



UPSC – CDS

Combined Defence Services
(CDS)

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Indian Economy



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1 CHAPTER

Fundamentals of Economy

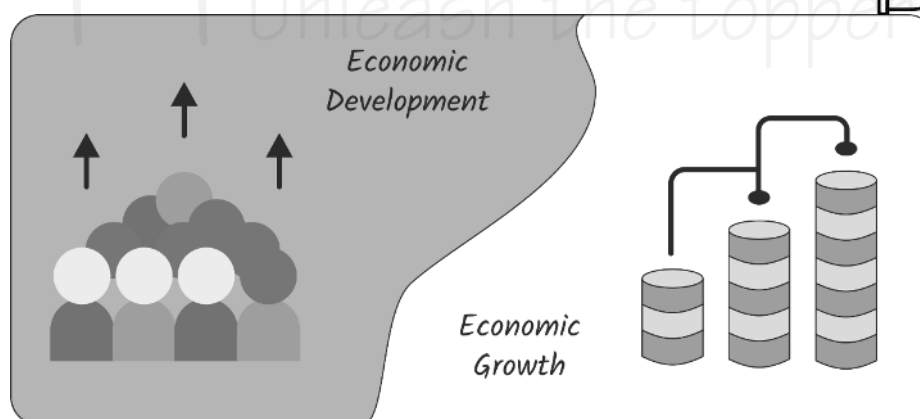
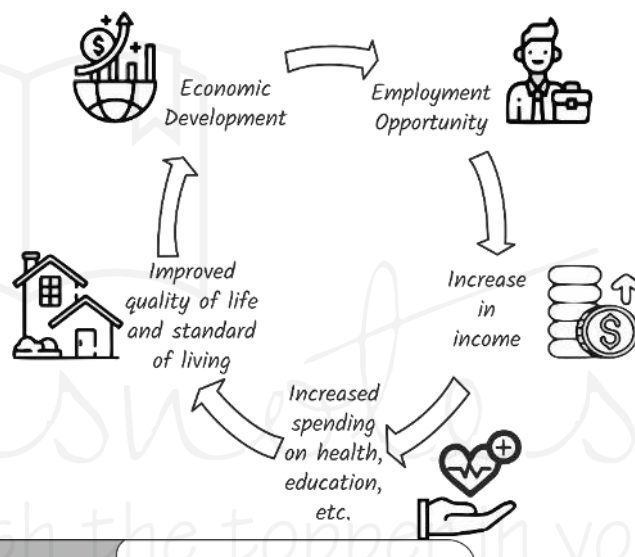
Economic Growth

- Economic growth refers to an increase in the real output of goods and services in the country over a period of time in its monetary value.
- It is measured by quantitative factors such as increase in real GDP or per capita income.
- It indicates the growth of national or per capita income but does not guarantee improvements in quality of life or equity.

Economic Development:

- Economic Development implies changes in income, savings and investment along with progressive changes in socio economic structure of the country (institutional and technological changes).

- The qualitative measures such as HDI (Human Development Index), gender-related index, Human poverty index (HPI), infant mortality, literacy rate etc. are used to measure economic development.
- It reflects progress in the quality of life in a country.



National Income

National Income is a measure of the total money value of goods and services produced by an economy over a period of time,

normally a year. There are different aspects of National Income such as GDP, GNP, NNP, Per capita Income, Personal Income, Disposable income etc.

1. Gross Domestic Product (GDP)

- Total value of all final goods and services produced in a country in a given financial year within the domestic territory by the resident of a country, including the foreign citizens and companies.
- Domestic Territory means all economic activities done within the boundary of a nation.
- Estimated at regular periods- for India it is from 1st April to 31st March.
- Calculated by Central Statistics Organization, Ministry of Statistics and Programme Implementation.
- 'Quantitative concept' and indicates internal strength of the economy.

Limitations of GDP

- It is a quantitative, not qualitative concept.

- Capital gains are not included in GDP.
- Issue of inclusion and exclusion.
- GDP is confined to economic activity within national borders, excluding contributions from residents abroad. This limitation distorts a nation's true economic power in a globalized economy.
- GDP does not provide insights into how income is distributed among the population.
- GDP measures only the value of new goods and services produced. Transactions involving second-hand goods, such as the resale of used cars or furniture, are not included in GDP calculations.
- Many important economic activities, such as household labor (e.g., childcare, eldercare, or domestic work), are not reflected in GDP.

Methods of Computing GDP

Methods of GDP Calculation		
Expenditure Method Consumption (C) + Investment (I) + Government Expenditure (G) + Net Exports (X-M) (i.e. exports – imports) Formula: $C + I + G + (X - M)$	Income Method Rent + Wages + Interest + Profits	Value Added/ Output Method Final value of all goods and services - Intermediate Costs

Nominal GDP – When the money value of goods and services included in GDP is estimated on the prices of current year, it is called GDP at current prices or nominal GDP.

Real GDP – when the value of goods and services included in GDP is estimated on the prices of base year, we get GDP at constant

prices or real GDP. Increase in real GDP implies increase in the production of goods and services. Therefore, the calculation of GDP at constant prices or real GDP gives us the correct picture of the economic performance of an economy.

Various Aspects of GDP Calculations

GDP Deflator ➤ Ratio of Nominal GDP to Real GDP ➤ Gives an idea of how the prices have moved from the base year to the current year. ➤ It is a measure of inflation, and it is more accurate and comprehensive when compared to CPI and WPI. However, it is less commonly used because it is calculated on a quarterly basis (CPI and WPI are released monthly).	GDP Growth Rate ➤ Measures how fast the economy is growing. ➤ Measures the change in GDP in two consecutive years or quarters. Real GDP Growth Rate = $\frac{(GDP_{Present} - GDP_{Past})}{GDP_{Past}} \times 100$
GDP at Market Price (GDP_{MP}) $(GDP_{MP}) = \text{Net domestic product at FC } (NDP_{FC}) + \text{Depreciation} + \text{Net Indirect tax.}$	GDP at Factor Cost (GDP_{FC}) $GDP_{MP} - \text{Indirect tax} + \text{Subsidy.}$

2. Net Domestic Product (NDP)

- It is the money value of all final goods and services produced within the domestic territory of a country during an accounting year and does not include depreciation.

Net Domestic Product (NDP) = Gross Domestic Product (GDP) – Depreciation.

- NDP will always be lower than GDP.
- NDP is not used across the world due to different rates of depreciation

3. Gross National Product (GNP)

- GNP is the total monetary value of all final goods and services produced by the residents of a country within a specific period, regardless of whether the production occurs domestically or abroad. It includes income earned by residents from investments outside the country, minus income earned by foreign residents from domestic investments.

GNP = GDP + Net Factor Income from Abroad (NFIA)

4. Net National Product (NNP)

- Value generated by removing depreciation from the gross national product.
- It is the purest income of a country.

NNP = GNP – Depreciation

5. Per Capita Income (PCI)

- Per capita Income or output per person is an indicator to show the living standard of people in a country. It is obtained by dividing the National Income by the population of a country.

Per Capita Income = $NNP_{FC} / \text{Population}$

The growth rate of Per capita income at constant prices was highest in 1988-89 (7.5%) until 2023-24

6. Personal Income (PI)

- Personal income is the total money income received by individuals and households of a country from all possible sources before direct taxes.

7. Disposable Income (DI)

- Disposable income means actual income which can be spent on consumption by individuals and families, thus,

$$\text{DI} = \text{Personal Income (PI)} - \text{Personal tax payments} - \text{Non-tax payments (such as fines)}$$

GDP Calculation regime in India

- The base year for GDP calculations was updated to 2011-12 from the previous base year of 2004-05.

Gross Domestic Product GDP

GDP = Sum of all goods and services produced in a country in given financial year

Net Domestic Product NDP

NDP = GDP - Depreciation on assets

Gross National Product GNP

GNP = GDP + Income from abroad

Net National Product NNP

NNP = GNP - Depreciation on assets
NNP = GDP + Income from abroad - Depreciation on assets

Economic Survey 2023-24

- GDP (at current price) for 2023-24 - Rs 295.36 Lakh Cr
- Real GDP growth rate for 2023-24 - 8.2%
- Nominal GDP growth rate for 2023-24 - 9.6%
- Contribution of sectors of economy in GVA (current price)-
- ✓ Agriculture (17.7 %) ✓ Industry (27.6 %) ✓ Services (54.7 %)

Concept of Public Good and Private good

Public good: Public goods are goods that are non-excludable and non-rivalrous, meaning that no one can be excluded from using them, and one person's use does not reduce availability for others.

e.g. National defense, Public Parks, Street Lights

Private good: Private goods are goods that are excludable and rivalrous, meaning that people can be prevented from using them, and one person's use reduces the availability for others.

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Private good: Private goods are goods that are excludable and rivalrous, meaning that people can be prevented from using them, and one person's use reduces the availability for others.

e.g. Cars, Clothing etc.

Measures of Economic

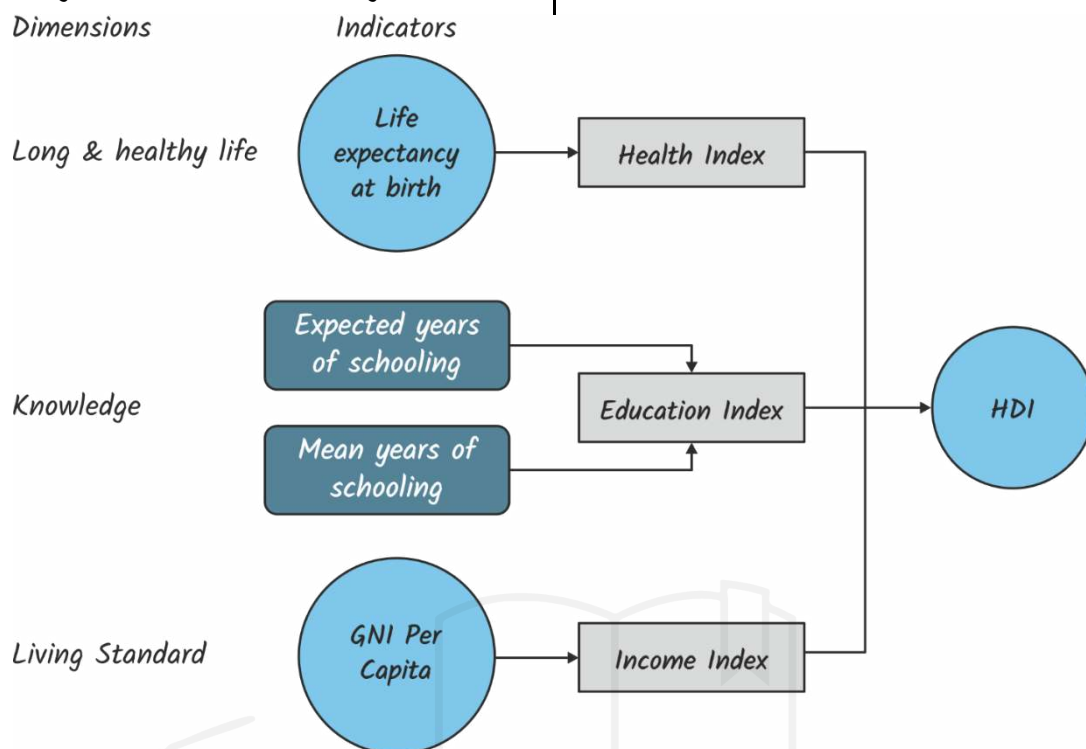
Development

1. Human Development Index (HDI)

The HDI was developed by the Pakistani economist Mahbub-ul-Haq working alongside Indian economist Amartya Sen in 1990. The United Nations Development

Program (UNDP) further used it to measure the country's development level. The HDI is a composite index of life expectancy at birth, adult literacy rate and

standard of living measured as a logarithmic function of GDP, adjusted to purchasing power parity.



Human Development Report 2023-24

- Theme - "Breaking the Gridlock: Reimagining Cooperation in a Polarized World."
- India's performance on various indicators-
 - ✓ India - 134th rank
 - ✓ HDI score- 0.644
 - ✓ India's life expectancy at birth has slightly improved from 67.2 years in 2021 to 67.7 years in year 2022.
 - ✓ Overall increase (5.88%) in expected years of schooling from 11.9 years to 12.6 years
- Performance of India's neighbourhood
 - ✓ Sri Lanka (78), China (75), Bhutan stands at 125 and Bangladesh at 129th position.

✓ Nepal (146) and Pakistan (164) have been ranked lower than India.

- Top Three Countries (Scores): Switzerland (0.967), Norway and Iceland.
- Worst performance- Somalia.

2. World Happiness Index 2024

The annual World Happiness Report is prepared in partnership of Gallup, the Oxford Wellbeing Research Centre, the UN Sustainable Development Solutions Network (SDSN), and the World Happiness Report's Editorial Board.

- The report considers six key factors: social support, income, health, freedom, generosity, and the absence of corruption.
- It assigns a happiness score based on an average of data over a three-year period.

World Happiness Report 2024

- Top rankings. Finland topped the list for the seventh year in a row.
- Worst - Afghanistan
- India- 126th
- India's rank in the happiness index is lower than its neighbouring countries like China (60), Nepal (93), Pakistan (108), Myanmar (118).

Gross National Happiness (GNH)

- A measure of happiness and well-being of people of the country.
- The four pillars of GNH's are
 1. Sustainable and equitable socio-economic development
 2. Environmental conservation
 3. Preservation and promotion of culture
 4. Good governance

- The nine domains of GNH are psychological well-being, health, time use, education, cultural diversity and resilience, good governance, community vitality, ecological diversity and resilience, and living standards.

3. Global Gender Gap Report

Global Gender Gap Index 2024

India ranked
129/146 countries
Rank 1: Iceland

- It is released by the World Economic Forum (WEF) since 2006.
- It measures gender parity in 146 countries and across four areas viz.
 - a) economic participation and opportunity
 - b) educational attainment
 - c) health and survival
 - d) political empowerment

Key Terms

- a) **Fiscal Year:** A fiscal year is a 12-month period used by governments and businesses for accounting and budgeting, which may differ from the calendar year. For example, In India, the fiscal year runs from April 1 to March 31 of the following year.
- b) **Market Price:** The final price at which the goods and services are sold in the market. It includes all the intermediate costs, subsidies and taxes.
- c) **Factor Cost:** Total cost of all the factors of production (Land, Capital, Labour and Management or Entrepreneur) consumed or used in producing a good or service.
- d) **Base Year:** A base year is a reference year used in economic and financial calculations to compare changes over time, such as inflation, GDP, or other economic indicators. Current Base year is 2011-12.
- e) **Constant Price:** It refers to the price prevailing in the base year.
- f) **Depreciation:** Reduction in the monetary value of an asset over time due to use, wear and tear or obsolescence.
- g) **Goods:** are tangible products that can be touched and measured, such as Consumer Goods (Items like clothing, food, and electronics) and Capital Goods (Equipment and machinery used in production, like factory machines and vehicles.)

- h) Services:** are intangible activities or benefits provided to consumers, such as-
- ✓ **Personal Services:** Haircuts, healthcare, and education
 - ✓ **Business Services:** like Consulting, accounting, and legal services.
- i) Final Goods and Services:** These are the goods and services which will be used or consumed.
- j) Intermediate Goods:** The goods and services which will be used for producing other goods and services.
- NOTE:** Together, goods and services comprise the output of an economy and are essential for meeting consumer needs and driving economic activity.

Key Theories in Development Economics

Theory	Proponent	Concept
Absolute Advantage	Adam Smith	Countries should specialize in producing goods they can produce more efficiently than others. This maximizes overall economic efficiency and wealth.
Comparative Advantage	David Ricardo	A country can benefit from trade by specializing in goods it can produce at a lower opportunity cost.
Big Push Theory	Paul Rosenstein Rodan	Large-scale investment in multiple sectors can overcome obstacles to industrialization and economic growth in developing countries.
Low-Level Equilibrium Trap	Richard R. Nelson	Developing countries can get trapped in a cycle of low income, low savings, and low investment, preventing economic growth.
Balanced Growth Theory	Ragnar Nurkse	Simultaneous investment in various sectors of the economy is necessary to ensure balanced and sustainable growth.
Unbalanced Growth Theory	Albert O. Hirschman	Strategic investment in key sectors can stimulate growth, leading to development that eventually spreads to other sectors.
Dependency Theory	Andre Gunder Frank, Paul Baran	The poverty of low-income countries stems from their exploitation by wealthy countries and the multinational corporations that are based in wealthy countries.
Stages of Economic Growth	Walt Rostow	Countries pass through five stages of development: Traditional Society, Preconditions for Take-off, Take-off, Drive to Maturity, and Age of High Mass Consumption.
Endogenous Growth Theory	Paul Romer, Robert Lucas	Economic growth is primarily driven by internal factors such as human capital, innovation, and knowledge, rather than external influences.

2 CHAPTER

Money, Money Supply and Monetary Policy

Money is any item or commodity that is widely accepted as a medium of exchange, a unit of account, and a store of value. It facilitates economic transactions by serving as a standardized measure of value and a means of deferred payment.

Money Supply

- The total stock of money in circulation among the public at a particular point of time is called money supply. Money supply refers to the total quantity of money held by public in various forms at any point of time in an economy. The main components of money supply are currency held by the public and net-demand deposits held by the commercial banks.
- Money supply is crucial for influencing economic activity, inflation, and interest rates.
- The money supply in Indian economy is generally measured in following forms:

Monetary Aggregate	Components
M1	Currency held by the Public (CU) + Demand deposits + other deposits held with the Reserve Bank of India.
M2	M1 + Savings deposits with Post Office.

M3	M1 + Time deposits of all commercial banks and co-operative banks (excluding interbank time deposits).
M4	M3 + Total deposits with Post Office savings organisations (excluding National Savings Certificates).

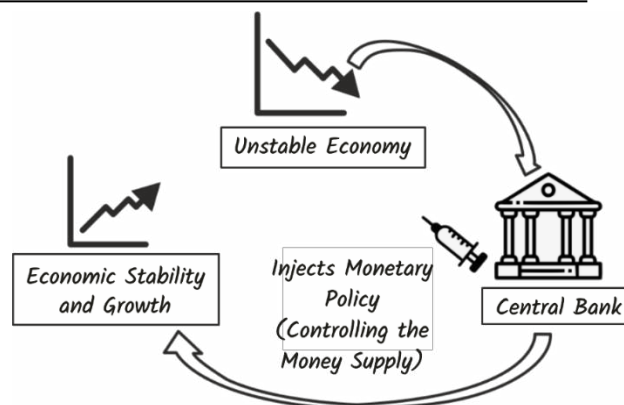
- M1 and M2 are called the Narrow Money and M3 and M4 are called the Broad money.
- M1 is most liquid whereas M4 is least liquid.
- M3 also called the Aggregate Money supply is the most commonly used measure for the money supply, RBI majorly focuses on this aggregate while designing Monetary Policy.

Key Terms:

1. **High Powered Money:** The total liability of RBI, is called the monetary base or high powered money. It consists of currency (notes and coins in circulation with the public and vault cash of commercial banks) and deposits held by the Government of India and commercial banks with RBI.

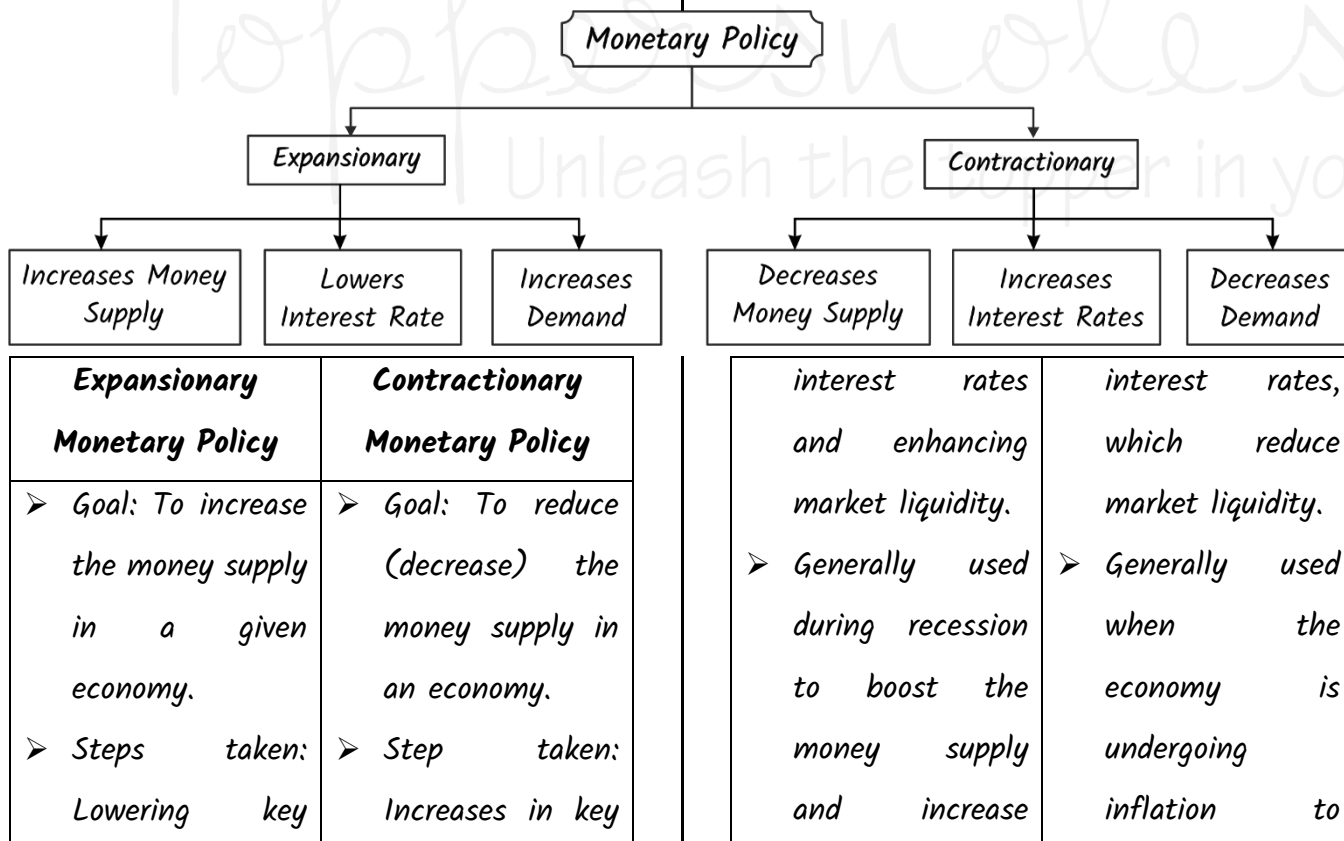
- ✓ The total money supply in the economy exceeds the amount of high-powered money because commercial banks create additional money by lending out part of their deposits.

- 2. Demand Deposits:** These are funds held in bank accounts that can be accessed on demand, typically through cheques or debit cards. They are liquid and can be withdrawn at any time. **Example:** Saving account balance of 50000/- can be withdrawn any time.
- 3. Time Deposits:** The deposits which have a fixed period to maturity are termed as Time Deposits. **Example:** Fixed Deposits (FDs).



- Monetary policy is a process implemented by the central bank to manage the money supply in order to achieve specific goals such as limiting inflation, maintaining an appropriate exchange rate, creating jobs, and promoting economic growth.
- It entails changing interest rates, either directly or indirectly, through open market operations, reserve requirements, or foreign exchange trading.
- Monetary policy can be expansionary or contractionary -

Monetary Policy



consumption and generate demand. (Fiscal stimulus)	reduce the money supply and decrease
➤ Dovish Monetary Policy. E.g.: Due to the COVID-19 situation present in the country in March 2020.	consumption and reduce demand. ➤ Hawkish Monetary Policy.

RBI and Monetary Policy

- The Reserve Bank of India Act of 1934 mandates the Reserve Bank of India (RBI) for implementing monetary policy.
- There have recently been many changes in the way India's monetary policy is formed, with the introduction of the Monetary Policy Framework (MPF), Monetary Policy Committee (MPC), and Monetary Policy Process (MPP).

Monetary Policy Framework (MPF)

In May 2016, the RBI Act was amended to give the central bank a legislative mandate for managing the country's monetary policy. This framework focuses on setting the policy (repo) rate based on the current economic conditions and adjusting liquidity to keep money market rates close to the repo rate. Changes in the repo rate impact the entire financial system through the money market, influencing aggregate demand, which is crucial for

controlling inflation and promoting economic growth.

Monetary Policy Committee (MPC)

- The MPC is a six-person committee appointed by the Central Government. It determines the policy interest rate required to achieve the inflation target in India.
- It was created by Raghuram Rajan.
- The MPC must meet at least four times per year to review. Quorum of four members is required.
- Each MPC member has one vote, and in the event of a tie, the Governor has a second or casting vote.
- Following the conclusion of each MPC meeting, the resolution adopted by the MPC is published.

NOTE: Inflation Targeting

- Adopted in 2016, the Reserve Bank of India (RBI) set an inflation target of 4% with a tolerance band of $\pm 2\%$
- This Allows the RBI to adjust its monetary policy stance based on economic conditions, such as growth and inflation trends.

Monetary Policy Committee, 2016

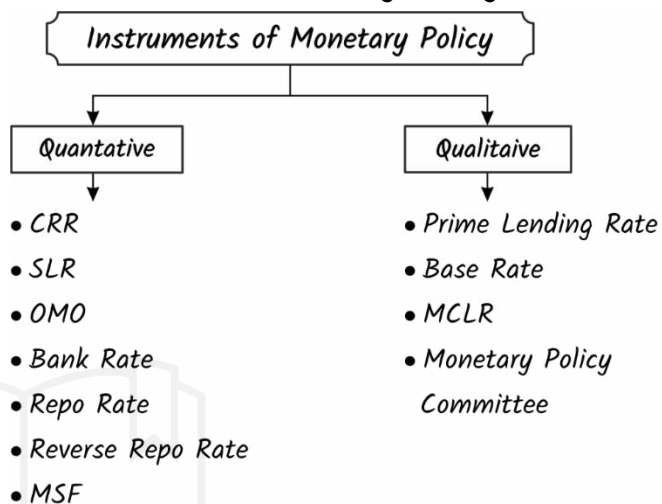
- Establishment: 2016.
- Recommended by: Urjit Patel Committee 2015.
- Aim: To bring transparency and accountability in deciding monetary policy.

- **Function:** Determines the policy interest rate required to achieve the inflation target.
- **Inflation target:** To be set once every five years.
 - ✓ It is set by the Government of India, in consultation with the Reserve Bank.
 - ✓ The current inflation target band (4% $\pm$ 2%) is appropriate for the next 5 years (2020-2025).

Dimension	Description
Structure	➤ 6 members (3 from RBI and 3 from Government of India) ➤ Chairman: RBI governor (Shaktikanta Das)

- Vice-chairman: RBI Deputy Governor (Dr. Michael D. Patra)
- Members: Ram Singh, Dr. Nagesh Kumar, Saugata Bhattacharya and Rajiv Ranjan.

Instruments of Monetary Policy



I. Quantitative Tools

Tools	Description
Cash Reserve Ratio (CRR)	➤ Determined by: Monetary Policy Committee. ➤ Banks must deposit a set percentage of their net demand and time liabilities (NDTL) with the Reserve Bank, as determined by the RBI. ➤ Bank has to reserve this in form of cash with the RBI. ➤ Interest: banks do not get any interest on money held by the RBI. ➤ Current status: 4.50% (April 2024) ➤ Impact ✓ If the RBI increases the CRR, the commercial banks have to deposit more money with the RBI and are left with less money to lend to customers. Thus, the effect is reduced money supply in the economy. ✓ If the RBI decreases the CRR, the commercial banks have to deposit less money with the RBI and are left with more money to lend to customers. Thus, the effect is increased money supply in the economy.

Net Demand and Time Liability (NDTL)

How much deposit is with the bank. It is calculated by adding Current /Saving Deposits with Term Deposits

Statutory Liquidity Ratio (SLR)	➤ Percentage of deposits that banks must maintain in highly liquid government securities. (Gold, Cash or Govt. securities) ➤ Kept in the form of a government security bond. ➤ Security Money on which the bank receives interest from RBI. ➤ Current status: 18% (April 2024). RESERVE RATIO = CRR + SLR ➤ Impact ✓ If RBI increases the SLR, the commercial banks are left with less money to lend to customers. Thus, the effect is reduced money supply in the economy. ✓ If RBI decreases the SLR, the commercial banks are left with more money to lend to customers. Thus, the effect is increased money supply in the economy..
Open Market Operations (OMO)	➤ Buying/Selling government securities by RBI to control the money supply. Government Securities (G-Sec) A promise of the full repayment of invested principal at maturity of the security. This is how the government obtains funds from various sources. ➤ Selling G-Sec: Reduces the money supply in the market. ✓ RBI sells securities to control inflation. ➤ Buying G-Sec: Increases the money supply in the market. ✓ RBI sells securities to control deflation by injecting liquidity out of the system.
Bank Rate	➤ The rate at which the commercial banks borrow money from RBI when they run short of reserves. ➤ The RBI sets the bank rate at 0.25% over the repo rate. ➤ Current status: 6.75% (April 2024). ➤ An increase in the Bank Rate results in reduced money supply in the economy and vice versa.
Marginal Standing facility (MSF)	➤ Introduced in 2011. ➤ It is an overnight loan facility that allows the banks to borrow from the RBI for one day. ➤ A window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely. ➤ Under this, government securities held under the SLR can be pledged. ➤ Its rate is always set higher than the Repo rate. ➤ Current status: 6.75% (April 2024).

Standing Deposit Facility (SDF)	➤ SDF is a facility that allows banks to deposit excess funds with the RBI without any collateral.
Liquidity Adjustment Facility (LAF)	
Repo Rate	➤ Rate at which the RBI loans to commercial banks to meet their short-term (90 Days) liquidity needs in exchange for a commitment ✓ To repurchase the same government assets at a later date. ➤ Current status: 6.50% (April 2024) ➤ Two Types: ✓ Overnight Repo: Borrowed for 24 Hours ✓ Term Repo: Borrowed for 7, 14, 21 etc., days. ➤ Impact ✓ Lowering the repo rate encourages borrowing, leading to increased spending and investment. ✓ Raising the repo rate discourages borrowing, leading to reduced spending and investment.
Reverse Repo Rate	➤ Rate at which the Reserve Bank absorbs liquidity from banks overnight. ✓ In exchange for qualified government securities held as collateral under the LAF. ➤ Lower rate than the repo rate. ➤ Current status: 3.35% (April 2024). ➤ Impact ✓ Higher reverse repo rate incentivizes banks to park funds with the central bank, reducing money available for lending and spending. ✓ Lower reverse repo rate may encourage banks to lend more, boosting economic activity

2. Qualitative Tools

Qualitative tools (such as Priority Sector Lending (PSL) and Loan-to-Value (LTV) ratios) regulate the allocation of loans to

specific sectors of the economy. Unlike quantitative tools, which manage the overall volume of loans, qualitative tools focus on how loans are distributed.

Tools	Description
Margin Requirements/ Loan to Value (LTV)	➤ Margin refers to the difference between the value of securities offered for loans and the value of loans actually granted. ➤ Example: If the collateral value is 1 lakh and LTV is set to 80% then maximum Rupees 80 thousand only can be given as loan. ➤ RBI can alter the percentage to boost or curb the demand. ➤ If RBI wants to control the flow of credit to a particular sector, it fixes a high margin for that sector. As a result, customers will take lesser loans for that sector.
Consumer Credit Regulation	➤ Credit made available by commercial banks (installments) for the purchase of consumer durables is known as consumer credit. ➤ If there is excess demand for certain consumer durables leading to their high prices, the RBI reduces consumer credit by: ✓ Increasing down payment, and/or ✓ Reducing the number of installments of repayment of such credit.
Priority Sector Lending	➤ The RBI mandates banks to lend a certain portion of their funds to specified sectors. ➤ E.g.: Agriculture, MSMEs, export credit, education, housing, social infrastructure, and renewable energy among others.
Moral suasion	➤ RBI Issue directives, have meetings, use persuasion and pressure, do inspections, and follow up regularly to maintain a certain level of money supply in the economy.
Direct Action	➤ When a commercial bank does not co-operate with RBI in achieving its desirable objectives then it takes direct action such as: ✓ Impose fines, ✓ ban non-cooperating banks ✓ refuse rediscounting their bills ✓ Refuse credit supply

NOTE –

- ✓ **Base Rate** – A minimum rate below which banks are not permitted to lend to their consumers.
- ✓ **Marginal Cost of Funds Based Lending Rates (MCLR)** – Lowest interest rate at which a bank can lend. It's a tenor-linked internal benchmark, which means the rate is set internally by the bank based on the remaining loan repayment time.

Tools Vs Inflation

Tool	To fight inflation	To fight deflation
Reserve Ratio (CRR, SLR)	Increase them	Decrease them
Open Market Operation (OMO)	RBI sell securities to collect cash/liquidity	RBI buy securities to supply cash in market
Bank Rate	Increase it	Decrease it
Repo Rate	Increase it	Decrease it
Reserve Repo	Its value is linked with Repo, hence cannot be increased/decreased independently.	
Marginal Standing Facility	Its value is linked with Repo, hence cannot be increased/decreased independently. Besides MSF = temporary firefighting, cash mismanagement.	

Policy Stances by RBI

Various Policy Stances of RBI	
Accommodative	➤ Central bank to expand the money supply to boost economic growth. ➤ A cut in the interest rates is seen, but a rate hike is ruled out. ➤ Usually, this policy is adopted when there is slowdown in the economy.
Neutral	➤ Central bank can either increase or decrease the policy rates, as per the macroeconomic conditions.
Hawkish	➤ Central bank's top priority is to keep inflation low. ➤ Bank may hike interest rates to curb the money supply and thus reduce the demand. ➤ Indicates tight monetary policy.
Calibrated Tightening	➤ Rate hike will happen in a calibrated manner. ➤ Bank may not increase rate every time but tilted towards a rate hike.

NOTE: Inflation Targeting

- Adopted in 2016, the Reserve Bank of India (RBI) set an inflation target of 4% with a tolerance band of $\pm 2\%$
- This allows the RBI to adjust its monetary policy stance based on economic conditions, such as growth and inflation trends.