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GS Paper 1 || Volume - 4

Indian Economy

SIERRA INNOVATIONS

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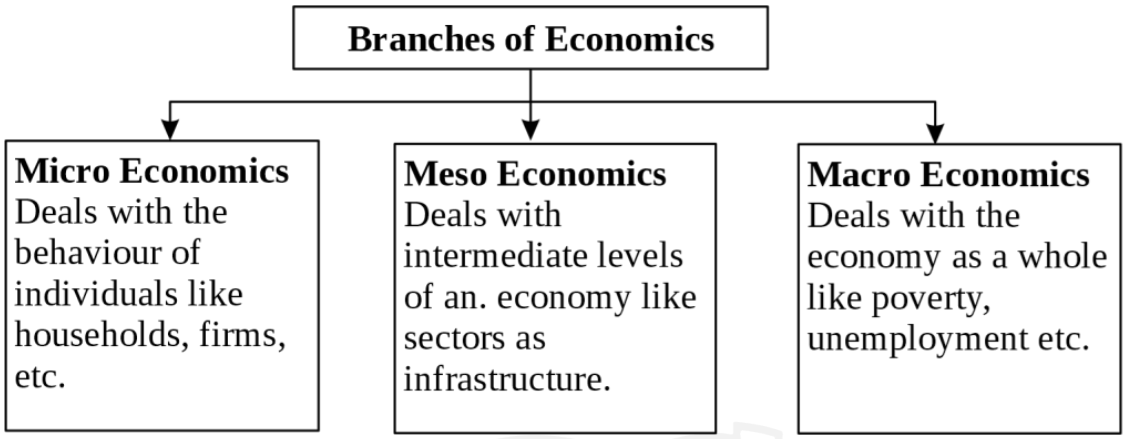
1 CHAPTER

Basic Concepts of Economy

Economics is a social science concerned with the production, distribution and consumption of goods and services.



Types Of Economy

- **Capitalist Economy**: Based on **laissez faire** with minimal government intervention. Private enterprises decide production, pricing, and supply based on market demand, and prices are determined by supply and demand forces.
- **Socialist Economy**: The government controls output and pricing, focusing on distributing goods based on need rather than affordability. Essential services like health care are provided free to citizens.
- **Mixed Economy**: Combines elements of both capitalism and socialism. The government intervenes to achieve social goals, redistributes wealth through taxes, and promotes social objectives alongside private sector activity.
- **Open Economy**: Engages in economic relations with the rest of the world. The demand for domestic goods includes domestic consumption, investment, government spending, and exports minus imports. Exports provide an additional demand for domestic goods and services.
- **Closed Economy**: Has no economic interactions with other countries. In a closed economy, saving, investment, GDP, and GNP are equal, while in an open economy, these may differ due to international trade.

Schools of Economic Thought

- **Classical View:** Believes in free markets as the most efficient way to allocate resources and advocates for limited government involvement, acting only as a fair and strict referee.
- **Keynesian View:** Argues that markets alone cannot efficiently allocate resources and it supports active government intervention to reallocate resources and stabilize the economy.

Structural Composition of an Economy

- **Primary Sector**: Refers to industries involved in the extraction of natural resources or the production of raw materials. Examples include fishing, farming, mining and more.
- **Secondary Sector:** Encompasses industries involved in the manufacturing of usable or finished goods. Examples include heavy industries such as steel, automotive and light industries such as food and cosmetics.

- **Tertiary Sector:** Refers to industries that offer services to businesses or end consumers. Examples include healthcare, insurance and more.
- **Quaternary Sector:** Involves industries focused on the creation and dissemination of knowledge. Examples include research and development, education etc.
- **Quinary sector:** Involves the highest levels of decision-making in an economy. Examples include NITI Aayog members, scientists.

Sectors of Economy

- **Formal Sector:** This sector consists of businesses that are officially registered with the government and are governed by various regulations, such as the Companies Act, Factories Act and Labour laws etc.
- **Informal Sector:** This sector consists of businesses that operate without legal regulation or the maintenance of regular financial records. Examples include landless laborers, farmers and vendors.

The **Real sector** of an economy drives economic output and GDP growth, encompassing activities like farming or textile production, which directly contribute to the economy's productivity and meet aggregate demand. It is essential for economic sustainability. In contrast, the **Financial sector** includes institutions providing financial services such as banks, insurance companies and investment firms, which generate revenue through loans and mortgages.

Goods

- Goods are products or services that satisfy people's needs and wants. They can be physical items, services, or a mix of both, and anything that offers value to consumers is considered a good.

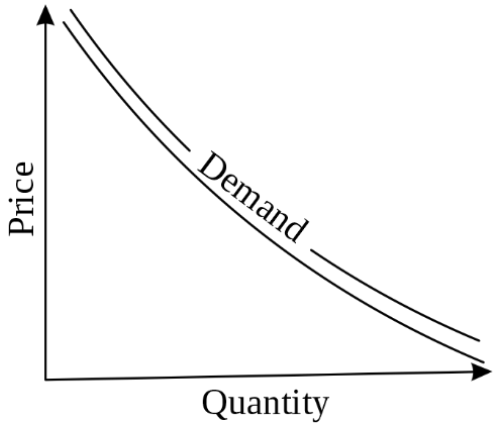
Types of Goods in an Economy:

- **Intermediate goods**: Products used by producers as inputs in the production process. Example: Rubber for tyres.
- **Final goods**: Items intended for final consumption, without further transformation or production. Example: Bicycle.
- **Consumer goods**: Goods purchased by consumers for personal use. Example: Sugar.
- **Capital goods**: Durable items utilized in the production process, such as machinery and tools.
- **Luxury goods**: Products for which demand increases with higher income levels. Example: Gold.
- **Complementary goods**: Goods that are used together. Example: Bread and butter, pen and refill.
- **Substitute goods**: Products that serve as alternatives to each other. Example: Tea and coffee.
- **Veblen (Snob) goods**: Goods for which demand increases as their price rises, often because people perceive them as better. Example: A rolex watch, private jets.
- **Giffen goods**: Goods where demand increases as prices rise, often considered inferior goods. Example: Bajra.
- **Public goods**: Goods that are non-rivalrous (one person's consumption doesn't reduce availability for others) and non-excludable. When the government provides a commodity for free, the opportunity cost shifts from the consumers to taxpayers. This means that while individuals receive the good at no cost, the expense is covered by the general population through taxes. Example: Parks, defense.
- **Private goods**: Goods that are both rivalrous (one person's consumption limits others') and excludable (can be restricted to specific users). Example: Club membership, houses.
- **Merit goods**: Goods with positive externalities, such as education or healthcare.
- **Demerit goods**: Goods with negative externalities. Example: liquor, cigarettes.

Stock and Flows

- Stocks refer to assets or goods that are present at a particular moment in time, while flows represent the quantities occurring over a specified period.
- Capital goods, like machinery, are considered stocks, whereas the changes in capital goods over time are classified as flows.

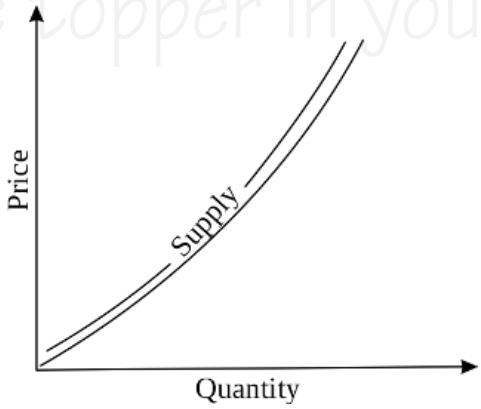
Law of Demand



- The Law of Demand states that, assuming all other factors are unchanged, when the price of a good or service increases, the quantity demanded by consumers decreases, and vice versa.
- For example, if smartphone prices fall, consumers are more likely to buy more. This inverse relationship between price and demand is a key principle in economics. However, this law applies only to normal goods.

1. **Demand Curve**
   - ✓ A price change usually leads to an inverse change in quantity demanded, with the demand curve sloping downward.
   - ✓ In some cases, a price decrease can reduce demand, and a price increase can boost it, causing the curve to slope upward.
   - ✓ The Speculative Effect can also reverse this trend, as consumers anticipate future price hikes.
   - ✓ Factors such as changes in income, prices of related goods and preferences can shift the demand curve.
   - ✓ An increase in these factors shifts the curve rightward, while a decrease shifts it leftward.
2. **Elasticity of Demand**
   - ✓ It measures how responsive the quantity demanded of a good or service is to price changes. It reveals how sensitive consumers are to variations in price.
3. **Types of Elasticity of Demand**
   - ✓ **Perfectly Elastic**: Infinite change in quantity for a small price change.
   - ✓ **Perfectly Inelastic**: No change in quantity regardless of price changes.
   - ✓ **Relatively Elastic**: Large change in quantity for a small price change.
   - ✓ **Unitary Elastic**: Proportional change in quantity and price.
   - ✓ **Relatively Inelastic**: Small change in quantity for a large price change.

Law of Supply



- The Law of Supply states that as prices rise, the quantity supplied increases, and as prices fall, the quantity supplied decreases.
- For instance, higher coffee prices encourage farmers to grow more, while lower prices reduce production. This reflects the direct relationship between price and supply.

1. **Elasticity of Supply**
   - ✓ It measures how responsive the quantity supplied of a good or service is to price changes.
   - ✓ It helps understand how producers adjust their output in response to price fluctuations.
2. **Types of Elasticity of Supply**
   - ✓ **Relatively Elastic Supply**: Quantity supplied changes more than proportionally to price.
   - ✓ **Unitary Elastic Supply**: Quantity supplied changes proportionally to price.
   - ✓ **Relatively Inelastic Supply**: Quantity supplied changes less than proportionally to price.

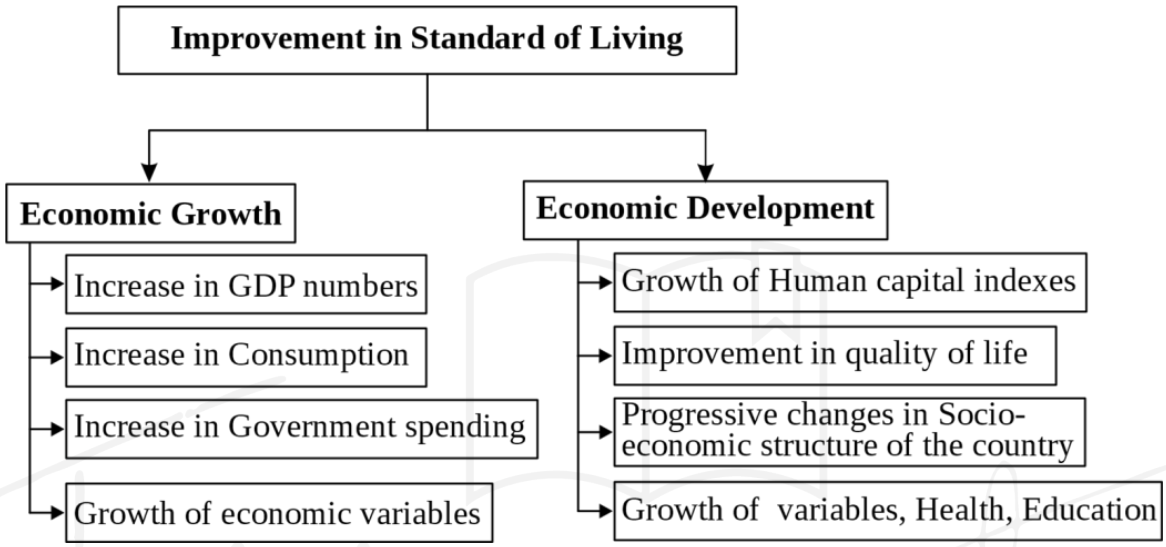
Income and Cross Elasticity

- **Income Elasticity**: Measures the response of quantity demanded or supplied to income changes.
- **Cross Elasticity**: Analyzes how the quantity demanded or supplied of one good responds to price changes of another good.

Economies of Scale

- Economies of scale occur when a company becomes more efficient in production, leading to cost advantages. Companies can lower product costs and increase production to achieve economies of scale.
- Example: Large supermarket chains benefit from economies of scale due to greater cash flow and a larger customer base. By purchasing groceries in bulk from suppliers, they reduce costs, enabling them to sell at lower prices compared to independent grocers.

Economic Growth V/s Economic Development



Important Economists and Their Books

Economist/Author	Book Title	Key Concept / Contribution
Gunnar Myrdal	Economic Theory and Under-developed Regions	Circular cumulative causation; regional inequality
Albert O. Hirschman	The Strategy of Economic Development	Unbalanced growth strategy in development economics
Nicholas Kaldor	Strategic Factors in Economic Development	Importance of manufacturing and increasing returns
Adam Smith	The Wealth of Nations (1776)	Classical economics; invisible hand; division of labor
Thomas R. Malthus	An Essay on the Principle of Population (1798)	Population grows geometrically, food supply arithmetically

Circular economy

- A circular economy is an economic model aimed at **eliminating waste** and **continually reusing resources**, in contrast to the traditional **linear model** of "take-make-dispose".
- Promotes recycling, reusing, and energy-efficient systems.
- Reduces the need for primary resource extraction.
- Promotes **closed-loop systems** to minimize waste.
- Waste from one process can become input for another.
- Encourages lean manufacturing and **industrial symbiosis**.

2 CHAPTER

National Income Accounting

- National Income Accounting offers a system for evaluating the overall economic activity within a country.
- It employs several key indicators to assess the economy's performance, production, income, and spending. Key metrics used in this process include: Gross Domestic Product (GDP), Net Domestic Product (NDP), Gross National Product (GNP), Net National Product (NNP), Gross National Income (GNI) and Net National Income (NNI).

Economic Territory

- It refers to the area under a country's governance where people, goods and capital move freely.
- It encompasses political borders, including territorial waters and airspace, as well as embassies, consulates and military bases abroad (excluding those within the country's political boundaries).
- It also includes ships, aircraft, and other transport operated by residents internationally, such as Air India's global services, as well as fishing vessels, oil rigs, and floating platforms operated in international waters or areas where the country holds exclusive operational rights.

Normal Residents V/s Indian Citizens

- **Normal Resident:** A person who lives in a country and has their economic interests centered there, including both nationals (e.g., Indians in India) and foreigners (e.g., non-nationals in India).
- **Citizens:** Indian nationals living within India or abroad.

GDP & National Income

- **Gross Domestic Product (GDP):** It refers to the total market value of all final goods and services produced within a country's borders during a specific period (typically a year). It encompasses the output of both domestic and foreign companies operating within the country.
- **National Income (NI):** It is a measure of the total factor incomes earned by a country's citizens, regardless of whether they are earned domestically or internationally. **Example**:
  - ✓ If a Japanese company generates Rs 200 crore in India, it contributes to India's GDP but not to its National Income, as the earnings belong to the Japanese entity.
  - ✓ On the other hand, if an Indian company earns Rs 600 crore in Japan, it is included in India's National Income but not in GDP, as it was produced outside India.
- **Net Domestic Product (NDP):** It is calculated by deducting depreciation (the wear and tear on capital) from GDP.
  - ✓ **Formula**: NDP = GDP − Depreciation
  - ✓ **Example**: If GDP is Rs 5000 crore and depreciation is Rs 100 crore, then: NDP= 5000−100= Rs 4,900 crore.

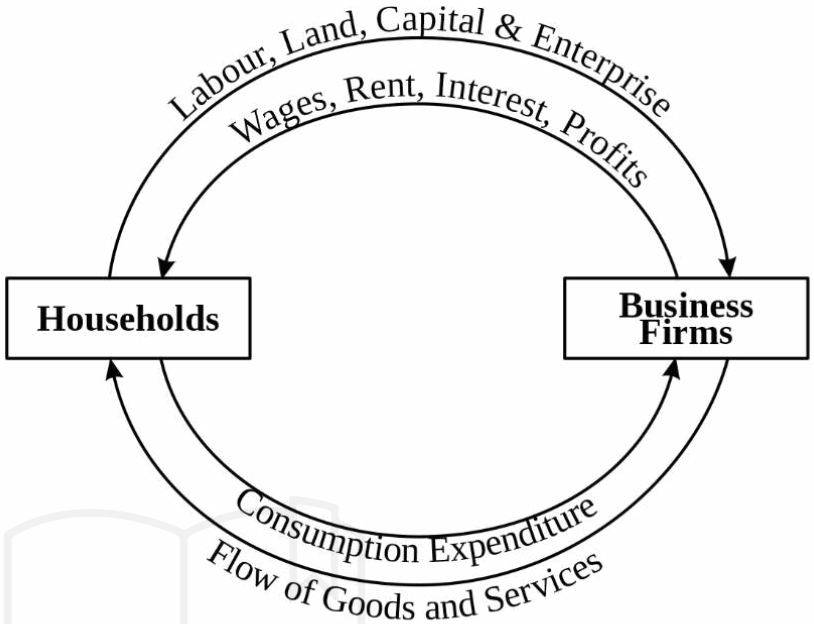
Note:

- **Depreciation** refers to the decline in the value of an asset over time due to usage and obsolescence.
- **Product Taxes and Subsidies** are taxes and subsidies directly applied to goods and services. Product taxes raise market prices, while subsidies lower them.

- **Intermediate Consumption** refers to goods and services that are consumed during the production process and are not included in GDP to prevent double-counting.
- **Net Factor Income from Abroad (NFIA)**: It represents the difference between the factor income earned by Indian residents abroad and the factor income earned by non-residents in India. (NFIA = Factor Income from Abroad to India – Factor Income from India to Abroad)

A. Circular Flow of Income

- Circular flow of income refers to the continuous movement of goods, services, production, earnings, and expenditure in an economy.
- Money circulates from producers to workers as wages, then back to producers as payments for goods.
- Factors of Production include land, labor, capital and entrepreneurship.
- Payments made for each factor are rent (for land), wages (for labor), interest (for capital), and profit (for entrepreneurship).



Circular Flow of Income in a Simple Two Sector Economy

Capital Output Ratio

- The Capital Output Ratio (COR) measures the amount of capital needed to produce one unit of output.
- It reflects the relationship between investment levels and the resulting increase in GDP, as well as the value of capital invested relative to the value of output produced.

- **Fixed capital** refers to long-term assets like buildings, machinery, and equipment, which provide ongoing benefits over time and support sustained operations. For example, a farmer's plough or a computer are considered fixed capital.
- In contrast, the **Working capital** pertains to short-term financial resources needed for daily operations, such as raw materials like petrol and yarn, which are used within a single production cycle.

Concepts Related to GDP

- **Nominal GDP:** It refers to the production of final goods and services in the current year, valued at the prices prevailing in that same year. No adjustments are made regarding the prices.
- **Real GDP:** It represents the current year's production of goods and services valued at base-year prices, which remain constant. This method provides a more accurate measure of GDP, as it avoids inflationary distortions that can inflate GDP figures in a given year due to high inflation rates.
- **Preston Curve:** It is a visual representation that illustrates the correlation between a country's per capita income (typically measured as GDP per capita) and its average life expectancy.
- **GDP Deflator:** The GDP deflator, also known as the implicit price deflator, is a measure of inflation. It represents the ratio of the value of goods and services produced in a specific year at current prices to the value of those goods and services at base-year prices.

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

If **GDP Deflator = 1**, there is no change in price level.

If **GDP Deflator > 1**, it indicates an increase in the price level.

If **GDP Deflator < 1**, it indicates a decrease in the price level.

Methods of GDP Calculation

- **Product/Value Added Method:**
  - ✓ It is the method to calculate GDP by summing the value added by each firm, which is the difference between a firm's output value and the cost of intermediate goods.
  - ✓ **Example**: A farmer produces wheat worth Rs 100, and a biscuit manufacturer uses Rs 50 worth of this wheat to produce biscuits worth Rs 200. The value added by the farmer is Rs 100, and the value added by the biscuit maker is Rs 150 (Rs 200 - Rs 50). Therefore, Gross Value Added = 100 + 150 = 250
    Formula: GDP = ∑(Value Added of All Firms)
- **Expenditure Method:**
  - ✓ The Expenditure Method calculates GDP by summing total spending in the economy, including consumption (C), investment (I), government spending (G) and net exports (X - M), where X represents exports and M represents imports.
  - ✓ **Example:** If consumers spend Rs 200 on domestic goods, businesses invest Rs 300, the government spends Rs 400, exports are Rs 200 and imports are Rs 100, then: GDP = 200 + 300 + 400 + (200−100) = Rs 1000.
    Formula: GDP = {C + I + G + (X-M)}
- **Income Method:**
  - ✓ The Income Method calculates GDP by summing all incomes earned by residents and firms, including wages, interest, profits and rent.
    Formula: GDP = ∑(Wages + Interest + Profit + Rent)

Price Concepts

- **Factor Cost (FC):** It is the production cost that excludes taxes and subsidies, reflecting the income earned by producers. It encompasses wages, rent, interest and profits.
- **Basic Price:** It includes the factor cost along with production taxes (such as property taxes on factories) minus production subsidies (like government assistance for factory operations).
  - ✓ **Example**: If a manufacturing unit's factor cost is Rs 100 crore, with Rs 15 crore in production taxes and Rs 10 crore in subsidies, the basic price would be:100 +15 − 10 = Rs 105 crore
  - ✓ Basic Price = Factor Cost + Production Taxes − Production subsidies
- **Market Price (MP):** It includes the basic price, plus product taxes (such as VAT or sales tax), minus product subsidies, representing the final price paid by consumers. Market Price = Basic Price + Product Taxes − Product Subsidies.
  - ✓ **Example**: If an item's basic price is Rs 500, with Rs 50 in product taxes and Rs 20 in product subsidies, then: Market Price = 500 + 50 − 20 = Rs 530.

Income Metrics

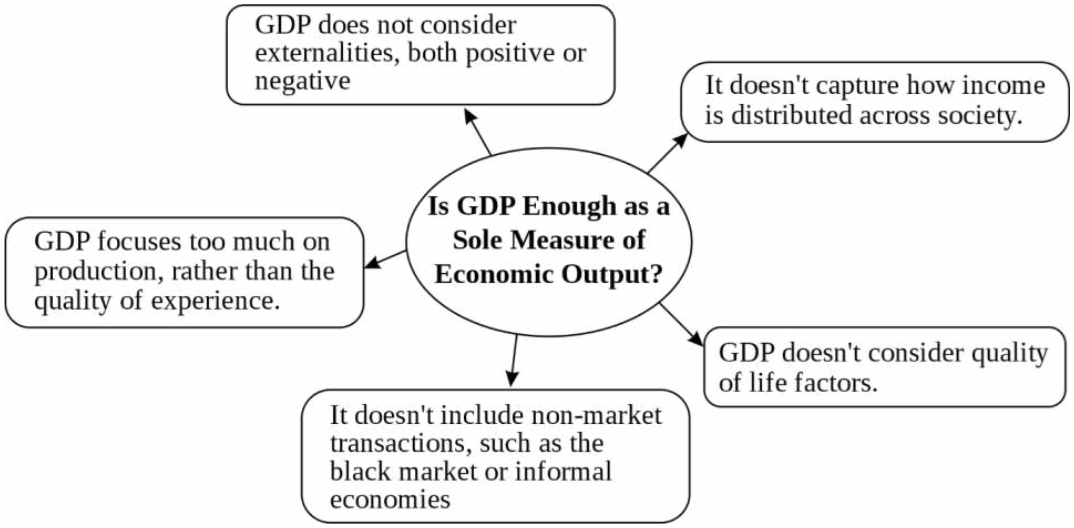
- Macroeconomic identities and concepts, such as Gross National Product (GNP), Net National Product (NNP), National Income (NI), Personal Income (PI) and Personal Disposable Income (PDI), are essential for understanding income distribution in an economy.

- These metrics also reflect the impact of factors like depreciation, taxes, subsidies and transfers.

1. **Gross National Product**: GNP measures the total economic output of a country, including income earned by its domestic factors of production abroad, minus income earned by foreign factors within the country. It is calculated as GDP plus net factor income from abroad. **Formula:** GNP = GDP + Net Factor Income from Abroad.
2. **Net National Product:** NNP is calculated by deducting depreciation from GNP. NNP= GNP - Depreciation.
3. **National Income (NI):** It is the NNP evaluated at market prices, adjusted for indirect taxes and subsidies. It indicates the income earned by the factors of production within the country.
   Formula: NI = NNP at Market Prices − Net Indirect Taxes (Indirect Taxes - Subsidies) = NNP at Factor Cost
4. **Personal Income (PI):** It represents the income received by households from National Income and is calculated by subtracting undistributed profits, corporate taxes, and net interest payments made by households, while adding transfer payments received from the government and firms.
   - ✓ **Undistributed Profits** refer to the portion of profit earned by firms and government enterprises that is not distributed among the factors of production.
   - ✓ Households also receive transfer payments (e.g., prizes, pensions) from the government and firms, which are added to the calculation of Personal Income.
     Formula: PI = NI − Undistributed Profits − Net Interest Payments Made by Households − Corporate Tax + Transfer Payments
5. **Personal Disposable Income (PDI):** It refers to the income available to households after subtracting personal taxes (e.g., income tax) and non-tax payments (e.g., Fees) from Personal Income (PI). It represents the amount of income households can use for their consumption or savings.
   Formula: PDI = PI − Personal Tax Payments − Non-Tax Payments.

B. Difference Between GVA & GDP

Aspect	GVA	GDP
Definition	Value of goods and services produced after deducting intermediate goods and services.	Market value of all final goods and services produced within the country.
Focus	Insight from the input or supplier side.	Insight from the output or consumer side.
Calculation Approach	Generally calculated sector-wise.	Calculated for the whole economy.
Price Basis	Calculated at Basic Prices.	Calculated at Market Prices.



Other Methods to Gauge Economic Well-Being

- **Green GDP:** It is an economic measure that incorporates the environmental consequences of a nation's economic growth. It is determined by deducting the costs associated with environmental damage and the depletion of natural resources from the country's Net Domestic Product (NDP).
- **Gross National Happiness (GNH):** It is a method of assessing a country's development by prioritizing the well-being of its people. It serves as an alternative to the traditional measure of GDP**.** Adopted first in Bhutan.
- **Genuine Progress Indicator (GPI):** GPI is proposed as an alternative or supplement to GDP for measuring economic growth. It assesses the impact of economic production and consumption on environmental and social factors. GPI considers whether these factors contribute positively or negatively to overall health and well-being.
- **Human Development Index (HDI):** It is a metric that evaluates a country's average performance in three key aspects of human development: health, education, and standard of living. The UNDP is responsible for compiling the HDI.

DID YOU KNOW

The Greendex is a survey created by National Geographic and GlobeScan to assess the environmental sustainability of individuals' consumer habits. It evaluates the environmental impact of the average consumer in various countries, taking into account both personal choices and those influenced by external factors. The Greendex compares countries based on similar behaviors and attitudes towards sustainability.

National income accounting is essential for measuring a country's economic performance through indicators like GDP and GNP. It helps assess economic growth, income distribution, and well-being. Despite limitations, it remains crucial for policymaking and economic analysis.

3 CHAPTER

Money and Money Supply

- The money and banking system comprises institutions like central and commercial banks that manage currency, regulate interest rates, and provide loans.
- It ensures economic stability, growth, and efficient resource allocation by facilitating the flow of money and credit.

Money & Its Evolution

- Money is defined as something widely accepted by society as a medium of exchange, serving as a unit of account, store of value, and a means for debt repayment.
- It emerged as a more efficient alternative to the barter system, where goods and services were exchanged directly without a monetary intermediary.
- The barter system faced challenges, such as the issue of "double coincidence of wants" (both parties needing what the other offers) and the difficulty of storing goods without loss of value.
- These problems led to the development of money as a common, easily transferable medium of exchange.

1. **Functions of Money**
   - ✓ **Medium of Exchange:** Money eliminates the double coincidence of wants, enabling smooth economic transactions.
   - ✓ **Unit of Account:** It standardizes the value of goods and services, making price comparison easy.
   - ✓ **Store of Value:** Money preserves wealth, offering liquidity for spending and saving.
   - ✓ **Standard of Deferred Payments:** It enables future payments in transactions.
   - ✓ **Means of Payment:** Money settles debts, taxes and obligations.

Legal tenders

- Currency notes and coins are also called legal tenders as they **cannot be refused** by any citizen of the country for settlement of any kind of trans-action.
- Cheques drawn on savings or current accounts, however, can be refused by anyone as a mode of payment. Hence, **cheques are not legal tenders.**

2. **Types of Money**
   - ✓ **Commodity Money:** Money with intrinsic value, such as gold or silver which holds worth independently of any government.
   - ✓ **Paper Money:** Currency notes issued by the government or central bank, representing a monetary value.
   - ✓ **Metallic Money:** Money made from precious metals like gold and silver, valued for portability, high density and convenience.

- ✓ **Bank Money:** Money held in demand deposits at commercial banks, accessible through cheques; considered "near money."
- ✓ **Fiat Money:** Government-issued money not backed by a physical commodity, deriving value from the issuing authority's guarantee, like currency notes and coins in India.
- ✓ **Plastic Money:** Physical cards, like debit, credit, or cash cards, used in place of cash transactions.
- ✓ **Helicopter Money:** A policy involving printing and distributing money to stimulate the economy through increased spending or tax cuts.
- ✓ **Bitcoins**: Bitcoin, introduced in 2009, is a digital currency that allows instant payments without the need for a central authority. It operates on an open-source protocol, and users can acquire Bitcoin through mining, exchanges, or peer-to-peer transactions.
- ✓ **Non-Fungible Token (NFT):** They are unique digital assets used to verify ownership of items like art or real estate and cannot be subdivided or exchanged one-to-one due to differing values. They are not banned but operate in grey zones.
- ✓ **Central Bank Digital Currency:** A CBDC is a digital legal tender issued by a central bank, backed by it for stability. Unlike cryptocurrencies, it's equivalent to fiat currency and exchangeable one-to-one. The RBI Governor recently highlighted the innovative features of India's **e-rupee**.

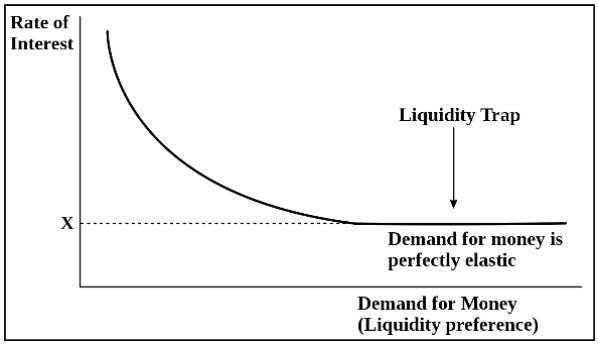
Digital Currency	**Cryptocurrency**
Normally backed by Central Bank (The RBI already introduced it in India)	Not backed by the central bank
Centralised	Decentralised
Not as transparent as only the sender, receiver and the banking authorities will be aware of the transactions	Transparent due to distributed ledger system; details regarding cryptocurrency transactions in public domain.

Demand & Supply of Money

1. Demand for Money:

- ✓ **Transaction Motive:** This motive for holding money is to conduct deals when income and expenditure timings differ. It is directly proportional to real GDP and price level.
- ✓ **Precautionary Motive:** It refers to the desire of people to hold cash reserves for certain unforeseen contingencies like sickness, accident etc. Higher the income of the individual, higher will be the cash balance for precautionary motive.
- ✓ **Speculative Motive:** Speculation involves anticipating future asset values; if people expect asset prices to rise, they invest in them to make future profits, and if they expect prices to fall, they convert holdings into money to avoid losses. It is inversely related to the market rate of interest.

A **liquidity trap** occurs when interest rates are extremely low, causing individuals to prefer holding cash or cash equivalents due to uncertainty about the economy's performance.



2. **Bond Market Dynamics and Speculative Money Flows:**
   - ✓ An increase in money supply leads to higher bond purchases, raising bond prices and lowering interest rates.
   - ✓ As interest rates fall, people expect future increases and anticipate capital loss, driving up speculative demand for money.
   - ✓ Conversely, when interest rates are high, people expect a decrease and convert money into bonds, reducing speculative demand for money.
3. **The Link Between Bond Yields and Interest Rates**
   - ✓ Bonds with fixed interest rates become more appealing when interest rates decrease, leading to higher demand and market value.
   - ✓ Conversely, when interest rates rise, bond prices fall to align with the yields of newly issued bonds.
   - ✓ Bond yield is calculated by dividing the annual interest by the current price, so when bond prices drop, yields increase, and when prices rise, yields decrease.
4. **Supply of Money:**
   - ✓ Money Supply refers to the total stock of money in circulation among the public at a given time, excluding money held by the government, RBI (in the form of CRR), and commercial banks (in the form of SLR).
   - ✓ It includes currency notes and coins, demand deposits (e.g., savings accounts), time deposits (e.g., fixed deposits), money in post office savings accounts, and inter-bank deposits (excluding CRR).
   - ✓ **Measures of Money Supply:**
     - Money supply measures are tools used to measure the money supply in an economy, with the Reserve Bank of India (RBI) using several aggregates:
       - ☞ **M0 (Reserve Money)** includes currency in circulation, bankers' deposits with the RBI and other deposits with the RBI.
       - ☞ **M1 (Narrow Money)** is the sum of currency held with the public and net demand deposits held by commercial banks.
       - ☞ **M2** includes M1 plus savings deposits with Post Office Savings Banks.
       - ☞ **M3 (Broad Money)** is M1 plus net time deposits with the banking system.
       - ☞ **M4** is M3 plus total deposits with Post Office Savings Organizations (excluding National Savings Certificates).

Measures of Money Supply		
Most Liquid **(Narrow Money)**	**M1** 1. Currency Notes 2. Coins 3. Demand Deposits with Bank (savings, current)	**M2** M1 + Post Office Savings Deposits
Less Liquid **(Broad Money)**	**M3** **M2** **+** Time deposits (up to 1 year) with banks + Call/term borrowings by banks	**M4** **M3** **+** Time deposits (over 1 year) with banks + Deposits

- ✓ In India, M0, M1, and M3 are most commonly used. The **RBI** also tracks new monetary aggregates like NM0, NM1, NM2 and NM3, which focus on the banking sector's balance sheet and liquidity like:
  - **NM0** is the sum of currency in circulation, bankers' deposits with the RBI, and other deposits with the RBI, which primarily include deposits from quasi-government institutions, foreign central banks and international agencies like the IMF.
  - **NM1 (Narrow Money)** includes currency with the public, current deposits with banks, the demand liabilities portion of savings deposits, and other deposits with the RBI. It represents currency and non-interest-bearing deposits in the banking sector.
  - **NM2** is NM1 plus short-term time deposits having maturity of up to one year.
  - **NM3 (Broad Money)** includes NM2, long-term time deposits and call/term funding from financial institutions, capturing the complete balance sheet of the banking sector.
- ✓ The Working Group also suggested the creation of **three Liquidity Aggregates**- L1, L2, and L3 - alongside the New Monetary Aggregates.
  - **L1** is the sum of NM3 and all deposits with Post Office Savings Banks (excluding National Savings Certificates).
  - **L2** includes L1, term deposits, term borrowing and certificates of deposit from financial institutions (FIs).
  - **L3** is the sum of L2 and public deposits from non-banking financial companies (NBFCs).

5. Determinants of Money Supply:

- ✓ Money supply is determined by several factors in the economy as:
  - **Central Bank Policy:**
    - ☞ Open Market Operations: Buying or selling government securities to manage the money supply.
    - ☞ Reserve Requirements: The percentage of deposits banks must hold in reserve, affecting lending capacity.
  - **Commercial Bank Actions:**
    - ☞ Lending Practices: Banks influence money supply by deciding how much to lend to individuals and businesses.
  - **Public Preferences:**
    - ☞ Holding Money: The public's preference for holding cash or depositing it in interest-bearing accounts affects the money supply.
  - **Economic Activity:**
    - ☞ Velocity of Money: The rate at which money circulates in the economy impacts its effect on economic activity.
  - **Government Influence:**
    - ☞ Government Spending: Fiscal policies and government expenditure, especially if financed by borrowing, can affect the money supply.
  - **Financial Innovation:**
    - ☞ New Financial Products: Introduction of new financial instruments can change the size and composition of the money supply.

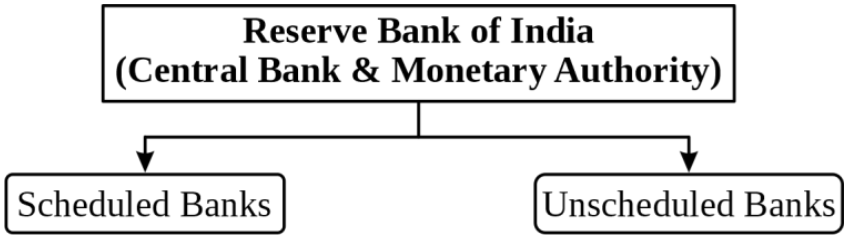
- **Effects of Money Supply on the Economy:**
  - ☞ Increase in money supply lowers interest rates.
  - ☞ More money in consumers' hands leads to higher spending.
  - ☞ Increased spending drives businesses to order more raw materials and boost production.
  - ☞ Higher business activity increases demand for labor.
  - ☞ A decline in money supply has the opposite effect.
  - ☞ Changes in money supply impact price levels and inflation.
  - ☞ Significant effects are also observed on inflation and interest rates.
- **Money Multiplier**
  - ☞ It refers to the amount of broad money banks create with each rupee of reserves or base money they hold. Reserves are the deposits banks must keep with the RBI and not lend out.
  - ☞ It is calculated as Money Multiplier = 1/r (where r is the reserve ratio) or as the ratio of M3 to M0 (M3/M0).

Money is crucial for economic transactions and the effective management of the money supply, influenced by central banks and public preferences, is essential for controlling inflation, interest rates, and promoting economic growth.

4 CHAPTER

Banking in India

- Banking in India plays a crucial role in economic growth by facilitating transactions, loans and investments.
- The system is diverse, comprising commercial, cooperative and rural banks, all regulated by the Reserve Bank of India (RBI).

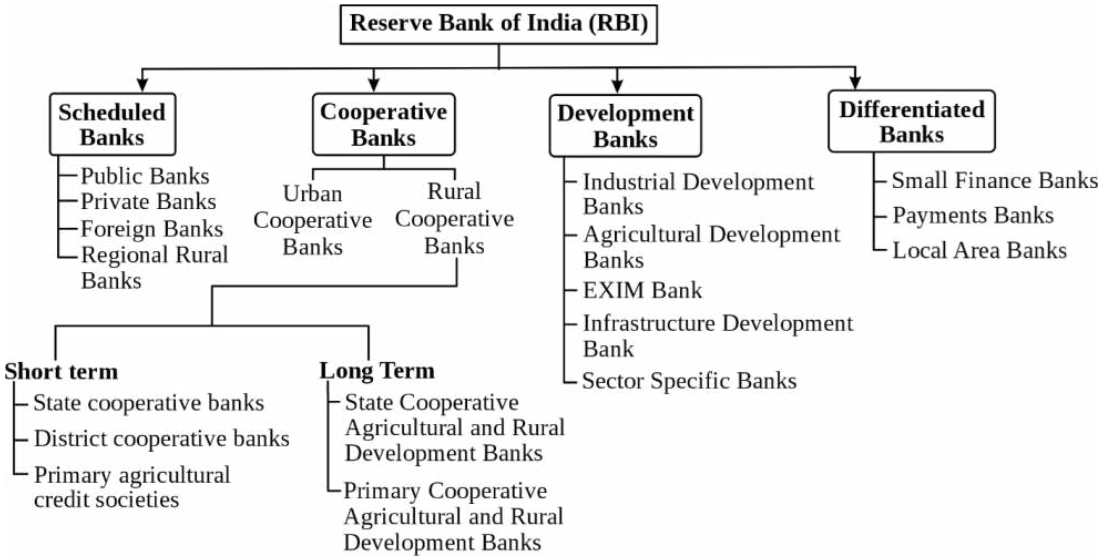


- Over time, the sector has expanded with the inclusion of private, foreign and digital banks, making banking more accessible, especially in rural areas.

Difference Between Scheduled & Non-Scheduled Banks

Point of distinction	Scheduled Banks	Non-Scheduled Banks
Definition	Banks listed in the second schedule of the RBI Act, 1934.	Banks not listed in the second schedule of the RBI Act, 1934.
Factors	Paid-up capital of ₹5 lakhs or more, affairs not detrimental to depositors.	No fixed criteria.
Regulatory Requirements	Must keep CRR deposits with RBI, file periodic returns.	Maintain CRR deposits with themselves, no periodic return filing.
Entitlements	Authorized to borrow from RBI, join clearinghouse, rediscount exchange bills.	Not authorized to borrow from RBI, not eligible for clearinghouse or rediscounting.
Risk	Financially stable, low risk to depositors.	Riskier for business.
Examples	Commercial Banks, Private and Public Sector Banks.	Local Area Banks (LABs), some Urban Cooperative Banks (UCBs).

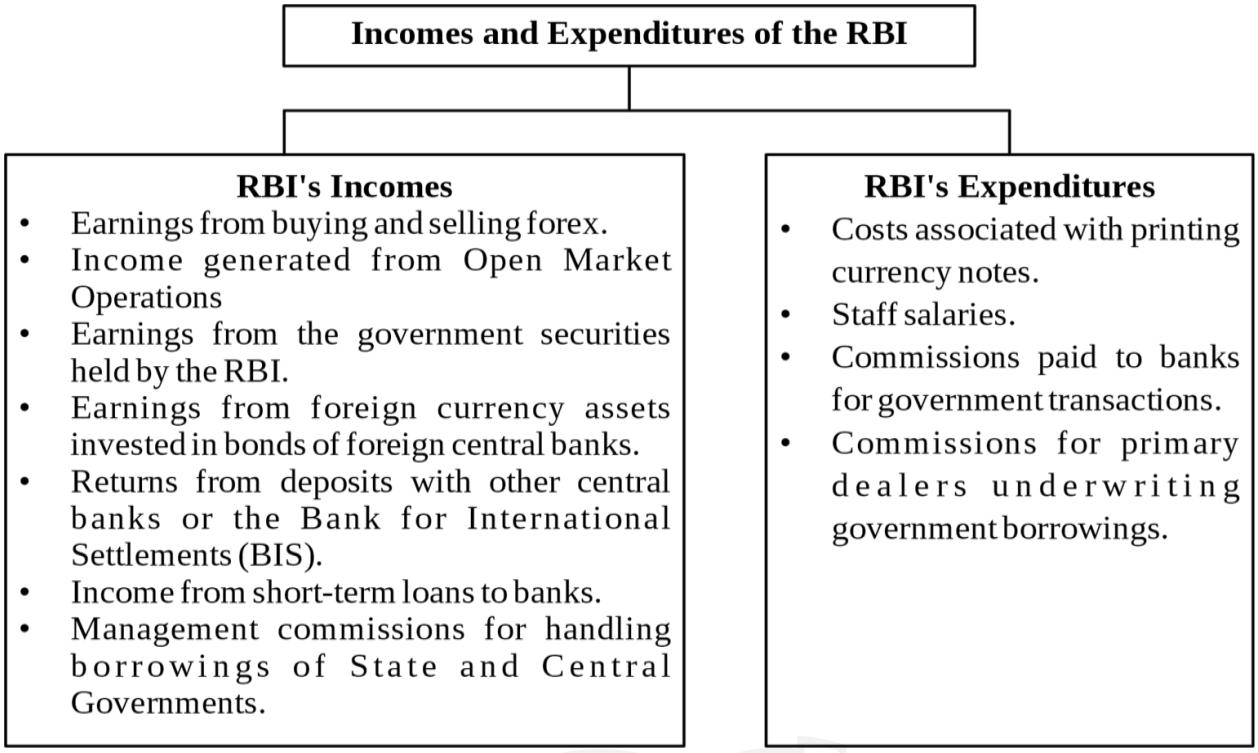
Composition of India's Banking Sector



1. Reserve Bank of India (RBI)

- ✓ The Reserve Bank of India (RBI) was established on April 1, 1935, under the Reserve Bank of India Act, 1934.
- ✓ Initially located in Calcutta, its central office was permanently moved to Mumbai in 1937, where the Governor resides and policies are created. Although it was privately owned at first, the RBI became fully government-owned after its nationalization in 1949.
- ✓ RBI is governed by a central board of directors, appointed by the Government of India according to the RBI Act, with terms lasting four years.
- ✓ **Functions of RBI:**
  - **Issuer of Bank Notes:** The RBI has the exclusive authority to issue currency notes, except for the 1 Rupee note and coins, which are issued by the Government of India.
  - **Banker to the Government:** The RBI serves as the financial agent and advisor to both the Central and State Governments. It manages government accounts, keeps deposits, provides short-term loans without interest, buys and sells Government Securities, and offers monetary advice.
  - **Bankers' Bank:** The RBI acts as the banker to all Scheduled Commercial Banks (SCBs). It maintains their reserves in the form of Cash Reserve Ratio, provides financial assistance against mortgaged securities, and rediscounts bills of exchange.
  - **Lender of the Last Resort:** In times of financial crisis, the RBI provides financial assistance to SCBs when they are unable to meet their financial obligations through regular channels.
  - **Custodian of Forex Reserves:** The RBI maintains foreign exchange reserves to stabilize the external value of the Indian rupee and promote international trade.
  - **Credit Control:** Using monetary policy tools, the RBI regulates money supply to control inflation or deflation and stabilize prices in the economy.
  - **Banking Regulator:** Under the RBI Act (1934) and Banking Regulation Act (1949), the RBI has the authority to regulate banks. This includes licensing banks, setting capital and reserve requirements, and ensuring the overall health of the banking system.
  - **Promotional Functions:** The RBI promotes the financial system by expanding the presence of commercial banks, encouraging banking habits, fostering financial inclusion, educating consumers.
  - **Supervisory Functions:** RBI holds the authority to issue licenses for establishing new banks, opening new branches, setting minimum reserve requirements, inspecting the operations of commercial banks both in India and abroad, and providing guidance to commercial banks within the country.
- ✓ **RBI Surplus:** The RBI is not liable to pay income tax and transfers its surplus to the government as per Section 47 of the RBI Act, 1934. Its total expenditure is much lower than net interest income, leading to surplus generation. Following the Malegam Committee's 2013 recommendations and the revised Economic Capital Framework by the Bimal Jalan committee in 2014-15, the RBI increased its surplus transfer to the government.
- ✓ **Minimum Reserve System of RBI:** The RBI follows the Minimum Reserve System for issuing currency notes. According to this system, the RBI must maintain a minimum reserve of gold and foreign securities worth ₹200 crore, with at least ₹115 crore in gold. The RBI is permitted to issue currency notes exceeding this minimum reserve based on economic demands and requirements.

✓ **Incomes and Expenditures of the RBI:**



2. Commercial Banks

- ✓ Commercial banks accept deposits and provide loans and credit facilities to individuals and businesses.
- ✓ They also offer services like payments, investments, and foreign exchange.
- ✓ Regulated by the central bank, they aim to generate profit while ensuring banking system stability.
- ✓ Assets include loans, investments in securities and reserves held by the bank as a percentage of total deposits. Liabilities consist of deposits from customers and bonds.
- ✓ Subdivision of Commercial Banks:
- ✓ **Public sector banks:**
  - Public sector banks are those where the government owns more than 50% of the total shares, and it sets the financial guidelines for their operations.
  - These banks operate under government oversight to ensure depositors' trust and the safety of their funds.
  - The largest public sector bank in India is the State Bank of India.
  - These banks focus on public welfare by offering customer-friendly schemes and charge lower fees compared to private banks.
  - Prominent Public sector banks include, SBI, PNB, Canara Bank, Bank of India, UCO Bank etc.
  - The FSIB, a government body under the Department of Financial Services (DFS) in the Ministry of Finance, is responsible for identifying and selecting talent for senior positions at government-owned financial institutions. It replaced the Bank Board's Bureau (BBB), which was deemed ineffective.
  - **Domestic Systemically Important Banks (D-SIBs):** They are Indian banks that are "too big to fail" domestically — meaning their failure can severely affect the financial system and economy of the country. They are identified and regulated by the RBI under Basel III guidelines. It includes SBI, ICICI & HDFC.

- ✓ **Private Sector banks:**
  - They are financial institutions owned and managed by private individuals or corporations, with the goal of generating profits for their shareholders.
  - Notable private sector banks in India include Axis Bank, Yes Bank.
- ✓ **Foreign Banks:**
  - They are financial institutions headquartered outside of India but with branches or subsidiaries operating within the country.
  - As part of global banking networks, they offer a wide array of financial services similar to domestic banks.
  - These banks primarily serve multinational corporations, foreign businesses, high-net-worth individuals and Indian customers.
  - Some prominent foreign banks operating in India include HSBC, CitiBank.
- ✓ **Regional Rural Banks:**
  - They were established in 1975 based on the recommendations of the Narasimhan Committee on Rural Credit.
  - This led to the enactment of the Regional Rural Banks Act in 1976.
  - They are regulated by the RBI and supervised by the National Bank for Agriculture and Rural Development (NABARD).
  - The equity of RRBs is distributed as follows: 50% is owned by the central government, 35% by sponsor banks and 15% by state governments.
  - They are managed by a Board of Directors, which includes one Chairman, three Directors nominated by the Central Government, up to two Directors nominated by the State Government, and up to three Directors nominated by the sponsor bank.
  - Overall, RRBs must allocate 75% of their total credit to priority sector lending.
  - The funds of RRBs come from owned funds, deposits, borrowings from NABARD, sponsor banks and other sources such as SIDBI and the National Housing Bank.

Lead Bank Scheme (LBS):

- ➢ Introduced in 1969 on the recommendation of the Gadgil Committee to enhance financial inclusion in rural and semi-urban areas by the RBI.
- ➢ Under this, a designated commercial bank (Lead Bank) is assigned to each district to coordinate the efforts of all banks and government agencies in that area to expand banking services and credit facilities.
- ➢ The Lead Bank is responsible for preparing the District Credit Plan, conducting State Level Bankers' Committee (SLBC) and District Consultative Committee (DCC).

3. Cooperative Banks

- ✓ Cooperative banks are financial institutions founded on a cooperative basis to conduct regular banking activities, such as accepting deposits and granting loans.
- ✓ These banks are formed by community members who pool funds to offer loans to each other at favourable terms.
- ✓ They are regulated under the Cooperative Societies Act or the Multi-State Cooperative Societies Act, 2002.
- ✓ Cooperative banks are governed by the Banking Regulations Act, 1949 & the Banking Laws (Cooperative Societies) Act, 1955.