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General Studies

Volume 7

Economy

SIERRA INNOVATIONS

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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

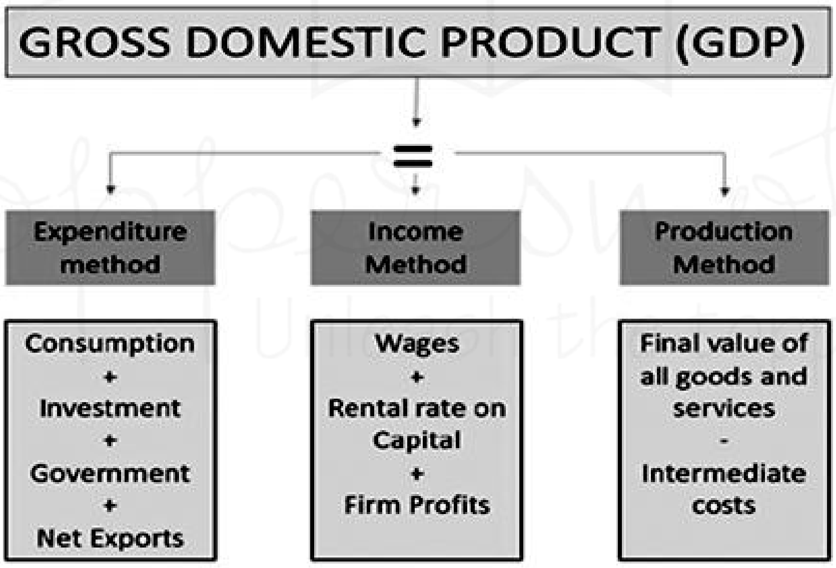
Gross Domestic Product (GDP)

- 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

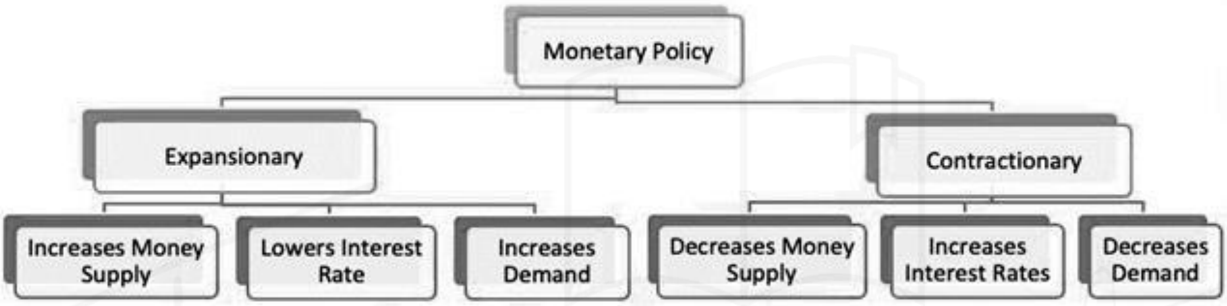
Expenditure Method	• National Income is **measured as the flow of expenditure.**
	• **Total expenditure** by the society summed up includes:
	  ○ **Personal consumption expenditure,**
	  ○ **Net domestic investment,**
	  ○ **Government expenditure on goods and services, and**
	  ○ **Net foreign investment.**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

- **A macroeconomic policy that regulates the amount of money in the economy.**
- **Reserve Bank of India (RBI) : controls the money supply** in India through quantitative and qualitative instruments.
- The **overall volume of credit [Money Supply]** is influenced by quantitative instruments.
- **RBI : Uses qualitative mechanisms**
  - **To impact loan availability** among various sorts of borrowers.
  - Also **prioritises inflation and economic growth.**



Quantitative Tools

Statutory Liquidity Ratio (SLR)	● **%age of deposits that banks must maintain** in highly liquid government securities.**(Gold or Govt. securities)** ● **Current status:** 18% (Dec. 2021)
Cash Reserve Ratio (CRR)	● **Determined by:** The **Monetary Policy Committee of the RBI.** ● Banks must deposit a set %age of their net demand and time liabilities (NDTL) with the Reserve Bank, as determined by the RBI. ● **Interest:** banks do not get any interest on money held by the RBI. ● **Current status:** 4 % (Dec. 2021) **Incremental CRR** A **100% incremental Cash Reserve Ratio (CRR) for the fortnight beginning November 26, 2016.**
Bank Rate	● E**conomy's benchmark interest rate.** ● **RBI's minimum lending rate to commercial banks** ● Used to communicate interest rate levels to commercial banks. ● The bank rate is **set at 0.25% over the repo rate by the RBI.** ● **Current status:** 4.25%(Dec. 2021)

Marginal Standing facility (MSF)	● **a penalty rate at which scheduled banks can borrow money** from RBI ○ In **excess of what they can borrow** through the LAF window. ● Its **rate is always set higher than the Repo rate.** ● **Goal:** to eliminate overnight lending rate volatility in the interbank market. ● **Current status:** 4.25%(Dec. 2021)
Liquidity Adjustment Facility	● **Commercial banks and primary dealers can use LAF** to borrow money via repurchasing agreements or repos/reverse repos. ● T**o assist banks** in correcting daily liquidity changes. ● It **enables banks to park surplus money** with the RBI in the event of excess liquidity. ● Also enables t**o obtain liquidity from the RBI on an overnight basis** against the collateral of government securities **in the event of a deficit.**
Repo Rate	● **Rate at which the RBI loans to commercial banks** to meet their short-term liquidity needs in exchange for a commitment ○ **To repurchase the same government assets** at a later date. ● **Current status:** 4% (Dec. 2021).
Reverse Repo Rate	● **Rate at which the Reserve Bank absorbs liquidity** from banks on an overnight basis. ○ **In exchange for qualified government securities** held as collateral under the LAF. ● **Lower rate than the repo rate.** ● **Current status:** 3.35%(Dec. 2021)

CRR Vs SLR		
Basic for comparison	**CRR**	**SLR**
Meaning	CRR is the percentage of money which the bank has to keep with the Central Bank of India in the form of cash.	The bank has to keep a certain percentage of their Net Time and Demand Liabilities in the form of liquid assets as specified by RBI.
Reserves in the form of	Cash	Cash and other assets like gold and government securities viz. Central and state government securities.
Effect	It controls excess money flow in the economy.	It helps in meeting out the unexpected demand of any depositor by selling the bonds.
Maintained with	RBI	Bank itself
Regulates	Liquidity in the economy	Credit growth in the economy
Interest on Reserve	Banks don't earn any interest on amount deposited on CRR	Banks can earn interest On SLR

LAF	MSF
Liquidity adjustment facility	Marginal standing facility
Minimum bidding amount is 5 cr.	1 cr.
All clients of RBI are eligible to bid.	Only scheduled commercial banks can bid.
Bank cannot sell Government security to RBI that is part of bank's SLR quota.	Bank can sell the government security from its SLR quota to RBI.
Bank can borrow any amount of money as long as it has the securities to sell.	Bank can maximum borrow upto 2% of its NDTL.
Suppose repo rate is "r%"	MSF lending rate is always (r+1)%

Open Market Operations

- OMO is **a credit policy component.**
- **OMO: Buying/Selling of government securities by RBI** to control money supply.

> **Government securities: 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 by sucking liquidity** out of the system.
- **Buying G-Sec: Increases the money supply in the market.**
  - **RBI** sells securities to **control Deflation by injecting liquidity** out of the system.

OMO's goal

- **To keep the economy's money supply under control.**
- **Carried out by commercial banks**, and the RBI does not deal directly with the general population.
- **One of the measures used by the RBI to level out liquidity** circumstances throughout the year.
- R**educe the impact on interest rates** and inflation.

Market Stabilization scheme

- **A monetary policy intervention: RBI sells government securities** in the economy to remove excess liquidity (or money supply).
- In April, **2004 : MSS started.**
- **Main function: To remove excess liquidity** or money from the economy by selling government bonds.
- MSS securities are **used to remove excess liquidity from the market** by issuing **Treasury Bills, Dated Securities, and other securities** on behalf of the government.
- The money obtained through the MSS is kept at the RBI.

Qualitative Tools

Margin Requirements	• It is the **difference b/w the current value of the collateral supplied** for a loan and the value of the loan issued.

	● Higher the margin, the smaller the loan. ● **Eg:** The margins will be reduced if the RBI believes that more credit should be given to priority industries.
Consumer credit Regulation	● **RBI regulates credit allocation** by commercial banks to various sectors. ● Ex: **RBI requires banks to issue 40%** of their credit to the priority sector.
Priority Sector Lending	● The RBI mandates **banks to lend a certain portion of their funds to specified sectors.** ● **Eg:** Agriculture, Micro, Small and Medium Enterprises (MSMEs), export credit, education, housing, social infrastructure, renewable energy among others. ● **Rationale:** To guarantee that **appropriate institutional financing reaches some of the economy's most vulnerable sectors,** which would otherwise be unattractive to banks in terms of profitability.
Moral suasion	● **Issue directives**, have meetings, use persuasion and pressure, do inspections, and follow up regularly.
Direct Action	● **Impose fines,** ● **ban non cooperating banks,** ● **refuse rediscounting of their bills,** ● **Refuse credit supply.**
Base Rate	● A **minimum rate below which banks are not permitted to lend** to their consumers. ● Following are the **primary components of the base rate system**: ○ **Cost of money** (interest rates offered by banks on deposits) ○ The **cost of keeping CRR running.** ○ **Earnings margin.** ○ Operating costs to keep the bank afloat. ● The 'repo rate' is not taken into account in the computations.
MCLR - Marginal Cost Of Funds Based Lending Rates	● **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. ● **calculated using 4 components** ○ **Funds' marginal cost of capital** ○ **Premium for tenors** ○ **Costs of operation** ○ **Negative carry** (due to a cash reserve ratio that is too high).
Net Demand and Time Liabilities	● It is the **difference b/w a bank's total demand and time liabilities** (deposits) (with the public or another bank) & the **deposits held by other banks** in the form of assets.

Government Securities (G-Sec)	● It's **a marketable instrument** issued by the federal government or individual states. ● Treasury Bills are **short-term G-secs** (with original maturities of less than one year). ● Government Bonds or Dated Securities are **long-term G-secs** (with original maturities of more than one year). ● **State governments do not issue Treasury Bills**, but both state and federal governments issue Government Bonds or Dated Securities.
Gross capital formation	● Refers to **the sum of gross additions to fixed assets** (fixed capital formation) plus changes in stocks over the counting period.'

 # Revised Priority Sector Lending guidelines

- **Start-ups can get up to Rs. 50 crores** from bank financing.
- **Loans to farmers** for solar power plant construction and solarisation of grid-connected agriculture pumps, as well as loans for the establishment of compressed biogas plants.
- **Farmers Producers Organisations (FPOs)** with guaranteed marketing of their goods at a fixed price have a higher credit limit.
- **The credit ceilings** for renewable energy, health infrastructure, and 'Ayushman Bharat' projects have been increased.
- **Aim:** To solve concerns related to geographical imbalances in the flow of priority sector credit at the district level.
- **Districts ranking according to their per capita loan flow to the priority sector.**
- **Creating a disincentive structure** for **districts with a large flow of priority sector lending** and an **incentive framework for areas with a low flow** of priority sector credit.
- PSL has been **given a higher weighting in 'designated areas,' where priority sector lending flow is comparatively low.**

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

Monetary Policy Committee

- **Establishment:** 2016.
- **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 in a five year.

- It is set by the Government of India, in consultation with the Reserve Bank.
- Current inflation target is pegged at 4% with -2/+2 tolerances till March 31, 2021.

- **3 month review:** If **inflation exceeds the target** for 3 months in a row.
  - **Repo Rate is reviewed and adjusted** by RBI on a regular basis in order to keep inflation under control.
  - A committee-based approach to monetary policy determination will bring a great deal of value and transparency to monetary policy choices.

Structure	**Members: 5 persons** ● **Chairman:** RBI governor. ● **Vice chairman:** RBI Dy.Governor.(Any 1 out of the total 4) **Other Members:** ● One Executive director of RBI **(Monetary policy incharge)** ● Two members from outside RBI. ○ **Term:** three years. ○ Cannot hold office of profit, ○ Cannot involve in work that has conflict of interest with RBI ○ Not eligible for re-appointment.
Decision making	● **Meetings:** Must meet once every two months. ● **Decision:** Majority voting ● Each person has one vote. ● Members cannot abstain from voting. ● **Tie breaker:** Casting vote power to Governor and Dy.Governor.
Transparency	● Must publish minutes of the meeting. ● Must publish Bi-annual report. ● In case of failure to contain inflation within the 2-6% range for three successive quarters, MPC will release a public statement signed by all members.

MONETARY TRANSMISSION

- The RBI by cutting the repo rate sends a signal to the rest of the banking system that the lending rates in the system should come down.
- **"Monetary policy transmission":** The process of repo rate cuts leading to interest rate cuts across the banking system.

LIQUIDITY MANAGEMENT FRAMEWORK

- **Liquidity Management:** The attempt of investors or managers to reduce liquidity risk exposure.
- **Function:** Liquidity, or a bank's capacity to meet cash and collateral obligations without incurring significant losses, is assessed.

- **Based on definition of liquidity, Liquidity management takes one of two forms:**
    - **One definition** of liquidity refers to **the ability to trade an asset**, such as a stock or bond, at its current price.
    - **The other definition of liquidity applies to large organizations**, such as financial institutions.
- **Banks** are often **evaluated on their liquidity, or their ability to meet cash and collateral obligations without incurring substantial losses.**

Urjit Patel committee

- **Formed by: RBI (**and not finance ministry)
- **Official name: Expert Committee to Revise and Strengthen the Monetary Policy Framework**
- **Chairman: Dr. Urjit Patel, Dy. Governor of RBI**

Recommendations

- **Shift to CPI (nominal anchor for inflation).**
- The target for **inflation is set at 4%.**
- Set within the frame of **a two-year duration.**
- **Inflation: predominant objective** of monetary policy.
- **Fiscal deficit as a ratio to GDP**: brought **down to 3%.**
- **Monetary policy decision -** be vested with a monetary policy committee (MPC)
- **Term of office of the MPC : 3 years** without prospect of renewal.
- **Fixed income financial products:** treated on a par with bank deposits for the needs of taxation and TDS.
- Need for a sharp **rise in the ratio of agricultural credit to agricultural GDP.**
- Necessity for subventions on interests: for lending in certain sectors to be re-visited.
- **Minimise volatility in capital inflows and outflows.**