

# Money And Credit

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## Practice Questions

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

**Answer:** Money is any item which is generally accepted as payment against any goods or services and repayment of debts. Money is widely accepted as a medium of exchange. Central Bank is the institution that authorizes money as a medium of exchange. Without money, all transactions would have to be conducted by barter, which involves direct exchange of one good or service for another. The difficulty with a barter system is that in order to obtain a particular good or service, one has to possess a good or service of equal value which the other party also desires. In other words, the exchange can take place only if there is a double coincidence of wants between the two parties. The chance of getting a perfect double coincidence of wants is negligible and makes the exchange difficult. Money eliminates this problem by serving as a medium of exchange that is accepted in all transactions, by all parties, irrespective of whether they desire each other's goods and services.

### **Q. 2. Who issue the currency notes in India?**

**Answer:** Money is widely accepted as a medium of exchange. Reserve Bank of India (RBI) is the institution that authorizes money as a medium of exchange. RBI is the central bank of India. RBI is the central authority that can authorize and issue the currency note and coins which are widely accepted as the medium of exchange. They act on behalf of the central government in most of the financial perspective of the country.

### **Q. 3. For which purpose is a major portion of the deposits with the banks used?**

**Answer:** Commercial banks play a very important role in the process of credit creation. Banks use a major portion of their deposits for further credit creation. The process of credit creation begins with banks' lending money out of deposits that are accepted from the people. But banks cannot lend the entire deposits as they are required to maintain a certain proportion of primary deposits in the form of reserves with the RBI under RBI & Banking Regulation Act. That reserve which is maintained with RBI is known as cash reserve ratio. After maintaining the required reserves, the bank can lend the remaining portion of deposits.

### **Q. 4. Whose signature is found on a 10-rupee note?**

**Answer:** Reserve Bank of India (RBI) is the institution that authorizes money as a medium of exchange. RBI is the central bank of India. RBI is the central authority that can authorize and issue the currency note and coins which are widely accepted as the medium of exchange. Thus signature of the then RBI Governor is found on a 10-rupee note.

**Q. 5. Give an example of how credit pushes a person into debt-trap.**

**Answer:** The debt trap is the situation when a person becomes indebted and there is no way in which the debt can be repaid. It mainly occurs in the agricultural sector in rural areas. The farmers require cheap credit for the purchase of pesticides, fertilisers, seeds and other farming equipment. But adverse situations like crop failure will make the farmers incapable of repayment. This debt increases with every fresh instalment of loans taken and finally results in a debt trap from which the farmers are not able to recover.

**Q. 6. How many members does a typical SHG comprise of?**

**Answer:** Self Help Group is a voluntary organization formed to enhance the microcredit for the members in it. The members of the organization save their money by fixing an amount to be deposited weekly, the amount will be such that it is affordable for everyone. That deposited money can be advanced as a loan to any of the member in the group who is actually in need of it. The loan will be advanced by the consent of all the group members. There will be transparency in the working of the organization because all the group members will be from the same neighbourhood. Normally an SHG will have 15-20 members.

**Q. 7. Explain any three drawbacks of the barter system.**

**Answer:** The barter system is the traditional form of transferring the goods and services for other goods and services. It is an old method of exchange. This system has been used for centuries and long before money was invented. People exchanged services and goods for other services and goods in return. Some of the major drawbacks of the system are:

- Double coincidence of wants: One of the most important drawbacks of the barter system was a double coincidence of wants in which the buyer and seller should agree to buy and sell each other's commodity in exchange. It is very difficult to find the buyer who is need of commodity which the seller wants to sell.
- Lack of proper valuation of goods: In a barter system there will not be an equal valuation of the goods. There will be no existence of costly good or cheaper goods. All the goods will be equal.
- Store of value: Barter system lacks the function of store of value because the sold commodities cannot be saved for future use whereas money can be easily saved as a deposit. The goods do not possess the quality to use for future requirements.

**Q. 8. What are the modern forms of money? Why the rupee is widely accepted as a medium of exchange?**

**Answer:** Anything that is acceptable as a medium of exchange and even the means of payment for the settlement of debts can be considered as money. The money as we see today has been the result of a long evolution process. In today's world, modern money consists of the following:

- **Currency notes and coins:** This is the modern form of money that is being used across the world. The precious metals and coins that were used in the early periods were inconvenient to be carried in large quantities. In place of this, paper currency was introduced that gave the convenience of the transaction to the users. They could carry large amounts in the form of currency notes. In the modern currency system, the currency notes and coins are issued by the central bank that is the apex monetary authority of the country. No one has the authority to reject the money that is being circulated by the central bank. Thus this became the most convenient method of conducting transactions and exchanges.
- **Deposits with banks:** Commercial bank accepts various types of deposits from the public. These deposits are payable after a certain time period. There are different types of deposits that are accepted by the commercial banks like demand deposits, savings deposit, current account deposit, permanent deposit and recurring deposit. Out of this, demand deposit is considered to be a form of money. Demand deposits can be withdrawn by the user as and when the amount is required without any restrictions using cheques. Thus it is also considered as a modern form of money.
- **Plastic money and e-money:** This developed with the development of internet facilities. Plastic money consists of debit cards, credit cards and other facilities. The users can carry them instead of carrying currency. A debit card allows the user to withdraw money from the account while credit card allows the user to overdraw beyond the account holder's balances. The expansion of the internet has also paved the way for the development of e-wallets like PayTm, Google Pay and other services through which transactions can be carried out.

In India, the rupee is widely accepted as a medium of exchange because of the authentication of the Reserve Bank of India (RBI). RBI plays an essential role in printing currencies. There is no other authority that has the power to issue and circulate the currency. It is the law that legalizes the use of rupee as a medium of exchange anywhere in India. No person can refuse the Rupee for the transaction. If Rupee is refused by anyone, they can be sued by law. Therefore it is the law that makes the rupee as a widely accepted as a medium of exchange in the country.

#### **Q. 9. Why are demand deposits considered as money?**

**Answer:** The commercial bank accepts various types of deposits from the public. These deposits are payable after a certain time period. There are different types of deposits that are accepted by the commercial banks like demand deposits, savings deposit, current account deposit, permanent deposit and recurring deposit. Out of this, demand deposit is considered to be a form of money. Demand deposits can be withdrawn by the

user as and when the amount is required without any restrictions using cheques. Thus it is also considered as a modern form of money.

**Q. 10. Why do lenders ask for collateral while lending? Explain.**

**Answer:** Collateral is an important requirement for the loan. Collateral is an asset that the borrower owns. The collateral can be anything that has monetary value in it. The bank demands the collateral for the guarantee against their repayment for the credit. The lender uses that collateral as a guarantee for that which borrower will repay the amount in future. If the borrower fails to repay the loan, the lender has the right to sell the collateral to obtain the compensation. Collateral can be land, building, gold, vehicle or anything of value owned by the borrower. The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Thus they have to rely on other sources.

**Q. 11. Why is there a great need to expand formal sector credit in India? Explain any three reasons.**

**Answer:** Formal source of credit includes all the sources for raising the credit from the institutions which are functioning under the guidelines of RBI or which work with specific rules and regulations. They are more reliable than informal sources. Banks and cooperatives are the main formal sources of credit.

The credit from the informal source is getting loans from institutions that do not come under the purview of any legal entity. Credit from these sources moneylenders, friends, relatives, traders and employer can be included under the informal sources of credit.

Formal sources of credit must be expanded over informal sources because:

- A high rate of interest: The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers. On the other hand, formal sources have a fixed rate of interest for different types of loans.
- Fewer savings: The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers. Thus only less income would be left with them after paying their loans back. Thus the savings with them would be minimal.
- Unfair means of extortion: The informal sources will not have any code of conduct and lenders can easily exploit the borrowers. They can use any illegal means to get their loans back. They may use their muscle power for the collection of loans. On the other hand, formal sources use only legal means in their dealings.

**Q. 12. Should there be a supervisor, such as the Reserve Bank of India, that look into the loan activities of informal lenders? Why would its task be quite difficult?**

**Answer:** The credit from the informal source is getting loans from institutions that do not come under the purview of any legal entity. Credit from these sources moneylenders, friends, relatives, traders and employer can be included under the informal sources of credit. Taking credit from informal sources has the following limitations:

- A high rate of interest: The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers. On the other hand, formal sources have a fixed rate of interest for different types of loans.
- Fewer savings: The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers. Thus only less income would be left with them after paying their loans back. Thus the savings with them would be minimal.
- Unfair means of extortion: The informal sources will not have any code of conduct and lenders can easily exploit the borrowers. They can use any illegal means to get their loans back. They may use their muscle power for the collection of loans. On the other hand, formal sources use only legal means in their dealings.

Because of all these, there should be a supervisory body that should supervise the activities of the informal sector. Also, a large segment of the rural population is largely dependent on informal sources. But the task of supervising them would be very difficult. This is mainly because of the following reasons:

- Vast reach: The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Thus they have to rely on other informal sources. This gives them a wide reach in the economy. Thus it will be difficult to control them.
- Influence: The moneylenders and other informal lenders will be highly powerful and influential in society. Thus it would be very difficult to control their activities.

**Q. 13. Why do you think that the share of formal sector credit is higher for the richer households compared to the poorer households?**

**Answer:** Formal source of credit includes all the sources for raising the credit from the institutions which are functioning under the guidelines of RBI or which work with specific rules and regulations. They are more reliable than informal sources. Banks and cooperatives are the main formal sources of credit. The share of formal sector credit is higher for the richer households compared to the poorer households because:

- Most of the formal sources of credit will be cheap compared to informal sources. Even though banks advance the loans with cheaper interest rate poor households are not able to avail that loan due to terms of credit and formalities.

- The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Thus they have to rely on other informal sources.
- Rural poor are not aware of the banking system because of the lack of education and awareness. Therefore they are forced to acquire a loan from the informal sources. Most of the people in rural areas don't have access to native bankers and other financial institution, this increases the share of informal sources of credit among the poor households.

**Q. 14. Describe the vital and positive role of credit with examples.**

**Answer:** Credit is the most significant component required for enabling economic development in the country. The availability of cheap and affordable credit is crucial for promoting the economic development of any country. The basic importance of money and credit in the economy can be summarised as:

- Promotes investment: From the viewpoint of development, another important role of money lies in making the magnitude of investment independent of the current level of savings. The greater the current savings, the greater the investment. The credit that the households, firms and government saves become part of the investment and further promoted economic development.
- Credit creation: One of the main functions of the commercial bank is credit creation. It is the banks that create credit for the producers to invest in the economy. The banks make the credit available by accepting the deposit from the people. The investment of the investors makes the economy better off and investment is made available by the bank.
- Promote economic growth: The saving potential and the addition to the existing stock of capital enables economic development. The expansion of credit through the credit creation process of the commercial banks also enables economic growth in the country.

**Q. 15. Why do rural borrowers depend on the informal sector for credit? What steps can be taken to encourage them to take loans from the formal sources? Explain any three.**

**Answer:** Formal source of credit includes all the sources for raising the credit from the institutions which are functioning under the guidelines of RBI or which work with specific rules and regulations. They are more reliable than informal sources. Banks and cooperatives are the main formal sources of credit.

The credit from the informal source is getting loans from institutions that do not come under the purview of any legal entity. Credit from these sources moneylenders, friends, relatives, traders and employer can be included under the informal sources of credit. The rural poor mainly depend on informal sources of credit because:



- Most of the formal sources of credit will be cheap compared to informal sources. Even though banks advance the loans with cheaper interest rate poor households are not able to avail that loan due to terms of credit and formalities.
- The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Thus they have to rely on other informal sources.
- Rural poor are not aware of the banking system because of the lack of education and awareness. Therefore they are forced to acquire a loan from the informal sources. Most of the people in rural areas don't have access to native bankers and other financial institution, this increases the share of informal sources of credit among the poor households.

Because of these reasons, the informal sources will be the most preferred by the poor households. The major steps that can be taken to encourage them to take loans from the formal sources are:

- Bring awareness: The rural poor must be given relevant awareness that formal source of credit can be obtained with a much lower interest rate than the informal sources. They must also be aware of the debt trap they are facing and the exploitation done by the informal source lenders.
- Cooperatives: Establishing the cooperative banks in all the rural areas will help the rural poor to reduce their dependence on the informal source lenders. The lenders must have proper knowledge of the area and people they are dealing with.
- SHGs: Promoting more number of Self Help Groups (SHGs) which will promote the rural poor to save the money by depositing it weekly and withdrawing it when required. Members of the SHGs should also take an initiative to bring awareness about the formal source of credit throughout the village.
- Legal steps: Laws and regulations must be enacted to control the informal sources of credit, especially money lenders. Both the lenders and borrowers must face legal implications if transactions are conducted through informal sources.
- Terms of credit: All the factors including interest rate, collateral, documents required and mode of repayment altogether comprise terms of credit. The terms of credit for advancing a loan from the banks should not be rigid. The documents required must be such that the rural poor should be able to afford it.

**Q. 16. Mention the characteristic of the formal and informal sources of credit in India.**

**Answer:** Formal source of credit includes all the sources for raising the credit from the institutions which are functioning under the guidelines of RBI or which work with specific

rules and regulations. They are more reliable than informal sources. Banks and cooperatives are the main formal sources of credit. The main features of formal sources of credit are:

- **Low-interest rates:** The interest rate charged by the formal sources will be less because they are functioning under the guidelines of the RBI. The formal sources have a fixed rate of interest for different types of loans.
- **Increased income:** The formal sources will charge only a fixed rate of interest which will reduce the cost of borrowers to repay the loans. Thus the income with the borrowers after paying their loans back will be higher. Thus the savings and the standard of living of people will increase.
- **Legal proceedings:** The formal sources will function under a proper code of conduct and lenders cannot easily exploit the borrowers. They can use only legal measures to get their loans back. Thus their dealings would be more secure and fair.
- **Limited reach:** The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Also, private banks will not be ready to open branches in places with no business. Thus they have only limited reach in the economy.

The credit from the informal source is getting loans from institutions that do not come under the purview of any legal entity. Credit from these sources moneylenders, friends, relatives, traders and employer can be included under the informal sources of credit. The main features of informal sources of credit are:

- **A high rate of interest:** The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers.
- **Fewer savings:** The informal sources like moneylenders will charge any rate of interest which will lead to huge cost the borrowers to repay and lenders can easily exploit the borrowers. Thus only less income would be left with them after paying their loans back. Thus the savings with them would be minimal.
- **Unfair means of extortion:** The informal sources will not have any code of conduct and lenders can easily exploit the borrowers. They can use any illegal means to get their loans back. They may use their muscle power for the collection of loans. On the other hand, formal sources use only legal means in their dealings.
- **Vast reach:** The requirement of collateral for taking loans from institutional sources makes it impossible for the poor to take loans from banks and other institutions. Thus they have to rely on other informal sources. This gives them a wide reach in the economy. Thus it will be difficult to control them.



- Influence: The moneylenders and other informal lenders will be highly powerful and influential in society. Thus it would be very difficult to control their activities.

**Q. 17. How has the introduction of plastic money enhanced the convenience of both, the depositor and the bank? Explain.**

**Answer:** Anything that is acceptable as a medium of exchange and even the means of payment for the settlement of debts can be considered as money. The money as we see today has been the result of a long evolution process. In today's world, modern money consists of currency notes and coins, demand deposits and plastic money.

Plastic money has emerged and developed with the expansion of internet facilities. Plastic money consists of debit cards, credit cards and other facilities. The users can carry them instead of carrying currency. A debit card allows the user to withdraw money from the account while credit card allows the user to overdraw beyond the account holder's balances. The introduction of this has benefitted both the consumers and the banks.

**The main benefits of plastic money from the point of view of the user are:**

- The most important benefit of carrying cards is the reduction in the amount of cash that has to be carried by the users. This will reduce the risk and inconvenience. This will also reduce the risk of theft.
- The cards can be used globally – anywhere and anytime. It has 24-hour access even in foreign countries. This reduces the time and cost involved in exchanging the currencies.
- A credit card can be used in case of contingencies and emergencies. Even though the charges of using a credit card are high, it can be used in acute necessities.
- Both credit and debit cards can be used for online payments. The expansion of the internet has enabled buyers to purchase commodities online. This has been made further simpler by payment using cards.
- The consumers have the benefit to track and keep a perfect record of their transaction. No transaction will be missed while using cards. This will help in the proper handling of money.

**The main advantages that banks have with the popularity of plastic money are:**

- The number of liquid cash dealings through banks will be reduced. This will reduce the chances of theft and misappropriations.

- The banks have the benefit to track and keep a perfect record of their transaction. No transaction will be missed while using cards. This will help in proper maintenance of all their dealings.
- The cash dealings will be reduced with the use of plastic cards. This will reduce the cost of operation and administration.