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CA Foundation – Business Economics

Last Minute Notes

(Only Important Points)

Economics Chapter 1

Nature & Scope of Business Economics

Disclaimer- These notes are meant only for **last-minute revision**. They are **not a substitute of Super Chart book** of MVSIR. Students must read each point in more detail & should refer to chart book for complete understanding.

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CHAPTER 1 - NATURE & SCOPE OF BUSINESS ECONOMICS | UNIT 1 - INTRODUCTION

1	Two fundamental facts of Economics ➤ Unlimited Wants ➤ Resources → relatively scarce resources (Problem of Scarcity) & have alternative uses
2	We cannot have everything we want with resources we have, we are forever forced to make choices .
3	Problem of scarcity is faced by EVERYONE & EVERY COUNTRY.
4	'Economics' is derived from Greek word ' Oikonomia '. Its meaning is ' household management '.
5	Till 19 th century, Economics was known as ' Political Economy '
6	Economics Definition • Adam Smith (Father of Economics) - Wealth Definition → wrote book- Wealth of Nations (1776) • JB Say - Economics science deals with wealth • Alfred Marshall - Welfare Definition • Lionel Robins (Robinson) - Scarcity Definition
7	Most economic problems are of complex nature , & are affected by several forces

8	Study of economics helps us in- ➤ Developing an analytical approach ➤ Choosing best course of action But Economics- ➤ cannot ensure → all problems are tackled ➤ Helps to examine a problem in its right perspective .						
9	Joel Dean defined "Business Economics" as use of economic analysis in formulation of business policies. Aka. Applied or Managerial Economics						
10	<table border="1"> <thead> <tr> <th>Micro Economics</th> <th>Macro Economics</th> </tr> </thead> <tbody> <tr> <td>Study of individuals or group of units. How individual efficiently allocate resources</td> <td>Study of economy as a whole. Analyzes overall eco. environment. Aggregate Economics</td> </tr> <tr> <td>Eg- Product pricing, Factor pricing, economic conditions of section of people, Location of industry.</td> <td>Eg- National Income, General price level Balance of trade (BoT) & payments (BoP), savings & investment, level of employment & economic growth rate</td> </tr> </tbody> </table>	Micro Economics	Macro Economics	Study of individuals or group of units . How individual efficiently allocate resources	Study of economy as a whole . Analyzes overall eco. environment . Aggregate Economics	Eg- Product pricing, Factor pricing , economic conditions of section of people , Location of industry.	Eg- National Income, General price level Balance of trade (BoT) & payments (BoP), savings & investment , level of employment & economic growth rate
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CHAPTER 1 - NATURE & SCOPE OF BUSINESS ECONOMICS | UNIT 1 - INTRODUCTION

11	Micro-economics deals primarily with: comparative statics, partial equilibrium, & positive economics.
12	<p>Nature of Business Economics</p> <p>1) Science (Social science) 2) Based largely on Micro Economics 3) Incorporates elements of Macro Analysis 4) Art 5) Pragmatic in Approach Micro-Economics → abstract & purely theoretical Business Eco → pragmatic (tackles practical prob.) 7) Interdisciplinary in nature 8) Normative in Nature</p> <ul style="list-style-type: none"> • <u>Positive Economics</u> – Descriptive, “What is” current situation, analyses cause & effect relationship • <u>Normative Economics</u> – Prescriptive, “What should be” done for welfare, involves value judgements
13	<p>Scope of Business Economics</p> <ul style="list-style-type: none"> ➤ <u>Operational / Internal Issues</u> (solved using Micro-Economics- Arise within org & are within control) ➤ <u>Environmental / External Factors</u> (solved using Macro-Economics)- Not within control of mgt; thus org. should fine-tune its policies accordingly

14	Economics	Business Economics
Meaning	Framing of principles	Application of principles
Character	Micro & Macro	Micro economic
Nature	Positive & normative	Normative
Scope	Wider Scope	Narrow scope

CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

15	<p>Economic system → Sum total of arrangements for the production and distribution of goods and services in a society.</p>
16	<p>Every economic system has to deal with central problem of scarcity of resources relative to wants.</p> <p>4 Central economic problems-</p> <ol style="list-style-type: none"> 1) What to produce? → What & how much to produce 2) How to produce? → Capital or Labour Intensive 3) For whom to produce? → How G/S distributed 4) What provisions are to be made for economic growth?

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CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

3 Types of Economies	Capitalism (free market or laissez-faire)	Socialism (Command or Controlled or Centrally Planned)	Mixed Economy
Meaning	<ul style="list-style-type: none"> ➤ All resources → private indv. for profit. ➤ Eg- USA, UK, Hong Kong etc. 	<ul style="list-style-type: none"> ➤ Karl Marx & Frederic Engels → 'Communist Manifesto' (1848) 	Includes best features of both capitalism & socialism
Characteristics	<ul style="list-style-type: none"> ➤ Profit motive is driving force ➤ Right to private property ➤ Freedom of enterprise & choice ➤ Consumer sovereignty- cons. is king ➤ Absence of Govt Interference ➤ Regulatory mechanism- COMPETITION- (optimum allocation of resources & cost minimized) 	Production by Govt. is aimed at maximizing welfare of public <ol style="list-style-type: none"> 1) Collective Ownership 2) Economic planning by CPA 3) Absence of Consumer Choice 4) Equal Income Distribution 5) Administered prices → set by Govt. 6) No Competition 	<u>There are three sectors of industries:</u> <ol style="list-style-type: none"> 1) Private sector 2) Public sector 3) Combined sector
Merits	<ul style="list-style-type: none"> ➤ Consumers benefitted – many good quality goods at low prices- results in higher standard of living ➤ Self-regulating and resources allocated by price mechanism ➤ Functions in a democratic framework ➤ Offers incentives for efficient economic decisions ➤ Encourages enterprise & risk taking 	<ol style="list-style-type: none"> 1) No waste on advertisement exp 2) Unemployment is minimised, 3) Business fluctuations are eliminated 6) Avoids class war 7) Right to work & min. standard of living 8) Labourers & cons. → no exploitation 9) Comprehensive social security 	<ul style="list-style-type: none"> ➤ Economic freedom & private property ➤ Consumers' sovereignty & freedom of choice. ➤ Economic planning & rapid development ➤ Greater equality ➤ Disadv. of competition averted by legislations



CHAPTER 1 | UNIT 2 - BASIC PROBLEMS OF AN ECONOMY AND ROLE OF PRICE MECHANISM

3 Types of Economies	Capitalism (free market or laissez-faire)	Socialism (Command or Controlled or Centrally Planned)	Mixed Economy
Demerits	<ul style="list-style-type: none"> ➤ Vast economic inequality- 'haves' & 'have-nots' ➤ Precedence of property rights over human rights ➤ Exploitation of labour & consumers. ➤ Resource misallocation ➤ Waste of resources - huge spent on advertisement 	<ul style="list-style-type: none"> 1) Bureaucracy & red tapism, corruption, favouritism 2) Not provide incentive to hard work 3) State monopolies - uncontrollable 5) No freedom of choice 6) No importance to efficiency. 7) Extreme form of socialism is not practicable (This economy is <u>myth</u>) 	<p>(Mixed economy is not a golden path between capitalism & socialism)</p> <ul style="list-style-type: none"> ➤ Excessive controls by state → constrained growth ➤ Poor implement of plans ➤ Higher rates of taxation ➤ Undue delays, Lack of efficiency, Corruption ➤ Poor performance of public sector
How it solves central problems?	<ul style="list-style-type: none"> 1) What to produce? → decided by consumers 2) How to produce? → LIT or CIT whichever is cheaper 3) For whom to produce? → Higher the income, higher buying capacity & higher demand for goods. 4) Provision (Saving & Invst) <ul style="list-style-type: none"> ➤ Interest Rate high- more saving ➤ More profit expectation- more invt 	<p>Central Planning Authority</p>	<p>It uses a mix of both price mechanism & central planning</p>

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CA Foundation – Business Economics

Last Minute Notes

(Only Important Points)

Economics Chapter 2

Theory of Demand & Supply

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

1	Demand is not same thing as desire to purchase.
2	Effective Demand = Desire + ATP + WTP
3	Two things about quantity demanded. i. Qd → expressed at a given price. ii. Qd → flow concept (Time period is important)
4	<p>Determinants of Demand</p> <p>i) Price of the good- price increases → demand decreases & vice versa</p> <p>ii) Price of related goods</p> <ul style="list-style-type: none"> • Complementary goods (goods used together) → Eg Car & Petrol → inverse relation • Substitute/Supplementary/Competing goods (goods which satisfy same want) → Eg Tea & Coffee → direct relation <p>iii) Disposable Income of Consumers Depends on nature of goods.</p> <p>iv) Taste & Preferences Modern or fashionable → higher demand.</p> <p>v) Consumers' Expectations If consumer expects → Increase in future price OR future income OR Shortage in future → Curr. Dem. Incr</p>

5) Nature of Good	Meaning
Normal Goods	Increase in income → higher demand.
Essential Consumer Goods	Satisfies basic needs of consumers. Incr. in demand < incr. in income.
Durable Goods (can be used more than once)	As people become richer → rise in importance of durable goods.
Inferior Goods	Increase in income → lesser demand. A same good may be normal for one condition & inferior in another.
Luxury / Prestige Goods	Demand rises beyond a level of income & keep rising as income incr.
6) 4 Types of "Effects" influences Tastes & preferences	
Demonstration Effect (Dekha-Dekhi)	Given by James Duesenberry , Desire of people to emulate (imitate) others.
Bandwagon Effect (Bhed-Chaal)	Extent to which demand is increased since others are also consuming same. Purchasing goods to be fashionable or stylish or to conform to people.



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

Snob Effect (function of consumption of others)	Extent to which demand is decreased since others are also consuming same . Desire to be exclusive (to dissociate from common herd)	c) The level of National Income & its Distribution	Higher national income → higher demand Rich → lower propensity to consume (PTC) Poor → higher PTC. Uneven Distribution → PTC less , demand less Even Distribution → PTC more , demand more
Veblen Effect (function of price)	Given by Thorstein Veblen . People buy high priced goods to show-off , style, money (conspicuous consumption).		e) Govt. policies and regulations
7) Other Factors (Determinants of Demand)		8 As per Alfred Marshall , Law of demand → ceterus paribus (other things equal), if price falls , qty dem will rise & vice versa	
a) Size of population	Larger size of population → higher demand	9 Demand schedule → table showing qty that buyers demand at different prices, per unit of time It obeys (follows) law of demand .	
b) Age Distribution of population	More old people, then demand for spectacles, sticks, etc. will be high. If more of children , demand for toys, toffees, etc. will be more. Migration from rural areas to urban areas, there decrease in demand in rural areas.	10 Demand curve → graphical presentation of demand schedule → Price on Y-axis & Qty Dem on X-axis . Slope of demand curve is → $-\Delta P/\Delta Q$ -ve sign in slope → consistent with law of demand.	
c) Consumer-credit facility & int. rates	Low interest rate, high demand More credit available, then high demand		

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

11	<p>Market demand → total qty that all buyers are willing to buy</p> <p>Market demand curve → horizontal (lateral) summation of all individual demand curves.</p>	<p>iv) a) Substitution effect When price of X falls, it becomes relatively cheaper than other goods → thus qty dem of X increases. When price falls, substitution effect is always positive Substitution effect will be stronger when: (a) goods are closer substitutes (b) there is lower cost of switching (c) there is lower inconvenience while switching</p> <p>iv) b) Income effect ➤ When price falls, consumer can <input type="checkbox"/> buy same quantity with lesser money, or <input type="checkbox"/> buy more of same good with same amount.</p> <p>➤ In case of inferior goods, <input type="checkbox"/> income effect works in opposite direction to substitution effect. <input type="checkbox"/> expansion in demand due to a price fall will take place only if SE > IE. <input type="checkbox"/> Here, violation of law of demand takes place when Negative IE > SE</p>
12	<p>Demand function states relationship between <input type="checkbox"/> demand (dependent variable) & <input type="checkbox"/> its determinants (independent variables) $D_x = f(\text{Price of Good, Income, Price of Related Goods})$</p>	
13	<p>Demand Equation of straight-line demand curve $Q = a - bP$ 'a' → vertical intercept & 'b' → slope.</p>	
14	<p>Rationale of the law of demand i) Utility maximising behaviour of Consumers ii) Arrival of new consumers iii) Different Uses iv) Price effect Total fall in qty demanded due to an increase in price is → Price effect. It has two components (given by Hicks & Allen) substitution effect & income effect.</p>	

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

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Exceptions to the law of demand

1) Conspicuous goods

- Aka. **Prestige** or **Snob** or **Veblen** goods
- Price of jewellery rises, demand may also rise as consumers attach a **snob value** to owning & expensive items. **Eg- Diamonds**
- By **Veblen** in **doctrine of Conspicuous Consumption**

2) Giffen Goods

- Given by **Robert Giffen** → as **price of bread incr.**, British workers **purchased more bread.**
- **Direct price-dem** relation → **upward** slope **dem** curve
- **Indirect income-dem** relation → **downward** slope **engel** curve
- All Giffen Goods are inferior Goods, but **all inferior goods are not Giffen** Goods

3) Conspicuous necessities

- Demand affected by **demonstration effect** of **consumption pattern of their social group**. These goods, due to **constant usage**, become **necessities** of life. Eg- **TV**, refrigerators, etc.

4) Future expectations about prices

When **prices are rising** → **expect** that **prices in future** will be **still higher** → **buy larger quantities** currently.

5) Irrational Consumer

- **Ignorant** of ruling price
- **Irrational** → **impulsive purchase** without calculation

6) Demand for necessities

Irrespective of price changes → have to consume minimum quantities of necessities. Eg- **Food** etc.

7) Speculative goods

In stock market → **more demand** when **price incr** & vice-versa.

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Changes in Demand vs Qty Demanded

Demand		Quantity Demanded	
It is the entire relationship between price & qty demanded .		It is the quantity which is demanded at a specific price .	
Represented by entire demand schedule & demand curve .		Represented by a point on demand curve .	
"Changes in Demand" occur due to changes in factors other than price of the good .		"Changes in Qty Demanded" occur due to changes in price of goods concerned .	
Favourable change	Unfavourable change	Increase in price	Decrease in price
Increase in Demand → Rightward shift in demand curve	Decrease in Demand → Leftward shift in demand curve	Contraction → Upward movement along same demand curve	Expansion → Downward movement along same demand curve



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

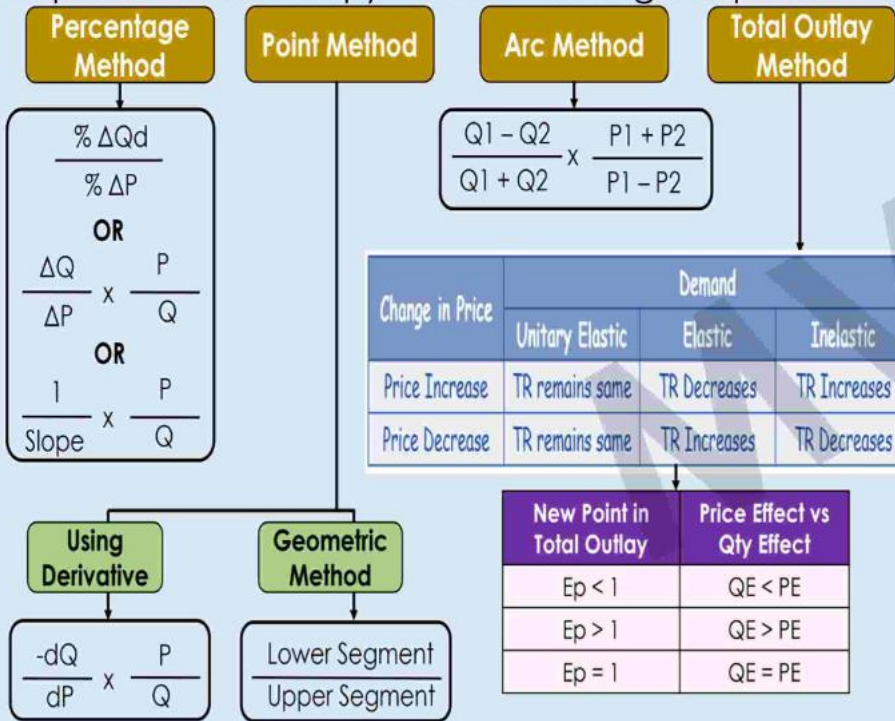
18

Objective of advertisement is to-
 ✓ **shift** demand curve to **right**, &
 ✓ **reduce elasticity** of demand

19

Price Elasticity of demand (Ep)

Responsiveness of qty dem to change in price



20

Value of Ep varies from $-\infty$ to 0, **however** while **interpreting** its value **we ignore -ve sign**

Value of Ep	Term	Meaning	Shape of Demand Curve
Ep = 0	Perfectly Inelastic Demand	Qd does not respond to change in price → %ΔQd = 0	Vertical-parallel to Y-axis
0 < Ep < 1	Inelastic Demand	%Δ Qd < %Δ Price	Steeper
Ep = 1	Unit Elastic Demand	%Δ Qd = %Δ Price	Rectangular Hyperbola
Ep > 1	Elastic Demand	%Δ Qd > %Δ Price	Flatter
Ep = ∞	Perfectly Elastic Demand	%Δ Price = 0 Small price reduction raises demand from 0 to ∞	Horizontal-parallel to X-axis

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Advt Elasticity of Dem. (Ea) → Value always **positive**

Percentage Method (Ea)		Arc Method (Ea)
$\frac{\% \Delta \text{Qty Dem.}}{\% \Delta \text{Advt Exp}}$	OR $\frac{\Delta Q}{\Delta A} \times \frac{A}{Q}$	$\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{A_1 + A_2}{A_1 - A_2}$

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CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 1 – THEORY OF DEMAND

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Determinants of Price Elasticity of Demand	
Availability of Substitutes	Goods having substitutes → Elastic No substitutes → Inelastic
Position of good in budget	Greater the proportion of income spent on a good → greater elasticity
Nature of need	Luxury goods (possible to postpone) → elastic Necessities (cannot be postponed) → inelastic
No. of uses	More uses of a good → greater elasticity
Time period	Long time to adjust to price change → elastic Short time period → inelastic
Habits	Consumer is habitual → inelastic
Tied demand	Tied demand → inelastic
Price Range	Very high price or very low-price range → inelastic Middle range → elastic demand.
Minor items	Cheap & complementary items → used with costlier product → inelastic demand .

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Income Elasticity of Dem. (E _y)	
Percentage Method (E_y)	Arc Method (E_y)
$\frac{\% \Delta \text{ Demand}}{\% \Delta \text{ Income}}$ OR $\frac{\Delta Q}{\Delta Y} \times \frac{Y}{Q}$	$\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{Y_1 + Y_2}{Y_1 - Y_2}$
Value of E _y	Type of Good
E _y = 0	No specific type of good
E _y is +ve → E _y > 0	Normal Goods
0 < E _y < 1	Necessities
E _y > 1	Luxury goods
E _y is -ve → E _y < 0	Inferior goods

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Cross Elasticity of Dem. (E _c)			
Percentage Method (E_c)		Arc Method (E_c)	
$\frac{\% \Delta \text{ Demand}(x)}{\% \Delta \text{ Price}(y)}$ OR $\frac{\Delta Q_x}{\Delta P_y} \times \frac{P_y}{Q_x}$		$\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{P_1 + P_2}{P_1 - P_2}$	
E _c = 0		Unrelated Goods	
E _c is +ve & Low	Remote Substitutes	E _c slightly below zero	Weak Complements
E _c is +ve & High	Close Substitutes	E _c is -ve & High	Strong Complements
E _c is +∞	Perfect Subst.	E _c is -∞	Perfect Compl.



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

1 All **desires, tastes and motives** of human beings are wants

Nature of Human Wants

- **Unlimited**
- **Differ in intensity**
- **Satiable**
- **Competitive**
- **Complementary**
- **Alternative**
- **Subjective** → vary from **person, time & place**
- Some wants **recur** whereas others **do not**
- May become **habits & customs**
- Affected by **income, taste, fashion, ads & customs**

2

Classification of Wants

Necessaries	Necessaries for life	Meet minimum physiological needs
	Necessaries for efficiency	To maintain longevity, energy & efficiency of work.
	Conventional necessities	Arise due to pressure of habit or compelling customs .

Comforts	They make life comfortable & satisfying . Comforts are less urgent than necessities.
Luxuries	Wants which are superfluous & expensive . Not essential for living.

3

Utility

- Utility → **anticipated / expected** satisfaction
- Commodity has utility **even when it is not consumed**

Cardinal Utility Approach	Ordinal Utility Approach
Here utility can be measured numerically .	Utility cannot be measured numerically → but can be ranked .
Law of Diminishing Marginal Utility (DMU) → by Marshall	Indifference Curve Analysis → by Hicks & Allen

4

Law of DMU

The **additional benefit** which a person derives from a given **increase in stock** of a thing **diminishes with every increase** in the stock that he already has.

Total Utility (TU) - **sum of marginal utilities**

- $TU = MU_1 + MU_2 + \dots + MU_n$

Marginal Utility (MU) - MU is **addition made to TU** due to **one additional unit** of good.

- $MU_n = TU_n - TU_{n-1}$



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

	Gulab Jamun	Marginal Utility (MU) (in Utils)	Total Utility (TU) (in Utils)
5	1 st Piece	50	50
	2 nd Piece	40	90
	3 rd Piece	28	118
	4 th Piece	10	128
	5 th Piece	0	128
	6 th Piece	-5	123

Observations

- 1) MU can be +ve, 0 or -ve.
- 2) MU diminishes throughout.
- 3) TU rises as long as MU is +ve, but at a diminishing rate.
- 4) When MU = 0, TU is maximum. It is a **satiation point** or **saturation point** → **refuse any extra unit** even if free
- 5) When MU is -ve, TU is diminishing.
- 6) MU = Slope of TU.

Assumptions of Marginal Utility Analysis

- a) Rationality
- b) Cardinal Measurability of Utility
- c) Money is the measuring rod of utility
- d) Other factors 'constant'
- e) Continuity in consumption
- f) Homogenous Units
- g) Standard Units
- h) Constancy of Marginal Utility of Money
- i) The Hypothesis of Independent Utility

Limitations of Marginal Utility Analysis

- a) Unrealistic assumptions
- b) Case of related goods
- c) Law is **not universal** (law does not apply in)
 - ✓ **Prestigious goods** → **gold, cash, diamond**
 - ✓ **Hobbies, rare collections**
 - ✓ People who **seek greater knowledge & info.**
 - ✓ **Creative art, painting, music, poetry**
 - ✓ **Habit forming commodities**
 - ✓ People with **miserly behaviour**

9 Marshallian theory of consumer's behavior is based on-
Hypothesis of **additive utilities** & **independent utilities**.



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

Consumer Equilibrium in Single Commodity

- 10
- Consumer in **equilibrium** → deriving maximum **satisfaction** from some qty of **one good**, where, **MU = Price**.
 - At equilibrium **marginal utility of money spent** → $MUM = MU_x / P_x = 1$
 - When price falls → **Buy more** of good
When price rises → **Buy less**
so as to equate the marginal utility to price.

Law of Equi-Marginal Utility

11

$$(MU_x / P_x) = (MU_y / P_y) = MUM$$

or

$$(MU_x / MU_y) = (P_x / P_y)$$

Consumer Surplus (CS)

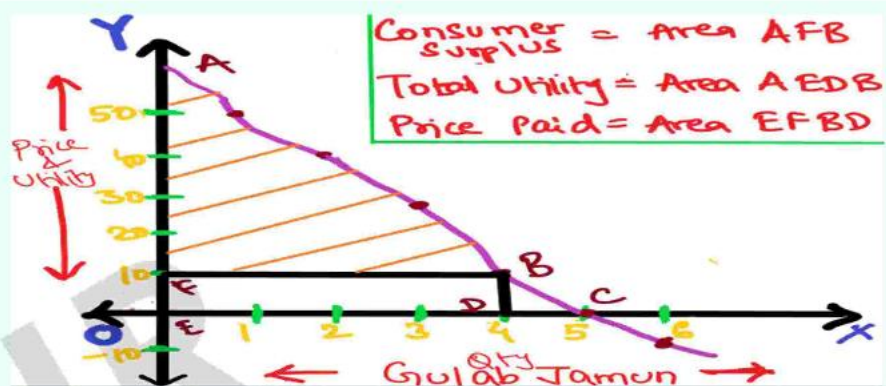
Alfred Marshall gave concept of CS.

12

CS = what consumer is ready to pay - what he actually pays OR **CS = MU - Price**

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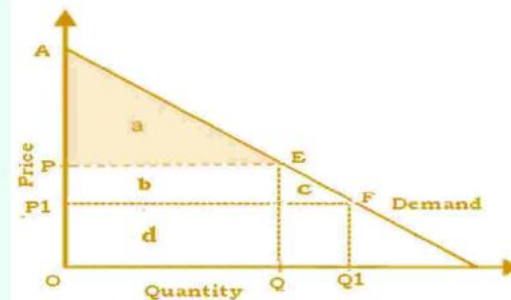


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- Concept of CS is **derived from law of DMU**.
- **Individual CS** → Area **below** indiv. demand curve & **above** price line
- **Total CS** → Area **below** market demand curve & **above** price line

15

Consumer Surplus – New Point

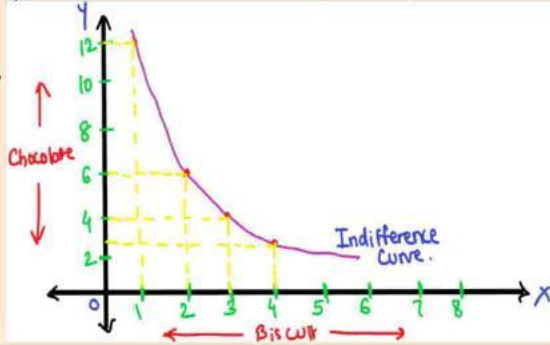


If **price falls** from P to P1, then-

- ✓ Increase in CS of **existing buyers** (area "b")
- ✓ CS now available to **new buyers** (area "c")

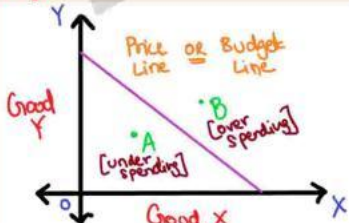


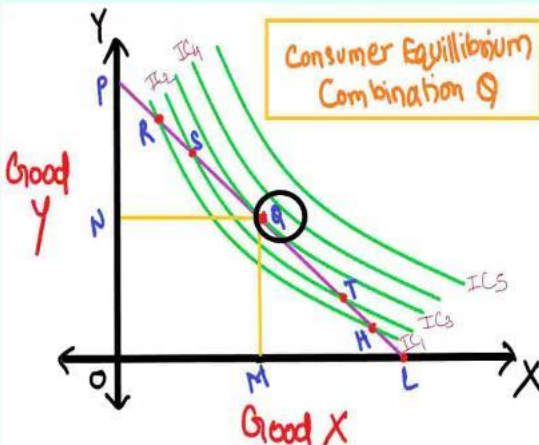
CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

16	<p>Important Limitations of CS</p> <p>1) In case of necessaries → CS is always infinite. 2) CS is affected by availability of substitutes. 3) No simple rule for deriving utility scale of prestige goods (e.g., diamonds).</p>	<p>Indifference Curve</p> <p>➤ IC is a curve which represents all those combinations of two goods which give same satisfaction. ➤ IC aka. iso-utility or equal utility curve.</p> 
17	<p>Ordinal Approach</p> <p>As per this, satisfaction → is a psychological phenomenon & cannot be measured.</p>	<p>Marginal Rate of Substitution (MRS)</p> <p>➤ MRS of X for Y → qty of Y whose loss can just be compensated by a unit gain of X → such that satisfaction remains same. ➤ MRS → absolute slope of IC → $MRS = \Delta Y / \Delta X$ or ➤ $MRS = MU_x / MU_y$</p>
18	<p>Assumptions of Indifference Curve Analysis</p> <p>1) Consumer knows his own tastes & preferences 2) Consumer is rational 3) Utility is ordinally expressible. 4) Transitive choices → If consumer prefers combi. A to B, & B to C, then he must prefer A to C 5) If combi. A has more commodities than B, then A must be preferred to B.</p>	<p>Properties of IC</p> <p>1) Downward sloping to right 2) Always convex to origin (since MRS is falling) 3) ICs can never intersect each other (but may or may not be parallel) 4) Higher IC represents higher level of satisfaction 5) IC never touch either axes</p>
19	<p>A consumer's preferences are monotonic, if & only if between 2 bundles, consumer prefers bundle which has-</p> <p>✓ More of at least one of the goods, & ✓ No less of the other good</p>	



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 2 – CONSUMER BEHAVIOUR

24	Indifference Curve in case of	
	Substitute Goods	Complementary Goods
	<ul style="list-style-type: none"> ➤ Downward Sloping ➤ Straight Line ➤ MRS is constant 	<ul style="list-style-type: none"> ➤ L-shaped ➤ Convex to origin ➤ 2 straight lines with right angle bent
25	<p>Indifference map Collection of many ICs → depicts complete picture of consumer's tastes.</p>	
26	<p>Budget Constraint ➤ Shows all combi. of 2 goods which consumer can buy, spending his given income on two goods. ✓ Any point on BL → spends all his money income ✓ Any point above BL (pt B) → over-spending ✓ Any point within BL (pt A) → under spending ➤ Slope of BL = 'Price Ratio' = P_x / P_y</p>	
	<p>➤ BL will shift when there is: <input type="checkbox"/> Change in price of goods, or <input type="checkbox"/> Change in income, or <input type="checkbox"/> Change in both</p> 	

27	<p>Consumer's Equilibrium (2 commodity- Ordinal Approach) Consumer is in equilibrium → deriving max possible satisfaction from goods.</p>	
	<p>Equilibrium at 'Combination Q', where budget line PL is tangent to indifference curve IC3 At equilibrium point, Slope of IC = Slope of BL $[MU_x / MU_y] = [P_x / P_y]$</p>	
28	<p>IC Analysis Vs Utility Analysis IC analysis is superior to utility analysis, as:</p> <ol style="list-style-type: none"> 1) No assumption of measurability of utility 2) Studies more than 1 commodity at a time 3) Does not assume constancy of MU of money 4) Segregates income effect from substitution effect. 	



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 3 – THEORY OF SUPPLY

<p>1</p> <p>Introduction</p> <ul style="list-style-type: none"> □ Demand → Consumer point of view □ Supply → Seller point of view □ 'Supply' refers to qty of G/S that producers are <ul style="list-style-type: none"> ➤ willing & ➤ able to offer to the market ➤ at various prices ➤ during a given period of time. □ Three important things about supply <ol style="list-style-type: none"> 1) Supply → what a firm offer for sale 2) Flow concept → 'so much' per unit of time 3) Supply requires → willingness & ability to supply. 	<p>4) State of technology Use of advanced tech → supply increases</p> <p>5) Government Policy</p> <ul style="list-style-type: none"> □ Increase in Taxes → supply decr. □ Increase in Subsidy → supply incr. □ More Restrictions → supply decr. <p>6) Number of sellers, Nature of competition and size of industry No. of sellers rise → Competition increase → More supply.</p> <p>8) Expectations Increase in anticipated future price → reduces its supply today</p>
<p>2</p> <p>Determinants of Supply</p> <ol style="list-style-type: none"> 1) Price of the good Ceterus paribus, price increases → Qs increases 2) Price of related goods A farmer sells wheat & soya. If price of wheat rises, supply of soya will decrease. 3) Prices of factors of production Rise in price of factors of prod. → increase in cost → supply decreases 	<p>3</p> <p>Law of Supply</p> <ul style="list-style-type: none"> ➤ Other things remaining constant, quantity supply will increase as price rises and vice versa. ✓ In short run → not easy to increase supply, ✓ In long run → supply can be easily adjusted ➤ Supply curve → upward sloping ➤ Slope of supply curve is → $\Delta P / \Delta Q$



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 3 – THEORY OF SUPPLY

Changes in Supply vs Quantity Supplied			
Supply		Quantity Supplied	
It is the entire relationship between price & qty supplied		It is the quantity which is supplied at a specific price .	
Represented by entire supply schedule & curve .		Represented by a point on the supply curve .	
"Changes in Supply" occur due to Changes in factors other than price of good .		"Changes in Qty Supplied" occur due to Changes in price of goods concerned .	
Favourable Change Increase in supply → Rightward shift in supply curve	Unfavourable Change Decrease in supply → Leftward shift in supply curve	Increase in Price Expansion → Upward movement along same supply curve	Decrease in Price Contraction → Downward movement along same supply curve

4

Elasticity of Supply			
5	Elasticity of supply → Responsiveness of qty supplied to a change in its price.	Percentage Method $\frac{\% \Delta Q_s}{\% \Delta P}$ OR $\frac{\Delta Q}{\Delta P} \times \frac{P}{Q}$ OR $\frac{1}{\text{Slope}} \times \frac{P}{Q}$	Point Method $\frac{dQ}{dP} \times \frac{P}{Q}$
		Arc Method $\frac{Q_1 - Q_2}{Q_1 + Q_2} \times \frac{P_1 + P_2}{P_1 - P_2}$	
Interpretation of Values of Elasticity of Supply			
Value of E_s	Term	Meaning	Shape of Supply Curve
$E_s = 0$	Perfectly Inelastic Supply	Q_s does not respond to change in price → $\% \Delta Q_s = 0$	Vertical-parallel to Y-axis
$0 < E_s < 1$	Inelastic Supply	$\% \Delta Q_s < \% \Delta \text{Price}$	Steeper
$E_s = 1$	Unit Elastic Supply	$\% \Delta Q_s = \% \Delta \text{Price}$	Supply Curve passes through origin
$E_s > 1$	Elastic Supply	$\% \Delta Q_s > \% \Delta \text{Price}$	Flatter

6



CHAPTER 2 – THEORY OF DEMAND & SUPPLY | UNIT 3 – THEORY OF SUPPLY

$E_s = \infty$	Perfectly Elastic Supply	$\% \Delta \text{Price} = 0$ Small price increase raises supply from 0 to ∞	Horizontal-parallel to X-axis
----------------	--------------------------	---------------------------------------------------------------------------------------	-------------------------------

Determinants of Elasticity of Supply (Only IMP Points)	
Incr. in Production → leads to huge cost incr.	Inelastic
Complex production process → require long time to produce (Eg- aircraft, cruise ship)	Inelastic
If after increase in price → short time period	Inelastic
Sellers expect → rise in future price	Inelastic
Inputs → Short in supply → require longer delivery period → highly specialized nature	Inelastic
Labour → highly skilled → scarce → require longer training period	Inelastic Supply
More no. of sellers → More competition	Elastic
Not working on full capacity → more spare capacity	Elastic
Key raw material → easily & cheaply available	Elastic

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8	➤ Market Equilibrium is a situation where, Qty dem = Qty supplied ➤ Intersection of demand & supply determines equilibrium price (aka. market clearing price)	P	Qd	Qs	Impact on Price
		8	15	52	Downward
		6	30	30	Equilibrium
		3	40	18	Upward

Social Efficiency
 ➤ **Social efficiency** → **net gains to society** from **all exchanges** in a market → **achieved** when both **producers & consumers** enjoying **maximum possible surplus**.
 ➤ **Consumer surplus** → MU – Price
 Area **below** demand curve & **above** price line

9

➤ **Producer surplus** → benefit derived by **producers** from **sale of goods above their cost of producing**.
 [SP – Cost]
 ➤ Area **above** supply curve & **below** price line.



ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

1	Production → process by which man utilises resources to transform them into G/S to make them satisfy human wants . (definition by James Bates & J.R. Parkinson)	5	Land Soil or earth's surface & all free gifts of nature . IMP Characteristics ✓ Supply of land is fixed ✓ Perfectly inelastic from economy view ✓ Relatively elastic from a indv. firm view ✓ Permanent & has indestructible powers ✓ Passive ✓ Immobile ✓ Multiple uses ✓ Heterogeneous
2	Production → also be defined as creation or addition of utility . During production we can confer 4 types of utility - 1) Form Utility 2) Place Utility 3) Time Utility 4) Personal Utility	6	Labour Human efforts which require use of physical exertion, skill and intellect . Labour must be done with motive of economic reward . IMP Characteristics of Labour ➤ Perishable , requires human effort, active factor, inseparable from labourer, mobile, ➤ Labour power differs ➤ Poor bargaining power ➤ Supply curve of labour- backward bending shape
3	Production does not include - • work done out of love & affection , • voluntary services & • goods produced for self consumption .		
4	Factors of Production (Inputs) ✓ Natural Resources - Land ✓ Human Endeavour - Labour, Capital & Entrepreneur		

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ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

7	<p>Capital</p> <ul style="list-style-type: none"> ➤ 'Produced means or Man-made instruments of production'. It refers to all assets that are a part of wealth (total assets) & are used for further production of wealth. ➤ Capital is a stock concept → yields a periodical income which is a flow concept <p>IMP Types of Capital</p> <ol style="list-style-type: none"> 1) Fixed capital - Durable nature 2) Circulating capital – For single use & is not available for further use. Eg, seeds, fuel, raw materials etc 3) Social capital - Belongs to society as a whole in form of roads, bridges, etc. 	<p>Stages of Capital Formation</p> <ol style="list-style-type: none"> 1) Savings 2) Mobilisation of savings 3) Investment
8	<p>Capital Formation (aka Investment)</p> <ul style="list-style-type: none"> ➤ It means a sustained increase in stock of real capital in a country. ➤ It involves production of more capital goods like, machines, factories, etc. which are used for further production of other goods. ➤ Required for creating additional productive capacity. 	<p>Entrepreneur</p> <p>Entrepreneur is a factor which</p> <ul style="list-style-type: none"> ➤ mobilises other factors, ➤ combines them in right proportion, ➤ initiates process of production & bears risks. <p>Functions of Entrepreneur</p> <ol style="list-style-type: none"> 1) Initiating business 2) Risk bearing or uncertainty bearing (cannot be delegated) 3) Innovation – Most Important Function
	<p>Study Economics & CA Inter FM & SM only from MVSIR</p>	<p>Enterprise Objectives</p> <ol style="list-style-type: none"> 1) Organic objectives- Basic minimum objective- survival, growth & expansion. 2) Economic objective- Profit & sales maximization. 3) Social objectives <ul style="list-style-type: none"> ➤ It lives in society & it cannot grow unless it meets the needs of the society. ➤ Supply of unadulterated goods & of standard quality. ➤ Create opportunities for employment.



ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

4) Human objectives

➤ Provide **fair deal to employees** at different levels

5) National objective

➤ **Remove inequality of opportunities** & provide fair opportunity to all to work.

➤ To **produce** according to **national priorities**.

➤ To help country become **self-reliant** and **avoid dependence** on other nations.

Production Function

Production function is a mathematical statement of **relationship** between **dependent** variable (**output**) & **independent** variable (**inputs**). [definition given by Samuelson]

$$Q = f(\text{Labour}, \text{Capital}) = f(L, K)$$

Assumptions of Production Function

- 1) Relationship between inputs & outputs exists for **specific period of time**
- 2) Production **technology** remains **constant**
- 3) **Output** resulting from use of inputs is **at maximum level**

11

Short Run

12

Short run → is a time period when a firm is doing **actual production** & where **at least one input is fixed** (**Capital fixed & Labour variable**)

Long Run

13

Long run → is a time period when a firm is **planning stage** & where all **inputs are variable**

Law of Variable Proportion (applies in Short Run)

Aka. **Law of returns to a variable input** OR **Law of diminishing returns**

As per this law, as we **increase quantity labour** (variable input), its **marginal product (MP)** eventually **declines**.

14

Assumptions of Law of Variable Proportions

- 1) **Technology constant**
- 2) **Some inputs** must be **fixed**
- 3) **Does not apply** where factors used in **fixed proportions**
- 4) Consider **only physical inputs & outputs**

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ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

TP vs AP vs MP

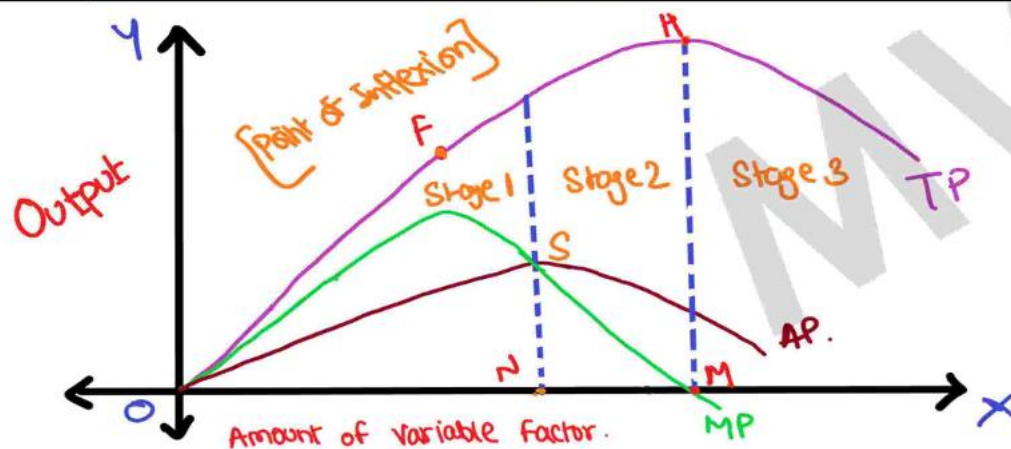
Total Product (TP): **Total output** resulting from using all inputs together.

Average Product (AP) = $TP / \text{No. of Units of Variable Factor}$

Marginal Product (MP): **Change in TP** per **unit change in quantity of variable factor**.

$$MP = \Delta TP / \Delta Q$$

$$\text{or } MP = TP_n - TP_{n-1}$$



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Relationship between AP & MP

- 16
- When AP rises $\rightarrow MP > AP$
 - When AP is maximum $\rightarrow MP = AP$
 - When AP falls $\rightarrow MP < AP$

Stage of Operation

- 17
- Never produce in Stage 1 & 3 are \rightarrow 'economic absurdity' or 'economic non-sense'
 - Rational producer \rightarrow Produce in stage 2

Returns to Scale (applies in Long Run)

- 18
- Change in scale \rightarrow **all factors of production** are **increased** or **decreased** in **same proportion**.

When **ALL inputs are increased**, a firm initially realizes-

I. Increasing Returns to Scale (IRS)

% Increase in Output $>$ % Increase in Input
then,

II. Constant Returns to Scale (CRS)

- 19
- % Increase in Output = % Increase in Input
It is also referred to as "**Linear Homogeneous Production Function**"
then,

III. Decreasing Returns to Scale (DRS)

% Increase in Output $<$ % Increase in Input



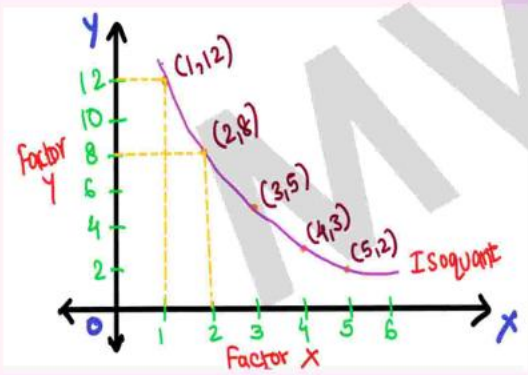
ECONOMICS CHAPTER 3 – UNIT 1 – THEORY OF PRODUCTION

20

Cobb-Douglas Production Function
 Applies not to individual firm but to **whole of manufacturing industry**.
Labour contributed about **3/4th** and **capital** about **1/4th** of **increase** in **production**
 Earlier formula..... $Q = K \cdot L^a \cdot C^{(1-a)}$
 Later updated the formula..... $Q = K \cdot L^a \cdot C^b$
 If, $a + b > 1$ **IRS**
 $a + b = 1$ **CRS**
 $a + b < 1$ **DRS**

21

Isoquants
 It represents **all those combinations** of **inputs** which can **produce** the **same level of output**.
 Aka.- equal-product curves, production indifference curves or iso-product curves.
MRTS- Marginal Rate of Technical Substitution → **Absolute value of Slope of Isoquant**



22

Properties of Isoquants
 a) **Negatively sloped**, (Slope of Isoquant = MRTS)
 b) **Convex to origin** due to diminishing MRTS
 c) Curve on **right** represents a **higher level of output**,
 d) **non-intersecting**.

23

IMP difference between isoquant & IC-
 • Isoquant – **qty of production** can be **quantified**
 • In IC- **not possible to quantify satisfaction**

24

Isocost
 ➤ **Isocost line**, aka. **Equal-Cost Line** or **budget line** or **budget constraint line**,
 ➤ It is **downward sloping straight line** → shows various alternative **combinations of two factors** which **firm can buy with given outlay (same exp amt)**.
 ➤ **Slope of Isocost = w / r** (Slope will be negative & constant)

25

Producer Equilibrium
 It will be achieved where **isocost line is TANGENT to isoquant**



ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

1	<p>Cost Concepts</p> <p>1) Accounting Costs & Economic Costs</p> <p>✓ Accounting (Explicit or Outlay) costs → expenses which will have to be incurred by firm & are recorded in financial statements.</p> <p>✓ Implicit Cost is cost of using self-owned factors. (not recorded in BOA)</p> <p>✓ Economic Cost = Explicit + Implicit Cost</p>	1.4	<p>5) Historical costs & Replacement costs</p> <p>✓ Historical cost → cost incurred in past on acquisition of an asset</p> <p>✓ Replacement cost → exp. that has to be incurred for replacing an old asset</p>
1.1	<p>2) Outlay costs & Opportunity costs</p> <p>✓ Outlay costs involve actual expenditure</p> <p>✓ Opportunity cost is cost of next best alternative opportunity which was foregone to pursue certain action.</p>	1.5	<p>6) Fixed Costs & Variable costs</p> <p>a) Fixed or constant or supplementary costs → do not vary with output. (function of capacity)</p> <p>☐ Eg- rent, property taxes, interest on loans etc</p> <p>☐ If firm shuts down for short period → fixed cost CANNOT be avoided (inescapable)</p> <p>b) Variable Costs (VC) → costs which vary with level of output (function of output)</p> <p>☐ If a firm shuts down for a short period, then VC can be avoided</p> <p>☐ Eg- wages, price of raw material, fuel, transportation cost etc</p>
1.2	<p>3) Traceable (Direct) costs & Non-Traceable (Indirect) costs</p> <p>✓ Direct costs → readily identified & traceable to product</p> <p>✓ Indirect costs → not easily & definitely identifiable</p>	1.6	<p>Shut down costs → costs which will continue even after operations are suspended. Eg- storing old machines.</p>
1.3	<p>4) Incremental costs & Sunk costs</p> <p>✓ Incremental cost → additional cost incurred as a result of a business decision</p> <p>✓ Sunk Costs → costs which are already incurred once & for all & cannot be recovered.</p> <p>✓ Eg- advertising, R&D etc.</p>	1.7	<p>7) Semi – Variable Cost</p> <p>Costs which are neither perfectly variable, nor absolutely fixed.</p>

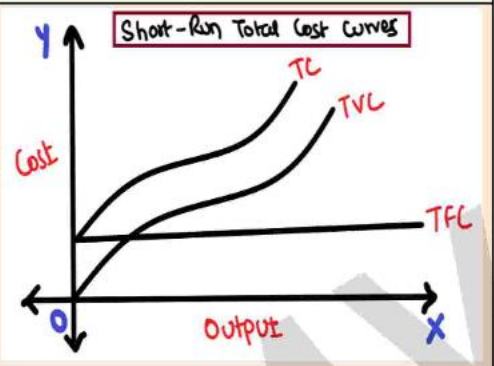


ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

1.8 **9) Stair-Step Variable Cost**
 Costs which may **increase in a stair-step fashion** → remain **fixed over certain range of output**; but **suddenly jump** to new higher level when output goes beyond a given limit.

Short Run Total Costs
 ➤ $TC = TFC + TVC$

Total Fixed Cost curve (TFC)
 ➤ **horizontal** straight line parallel to **X-axis**
 ➤ Starts from a point on the **Y-axis**



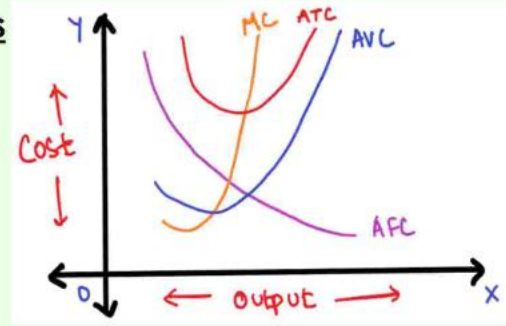
2 **Total Variable Cost (TVC)**
 ➤ Initially **increases at a decreasing rate** and then at an **increasing rate**. (Inverted-S shaped)

Total Cost Curve (TC)
 ➤ Obtained by adding vertically the TFC curve and the TVC curve.
 ➤ **Slopes** of TC & TVC are **same** (Inverted-S shaped)
 ➤ At each point the TC & TVC curves have **vertical distance equal to TFC**.

Short Run Average Costs

Average Fixed Cost curve (AFC)

- $AFC = TFC / Q$
- AFC is **fixed cost per unit of output**.
- AFC **falls** as **output increases**.
- Shape- **rectangular hyperbola**
- AFC **never touch the X-axis** as AFC **cannot be zero**.



Average Variable Cost (AVC)

- $AVC = TVC / Q$
- AVC curve will **first fall**, then reach a **minimum** and then **rise** (U-shaped)

Average Total Cost (ATC or AC or SAC)

- $ATC = TC / Q$ or $ATC = AFC + AVC$
- ATC curve is **U-shaped**
- **SAC** Curve is aka. **PLANT Curve**

3

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ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

Marginal Cost Curve (MC)

➤ MC is **addition made to total cost** by **production of an additional unit** of output.

$$MC = \Delta \text{ in TC} / \Delta \text{ in Output}$$

Or

$$MC = \Delta \text{ in TVC} / \Delta \text{ in Output}$$

- MC is **independent of fixed cost**.
- Value of MC comes **due to changes in variable costs**.
- MC curve is **"U" shaped**
- MC Curve **intersects AC & AVC** curve at their respective **minimas (minimum points)**..

MC & AC

AC falls → MC < AC

AC rises → MC > AC

AC min. → MC = AC

MC & AVC

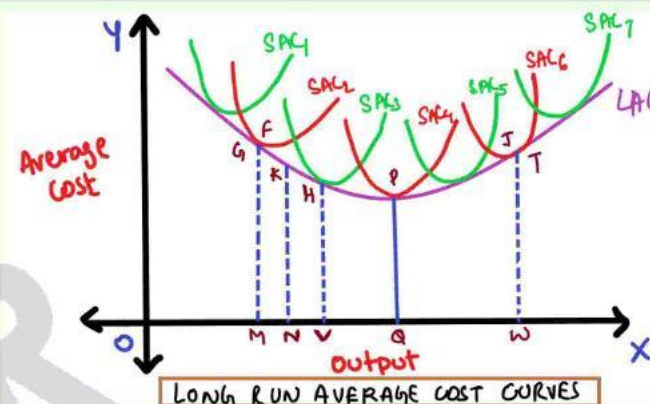
AVC falls → MC < AVC

AVC rises → MC > AVC

AVC min. → MC = AVC

Long Run Average Cost (LAC) Curve

- A firm **plans for long run & operates in short run**.
- In long run → can **build any size or scale of plant & move from one plant to another**.
- Long run is **planning horizon**.



- LAC Curve → aka. **Planning** or **Envelope** or **Boat Curve**
- It is **tangent to each of SAC curves**
- When **LAC is declining** → tangent to **falling portions of SAC**
- When **LAC is rising** → tangent to **rising portions of SAC**
- "OQ" is **optimum output** → LAC is at minimum (here production is done at **FULL CAPACITY**)
- **Falling portion (negatively sloped)** of LAC- due to **IRS** or **Economies of Scale**
- **Rising portion (positively sloped)** of LAC- due to **DRS** or **Diseconomies of Scale**



ECONOMICS CHAPTER 3 – UNIT 2 – THEORY OF COST

SCALE OF PRODUCTION

Economies of scale → **Decrease in Avg cost** due to increase in production.

Internal Economies

They accrue to firm when it **expands its output** → arise due to **endogenous (internal) factors**

Internal Economies & Diseconomies

- 1) Technical
- 2) Managerial
- 3) Commercial
- 4) Financial
- 5) Risk bearing

External Economies

They are **benefits** accruing to **each member firm** of industry as a result of **expansion of industry**.

External Economies & Diseconomies

- 1) Cheaper raw materials & equipment
- 2) Technological external economies
- 3) Development of skilled labour
- 4) Growth of ancillary industries
- 5) Better transportation & marketing
- 6) Economies of Information

4

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ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

<p>1 From where does the concept of price arises ? Free Goods - Goods are free or have zero prices, abundant in supply & do not have scarcity. Example: air, sunlight etc Economic Goods – Scarce in relation to their demand & have opportunity cost→ exchangeable in market & command a price.</p>	<p>4 Classification of Markets I) General Classification a) Factor Market – Where firms buy the inputs to produce G/S. b) Product Markets – Where households buy G/S they want from firms.</p>
<p>2 Value in exchange or exchange value (given by Ricardo)→ amount of G/S which we may obtained in market in exchange of money. In Economics, we are only concerned with exchange value.</p>	<p>4.1 II) Geographical Area Classification a) Local Market – Limited to a local area. Highly perishable goods bulky articles. b) Regional Market – Cover wider area like few adjacent cities or states. c) National Markets - Demand is limited to national boundaries of country. Eg- Hindi books d) International Markets – High value & small bulk goods. Eg- Gold & Silver.</p>
<p>3 Meaning of Market Market→ collection of buyers & sellers with potential to trade. Market need not be formal or held in a particular place. Elements of Markets 1) Buyers & sellers; 2) Product or service; 3) Bargaining for a price; 4) Knowledge about market conditions; 5) One price for G/S at a given time.</p>	<p>4.2 III) Regulation a) Regulated Market – Transactions are statutorily regulated. Eg. Stock exchange b) Unregulated Market – Aka. free market - no stipulations on transactions.</p>



ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

4.3	<p>IV) Time (Given by Alfred Marshall)</p> <p>a) Very Short Period Market – Aka. Market period – here supply is fixed. Price is dependent on demand.</p> <p>b) Short Period Market – Here, supply can be moderately adjusted.</p> <p>c) Long-period Market - All factors become variable & supply can be fully adjusted. Here price is called 'normal price'.</p> <p>d) Very long-period Market – Aka. secular period</p>	<p>Concepts Of TR, AR & MR</p> <p>I) Total Revenue (TR) Amount of money which a firm realises by selling a commodity. [$TR = P \times Q$]</p> <p>II) Average Revenue (AR) AR is revenue earned per unit of output. AR = Price = TR / Q Also, AR curve = Demand Curve of firm</p> <p>III) Marginal Revenue (MR) MR is change in TR resulting from sale of an additional unit of commodity. (MR is slope of TR) $MR = \Delta TR / \Delta Q$ or $MR_n = TR_n - TR_{n-1}$ or $MR = dTR / dQ$</p>
4.4	<p>V) Nature of Transaction</p> <p>a) Spot / cash Market b) Forward or Future Market</p>	<p>6 AR = Price → Happens in ALL types of market AR = Price = MR → ONLY in Perfect Comp.</p>
4.5	<p>VI) Volume of Business</p> <p>a) Wholesale Market- Goods sold in bulk or large quantities. Transactions between traders</p> <p>b) Retail Market- Goods sold in small qty. Market for ultimate consumers.</p>	<p>Concepts of TR, AR & MR in Imperfect & Perfect Competition</p> <p>For falling AR (in Imperfect Competition)</p> <p><input type="checkbox"/> AR curve slopes downward</p> <p><input type="checkbox"/> MR < AR → MR declines more rapidly than AR → bcoz any reduction in price applies to all units sold.</p> <p><input type="checkbox"/> TR → Inverted U shaped</p> <p><input type="checkbox"/> When MR = 0, then TR is maximum</p>



ECONOMICS CHAPTER 4 – UNIT 1 – MEANING AND TYPES OF MARKETS

8 For **constant AR** (in Perfect Competition)
 □ **MR = AR = Price**
 □ AR Curve = Demand Curve = MR Curve → **Horizontal straight line** parallel to X axis → **Perfectly elastic demand** ($E_p = \infty$)
 □ TR → **upward sloping straight line**

9 **Relationship → AR, MR, TR & Price Elasticity of Demand**

$MR = AR \times \frac{e - 1}{e}$	Value of e	MR
	e = 1	MR = 0
	e > 1	MR → positive
	e < 1	MR → negative

Ignore -ve sign in "e" while using above formula

10 **Behavioural Principles**

Principle 1	Principle 2
➤ A firm should not produce at all if its total variable costs are not met (TR ≤ TVC) ➤ At shut down point : □ Price is equal to AVC □ TR = TVC □ Total loss = TFC	A firm will maximum profits (or minimize losses) at MR = MC

CHAPTER 4 – UNIT 2 – DETERMINATION OF PRICES

	Situation	Effect	
1	Mkt Price > Equi Price i.e., Qty Sup. > Qty Dem. (Surplus)	Downward Pressure on Price	Qs decreases & Qd increases Upto Equilibrium
2	Mkt Price < Equi Price i.e., Qty Sup < Qty Dem (Shortage)	Upward Pressure on Price	Qs increases & Qd decreases Upto Equilibrium

S. No.	Situation	Effect	
		Equi Price	Equi Qty
3.	Increase in Demand	Increase	Increase
4.	Decrease in Demand	Decrease	Decrease
5.	Increase in Supply	Decrease	Increase
6.	Decrease in Supply	Increase	Decrease



ECONOMICS CHAPTER 4 – UNIT 2 – DETERMINATION OF PRICES

3

- When **both demand & supply increase**, but no other data given → then **EQ increases**, but effect on **EP cannot be determined**
- Similarly, when **both demand & supply decrease** but no other data given → then **EQ decreases** but effect on **EP cannot be determined**

4

- When **demand increases & supply decreases** → **EP rises** but effect on **EQ cannot be determined**
- When **demand decreases & supply increases** → **EP falls** but effect on **EQ cannot be determined**

CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

1

Features / Characteristics of Perfect Competition

- 1) Large number of buyers and sellers –
 - Share of **each seller & buyer** in market → is too small - **unable to influence price, demand or supply**
- 2) Homogenous or Identical Products –
 - **Perfect substitutes**
 - **Buyers have no preference** between different sellers
- 3) Free Entry & Exit - **No legal or market related barriers**

Above 3 characteristics are conditions for **pure competition**

4) Perfect knowledge of market condition –

- Both **buyers & sellers have all information**

5) Very low transaction costs –

- **No advertisement** required.

6) All firms individually are price takers –

- Firms & buyers **have to accept price determined by market forces**
- There is **perfect knowledge** and **perfect mobility** of resources

2

- Perfect comp is a **myth**.

- Eg- **agricultural products**, financial instruments (**stock**, bonds, **foreign exchange**), precious metals (gold, silver, platinum)

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CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

Equilibrium
Perfect Competition

PC Industry

PC Firm

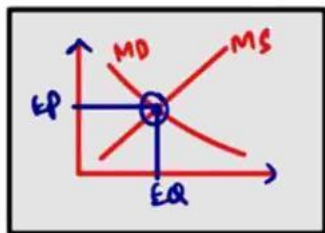
Short Run

Long Run

Short Run

Long Run

Market Demand = Market Supply



3 Conditions

1) All Firms are at equilibrium (maximum Profit)

2) No incentive for firms to enter or exit, Since all firms earning just normal profits

3) Price - MD = MS

2 Conditions

1) MR = MC

2) MC Curve should cut MR from below MC → +ve Slope

Above conditions are same for Monopoly & Monopolistic Comp.

A PC firm can in short run-
 Normal Profit → AR = AC or
 Super Normal Profit → AR > AC or
 Losses → AR < AC

When firm has adjusted plant, to produce at min. point of Lac curve

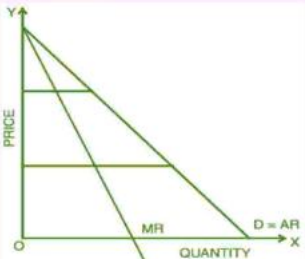
Which is tangent to Demand Curve (AR)

AR = LMC = SAC = SMC = MR = Price

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CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

3	<ul style="list-style-type: none"> ➤ Firm is in equilibrium → maximizes its profit. ➤ PC Firms are price-takers. They have to accept price determined by market forces. ➤ Demand curve of each PC firm is perfectly (or infinitely) elastic ➤ In PC firm, MC curve above AVC has identical shape of firm's supply curve. 	<p>3) Market power –</p> <ul style="list-style-type: none"> ▪ Ability to charge a price above MC & earn a positive profit (AR > MC) → Allocative Inefficiency ▪ Due to above reason, supply curve of monopoly is indeterminate. <p>4) No close substitutes –</p> <ul style="list-style-type: none"> ▪ Extreme Product Differentiation ▪ Cross elasticity of demand = zero or very small. ▪ Price elasticity of demand = less than 1. ▪ Steep downward sloping demand curve.
4	<ul style="list-style-type: none"> ➤ In PC (long run) → market mechanism leads to optimal allocation of resources which is shown by- <ul style="list-style-type: none"> ✓ Consumers pay minimum possible price → just covers MC i.e. MC = AR → Allocative Efficiency ✓ Plants are used to full capacity → no wastage of resources i.e. MC = AC → Productive Efficiency 	<p>7</p> <p>Monopolist's Revenue Curves</p> <ul style="list-style-type: none"> ☐ AR & MR both are downward sloping curves. ☐ Slope of MR = 2 x Slope of AR <p>MR curve lies half-way between AR curve & Y axis. i.e. it cuts horizontal line between Y axis & AR into two equal parts.</p> <ul style="list-style-type: none"> ☐ AR cannot be zero, but MR can be zero or even negative. 
5	<p>Monopoly</p> <p>'Monopoly' = "alone to sell" → single seller.</p> <p>Pure monopoly is never found in practice.</p> <p>Natural monopoly arises when there are very large economies of scale.</p>	<p>8</p> <p>Monopolies are mainly of two types</p> <p>Simple monopoly Monopolist charges uniform price from all buyers</p> <p>Discriminating monopoly Monopolist charges different prices from different buyers of same g/s</p>
6	<p>Features of Monopoly</p> <ol style="list-style-type: none"> 1) Single seller - No distinction between firm and industry (absence of competition) 2) Barriers to Entry - Strong barriers to entry 	



CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

10 Can a monopolist incur losses in short run?

YES, if $AR < AC$

Should firm shutdown ?

It depends,

If $AR < AVC$, then shutdown or else continue

11 Equilibrium of Monopoly in Long Run

➤ In **absence of competition**, monopolist **need not produce at optimal level**. He **need not reach minimum of LAC** curve.

➤ **Monopolist will not continue** if he makes **losses in long run**.

➤ He will **continue** to make **super normal profits** even in **long run** → due to **blocked entry**.

12 Price Discrimination

➤ It occurs when a **producer sells** a G/S to **different buyers** at **two or more different prices** for **reasons not associated with differences in cost**.

➤ Adopted by **monopolist** → **to earn abnormal profits**.

➤ Price discrimination **cannot happen under PC**

13 Conditions for Price Discrimination

1) **Seller** should have **some control over supply**

2) Seller should be **able to divide his market** into **two or more sub-markets**.

3) **Price-elasticity** of product should be **different in different sub-markets**.

4) **Not possible** for **buyers of low-priced market** to **resell** to **buyers of high-priced market** (**no market arbitrage**)

14 Degrees Price Discrimination by Prof. AC Pigou

First Degree (Customer Wise)	Extract entire consumer surplus)
Second Degree (Quantity wise)	There are two possibilities here: 1) Larger quantities available at lower unit price. 2) Each consumer pays different price for consecutive purchases .
Third Degree (Attribute wise)	Divide consumers into separate sub-markets & charge different prices in different sub-markets .

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CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

15	<p>Monopolistic Competition</p> <ul style="list-style-type: none"> ➤ Large no. of sellers selling differentiated (similar but not identical) products → to attract customers on some basis other than price. ➤ Eg- soaps, detergent, toothpaste etc ➤ Contains some features of both markets– monopoly & perfect comp. 	
16	<p>Features of Monopolistic Competition</p>	
	1	<p>Large no. of sellers Each seller small share in mkt</p>
	2	<p>Product differentiation Differentiated on basis of brands → close substitutes → price elasticity of demand elastic (e>1).</p>
	3	<p>Freedom of entry and exit Free to enter or exit market</p>
	4	<p>Non-price competition Avoid price wars</p>
17	<p>Equilibrium of Monopolistic Comp Firm in Long Run</p> <ul style="list-style-type: none"> ➤ In long run → all monopolistic comp. firms → earn only normal profits. 	

	<p>At long run equilibrium monopolistic competition firm- ✓ do not produce at min point of LAC ✓ but at falling portion of LAC curve → leading to excess capacity.</p>		
18	PC	Monopolistic Comp.	Monopoly
	Lowest Price	Price is high than PC	Highest price
	Highest Eq Qty	Eq Qty less than PC	Eq Qty is lowest
19	<p>Oligopoly → 'competition among few' (2 to 10 firms) Eg- cold drinks, automobile, Airlines, mobile telephony & Internet providers etc.</p>		
	<p>Features / Characteristics of Oligopoly</p> <ul style="list-style-type: none"> <input type="checkbox"/> Strategic Interdependence, <input type="checkbox"/> Importance of advertising and selling costs, <input type="checkbox"/> Group Behaviour 		
20	<p>Types of Oligopoly</p> <p>1) Pure or perfect oligopoly → product is homogeneous in nature, e.g. Aluminium industry. It tends to process raw materials that used as inputs by other industries.</p> <p>Differentiated or imperfect oligopoly → goods are differentiated → e.g. Talcum powder.</p>		



CHAPTER 4 – UNIT 3 – PRICE OUTPUT DETERMINATION UNDER DIFFERENT MARKET FORMS

20.1	<u>Open oligopoly</u> → new firms can enter market In <u>closed oligopoly</u> entry is restricted.
20.2	<u>Collusive oligopoly</u> → When few firms act in collusion → fixing price or output or both. <u>Competitive oligopoly</u> → When there is absence of such an understanding.
20.3	<u>Partial Oligopoly</u> → when industry is dominated by one large firm (price leader) <u>Full oligopoly</u> → Absence of price leadership.
20.4	<u>Syndicated oligopoly</u> → Firms sell products through centralized syndicate. <u>Organized oligopoly</u> → Firms organize themselves into a central association for fixing prices, output, quotas, etc.
21	<u>Oligopoly Models</u> a) <u>Cournot model</u> → firms' control variable is output. They do not collude. b) <u>Bertrand model</u> , price is control variable c) <u>Stackelberg's model</u> leader commits to an output → rest of firms are followers
22	Oligopoly cartel → Eg- OPEC

23	<p><u>Kinked Demand Curve</u></p> <ul style="list-style-type: none"> ➤ Demand curve of oligopoly is INDETERMINATE ➤ But Paul A. Sweezy, gave concept of kinked demand curve (based on many assumptions). ➤ Price rigidity (sticky) & Qty rigidity under oligopoly is explained by Sweezy's Model ➤ Kinked demand curve has 'kink' at level of prevailing price. ☐ Demand curve above prevailing price is elastic (when a firm raises price, competitors do not follow) ☐ Demand curve below prevailing price level is inelastic. (when a firm decreases price, competitors will follow) 								
	24	<p><u>Other Forms of Market</u></p> <table border="1"> <tr> <td>Duopoly</td> <td>Oligopoly of only two firms.</td> </tr> <tr> <td>Oligopsony</td> <td>Only few buyers.</td> </tr> <tr> <td>Monopsony</td> <td>Single buyer of G/S</td> </tr> <tr> <td>Bilateral monopoly</td> <td>Combination of monopoly & monopsony market</td> </tr> </table>	Duopoly	Oligopoly of only two firms .	Oligopsony	Only few buyers .	Monopsony	Single buyer of G/S	Bilateral monopoly
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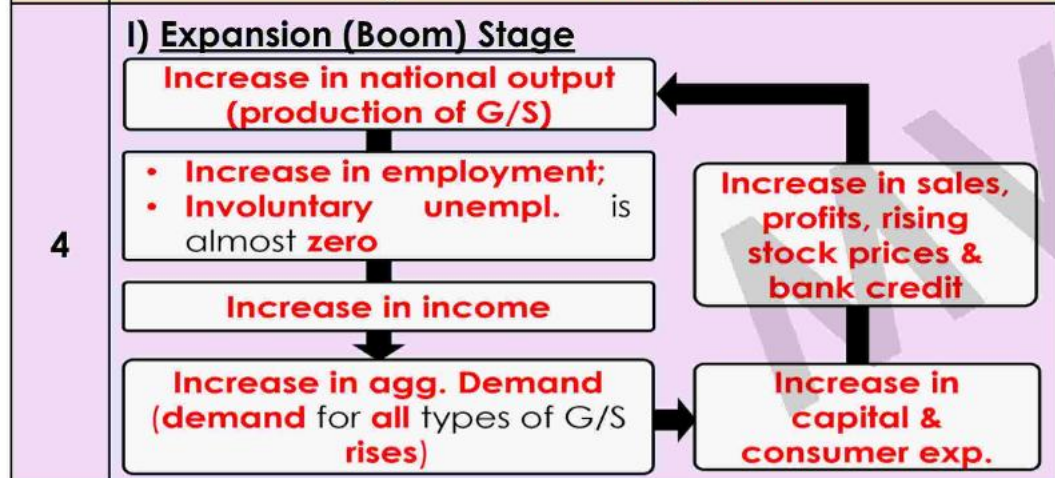


CHAPTER 5 – BUSINESS CYCLES

1 The **rhythmic fluctuations** in **aggregate economic activity** over a **period of time** → business cycles or trade cycles. (How Real GDP changes wrt. time)

2 **Good trade** → rising prices & low unemployment
Bad trade → falling prices & high unemployment

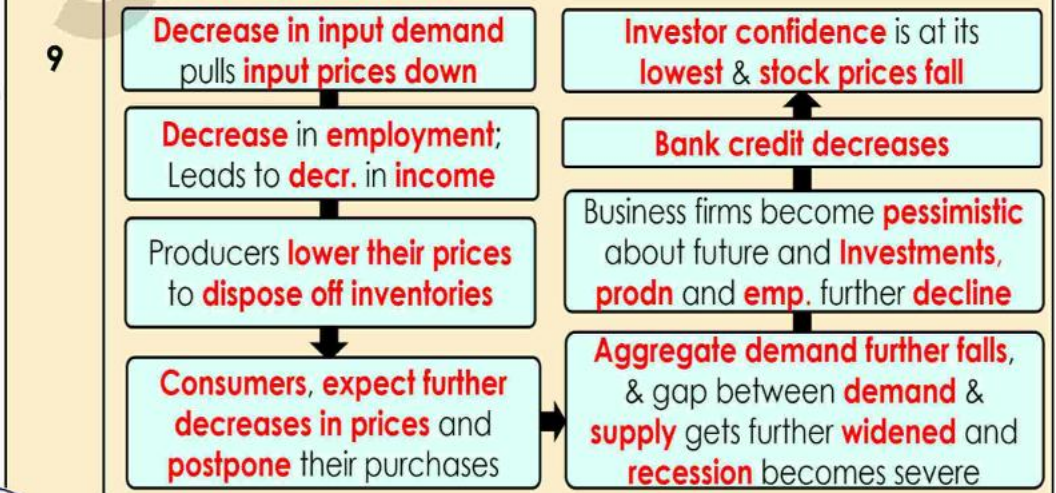
3 ➤ **Phases of Business Cycles**- Expansion, Peak, Contraction, Trough
 ➤ Peak & Trough → called **Turning Points**



5 In later stages of expansion → increased cost of living & greater strain on **fixed income earners**. Consumers begin to **review their consumption expenditure** on durable goods.

8 **II) Peak (Prosperity) Stage**
 Actual **demand stagnates**.
Top or **highest point** of business cycle.

9 **III) Contraction (Downswing or Recession)**
 ➤ **Producers do not instantaneously recognize pulse** of economy (that contraction is coming) & **keep anticipating high level of demand** → Leading to **Supply > Demand**.
 ➤ Later, producers cancel **future investment** plans & **orders of inputs** incl. **labour**.
 ➤ Decline of agg. economic activity **over a period of time** is **RECESSION**



CHAPTER 5 – BUSINESS CYCLES

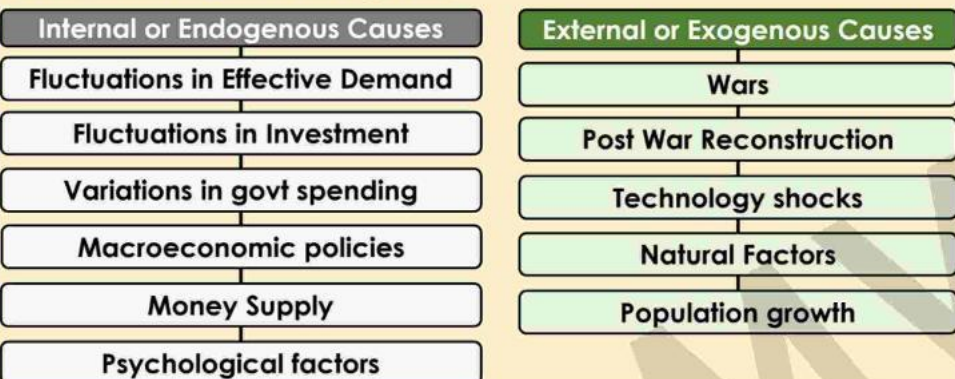
10	<p>IV) Trough (aka Depression)</p> <ul style="list-style-type: none"> ➤ Growth rate becomes negative → national income & exp. declines rapidly. ➤ Prices are lowest - forcing some firms to shutdown. ➤ Mounting unemployment. ➤ Typical feature fall in interest rate → people hold more liquid money ➤ May Lead to possible banking or financial crisis. ➤ Large number of bankruptcies & liquidation. 	<p style="text-align: center;">Lagging Indicators</p> <p>14 Reflect historical performance & these indicators change only after economic trend has already occurred. Eg- unemployment, corporate profits, labour cost per unit, interest rates, prime rate, consumer price index, commercial lending activity</p>
11	<p>Recovery</p> <ul style="list-style-type: none"> ➤ Process of reversal is initially felt in labour market. Pervasive unemployment forces workers to accept lower wages. ➤ Spurring of investment causes recovery of economy. 	<p style="text-align: center;">Coincidental / Concurrent Indicators</p> <p>15 They coincide or occur simultaneously with business-cycle movements → describe current state. Eg- GDP, industrial production, inflation, personal income, retail sales</p>
12	<p>Indicators</p> <p>Economists use changes in a variety of activities to measure business cycle & predict where economy is headed towards.</p>	<p>16 Features Of Business Cycles</p> <ul style="list-style-type: none"> a) Occur periodically, but do not exhibit same regularity → duration & intensity varies. b) Phases seldom display smoothness & regularity. c) Originate in free market economies. d) Capital & durable consumer goods industries are disproportionately affected. Industrial sector is more prone compared to agri. sector e) Complex phenomena → do not have uniform characteristics & causes.
13	<p style="text-align: center;">Leading Indicators</p> <p>Changes before economy starts to follow a particular pattern. Eg- Changes in Stock Price, new orders for goods, building permits for private houses, delayed deliveries</p>	<p style="text-align: center;">Study Economics & CA Inter FM & SM only from MVSIR</p>



CHAPTER 5 – BUSINESS CYCLES

- f) **Repercussions** get **simultaneously** felt on **all economic variables**
- g) **Contagious & international.**
- h) Have **serious consequences** on **well-being** of society.

Causes of Business Cycles



17

Cyclical Business

Businesses whose **fortune** is **linked to rate of economic growth**
 Eg- **fashion retailers, electrical goods (white goods), house-builders, restaurants**, etc.

19

Demand-Pull Inflation

Inflation when → **demand** is **more than supply**

20

Examples of Business Cycles

- 1) Great Depression of 1930
- 2) Information Technology bubble burst of 2000 (Aka. Dot.Com bubble)
- 3) Global Economic Crisis (2008-09) (Aka. sub-prime crisis)

21

18

Name	Cause of Business Cycle
Keynes	Fluctuations in aggregate effective demand (& investments)
Pigou	Anticipations → optimism or pessimism
Schumpeter	Innovation theory.
Nicholas Kaldor	Cobweb theory
Hawtrey	Monetary phenomenon → changes in supply of money

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CHAPTER 6 – NATIONAL INCOME | UNIT 1

1	<p>Gross domestic product (GDP) is-</p> <ul style="list-style-type: none"> ➤ monetary value of ➤ all final ➤ economic G/S, ➤ gross of depreciation, ➤ produced ➤ within domestic territory ➤ during a given time period. 	4	<p>NI & GDP is a 'flow' measure of output per time period & includes only those G/S produced in current period</p>
2	<p>Final Goods Goods used either for consumption or investment. Neither resold nor undergo further transformation. Only final goods is considered in GDP, to avoid double counting.</p>	5	<p>Exclusions from GDP</p> <ul style="list-style-type: none"> ➤ Transfer Payments - Making a payment, without G/S being received in return. ➤ Financial transactions - Stocks & bonds exchanged during the period are not included. However, value of services that accompany sale & purchase (e.g. brokerage) is included. ➤ Sale of 2nd Hand goods ➤ Non-reported output - illegal transactions. Eg - narcotics & gambling
3	<p>Intermediate goods</p> <ul style="list-style-type: none"> ➤ Used either for- <ul style="list-style-type: none"> ❑ resale or ❑ for further production in same year. <p>They do not end up in final consumption, and are not capital goods either.</p> <ul style="list-style-type: none"> ➤ They have derived demand. ➤ If they remain for more than one year → treated as final goods. 	6	<p>Nominal GDP (aka. GDP at current year price)</p> <ul style="list-style-type: none"> ➤ CY output (x) CY Prices ➤ Nominal GDP changes for two reasons. <ol style="list-style-type: none"> 1) Qty of G/S produced changes, & 2) When market prices change.
		7	<p>Real GDP (aka. GDP at constant price)</p> <ul style="list-style-type: none"> ➤ CY Output (x) BY Price ➤ It is inflation adjusted GDP ➤ It changes only when there is change in Qty prod. ➤ Not affected by changes in prices ➤ Real GDP- better measure of economic well being



CHAPTER 6 – NATIONAL INCOME | UNIT 1

8	$\text{GDP Deflator} = \frac{\text{Nominal}}{\text{Real GDP}} \times 100$	13	<u>Mixed Income of Self Employed</u> Difficult to separate labour income from capital income when people provide both labour and capital services .
8.1	$\text{Inflation rate in Yr 2} = \frac{\text{GDP deflator in Yr 2} - \text{GDP deflator in Yr 1}}{\text{GDP Deflator in Yr 1}} \times 100$	14	<u>Net Domestic Product at Factor Cost (NDP FC)</u> (AKA - Domestic Income or Factor Income earned in Domestic Territory) = Compensation of employees (+) Operating Surplus (R,I,P) (+) Mixed Income of Self- employed
9	<u>Domestic Vs National</u> 'National' → normal residents within or outside domestic territory → broader concept compared to 'domestic'. 'Domestic' → production done WITHIN domestic territory	15	National Income (NNPFC) = NDPFC + NFIA
10	<u>Resident Unit</u> - Unit having predominant (major) economic interest in economic territory of country for 1 year or more irrespective of nationality or legal status	16	As per CSO → ' National income is sum total of factor incomes generated by normal residents of a country like wages, rent, interest & profit in an accounting year '.
11	<u>Net Factor Income From Abroad</u> = Factor Income from abroad (-) Factor Income to Abroad	17	<u>3 Golden Rules of NI</u> 1) Gross – Depreciation = Net 2) MP = FC + IDT - Subsidy or MP = FC + NIT 3) Domestic + NFIA = National
12	<u>Operating Surplus</u> = Rent + Interest + Profit → (R,I,P)		



CHAPTER 6 – NATIONAL INCOME | UNIT 1

18	<p>GDP Per Capita</p> <ul style="list-style-type: none"> ➤ Measure of country's economic output per person. ➤ Indicator of the standard of living of a country. ➤ GDP Per Capita = Real GDP / Total Population 	23	<ul style="list-style-type: none"> ➤ Income from domestic product (NDPfc) accruing to public sector (Govt Income) = Income from P/E accruing to govt admin dep + Savings of Non dep enterprises ➤ Income from domestic product (NDPfc) accruing to private sector = NDPfc (-) Govt Income
19	<p>Indirect Taxes and Subsidies</p> <p>1) Production Taxes & Production Subsidies Independent of volume (qty) of actual production</p> <p>2) Product Taxes & Product Subsidies Paid or received on per unit of product</p>	24	<p>Private Income</p> <p>A measure of income (both factor & transfer income) which accrues to private sector from all sources within & outside the country.</p> <p>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</p>
20	<p>Basic Price = FC + Production Tax – Production Subsidy Market Price = BP + Product Tax – Product Subsidy</p>	25	<p>Net National Disposable Income (NNDI)- The amount of G/S domestic economy has at its disposal.</p> <ul style="list-style-type: none"> ➤ NNDI = NNPfc + Net IDT + Net Current Trf. from rest of world ➤ GNDI = NNDI + Depreciation (Ignore "Govt transfer pay" in GNDI/NNDI)
21	<p>Personal Income (PI)</p> <p>Income received by household sector including Non-Profit Institutions Serving Households from all sources</p> <p>PI = National Income + income recd but not earned - income earned but not received</p>		
22	<p>Disposable Personal Income (DI)</p> <p>It is a measure of amount of money in hands of individuals → available for consumption or savings.</p> <p>DI = Personal Income – PI Tax – Non Tax Payment</p>		



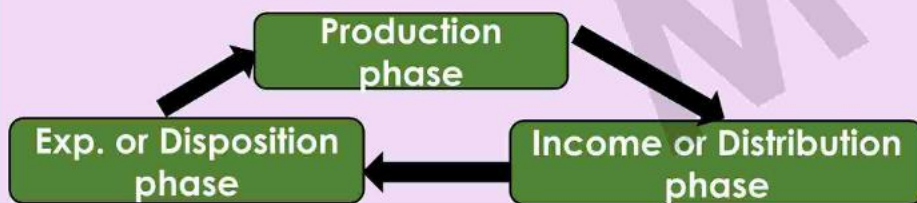
CHAPTER 6 – NATIONAL INCOME | UNIT 1

Particulars	Includes	Remarks
National Income	Earned Income recd. or not recd.	All sectors
Personal Income	Earned Income recd. & Transfer Income recd.	Household sector including NPISH
Private Income	Earned Income recd. or not recd. & Transfer Income recd. or not recd.	Private Sector

26

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-



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Method	Data Required	What is measured?
Value Added or Product 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 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
27	Value Added Method Value of Output (-) Intermediate Cons. (of all sectors: PS, SS, TS) = GVA mp or GDP mp	



CHAPTER 6 – NATIONAL INCOME | UNIT 1

28	<p>➤ GVamp (-) Dep (+) NFIA (-) NIT = NNPfc (NI)</p> <p>➤ If Value of Output is not given, then Value of Output = Sales + Change in Stock Where, Change in Stock = Cl Stock (-) Op Stock</p>	<p>Expenditure Method GDP mp = PFCE + GDCF + GFCE + (X-M)</p> <p>☐ GDCF includes-</p> <p>➤ Gross Domestic Fixed Capital Formation, i.e Invt in Fixed Assets by household, Pvt Business, Govt</p> <p>➤ Changes in Inventory OR Inventory Investment</p> <p>➤ Net Acquisition of Valuables</p> <p>☐ GDCF – Dep = NDCF</p>
29	<p>If Value of Output is not given separately Value of Output = Sales + Change in Stock Where, Change in Stock = Cl. Stock – Op. Stock</p>	<p>Who is responsible for calculating National Income in India ?</p> <p>32 MoSP&I → CSO → National Accounts Division which compiles National Accounts Statistics (NAS)</p>
30	<p>Income Method Compensation of Employees + Operating Surplus (R, I, P) + Mixed Income of Self-Emp = NDP fc + NFIA = NNP fc (National Income)</p> <p>O.E. includes - wages and sal., bonus, D.A., commission, employers' contri. to PF and imputed value of pay in kind.</p> <p>Profit = Corp. taxes + Dividend + Undistributed Profits</p>	<p>Combination of methods used in India to measure NI-</p> <p>➤ Value-added method → commodity producing sectors like agri & mfg.</p> <p>➤ income method → small scale sector</p> <p>➤ expenditure method → construction sector</p>
<p>✓ Study Economics & CA Inter FM/SM from MVSIR (online mode)- on Ultimate CA platform</p>		<p>34 Method for measurement of NI in developed economies: Mostly Income method → sometimes expenditure method also used.</p>



CHAPTER 6 – NATIONAL INCOME | UNIT 1

System Of Regional Accounts In India**State Income or Net State Domestic Product (NSDP)**

→ value in **monetary terms** of qty of **all G/S produced** in **state** within a given **period of time** accounted **without duplication**.

Per Capita State Income → **NSDP (State Income)** divided by **mid-year projected population** of the state.

Prepared by State Income Units of respective State Directorates of Economics and Statistics (DESS). **CSO assists** them.

Certain activities like **railways, communications, banking** etc → **cut across state boundaries**, & their **contribution cannot be assigned to any one state** → known as the '**Supra-regional sectors**'

Can GDP a country be taken as an index of welfare?

No, since GDP measures **exclude** the following-

- a) **Income distributions**
- b) Quality improvements due to **tech & managerial innovations**.
- c) **Productions hidden from govt.** (drugs, gambling etc.).

- d) **Non-market production & Non-economic contributors** → health, education levels etc.
- e) **Disutility of loss of leisure time**
- f) **Economic 'bads':** crime, pollution, traffic congestion etc which make us worse off.
- g) **Volunteer work** rendered **without remuneration**
- h) Things that contribute to economic welfare- **leisure time, fairness, gender equality** etc.
- i) **Distinction between production that makes us better off & which prevents us from becoming worse off**, for e.g. **defence exp** → **Increased exp on police** due to **increase in crimes** may incr. **GDP** but these **exp** only prevent us from becoming worse off.

Limitations And Challenges of NIConceptual difficulties

- 1) **lack** of an **agreed definition** of NI
- 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**,
- 6) services of **durable goods**,
- 7) **valuation** of **govt. services**



CHAPTER 6 – NATIONAL INCOME

Challenges

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

Usefulness And Significance Of National Income Estimates

32

- 1) **Framework** for analyzing **short-run performance**.
- 2) Helps **businesses to forecast future demand**.
- 3) **Economic welfare** depends on **value of national income**
- 4) **Composition of NI of different sectors & variations** in them.
- 5) Provides **quantitative basis** for **assessing & evaluating economic policies**
- 6) Shows **income distribution & inequality in its distribution**. Make **comparisons** using **ratios of investment, taxes, to GDP**.
- 7) Guide to make **policies for growth & inflation**.

CHAPTER 6 | UNIT 2 - Keynesian Theory of National Income

33

- In **previous unit, 'ex post' (realized)** values were used
- Eg- aggregate consumption (C)** denotes what **people have actually consumed**
- In this unit variables are defined in **'ex-ante' (anticipated)** terms or in terms of **what is intended or planned**.
- Ex-ante values are used to **predict** what **equilibrium value of output or GDP** is.

34

- **Natural level of real GDP** → Level of GDP where **resources are fully employed**.
- Before Keynes, **classical economists** said that **economy is self-regulating & capable of automatically achieving equilibrium** at **'natural level'** of **real GDP**
- But, Keynes said that **markets do not automatically lead to full-employment equilibrium**.
- So, **output will remain at less than full employment level unless** there is **insufficient spending**.



CHAPTER 6 – NATIONAL INCOME | UNIT 2

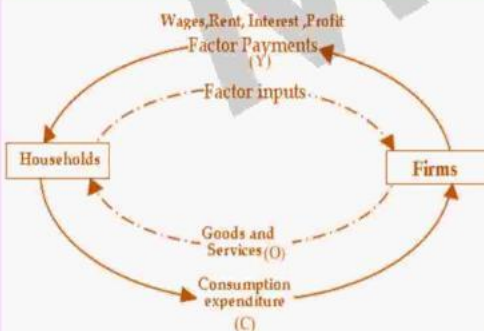
3 models of economy as per Keynes

- 35
- 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

- 36
- 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.
 - In the figure-
 - ❑ Circular **broken lines** - factor and product flows- 'real flows'
 - ❑ **Continuous line** with arrows show **money flows**

- 37
- Factor Payments**
 - = Household Income
 - = Household Expenditure
 - = Value of Output
 - = Total Receipts of Firms



38 Consumption function → $C = a + b.Y_d$

39 Average Propensity to Consume
 $APC = C / Y$
 Consumption is **decreasing function of level of income**. (As income increases, APC decreases)

40 Marginal Propensity to Consume (MPC = "b")
 $MPC = \Delta C / \Delta Y = b$
 Keynes **assumes** → increase in cons. < increase in Y_d ($b < 1$). i.e. $0 < b < 1$
MPC is slope of consumption line

41 Saving function → $S = -a + (1-b).Y_d$

42 Marginal Propensity to Save
 $MPS = \Delta S / \Delta Y = 1 - b$
 $MPC + MPS = 1$; $MPS 0 < b < 1$
 Also, **MPS is slope of savings line**

43 Average Propensity to Save
 $APS = S / Y$
 Saving is **increasing function of level of income**. (As income increases, APC decreases)



CHAPTER 6 – NATIONAL INCOME | UNIT 2

	Y	C	S	MPC	MPS	APC	APS
44	0	50	-50	-	-	∞	$-\infty$
	100	125	-25	0.75	0.25	1.25	-0.25
	200	200	0	0.75	0.25	1.00	0
	300	275	25	0.75	0.25	0.92	0.08
	400	350	50	0.75	0.25	0.88	0.12

Aggregate Supply (AS)

45 Ex ante AS \rightarrow **total supply of G/S** which firms **plan on selling** during a specific time period.

AS = Agg. Production = Factor Payments = Factor Incomes [National Income \rightarrow Y]

Aggregate Demand (AD)

46 Ex-Ante AD is total **planned expenditure** in the economy.

Equilibrium output

47 When **desired amount of output demanded equals amount produced**. (AS = AD)

Two Sector Model

- 48
- 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

- 49
- Household + Business + Government Sector
 - $AD = C + I + G$
(I & G are constant)
 - $AS = C + S + T$
 - Equilibrium is achieved when -
 $AD = AS$ or $C + I + G = C + S + T$ or
 $I + G = S + T$
- Govt adds following flows to circular flow :
- 1) **Taxes**
 - 2) **Transfer payments & subsidy payments**
 - 3) **Govt purchases**
 - G/S from business
 - factors of prod from household, and
 - 4) **Govt borrowing in financial markets to finance deficits** (if any, when $G > T$)



CHAPTER 6 – NATIONAL INCOME | UNIT 2

Four Sector Model

➤ Household + Business + Govt. + Foreign Sector

➤ $AD = C + I + G + (X - M)$

(I, G & X constant)

➤ $AS = C + S + T$

➤ Equilibrium is achieved when -

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

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

50

Foreign sector adds following flows to circular flow :

- 1) exports,
- 2) imports and
- 3) net capital inflow (capital inflow - capital outflow)

If $(X > M)$, then NX is +ve

→ then NI incr.

If $(X < M)$, then NX is -ve

→ then NI decr.

51

Leakage & Injection

❑ **Leakage-** Outflow of income from circular flow model. Leakages are that part of income which is not used to purchase goods of current year or what households withdraws.

❑ **Injection-** Inflow of income to circular flow → leads to increase in volume of income.

52

❑ When $AS = AD$ → Leakages = Injections
Then national income will be in equilibrium.

❑ When $AS > AD$ → Leakages > Injections
Stock Surplus or Deficient Demand → inventories will pile up → firms decrease production in future → lead to fall in output & income in future. (NI will fall)

❑ When $AS < AD$ → Leakages < Injections
Stock Shortage or Excess Demand → unexpected sales would draw down inventories (stock-out) → thus, hiring more workers & expanding production (NI will rise)

53

Deflationary Gap

Deficient Demand means,
Actual AD < Potential AD

Deficient demand → leads to 'deflationary gap'
Occurs during contraction.

Leads to unplanned inventories pile up & thus decrease production & employment until under-employment equilibrium is reached.

CHAPTER 6 – NATIONAL INCOME | UNIT 2

54	<p style="text-align: center;"><u>Inflationary Gap</u></p> <p>➤ Excess Demand means, Actual AD > Potential AD</p> <p>➤ Excess demand → leads to 'inflationary gap'. Occurs during expansion → leads to demand pull inflation.</p>	<p>5. undistributed profits of companies</p> <p>6. part of income used for payment of debts</p> <p>7. scarcity of G/S despite having high MPC</p>
55	<p style="text-align: center;"><u>Investment Multiplier</u></p> <p>Investment Multiplier (k) explains how many times equilibrium NI increases as result of increase in autonomous investment.</p> $K = \frac{\Delta Y}{\Delta I} \text{ or } \frac{1}{1 - MPC} \text{ or } \frac{1}{MPS}$	<p style="text-align: center;"><u>How to solve numericals of equilibrium NI (Y) & multiplier ?</u></p> <p>Step 1 : Find Disposable Income (Y_d) in terms of $Y = Y - T - t.Y + TR$</p> <p>Step 2 : Input the above value of Y_d in consumption function → $C = a + b.Y_d$</p> <p>Step 3 : At equilibrium → AS = AD → Thus, $Y = C + I + G + (X-M)$</p> <p>Step 4 : Input value of "C" in above equation & find Y (equilibrium NI).</p> <p>Step 5 : Find value of multiplier as per data given in question & below summary-</p> <p>➤ 2 Sector → $K = 1 / (1 - b)$</p> <p>➤ 3 Sector</p> <p><input type="checkbox"/> If prop. tax (t) is not given → $K = 1 / (1 - b)$</p> <p><input type="checkbox"/> If prop. tax (t) is given → $K = 1 / 1 - [b(1-t)]$</p> <p>➤ 4 Sector</p> <p><input type="checkbox"/> If prop. tax (t) is not given → $K = 1 / (1 - b + m)$</p> <p><input type="checkbox"/> If prop. tax (t) is given → $K = 1 / 1 - [b(1-t)] + m$</p>
56	<p style="text-align: center;"><u>Import</u> → $M = M + mY$</p> <p>Marginal propensity to import → $m = \Delta M / \Delta Y$</p>	
57	<p>The more powerful leakages are - the smaller will be multiplier.</p> <p>The leakages are caused due to:</p> <ol style="list-style-type: none"> progressive rates of taxation high liquidity preference demand met out of existing stocks or imports additional income spent on purchasing existing wealth 	



CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

1	Macroeconomics → study of economy as a whole. 3 main macroeconomic goals for any nation- economic growth, high levels of employment & stable price levels.
2	Adam Smith was a bold advocate of free markets & minimal governmental activity. As per him, govt.'s functions are- national defense, establishing a system of justice, establishment & maintenance of public institutions
3	Richard Musgrave , in his book 'The Theory of Public Finance' (1959), gave 3 roles of government- ➤ Microeconomic functions ✓ Allocation Function - to correct sources of inefficiency ✓ Redistribution Function – ensures distribution of wealth & income is fair ➤ Macroeconomic function ✓ Stabilization Function - Monetary & fiscal policies for macroeconomic stability
4	Economic efficiency → where all resources are allocated in best way possible , minimizing waste & inefficiency. If a market is left to itself , it leads to inefficient & misallocation of society's scarce resources . Thus, market failures provide for government's allocative function

5	Allocation instruments which govt. can use to influence resource allocation 1) Govt may directly produce an economic good 2) Govt may influence private allocation through- ✓ Incentives : Tax concessions, Subsidies ✓ Disincentives : Increase in Taxes, Bans 3) Govt may influence allocation through competition policies . Eg- Competition Act 2002 4) Govts' regulatory activities → licensing, min wages etc. 5) Govt sets legal & administrative frameworks 6) any mixture of above
6	Distribution Function- If left to market, distribution of income in society is likely to be skewed & thus govt. has to intervene to ensure more socially optimal & egalitarian distribution . ➤ Related to question → for whom should an economy produce G/S. ➤ It also also relates to manner in which effective demand is divided among individuals of society

- ✓ Study Economics & CA Inter FM/SM from MVSIR (online mode)- on **Ultimate CA platform**
- ✓ Buy MVSIR's books & quiz- **mvsir.in**



CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

7	<p>Examples of Redistribution function</p> <ol style="list-style-type: none"> 1) Taxation policies- progressive taxation of rich & provision of subsidy to poor 2) Proceeds from progressive taxes used for financing public services that benefit poor 3) Employment reservations to protect certain segments 4) Unemployment benefits & transfer payments to deprived sector 5) Families below poverty line -monetary aid & aid in kind 6) Regulation of mfg. & sale of certain products to ensure well-being 7) Special schemes for backward & vulnerable sections 	9	<p>Deficit budget (Exp > Rev) - stimulate economic activity Surplus budget (Rev>Exp)- slow down economic activity.</p>
8	<p>Stabilization Function Macroeconomic stability is said to exist when:</p> <ol style="list-style-type: none"> 1) economy's output = production capacity, 2) economy's total spending = total output 3) economy's labour resources are fully employed, and 4) Inflation is low and stable. <p>Rationale</p> <ul style="list-style-type: none"> ➤ A market economy does not automatically generate full employment and price stability on its own. ➤ Recessions, inflation etc.- prolonged for longer periods ➤ Becomes complex due to 'contagion effect' (increased international interdependence)→ instability get transmitted from one country to other. 	10	<p>Fiscal federalism- Given by Richard Musgrave, deals with the division of govt functions & financial relations among the different levels of govt.</p> <p>As per Musgrave, responsibility of-</p> <ul style="list-style-type: none"> ➤ central (union/federal) govt → economic stabilization & income redistribution, and ➤ state govt → allocation of resources
		11	<p>India is a federation of 28 states & 8 union territories.</p>
		12	<p>Article 246 of Constitution→ demarcates powers of union & state into three lists-</p> <ol style="list-style-type: none"> 1) Union list- items where union parliament can legislate 2) State list- items for state legislative assemblies 3) Concurrent list- for both. <p>Conflicting legislation in concurrent list→ centre prevails.</p>
		13	<p>Taxes levied by central (union) government income tax (other than agricultural income), customs duties, excise duties, corporation tax, tax on capital value of assets, security transaction tax, central GST, taxes other than stamp duties etc</p>



CHAPTER 7 – PUBLIC FINANCE | UNIT 1 – FISCAL FUNCTIONS: AN OVERVIEW, CENTRE AND STATE FINANCE

16	Taxes levied by state government taxes on agricultural income, lands & buildings, mineral rights, electricity, vehicles, tolls, professions, land revenue	22	GST accounts for- 35% of tax revenue of union & 44% of tax revenue of states .		
17	Property of the union is exempt from state taxation , & vice versa. (ek dusre pe tax nahi lagate)	23	Supreme court verdict in May 2022 , Union & state legislatures have " equal, simultaneous and unique powers " to make laws on GST		
18	Articles 268 to 281 of constitution → provisions in respect of distribution of finances among states .	24	GST system replaced old production-based taxation system with a consumption based one. For loss of revenue of manufacturing states → provide compensation by levying cess on luxury goods & demerit goods → proceeds are credited to compensation fund . Top five GST compensation receiving states were Maharashtra, Karnataka, Gujarat, Tamil Nadu, & Punjab		
19	Finance Commission (Article 280) - Responsible for: ➤ evaluating state of finances of union & state govt, ➤ recommending the sharing of taxes between them ➤ lay down principles determining distribution of taxes among states	25	Expenditure Decentralization Central govt ✓ defence, ✓ foreign affairs, ✓ foreign trade ✓ Foreign exch mgt, ✓ money & banking, ✓ cross-state transport, ✓ communication.	State govt ✓ agriculture & industry, ✓ social sector services- • health & education, • police protection, • state roads & infrastructure.	Local self govts -municipalities & panchayats ➤ public utility services like- ✓ water supply ✓ sanitation, ✓ local roads, ✓ electricity
20	Vertical Equity (deciding about share of all states in revenue collected by centre) → 41% for 2021-26 Horizontal Equity (allocation among states their share of central revenue). Criteria for distribution (horizontal equity)- (a)Income Distance (d)Demographic performance (b)Area (e)Forest and ecology (c)Population (2011) (f)Tax & fiscal efforts	26	Borrowing by Govt of India & borrowing by states → Article 292 & 293 of Constitution		
21	GST came on 1 July 2017 - subsumes majority of indirect tax. For any particular G/S, SGST & CGST rates are equal . Integrated GST (IGST) on inter-state movement				



CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

1	<p>Market failure A situation in where free market → misallocation of society's scarce resources leading to- overproduction or underproduction of particular G/S leading to a less than optimal outcome.</p>
2	<p>Two types of market failure a) Complete market failure- "Missing markets" - when market does not supply products at all b) Partial market failure- occurs when market does actually function, but it produces either- wrong quantity or at wrong price.</p>
3	<p>Why do markets fail ? OR Reasons for market failure I) Market Power , II) Externalities III) Public Goods , IV) Incomplete Information</p>
3 (a)	<p>Market power or monopoly power → ability of firm to raise market price over its marginal cost. (Price > MC) Here producers restrict output, & keep price high</p>
3 (b)	<p>Externalities are costs or benefits that do not reflect as part of market price. They are also referred to as 'spillover effects', OR 'neighbourhood effects' 'third-party effects' OR 'side-effects', as originator of externality imposes costs or benefits on others who are not responsible for initiating effect.</p>

	<p>Externalities can be- i) NPE (initiated in production confers external cost) • Received in production Eg- Factory discharges untreated waste into a nearby river → affects fish output → less catch for fishermen • Received in consumption Eg- Factory discharges untreated waste into a nearby river- causing health hazards while drinking & bathing</p>
3 (b)	<p>ii) NCE (initiated in consumption confers external cost) • Received in production Eg- act of undisciplined students talking & creating disturbance in a class • Received in consumption Eg- smoking cigarettes in public place causing passive smoking by others</p>
	<p>iii) PPE (initiated in production confers external benefit) • Received in production Eg- Firm offers training to employees - generates +ve benefits for other firms while they hire same workers. • Received in consumption Eg- When an individual raises an attractive garden & persons walking by enjoy the garden</p>



iv) PCE (initiated in prod. confers external benefit)

- Received in production

Eg- Consumption of **services health club by employees** → **external benefit to firm**

- Received in consumption

Eg- If people **get immunized against contagious diseases** → **benefit to others**

How externalities cause inefficiency and market failure ?

- **Private cost** is **cost** incurred by producer directly involved in production → **appears in accounts**.
- **Supply curve** → shows only **private marginal costs**.
- **External costs** are borne by third parties not directly involved in transaction.

4

Social costs → **total costs to society** on account of **production or consumption**.

Social Cost = Private cost + External Cost

- Each **firm's cost** considers **only private cost** & do **not incorporate externalities**
- Goods having **-ve** externality → **over-produced**
- Goods having **+ve** externality → **under-produced**

Public Goods

➤ Aka. '**collective consumption good**' or social good

➤ Given by **Paul A. Samuelson**

Characteristics of Public Goods

- 1) Consumption is **collective** in nature.
 - 2) **Non-Rivalrous** : Simultaneous consumption is possible.
 - 3) **Non-excludable** : One individual **cannot deny other individuals'** consumption, **even if** they have **not paid** for it.
 - 4) **Indivisibility**
 - 5) **Additional resource cost** of another person is '**zero**'
 - 6) **No direct payment** by the consumer is involved
 - 7) **More vulnerable** to issues → **externalities, inadequate property rights, & free rider** problem.
- Public goods will **not be produced** at all or will be **under-produced**.

5

Private goods are **scarce** & **must purchase** at a **price**.

- Do **not** face **free-rider problem**.
 - **Excludable** → payment is must to access
 - **Rivalrous** → Simultaneous consumption is possible.
- Normally markets **efficiently allocate resources** for private goods.

6

Impure Public Goods- having features of **both Public & Private goods**

CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

7	<p>Incomplete Information Perfect information → both buyers & sellers have complete information</p> <p>Information failure leads to – a) asymmetric information, b) adverse selection and c) moral hazard</p>
7.1	<p>a) Asymmetric Information Means imbalance in information, i.e when seller knows more than buyer or vice versa → distort choices & thus market failure.</p>
7.2	<p>b) Adverse Selection Asymmetric information generates adverse selection. When one party, say X, has some information that other party Y does not → the value of transaction is known more accurately to X → and X may take advantage of Y's ignorance Eg- Health insurers know less about health conditions of buyers → unable to differentiate between high-risk and low-risk persons.</p>

7.3	<p>Lemons Problem (given by George Akerlof) Lemons- Both poor & good quality used cars Generally used car on sale is 'lemon' → buyers' willingness to pay will be based on 'average quality' of used cars. Asymmetric info leads to elimination of high-quality goods from market. People end up either- • selecting a sub-standard product or • leaving the market altogether.</p>
7.4	<p>c) Moral Hazards It is about informed person's taking advantage of a less-informed person through an unobserved action. Eg- deliberately risk-taking due to comprehensive insurance cover.</p>
Govt Intervention to CORRECT market failure	
8	<p>Minimize Market Power Establishing regulations designed to promote competition & prohibit actions restraining competition.</p>
<p>✓ Study Economics & CA Inter FM/SM from MVSIR (online mode)- on Ultimate CA platform</p>	



CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

<p>9</p>	<p>Government intervention to correct Negative Externalities</p> <p>i) Direct Controls Direct controls, (aka command solutions), prohibit activities that create negative externalities or require that negative externality be limited to a certain level.</p> <p>ii) Market Based Policies Market-based policies provide economic incentives so that self interest of market participants would achieve socially optimal solution.</p> <p>Market based approaches affect market price by- > Setting price directly- by pollution tax > Setting price indirectly- by cap-&-trade system</p>	<p>11</p> <p>Problems in pollution tax</p> <p>1) Difficult to determine → complex & costly administrative procedures.</p> <p>2) If demand for good is inelastic → tax have less effect in reducing demand.</p> <p>3) Tax have negative consequences on employment & investments → producers shift their factories to other countries.</p>
<p>10</p>	<p>Pollution Tax</p> <ul style="list-style-type: none"> ➤ This tax depends on amount of pollution firm produces. ➤ Aka. Pigouvian taxes after A.C. Pigou ➤ Making the polluter pay → tax increases private cost & thus decreases output of good which creates negative externality. ➤ Proceeds from tax → used for projects that protect environment. 	<p>12</p> <p>Tradable Emission Permits</p> <ul style="list-style-type: none"> ➤ Use of tradable permits to limit emissions is called 'cap and trade'. ➤ Tradable permit → license that allows to release a unit of pollution into environment over a period of time. ➤ A firm that generates emissions above what is allowed → penalized with fines. ➤ A firm which produces less pollution can sell their permits & earn money. ➤ High polluters have to buy more permits → which increases their costs & makes them less competitive & less profitable.
<p>13</p>	<p>Government intervention to correct Positive Externalities Govt provides (Pigouvian subsidy)–</p> <ul style="list-style-type: none"> a) corrective subsidies to producers-to increase supply b) Corrective subsidies to consumers - to increase demand 	<p>13</p> <p>Government intervention to correct Positive Externalities Govt provides (Pigouvian subsidy)–</p> <ul style="list-style-type: none"> a) corrective subsidies to producers-to increase supply b) Corrective subsidies to consumers - to increase demand



14	<p>Government intervention in case of merit goods</p> <ul style="list-style-type: none"> ➤ Merit goods → have positive externalities & are socially desirable. ➤ But are under-produced & under-consumed ➤ Eg- education, health care, waste management etc ➤ Govt can provide- <ol style="list-style-type: none"> 1) Regulation → how private activity may be conducted. 2) Prohibit some activities, set standards & issue mandates. 3) Use legislation to enforce consumption (Eg helmets) 4) Compel individuals to consume such good. (Eg- Right of Children to Free & Compulsory Education Act, 2009) 5) Ultimate encouragement → make the good completely free → leads to substantial demand. 	<p>How do governments correct market failure resulting from demerit goods ?</p> <ol style="list-style-type: none"> 1) Enforce complete ban → but still can be secretly driven underground & traded in hidden market 2) Imposing unusually high taxes → But, if demand is inelastic → sellers can shift tax burden to consumers. 3) Fix minimum price below which demerit good should not be sold. (price floor) 4) Through persuasion, achieved by negative advertising campaigns 5) Through legislations that prohibit advertising or promotion 6) Strict regulations- to limit access to children 7) Spatial restrictions
14.1	<p>Government intervention in case of demerit goods</p> <ul style="list-style-type: none"> ➤ Demerit goods are socially undesirable. Eg- cigarettes, alcohol etc. ➤ Its consumption → imposes negative externalities. (over-prod. & over-cons.) ➤ All goods with negative externalities are not essentially demerit goods; e.g. steel. 	<p>Government intervention in case of Public goods</p> <ul style="list-style-type: none"> ➤ Important public goods- Eg- defence, establishment & maintenance of legal system → are directly provided by govt. ➤ Excludable public goods → provided by govt & can be financed through entry fees. ➤ Some public goods are provided by voluntary contributions and private donations by corporate entities and NGOs.



CHAPTER 7 – PUBLIC FINANCE | UNIT – 2: MARKET FAILURE / GOVERNMENT INTERVENTION TO CORRECT MARKET FAILURE

16	<p>Price Intervention: Non-Market Pricing Price intervention → legal restrictions on price.</p> <p>a) Price Floor (min price buyers are required to pay) or ✓ Price set above the equilibrium price ✓ Eg- MSP, minimum wages, making demerit goods expensive etc</p> <p>b) Price Ceiling (max price sellers allowed to charge) ✓ Price set below the equilibrium price ✓ Eg- rent controls, black marketing, Shortages in market, problem of allocation of limited supplies among large no. of consumers etc</p>
17	<p>Correcting Information Failure</p> <p>1) Mandatory labelling & content disclosures. 2) Mandatory disclosure of information. 3) Public dissemination of information to improve knowledge 4) Regulation of advt & setting of advt standards</p>
18	<p>Equitable Distribution Govt can provide-</p> <p>1) progressive income tax, 2) targeted budgetary allocations 3) unemployment compensation 4) transfer payments, subsidies, job reservations, etc.</p>

19	<p>➤ Government Failure</p> <p>➤ When govt intervention to correct a market failure → creates inefficiency & misallocation of resources.</p> <p>➤ Also can produce fresh & more serious problems</p>
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UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

20	<p>➤ Budget is a statement that presents details of-</p> <ul style="list-style-type: none"> • 'where money comes from' & • 'where money goes to'. <p>➤ Govt budget is a document presented for approval & legislation by a government and contains estimates of proposed exp & proposed means of financing them.</p> <p>➤ Contains estimates of govt's accounts for next fiscal year called budgeted estimates.</p>
21	<p>Budgetary process is means by which executive & legislative branches together formulate a coherent set of taxing & spending proposals.</p>
22	<p>Article 112 of constitution-</p> <p>'President shall present to both houses of parliament a statement of estimated receipts & expenditure of govt of India → called as "Annual Financial Statement".</p>



PROCESS OF BUDGET (SUMMARY)



Budget is prepared by MoF in consultation with NITI Aayog.

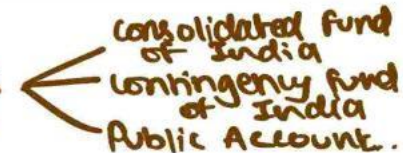
- 1) MoF → Budget Division → Schedule → Budget Circular
 - Detailed instructions & formats for preparing estimates of exp
 - ↳ Ministries, State, UTs, Autonomous Bodies
- 2) Pre-Budget Consultations
 - Union FM → State FM, Industry Associations, Representatives from various sectors, experts from NITI Aayog & economists etc.
- 3) Proposed Budget (Draft) is prepared
- 4) Union FM → Prime Minister y Budget **FREEZE**
- 5) **Halwa Ceremony** → Marking completion & printing of budget documents.



CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

• Budget Documents

a) Annual Financial Statements (AFS) → Govt. Receipts & Expenditure



b) Demand for Grants (DG)

c) Finance Bill

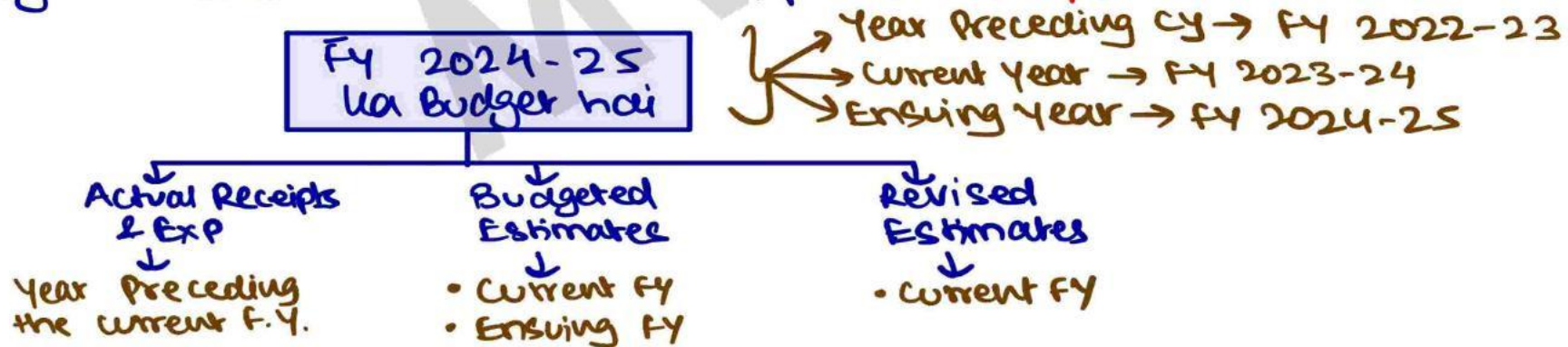
d) Statements mandated under FRBM Act.

i) Macro Economic Framework Statement

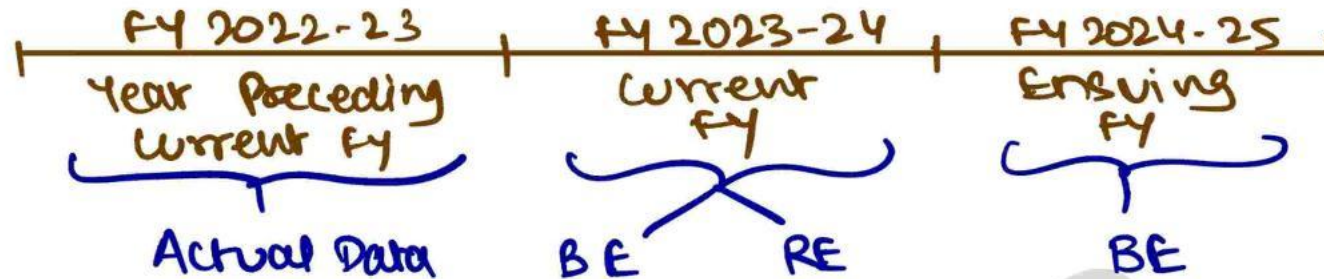
ii) Medium-term Fiscal Policy cum Fiscal Policy Strategy Statement.

e) & other documents → Explanatory Statements.

• Budget shows info of REC. & Exp. of 2 years.



CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT



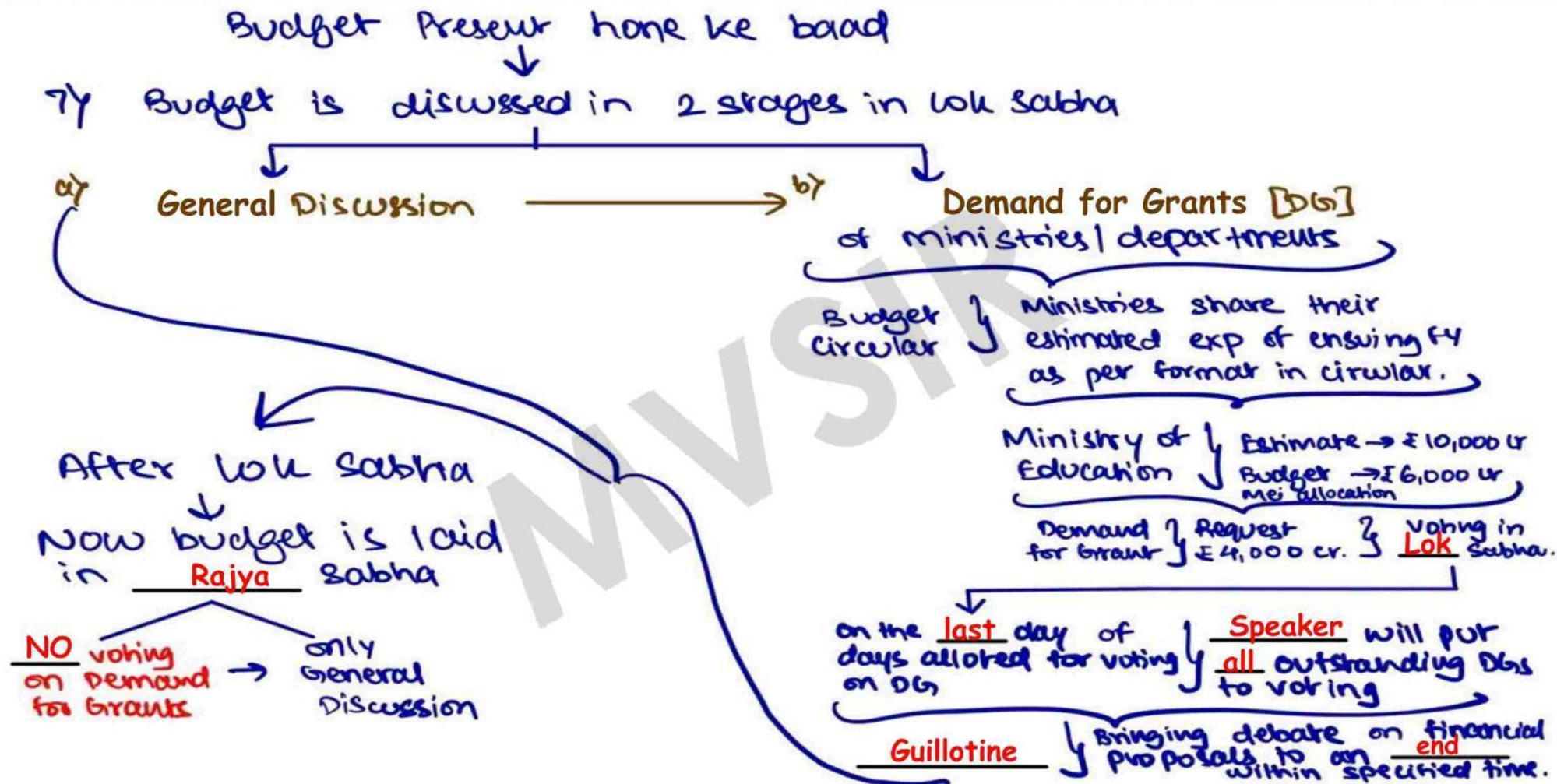
By Budget Speech → FM → Lok Sabha.

Part A

- Current Macro Economic Situation
- Budgeted Estimates for Ensuing FY.
- Priorities of Govt.
- Total funds raised by Taxes & Borrowing.
- Proposed Allocation of Expenditure to diff. sectors [Appropriation Bill]
- Fresh schemes for Diff. sectors.

Part B

- Progress of Govt on various developmental measures
- Direction of future policies
- Tax proposals & variations in current taxation system [Finance Bill]



CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

8y After general discussion & voting on Dh,
 now Govt. introduces -
 → Appropriation Bill → Give authority to Govt. → incur exp. from Consolidated fund of India
 ↓ After Appr. Bill is passed

→ Finance Bill is taken up for consideration
 ↳ Motion for leave to introduce FB cannot be opposed.
 ↳ Parliament has to pass F.B. within **75 days**

10y from **FY 2017-18**,
 date of presentation of Budget ↓ **1 Feb**

11y Earlier Railway Budget was presented separately by Minister of Railways.
 But ↓
 from **FY 2017-18**,
 Railway Budget is merged with General Budget

9y After Finance Bill Passed by Lok Sabha
 ↳ sent to Rajya Sabha → Has to return it with **14 days** with/without recommendations

Recommendations of RS may be accepted or rejected by LS.

Lastly, FB will be sent to President
 After Assent by FB → Finance Act.

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CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

23	<p>Department of Revenue of Ministry of Finance controls revenue matters relating to direct & indirect taxes through two boards-</p> <ol style="list-style-type: none"> 1. Central Board of Direct Taxes (CBDT) 2. Central Board of Indirect Taxes & Customs (CBIC) 	<p>Central govt expenditure is classified in six broad categories :</p> <p>A. Centre's Expenditure:</p> <ul style="list-style-type: none"> ➤ Establishment Exp of Centre; ➤ Central sector schemes, and ➤ Other central exp → on CPSEs & Autonomous Bodies <p>B. Centrally Sponsored Schemes & other Transfers: The transfers include</p> <ul style="list-style-type: none"> ➤ Centrally sponsored schemes ➤ Finance Commission transfers and ➤ Other transfers to states
24	<p>Department of Expenditure of Ministry of Finance → nodal department for overseeing public financial management system of govt.</p> <p>It is responsible for-</p> <ol style="list-style-type: none"> a) implementation of recommendations of Finance Commission & Central Pay Commission, b) monitoring of audit comments/observations, c) preparation of central government accounts. d) assisting central ministries in- <ul style="list-style-type: none"> ✓ controlling costs & prices of public services, ✓ reviewing systems & procedures to optimize exp. 	<p>Economic costs of unproductive public exp:</p> <ul style="list-style-type: none"> ✓ larger deficits ✓ higher levels of taxation, ✓ lower economic growth, ✓ fewer resources available for use elsewhere, and ✓ greater debt burden in the future.
25	<p>One of explanatory documents in budget is 'Expenditure Profile' → consists data of all ministries to outline a profile of general financial performance of Govt.</p>	<p>✓ Study Economics & CA Inter FM/SM from MVSIR (online mode)- on Ultimate CA platform</p> <p>✓ Buy MVSIR's books & quiz- mvsir.in</p>



Central Government

Revenue Receipts

→ Neither create liability
→ Nor cause any reduction in assets

Tax Revenue

Corp. Tax, Income Tax, GST, custom Duty etc

Non-Tax Revenue

Interest Recd, Dividend Recd, Surplus from RBI etc.

Ch Net Tax = Total Tax (-) Sh (-) NCCD Recd by Ch share Revenue

Revenue Expenditure

- Exp which does not lead to creation of assets
- Exp for normal functioning of Govt. Departments.
- Eg - Interest on loan, Grant to SG, Salary, Rent, Electricity etc.

Capital Expenditure

Creation of Assets

- Physical Assets
CG acquired land, M/L, Bid. etc
- Financial Assets
Invr in Shares, Ch giving loan & adv.

Reduction in Liabilities

- Repayment of Loans & Adv. (Principal Am)
- Payment of PF etc.

Capital Receipts

Increase in Liabilities

Debt Capital Receipt

Market loans, Treasury Bills, Security against small savings, external debt, state Provident fund

Reduction in Assets

Non-Debt Capital Receipt

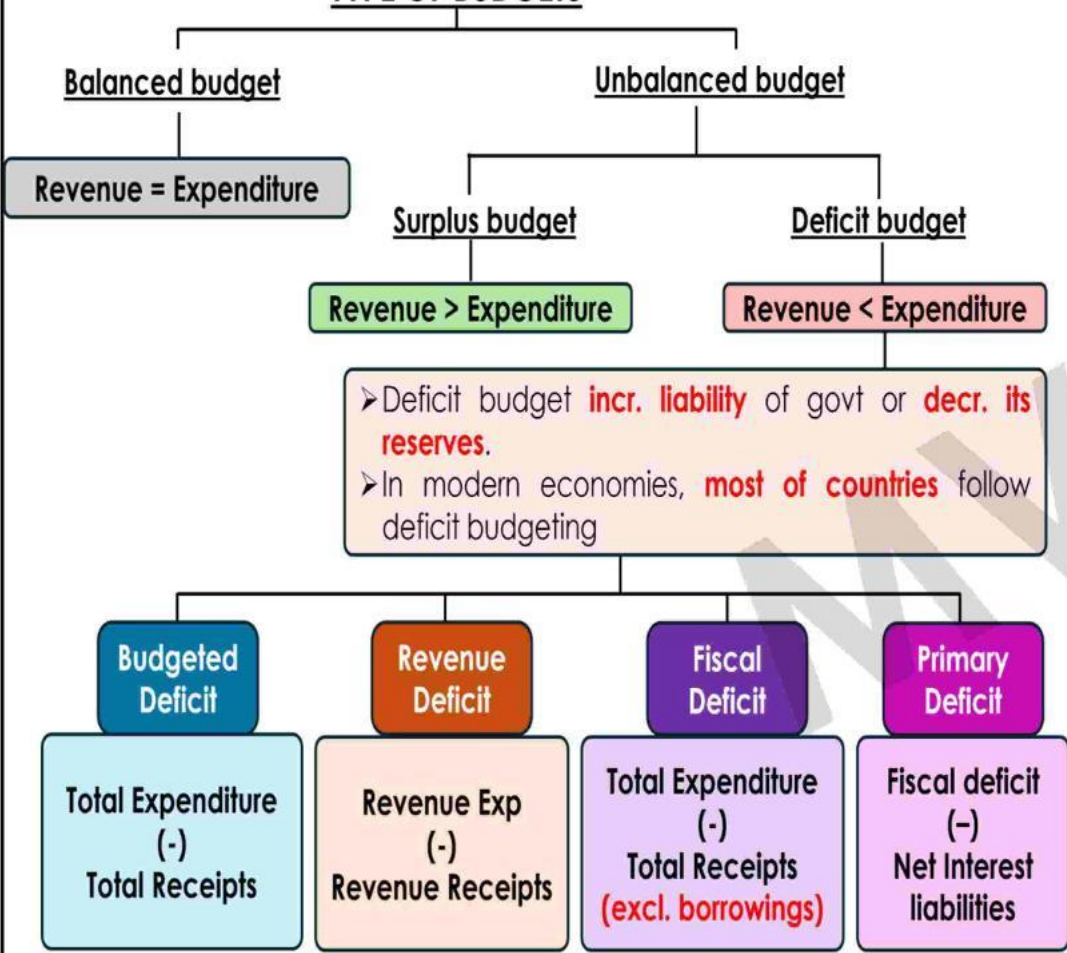
Recovery of loans & Adv., Dis-investment, Sale of move. Assets.

Repayment of Debt Capital Receipts is Capital Expenditure



CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

TYPE OF BUDGETS



- 28 Public Debt Management**
- > Govt is generally **largest borrower** in any economy.
 - > Public debt - means **debt taken by govt**, which is to be **repaid at a future date** with **interest**. (debt is credited to **Consolidated Fund of India**)
 - > Debt servicing is a **continuous exercise** (not a one-time exercise) → as a portion of debt falls due, govt simply **refinances debt** → **sells new bonds** & uses its proceeds to **pay off old debt**.
- 29**
- > **Debt management strategy** is based on **3 pillars**-
 - 1) low cost of borrowing,**
 - 2) risk mitigation,**
 - 3) market development.**

Institutions responsible for public debt management are	
Domestic marketable debt	Internal Debt Management Department (IDMD) of RBI
External Debt ✓ bilateral loans- (loan from one country/govt) ✓ multilateral loans (major part of external debt)- loans from multilateral agencies	Department of Economic Affairs in Ministry of Finance (MOF)



CHAPTER 7 | UNIT 3 – THE PROCESS OF BUDGET MAKING: SOURCES OF REVENUE, EXPENDITURE MANAGEMENT AND MANAGEMENT OF PUBLIC DEBT

30	From 1997→ RBI provides short-term credit up to 3 months to state govts in form of Ways and Means Advances (WMA) .		It is a progress card on what various ministries have done with the outlays in previous annual budget.
31	Fiscal Responsibility & Budget Management (FRBM) (2003) → provides legislative framework for reduction of fiscal deficit & debt of govt to sustainable level. Objectives are: 1) inter-generational equity , 2) long run macroeconomic stability , 3) better coordination between fiscal & monetary policy, and 4) transparency in fiscal operation of govt.	35	Consolidated Fund of India ➤ All revenues, loans & money received by govt are credited to this fund & all exp are incurred from this fund . ➤ Money can be spent from this fund → only if approved by parliament .
32	Public Debt Management Cell (PDMC) was created in 2016 under Department of Economic Affairs.	36	Contingency Fund of India It is placed at disposal of President to enable her to make advances to Govt to meet urgent unforeseen expenditure . (no approval from Parliament reqd) After spending from this fund→ amount is recouped from Consolidated Fund of India .
33	RBI Retail Direct' facility announced by RBI on 5 th Feb, 2021: ➤ improving ease of access by retail investors through online access to govt securities ➤ provide facility to open govt securities account	37	Public Account Article 266(1) of Constitution→ this account is used in relation to all fund flows where govt is acting as a banker . (no approval from Parliament reqd) Eg- Provident Funds & Small Savings .
34	Outcome budget It establishes direct link between budgetary allocations of schemes & its annual performance targets .	38	Cut Motions Motions for reduction to various demands for grants are made in form of cut motions.



CHAPTER 7 – PUBLIC FINANCE | UNIT – 4 : FISCAL POLICY

39	<p>Meaning Fiscal policy involves use of govt- spending, taxation & borrowing to influence both-</p> <ul style="list-style-type: none"> ➤ pattern of economic activity & ➤ level of growth of agg. demand, output & employment 	<p>Contractionary fiscal policy (CFP) To stimulate economy during inflation-</p> <ul style="list-style-type: none"> ➤ decreasing aggregate exp, and ➤ increase in taxes <p>It leads to smaller govt budget deficit or larger surplus. CFP is resorted to close inflationary gap</p>
40	<p>Objectives The most common objectives of fiscal policy are:</p> <ul style="list-style-type: none"> ➤ full employment ➤ price stability, ➤ economic development ➤ Equitable distribution <p>Importance & priority of these may vary from country to country-</p> <ul style="list-style-type: none"> ➤ stability & equality → priority of developed nations, ➤ economic growth, employment & equity → priority of developing countries 	<p>Instruments of Fiscal Policy</p> <ol style="list-style-type: none"> 1. Govt expenditure 2. Taxes 3. Public Debt 4. Govt Budget
41	<p>Types of Fiscal Policy Expansionary fiscal policy (EFP) To stimulate economy during contraction/recession-</p> <ul style="list-style-type: none"> ➤ increasing aggregate exp, & decrease in taxes <p>It leads to larger govt budget deficit or smaller surplus. EFP is resorted to close contractionary gap.</p>	<p>Govt expenditure 3 Types-</p> <ul style="list-style-type: none"> ➤ Current exp. → day-to-day running of govt ➤ Capital exp. → buy capital equipments & infrastructure, and ➤ Transfer payments → govt spending which does not contribute to GDP.
41.1		<p>Taxes Taxes determine size of disposable income → which determines aggregate demand.</p>



<p>42.3</p> <p>Public Debt Public debt may be-</p> <ul style="list-style-type: none"> ➤ Internal Debt- Govt borrows from its own people in country. ➤ External Debt- Govt borrows from outside sources <p>Market Loans Govt issues treasury bills & securities of which are traded in debt markets.</p> <ul style="list-style-type: none"> ➤ For capital projects→ long-term capital bonds are issued ➤ For short-term govt expenditure→ treasury bills are issued. <p>Small Savings These are public borrowings→ not negotiable & not tradeable. Eg- National Savings Certificate etc.</p> <p>During Inflation Borrowing from public (new issue)→ by sale of securities→ curtails aggregate demand→ Part of CFP.</p> <p>During Recession Repayments of debt→ increase availability of money & increase aggregate demand→ Part of EFP.</p>	<p>Government Budget Net effect of budget on aggregate demand depends on govt's budget balance.</p> <ul style="list-style-type: none"> ❑ Balanced budget: (Revenue = Exp) No net effect on agg. demand since leakages (taxes) = injections (exp) 42.4 ❑ Budget surplus: (Revenues > Exp) It has negative net effect on agg. demand since leakages > injections It reduces national debt ❑ Budget deficit: (Revenues < Exp) It has positive net effect on agg. demand since injections > leakages It adds to the national debt <p>43 Fiscal policy for long-run economic growth Demand-side policies unaccompanied by policies to stimulate aggregate supply cannot produce long-run economic growth.</p> <p>✓ Study Economics & CA Inter FM/SM from MVSIR (online mode)- on Ultimate CA platform ✓ Buy MVSIR's books & quiz- mvsir.in</p>
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CHAPTER 7 – PUBLIC FINANCE | UNIT – 4 : FISCAL POLICY

Fiscal policy for reduction in inequalities of income and wealth

How **govt exp & taxes** - designed for redistribution-

- **Progressive direct tax** system
- **Indirect taxes** can be **differential-** (More tax on Luxury goods, Less tax on Necessities)

Spending programmes targeted on welfare measures-

44

- **Poverty alleviation** programmes
- Free or subsidized **medical care, education**
- **Infrastructure** provision on a **selective basis**
- **Subsidized production** of products of **mass** consumption
- Public production or grant of **subsidies** to ensure sufficient supply of **essential goods**
- **Strengthening human capital** for enhancing employability etc

Limitations of fiscal policy

45

- 1) **Bad Timing**
- 2) Difficulties in **instantaneously changing** govts' spending & tax policies
- 3) Practically **difficult to reduce govt spending** on some items → **defence, social security, huge capital projects** which are **already midway**.

4) **Public works cannot be adjusted easily** → highways/dams have **long gestation period**.

5) Certain fiscal measures **cause disincentives**

6) **Increase in govt borrowing** creates **perpetual burden** on future generations.

7) Lags

i. **Recognition Lag** - **Lag in recognizing need** for a policy change

ii. **Decision Lag** - **Delays in deciding** on most appropriate policy.

iii. **Implementation Lag** - Delays in **bringing in legislation** & implementing them

46

iv. **Impact Lag** - **Outcomes** of a policy are **not visible for some time**

8) Crowding Out

➤ During **recession** → **govt** resorts to EFP by **increasing govt exp**.

➤ When govt **spending exceeds tax** revenue, it borrows from market → **raising the demand for loans** and **pushing interest rates up**.

➤ Higher interest rates **reduce interest-sensitive private investment**. (private sector crowds out from loan market due to govt)

➤ Fall in private spending **offsets** rise in govt exp.

➤ As a result, **fiscal policy becomes ineffective** & hurt long-term economic growth due to crowding out.



Special types of Govt Expenditure

47

1) Pump Priming

Pump priming involves a **one-shot injection** of govt. expenditure into a depressed economy with aim of **boosting business confidence** & encouraging larger private investment.

2) Compensatory Spending

When govt **spending** is **deliberately carried out** with intention to **compensate for deficiency in private investment**.

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Non-Discretionary stabilizers Vs. Discretionary fiscal policy**1) Non-Discretionary stabilizers Or Automatic Stabilizers**

They are part of structure of economy & are '**built-in**' fiscal mechanisms that **operate automatically** to stabilize economy.

Eg- already existing policy of tax, govt exp & unemployment benefits etc.

2) Discretionary fiscal policy

It refers to **deliberate policy actions** to **change levels of expenditure, taxes** to influence national output, employment & prices.

Eg- **deliberating changing tax rates** when existing policy is not able to stabilize economy automatically

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CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

1	<p>Fiat Money</p> <ul style="list-style-type: none"> • Aka. token money → no intrinsic value. • Used as medium of exchange as govt made them “legal tender” 	5	<p>Demand for money</p> <ul style="list-style-type: none"> ➤ If people desire to hold money (in cash), we say there is demand for money. ➤ Demand for money is derived demand
2	<p>Definition of Money</p> <p>For policy purposes → set of liquid financial assets → variation in stock of which → impact on agg. economic activity.</p> <p>As statistical concept → include liquid liabilities of financial intermediaries/issuers (RBI)</p>	6	<p>Theories of demand for money</p> <p>I) Classical Approach: Quantity Theory of Money</p> <ul style="list-style-type: none"> ➤ Given by Irving Fisher → book ‘The Purchasing Power of Money’ (1911). ➤ As per QTM, money in circulation (M) & price level (P) are directly related to each other. ➤ Aka. ‘equation of exchange’ or ‘transaction approach’
3	<p>Characteristics of Money</p> <p>Generally acceptable, durable, effortlessly recognizable, difficult to counterfeit, relatively scarce, portable, possessing uniformity, divisible into smaller parts without losing value</p>	<p>MV = PT</p> <p>PT = Total demand of money ; MV = Total supply of money</p>	
4	<p>Functions of Money</p> <ol style="list-style-type: none"> 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 	<p>➤ Later, Fisher extended above equation to include credit money (M') & its velocity (V')</p> <p>Expanded Form : $MV + M'V' = PT$</p> <ul style="list-style-type: none"> ➤ As per QTM → More Transactions → More Demand of Money 	



CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

6.1	<p>II) Cambridge Approach (Aka Cash Balance Approach)</p> <p>➤ Money increases utility in two ways-</p> <p>1) Split-up of sale and purchase to two different point of time</p> <p>2) hedge against uncertainty. (money- a temporary store of wealth)</p> <p>➤ Higher income -> greater transactions -> greater demand for money.</p> <p style="text-align: center;">$M_d = k PY$</p> <p>Where; k = Cambridge k = proportion of nominal income (PY) that people want to hold as cash</p>	7.2	<p>b) Precautionary motive Keeping a portion of income to finance unanticipated exp due to unforeseen contingencies. Prec. demand is income elastic & interest inelastic</p>
7	<p>III) Keynesian Theory of Demand for Money (Liquidity Preference Theory)</p> <p>Demand for money = Transactions Demand (+) Precautionary Demand (+) Speculative Demand</p>	7.3	<p>c) Speculative motive Money demand to take advantage of future changes in rate of interest or bond prices. To exploit attractive investment opportunity Return on money → zero Returns on bonds → two types → interest payment & expected rate of capital gain</p>
7.1	<p>a) Transactions motive Money demanded to bridge time gap between receipt of income & planned exp.</p> <p>Trans. demand → directly related to income</p> <p style="text-align: center;">$L_r = kY$</p> <p>Where, k → ratio of earnings kept for trans. Purposes</p>	8	<p>Market Value of Bond inversely related to Market Rate of Interest</p> <p style="text-align: center;">Current rate of interest (rn) > Critical rate of interest (rc)</p> <ul style="list-style-type: none"> • People expect a fall in intt rate (rise in bond prices) • People will convert their cash balances into bonds <p style="text-align: center;">Current rate of interest (rn) < Critical rate of interest (rc)</p> <ul style="list-style-type: none"> • People expect a rise in intt rate (fall in bond prices) • People would hold their wealth in the form of liquid cash rather than bonds



CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

Liquidity Trap

- 9
- When after a huge fall in **interest rates** → **expectation** is it **cannot further fall**.
 - So now when in future → **interest rates will rise** → **bond prices will fall**
 - To **hold bonds** at this low interest rate is to take **almost certain risk** of a **capital loss**
 - Thus,
 - ☐ desire to **hold bonds** is **very low & approaches zero**, and
 - ☐ demand to **hold money** in liquid form **approaches infinity**.
 - **Speculative money demand (SMD)** curve becomes **perfectly elastic** with respect to interest rate & becomes **parallel to X axis**.
 - This is '**Liquidity trap**' → aka. ineffective monetary policy.
 - Empirical evidence of Liquidity Trap is found during "**Global Financial Crisis of 2008**"

Post-Keynesian developments in Theory of Demand for MoneyIV) Inventory Approach to Transaction Balances

- 10
- Given by Baumol & Tobin
 - Aka **Inventory Theoretic Approach**), in which money is viewed as **inventory held for transaction purposes**.
 - People hold **optimum combination of bonds & cash balance** → which **minimizes opp. cost**.
 - Level of inventory holding (money demand)- is **DIRECTLY RELATED** to
 - ☐ **Income**
 - ☐ **Cost of making transfer** from money to bonds
 - & is **INDIRECTLY RELATED** to
 - ☐ **Carrying cost (opp. cost)**- (interest income foregone by holding money)
 - ☐ **Number of bond transactions**

CHAPTER 8 – Money Market | UNIT 1 - THE CONCEPT OF MONEY DEMAND: IMPORTANT THEORIES

10.1	<p>V) Friedman's Restatement of Quantity Theory</p> <p>Given by Milton Friedman → asset price theory.</p> <p>Friedman's 4 determinants of demand for money</p> <p>1) Total wealth = Permanent Income / discount rate</p> <p>2) Positively related to the Price Level, P</p> <p>3) Rises if opportunity costs of money holdings decline</p> <p>4) Inflation - Positive inflation rate reduces real value of money & increases opportunity costs of money holdings</p>
10.2	<p>VI) Demand for Money as Behaviour toward Risk</p> <p>Given by Tobin in Based on principles of Portfolio Management</p> <p>People hold an optimally structured wealth portfolio which comprises both</p> <ul style="list-style-type: none"> > Bonds- (provides return for risk) > Money- (No return, but also no risk) <p>Demand for money depends negatively on interest rate.</p>

UNIT 2 - CONCEPT OF MONEY SUPPLY

11	<p>Money supply = Total qty of money available with public</p> <p>'Public' is defined to include all economic units except the producers of money (i.e. Govt., & banking system- RBI & banks).</p>
12	<p>Supply of money → stock variable</p> <p>Change in stock of money → flow variable</p> <p>Stock of money available to 'public' → always smaller than total stock of money in an economy.</p> <p>Total money stock of a country = High powered money + Credit Money</p>
13	<p>➤ Supply of money' EXCLUDES</p> <ul style="list-style-type: none"> <input type="checkbox"/> interbank deposits and <input type="checkbox"/> money held by government and <input type="checkbox"/> money held by banking system
14	<p>Empirical analysis of money supply is important as it-</p> <ol style="list-style-type: none"> 1) Facilitates analysis of monetary developments 2) Evaluate whether stock of money in economy is consistent standards for price stability & helps RBI in making monetary policy



CHAPTER 8 – Money Market | UNIT 2 - CONCEPT OF MONEY SUPPLY

Measurement of money supply
Reserve money (M0) is also known as- central bank money, base money or, high-powered money

	Currency in circulation		Currency with Public
+	Bankers' deposits with RBI	+	Demand deposits with banks (Current A/c & Saving A/c)
+	Other deposits with the RBI	+	Other deposits with RBI
	Reserve Money (M0)		M1 (Narrow Money)
	M1		M1
+	Savings dep with Post Office	+	Time deposits with Banks
	M2		M3 (Broad Money)
	M3		Notes in Circulation
	Total dep. with Post Office (excl. National Savings Cert.)	+	Circulation of Rupee Coin
+		+	Circulation of Small Coins
		-	Cash on Hand with Banks
	M4		Currency with Public

15

➤ **Descending order of liquidity – M1 (Most Liquid) & M4 (Least Liquid)**

Money Multiplier (m)
 Money multiplier process explains **how an increase in monetary base the money supply to increase by a multiplied amount.**

1st Formula Money Multiplier (m) = $\frac{\text{Money supply (M)}}{\text{Monetary Base (MB)}}$

2nd Formula

Money Multiplier (m) = $\frac{1 + c}{r + e + c}$
 where,
 c = currency ratio = currency / deposits
 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) People **never hold currency** (c = 0) Then,
Money Multiplier (m) = 1 / Required Reserve Ratio = 1 / R
Above can aka. → Credit Multiplier or Deposit Multiplier or Deposit Expansion Multiplier

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CHAPTER 8 – Money Market

17	Determinants of Money Supply (By Milton Friedman & Anna Schwartz) 1) Stock of high-powered money (H) Depends upon Behaviour of Central Bank	3) Currency Deposit Ratio (c) = C / D Depends upon Behaviour of Public ✓ If public keeps more money in their pocket & less in bank → increase in currency ratio → banks create less credit money → m falls. ✓ Increase in Time deposit-demand deposit ratio TD/DD ratio → higher the multiplier
17.1	2) Reserve-ratio (r) = R / D ✓ Depends upon Behaviour of Commercial Bank If required reserve ratio increases - ➤ banks will decrease lending, ➤ causing a decline in deposits and hence money supply will decline. ✓ Smaller r → larger the money multiplier	UNIT 3 - MONETARY POLICY
17.2	Excess Reserves (ER) ER are funds that bank keeps as reserve beyond what is required → buffer against unexpected events requiring cash. ER = Total reserve (TR) – Reqd. Reserve (RR) ✓ Excess Reserves of commercial banks do not lead to any additional loans , and thus, do not lead to creation of money ✓ Smaller the excess reserve ratio → larger will be the money multiplier ✓ When costs to bank of holding ER (market rate of interest) rises , level of ER falls → m will be larger	18 Monetary Policy Defined ➤ RBI uses monetary policy to manage economic fluctuations & achieve price stability (inflation is low & stable) ✓ When RBI lower interest rates , monetary policy is easing. ✓ When it raises interest rates, monetary policy is tightening
19		19 The Monetary Policy Framework 3 basic components- (i) objectives of monetary policy, (ii) analytics of monetary policy (transmission mechanisms) (iii) operating procedure



CHAPTER 8 – Money Market | UNIT 3 - MONETARY POLICY

20	<u>Objectives of monetary policy</u> Primary objective → maintaining balance between price stability & economic growth .	<u>Indirect Instruments-</u> a) Repos b) Open market operations c) Standing facilities d) Market-based discount window
21	<u>Objectives of Monetary Policy in case of developing countries</u> 1) maintaining economic growth 2) adequate flow of credit to productive sectors 3) sustaining moderate structure of interest rates , 4) creation of efficient market for govt. securities .	<u>Operating Procedures and Instruments</u> <u>Quantitative tools</u> 1. Reserve Ratio → Banks keep aside % of Net Demand & Time Liabilities . They have two types- 2. Cash Reserve Ratio (CRR) → Banks set aside this portion in cash with RBI . Bank can neither lend it nor can it earn any interest on CRR 3. Statutory Liquidity Ratio (SLR) → Banks set aside this portion in liquid assets- like cash or gold or RBI approved securities (unencumbered). Banks are allowed to earn interest on these securities. 4. Open Market Operations (OMO) → To control money supply → RBI buys & sells govt securities . ✓ When RBI sells govt securities → liquidity is sucked from market (done to control inflation), ✓ When RBI buys securities → Money Supply increases (done during contraction/depression)
22	<u>Transmission of Monetary Policy</u> How changes to monetary policy affect interest rates & further affect economic activity & inflation 1) Saving and Investment Channel 2) Cash-flow Channel 3) Asset Prices and Wealth Channel 4) Exchange Rate Channel	24
23	<u>Instrument of Monetary Policy</u> <u>Direct Instruments</u> a) CRR & SLR b) directed credit in form of prescribed targets for preferred sectors c) administered interest rates .	



CHAPTER 8 – Money Market | UNIT 3 - MONETARY POLICY

25	<p>Qualitative tools - Selective tools that impact money supply of specific sector of economy</p> <p>1. Margin requirements → When margin req is raised, customers will be able to borrow less</p> <p>2. Moral suasion → By way of persuasion RBI convinces banks to keep money in govt securities, rather than certain sectors.</p> <p>3. Selective credit control → Controlling credit by not lending to selective industries or speculative businesses.</p>	<p>2a. Repo Rate → Repo rate is rate at which banks borrow from RBI on a short-term basis against a repurchase agreement</p> <p>2b. Reverse Repo Rate → 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</p> <p>3. Marginal Standing Facility (MSF) Rate → Penal rate at which RBI lends money to banks, over rate available under repo policy. Banks availing MSF Rate can use maximum of 1% of SLR securities → MSF Rate = Repo Rate + 1</p>
26	<p>Market Stabilisation Scheme (MSS) Under MSS, Govt of India borrow from RBI & issues treasury-bills/dated securities → done to absorb excess liquidity from banking system → caused by large foreign capital inflows</p>	<p>Monetary Policy Framework Agreement</p> <ul style="list-style-type: none"> ➤ Agreement between Govt & 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. ➤ Inflation target → set by Govt in consultation with RBI, once in every five years. <p>Accordingly, Central Government has notified-</p> <ul style="list-style-type: none"> ➤ 4 % → Consumer Price Index (CPI) → target for Aug 5, 2016 to Mar 31, 2021, with the- <ul style="list-style-type: none"> ✓ upper tolerance limit of 6%, ✓ lower tolerance limit of 2%
27	<p>Policy Rates</p> <p>1. Bank Rate → Interest rate at which RBI lends long term funds to banks → bank rate. Now used to prescribe penalty to bank if it does not maintain the prescribed SLR or CRR</p> <p>2. Liquidity Adjustment Facility (LAF) → RBI uses LAF as an instrument to adjust liquidity & money supply. The following types of LAF are-</p>	<p>28</p>



CHAPTER 8 – Money Market | UNIT 3 - MONETARY POLICY

29

The RBI is mandated to publish a **Monetary Policy Report** every **six months**

30

Monetary Policy Committee (MPC)

A **6-member committee** consisting of-

- **RBI Governor** (Chairperson),
- **RBI Deputy Governor** in charge of monetary policy,
- **One official** nominated by **RBI Board** and
- **Remaining three CG nominees.**

MPC is required to **meet at least 4 times a year**

MPC shall determine **policy rate** (repo rate) required to achieve inflation target.

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CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

1 International trade is **exchange of G/S** & resources **between countries**
 It involves **transactions-**
 ➤ between **residents of different countries**
 ➤ involves **transactions in multiple currencies**
 ➤ **greater complexity** as it involves **heterogeneity of customers** and **currencies, differences in legal systems business practices, more elaborate documentation** etc

- 2 **Theories of international trade**
 1) Mercantilists' View of International Trade
 2) Theory of Absolute Advantage
 3) Theory of Comparative Advantage
 4) Heckscher-Ohlin Theory of Trade
 5) New Trade Theory

3 **Mercantilists' View of International Trade**
 ➤ **Maximizing exports** (to bring more "**specie**") & **minimizing imports** through **very high tariffs**.
 ➤ Trade is "**zero-sum game**" → one country's **gain** is **equal** to another country's **loss** → **net change in wealth** among the participants is **zero**.
 ➤ Mutually Gainful trade (MGT) is **not possible**.

4 **The Theory of Absolute Advantage**
 ➤ Given by **Adam Smith**
 ➤ Ability of a country to **produce greater qty** of a good, than competitors, using **same amount of resources**.
 ➤ Used **labor as only input**.
 ➤ Trade will happen **only if each of two countries** can **produce one good** at an **absolutely lower cost** than other country.

Commodity	Productivity of Labour Output per Hour of Labour	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	5

➤ A will produce & export wheat, while B → cloth.
 ➤ In this theory **MGT is possible**.

5 **The Theory of Comparative Advantage**
Ricardo → even if one nation is **less efficient** than other nation in **production of all commodities**, there is **still scope for mutually beneficial trade** (MGT is possible)



CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

Commodity	Productivity of Labour (Output per Hour of Labour)	
	Country A	Country B
Wheat (units/hour)	6	1
Cloth (units/hour)	4	2

In above eg, **A has absolute advantage in production of both** wheat & cloth

- Wheat [6 : 1]
- Cloth [4 : 2]

But, A has **greater absolute adv (comparative adv) → wheat**

Further, B has **lower absolute disadv (comparative adv) → cloth.**

The Heckscher-Ohlin Theory of Trade

Aka. **Factor-Endowment** Theory or **Modern** Theory
'**Factor endowment** → **availability** of resources- **labour & capital.**

It states that a country-
 ➤ specialize in **export** of good whose **production** requires intensive **use of its abundant resources**, &
 ➤ **imports** a commodity whose **production** requires intensive **use of its scarce resources.**

- ❑ **Capital abundant country-** Produce & export **capital-intensive goods**
- ❑ **Labour-abundant country-** Produce & export **labour-intensive goods.**

Factor-Price Equalization Theorem (Corollary to H-O Theory)- International trade **equalizes factor prices between the trading nations** → Trade in finished goods become **perfect substitutes** of trade in factors of production.

	Theory of Comparative Adv.	Heckscher-Ohlin (Modern Theory)
7	Based on labour theory of value	Based on money cost - more realistic.
	Considered labour as sole factor (one factor model)	Widened scope - labour & capital → 2 factor model
	Diff in cost due to differences in productive efficiency of workers	Diff in cost due to differences in factor endowments.



CHAPTER 9 – International Trade | UNIT 1 - THEORIES OF INTERNATIONAL TRADE

New Trade Theory

Nowadays countries trade in **similar products**. Eg- electronics, IT, cars etc

Market takes form of **monopolistic competition**

2 Reasons for NTT-

a) Economies of Scale

b) Network Effects- Value of G/S is enhanced as no. of individuals using it increases → **bandwagon effect**. Eg- **WhatsApp** & **Windows**

8

UNIT 2 - THE INSTRUMENTS OF TRADE POLICY

Tariffs

- Aka. **customs duties** → **taxes or duties** imposed on **import/export** of G/S.
- They are the **most visible** & **universally used trade measures**
- They **increase price** of G/S imported → to **contract domestic demand** & **regulate volume of imports**
- They also **raise revenue of govt.**

1

Types of Tariff

- 1) **Specific Tariff** - **Fixed amount of money** per physical unit (qty) → Disadvantage- Its **protective value varies inversely** with **price** of the import
- 2) **Ad Valorem Tariff**- When duty is **levied as fixed % of value of traded commodity**. This tariff **preserves protective value** of tariff on home producer, but gives incentives to **deliberately undervalue price on invoices**.
- 3) **Mixed Tariffs**- Specific tariff or ad valorem → **whichever is higher**.
- 4) **Compound Tariff**- Adding up a **specific duty** to ad valorem duty (CT= $tsq + tapq$)
- 5) **Technical/Other Tariff**- Calculated on basis of **specific contents of imported goods**
- 6) **Tariff Rate Quota**- **Combine two policy instruments: quotas & tariffs**.
- 7) **Variable Tariff**- A duty fixed to bring **price of an imported goods** upto level of **domestic support price**.
- 8) **Most-Favoured Nation Tariffs** - Tariffs between **countries which are members of WTO** → MFN rates are **highest** that **WTO members charge each other**.
- 9) **Preferential Tariff**- Countries promise to give another country's products **lower tariffs than their MFN rate**. These agreements are **reciprocal**.

2



CHAPTER 9 – International Trade | UNIT 2 - Instruments of Trade Policy

- 10) **Bound Tariff**- A WTO member **binds** itself with **legal commitment not to raise tariff rate** above a certain level (maximum level of import duty)→ Once bound, a member can only **increase** its level **after negotiating with trading partners & compensating them for possible losses.**
- 11) **Applied Tariffs**- **Duty that is actually charged on imports** on MFN basis. Applied tariff should not be higher than bound level.
- 12) **Escalated Tariff**- **Tariff rates on imports of manufactured goods** are **higher than tariff rates on inputs & raw mat.** (is **discriminatory** in nature)
- 13) **Prohibitive tariff** - It is **set so high** that **no imports can enter.**
- 14) **Anti-dumping duty** – It is a **protectionist tariff** → when govt believes are **priced below fair market value.** **Dumping** occurs when **manufacturers sell goods in foreign country-**
- ❑ **below sales prices in their domestic market** or
 - ❑ **below full average cost** of product.
- 15) **Countervailing duties**- CVD is charged in importing country to **offset advantage that exporters get from subsidies** (from their govt.) to ensure fair pricing of imported G/S & thus **protecting domestic** firms.

Non – tariff measures (NTMs)

- Hidden or invisible measures that interfere with free trade
- **Mandatory requirements or regulations**→ legally set by govt.

Technical Measure

Product-specific properties such as **characteristics** of product, **technical specifications & production processes.**

Non-Technical Measures

Non-technical measures **relate to trade requirements;** for ex; **shipping requirements, custom formalities, trade rules, taxation policies, etc**

Sanitary & Phytosanitary (SPS) Measures- These are applied to **protect human, animal or plant life** from **risks arising from additives, pests,** etc. or disease-causing organisms and to **protect biodiversity.**

Ban on imports on basis of **quality & hygienic requirements.**

Technical Barriers to Trades (TBT)

Covers both **food & non-food products** - refer to mandatory '**Standards & Technical Regulations**' - define characteristics that product should have, like size, design, packaging, etc.



CHAPTER 9 – International Trade | UNIT 2 - Instruments of Trade Policy

Non – tariff Barriers (NTBs)

3

NTBs are **discriminatory NTMs**, which are used as means to **circumvent free-trade rules** and **favour domestic industries at expense of foreign competition**.

NTBs are a subset of NTMs that have 'protectionist or discriminatory intent'

Types of Non-technical measures (IMP only)

4

1) **Import Quotas**- direct restriction on **quantity of good will be allowed into country**. Types of import quota-

a) **Binding Quota**- They are **set below the free trade level of imports**.

b) **Non-binding quota**- It is **set at or above the free trade level** of imports, thus having **little effect on trade**.

c) **Tariff rate quotas (TRQs)** → **quotas (+) tariffs**.

2) **Price Control Measures**- **Control prices** of imported goods in order **to support domestic price of products** when **import prices are lower**. Aka. '**para-tariff**' measures → **increase cost** by **fixed percentage** or by a **fixed amount**.

Eg: A minimum import price established for sulphur.

4) **Financial Measures**- It includes measures like **advance payment requirements** & foreign exchange controls- like **denying use of foreign exchange** for certain imports.

5) **Government Procurement Policies**- It involve **mandates** that whole of **specified percentage of govt purchases** should be **from domestic firms**.

6) **Trade-Related Investment Measures**-

a) Requirement to **use certain levels of locally made components**

b) **restricting level of imported components**, and

c) **limiting purchase or use of imported products** to an amount related to **value of local products that it exports**.

Rules of origin- **Country of origin** means **country in which a good was produced** → used to **determine national source of product** → **Duties & restrictions** in some cases **depend upon source of imports**.

8) **Safeguard Measures**- Measures to restrict imports **temporarily** if its **domestic industry is injured** → caused by **surge in imports**.

9) **Embargos**- **Total ban** imposed by govt **on import or export of some goods** to **particular country** for a **specified period** → **most extreme form** of trade barrier.



CHAPTER 9 – International Trade | UNIT 2 - Instruments of Trade Policy

Export-related measures

Ban on exports

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

Export Taxes

Tax collected on exported goods → either **specific** or **ad valorem**.

It **raises price** of exports thus, **decreasing exports** & **increasing domestic supply** → **higher domestic consumption**.

Export Subsidies & Incentives

Govt **provide financial contribution to domestic producers** in form of **grants, loans, duty drawback** etc.

Voluntary Export Restraints

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

VER is done **to appease importing country** & **avoid the effects of possible retaliatory trade restraints**.

VERs cause **domestic prices to rise** & **loss of domestic consumer surplus**

CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

Regional Trade Agreements (RTAs)

- RTAs → **groupings of countries**, which are formed with **objective of reducing barriers to trade**.
- As of 1 February 2021, **339 RTAs** were in force.
- Eg- **North American Free Trade Agreement (NAFTA)** between **Canada, Mexico, & US**, → replaced by **US-Mexico-Canada Agreement (USMCA)**

Types of RTAs

- 1) **Unilateral trade agreements** (ek tarfa)
- 2) **Bilateral Agreements**- set rules of trade **between 2 countries**. E.g. EU-South Africa FTA, ASEAN-India FTA.
- 3) **Regional Preferential Trade Agreements**- among a group of countries **reduce trade barriers on reciprocal & preferential basis** for **only members** of the group. E.g. GSTP



CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

4) **Free-trade area (FTA)**- group of countries that **eliminate all trade barriers**. Members **retain independence** in determining their **tariffs with non-members**. Eg- ASEAN-India FTA (AIFTA).

5) **Trading Bloc**- **group of countries** that have **FTA** between themselves & **apply a common external tariff to other countries**. Customs Union, Common Market, Economic Union are types of Trading Bloc.

6) **Customs union**- group of countries that **eliminate all tariffs** on trade among themselves but **maintain a common external tariff** with other countries.

7) **Common Market**- It involves **free flow of output & factors** of production → by reducing or **eliminating internal tariffs** → by creating **common set of external tariffs**. There are **common barriers** against non-members (e.g- EU, ASEAN)

8) **Economic & Monetary Union**- Here members share **common currency** → necessary to have **strong convergence in macro-economic policies**. eg, European Union

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3

- General Agreement on Tariffs and Trade (GATT) was a **multilateral trade agreement** which **provided rules of international trade** from **1948 to 1994** (47 years)
- **8th round of GATT (Uruguay Round)** of 1986-94, was **last** & culminated in **birth of WTO**.

GATT lost its relevance by 1980s

4

- 1) **Obsolete** to **fast-evolving world trade** due to globalisation
- 2) **International investments** expanded substantially
- 3) **Intellectual property rights & services** were **not covered**
- 4) **World merchandise trade increased** & was beyond its scope.
- 5) **Ambiguities** in **multilateral system** were heavily exploited
- 6) Efforts at **liberalizing agricultural trade** were **not successful**
- 7) **Inadequacies in institutional structure** & dispute settlement
- 8) It was **not a treaty**



CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

Birth of WTO → 1st July, 1995

Objectives of WTO

Principal objective → facilitate flow of international trade smoothly, freely & fairly.

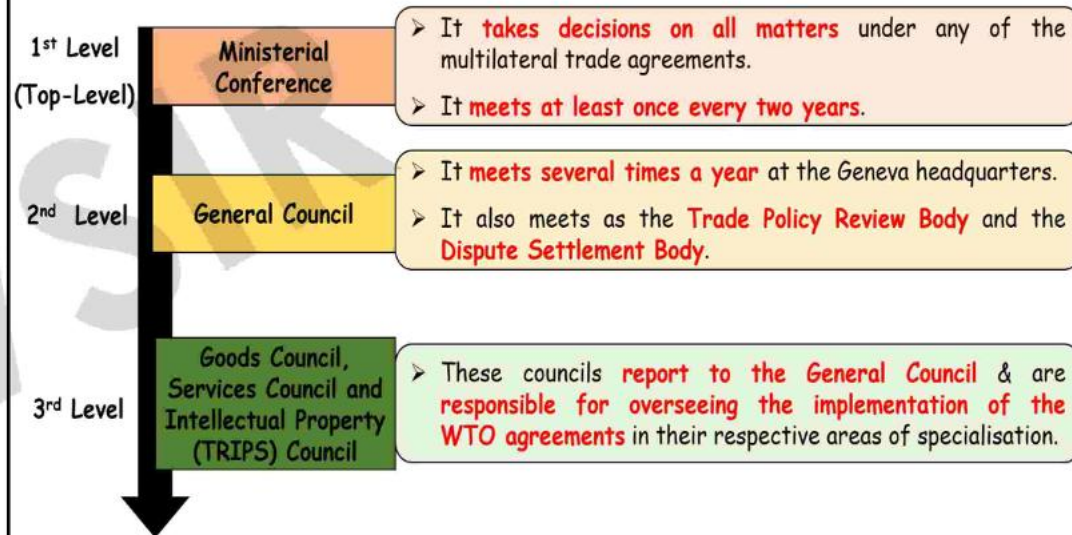
The WTO has six key objectives-

- 1) to set & enforce **rules** for international trade
- 2) to provide a **forum** for **negotiating & trade liberalization**
- 3) to **resolve trade disputes**
- 4) to **increase transparency** of **decision-making**
- 5) to **cooperate with other major international economic institutions**
- 6) to **help developing countries**

5

Structure of the WTO

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



WTO has **164 members** → of which **117 are developing countries**.

The **WTO trade monitoring reports** have been prepared by the **WTO Secretariat** since 2009.

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CHAPTER 9 – International Trade | UNIT 3 - TRADE NEGOTIATIONS

Guiding Principles of WTO

1) **Most-favoured-nation (MFN)** – [Trade without discrimination]

Grant **someone a special favour** then you have to **do the same for all other WTO members**.

2) **National treatment**

Treating foreigners and locals equally → **imported and locally-produced goods** should be treated **equally** — at least **after foreign goods have entered domestic market**.

3) **Freer trade: gradually, through negotiation**

4) **Promoting fair competition**

5) **Predictability: through binding and transparency**

A country can **change its bindings**, but **only after negotiating** with its trading partners & **compensating them for loss** of trade. (In **agriculture**, **100% of products** now have **bound tariffs**)

6) **Encouraging development and economic reform**

WTO Agreements

Aka. **WTO's trade rules** → they are "**rules-based**"

Important Agreements-

1. **Agreement on Agriculture** → focus on **3 areas** of **market access, domestic support & export subsidies**.

2. **Agreement on Textiles and Clothing** replaced the **Multi-Fibre Arrangement (MFA)**

3. **Agreement on Trade-Related Investment Measures (TRIMs)**

4. **Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS)**

5. **Plurilateral Trade Agreements**

Multilateral negotiations → involves **entire WTO contracting parties**.

Plurilateral negotiations → involve several countries but **do not involve all WTO countries**.

The Doha Round

Most controversial topic → **agriculture trade**.

G20 Economies

➤ G-20 was founded in 1990, as a forum for countries to **discuss global economic & financial issues**.

➤ **G20 members are:** Argentina; Australia; Brazil; Canada; China; European Union; France; Germany; India; Indonesia; Italy; Japan; the Republic of Korea; Mexico; the Russian Federation; Saudi Arabia; South Africa; Turkey; UK, USA.

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CHAPTER 9 – International Trade | UNIT 4 - Exchange Rates and its Economic Effects

1	<p>Exchange rate Aka. foreign exchange (FX) rate, is price of one currency expressed in terms of units of another currency.</p> <p>Two ways to express nominal exchange rate-</p> <p>1) Direct Quote (European Currency Quotation) It is number of units of local currency exchangeable for one unit of a foreign currency Foreign currency (USD) = base currency Domestic currency (INR) = counter currency Eg: USD 1 = INR 90</p> <p>2) Indirect Quote (American Currency Quotation) It is a number of units of foreign currency exchangeable for one unit of local currency Domestic currency (INR) = base currency foreign currency (USD) = counter currency. Indirect Quote = 1 / Direct Quote Eg: INR 1 = USD 0.011</p>
2	<p>The rate between Y and Z which is derived from the given rates of another set of two pairs of currency (say, X and Y, and, X and Z) is called cross rate Eg- USD 1 = INR 75 ; 1 GBP = USD 1.40 Then cross rate → 1 GBP = INR 105</p>

3	<p>Exchange Rates Regimes Exchange rate regime → system by which a country manages its currency with respect to foreign currencies. 3 Types- free, fixed, managed floating</p>	
Types of exchange rate regimes (ERR)		
Basis	Free floating ERR (aka. flexible exch rate)	Fixed ERR (aka. pegged exch rate or hard peg)
Meaning	<ul style="list-style-type: none"> Value is market determined using demand & supply Govt or central bank do not interfere → self-regulating 	<p>Central bank or govt announces what its currency will be worth.</p>
Advantages	<ol style="list-style-type: none"> Govt can pursue own independent monetary policy. Allows exch rate to be used as a policy tool No obligation to intervene 	<ol style="list-style-type: none"> Avoids fluctuations & eliminates risks & transaction costs Reduced speculation Imposes discipline & generates lower inflation. Stability encourages investment. Pegging enhances credibility



CHAPTER 9 – International Trade | UNIT 4 - Exchange Rates and its Economic Effects

Types of exchange rate regimes (ERR)

Basis	Free floating ERR (aka. flexible exchange rate)	Fixed ERR (aka. pegged exchange rate or hard peg)
Disadvantages	<p>1) Unpredictability - Volatile exchange rates (uncertain)</p> <p>2) It adds a risk premium- makes international transactions riskier</p>	<p>1) Lacks flexibility</p> <p>2) Central bank → required to maintain huge foreign exchange reserves.</p>

4 **Managed floating ERR**
 • Aka. **dirty floating** or **soft peg**
 ➤ Exch rates are still **free to float**, but govt. or central bank try to **influence** their values.
 ➤ To **prevent sudden large swings** in value.

Nominal exchange rate Vs. Real exchange rate

It refers to **rate** at which a person can **trade the currency** of one country for the **currency of another country**.
 Eg → 1 USD = Rs 90

Rate at which a person can **trade G/S** of one country for **G/S of another**.

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

5 **Real Effective Exchange Rate (REER)**
 ➤ REER is **inflation adjusted NEER**
 ➤ An **increase in REER** → **exports expensive & imports cheaper** → indicating **loss in trade competitiveness.**

6 **Other Terms**
 1) **Vehicle Currency**- A currency that is **widely used** in international contracts → even when it is **not national currency** of either parties. Eg- US Dollars.
 2) **Arbitrage**- Making **risk-less profits** by **exploiting price differences** at **different places**. Due to **arbitrage** → at any given moment, **all markets** tend to have **same exchange rate.**

	Devaluation	Depreciation
1.	Deliberate downward adjustment by govt or cb.	Decrease in value due to market forces of demand & supply
2.	Occurs in fixed regime	Occurs in floating regime

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CHAPTER 9 – International Trade

Impacts of currency depreciation

- 7
- 1) lowers price of exports → **exports incr.** & **imports decr.**, thus **improves trade balance.**
 - 2) **increases demand** both for domestic import-competing goods & for exports,
 - 3) leads to **output expansion,**
 - 4) encourages **economic activity**

Impacts of currency appreciation

- 8
- 1) raises price of exports → **exports decr.** & **imports incr.**
 - 2) **adversely affect competitiveness** of domestic industry, cause **larger deficits** and
 - 3) **worsens** trade balance.

UNIT 5 - International Capital Movements

- 1
- Foreign capital → any **inflow of capital into home country from abroad.**

Components of Foreign Capital Flows

- 2
- 1) Foreign Aid or Assistance
 - 2) Borrowings
 - 3) International Investments (FDI/FPI)
 - 4) Deposits from NRIs

Foreign Direct Investment (FDI)

- 3
- When resident of one country (i.e. home country) acquires ownership of asset in another country (i.e. host country)
 - Acquisition of **at least 10% shares** → involving **long-term relationship** & reflecting **lasting interest & control**

3 Components of FDI

- 4
- 1) **Equity capital**
 - 2) **Reinvested** earnings
 - 3) Other direct capital → **intra- company loans**

The main forms of direct investments / Modes Of FDI

- 5
- 1) opening of **overseas companies** → subsidiaries or branches,
 - 2) creation of **joint ventures**
 - 3) joint development of **natural resources** and
 - 4) **purchase of companies** in country receiving foreign capital
 - 5) **Green field** investment (**freshly starting** production)
 - 6) **Brownfield** investments (**using existing infrastructure** by merging)
- Eg- In India **100% FDI (automatic route)** in Brownfield Airports

CHAPTER 9 – International Trade | UNIT 5 - International Capital Movements

6	<p>Types of FDI</p> <p>1) Horizontal FDI- Investor establishes same type of business in foreign as it operates in its home country. Eg- cell phone service provider of India provide same service USA.</p> <p>2) Vertical FDI- Investor establishes a business in foreign which is different from main business, but supplements its major activity. Eg- car mfg co. acquire a foreign company that supplies tyres.</p> <p>3) Conglomerate FDI- Investor invests in foreign business that is unrelated to its existing business (no previous experience). Eg- car mfg co. acquire a foreign restaurant chain.</p> <p>4) Two-Way FDI- Reciprocal investments between countries → when some industries are more advanced in one nation (Eg- computer in USA), while other industries are efficient in other nations (Eg- automobile in Japan).</p>	<ul style="list-style-type: none"> ➤ Where there is no approval → co. can seek permission from Foreign Investment Facilitation Portal (FIFP). ➤ Permission for FDI is not uniform for all sectors.
7	<p>There are two routes to for FDI in India</p> <p>1) Government Route – Prior approval of govt required</p> <p>2) Automatic Route</p>	<p>Sectors FDI is prohibited in India under all routes-</p> <ul style="list-style-type: none"> ❖ Atomic Energy ❖ Lottery Business ❖ Gambling and Betting ❖ Business of Chit Fund ❖ Nidhi Company ❖ Agricultural & Plantations (but Tea Plantation allowed) ❖ Housing & Real Estate ❖ Trading in TDRs ❖ Manufacture of cigars & tobacco.
9		<p>Foreign portfolio investment (FPI)</p> <ul style="list-style-type: none"> ➤ FPI flow of 'financial capital' → does not involve ownership or control ➤ Investment in shares & bonds etc in foreign stock market. ➤ Acquisition of shares in foreign co. → at or below 10 %



CHAPTER 9 – International Trade | UNIT 5 - International Capital Movements

FDI	FPI
Investment in physical assets	Investment in financial assets
Long term	Short term
Difficult to withdraw	Easy to withdraw
Not speculative	Speculative
Direct impact on employment of labour	No such impact
Involves technology transfer	Does not involve tech transfer
Interest in mgt & control	No such interest

- 10** Major reasons for FDI
- i. Economies of scale → leading to more profits,
 - ii. Risk diversification,
 - iii. retention of trade patents,
 - iv. capture of emerging markets,
 - v. lower host country environmental & labour standards,
 - vi. bypassing of non-tariff & tariff barriers,
 - vii. cost-effective availability of inputs
 - viii. tax & investment incentives.

- 11** Deterrents to FDI
- i. Poor macro-economic environment
 - ii. Unfavourable resource and labour market conditions
 - iii. Unfavourable legal and regulatory framework
 - iv. Lack of host country trade openness

- 12** Benefits of FDI
- 1) **Fosters competition** & generates a **competitive environment** in host country
 - 2) Allows countries to finance **more investment** than supported by domestic savings.
 - 3) Accelerate **growth** & foster **economic development**
 - 4) **Promote political & structural reforms** important to attract foreign investors
 - 5) Generates **direct employment** in **recipient country**.
 - 6) Enhances **people-to-people relations** & promotes **bilateral & international relations**.
 - 7) **Weakens market power** of domestic monopolies
 - 8) **Better work culture & higher productivity standards** brought in by foreign firms

- 13** World Investment Report 2022 → India was ranked **8th** among the **world's major FDI recipients** in 2020.



CHAPTER 9 – International Trade | UNIT 5 - International Capital Movements

Problems of FDI

- 14
- 1) FDIs **concentrate on capital-intensive methods** → so **hire few workers**.
 - 2) FDI **moves towards regions** having more **resources & infrastructure** → leads to regional disparity
 - 3) **Slows down domestic govts** to generate more domestic savings.
 - 4) Borrowings by foreign firms can **raise interest rates** in **host country**.
 - 5) Due to **imported inputs** or when **profits are repatriated** → pressure on **host country's balance of payments & home currency**.
 - 6) Host country is left with **routine mgt jobs** that demand **lower skills & ability**
 - 7) Production concentrated on items of **elite & popular consumption**
 - 8) Foreign firm with **deep pockets** may **undercut competitive local industry & drive out domestic firms**
 - 9) FDI may have **adverse impact** on host country's commodity **"terms of trade"** (defined as price of a country's exports divided by price of its imports). Huge exports → lead to **over-supply** & thus **export prices decrease**.

10) Ruthless **exploitation of natural resources & environmental damage**.

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CHAPTER 10 – INDIAN ECONOMY

1	Between 1st & 17th century AD → India was largest economy of ancient & medieval world . → controlled between 1/3rd & 1/4th of world's wealth . (India was self-reliant & prosperous)	➤ Destruction of Indian manufactures → due to hostile imperial policies & competition from machine-made goods.
2	➤ Earliest known book on ancient Indian economic philosophy is ' Arthashastra ' by Kautilya (Chanakya) → genre of political philosophy . ➤ Handbook for King Chandragupta Maurya ➤ The major focus of work is on means of fruitfully maintaining and using land . ➤ True kingship is defined as a ruler's subordination of his own desires & ambitions to good of his people	<p>Stagnated Nature of Industrialisation During Colonial Era</p> <p>➤ Cotton mill industry → 9 million spindles in 1930s ➤ Jute mills expanded in Calcutta → global demand for ropes.. ➤ At end of 19th century, Indian jute mill industry was largest in world in terms of amt of raw jute consumed. ➤ Producer goods industries → no expansion → because of pressure from English producers to discourage devp of industries in India. ➤ Share in NDP of mfg sector → 7% in 1946.</p>
3	<p>Period of British Rule 2 sub periods:</p> <ul style="list-style-type: none"> • East India Company → 1757 to 1858 • British government → 1858 to 1947 <p>➤ Industrial revolution in Britain in latter half of 18th century → there arose need of 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 → heavy tariffs Indian Imports from Britain → lower tariffs (Indian goods lost their competitiveness)</p>	<p>➤ INDIAN ECONOMY: POST-INDEPENDENCE (1947-1991) ➤ At time of independence, India had a literacy rate of 18% & 32 years of life expectancy in 1951. ➤ Nehruvian model supported social & economic redistribution & industrialization ➤ Rapid industrialization of economy was cornerstone of Nehru's development strategy. ➤ Planning Commission of India was established in 1950 → to plan development of nation → through five-year plans</p>



CHAPTER 10 – INDIAN ECONOMY

7	<p>Industrial Policy Resolution</p> <ul style="list-style-type: none"> ➤ Industrial Policy Resolution (IPR) (1948) → expanded role of public sector & licensing to the private sector. It granted govt. monopoly in- atomic energy, arms and ammunition, & railways ➤ IPR of 1956 → provided framework for industrial devp→ but lopsided as lead to huge expansion of scope of public sector. (dampening of private sector initiatives) 	11	<ul style="list-style-type: none"> ➤ Green Revolution was initiated soon by- <ul style="list-style-type: none"> ➤ innovative farm technologies & HYV seed→ focus on wheat & rice ➤ intensive use of water, fertilizer and pesticides
8	<ul style="list-style-type: none"> ➤ Policies in 1950's were guided by two economic philosophies: <ol style="list-style-type: none"> 1. Nehru ji → build socialistic society & focus on heavy industry 2. Gandhi ji→ focus on small scale, cottage industry and village republics 	12	<p>Nationalisation of Banks Taking of full control & mgt. from Private Sector by Govt. Govt nationalized-</p> <ul style="list-style-type: none"> ✓ 14 banks in 1969 and ✓ then 6 in 1980.
9	<p>In 1950–80→ India's avg annual GDP growth rate - 'Hindu growth rate'- was 3.5 %.</p>	13	<p>The economic performance during "1965-81" is the worst in independent India's history.</p>
10	<p>Agriculture Issues & Green Revolution</p> <ul style="list-style-type: none"> ➤ Agri devp till mid 1960s → institutional model i.e. land reforms, farm cooperatives & no importance to technocratic areas like R&D , irrigation. ➤ 2 severe droughts struck India in 1966 & 1967. India had to depend on USA for food aid under PL 480. 	14	<p>M RTP Act, 1969 was aimed at regulation of large firms which had relatively large market power.</p>
		15	<p>In 1967, many products were reserved for exclusive manufacture by the small scale sector</p>
		16	<p>THE ERA OF REFORMS</p> <ul style="list-style-type: none"> ➤ The initiatives from 1981 to 1989→ referred as 'early liberalization' ➤ Aka. 'reforms by stealth' → ad-hoc & not widely publicized nature. ➤ The early reforms of 1980's covered three areas- industry, trade and taxation.

