18

Money and Credit

The changing nature of money

We need money in our daily lives. It is a medium of exchange. Most of the goods and services we need are bought using money. We pay people for these goods and services. The money we pay – rupees and paise – is known as currency. For many other purchases we may pay using bank deposits. Money facilitates all types of exchanges.

The nature of money has evolved over the years. We learned about the use of metals as a medium of exchange in the history chapters. We saw how difficult it was to keep this money safe and secure. There was always the fear of robbery when taking them from one place to another. Trading was not easy because facilities for weighing were not always available. Some of these problems were resolved when coins began to be used. Coins gave exact

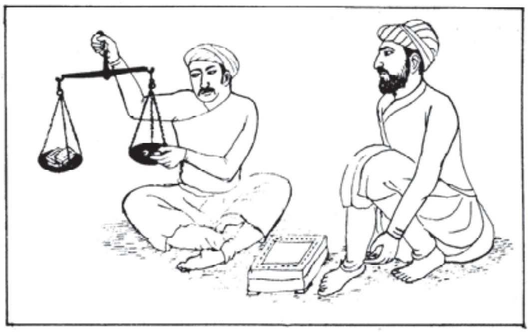


Figure 18.1: Silver being weighed in the mint

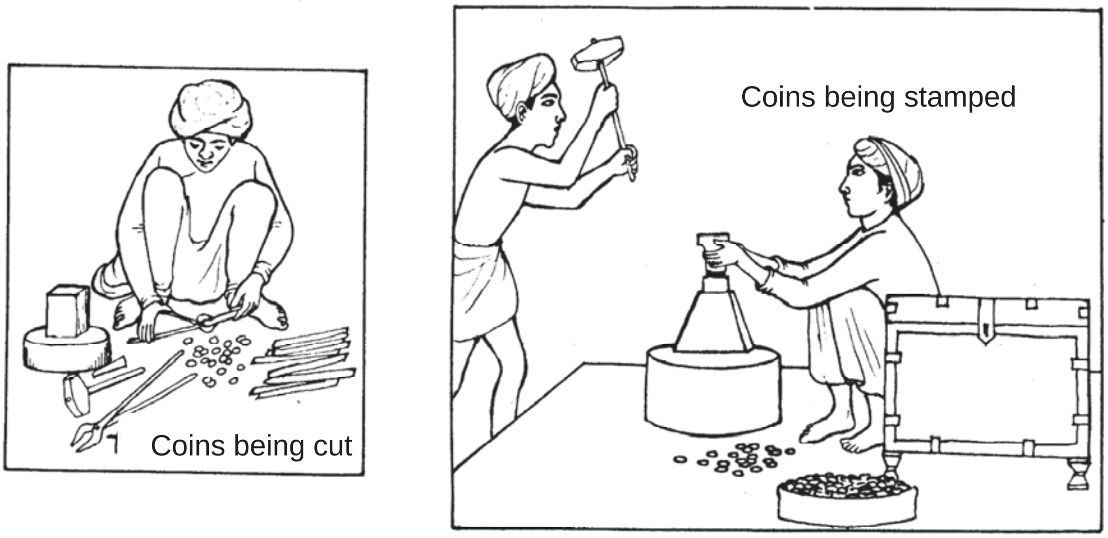


Figure 18.2: Traders would bring silver and get their coins made in the mint. This would be used by them for trading

measurements. Their value was certified and ensured by the prestige and reputation of the kings who issued them, as you can see in the following illustrations.

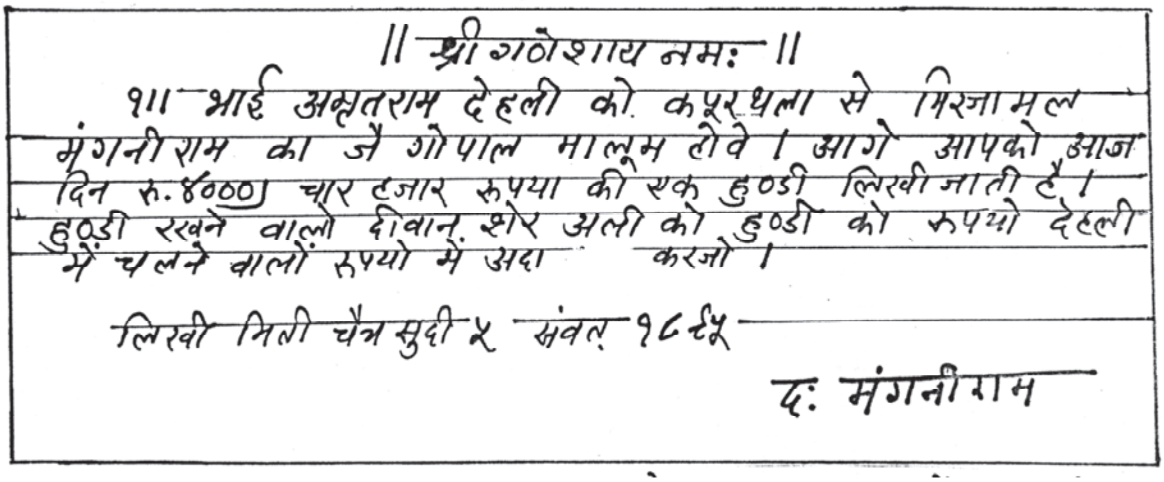
Metal coins soon began to be widely used as money. But although coins made exchange easier there were some problems. Coins used in business and trade had to be tested to ensure their authenticity. But malpractices such as scratching, chipping would result in small differences in weight. Over time this inevitably raised doubts about their purity. Some people also began to produce coins with adulterated metals. To prevent such malpractices and discrepancies, greater security measures were used in minting coins. For example, the layer of metal on the outer rim of the coins was made thicker to prevent tampering.

Figure 18.3: A gold coin used in India

Figure 18.4: An Indian coin minted during British colonial rule

As trade expanded, new problems surfaced. When buying goods, traders would have to pay only with coins that were authorised and used in that region. Each region had its own authorised coins. Traders therefore felt the need to exchange coins in every region they traded. Thus coin exchange became a business in its own right.

Indian traders came up with their own solution to the exchange problem, which did not require carting loads of coins from one place to another. They wrote a *hundi* (a special letter to pay the bearer) for the city where they purchased their goods.



|| श्री गणेशाय नमः ||
९।। भाई अमृतराम देहली को कपूरथला से मिरजामल
मंगनीराम का जै गोपाल मालूम होवे । आगे आपको आज
दिन रु. ४०००) चार हजार रुपया की एक हुण्डी लिखी जाती है ।
हुण्डी रखने वालो दीवान शेर अली को हुण्डी को रुपयो देहली
में चलने वालो रुपयो में अदा करजो ।
लिखी मिती चैत्र सुदी ५ संवत १८६५
द: मंगनीराम

Figure 18.5: A hundi

The *hundi* in Figure 18.5 is an example. In this example, Diwan Sher Ali of Kapurthala has to go to Delhi to buy goods. He deposits Rs4,000 with Mirzamal Mangiram, a money exchange trader in Kapurthala. Mangiram also has an office in Delhi. He writes a letter, a *hundi to* his accountant there to give Sher Ali Rs4,000 when he reaches Delhi. Sher Ali uses the money in Delhi to buy goods.

We see in this example how the spread of trade led to new forms of money being used in practice. In this way Paper money began to come into use. A similar development of paper money can be seen in the circulation of receipts among traders. These receipts, issued by jewellers, began to be accepted as secure guarantees that the jeweller would return the gold or silver on production of the receipt. Thus, trust in jewellers grew and traders then began accepting promissory notes or receipts issued by jewellers as legitimate money for carrying out their trade deals. In this way, an initial banking system managed by jewellers *or Sarafs* evolved that was widely accepted. Hence a trust built up around the use of receipts as paper money.

The nature of money in the modern age

Today, we use rupees and paise as a medium of exchange. It is universal trust that made this possible. Everyone accepts their use. This trust is reinforced by the government giving legal sanction to this currency. This means the national currency is legal tender and no one can refuse to accept it as a medium of exchange.

Figure 18.6: The promise of a Rs100 note

In keeping with tradition, rupee notes carry the following promise: I promise to pay the bearer the sum of … rupees. Earlier, the promise was to pay the bearer of the jeweller's receipt the same value in gold or silver. So, if you lose faith in the currency issued by the bank, you can claim the same value in gold or silver.

Today, it is only the assurance of the government that the promise of the note in your hand will be accepted as legal tender in the market. You can buy goods with the money. The validity of money rests on the acceptance buy the people and their faith in their government. Let us now try and understand how the government builds this trust among the people.

In the present age, we use both cash and bank deposits for our financial dealings. We use cheques, debit cards and other means besides cash to buy goods. The bank issues cheque books and debit cards to us on the basis of our deposits. We issue cheques to shopkeepers or retailers for the goods and services we buy from them. The shopkeepers deposit the cheques in their accounts. The bank verifies the cheques and honours them by transferring the amount to their accounts. The deposits kept as a bank account thus simplifies and streamlines the exchange. Hence, bank deposits are an important form of money in the modern age.

Banks keep the money of account holders in savings accounts, current accounts or as fixed deposits.

We deposit some of our income in our savings accounts. That is why they are called savings accounts. Commercial clients and businesspeople need money for their regular trade deals so they put their money in current accounts. Money is deposited and withdrawn from these accounts on a daily basis. That is why they are called current accounts. We can withdraw money whenever we need it from current and savings accounts or we can issue a cheque to make a payment to anyone. The money in

Figure 18.7: A card swipe machine

Figure 18.8: A debit card

these accounts belongs to us and we keep it with the bank for security and convenience. The bank assures us that the money will always be available whenever we demand. That is why the funds in such accounts are called demand deposits. They make exchanges practical and simple. Let us see a few examples to understand this.

A debit card is readily accepted for making a payment. The bank issues the card to make money transfers from our account. These cards carry information about the account and personal information of the account holder. When a customer presents the card to a shopkeeper to make a payment for any goods she buys, the shopkeeper swipes the card in the card swipe machine in his shop. The machine verifies the bank account details of the customer who then enters her pin code to sanction the payment. The bill amount is then transferred from the customer's account to the shopkeeper's account.

If you wish to pay a shopkeeper by cheque for a cash-less purchase you make, how do you issue the cheque to the shopkeeper? Fill in the details in the cheque format given in the example below to understand how this is done.

Figure 18.9: A cheque

You can also easily use your fixed deposits in a bank to make a payment. A fixed deposit is an amount that a client does not normally want to withdraw before a fixed period of time. The bank gives a higher rate of interest for such deposits. You can understand how this is done by answering the following question:

Regina has Rs20,000 in her savings account and Rs1,00,000 in fixed deposits. She has to pay Rs40,000 to a shopkeeper for the purchases she has made. What should she do before issuing a cheque? Discuss in class.

These transactions can be done without spending cash. That is why they are called cash-less payments. The bank offers this facility on the basis of the money we have deposited in the bank. So it our bank account that makes such payments possible. Also, such payments are possible only because of the reciprocal exchange arrangement between banks. Clients hold accounts in different banks so this arrangement makes it possible to easily transfer money from one account to another. This inter-bank transfer system has been established by the government.

So we see that money has two forms. First is the cash we have in hand and the second is the demand deposit we have in the bank, which the bank makes available to us whenever we demand the amount.

The stock or volume of money that is presently available in India in these two forms is as follows:

Money stock as on March 31, 2016	
Currency or cash (coins and notes) with the publicDemand	Rs 13,86,000 crore
deposits in all banks (savings and current accounts)	Rs 8,91,000 crore
Fixed deposits of the public in all banks	Rs 82,54,000 crore

Source: RBI March 31, 2016

So we can see how important the system of bank deposits is for money. The money in bank accounts is used for exchange or is kept as savings. The government is responsible for ensuring that the bank system is stable and functions well. Only then do people trust the system and use it. It must be universally accepted. We shall now see how banks are managed and operated.

What is the difference between a savings account and a fixed deposit account?

Do you think that the use of cash will decrease and the use of bank accounts will keep increasing in future? Discuss in class.

Visit a bank and find out the following:

How can we transfer money electronically to a person's account without writing a cheque? (Get information on RTGS and NIFT).

In what way is electronic exchange of money more convenient than exchange by cheque? Are there any dangers in the process?

What is a credit card?

One of the special characteristics of money (cash and bank accounts) is that it is acceptable for all kinds of financial exchange. This universal acceptance is what establishes its reputation. It simplifies exchange for us.

The prices of goods in any country are measured in terms of the money that is used in that country. It is this that indicates the cost of goods or services. A person can use this money to purchase different goods and all financial transactions use this unit. That means a person can pay for any goods he needs by measuring the price indicated on the goods in terms of the unit of money used in that country.

Money is thus the basis of all possible payments, both present and future. For example, if we take a loan of Rs10,000 from a person on the condition that we will repay the amount after two years, then we will return the principal amount of Rs10,000 after two years along with the interest on the principal. In the same way, we can freely use any money we possess at present in future. This convenience or facility that we take for granted is possible only because of the universal acceptance of currency for exchange. Today, we hardly exchange goods and services for other goods and services like in the past-barter trade. Instead, we use money as a medium of exchange to trade goods and services. Money exchange solves all those problems people used to face in the past in trading goods and services.

What do you understand by the term money? Explain in your own words.

We often see shopkeepers using a toffee or chocolate as cash. Why do they do that? Is this an acceptable and convenient arrangement? Discuss in class.

Write in your own words how money becomes a unit for measuring prices in any country and also becomes a medium of exchange on which all future payments are based.

Issuance of money

All countries issue their money through their central bank. This central bank is the bank of all banks in the country. India's central bank is the Reserve Bank of India (RBI). It is the authorised institution to print and issue all the currency-notes and coins- of the country. The Government of India issues coins. The banks that we see all around us are called commercial banks. The RBI gives them permission to operate. It stipulates the policies and rules for their operations. The RBI's policies govern the lending transactions, interest rates for deposits and all economic regulations of the commercial banks.

Figure 18.10: The Reserve Bank of India headquarters

Let us now take a look at the currencies of some countries and the banks that issue these currencies. We have seen that all countries issue their currency through their central bank, which also governs all their economic activities. The currency of each country gives us important information about the history and people of that country. Let us see the information contained in the currency of some countries.

(Do with the help of your teacher)

No	Country	Currency	Issuing bank
1	India	Rupee	Reserve Bank of India
2	Bangladesh	Taka	Bangladesh Bank
3	Russia	Rouble	Bank of Russia
4	Afghanistan	Afghani	Central Bank of Afghanistan
5	China	…………………………	……………………………….
6	United States of America	……………………………….	……………………………….
7	Japan	……………………………….	……………………………….
(Fill in the blanks with the names of the currencies and central banks of these countries)			

Activity

With the help of your teacher, make a chart of the pictures of the currencies of these countries.

Visit a bank and find out: What are the RBI rules that the bank has to observe in deciding the interest rates it will give for various accounts? Prepare a report.

Banking operations

We saw that it is the duty of banks to provide cash whenever the account or deposit holder makes a demand. Banks have many account holders. The situation never arises that all the account holders demand their money as cash at the same time. Suppose a bank has 2,000 account holders. On average, around 25-50 of them would approach the bank daily to demand cash. The number would probably be more in the first few days of every month and less subsequently. If the account holder is a farmer, she would demand more cash at the time of sowing her crop and would deposit more money after the harvest. Only a limited number of people demand cash on any given day. The bank learns from experience how much cash on an average would be required. So it arranges to have enough cash available to meet this range of daily needs.

The Reserve Bank has made a rule that all banks should have adequate liquidity for their daily operations. Banks must build trust among the people by upholding the promise to give them cash when they demand it. Normally, all people do not come to the bank to demand cash. They want to keep their deposit safe and withdraw cash only when they require it. They also carry out their financial transactions by cheque or by other cash less ways. So the question is: What does the bank do with the money people have deposited with it?

Banks perform two important functions. On one hand they open accounts for people to deposit their money and use them as they require. On the other hand they give people loans and charge interest on these. Both functions are two sides of the relationship with people. On one side are people who are deposit holders with the bank and on the other side are people who have taken loans from the bank.

You might have often heard of banks giving people loans to set up a shop, construct a factory or buy a motor vehicle or tractor. Where does the bank get the money to extend loans to people? You might have seen that people put their savings in the bank, either in savings accounts or fixed deposit accounts. The bank extends loans to people from the money deposited with it. The bank runs its operations and also gives interest to the savings and term account holders from the interest it earns from its borrowers. The bank is in between these two groups of people in our society.

Source: NCERT 10th standard economics textbook

Figure 18.11

Why are the banks we see in our neighbourhood called 'commercial banks'? Discuss in class.

Credit

We use money we have to pay for the things we need. However many times we don't have enough for some purchases. We may need to take loans. We borrow money from our relatives or people we

"Madam, how much you need loan."

Figure 18.12

know or from traders or from institutions that extend loans such as banks and other financial institutions. The bank, individual or other institution extends the loan after assessing our financial capacity and we repay the loan after a fixed period of time with interest. Traders often give us time to pay for our purchases. At times traders give money to make purchases so that the final good is sold to them. These loans or loan-like situations are called credit.

Credit helps us to meet many of our current and future needs. It enhances our immediate buying capacity. The bank or lender receives rent on the loan in the form of the interest charged. Interest is the rent we pay to the bank for using its money for some time. It is given to the bank along with the principal, which is the amount that we had borrowed. Thus, just as the money loaned to a person allows him to buy the things he needs, the credit facility extended by a trader to his customers enables him to sell his goods. So the credit arrangement helps both the trader and the customer to achieve their immediate interests. Let us try and understand this with the help of an example.

> *Suresh is a working person who earns a regular monthly income. However, he cannot build himself a house with his limited income. He takes a loan with certain conditions.*
>
> *The housing loan given by the bank opens up opportunities for the services and materials of many people in the construction business – building material traders, artisans like masons and carpenters, etc. As a result, many people are able to earn money and their income rises. The house that Suresh builds with the loan remains mortgaged to the bank. He can clear the mortgage by returning the loan amount plus interest over a period of 10 years. In this case, the loan has a positive benefit. Most bank loans are usually given by mortgaging some asset. It could be property, land, gold, building, machines, vehicles or other assets.*

A loan facility, thus, gives us the opportunity to realise our needs and increase our income and wealth. But people can also be trapped by the burden of repaying a loan as the following example shows:

> *Swapna is a small farmer who cultivates peanuts on her three acres of land. She takes a loan to meet her cultivation expenses from the local moneylender in the hope that she can repay the loan once the crop is harvested. Unfortunately, the crop is ravaged by pests. She sprays expensive insecticides but they are ineffective. With the entire crop destroyed by the pest attack, she cannot repay the moneylender. Within a year, the amount of money she has to return becomes a large sum because of the accumulating interest. But she has to take another loan to buy the inputs for her next crop. This year, the harvest is normal. But she does not earn enough money to repay the growing loan. She finds herself trapped in a web of debt. She is forced to sell a portion of her land to repay her debts.*

In Sapna's case, it was impossible to repay the loan because the crop was destroyed. She had to sell some of her land to repay her loan. So, instead of helping to increase her income, the loan trapped her in debt. This is called the debt trap. The debtor suffers a lot in escaping from this web. Here, a loan has a negative impact, making the condition worse than before.

Terms and conditions for loans

Figure 18.13

We can get a better understanding of how a loan works and the impact it has by knowing the terms and conditions on which it is given. A loan is given on a fixed interest rate. The debtor returns the principal (the loan amount) along with the accumulated interest. The lender can also demand that something be mortgaged as security for the loan. This could be property owned by the debtor, such as land, buildings, vehicles, livestock, bank deposits etc, which serve as a guarantee that the debtor will return the loan with interest. In case the debtor fails to repay the loan, the lender has the right to sell the mortgaged property to recover the loan dues.

On the basis of the above facts, we can say that institutional credit (banks, government cooperative societies etc) offers loans on simple terms and lower rates of interest that suits the needs of borrowers. As we learnt in Class IX, the government continues its efforts to make cheap and easy loans available to farmers, small traders, artisans and other needy people. These efforts ensure and enhance the social security of the people. They also create a positive environment for institutional credit.

Project work

Talk to people in your neighbourhood and find out whether they have sometimes taken short- or long-term loans to meet their needs. Did these loans have a positive or negative impact? Prepare a report of your findings.

Answer the following questions:

1. **How did Sapna's loan grow into such a huge amount?**
2. **If a person takes a loan of Rs10000 at the time of his need at 5% interest per month, how much money would he have to repay after a year?**
3. **How do self-help groups get around the need for security for a loan? Discuss in class.**

Role of the Reserve Bank of India

Try and recall in which contexts we had referred to the Reserve Bank of India in this chapter.

We saw many references to the Reserve Bank of India and the important role it plays in creating the banking system and building trust in it. In this system, the bank deposits becomes a form of money. We can withdraw cash according to our needs or use cheques to carry out financial transactions. The Reserve Bank formulates rules that banks have to observe, thereby ensuring that the system remains functional.

For example, all banks have to keep cash equal to 4% of their deposits with the Reserve Bank to ensure liquid cash is available whenever needed. Apart from this, given their experience of their average daily cash needs, they keep enough cash to pay to their account holders whenever they demand cash. Banks also have to take out an insurance cover for Rs1 lakh for every account holder.

This insurance is used only in rare circumstances when the bank is unable to perform its functions and closes down. Sometimes, rumours spread that a bank is failing, loans are going bad, and hence the money of its account deposit holders is insecure. In such a situation, the Reserve Bank is expected to intervene and reassure the account holders because it is responsible for monitoring the affairs of the bank and protecting its stability. The Reserve Bank also has to ensure liquidity in the market and there is no shortage of notes and coins. It prints notes and mints coins to meet the market demand. The government has to strictly monitor the market to ensure that counterfeit notes are not in circulation.

The Reserve Bank of India implements several rules to govern loan transactions and the lending activities of banks. For example, no commercial bank is permitted to buy or sell property for earning a profit. The bank can sell property mortgaged with it to recover the loan dues of a debtor only when the debtor defaults and is unable to repay the loan. The bank can also invest money, but only within limits such as the restrictions for investment in the share market.

The Reserve Bank of India has the right to monitor the activities of all commercial banks and ensure that the loans they extend are secured and the number of loan defaulters is limited. It often has to take strict action against erring banks and monitor their activities to ensure that public trust in the banking system is maintained.

Banks have to focus their lending activities on those sectors of the economy that are a priority in government policies. Pressure is, thus, applied on them to extend loans for agriculture, education, housing, small-scale industry, exports, the official policy being that 40% of bank lending should be for these sectors.

The government's role is to ensure the health, security and stability of the banking system. From a development perspective, it's goal is also to ensure that the lending activities of the banking system reaches the deprived sections of society and the neglected sectors of the economy.

EXERCISES

1. Choose the correct options in the following:

1. The central bank of the Government of India is:

   a) State Bank of India b) Central Bank of India

   c) State Cooperative Bank d) Reserve Bank of India

2. This is a form of money today:

   a) Gold and silver b) Livestock

   c) Bank savings account d) Buildings

3. This is not a part of institutional credit:

   a) Bank b) Cooperative society

   c) Trader d) All of them

4. The interest rate is highest in which account:

    a) Savings account   b) Current account

    c) Fixed deposit   d) None of these

2. Fill in the blanks:

1. …........…………………………….. is a medium for making our financial transactions simple.
2. A Rs10 note has the ………………………………………………… signature.
3. Currency is issued by the …………………………………………………………. bank.
4. Loans have a fixed …………………………………………….. rate.
5. A ……………………………………………… account earns less interest.

3. What is the purpose of credit?

4. Why is a measure for money essential?

5. What is the purpose of a demand deposit?

6. What are the different types of bank accounts in which people deposit money?

7. Can you predict what new forms of money may emerge 30 years from now?

8. What can be done to make bank loans available to everyone?

9. How does a loan that can increase our income also trap us in a web of debt? Explain with examples from around you.

10. Why are terms and conditions like interest rate, time period, guarantee, mortgage etc necessary for giving a loan? Explain with an example for each condition.

11. If the Reserve Bank of India did not exercise control over commercial banks, what impact would it have on the money and credit system?

12. Credit is needed for personal expenditure and trade. Give any three examples to explain.

13. What is the basis for treating deposits in the bank as money?

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