MONEY AND CREDIT

CHAPTER COVERAGE

- ✦ Barter exchange system
- ✦ Functions of money
- ✦ Terms of credit
- ✦ Self Help Groups (SHGs)
- ✦ Modern forms of money
- ✦ Loan activities of Banks
- ✦ Formal credit sector in India
- ✦ Functions of Central Bank & Commercial Banks

BARTER SYSTEM

The system of exchanging goods is known as barter system.

◈ **Limitation of Barter system :**

1. Two people with different types of needs and goods must be there to satisfy each other's needs.
2. There are many products which cannot be divided.
3. Valuation of goods is very difficult.
4. It was time consuming.

MONEY AS MEDIUM OF EXCHANGE

(1) It is an important function of money. It means that money act as an intermediary for the goods and services in an exchange of transaction. Use of money as a medium of exchange has removed the major difficulty of double coincidence of wants in the barter system.

(2) This function of money has classified all transactions on the basis of time and place. Now, the seller can sell the goods at any time & place goods at his Convenience.

◈ **Double coincidence of want :**

It means both parties i.e. buyer and seller have to agree to sell and buy each other commodities. In barter system, double coincidence of wants is an essential feature. But when money is used it eliminates this requirement.

◈ **Advantage of Money :**

1. It is used as a medium of exchange.
2. It offers economic freedom to the people.
3. It is used for purchasing goods and services.
4. It is easy to store money.

◈ **Measure of value :**

Money serves as measure of value in terms of unit of account. Unit of account means that the value of each good or services is measured in the monetary unit.

◈ **Modern forms of money :**

(i) It includes currency - papernotes - coins and deposits with the bank.

(ii) Traditional forms of money included silver, gold & copper.

Money is used as a medium of exchange because :

1. It is authorised by the government of the country.
2. Its demand and supply can be controlled by the central Bank of the country. In case of India the Reserve Bank of India issues currency notes on half of the central government.
3. In India the law legalises the use of rupee as a medium of payment that can not be refused in settling transactions in India No Individual can legally refuse a payment made in rupees.
4. Value of each good or services is measured in the monetary unit.

◈ **Monetary system adopted by India :**

1. India has adopted paper currency standard which is also referred as the managed currency standard.

2. The monetary standard means the types of standard money used and the standard refers to legal money in which the government discharges its obligations. The monetary standard is thus synonymous with the standard money adopted. Thus in India paper currency is the unlimited legal tender i.e., it is used to settle debts and make payments to an unlimited amount.

3. Reserve Bank of India issues all currency notes and coins expect one rupee notes and coins which are issued by Ministry of Finance.

4. The system governing note issue is the minimum reserve system which means that we have kept a reserve of 200 crore and the Central Bank is permitted to issue notes to any extent.

◈ **Deposits with Banks :**

People who have extra money can deposit it with the banks by opening a bank account in their name. Banks accept the deposits and also pay an interest rate on the deposits. In this way peoples money is safe with the banks and earns an interest.

◈ **Demand Deposits :**

People also have the provision to withdraw the money as and when they required. Since the deposits in the bank accounts can be withdrawn on demand these deposits are called demand deposits.

◈ **Advantages of depositing money in the bank :**

1. It is a safer place to keep money as compared to the house or a working place.
2. People can earn interest on the deposited money.
3. People have the provisions to withdraw the money as and when they require.
4. People can also make payments through cheques.

◈ **Cheque :**

Any person who has an account with the bank can make his Payments through cheque.

It 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.

◈ **Advantages :**

1. It is the safest mode of transaction.
2. It is easy to carry a cheque as compared to money.

◈ **Central Bank :**

Is an apex institution in the banking and financial structure of a country. It plays a leading rote in controlling, regulating, supervising and developing the banking and financial structure of the economy.

Functions of a Central Bank

(i) It issues the currency notes.

(ii) It acts as a Banker to the government.

(iii) Central Bank acts as a banker of banks.

(iv) Central bank also function is as the custodian of foreign exchange reserve of a country.

(v) It controls credit.

(vi) It also perform a developmental and promotional function.

- **Reserve Bank of India (RBI) :**

The Reserve Bank of India supervises the functioning of formal sources of loans. For instance, the banks maintain a minimum cash balance out of the deposits they receive. The RBI monitors that the banks actually maintain the cash balance. Similarly, the RBI sees that the banks give loan not just to profit making businesses and traders but also to small cultivators, small scale industries, to small borrowers etc, Periodically, banks have to submit information to the RBI on how much they are lending to whom, at what interest rate, etc. The supervision of RBI is necessary due to the following reasons.

(i) It is required to safe deposits of the peoples with the banks and the cooperative society.

(ii) It gives a power to RBI to force banks to maintain a minimum cash balance of the deposits they receives.

(iii) The RBI can check the other banks to loan only to honest and real needy people who are having capacity to repay the loan along with interest on time

(iv) RBI checks that all formal credit agencies are following the economic policy or guidelines laid down by the government of the country.

- **Commercial banks :**

A banking company is one which transacts the business of banking which means accepting deposits for the purpose of Indian companies lending or investment, deposits of money from the public, repayable on demand or otherwise withdrawable by cheque, draft etc. Commercial banks are also called joint stock banks because they are organized in the same manner as joint stock companies.

Main features of commercial banks are –

(i) It deals with money; it accepts deposits and advances loans.

(ii) It also deals with credit. It has the power to create credit.

(iii) It is a commercial institution, whose aim is to earn profit.

(iv) It is a unique financial institution that creates demand.

(v) It deals with the general public.

LOAN ACTIVITES OF BANKS

1. Bank keeps only a small proportion of their deposits as cash with themselves. (About 15 % for their provision)
2. Banks use the major portion of the deposits to extend loans. Bank makes use of deposits to meet the loan requirements of the people.
3. In this way Bank mediates between those who have surplus funds and those who are in needs of funds.
4. Bank charges a higher interest rate on loans than what they offer on deposits. The difference between what is charged from the borrowers and what is paid to the depositors is their main source of income.

- **Credit :**

It refers to an agreement in which the lender supplies the borrower with money goods or services in return for the promise of future payment.

- **Importance of Credit :**

1. It helps the people to purchase houses.
2. It helps the businessman to expand their business.
3. The difference between the lending rate and borrowing rate is the source of income for the banks.
4. In rural areas, the main demand for credit is for crop production. There is a minimum stretch of three to four months between the time when the farmers buy these inputs and when they sell the crops. Farmers usually take crop loans at the beginning of the season and repay the loan after harvest. Repayment of the loan is crucially dependent on the income from farming.

- **Disadvantages of Credit :**

1. Banks charge a very high rate of interest which means a large part of earning of the borrowers is used to repay the loan.
2. If the borrowers fail to repay the loan, the bank has the right to sell the assets of the borrowers.
3. If loan is used for unproductive activities the borrower can be pushed into a debt trap.
4. Banks don't provide credits to the poor people as they don't have any approved security.

TERMS OF CREDIT

- **Interest Rate :**

Every loan agreement specifies an interest rate which the borrower must pay to the bank along with the repayment of the principal amount.

There are two types of interest rate :

(a) Fixed :

This rate is fixed and do not change throughout the loan period.

(b) Floating :

This rate vary according to the bank's policy and policy of the R.B.I.

- **Debt trap :**

It is a situation which pushes the borrower into a situation from which recovery is very painful.

- **Collateral :**

It is an asset that the borrower owns (such as lands, building, vehicles, livestocks, deposits with bank) 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 collateral to obtain payment.

LOANS FROM COOPERATIVES

I. Aims :

The main aim of these societies is to give short period and medium term loan to its member. These societies encourage the habit of thrift among its member.

II. Finance :

To run their affairs, these societies procure credit from various sources. These sources may be divided into two parts.

(a) Internal Sources : There are many sources such as entry fee, share capital, deposits of members & reserves.

(b) **External sources :** The government, central financial institutes, Reserve Bank of India and other external sources.

III. Loans :

These societies give short period loans to their members for productive purposes. The society can also give, upto certain limit, medium period loans.

◈ **Central Co-operative Bank :**

These banks were established according to the Co-operative Societies Act, 1912.

Functions :

(a) These banks give interest-free loan to the primary Agricultural societies, but from others interest is charged.

(b) These banks also perform general banking function such as to accept deposit from the people, transfer of money etc.

(c) These banks help the primary societies in solving their problems.

➤ SECTORS OF CREDIT IN INDIA

1. **Formal lender resources :**

   These include those resources which are controlled by the government. Banks and Cooperatives Bank falls in to the formal category. The rate of interest is very low.

2. **Informal lender resources :**

   These include money lenders, traders, relatives and friends.

Difference between formal and informal credit

Formal	Informal
1. These resources work under the supervision of the R.B.I.	**1.** These do not work under any government organisation.
2. The rate of interest is very low.	**2.** Thre rate of interest is very high.
3. Commercial banks, cooperative bank societies are the main sources of formal credit.	**3.** Relatives, money lender and land lord are the main sources of informal credit.

◈ **Unequal distribution of formal sector loans :**

Even after more than 50 years of independence most of rural and poor people still depend on non formal resources for their loan requirements. 85 % of the loan taken by poor house holds in the urban areas are from informal sources. The poor households have to pay a heavy price for borrowing.

➤ SELF HELP GROUPS (SHG) FOR THE POOR

It helps in pooling the saving of the members, who are poor women. Members can get timely loans for a variety of purposes and at a reasonable rate of interest.

- **Major feature of SHGs :**

1. A typical SHGs can have 15-20 members usually belonging to the same village.
2. The main motive of SHGs to pool the savings of the poor people.
3. Saving per member can vary from Rs. 25 to Rs. 100 or more depending on the ability of the people and the strength of the group.
4. It provides loans to their members at a reasonable rates.
5. After a year or two, if the group is regular in savings, it becomes eligible for bank loans.
6. Loan is sanctioned in the name of the group with the main motive to create self employment opportunities for the members.
7. Most of the SHGs work in a democratic way.

GLOSSARY

1. **Barter System :** The system of exchanging goods is known as Barter system.
2. **Double coincidence of wants :** It means both parties i.e. buyer a seller have to agree to sell and buy each other commodities.
3. **Cheque :** It 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.
4. **Cash Reserve Ratio :** The part of the total deposit which the bank keeps with itself in cash form is called cash Reserve Ratio.
5. **Credit :** An agreement in which lender supplies the borrower with money, goods or services in return for the promise of future payment.
6. **Formal lender Resources :** There include those resources which are controlled by the government. e.g. Banks & Cooperatives.
7. **Informal lender resources :** These include money lenders, traders, friends and relatives.
8. **Debt trap :** It is a situation which pushes the borrower into a situation from which recovery is very painful.
9. **Money :** Any things which is generally accepted by the people in exchange of goods or services or in repayment of debts.
10. **Demand Deposits :** Deposits in the bank which are payable on demand are called demand deposits.