Economics Class 06

20th July, 2023 at 9:00 AM

REVISION OF THE PREVIOUS CLASS (9:00 AM):

- Post-Independence India chose to go for import-substitution-industrialization.
- In the 1960s and 1970s, license Raj contributed to manufacturing companies working at sub-optimal levels.
- The agriculture sector was also not performing well because the Green Revolution was in its nascent stages.
- The government had to continue vital imports like crude oil, food, etc.
- Costlier goods(imports and domestically produced) caused high inflation.
- Higher import bills caused a higher **trade deficit.**
- The situation was worsened by the global oil crisis of the 1970s.
- The structural deficiencies along with other factors kept on compounding till we faced the economic crisis in 1991.
- The 1991 crisis compelled India to take reforms to become a more open economy.
- The 1990s began with another pivotal event- The fall of the USSR.
- The **Balance of Payments (BOP)** is an accounting statement of Indian transactions with the rest of the world.
- A BOP crisis arises when the value of imports of any nation becomes too large than the value of its exports.
- The transactions under BOP are broadly classified into Current Accounts & Capital Accounts(FDI, FII, ECB, etc).

Current Account:

- These have no future implications.
- **The components of the Current Account are:**
- (a) Merchandize trade- Imports and exports of goods to and from a country.
- (b) Invisibles- It has three sub-components:
- (b)(1) Trade in Services-imports & Exports.
- (b) (2) Remittances/Transfers/Grants- Money sent or received during the year in the form of transfers.
- (b) (3) Earnings/Incomes.

IMF intervention in India:

- IMF accepted to pull India out of the balance of payments crisis.
- India was accepted to implement structural changes in India towards a market economy.
- These structural changes included a reduction of the government's influence in determining the prices of commodities.
- The Indian economy was to move towards being a Market economy where supply & demand will determine prices.
- IMF intervention pulled India from the BOP crisis and ushered in capitalism.
- Capitalism also has social impacts in India like increased inequality, public preference for economic growth over anything else, etc.

BASICS OF BANKING (9:30 AM):

- The primary functions of the banks are to keep deposits and extend loans
- Assets are the items that banks own- loans given, securities held, reserves they hold, etc.
- Liabilities of the banks are the items that the bank owes to some other entity- deposits held by the banks, loans taken by the banks, etc.

Non-Performing Assets (NPA):

- If no return (principal or interest) is made on the loans extended by banks for more than 90 days, banks classify the loan as **Non-Performing Assets (NPA).**
- NPA will affect the profitability of the banks.

Capital Account:

- It is a sub-account under BOP.
- It consists of transactions between Residents(R) & Non-Residents(NR) that have future implications.
- **Broadly there are two components:**
- Investments & Borrowings.
- India before 1991 had complete restrictions on the movement of investments.
- The restrictions were subsequently liberalized after 1991.

Foreign Direct Investment (FDI):

- It is an investment moving into the country with the intention of doing business, setting up subsidiary firms, acquiring existing firms for business, etc.
- In FDI, there is ownership of assets.
- FDI helps in bringing in new technologies and creating jobs.

FOREIGN INSTITUTIONAL INVESTMENT (FII) (10:00 AM):

- These are investments that enter the Indian stock market through a foreign institution.
- FIIs are regulated by SEBI and are highly volatile (**Hot Money).**
- Here volatile means they can move in and out of India very fast as per the growth and slump prospects they see in India and other nations.
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Diversification of economy:

Countries must diversify their avenues for raising money.

Ideally, the economy must have as much as possible a large number of sub-sectors under primary, secondary, and tertiary sectors.

Such diversification is necessary so that the country withstands external or internal shocks.

Over-dependence on a single or a few sectors might cause of increase troubles in the economy.

For example, the Sri Lankan economy was mainly dependent on Agricultural exports (Rice & Tea) and tourism.
Their overnight banning of chemical fertilizers for organic fertilizers saw a large decline in agricultural production, so a decline in exports.

Covid restrictions saw a collapse in the tourism sector.

Hence, Sri Lanka plunged into crisis.

EXTERNAL COMMERCIAL BORROWING (ECB) (10:30 AM):

- These are the long-term loans taken by Indian corporates from outside India.
- These loans are mainly of commercial nature (no concessional interest rates).

- The reason why corporates seek loans from abroad is the lower interest rates that some other countries might offer.

External assistance:

- These are soft loans(loans at concessional interest rates) generally taken by the Indian government from foreign institutions like IMF and World Bank.
- Both ECB and External assistance are part of the capital account.

Structural reforms suggested by IMF for helping India in 1991:

- The reforms could be classified into six heads:

I. Finance Sector reforms:

- This mainly included reforms in the banking sector to facilitate the opening and expansion of private banks.

II. Industrial reforms:

- India tried to move away from the license raj era through:
- De-Regulation
- De-licensing
- Disinvestment

III.Micro, Small & Medium Enterprises (MSME) reforms:

- Utilize their exports & job creation potential.
- The sector was focussed earlier too.

IV. Fiscal Reforms:

- Tax reforms:
- Reduction of tax rates.
- Increasing tax efficiency.
- The aim was a reduction of fiscal deficit/debt

V. Foreign Investments:

- Taking steps to encourage FDI, FII, etc.

VI.External Sector reforms:

- Currency value is to be determined by the market and not the government.
- The above reforms were termed **First Generational Reforms.**
- Even in the 1980s reforms done under **Rajiv Gandhi** brought India above the **Hindu Rate of Growth.**
- The rate of growth strengthened after the 1990s.

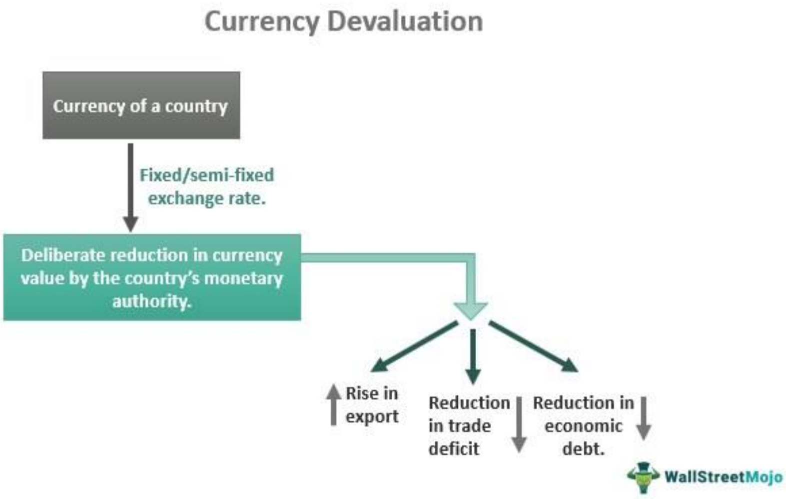
Second-Generation Reforms:

- The reforms were taken after 1999-2000.
- The aim was to continue the benefits achieved through first-generation reforms and also to plug in the loopholes in the first-generation reforms.
- These were difficult to implement and they mainly focussed on:
- **I. Legal reforms- liberalization of labor laws like Rajasthan.**
- India has been known for having strict labor laws.
- To avoid worker exploitation as seen during British Rule, there were restrictions imposed on the retrenchment of labor.
- The step proved counter-productive as industries went for having **contractual labor** rather than permanent employment.
- Industries (domestic & foreign) prefer efficient & trained labor and liberal/flexible labor laws(**Hire & Fire**); India lacked both.
- **II. Factor market reforms- removing administered pricing reforms(removal of subsidies on retail items like petrol, diesel, etc).**

- Government interference in pricing mechanisms for various commodities distorts the market for private participation.
- Such interferences also increase government deficits.
- The government progressed towards this through **Nudging** - persuading people to take certain individual steps which will help in meeting the government's aims.
- We saw it through felicitating taxpayers, campaigns like **Give-It-Up** for LPG subsidy, etc.
- **III. Capital account convertibility, etc.**
- These reforms are believed to be difficult to implement, as we saw with the recent **Farm Laws.**

Currency War:

- It refers to the competitive devaluation of currencies to make exports cheaper.



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DUTCH DISEASE (11:20 AM):

- Over-appreciation of currencies makes exports non-competitive.
- After the Netherlands discovered oil reserves in **the North Sea** in the 1960s, it started exporting crude oil.
- A large inflow of foreign currencies, especially US dollars started.
- The large inflow appreciated the value of the Dutch currency.
- Stronger currency made all other non-oil Dutch products costlier and hence non-competitive.
- The situation later caused a decline in industrial output, employment, and GDP growth.
- In the long run, the discovery of oil was hence detrimental to the Netherlands.

Law of Demand:

- For most objects, the price of the good is inversely proportional to the demand for the good.
- In most cases, if income increases, more quantity is demanded and the demand curve is said to have shifted **Rightwards**

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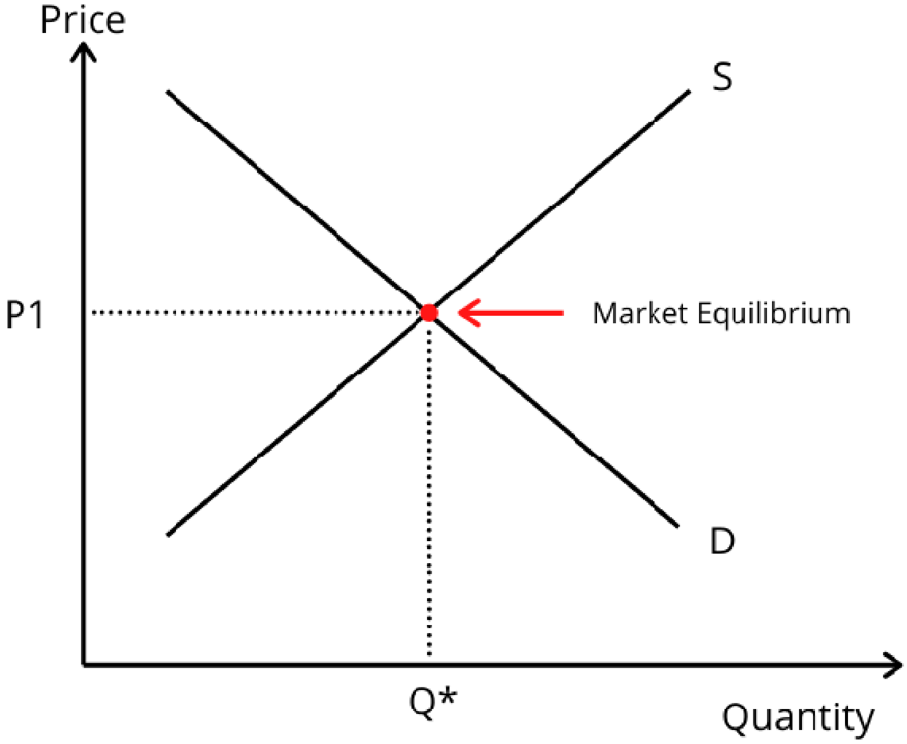
Market Equilibrium:

- It is a state of rest in which the quantity supplied matches the quantity demanded.
- **For example,** if sellers of pens are willing to sell 100 pens at a price of Rs 10 per pen and buyers are willing to buy 100 pens at that price, this market would be in equilibrium at the price of Rs 10 and at the quantity of 100 pens.



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- Proponents of the Free-market economy talk about the **Invisible Hand of the Market.**
- It refers to the automatic process through which equilibrium is determined and maintained on the basis of demand and supply.
- In cases of a financial crisis, when demand(purchasing power), supply, or both decreases, the curve moves toward the left.
- The government tries to intervene through **Fiscal Stimulus.**
- This step is expected to create demand and shift the curve rightwards.
- Sudden and large inflows and outflows of foreign capital can appreciate or depreciate the rupee.
- The RBI can intervene in such situations through **Sterilization.**

- Under sterilization, a central bank seeks to limit the effect of inflows and outflows of foreign capital on the domestic money supply.

Currency Convertibility:

- It is nothing but converting one currency into another with minimum restrictions.
- Even today, the Indian rupee is only partially convertible:
- The Indian rupee is fully convertible with respect to the current account and it is partially convertible with respect to the capital account.
- Before 1991, there were restrictions on current account capability also.

Current Account Convertibility:

- Current Account convertibility allows free inflows and outflows of foreign currency for the transactions that will be mentioned in the current account.
- It will include purposes like :
- I. Indians buying foreign goods and services (imports).
- II. Indians selling foreign goods and services (exports).
- III. Indians receiving and sending remittances.
- IV. Accessing foreign currency for travel, studying abroad, medical tourism purposes, etc.

Capital Account Convertibility:

- It means the freedom to convert the rupee into any foreign currency, and foreign currency back into rupee for capital account transactions.
- It will accord Indians the freedom to convert domestic financial assets into foreign financial assets at a market-determined exchange rate.
- It will lead to a free exchange of currency at a lower rate and an unrestricted movement of capital.

Currency Exchange Rate Regimes:

Free Float:

- The currency exchange rate is market-determined- the demand and supply are based on market forces.
- There is no intervention by the central bank or the government, and the demanders and suppliers are free to transact at any given exchange rate.
- Since the demand and supply constantly change, therefore exchange rate also continuously fluctuates.

Fixed Float:

- The demand and supply are controlled on the basis of a fixed exchange rate set by the authority.
- The government and the central bank may have certain objectives(economic or strategic) that they would like to achieve via the exchange rate.
- As such, they set it at a particular value and then maintain it at that level by controlling demand or supply, or both.
- For example, the government may fix the exchange rate at 1$=50 rupees, at which the demand for dollars may be greater than its supply.
- To keep the prices fixed at this level, the authority would have to provide dollars itself-augment the supply, or restrict people from demanding dollars(control the demand).

Dirty/Mixed/Managed Float:

- RBI follows a dirty float mechanism, where the currencies are allowed to move as per the market, but under certain circumstances, RBi conducts sterilization activities.

1997 South East Asian Crisis:

- It started in Thailand.
- Most of these countries suffered due to full capital account convertibility.
- Full Capital account convertibility allowed companies to easily move out(easy flight of capital).

- The Indian government was hesitant to bring complete convertibility.
- It appointed **Tarapore Committee I & II** to suggest reforms related to capital account convertibility.

The topics for the next class are the remaining basics of Economy and Monetary Policy.