

Money and Credit

Previous Year Short Answer Questions

Q.1. What do the banks do with the 'Public Deposits'? Describe their working mechanism. [2008]

Ans. Banks accept deposits from the Public and use the major portion of these deposits to extend loans. There is a huge demand for loans for various economic activities. Banks make use of these deposits to meet the loan requirement of the people and thereby earn interest. This is, in fact, the main source of income of the bank. In this way, bank acts as a mediator 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.

Q.2. What are demand deposits? Describe any three salient features of demand deposits. [2008]

Ans. People with surplus money or extra amount deposit it in banks. The banks keep the money safe and give an interest on it. The deposits can be drawn at any time on demand by the depositors. That is why they are called 'demand deposits'.

(i) The demand deposits encashable by issuing cheques have the essential features of money.

(ii) They make it possible to directly settle payments without the use of cash.

(iii) Since demand drafts/cheques are widely accepted as a means of payment along with currency, they constitute money in the modern economy.

Q.3. Mention any three points of distinction between formal sector loan and informal sector loan. [2010]

Ans.

| Formal Sources of Credit | Informal sources of Credit |
|--|---|
| Formal sources of credit are generally provided by banks and cooperatives. | Informal sources of credit are generally provided by moneylenders, traders, employers, relatives and friends. |

| | |
|--|---|
| Interest rate for repaying loans is lower. | Interest rate for repaying loans is costlier. |
| RBI supervises the functioning of formal sources of loan and also ensures that these facilities should also be given to small cultivators and small borrowers. | In informal sector no such organisation is there to supervise the credit activities of lenders that they used to charge higher rate of interest on loans. |

Previous Year Long Answer Questions

Q.1. Explain any two features each of formal sector loans and informal sector loans. [2011 (T-2)]

Ans. Formal Sector Loans:

Formal sector loans include loans from banks and cooperatives. Features of formal sector loans are :

- (i) Formal sectors provide cheap and affordable loans and their rate of interest is monitored by RBI.
- (ii) Formal sector strictly follows the terms of credit which includes interest rate, collateral, documentation and the mode of repayment.

Informal Sector Loans :

Informal sector loans include loans from moneylenders, traders, employers, relatives, friends etc. Features for informal sector loans are :

- (i) Their credit activities are not governed by any organisation, therefore they charge higher rate of interest.
- (ii) Informal sector loan providers know the borrowers personally, and hence they provide loans on easy terms without collateral and documentation.

Q.2. What are the two main reasons for formal credit not being available to the rural poor? Why is there a need to expand rural credit? [2011 (T-2)]

Ans. The two main reasons for formal credit not being available to rural poor are :

- (i) Absence of collateral and documentation is the main reason which prevents rural poor from getting bank loans.

(ii) The arrangements of informal sector loans are flexible in terms of timelines, procedural requirements, interest rates etc. They are adjustable according to the needs and convenience of the borrower.

There is a need to expand rural credit from the side of formal sector because:

- (i) Informal sectors exploit rural poor by putting them in debt-traps.
- (ii) Cheap and affordable credit for rural poor is important for the country's overall development.

Q.3. Why do the 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 two. [2011 (T-2)]

Ans. The rural borrowers depend on the informal sector for credit because:

- (i) Absence of collateral and documentation with rural borrowers.
 - (ii) Flexible loans in terms of timelines, interest rates, procedural requirements etc. are provided to rural borrowers by informal sectors.
- Steps that can be adopted to encourage them to take loans from the formal sources are :
- (i) Awareness among rural borrowers against the exploitation of informal sectors. Need to aware them regarding high rate of interest and debt traps made by such moneylenders.
 - (ii) Promotion to self-help groups. These groups collect their savings as per their own ability to save. Members can take small loans from the groups to meet their requirements. If the group is regular in savings for year or two, it can avail loan from the bank.

Q.4. 'Cheap and affordable credit is crucial for the country's development'. Explain the statement with four points.

OR

Why do we need to expand formal source of credit in India? Explain any four reasons. [2011 (T-2)]

Ans. If the loans are cheap and affordable, this can lead to country's development in the following ways :

- (i) Cheap loans result in higher incomes and higher profits which can help in the expansion of business.

- (ii) More and more people can be benefitted by the loans in their businesses.
- (iii) This can help in making more and more agricultural activities, small-scale industries etc. Credit can be distributed more equally which helps in benefitting the poors by the help of cheaper loans.

Q.5. Answers the following questions :

- (a) Why are banks unwilling to lend loans to small farmers?**
- (b) Besides banks, what are the other sources of credit from which the small farmers can borrow.**
- (c) Explain how terms of credit can be unfavorable for the small farmers.**
- (d) From where can small farmers get cheap loans?**

Ans. (a) Banks provide loans after collateral and documentation securities, which generally the small farmers failed to comply with. Therefore, banks are unwilling to lend loans to small farmers.

(b) There are several informal sources of credit like landlords, moneylenders, traders, relatives and friends etc.

(c) Terms of informal credit can put the small farmers into debt-traps. Higher rate of interest and unfavorable conditions expit farmers by the situation of multiple loans.

(d) Farmers can get cheap and safe loans from formal credit providers i.e., banks and cooperative societies.

Q.6. Which are the two major sources of formal sector credit in India? Why do we need to expand formal sources of credit? [2011 (T-2)]

Ans. The two major sources of formal sector credit in India are — commercial banks and cooperative societies.

We need to expand formal sources of credit due to following reasons :

- (a) Informal sources of credit exploit the poors resulting in putting them into debt-traps.
- (b) Formal sources of credit are cheaper and thus they help in country's development.

Q.7. What is meant by term of credit? What does it include? [2011 (T-2)]

Ans. Terms of credit are the requirements need to be satisfied for any credit arrangements. It includes interest rate, collateral, documentation and mode of

repayment. However the terms of credit vary depending upon the nature of lender, borrower and loan.

Q.8. How does the Reserve Bank of India supervise the functioning of banks? Why is this necessary? [2011 (T-2)]

Ans. Reserve Bank of India (RBI) supervised the banks in the following ways :

- (i) It monitors the balance kept by banks for day-to-day transactions.
- (ii) It checks that the banks give loans not just to profit-making businesses and traders but also to small borrowers.
- (iii) Periodically banks have to give details about lending, borrowers and interest rate to RBI. It is necessary for securing public welfare. It avoids the bank to run the business with profit motive only. It also keeps a check on interest rate of credit facilities provided by bank. RBI makes sure that the loans from the banks are affordable and cheap.

Q.9. Describe four features of Self-Help Group (SHG). [2011 (T-2)]

Ans. The features of Self-Help Group (SHG) are :

- (i) People form their personal groups for the purpose of savings and also lend money among themselves.
- (ii) Rate of interest is lower than informal service providers.
- (iii) They can also avail loans from banks if their savings are regular.
- (iv) Decisions regarding the savings and loan activities are taken by group members.

Q.11. What is double coincidence of want? How has money solved this problem? [2011 (T-2)]

Ans. Things exchanged for other things without the use of money is known as barter system. The barter system laid the foundation of trade but trade was limited to the bounds of a village or town. Hence, in a barter system when both the parties agree to sell and buy each other's commodities, it is known as double coincidence of wants. Whatever commodity a person desires to sell is exactly what commodity the other wishes to buy.

Without double coincidence of wants exchange of goods is not possible. Therefore, it is

an essential feature. Money eliminates the need of double coincidence of wants. One can easily exchange their goods in exchange of money and later on pay money for the desired commodities. Money acts as a intermediate in the process of exchange, it is called as medium of exchange.

Q.12. How do banks mediate between those who have surplus money and those who need money? [2011 (T-2)]

Ans. People keep their surplus money in banks for safety and interest which is provided by banks to them. Banks again keep only a small proportion of their cash with themselves. These days banks keep only 15% of the total deposits with them. Rest of the money banks keep to extend loans. Banks charge interest on loans which is higher than the interest on deposits.

This surplus interest becomes the source of income for the banks. The 15% of cash deposits which banks keep with themselves helps to carry on with, day-to-day transactions. Like every day, depositors come to withdraw some of their cash.



Q.13. Differentiate between formal and informal sources of credit. [2011 (T-2)]

Ans.

| Formal Sources | Informal Sources |
|---|--|
| 1. Formal sources of credit are loans from banks and cooperative societies. | 1. Informal sources of credit are money- lenders, traders, employers, relatives, friends etc. |
| 2. Functioning of formal sources of credit is governed by Reserve Bank of India. Their interest rate and money lending details are periodically checked by RBI. | 2. There is no organisation that manages or check the credit activities performed by informal sources. |
| 3. Rate of interest is common and fixed for all formal sources and borrowers. | 3. Rate of interest depends upon the choice of moneylenders. |

| | |
|---|--|
| 4. Formal sources of credit needs to satisfy all the terms of credit before credit, activities. | 4. Informal sources of credit are flexible in terms of credit. |
| 5. They provide cheap and affordable credit for both urban and rural borrowers interest. | 5. They generally charge higher rate of |

Q.14. Mention four characteristics each of the formal and informal sources of credit in India. [2011 (T-2)]

Ans. Features of formal sources of credit are :

- (a) Formal sources of credit are provided by banks and cooperative societies to the borrowers.
- (b) Reserve Bank of India (RBI) governs the functioning of formal source of credit. RBI periodically checks the interest rate and other details of these sources.
- (c) They follow proper terms of credit which includes collateral, documentation, rate of interest and mode of repayment.
- (d) They provide cheap and affordable credits with common terms of credit for all.

Features of informal sources of credit are :

- (a) Informal sources of credit are moneylenders, traders, employers, relatives, friends etc.
- (b) There is no government or private organisation that manages or check the credit activities performed by informal sources.
- (c) Their terms of credit are flexible for the personal benefit of the lenders and condition of borrowers.
- (d) They generally charge higher rates of interest and exploit the borrowers for their own benefits.

Q.15. Study the table given below and answer the questions that follow: [2011 (T-2)]

PEOPLE DEPENDING ON FORMAL SECTOR CREDIT IN URBAN AREAS

| Category | Percentage of people |
|----------------------------|----------------------|
| Poor households | 15% |
| Households with few assets | 47% |
| Well-off households | 72% |
| Rich households | 90% |

(i) Poor households share of formal credit in the urban areas is low as compared to that of rich households. Why is it so?

(ii) Mention two difficulties faced by poor households in taking loan from a formal sector.

Ans. (i) Poor households share of formal credit in urban areas is low as compared to that of rich households due to the following reasons :

(a) Poors generally lack in collateral guaranters and do not have proper mode of repayment.

(b) Informal sources of credit are generally flexible in timings, rate of interest, repayment schedule etc.

Therefore, it is easier for poors to approach moneylenders as they know them personally.

(ii) (a) Poors are not able to satisfy general terms of credit mostly collateral guarantees.

(b) Informal moneylenders know the poor borrowers personally and therefore flexible in terms of repayment schedule, amount and interest etc.

Q.16. What are the modern forms of money currency in India? Why is it accepted as a medium of exchange? How is it executed? [2008]

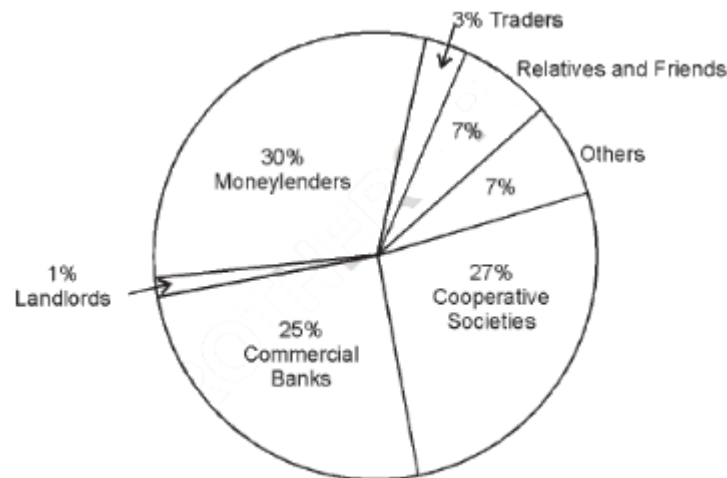
Ans. Modern forms of money include currency (paper notes) and coins. It is accepted as a medium of exchange because the currency is authorised by the government of India. No individual in India can legally refuse a payment made in rupee. Any person holding money can easily exchange it with any commodity or service that he desires. It acts as intermediate in the exchange process of different countries.

Q.17. Why are transactions made in money? Explain with suitable examples. [2009]

Ans. Money is accepted as a medium of exchange because the currency is authorised by the government of India. In money transactions, money can be paid for any goods or

services one desires. For example: the producer of shoes may want wheat in exchange for his shoes. But he may find it difficult to find a person who is also willing to exchange his wheat for shoes. So simultaneous fulfilment of mutual wants is the first and foremost condition to buy and sell the commodity. In money transaction one can buy a commodity whenever one wants it. One does not have to wait for another person to agree to an exchange of goods.

Q.18. Study the diagram given below and answer the questions that follow: [2008]



Sources of credit for Rural Households in India in 2003.

- (a) Which are the two major sources of credit for rural households in India?
- (b) Which one of them is the most dominant source of credit for rural households?
- (c) What is the most dominant source of credit? Give two reasons.

Ans. (a) Moneylenders and cooperative societies.

(b) Moneylenders

(c) (i) Moneylenders do not ask for a collateral.

(ii) Complicated paper work or documentation is not involved.

Q.19. What are the various sources of credit in rural areas? Which one of them is the most convenient source of credit? Why is it most convenient? Give two reasons. [Delhi 2008]

Ans. Various sources of credit in rural areas are:

(i) Agricultural traders,

- (ii) Moneylenders,
- (iii) Commercial banks,
- (iv) Cooperative societies and
- (v) Relatives and friends.

The most convenient source of credit is a moneylender. It is most convenient because of the following two reasons:

- (i) There is no need of documentation process while taking loan from informal sources (moneylenders).
- (ii) No collateral is required. Collateral is an asset that the borrower owns (such as land, building, livestock etc.) and uses this as a guarantee to the lender until the loan is repaid.

Q.20. Differentiate between Reserve Bank of India RBI and Commercial Bank.

Ans.

| Reserve Bank of India | Commercial Bank |
|---|---|
| It has the sole monopoly right to issue currency notes. | No such thing is done by commercial bank. |
| It is the apex bank in the money market of a country. | It is a unit in the banking structure of the country. |
| It does not deal with the public. | It directly deals with the public and business firms. |
| It acts as a banker to the government. | It has no such responsibility towards the state. |