then it is owned and controlled by Government of India.

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Know this :

The Preamble of the Reserve Bank of India describes the basic functions of the Reserve Bank as : "...to regulate the issue of Bank Notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage."

Functions of central bank or RBI

1) Monopoly of Note issue : RBI has the monopoly of issuing currency notes of Rs 2 and above namely Rs 5, Rs 10, Rs 100, Rs 500, and Rs 1000. One Rupee is issued and circulated by RBI on behalf of the Government, though the right of issue of one rupee notes or coins is with the Central Government.

2) Acts as Banker to Government : The RBI accepts the deposits of Central and State Governments. It collects the money on behalf of the Government like taxes and other charges. On specific instruction, it also makes the payments on behalf of the Government. It issues Government bonds, Treasury bill and also acts as financial adviser to the Government.

Reserve Bank of India

RBI also extends ways and means advances to Central and State Governments. "Ways and Means Advances" (WMA) is not a commercial bank credit. This facility is provided to meet temporary mismatches between revenue collections and revenue expenditures of governments. The maximum volume and period of such advances are governed by agreements between RBI and the concerned government.

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3) Bankers bank : It acts as bankers bank. It controls all the banks of the country. All the banks of the country have to keep one part as reserve out of their deposits in the RBI. Whenever banks need additional money RBI provides credit to them.It guides the banks in monetary mangement.

Face Value of Notes

4) Acts as National Clearing House : RBI acts as the clearing house for settlement of banking transactions economically. This function helps banks to settle their inter banks claims easily.

5) Acts as the controller of Credit : The RBI controls or expands the credit creation of commercial banks, according to desired monetary situation in the economy. The RBI uses both quantitative and qualitative methods to control or expand the credit.

6) Custodian of Foreign Exchange Reserves : The RBI acts as the custodian of foreign exchange reserves. Adequate reserves will help to maintain foreign exchange rates. In order to minimize the undue fluctuations, depending upon the situations, it may resort to buying and selling of foreign currencies.

7) Publishes the Economic Statistics and Other Information : The RBI collects statistics on economics and financial matters and publishes it periodically. It also publishes report on currency and finance, Financial conditions, State finances, Hand book of statistics on Indian economy and others.

8) Promotion of Banking Habits : The RBI institutionalizes saving through the promotion of banking habit and expansion of the banking system in unbanked areas.

9) Facilities for Agriculture : The RBI extends indirect financial facilities to agriculture regularly. Through NABARD it provides short-term and long-term financial facilities to agriculture and allied activities.

- *The oldest existing central bank is Sweden's "Riks Bank 'established in 1668.*
- *Britain Central Bank 'Bank of England was established in 1694.*
- *USA Central Bank 'Federal Reserve System' was established in 1913.*

RBI is playing an important role in the development strategy of Indian Economy. The Reserve Bank has a rich tradition of data collection, generating sound economic research, and knowledge sharing. The Reserve Bank's measures have helped the nation to come out of many financial crises.

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EXCERCISES

I. Fill in the blanks with suitable words.

1) Indian rupee is derived from ___________ .
2) Cheque is an instrument from ___________ .
3) The banks which deal with foreign currency are called ___________ .
4) The Reserve Bank of India was established in the year ___________ .
5) The money of Japan is ___________ .
6) Government of India nationalized 14 commercial Banks in ___________ .

II. Answer the following questions.

1) What is Barter exchange system ?
2) State the means of money
3) Which is the central bank of India ?
4) Explain the functions of money
5) Mention the different types of banks
6) Explain the functions of RBI

III. Activities :

1) Give a report on the functions of commercial banks with real observation.
2) Visit your nearest bank, observe their functions.

IV. Project :

1) Explain the evolution of money with pictorial information.

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