

Money and Credit

Let's Work These Out

Page No. 21

1. How does the use of money make it easier to exchange things?

Ans. The use of money makes it easier to exchange things because

- it is accepted as a medium of exchange.
- it serves as a unit of value.
- it solves the problem of double coincidence of wants.

2. Can you think of some examples of goods and services being exchanged or wages being paid through Barter system?

Ans. In rural areas, usually foodgrains are exchanged for other crops in some cases. In even some government schemes, labourers are paid not in cash but in kind, e.g., 5 kg of wheat per day of work.

Page No. 42

1. M. Salim wants to withdraw ₹ 20,000 in cash for making payments. How would he write a cheque to withdraw money?

Ans.

Pay Self

रुपये Rupees Twenty Thousands only

विवरण Date X Y 2002

या धारक को Or Bearer

₹.Rs. 20,000

अवा करे

आ. सं. A/c. No. 0318000400022378

भारतीय स्टेट बैंक
State Bank of India
4, Mellford City, Rohta Road
Meerut (U.P.)

M. Salim

2. Tick the correct answer.

After the transaction between Salim and Prem,

- Salim's balance in his bank account increases, and Prem's balance increases.
- Salim's balance in his bank account decreases and Prem's balance increases.
- Salim's balance in his bank account increases and Prem's balance decreases.

Ans. (ii) Salim's balance in his bank account decreases and Prem's balance increases.

3. Why are demand deposits considered as money?

Ans. Demand deposits are considered as money, because they can be withdrawn when required and the money withdrawn can be used for making payments. So, they are also considered as money in the modern economy.

1. Fill the following table.

	Salim	Swapna
Why did they need credit? What was the risk? What was the outcome?		

Ans.

	Salim	Swapna
Why did they need credit?	To meet the working capital needs.	To meet the expenses of cultivation.
What was the risk?	No or little unknown risk.	Risk of crop failure.
What was the outcome?	Supplied the orders, earned profits and repaid the loans.	Crop failed; found herself in the debt trap.

2. Suppose Salim continues to get order from traders. What would be his position after six years?

Ans. If Salim continues to get orders from traders for the next six years, he can use the profits from the sales of shoes to finance his future business. Then he will not have to borrow money from any source of credit.

3. What are the reasons that make Swapna's situation so risky? Discuss factors - pesticides, role of money lenders, climate.

Ans. The reasons for Swapna's situation being risky are
 (a) Failure of crop due to either poor rainfall (climate problem) or attack on the crop by pests. Pesticides will reduce or eliminate the attack by pests and good rainfall will eliminate the risk due to climate.
 (b) Here the role of money lenders is important because they charge high interest rates and also will take away part of Swapna's land if she defaults on loan repayment when her crop fails. This will reduce her earning power even further in the future.

1. A House Loan Megha has taken a loan of `5 lakh from the bank to purchase a house. The annual interest rate on the loan is 12% and the loan is to be repaid in 10 years in monthly instalments. Megha had to submit to the bank, documents showing her employment records and salary before the bank agreed to give her the loan. The bank retained as collateral the papers of the new house, which will be returned to Megha only when she repays the entire loan with interest.

Fill the following details of Megha's housing loan.

(a) Loan amount (In Rupees) (b) Duration of loan (c) Documents required (d) Interest rate (e) Mode of repayment (f) Collateral	
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Ans.

Loan amount (In Rupees)	5 Lakhs
Duration of loan	10 years
Documents required	Salary slips, employment record
Interest rate	12% per annum
Mode of repayment	Monthly installment in cash/by cheque
Collateral	New house papers

2. Why do lenders ask for collateral while lending?

Ans. Lenders ask for collateral while lending because if payment of interest and repayment of the principal are not made on time, as the last resort the lenders can sell the collateral assets and recover their money.

3. Given that a large number of people in our country are poor, does it in any way affect their capacity to borrow?

Ans. Poor have low capacity to borrow since they have no collateral to offer. As such, they cannot get any credit from formal sources of credit like banks and co-operatives. They mostly take loans from informal sources of credit like money lenders, friends, relatives, etc.

4. Fill in the blanks choosing the correct option from the brackets.

While taking a loan, borrowers look for easy terms of credit. This means..... (low/high) interest rate, (easy/tough) condition; for repayment, (less/more) collateral and documentation requirements.

Ans. low, easy, less.

Page No. 47

1. List the various sources of credit in Sonpur.

Ans. Various sources of credit in village Sonpur are

- (i) Village moneylender
- (ii) Traders
- (iii) Landowner as moneylender
- (iv) Commercial banks
- (v) Krishak co-operative society

2. Loans from Co-operatives Besides banks, the other major source of cheap credit in rural areas are the co-operative societies (or co-operatives). Members of a co-operative pool their resources for co-operation in certain areas. There are several types of co-operatives possible such as farmers co-operatives, weavers co-operatives, industrial workers co-operatives, etc.

Krishak Co-operative functions in a village not very far away from Sonpur. It has 2300 farmers as members. It accepts deposits from its members. With these deposits as collateral, the Co-operative has obtained a large loan from the bank. These funds are used to provide loans to members. Once these loans are repaid, another round of lending can take place.

Krishak Co-operative provides loans for the purchase of agricultural implements, loans for cultivation and agricultural trade, fishery loans, loans for construction of houses and for a variety of other expenses.

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Krishak Co-operative provide loans for the purchase of agricultural implements, loans for cultivation and agricultural trade, fishery loans, loans for construction of houses and for a variety of other expenses.

3. Compare the terms of credit for the small farmer, the medium farmer and the landless agricultural worker in Sonpur.

Ans. (a) Terms of credit for small farmer

- High rate of interest.
- Promise to sell crops to traders at low prices as repayment of loan.

(b) Terms of credit for medium farmer.

- They can take loans from banks or from co-operatives who charge very low rate of interest.
- Loan can be paid back in the next three years.

(c) Landless agricultural workers in Sonpur

- Borrower has no means to repay the loan in cash. So, he pledges to repay loans by working for the landowner
- Rate of interest is high.

4. Why will Arun have a higher income from cultivation compared to Shyamal?

Ans. Arun gets a loan from the commercial bank at a rate of interest 8.5% per annum, while Shyamal gets loans from a village moneylender at an interest rate of 5% per month (i.e., 60% per annum). Arun has the capacity to pay bank loans as compared to Shyamal and gets a fresh loan in next three years. Like Shyamal he is not bound to sell his produce to the moneylenders who give a low price. He can sell his produce at market rates.

5. Can everyone in Sonpur get credit at a cheap rate? Who are the people who can?

Ans. Everyone cannot get credit at a cheap rate. Only the following people are able to get it

- Who have some collateral.
- Who have organised themselves into co-operative society.
- Who can fulfil the banks documentation requirements.

6. Tick the correct answer.

(i) Over the years, Rama's debt

- (a) will rise.**
- (b) will remain constant.**
- (c) will decline.**

(ii) Arun is one of the few people in Sonpur to take a bank loan because

- (a) other people in the village prefer to borrow from the moneylenders.**
- (b) banks demand collateral which everyone cannot provide.**
- (c) interest rate on bank loans is same as the interest rate charged by the traders.**

Ans. (a), (b)

7. Talk to some people to find out the credit arrangement that exists in your area. Record your conversation. Note the differences in the terms of credit across people.

Ans. Do it yourself (A practical question, which can be attempted by collecting various views.

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

Ans.

Points on Which Different	Formal Sources of Credit	Informal Sources of Credit
Borrower's capability	Richer people having assets which can be pledged as collateral	Poorer people not having assets which can be pledged
Rate of interest	Reasonably low	Very high
Sources	Banks and co-operative societies	Traders, moneylenders, landowners, etc
Action on default of payment	Collateral can be confiscated and sold to recover the loan	Borrowers can be made as bonded labourers or made to part with land owned by them

2. Why should credit at reasonable rates be available for all?

Ans. Credit at reasonable rates should be available for all, so that the poor people can benefit from the cheaper loans.

3. Should there be a supervisor, such as the Reserve Bank of India, that looks into the loan activities of informal lenders? Why would its task be quite difficult?

Ans. There should be a supervisor for checking the loan activities of Informal lenders. However, its task is quite difficult because informal sector constitutes many people who have different kind of business of their own, besides lending. They are not registered with the government.

4. Why do you think that the share of formal sector credit is higher for the richer households compared to the poorer households?

Ans. The share of the formal sector credit is higher for the richer households because the richer households are in a better position to provide collateral and other necessary documents which are required by the banks and co-operatives. Richer households have means to exert pressure on banks and co-operatives to sanction loans. Richer households have greater capacity to repay the loans compared to the poor households.

Exercises

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

Ans. It is true that in situations with high risks, credit might create problems for the borrower, e.g., a small farmer takes a loan to meet the expenses of cultivation, hoping that his harvest would help him to repay the loan. But if his crop fails due to shortage of rain or for any other reason, he will be unable to repay the loan. In such situations a small farmer has to sell a part of his land to repay the loan. Such cases have high risks because the payment of loan entirely depends on good a crop which in turn depends on good rain. HYV seeds fertilizers, pesticides and other factors. This type of loan pushes the farmer into a debt-trap in the case of crop failure and the position of the farmer becomes worse off than before.

2. How does money solve the problem of double co-incidence of wants? Explain with an example of your own.

Ans. Double coincidence of wants is an essential feature in a barter system where goods are directly exchanged without the use of money. But on other hand in an economy where money is in use, by providing the crucial intermediate step, it eliminates the need for double coincidence of wants.

A person holding money can easily exchange it for any commodity in service that he or she might want. e.g., it is no longer necessary for shoemaker to look for a farmer who will buy these shoes and at the same time sell him rice. All he has to do is find a buyer for his shoes. Once he has exchanged his shoes for money he can purchase rice or any commodity in the market.

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

Ans. Banks use the major portion of deposits with them to extend loans to people who need money. There is a huge demand for loans for various economic activities. In this way, banks mediate between those who have surplus funds and those who are in need of these funds. Banks charge a higher rate of interest on loans compared to what they offer on deposits. The difference between what is charged from borrowers and what is paid to depositors is their main source of income. Thus, by accepting deposits and by advancing loans, banks mediate between those who have surplus money and those who need money.

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 rupees note 'I Promise To Pay The Bearer The Sum Of Ten Rupees.' 'Governor' Reserve Bank of India Guaranteed by the Central Government'. A 10 Rupee note is acceptable as a medium of exchange because this is authorized by the government of the country. In India, the Reserve Bank of India issues currency notes on behalf of the Central Government. As per Indian Law, no other individual or organization is allowed to issue currency.

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

Ans. The formal sector still meets only about half of the total credit needs of the rural people. The remaining credit needs are met from informal sources. Most loans from informal lenders carry a very high interest. The formal sources of credit for lending need to expand their operations particularly in rural areas, so that the dependence, on informal sources of credit reduces.

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

Ans. The basic idea behind the SHGs is meant to create self - employment opportunities for the poor. The SHGs help poor borrowers to 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 organizations of rural poor.

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

Ans. A number of borrowers have no collateral to pledge against loans. Collateral is an asset that the borrower owns and pledges as a guarantee to the lender until the loan is repaid. The main demand for loans is for crop production. Repayment of the loan is crucially dependent on the income from farming. Whether loans would be useful or not, therefore, depends on the risks in the situation. That is why, banks have no interest to lend to such borrowers. Thus, the banks might not be willing to lend to those borrowers who have no collateral and whose repaying capacity is not guaranteed.

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

Ans. The Reserve Bank of India supervises the functioning of banks in the following ways

- (a) The RBI monitors the banks in maintaining a minimum cash balance out of the deposits they receive.
- (b) The RBI sees that the banks give loans not just to profit-making business and traders but also to small cultivators, small scale industries, small borrowers etc. This is done by periodical statements submitted by banks to RBI which contain information regarding how much the banks are lending to whom, at what rate of interest, etc.
- (c) This supervision is necessary to ensure that equality is preserved in business and industry so that small industries also grow. Also, RBI makes sure that banks do not loan out more money than they are supposed to, as this can lead to crisis situations. An example is the great depression of the 1930s, as it affected the world economy.

9. Analyse the role of credit for development.

Ans. Development is sustained by a proper credit policy. By giving loans to industries and trade, banks provide them with the necessary funds for carrying on their business without problems. This results in increased production and services, more employment and also profits. Caution is employed by the lenders when high risks are expected, so that there are no losses.

Credit from the formal sector needs to be increased as loans from the informal sector, which have very high interest rates, do more harm than good. For this reason, it is important that the formal sector gives out more loans so that borrowers are not exploited by informal sector moneylenders, and the results definitely will contribute to national development.

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 whether to borrow from a bank or moneylender on the following terms of the loan.

- (a) The documentation and collateral required (he should be able to make these available).
- (b) The rate of interest charged.
- (c) The mode of repayment (periodicity, cash/kind, etc)
- (d) The penalty in case of default in repayment.

11. In India about 80% 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 unfavorable for the small farmer.

(d) Suggest some ways by which small farmers can get cheap credit to.

Ans. (a) Small farmers normally have no collateral to pledge against loans. Collateral is an asset that the borrower owns and uses this as a guarantee to a lender until the loan is repaid. That is why banks have no interest to lend to small farmers.

(b) These small farmers take loans from co-operatives, SGHs and informal lenders like moneylenders, traders, employers, 'relatives and friends, etc.

(c) An example of unfavourable terms of credit for the small farmer is Shiva is a small farmer. He borrows money at the rate of 4 % per month (i.e., 48 % per annum) from a local moneylender to grow his crop. But the crop fails due to severe drought. As a result Shiva has to sell a part of his land to repay the loan. Now his condition becomes worse than before.

(d) Small farmers can get cheap credit from sources like regional rural banks, agricultural co-operatives and SHGs.

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) Bank deposit
(v) Collateral
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 organization
 - (ii) Formal sources of credit does not include
 - (a) banks
 - (b) co-operatives
 - (c) employers
- Ans. (i) b, (ii) c

Additional Project/Activity

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.

Occupation	Reason for Needing a Loan
Construction worker	
Graduate student who is computer literate	
Migrant labourer in Delhi	
A person employed in government service	
Household maid	
Small trader	
Auto rickshaw 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?

Ans.

Occupation	Reason for Needing a Loan
Construction worker	To meet a medical emergency in the family
Graduate student who is computer literate	To pay the fees for a higher degree
Migrant labourer in Delhi	To purchase a flat
A person employed in government service	For expenses related to his daughter's wedding
Household maid	To meet the daily expenses
Small trader	To run his business efficiently
Auto rickshaw driver	To replace his old auto rickshaw with a new one
A worker whose factory has closed down	To meet his expenses till he gets employed again

Classification Regarding Ability to get a Loan

Those Who Might Get a Bank Loan	Those Who Might Not Get a Bank Loan
Graduate student who is computer literate	Construction worker
A person employed in government service	Migrant labourer in Delhi
Small trader	Household maid
Auto rickshaw driver	A worker whose factory has closed down

The criteria I have used for this classification are

(a) Does the borrower have the potential to repay the loan or not? People with a secure job or a running business will get a loan because they have the capability to repay the installments. Here the government servant and small trader will be successful, whereas the migrant labourer, household maid, construction worker and worker whose factory has closed down will not be successful.

(b) Whether the borrower is able to pledge collateral on which to guarantee the loan taken. Here the auto rickshaw driver can pledge his auto rickshaw to the bank and the graduate student can pledge any capital asset owned by him. These two are the basic prerequisites for getting a loan from a bank.