Ch. – 3 – Lecture Notes
'Economics'
"Money and Credit"

MONEY AS A MEDIUM OF EXCHANGE:

- A person holding money can exchange it for any commodity or service that he or she might want. Thus, everyone prefers to receive payments in money and then exchange the money for things that they want.
- **Double coincidence of wants** - Both parties have to agree to sell and buy each other commodities. What a person desires to sell is exactly what the other wishes to buy.
- In a barter system where goods are directly exchanged without the use of money, the double coincidence of wants is an essential feature.
- In contrast, in an economy where money is in use, money by providing the crucial intermediate step eliminates the need for double coincidence of wants.
- Money acts as an intermediate in the exchange process, it is called a **medium of exchange**. This is known as **Barter System**.

MODERN FORMS OF MONEY:

- Before the introduction of coins, a variety of objects was used as money like cattle and grains. Thereafter comes the use of metallic coins like gold, silver, copper.

1. Currency:

- Currency includes – paper notes and coins.
- Money is accepted as a medium of exchange because **the currency 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.

2. Deposit with banks:

- People deposit money with the banks by the opening a bank account in their name.
- Banks accept the deposits and also pay an amount as interest on the deposits.
- People also have the provision to withdraw the money as and when they require.
- Since the deposits in the accounts can be withdrawn on demand, these deposits are called **demand deposits.**
- It is this facility which lends it the essential characteristics of money.

3. Cheques:

- For payment by cheque, the buyer who has an account with the bank, make out a cheque for a specific amount.
- **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 issued.
- The facility of cheque against demand deposits makes it possible to directly settle payments without the use of cash.
- Since demand deposits are accepted widely as a means of payment, along with currency, they constitute money in the modern economy.
- But for the banks, there would be no demand and no payments by cheques against these deposits.
- The modern forms of money – currency and deposits – are closely linked to the working of the modern banking system.

LOAN ACTIVITIES OF BANKS:

- Banks keep only a small proportion of their deposits as cash with themselves.
- This is kept as a provision 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.
- **Banks use the major portion of the deposits to extend loans.**
- 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.
- In this way, banks mediate between those who have surplus funds and those who are in need of these funds.
- Banks charge a higher interest rate on loans than 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.

TWO DIFFERENT CREDIT SITUATIONS

- **Credit (loan) refers** to an agreement in which the lender supplies the borrower with money, goods or services in return for the promise of future payment.
- In one situation credit helps to increase earnings and therefore the person is better off than before.
- In another situation, because of the crop failure, credit pushes the person into a debt trap.

TERMS OF CREDIT:

- Every loan agreement specifies an interest rate which the borrower must pay to the lender along with the repayment of the principal addition, lenders may demand **collateral** against the loan.
- **Collateral-** an asset that the borrower owns and uses this as a guarantee to a lender until the loan is repaid.
- **Terms of credit-** interest rate, collateral and documentation requirement, and the mode of repayment together comprise what is called the terms of credit.

Loans from Cooperatives

- Besides banks, the other major source of cheap credit in rural areas are the cooperative societies (or cooperatives).
- There are several types of cooperatives possible such as farmers cooperatives, weavers cooperatives, industrial workers cooperatives, etc.

FORMAL SECTOR CREDIT IN INDIA:

- The various types of loans can be conveniently grouped as formal sector and informal sector loans.

1. Formal Sector:

- Formal sector involves loans from banks and cooperatives.
- **The Reserve Bank of India** supervises the functioning of formal sources of loans.
- For instance, we have seen that the banks maintain a minimum cash balance out of the deposits they receive.
- The RBI monitors the banks in actually maintaining a cash balance.
- Periodically, banks have to submit information to the RBI on how much they are lending, to whom, at what interest rate, etc.

2. Informal Sector:

- **The informal lenders include** moneylenders, traders, employers, relatives and friends, etc.
- There is no organization that supervises the credit activities of lenders in the informal sector.
- They can lend at whatever interest rate they choose.
- There is no one to stop them from using unfair means to get their money back.
- Compared to the formal lenders, most of the informal lenders charge a much higher interest on loans. Thus, the cost to the borrower of informal loans is much higher.
- **The Higher cost of borrowing means** a large part of the earnings of the borrowers is used to repay the loans.

Formal sector or informal credit who gets what?

- 85% of the loans taken by poor households in the urban areas are from informal sources.
- **Urban households take only 10% of their loans are from informal sources, while 90% are from formal sources.**
- The rich households are availing cheap credit from informal lender whereas the poor households have to pay a large amount of borrowing.
- 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.
- 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.
- While formal sector loans need to expand, it is also necessary that everyone receives these loans.
- It is important that the formal credit is distributed more equality so that the poor can benefit from the cheaper loans.

SELF-HELP GROUPS FOR THE POOR:

- In the previous section, we have seen that poor households are still dependent on informal sources of credit.
- Banks are not present everywhere in rural India.
- Even when they are present, getting a loan from a bank is much more difficult than taking a loan from informal sources.
- **The absence of collateral is one of the major resources which prevent the poor from getting the bank loans.**
- Informal lenders such as moneylender, on the other hand, known the borrowers personally and hence are often willing to give a loan without collateral.
- However, the moneylenders charge very high rates of interest, keep no records of the transactions and harass the poor borrower.
- In recent years, people had tried out some newer ways of providing loans to the poor.

Summary:

- **Credit is available from a variety of sources.** These can be either formal sources or informal sources.
- **Terms of credit vary substantially between formal and informal lenders.** At present, it is the richer households who receive credit from formal sources whereas the poor have to depend on the informal sources.
- It is essential that the total formal sector credit increases so that the dependence on the more expensive informal credit becomes less.