



**EDEN IAS**

**ECONOMY**

**UPSC PREP**



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# UNIT-I

## [INTRODUCTION]

### ECONOMICS AND ECONOMY

**Economics is a social science concerned with the production, distribution, and consumption of goods and services.** It studies how individuals, businesses, governments, and nations make choices on allocating resources to satisfy their wants and needs, and tries to determine how these groups should organize and coordinate efforts to achieve maximum output.

**Economic analysis often progresses through deductive processes**, including mathematical logic, where the implications of specific human activities are considered in a “means-ends” framework. **Economics is the study of how people allocate scarce resources for production, distribution, and consumption, both individually and collectively.** Since resources (Physical, Human or Monetary) are limited economics is also known as the “Science of Scarcity”. **Microeconomics looks at the behavior of individuals and firms. Macroeconomics looks at regional, national, or global aggregates.**

**Economics is especially concerned with efficiency in production and exchange, and uses models and assumptions to understand how to create incentives and policies that will maximize efficiency.** Economists formulate and publish numerous economic indicators to help study the economy. These can also be very useful to investors to judge how economic conditions will move markets and to guide investment decisions. **Economics focuses on the behaviour and interactions of economic agents and how economies work.**

### ECONOMIC AGENTS

An economic agent could be an individual, firm, government etc who make economic decisions like buying, selling, investments etc. Economic agents affect economic indices and get affected by economic indicators. In other words **Economic agents** are any individuals, institutions or groups of institutions that play a part in any economic circuit through their rational actions and decisions.

Although Economic agents have different roles in the production, investment or consumption circuit, they establish essential economic relationships with each other.

The three common examples of economic agents are

- **State/Government**-that makes consumption, investment and economic policy decisions; State often regulates or facilitates the economic decisions of other economic actors
- **Households**-who make decisions on consumption of goods and services and on savings, depending on their income
- **Companies**-which make investment, production and employment related decisions.

These three agents and financial institutions are part of a closed economy. However, it is increasingly necessary to consider a fourth agent - **outside regions** with which the other economic agents do considerable business in an open economy.

Economy is **the relationship between production, trade and the supply of money in a particular country or region**. Economics when applied over geography gives Economy. For example:-The Indian Economy, The British Economy, the Economy of South East Asia etc. **Economic, without an “s”, is an adjective meaning “connected with economy**. Economical, on the other hand, carries a somewhat figurative meaning of “not requiring too much of something” (such as money, space, time, etc.)

## FACTORS OF PRODUCTION

Factors of production is an economic term that describes the inputs used in the production of goods or services in order to make profit. They include any resource needed for the creation of a good or service. All factors of production are categorised into four broad groups

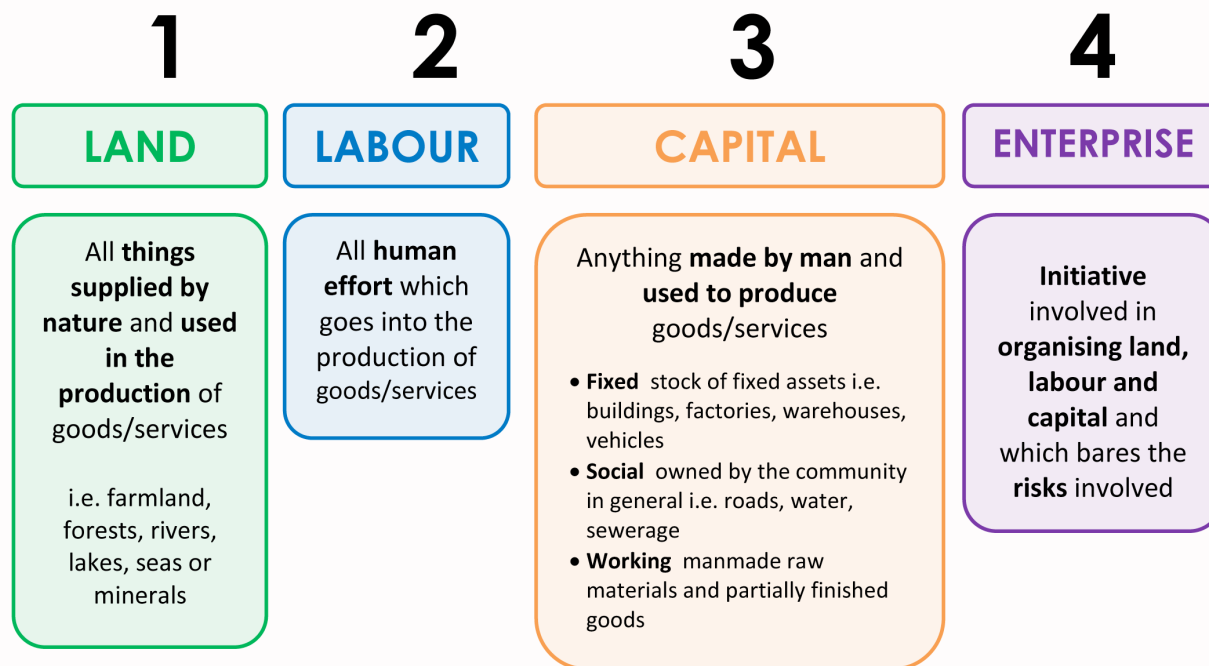
- a) LAND
- b) LABOUR
- c) CAPITAL
- d) ENTREPRENEUR

The costs that are paid for using the factors of production are referred to as Factor Costs. These Factor costs become income for those who render the Factor Services.

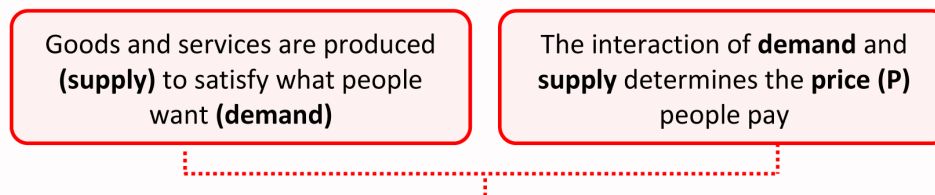
FACTOR OF PRODUCTION	FACTOR COSTS/INCOME
LAND	RENT
LABOUR	WAGES/SALARIES
CAPITAL	INTEREST
ENTREPRENEUR	PROFIT

## The Factors of Production (FOPs) and Economic Resources

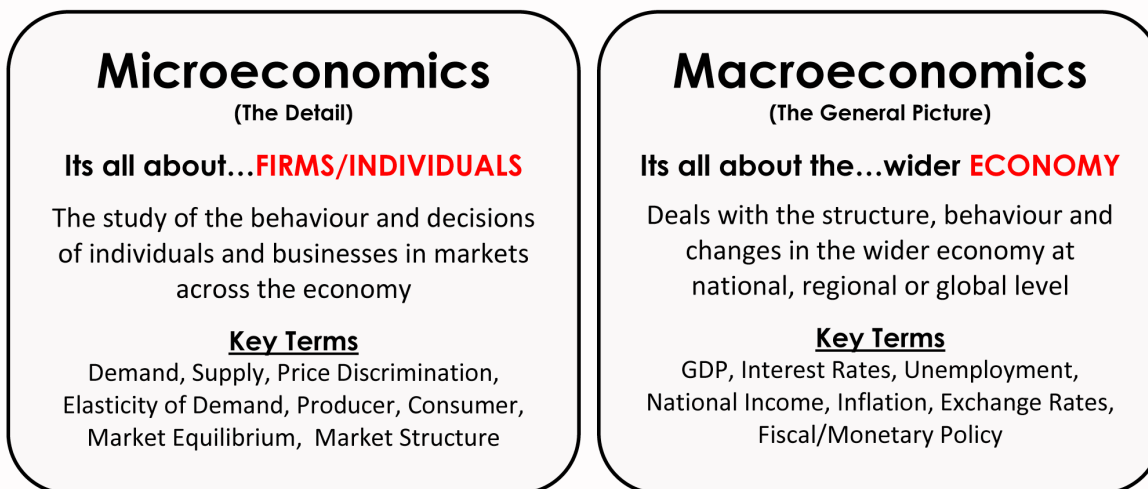
Factors of production are the resources of **LAND**, **LABOUR**, **CAPITAL** and **ENTERPRISE** used to produce goods and services



The production of every good/service requires a certain combination of each FOP



## 2 Economic Fields



## Economies of Scale

An economics term that describes a competitive advantage that large entities have over smaller entities.

Manufacturing costs can fall 70% to 90% every time the business doubles its output.

**Internal**  
The sheer size of the company allowing bulk purchases.

**External**  
Receiving preferential treatment from government or other external sources.

Diseconomies of scale can result if a company becomes less efficient.

Large shipping companies can use ships that carry as many goods as 16 freight trains.

## ECONOMIC SYSTEM AND ECONOMIC ORGANISATION

Due to the problem of scarcity, every economic system (be it capitalist, socialist, or any other economic system) needs to function to satisfy societal needs. Given such scarce resources, it believed that choices must be made regarding:

- What to produce?
- How much of each commodity to produce?
- How to produce it?
- For whom to produce?

**Every society sets up some means for answering its fundamental economic questions. This entity is called the economic system.**

Basically, an economic system refers to the means by which decisions involving economic variables are made in a society. In this light, a society's economic system determines how the society answers its fundamental economic questions of, again, what to produce, how the output is to be produced, who is to get this output, and how future growth will be facilitated. The essential differences of economic systems lie in the extent to which economic decisions are made by individual as opposed to governmental bodies and in whether the means of production are privately or publicly owned.

### Types of Economic Systems

There are different types of economic system. These include: the traditional, the command/socialist economy, pure capitalism, and mixed economic systems.

- **The traditional economy.** This is the type of economy in which the organization of production and distribution is frequently governed by tribal rules or customs. This type existed mostly in the early stages of development where the economy is strongly linked to the social structure of the community and people perform economic tasks for non-economic reasons. In the traditional



economy, economic matters are largely determined by social or religious customs and traditions. For example, women may plough fields because that is their customary role and not because they are good at doing so. Traditional economic systems are often found in less developed countries, where they may be a hindrance to economic progress.

- **The command economy.** In the command economy, an authoritarian central government calls the tune. It operates on instruction from those in power. In this type of economy, decisions in connection with the functions of an economic system are taken on a collective or group basis. There is collective ownership of factors of production. The group that owns the factors of production and takes decisions may be some government body. A command economy is a centrally planned economy. There is typically very little freedom of choice. The occupation of workers, the quantities of which type of commodity to be produced, and the distribution of income are determined by the central planners who make arrangements for future economic growth. Cuba, North Korea, Russia, and Iran are examples of economies that are closest to perfect command economies.
- **Pure capitalism.** Pure capitalism is an economic system based on private ownership and the freedom of individuals to conduct their economic affairs without interference from government bodies or other groups. Capitalist economic systems are characterized by a great deal of freedom of choice exercised by consumers and business firms in the market for commodities and resources. The capitalist economy is also known as the free exchange economy or market economy. The essence of pure capitalism is freedom. There is freedom to own property, freedom to buy and sell, and freedom from government interference in the economic aspect of each individual's life. Capitalism is best characterized by the economy of the United States, even though it is not a purely capitalist economy.
- **Mixed economy.** Many economies are best described as mixtures of capitalistic and command systems. The United States and other countries where markets are heavily relied on to allocate resources and distribute output are known as mixed capitalistic systems. The characteristics of free enterprise system are manifested in most of its economic activities. However, some of its economic decisions of the mixed economy are taken on collective basis and some of the productive resources or goods are owned by a governmental body. In the mixed capitalistic economic system, both government and private decisions are important.

## DIFFERENCE BETWEEN MICRO AND MACRO ECONOMICS

Economics is divided into two different categories: Microeconomics and Macroeconomics. While these two branches of economics appear to be different, they are actually interdependent and complement one another since there are many overlapping issues between the two fields.

Microeconomics is the study of economics at the individual level. It is the study of particular markets, and segments of the economy. It looks at issues such as consumer behaviour, individual labour markets, and the theory of firms. Macro economics, on the other hand, is the study of the whole economy. It looks at 'aggregate' variables, such as aggregate demand, national output and inflation.

**Micro economics is concerned with issues like:**

- Supply and demand in individual markets
- Individual consumer behaviour. e.g. Consumer choices
- Individual labour markets – e.g. demand for labour, wage determination

- Externalities arising from production and consumption. e.g. Positive or Negative Externalities

### Macro economics is concerned with issues like:

- Monetary and Fiscal policy. e.g. what effect do interest rates have on the whole economy?
- Reasons for inflation and unemployment.
- Economic growth and Production Cycle
- International trade and globalisation
- Reasons for differences in living standards and economic growth between countries.
- Government borrowing and investments

Microeconomics works on the principle that markets soon create equilibrium. In macro economics, the economy may be in a state of disequilibrium (boom or recession) for a longer period. There is little debate about the basic principles of micro-economics. Macro economics is more contentious. There are different schools of macro economics offering different explanations (e.g. Keynesian, Monetarist, Austrian, Real Business cycle etc).

The main difference between microeconomics and macroeconomics is scale. But, there are other differences.

### Equilibrium – Disequilibrium

Classical economic analysis assumes that markets return to equilibrium. If demand increases faster than supply, this causes price to rise, and firms respond by increasing supply. For a long time, it was assumed that macro economy behaved in the same way as micro economic analysis. **Before, the 1930s, there wasn't really a separate branch of economics called macroeconomics.**

### Great Depression and birth of Macroeconomics

In the 1930s, economies were clearly not in equilibrium. There was high unemployment, output was below capacity, and there was a state of disequilibrium. Classical economics didn't really have an explanation for this dis-equilibrium, which from a micro perspective, shouldn't occur.

In 1936, **J.M.Keynes** produced his **The General Theory of Employment, Interest and Money**. This examined why the depression was lasting so long. It examined why we can be in a state of disequilibrium in the macro economy. Keynes observed that we could have a negative output gap (disequilibrium in the macro-economy) for a prolonged time. In other words, microeconomic principles of markets, didn't necessarily apply to macro economics. Keynes wasn't the only economist to investigate this new branch of economics. For example, Irving Fisher examined the role of debt deflation in explaining the great depression. But, Keynes' theory was the most wide-ranging explanation and played a large role in creating the new branch of macro-economics. Since 1936, macroeconomics developed as a separate strand within economics. There have been competing explanations for issues such as inflation, recessions and economic growth.

### Similarities between microeconomics and macroeconomics

Although it is convenient to split up economics into two branches – microeconomics and macroeconomics, it is to some extent an artificial divide.

- Micro principles are used in macro economics. If you study the impact of devaluation, you are likely to use same economic principles, such as the elasticity of demand to changes in price.

- Micro effects macro economics and vice versa. If we see a rise in oil prices, this will have a significant impact on cost-push inflation. If technology reduces costs, this enables faster economic growth.
- Blurring of distinction. If house prices rise, this is a micro economic effect for the housing market. But, the housing market is so influential that it could also be considered a macro-economic variable, and will influence monetary policy.
- There have been efforts to use computer models of household behaviour to predict the impact on the macro economy.

## OPEN vs CLOSED ECONOMY

**An open economy is an economy in which there are economic activities between the domestic community and outside.** People and even businesses can trade in goods and services with other people and businesses in the international community, and funds can flow as investments across the border.

**A closed economy is one that has no trade activity with outside economies.** The closed economy is self-sufficient, which means no imports come into the country and no exports leave the country. The purpose of a closed economy is to provide domestic consumers with everything they need from within the country's borders.

**Maintaining a closed economy is difficult in modern society** because raw materials, such as crude oil, play a vital role as inputs to final goods. Many countries do not have raw materials naturally and are forced to import these resources. Closed economies are counterintuitive to modern, liberal economic theory, which promotes the opening of domestic markets to international markets to capitalize on comparative advantages and trade. Recent globalization implies that economies are tending to become more open to take advantage of international trade. A good example of a raw material that is traded globally is petroleum.

### Why Close Off an Economy?

A completely open economy runs the risk of becoming overly dependent on imports. Also, domestic producers may suffer because they cannot compete at low international prices. Therefore, governments use controls like tariffs, subsidies, and quotas to support domestic enterprises.

Although closed economies are rare, a government may close off a specific industry from international competition. Some oil-producing countries have a history of prohibiting foreign petroleum firms from doing business within their borders.

### Real World examples of Closed Economies

There are no completely closed economies. Brazil imports the least amount of goods—when measured as a portion of the gross domestic product (GDP)—in the world and is the world's most closed economy. Brazilian companies face challenges in terms of competitiveness, including exchange rate appreciation and defensive trade policies. In Brazil, only the largest and most efficient companies with significant economies of scale can overcome barriers to export. North Korea is closed not by choice but because of economic sanctions.

## WHAT IS PROTECTIONISM?

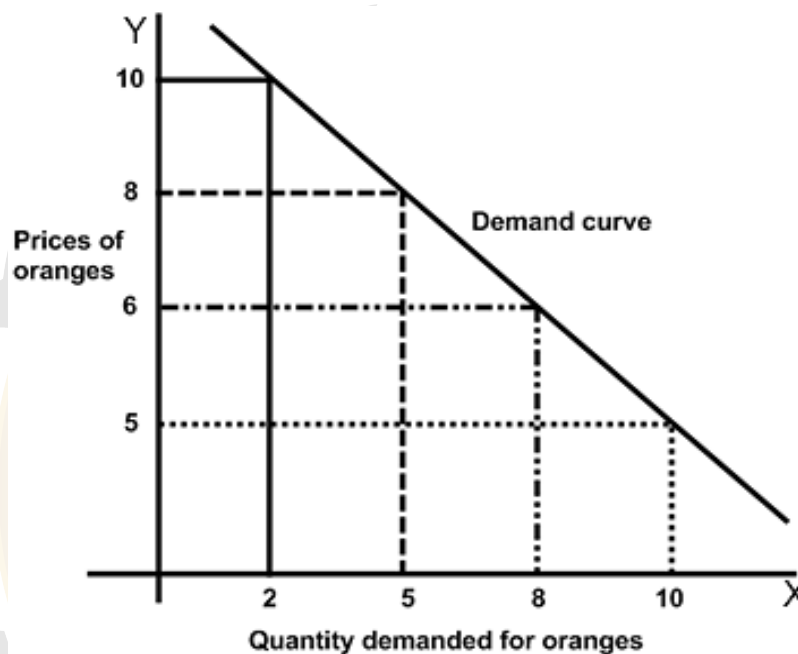
**Protectionism is the economic policy of restricting imports from other countries through methods such as tariffs on imported goods, import quotas, and a variety of other government regulations.**

# UNIT-II

## [MICROECONOMICS]

### LAW OF DEMAND

In microeconomics, the law of demand states that, “conditional on all else being equal, **as the price of a good increases (↑), quantity demanded decreases (↓)**; conversely, as the price of a good decreases (↓), quantity demanded (↑)”



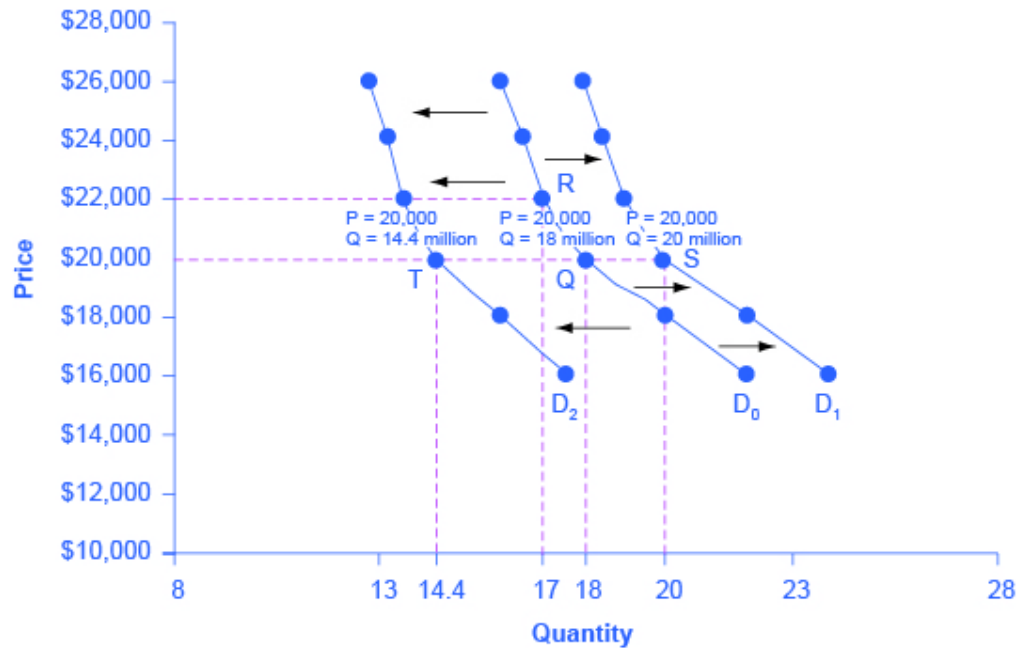
In other words, the law of demand describes an inverse relationship between price and quantity demanded of a good. Alternatively, other things being constant, quantity demanded of a commodity is inversely related to the price of the commodity. For example, a consumer may demand 2 kilograms of apples at Rs. 50 per kg; he may, however, demand 1 kg if the price rises to Rs. 100 per kg. This has been the general human behaviour on relationship between the price of the commodity and the quantity demanded. The factors held constant refer to other determinants of demand, such as the prices of other goods and the consumer's income. **Demand curves relate the prices and quantities demanded assuming no other factors change. This is called the ceteris paribus assumption.**

### Shifts in the Demand Curve

Changes in factors like average income and preferences can cause an entire demand curve to shift right or left. This causes a higher or lower quantity to be demanded at a given price.

### How does income affect demand?

Say we have an initial demand curve for a certain kind of car. Now imagine that the economy expands in a way that raises the incomes of many people, making cars more affordable. This will cause the demand curve to shift.



As a result of the higher income levels, the demand curve shifts to the right, towards D<sub>1</sub>. People have more money on average, so they are more likely to buy a car at a given price, increasing the quantity demanded.

A decrease in incomes would have the opposite effect, causing the demand curve to shift to the left, towards D<sub>2</sub>. People have less money on average, so they are less likely to buy a car at a given price, decreasing the quantity demanded.

### NORMAL AND INFERIOR GOODS

**A product whose demand rises when income rises, and vice versa, is called a normal good.** A few exceptions to this pattern do exist, though. As incomes rise, many people will buy fewer generic-brand groceries and more name-brand groceries. They are less likely to buy used cars and more likely to buy new cars. They will be less likely to rent an apartment and more likely to own a home, and so on. **A product whose demand falls when income rises, and vice versa, is called an inferior good.** In other words, when income increases, the demand curve shifts to the left.

### Other Factors that shift Demand Curves

Income is not the only factor that causes a shift in demand. Other things that change demand include tastes and preferences, the composition or size of the population, the prices of related goods, and even expectations. A change in any one of the underlying factors that determine what quantity people are willing to buy at a given price will cause a shift in demand. Graphically, the new demand curve lies either to the right, an increase, or to the left, a decrease, of the original demand curve.

### Changing tastes or preferences

Changes like these are largely due to movements in taste, which change the quantity of a good demanded at every price—that is, they shift the demand curve for that good, rightward when preferences turn positive and leftward when preferences turn negative.

## Changes in the composition of the population

A society with relatively more elderly persons has a higher demand for nursing homes and hearing aids. Similarly, changes in the size of the population can affect the demand for housing and many other goods. Each of these changes in demand will be shown as a shift in the demand curve.

## Related goods

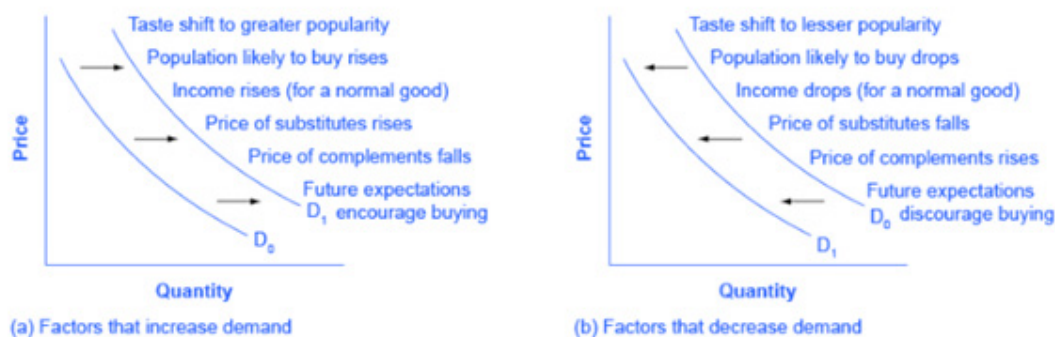
The demand for a product can also be affected by changes in the prices of related goods such as substitutes or complements. A substitute is a good or service that can be used in place of another good or service. A lower price for a substitute decreases demand for the other product. A higher price for a substitute good has the reverse effect.

Other goods are complements for each other, meaning that the goods are often used together because consumption of one good tends to enhance consumption of the other. Examples include breakfast cereal and milk; notebooks and pens or pencils; cricket balls and cricket bats etc. A higher price for skis would shift the demand curve for a complement good like ski resort trips to the left, while a lower price for a complement has the reverse effect.

## Changes in expectations about future prices

While it is clear that the price of a good affects the quantity demanded, it is also true that expectations about the future price—or expectations about tastes and preferences, income, and so on—can affect demand. For example, if people hear that a cyclone is approaching, they may rush to the store to buy flashlight batteries and bottled water. If people learn that the price of a good like coffee is likely to rise in the future, they may head for the store to stock up on coffee now. These changes in demand are shown as shifts in the curve. Therefore, a shift in demand happens when a change in some economic factor other than price causes a different quantity to be demanded at every price.

### Factors That Shift Demand Curves



## GIFFEN GOODS

**A Giffen good is an inferior good that people consume more of as the price rises and vice versa—violating the basic law of demand in microeconomics**

The term "Giffen good" was coined in the late 1800s, named after noted Scottish economist, statistician, and journalist, **Sir Robert Giffen**. Giffen good is typically inferior products that do not have readily available substitutes. All Giffen goods are inferior, but all inferior goods aren't Giffen goods.

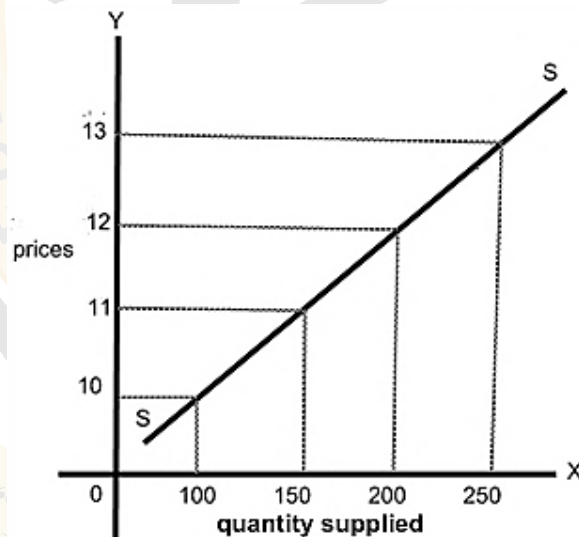
## VEBLen GOODS

**Veblen goods are types of luxury goods for which the quantity demanded increases as the price increases, an apparent contradiction of the law of demand, resulting in an upward-sloping demand curve.**

Some goods become more desirable because of their high prices. For example, in the 1990s when "fashion" jeans became popular, one retailer was able to sell more after raising the price. A higher price may make a product desirable as a status symbol in the practices of conspicuous consumption and conspicuous leisure. Veblen goods are named after American economist **Thorstein Veblen**, who first identified conspicuous consumption as a mode of status-seeking. A corollary of the Veblen effect is that lowering the price decreases the quantity demanded

## LAW OF SUPPLY

**The law of supply** is a fundamental principle of economic theory which states that, keeping other factors constant, **an increase in price results in an increase in quantity supplied**. In other words, there is a **direct relationship between price and quantity**: quantities respond in the same direction as price changes. This means that producers are willing to offer more of a product for sale on the market at higher prices by increasing production as a way of increasing profits.

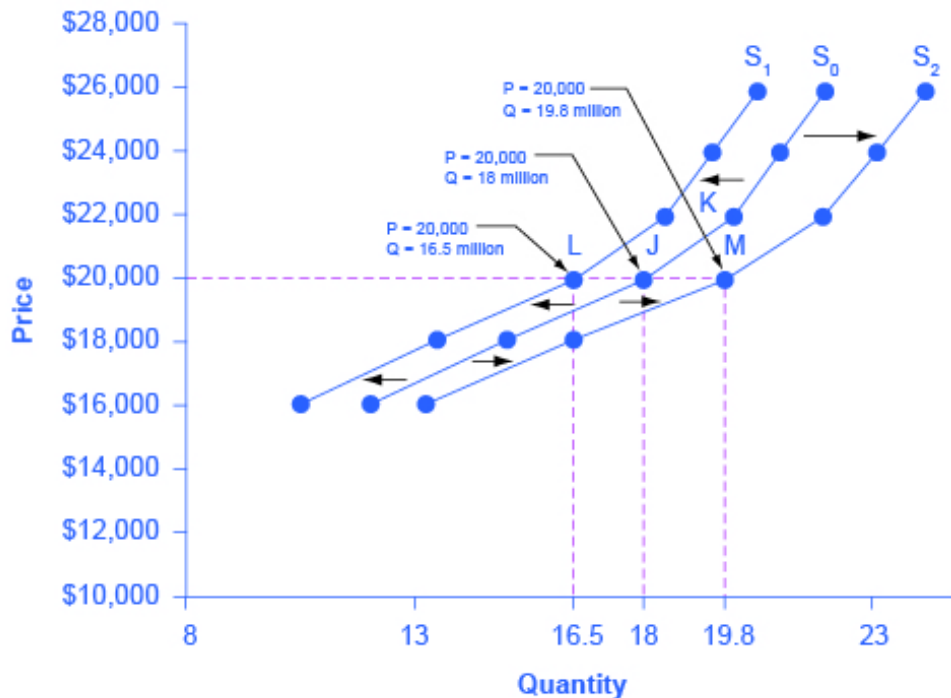


Changes in production cost and related factors can cause an entire supply curve to shift right or left. This causes a higher or lower quantity to be supplied at a given price. Supply curves relate prices and quantities supplied assuming no other factors change. This is called the ceteris paribus assumption.

### Shifts in the Supply Curve

A supply curve shows how quantity supplied will change as the price rises and falls, assuming ceteris paribus—no other economically relevant factors are changing. If other factors relevant to supply do change, then the entire supply curve will shift. A shift in supply means a change in the quantity supplied at every price.

Say we have an initial supply curve for a certain kind of car. Now imagine that the price of steel—an important ingredient in manufacturing cars—rises so that producing a car becomes more expensive.



As a result of the higher manufacturing costs, the supply curve shifts to the left, toward  $S_1$ . Firms will profit less per car, so they are motivated to make fewer cars at a given price, decreasing the quantity supplied.

A decrease in costs would have the opposite effect, causing the supply curve to shift to the right, toward  $S_2$ . Firms would profit more per car, so they would be motivated to make more cars at a given price, increasing the quantity supplied.

### Other factors that affect supply

In the example above, we saw that changes in the prices of inputs in the production process will affect the cost of production and thus the supply. Several other factors affect the cost of production, too.

### Natural conditions

Recently, the Manchurian Plain in Northeastern China—which produces most of the country's wheat, corn, and soybeans—experienced its most severe drought in 50 years. A drought decreases the supply of agricultural products, which means that at any given price, a lower quantity will be supplied. Conversely, especially good weather would shift the supply curve to the right.

### New technology

When a firm discovers a new technology that allows it to produce at a lower cost, the supply curve will shift to the right as well. For instance, in the 1960s, a major scientific effort nicknamed the Green Revolution focused on breeding improved seeds for basic crops like wheat and rice. By the early 1990s, more than two-thirds of the wheat and rice in low-income countries around the world was grown with these Green Revolution seeds—and the harvest was twice as high per acre. A technological improvement that reduces costs of production will shift supply to the right, causing a greater quantity to be produced at any given price.

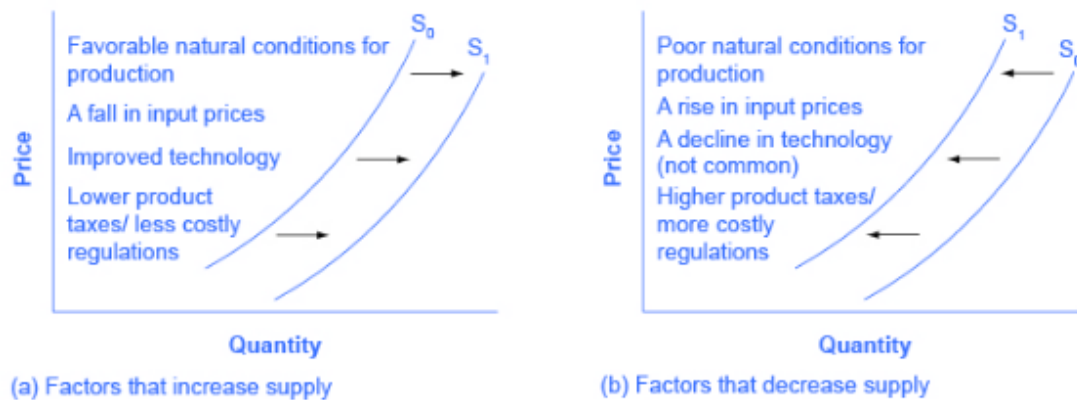


## Government policies

Government policies can affect the cost of production and the supply curve through taxes, regulations, and subsidies. Taxes are treated as costs by businesses. Higher costs decrease supply for the reasons discussed above. Another example of policy that can affect cost is the wide array of government regulations that require firms to spend money to provide a cleaner environment or a safer workplace; complying with regulations increases costs.

A government subsidy, on the other hand, is the opposite of a tax. A subsidy occurs when the government pays a firm directly or reduces the firm's taxes if the firm carries out certain actions. From the firm's perspective, taxes or regulations are an additional cost of production that shifts supply curve to the left, leading the firm to produce a lower quantity at every given price. Government subsidies, however, reduce the cost of production and increase supply at every given price, shifting supply to the right.

### Factors that shift supply curves



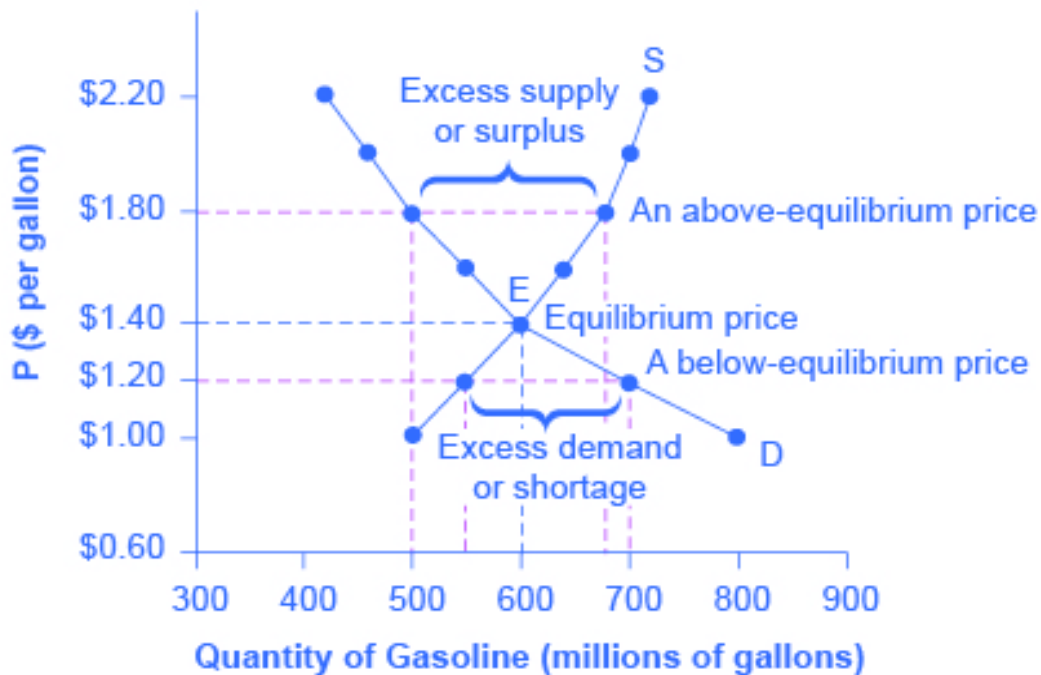
## MARKET EQUILIBRIUM

In economics, economic equilibrium is a situation in which economic forces such as supply and demand are balanced and in the absence of external influences the (equilibrium) values of economic variables will not change. **Market equilibrium in this case is a condition where a market price is established through competition such that the amount of goods or services sought by buyers is equal to the amount of goods or services produced by sellers.** This price is often called the **competitive price** or **market clearing price** and will tend not to change unless demand or supply changes, and the quantity is called the “**competitive quantity**” or **market clearing quantity**.

**Supply and demand curves intersect at the equilibrium price. This is the price at which the market will operate.**

Because the graphs for demand and supply curves both have price on the vertical axis and quantity on the horizontal axis, the demand curve and supply curve for a particular good or service can appear on the same graph. Together, demand and supply determine the price and the quantity that will be bought and sold in a market.

## Intersecting supply and demand curves



The demand curve, D, and the supply curve, S, intersect at the equilibrium point E, with an equilibrium price of 1.4 dollars and an equilibrium quantity of 600. The equilibrium is the only price where quantity demanded is equal to quantity supplied. At a price above equilibrium, like 1.8 dollars, quantity supplied exceeds the quantity demanded, so there is excess supply. At a price below equilibrium, such as 1.2 dollars, quantity demanded exceeds quantity supplied, so there is excess demand.

The equilibrium price is the only price where the plans of consumers and the plans of producers agree—that is, where the amount consumers want to buy of the product, quantity demanded, is equal to the amount producers want to sell, quantity supplied. This common quantity is called the equilibrium quantity. At any other price, the quantity demanded does not equal the quantity supplied, so the market is not in equilibrium at that price.

The word equilibrium means balance. If a market is at its equilibrium price and quantity, then it has no reason to move away from that point. However, if a market is not at equilibrium, then economic pressures arise to move the market toward the equilibrium price and the equilibrium quantity.

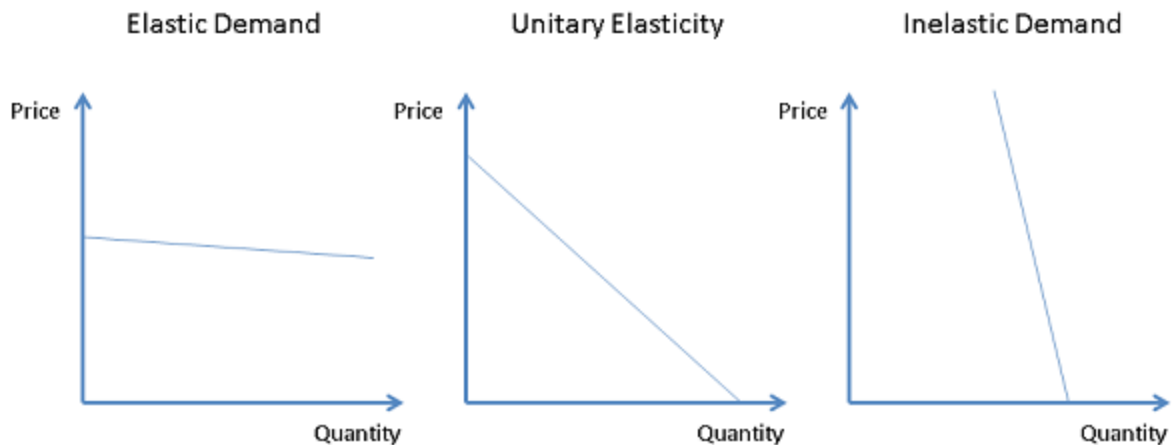
## ELASTICITY OF DEMAND

In economics, the **demand elasticity (elasticity of demand)** refers to how sensitive the demand for a good is to changes in other economic variables, such as prices and consumer income. Demand elasticity is calculated as the percent change in the quantity demanded divided by a percent change in another economic variable. Higher demand elasticity for an economic variable means that consumers are more responsive to changes in this variable. Elasticity of Demand (Ed) can be expressed by the following formula

$$\text{Ed} = \frac{\% \text{ Change in Quantity Demanded}}{\% \text{ Change in the Economic Variable}}$$

## Types of Demand Elasticity

One common type of demand elasticity is the price elasticity of demand, which shows the responsiveness of the quantity demanded for a good relative to a change in its price. Firms collect data on price changes and how consumers respond to such changes. They then later calibrate their prices accordingly to maximize profits. Another type of demand elasticity is cross-elasticity of demand, which is calculated by taking the percent change in quantity demanded for a good and dividing it by the percent change of the price for another good. This type of elasticity indicates how demand for a good reacts to price changes of other goods.



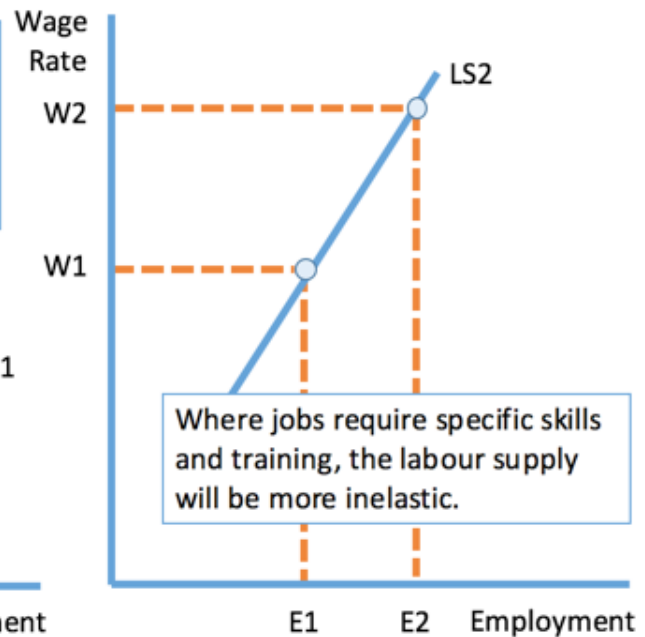
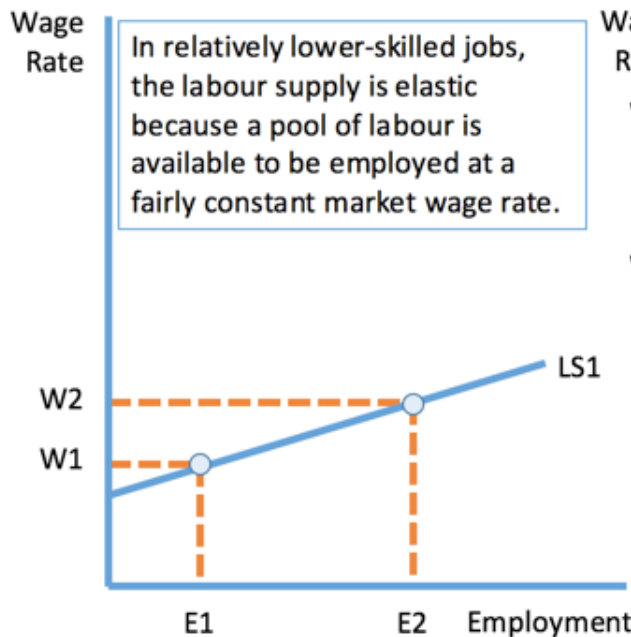
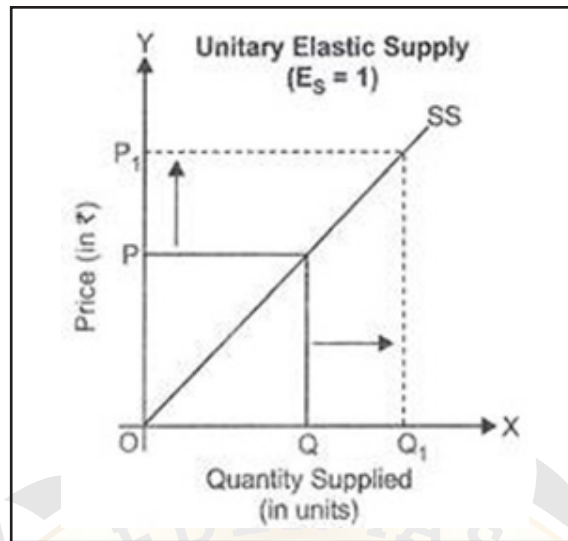
Demand elasticity is typically measured in absolute terms. If demand elasticity is greater than 1, it is elastic: Demand is sensitive to economic changes (e.g., price). Demand elasticity that is less than 1 is inelastic: Demand does not change relative to economic changes such as price. Demand is unit elastic when the absolute value of demand elasticity is equal to 1, which means that demand will move proportionately with economic changes.

## ELASTICITY OF SUPPLY

In economics, the **supply elasticity (elasticity of supply)** refers to how sensitive the supply for a good is to changes in other economic variables, such as prices, subsidies and taxes. The elasticity is represented in numerical form, and is defined as the percentage change in the quantity supplied divided by the percentage change in economic variable. Elasticity of Supply ( $E_s$ ) can be expressed by the following formula

$$E_s = \frac{\% \text{ Change in Quantity Supplied}}{\% \text{ Change in the Economic Variable}}$$

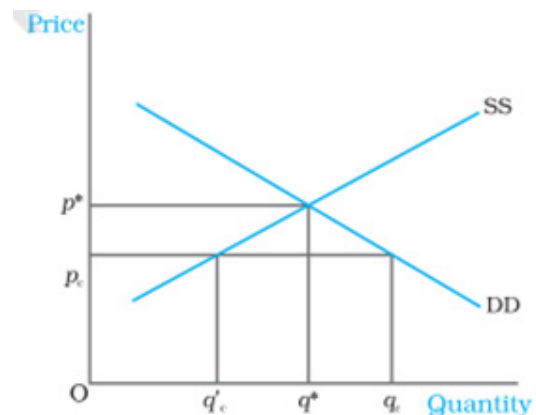
When the elasticity is less than one, the supply of the good can be described as inelastic; when it is greater than one, the supply can be described as elastic. If the elasticity is exactly one, the good is said to be unit-elastic.



## PRICE CEILING

It is not very uncommon to come across instances where government fixes a maximum allowable price for certain goods. **The government-imposed upper limit on the price of a good or service is called price ceiling.** Price ceiling is generally imposed on necessary items like wheat, rice, kerosene, sugar and it is fixed below the market-determined price since at the market-determined price some section of the population will not be able to afford these goods. Let us examine the effects of price ceiling on market equilibrium through the example of market for wheat.

**The equilibrium price and quantity of wheat are  $p^*$  and  $q^*$  respectively. When the government imposes price ceiling at  $p_c$  which is lower than the equilibrium price level, the consumers demand  $q_c$  kilograms of wheat whereas the firms supply  $q_c'$  kilograms. Therefore, there will be an excess demand for wheat in the market at that price.**



Hence, though the intention of the government was to help the consumers, it would end up creating shortage of wheat. Therefore, to ensure availability of wheat to everyone, ration coupons are issued to the consumers so that no individual can buy more than a certain amount of wheat and this stipulated amount of wheat is sold through ration shops which are also called fair price shops.

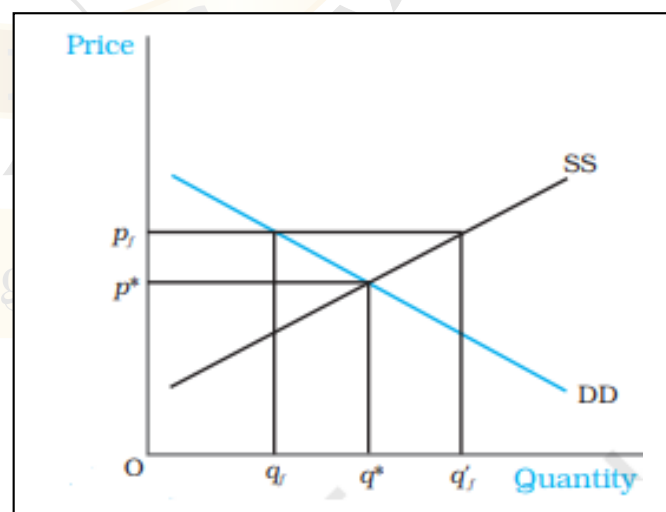
In general, price ceiling accompanied by rationing of the goods may have the following adverse consequences on the consumers: (a) Each consumer has to stand in long queues to buy the good from ration shops. (b) Since all consumers will not be satisfied by the quantity of the goods that they get from the fair price shop, some of them will be willing to pay higher price for it. This may result in the creation of black market.

## PRICE FLOOR

For certain goods and services, fall in price below a particular level is not desirable and hence the government sets floors or minimum prices for these goods and services. The government imposed lower limit on the price that may be charged for a particular good or service is called price floor. Most well-known examples of imposition of price floor are agricultural price support programmes and the minimum wage legislation. Through an agricultural price support programme, the government imposes a lower limit on the purchase price for some of the agricultural goods and the floor is normally set at a level higher than the market-determined price for these goods. Similarly, through the minimum wage legislation, the government ensures that the wage rate of the labourers does not fall below a particular level and here again the minimum wage rate is set above the equilibrium wage rate

Through an agricultural price support programme, the government imposes a lower limit on the purchase price for some of the agricultural goods and the floor is normally set at a level higher than the market-determined price for these goods. Similarly, through the minimum wage legislation, the government ensures that the wage rate of the labourers does not fall below a particular level and here again the minimum wage rate is set above the equilibrium wage rate.

**The market equilibrium here would occur at price  $p^*$  and quantity  $q^*$ . But when the government imposes a floor higher than the equilibrium price at  $p_f$ , the market demand is  $q_f$  whereas the firms want to supply  $q'_f$ , thereby leading to an excess supply in the market equal. In the case of agricultural support, to prevent price from falling because of excess supply, government needs to buy the surplus at the predetermined price. This hurts fiscal consolidation.**



# UNIT-III

## [NATIONAL INCOME ACCOUNTING]

### CONSUMER GOODS AND CAPITAL GOODS

In economics, goods are considered as those commodities which are capable of satisfying human wants and desires. Goods are primarily classified into two groups, i.e. consumer goods and capital goods.

Capital goods and consumer goods are classified based on how they are used. **A capital good is any good used to help increase future production. Consumer goods are any goods used by consumers and have no future productive use.**

#### Consumer Goods

**A consumer good is any good purchased for consumption and not used later for the production of another consumer good.** Consumer goods are sometimes called final goods because they end up in the hands of the consumer or the end user. **Consumer goods can be sub-divided into Consumer Durables (e.g. Television, Car, Refrigerator etc) and Consumer Non-durables (e.g. Bread, Biscuit etc). Consumer durables generally have a longer shelf life.**

Consumer goods can be classified in four ways:

- **Convenience goods** are consumed and purchased regularly, such as milk.
- **Shopping goods** require more thought and planning and include appliances and furniture.
- **Specialty goods** are typically more expensive and cater to a niche market. Items like jewelry fall into this section.
- **Unsought goods** are only purchased by some consumers to serve a specific need. Life insurance falls into this section.

#### Capital Goods

**Capital goods are the goods which are deployed by the organization as input in the production of other capital goods or consumer goods and services.** Capital goods include plant and machinery, equipment, furniture, vehicles, office building etc.

The most common capital goods are property, plant, and equipment (PPE), or fixed assets such as buildings, machinery and equipment, tools, and vehicles. Capital goods are different from financial capital, which refers to the funds companies use to grow their businesses. Natural resources not modified by human hands are not considered capital goods, although both are factors of production. **For the accumulation of capital goods, businesses rely on savings, investments, or loans.**

**Economists and businesses pay special attention to capital goods because of the role they play in improving the productive capacity of a firm or country.** In other words, capital goods make it possible for companies to produce at a higher level of efficiency. For example, consider two workers digging ditches. The first worker has a spoon and the second worker has a tractor with a hydraulic shovel. The second worker can dig much faster because he has the superior capital good.

**The same physical good could be a consumer good or a capital good. It just depends on how it will be used.** An apple bought at a grocery store and immediately eaten is a consumer good. An identical apple bought by a company to make apple juice is a capital good. The difference, again, lies in its utilization. Hence line of demarcation amidst these two types of goods is very thin and blur. **The only point that forms a base for the difference between consumer goods and capital goods is their use.** The word consumer goods is generally used to indicate both consumer goods and services.

## INTERMEDIATE GOODS AND FINAL GOODS

An intermediate good is a product used to produce a final good or finished product. Intermediate goods are sold between industries for resale or the production of other goods. These goods are also called semi-finished products because they are used as inputs to become part of the finished product. **Intermediate goods are vital to the production process, which is why they are also called producer goods.** When they are used in the production process, they are transformed into another state.

There are typically three options for the use of intermediate goods. A producer may make and use their own intermediate goods. The producer may also produce the goods and then sell them, which is a highly common practice between industries. Companies buy intermediate goods for specific use in creating either a secondary intermediate product or in producing the finished good. Inevitably, all intermediate goods are either a component of the final product or are completely reconfigured during the production process. The value of the final good incorporates the value of intermediate goods.

Consider a farmer who grows wheat. The farmer sells his crop to a miller for \$100 giving the farmer \$100 in value. The miller breaks down the wheat to make flour—a secondary intermediate good. The miller sells the flour to a baker for \$200 and creates \$100 in value ( $\$200 \text{ sale} - \$100 \text{ purchase} = \$100$ ). The final good, which is sold directly to the consumer, is the bread. The baker sells all of it for \$300, adding another \$100 of value ( $\$300 - \$200 = \$100$ ). The final price at which the bread is sold is equal to the value that is added at each stage in the production process ( $\$100 + \$100 + \$100$ ).

A final good is a product that the final consumer uses or consumes. The good (product) does not require any additional processing. A company makes a final good for the direct use of the final consumer. Final goods do not undergo any economic transformation in the production cycle and are available for the consumer. While calculating Gross Domestic Product (GDP) final goods are only considered.

## GROSS DOMESTIC PRODUCT (GDP)

**The Gross Domestic Product (GDP) is an estimate of the monetary value of all the final goods produced within the domestic boundaries of a nation during a period of time, normally taken as a year.**

- **GDP is a flow variable.** The total goods or assets possessed by the people of any country at any given point of time is known as National Wealth. National wealth, unlike the GDP, is a stock.
- **GDP does not include imports** as imported goods and services are not produced within the domestic boundaries.
- **GDP calculation is an estimate** which is generally done on the basis of some survey or economic indicators.
- **While calculating GDP money value of intermediate goods are not considered** as the value of final goods include the value of intermediate goods. **If the value of intermediate goods are also considered then it would lead to a problem called Double Counting.**

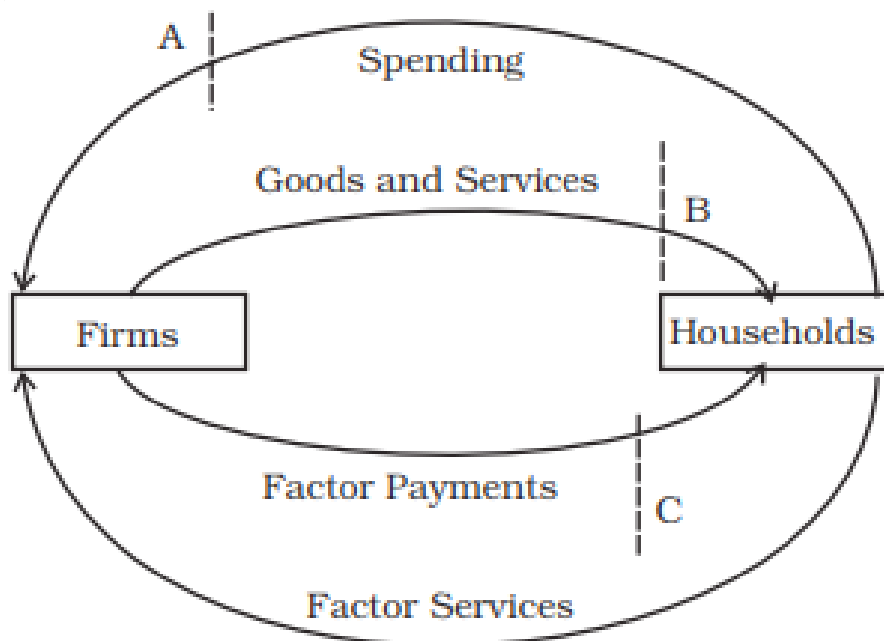
## CIRCULAR FLOW OF INCOME AND GDP CALCULATION

Consider a simple economy – without a government, external trade or any savings. There are only two entities viz. Households and Firms. The households receive their payments from the firms for productive activities they perform for the latter. There may fundamentally be four kinds of contributions that can be made during the production of goods and services (a) contribution made by human labour, remuneration for which is called wage (b) contribution made by capital, remuneration for which is called interest (c) contribution made by entrepreneurship, remuneration of which is profit (d) contribution made by fixed natural resources (called ‘land’), remuneration for which is called rent. In this simplified economy, there is only one way in which the households may dispose off their earnings – by spending their entire income on the goods and services produced by the domestic firms.

The other channels of disposing their income are closed: we have assumed that the households do not save, they do not pay taxes to the government – since there is no government, and neither do they buy imported goods since there is no external trade in this simple economy.

In other words, factors of production use their remunerations to buy the goods and services which they assisted in producing. The aggregate consumption by the households of the economy is equal to the aggregate expenditure on goods and services produced by the firms in the economy. The entire income of the economy, therefore, comes back to the producers in the form of sales revenue. There is no leakage from the system – there is no difference between the amount that the firms had distributed in the form of factor payments (which is the sum total of remunerations earned by the four factors of production) and the aggregate consumption expenditure that they receive as sales revenue.

In the next period the firms will once again produce goods and services and pay remunerations to the factors of production. These remunerations will once again be used to buy the goods and services. Hence year after year we can imagine the aggregate income of the economy going through the two sectors, firms and households, in a circular way.



When the income is being spent on the goods and services produced by the firms, it takes the form of aggregate expenditure received by the firms. Since the value of expenditure must be equal to the value of goods and services, we can equivalently measure the aggregate income by calculating the aggregate value of goods and services produced by the firms. When the aggregate revenue received by the firms is paid out to the factors of production it takes the form of aggregate income.



Since the same amount of money, representing the aggregate value of goods and services is moving in a circular way, if we want to estimate the aggregate value of goods and services produced during a year we can measure the annual value of the flows at any of the dotted lines indicated in the diagram.

We can measure the uppermost flow (at point A) by measuring the aggregate value of spending that the firms receive for the final goods and services which they produce. This method will be called the **expenditure method**. If we measure the flow at B by measuring the aggregate value of final goods and services produced by all the firms, it will be called **product method**. At C, measuring the sum total of all factor payments will be called **income method**.

Observe that the aggregate spending of the economy must be equal to the aggregate income earned by the factors of production (the flows are equal at A and C). Now let us suppose that at a particular period of time the households decide to spend more on the goods and services produced by the firms. For the time being let us ignore the question where they would find the money to finance that extra spending since they are already spending all of their income (they may have borrowed the money to finance the additional spending). Now if they spend more on the goods and services, the firms will produce more goods and services to meet this extra demand. Since they will produce more, the firms must also pay the factors of production extra remunerations. How much extra amount of money will the firms pay? The additional factor payments must be equal to the value of the additional goods and services that are being produced. Thus the households will eventually get the extra earnings required to support the initial additional spending that they had undertaken. In other words, the households can decide to spend more – spend beyond their means. And in the end their income will rise exactly by the amount which is necessary to carry out the extra spending. Putting it differently, an economy may decide to spend more than the present level of income. But by doing so, its income will eventually rise to a level consistent with the higher spending level. This may seem a little paradoxical at first. But since income is moving in a circular fashion, it is not difficult to figure out that a rise in the flow at one point must eventually lead to a rise in the flow at all levels. Hence GDP calculated by any of the above methods will yield the same result.

## DEPRICIATION AND NET DOMESTIC PRODUCT (NDP)

To come back to our discussion on the measure of final output, that part of our final output that comprises of capital goods constitutes gross investment of an economy. These may be machines, tools and implements; buildings, office spaces, storehouses or infrastructure like roads, bridges, airports or jetties. But all the capital goods produced in a year do not constitute an addition to the capital stock already existing. A significant part of current output of capital goods goes in maintaining or replacing part of the existing stock of capital goods. This is because the already existing capital stock suffers wear and tear and needs maintenance and replacement. A part of the capital goods produced this year goes for replacement of existing capital goods and is not an addition to the stock of capital goods already existing and its value needs to be subtracted from gross investment for arriving at the measure for net investment. This deletion, which is made from the value of gross investment in order to accommodate regular wear and tear of capital, is called depreciation. So new addition to capital stock in an economy is measured by net investment or new capital formation, which is expressed as

$$\text{Net Investment} = \text{Gross investment} - \text{Depreciation}$$

Let us consider a new machine that a firm invests in. This machine may be in service for the next twenty years after which it falls into disrepair and needs to be replaced. We can now imagine as if the machine is being gradually used up in each year's production process and each year one twentieth of its original value is getting depreciated. So, instead of considering a bulk investment for replacement after twenty years, we consider an annual depreciation cost every year. This is the usual sense in which the term depreciation is used and inherent in its conception is the expected life of a particular capital good, like twenty years in our example of the machine. Depreciation is thus an annual allowance for wear and tear of a capital good

When we subtract the depreciation costs from the Gross Domestic Product (GDP) we get the Net Domestic Product (NDP). It is expressed as

$$\text{NET DOMESTIC PRODUCT (NDP)} = \text{GROSS DOMESTIC PRODUCT (GDP)} - \text{DEPRICIATION}$$

## FACTOR COST AND MARKET PRICE

Factor cost is the cost incurred in production, whereas market price is the price prevalent in the market at any given point of time. Market prices may not reflect the actual price of production as they might be distorted due to the extension of product subsidies or imposition of product taxes. Hence to arrive at the actual cost of production (i.e. Factor cost) we must deduct the taxes and add the subsidies to market price. The resultant cost would be factor cost, it is expressed as

$$\text{FACTOR COST} = \text{MARKET PRICE} - \text{INDIRECT TAXES} + \text{SUBSIDIES}$$

$$\begin{aligned} \text{MARKET PRICE} &= \text{FACTOR COST} + \text{INDIRECT TAXES} - \text{SUBSIDIES} \\ \text{FACTOR COST} &= \text{MARKET PRICE} - (\text{INDIRECT TAXES} - \text{SUBSIDIES}) \\ \text{FACTOR COST} &= \text{MARKET PRICE} - \text{NET INDIRECT TAXES} \\ \text{MARKET PRICE} &= \text{FACTOR COST} + \text{NET INDIRECT TAXES} \end{aligned}$$

Hence,

$$\text{GDP at Factor Cost} = \text{GDP at Market Price} - \text{Indirect Taxes} + \text{Subsidies}$$

## GROSS NATIONAL PRODUCT (GNP)

$$\text{GNP} = \text{GDP} + \text{NET FACTOR INCOME FROM ABROAD (NFIFA)}$$

Net Factor Income from abroad refers to the difference between the income received and income paid. In other words it refers to the difference between the income earned by Indians from abroad for rendering factor services and income paid to foreigners for the factor services rendered by them in India. For India the GDP is more than its GNP, this indicates that the Indians pay more to foreigners than what they receive from foreign lands. GNP is also known as the Gross National Income (GNI).

## NET NATIONAL PRODUCT (NNP)

Net national product (NNP) is the monetary value of finished goods and services produced by a country's citizens, overseas and domestically, in a given period (i.e., the gross national product (GNP) minus the amount of GNP required to purchase new goods to maintain existing stock (i.e., depreciation).

$$\text{NNP} = \text{GNP} - \text{DEPRECIATION}$$

NNP is often examined on an annual basis as a way to measure a nation's success in continuing minimum production standards. The NNP is expressed in the currency of the nation it represents. In the United States, the NNP is expressed as in dollars; for EU member nations, the NNP is expressed in Euros.

The NNP can be extrapolated from the GNP by subtracting the depreciation of any assets, also known as the capital consumption allowance. The depreciation of the asset's figure is determined by assessing the loss of the value of assets attributed to normal use and aging. The relationship between a nation's GNP and NNP is similar to the relationship between its gross domestic product (GDP) and net domestic product (NDP). NNP at Factor Cost is popularly known as National Income.

## REVISION OF THE BASE YEAR AND NATIONAL INCOME ACCOUNTING

Earlier, government was calculating all the data for GDP at factor cost. This was called GDP of India. It was evaluated using output method (Base 2004-05).

In the new definition of the economic growth, GDP is estimated at market prices, which includes indirect taxes but excludes subsidies. Earlier, GDP growth was estimated at factor cost, which excludes indirect taxes but includes subsidies.

The Base year for GDP calculation has been shifted to 2011-12 from the earlier base of 2004-05. **Headline GDP** is now **GDP at constant market prices** as per the new GDP series.

**Sector-wise estimates of Gross Value Added will now be given at Basic prices instead of Factor Cost.** The difference between Factor cost and **Basic prices** is that the **Production taxes are included and Production subsidies excluded** in Basic prices. Whereas **Production taxes are excluded and Production subsidies are included** while calculating **Gross Value Added at Factor Cost**.

**GDP at Constant market price = GVA at Basic prices + Product taxes - Product subsidies**

**GVA at Basic prices = CE + OS/MI + CFC + Production taxes - Production subsidies**

**GVA at Factor Cost = GVA at Basic prices - Production taxes + Production subsidies**

\*CE= Compensation of Employees; OS= Operating Surplus; MI= Mixed Income; CFC = Consumption of Fixed Capital

**Production taxes or Production subsidies are paid or received with respect to the Production process and are independent of the total volume of Production.** Eg: - Land Revenue (Production Taxes); Subsidy on Electricity to Farmers (Production Subsidies)

**Product taxes or Product Subsidies are paid or received on per unit of Product and thus depend on the total volume of Production.** Eg: - Excise Duty; Sales Tax; Import and Export Duties; Service Tax (Product Taxes); Subsidy on LPG, Food and Fertilizer (Product Subsidy)

## OTHER CHANGES

- Better coverage of the Corporate Sector both in manufacturing and services by incorporation of annual accounts of companies as filed with the ministry of Corporate Affairs (MCA) under the new e-governance initiative [MCA- 21 Database]. MCA 21 Database has helped in accounting activities other than those which are related to manufacturing.
- Comprehensive coverage of Financial Sector by inclusion of information from the accounts of stock brokers, stock exchanges, asset management companies, mutual funds, pension funds and regulating bodies including SEBI, IRDA and PFRDA
- Improved coverage of activities of local bodies and autonomous institutions covering around 60% of the grants/ transfers provided to these institutions

# UNIT-IV

## [FOREX MARKET]

### FOREX MARKET

The forex market is the market in which participants can buy, sell, exchange, and speculate on currencies. The forex market is made up of banks, commercial companies, central banks, investment management firms, hedge funds, and retail forex brokers and investors. The currency market is considered to be the largest financial market with over \$5 trillion in daily transactions, which is more than the futures and equity markets combined.

Up until World War I, currencies were pegged to precious metals, such as gold and silver. But the system collapsed and was replaced by the Bretton Woods agreement after the Second World War. That agreement resulted in the creation of three international organizations to facilitate economic activity across the globe. They were the International Monetary Fund (IMF), General Agreement on Tariffs and Trade (GATT), and the International Bank for Reconstruction and Development (IBRD). The new system also replaced gold with the US dollar as peg for international currencies. The US government promised to back up dollar supplies with equivalent gold reserves.

But the Bretton Woods system became redundant in 1971, when US president Richard Nixon announced “temporary” suspension of the dollar’s convertibility into gold. Currencies are now free to choose their own peg and their value is determined by supply and demand in international markets. Foreign exchange markets are made up of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers and investors.

### TYPES OF EXCHANGE RATE AND CURRENCY MOVEMENTS

In finance, an exchange rate (also known as a foreign-exchange rate, forex rate, or rate) between two currencies is the rate at which one currency will be exchanged for another. It is also regarded as the value of one country’s currency in terms of another currency. In simple words exchange rate refers to the number of units of a local currency required to purchase one unit of some internationally recognised standard currency usually the US Dollar. The way in which an authority manages its currency in relation to other currencies and the foreign exchange market is known as the exchange rate regime. The three major types of exchange rate systems are the fixed rate, the floating rate, and the managed rate.

#### Fixed Exchange Rate

A fixed exchange rate, sometimes called a pegged exchange rate, is a type of exchange rate regime in which a currency’s value is fixed against either the value of another single currency, a basket of other currencies, or another measure of value, such as gold. The purpose of a fixed exchange rate system is to keep a currency’s value within a narrow band.

Few economists feel fixed rates provide greater certainty for exporters and importers. Fixed rates also help the government maintain low inflation, which, in the long run, keep the interest rates down and stimulates trade and investment. China is well-known for its fixed exchange rate. It was one of the few countries that could impose a fixed rate by making it illegal to trade its currency at any other rate.

#### Floating Exchange Rate

A floating exchange rate or fluctuating exchange rate is a type of exchange rate regime wherein a currency’s value is allowed to freely fluctuate according to the foreign exchange market. In a floating exchange rate the market forces of demand and supply determine the exchange rate. It is also known as market exchange rate or freely floating exchange rate.

A currency that uses a floating exchange rate is known as a floating currency. The dollar is an example of a floating currency. Many economists believe floating exchange rates are the best possible exchange rate regime because these regimes automatically adjust to economic circumstances. These regimes enable a country to dampen the impact of shocks and foreign business cycles, and to preempt the possibility of having a balance of payments crisis. However, they also engender unpredictability as the result of their dynamism.

## Managed Exchange Rate

Generally the central bank will set a range which its currency's value may freely float between. If the currency drops below the range's floor or grows beyond the range's ceiling, the central bank takes action to bring the currency's value back within range. A managed float regime is a hybrid of fixed and floating regimes. A managed float captures the benefits of floating regimes while allowing central banks to intervene and minimize the risk of harmful effects due to radical currency fluctuations that are a characteristic of floating regimes.

### DIRTY FLOATATION

Managed float regimes, otherwise known as dirty floats, are **where exchange rates fluctuate from day to day and central banks attempt to influence their countries' exchange rates by buying and selling currencies**. Almost all currencies are managed since central banks or governments intervene to influence the value of their currencies. So when a country claims to have a floating currency, it most likely exists as a managed float.

## DEVALUATION AND REVALUATION

Currency devaluation and revaluation refer to opposite changes to a country's official currency in comparison to other currencies. Devaluation is the deliberate lowering of the exchange rate while revaluation is the deliberate rise of the exchange rate. In a fixed exchange rate system, both devaluation and revaluation can be conducted by policymakers, usually motivated by market pressures.

### Currency Devaluation

Devaluation of a currency is a deliberate lowering of an official exchange rate of a country and setting a new fixed rate with respect to a reference of foreign currency such as the USD. It should not be confused with depreciation which is the decrease in the currency value as compared to other major currency benchmarks due to market forces. The process of devaluation tends to render the foreign currency more expensive than the local currency.

For instance, a country whose 10 units of its currency is equivalent to one dollar may decide to devalue its currency by fixing 20 units to be equal to one dollar.

### Reasons for Devaluation

- Countries often use currency devaluation for economic policies. Lowering of the home currencies as compared to foreign currencies can improve exports, shrink trade deficits, and reduce a country's debt burden.
- When the local currency is cheaper than the foreign currency, exports will be encouraged and imports discouraged. This is because foreign countries will find the prices of goods cheaper in the devaluing country. Caution should be exercised, however, to avoid extensive exports as this could cause an offset to the expected demand and supply which could increase the prices of goods and normalize the devaluation effect.

- Devaluation helps solve the effects of trade deficit since it will cause a balance of payments since the exports will be higher than the imports.
- If a government has sovereign debts to pay on a regular basis, and the payment of this debt is fixed, maintaining a weaker currency makes the debt less expensive over time. The same should also be done with caution as countries might resort to a race to the bottom war nullifying the effect of devaluing.

### Effects of Devaluation

- An increase in demand for exported goods can lead to inflation. When this happens, the government can raise interest rates but at a cost since it will slow the country's economy.
- Devaluation can also cause psychological damage to the foreign investors. This is because a weaker currency may be viewed as an indication of economic weakness hence scaring away foreign investors.
- Another effect of devaluation is that it may lead to concerns by neighboring countries to devalue their currencies too in the race to the bottom hence causing financial instability in the bordering markets. (Currency wars)

### Currency Revaluation

Revaluation is a significant rise in a country's official exchange rates in relation to a foreign currency. The process of revaluation is usually done by the central bank of the revaluing country. For instance, a country whose 10 units of its currency is equivalent to one dollar may decide to revalue its currency by fixing 5 units to be equal to one dollar.

### Causes of Currency Revaluation

Changes in interest rates of various countries could cause a country to resort to currency revaluation so as to maintain its profitability and economic competitiveness.

Countries can also revalue their currency for speculative purposes. For instance, prior to the 2016 Brexit by Britain, a lot of other countries' currencies fluctuated because of speculative reasons and need to remain profitable despite any outcome of the vote.

Currency revaluation is different from currency appreciation which is determined by market forces of demand and supply. Currency revaluation makes imports attractive and exports uncompetitive. Currency revaluation is typically associated with a pegged exchange rate.

### International Monetary Fund

The issue of currency revaluation and devaluation led to the establishment of the International Monetary Fund (IMF), a body that regulates the frequent devaluation and revaluation that are used by different countries to unfairly gain a competitive advantage over others. The IMF has also given each member a right to choose an exchange rate to use. These policies have helped the ill-advised motives of devaluation and revaluation.

## DEPRECIATION AND APPRECIATION

In finance and accounting, terminology is everything. Depreciation and appreciation are two sides of the same coin. Depreciation is when the value of assets goes down, and appreciation is when the value of assets goes up.

Currency depreciation is the loss of value of a country's currency with respect to one or more foreign reference currencies, typically in a floating exchange rate system in which no official currency value is maintained. Currency appreciation in the same context is an increase in the value of the currency. Short-term changes in the value of a currency are reflected in changes in the exchange rate.

### Currency Depreciation

Currency Depreciation refers to decrease in the value of domestic currency in terms of foreign currency. It makes the domestic currency less valuable and more of it is required to buy the foreign currency. For example:

- (i) Rupee is said to be depreciating if price of \$1 rises from Rs 45 to Rs 50.
- (ii) A change from \$3 = £1 to \$2 = £1 represents that UK Pound is depreciating.

Depreciation of domestic currency means a fall in the price of domestic currency (say, rupee) in terms of a foreign currency (say, \$). It means, with same amount of dollars, more goods can be purchased from India, i.e. exports to USA will increase as they will become relatively cheaper.

Currency depreciation makes domestic goods cheaper in foreign country as more of such goods can now be purchased with same amount of foreign currency. So, it leads to increase in exports.

### Currency Appreciation

Currency Appreciation refers to increase in the value of domestic currency in terms of foreign currency. The domestic currency becomes more valuable and less of it is required to buy the foreign currency. For example:

- (i) Indian rupee appreciates when price of \$1 falls from Rs. 50 to Rs 45.
- (ii) A change from \$3 = £1 to \$5 = £1 represents that the UK pound is appreciating.

Appreciation of domestic currency means a rise in the price of domestic currency (say, rupee) in terms of a foreign currency (say, \$). Now, one rupee can be exchanged for more \$, i.e. with same amount of money, more goods can be purchased from USA. It leads to increase in imports from USA as American goods will become relatively cheaper.

Currency appreciation makes foreign goods cheaper in domestic country as more of such goods can now be purchased with same amount of domestic currency. So, it leads to increase in imports.

## PURCHASING POWER PARITY (PPP)

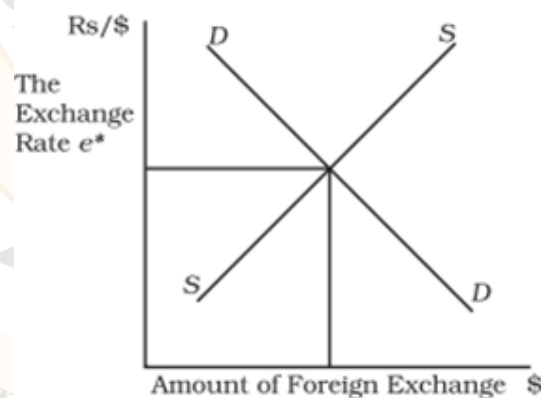
The price of one currency in terms of the other is known as the exchange rate. Since there is a symmetry between the two currencies, the exchange rate may be defined in one of the two ways. First, as the amount of domestic currency required to buy one unit of foreign currency, i.e. a rupee-dollar exchange rate of Rs 50 means that it costs Rs 50 to buy one dollar, and second, as the cost in foreign currency of purchasing one unit of domestic currency. In the above case, we would say that it costs 2 cents to buy a rupee.

**Purchasing power parity (PPP)** is an economic theory that compares different countries' currencies through a «**basket of goods**» approach. According to this concept, two currencies are in equilibrium or at par when a **basket of goods** (taking into account the exchange rate) is priced the **same** in both countries.

The practice in economic literature, however, is to use the former definition – as the price of foreign currency in terms of domestic currency. This is the **bilateral nominal exchange rate** – bilateral in the sense that they are exchange rates for one currency against another and they are nominal because they quote the exchange rate in money terms, i.e. so many rupees per dollar or per pound. However, returning to our example, if one wants to plan a trip to London, she needs to know how expensive British goods are relative to goods at home. The measure that captures this is the real exchange rate – the ratio of foreign to domestic prices, measured in the same currency. It is defined as

$$\text{Real exchange rate} = \frac{eP_f}{P}$$

Where  $P$  and  $P_f$  are the price levels here and abroad, respectively and  $e$  is the rupee price of foreign exchange (the nominal exchange rate). The numerator expresses prices abroad measured in rupees; the denominator gives the domestic price level measured in rupees, so the real exchange rate measures prices abroad relative to those at home. **If the real exchange rate is equal to one, currencies are at purchasing power parity.** This means that goods cost the same in two countries when measured in the same currency. For instance, if a pen costs \$4 in the US and the nominal exchange rate is Rs 50 per US dollar, then with a real exchange rate of 1, it should cost Rs 200 ( $eP_f = 50 \times 4$ ) in India. If the real exchange rises above one, this means that goods abroad have become more expensive than goods at home. If the real exchange falls below one, this means that goods abroad have become more cheaper than goods at home. The real exchange rate is often taken as a measure of a country's international competitiveness.



Since a country interacts with many countries, we may want to see the movement of the domestic currency relative to all other currencies in a single number rather than by looking at bilateral rates. That is, we would want an index for the exchange rate against other currencies, just as we use a price index to show how the prices of goods in general have changed. This is calculated as the **Nominal Effective Exchange Rate (NEER)** which is a multilateral rate representing the price of a representative basket of foreign currencies, each weighted by its importance to the domestic country in international trade (the average of export and import shares is taken as an indicator of this). **The Real Effective Exchange Rate (REER)** is calculated as the weighted average of the real exchange rates of all its trade partners, the weights being the shares of the respective countries in its foreign trade. It is interpreted as the quantity of domestic goods required to purchase one unit of a given basket of foreign goods.



# UNIT-V

## [CAPITAL FORMATION]

### GROSS DOMESTIC SAVINGS (GDS)

We all know that GDP is the money value of all the final goods and services produced in the domestic territory of a country in a year's time. So, Gross Domestic Product (GDP) measures the total output of goods and services for final use occurring within the domestic territory of a given country. A part of this total monetary value i.e. GDP is consumed. What is left after consumption is known as "saving."

$$\text{GDS} = \text{GDP} - \text{Final Consumption}$$

So, **Gross Domestic Savings (GDS) is the Gross Domestic Product (GDP) minus final consumption.** The saved money is either kept with the public or is invested back. **When the saved money is invested back, it is known as Capital Formation.** The Ratio of saving and investments is very important for the economic health of the country.

**Gross Domestic Savings** is different from the **Gross National Savings**, which is equal to **Gross Domestic Savings (Gross Domestic Product minus final consumption) plus net income and net current transfers from abroad.**

$$\text{GNS} = \text{GDS} + \text{Net Income and Net Current transfers from abroad}$$

The Gross Domestic Saving has two parts. One is Public Sector, another is Private sector. The largest segment of Private sector is the Household sector. Another segment of the Private sector is the private corporate sector. In terms of contribution to total GDS Household sector is followed by the Private Corporate Sector. Public Sector's contribution is less when compared to the Household or Private Corporate Sector.

### GROSS FIXED CAPITAL FORMATION (GFCF)

Capital formation is a term used to describe the net capital accumulation during an accounting period for a particular country. The term refers to additions of capital stock, such as equipment, tools, transportation assets and electricity. Countries need capital goods to replace the ones that are used to produce goods and services. If a country cannot replace capital goods, production declines. Generally, the higher the capital formation of an economy, the faster an economy can grow its aggregate income.

Producing more goods and services can lead to an increase in national income levels. In order to add capital stock, a country needs to generate savings and investments. Countries with higher level of savings can invest more into the economy; on the other hand countries with relatively less savings have to depend upon foreign inflows for the purposes of investments. Many developing countries depend upon foreign inflows especially during the early stages of economic development.

**Gross fixed capital formation (GFCF) is defined as the acquisition (including purchases of new or second-hand assets) and creation of assets by producers for their own use, minus disposals of produced fixed assets.** The relevant assets relate to products that are intended for use in the production of other goods and services for a period of more than a year. The term "produced assets" means that only those assets that come into existence as a result of a production process recognised in the national accounts are included.

**GFCF is called “gross” because the measure does not make any adjustments to deduct the consumption of fixed capital (depreciation of fixed assets) from the investment figures.** For the analysis of the development of the productive capital stock, it is important to measure the value of the acquisitions less disposals of fixed assets beyond replacement for obsolescence of existing assets due to normal wear and tear. “Net fixed investment” includes the depreciation of existing assets from the figures for new fixed investment, and is called **Net Fixed Capital Formation (NFCF)**.

**GFCF is not a measure of total investment, because only the value of net additions to fixed assets is measured, and all kinds of financial assets are excluded, as well as stocks of inventories and other operating costs** (the latter included in intermediate consumption). If, for example, one examines a company balance sheet, it is easy to see that fixed assets are only one component of the total annual capital outlay.

### INCREMENTAL CAPITAL OUTPUT RATIO (ICOR)

The incremental capital output ratio (ICOR) is a frequently used tool that explains the relationship between the level of investment made in the economy and the consequent increase in GDP. **ICOR indicates the additional unit of capital or investment needed to produce an additional unit of output.**

$$ICOR = \frac{\text{annual investment}}{\text{annual increase in GDP}}$$

The Incremental Capital-Output Ratio (ICOR) is the ratio of investment to growth which is equal to the reciprocal of the marginal product of capital. **Higher the ICOR, the lower the productivity of capital or the marginal efficiency of capital.** The ICOR can be thought of as a measure of the inefficiency with which capital is used. In most countries the ICOR is in the neighborhood of 3. It is a topic discussed in economic growth.

# UNIT-VI

## [PUBLIC FINANCE]

### CLASSIFICATION OF TAXES

**A tax is a mandatory financial charge or some other type of levy imposed upon a taxpayer by a governmental organization in order to fund various public expenditures.** A failure to pay, along with evasion of or resistance to taxation, is punishable by law. However the government can exclude certain individuals, groups or institutions from the burden of taxation by law. **Further there exists no quid pro quo between payment of taxes and provision of public goods and services.** Certain vulnerable sections benefit from government expenditure irrespective of their contribution to the tax revenues. Taxes can be broadly classified into three types

- **Direct and Indirect Taxes**
- **Specific and Ad-Valorem Taxes**
- **Progressive, Regressive and Proportional Taxes**

#### Direct and Indirect Taxes

**Direct Taxes, as the name suggests, are taxes that are directly paid to the government by the taxpayer.** It is a tax applied on individuals and organizations directly by the government e.g. income tax, corporation tax, wealth tax etc. **In direct tax the burden of taxation falls on the same person over whom the tax is imposed i.e. the burden cannot be shifted.** Direct taxes are generally taxes on income and property.

**An indirect tax is a tax levied by the Government on goods and services and not on the income, profit or revenue of an individual or institution and its burden can be shifted.** In other words **the indirect tax is imposed over someone but its burden falls on someone else.** Customs Duty, Service Tax, Goods and Services tax (GST) are examples of indirect taxes. The Government often increases the tax rate when there is a monetary inflation which in turn reduces the demand for goods and services and as a result of descending demand, the inflation is bound to condense.

#### Specific and Ad-Valorem Taxes

Specific tax is a tax imposed on some specific attribute of the good or service irrespective of its value. Like taxes on quantity, weight, length, size etc are examples of specific tax. Ad-valorem taxes are taxes imposed on the value (generally taken as money value) of the good or service. The most common ad valorem taxes are property taxes levied on real estate. However, ad valorem taxes may also extend to a number of tax applications, such as import duty taxes on goods from abroad.

#### Progressive, Regressive and Proportional Taxes

**A progressive tax is defined as a tax whose rate increases as the payer's income increases.** That is, individuals who earn high incomes have a greater proportion of their incomes taken to pay the tax. **A regressive tax, on the other hand, is one whose rate increases as the payer's income decreases.** In other words under regressive tax structure as the income increases the burden of taxes decreases. **A proportional tax system, also referred to as a flat tax system, assesses the same tax rate on everyone regardless of income or wealth.**

**PROGRESSIVE TAX STRUCTURE**

INCOME	TAX RATE
100000	10%
500000	20%
1000000	30%

**REGRESSIVE TAX STRUCTURE**

INCOME	TAX RATE
100000	25%
500000	15%
1000000	10%

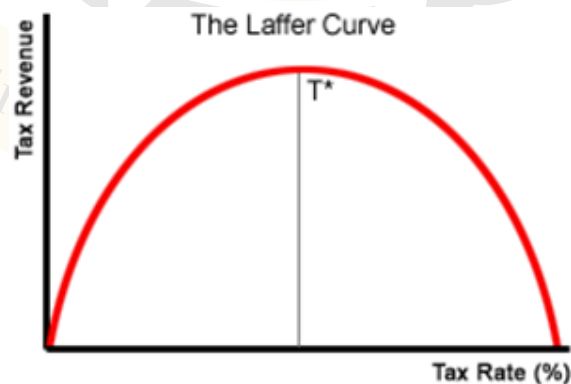
**PROPORTIONAL TAX STRUCTURE**

INCOME	TAX RATE
100000	10%
500000	10%
1000000	10%

**LAFFER CURVE AND TAX REVENUES**

The Laffer curve is a theory developed by supply-side economist Arthur Laffer to show the relationship between tax rates and the amount of tax revenue collected by governments. The curve is used to illustrate Laffer's main premise that the more an activity — such as production — is taxed, the less of it is generated. Likewise, the less an activity is taxed, the more of it is generated.

The Laffer curve suggests that, as taxes increase from low levels, tax revenue collected by the government also increases. It also shows that tax rates increasing after a certain point ( $T^*$  on the diagram below) would cause people not to work as hard or not at all, thereby reducing tax revenue. Eventually, if tax rates reached 100 per cent, shown as the far right on his curve, all people would choose not to work because everything they earned would go to the government. Governments would like to be at point  $T^*$  because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard.

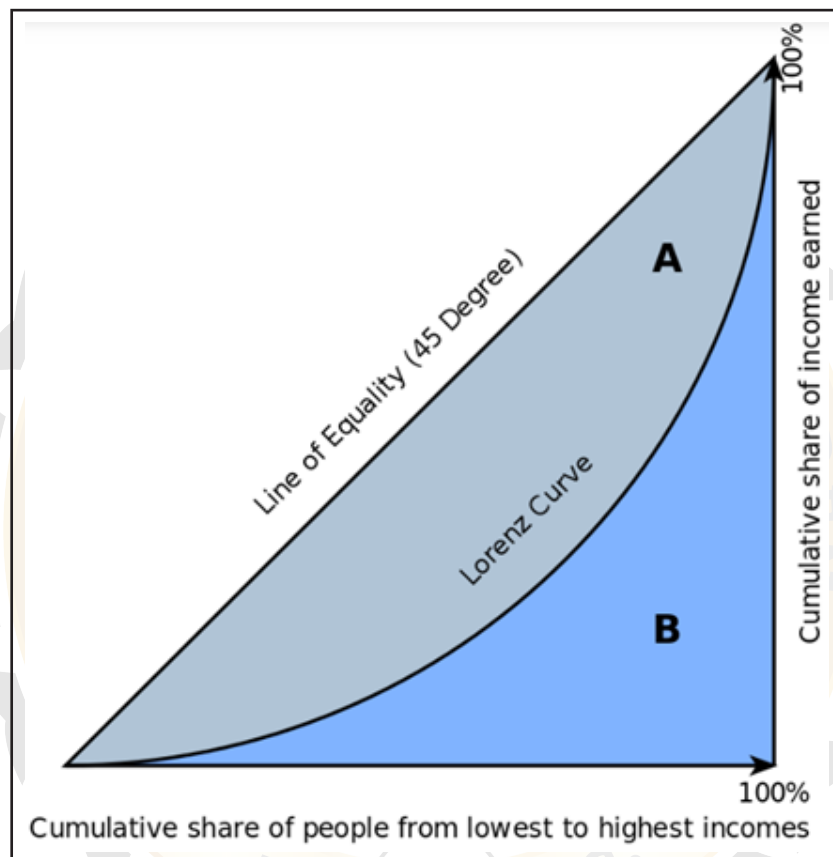


There are some fundamental problems with the Laffer curve — notably that it is far too simplistic in its assumptions. While the curve assumes that societies function on a single tax rate and a single supply of labor, that can't be further from the truth. In reality, public finance structures are much more complex. The curve does not take into account how revenue is affected by multivalued tax rates. Simply, the fact that any increase in the tax rate to a certain percentage may not necessarily equate to the same revenue as a decrease in the tax rate. The curve also does not take into account any avoidance of taxes at any level.

## LORENZ CURVE AND GINI COEFFICIENT

The Lorenz curve is a graphical representation of income inequality or wealth inequality developed by American economist Max Lorenz in 1905. The graph plots percentiles of the population on the horizontal axis according to income or wealth. It plots cumulative income or wealth on the vertical axis, so that an x-value of 45 and a y-value of 14.2 would mean that the bottom 45% of the population controls 14.2% of the total income or wealth.

The Lorenz curve is often accompanied by a straight diagonal line with a slope of 1, which represents perfect equality in income or wealth distribution; the Lorenz curve lies beneath it, showing the actual distribution.



While the Lorenz curve is most often used to represent economic inequality, it can also demonstrate unequal distribution in any system. The farther away the curve is from the baseline, represented by the straight diagonal line, the higher the level of inequality. In economics, the Lorenz curve denotes inequality in the distribution of either wealth or income; these are not synonymous since it is possible to have high earnings but zero or negative net worth, or low earnings but a large net worth.

The **Gini index** or **Gini coefficient** is a statistical measure of distribution developed by the Italian statistician Corrado **Gini** in 1912. It is often used as a gauge of economic inequality, measuring income distribution or, less commonly, wealth distribution among a population. The area between the straight line and the curved line, expressed as a ratio of the area under the straight line, is the Gini coefficient, a measurement of inequality.

It can range from 0 (or 0%) to 1 (or 100%). Complete equality, in which every individual has the exact same income or wealth, corresponds to a coefficient of 0. Plotted as a Lorenz curve, complete equality would be a straight diagonal line with a slope of 1 (the area between this curve and itself is 0, so the Gini coefficient is 0). A coefficient of 1 means that one person earns all of the income or holds all of the wealth.

## UNION BUDGET

**The annual financial statement on revenue and expenditure is popularly known as the budget.**

According to the Constitution of India, there exists a **three-tier system of government in India** viz. Central (or Union) government, State governments and Local governments (like Municipal Corporation, Municipal Committee, Zila Parishad, etc.). Accordingly, these governments prepare their own respective budgets (known as the **Union Budget, State Budget** and **Municipal Budget** respectively).

**A Budget is an estimate of expected revenues** (short-term and long-term) and **proposed expenditures** (short-term and long term) during a fiscal year. (1st April to succeeding 31st March).

### WHO MAKES THE BUDGET?

Budget is made through a consultative process involving the Ministry of Finance, PMO, NITI Aayog and the Spending ministries. Finance ministry issues guidelines for spending based on which ministries present their demands. **The Budget Division of the Department of Economic Affairs, Ministry of Finance** is the Nodal Body responsible for producing the Budget.

### FIVE DEPARTMENTS OF MINISTRY OF FINANCE

**Department of Economic Affairs; Department of Expenditure; Department of Revenue; Department of Financial Services; Department of Investment and Public Asset Management**

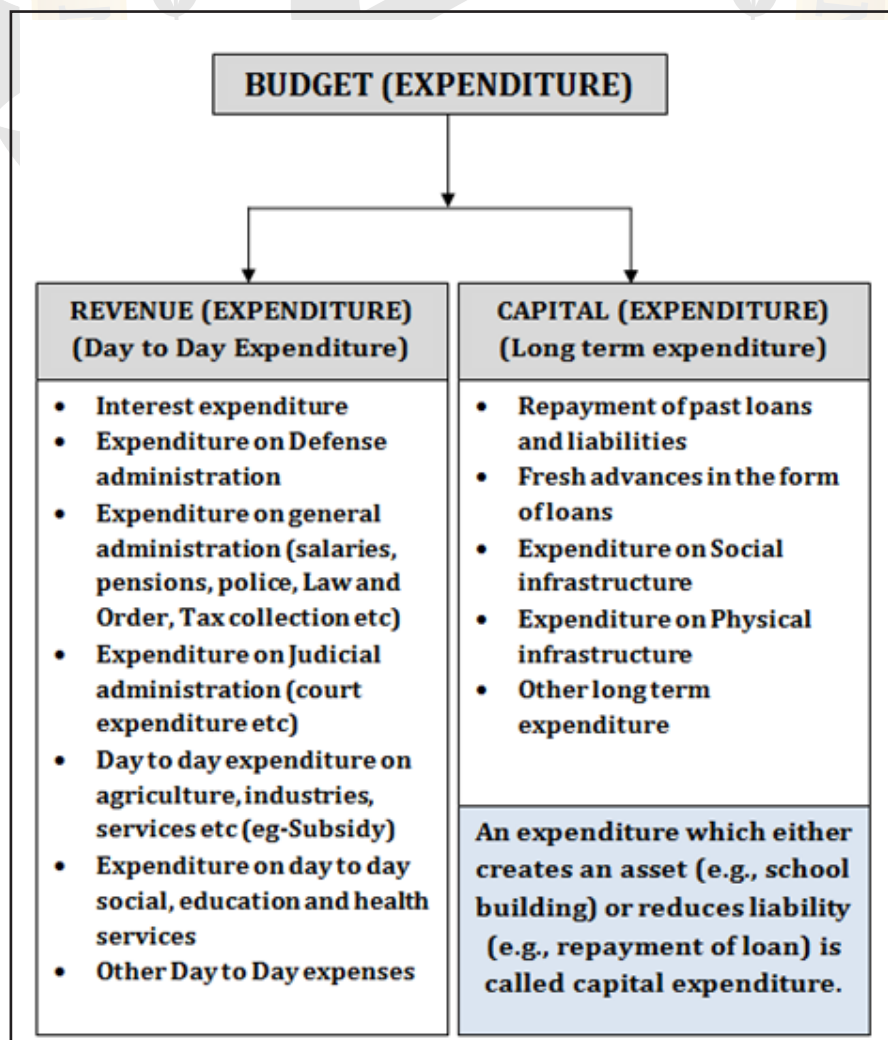
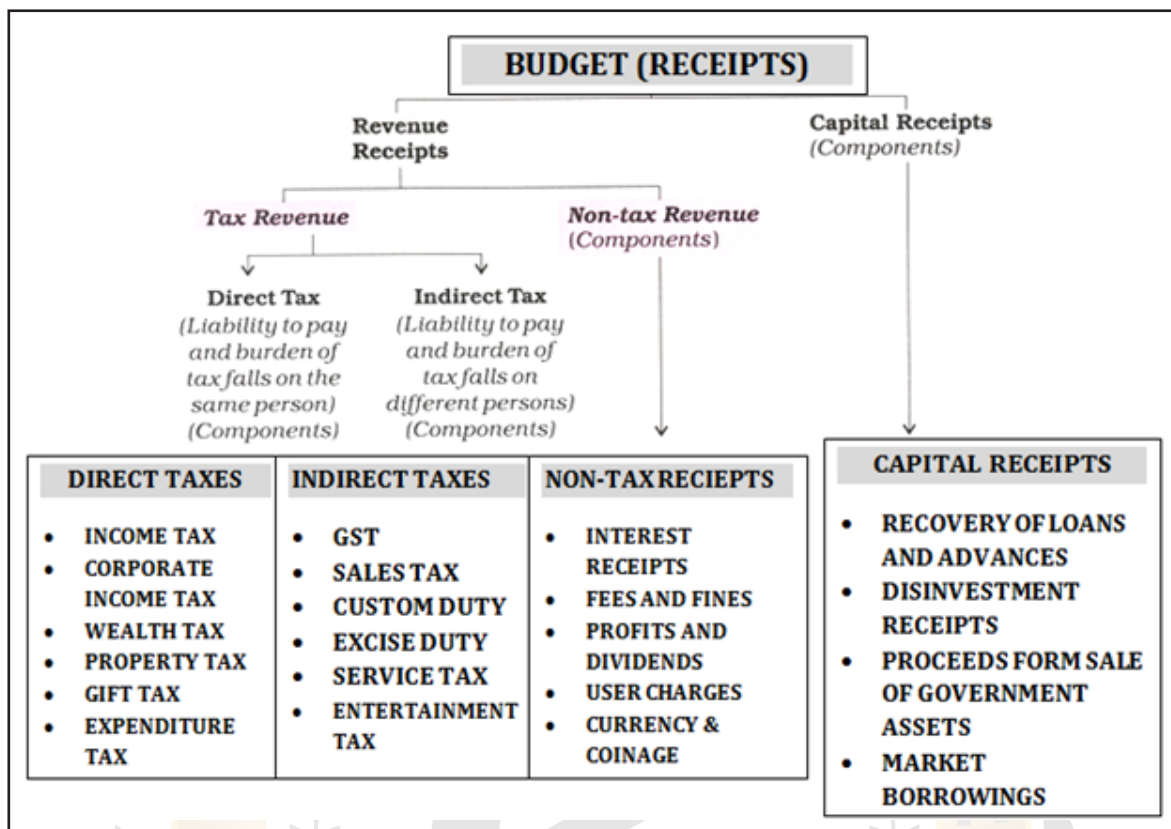
The Union Budget is broadly divided into two parts the Revenue Budget and the Capital Budget. The Revenue budget deals with the Revenue account (i.e. day today receipts and expenditure) while the Capital budget deals with the Capital account (it deals with long term receipts and expenditure). When the total receipts exceed total expenditure it is known as surplus budget. When the total expenditure exceed total revenue it is known as a deficit budget while when the total receipts is equal to total expenditure it is known as a balanced budget. Revenue expenditure is mostly incurred for consumption; however some of it can also create capital or assets. Capital expenditure is popularly known as Capital disbursements.

### EVERY BUDGET PRESENTS INFORMATION UNDER FOUR BROAD HEADS

- 1) Budget estimate for the next financial year-**(BE)-NEXT FISCAL YEAR**
- 2) Budget estimates of current financial year-**(BE)-CURRENT FISCAL YEAR**
- 3) Revised estimates for the current fiscal year-**(RE) - CURRENT FISCAL YEAR**
- 4) Actual estimates for previous financial year. **(AE)-PRECEDING FISCAL YEAR**

**Capital expenditure which leads to creation of assets are (a) expenditure on purchase of land, buildings, machinery, (b) investment in shares, loans by Central government to state government, foreign governments and government companies, cash in hand and (c) acquisition of valuables. Such expenditures are incurred on long period development programmes, real capital assets and financial assets. This type of expenditure adds to the capital stock of the economy and raises its capacity to produce more in future.**

## DIFFERENT PARTS OF THE UNION BUDGET



## Can Revenue Expenditure be productive?

**The purpose of Revenue expenditure is not to build up any capital asset, but to ensure normal functioning of government machinery.** Traditionally, all grants given to state governments are treated as revenue expenditure even though some of the grants may be before creation of assets.

## VOTE ON ACCOUNT AND INTERIM BUDGET

The **budget presented during the election year is an interim budget which seeks a vote-on-account** for few months to help the government to conduct its business and run the administrative machinery smoothly till a new government is selected.

### What is an interim budget?

- An interim Budget refers to the budget of a government that is going through a transition period. The interim Budget helps span the transition time between the two governments, entrusting the responsibility of a full budget on the new government.
- Through the interim budget, Parliament passes a vote-on-account that allows the government to meet the expenses of the administration until the new Parliament considers and passes the budget for the whole year.
- The new incoming government will have the full authority to change the estimates when the final budget is presented.
- **An interim Budget is a complete set of accounts, including both expenditure and receipts. But it may not contain big policy proposals.**
- **Although constitutionally the government can make tax changes in the interim budget, in most of the interim budgets presented since Independence major tax changes has not occurred.**

### What is a Vote-on-account?

- **Vote-on-Account is a special provision by which the government obtains Parliament's approval for funds sufficient to incur expenditure for a part of the year.**
- **Vote-On-Account represents the expenditure side of the government's budget** while general budget includes both income and expenditure in the form of Financial and Appropriation Bill.
- **A Vote-On-Account is treated as a formal matter and passed by the Lok Sabha without discussion as opposed to General or Interim budget.**
- One of the essential features of a **Vote-on-Account is that it cannot alter the Direct Taxes** since they need to be passed by the Financial Bill.
- The vote on account typically does not seek funds for major projects or new initiatives. This usually awaits the presentation of the full Budget. The new government elected may have different ideas in mind for the allocation of resources.

**Article 266 of the Constitution of India mandates that Parliamentary approval is required to draw money from the Consolidated Fund of India. Besides, Art 114 (3) of the Indian Constitution stipulates that no amount can be withdrawn from the Consolidated Fund without the enactment of a law (appropriation bill).**



**While a vote-on-account deals only with the expenditure side of the government's budget, an interim Budget is a complete set of accounts, including both expenditure and receipts.**

### **The Parliamentary Approval takes its time!**

The full budget is usually passed only after long discussions. Even though the government (executive) seeks approval of expenditure for the next financial year (April 1 to March 31) in the current financial year itself, the approval from legislature takes time.

Very often, discussion and voting of demands for grants and passing of Appropriation Bill go beyond the current financial year. **This was precisely the case before 2016 when the budget was presented on the last working day of February, and it was difficult to get passed within the same financial year.**

**A special provision is, therefore, made for a 'vote-on-account' by which the government obtains the vote of Parliament for a sum sufficient to incur expenditure on various items for a part of the year. This sanction of Parliament for withdrawal of money from the Consolidated Fund of India is allowed to meet the government's expenses till the appropriation bill is passed or a new government is formed.**

**Is it mandatory for the government to present a vote on account instead of a full budget in an election year?**

**It is not mandatory for the government to present a 'vote-on-account' in an election year.** Though the convention is to present an interim budget and get the fund required for spending via the vote on account route, the government (if it wishes so) can even go for a Full Budget and get the appropriation bills passed to get the finances.

However, during an election year, the ruling government generally opts for a vote-on-account or interim budget instead of a full budget. While technically, it is not mandatory for the government to present a vote-on-account, but it would be inappropriate to impose policies that may or may not be acceptable to the incoming government taking over in the same year.

**Can the finance minister make policy statements while presenting the vote-on-account?**

**Barring any announcement on taxation**, the finance minister's speech before seeking Parliament's approval of the vote-on-account can contain his intentions on economic policy.

**eg:-** When former finance minister Yashwant Sinha presented the vote-on account in 1991, he announced the Chandra Shekhar government's plan to divest government equity in public sector undertakings.

**For how long the 'vote-on-account' can be in force?**

**Normally**, the vote-on-account is taken for **two months** only. **But during an election year or when it is anticipated that the main demand for grants and Appropriation Bill will take longer time than two months, the vote-on-account may be passed for a period exceeding two months.** For example, in 2019, **Vote on Account has been taken for 4 months.** Typically this period does **not exceed six months**, as that is the maximum gap possible between two sittings of the Parliament. **Normally a vote-on-account is in operation till the full Budget is passed.**

**P. Chidambaram had presented the last interim budget of the UPA Government on February 17, 2014, while Arun Jaitley presented the full budget - and the Modi government's first one - five months later. The Union Interim Budget 2019 was presented by Finance Minister Piyush Goyal on 1st February 2019.**

## STAGES OF BUDGET PRESENTATION

- The **Secretary General of the Lok Sabha Secretariat** seeks approval of the **President** of India after the Speaker agrees to the date suggested by the Government.
- On the Morning of the Budget presentation, the Government seeks approval from the President through a **“Summary for the President”** (Which is already approved by the Prime Minister and the Finance Minister)
- The Finance Minister briefs the cabinet on the Budget proposals through a **“Summary for the Cabinet”** just before he presents the Budget in the Parliament.
- Then the Finance Minister proceeds to the Lok Sabha where he lays the Budget estimates on the floor of the House outlining key estimates and proposals
- The **FM’s Budget Speech has two parts**-Part A deals with the general economic condition and policy statements based on the Economic survey and Part B contains Tax Proposals and Expenditure Mechanisms.
- The **Annual Financial Statement is tabled in the Rajya Sabha after the FM’s Budget Speech** in the Lok Sabha.

## APPROVAL OF THE BUDGET

The presentation of the budget is followed by a general discussion in both the houses of the Parliament. The estimates of expenditure embodied in the annual financial statement is shown under two heads

- 1) **Expenditure charged on the Consolidated Fund of India (Non-Votable )**
- 2) **Expenditure proposed to be made from the Consolidated Fund of India (Demand for grants)**

**Note-** No demand for a grant shall however be made except on the recommendation of the President of India.

After the grants are voted by the House of the People, the grants so made by the house of the people as well as the expenditure charged on the Consolidated fund of India are incorporated in an **Appropriation Bill**. (It provides the legal authority for the withdrawal of these sums from the Consolidated fund of India)

Similarly the taxing proposals of the Budget are embodied in another bill known as the **Annual Finance Bill**. Both these bills are treated as Money Bills and the special procedure for Money bills is followed hereafter.

## GENDER BUDGETING

A gender budget is not a separate budget for women. Instead the gender budgets are attempt to assess government priorities as they are reflected through the budget and examine how they impact women and men. “Women Budgets”, “Gender Budgets”, “Gender Sensitive Budgets”, “Gender-Responsive Budgets” etc are all terms that are used interchangeably. A Gender-Responsive Budget is a budget that acknowledges the gender patterns in society and allocates the money to implement policies and programs that will change these patterns in a way that moves towards a more gender equal society. It aims at dealing with

budgetary gender inequality issues, including gender hierarchies and the discrepancies between women's and men's salaries. Gender budgeting allows governments to promote equality through fiscal policies. This practice does not always target intentional discrimination, but rather forces an awareness of the effects of financial schemes on all genders.

## DEFICITS

Revenue account comprises of Revenue receipts and Revenue expenditure; Capital account comprises of capital receipts and capital expenditure; when receipts exceed expenditure it is known as a surplus situation; when expenditure exceeds revenue it is known as a deficit situation

DEFICIT TYPES	DESCRIPTION
BUDGET DEFICIT	TOTAL EXPENDITURE -TOTAL RECEIPTS
MONETIZED DEFICIT	PRINTING OF FRESH CURRENCY (GOVT BORROWING FROM RBI)
FISCAL DEFICIT	TOTAL EXPENDITURE - (REVENUE RECIEPTS + NON-DEBT CREATING CAPITAL RECIEPTS)
PRIMARY DEFICIT	FISCAL DEFICIT - INTEREST PAYMENTS
REVENUE DEFICIT	REVENUE EXPENDITURE - REVENUE RECIEPTS
EFFECTIVE REVENUE DEFICIT	REVENUE DEFICIT - GRANTS FOR CREATION OF CAPITAL ASSETS

## ZERO-BASE BUDGETING

Zero-based budgeting (ZBB) is a method of budgeting in which all expenses must be justified for each new period. The process of zero-based budgeting starts from a "zero base," and every function within an organization is analyzed for its needs and costs. Budgets are then built around what is needed for the upcoming period, regardless of whether each budget is higher or lower than the previous one.

ZBB allows top-level strategic goals to be implemented into the budgeting process by tying them to specific functional areas of the organization, where costs can be first grouped and then measured against previous results and current expectations.

Because of its detail-oriented nature, zero-based budgeting may be a rolling process done over several years, with a few functional areas reviewed at a time by managers or group leaders. Zero-based budgeting can help lower costs by avoiding blanket increases or decreases to a prior period's budget. It is, however, a time-consuming process that takes much longer than traditional, cost-based budgeting.

## Zero-Based Budgeting vs. Traditional Budgeting

Traditional budgeting calls for incremental increases over previous budgets, such as a 2% increase in spending, as opposed to a justification of both old and new expenses, as called for with zero-based budgeting. Traditional budgeting analyzes only new expenditures, while ZBB starts from zero and calls for a justification of old, recurring expenses in addition to new expenditures. Zero-based budgeting aims to put the onus on managers to justify expenses, and aims to drive value for an organization by optimizing costs and not just revenue.

## OUTCOME BUDGETING

Under outcome budgeting, each Ministry presents a preliminary Outcome Budget to the Finance Ministry, which is responsible for compiling them. The Outcome Budget becomes a progress card on what various Ministries and Departments have done with the outlays in the previous annual budget. It measures the development outcomes of all government programmes and whether the money has been spent for the purpose it was sanctioned including the outcome of the fund usage. Outcome budget is a performance measurement tool that helps in:

- Better service delivery
- Decision-making
- Evaluating programme performance and results
- Communicating programme goals
- Improving programme effectiveness
- Make budgets cost effective
- Fix accountability
- Aid better scheme management

**Outcome budgeting makes government programmes more result oriented, instead of outlay oriented.** Under outcome budgeting, the document shows physical dimensions of the financial budget indicating the actual physical performance in the previous year, current year and targeted performance during the projected (next) year.

## DIRECT BENEFIT TRANSFERS (DBT)

Direct Benefits Transfer (DBT) simply involves transferring the subsidy amount and other benefits (called transfers) directly to the beneficiaries' bank accounts instead of providing it through government offices. Transfer means payment made by the government without receiving anything in return from the beneficiary. Subsidies, scholarships are the main example for transfers.

## What are the Advantages of DBT?

The main advantage of the DBT is that leakages are avoided as the government directly provides the fund to the beneficiary. Money is directly sent into the bank account of the beneficiary.

Another advantage of DBT is that it helps the government to better target the beneficiary. Here the facilitating mechanism is Aadhaar. Since Aadhaar is the universal ID, government can identify the beneficiary from his Aadhaar details while connecting it with DBT. The Supreme Court has upheld the validity of Aadhaar as an instrument for identifying beneficiaries of government schemes, initiatives and programmes

## CROWDING OUT

In economics, crowding out is a phenomenon that occurs when increased government involvement in a sector of the market economy substantially affects the remainder of the market, either on the supply or demand side of the market. One type frequently discussed is when expansionary fiscal policy reduces investment spending by the private sector.

Sometimes, government adopts an expansionary fiscal policy stance and increases its spending to boost the economic activity. This leads to an increase in interest rates. Increased interest rates affect private investment decisions. With higher interest rates, the cost for funds to be invested increases and affects their accessibility to debt financing mechanisms. This leads to lesser investments and the prospective investors “Crowd-Out” or postpone their investments decisions. Under such circumstances some investors might shift their interest to off-shore economies.

Long-run crowding out might slow the rate of capital accumulation. If there is less borrowing, less capital accumulation will occur. More capital contributes to an economy’s ability to produce goods and services in the long run. Therefore, a potential long-run impact of deficits and debts is a slower rate of economic growth because the deficit has crowded out private investments in capital.

## FISCAL DRAG AND FISCAL NEUTRALITY

**In a progressive taxation structure not indexed to inflation as the inflation increases the wages or salaries rise (wage-inflation spiral). This causes bracket creep for many individuals and institutions. Hence the government ends up with more than expected revenues. This phenomenon is known as Fiscal Drag.**

Fiscal drag can also work in opposite direction. If there is deflation and falling wages, fewer workers would be in the higher tax bracket. Fiscal drag can be overcome by indexing tax brackets to earnings or inflation. However, this is not usually done.

Fiscal drag has the effect of reducing (or limiting) the aggregate demand and thus becomes an example of a mild deflationary fiscal policy. It could also be viewed as an automatic fiscal stabilizer because higher earnings growth will lead to higher tax and therefore moderate inflationary pressure in the economy. Because **fiscal drag can operate as an economic stabilizer**, fiscal drag can influence economic equality among citizens of the same region.

Fiscal neutrality occurs when taxes and government spending are neutral, with neither affecting demand. Fiscal neutrality creates a condition where demand is neither stimulated nor diminished by taxation and government spending. A balanced budget is an example of fiscal neutrality, where government spending is covered almost exactly by tax revenue – in other words, where tax revenue is equal to government spending.

Fiscal neutrality centers on the idea that a tax should not distort economic behavior. For example, income tax may influence the number of hours a worker is willing to work, possibly their level of effort as well. This is an example of a tax that clearly alters or influences people’s behavior from a state that would have

been different in the absence of a tax. On the other hand, a poll tax (a lump sum on each adult per year) is non-distortionary because it does not affect economic choice. Here, the tax does not affect one's behavior. This is also known as an efficient tax because it doesn't distort economic behavior.

## TOBIN TAX

Tobin tax, proposed tax on short-term currency transactions. A Tobin tax is designed to deter only speculative flows of hot money—money that moves regularly between financial markets in search of high short-term interest rates. It is not meant to impact long-term investments. The shorter the investment cycle (i.e., the time between buying and selling a currency), the higher the effective rate of tax—thus providing market-based incentives for lengthening the term structure of investments.

Although they may be known by other names, such taxes tend to be named after the American economist James Tobin, who first popularized the idea of a levy on currency transactions in the early 1970s. James Tobin won the Nobel Prize for Economics in 1981.

## PUMP PRIMING AND FISCAL STIMULUS PACKAGES

**Pump priming is the action taken to stimulate an economy, usually during a recessionary period, through government spending and interest rate and tax reductions.** The term pump priming is derived from the operation of older pumps - a suction valve had to be primed with water so that the pump would function properly.

Pump priming assumes that the economy must be primed to function properly once again. In this regard, government spending is assumed to stimulate private spending, which in turn should lead to economic expansion.

**Pump priming involves introducing relatively small amounts of government funds into a depressed economy in order to spur growth.** This is accomplished through the increase in purchasing power experienced by those affected by the injection of funds, with the goal of prompting higher demand for goods and services. The increase in demand experienced through pump priming can lead to increased profitability in the private sector, which assists with overall economic recovery.

**Pump priming relates to the Keynesian economic theory, named after noted economist John Maynard Keynes,** which states that government intervention within the economy, aimed at increasing aggregate demand, can result in a positive shift within the economy. This is based on the cyclic nature of money within an economy, in which one person's spending directly relates to another person's earnings, and that increase in earnings leads to a subsequent increase in spending

A stimulus package is a package of economic measures put together by a government to stimulate a floundering economy. **The objective of a stimulus package is to reinvigorate the economy and prevent or reverse a recession by boosting employment and spending.**

The theory behind the usefulness of a stimulus package is rooted in Keynesian economics, which argues that the impact of a recession can be lessened with increased government spending.

A stimulus package is a number of incentives and tax rebates offered by a government to boost spending in a bid to pull a country out of a recession or to prevent an economic slowdown. A stimulus package can either be in the form of a monetary stimulus or a fiscal stimulus. A monetary stimulus involves cutting interest rates to stimulate the economy. When interest rates are cut, there is more incentive for people to borrow as the cost of borrowing is reduced. An increase in borrowing means there'll be more money in circulation, less incentive to save, and more incentive to spend. Lowering interest rates could also weaken the exchange rate of a country, thereby leading to a boost in exports. When exports are increased, more money enters the economy, encouraging spending and stirring up the economy.

Another form of monetary stimulus is quantitative easing, an expansionary monetary policy in which the central bank of a country purchases large quantity of financial assets, such as bonds, from commercial banks and other financial institutions. The purchase of these assets in large amounts increases the excess reserves held by the financial institutions, facilitates lending, increases the money supply in circulation, drives up the price of bonds, lowers the yield, and lowers interest rates. A government will usually opt for quantitative easing when conventional monetary stimulus is no longer effective.

## FRBM AND FISCAL CONSOLIDATION

**The Fiscal Responsibility and Budget Management (FRBM) Act was enacted in 2003 which set targets for the government to reduce fiscal deficits.** The targets were put off several times. In May 2016, the government set up a committee under **NK Singh** to review the **FRBM Act**. The government believed the targets were too rigid. The committee recommended that the government should target a fiscal deficit of 3 per cent of the GDP in years up to March 31, 2020 cut it to 2.8 per cent in 2020-21 and to 2.5 per cent by 2023.

**Fiscal consolidation is a process where government's fiscal health improves over a period of time and such improvement is generally indicated by reduced fiscal deficit.** Improved tax revenue realization and better aligned expenditure are the components of fiscal consolidation as the fiscal deficit reaches at a manageable level. According to Financial time's lexicon, "**Fiscal consolidation is a reduction in the underlying fiscal deficit. It is not aimed at eliminating fiscal debt.**"

In India, fiscal deficit is the prime indicator to show the fiscal health of the government. Effectively, fiscal deficit indicate the amount of government borrowing for that particular year. Excess fiscal deficit produces some adverse effects. For the government it causes interest payment burden and for the economy it produces inflationary effect, and crowding out.

## FISCAL CONSOLIDATION IN INDIA

In India, fiscal consolidation or the fiscal roadmap for the centre is expressed in terms of the budgetary targets (fiscal deficit and revenue deficit) to be realized in successive budgets. The Fiscal Responsibility and Budget Management (FRBM) Act gives the targets for fiscal consolidation in India. According to FRBM, the government should eliminate revenue deficit and reduce fiscal deficit to 3% (medium term) of the GDP. Amendment to the FRBM in 2015 makes a rolling target.

Following measures from the expenditure side and revenue side are envisaged by the government to achieve fiscal consolidation.

- **Improved tax revenue realization:** For this, increasing efficiency of tax administration by reducing tax avoidance, eliminating tax evasion, enhancing tax compliance etc. are essential.
- **Enhancing tax GDP ratio** by widening the tax base and minimizing tax concessions and exemptions also improves tax revenues.
- **Better targeting of government subsidies** and extending **Direct Benefit Transfer** scheme to more subsidies.

Higher economic growth rate will help government to get higher tax revenues. In a country like India augmentation of tax revenue is necessary to bring fiscal consolidation as there are limitations with respect to reduction in government expenditure.

# UNIT-VII

## [INFLATION AND BUSINESS CYCLE]

### INFLATION

In economics, inflation is a sustained increase in the general price level of goods and services in an economy over a period of time. Inflation can also be defined as a scenario where too much money chases too few goods and services. It can also be defined as a sustained fall in the value of money observed over a period of time that generates expectations of a future fall.

When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation reflects a reduction in the purchasing power per unit of money – a loss of real value in the medium of exchange within the economy. This loss of purchasing power impacts the general cost of living for the common public which ultimately leads to a deceleration in economic growth. The consensus view among economists is that sustained inflation occurs when a nation's money supply growth outpaces economic growth.

To combat this, a country's appropriate monetary authority, like the central bank, then takes the necessary measures to keep inflation within permissible limits and keep the economy running smoothly. Inflation is measured in a variety of ways depending upon the types of goods and services considered

### TYPES OF INFLATION

Depending upon the range of increase, and its severity, inflation may be classified into three broad categories.

- a) **Creeping inflation** -Such inflation is slow and on predictable lines. Low inflation takes place in a longer period and the range of increase is usually in 'single digit'.
- b) **Galloping inflation**- When inflation takes place in the range of double-digit or triple-digit in a year it is known as galloping inflation. Terms like **Hopping inflation, Jumping inflation, Running inflation** and **Runaway inflation** are also used to indicate such double or triple digit inflation
- c) **Hyperinflation**- In economics, hyperinflation is very high and typically accelerating inflation. The rise in inflation rate is not only very high but it occurs over a very short period of time often overnight. It quickly erodes the real value of the local currency, as the prices of all goods increase. This causes people to minimize their holdings in that currency as they usually switch to more stable foreign currencies, often the US Dollar.

**Hyperinflation is extremely fast or out-of-control inflation. Hyperinflation occurs when price increases are so wild that the concept of inflation is meaningless.**

### DEMAND PULL AND COST PUSH INFLATION

The terms cost-push inflation and demand-pull inflation are associated with Keynesian Economics. Inflation is caused by some combination of four factors. Those four factors are:

- a) **Demand for goods and services goes up**
- b) **Supply of goods and services goes down**
- c) **Supply of money goes up**
- d) **Demand for money goes down**



Each of these four factors is linked to the core principles of supply and demand, and each can lead to an increase in price or inflation.

## Demand-Pull Inflation

“The inflation resulting from an increase in aggregate demand is called **demand-pull inflation**. Such inflation may arise from any individual factor that increases aggregate demand, but the main ones that increase aggregate demand are:

1. **Increase in the money supply**
2. **Increase in government expenditure**
3. **Increase in the price level in the rest of the world**
4. **Speculation of a future price rise**

Demand pull inflation is caused by increased demand in the economy, without adequate increase in supply of output. The situation of “too much money chasing too few goods” is an instance of demand pull inflation. Inflation caused by an increase in aggregate demand is inflation caused by an increase in the demand for goods. That is to say that when consumers (including individuals, businesses, and governments) all desire to purchase more goods than the economy can currently produce, those consumers will compete to purchase from that limited supply which will drive prices up. Consider this demand for goods a game of tug of war between consumers: as demand increases, prices are «pulled up.»

### How it can be addressed?

Monetary policy is best fit to tackle demand pull inflation. An increase in repo rate will decrease demand for loans for consumption and production and in this way will reduce the demand for commodities. Similarly, additional taxation by the government and reduced public expenditure are also good for demand management.

## Cost-Push Inflation

Cost-push inflation means prices have been “pushed up” by increases in the costs of any of the four factors of production—labour, capital, land, or entrepreneurship—when companies are already running at full production capacity. Companies cannot maintain profit margins by producing the same amounts of goods and services when their costs are higher.

**For cost-push inflation to occur, demand for goods must be static or inelastic.** That means demand must remain constant while the supply of goods and services decreases. One example of cost-push inflation is the oil crisis of the 1970s.

Moreover, cost-push inflation may also be caused by depletion of natural resources, monopoly and so on. There are three kinds of cost-push inflation:

- **Wage-push inflation:** When the monopolistic groups of the society like labour union exercise their monopoly power, to enhance their money wages above the competitive level, which cause an increase in the cost of production.
- **Profit-push inflation:** When the monopoly power is used by the firms operating in the monopolistic and oligopolistic market to increase their profit margin, leading to rise in the price of goods and services (**Cartelisation**).
- **Supply shock inflation:** A type of inflation arising due to unexpected fall in the supply of necessary consumer goods or major industrial inputs.

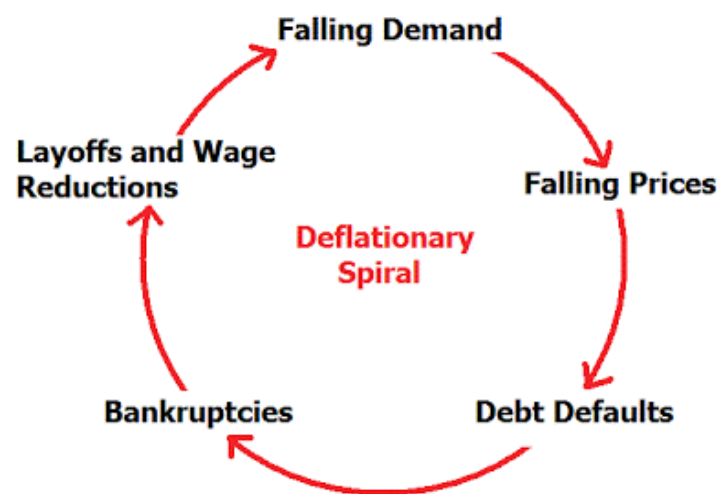
## How it can be addressed?

Administrative controls on price rise and income policy appear as possible solutions that can address cost-push inflation.

## DEFLATION

Deflation is a sustained decrease in the general price level of goods and services in an economy observed over a period of time. **Deflation occurs when the inflation rate falls below 0%**. Deflation happens naturally when the money supply of an economy is fixed. In times of deflation, the purchasing power of currency and wages are higher than they otherwise would have been.

Deflation is caused by a number of factors but is largely attributed to two: a decline in aggregate demand (leftward shift in the aggregate demand curve) and increased productivity. A decline in aggregate demand typically results in subsequent lower prices. Causes of this shift include reduced government spending, stock market failure, consumer desire to increase savings, and tightening monetary policies (higher interest rates). Regarding productivity, companies operate more efficiently as technology advances. These operational improvements lead to lower production costs and cost savings transferred to consumers in the form of lower prices. However Deflation breeds deflation as during deflation consumers postpone their purchases and hence there is further fall in aggregate demand. Thus deflation is often accompanied by unemployment and recession.



Deflation makes it less economical for governments, businesses, and consumers to use debt financing. However, deflation increases the economic power of savings-based equity financing. From an investor's point of view, companies that accumulate large cash reserves or that have relatively little debt are more attractive under deflation. The opposite is true of highly indebted businesses with little cash holdings.

## DISINFLATION

**Disinflation is a decrease in the rate of inflation** – a slowdown in the rate of increase of the general price level of goods and services in a nation's gross domestic product over time. It is the opposite of reflation. **It is used to describe instances when the inflation rate has reduced marginally over the short term. It should not be confused with deflation, which can be harmful to the economy.**

Disinflation is commonly used to describe a period of slowing inflation. Unlike inflation and deflation, which refer to the direction of prices, disinflation refers to the rate of change in the rate of inflation. Although sometimes confused with deflation, disinflation is not considered as problematic because prices do not actually drop, and disinflation does not usually signal the onset of a slowing economy. Deflation is represented as a negative growth rate, such as -1%, while disinflation is shown as a change in the inflation rate from 3% one year to 2% the next.

## INFLATION SPIRAL

The wage-price spiral is an economic term that describes the phenomenon of price increases as a result of higher wages. When workers receive a wage hike, they demand more goods and services and this, in turn, causes prices to rise. The wage increase effectively increases general business expenses that are passed on to the consumer in the form of higher prices. It is essentially a perpetual loop or cycle of consistent price increases. The wage-price spiral reflects the causes and consequences of inflation, and it is, therefore, characteristic of Keynesian economic theory.

## INFLATION TARGETING

In recent years, many central banks, including the RBI, have adopted a technique called inflation targeting to control the general rise in the price level. **In this framework, a central bank estimates and makes public a projected, or “target,” inflation rate and then attempts to steer actual inflation toward that target, using such tools as interest rate changes.**

### Why inflation targeting?

In general, a monetary policy framework provides a nominal anchor to the economy. A nominal anchor is a variable policymakers can use to tie down the price level. One nominal anchor central banks used in the past was a currency peg—which linked the value of the domestic currency to the value of the currency of a low-inflation country. But this approach meant that the country’s monetary policy was essentially that of the country to which it pegged, and it constrained the central bank’s ability to respond to such shocks as changes in the terms of trade (the value of a country’s exports relative to that of its imports) or changes in the real interest rate. As a result, many countries began to adopt flexible exchange rates, which forced them to find a new anchor.

Many central banks then began targeting the growth of money supply to control inflation. This approach works if the central bank can control the money supply reasonably well and if money growth is stably related to inflation over time. Ultimately, monetary targeting had limited success because the demand for money became unstable—often because of innovations in the financial markets. As a result, many countries with flexible exchange rates began to target inflation more directly, based on their understanding of the links or “transmission mechanism” from the central bank’s policy instruments (such as interest rates) to inflation.

### How does inflation targeting work?

Inflation targeting is straightforward, at least in theory. The central bank forecasts the future path of inflation and compares it with the target inflation rate (the rate the government believes is appropriate for the economy). The difference between the forecast and the target determines how much monetary policy has to be adjusted. Some countries have chosen inflation targets with symmetrical ranges around a midpoint, while others have identified only a target rate or an upper limit to inflation. Most countries have set their inflation targets in the low single digits. A major advantage of inflation targeting is that it combines elements of both “rules” and “discretion” in monetary policy. This “constrained discretion” framework combines two distinct elements: a precise numerical target for inflation in the medium term and a response to economic shocks in the short term.

Rather than focusing on achieving the target at all times, the approach has emphasized achieving the target over the medium term—typically over a two- to three-year horizon. This allows policy to address other objectives—such as smoothing output—over the short term. Thus, inflation targeting provides a rule-like framework within which the central bank has the discretion to react to shocks. Because of inflation targeting’s medium-term focus, policymakers need not feel compelled to do whatever it takes to meet targets on a period-by-period basis.

## REFLATION, STAGFLATION AND SKEWFLATION

**Reflation** is the act of stimulating the economy by increasing the money supply or by reducing taxes, seeking to improve aggregate demand in the economy, following a dip in the business cycle. It is the opposite of disinflation. As such, the term “reflation” is also used to describe the first phase of economic recovery after a period of contraction. Reflation policies can include reducing taxes, changing the money supply and lowering interest rates.

### REFLATION IS NEVER BAD

It is important not to confuse reflation with inflation. Firstly, reflation is not bad in that it is a period of price increases when an economy is striving to achieve full employment and growth, whereas inflation is often considered bad as it is characterized by rising prices during a period of full capacity.

**Stagflation** is a condition of slow economic growth and relatively high unemployment, or economic stagnation, accompanied by rising prices, or inflation. It can also be defined as inflation and a decline in gross domestic product (GDP)

Stagflation can prove to be a particularly tough problem for governments to deal with due to the fact that most policies designed to lower inflation tend to make it tougher for the unemployed, and policies designed to ease unemployment cause inflation. Usually, when unemployment is high, spending declines, as do the prices of goods. Stagflation occurs when the prices of goods rise while unemployment increases and spending declines. Stagflation is also considered an unnatural phenomenon since inflation shouldn't happen when an economy is weak. In most cases, weak or slower economic growth should prevent inflation from happening.

### Theories on the Causes of Stagflation

There are two main theories on what causes stagflation. One theory states that this economic phenomenon is caused when a sudden increase in the cost of oil reduces an economy's productive capacity. Because transportation costs rise, producing products and getting them to shelves gets more expensive and prices rise even as people get laid off.

Another theory is that the confluence of stagnation and inflation are results of poorly made economic policy. Simply allowing inflation to go rampant, and then suddenly snapping the reins on inflation is one example of poor policy that some have argued can contribute to stagflation, while others cite harsh regulation of markets, goods and labour combined with excessive printing of currency by central banks as another possible cause of stagflation.

**Stagflation happened in the United States during the 1970s, when the country underwent a recession that saw five quarters of negative GDP growth. Inflation doubled in 1973 and hit double digits in 1974; unemployment hit 9 percent by May 1975.**

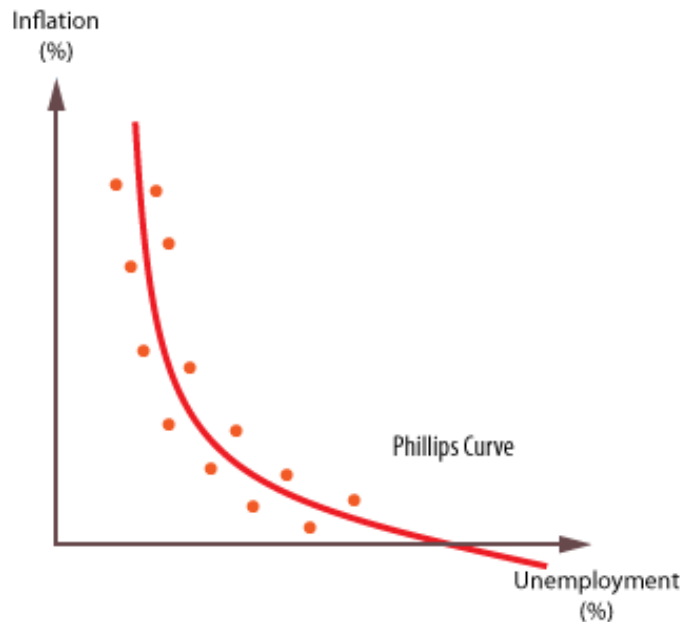
**Skewflation** means the skewness of inflation among different sectors of the economy — some sectors are facing huge inflation, some none and some deflation. Skewflation refers to a situation when inflationary tendencies are visible only in select items. The higher food inflation in India is a case of Skewflation. In other words we can say Skewflation is sustained price rise in some particular commodities only.

## PHILLIP'S CURVE- INFLATION AND UNEMPLOYMENT

The Phillips curve is an economic concept developed by Alban William Housego Phillips, popularly known as Bill Phillips. He was a New Zealander who spent most of his academic career as a professor of economics at the London School of Economics. His best-known contribution to economics is the Phillips curve.

**The Phillips curve shows the relationship between unemployment and inflation in an economy.**

Phillips analysed annual wage inflation and unemployment rates in the UK for the period 1860 – 1957, and then plotted them on a scatter diagram. The data appeared to demonstrate an inverse and stable relationship between wage inflation and unemployment. Later economists substituted price inflation for wage inflation. When economists from other countries undertook similar research, they also found very similar curves for their own economies.



The curve suggested that changes in the level of unemployment have a direct and predictable effect on the level of price inflation. The accepted explanation during the 1960's was that a fiscal stimulus, and increase in Aggregate Demand (AD), would trigger the following sequence of responses:

- An increase in the demand for labour as government spending generates growth.
- The pool of unemployed will fall.
- Firms must compete for fewer workers by raising nominal wages.
- Workers have greater bargaining power to seek out increases in nominal wages.
- Wage costs will rise.
- Faced with rising wage costs, firms pass on these cost increases in higher prices.

It quickly became accepted that policy-makers could exploit the trade-off between unemployment and inflation - a little more unemployment meant a little less inflation.



During the 1960s and 70s, it was common practice for governments around the world to select a rate of inflation they wished to achieve, and then expand or contract the economy to obtain this target rate. This policy became known as stop-go, and relied strongly on fiscal policy to create the expansions and contractions required.

### **The breakdown of the Phillips curve**

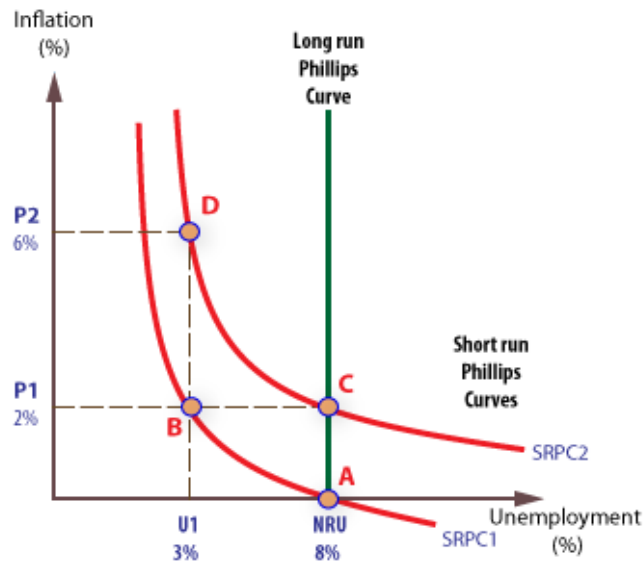
By the mid 1970s, it appeared that the Phillips Curve trade off no longer existed - there no longer seemed a stable pattern. The stable relationship between unemployment and inflation appeared to have broken down. It was possible to have a number of inflation rates for any given unemployment rate.

American economists Friedman and Phelps offered one explanation - namely that there is not one Phillips curve, but a series of short run Phillips Curves and a long run Phillips Curve, which exists at the natural rate of unemployment (NRU). Indeed, in the long-run, there is no trade-off between unemployment and inflation.

### **The new-Classical explanation - the importance of expectations**

Although there are disagreements between new-Classical economists and monetarists, the general line of argument about the breakdown of the Phillips curve runs as follows.

Assume that the economy starts from an equilibrium position at point A, with inflation currently at zero, and unemployment at the natural rate of 10% (NRU = 10%). Secondly, given the public's concern with unemployment, assume the government attempts to expand the economy quickly by way of a fiscal (or monetary) stimulus, so that AD increases and unemployment falls.



Initially, the economy moves to **B**, and there is a fall in unemployment to 3% (at  $U_1$ ) as jobs are created in the short term. Having more bargaining power, workers bid-up their nominal wages. As wage costs rise, prices are driven-up to 2% (at  $P_1$ ). The effects of the stimulus to AD quickly wear out as inflation erodes any gains by households and firms. Real spending and output return to their previous levels, at the NRU.

According to the new-Classical view, what happens next depends upon whether the price inflation has been understood and expected – in which case there is no money illusion – or whether it is not expected – in which case, money illusion exists. If workers have bid-up their wages in nominal terms only, they have suffered from money illusion, falsely believing they will be better off – in this case, the economy will move back to point **A** at the NRU, but with inflation only a temporary phenomenon. However, if they understand that price inflation will erode the value of their nominal wage increases, they will bargain for a wage rise that compensates them for the price rise. Again, the economy will move back to the NRU (with unemployment at 10%), but this time carrying with it the embedded inflation rate of 2% – an move to point **C**. The economy will hop to  $SRPC^2$  (which has a higher level of expected inflation – i.e. 2%, rather than 0%). Any further attempt to expand the economy by increasing AD will move the economy temporarily to **D**. However, in the long-run the economy will inevitably move back to the NRU.

The conclusion drawn was that any attempt to push unemployment below its natural rate would cause accelerating inflation, with no long-term job gains. The only way to reverse this process would be to raise unemployment above the NRU so that workers revised their expectations of inflation downwards, and the economy moved to a lower short-run Phillips curve.

## CONSEQUENCES OF INFLATION

### Effects on Distribution of Income and Wealth

The impact of inflation is felt unevenly by the different groups of individuals within the national economy—some groups of people gain by making big fortune and some others lose.

#### (a) Creditors and debtors:

During inflation creditors lose because they receive in effect less in goods and services than if they had received the repayments during a period of low prices. Debtors, on other hand, as a group gain during inflation, since they repay their debts in currency that has lost its value (i.e., the same currency unit will now buy less goods and services).

**(b) Producers and workers:**

Producers gain because they get higher prices and thus more profits from the sale of their products. As the rise in prices is usually higher than the increase in costs, producers can earn more during inflation. But, workers lose as they find a fall in their real wages as their money wages do not usually rise proportionately with the increase in prices. They, as a class, however, gain because they get more employment during inflation.

**(c) Fixed income-earners:**

Fixed income-earners like the salaried people, rent-earners, landlords, pensioners, etc., suffer greatly because inflation reduces the value of their earnings.

**(d) Investors:**

The investors in equity shares gain as they get dividends at higher rates because of larger corporate profits and as they find the value of their shareholdings appreciated. But the bondholders lose as they get a fixed interest the real value of which has already fallen.

**(e) Traders, speculators, businesspeople and black-marketers:**

They gain because they make more profits from the persistent rise in prices.

**(f) Farmers:**

Farmers also gain because the rise in the prices of agricultural products is usually higher than the increase in the prices of other goods.

Thus, inflation brings a shift in the pattern of distribution of income and wealth in the country, usually making the rich richer and the poor poorer. Thus during inflation there is more and more inequality in the distribution of income.

**Effects on Production**

The rising prices stimulate the production of all goods—both of consumption and of capital goods. As producers get more and more profit, they try to produce more and more by utilising all the available resources at their disposal.

But, after the stage of full employment the production cannot increase as all the resources are fully employed. Moreover, the producers and the farmers would increase their stock in the expectation of a further rise in prices. As a result hoarding and cornering of commodities will increase.

But such favourable effects of inflation upon production are not always found. Sometimes, production may come to a standstill position despite rising prices, as was found in recent years in developing countries like India, Thailand and Bangladesh. This situation is described as stagflation.

**Effects on Income and Employment**

Inflation tends to increase the aggregate money income (i.e., national income) of the community as a whole on account of larger spending and greater production. Similarly, the volume of employment increases under the impact of increased production. But the real income of the people fails to increase proportionately due to a fall in the purchasing power of money.



## Effects on Business and Trade

The aggregate volume of internal trade tends to increase during inflation due to higher incomes, greater production and larger spending. But the export trade is likely to suffer on account of a rise in the prices of domestic goods. However, the business firms expand their businesses to make larger profits. During most inflation since costs do not rise as fast as prices profits soar. But wages do not increase proportionate with prices, causing hardships to workers and making more and more inequality. As the old saying goes, during inflation prices move in escalator and wages in stairs.

## Effects on the Government Finance

During inflation, the government revenue increases as it gets more revenue from income tax, sales tax, excise duties, etc. Similarly, public expenditure increases as the government is required to spend more and more for administrative and other purposes. But the rising prices reduce the real burden of public debt because a fix sum has to be paid in installment per period.

## Effects on Growth

A mild inflation promotes economic growth, but a runaway inflation obstructs economic growth as it raises cost of development projects. Although a mild dose of inflation is inevitable and desirable in a developing economy, a high rate of inflation tends to lower the growth rate by slowing down the rate of capital formation and creating uncertainty.

**The middle-class people suffer hard as the real value of their income becomes very low. Inflation is also unjust as it makes one class of people richer and the other poorer. But the most serious effect of inflation from the standpoint of the economy is that it makes the economic environment of business unstable**

## MEASUREMENT OF INFLATION

Measuring inflation is a difficult problem for statisticians. To do this, a number of goods that are representative of the economy are put together into what is referred to as a “market basket.” The cost of this basket is then compared over time. This results in a price index, which is the cost of the market basket today as a percentage of the cost of that identical basket at some point of reference during the year.

### Measurement of Inflation in India

There are two main set of inflation indices for measuring price level changes in India – the Wholesale Price Index (WPI) and the Consumer Price Index (CPI). The WPI, where prices are quoted from wholesalers, is constructed by Office of Economic Affairs, Ministry of Commerce and Industries. In the case of CPI (prices quoted from retailers), there are several indices to measure it: CPI for industrial labourers (CPI-IL), agricultural labourers (CPI-AL) and rural labourers (CPI-RL) besides an all India CPI.

In addition, Gross Domestic Product (GDP) deflator and Private Final Consumption Expenditure (PFCE) deflator from the National Accounts Statistics (NAS) provide an implicit economy-wide inflation estimate.

## Consumer Price Index

Two Ministries – Ministry of Statistics and Programme Implementation (MOSPI) and Ministry of Labour and Employment (MOLE) are engaged in the construction of different CPIs for different groups/sectors. CPI inflation is also called as retail inflation as the prices are quoted from retailers. Following are the various CPIs.

- a) CPI for all India or CPI combined.
- b) CPI for Agricultural Labourers (AL)
- c) CPI for Rural Labourers (RL); and
- d) CPI for Industrial Workers (IW)

### (i) CPI by MOSPI (CSO)

The CSO, which comes under MOSPI, is constructing the rural, urban and the combined CPIs. They are published from 2011 onwards. Of these, the CPI combined is the most important of all the CPIs as it is relevant for all categories of people.

**In April 2014, the RBI has selected the all India CPI (of CSO) as the inflation index to target inflation under its new inflation targeting monetary policy framework. RBI's decision has made the CPI as the prime inflation index.**

### (ii) CPIs by MOLE (Labour Bureau)

The Labour Bureau, Ministry of Labour and Employment (MOLE) is preparing different indices for various categories of people. These were CPI for Rural Labourers (CPI-RL), CPI for Agricultural Labourers (CPI-AL) and CPI for Industrial Workers (CPI-IW). There was a CPI for Urban Non-Manual Employees (CPI-UME), but it was discontinued from April 2010.

Index	Agency	Base Year	Number of Commodities
WPI	Office of Economic Affairs, Ministry of Commerce and Industries	2011-12	697
CPI All India, CPI -Urban and Rural	CSO, Ministry of Statistics and Programme Implementation	2012	448 (rural) 460 (urban)
CPI-AL	Labour Bureau, Ministry of Labour and Employment	1986-87	
CPI-RL		1986-87	
CPI-IW	Labour Bureau, Ministry of Labour and Employment	2001	

Since these CPIs were for specific categories of workers, it lacked the quality of an all India index. On the other hand, the first three indices are for specific occupational categories. The CPI compiled and released at national level by MOLE reflect fluctuations in retail prices relating to specific segments of population in the country like industrial Workers (CPI-IW), agricultural laborers (CPI-AL) and rural labourers (CPI-RL).

### What is the difference between the various CPIs?

Difference between the various CPIs is not just that they measure price level changes for different sectors or groups. In addition to such a sector specific price level measurement; these indices differ in terms of their geographical coverage, commodities included, weights assigned to the different commodity groups and the base year on the basis of which price level changes are compared.

### The Wholesale Price Index (WPI)

The WPI is published by the Office of Economic Adviser, Ministry of Commerce and Industry. It is in use since 1942 and is being published from 1947 regularly. It has a long history for serving as the nationwide inflation indicator till the emergence of the combined CPI in 2011. An important feature of the WPI which separate it from the CPI is that prices are collected from wholesalers.

### POINT TO POINT INFLATION

Point to Point Inflation compares the rate of inflation prevalent during the present week of a particular month to the prices prevalent during the same week of that particular month in the previous year (or Base Year). Theoretically it can be defined as a measure that compares prices at two corresponding similar points.

### CORE INFLATION

Core inflation is the change in costs of goods and services, but does not include those goods and services that face high volatility in prices. In other words it is an inflation measure which excludes transitory or temporary price volatility as in the case of some commodities such as food items, energy products etc.

### GDP DEFLATOR

The GDP deflator, also called implicit price deflator, is a measure of inflation. It is the ratio of the value of goods and services an economy produces in a particular year at current prices to that of prices that prevailed during the base year.

This ratio helps show the extent to which the increase in gross domestic product has happened on account of higher prices rather than increase in output. Since the deflator covers the entire range of goods and services produced in the economy — as against the limited commodity baskets for the wholesale or consumer price indices — it is seen as a more comprehensive measure of inflation.

$$\text{GDP Deflator} = \frac{\text{Nominal GDP}}{\text{Real GDP}} * 100$$

### Real vs Nominal GDP

GDP price deflator measures the difference between real GDP and nominal GDP. Nominal GDP differs from real GDP as the former doesn't include inflation, while the latter does. As a result, nominal GDP will most often be higher than real GDP in an expanding economy.

## ECONOMIC CYCLE

All countries experience regular ups and downs in the growth of output, jobs, income and spending.

### Boom

- A boom occurs when real national output is rising at a rate faster than the trend rate of growth. Some of the characteristics of a boom include:
- A fast growth of consumption helped by rising real incomes, strong confidence and a surge in house prices and share prices
- A pickup in demand for capital goods as businesses invest in extra capacity to meet strong demand and to make higher profits
- More jobs created and falling unemployment and higher real wages
- High demand for imports which may cause the economy to run a larger trade deficit because it cannot supply all of the goods and services that consumers are buying
- Government tax revenues will be rising as people earn and spend more and companies are making larger profits – this gives the government money to increase spending in areas such as education, the environment, health and transport
- An increase in inflationary pressures if the economy overheats and has a positive output gap

### Slowdown

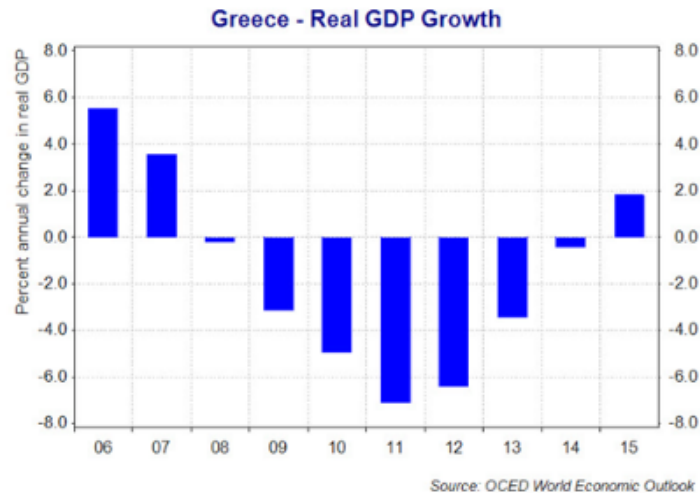
- A slowdown occurs when the rate of growth decelerates – but national output is still rising
- If the economy grows without falling into recession, this is called a soft-landing

### Recession

A recession means a fall in the level of real national output i.e. a period when growth is negative, leading to a contraction in employment, incomes and profits. **Generally a fall in real GDP for two consecutive quarters i.e. six months is considered as recession.**

## The Difference between Recession and Depression

- A depression is a prolonged slump where real GDP falls by more than 10% from the peak of the cycle to the trough
- In Greece, real GDP has fallen in seven successive years and real GDP is more than 25% lower than at the peak of the cycle

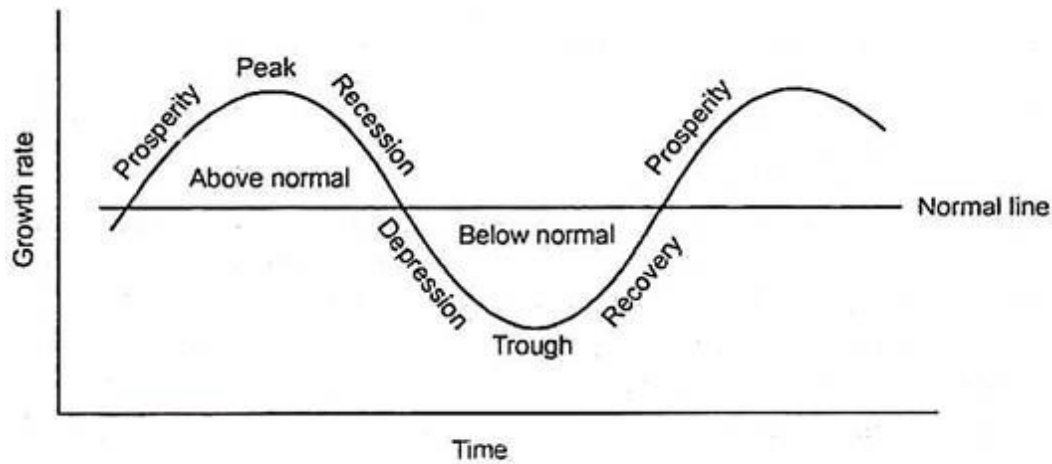


A recession is a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in real GDP, real income, employment, industrial production, and retail sales. There are many symptoms of a recession – here is a selection of key indicators:

- A fall in purchases of components and raw materials (i.e. intermediate products)
- Rising unemployment and fewer job vacancies available for people looking for work
- A rise in the number of business failures and businesses announcing lower profits and investment
- A decline in consumer and business confidence
- A contraction in consumer spending & a rise in the percentage of income saved
- A drop in the value of exports and imports of goods and services
- Large price discounts offered by businesses in a bid to sell their excess stocks
- Heavy de-stocking as businesses look to cut back when demand is weak – causes lower output
- Government tax revenues are falling and welfare benefit spending is rising
- The budget (fiscal) deficit is rises quickly.

### Recovery

This occurs when real GDP picks up from the trough reached at the low point of the recession. The state of business confidence plays a key role here. Any recovery might be subdued if businesses anticipate that it will be temporary or weak in scale. A recovery might follow a deliberate attempt to stimulate demand.



Phases of business cycle

### Why is GDP growth difficult to forecast?

When economists make forecasts about the future path for an economy they have to accept the inevitability of forecast errors. No macroeconomic model can hope to cope with the fluctuations and volatility of indicators such as inflation, exchange rates and global commodity prices. Hence many factors that make it difficult to make a forecast include

- Uncertain business confidence levels
- Fluctuations in exchange rate
- External events e.g. volatile oil and gas prices
- Uncertain reactions to macro policy changes
- Rate of business job creations

# UNIT-VIII

## [MONETARY POLICY AND BANKING]

### RESERVE BANK OF INDIA (RBI)



### Reserve Bank of India

- **1926:** The Royal Commission on Indian Currency and Finance recommended the creation of a central bank for India.
- **1927:** A bill to give effect to the above recommendation was introduced in the Legislative Assembly. But it was later withdrawn due to lack of agreement among various sections of people.
- **1933:** The White Paper on Indian Constitutional Reforms recommended the creation of a Reserve Bank. A fresh bill was introduced in the Legislative Assembly.
- **1934:** The Bill was passed and received the Governor General's assent
- **1935:** The Reserve Bank commenced operations as India's central bank on April 1 as a private shareholders' bank with a paid up capital of rupees five crores (rupees fifty million).
- **1942:** The Reserve Bank ceased to be the currency issuing authority of Burma (now Myanmar).
- **1947:** The Reserve Bank stopped acting as banker to the Government of Burma.
- **1948:** The Reserve Bank stopped rendering central banking services to Pakistan.
- **1949:** The Government of India nationalized the Reserve Bank under the Reserve Bank (Transfer of Public Ownership) Act, 1948.

Currently, the Bank's Central Office, located at Mumbai, has twenty-seven departments. These departments frame policies in their respective work areas. They are headed by senior officers in the rank of Chief General Manager.

### Structure of the RBI

The central board of directors is the main committee of the central bank. The Government of India appoints the directors for a four-year term. The Board consists of a governor, and not more than four deputy governors; four directors to represent the regional boards— usually the Economic Affairs Secretary and the Financial Services Secretary — from the Ministry of Finance and 10 other directors from various fields.

Two of the four deputy governors are traditionally from RBI ranks and are selected from the Bank's Executive Directors. One is nominated from among the Chairpersons of public sector banks and the other is an economist. An Indian Administrative Service officer can also be appointed as deputy governor of RBI and later as the governor of RBI as with the case of Y. Venugopal Reddy and Duvvuri Subbarao.

## Branches of the RBI

The RBI has four regional representations viz. New Delhi, Chennai, Kolkata and Mumbai. The regional representations, each formed of five members who are appointed for a period of four years by the central government on the advice of the central board of directors, serve as forum for regional banks and perform such tasks that are delegated by the Central Board of Directors from time to time.

## Supporting Bodies

It has two training colleges for its officers, viz. Reserve Bank Staff College, Chennai and College of Agricultural Banking, Pune. There are three autonomous institutions run by RBI namely National Institute of Bank Management (NIBM), Indira Gandhi Institute of Development Research (IGIDR), Institute for Development and Research in Banking Technology (IDRBT). There are also four Zonal Training Centres at Mumbai, Chennai, Kolkata and New Delhi.

## FUNCTIONS OF THE RBI

The main functions of the RBI include:

- **Monetary authority:** formulates, implements, and monitors India's monetary policy. The main objectives of which are maintaining price stability, ensuring adequate flow of credit to productive sectors, and financial stability
- **Issuer of currency:** issues currency and coins, and exchanges or destroys currency notes and coins unfit for circulation
- **Banker and debt manager to government of India:** performs merchant banking functions for central and state governments and also acts as their banker. It determines how best to raise money in debt markets to help the government finance its requirements.
- **Banker to banks:** RBI enables clearing and settlement of inter-bank transactions, maintains banks' accounts for statutory reserve requirements, and acts as lender of last resort
- **Regulator and supervisor of the financial system:** protects the interests of depositors, facilitates orderly development and conduct of banking operations, and maintains financial stability through preventive and corrective measures
- **Manager of foreign exchange:** regulates transactions related to the external sector, enables development of the foreign exchange market (forex), ensures smooth functioning of the domestic forex market, and manages India's foreign currency assets and gold reserves
- **Regulator and supervisor of payment and settlement systems:** The Payment and Settlement Systems Act of 2007 (PSS Act) gives the Reserve Bank oversight authority, including regulation and supervision, for the payment and settlement systems in the country. In this role, the RBI focuses on the development and functioning of safe, secure and efficient payment and settlement mechanisms. Two payment systems National Electronic Fund Transfer (NEFT) and Real Time Gross Settlement (RTGS) allow individuals, companies and firms to transfer funds from one bank to another. These facilities can only be used for transferring money within the country.
- **Maintaining financial stability:** an explicit objective of the RBI since the early 2000s



- **Development:** RBI ensures credit availability to productive economic sectors, establishes institutions to develop India's financial infrastructure, expands access to affordable financial services, and promotes financial education and literacy

### MINIMUM RESERVE SYSTEM

**Under the Minimum Reserve System, the RBI has to keep a minimum reserve of Rs 200 crore comprising of gold coin and gold bullion and foreign currencies. Out of the total Rs 200 crores, Rs115 crore should be in the form of gold coins or gold bullion. Under the Minimum Reserve System, RBI can issue unlimited amount of currency by keeping the reserve. But RBI follows some principle or rule for issuing new currencies based upon economic growth and transaction needs of the people.**

### How RBI issues new currencies?

For every year, RBI makes a money supply expansion target based on the expected economic growth. Higher the economic growth, higher will be the expansion of newly issued money by the RBI. This strategy helps RBI to contain inflation as well as enabling people to meet their transaction needs.

Similarly, the RBI secures assets while issuing new currency into the economy. These assets are foreign currencies or government bonds. Every unit of new currency is a liability of the RBI. To match this liability, there should be equal volume of assets as well. The procured foreign currency and government bonds constitute to the assets of the RBI whereas the newly issued currency is its liability. Foreign currencies purchased by the RBI are kept at Banking Department whereas the reserves used for issuing new currency (under MRS) is kept at Issue Department.

### MONETARY POLICY COMMITTEE

The Monetary Policy Committee (MPC) is a committee of the central bank — Reserve Bank of India, headed by its Governor. It was set up by amending the RBI Act after the government and RBI agreed to task RBI with the responsibility for price stability and inflation targeting. The RBI and the government signed the Monetary Policy Framework Agreement on February 20, 2015.

### Structure of the MPC

The Monetary Policy Committee (MPC) is formed under the RBI with six members. Three of the members are from the RBI while the other three members are appointed by the government. Members from the RBI are the Governor who is the chairman of the MPC, a Deputy Governor and one officer of the RBI. The government members are appointed by the Centre on the recommendations of a search-cum-selection committee which is to be headed by the Cabinet Secretary.

The Committee is to meet at least four times a year and make public its decisions following each meeting. The quorum for the meeting of the MPC is four members. There will be no reappointment of the committee.

Under MPC, the governor has a casting vote and doesn't enjoy veto power (there was veto power for him under Technical Advisory Committee (TAC)). Decisions will be taken on the basis of majority vote.

## Function of the MPC

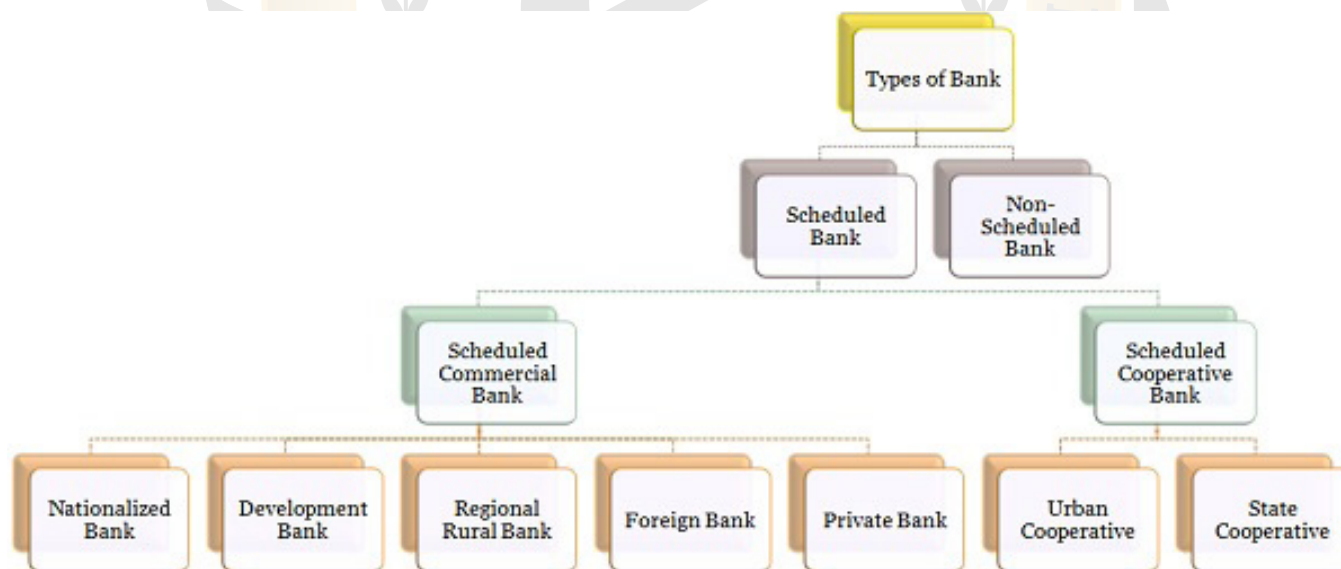
The main responsibility of the MPC will be to achieve the inflation targets set by the RBI. The MPC decides the changes to be made to the policy rate (repo rate) to contain inflation within the target (based on CPI) level set under India's inflation targeting regime. Members of the MPC can suggest reasons for their support or opposition for a policy rate change. This will be published in the minutes of the MPC and the minutes should be published after 14 days of MPC meeting. The minutes should contain the reasons for each member proposing or opposing the monetary policy decision taken by the MPC.

In case the inflation target is not achieved (2% higher or lower than the set target of 4% for continuous three quarters), the RBI has to give an explanation to the government about the reasons, the remedial actions and the estimated time for realizing the target. Another responsibility for the RBI is to publish a Monetary Policy Report every six months, elaborating inflation forecasts and inflation sources for the next six to eighteen months.

The government may, if it considers necessary, convey its views, in writing, to the MPC from time to time. RBI is mandated to furnish necessary information to the MPC to facilitate their decision making.

## SCHEDULED AND NON-SCHEDULED BANKS

Banking sector of India can be broadly divided into two major groups' i.e. scheduled banks and Non-Scheduled Banks. Banks which have been included in the second schedule of the RBI Act, 1934 are called Scheduled Banks while non scheduled banks are not included in the second schedule of the RBI Act, 1934.



BASIS FOR COMPARISON	SCHEDULED BANKS	NON-SCHEDULED BANKS
Meaning	A Scheduled bank is a banking corporation whose minimum paid up capital is Rs. 5 lakhs and does not harm the interest of the depositors.	Non-scheduled banks are the banks which do not comply with the rules specified by the Reserve Bank of India, or say the banks which do not come under the category of scheduled banks.
Second Schedule	Listed in the second schedule.	Not-listed in the second schedule.
Cash Reserve Ratio	Maintained with RBI.	Maintained with themselves.
Borrowing	Scheduled banks are allowed to borrow money from RBI for regular banking purposes.	Non-Scheduled banks are not allowed to borrow money from RBI for regular banking purposes.
Returns	To be submitted periodically.	No such provision of submitting periodic returns.
Members of clearing house	It can become a member of clearing house.	It cannot become member of clearing house.

## QUANTITATIVE CREDIT CONTROL MEASURES

Credit control is most important function of Reserve Bank of India. Credit control in the economy is required for the smooth functioning of the economy. RBI tries to maintain monetary stability. There are two types of credit control mechanisms employed by the RBI, they are:

- Quantitative Credit Control Mechanisms
- Qualitative Credit Control Mechanisms

**By quantitative credit control we mean the control of the total quantity of credit.**

For Example- let us consider that the Central Bank, on the basis of its calculations, considers that Rs. 50,000 is the maximum safe limit for the expansion of credit. But the actual credit at that given point of time is Rs. 55,000. Thus it then becomes necessary for the central bank to bring it down to 50,000 by tightening its policies. Similarly if the actual credit is less, say 45,000, then the apex bank regulates its policies in favor of pumping credit into the economy. Different tools used under this method are-

**Bank rate-** Section 49 of the Reserve Bank of India Act 1934 defines Bank Rate as “the standard rate at which it (RBI) is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under this Act”.

When the commercial bank for instance, has lent or invested all its available funds and has little or no cash over and above the prescribed minimum, it may ask the central bank for funds. It may either re-discount some of its bills with the central bank or it may borrow from the central bank against the collateral of its own promissory notes.

In either case, the central bank accommodates the commercial bank and increases the latter's cash reserves. This Rate is increased during the times of inflation when the money supply in the economy has to be controlled.

At any time there are various rates of interest ruling at the market, like the deposit rate, lending rate of commercial banks, market discount rate and so on. But, since the central bank is the leader of the money market and the lender of the last resort, all other rates are closely related to the bank rate. The changes in the bank rate are, therefore, followed by changes in all other rates as the money market.

**Cash Reserve Ratio (CRR)** - Cash Reserve Ratio (CRR) is the share of a bank's total demand and time liabilities that is mandated by the Reserve Bank of India (RBI) to be maintained with the latter in the form liquid cash.

In order to determine the base rate, the Cash Reserve Ratio acts as one of the reference rates. Base rate means the minimum lending rate which is determined by the Reserve Bank of India (RBI) and no bank is allowed to lend funds below this rate. This rate is fixed to ensure transparency with respect to borrowing and lending in the credit market. The Base Rate also helps the banks to cut down on their cost of lending so as to be able to extend affordable loans. Apart from this, there are two main objectives of Cash Reserve Ratio:

- Cash Reserve Ratio ensures that a part of the bank's deposit is with the Central Bank and is hence, safe
- Another objective of CRR is to keep inflation under control. During high inflation in the economy, RBI increases the CRR.

**Statutory Liquidity Ratio (SLR)** - Every bank must have a minimum portion of their Net Demand and Time Liabilities (NDTL) in the form of cash, gold or other liquid assets by the day's end. The ratio of these liquid assets to the demand and time liabilities is called as the Statutory Liquidity Ratio.

**The Reserve Bank of India has the authority to increase this ratio up to 40%.** The increase in this ratio constricts the ability of the bank to inject money into the economy. SLR (among other tools) is instrumental in ensuring the solvency of the banks and money flow in the economy. **Section 24 and Section 56 of the Banking Regulation Act 1949 mandates all commercial banks in India to maintain SLR.** The main purpose of SLR is to ensure success of the government's borrowing programme. The SLR liquidity is mostly parked in G-secs.



## DIFFERENCE BETWEEN SLR AND CRR

Statutory Liquidity Ratio (SLR)	Cash Reserve Ratio (CRR)
In case of SLR, banks are asked to have reserves of liquid assets which include both cash and gold.	The CRR requires banks to have only cash reserves with the RBI
Banks earn returns on money parked as SLR	Banks don't earn returns on money parked as CRR
SLR is used to control the bank's leverage for credit expansion.	The Central Bank controls the liquidity in the Banking system with CRR.
In case of SLR, the securities are kept with the banks themselves which they need to maintain in the form of liquid assets.	In CRR, the cash reserve is maintained by the banks with the Reserve Bank of India.

"Empowering Endeavours"

## LIQUID ASSETS

These are assets one can easily convert into cash – like gold, treasury bills, govt-approved securities, government bonds and cash reserves. Additionally, it also consists of securities, eligible under Market Stabilization Schemes and those under the Market Borrowing Programmes.

## NET DEMAND AND TIME LIABILITIES

NDTL refers to the total demand and time liabilities (deposits) that is held by the banks of public and with other banks. Demand deposits consist of all liabilities which the bank needs to pay on demand. They include current deposits, demand drafts, balances in overdue fixed deposits and demand liabilities portion of savings bank deposits.

Time deposits consist of deposits that need to repay on maturity, where the depositor can't withdraw money immediately. Instead, he must wait until the lock-in tenure is over to access the funds. Fixed deposits, time liabilities portion of savings bank deposits and staff security deposits are some examples. The liabilities of a bank include call money market borrowings, certificate of deposits and investment deposits in other banks.

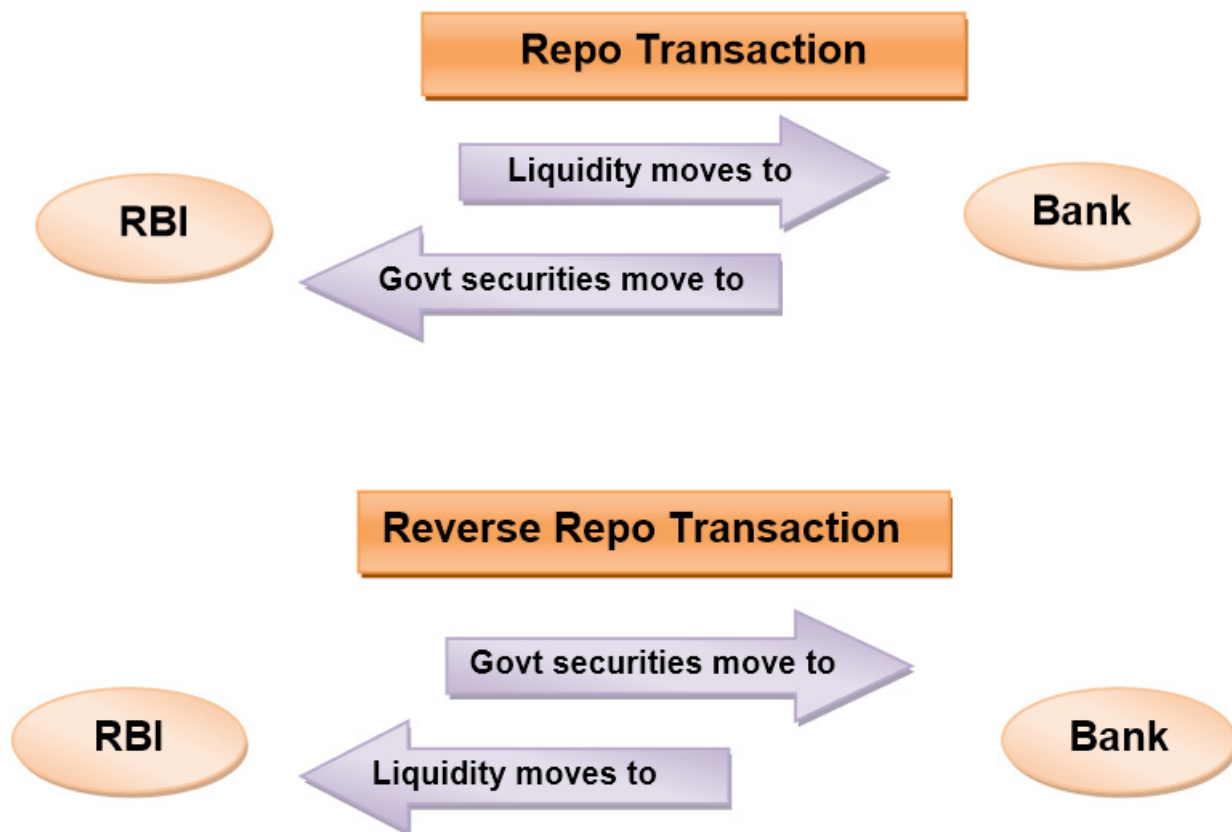
## LEGAL TENDERS

Legal tender is any official medium of payment recognized by law that can be used to extinguish a public or private debt, or meet a financial obligation. The national currency is legal tender in practically every country. A creditor is obligated to accept legal tender toward repayment of a debt. Legal tender can only be issued by the national body that is authorized to do so, such as the U.S. Treasury in the United States, the Royal Canadian Mint in Canada or the RBI in India

## LIQUIDITY ADJUSTMENT FACILITY (LAF)

A liquidity adjustment facility (LAF) is a tool used in monetary policy, primarily by the Reserve Bank of India (RBI) that allows banks to borrow money through repurchase agreements (repos) or for banks to make loans to the RBI through reverse repo agreements. This arrangement manages liquidity pressures and assures basic stability in the financial markets. In the United States, the Federal Reserve transacts repos and reverse repos under its open market operations. **The RBI introduced the LAF as a result of the Narasimham Committee on Banking Sector Reforms (1998).**

**Open Market Operations (OMOs)** - Open market operations (OMO) refer to a central bank's buying and selling of government securities in the open market in order to expand or contract the amount of money in the banking system. Securities' purchases inject money into the banking system and stimulate growth, while sales of securities do the opposite and contract the economy. RBI conducts the OMOs through Repo and Reverse Repo systems.



**REPO-** Repo stands for '**Repurchasing Option**'. It is a contract in which banks provide eligible securities such as Treasury Bills to the RBI while availing overnight loans. An agreement to buy them back at a predetermined price will also be in place. The interest rate levied on these kinds of repo transactions is known as the Repo rate. Through Repo mechanism the Central Bank injects liquidity into the system. REPOs range from overnight to 7-day REPO to 14-day Repo.

The components of a repo transaction between the RBI and the bank are as follows:

- Banks provide eligible securities (RBI-recognized securities that are above the Statutory Liquidity Ratio limit).
- RBI generally gives 1 day or overnight loan to the bank.
- RBI charges an interest (repo rate) from the bank.
- Banks repay the loan after one day and repurchase the security they gave as collateral.

**REVERSE REPO-** A Reverse Repo Rate is a rate that RBI offers to banks when they deposit their surplus cash with RBI for shorter periods. In other words, it is the rate at which the RBI borrows from the commercial banks. When banks have excess funds, but don't have any other lending or investment options, they deposit/lend the surplus funds with the RBI. This way banks can raise additional interest from their funds.

The reverse repo rate has an inverse relationship with the money supply in the economy. During high levels of inflation in the economy, the RBI increases the reverse repo. It encourages the banks to park

more funds with the RBI to earn higher returns on idle cash. As a result, every excess rupee is put to use in banking system. Banks are left with lesser cash to extend loans, curbing the purchasing power of individuals.

Repo Rate	Reverse Repo Rate
It is the rate at which RBI lends money to the banks	It is the rate at which RBI borrows money from banks
It is higher than reverse repo rate	It is lower than repo rate
It is used to control inflation	It is used to control money supply
It involves sale of securities which would be repurchased in future.	It involves transfer of money from one account to another.

### MARGINAL STANDING FACILITY (MSF)

Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely. Under MSF banks borrow from the central bank by pledging government securities at a rate higher than the repo rate under liquidity adjustment facility or LAF. The MSF rate is pegged 100 basis points or a percentage point above the repo rate. Under MSF, banks can borrow funds up to one percentage of their net demand and time liabilities (NDTL).

### PRIORITY SECTOR LENDING (PSL)

Priority Sector Lending refers to those sectors of the economy which may not get timely and adequate credit in the absence of this special dispensation. **Priority Sector Lending** is an important role given by the Reserve Bank of India (RBI) to the banks for providing a specified portion of the bank lending to few specific sectors like agriculture and allied activities, micro and small enterprises, poor people for housing, students for education and other low income groups and weaker sections.. This is essentially meant for an all round development of the economy as opposed to focusing only on the financial sector.

## QUALITATIVE CREDIT CONTROL MEASURES

The qualitative or selective methods of credit control are adopted by the Central Bank in its pursuit of economic stabilisation and as part of credit management.

**By Quality we mean the uses to which bank credit is directed.**

For example- the bank may feel that spectators or the big capitalists are getting a disproportionately large share in the total credit, causing various disturbances and inequality in the economy, while the small-scale industries, consumer goods industries and agriculture are starved of credit.

Correcting this type of discrepancy is a matter of qualitative credit control. Qualitative method controls the manner of channelizing of cash and credit in the economy. It is a 'selective method' of control as it restricts credit for certain section where as expands for the other known as the 'priority sector' depending on the situation. Tools used under this method are-



**Margin Requirements-** Changes in margin requirements are designed to influence the flow of credit against specific commodities. The commercial banks generally advance loans to their customers against some security or securities offered by the borrower and acceptable to banks.

More generally, the commercial banks do not lend up to the full amount of the security but lend an amount less than its value. The margin requirements against specific securities are determined by the Central Bank. A change in margin requirements will influence the flow of credit. For eg- a person mortgages his property worth Rs. 100,000 against loan. The bank will give loan of Rs. 80,000 only. The marginal requirement here is 20%.

A rise in the margin requirement results in a contraction in the borrowing value of the security and similarly, a fall in the margin requirement results in expansion in the borrowing value of the security. The Reserve Bank of India has been using this method since 1956.

**Rationing of credit-** Rationing of credit is a method by which the Central Bank seeks to limit the maximum amount of loans and advances and, also in certain cases, fix ceiling for specific categories of loans and advances.

In this the Central Bank discourages the granting of loans to stock exchanges by refusing to re-discount the papers of the bank which have extended liberal loans to the speculators. This is an important method of credit control and this policy has been adopted by a number of countries like Russia and Germany.

**Direct Action:-** Under this method if the Commercial Banks do not follow the policy of the Central Bank, then the Central Bank has the only recourse to direct action. This method can be used to enforce both quantitatively and qualitatively credit controls by the Central Banks. This method is not used in isolation; it is used as a supplement to other methods of credit control.

Direct action may take the form either of a refusal on the part of the Central Bank to re-discount for banks whose credit policy is regarded as being inconsistent with the maintenance of sound credit conditions. Even then the Commercial Banks do not fall in line, the Central Bank has the constitutional power to order for their closure.

This method can be successful only when the Central Bank is powerful enough and has cordial relations with the Commercial Banks. Mostly such circumstances are rare when the Central Bank is forced to resist to such measures.

**Regulation of Consumer's Credit-** Regulation of consumer credit is designed to check the flow of credit for consumer durable goods. This can be done by regulating the total volume of credit that may be extended for purchasing specific durable goods and regulating the number of installments through which such loan can be spread. Central Bank uses this method to restrict or liberalise loan conditions accordingly to stabilise the economy.

**Moral Suasion-** This method is also known as "moral persuasion" as the method that the Reserve Bank of India, being the apex bank uses here, is that of persuading the commercial banks to follow its directions/orders on the flow of credit. It also be part of meetings between RBI and Commercial Banks. RBI persuades the commercial bank to follow their policies. RBI puts a pressure on the commercial banks to put a ceiling on credit flow during inflation and be liberal in lending during deflation.

**Publicity-** RBI uses media for the publicity of its views on the current market condition and its directions that will be required to be implemented by the commercial banks to control the unrest. Though this method is not very successful in developing nations due to lack of banking literacy which makes it difficult for people to understand such policies and its implications

# UNIT-IX

## [EXTERNAL SECTOR]

### CURRENT ACCOUNT AND FOREIGN TRADE

The current and capital accounts represent two halves of a nation's balance of payments. The current account represents a country's net income over a period of time, while the capital account records the net change of assets and liabilities during a particular year.

#### Definition of Current Account

The Balance of Payment is a set of accounts which comprises of two major accounts, one of which is the Current Account. **Current Account is the record of the inflow and outflow of money to and from the country during a year, due to the trading of commodity, service, and income.** The account is an indicator of the status of the economy. The major components of a current account are:

- **The Balance of Trade (only visible items i.e. goods):** Goods imported and exported to and from the country.
- **Trading of Services:** Services received from other countries and rendered to other nations.
- **Net investment income:** Income from foreign investment less payments on foreign investments.
- **Net transfers:** Current transfers in the form of donations, gifts, aids, remittances etc. form part of net cash transfer.

Current Account is the record of the exchange of commodities and services for the recent period. It shows the flow of foreign trade. In India, reporting of the account is done by the Central Bank. If the account shows a negative balance, then it means that the imports are greater than exports or consumption exceeds savings. Similarly, if there is a positive balance, then it is a symbol of exports over imports.

#### Calculation of the Current Account

Normally, the current account is calculated by adding up the 4 components of current account: goods, services, income and current transfers.

**Goods or Merchandise-** Being movable and physical in nature, goods are often traded by countries all over the world. When a transaction of certain good's ownership from a local country to a foreign country takes place, this is called an "export". The other way around, when a good's owner changes to a local inhabitant from a foreigner, is defined to be an "import". In calculating current account, exports are marked as credit (the inflow of money) and imports as debit (the outflow of money).

**Services-**When an intangible service (e.g. tourism) is used by a foreigner in a local land and the local resident receives the money from a foreigner, this is also counted as an export, thus a credit.

**Income-**A credit of income happens when an individual or a company of domestic nationality receives money from a company or individual with foreign identity. A foreign company's investment upon a domestic company or a local government is considered as a debit.

**Current transfers-**Current transfers take place when a certain foreign country simply provides currency to another country with nothing received as a return. Typically, such transfers are done in the form of donations, aids, remittances or official assistance.

A country's current account can be calculated by the following formula:

$$CA = (X - M) + NY + NCT$$

Where CA is the current account, X and M are respectively the export and import of goods and services, NY the net income from abroad, and NCT the net current transfers.

### BALANCE OF TRADE (BoT)

In India Balance of trade is the difference in the value of exports and imports of only visible or tangible items (merchandise). Balance of trade or BoT includes imports and exports of goods alone i.e., visible items. If exports exceed imports it is referred to as trade surplus and when imports exceed exports it is referred to as Trade Deficit.

### BALANCE OF INVISIBLES (BoI)

Balance of Invisibles (BoI) refers to the difference between inflows and outflows of services, income and transfers. In other words it includes all those inflows and outflows of the current account that are non-tangible in nature or are invisible.

### CURRENT ACCOUNT DEFICIT (CAD)

A current account deficit happens when a country spends more money on what it imports compared to the money it receives for what it exports. That means there is more money leaving the country than there is coming in. The current account of a country is the money it receives and pays for goods and services, investments, and other things such as any money sent abroad, salaries, and pensions. Current account deficits mainly occur in developed or underdeveloped countries. The current accounts of emerging markets typically operate in a surplus.

A deficit isn't necessarily a bad thing. A country may have a deficit because it is importing the inputs it needs to produce goods and services it will export in the future. In that case, it may plan to create a current account surplus, which ultimately makes it an attractive investment opportunity for foreigners. The deficit may be problematic, though, if a country decides to overspend on its exports when it could be spending money on domestic production.

The longer a deficit remains on a country's books; the worse off it will be for its future generations. That means they will be saddled with excessive levels of debt and heavy interest payments to make to its creditors.

When a country has a deficit, it must find a way to make up for the shortfall. Deficits are reduced through the capital account, which records transactions between entities in one country and those in the rest of the world. That means the deficit can be reduced through the sale of assets, foreign currency, and through foreign direct investment.

Another way to reduce the deficit is to increase the value of its exports compared to its imports. But this can put economic or political pressure from international trade partners in the form of tariffs.

CURRENT ACCOUNT
1. EXPORTS
2. IMPORTS
3. TRADE BALANCE (1-2)
4. INVISIBLES (NET)
<ul style="list-style-type: none"> <li>• Services</li> <li>• Income</li> <li>• Transfers</li> </ul>
5. GOODS & SERVICES BALANCE
6. CURRENT ACCOUNT BALANCE (3 + 4)

### TWIN DEFICIT (TD)

Economies that have both a Fiscal Deficit (FD) and a Current Account Deficit (CAD) are often referred to as having "twin deficits." India suffers from twin deficit

## CAPITAL ACCOUNT AND FOREIGN INFLOWS

The capital account of BoP records all such transactions between residents of a country and the rest of the world which relate to purchase and sale of foreign assets and liabilities during a year. In short, it is a record of inflows and outflows of capital which brings a change in a country's foreign assets and liabilities. Capital account flows consist of investments, loans, commercial borrowings, banking, capital, etc.

### Components of Capital Account

**External Assistance** - External Assistance to India denotes multilateral and bilateral loans received under the agreements between Government of India and other Governments/International institutions and repayments of such loans by India, except loan repayment to erstwhile Rupee area countries that are covered under the Rupee Debt Service. External assistance by India denotes aid extended by India to other foreign Governments under various agreements and repayment of such loans.

**External Commercial Borrowings**- External Commercial Borrowing (ECBs) are loans in India made by non-resident lenders in foreign currency to Indian borrowers. They are used widely in India to facilitate access to foreign money by Indian corporations and PSUs (public sector undertakings). It covers all medium/long term loans. Commercial Borrowings by India denote loans extended by the Export Import Bank of India [EXIM Bank] to various countries and repayment of such loans.

**Foreign Investment**- This refers to investment to and from the Rest of the world. Investment may be direct or portfolio, (a) Direct investment means purchasing an asset and acquiring control of the same, e.g. purchase of a house abroad, (b) As against it, portfolio investment means acquisition of an asset that does not give control over asset, e.g. purchase of a bond issued by a foreign government.

**Banking capital** comprises of three components: (a) foreign assets of Commercial Banks (b) foreign liabilities of Commercial Banks and (c) others. Foreign assets of Commercial Banks consist of (i) foreign currency holdings; and (ii) rupee overdrafts to non-resident banks. Foreign liabilities of commercial banks

consists of (i) Non- resident deposits, which comprises receipt and redemption of various non-resident deposit schemes; and (ii) liabilities other than non- resident deposits which comprises rupee and foreign currency liabilities to nonresident banks and official and semi-official institutions. Others under banking capital include movement in balances of foreign central banks and international institutions like IBRD, IDA, ADB, IFC, IFAD etc. maintained with RBI as well as movement in balances held abroad by the embassies of Indian in London and Tokyo

**Short term loans** – denotes drawals in respect of loans, utilized and repayments with a maturity of less than one year.

**Other capital** – comprises mainly the leads and lags in exports receipts (difference between the custom data and the banking channel data). This is a residual item and includes all capital transactions not included elsewhere. It particularly includes funds held abroad, advance receipts under deferred exports, India's subscription to International institution, quota payments to IMF, delayed export receipts, remittances towards recouping the losses of branches/subsidiaries and the like.

CAPITAL ACCOUNT
i. External Assistance (net)
ii. External Commercial Borrowings (net)
iii. Short-term credit
iv. Banking Capital(net) of which: Non-Resident Deposits (net)
v. Foreign Investment(net) of which A. FDI (net) B. Portfolio (net)
vi. Other Flows (net)

## BALANCE OF PAYMENT (BoP)

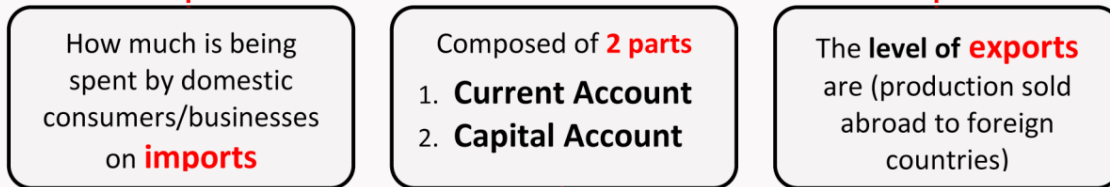
The balance of payments (BOP) is a statement of all transactions made between entities in one country and the rest of the world over a defined period of time, such as a quarter or a year.

The balance of payments (BOP), also known as balance of international payments, summarizes all transactions that a country's individuals, companies and government bodies complete with individuals, companies and government bodies outside the country. These transactions consist of imports and exports of goods, services and capital, as well as transfer payments, such as foreign aid and remittances. A country's balance of payments and its net international investment position together constitute its international accounts.

## The Balance of Payments

The Balance of Payments (BOP) is a record of all the financial transactions that are made between all those active in the domestic economy (consumers, businesses and the government) and the rest of the world

### Includes



### CURRENT ACCOUNT

All flows of money received from the purchase of goods/services

### CAPITAL ACCOUNT

All flows associated with 'capital' items i.e. private capital, official capital and banking

$$\text{Visible Balance (of Trade)} = \text{Exports (Goods)} - \text{Imports (Goods)}$$

**Invisible Balance** = Exports (Services) - Imports (Services)

**Exports (Services)**  
Examples

- Earnings of domestic airlines from foreign passengers
- Earnings of domestic hotels from foreign guests
- Earnings of domestic singers/bands from abroad
- Subsidies received domestically from the EU
- Earnings of Irish consultancies from foreign clients

**Imports (Services)**  
Examples

- Your own citizens using foreign airlines
- Spending by your own citizens on holidays abroad
- Payments by your own citizens to foreign companies
- Earnings of foreign artists in your country
- Taxes pay by your country to the EU
- All interest pay on debt owed to those abroad

**Private Capital Transactions**  
Purchases of land, factory buildings or company shares

+

**Official Capital Transactions**  
Government borrowing and the sale of government stock/bonds to foreigners by the government

+

**Banking Transactions**  
Change in net external position of banks

$$= \text{Total Capital Transactions}$$

$$\text{Net Balance on Current Account} + \text{Total Capital Transactions}$$

**Net Investment Income**  
Interest payments, profits and dividends from external assets owned by nationals but sited abroad

**Current Transfers**  
Private transfers between countries and government transfers (to EU, UN and other international bodies)

$$= \text{Net Balance on Current Account}$$

$$\text{Visible Balance} + \text{Invisible Balance} + \text{Net Investment Income} + \text{Current Transfers}$$

$$= \text{BOP on Capital/Current Account}$$

## FOREX RESERVES

Foreign exchange reserves are assets held on reserve by a central bank in foreign currencies. These reserves are used to back liabilities and influence monetary policy. These reserves act as a buffer during the challenging times to the economy. The components of India's FOREX Reserves include Foreign currency assets (FCAs), Gold Reserves, Special Drawing Rights (SDRs) and RBI's Reserve position with International Monetary Fund (IMF). FCAs constitute largest component of Indian Forex Reserves and are expressed in US dollar terms.

Most foreign exchange reserves are held in U.S. dollars, with China being the largest foreign currency reserve holder in the world. Economists suggest that it's best to hold foreign exchange reserves in a currency that is not directly connected to the country's own currency. After balancing the BoP account any left overs are added to the Forex reserves

**Movement in Reserves**— Movements in the reserves comprises changes in the foreign currency assets held by the RBI and SDR balances held by the Govt. of India. These are recorded after excluding changes on account of valuation. Valuation changes arise because foreign currency assets are expressed in US dollar terms and they include the effect of appreciation/ depreciation of non-US currencies (such as Euro, Sterling, and Yen) held in reserves.

### SPECIAL DRAWING RIGHTS (SDRs)

This is a kind of reserve of foreign exchange assets comprising leading currencies globally and created by the International Monetary Fund in the year 1969. Before its creation, the international community had to face several restrictions in increasing world trade and the level of financial development as gold and US dollars, which were the only means of trade, were in limited quantities. In order to address the issue, SDR was created by the IMF.

SDR is often regarded as a 'basket of national currencies' comprising four major currencies of the world - US dollar, Euro, British Pound and Yen (Japan). The composition of this basket of currencies is reviewed every five years wherein the weightage of currencies sometimes get altered.

## FDI AND FPI

Foreign Direct Investment (FDI) and Foreign Portfolio Investment (FPI) are the two important forms of foreign capital. The real difference between the two is that while FDI aims to take control of the company in which investment is made; FPI aims to reap profits by investing in shares and bonds of the invested entity without controlling the company.

Both FDI and FPI are the most well sought type of foreign capital by the developing world. Usually, both these are measured in terms of the percentage of the shares they own in a company (i.e. 10%, 20% etc).

According to the existing regulation by the SEBI, FPI is investment in shares of a company not exceeding 10% of the total paid up capital of the company. Any investment above 10% is FDI as with that size of shareholding, the foreign investor can exert control in the management of the company.

A marvellous advantage of both FDI and FPI is that the receiving country need not repay the debt like in the case of External Commercial Borrowings (foreign loans). Both are thus described as non –debt creating, and hence involve no payment obligations. Their own servicing depends on future growth of the economy. This is why most developing countries prefer FDI and FPI compared to other forms of foreign capital like ECBs.

The similarity between the two ends here. A one-to one comparison will reveal that FDI is superior to FDI from the angle of a developing country like India.

## What is Foreign Direct Investment (FDI)?

FDI is investment by non-resident entities like MNCs to carryout business operations in India with management of investment, production of goods or services, employing people and marketing their products. Transfer of technology is also treated as FDI. In FDI, both the ownership and control of the firm is with the investor. The foreign investor usually takes a considerable stake or shareholding in the company and exerts management influences completely or partially, depending on his shareholding.

## What is Foreign Portfolio Investment?

FPI on the other hand is investment in shares, bonds, debentures, etc. According to the IMF, portfolio investment is defined as cross-border transactions and positions involving debt or equity securities, other than those included in direct investment or reserve assets.

## FDI vs. FPI

FDI means real investment; whereas FPI is monetary or financial investment –Here, FDI means the investor makes investment in buildings and machineries directly in the company in which he has made the investment. FPI doesn't create such productive asset creation directly. It is just financial investment. FDI is certain, predictable, takes production risks, have stabilizing impact on production. It directly augments employment, output, export etc. The major merit of FDI is that it is non debt creating as well as non-volatile (less fluctuating).

FPI on the other hand is investment aimed at getting profits from shares, interests from deposits etc. It is otherwise known as **hot money** or **fly-by-night capital**. The portfolio investors park their money in the capital market only for a short period of time. Its destination period is so small and is empirically considered as fluctuating (often short term) capital. It is highly volatile, a fair weather friend, speculative, involves exchange risks and may lead to capital flight and currency crisis affecting real economic variables. It is destabilizing in the foreign exchange market. Fluctuations in the mobility of FPI affects foreign exchange rate, domestic money supply, value of rupee, call money rates, security market etc. FII (Foreign Institutional Inflows) inflows depend on two factors: first, return potential of the destination market (host country) and second availability of risk capital at source geographies (home market; countries like the US). A change in environment in any of these will result in quick reversal of the flows.

**If FDI is certain, long term and less fluctuating, FPI is speculative, highly volatile and un-predictive. Hence, FDI is superior to FPI.**

## ROUND TRIPPING

One of the leading puzzles related to cross border flow of investment is the phenomenon of 'Round tripping FDI'. Here, money from a country (eg. India) flows to a foreign country (Mauritius) and comes back as foreign direct investment to India.

**Round tripping of FDI refers to the capital belonging to a country, which leaves the country and then is reinvested in the form of FDI.**



## Why round tripping happens?

There are a number of observed factors that promotes round tripping. Tax concessions allowed in the foreign country encourages individuals to park money there. The money will be invested in a company formed there (Mauritius) and later this company will be taking back the money as foreign direct investment into the home country (India).

Under the income tax law, a Mauritius based company that made investment in India has to pay its tax in Mauritius. An advantage for the Indian businessman parking his money in the Mauritius formed company is that tax there is significantly low.

Another promotional factor for round tripping is highlighted by the government's White Paper on Black Money. According to it, black money from India is transferred to foreign countries like Mauritius and returned to India as FDI. This is another form of round tripping. Mauritius is the largest source of foreign investment into India.

### TAX HAVENS

A tax haven is a country that offers foreign individuals and businesses little or no tax liability in a politically and economically static environment. Tax havens also share limited or no financial information with foreign tax authorities. Tax havens do not require residency or business presence for individuals and businesses to benefit from their tax policies. Due to the globalization of business operations, an increasing number of corporations are keeping cash in offshore tax havens to minimize corporate taxes.

### MAJOR TAX HAVENS



## TREATY SHOPPING

“Treaty shopping” generally refers to a situation where a person, who is resident in one country (say the “home” country) and who earns income or capital gains from another country (say the “source” country), is able to benefit from a tax treaty between the source country and yet another country (say the “third” country). This situation often arises where a person is resident in the home country but the home country does not have a tax treaty with the source country.

For example, a corporation (“CayCo”) resident in the Cayman Islands (the home country) may own a corporation (“USCo”) in the U.S. (the source country). Dividends paid from USCo to CayCo would be subject to a 30% U.S. withholding tax. If CayCo were to form a corporation (“UKCo”) in the U.K. (the third country) and transfer the stock of USCo to UKCo, dividends would be paid from USCo to UKCo and, without anti-treaty shopping rules, these dividends would qualify for benefits under the U.S.-U.K. Income Tax Treaty.

If this approach were successful, the dividend withholding tax of 30% on dividends paid by USCo could be reduced to zero. In addition, because the U.K. does not impose any withholding taxes on dividends paid to non-U.K. residents, the overall tax rate of the group may decrease. However, the U.K. income tax rules would need to be reviewed to confirm that dividends from USCo to UKCo would not be subject to U.K. income taxes.

Different countries attack this problem in different ways. The U.S. generally includes in its tax treaties with other countries specific rules that limit the benefits under the treaty in certain circumstances. These rules are typically called “**limitation on benefits**” or “**LOB**” provisions. Other countries, such as Canada, generally rely on domestic law anti-treaty shopping provisions, rather than including the rules within the treaty itself.

Domestic law anti-treaty shopping rules are often implemented by providing that only “beneficial owners” of the payments are entitled to treaty benefits. For instance, in the example above, if CayCo and UKCo had invested into a Canadian corporation (“CanCo”) rather than into USCo, the Canadian anti-treaty shopping provisions may conclude that CayCo is the beneficial owner of dividends paid by CanCo. As a result, the CanCo dividend may not qualify for reduced treaty benefits under the Canadian-U.K. Treaty.

**The anti-treaty shopping provisions are some of the most complex international tax rules in existence.**

## PARTICIPATORY NOTES AND HEDGE FUNDS

A participatory note, commonly known as a P-note or PN, is an instrument issued by a registered foreign institutional investor (FII) to an overseas investor who wishes to invest in Indian stock markets without registering themselves with the market regulator, the Securities and Exchange Board of India (SEBI).

SEBI permitted foreign institutional investors to register and participate in the Indian stock market in 1992. Investing through P-notes is very simple, and hence very popular amongst foreign institutional investors.

A hedge fund is an investment fund that pools capital from accredited investors or institutional investors and invests in a variety of assets, often with complex portfolio-construction and risk management techniques.

Hedge funds may be aggressively managed or make use of derivatives and leverage in both domestic and international markets with the goal of generating high returns (either in an absolute sense or over a specified market benchmark). It is important to note that hedge funds are generally only accessible to accredited investors as they require fewer regulations than other funds. One aspect that has set the hedge fund industry apart is the fact that hedge funds face less regulation than mutual funds and other investment vehicles. P-notes are often issued to Hedge Funds.

# UNIT- X

## [MONEY MARKET & CAPITAL MARKET]

A financial market brings buyers and sellers together to trade in financial assets such as stocks, bonds, commodities, derivatives, and currencies. The purpose of a financial market is to set prices for global trade, raise capital, and transfer liquidity and risk. Although there are many components to a financial market, two of the most commonly used are money markets and capital markets.

Government and corporate entities use money markets as a means for borrowing and lending in the short term, usually for assets being held for up to a year. Conversely, capital markets are more frequently used for long-term assets, which are those with maturities of greater than one year.

Capital markets include the equity (stock) market and debt (bond) market. Together, money markets and capital markets comprise a large portion of the financial market and are often used together to manage liquidity and risks for companies, governments, and individuals.

Money markets are organised or unorganized markets where banks, financial institutions, money dealers and brokers trade in financial instruments for a short period of time. They trade in short-term debt instruments like trade credit, commercial paper, certificate of deposits, T bills etc. which are highly liquid and can be redeemed in the period of less than a day.

**Trading in the money market is done mostly through Over-the-Counter (OTC) i.e. no or little use of exchanges.** They provide businesses with short-term credit and play a major role in providing liquidity in the economy over the short term. It helps the business and industries with working capital requirements. According to the RBI, “the money market is a market for short-term financial assets that are close substitutes of money”.

### INTER-BANK CALL MONEY MARKET

The call money market (CMM) the market where overnight (one day) loans can be availed by banks to meet liquidity. Banks who seeks to avail liquidity approaches the call market as borrowers and the ones who have excess liquidity participate there as lenders. The CMM is functional from Monday to Friday. Banks can access CMM to meet their reserve requirements (CRR and SLR) or to cover a sudden shortfall in cash on any particular day.

Effectively, the Call Money Market is the main market oriented mechanism to meet the liquidity requirements of banks. The call money is usually availed for one day. If the bank needs funds for more days, it can avail money through notice market. Here, the loan is provided from two days to fourteen days. Hence it is also known as **money at call and short notice market**. The call rate is the rate of interest on such short term inter-bank borrowing and lending. It is the best indicator of the liquidity situation in the economy.

Participants in the call money market are banks and related entities specified by the RBI. Scheduled commercial banks (excluding RRBs), co-operative banks (other than Land Development Banks) and Primary Dealers (PDs), are permitted to participate in call/notice money market both as borrowers and lenders. As per the new regulations, Payment Banks are also allowed to participate in CMM as both lenders and borrowers.

Banks are the dominant participants in the CMM and hence it is often known as interbank call money market. Dealing in call money is done through the electronic trading platform called Negotiated Trading System (NDS). The Call Money Market is known as the most sensitive segment of the financial system.

## MUMBAI INTERBANK OFFER RATE (MIBOR)

MIBOR is the acronym for Mumbai Interbank Offer Rate, the yardstick of the Indian call money market. It is the rate at which banks borrow unsecured funds from one another in the interbank market. At present, it is used as a reference rate for floating rate notes, corporate debentures, term deposits, interest rate swaps and forward rate agreements. The pricing of overnight indexed swaps, a type of overnight interest rate swap used for hedging interest rate risk is based on overnight MIBOR.

## BILL MARKET

Bill Market refers to the market for short-term bills generally of three months maturity. A bill is a promise to pay a specified amount by the borrower (drawer) to the creditor (drawee). Bills are of three types- (a) bills of exchange or commercial bills used to finance trade; (b) finance bills or promissory notes; and (c) treasury bills used to meet temporary financial needs to the government. These bills may be bought and sold in the discount market which consists of commercial banks, discount houses and other institutions. The Bills are often issued at discount to face value and hence this market is also known as the discount market.

The bill market plays an important role in the banking and monetary system of the country because of the following reasons:

- It helps to meet the short-term financial requirements of individuals, companies and the government.
- The commercial banks which have surplus funds can invest them profitably in these bills,
- The commercial bank can dispose of these bills easily or can get them rediscounted by the Reserve Bank of India whenever they require cash.

Keeping in view the usefulness of the bills as instruments of credit to both business and banks, their self-liquidating nature and easier regulation of banks' bill finance by the central bank, the Reserve Bank of India has been making efforts to develop a bill market in the country.

## G-SECS-T-BILLS & DATED SECURITIES

A Government Security (G-Sec) is a tradeable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills, with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). G-Secs carry practically no risk of default and, hence, are called risk-free gilt-edged instruments.

Treasury bills or T-bills, which are money market instruments, are short term debt instruments issued by the Government of India and are presently issued in three tenors, namely, 91 day, 182 day and 364 day. Treasury bills are zero coupon securities and pay no interest. Instead, they are issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury bill of Rs.100/- (face value) may be issued at say Rs. 98.20, that is, at a discount of say, Rs.1.80 and would be redeemed at the face value of Rs. 100/-. The return to the investors is the difference between the maturity value or the face value (that is Rs.100) and the issue price.

Dated G-Secs are securities which carry a fixed or floating coupon (interest rate) which is paid on the face value, on half-yearly basis. Generally, the tenor of dated securities ranges from 5 years to 40 years. The Public Debt Office (PDO) of the Reserve Bank of India acts as the registry / depository of G-Secs and deals with the issue, interest payment and repayment of principal at maturity. Most of the dated securities are fixed coupon securities. In case, there are two securities with the same coupon and are maturing in the same year, then one of the securities will have the month attached as suffix in the nomenclature.

### Why should one invest in G-Secs?

Holding of cash in excess of the day-to-day needs (idle funds) does not give any return. Investment in gold has attendant problems in regard to appraising its purity, valuation, warehousing and safe custody, etc. In comparison, investing in G-Secs has the following advantages:

- Besides providing a return in the form of coupons (interest), G-Secs offer the maximum safety as they carry the Sovereign's commitment for payment of interest and repayment of principal.
- They can be held in book entry, i.e., dematerialized/ scripless form, thus, obviating the need for safekeeping. They can also be held in physical form.
- G-Secs are available in a wide range of maturities from 91 days to as long as 40 years to suit the duration of varied liability structure of various institutions.
- G-Secs can be sold easily in the secondary market to meet cash requirements.
- G-Secs can also be used as collateral to borrow funds in the repo market.
- Securities such as State Development Loans (SDLs) and Special Securities (Oil bonds, UDAY bonds etc) provide attractive yields.
- The settlement system for trading in G-Secs, which is based on Delivery versus Payment (DvP), is a very simple, safe and efficient system of settlement. The DvP mechanism ensures transfer of securities by the seller of securities simultaneously with transfer of funds from the buyer of the securities, thereby mitigating the settlement risk.
- G-Sec prices are readily available due to a liquid and active secondary market and a transparent price dissemination mechanism.
- Besides banks, insurance companies and other large investors, smaller investors like Co-operative banks, Regional Rural Banks, Provident Funds are also required to hold G-Secs as per law.

### CERTIFICATE OF DEPOSITS (CDs)

Certificate of Deposit (CD) is a negotiable money market instrument and issued in dematerialised form or as a Promissory Note against funds deposited at a bank or other eligible financial institution for a specified time period. Guidelines for issue of CDs are presently governed by various directives / guidelines issued by the Reserve Bank of India (RBI), as amended from time to time.

CDs can be issued by (i) scheduled commercial banks {excluding Regional Rural Banks and Local Area Banks}; and (ii) select All-India Financial Institutions (FIs) that have been permitted by RBI to raise short-term resources within the umbrella limit fixed by RBI.

CDs can be issued to individuals, corporations, companies (including banks and PDs), trusts, funds, associations, etc. Non-Resident Indians (NRIs) may also subscribe to CDs, but only on non-repatriable basis, which should be clearly stated on the Certificate. Such CDs cannot be endorsed to another NRI in the secondary market.

The maturity period of CDs issued by banks should not be less than 7 days and not more than one year, from the date of issue. FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue.

CDs may be issued at a discount on face value. Banks / FIs are also allowed to issue CDs on floating rate basis provided the methodology of compiling the floating rate is objective, transparent and market-based. The issuing bank / FI is free to determine the discount / coupon rate. The interest rate on floating rate CDs would have to be reset periodically in accordance with a pre-determined formula that indicates the spread over a transparent benchmark. The investor should be clearly informed of the same.

Banks have to maintain appropriate reserve requirements, i.e., cash reserve ratio (CRR) and statutory liquidity ratio (SLR), on the issue price of the CDs.

CDs in physical form are freely transferable by endorsement and delivery. CDs in demat form can be transferred as per the procedure applicable to other demat securities. There is no lock-in period for the CDs. All OTC trades in CDs shall be reported within 15 minutes of the trade on the reporting platform of Clearcorp Dealing Systems (India) Ltd. (CDSIL).

Minimum amount of a CD should be Rs.1 lakh, i.e., the minimum deposit that could be accepted from a single subscriber should not be less than Rs.1 lakh and in multiples of Rs. 1 lakh thereafter.

## COMMERCIAL PAPER (CP)

Commercial Paper (CP) is an unsecured money market instrument issued in the form of a promissory note. CP, as a privately placed instrument, was introduced in India in 1990 with a view to enable highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors. Subsequently, primary dealers (PDs) and all-India financial institutions (FIs) were also permitted to issue CP to enable them to meet their short-term funding requirements. The guidelines for issue of CP, incorporating all the amendments issued till date, are given below for ready reference.

### Eligibility for Issue of CP:

- a) Companies, PDs and FIs are permitted to raise short term resources through CP.
- b) A company would be eligible to issue CP provided:
  - The tangible net worth of the company, as per the latest audited balance sheet, is not less than Rs.4 crore;
  - The company has sanctioned working capital limit by bank/s or FIs; and
  - The borrowal account of the company is classified as a Standard Asset by the financing bank/institution.

### Issue of CP – Credit enhancement, limits, etc.

- a) CP shall be issued as a 'stand alone' product. Further, it would not be obligatory in any manner on the part of the banks and FIs to provide stand-by facility to the issuers of CP.
- b) Banks and FIs may, based on their commercial judgement, subject to the prudential norms as applicable to them, with the specific approval of their respective Boards, choose to provide stand-by assistance/credit, back-stop facility etc. by way of credit enhancement for a CP issue.

- c) Non-bank entities (including corporates) may provide unconditional and irrevocable guarantee for credit enhancement for CP issue provided:
- The issuer fulfils the eligibility criteria prescribed for issuance of CP;
  - The guarantor has a credit rating at least one notch higher than the issuer given by an approved CRA; and
  - The offer document for CP properly discloses the net worth of the guarantor company, the names of the companies to which the guarantor has issued similar guarantees, the extent of the guarantees offered by the guarantor company, and the conditions under which the guarantee will be invoked.
- d) The aggregate amount of CP that can be issued by an issuer shall at all times be within the limit as approved by its Board of Directors or the quantum indicated by the CRA for the specified rating, whichever is lower.
- e) Banks and FIs shall have the flexibility to fix working capital limits, duly taking into account the resource pattern of company's financing, including CP.
- f) An issue of CP by an FI shall be within the overall umbrella limit prescribed in the Master Circular on Resource Raising Norms for FIs, issued by the Reserve Bank of India, Department of Banking Operations and Development, as prescribed/ updated from time-to-time.
- g) The total amount of CP proposed to be issued should be raised within a period of two weeks from the date on which the issuer opens the issue for subscription. CP may be issued on a single date or in parts on different dates provided that in the latter case, each CP shall have the same maturity date.
- h) Every issue of CP, and every renewal of a CP, shall be treated as a fresh issue.

### Eligibility for Investment in CP

- a) Individuals, banks, other corporate bodies (registered or incorporated in India) and unincorporated bodies, Non-Resident Indians and Foreign Institutional Investors (FIIs) shall be eligible to invest in CP.
- b) FIIs shall be eligible to invest in CPs subject to (i) such conditions as may be set for them by Securities Exchange Board of India (SEBI) and (ii) compliance with the provisions of the Foreign Exchange Management Act, 1999, the Foreign Exchange (Deposit) Regulations, 2000 and the Foreign Exchange Management (Transfer or Issue of Security by a Person Resident Outside India) Regulations, 2000, as amended from time to time.

## DEBT MARKET & EQUITY MARKET

The debt market is the market where debt instruments are traded. Debt instruments are assets that require a fixed payment to the holder, usually with interest. Examples of debt instruments include bonds (government or corporate) and mortgages. The equity market (often referred to as the stock market) is the market for trading equity instruments.

How are debt instruments different from equity instruments?

- a) Equity financing allows a company to acquire funds (often for investment) without incurring debt. On the other hand, issuing a bond does increase the debt burden of the bond issuer because contractual interest payments must be paid— unlike dividends, they cannot be reduced or suspended.
- b) Those who purchase equity instruments (stocks) gain ownership of the business whose shares

they hold (in other words, they gain the right to vote on the issues important to the firm). In addition, equity holders have claims on the future earnings of the firm.

- c) In contrast, bondholders do not gain ownership in the business or have any claims to the future profits of the borrower. The borrower's only obligation is to repay the loan with interest.
- d) Bonds are considered to be less risky investments for at least two reasons. First, bond market returns are less volatile than stock market returns. Second, should the company run into trouble, bondholders are paid first, before other expenses are paid. Shareholders are less likely to receive any compensation in this scenario.
- e) Equities are inherently riskier than debt and have a greater potential for big gains or big losses.

### DEBENTURES

In corporate finance, a debenture is a medium- to long-term debt instrument used by large companies to borrow money, at a fixed rate of interest. Since debentures have no collateral backing, debentures must rely on the creditworthiness and reputation of the issuer for support. Debentures can be convertible, non-convertible or partially-convertible into equity instruments

## PRIMARY MARKET & SECONDARY MARKET

The most important type of capital market is the primary market. It is what we call the new issue market. It exclusively deals with the issue of new securities, i.e. securities that are issued to investors for the very first time. The main function of the primary market is capital formation for the companies, governments, institutions etc. It helps investors invest their savings and extra funds in companies starting new projects or enterprises looking to expand their operations. In the primary capital market, investors buy directly from the issuing company. In the secondary market, investors trade securities among themselves. The companies raise money in the primary market through securities such as shares, debentures, loans and deposits, preference shares etc.

### Initial Public Offering (IPO)

The process of offering shares in a private corporation to the public for the first time is called an initial public offering (IPO). Growing companies that need capital will frequently use IPOs to raise money by selling shares to the public. In an initial public offering, the issuer, or company raising capital, brings in underwriting firms or investment banks to help determine the best type of security to issue, offering price, amount of shares and time frame for the market offering. IPO is also referred to as public offering or "going public."

### Follow on Public Offer (FPO)

A follow-on public offer (FPO) is the issuance of shares to investors by a public company that is currently listed on a stock market exchange. An FPO is a stock issue of additional shares made by a company that is already publicly listed and has gone through the IPO process. FPOs are popular methods for companies to raise additional equity capital in capital markets through an issue of stock.

### Rights Issue (RI)

A rights offering (rights issue) is a group of rights offered to existing shareholders to purchase additional stock shares, known as subscription warrants, in proportion to their existing holdings. These are considered to be a type of option since it gives a company's stockholders the right, but not the obligation, to



purchase additional shares in the company. In a rights offering, the subscription price at which each share may be purchased is generally discounted relative to the current market price. Rights are often transferable, allowing the holder to sell them in the open market.

## Private Placement (PP)

A private placement involves the sale of securities to a relatively small number of select investors. Investors targeted include wealthy accredited investors, large banks, mutual funds, insurance companies and pension funds. A private placement is different from a public issue in which securities are made available for sale on the open market to any type of investor.

- A private placement is a capital raising event involving the sale of securities to a relatively small number of select investors (Qualified Institutional Buyers)
- A private placement is far less expensive and faster than other means of raising capital.
- Investors in private placement offerings often expect higher returns for taking greater risks.

### QUALIFIED INSTITUTIONAL BUYERS (QIBs)

Qualified Institutional Buyers are those institutional investors who are generally perceived to possess expertise and the financial muscle to evaluate and invest in the capital markets

## Secondary Market

This is more commonly known as the stock market or the stock exchange. Here the securities (shares, debentures, bonds, bills etc) are bought and sold by the investors. The secondary market is where securities are traded after the company has sold its offering on the primary market. The Bombay Stock Exchange (BSE), The New York Stock Exchange (NYSE), London Stock Exchange, and NASDAQ are secondary markets.

The main point of difference between the primary and the secondary market is that in the primary market only new securities were issued, whereas in the secondary market the trading is for already existing securities. There is no fresh issue in the secondary market.

- The securities are traded in a highly regularised and legalized market within strict rules and regulations. This ensures that the investors can trade without the fear of being cheated. In the last decade or so due to the advancement of technology, the secondary capital market in India has seen a great boom.
- Small investors have a much better chance of trading securities on the secondary market since they are excluded from IPOs. Anyone can purchase securities on the secondary market as long as they are willing to pay the asking price per share.
- A broker typically purchases the securities on behalf of an investor in the secondary market. Unlike the primary market, where prices are set before an IPO takes place, prices on the secondary market fluctuate with demand. Investors will also have to pay a commission to the broker for carrying out the trade.
- The volume of securities traded varies from day to day, as supply and demand for the security fluctuates. This also has a big effect on the security's price.

Because the initial offering is complete, the issuing company is no longer a party to any sale between two investors, except in the case of a company stock buyback. Once a security has traded on the primary market, it will then open up for trade to smaller investors on the secondary market.

### STOCK SPLIT

A stock split is a corporate action in which a company divides its existing shares into multiple shares to boost the liquidity of the shares. Although the number of shares outstanding increases by a specific multiple, the total money value of the shares remains the same compared to pre-split amounts, because the split does not add any real value. The most common split ratios are 2-for-1 or 3-for-1, which means that the stockholder will have two or three shares, respectively, for every share held earlier.

### STOCK BUY BACK

Stock buybacks refer to the repurchasing of shares of stock by the company that issued them. A buyback occurs when the issuing company pays shareholders the market value per share and re-absorbs that portion of its ownership that was previously distributed among public and private investors.

## DERIVATIVE MARKET- FUTURES & OPTIONS

The derivatives market is the financial market for derivatives, financial instruments like futures contracts or options, which are derived from other forms of assets. The market can be divided into two, that for exchange-traded derivatives and that for over-the-counter derivatives. **A derivative is a contract between two or more parties whose value is based on an agreed-upon underlying financial asset** (like a security) or set of assets (like an index). Common underlying instruments include bonds, commodities, currencies, interest rates, market indexes and stocks. Futures contracts, forward contracts, options, swaps, and warrants are commonly used derivatives.

A futures contract, for example, is a derivative because its value is affected by the performance of the underlying asset. Similarly, a stock option is a derivative because its value is “derived” from that of the underlying stock. While a derivative’s value is based on an asset, ownership of a derivative doesn’t mean ownership of the asset.

There are two classes of derivative products - “lock” and “option”. Lock products (e.g. swaps, futures, or forwards) bind the respective parties from the outset to the agreed upon terms over the life of the contract. Option products (e.g. interest rate swaps), on the other hand, offer the buyer the right, but not the obligation, to become a party to the contract under the initially agreed upon terms.

The risk-reward equation is often thought to be the basis for investment philosophy and derivatives can be used to either mitigate risk (hedging) or assume risk with the expectation of commensurate reward (speculation).

### Call Option, Put Option and Double Option

A call option gives the holder the right to buy but imposes no obligation on buying. A put option gives the holder the right to sell but imposes no obligation to sell. A double option gives both the right to buy and right to sell and imposes no obligation either with respect to buying or selling. An entity using options often pays a premium for using it.

## DEVELOPMENT FINANCIAL INSTITUTIONS (DFIs)

Development Financial Institutions are specialized institutions set up primarily to provide development/Project finance especially in developing countries. These development banks are usually majority-owned by national governments. The source of capital of these banks is national or international development funds.

DFIs give sector-specific loans to various sectors- industry, agriculture, housing, infrastructure, export finance etc. The first DFI was the Industrial Financial Corporation of India (IFC) that was launched in 1948. The IDBI, UTI, NABARD, EXIM Bank, SIDBI, NHB, IIFCL etc are the other major DFIs. Later several of them were converted into banks as industry got opportunity to avail funds from the capital market (equity and debt) with the development of the capital market.

## FINANCIAL INTERMEDIARIES

A financial intermediary is an entity that acts as the middleman between two parties in a financial transaction, such as a commercial bank, investment banks, mutual funds and pension funds. Financial intermediaries offer a number of benefits to the average consumer, including safety, liquidity, and economies of scale involved in commercial banking, investment banking and asset management. Although in certain areas, such as investing, advances in technology threaten to eliminate the financial intermediary, disintermediation is much less of a threat in other areas of finance, including banking and insurance.

### Functions of Financial Intermediaries

Financial intermediaries move funds from parties with excess capital to parties needing funds. The process creates efficient markets and lowers the cost of conducting business. For example, a financial advisor connects with clients through purchasing insurance, stocks, bonds, real estate and other assets. Banks connect borrowers and lenders by providing capital from other financial institutions and from the Central Bank. Insurance companies collect premiums for policies and provide policy benefits. A pension fund collects funds on behalf of members and distributes payments to pensioners.

### Mutual Funds as Financial Intermediaries

A mutual fund is a professionally managed investment fund that pools money from many investors to purchase securities. These investors may be retail or institutional in nature.

Mutual funds have advantages and disadvantages compared to direct investing in individual securities. The primary advantages of mutual funds are that they provide economies of scale, a higher level of diversification, they provide liquidity, and they are managed by professional investors. On the negative side, investors in a mutual fund must pay various fees and expenses.

Primary structures of mutual funds include open-end funds, unit investment trusts, and closed-end funds. Exchange-traded funds (ETFs) are open-end funds or unit investment trusts that trade on an exchange. Mutual funds are also classified by their principal investments as money market funds, bond or fixed income funds, stock or equity funds, hybrid funds or other. Funds may also be categorized as index funds, which are passively managed funds that match the performance of an index, or actively managed funds. Hedge funds are not mutual funds; hedge funds cannot be sold to the general public and are subject to different government regulations.

### Benefits of Financial Intermediaries

Through a financial intermediary, savers can pool their funds, enabling them to make large investments, which in turn benefits the entity in which they are investing. At the same time, financial intermediaries pool risk by spreading funds across a diverse range of investments and loans. Loans benefit households

and countries by enabling them to spend more money than they have at the current time.

Financial intermediaries also provide the benefit of reducing costs on several fronts. For instance, they have access to economies of scale to expertly evaluate the credit profile of potential borrowers and keep records and profiles cost-effectively. Last, they reduce the costs of the many financial transactions an individual investor would otherwise have to make if the financial intermediary did not exist.

## VENTURE CAPITALISTS (VCs)

A venture capitalist (VC) is an investor who provides capital to firms exhibiting high growth potential in exchange for an equity stake. This could be funding startup ventures or supporting small companies that wish to expand but do not have access to equities markets. Venture capitalists are willing to risk investing in such companies because they can earn a massive return on their investments if these companies are a success. VCs experience high rates of failure due to the uncertainty that is involved with new and unproven companies.

Venture capital (VC) is a type of private equity, a form of financing that is provided by firms or funds to small, early-stage, emerging firms that are deemed to have high growth potential, or which have demonstrated high growth (in terms of number of employees, annual revenue, or both).

## ANGEL INVESTORS (AIs)

Angel investors are a class of well-to-do investors, usually experienced industry folk who take equity stakes in startups. They take very early-stage businesses under their wing. Angel investors literally step in where others fear to tread. They often operate through creation of funds called Angel Funds (AFs).

These funds that pool money from many individual 'angels' so that they can invest sizeable amounts into start-ups and enjoy better negotiating power while doing so. Angel Funds in India, are regulated by SEBI, which lumps them with venture capital funds, SME funds, social impact funds and sundry other funds, under the umbrella regulations for Alternative Investment Funds (AIFs).

## VIABILITY GAP FUNDING (VGF)

Viability literally means ability to survive successfully. VGF is an economic instrument (or scheme) of Government of India, launched in 2004 with the motive of supporting projects which come under public-private partnerships (PPP) model. Basically, it is a grant to support projects that are economically justified but are not financially viable.

Latest examples of these are UDAN Regional connectivity scheme and Metro rail projects. Under this scheme, the central government offers a VGF upto 20% for a particular project. VGF is generally provided to those projects which have a long gestation period (time difference between your investment and it earning profit for you) and when the user charges cannot be increased to commercial levels. All in all, it is government's way of promoting PPP model and distributing its money for building infrastructure more efficiently.

# UNIT- XI

## [POVERTY & UNEMPLOYMENT]

### MEASUREMENT OF POVERTY IN INDIA

Growth is not the sole objective of economic policy. It is necessary to ensure that the benefits of growth accrue to all sections of the society. Eradication of poverty is thus an important objective. Human beings need a certain minimum consumption of food and nonfood items to survive. However the perception regarding what constitutes poverty varies over time and across countries. Nevertheless there is need for a measure of poverty. Only then, it will be possible to evaluate how the economy is performing in terms of providing a certain minimum standard of living to all its citizens. Measurement of Poverty has, therefore, important policy implications.

A definition of poverty in terms of subsistence level has had wide acceptance as it seems to be in accordance with common sense which describes poverty as lack of the income needed to acquire the minimum necessities of life. **Poverty is an extremely complex phenomenon, which manifests itself in a range of overlapping and interwoven economic, political and social deprivations. These include lack of assets, low income levels, hunger, poor health, insecurity, physical and psychological hardship, social exclusion, degradation and discrimination, and political powerlessness and disarticulation.**

Two basic approaches to the concept of poverty were found in economic literature, namely, absolute poverty and relative poverty. The concept of absolute poverty is based on absolute norms for living (measured in terms of consumption expenditure) laid down according to specified minimum standard and all such individuals or groups whose consumption expenditure is found to be below this standard are classified as poor. This concept is directly related to the minimum level of consumption. Under the relative concept of poverty, a family (or an individual) is deemed to be poor if its level of income or consumption expenditure falls below a predetermined level.

Then the income distribution of the population in different fractile groups is estimated and a comparison is made between the level of living of people in the bottom layer and the top layers of the population to assess the relative standard of poverty. The concept of relative poverty has received little attention. The concept of relative poverty is more suitable for developed countries while the absolute concept is relevant for the developing countries. In addition, the concept of poverty has two connotations, namely, individualized poverty and collective poverty. The concept of individualized poverty is concerned with those poor individuals who are not able to incur even the minimum expenditure on most essential items viz., food, clothing and housing and collective poverty refers to social systems.

Studies on poverty in India began with the pioneering work of **Dadabhai Naoroji** in the later part of the 19th century. Naoroji had traced out the mass poverty to the British colonial rule which drained out systematically economic amounts of wealth through unequal trade interest and dividend salaries and pensions in 1930's and 40s.

The first specific and scientific attempt to identify the poor and to measure the extent of poverty was made by an expert committee constituted by the Government of India in July 1962. It has put the nationally desirable minimum level of consumer expenditure at Rs. 20 per capita per month according to 1960-61 prices. In 1971, **Dandekar and Rath** introduced the calories concept explicitly they considered the energy requirement of 2250 calories as the basic need per day per person. According to them this minimum level of consumption would require an expenditure of Rs.20/- per head per month for rural areas and Rs. 22.50/- for urban areas according to 1960-61 prices.

**Dantwala**, 1973 stated that there cannot be a single universal norm of poverty. The brief description about development in methodology and measurement of poverty ratio at national and state level is highlighted below.

## Working Group (1962)

The Planning Commission constituted a Working Group in 1962 to find out a desirable minimum level of living for the population. The Working Group recommended that the national minimum consumption expenditure for a household of five persons (four adult consumption units) should be not less than Rs.100 per month or Rs.20 per capita per month in terms of 1960-61 prices. For urban areas, this figure was Rs.125 per month or Rs.25 per capita per month to cover the higher prices there. The poverty line excluded expenditure on health and education, both of which, it was assumed, were to be provided by the State. The Working Group (1962) appeared to have taken into account the recommendation of balanced diet made by the Nutrition Advisory Group of the Indian Council of Medical Research (ICMR) in 1958. This poverty line was widely used in the 1960s and 1970s to estimate the poverty ratio at national and state level.

## Task Force 1979: Alagh

The Planning Commission in July 1977 constituted the Task Force on —Projections of Minimum Needs and Effective Consumption Demand|| under the Chairmanship of Dr. Y. K. Alagh. The Task Force submitted its report in January 1979. The average calorie requirements were estimated, separately for the all-India rural and urban areas as a population-weighted average of the age-gender-activity specific calorie allowances recommended by the Nutrition Expert Group (1968) by reference to the 1971 population Census.

The estimated calorie norm was 2400 kcal per capita per day in rural areas and 2100 kcal per capita per day in urban areas. To work out the monetary equivalent of these norms, 28th Round (1973-74) NSS data relating to household consumption both in quantitative and value terms were used. Based on the observed consumer behaviour in 1973-74 it was estimated that, on an average, consumer expenditure (food and non-food) of Rs.49.09 per capita per month was associated with a calorie intake of 2400 per capita per day in rural areas and Rs.56.64 per capita per month with a calorie intake of 2100 per day in urban areas. This Monthly Per Capita Expenditure (MPCE) was termed as poverty line. The poverty lines for later years were estimated by updating the poverty lines of the year 1973-74 for price changes.

## Expert Group 1993: Lakdawala

The Planning Commission, in September 1989, constituted the Expert Group on Estimation of Proportion and Number of Poor to “look into the methodology for estimation of poverty and to re-define the poverty line, if necessary”. The Expert Group submitted its Report in July 1993. The Government accepted the Expert Group methodology in March 1997 as the basis for computing the official estimates of poverty in India. The Expert Group (Lakdawala) did not redefine the poverty line. It retained the one defined by the Task Force (Alagh) which was at national level in rural and urban areas. It disaggregated these national poverty lines into state-specific poverty lines in order to reflect the inter-state price differentials.

The national rural poverty line of Task Force (Alagh) was disaggregated into state specific poverty lines using inter-state price differentials measured by Fisher’s Index. These state-specific poverty lines of base year (1973-74) were updated for subsequent years using state-specific price indices especially constructed by taking weighted average of the commodity group-wise Consumer Price Index of Agricultural Labourers (CPIAL) of (a) food (b) fuel and light, (c) clothing and footwear and (d) miscellaneous with their respective weights in the national consumption basket of the poor in 1973-74.

Two factors largely distinguish the Expert Group (Lakdawala) methodology of poverty estimation from those of the Task Force (Alagh). First, the Expert Group (Lakdawala) method uses state-specific poverty lines as against national poverty line for estimation of poverty in the state; it thereby captures the cost of living in the states more accurately (as compared to the Task Force method). Second, the Expert Group (Lakdawala) uses the state-wise consumption distribution of the NSS without any adjustment to the NAS consumption. This is a major departure from the Task Force method, which did this adjustment on a pro-rata basis. In March 1997, the Government adopted the Expert Group (Lakdawala) methodology for

poverty estimation as the basis for computing the official estimates of poverty and using this methodology the Planning Commission estimated the poverty ratios in rural and urban areas of different States/UTs for the year 1973-74 (NSS 28th Round consumer expenditure data, which was used to estimate the poverty line by the Task Force), and for the years 1977-78, 1983, 1987-88 and 1993-94 for which the large sample survey consumer expenditure data were then available from the 32nd, 38th, 43rd and 50th Rounds of the NSS. Subsequently, using the same methodology the Planning Commission estimated the poverty ratios at the national and states level for the years 1999-2000 and 2004-05, using the NSS large sample survey consumer expenditure data of 55th and 61st Rounds respectively. The official estimate of poverty was derived by the Planning Commission using the Expert Group (Lakdawala) methodology until January 2011.

### **Expert Group (Tendulkar)**

The Expert Group under the chairmanship of Suresh D. Tendulkar was constituted by the Planning Commission in December 2005. It was mandated to: (a) examine the issues relating to the comparability of the NSS 50th (1993-94), NSS 55th (1999-2000) and NSS 61st (2004-05) Round consumer expenditure data and suggest methodologies for deriving such comparability with past and future survey data; (b) review alternative conceptualizations of poverty, and associated technical aspects of procedures of measurement and data base for empirical estimation including procedures for updating over time and across states, and (c) recommend any changes in the existing procedures of official estimates of poverty. The Expert Group (Tendulkar) submitted its recommendations to the Planning Commission in November 2009. In its report, the Tendulkar committee (Planning Commission 2009) noted three deficiencies of the Lakdawala poverty lines. First, the poverty line baskets remained tied to consumption patterns observed in 1973-74. But more than three decades later, these baskets had shifted, even for the poor. Second, the consumer price index for agricultural workers understated the true price increase.

This meant that over time, the upward adjustment in the rural poverty lines was less than necessary so that the estimated poverty ratios understated rural poverty. Finally, the assumption that health and education would be largely provided by the government, underlying Lakdawala lines, did not hold any longer. Private expenditures on these services had risen considerably, even for the poor. This change was not adequately reflected in the Lakdawala poverty lines. The Expert Group (Tendulkar) did not construct a poverty line. It adopted the officially measured urban poverty line of 2004-05 based on Expert Group (Lakdawala) methodology and converted this poverty line (which is URP-consumption based) into MRP consumption. The national urban poverty ratio in 2004-05 as per the Expert Group (Tendulkar) methodology is identical to the one estimated by the Expert Group (Lakdawala) methodology, which is 25.7 per cent. The shift from MPCE estimates on URP (that underlay the poverty ratio with the Lakdawala methodology) to those on MRP in the Expert Group (Tendulkar) methodology significantly raised the all-India Urban poverty line level of MPCE from 538.60 to Rs 578.80.

The poverty lines defined by the Tendulkar Committee did not reflect the changing times and aspirations of the people. The high rate of increase in per capita income and consumption in the first decade of this century and the consequential changes in the structure of the economy as well as in people's perspectives on poverty was viewed as requiring a fresh look at the poverty line and its composition. This provides the backdrop to the setting up of the Expert Group (Rangarajan). As a first step towards defining the food component of the poverty line basket, the Expert Group (Rangarajan) has recomputed the average requirements of calories, proteins and fats, per-capita per-day at the all-India level for 2011-12, separately for the rural and the urban populations.

This has been done by reference to the 2010 ICMR norms differentiated by age, gender and activity-status. The average calorie requirement works out to 2155 kcal per capita per day in rural areas and 2090 kcal per capita per day in urban areas. It is readily seen that for rural India, these revised calorie norms for 2011-12 are substantially lower than those derived by the Task Force (Alagh). In the case of urban areas, however, due to a more pronounced shift in the age-distribution towards adults with higher calo-

requirements, the revised calorie norm for the urban population is only marginally lower than those derived by the Task Force (Alagh).

The Monthly Per-capita Consumption Expenditure (MPCE) of Rs 972 in rural areas and Rs 1407 in urban areas constitute the new poverty lines at the all- India level as per the recommendation of the Expert Group (Rangarajan). They translate to a monthly per household expenditure of Rs 4860 / in Rural India and of Rs 7035/ for urban India— assuming a family of 5-members in each case. The existing Official Planning Commission poverty lines for 2011-12 , based on Expert Group (Tendulkar) methodology and derived from the Mixed Recall Period (MRP) consumption distribution of the NSSO , are Rs 816/ and Rs 1000/ per capita per month, for, respectively, the all- India Rural and Urban populations.

The Expert Group (Rangarajan) poverty lines, based on consumption estimates on MMRP are, thus 19 percent higher for Rural India and 41 percent higher for Urban India. Because of the differences in the underlying recall periods, only a part of the total difference (Rs 156 for rural India & Rs 407 in urban India) between the current official poverty lines and those proposed by the Expert Group (Rangarajan) is real. The poverty lines in 2011-12 at the national level are expressed as monthly per capita consumption expenditure of Rs. 972 in rural areas and Rs. 1407 in urban areas, both at 2011- 12 prices. These poverty lines are estimated from the MMRP (Modified Mixed Recall Period) consumption expenditure distribution of NSS 68th Round. These national level poverty lines are disaggregated into state-specific poverty lines in order to reflect the inter-state price differential. The method of constructing the state-wise poverty lines from the national level poverty line in 2011-12 is broadly similar to that outlined by the Expert Group (Tendulkar)

### POVERTY LINE

The poverty threshold, poverty limit or poverty line is the minimum level of income deemed adequate in a particular country. In practice, like the definition of poverty, the official or common understanding of the poverty line is significantly higher in developed countries than in developing countries.

## TYPES OF UNEMPLOYMENT

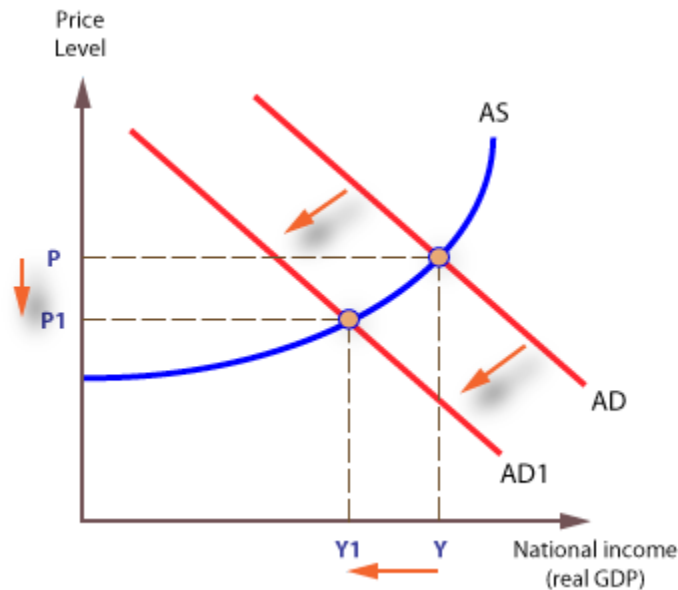
There are several types of unemployment, each one defined in terms of cause and severity.

### Cyclical unemployment

Cyclical unemployment exists when individuals lose their jobs as a result of a downturn in aggregate demand (AD). If the decline in aggregate demand is persistent, and the unemployment long-term, it is called either demand deficient, general, or Keynesian unemployment

Demand deficient unemployment is caused by a lack of aggregate demand, with insufficient demand to generate full employment.





**Structural unemployment**

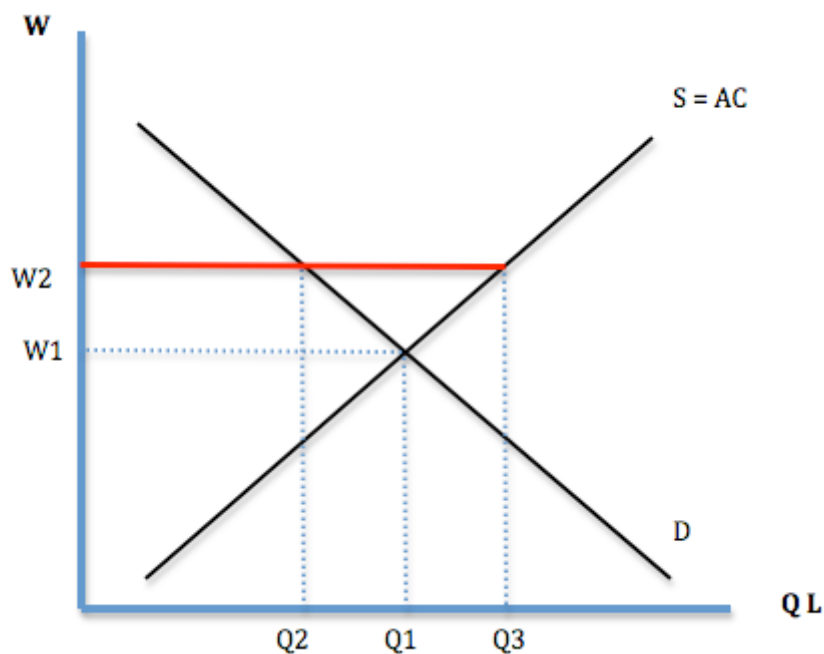
Structural unemployment occurs when certain industries decline because of long term changes in market conditions. Globalisation is an increasingly significant cause of structural unemployment in many countries. This employment generally occurs when there is structural change in the economy for eg from agrarian to industrial.

**Regional unemployment**

When structural unemployment affects local areas of an economy, it is called 'regional' unemployment.

**Classical unemployment**

Classical unemployment is caused when wages are 'too' high. This explanation of unemployment dominated economic theory before the 1930s, when workers themselves were blamed for not accepting lower wages, or for asking for too high wages. Classical unemployment is also called **real wage unemployment**. **Real Wage Unemployment.** e.g. powerful trades unions bargaining for wages above the equilibrium. (this may be exacerbated by fall in aggregate demand)



## Seasonal unemployment

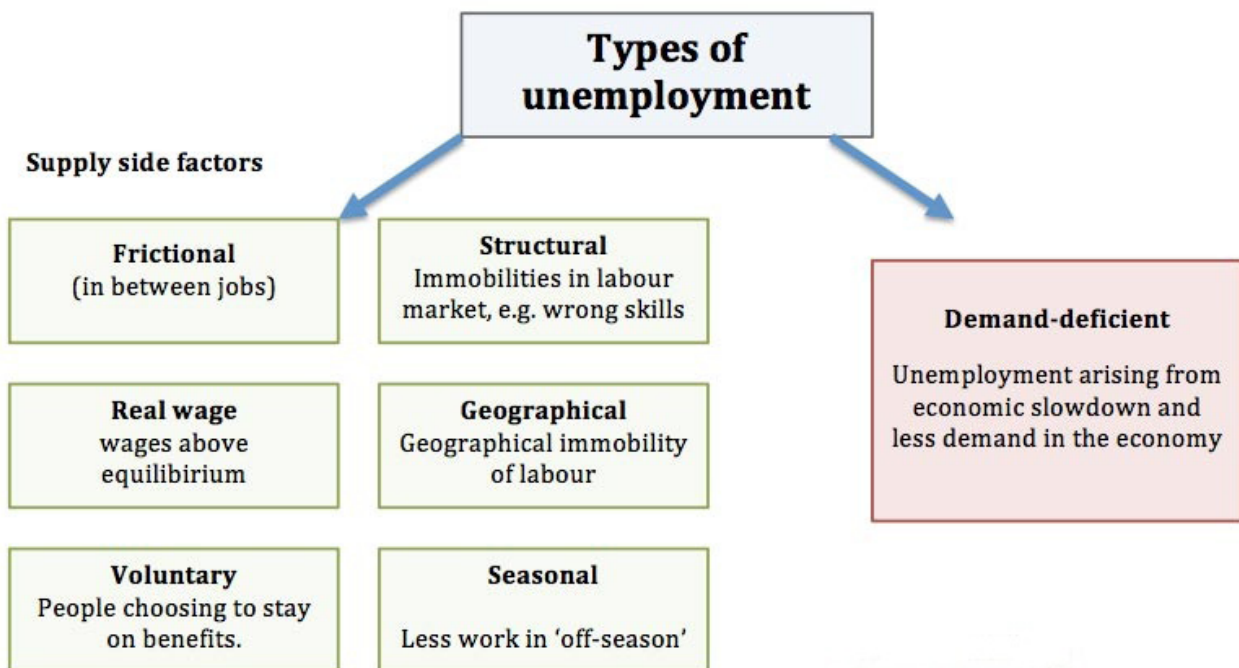
Seasonal unemployment exists because certain industries only produce or distribute their products at certain times of the year. Industries where seasonal unemployment is common include farming, tourism, and construction.

## Frictional unemployment

Frictional unemployment, also called *search unemployment*, occurs when workers lose their current job and are in the process of finding another one. There may be little that can be done to reduce this type of unemployment, other than provide better information to reduce the search time. **This suggests that full employment is impossible at any one time because some workers will always be in the process of changing jobs.**

## Voluntary unemployment

Voluntary unemployment is defined as a situation when workers choose not to work at the current equilibrium wage rate. For one reason or another, workers may elect not to participate in the labour market. There are several reasons for the existence of voluntary unemployment including excessively generous welfare benefits and high rates of income tax. Voluntary unemployment is likely to occur when the equilibrium wage rate is below the wage necessary to encourage individuals to supply their labour.



## The natural rate of unemployment

This is a term associated with new Classical and monetarist economists. It is defined as the rate of unemployment that still exists when the labour market is in equilibrium, and includes seasonal, frictional and voluntary unemployment. The US economist Milton Friedman first used the concept to help explain the connection between unemployment and inflation. Friedman argued that if unemployment fell below the natural rate there would be an increase in the rate of inflation.

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