Chapter 20: Money and Credit

Exercise 20.1 — Exercises

Q1 In situations with high risks, credit might create further problems for the borrower. Explain.

SOLUTION

Whether credit helps a borrower or pushes him into trouble depends on the risks in the situation and whether there is some support in case of loss. In high-risk situations, if things go wrong the borrower may be unable to repay and the debt grows into a large amount.

The chapter illustrates this through Swapna, a small farmer who took a loan from the moneylender to meet the expenses of cultivating groundnut. Midway through the season the crop was hit by pests and failed. She was unable to repay the moneylender, and the debt grew over the year into a large amount.

Next year she took a fresh loan for cultivation. Even though it was a normal crop, the earnings were not enough to cover the old loan. Caught in debt, she had to sell a part of her land to pay it off. Credit, instead of helping her improve her earnings, left her worse off. This is what is commonly called a debt-trap — credit pushes the borrower into a situation from which recovery is very painful.

Answer: In a high-risk situation, if the venture fails (like Swapna's crop failure) the borrower cannot repay, the debt keeps growing into a large amount, and he may be pushed into a debt-trap — often having to sell assets like land to clear the loan.

Q2 How does money solve the problem of double coincidence of wants? Explain with an example of your own.

SOLUTION

In a barter system goods are directly exchanged without the use of money, so both parties have to agree to sell and buy each other's commodities. What one person wants to sell must be exactly what the other wishes to buy. This is called double coincidence of wants, and it is an essential feature of barter.

In an economy where money is in use, money provides a crucial intermediate step and eliminates the need for this double coincidence. A person no longer has to find someone who wants exactly what he is selling and is also selling exactly

what he wants.

Example: A carpenter who makes tables and wants to buy rice need not search for a rice farmer who happens to want a table. He simply sells his table for money to any buyer, then uses that money to buy rice from any seller. Since money acts as an intermediate in the exchange process, it is called a medium of exchange.

Answer: Money acts as a medium of exchange: instead of matching a buyer and seller who each want exactly what the other has, a person sells his goods for money and then uses that money to buy whatever he needs from anyone — removing the need for a double coincidence of wants.

Q3 How do banks mediate between those who have surplus money and those who need money?

SOLUTION

Banks accept deposits from the public and pay interest on those deposits, keeping people's money safe with the provision to withdraw it on demand. Banks keep only a small proportion of their deposits as cash with themselves — about 5 per cent — to pay depositors who may come to withdraw money on any given day.

Banks use the major portion of the deposits to extend loans, since there is a huge demand for loans for various economic activities. In this way, banks mediate between those who have surplus funds (the depositors) and those who are in need of these funds (the borrowers).

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.

Answer: Banks collect surplus money as deposits (paying interest on them) and lend the major portion out to borrowers who need money — charging borrowers a higher rate than they pay depositors, and earning the difference as income.

Q4 Look at a 10 rupee note. What is written on top? Can you explain this statement?

SOLUTION

On top of the note it is written 'Reserve Bank of India', because in India the Reserve Bank of India issues currency notes on behalf of the central government.

Modern currency has no use of its own — it is not made of precious metal such as gold, silver or copper. It is accepted as a medium of exchange because the currency is authorised by the government of the country.

As per Indian law, no other individual or organisation is allowed to issue currency. Moreover, the law legalises the use of the rupee as a medium of payment that cannot be refused in settling transactions in India — no individual in India can legally refuse a payment made in rupees. Hence the rupee is widely accepted as a medium of exchange.

Answer: 'Reserve Bank of India' is written on top, because the RBI issues currency notes on behalf of the central government; no other individual or organisation may issue currency, and by law a payment in rupees cannot be refused, which is why the rupee is widely accepted.

Q5 Why do we need to expand formal sources of credit in India?

SOLUTION

The formal sector still meets only about half of the total credit needs of the rural people; the remaining needs are met from informal sources. Most loans from informal lenders carry a very high interest rate and do little to increase the income of the borrowers.

There is no organisation that supervises the credit activities of lenders in the informal sector, so they can lend at whatever interest rate they choose and there is no one to stop them from using unfair means to recover their money. Higher cost of borrowing means a larger part of the borrower's earnings goes to repay the loan, leaving less income and, in some cases, leading to a debt-trap.

Therefore banks and cooperatives need to increase their lending, particularly in rural areas, so that dependence on informal sources reduces. It is also necessary that formal credit is distributed more equally, because at present it is the richer households who receive formal credit while the poor depend on informal sources. Cheap and affordable credit is crucial for the country's development.

Answer: Because the formal sector meets only about half of rural credit needs while informal lenders charge very high, unsupervised interest rates that trap borrowers; expanding and equally distributing cheap formal credit reduces this dependence and is crucial for the country's development.

Q6 What is the basic idea behind the SHGs for the poor? Explain in your own words.

SOLUTION

The basic idea behind Self Help Groups (SHGs) is to organise the rural poor, in particular women, into small groups and pool (collect) their savings. A typical SHG has 15-20 members, usually belonging to one neighbourhood, who meet and save regularly, with savings per member varying from Rs 25 to Rs 100 or more.

Members can take small loans from the group itself to meet their needs; the group charges interest on these loans, but this is still less than what the moneylender charges. After a year or two, if the group is regular in savings, it becomes eligible for a loan from the bank. The loan is sanctioned in the name of the group and is meant to create self-employment opportunities for the members.

The group itself decides the loans to be granted, the interest to be charged and the repayment schedule, and it is responsible for repayment; any case of non-repayment by a member is followed up seriously by the others. Because of this, banks are willing to lend to poor women organised in SHGs even without collateral. Thus SHGs help borrowers overcome the problem of lack of collateral and also help women become financially self-reliant.

Answer: The idea is to organise the rural poor, especially women, into small groups (15-20 members) that pool their savings and give small loans to members at low interest; regular saving makes the group eligible for bank loans without collateral, and the group's shared responsibility for repayment makes banks willing to lend to the poor.

Q7 What are the reasons why the banks might not be willing to lend to certain borrowers?

SOLUTION

Bank loans require proper documents and collateral. Collateral is an asset that the borrower owns (such as land, building, vehicle, livestock or deposits with banks) and uses as a guarantee to the lender until the loan is repaid; if the borrower fails to repay, the lender can sell the collateral to obtain payment.

The absence of collateral is one of the major reasons that prevents the poor from getting bank loans — many borrowers cannot provide the collateral and documentation that banks demand.

In high-risk situations there is also the danger that the borrower will be unable to repay (as with Swapna's crop failure). Banks are therefore unwilling to lend where there is no collateral and no proper documents, which is why the poor often have to depend on informal lenders instead.

Answer: Banks are unwilling to lend to borrowers who cannot provide the collateral and proper documents that banks demand — absence of collateral is a major reason the poor are refused bank loans and must turn to informal lenders.

Q8 In what ways does the Reserve Bank of India supervise the functioning of banks? Why is this necessary?

SOLUTION

The Reserve Bank of India supervises the functioning of formal sources of loans. It sees that the banks maintain a minimum cash balance out of the deposits they receive, and it monitors the banks in actually maintaining this cash balance.

The RBI also sees that the banks give loans not just to profit-making businesses and traders but also to small cultivators, small scale industries, small borrowers, etc. Periodically, banks have to submit information to the RBI on how much they are lending, to whom and at what interest rate.

This supervision is necessary because, unlike the informal sector, there must be an organisation ensuring that banks are safe (keeping enough cash to pay depositors) and fair — so that credit reaches all sections, including small and poor borrowers, and not only the rich.

Answer: The RBI checks that banks keep a minimum cash balance from their deposits, ensures loans reach small cultivators and small borrowers (not only big businesses), and periodically collects information on how much banks lend, to whom and at what rate. This is necessary to keep banks safe and to see that credit is distributed fairly.

Q9 Analyse the role of credit for development.

SOLUTION

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. It can play a vital and positive role or push a borrower into difficulty, depending on the situation.

In the festival-season example, the shoe manufacturer Salim received an order for 3,000 pairs of shoes. He obtained credit — leather on promise of later payment and a cash advance from the trader — to meet the working capital needs of production. The credit helped him hire workers, buy raw materials, complete production on time, make a good profit and repay the loan. Here credit plays a vital and positive role, helping to increase earnings.

But in Swapna's case the crop failed, she could not repay, and credit pushed her into a debt-trap where she had to sell part of her land. So credit's role in development depends on the risks and on whether cheap, affordable credit is available: cheap and affordable credit is crucial for the country's development, enabling people to grow crops, do business and set up small-scale industries, whereas high-cost informal credit does little to increase incomes.

Answer: Credit can help development when it lets people meet production needs and increase earnings (as with Salim completing his shoe order at a profit), but it can harm the borrower when the venture fails (as with Swapna's debt-trap). Hence cheap, affordable credit is crucial for the country's development, while high-cost informal credit does little to raise incomes.

Q10 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.

SOLUTION

Manav should compare the terms of credit offered by each source. The terms of credit comprise the interest rate, the collateral and documentation requirement, and the mode of repayment; these vary substantially from one credit arrangement to another and depend on the nature of the lender and the borrower.

A bank charges a lower interest rate than a moneylender, since most informal lenders charge a much higher interest, making the cost of borrowing higher. However, a bank requires proper documents and collateral, and its absence is a major reason the poor cannot get bank loans. A moneylender, on the other hand, often knows the borrower personally and may give a loan without collateral, but charges a very high rate of interest and may use unfair means to recover the money.

So Manav should weigh the interest rate, whether he can provide collateral and documents, and the conditions of repayment. If he can meet the bank's requirements, borrowing from the bank is cheaper and safer; if he cannot provide collateral, he may be forced to the moneylender despite the higher cost.

Answer: Manav should compare the terms of credit — interest rate, collateral/documentation required, and mode of repayment. A bank offers a lower interest rate but demands collateral and documents; a moneylender may lend without collateral but at a very high rate. If Manav can provide collateral, the bank is the cheaper, safer choice.

Q11 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.

SOLUTION

(a) Banks require proper documents and collateral. Absence of collateral is one of the major reasons preventing small and poor farmers from getting bank loans, so banks may be unwilling to lend to them because they cannot provide the required collateral and documentation, and because crop failure makes repayment risky.

(b) Small farmers can borrow from informal sources, which include moneylenders, traders, employers, relatives and friends. (The formal sources are banks and cooperatives.)

(c) Terms of credit can be unfavourable when the interest rate is very high and collateral is demanded. For example, Swapna took a loan from the moneylender to grow groundnut; when the crop failed she could not repay, the debt grew into a large amount, and to repay it she had to sell a part of her land. The high cost of informal borrowing pushed her into a debt-trap and left her worse off.

(d) Small farmers can get cheap credit if banks and cooperatives increase their lending, particularly in rural areas, so that dependence on informal sources reduces, and if formal credit is distributed more equally so that the poor also benefit from cheaper loans. Organising the poor into Self Help Groups (SHGs) also helps them obtain timely loans at a reasonable interest rate even without collateral.

Answer: (a) They cannot provide the collateral/documents banks demand, and crop failure makes repayment risky. (b) Informal sources — moneylenders, traders, employers, relatives and friends. (c) e.g. Swapna's high-interest moneylender loan turned into a debt-trap on crop failure, forcing her to sell land. (d) Expand and equally distribute formal credit from banks/cooperatives in rural areas, and use SHGs to get cheap collateral-free loans.

Q12 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.

SOLUTION

(i) Poor — poor households have to depend largely on informal sources, while richer households avail cheap credit from formal lenders.

(ii) Higher — higher cost of borrowing means a larger part of the borrower's earnings is used to repay the loan, increasing the debt-burden.

(iii) The Reserve Bank of India — it issues currency notes on behalf of the central government, and no other individual or organisation may issue currency.

(iv) Deposits — the difference between the higher rate charged from borrowers and the rate paid to depositors is the bank's main income.

(v) Collateral — an asset the borrower owns (land, building, vehicle, livestock, bank deposits) used as a guarantee until the loan is repaid.

Answer: (i) Poor (ii) Higher (iii) The Reserve Bank of India (iv) Deposits (v) Collateral

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Q13 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.

SOLUTION

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

(ii) Formal sources of credit are banks and cooperatives. Employers are an informal source, so employers are not a formal source of credit.

Answer: (i) (b) Members. (ii) (c) Employers.