CA Foundation – June 2024

(New Syllabus)

Business Economics Last Day Summary

By CA Mohnish Vora (MVSIR)

Note-

These notes are only a summary of some important topics of relevant chapters for LAST DAY STUDIES.

Students can refer following MVSIR's Books-

- Micro Eco Shastra- for detailed topics
- Super Chart Book- All important topics for revision

Students can order above books from- mvsir.in (Super Charts can also be bought in e-book form)

CA Mohnish Vora (MVSIR)

- CA, CFA LEVEL 1, B.COM
- Faculty for
  - CA Foundation- Business Economics
  - CA Intermediate- Financial Mgt & Strategic Mgt
- 4+ years of teaching experience
- Passionate about teaching, started teaching at a young age
- Known for making difficult concepts easy by innovative examples, charts, summary & tricks
- Taught thousands of students on various online platforms in a short span of time
- Author of Best selling Books on Economics, BCK, FM

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Business Economics
Last Day Summary

Chapter 6
National Income

By CA Mohnish Vora (MVSIR)

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Chp 6: Determination of National Income
Unit 1: Macro Economic Aggregates and Measurement of National Income

- The **performance of an economy** depends on **output** of goods and services produced by it, which is measured by National Income.
- In order to calculate National Income, first we need to understand the concept of GDP.

- **Gross domestic product (GDP)** is a measure of-
  - ✓ **monetary value** of
  - ✓ all **final**
  - ✓ **economic** goods and services,
  - ✓ **gross of depreciation**,
  - ✓ **produced within the domestic territory** of a country
  - ✓ **during a given time period**.

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

Also, according to the **Central Statistical Organisation (CSO)** 'National income is the **sum total of factor incomes** generated by the **normal residents** of a country in the form of **wages, rent, interest and profit** in an **accounting year**'.

EXCLUSIONS FROM GDP & NATIONAL INCOME

1) **Transfer Payments** (Govt. **making a payment**, **without goods** or services **received in return**)
2) **Financial transactions** (**Stocks & bonds transactions** – do **not** involve current production)
   But, **value of services accompanying sale** (e.g. fees to agents/broker) **is included**.
3) **Sale of 2nd Hand goods**
4) **Non-reported output – illegal transactions.** Eg – narcotics and gambling

NOMINAL GDP vs REAL GDP

- '**Nominal GDP**' or '**GDP at current prices**' changes due to 2 reasons-
  1) Qty produced **changes**, and/or
  2) When **market prices change**.

  Changes in GDP due to changes in price **fail to explain performance of economy**

- **Real GDP** or **GDP at constant prices** is an **inflation adjusted** measure of GDP
  - ✓ **Not affected** by changes in **prices**;
  - ✓ **Changes only when** there is change in **qty produced**.

  Thus, Real GDP is a **better measure** of **economic well being**

GDP Deflator

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

$$\text{Inflation rate in Yr 2} = \frac{\text{GDP deflator in Yr 2} - \text{GDP deflator in Yr 1}}{\text{GDP Deflator in Yr 1}} \times 100$$

DOMESTIC VS NATIONAL

- 'National' → normal residents of a country who may be within or outside domestic territory of a country & is a broader concept compared to the term 'domestic'.
- The term 'domestic' refers to production done by people WITHIN the domestic territory

IMPORTANT FORMULAS

- **Net Factor income from abroad (NFIA)**

  = Factor income earned by domestic factors of production employed in rest of world (-) Factor income earned by factors of production of rest of world employed in domestic territory

- **Operating Surplus** = Rent + Interest + Profit .....(also add Loyalty if given in Question)

- **3 Golden Rules of NI**

1) Gross – Depreciation = Net
2) MP = FC + IDT - Subsidy ....or.... MP = FC + NIT
3) Domestic + NFIA = National

Total 8 Aggregates

1) GDP at MP	5) GNP at MP
2) GDP at FC	6) GNP at FC
3) NDP at MP	7) NNP at MP
4) NDP at FC	8) NNP at FC

- **Net Domestic Product at Factor Cost (NDP FC)**

  (aka. - Domestic Income or Factor Income earned in Domestic Territory)

  = Compensation of employees (+) Operating Surplus (+) Mixed Income

- **National Income (NNPFC)** = NDPfc + NFIA

- **GDP Per Capita**

✓ Measure of country's economic output per person. Indicator of standard of living of country

✓ GDP Per Capita = Real GDP / Total Population

- **Indirect Taxes and Subsidies**

1) **Production Taxes & Production Subsidies**

These are independent of the volume of actual production

2) **Product Taxes & Product Subsidies**

Paid or received on per unit of product

Basic Price		Market Price	
=	Factor Price	=	Basic Price
+	Production Taxes	+	Product Taxes
-	Production Subsidy	-	Product Subsidy

Personal Income

Income received by household sector including Non-Profit Institutions Serving Households from all sources

=	National Income
+	income recd but not earned
-	income earned but not recd

Disposable Personal Income

It is a measure of amount of money in the hands of the individuals that is available for their consumption or savings.

=	Personal Income
-	Personal Income Tax
-	Non Tax Payment

Income from domestic product accruing to private sector

=	NDP fc
-	Income from Prop. & Ent accruing to govt admin dep
-	Savings of Non dep enterprises

Private Income

It is a measure of the income (**both factor income and transfer income**) which **accrues to private sector** from **all sources within and outside** the country.

	Private Income
=	Income from domestic product accruing to private sector
+	Net factor income from abroad
+	National debt interest
+	Current transfers from government & rest of world

Net National Disposable Income (NNDI)

The amount of G/S domestic economy has at its disposal.

=	National Income (NNP fc)
+	Net Indirect Taxes
+	Net Current Trf. from rest of world

- **GNDI = NNDI + Depreciation**
- Ignore "**Govt transfer pay**" in calculation og GNDI / NNDI

Circular flow of income

Circular flow of income refers to the **continuous circulation** of- **production, income generation & expenditure** involving **different sectors** of the economy. There are 3 phases-

Production phase	Firms **produce** G/S with help of factor services.
Income or Distribution phase	The **flow of factor incomes** in the form of **rent, wages, interest and profits** from firms **to** the **households** occurs
Exp. or Disposition phase	**Income received** by factors is **spent** on **consumption of** G/S and **investment** goods. This **exp. leads to further production** of G/S & **sustains circular flow.**

Method	Data Required	What is measured?
Value Added Method or Product Method or Industrial Origin or Net Output Method	The sum of net values added by all the producing enterprises of the country	Contribution of production units
Factor Income Method or Factor Payment or Distributed Share	Total factor incomes generated in the production of goods and services	Relative contribution of factor owners
Expenditure method or Income Disposal	Sum of exp. of 3 spending units- 1. government, 2. consumer households, and 3. producing enterprises (firms)	Flow of consumption and investment expenditures

VALUE ADDED METHOD

Step 1- Calculate GVA for each sector

	Value of Output
-	Intermediate Cons.
=	**Gross Value Added**

Step 2- Calculate GVAmp by adding GVA of all sectors

	GVA by Primary Sector
+	GVA by Secondary Sector
+	GVA by Tertiary Sector
=	**GVA mp (GDP mp)**

Step 3- Calculate NNP fc from GDP mp

NNP fc (National Inc.)
GDP mp **(-) Depreciation** **(+) NFIA** **(-) Net Indirect Taxes**

- **If "Value of Output" is not given separately, then**

Value of Output = **Sales (+) Change in Stock**

(where→ Change in Stock = Cl. Stock – Op. Stock)

EXPENDITURE METHOD

Step 1- Calculate GDP mp

	Private Final Consumption Expenditure (PFCE) **(C)**
+	Gross Domestic Capital Formation (GDCF) **(I)**
+	Government / Public Final Consumption Exp. (GFCE) **(G)**
+	Net Exports **(X-M)**
=	**GDP mp**

Step 2- Calculate NNP fc from GDP mp

NNP fc (National Inc.)
GDP mp **(-) Depreciation** **(+) NFIA** **(-) Net Indirect Taxes**

GDCF (if not given in Q)

= Gross Domestic Fixed Capital Formation (H/B/G)
(+) Inventory Investment
(+) Net Acq. of Valuables

INCOME METHOD

	Compensation of Employees
+	Operating Surplus (R, I, P)
+	Mixed Income of Self-Emp
=	**NDP fc**
+	NFIA
=	**NNP fc (National Income)**

Comp. of Emp. does **not** include "Employee's Contribution to PF"

NI as per Inc. Method does **not** include-
→Int. paid by govt/firm
→Capital gains, windfall profits etc

NATIONAL INCOME IN INDIA

Ministry of Statistics and Programmed Implementation (MoSP&I)
↓
Central Statistical Organization (CSO)
↓
National Accounts Division
↓
National Accounts Statistics

Reliable statistical data is not available → not possible to estimate India's NI wholly by one method.

Therefore, a **combination of methods is used**.
- **Value-added method** → **commodity producing sectors like agriculture** and manufacturing.
- In **small scale sector** → **income method**, &
- In **construction sector** → **expenditure method**.

Method used for National Income in developed economies:
Income method → most suitable
But, sometimes **expenditure method** also used.

SYSTEM OF REGIONAL ACCOUNTS IN INDIA

State Income or **Net State Domestic Product (NSDP)** is a measure in **monetary terms** of volume of **all G/S produced** in **state** within a given **period of time** (generally a year) accounted **without duplication**.

Per Capita State Income is obtained by **dividing the NSDP (State Income)** **by** the **midyear projected population** of the state.

State level estimates are **prepared by** the **State Income Units** of respective State Directorates of Economics and Statistics (DESs). **CSO assists** & advices in **preparation**

Certain activities such as **railways, communications, banking and insurance and central government administration**, that **cut across state boundaries**, and thus their **economic contribution cannot be assigned to any one state** directly are known as the '**Supra-regional sectors**' of the economy. The estimates for these **compiled for economy as a whole** & **allocated to states** on basis of **relevant indicators**.

Can GDP be index of welfare?

No, since GDP measures **exclude** the following which are **critical for the overall wellbeing** of citizens.

a) **Income distributions**
b) Quality improvements → **technological** & **managerial innovations.**
c) **Productions hidden from govt.**, → **evading taxes** or **illegal** (**drugs, gambling etc.**).
d) **Non-market production** and **Non-economic contributors** → **health**, **education levels** etc.
e) **Economic 'bads'** → **crime**, **pollution**, **traffic congestion** etc which make us **worse off**.
f) **Volunteer work** → **without remuneration**
g) **Leisure time**, **fairness**, **gender equality**, **security of community feeling** etc.,

Limitations And Challenges of NI

Conceptual difficulties
1) **lack** of an **agreed definition** of national income,
2) **accurate distinction** between **final** & **intermediate** goods,
3) issue of **transfer payments**,
4) **difficulty** of **incorporating distribution of income**,
5) **valuation of a new good** at **constant prices**, and

Challenges
1) **Inadequacy of data** and **lack of reliability** of available data,
2) **absence** of **recording of incomes** due to **illiteracy and ignorance**,
3) **lack** of **proper occupational classification**, and
4) accurate **estimation** of **consumption of fixed capital**
5) production for **self-consumption**

Chp 6: Determination of National Income
Unit 2: The Keynesian Theory of Determination of National Income

INTRODUCTION

- In **previous unit, 'ex post'** (**realized**) values were used. In this unit, **Ex-ante** (**anticipated**) values are used, if we want to **predict** what **equilibrium value of output or GDP** is.

- Before Keynes, **classical economists** said that **economy is self-regulating** and is always **capable of automatically achieving equilibrium** at '**natural level**' of **real GDP**

- However, Keynes in his "**General Theory of Employment Interest & Money**" → **markets** would **not automatically** lead to **full-employment equilibrium,** as **prices & wages are sticky (rigid)**, especially **downward**. This **prevents economy** from **returning to natural level** of real GDP. So, **output will remain at less than full employment level unless** there is **insufficient spending**.

- Keynesian theory of income determination is presented in **3 models**:

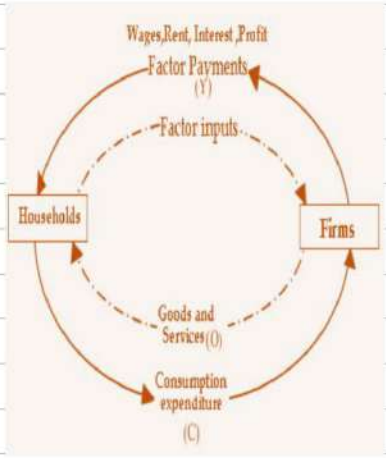
1) **Two-sector** = household + business,
2) **Three-sector** = household + business + government,
3) **Four-sector** = household + business + govt. + foreign

Circular Flow in a Simple Two-sector Model

- The **circular flow of income** is a process where the **national income** and **expenditure** of an economy **flow in a circular manner continuously** through time.

- Two sector economy model assumes **only two sectors** in economy viz., **households** and **firms**, with only **consumption** and **investment** outlays.

- In the figure-
  - Circular **broken lines** - factor and product flows- '**real flows**'
  - **Continuous line** with arrows show **money flows**



Factor Payments
= Household Income
= Household Expenditure
= Value of Output
= Total Receipts of Firms

Important Concepts

1) **Consumption function**- Functional **relationship between consumption spending and disposable income** → $C = f(Y) = a + b.Yd$

2) **Average Propensity to Consume**- Ratio of **total consumption to total income.**

$$APC = C / Y$$

Consumption is **decreasing function of income.**

3) **Marginal Propensity to Consume (MPC = "b")-** **Increment in consumer expenditure per unit of increment to income.** → **MPC = ΔC / ΔY = b**

✓ Keynes **assumes** that **consumption increases with an increase in Yd**, but that increase in consumption < increase in Yd

✓ Value of MPC is **between 0 & 1**.

✓ MPC is also the **slope of consumption line**

4) **Saving function-** Functional **relationship between saving & income** → **S = f(Y) = -a + (1-b).Yd**

5) **Marginal Propensity to Save**

✓ **Increment in saving per unit increase in disposable income.**

MPS = ΔS / ΔY = 1- b & **MPC + MPS = 1** ; **MPS 0 < b < 1**

Also, **MPS is slope of savings line**

6) **Average Propensity to Save-** Ratio of **total saving** to **total income.** → **APS = S / Y**

Saving is **increasing function of income.**

7) **Aggregate Supply (AS)-** Ex ante or planned AS → **total supply of G/S** which firms plan on selling during a specific time period.

✓ AS = Agg. Production = Factor Payments = Factor Incomes [National Income → Y]

8) **Aggregate Demand (AD)-** Total planned expenditure in the economy.

9) **Equilibrium output-** **Desired amount of output demanded** = **amount produced**. **(AD = AS)**

Two Sector Model

- Household Sector & Business Sector only
- AD = C + I (I is assumed to be constant)
- AS = C + S
- Equilibrium is achieved when - AD = AS **or** C + I = C + S **or** I = S

Three Sector Model

- Household + Business + Govt Sector
- AD = C + I + G (I & G are assumed to be constant)
- AS = C + S + T
- Equilibrium is achieved when AD = AS **or** C + I + G = C + S + T **or** I + G = S + T

Govt sector adds following flows to 2 sector model:

1) **Taxes**
2) **Transfer payments** & **subsidy payments**
3) **Govt purchases**
4) **Govt borrowing** to **finance deficits** (when G > T)

Four Sector Model

- Household + Business + Govt. + Foreign Sector
- AD = C + I + G + (X - M) (I, G & X are assumed to be constant)
- AS = C + S + T
- Equilibrium is achieved when - AD = AS or C + I + G + (X – M) = C + S + T or I + G + X = S + T + M

Foreign sector adds following flows to circular flow of 3 sector model:

1) **exports**,
2) **imports** and
3) **net capital inflow** which is the difference between capital outflow and capital inflow

If **(X > M) is +ve** then **NI increases.**

If **(X > M) is -ve** then **NI decreases.**

LEAKAGES & INJECTIONS

❑ **Leakage-** **Outflow of income from circular flow**→ part of income **not used to purchase goods**.

- 2 sector Model : Leakages = S
- 3 sector Model : Leakages = S + T
- 4 sector Model : Leakages = S+ T + M

❑ **Injection-** It is an **inflow of income to the circular flow**. Due to injection, the **volume of income increases**.

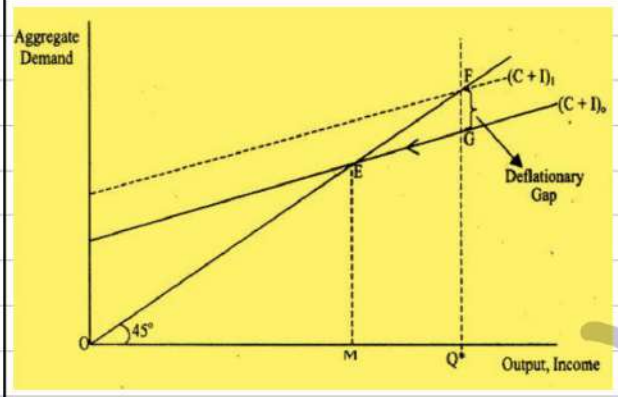
- 2 sector Model : Injection = I
- 3 sector Model : Injection = I + G
- 4 sector Model : Injection = I + G + X

❑ If **AS = AD → Leakages = Inj.** NI will be in **equilibrium**.

❑ If **AS > AD → Leakages > Inj.** Stock Surplus or Deficient Demand → **(NI will fall)**

❑ If **AS < AD → Leakages < Inj.** Stock Shortage or Excess Demand → **(NI will rise)**

DEFLATIONARY & INFLATIONARY GAP

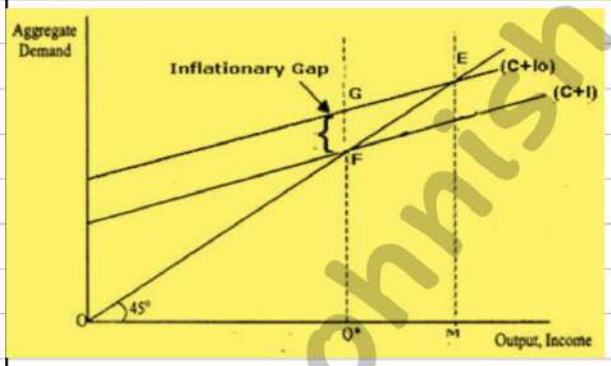


Deflationary Gap

If actual AD < **full employment level of output** → **deficient demand**.

It leads to '**recessionary gap**' or '**contractionary gap**'. Occurs when economy is in contraction.

Firms will **experience unplanned build-up of inventories → decrease in output & income** in future until **under-employment equilibrium is reached at E**.



Inflationary Gap

If actual AD > **full employment level of output** → **excess demand**.

It leads to '**inflationary gap**',. Occurs during **expansion** & causes **demand pull inflation**.

Real output will be constant, but rise in prices will cause **increase in nominal output** until **new equilibrium** is reached at **point E**.

INVESTMENT MULTIPLIER

Investment Multiplier (k) → **how many times equilibrium NI (Y) increases** as result of **increase in autonomous investment (I)**.

More the leakages → Smaller the multiplier

$$K = \frac{\Delta Y}{\Delta I} \text{ or } \frac{1}{1 - MPC} \text{ or } \frac{1}{MPS}$$

IMPORT

Import function is-

M= M + mY

Marginal propensity to import ->

m = Δ M / Δ Y

is assumed to be constant.

SUMMARY OF MULTIPLIER

How to solve Numerical MCQs of National Income?

Will make students write above in marathon class on "Ultimate CA" YouTube Channel.

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Chapter 8
Money Market

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Chapter 8 - Money Market
Unit 1 – The Concept Of Money Demand: Important Theories

BASICS

- **Money** is something that **holds its value over time**, can be **easily translated into prices,** and is **widely accepted**.
- **Fiat Money-** Fiat money (aka. token money) has **no intrinsic value** (materially worthless), that is, it has no value if it were not used as money. It is used as medium of exchange as govt has, by law, made them "**legal tender,**" which means, **they serve, by law, as means of payment**.

DEFINITION OF MONEY

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

As a **statistical concept**, money could include certain **liquid liabilities** of a particular set **of financial intermediaries** or other issuers'.

CHARACTERISTICS OF MONEY

Money should be:

- generally **acceptable**
- **durable** or long-lasting
- effortlessly **recognizable**.
- **difficult to counterfeit** i.e. not easily reproducible by people
- relatively **scarce**, but has elasticity of supply
- **portable** or easily transported
- possessing **uniformity**; and
- **divisible** into smaller parts in usable quantities or fractions **without losing value**

FUNCTIONS OF MONEY

1) Convenient medium of exchange
2) Explicitly defined unit of value or unit of account
3) Serves as a unit or standard of deferred payment
4) Store of value

DEMAND FOR MONEY

- If **people desire to hold money**, we say there is **demand for money**.
- Demand for money is in the nature of **derived demand**; it is **demanded for its purchasing power**.

THEORIES OF DEMAND FOR MONEY

I) CLASSICAL APPROACH: QUANTITY THEORY OF MONEY

- Given by **Irving Fisher** in his book 'The Purchasing Power of Money'
- As per QTM, **money in circulation (M)** & **price level (P)** are directly **related** to each other. (Linear) That is, changes in prices or changes in the value or purchasing power of money are determined by changes in quantity of money in circulation.
- QTM is aka. '**equation of exchange**' or '**transaction approach**'

MV = PT

- Later, Fisher **extended the equation** of exchange to **include demand (bank) deposits (M')** **and their velocity (V')**

Expanded Form : MV + M'V' = PT

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

II) CAMBRIDGE APPROACH

- Aka **Cash Balance Approach** or **Neo-Classical Theory**

- **Money increases utility** in the following **two ways-**
  1) **Split-up of sale and purchase** to two different points of time (transaction motive)
  2) **hedge against uncertainty**. (temporary store of wealth)

- Since **sale & purchase** do **not take place simultaneously**, people need '**temporary abode**' of purchasing power as hedge against uncertainty.

- **How much money will be demanded as per Cambridge Approach?**

→ **Higher the income** -> **greater the transactions** -> **greater demand for money**.

Md = k PY

PY = nominal income ,

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

Iii) Keynesian Theory of Demand for Money

- Aka. '**Liquidity Preference Theory**'→ people demand money for three motives:

Transactions motive, Precautionary motive, & Speculative motive

a) Transactions motive

Money for **current transactions** for **personal** & **business** exchange (income motive & business motive).

Money is demanded **to bridge time** gap between receipt of **income** & planned **exp.**

Transaction demand for money is **directly related** to level of income

Lr = kY

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

b) Precautionary motive

Portion of income kept to **finance unanticipated exp** which occur due to **unforeseen contingencies.**

Precautionary money balances are **income elastic** and & **interest inelastic**

c) Speculative motive

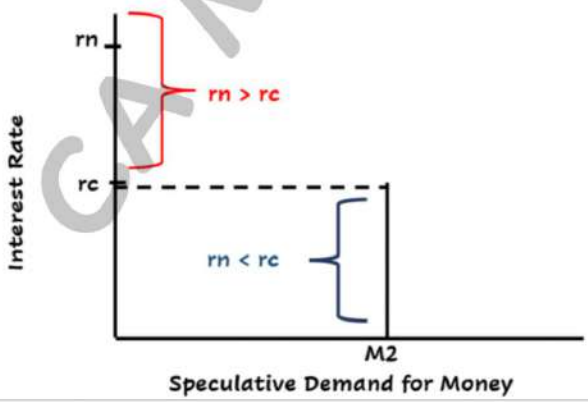
People also demand money to **take advantage of future changes in rate of interest,** which is same as future changes in bond prices. (to **exploit** any **attractive investment opportunity)**

Assumed that **return on money is zero,** while **returns on bonds** are of **two types**: **interest payment** & **capital gain**

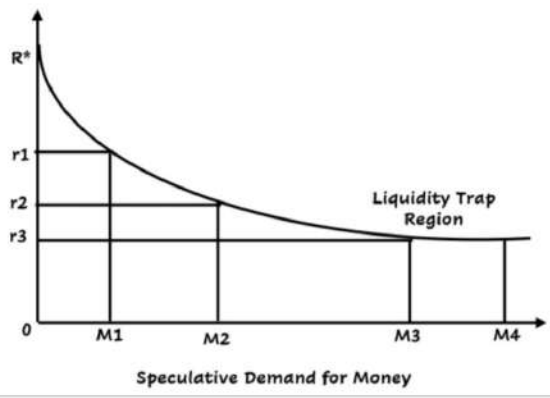
Market Value of Bond inversely related to Market Rate of Interest

Current rate of interest (rn) > Critical rate of interest (rc)	Current rate of interest (rn) > Critical rate of interest (rc)
People **expect a fall in interest rate** (**rise** in bond prices) People will **convert their cash balances into bonds** (SDM Decr & Bond Incr)	People **expect a rise in interest** rate (**fall** in bond prices) People would hold their wealth in **liquid cash** rather than bonds. (SDM Incr & Bond Decr)

Individual's Speculative Demand for Money



Aggregate Speculative Demand for Money



❑ **Liquidity Trap**

➢ When **interest rates fall to very low levels,** the **expectation** is that now **cannot go further lower** & will **move upwards** in future.

➢ Thus, when **interest rates rise in future**, the **bond prices will fall** leading to taking **risk** of a **capital loss** in future

➢ Thus at such low interest rates-

❑ desire to **hold bonds** is **very low** and **approaches zero**, and

❑ demand to **hold money** in liquid form **approaches infinity.**

➢ The **speculative demand of money curve** becomes **parallel to** the **X axis**, i.e, **perfectly elastic** with respect to interest rate.

➢ This situation is called a '**Liquidity trap**'. **(ineffective monetary policy)**

➢ Empirical evidence of Liquidity Trap is found during "**Global Financial Crisis (2008)"**

Post-Keynesian developments in Theory of Demand for Money

IV) Inventory Approach to Transaction Balances

➢ Aka. **Inventory Theoretic Approach**
➢ Given by **Baumol and Tobin**, in which money is viewed as an **inventory held for transaction purposes.**

➢ Inventory models assume that there are **two media for storing value:**
1) **Money &**
2) **an interest-bearing alternative financial asset**

➢ There is **fixed cost of making transfers** between money & alternative assets e.g. **brokerage**
➢ As per Baumol, people hold an **optimum combination** of **bonds and cash balance,** i.e., an amount that **minimizes opportunity cost.**

➢ The level of inventory holding (holding money in cash)-
is **DIRECTLY RELATED** to
❑ **Income of person**
❑ **Cost of making transfer between money and bonds**
&
is **INDIRECTLY RELATED** to
❑ **Carrying cost**
❑ **Number of times bond transaction are made**

V) Friedman's Restatement of Quantity Theory

Milton **Friedman extended Keynes' speculative money demand** within the framework of **asset price theory.**
Friedman's **four determinants** of the demand for money
1. **Total wealth = Permanent Income / discount rate**

Where, discount rate is average return on five asset
2. Positively related to the **Price Level, P**
3. Rises if **opportunity costs** of money holdings (i.e. returns on bonds and stock) decline
4. **Inflation** – Positive inflation rate reduces the real value of money balances, thereby increasing the opportunity costs of money holdings

IV) Inventory Approach to Transaction Balances

Given by Tobin in his article, **'Liquidity Preference as Behaviour towards Risk'**
This theory is based on the principles of **"Portfolio Management"**

An individual would hold **optimally structured portfolio** which is **comprised of both**
> **Bonds-** (provides return for the risk borne) and
> **Money-** (No return, but also no risk)

Just as Keynes' theory, Tobin's theory also implies that **demand for money** depends **negatively on the interest rate.**

Chapter 8 - Money Market
Unit 2 – CONCEPT OF MONEY SUPPLY

BASICS

- The term money supply denotes **the total quantity of money available with public**
- Two things about any measure of money supply:

Supply of money is a **stock variable** **Change in stock of money is a flow variable**	It refers to stock of money **available to 'public'.** This is **always smaller than the total stock of money that really exists** in economy.

- **'Public'** **all economic units except the producers of money** (i.e. the government and the banking system).
- **Government** = CG, all SGs, and local bodies.
- **Banking system** means **RBI** and all **banks that accept demand deposits**

- Thus, **'supply of money'** **EXCLUDES**
  - **interbank deposits** and
  - money held by **government** and
  - money held by **banking system**

Rationale of measuring money supply

Empirical analysis of money supply is important because-

1) Facilitates **analysis of monetary developments** → to understand causes of money growth.
2) Provides a **framework** to evaluate whether money supply is consistent with-**standards for price stability** and to **understand nature of deviations.** It helps in **making monetary policy**

Sources of money supply

Central Banks → **High powered money or Monetary Base**

It is **issued by monetary authorities**, & is **source** of all other forms of money.
The currency issued by central bank is **'fiat money'** & is **backed by supporting reserves** → its **value is guaranteed by Govt.**

Banking system → **Credit Money**

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

High powered money + Credit Money = Total money stock of a country

- The concept of money has experienced evolution from **Commodity** to **Metallic** to **Paper** to **Digital Currency.**

- Reserve Bank has introduced a concept of **Central Bank Digital Currencies (CBDCs)- as legal tender issued by a central bank in a digital form.** It is like **sovereign paper currency** but takes a **different form, exchangeable at par with existing currency** and shall be accepted as a medium of payment, legal tender and a safe store of value. CBDCs would appear as liability on a central bank's balance sheet.

- Also, **Crypto currencies** are **not legally recognized** in India as currency & are not **money.**

Measurement of money supply

- **Reserve money (M0)** is aka.- **central bank money** or **base money** or **high-powered money**

Reserve money determines -

- ✓ level of liquidity and
- ✓ price level in economy and,

thus, its management is of crucial importance to stabilize the economy.

	Currency in circulation
+	Bankers' deposits with RBI
+	Other deposits with the RBI
	Reserve Money (M0)

	Currency with Public
+	Demand deposits with banks (Current A/c & Saving A/c)
+	Other deposits with RBI
	M1 (Narrow Money)

	M1
+	Savings dep with Post Office
	M2

	Notes in Circulation
+	Circulation of Rupee Coin
+	Circulation of Small Coins
-	Cash on Hand with Banks
	Currency with Public

	M1
+	Time deposits with Banks
	M3 (Broad Money)

	M3
+	Total dep. with Post Office (excl. National Savings Cert.)
	M4

Difference M0 & M1	M0	M1
Bank Reserves	✓	✗
Bank Deposits	✗	✓

- **The above are given in descending order of liquidity – M1 (Most Liquid) & M4 (Least Liquid)**
- **'Other deposits' with the RBI excludes** those **held by govt** (Central & State Govt.)

Money Multiplier (m)

The money multiplier process explains **how an increase in monetary base** causes **money supply to increase by a multiplied amount**

1st Formula

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

where, Monetary Base = Currency in circulation + Bank reserves

2nd Formula

$$\text{Money Multiplier (m)} = \frac{1 + c}{r + e + c}$$

where,
- **c = currency ratio** = currency / dep.
- **r = required reserve ratio** = required reserves / deposits
- **e = excess reserve ratio** = excess reserves / deposits

3rd Formula

If we **assume-**
1) **Banks never hold excess reserves**. (e = 0)
2) Individuals and non-bank corporations **never hold currency** (c = 0)

Then, money multiplier is **reciprocal of the required reserve ratio**.

Money Multiplier (m) = 1 / Required Reserve Ratio
= 1 / R

m = 1 / R

Above formula can also be referred as
Credit Multiplier or
Deposit Multiplier or
Deposit Expansion Multiplier

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

Determinants of Money Supply

- Money multiplier approach to money supply given by Milton Friedman and Anna Schwartz, (1963) considers **three determinants-**
  1. **Stock of high-powered money (H)** → Depends upon Behaviour of Central Bank
  2. **Reserve-ratio (r) = R / D** →Depends upon Behaviour of Commercial Banks
  3. **Currency Deposit Ratio (c) = C / D** → Depends upon Behaviour of Public

1. Stock of high-powered money (H)

- Money supply **varies directly** with supply of high-powered money.

2. Reserve-ratio (r) = R / D

- If required reserve ratio **increases -**
  - ✓ banks will decrease lending,
  - ✓ causing a decline in deposits

  and hence money supply will **decline** .....& vice versa

- **Smaller** the 'r' → **larger** the 'm'

❑ **Excess Reserves (ER)** are funds that a bank keeps as reserve beyond what is required by regulation as a **buffer against unexpected events requiring cash.**

❑ **Excess reserves (ER) = Total reserve (TR) – Reqd. Reserve (RR)**

➢ Excess Reserves **do not lead to any additional loans.**

➢ **Smaller** the Excess Reserve Ratio 'e' → **larger** the 'm'

➢ When **opportunity cost to bank of holding ER rises , level of ER falls m** will be **larger**

➢ If expected deposit outflows increase, banks will will **increase ER ratio. Thus, m will fall**

➢ Eg- During festival season, people decide to use ATMs very often

3. Currency Deposit Ratio (c) = C / D

➢ If public keeps more **money in cash,** leads to an **increase in 'c'** & **banks can create less credit money,** thus **m falls.**

Eg- Fearing shortage of money in ATMs, people decide to hoard money

➢ Currency-deposit ratio (c) also represents **degree of adoption of banking habits** by people, affected by **degree of financial sophistication,** ease & access to financial services etc.

Eg- 1) Banks open **large number ATMs** all over the country, or

2) **E-banking becomes very common** and nearly all people use them

✓ Above factors will **reduce 'c';** thus **increasing 'm'** & **money supply**

❑ The **time deposit-demand deposit ratio** (TD/DD ratio) i.e. how much money is kept as time deposits compared to demand deposits.

➢ An **increase in TD/DD ratio → higher the 'm'**

Monetary Policy and Money Supply

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

Eg - Open Market Operations (OMO) by central banks.

Purchase of govt. securities injects high powered money (monetary base) into system.

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

Effect of government expenditure on money supply

When **RBI lends to governments** under **Ways & Means Advances (WMA)/overdraft (OD)** → leads to **generation of excess money supply in economy** through money multiplier process.

Chapter 8 - Money Market
UNIT 3 - MONETARY POLICY

Introduction

- RBI uses monetary policy to **manage economic fluctuations** & achieve **price stability**, which means that **inflation is low** and **stable.**
- RBI conducts monetary policy by adjusting supply of money, usually **through buying or selling** securities in open market.
- **Open market operations** affect short-term interest rates, which in turn influence longer-term rates & economic activity.
- ✓ When RBI **lower interest rates**, monetary policy is **easing.**
- ✓ When it **raises** interest rates, monetary policy is **tightening**

The Monetary Policy Framework

It has three basic components-
(i) **objectives** of monetary policy,
(ii) **analytics** of monetary policy which focus on transmission mechanisms, &
(iii) **operating procedure** which focuses on operating targets & instruments

Objectives of monetary policy

The primary objective of monetary policy is maintenance of **judicious balance** between **price stability** & **economic growth.**

Objectives of Monetary Policy in case of developing countries

1) maintenance of **economic growth**
2) ensuring **adequate flow of credit to productive sectors**
3) sustaining a **moderate structure of interest rates,**
4) creation of an **efficient market for govt securities.**

Transmission of Monetary Policy

It describes **how changes** made by RBI to its monetary policy settings **flow through to economic activity** and inflation.
The transmission has two stages.
1. Changes to monetary policy **affect interest rates** in economy.
2. Changes to interest rates **affect economic activity** & **inflation**

Channels of Monetary Policy Transmission

1) Saving and Investment Channel
2) Cash-flow Channel
3) Asset Prices and Wealth Channel
4) Exchange Rate Channel

Operating Procedures and Instruments

Quantitative tools
Credit control tools that impact money supply of entire economy

1.	**Reserve Ratio**	Reserve ratio is of **two types-**
1a.	**Cash Reserve Ratio (CRR)**	Banks are required to set aside a portion of NDTL in **cash with RBI**. RBI not required to pay interest on CRR amount.
1b.	**Statutory Liquidity Ratio (SLR)**	Banks are also required to set aside a portion of NDTL **with itself**, in form of **liquid assets- cash, gold** or **RBI approved securities**. Banks are **allowed to earn interest** on these securities.
2.	**Open Market Operations (OMO)**	RBI buys and sells government securities in the market. When RBI **sells** government securities, the **liquidity is sucked** from market→ it is done to control inflation. The **objective** is to keep a check on **temporary liquidity mismatches** in market owing to foreign capital flow.

Qualitative tools
These are selective credit control tools that have affect money supply of specific sector & not whole economy.

1.	**Margin requirements**	When margin requirements are raised→ customers borrow less
2.	**Moral suasion**	By way of persuasion, the RBI convinces banks to keep money in government securities, rather than certain sectors.
3.	**Selective credit control**	Controlling credit by not lending to selective industries.

Market Stabilisation Scheme (MSS)	Under MSS, the **Govt of India borrows from RBI** (additional to its normal borrowing) and issues treasury-bills, for **absorbing excess liquidity** from market arising from large capital inflows.

Policy Rates

1.	**Bank Rate**	The interest rate at which RBI **lends long term funds** to banks. Aka. Discount rate. Bank rate is used to prescribe **penalty to bank** if it does **not maintain** prescribed **SLR or CRR**
2.	**Liquidity Adjustment Facility (LAF)**	RBI uses LAF as an instrument to adjust liquidity and money supply. The following types of LAF are-
2a.	**Repo Rate**	Repo rate is the rate at which **banks borrow from RBI** on a **short-term** basis against a **repurchase agreement**.
2b.	**Reverse Repo Rate**	It is the reverse of repo rate, i.e., this is the **rate RBI pays to banks** in order to **keep additional funds in RBI**. It is **linked to repo rate**→ **Reverse Repo Rate = Repo Rate – 1**
3.	**Marginal Standing Facility (MSF) Rate**	MSF Rate is the **penal rate** at which **RBI lends money to banks**, **over** the rate available under the **rep policy**. Banks availing MSF Rate can use a **maximum of 1% of SLR securities**. **MSF Rate = Repo Rate + 1**

Organisational Structure For Monetary Policy Decisions

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

- Announcement of an official target range for inflation is known as **inflation targeting**. (**'Flexible inflation targeting framework'**)

- The **inflation target** is to be **set by the Government of India**, in **consultation with RBI**, **once in every five years**.
-
- Accordingly, Central Government has notified-
- **4 per cent Consumer Price Index (CPI)** inflation as the **target** for period from **Aug 5, 2016 to Mar 31, 2021**

  with the-
  - ✓ **upper tolerance limit of 6 per cent** and
  - ✓ **lower tolerance limit of 2 per cent**.

- **Monetary Policy Report** is to be published every **6 months**, explaining **sources of inflation** & **forecasts** of inflation for the coming **6-18 months**

- The following are factors lead to a **failure to achieve inflation target**
- **Average inflation** > **upper tolerance** level, for any **three consecutive quarters**; or
- **Average inflation** < **lower tolerance** level, for any **three consecutive quarters**.

Monetary Policy Committee (MPC)

It is a **6-member committee** consisting of-

- **RBI Governor** (Chairperson),
- **RBI Deputy Governor** in charge of monetary policy,
- **One official** nominated by the **RBI Board** and
- **Remaining three central government nominees** representing Govt of India

MPC is required to **meet at least 4 times a year** & **decisions** adopted by MPC are **published** after conclusion of every meeting.

MPC shall determine policy rate required to achieve inflation target.

CA Foundation – June 2024
(New Syllabus)

Business Economics
Last Day Summary

Chapter 10
Indian Economy

By CA Mohnish Vora (MVSIR)

Note-

These notes are only a summary of some important topics of relevant chapters for LAST DAY STUDIES.

Students can refer following MVSIR's Books-

- Micro Eco Shastra- for detailed topics
- Super Chart Book- All important topics for revision

Students can order above books from- mvsir.in (Super Charts can also be bought in e-book form)

STATUS OF INDIAN ECONOMY: PRE INDEPENDENCE PERIOD (1850 -1947)

- Between **1st & 17th century AD** → India was **largest economy of ancient & medieval world**.
- It was prosperous & self-reliant → controlled between **1/3rd & 1/4th of world's wealth.**
- **Agriculture** was **dominant occupation**, & main source of livelihood for majority of people.
- It also had a **highly skilled set of artisans & craftsmen** who produced **handicrafts & textiles.**

Ancient Economic Philosophy of India

- The **earliest treatise on ancient Indian economic philosophy** is '**Arthashastra**' by Kautilya (Chanakya) (321–296 BCE).
- Arthashastra → important works on statecraft in the genre of **political philosophy**.
- It was handbook for **King Chandragupta Maurya**, founder of Mauryan empire→ containing directives as to **how to reign** over kingdom & **encouraging direct action in political concerns**
- **Artha** is not wealth alone; → also includes all aspects of **material well-being**.
- **Arthashastra → science of 'artha' or material prosperity,** or "the means of subsistence of humanity," which is, primarily, '**wealth**' and, secondarily, '**the land**'.
- Major focus → means of **fruitfully maintaining and using land**.
- Kautilya emphasized on **robust agricultural initiatives** which will fill state's treasury.
- **Taxes** → charged **equal** for private & state-owned business, **fair** to all & **easily understood**.
- **True kingship** → **ruler's subordination of his own desires** to the **good of his people**;
- King's policies should reflect → **concern for greatest good of greatest number of his subjects**.
- **7 vital elements** →**King, Ministers, Farmlands, Fortresses, Treasury, Military** and **Allies**.

Period of British Rule

- The period of **British rule** can be divided into two sub periods:
  - Rule of **East India Company** from **1757 to 1858**
  - **British government** in India from **1858 to 1947**

- **Industrial revolution in Britain** in latter half of 18th century → required **raw material** & **markets for finished goods**→ led to change in nature of India's foreign trade from **exporter of manufactures** to **exporter of raw materials**

- **Indian exports** of finished goods were subjected to **heavy tariffs** and the **imports** were charged **lower tariffs** under the policy of **discriminatory tariffs** followed by the **British**. This made the India's **exports of finished goods costlier** & **imports cheaper**. Thus, Indian goods lost their competitiveness.

- The following led to **destruction** of **Indian handicrafts & manufactures**
  - **external** & **domestic demand** for **indigenous products fell sharply**
  - **hostile imperial policies** to serve British interests & competition from machine-made goods
  - Problem aggravated by **shift in demand** by **domestic consumers favouring foreign goods** as Indians wanted to affiliate themselves with western culture & life.

Stagnated Nature of Industrialisation: During the Colonial Era

- Indian **cotton mill industry** had **9 million spindles** in 1930s→ (**5th position** in **no. of spindles**)
- **Jute mills** expanded rapidly in **Calcutta** → global demand for **ropes**. At the **end of the 19th** century, **Indian jute mill industry was largest in world** in amount of **raw jute consumed.**
- Heavy industries like **iron industry** were **established** in **1814** by British capital.
- India's **iron industry was ranked 8th in world** in terms of output **in 1930**.
- **Before Great Depression(1930), India** was **ranked 12th largest industrialised country** measured by the value of manufactured products.
- The **producer goods industries**→ **did not show expansion** → because of pressure exerted by the English producers to **discourage development of industries in India** which were likely to compete with them.
- The **share in** Net Domestic Product (**NDP**) of **manufacturing sector** → **7% in 1946**.

Indian Economy: Post-independence (1947- 1991)

- **At time of independence**, India → **literacy rate 18%** & **32 yrs life expectancy in 1951**. India's poverty was in terms of income & human capital.
- **Nehruvian model** which supported social & **economic redistribution** and **industrialization** directed by the state came to **dominate the post-Independence Indian economic policy**.
- **Planning Commission of India** established in **1950** → plan for **economic development** in line with **socialistic strategy** → through **5-year plans** (First FYP- **1951**)
- **Rapid industrialization of economy** was **cornerstone** of **Nehru's development strategy**.
- The concept of '**planned modernization**' meant a **systematic planning to support industrialization**. (bureaucrats and technocrats)

Industrial Policy Resolution

- The **Industrial Policy Resolution (1948)** → expanded role of public sector & licensing to the private sector. It granted **state (govt.) monopoly** for strategic areas such as-
  - ✓ **atomic energy, arms and ammunition, & railways**.

  Also, rights to new investments in basic Industries were exclusively given to state.
- The **policies** in **1950's** were guided by two **economic philosophies**:

1. **Nehru's visualization** to **build a socialistic society** with **emphasis on heavy industry**, and
2. The **Gandhian philosophy of small scale and cottage industry** and **village republics**

- The **Industrial Policy Resolution of 1956** → framework for industrial development, but was lopsided as it supported **enormous expansion of scope of public sector**. (lead to **dampening of private sector initiatives**)

- India followed an **open** foreign trade policy **until late 1950s**. A **balance of payments crisis** emerged in **1958** causing concerns **regarding foreign exchange depletion**.
- Consequently, it lead to **gradual tightening of trade** & **reduction in investment-licensing** of new investments requiring imports of capital goods. These import controls were till **1966**.

- In first **3 decades after independence (1950–80)**, India's average annual rate of growth of GDP- '**Hindu growth rate**'- was **3.5 %**.

Agriculture Issues & Green Revolution

- **Strategy for agricultural development** till mid 1960s was reliance on **institutional model i.e. land reforms, farm cooperatives** etc. and no importance given to technocratic areas like R&D , irrigation etc.

- With continuous failures of monsoon, two severe **droughts struck India in 1966 & 1967**.

- The **agricultural sector recorded substantial negative growth** and India faced a serious food problem. **India had to depend on the United States for food** aid under PL 480.

- Restructuring of agricultural policy → '**green revolution**' was initiated soon → which was materialised by-
  - **innovative farm technologies, including high yielding seed varieties** &
  - **intensive use of water, fertilizer and pesticides**

Nationalisation of Banks

- The **government nationalized-**
  - ✓ **14 banks in 1969** and
  - ✓ then followed it up with **nationalizing another 6 in 1980**.

Indian Economy - Worst Performance

- The **economic performance** during "**1965-81**" **is the worst** in **independent India's history**.
- This happened due to-
  - ✓ **decline in productivity**.
  - ✓ license-raj,
  - ✓ the autarchic policies that dominated the 1960s and 1970s,
  - ✓ external shocks such as **three wars** (in 1962, 1965, and 1971),
  - ✓ major droughts (in 1966 and 1967), and
  - ✓ oil shocks of 1973 and 1979.

Monopolies and Restrictive Trade Practices (MRTP) Act, 1969

- The MRTP Act, 1969 was aimed at **regulation of large firms** which had relatively **large market power**. Several **restrictions** were placed on them in terms of **licensing**, **capacity addition**, **mergers** and acquisitions.
- Thus, policies restricting the **possibility of expansion of big business houses kept their entry away** from nearly all but a **few highly capital intensive sectors**.

Reservation for Small Scale Sector

- In **1967**, many products were **reserved** for exclusive manufacture by the **small scale sector**
- It was thought that this policy will encourage **labour-intensive economic growth & allow redistribution of income**.
- However, this policy **excluded all big firms from labour intensive industries** and **India** was **not able to compete** in the **world market** for these products. **Stringent labour laws** also discouraged labour intensive industries.

The Era of Reforms

- The initiatives, spanning **1981 to 1989**, were referred to as '**early liberalization**' which aimed at **changing** prevailing thrust on '**inward-oriented**' **trade and investment practices**.
- This liberalization is often referred to as '**reforms by stealth**' to denote its **ad-hoc & not widely publicized nature**.
- The **average annual growth rate of GDP** during-
  - **sixth plan period** (1980–1985) was **5.7 %** and
  - **seventh plan period** (1985–1990) was **5.8 %**
- The **early reforms of 1980's** covered **three areas**- **industry**, **trade** and **taxation**.

❑ The prominent **industrial policy initiatives** during this period directed towards **removing constraints on growth** were:

- ✓ In 1985 delicensing of **25 broad categories** of industries was done.
- ✓ The facility of '**broad-banding**' was accorded for industry groups to **allow flexibility and rapid changes** in their product mix without going in for **fresh licensing**.
- ✓ The **asset limit** above which firms were subject to **MRTP regulations** was **raised** from **20 crore** to **100 crore.**
- ✓ The **multipoint excise duties** was **converted** into a **modified value-added** (**MODVAT**) tax which reduced taxation on inputs.
- ✓ **Establishment** of the Securities and Exchange Board of India (**SEBI**) in **April 12, 1988**
- ✓ The **open general licence (OGL)** list was expanded & the number of capital goods items reached **1,329** in April 1990.
- ✓ Several **export incentives** were introduced and expanded

- ✓ **Exchange rate** was set at a **level** → to **expand exports** & **reduced pressure on foreign exchange** needed for imports
- ✓ **Price and distribution controls** on **cement** and **aluminum** were entirely **abolished**.
- ✓ Based on the real effective exchange rate (REER), the rupee was depreciated by about **30.0 per cent** from 1985–86 to 1989–90.
- ✓ The **budget for 1986** introduced policies of-
  - ❖ cutting taxes further,
  - ❖ **liberalising imports &**
  - ❖ **reducing tariffs**.

➢ Thus, **liberalization in the 1980s** served as necessary **foundation** for the more **universal and organized reforms of the 1990s.**

The Economic Reforms of 1991

➢ The economic reforms in 1991 under the **Narsimha Rao government**.

➢ The **causes** attributed to the immediate **need for such a drastic change** are:

1) Large **fiscal deficit** (financed by **huge debt),** & adverse balance of payments.
2) Persistent huge deficits → **swelling public debt** → govt revenue used for **interest payments**
3) **Surge in oil prices** (due to gulf war in 1990) & thus **strain on a balance of payments**.
4) The **foreign exchange reserves** touched **lowest point** → only **$1.2 billion** → sufficient for only two weeks of imports.
5) **Tightening of import restrictions** to collect forex for essential imports resulted in **reduction in industrial output**.
6) India had to **depend on external borrowing** from **International Monetary Fund** which in turn puts stringent conditions.
7) **Fragile political situation** along with economic crises → led to '**crisis of confidence**'.

➢ 1991 reforms→ known as **LPG- Liberalization**, **Privatization** and **Globalisation**, had **two major objectives**:

1) **reorientation** of the economy from a centrally directed and highly controlled one to a '**market friendly' or market oriented economy**.
2) **macroeconomic stabilization** by substantial reduction in fiscal deficit.

➢ The policies can be broadly classified as:

1) **stabilization measures** → **short term** measures → for **problems of inflation** & **adverse balance of payment,** &
2) **structural reform measures** → **long term** → aimed at **bringing in productivity** & **competitiveness** by **removing structural rigidities** in different sectors of economy.

Fiscal Reforms

- Bringing in fiscal discipline by reducing the fiscal deficit was vital because-
  - ✓ **excess domestic demand**,
  - ✓ **surge in imports** and
  - ✓ **widening of the current account deficit (CAD)**

  This was attempted by measures to **increase govt revenues** & **curtail govt exp**.

- Measures to this effect included:
  1) Introduction of a **stable and transparent tax structure**,
  2) Ensuring **better tax compliance**,
  3) Thrust on **curbing government expenditure**
  4) **Reduction** in **subsidies and abolition of unnecessary subsidies**
  5) **Disinvestment** of part of **govt's equity holdings** in select PSUs &
  6) **Encouraging private sector participation**.

Monetary & Financial Sector Reforms

- The focus was mostly on-
  - **reducing the burden of NPAs** on government banks,
  - introducing and sustaining competition, and
  - **deregulating interest rates**.

- These included many measures, important among them are:

1) **Interest rate liberalization** & **reduction in controls on banks** by **RBI** in respect of interest rates.
2) **Opening of new private sector banks** & facilitating competition among public, private sector and foreign banks and removal of **administrative constraints.**
3) **Reduction in reserve requirements** namely, SLR & CRR, in line with recommendations of the **Narasimham Committee Report, 1991**.
4) **Liberalisation of bank branch licensing policy** and granting of freedom to banks in respect of **opening, relocating or closure of branches**
5) **Prudential norms of accounting** in respect of classification of assets, disclosure of income and provisions for bad debt, to ensure books of banks reflect truthful financial position.

Reforms in Capital Markets

- SEBI which was set up in 1988 was given **statutory recognition in 1992.**

- It is an **independent regulator of the capital market** → creates a **transparent environment** which would **facilitate mobilization of adequate resources** and their efficient allocation.

The 'New Industrial Policy'

➢ The '**New Industrial Policy**' was announced on **24 July 1991** → substantially deregulate industry to promote growth of a **more efficient and competitive industrial economy**.

➢ To facilitate **domestic industry**, a series of **reforms** were introduced-

1. Ended **'License Raj'** by **removing licensing restrictions** industries **except for 18,** later reduced to 5, namely-
   1) arms and ammunition,
   2) atomic substances,
   3) **narcotic drugs** and
   4) **hazardous chemicals**,
   5) distillation and brewing of alcoholic drinks and cigarettes and cigars

   as these have **severe implications on health, safety, and environment**.

2. Public sector was limited to eight sectors based on security and strategic grounds. Subsequently only two items remained – **railway transport and atomic energy**

3. **MRTP Act** was restructured and the provisions relating to merger, amalgamation, and takeover were repealed. This has eliminated the need for pre-entry scrutiny of investment decisions and **prior approval for large companies for capacity expansion or diversification**.

4) Products reserved for **small-scale industries** → **dereserved** enabling entry of large scale ind

5) The policy **ended the public sector monopoly** in many sectors. Now industries reserved for public sector are only a part of **atomic energy generation** and **railway transport**.

6) **Foreign investment** → liberalized → concept of **automatic approval** was introduced. FDI is prohibited only in **four sectors** viz. **retail trade, atomic energy, lottery business & betting and gambling.**

7) **External trade** was further **liberalised** by substituting 'the positive list approach' of listing license-free items on the **OGL** list with the **negative list approach**.

8) In **1990-91**, the **highest tariff rate** was **355%**. The top tariff rate was brought down to 10% in 2007-08, with some exceptions such as automobile at 100%

9) Rupee was **devalued by 18%** against the dollar.

10) **Disinvestment** of government holdings of equity in PSUs. PSUs were provided with **greater autonomy in decision making** and **opportunity for professional management**. The **budgetary support** to public sector was **progressively reduced**.

Notes

NITI AAYOG: A bold step for transforming India

- Planning Commission was abolished in 2014→ & on **1st Jan 2015** it was replaced by the **National Institution for Transforming India (NITI) Aayog**.

- The major objective of such a move was to-
  - ✓ '**spur innovative thinking** by objective 'experts', &
  - ✓ promote '**co-operative federalism**' by enhancing the voice & influence of states'.

- NITI Aayog is expected to serve as a '**Think Tank**' of the government & a 'directional and policy dynamo'.

- **The key initiatives of NITI Aayog are:**

1. **'LiFE'** which envisions **replacing** the prevalent **'use-and-dispose' economy**
2. **National Data and Analytics Platform** (NDAP) facilitates and **improves access to Indian government data**
3. **Shoonya campaign** aims to **improve air quality** in India by accelerating the **deployment of electric vehicles**
4. **E-Amrit** is a one-stop destination for all information on **electric vehicles**

5. **India Policy Insights** (IPI)
6. **'Methanol Economy'** programme → for **reducing India's oil import bill**, **greenhouse gas emissions**, & **converting coal reserves** and municipal **solid waste into methanol**, and
7. **'Transforming India's Gold Market'** → recommend measures for tapping into the potential of the sector and provide a **stimulus to exports and economic growth**.

❑ **Shortcomings of NITI Aayog**

- NITI has a **limited role**→ does not produce national plans, control expenditures, or review state plans.
- It is **excluded from the budgeting process**.
- It **lacks autonomy & balance of power** within policy making apparatus of central govt.
- The termination of Planning Commission → strengthened Ministry of Finance, with its 'fixation of macroeconomic stability & natural instinct to limit expenditure'.
- It **lacks the independence** & **power** to perform as a '**counterweight**' to act as a "**voice of development**" **concerned with inequities**.

The Current State of the Indian Economy: A brief overview

I) **The Primary Sector**

- Agriculture, with its allied sectors, is the **largest source of livelihood** in India.

- **India** has **emerged as-**
  - ✓ **world's largest producer** of **milk**, **pulses**, **jute** and **spices**.
  - ✓ **largest area planted** under **wheat**, **rice** and **cotton**.
  - ✓ **2nd largest producer** of **fruits**, **vegetables, tea, farmed fish, cotton, sugarcane, wheat, rice, cotton, and sugar.**
  - ✓ **world's 6th largest food and grocery** market is the
  - ✓ **world's largest cattle herd** (buffaloes).

- **47% of India's population** is **directly dependent on agriculture** for living. It contributed **18.80%** to the Gross Domestic Product (**GDP**).

- **Food grains production has reached 315.7 million tonnes in 2021-22.**
- **Private investment** in agriculture has increased to **9.3%** in 2020-21.

- Agri sector had a growth of **3.50%** in 2022-23, driven by **buoyant rabi sowing**
- **Export of agricultural** → touched an all-time peak of **Rs 3,74,611 crore** during last one year, & it **rose by 25 percent within 6 months of current financial year 2022-23** (Apr-Sep)

- **Agricultural and Processed Food Export Development Authority (APEDA)** is entrusted with the **responsibility** of **export promotion of agri-products**.

A large number of measures were undertaken by government to improve agri. sector-

1) Allowing **100% FDI** in marketing of food products and in food product E-commerce under the automatic route
2) **Income support** to farmers through **PM KISAN**
3) Fixing of **Minimum Support Price (MSP)** at **1.50 times** the **cost of production**
4) **Institutional credit** for agriculture sector at **concessional rates**
5) Launch of the **National Mission for Edible Oils**
6) **Pradhan Mantri Fasal Bima Yojana (PMFBY)** – a novel **insurance scheme** for financial support to farmers **suffering crop loss/damage**
7) **Mission for Integrated Development of Horticulture** (MIDH) for the holistic growth of the **horticulture** sector
8) Provision of **Soil Health Cards**
9) **Paramparagat Krishi Vikas Yojana** (PKVY) supporting and promoting **organic farming**, and **improvement of soil health**.
10) **Agri Infrastructure Fund**, a medium / long term debt financing facility for investment in viable projects for post-harvest management Infrastructure and community farming assets
11) Promotion of **Farmer Producer Organisations** (FPOs) to **ensure better income** for the producers through an organization of their own.
12) **Per Drop More Crop (PDMC)** scheme to **increase water use efficiency** at the farm level
13) Setting up of **Micro Irrigation Fund**
14) Initiatives towards **agricultural mechanization**
15) Setting up of **E-NAM** **-a pan-India electronic trading portal** which networks the existing **APMC mandis** to create a **unified national market** for agricultural commodities.
16) Introduction of **Kisan Rail** for **improvement** in farm produce **logistics**, and
17) Creation of a **Start-up Eco system** in agriculture and allied sectors

II) The Secondary Sector

- Secondary sector contributes **30%** of **total gross value added** in the country and employing over **12.1 crores** of people.
- The industrial sector in India broadly **comprises of-** manufacturing, heavy industries, fertilizers, pharmaceuticals, chemicals and petrochemicals, oil and natural gas, food processing, mining, defence products, textiles, retail, micro, small & medium enterprises, cottage industries and tourism.
- The **share of informal sector in the economy is more than 50% of GVA**.
- Manufacturing sector accounts for **78% of total production**.
- In **Jan 31, 2023** the Manufacturing Purchasing Managers' Index (PMI) in India stood at 55.4. **India's rank in the Global Innovation Index** (GII) improved to **40th in 2022 from 81st in 2015.**

➢ **Department for Promotion of Industry and Internal Trade (DPIIT)** has a role in **formulation and implementation** of **industrial policy** and **strategies for industrial development.**

➢ **Some of the policies are presented below:**

1) **Introduction** of **GST** on **1 July 2017** as single indirect tax **replacing** many indirect taxes.
2) **Reduction of corporate tax to domestic comp.** giving an option to pay income-tax at **22%**
3) '**Make in India**' is a **'Vocal for Local'** initiative launched in 2014 to- facilitate **investment, innovation, infrastructure** in India.
4) '**Ease of Doing Business**' → simplification of procedures, rationalization of legal provisions, digitization of government processes, and decriminalization of minor defaults. India ranks **63rd** in the **World Bank's** annual **Doing Business Report** (DBR), 2020
5) **The National Single Window System** is a one-stop-shop for **investor related approvals** & provide **continuous facilitation and support to investors**.
6) **PM Gati Shakti National Master Plan** to **facilitate data-based decisions** related to integrated planning of **multi-modal infrastructure**, thereby reducing logistics cost.
7) **National Logistics Policy (NLP)**→ aims to lower cost of logistics
8) To become 'Atmanirbhar', the **Production Linked Incentive (PLI) Scheme** was initiated for **14 key sectors** to enhance India's manufacturing capabilities and export competitiveness.
9) **Industrial Corridor Development Programme: Greenfield Industrial regions** with sustainable infrastructure and to make available '**plug and play' infrastructure at the plot level.**
10) **FAME-India Scheme** (Faster Adoption and Manufacturing of Hybrid and Electric Vehicles) to **promote manufacturing of electric and hybrid vehicle technology**
11) '**Udyami Bharat**' → empowerment of Micro Small and Medium Enterprises (MSMEs).
12) **PM Mega Integrated Textile Region and Apparel** (PM MITRA): ensure **world-class industrial infrastructure** & **boost FDI** and **local investment in the textiles sector**.
13) **Opening up for global investments**: Make India a more attractive investment destination
14) **100 per cent FDI under automatic route** is permitted for the sale of **coal**, and **coal mining** activities, & insurance intermediaries.
15) **Foreign Investment Promotion Board (FIPB)** was abolished in May 2017, and replaced by **Foreign Investment Facilitation Portal** (**FIFP**). Under FIFP, process for granting FDI approvals has been simplified. FDI has **increased jumped by 39% since FIFP** came.
16) **Remission of Duties and Taxes on Export Products (RoDTEP) 2021 formed to replace the existing MEIS** (Merchandise Exports from India Scheme) to boost exports. It provides for **rebate** of all hidden central, state, and local duties/taxes/levies on goods exported
17) **Start-up India Programme** → facilitator for ideas & innovation in the country. **India's rank** in the **Global Innovation Index** (GII) → **40th in 2022**.
18) **Public Procurement (Preference to Make in India) Order, 2017** gives preference to **locally manufactured goods/serv.** in **public procurement** thereby giving boost to industrial growth.
19) **Emergency Credit Line Guarantee Scheme (ECLGS)** is a fully guaranteed emergency credit line to **monitor lending institutions**.

➢ India is gearing up for **4th industrial revolution** or **Industry 4.0** in which focus will be on- **cloud computing, IoT, machine learning, & artificial intelligence (AI).**
➢ The **National Manufacturing Policy** which aims to **increase the share of manufacturing in GDP to 25% by 2025** is a step in this direction.

III) The Tertiary Sector

- Unlike the usual economic development process of nations where **economic growth has led to a shift from- agriculture to industries**,
  India has unique experience of **bypassing the secondary sector** in the growth trajectory by a **shift from agriculture to services sector.**

The broad classification of services as per the National Industrial Classification, 2008	
1.	Wholesale and retail trade and repair of vehicles
2.	Transportation and storage
3.	Accommodation and food service activities
4.	Information and communication
5.	Financial and insurance activities
6.	Real estate activities
7.	Professional, scientific and technical activities
8.	Administrative and support services
9.	Public administration, defence and compulsory social security
10.	Education
11.	Human health and social work activities
12.	Arts, entertainments and recreation
13.	Other service activities
14.	Activities of households as employers, undifferentiated goods and services producing activities of households for own use
15.	Activities of extra territorial organizations and bodies

- The **service sector** refers to **industry producing intangible goods** viz. services as output.

- The services sector is the **largest sector of India** & accounts for **53.89% of total India's GVA**. Gross Value Added (GVA) of services sector is estimated at **₹ 96.54 lakh crore** in 2020-21.

- The service sector is the **fastest growing sector** in India and has the **highest labour productivity**. The exceptionally rapid expansion of **knowledge-based services** such as **professional** and **technical services** has been responsible for the faster growth of the services sector.

- The start-ups which have grown remarkably over the last few years mostly belong to the **services sector**.

- **India** is among **top 10** WTO members in **service exports and imports**.

- India's **services exports** at **US$ 27.0 billion** recorded robust growth in November 2022 due to software, business, and travel services.

- While exports from all other sectors were adversely affected, India's services exports remained **resilient during the Covid-19 pandemic**. The reasons are the **higher demand** for **digital support** and need for **digital infrastructure modernization**.

- Services sector is **largest recipient of FDI inflows**. FDI equity inflows into the services sector accounted for **more than 60 per cent** of the total FDI equity inflows into India.

- The **World Investment Report 2022 of UNCTAD** places **India** as **7th largest recipient of FDI in the top 20 host countries in 2021**.

- In 2021-22, India received the **highest-ever FDI inflows of US$ 84.8 billion** including **US$ 7.1 billion** FDI equity inflows in the **services sector**.

- To ensure liberalisation, government permitted **100% foreign participation** in **telecommunication services** through Automatic Route.

- The **FDI ceiling in insurance companies** was also raised from 49 to **74%**.

- Measures undertaken by the Government, such as the launch of the **National Single-Window system** and **enhancement in the FDI ceiling** through the **automatic route**, have played a significant role in facilitating investment.

Conclusion

- The **India Development Update (IDU) of the World Bank** published in November 2022, observes that India had to face an unusually challenging external environment-
  - Russia-Ukraine war,
  - **increased crude oil** and **commodity prices**,
  - **persistent global supply disruptions**,
  - **tighter financial conditions** and
  - **high domestic inflationary pressures**.

- Despite all these, the **real GDP of India grew by 6.3 percent in July-September** of **2022-23 driven by strong private consumption** and **investment**.

- The report observes that **India's economy** is relatively **more insulated from global spillovers** than other emerging markets

- As such, compared to other emerging economies, **India is much more resilient to withstand adversities in the global arena.**

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