CA FOUNDATION

MARATHON

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Business Economics
Part 2

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Topic : MEANING OF NATIONAL INCOME

National Income Accounting, pioneered by the Nobel prize-winning economists Simon Kuznets and Richard Stone, is the system of macro-economic accounts from the stage of production of goods and services to the stage of their final disposal.

National Income is defined as the net value of all economic goods and services produced within the domestic territory of a country in an accounting year plus the net factor income from abroad.

Topic : USEFULNESS AND SIGNIFICANCE OF NATIONAL INCOME ESTIMATES

- Framework for analyzing and evaluating the short-run performance of an economy
- Pattern of demand for goods and services
- Economic welfare
- Quantitative basis for assessing and choosing economic policies
- Throw light on income distribution
- Assist in determining eligibility for loans etc.
- A guide to make policies for growth and inflation
- Forecasting about the future development trends of the economy

Topic : DIFFERENT CONCEPTS OF NATIONAL INCOME

1. Gross vs Net

Gross $\longrightarrow$ Net

(-) Depreciation

2. Domestic Product vs National Product

Domestic $\longrightarrow$ National

+ Net Factor Income From Abroad

Or - Net Factor Income TO Abroad

3. Market Price Vs Factor Cost

Market Price → Factor Cost

+ Indirect Taxes
- Subsidies

} (-) Net Indirect Tax

Topic : Real GDP VS Nominal GDP

Real GDP or GDP At Constant Prices	Nominal GDP or GDP At Current Prices
Measurement of Value of Output at the Price Level of a selected "Base Year".	Measurement of Value of Output at the Price Level of the "Current Year".
National Income is affected only by changes in Output levels.	National Income is affected by changes in Price levels and Output levels.
National Income changes only when production / physical output changes.	National Income changes even if prices change, without any change in production / physical output. .

Topic : GDP Deflator

It is the ratio of Nominal GDP (at Current Prices) to Real GDP (at Constant Prices)

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

GDP deflator is the price index used to convert nominal GDP to real GDP

Topic : PER CAPITA INCOME

GDP_{FC} per capita = GDPFC ÷ Population

Topic : Methods Of Calculating National Income

Method 1: Value Added Method	
Particulars	**Amount**
Gross Value Added by Primary Sector	-
Add: Gross Value Added by Secondary Sector	-
Add: Gross Value Added by Tertiary Sector	-
GDP_{MP}	-
Less: Depreciation	-
Add: NFIA	-
Less: Net Indirect Tax	-
NNP_{FC}	

Topic : Methods Of Calculating National Income

Gross Value Added (GDPMP)	=	Value Of Output – Intermediate Consumption
Value Of Output	=	Sales + Change in stock

Topic : Methods Of Calculating National Income

\# Question

Calculate National Income by Value Added Method with the help of following data:

- Sales 700;
- Opening stock 500;
- Intermediate Consumption 350;
- Closing Stock 400;
- Net Factor Income from Abroad 30;
- Depreciation 150;
- Excise Tax 110;
- Subsidies 50.

Topic : Methods Of Calculating National Income

Method 2: Income Method (NDPFC)		
Particulars	Amount	Amount
Compensation Of Employees		
Wages & Salaries In Cash + KIND	-	
Employer Contribution to social security schemes	-	-
Operating Surplus		
(i) Income From Property	-	
Rent + Royalty + Interest Income	-	
(ii) Income From Entrepreneurship (Profits)		
Corporate Tax + Dividend + Retained Earnings	-	
Mixed Income		-
NDP_{FC}		-

Topic : Methods Of Calculating National Income

Method 2: Income Method (NDPFC)		
Particulars	**Amount**	**Amount**
Add: NFIA		-
NNP_{FC}		-

Topic : Methods Of Calculating National Income

\# Question

From the following data, calculate NNPFC, NNPMP, GNPMP and GDPMP.

- Operating surplus 2000;
- Mixed income of self-employed 1100;
- Rent 550; Profit 800;
- Net indirect tax 450;
- Consumption of fixed capital 400;
- Net factor income from abroad -50;
- Compensation of employees 1000.

Topic : Methods Of Calculating National Income

Method 3: Expenditure Method (GDPMP)		
Particulars	**Amount**	**Amount**
Private Final Consumption Expenditure		-
Government Final Consumption Expenditure		-
Gross Domestic Capital Formation		
(i) Gross Fixed Capital Formation		
• Gross Business Fixed Investment	-	
• Gross Residential Construction Investment	-	
• Gross Public Investment	-	-
(ii) Inventory Investment (Change In Stock)		-
Net Exports		-
GDP_{MP}		-

Topic : Methods Of Calculating National Income

Question

Calculate GNP at FC:

(i)	Net domestic fixed capital formation	350
(ii)	Closing stock	100
(iii)	Government final consumption expenditure	200
(iv)	Net indirect taxes	40
(v)	Opening stock	60
(vi)	Consumption of fixed capital	50
(vii)	Net exports	(-)10
(viii)	Private final consumption expenditure	1,500
(ix)	Imports	20
(x)	Net factor income from abroad	(-) 30

Topic : Private Income / Personal Income / Personal Disposable Income

Particulars	Amount
NNP_{FC}	-
Less: Income from Property and Entrepreneurship accruing to Government Administrative Departments (Railways, Post Office etc)	-
Less: Savings of Non-departmental Enterprises.	-
Income From Domestic Product Accruing To Private Sector	-
Add: National Debt Interest	-
Add: Current Transfers from Government	-
Add: Net Current Transfers from rest of the world.	-
Private Income	-

Topic : Private Income / Personal Income / Personal Disposable Income

Private Income	-
Less: Undistributed profits	-
Less: Corporate Tax	-
Personal Income	-
Less: Personal taxation	-
Less: Non tax payments i.e. fees, penalty, fines to government	-
Personal Disposable Income	-

Topic : Private Income / Personal Income / Personal Disposable Income

#Question

From the following data, estimate National Income and Personal Income

- Net national product at market price = 1,891;
- Income from property and entrepreneurship accruing to government administrative departments = 45;
- Indirect taxes = 175;
- Subsidies = 30;
- Saving of non-departmental enterprises = 10;
- Interest on National debt = 15;
- Current transfers from government = 35;
- Current transfers from rest of the world = 20;
- Saving of private corporate sector = 25;
- Corporate profit tax = 25.

Topic : Net National Disposable Income (NNDI)

NNDI =

Net National Income

+

other net current transfers from the rest of the world (Receipts -payments)

Topic : Gross National Disposable Income (GNDI)

$$GNDI = NNDI + CFC$$

Unit 2 National Income As Per Keynes

Topic : NATIONAL INCOME AS PER KEYNES

A comprehensive theory of National Income was first put forward by the British economist John Maynard Keynes in his masterpiece 'The General Theory of Employment Interest and Money' published in 1936.

The Keynesian theory of income determination is presented in three models:

1. The two-sector model consisting of the household and the business sectors,
2. The three-sector model consisting of household, business and government sectors, and
3. The four-sector model consisting of household, business, government and foreign sectors.

Topic : CIRCULAR FLOW IN A SIMPLE TWO-SECTOR MODEL

- Only two sectors in the economy viz., households and firms,
- Only consumption and investment outlays,
- Households own all factors of production,
- They sell their factor services to earn factor incomes,
- They do not save,
- No corporations, corporate savings or retained earnings,

Topic : CIRCULAR FLOW IN A SIMPLE TWO-SECTOR MODEL

- $Y = Y_d$
- No government, no taxes, no government expenditure or transfer payments,
- The economy is a closed economy, i.e., foreign trade does not exist.
- Factor Payments = Household Income = Household Expenditure = Total Receipts of Firms = Value of Output

Topic : THE AGGREGATE DEMAND FUNCTION (AD): TWO-SECTOR MODEL

Aggregate demand (AD) or aggregate expenditure consists of only two components:

(i) Ex ante aggregate demand for consumer goods (C), and

(ii) Ex ante aggregate demand for investment goods (I)

$$AD = C + I \text{ (Constant Investment)}$$

Topic : THE CONSUMPTION FUNCTION (C)

Functional relationship between aggregate consumption expenditure and aggregate disposable income

$C = a + bY$

Where,

C = Aggregate consumption expenditure;

Y = Total disposable income;

a = Consumption at zero level of disposable income;

b = MPC [The slope of the function = $(\Delta C/\Delta Y)$]

Topic : MARGINAL PROPENSITY TO CONSUME (MPC) ‘b’

MPC (b) = $\Delta C/\Delta Y$

The Keynesian assumption is that consumption increases with an increase in disposable income, but that the increase in consumption will be less than the increase in disposable income ($b < 1$) i.e $0 < b < 1$.

Topic : AVERAGE PROPENSITY TO CONSUME (APC)

APC = Total Consumption/Total Income, or

= **C/Y**

the proportion of income spent on consumption decreases as income increases

Topic : THE SAVING FUNCTION (S)

$S = f(Y)$

$S = (-)\, a + (1-b)Y$

Where;

S = Aggregate Savings;

Y = Total disposable income;

$(-)\, a$ = Dis-savings at zero level of income;

$1-b$ = MPS

Topic : THE MARGINAL PROPENSITY TO SAVE (MPS) '1 - b'

MPS $= \Delta \boldsymbol{S} / \Delta Y$, or

$= 1 - b$

- MPC is always less than unity, but greater than zero, i.e., $0 < b < 1$
- $MPC + MPS = 1$

Topic : AVERAGE PROPENSITY TO SAVE (APS)

APS = Total Saving/Total Income, or

$= \mathbf{S}/Y$

Topic : Aggregate Supply

- Ex ante or planned aggregate supply is the total supply of goods and services which firms in a national economy plan on selling during a specific time period.
- It is equal to the national income of the economy, which is either consumed or saved.

$$AS = C + S; \text{ or}$$
$$AS = Y$$

Topic : THE TWO-SECTOR MODEL OF NATIONAL INCOME DETERMINATION

The equilibrium level of income and output in the Keynesian framework is that level at which

AD =AS (Y), Or

Savings = Investment

Equilibrium equation in 2 sector model

$Y = AD$

$Y = C + I$

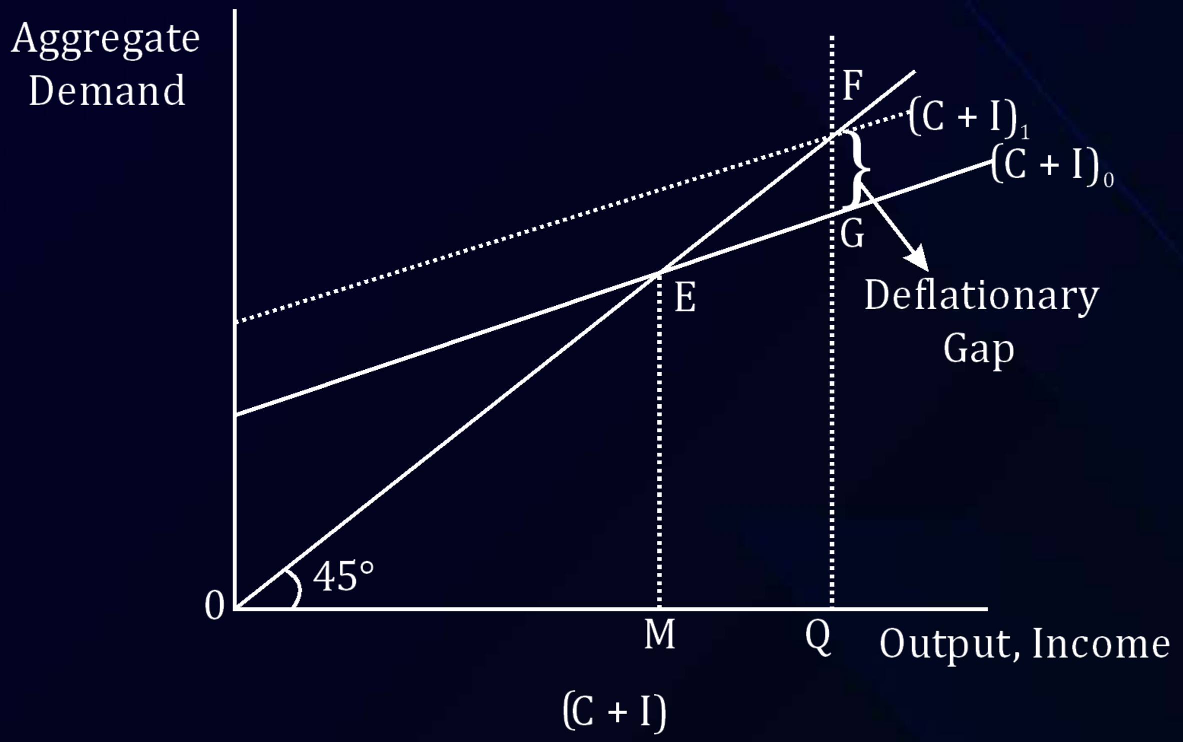
$Y = a + bY + I$

Topic : Equilibrium with Unemployment or Inflation

An important point to remember is that Keynesian equilibrium with equality of planned aggregate expenditures and output need not take place at full employment.

a) Deflationary Gap

- If the AD is for an amount of output less than the full employment level of output, then we say there is deficient demand.
- Deficient demand gives rise to a 'deflationary gap' or 'recessionary gap' or 'contractionary gap'.

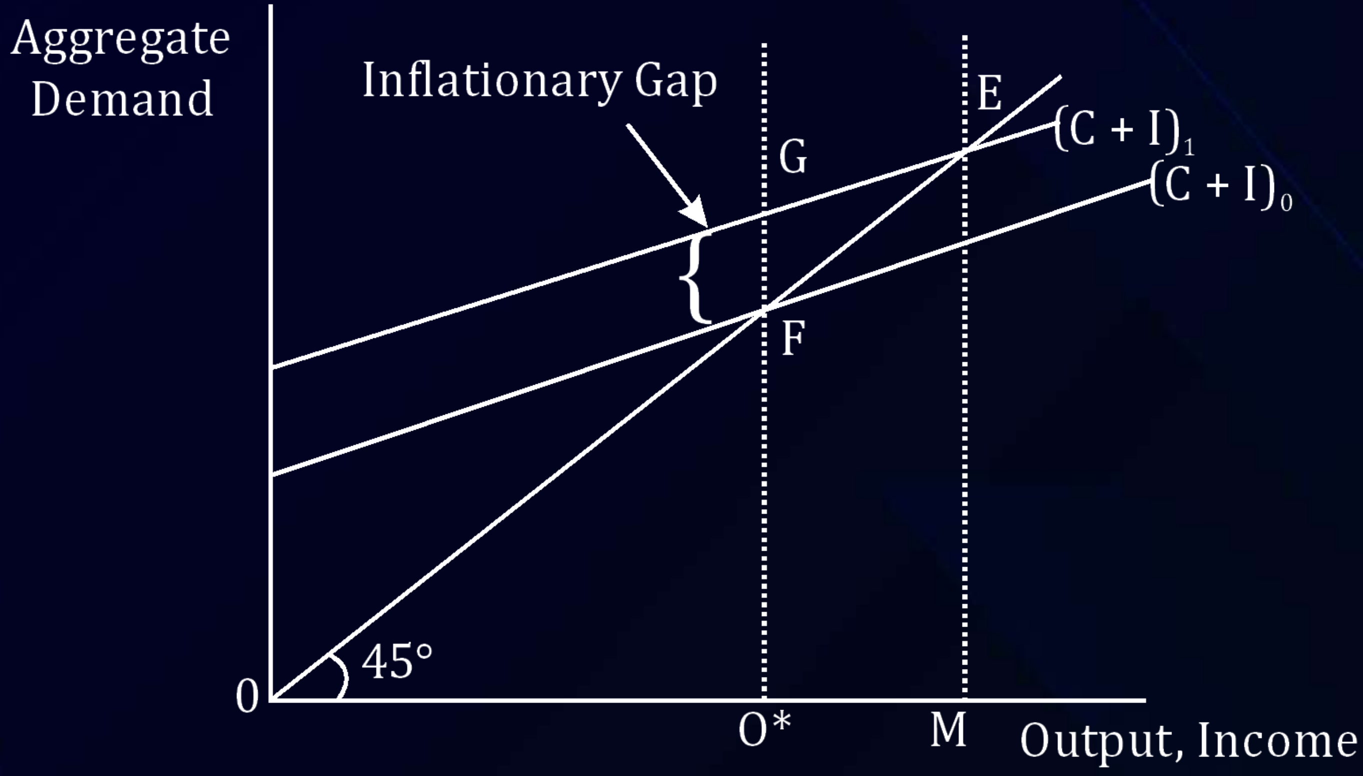


Topic : Equilibrium with Unemployment or Inflation

b) Inflationary Gap

If the AD is for an amount of output greater than the full employment level of output, then we say there is excess demand.

Excess demand gives rise to 'inflationary gap'.



Topic : THE INVESTMENT MULTIPLIER

- The process of increase in national income due to increase in investment depicts the investment multiplier

$$k = \Delta Y / \Delta I \text{ or}$$
$$k = 1 \;/\; 1\text{-}b \text{ or}$$
$$k = 1/\ MPS$$

- Higher the consumption, higher will be the multiplier.
- The maximum value of multiplier is infinity when the value of MPC is 1

Topic : DETERMINATION OF EQUILIBRIUM INCOME: THREE SECTOR MODEL

Aggregate demand in the three sector model:

$$AD = C + I + G$$

The consumption function is

$C \quad = a + b\,Y_d$

$Y_d \quad = Y - T + TR$

$T \quad = \bar{T} + t\,Y$

Where,

$\bar{T}$ = autonomous constant tax

t = income tax rate

Topic : TAX MULTIPLIER

Taxes act as leakage from the economic system.

Thus, tax multiplier when, $T=\bar{T}-tY$, is $\frac{1}{1-b(1-t)}$

Topic : TAX MULTIPLIER

\# Question

Consumption $C = 75 + 0.5\,(Y\text{-}T)$; Investment $I = 80$; Total tax $T = 25 + 0.1Y$; Government expenditure $G = 100$.

(a) Find out equilibrium income?

(b) What is the value of multiplier?

(c) Calculate Tax Multiplier

Topic : DETERMINATION OF EQUILIBRIUM INCOME: FOUR SECTOR MODEL

$Y = C + I + G + (X - M)$

Where

$C = a + b(Y - T)$

$M = \bar{M} + mY$

Where,

M = Aggregate Imports

m = Marginal Propensity to import

Topic : FOREIGN TRADE MULTIPLIER

Foreign Trade Multiplier = $\frac{1}{1-b+m}$

Topic : TRADE BALANCE

Trade Balance = X – M

Topic : TRADE BALANCE

Question

An economy is characterised by the following equation

- Consumption $C = 60+0.9Yd$
- Investment $I = 10$
- Government expenditure $G = 10$
- Tax $T = 0$
- Exports $X = 20$
- Imports $M = 10 + 0.05\ Y$

What is the equilibrium income? Calculate trade balance and foreign trade multiplier.

Chapter Name

PUBLIC FINANCE

UNIT – 01
FISCAL FUNCTIONS: AN OVERVIEW

Topic : WORDS OF ADAM SMITH ON PUBLIC FINANCE

Adam Smith saw an important resource allocation role for government when he underlined the role of government in national defence, maintenance of justice and the rule of law, establishment and maintenance of highly beneficial public institutions and public works which the market may fail to produce on account of lack of sufficient profits.

Topic : RICHARD MUSGRAVE'S THREE BRANCH TAXONOMY ON PUBLIC FINANCE

Richard Musgrave, in his classic treatise 'The Theory of Public Finance' (1959), introduced the three branch taxonomy of the role of government in a market economy:

- Resource Allocation (efficiency),
- Income Redistribution (fairness) and
- Macroeconomic Stabilization.

Topic : THE ALLOCATION FUNCTION

Resource allocation refers to the way in which the available factors of production are allocated among the various uses to which they might be put. One of the most important functions of an economic system is the optimal or efficient allocation of scarce resources so that the available resources are put to their best use and no wastages are there.

Topic : MAIN REASONS OF NEED OF EFFICIENT ALLOCATION

- Imperfect competition and presence of monopoly power
- Markets typically fail to provide collective goods
- Externalities
- Factor immobility which causes unemployment and inefficiency
- Imperfect information, and
- Inequalities in the distribution of income and wealth.

Topic : STATE OR GOVERNMENT AND ALLOCATION

The allocative function in budgeting determines who and what will be taxed as well as how and on what the government revenue will be spent. It is concerned with the provision of public goods and the process by which the total resources of the economy are divided among various uses and an optimum mix of various social goods (both public goods and merit goods).

Topic : ALLOCATION INSTRUMENTS

- Government may directly produce the economic good,
- Government may influence private allocation through incentives and disincentives,
- Government may influence allocation through its competition policies, merger policies etc.,
- Governments' regulatory activities such as licensing, controls, minimum wages etc.,
- Government sets legal and administrative frameworks, and
- Any of a mixture of intermediate techniques may be adopted by governments.

Topic : REDISTRIBUTION FUNCTION

It is concerned with the adjustment of the distribution of income and wealth so as to ensure distributive justice namely, equity and fairness. The distribution function also relates to the manner in which the effective demand over the economic goods is divided among the various individual and family spending units of the society.

Topic : AIM OF REDISTRIBUTUION FUNCTION

- To achieve an equitable distribution of societal output among households,
- Advancing the well-being of all,
- Providing equality in income, wealth and opportunities,
- Providing security for people who have hardships, and
- Ensuring that everyone enjoys a minimal standard of living.
- Progressive taxation of the rich and subsidy to the poor households,
- Financing public services, especially those that benefit low-income households,
- Employment reservations and preferences,
- Regulation of the manufacture and sale of certain products to ensure the health and well-being of consumers, and
- Special schemes for backward regions and for the vulnerable sections.

Topic : STABILIZATION FUNCTION

The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation.

Topic : CONCERN OF STABILIZATION FUNCTION

- Labour employment and capital utilization,
- Overall output and income,
- General price levels,
- Balance of international payments, and
- The rate of economic growth.

QUESTION

#Q. Macroeconomic stabilization may be achieved through

A Free market economy

B Fiscal policy

C Monetary policy

D (b) and (c) above

QUESTION

#Q. Which of the following policies of the government fulfils the redistribution function

A. Parking the army on the northern borders of the country

B. Supply of food grains at subsidized prices to the poor people

C. Controlling the supply of money through monetary policy

D. All of the above

QUESTION

#Q. The justification for government intervention is best described by

A. The need to prevent recession and inflation in the economy

B. The need to modify the outcomes of private market actions

C. The need to bring in justice in distribution of income and wealth

D. All the above

QUESTION

#Q. When a government offers unemployment benefits and also resorts to progressive taxation which function does it seem to fulfill?

A. It is trying to establish stability in an economy

B. It is trying to redistribute income and wealth

C. It is trying to allocate resources to their most efficient use

D. It is creating a source of market failure

UNIT – 02
MARKET FAILURE

Topic : THE CONCEPT OF MARKET FAILURE

Market failure is a situation in which the free market leads to misallocation of society's scarce resources in the sense that there is either overproduction or underproduction of particular goods and services leading to a less than optimal outcome.

There are four major reasons for market failure. They are:

- Market power,
- Externalities,
- Public goods, and
- Incomplete information

Topic : MARKET POWER OR MONOPOLY POWER

Market power or monopoly power is the ability of a firm to profitably raise the market price of a good or service over its marginal cost.

Topic : EXTERNALITIES

Sometimes, the actions of either consumers or producers result in costs or benefits that do not reflect as part of the market price. Such costs or benefits which are not accounted for by the market price are called externalities because they are "external" to the market. The four possible types of externalities are:

- Negative production externalities
- Positive production externalities
- Negative consumption externalities ,and
- Positive consumption externalities

Topic : EXTERNALITIES

1. **Negative Production Externalities:**
   "A negative externality initiated in production which imposes an external cost on others may be received by another in consumption or in production."

2. **Positive production externalities:**
   "A positive production externality initiated in production that confers external benefits on others may be received in production or in consumption."

3. **Negative consumption externalities:**
   "A negative consumption externalities initiated in consumption which imposes an external cost on others may be received by another in consumption or in production."

4. **Positive consumption externalities:**
   "A positive consumption externality initiated in consumption that confers external benefits on others may be received in consumption or in production."

Topic : PUBLIC GOODS/COLLECTIVE CONSUMPTION GOODS/SOCIAL GOODS

Paul A. Samuelson who introduced the concept of 'collective consumption good' in his path-breaking 1954 paper 'The Pure Theory of Public Expenditure' is usually recognized as the first economist to develop the theory of public goods.

A public good (also referred to as collective consumption good or social good) is defined as one which all enjoy in common in the sense that each individual's consumption of such a good leads to no subtraction from any other individuals' consumption of that good.

Topic : CLASSIFICATION OF PUBLIC GOODS

Pure Public Goods: 'Which perfectly satisfy non rivalness and non-excludability'
Eg. Defence, Highways etc

Impure Public Goods:
Hybrid goods that possess some features of both public and private goods. These goods are partially rivalrous.
Eg. Indian Railways

Topic : FREE RIDER PROBLEM

'Free riding is 'benefiting from the actions of others without paying'

Due to free-rider problem, the following two outcomes are possible:

- ➢ No public good
- ➢ Under production public goods

Topic : INCOMPLETE INFORMATION

Complete information is an important element of competitive market. Perfect information implies that both buyers and sellers have complete information about anything that may influence their decision making.

Asymmetric Information and Lemons (poor items in market) Problem

Asymmetric information occurs when there is an imbalance in information between buyer and seller.

Topic : INCOMPLETE INFORMATION

Adverse selection

A situation in which asymmetric information about quality eliminates high-quality goods from a market.

Moral hazard

An informed person's taking advantage of a less-informed person through an unobserved action. It arises from lack of information about someone's future behavior.

Topic : THE FORMS OF GOVERNMENT INTERVENTION

- Government Intervention
  - Direct
    - As supplier Public Goods/Information
    - As buyer / Procurement
  - Indirect
    - Taxes /subsidies to alter costs
    - Regulation /influence

Topic : GOVERNMENT INTERVENTION TO MINIMIZE MARKET POWER

- By establishing rules and regulations

  For example, in India, we have the Competition Act, 2002 (as amended by the Competition (Amendment) Act, 2007)
- Price regulation in the form of setting maximum prices that firms can charge
- Determines an acceptable price, called as rate-of-return regulation
- Setting price-caps based on the firm's variable costs, past prices, and possible inflation and productivity growth

Topic : GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

- Direct controls
- Market-based policies

Topic : GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

Direct Controls:

- Prohibit specific activities or limited to a certain level,
- Stringent rules are in place in respect of tobacco advertising, packaging and labeling etc.,
- Governments may pass laws to alleviate the effects of negative externalities,
- Government stipulated environmental standards are rules

For example, India has enacted the Environment (Protection) Act, 1986.

Topic : GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

The Market Based Approaches:

- Setting the price directly through a pollution tax (Pigouvian taxes),
- Setting the price indirectly through the establishment of a cap-and-trade system (tradable emissions permits).

Topic : GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

IN CASE OF POSITIVE EXTERNALITIES:

Subsidies involve government paying part of the cost to the firms in order to promote the production of goods having positive externalities.

Topic : GOVERNMENT INTERVENTION IN THE CASE OF MERIT GOODS

- Merit goods are goods which are deemed to be socially desirable

Examples: Education, health care, welfare services, fire protection, waste management, public libraries, museum and public parks etc.

- Free of cost direct provision of merit goods by government.

Topic : GOVERNMENT INTERVENTION IN THE CASE OF DEMERIT GOODS

- At the extreme, government may enforce complete ban,
- Negative advertising campaigns,
- Prohibit the advertising or promotion of demerit goods,
- Strict regulations to limit access to the good,
- Regulatory controls in the form of spatial restrictions e.g. smoking in public places,
- Imposing unusually high taxes,
- Fix a minimum price.

Topic : GOVERNMENT INTERVENTION IN THE CASE OF PUBLIC GOODS

- Direct provision of a public good (free of cost),
- Excludable public goods can be provided by government and the same can be financed through entry fees.
- Grant licenses to private firms to build a public good facility.

Topic : PRICE INTERVENTION

Price controls may take the form of either

- A price floor (a minimum price buyers are required to pay) or
- A price ceiling (a maximum price sellers are allowed to charge for a good or service)

Topic : GOVERNMENT INTERVENTION FOR CORRECTING INFORMATION FAILURE

- Accurate labeling and content disclosures by producers,
- Public dissemination of information,
- Regulation of advertising and setting of advertising standards.

Topic : GOVERNMENT INTERVENTION FOR EQUITABLE DISTRIBUTION

- Progressive income tax,
- Targeted budgetary allocations,
- Unemployment compensation,
- Transfer payments,
- Subsidies,
- Social security schemes,
- Job reservations,
- Land reforms,
- Gender sensitive budgeting etc.

QUESTION

#Q. Market power

A. Makes price equal marginal cost and produce a positive external benefit on others

B. Can cause markets to be inefficient because it keeps price and output away from equilibrium of supply and demand

C. Makes the firms price makers and restrict output so as to make allocation inefficient

D. (B) and (C) above

QUESTION

#Q. The Competition Act, 2002 aims to

A. Protect monopoly positions of firms that have developed unique innovations

B. To promote and sustain competition in markets

C. To determine pricing under natural monopoly

D. None of the above

QUESTION

#Q. If governments make it compulsory to avail insurance protection, it is because

A) Insurance companies need to he running profitably

B) Insurance will generate moral hazard and adverse selection

C) Insurance is a merit good and government wants people to consume it

D) None of the above

QUESTION

#Q. Smoking in public is a case of

A. Negative consumption externality

B. Negative production externality

C. Internalising externality

D. None of the above

QUESTION

#Q. If an individual tends to drive his car in a dangerously high speed because he has a comprehensive insurance cover, it is a case of

A. Free riding

B. moral hazard

C. Poor upbringing

D. Inefficiency

UNIT – 03
FISCAL POLICY

Topic : BUDGET CONCEPTS

TYPE OF BUDGETS

1. **Balanced budget:** A balanced budget is a budget in which revenues are equal to expenditures. Thus, neither a budget deficit nor a budget surplus exists. Revenue does not fall short of expenditure. i.e., revenue is equal to expenditure (Revenue = Expenditure).

2. Unbalanced budget: The budget may either be surplus or deficit.

- **A surplus budget:** when estimated government receipts are more than the estimated government expenditure it is termed as surplus budget. When the government spends less than the receipts the budget becomes surplus. Briefly put, public revenue exceeds public expenditure (R > E.)

- **A deficit budget:** when estimated government receipts are less than the government expenditure, it is termed as a deficit budget. A deficit budget increases the liability of the government or decreases its reserves. In modern economies, most of the countries follow deficit budgeting.

CAPITAL RECEIPTS

Capital receipts are those receipts that lead to a reduction in the assets or an increase in the liabilities of the government. Examples include recoveries of loans, earnings from disinvestment and debt.

REVENUE RECEIPTS

Revenue receipts can be defined as those receipts which neither create any liability nor cause any reduction in the assets of the government. There are two sources of revenue receipts for the government – tax revenues and non-tax revenues.

REVENUE EXPENDITURE

Revenue expenditure is expenditure incurred for purposes other than creation of physical or financial assets of the central government. It relates to those expenses incurred for the normal functioning of the government departments and various services, interest payments on debt incurred by the government, and grants given to state governments and other parties (even though some of the grants may be meant for creation of assets).

CAPITAL EXPENDITURE

There are expenditures of the government which result in creation of physical or financial assets or reduction in financial liabilities. This includes expenditure on the acquisition of land, building, machinery and equipment, investment in shares, and loans and advances by the central government to state and union territory governments, PSUs and other parties.

When a government spends more than it collects by way of revenue, it incurs a budget deficit. There are various measures that capture government deficit and they have their own implications for the economy.

BUDGETARY DEFICIT OR OVERALL DEFICIT Budgetary

Deficit is defined as the excess of total estimated expenditure over total estimated revenue is the difference between all receipts and expenditure, both revenue and capital.

REVENUE DEFICIT

The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts. It shows the shortfall of government's current receipts over current expenditure. It shows the government revenue is insufficient to meet the regular expenditures in connection with the normal functioning of the government, or the government is diverting resources from other sectors to finance its current expenditure.

Revenue deficit = Revenue expenditure – Revenue receipts

FISCAL DEFICIT

- The excess of total expenditure over total receipts excluding borrowings during a given fiscal year is called the fiscal deficit.
- In other words, fiscal deficit is the difference between the government’s total expenditure and its total receipts excluding borrowing.
- It is often presented as a percentage of the gross domestic product (GDP).

Fiscal deficit = Total Expenditure – Total Receipts excluding borrowing

Fiscal Deficit = (Revenue Expenditure + Capital Expenditure) – (Revenue Receipts + Capital Receipts excluding borrowing)

Fiscal Deficit = (Revenue Expenditure- Revenue Receipts) + (Capital Expenditure – Capital Receipts excluding borrowing)

Fiscal Deficit = Revenue Deficit + (Capital Expenditure - Capital Receipts excluding borrowing)

PRIMARY DEFICIT

- Primary deficit is defined as fiscal deficit of current year minus interest payments on previous borrowings.
- In other words whereas fiscal deficit indicates borrowing requirement inclusive of interest payment, primary deficit indicates borrowing requirement exclusive of interest payment.
- The goal of measuring primary deficit is to focus on present fiscal imbalances.

Primary deficit = Fiscal deficit – Net Interest liabilities

Net interest liabilities interest payments minus interest receipts by the government on domestic lending.

GUILLOTINE

The parliament has very limited time for examining the expenditure demands of all the ministries. So, once the prescribed period for the discussion on demands for grants is over, the speaker of Lok Sabha puts all the outstanding demands for grants, whether discussed or not, to the vote of the house. This process is popularly known as 'Guillotine'.

CUT MOTIONS

Motions for reduction to various demands for grants are made in the form of cut motions seeking to reduce the sums sought by government on grounds of economy or difference of opinion on matters of policy or just in order to voice a grievance.

CONSOLIDATED FUND OF INDIA

All revenues received, loans raised and all moneys received by the government in repayment of loans are credited to the Consolidated Fund of India and all expenditures of the government are incurred from this fund. Money can be spent through this fund only if appropriated by the parliament. The consolidated Fund has further been divided into 'revenue' and 'capital' divisions.

CONTINGENCY FUND OF INDIA

A fund placed at the disposal of the President to enable him/her to make advances to the executive/Government to meet urgent unforeseen expenditure. Contingency fund enables the government to meet unforeseen expenditure and does not require prior legislative approval, unlike with the Consolidated Fund. For meeting such exigencies, advances are made to the executive from the contingency fund which is subsequently reported to the Parliament for recoupment from the Consolidated Fund of India.

PUBLIC ACCOUNT

Under provisions of Article 266(1) of the Constitution of India, public account is used in relation to all the fund flows where government is acting as a banker. Examples include Provident Funds and Small Savings. This money does not belong to government but is to be returned to the depositors. The expenditure from this fund need not be approved by the parliament.

QUESTION

#Q. Corporate tax

A. is collected by the union government and can be a capital receipt or revenue receipt

B. may be collected by the respective states and fall under revenue receipts

C. may be collected either by the centre or states and fall under revenue receipts

D. is collected by the union government and is a revenue receipt

QUESTION

#Q. Government borrowings from foreign governments and institutions

A) Capital receipt

B) Revenue receipt

C) Accounts for fiscal deficit

D) Any of the above depending on the purpose of borrowing

QUESTION

#Q. The revenue deficit for country A is.

A 5,000

B 24,000

C 4,500

D None of these

	₹ Crores
Revenue receipts	20,000
Recovery of loans	1,500
Borrowing	15,000
Other Receipts	5,000
Expenditure on revenue account	24,500
Expenditure on capital account	26,000
Interest payments	2,000

QUESTION

#Q. Fisal deficit of country A is.

A 14,000

B 24,000

C 23,000

D None of these

	₹ Crores
Revenue receipts	20,000
Recovery of loans	1,500
Borrowing	15,000
Other Receipts	5,000
Expenditure on revenue account	24,500
Expenditure on capital account	26,000
Interest payments	2,000

QUESTION

#Q. Primary deficit of country A is

A 26,000

B 26,500

C 22,000

D 24,500

	₹ Crores
Revenue receipts	20,000
Recovery of loans	1,500
Borrowing	15,000
Other Receipts	5,000
Expenditure on revenue account	24,500
Expenditure on capital account	26,000
Interest payments	2,000

QUESTION

#Q. A budget is said to be unbalanced when

A) when government's revenue exceeds government's expenditure

B) when government's expenditure exceeds government's revenue

C) either budget surplus of budget deficit occurs

D) All the above

QUESTION

#Q. Budget of the government generally impacts

A) the resource allocation in the economy

B) redistribution of income and enhance equity

C) stability in the economy by measures to control price fluctuations

D) all the above

UNIT – 04
FISCAL POLICY

Topic : INTRODUCTION (FISCAL POLICY)

Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and level of growth of aggregate demand, output and employment.

Topic : OBJECTIVES OF FISCAL POLICY

- Achievement and maintenance of full employment,
- Maintenance of price stability,
- Acceleration of the rate of economic development, and
- Equitable distribution of income and wealth,

Topic : AUTOMATIC STABILIZERS VERSUS DISCRETIONARY FISCAL POLICY

- In automatic or non discretionary fiscal policy, the tax policy and expenditure pattern are so framed that taxes and government expenditure automatically change with the change in national income.
- Discretionary fiscal policy refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment and prices.

Topic : INSTRUCTMENTS OF FISCAL POLICY

- Taxes,
- Government expenditure,
- Public debt and
- Budget.

Topic : GOVERNMENT EXPENDITURE AS AN INSTRUMENT OF FISCAL POLICY

Government expenditures include:

- Current expenditures to meet the day to day running of the government,
- Capital expenditures (capital equipments and infrastructure), and
- Transfer payments.

Topic : TAXES AS AN INSTRUMENT OF FISCAL POLICY

- During recession and depression, the tax policy is framed to encourage private consumption and investment,
- During inflation, new taxes can be levied and the rates of existing taxes are raised to reduce disposable incomes and to wipe off the surplus purchasing power.

Topic : PUBLIC DEBT AS AN INSTRUMENT OF FISCAL POLICY

- Borrowing from the public through the sale of bonds and securities curtails the aggregate demand in the economy,
- Repayments of debt by governments increase the availability of money in the economy and increase aggregate demand.

Topic : BUDGET AS AN INSTRUMENT OF FISCAL POLICY

- A balanced budget will have no net effect on aggregate demand
- A budget surplus has a negative net effect on aggregate demand since leakages exceed injections,
- A budget deficit has a positive net effect on aggregate demand since total injections exceed leakages from the government sector.

Topic : TYPES OF FISCAL POLICY

- Expansionary fiscal policy is designed to stimulate the economy during the contractionary phase of a business cycle or when there is an anticipation of a business cycle contraction,
- Contractionary fiscal policy is designed to restrain the levels of economic activity of the economy during an inflationary phase or when there is anticipation of a business-cycle expansion which is likely to induce inflation.

Topic : FISCAL POLICY FOR REDUCTION IN INEQUALITIES OF INCOME AND WEALTH

- A progressive direct tax system
- Indirect taxes can be differential
- A carefully planned policy of public expenditure helps in redistributing income from the rich to the poorer sections of the society.

Topic : CROWDING OUT

An increase in the size of government spending during recessions will ‘crowd-out’ private spending in an economy and lead to reduction in an economy’s ability to self-correct from the recession, and possibly also reduce the economy’s prospects of long-run economic growth.

QUESTION

#Q. During recession fiscal policy of the government should be directed towards

A. Increasing the taxes and reducing the aggregate demand

B. Decreasing taxes to ensure higher disposable income

C. Increasing government expenditure and increasing taxes

D. None of the above

QUESTION

#Q. Name the policy that accords with expenditure and taxation policies decisions of the government?

A) Monetary Policy

B) Fiscal Policy

C) Labor Market Policies

D) Trade Policy

QUESTION

#Q. Which one among the following is a tool of Fiscal Policy?

A Government Research

B Election

C Taxation

D None of the above

QUESTION

#Q. An increase in personal income taxes

A. Reduces disposable incomes leading to fall in consumption spending and aggregate demand

B. Is desirable during inflation or when there is excessive levels of aggregate demand

C. Is to compensate the deficiency in effective demand by boosting aggregate spending

D. Both (a) and (b) are correct

QUESTION

#Q. Fiscal policy refers to the

A. Use of government spending, taxation and borrowing to influence the level of economic activity

B. Government activities related to use of government spending for supply of essential goods

C. Use of government spending, taxation and borrowing for reducing the fiscal deficits

D. (a) and (b) above

Chapter Name

Chapter - 8

Money Market

Chapter 8: Money Market

Unit 1: The Concept of Money Demand: Important Theories

Unit 2: The Concept of Money Supply

Unit 3: Monetary Policy

Money: money can be anything that can serve as a

(1) store of value, which means people can save it and use it later–smoothing their purchases over time;

(2) unit of account, that is, provide a common base for prices; or

(3) medium of exchange, something that people can use to buy and sell from one another.

Money is something that holds its value over time, can be easily translated into prices, and is widely accepted.

- The Theories of Demand For Money
  - QTM/ Fisher
    - MV=PT
  - Cambridge Approach
    - MV=KPV (Constant Saving) - it focus on stoke
  - Keynesian Theory
    - People Hold Money for 3 motives
      1) Transaction 2) Precautionary
      3) Speculative Demand for future opportunity.
- Post Keynesian Development in the theory of Demand of Money
  - Inventory
    - Cost Of Brokerage
      (Should be Considered while Deposit in bonds)
      -ROI -Brokerage -Optimum Combination of Bonds & Cash.
  - Friedmon
    - Consider Permanent Income
      -Determinate of Demand for supply -Wealth
      -Price –Inflation -ROI
  - Demand For Money
    - Liquidity Pref/ Tobin
      -If Interest rate is high then the Invest in bond or else hold
      -More Interest Rate = More Bonds

Topic: Classical Approach: Quantity Theory of Money (QTM)

Given by Irving Fisher in his book The Purchasing Power of Money' published in 1911.

As per QTM, money supply (M) & price level (P) are directly related to each other. (Linear)

PT

It is also known as 'equation of exchange' or 'transaction approach'

$$100 \times 2 = MV = PT \quad 2 \times 100 = 200$$

Where, M = the total amount of money in circulation in an economy

V = transactions velocity of circulation i.e. no. of times money changes hand

P = average price level (P= MV/T) ; PT = Total demand of money

T = the total number of transactions; MV = Total supply of money

Topic: Classical Approach: Quantity Theory of Money (QTM)

Expanded Form:

$$MV + M'V' = PT$$

Where, M' the total quantity of credit money

V'= velocity of circulation of credit money

As per QTM, people would hold money in a quantity proportional to total transactions irrespective of interest rate [More Transactions → More Demand of Money]

Topic: The Cambridge Approach

Also known as Cash Balance Approach or Neo-Classical Theory

Money increases utility in the following two ways-

- ➢ Split-up of sale and purchase to two different points of time (represents transaction motive)
- ➢ hedge against uncertainty. (represents money's role as a temporary store of wealth)

Since sale and purchase of commodities by individuals do not take place simultaneously, people need a 'temporary abode of purchasing power as a hedge against uncertainty.

How much money will be demanded as per Cambridge Approach? It depends partly on income and partly on wealth and interest rates.

Topic: The Cambridge Approach

- Higher the income greater the transactions → greater demand for money. Demand for money was determined by need to conduct transactions which will have a positive relationship to value of aggregate expenditure.

$$Md = kPY$$

100
↓
40% = 0.4

Where, Md is the demand for money balances,

Y = real national income,

P = average price level of currently produced goods and services

PY = nominal income.

K = Cambridge k proportion of nominal income (PV) that people want to hold as cash

The equation above explains that the demand for money (M) equals k proportion of the total money income.

Topic: Keynesian Theories of Money Demand

- it is also known as Keynes's Liquidity Preference Theory
- This theory explains - Why do individuals hold money?
- **Three Motives**
  1. Transactions motive
  2. Precautionary motive
  3. Speculative motive

Topic: Transactions Motive

Transaction demand for money is directly related to level of income

$$\boxed{Lr = ky}$$

Where, Lr, is the transactions demand for money,

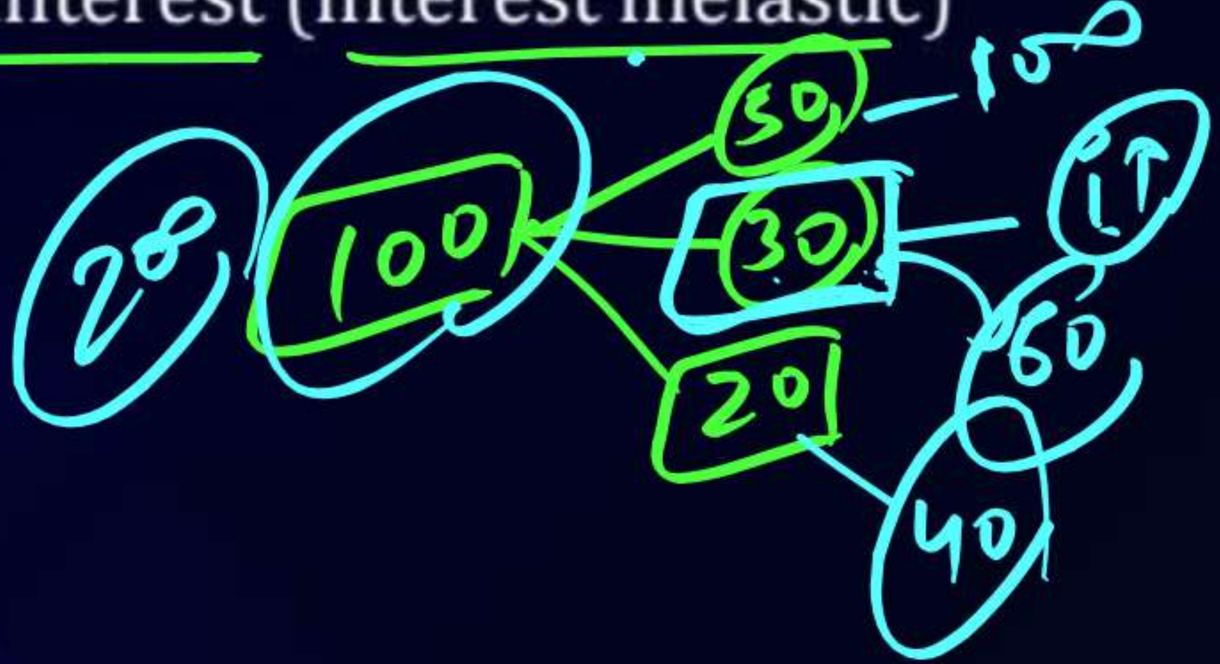
k is the ratio of earnings which is kept for transactions purposes Y is the earnings.

Individuals & businesses keep a portion of their income to finance.

Topic: Precautionary Motive

Individuals & businesses keep a portion of their income to finance unanticipated expenditures which may occur due to unforeseen and unpredictable contingencies.

Keynes regarded the precautionary balances as income elastic and not very sensitive to rate of interest (interest inelastic)



Topic: Speculative Motive

People demand to hold money balances to take advantage of the future changes in the rate of interest, which is the same as future changes in bond prices. (to exploit any attractive investment opportunity)

Keynes assumed that expected return on money is zero, while expected returns on bonds are of two types, namely:

The interest payment

The expected rate of capital gain

When the current rate of interest (rn) is higher than the critical rate of interest (rc), the entire wealth is held by individual in form of government bonds & vice versa

$r_n < r_c$

$>$

Topic: Liquidity Trap

When interest rates fall to very low levels, the expectation is that since the interest rate is very low it cannot go further lower and that in all possibility it will move upwards.

Thus,

- desire to hold bonds is very low and approaches zero, and
- demand to hold money in liquid form approaches infinity.

Topic: Liquidity Trap

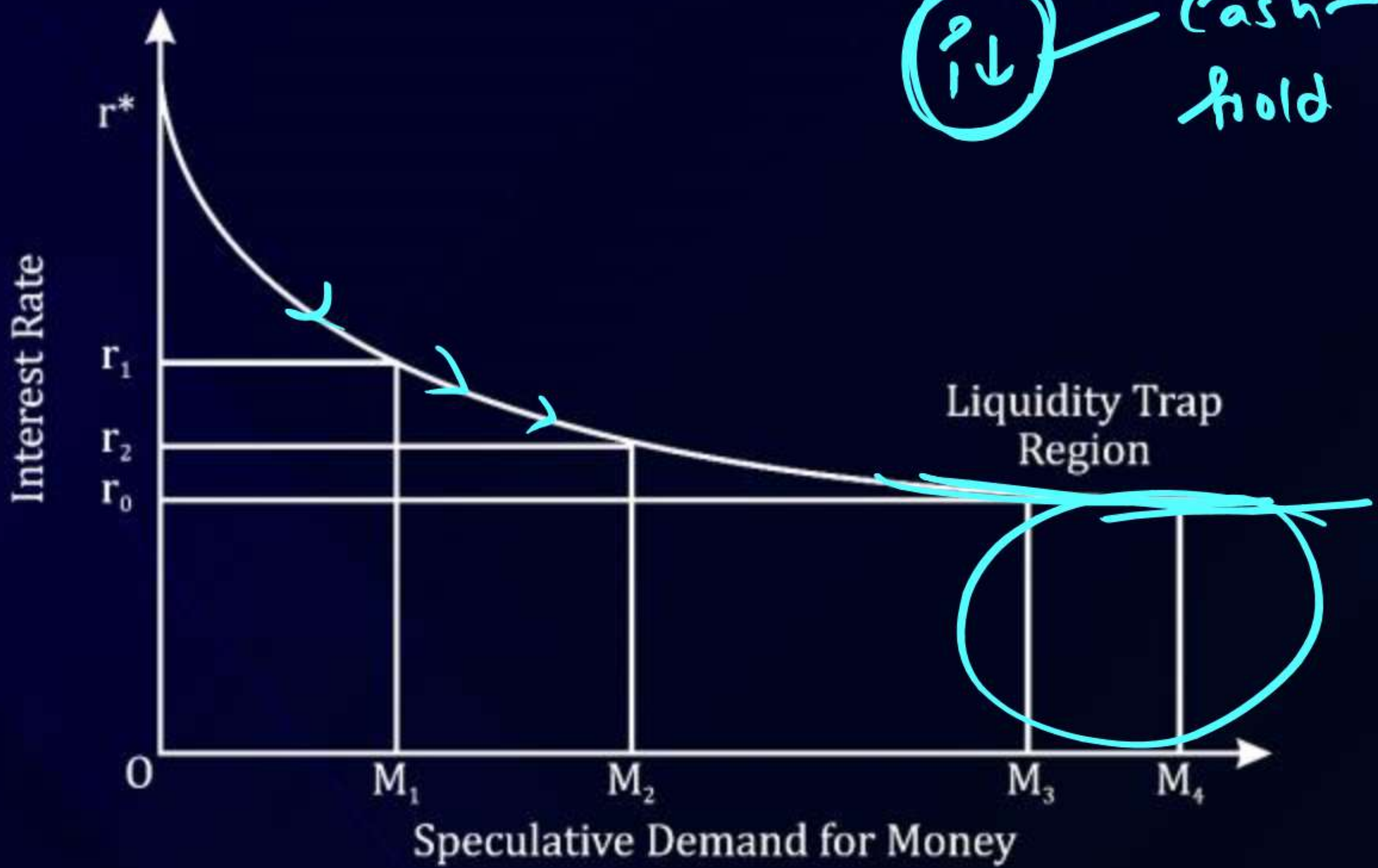
The speculative demand becomes perfectly elastic with respect to interest rate and the speculative money demand curve becomes parallel to the X axis.

This situation is called a 'Liquidity trap'. In such a situation, the monetary authority is unable to stimulate the economy with monetary policy.

The liquidity trap is synonymous with ineffective monetary policy.

Topic: Liquidity Trap

i↓ — Cash → Liquid
hold



Post-Keynesian developments in the theory of Demand for Money

- Inventory Approach to Transaction Balances
- Friedman's Restatement of the Quantity Theory
- Demand for Money as Behavior toward Risk

Topic: Inventory Approach to Transaction Balances

It was given by Baumol (1952) and Tobin (1956) (this theory is also known as Inventory Theoretic Approach), in which money or 'real cash balance' was essentially viewed as an inventory held for transaction purposes.

Inventory models assume that there are two medium for storing value:

1. Money 80
2. an interest-bearing alternative financial asset 20

There is fixed cost of making transfers between money & alternative assets e.g brokerage

As per Baumol, people hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes opportunity cost.

Topic: Inventory Approach to Transaction Balances

The level of inventory holding (holding money in cash)- is DIRECTLY RELATED to

- Income of person
- Cost of making transfer between money and bonds

The level of inventory holding (holding money in cash)- is INDIRECTLY RELATED to

- Carrying cost - (interest income sacrificed by holding money)
- Number of times bond transaction

i↑

80

Baumol has proved that the average amount of cash withdrawal which minimises cost is given by–

$$\boxed{C = \sqrt{2bY / r}}$$

This means that the average amount of cash withdrawal which minimises cost is the square root of the two times broker's fee multiplied by the size of an individual's income and divided by the interest rate. This is also called Square Root Rule.

Topic: Friedman's Restatement of the Quantity Theory

Milton Friedman (1956) extended Keynes' speculative money demand within the framework of asset price theory.

Demand for money is affected by-

- Permanent income (present expected value of all future income)
- Relative returns on assets. (which incorporate risk)

Topic: Friedman's Four Determinants of the Demand for Money

1. Money demand is a function of total wealth

   Total wealth = Permanent Income / discount rate

   Where, discount rate is average return on five asset classes in money, bonds, equity, physical capital and human capital.

2. Money demand is Positively related to the Price Level, P
3. Money demand Rises if opportunity costs of money holdings (i.e. returns on bonds and stock) decline
4. Inflation

   Positive inflation rate reduces the real value of money balances, thereby increasing the opportunity costs of money holdings

Topic: Demand for Money as Behavior toward Risk

Given by Tobin in his article, 'Liquidity Preference as Behavior towards Risk' (1958)
According to Tobin, an individual would hold an optimally structured wealth portfolio which is comprised of both

- Bonds- (provides return for the risk borne) and
- Money- (No return, but also no risk)

The rational behavior of a risk-averse/risk-hater economic agent induces him to hold an optimally structured wealth portfolio which is comprised of both bonds & money.

$\boxed{\text{Unit-2}}$

The concept of Money Supply

- The Sources of Money Supply
- Measurement of Money Supply
- Determinants of Money Supply
- The concept of Money Multiplier

m

RBI

100 → 90

High Powered money

Topic: Basics

(1) The term money supply denotes the total quantity of money available with public

Two things about any measure of money supply:

(i) The supply of money is a stock variable i.e. it refers to the total amount of money at any particular point of time.

It is the change in the stock of money (say, increase or decrease per month or year,), which is a flow.

(ii) The stock of money always refers to the stock of money available to the 'public' as a means of payments and store of value.

80

This is always smaller than the total stock of money that really exists in an economy. 100

Topic: Sources of Money Supply

(1) Central Banks

(i) High powered money or Monetary Base

It is issued by monetary authorities, which is the source of all other forms of money.

The currency issued by the central bank is 'fiat money' and is backed by supporting reserves and its value is guaranteed by the government.

(2) Banking system

(i) Credit Money

Banks create money supply in the process of borrowing lending transactions with the public.

High powered money + Credit Money = $\boxed{\text{Total money stock of a country.}}$

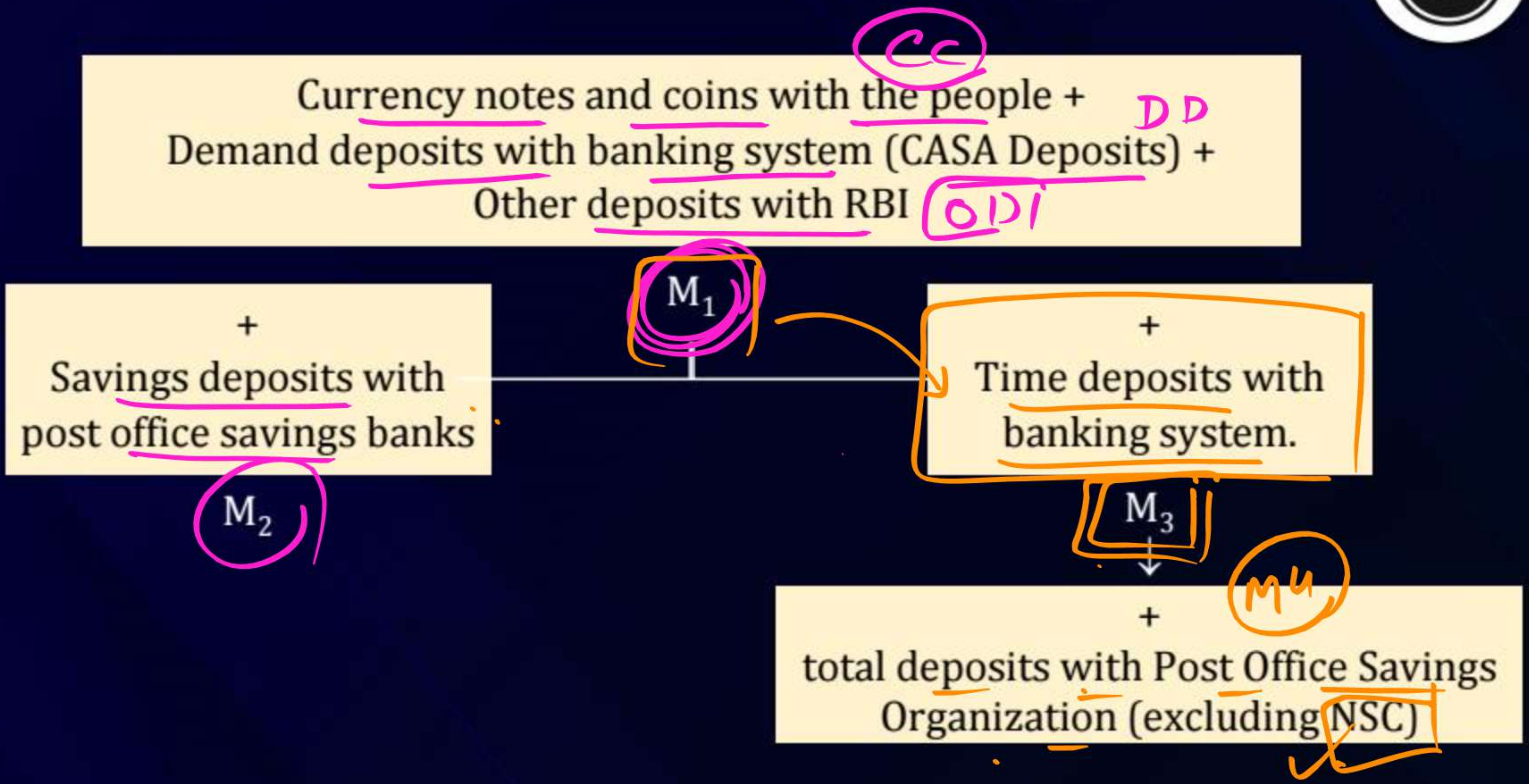
$M_1 = \boxed{Cc + DD + OD}$

$DD \rightarrow$ CASA

M_2

M_3

M_4


Currency notes and coins with the people +
Demand deposits with banking system (CASA Deposits) +
Other deposits with RBI
CC
DD
ODI
M1
+
Savings deposits with post office savings banks
M2
+
Time deposits with banking system.
M3
+
total deposits with Post Office Savings Organization (excluding NSC)
M4

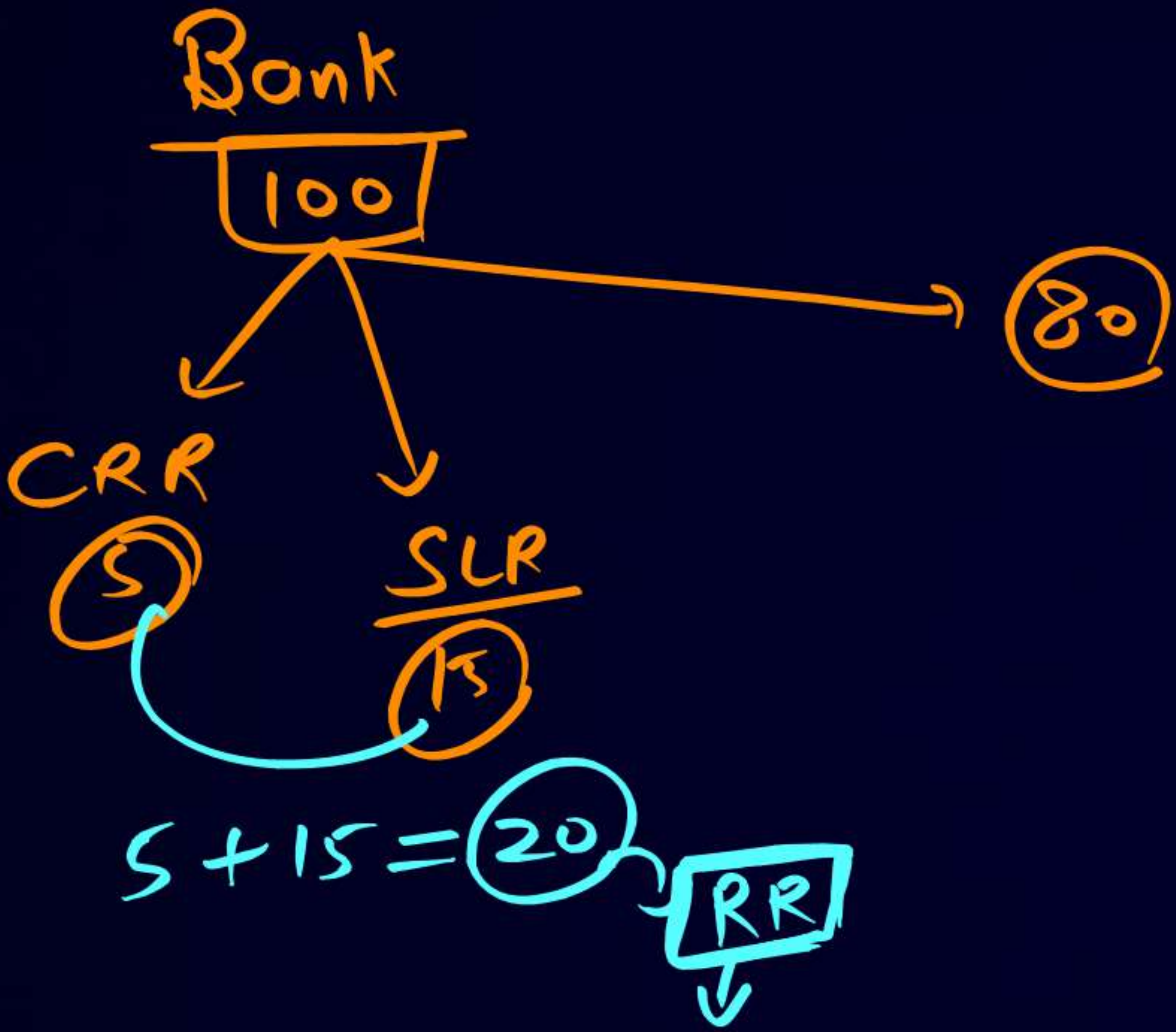
- M1 - Narrow Money
- M3 - Broad Money

M_1 = Currency notes and coins with the people + demand deposits with the banking system (Current and Saving deposit accounts) + other deposits with the RBI.

M_2 = M1 + savings deposits with post office savings banks.

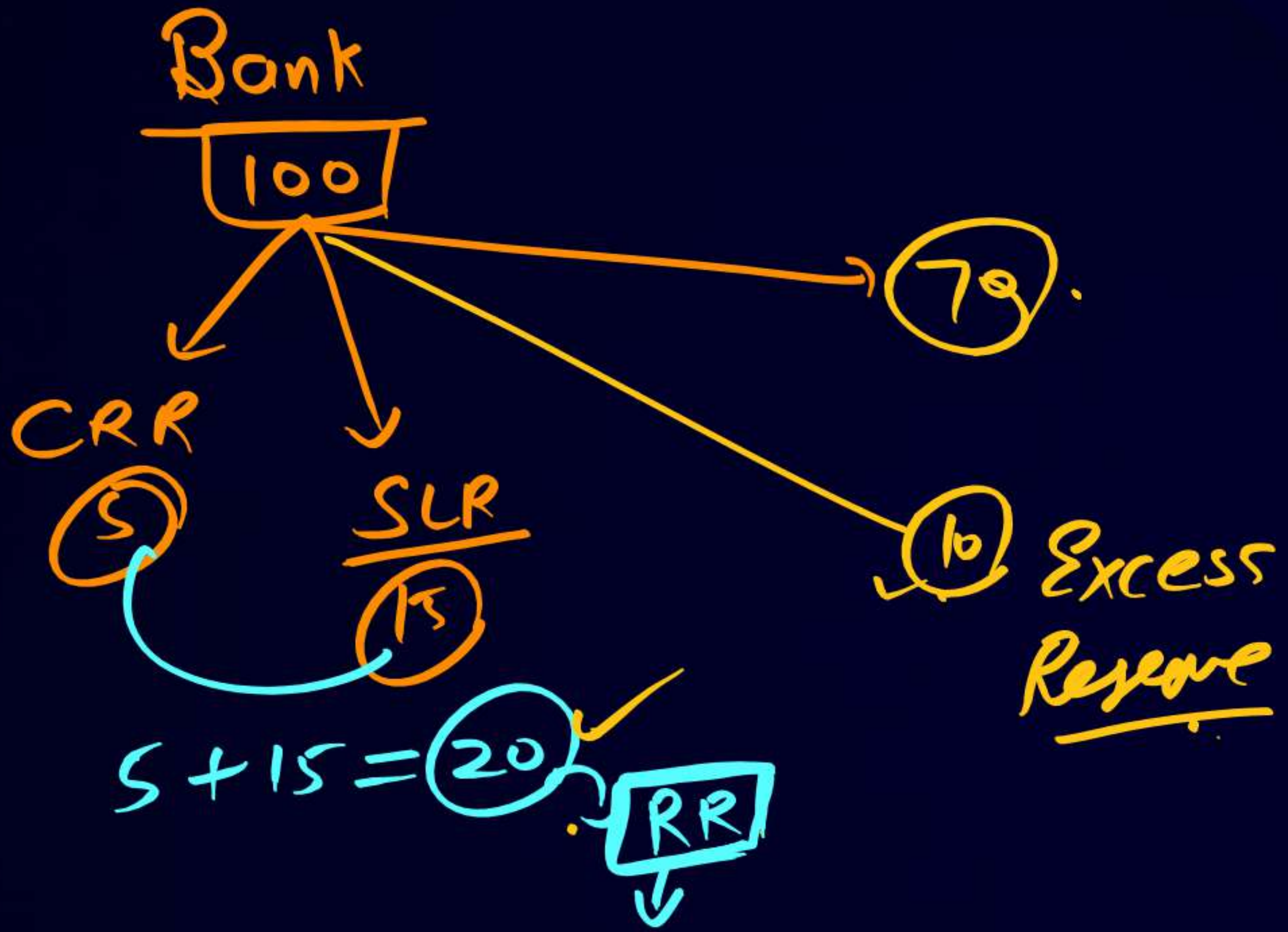
M_3 = M1 + time deposits with the banking system.

M_4 = M3 + total deposits with the Post Office Savings Organization (excluding National Savings Certificates).



No Excess Reserve

$$\frac{1}{LRR} = \frac{1}{RR}$$


Bank
100
CRR
5
SLR
15
70
10
Excess Reserve
5+15=20
RR

Topic: Money Multiplier

- The money multiplier process explains how an increase in the monetary base causes the money supply to increase by a multiplied amount.
- Ratio of stock of money to stock of high powered money

Topic: 1st Formula

$$\text{Money Multiplier (m)} = \boxed{\frac{\text{Money supply}}{\text{Monetary Base}}}$$

Monetary Base = Currency in circulation + Bank reserves.

$$m = \frac{C + D}{C + RR + ER}$$

$$= \frac{D\left(\frac{C}{D} + 1\right)}{D\left(\frac{C}{D} + \frac{RR}{D} + \frac{ER}{D}\right)}$$

$$\boxed{m = \frac{C + 1}{C + r + e}}$$

The above formula can also be referred to as the **Credit Multiplier** or **Deposit Multiplier** or **Deposit Expansion Multiplier**

It describes amount of additional money created by commercial bank through process of lending the available money it has in excess of central bank's reserve requirements.

Determinants of Money Supply

Money multiplier approach to money supply propounded by Milton Friedman & Anna Schwartz, (1963) considers three factors as immediate determinants of money supply

- **Stock of high-powered money (H)**
  - Depends upon Behavior of Central Bank
- **Reserve-ratio (r) = Reserves / Deposits or R/D**
  - Depends upon Behavior of Commercial Banks
- **Currency-deposit ratio or Currency Ratio (c) = C/D**
  - Depends upon Behaviour of Public

Topic: Reserve Money

Reserve money, also known as

- Central Bank Money,
- Base Money or
- High-Powered Money

Reserve Money determines –

- Level of Liquidity and
- Price Level in economy and,

Thus, its management is of crucial Importance to stabilize the economy.

Sell

Bond

RBI

MS ↓

Topic: Monetary Policy and Money Supply

If the central bank of a country wants to stimulate economic activity it does so by infusing liquidity into the system.

Eg. Open Market Operations by central banks.

- Purchase of government securities injects high powered money (monetary base) into the system.

Assuming that

– banks do not hold excess reserves and

– also that there is demand for loans from businesses, credit creation process by banking system will create money to the tune of

$$\boxed{\Delta \text{ Money Supply} = \frac{1}{R} \times \Delta \text{ Reserves}}$$

Topic: Effect of Government Expenditure on Money Supply

Whenever central and state governments' cash balances fall short of the minimum requirement, they are eligible to avail of a facility called Ways and Means Advances (WMA)/overdraft (OD) facility.

When RBI lends to governments under WMA/OD, it results in the generation of excess reserves (i.e., excess balances of commercial banks with the Reserve Bank).

This happens because when government incurs expenditure, it involves debiting the government balances with the Reserve Bank and crediting the receiver (for e.g., salary account of government employee) account with the commercial bank.

The extra reserves thus created can potentially lead to an increase in money supply through the money multiplier process.

Unit-3

- Monetary Policy
  - The Monetary Policy Framework
    - Objectives of Monetary Policy
    - Analytics of Monetary Policy
    - Operating Procedures & Instruments
  - The Organizational Structure for Monetary Policy Decisions
    - The Monetary Policy Framework Agreement
    - The Monetary Policy Committee (MPC)

Topic: Meaning of Monetary Policy

Monetary policy refers to the use of monetary policy instruments by the central bank to regulate the availability and cost of money and credit to-

- promote economic growth,
- price stability.

Topic: Objectives of Monetary Policy

Primary objective of monetary policy is maintenance of judicious balance between price stability & economic growth.

Topic: Objectives of Monetary Policy

Objectives of Monetary Policy in case of developing countries :

(1) maintenance of economic growth

(2) ensuring an adequate flow of credit to the productive sectors

(3) sustaining a moderate structure of interest rates to encourage investments,

(4) creation of an efficient market for government securities.

G-sec

Topic: Transmission of Monetary Policy

The transmission of the monetary policy describes how changes made by RBI to its monetary policy settings flow through to economic activity and inflation. In simple terms, the transmission can be summarised in two stages.

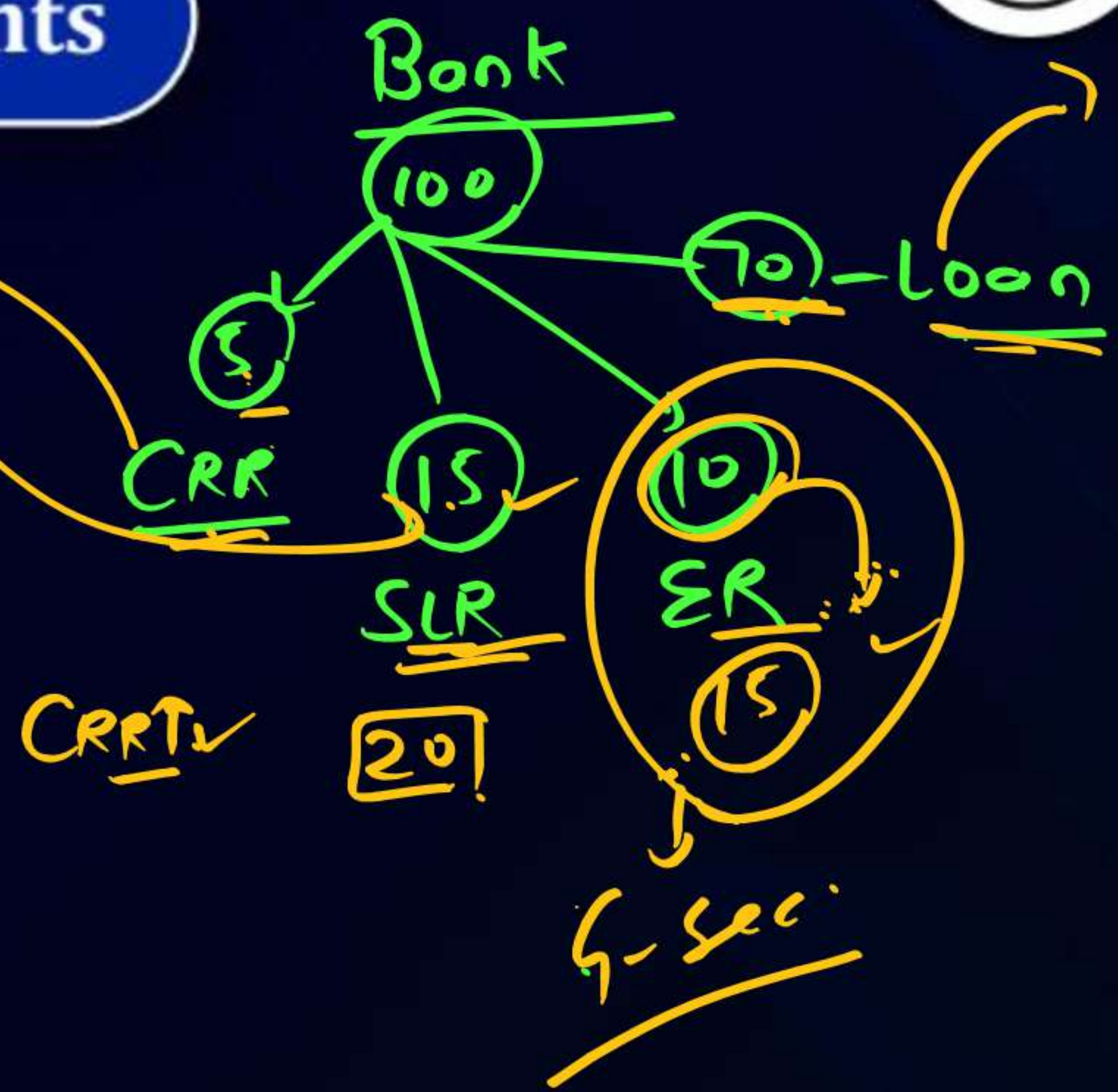
$m^s\uparrow \rightarrow i\downarrow$

1. Changes to monetary policy affect interest rates in the economy.
2. Changes to interest rates affect economic activity and inflation

$i\uparrow$

Topic: Important Instruments

(1) Cash Reserve Ratio (CRR)
(2) Statutary Liquidity Ratio (SLR)
(3) Liquidity Adjustment Facility (LAF)
(4) Marginal Standing Facility (MSF)
(5) Market Stabilisation Scheme (MSS)
(6) Bank Rate
(7) Open Market Operations



Topic: Operating Procedures & Instruments

Quantitative tools

These are the tools of monetary policy that affect money supply in the entire economy.

(1) Reserve Ratio : Banks are required to keep aside a set percentage of cash reserves or RBI approved assets. Reserve ratio is of two types.

- **(a) Cash Reserve Ratio (CRR) :** Banks are required to set aside this portion in cash with the RBI.
- **(b) Statutory Liquidity Ratio (SLR) :** Banks are required to set aside this portion in liquid assets such as gold or RBI approved securities such as government securities.

Topic: Operating Procedures & Instruments

(2) **Open Market Operations (OMO)** : In order to control money supply, the RBI buys and sells government securities in the open market.

When the RBI sells government securities, the liquidity is sucked from the market, and the exact opposite happens when RBI buys securities. The latter is done to control inflation.

The objective of OMOs are to keep a check on temporary liquidity mismatches in the market, owing to foreign capital flow.

Topic: Qualitative Tools

100 — 80

$\boxed{20}$

Qualitative tools are selective tools of monetary policy that affect the money supply of a specific sector of the economy.

(1) **Margin requirements :** The RBI prescribes a certain margin against collateral, which in turn impacts the borrowing habit of customers. When the margin requirements are raised by the RBI, customers will be able to borrow less.

(2) **Moral suasion :** By way of persuasion, the RBI convinces banks to keep money in government securities, rather than certain sectors.

(3) **Selective credit control :** Controlling credit by not lending to industries or selective speculative businesses.

PSL

Topic: Qualitative Tools

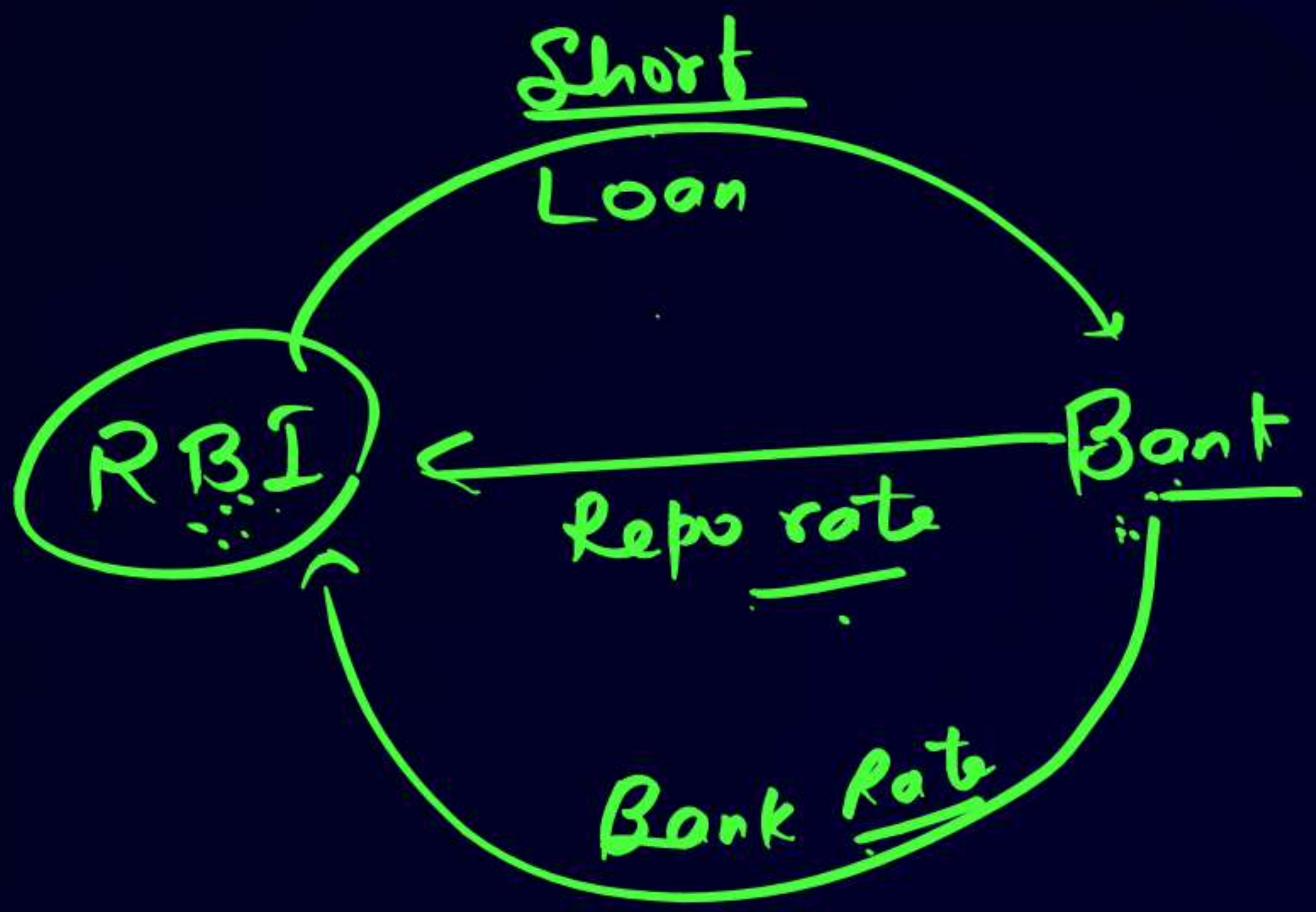
(4) **Market Stabilization Scheme (MSS):** Under MSS the Government of India borrows from the RBI (such borrowing being additional to its normal borrowing requirements) and issues treasury-bills/dated securities.

Topic: Policy Rates

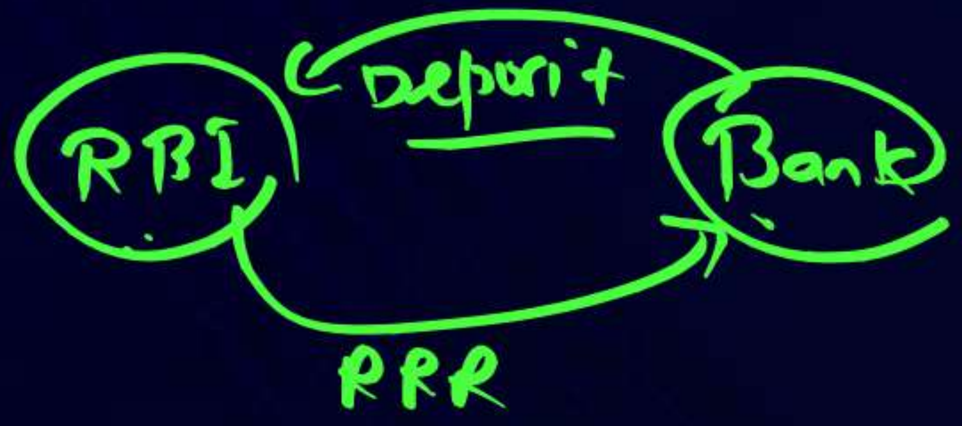
(1) **Bank Rate :** The interest rate at which RBI lends long term funds to banks is referred to as the bank rate.

However, presently RBI does not entirely control money supply via the bank rate. It uses Liquidity Adjustment Facility (LAF) repo rate as one of the significant tools to establish control over money supply.

(2) **Liquidity Adjustment Facility (LAF):** RBI uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are-


Short
Loan
RBI
Bank
Repo rate
Bank Rate

Topic: Policy Rates



(a) **Repo Rate :** Repo rate is the rate at which banks borrow from RBI on a short-term basis against a repurchase agreement. Under this policy, banks are required to provide government securities as collateral and later buy them back after a pre- defined time.

(b) **Reverse Repo Rate :** It is the reverse of repo rate, i.e., this is the rate RBI pays to banks in order to keep additional funds in RBI.

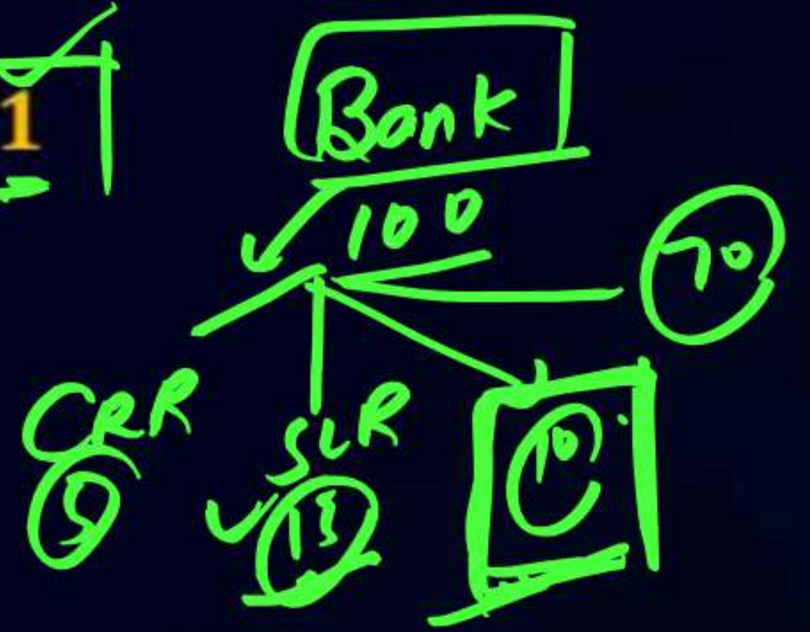
It is linked to repo rate in the following way:

Reverse Repo Rate = Repo Rate – 1

Topic: Policy Rates

(3) **Marginal Standing Facility (MSF) Rate :** MSF Rate is the penal rate at which the Central Bank lends money to banks, over the rate available under the rep policy. Banks availing MSF Rate can use a maximum of 1% of SLR securities.

MSF Rate = Repo Rate + 1



Topic: Organizational Structure For Monetary Policy Decisions

The Reserve Bank of India (RBI) Act, 1934 was amended in 2016, for giving a statutory backing to the Monetary Policy Framework Agreement.

It is an agreement reached between the Government of India and the RBI on the maximum tolerable inflation rate that the RBI should target to achieve price stability.

The amended RBI Act (2016) provides for a statutory basis for the implementation of the 'flexible inflation targeting framework.

Announcement of an official target range for inflation is known as inflation targeting.

Topic: Organizational Structure For Monetary Policy Decisions

The Expert Committee under Urijit Patel revised the monetary policy framework, in January, 2014 & suggested to abandon the 'multiple indicator' approach and make inflation targeting the primary objective of its monetary policy.

The inflation target is to be set by the Government of India, in consultation with RBI, once in every five years.

Accordingly, Central Government has notified-

4 per cent Consumer Price Index (CPI) inflation as the target for period from Aug 5, 2016 to Mar 31, 2021 with the-

upper tolerance limit of 6 per cent and lower tolerance limit of 2 per cent.

Topic: Organizational Structure For Monetary Policy Decisions

The RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months

The following factors are notified by the central government as constituting a failure to achieve the inflation target

- Average inflation is more than upper tolerance level of inflation target for any three consecutive quarters; or
- Average inflation is less than lower tolerance level for any three consecutive quarters.

Chapter Name

Chapter - 9

INTERNATIONAL TRADE

Topic: Theories of international trade

Unit-1

(1) The Mercantilists' View of International Trade
(2) The Theory of Absolute Advantage
(3) The Theory of Comparative Advantage
(4) The Heckscher-Ohlin Theory of Trade
(5) New Trade Theory - An Introduction

Topic: The Mercantilists' View of International Trade

- **Mercantilism,** which is derived from the word **mercantile, "trade** and **commercial affairs".** Mercantilism according to **Microsoft Encarta Dictionary (2009),** was the **economic policy in Europe** from 16th to 18th centuries.
- Mercantilism advocated maximizing exports in order to bring in more **"specie"** (money in the form of precious metals rather than notes) and **minimizing imports** through the state **imposing very high tariffs on foreign goods.**

- This view argues that trade is **a zero-sum game**', with winners who win, does so only at the expense of losers and **one country's gain** is **equal** to **another country's loss,** so that the **net change in wealth** or benefits **among the participants is zero.**
- The arguments put forth by mercantilists were later proved to have many shortcomings by later economists

Topic: The Theory of Absolute Advantage

- According to **Adam Smith,** a country will **specialize in production & export** of commodity in which it has an **absolute cost advantage**
- The principle of absolute advantage refers to the **ability of a party** (an individual, or firm, or country) to produce a greater quantity of **a good, product, or service than competitors, using the same amount of resources.**
- Adam Smith described principle of absolute advantage in the context of international trade, using **labor as the only input.**
- **Exchange of goods** between two countries will take place **only if each of two countries** can **produce one commodity** at an **absolutely lower production cost than the other** country

Topic: The Theory of Comparative Advantage

This law, given by By Ricardo states that even **if one nation is less efficient than** (has an absolute disadvantage with respect to) **other nation in production of all commodities** there is still **scope for mutually beneficial trade.**

Commodity	Productivity of Labour (Output per Hour of Labour)	
	Country A	Country B
Rajma (units/hour)	5	1
Rice (units / hour)	3	2

However, A has **greater absolute advantage (comparative advantage) in case of Rajma** Hence A should specialize in **production & export of Rajma.**

Further, B has **lower absolute disadvantage (comparative advantage) in case of cloth.** Hence B should specialize in **production & export of Rice**

Douglas Irwin (2009) calls comparative advantage "good news" for economic development. "Even if a developing country lacks an absolute advantage in any field, it will **always have a comparative advantage** in the production of some goods," and will **trade profitably with advanced economies.**

Topic: The Heckscher-Ohlin Theory of Trade

This theory is also known as Factor-Endowment Theory of Trade or Modern Theory of Trade or Heckscher-Ohlin Samuelson theorem.

This theory states that **comparative advantage in cost** of production is explained exclusively by the **differences in factor endowments** of the **nations** Factor endowment' refers to the **overall availability** of usable resources- **labour & capital**

It states that a country tends to-

- specialize in the **export** of a commodity whose **production** requires intensive **use of its abundant resources** and
- imports a commodity whose **production** requires intensive **use of its scarce resources**

- Capital abundant country- **Produce and export capital-intensive goods** relatively more cheaply than other countries.
- Labour-abundant country- **Produce and export labour-intensive goods** relatively more cheaply than another country.

Korea USA

Samsung iPhone

Topic: New Trade Theory

New Trade Theory helps in understanding **why developed & big countries** are trade partners when they are **trading similar Goods & Services.** Eg- electronics, IT, cars etc.

Those **countries with the advantages** will **dominate the market** and the market takes the form of **monopolistic competition.**

Two key concepts give advantages to countries that import goods to compete with products from the home country.

(1) Economies of Scale- If firm **serves domestic as well as foreign market** then it **can reap benefit of large scale of production & increase profits.**

(2) Network Effects- The value of goods and services is enhanced as number of individuals using it increases. This is called **bandwagon effect Consumers like more choices** but they also **want goods and services with high utility** and **network effect increases utility** Eg- **What's App** and software like **Windows.**

Unit - 2

Instrument of Trade Policy

Topic: Basic Definitions

- **Trade policy:** It consists of **all instruments** that govts may use to **promote or restrict imports & exports.**
- Instruments of trade policy are-
  (1) **price- related measures** such as tariffs and
  (2) **Non-price measures** or non-tariff measures (NTMs).

The Instruments of Trade Policy

- Tariffs
- Non-Tariff Measures (NTMs)
- Export-Related Measures

import price = 10

Tariff = 6

$\boxed{16}$ →

Topic: Types of Tariffs

(1) **Specific Tariff-** It is **fixed amount of money** per physical unit or according to weight or measurement of commodity imported or exported.

Disadvantage- Its **protective value varies inversely** with the **price** of the import

$\boxed{100}$

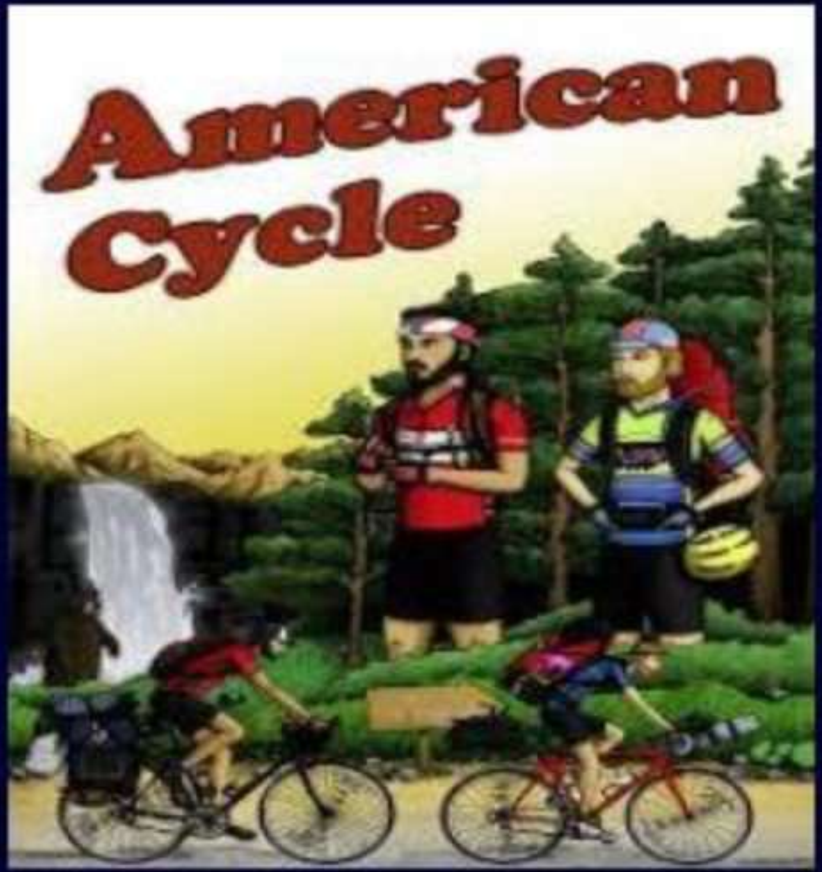
5% → ad-veloram

₹10 → Specific

(2) **Ad Valorem Tariff-** When duty is **levied as fixed percentage of value of traded commodity.**

A 30% ad valorem tariff on any American cycle.

This tariff **preserves protective value** of tariff on home producer, but it **gives incentives to deliberately undervalue good's price on invoices** to reduce tax burden.



Phone $\boxed{100000}$ + 12000 = 1,12000

$\boxed{10\%}$ $\Downarrow$ 10000 | $\boxed{2000}$ $\Rightarrow$ Compound Tariff

$\boxed{\text{Mixed!}}$

(3) **Mixed Tariffs-** They are expressed **either** on **basis of value** of imported goods (an ad valorem rate) **or** on **basis of a unit of measure** of the imported goods (a specific duty) **whichever is higher.** For Eg, duty on American cycle : 10% ad valorem or Rs. 4000 fixed tax , whichever is higher.

(4) **Compound Tariff-** It is generally calculated by **adding up a specific duty** to **an ad valorem duty.**

Thus, on an import with quantity q and price p, a compound tariff collects a revenue = $t_s q + t_a pq$.

where t_s is the specific tariff and ta is the ad valorem tariff

For example: duty on cheese at 10% ad-valorem plus 200 per kilogram.

$\boxed{\text{Phone}}$ — $q = 5$, $p = 100000$

$t_s = 1000$, $t_a = 10\%$

$= t_s \cdot q + t_a \cdot p \cdot q$

$1000 \times 5 + 0.1 \, \boxed{500000}$

$5000 + 50000 = 55000$

(5) **Technical/Other Tariff-** These are calculated on the basis of the **specific contents of imported goods** i.e. **duties are payable by its components** or related items. For Eg- **Rs. 10000** on **each E-rikshaw** plus **Rs. 100/per kg** on battery.

iphone → Handset

charger
Earphone } components

(6) **Tarrif Rate Quota-** TRQs **combine two policy instruments quotas** and **tariffs** Imports entering **under specified quota portion** are subject to **lower or zero tariff rate.** Imports **above quantitative threshold** of quota face a **much higher tariff.**

Liquor | Chocolate | Gold

$\boxed{Q = 1}$ ⇒ No tax ⇒

Q = 2 → 1 → 10%

WTO — 164 → MFN

Max → $\boxed{15\%}$ — MFN

(7) **Most-Favoured Nation Tariffs-** Import tariffs which **countries promise to impose on imports from other members of WTO,** unless country is part of a preferential trade agreement. In practice, MFN rates are the **highest** that **WTO members charge each other.** Some countries **impose higher tariffs on countries** that are **not part of the WTO.**

15

less — $\boxed{10\%}$

USA — India

(8) **Variable Tariff-** A duty typically fixed to **bring the price of an imported commodity up to level of the domestic support price** for the commodity.

china

$\boxed{9000}$

7000
\+ 2000

9000

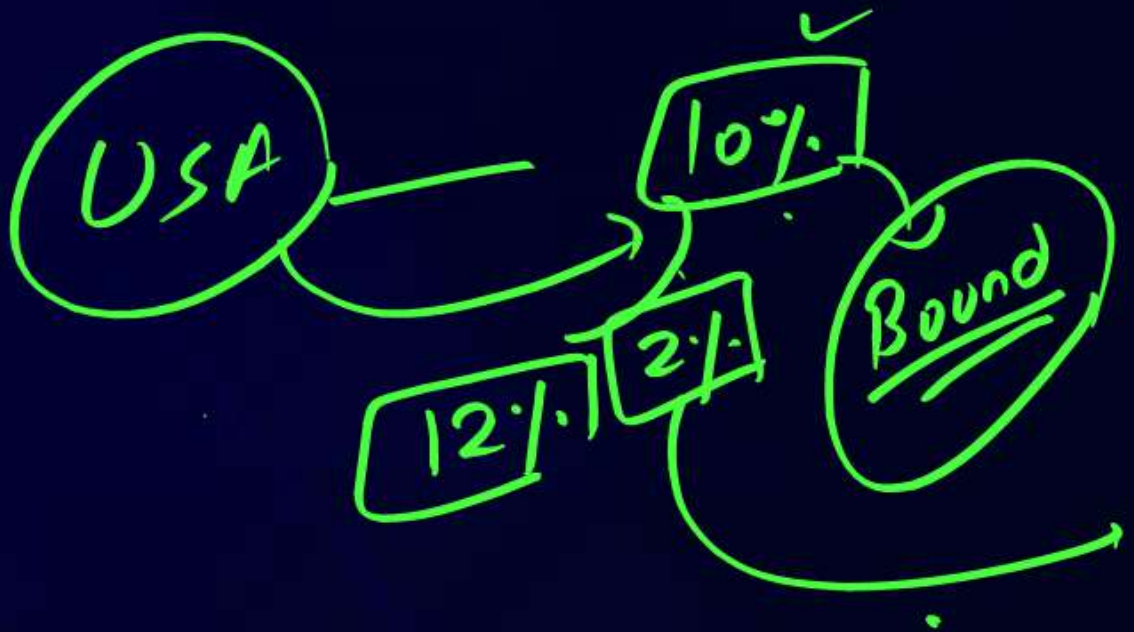
(9) **Preferential Tariff-** Countries promise to give another country's products **lower tariffs than their MFN rate.** These agreements are reciprocal, Examples are **preferential duties in the EU region** under which a good coming from one EU country to another is charged zero tariff rate. Countries, may also grant **'unilateral preferential treatment'** Eg- Generalized System of Preferences (GSP)

15%

16%

1 → 10%

(10) **Bound Tariff-** A WTO member **binds itself with legal commitment not to raise tariff rate above a certain level** (maximum level of import duty). A member is always **free to impose a tariff that is lower** than bound level. Once bound, a tariff rate becomes permanent and a member can only **increase** its level **after negotiating with its trading partners and compensating them for possible losses** of trade.



(11) Applied Tariffs- Duty that is actually charged on imports on a Most- Favoured Nation (MFN) basis. Applied tariff should not be higher than the bound level.

MFN = 15%

PT = 10%

BT = 9%

USA → PAK

→ $\boxed{15\%}$

Applied

(12) **Escalated Tariff-** Tariff **rates on imports of manufactured goods** are higher than tariff **rates on intermediate inputs and raw materials.** For example, a 5% tariff on raw material of cycle and 10% tariff on American cycle. This type of tariff is **discriminatory** as it **protects manufacturing industries in importing countries** and **adversely affects industries of exporting countries.**

(13) Prohibitive tariff - It is set so high that no imports can enter

$\boxed{10000\%}$

(14) **Import subsidies-** It is simply a **payment per unit or as percent of value for importation of a good** (i.e., a negative import tariff)

$\boxed{100} - 5 = 95$

Sub

10000 $\xrightarrow{4000}$ 6000 + 4000 ⇒ ADP

China

India

10000

govt.

5000 + 5000 = 10000

CVD

(15) **Tariffs as Response to Trade Distortions- Countries affected by 'unfair' foreign-trade practices, respond** quickly by measures in the form of **tariff responses to offset the distortion.** (it is also known as "trigger-price" mechanisms)

(16) **Anti-dumping duty(ADD)** - It is a **protectionist tariff** that a domestic govt. imposes on **imports** that it believes are **priced below fair market value.**

- Dumping occurs when **manufacturers sell goods in a foreign** country-
  - **below the sales prices in their domestic market** or
  - **below their full average cost** of the product.
- Dumping may also be resorted to as a **predatory pricing** practice to **drive out domestic producers** from market & to establish monopoly.
- Dumping is **unfair and threat to domestic producers** and thus, ADD is charged. This is **justified only if** the **domestic industry is seriously injured** by import competition, and **protection** is in **national interest.**

(17) **Countervailing duties-** CVD is charged in an importing country to **offset advantage that exporters get from subsidies** (from their govt.) to ensure fair pricing of imported goods and thus **protecting domestic** firms.

Topic: Non-tariff measures (NTMs)

Non-tariff measures comprise all types of measures which **alter the conditions** of **international trade**, including **policies and regulations** that restrict trade and those that facilitate it.

NTMs are divided into technical measures and non-technical measures.

Topic: Technical Measures

Technical measures refer to **product-specific properties** such as **characteristics** of the product, **technical specifications** and **production processes.**

These measures are intended for **ensuring product quality, food safety, environmental protection,** national security and protection of animal and plant health.

1. **Sanitary & Phytosanitary (SPS) Measures**

   These are applied to **protect human, animal or plant life** from **risks arising from additives, pests,** etc. or disease-causing organisms and to **protect biodiversity.**

These include **ban or prohibition of import of certain goods,** all measures governing **quality** and **hygienic requirements.** For Eg- **prohibition of import of poultry from countries affected by avian flu** etc.

2. **Technical Barriers to Trades (TBT)**

It Covers both **food and non-food products -** refer to mandatory **'Standards and Technical Regulations'** define specific - characteristics that product should have, like size, design, packaging, etc. excluding measures covered by SPS.

Conformity assessment procedures (e.g. testing, & certification) are done for this.

Eg: **food laws, quality standards** etc.

Topic: Non-Technical Measures

Non-technical measures **relate to trade requirements:** for example: **shipping requirements, custom formalities, trade rules, taxation policies, etc.**

These are further distinguished as:

(1) **Hard measures** (eg. Price and quantity control measures),

(2) **Threat measures** (e.g. Anti-dumping and safeguards) and

(3) **Other measures** such as trade-related finance and investment measures.

   (a) **Import-related measures -** measures imposed by importing country, and

   (b) **Export-related measures -** measures imposed by exporting country itself

Topic: Non-Technical Measures

(c) **Procedural obstacles (PO)** - practical problems in administration, transportation, delays in testing, certification etc. which makes it difficult for org. to comply.

T , NT , Export

Topic: Export-Related Measures

These refer to all measures applied by government of exporting country including both technical and non-technical measures.

Ban on exports

Eg- during periods of shortages, export of agricultural products such as onion, wheat etc. may be **prohibited to make them available for domestic consumption.**

Export Taxes

An export **tax is a tax collected on exported goods** and may be either **specific or ad valorem.**

The effect of an export tax is to **raise price** of good and to **decrease exports.**

It **increases domestic supply,** it also **reduces domestic prices** and leads to **higher domestic consumption.**

Topic: Export-Related Measures

Export Subsidies and Incentives

Tariffs on imports hurt exports and therefore countries have developed **compensatory measures** of different types for exporters like **export subsidies, duty drawback,** duty free access to imported intermediates etc.

Government usually **provide financial contribution to domestic producers** in form of **grants, loans,** equity infusions etc. or give some form of **income or price support.**

Voluntary Export Restraints

They refer to a type of informal quota administered by an exporting country **voluntarily restraining the quantity of goods that can be exported out** of that country during a specified period of time.

unit-3

Trade Negotiations

$\boxed{\text{RTA}}$

Topic: Regional Trade Agreements (RTAS)

RTAs are defined as **groupings of countries** (not necessarily belonging to the same geographical region), which are formed with the **objective of reducing barriers to trade** between member countries.

Topic: Type of RTAs

- Types of RTA
  - Unilateral Trade Agreements
  - Bilateral Agreement
  - Regional Preferential Trade Agreements
  - Trading Bloc
  - Customs Union
  - Common Markets
  - Economic and Monetary Union

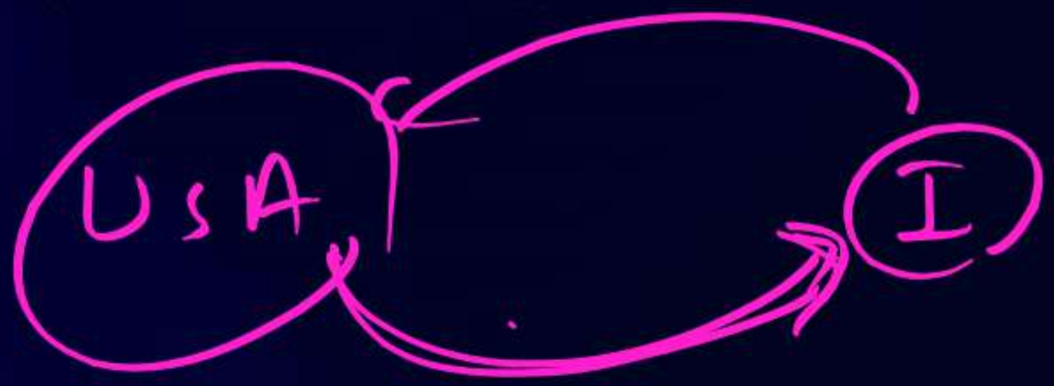
Topic: Type of RTAs

(1) **Unilateral trade agreements-** under which an **importing country offers incentives** to **encourage the exporting country** to **improve the exporting country's economy.** E.g. Generalized System of Preferences.

USA ← Export India

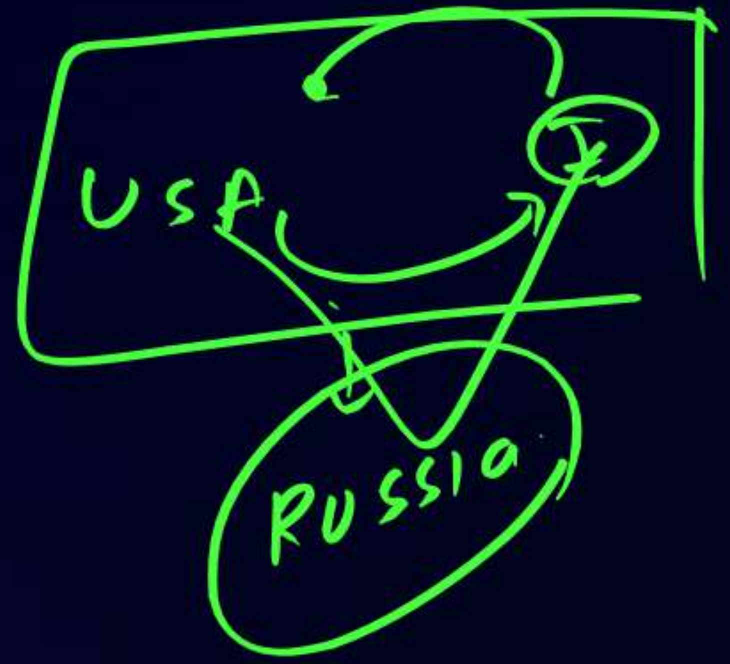
Topic: Type of RTAs

(2) **Bilateral Agreements-** are agreements which set rules of trade **between two countries,** two blocs or a bloc and a country. These may be **limited to certain goods and services** or certain types of market entry barriers. E.g. ASEAN-India Free Trade Area.



Topic: Type of RTAs

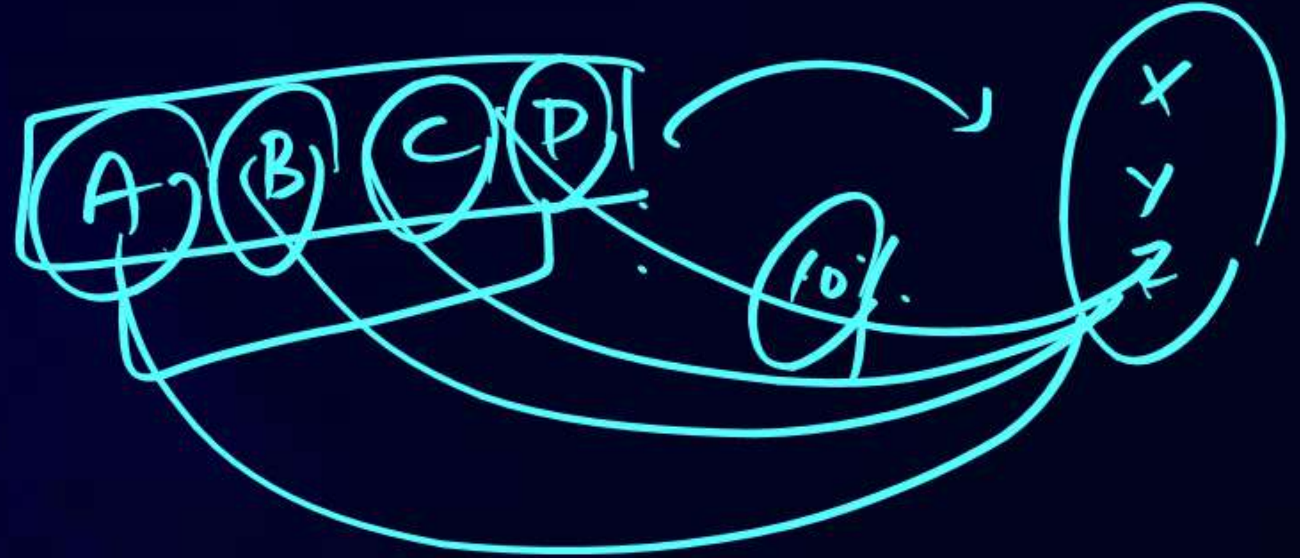
(3) **Regional Preferential Trade Agreements-** among a group of countries **reduce trade barriers on a reciprocal and preferential basis** for **only the members** of the group. E.g. Global System of Trade Preferences among Developing Countries (GSTP)



Topic: Type of RTAs

(4) **Trading Bloc**- has a **group of countries** that have a **free trade agreement** between themselves and may **apply a common external tariff to other countries.**

Example: Arab League (AL), European Free Trade Association (EFTA)



Topic: Type of RTAs

FTA

(5) **Free-trade area-** is a **group of countries** that - **eliminate all tariff and quota barriers** on trade with the objective of increasing exchange of goods with each other. Members **retain independence in determining their tariffs with non-members.**

Example: NAFTA

A B C D

x
y
z

Topic: Type of RTAs

(6) **Customs union-** is group of countries that eliminate all tariffs on trade among themselves but **maintain a common external tariff on trade with countries outside the union** (thus, technically violating MFN).

Eg- European Union etc.

Topic: Type of RTAs

(7) **Common Market-** It deepens a customs union by providing for the **free flow of output and of factors of production** (labour, capital and other productive resources) by reducing or **eliminating internal tariffs** on goods and by **creating a common set of external tariffs.** There are also **common barriers against non-members** (e.g., EU, ASEAN)

Topic: Type of RTAs

(8) **Economic and Monetary Union** - Here members share a common currency. Adoption of **common currency** also makes it necessary to have a strong convergence in macroeconomic policies. For eg, European Union countries adopt a single currency.

1948

GATT — goods

$\boxed{G, S, IP} \longrightarrow \boxed{WTO}$

Topic: GATT

- The General Agreement on Tariffs and Trade (GATT) covers international trade in goods. The workings of the GATT agreement are the responsibility of the Council for Trade in Goods (Goods Council) which is made up of representatives from all WTO member countries.
- The Goods Council has 10 committees dealing with specific subjects (such as agriculture, market access, subsidies, anti-dumping measures, and so on). Again, these committees consist of all member countries.

Topic: The Uruguay Round and The Establishment of WTO

- The Uruguay Round brought about the biggest reform of the world's trading system.
- **Members established 15 groups** to work on **limiting restrictions** in the areas of tariffs, non-tariff barriers, tropical products, natural resource products, textiles and clothing, agriculture, safeguards against sudden 'surges' in imports, subsidies, countervailing duties, trade related intellectual property restrictions, trade related investment restrictions.
- The **agreement was signed by most countries on April 15, 1994,** and took **effect** on **July 1, 1995.**

Topic: Structure of the WTO

- The WTO activities are supported by a **Secretariat** located in **Geneva**, headed by a **Director General**.
- It has a **three-tier system of decision making**

1st Level (Top-Level)	Ministerial Conference	It **takes decisions on all matters** under any of the multilateral trade agreements. It meets at least once every two years.
2nd Level	General Council	It **meets several times a year** at the Geneva headquarters. It also meets as the **Trade Policy Review Body** and the **Dispute Settlement Body.**

Topic: Structure of the WTO

3rd Level	Goods Council, Services Council and Intellectual Property (TRIPS) Council

- These councils **report to the General Council** & are **responsible for overseeing the implementation of the WTO agreements** in their respective areas of specialization.

Topic: Important Guiding Principles

Trade without discrimination

(1) MFN: This principle states that **any advantage** or immunity **granted by any one country to other,** shall be **extended immediately and unconditionally** to **like product originating from other countries.** Under the WTO agreements, if a country lowers a trade barrier or opens up a market for one country, it has to do so for the same for all other WTO members.

(2) National Treatment: A country should **not discriminate between its own and foreign . Give others same treatment as one's own nationals.**

Unit - 4

Exchange Rate and its Economic Effects

Foreign Exchange

₹83 : $1

There are three broad categories of exchange rate systems.

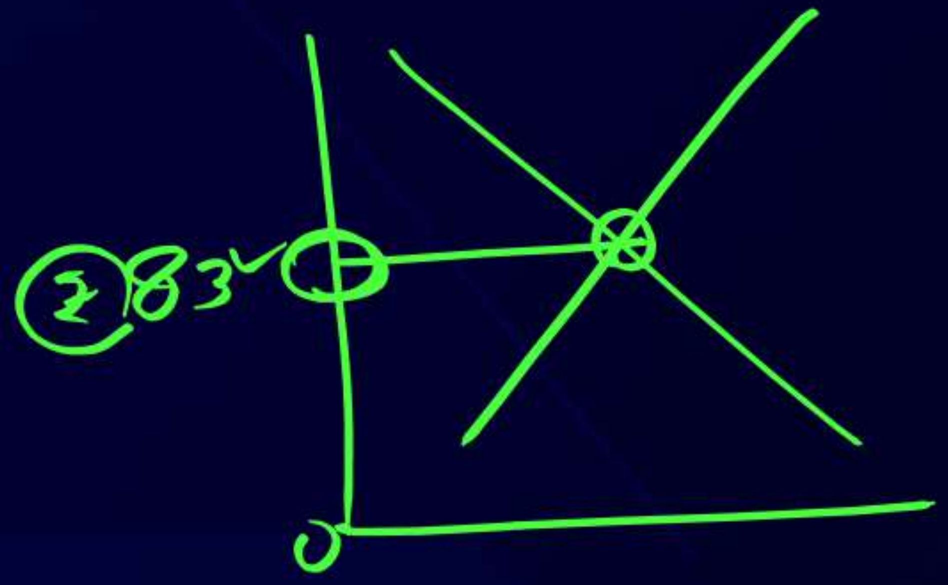
1. In one system, **exchange rates are set purely by private market forces with no government involvement**. Values change constantly as the demand for and supply of currencies fluctuate.
2. In another system, **currency values are allowed to change**, but **governments participate in currency markets** in an effort to influence those values.
3. Finally, **governments may seek to fix the values of their currencies**, either **through participation** in the market or through regulatory policy

There are **two** major types of exchange rate regimes at the extreme ends;

(i) **Floating** exchange rate regime (also called a flexible exchange rate), and

(ii) **Fixed** exchange rate regime

DD | SS



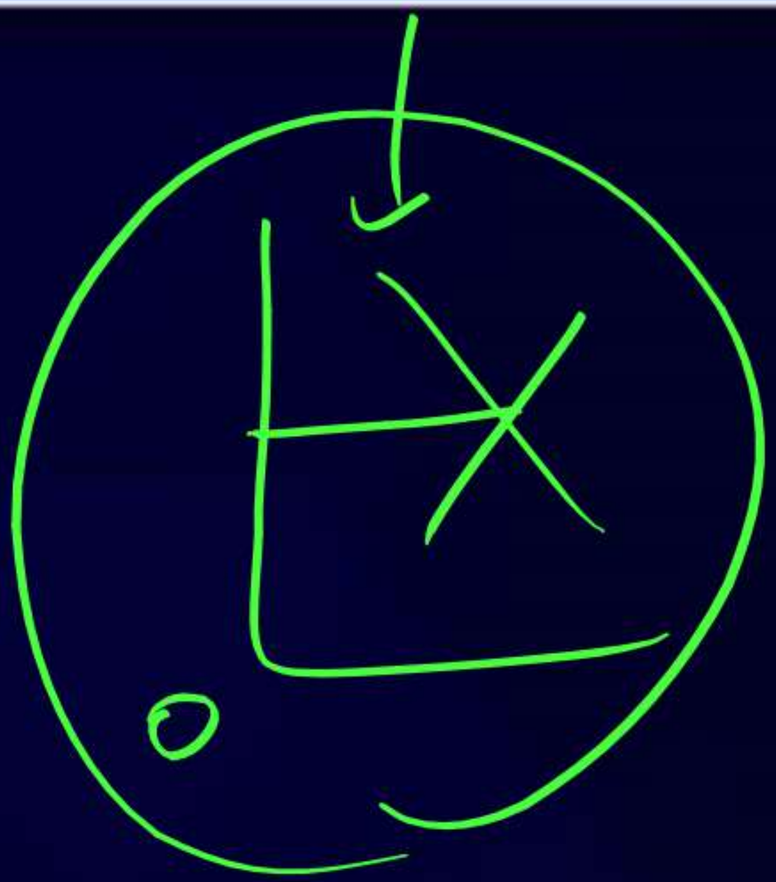
75:1

₹83 = $1

90:1

managed

Topic: Nominal Versus Real Exchange Rates



1 ⇒ $1

1 ⇒ ₹90

90 : 1

$$\text{Real Exchange Rate} = \frac{(\text{Nominal Exchange Rate}) \times \text{Domestic Price}}{\text{Foreign Price}}$$

$$\text{Real Exchange Rate} = \text{Nominal Exchange Rate} \times \frac{\text{Domestic Price Index}}{\text{Foreign Price Index}}$$

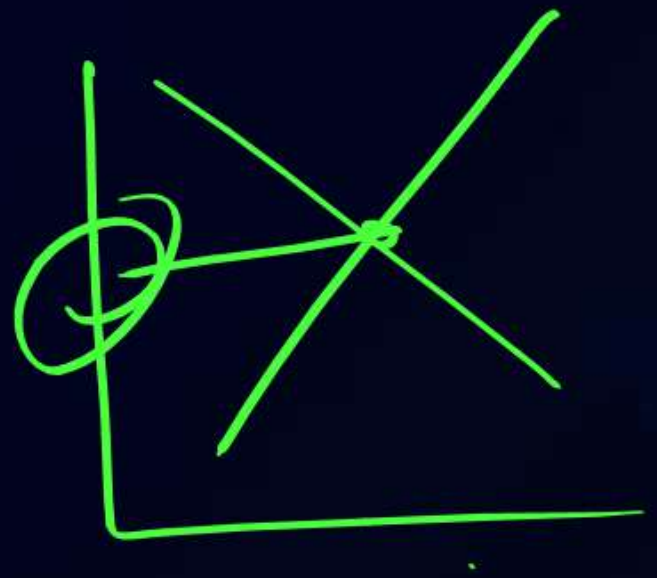
$\boxed{\$1 = ₹83} \Rightarrow$ spot

Topic: In the Foreign Exchange Market, There are Various Types of Exchange Rates

1. **Spot Exchange Rates:** These rates are for immediate settlement, typically within two days, and are used for current transactions.
2. **Forward Exchange Rates:** These rates are used for future transactions and specify the exchange rate for a future date. Parties agree to buy or sell currencies at a predetermined rate in the future. A forward premium occurs when the forward exchange rate is higher than the spot exchange rate, while a forward discount is when the forward rate is lower than the spot rate.

Topic: Determination of Nominal Exchange

The external value of a domestic currency, or its exchange rate, is primarily determined by the forces of supply and demand in the domestic foreign exchange market. In this market, the supply of and demand for foreign exchange play a crucial role in shaping the currency's value in relation to other currencies.



Topic: Participants in the Foreign Exchange Market Seek (Demand) Foreign Currency for Various Reasons, Including

1. Buying goods and services from foreign countries.
2. Conducting unilateral transfers, such as gifts, awards, grants, donations, or endowments.
3. Making investment income payments to foreign entities.
4. Investing in foreign financial assets, such as stocks or bonds.
5. Opening foreign bank accounts.
6. Acquiring direct ownership of real capital in other countries.
7. Engaging in speculation and hedging activities to manage risk associated with currency fluctuations.

Topic: Supply of Forex Results Form

1. Exports of goods and services
2. Conducting unilateral transfers, such as gifts, awards, grants, donations, or endowments
3. Receiving investment income from foreign entities.
4. Investment made by foreign countries
5. Placement of bank deposits by foreigners
6. Loans paid bank by foreign Country
7. Speculation and hedging activities

$\boxed{\text{unit. 5}}$

Foreign capital

Components of foreign capital flows

- Foreign aid or assistance
  - Bilateral or direct inter government grants.
  - Multilateral aid from many governments who pool funds with international organizations like the World Bank.
  - Tied aid with strict mandates regarding the use of money or untied aid where there are no such stipulations.
  - Foreign grants which are voluntary transfer of resources by governments, institutions, agencies or organizations
- Borrowings
  - Direct inter government loans
  - Loans from international institutions (e.g. world bank, IMF, ADB)
  - Soft loans for eg. from affiliates of World Bank such as IDA
  - External commercial borrowing, [ECBs are loans in India made by non- resident lenders in foreign currency to borrowers] and
  - Trade credit facilities
- Deposits from non-resident Indians (NRT)
  - Foreign portfolio investment (FPI) in bonds, stocks and securities, and
  - Foreign direct investment (FDI) in industrial, commercial and similar other enterprises
- Other investment

Topic: Meaning of FDI

10%, Branch

FPI ⟹ less 10%

Topic: Components of FDI

1. Equity capital
2. Reinvested earnings
3. Other direct capital in the form of intra- company loans between direct investors (parent enterprises) and affiliate enterprises

Chapter Name

Chapter - 10

INDIAN ECONOMY

Chapter coverage

Before 1947

1757

1858

EIC

1858

1947

After 1947

1947-1991

1991 onwards

Topic: Before the Advent of British Rule India Was

(1) Self reliant economy

(2) Agriculture was the main source of livelihood

(3) Famous for handicrafts (in the field of cotton, silk, metal, precious stones etc.)

Topic: Status of Indian Economy: Pre Independence Period (1850 -1947)

(1) India was knowns as the largest economy in the ancient and medieval world between the 1st and 17th centuries AD.

(2) Between one third and one fourth of the world's wealth during this period was controlled by India.

(3) The economy consisted of self-sufficient villages and cities, serving as centers for commerce, pilgrimage & administration.

(4) Cities offered more opportunities for diverse occupations and economic activities compared to villages.

(5) The structure of villages was based on a simple division of labor, influenced by race, class, and gender, leading to economic and social differentiation.

Topic: Status of Indian Economy: Pre Independence Period (1850 -1947)

(6) Agriculture was the dominant occupation, but there were highly skilled artisans and craftsmen producing superior quality manufactures, handicrafts, and textiles for the global market.

The advent of the Europeans and the British marked a shift in the economic history of India. The period of British rule can be divided into two sub periods:

(1) The rule of East India Company from 1757 to 1858

(2) British government in India from 1858 to 1947

- British colonialism in India, influenced by the Industrial Revolution, led to a shift in India's role from a manufacturer to a supplier of raw materials.
- British policies imposed heavy tariffs on Indian exports of finished goods while keeping lower tariffs on imports, making Indian products less competitive.
- This discriminatory tariff policy, aimed at serving British interests, resulted in a sharp decline in both external and domestic demand for Indian goods.

- Factory-based production did not exist in India before 1850, and modern industrial enterprises began to grow in the mid-19th century under colonial rule.
- Cotton milling industry in India expanded steadily, achieving high international competitiveness, with **9 million spindles** in the 1930s, ranking fifth globally.
- Jute mills (mainly situated around Kolkata), responding to global demand, made India the largest producer in the world by the late 19th century.
- Other industries such as brewing, paper-milling, leather-making, matches, and rice-milling also developed during the century.
- Heavy industries, like the iron industry established in 1814 (by British money), ranked India eighth globally in terms of output in 1930.

- Some industries in India reached global standards by the early 20th century, and, just before the Great Depression, it was the twelfth largest industrialized country by the value of manufactured products.
- Pressure from English producers influenced policy formulation, discouraging the development of industries that could compete with English producers.
- India's industrial growth was insufficient to bring about a general economic transformation, with the manufacturing sector's share in the net domestic product (NDP) reaching only 7% in 1946.
- Factory employment in India remained small, accounting for 0.4% of the total population in 1900 and 1.4% in 1941.

Topic: Post-independence (1947-1991)

- At the time of independence, India was predominantly rural, with a largely illiterate and impoverished/poor population.
- The society was deeply stratified, and India faced challenges not just in income but also in human capital, with a literacy rate just above 18 percent and a life expectancy of barely 32 years in 1951.
- The Nehruvian model, influenced by historical factors, dominated post-independence economic policy, focusing on social & economic redistribution, and state-led industrialization.
- Centralized economic planning and direction were core to India's development strategy, executed through the Planning Commission and five-year plans.

- The early days of independence saw a focus on rapid industrialization, with the central government having authority to design economic strategy and coordinate investments with the private sector.
- Nehru's development strategy emphasized 'planned modernization,' with a significant role envisioned/imagine for the state in industrialization.
- The Industrial Policy Resolution of 1948 expanded the public sector's role and introduced licensing for the private sector, granting state monopoly in strategic areas such as atomic energy, arms, ammunition, and railways. New investments in basic industries were exclusively given to the state.

- **The policies in 1950's were guided by two economic philosophies:**
  (1) The then prime minister Nehru's visualization to build a socialistic society with emphasis on heavy industry, and
  (2) The Gandhian philosophy of small scale and cottage industry and village republics
- The Industrial Policy Resolution of 1956 emphasized public sector expansion, leading to a dampening/dishearten of private initiative and enterprise, with long-lasting negative consequences for industrial growth.
- Until the late 1950s, India followed an open foreign investment and trade policy, but a balance of payments crisis in 1958 led to a tightening of trade and reduced investment licensing for new investments requiring imports of capital goods.

- Comprehensive import controls were maintained until 1966.
- In the first three decades after independence (1950–80), India's average annual GDP growth rate, known as the 'Hindu growth rate,' was a modest 3.5 percent.
- The initial focus was on capital-intensive projects like dams, power plants, and heavy industrialization rather than consumer goods, contributing to the "Hindu growth rate."
- In the mid-1960s, India witnessed a major shift in economic strategy, marked by inadequate prioritization of agriculture during the second plan and reduced outlays.
- The existing strategy for agricultural development relied on institutional models like land reforms and farm cooperatives, with limited emphasis on technocratic areas like research and development and irrigation.

- Severe droughts in 1966 and 1967 led to negative growth in the agricultural sector, prompting a serious food problem and dependence on the United States for aid.
- The need for a quantum/quantity jump in food grain production shifted the focus to increasing agricultural productivity, initiating the 'green revolution.'
- The green revolution involved restructuring agricultural policy, emphasizing innovative technologies like high-yielding seed varieties and intensive use of water, fertilizer, and pesticides, successfully increasing food grain production.
- Simultaneously, the government introduced stringent administrative controls on trade and industrial licensing and launched a wave of nationalization, including the nationalization of 14 banks in 1969 and another 6 in 1980.

- The interventionist policies of the 1960s had irreparable consequences in the following decade.
- The economic performance from 1965 to 1981 marked the worst period in independent India's history, with growth decline attributed mainly to productivity loss.
- Autarchic policies, license-raj, three wars (1962, 1965, 1971), major droughts (1966, 1967), and oil shocks (1973, 1979) contributed to two decades of decelerated growth.
- India's closed economy missed opportunities in the rapidly growing world economy.
- Government policies aimed at equitable distribution of income and wealth undermined wealth creation incentives and were largely anti-growth.

- The MRTP Act of 1969 regulated large firms, restricting their market power through licensing, capacity limitations, and restrictions on mergers and acquisitions.
- The policy of reserving products for exclusive manufacture by the small scale sector from 1967 aimed at promoting small industries but excluded big firms from labor-intensive industries, hindering global competitiveness.
- Stringent labor laws discouraged labor-intensive industries in the organized sector.
- Policymakers and industrialists realized that the strict regime lacked incentives and openness necessary for sustained rapid growth.

Topic: Post-independence (1947-1991)

Topic: The Era of Reforms

(1) Seeds of liberalization and reforms were planted in the 1980s, especially after 1985.

(2) Early 1980s saw efforts to restore price stability through tight monetary policy, fiscal moderation, and some structural reforms, referred to as 'early liberalization.'

(3) This period aimed at changing the 'inward-oriented' trade and investment practices, often called 'reforms by stealth' due to its ad hoc and not widely publicized nature.

(4) Despite not being a comprehensive package like the 1991 reforms, these efforts contributed to higher growth rates in the 1980s compared to the previous three decades.

(5) The average annual GDP growth rate during the sixth plan period (1980–1985) and the seventh plan period (1985–1990) were 5.7 and 5.8 percent, respectively.

(6) Early reforms in the 1980s focused on industry, trade, and taxation, accompanied by skillful exchange rate management.

(7) Industrial policy initiatives included

   (a) delicensing 25 broad categories of industries in 1985, broad-banding for industry groups to allow flexibility in their product mix, and raising the asset limit subject to MRTP regulations for larger firms.

   (b) Conversion of multipoint excise duties into a modified value-added (MODVAT) tax reduced taxation on inputs.

(c) Establishment of the Securities and Exchange Board of India (SEBI) in 1988.

(d) Expansion of the open general license (OGL) list and introduction of export incentives.

(e) Realistic exchange rates, expansion of OGL list, and export incentives helped boost exports and reduce foreign exchange pressure.

(f) Abolition of price and distribution controls on cement and aluminum.

(g) Rupee depreciation by about 30% from 1985–86 to 1989–90, based on the real effective exchange rate (REER).

(h) The 1986 budget introduced policies to cut taxes, liberalize imports, and reduce tariffs.

(8) The growth performance of the economy was hindered by structural inadequacies and distortions.

(9) Private sector investments were inhibited due to complex licensing policies, public sector reservations, & excessive government controls.

(10) Reservation of goods for the small scale sector and price controls discouraged private sector investments.

(11) The public sector, despite its massive size and monopoly, suffered from inefficiency, government controls, and bureaucratic procedures, yielding low returns on investment.

(12) The MRTP Act created barriers for entry, diversification, and expansion for large industrial houses.

(13) Import controls, tariffs, quotas, and restrictions prevented foreign competition and investments to protect domestic industries.

(14) Despite limited scope and lack of a clear roadmap, the reforms in the 1980s instilled confidence in politicians and policymakers regarding the efficacy of policy changes for sustained economic growth.

(15) The belief in well-regulated competitive markets as drivers of economic growth and increased total welfare gained acceptance.

(16) Liberalization in the 1980s laid the necessary foundation for the more comprehensive reforms of the 1990s.

Topic: The Economic Reforms of 1991

India embarked on a bold set of economic reforms in 1991 under the Narsimha Rao government. The immediate need for drastic economic reforms in the 1990s was driven by several factors:

(1) Fiscal initiatives in the 1980s led to consistently exceeding revenue receipts, resulting in unsustainable fiscal deficits financed by domestic and external debt.

(2) Persistent deficits led to a significant increase in public debt, with a large portion of government revenues allocated to interest payments.

(3) The Gulf War in 1990 triggered a surge in oil prices, causing severe strain on the balance of payments.

(4) Foreign exchange reserves reached a critical low of $1.2 billion, only sufficient for two weeks of imports, prompting the need for economic reforms.

(5) Tightening import restrictions to secure foreign exchange for essential imports led to a reduction in industrial output.

(6) Dependency on external borrowing from the International Monetary Fund (IMF) subjected India to stringent conditions for additional drawings, influencing corrective policy measures.

(7) The fragile political situation, coupled with economic crises, created a 'crisis of confidence' that emphasized the urgency for comprehensive economic reforms in India.

The year 1991 marked a paradigm shift in the Indian policy reforms. The nation which had embraced the 'socialist model', with the state playing an overriding role in the economy had the history of the government persistently intervening in the markets. Collapse of the Soviet Union and the spectacular success of China, based on outward oriented policies were lessons for the Indian policy makers. The reforms instituted in 1991 aimed to move the economy toward greater market orientation and external openness.

The reforms, popularly known as liberalization, privatization and globalisation, spelt a major shift in economic philosophy and fundamental change in approach and had two major objectives:

(1) reorientation of the economy from a centrally directed & highly controlled one to a 'market friendly' or market oriented economy.

(2) macroeconomic stabilization by substantial reduction in fiscal deficit.

The reform measures of 1991 were driven by critical economic, fiscal, and balance of payments crises, structured as a core package to address these challenges and structural rigidities. The overarching policy paradigm aimed at shifting from central direction to market orientation. These measures can be broadly classified into two categories:

(1) Stabilization Measures:

- Short-term measures to address inflation and the adverse balance of payments.
- Implemented to stabilize the immediate economic challenges.

(2) Structural Reform Measures:

- Long-term and continuing in nature.
- Aimed at enhancing productivity and competitiveness by eliminating structural rigidities in various sectors of the economy.

Topic: The Fiscal Reforms

1. Introduction of a stable and transparent tax structure.
2. Emphasis on better tax compliance to increase revenue collection.
3. Focus on curbing government expenditure
4. Reduction and abolition of unnecessary subsidies
5. Disinvestment of government equity in selected public sector undertakings.
6. Encouraging of private sector participation

In order to bring in fiscal discipline, it was essential to do away with the temptation to finance deficit thorough the easy path of money creation. Therefore, the government entered into a historic agreement with the Reserve Bank in September 1994 to bring down the fiscal deficit in a phased manner to nil by 1997–98.

Topic: Monetary & Financial Sector Reforms

Focus on reducing nonperforming assets burden on government banks.

These refroms included many measures like :

(i) Interest rate liberalization and reduced controls by the Reserve Bank of India on loan and deposit rates.

(ii) Opening new private sector banks to foster competition and removing administrative constraints that reduced efficiency.

(iii) Reduction in reserve requirements (SLR and CRR) as per recommendations of Narasimham Committee report.

(iv) Liberalization of bank branch licensing policy and granting freedom for branch operations.

(v) Introduction of prudential norms for accounting, asset classification, income disclosure, and bad debt provisions in line with Narasimham Committee recommendations.

Topic: Reforms in Capital Markets

The Securities and Exchange Board of India (SEBI) which was set up in 1988 was given statutory recognition in 1992.

The 'New Industrial Policy'.

The 'New Industrial Policy' announced by the government on 24 July 1991.

In order to provide greater competitive stimulus to the domestic industry, a series of reforms were introduced

(1) Removal of licensing restrictions for all industries, except for 5 related to security, safety, and environmental concerns.

(2) Limiting the public sector to eight sectors, ultimately reducing it to railway transport and atomic energy.

(3) Restructuring of the MRTP Act, eliminating pre-entry scrutiny and prior approval for large companies.

(4) De-reservation of goods produced by small-scale industries to allow entry of large-scale industries.

(5) Reduction of public sector monopoly, reserving only eight industries for strategic and security reasons.

(6) Liberalization of foreign investment, introducing automatic approval for FDI up to 51%, later extended to nearly all industries except reserved ones.

(7) Liberalization of external trade, shifting from a positive list to a negative list approach, eliminating import licensing for most goods.

(8) Reduction of highest tariff rate from 355% in 1990-91 to 85% by 1993-94 to 50% by 1995-96 to 10% by 2007-08, with exceptions for certain goods.

(9) 18% devaluation of the rupee against the dollar.

(10) Bold step of disinvestment in government holdings of equity share capital of public sector enterprises, providing greater autonomy and professional management.

Topic: Trade Policy Reforms

The trade policy reforms aimed at:

- dismantling of quantitative restrictions on imports and exports
- focusing on a more outward oriented regime with phased reduction and simplification of tariffs, and.
- removal of licensing procedures for imports.

To boost exports, various incentives were introduced, including the removal of export duties. In 1991, India devalued the rupee by 18-19% under a fixed exchange rate system. A dual exchange rate regime was established in March 1992, allowing importers to pay at free-market rates for some imports and at a government-mandated rate for others. By March 1993, the exchange rate was unified, and India adopted a managed floating exchange rate system.

India has witnessed vast changes over the last 31 years of economic reforms. Changes enumerated below are only broad observations and are in no way comprehensive.

- India has increased economic integration with the global economy.
- Shift towards a market-oriented economy with reduced government intervention.
- Significant growth in private sector investment and initiatives.
- Sectors like auto components, telecommunications, software, pharmaceuticals, and biotechnology have high international competitiveness.
- Eased trade controls for access to foreign technology, inputs, know-how, and finance.

- Stable foreign direct investment and substantial foreign portfolio investments.
- Strong foreign exchange reserves, among the world's largest.
- Services trade surplus, particularly in information technology and financial services.
- Lower pressure on the Indian rupee compared to other emerging market economies.
- Increased incomes, large domestic market, and high aggregate demand sustain the economy.
- Better positioned than many emerging market economies to handle global challenges.
- Substantial reduction in poverty.

- Reforms led to increased competition and efficiency in sectors like banking and insurance.
- Phenomenal growth in infrastructure sectors.
- Decline in the value-added share of agriculture and allied activities over four decades.
- Deepening of India's financial sector due to increased liberalization.
- Constraints include high fiscal deficit, inflation, and debt at 86% of GDP in FY21/22, higher than the average for emerging market and developing economies (EMDEs) at 64.5% for 2022 (IMF).

Topic: NITI AAYOG: A Bold Step For Transforming India

- For nearly sixty four years, the Planning Commission of India a powerful advocate of public investment-led development.
- The new ideologies of the neoliberal era with their centre of attention on market orientation and shrinking/decreasing roles of the government were becoming popular.
- On **1st January 2015**, the apex policy-making body namely Planning Commission, was replaced by the **National Institution for Transforming India (NITI) Aayog.**

- The major objective of such a move was to 'spur/inspire innovative thinking by objective 'experts' and promote 'co-operative federalism' by enhancing the voice and influence of the states'. NITI Aayog is expected to serve as a 'Think Tank' of the government. [and] a 'directional and policy dynamo'.
- NITI Ayog will work towards the following objectives:

(1) To **evolve a shared vision** of national development priorities, sectors and strategies with the active involvement of states.

(2) To **faster cooperative federalism** through structured support initiatives and mechanisms with the states on a continuous basis, recognizing that strong states make a strong nation.

(3) To **develop mechanisms to formulate credible plans** at the village level and aggregate these progressively at higher levels of government

(4) Interests of national security are incorporated in economic strategy and policy.

(5) To **pay special attention** to the sections of our society that may be at **risk of not benefiting adequately** from **economic progress.**

(6) To design strategic and long-term policy and programme frameworks and initiatives, and monitor their progress and their efficacy/impact

(7) To **provide advice and encourage partnerships** between key stakeholders and national and international like-minded think tanks, as well as educational and policy research institutions.

(8) To **create a knowledge, innovation and entrepreneurial support system** through a collaborative community of national & international experts, practitioners & other partners.

(9) To **offer a platform** for the **resolution of inter-sectoral** and inter **departmental issues** in order to accelerate the implementation of the development agenda.

(10) **To maintain a state-of-the-art** resource centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their dissemination to stake- holders.

(11) To **actively monitor and evaluate the implementation** of **programmers** and **initiatives**, including the identification of the needed resources so as to strengthen the probability of success and scope of delivery.

(12) To focus on **technology up gradation** and capacity building for implementation of programmers and initiatives.

(13) To undertake other activities as may be necessary in order to further the execution of national development agenda, and objectives mentioned above.

➢ **The key initiatives of NITI Aayog are: (v.imp)**

(1) 'Life' which envisions replacing the prevalent 'use-and-dispose' economy

(2) The National Data and Analytics Platform (NDAP) facilitates and improves access to Indian government data

(3) Shoonya' campaign aims to improve air quality in India by accelerating the deployment of electric vehicles

(4) **E-Amrit is a one-stop destination for all information on electric vehicles**

(5) **India Policy Insights** (IPI)

(6) **'Methanol Economy'** programme is aimed at **reducing India's oil import bill, greenhouse gas** (GHG) **emissions**, and **converting coal reserves** and municipal **solid waste into methanol**, and

(7) **'Transforming India's Gold Market'** constituted by NITI Aayog to recommend measures for tapping into the potential of the sector and provide a stimulus to exports and economic growth.

There are arguments put forth by experts about the weaknesses of the system. They argue that NITI has a limited role; it does not produce national plans, control expenditures, or review state plans. The **major shortcoming of NITI is its exclusion from the budgeting process.** It **also lacks autonomy and balance of power** within policy making apparatus of the central government. The termination of the Planning Commission has strengthened the hand of the Ministry of Finance, with its 'fixation on near-term macroeconomic stability and the natural instinct to limit expenditure'. But **NITI lacks the independence** and **power** to perform as a **'counterweight'** to act as a **"voice of development" concerned with inequities.**

Topic: The Current State of The Indian Economy: A Brief Overview

The Current State of The Indian Economy is described via - **primary, secondary and tertiary.**

Topic: The Primary Sector

- Agriculture, with its allied sectors, is indisputably the largest source of livelihood in India. Till the end of 1960's, India was a food deficient nation and depended on imports.
- **India** has **emerged as the world's largest producer of milk, pulses, jute** and **spices.** India has the largest area planted under **wheat, rice** and cotton.
- It is the **second-largest producer** of **fruits, vegetables, tea, farmed fish, cotton, sugarcane, wheat, rice, cotton, and sugar.**

Indian food and grocery market is the **world's sixth largest,** with retail contributing **70% of the sales.** India has the **world's largest cattle herd** (buffaloes). The Indian livestock sector attained a record growth of 6.6 per cent during the last decade **(2010-19) emerging as a major producer of milk, egg and meat in the world.**

- India grows large varieties of **cash crops of which cotton, jute** and **sugarcane** are prominent. Although the share of agriculture has been declining in overall gross value added (GVA) of India, it continues to grow in absolute terms.

- A number of liberalization measures are adopted by the government. The Government of India has allowed 100% FDI in marketing of food products and in food product E-commerce under the automatic route.

- A few such recent measures are:
- **Income support** to farmers through **PM KISAN**
- Fixing of Minimum Support Price (MSP) at one-and-a half times the cost of production
- Institutional credit for agriculture sector at concessional rates
- Launch of the National Mission for Edible Oils. **Pradhan Mantri Fasal Bima Yojana (PMFBY)** - a novel insurance scheme for financial support to farmers suffering crop loss/damage

- **Mission for Integrated Development of Horticulture** (MIDH) for the holistic growth of the horticulture sector
- **Provision of Soil Health Cards**
- Paramparagat Krishi Vikas Yojana (PKVY) supporting and promoting organic farming, and improvement of soil health.
- **Agri Infrastructure Fund,** a medium / long term debt financing facility for investment in viable projects for post-harvest management Infrastructure and community farming assets
- **Promotion of Farmer Producer Organisations** (FPOs) to ensure better income for the producers through an organization of their own.

- **Per Drop More Crop (PDMC)** scheme to increase water use efficiency at the farm level
- **Setting up of Micro Irrigation Fund**
- **Initiatives towards agricultural mechanization**
- **Setting up of E-NAM-a pan-India electronic trading portal** which networks the existing APMC mandis to create a unified national market for agricultural commodities.
- **Introduction of Kisan Rail** for improvement in farm produce logistics, and
- **Creation of a Start-up Eco system** in agriculture and allied sectors

Topic: The Secondary Sector

- The Indian industry holds a significant position in the Indian economy contributing about 30 percent of total gross value added in the country and employing over 12.1 crores of people. The industrial sector in India broadly comprises of manufacturing, heavy industries, fertilizers, pharmaceuticals, chemicals and petrochemicals, oil and natural gas, food processing, mining, defence products, textiles, retail, micro, small & medium enterprises, cottage industries and tourism.
- The **share of informal sector in the economy is more than 50% of GVA.** Rapid industrial growth of domestic industries and diversification of industrial structure are essential elements for sustainable economic growth.

- In India, industrial production measures the output of businesses integrated in industrial sector of the economy.
- **Manufacturing** is the most important sector and **accounts for 78 percent of total production.** The manufacturing GVA at current prices was estimated at **US$ 77.47 billion in the third quarter of financial year 2021-22** and has contributed around **16.3% to the nominal GVA during the past ten years.**
- In 2022-23 (until September 2022), the combined index of eight core industries* stood at 142.8 driven by the production of coal, refinery products, fertilizers, steel, electricity and cement industries.
- In **Jan 31, 2023** the Manufacturing Purchasing Managers' Index (PMI) in India stood at 55.4. **India's rank in the Global Innovation Index** (GII) improved to **40th in 2022 from 81st in 2015.**

The Department for Promotion of Industry and Internal Trade (DPIIT) has a role in the formulation and implementation of industrial policy and strategies for industrial development in conformity with the development needs and national objectives.

Ever since independence, many innovative schemes are undertaken by different governments from time to time to boost industrial performance.

Some of the policies are presented below:

- ❑ **Introduction** of goods and services tax **(GST)** on **1 July 2017** as a single domestic indirect tax law for the entire country **replacing** many indirect taxes in India such as the **excise duty, VAT, services tax,** etc.
- ❑ **Reduction of corporate tax to domestic companies** giving an option to pay income-tax at the rate of **22%** subject to condition that they will not avail any exemption/incentive.

- **'Make in India' is a 'Vocal for Local'** initiative launched in 2014 to facilitate investment, foster innovation, build excellent infrastructure and make India a hub for manufacturing, design and innovation. **Make in India 2.0'** is now **focusing on 27 sectors,** which include **15 manufacturing sectors** and **12 service sectors.**
- 'Ease of Doing Business' with key focus areas as simplification of procedures, rationalization of legal provisions, digitization of government processes, and decriminalization of minor, technical or procedural defaults. India ranks 63rd in the World Bank's annual Doing Business Report (DBR), 2020 as against 77th rank in 2019 registering a jump of 14 ranks.

- **The National Single Window System** is a one-stop-shop for investor related approvals and services in the country and aims to provide continuous facilitation and support to investors.
- **PM Gati Shakti National Master Plan** to facilitate data-based decisions related to integrated planning of multimodal infrastructure, thereby reducing logistics cost.
- **National Logistics Policy (NLP)** launched in September 2022, aims to lower the cost of logistics & make it at par with other developed countries.
- Keeping in view **India's vision of becoming 'Atmanirbhar',** the Production Linked Incentive (PLI) Scheme was initiated in March 2020 for 14 key sectors to enhance India's manufacturing capabilities and export competitiveness. PLI Scheme is now extended for white goods/heavy consumer durables (air conditioners and LED lights).

- **Industrial Corridor Development Programme:** Greenfield Industrial regions/areas/nodes with sustainable infrastructure and to make available **'plug and play' infrastructure at the plot level.**
- **FAME-India Scheme** (Faster Adoption and Manufacturing of Hybrid & Electric Vehicles) to **promote manufacturing of electric and hybrid vehicle technology** and to ensure sustainable growth of the same.
- **'Udyami Bharat'** aims at the empowerment of Micro Small and Medium Enterprises (MSMEs).
- **PM Mega Integrated Textile Region and Apparel** (PM MITRA): to ensure **world-class industrial infrastructure** which would attract cutting age technology and **boost FDI** and **local investment in the textiles sector.**

- **Opening up for global investments:** To make India a more attractive investment destination, the government has implemented several **radical** and **transformative FDI reforms** across sectors such as **defence, pension, e-commerce activities etc.**
- **100 per cent FDI under automatic route** is permitted for the sale of coal and coal mining activities, including associated processing infrastructure and for insurance intermediaries.
- **Foreign Investment Promotion Board (FIPB)** was abolished in May 2017, and a **new regime** namely **Foreign Investment Facilitation Portal (FIF)** has been put in place. Under the new regime, the process for granting FDI approvals has been simplified. **853 FDI proposals were disposed off in the last 5 years. FDI has increased jumped by 39% since FIF** came into being.

- **Remission of Duties and Taxes on Export Products (RODTEP) 2021 formed to replace the existing MEIS** (Merchandise Exports from India Scheme) to boost exports. It provides for rebate of all hidden central, state, and local duties/taxes/levies on the goods exported which have not been refunded under any other existing scheme.
- Initiatives towards fostering innovation include incubation, handholding, funding, industry-academia partnership and mentorship and strengthening of IPR regime.
- **National Logistics Policy (NLP) is comprehensive policy framework** for the **Logistics Sector.**
- **Start-up India Programme** acts as the facilitator for ideas and innovation in the country. **India's rank** in the **Global Innovation Index** (GII) has improved from **81st in 2015 to 40th in 2022.**

- **Public Procurement (Preference to Make in India) Order, 2017** gives preference to locally manufactured goods, works and services in public procurement thereby giving boost to industrial growth.
- **The Emergency Credit Line Guarantee Scheme (ECLGS)** is a fully guaranteed emergency credit line to monitor lending institutions.

India is gearing up for the **fourth industrial revolution or Industry 4.0** in which manufacturing transformation needs to integrate new technologies such as **cloud computing, IoT, machine learning, and artificial intelligence (AI).** The National Manufacturing Policy which aims to **increase the share of manufacturing in GDP to 25 percent by 2025** is a step in this direction.

Topic: The Tertiary Sector

A remarkable feature of the **post reform Indian economy** is the **overarching role of the services sector** in generating growth of income and employment. Unlike the usual economic development process of nations where **economic growth has led to a shift from agriculture to industries**, or from the **primary sector to the secondary sector**, India has the unique experience of **bypassing the secondary sector** in the growth trajectory/path by a **shift from agriculture to the services sector.**

Summary

Marathon

Time

Super-Duper
Fast
Revision


THANK YOU