

Economics

CHAPTER 1

MONEY AND CREDIT

TEXTBOOK EXERCISES

Q.1. In situations with high risks, credit might create further problems for the borrower. Explain.

Ans. It is true that in situations of high risks, credit might create problems for the borrower. For example, if a small farmer takes a loan to meet the expenses of cultivation, hoping that his harvest would help repay the loan and his crop fails due to shortage of rain or for any other reason, he will be unable to repay the loan. In such cases, a small farmer has to sell a part of his land to repay the loan. Such situations have high risks because the repayment of loan depends on good harvest that in turn depends on good rain, pesticides and other factors. Failure of crops create further problems for the borrowers. Credit does not improve his earnings but leaves him worse off than before. Credit in high risks situations pushes the borrower into a debt trap, a situation from which recovery is very painful.

Q.2. How does money solve the problem of double coincidence of wants ? Explain with an example of your own.

Ans. Money solves the problem of double coincidence of wants because it acts as an intermediate in the exchange process. People may purchase anything with money. There is no need to have any goods or commodities for exchange. Money acts as a medium of exchange. For example, a person working as an engineer in a government department gets salary from his office. With that money (salary) he purchases different goods from the market according to the

requirements of his family. He makes payment in cash and does not need any product for exchange as required under the double coincidence of wants. Thus, money acts as an intermediate in the exchange process.

Q.3. How do banks mediate between those who have surplus money and those who need money ?

Ans. People hold money as deposits with banks which pay an interest rate on them. People do not withdraw their cash daily. The banks, therefore, hold only 15 per cent of their deposits as cash with themselves in order to pay the depositors who might come to withdraw money from the bank on any given day. Since, on any particular day, only some of its many depositors come to withdraw cash, the bank is able to manage with this cash.

They use major portion of the deposits to extend loans to those who need money. The banks make use of the deposits to meet the loan requirements of the people. Thus, in this way, the banks mediate between those who have surplus money and those who need money. Banks charge a higher interest rate on loans than what they offer on deposits. The difference between the two is the main source of income of the banks.

Q.4. Look at a 10 rupee note. What is written on top ? Can you explain this statement ?

Ans. The following words are written at the top of a 10 rupee note :

“Reserve Bank of India Guaranteed By The Central Government”

“I promise to pay the bearer the sum of Ten Rupees.” Governor.

It implies that the notes are issued by the Reserve Bank of India. The Governor of the Reserve Bank promises to pay the bearer the sum of ten rupees. The notes have been guaranteed by the Central Government and in case of failure of the currency *i.e.* Ten Rupee notes, people can claim the amount from the Central Government. It also implies that the use of rupee is a legal currency and no one can refuse payment made in it. It is medium of exchange in India.

Q.5. Why do we need to expand formal sources of credit in India ?

Ans. We need to expand formal sources of credit in India due to the following reasons :

(i) The moneylenders or the agricultural traders charge a much higher interest on loans. They generally charge 5 per cent per month whereas the banks charge about 10 to 15 per cent per annum.

(ii) The farmers who take loans from a trader are forced to sell their crop to him at low price. As a result of it, the farmers suffer while the traders make profit by selling grains at higher price.

(iii) Higher interest means the borrower has to pay a major portion of his earnings to repay the interest and principal of the loan. This sometimes lead to debt trap for the borrowers.

(iv) On the other hand, banks and cooperatives charge less interest and do not exploit the borrowers. Under these circumstances, there is need for expansion of formal sources of credit in India.

This would also lead to higher incomes and many people could then borrow cheaply for a variety of needs. It may be added that cheap and affordable credit is crucial for the development of the country.

Q.6. What is the basic idea behind the SHGs for the poor ? Explain in your own words.

Ans. The basic idea behind the SHGs (Self-help Groups) is to organise rural poor, in particular women, so that they may pool their savings and help them to borrow money without collateral. The banks are not present in every village. The members of a SHG can take loans from the group to meet their needs. The group charges interest but it is lower than the moneylenders in the rural areas. After a year or two, the group can take loan from the bank. This loan is meant to create self-employment opportunities for the members. Thus SHGs help borrowers to overcome the problems of lack of collateral and help the poor in the rural area.

Q.7. What are the reasons why the banks might not be willing to lend to certain borrowers ?

Ans. Bank loans require proper documents and collateral. People who do not apply for loan with proper documents and collateral are refused loans by the banks. Generally, the poor fall in this category and absence of collateral is one of the main reasons for not sanctioning loans to them.

Q.8. In what ways, does the Reserve Bank of India supervise the functioning of banks ? Why is this necessary ?

Ans. (a) The Reserve Bank of India supervises the functioning of banks in the following ways :

- (i) The RBI monitors that the banks actually maintain the required cash balance.
- (ii) It sees that the banks give loans not just to profit-making businesses and traders but also to small cultivators, small-scale industries, small-borrowers.
- (iii) The banks submit information to the RBI about loans sanctioned to different categories of persons alongwith terms and conditions of the loans. In this way, RBI sees that the loans are sanctioned to all including the poor.

(b) The supervision of the Reserve Bank of India over the functioning of the banks is necessary. It is to know how much the banks are lending, to whom and at what interest rate. It is to ensure that the banks do not exploit the borrowers like the moneylenders in the rural areas.

Q.9. Analyse the role of credit for development.

Ans. The role of credit for development is very significant as mentioned below :

- (i) It helps in increasing economic activities of the borrowers.
- (ii) If credit is made available to the poor people on reasonable terms and conditions, they can improve their economic condition. This will help in the over all development.
- (iii) Credit may increase the activities in the secondary sector *i.e.*, manufacturing sector.

Thus, with credit people could grow crops, do business, set up small-scale industries. They could set up new industries or trade in goods. Therefore, credit is crucial for the country's development.

Q.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.

Ans. Manav will decide to borrow from the bank or the moneylender on the following basis :

- (i) Rate of interest.
- (ii) Terms for repayment of loan.
- (iii) Other conditions such as collateral.

Wherever the above conditions favour him or are more satisfactory, he will take loan from them accordingly. Generally, in India, the terms and conditions that are offered in the formal

sector *i.e.*, the banks and cooperatives are better than the informal sector *i.e.*, moneylenders who charge much higher rate of interest.

Q.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.

Ans. (a) The banks might be unwilling to lend to small farmers because the farmers usually take crop loan at the beginning of the season and repay the loan after harvest. Repayment of loan is dependent on the income from farming. And in case of crop failure, repayment becomes impossible. In such cases, the recovery of loan from the small farmers becomes very difficult. The small farmers have to sell part of the land to repay the loan that is why banks do not want to give loans to small farmers.

(b) Small farmers usually borrow from moneylenders or agricultural traders.

(c) In case of failure of crops, it becomes impossible for small farmers to repay the loan by selling their crops. Thus in order to repay, the small farmers sell a part of the land. This leads to worsening of their condition. Sometimes, small farmers give collateral or security against loans. The collateral generally consists of land, building, vehicles, livestock. In case of non-repayment of loan, the lender may sell the collateral to recover loan. Under above conditions, the terms of credit become unfavourable for the small farmers.

(d) Small farmers can get cheap credit by forming cooperatives. They can form cooperatives which can obtain a large loan from the bank. The cooperatives use the bank loan to provide loans to members at cheaper rates than the moneylenders.

Q.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.

Ans. (i) poor
(ii) High
(iii) Reserve Bank of India
(iv) deposits
(v) Land.

Q.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.

Ans. (i) (b) Members (ii) (c) Employers.

MULTIPLE CHOICE QUESTIONS

Q.1. Which of the following is correct about the double coincidence of wants ?

- (a) Goods are not directly exchanged without the use of money.
- (b) A person desires to sell what the other wishes to buy without goods.
- (c) A person desires to sell double of his goods to other.
- (d) Both parties agree to sell and buy each other's commodities.

Ans. (d) Both parties agree to sell and buy each other's commodities.

Q.2. Name the system in which double coincidence of wants is an essential feature.

- (a) Barter system
- (b) Money economy
- (c) Global economy
- (d) None of the above

Ans. (a) Barter system.

Q.3. Which of the following is a form of modern currency ?

- (a) Gold coins
- (b) Silver coins
- (c) Paper notes
- (d) None of the above

Ans. (c) Paper notes.

Q.4. Why is currency accepted as a medium of exchange ?

- (a) Authorised by the state government like state of Haryana.
- (b) Authorised by the Government of a country e.g., Indian Government.
- (c) Authorised by the Parliament.
- (d) Authorised by the President.

Ans. (b) Authorised by the Government of a country e.g., Indian Government.

Q.5. What is a paper instructing the bank to pay a specific amount from the person's account to another person called ?

- (a) Draft
- (b) Pay Order
- (c) Hundi
- (d) Cheque

Ans. (d) Cheque.

Q.6. Which of the following is not a modern form of money ?

- (a) Currency
- (b) Deposits
- (c) Draft
- (d) None of the above

Ans. (c) Draft.

Q.7. Which of the following institutions is authorised to issue currency in India ?

- (a) Reserve Bank of India
- (b) State Bank of India
- (c) President
- (d) Parliament

Ans. (a) Reserve Bank of India.

Q.8. Which of the following reason is correct as to why no person can refuse to accept payment in rupees ?

- (a) A legal currency (b) Accepted by the people
(c) It is easy to handle (d) Useful in transactions

Ans. (a) A legal currency.

Q.9. Which of the following is not a term of credit ?

- (a) Interest rate (b) Collateral
(c) Mode of repayment (d) None of the above

Ans. (d) None of the above.

Q.10. When did Professor Muhammad Yunus of Bangladesh get Nobel Prize for Peace ?

- (a) 2004 (b) 2005
(c) 2006 (d) 2007

Ans. (c) 2006.

Q.11. The abbreviation SHG stands for what ?

- (a) Small Help Groups (b) Self-Help Groups
(c) Social Help Groups (d) Subscriber's Help Groups

Ans. (b) Self-Help Groups.

Q.12. In a Self Help Group who takes most of the important decisions regarding the savings and loan activities are taken ?

- (a) Village (b) Bank
(c) Community (d) Group members

Ans. (d) Group members.

Q.13. Which of the following is not an advantage of Self-Help Groups ?

- (a) Grant of timely loans.
(b) Reasonable interest.
(c) A platform to discuss various issues.
(d) Does not help women to become self-reliant.

Ans. (d) Does not help women to become self-reliant.

Q.14. Which of the following banks was founded by Muhammad Yunus ?

- (a) State Bank (b) Imperial Bank.
(c) New Bank (d) Grameen Bank

Ans. (d) Grameen Bank.

QUESTIONS OF 3/5 MARKS

Answers should be in about 80/120 words :

Q.1. Explain double coincidence of wants. In which system it is an essential feature ?

Ans. (i) In double coincidence of wants, there should be two parties and both have to agree to sell and buy each other's commodities.

(ii) In a barter system where goods are directly exchanged without the use of money, double coincidence of wants is an essential feature.

Q.2. Why are transactions made in money ? Explain with suitable examples.

Ans. The transactions in money are made due to the following reasons :

(i) A person holding money can easily exchange it for any commodity or service that he or she might want.

(ii) Money solves the problem of double coincidence of wants because it acts as an intermediate in the exchange process.

(iii) People may purchase anything with money. There is no need to have any goods or commodities for exchange. Money acts as a medium of exchange.

For example, a person is working as an engineer in a government department. He gets salary from his office. With that money (salary) he purchases different goods from the market according to the requirements of his family. He makes payment in cash and does not need any product for exchange as required under the double coincidence of wants. Thus, money acts as an intermediate in the exchange process and all transactions are made in money.

Q.3. Write a note on deposits with banks.

Ans. (i) Reasons to deposit money with the banks : People do not need all the money for their needs. They keep some money in cash with them for their daily requirements. Rest of the money or spare money is kept in the banks as deposits. They open an account and keep extra-cash in the bank which pay an interest rate on the deposits. People earn interest on their extra-cash. Another advantage of deposits is that their money is safe in the bank. There is no fear of theft.

(ii) Withdrawal from the deposits : People can withdraw money from their deposits as and when required.

(iii) Modes of withdrawal : The money can be withdrawn on demand in cash by withdrawal slip by the depositor himself or it can be withdrawn by cheque.

(iv) Demand deposits : Since the deposits in the bank accounts can be withdrawn on demand, these deposits are called demand deposits. Demand deposits are accepted widely as a means of payment along with currency, they constitute money in the modern economy.

(v) Payments by cheque : The account holder gets facility of issuing cheques. This facility enables a person to make payments by cheques without the use of cash.

Q.4. What is a cheque ? Describe how cheque payments are made and realised.

Ans. (i) 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.

(ii) If a person has to make a payment, he issues a cheque for a specific amount in his name such as NDPL. The NDPL will deposit the cheque in their own account in the bank. Thereafter, the money is transferred from one bank to another bank account in a couple of days. Thus, transaction takes place without any payment of cash from one bank account to another bank account.

Q.5. Describe two different credit situations where credit plays a positive role and a negative role.

Ans. Two different credit situations where credit plays a positive and a negative role are as given below :

(i) Credit and a positive role : A trader obtains credit to meet the working capital needs of production. The credit helps him to meet the on going expenses of production, complete production on time and thereby increase his earnings. In such a situation credit plays a positive role.

(ii) Credit and a negative role : A farmer takes a loan to meet the expenses of cultivation hoping that there would be good harvest and he would repay the loan. The harvest, however, fails and the farmer is unable to repay the loan. Next year again he takes loan but the crop is not

very good. He again is not in a position to repay the loan. So he has no option but to sell a part of his land to pay off the debt.

Thus, in one situation credit helps to increase earnings and the person is better off than before. In the second situation credit pushes the person into a debt trap and he has to sell a part of his land.

Q.6. What is collateral? Given that a large number of people in our country are poor, does the collateral in any way affect their capacity to borrow?

Ans. (i) Collateral is an asset that the borrower owns (such as land, building, vehicle, livestock, deposits with banks) and uses this as a guarantee to a lender until the loan is repaid. If the borrower fails to repay the loan, the lender has the right to sell the asset or collateral to obtain the payment.

(ii) The collateral affects the capacity of the poor to borrow because absence of collateral prevents them from getting loans from the banks. They are compelled to take loan from the moneylenders at higher rate of interest. The moneylenders keep no records of the transactions and harass the poor borrowers.

Q.7. What are the differences between formal and informal sectors of credit or loans?

Or

Explain any two features each of formal sector loans and informal sector loans.

Ans. The main differences between formal sector and informal sector loans are as given below:

<i>Formal sector</i>	<i>Informal sector</i>
(i) Formal sectors sources are banks and cooperatives.	(i) Informal sector sources are moneylenders, traders, employers, relatives and friends.
(ii) The banks and cooperatives charge less rate of interest <i>i.e.</i> , about 10 per cent per annum or so.	(ii) Informal sector sources charge higher interest <i>i.e.</i> , 3 to 5 per cent per month.
(iii) It results in more income and better condition of the borrower. There is improvement in his financial condition.	(iii) Higher rate of interest results in less income for the borrowers. It sometimes leads to debt-trap.
(iv) Reserve Bank of India supervises the functioning of formal sources of loans.	(iv) There is no organisation which supervises the credit activities of the lenders in the informal sector. They do whatever is in their interest.

Q.8. Why should credit at reasonable rates from the banks and cooperatives be available for all?

Ans. Credit at reasonable interest rates should be available for all so that they may increase their income and help in the over all development of the country. High interest rate do little to increase the income of the borrowers. Thus, it is necessary that the banks and cooperatives increase their lending particularly in rural areas, so that the dependence of the people on informal sources of credit reduces. In addition to this more credit should be given to the poor to get maximum benefit from the cheaper loans. This will help in increasing their income as well as standard of living.

Q.9. Describe the pattern of formal and informal sources of credit in urban areas. Why do we need to expand formal sources of credit ?

Ans. (a) The people in the urban areas are divided into four categories :

- (i) Poor households
- (ii) Households with few assets
- (iii) Well-off households
- (iv) Rich households.

85 per cent of the poor households take loans from informal sources whereas only 10 per cent of the rich households take loans from informal sources. 90 per cent of the rich households take loans from the formal sources.

(b) In urban areas, poor households suffer at the hands of informal sources. The same is the position in rural areas. Most of the informal lenders charge a much higher interest on loans. As a result of it, larger part of the earnings of the borrowers is used to repay the loan in some cases, the amount to be repaid becomes greater than the income of the borrower. People lead to debt trap. These reasons make it necessary to expand the formal sources of credit *i.e.*, banks and cooperatives which will make available cheap and affordable credit to the people.

Q.10. What are Self-Help Groups ? Describe in brief their functioning including their aim and importance.

Ans. (1) A typical Self-Help Group has 15-20 members, usually belonging to one neighbourhood who meet and save regularly.

(2) The functioning of SHGs is as given below :

(i) Aim : The aim of Self-Help Group is to organise rural poor, women in particular and collect their savings and to take loans from the group to meet their needs. The group takes loan from the bank to create self-employment opportunities for the members.

(ii) Working of the SHG : Decisions on loans and savings are taken by the group members. All matters relating to the purpose, amount, interest rate, repayment schedule are decided by the group members. The group is responsible for the repayment of the loan. Non-repayment of loan by any member is followed up seriously by other members of the group.

(iii) Importance : (a) SHGs have helped borrowers overcome the problem of lack of collateral because the banks are willing to lend to the poor women organised in SHGs, even though they have no collateral as such.

(b) The borrowers can get timely loans at a reasonable interest rate.

(c) It has helped women in the rural areas to become financially self-reliant.

(d) The meetings of the groups provide a platform to discuss and act on a variety of social issues such as health, nutrition and domestic violence.

Thus, SHGs are playing a significant role in the improvement of the condition of the poor, particularly women.

Q.11. Discuss the role played by Grameen Bank of Bangladesh in improvement of the condition of the poor particularly women.

Ans. Grameen Bank of Bangladesh was started in the 1970s. It has now over 6 million borrowers in about 40,000 villages. Almost all 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 they can start and run a variety of small income-generating activities successfully.

Thus, the Grameen Bank has played a significant role in the improvement of the condition of the poor women in Bangladesh. Professor Muhammad Yunus, the founder of Grameen Bank and recipient of 2006 Nobel Prize for Peace has stated about the need of granting loan to the poor on reasonable rates of interest as follows :

“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.”

VALUE BASED QUESTIONS

Read the passages given below and answer the questions that follow :

1. ‘People deposit extra-cash with the banks by opening a bank account in their name. Banks accept the deposits and also pay an interest rate on the deposits.’

(i) What are the advantages of depositing money in the banks ?

(ii) Which are the valuable habits that people learn by deposits in the banks ?

Ans. (i) The advantages of deposits in the bank are as given below :

(a) People earn interest on deposits.

(b) People’s money is safe as there is no fear of theft or robbery.

(c) People can use money as and when required by them.

(ii) The following valuable habits are learnt by the people by deposits in the bank :

(a) Saving money for the future.

(b) It enables them to plan for the future.

(c) Cuts their unnecessary expenditure.

2. ‘The SHGs help borrowers overcome the problem of lack of collateral. They can get timely loans for a variety of purposes and at a reasonable interest rate. Moreover SHGs are the building blocks of organisation of the rural poor.’

(i) What is a SHG ?

(ii) Describe the values for which it has become advantageous for the rural poor.

Ans. (i) A Self Help Group is a group of 15-20 people, particularly women, who meet and save regularly depending on the ability of the people to save.

(ii) The SHG has become advantageous for the following values :

(a) Regular savings are made by the members.

(b) The members take part in the deliberations of the SHG and take decisions regarding loan activities.

(c) Women get a platform to discuss and act on a variety of social issues such as health, nutrition and domestic violence.