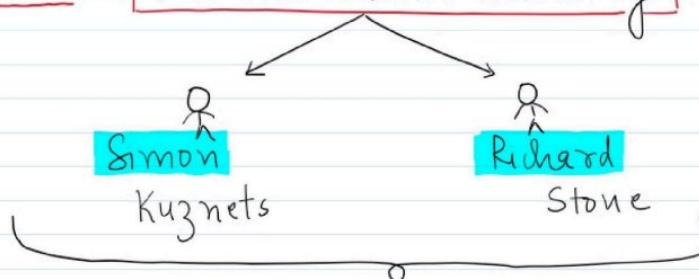


CH 6 Unit 1

National Income Accounting

(5-7 Marks)



The Central Statistical Organisation (CSO) in the Ministry of Statistics & Programme Implementation (MOS + PI) is responsible for the compilation of National Accounts Statistics. At the state level, State Directorates of Economics and Statistics (DESs) have the responsibility of compiling their state domestic product and other aggregates.

Why ?? (What is the usefulness?)

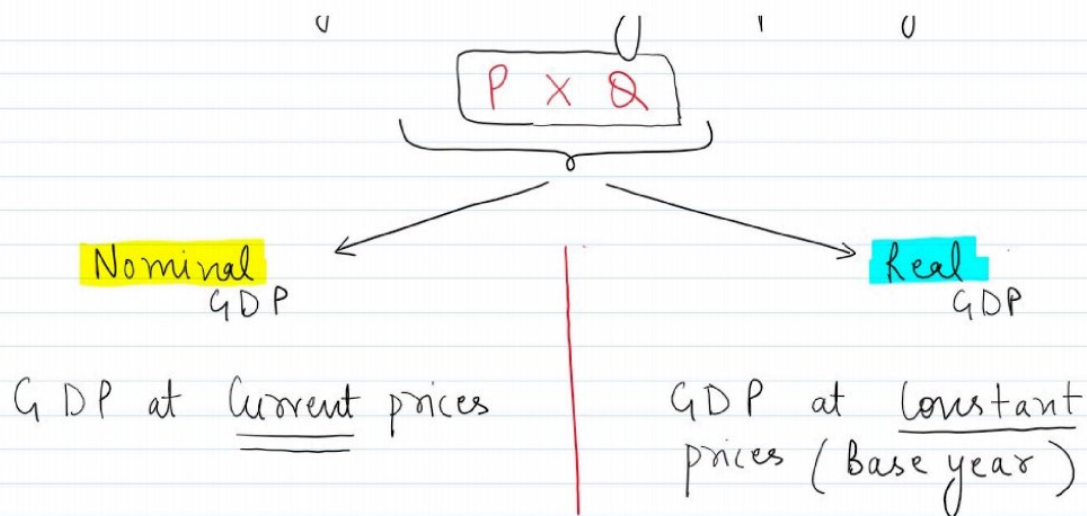
- helps business to forecast future demand of product
- it shows composition & structure of National Income
- It helps government in making policies
- International comparisons

100 □ output (National Income)	90 Guns	20 Guns	5 Guns
	10 shoes	80 clothes	95 Bread

* CONCEPTS

- ① Gross Domestic Product (GDP) - It is the money value of all final goods & services produced in the country within a given period of time.

$$P \times Q$$



② GDP Deflator (Price Index) = $\frac{\text{Nominal GDP}}{\text{Real GDP}} \times 100$

eg ①

Nominal GDP = 1200 crore

Real GDP = ??

Price Index = 120

Sol:-

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

$$120 = \frac{1200}{\text{Real GDP}} \times 100$$

$$\text{Real GDP} = \frac{1200 \times 100}{120}$$

$$= 1,000 \text{ crores}$$

eg ②

Real GDP = 450

Price Index = 120

Find Nominal GDP

Sol:-

$$\text{Nominal GDP} = \frac{120 \times 450}{100} = 540$$

$$\textcircled{3} \quad \text{Inflation Rate (year 2)} = \frac{\text{GDP deflator (year 2)} - \text{GDP deflator (year 1)}}{\text{GDP deflator (year 1)}} \times 100$$

eg :- GDP deflator (2024) = 150
GDP deflator (2025) = 165

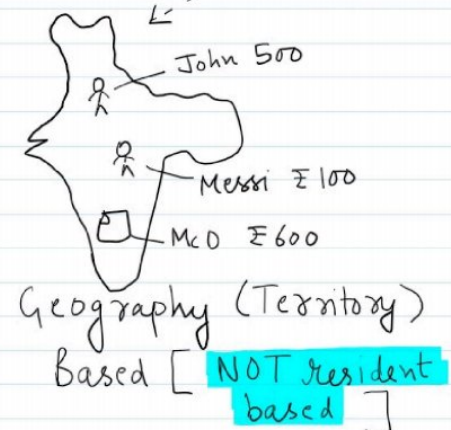
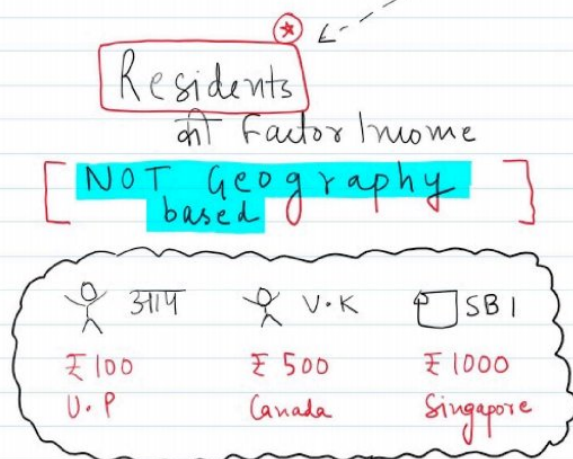
$$\text{Inflation Rate} = \frac{165 - 150}{150} \times 100 = 10\%$$

$$\textcircled{4} \quad \text{Depreciation} = \text{Gross} - \text{Net}$$

(Consumption of fixed capital)

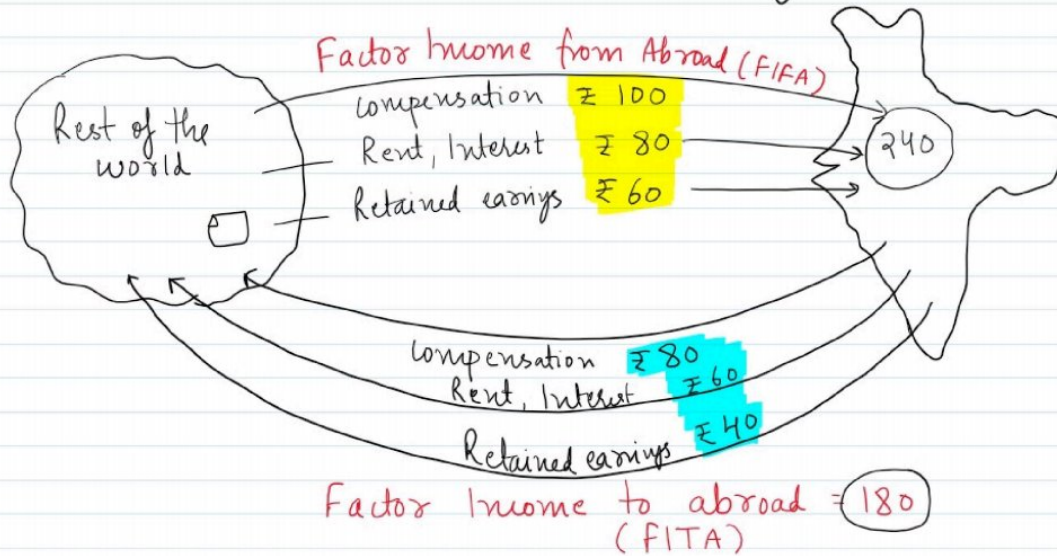
$$\textcircled{5} \quad \text{Net factor Income from abroad (NFIA)} = \text{National product} - \text{Domestic product}$$

(National Income) (Domestic Income)

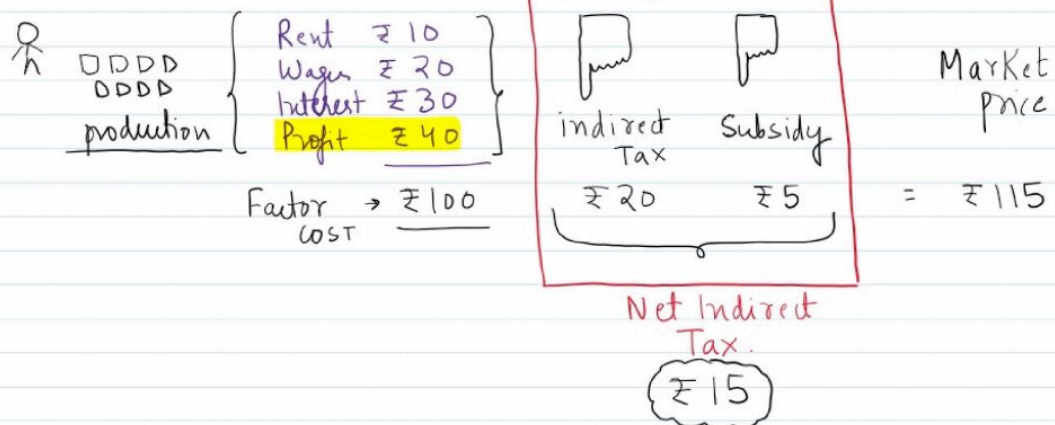


* NFIA = Net Compensation of Employees
(+) Net Income from Property & Entrepreneurship

- (+) Net Income from Property & Entrepreneurship
(+) Net Retained Earnings



⑥ Net Indirect Taxes (NIT) = Market price (-) Factor cost



* Net Indirect Tax = Indirect Tax (-) Subsidy

Q1 :- GDP_{MP} = 2000
Dep = 50
NFIA = 20

$$NIT = 30$$

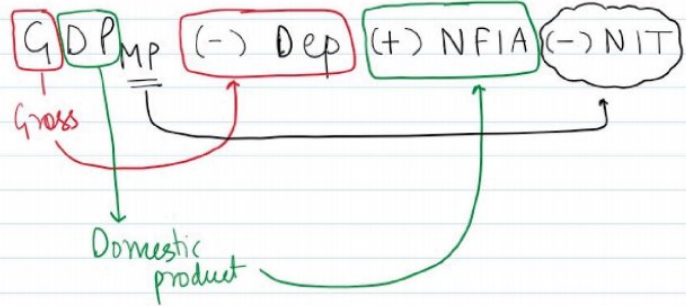
Find NNP_{FC}

Sol:-

$$\underline{NNP}_{FC} =$$

Net

National Product



$$= 2000 (-) 50 + 20 (-) 30$$

$$= 1940$$

Q2-

$$NNP_{FC} = 1600$$

$$Dep = 50$$

$$NFIA = 20$$

$$NIT = (-) 10$$

Find (i) NNP_{MP} (ii) GNP_{FC} (iii) GDP_{MP} (iv) NDP_{FC}

(i) NNP_{MP}	(ii) GNP_{FC}	(iii) GDP_{MP}	(iv) NDP_{FC}
$NNP_{FC} (+) NIT$ $1600 + (-10)$ $= 1590$	$NNP_{FC} (+) Dep$ $1600 + 50$ $= 1650$	$GNP_{FC} - NFIA + NIT$ $1650 - 20 + (-10)$ $= 1620$	$NNP_{FC} - NFIA$ $1600 - 20$ $= 1580$

⑦ Domestic Income (NDP_{FC})

Net

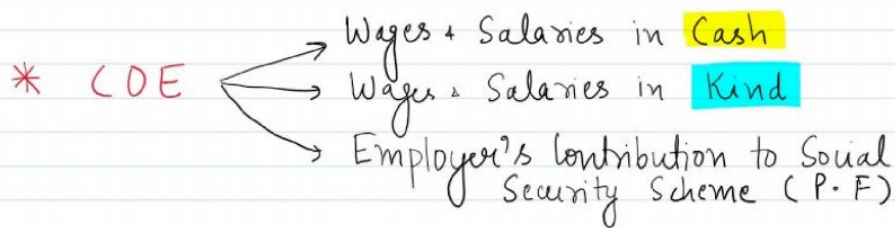
Domestic Product

at Factor Cost

$$NDP_{FC} = \text{Compensation of employees} (+) \text{Operating Surplus} (+) \text{Mixed Income of self employed}$$

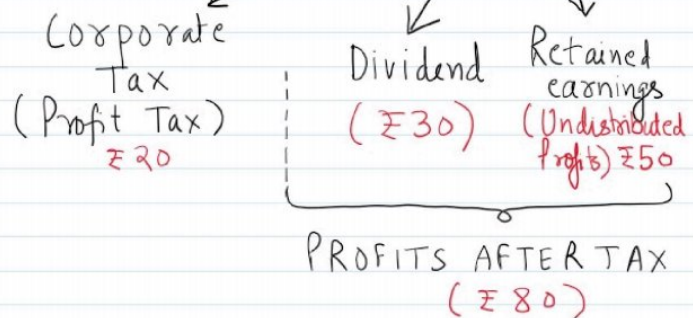
1.1.2022, Calicut, India





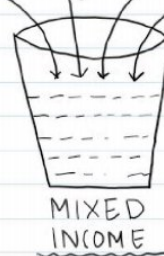
* Operating Surplus = Income from Property + entrepreneurship

= Rent (+) Royalty (+) Interest (+) PROFITS (₹100)



* Mixed Income of self employed (eg doctor, Lawyer)

Rent + wages + Int + profit



⑧ National Income (NNP_{Fc})

Net National Product at Factor Cost

= Domestic Income (+) NFIA

= NDP_{Fc} (+) NFIA

⑨ Per Capita Income

$$= \frac{\text{GDP (Adjusted by Inflation)}}{\text{Total Population}}$$

Real
wala

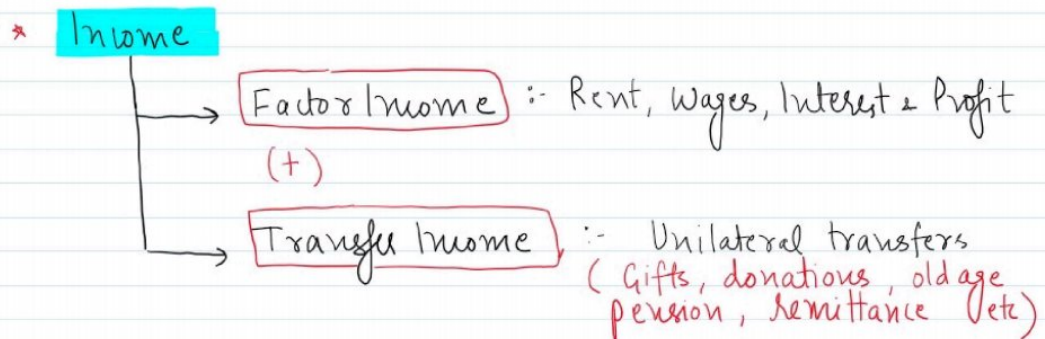
* It is an indicator of **STANDARD OF LIVING** of country

⑩, ⑪ & ⑫ Private Income, Personal Income and Disposable Income

Imp.

Private Income = **Income** ^{*} accrue to private sector from **all sources** within & outside country

Personal Income = **Income** ^{*} of household sectors (including NPOs serving households)



Personal Disposable Income = Amount of money in the hands of individuals that is **available** for consumption or saving

for consumption or saving

↓
खर्च करने
के लिए

↓
बचत करने
के लिए

For better understanding

$$\textcircled{A} \text{ Income from Domestic product } \begin{array}{l} \text{accounting to Private} \\ \text{sector} \end{array} \left[\text{NDP}_{FC} \text{ accounting to Private Sector} \right] = \text{NDP}_{FC} (-) \text{ Surplus of Government sector}$$

* Surplus of Government sector means :-

(i) Income from property & entrepreneurship accounting to Government

(ii) Savings of Non departmental undertakings (सरकारी दफतर)

$$\textcircled{B} \text{ Private Income} = \text{NDP}_{FC} \text{ accounting to Private Sector} \\ (+) \text{ NFIA} \\ (+) \text{ Net Current transfers from ROW} \\ (+) \text{ Net Current transfers from Govt} \\ (+) \text{ National Debt Interest}$$

$$\textcircled{C} \text{ Personal Income} = \text{Private Income} \\ (-) \text{ Undistributed profits (i.e. Retained earnings)} \\ (-) \text{ Corporate Taxes (i.e. Profit tax)}$$

* Personal Income = National Income

(+) Income received but not earned

(-) Income earned but not received

$$* \text{ Personal Income} = \text{National Income} (-) \text{ Undistributed profits} (-) \text{ Corporate Tax} (-) \text{ Net Interest payments by Households} (+) \text{ Transfer payments to Households from firms and government}$$

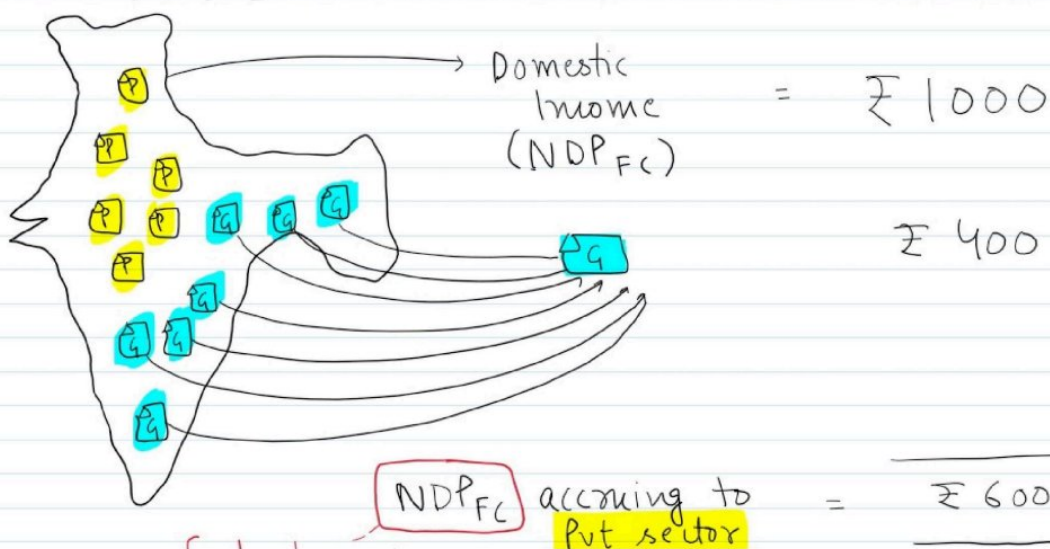
(D) Disposable Personal Income (Personal Disposable Income) = Personal Income (-) Personal Taxes (-) Non Tax payments (like fines, penalties)

$$* \text{ GNDI (Gross National Disposable Income)} = \text{GNP}_{MP} (+) \text{ Net Current transfers from ROW}$$

$$* \text{ NNDI (Net National Disposable Income)} = \text{NNP}_{MP} (+) \text{ Net Current transfers from ROW}$$

OR

$$= \text{GNDI} (-) \text{ Depreciation}$$



✓

Factor Income (Domestic Territory) $\boxed{NDP_{FC}}$ accruing to Pvt sector $\boxed{RIL}$ = ₹ 600

Factor Income $\leftarrow$ (+) $\boxed{NFA}$ (विदेशी) ₹ 100

(+) Net Current Transfer from ROW ₹ 200

(+) Net Current Transfer from Govt ₹ 300

transfer income

(+) National Debt Interest ₹ 100

Govt (सरकार) $\leftarrow$ LOAN $\leftarrow$ Pvt Co. Interest

PRIVATE INCOME ₹ 1300

Pvt Income = 1300 $\boxed{RIL}$ ₹ 1300

(-) Corporate Tax ₹ 300

(-) Undistributed profits ₹ 600

= ₹ 400

Personal Income

Gopal

₹ 400 (Personal Income)

(-) Personal Tax ₹ 100

(-) Fines ₹ 200

= ₹ 100

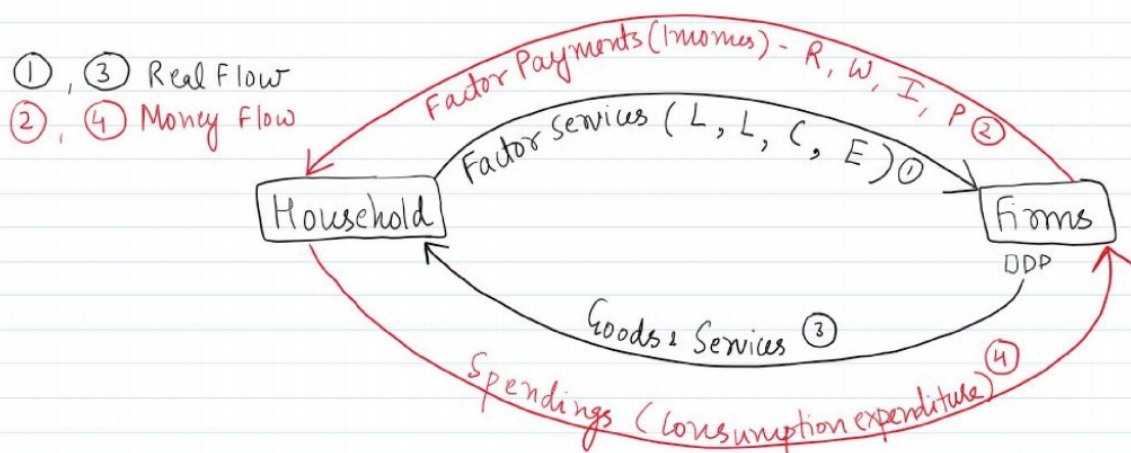
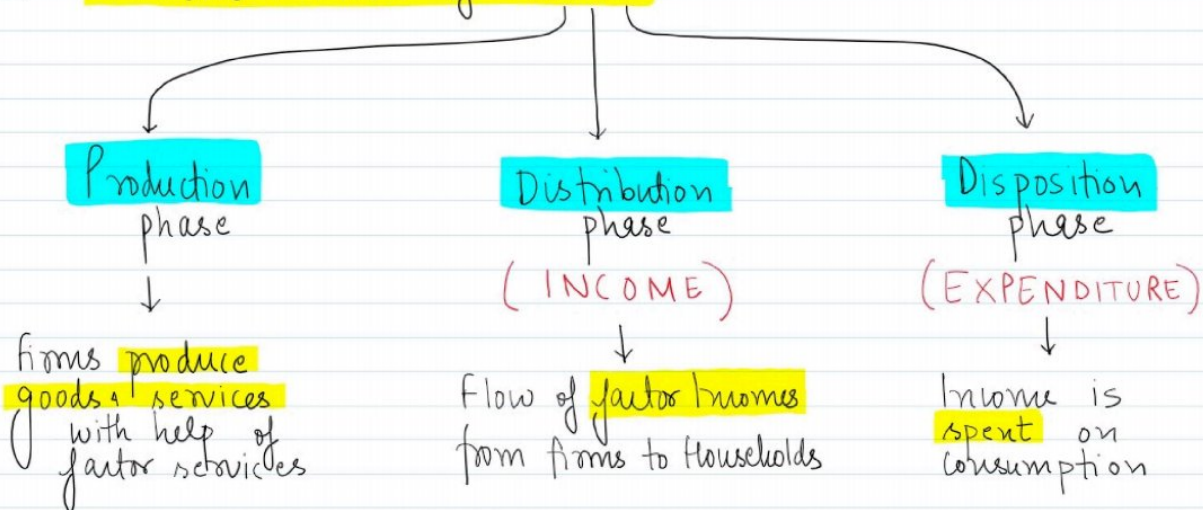
Personal Disposable Income

x ————— x ————— x ————— x ————— x

* Measurement of National Income

* Measurement of National Income

I Circular Flow of Income



II Production Method (Value Added Method)

→ Identify the producing enterprises into three sectors:-

- a) Primary sector
- b) Secondary sector
- c) Tertiary sector

→ Calculate GVA_{MP} of each sector

$$\text{Gross Value Added at Market price} = \text{Value of Output} (-) \text{Intermediate Input}$$

Gross Value
Added at Market
price

= Value of Output (-) Intermediate
consumption

$$\text{SALES}^* + \Delta \text{Stock}$$

Purchase of
Raw Materials
(i.e. Non factor
Inputs)

* Sales

→ Domestic Sales
(+)
→ EXPORTS

closing (-) Opening

* Purchases

→ Domestic Purchase
(+)
→ IMPORTS

$$GDP_{MP} = GVA_{MP} \text{ (Primary)} (+) GVA_{MP} \text{ (Secondary)} (+) GVA_{MP} \text{ (Tertiary)}$$

$$GDP_{MP} = \sum GVA_{MP}$$

$$\therefore \text{National Income} = GDP_{MP} (-) \text{Depreciation} (+) \text{NFIA} \text{ (NNP}_{FC}) (-) \text{NIT}$$

* Production for self consumption, Imputed Rent, Own account production are included in value of Output.

III INCOME METHOD

$$NDP_{FC} \text{ (Domestic Income)} = \text{Compensation of Employees} (+) \text{Operating Surplus} (+) \text{Mixed Income}$$

$$\therefore NNP_{FC} = NDP_{FC} + \text{NFIA}$$

$$\therefore \text{NNP}_{FC} = \text{NDP}_{FC} + \text{NFA}$$

IV EXPENDITURE METHOD

(Income Disposal Approach)

" $\frac{\text{रद्द-उत्}$ "

$$\text{GDP}_{MP} = \text{Final Consumption expenditure}^* (+) \text{Gross Domestic Capital formation}^* (+) \text{Net exports}$$

(i.e. Gross Investment)

* Final Consumption expenditure

Households :- Private Final Consumption expenditure (PFCE)

Government :- Government Final Consumption expenditure (GFCE)
 { e.g. :- education, healthcare, defence, subsidies, scholarship etc etc }

* Gross Domestic Capital Formation
 (Gross Investment)

निवेश

= Gross Domestic FIXED Capital formation (+) Inventory Investment (Δ Stock)

(मंकी अवधि का निवेश)

CI - OP

* Net exports = Exports (-) Imports

$$\therefore \text{NNP}_{FC} = \text{GDP}_{MP} (-) \text{Depreciation} (+) \text{NFA} (-) \text{NIT}$$

* System of Regional Accounts in India *

* System of Regional Accounts in India *

- Regional Accounts provide integrated database on the numerous transactions taking place in regional economy. At present, all states + union territories of India compute state income estimates and district level estimates.
- State Income or Net State Domestic Product (NSDP) is measured by state

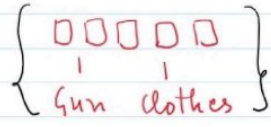
* GDP and Welfare *

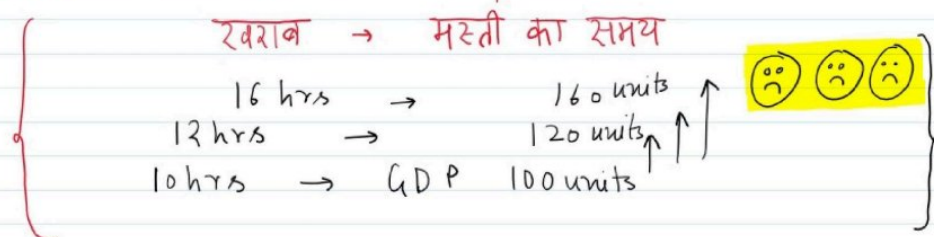


IS IT TRUE ??

NO

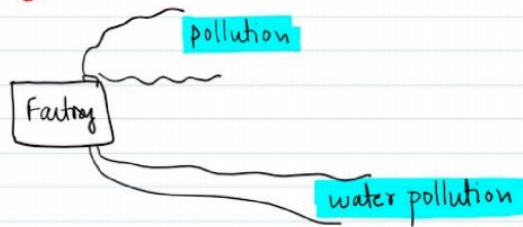
GDP measure excludes some of the following points :-

- Distribution of income 
- Quality improvements in technology
- Illegal transactions (Drugs, Gambling)
- Non Market production (education level & health level)
- Economic "Bads" (Crime, Pollution, traffic)
- Disutility of loss of leisure time



- Positive & Negative externalities

- Positive & Negative externalities



- Etc Etc.

* Limitations and Challenges of NI computation

- Lack of agreed definition of national income
- Accurate distinction between final & intermediate expenditure
- Transfer payments
- Difficulty of incorporating distribution of income
 - { Rent
Wages
Interest
Profit }
- Valuation of Government "Services"

- Inadequacy of data
- Presence of Non-monetised sector
- Absence of recording of income due to illiteracy
- Lack of accurate estimation of depreciation

x ————— x ————— x ————— x ————— x

CH 6 Unit 2

The Keynesian Theory of Determination of National Income

① INTRODUCTION

1930 ☹️ ☹️ ☹️ ☹️ ☹️ ☹️ ☹️ ☹️ ☹️
The Great Depression

1936 :- John Maynard Keynes's General theory of Employment, Interest and Money was published

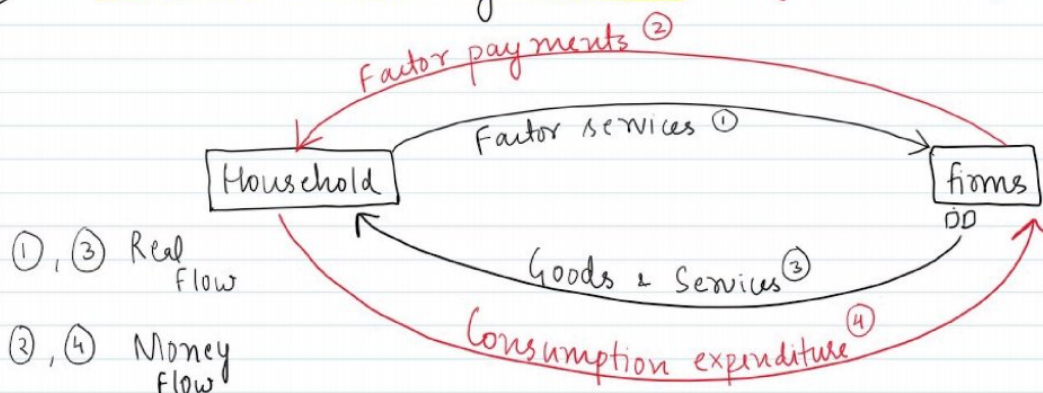
→ Consumption & Income relation

→ Savings

→ Multiplier etc

Household & Firms [] Two sector economy
Household, Firms & Government [] Three sector economy
H/H, Firms, Govt & ROW [] Four sector economy

② Circular flow of Income (2 sector)



*
$$\text{Factor Payments } \textcircled{2} = \text{Value of Output } \textcircled{4} *$$

③ Aggregate Demand (AD)

PLANNED EXPENDITURE
 Ex-ANTE

AD has two components :-

- Ex- Ante demand for Consumer Goods (C)
- Ex- Ante demand for Investment Goods (I)

$$\therefore AD = C + I$$

"Constant Investment"

3 (A) CONSUMPTION FUNCTION

$$C = f(Y)$$

Consumption is the function of "Income"

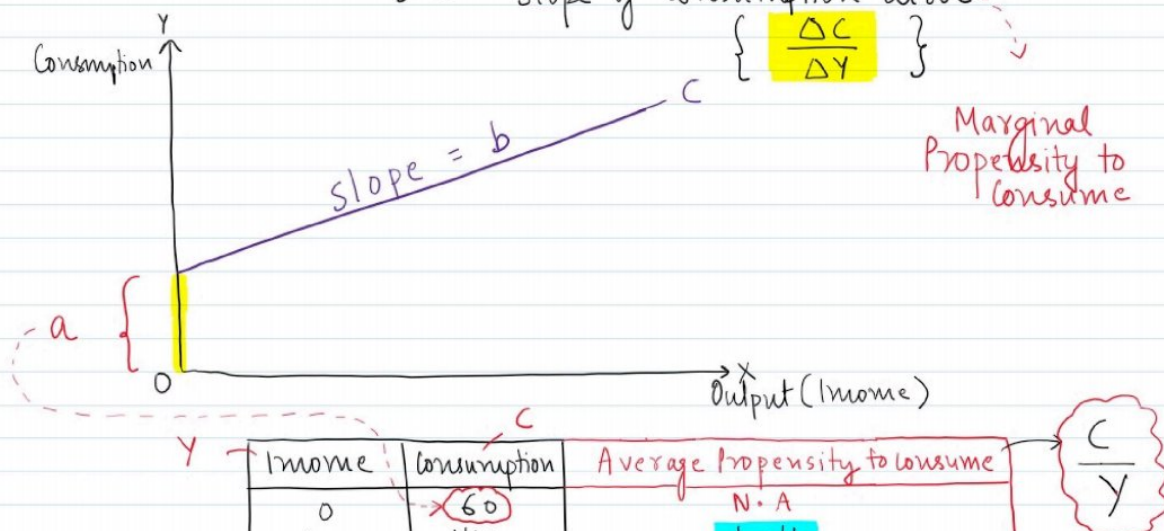
$$C = a + bY$$

a = Autonomous consumption

b = slope of consumption curve

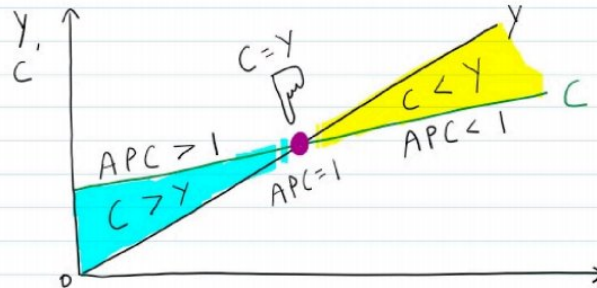
$$\left\{ \frac{\Delta C}{\Delta Y} \right\}$$

Marginal Propensity to Consume



Income	Consumption	Average Propensity to Consume
0	60	N.A
100	140	1.4
200	220	1.1
300	300	1
400	380	0.95
500	460	0.92

$$\bar{y}$$



* Consumption, Income and Savings Relation

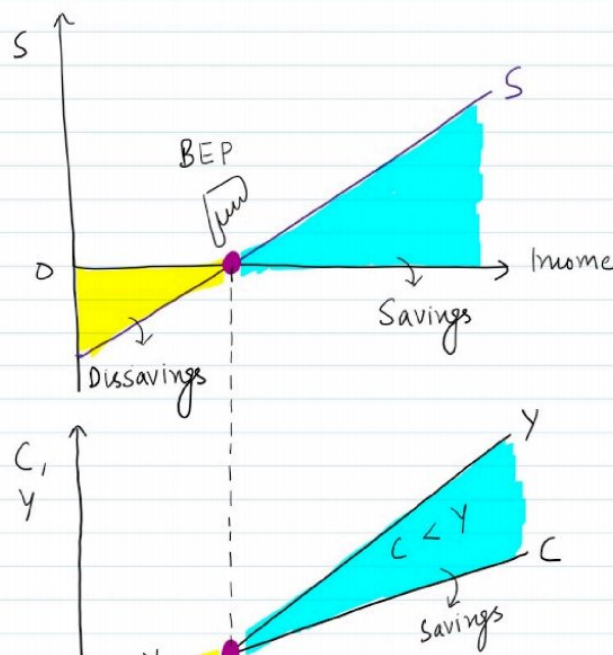
$$S = f(Y)$$

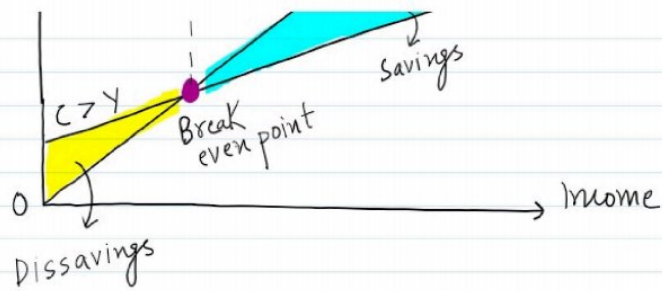
Savings is the function of Income

Income (Y)	Consumption (C)	Savings (Y-C)
0	60	-60
100	140	-40
200	220	-20
300	300	0
400	380	20
500	460	40

Break
even
Point

$$S = Y - C$$





$$\begin{aligned}
 S &= Y - C \\
 &= Y - [a + bY] \\
 &= Y - a - bY \\
 &= -a + Y - bY
 \end{aligned}$$

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

Negative Autonomous consumption (pointing to $-a$)
 Slope of Savings curve (Marginal Propensity to Save) (pointing to $(1-b)$) $\rightarrow \frac{\Delta S}{\Delta Y}$

3(B) $MPC = \frac{\Delta C}{\Delta Y}$ (i.e. Slope of Consumption curve)

$MPS = \frac{\Delta S}{\Delta Y}$ (i.e. Slope of Savings curve)

$APC = \frac{C}{Y}$

$APS = \frac{S}{Y}$

$$MPC + MPS = 1$$

$$APC + APS = 1$$

④ Aggregate Supply (AS)

AS represents **Income** i.e. Y

AS has two components :-

a) Consumption (C)

b) Savings (S)

$$AC = V - r + C$$

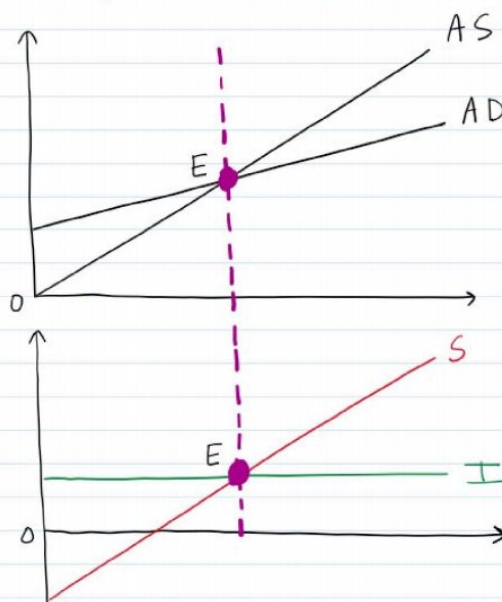
$$AS = Y = C + S$$

* National Income Determination (2 sector)

Consumers. $\leftarrow$ $AD = AS$ $\rightarrow$ producers (firms)
 $\begin{matrix} \square\square\square \\ \square\square\square \end{matrix}$ "Realised" $\begin{matrix} \square\square\square \\ \square\square\square \end{matrix}$ "expect"
 Realised Value = Expected Value

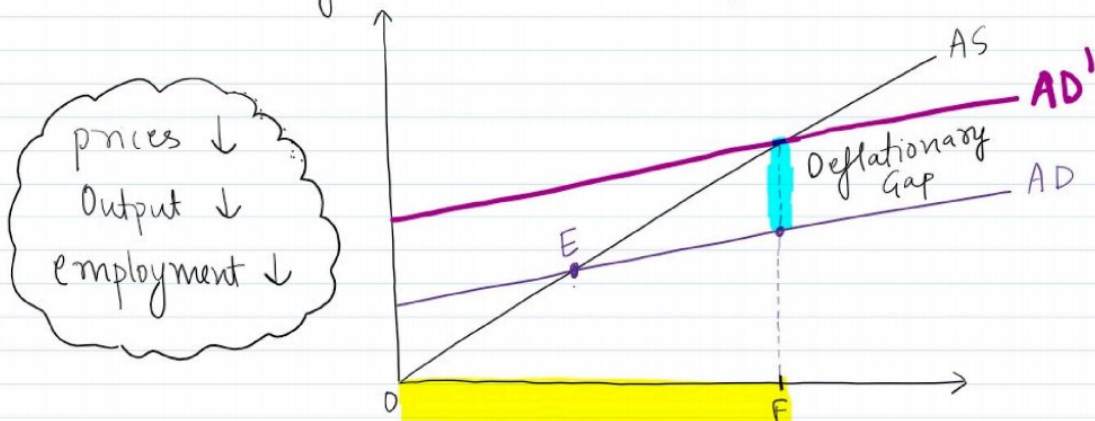
$$\cancel{C} + I = \cancel{C} + S$$

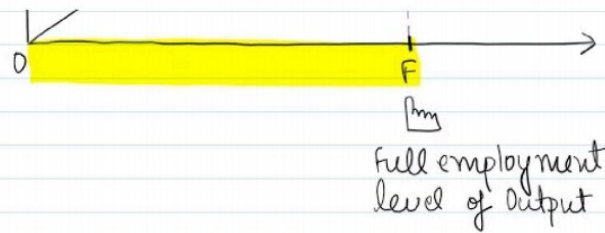
$$I = S$$



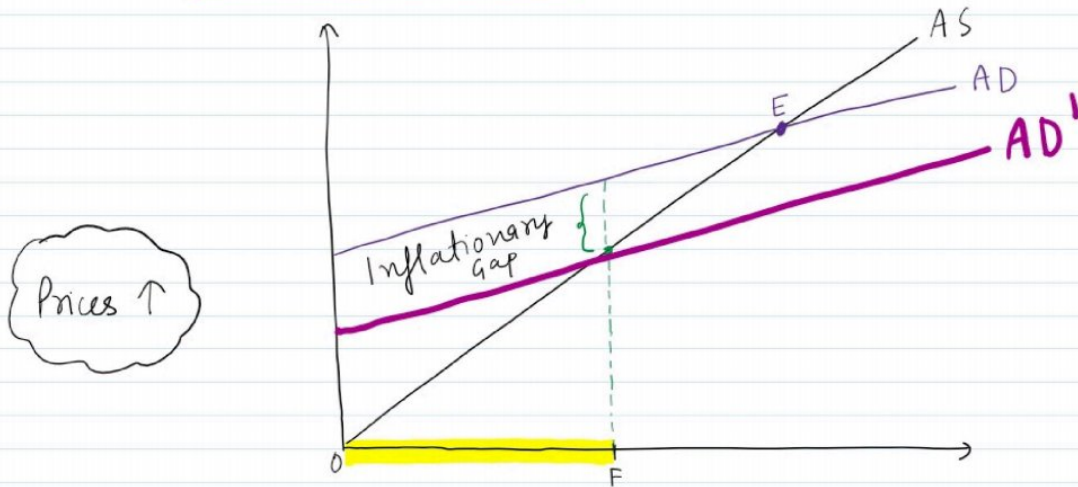
* EQUILIBRIUM with Unemployment or Inflation

(a) Deficient Demand (demand $<$ Y)





(b) Excess demand



(5) Investment Multiplier

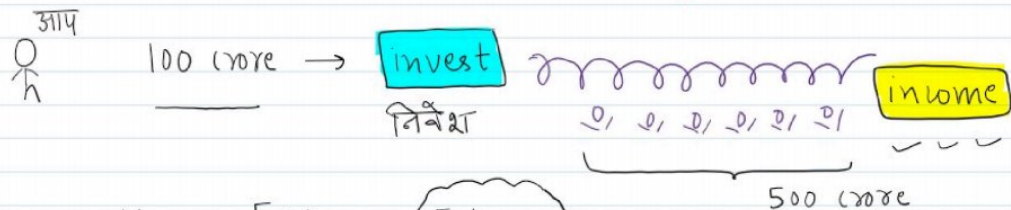
→ It shows the responsiveness of change in Investment on change in income

i.e

$$K = \frac{\Delta Y}{\Delta I}$$

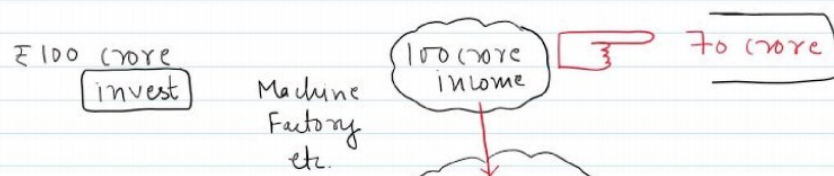
change in income

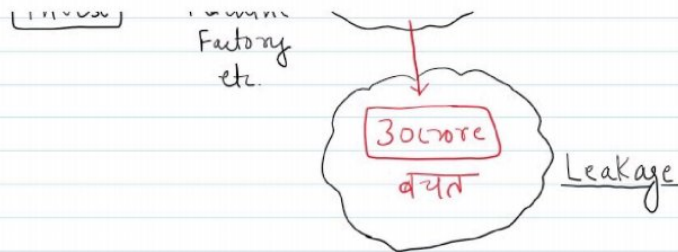
change in Investment



$$\therefore K = \frac{500}{100} = 5 \text{ times}$$

→ This process stops due to LEAKAGES (i.e Savings)





→ Investment multiplier can also be calculated as :-

$$\frac{1}{1 - MPC}$$

or

$$\frac{1}{MPS}$$

K & MPC have a **direct** relation

MPC	K
0.2	1.25
0.5	2
0.8	5

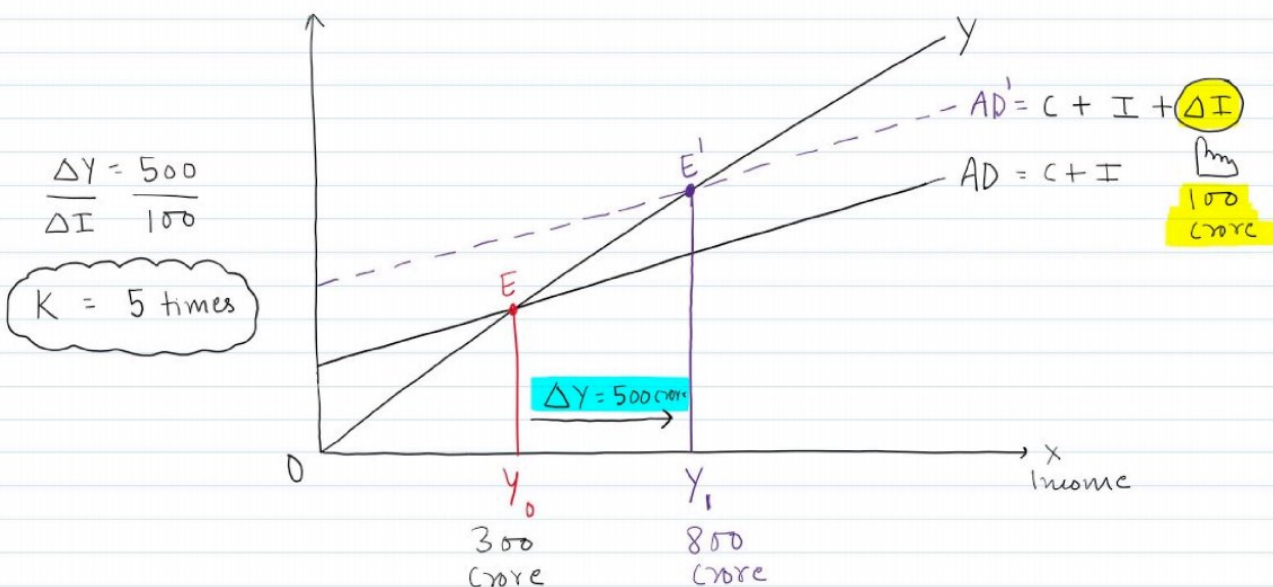
MPC ↑ K ↑

K & MPS have **inverse** relation

MPS	K
0.2	5
0.5	2
0.8	1.25

MPS ↑ K ↓

$$1 \leq K \leq \infty$$



Core Core

* More powerful these leakages are, the smaller the value of multiplier

$\left\{ \begin{array}{l} \text{leakage (MPS)} \uparrow \\ \text{अवधि} \end{array} \right. \quad \text{multiplier (K)} \downarrow \right\}$

Leakages are caused due to :-

- Increase in Taxes
- Decrease in MPC
- Increase in demand of consumer goods *
- Undistributed profits of companies
(i.e. Retained Earnings)

* Underdeveloped countries

MPC is HIGH (0.9/1 खर्चा ज्यादा करना चाहते हैं)

K is LOW

Why ???

Increase in consumption ✓
but Increase in production is not possible
rather prices increase

⑥ Determination of Equilibrium Income - ③ sector

HH Firms Govt
 (✓) (✓) (✓)

$$\boxed{AS = AD}$$

Taxes i.e. Government income

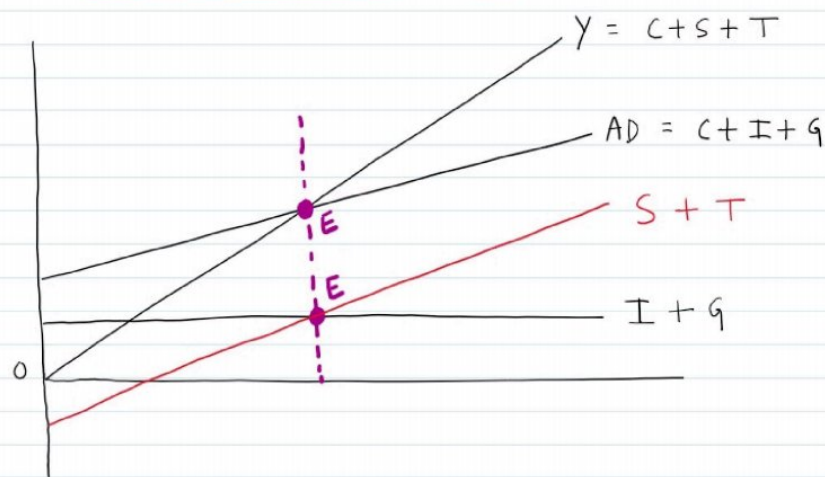
$$C + S + T = C + I + G$$

Government expenditure
(सरकार का खर्चा)

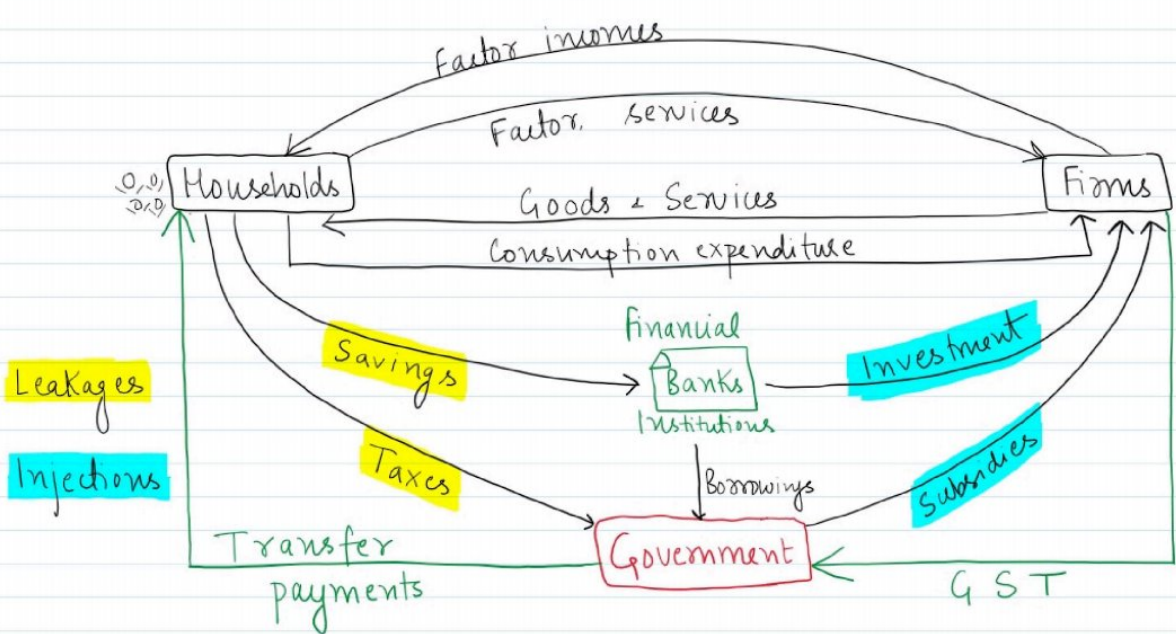
$$S + T = I + G$$

$$S + T = I + G$$

20-11



Circular flow of Income



FORMULA (V.Imp)

$$Y = C + I + G$$

here $C = a + b Y_d$

here $Y_d = Y - T$ (Disposable Income) $\rightarrow$ Lumpsum Taxes

$$Y = a + b Y_d + I + G$$

$$\rightarrow Y = a + bY_D + I + G$$

$$Y = a + b(Y - T) + I + G$$

$$Y = a + bY - bT + I + G$$

$$Y - bY = a - bT + I + G$$

$$Y(1 - b) = a - bT + I + G$$

3 sector & equilibrium condition.

$$Y = \frac{1}{(1 - b)} [a - bT + I + G]$$

(R)

(ii) When $Y_D = Y - T (+) TR$

Disposable income

Autonomous transfer payment

Now

$$Y = C + I + G$$

$$Y = [a + bY_D] + I + G$$

$$Y = a + b(Y - T + TR) + I + G$$

$$Y = a + bY - bT + bTR + I + G$$

$$Y - bY = a - bT + bTR + I + G$$

$$Y(1 - b) = a - bT + bTR + I + G$$

$$(R) \quad Y = \frac{1}{(1 - b)} [a - bT + bTR + I + G]$$

(iii) When Tax is a function of Income

$$T = \bar{T} + tY$$

Total Tax
Autonomous constant Tax
income tax Rate

Now

$$Y = C + I + G$$

Now

$$Y = C + I + G$$

$$Y = a + bY_D + I + G$$

$$Y = a + b(Y - T) + I + G$$

$$Y = a + b[Y - (\bar{T} + tY)] + I + G$$

$$Y = a + b[Y - \bar{T} - tY] + I + G$$

$$Y = a + bY - b\bar{T} - btY + I + G$$

$$Y - bY + btY = a - b\bar{T} + I + G$$

$$Y(1 - b + bt) = a - b\bar{T} + I + G$$

$$Y = \frac{1}{(1 - b + bt)} [a - b\bar{T} + I + G]$$

(R)

" TAX MULTIPLIER "

(iv)
=

When $Y_D = Y - T + TR$

Now,

$$Y = C + I + G$$

$$Y = a + bY_D + I + G$$

$$Y = a + b[Y - T + TR] + I + G$$

$$Y = a + b[Y - (\bar{T} + tY) + TR] + I + G$$

$$Y = a + b[Y - \bar{T} - tY + TR] + I + G$$

$$Y = a + bY - b\bar{T} - btY + bTR + I + G$$

$$Y - bY + btY = a - b\bar{T} + bTR + I + G$$

$$Y(1 - b + bt) = a - b\bar{T} + bTR + I + G$$

$$Y = \frac{1}{(1 - b + bt)} [a - b\bar{T} + bTR + I + G]$$

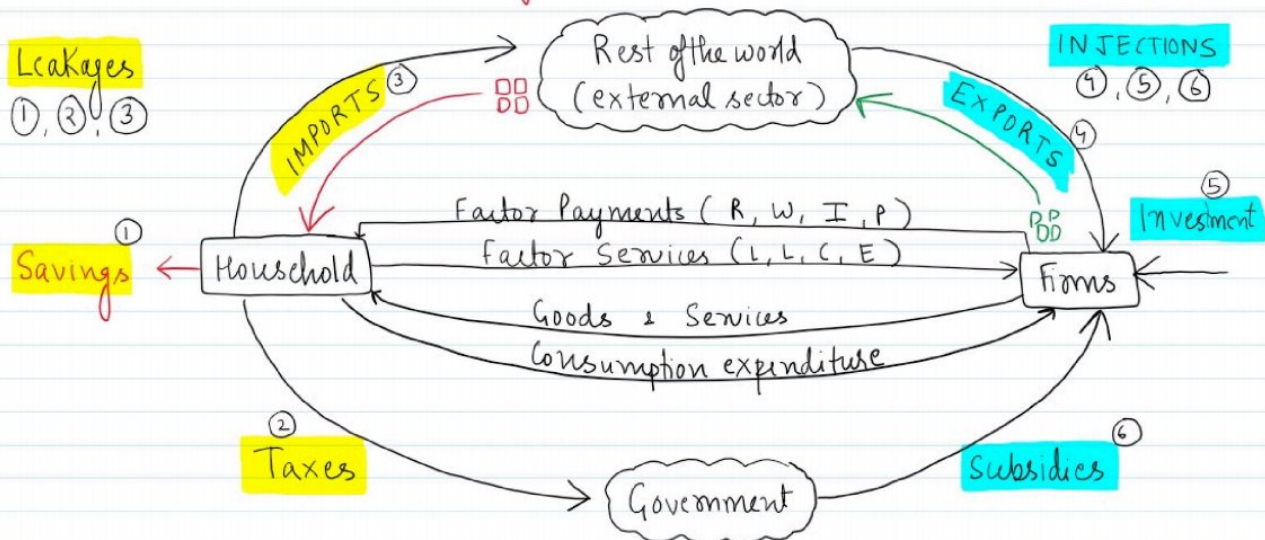
(R)

" TAX MULTIPLIER "

"TAX MULTIPLIER"

⑦* Equilibrium level of Income - ④ sector economy

1. Circular flow of Income



2. EQUILIBRIUM

$$AS = AD$$

$$Y = AD$$

$$C + S + T = C + I + G + \text{Net exports.}$$

$$C + S + T = C + I + G + (X - M)$$

$$\cancel{C} + S + T + M = \cancel{C} + I + G + X$$

$$S + T + M = I + G + X$$

New

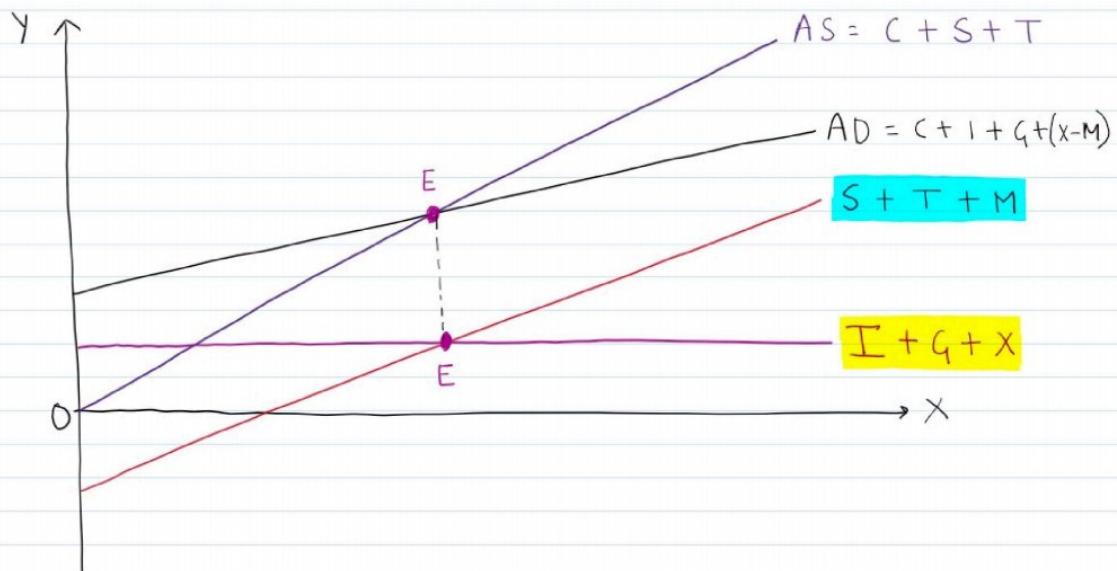
$$* M = \bar{M} + mY$$

Autonomous Imports
propensity to import
Income

here $m = \frac{\Delta M}{\Delta Y} = \frac{\text{change in Imports}}{\text{change in Income}}$

$Y \uparrow$

$$AS = C + S + T$$



At equilibrium

$$AS = AD$$

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

$$Y = (a + bY_D) + I + G + X - [\bar{M} + mY]$$

$$Y = a + b(Y - T) + I + G + X - \bar{M} - mY$$

$$Y = a + \underbrace{bY}_{-bT} + I + G + X - \bar{M} - \underbrace{mY}$$

$$Y - bY + mY = a - bT + I + G + X - \bar{M}$$

$$Y(1 - b + m) = a - bT + I + G + X - \bar{M}$$

$$\textcircled{R} \quad Y = \frac{1}{(1 - b + m)} [a - bT + I + G + X - \bar{M}]$$

" FOREIGN TRADE MULTIPLIER "

$$* \text{ Foreign Trade Multiplier} = \frac{1}{(1 - b + m)} = \frac{\overset{\text{Income}}{\Delta Y}}{\underset{\text{Exports}}{\Delta X}}$$

if $X < M$ then National Income **DECREASES**

if $X < M$ then National Income **DECREASES**

if m increases then foreign trade multiplier **DECREASES**
propensity to import

Q1 :-
 $b = 2$
 $m = 4$
find FTM

Sol:- FTM = $\frac{1}{(1 - b + m)}$
 $= \frac{1}{1 - 2 + 4}$
 $= \frac{1}{3}$
 $= 0.3\bar{3}$

Q2 :-
 $b = 2$
 $m = 6$
find FTM

Sol:- FTM = $\frac{1}{1 - b + m}$
 $= \frac{1}{1 - 2 + 6}$
 $= \frac{1}{5} = 0.2$

Q3 -
 $\Delta Y = 1000$
MPC = 75%
find i) ΔI
ii) ΔC

Sol:- MPC = 75% = $\frac{75}{100} = 0.75$

$$K = \frac{1}{1 - \text{MPC}} = \frac{1}{1 - 0.75} = \frac{1}{0.25} = 4$$

$$K = \frac{\Delta Y}{\Delta I}$$

$$4 = \frac{1000}{\Delta I}$$

$$\therefore \Delta I = \frac{1000}{4} = 250$$

$$MPC = 0.75 = \frac{\Delta C}{\Delta Y}$$

$$0.75 = \frac{\Delta C}{1000}$$

$$\therefore \Delta C = 0.75 \times 1000 = 750$$

Q4- $C = 100 + 0.8(Y - T + TR)$

$$I = 200$$

$$T = 25 + 0.1Y$$

$$TR = 50$$

$$G = 100$$

Find equilibrium level of income i.e Y

Sol:-

Equilibrium

$$Y = C + I + G$$

$$Y = 100 + 0.8(Y - T + TR) + 200 + 100$$

$$Y = 100 + 0.8(Y - (25 + 0.1Y) + 50) + 200 + 100$$

$$Y = 100 + 0.8(Y - 25 - 0.1Y + 50) + 300$$

$$Y = 100 + 0.8(0.9Y + 25) + 300$$

$$Y = 100 + 0.72Y + 20 + 300$$

$$Y - 0.72Y = 100 + 20 + 300$$

$$0.28Y = 420$$

$$Y = \frac{420}{0.28} = 1500$$

Q5- $C = 60 + 0.9Y_D$

$$T = 10$$

Q5-

$$C = 60 + 0.9Y_D$$

$$I = 10$$

$$G = 10$$

$$T = 0$$

$$X = 20$$

$$M = 10 + 0.05Y$$

Find equilibrium level of Income.

Sol:-

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

$$Y = 60 + 0.9Y_D + 10 + 10 + \{20 - (10 + 0.05Y)\}$$

$$Y = 60 + 0.9(Y - T) + 20 + 20 - 10 - 0.05Y$$

$$Y = 60 + 0.9(Y - 0) + 30 - 0.05Y$$

$$Y = 60 + 0.9Y + 30 - 0.05Y$$

$$Y = 90 + 0.85Y$$

$$Y - 0.85Y = 90$$

$$0.15Y = 90$$

$$Y = \frac{90}{0.15} = 600$$

$$FTM = \frac{1}{1-b+m}$$

$$\left[\begin{array}{l} b = 2 \\ m = 4 \end{array} \right]$$

$$= \frac{1}{1-2+4} = \frac{1}{3} = 0.3\bar{3}$$

Now $m = 6$

$$FTM = \frac{1}{1-2+6} = \frac{1}{5} = 0.2$$

CH-7 :

PUBLIC FINANCE

(8 Marks)

(Unit 1 : Fiscal functions : Overview)

① Introduction

RBI

Monetary policy

Govt

Fiscal policy

0, 0, 0, 0, 0, 0, 0, 0, 0, 0

→ The actions of government have impact on the economy

Borrow money

public welfare

incurs expenditure

0, 0, 0

Three Main Macro Economic goals for any nation

→ Economic "Growth"

→ High level of "employment"

→ "Stable" Price levels.

* Government has to intervene in all above matters

* Government has to intervene in all above matters and take decisions.

② Role of Government in Economic System

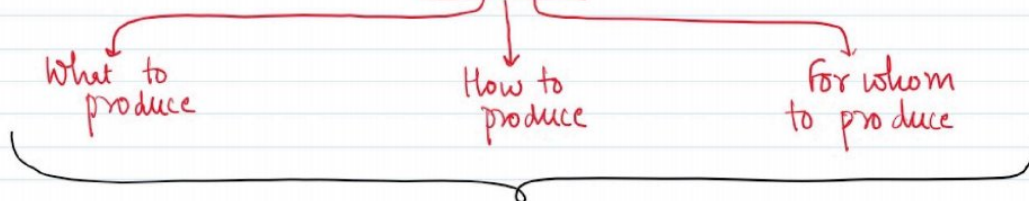
Economic System

(It is a system which provides means to work + earn a living)

SCARCITY

(unlimited human wants with limited resources)

Problems



Three types of economic system

Capitalist
(Refer CH 1)

Socialist
(Refer CH 1)

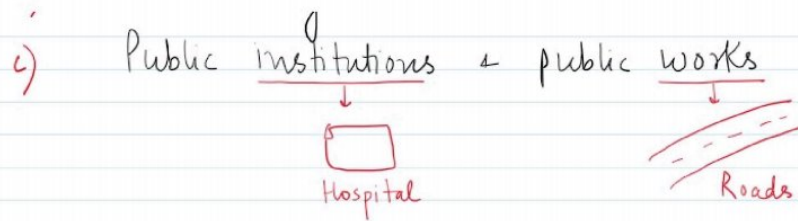
Mixed
(Refer CH 1)

* ADAM SMITH

• Favoured FREE MARKET (i.e. Capitalist)

but role of Government should be in :-

- National Defense
- Justice system
- Public institutions + public works

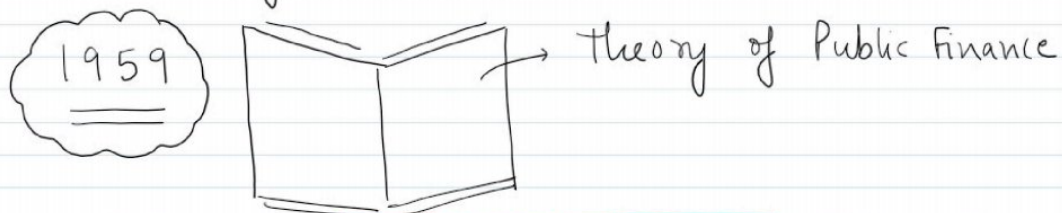


* 1930 - "Great Depression"

After this government's role in economy gained importance.
Government performs economic functions

Fiscal functions or Public Finance functions

* Richard Musgrave &



introduced three branch taxonomy of the role of government in market economy

Resource allocation

↓
to ensure efficiency

Income redistribution

↓
to guarantee "fairness"

Macro economic stabilization

↓
to ensure price stability

③ "THE ALLOCATION FUNCTION"

- Optional allocation of resources for MAXIMUM SATISFACTION
- Minimum waste

- Minimum waste
- Minimum inefficiency

Private Sector (Market economy)	State (Socialist economy)
• Role of demand & supply • Consumer sovereignty • Public goods (↓) • Merit goods (↓)	• Government decides • Public goods (↑) • Merit goods (↑)

- Efficient allocation takes place in Perfectly competitive market, but in reality markets are never perfectly competitive.
- Some reasons for inefficient allocation :-
 - a) Imperfect competition
 - b) Lack of public goods
 - c) Incomplete market - i.e. lack of merit goods
 - d) Over use of resources (environment)
 - e) Externalities (eg. Pollution)
 - f) Factor immobility
 - g) Inequalities of income
- According to Richard, government should intervene in market to bring about improvement in social welfare

↓

(eg. production & consumption of dement goods are controlled by government)
- The resource allocation role of government's policy focuses on the potential for the government to

- The resource allocation role of government's policy focuses on the potential for the government to improve economic performance through its expenditure & tax policies. It determines :-

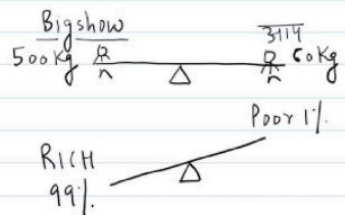
- who and what will be taxed
 - how much and on what government revenue will be revenue
 - optimum mix of various social goods
- etc
- Public goods + Merit Goods

- A variety of allocation instruments are available by which government can influence resource allocation in the economy. For eg:-

- government may directly produce an economic good like electricity
- government may influence allocation through "legislation" & force
 ↳ ban on single use plastic
- government's regulatory activities eg licensing

④ REDISTRIBUTION FUNCTION

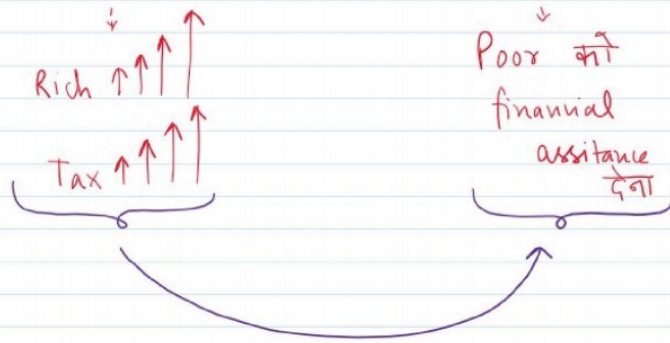
- Generally distribution of income & wealth is **SKewed**



- This function relates to the basic question of **FOR WHOM** **TO produce**
- This function also relates to the manner in which effective demand over the economic goods is divided among the various individuals

It is divided among the various individuals

Progressive taxes + Subsidies



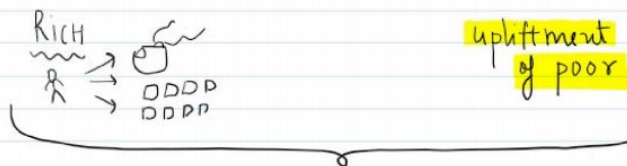
This function aims at :-

- redistribution of income
- Social welfare
- provide equality of income
- provide security (in terms of fulfilment of basic needs)

few examples :-

- Progressive taxes
- food grains at subsidised prices to BPL households
- Employment reservations
- Unemployment benefits etc

Efficiency vs Equity



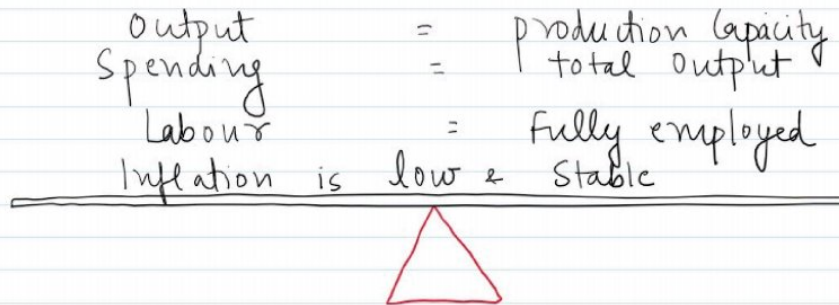
→ Greater equity can be achieved through high taxes on Rich ; but this could act as disincentive to entrepreneurship & discourage people from making savings & investments.

disincentive to entrepreneurship & discourage people from making savings & investments.

→ Therefore redistribution measures should be accomplished with minimal efficiency costs.

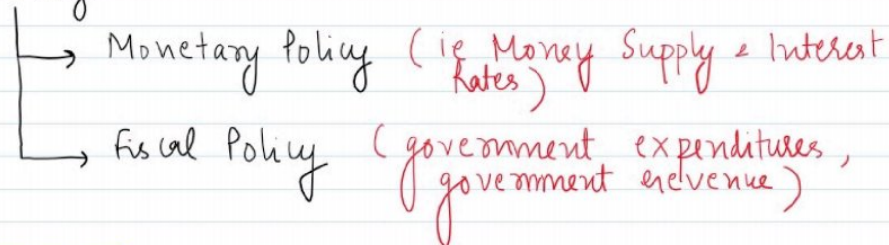
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STABILIZATION FUNCTION

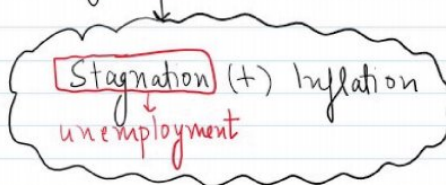


- Keynes believed that economy does not automatically generate full employment, therefore government has to interfere.

- for stability



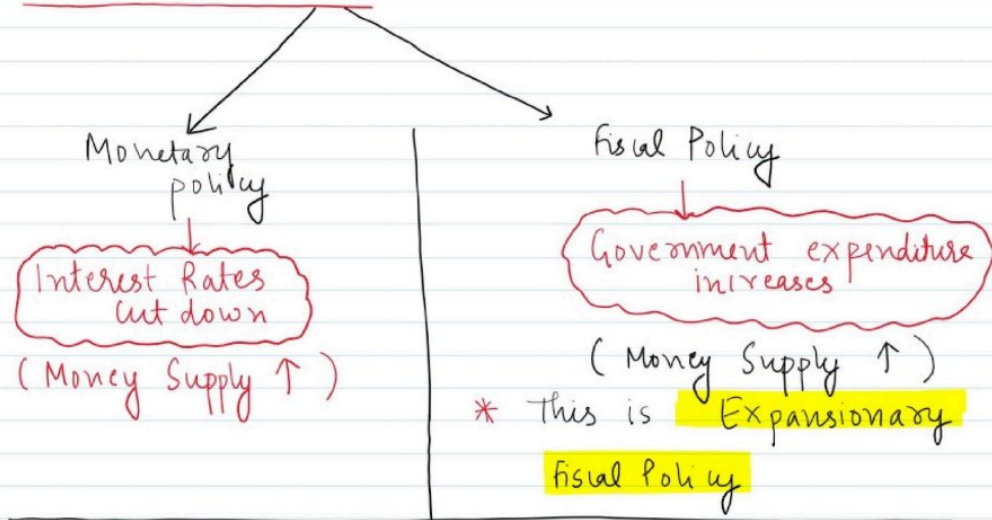
- Stagflation is also problem



- Stabilization issue also become more complex due to CONTAGION EFFECT (ie increased international interdependence & financial integration causes forces of instability)

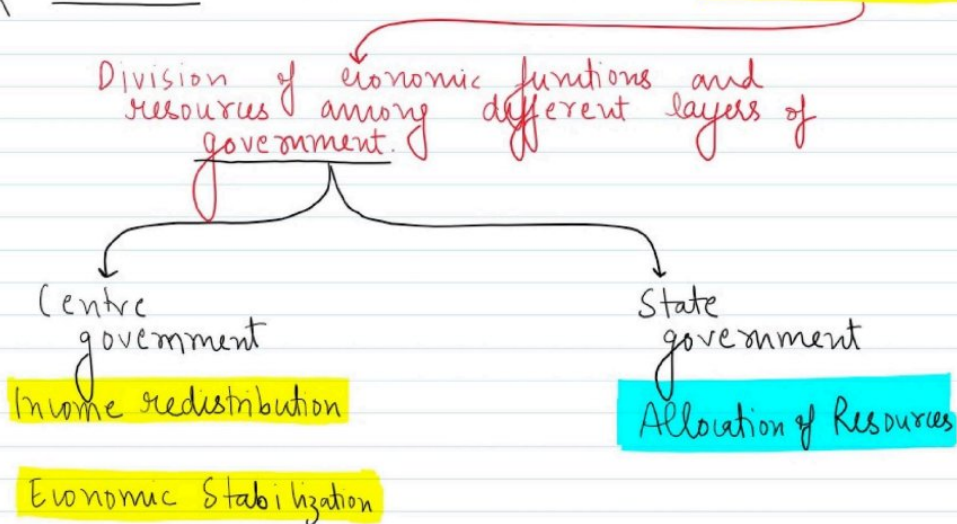
- Stabilization function is concerned with :-
labour employment, capital utilisation,
overall output, general price level,
balance of international payments and
rate of economic growth.

• "COVID scenario"



* To control inflation, government adopts
Contractionary Fiscal Policy

- R Richard introduced a term "FISCAL FEDERALISM"



- * In India, Article 246 of Constitution demarcates the powers of the union & the state by classifying their powers into three lists :-
a) Union list

- a) Union list
- b) State list
- c) Concurrent list

* In case of conflicting legislation in concurrent list, the law passed by centre prevails.

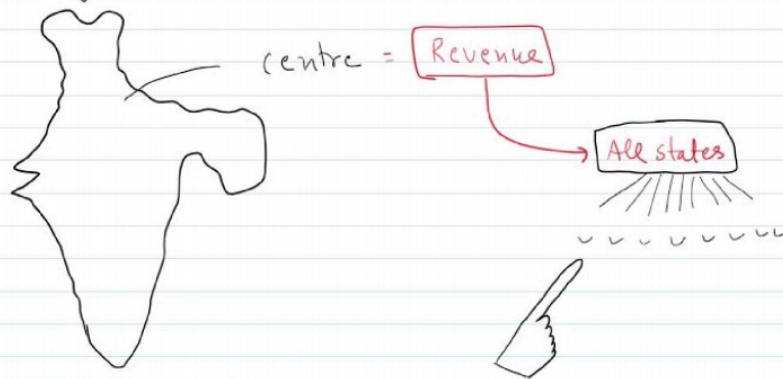
*

TAXES

- by Centre :- Income tax, Corporate Tax, Wealth Tax, Export duties, STT (Securities Transaction Tax), Customs, CGST
- by State :- Tax on Agricultural income, Tax on electricity, Toll tax etc

*

Article 268 to 281 of Constitution contain specific provision in respect of distribution of finances among state



*

Finance Commission facilitate such transfers

- It makes recommendations to President as well
- 15th Finance Commission was constituted on **27 Nov 2017**
- Finance Commission also consider issues related to :-
 - a) Vertical equity - share of all states in revenue collected by centre
 - b) Horizontal equity - allocation among

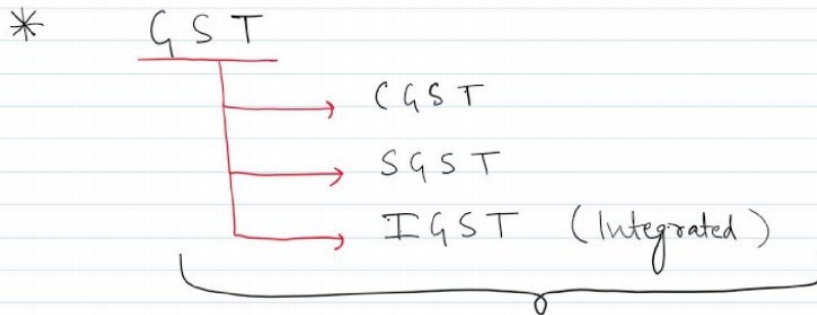
b) Horizontal equity - ^{by centre} allocation among states

* Gross Tax Revenue (of Union)	xxx
(-) <u>Cesses</u>	(xxx)
(-) ^{Tax} <u>Surcharges</u>	(xxx)
(-) <u>Non Tax Revenues</u>	(xxx)

Net Divisible Pool (NDP) xxx

Some share
to States
~~~~~

Remaining  
with Centre  
~~~~~



GST compensation is given to State to compensate for loss of revenue due to introduction of GST

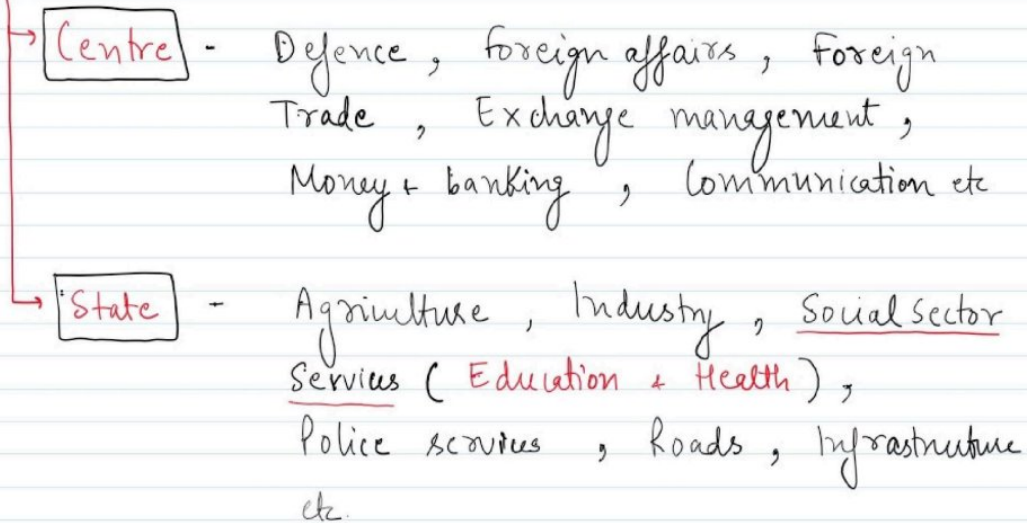
* In May 2022, Supreme Court said that Union & State government have "EQUAL Simultaneous & unique powers" to make laws on GST

* For 2021-26, % share of states in central taxes is 41%. Criteria for determining this distribution includes :-

- 1) Income distance
- 2) Population

- 1) Income distance
- 2) Population
- 3) Area
- 4) Demographic performance
- 5) Forest & ecology
- 6) Tax & fiscal efforts.

* Responsibilities



CH7 Unit 2

MARKET FAILURE

(inefficient allocation of resources)

Complete Market failure

↓

This is a case of " missing markets " and occurs when the market does not supply products at all despite the fact that such product or service are wanted by the people eg pure public goods.

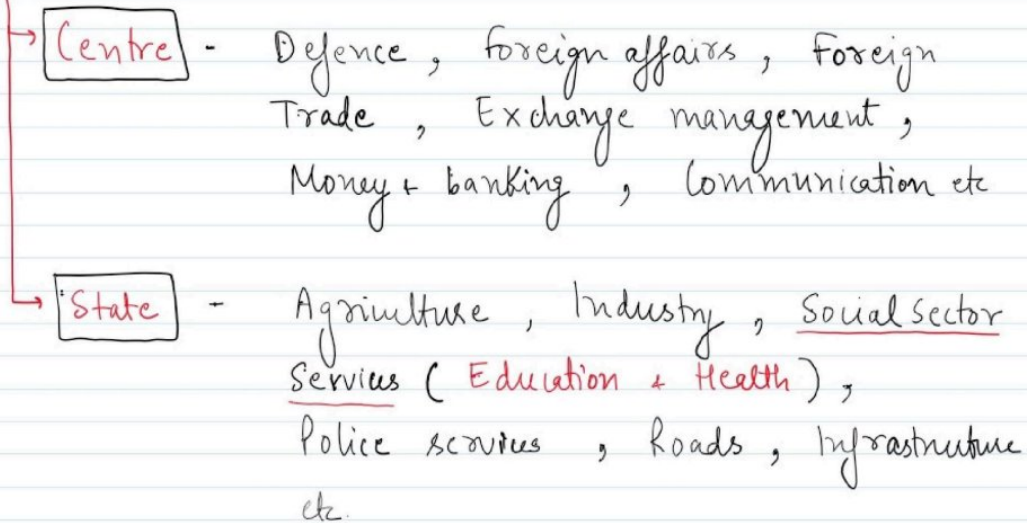
Partial Market failure

↓

Failure occurs when the market does actually function, but it produces either the wrong quantity or at the wrong price. This results in loss of economic welfare

- 1) Income distance
- 2) Population
- 3) Area
- 4) Demographic performance
- 5) Forest & ecology
- 6) Tax & fiscal efforts.

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CH7 Unit 2

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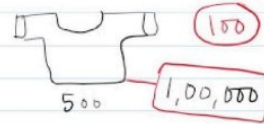
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Partial Market failure

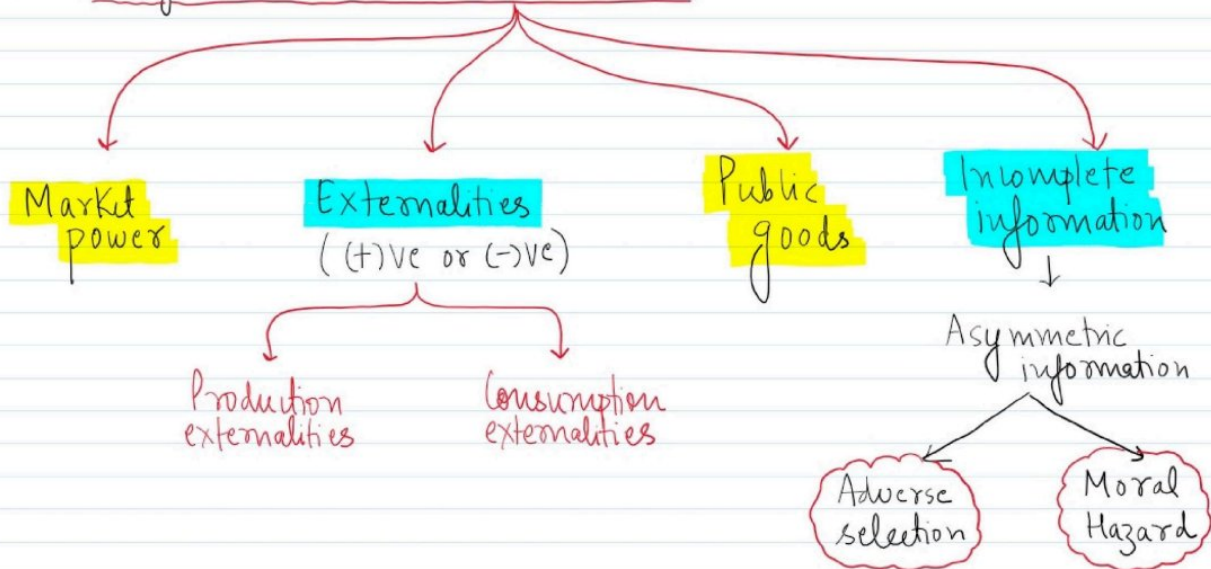
↓

Failure occurs when the market does actually function, but it produces either the wrong quantity or at the wrong price. This results in loss of economic welfare

parks



* Why do Markets Fail ??



GOVERNMENT Intervention in all these above

I Market 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.
- Excessive market power causes the single producer or a small number of producers to restrict output.
- Thus, market fails to produce right quantity of goods & services at the right price.

II EXTERNALITIES

- Externalities are costs (नुकसान / negative externalities)

→ Externalities are **losses** (negative externalities) or **benefits** (positive externalities), which are not reflected in free market prices.

→ Externalities are also referred to as

- Spill over effect
- Neighbourhood effect
- Third party effect
- Side effect

→ Production externalities

(+) VC

A firm offering **trainings** to its employees

(-) VC

factory produces wastes or pollution

→ Consumption externalities

+ve

- Consumption of the service of health club.
- people get immunized against contagious diseases.

(-)ve

- smoking cigarettes in public place.
- Fav.* Art of undisciplined students talking and creating disturbance in class.

* How externalities cause market failure?

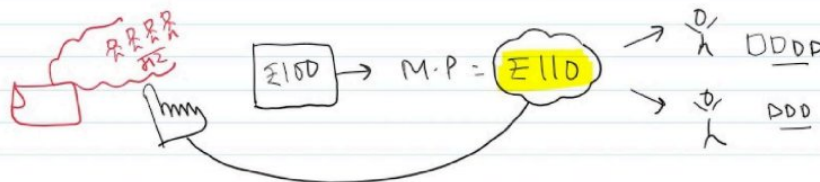
→ Private cost - Cost of production incurred by

- **Private cost** - Cost of production incurred by firm eg wages, raw material etc
- **Social cost** - **total cost** to the society on the amount of production

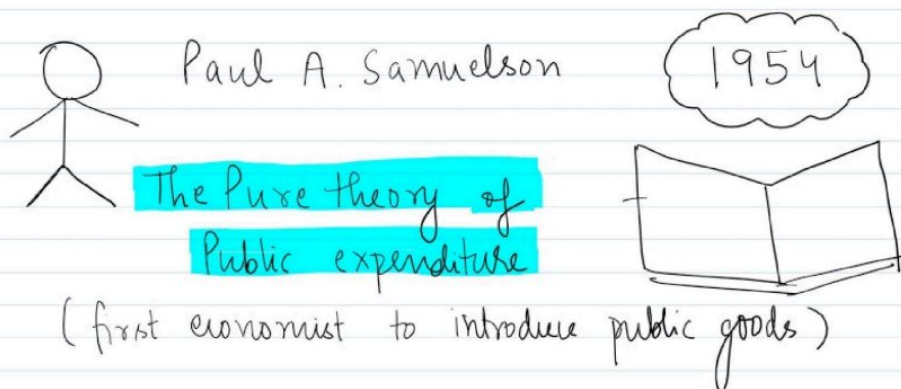
$$\text{Social cost} = \text{Private cost} (+) \text{Negative externalities}$$

or $\text{Social cost} = \text{Private cost} (+) \text{External cost}$

- The market price determined without incorporating externalities are not ideal. Such prices send incorrect signals to the producers & consumers and cause either over production or under production.



III PUBLIC GOODS / SOCIAL GOODS



Private Good →

- **No free rider problem**
- These are **excludable**
- Consumption of private good is **rivalrous**

park → **Public Good**

- Free rider problem is there.
- Non-excludable
- Non-rivalrous
- Indivisibility.

good is 'rivalrous'

• non-rivalrous

• Indivisibility

• More vulnerable to externalities + other issues

→ Producers are not motivated to produce socially optimal amount of products if they cannot charge a positive price for them or make profits from them. Thus, there is market failure in the case of public goods.

IV | INCOMPLETE INFORMATION

- Perfect information implies that both buyer & seller have complete information about anything that may influence their decision making. However, this assumption is not fully satisfied in real markets because of :-

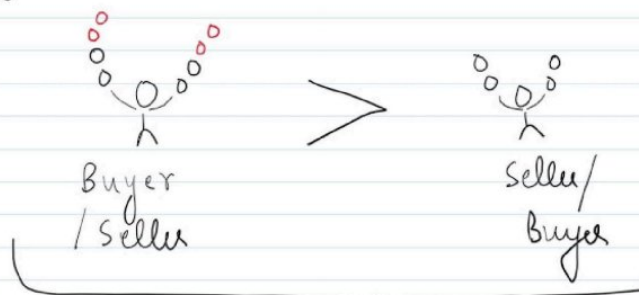
doctor
surgeon
consumer
producer

a) Complexity of product/service

b) Difficulty of getting correct information

c) Deliberate misinformation by interested parties

→ Asymmetric information



it occurs when there is an imbalance in information between the buyer & seller.

eg :- Landlords know more about their

eg :- Landlords know more about their property

:- Borrower knows more about their ability to repay

Adverse Selection



The party which has more information (let say Mr X) may take advantage of other's ignorance (let say Mr. Y). Thus Mr. Y will be at loss.

eg. Insurance

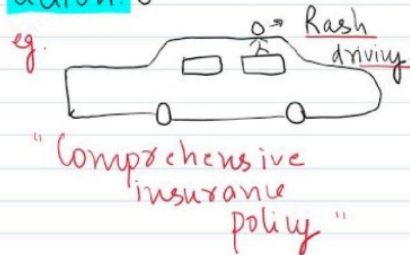
↑ premium



Moral Hazard



Moral hazard arises when there is externality. It is about the opportunism characterised by an informed person's taking advantage of a less-informed person through an unobserved action.



* Thus, asymmetric information leads to elimination of high quality goods from the markets. Economic agents end up either selecting sub-standard product or leaving the market altogether

* GOVERNMENT INTERVENTION

① TO MINIMISE MARKET POWER

① To MINIMISE MARKET POWER

- Competition Act, 2002 (as amended by Competition (Amendment) Act, 2007)
- Market liberalisation
- "Control" on Merger + Acquisition
- Price Capping
- Patronage to consumer associations
- Reduction in Import Controls
- Nationalisation

Support

* However sometimes government give patents and copyrights & protect monopoly position of a firm
☹️

② To Correct Externalities

Reduce effect of negative externalities

Government initiatives

(i) Direct Control (Command Solutions)

- Fix emission of pollutants (penalties for exceeding limits)
- Licensing
- Make laws

(ii) Market Based Policies

[environmental taxes and Cap and Trade] i.e. setting price

Promote positive externalities

(i) Corrective subsidies to producers

aimed at increasing SUPPLY of good

eg Subsidy on Fertilizers

(ii) Corrective Subsidies to consumers

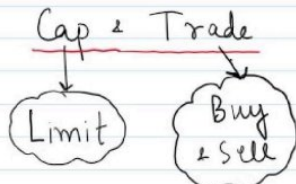
Trade] i.e. setting price
 directly through pollution tax or
 setting price indirectly through cap
 & trade

* A.C. Pigou } Pigouvian taxes

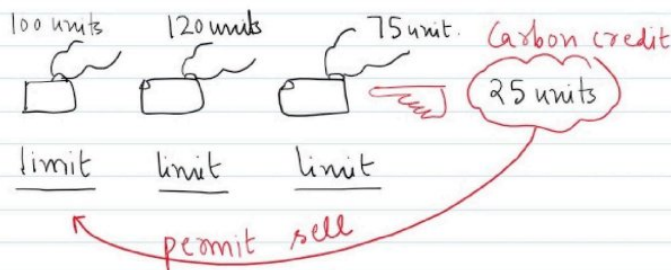
It is difficult
 to determine

If demand is
 inelastic then
 these taxes
 may not be
 effective

Adverse
 effect
 on
 Employment



- Total pollution allowed to be emitted during each period.
- Concept of Permits + Concept of Carbon Credit



- Tradeable permits have been used since 1980s in US.

In India - Perform Achieve & Trade (PAT),
 RPO (Renewable Purchase Obligation)
 REC (Renewable Energy Certificate)
 Energy Conservation (Amendment) Bill, 2022

to Consumers
 aimed at increasing
 DEMAND of good

eg Subsidies on education

* Also government
 engage in :-

- Aforestation
- Reforestation
- protection of water bodies etc

③ In case of Merit Goods

- Compulsory Insurance protection
- Compulsory immunization
- Use of legislation (eg use of helmets, seatbelts)
- Free education / Free medical services

④ In case of Dement Good → Alcohol, Tobacco, drugs, cigarettes

- Complete Ban → Hidden market is there.
- Negative advertising (persuasion)
- Prohibit advertisement of these goods.
- Restriction in public areas
- Imposing high taxes

Demand of these products are generally INELASTIC, so increase in price due to high taxes have very less effect on demand (Also, sellers can shift the tax on consumers)

☞ Disclaimer : "Do not touch."

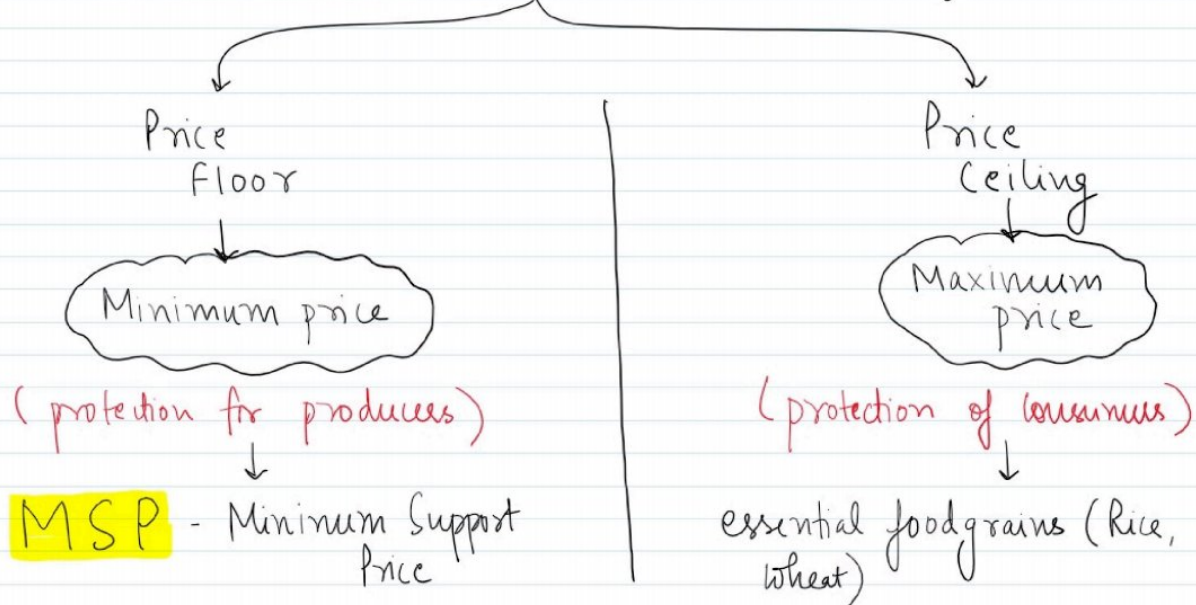
⑤ In Case of Public Goods

- Defence, legal system, fire protection, disease prevention etc are provided

disease prevention etc are provided by government

- Parks or museums can be financed through "entry fees"
- Government may grant license to private firms to build good public facility
- Government may invite voluntary contributions and private donations.

⑥ Price Intervention (Non Market Pricing)



⑦ For Correcting Information Failure

- Government makes accurate labelling mandatory
- Mandatory disclosures (eg - SEBI makes it compulsory for companies)
- Public dissemination → प्रचार

- Regulation on Advertising

⑧ For Equitable Distribution

- One of the most important activities of government is to redistribute incomes so that there is equity & fairness in the society
- Progressive taxes
- Unemployment allowances
- Job reservations
- Land reforms
- Gender sensitive budgeting
- etc.

but sometimes Government failure occurs when:-

- Intervention is ineffective causing waste of resources
- Intervention produces fresh & more serious problems

x ————— x ————— x ————— x ————— x ————— x ————— x

CH-7 Unit 3 Process of Budget Making

① Introduction

- Government all over the world have to perform manifold functions from protecting territories, maintaining law & order, provision of public goods and implementation of comprehensive plans for economic & social welfare of its citizens.
- A budget is a statement that presents the details of "where the money comes from and where

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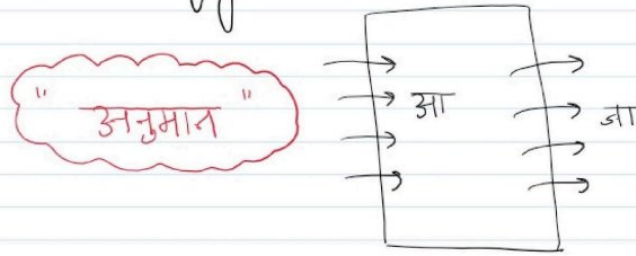
x ——— x ——— x ——— x ——— x ——— x ——— x

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→ A budget is a statement that presents the details of "where the money comes from and where the money goes to"



The budget also contains estimates of the government's amounts for next fiscal year called budgeted estimates

v. Imp
2 R

Process of Budget Making

→ The Budget is prepared by the Ministry of Finance in consultation with NITI Aayog & other relevant ministries.
(National Institution for Transforming India)

→ The Budget must be presented and approved by both houses of parliament before the beginning of fiscal year. (1 April - 31 March)

→ Article 112 of Constitution provides that in respect of every financial year the president shall cause to be laid before both the houses of parliament a statement of estimated receipts and expenditure of the government of India for that year, referred as Annual financial Statement

→ The budgetary procedure are :-

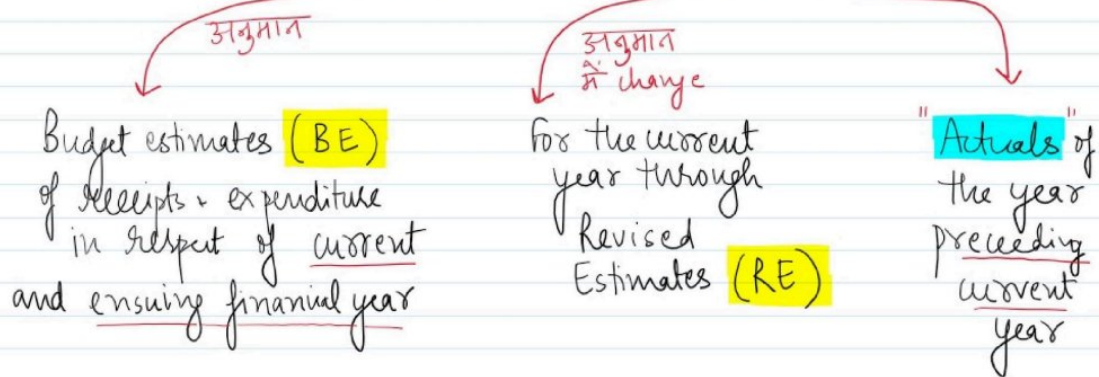
- (i) Preparation of Budget
- (ii) Presentation and enactment of Budget
- (iii) Execution of the budget

→ The budget process mainly consists of two activities
a) Administrative process - documentation

- U a) Administrative process - documentation
b) Legislative process - legal process

→ A series of pre budget consultations are done by the union finance minister with chief ministers of states, various stakeholders etc

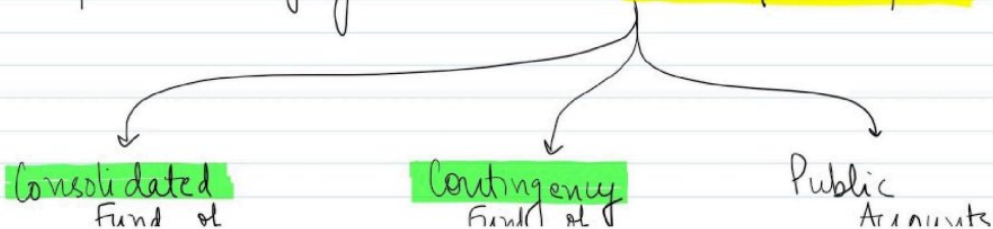
→ The Budget documents depict information relating to receipts and expenditures for 2 years



→ The budget speech of Finance Minister is usually in 2 parts

- Part A of Budget gives an outline of prevailing macro economic situation of the country and budget estimates for next financial year.
- Part B of Budget speech details the progress the government has made on various developmental measures and also the tax proposals.

→ The annual financial statement shows the receipts and expenditure of government in 3 separate parts



Consolidated
Fund of
India

Contingency
Fund of
India

Public
Accounts

→ The list of Budget documents presented to the Parliament, besides the finance minister's speech, is given below

a) Annual Financial Statements (AFS)

b) Demand for Grants (DG)

c) Finance bill

d) Statements mandated under FRBM Act :-

Fiscal Responsibility
& Budget Management

→ Macro-Economic framework statement

→ Medium-Term Fiscal policy cum Fiscal policy strategy statement.

→ The expenditure of certain categories (e.g. - allowances of President, emoluments of Supreme court judges etc.) are charged on "Consolidated Fund of India"

(*) By convention in an election year, the budget may be presented **TWICE**

→ The Budget is discussed in two stages in Lok Sabha. The Lok Sabha has the power to concur or to refuse any demand or even reduce the amount of grant sought by government.

10000
crore
वर्ष

The Budget is laid on the table of the Rajya Sabha soon after the finance minister has completed the speech in Lok Sabha. The Rajya Sabha, does not vote on the demands of grant and there is only general discussion.

→ After the general discussion the government introduces

→ After the general discussion, the government introduces **Appropriation Bill**

It is intended to give **authority** to the government to incur **expenditure** from and out of **consolidated fund of India**.

Motions for reduction to various demands for grants are made in the form of **CUT MOTIONS** seeking to reduce the sum sought by the government. ^{100000 crore}

→ The **finance bill** seeking to give effect to the government's **taxation** proposal is introduced in Lok Sabha immediately after the presentation of General Budget. The finance bill is taken up for consideration and passing after the Appropriation bill is passed.
(Finance Bill has to be passed within **75 days** of its introduction)

→ After the finance bill has been passed by Lok Sabha, it is transmitted to Rajya Sabha for recommendations. It has to be returned back within **14 days** (Recommendation of Rajya Sabha may be accepted or rejected by Lok Sabha)

* On the **last day** of the days allotted for discussion on the **demands for grants**, the speaker puts all the outstanding demands for grants to **vote of the house**. This process is called **"GUILLOTINE"**

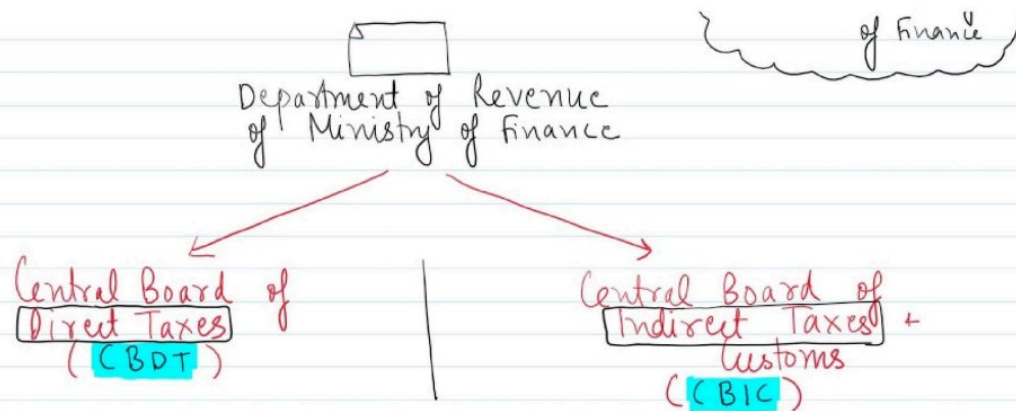
* Since 2017-18, the date of presentation of budget has been advanced to **1st February**. Merging of **Railway Budget** with General Budget

3

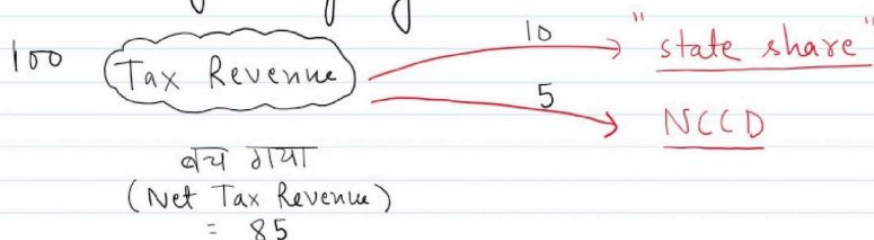
Sources of Revenue

Department of Revenue

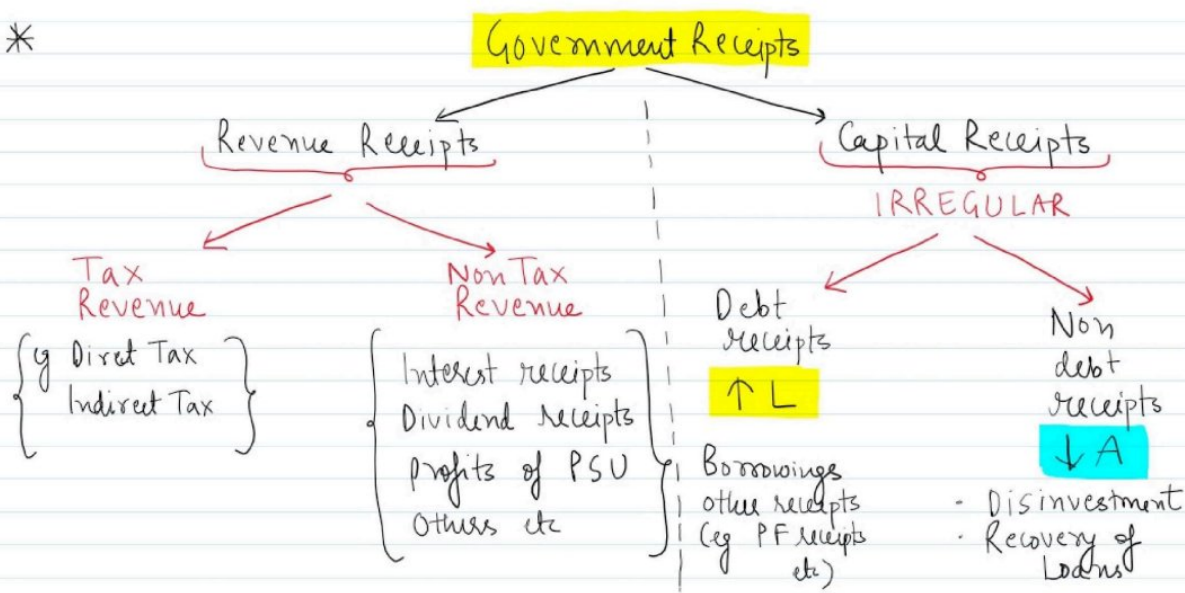
MOF = Ministry of Finance



- * Centre's Net Tax Revenue is the total of tax revenue after paying of the state's share and of the National Calamity Contingent Duty (NCCD) transferred to National Calamity Contingency.



*



④

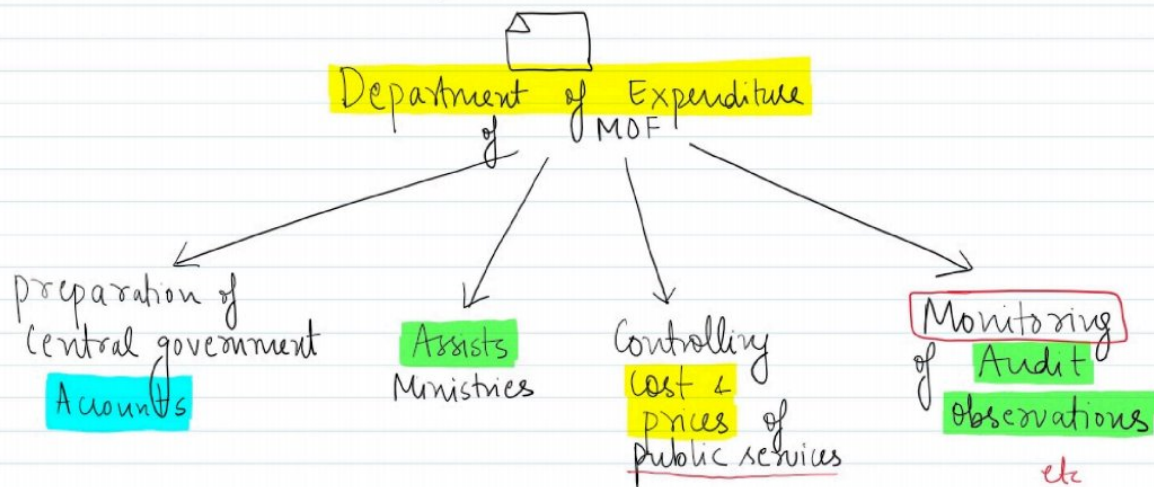
Public expenditure Management.

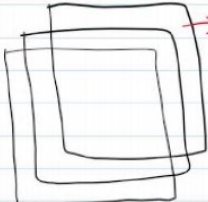
→ Public expenditure is necessary to accelerate economic growth and to promote employment opportunities.

opportunities.

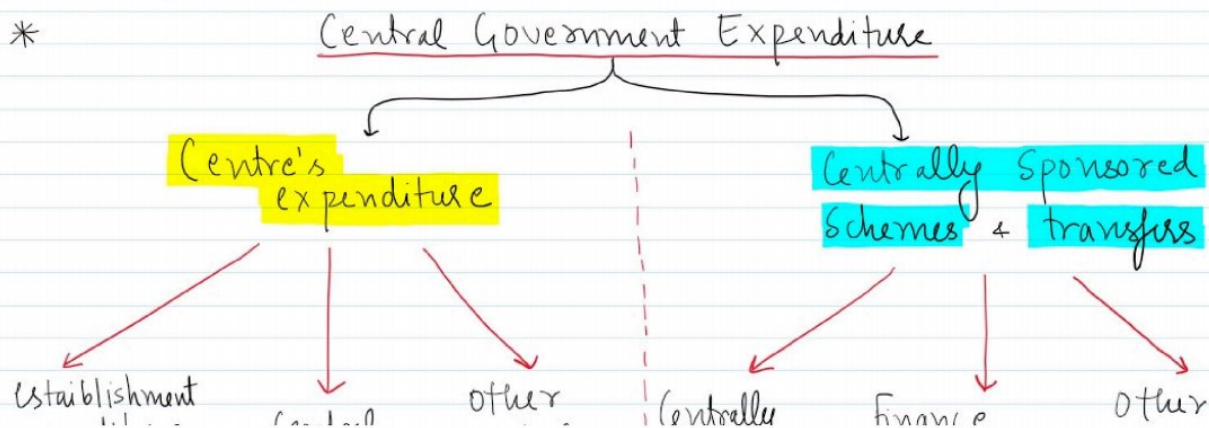
→ But unproductive public expenditure may lead to:-
(वैयर्थता का स्वरूप)

- larger deficits 😞
- high taxes 😞
- low economic growth 😞
- greater debt burden. 😞



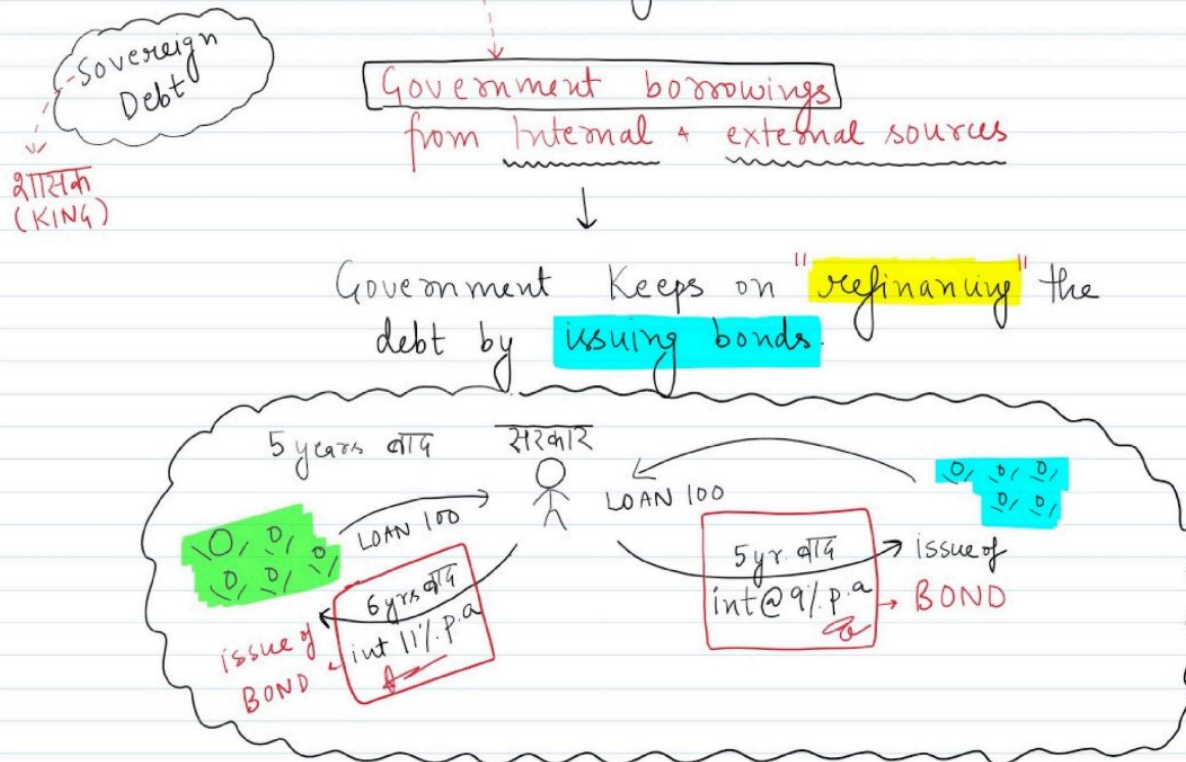
*  → expenditure profile → After approval of Finance Minister; circulated to the Ministries.

Budget documents



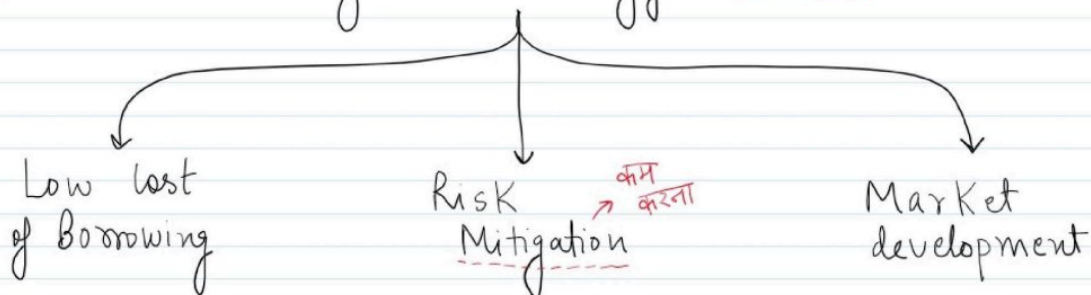
Establishment expenditure Central Sector Schemes other Central expenditures Centrally sponsored Schemes Finance Commission transfer Other transfer to States

5 ^{*imp} Public Debt Management (2 Marks)



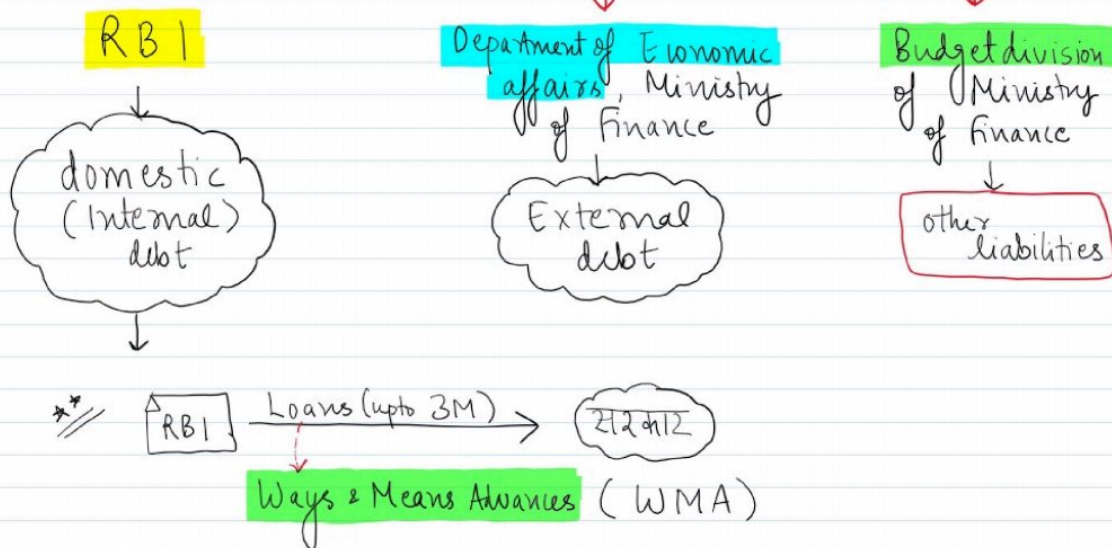
→ Debt sustainability is an important indicator of overall macro economic health of country

→ Debt Management Strategy (Pillars)



→ Institutions responsible for public debt management

→ Institutions responsible for public debt management



* FRBM was passed in 2003 to promote legislative framework for reduction of deficit.

Fiscal Responsibility & Budget Management

* Public debt Management Cell (PDMC) was created in 2016 under Department of Economic Affairs.

* **Public debt** ₹ 1,69,46,666 crore
(31 March 2024)

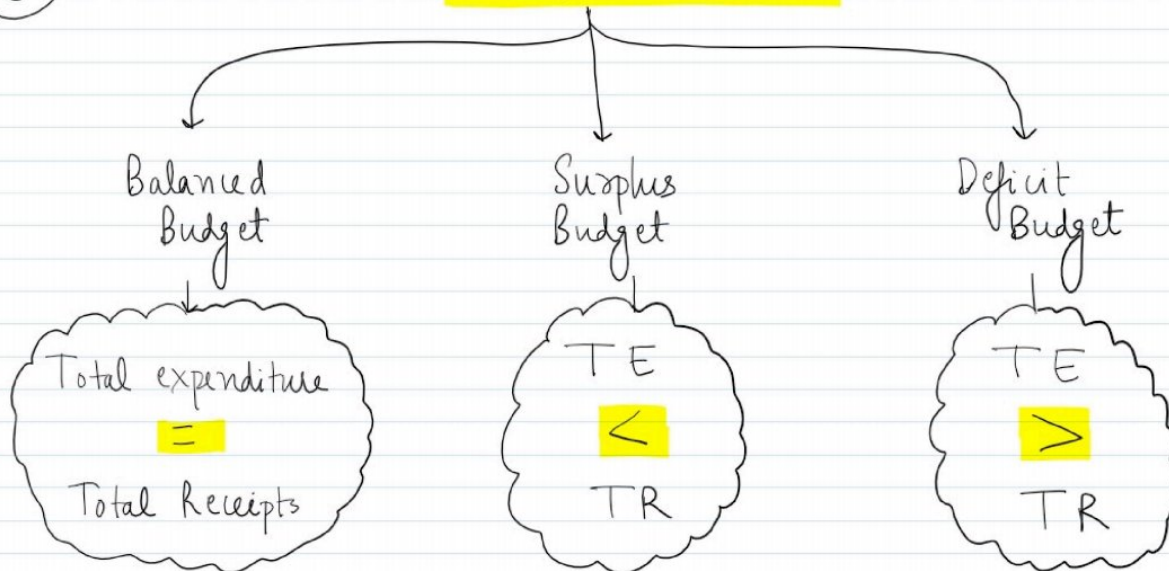
Category	Amount (₹ crore)
Internal	₹ 1,64,23,983
External	₹ 5,22,683

* RBI is developing **G-Sec Market** to broaden investor participation.
(**Retail Direct Scheme**)

Government Securities

⑥

BUDGET CONCEPT



* $TE = \text{Capital expenditure (+) Revenue expenditure}$

* $TR = \text{Capital receipts (+) Revenue Receipts}$

CE :	$\uparrow A$ or $\downarrow L$	Roads construction, Repayment of loan.
RE :		Subsidies given, Salary given, Interest payments
CR :	$\uparrow L$ or $\downarrow A$	Borrowings, Disinvestment
RR :		Tax revenue, Non Tax Revenue.

⑦

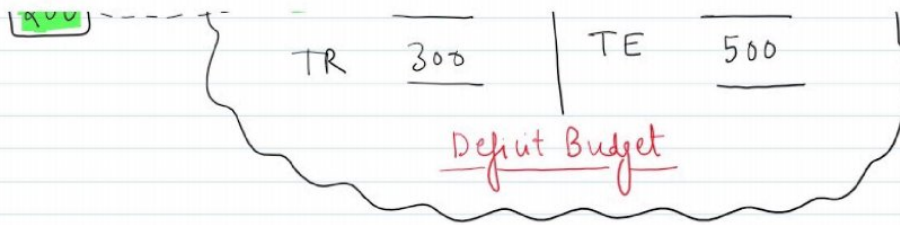
Budget Deficit

= Total expenditure (-) Total receipts

Fiscal deficit.
Borrowing

200

RR = 100	RE 150
CR = 200	CE 350
TR 300	TE 500



$$\begin{aligned}
 \rightarrow \text{Revenue Deficit} &= \text{Revenue expenditure} (-) \text{Revenue Receipts} \\
 &= 150 (-) 100 \\
 &= 50
 \end{aligned}$$

$\rightarrow$ Fiscal Deficit
 (Signifies Borrowings)

$$\begin{aligned}
 &= \text{Total expenditure} (-) \text{Total Receipts (excluding Borrowings)} \\
 &= 500 (-) 300 \\
 &= 200 \text{ (Borrowings)}
 \end{aligned}$$

OR

$$\begin{aligned}
 &= \text{Revenue deficit} (+) \text{Capital expenditure} (-) \text{Capital receipts (excluding Borrowings)} \\
 &= 50 (+) 350 (-) 200 \\
 &= 200 \text{ (signifies Borrowings)}
 \end{aligned}$$

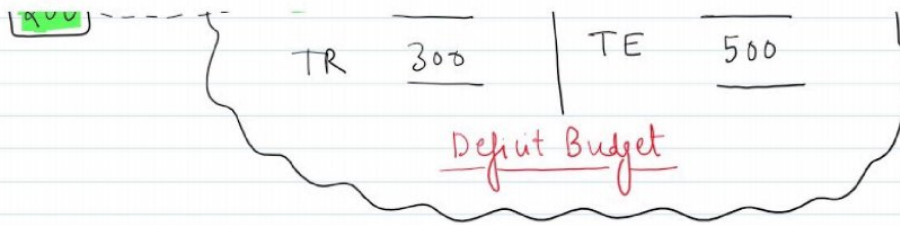
$\rightarrow$ Primary Deficit

$$= \text{Fiscal Deficit} (-) \text{Net Interest liabilities}$$

CH 7
Unit 4

"Fiscal Policy"

(1) Introduction



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 \end{aligned}$$

$\rightarrow$ Primary Deficit

$$= \text{Fiscal Deficit} (-) \text{Net Interest liabilities}$$

CH 7
Unit 4

"Fiscal Policy"

(1) Introduction

① Introduction

→ Budgetary policy could be broadly classified into public revenue^① including taxation, public expenditure^②, public debt^③ and finally deficit financing^④

सरकार का
Revenue
(income)

सरकार
की
Borrowings

Budget
↓
deficit
की
भरपाई

सरकार का
खर्चा

→ Fiscal policy is the deliberate policy of the government under which it uses the instruments of :-

- | | |
|----------------------|--------------------|
| • Taxation | - सरकार का Revenue |
| • Public expenditure | - " " खर्चा |
| • Public borrowings | - " की Borrowings |

→ fiscal policy is in the nature of demand side policy

Imp → An economy which is producing at full employment level does not require government action in the form of fiscal policy

② OBJECTIVES OF FISCAL Policy

- Achievement & maintenance of full employment
- Maintenance of Price stability
- Acceleration of the rate of economic development
- equitable distribution of income & wealth

$$\begin{array}{ccccccc} * & \text{GDP} & = & C & + & I & + & G & + & NX \\ & & & | & & | & & | & & | \\ & & & \text{Household} & & \text{निवेश} & & \text{सरकार} & & \text{Net} \\ & & & \text{का खर्चा} & & \text{का खर्चा} & & \text{का खर्चा} & & \text{Exports} \end{array}$$

Household का खर्चा निवेश का खर्चा $\leftarrow$ Govt का खर्चा Net Exports $(X - M)$

③

TYPES OF FISCAL POLICY

Expansionary Fiscal Policy

- It is a policy measure to close a recessionary gap.
(i.e. deflation) $\rightarrow$ "economy में demand कम है"
- Cut all types of Tax
- Increase in Public expenditure
- While resorting to expansionary fiscal policy, the government may run into budget deficits

Contractionary Fiscal Policy

- It refers to the deliberate policy of government applied to curtail aggregate demand and consequently the level of economic activity. In other words, it is a fiscal policy to eliminate Inflationary Gap
- Increase in taxes
- Decrease in Public expenditure
- Contractionary fiscal policy should ideally lead to smaller budget deficit

④

INSTRUMENTS OF FISCAL POLICY

I. Government Expenditure

- Current expenditures to meet day to day running of the government.
- Capital expenditures (in form of investment)
- Transfer Payments - which do not contribute to GDP

↳ **Transfer Payments** - which do not contribute to GDP

↑ Expenditure :- AD ↑ inflation ↑
↓ Expenditure :- AD ↓ inflation ↓

II

TAXES

↳ Direct Tax
↳ Indirect Tax

Taxes ↑ Disposable income ↓ AD ↓
Taxes ↓ Disposable income ↑ AD ↑

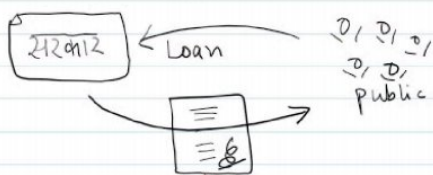
III

Public Debt

Internal External

Forms of Public debt

Market Loans



Treasury bills,
Government Securities

Negotiable (✓)

Tradeable (✓)

Small Savings

It represents public borrowings, which are **not negotiable** and are **not traded**
(eg National Savings Certificate, National Development Certificate etc)

Negotiable (✓)

Tradeable (✓)

National Development Certificate etc)

Public debt (↑) AD (↓)

Public debt (↓) AD (↑)

* Important points relating to Fiscal Policy *

① Budget as Instrument of Fiscal Policy

Balanced Budget : $TR = TE$ $\Rightarrow$ No effect on AD
Leakages = Injections

Surplus Budget : $TR > TE$ खर्च कम है $\Rightarrow$ AD (↓)
Leakages > Injections

Deficit Budget : $TR < TE$ खर्च ज्यादा है $\Rightarrow$ AD (↑)
Leakages < Injections

② Fiscal Policy for Long Run Economic Growth

→ Fiscal policies such as those involving infrastructure spending generally have positive supply side effects

Roads
24x7 electricity



producers "(+)ve"

→ Government provisions for public goods such as education, healthcare, nutrition etc provide momentum for long run economic growth.

Momentum for long run economic growth.

→ Tax and spending policies can be effectively used to correct market failures resulting from externalities.

③

Fiscal Policy for Reducing Inequality of Income

→ Progressive direct tax system

→ Differential Indirect tax system

{
Luxury Goods → 28% Tax
Necessity Goods → 0% Tax
}

→ Other measures :-

→ Poverty alleviation programmes

→ Free or subsidized medical care, education, housing etc

→ Various social security schemes (old age pension etc)

→ etc etc

④

LIMITATIONS of Fiscal Policy

(i) Different lags :-

a) Recognition lag - There is difficulty in collecting accurate & timely data

b) Decision lag - Delays are likely to occur to make decision on the most appropriate policy.

c) Implementation lag - Even when appropriate policy measures are decided on, there are possible delays in bringing in legislation & implementing them.

d) Impact lag - It occurs when the outcomes of a policy are not visible in sometime

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(ii) It is practically difficult to reduce government spendings on various items.

(iii) Public works cannot be adjusted easily along with movements of trade cycle

{ eg project → HIGHWAY }
3 years long gestation period



(iv) Supply-side economists are of the opinion that certain fiscal measures will cause disincentives

{ Profit Tax (↑) investors (producer) ☹️ }

(v) Increase in government borrowings will create perpetual "burden of debt" on future

5

CROWDING OUT

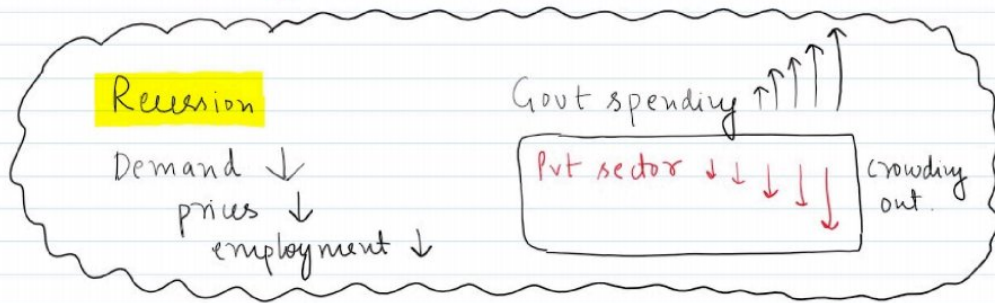
→ Increase in government spending during recessions will "crowd out" private spending in economy.

→ In other words when spending by government in an economy replaces private spendings, the latter is said to be crowded out.

→ As a result, the effectiveness of expansionary fiscal policy in stimulating aggregate demand will be diminished to a great extent (may possibly reduce economy's prospects of long term economic growth)

economic growth)

* However during deep recessions crowding out is less likely to happen as private investments are already minimal.



CH 8

MONEY MARKET

(8-10 Marks)

UNIT 1: The concept of Money Demand

1 INTRODUCTION

→ Money can be anything that can serve as :-

- (i) Store of value
 - (ii) Unit of account -----> common base for prices
 - (iii) Medium of exchange
- you can save it for future
- which can be used to buy & sell goods or services

→ Money is something that holds its value over time, can be easily translated into prices, and is widely accepted. Many different things have been used as money over the years.

Cowry Shells

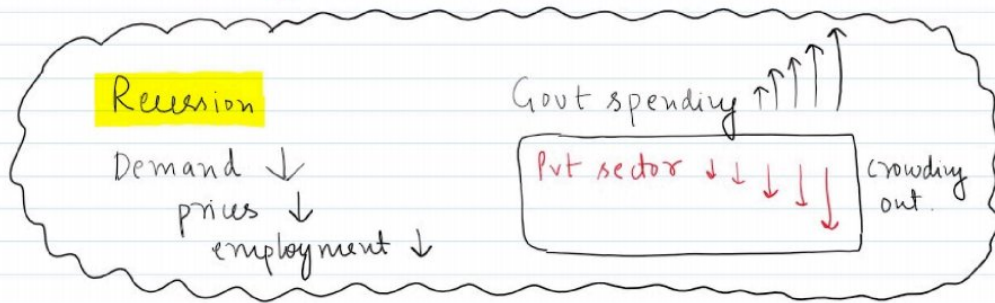
Barley
(cereal grain)

Peppercorns

Gold & Silver

economic growth)

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CH 8

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Peppercorns

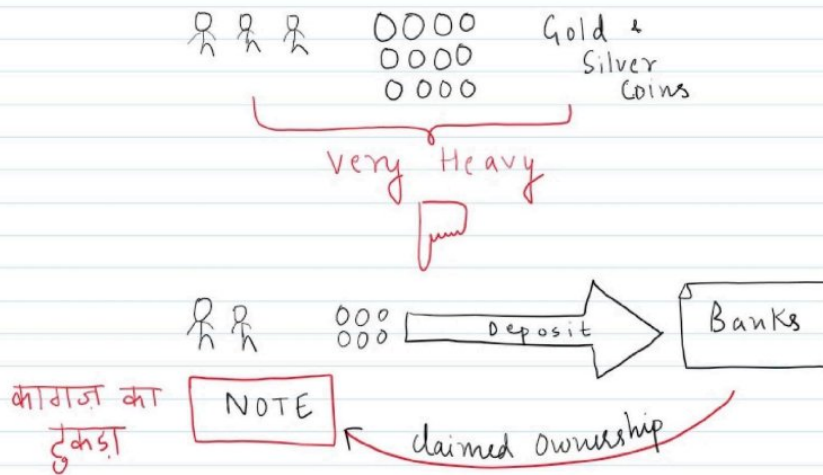
Gold & Silver

Shells

(Cereal Grain)

Silver

→ FIAT MONEY



Eventually the paper claim on the precious metals was delinked from the metal. When that link was broken, fiat money was born.

Fiat money is materially worthless, but has value simply because a nation collectively agrees to ascribe a value to it. (In short, money works because people believe that it will)

②

Money can be defined for policy purposes as the set of liquid financial assets, the variation in stock of which could impact on aggregate economic activity. As statistical concept, money could include certain liquid liabilities of a particular set of financial intermediaries or other issuers.

- RBI Manual on Financial & Banking Statistics, 2007

→ Functions of Money (Characteristics of Money)

- (i) Generally acceptable
- (ii) Durable i.e. Long lasting
- (iii) Effortlessly recognisable
- (iv) Difficult to counterfeit --- "duplicate का मत" पादा
- (v) Relatively Scarce [but has elasticity of supply]

(v) Relatively Scarce [but has elasticity of supply]

Supply zero नहीं होनी चाहिए

(vi) Portable

(vii) Possess Uniformity

(viii) Divisible into "smaller parts"

→ How is money measured ?

In official statistics, the amount of money in an economy is generally measured through what is called broad money.

which encompasses everything that provides a store of value and liquidity

International Monetary Fund
IMF

Broad money consists :-

Narrow Money

→ National Currencies (generally issued by Central government)

→ Transferable deposits (which include demand deposits, cheques, etc)

Current A/c

→ Other deposits (such as Non transferable savings deposits, term deposits, repurchase agreements etc)

F.D

in which one party sells a security and agrees to buy it back at fixed price

* Securities other than shares (like tradeable certificates of deposit, commercial papers etc)

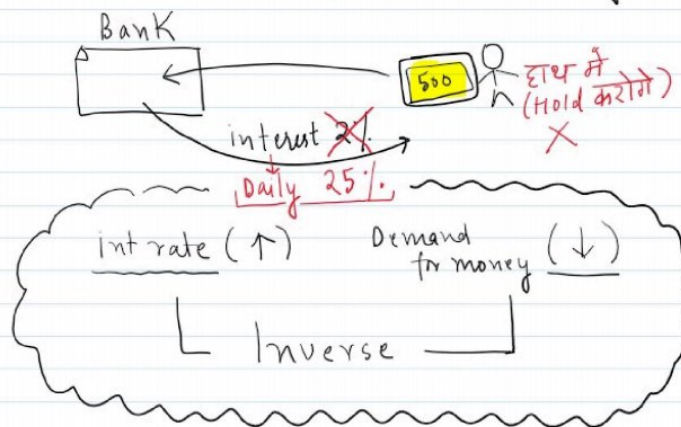
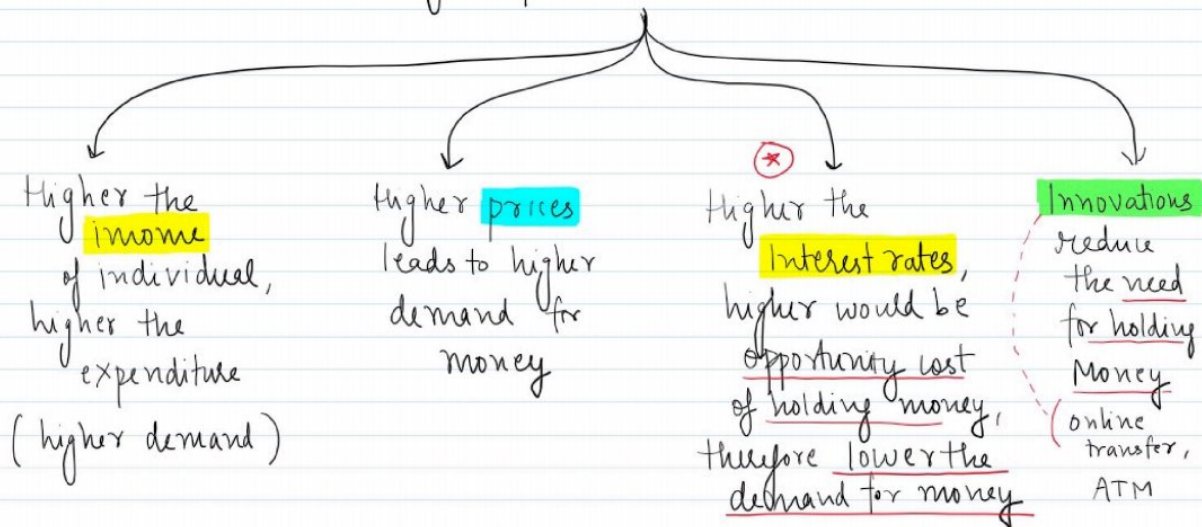
2

Demand for MONEY

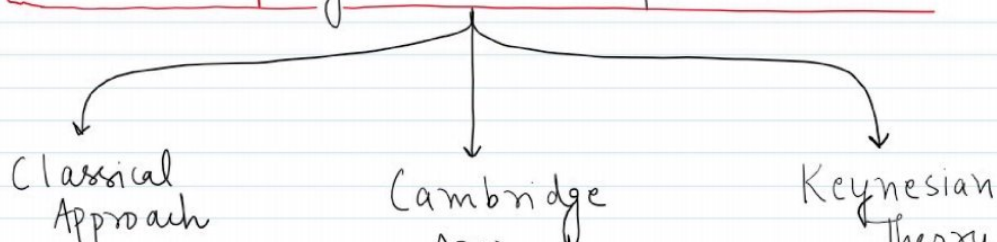
→ If people desire to hold money, we say there is demand for money

→ The demand for money is in nature of

- The demand for money is in nature of "DERIVED DEMAND", it is demanded for its purchasing power.
- Demand for money is actually demand for liquidity and demand to store value
- Some important variables on which demand for money depends on are :-



③ Theories of Demand for MONEY



Classical
Approach

Cambridge
Approach

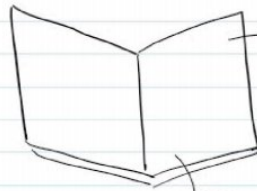
Keynesian
Theory
(V.Imp)

I. CLASSICAL APPROACH

(Quantity Theory of Money - OTM)

Irving
Fisher

(Yale University)

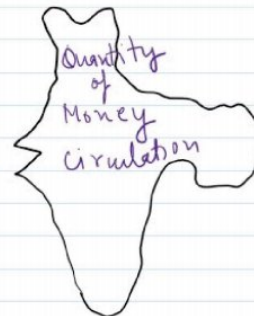


The Purchasing
Power of Money

1911

Demand for Money
is for Transaction purpose

→ Changes in general level of commodity prices or changes in value or purchasing power of money are determined first and foremost by change in the quantity of money in circulation



→ Fisher's version or also termed as "equation of exchange" or transaction approach

$$M V = P T$$

M = Total money in circulation (on an average)
V = "transaction velocity" of circulation

V = "transaction **velocity**" of circulation
 (i.e. **average** number of times across all transactions a unit of money is spent)

$\begin{cases} P = \text{Average **Price** level} \\ T = \text{"**Total number**" of transactions} \end{cases}$

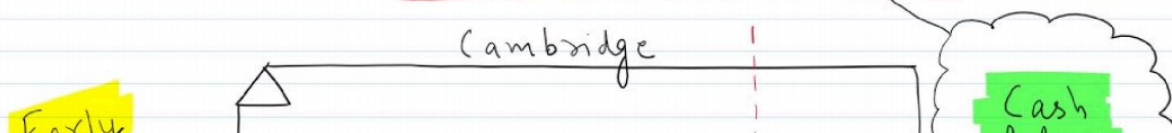
- Later economists replaced 'T' by **Real Output** Y
- After some time, Fisher extended the equation

$$\underbrace{MV + M'V'}_{\substack{\text{Demand deposits} \\ \text{M' and Velocity} \\ \text{SUPPLY of Money}}} = \underbrace{PT}_{\text{DEMAND for Money}}$$

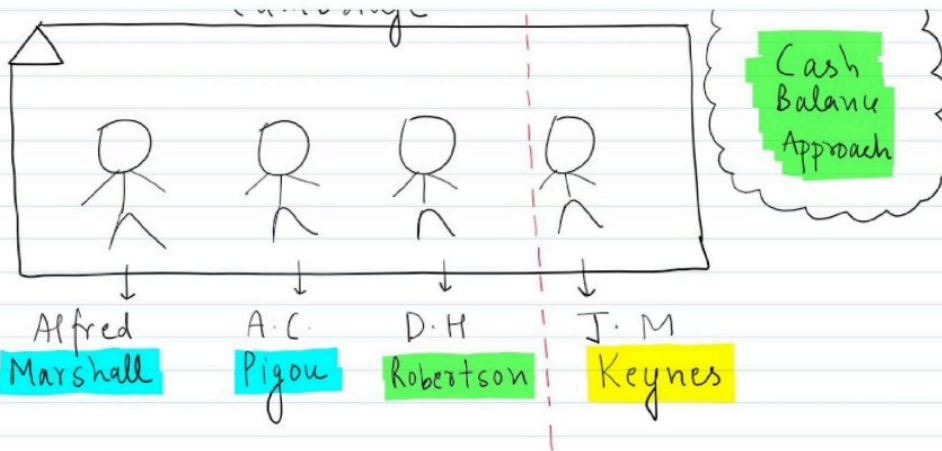
→ Velocity of Money in circulation (V) and velocity of credit money (V') remain constant
 (demand deposits)

T is a function of National Income and since **Fisher assumed the full employment levels** in the economy, T also remains constant in short run.

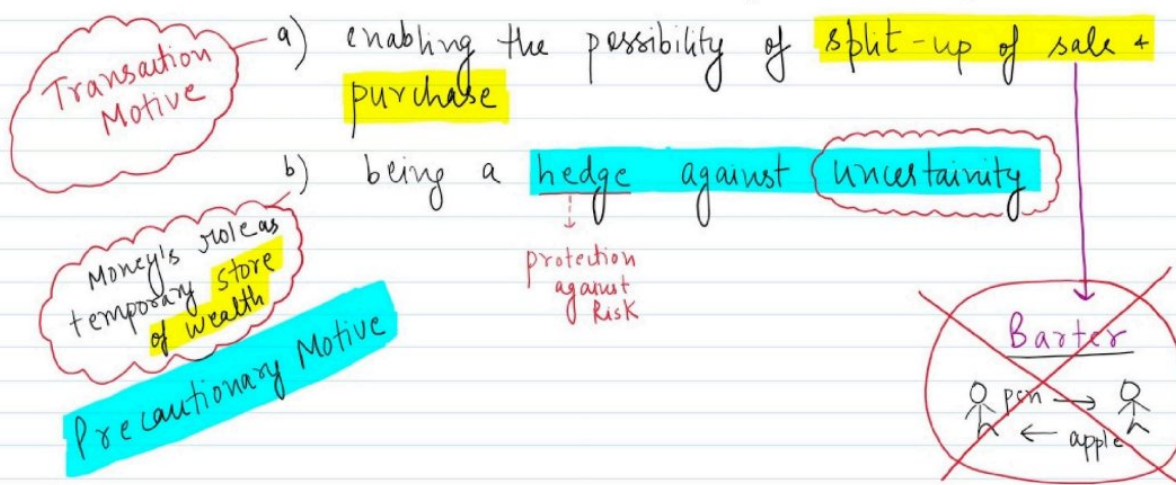
II CAMBRIDGE APPROACH



Early 1900s



→ Cambridge approach holds the view that money increases utility in the following ways :-



→ Now, the question is how much money will be demanded ?? The answer is - it depends partly on income and partly on other factors like wealth, interest rates etc

→ The Cambridge money demand function is :-

$$M_d = KPY$$

1500 M_d = Demand for Money

100 Y = Real Nation Income / Real Output

$100 \quad Y = \text{Real Nation Income / Real output}$
 $\text{£}20 \quad P = \text{Average Price level of currently produced goods \& services}$
 $\text{£}2000 \quad PY = \text{NOMINAL Income}$

75% $K =$ proportion of Nominal Income that people wants to hold as cash balances

This K is also known as "Cambridge K " - it is a parameter reflecting economic structure and monetary habits, namely the ratio of total transactions to income and the ratio of desired money balances to total transactions

Real Output $\times$ Current prices $=$ Nominal Income
 $100 \text{ units} \times \text{£}20 \text{ p.u.} = \text{£}2000$

$1500 = 75\% \times 2000$

$1500 = 75\% \times \text{Real} \times \text{Current prices}$

$M_d = K \times Y \times P$

$M_d = KPY$

1500 Cash balance

K

75%

Demand for Money

$M_d = KPY$

Demand for money in this equation is a linear function of Nominal Income

0

Nominal Income

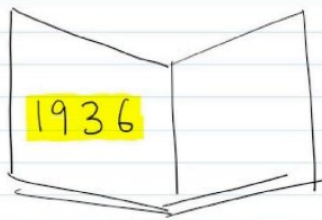
0 $\xrightarrow{\quad}$ x
Nominal Income

K = slope of function

$$K = \frac{M_d}{PY}$$

III. The Keynesian Theory of Demand for Money (Liquidity Preference Theory)

J.M
Keynes



The General Theory
of Employment,
Interest & Money

"People want to hold money rather than investing in securities"

People hold money (M) in cash for ③ motives

- Transaction Motive
- Precautionary Motive
- Speculative Motive

① Transaction Motive

→ relates to the need for cash for current transactions for personal + business exchange



"Bread"

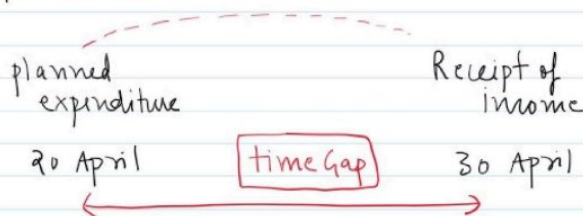


"Machine"

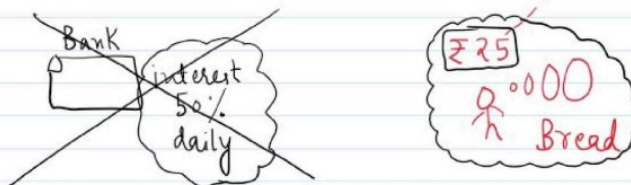
→ the transaction motive is further classified into Income motive and business (trade) motive

→ Both the above motives stressed on the requirement of individuals and businesses respectively to bridge the time gap between receipt of income & planned expenditure

bridge the time gap between receipt of income & planned expenditure



→ Keynes did not consider the transaction balances as being affected by interest rates



→ The transaction demand for money is directly proportional to income levels

$$L_R = K Y$$

Demand for Transaction money
(Transaction Demand for money)

is the ratio of earnings which is kept for transactions purposes

earnings

assume

$$\begin{matrix} \text{£25} \\ L_R \end{matrix}$$

=

$$\begin{matrix} 25\% \times \text{£100} \\ K \quad Y \end{matrix}$$

→ Keynes considered the aggregate demand for money for transaction purpose as sum of individual demand, therefore aggregate transaction demand for money is function of National income

	earnings (income)	K	transaction demand for money
	£ 100	25%.	£ 25
	£ 200		£ 50

1	£ 200
2	£ 300
3	£ 400
"National Income"	£ 1000

£ 40

£ 50

£ 70

£ 10

£ 155

Aggregate Transaction demand

B Precautionary Motive

- The amount of money demanded under precautionary motive depends on size of income, prevailing economic or political conditions, personal characteristics (like optimism, pessimism, farsightedness etc)
- It is also not very sensitive to rate of interest.

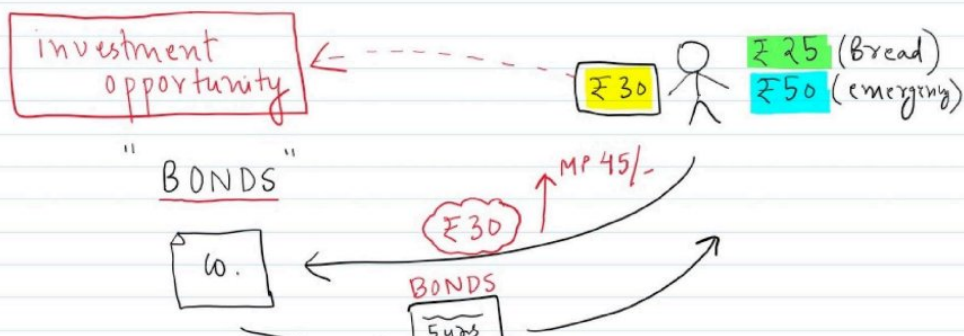
~~Bank Int 25%~~

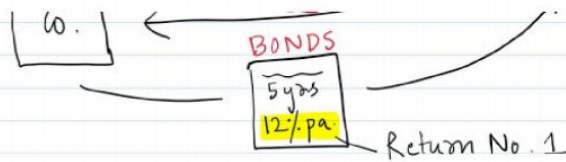
£ 50 emergency

C Speculative Motive

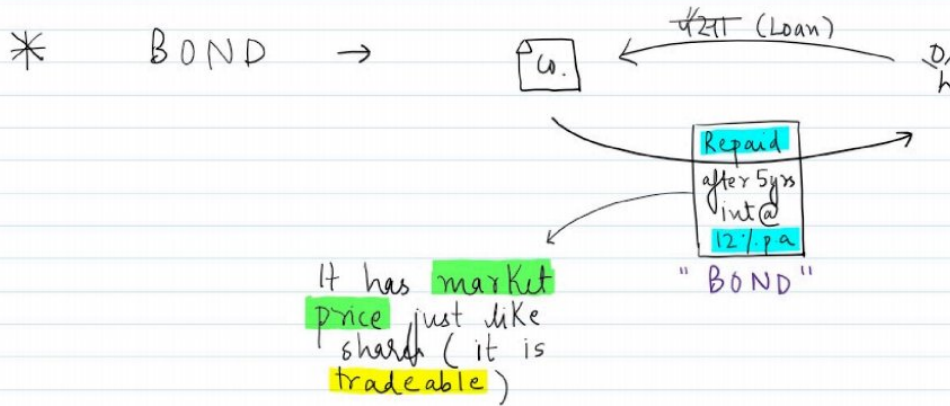
- The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash expenditure.
- Keynes assumed that expected returns on bonds are of two types :-
 - a) Interest payments
 - b) expected Rate of Capital Gains

Market price increases.





* Market Rate of Interest → Interest rate offered in market on cash deposit



* Current Rate of Interest vs Critical Rate of Interest

"ACTUAL" (₹) 6% p.a. vs NORMAL (रौना यादिए) 6.5% or 5.5%



if Current Rate > Critical Rate

actual ₹ 10% > Normal रौना यादिए 6%

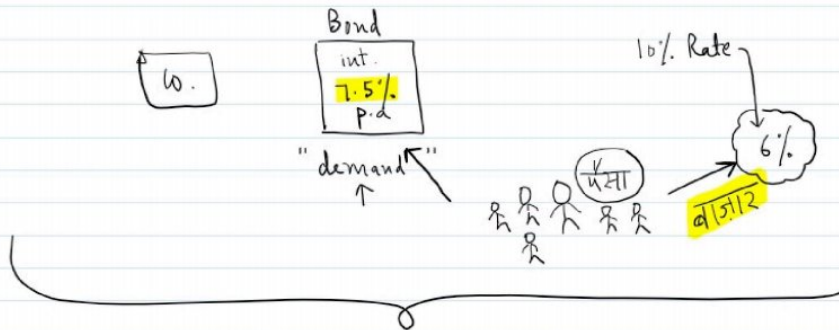
then he expects the rate of interest to fall in future

and when Rate of Interest falls → Inverse relation between interest rates & Bond prices.

Bond Prices Rises

Bond

* Bond prices.



So they will try to convert their cash holdings into bonds because :-

- (i) they can earn higher interest rate
- (ii) they expect "Capital Gain".

"₹2"

खरीद	₹10
M.P	₹12

*

wealth holder \$\$\$\$\$

if Current Rate (6%) < Critical Rate (10%)

then he expects the rate of interest to rise in future
and when rate of interest rises
then Bond Price falls

So, they will try to hold liquid cash rather than bonds because :-

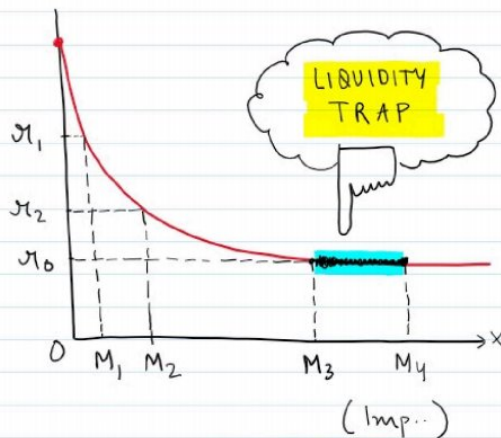
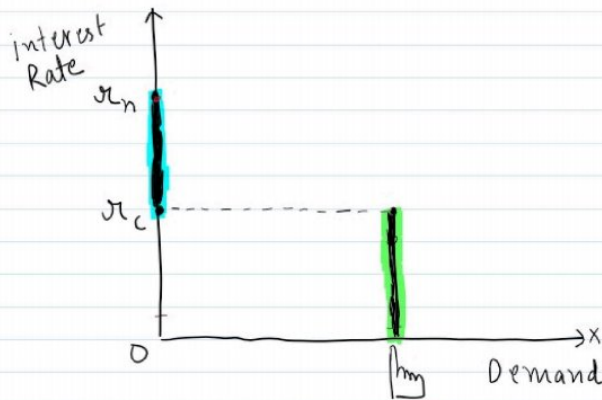
- a) Loss of Interest forgone is small
- b) they can avoid capital loss.
- c) they can later buy bonds at lower prices

* Current Rate is HIGH :- Low speculative demand for money

* Current Rate is Low :- HIGH speculative demand for money,

* current rate is LOW :- HIGH speculative demand for money

INVERSE
RELATION



Individual Aggregate
SPECULATIVE DEMAND FOR MONEY

* LIQUIDITY TRAP [or Ineffective Monetary Policy]

RBI $\rightarrow$ follows expansionary Monetary Policy

open market operations

Buy Government Securities

To Increase money supply
To Increase Income
To Increase AD
To stimulate economic Growth.

BUT

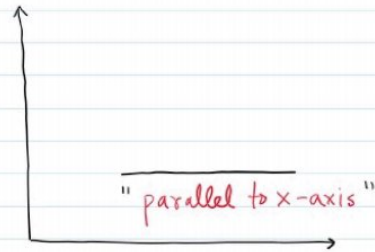
JAPAN

10 year yield

0.2% p.a

Interest rates are too low that people do not want to hold bonds and only

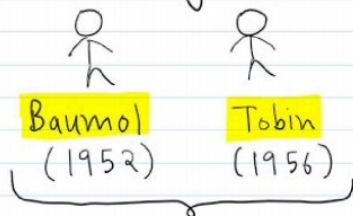
Interest rates are too low that people do not want to hold bonds and only want to keep liquid cash i.e. Speculative demand becomes **PERFECTLY ELASTIC** with respect to interest rates.



④ **Post Keynesian Developments**

"Keynes के बाद"

(i) **Inventory Approach to Transaction Balances**



→ They determined a theory of **transaction demand** for money, known as **Inventory Theoretic approach**

emphasises on **Store of Value**

In this approach, money (real cash balance) was essentially viewed as Inventory held for transaction purposes

→ Inventory model assumes that there are two media of store of value :-

- दिए हैं
- a) Money and
 - b) Interest bearing alternative financial asset
जिस पर interest मिले
(Bank, Bond, share)

→ There is a **fixed cost** of making transfers between

→ There is a fixed cost of making transfers between money and such alternative financial assets

FIX

"Broker's charges"

Shares, deb,
Bonds.

→ Baumol asserts that individuals hold money for transaction purposes

→ They also incur "cost" when they hold the inventories of money

ETAT ₹ 100,000

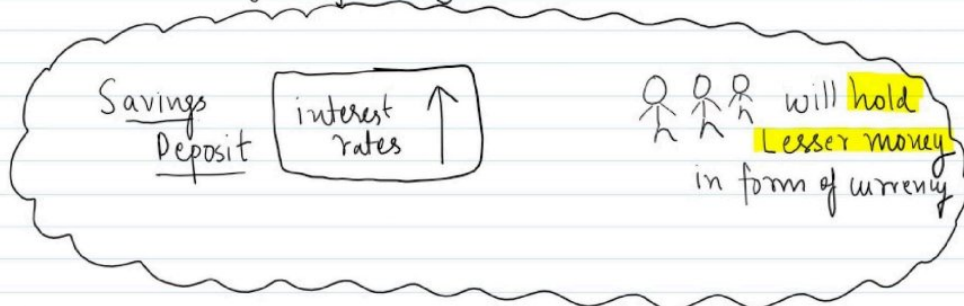
Opportunity cost

lost forgone is the interest rate which they could have earned if they invest their wealth in savings deposit or fixed deposits or bonds or shares.

→ Bonds & Shares provide higher returns but are RISKY

→ Savings deposit are quite safe and riskfree but returns are low.

→ Baumol and Tobin proclaim that transaction demand for money depends on Rate of Interest



→ Baumol has proved that the average amount of cash withdrawn which minimises cost is given by:-

$$C = \sqrt{\frac{2bY}{r}}$$

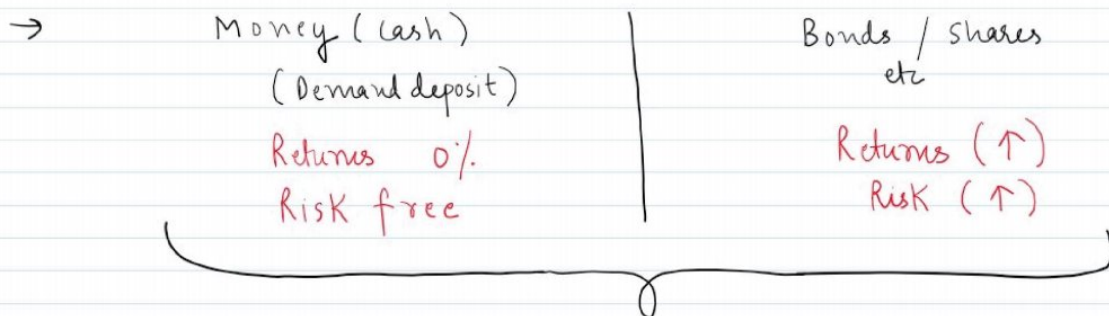
b is broker's fee
 Y is individual's income
 r is rate of interest

→ This approach also suggests that the demand for money and bonds depends on the lost of making transfer between the two.

Broker's fee

Broker's fee ↑ lost of transfer ↑

It will lead to lower transactions.

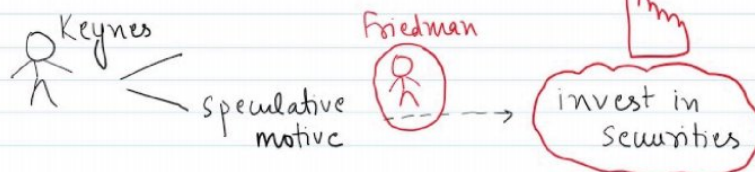


Asset allocation
is individual's choice

② Friedman's Restatement of the "Quantity Theory"

⋈ Milton Friedman → He extended Keynes's speculative money demanded within the framework of asset price theory.
(1956)

→ He treats the demand for money as nothing more than the application of a more general theory of demand for capital assets.

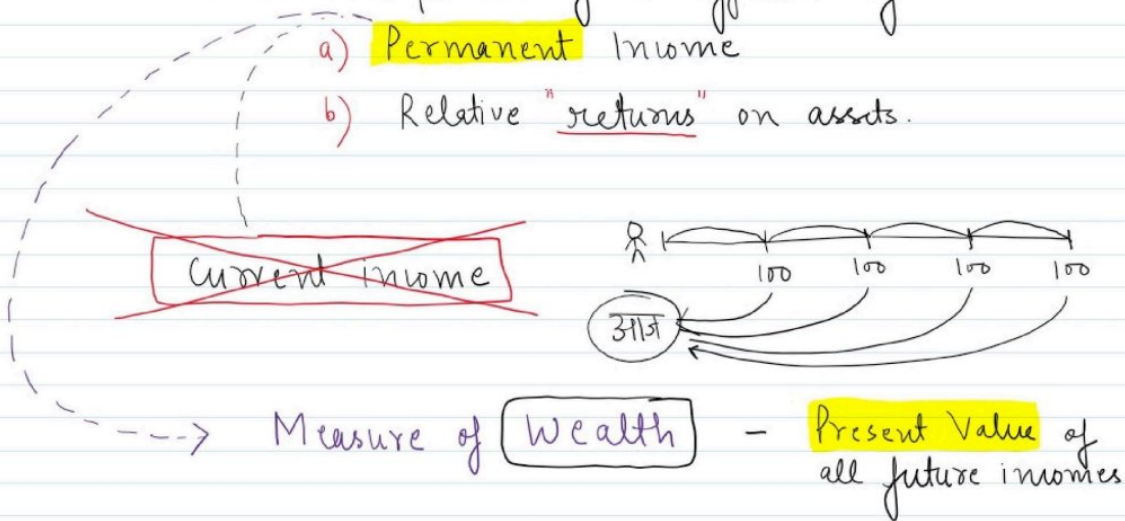


speculative motive $\rightarrow$ invest in securities

$\rightarrow$ Demand for money is affected by :-

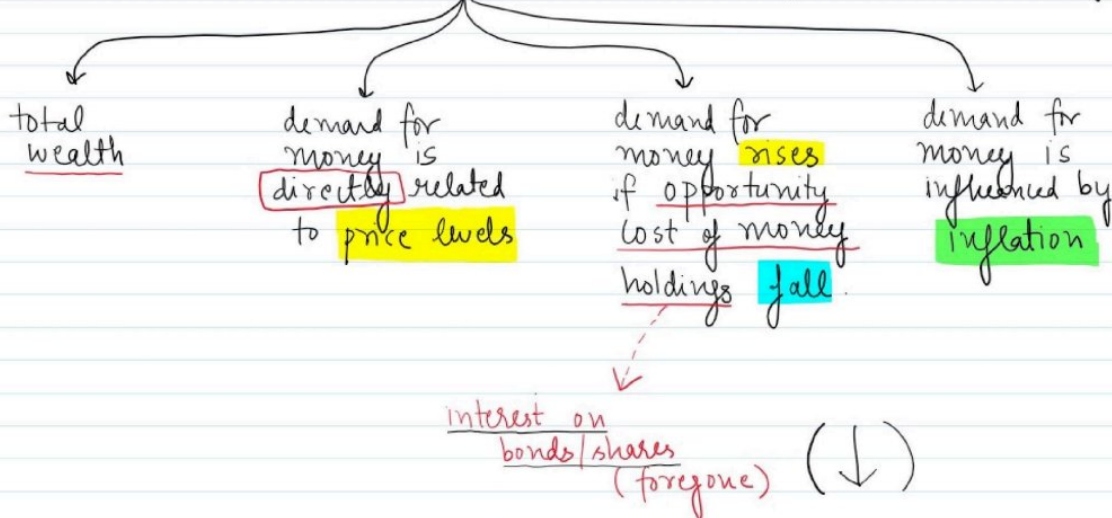
a) Permanent Income

b) Relative "returns" on assets.



$\rightarrow$ Friedman maintains that it is the permanent income which affects demand for money

$\rightarrow$ He determines 4 determinant of demand for money



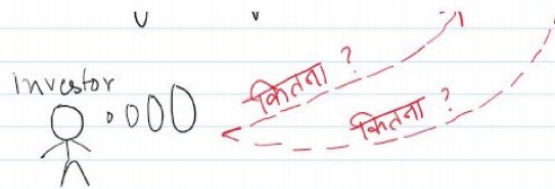
③ Demand for Money as Behavior toward Risk



James Tobin

$\rightarrow$ According to him, an investor is faced with a problem of what proportion of his portfolio of financial assets he should keep in form of ready money and in form of investment

investor



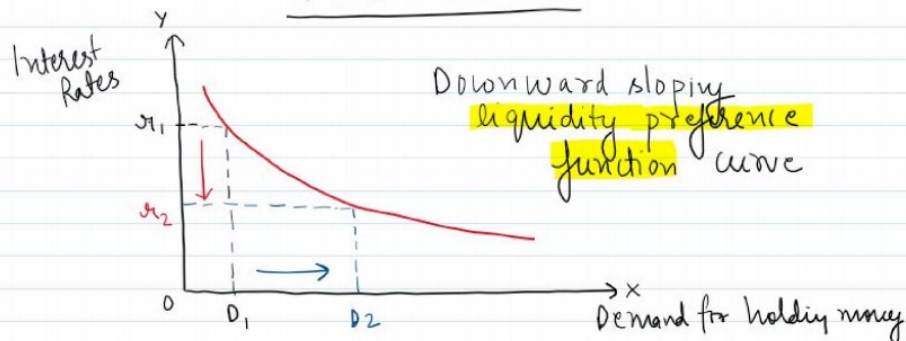
→ According to him, an individual's behaviour shows **RISK AVERSION**, which means they prefer less risk

Bonds or shares	Ready Money
Risk (↑)	Risk (x)
Return (↑)	Return (x)

→ Interest Rate (↑) Demand for holding money (↓)

→ Interest rate (↓) Demand for holding money (↑)

" INVERSE "



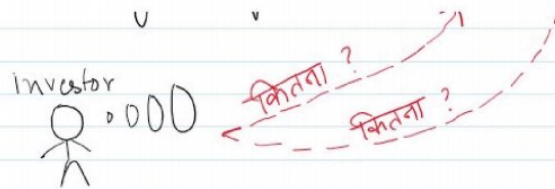
CH 8 Unit 2

Concept of Money Supply

(V.V.V. Simple)

① Introduction

→ In real world, Money can be defined for policy purposes as a **set of liquid financial assets**, the variation in stock of which could impact aggregate economic activity.



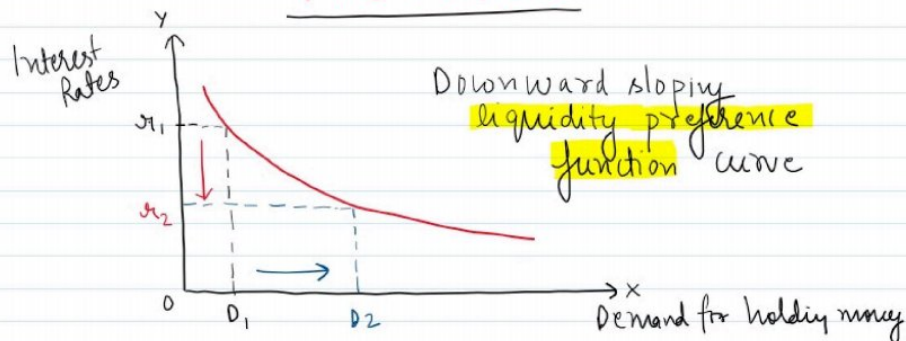
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Bonds or shares	Ready Money
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" INVERSE "



CH 8 Unit 2

Concept of Money Supply

(V.V.V. Simple)

① Introduction

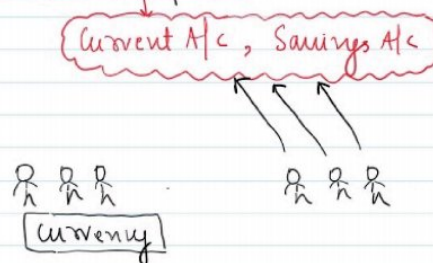
→ In real world, Money can be defined for policy purposes as a **set of liquid financial assets**, the variation in stock of which could impact aggregate economic activity.

Aggregate economic activity.

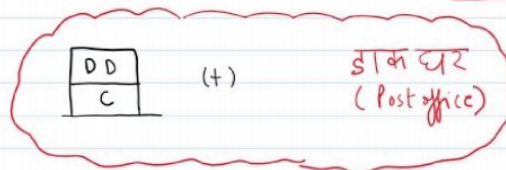
→ "Economic stability" requires that supply of money at any time should be maintained at optimum level



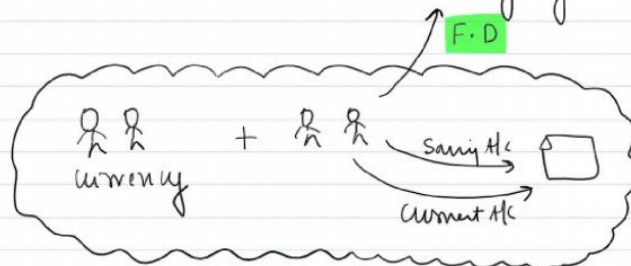
→ M_1 i.e. Narrow money means currency with Public (+) Demand deposits with Banking system.



→ M_2 is M_1 (+) Savings deposit of "post office" savings Bank.



→ M_3 i.e. Broad Money = M_1 + Time deposits with Banking system.



→ Money Supply is the stock of money held by "public" at a given point of time

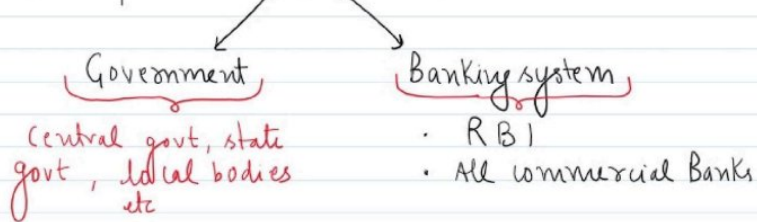
M_3 as at 31st March 2022 : ₹ 2,04,93,729 crore

M_3 as at 31st March 2022 : ₹ 2,04,93,729 crore

"Public"

↳ all economic units (individuals, firms + institutions)

except producers of Money



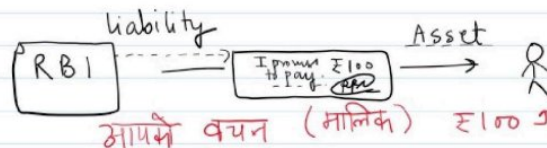
② Rationale of Measuring Money Supply

- It facilitates "analysis of monetary developments" in order to provide a deeper understanding of the causes of money growth
- the central banks all over the world adopt monetary policy to stabilise price level and GDP growth by directly controlling the supply of money.

③ Sources of Money Supply

(A) CENTRAL BANK

- Central Bank issues currency notes
- Paper currency is such a representative money, and is a debt instrument
- It is a liability of the central bank and an asset of the holding public



- High powered money issued by monetary authorities is the source of all other forms of money

(H)

(H)

forms of money

→ The currency issued by Central Bank is called
"FIAT MONEY"

order of authority

Fiduciary money - Based on Trust
"Cheque"

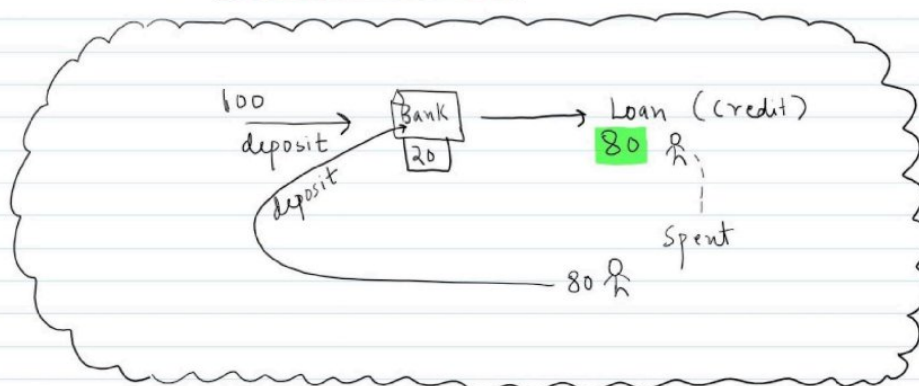
→ The currency issued by Central Bank is, in fact, a "liability" of the central bank & the government.

Therefore, in principle, it must be backed by an equal value of assets mainly in form of gold and foreign exchange reserves.

In practice, however most countries adopted "a minimum reserve system" where in the central bank is empowered to issue currency to any extent by keeping only certain minimum reserve of gold and foreign securities.

(B) COMMERCIAL BANKS

→ The total supply of money in the economy is also determined by the extent of credit created by commercial banks in the country. Money so created by the commercial banks is called CREDIT MONEY.



→ Advancement in Technology has made it possible for the development of new form of money i.e CBDCs (Central Bank Digital Currencies)

C BDCs (Central Bank Digital Currencies)

RBI defines C BDC as the "legal tender" issued by Central Bank in digital form. (Digital Rupee ₹)

→ Crypto currencies face significant legislative uncertainties and are not legally recognised in India as currency.
(Hence not considered as money)

④ Measurement of Money Supply

→ Till 1967-68, the RBI used to publish only a single narrow measure of money supply i.e.

M_1

→ From 1967-68, a broader measure of money supply called Aggregate Monetary Resources (AMR) was additionally published.

→ From 1977, following the recommendations of the Second Working Group on Money Supply (SWG), the RBI has been publishing data on four alternative measures :-

M_1 = Currency Notes & coins with public (+) Demand deposits with Banking system (+) Other deposits with RBI.

M_2 = M_1 (+) Savings deposit with Post office Savings Bank

M_3 = M_1 (+) Time deposits with Banking system

M_4 = M_3 (+) "Total deposits" with Post office Savings Organisations (excluding National Savings certificates)

* In 1998, RBI starts publishing a set of four new monetary aggregates

NIM = Currency with public (+) Demand deposits with

$NM_1 =$ Currency with public (+) Demand deposits with banking system (+) other deposits with RBI.

$NM_2 = NM_1 (+)$ Short term time deposits of residents (upto one year)

$NM_3 = NM_2 (+)$ Long term time deposits of residents (+) "Term funding" from financial institutions

Liquidity aggregates are :-

$L_1 = NM_3 (+)$ All deposits with Post office Savings organisation (excluding NSC)

$L_2 = L_1 (+)$ Term deposits with term lending institutions and refinancing institutions
(+) Term borrowings by above institutions
(+) Certificate of Deposits (CDs) issued by above institutions

⑤ Concept of Money Multiplier

→ The money created by the RBI is known as High Powered Money (H) [Known as Monetary Base]

→ The Money Supply is defined as

$$M = C + D$$

$\swarrow \quad \quad \downarrow \quad \quad \searrow$
Money Supply Currency held by Public Demand deposits.

→ Money Supply is affected by Monetary Base and Money multiplier.

$$M = m \times MB$$

$\downarrow \quad \quad \quad \searrow$
Money Multiplier Monetary Base (High Powered Money (H))

↓
Money
Multiplier

↳ Monetary Base
(High Powered Money (H))

$$\therefore m = \frac{M}{MB} = \frac{\text{Money Supply}}{\text{Monetary Base}}$$

Money Multiplier is Ratio that relates the change in Money Supply to given change in Monetary Base

→ What affects the size of money multiplier?

The money multiplier is reciprocal of the reserve ratio i.e. If R is reserve ratio of all commercial Banks then

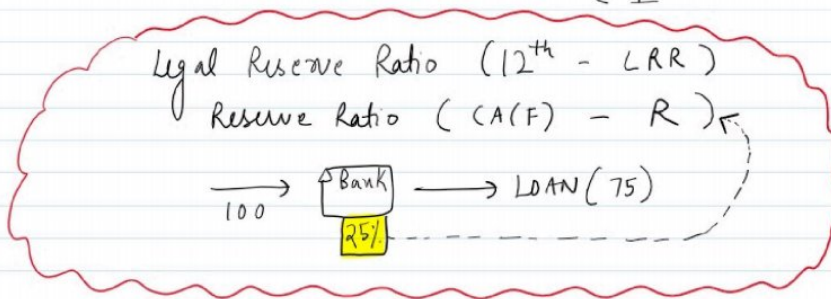
$$m = \frac{1}{R} \quad \left\{ \text{Inverse relation} \right\}$$

eg:- $R = 25\%$
Find m

Sol:- $m = \frac{1}{R} = \frac{1}{0.25} = 4 \text{ times}$

$$M = m \times MB$$

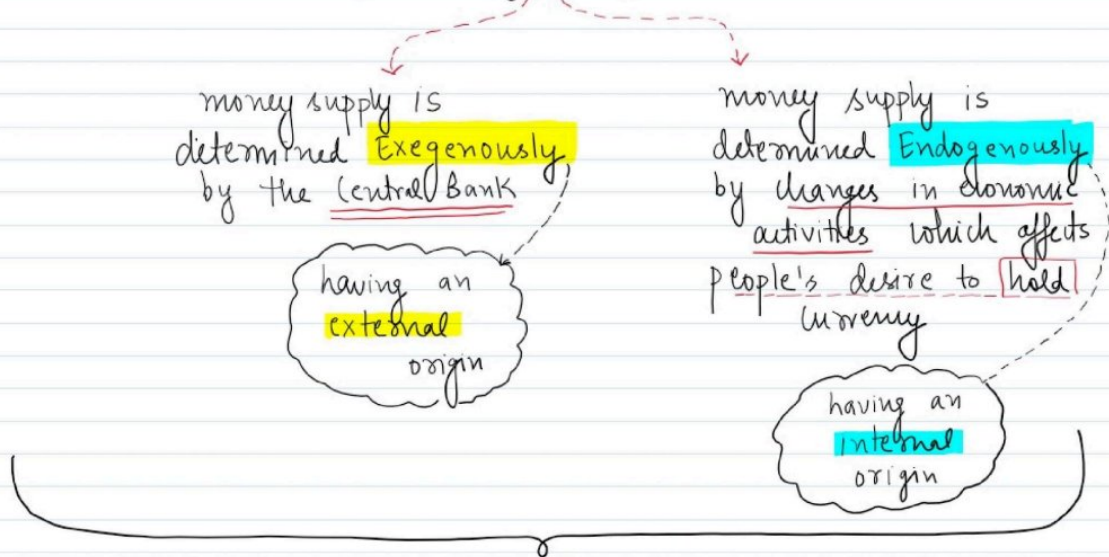
₹ 4 ₹ 1



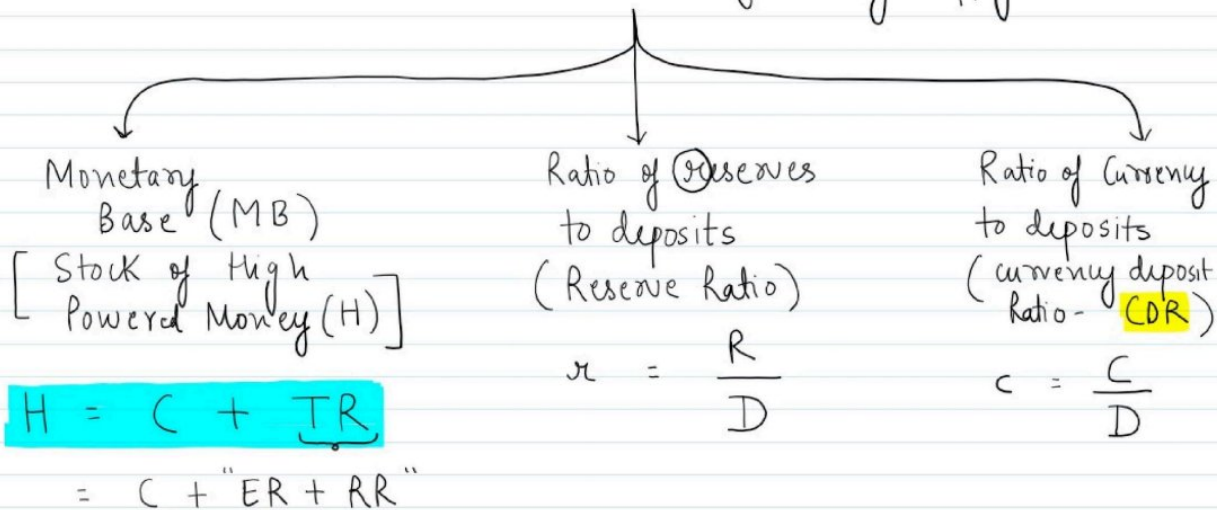
⑥ Money Multiplier approach to Supply of Money (Determinants of Money Supply)

→ There are two alternative theories in respect of determination of money supply.

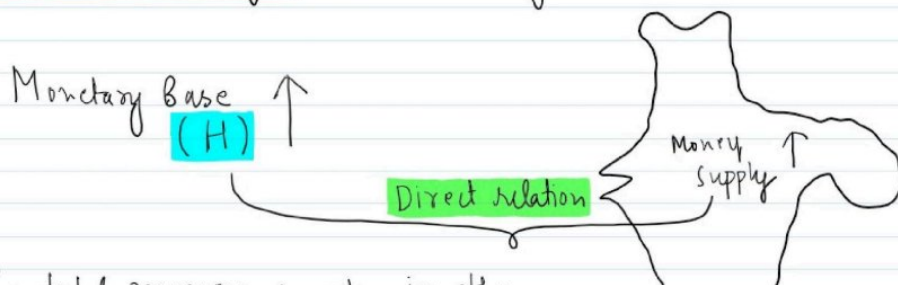
determination of money supply



The money multiplier approach to money supply was propounded by **Milton Friedman** and **Anna Schwartz** (1963) considers **three** factors as immediate determinants of money supply :-



(i) **High Powered Money** (**Behavior of Central Bank**)



→ The total money supply in the economy will vary directly with supply of high powered money

(ii) "Reserve" to "Deposit" ratio (r) [Behavior of Commercial Banks]

$$r = \frac{R}{D}$$

$\xrightarrow{\text{Reserve}} R$ $\xrightarrow{\text{Deposit}} D$

Loan 80 ← $\frac{20 \text{ Reserve}}{100 \text{ Deposit}}$

= 20% $\rightarrow r$
"LRR in Class 12"

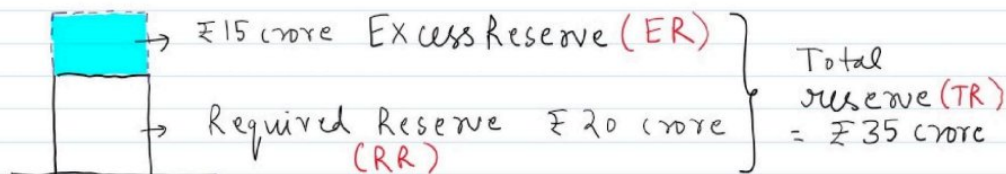
Loan 70 ← $\frac{30 \text{ Reserve}}{100 \text{ Deposit}}$ $r = 30\%$

Loan 55 ← $\frac{45 \text{ Reserve}}{100 \text{ Deposit}}$ $r = 45\%$
घटती जा रही (credit Money) बढ़ती जा रही है



If the reserve ratio falls, there will be greater expansion of deposits and money supply will increase [∴ INVERSE relation]

*



$$\therefore TR = RR + ER$$

→ If interest rate increases, it means that the opportunity cost of holding excess reserve rises because the banks have to sacrifice possible higher earnings and hence the desired ratio

because the banks have to sacrifice possible higher earnings and hence the desired ratio of excess reserves (ER) to deposits "fall"

$$e = \frac{ER}{D}$$

3114

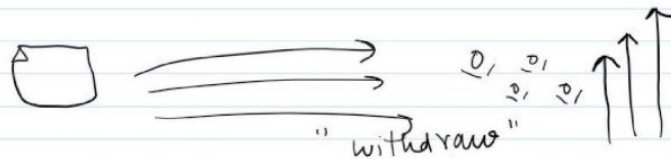
15 crore (ER)
20 crore (RR)

int rate ↑↑↑

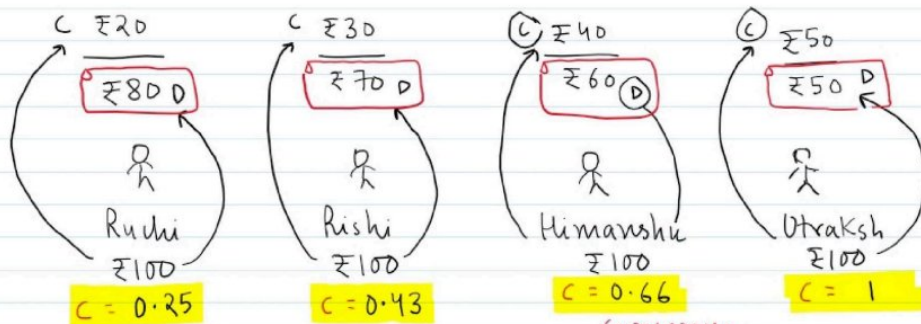
ER का

INVERSE relation between ER and market interest rate

* If bank fears that deposit outflows are likely to increase then it will **INCREASE** the ER



(iii) Currueny Deposit Ratio (c) [Behavior of Public]



$$c = \frac{C}{D}$$

C - Currueny
D - Deposit

→ The Currueny deposit Ratio (c) represents the degree of adoption of Banking habits by the people

→ The smaller the CDR (c), the larger would be

→ The smaller the CDR (c), the larger would be money multiplier (i.e. **INVERSE** relation)

* TD-DD Ratio



$$\frac{£20 (F.D) - 5\%}{£80 (D.D) \rightarrow 1\% \text{ Day}}$$

0.25

1

£100

$$\frac{£30 (F.D)}{£70 (D.D)}$$

0.43

2

£100

$$\frac{£40}{£60}$$

0.66

3

£100

Bank

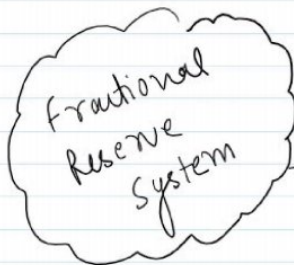
FD £20

F.D £30

F.D £40

→ Increase in TD-DD Ratio means greater availability of free reserves and consequently larger money deposit and monetary expansion is possible (i.e. **DIRECT** relation)

* Money Supply is affected by :-



- (i) H
- (ii) m
- (iii) R
- (iv) C
- (v) e

→ **DIRECT** relation

→ **INVERSE** relation

$$* \quad M = C + D \quad \text{--- (1)}$$

Money Supply Currency Demand Deposits

$$M = cD + D$$

$$M = (c + 1) D$$

$$\left\{ \begin{array}{l} c = \frac{C}{D} \\ C = cD \end{array} \right\}$$

$$M = (C + 1) D$$

eg ②

$$H = C + TR$$

$$= C + R$$

$$H = C + rD$$

$$H = cD + rD$$

$$H = (c + r) D$$

$$\therefore D = \frac{H}{(c + r)}$$

$$\left\{ ER = 0 \right\}$$

$$\left\{ r = \frac{R}{D} \right\}$$

$$R = rD$$

$$M = (C + 1) \frac{H}{(c + r)}$$

$$M = \frac{(C + 1)}{(c + r)} \cdot H$$

Money Supply $\swarrow$

High Powered Money (Monetary Base) $\searrow$

money multiplier (m)

$$\therefore m = \frac{C + 1}{c + r}$$

When there Excess Reserves then

$$\left\{ m = \frac{C + 1}{c + r + e} \right\}$$

eg :-

$$r = 10\%$$

$$C = 400$$

$$D = 800$$

$$E = 0.8$$

$$r = \frac{10}{100} = 0.1$$

$$c = \frac{C}{D} = \frac{400}{800} = 0.5$$

$$e = \frac{E}{D} = \frac{0.8}{800} = 0.001$$

$$E = 0.8 \quad e = \frac{E}{D} = \frac{0.8}{800} = 0.001$$

Sol:-

find m

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

$$= \frac{0.5 + 1}{0.5 + 0.1 + 0.001} = \boxed{2.495} \text{ approx}$$

⑦ "Monetary Policy" & Money Supply

Policy of
Central Bank

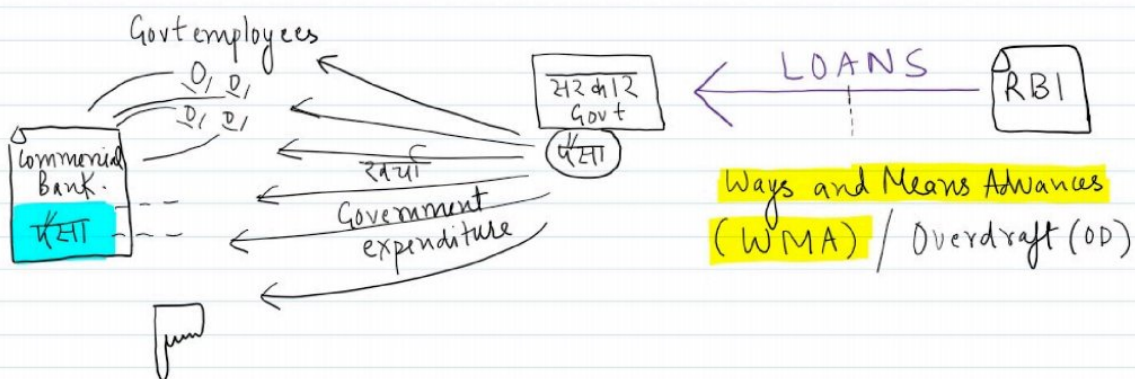
eg:- Bank rate ($\uparrow$) Money Supply ($\downarrow$)
Repo rate ($\uparrow$)

Open Market Operation

$\hookrightarrow$ Sell Govt securities : Money Supply ($\downarrow$)

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

⑧ Government Expenditure & Money Supply



Money supply will also increase.

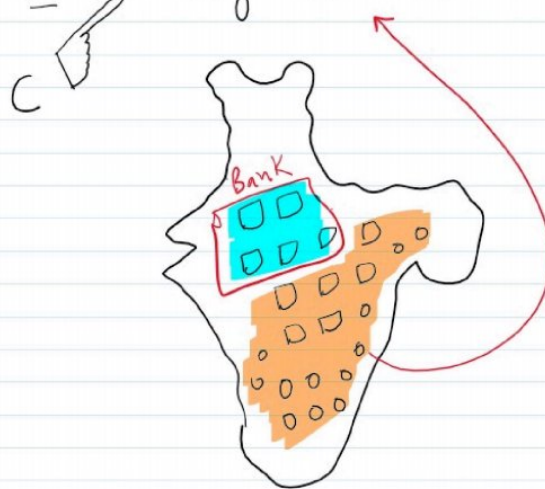
9

Important Points & Formulae

(i) Reserve Money / Central Bank Money / Base Money /
High Powered Money

= Currency in Circulation
(+) Bankers deposit with RBI
(+) Other deposit with RBI

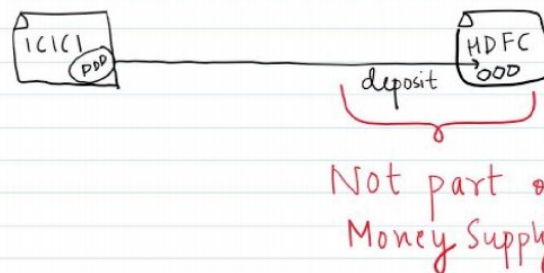
(ii) Currency with Public = Notes in Circulation
(+) All coins in Circulation
(-) Cash on hand with Banks



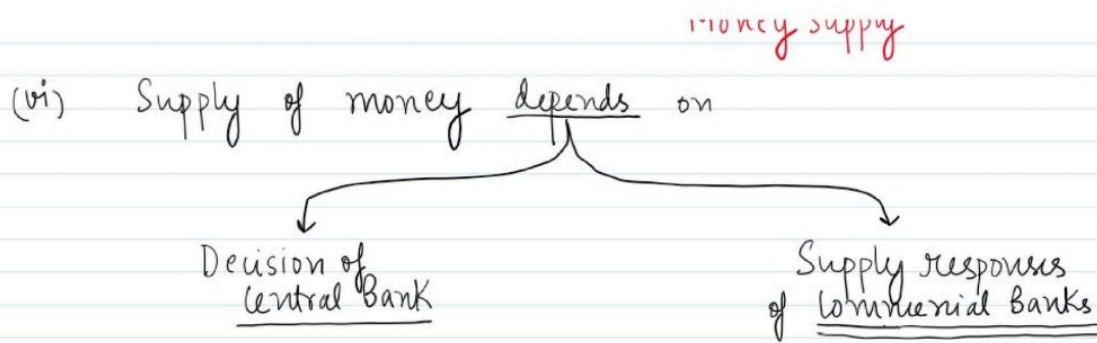
(iii) Deposit money of Public = Demand Deposit with Bank
(+) Other deposit with RBI

(iv) $M_1 = \underbrace{C}_{(ii)} + \underbrace{DD + OD}_{(iii)}$

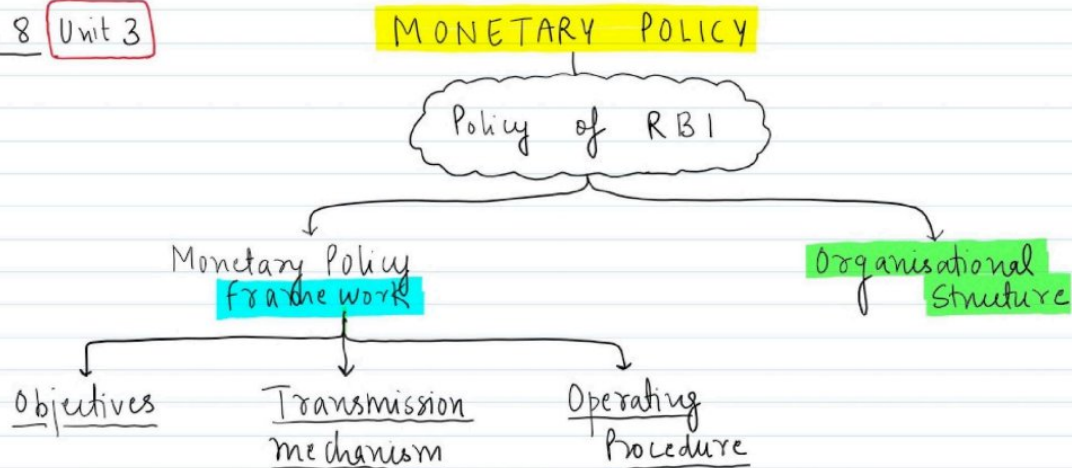
(v) Inter Bank Deposits



(vi) Supplier of money depends on



Ch 8 Unit 3

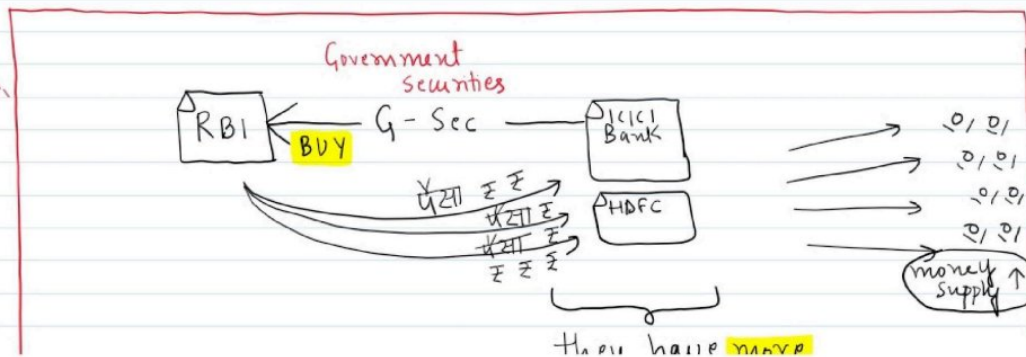


① **Monetary Policy** - RBI conducts monetary policy by adjusting the supply of money, usually through buying or selling securities in the open market.

Open market operations affect short term interest rates, which in turn affects long term interest rates and economic activity.

When RBI lowers the interest rate, monetary policy is easing (expansionary monetary policy).

When RBI increases the interest rate, monetary policy is tightening (contractionary monetary policy).



$z \approx -$ (money supply $\uparrow$)
 they have more money to lend
 → When this happens, bank will reduce interest rates to make borrowings more attractive

② Monetary Policy Framework

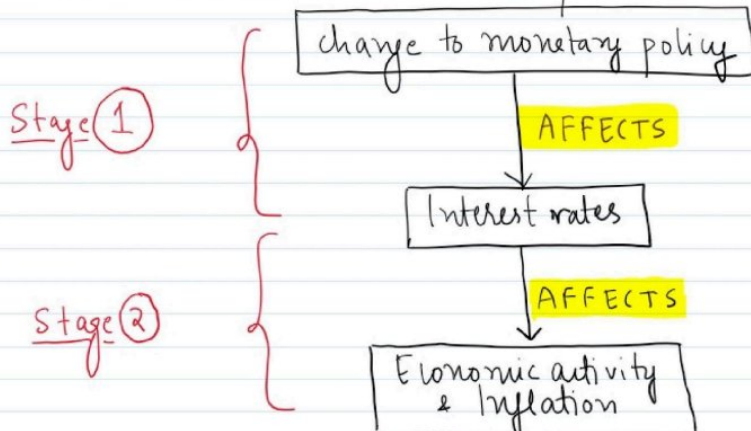
(A) OBJECTIVES of Monetary Policy

- The RBI Act, 1934, in its preamble sets out the objectives of the Bank as "to regulate the issue of Bank notes and keeping of reserves with a view to securing monetary stability in India and generally to operate the currency and credit system of the country to its advantage".
- Fundamentally, the primary objective of monetary policy has been the maintenance of judicious balance between price stability and economic growth

Managed Floating

(B) TRANSMISSION OF Monetary Policy

- The transmission can be presented as :-



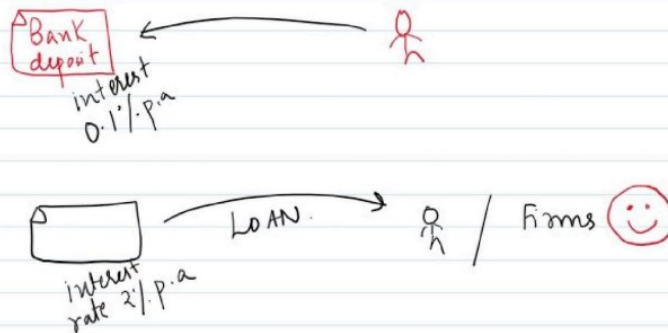
- Channels of Monetary Policy Transmission

(i) Saving & Investment Channel

- Lower interest rates on bank deposits

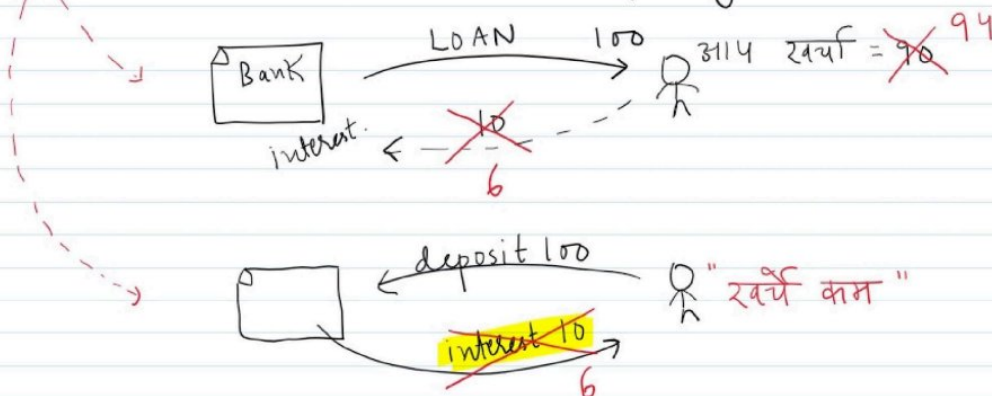
(i) Saving & Investment Channel

- Lower interest rates on bank deposits reduce the incentive of households to save.
- Lower interest rates for loans can encourage the households & business to borrow more.



(ii) Cash-flow Channel

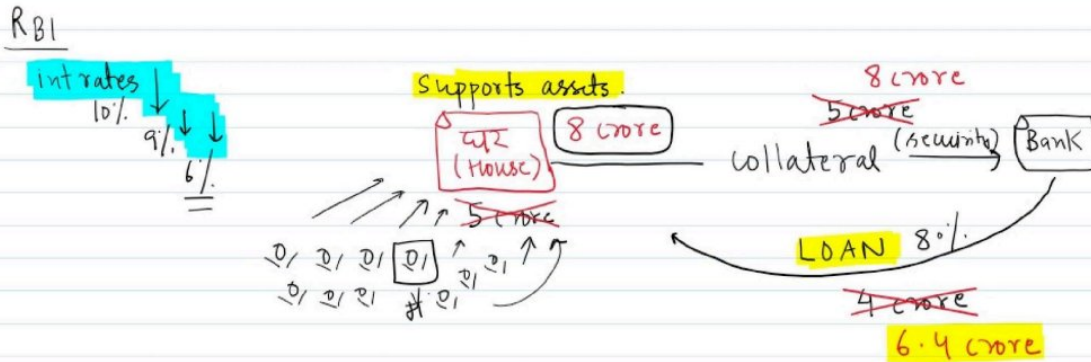
- Reduction in lending rates reduces interest repayments on debt, increasing the amount of cash available for households / firms to spend on goods & services.
- At the same time, a reduction in interest rates reduces the income that households / firms get from deposits and some may choose to restrict their spendings.



(iii) Asset Prices & Wealth Channel

- Asset prices & wealth influence how much people can borrow & how much they spend in economy.
- Lower interest rates support asset prices (e.g. housing) by encouraging demand for assets
- Higher Asset price also increases the collateral

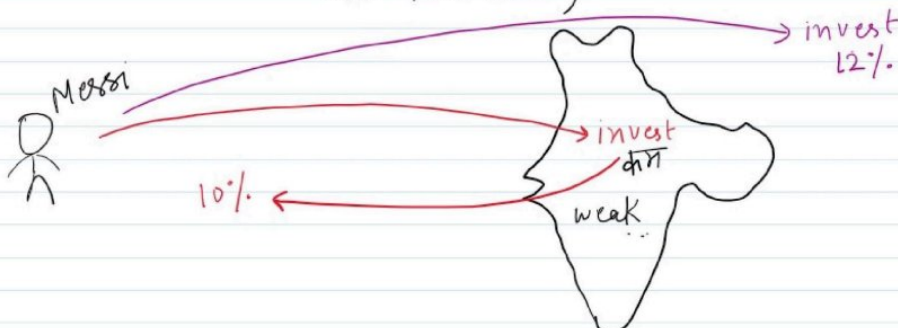
- Higher Asset price also increases the collateral of the asset that is available for banks to lend against. This can make borrowings much easier for households / firms



(iv) Exchange Rate Channel

- Lower interest rates reduce the returns investors earn from assets in India. Lower returns reduce demand for assets in India, thus foreign investors shift their funds from India.

- Reduction in interest rates result in lower exchange rate, making foreign goods costlier and domestic goods cheaper. This leads to increase in exports and decrease in imports.
(Due to increase in exports, inflation may also increase)
- currency depreciation ←

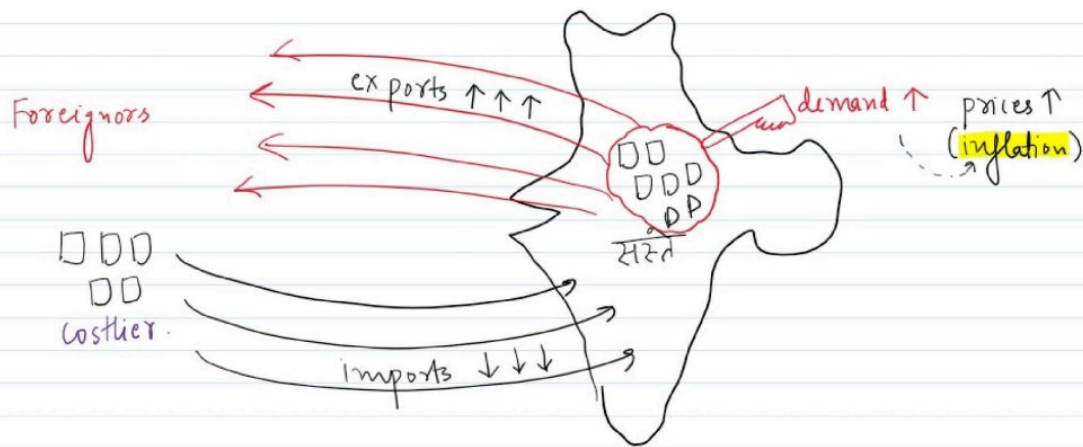


1\$ = ₹ 80

1\$ = ₹ 100

weak

currency depreciation



(C) Operating Procedures & Instruments

- (i) **Quantitative tools** - tools applied by the policy that impact money supply in the entire economy
- (ii) **Qualitative tools** - Specific tools or selective tools that affect money supply in specific sector

Tools :-

a) Reserve Ratio

→ **CRR** : Cash Reserve Ratio refers to the fraction of total **net demand** and **time liabilities** (NDTL) of a scheduled commercial bank in India which it should maintain as cash deposit with RBI

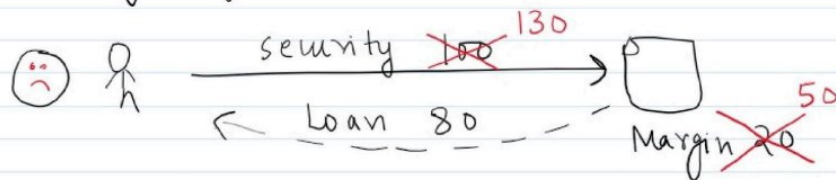
→ **SLR** : Statutory liquidity Ratio is what the scheduled commercial banks in India are required to maintain as fixed % of their Net Demand & Time liabilities (NDTL) in

Net Demand & Time liabilities (NDTL) in
Cash, Gold or approved securities

b) Open Market Operations (✓)

Qualitative
c) **Moral Suasion** :- By way of persuasion, the RBI convinces banks to keep money in government securities, rather than in certain sectors

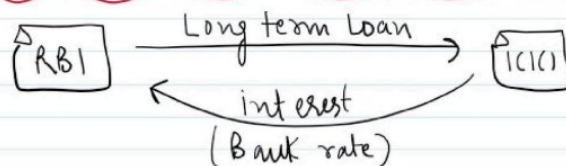
Qualitative
d) **Margin requirement** :- RBI prescribes certain margin (difference between security and loan amount) against collateral, which affects borrowing of the customers.



→ **Market Stabilisation Schemes (MSS)**

It includes policy Rates like Bank rate

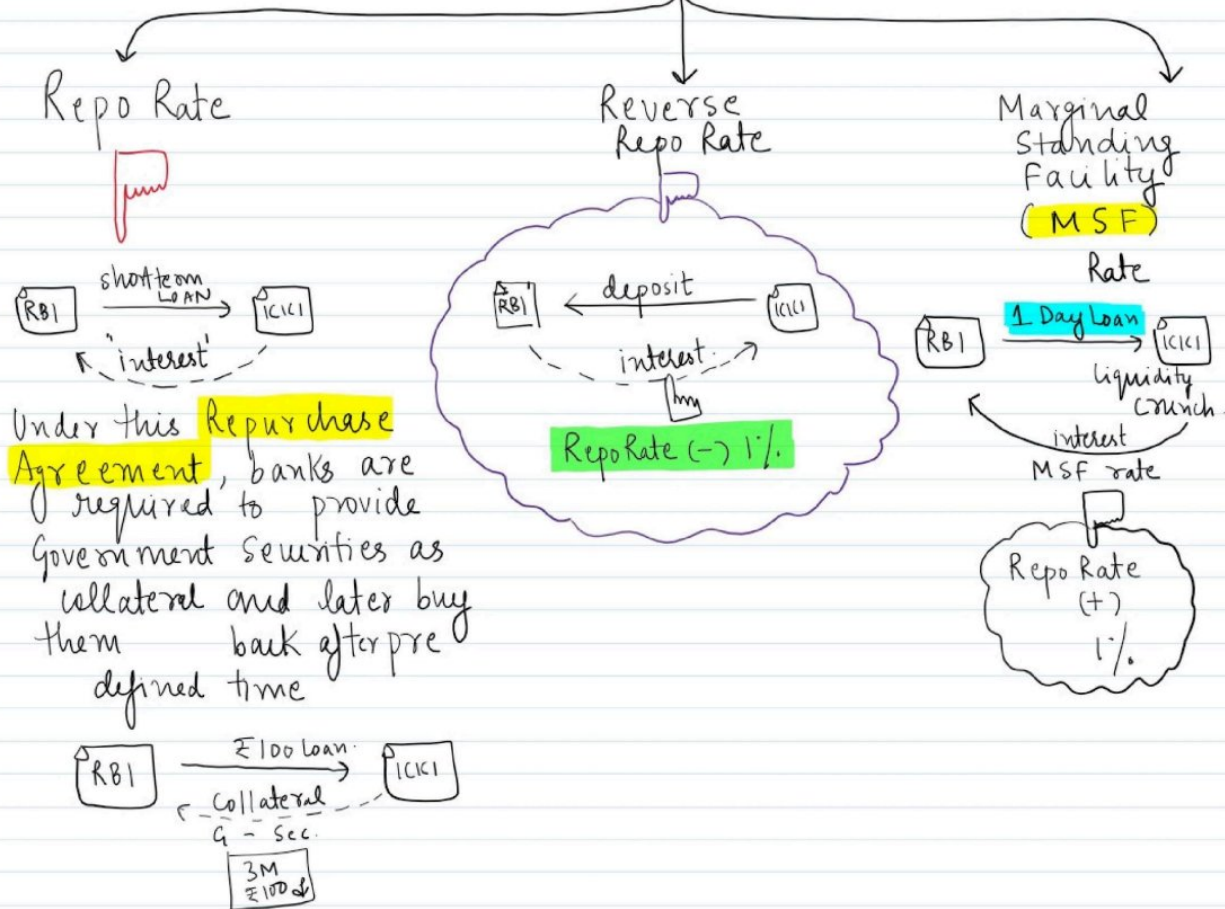
The interest rate at which RBI lends long term funds to commercial Banks.



However, presently RBI also uses Liquidity Adjustment Facility (LAF)

instruments to adjust liquidity

(instruments to adjust liquidity)



* Rates ↑
(Bank rate, Reverse Repo, Repo Rate, CRR, SLR)

Money Supply ↓

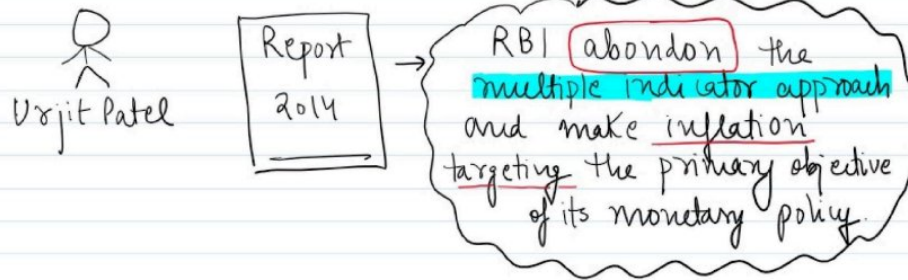
Contractionary Monetary Policy

3. ORGANISATIONAL STRUCTURE

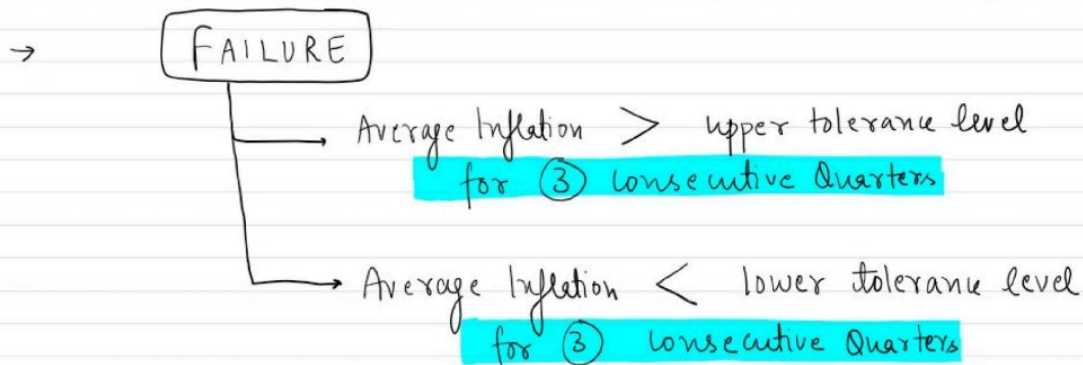
→ The RBI Act, 1934 was amended on June 27, 2016 for giving a statutory backing the monetary Policy framework Agreement (MPFA) and for setting up Monetary Policy Committee (MPC). The Monetary Policy framework Agreement is an agreement reached between GOI + RBI on maximum

every financial system is very complex
Reached between GOI + RBI on maximum
tolerable inflation rate that RBI should target
to achieve price stability.

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



→ The Central Government has notified 4%
Consumer Price Index (CPI) Inflation as target



→ RBI is mandated to publish a Monetary
Policy Report every 6 months

CH 9:- INTERNATIONAL TRADE (8-10 Marks)

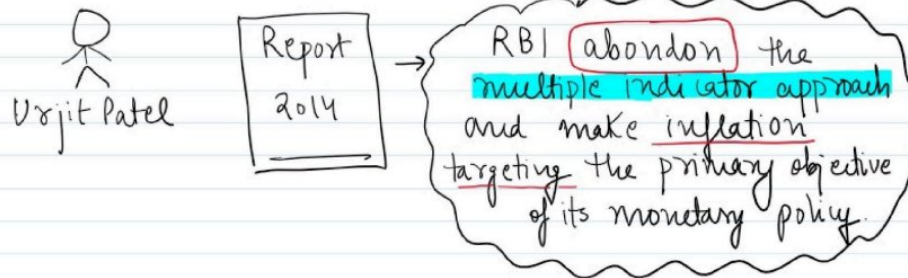
Unit 1:- Theories of International Trade

① INTRODUCTION

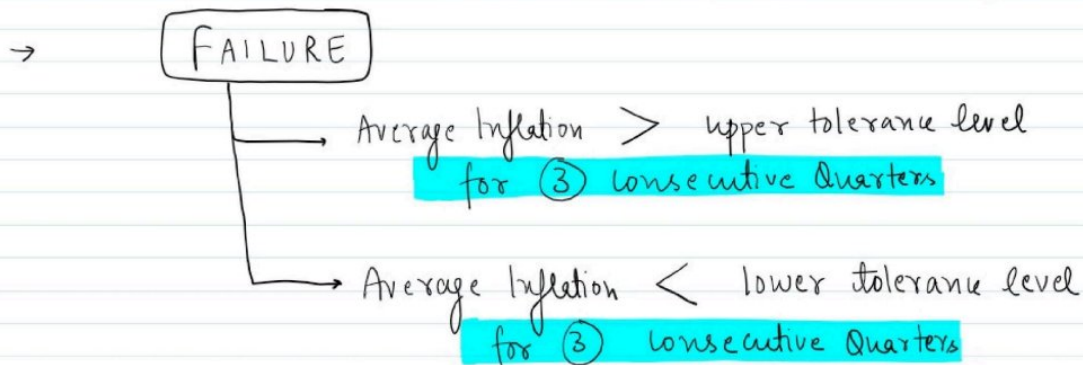
→ International Trade is the exchange of goods + services

every financial system is very complex
Reached between GOI + RBI on maximum
tolerable inflation rate that RBI should target
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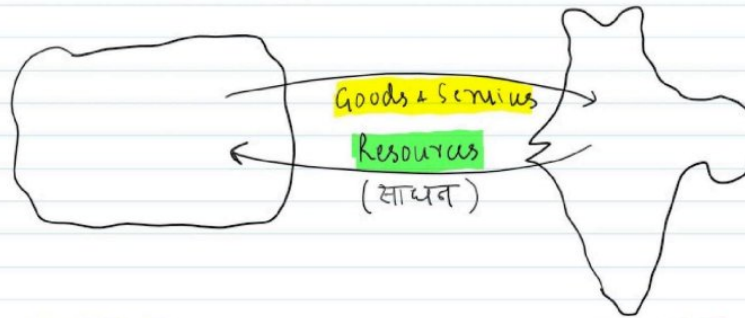
CH 9:- INTERNATIONAL TRADE (8-10 Marks)

Unit 1:- Theories of International Trade

① INTRODUCTION

→ International Trade is the exchange of goods + services

→ International Trade is the exchange of goods + services as well as resources between countries

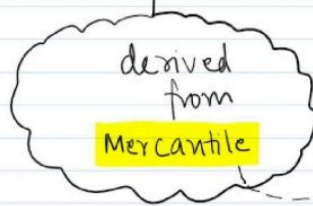


→ <u>Benefits</u>	<u>Demerits</u>
• Economic <u>efficiency</u> and <u>contributes</u> to <u>economic growth</u> + <u>rising incomes</u> • Greater <u>efficiency</u> in use of <u>natural, human, industrial and financial resources</u> engenders "<u>productivity gains</u>". • Access to <u>new markets</u> and <u>new materials</u> • Stimulates <u>Innovation</u> • Improvement in <u>Quality of goods & services</u> • Contribute to <u>human resource development</u>. • <u>Strengthen bonds</u> between <u>countries</u> etc etc etc.	• Often not equally <u>beneficial</u> to all <u>nations</u> • <u>Economic exploitation</u> of <u>undeveloped nations</u> • Substantial <u>environmental damage</u> • Exhaustion of <u>natural resources</u> • <u>Trade cycles</u> are also likely to <u>get transmitted rapidly</u> to <u>other countries</u>  • <u>Dependence</u> of <u>undeveloped countries</u> on <u>foreign nations</u> • There is often <u>lack of transparency</u> • Too much of <u>export orientation</u> etc etc etc etc etc

(2) "IMPORTANT THEORIES"

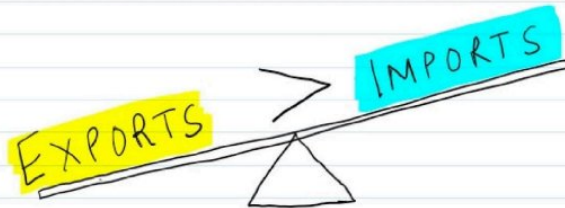
② "IMPORTANT THEORIES"

(i) The Mercantilists' view of International Trade



"trade & commercial affairs"

Key Point :-



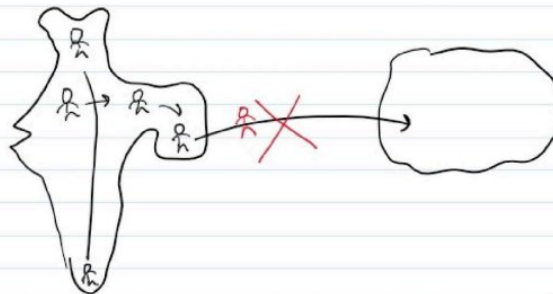
Favourable
BOT/BOP

→ According to Microsoft Encarta Dictionary (2009),
Mercantilism is the economic policy trending in Europe from 16th to 18th century where the government used power to control industry and trade with the belief that national power is achieved and sustained by having large quantities of exports over imports.

(ii) Theory of Absolute Advantage (Adam Smith)

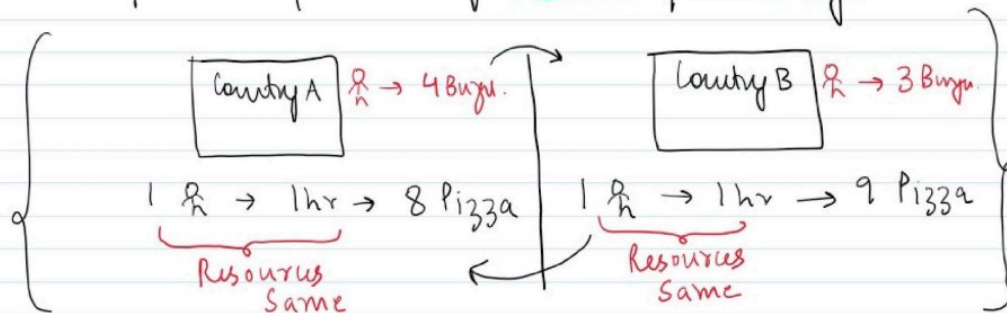
→ In this theory, Adam Smith assumed :-

- (a) Trade between two countries
- (b) Two commodity
- (c) No transportation cost
- (d) Labour was mobile within country but immobile between countries



(c) He assumed that any trade between the two countries considered would take place if each of the two countries had an absolutely lower cost in the production of one of the commodities.

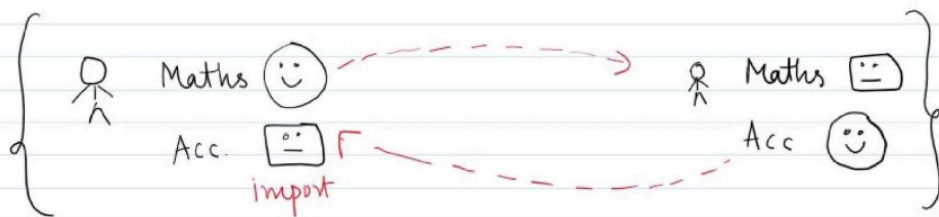
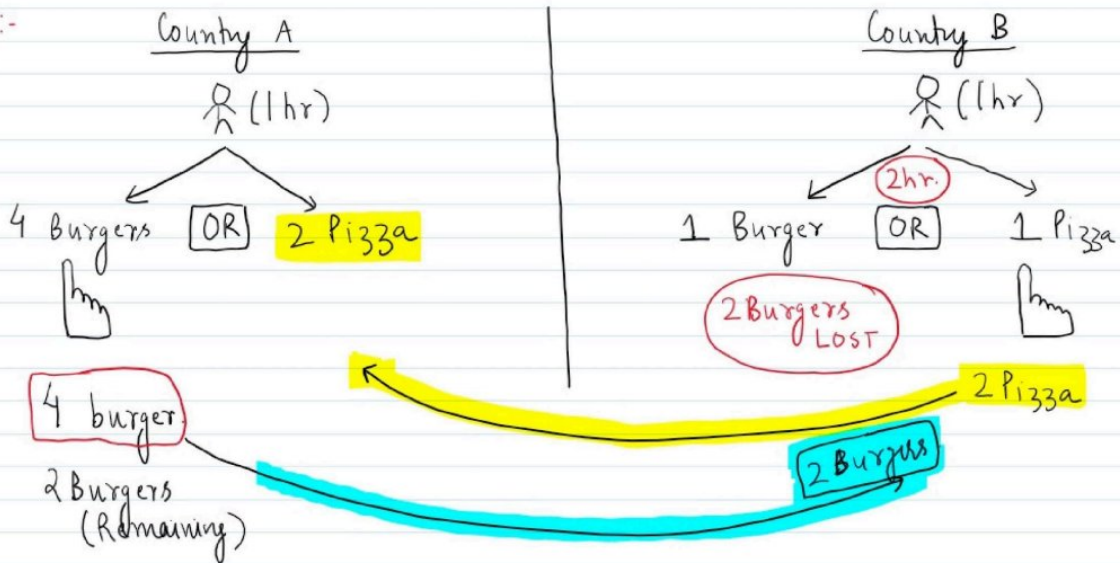
Adam Smith thought that the basis of International Trade was Absolute cost advantage. The principle of Absolute advantage refers to the ability of a party to produce greater quantity of a good, using the same amount of resources. (Simple comparison of labour productivity)



(iii) Theory of Comparative Advantage

- One of the most important concepts in economics is given by DAVID RICARDO.
- Ricardo observed that trade was driven by comparative rather than absolute cost.
- Ricardo's insight was that such a country would still benefit from trading according to comparative advantage - exporting products in which absolute advantage was greatest and importing products in which absolute advantage was comparatively less.

eg:-

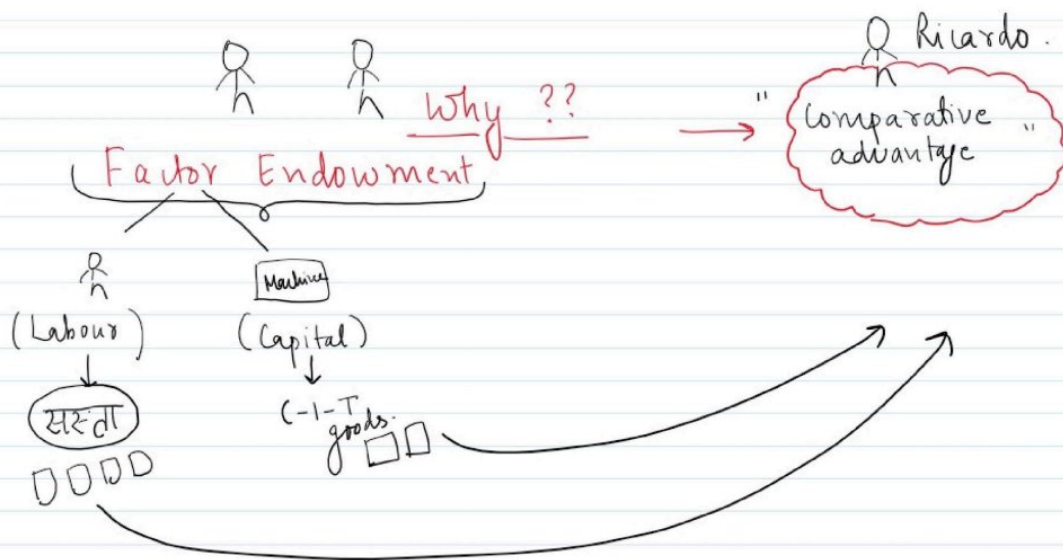


(iv) Heckscher - Ohlin Theory

- This theory is also known as Factor Endowment theory or Modern Theory of Trade
- It states that comparative advantage in cost of production is exclusively by the differences in factor endowment
- A country tends to specialise :-
 - In Exports - whose production requires intensive use of its "abundant" resources
 - In Imports - whose production requires intensive use of its "scarce" resources.
- Capital Abundant economy will produce and export capital intensive goods and labour abundant economy will produce and export labour intensive goods.



Ricardo.



* Theory of comparative cost <u>RICARDO</u>	Modern Theory <u>दी दोस्त</u>
- Based on <u>Labour</u> theory of value - Considered <u>labour</u> as sole factor - Studies only comparative costs of goods concerned. - It is <u>Normative</u> in nature ↓ "Should be" "क्या होना चाहिए"	- Based on <u>money</u> cost which is more realistic - Considered <u>labour</u> as well <u>Capital</u> as important factors - Considers relative prices of the factors (labour + capital) - It is <u>positive</u> in nature ↓ "What is" "क्या है"

(V) Globalisation + New International Trade Theories

→ American economist & journalist **Paul Krugman** received **2008 Nobel Prize** for Economics for his work in economic geography and in identifying international Trade patterns. In late 1970s, Krugman noticed that the earlier model did not fit into

noticed that the earlier model did not fit into the international trade data.

Refer (iv) { The Heckscher-Ohlin model predicted that trade would be based on such factors as Ratio of capital to labour

or $\begin{matrix} 80 & : & 20 \\ 30 & : & 70 \end{matrix}$ } Factor endowment

But Krugman noticed that most of the international trade takes place between countries with roughly the same ratio of capital to labour.

→ Krugman defended free trade
{ " In Praise of Cheap Labor " published in Slate in 1997 }

cheap labour को outsource करें

→ Paul A Samuelson :- The factor price equalization theorem

international trade equalizes the factor prices between trading nations

→ NTT (New Trade Theory) gave two advantages to the countries that import goods to compete with domestic goods :-

(a) Economies of Scale

Scale of Production ($\uparrow$) Cost ($\downarrow$)

Scale of Production ($\uparrow$) COST ($\downarrow$)

(b) **Network effect (Bandwagon Effect)**

(eg WhatsApp or Microsoft Windows)

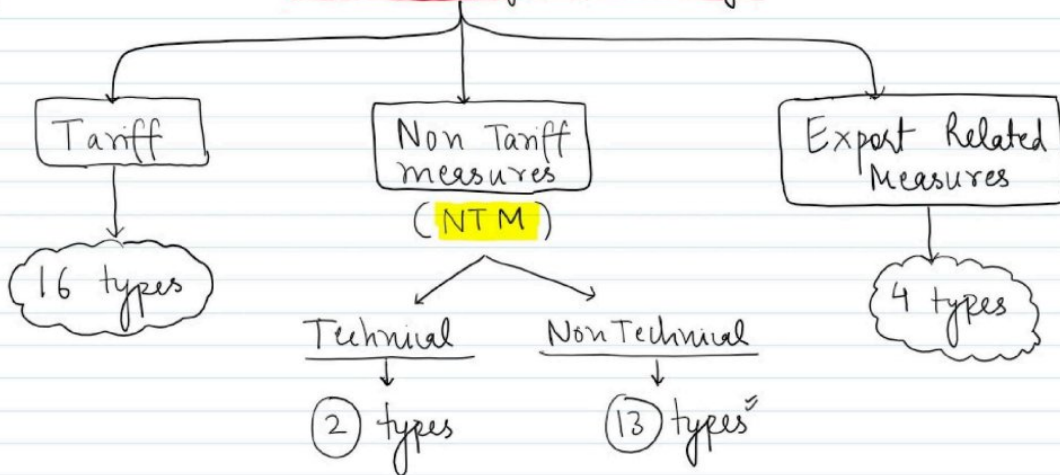
- The way one person's value for a good or service is affected by value of that good or service to others.

The value of product or service is enhanced as the number of individuals using it increases.

x ————— x ————— x ————— x ————— x

Unit 2

Instruments of Trade Policy

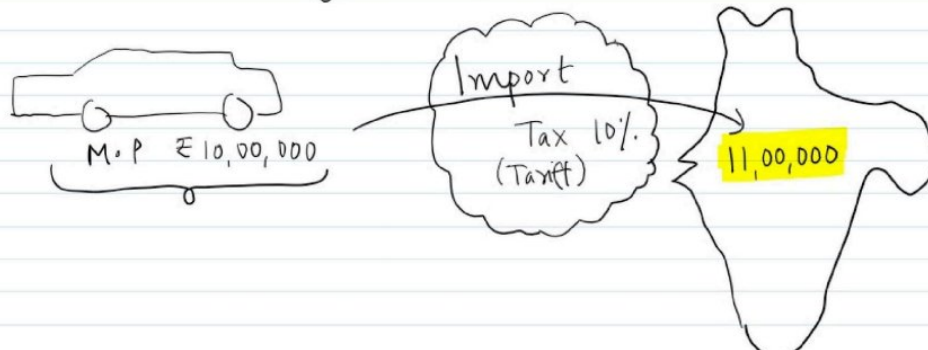


I TARIFF

→ Tariff is known as custom duties imposed on goods and services which are imported or exported.

→ In this unit, tariff would refer to import duties

* Tariff leave the world market price of the goods unaffected, while raising their prices in the domestic market



Scale of Production ($\uparrow$) COST ($\downarrow$)

(b) **Network effect (Bandwagon Effect)**

(eg WhatsApp or Microsoft Windows)

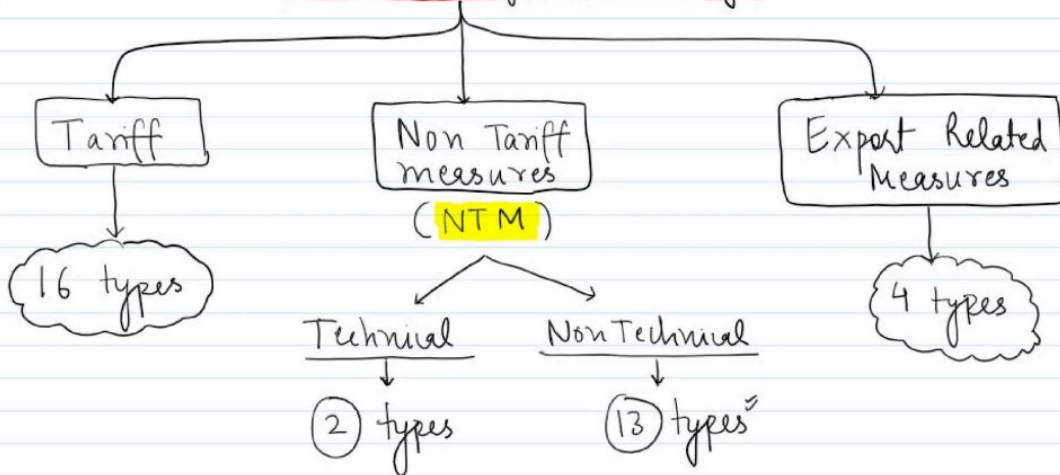
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Unit 2

Instruments of Trade Policy

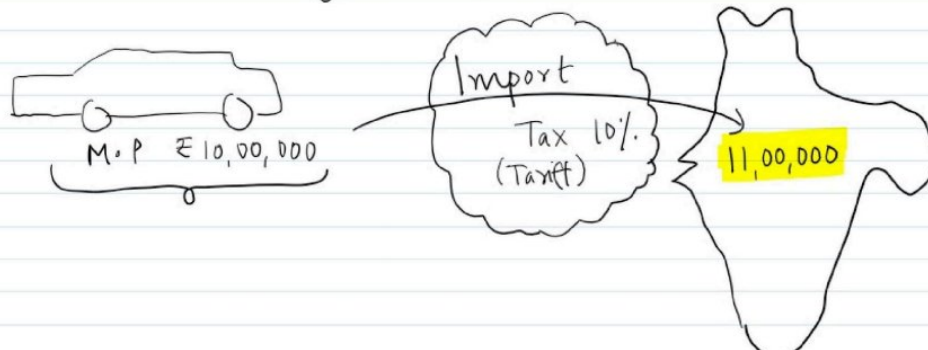


I TARIFF

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① Specific Tariff - fixed amount of money per physical unit

eg - £1000 per bicycle.

② Ad Valorem tariff - fixed % of the value of commodity

eg - 20% on value of bicycle



* Generally it leads to deliberate undervaluation.



③ Mixed Tariff - tariff is expressed either on the basis of quantity or on the basis of value



eg - Tariff on Cheese at 5% ad valorem or £100 per Kg ; whichever is HIGHER

* Compound Tariff / Duty - combination of both advalorem and specific tariff

eg. Tariff on Cheese 5% ad valorem + £100 per Kg

④ Technical / Other Tariff

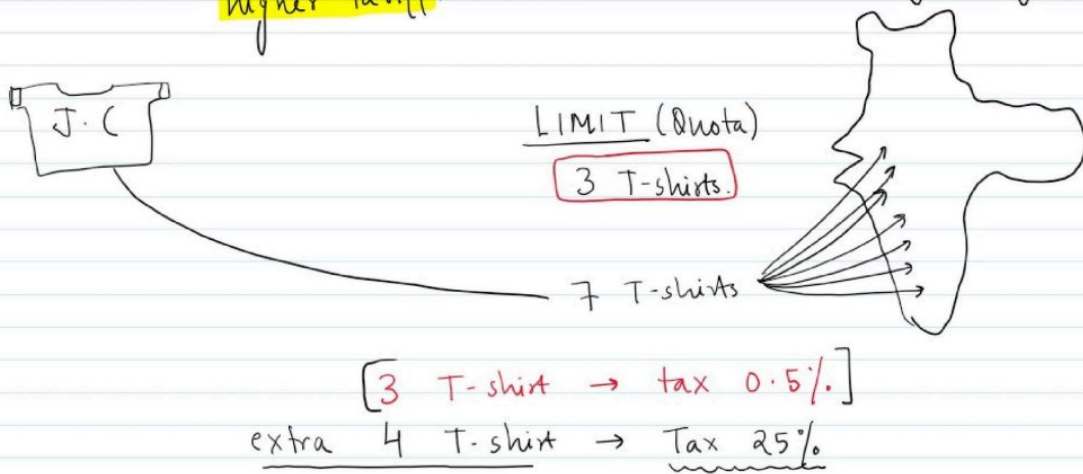
- calculated on basis of "specific contents" of imported goods

- calculated on basis of specific contents of imported goods

eg :- £ 3000 on solar panel and £ 50 per Kg on the battery installed.

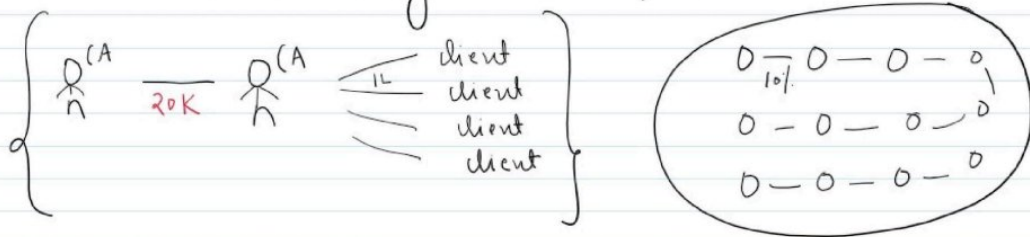
⑤* Tariff Rate Quotas (TRQ)

- combines two policy instruments : Quotas & Tariff
- Imports entering "under the specific quota" portion are usually charged lower tariff and imports above the threshold usually charged higher tariff.



⑥ Most favoured Nation Tariffs (MFN)

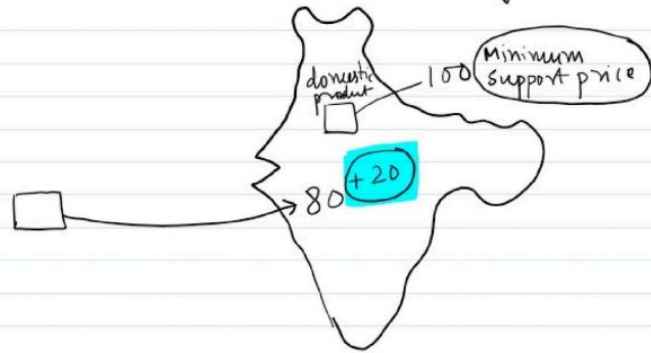
- refers to import tariffs which countries promise to impose on imports from other members of WTO
- MFN rates are the highest that WTO members charge each other



⑦ Variable Tariff

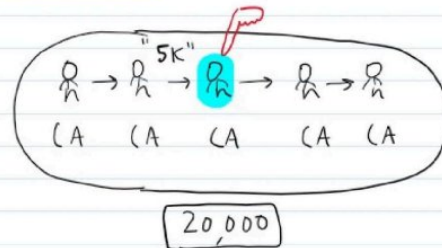
- duty typically fixed to bring the price of an imported commodity up to level of

- duty typically fixed to bring the price of an imported commodity up to level of the domestic support price of the country



⑧ Preferential tariff

- Nearly all countries are part of at least one preferential trade agreement under which they promise to give other country's product lower tariff than MFN rate

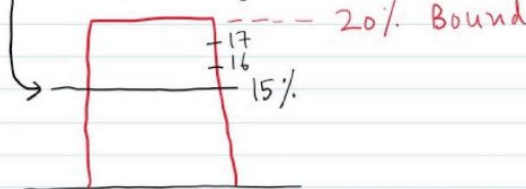


⑨ Bound Tariff

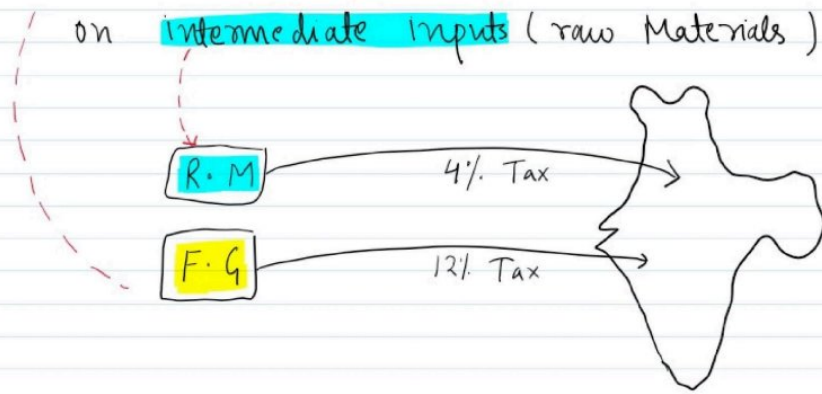
- Under this WTO member binds itself with a legal commitment not to raise tariff rate above a certain level

⑩ Applied Tariff

- It is the actually charged tariff on MFN basis



- ### ⑪ Escalated Tariff
- it is a system where in the nominal tariff rates on import of manufactured goods are higher than the nominal tariff rates on intermediate inputs (raw Materials)

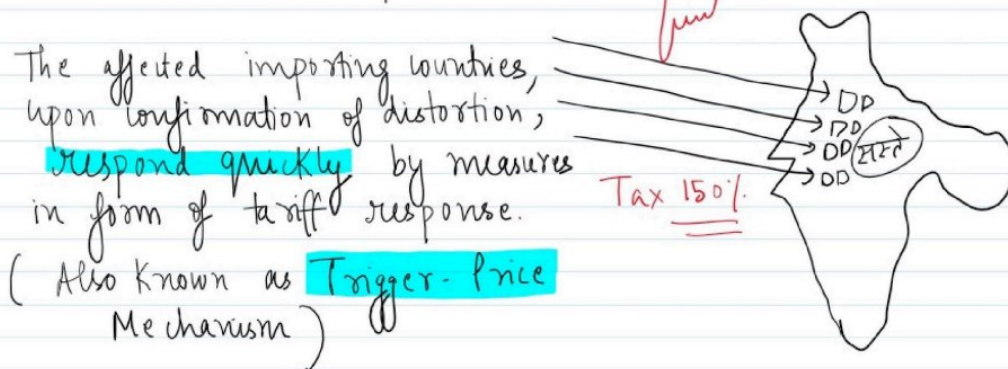


- (12) Prohibitive tariff - It is a tariff set so high that no imports can enter

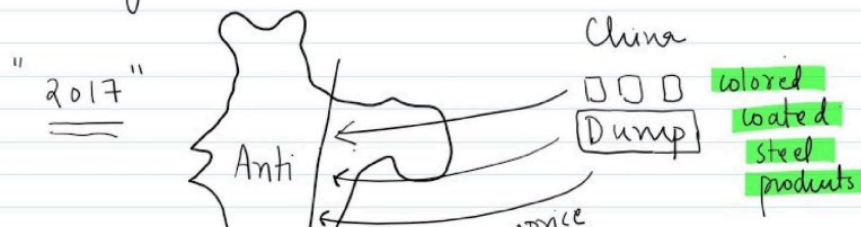


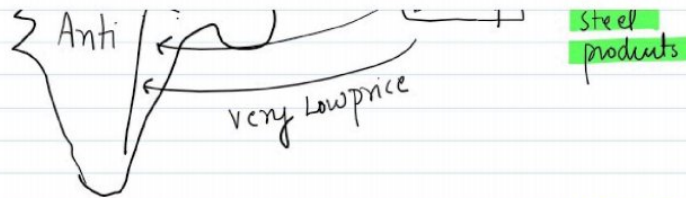
- (13) Import Subsidies - An import subsidy is simply a "payment" per unit or as % of value on goods imported.

- (14) Tariff as Response to "Trade Distortion"

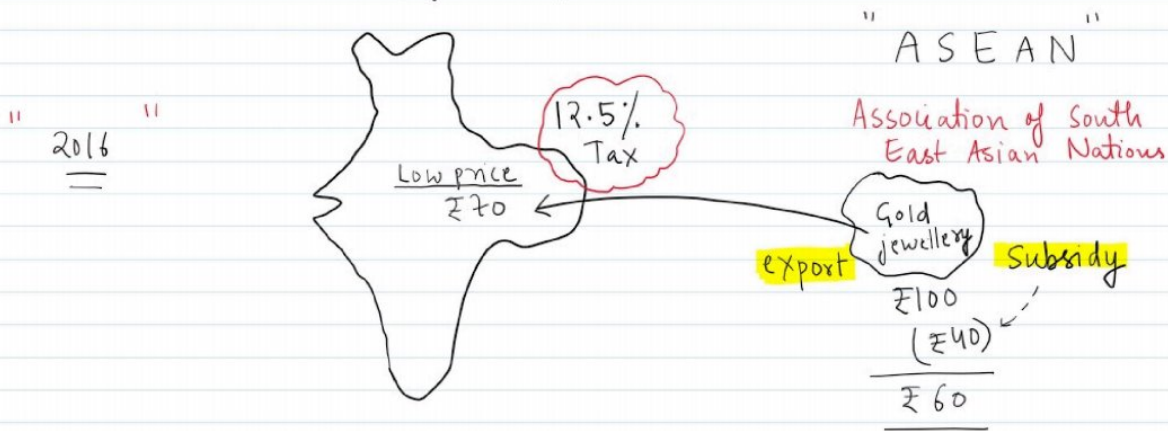


- (15) Anti-Dumping Duty - It is a protectionist tariff that domestic government imposes on foreign imports that it believes are priced below fair market value



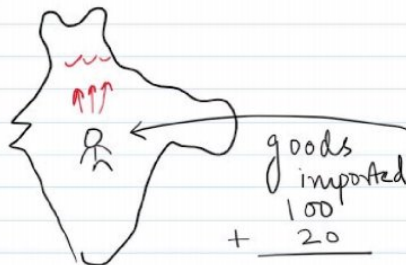


- ⑩ Countervailing duties - Tariffs that aim to offset the artificially low prices charged by exporters who enjoys export subsidies



* Effects of Tariff

- It creates obstacle to trade
- Imported Goods becomes expensive
- Tariff encourages production + consumption of domestically produced good.
- Producers importing goods may charge higher prices, which may lead to increase in their profits.

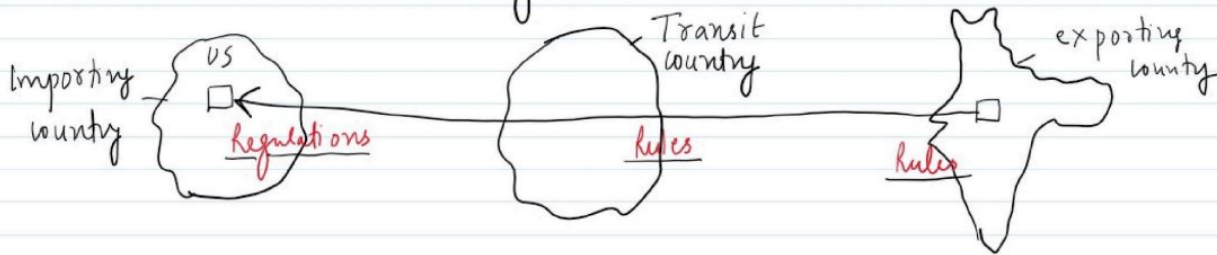


- Tariff also increases government revenue

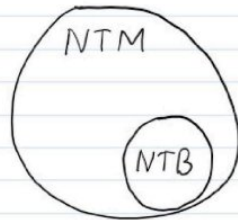
III Non Tariff Measures (NTM)

Non Tariff Measures (NTM)

- NTMs consists of mandatory requirements, rules, or regulations that are legally set by the government of the exporting, importing, or the transit country.



- NTMs are not the same as non-tariff barriers
[$NTM \neq NTB$]



NTB is subset of NTM

- Two types :-

① Technical Measures

(a) Sanitary and Phytosanitary (SPS) measures

- to protect human, animal or plant life from risks arising from pests, toxins, contaminants etc & to protect biodiversity

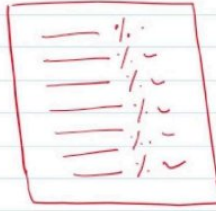
eg :- Prohibition of Poultry from countries affected by flu

(b) Technical Barriers to Trade (TBT)

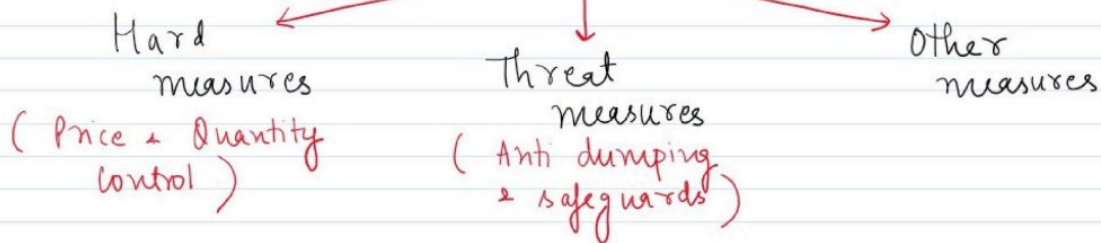
- It covers both food and non-food traded products refer to mandatory "Standards and Technical Regulations" that define the specific characteristics that product should have

eg :- Food Laws, Labelling

eg :- Food Laws, Labelling



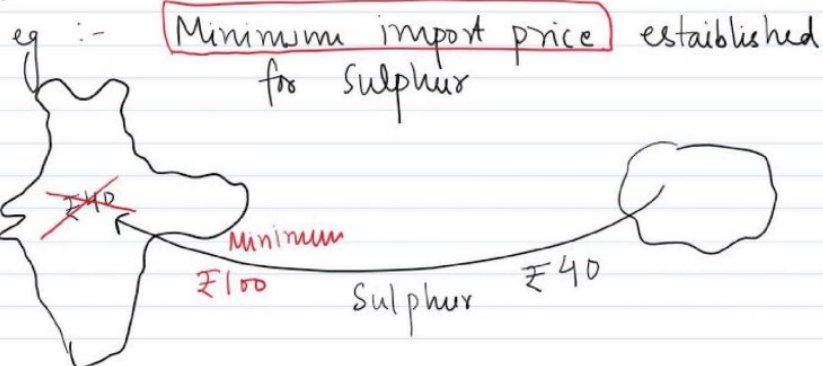
② **Non Technical Measures** - It relates to trade requirements like shipping requirements, custom formalities, trade rules, taxation policies etc



(i) **Import Quotas**

- Import quota is a direct "restriction" which specifies that only a certain physical amount of the good will be allowed into the country during a given period of time (generally 1 year)

(ii) **Price control measures** - **Steps taken** to control or influence the prices of imported goods in order to support the domestic prices of certain products



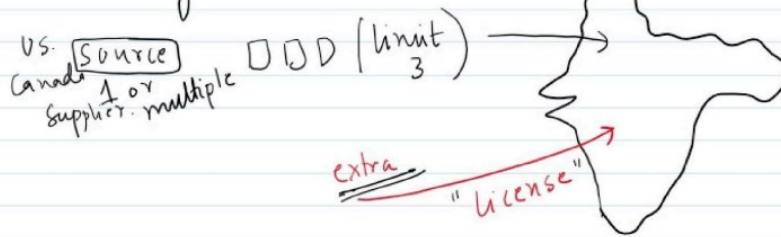
(iii) **Non-automatic licensing & prohibitions**

(iii)

Non-automatic licensing & prohibitions

- These measures are normally aimed at limiting the quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier.

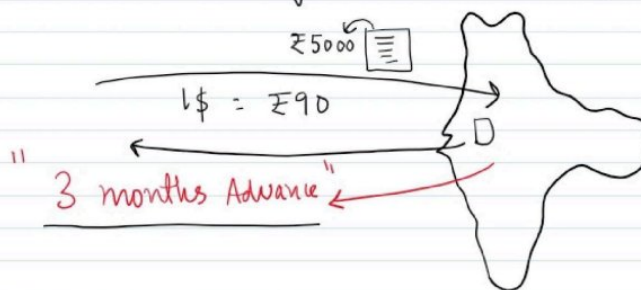
for eg:- textiles may be allowed only on discretionary license by the importing country.



(iv)

Financial Measures

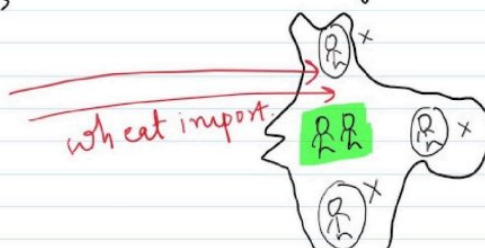
- The objective of these measures is to "increase the import costs" by regulating the access to and cost of foreign exchange for imports and to define the terms of payments.



(v)

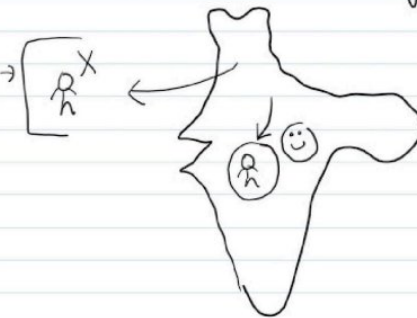
Measures affecting competition

- These measures are aimed at granting exclusive or special preferences / privileges to one or few limited group of economic operators



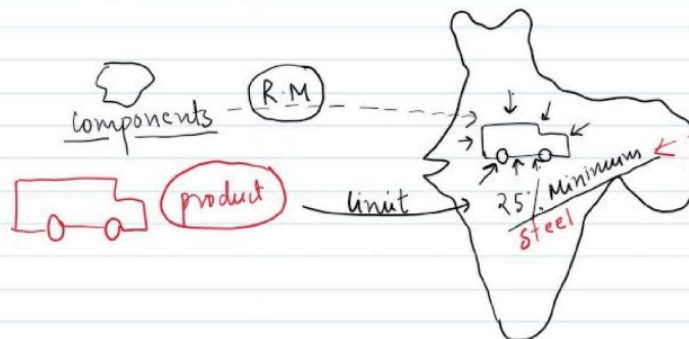
(vi) **Government Procurement Policies**

- सरकार खरीदना
- Government may give preference to the local tenders rather than foreign tenders



(vii) **Trade related Investment Measures**

- Requirement to use certain minimum levels of locally made components
- Restricting the level of imported components
- Limiting the purchase / use of imported products



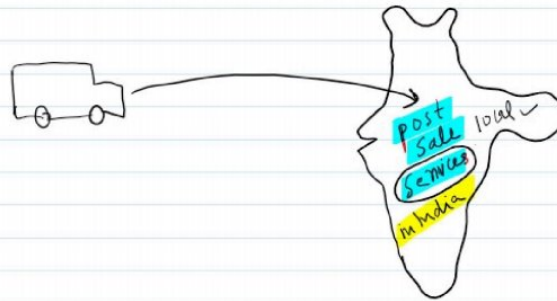
(viii) **Distribution Restrictions** - These are limitations imposed on distribution of goods in the importing country involving additional license or certification requirement

eg:- Restriction that imported fruits may be sold only through outlets having refrigeration facilities.

restriction that imported fruits may be sold only through outlets having refrigeration facilities.



(ix) **Restriction on Post-Sales Services**



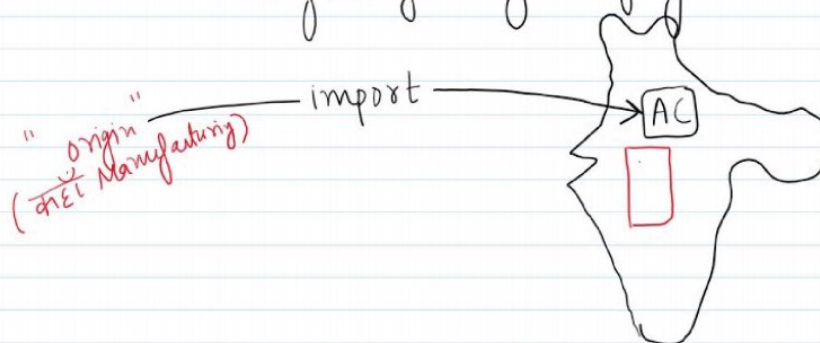
- Services may be reserved to local service companies of the importing country.

(x) **Administrative procedures**

- Any kind of particular procedure and formalities

(xi) **Rules of Origin**

- Important procedural obstacle occur in the home country for making available certifications regarding origin of goods.



(xii) **Safeguard Measures** - Restrict imports of a product "temporarily".

(xiii) **Embargos** - It is a "total ban" imposed by

- (xiii) **Embargos** - It is a **total ban** imposed by government on import / export of particular product for indefinite period.

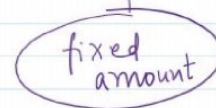
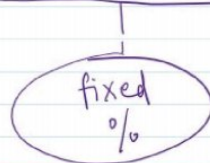
III. **EXPORT Related Measures**

- (i) **Ban on exports** - During the period of **shortage**, export of agricultural products may be prohibited to make them available for domestic consumption



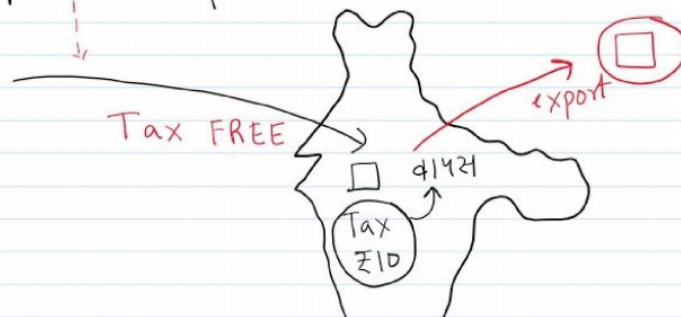
- (ii) **Export taxes**

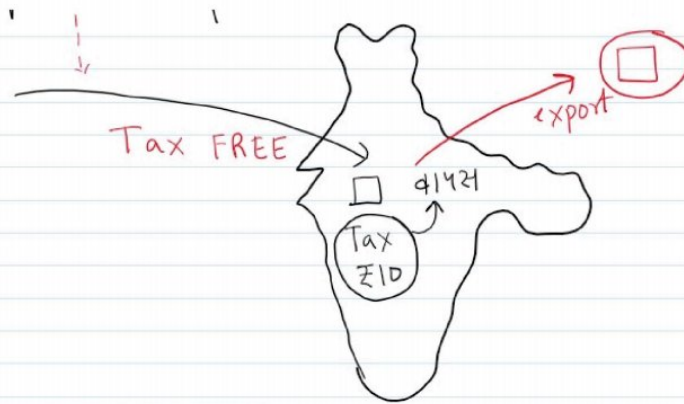
- Export tax is a tax collected on exported goods and may be specific or ad valorem



- (iii) **Export Subsidies + Incentives**

→ like **duty drawback**, **duty free** access to imported components etc





(iv) **Voluntary Export Restraints** - VER is type of **hypomol** quota administered by exporting country voluntarily **restraining the quantity of goods** that can be exported out of the country during a specified period of time.

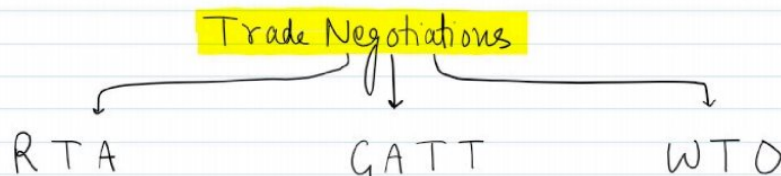
जान कर	रौकना	Limit (quota)
DD		5 T-shirt

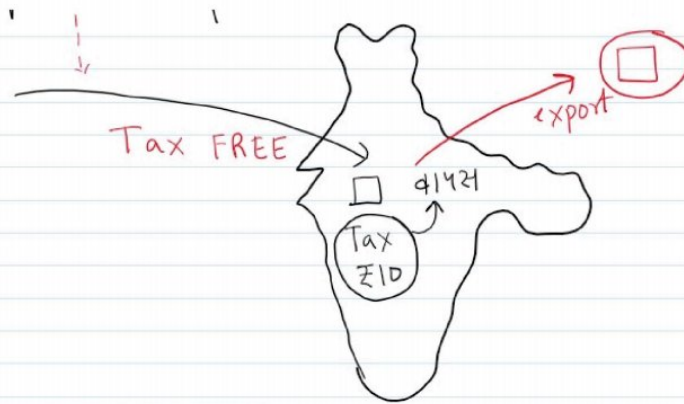
* Recent developments

- Free Trade Agreement with **Mauritius** on **1 April 2021**
- 18 Feb 2022 : Comprehensive economic Partnership Agreement (**CEPA**) with UAE
- Economic Cooperation & Trade Agreement (**ECTA**) with **Australia** on 2nd April 2022

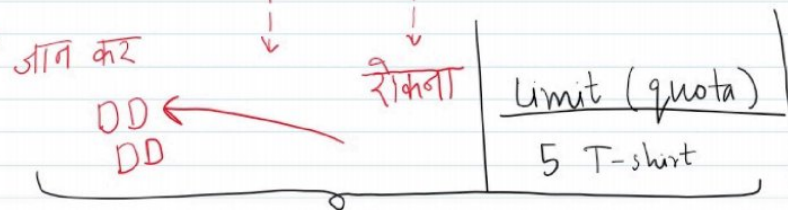
x ————— x ————— x ————— x ————— x

Unit 3





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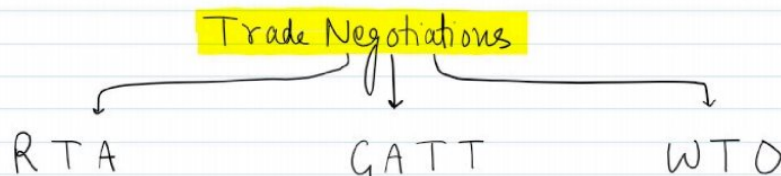


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x ————— x ————— x ————— x ————— x

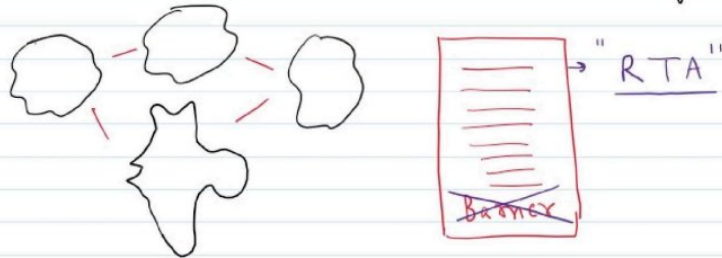
Unit 3



1. Regional Trade Agreements (RTA)

→ RTAs are defined as grouping of countries which are formed with the objective of reducing barriers to trade between member countries.

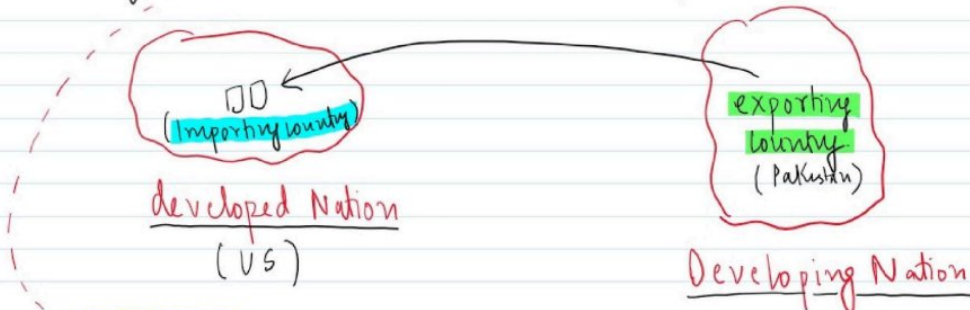
{ As on 1st Feb 2021, 339 RTAs were in force }



→ Types of RTA

① Unilateral Trade Agreements - Under this an importing country offers "trade incentives" in order to encourage the exporting country (eg Generalised System of Preferences)

"ONE WAY"



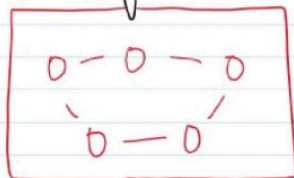
→ GSP - it promotes economic development by eliminating duties on various products.

② Bilateral Agreements - agreements that set rules of trade between two countries, two blocs or a bloc and a country (eg :- ASEAN-India Free Trade Area)

"Two way"

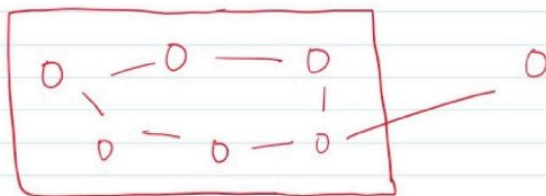


- ③ **Regional Preferential Trade Agreements** - Agreements among a group of countries to reduce trade barriers on a **reciprocal + preferential** basis only for the members of group [eg **GSTP**]



Global System of Trade Preferences

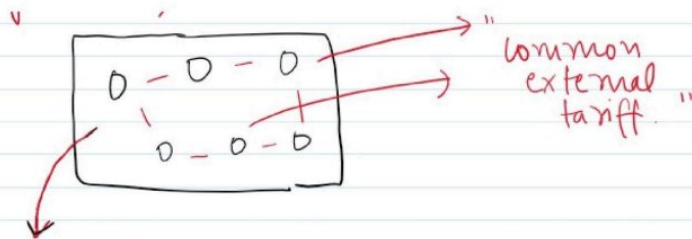
- ④ **Trading Bloc** - group of countries that have "free trade agreement" between themselves and may apply a common **external tariff** to other countries. Eg - Arab League (AL), European Free Trade Association (EFTA)



- ⑤ **Free trade Area** - It is a group of countries that **eliminate all tariff + quota barriers** on trade with objective of increasing exchange of goods among themselves. (eg - ASEAN - India Free Trade area)

- ⑥ **A customs union** is a group of countries that **eliminate all tariffs** on trade among themselves, but maintain a common external tariff on trade with other countries. (It is technically **violation of MFN**)





⑦ **Common Market** - A common market deepens a custom union by providing for free flow of output and of factors of production by reducing or eliminating internal tariffs and by creating common external tariff. (eg EU, ASEAN)

⑧ **Economic & Monetary Union** - Free transit of goods & services through the borders. (eg EU)
 "Single currency"

2. General Agreements on Tariff & Trade (GATT)

- GATT covers International trade in goods.
- The workings of GATT agreements are the responsibility of the Council for Trade in Goods (Goods Council).
- The Goods Council has 10 committees. These committees consist of all member countries.
- The GATT lost its relevance by 1980s because
 - a) Intellectual property rights & trade in services were not covered
 - b) Ambiguities in multilateral system.

Confusion

{ 1-20 Room 1
 { 15-31 Room 2 }

GOODS & Trade

{ 1-20 Room 1 }
{ 15-31 Room 2 } → GOODS 411 Trade ✓

- c) World merchandise trade increased a lot and it was beyond the scope of GATT
- d) Efforts at liberalizing agriculture were not successful 😞
- e) Inadequacies in "dispute settlement system"
- f) It was "NOT a treaty"

* URUGUAY ROUND

- Uruguay round brought about the biggest reform of the world's trading system. Members established 15 groups to work on limiting restrictions.
- The Round started in Punta del Este in Uruguay in September 1986. In December 1993, the Uruguay round (8th) was the most ambitious & largest ever round with 123 countries participated, was completed.
- The agreement was signed by most countries on 15 April, 1994 and with effect from 1 July 1995 marked the birth of "WTO".

3. World Trade Organisation (WTO)

- Six key objectives :-
 - (i) to set and enforce rules for international trade
 - (ii) to provide forum for negotiations

- =
- (i) to provide ^{वित्त} forum for negotiations
 - (ii) to resolve disputes
 - (iii) to increase transparency
 - (iv) to involve in global economic management
"international ~~अर्थ~~ Management"
 - (v) to help developing nations

→ Structure of WTO

WTO activities are supported by a Secretariat located in GENEVA by Director General.

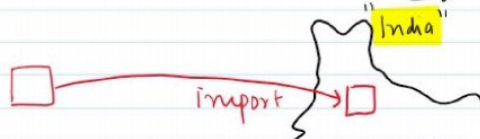
It has three tier system of decision making

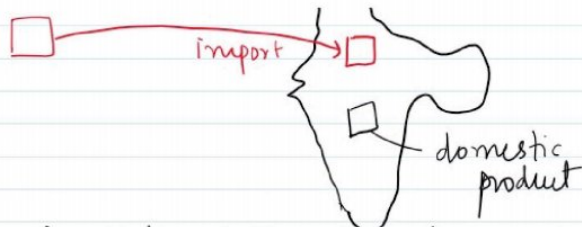


WTO accounts for almost 95% of world trades and currently having 164 member countries (of which 117 are developing countries)

→ "Guiding Principle of WTO"

- ① Most Favoured Nation (MFN) - treating other people equally.
- ② National Treatment - Treating foreigners and locals equally.





this principle of National Treatment is also found in all three main WTO agreements

(Article 3 of GATT , Article 17 of GATS and Article 3 of TRIPS)

↓
Goods

↓
General Agreement on Trade in Services

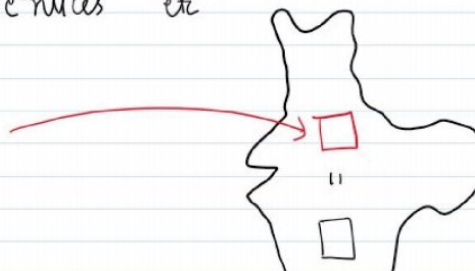
↓
Agreement on Trade Related Aspects of Intellectual Property Rights

③ Free Trade - WTO allows progressive liberalisation

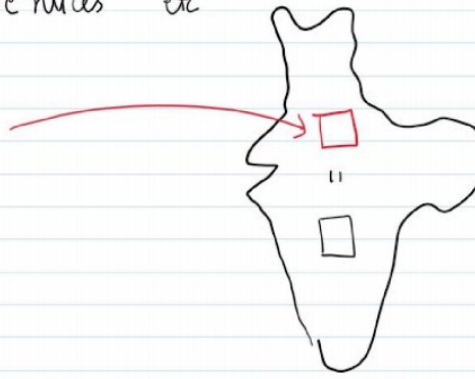
और-२ Barriers खोल करतें हैं

④ Predictability - In WTO, when countries agree to open their markets for goods or services, they "bind" their commitments. Countries should make trade rules as clear as possible (transparent)

⑤ Promoting fair competition - WTO promotes fair competition in agriculture, intellectual property, services etc

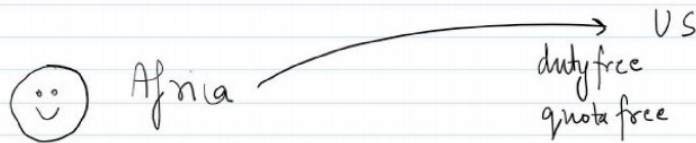


property, services etc



⑥ Encouraging development & economic reform

- Developed countries have started to allow duty free & quota free imports for almost all products from least developed countries.



→ WTO Agreements :-

- Agreement on Agriculture
- Agreement on Application of SPS measures
- Agreement on Textiles & Clothing replaced the Multi-Fibre Agreement (MFA) since 1974
- Agreements on TBT (Technical Barriers to Trade)
- Agreements on TRIMs (Trade Related Investment Measures)
- Agreements relating Anti-Dumping
- Custom valuation agreements
- Agreements relating to Pre-shipment Inspection (PSI)
- Agreements on rules of origin

- Agreements on rules of origin
- Agreements on Import licensing procedure
- Agreements on Subsidies and Countervailing measures
- GATS and TRIPS
- Trade Policy Review Mechanism (TPRM)
- Plurilateral Agreements
 - It involves several countries with common interest but do not involve all WTO countries

* DOHA Round (9th)

- Qatar in November 2001
- Talks about negotiations including 20 areas of trade
- Most controversial topic was "agriculture trade"

* G20

- "Group of 20" is the premier forum for international economic cooperation. India holds the Presidency of G20 from 1 Dec 2022 to 30 Nov. 2023
- G20 was founded in 1999 after the Asian financial crises
- Since beginning of COVID-19, trade related measures were implemented by G20 and 61% measures were "trade facilitating".

61% measures were "trade facilitating"
(39% " " "trade Restrictive").

By October 2022, 77% of export restrictions
has been repealed
→ खत्म कर दी

CH 9
Unit 4

Exchange Rates and its Economic effects

① INTRODUCTION

- A foreign currency transaction that is denominated in or requires settlement in foreign exchange
- Exchange Rate is the rate at which the currency of one country is exchanged for the currency of another country.

eg.

$$1 \$ = ₹ 80$$

$$1 \text{ pen} = ₹ 10$$

$$1 \text{ pizza} = ₹ 100$$

- A direct quote (European Currency Quotation) is the number of units of local currency exchangeable for one unit of foreign currency
 $₹ 80 / \$$ $1 \$ = ₹ 80$

- An indirect quote (American Currency Quotation) is the number of units of foreign currency exchangeable for one unit of local currency

$$\$ 0.0125 / ₹$$
$$1 ₹ = 0.0125 \$$$

② Exchange Rate Regimes (3 Regimes)

(i) Free-Floating exchange Rate System

- Rate determined by market forces of

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CH 9
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② Exchange Rate Regimes (3 Regimes)

(i) Free-Floating exchange Rate System

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- Rate determined by market forces of demand + supply
- NO Government intervention
- Self Regulating 😊
- No need to maintain foreign currency Reserves 😊
- Less stability 😞
- Speculation can be there 😞
- International trades are riskier

(ii) Managed Floating System

- Government + Central Banks often seek to increase or decrease their exchange rates by buying or selling their own currencies
- Such intervention is likely to have only a small impact

(iii) Fixed Exchange Rate system

- Set by Government
- Stability 😊
- Less speculation 😊
- Avoids currency fluctuation 😊
- Government has to keep huge foreign currency reserves 😞
- It enhances international trade + investment 😊

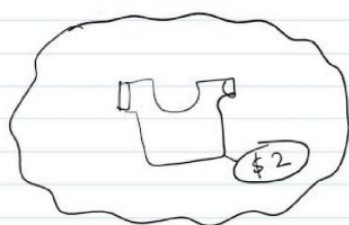
* Basically, free floating exchange rate system is efficient and transparent. It allows Central Bank to pursue its own independent monetary policy 😊

③ Nominal and "Real" exchange Rates

- Nominal exchange rate is expressed in units of

- Nominal exchange rate is expressed in units of one currency per unit of other currency. A real exchange rate adjusts this for changes in price levels.
- A real exchange rate is the rate at which a person can trade the goods or services one country for the goods or services of another.

$$\text{Real exchange Rate} = \frac{\text{Nominal exchange Rate} \times \text{Domestic prices}}{\text{Foreign Prices}}$$



Nominal exchange Rate

$$1\$ = ₹1$$



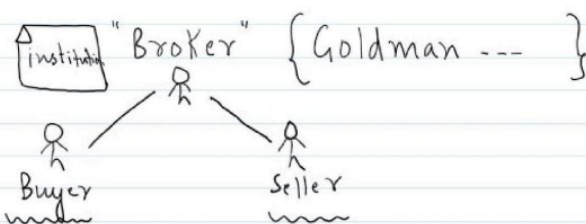
$$\begin{aligned} \text{Real exchange Rate} &= ₹1 \times \frac{5}{2} \\ &= 2.5 \end{aligned}$$

$$\text{* Real effective exchange Rate (REER)} = \frac{\text{Nominal exchange Rate}}{\text{Price deflator}}$$

④ Foreign Exchange Market

- Forex market mainly consists of commercial banks & brokerage houses. (Known as market makers)

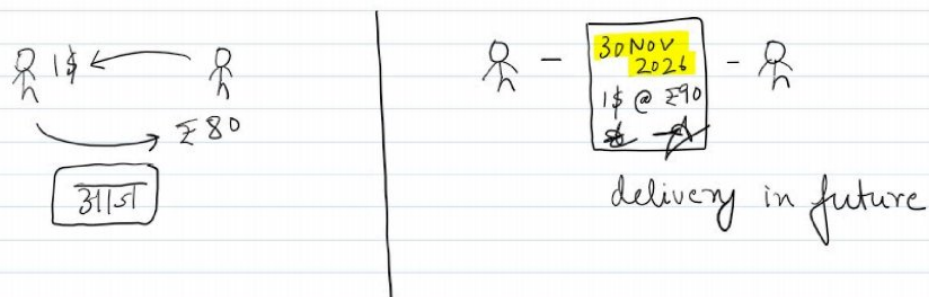
Commercial Banks.



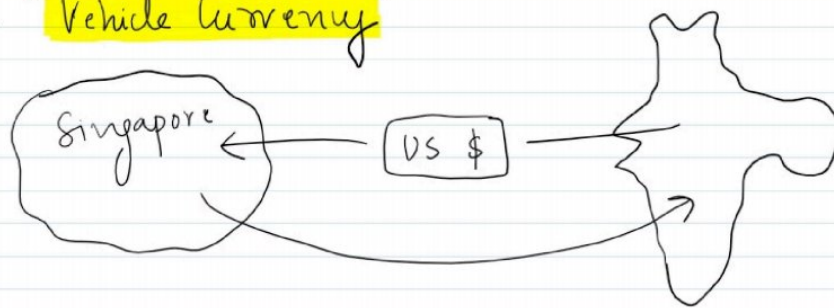
- In foreign exchange market, there are two types of

→ In foreign exchange market, there are two types of transactions :-

- currency transactions which are carried out in the spot market and exchange involves immediate delivery
- future transactions wherein contracts are agreed upon to buy or sell currencies for future delivery which are carried out in forward / futures market

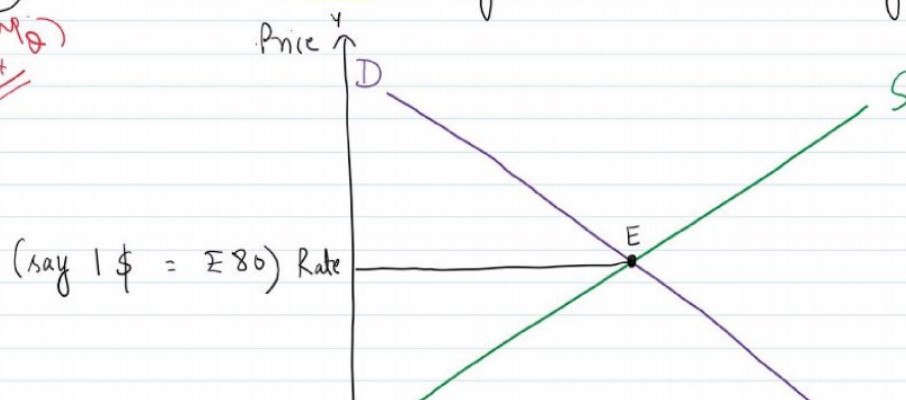


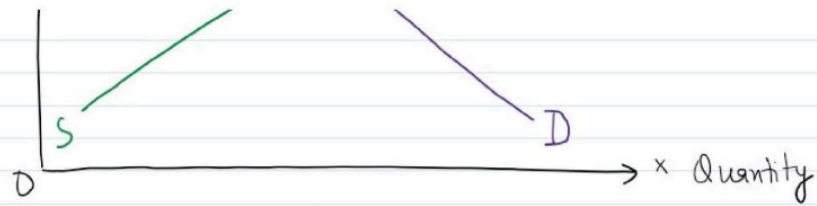
* A foreign exchange transaction can involve any two currencies, but mostly US \$ is involved (even though it is not the national currency of either of the countries). Thus, US \$ is called "Vehicle Currency".



⑤
V. Imp
(Max)

Determination of Nominal exchange Rate





Why demand ?
(Why \$ is demanded ?)

- To purchase goods & services from foreign country
- Foreign Tour
- To send unilateral transfers
- To make investment in foreign countries
- To open foreign Bank A/c
- For Speculation
- etc etc

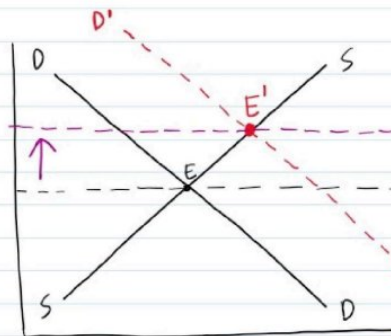
Why Supply ?
(Why inflow of \$?)

- Exports
- Investments by foreigners in our country
- Unilateral transfer received
- Foreigners visiting India
- Speculation
- etc etc etc

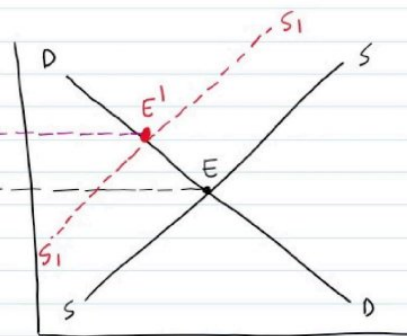
*
(say 1\$ = ₹86) R_1
(say 1\$ = ₹80) R

HOME
currency
depreciation

"रुपया कमजोर"



Increase in Demand *

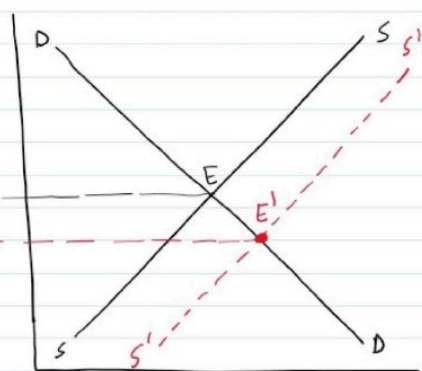
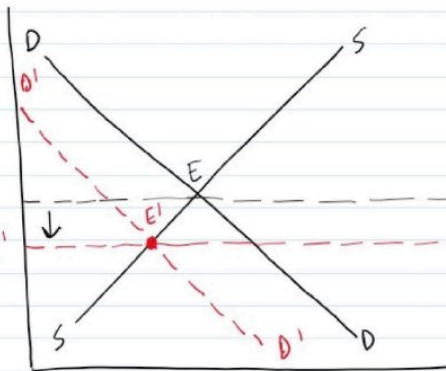


Decrease in Supply *

*

(say 1\$ = ₹80) R
(say 1\$ = ₹75) R_1

HOME
currency



Home
Currency
Appreciation

(रुपया मजबूत)

Decrease in demand

Increase in Supply

* Effects of Currency Depreciation + Currency Appreciation

Exchange Rate
depreciation lowers the relative price of country's exports (export rises), raises the relative price of its imports (import falls), leads to output expansion, encourages economic activity, increases international competitiveness and improves Balance of trade.

Currency appreciation raises the price of exports, (decreases export), increases imports, adverse effect on competitiveness, causes larger deficits + worsens the trade balance.

⑥ Depreciation (Appreciation) VS Devaluation (Revaluation)

Earlier 1\$ = ₹ 80

Now 1\$ = ₹ 85

Earlier 1\$ = ₹ 80

Now 1\$ = ₹ 85

Depreciation

रुपया कमजोर हो गया

Devaluation

It occurs due to market forces of demand + supply

deliberately done by government

X ————— X ————— X ————— X ————— X

CH 9
Unit 5

International Capital Movements

① Foreign Capital

→ Foreign Capital includes any inflow of capital into the home country from abroad



Home
Currency
Appreciation

(रुपया मजबूत)

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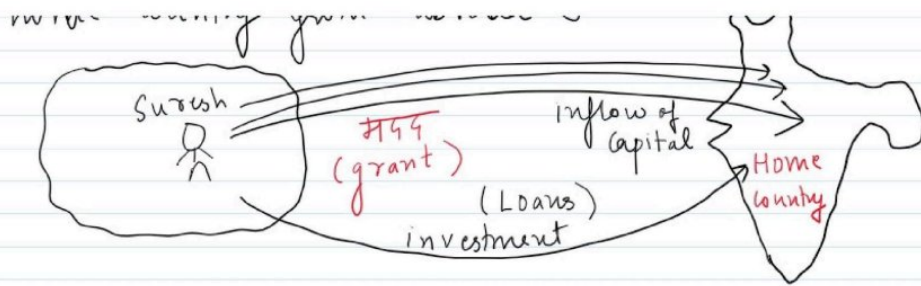
CH 9
Unit 5

International Capital Movements

① Foreign Capital

→ Foreign Capital includes any inflow of capital into the home country from abroad





No detail	1. Foreign aid or assistance (MFD)	→ Bilateral or direct inter government grants → Multilateral aid from many government → Tied aid with stipulation ^{condition} → Untied aid with no stipulation → foreign grants (voluntary) from institutions or organisations.
No detail	2. Borrowings (Loan)	→ Direct inter government loans → loans from international institutions → Soft loans (No harsh conditions) → External "commercial" borrowings → Trade "credit" facilities
No detail	3. Deposits from NRI (Non Resident)	—
"Detail"	4. Investments (निवेश)	→ Foreign Portfolio Investment (FPI) → Foreign Direct Investment (FDI)

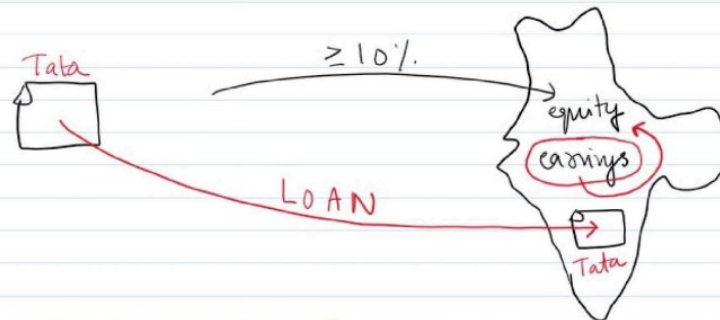
② Foreign Direct Investment (FDI)

- According to IMF and OECD, the acquisition of at least 10% of ordinary shares or voting power in a public or private enterprise by Non-resident investors makes FDI

investors makes FDI

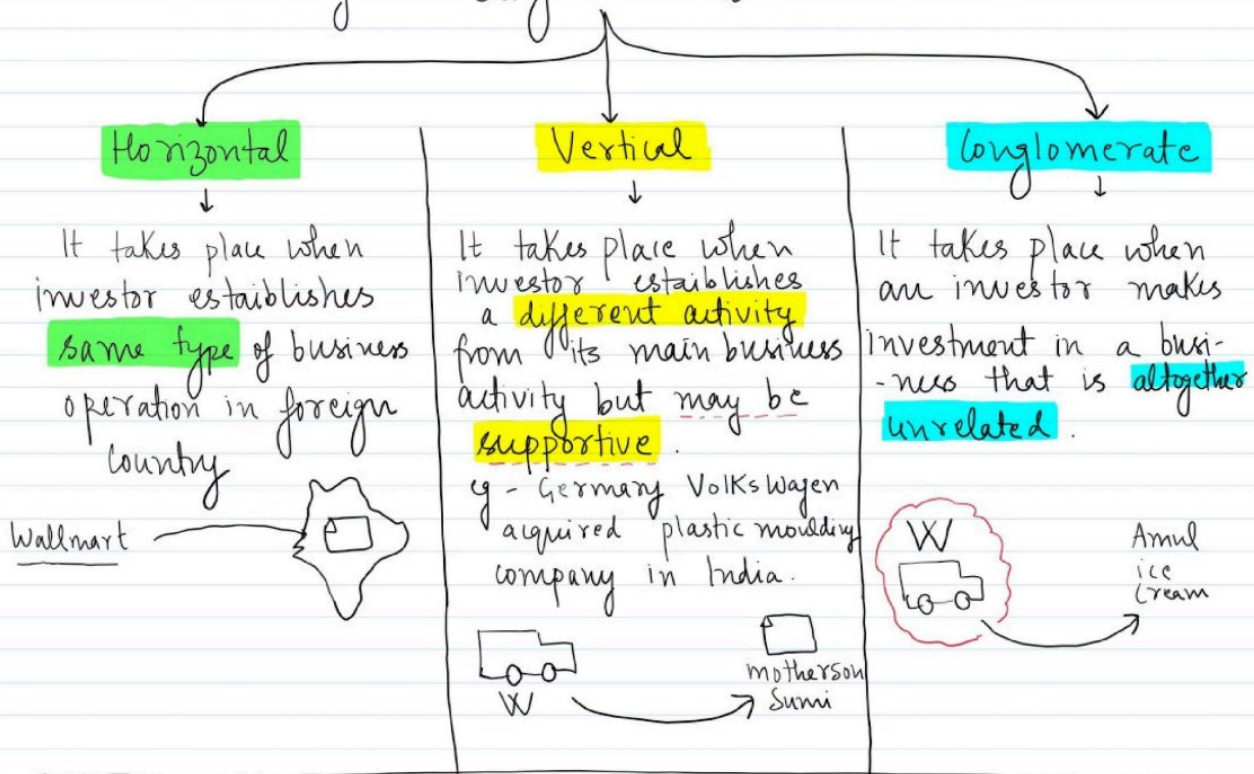
→ FDI has 3 components :-

- Equity capital
- Reinvested earnings
- Other direct capital (eg Intra-company loans)



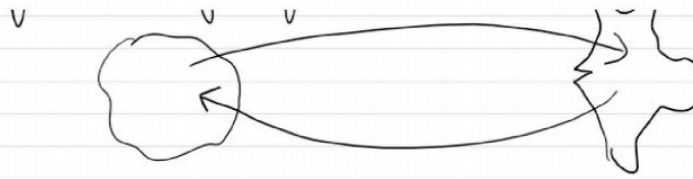
→ FDI are real investments in factories, assets, land, inventories etc and involve foreign ownership of production facilities.

→ FDI may be categorised as :-



* Two way direct foreign investment

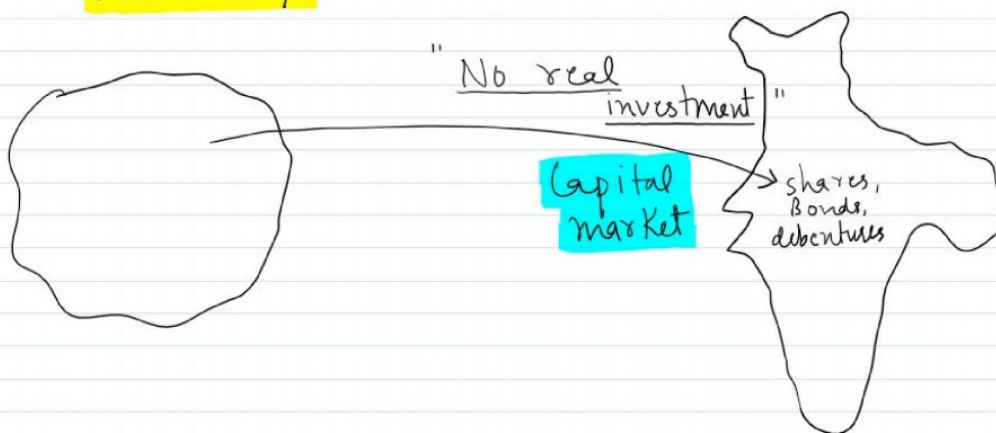




③

Foreign Portfolio Investment (FPI)

- Foreign portfolio Investment is the flow of financial capital rather than real capital
(does not involve ownership or control on part of Investor)
- These flows are generally short term and have their immediate effects on BOP and exchange rates (No major effects on production or income generation)
- Portfolio Investments are characterised by lower stakes in companies with their total stake at below 10%



- * Speculation → FPI (✓)
- * Direct impact on Employment → FDI (✓)
- * Difficult to withdraw → FDI (✓)
- * Interest in Management → FDI (✓)

* Interest in Management $\rightarrow$ FDI ($\checkmark$)

* Financial assets $\rightarrow$ FPI ($\checkmark$)

* Physical assets $\rightarrow$ FDI ($\checkmark$)

* Short term $\rightarrow$ FPI ($\checkmark$)

④ REASONS FOR FDI

The main reasons for FDI are :-

(i) Profits 😊

(ii) higher rate of return $\uparrow$

(iii) Possible "economies" of large scale operations

(iv) Risk diversification

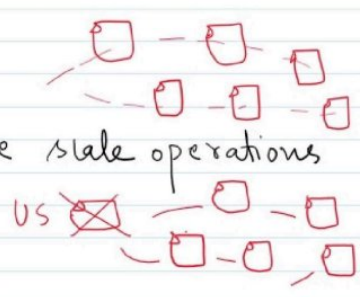
(v) Capture of "emerging" markets

(vi) lower host country environmental & labour standards

(vii) By passing "tariff" & "non tariff" barriers

(viii) Cost effective availability of inputs

(ix) Tax benefits



* FDI takes place through :-

a) Opening subsidiary company or associate

b) equity injection - lumpsum investment

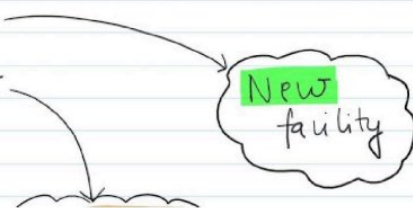
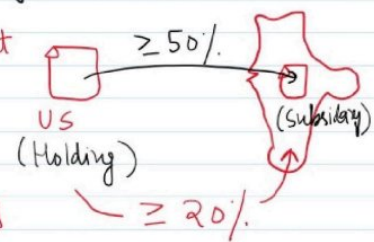
c) acquiring control

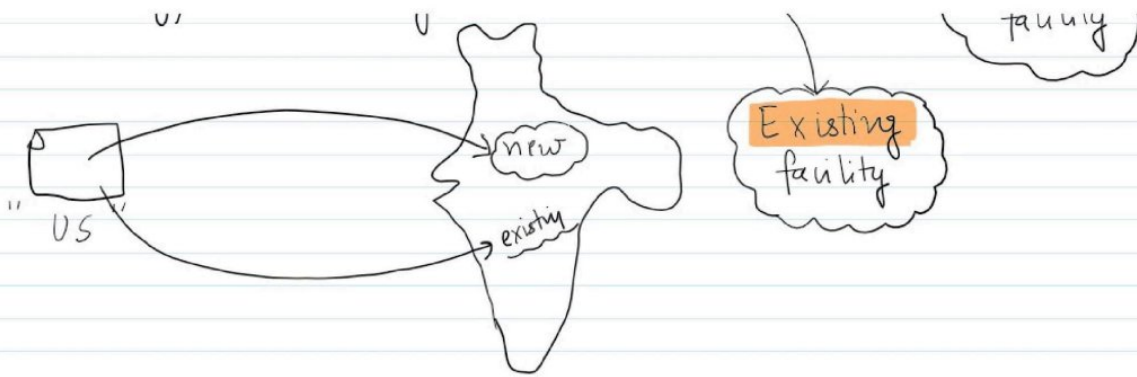
d) Mergers & Acquisitions

e) Joint Venture

f) Green field Investment

g) Brown field Investment





5 Problems of FDI

- Use of inappropriate capital intensive methods in labour abundant country
- Increase in regional disparity
- Crowding out of domestic investment
- Diversion of capital resulting in distorted pattern of production
- Instability in BOP + exchange rates
- Repatriation of profits
- Anti ethical market distortions
- "off-shoring" or shifting of jobs
- Over exploitation of natural resources
- Decrease in competitiveness of domestic companies
- Jeopardizing national security
- Worsening commodity terms of trade etc etc

Mumbai ↑↑
X city ☹️

domestic company ☹️

"Harmful" ←

$$\frac{\text{Prices of Exports}}{\text{Prices of Imports}}$$

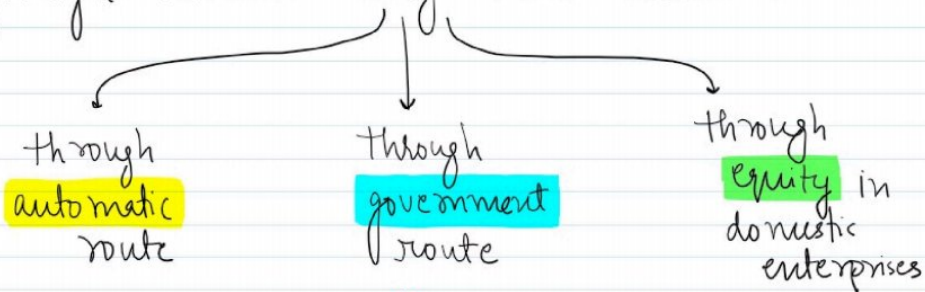
6 Benefits of FDI

- New Innovations

- New Innovations
- Higher efficiency
- Higher employment
- Better Products
- Lower prices
- Welfare for consumers
- Better access to foreign markets
- Improvement in BOP etc etc etc

* **MAURITIUS** is the leading country in respect of Inflow of FDI to India

* A foreign investor may enter India :-



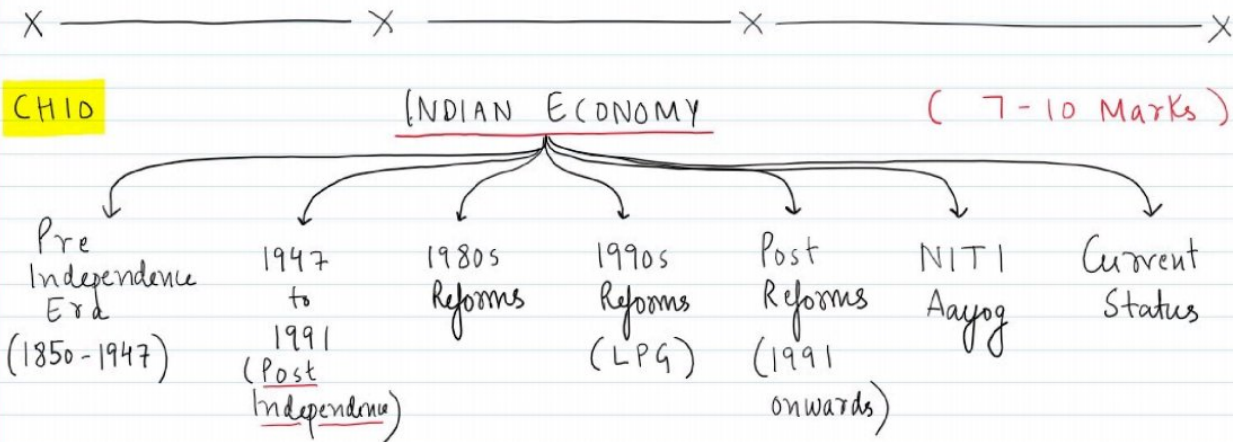
* FDI is prohibited in **Chit fund + Nidhi Company**

* According to RBI, Overseas direct investment stood at **US \$ 1,922.51 million** in Sep 2022

Investment made
by Indian companies
in foreign companies

* According to World Investment Report 2022, India was ranked **8th** among the world's

India was ranked 8th among the world's major FDI recipients. (US \$ 81,973 million during 2020-21)



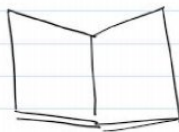
I. Pre Independence Era (1850-1947)

- Indian economy was prosperous and self-reliant
- It controlled between $\frac{1}{3}$ rd + $\frac{1}{4}$ th of world's wealth
- Agriculture was dominant occupation
- highly skilled artisans + craftsmen
- Well Known Handicraft industry

* Ancient Philosophy of India



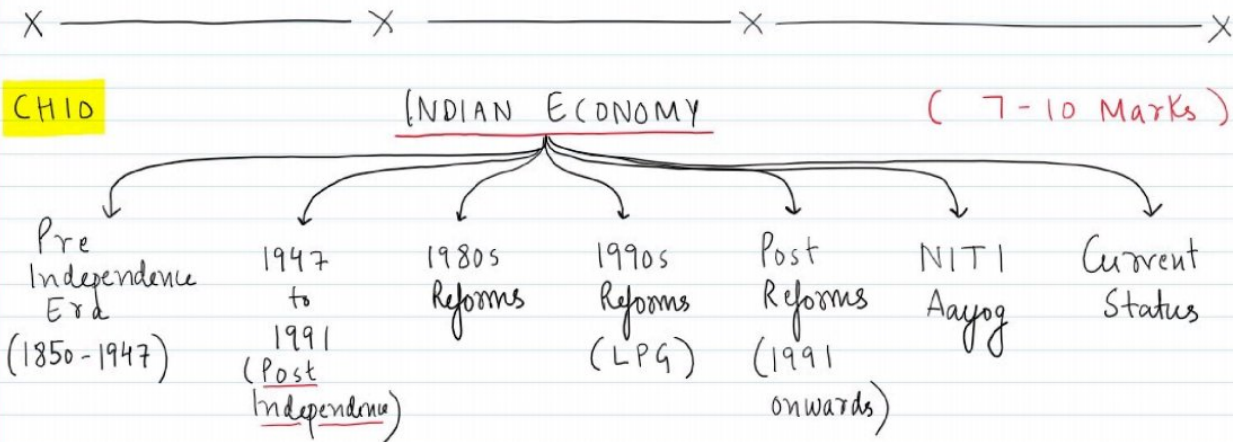
Chanakya



" Arthashastra "

- Arthashastra is the science of "Artha" or "material well being", which is primarily "wealth" + secondarily "the land"

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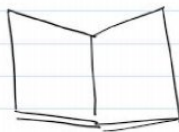
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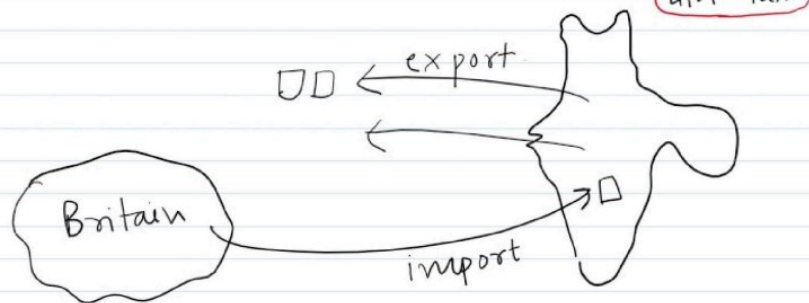
→ The ancient period of British rule can be divided into :-

- a) Rule of East India Company (1757 to 1858)
- b) British Government (1858 to 1947)

→ The Indian exports of finished goods subject to heavy tariffs.

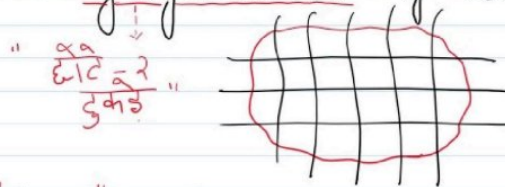
→ Imports from British were subject to lower tariffs.

Discriminatory
Tariff Policy

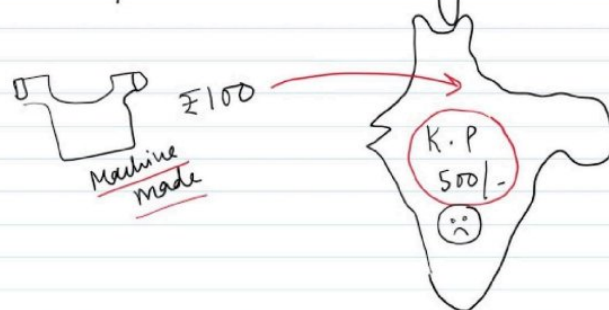


→ Large scale unemployment and absence of alternative sources of employment which forced many to depend on AGRICULTURE.

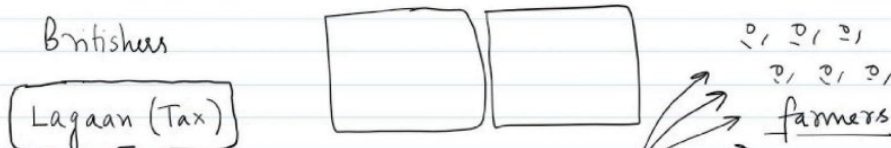
→ Sub division & fragmentation of land holdings

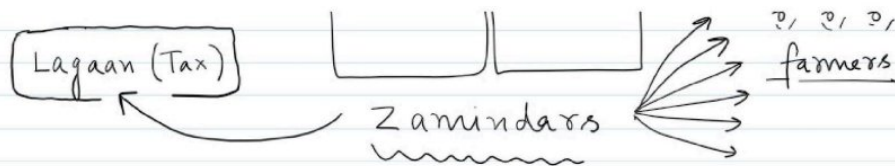


→ Imports of "cheap" machine made goods from Britain



→ Zamindari System (land settlement system)





- High indebtedness of agriculturists.
- "Factory based production" did not exist till 1850
- At the end of 19th century, the Indian Jute Mill industry was the largest in the world. In addition, paper-milling, leather-making, rice-milling industries also developed. Heavy industries such as iron industry were established in 1814 by Britishers.

III

POST INDEPENDENCE (1947-1991)

- Literacy rate was around 18%.
- life expectancy was 32 years
- India adopted Nehruvian model which supported social & economic redistribution

economic growth by equity
and distributive justice

- 5 years plans were developed and monitored by Planning Commission

- 1948 :- 1st Industrial Policy Resolution

expanded role of
public sector and licensing
for private sector

- The policies in 1950s were guided by two economic philosophies :-

→ The policies in 1950s were guided by two economic philosophies :-

- (a) to build socialistic society with emphasis on heavy industries
- (b) The Gandhian philosophy of small scale and ottage industries

→ 1956 : 2nd Industrial Policy Resolution

private investments were discouraged and more focus on public sector investments

→ India followed open foreign Investment Policy and relatively open trade policy.

→ BOP crisis emerged in 1958 (import > export)

→ "Import controls were maintained till 1966"
(रोकना)

→ From 1950-1980, India's annual growth rate of GDP was 3.5%

Hindus Growth Rate

→ 1966 :- Green Revolution (HYV seeds)

High Yielding Variety

→ Due to food shortage, India had to depend on US for food aid

→ 1969 :- (14) Banks were nationalised

1980 :- (6) more Banks were nationalised

→ The performance during 1965-1981 is WORST

WORST

- During 1960s + 1970s there were **license Raj**
- Major droughts were there in 1966 and 1967 and oil shocks in 1973 and 1979
- 1969 : The Monopolies + **Restrictive** Trade Practices Act
- Stringent labour laws (It discouraged labour intensive technique)
"कठोर"
(Harsh)

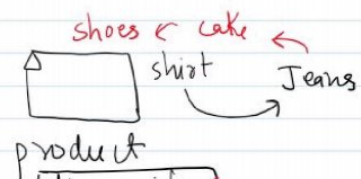
III REFORMS (1980s)

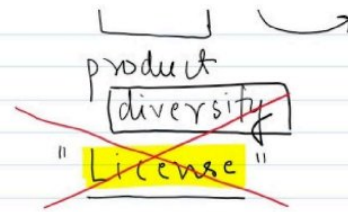
- The annual growth rate of GDP during 1980 - 1985 and 1985 - 1990 were 5.7% and 5.8% respectively

- 1980s Reforms broadly covers three areas :-



- In 1985, **delicensing** of (25) industries was done
- The facility of **Broad banding** was accorded for industries i.e. allow flexibility and rapid changes in their product mix without any fresh license





- The "multipoint excise duty" were converted into Modified Value Added Tax (MODVAT)
- 12 April 1988 : Establishment of SEBI (Securities Exchange Board of India)
- Several export incentives were introduced
- The rupee was devalued by 30% from 1985-86 to 1989-90
- Budget for 1986 introduced policies of cutting taxes, liberalising imports and reducing tariffs
- * The Reforms in 1980s were limited in Scope and thus bigger reforms were organised in 1990s.

IV REFORMS 1991 (LPG)

- Reasons for Reforms in 1991 :-
 - ① Huge deficits (Total expenditure of Government is higher than their total receipts)
 - ② BOP crisis (oil prices triggered by gulf war in 1990)
 - ③ foreign exchange reserves touched the

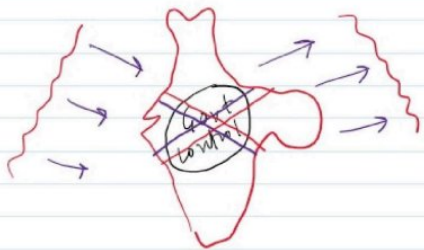
- ③ foreign exchange reserves touched the lowest point 😞
- ④ India had to depend on external borrowings from International Monetary Fund
- ⑤ Poor performance of Public sector Undertakings

* Crisis of confidence 😞 *

therefore the reforms were initiated in 1991 and popularly known as L P G.

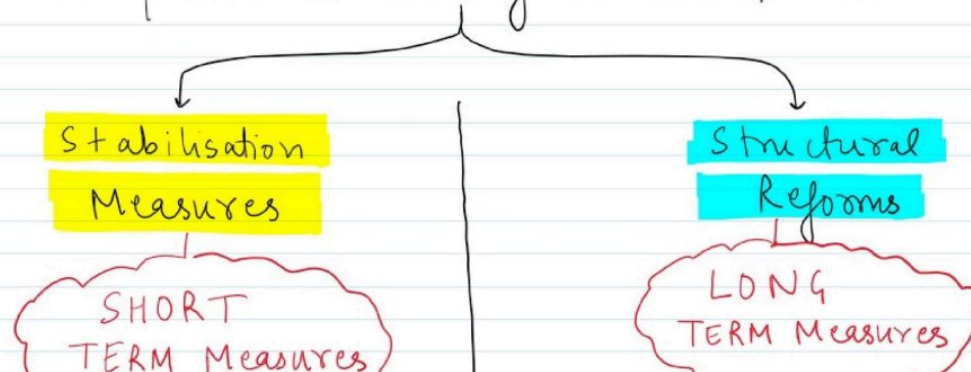
→ The reforms had two major objectives :-

- (i) Reorientation of the economy from centrally directed and highly controlled one to "market friendly" or "market oriented economy"
- (ii) Macro economic stabilisation by substantial reduction in fiscal deficit.



Borrowings कम करनी है

→ The policies can broadly be classified as :-



SHORT TERM Measures

Overcome BOP crisis
Control Inflation

LONG TERM Measures

Efficiency increase
Unemployment decrease

(A) FISCAL Reforms

→ There was fiscal deficit in the economy and we had a large Current A/c deficit (CAD). Therefore Fiscal reforms were needed.

→ Introduction of stable + transparent tax structure

→ Better "tax compliance"

→ Curbing Government expenditure

→ Reduction in Subsidies

→ Disinvestment

→ Encouraging "private investments"

* Government entered into a historic agreement with RBI in September 1994 to bring down fiscal deficit in phased manner to Nil by 1997-98.

Current A/c Deficit (CAD)
(exp > Receipts)

Fiscal deficit
(exp > Receipts)
Borrowings

(B) Monetary and Financial Sector Reforms

→ Interest rate liberalisation

→ Reduction in controls on Bank by RBI

→ Opening new private Banks

Reduction in controls on Bank by RBI

- Opening new private Banks
- Reduction in Reserve requirements i.e (RR, SLR etc) (Recommendation by Narsimhan Committee)
- Liberalising of Bank "branch" licensing policy
- Prudential Norms of accounting were introduced. (classification of Assets)

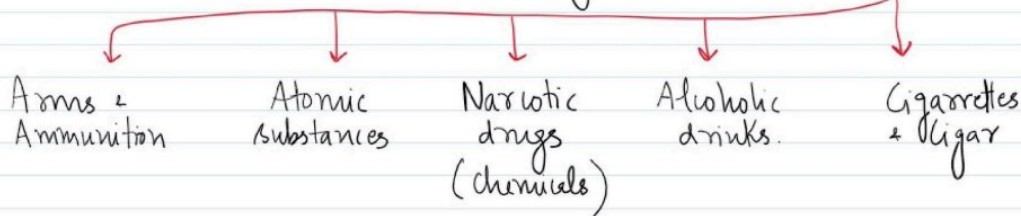
(C) Capital Market Reforms

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

(D) New Industrial Policy

- New Industrial policy was announced on 24 July 1991

- Put an end on Licence Raj - Removing license for all industries except for (18) industries. Subsequently reduced to (5)



- Public Sector was limited to (8) sectors only. Subsequently only (2)
 - Railways
 - Atomic energy

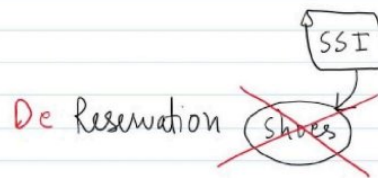
- MRTAP Act was restructured

→ MRTTP Act was restructured

- restriction in concentration of economic power in few hands.
- control of monopolies
- "prohibit" restrictive trade practices



→ Many goods produced by small scale industries were De reserved



→ This policy ended the public sector monopoly in many sectors

→ foreign investments was also liberalised
(concept of Automatic Approval was introduced for foreign direct investment upto 51%.)

→ External trade was also liberalised

→ Rupee was devalued by 18% against dollar.

(E) Trade Policy Reforms

→ dismantling of "quantitative restrictions" on import & export

limits ~~ETP~~

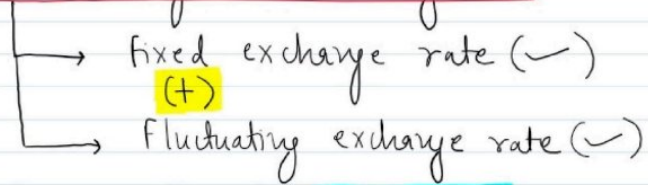
→ focus on outward oriented regime

~~Inward looking trade policy~~

~~Inward looking trade policy~~

→ Removal of licensing procedures for imports.

* In 1991, the Indian Government devalued rupee by around 18%. In 1992, the government decided to establish a dual exchange rate regime



1993 onwards, India adopted Managed Floating exchange rate regime

* * CRUX of all above Reforms :-

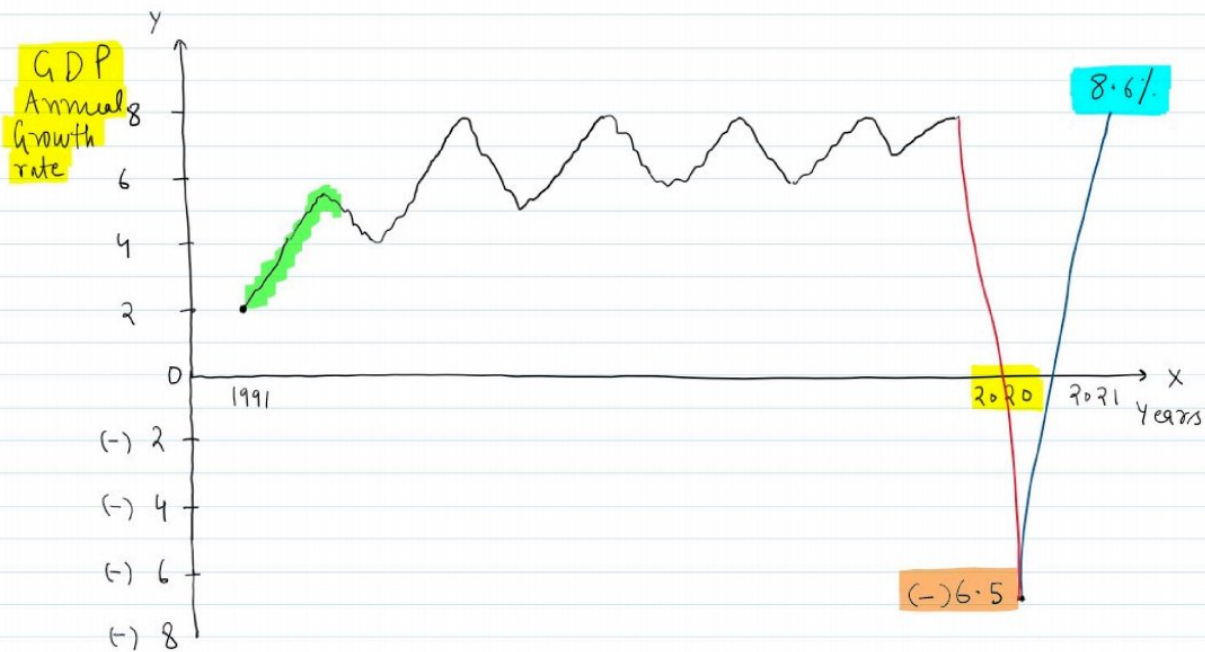
- India has progressively moved towards market oriented economy
 - Growth of Private sector investment
 - Ease of trade 😊
 - Robust demand for Information Technology and financial services has kept the services trade surplus high.
(Inflows > outflows)
 - Poverty has reduced substantially
 - Reforms led to Increased Competition
 - Improvement in financial sector.
- ☹ However, the fiscal deficit of the country remains high

TT

Post 1991

V

POST REFORMS



VI

NITI Aayog

→ On 1 Jan 2015, the apex policy making body namely Planning Commission, was replaced by National Institution for Transforming India (NITI) Aayog (Think Tank of the government)

→ Objectives :-

- National development
- help अर्थ (support) fooster cooperative federalism → centre & state division of power → सहसंयोजन
- develop mechanisms to formulate credible plans at village levels
- design strategic and long term policy
- offer platform for resolution of inter-"sectoral" and inter-"departmental" issues

- offer platform for resolution of inter-"sectoral" and inter"departmental" issues
- Focus on technological updation
- Etc Etc Etc

Key Initiatives (H.W study about them)

- "LIFE" - replaces the prevalent "use and dispose" economy
- The National Data & Analytics Platform (NDAP) facilitates and improves access to Indian government data
- Shooonya campaign - improve air quality
- E-Amrit - electronic vehicles
- India Policy Insights (IPI)
- Methanol Economy - aimed at reducing India's oil import bill, Green house gas emission and converting coal reserves & solid wastes into Methanol
- Transforming India's Gold market

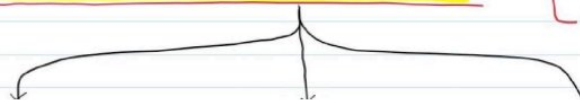
Weaknesses

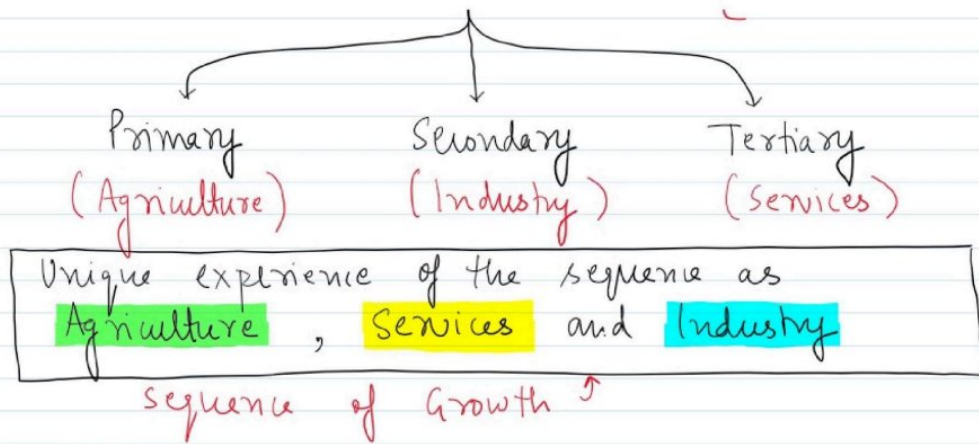
- limited role
- exclusion from "Budgeting process"
- lacks autonomy → (Freedom → Power)
- Termination of Planning Commission strengthens the "Ministry of finance."

VII

CURRENT STATE

[100% Ratta]





1. Primary Sector

- India has emerged as world's largest producer of milk, pulses, jute and spices.
- India has the largest area planted under wheat, rice and cotton
- India is the second largest producer of fruits, vegetables, tea, fish, cotton, sugarcane, wheat, rice and sugar.
- Indian food & grocery market is the world's 6th largest (contributing 70% of the retail sales)
- India has the world's largest cattle herd (buffaloes)
- India is among top ten exporters of agricultural products in the world. Agricultural and Processed Food Export Development Authority (APEDA) is entrusted with the responsibility of export promotion.
- Various measures are adopted by government such as :-
 - 100% FDI in marketing of food products
 - Income support to farmers (PM KISAN)
 - Fixing of MSP (Minimum Support Price)
 - National Mission for Edible Oils
 - Pradhan Mantri Fasal Bima Yojna (PMFBY)
 - Paramparagat Krishi Vikas Yojna (PKVY)

- Paramparagat Krishi Vikas Yojna (PKVY)
- Agri Infrastructure Fund
- Per Drop more Crop (PDMC)
- Micro Irrigation Fund
- Farmer Producer Organisation (FPO)
- **E-NAM** - National Agriculture Market
- Pan India electronic trading portal
- Start up Ew system
- Etc Etc Etc

- Issues**
- Fragmented land holdings
 - low farm productivity
 - low marketable surplus
 - Inadequate Infrastructure
 - Low level of technological upgradation
 - Inadequate post-harvest infrastructure
 - Etc Etc Etc

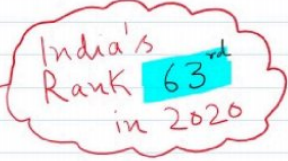
2. Secondary Sector

- Industrial sector contributes about **30%** of Gross Value Added (GVA)
- It employs over **12.1 crores** of people
- Manufacturing accounts for **78%** of total production.
- India's rank in Global Innovation Index (GII) improved to **40th** in 2022 from **81st** in 2015

... 10 in 2022 from 81st in 2015

→ The Department for Promotion of Industry and Internal Trade (DPITT) has a role in the formulation and implementation of Industrial policy.

→ Some Policies :-

- Vocal for local
- Ease of doing Business 
- National Single Window System.
- Make in India
- PM Gati Shakti National Master Plan
- National Logistics Policy (NLP)
- FAME - India Scheme - promote electric & hybrid vehicle
- Remission of Duties & Taxes on Export Products (RoDTEP) 2021 - It replaced Merchandise Exports from India Scheme
- Start Up India
- Emergency Credit Line Guarantee Scheme
- Foreign Investment Facilitation Portal - It replaced Foreign Investment Promotion Board (FIPB)
- Etc Etc

Challenges

- Inadequate Infrastructure
- heavy reliance on Imports

- inadequate infrastructure
- heavy reliance on imports
- Inadequate Manpower
- Strained labour-management relation
- Slow external demand
- Lower export competitiveness
- Supply chain uncertainties.
- Etc Etc

तनावपूर्ण

③ SERVICE sector

- It is the largest sector of India
- It accounts for 53-89% of India's GVA
- It has highest labour productivity
- It is the fastest growing sector
- India is among top 10 WTO members in service exports & imports
- India's service exports at US \$ 27 billion (Nov 2022)
- To ensure liberalisation of investment, government has permitted 100% foreign participation in telecommunication services through automatic route
- The India Development Update (IDU) of the World Bank published in 2022 holds optimistic view that compared to other emerging economies, India is more resilient to adversities

"adaptive"

x ————— x ————— x ————— x ————— x ————— x