

Bcom sem 3 gm notes for exam

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Unit 1

1. Definition of Money

Economics defines money from different perspectives:

* General Definition: Money is a universally accepted medium that is used to exchange goods and services.

* Prof. According to Walker: "Money is what makes money work." ("Money is what money does.")

* Prof. According to Marshall: "Money is any thing that is used at any time and place, without special inspection or assurance, in the purchase of goods and services or in the payment of debts."

* Prof. According to Crowther: "Money is something which is universally accepted as a medium of exchange and which acts as a measure of value and a store of value."

2. Functions of Money

According to economist Kinley, the functions of money are mainly divided into three categories:

(A) Primary Functions :

1. Medium of Exchange:

The biggest limitation of the barter system was the 'matching of needs'. Money has solved this problem.

People earn money by selling their goods or services and can buy goods or services of their choice with that money.

□ .Measure of Value / Unit of Account

Money is a yardstick to measure the value of all goods and services.

* The price of everything is fixed in financial units (such as in rupees), which makes it very easy to compare.

(b) Secondary Functions :

1. As a store of value:

In the barter system, it was difficult to store wheat, rice or cattle for a long time.

* Money can be easily stored as savings for future needs as its purchasing power is maintained.

□. Standard of Deferred Payments

* The modern economy runs on credit. Money has made it easier to calculate and repay future debts, loans or interest.

3. Instrument of Transfer of Value :

* The transfer of value or property from one place to another or from one person to another (e.g., selling land or building and buying it elsewhere) can easily be done through money.

(c) Contingent Functions :

* **Distribution of National Income:** The distribution of national income among the means of production (land, capital, labour, employer) in the form of rent, interest, wages and profits is possible only through money.

Marginal appeasement: Consumers and producers can use their limited money in a way that gives them maximum satisfaction or profit.

Basis of Credit: Cash reserves are the basis of cheques, drafts or loans given by banks and financial institutions.

□.Concept of Money / Narrow Money

In economics, the concept of money is understood on the basis of its liquidity.

*Legal Tender / Narrow Money

* This is money which is completely liquid and is considered to be universal by the law of the land.

* No one can refuse to accept it.

* Components of Money:

* Currency Notes and Coins: Cash issued by the Reserve Bank of India (RBI) and the government.

Demand Deposits / Bank Money: Money from current and savings accounts in banks can be withdrawn in cash at any time through cheque or debit card.

4. Concept of Near Money

Meaning:

'Near Money' or Quasi-Money is a financial asset which is not itself a direct medium of cash or exchange, but can be converted into cash in a very short time and without any significant loss.

Key features:

* Direct use is not possible: You can send FDs to the shopkeeper in the market. You can't buy things directly by giving a paper or shares of FD.

High Liquidity: It can be converted into cash very quickly.

* Interest or Returnable Assets: Cash does not yield interest, but there is some interest or return on the nearby money.

Examples of nearby money:

* Fixed Term Deposits (FDs): Term deposits kept in the bank can be cashed by paying or withdrawing penalties when required.

Government Securities / Treasury Bills: Short-term bonds issued by the government.

* Shares and Debentures: Securities of companies that can be easily sold in the stock market.

* Insurance Policies: Policies with surrender value.

* National Savings Certificates - NSC

5. Difference Between Money and Nearby Money (Quick Summary)

Acceptance: Money is a universally accepted medium of exchange; Whereas Near Money cannot be used for direct exchange.

* Liquidity: Money is 100% completely liquid; While the liquidity in the nearby money is slightly lower (it has to be converted into cash).

* Reimbursement/Interest: No interest on cash on hand; While close money pays interest or dividends to investors.

1. Meaning and Objectives of Demand for Money

Meaning:

Demand for money is the desire or need of people or businesses to keep money in the form of cash at a particular time. In economics, it is also called 'Liquidity Preference'.

Main Objectives of Demand for Money (Objectives/Motives):

People want to keep cash with them mainly for three main purposes:

1. Transaction Motive:

* Cash is needed to buy goods and services in daily life, pay bills, and meet daily expenses.

* Since there is a difference between the period of income and the period of spending, people keep cash on hand.

2. Precautionary Motive:

People save cash to deal with unforeseen and unforeseen situations (such as illness, accident, unemployment or family events).

3. Speculative Motive:

* People keep cash to make a profit from future changes in the price of interest rates and securities (bonds/shares).

2. Classical View on Demand for Money

According to classical economists (such as Adam Smith, David Ricardo, and most notably Irving Fischer), money is only a medium of exchange.

Key Ideas:

* People do not demand money to save money, but only to buy goods and services.

The demand for money is mainly based on the size of the nominal income and transactions.

According to the classical view, there is always a state of 'full employment' in an economy.

Irving Fisher's Quantity Theory Formula:

Fisher's basic formula for demanding money for transactions:

$$M \cdot V = P \cdot T$$

Or in the context of Demand for Money (MD):

$$M_d = (P \cdot T) / V$$

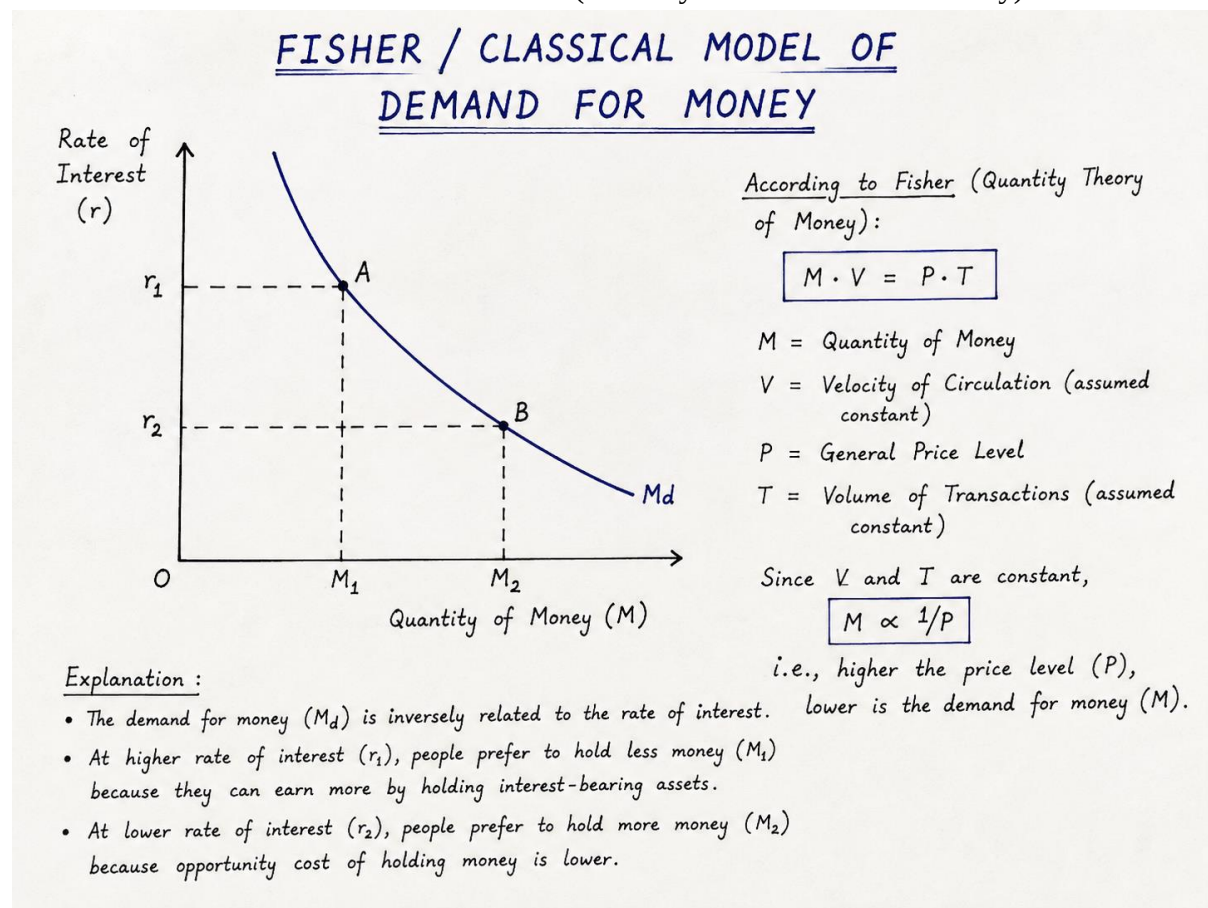
Where:

* MD = Total Demand for Money

* P = Price Level

* T = Total Volume of Transactions

* V = □□□□□□ □□□□□□ □□□ (Velocity of Circulation of Money)



Fisher's (Classical) Model of Demand for Money – Explanation of the Graph

Formula (easily copyable):

$$M_d = k \times (P \times Y) / r$$

or

$$M^d = k(PY)/r$$

Icons used in formula:

MD = Demand for real money

P = price level

Y = Actual income

r = Rate of Interest

k = Static parameter

Graph Explanation

The rate of interest (r) is shown on the vertical axis (Y-axis).

The demand for real money (MD) is shown on the horizontal axis (X-axis).

The Md line is a negative slope from left to right, indicating that there is an inverse relationship between interest rates and demand for money.

Point A

When the rate of interest is r_1 , the demand for money is M_1 .

Point B

When the interest rate is less than r_2 (less than r_1), the demand for money increases to M_2 .

Conclusion

When the rate of interest (r) increases, the demand for money (MD) decreases.

When the interest rate (r) falls, the demand for money (MD) increases.

So there is an inverse relationship between MD and R.

Therefore, the Md Curve has a negative slope.

An exam-oriented line

"According to Fischer's classical model, there is an inverse relationship between interest rates and the demand for money. Therefore, the curve of demand for money is a negative slope from left to right.

3. Keynesian View on Demand for Money

Lord John Maynard Keynes introduced the 'Liquidity Preference Theory' in his book 'Liquidity Preference Theory' in 1936. According to Keynes, money is not only a medium of exchange but also a store of value.

Keynes divides the demand for money into three parts:

1. Demand for Transaction and Precautionary Purposes (L1):

* The demand for money for both these purposes is mainly based on the income (Y) of the individual.

* Demand for cash for transactions and precautions increases as revenues increase.

Formula:

$$L1 = f(Y)$$

2. Demand for speculative purposes (L2):

This is Keynes's most important idea. The demand for speculative money depends on the rate of interest (r).

* There is an inverse relationship between the rate of interest and the demand for speculative money:

When interest rates are high, people tend to keep less cash and invest in bonds because of the high opportunity cost of keeping cash.

* When interest rates are low, people keep more cash with them by selling bonds (the demand for money increases).

Formula:

$$L2 = f(r)$$

Keynes Total Demand for Money Formula:

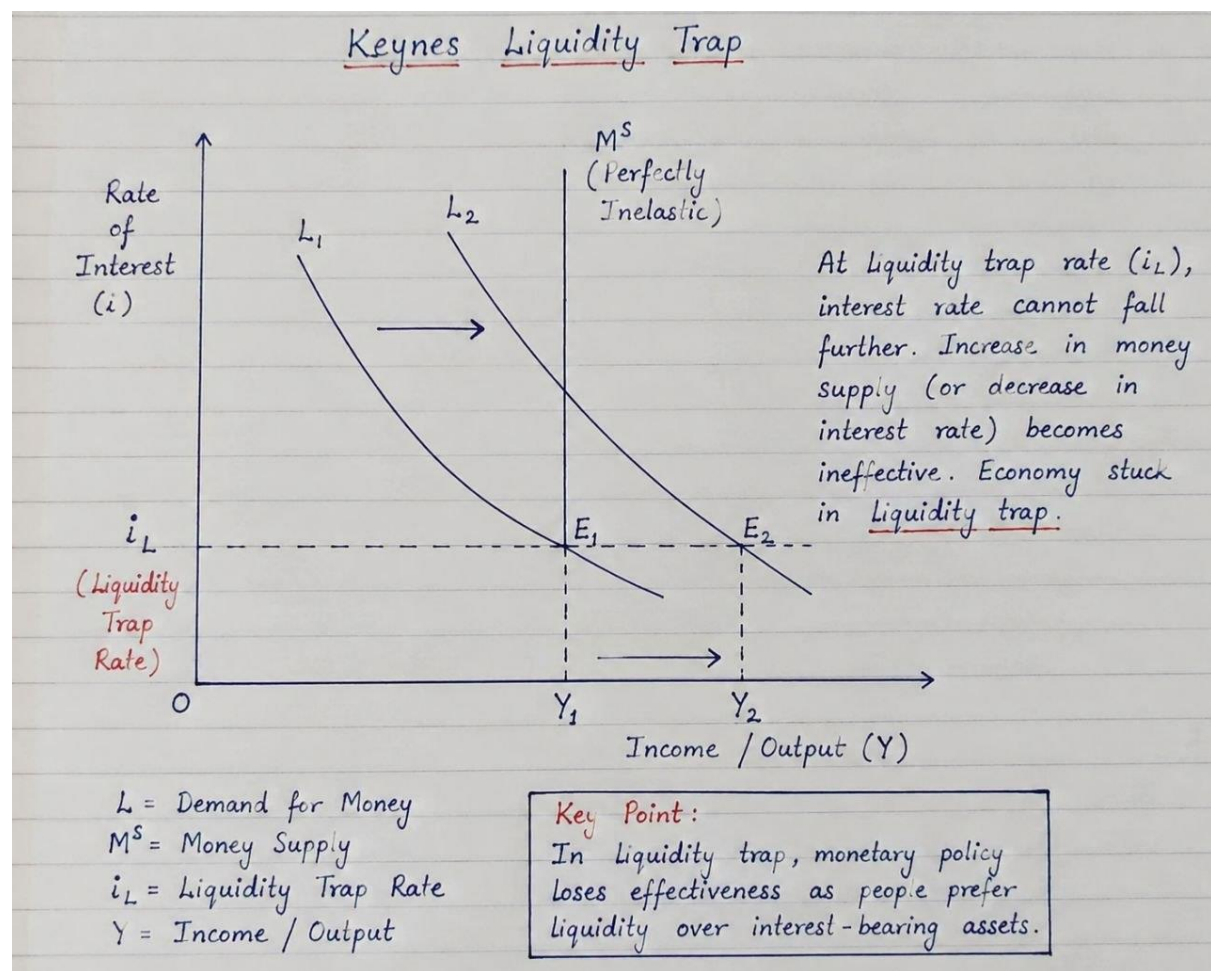
$$M_d = L_1(Y) + L_2(r)$$

or

$$M_d = L(Y, r)$$

Where:

- * MD = Total Demand for Money
- * L1 = Demand based on income (transaction + precaution)
- * L2 = Demand based on interest rate (speculative)
- * Y = National Income.
- * r = Rate of Interest



Keynes's Liquidity Trap – Graph Explanation

Formula

$$L = L(r, Y)$$

or

$$L = f(r, Y)$$

Icons used in formula:

L = Liquidity Preference

r = Rate of Interest

Y = Income

M = Amount of money

r_{min} = Minimum rate of interest

□□□□□□ □□□□□□ (Diagrammatic Explanation)

The rate of interest (r) is shown on the vertical axis (Y-axis).

The amount of money (M) is shown on the horizontal axis (X-axis).

L₁ and L₂ of money Demand Curves □□.

As income (Y) increases, the demand for money increases, so the demand curve moves rightwards from L₁ to L₂.

Liquidity Trap

When the interest rate drops to r_{min} (minimum interest rate), people prefer to keep more money in cash.

At this time, the amount of money increases from y₁ to y₂, but the interest rate remains constant at the r_{min}.

Due to this, the demand curve becomes horizontal.

This horizontal part is called a liquidity trap.

(Conclusion)

When interest rates reach R_{min}, people prefer to have cash rather than bonds or other investments.

Despite the increase in the amount of money, the rate of interest does not increase.

Since the interest rate is stable, the investment (I) does not increase.

Income (Y) and employment also do not increase due to lack of investment.

So merely increasing the money supply does not improve the economy.

An exam-oriented line

"According to Keynes's liquidity trap, when interest rates reach the lowest level, people put more money in cash. In such a situation, even as the amount of money increases, the rate of interest, investment and income does not increase."

4. Factors Affecting Demand for Money

The main factors influencing the demand for money are as follows:

* Level of Income: As the income of a person or country increases, transactions and consumption increase, which directly increases the demand for cash.

Rate of Interest: Interest rate is the cost of keeping cash in hand. If the interest rate increases, the demand for money decreases and if the interest rate falls, the demand for money increases.

* Price Level / Inflation: When the prices of goods and services increase in the market (inflation), more money is needed to buy the same things, so the demand for money increases.

* Payment System & Frequency: If the salary or income is received weekly or daily, then cash has to be kept less, but if it is monthly then more cash has to be kept.

* Availability of Credit and Digital Financial Tools: With the increase in facilities like credit cards, UPI, net banking, the need for people to carry physical cash on their hands has decreased.

* Future Expectations: If there is a fear of rising prices or a recession in the future, people prefer to keep more money in the form of cash as a precaution.

* Availability of Wealth and Financial Assets:

If there are more and safer investment options in the economy, such as stocks, bonds or mutual funds, people invest in them with less cash.

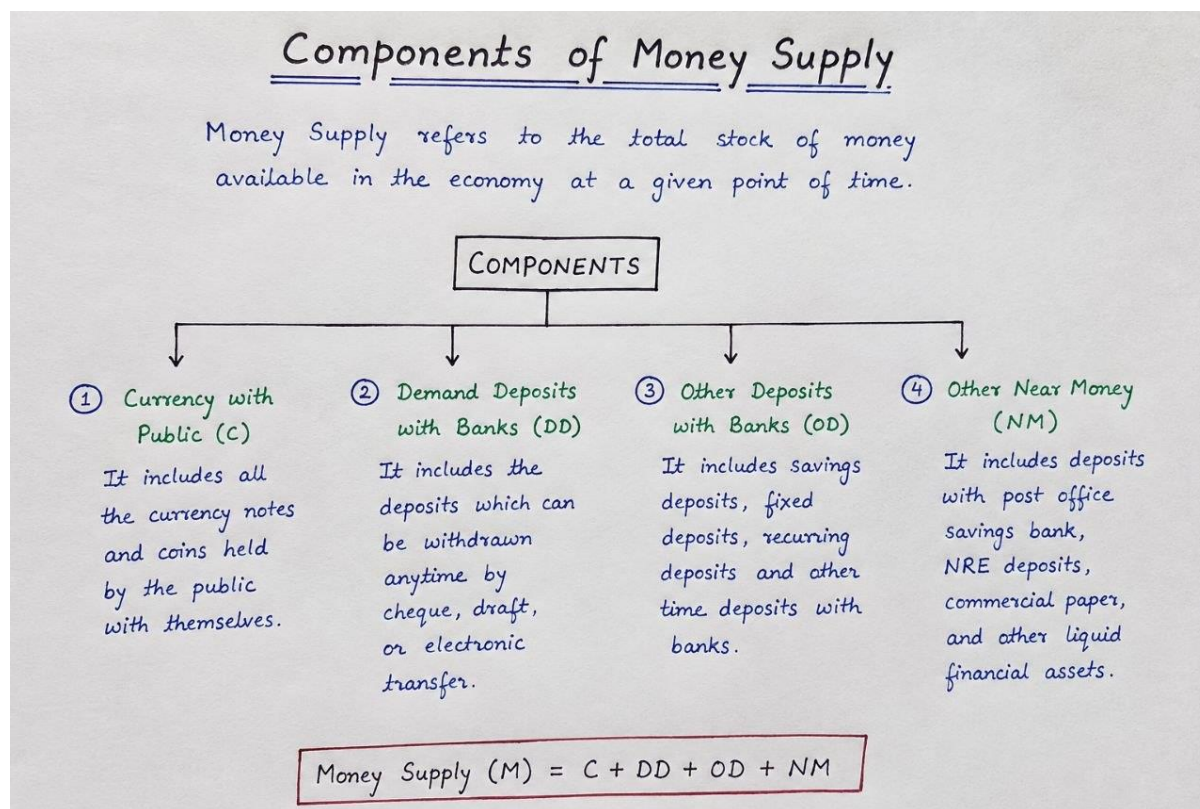
1. Meaning of Money Supply

Money supply is the amount of total cash and liquid financial assets available with people, businesses and institutions at a particular time in an economy.

Stock Concept : The supply of money is a 'stock' concept because it refers to the amount of money available in the country on a particular date.

* Exception: The money supply does not include the cash surplus held by the government and its own money held by the Reserve Bank of India (RBI) or the banking system, as they are the Issuers/Creators of Money.

2. Components of Money Supply in India



There are 4 main components (M1, M2, M3, M4) used by the Reserve Bank of India (RBI) to measure money supply in India since 1977:

1. **M1 (Narrow Money):**

M1 is the most liquid component of the money supply.

Formula:

$$\underline{M1 = C + DD + OD}$$

Where:

* C (Currency): Currency with the public.

DD (Demand Deposits): Demand deposits in the current and savings accounts of the public in commercial banks.

OD (Other Deposits with RBI): Other deposits held by the Reserve Bank (such as deposits of foreign central banks and international institutions).

□. **M2:**

M2 is a slightly broader concept than M1 which also includes post office savings.

Formula:

$$\underline{M2 = M1 + \text{Post Office Savings Deposits}}$$

Where:

* Post Office Savings Deposits: Public Savings Deposits in Post Office Savings Banks.

3. M3 (Broad Money):

M3 is most commonly used in India's economic policies and financial analysis.

Formula:

$$\underline{M3 = M1 + \text{Time Deposits with Commercial Banks}}$$

Where:

Time Deposits with Commercial Banks: Fixed Deposits (FDs) held by commercial banks.

4. M4:

M4 is the widest but least liquid component of the money supply.

Formula:

$$\underline{M4 = M3 + \text{Total Post Office Deposits (excluding NSC)}}$$

Where:

* Total Post Office Deposits: All Post Office Deposits (except National Savings Certificates - NSC).

Quick Formula Summary of Money Supply Formulas:

$$M1 = C + DD + OD$$

$$M2 = M1 + \text{Post Office Savings Deposits}$$

$M3 = M1 + \text{Bank Time Deposits}$

$M4 = M3 + \text{Total Post Office Deposits (Excluding NSC)}$

3. Factors Affecting Money Supply

The money supply in an economy is not determined by itself, but is directly influenced by various economic and policy factors:

1. Monetary Policy of RBI:

* Cash Reserve Ratio (CRR): If the RBI CRR increases, commercial banks have to reserve more money, which reduces the lending power and reduces the money supply.

* Repo Rate and Bank Rate: Increasing the repo rate makes lending expensive for banks, leading to people taking less loans and reducing the money supply.

Open Market Operations (OMO): If the RBI buys government securities from the market, money flows into the market and the supply increases.

2. Credit Creation by Commercial Banks:

* Commercial banks create credit by creating derivative deposits from primary deposits.

* If banks lend more, credit creation in the economy increases and the money supply (especially M1 and M3) grows faster.

3. Fiscal Policy and Deficit Financing of the Government:

* When the government's expenditure exceeds its revenue, the government borrows from the RBI to meet the deficit by printing new notes (deficit financing).

* The printing of new notes adds high-powered money to the economy, which directly increases the money supply.

4. Public's Preference for Cash vs Deposits:

If people prefer to keep their money in cash instead of depositing it in the bank, then the ability of banks to create credit decreases, thereby reducing the total supply of money.

5. Foreign Exchange Reserves:

When foreign exchange (FDI/FPI) increases in the country or foreign currency (dollars) come into India due to increase in exports, the RBI buys those dollars and puts the Indian rupees in the market in return, thereby increasing the money supply in the country.

6. Government Borrowing:

If the government borrows large amounts from the banking system, it also increases the financial liquidity in the economy.

Key Points to Remember for the Exam (Quick Exam Recap):

- * Most Liquid: M1
- * Broad Money: M3
- * High-Powered Money (H):
 $H = C + R$ (C = Currency with Public,
R = Bank Reserves with RBI)

Quantity Theory of Money (QTM)

Money Dimension Theory is a fundamental principle of economics which explains the relationship between the money supply and the general price level in an economy.

The fundamental principle of this principle is:

> "If other factors remain the same, an increase in the money supply increases the price level by the same proportion and reduces the value (purchasing power) of money."

> money dimension theory is broadly classified into four approaches:

1. Cash Transaction Approach - Irving Fisher

This Approach 1911 In the American Economist Irving Fisher (Irving Fisher) by Theirs P Stack "The Purchasing Power of Money" In the Presentation to Came was . to him ' Cambridge .

Main latitudes and assumptions:

According to Fischer, money is only a medium of exchange.

People keep money only for the purchase and sale of goods and services.

- * Full employment prevails in the economy.

The velocity of money and the size of the total transactions remain constant in a short period of time.

Fisher's Equation:

$$M * V = P * T$$

Later, Fischer expanded the equation by taking into account credit money:

$$M * V + M' * V' = P * T$$

Where:

- * M = Cash Money Supply
- * V = Velocity of Currency
- * M' = Bank Credit/Deposits
- * V' = Velocity of Credit
- * P = General Price Level
- * T = Total volume of transactions of goods and services

Formula for finding (P) value level:

$$P = (M * V + M' * V') / T$$

Conclusion:

If V, V', and T remain constant, the price level (P) is directly dependent on the money supply (M). Doubling the money supply also doubles the price level.

□. Cash Balance Approach - Cambridge Approach

This approach was developed by Cambridge University economists Alfred Marshall, A.C. A.C. Pigou, D.H. D.H. Robertson, and J.M. Robertson. Developed by Keynes (in the early stages).

Key differences and assumptions:

Fisher emphasized the supply side of money, while Cambridge economists emphasized the demand side of the store of value.

People want to keep a part of their total income in the form of cash balance for emergency needs. This part is called 'k'.

(Cambridge Equations):

(A) Marshall's Equation :

$$M = k * Y$$

or

$$M = k * P * y$$

Where:

* M = Money Supply

* P = price level

* y = Real Income.

* Y = Numerical National Income (Nominal Income = P * y)

* k = The percentage of people who want to keep a portion of their income in cash.

(b) Pigou's Equation :

$$P = (k * Y) / M$$

(Note: In Pigou's equation, P represents the purchasing power/value of money).

Relationship between Fischer and Cambridge:

Mathematically, Cambridge's 'k' is the inverse of Fischer's velocity 'V':

$$k = 1 / V$$

3. Keynesian Reformulation Approach

John Maynard Keynes in his book "General Theory of Employment, Interest and Money" (1936) strongly criticized the old dimension theory and reformulated the relationship between the money supply and the price level.

Keynes's New Approach:

According to Keynes, changes in the money supply do not directly affect the price level, but it affects the price level indirectly through the rate of interest, investment, production and employment.

Keynes's Transmission Mechanism:

1. Increase in money supply (M)
2. Reduction in Interest Rate
3. Increase in investment (I)
4. Increase in production, income and employment (Y, E)
5. & Effect on Price Surface

Two situations:

*** Unemployment Situation:**

As long as there are unused resources or unemployed labor available in the economy, increasing the money supply will only increase production and employment, not prices (P).

*** Full Employment Situation:**

Once the country reaches full employment, then if the money supply increases, then production cannot increase. It is in this situation that true inflation occurs and the price level rises.

4. Milton Friedman's Modern Quantity Theory

Milton Friedman, a Nobel laureate economist at the Chicago School of Economics (1956), made a modern restatement of the magnitude theory of money. This approach is also called 'Monetarism'.

Key Perspective:

According to Friedman, the theory of the dimension of money is not a theory of price or production, but a "theory of demand for money".

Money is a form of wealth. Just as people invest in various assets (e.g. stocks, bonds, land, durable goods), cash is also a part of an asset portfolio.

Friedman's Demand for Money Formula:

$$\mathbf{Md = f(Y_p, w, R_m, R_b, R_e, dp/dt, u)}$$

Where:

* MD = Total Demand for Money

* Y_p = Permanent Income

* w = Ratio of Human to Non-Human Wealth

* R_M = Expected Return on Money.

* R_b = □□□□□□ □□ □□□□□ □□□□ (Expected Return on Bonds)

* R_e = □□□□ □□ □□□□□ □□□□ (Expected Return on Equities/Shares)

* dp/dt = Expected rate of inflation / change in prices (Expected Inflation Rate)

* u = Other factors indicating people's preferences and attitudes (Utility/Preferences)

The essence of Friedman's approach:

The demand for money is based on permanent income and it remains highly stable.

Instability and inflation in the economy are caused by unnecessary changes in the money supply by the government or the central bank.

Quick Comparison Summary of Key Approaches

Fisher : Money is only a medium of exchange. Equation: $M * V = P * T$

Cambridge: Money is the accumulator of value (cash balance). Equation: $M = k * P * y$

* Keynes: The money supply indirectly affects the price and production through the rate of interest.

Friedman: Money is a part of wealth. QTM is the principle of demand for money. Equation: $M_d = f(Y_p, R_b, R_e, \dots)$

Unit 2

~~Topic 1~~

1. Meaning and Introduction of Inflation

General Meaning: In economics, the continuous and comprehensive increase in the prices of goods and services in the market is called 'inflation'.

* Depreciation: In an inflationary situation, the money supply increases, but the production of goods does not increase in that proportion. As a result, the purchasing power of money decreases and people have to pay more to buy the same thing.

* Principle: Inflation is often described as "when too much money chases too few goods."

2. Definitions of Inflation

Economists have given the following specific definitions of inflation:

* Prof. According to Crowther: "Inflation is a situation in which the value of money decreases and prices rise."

* Prof. According to Pigou: "Inflation occurs when financial income rises more rapidly in an economy than actual output."

* Prof. According to Ackley: "Inflation is a constant and significant increase in the price level."

* Prof. According to Keynes: "If the money supply is increased after the state of full employment is attained, it creates true inflation."

3. Features of Inflation

1. Continuous increase in price level: Inflation does not stop increasing in a single day, but it shows a continuous upward trend over a long period of time.

2. General Rise in Prices: Inflation does not only increase the prices of one or two things, but also increases the prices of most of the goods and services in the economy.

3. Decrease in purchasing power of money: Due to the increase in prices, less items can be bought with the same amount than before, i.e., the intrinsic value of money decreases.

4. Financial Factor : Inflation is a monetary phenomenon where the supply of money exceeds the actual production.

5. Post-employment inflation: Production cannot be increased after the economy reaches full employment, so prices start rising rapidly.

6. Redistribution of income and wealth: Inflation makes the rich/industrialists richer as their profits increase, while the real income of salaried and poor sections with fixed incomes decreases.

7. Self-Sustaining:

Once the price rises, the labourers demand higher wages, which increases the cost of production and raises the price again.

4. Causes of Inflation

The causes of inflation are mainly divided into two parts:

(a) Demand-Pull Factors:

When the aggregate demand for goods and services in an economy exceeds their aggregate supply, 'demand driven inflation' occurs. The main reasons for this are as follows:

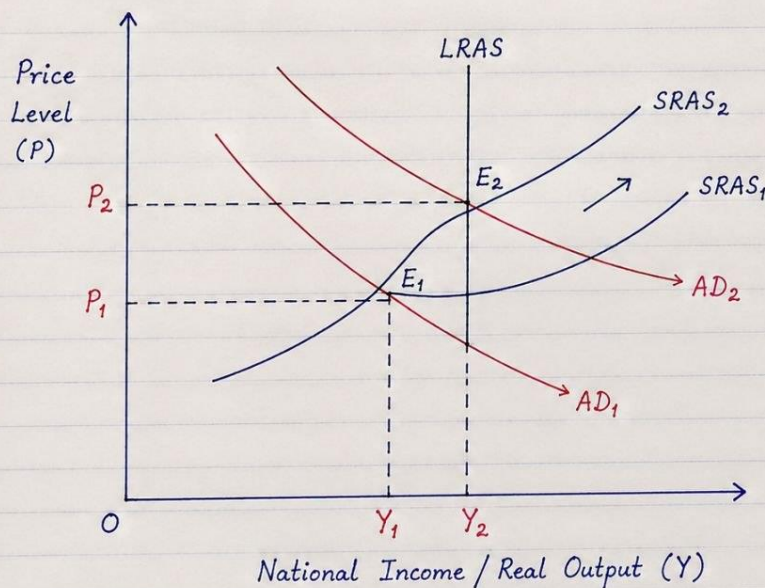
Demand Pull Inflation — Explanation of the Graph

Definition

When the total demand (AD) increases and the total supply (AS) remains stable, Then the general price level increases.

This condition is called demand pull inflation.

Demand Pull Inflation



Explanation :

When aggregate demand increases from AD_1 to AD_2 due to factors like increase in money supply, higher government spending, rise in exports, etc., the overall price level rises from P_1 to P_2 .

Key Points :

- Increase in Aggregate Demand ($AD_1 \rightarrow AD_2$).
- Prices rise from P_1 to P_2 .
- Output increases from Y_1 to Y_2 (may be up to full employment level).
- Inflation caused by excess demand in the economy.

Key parts of the graph

P = Price Level

Y = Real Output.

AD = Aggregate Demand

ASLR = Long Run Aggregate Supply.

Y_2 = Full Employment Output.

P_1 = Initial price level

P_2 = New price level

E_1 = Initial equilibrium point

E_2 = New equilibrium point

Explanation of the graph

1. Initial position:

AD_1 and ASLR intersect each other at point E_1 .

At this time:

Price level = P_1

Actual product = Y_1

2. Increase in total demand:

AD1 → AD2

Total demand increases from AD1 to AD2 due to increase in people's demand, consumption, investment or government spending.

3. Total supply stable:

ASLR = Stable

In the long run, production remains stable at Y_f as the economy is at full employment levels.

4. The New Balance:

AD2 and ASLR intersect at point E2.

So:

Price Layer : $P_1 \rightarrow P_2$

Real Product : $Y_1 \rightarrow Y_2$

That is, the price level increases, but the actual production does not increase.

Main meaning of graph

AD ↑ + AS Stable

↓

Price Layer ↑

↓

$P_1 \rightarrow P_2$

↓

Product Fixed at Y_2

Conclusion

If the total demand (AD) increases and the total supply (AS) remains stable,

So the price level increases, but at the level of full employment.

There is no increase in actual production (Y_f).

This condition is called demand pull inflation.

A short line to write in an exam

"More money chases fewer goods" — that is, an increase in aggregate demand.

This leads to an increase in price levels against a steady supply.

1. Increase in Money Supply:

Easing of lending policy by the central bank (RBI) or more lending by banks increases the supply of money in the market, which increases the purchasing power and demand of the people.

2. Increase in Government Expenditure:

When the government spends on infrastructure, defence, or welfare schemes on a large scale, money reaches the hands of the people, which increases the demand in the market.

3. Deficit Financing:

The government borrows money from the RBI to meet its budget deficit by printing new notes, which adds money directly to the economy without increasing production.

Population Growth

In countries like India, the demand for consumer goods (grains, housing, clothes) is constantly increasing due to rapid population growth.

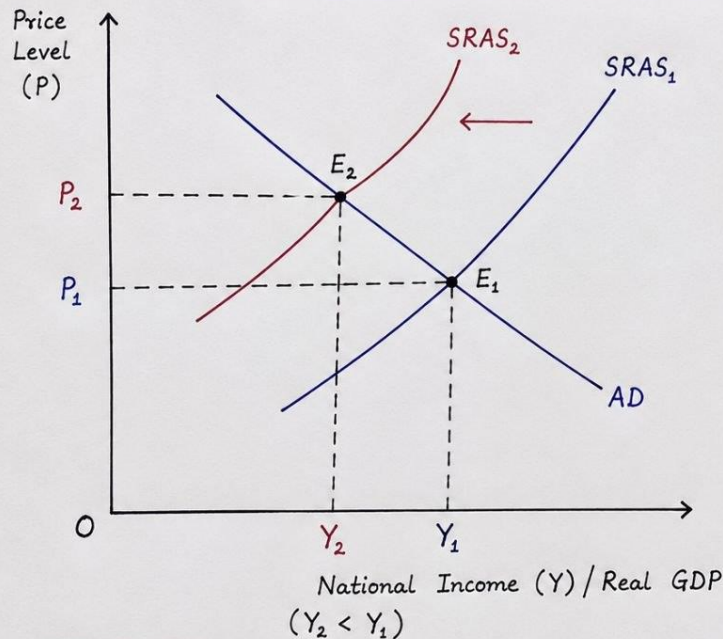
5. The menace of black money:

The black money collected through tax evasion is spent on entertainment and non-productive goods, creating artificial demand in the market.

(B) Cost-Push Factors:

When producers raise prices due to the increase in the cost of producing goods, 'cost-induced inflation' is generated. The main reasons for this are as follows:

COST-PUSH INFLATION



Cause :

- Increase in wages
- Rise in raw material prices
- Higher fuel / energy costs
- Indirect taxes, etc.

→ These increase cost of production and shift SRAS to the left.

Explanation :

Due to rise in costs of factors of production (wages, raw materials, fuel, etc.), firms' production cost increases. As a result, SRAS shifts leftward from $SRAS_1$ to $SRAS_2$. At the new equilibrium E_2 , the price level rises from P_1 to P_2 and real output falls from Y_1 to Y_2 .

Result :

- Price Level $\uparrow$ (P_1 to P_2)
- Real Output $\downarrow$ (Y_1 to Y_2)

This is Cost-Push Inflation.

Cost-Push Inflation — Explanation of the Graph

Definition

While the total supply (AS) decreases due to the increase in the cost of production And as a result, the price level increases.
This is called cost push inflation.

Key parts of the graph

P = □□□ □□□□ (Price Level)

Y = Real Output.

AD = □□□ □□□□ (Aggregate Demand)

AS1 = Initial Total Supplies

AS2 = New Total Supply

P1 = Initial price level

P2 = New price level

Y1 = Initial actual production

Y2 = New real product

E1 = Initial equilibrium point

E2 = New equilibrium point

Explanation of the graph

1. Initial equilibrium

AS1 and AD intersect each other at point E1.

At this time:

Price level = P1

Actual production = Y1

2. Increase in cost of production

Reasons for increase in cost of production:

- Increase in raw material prices
- Increase in wages
- Increase in taxes
- Increase in prices of imported inputs
- Natural disaster or war
- Increase in energy and fuel prices

3. Decline in total supplies

Rising production costs motivate manufacturers to produce less. So the total supply curve moves to the left.

AS1 → AS2

4. The New Balance

Now AS2 and AD intersect at point E2.

So:

Price Layer : P1 → P2

Real Product : Y1 → Y2

Here:

$P2 > P1$

$Y2 < Y1$

That is, the price increases and the production decreases.

Main meaning of graph

Product Expenses ↑
↓
Total Supplies ↓
↓
AS1 → AS2
↓
Price Layer ↑
↓
P1 → P2

Simultaneously

Real Product ↓
↓
Y1 → Y2

Causes of cost-push inflation

1. Increase in raw material prices.
2. Increase in wages.
3. Increase in taxes and excise taxes.
4. Increase in prices of imported inputs.
5. Increase in fuel and energy prices.
6. Increase in production costs due to natural calamity, war, etc.

Results

1. Price levels rise.
2. Actual production decreases.
3. People's purchasing power decreases.
4. Unemployment may increase.
5. Economic growth may slow down.

Exam Conclusion

The total supply moves to the left as the cost of production increases.
As a result, the price level increases and the actual production decreases.
This condition is called cost push inflation.

The easiest way to remember

Cost ↑ → AS ↓ → Price ↑ + Output ↓

Demand Pull: AD ↑ → Price ↑

Cost Push: Cost ↑ → AS ↓ → Price ↑ + Output ↓

1. Rise in wages:

When workers and trade unions increase their wages, the cost of production increases, to compensate for which the owners increase the price of the commodity.

2. Increase in Raw Material Cost:

The increase in the prices of steel, coal, cement and especially crude oil (petrol/diesel) increases the cost of transportation and production costs.

3. Increase in indirect taxes:

When the government increases the rates of indirect taxes such as GST or excise duty, the final selling price of the goods directly increases.

4. Imported Inflation:

When India imports expensive raw materials or machinery from abroad (such as expensive crude oil), the goods produced in the country automatically become expensive.

5. Natural Factors and Decrease in Production:

Droughts, floods or cyclones reduce agricultural production, leading to a sharp rise in the prices of cereals and vegetables.

Quick Exam Recap:

* Meaning: A continuous and comprehensive increase in the price level, a decrease in the value of money.

* Symptoms: Cumulative price rise, depletion of purchasing power, financial event, redistribution.

Demand-driven factors: Money supply, government spending, deficit, population growth, black money.

* Cost-driven factors: Increase in wages, raw materials/oil prices, indirectly, import inflation.

~~Topic 2~~

1. Consumer Price Index (CPI)

Meaning and concept:

The Consumer Price Index (CPI) is an index that measures the average change in the prices of goods and services purchased by consumers at the retail level in an economy. It is also known as 'retail inflation'.

The CPI takes into account the final price that the customer pays (which includes indirect and local profits). In India, the National Statistical Office (NSO), which functions under the Ministry of Statistics and Programme Implementation (MoSPI), releases CPI every month.

Salient features and improvements:

* *Base Year*: At present, the base year of CPI is 2012 = 100.

Basket of Goods and Services: CPI includes not only physical goods but also services. These include things like food and beverages, house rent, clothing, education, health, transport and entertainment.

Food Share: Food and beverages account for the highest (about 45.86%) contribution to the CPI.

The main classifications of CPI are:

1. CPI (Rural): For rural consumers.
2. CPI (Urban): For urban consumers.
3. CPI (Combined): A combined measure of both rural and urban (used to measure the main inflation of a country).
4. CPIs for Specific Groups: CPI-IW (for Industrial Workers), CPI-AL (Agricultural Labourers) issued by the Labour Bureau, Ministry of Labour.

Importance and Use:

* *Reserve Bank of India (RBI) Policy*: After the recommendation of the Raghuram Rajan Committee in 2014, the RBI has adopted CPI (Combined) as the key parameter for determining monetary policy/repo rate.

* *Dearness Allowance*: CPI-IW is used to determine the dearness allowance of government and organized sector employees.

2. Wholesale Price Index (WPI)

Meaning and concept:

The Wholesale Price Index (WPI) measures the changes in the price of goods in the financial transactions between producers and wholesalers at the first wholesale level. It is also known as 'headline or wholesale inflation'.

In India, the Office of Economic Adviser, Ministry of Commerce and Industry releases WPI data every month.

Key Features and Structure:

* **Base Year:** At present, the base year of WPI is 2011-12 = 100.

Goods Only: The biggest limitation of WPI is that it does not include services. It treats only physical goods.

* **(Three Main Groups & Weights):**

1. Primary Articles - **22.62% weight:** Foodstuffs, non-food agricultural products and minerals.
 2. Fuel & Power - **13.15% weight:** Petroleum, diesel, LPG and electricity.
 3. Manufactured Products - **64.23% weight:** Textiles, chemicals, metals, machinery and processed food (highest weight).
- Importance and Use:

* **Estimation of Cost of Production:** The WPI shows how much raw material and production costs for industries and factories are rising.

* **Measurement of trade risk:** Price fluctuations in the wholesale market can be used to understand the supply chain and business profitability in the economy.

CPI & WPI

CPI (Consumer Price Index)

Meaning : CPI measures the average change in prices of a basket of goods and services consumed by the households.

Purpose : • It is used to measure the cost of living and inflation experienced by consumers.

Coverage : • Covers goods and services used by households for their day-to-day consumption.
• Includes food, clothing, housing, transport, education, medical care, recreation, etc.

Base Year (India) : 2012 = 100

Formula :

$$CPI = \frac{\text{Cost of Basket in Current Year}}{\text{Cost of Basket in Base Year}} \times 100$$

Compiled by : National Statistical Office (NSO), Ministry of Statistics & Programme Implementation, Govt. of India.

Key Differences :

WPI (Wholesale Price Index)

Meaning : WPI measures the average change in prices of goods at the wholesale level.

Purpose : • It is used to measure inflation at the wholesale/producer level.

Coverage : • Covers only goods (no services).
• Includes primary articles, fuel & power, manufactured products.

Base Year (India) : 2011-12 = 100

Formula :

$$WPI = \frac{\text{Cost of Basket in Current Year}}{\text{Cost of Basket in Base Year}} \times 100$$

Compiled by : Office of the Economic Adviser, Department for Promotion of Industry and Internal Trade (DPIIT), Ministry of Commerce & Industry, Govt. of India.

Basis	CPI	WPI
Measures	Cost of living (Retail level)	Price of goods (Wholesale level)
Coverage	Goods and Services	Only Goods
Level	Consumer level	Producer/Wholesale level
Objective	Measures inflation felt by consumers	Measures inflation at wholesale level
Base Year (India)	2012 = 100	2011-12 = 100

3. Quick Comparison between CPI and WPI

* **Trade Level:** CPI measures at the retail/consumer level; While WPI measures at the wholesale level.

- * Inclusion of services: CPI includes both goods + services; WPI only has goods (not services).
- * Highest Weightage: Food ~ 45.8% is given the highest weight in the CPI; While Manufactured Goods ~ 64.2% have been weighted in WPI.
- * Use of RBI: RBI uses CPI (Combined) to determine monetary policy and interest rates.

Topic-3

Stagflation

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1. Meaning and Introduction

- * Concept: In economics, stagflation is a combination of two words: stagnation + inflation.
- * Definition: When there are three serious problems in the economy at once, it is called stagflation:
 - * High Inflation: Continuous increase in the prices of goods and services.
 - * Stagnant Growth: The decline or stabilization of the growth rate of GDP.
 - * High Unemployment: Loss of jobs and increase in unemployment due to decrease in production.
- * Contrary to traditional thinking: According to traditional Keynesian economics, there is an inverse relationship between inflation and unemployment (as the Phillips curve shows: if inflation rises, unemployment decreases). But stagflation is an extraordinary situation where both inflation and unemployment prevail at high levels simultaneously.

Historical background: The term was first coined in 1965 by British politicians Harold Macmillan and Norman MacLeod. But globally, stagflation was first seen on a large scale in the US and Western countries in the 1970s (1970s oil crisis) when OPEC countries suddenly quadrupled oil prices.

2. Causes of Stagflation

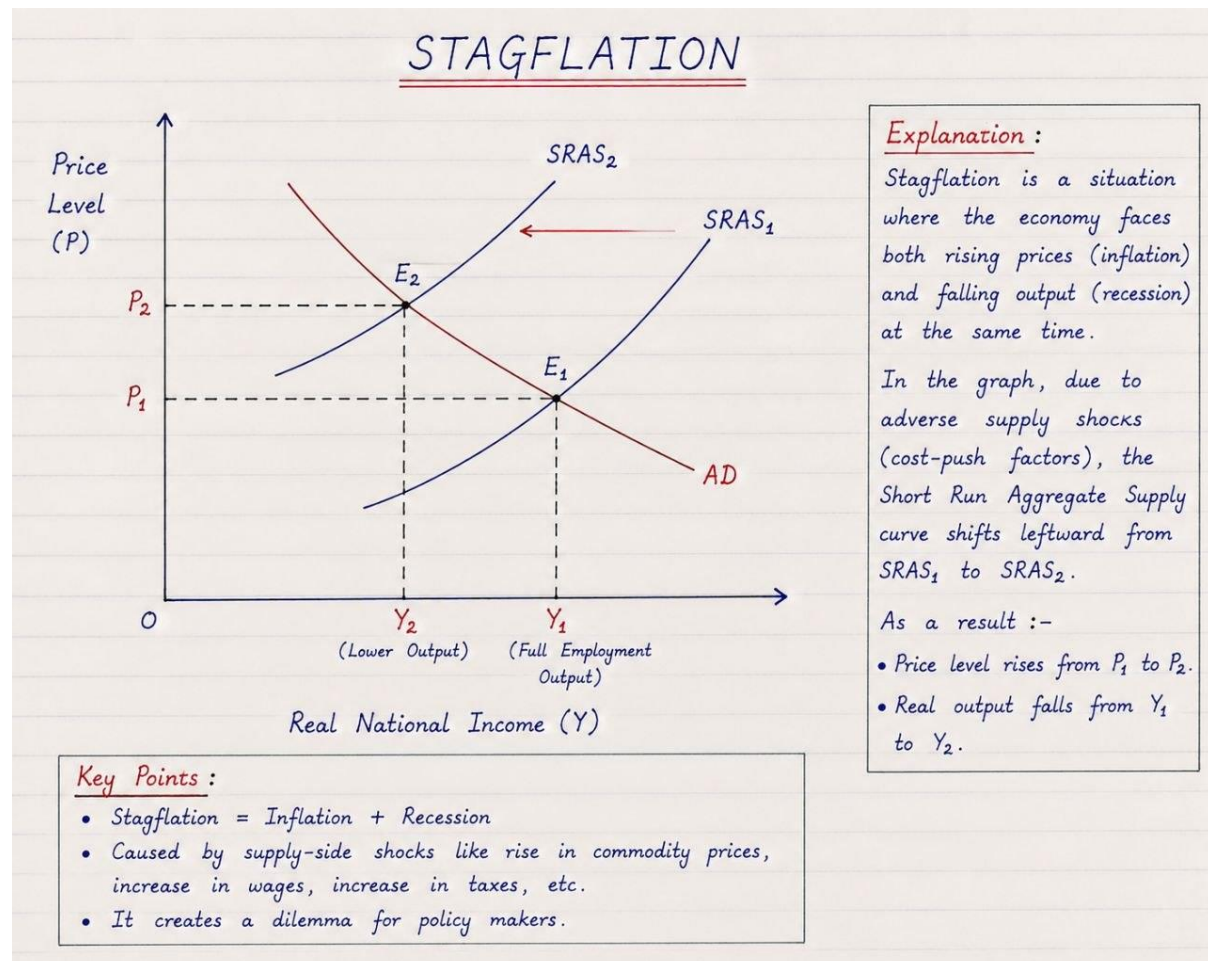
According to economists, there are two main factors responsible for the occurrence of stagflation:

1. Supply-side shock:

When there is a sudden and sharp increase in the prices of raw materials (such as crude oil/petroleum), which are essential for the economy, the cost of production increases drastically. This causes manufacturers to reduce production (recession) as well as raise prices (inflation).

2. Weak and Contradictory Government Policies (Inappropriate Macroeconomic Policies):

If the government increases the money supply rapidly but at the same time imposes strict restrictions or high taxes on industries and the labour market, then instead of increasing production, inflation only increases.



Stagflation — Graph Explanation

Definition

When there is a simultaneous high inflation in the economy,

Falling real output and high unemployment

When high unemployment is seen, it is called stagflation.

Key parts of the graph

P = Price Level

Y = Real Output.

AD = Aggregate Demand

AS = Aggregate Supply

AD1 = Initial Total Demand

AD2 = New Total Demand

AS1 = Initial Total Supplies

AS2 = New Total Supply

P1 = Initial price level

P2 = New price level

Y1 = Initial actual production

Y2 = New real product

E1 = Initial equilibrium

E2 = New equilibrium

Explanation of the graph

1. Initial position

AD1 and AS1 intersect at point E1.

At this time:

Price level = P1

Actual production = Y1

2. Decline in aggregate demand

Total demand in the economy decreases:

AD1 → AD2

3. Reduction in total supplies

At the same time, total supplies are reduced due to increase in cost of production, increase in raw material prices, etc.

AS1 → AS2

4. The New Balance

Now AD2 and AS2 intersect at point E2.

So:

Price Layer : P1 → P2

Real Product : Y1 → Y2

Where:

P2 > P1

Y2 < Y1

That is, the price level increases, while the actual production decreases.

Main meaning of graph

Inflation ↑
+
Product ↓
+
Unemployment ↑
↓
Stagflation

Causes of stagflation

1. Increase in petrol and fuel prices.
2. Increase in raw material prices.
3. Supply chain disruption.
4. Wars and natural disasters.
5. Wrong economic policies of the government.
6. Increase in taxes and expenditure.

Results

1. Price levels rise.
2. Actual production decreases.
3. Unemployment increases.
4. People's purchasing power decreases.
5. There is a recession-like situation in the economy.

Exam Conclusion

When inflation rises simultaneously in the economy,
Real production decreases and unemployment increases,
This condition is called stagflation.

Easy to remember

Stagflation = Inflation ↑ + Output ↓ + Unemployment ↑

In graph:

AD1 → AD2

AS1 → AS2

P1 → P2 (Price Increase)

Y1 → Y2 (Product Decreases)

3. Solutions and Policy Dilemma

Getting out of stagflation is considered to be the most difficult challenge for the central bank (RBI) and the government, as the policy weapons to curb both inflation and recession work at odds with each other:

* If bank interest rates are high (Tight Monetary Policy):

Raising interest rates may bring inflation under control, but it will further reduce investment and output as credit becomes more expensive, making recession and unemployment more severe.

* If the government increases spending or makes loans cheaper (Expansionary Policy):

Increasing the money supply may reduce recession and unemployment, but it also exacerbates inflation in the market.

□□□□ (Way Forward):

Supply-side reforms are needed to overcome stagflation:

- * Enhancing technology and productivity to reduce the cost of production.
- * Reduce unnecessary taxation and legal burden on industries.
- * Reduce dependence on conventional fuels by adopting other energy options (such as renewable energy).

Quick Exam Recap

- * Definition: Stagnation + Inflation + Unemployment together.
- * Main cause: Supply shock - factors like increase in crude oil prices.
- * Philips curve: The traditional Phillips curve principle does not work in the case of stagflation.

~~Topic 4~~

Inflationary Gap

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□. □□□□ □□□ □□□□□ (Meaning and Concept)

* Concept: The theory of inflationary intervals was introduced by the famous economist Lord John Maynard Keynes in his book "How to Pay for the War" in 1940.

* Definition: When the aggregate demand in an economy exceeds the actual output at the time of full employment, the difference between the two is called the 'inflationary gap'.

* Basic Principle: After full employment is achieved, all the resources (labour, land, capital) in the economy are fully utilized. Therefore, the actual production cannot be increased even if the financial demand increases. As a result, the additional demand only increases the prices of goods and services, which leads to inflation.

2. Mathematical Representation of Inflation Interval

If the GDP Y_F at the level of total employment in the country and the aggregate demand in the market is AD:

Where:

* $AD > Y_F$ (Financial demand is greater than the actual output of full employment).

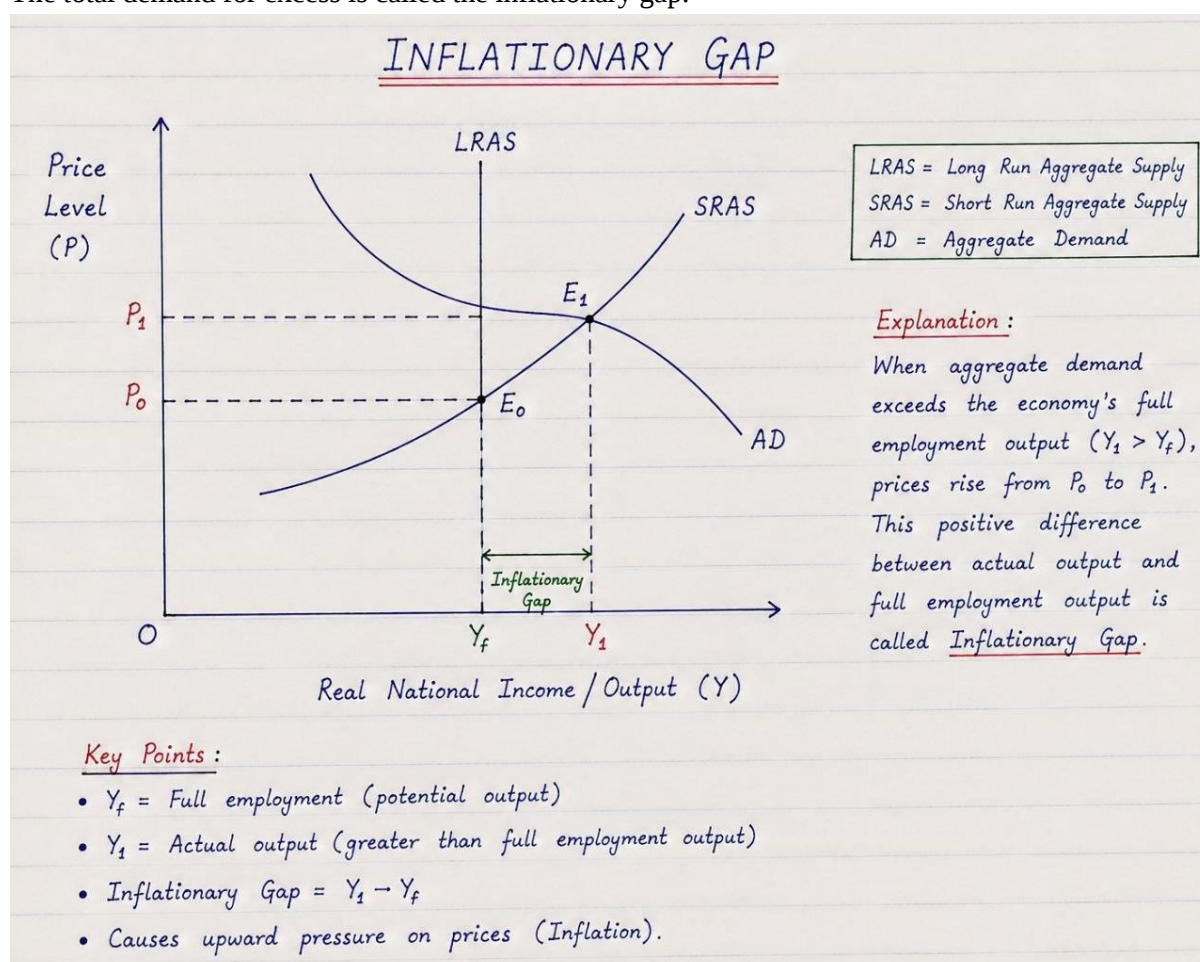
Inflationary Gap — Explanation of the Graph

Definition

When the total demand in the economy (AD) is the level of full employment.

(Full Employment Level),

The total demand for excess is called the inflationary gap.



Key parts of the graph

P = (Price Level)

Y = Real Output / Income

AD = (Aggregate Demand)

LAS = Long Run Aggregate Supply.

AD1 = Initial Total Demand

AD2 = Increased Total Demand

P1 = Initial price level

P2 = New price level

Yf = Production of Total Employment

Y2 = Production due to increased total demand

E0 = Initial equilibrium point

E1 = New equilibrium point

Explanation of the graph

1. Initial position

AD1 and LAS intersect at point E0.

At this time:

Price level = P1

Product = Yf

Here YF shows the production of full employment.

2. Increase in total demand

Total demand increases for a reason:

AD1 → AD2

The new total demand AD2 intersects the LAS at point E1.

3. New status

At point E1:

Price level = P2

Product = Y2

Where:

$$P_2 > P_1$$

$$Y_2 > Y_f$$

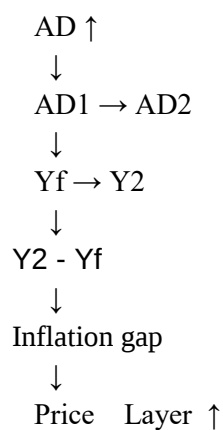
That is, the total demand has exceeded the total employment output.

4. Inflationary gap

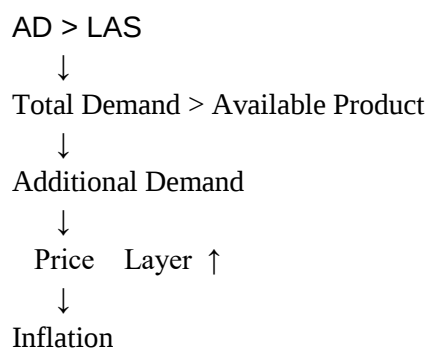
The gap between total employment output Y_f and production Y_2 due to new total demand is called the inflation gap.

$$\text{Inflationary Gap} = Y_2 - Y_f$$

Simple graphical meaning



Why is there inflation?



Formula — Copy Easily

$$\text{Inflationary Gap} = Y_2 - Y_f$$

or

$$\text{Inflation Gap} = \text{Actual Production} - \text{Full Employment Output}$$

Here:

Y_2 = Actual production
 Y_f = Production of Total Employment

Main Conclusion

When the total demand (AD) exceeds the full employment level,
The additional demand is then called inflation gap.
The price level increases due to the inflation gap.

Easy way to remember in exams

$AD \uparrow \rightarrow AD > LAS \rightarrow Y_2 > Y_f \rightarrow \text{Inflationary Gap} \rightarrow \text{Price Level} \uparrow$

In a nutshell:

Inflationary Gap = Excess Demand at Full Employment

3. Remedies to Eliminate Inflationary Gap

In order to eliminate the inflationary gap, it is necessary to reduce the aggregate demand in the economy. For this, the following steps are taken:

1. Fiscal Policy Measures:

- * Reduction in government spending: The government reduces its non-productive expenditure and expenditure on public schemes.
- * Increase in taxes: Increasing direct taxes (income tax) reduces disposable income of the people, which reduces demand.

2. Monetary Policy Measures:

- * Interest rate hikes: RBI hikes repo rate and bank rate, making loans more expensive and reducing liquidity from the market.
- * Increase in CRR and SLR: Banks' ability to lend is curbed.

Quick Exam Recap

- * In the submission: J. M. J.M. Keynes.
- * Condition: There should be full employment in the economy.
- * Root Cause: Total Demand (AD) exceeds the total employment output (Y_f).
- * Result: Actual production does not increase, only prices (inflation) increase.

Effects of Inflation

Inflation has a profound impact on all sectors of the economy such as production, distribution, consumption and financial stability. It's not just that the effects of inflation are negative; Moderate or mild inflation is favourable for the growth of the economy, but excessive and uncontrolled inflation disrupts the entire economy.

The main impact of inflation can be classified into the following categories:

1. Effects on Different Social Groups

The impact of inflation does not affect all sections of society equally. It redistributes income and wealth to society:

** Fixed Income Group:*

Salaried people, employees, pensioners and labourers are the worst affected by inflation. As the financial income remains stable, their real income and purchasing power decrease due to the increase in prices, leading to a decline in their standard of living.

** Producers and Businessmen:*

Producers and traders benefit during inflation. The difference between the previous low price of raw materials and the high selling price of finished goods increases their profit.

* Creditors and Creditors:

Debtors: Debtors benefit from the depreciation of money during inflation as they have to return money with less purchasing power

.

* Creditors: The person or institution that lends money suffers because the actual purchasing power of the amount they get back is less.

* Investors:

* People who have invested in fixed interest paying instruments such as government bonds or debentures suffer losses.

* People who have invested in equity stocks, land or gold get the benefit of price hike.

2. Effects on Production

Mild inflation stimulates production, but high inflation hinders the production process:

* *Initial positive impact (increase in investment):* Manufacturers invest more in the startup in anticipation of rising prices and higher profits, thereby increasing production and employment.

** Misallocation of Resources:*

In times of hyper-inflation, manufacturers tend to produce speculative and luxurious items (where profits are higher) rather than making quality and cheap goods.

* Decrease in Savings and Capital Formation: Due to the increase in prices, the consumption expenditure of the people increases, which reduces their ability to save. As savings decrease, the rate of capital creation in the country decreases.

** Decrease in product quality:* To take advantage of the shortage of goods, manufacturers start making inferior quality or adulterated goods for quick disposal.

3. Effects on Foreign Trade

** Decrease in Exports:* Due to inflation, the cost of domestic production increases and the goods of the country become expensive. As a result, the goods of the country lose their competitiveness in the international market and the exports decrease.

** Increase in imports:* Since local goods are expensive in the country, people prefer to buy cheap goods coming from abroad, which increases imports.

** Adverse Balance of Payments:* Due to the decrease in exports and increase in imports, there is a serious deficit in the balance of payments of the country.

4. Effects on Monetary & Banking System

** Loss of trust in money:* If inflation becomes hyper-inflation, people stop accepting money and turn back to the barter system.

** Impact on Banking Savings:* Real interest rate = nominal rate - inflation becomes negative. As a result, people prefer to invest in land or gold instead of depositing money in banks.

5. Social and Moral Effects

Inequality in Society: Inflation widens the gap between the rich and the poor, leading to social discontent.

** Deterioration of moral values:* Evils such as black marketing, hoarding, adulteration and corruption in the market grow rapidly in the lure of making more profits.

Quick Exam Recap:

** Beneficiaries:* Businessmen, businessmen, debtors, investors in stocks.

** Sufferers:* Salaried, pensioners, creditors, poor class.

** Impact on trade:* Exports decline and imports increase (transaction deficit).

** Impact on the economy:* Decline in savings and capital creation, loss of purchasing power of money.

~~Topic 6~~

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Anti-Inflationary Measures

In an economy, when prices rise continuously and comprehensively, the purchasing power of the people decreases and financial instability occurs. There are three main types of measures implemented by the government and the central bank (RBI) to control inflation:

1. Monetary Measures

Monetary policy is carried out by the central bank of the country (Reserve Bank of India (RBI)). Its main objective is to absorb excess liquidity from the market and control credit creation.

* Increase in Bank Rate & Repo Rate:

The RBI increases the repo rate and bank rate, making it more expensive for commercial banks to borrow. As a result, banks raise interest rates on loans for customers, leading to people and businesses taking on fewer loans and reducing the supply of money in the market.

* Increase in Cash Reserve Ratio (CRR) and SLR:

The RBI increases the CRR (Cash Reserve Ratio) and SLR (Statutory Liquidity Ratio) rates. This has forced commercial banks to reserve a large part of their deposits, thereby reducing their ability to lend.

* Open Market Operations (OMO):

RBI sells government securities (Government Securities/Bonds) in the open market. Investors and banks buy these bonds, so that the cash from the market comes back to the RBI.

* Selective Credit Control:

Tightening the conditions for availing loans and increasing the margin requirement for speculative or black marketing (such as cereals or oilseeds).

2. Fiscal Measures

Fiscal policy is the policy presented by the government of the country. Its main objective is to reduce the aggregate demand in the market by reducing the disposable income in the hands of the people.

* □□□□□□ □□□□□□ □□□□□ (Reduction in Government Expenditure):

During inflation, the government should cut down on its non-developmental and non-productive expenditures (e.g., administrative expenses, subsidies, grand events).

* Increase in Direct Taxes:

The government increases the rates of income tax and corporate tax. Rising taxes reduce the income people have to make purchases, thereby reducing the demand for goods.

* Increase in Public Debt / Incentive to Savings:

The government borrows money from the public by issuing new savings schemes (such as NSC, PPF, government bonds), thereby reducing the amount of cash available to the people.

* Control on Deficit Financing:

To meet the budget deficit, the printing of new currency should be stopped or limited.

3. Direct, Commercial and Supply-Side Measures

Inflation cannot be completely controlled by mere reduction in demand, so the following direct measures are taken to increase the supply:

* Increase in Production:

To encourage farmers and industries and provide raw materials to increase the production of consumer goods (especially cereals, milk, clothing).

* Increase in imports:

Reduce the customs duty on imports of items that are in acute shortage in the country and have high prices (such as pulses, edible oils, or crude oil) to increase the supply.

* Restricting Exports:

Prohibition on export of essential commodities or imposition of high export duty for essential commodities in the country to ensure availability of goods in the domestic market.

Public Distribution System (PDS):

Providing essential commodities at affordable prices to the poor and middle class through ration shops.

* Strict laws against hoarding and black marketing:

Legal action should be taken against hoarders who indulge in illegal stocking under the 'Essential Commodities Act'.

* □□□□□ □□□□□ (Price Control & Wage Freeze):

At times of hyperinflation, the government legally fixes the maximum selling price of certain basic goods.

Quick Exam Recap

Monetary measures (RBI): Repo rate, CRR/SLR $\uparrow$, sale of government bonds (reducing the money supply).

* Fiscal measures (government): Government spending, income tax, curbing the printing of new notes.

* Direct solutions: Increase production, import of scarce items, stop exports, provide cheap food grains through PDS.

~~Topic 6~~

Indexation Policy

1. Meaning of Indexation Policy

* General Definition: Indexation is the method of adjusting any monetary value, asset value, wage or tax calculation data with the price index in view of the decrease in the purchasing power of money due to inflation.

* In the field of taxation and finance: When a person sells his long-term securities or assets (such as land, house, gold), his original purchase price is converted into the present time price using the Cost Inflation Index (CII). This process is called the 'indexation policy'.

* Main Objective: To ensure that nominal capital gains arising out of inflation are not taxed unfairly or excessively and that the taxpayer pays tax only on real gains.

2. How does indexation work? (Mechanism & Formula)

The government notifies the Cost Inflation Index (CII) every year. On the basis of this index, the Indexed Cost of Acquisition of an asset is calculated:

Formula to find the revised purchase price:

* Result: This calculation increases the original value of the asset on paper. As a result, the difference between the selling price and the revised price (taxable capital gain) decreases and the tax liability decreases significantly.

3. Applications of Indexation Policy

1. Capital Gains Taxation:

This policy is used to calculate Long Term Capital Gains (LTCG) at the time of sale of real estate, gold and old debentures/bonds.

2. Wage Indexation (Dearness Allowance):

* Dearness Allowance (DA) is a form of wage index that is linked to the Consumer Price Index (CPI).

3. Inflation-Indexed Bonds (IIBs):

* Bonds are issued by the government whose interest and capital values automatically increase in line with the rate of inflation, so that investors can maintain their purchasing power.

4. Benefits and Limitations of Indexation Policy (Benefits)

:

* *Reduction in tax burden*: The taxpayer does not have to pay tax on artificial profits inflated due to inflation, which leads to tax savings.

* *Real Profitability*: The investor gets to know the real rate of return of his investment.

* *Encourage long-term investments*: People hold properties or securities for a longer period of time to reap the benefits of indexation.

Limitations and Policy Changes:

* *Reduction in government revenue*: Indexation reduces the capital tax revenue received by the government.

* Recent Tax Policy Updates:

* *Debt Mutual Funds*: The benefit of indexation has been withdrawn from debt mutual funds purchased after April 1, 2023.

* *Real Estate/Properties*: From the 2024 budget, a new tax rate of 12.5% without indexation or an option of 20% with indexation has been made available on the sale of immovable properties with certain conditions.

Quick Summary for the Exam

* Indexation: The policy of adjusting the effect of inflation with the monetary price/purchase value.

* Tool: Cost Inflation Index (CII) released by the Ministry of Finance.

* Main Objective: To reduce the tax burden on the taxpayer and protect capital from inflation.

Topic 7

Natural Rate of Unemployment and Phillips Curve

1. The Phillips Curve Meaning and Introduction

History: New Zealand economist A. W. Smith was born in 1958. This theory was proposed by A.W. Phillips on the basis of data from Britain (UK) from 1861 to 1957.

Fundamental Principle: The Philips curve represents the inverse/negative relationship between the inflation rate and the unemployment rate.

* Methodology:

* When the unemployment rate in the country is low, wages and prices rise rapidly as the demand for labor is high (high inflation).

* When the unemployment rate is high, inflation remains low because people have less purchasing power.

* Short-Run Phillips Curve (SRPC): In the short term, the government can reduce unemployment by taking policy decisions at the expense of a little more inflation.

2. Natural Rate of Unemployment (NRU)

Concept: This concept was proposed in the late 1960s by the Nobel laureate economists Milton Friedman and Edmund Phelps.

* Definition: The minimum and stable level of unemployment prevailing in the economy at full employment is called the 'Natural Rate of Unemployment'. It is also known as NAIRU (Non-Accelerating Inflation Rate of Unemployment).

* Exception: The natural rate does not mean 'zero unemployment'. Even if the economy is fully functional, the following two transient unemployment always exist:

* Frictional Unemployment: Intermittent unemployment while looking for a new job or changing locations.

Structural Unemployment: Unemployment due to changes in technology or skills.

3. Long-Run Phillips Curve (LRPC)

* Friedman-Phelps Review: According to Friedman, unemployment can be reduced by monetary policy in the short term, but in the long run, workers and businesses adapt to inflation expectations.

Result: In the long run, the unemployment rate naturally returns to its natural rate (NRU).

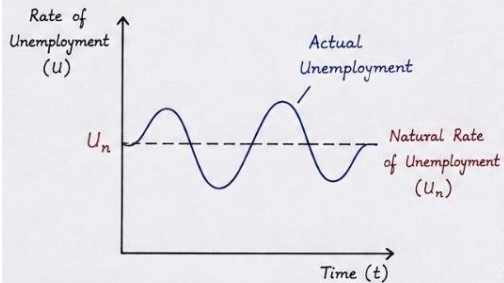
* Shape: Therefore, the long-term Philips curve (LRPC) forms a completely vertical line at the natural rate of unemployment. This shows that in the long run, no trade-off between inflation and unemployment is possible.

NATURAL RATE OF UNEMPLOYMENT & PHILLIPS CURVE

(A) NATURAL RATE OF UNEMPLOYMENT

The natural rate of unemployment is the normal rate around which the actual rate of unemployment tends to fluctuate in the long run.

Graph :

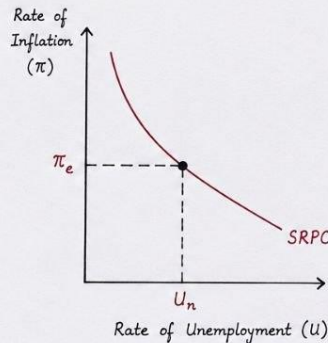


U_n = Natural Rate of Unemployment
Actual Unemployment fluctuates around U_n in the long run.

(B) PHILLIPS CURVE

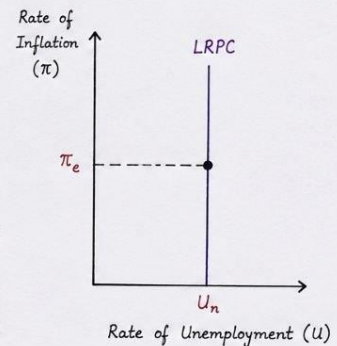
(i) SHORT RUN PHILLIPS CURVE

Inverse relationship between inflation and unemployment in the short run.



(ii) LONG RUN PHILLIPS CURVE

In the long run, there is no systematic relationship between inflation and unemployment.



U_n = Natural Rate of Unemployment

π_e = Expected Rate of Inflation

SRPC = Short Run Phillips Curve (Downward Sloping)

LRPC = Long Run Phillips Curve (Vertical)

The Natural Unemployment Rate and the Phillips Curve

(Natural Rate of Unemployment & Phillips Curve)

1. Natural Rate of Unemployment

Definition

The natural unemployment rate is the unemployment rate with the status of full employment.
It's consistent.

It is usually denoted by U_n^* or U_n^* .

U_n^* = Natural Unemployment rate
 U = Real unemployment rate

Explanation of the graph

The unemployment rate (U) is shown on the vertical axis.

Time is shown on the horizontal axis.

The real unemployment rate fluctuates over time.

But in the long run, it stays around the U_n^* i.e. natural unemployment rate.

Real Unemployment Rate $\uparrow$
↓
 A^* of around
↓
Natural Unemployment Rate

Key Features

1. The natural unemployment rate does not indicate zero unemployment.
2. It is frictional and structural
(Structural) includes unemployment.
3. Unemployment to bring down inflation steadily
 A^* than Down Kept
4. Real unemployment rate over the long term
 A^* of Around Stable To be increased

2. Phillips Curve

Philips Curve of inflation Rate (p) and of unemployment Rate (U) $\square\square\square\square\square\square$
 $\square\square\square\square\square\square\square\square\square\square$.

p = Inflation rate
U = Unemployment Rate

(a) Short Run Phillips Curve

In the short term, the Philips curve is downward sloping.

Explanation of the graph

Standing Axis On Inflation (π).

The unemployment rate on the horizontal axis is (U).

SRPC is a short-term Philips curve.

At point A:

Unemployment = U_1

Inflation = p_1

At point B:

Unemployment = U_2

Inflation = p_2

Where:

$U_1 < U_2$

$P_1 > P_2$

Meaning:

Unemployment $\uparrow \rightarrow$ Inflation $\downarrow$

Unemployment $\downarrow \rightarrow$ Inflation $\uparrow$

Therefore, in the short term, there is a trade-off between inflation and unemployment.

The easiest way to remember

Short Run:

$U \downarrow \rightarrow \uparrow$

$U \uparrow \rightarrow \downarrow$

(B) Long Run Phillips Curve

In the long run, the Phillips curve is vertical.

It is represented by the LRPC.

Explanation of the graph

The vertical LRPC is located at U_n^* .

In the long run, the rate of unemployment remains at the natural unemployment rate $(U_n)^*$.

Even if the rate of inflation changes, the unemployment rate does not remain permanently below U_n^* .

LRPC = Vertical

$U = U_n^*$

Meaning:

Long-term inflation and unemployment

There is no permanent trade-off in between.

Difference Between Short-Term and Long-Term Philips Curve

In the short term:

SRPC = $\pi = \pi^e + \alpha(u - u_n^*)$

There is a trade-off between inflation and unemployment.

In the long run:

LRPC = $\pi = 0$

Unemployment remains at U_n^* .

There is no permanent trade-off between inflation and unemployment.

Easy Comparison

Short Run:

$U \downarrow \rightarrow \pi \uparrow$

$U \uparrow \rightarrow \pi \downarrow$

Trade-off = π vs U

Long Run:

$U = U_n^*$

Trade-off = π vs U

Main Conclusion

In the short term, as the Phillips curve slips downwards.

There is a trade shutdown amid inflation and unemployment.

But in the long run, the Phillips curve stands on U_n^* .

So in the long run, the economy has a natural unemployment rate

(A^*) On Stable Stay is $\pi = 0$ and $U = U_n^*$

There are no permanent trade-offs in between.

The easiest way to remember in an exam

Short Run → Phillips Curve ↓ → Trade-off

Long Run → Phillips Curve | → $U = U_n^*$ → No Trade-off

Quick Exam Recap

* Short duration (SRPC): The correlation between inflation and unemployment (a downward curve from left to right).

* Long duration (LRPC): Vertical line on the natural rate of unemployment (NRU).

* Key findings: Unemployment below the natural rate cannot be maintained even if inflation rises in the long run.

~~Topic 8~~

1. Meaning of Deflation.

General Meaning: Deflation is the opposite of inflation. When there is a continuous and universal decline in the prices of goods and services in an economy, it is called 'deflation'.

* Purchasing power of money: Due to the fall in prices, the purchasing power of money increases, that is, more things can be bought with the same amount than before.

Negative Inflation Rate: When the inflation rate drops below zero ($<0\%$), the economy is said to be facing deflation.

* Economic Perspective: Although it may seem good at first glance to get things cheaper, Deflation is considered extremely dangerous in economics as it reduces the profits of industries, leading to wage cuts and unemployment which is called the 'Deflationary Spiral'.

2. Main Causes of Deflation

There are two main factors responsible for deflation in the economy:

(a) Demand-Side Causes:

When the aggregate demand for goods and services in the market decreases, traders are forced to reduce the price to sell goods:

1. Decrease in Money Supply:

When the central bank (RBI) adopts a tight monetary policy or increases interest rates drastically, the supply of money in the market decreases, which reduces the purchasing power of the people.

2. Low Consumer Confidence:

In times like war, economic instability or pandemics, people stop spending due to future insecurity and increase savings, leading to a dip in demand.

3. Reduction in Government Spending:

When the government cuts its development spending and schemes, the circulation of money in the market decreases.

4. Credit Crunch:

When the financial condition of banks is weak or banks reduce lending, investors and consumers cannot buy.

(B) Supply-Side Causes:

When the aggregate supply of goods in an economy exceeds the demand:

1. Technological Advances:

With the introduction of new and modern technology in the manufacturing sector, the cost of production is greatly reduced, so that the goods are available in the market quickly and cheaper.

2. Fall in Input Costs:

The price of raw materials (such as crude oil, steel or electricity) falls in the international market due to which the final production cost of goods decreases.

3. Overproduction:

When industries produce more goods than demand, prices have to be lowered to empty excess stock.

Quick Exam Recap

* Meaning: Continued decline in prices, increasing purchasing power of money, negative inflation ($<0\%$).

* Demand-driven factors: Reduced money supply, high interest rates, cuts in government spending, deferred spending by consumers.

* Supply-side factors: new technologies, reduced production costs, and overproduction.

Unit 3

Central Bank: Meaning, Functions & Tools of Credit Control

1. Meaning and Introduction of Central Bank

(a) General Meaning:

The Central Bank is the apex bank of the entire banking and financial system of the country. It regulates, manages and controls the money supply, credit and banking sector in the country.

The central bank does not deal directly with customers or work with the intention of making a profit like other ordinary commercial banks. Its main objective is to maintain economic stability in the country and to provide a suitable environment for rapid growth of the economy.

The Central Bank of India: Reserve Bank of India (RBI) was established on April 1, 1935.

* The central bank of the United States: The Federal Reserve.

* The central bank of Britain: The Bank of England.

(B) (Definitions):

* Prof. According to De Kock:

"Central Bank is the apex bank of the country which controls the financial and banking framework of the entire economy and works in the economic interest of the country."

* Prof. According to Hawtrey:

"The central bank is the central institution of the banking system acting as the 'Lender of the Last Resort'.

* Prof. According to Sayers:

"The central bank is the banking institution that controls the financial system of the country."

2. Functions of Central Bank

The functions of the central bank are mainly divided into three categories: (1) traditional or financial functions, (2) regulatory functions, and (3) developmental functions.

(a) Traditional / Monetary Functions:

1. Issue of Currency Notes (Bank of Issue):

* The central bank has a monopoly on printing currency notes in the country.

* RBI in India (except Re 1 notes and coins, which are issued by the Ministry of Finance) From 2 to Rs. It issues all notes up to Rs 500.

* This work brings uniformity in the 'medium of exchange' and maintains public confidence in the currency. For this, the central bank keeps a gold or foreign exchange reserve (Minimum Reserve System).

2. Banker, Agent & Advisor to the Government:

As a banker: He maintains accounts of the central and state governments, deposits cash and makes payments on behalf of the government.

* As an agent: Arranges public debt for the government by issuing treasury bills (T-bills) and government bonds on behalf of the government.

* As an advisor: Provides financial advice to the government on matters such as monetary policy, taxation, import-export and inflation.

3. Bankers' Bank and Supervisor:

All commercial banks in the country operate under the legal supervision of the central bank.

* Commercial banks have to reserve a certain percentage of their deposits (CRR) with the central bank.

* It takes decisions like opening new bank branches, mergers and cancellation of licences.

4. Lender of the Last Resort:

* When commercial banks face acute financial crunch and cannot get credit from outside sources, the central bank will take their first class action
Provides credit in times of crisis by exceeding securities.

5. Custodian of Foreign Exchange Reserves:

All the foreign exchange reserves (dollars, euros, gold, etc.) of the country are reserve with the central bank.

It maintains stability in the exchange rate of the country's currency (rupee) in the international market.

6. Clearing House Function:

The central bank acts as a clearing house for mutual settlement of cheques and payments between different banks on a daily basis, so that account adjustments can be made without the need for cash movement

.

(b) Developmental Functions :

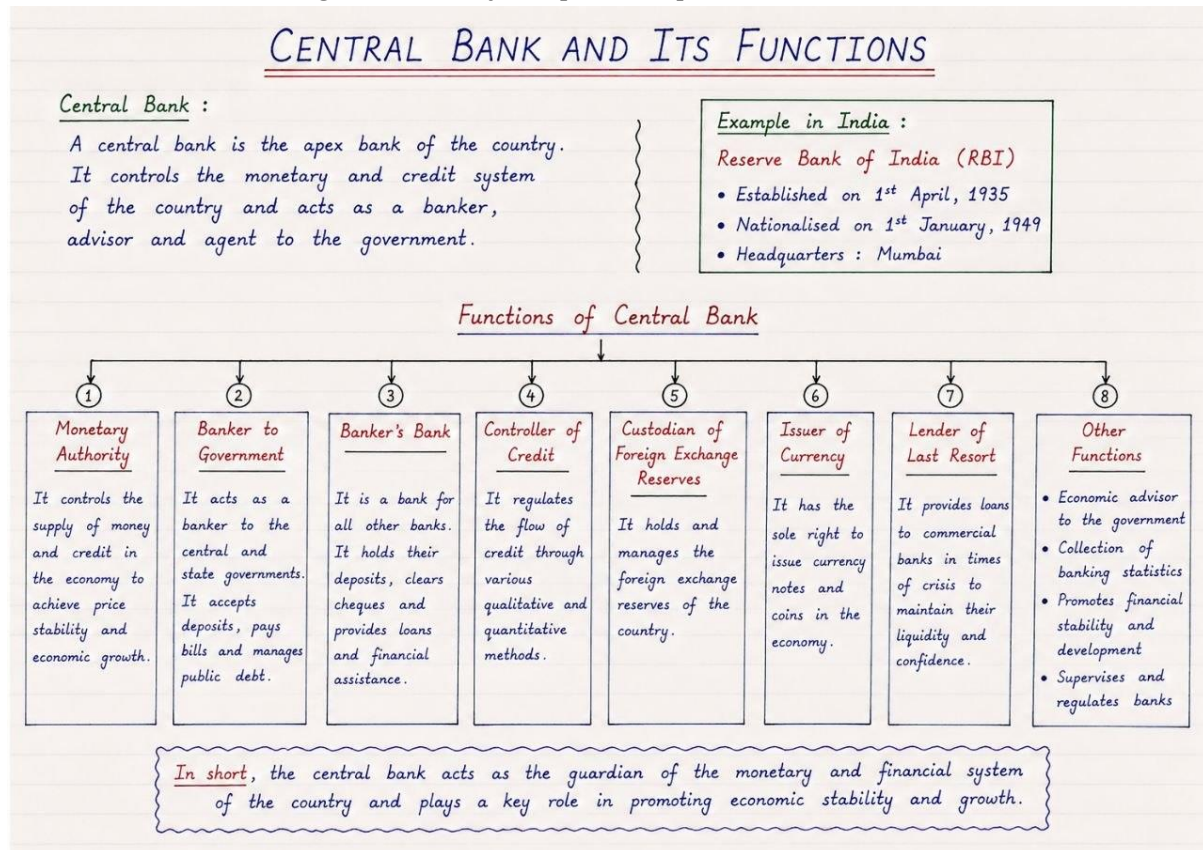
1. Expansion of banking facilities: Expansion of banking branches in rural and remote areas.

2. Agriculture and Rural Credit: Creating a framework for providing cheap crop credit to farmers through apex bodies like NABARD.

3. Promotion of Small and Medium Enterprises (MSMEs): Providing easy credit to small entrepreneurs through institutions like SIDBI.

4. Financial Inclusion: Linking the poor and underprivileged sections of the country with bank accounts (such as Jan Dhan Yojana).

5. Collection and Publication of Statistical Information: To collect accurate data on the economy, inflation, GDP and banking of the country and publish reports.



□. (Tools of Credit Control)

The most important function of a central bank is to control credit creation or the supply of money in the economy.

If the credit level in the economy is too high, then inflation occurs, and if the credit level decreases, then there is deflation.

The central bank uses credit control tools to prevent both of these situations.

Credit control tools are divided into two main categories:

* Quantitative Tools

* Qualitative or Selective Tools

(a) Quantitative Tools :

These instruments affect the total amount of money and the amount of credit throughout the economy in a similar way.

1. Bank Rate:

* **Meaning:** The interest rate at which the central bank provides long-term loans to commercial banks is called the 'bank rate'.

* **Methodology:**

* **At the time of inflation:** The central bank raises the 'bank rate'. As loans become expensive for banks, they also raise interest rates on loans for customers. As a result, people take out fewer loans and the supply of money in the market decreases.

* **In times of recession:** The central bank lowers the 'bank rate', making loans cheaper and increasing the investment of money in the market.

2. Repo Rate and Reverse Repo Rate:

Repo Rate: The rate at which the central bank lends money to commercial banks for a short period of time (1 to 14 days) is called the repo rate.

* **Inflation:** The repo rate is increased.

* **In a recession:** The repo rate is reduced.

* **Reverse Repo Rate:** When commercial banks deposit their excess cash with the central bank, the interest paid by the central bank is called the reverse repo rate.

3. Open Market Operations (OMO):

* **Meaning:** The process of buying and selling government securities (Government Securities/Bonds) in the open market by the central bank.

* **Methodology:**

* **At the time of inflation:** The central bank sells government bonds in the market. People and banks buy these bonds, so that cash from the market comes back to the central bank and credit creation decreases.

* **In times of recession:** The central bank buys bonds, so that cash is added to the market.

4. Cash Reserve Ratio (CRR):

* **Meaning:** Every commercial bank has to reserve a certain percentage of its total deposits (Net Demand and Time Liabilities (NDTL) with the central bank in cash.

* **Methodology:**

* The central bank raises CRR rates to curb inflation, leaving banks with less money to lend.

* The CRR rate is reduced to avoid a recession.

5. Statutory Liquidity Ratio (SLR):

* Meaning: Every commercial bank has to keep a certain percentage of its total deposits in liquid form of cash, gold or valid government securities.

* Impact: Increasing the SLR decreases the lending capacity of banks and reducing the SLR increases the lending capacity.

(B) Qualitative / Selective Tools:

These tools are used to direct and control credit in specific sectors (such as agriculture, industry, or speculation) rather than the entire economy.

1. Change in Margin Requirements:

* Meaning: The difference between the value of the mortgaged property and the amount of the loan given at the time of taking a loan is called 'margin'. (For example, if you get a loan of Rs. 80 against Rs. 100 land, the margin is 20%).

* Use: The central bank increases margins in areas where speculation is to be stopped (so as to get less credit) and reduces margins in areas where it wants to be encouraged (such as agriculture).

2. Rationing of Credit:

* The central bank fixes the maximum credit limit (quota) for different sectors to prevent excess money from flowing into non-productive sectors.

3. Moral Choice:

The central bank conducts circulars, meetings and conferences to make ethical appeals or advice to commercial banks to abide by its policies.

4. Direct Action:

* When a commercial bank continues to violate the rules or guidelines of the central bank, the central bank imposes a penalty, stops refinancing or cancels its banking licence.

CENTRAL BANK		TOOLS OF CREDIT CONTROL	
A central bank is the apex bank of the country which controls the monetary and credit system. It formulates and implements monetary policy to achieve economic objectives.		Credit control refers to the techniques used by the central bank to regulate the flow of credit in the economy in order to achieve monetary stability.	
<u>Functions of Central Bank (RBI)</u> - Issue of currency - Banker to the Government - Banker's bank (Banker to other banks) - Controller of credit - Custodian of foreign exchange reserves - Lender of last resort - Promoter of economic development - Regulator and supervisor of banks - Performs other miscellaneous functions.		<u>1. Quantitative (General) Tools</u> Bank Rate Policy - Change in bank rate affects the cost of borrowing of commercial banks. Cash Reserve Ratio (CRR) - The fixed percentage of deposits that banks must keep with RBI. Statutory Liquidity Ratio (SLR) - The fixed percentage of deposits that banks must maintain in the form of liquid assets. Open Market Operations (OMO) - Buying or selling of government securities by RBI to control liquidity in the economy. Repo Rate Policy - Rate at which RBI lends short-term funds to commercial banks against securities. Reverse Repo Rate - Rate at which RBI borrows funds from commercial banks.	
<u>Objectives</u> - Maintaining price stability. - Ensuring adequate supply of credit. - Promoting economic growth. - Controlling inflation. - Maintaining balance in balance of payments. - Promoting financial stability.		<u>2. Qualitative (Selective) Tools</u> Margin Requirements - It refers to the margin to be maintained by banks before granting loans. Rationing of Credit - RBI sets ceiling on the amount of credit that banks can extend to specific sectors. Selective Credit Controls - Imposing restrictions on credit for non-essential or speculative activities. Moral Suasion - RBI influences banks through appeals, advice and persuasion. Consumer Credit Regulations - Regulating credit for personal and household consumption. Direct Action - RBI issues direct instructions to banks regarding credit expansion.	
<u>RBI</u> - Established on 1st April, 1935 - Nationalized on 1st Jan, 1949 - Headquarters - Mumbai - Present Governor - Shri Sanjay Malhotra (25th Dec, 2024)		* Note : RBI uses both quantitative and qualitative tools depending on the economic situation.	

□. □□□□□□□□ (Conclusion)

The central bank is the heart of the country's financial system. From the monopoly to the monopoly of printing money, the central bank skillfully uses quantitative and qualitative tools to control inflation and recession in the economy.

At present, the Reserve Bank of India (RBI) through its Monetary Policy Committee (MPC) plays an important role in maintaining the economic growth rate and controlling inflation in the country by using instruments such as the bank rate and the repo rate.

Quick Exam Recap:

- * **Meaning:** The country's apex bank (RBI), regulation of the banking sector and financial stability.
- * **Main functions:** printing of notes, government bank, bank of banks, protection of foreign exchange, last resort.
- * □□□□□□□□ □□□□ (Quantitative): Bank Rate, Repo Rate, OMO, CRR, SLR.
- * □□□□□□□□ □□□□ (Qualitative): Margin Requirement, Credit Rationing, Moral Suasion, Direct Action.

Topic 2

1. Banking and Digitalization

(a) Meaning and Concept

Digitalisation of banking means the transformation of traditional paper-based and physical banking services into modern electronic and digital platforms.

In the past, customers had to go to a physical branch to deposit, withdraw or transfer money. Due to digitization, all services are now available 24×7 (anytime and anywhere) through smartphones, computers and internet.

(B) Main Types of Digital Banking

1. Internet Banking/Net Banking:

Check account balance, fund transfer (NEFT, RTGS, IMPS), and make bill payments through the bank's official website.

2. Mobile Banking:

To do all financial transactions through the bank's mobile app (e.g. YONO SBI, iMobile) from the phone.

3. Unified Payments Interface (UPI):

A very popular medium developed by NPCI, where instant payments can be made by scanning a VPA or QR code (e.g. BHIM, Google Pay, PhonePe).

4. ATMs and Cash Deposit Machines (ATMs & CDMs):

Cash withdrawals or direct deposits to the account for 24 hours without going to the bank in person.

5. Plastic Money (Debit and Credit Cards):

Payments can be made through debit and credit cards through POS machines or online shopping.

6. Digital Wallets:

Fast payments by adding money to wallets like Paytm or Freecharge.

2. Digital Currency

(a) Meaning and Definition

Meaning: Digital currency is a form of money that exists only in electronic or digital form. It cannot be physically touched (in the form of notes or coins).

* Definition: "A digital currency is money that can be stored and transferred in electronic form, which becomes acceptable as a measure of value, a medium of exchange, and a means of accumulation."

(B) Main Types of Digital Currency

Digital currency is broadly divided into three categories:

1. Central Bank Digital Currency (CBDC):

It is a digital currency issued and controlled by the country's central bank (such as the RBI of India).

It is the digital form of the country's legal tender.

* Example: India's e-Rupee (e-RUPI).

2. Cryptocurrency:

It is a decentralized digital currency based on blockchain technology.

It is not controlled by the government or central bank of any country.

* Examples: Bitcoin, Ethereum.

3. Stablecoins:

These are cryptocurrencies whose value is pegged to a physical asset (such as the US dollar or gold), so that their price does not fluctuate excessively.

*Example : Tether (USDT), USD Coin (USDC).

(c) Features of Digital Currency

1. Lack of Intangibility: It cannot be kept in the pocket; It stays in the form of digital code in software, digital wallets or computer ledgers.
2. Instant and Borderless Transactions: Money can be sent to any corner of the world in a matter of seconds.
3. Technology Dependent: Its implementation requires blockchain, encryption and a strong digital network.
4. Price Volatility: CBDs are completely volatile, while cryptocurrencies are highly volatile.
5. Savings in ideas and expenses: The cost of printing and transporting paper notes becomes zero.

(d) Advantages of Digital Currency

1. Fast and Easy Payments: Transactions are completed in 24×7 seconds, irrespective of banking hours or holidays.
2. Reduction in currency printing and operating costs: Printing physical notes, transporting them securely, and depositing them in ATMs save billions of rupees.
3. International fund transfers are cheaper: Cross-border remittances reduce banking charges and time.

4. Financial Inclusion: In remote areas where there are no bank branches, people are directly connected to the financial infrastructure through smartphones.

5. Curb Corruption and Black Money: Black marketing and counterfeit currency are prevented as digital tracking of every official digital money transaction such as CBDC is possible.

6. Direct Benefit Transfer (DBT): Government subsidies and welfare schemes are directly deposited into the accounts of the poor without any middlemen.

(e) Disadvantages and Challenges of Digital Currency

1. Cyber Security and Hacking Risk: There is a risk of money being stolen from digital wallets through hacking, phishing and virus attacks.

2. Digital Illiteracy: In countries like India, it is difficult for the rural and elderly population to use smartphones or digital technology.

3. Lack of Privacy: Transactions with physical cash remain secret, while digital tracking of digital transactions poses a risk of personal privacy.

4. Dependency on internet and electricity: Transactions come to a halt when there is no network connectivity or when the server is down.

5. Financial instability (in the case of crypto): Small investors suffer huge losses due to sudden large fluctuations in the price of unregulated currencies such as Bitcoin.

6. Monitoring and Legal Complexity: There is a lack of uniform laws or tax policies for digital currencies globally.

Quick Exam Recap

* Digitalization of banking: From paper-based banking to electronic/app based system (UPI, Net Banking, ATM).

* Digital currency: Only electronic money without physical form.

* Types: CBDC (official, such as e-Rupee), cryptocurrencies (unregulated, such as Bitcoin), stablecoins.

* Key advantages: Faster transactions, saving cost of printing notes, transparency.

* Major disadvantages: cybercrime, digital illiteracy, lack of privacy, dependence on the internet.

Topic 3

Digital Currency: Meaning, Types, Features, Advantages & Disadvantages

1. Meaning and Introduction of Digital Currency

(a) General Meaning:

Digital currency is a form of money that exists only in electronic or digital form. It cannot be touched in physical form like paper notes or metal coins.

It is stored and transferred through computers, smartphones, internet and digital wallets. This money becomes acceptable as a measure of value, a medium of exchange, and a means of accumulation.

(B) (Definitions):

* Simple Definition: "Digital currency is money in electronic form, which can be used for all kinds of financial transactions and payments, even in the absence of physical notes or coins."

* According to the European Central Bank (ECB): "A digital currency is a representation of an invisible or digital value, issued and controlled by developers as well as accepted by members of a particular digital community."

2. Main Types of Digital Currency

Digital currency can be divided into three main categories based on its control and technology:

1. Central Bank Digital Currency (CBDC):

It is a digital currency officially issued and fully regulated by the country's central bank (such as the RBI of India).

It is the digital incarnation of the country's legal tender. Its value is the same as physical cash.

* Examples: India's e-Rupee, China's e-CNY.

2. Cryptocurrency:

It is a decentralized digital currency based on blockchain technology and cryptography.

It is not controlled by the government or central bank of any country. Its rates depend on market demand and supply.

* Examples: Bitcoin, Ethereum.

3. Stablecoins:

These are cryptocurrencies that are pegged to a physical asset (such as U.S. dollars, government bonds, or gold) to prevent their value from rising or falling exponentially.

* Examples: Tether (USDT), USD Coin (USDC).

3. Features of Digital Currency

1. *Intangibility*: It cannot be held in the form of paper notes or coins. It is stored only in computer code or electronic ledger.
2. *Technology Dependent*: Smartphones, computers, internet and digital wallets are essential for the use of this money.
3. *Instant Transactions*: Domestic or international transactions are completed in 24×7 seconds without any banking time limit.
4. *Centralised or Decentralised*: Currencies like CBDC are centralized (government) while cryptocurrencies are decentralized (unregulated).
5. *Zero cost of production and transportation*: Zero cost of printing physical notes, paper and ink and safe transportation.
6. *Digital Tracking*: The Official Digital Currency (CBDC) has a digital record of every transaction, so that the transaction of money becomes transparent.

4. Advantages of Digital Currency

1. *Faster and time saving*: Instant payment can be made from anywhere without having to go to the bank in person or without lengthy processes.
2. *Major reduction in currency handling costs*: Billions of rupees annually are saved for the government and central banks on printing, storing and transporting banks/ATMs to banks/ATMs.
3. *International Transfers Cheap and Fast (Cross-Border Payments)*: The time taken to send money from one country to another (which was earlier 2-3 days) and the banking processing charges are significantly reduced.
4. *Financial Inclusion*: Even the poorest of the poor in remote areas where there are no bank branches can connect directly to the financial infrastructure through smartphones.
5. *Curb Black Money and Counterfeit Notes*: Unlike physical notes, counterfeit currency cannot be made. Also, digital tracking of transactions prevents black marketing.
6. *Direct Benefit Transfer (DBT)*: Government assistance, pension or subsidy money is directly deposited into the digital wallet of the poor without middlemen or corruption.

5. Disadvantages and Challenges of Digital Currency

1. Cyber security and hacking risk: There is a high risk of money being stolen due to cyber attacks, data leaks or wallet hacks on the digital system.
2. Digital Illiteracy: In countries like India, it is difficult for the rural and elderly population to understand and use smartphones or digital technology.
3. Complete dependence on internet and electricity: Transactions come to a halt when there is no network connectivity, internet is down or bank server is down.
4. Lack of Privacy: Transactions in cash remain private, while all transactions in official digital currency are tracked by the government or central bank, which threatens personal privacy.
5. Lack of official control (in the case of crypto): The price of unregulated cryptocurrencies such as Bitcoin suddenly drops drastically, causing small investors to lose their deposits.
6. Use in Illegal Activities: Decentralized or anonymous digital currencies are at risk of being used for money laundering, drug trade or terrorist funding.

□. (Conclusion)

Digital currency is the direction of the financial future of the world. It is revolutionizing traditional banking and cash transactions. However, if challenges such as cyber security, digital literacy and a strong legal framework are properly addressed, digital currency will play the most important role in making the economy more transparent, faster and efficient.

Quick Exam Recap:

- * Meaning: Invisible money in electronic form.
- * Main Types:
 - * CBDC: Issued by the central bank (e.g. e-Rupee).
 - * Cryptocurrency: decentralized/unregulated (such as Bitcoin).
 - * Stablecoins: The value associated with the asset (such as USDT).
- * Key advantages: Cost of printing notes, faster transactions, transparency.
- * Key limitations: cyber security risk, dependence on the internet, digital illiteracy.

~~Topic 5~~

1. Introduction of the International Monetary Fund (IMF)

* Founded: USA in July 1944. The IMF was established as a result of an international conference held at Bretton Woods in New Hampshire. Therefore, the IMF and the World Bank are also called the 'Bretton Woods Twins'.

* Beginning of Operations: The IMF officially began operations on December 27, 1945.

Headquarters: Washington, D.C. (Washington D.C., USA).

Member Countries: 190 countries.

Special Currency (SDR): The IMF has its own accounting instrument called SDR (Special Drawing Rights) or 'Paper Gold'.

* Form: It is a specialized financial agency of the United Nations (UN), which is tasked with maintaining global financial stability.

2. Objectives of IMF

1. Global Monetary Cooperation:

To provide a permanent forum for consultation and cooperation among member countries on international financial issues.

2. Exchange Rate Stability:

To prevent excessive fluctuations in the exchange rates of currencies of different countries and to prevent competition in currency devaluation.

3. Expansion of International Trade:

Promote the balanced development of world trade so as to increase employment and real incomes in all member countries.

4. Correcting Balance of Payments (BoP Crises):

Short and medium term financial assistance to member countries that have severe and temporary deficits in their BoP payments.

5. Establishment of Multilateral Payment System :

Removal of foreign exchange restrictions on trade transactions between member countries.

6. Global Poverty Alleviation and Economic Growth:

Achieving sustainable development by helping developing and vulnerable economies formulate economic policies.

3. Functions of IMF

The functions of the IMF are broadly classified into three main pillars:

(a) Surveillance Function :

The IMF continuously monitors the economic and monetary policies of all its 190 member countries.

- * It warns member states in advance of risks (such as inflation, recession, or debt crisis) to the global economy.

For this, the IMF releases global reports such as the 'World Economic Outlook' and the 'Global Financial Stability Report' every year.

(b) Financial Assistance / Lending Function:

- * When a member country is facing a foreign exchange shortage or a severe BoP crisis (such as India in 1991 and Sri Lanka in 2022-23), the IMF gives them an emergency loan.

- * Credit Facilities: The IMF provides loans to its members through various channels such as Stand-By Arrangements (SBA), Extended Fund Facility (EFF), and Rapid Credit Facility (RCF).

- * Along with this loan, the IMF also stipulates the member country to implement drastic structural reforms in its economy.

(c) Capacity Building and Technical Assistance:

The IMF provides free technical guidance and training to the finance ministries and central banks of developing countries in the areas of tax policy, monetary policy, banking reform and statistics.

Quick Exam Recap:

Founded: 1944 (Bretton Woods Council), Year of Establishment: 1945.

Headquarters: Washington, D.C.

- * Currency/Accounting Asset: SDR (Special Drawing Rights / Paper Gold).

- * Main objectives: Balance of payments (BoP) deficit, exchange rate stability, global financial support.

INTERNATIONAL MONETARY FUND (IMF)

IMF is an international organization that works to promote monetary cooperation, ensure financial stability, facilitate international trade, promote high employment and sustainable economic growth.

Established : 27 December 1945

Headquarters : Washington, D.C., USA

Members : 190 countries
(As on 2024)

Managing Director : Kristalina Georgieva

OBJECTIVES

- ① To promote international monetary cooperation through a permanent institution.
- ② To facilitate the expansion and balanced growth of international trade.
- ③ To promote exchange stability and to maintain orderly exchange arrangements among members.
- ④ To assist in establishing a multilateral system of payments for current transactions.
- ⑤ To make resources of the Fund temporarily available to members to meet balance of payments difficulties.
- ⑥ To reduce the duration and degree of disequilibrium in the international balance of payments.
- ⑦ To provide confidence to members by making the Fund resources available on adequate safeguards.

FUNCTIONS

- ① Promotional Function : Promotes international monetary cooperation and encourages expansion of world trade and economic growth.
- ② Surveillance Function : It keeps under review the economic and financial policies of member countries.
- ③ Financial Assistance Function : It provides short-term loans to members to help them overcome balance of payments difficulties.
- ④ Exchange Stability Function : It promotes stability in exchange rates and discourages competitive devaluation.
- ⑤ Technical Assistance Function : It provides technical expertise and training to member countries.
- ⑥ Facilitative Function : It helps in establishing a multilateral system of payments for current transactions.
- ⑦ Confidence Building Function : It builds confidence of members by providing financial support on adequate safeguards.

Note : The IMF does not lend for development projects. Its loans are for short-term balance of payments support with conditions for economic stability.

1. Introduction to the World Bank.

Founding: It was established as a result of an international conference held in July 1944 at Bretton Woods, New Hampshire, USA. Hence it and the IMF are also called the 'Bretton Woods Twins'.

Original Legal Name: The World Bank's original and legal name is the International Bank for Reconstruction and Development (IBRD).

* Commencement of Operations: Official work began on June 25, 1946.

Primary Objective: To reconstruct the economies of the European countries which were destroyed in the Second World War.

Headquarters: Washington, D.C. (Washington D.C., USA).

Member countries: 189 countries.

(World Bank Group - WBG):

The World Bank is not a single bank but it is a group of 5 international organisations:

1. IBRD: Provides loans to middle-income and creditworthy countries.

2. IDA (International Development Association): Provides interest-free or very cheap loans to the poorest countries (called the World Bank's 'Soft Loan Window').

3. IFC (International Finance Corporation): Promotes and lends to the private sector in developing countries.

4. MIGA (Multilateral Investment Guarantee Agency): Provides insurance to foreign investors against political risks.

5. ICSID (International Centre for Settlement of Investment Disputes): International Investment Disputes Resolution (India is not a member).

(Note: The combined consortium of IBRD and IDA is generally referred to as the 'World Bank').

2. Objectives of World Bank

1. Poverty Alleviation and Improvement of Living Standards: Poverty reduction through human development (education, health, clean drinking water) in developing and backward countries.

2. Infrastructure Development: To provide long term investment in the member countries for the construction of permanent infrastructure such as roads, ports, power projects, irrigation and transportation.

3. Rebuilding War-stricken Economies: Rebuilding the economies of countries affected by war or natural disasters.

4. Encourage private foreign investment: Encourage private investors to invest in developing countries by providing guarantees.

5. Balanced development of international trade: Enhancing the productive capacity of member countries and international trade through long-term productive investments.

6. Environmental and Sustainable Development: Priority should be given to projects related to climate change, renewable energy and environmental protection.

3. Functions of World Bank

(a) Providing Long-Term Lending:

The World Bank mainly offers loans for long term periods of 15 to 20 years and at very reasonable rates.

* It grants loans only for specific development projects (such as dams, highways, smart cities, digital missions).

(b) Grants and Concessional Loans to Poor Countries :

* Its organization, IDA, provides loans and grants to the world's poorest countries at 0% or very nominal processing charges.

(c) Technical Assistance and Advisory :

* Advises developing countries on free experts in planning large infrastructure projects, preparing technical designs and project management.

(d) Guarantee Function:

If a private investor or bank is not willing to invest money in a developing country's project, the World Bank protects that investment by acting as a guarantor.

(e) Knowledge and Research Hub :

The World Bank conducts research on topics such as international development, poverty, and education.

It publishes global reports such as the 'World Development Report' every year.

WORLD BANK

The World Bank is an international financial institution that provides loans and grants to developing countries for the purpose of capital projects.

OBJECTIVES

- ① To promote economic development by providing financial and technical assistance for productive projects.
- ② To reduce poverty by supporting projects that improve people's living standards.
- ③ To promote international trade by encouraging investment and capital flows for productive purposes.
- ④ To promote long-term balance in the balance of payments by assisting member countries.
- ⑤ To encourage private investment by supporting policies and projects that attract private capital.

FUNCTIONS

- ① Provides Loans : It provides loans to member countries at concessional interest rates for development projects.
- ② Provides Grants : It provides grants to the poorest countries that cannot afford to repay loans.
- ③ Technical Assistance : It helps member countries with technical expertise, training and advisory services.
- ④ Policy Advice : It advises governments on economic policies for growth, poverty reduction and development.
- ⑤ Promotes Private Investment : It supports private sector development by providing loans, guarantees and risk insurance.
- ⑥ Supports Infrastructure Development : It finances projects in areas like transport, energy, education, health and water supply.
- ⑦ Promotes Global Cooperation : It works with other international organizations to achieve global development goals.

Note : The World Bank is not a bank in the ordinary sense. It is a group of five related institutions, the main one being IBRD.

About :

Established in : 1944
Headquarters : Washington, D.C., USA
Members : 189 countries
Head : President

Quick Exam Recap:

Original name: IBRD (Founded: 1944, Bretton Woods).

Headquarters: Washington, D.C.

Core Poverty Alleviation, Long-Term Credit (15-20 years) and Infrastructure Development.

* Difference between IMF and World Bank: The IMF provides loans to cover the short-term payment deficit (BoP); While the World Bank provides loans for long-term development projects.

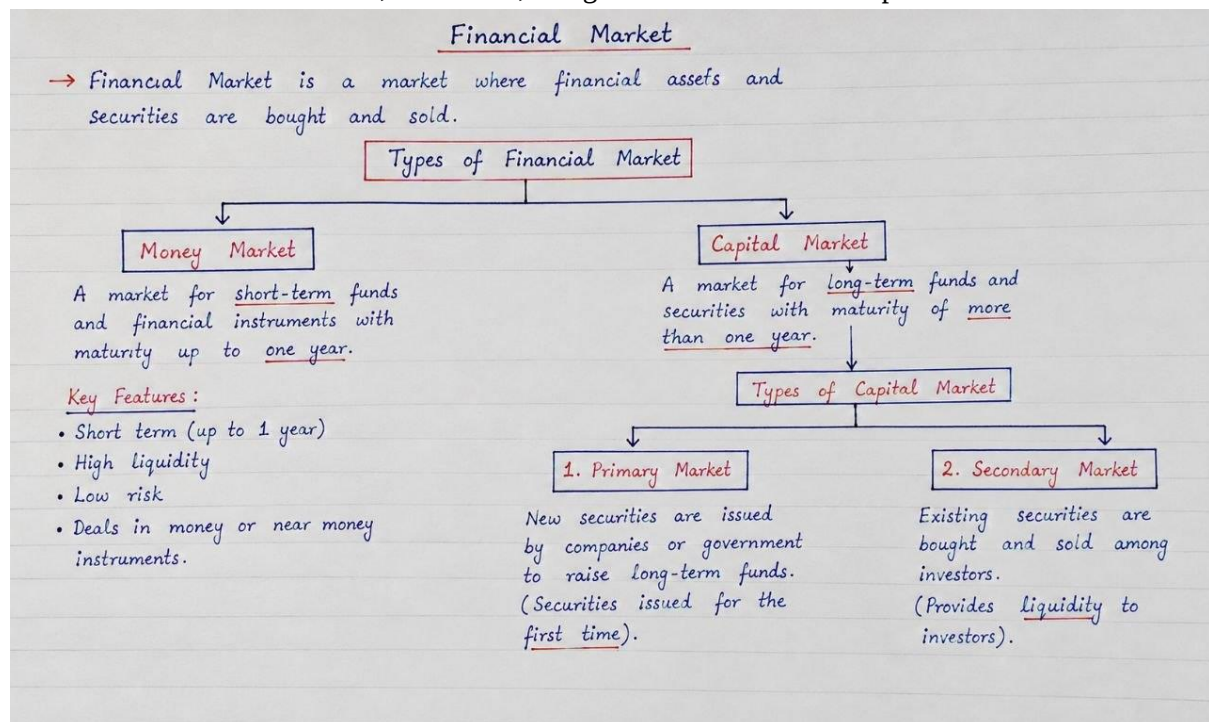
UNIT 4

1. Meaning of Financial Market

General Meaning: A financial market is a market where financial assets such as shares, debentures, bonds, government securities, and short-term financial instruments are bought and sold.

* Role of Intermediary: The financial market acts as a link or intermediary between the savings group and the investor/borrower group in the country. Topix

Mechanism: Ordinary citizens or institutions invest their surplus savings in the financial market, which channels the funds to industries, businesses, and governments that need capital.



Main Types of Financial Markets:

1. Money Market:

Short-term (up to 1 year) financial instrument market (e.g. Treasury bills, commercial papers).

2. Capital Market:

The market for long-term financial instruments (e.g., stock market, bond market).

2. Importance of Financial Markets

Financial markets are considered to be the pillars of economic development of any country. Its main advantages and importance are as follows:

(a) Mobilization of Savings and Capital Formation :

The financial market collects the small savings of the people and invests them in productive sectors.

This increases the rate of capital formation in the country, which is essential for the establishment of new industries.

(B) Price Discovery:

The prices of various financial securities (such as shares or bonds) are automatically determined by the forces of demand and supply in the financial market.

* This gives investors an idea of the true value of their assets.

(c) Providing Liquidity :

Investors can sell their securities (shares/bonds) in the financial market and convert them into cash.

This high liquidity motivates people to invest in the market without any hesitation.

(d) Reduction in Transaction Cost:

The financial market brings investors and companies on the same platform.

This saves the cost, time and effort of obtaining information, thereby reducing transaction and information costs.

(e) Accelerating Economic Growth:

* Easy availability of required capital to industries and infrastructure projects increases manufacturing, trade and employment opportunities in the country, leading to GDP growth.

(F) Risk Management:

The financial market offers a variety of instruments (such as mutual funds, derivatives, and insurance) so that investors can diversify their risk across different sectors.

Quick Recap for Exams:

Financial Markets: The link that connects savers and investors.

* The main 2 parts: the money market (short duration) + the capital market (long term).

* Key benefits: mobility of savings, capital creation, liquidity, pricing and economic development of the country.

1. Concept of Money Market

* Meaning:

Money market is a market for short-term financial assets and securities.

* Period: In this market, financial instruments with a maturity period of 1 day to a maximum of 1 year (365 days) are bought and sold.

* Instruments: Treasury Bills (T-Bills), Commercial Papers (CP), Certificate of Deposit (CD), Call Money and Commercial Bills.

* Liquidity: These instruments have high liquidity and can be converted into cash quickly.

* Regulator: The money market in India is mainly regulated by the Reserve Bank of India (RBI).

2. Objectives of the Financial Market

1. Meeting short term financial needs:

To provide a platform to the Government, commercial banks and industry to meet their short-term liquidity needs.

2. Efficient use of excess liquidity:

Banks or institutions which have unused short-term money lying with them should be given an opportunity to invest to earn interest.

3. Medium of Influence of the Central Bank (RBI):

To provide a platform for the implementation of RBI's monetary policy instruments (e.g. repo rate, OMO).

4. Providing Credit to the Government:

To provide funds to the government to meet its short-term cash mismatch through instruments such as treasury bills (T-bills).

5. Helping trade and industry:

To provide working capital to traders and industrialists through the sale of commercial bills.

6. Maintaining Balance in the Banking Sector:

Equilibrium of cash crunch between banks through the call money market.

7. Helping with Cash Management:

To help financial institutions manage their cash balances properly and safely.

8. Laying the foundation for long-term investment:

To create a conducive environment for the capital market by bringing short-term stability to the economy.

3. Characteristics of Indian Money Market

1. Dichotomous Structure:

The Indian financial market is divided into two distinct parts: the organised sector and the unorganised sector.

2. Central Control of RBI:

The organised financial market is fully controlled and guided by the Reserve Bank of India (RBI).

3. Domination of Commercial Banks:

Commercial banks, public and private, act as the largest participants in the Indian financial market.

4. Availability of multiple tools:

There are different types of instruments available in the market such as T-Bills, CDs, CPs, and Call Money.

5. Change in Seasonal Demand:

Since the Indian economy is agrarian, the demand for money suddenly increases during the harvest season.

6. Presence of Unorganized Sector:

Money lenders and indigenous bankers are still active in rural and small towns of the country.

7. Variation in Interest Rates:

There is a significant difference in interest rates between the organised and unorganised sectors, as well as between different instruments of the financial market.

8. Activation of Non-Banking Financial Companies (NBFCs):

LICs, GICs, and various NBFCs also provide large amounts of funds in the money market.

9. Digitization and Improvements:

In recent years, trading and payments through online platforms like e-Kuber, NDS-Call have become very fast and transparent.

10. Limited Development of Secondary Market:

In India, the secondary market for money market instruments to be bought and sold before the expiry date is not yet fully developed.

4. Shortcomings/Limitations of the Indian Financial Market

1. Lack of coordination between organized and unorganized sector:

Since there is no direct coordination or control between the organised banking sector and the domestic bankers/moneylenders, RBI's policies may not be uniformly applicable across the economy.

2. Underdevelopment of Bill Market:

The commercial bill market in India is far behind in comparison to other developed countries.

3. Diversity in Interest Rates:

There is a huge variation in the interest rates of different banks, financial institutions and unorganised moneylenders.

4. Lack of financial resources:

The short-term funds available with the financial market are often underfunded against the needs of rapidly growing industries and businesses.

□. Seasonal Volatility

In some months of the year (especially during the agricultural season), there is a severe shortage of money and the rest of the time there is surplus liquidity.

6. Lack of liquidity in secondary market:

The market for immediate resale of commercial paper or certificate of deposit is limited.

7. Unequal spread of banking facilities:

Rural and remote areas still do not have access to adequate modern banking facilities, leaving people dependent on unorganised moneylenders.

8. Limit of Foreign Trade Credit:

Short-term shipment credit or foreign exchange credit facilities required for international trade are still subject to reform.

9. Lack of information and awareness on financial instruments:

Small investors or small traders are fairly unaware of the various modern financial market instruments (such as T-Bills or CPs).

10. Volatility of Call Money Market:

The call money market (lending for 1 day) sees very large and fast fluctuations in interest rates, which makes it risky for smaller participants.

Instruments of Money Market

A money market is a market for short term financial assets (1 day to 1 year). In this market, the government, commercial banks, corporate companies and financial institutions use various instruments to meet their short-term liquidity needs.

A detailed explanation of the key instruments is as follows:

1. (Treasury Bills - T-Bills)

Meaning: A Treasury Bill is a short-term government security issued by the Reserve Bank of India (RBI) on behalf of the Government of India.

Objective: To provide funds to the government to meet its short-term cash deficit.

Maturity Period: It is mainly issued for 3 types of periods:

- * □□ □□□□□□ (91-Day T-Bill)
- * □□□ □□□□□□ (182-Day T-Bill)
- * □□□ □□□□□□ (364-Day T-Bill)

* Zero-Coupon Bonds: No interest is paid on T-Bills, but they are issued at a discount over their face value and are recovered at full value at maturity.

* Risk-Free: Since it is guaranteed by the government, it has zero default risk, so it is also called 'gilt-edged' security.

Yield/Interest Formula for T-Bills:

$$\text{Yield} = ((\text{Face Value} - \text{Issue Price}) / \text{Issue Price}) * (365 / \text{Maturity Days}) * 100$$

□. Commercial Paper - CP

* Meaning: An unsecured promissory note issued by large and financially capable corporate companies with a high credit rating.

* Beginnings: It was started in India in 1990.

Maturity: Usually issued for a period of 7 days to 1 year.

* Objective: Companies issue CPs to meet their working capital requirements as well as bridge financing for the issuance of new securities.

* Form: They are also issued at a discount on the philosophical price, just like T-Bills.

3. Certificate of Deposit (CD)

* Meaning: A Certificate of Deposit is a negotiable investment letter issued by Scheduled Commercial Banks and select Indian Financial Institutions (such as IDBI, SIDBI).

* Beginning: It was started in 1989 by the RBI in India.

* Maturity

* By Banks: 7 days to 1 year.

* By financial institutions: 1 year to 3 years.

* Feature: This is a large value deposit held in the form of a demat or promissory note, which offers a higher interest rate than normal savings account deposits.

4. Call Money and Notice Money

* Meaning: When a commercial bank borrows from another commercial bank for a very short period of time to meet its cash reserve ratio requirements, it is called call money or notice money.

* **Classification:**

* Call Money: Loan for 1 day (overnight) only.

* Notice Money: Loan for a tenure ranging from 2 days to 14 days.

* Term Money: Loan for a tenure of more than 15 days.

* Call Rate: The interest rate paid on call money is called 'Call Rate', which is highly volatile depending on demand and supply.

5. Commercial Bills / Bill of Exchange)

* Meaning: A bill of exchange is a bill of exchange written by the seller (writer) on the buyer (receiver) at the time of the sale of goods.

* Process: The seller can go to the bank and discount the bill before the maturity period for his financial needs.

* Duration: Usually has a tenure of 30 days, 60 days or 90 days.

* Bill Market: Banks can get money by re-discounting these bills from the central bank (RBI).

6. Cash Management Bills (CMBs)

* **Meaning:** This is a very short-term instrument launched by the Government of India and the RBI in 2010.

* **Duration:** It has a maturity period of less than 91 days (e.g., 14 days, 28 days, or 56 days).

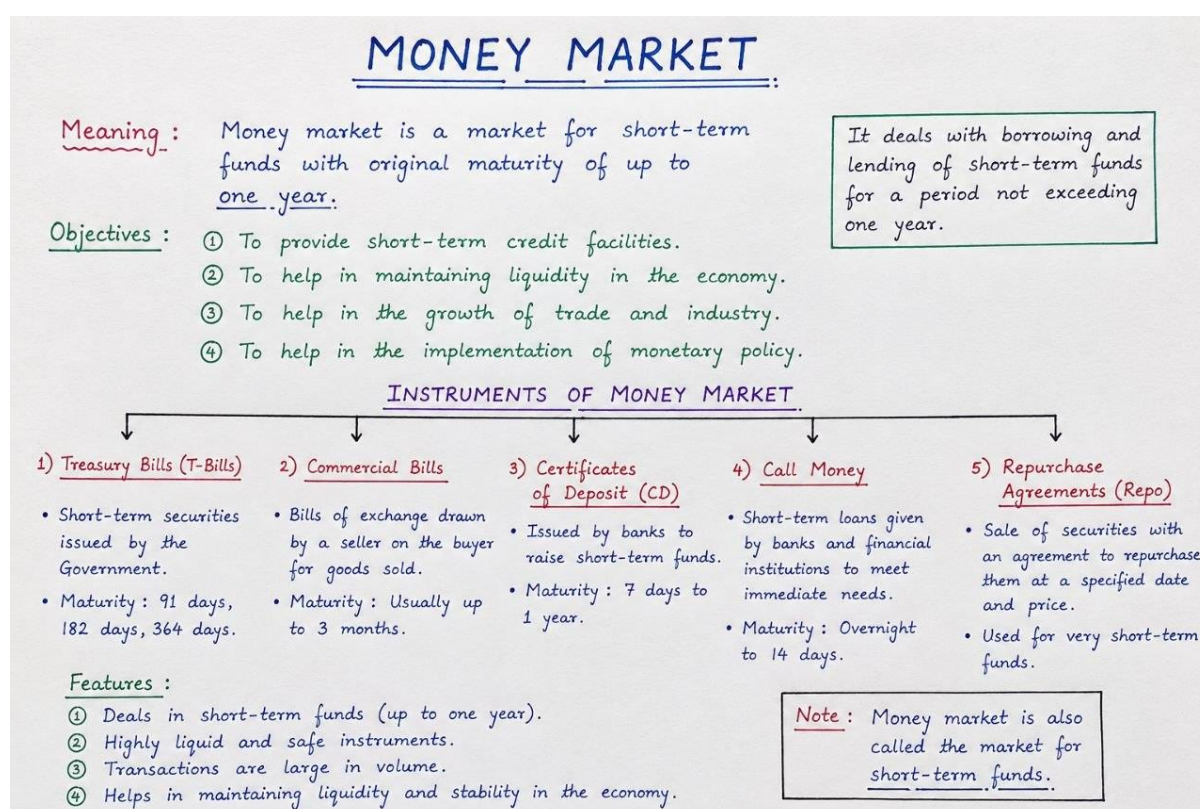
* **Objective:** These bills are issued only to meet the temporary mismatches in cash flow that arises suddenly in the government exchequer.

7. Repo and Reverse Repo Agreements

* **Meaning:** These are contracts where one party makes money by selling government securities and promises to buy back those securities at a fixed price at a fixed date in the future.

Repo - Repurchase Option: Banks get short-term loans by pledging their government securities to the RBI

* **Reverse Repo:** The RBI deposits additional cash from banks and issues government securities with interest.



Quick Comparison Summary for Exams

* **T-Bills:** Issued by the government, 91/182/364 days, with zero risk, exclusion.

* **Commercial Paper (CP):** By competent companies, 7 days to 1 year, for working capital.

* **Certificate of Deposit (CD):** Issued by banks, 7 days to 1 year, transferable.

* **Call Money:** Loan between banks, 1 day period (to maintain CRR).

* Commercial Bills: Letter of exchange between traders on credit and sale (30-90 days).

1. Concept of Capital Market.

Meaning: Capital market is a financial market where long-term and medium-term funds or financial instruments are bought and sold.

* Duration: Usually financial assets (such as shares, debentures, bonds) for a period of more than 1 year are included in this market.

Introduction: The capital market pools the savings of the common savers (citizens/institutions) of the country and provides it for long-term investment in new industries, factories, and infrastructure projects.

Regulator: The capital market in India is regulated and regulated by SEBI (Securities and Exchange Board of India).

2. Objectives of Capital Market

1. Providing long-term capital: Providing long-term funding to new companies and existing industries for their expansion, modernization and new projects.

2. Boost Capital Formation: Encourage the small savings of the country and divert them to productive sectors.

3. Safeguarding Investor Interests: Protecting small and large investors from speculation and fraud through transparent operations and SEBI regulations.

4. Maintain liquidity in securities: Allow investors to get cash by selling their shares and bonds at any time through the stock exchange.

5. Increase the rate of economic growth: To raise capital required for the development of large-scale industries and infrastructure (such as roads, power, ports) in the country.

6. Optimal Resource Allocation: Create an environment where industries which are more efficient and profitable can easily access capital.

7. Attracting Foreign Investment (FDI/FPI): To make the country's stock markets consistent and attractive for international investors.

8. Assisting companies in price discovery: Determining the true market value of securities based on demand and supply.

3. Features of Capital Market

1. Long Term Fund Market: This market trades securities for a period of more than 1 year (usually 5 to 20 years or permanent).

2. Presence of Intermediaries: Intermediaries such as merchant bankers, stock brokers, underwriters and depositories (NSDL/CDSL) play an important role in the capital market.

3. Multiple Instruments: Various instruments such as equity shares, preference shares, debentures, government bonds and mutual funds are available in this market.

4. High Risk: Since the volatility of the capital market is higher than that of the money market, the risk of investment is high.

5. Strict regulation of SEBI: All capital market activities are governed and supervised under the statutory framework of SEBI.

6. Presence of Secondary Market: Stock exchanges (e.g. BSE, NSE) are available to buy and sell securities issued earlier.

7. Large Investor Base: This market is attended by ordinary citizens to banks, insurance companies (LICs), mutual funds and foreign institutional investors (FIIs).

8. Thermometer of Economic Growth: Stock market indices (such as Sensex and Nifty) indicate the direction of economic health and development of the country.

4. Types of Capital Market

The capital market is mainly divided into two parts:

(A) Primary Market / New Issues Market (NIM):

Meaning: The market in which new securities (shares or debentures) are issued to the public for the first time is called the primary market.

Objective: Companies raise fresh funds directly for their new projects or areas.

* Methods:

- * IPO (Initial Public Offer)
- * FPO (Follow-on Public Offer)
- * Rights Issue
- * Private Placement

(B)(Secondary Market / Stock Market):

Meaning: A market in which pre-existing or issued securities are traded among investors is called a secondary market.

* Location: It is mainly managed by stock exchanges (e.g. BSE, NSE).

* Objective: To give investors an opportunity to acquire liquidity by selling their old securities.

5. Difference Between Money Market and Capital Market (Money Market vs Capital Market)

1. Meaning and Purpose:

Money Market: There is a market for short-term funds and financial instruments. It provides working capital.

Capital Market: It is a long- and medium-term fund market. It provides fixed capital (investment).

2. Maturity Period):

Money Market: From 1 day to a maximum of 1 year (365 days).

Capital Market: For a period of more than 1 year (5 years, 10 years or infinity).

3. Main Instruments:

* Money Market: Treasury Bills (T-Bills), Commercial Papers (CP), Certificate of Deposit (CD), Call Money.

* Capital Market: Equity shares, preference shares, debentures, government and corporate bonds, mutual funds.

4. Participants

* Financial markets: Reserve Bank (RBI), commercial banks, financial institutions, government.

* Capital market: Stock brokers, individual investors, insurance companies, mutual funds, foreign investors (FIIs).

5. Regulator:

* Money Market: Reserve Bank of India (RBI).

Capital Market: Securities and Exchange Board of India (SEBI).

6. Investment Risk Factor:

Money Market: Since it is short-term, the risk level is very low.

Capital Market: The risk is high due to price fluctuations and the long term.

7. Return on Investment

* Money Market: The rate of return (interest) is low and limited.

Capital Market: There is a possibility of high returns in the form of dividends and capital gains.

8. Liquidity:

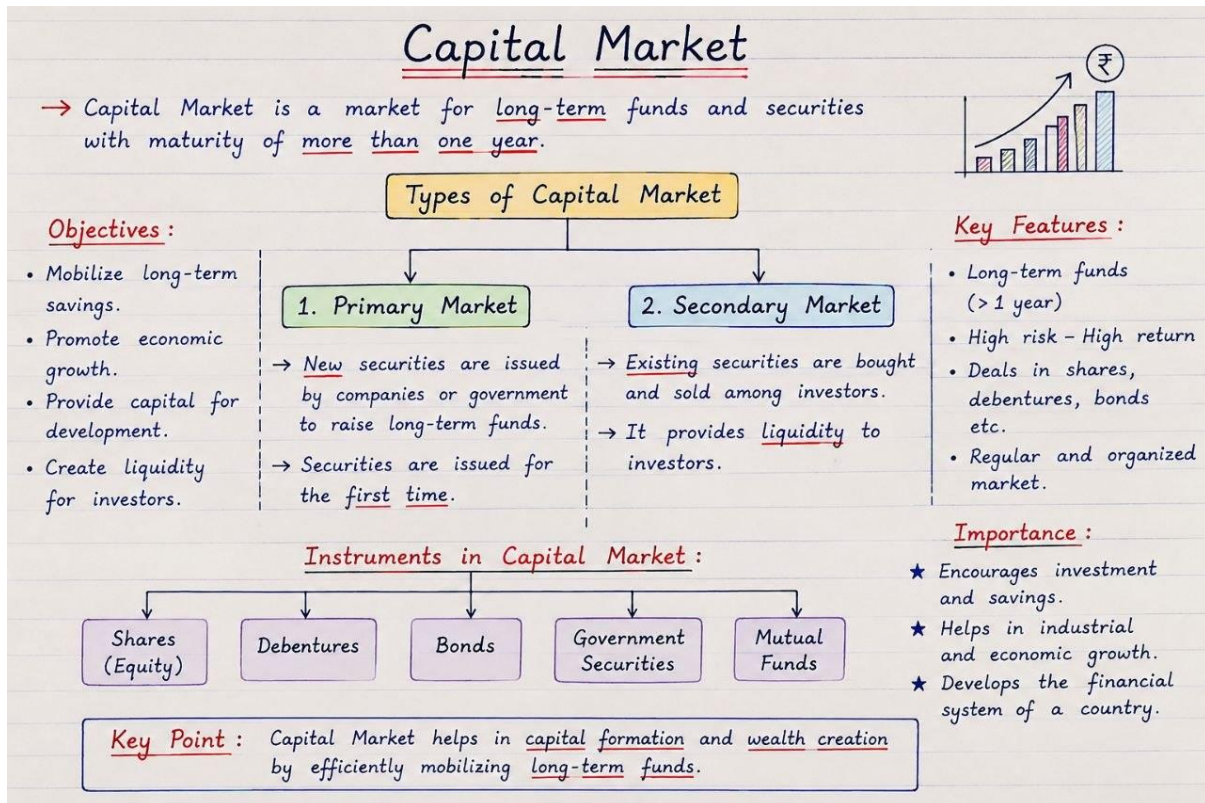
* Money market: Very high liquidity (possible to convert quickly into cash).

Capital Market: Liquidity is relatively low compared to money markets.

Quick Exam Recap:

Money Market: Short duration (< 1 year), RBI control, low risk, T-Bills/CP/CD.

* Capital Market: Long tenure (> 1 year), SEBI control, high risk/returns, shares/debentures.



1. Primary Market and its Instruments

Meaning of Primary Market:

The primary market is also known as the 'New Issues Market (NIM)'.

This is a market where companies, government or financial institutions raise fresh funds or capital directly by issuing new securities against the public for the first time.

Here the buying and selling takes place directly between the company and the investor.

Methods/Instruments of Primary Market:

1. Initial Public Offer (IPO):

When an unlisted company issues its shares or securities for the first time to the general public, it is called an IPO.

□. Follow-on Public Offer - FPO

When a company that is already listed on the stock exchange issues new shares to the public again to raise additional capital, it is called an FPO.

3. Rights Issue:

* When a company gives its existing partners/shareholders the right to purchase the first purchase of their existing shares in proportion to their existing shares, it is called a 'rights issue'.

4. Bonus Issue

* The company allots additional shares free of cost to existing shareholders from its dividend or reserve fund.

5. Private Placement:

* The company sells shares directly to select large investors (such as banks, mutual funds, or insurance companies) instead of issuing shares to the public.

2. Secondary Market and its Instruments

Meaning of secondary market:

*Secondary Market means (Stock Market / Stock Exchange).

This is a market where previously issued and listed securities are traded among investors.

* Here the company does not get money directly, but the old investor gets liquidity and the new investor gets shares.

In India, BSE (Bombay Stock Exchange) and NSE (National Stock Exchange) are the main subsidiary markets.

Instruments/Trading Assets in Secondary Market:

1. Listed Equity Shares:

Shares purchased from the primary market are freely traded in the secondary market.

2. Traded Debentures and Bonds:

Daily buying and selling of company or government bonds.

3. Derivatives (Derivatives - Futures & Options):

* Futures: A legal contract to buy or sell security at a price fixed at a future date.

* Options: Hedging against risk by paying a fixed premium through call and put options.

4. Exchange Traded Funds (ETFs):

Instruments similar to mutual funds that can be bought and sold in real-time like ordinary stocks in the stock market (e.g. Nifty BeES, Gold ETF).

3. Instruments of Capital Market in Detail

Capital market instruments are mainly divided into three categories:

(a) Ownership Securities / Equity:

1. Equity Shares / Ordinary Shares

- * **Meaning:** The person who buys the equity share becomes the co-owner of the company.
- * **Returns:** They get dividends from the company's profits, the rate of which is not fixed.
- * **Risk and Voting:** These shareholders take the most risk and have voting rights at the company's general meetings.

2. Preference Shares:

- * **Meaning:** Investors get 'preference' over ownership rights in these stocks.
- * **Features:**
 - * The first right to receive dividends at a fixed rate from the profits of the company.
 - * First choice over equity shareholders in getting their capital back at the time of dissolution of the company.

Voting Rights: Generally, they do not have the right to vote.

(B) (Debt Securities / Credit Instruments):

1. Debentures:

- * **Meaning:** A debenture is a document that acknowledges the long-term debt received by a company from the general public or institutions.
- * **Return:** The debenture holder is paid interest at a fixed rate, irrespective of the profit or loss of the company.
- * **Types:** Secured, Unsecured, Convertible, and Non-convertible.

2. Government Bonds / G-Secs:

- * **Meaning:** Bonds issued by the central or state governments to raise funds for long-term infrastructure projects.
- * **Risk:** Since it is a government guarantee, it is risk-free.

3. Corporate Bonds:

* Letters of interest issued by large private or public sector companies for long-term loans.

(c) Hybrid and Other Instruments :

1. Mutual Fund Units:

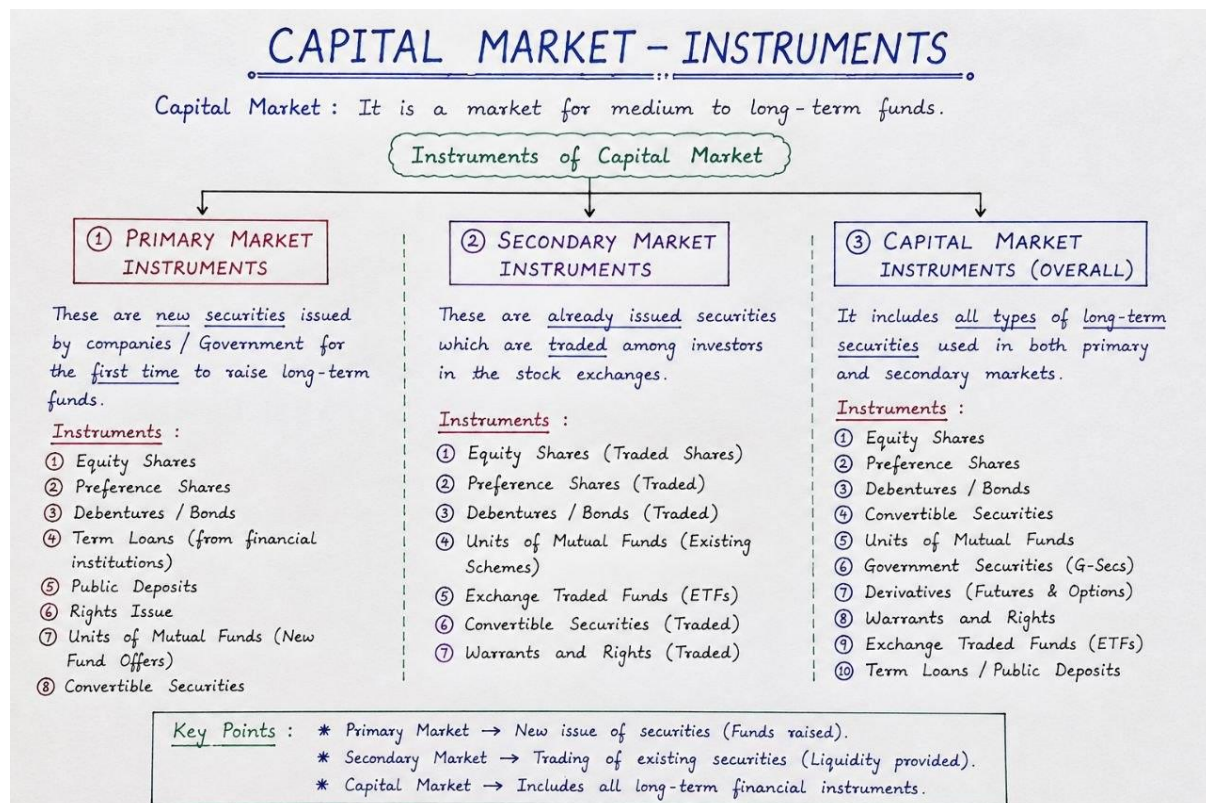
* Financial institutions (AMCs) collect money from small investors and invest it in stocks, bonds and portfolios of various securities.

2. Convertible Debentures:

* Debentures that are converted into equity shares, either fully or partially, after a certain period of time.

□. □□□□□□□□ □□□□□□ (Global & American Depository Receipts - ADRs / GDRs):

Indian companies issue ADRs (for the US) and GDR (for the global market) to raise capital from foreign stock exchanges.



Quick Recap for the Exam:

* Primary Market: New Securities (IPO/FPO/Rights Issue) - Direct investor from the company.

- * Secondary Market: Buy and Sell Old Securities (BSE/NSE) - Investor to Investor.
- * Capital Market Instruments:
 - * Equity/Preference Shares: Owned capital (dividends).
 - * Debentures/Bonds: Erasing debt (fixed interest).
 - * Mutual Funds/ADR/GDR: Modern and hybrid instruments.