

# Money and Credit

## Long Answer Questions

**1.** What do the banks do with the deposits which they accept from the public?

- Ans. (i) Banks keep only a small portion of their deposits (about 15 per cent), as cash.  
(ii) This is kept as provision to pay the depositors who might come to withdraw money from the bank on any given day.  
(iii) Banks use the major portion of the deposits to extend loans.  
(iv) There is a huge demand for loans for various economic activities. Banks make use of the deposits to meet the loan requirements of the people.  
(v) In this way, banks mediate between those who have surplus funds (depositors) and those who are in need of these funds, (borrowers).  
(vi) Banks charge a higher rate of interest on loans than what they offer on deposits.  
(vii) The difference between what is charged from borrowers and what is paid to depositors is their main source of income.

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

- Ans. Reasons:  
(i) There is no organisation which supervises the credit activities of lenders in the informal sector.  
(ii) They can lend at whatever interest rate they choose.  
(iii) There is no one to stop them from using unfair means to get their money back.  
(iv) The higher interest rate of borrowing can mean that the amount to be repaid is greater than the income of the borrower.  
(v) This could lead to increasing debt and eventually a debt trap situation.  
(vi) Also, people who might wish to start a business by borrowing may not do so because of the high cost of borrowing.  
For these reasons, banks and cooperative societies need to lend more. This would lead to higher incomes and many people could then borrow at cheap rates for a variety of needs. Cheap and affordable credit is crucial for the country's development.

**3.** Why are poor households still dependent on informal sources of credit?

- Ans. Reasons:  
(i) Banks are not present everywhere in rural India.  
(ii) Even if they are present, getting a loan from a bank is much more difficult than taking a loan from informal sources.  
(iii) Bank loans require proper documents and a collateral. Absence of collateral is one of the major reasons which prevents the poor from getting bank loans.  
(iv) Informal lenders like moneylenders know the borrower personally and hence, are often willing to give a loan without a collateral.  
(v) The borrowers can, if necessary, approach the moneylender even without repaying their earlier loans.  
(vi) However, the moneylenders charge very high rates of interest, keep no records of the transactions and harass the poor borrowers.

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

- Ans. (i) The idea is to organise the rural poor, in particular women, into small Self Help Groups (SHGs) and pool their savings.  
(ii) A typical SHG has 15 to 20 members, who meet and save regularly.  
(iii) Savings per member varies from ₹ 25 to ₹ 100 or more, depending on the ability of the people to save.

- (iv) Members can take small loans from the group itself to meet their needs.
- (v) The group charges interest on these loans, but still less than what the moneylender charges.
- (vi) After a year or two, if the group is regular in savings, it becomes eligible for availing loans from the bank.
- (vii) Loan is sanctioned in the name of the group and is meant to create self-employment opportunities for the members.
- (viii) Most of the important decisions regarding the savings and loan activities are taken by the group members.
- (ix) The group decides as regards the loan to be granted—the purpose amount, interest to be charged and repayment schedule, etc.
- (x) Any case of non-repayment of the loan by any one member is followed seriously by other members of the group.

**5.** What are the advantages of SHGs?

Ans. Advantages of SHGs:

- (i) The SHGs help the borrower to overcome the problem of lack of collateral.
- (ii) They can get timely loans for a variety of purposes and at a reasonable interest rate.
- (iii) SHGs are the building blocks of organisation of the rural poor.
- (iv) Not only do they help women become financially self-reliant, the regular meetings of the group provide a platform to discuss and act on a variety of social issues such as health, nutrition, domestic violence, etc.

**6.** What are the differences between formal and informal sources of credit?

Ans. Formal sources:

- (i) These sources of credit are registered by the government and have to follow its rules and regulations.
- (ii) RBI supervises the functioning of formal sources of credit.
- (iii) They generally charge lower rates of interest.
- (iv) Their main motive is social welfare.

Example: Banks and cooperatives.

Informal sources:

- (i) These include those small and scattered units which are largely outside the control of the government.
- (ii) There is no organisation which supervises the credit activities.
- (iii) They charge much higher rates of interest.
- (iv) Their main motive is profit-making.

Example: Moneylenders, traders, employees, relatives and friends, etc.

**7.** Why is currency accepted as a medium of exchange?

Ans. (i) It is accepted as a medium of exchange because the currency is authorized by the government of the country.

(ii) In India, the Reserve Bank of India issues currency notes on behalf of the Central Government.

(iii) As per Indian law, no other individual or organisation is allowed to issue currency.

(iv) Moreover, the law legalises the use of rupee as a medium of payment that cannot be refused in settling transactions in India.

(v) No individual in India can legally refuse a payment made in rupees.

Hence the rupee is widely accepted as a medium of exchange.

**8.** What is a cheque? How does it replace currency?

Ans. A 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 drawn.

(i) The facility of cheque against demand deposits makes it possible to directly settle the payments without the use of drawn.

- (ii) For payment through cheque, the payer who has an account with the bank, makes out a cheque of a specific amount.
- (iii) The money is transferred from one bank account to another in a couple of days. The transaction is complete without any payment of cash.

**9.** What do the banks do with the deposits which they accept from the public?

- Ans.
- (i) Banks keep only a small portion of their deposits as cash with themselves, say about 15 per cent.
  - (ii) This is kept as provisions to pay the depositors who might come to withdraw cash from the bank on any given day.
  - (iii) Banks use the major portion of the deposits to extend loans.
  - (iv) There is a huge demand for loans for various economic activities.
  - (v) Banks make use of the deposits to meet the loan requirements of the people.
  - (vi) In this way, banks mediate between those who have surplus funds (depositors) and those who are in need of these funds (the borrowers).
  - (vii) Banks charge a higher interest rate on loans than what they offer on deposits.
  - (viii) The difference between what is charged from borrowers and what is paid to depositors is their main source of income.

**10.** What is credit? How can credit be both an asset as well as a debt trap?

- Ans.
- 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.
- (i) Example of credit as an asset: During the festival season, a shoe manufacturer has received an order of making shoes in bulk, within a month's time. To complete production, he hired some extra workers and has to purchase the raw materials. He asks the supplier to supply leather now and promises to pay him later. Then he took some advance payment from the trade. By the end of the month, he is able to deliver the order, make a good profit and repay the money he had borrowed.
  - (ii) Example of credit as debt trap: A farmer picks up the loan from a moneylender to meet the expenses of cultivation. But unfortunately the crop is hit by the pests and fails. So, he is unable to repay the loan and debt grows larger with interest. Next year, he picks up a fresh loan and is able to have a normal crop that year. But earnings are not enough to pay the earlier debt. So, he is caught in a debt trap. He can repay the loan, only after selling a part of the land.
- In shoemaker's case credit plays a vital and positive role, whereas in farmer's case credit pushes the borrower into a situation from which recovery is very painful.

**11.** What are the terms of credit?

- Ans.
- (i) Every loan agreement specifies an interest rate which the borrower must 'pay to the lender along with repayment of the principal.
  - (ii) In addition, lender may demand collateral i.e. an asset that the borrower owns and uses this as a guarantee until the loan is repaid.
  - (iii) If the borrower fails to repay the loan, the lender has the right to sell the collateral to obtain payment.
  - (iv) Terms of credit comprise interest rate, collateral and documentation requirement, and the mode of repayment.
  - (v) The terms of credit vary substantially from one credit arrangement to another. They may vary depending on the nature of the lender and the borrower.

**12.** Why do poor farmers get into debt trap of informal sector?

- Ans.
- (i) There is no organisation which supervises the credit activities of lenders in the informal sector.
  - (ii) They can lend at whatever interest rate they choose.
  - (iii) There is no one to stop them from using unfair means to get their money back.
  - (iv) Compared to the formal lenders, most of the informal lenders charge a much higher interest rate on loans. So, the cost to the borrowers of informal loans is much higher.

(v) Higher cost of borrowing means a larger part of the earnings of the borrower is used to repay the loan.

(vi) The higher interest rate of borrowing can mean that the amount to be repaid is greater than the income of the borrower. This could lead to increasing debt and debt trap.

**13.** "The rich households are availing cheap credit from formal lenders whereas the poor households have to pay a heavy price for borrowing." Comment.

Ans. (i) The formal sector still meets only about half of the total credit needs of the rural people.

(ii) The remaining credit needs are met from informal sources.

(iii) Most loans from informal lenders carry a very high interest rate and do little to increase the income of the borrowers.

(iv) Thus, it is necessary that banks and cooperatives increase their lending particularly in the rural areas, so that the dependence on informal sources of credit reduces.

(v) While formal sector loans need to expand, it is also necessary that everyone receives these loans.

(vi) At present, it is the rich households who receive formal credit whereas the poor have to depend on the informal sources.

**14.** Who takes the important decisions of SHGs and why?

Ans. (i) Most of the important decisions regarding the savings and loan activities are taken by the group members.

(ii) The group decides as regards the loans to be granted—the purpose, amount, interest to be charged, repayment schedule, etc.

(iii) It is the group which is responsible for the repayment of the loan.

(iv) In case of default by any one member, it is followed up seriously by other members in the group.

(v) Because of this feature, banks are willing to lend to the poor women when organised in SHGs even though they have no collateral as such.

**15.** State any three advantages of an ATM.

Ans. (i) ATM is a provision called the Automated Teller Machine.

(ii) In case of an ATM, direct interaction with the bank is not required.

(iii) Money can be withdrawn from the ATM during the entire twenty-four hours in a day, whereas banks close their public dealings at a particular time, binding the depositor to come within that stipulated period.