Chapter 3rd: Money and Credit Notes

Money as a Medium of Exchange

1. Role of Money in Daily Transactions:

- Money is extensively used in daily life for various transactions involving buying, selling, and exchanging goods and services.

2. Types of Transactions with Money:

- Transactions can involve buying and selling goods, exchanging services for money, or making promises to pay money later.

3. Convenience of Using Money:

- Money facilitates easy exchange as individuals prefer receiving payments in money, which can then be exchanged for desired commodities or services.

4. Example of Shoe Manufacturer:

- Consider the example of a shoe manufacturer who first sells shoes for money and then uses the money to buy wheat, showcasing the utility of money in transactions.

5. Elimination of Barter System Challenges:

- Money eliminates the challenges of the barter system, such as the need for a double coincidence of wants, where both parties must desire each other's commodities for an exchange to occur.

6. Double Coincidence of Wants Defined:

- Double coincidence of wants refers to the situation where what one person wants to sell matches precisely with what another person wants to buy, which is essential in a barter system.

7. Role of Money as a Medium of Exchange:

- Money serves as an intermediary in exchanges, removing the requirement for double coincidence of wants and simplifying transactions in an economy.

8. Facilitating Trade and Commerce:

- By acting as a medium of exchange, money facilitates trade and commerce by enabling individuals to easily exchange goods and services without the limitations of the barter system.

9. Convenience for Economic Participants:

- Participants in the economy benefit from the convenience of using money, as it streamlines transactions and expands opportunities for buying and selling various goods and services.

10. Significance of Money in Economic Activities:

- Money's role as a medium of exchange is crucial for the smooth functioning of economic activities, promoting efficiency and enabling specialization in production and consumption.

Modern Forms of Money

1. Definition of Money:

- Money serves as a medium of exchange in transactions, facilitating the buying and selling of goods and services.

2. Early Forms of Money in India:

- In ancient India, commodities such as grains and cattle were used as forms of money for conducting transactions.

3. Transition to Metallic Coins:

- The use of metallic coins, including gold, silver, and copper, replaced earlier forms of money and persisted until recent centuries.

4. Significance of Metallic Coins:

- Metallic coins played a significant role as a standardized form of currency, facilitating trade and commerce with their intrinsic value and durability.

Currency

1. Definition of Modern Currency:

- Modern currency comprises paper notes and coins, serving as mediums of exchange in economic transactions.

2. Composition of Modern Currency:

- Unlike earlier forms of money made of precious metals like gold, silver, and copper, modern currency is not inherently valuable.

3. Government Authorization:

- Modern currency is accepted as a medium of exchange because it is authorized by the government of the country.

4. Issuance of Currency in India:

- In India, the Reserve Bank of India (RBI) issues currency notes on behalf of the central government.

5. Legal Status of Currency:

- Indian law prohibits any individual or organization other than the government from issuing currency.

6. Mandatory Acceptance:

- The law in India mandates the acceptance of the rupee as a medium of payment, and no individual can legally refuse a payment made in rupees.

7. Role of Reserve Bank of India (RBI):

- The RBI plays a crucial role in regulating and managing the issuance and circulation of currency in the country.

8. Rupee's Acceptance:

- Due to its legal status and government backing, the Indian rupee is widely accepted as a medium of exchange for settling transactions within the country.

9. Legal Tender Laws:

- Legal tender laws ensure that currency issued by the government must be accepted as payment for goods and services and in the settlement of debts.

10. Importance of Government Authority:

- Government authorization and legal recognition are essential factors that establish trust and confidence in the acceptance and usability of modern currency.

Deposits with Banks

1. Forms of Holding Money:

- People hold money in two primary forms: currency (cash) and deposits with banks.

2. Reason for Depositing Money in Banks:

- Individuals deposit extra cash with banks to ensure its safety and earn interest on their deposits.

3. Interest on Deposits:

- Banks pay interest on the deposits made by individuals, providing an incentive for depositors to keep their money with the bank.

4. Withdrawal Provision:

- Depositors have the provision to withdraw their money from their bank accounts as and when required.

5. Demand Deposits Definition:

- Deposits in bank accounts that can be withdrawn on demand by the depositor are termed as demand deposits.

6. Characteristic of Demand Deposits:

- Demand deposits possess the essential characteristic of money as they can be used as a medium of exchange.

7. Payment through Cheques:

- Payment through cheques allows individuals to settle transactions without the need for physical cash.

8. Role of Cheques:

- Cheques act as instructions to the bank to pay a specific amount from the payer's account to the payee.

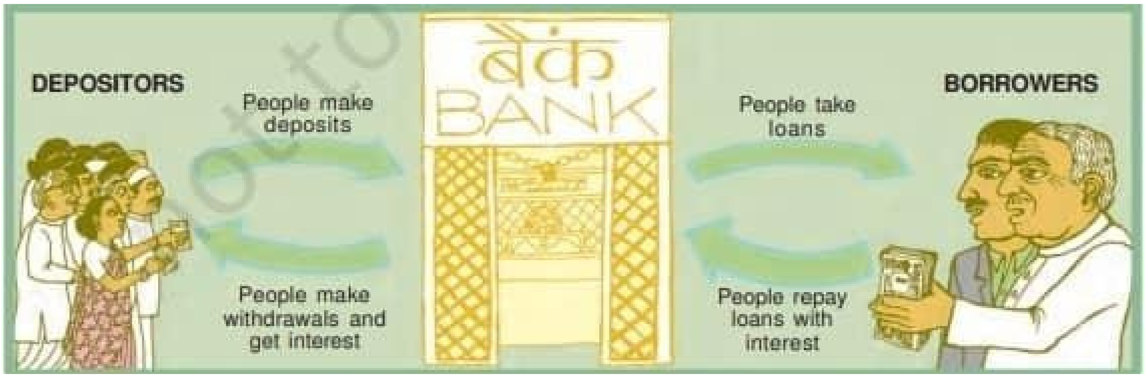
9. Importance of Banks:

- Banks play a crucial role in facilitating demand deposits and payments through cheques, linking modern forms of money to the functioning of the banking system.

10. Integration of Currency and Deposits:

- Both currency and demand deposits are widely accepted as means of payment, collectively constituting money in the modern economy.

Loan Activities of Banks



1. Utilization of Deposits:

- Banks use deposits from the public for various purposes.

2. Cash Reserves:

- Banks keep only a small fraction of deposits as cash reserves, typically around 15% in India.

3. Purpose of Cash Reserves:

- Cash reserves are maintained to meet the withdrawal demands of depositors.

4. Loan Extension:

- The majority of deposits are used by banks to extend loans to borrowers.

5. Loan Demand:

- There is a significant demand for loans for various economic activities.

6. Role of Banks:

- Banks act as intermediaries, connecting depositors with surplus funds to borrowers in need.

7. Interest Rate Differential:

- Banks charge a higher interest rate on loans compared to the interest rate they offer on deposits.

8. Income Source for Banks:

- The difference between the interest earned on loans and the interest paid to depositors forms the main source of income for banks.

Two Different Credit Situations

1. Definition of Credit:

- Credit, also known as a loan, involves an agreement where the lender provides money, goods, or services to the borrower with the expectation of future repayment.

2. Role of Credit in Transactions:

- Credit plays a crucial role in day-to-day activities by enabling individuals and businesses to access resources they need before making full payment, thereby facilitating economic transactions.

Let us see how credit works through the following two examples:

(A) Festival Season

1. Scenario Description:

- Salim, a shoe manufacturer, receives a bulk order for 3,000 pairs of shoes to be delivered within a month during the festival season.

2. Use of Credit in Production:

- Salim utilizes credit to meet the working capital requirements of production.
- He obtains loans from two sources: a leather supplier and a large trader who advances cash as an advance payment for a portion of the order.

3. Benefits of Credit:

- Credit enables Salim to procure raw materials and hire additional workers, facilitating the timely completion of production.
- By successfully utilizing credit, Salim can fulfil the *order, earn a profit,* and *repay the borrowed money,* highlighting the positive role of credit in business operations.

(B) Swapna's Problem

1. Scenario Description:

- Swapna, a small farmer, faces challenges with her groundnut crop due to pest infestation, leading to crop failure and accumulation of debt.

2. Demand for Credit in Rural Areas:

- The main demand for credit in rural areas is for crop production, involving costs like seeds, fertilisers, pesticides, etc.
- Farmers typically take crop loans at the beginning of the season and repay after harvest, with repayment dependent on farming income.

3. Consequences of Crop Failure and Debt:

- Crop failure leads to an inability to repay loans, resulting in a debt trap for farmers like Swapna.
- Swapna's situation illustrates how credit, instead of improving earnings, exacerbates financial distress, forcing her to sell part of her land.

4. Debt Trap and Risk Mitigation:

- A debt trap occurs when credit pushes borrowers into a situation of worsening financial conditions, making recovery difficult.
- Whether credit is beneficial depends on the risks involved and the availability of support in case of loss, highlighting the importance of risk management in credit utilization.

Terms of Credit

1. Loan Agreement Components:

- Every loan agreement includes an interest rate to be paid along with the repayment of the principal amount.
- Lenders may also require collateral or security against loans.

2. Understanding Collateral:

- Collateral is an asset owned by the borrower, such as land, buildings, vehicles, livestock, or bank deposits, used as a guarantee to the lender until the loan is repaid.
- In case of loan default, the lender has the right to sell the collateral to recover the outstanding amount.

3. Examples of Collateral:

- Common examples of collateral include land titles, bank deposits, livestock, and other valuable assets.

4. Terms of Credit:

- Interest rate, collateral, documentation requirements, and repayment mode collectively constitute the terms of credit.
- These terms vary significantly depending on the lender, borrower, and specific credit arrangement.

5. Variation in Credit Terms:

- The terms of credit can vary widely across different credit arrangements, influenced by factors such as the nature of the lender and borrower.

Loans from Cooperatives

1. Cooperative Societies as Credit Sources:

- Cooperative societies serve as significant sources of affordable credit in rural areas alongside banks.
- They operate by pooling resources from members to offer financial assistance.

2. Types of Cooperatives:

- Different types of cooperatives exist, such as farmers', weavers', and industrial workers' cooperatives, catering to specific needs.

3. Example: Krishak Cooperative:

- Krishak Cooperative, near Sonpur, comprises 2300 farmer members.
- It accepts member deposits, using them as collateral to secure loans from banks.

4. Utilization of Funds:

- Funds acquired by Krishak Cooperative are used to provide loans for various purposes, including purchasing agricultural implements, cultivation, agricultural trade, fishery activities, and house construction.

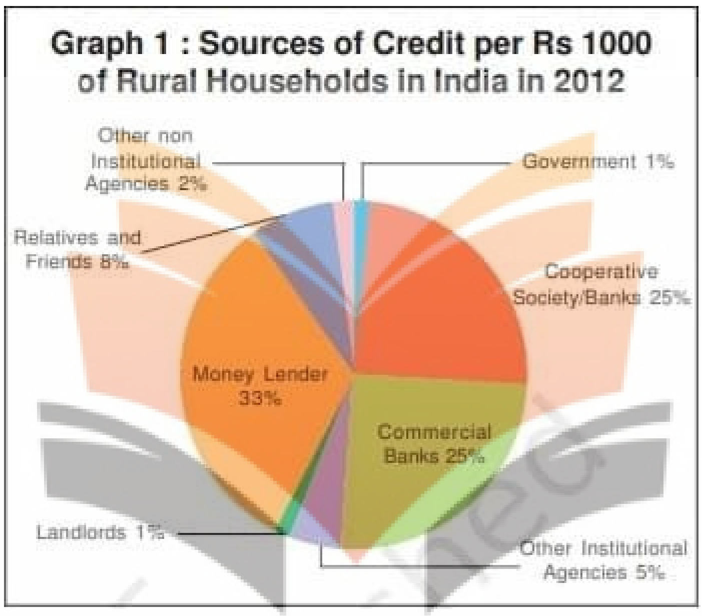
5. Loan Repayment and Continuation:

- After members repay their loans, the cooperative can initiate further lending, ensuring continuous financial support.

6. Role in Rural Development:

- Cooperatives like Krishak Cooperative play a vital role in rural development by offering accessible and cost-effective credit facilities to farmers and rural residents.

Formal Sector Credit in India



1. Formal Sector vs. Informal Sector Loans:

- Loans obtained from banks and cooperatives constitute formal sector loans.
- Informal sector loans include those obtained from moneylenders, traders, employers, relatives, and friends.

2. Supervision by Reserve Bank of India (RBI):

- RBI oversees the functioning of formal lenders like banks to ensure compliance with regulations.
- It monitors factors such as maintaining minimum cash balances, diversification of lending, and submission of lending data.

3. Absence of Supervision in the Informal Sector:

- Informal lenders operate without oversight, allowing them to set interest rates and employ unfair practices without regulation.

4. Cost of Borrowing:

- Informal lenders typically charge higher interest rates compared to formal lenders, resulting in a higher cost of borrowing for borrowers.
- This high cost reduces the disposable income of borrowers, impacting their financial stability.

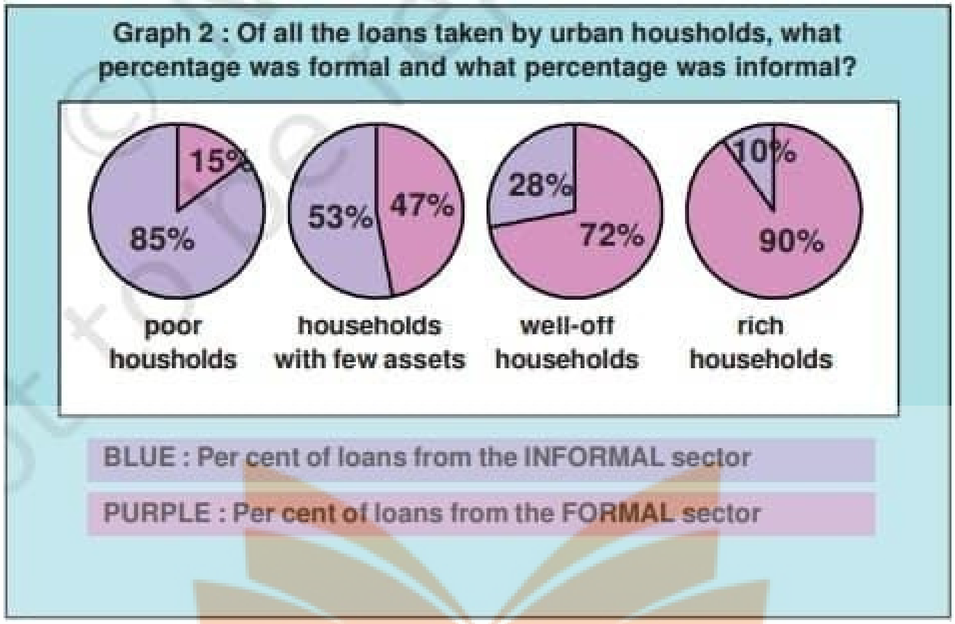
5. Risk of Debt Trap:

- The high-interest rates in the informal sector can lead to increasing debt burdens for borrowers, potentially trapping them in debt cycles.
- Borrowers may struggle to repay loans, risking financial ruin and hindering their ability to start businesses or invest in ventures.

6. Importance of Affordable Credit:

- Affordable credit from formal lenders like banks and cooperatives is essential for economic development.
- Access to cheap credit enables individuals to invest in agriculture, businesses, and small-scale industries, fostering economic growth and prosperity.

Formal and Informal Credit: Who gets what?



1. Urban Credit Scenario:

- Graph 2 illustrates the distribution of credit sources among urban households, categorized based on economic status.
- Poor urban households rely significantly on informal sources, with 85% of their loans sourced informally.
- In contrast, only 10% of loans taken by rich urban households are from informal sources, with 90% sourced formally.

2. Rural Credit Patterns:

- Similar trends are observed in rural areas, where rich households predominantly access formal credit, while poor households resort to informal sources.
- The disparity highlights the unequal access to affordable credit between different economic groups.

3. Credit Needs in Rural Areas:

- Despite the importance of formal credit, it only fulfils around half of the total credit requirements in rural regions.
- A significant portion of rural credit needs is still met through informal sources due to various factors.

4. High-Interest Rates of Informal Loans:

- Loans from informal lenders typically carry exorbitant interest rates, imposing financial burdens on borrowers.
- These loans often fail to contribute substantially to the income generation of borrowers.

5. Role of Formal Sector Expansion:

- There's a pressing need for banks and cooperatives to increase lending in rural areas to reduce dependence on informal credit sources.
- Expanding formal sector lending can alleviate the financial strain on borrowers and stimulate economic growth in rural communities.

6. Equitable Distribution of Formal Credit:

- Efforts should be made to ensure that formal credit is distributed more equitably across all economic strata.
- Equal access to formal credit can empower impoverished households by providing them with cheaper loan options, thereby fostering financial inclusion and socio-economic development.

Self-Help Groups for the Poor

A women's self-help group meeting in Gujarat

1. Dependency on Informal Credit:

- Poor households often rely on informal sources of credit due to limited access to formal banking facilities in rural areas.
- Obtaining loans from banks is challenging for the poor as it requires proper documentation and collateral, which they often lack.

2. Challenges with Bank Loans:

- Banks demand collateral and proper documentation for loan approval, making it difficult for the poor to meet these requirements.
- Lack of collateral acts as a major barrier for poor individuals seeking loans from banks.

3. Role of Moneylenders:

- Moneylenders provide loans to the poor without collateral, leveraging personal relationships and flexibility in repayment terms.
- However, moneylenders impose exorbitant interest rates, maintain no transaction records, and often harass borrowers.

4. Introduction of Self-Help Groups (SHGs):

- SHGs are formed to organize the rural poor, especially women, and pool their savings to provide loans within the group.
- Typically comprising 15-20 members, SHGs enable members to access small loans at lower interest rates compared to moneylenders.

5. Functions of SHGs:

- SHGs decide on loan disbursement, amount, purpose, interest rates, and repayment schedules democratically.
- Members collectively bear the responsibility for loan repayment, fostering a sense of accountability and solidarity within the group.

6. Benefits of SHGs:

- SHGs address the collateral problem by allowing members to access loans based on group savings and repayment track records.
- Timely access to affordable loans enables SHG members to invest in income-generating activities and acquire assets, leading to financial empowerment and poverty alleviation.

7. Social Impact of SHGs:

- SHGs serve as platforms for discussing and addressing social issues such as health, nutrition, and domestic violence, promoting community development and women's empowerment.

Grameen Bank of Bangladesh

1. The success of Grameen Bank:

- Grameen Bank of Bangladesh is renowned for its success in providing credit to the poor at reasonable rates.
- Established in the 1970s as a small project, it has grown significantly, with over 9 million members across 81,600 villages by 2018.

2. Focus on Women and the Poor:

- Grameen Bank primarily serves women from the poorest sections of society, emphasizing their reliability as borrowers.
- The bank's success highlights the potential of poor women to initiate and manage various small income-generating activities effectively.

3. The scale of Impact:

- By extending credit to millions of individuals engaged in small pursuits, Grameen Bank has contributed significantly to socio-economic development.
- The bank's model demonstrates how empowering the poor with access to credit can lead to substantial positive outcomes at the grassroots level.

4. Quotable Insight:

- The statement emphasizes the transformative potential of providing appropriate and reasonable credit terms to millions of small-scale entrepreneurs, emphasizing the cumulative effect of their efforts on development.

Summary

1. Modern Forms of Money and Banking:

- Understanding the connection between modern forms of money and the banking system is crucial.
- Depositors entrust their money to banks, while borrowers access loans from these banks to facilitate economic activities.

2. Role of Credit in Economic Activities:

- Economic activities often necessitate loans or credit to sustain operations and promote growth.
- Credit can have both positive and negative impacts on borrowers, depending on the circumstances.

3. Formal and Informal Sources of Credit:

- Credit can be sourced from formal institutions like banks and cooperative societies, or from informal sources.
- Terms of credit differ significantly between formal and informal lenders, influencing the cost and accessibility of loans.

4. Need for Increased Formal Sector Credit:

- Currently, formal sector credit is predominantly accessed by richer households, leaving the poor reliant on costly informal credit.
- It's imperative to boost total formal sector credit to reduce dependence on expensive informal credit sources.

5. Equitable Distribution of Formal Credit:

- Efforts should be made to ensure that a larger proportion of formal loans reaches the poor, promoting inclusive development.
- Enhancing access to formal credit for the poor through banks and cooperatives is vital for fostering economic growth and reducing poverty.