

INTER CA
MAY '19
REVISION NOTES
ECONOMICS

CHAPTER: 1 NATIONAL INCOME
UNIT 1: DETERMINATION OF NATIONAL INCOME

NATIONAL INCOME - MEANING

National Income is defined as the net value of all economic goods and services produced within the domestic territory of a country in an accounting year plus the net factor income from abroad. National income is the sum total of factor incomes generated by the normal residents of a country in the form of wages, rent, interest and profit in an accounting year.

NATIONAL INCOME - USEFULNESS AND SIGNIFICANCE

1. Evaluate performance of an economy
2. Indicate demand pattern of consumer which is useful for industries
3. Economic welfare depends on national income
4. It help government to make sector wise development programme & policy
5. It help government in assessment and selection of economic policies
6. It shows income inequality between different group of income earners
7. It makes possible to calculate important ratio like govt. expenditure to GDP.
8. International comparison possible which assist in determining eligibility for loan and or other funds
9. Provide a guide to make policy for growth and inflation
10. Make projections for future development trend of the economy

DIFFERENT CONCEPTS OF NATIONAL INCOME

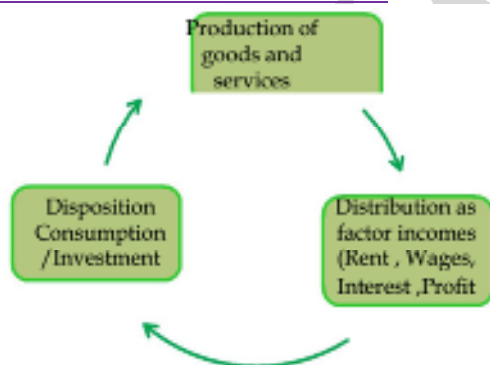
DIFFERENT CONCEPTS	CALCULATIONS
Gross domestic product (GDP) (at market price)	= Value of output in the domestic territory – Value of intermediate goods and services Note: (1) Output in domestic territory only (by resident or foreigners) (2) It includes services (3) Gross means gross of depreciation (4) Output at market price (5) It includes production for own consumption (6) It is calculated for a particular time period. So only current period output is included (7) Not includes followings: a) Transfer payment i.e. Pension, social security benefit, unemployment compensation, welfare payment etc. b) Financial transactions c) Illegal transactions d) Non-economic activities like hobbies, House keeping, work done out of love and affection e) Non-reported output generated through illegal Transaction
Gross National Product (at market price) (GNP)	= GDP + Net factor income from abroad Note: Net factor income from abroad = Income of country citizen and companies earn abroad – Income of foreign citizen and companies earn in that country
Net Domestic Product (at market price) (NDP)	= GDP – Depreciation
Net National Product (at market price) (NNP)	= NDP – Depreciation
GDP (at factor cost)	= GDP at market price – Indirect tax + Subsidies Note: Indirect tax = Excise + Custom + GST + Factory license

		fees + Tax of local authorities + Pollution tax etc.
NDP (at factor cost)		= NDP at market price – Indirect tax + Subsidies
NNP (at factor cost)		= NNP at market price – Indirect tax + Subsidies
Per Capita income		= GDP adjusted with inflation/Population
Personal Income (Sum of all income that are actually received by household from all the sources)		= National income + Income received but not earned – Income earned but not received Note: (1) Income received but not earned means transfer payment (2) Income earned but not received means undistributed profit of business and corporate tax (3) It includes income of Non-profit institution serving household
Disposable Personal Income		= Personal income – Personal income tax – Any other compulsory payment made to the government

NOMINAL GDP vs. REAL GDP

- (1) Nominal GDP means GDP calculated at current price. Real GDP means GDP calculated at base year price
- (2) Nominal GDP increase with increase in price level. Real GDP remain constant with increase in price level
- (3) Nominal GDP change with change in price and output both. Real GDP change with change in output only.
- (4) Comparison of current year Nominal GDP with last year Nominal GDP will not give correct comparison of increase/decrease of GDP. Comparison of Real GDP of different year is the correct comparison.

CIRCULAR FLOW OF INCOME



Above given process flow is called circular flow of income. This process flows continuously. National income can be calculated as per any of the three angle namely Production, Income and Expenditure.

Corresponding to the three phases, there are three methods of measuring national income. They are: Value Added Method, Income Method; and Expenditure Method.

PRODUCT METHOD OR VALUE ADDED METHOD

National income = Market value of output
 Less: Value of intermediate goods
 Less: Depreciation
 Less: Indirect tax
 Add: Subsidies
 Add: Net factor income from abroad

Note: The values of the following items are also included:

- (i) Own account production of fixed assets by govt., enterprises and households.
- (ii) Production for self- consumption, and
- (iii) Imputed rent of owner occupied houses.
- (iv) Services

INCOME METHOD

National Income = Compensation of employees

Add: Operating surplus (rent + interest + profit)

Add: Mixed income of self employed

Add: Net factor income from abroad

Note:

- (1) Income method may be most suitable for developed economies where people properly file their income tax returns.
- (2) Mixed income of self-employed = Sometimes it is difficult to segregate labour income from capital income. For example self-employed person. In this case, a new category of income called mixed income is introduced which include labour and capital income both.

EXPENDITURE METHOD

National income = Private final consumption expenditure

Add: Government final consumption expenditure

Add: Gross domestic capital formation

Add: Net exports

Add: Net factor income from abroad

Less: Indirect tax

Add: Subsidies

Less: Depreciation

Note:**(1) Private final consumption expenditure:**

It includes all expenses of household and nonprofit institute serving household except expenditure on purchase or construction of building. It include value of goods which are produced for own consumption by household, Imputed cost of owner occupied building.

(2) Govt. final consumption expenditure:

Expenditure on services provided by the government such as defense, education, healthcare, operating expenses etc. are included. Transfer payments are not included

(3) Gross domestic capital formation:

It includes (a) Gross fixed capital formation (b) Expenditure on change in Inventory.

a. Gross fixed capital formation means Expenditure on purchase or construction of building by household, Expenditure on fixed assets by business, and Expenditure on fixed assets (Public assets) by government.

b. Expenditure on change in inventory means closing stock - opening stock

(4) Net Exports: Export - Import**LIMITATION AND CHALLENGES OF NATIONAL INCOME COMPUTATION****General difficulties**

- a) Due to income inequality, per capita income is inadequate measure of welfare.
- b) (b) Quality improvements in systems and processes due to technological as well as managerial innovations which reflect true growth in output from year to year.
- c) Productions hidden from government authorities
- d) Non-market production and Non-economic contributors to well-being
- e) The dis-utility of loss of leisure time.
- f) Bad economic which make us worse off.
- g) The volunteer work and services rendered without remuneration in the economy
- h) Many things that contribute to our economic welfare such as, leisure time, fairness, gender equality, security of community feeling etc.,
- i) Non-productive services included in GDP for example police services.

Conceptual difficulties

- (a) Lack of an agreed definition of national income,
- (b) Accurate distinction between final goods and intermediate goods,
- (c) Issue of transfer payments,
- (d) Services of durable goods,

- (e) Difficulty of incorporating distribution of income
- (f) Valuation of a new good at constant prices, and
- (g) Valuation of government services
- (h) Inadequacy of data and lack of reliability of available data,
- (i) Presence of non-monetized sector,
- (j) Production for self-consumption,
- (k) Absence of recording of incomes due to illiteracy and ignorance,
- (l) Lack of proper occupational classification, and
- (m) Accurate estimation of consumption of fixed capital

THE SYSTEM OF REGIONAL ACCOUNTS IN INDIA

All the State and Union territories of India compute state income estimates and district level estimates. Net State Domestic Product (NSDP) is calculated for by every state for a given period of time (generally a year). Per capita income is calculated by dividing NSDP by the mid-year projected population of the state. It is calculated by the state income units of the respective State Directorates of Economic and Statistics (DESS). The Central Statistical Organization assists them.

There are some activities that cut across state boundaries known as 'Supra-regional sectors'. For example railways, communications, banking etc. The estimates for these sectors are calculated economy as a whole and allocated to the state on the basis of relevant indicators

UNIT 2: THE KEYNESIAN THEORY (NATIONAL INCOME)

KEYNESIAN THEORY OF NATIONAL INCOME DETERMINATION

- (a) The two-sector model
- (b) The three-sector model
- (c) The four-sector model

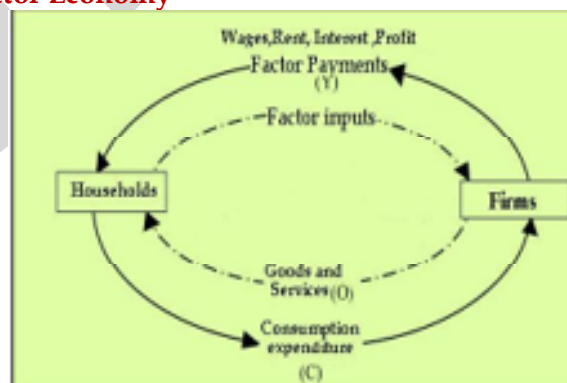
TWO SECTOR MODEL

Two sector model assume that:

- (a) Only two sector in the economy viz household and firms
- (b) No government sector: No tax, No govt. expenditure, No transfer payment
- (c) No foreign trade
- (d) Factor price, product price, supply of capital and technology, all are constant
- (e) No retained earning
- (f) No any injection into or leakage from the system
- (g) High rate of unemployment

Circular flow of income and expenditure is as follows:

Circular Flow in a Two Sector Economy



The circular broken lines with arrows show factor and product flows and continuous line with arrows show money flows.

Household owns all factor of production and supply all these factors to firm and get factor income. Whatever income they received from firms again paid to firms on purchase of goods and services. Business firms received all factors of production from household and pay factor income to household. Whatever amount they paid to household again received by them on sale of goods and services.

Factor payment = Household income = Household expenditure = Total receipt of firms = Value of output

An economy can be said to be in equilibrium when the production plans of the firms and the expenditure plans of the households match.

National income = Net National Product

AGGREGATE DEMAND FUNCTION

$$AD_0 = C + I$$

C = Aggregate demand of consumer goods

I = Aggregate demand for investment goods

CONSUMPTION FUNCTION

$$C = a + bY$$

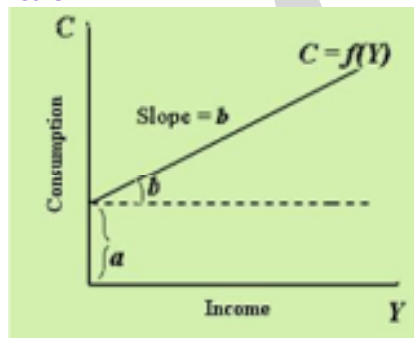
C = Aggregate consumption expenditure

a = Constant term which denotes the value of consumption at zero level of disposable income

b = Marginal propensity to consume

Y = Total disposable income

The Keynesian Consumption Function



The Keynesian assumption is that consumption increases with an increase in disposable income. But increase in consumption will be less than the increase in disposable income i.e. $0 < b < 1$. This fundamental relationship between income and consumption plays a crucial role in the Keynesian theory of income determination.

MARGINAL PROPENSITY TO CONSUME (b)

The value of the increment to consumer expenditure per unit of increment to income is termed the Marginal Propensity to Consume (MPC).

It is calculated as: $MPC = b = \Delta C / \Delta Y$

ΔC = Change in consumption

ΔY = Change in income

Although the MPC is not necessarily constant for all changes in income (in fact, the MPC tends to decline at higher income levels), most analysis of consumption generally works with a constant MPC.

AVERAGE PROPENSITY TO CONSUME

The ratio of total consumption to total income is known as the average propensity to consume (APC). It is calculated as follows: C/Y

The proportion of income spent on consumption decreases as income increases.

THE SAVING FUNCTION

National income $Y = C + S$ which shows that disposable income is, by definition, consumption plus saving. Therefore, $S = Y - C$.

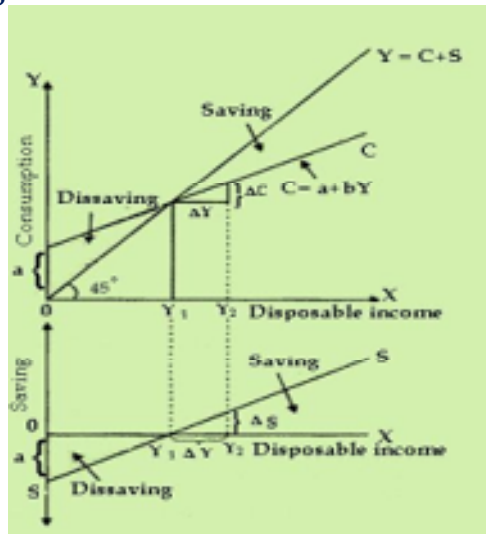
THE MARGINAL PROPENSITY TO SAVE

This increment to saving per unit increase in disposable income $(1 - b)$ is called the marginal propensity to save (MPS). It is calculated as: $\Delta S / \Delta Y$ or $1 - b$

Saving is an increasing function of the level of income i.e. saving increases as income increases.

AVERAGE PROPENSITY TO SAVE

The ratio of total saving to total income is called average propensity to save (APS).

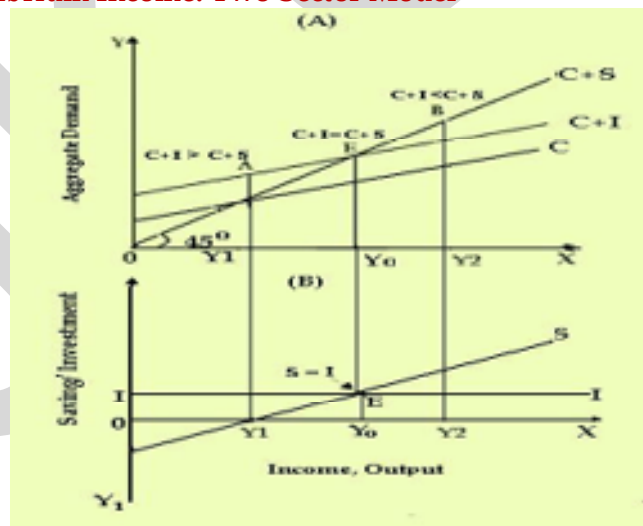
CONSUMPTION AND SAVING FUNCTIONThe Consumption and Saving Function

As per above diagram, Below Y_1 income level, consumption is more than income. Saving is negative. Above Y_1 income level, consumption is less than income and saving is positive. At Y_1 income level, consumption and income is equal and saving is zero.

As level of income increase, Average propensity to consume decrease and Average propensity to saving increase.

TWO SECTOR MODEL OF NATIONAL INCOME DETERMINATION (EQUILIBRIUM)

The equilibrium level of national income is a situation in which aggregate demand ($C + I$) is equal to aggregate supply ($C + S$) OR $I = S$.

Determination of Equilibrium Income: Two Sector Model

Where: C = Consumption of consumable goods; I = Investment; S = Saving
E = Equilibrium point; Y = Income

At equilibrium point:

- Aggregate demand ($C + I$) = Aggregate supply ($C + S$)
- $S = I$
- Consumer plan = Producer plan
- Saver plan = Investor plan
- No tendency for output to change

If $C+I > C+S$

If actual demand is more than equilibrium, excess demand makes business to sell more than what they currently produce, unexpected sales would decrease inventories investment, rising production by hiring extra workers, which will increase aggregate income and again demand and supply will be equal. It means an increase in aggregate spending makes the aggregate demand schedule shift upward. As a result, the equilibrium point would shift upward causing an increase in the national income.

If $C+I < C+S$

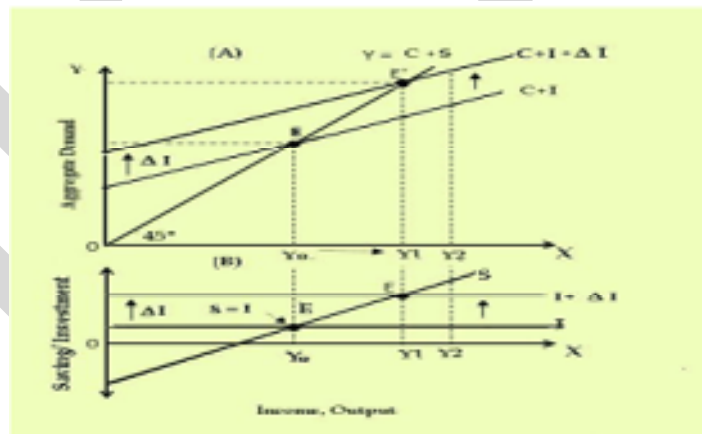
If actual demand is less than equilibrium, supply exceeds demand, business firms would be unable to sell output, increase large inventory investment, tendency for output to fall, which will decrease aggregate income and again demand and supply will be equal. It means an decrease in aggregate spending makes the aggregate demand schedule shift downward. As a result, the equilibrium point would shift downward causing an decrease in the national income.

Therefore, it may be inferred that a change in aggregate spending will shift the equilibrium from one point to another and a shift in the equilibrium will change the level of national income. The proposition put forth above tells us only the direction of change in the national income resulting from the change in the aggregate demand. It does not quantify the relationship between the two variables, i.e.; it does not tell us the magnitude of change in national income due to a given change in aggregate spending.

THE INVESTMENT MULTIPLIER

Investment multiplier explains how many times the aggregate income increases as a result of an increase in investment. When the level of investment increases by an amount say ΔI , the equilibrium level of income will increase by some multiple amounts, ΔY . The ratio of ΔY to ΔI is called the investment multiplier, k .

It is calculated as: $k = \Delta Y / \Delta I$

Effect of Changes in Autonomous Investment

In the above diagram, an increase in autonomous investment shifts the aggregate demand schedule from $C+I$ to $C+I+\Delta I$. Correspondingly, the equilibrium shifts from E to E_1 and the equilibrium income increases more than proportionately from Y_0 to Y_1 . Change in income is more than change in investment.

Multiplier expresses the relationship between an initial increment in investment and the resulting increase in aggregate income. As per investment multiplier, when there is an increase in investment, change in income is more than change in investment. It is due to marginal propensity to consume. Higher the marginal propensity to consume, higher the investment multiplier and vice versa. Investment multiplier can be calculated as follows: $k = 1/1-MPC$ or $1/MPC$

If MPC is one, investment multiplier is infinite

If MPC is zero, investment multiplier is one

If MPC is low, investment multiplier is low

If MPC is high, investment multiplier is high

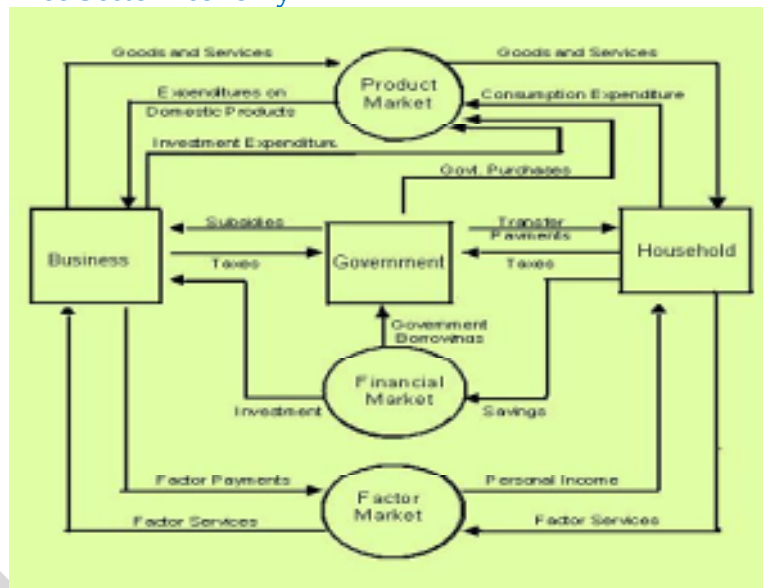
Investment multiplier is affected by leakages. Higher the leakage, lower the investment multiplier and vice versa. These leakages are as follows:

- High tax
- High liquidity preference
- Increased demand met out of the existing stock or through imports
- Additional income spent on purchasing existing shares or government Securities
- Undistributed profit
- Increment in income used for payment of debts
- Full employment exist
- Scarcity of goods and services

THREE SECTOR MODEL

Circular flow

Circular Flow in a Three Sector Economy

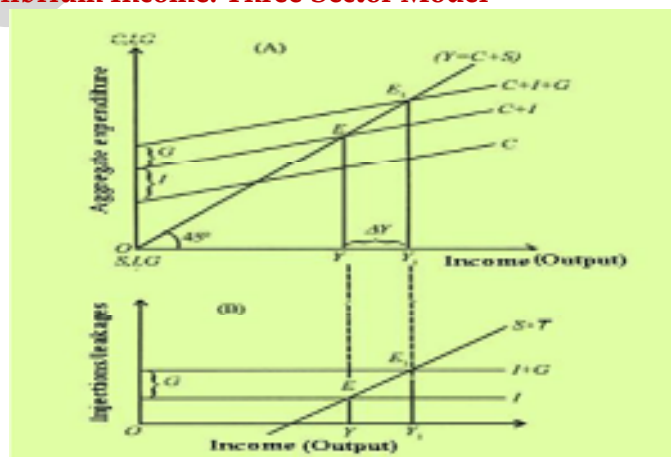


There are three sectors viz. household, business firm, and the government. Government add to flow in the following ways:

- Taxes flow to government from household and business firm
- Transfer payments to household sector
- Subsidy payments to the business sector
- Government purchases goods and services from business sector
- Government borrowing in financial markets to finance the deficits occurring when taxes fall short of government purchases

Equilibrium income

Determination of Equilibrium Income: Three Sector Model



Now: The aggregate demand function = $C+I+G$

The supply function = $C + S + T$

G= Government expenditure

T = Tax

Equilibrium is identified as the intersection between the $C+I+G$ line and the 45- degree line. The equilibrium income is Y_1 . At equilibrium point, $I+G$ equal to $S+T$.

If $C+I+G > C+S+T$

If actual demand is more than equilibrium, excess demand makes business to sell more than what they currently produce, unexpected sales would decrease inventories investment, rising production by hiring extra workers, which will increase aggregate income and again demand and supply will be equal. It means an increase in aggregate spending makes the aggregate demand schedule shift upward. As a result, the equilibrium point would shift upward causing an increase in the national income.

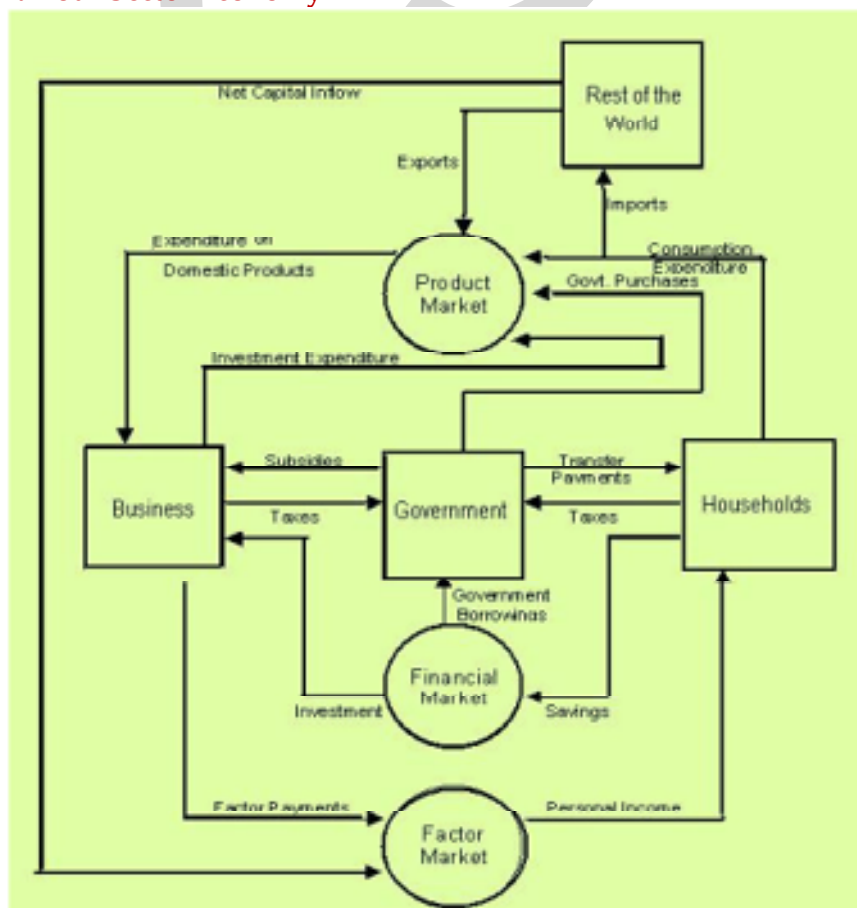
If $C+I+G < C+S+T$

If actual demand is less than equilibrium, supply exceeds demand, business firms would be unable to sell output, increase large inventory investment, tendency for output to fall, which will decrease aggregate income and again demand and supply will be equal. It means an decrease in aggregate spending makes the aggregate demand schedule shift downward. As a result, the equilibrium point would shift downward causing an decrease in the national income.

FOUR SECTOR MODEL

The four sector model includes all four macroeconomic sectors, the household sector, the business sector, the government sector, and the foreign sector. The foreign sector includes households, businesses, and governments that reside in other countries. The following flowchart shows the circular flow in a four sector economy.

Circular Flow in a Four Sector Economy



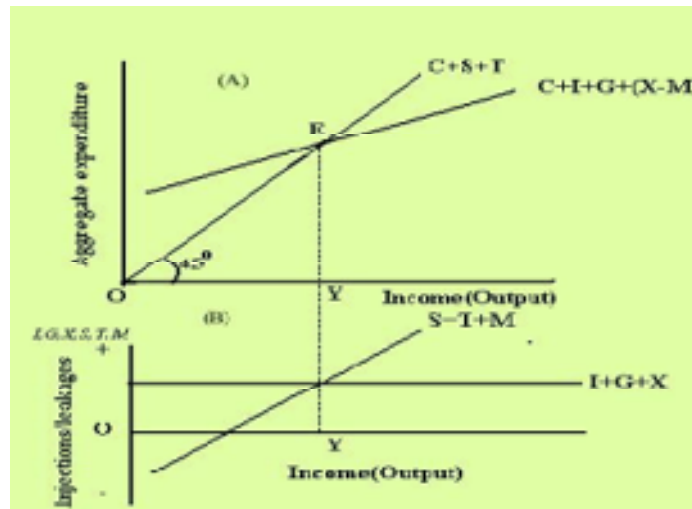
EQUILIBRIUM INCOME

Total Aggregate demand = $C + I + G + (X - M)$

Total Aggregate supply = $C + S + T$

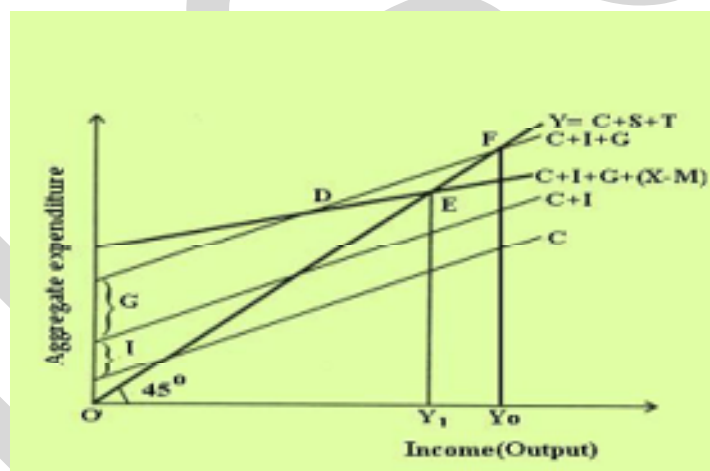
X = Export

M = Import



Equilibrium is identified as the intersection between the $C + I + G + (X - M)$ line and the 45-degree line. The equilibrium income is Y. At equilibrium point, $I + G + X$ equal to $S + T + M$.

If import is more than export, demand function decrease, and equilibrium point shift downwards as follows



CHAPTER: 2 PUBLIC FINANCE
UNIT 1: FISCAL FUNCTION AN OVERVIEW

ROLE OF GOVERNMENT IN AN ECONOMIC SYSTEM

The functions of government are separated into three:

- a) Resources allocation (efficiency)
- b) Income distribution (fairness)
- c) Macroeconomic stabilization

The allocation and distribution function are microeconomic function and stabilization is macroeconomic function. The allocation function aims to correct the sources of inefficiency in the economic system while the distribution role ensures that the distribution of wealth and income is fair. Monetary and fiscal policy, the problems of macroeconomic stability, maintenance of high levels of employment and price stability etc fall under the stabilization function.

ALLOCATION FUNCTION

Meaning

Resource allocation refers to allocation of factors of production to the various uses. It is optimal and efficient allocation of available resources so that resources are put to their best use and no wastages are there.

Reason

Allocation of resources is based on demand and supply in market. In the absence of govt. intervention, market failure may occur. It means resources are misallocated by too much production of certain goods and too little production of certain other goods. The main purpose of allocation function is maximizing social welfare.

Reasons for market failure in proper allocation

1. Imperfect competition and presence of monopoly in the market which reduce welfare of consumers
2. Failure of market to provide collective goods which is consumed commonly by all the people.
3. Externalities exist
4. Factor immobility which causes unemployment and inefficiency
5. Imperfect information
6. Inequalities in the distribution of income and wealth.

Instruments for allocation function

There are many instruments by which government can perform its allocation function some of which are as follows:

1. Government can directly produce goods
2. Government may influence private allocation through incentives and disincentives
3. Competition policies, merger policies which affect the structure of industry and commerce
4. Regulatory activities such as licensing, control, minimum wages, and directives on location of industry
5. Government sets legal and administrative frameworks.

Govt. contribute to distortions

Sometimes government may contribute to market distortions, reasons are:

- (a) Inadequate information,
- (b) Conflicting objectives
- (c) Administrative costs involved in government intervention etc.

REDISTRIBUTION FUNCTION

Meaning

Distribution function is concerned with the distribution of income and wealth so as to ensure distributive justice, equity and wealth. When there is high inequality in distribution of income and wealth, government intervene for distributive justice and wealth.

Objectives

- (1) Achieve an equitable distribution of social output among household
- (2) Advancing the well-being of those member of the society who suffer from deprivations of different type
- (3) Providing equality in income, wealth and opportunities
- (4) Provide security for people who had hardship
- (5) Ensuring that everyone enjoy a minimal standard living

Instruments

- (1) Taxation policies
- (2) Financing public services for the benefits of low income households
- (3) Employment reservation and preferences to protect certain segments of the population
- (4) Regulation of the manufacture and sale of certain products to ensure the health and well-being of consumers
- (5) Special schemes for backwards regions etc.

There should be optimal budgetary policy towards any distributional change so there should be proper tradeoff between efficiency and equity. This function should be accomplished with minimal costs by carefully balancing between equity and efficiency objectives.

STABILIZATION FUNCTION

Meaning

Instability in economy mainly arises due to business cycle. The market mechanism is limited in its capacity to prevent or to resolve the disruptions caused by the fluctuations in economic activity. In the absence of appropriate corrective intervention by the government, the instabilities that occur in the economy in the form of recessions, inflation etc. may be prolonged for longer periods causing enormous hardships to people especially the poorer sections of society. It is also possible that a situation of stagflation (a state of affairs in which inflation and unemployment exist side by side) may set in and make the high problem. The stabilization issue also becomes more complex as the increased international interdependence causes forces of instability to get easily transmitted from one country to other countries this is also known as contagion effect". The stabilization function is one of the key functions of fiscal policy and aims at eliminating macroeconomic fluctuations arising from suboptimal allocation. Areas covered in stabilization function. The stabilization function is concerned with the performance of the aggregate economy in terms of:

- (1) Labour employment and capital utilization
- (2) Overall output and income
- (3) General price level
- (4) Balance of international payments
- (5) The rate of economic growth

Components in fiscal policy related to stabilization function

1. Overall effect generated by the balance between source of resources like taxation, borrowing etc., and use of resources i.e. government expenditure.
2. A microeconomic effect generated by the specific policies it adopts.

Implementation of stabilization function

Stabilization function implemented through Monetary policy or Fiscal policy.

Monetary policy: Increase or decrease in money supply or interest rate to affect inflation, output, consumption, investment etc.

Fiscal policy: Government expenditure policy and taxation policy to affect economic activities like production, investment, saving, inflation, income, demand etc. Expansionary fiscal policy is adopted to end recession and contractionary fiscal policy is resorted to for controlling inflation.

UNIT 2: MARKET FAILURE

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

There are two aspects of market failures namely, demand-side market failures and supply side market failures. Demand-side market failures are said to occur when the demand curves do not take into account the full willingness of consumers to pay for a product. Supply-side market failures happen when supply curves do not incorporate the full cost of producing the product.

REASONS OF MARKET FAILURE

- (1) Market power,
- (2) Externalities,
- (3) Public goods, and
- (4) Incomplete information

MARKET POWER

Market power is also known as monopoly power. In case of monopoly, producer produces less and charged high price from the consumer. Market power or monopoly power is the ability of a firm to profitably raise the market price of a good or service over its marginal cost. Firms that have market power are price makers. Market power can cause markets to be inefficient because it keeps price higher and output lower than the outcome of equilibrium of supply and demand.

EXTERNALITIES

When consumption or production activity of one has an indirect effect on other's consumption or production activities and such effects are not reflected directly in market prices, it is called externalities. The unique feature of an externality is that it is initiated and experienced not through the operation of the price system, but outside the market. The cost (benefit) of it is not borne (paid) by the parties. **Externalities are also referred to as 'spillover effects', 'neighborhood effects' 'third party effects' or 'side-effects',** as the originator of the externality imposes costs or benefits on others who are not responsible for initiating the effect.

Unidirectional and Reciprocal Externalities

When one creates externality which affect another and another create externality at the same time which affect the first, it is called reciprocal. But if one create externality which affect another and no externality is created by the another person on the first person, it is called unidirectional.

Positive and Negative externalities

Externalities can be positive or negative. Negative externalities occur when the action of one party imposes costs on another party. Positive externalities occur when the action of one party confers benefits on another party. The four possible types of externalities are:

(a) Negative production externalities

A negative externality initiated in production which imposes an external cost on others may be received by another in consumption or in production.

(b) Positive production externalities

A positive production externality initiated in production that confers external benefits on others may be received in production or in consumption.

(c) Negative consumption externalities

Negative consumption externalities initiated in consumption which produce external costs on others may be received in consumption or in production.

(d) Positive consumption externalities

A positive consumption externality initiated in consumption that confers external benefits on others may be received in consumption or in production.

MARKET FAILURE BY EXTERNALITIES (NEGATIVE EXTERNALITIES)

Private cost: It is the total cost of production which is to be incurred by producer i.e. raw material, labour, overhead etc.

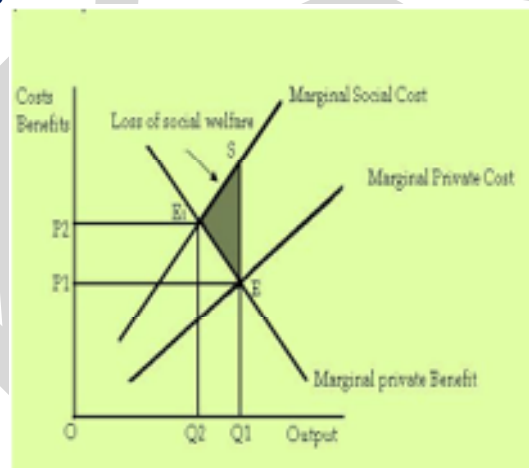
Social costs: Social cost are private cost borne by individuals directly involved in a transaction together with the external cost borne by the third parties not directly involved in the transaction.

Social cost = Private cost + External cost

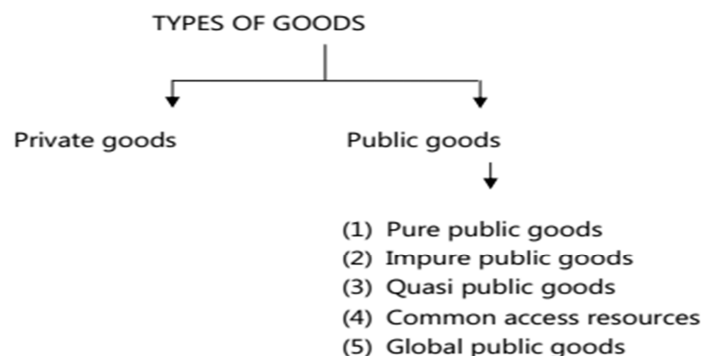
External cost is the damages from externalities.

Market failure: Price charged by producer is only private cost. It does not includes external cost. No consideration of externalities in the price of goods and services. Price is less than social cost so there is over production of goods. As a result of over production of goods, there is loss of social welfare which is equal to difference between social cost and social benefit. It is the situation of market failure. Externalities cause market inefficiencies because they hinder the ability of market prices to convey accurate information about how much to produce and how much to consume. It is serious problem but does not usually float up much because:

- (1) The society does not know precisely who are the producers of harmful externalities
- (2) Even if the society knows it, the cause-effect linkages are so unclear that the negative externality cannot be unquestionably traced to its producer.

Negative Externalities and Loss of Social welfarePUBLIC GOODS

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

TYPES OF GOODS

PRIVATE GOODS

1. It yields utility to people. Anyone who wants to consume them must purchase them.
2. Owners of private goods can exercise private property rights.
3. Its consumption is 'rivalrous' that is consumption by one prevent consumption by other.
4. These are 'excludable' i.e. it exclude or prevent consumers who have not paid for them from consuming them or having access to them.
5. Private goods do not have the free rider problem.
6. It can be rejected by consumers if their needs, preferences or budget change.
7. Additional production and supply require additional resource costs.
8. Whenever there is inequality in income distribution in an economy, issues of fairness and justice tend to arise with respect to private goods.
9. Normally, the market will efficiently allocate resources for its production.

A few examples of private goods are food item, clothing, television, car, house etc.

PURE PUBLIC GOODS

1. No direct payment by the consumer
2. Public good is non-rival in consumption. That is, your consumption of a public good in no way interferes with its consumption by other people.
3. Public goods are non-excludable. Consumers cannot be excluded from consumption benefits. If the good is provided, one individual cannot deny other individuals' consumption.
4. Public goods are characterized by indivisibility. The total amount consumed is the same for each individual.
5. Public goods are generally more vulnerable to issues such as externalities, inadequate property rights, and free rider problems.
6. Once a public good is provided, the additional resource cost of another person consuming the goods is 'zero'.

A few examples of public goods are: national defense, highways, public education, scientific research which benefits everyone, law enforcement, lighthouses, fire protection, disease prevention and public sanitation etc.

IMPURE PUBLIC GOODS

There are some goods which is neither pure private goods nor pure public goods. Some characteristics of public goods are there and some characteristics of private goods are there. These are called impure public goods. For example toll road, cinema, satellite television etc.

QUASI PUBLIC GOODS (MIXED GOODS)

The quasi-public goods or services, also called a near public good (for e.g. education, health services) possess nearly all of the qualities of the private goods and some of the benefits of public good. It is easy to keep people away from them by charging a price or fee. However, it is undesirable to keep people away from such goods because the society would be better off if more people consume them. This particular characteristic namely, the combination of virtually infinite benefits and the ability to charge a price results in some quasi-public goods being sold through markets and others being provided by government.

Markets for the quasi-public goods are considered to be incomplete markets and their lack of provision by free markets would be considered as inefficiency and market failure.

COMMON ACCESS RESOURCES

Common access resources or common pool resources are a special class of impure public goods. Some important natural resources fall into this category. For example fisheries, rivers, sea, earth atmosphere etc. These are non-excludable as people cannot be excluded from using them. These are rival in nature as their consumption lessens the benefit available to others. They are generally available free of charge.

Since price mechanism does not apply to common resources, producers and consumers do not pay for these resources and therefore, they overuse them and cause their depletion and degradation. This creates threat to the sustainability of these resources and, therefore, the availability of common access resources for future generations.

GLOBAL PUBLIC GOODS

There are several public goods benefits of which accrue to everyone in the world. These goods have widespread impact on different countries and regions, population groups and generations. These are goods whose impacts are indivisibly spread throughout the entire globe.

The WHO delineates two categories of global public goods namely, final public goods which are 'outcomes', (e.g. the eradication of polio) and intermediate public goods, which contribute to the provision of final public goods. (e.g. International Health Regulations aimed at stopping the cross-border movement of communicable diseases and thus reducing cross-border health risks). Similarly, the World Bank identifies five areas of global public goods which it seeks to address: namely, the environmental commons (including the prevention of climate change and biodiversity), communicable diseases (including HIV/AIDS, tuberculosis, malaria, and avian influenza), international trade, international financial architecture, and global knowledge for development. The distinctive characteristic of global public goods is that there is no mechanism (either market or government) to ensure an efficient outcome.

THE FREE RIDER PROBLEM

The incentive to let other people pay for a good or service, the benefits of which are enjoyed by an individual is known as the free rider problem. In other words, free riding is 'benefiting from the actions of others without paying'. A free rider is a consumer or producer who does not pay for a nonexclusive good in the expectation that others will pay.

Public goods provide a very important example of market failure, in which the self-interested behavior of individuals does not produce efficient results. We shall now see how free riding is applicable in the case of public goods. Consumers can take advantage of public goods without contributing sufficiently to their production. The absence of excludability in the case of public goods and the tendency of people to act in their own self-interest will lead to the problem of free riding. If individuals cannot be excluded from the benefit of a public good, then they are not likely to express the value of the benefits which they receive as an offer to pay. In other words, they will not express to buy a particular quantity at a price. Briefly put, there is no incentive for people to pay for the good because they can consume it without paying for it. There is an important implication for this behavior. If every individual plays the same strategy of free riding, the strategy will fail because nobody is willing to pay and therefore, nothing will be provided by the market. Then, a free ride for any one becomes impossible.

On account of the free rider problem, there is no meaningful demand curve for public goods. If individuals make no offers to pay for public goods, then the profit maximizing firms will not produce them.

In fact, the public goods are valuable for people. If there is no free rider problem, people would be willing to pay for them and they will be produced by the market. As such, if the free-rider problem cannot be solved, the following two outcomes are possible:

1. No public good will be provided in private markets
2. Private markets will seriously under produce public goods even though these goods provide valuable service to the society.

INCOMPLETE INFORMATION

Incomplete information arises due to the followings:

- (1) Complex nature of product and services
- (2) High cost of acquiring information and time consuming.
- (3) Ignorance of people etc.

Information failure is widespread in numerous market exchanges. When this happens misallocation of scarce resources takes place and equilibrium price and quantity is not established through price mechanism. This results in market failure.

Asymmetric information

Asymmetric information occurs when there is an imbalance in information between buyer and seller. This can distort choices. These are situations in which one party to a transaction knows a material fact that the other party does not. This phenomenon, which is sometimes referred to as the 'lemons problem', is an important source of market failure. With asymmetric information, low quality goods can drive high quality goods out of the market.

Adverse selection

Adverse selection is a situation in which asymmetric information about quality eliminates high - quality goods from a market. For example health insurance.

Moral hazard

Moral hazard is opportunism characterized by an informed person's taking advantage of a less - informed person through an unobserved action. It arises from lack of information about someone's future behavior. Moral hazard occurs when an individual knows more about his or her own actions than other people do. This leads to a distortion of incentives to take care or to exert effort when someone else bears the costs of the lack of care or effort. For example car insurance.

Asymmetric information, adverse selection and moral hazard affect the ability of markets to efficiently allocate resources and therefore lead to market failure because the party with better information has a competitive advantage.

UNIT 3: GOVT. INTERVENTION TO CORRECT MARKET FAILURE

GOVERNMENT INTERVENTION TO MINIMIZE MARKET POWER

Establishment of rules and regulations: Government can establish rules and regulation to prohibit actions which are likely to restrain competition. These legislations differ from country to country. Such legislations generally aim at prohibiting contracts, combinations and collusions among producers or traders which are in restraint of trade and other anticompetitive actions.

Price regulation: Price regulation in the form of setting maximum prices that firms can charge. Price regulation is most often used for natural monopolies that can produce the entire output of the market at a cost that is lower than what it would be if there were several firms. In some cases, the government's regulatory agency determines an acceptable price, so as to ensure a competitive or fair rate of return. This practice is called rate-of-return regulation.

GOVERNMENT INTERVENTION TO CORRECT EXTERNALITIES

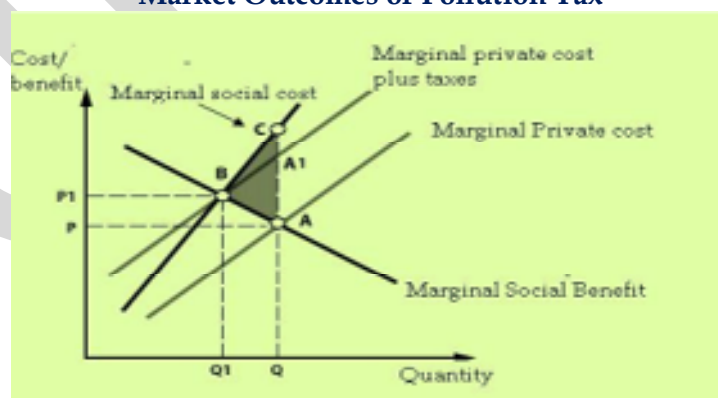
Rules and regulation (Direct control)

- (1) Ban on production or consumption of some goods
- (2) Establish environmental standards
- (3) Limiting emissions
- (4) Fix emissions standards (limit)
- (5) Install pollution-abatement mechanism
- (6) Charge emission fee
- (7) Establish special bodies/boards

Environmental taxes or pollution tax (Market based approach)

One method of ensuring internalization of negative externalities is imposing pollution taxes. The size of the tax depends on the amount of pollution a firm produces. More precisely, the tax is placed on the externality itself (the amount of pollution emissions) rather than on output (say, amount of steel). For each unit of pollution, the polluter must choose either to pay the tax or to reduce pollution through any means at its disposal. Tax increases the private cost of production or consumption as the case may be, and would decrease the quantity demanded and therefore the output of the good which creates negative externality. The proceeds from the tax, some argue, can be specifically earmarked for projects that protect or enhance environment.

Market Outcomes of Pollution Tax



However, there are problems in administering an efficient pollution tax.

- (1) Difficult to determine and administer.
- (2) Complex and costly administrative procedure.
- (3) It only establishes an incentive system for use of methods which are less polluting.
- (4) In case of goods having inelastic demand, this will have an inflationary effect and may reduce consumer welfare.
- (5) Pollution taxes also have potential negative consequences on employment and investments because high pollution taxes in one country may encourage producers to shift their production facilities to those countries with lower taxes.

Cap and trade (Market based approach)

The second approach to establishing prices is tradable emissions permits (also known as cap-and-trade). These are marketable licenses to emit limited quantities of pollutants and can be bought and sold by polluters. Under this method, each firm has permits specifying the number of units of emissions that the firm is allowed to generate. A firm that generates emissions above what is allowed by the permit is penalized with substantial monetary sanctions. These permits are transferable, and therefore different pollution levels are possible across the regulated entities. Permits are allocated among firms, with the total number of permits so chosen as to achieve the desired maximum level of emissions. By allocating fewer permits than the free pollution level, the regulatory agency creates a shortage of permits which then leads to a positive price for permits. This establishes a price for pollution, just as in the tax case. The high polluters have to buy more permits, which increases their costs, and makes them less competitive and less profitable. The low polluters receive extra revenue from selling their surplus permits, which makes them more competitive and more profitable. Therefore, firms will have an incentive not to pollute.

Advantages:

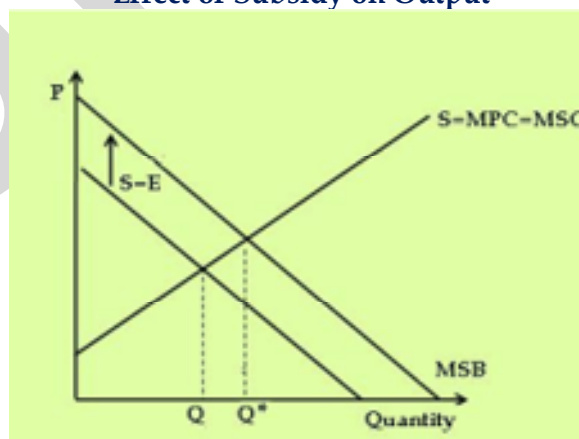
- (1) The system allows flexibility and reward efficiency
- (2) It is administratively cheap and simple to implement and ensures that pollution is minimised in the most cost-effective way
- (3) It also provides strong incentives for innovation.
- (4) Consumers may benefit if the extra profits made by low pollution firms are passed on to them in the form of lower prices.

Disadvantages:

- (1) They do not in reality stop firms from polluting the environment;
- (2) They only provide an incentive to them to do so.
- (3) Price level increase of inelastic goods.

Positive externality

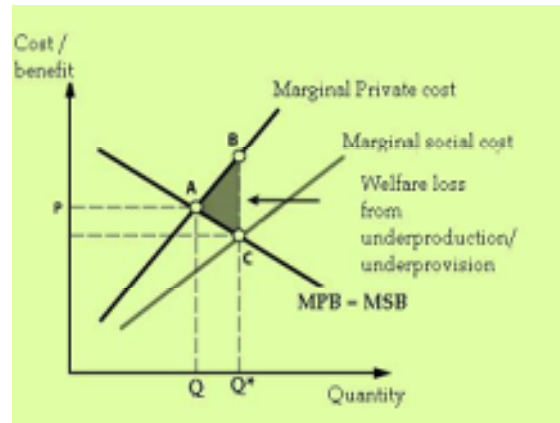
In case of goods, production of which have positive externality, Government provide subsidy. Subsidies involve government paying part of the cost to the firms in order to promote the production of goods having positive externalities. This is in fact a market-based policy as subsidies to producers would lower their cost of production. A subsidy on a goods which has substantial positive externalities would reduce its cost and consequently price, shift the supply curve to the right and increase its output. A higher output that would equate marginal social benefit and marginal social cost is socially optimal.

Effect of Subsidy on Output

In the case of products and services whose externalities are vastly positive and pervasive, government enters the market directly as an entrepreneur to produce and provide them. For example, fundamental research to protect the futuristic technology interest of the society is, in most cases, funded by government as the market may not be willing to provide them. Governments also engage in direct production of environmental quality.

GOVERNMENT INTERVENTION IN THE CASE OF MERIT GOODS

Merit goods are goods which are deemed to be socially desirable. Substantial positive externalities are involved in the consumption of merit goods and therefore the government deems that its consumption should be encouraged. Examples of merit goods include education, health care, welfare services, housing, fire protection, waste management, public libraries, museum and public parks. Merit goods are rival, excludable, limited in supply, rejectable by those unwilling to pay, and involve positive marginal cost for supplying to extra users. Merit goods can be provided through the market, but are likely to be under-produced and under consumed through the market mechanism so that social welfare will not be maximized.

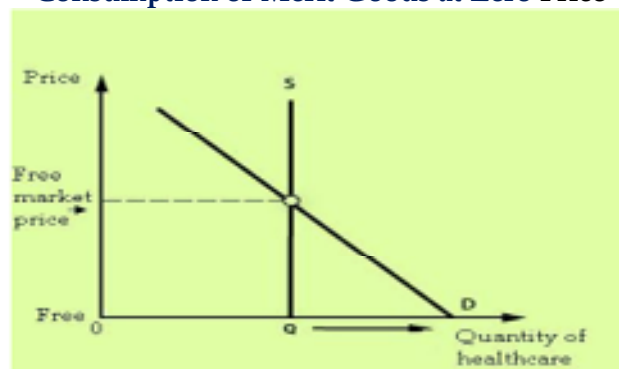
Market Outcome for Merit Goods**The reasons for government provision of merit goods are:**

- (1) Information failure is widely prevalent with merit goods.
- (2) Equity considerations demand that merit goods such as health and education should be provided free on the basis of need rather than on the basis of individual's ability to pay.
- (3) There is a lot of uncertainty as to the need for merit goods so consumer is not able to plan their expenditure for merit goods and save for it.

Government can intervene in the followings ways:

- (1) Subsidies
- (2) Direct government provision
- (3) Regulations
- (4) Combination of government provision and market provision.
- (5) Prohibition on some type of goods and activities, set standards and issue mandates making others oblige.
- (6) Government could also use legislation to enforce the consumption of a good which generates positive externalities?
- (7) A variety of regulatory mechanisms may also be set up by government to enhance consumption of merit goods and to ensure their quality.

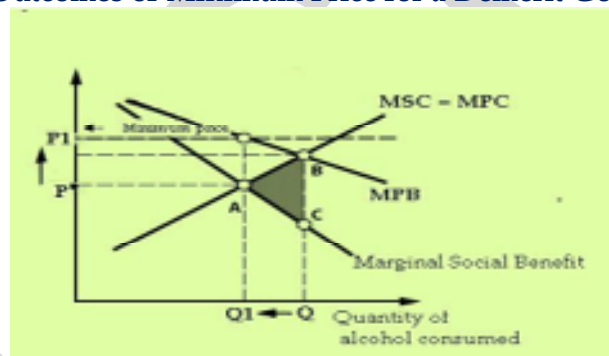
When merit goods are directly provided free of cost by government, there will be substantial demand for the same. As can be seen from the following diagram, when people are required to pay the free market price, people would consume only OQ quantity of healthcare. If provided free at zero prices, the demand OD far exceeds supply.

Consumption of Merit Goods at Zero Price

GOVERNMENT INTERVENTION IN CASE OF DEMERIT GOODS

Demerit goods are goods which are believed to be socially undesirable. Examples of demerit goods are cigarettes, alcohol, intoxicating drugs etc. The consumption of demerit goods imposes significant negative externalities on the society as a whole and therefore the private costs incurred by individual consumers are less than the social costs experienced by the society. The production and consumption of demerit goods are likely to be more than optimal under free markets. The marginal social cost will exceed the market price and overproduction and over-consumption will occur, causing misallocation of society's scarce resources. The generally held argument is that consumers overvalue demerit goods because of imperfect information and they are not the best judges of welfare with respect to such goods. The government should therefore intervene in the marketplace to discourage their production and consumption in the following ways:

- (1) Government may enforce complete ban on a demerit good.
- (2) Negative advertising campaigns which emphasize the dangers associated with consumption of demerit goods.
- (3) Through legislations that prohibit the advertising or promotion of demerit goods in whatsoever manner.
- (4) Strict regulations of the market for the good may be put in place so as to limit access to the good.
- (5) Regulatory controls in the form of spatial restrictions.
- (6) Imposing unusually high taxes
- (7) Fix minimum price which effect is explained as follows:

Outcomes of Minimum Price for a Demerit Good**Limitations:**

- (1) Determination of tax is difficult
- (2) The demand for demerit goods such as, cigarettes and alcohol is often highly inelastic, so that any increase in price resulting from additional taxation causes a less than proportionate decrease in demand.
- (3) The effect of stringent regulation such as total ban is seldom realized in the form of complete elimination of the demerit good; conversely such goods are secretly driven underground and traded in a hidden market.

GOVERNMENT INTERVENTION IN THE CASE OF PUBLIC GOODS

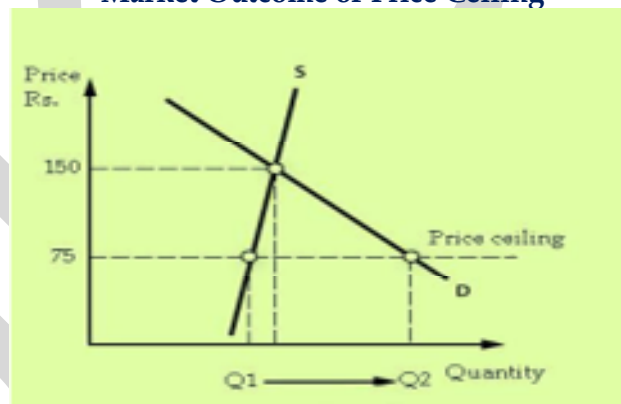
- (1) Direct provision of a public good by government can help overcome free-rider problem which leads to market failure. Direct provision by governments through the use of general government tax revenues is the good option.
- (2) Charge entry fee for use of public goods
- (3) Excludable public goods can be provided by government and the same can be financed through entry fees.
- (4) Grant licenses to private firms to build a public good facility and maintain strict control on the price charged by the private firms
- (5) Certain goods are produced and consumed as public goods and services despite the fact that they can be produced or consumed as private goods. This is because, left to the markets and profit motives, these may prove dangerous to the society. Examples are scientific approval of drugs, production of strategic products such as atomic energy, provision of security at airports etc.

PRICE INTERVENTION : NON MARKET PRICING**MINIMUM SUPPORT PRICE (PRICE FLOOR)**

Government usually intervenes in many primary markets which are subject to extreme as well as unpredictable fluctuations in price. For example in India, in the case of many crops the government has initiated the Minimum Support Price (MSP) programme as well as procurement by government agencies at the set support prices. The objective is to guarantee fixed and assured incomes to farmers. In case the market price falls below the MSP, then the guaranteed MSP will prevail.

Market Outcome of Minimum Support Price**MAXIMUM PRICE (PRICE CEILING)**

When prices of certain essential commodities rise excessively, government may resort to controls in the form of price ceilings (also called maximum price) for making a resource or commodity available to all at reasonable prices. For example: maximum prices of food grains and essential items are set by government during times of scarcity. A price ceiling which is set below the prevailing market clearing price will generate excess demand over supply.

Market Outcome of Price Ceiling**GOVERNMENT INTERVENTION FOR CORRECTING INFORMATION FAILURE**

- (1) Makes it mandatory to have accurate labeling and content disclosures by producers.
- (2) Public dissemination of information.
- (3) Regulation of advertising and setting of advertising standards.

GOVERNMENT INTERVENTION FOR EQUITABLE DISTRIBUTION

Equity can be brought about by redistribution of endowments with which the economic agents enter the market. Some common policy interventions include: progressive income tax, targeted budgetary allocations, unemployment compensation, transfer payments, subsidies, social security schemes, job reservations, land reforms, gender sensitive budgeting etc. Government also intervenes to combat black economy and market distortions associated with a parallel black economy.

UNIT 4: FISCAL POLICY**FISCAL POLICY- MEANING**

Fiscal policy involves the use of government spending, taxation and borrowing to influence both the pattern of economic activity and level of growth of aggregatedemand, output and employment. In other words, fiscal policy is designed to influence the pattern and level of economic activity in a country. Fiscal policy is in the nature of a demand-side policy. Governments of all countries pursue innumerable policies to accomplish their economic goals such as rapid economic growth, equitable distribution of wealth and income, reduction of poverty, price stability, exchange rate stability, full employment, balanced regional development etc.

OBJECTIVES OF FISCAL POLICY

- (1) Achievement and maintenance of full employment,
- (2) Maintenance of price stability,
- (3) Acceleration of the rate of economic development, and
- (4) Equitable distribution of income and wealth,

Priorities of these objectives may vary from country to country. Stability and equality may be the priorities of developed countries while economic growth and equity may get higher priorities in developing countries

NON-DISCRETIONARY FISCAL POLICY (AUTOMATIC STABILIZERS)

Fiscal policies which operate automatically are non-discretionary policies. These are built in policies and part of the structure of the economy. It automatically reduces the expansions and contractions of the business cycle without any government intervention.

Taxation policy and government expenditure works automatically. Instability caused by business cycle automatically dampened without any need for discretionary policy action. It automatically increases aggregate demand when recession is there and reduces aggregate demand when there is inflation in the economy. Personal income taxes, corporate income taxes and transfer payments (unemployment compensation, welfare benefits) are prominent automatic stabilizers.

At the time of recession

During recession – Income reduce – Tax reduce (Personal & corporate) – Government expenditure (transfer payment) increased – Disposal income increased – Demand increased – Output increase.

At the time of inflation

During inflation – Income increase – Tax increase (Personal & corporate) – Government expenditure (transfer payment) decreased – Disposal income reduced – Demand reduce – Price level decrease.

DISCRETIONARY FISCAL POLICY (DELIBERATE FISCAL POLICY)

Discretionary fiscal policy for stabilization refers to deliberate policy actions on the part of government to change the levels of expenditure, taxes to influence the level of national output, employment and prices.

$$GDP = C + I + G + NX$$

C = Private consumption

I = Private Investment

G = Government expenditure

NX = Net export

Governments can influence economic activity (GDP) by controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfer payments and expenditure.

INSTRUMENTS OR TOOLS OF FISCAL POLICIES

Tools of fiscal policy are of four types:

- A. Government expenditure
- B. Tax
- C. Public debt
- D. Government budget

GOVERNMENT EXPENDITURE

Govt. expenditure are of three types:

- (1) current expenditures to meet the day to day running of the government,
- (2) capital expenditures which are in the form of investments made by the government in capital equipment's and infrastructure, and
- (3) transfer payments

In case of recession

High govt. expenditure – Increase employment directly and indirectly – Increase income – Increase demand – Increase output – Industrial growth

In case of Inflation

Low govt. expenditure – Decrease employment directly and indirectly – Decrease income – Decrease demand – Decrease price level

Pump priming: Pump priming assumes that when private spending becomes deficient, certain volumes of public spending will help to revive the economy. Compensatory spending: **Compensatory spending:** is said to be resorted to when the government spending is carried out with the obvious intention to compensate for the deficiency in private investment.

TAXES

In case of recession

Low tax – High business and personal disposal income – Increase demand – Increase output – Industrial growth due to high demand and low corporate tax

In case of inflation

High tax and new tax – Decrease purchasing power – Decrease demand – Decrease price level

However, excessive taxation usually decrease new investments and therefore the government has to be cautious about a policy of tax increase.

PUBLIC DEBT

Internal and External debt: When the government borrows from its own people in the country, it is called internal debt. When the government borrows from outside sources, the debt is called external debt.

Market loan and Small saving: In the case of market loan, the government issues treasury bills and government securities of varying denominations and duration which are traded in debt markets. The small savings represent public borrowings, which are not negotiable and are not bought and sold in the debt market e.g., NSC, NDC etc.

In case of recession

Repayment of loan – Supply of money increase in market – Demand increase – Production increase – Industrial growth increase

In case of inflation

Borrowing – Supply of money decrease – demand decrease – Price level decrease

BUDGET

The budget is simply a statement of revenues earned from taxes and other sources and expenditures made by a nation's government in a year.

Types of budget and its effect: Balance, Deficit, and Surplus

Balanced budget: When expenditures in a year equal its revenues for that year. No effect on demand.

Surplus budget: When the government collects more than what it spends. It reduces demand and control inflation. It decreases nation's debt. But it reduce indus

Deficit budget: When the government expenditure in a year is greater than the tax revenue it collects. It increases demand, output, employment and industrial growth. But it increase nation's debt.

TYPES OF FISCAL POLICY

Fiscal policies are of two types namely Expansionary and Contractionary.

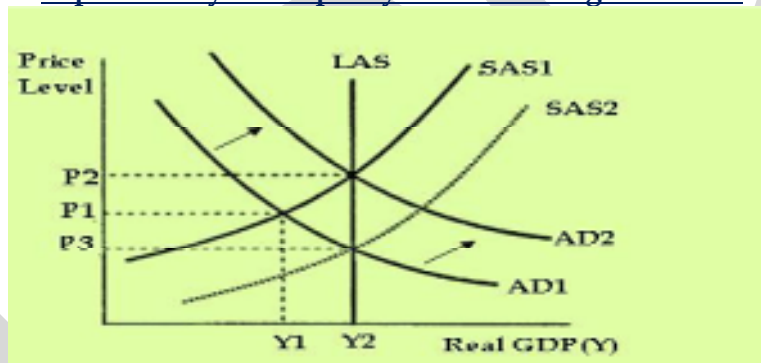
Expansionary fiscal policy: It is designed to stimulate the economy during the recession phase of a business cycle. This is accomplished by increasing aggregate expenditures and aggregate demand through an increase in all types of government spending and or decrease in taxes.

Contractionary fiscal policy: It is designed to restrain economic activity during inflation phase. This is carried out by decreasing the aggregate expenditures and aggregate demand through a decrease in all types of government spending and/ or an increase in taxes.

EXPANSIONARY FISCAL POLICY

Expansionary fiscal policy is adopted in the situation of recession. During recession, overall income decrease, due to decrease in employment. Decrease in income result in to decrease in demand and ultimately decrease output. There is slump in overall economic activity, the government can resort to expansionary fiscal policies.

An expansionary fiscal policy is used to close a 'recessionary gap'. A recessionary gap, also known as a contractionary gap, is said to exist if the existing levels of aggregate production is less than what would be produced with full employment of resources. It represents the difference between the actual aggregate demand and the aggregate demand which is required to establish the equilibrium at full employment level of income. Recessionary gap occurs when the aggregate demand is not sufficient to create conditions of full employment.

Expansionary Fiscal policy for Combating Recession

In expansionary fiscal policy, Government can increase expenditure. Government can incur budget deficit. Increase expenditure will increase employment result in to increase disposable income. Increase in disposable income increase demand which finally increase output.

The amount of government expenditure depends on GNP gap created due to recession and size of multiplier. If GNP gap created is high, high expenditure have to be incurred and vice versa. If multiplier is high, low government is required and vice versa. Multiplier means ratio of change in GNP in response to change in government expenditure.

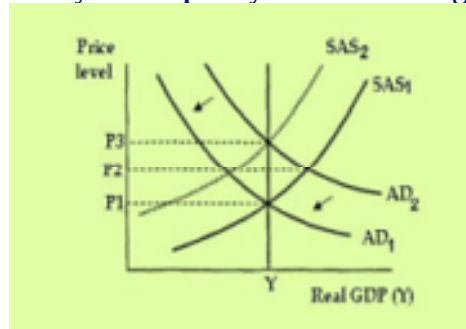
For expenditure, government should go for a deficit budget which may be financed either through borrowing or through monetization (creation of additional money to finance expenditure). If fund is borrowing, it should not increase interest rate in market otherwise it will decrease private investment. Fund for expenditure should not be arranged through increase in tax. If tax rate increase, it will decrease disposable income.

CONTRACTIONARY FISCAL POLICY

Contractionary fiscal policy refers to the deliberate policy of government applied to decrease aggregate demand and to decrease price level.

When aggregate demand rises beyond what the economy can potentially produce by fully employing it's given resources, it gives rise to inflationary pressures in the economy. Due to increase in consumption expenditure, inflationary gap occur. Under such circumstances, a contractionary fiscal policy will have to be used. This can be achieved either by:

- (1) Decrease in government spending
- (2) Increase in personal income taxes and/or business taxes
- (3) A combination of both

Contractionary Fiscal policy for Combating Inflation**FISCAL POLICY FOR LONG RUN ECONOMIC GROWTH**

Fiscal policies such as those involving infrastructure spending generally have positive supply-side effects. When government supports building a modern infrastructure, the private sector is provided with the requisite overheads it needs. Government provision of public goods such as education, research and development etc. provide momentum for long-run economic growth. A well designed tax policy that rewards innovation and entrepreneurship, without discouraging incentives will promote private businesses who wish to invest and thereby help the economy grow.

FISCAL POLICY MECHANISM FOR REDUCTION IN INEQUALITIES

- (1) Income tax differentiation. High tax on rich people and low tax on poor people
- (2) Indirect taxes differentiation. High tax on luxuries goods and low tax on goods which is largely used by low income group.
- (3) Government spending on welfare programme for poor people such as:
 - (a) Poverty alleviation programmes
 - (b) Free or subsidized medical care, education, housing, essential commodities etc. to improve the quality of living of poor
 - (c) Infrastructure provision on a selective basis
 - (d) Various social security schemes under which people are entitled to oldage pensions, unemployment relief, sickness allowance etc.
 - (e) Subsidized production of products of mass consumption
 - (f) Public production and/ or grant of subsidies to ensure sufficient supply of essential goods, and
 - (g) Strengthening of human capital for enhancing employability etc.

LIMITATION OF FISCAL POLICIES

1. Problem of lag (delay). There are significant lags are: (a) Recognition lag (b) Decision lag (c) Implementation lag (d) Impact lag
2. Government spending and tax policy cannot be change immediately.
3. Difficult to reduce some govt. spending such as defence, social security etc.
4. Public works cannot be adjusted easily along with movements of the trade cycle.
5. Due to uncertainties, there are difficulties of forecasting the situation and in determining the accurate policy to be undertaken.
6. Conflicts between different objectives of fiscal policy such that a policy designed to achieve one goal may adversely affect another.
7. Certain fiscal measures will cause disincentives for business.
8. Deficit financing increases the purchasing power of people which increase prices.
9. Increase in government borrowing creates perpetual burden.
10. Government borrowings increase interest rate. Interest rate increase is negative for business investment.
11. Due to various lags, it is possible that when fiscal policy is implemented, already situation is on a path of recovery.

CROWDING OUT

When spending of government increase during recession, sometimes it decreases private spending which is known as Crowding Out. In other words, when spending by government in an economy replaces private spending, the latter is said to be crowded out.

It is the situation in which increase in government spending reduces private or business investment and ultimately reduces industrial growth.

When this happen, the impact of government spending on aggregate demand would be smaller than what it should be and therefore fiscal policy may become ineffective. An increase in the size of government spending during recessions will 'crowd-out' private spending in an economy and lead to reduction in an economy's ability to self-correct from the recession, and possibly also reduce the economy's prospects of long-run economic growth .

Some examples are given:

- (a) **Government freely distribute goods** – Demand for that goods decrease in market – Reduce business investment for that goods Industry
- (b) **Government increase spending by borrowing** – Rate of interest increase – Reduce business investment
- (c) **Increase budget deficit** – Government raise fund from market – Interest rate increase – Reduce business investment
- (d) **Increase government spending** – Borrowing from market – Interest rate increase – Money supply decrease – Demand decrease – Industrial growth decrease

CHAPTER: 3 MONEY AND MONEY MARKET
UNIT 1 : MONETARY POLICY

UNIT CONTENT:

- ❖ Monetary Policy – Meaning
- ❖ Monetary policy – Objectives
- ❖ Monetary policy - Transmission mechanism
- ❖ Monetary policy - Operating procedure
- ❖ Monetary policy - Instruments
 - (a) Cash Reserve Ratio
 - (b) Statutory Liquidity Ratio
 - (c) Liquidity Adjustment Facility
 - (d) Marginal Standing Facility
 - (e) Market Stabilization Scheme
 - (f) Open Market Operation
 - (g) Bank Rate
- ❖ Organizational structure for monetary policy decision
 - (a) Monetary policy framework agreement
 - (b) Monetary policy committee

MONETARY POLICY - MEANING

Monetary policy refers to the use of monetary policy instruments which are at the disposal of the central bank to regulate the availability, cost and use of money and credit to:

- promote economic growth,
- Price stability,
- Optimum levels of output,
- Optimum employment,
- Balance of payments equilibrium,
- Stable currency
- Any other goal of government's economic policy.

OBJECTIVES OF MONETARY POLICY

- a) Stability in price or controlling inflation
- b) Full employment
- c) Regulate the issue of bank notes
- d) Operates currency and credit system to its advantages
- e) Ensure adequate flow of credit to the productive sector
- f) Maintenance of a judicious balance between price stability and economic growth.
- g) Debt management
- h) Rapid economic growth
- i) Moderate long term interest rate
- j) External balance of payments equilibrium

MONETARY TRANSMISSION MECHANISM

The process or channels through which the change of monetary policy affects the level of product and prices is known as 'monetary transmission mechanism'. There are mainly four different mechanisms through which monetary policy influences the price level and the national income. These are:

- (a) the interest rate channel,
- (b) the exchange rate channel,
- (c) the quantum channel
- (d) the asset price channel

(a) Interest rate channel:

Contractionary policy: Increase in interest rate – Low borrowing – Cut investment – High borrowing reduced demand – Finally fall in output and employment.

Expansionary policy: Opposite effect.

(b) Exchange rate channel:

Contractionary policy: Appreciation of the domestic currency - Domestically produced goods more expensive - Exports fall and import increase – Fall in output and employment.

Expansionary policy: Opposite effect

(c) Quantum channel or bank lending channel:

Contractionary policy: Decrease Bank lending through decrease in supply of money – Cut investment – Fall in output and employment

Expansionary policy – Opposite effect.

(d) Assets price channel or balance sheet channel:

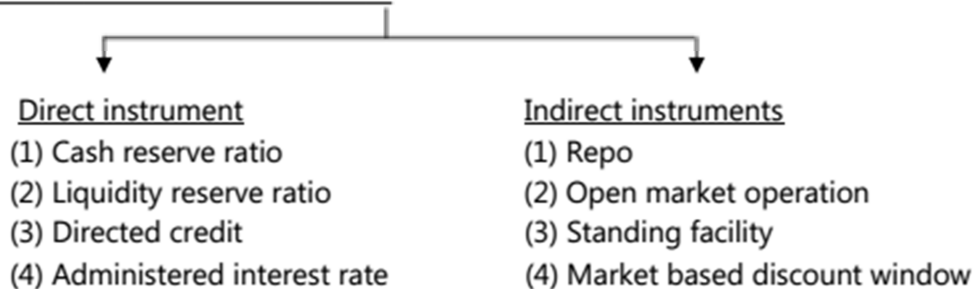
Contractionary policy: Increase bank interest rate – High interest payment – High cost of capital – Decrease in value of business – Decrease price of equity share – Decrease in demand due to high interest payment - Fall in output and employment

Expansionary policy: Opposite effect

OPERATING PROCEDURE AND INSTRUMENTS

Operating procedure means implementation of monetary policy by RBI. There are three steps:

- (1) Choose operating target: Choose variable which we want to influence directly
- (2) Choose intermediate target: Variable which we hope to influence through operating target
- (3) Choose policy instrument: Select tool to be used to accomplish our target

INSTRUMENTS OF MONETARY POLICY**CASH RESERVE RATIO**

Cash Reserve Ratio refers to the fraction of the total net demand and time liabilities of a scheduled commercial bank which it should maintain as cash deposit with the Reserve Bank. Non Bank Financial Institutions are outside the purview of this reserve requirement. No interest on reserve but penalty on non-maintenance.

During inflation:

High CRR → Reduced lending → Low liquidity → Fall in output and demand → reduced price

During slowdown in the economy:

Low CRR → Increased lending → Increase liquidity → Increase output and demand.

STATUTORY LIQUIDITY RATIO

It refers to fraction of total demand and time liabilities of a commercial bank are required to maintain in one of the following forms:

1. Cash
2. Gold
3. Investments in un-encumbered Instruments that include:
 - a) Treasury-bills of the Government of India.
 - b) Dated securities including those issued by the Govt. of India from time to time under the market borrowings programme and the Market Stabilization Scheme (MSS).
 - c) State Development Loans (SDLs) issued by State Governments under their market borrowings programme.
 - d) Other instruments as notified by the RBI.

Failure to maintain it is liable to penalty.

Contraction policy:

Increase SLR → Reduced lending → Reduced liquidity → Low investment → Low Out and demand → Reduced price

Expansion policy:

Decrease SLR → Increase lending → Increase liquidity → increase investment → High output employment.

LIQUIDITY ADJUSTMENT FACILITY

This facility provided by RBI to assist commercial banks to adjust their day to day mismatch liquidity. RBI provides financial accommodation to the commercial bank through Repo and Reverse Repo under Liquidity adjustment facility.

Repurchase option (REPO): When commercial bank sell securities to RBI with an agreement to repurchase the securities on agreed future date is called Repo. It is basically borrowing by commercial bank from RBI on security of govt. securities or any other specified securities. The interest rate charged by RBI on such transaction is called REPO rate. It increases liquidity in the system.

Reverse repo: When commercial bank purchase securities from RBI with an agreement to resell the securities on agreed future date is called reverse repo. It is basically borrowing by RBI from banks on security of govt. securities or any other specified securities. It decreases liquidity in the system. The interest rate paid by RBI for such transaction is called reverse repo rate.

MARGINAL STANDING FACILITY

If a commercial bank require fund over and above LAF, it can borrow by reducing statutory liquidity ratio up to a limit in case of emergency. It is called Marginal standing facility. There is high rate of interest which include penal rate above repo rate.

Main aim of MSF is reducing volatility in the overnight lending rates and to enable smooth monetary transmission. The MSF would be the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility on which the rates are lower compared to the MSF. On MSF, high rate; on REPO, rate at the middle and on Reverse repo at lower rate.

MARKET STABILISATION SCHEME

If there is large inflow of foreign capital, Govt. absorb excess liquidity by this scheme. In this scheme, Govt. borrow fund from RBI which is additional borrowing to its normal borrowing requirement and issues treasury bills securities. It is also called sterilization process.

OPEN MARKET OPERATIONS

In case of high inflation: Sale govt. Securities in market – Decrease liquidity in market – Demand decrease – Investment decrease – Inflation reduce
In case of recession: Buy Govt. Securities – Liquidity increase – Demand increase – Investment increase – Output and employment increase

BANK RATE

It is standard rate at which the RBI is prepared to buy or re-discount bills of exchange or other commercial paper eligible for purchase under the Act. The bank rate once used to be the policy rate in India. Discounting/rediscounting of bills of exchange by the Reserve Bank has been discontinued on introduction of Liquidity Adjustment Facility (LAF). Now, bank rate is used only for calculating penalty on default in the maintenance of Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR).

ORGANISATIONAL STRUCTURE FOR MONETARY POLICY DECISIONS

(1) THE MONETARY POLICY FRAMEWORK AGREEMENT

There is agreement between RBI and Government of India to fix target rate and maximum and minimum tolerable inflation rate which is also known as inflation targeting. At present, inflation targeting is the primary objectives of monetary policy.

Inflation target will be set by Government of India in consultation with RBI once in every five year. Present inflation target rate is 4% and upper tolerance rate is 6% and lower tolerance rate is 2%. The RBI is mandated to publish monetary policy report every six months.

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

- a) The average inflation is more than the upper tolerance level of the inflation target for any three consecutive quarters; or
- b) The average inflation is less than the lower tolerance level for any three consecutive quarters.

(2) THE MONETARY POLICY COMMITTEE

Member:

Total six members

- (1) RBI Governor: Chairperson
- (2) RBI Deputy Governor: In charge of monetary policy
- (3) One official nominated by RBI board
- (4) Three central government nominee (persons of ability, integrity and standing, having knowledge and experience in the field of Economics or banking or finance or monetary policy)

Function:

Determine policy rate to achieve the inflation target and meets daily to review the liquidity conditions so as to ensure that the operating target of monetary policy (weighted average lending rate) is kept close to the policy repo rate.

Operation

Fixing of the benchmark policy interest rate (repo rate) is through debate and majority vote by this panel of experts.

The Reserve Bank's Monetary Policy Department (MPD) assists the MPC in formulating the monetary policy.

The Financial Markets Operations Department (FMOD) operationalises the monetary policy, mainly through day -to-day liquidity management operations.

Objective

The system is intended to incorporate diversity of views, specialized experience, independence of opinion, representativeness, and accountability

UNIT 2 : DEMAND OF MONEY

Unit content:

- ❖ Money - Meaning
- ❖ Function of money
- ❖ Essential characteristics of money
- ❖ Demand of money
- ❖ Theories for demand of money
 - Classical Approach: The quantity theory of money
 - The neo classical approach: The Cambridge approach
 - The Keynesian theory of demand of money
 - Inventory approach to transaction balances (Baumol model)
 - Friedman's Restatement of the quantity theory
 - The demand of money as behavior towards risk.

MONEY - MEANING

- It refers to assets commonly used and accepted as a means of payment or as a medium of exchange or of transferring purchasing power without any cost.
- Anything that would act as a medium of exchange is not necessarily money.

FUNCTIONS OF MONEY

- Money act as a medium of exchange
- Money act as an instrument that facilitates easy exchange of goods and services.
- Money functions as a common measure of value.
- Money serves as a unit or standard of deferred payment (future payment)
- Money act as a value of store
- Money functions as a source of purchasing power
- Money also functions as a permanent store of value.

ESSENTIAL CHARACTERISTICS OF MONEY

- Acceptable
- Durable
- Recognizable without efforts.
- Difficult to counterfeit
- Relatively scarce
- Portable
- Possessing uniformity
- Divisible

DEMAND FOR MONEY

- Demand for money means how much wealth should be in the form of money.
- Demand for money depends on many factors, illustrative list is given:
 - (a) Income – Directly related
 - (b) Price level – Directly related
 - (c) Rate of interest – Inversely related
 - (d) Real GDP – Directly related
 - (e) Degree of financial innovations – Inversely related

THEORIES FOR DEMAND OF MONEY

- (a) Classical approach: The quantity theory of money
- (b) The neo classical approach: The Cambridge approach
- (c) Keynesian theory
- (d) Investment approach to transaction balance
- (e) Friedman's restatement of the quantity theory
- (f) The demand for money as behaviour towards risk

(A) THE QUANTITY THEORY OF MONEY (BY FISHER)

It is also known as cash transaction approach. As per this approach, people demand money for transaction purpose. It means demand of money is depends on price level and number of transaction. Fisher has explained his theory in terms of his equation of exchange which is as follows:

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

Where: M = The amount of money in circulation in an economy (average)

V = Transaction velocity of circulation

M' = The total quantity of credit money

V' = Velocity of circulation of credit money

P = Average price level

T = Total amount of goods and services exchanged for money

The total volume of transactions (T) multiplied by the price level (P) represents the demand for money. The demand for money (PT) is equal to the supply of money (MV + M'V'). In any given period, the total value of transactions made is equal to PT and the value of money flow is equal to MV + M'V'. Thus, there is an aggregate demand for money for transactions purpose and more the number of transactions people want, greater will be the demand for money.

As per Fisher 'Other things remaining same, quantity of money is the main determinant of price level or the value of money'. If the quantity of money is doubled, the price level will also double and the value of money will be one half. If the quantity of money is reduced by one half, the price level will also be reduced by one half and the value of money will be twice.

(B) CASH BALANCE APPROACH (MARSHALL, PIGOU, ROBERTSON, KEYNES)

Cash balance approach considers the demand for money not as a medium of exchange but as a store of value. The demand for money is the demand to hold cash for two purposes:

- (a) Transaction purpose
- (b) Precautionary purpose

Demand of money depends partly on income and partly on other factors of which important ones are wealth and interest rates. The former determinant of demand i.e. income, points to transactions demand such that higher the income, the greater the quantity of purchases and as a consequence greater will be the need for money as a temporary abode of value to overcome transactions costs.

The Cambridge equation is stated as:

$$M_d = k PY$$

Where M_d = demand for money

PY = National income

K = proportion of nominal income that people wants to hold as cash balance

The Cambridge equation shows that given the supply of money at a point of time, the value of money is determined by the demand for cash balance. When the demand for money increases, people will reduce their expenditure on goods and services in order to have larger cash holding, reduced demand for goods and services will bring down the price level and raise the value of money. On the contrary, fall in the demand for money will raise the price level and lower the value of money.

(C) KEYNESIAN THEORY OF DEMAND OF MONEY

According to Keynes, people hold money (M) in cash for three motives:

- (a) Transactions motive,
- (b) Precautionary motive, and
- (c) Speculative motive.

The sum of the transaction, precautionary, and the speculative demand, is the total demand for money. An increase in income increases the transaction and precautionary demand for money and a decrease in the rate of interest increases the speculative demand of money.

The transaction motive

The transactions motive for holding cash relates to the need for cash for current transactions for personal and business exchange. The transaction demand for money is directly related to the level of income. It can be calculated as follows:

$$L_r = kY$$

L_r = Transaction demand for money

k = ratio of earning which is kept for transaction purposes

Y = earning

The precautionary motive

Individuals as well as businesses keep a portion of their income to finance unanticipated expenditures. It depends on the size of income, prevailing economic as well as political conditions and personal characteristics of the individual etc.

The speculative motive

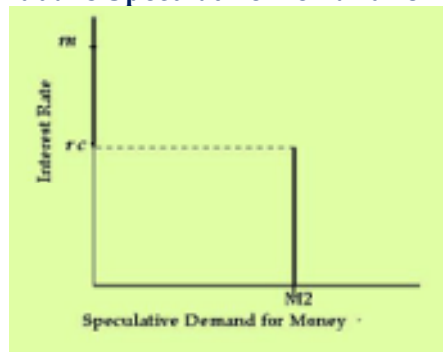
The speculative motive reflects people's desire to hold cash in order to be equipped to exploit any attractive investment opportunity requiring cash. Investment gives two type of income viz. interest and capital gain.

If current rate of interest is higher than the critical rate of interest, bond price is expected to increase. Person will invest in bond to earn high interest and capital gain, so demand of money decrease.

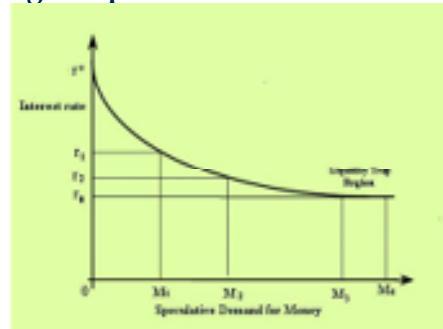
If the current rate of interest is lower than the critical rate of interest, bond price is expected to decrease. Person will hold cash to avoid capital loss and low interest, so demand of money increase.

The inference from the above is that the speculative demand for money and interest are inversely related.

Individual's Speculative Demand for Money



Aggregate Speculative Demand for Money

**(D) INVENTORY APPROACH TO TRANSACTION BALANCES (BY BAUMOL)**

Baumol used business inventory approach to analyze the behavior of individuals. Demand of money depends on two factors viz. Interest rate and Transaction cost. If people hold money, there is loss of interest. To earn interest, they have to invest money into bonds. But conversion of money into bonds or bonds into money involves some expenditure which is transaction cost. If rate of interest is high and transaction cost is low, people convert maximum money into bond and hold minimum cash which decrease demand of money. If rate of interest is low and transaction cost is high, people hold maximum amount in cash rather than bond which increase demand of money.

The individual will choose the number of times the transfer between money and bonds takes place in such a way that the net profits from bond transactions (Interest – Transaction cost) are maximized. Therefore, they hold an optimum combination of bonds and cash balance, i.e., an amount that minimizes the opportunity cost and transfer cost.

(E) FRIEDMAN'S RESTATEMENT OF THE QUANTITY THEORY

Friedman states that demand for money is more general theory of demand for capital assets. Demand for money is affected by the same factors as demand for any other assets namely Income and relative return (risk). There are four determinants of demand of money which is as follows:

- (a) **Wealth:** Demand of money is a function of total wealth. People demand money to create wealth. They require money to earn money.
Wealth = Permanent income / discount rate
Permanent income is expected future income, which can be earned from five assets namely money, bonds, equity, physical assets, and human capital
- (b) **Price level:** Price level rise, demand of money rise and vice versa
- (c) **Interest rate:** Inversely related
- (d) **Inflation:** Inversely related

(F) DEMAND FOR MONEY AS BEHAVIOUR TOWARDS RISK (TOBIN)

A person can hold money or he can invest his money. There are two factors which determine how much he should invest and what amount he should hold with him. First factor is return and second factor is risk.

If he invests his money in bond, he can earn interest but there is risk in investment because there is price volatility of bond. It means return attached with risk. If he held money with him, there is no return but there is no risk of price volatility. It means he has to consider both factor at the time of investment viz. return and risk.

If there is high return on investment compare to risk, the individual will increase the proportion of wealth in bonds and decrease the holding of money. If there is low return on investment compare to risk, the individual will increase the proportion of wealth in cash and increase the demand of money.

UNIT 3 : MONEY SUPPLY

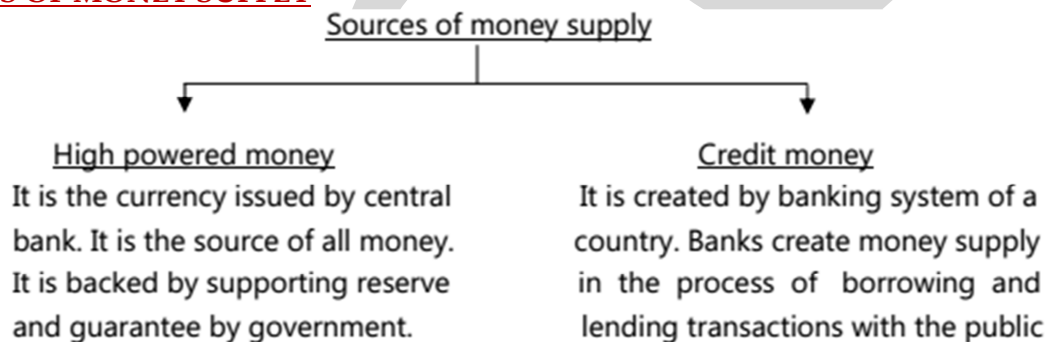
MONEY SUPPLY

Money supply means the stock of money. It refers to the stock of money available to the public as a means of payment and store of value. Public includes household, firms and institutions except Government and the banking system. Demand deposit with bank is included in the meaning of money supply.

RATIONALE OF MEASURING MONEY SUPPLY

1. Money supply is used for analysis. Analysis helps in understanding causes of money growth.
2. Supply of money is used for price stability. Supply of money is compared with standard and if there is deviation, it can be controlled.

SOURCES OF MONEY SUPPLY



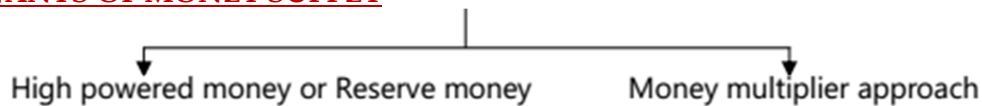
MEASUREMENT OF MONEY SUPPLY

The RBI has been publishing data on four alternative measures of money supply denoted by M1, M2, M3 and M4 besides the reserve money, which are as follows:

M₁	= Currency notes and coins with the public + Demand deposit of banks + Other deposits of RBI
M₂	= M ₁ + Saving deposits with post office saving bank
M₃	= M ₁ + Net time deposits with the banking system
M₄	= M ₃ + Total deposits with the post office saving (excluding NSC)

Note:

- (1) The RBI regards these four measures of money stock as representing different degrees of liquidity. It has specified them in the descending order of liquidity, M1 being the most liquid and M4 the least liquid of the four measures.
- (2) Currency = Paper currency + coins.
- (3) Demand deposits = Current A/c deposit + Saving A/c deposit (excluding Interbank deposit)
- (4) Other deposit of RBI = Demand deposit with RBI of quasi-government institutions, other financial institutions, Foreign central bank and governments, International agencies such as IMF and the World bank.

DETERMINANTS OF MONEY SUPPLY**HIGH POWERED MONEY**

It is the currency issued by central bank. It is the source of all money. It is backed by supporting reserve and guarantee by government.

High powered money = Currency with the public + Banker's deposit with the RBI + Other deposits with the RBI

MONEY MULTIPLIER

It denotes by how much the money supply will change for a given change in high-powered money. It indicates what multiple of the monetary base is transformed into money supply. It is ratio that relates the changes in the money supply to a given change in monetary base. The money supply is defined as: $M = m \times MB$

M = money supply,

m = money multiplier

MB = monetary base or high powered money.

Money multiplier: $m = M/MB$

MONEY MULTIPLIER APPROACH TO SUPPLY OF MONEY

As per money multiplier approach, supply of money is affected by three factors:

- the stock of high-powered money (H): Behavior of the Central bank
- the ratio of reserves to deposits, $e = \{ER/D\}$: Behavior of commercial bank
- the ratio of currency to deposits, $c = \{C/D\}$: Behavior of the general public

(a) The stock of high powered money (The behavior of the central bank)

Central bank change money supply by two ways:

- Supply of high powered money
- Reserve ratio

Supply of high powered money: If supply of high power money increase, there is increase of money supply and vice versa. It means supply of money and money multiplier is directly related to supply of high powered money

Reserve Ratio: If Central bank increase reserve ratio, supply of money decrease and vice versa. It means supply of money and money supplier is inversely related to reserve ratio.

(b) The ratio of excess reserve to deposit (The behavior of commercial bank)

Bank generally maintains extra reserve other than statutory ratio. The purpose of maintenance of excess reserve is the expected risk of deposit outflow.

Ratio of Excess reserve to deposit is called excess reserve ratio which can be calculated as

Follows: $\text{Excess reserve ratio} = \text{Excess reserve} / \text{Deposit}$

Higher excess reserve ratio – Low loan – Low money supply

Lower excess reserve ratio – High loan – High money supply

Excess reserve ratio depends on: (a) Interest rate (b) Expected deposit outflow

If interest rate is high, excess reserve ratio is low and vice versa. It means excess reserve ratio is inversely related to interest rate.

If there is high expectancy of deposit outflow, excess reserve ratio is high and vice versa. It means excess reserve ratio is directly related to expectancy of deposit outflow.

(c) The ratio of currency to deposit (The behavior of public)

The public either hold cash or deposit it into bank account. There is currency ratio which represent holding of currency to deposit.

Higher the ratio means people hold high currency and deposit money falls. If deposit is low, bank can create only less credit money. Money multiplier falls and ultimately supply of money decrease.

Lower the ratio means people hold less currency and deposit high amount in bank. If deposit is high, bank can create high credit money. Money multiplier increase and ultimately supply of money increase.

There is one more ratio which is Time deposit-demand deposit ratio. High ratio means high time deposit, less reserve by bank, higher credit money, high credit multiplier and ultimately high money supply. Low Time deposit-demand deposit ratio means low time deposit, high reserve by bank, low credit money, low credit multiplier and ultimately low money supply.

It means, size of money multiplier is determined by required reserve ratio at the central bank, the excess reserve ratio of the commercial bank, and the currency ratio of the public. Higher ratios means lower the size of money multiplier and low money supply. Lower ratio means higher the size of money multiplier, and high money supply.

EFFECT OF GOVERNMENT EXPENDITURE ON MONEY SUPPLY

Due to increase in government expenditure, money supply increase. For expenditure, government borrows from RBI and pay as expenditure to the public. Public deposit money in to bank account which create further money (credit money).

(Note : Kindly study New monetary aggregates , Reserve money ,and L1,L2,L3 from ICAI module)

CHAPTER: 4 INTERNATIONAL TRADE
UNIT 1: THEORIES OF INTERNATIONAL TRADE

*** Define international trade and describe how it differs from internal trade?**

Solution:

International trade is the exchange of goods and services as well as resources between countries. It involves transactions between residents of different countries. Whereas domestic trade or internal trade involves exchange of goods and services within the domestic territory of a country.

Internationally trade involves transaction in multiple currencies whereas domestic trade place only using domestic currency.

Compared to internal trade, international trade has greater complexity as it involves heterogeneity of customers and currencies, differences in legal systems, more elaborate documentation, and diverse restrictions in the form of taxes, regulations, duties, tariffs, quotas, trade barriers, standards, and restraints to movement of specified goods and services and issues related to shipping and transportation.

For international trade certain general rules of trade are followed by the countries which are made my international bodies like the WTO. On the other hand in case of internal trade the laws are sole prerogative of the country.

*** Critically examine the arguments for and against international trade? (MERITS)**

Solution:

International trade may lead to a lot of advantages for countries as it leads of opening up of the global economy leading to expansion of the domestic market internationally. Following are the arguments in the favour of international Trade:

- It is powerful **stimulus to economic efficiency** and contributes to economic growth and rising incomes.
- It includes companies to reap the quantitative and qualitative benefits of extended division of labour.
- Manufacturing capabilities and benefits from economics of large scale production.
- Reduction in domestic price due to increased competition thereby increasing the living standard of citizens.
- International trade **provides access to new market** and new material and enables sourcing of inputs and components internationally at competitive prices.
- Exports **stimulate economic growth by creating jobs**, which could potentially reduce poverty.

Following are the main arguments against International Trade (DEMERITS)

- **Possible negative labour market outcomes** in terms of labour- saving technological change that depress demand for unskilled workers, loss of labourers bargaining power.
- Economic exploitation is a likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally.
- Excessive stress on exports and profit-driven exhaustion of natural resources due to unsustainable production and consumption.
- It may have adverse effect on the development of domestic industries and may even threaten the survival of infant industries.
- Risky dependence of underdeveloped countries on foreign nation impairs economic autonomy and endangers their political sovereignty.
- Instead of cooperation among nation, **trade may breed rivalry** on account of severe competition.

*** What are the major argument against international trade? (DEMERITS)****Solution:**

Liberal global trade and investments are often criticized as detrimental to national interest. The major arguments put forth against trade openness are:

- Possible negative labour market outcomes in terms of labour – saving technological change that depress demand for unskilled workers, loss of labourers' bargaining power.
- Economic exploitation is likely outcome when underprivileged countries become vulnerable to the growing political power of corporations operating globally. The domestic entities can be easily outperformed by financially stronger transactional companies.
- Excessive stress on exports and profit – driven exhaustion of natural resources due to unsustainable production and consumption.
- It may have adverse effect on the development of domestic industries and may even threaten the survival of infant industries.
- Instead of cooperation among nation, trade may breed rivalry on account of severe competition.

*** Explain the Heckscher-Ohlin theory of International trade.****Solution:**

The Heckscher – Ohlin model is a theory in economics explaining that countries export what can be most efficiently and plentifully produced. This model is to evaluate trade and, more specifically, the equilibrium of trade between two countries that have varying specialties and natural resources. Emphasis is placed on the exportation of goods requiring factors of production that a country has in abundance and the importation of goods that a nation cannot produce as effectively.

According to this theory, international trade is but a special case of inter-regional trade. Different regions have different factor endowments, that is, some regions have abundance of labour, but scarcity of capital; whereas other regions have abundance of capital, but scarcity of labour. Different goods have different production functions, that is, factor of production are combined in different proportions to produce different commodities. While some goods are produced by employing a relatively larger proportion of labour and relatively small proportion of capital, other goods are produced by employing a relatively small proportion of labour and relatively larger proportion of capital.

Therefore, difference in factor endowment is the main cause of international trade as well as inter-regional trade. According to Ohlin, the immediate cause of inter-regional trade is that goods can be bought cheaper in terms of money than they can be produced at home and this is the case of international trade as well. The cause of difference in the relative prices of goods is the difference the amount of factor endowments, like capital and labour, between two countries.

Thus, it can be concluded that this theory states that labour-abundant countries have comparative cost advantage in the production of goods which require labour-intensive technology and by the same reasoning, capital – abundant countries have comparative cost advantage in the production of goods that needs capital – intensive technology.

UNIT 2: THE INSTRUMENT OF TRADE POLICY

*** Define 'trade policy'. What are the major objectives of trade policy?**

Solution:

Trade policy encompasses all instrument that governments may use to promote or restrict imports and exports. Trade policy also includes the approach taken by countries in trade negotiations.

Following are some of the major objectives of Trade Policy:

- To provide a stable and sustainable policy environment for foreign trade in merchandise and services.
- To link rules, procedures and incentive for exports and imports with other initiative such as "Make in India", Digital India and skill India to create an 'Export Promotion Mission' for India.
- To provide a mechanism for regular appraisal in order to rationalize import and reduce the trade imbalance.
- To allow import of technology and equipment's which may help in establishing new industrial enterprises, produce new product and adopt a new process for higher production levels.
- To accelerate the country's transition to a globally oriented vibrant economy to deriving maximum benefits from expanding global market opportunities;
- To provide consumers with good quality product at reasonable prices through regulated imports of such products.

*** Effect of Tariffs:**

Solution:

- Tariff barriers create obstacles to trade, decrease the volume of imports and exports and therefore of international trade.
- Tariffs encourage consumption and production of the domestically produced import substitutes and thus protect domestic industries.
- Producers in the importing country experience an increase in well – being as a imposition of tariff. The price increase of their product in the domestic market increases producer surplus in the industry. The price increase also induces an increase in the exiting firms and possibly addition of new firms due to entry into industry to take advantage of the new high profits and consequently an increase in employment in the industry.
- Tariffs create trade distortions by disregarding comparative advantage and prevent countries from enjoying gains from trade arising from comparative advantage.
- Tariffs increase government revenues of the importing country by the value of the tariff it charges.

*** Evaluate the use of tariffs as policy instrument.**

Solution:

A tariff is a tax imposed on the import or export of goods. In general parlance, however, it refers to "import duties" charged at the time of goods are imported.

Tariff is also a policy tool to protect domestic industries by changing the conditions under which goods compete in such a way that competitive imports are placed at a disadvantage. In point of fact, a cursory examination of the tariff rates employed by different countries does seem to indicate that they reflect, to a considerable extent, the competitiveness of domestic industries.

Following are example of some tariffs used as an instrument of trade policy (Types of tariffs)

Specific Tariff: A specific tariff is an import duty that assigns a fixed monetary tax per physical unit of the good imported. It is calculated on the basis of unit measure, such as weight, volume, etc., of the imported good.

Ad valorem tariff: An ad valorem tariff is levied as a constant percentage of the monetary value of one unit of the imported good.

Mixed Tariffs: Mixed tariffs are expressed either on the basis of the value of the imported goods (an ad valorem rate) or on the basis of a unit of measure of the imported goods (a specific duty) depending on which generates the most income.

Compound Tariff or a Compound Duty: It is a combination of an ad valorem and a specific tariff. That is, the tariff is calculated on the basis of both the value of the imported goods (an ad valorem duty) and a unit of measure of the imported goods (a specific duty).

Technical/Other Tariff: These are calculated on the basis of the specific contents of the imported goods i.e. the duties are payable by its components or related items.

Tariff Rate Quotas: Tariff rate quotas (TRQs) combine two policy instrument: quotas and tariffs. Imports entering under the specified quota portion are usually subject to a lower (sometimes Zero), tariff rate. Imports above the quantitative threshold of the quota face a much higher tariff.

Most-Favored Nation Tariffs: A country grants this clause to another nation if it is interested in increasing trade with that country.

Variable Tariff: A duty typically fixed to bring the price of an imported commodity up to domestic support price for the commodity.

Preferential Tariff: A lower tariff is charged from goods imported from a country which is given preferential treatment. Examples are preferential duties in the EU region under which a good coming into one EU country from another is charged Zero tariffs.

Bound Tariff: A bound tariff is which a WTO member binds itself with a legal commitment not to raise it above a certain level. The bound rates are specific to individual products and represent the maximum level of import duty that can be levied on a product imported by that member.

Applied Tariffs: It is charged on imports on a Most Favoured Nation (MFN) basis. A WTO member can have an applied tariff for product that differ from the bound tariff for that product as long as the applied level is not higher than the bound level.

*** Anti-dumping Duties:**

Solution:

An anti-dumping duty is a **protectionist tariff** that a domestic government imposes on foreign imports that it believes are priced below fair market value. Dumping is process where a company exports a product at a price lower than the price normally charges in its own home market. To protect local business and markets, many countries impose stiff duties on products they believed are being dumped in their national market.

Dumping may be persistent, seasonal, or cyclical. Dumping may also be resorted to as a predatory pricing practice to drive out established domestic producers from the market and to establish monopoly position. Dumping is an international price discrimination where the exporters deliberately forego money in order to harm the domestic producers of the importing country. This is unfair and constitutes a threat to domestic producers.

*** Countervailing Duties:****Solution:**

It is levied on imported goods to offset subsidies made to producers of these goods in the exporting country. Countervailing duties (CVD) are meant to level the playing field between domestic producers of a product and foreign producers of the same product who can afford to sell it at a lower price because of the subsidy they receive from their government.

If left unchecked, such subsidized imports can have a severe effect on domestic industry, forcing factory closures and causing huge job losses. As export subsidies are considered to be an unfair trade practice, the World Trade Organization (WTO) – which deals with the global rules of trade between nations – has detailed procedures in place to establish the circumstance under which countervailing duties can be imposed by an importing nation. For example, in 2016, in order to protect its domestic industry, India imposed 12.5% countervailing duty on Gold jewellery imports from ASEAN.

*** Outline the different non – tariff measures adopted by countries.****Solution:**

Non-tariff measures (NTMs) are policy measures that can be potentially have an economic effect on international trade in goods, changing quantities traded, or prices or both.

I. Technical Measures:

Sanitary and Phytosanitary (SPS) Measures: SPS measures are applied to protect human, animal or plant life from risks arising from additives, pests, contaminants, toxins or disease – causing organisms and to protect biodiversity. These include ban or prohibition of import of certain goods, all measures governing quality and hygienic requirement, production processes, and associated compliance assessments. For example; prohibition of import of poultry from countries affected by avian flu, meat and poultry processing standards to reduce pathogens, residue limits for pesticides in foods etc.

Technical Barriers To Trade (TBT): Technical Barriers to Trade (TBT) which cover both food and non-food traded products refer to mandatory 'Standards and Technical Regulation' that define the specific characteristic that a product should have, such as its size, shape, design, labelling / marketing / packaging, functionally or performance and production methods, excluding measures covered by the SPS Agreement.

II. Non- Technical Measures

- **Imported Quotas:** An imported quota is a direct restriction which specifies that only a certain physical amount of the good will be allowed into country during a given time period, usually one year. Import quotas are typically set below the free trade level of imports and usually enforced by issuing licenses.
- **Price Control Measures:** Price control measures (including additional taxes and charges) are steps taken to control or influence the prices of imported goods in order to support the domestic price of certain products when the import prices of these goods are lower.
- **Non-automatic Licensing and Prohibition:** These measures are normally aimed at limiting the quantity of goods that can be imported, regardless of whether they originate from different sources or from one particular supplier.
- **Financial Measures:** The objective of financial measures is to increase import costs by regulating the access to and cost of foreign exchange for imports and to define the terms of payment. It includes measures such as advance payment requirements and foreign exchange controls denying the use of foreign exchange for certain types of imports or for goods imported from certain countries.
- **Measures Affecting Competition:** These measures are aimed at granting exclusive or special preference or privileges to one or a few limited group of economic operators. It

may include government imposed special channel or enterprises, and compulsory use of national services.

- **Trade-Related Investment Measures:** These measures include rules on local content requirements that mandate a specified fraction of a final good should be produced domestically.
- **Restriction on Post-sales Services:** Producers may be restricted from providing after-sales services for exported goods in the importing country. Such services may be reserved to local service companies of the importing country.
- **Safeguard Measures** are initiated by countries to restrict imports of a product temporarily if its domestic industry is injured or threatened with serious injury caused by a surge in imports.
- **Embargos:** An embargo is a total ban imposed by government on import or export of some or all commodities to particular country or regions for a specified or indefinite period.

*** Explain the concept of 'Voluntary Export Restraints'**

Solution:

Voluntary Export Restraints (VERs) refer to a type of informal quota administered by an exporting country voluntarily restraining the quantity of goods that can be exported out of that country during a specified period of time.

Such restraints originate primarily considerations and are imposed based on negotiation of the importer with the exporter. The inducement for the exporter to agree to a VER is mostly to appease the importing country and to avoid the effects of possible retaliatory trade restraints that may be imposed by the importer.

Voluntary Export Restraints may arise when cause, as do tariffs and quotas, domestic prices to rise and cause loss of domestic consumer surplus.

Typically, VERs are a result of requests made by the importing country to provide a measure of protection for its domestic businesses that produces competing goods. VERs are often created because the exporting countries would prefer to impose their own restriction than risk sustaining worse terms from tariffs and/or quotas. Producers in the importing country experience an increase in well-being, though, as there is decreased competition, increased in price, profits, and employment. In spite of these benefits to producers, VERs reduces national welfare, by creating negative trade effect, negative consumption distortions, and negative production distortions.

UNIT 3: TRADE NEGOTIATIONS

*** Describe the structure and guiding principles of the World Trade Organization.**

Solution:

The World Trade Organization (WTO) is the only global international organization dealing with the rules of trade between nations. At its heart are the WTO agreements, negotiated and signed by the bulk of the world's trading nations and ratified in their parliaments. The goal is to help producers of goods and services, exporters, and importer conduct their business. The World Trade Organization - is the international organization whose primary purpose is to open trade for the benefit of all.

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. The WTO's top level decision-making body is the Ministerial Conference which can take decision on all matters under any of the multilateral trade agreements. The Ministerial Conference meets at least once every two years.

The next level, the Goods Council, services Council and Intellectual Property (TRIPS) Council report to the General Council. These councils are responsible for overseeing the implementation of the WTO agreements in their respective areas of specialization.

Right from its inception, the WTO has been driven by a number of fundamental principle which are the foundations of the multilateral trading system.

*** Explain the major guiding principles of WTO?**

Solution:

Trade without discrimination: Under the agreements, countries cannot normally discriminate between their trading partners. If a country lowers a trade barrier or opens up a market, it has to do so for the same goods or services from all other members.

The National Treatment Principle (NTP): Any country should not discriminate between its own and foreign products, services or nationals. For instance, once imported apples reach Indian market, that cannot be discriminated against and should be treated at par in respect of marketing opportunities, product visibility or any other aspect with locally produced apples.

Freer trade: Lowering trade barriers for opening up markets is one of the most obvious means of encouraging trade as dictated by the WTO.

Predictability: Foreign companies, investors and governments should be confident that the trade barriers will not be raised arbitrarily. This is achieved through 'binding' tariff rates, discouraging the use of quotas and other measures used to set limits on quantities of imports, establishing market-opening commitments and other measures to ensure transparency.

Greater competitiveness: This is to be achieved by discouraging "unfair" practices such as export subsidies, dumping etc.

Tariffs as legitimate measures for the protection of domestic industries: The imposition of tariffs should be the only method of protection, and tariff rates for individual items should be gradually reduced through negotiation 'on a reciprocal and mutually advantageous' basis.

Transparency in Decision Making: The WTO insists that any decision by members in the sphere of trade or in respect of matter affecting trade should be transparent verifiable.

Progressive Liberalization: Many trade issues of a controversial nature similar to labour standards, non-agricultural market access, etc. be liberalization after discussion.

Special privileges to less developed countries: With majority of WTO members being developing countries and countries in transition to market economics, the WTO deliberations favour less developed countries by giving them greater flexibility, special privileges and permission to phase out the transition period.

Protection of Health & Environment: The WTO's agreements support measures to protect not only the environment but also human, animal as well as plant health.

A transparent, effective and verifiable dispute settlement mechanism: Trade relations frequently involve conflicting interests. Any dispute arising out of violation of trade rules leading to infringement of right under the agreement or misunderstanding arising as regards the interpretation of rules are to be settled through consultation.

*** Function of WTO.**

Solution:

Following are some of the major concerns in respect of functioning of the WTO:

- The progress of multilateral negotiation on trade liberalization is very slow and the requirement of consensus among all members acts as a constraint and create rigidity in the system. As a result, countries find regionalism a plausible alternative.
- The complex network of regional introduces uncertainties and murkiness in the global trade system.
- The achievement in liberalizing trade in agriculture, textiles, and apparel, and in many other areas of international commerce has been negligible.
- The latest negotiations, such as the Doha Development Round, have run into problems, and their definitive success is doubtful.
- Most countries, particularly developing countries are dissatisfied with the WTO because, in practice, most of the promises of the Uruguay Round agreement to expand global trade has not materialized.

UNIT 4: EXCHANGE RATE AND ITS ECONOMIC EFFECTS

*** Describe the functioning of the foreign exchange market?**

Solution:

The foreign exchange market is a global decentralized or over-the-counter (OTC) market for the trading of currencies. This market determined the foreign exchange rate. It includes all aspects of buying, selling and exchanging currencies at current or determined prices. In terms of trading volume, it is by far the largest market in the world.

The foreign exchange market works through financial institutions, and operates on several levels. Behind the scenes, banks turn to a smaller number of financial firms known as “dealers”, who are involved in large quantities of foreign exchange trading.

Most foreign exchange dealers are banks, sometimes it is also called the “interbank market”. Trades between foreign exchange dealers can be very large, involving hundreds of millions of dollars.

Foreign exchange market speculation, based on the differential interest rate between two currencies.

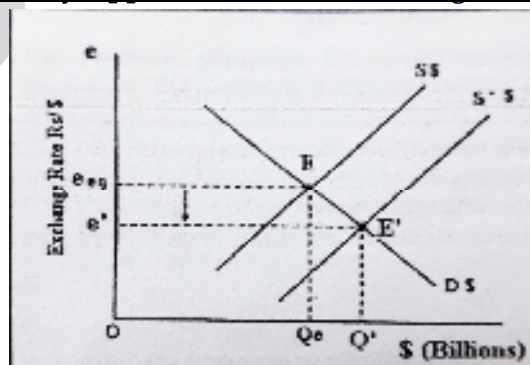
*** What do you understand by appreciation and depreciation of currency? How do they affect real economy?**

Solution:

The terms, currency appreciation’ and currency depreciation’ describe the movement of the exchange rate.

Currency appreciation is an increase in the value of one currency in terms of another. Currencies appreciate against each other for various reasons, including government policy, interest rates, trade balance and business cycles. Currencies are quoted and traded in pairs.

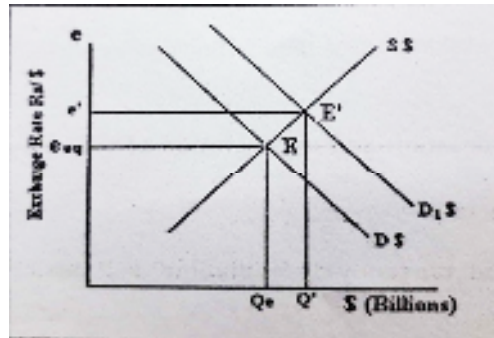
Currency depreciation is a fall in the value of a currency in a floating exchange rate system. Currency depreciation can occur due to any number reasons- economic fundamental, interest rate differentials, political instability, risk aversion among investors and so on.

Home-currency Appreciation under Floating Exchange Rates

An increase in the supply of foreign shifts the supply curve to the right to ‘S1 \$’ and as a consequence, the exchanges rate declines to ‘e1’. It means, that lesser units of domestic currency (here Indian Rupees) are required to buy a unit of foreign exchange (dollar), and that the domestic currency (the Rupees) has appreciated.

Effects of currency appreciation on the economy:

- Exports become more expensive. The price of exports will increase making exports more expensive. Therefore with a higher price, we would expect to see a fall in the quantity of exports.
- Imports become cheaper: Domestic consumers will find that more goods can be purchased with the same amount of money. Therefore, with cheaper imports, we would expect to see an increase in the quantity of imports.
- Lower (X-M) with lower export demand and greater spending on imports, we would expect a fall in domestic Aggregate Demand (AD), causing lower growth.
- Lower inflation. An appreciation tends to cause lower inflation because import prices are cheaper. The cost of imported goods and raw materials will fall after an appreciation, e.g. imported oil will decrease, leading to cheaper petrol prices.

Home-Currency Depreciation under Floating Exchange Rates

The market reaches equilibrium at point 'E' with equilibrium exchange rate ' e_{eq} '. An increase in domestic demand for the foreign currency, with supply of dollars remaining constant, is represented by a rightward shift of the demand curve to ' $D1\$$ '.

The equilibrium exchange rate rises to ' $e1$ '. It means that more units of domestic currency (here Indian Rupees) are required to buy a unit of foreign exchange (dollar) and that the domestic currency (the Rupee) has depreciated.

Effects of currency depreciation on the economy:

- Exports will become cheaper: A depreciation of the domestic currency will make exports more competitive and appear cheaper to foreigners. This will increase demand for exports.
- Imports will become more expensive. A depreciation means imports, such as petrol, food and raw materials will become more expensive. This will reduce demand for imports.
- Increased aggregate demand (AD). A depreciation could cause higher economic growth. Part of AD is (X-M) therefore higher exports and lower imports should increase AD.
- Inflation is likely to occur following a depreciation because Imports are more expensive – causing cost push inflation.

*** Effect of currency depreciation on the economy:****Solution:**

- Depreciation lowers the relative price of exports and raises the relative price of its imports. When a country's currency depreciates, foreigners find that its exports are cheaper and domestic residents find that imports from abroad are more expensive.
- Importers will be affected most as they will have to pay more rupees on importing products.
- A depreciation of domestic currency primarily increases the price of foreign goods relative to goods produced in the home country and diverts spending from foreign goods to domestic goods. Increased demand, both for domestic import-competing goods and for exports encourages economic activity and creates output expansion.
- By lowering exports prices, currency depreciation helps increase the international competitiveness of domestic industries, increases the volume of exports and promotes trade balance.

- When a country's currency depreciates, production for exports and of import substitutes become more profitable.
- The fiscal health of a country whose currency depreciates is likely to be affected with rising export earnings and import payments and consequent impact on current account balance.
- Depreciation is also likely to add to consumer price inflation in the short run, directly through its effect on prices of imported consumer goods and also due to increased demand for domestic goods.
- Depreciation may also cause contractionary effects. In an under developed or semi industrialized country, where- input (such as oil) and components for manufacturing are mostly imported and cannot be domestically produced, increased import prices will increase firms' cost of production, push domestic prices up and decrease real output.
- A widening current account deficit is a danger signal as far as growth prospects of the overall economy is concerned. If export earnings rise faster than the imports spending then current account will improve otherwise not.
- A depreciated domestic currency would also increase debt burden on institutions and lower their profits and impact their balance sheets adversely.

*** Effect of Currency Appreciation on the Economy.**

Solution:

- Exports become more expensive. The price exports will increase making exports more expensive. Therefore with higher price, we would expect to see a fall in the quantity exports.
- Imports become cheaper: Domestic consumers will find that more goods can be purchased with the same amount of money. Therefore, with cheaper imports, we would expect to see an increase in the quantity of imports.
- Lower inflation. An appreciation tends to cause lower inflation because import prices are cheaper. The cost of imported goods and raw materials will fall after an appreciation, e.g. imported oil will decrease, leading to cheaper petrol prices.
- If the economy is facing a boom, an appreciation of domestic currency would trim inflationary pressures and soften the rate of growth of the economy.
- With increasing export prices, the competitiveness of domestic industry is adversely affected and, therefore, firms have greater incentives to introduce technological innovations and capital intensive production to cut costs to remain competitive.

Following are the ways through which an economy will lose when there is overvaluation (appreciation/ revaluation):

- If appreciation sets in during the recessionary phase, the result would be further fall in aggregate demand and higher levels of unemployment.
- With increasing export prices, the competitiveness of domestic industry is adversely affected. This may lead to the start of contractionary cycle thereby decreasing the rate of GDP growth.
- Increasing imports and declining exports are liable to cause larger deficits and worsen the current account.

UNIT 5: INTERNATIONAL CAPITAL MOVEMENTS

*** What are the different types of foreign capital?**

Solution:

‘Foreign capital’ is a comprehensive term which takes into consideration any inflow of capital into the home country from abroad. Foreign capital may flow into an economy in different ways. Some of the important components of foreign capital flows are:

1. Foreign aid or assistance which may be:

- a) Bilateral or direct inter-government grants
- b) Multilateral aid from many governments who pool funds to international organization like the World Bank
- c) Tied aid with strict mandates regarding the use of money or united aid where there are no such stipulations
- d) Foreign grant which are voluntary transfer of resources by governments, institutions, agencies or organizations

2. Borrowings which may take different forms such as:

- a) Direct inter-government loans
- b) Loans from international institutions (e.g. world bank, IMF, ADB)
- c) Soft loans for e.g. from affiliates of World Bank such as IDA
- d) External commercial borrowing, and
- e) Trade credit facilities

3. Deposits from non-resident Indians (NRI)

NRI deposits refers to funds deposited by a Non-Resident Indian or NRI with a financial institution authorized by the Reserve Bank of India to provide such services. A Non-Resident Indian citizen who primarily resides outside of India.

4. Investment in the form of:

1. Foreign portfolio investment (FDI) in bonds, stocks and securities, and
2. Foreign direct investment (FDI) in industrial, commercial and similar other enterprises.

*** Define foreign direct investment (FDI). What are the features of FDI?**

Solution:

Foreign direct investment (FDI) is an investment made by a company or individual in one country in business interest in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

FDI has three components, viz., equity capital, reinvested earnings and other direct capital in the form of intra-company loans between direct investors (parent enterprises) and affiliate enterprises.

Foreign direct investor may be individuals, incorporated private or public enterprises, Associated groups of individuals or enterprises, governments or government agencies, estates, trusts, or other organizations or any combination of the above mentioned entities.

The main forms of direct investments are: the opening of overseas companies, including the establishment of subsidiaries or branches, creation of joint ventures on a contract basis, joint development of natural resources and purchase or annexation of companies in the country receiving foreign capital.

Following are the main features of FDI:

- Investment involves creation of physical assets
- Has a long term interest and therefore remain invested for long
- Relatively difficult to withdraw
- Not speculative in nature
- Often accompanied by transfer of Funds, resources, technology, strategies, know-how etc.
- Direct impact on employment of labour and wages
- Provides interest in management and control

*** What are the characteristics of foreign portfolio investment (FDI)?****Solution:**

Foreign Portfolio Investment (FDI) also very commonly known as **Foreign Institutional Investment**, consists of securities and other financial assets passively held by foreign investors. It does not provide the investor with direct ownership of financial assets and is relatively liquid depending on the volatility of the market.

Unlike FDI, portfolio capital, in general, moves to investment in financial stocks, bonds and other financial instruments and is effected largely by individuals and institutions through the mechanism of capital market. These flows of financial capital have their immediate effect on balance or exchange rates rather than on production or income generation.

Foreign portfolio investment (FDI) is not concerned with either manufacture of goods or with provision of services. Such investor also do not have any intention of exercising voting power or controlling or managing the affairs of the company in whose securities they invest. The singular intention of a foreign portfolio investor is to earn a remunerative return through investment in foreign securities and is primarily concerned about the safety of their capital, the likelihood of appreciation in its value, and the return generated. Logically, portfolio capital moves to a recipient country which has revealed its potential for higher returns and profitability.

Following are the main characteristics of FPI:

- Investment is only in financial assets
- Only short term interest and generally remain invested for short periods.
- Relatively easy to withdraw
- Speculative in nature
- Transfer of Funds only
- No direct impact on employment of labour and wages
- Increase in capital inflow in the country only.
- No abiding interest in management and control
- Securities are held purely as a financial investment and no significant degree of influence on the management of the enterprise

*** Describe Reasons for FDI****Solution:**

Economic prosperity and the relative abundance of capital are necessary prerequisites for export of capital to other countries. Many economies and organizations have accumulation of huge mass of reserve capital seeking profitable use. The primary aim of economic agent being maximization of their economic interests, the opportunity to generate profits available in other countries often entices such entities to make investments in the other countries.

Following are the main factors influencing foreign direct investments:

- The increasing interdependence of national economies and the consequent trade relations and international industrial cooperation established among them
- Internationalization of production and investment of transnational corporations in their subsidiaries and affiliates.
- Desire to reap economies of large-scale operation arising from technological growth
- Lack of feasibility of licensing agreement with foreign producers in view of the rapid rate of technological innovations
- Necessity to retain direct control of production knowledge or managerial skill (usually found in monopolistic or oligopolistic markets) that could easily and profitably be utilized by corporations
- Desire to procure a promising foreign firm to avoid future competition and the possible loss of export markets.
- Risk diversification so that recessions or downturns may be experienced with reduced severity
- Shared common language or common boundaries and possible saving in time and transport costs because of geographical proximity
- Necessity to retain complete control over its trade patent and to ensure consistent quality and service or for creating monopolies in a global context
- Promoting optimal utilization of physical, human, financial and other resources
- Lower environment standards in the host country and the consequent relative saving in costs
- Stable political environment and overall favourable investment climate in the host country

*** Enumerate the host country determinates of foreign direct investment?****Solution:**

The chief motive for shifting of capital between different regions/countries or between different industries is the expectation of higher rate of return than what is possible in the home country. Investment in a host country may be found profitable by foreign firms because of some firm-specific knowledge or assets (such as superior management skills or an important patent) that enable the foreign firm to gainfully outperform the host country's domestic firms.

Following are the main determinates leading to FDI in the host country:

- Desire to procure a promising foreign firm to avoid future competition and the possible loss of export markets
- Risk diversification so that recessions or downturn may be experienced with reduced severity
- Shared common language or common boundaries and possible saving in time and transport costs because of geographical proximity
- Lower environment standard in the host country and the consequent relative savings in costs
- Stable political environment and over all favourable investment climate in the host country
- Tax differentials and tax policies of the host countries which support direct investment

*** What are the factors in the host country that discourage inflow of foreign investments?****Solution:**

Inflow of foreign capital to any country largely happen due to the potential of the host country to allow the investment grow at a higher rate in the long run due to unutilized potential in the host country.

But there may be several factors which may discourage the inflow of foreign capital in the host country.

Following are the main factors that may discourage inflow of foreign capital:

- Host country discouraging inflow of foreign investment are infrastructure lags,
- High rate of inflation,
- Balance of payment deficits,
- Poor literacy and low labour skills,
- Rigidity in the labour market,
- Bureaucracy and corruption,
- Unfavourable tax regime and cumbersome legal formalities and delays,
- Small size of market and lack of potential for its growth,
- Political instability,
- Absence of well-defined property rights,
- Exchange rate volatility,
- Poor track-record of investments,
- Prevalence of non-tariff barriers and stringent regulations,
- Lack of openness,
- Language barriers

*** Explain the different modes of foreign direct investment (FDI)?**

Solution:

Foreign direct investment (FDI) is an investment made by a company or individual in one country in business interest in the another country, in form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.

Foreign direct investments can be made in a variety of ways (modes), such as:

- i. Opening of a subsidiary or associate company in a foreign country,
- ii. Equity injection into an overseas company,
- iii. Acquiring a controlling interest in an existing foreign company,
- iv. Mergers and acquisitions (M&A)
- v. Joint venture with foreign company.
- vi. Green field investment (establishment of a new overseas affiliates for freshly starting production by a parent company).

*** Merits of FDI**

Solution:

Following are some of the benefits of Foreign Direct Investments in the host country:

- FDI foster competition and generates a competitive environment in the host country. The domestic enterprises are compelled to compete with the foreign enterprises operating in the domestic market. This results in positive outcomes in the form of cost-reducing and quality-improving innovations, higher efficiency.
- FDI can accelerate growth and foster economic development by providing the much needed capital, technological know-how, management skills and marketing methods and critical human capital skills in the form of managers and technicians.
- Competition for FDI among national governments also has helped to promote political reforms important to attract foreign investors, including legal systems and macroeconomics policies.
- FDI generates direct employment in the host country. Subsequent FDI as well as domestic investments propelled in the downstream and upstream project that comes up in multitude of other services generate multiplier effects on employment and income.
- There is also greater possibility for the promotion of ancillary units resulting in job creation and skill development for workers.
- Increased competition resulting from the inflow of foreign direct investments facilities weakening of the market power of domestic monopolies.

*** Demerits of FDI****Solution:**

Some skeptics argue that foreign entities are highly focused on profits and have eye on exploiting the natural resources and are almost always not genuinely interested in the development needs of host countries. Foreign capital is perceived by the critics as an instrument of imperialism, or as a perpetrator of dependence and inequality both between nations and within nations.

Following are the general arguments put forth against the entry of foreign capital:

- FDI are likely to concentrate on capital-intensive methods of production and service so that they need to hire only relatively few workers. This may lead to severe unemployment in a labour abundant economies.
- If the host corporations are able to secure incentives in form of tax holidays or similar provisions, the host country loses tax revenues.
- When profits are repatriated, a strain is placed on the host country's balance of payments and the home currency leading to its depreciation.
- Jobs that require expertise and entrepreneurial skills for creative decision making may generally be retained in the home country and therefore the host country is left with routine management jobs that demand only lower levels of skills and ability.
- Foreign entities are usually accused of being anti-ethical as they frequently resort to methods like aggressive advertising and anticompetitive practices which would induce market distortions.
- FDI is also held responsible by many for ruthless exploitation of natural resources and the possible environmental damage.

*** Distinguish between FDI and FPI****Solution:**

Foreign direct investment (FDI)	Foreign portfolio investment (FPI)
Investment involves creation of physical assets	Investment is only in financial assets
Has a long term interest and therefore remain invested for long	Only short term interest and generally remain invested for short periods
Relatively difficult to withdraw	Relatively easy to withdraw
Not speculative in nature	Speculative in nature
Often accompanied by transfer of Funds, resources, technology, strategies, know-how etc.	Transfer of Funds only.
Direct impact on employment of labour and wages	No direct impact on employment of labour and wages
Increase in country's Gross Domestic Product (GDP)	Increase in capital inflow in the country only

*** Which are the sectors in India where FDI is prohibited? Why?****Solution:****In India, foreign investment is prohibited in the following sectors:**

- Lottery business including Government/private lottery, online lotteries, etc.
- Gambling and betting including casinos etc.
- Chit funds
- Nidhi company
- Trading in Transferable Development Right (TDRs)
- Real Estate Business or Construction of Farm Houses
- Manufacturing of cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes.

*** Fixed Exchange Rate or Pegged exchange rate ?****Solution:**

- i. Under fixed exchange rate system country's government and central bank decides the rate and direction of currencies
- ii. When exchange rate is generally determined by the market force. (Time being) it is called **Soft peg**
- iii. When central bank sets fixed on unchanging value of exchange it is called **hard peg**.
- iv. A fixed exchange rate avoids currency fluctuations and eliminates exchange rate risks.
- v. This system imposes discipline on country's monetary authorities and therefore likely to generate lower level inflation
- vi. Fixed exchange rate system encourages greater trade and investment and also ensures stabilities
- vii. Under fixed exchange rate system countries have to maintain adequate amount of foreign exchange reserves.

*** Flexible exchange rate system. Or Floating exchange rate ?****Solution:**

- i. Under this system equilibrium exchange rates of countries' currencies is market determined. (i.e.) Demand for and supply of currency relative to other currency determines the exchange rate.
- ii. Under this system, there is no intervention of central bank or government
- iii. Under floating exchange rate system, central bank can pursue its own independent monetary policies.
- iv. Under floating exchange rate, countries are not required to maintain huge foreign exchange reserve
- v. The greatest Disadvantage of floating exchange rate, it generates lots of uncertainty to International transactions.
- vi. This system has a greater policy flexibility but less stability.

*** Difference between Spot Exchange Rate and Forward Exchange Rate:****Solution:**

Spot Exchange Rate	Forward Exchange Rate
It is an exchange rate which is quote at a particular time and payable on the spot for immediate delivery of foreign current	It is an rate which is quoted for a transaction over the period of time. The actual transaction would materialized in future at predetermined rate
In case of spot exchange rate, physical delivery of foreign exchange takes place immediately however in case of whole sale transaction it may ++ 2cdays.	In case of forward rate there is no immediate physical delivery as transaction takes place in future.
Spot exchange rate is a current date which is determined by market force of demanding & supply.	It is used for transaction in future. This rate is agreed upon by buyers & sellers at predetermined price.
Spot exchange rate doesn't provide hedging facility as transaction is done on the spot.	Forward exchange rate is a part of hedging process which helps to minimize foreign exchange fluctuation risk.

Note: kindly study Devaluation and revaluation answer from ICAI Module