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Subject: Economics-II
(Macroeconomic Analysis) L4 C4

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Unit-1

Interdependence of micro and macro economics:

Micro and macro economics are the two sides of the same coin. There is close interdependence between the two. We cannot analyses the individual behavior without the assuming to aggregate and likewise aggregate cannot be effective unless individual variables are kept under consideration.

Micro economics contributes towards macro economics in a number of ways as:-
1.*Study of economic fluctuations*:-Business cycles which are universal in every sector, are influenced by both individuals and aggregate factors. Unless we review both micro and aggregate variables, we cannot provide an appropriate solution to business cycles. Therefore to study trade cycle's micro and macro economics contribute significantly.

2.*Basis of economic laws*:-Micro economics acts as a basis macro economics because macro is an aggregate of individual units. The success and accuracy of aggregates depends on the individual units. Similarly, macro theories are used by micro economists.

3.*Role in international trade*:-In international trade both the approaches are used. Economists have developed their theories on the basis of micro economics presuming full employment of resources and mobility of factors move production. However, modern economists looked on the economy as a whole and recognized the role of aggregates. So general equilibrium is nothing but an extension of equilibrium of micro economics.

4.*Balance of payments and interdependence*:-Balance of payments problem is also a burning problem for economy. An individual sector may have favorable balance of payments whereas other sectors, unfavorable balance of payments. On theother hand. The overall position of an economy is to be assessed from aggregate position of all sectors.

5.*Theory of tariffs*:-Many economists have propounded that modern macro approaches of imposing tariffs with the intension of correcting balance of payments position is virtually based on the theory of monopoly. So micro economics has influenced the modern macro economics theory.

Keynesian economics:

Keynesian economics (or **Keynesianism**) is the view that in the short run, especially during recessions, economic output is strongly influenced by aggregate demand (total spending in the economy). In the Keynesian view, aggregate demand does not necessarily equal the productive capacity of the economy; instead, it is influenced by a host of factors and sometimes behaves erratically, affecting production, employment, and inflation

The theories forming the basis of Keynesian economics were first presented by the British economist John Maynard Keynes in his book, *The General Theory of Employment, Interest and Money*, published in 1936, during the Great Depression. Keynes contrasted his approach to the 'classical' economics that preceded his book. The interpretations of Keynes that followed are contentious and several schools of economic thought claim his legacy.

Keynesian economists often argue that private sector decisions sometimes lead to inefficient macroeconomic outcomes which require active policy responses by the public sector, in particular, monetary policy actions by the central bank and fiscal policy actions by the government, in order to stabilize output over the business cycle. Keynesian economics advocates a mixed economy – predominantly private sector, but with a role for government intervention during recessions.

Keynesian economics served as the standard economic model in the developed nations during the later part of the Great Depression, World War II, and the post-war economic expansion (1945–1973), though it lost some influence following the oil shock and resulting stagflation of the 1970s.The advent of the global financial crisis in 2008 has caused a resurgence in Keynesian thought.

Classical economics:

Classical economics is widely regarded as the first modern school of economic thought. Its major developers include Adam Smith, Jean-Baptist Say, David Ricardo, Thomas Malthus and John Stuart Mill.

Adam Smith's *The Wealth of Nations* in 1776 is usually considered to mark the beginning of classical economics. The school was active into the mid 19th century and was followed by neoclassical economics in Britain beginning around 1870, or, in Marx's definition by "vulgar political economy" from the 1830s. The definition of classical economics is debated, particularly the period 1830–70 and the connection to neoclassical economics. The term "classical economics" was coined by Karl Marx to refer to Ricardian economics – the economics of David Ricardo and James Mill and their *predecessors* – but usage was subsequently extended to include the *followers* of Ricardo.

Classical economists claimed that free markets regulate themselves, when free of any intervention. Adam Smith referred to a so-called invisible hand, which will move markets towards their natural equilibrium, without requiring any outside intervention.

As opposed to Keynesian economics, classical economics assumes flexible prices both in the case of goods and wages. Another main assumption is based on Say's Law: supply creates its own demand - that is, aggregate production will generate an income enough to purchase all the output produced; this implicitly assumes, in contrast to Keynes, that there will be net saving or spending of cash or financial instruments. Another postulate of classical economics is the equality of savings and investment, assuming that flexible interest rates will always maintain equilibrium.

Differences Between Classical & Keynesian Economics:

Economics is the quantitative and qualitative study on the allocation, distribution and production of economic resources. Economics often studies the monetary policy of a government and other information using mathematical or statistical calculations. Qualitative analysis is made by making judgments and inferences from fiscal information. Two economic schools of thought are classical and Keynesian. Each school takes a different approach to the economic study of monetary policy, consumer behavior and government spending. A few basic distinctions separate these two schools.

Basic Theory:

Classical economic theory is rooted in the concept of a laissez-faire economic market. A laissez-faire--also known as free--market requires little to no government intervention. It also allows individuals to act according to their own self interest regarding economic decisions. This ensures economic resources are allocated according to the desires of individuals and businesses in the marketplace. Classical economics uses the value theory to determine prices in the economic market. An item’s value is determined based on production output, technology and wages paid to produce the item. Keynesian economic theory relies on spending and aggregate demand to define the economic marketplace. Keynesian economists believe the aggregate demand is often influenced by public and private decisions. Public decisions represent government agencies and municipalities. Private decisions include individuals and businesses in the economic marketplace. Keynesian economic theory relies heavily on the fact that a nation’s monetary policy can affect a company’s economy.

Government Spending:

Government spending is not a major force in a classical economic theory. Classical economists believe that consumer spending and business investment represents the more important parts of a nation& economic growth. Too much government spending takes away valuable economic resources needed by individuals and businesses. To classical economists, government spending and involvement can retard a nation’s economic growth by increasing the public sector and decreasing the private sector. Keynesian economics relies on government spending to jumpstart a nation’s economic growth during sluggish economic downturns. Similar to classical economists, Keynesians believe the nation’s economy is made up of consumer spending, business investment and government spending. However, Keynesian theory dictates that government spending can improve or take the place of economic growth in the absence of consumer spending or business investment.

Short vs. Long-term Affects

Classical economics focuses on creating long-term solutions for economic problems. The effects of inflation, government regulation and taxes can all play an important part in developing classical economic theories. Classical economists also take into account the effects of other

current policies and how new economic theory will improve or distort the free market environment. Keynesian economics often focuses on immediate results in economic theories. Policies focus on the short-term needs and how economic policies can make instant corrections to a nation& rsquo; s economy. This is why government spending is such a key cog of Keynesian economics. During economic recessions and depressions, individuals and businesses do not usually have the resources for creating immediate results through consumer spending or business investment. The government is seen as the only force to end these downturns through monetary or fiscal policies providing instant economic results.

Goals of macroeconomic policy:

The three primary macroeconomic policy goals are economic growth, low unemployment and low inflation.

The three primary macroeconomic policy goals are economic growth, low unemployment, and low inflation. Economic growth is an increase in a country's standard of living. Unemployment is the condition of wanting, but not having, a paid job. Inflation is a general increase in the price level, which is the general level of prices for goods and services in an economy. A price index is used to measure the price level. All three goals are important because of their influence on the standard of living. Economic growth is the primary determinant of the standard of living, however, and is thus the ultimate macroeconomic goal.

Stocks and Flows:

Economics, business, accounting, and related fields often distinguish between quantities that are stocks and those that are flows. These differ in their units of measurement. A *stock* variable is measured at one specific time, and represents a quantity existing at that point in time (say, December 31, 2004), which may have accumulated in the past. A *flow* variable is measured over an interval of time. Therefore a flow would be measured *per unit of time* (say a year). Flow is roughly analogous to rate or speed in this sense.

For example, U.S. nominal gross domestic product refers to a total number of dollars spent over a time period, such as a year. Therefore it is a flow variable, and has units of dollars/year. In contrast, the U.S. nominal capital stock is the total value, in dollars, of equipment, buildings, inventories, and other real assets in the U.S. economy, and has units of dollars. The diagram provides an intuitive illustration of how the *stock* of capital currently available is increased by the *flow* of new investment and depleted by the *flow* of depreciation.

Stocks and flows in accounting:

Thus, a stock refers to the value of an asset at a balance date (or point in time), while a flow refers to the total value of transactions (sales or purchases, incomes or expenditures) during an

accounting period. If the flow value of an economic activity is divided by the average stock value during an accounting period, we obtain a measure of the number of turnovers (or rotations) of a stock in that accounting period. Some accounting entries are normally always represented as a flow (e.g. profit or income), while others may be represented both as a stock or as a flow (e.g. capital).

A person or country might have stocks of money, financial assets, liabilities, wealth, real means of production, capital, inventories, and human capital (or labor power). Flow magnitudes include income, spending, saving, debt repayment, fixed investment, inventory investment, and labor utilization.

Comparing stocks and flows:

Stocks and flows have different units and are thus not *commensurable* – they cannot be meaningfully *compared, equated, added, or subtracted.* However, one may meaningfully take *ratios* of stocks and flows, or multiply or divide them. This is a point of some confusion for some economics students, as some confuse taking ratios (valid) with comparing (invalid).

The ratio of a stock over a flow has units of (units)/(units/time) = time. For example, the debt to GDP ratio has units of years (as GDP is measured in, for example, dollars per year whereas debt is measured in dollars), which yields the interpretation of the debt to GDP ratio as "number of years to pay off all debt, assuming all GDP devoted to debt repayment".

The ratio of a flow to a stock has units 1/time. For example, the velocity of money is defined as nominal GDP / nominal money supply; it has units of (dollars / year) / dollars = 1/year.

In discrete time, the change in a stock variable from one point in time to another point in time one time unit later is equal to the corresponding flow variable per unit of time. For example, if a country's stock of physical capital on January 1, 2010 is 20 machines and on January 1, 2011 is 23 machines, then the flow of net investment during 2010 was 3 machines per year. If it then has 27 machines on January 1, 2012, the flow of net investment during 2010 and 2011 averaged $3\frac{1}{2}$ machines per year.

National Product and Domestic Product:

Gross national product (**GNP**) is the market value of all the products and services produced in one year by labor and property supplied by the residents of a country. Unlike Gross Domestic Product (GDP), which defines production based on the geographical location of production, GNP allocates production based on ownership.

GNP does not distinguish between qualitative improvements in the state of the technical arts (e.g., increasing computer processing speeds), and quantitative increases in goods (e.g., number of computers produced), and considers both to be forms of "economic growth".

Basically, GNP is the total value of all final goods and services produced within a nation in a particular year, plus income earned by its citizens (including income of those located abroad), minus income of non-residents located in that country. GNP measures the value of goods and services that the country's citizens produced regardless of their location. GNP is one measure of the economic condition of a country, under the assumption that a higher GNP leads to a higher quality of living, all other things being equal.

Gross National Product (GNP) is often contrasted with Gross Domestic Product (GDP). While GNP measures the output generated by a country's enterprises (whether physically located domestically or abroad) GDP measures the total output produced within a country's borders - whether produced by that country's own local firms or by foreign firms.

When a country's capital or labour resources are employed outside its borders, or when a foreign firm is operating in its territory, GDP and GNP can produce different measures of total output. In 2009 for instance, the United States estimated its GDP at $14.119 trillion, and its GNP at $14.265 trillion.

GDP vs GNP:

All attributes | Differences | Similarities

Improve this chart	GDP	GNP
Stands for:	Gross Domestic Product	Gross National Product
Definition:	An estimated value of the total worth of a country's production and services, on its land, by its nationals and foreigners, calculated over the course on one year	An estimated value of the total worth of production and services, by citizens of a country, on its land or on foreign land, calculated over the course on one year
Formula for Calculation:	GDP = consumption + investment + (government spending) + (exports − imports)	GNP = GDP + NR (Net income inflow from assets abroad or Net Income Receipts) - NP (Net payment outflow to foreign assets)
Uses:	Business, Economic Forecasting	Business, Economic Forecasting

circular Flow of Income:

In economics, the terms circular flow of income or circular flow refer to a simple economic model which describes the reciprocal circulation of income between producers and consumers.[In the circular flow model, the inter-dependent entities of producer and consumer are referred to as "firms" and "households" respectively and provide each other with factors in order to facilitate the flow of income.Firms provide consumers with goods and services in exchange for consumer expenditure and "factors of production" from households. More complete and realistic circular flow models are more complex. They would explicitly include the roles of government and financial markets, along with imports and exports.

Human wants are unlimited and are of recurring nature therefore, production process remains a continuous and demanding process. In this process, household sector provides various factors of production such as land, labor, capital and enterprise to producers who produce by goods and services by coordinating them. Producers or business sector in return makes payments in the form of rent, wages, interest and profits to the household sector. Again household sector spends

this income to fulfill its wants in the form of consumption expenditure. Business sector supplies them goods and services produced and gets income in return of it. Thus expenditure of one sector becomes the income of the other and supply of goods and services by one section of the community becomes demand for the other. This process is unending and forms the circular flow of income, expenditure and production.

A continuous flow of production, income and expenditure is known as circular flow of income. It is circular because it has neither any beginning nor an end. The circular flow of income involves two basic assumptions:- 1.In any exchange process, the seller or producer receives the same amount what buyer or consumer spends. 2.Goods and services flow in one direction and money payment to get these flow in return direction, causes a circular flow.

Circular flows are classified as: Real Flow and Money Flow. Real Flow- In a simple economy, the flow of factor services from households to firms and corresponding flow of goods and services from firms to households is known to be as real flow.

Assume a simple two sector economy- household and firm sectors, in which the households provides factor services to firms, which in return provides goods and services to them as a reward. Since there will be an exchange of goods and services between the two sectors in physical form without involving money, therefore, it is known as real flow.

Money Flow- In a modern two sector economy, money acts as a medium of exchange between goods and factor services. Money flow of income refers to a monetary payment from firms to households for their factor services and in return monetary payments from households to firms against their goods and services. Household sector gets monetary reward for their services in the form of rent, wages, interest, and profit form firm sector and spends it for obtaining various types of goods to satisfy their wants. Money acts as a helping agent in such an exchange.

Assumptions:

The basic circular flow of income model consists of seven assumptions:

1. The economy consists of two sectors: households and firms.
2. Households spend all of their income (Y) on goods and services or consumption (C). There is no saving (S).
3. All output (O) produced by firms is purchased by households through their expenditure (E).
4. There is no financial sector.
5. There is no government sector.
6. There is no overseas sector.
7. It is a closed economy with no exports or imports.

Effective Demand-Aggregate Demand and Aggregate Supply:

Principle of Effective Demand: Aggregate Demand and Aggregate Supply

Introduction:

The logical starting point of Keynes's theory of employment is the principle of effective demand. In a entrepreneurial economy, the level of employment is based on effective demand. Thus employment results from a deficiency of effective demand and the level of employment can be raised by increasing the level of effective demand.

Aggregate Demand Price:

"The aggregate demand price for the output of any given amount of employment is the total sum of money or proceeds which is expected from the sale of the output produced when that amount of labour is employed." Thus the aggregate demand price is the amount of money which the entrepreneurs expect to get by selling the output produced by the number of men employed. In other words it refers to the expected revenue from the sale of output produced at a particular level of employment. Different aggregate demand prices relate to different levels of employment in the economy.

A statement showing the various aggregate demand prices at different levels of employment is called the aggregate demand price schedule or aggregate demand function. "The aggregate demand function." according to Keynes, "relates any given level of employment to the expected proceeds from that level of employment."

The below tablet represents the aggregate demand schedule where it reveals that, with the increase in the level of employment proceeds, expected rise and at lower levels of employment decline. When 900 thousand people are provided employment the aggregate demand price is $560 million and when 250 thousand people are provided jobs, it is $480 million.

According to Keynes the aggregate demand function is an increasing function of the level of employment and is expressed as D = F (N), where D is the proceeds which entrepreneurs expect from the employment of N men.

In macroeconomics, aggregate demand (AD) is the total demand for final goods and services in the economy (Y) at a given time and price level. It is the amount of goods and services in the economy that will be purchased at all possible price levels. This is the demand for the gross domestic product of a country when inventory levels are static. It is often called effective demand, though at other times this term is distinguished.

It is often cited that the aggregate demand curve is downward sloping because at lower price levels a greater quantity is demanded. While this is correct at the microeconomic, single good

level, at the aggregate level this is incorrect. The aggregate demand curve is in fact downward sloping as a result of three distinct effects: Pigou's wealth effect, the Keynes' interest rate effect and the Mendel-Fleming exchange-rate effect.

Unit-2

Functions for money, classification, supply and demand for money:

Monetary theory develops the link between money supply and other macroeconomic variables, including the price level and output (GDP). In this chapter we begin with competing theories of money demand and some empirical evidence about the behavior of money demand.

I. The Quantity Theory of Money

This theory, developed by the classical economists over 100 years ago, related the amount of money in the economy to nominal income. Economist Irving Fisher is given credit for the development of this theory. It begins with an identity known as the **equation of exchange**:

MV = PY

Where M is the quantity of money, P is the price level, and Y is aggregate output (and aggregate income). V is velocity, which serves as the link between money and output. **Velocity** is the number of times in a year that a dollar is used to purchased goods and services.

The equation of exchange is an identity because it must be true that the quantity of money, times how many times it is used to buy goods equals the amount of goods times their price.

To move towards the quantity theory of money, Fisher makes two key assumptions:

1. Fisher viewed velocity as constant in the short run. This is because he felt that velocity is affected by institutions and technology that change slowly over time.
2. Fisher, like all classical economists, believed that flexible wages and prices guaranteed output, Y, to be at its full-employment level, so it was also constant in the short run.

Putting these two assumptions together lets look again at the equation of exchange:

MV = PY

If both V and Y are constant, then changes in M must cause changes in P to preserve the equality between MV and PY. This is **the quantity theory of money: a change in the money supply, M, results in an equal percentage change in the price level P.**

We can further modify this relationship by dividing both sides by V:

M = (1/V) x PY

Since V is constant we can replace (1/V) with some constant, k, and when the money market is in equilibrium, Md = M. So our equation becomes

Md = k x PY

So under the quantity theory of money, money demand is a function of income and does not depend on interest rates.

Is Velocity Constant?

A constant V is key to the quantity theory of money. For Fisher, the assumption was a leap of faith since data on GDP and the money supply did not exist in 1911. However, looking at that data in Figure 1, page 542, we see very clearly that velocity is not constant, even in the short run. In particular, velocity drops significantly during recessions.

With the problems of the Great Depression, economists began to look for factors other than income that influence money demand.

II. Keynes Liquidity Preference Theory

In 1936, economist John M. Keynes wrote a very famous and influential book, The General Theory of Employment, Interest Rates, and Money. In this book he developed his theory of money demand, known at the **liquidity preference theory**. His ideas formed the basis for the liquidity preference framework discussed in chapter 5.

Keynes believed there were 3 motives to holding money:

- **Transactions motive.** Money is a medium of exchange, and people hold money to buy stuff. So as income rises, people have more transactions and people will hold more money

- **Precautionary motive.** People hold money for emergencies (cash for a tow truck, savings for unexpected job loss). Since this also depends on the amount of transactions people expect to make, money demand is again expected to rise with income.

- **Speculative motive.** Money is also a way for people to store wealth. Keynes assumed that people stored wealth with either money or bonds. When interest rates are high, rate would then be expected to fall and bond prices would be expected to rise. So bonds are more attractive than money when interest rates are high. When interest rates are low, they then would be expected to rise in the future and thus bond prices would be expected to fall. So money is more attractive than bonds when interest rates are low. **So under the speculative motive, money demand is negatively related to the interest rate.** (We have seen this already in chapter 5).

Keynes also modeled money demand as the demand for the REAL quantity of money (real balances) or M/P. In other words, if prices double, you must hold twice the amount of M to buy the same amount of stuff, but your real balances stay the same. So people chose a certain amount of real balances based on the interest rate, and income:

M/P = f(i, Y) The importance of interest rates in the Keynesian approach is the big difference between Keynes and Fisher. With this difference also come different implications about the behavior of velocity. Consider the two equations:

MV = PY
M/P = f (i, Y)

so M = PY/V in the first equation. Substituting in the second equation:

Y/V = f(i, Y) or V = Y/(f(i,Y)).

This means that under Keynes' theory, velocity fluctuates with the interest rate. Since interest rates fluctuate quite a bit, then velocity must too. In fact, velocity and interest rates will move in the same direction. Both are procyclical, rising with expansions and falling during recessions.

Further Developments to the Keynesian Approach:

After World War II, Keynes economic theories became very influential and other economists further refined his motives for holding money. One of these economists, James Tobin, later won a Nobel Prize for his contributions.

Tobin (and another economist Baume) both developed theories and how the transactions demand for money is also related to the interest rate. As interest rates rise, the opportunity cost of holding cash for transactions will also rise, so the transactions part of money demand is also negatively related to the interest rate. Similarly, people will hold fewer precautionary balances when interest rates are high.

One problem with Keynes' speculative demand is that his theory predicted that people would hold wealth as either money or bonds, but not both at once. That is not realistic. Tobin avoided this problem by observing that the return to money is much less risky than the return to bonds, so that people will still hold some money as a store of wealth even when interest rates are high. This diversification is attractive because is reduces risk.

Still one problem with money demand remains. There are other low risk interest bearing assets: money market mutual funds, U.S. Treasury Bills, and others. So why would anyone hold money (M1) as a store of wealth? Economist today still tries to develop models of investor behavior to solve this "rate of return dominance" puzzle.

III. Friedman's Modern Quantity Theory of Money

Milton Friedman (another Nobel Prize winner) developed a model for money demand based on the general theory of asset demand. Money demand, like the demand for any other asset, should be a function of wealth and the returns of other assets relative to money. His money demand function is as follows:

$$\left(\frac{M^d}{P}\right) = f\left(Y_p, r_b - r_m, r_e - r_m, \pi_e - r_m\right)$$

Where Yp = permanent income (the expected long-run average of current and future income)
rb = the expected return on bonds

rm = the expected return on money
re = the expected return on stocks
pi(e) = the expected inflation rate (the expected return on goods, since inflation is the increase in the price (value) of goods)

Money demand is positively related to permanent income. However, permanent income, since it is a long-run average, is more stable than current income, so this will not be the source of a lot of fluctuation in money demand

The other terms in Friedman's money demand function are the expected returns on bonds, stocks and goods RELATIVE the expected return on money. These items are negatively related to money demand: the higher the returns of bonds, equity and goods relative the return on money, the lower the quantity of money demanded. Friedman did not assume the return on money to be zero. The return on money depended on the services provided on bank deposits (check cashing, bill paying, etc) and the interest on some checkable deposits.

Friedman vs. Keynes :

When comparing the money demand frameworks of Friedman and Keynes, several differences arise

- Friedman considers multiple rates of return and considers the RELATIVE returns to be important
- Friedman viewed money and goods and substitutes.
- Friedman viewed permanent income as more important than current income in determining money demand

Friedman's money demand function is much more stable than Keynes'. Why? Consider the terms in Friedman's money demand function:

- permanent income is very stable, and
- the spread between returns will also be stable since returns would tend to rise or fall all at once, causing the spreads to stay the same. So in Friedman's model changes in interest rates have little or no impact on money demand. This is not true in Keynes' model.

If the terms affecting money demand are stable, then money demand itself will be stable. Also, velocity will be fairly predictable.

IV. Empirical Evidence on Money Demand

So who is right? Well, the chief differences between Keynes and Friedman lie in the sensitivity of money demand to interest rates and the stability of the money demand function over time. Looking at the data on these two features will yield some answers about the best theory of money demand.

Tobin did some of the earliest research on the relationship between interest rates and money demand and concluded that money demand IS sensitive to interest rates. Later research in the 1950s and 1960s backed up his findings. Furthermore, the sensitivity did not change over time. Many researchers looked at this question and their findings are remarkably consistent (which in economics is somewhat miraculous :)).

Now for the stability of the money demand function. Up until the mid-1970s, researchers found the money demand function to be remarkably stable. In other words, money demand functions estimated in the 1930s, worked just as well predicting money demand in the 1950s or 1960s. The relationship between money demand, income and interest rates did not change over time.

However, starting in 1974, the stability of the money demand function (M1) began to breakdown. Existing money demand functions were overpredicting money demand (i.e. actual money demand was lower than what old money demand functions were predicting). This case of the "missing money" was a problem for policy makers that relied on these functions to predict the effects of monetary policy. What caused this breakdown? It is likely that financial innovations in the 1970s (money market accounts, NOW accounts, electronic funds transfers) changed the working definitions of money even though our official definitions did not change. This problem grew worse in the 1980s.

With the problems in the M1 money demand functions, policy makers turned to M2 money demand. However, the stability of M2 money demand functions also broke down in the 1990s. This cause the Federal Reserve to stop setting targets for M2 in 1992 after abandoning M1 targets in 1987.

Inflation and deflation:

In economics inflation means, a rise in general level of prices of goods and services in a economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services. Thus, inflation results in loss of value of money. Another popular way of looking at inflation is "too much money chasing too few goods". The last definition attributes the cause of inflation to monetary growth relative to the output / availability of goods and services in the economy.

In case the price of say only one commodity rise sharply but prices of other commodities falls, it will not be termed as inflation. Similarly, in case due to rumors if the price of a commodity rises during the day itself, it will not be termed as inflation.

What are different types of inflation**:**

(a) DEMAND - PULL INFLATION: In this type of inflation prices increase results from an excess of demand over supply for the economy as a whole. Demand inflation occurs when supply cannot expand any more to meet demand; that is, when critical production factors are being fully utilized, also called Demand inflation.

(b) COST - PUSH INFLATION: This type of inflation occurs when general price levels rise owing to rising input costs. In general, there are three factors that could contribute to Cost-Push inflation: rising wages, increases in corporate taxes, and imported inflation. [imported raw or partly-finished goods may become expensive due to rise in international costs or as a result of depreciation of local currency

Types of inflation such as:

(1) currency inflation whereby prices rise NOT because of an increase in money supply, but a decline in value of the currency on world markets (*i.e.* G5 manipulation of dollar 40% lower in 1985 led to 1987 Crash & capital flight back to Japan creating bubble there);

(2) capital concentration into one sector causing bubble which can be purely domestic or inspired internationally with rising currency as was the case in Japan 1989 or USA into 1929;

(3) the classroom plain vanilla idea of a rise in prices with an increase in in money supply such as sudden discovery of gold in California, Australia and Alaska during 19th century, and the import of gold and silver from America into Europe by Spain that created wholesale systemic inflation in all European economies, and

(4) Commodity inflation that is caused by a drop in supply such as food due to weather or exhaustion of resources.

(5) Money supply remains unchanged, but the VELOCITY increases from leverage (i.e. lending).

Deflation:

Deflation is the opposite of inflation. Deflation refers to situation, where there is decline in general price levels. Thus, deflation occurs when the inflation rate falls below 0% (or it is negative inflation rate). Deflation increases the real value of money and allows one to buy more goods with the same amount of money over time. Deflation can occur owing to reduction in the supply of money or credit. Deflation can also occur due to direct contractions in spending, either in the form of a reduction in government spending, personal spending or investment spending. Deflation has often had the side effect of increasing unemployment in an economy, since the process often leads to a lower level of demand in the economy. In economics, deflation is a decrease in the general price level of goods and services.[1] Deflation occurs when the

inflation rate falls below 0% (a negative inflation rate). This should not be confused with disinflation, a slow-down in the inflation rate (i.e., when inflation declines to lower levels).[2] Inflation reduces the real value of money over time; conversely, deflation increases the real value of money – the currency of a national or regional economy. This allows one to buy more goods with the same amount of money over time.

Economists generally believe that deflation is a problem in a modern economy because it increases the real value of debt, and may aggravate recessions and lead to a deflationary spiral.[3] Historically not all episodes of deflation correspond with periods of poor economic growth.[4] Deflation occurred in the U.S. during most of the 19th century (the most important exception was during the Civil War). This deflation was caused by technological progress that created significant economic growth.[5][6][7] This deflationary period of considerable economic progress preceded the establishment of the U.S. Federal Reserve System and its active management of monetary matters.

Deflation is likewise multidimensional

(1) the classroom version of a decrease in money supply;

(2) Failure of money supply expansion to match increase in demand for money

- (a) as in deleveraging during economic decline as VELOCITY collapses and thus even QE1, QE2, QE3 failed to produce inflation because they were less than the destruction of capital from deleveraging
- (b) the classic contraction in money supply during economic declines relative to the shift in demand from assets to liquidity
- (c) rise in the demand for money outpaces the available supply as in flight to quality
- money supply growth falls below economic expansion
- money supply growth falls below population expansion (more people making due with the same amount of money)

(3) contraction in available capital due to rising costs private or public

- (a) from sudden price sock as in OPEC during 1970s creating STAGFLATION
- (b) sudden rise in taxation causing decline in VELOCITY of money
- (c) confiscation of assets by regulation
- (d) historical forced loans,
- (e) criminalization of normal human activity to confiscate assets as penalty under pretense of law

(4) in a precious metal money supply the debasement of new currency causes Gresham's Law whereby the the older money supply is then hoarded thereby shrinking the TOTAL supply of money

(a) this causes prices to rise in terms of the debased new currency ONLY creating an admixture of inflation (rising prices systemically) coinciding with a deflation caused by the contraction in the TOTAL available money supply

(5) collapse in government / rule of law causes wealth to shift and concentrate in tangible assets (flight to quality) that survives the transition to a new government and monetary system

(a) this is normally associated with a collapse in the legal tender status of money whereby government no longer accepts its own currency in payment for taxes

(i) as was the case in Rome

(ii) Japan constantly demonetized previous currency or devalued it by a factor of 10 causing wealth to hoard in tangible assets and barter to emerge as rice displaced coins for 600 years because of devaluation by government

Monetary policy:

Many economists have given various definitions of monetary policy. Some prominent definitions are as follows.

According to Prof. Harry Johnson,

"A policy employing the central banks control of the supply of money as an instrument for achieving the objectives of general economic policy is a monetary policy."

According to A.G. Hart,

"A policy which influences the public stock of money substitute of public demand for such assets of both that is policy which influences public liquidity position is known as a monetary policy."

From both these definitions, it is clear that a monetary policy is related to the availability and cost of money supply in the economy in order to attain certain broad objectives. The Central Bank of a nation keeps control on the supply of money to attain the objectives of its monetary policy.

Objectives of Monetary Policy:

The objectives of a monetary policy in India are similar to the objectives of its five year plans. In a nutshell planning in India aims at growth, stability and social justice. After the Keynesian revolution in economics, many people accepted significance of monetary policy in attaining following objectives.

1. Rapid Economic Growth
2. Price Stability
3. Exchange Rate Stability
4. Balance of Payments (BOP) Equilibrium
5. Full Employment
6. Neutrality of Money
7. Equal Income Distribution

These are the general objectives which every central bank of a nation tries to attain by employing certain tools (Instruments) of a monetary policy. In India, the RBI has always aimed at the controlled expansion of bank credit and money supply, with special attention to the seasonal needs of a credit.

Let us now see objectives of monetary policy in detail:-

1. Rapid Economic Growth: It is the most important objective of a monetary policy. The monetary policy can influence economic growth by controlling real interest rate and its resultant impact on the investment. If the RBI opts for a cheap or easy credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth. Faster economic growth is possible if the monetary policy succeeds in maintaining income and price stability.
2. Price Stability: All the economics suffer from inflation and deflation. It can also be called as Price Instability. Both inflation are harmful to the economy. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. It helps in reducing the income and wealth inequalities. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.
3. Exchange Rate Stability: Exchange rate is the price of a home currency expressed in terms of any foreign currency. If this exchange rate is very volatile leading to frequent ups and downs in the exchange rate, the international community might lose confidence in our economy. The monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.
4. Balance of Payments (BOP) Equilibrium: Many developing countries like India suffers from the Disequilibrium in the BOP. The Reserve Bank of India through its monetary policy tries to maintain equilibrium in the balance of payments. The BOP has two aspects i.e. the 'BOP Surplus' and the 'BOP Deficit'. The former reflects an excess money supply in the domestic economy, while the later stands for stringency of money. If the monetary policy succeeds in maintaining monetary equilibrium, then the BOP equilibrium can be achieved.

5. Full Employment: The concept of full employment was much discussed after Keynes's publication of the "General Theory" in 1936. It refers to absence of involuntary unemployment. In simple words 'Full Employment' stands for a situation in which everybody who wants jobs get jobs. However it does not mean that there is a Zero unemployment. In that senses the full employment is never full. Monetary policy can be used for achieving full employment. If the monetary policy is expansionary then credit supply can be encouraged. It could help in creating more jobs in different sector of the economy.
6. Neutrality of Money : Economist such as Picketed, Robertson have always considered money as a passive factor. According to them, money should play only a role of medium of exchange and not more than that. Therefore, the monetary policy should regulate the supply of money. The change in money supply creates monetary disequilibrium. Thus monetary policy has to regulate the supply of money and neutralize the effect of money expansion. However this objective of a monetary policy is always criticized on the ground that if money supply is kept constant then it would be difficult to attain price stability.
7. Equal Income Distribution: Many economists used to justify the role of the fiscal policy is maintaining economic equality. However in recent years economists have given the opinion that the monetary policy can help and play a supplementary role in attainting an economic equality. Monetary policy can make special provisions for the neglect supply such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Thus in recent period, monetary policy can help in reducing economic inequalities among different sections of society.

Instruments of Monetary Policy - Quantitative & Qualitative Tools:

The instruments of monetary policy are tools or devise which are used by the monetary authority in order to attain some predetermined objectives. There are two types of instruments of the monetary policy as shown below.

(A) Quantitative Instruments or General Tools:

The Quantitative Instruments are also known as the General Tools of monetary policy. These tools are related to the Quantity or Volume of the money. The Quantitative Tools of credit control are also called as General Tools for credit control. They are designed to regulate or control the total volume of bank credit in the economy. These tools are indirect in nature and are employed for influencing the quantity of credit in the country. The general tool of credit control comprises of following instruments.

1. Bank Rate Policy (BRP):

The Bank Rate Policy (BRP) is a very important technique used in the monetary policy for influencing the volume or the quantity of the credit in a country. The bank rate refers to rate at which the central bank (i.e RBI) rediscounts bills and prepares of commercial banks or provides advance to commercial banks against approved securities. It is "the standard rate at which the bank is prepared to buy or rediscount bills of exchange or other commercial paper eligible for purchase under the RBI Act". The Bank Rate affects the actual availability and the cost of the

credit. Any change in the bank rate necessarily brings out a resultant change in the cost of credit available to commercial banks. If the RBI increases the bank rate than it reduce the volume of commercial banks borrowing from the RBI. It deters banks from further credit expansion as it becomes a more costly affair. Even with increased bank rate the actual interest rates for a short term lending go up checking the credit expansion. On the other hand, if the RBI reduces the bank rate, borrowing for commercial banks will be easy and cheaper. This will boost the credit creation. Thus any change in the bank rate is normally associated with the resulting changes in the lending rate and in the market rate of interest. However, the efficiency of the bank rate as a tool of monetary policy depends on existing banking network, interest elasticity of investment demand, size and strength of the money market, international flow of funds, etc.

2. Open Market Operation (OMO):

The open market operation refers to the purchase and/or sale of short term and long term securities by the RBI in the open market. This is very effective and popular instrument of the monetary policy. The OMO is used to wipe out shortage of money in the money market, to influence the term and structure of the interest rate and to stabilize the market for government securities, etc. It is important to understand the working of the OMO. If the RBI sells securities in an open market, commercial banks and private individuals buy it. This reduces the existing money supply as money gets transferred from commercial banks to the RBI. Contrary to this when the RBI buys the securities from commercial banks in the open market, commercial banks sell it and get back the money they had invested in them. Obviously the stock of money in the economy increases. This way when the RBI enters in the OMO transactions, the actual stock of money gets changed. Normally during the inflation period in order to reduce the purchasing power, the RBI sells securities and during the recession or depression phase she buys securities and makes more money available in the economy through the banking system. Thus under OMO there is continuous buying and selling of securities taking place leading to changes in the availability of credit in an economy. However there are certain limitations that affect OMO via; underdeveloped securities market, excess reserves with commercial banks, indebtedness of commercial banks, etc.

3. Variation in the Reserve Ratios (VRR):

The Commercial Banks have to keep a certain proportion of their total assets in the form of Cash Reserves. Some part of these cash reserves are their total assets in the form of cash. Apart of these cash reserves are also to be kept with the RBI for the purpose of maintaining liquidity and controlling credit in an economy. These reserve ratios are named as Cash Reserve Ratio (CRR) and a Statutory Liquidity Ratio (SLR). The CRR refers to some percentage of commercial bank's net demand and time liabilities which commercial banks have to maintain with the central bank and SLR refers to some percent of reserves to be maintained in the form of gold or foreign securities. In India the CRR by law remains in between 3-15 percent while the SLR remains in between 25-40 percent of bank reserves. Any change in the VRR (i.e. CRR + SLR) brings out a change in commercial banks reserves positions. Thus by varying VRR commercial banks lending capacity can be affected. Changes in the VRR helps in bringing changes in the cash reserves of commercial banks and thus it can affect the banks credit creation multiplier. RBI increases VRR

during the inflation to reduce the purchasing power and credit creation. But during the recession or depression it lowers the VRR making more cash reserves available for credit expansion.

(B) Qualitative Instruments or Selective Tools :

The Qualitative Instruments are also known as the Selective Tools of monetary policy. These tools are not directed towards the quality of credit or the use of the credit. They are used for discriminating between different uses of credit. It can be discrimination favoring export over import or essential over non-essential credit supply. This method can have influence over the lender and borrower of the credit. The Selective Tools of credit control comprises of following instruments.

1. Fixing Margin Requirements:

The margin refers to the "proportion of the loan amount which is not financed by the bank". Or in other words, it is that part of a loan which a borrower has to raise in order to get finance for his purpose. A change in a margin implies a change in the loan size. This method is used to encourage credit supply for the needy sector and discourage it for other non-necessary sectors. This can be done by increasing margin for the non-necessary sectors and by reducing it for other needy sectors. Example: - If the RBI feels that more credit supply should be allocated to agriculture sector, then it will reduce the margin and even 85-90 percent loan can be given.

2. Consumer Credit Regulation:

Under this method, consumer credit supply is regulated through hire-purchase and installment sale of consumer goods. Under this method the down payment, installment amount, loan duration, etc is fixed in advance. This can help in checking the credit use and then inflation in a country.

3. Publicity:

This is yet another method of selective credit control. Through it Central Bank (RBI) publishes various reports stating what is good and what is bad in the system. This published information can help commercial banks to direct credit supply in the desired sectors. Through its weekly and monthly bulletins, the information is made public and banks can use it for attaining goals of monetary policy.

4. Credit Rationing:

Central Bank fixes credit amount to be granted. Credit is rationed by limiting the amount available for each commercial bank. This method controls even bill rediscounting. For certain purpose, upper limit of credit can be fixed and banks are told to stick to this limit. This can help in lowering banks credit expoursure to unwanted sectors.

5. Moral Suasion:

It implies to pressure exerted by the RBI on the indian banking system without any strict action for compliance of the rules. It is a suggestion to banks. It helps in restraining credit during inflationary periods. Commercial banks are informed about the expectations of the central bank through a monetary policy. Under moral suasion central banks can issue directives, guidelines and suggestions for commercial banks regarding reducing credit supply for speculative purposes.

6. Control Through Directives:

Under this method the central bank issue frequent directives to commercial banks. These directives guide commercial banks in framing their lending policy. Through a directive the central bank can influence credit structures, supply of credit to certain limit for a specific purpose. The RBI issues directives to commercial banks for not lending loans to speculative sector such as securities, etc beyond a certain limit.

7. Direct Action:

Under this method the RBI can impose an action against a bank. If certain banks are not adhering to the RBI's directives, the RBI may refuse to rediscount their bills and securities. Secondly, RBI may refuse credit supply to those banks whose borrowings are in excess to their capital. Central bank can penalize a bank by changing some rates. At last it can even put a ban on a particular bank if it does not follow its directives and work against the objectives of the monetary policy. These are various selective instruments of the monetary policy. However the success of these tools is limited by the availability of alternative sources of credit in economy, working of the Non-Banking Financial Institutions (NBFIs), profit motive of commercial banks and undemocratic nature off these tools. But a right mix of both the general and selective tools of monetary policy can give the desired results.

Money markets and capital markets:

As money became a commodity, the money market became a component of the financial markets for assets involved in short-term borrowing, lending, buying and selling with original maturities of one year or less. Trading in the money markets is done over the counter and is wholesale. Various instruments exist, such as Treasury bills, commercial paper, bankers' acceptances, deposits, certificates of deposit, bills of exchange, repurchase agreements, federal funds, and short-lived mortgage-, and asset-backed securities.[1] It provides liquidity funding for the global financial system. Money markets and capital markets are parts of financial markets. The instruments bear differing maturities, currencies, credit risks, and structure. Therefore they may be used to distribute the exposure.

Participants:

The money market consists of financial institutions and dealers in money or credit who wish to either borrow or lend. Participants borrow and lend for short periods of time, typically up to thirteen months. Money market trades in short-term financial instruments commonly called "paper." This contrasts with the capital market for longer-term funding, which is supplied by bonds and equity.

The core of the money market consists of interbank lending--banks borrowing and lending to each other using commercial paper, repurchase agreements and similar instruments. These instruments are often benchmarked to (i.e. priced by reference to) the London Interbank Offered Rate (LIBOR) for the appropriate term and currency.

Finance companies typically fund themselves by issuing large amounts of asset-backed commercial paper (ABCP) which is secured by the pledge of eligible assets into an ABCP conduit. Examples of eligible assets include auto loans, credit card receivables, residential/commercial mortgage loans, mortgage-backed securities and similar financial assets. Certain large corporations with strong credit ratings, such as General Electric, issue commercial paper on their own credit. Other large corporations arrange for banks to issue commercial paper on their behalf via commercial paper lines.

In the United States, federal, state and local governments all issue paper to meet funding needs. States and local governments issue municipal paper, while the US Treasury issues Treasury bills to fund the US public debt:

- Trading companies often purchase bankers' acceptances to be tendered for payment to overseas suppliers.
- Retail and institutional money market funds
- Banks
- Central banks
- Cash management programs
- Merchant banks

Functions of the money market:

- Transfer of large sums of money
- Transfer from parties with surplus funds to parties with a deficit
- Allow governments to raise funds
- Help to implement monetary policy
- Determine short-term interest rates

Common money market instruments:

- Certificate of deposit - Time deposit, commonly offered to consumers by banks, thrift institutions, and credit unions.
- Repurchase agreements - Short-term loans—normally for less than two weeks and frequently for one day—arranged by selling securities to an investor with an agreement to repurchase them at a fixed price on a fixed date.
- Commercial paper - short term usanse promissory notes issued by company at discount to face value and redeemed at face value
- Eurodollar deposit - Deposits made in U.S. dollars at a bank or bank branch located outside the United States.
- Federal agency short-term securities - (in the U.S.). Short-term securities issued by government sponsored enterprises such as the Farm Credit System, the Federal Home Loan Banks and the Federal National Mortgage Association.
- Federal funds - (in the U.S.). Interest-bearing deposits held by banks and other depository institutions at the Federal Reserve; these are immediately available funds that institutions borrow or lend, usually on an overnight basis. They are lent for the federal funds rate.
- Municipal notes - (in the U.S.). Short-term notes issued by municipalities in anticipation of tax receipts or other revenues.
- Treasury bills - Short-term debt obligations of a national government that are issued to mature in three to twelve months.
- Money funds - Pooled short maturity, high quality investments which buy money market securities on behalf of retail or institutional investors.
- Foreign Exchange Swaps - Exchanging a set of currencies in spot date and the reversal of the exchange of currencies at a predetermined time in the future.

Capital market:

Capital markets are financial markets for the buying and selling of long-term debt- or equity-backed securities. These markets channel the wealth of savers to those who can put it to long-term productive use, such as companies or governments making long-term investments. Financial regulators, such as the UK's Bank of England (BoE) or the U.S. Securities and Exchange Commission (SEC), oversee the capital markets in their jurisdictions to protect investors against fraud, among other duties.

Modern capital markets are almost invariably hosted on computer-based electronic trading systems; most can be accessed only by entities within the financial sector or the treasury departments of governments and corporations, but some can be accessed directly by the public. There are many thousands of such systems, most only serving only small parts of the overall capital markets. Entities hosting the systems include stock exchanges, investment banks, and government departments. Physically the systems are hosted all over the world, though they tend to be concentrated in financial centers like London, New York, and Hong Kong. Capital markets are defined as markets in which money is provided for periods longer than a year.

A key division within the capital markets is between the primary markets and secondary markets. In primary markets, new stock or bond issues are sold to investors, often via a mechanism known as underwriting. The main entities seeking to raise long-term funds on the primary capital markets are governments (which may be municipal, local or national) and business enterprises (companies). Governments tend to issue only bonds, whereas companies often issue either equity or bonds. The main entities purchasing the bonds or stock include pension funds, hedge funds, sovereign wealth funds, and less commonly wealthy individuals and investment banks trading on their own behalf. In the secondary markets, existing securities are sold and bought among investors or traders, usually on a securities exchange, over-the-counter, or elsewhere. The existence of secondary markets increases the willingness of investors in primary markets, as they know they are likely to be able to swiftly cash out their investments if the need arises.

A second important division falls between the stock markets (for equity securities, also known as shares, where investors acquire ownership of companies) and the bond markets (where investors become creditors).

The money markets are used for the raising of short term finance, sometimes for loans that are expected to be paid back as early as overnight. Whereas the *capital markets* are used for the raising of long term finance, such as the purchase of shares, or for loans that are not expected to be fully paid back for at least a year.

Funds borrowed from the *money markets* are typically used for general operating expenses, to cover brief periods of illiquidity. For example a company may have inbound payments from customers that have not yet cleared, but may wish to immediately pay out cash for its payroll. When a company borrows from the primary *capital markets*, often the purpose is to invest in additional physical capital goods, which will be used to help increase its income. It can take many months or years before the investment generates sufficient return to pay back its cost, and hence the finance is long term

Together, *money markets* and *capital markets* form the financial markets as the term is narrowly understood. The capital market is concerned with long term finance. In the widest sense, it consist of a series of channels through which the saving of the community are made available for industrial and commercial enterprises and public authorities

Examples of capital market transactions:

A government raising money on the primary markets:

When a government wants to raise long term finance it will often sell bonds to the capital markets. In the 20th and early 21st century, many governments would use investment banks to organize the sale of their bonds. The leading bank would underwrite the bonds, and would often head up a syndicate of brokers, some of whom might be based in other investment banks. The syndicate would then sell to various investors. For developing countries, a multilateral development bank would sometimes provide an additional layer of underwriting, resulting in risk being shared between the investment bank(s), the multilateral organization, and the end investors. However, since 1997 it has been increasingly common for governments of the larger nations to bypass investment banks by making their bonds directly available for purchase over the Internet. Many governments now sell most of their bonds by computerized auction. Typically large volumes are

put up for sale in one go; a government may only hold a small number of auctions each year. Some governments will also sell a continuous stream of bonds through other channels. The biggest single seller of debt is the US Government; there are usually several transactions for such sales every second, which corresponds to the continuous updating of the US real time debt clock.

Commercial Banking-functions organization and operations:

Introduction to Banks:

Banks have developed around 200 years ago. The natures of banks have changed as the time has changed. The term bank is related to financial transactions. It is a financial establishment which uses, money deposited by customers for investment, pays it out when required, makes loans at interest exchanges currency etc. however to understand the concept in detail we need to see some of its definitions. Many economists have tried to give different meanings of the term bank.

Nature of Commercial Banks:

Commercial banks are an organization which normally performs certain financial transactions. It performs the twin task of accepting deposits from members of public and make advances to needy and worthy people from the society. When banks accept deposits its liabilities increase and it becomes a debtor, but when it makes advances its assets increases and it becomes a creditor. Banking transactions are socially and legally approved. It is responsible in maintaining the deposits of its account holders.

Definitions of Commercial Banks:

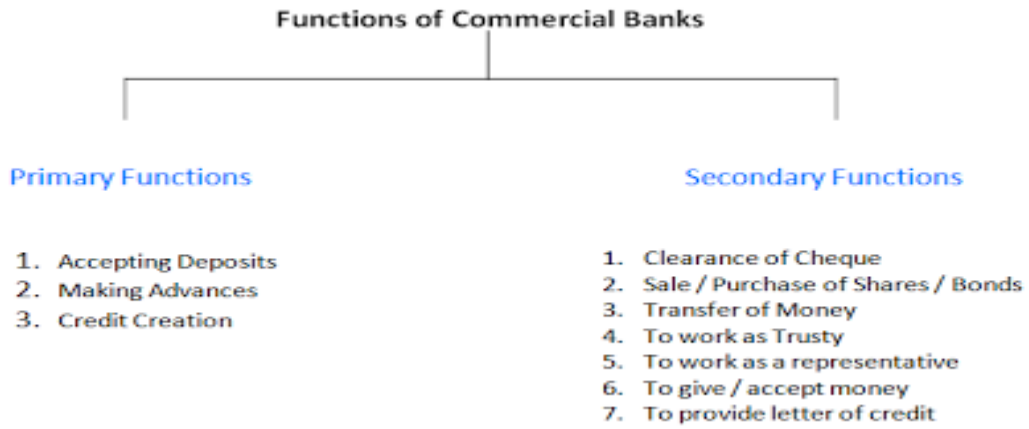
While defining the term banks it is taken into account that what type of task is performed by the banks. Some of the famous definitions are given below:

According to Prof. Sayers, "A bank is an institution whose debts are widely accepted in settlement of other people's debts to each other." In this definition Sayers has emphasized the transactions from debts which are raised by a financial institution.

According to the Indian Banking Company Act 1949, "A banking company means any company which transacts the business of banking. Banking means accepting for the purpose of lending of investment of deposits of money from the public, payable on demand or other wise and withdraw able by cheque, draft or otherwise."

Functions of Commercial Banks:

Commercial bank being the financial institution performs diverse types of functions. It satisfies the financial needs of the sectors such as agriculture, industry, trade, communication, etc. That means they play very significant role in a process of economic social needs. The functions performed by banks are changing according to change in time and recently they are becoming customer centric and widening their functions. Generally the functions of commercial banks are divided into two categories viz. primary functions and the secondary functions. The following chart simplifies the functions of banks.



Primary Functions of Commercial Banks:

Commercial Banks performs various primary functions some of them are given below :

1. Accepting Deposits : Commercial bank accepts various types of deposits from public especially from its clients. It includes saving account deposits, recurring account deposits, fixed deposits, etc. These deposits are payable after a certain time period.
2. Making Advances : The commercial banks provide loans and advances of various forms. It includes an over draft facility, cash credit, bill discounting, etc. They also give demand and demand and term loans to all types of clients against proper security.
3. Credit creation : It is most significant function of the commercial banks. While sanctioning a loan to a customer, a bank does not provide cash to the borrower Instead it opens a deposit account from where the borrower can withdraw. In other words while sanctioning a loan a bank automatically creates deposits. This is known as a credit creation from commercial bank.

Secondary Functions of Commercial Banks:

Along with the primary functions each commercial bank has to perform several secondary functions too. It includes many agency functions or general utility functions. The secondary functions of commercial banks can be divided into agency functions and utility functions.

Agency Functions : Various agency functions of commercial banks are

1. To collect and clear cheque, dividends and interest warrant.
2. To make payment of rent, insurance premium, etc.
3. To deal in foreign exchange transactions.
4. To purchase and sell securities.
5. To act as trusty, attorney, correspondent and executor.
6. To accept tax proceeds and tax returns.

General Utility Functions: The general utility functions of the commercial banks include

1. To provide safety locker facility to customers.
2. To provide money transfer facility.
3. To issue traveler's cheque.
4. To act as referees.
5. To accept various bills for payment e.g. phone bills, gas bills, water bills, etc.
6. To provide merchant banking facility.
7. To provide various cards such as credit cards, debit cards, Smart cards, etc.

Central Banking- functions and credit control:

A Central Bank is defined in terms of its functions and as per Vera Smith, **"**The primary definition of Central Banking is a banking system in which a single bank has either complete control or a residuary monopoly of note issue.**"**

As per Sayers, the Central Bank **"**Is the organ of Government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behavior of financial institutions so as to support the economic policy of the government.**"**

The broadest definition has been given by Economist De Knock and as per him a Central Bank is **"**A Bank which constitutes the apex of the monetary and banking structure of its country and which performs as best as it can in the national economic interest, the following functions:

1. The regulation of currency in accordance with the requirements of business and the general public for which purpose it is granted either the sole right of note issue or at least a partial monopoly thereof.
2. The performance of general banking and agency of the state.
3. The custody of the Cash Reserves of the Commercial Banks.

4. The granting of accommodation in the form of re-discounts and collateral advances to commercial banks, bill brokers and dealers or other financial institutions and the general acceptance of the responsibility of lender of the last resort.

5. The custody and management of the nation's reserves of international currency. The settlement of clearance balances between the banks.
6. The control of credit in accordance with the needs of business and with a view to carrying out the broad monetary policy adopted by the state."

Functions of a Central Bank:

Majority of Economists has accepted the following functions to be performed by a Central Bank and it is been framed by the economist De Knock.

1. Regulator of Currency:

- The central bank is the issue bank and it has a monopoly note issue. Notes issued by it flows as legal tender money.
- The issue department issues notes and coins to commercial banks and coins are manufactured in the government mint but are placed into flow through the central bank.
- Various Central banks had been adopting varied modes of note issue in various nations. The central bank is obligatory by statute to hold a specified volume of gold and foreign securities versus the notes issue.
- In few nations, the quantity of gold and foreign securities abides a fixed proportion amidst 30 to 45 percent of the total notes issued.
- In few other nations, a minimum specified quantity of gold and foreign currencies is obligatory to be kept against note issue by the Central Bank.

2. Banker, Fiscal Agent and Adviser to the Administration:

- In general, Central Bank performs as bankers, fiscal agents and advisers to their corresponding law of administration. As a banker to the law of administration, the central bank holds the deposit investment of the central and state governments and makes spending on behalf of the law of administration. And hence, however, it denies paying interest on government deposit investments.
- It purchases and sells foreign currencies on behalf of the law of administration.
- It holds the inventories of gold of the law of administration and thus it is the guardian of administration's finance and affluence.
- As a fiscal agent, the central bank makes short term loans to law of administration for a term not more than 90 days.
- As an adviser, the central bank advises government on fiscal and money matters as protecting, devaluation and revaluation, inflation or deflation of the currency, balance of payments, deficit financing etc.

3. Guarding of Cash Reserves of Commercial Banks:

- Commercial banks are necessitated by law to keep reserves equal to a certain percentage of both time and demand deposits liabilities with the central bank.
- It is on the origin of these reserves that the central bank shifts funds from one bank to another to make possible the clearing of cheques.
- Thus the central bank performs as the guardian of the cash reserves of commercial banks and facilitates in making feasible their transactions.

Function of Central Bank:

In the monetary and banking setup of a country, central bank occupies central position and perhaps, it is because of this fact that this called as the central bank. In this way, this bank works as an institution whose main objective is to control and regulate money supply keeping in view the welfare of the people. Central bank is an institution that fulfills the credit needs of banks and other credit institution, which woks as banker to the banks and the government and which work for the economic interest of the country.

1. Monopoly of note issue:

Note issue primarily is the main function of a central bank in every country. These days, in all the countries where there is a central bank generally it has got the monopoly of the sole right of note issue. In the beginning this was not the function of central bank, but gradually all the central bank gas acquires this function.

There are many advantages of the note issue by central banks some important ones are as follow:
1. Central bank controls the credit creating power of commercial bank. By controlling the amount of currency in circulation, the volume of credit can be controlled to quite a large extent.
2. People have more confidence in the currency issued by the control bank because it has the protection and recognition of the government.

3. In the event of monopoly of note issue of central bank, there will be uniformity in the currency system in the country.

4. The currency of the country will be flexible if the central bank of the country has the monopoly of note issue because central bank can bring about changes very early in the volume of paper money according to the needs of business, industry and messes.

5. The system of note issue has some advantages. If the central bank of the country has the monopoly of note issue, all such advantages will accrue to the government.

2. Bankers, Agent and Adviser to the Government:

As banker to the government, central bank provides all those service and facilities to the government which public gets from the ordinary banks. It operates the account of the public enterprise. It mangers government departmental undertaking and government funds and where there is a need gives loan to the government. From time to time, central bank advice the government on monetary, banking and financial matters.

3. Custodian of Cash Reserve of Commercial Bank:

Central bank is the bank of banks. This signifies that it has the same relationship with the commercial banks in the country that they gave with their customers. It provides security to their cash reserves, give them loan at the time of need, gives them advice on financial and economic matter and work as clearing house among various members bank.

4. Custodian of Nation's Reserve of International:

Central bank is the custodian of the foreign currency obtained from various countries. This has become an important function of central bank. These days, because with its help it can stabilize the external value of the currency.

5. Lender of The Last Resort:

Central bank works as lender of the last resort for commercial banks because in the time of need it provides them financial assistance and accommodation. Whenever a commercial bank faces financial crisis, central bank as lender of the last resort comes to its rescue by advancing loans and the bank is saved from being failed.

6. Clearing House Function:

All commercial bank have their accounts with the central bank. Therefore, central bank settles the mutual transactions of banks and thus saves all banks controlling each other individually for setting their individual transaction.

7. Credit Control:

These days, the most important function of a central bank is to control the volume of credit for bringing about stability in the general price level and accomplishing various other socio economic objectives. The significance of this function has increased so much that for property understanding it. The central bank has acquired the rights and powers of controlling the entire banking. A central bank can adopt various quantitative and qualitative methods for credit control such as bank rate, open market operation, changes in reserve ratio selective controls, moral situation etc.

Other Functions:

Besides the 7 functions explained above, central banks perform many other functions that are as follows:

8. Collection of Data

Central banks in almost all the countries collects statistical data regularly relating to economic aspects of money, credit, foreign exchange, banking etc. from time to time, committees and commission are appointed for studying various aspects relating to the aforesaid problem.

9. Central Banking in Developing Countries

The basic problem of underdeveloped countries is the problem of lack of capital formation whose main causes are lack of saving and investment. Therefore, central bank can play an important role by promoting capital formation through mobilizing saving s and encouraging investment

Non-Banking Financial Institutions-meaning, role; distinction between banks and NBFI:

A non-bank financial institution (NBFI) is a financial institution that does not have a full banking license or is not supervised by a national or international banking regulatory agency. NBFIs

facilitate bank-related financial services, such as investment, risk pooling, contractual savings, and brokering. Examples of these include insurance firms, pawn shops, cashier's check issuers, check cashing locations, payday lending, currency exchanges, and microloan organizations. Alan Greenspan has identified the role of NBFIs in strengthening an economy, as they provide "multiple alternatives to transform an economy's savings into capital investment [which] act as backup facilities should the primary form of intermediation fail."

Role in Financial System:

NBFIs supplement banks by providing the infrastructure to allocate surplus resources to individuals and companies with deficits. Additionally, NBFIs also introduces competition in the provision of financial services. While banks may offer a set of financial services as a packaged deal, NBFIs unbundle and tailor these service to meet the needs of specific clients. Additionally, individual NBFIs may specialize in one particular sector and develop an informational advantage. Through the process of unbundling, targeting, and specializing, NBFIs enhances competition within the financial services industry.

Growth:

Some research suggests a high correlation between a financial development and economic growth. Generally, a market-based financial system has better-developed NBFIs than a bank-based system, which is conducive for economic growth.

Stability:

A multi-faceted financial system that includes non-bank financial institutions can protect economies from financial shocks and enable speedy recovery when these shocks happen. NBFIs provide “multiple alternatives to transform an economy's savings into capital investment, [which] serve as backup facilities should the primary form of intermediation fail.”

However, in the absence of effective financial regulations, non-bank financial institutions can actually exacerbate the fragility of the financial system.

Since not all NBFIs are heavily regulated, the shadow banking system constituted by these institutions could wreak potential instability. In particular, CIVs, hedge funds, and structured investment vehicles, up until the 2007-2012 global financial crisis, were entities that focused NBFI supervision on pension funds and insurance companies, but were largely overlooked by regulators.

Because these NBFIs operate without a banking license, in some countries their activities are largely unsupervised, both by government regulators and credit reporting agencies. Thus, a large NBFI market share of total financial assets can easily destabilize the entire financial system. A prime example would be the 1997 Asian financial crisis, where a lack of NBFI regulation fueled a credit bubble and asset overheating. When the asset prices collapsed and loan defaults skyrocketed, the resulting credit crunch led to the 1997 Asian financial crisis that left most of Southeast Asia and Japan with devalued currencies and a rise in private debt.

Due to increased competition, established lenders are often reluctant to include NBFIs into existing credit-information sharing arrangements. Additionally, NBFIs often lack the technological capabilities necessary to participate in information sharing networks. In general, NBFIs also contribute less information to credit-reporting agencies than do banks

Types of Non-Bank Financial Institutions:

Risk Pooling Institutions:

Insurance companies underwrite economic risks associated with illness, death, damage and other risks of loss. In return to collecting an insurance premium, insurance companies provide a contingent promise of economic protection in the case of loss. There are two main types of insurance companies: general insurance and life insurance. General insurance tends to be short-term, while life insurance is a longer-term contract, which terminates at the death of the insured. Both types of insurance, life and general, are available to all sectors of the community**.**

Although insurance companies don't have banking licenses, in most countries insurance has a separate form of regulation specific to the insurance business and may well be covered by the same financial regulator that also covers banks. There have also been a number of instances where insurance companies and banks have merged thus creating insurance companies that do have banking licenses.

Contractual Savings Institutions:

Contractual savings institutions (also called institutional investors) give individuals the opportunity to invest in collective investment vehicles (CIV) as a fiduciary rather than a principal role. Collective investment vehicles pool resources from individuals and firms into various financial instruments including equity, debt, and derivatives. Note that the individual holds equity in the CIV itself rather what the CIV invests in specifically. The two most popular examples of contractual savings institutions are pension funds and mutual funds.The two main types of mutual funds are open-end and closed-end funds. Open-end funds generate new investments by allowing the public to purchase new shares at any time, and shareholders can liquidate their holding by selling the shares back to the open-end fund at the net asset value. Closed-end funds issue a fixed number of shares in an IPO. In this case the shareholders capitalize on the value of their assets by selling their shares in a stock exchange.

Mutual funds are usually distinguished by the nature of their investments. For example, some funds specialize in high risk, high return investments, while others focus on tax-exempt securities. There are also mutual funds specializing in speculative trading (i.e. hedge funds), a specific sector, or cross-border investments.

Pension funds are mutual funds that limit the investor's ability to access their investments until a certain date. In return, pension funds are granted large tax breaks in order to incentivize the working population to set aside a portion of their current income for a later date after they exit the labor force (retirement income).

Market Makers:

Market makers are broker-dealer institutions that quote a buy and sell price and facilitate transactions for financial assets. Such assets include equities, government and corporate debt, derivatives, and foreign currencies. After receiving an order, the market maker immediately sells from its inventory or makes a purchase to offset the loss in inventory. The differential between the buying and selling quotes, or the bid-offer spread, is how the market-maker makes profit. A major contribution of the market makers is improving the liquidity of financial assets in the market.

Difference between bank and nonbanking financial institution:

A Bank is an organization that accepts customer cash deposits and then provides financial services like bank accounts, loans, share trading account, mutual funds, etc.

A NBFC (Non Banking Financial Company) is an organization that does not accept customer cash deposits but provides all financial services except bank accounts.

a) A bank interacts directly with customers while an NBFI interacts with banks and governments.

(b) A bank indulges in a number of activities relating to finance with a range of customers, while an NBFI is mainly concerned with the term loan needs of large enterprises.

(c) A bank deals with both internal and international customers while an NBFI is mainly concerned with the finances of foreign companies.

(d) A bank's man interest is to help in business transactions and savings/ investment activities while an NBFI's main interest is in the stabilization of the currency

Unit-3

Tax system- its meaning and classification:

A tax (from the Latin *taxo*; "rate") is a financial charge or other levy imposed upon a taxpayer (an individual or legal entity) by a state or the functional equivalent of a state such that failure to pay is punishable by law. Taxes are also imposed by many administrative divisions. Taxes consist of direct or indirect taxes and may be paid in money or as its labor equivalent.

According to Black's Law Dictionary, a tax is a "pecuniary burden laid upon individuals or property owners to support the government [...] a payment exacted by legislative authority." It "is not a voluntary payment or donation, but an enforced contribution, exacted pursuant to legislative authority" and is "any contribution imposed by government [...] whether under the name of toll, tribute, tall age, gable, impost, duty, custom, excise, subsidy, aid, supply, or other name."

Classification of Taxes:

Modern Tax systems comprise of many types of taxes. Proper classification of the sundry taxes is essential to understand the nature and significance of different taxes. Usually, taxes are classified on the basis of form, nature, aim and methods of taxation. The following classifications are common in all modern tax systems:

- **Direct and Indirect taxes:**

  Direct tax and Indirect tax are defined by different economists and experts on public finance in different ways, based on different criteria like based on 'shifting of tax, based on 'the intention of the legislature or government', based on the relation between the tax payer and the revenue authorities and based on the timing of appraising or striking the income of the tax payer. The most practical and convenient way to distinguish between direct and indirect taxes which are in conformity with "generally accepted view" of direct and indirect taxes. Corporation tax which is directly paid to the state may be called as direct taxes. On the other hand, taxes which affect the income and property of persons through their consumptions may be called as direct taxes. Thus, customs and excise duties, sales tax fall under the category of indirect taxes.

- **Specific duties and Ad-valorem duties:** Specific duties are based on specific characteristics or measures or qualities of goods. Advalorem duties are base on the value of goods. Specific duties are levied on the basis of physical attributes like length, weight, volume, etc., of the commodities. Specific duties are simple, easy to estimate and administer. As a result, most of the goods were taxed on the basis of specific duties till recently.

  The Latin word 'Advalorem' means 'according to value'. Advalorem duty is a duty expressed as percentage of the value of the commodity. It is levied on the value of the goods. Advalorem duties result in higher tax revenue with increase in volume as well as price of goods.

- **Proportional, Progressive, Regressive and regressive taxes:**
  - Proportional Taxation: It is a tax system in which the tax rate remains constant irrespective changed in the 'Tax Base'. Here tax is at a uniform rate and Ta payable is

steady. So, in this method the rate of tax increases with increase in the income. The applicable rate depends upon the income level of individuals.

- Regressive Taxation: It is one where the rate of tax decreases as the tax base increases. So, the rate of tax decreases for higher incomes.
- Digressive Taxation: It is one where the rate of tax increases up to a certain limit and after that the rate of tax is constant for further increases in income. This system may be called as a mixture of proportional and progressive tax systems.

Single and Multiple Tax Systems:

- Single tax System: 'Single Tax' means only one kind of tax. It implies tax on only one thing or one class of things or one class of people. The tax may be collected regularly at periodic intervals.
- Multiple Tax system: Multiple tax system means a tax system comprising several types of tax. They may include both direct and indirect taxes. In such a system, every class of citizen may be called upon to "contribute his mite" towards State revenues

Public Finance vs. Private Finance:

For years, we have been told that privatization of everything is best and government is Good for little, if not nothing. The recent seizing of the credit market is clear evidence that Private finance has failed. After $236 trillion of production in the United States since 1945, Total credit market debt is larger than ever, $50 trillion. To maintain the pattern of debt growth In 2008, another $4 trillion of debt is needed. If more debt brings recovery, which has always Been the case, more than $4 trillion of additional debt will be needed in 2009. Meanwhile Hundreds of thousands of homes have been foreclosed and major investment firms and banks Have collapsed.

The cause of the current crisis is debtor exhaustion. Sub-prime mortgages are but one Example of efforts by persons working for creditors to find more debtors. Given that creditworthy debtors were already overburdened and unwilling to take on yet more debt, the Purveyors of debt dug into the "less-than-credit-worthy" population. It is not creditors that Need relief; it is debtors! That relief can be provided through public finance.

	Private Finance	Public Finance
1	Creates debt.	Creates legal tender.
2	Credit supply is temporary, exists only as long as debt and interest continue to be paid and re-borrowed.	Money supply is permanent, debt-free and interest-free.
3	For profit, requires charges above cost.	Tax supported, can operate at cost.
4	Governed by the wealthy.	Governed by elected representatives.

Fiscal Policy- concept, objectives and instruments:

Definitions

"By fiscal policy we denote to government actions afflicting its receipts and outlays which are ordinarily taken as measured by the government's receipts, its surplus or deficit."

"A policy under which the government uses its outlay and revenue programmes to produce desirable effects and avoid undesirable effects on the national earnings, manufacturing and employment."

Otto Eckstein defines fiscal policy as "changes in taxes and expenditures which aim at short run goals of full employment and price level stability."

Objectives of Fiscal Policy

The following are the objectives –

1. To uphold and accomplish full employment.
2. To alleviate the price level.
3. To soothe the development rate of financial system.
4. To sustain symmetry in the balance of payment.
5. To endorse the monetary development of under developed nations.

Instruments of Monetary Policy

Monetary policy through variations in government outlays and taxation profoundly afflicts national earnings, employment, productivity and prices. An enhancement in public outlay during depression adds to the total demand for merchandise and services and leads to a large enhancement in earnings thus enhancing consumption and investment outlays of the people. Alternatively, a decrease of public expenditure during inflation decreases total demand, national earnings, employment, productivity and prices, whilst an enhancement in taxes is likely to decrease disposable earnings thus decreases consumption and investment outlays. Therefore government can manage depression and inflationary pressures in the fiscal system by a judicious combination of outlay and taxation programmers.

Central Budget:

Government has several policies to implement in the overall task of performing its functions to meet the objectives of social & economic growth. For implementing these policies, it has to spend huge amount of funds on defence, administration, and development, welfare projects & various other relief operations. It is therefore necessary to find out all possible sources of getting funds so that sufficient revenue can be generated to meet the mounting expenditure.The term budget is derived from the French word "*Budgette*" which means a "leather bag" or a "wallet". It is a statement of the financial plan of the government. It shows the income & expenditure of the government during a financial year, which runs generally from 1stApril to 31st March. Budget is most important information document of the government. One part of the government's budget is similar to company's annual report. This part presents the overall picture of the financial performance of the government. The second part of the budget presents government's financial plans for the period upto its next budget.

So, every citizen of a nation from the common man to the politician is eager to know about the budget as they would like to get an idea of the :-

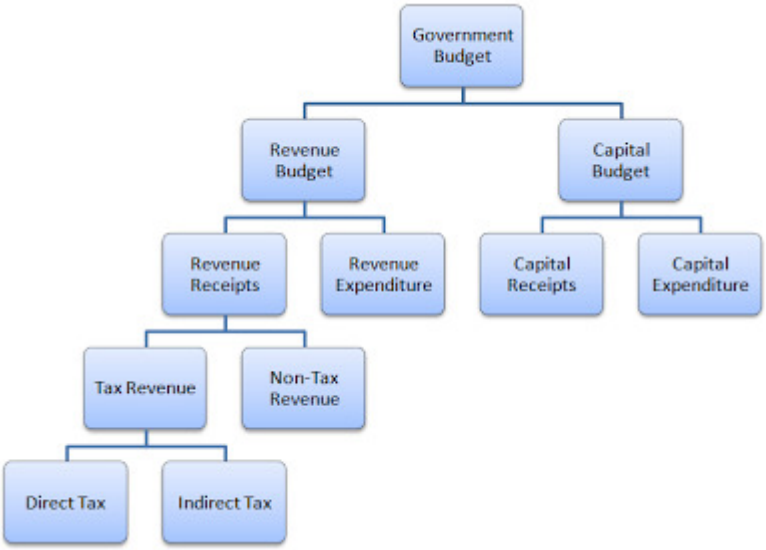
1. Financial performance of the government over the past one year.
2. To know about the financial programmes & policies of the government for the next one year.
3. To know how their standard of living will be affected by the financial policies of the government in the next one year.

Definitions of Budget

According to Tayler, "Budget is a financial plan of government for a definite period". According to Rene Stourm, "A budget is a document containing a preliminary approved plan of public revenues and expenditure".

Components of Government Budget

The main components or parts of government budget are explained below.



1. Revenue Budget

This financial statement includes the revenue receipts of the government i.e. revenue collected by way of taxes & other receipts. It also contains the items of expenditure met from such revenue.

(a) Revenue Receipts

These are the incomes which are received by the government from all sources in its ordinary course of governance. These receipts do not create a liability or lead to a reduction in assets.

Revenue receipts are further classified as tax revenue and non-tax revenue.

i. **Tax Revenue** :-

Tax revenue consists of the income received from different taxes and other duties levied by the government. It is a major source of public revenue. Every citizen, by law is bound to pay them and non-payment is punishable. Taxes are of two types, viz., Direct Taxes and Indirect Taxes. Direct taxes are those taxes which have to be paid by the person on whom they are levied. Its burden can not be shifted to someone else. E.g. Income tax, property tax, corporation tax, estate duty, etc. are direct taxes. There is no direct benefit to the tax payer.

Indirect taxes are those taxes which are levied on commodities and services and affect the income of a person through their consumption expenditure. Here the burden can be shifted to some other person. E.g. Custom duties, sales tax, services tax, excise duties, etc. are indirect taxes.

ii. **Non-Tax Revenue** :-

Apart from taxes, governments also receive revenue from other non-tax sources.

The non-tax sources of public revenue are as follows :-

1. Fees **:** The government provides variety of services for which fees have to be paid. E.g. fees paid for registration of property, births, deaths, etc.
2. Fines and penalties : Fines and penalties are imposed by the government for not following (violating) the rules and regulations.
3. Profits from public sector enterprises : Many enterprises are owned and managed by the government. The profits receives from them is an important source of non-tax revenue. For example in India, the Indian Railways, Oil and Natural Gas Commission, Air India, Indian Airlines, etc. are owned by the Government of India. The profit generated by them is a source of revenue to the government.
4. Gifts and grants : Gifts and grants are received by the government when there are natural calamities like earthquake, floods, famines, etc. Citizens of the country, foreign governments and international organisations like the UNICEF, UNESCO, etc. donate during times of natural calamities.
5. Special assessment duty : It is a type of levy imposed by the government on the people for getting some special benefit. For example, in a particular locality, if roads are improved, property prices will rise. The Property owners in that locality will benefit due to the appreciation in the value of property. Therefore the government imposes a levy on them which is known as special assessment duties.

iii. **India's Revenue Receipts** :-

The tax revenue provides major share of revenue receipts to the central government of India. In 2006-07 tax revenue (direct + indirect taxes) of central government was Rs. 3,27,205 crores while non-tax revenue was Rs. 76,260 crores.

(b) Revenue Expenditure :

Revenue expenditure is the expenditure incurred for the routine, usual and normal day to day running of government departments and provision of various services to citizens. It includes both development and non-development expenditure of the Central government. Usually expenditures that do not result in the creations of assets are considered revenue expenditure.

Expenses included in Revenue Expenditure:-

1. Expenditure by the government on consumption of goods and services.
2. Expenditure on agricultural and industrial development, scientific research, education, health and social services.
3. Expenditure on defence and civil administration.
4. Expenditure on exports and external affairs.
5. Grants given to State governments even if some of them may be used for creation of assets.
6. Payment of interest on loans taken in the previous year.
7. Expenditure on subsidies.

iii. **India's Defense Expenditure** :-

In 2006-07, Defense expenditure of the central government of India was Rs. 51,542 crores.

2. Capital Budget

This part of the budget includes receipts & expenditure on capital account projected for the next financial year. Capital budget consists of capital receipts & Capital expenditure.

(a) Capital Receipts

Receipts which create a liability or result in a reduction in assets are called capital receipts. They are obtained by the government by raising funds through borrowings, recovery of loans and disposing of assets.

Items included in Capital Receipts :-

1. Loans raised by the government from the public through the sale of bonds and securities. They are called market loans.
2. Borrowings by government from RBI and other financial institutions through the sale of Treasury bills.
3. Loans and aids received from foreign countries and other international Organizations like International Monetary Fund (IMF), World Bank, etc.
4. Receipts from small saving schemes like the National saving scheme, Provident fund, etc.
5. Recoveries of loans granted to state and union territory governments and other parties.

(b) Capital Expenditure:

Any projected expenditure which is incurred for creating asset with a long life is capital expenditure. Thus, expenditure on land, machines, equipment, irrigation projects, oil exploration and expenditure by way of investment in long term physical or financial assets are capital expenditure.

Burden of deficits and debts:

Government debt is the stock of outstanding IOUs issued by the government at any time in the past and not yet repaid. Governments issue debt whenever they borrow from the public; the magnitude of the outstanding debt equals the cumulative amount of net borrowing that the government has done. The deficit is the addition in the current period (year, quarter, month, etc.) to the outstanding debt. The deficit is negative whenever the value of outstanding debt falls; a negative deficit is called a surplus....

While robust growth in the quarter century after WWII allowed a fairly rapid reduction of debt/GDP ratios, this is not likely to happen now. The current high public debt levels in the United States and Europe are not going to disappear soon thanks to vigorous growth. In addition, the aging of the population is going to significantly add to the current fiscal problems induced by the Great Recession. Major discretionary policy intervention will be needed on both sides of the Atlantic in the next several years. The paper by Hubbard identifies
clearly the costs of deficits. Together with the work by Reinhart and Roofs (2009), observations about the costs of debt burden on growth, Hubbard reminds us of the seriousness of the situation. Ben Friedman himself, in his *Day of Reckoning* volume (Friedman 1988),
warned about the evils of excessive debt of the eighties.

Interest Rates:

One of the costs of excessive deficits is their effects on interest rates. We can classify the latter into two such effects. One occurs even when there is no default risk, and it has simply to do with the increase in quantity of Treasury bonds offered in the market. Currently interest rates on "safe" public debt are low, but they can only increase. The second source of problems comes from default risk. For the first time in decades, some forms of default or restructuring have been openly discussed for several OECD countries—Greece, Ireland, Italy, Portugal, and Spain. Even the United States has lost its triple-A status. Default risk can trigger a dangerous spiral. The more the markets fear a default, the higher the interest rate premium they ask; the
latter makes the solvency of the government in question even more problematic, inducing markets to require even higher interest rate premiums.
This problem has been aggravated by a very late awakening of markets in Europe. For the first decade of the euro, the interest rates on public debts in Europe converged almost fully to those of Germany. Greece, Portugal, and Spain were borrowing large quantities of funds at very low rates, contributing to creating large imbalances. Suddenly, after the financial crisis, markets woke up to the idea that Greek debt was not German debt! Currently the interest differentials
Between countries in Europe are large.

The Tax Burden:

Large public debt implies a large interest rate burden. To the extent that the interest rate burden is financed by tax revenues, the distortionary costs of taxation induced by large public debts become relevant. European countries and (to a lesser extent) the United States have high tax rates, and the top of the Lifer curve may be appearing on the not too distant horizon. For countries with debt levels approaching 100 percent of GDP, even relatively small increases in rates, holding primary spending constant, would lead to a significant increase in distortionary tax rates.

Rigidity of Fiscal Responses:

When a country has accumulated a high debt, it loses the necessary flexibility for responding aggressively with deficits if a recession occurs. Even allowing automatic stabilizers to "do their job" may become overly costly because of a dangerous debt dynamic. Thus, high-debt countries may have to contain deficits even during recessions, leading to dangerous vicious circles: the deeper the recession, the larger the deficits; the larger the latter, the more stringent the budget constraint for highly indebted countries and the higher the pressure to reduce deficits, aggravating the recession.

How to Reduce Deficits:

We are currently witnessing a lively debate on the issue of how and when to reduce deficits. Two critical questions are as follows:
(i) What are the short-run costs of a fiscal tightening?
(ii) How does one minimize the costs of fiscal adjustments?

On both questions we, as economists, do not know as much as we would like or perhaps we should. The issues are complicated, because of very difficult "identification" problems. Suppose we observe that the ratio of spending of GDP goes down while GDP goes up. What causes what? How do we disentangle the issue? Also, fiscal policy experiments—in particular, large fiscal adjustments—are accompanied by a host of other policies, such as more or less loose monetary policy, exchange rate devolutions, and structural reforms. Therefore
it is often difficult to isolate the effects of fiscal policy from everything else.

A lively debate is alive today in the profession. This is not the place for a full review of the recent literature on fiscal policy, but the following points represent my readings of the results.
• Spending multipliers (i.e., the effect of one dollar of discretionary
spending on GDP) are estimated between roughly 0.8 and 1.5. Some estimates fall outside of that range, but most fall within it.

• The effect of government spending on employment has weakened in the latest recessions.
• Tax multipliers are (much) larger than spending multipliers.
• Spending multipliers are slightly larger in recessions.
Overall these results should give pause to those who hold a textbook Keynesian view of public finance. According to the latter, spending multipliers should be larger than tax multipliers, and spending multipliers should be (much) larger than one. The wide range of estimates
Does not allow us to draw firm conclusions on how much one should use discretionary government spending as a countercyclical tool, but they certainly are not an endorsement of a very proactive stand. In addition, those estimates do not deal with two additional

Issues. One is the "long and variable lags" and the effect on deficits. That is, by the time an expansionary fiscal package is designed, approved, implemented, and spent, it may take so long that it may reach the wheels of the economy when it is too late, i.e., in the wrong
part of the cycle. In addition, deficit spending (including the effect of automatic stabilizers) should be compensated by surplus during expansions. But often, for political reasons, it is not, and deficit spending during recessions accumulates in large debts, because they

are never compensated. Therefore my reading of this evidence is that one should be careful in using discretionary spending as a countercyclical fiscal policy tool, above and beyond automatic stabilizers Let's now turn to the second issue, namely how costly it's going to be to reduce deficits. Virtually everyone would agree that in the medium run, having a solid fiscal position facilitates public policies and growth. The most hotly debated issue is what are the short-run costs of the kind of large deficit-reduction policies that are needed both in several European countries and in the United States. Once again, this is not the place for a survey of the rather vast literature on these issues. Much of this literature, starting in the early nineties, has studied

Several examples of large fiscal adjustments that have occurred in OECD countries. My reading of the results is as follows:

• Spending based on adjustments is less costly in terms of short run recessions than tax-based adjustments.

• Only spending-based adjustments are likely to lead to a long lasting stabilization and reduction of the debt/GDP ratio. This is because without putting a break on programs which automatically grow, tax revenues cannot keep up with spending increases, especially with an aging population. Which program are better candidates for cuts vary across countries but typically include pensions, health spending, and various other types of subsidies. In many European countries, government employment is overextended and public-sector wages have grown more than private-sector ones.

• In some cases, spending-based adjustments have been much less costly than a standard Keynesian model would predict, and in fact they have been accompanied by expansionary effects on the economy.

• In these cases, a swift response of private-sector investment (in addition to private consumption) has "crowded in" aggregate private demand.

• These "expansionary" fiscal contractions are helped when they are accompanied by a structural reform package that indicates a "regime change."

• In small open economies, exchange rate devaluations helped in the short run.

These results are sometimes labeled as "non-Keynesian effects" of fiscal policy, Namely the possibility that a fiscal adjustment does not bring about a deep recession even in the short run. Several non-Keynesian channels that could counteract the standard effects of spending cuts on aggregate demand have been discussed in the literature.

Unit-4

Poverty is the state of one who lacks a certain amount of material possessions or money.[1] Absolute poverty or destitution refers to the deprivation of basic human needs, which commonly includes food, water, sanitation, clothing, shelter, health care and education. Relative poverty is defined contextually as economic inequality in the location or society in which people live.

For much of history, poverty was considered largely unavoidable as traditional modes of production were insufficient to give an entire population a comfortable standard of living. After the industrial revolution, mass production in factories made wealth increasingly more inexpensive and accessible. Of more importance is the modernization of agriculture, such as fertilizers, to provide enough yield to feed the population. The supply of basic needs can be restricted by constraints on government services such as corruption, tax avoidance, debt and loan conditionality's and by the brain drain of health care and educational professionals. Strategies of increasing income to make basic needs more affordable typically include welfare, economic freedoms, and providing financial services.

Definitions:

Poverty reduction is a major goal and issue for many international organizations such as the United Nations and the World Bank. The World Bank estimated 1.29 billion people were living in absolute poverty in 2008. Of these, about 400 million people in absolute poverty lived in India and 173 million people in China. In USA 1 in 5 children lives in poverty. In terms of percentage of regional populations, sub-Saharan Africa at 47% had the highest incidence rate of absolute poverty in 2008. Between 1990 and 2010, about 663 million people moved above the absolute poverty level. Still, extreme poverty is a global challenge; it is observed in all parts of the world, including the developed economies.

United Nations: Fundamentally, poverty is a denial of choices and opportunities, a violation of human dignity. It means lack of basic capacity to participate effectively in society. It means not having enough to feed and clothe a family, not having a school or clinic to go to, not having the land on which to grow one's food or a job to earn one's living, not having access to credit. It means insecurity, powerlessness and exclusion of individuals, households and communities. It means susceptibility to violence, and it often implies living in marginal or fragile environments, without access to clean water or sanitation.

World Bank: Poverty is pronounced deprivation in well-being, and comprises many dimensions. It includes low incomes and the inability to acquire the basic goods and services necessary for survival with dignity. Poverty also encompasses low levels of health and education, poor access to clean water and sanitation, inadequate physical security, lack of voice, and insufficient capacity and opportunity to better one's life.

Copenhagen Declaration: *Absolute poverty* is a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. It depends not only on income but also on access to social services.The term 'absolute poverty' is sometimes synonymously referred to as 'extreme poverty.

Absolute poverty:

Poverty is usually measured as either absolute or relative (the latter being actually an index of income inequality). Absolute poverty refers to a set standard which is consistent over time and between countries.

First introduced in 1990, the dollar a day poverty line measured absolute poverty by the standards of the world's poorest countries. The World Bank defined the new international poverty line as $1.25 a day for 2005 (equivalent to $1.00 a day in 1996 US prices). but have recently been updated to be $1.25 and $2.50 per day. Absolute poverty, extreme poverty, or abject poverty is "a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health, shelter, education and information. It depends not only on income but also on access to services." The term 'absolute poverty', when used in this fashion, is usually synonymous with 'extreme poverty': Robert McNamara, the former President of the World Bank, described absolute or extreme poverty as, "...a condition so limited by malnutrition, illiteracy, disease, squalid surroundings, high infant mortality, and low life expectancy as to be beneath any reasonable definition of human decency". Australia is one of the world's wealthier nations. In his article published in Australian Policy Online, Robert Tinton notes that, "While this amount is appropriate for third world countries, in Australia, the amount required to meet these basic needs will naturally be much higher because prices of these basic necessities are higher."

However as the amount of wealth required for survival is not the same in all places and time periods, particularly in highly developed countries where few people would fall below the World Bank's poverty lines, countries often develop their own National poverty lines.

An absolute poverty line was calculated in Australia for the Henderson poverty inquiry in 1973. It was $62.70 a week, which was the disposable income required to support the basic needs of a family of two adults and two dependent children at the time. This poverty line has been updated regularly by the Melbourne Institute according to increases in average incomes; for a single employed person it was $391.85 per week (including housing costs) in March 2009. In Australia the OECD poverty would equate to a "disposable income of less than $358 per week for a single adult (higher for larger households to take account of their greater costs).

For a few years starting 1990, The World Bank anchored absolute poverty line as $1 per day. This was revised in 1993, and through 2005, absolute poverty was $1.08 a day for all countries on a purchasing power parity basis, after adjusting for inflation to the 1993 U.S. dollar. In 2005, after extensive studies of cost of living across the world, The World Bank raised the measure for global poverty line to reflect the observed higher cost of living.Now, the World Bank defines extreme poverty as living on less than US$1.25 (PPP) per day, and *moderate poverty*as less than $2 or $5 a day (but note that a person or family with access to subsistence resources, e.g. subsistence farmers, may have a low cash income without a correspondingly low standard of living – they are not living "on" their cash income but using it as a top up). It estimates that "in 2001, 1.1 billion people had consumption levels below $1 a day and 2.7 billion lived on less than $2 a day."A *dollar a day*, in nations that do not use the U.S. dollar as currency, does not translate to living a day on the equivalent amount of local currency as determined by the exchange rate.Rather, it is determined by the purchasing power parity rate, which would look at how much local currency is needed to buy the same things that a dollar could buy in the United States.Usually, this would translate to less

local currency than the exchange rate in poorer countries as the United States is a relatively more expensive country.

The poverty line threshold of $1.25 per day, as set by The World Bank, is controversial. Each nation has its own threshold for absolute poverty line; in the United States, for example, the absolute poverty line was US$15.15 per day in 2010 (US$22,000 per year for a family of four),[while in India it was US$ 1.0 per day[and in China the absolute poverty line was US$ 0.55 per day, each on PPP basis in 2010. These different poverty lines make data comparison between each nation's official reports qualitatively difficult. Some scholars argue that The World Bank method sets the bar too high, others argue it is low. Still others suggest that poverty line misleads as it measures everyone below the poverty line the same, when in reality someone living on $1.2 per day is in a different state of poverty than someone living on $0.2 per day. In other words, the depth and intensity of poverty varies across the world and in any regional populations, and $1.25 per day poverty line and head counts are inadequate measures.

The proportion of the developing world's population living in extreme economic poverty fell from 28 percent in 1990 to 21 percent in 2001.Most of this improvement has occurred in East and South Asia.In East Asia the World Bank reported that "The poverty headcount rate at the $2-a-day level is estimated to have fallen to about 27 percent [in 2007], down from 29.5 percent in 2006 and 69 percent in 1990." In Sub-Saharan Africa extreme poverty went up from 41 percent in 1981 to 46 percent in 2001, which combined with growing population increased the number of people living in extreme poverty from 231 million to 318 million.

In the early 1990s some of the transition economies of Central and Eastern Europe and Central Asia experienced a sharp drop in income.The collapse of the Soviet Union resulted in large declines in GDP per capita, of about 30 to 35% between 1990 and the trough year of 1998 (when it was at its minimum). As a result poverty rates also increased although in subsequent years as per capita incomes recovered the poverty rate dropped from 31.4% of the population to 19.6%

World Bank data shows that the percentage of the population living in households with consumption or income per person below the poverty line has decreased in each region of the world since 1990

Concept of relative poverty:

In 1776 Adam Smith in the Wealth of Nations argued that poverty is the inability to afford, "not only the commodities which are indispensably necessary for the support of life, but whatever the custom of the country renders it indecent for creditable people, even of the lowest order, to be without."

In 1958 J. K. Galbraith argued that, "People are poverty stricken when their income, even if adequate for survival, falls markedly behind that of their community."

In 1964 in a joint committee economic President's report in the United States, Republicans endorsed the concept of relative poverty. "No objective definition of poverty exists... The definition varies from place to place and time to time. In America as our standard of living rises, so does our idea of what is substandard."

In 1965 Rose Friedman argued for the use of relative poverty claiming that the definition of poverty changes with general living standards. Those labeled as poor in 1995, would have had "a higher standard of living than many labeled not poor" in 1965.

In 1979, British sociologist, Peter Townsend published his famous definition, "individuals [...] can be said to be in poverty when they lack the resources to obtain the types of diet, participate in the activities and have the living conditions and amenities which are customary, or are at least widely encouraged or approved, in the societies to which they belong

Brian Nolan and Christopher T. Whelan of the Economic and Social Research Institute (ESRI) in Ireland explained that, "poverty has to be seen in terms of the standard of living of the society in question."

Relative poverty measures are used as official poverty rates by the European Union, UNICEF and the OEDC. The main poverty line used in the OECD and the European Union is based on "economic distance", a level of income set at 60% of the median household income.

Characteristics:

The effects of poverty may also be causes, as listed above, thus creating a "poverty cycle" operating across multiple levels, individual, local, national and global

Health:

One third of deaths – some 18 million people a year or 50,000 per day – are due to poverty-related causes: in total 270 million people, most of them women and children, have died as a result of poverty since 1990. Those living in poverty suffer disproportionately from hunger or even starvation and disease. Those living in poverty suffer lower life expectancy. According to the World Health Organization, hunger and malnutrition are the single gravest threats to the world's public health and malnutrition is by far the biggest contributor to child mortality, present in half of all cases. Almost 90% of maternal deaths during childbirth occur in Asia and sub-Saharan Africa, compared to less than 1% in the developed world.

Those who live in poverty have also been shown to have a far greater likelihood of having or incurring a disability within their lifetime. Infectious such as malaria and tuberculosis can perpetuate poverty by diverting health and economic resources from investment and productivity; malaria decreases GDP growth by up to 1.3% in some developing nations and AIDS decreases African growth by 0.3–1.5% annually.

Business Cycle and Characteristics of Business Cycle:

Business cycle is also called Trade Cycle. The business is never steady. There are always ups and downs in economic activity. This cyclical movement both upwards and downwards is commonly called Trade Cycle. This is a wave like movement in regular manner in business cycle. In business, there are flourishing activities, which take economy to prosperity and growth whereas there are periods when there is recession, which leads to decline in the employment, income and output. When the economy goes into downswing then there is a stage of recovery to reach a new boom.

According to Keynes, "Trade Cycle is composed of periods of good trade characterized by rising price and low unemployment percentage altering with periods of bad trade characterized by falling price and high unemployment percentage." In the simple words – Business Cycle is a fluctuation of the economy characterized by periods of prosperity followed by periods of depression.

Characteristics of Business Cycle:

The fluctuations are wave like movement and are recurrent in nature. Business Cycle is characterized by waves of expansion and contraction. But these are not only two phases of business cycle. There are four phase of business cycle – Expansion, Recession, Contraction and Revival or Recovery.

The movement from peak to trough and again though to peak is not symmetrical. According to Keynes, prosperity phase of business cycle comes to end fast but dip is gradual and slow.

Business Cycle is self generating. Every phase has germs of the next phase, that is, expansion has the germs of the recession in it.

UNEMPLOYMENT AS A SOCIAL AND ECONOMIC INDICATOR:

The various mechanisms affecting the cyclical fluctuations of unemployment
as discussed above have implications for the interpretation of measured unemployment
as a social and economic indicator. The implications depend, however,
on what unemployment is meant to indicate. Three roles of unemployment are
Considered below, namely:
- a measure of under-utilization of labor;
- an indicator of social hardship;
- a determinant of wage pressure.

From the point of view of under-utilization of labor, both the cyclical employment responsiveness and labor-force responsiveness have important implications. If expanding output leads to a strong employment response while the labor Force remains unchanged, then unemployment falls strongly with rising output.

However, to the extent an increase in production gives rise to rising productivity And rising employment induces an increase in the labor-force, potential output Expands as a result of increasing actual output.lG coming out of a downturn, Countries with responsive productivity and labor force may thus be able to expand for longer, or more strongly, before inflationary pressures

develop and Corrective policies are called for. In this sense, cyclical fluctuations of productivity and cyclical labor-force variations - and not just measured unemployment – are relevant for gauging the full extent of under-utilization of labor and the associated output loss during a slowdown.

Some of the same factors which reduce the usefulness of unemployment as Measure of labor utilization render it dubious as an indicator of social hardship. Given the flexible response of the labor force to changes in employment, and given the flexibility of hours worked with respect to output, changes in measured Unemployment under-represent changes in gainful employment and earned Income. Unemployment, accordingly, does not fully reflect the amount of economic hardship caused by cyclical downturns. On the other hand, unemployment compensation partly cushions against economic hardship caused by job loss. To the extent that the status of "official" unemployment confers the right of receiving income transfers exceeding those available to non-participants of otherwise identical income and wealth characteristics, there is of course an obvious difference between the unemployed and the non-participants. Preferential access to income support may be one reason for individuals to remain "unemployed" rather than drop out of the labour force once they lose their job.

Economic Interpretation of Unemployment:

Frictional Unemployment: the usual amount of unemployment resulting from

- people who have left jobs that did not work out
- people who are entering or reentering the labor force

Structural Unemployment: results from permanent shifts in the pattern of demand for goods and services or from changes in technology. Therefore workers need to learn new skills or move to other locations.

Cyclical Unemployment: occurs during periods of contraction or recession, or in any period when the economy fails to operate at its potential.

Total amount of unemployment in any month

= frictional + structural + cyclical unemployment

where frictional and structural unemployment result from natural and unavoidable occurrence in a dynamic economy, and the cyclical unemployment is the result of imbalances between aggregate purchases and the aggregate production corresponding to full employment (this is controllable).

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