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Paper 3 – Volume 1

Economy

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G.S. PAPER – 3 VOLUME – 1

ECONOMY

1 CHAPTER National Income

- **National income:** The total value of **final goods and services produced by the normal residents during an accounting year, after adjusting depreciation.**
  - It is Net National Product (NNP) at Factor Cost (FC)
  - It does not include taxes, depreciation and non-factor inputs (raw materials)
- Also **useful in determining the country's progress.**
- It Includes: **Wages, interest, rent, and profit received** by components of production such as: **labour, capital, land, and entrepreneurship**
- **Domestic Income:** Total value of final **goods and services produced within a domestic territory** during an accounting year, **after adjusting depreciation.**
  - **It is NDP at Factor Cost.**
- **Both NNP and NDP can be measured at constant prices (real income) or market prices (nominal income)**
- **National income: Domestic Income + NFIA**

Some Important Terms	
Factor Cost	● **Total cost of all the factors of production** consumed or used in producing a good or service.
Basic Price	● **Amount a producer receives from a purchaser** for a unit of a good or service provided **as output, minus any tax due and any subsidy due** on that unit as a result of its production or sale.
Market Price	● Price at which **a thing is sold in the market**. ● **Covers wages, rent, interest, input prices, profit, & other costs of production**. ● Also **covers government-imposed taxes** & government-provided producer **subsidies**.
Depreciation	● The **wear and tear of capital assets** ● **Capital consumption allowance** - another term for depreciation.
Transfer Payments	● A **monetary payment** for which **no goods or services are exchanged.** ● **Efforts by local, state, and federal governments to redistribute money to individuals in need** are usually referred to as transfer payments. ● **Transfer payments** such as Social Security and unemployment insurance are popular in the United States. ● **Transfer payments are not typically used to describe corporate bailouts and subsidies.**

Aspects of National Income

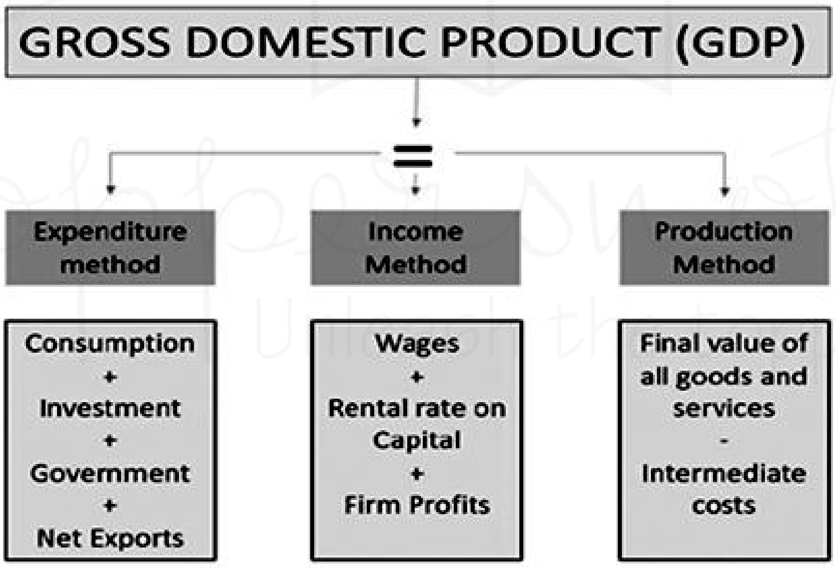
Gross Domestic Product (GDP)

- Total value of **goods and services produced in a country.**
- Economic indicator used to **gauge a country's economic growth**.

- Estimated **at regular periods** (such as quarterly, yearly).
    - For India it is from **1st April to 31st March.**
- **Production area for calculation of GDP** includes
    - A **country's geographical borders** including its **Exclusive Economic Zones (EEZ)** (up to 200 nautical miles or 360 kms)
    - A **country's embassy** in different nations
    - **Production in moving vehicles** like ships, aircraft, etc.
- **Goods included:** all final goods and services **produced by the normal residents and non-residents in the domestic territory** of the country
    - does **not include Net Factor Income from Abroad** (NFIA)
- **Calculated by Central Statistics Organization,** Ministry of Statistics and Programme.
- **'Quantitative concept'** and indicates **internal strength of the economy**.
- **Used by the IMF & World Bank** in **comparative analyses** of member economies.

GDP = consumption + investment + government spending + exports - imports

Methods for Calculating GDP



Nominal GDP	Real GDP
• Total financial business value **produced inside the country.** • **Without Inflation** adjusted. • At **Current year prices.** • **High Worth** • Compares quarters of a year.	• GDP metric adjusted: With changes in the general price level. • **Inflation-adjusted** • At **regular prices** • **Low Worth** • Compares two or more FYs
Nominal GDP = Current Year Production ✕ Current Year Price	**Real GDP = Current Year Production ✕ Base Year Price**
• does **not truly indicate the real performance** of economy	• only **change in real production of goods and services** is captured.

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.**

GDP Deflator = Nominal GDP / Real GDP

GDP Growth Rate:

- Measures **how fast the economy is growing**.
- Measures the **change in GDP in two consecutive years** or quarters.

GDP Growth Rate = 100 x [(GDP current year/quarter – GDP prev. year/quarter) / GDP prev. year/quarter]

- **Real Economic Growth Rate** takes into account the **buying power** and is **inflation-adjusted.**

GDP at Factor Cost (GDPFC)

- Factor cost is the cost of producing a commodity. It includes the cost of land, labour, capital and the profits of the producer.

GDP at Market Price (GDPMP)

- Market price includes net indirect taxes along with the factor cost. (Net indirect tax is the difference b/w total indirect tax and subsidies)

GDPMP = GDPFC + Indirect tax - Subsidy

Gross Value Added (GVA)

- **economic productivity metric** that measures contribution of a corporate subsidiary, company, or municipality to an economy, producer, sector, or region.
- **used to adjust GDP** and measure how much money a product or service has contributed toward meeting a company's fixed costs.

GVA = GDP + Subsidies - Taxes

Net Domestic Product (NDP)

- **Net worth** of all goods and services **generated inside a country's geographic borders.**
- **Value of depreciation** of national capital assets such as **machinery, houses, and cars is subtracted** from the GDP to calculate NDP
- **Other considerations:** such as asset **obsolescence and complete destruction**, also taken into account by the NDP.

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

- **Significance**
  - To understand the historical **situation of the loss** due to depreciation to the economy.
  - To **understand and analyze the sectoral situation** of depreciation in industry and trade in comparative periods.
  - **Showcase the achievements of the economy** in the area of R&D, which have tried curing the levels of depreciation in a historical time period.

Gross National Product (GNP)

- **Total value of all goods and services** produced by citizens and enterprises in a country, regardless of **where they are produced**
- It is the **GDP of a country added with its income from abroad.**
- **' Income from Abroad' includes:**
    - **Trade Balance:** net outcome at year end of the total exports and imports of a country
    - **Interest on External Loans:** balance of **interest on the money lent by the country and the interest on the money it has borrowed** from other countries.
        - **India** has always been a **'net borrower'** from the world economies.
    - **Private Remittances:** account of the **'private transfers' by Indians working abroad** (to India) and **foreign nationals working in India** (to their home countries).

GNP(Y) = Consumption expenditure (c) + Investment (I) + Government expenditure (G) + Net exports (X) + Net income from Abroad(Z).

- **Y = C + I + G + X + Z**

- **Factors to GNP: Manufacturing** of items such as **equipment, machinery, agricultural products, and cars** & some services such as **consulting, education, and health care.**
- **The cost of delivering services** is **not calculated.**
- When **a citizen holds dual citizenship** : **GNP per capita** is utilized to calculate GNP on a **country-by-country basis**.
- In that situation, their **earnings are counted twice**, as each country's GNP.

Net National Product (NNP)

- **Value generated by removing depreciation** from the gross national product.
- **Determines how much a country can consume** in a specific time span.

NNP = GNP – Depreciation

or

NNP = GDP + Income from Abroad – Depreciation

- When a country's net national product **(NNP) dips or falls**,
    - Businesses **contemplate shifting to industries** that are **considered recession-proof.**

Personal Income	● Amount of **money earned collectively by the citizens of a country**. ● **Ex.: Money** obtained from **employment, dividends and distributions paid by investments, rents derived from property ownership, and profit sharing** from enterprises. ● Taxation is imposed on personal income in most cases. **PI = National Income – Undistributed Profits – Net interest paid by households – Corporate tax + Transfer payments to the households from the government and firms**
Personal Disposable Income	● **Income available to the households** that they can spent as they wish ● Income available after payment of taxes and other non-tax payments **PDI = PI – Personal tax payments – non-tax payments**

National Disposable Income	• **sum of the gross (or net) disposable incomes** of the institutional sectors. **Gross (or net) NDI = gross (or net) national income (at market prices) - current transfers payable to non-resident units.**

Methods of computing National Income

Income Method	• Estimated **by adding all production factors** (rent, salary, interest, profit) & **mixed-income by self-employed.** • We add all net income payments received by all citizens of a country in a given year using this procedure. • **Net incomes from all factors of production** are added. ○ **Eg: net rents, wages, interest, and profits**. • **Income received** in the form of **transfer payments** is **not included.** **Net National Income = Compensation of Employees + Operating surplus mixed (W +R +P +I) + Net income + Net factor income from abroad.** Where, ■ W = Wages and salaries ■ R = Rental Income ■ P = Profit ■ I = Mixed Income

Product/Value Added Method	• **Aggregate value of final goods and services** produced in a country **throughout a financial year** at market prices.
	• **To calculate GNP**,
	  ○ data from all productive activities are gathered and analysed, including :
	    ■ **agricultural goods,**
	    ■ **minerals, and**
	    ■ **industrial products**
	    ■ Contributions to production **made by transportation, insurance, communication, attorneys, doctors, and teachers, etc.**
	National Income = GNP – Cost of Capital – Depreciation – Indirect Taxes

Expenditure Method	• National Income is **measured as the flow of expenditure.**
	• **Total expenditure** by the society summed up includes:
	  ○ **Personal consumption expenditure,**
	  ○ **Net domestic investment,**
	  ○ **Government expenditure on goods and services, and**
	  ○ **Net foreign investment.**
	National Income = National Product = National Expenditure

Standing Committee on Economic Statistics

- **Constituted by:** Ministry of Statistics and Programme Implementation (MOSPI)
- **Chairman:** former **Chief Statistician**
- **Functions**
  - **Analyse and Develop:** country's surveys on employment, industry, and services.
  - **Look at the current framework** of data sources, indicators, and definitions.
    - For **index of industrial production, periodic labour force surveys, time use surveys, economic censuses, and unorganised sector statistics**.
  - **4 standing committee**s on : labour force statistics, industrial statistics, services sector, and unincorporated sector firms will be absorbed into the SCES.
  - **108 economists and social scientists** expressed worry over **"political involvement"** in influencing statistical data in India.
  - **Appealed for the statistical organisations' "institutional independence**" and integrity to be restored.

2 CHAPTER

MONEY AND MONEY SUPPLY

Evolution of Money

Barter system	***Exchange of commodities with the mediation of money*** ● No concept of money and banking.
Concept of Money	***"Money is the most commonly accepted medium of exchange"*.** ● Any object accepted as **means of payment** ex. Currency, coins etc. ● **Money acts as a facilitator only**, not a necessity.

Functions of Money

Unit of exchange	● To **measure the values of all goods and services**. ● **Expressed in Price** (Monetary value/unit of good or service). ● **Eg:** In India Rupees per unit of a good (kilogram, liter etc.)
Medium of exchange	● Object that is **accepted as a form of payment**. ● It indicates the freedom of choice that use of money offers (whatever goods and services). ● This function is available properly if the value of money remains constant.
Standard of Deferred Payments	● For deferred of future payments. ● Ex. **pensions, principle and interest on debt**, salaries etc.
Store of Value	● Can be kept and later exchanged for products and services ● Money holders have a broad range of purchasing power. ● Bonds, property, and houses, Ex: can all serve the same purpose as money.

Classification of Money

Full-bodied Money

- Money whose value as a commodity for non-monetary purposes is as great as its face value.
- Ex. **gold, silver, cattle** etc.

Representative Full-bodied Money

- Type of money which is **made of paper**.
- **Advantage- convenient to engage in trade** which requires large sums of money.

Credit Money

- **Money** whose **value is more than the commodity value** of the material from which money is made.

Types of Money

Reserve Money	● **Most important element** of the RBI's monetary policy. ● **RBI: issues currency notes** in denominations of Rs. 2, 5, 10, 20, 50, 100, and 2000 rupees. ● **RBI(On behalf of the Indian government) :** ○ Issues currency in the form of **1 rupee notes and coins** & smaller denomination coinage. There are **6 types** of Reserve Money : ● RBI's net credit to the government. ● RBI's net credit to the Banks. ● RBI's net credit to the commercial banks. ● Net forex reserve with the RBI. ● Govt's currency liabilities to the public. ● Net non-monetary liabilities of the RBI.
Narrow Money	● All physical money, such as coins and cash, as well as demand deposits and other liquid assets held by the RBI. ● **Narrow Money (M1) ➔ Currency + Bank Money held by the people.** ● It excludes public time deposits in the banking system, ○ They are income-producing assets and hence are not liquid.
Near Money	● Some financial assets, such as currency notes and chequable deposits, may not be as liquid. ● **Ex. : Time deposits, Bankers Acceptances, Bills of Exchanges,** government and private bonds, Saving certificates, Shares, and other financial instruments, ● **Have power of money** but are **unable** to perform immediate economic activities. ● Highly liquid(can be easily converted into money). ● **Eg:** ○ **Savings account,** ○ **Money funds,** ○ **Bank time deposits (certificates of deposit),** ○ **government treasury securities (such as T-bills),** ○ **Bonds near their redemption date,** ○ **Foreign currencies like US dollar, euro or yen.**
Hard Money	● M**oney issued with the backing of gold** or other very credible assets. ● Hard money avoids the risks of inflation.
Soft Money	● **Paper currency backed by government bonds**. ● **Money printed without sufficient reserves,** like gold, in proportion to the new money. ● Under soft money, there is a **stronger element of inflation.**
Fiat Money	● **Fiat money refers to banknotes and coins.** ● They don't have the same inherent worth as a gold or silver coin.

	● aka **legal tenders**, ○ No citizen can refuse to accept them as payment.
Hot Money	● Funds: flow into a country to take advantage of the country's favourable interest rates. ● They have an impact on the recipient country's balance of payments and enhance the exchange rate.
Legal Tender Money	● **RBI Act of 1934 : grants** RBI **sole authority to create bank notes.** ● Legal tender for currency notes is infinite. ● When fiat money is legally recognised for all debts and transactions across the country, it is called as "legal tender."

- **Monetization:** The process of **transforming something into money**.
  - **In banking:** The process of converting or establishing anything into legal tender.
- **Demonetization:** Demonetization is the process of removing the legal tender status of a monetary unit.
  - The **present form or forms of money are withdrawn** from circulation and **replaced with new notes or coins.**

Cryptocurrencies and Bitcoin

- **Type of digital or virtual currency** that serves as a medium of transaction.
- **not issued by a central authority** and **does not exist in physical form** (like paper money)
- **Bitcoin : f**irst decentralised cryptocurrency, released as open-source software in 2009.
- Other popular cryptocurrencies : **Ethereum, Ripple, NEO, Litecoin, Bitcoin Cash, Libra, Binance Coin etc.**

Central bank digital currency

- **RBI** recommended broadening the definition of **"bank note" to include digital currency.**
- **CBDC:** A **digital version of fiat currency that may be exchanged via blockchain-backed wallets** and is **controlled by the central bank**.
- Digital type of **legal money issued by a central bank.**
- **Based on bitcoin**, but **it differs from decentralised virtual currencies and crypto assets**, which are not **created by the government** and are not "legal tender."
- **Fiat Money:** A **government-issued currency** not backed by a commodity such as gold
- **Central banks have more power over the economy** since they can regulate how much money is produced using fiat money.

Need

- **Addressing the Malpractices:** RBI may control malpractices by regulating digital money.
- **Addressing Volatility:** Since the value of cryptocurrency is solely determined by speculation (demand and supply), thus becoming extremely volatile.
- **Digital Currency Proxy War:** In the digital era, to push back against the inevitable proxy war which

threatens our national and financial security.

- **Reducing Dependency on Dollar:** gives India the potential to build Digital Rupee as a superior currency for commerce with its strategic partners, reducing its reliance on dollar.
- **Advent of Private Currency:** If private currencies gain acceptance, national currencies with limited convertibility are likely to be threatened.

Significance

- **Lower the cost of currency maintenance** while allowing real-time payments to be made without the need for interbank settlement.
- **Cost of printing, transporting, and storing paper currency can be significantly reduced.**
- It will also **reduce the public harm caused by the use of private virtual currency.**
- It will **allow users to execute domestic and cross-border transactions** without the involvement of a third party or a bank.
- It has the **potential to deliver major benefits**, such as less reliance on currency, increased seigniorage owing to lower transaction costs, and lower settlement risk.
- It might also lead to **a more stable, reliable, trustworthy, regulated, and legal tender-based payment method.**

Issues

- **Problem in RBI's Scrutiny:** The scope of CBDCs, the underlying technology, the validation procedure, and the distribution architecture.
- **Legal adjustments will be required**, as the present provisions of RBI Act were designed with cash in a physical form in mind.
- **Amendments required:** Coinage Act, the Foreign Exchange Management Act (FEMA), and the Information Technology Act.
- Another source of concern is the **sudden flight of money from a bank during a period of stress.**

Recent Developments

- **El Salvador:** The world's first country to accept Bitcoin as legal cash.
- **The United Kingdom:** Looking into the possibility of establishing a central bank digital currency (Britcoin).
- **China:** Testing its official digital money, dubbed "Digital Currency Electronic Payment, DC/EP" unofficially, in 2020.
- **After digital currencies were used in frauds, the RBI banned banks and other regulated entities from supporting crypto transactions in April 2018.** The restriction was **declared unlawful by the Supreme Court in March 2020.**

Way Forward

- India will be able to **empower its citizens by allowing them to freely use the digital rupee** in our ever-expanding digital economy and breaking free from an obsolete banking system.
- **Policymakers must properly assess the potential of the Digital Rupee in India**, taking into account its influence on the macroeconomy and liquidity, banking systems, and money markets.

Money Supply and Monetary Aggregates

Money Market

- **A group of financial organisations** that deal in short-term securities, loans, gold, and foreign currency.
- **Trades in financial assets** with maturities ranging from one day to one year.
- Commercial banks are the **primary money lenders**
- **Incharge: RBI.**

Components of Money Market in India

Organised Sector	Unorganised Sector
• Call and Notice Money Market • Treasury Bills Market • Commercial Bills Market • Market for Certificate of Deposits (CDs) • Market for Commercial Papers (CPs) • Repo Market • Money Market Mutual Funds (MMMFs) • Discount and Finance House of India (DFHI)	• Indigenous Bankers • Money Lenders • Unregulated Non-Bank Financial Intermediaries (Chit Funds, Nidhi's and Loan Companies) • Finance Brokers

Organised Sector

Call and Notice Money Market	• Deals with One-day loans, aka. call loans or call money, are a type of short-term loan. • Banks, both lending and borrowing, are the main participants.

Treasury Bills Market	• **Short term liability** of the Central Government.
	• **2 types**
	  ○ **Ordinary Treasury Bills:** issued to provide investment outlets to state governments, semi-government departments, and other entities.
	  ○ **Ad hoc Treasury Bills:** issued to provide investment outlets to :
	    ■ state governments,
	    ■ semi-government departments,
	    ■ And other entities.
	    ■ Freely tradable & can be sold to the general public or to banks.
	• Treasury bills are **issued by the government whenever funds are required** (issued for not more than 12 months).

Commercial Bills Market	• **Firms in the business :** issue these certificates. • **Goal:** To compensate the seller while the buyer delays payment. • The discount rate on invoices is the interest rate charged.
Market for Certificate of	• **Introduced by the RBI in 1989.** • Issued by a bank or other entity that accepts short-term deposits.

Deposits(CDs)	● **Similar to term deposits,** except they can be traded in the short-term money market. ● Commercial banks are not allowed to issue CDs. ● **Only 6** Financial institutions - **IDBI, IFCI, ICICI, SIDBI, EXIM and Indian Reconstruction Bank of India**.
Market for Commercial Papers(CPs)	● **Introduced in India in 1990.** ● CP is a tool used by corporations to raise short-term cash. ● A listed business with at least Rs 5 crore in working capital can issue CPs. ● Other requirements include a **CRISIL P2 or ICRA A2 rating every 6 months.**
Repo Market	● **A money market instrument.** ● Holders sell securities to an investor with the commitment to repurchase them at a predetermined pace. ● Securities are purchased with a simultaneous promise to resell at a **predetermined rate** in a **reverse repo transaction**. ● Repo market **instruments** ○ **Government securities,** ○ **treasury bills,** ○ **State Government securities,** ○ **PSEs bonds** ○ **Private corporate securities.**
Money Market Mutual Funds(MMMFs)	● **Similar to mutual funds** but in the short term. ● **Introduced by the RBI in 1992.** ● Banks, public financial institutions, and private sector institutions : permitted to establish MMMFs.
Discount and Finance House of India(DFHI)	● **Set up by the RBI in 1988.** ● Development of the money market and provision of liquidity for money market instruments.

Unorganised Sector

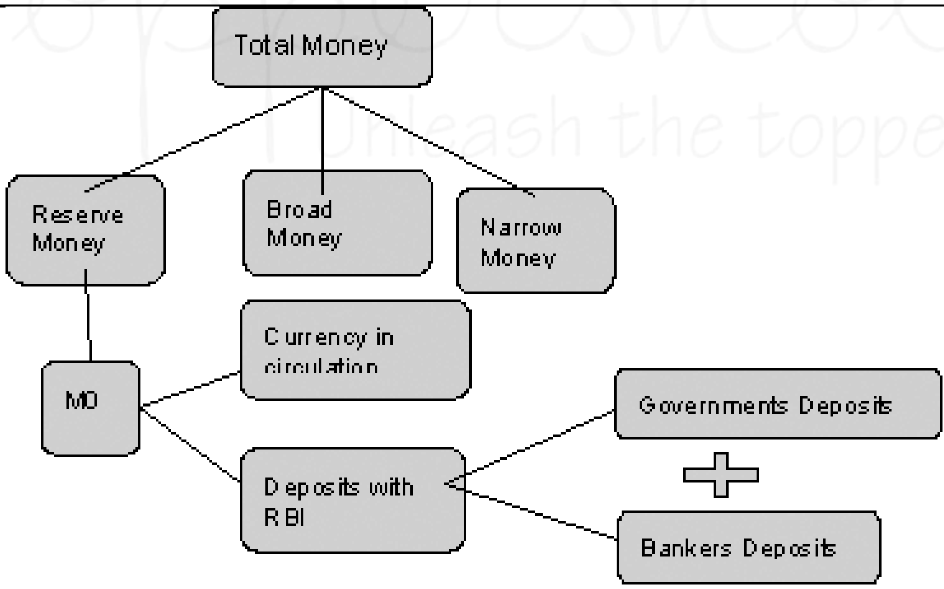
Money Lenders	● Constitute **India's most localised money market** and operate in the most exploitative manner. ● **Person-to-person loan** with some form of collateral.
Unregulated Non-Bank Financial Intermediaries	● **Organizations :** Although it provides bank-related financial services, it lacks banking licensing. ● **Chit Funds** : ○ popular type of savings institutions. ○ Refers to a group of people agreeing to contribute a specified amount over time in installments.

	○ Under the **Chit Funds Act of 1982**, the separate State government manages, conducts, and regulates the funds. ● **Nidhi companies** : ○ Regulated by The **Ministry of Corporate Affairs under Companies Act, 1956.** ○ A class of NBFCs, RBI can issue directives for them. ○ Deals with their **shareholder-members only.** ○ **Exempted** from the core **provisions of the RBI Act.**

Money Supply

- Amount of money in circulation in a given economy at any given time.
- **Except** for the State Treasury, Central Bank, and Commercial Banks, it is the total stock of money held by people, which includes individuals, businesses, the government, and its constituent bodies.
- **System of notes issued and adopted** by a country determines the amount of money available in that country.
  - For instance, India adopted the Minimum Reserve System in 1957.
  - **RBI :** To maintain a **minimum reserve of Rs.200 Crores;** consisting of :
    - **Gold** (the value of gold should not be less than Rs.115 Crores).
    - **Foreign securities**.

Note: Bank money is considered as secondary money whereas cash money is k/a high powered money.



Money Multiplier

- It calculates **how much money banks can create** in the form of deposits for every unit of money they maintain as reserves.
- It is **Broad money (M3) ÷ Reserve Money (M0).**
- When Reserve money rises, Broad money rises with it.
- It explains **how a little initial deposit leads to a larger overall growth** in the money supply.
- It shows the **extent to which changes in the quantity of deposits affect the money supply.**

Monetary Aggregates

- **M1 = Currency with the public + Demand deposits with the Commercial Banks + Other deposits with the RBI.**
- **M2 = M1 + Post Office Savings Bank Deposits.**
- **M3 = M1 + Time Deposits with the commercial banks.**
- **M4 = M3 + Total Post Office Deposits (excluding NSCs).**

- **Narrow Money (M1) = Currency with the public + Demand Deposits of public in Banks**
- When a third component i.e. Post office Savings Deposits is also added to M1, it becomes M2.
- **Broad Money (M3) = M1 + Time deposits with the banking system.**