2018

INTEGRATED LEARNING PROGRAMME, ILP

IASBABA

[ECONOMIC DEVELOPMENT- GS 3]

Integrated Learning Programme 2018 is a step towards ‘Enabling a person located at the most remote destination a chance at cracking AIR 1 in UPSC/IAS’

- *This is just a revision material—we've tried our best to help you get a thorough understanding of the concepts involved. But for you to excel, a minimum of 2-3 readings of concepts given in NCERT or this value add is important over a course of time.*
- *This document will give you enough inputs to support and enrich your Mains answers.*
- *Topics like Growth & Development, Poverty Issues, Employment Issues, Industries and Infrastructure needs detailed coverage. We will cover them with Mains perspective in other/future Value Adds.*
- *Environment related concepts will be covered under Environment Blocks.*
- *Topics of Human Geography are more important from dynamic perspective. It is a mix of economy-geography related concepts. It will be covered with contemporary developments as per related topics in respective Value Adds.*

Development Policies & Experiences of 1947-90

Objective is to understand—

- Overview of the state of the Indian economy— basic features of the Indian economy, and its development
- Factors that led to the underdevelopment and stagnation of the Indian economy
- Overview of the goals of five year plans
- Series of steps taken to lead the country on to a path of planned economy
- Critical appraisal: Merits and limitations of planned development

State of India's economy prior to the country's independence

Before the advent of the British rule: India had an independent economy; Well-known for

- Handicraft industries in the fields of cotton and silk textiles, metal and precious stone works etc. besides agriculture
- Reputation of the fine quality of material used and the high standards of craftsmanship

Purpose of the British colonial rule in India: To reduce the country to being a feeder economy for Great Britain's own rapidly expanding modern industrial base

- **Economic policies pursued-** concerned more with the protection and promotion of the economic interests of their home country than with the development of the Indian economy
- **A fundamental change in the structure of the Indian economy was brought about—** India was transformed into a net supplier of raw materials and consumer of finished industrial products from Britain
- **No attempt to conduct proper estimation-** The colonial government never made any sincere attempt to estimate India's national and per capita income
- **Notable estimators:** Dadabhai Naoroji, William Digby, Findlay Shirras, V.K.R.V. Rao and R.C. Desai

Rao: Estimates of the national and per capita incomes during the colonial period by him were considered very significant

Rao's Studies: Found that the country's growth of aggregate real output during the first half of the twentieth century was less than two per cent coupled with a meagre half per cent growth in per capita output per year.

Agriculture Sector

India's economy under the British: Fundamentally agrarian — about 85 per cent of the country's population lived mostly in villages and derived livelihood directly or indirectly from agriculture

Stagnated agriculture scene: Agriculture as a sector had already been crowded with involvement of maximum population, but ironically it kept experiencing stagnation and deterioration leading to a very low agricultural productivity, in absolute terms.

- ✓ **Various systems of land settlement** introduced by the colonial government (the zamindari system which was implemented in the then Bengal Presidency comprising parts of India's present-day eastern states, the profit accruing out of the agriculture sector went to the zamindars instead of the cultivators with no zamindars initiating to strive for the development of agriculture→ Misery & social tension
- ✓ **Terms of the revenue settlement:** Right from the practice of fixing dates for depositing specified sums of revenue, failing which the zamindars were to lose their rights worked in a very bad taste (Zamindar's headache)
- ✓ **Zero development of inputs involved:** Low levels of technology, lack of irrigation facilities and negligible use of fertilisers→ dismal level of agricultural productivity
- ✓ **Partition of the country:** A sizeable portion of the undivided country's highly irrigated and fertile land went to Pakistan leading to an adverse impact upon India's output from the agriculture sector (Jute industry- whole of the area went away to East Pakistan—present day Bangladesh; country had a monopoly)

Rare growth situation experienced-

- Due to the expansion of the aggregate area under cultivation
- Relatively higher yield of cash crops in certain areas of the country due to commercialisation of agriculture→ Did not help farmers in improving their economic condition as, instead of producing food crops, now they were producing cash crops which were to be ultimately used by British industries back home

Industrial Sector

Manufacturing: India could not develop a sound industrial base even while carrying the legacy of churning out the best handicraft stuff in the world—it declined rapidly and no corresponding modern industrial base was allowed to take its place

Primary motive of the colonial government behind using the policy of systematic deindustrialisation—

- To reduce India to the status of a mere exporter of important raw materials for the upcoming modern industries in Britain
- To turn India into a sprawling market for the finished products of those industries so that their continued expansion could be ensured to the maximum advantage of their home country — Britain

Decline of the indigenous handicraft industries:

- Created massive unemployment
- A new demand in the Indian consumer market, which was now deprived of the supply of locally made goods→ to be profitably met by the increasing imports of cheap manufactured goods from Britain

Second half of the nineteenth century→ Modern industry began to take root in India but its progress remained very slow

Confined to the setting up of cotton and jute textile mills

- Cotton textile mills: In the western parts of the country- Maharashtra and Gujarat (Indians)
- Jute mills: Dominated by the foreigners—mainly concentrated in Bengal

Twentieth century

Iron and steel industries began coming up—The Tata Iron and Steel Company (TISCO) was incorporated in 1907

Other industries: sugar, cement, paper etc. came up after the Second World War.

Capital goods industry: Though necessary to help promote further industrialisation, this industry did not bloom.

Capital goods industry *means industries which can produce machine tools which are, in turn, used for producing articles for current consumption*

Limited area of operation of the public sector—remained confined only to the railways, power generation, communications, ports and some other departmental undertakings.

Growth rate of the new industrial sector and its contribution to the Gross Domestic Product (GDP) remained very small.

The industrial sector thus, was left out crying for modernisation, diversification, capacity building and increased public investment

Foreign Trade

Ancient times: India has been an important trading nation

Colonial Government: Followed restrictive policies of commodity production, trade and tariff→ adversely affected the structure, composition and volume of India's foreign trade

India: Became an exporter of primary products such as raw silk, cotton, wool, sugar, indigo, jute etc. and an importer of finished consumer goods like cotton, silk and woollen clothes and capital goods like light machinery produced in the factories of Britain

India became a puppet in the hands of: Britain— maintained a monopoly control over India's exports and imports leading to more than half of India's foreign trade to be restricted to Britain while the rest was allowed with a few other countries like China, Ceylon (Sri Lanka) and Persia (Iran). The opening of the Suez Canal further intensified British control over India's foreign trade

Generation of a large export surplus—Drain of Wealth— oriented to feed the Industrial Revolution in Britain

- Several essential commodities—food grains, clothes, kerosene etc. — suffered acute scarcity in the domestic market
- No generation of flow of gold or silver into India—used to make payments for
  - The expenses incurred by an office set up by the colonial government in Britain
  - Expenses on war fought by the British government
  - The import of invisible items

Highway between India & Britain—Suez Canal

- ✓ Suez Canal is an artificial waterway running from north to south across the Isthmus of Suez in north-eastern Egypt
- ✓ Connects Port Said on the Mediterranean Sea with the Gulf of Suez (an arm of the Red Sea)
- ✓ Provides a direct trade route for ships operating between European or American ports and ports located in South Asia, East Africa and Oceania by doing away with the need to sail around Africa
- ✓ It was opened in 1869 reduced the cost of transportation, and made access to the Indian market easier

Demographic Trend

1st documentation of the population of British India: Through a census in 1881; every ten years such census operations were carried out

Revealed: The unevenness in India's population growth

India's stages of demographic transition:

1st stage: Before 1921

2nd stage: After 1921; neither the total population of India nor the rate of population growth at this stage was very high and the various social development indicators were also not quite encouraging

- ✓ **Overall literacy level:** less than 16 per cent; the female literacy level was at a negligible low of about seven per cent
- ✓ **Public health facilities:** either unavailable to the larger population or, when available, were highly inadequate
- ✓ Rampant occurrence of water and air-borne diseases taking a huge toll on life—the overall mortality rate was very high and the infant mortality rate was quite alarming—about 218 per thousand in contrast to the present infant mortality rate of 38 per thousand (WB & UNICEF)
- ✓ Life expectancy was also very low—32 years
- ✓ Extensive poverty prevailed in India during the colonial period which contributed to the worsening profile of India's population of the time

Occupational Structure

Occupational structure: It means the distribution of working persons across different industries and sectors

Colonial period: Very little signs of changes

Largest share of workforce: Witnessed in agriculture- remained at a high of 70-75 per cent

Manufacturing and the services sectors: Accounted for only 10 and 15-20 per cent

Growth in regional variation:

- ✓ Parts of the then Madras Presidency, Maharashtra and West Bengal witnessed a decline in the dependence of the workforce on the agricultural sector with a commensurate increase in the manufacturing and the services sectors
- ✓ Increase in the share of workforce in agriculture during the same time- Orissa, Rajasthan and Punjab

Madras Presidency: areas of the present-day states of Tamil Nadu, Andhra Pradesh, Kerala and Karnataka

Infrastructure

Colonial times: Development of basic infrastructure (railways, ports, water transport, posts and telegraphs)

Why did this development happen— To sub-serve various colonial interests (not to provide basic amenities to the people)

Roads:

- ✓ To mobilise the army within India
- ✓ To draw out raw materials from the countryside to the nearest railway station or the port to send these to far away England or other lucrative foreign destinations
- ✓ To reach out to the rural areas during the rainy season

Railways:

Introduction: In 1850 (one of their most important contributions)

- ✓ Affected the structure of the Indian economy in two important ways—
- ✓ Enabled people to undertake long distance travel thereby breaking geographical and cultural barriers
- ✓ Fostered commercialisation of Indian agriculture which adversely affected the comparative self-sufficiency of the village economies in India
- ✓ Volume of India's export trade expanded with benefits rarely been accrued to the Indian people

Social benefits outweighed the country's huge economic loss with the 'railways' needing further upgradation, expansion and public orientation

Development of the inland trade and sea lanes: Mixed reaction to the development of these as sometimes they proved uneconomical (Coast Canal on the Orissa coast)

Electric telegraph: Served the purpose of maintaining law and order

Postal services: Was useful but remained inadequate

Indian Economy (1950-1990)

To get an insight into—

- Development of Five year Plans
- Development policies in different sectors
- Understand merits and limitations of a regulated economy

Types of Economic Systems

What to produce?

How to produce?

How to distribute?

A. Market economy or Capitalism:

- Production of those consumer goods which are in demand i.e., goods that can be sold profitably either in the domestic or in the foreign markets
- Goods produced are distributed among people not on the basis of what people need but on the basis of what people can afford and are willing to purchase

B. Socialist society:

- The government decides what goods are to be produced in accordance with the needs of society—assumed that the government knows what is good for the people of the country as well as how they should be distributed.
- A socialist society has no private property since everything is owned by the state.

C. Mixed Economy:

- Most economies are mixed economies, i.e., the government and the market together answer the three questions of what to produce, how to produce and how to distribute what is produced
- The market will provide whatever goods and services it can produce well, and the government will provide essential goods and services which the market fails to do.

In India…

India would be a 'socialist' society with a strong public sector but also with private property and democracy; the government would 'plan' economy with the private sector being encouraged to be part of the plan effort.

Reflections: The 'Industrial Policy Resolution' of 1948 + Directive Principles of the Indian Constitution

1950: The Planning Commission was set up (Prime Minister-its Chairperson)

Led to: An era of ***five year plans***

Plan: To spell out as to how the resources should be distributed in the country

Goals of the five year plans: Growth, Modernisation, Self-reliance and Equity

Growth:

- Refers to increase in the country's capacity to produce the output of goods and services within the country
- Good indicator of economic growth is the steady increase in the Gross Domestic Product (GDP)—the market value of all the goods and services produced in the country during a year.
- The **GDP** of a country is derived from the different sectors of the economy—the contribution made by each of these sectors makes up the structural composition of the economy.

Modernisation:

- Steps taken by a factory to increase output by using a new type of machine and this adoption of new technology is called modernisation
- Also, refers to changes in social outlook (the recognition that women should have the same rights as men)

Self-reliance:

- The first seven five year plans gave more importance to self-reliance which means avoiding imports of those goods which could be produced in India itself→ in order to reduce our dependence on foreign countries, especially for food
- There was a fear that dependence on imported food supplies, foreign technology and foreign capital may make India's sovereignty vulnerable to foreign interference in our policies.

Equity:

Philosophy: To ensure that the benefits of economic prosperity reach the poor sections as well instead of being enjoyed only by the rich—every Indian should be able to meet his or her basic needs such as food, a decent house, education and health care; and inequality in the distribution of wealth should be reduced.

Addressing agricultural needs

Land Reforms

Intermediaries (variously called zamindars, jagirdars etc.) merely collected rent from the actual tillers of the soil without contributing towards improvements on the farm

The low productivity of the agricultural sector forced India to import food from the United States of America (U.S.A.).

Equity in agriculture: Land reforms—change in the ownership of landholdings

Steps were taken to abolish intermediaries and to make the tillers the owners of land—ownership of land would give incentives to the tillers to invest in making improvements provided sufficient capital was made available to them.

Land ceiling: Fixing the maximum size of land which could be owned by an individual—to reduce the concentration of land ownership in a few hands

Around 200 lakh tenants came into direct contact with the government — they were freed from being exploited by the zamindars→ incentive to increase output→growth in agriculture

But there still were cases wherein

- The zamindars continued to own large areas of land (usage of loopholes in the legislation)
- Tenants were evicted and the landowners claimed to be self-cultivators (the actual tillers)

Hurdles faced by the land ceiling legislation

- The big landlords challenged the legislation in the courts→delayed its implementation
- Used this delay to register their lands in the name of close relatives→to escape from the legislation

Success of Land reforms witnessed: Kerala and West Bengal; had governments committed to the policy of land to the tiller

The Green Revolution

During independence: About 75 per cent of the country's population→dependent on agriculture

Marred with low productivity→use of old technology + absence of required infrastructure

India's agriculture→ dependant upon monsoon; and if the monsoon fell short the farmers were in trouble (if no access to irrigation facilities)

Stagnation in agriculture shifted—Green Revolution

- The large increase in production of food grains resulting from the use of high yielding variety (HYV) seeds especially for wheat and rice
- This also meant usage of fertiliser and pesticide in the correct quantities as well as regular supply of water; the need for these inputs in correct proportions is vital

Check-list for farmers: Reliable irrigation facilities as well as the financial resources to purchase fertiliser and pesticide

1st phase of the green revolution (approximately mid 1960s upto mid 1970s)

- The use of HYV seeds was restricted to the more affluent states such as Punjab, Andhra Pradesh and Tamil Nadu.
- Use of HYV seeds proved beneficial for the wheat-growing regions only

2nd Phase of the green revolution (mid-1970s to mid-1980s):

- Spread of the HYV technology to a larger number of states and this benefited more variety of crops thus, enabling India to achieve self-sufficiency in food grains
- To increase growth in agricultural output & contribute to the country's economy—it is important to keep a substantial amount of agricultural produce to be sold in the market (and not consumed by the farmers himself)

The portion of agricultural produce which is sold in the market by the farmers is called marketed surplus.

Observations of C.H. Hanumantha Rao

A good proportion of the rice and wheat produced during the green revolution period (available as marketed surplus) was sold by the farmers in the market→ decline in the price of food grains.

Low-income groups- Benefited from this decline in relative prices (spend a large percentage of their income on food)

Enabled the government to procure sufficient amount of food grains to build a stock which could be used in times of food shortage

Risks involving technology:

- Possibility of increase in the disparities between small and big farmers—since only the big farmers could afford the required inputs, thereby reaping most of the benefits of the green revolution
- HYV crops were more prone to attack by pests

Fears remained 'fears'— because of the steps taken by the government

- Provided loans at a low interest rate to small farmers
- Subsidised fertilisers so that small farmers could also have access to the needed inputs; since the small farmers could obtain the required inputs, the output on small farms equalled the output on large farms in the course of time→ benefited the small as well as rich farmers
- Risks due to pest attack were minimised with the services rendered by research institutes established by the government

Subsidies

Why: necessary to use subsidies to provide an incentive for adoption of the new HYV technology by small farmers in particular—to encourage farmers to test the new technology

Case against continuing subsidies—

- Once the technology is found profitable and is widely adopted, subsidies should be phased out since their purpose has been served— meant to benefit the farmers but a substantial amount of fertiliser subsidy also benefits the fertiliser industry; and among farmers, the subsidy largely benefits the farmers in the more prosperous regions
- Ends up not providing benefit to the target group and it is a huge burden on the government's finances

Need to continue with agricultural subsidies— Farming in India continues to be a risky business as most of the farmers are very poor and they will not be able to afford the required inputs without subsidies→will increase the inequality between rich and poor farmers and violate the goal of equity

Correct way forward: Ensure that only the poor farmers enjoy the benefits

Observation: As a nation becomes more prosperous, the proportion of GDP contributed by agriculture as well as the proportion of population working in the sector declines considerably

Between 1950 and 1990: The proportion of GDP contributed by agriculture declined significantly but not the population depending on it (67.5 per cent in 1950 to 64.9 per cent by 1990)—the industrial sector and the service sector did not absorb the people working in the agricultural sector

Industry & Trade

Poor nations can progress only if they have a good industrial sector as industry provides employment which is more stable than the employment in agriculture; it promotes modernisation and overall prosperity→ more emphasis on its growth in the FYPs

Post-independence: Need to expand the industrial base with a variety of industries if the economy was to grow

Market and State in Indian Industrial Development:

- At the time of independence— lack of capital to undertake investment in industrial ventures required for the development of our economy; small market being unable to encourage industrialists to undertake major projects→ *state had to play an extensive role in promoting the industrial sector*
- Development of the economy on socialist lines: Policy of the state controlling the commanding heights of the economy—the state would have complete control of those industries that were vital for the economy
- Policies of the private sector needed to be complimentary to those of the public sector, with the public sector leading the way.

Industrial Policy Resolution 1956 (IPR 1956):

Formed the basis of the Second Five Year Plan—to build the basis for a socialist pattern of the society

Classification of Industries—three categories:

1st: industries which would be exclusively owned by the state

2nd: industries in which the private sector could supplement the efforts of the state sector, with the state taking the sole responsibility for starting new units

3rd: the remaining industries which were to be in the private sector; was kept under state control through a system of licenses.

- Only with the issuance of license could any industry be established—to promote industry in backward regions→it was easier to obtain a license if the industrial unit was established in an economically backward area
- Were given certain concessions such as tax benefits and electricity at a lower tariff→ To promote regional equality
- Even an existing industry had to obtain a license for expanding output or for diversifying production (producing a new variety of goods)→to ensure that the quantity of goods produced was not more than what the economy required
- License to expand production was given only if the government was convinced that the economy required the larger quantity of goods.

Small-scale Industry:

Karve Committee: In 1955→possibility of using small-scale industries for promoting rural development

A 'small-scale industry' is defined with reference to the maximum investment allowed on the assets of a unit

- More 'labour intensive' i.e., they use more labour than the large-scale industries and, therefore, generate more employment

- Inability to compete with bigger firms— reservation of a certain number of products for the small-scale industry; the criterion of reservation being the ability of these units to manufacture the goods
- Were given concessions- lower excise duty and bank loans at lower interest rates

Trade Policy—Import Substitution

The industrial policy that we adopted was closely related to the trade policy

1st seven FYPs: Trade was characterised by an inward looking trade strategy→ Import substitution; aiming at replacing or substituting imports with domestic production

('Make in India' should ring in your head at the moment)

Protection from imports took two forms: Tariffs and Quotas

Tariffs: Tax on imported goods; they make imported goods more expensive and discourage their use.

Quotas: Specify the quantity of goods which can be imported

Both restrict imports and, therefore, protect the domestic firms from foreign competition.

Policy of protection:

- Based on the notion that industries of developing countries are not in a position to compete against the goods produced by more developed economies—assumed that if the domestic industries are protected they will learn to compete in the course of time
- Feared the possibility of foreign exchange being spent on import of luxury goods if no restrictions were placed on imports

Until the mid-1980s: Hardly any promotion of exports until the mid-1980s

Effect of Policies on Industrial Development:

- Proportion of GDP contributed by the industrial sector increased in the period from 11.8 per cent in 1950-51 to 24.6 per cent in 1990-91
- Rise in the industry's share of GDP—important indicator of development
- Witnessed six per cent annual growth rate of the industrial sector
- Diversification of the Indian industries was ensured—
  - Promotion of small-scale industries gave opportunities to those people who did not have the capital to start large firms to get into business
  - Protection from foreign competition enabled the development of indigenous industries in the areas of electronics and automobile sectors
  - Public sector enterprises sparked off debated among economists—state enterprises continued to produce certain goods and services (often monopolising them)
  - No distinction was made between what the public sector alone can do and what the private sector can also do
  - Some scholars argued that state should get out of areas which the private sector can manage and the government should concentrate its resources on important services which the private sector cannot provide.
  - The marathon continues for public sector firms even after incurring huge losses but they continue to function causing a drain on the nation's limited resources whereas a loss-making private firm will not waste resources by being kept running despite the losses.
  - Obtaining a license was a rigorous part of the process—being widely misused by the industrial houses; a big industrialist would get a license not for starting a new firm but to prevent competitors from starting new firms→ Permit license raj—prevented certain firms from becoming more efficient
  - Restrictions on imports- proved to be a bane as the Indian consumers had to purchase whatever the Indian producers produced—no incentive to improve the quality of their goods.

- Public sector is not meant for earning profits but to promote the welfare of the nation→ should be evaluated on the basis of the extent to which they contribute to the welfare of people and not on the profits they earn.

The above points of contention/arguments led the government to introduce a new economic policy in 1991.

Architect of Indian Planning: Mahalanobis (2nd FYP)

Liberalisation-Privatisation-Globalisation

Objectives:

- Understand the background of the reform policies introduced in India in 1991
- Understand the mechanism through which reform policies were introduced
- Comprehend the process of globalisation and its implications for India
- Understand the impact of the reform process on various sectors

1991

India met with an economic crisis relating to its external debt—

- Government was unable to make repayments on its borrowings from abroad
- Foreign exchange reserves dropped to levels that were not sufficient
- Compounded by rising prices of essential goods

→Inefficient management of the Indian economy in the 1980s

What happens when expenditure is more than income→ Government borrows to finance the deficit from banks and also from people within the country and from international financial institutions.

India:

- Government had to overshoot its revenue to meet problems like unemployment, poverty and population explosion (revenues were very low; no chance of generating immediate returns)→ No generation of additional revenue even via taxation
- Income from public sector undertakings— not very high to meet the growing expenditure
- Borrowed foreign exchange: Spent on meeting consumption needs
- Lack of attention: Reduction in profligate spending & boosting of exports to pay for the growing imports

Late 1980s…

- Government expenditure exceeded its revenue by large margins→ unsustainable
- Sharp rise in the prices of many essential goods
- Imports grew at a very high rate without matching growth of exports
- Foreign exchange reserves declined to a level that was not adequate to finance imports for more than two weeks.
- No sufficient foreign exchange to pay the interest that needs to be paid to international lenders.

India took a step…

Approached the International Bank for Reconstruction and Development (IBRD)—World Bank and the International Monetary Fund (IMF) and received $7 billion as loan to manage the crisis

How to avail the loan: International agencies expected India to liberalise and open up the economy by

- Removing restrictions on the private sector
- Reducing the role of the government in many areas
- Removing trade restrictions

What did India do—India agreed to the conditionality's of World Bank and IMF—announced the **New Economic Policy (NEP)**

- Towards creating a more competitive environment in the economy
- Removing the barriers to entry
- Growth of firms

The nature of policies—

- Stabilisation measures are short-term measures—to correct some of the weaknesses that have developed in the balance of payments and to bring inflation under control→ need to maintain sufficient foreign exchange reserves and keep the rising prices under control

- Structural reform policies are long-term measures, aimed at improving the efficiency of the economy and increasing its international competitiveness by removing the rigidities in various segments of the Indian economy→ policies fall under three heads viz., liberalisation, privatisation and globalisation

Liberalisation

Introduced to put an end to these restrictions and open up various sectors of the economy

Liberalisation measures of 1980s: In areas of industrial licensing, export-import policy, technology upgradation, fiscal policy and foreign investment

Reform policies initiated in 1991: industrial sector, financial sector, tax reforms, foreign exchange markets and trade and investment sectors

Deregulation of Industrial Sector:

- *Industrial licensing:* abolished for almost all but product categories — alcohol, cigarettes, hazardous chemicals industrial explosives, electronics, aerospace and drugs and pharmaceuticals
- Reservations for Public sector: defence equipment, atomic energy generation and railway transport
- Private sector was not allowed in many industries
- Deregulation of goods produced in small scale industries
- Market mechanism to determine the prices.

Financial Sector Reforms:

Financial sector: Financial institutions such as commercial banks, investment banks, stock exchange operations and foreign exchange market

Controlled by: Reserve Bank of India (RBI); various norms and regulations exists for all the banks and other financial institutions in India

Major aim of financial sector reforms: Reduce the role of RBI from regulator to facilitator of financial sector enabling the financial sector to be allowed to take decisions on many matters without consulting the RBI

Reform policies led to—

- Establishment of private sector banks, Indian as well as foreign.
- Foreign investment limit in banks was raised to around 50 per cent.
- Banks fulfilling certain conditions were given freedom to set up new branches without the approval of the RBI and rationalise their existing branch networks.
- Foreign Institutional Investors (FII) such as merchant bankers, mutual funds and pension funds: allowed to invest in Indian financial markets

Tax Reforms

Concerned with the reforms in government's taxation and public expenditure policies (fiscal policy)—

Direct taxes: consist of taxes on incomes of individuals as well as profits of business enterprises

- Witnessing a continuous reduction in the taxes on individual incomes as it was felt that high rates of income tax were an important reason for tax evasion
- Accepted norm is that the moderate rates of income tax encourage savings and voluntary disclosure of income

Rate of corporation tax has been gradually reduced

Reforms in the ***indirect taxes,*** taxes levied on commodities, in order to facilitate the establishment of a common national market for goods and commodities

Simplification in terms of procedures and lowering of rates has been incorporated to encourage better compliance on the part of taxpayers

Foreign Exchange Reforms

- To resolve the balance of payments crisis, the rupee was devalued against foreign currencies, leading to an increase in the inflow of foreign exchange
- Also, resolved to free the determination of rupee value in the foreign exchange market from government control

- ***Presently:*** Markets determine exchange rates based on the demand and supply of foreign exchange.

Trade and Investment Policy Reforms:

- Liberalisation of trade and investment regime was initiated to increase international competitiveness of industrial production and also foreign investments and technology into the economy
- Aim: To promote the efficiency of the local industries and the adoption of modern technologies
- The trade policy reforms aimed at—
    - Dismantling of quantitative restrictions on imports and exports
    - Reduction of tariff rates
    - Removal of licensing procedures for imports
- Import licensing was abolished except in case of hazardous and environmentally sensitive industries
- Quantitative restrictions on imports of manufactured consumer goods and agricultural products were also fully removed
- Export duties have been removed to increase the competitive position of Indian goods in the international markets.

Privatisation

What: Shedding of the ownership or management of a government owned enterprise

Can Government companies be converted into private companies—

- By withdrawal of the government from ownership and management of public sector companies
- By outright sale of public sector companies

Disinvestment: Privatisation of the public sector undertakings by selling off part of the equity of PSUs to the public— to improve financial discipline and facilitate modernisation

Government envisaged that:

- Privatisation could provide strong impetus to the inflow of FDI
- Had made attempts to improve the efficiency of PSUs by giving them autonomy in taking managerial decisions

Globalisation— 'creating a borderless world'

What: Outcome of the policies of liberalisation and privatisation as well as the set of various policies that are aimed at transforming the world towards greater interdependence and integration; involving creation of networks and activities transcending economic, social and geographical boundaries

Outsourcing: One of the important outcomes of the globalisation process— wherein a company hires regular service from external sources, mostly from other countries, and this phenomenon has intensified with the growth of fast modes of communication—the growth of Information Technology (IT). Most multinational corporations are outsourcing their services to India where they can be availed at a cheaper cost with reasonable degree of skill and accuracy

Why in India: The low wage rates and availability of skilled manpower in India have made it a destination for global outsourcing in the post-reform period.

World Trade Organisation (WTO)

Founded in: 1995, a successor organisation to the General Agreement on Trade and Tariff (GATT)

GATT: Established in 1948 as the global trade organisation to administer all multilateral trade agreements by providing equal opportunities to all countries in the international market for trading purposes

WTO's rule:

- Establish a rule-based trading regime in which nations cannot place arbitrary restrictions on trade
- To enlarge production and trade of services
- To ensure optimum utilisation of world resources
- To protect the environment

WTO agreements: Cover trade in goods as well as services to facilitate international trade (bilateral and multilateral) through removal of tariff as well as non-tariff barriers and providing greater market access to all member countries.

India: Has kept its commitments towards liberalisation of trade—by removing quantitative restrictions on imports and reducing tariff rates

Think: *Is India's membership at WTO useful? Discuss. (Interview based)*

Note- LPG will be covered in detail later.

Indian Economy & Reforms

GDP Growth: The growth of GDP increased from 5.6 per cent during 1980-91 to 6.4 per cent during 1992-2001→ an increase in the overall GDP growth in the reform period

Industries: Growth of agriculture and industrial sectors had declined whereas the growth of service sector has recently gone up→ growth is mainly driven by the growth in the service sector

Opening up of the economy: Has led to rapid increase in foreign direct investment, foreign exchange reserves as well as the foreign investment

Lacunaes: There have been wide criticisms over the inability of the reforms to mark a serious change in the areas of employment, agriculture, industry, infrastructure development and fiscal management.

Growth and Employment: Has not generated sufficient employment opportunities

Reforms in Agriculture: Did not benefit much

- Public investment in agriculture sector especially in infrastructure, which includes irrigation, power, roads, market linkages and research and extension (played a crucial role in the Green Revolution) were reduced.
- Moreover, the removal of fertiliser subsidy has led to increase in the cost of production (severely affected the small and marginal farmers)
- Several policy changes such as reduction in import duties on agricultural products, removal of minimum support price and lifting of quantitative restrictions on agricultural products adversely affected Indian farmers as it laid them bare at the mercy of international competition.
- The export-oriented policy strategies in agriculture led to a shift from production for the domestic market towards production for the export market focusing on cash crops in lieu of production of food grains→ putting pressure on prices of food grains.

Reforms in Industry: Recorded a slowdown→decreasing demand of industrial products due to various reasons such as cheaper imports, inadequate investment in infrastructure etc.

Cheaper imports had replaced the demand for domestic goods leading to a stiff competition for the domestic manufacturers. Lack of investment has rendered the infrastructure facilities and the power supply to remain inadequate due to lack of investment

Disinvestment: Critics point out towards the fact that the assets of PSUs have been undervalued and sold to the private sector→ a substantial loss to the government has thus, been witnessed and the proceeds from disinvestment were used to offset the shortage of government revenues rather than using it for the development of PSUs and building social infrastructure in the country.

Reforms and Fiscal Policies: Economic reforms had placed limits on the growth of public expenditure especially in the social sectors with the tax reductions aiming at yielding larger revenue and curbing of tax evasion→ did not result in increase in tax revenue for the government and the scope for raising revenue through customs duties were curtailed completely. However, tax incentives were provided to the foreign investors to reduce the scope for raising tax revenues leading to a ***negative impact on developmental and welfare***.

Poverty

*This and the subsequent chapters will be covered very briefly as it needs to be covered w.r.t the contemporary issues of our times in detail—**Poverty Issues are covered in other VAN***

India's development pattern has envisaged from the beginning—

- Emphasis on the upliftment of the poorest of the poor (Antyodaya)
- Integration of the poor into the mainstream
- Achieving a minimum standard of living for all

Poverty-struck—

On the basis of their occupation and ownership of assets:

Rural poor work mainly as landless agricultural labourers, cultivators with very small landholdings, landless labourers who are engaged in a variety of non-agricultural jobs and tenant cultivators with small land holdings.

Urban poor- largely the overflow of the rural poor who have migrated to urban areas in search of alternative employment and livelihood, labourers who do a variety of casual jobs and the self-employed who sell a variety of things on roadsides and are engaged in various activities. Most of the urban poor are either unemployed or intermittently employed as casual labourers.

Casual labourers are among the most vulnerable in society: no job security, no assets, limited skills, sparse opportunities and no surplus to sustain them

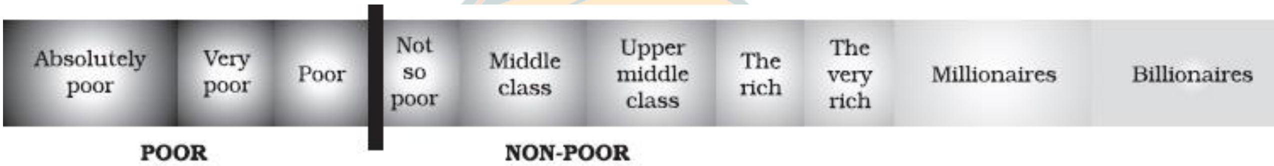
Poverty: Very closely related to nature of employment—Unemployment or under employment and the casual and intermittent nature of work in both rural and urban areas that compels indebtedness, in turn, reinforces poverty.

Indebtedness is one of the significant factors of poverty

How does the government identify the poor?

First to discuss the concept of a Poverty Line: Dadabhai Naoroji

- Used the menu for a prisoner and used appropriate prevailing prices to arrive at what may be called 'jail cost of living'.
- Absence of children in jail led him to appropriately adjust this cost of living to arrive at the poverty line
- Arrived at the weighted average of consumption of the three segments— gives the average poverty line, which comes out to be three-fourth of the adult jail cost of living



Categorising Poverty

Chronic Poor: People who are always poor and those who are usually poor but who may sometimes have a little more money (example: casual workers)

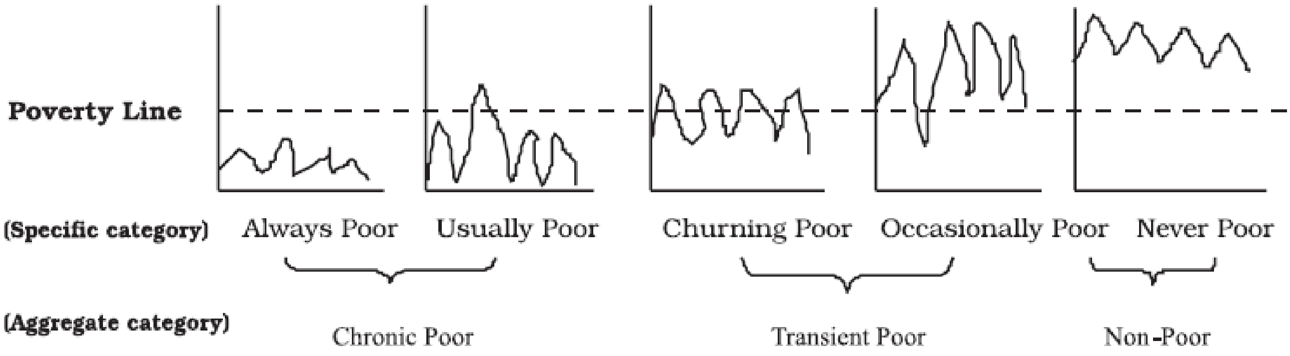
Churning poor: they regularly move in and out of poverty (example: small farmers and seasonal workers) and the occasionally poor who are rich most of the time but may sometimes have a patch of bad luck (transient poor)

Non-poor: Those who are never poor

The Poverty Line:

- Determine it by the monetary value (per capita expenditure) of the minimum calorie intake that was estimated at 2,400 calories for a rural person and 2,100 for a person in the urban area (earlier)
- In 1999-2000, the poverty line was defined for rural areas as consumption worth Rs. 328 per person a month and for urban areas it was Rs. 454.

What do you think—is the Government calculating the Poverty Line appropriately? Which are the committees that have formulated formulas/benchmarks on these?



Issues faced by the poverty-line mechanism

- Groups all the poor together and does not differentiate between the very poor and the other poor
- Though helpful in identifying the poor as a group to be taken care of by the government, it's difficult to identify who among the poor need help the most.
- Does not take into consideration social factors that trigger and perpetuate poverty such as illiteracy, ill health, lack of access to resources, discrimination or lack of civil and political freedoms

Aim of poverty alleviation schemes: To improve human lives by expanding the range of things that a person could be and could do

Government claims of decline in poverty levels on the basis of: Higher rate of growth, increase in agricultural production, providing employment in rural areas and economic reform packages introduced in the 1990s. Critics do not support this viewpoint and point out that the way the data is collected, items that are included in the consumption basket, methodology followed to estimate the poverty line and the number of poor is manipulated to arrive at the reduced figures of the number of poor in India.

Think:

1. *What are the limitations exhibited by the official estimation of poverty?*
2. *Are you aware about the 'Sen Index' and the tools used to measure the level and spread of poverty?*
3. *Present estimation of poverty line is based on which committee?*

Head Count Ratio: When the number of poor is estimated as the proportion of people below the poverty line

Data on poverty: Estimated on the basis of consumption expenditure data collected by the National Sample Survey Organisation (NSSO)

Major shift: From rural to urban

In the 1990s, the absolute number of poor in rural areas had declined whereas the number of their urban counterparts increased marginally

Note: The poverty ratio is declining continuously for both urban and rural areas

Causes behind Poverty

- Low levels of education and skills
- Infirmity, ill health, sickness
- Discrimination

These can be caused as a result of

- Social, economic and political inequality
- Social exclusion
- Unemployment
- Indebtedness
- Unequal distribution of wealth

Economy-wide problems:

- Low capital formation
- Lack of infrastructure
- Lack of demand
- Pressure of population
- Lack of social/welfare nets

Aggregate poverty: Sum of individual poverty

Impact of the British rule on Indian living standards

De-industrialisation in India- Imports of manufactured cotton cloth from Lancashire in England displaced the local production, and India reverted to being an exporter of cotton yarn (not the cloth)

Unequal distribution of income and asset→ has led to the persistence of poverty in India

Creation of two distinct groups in society:

- Those who possess the means of production and earn good incomes
- Those who have only their labour to trade for survival

Gap between the rich & poor: Ever-widening

Features of Poverty Alleviation Schemes

Primary objective of the developmental strategies: Social justice

Government's approach to poverty reduction consisted of three dimensions—

a. Growth-oriented approach: Based on the expectation that

- The effects of economic growth — rapid increase in gross domestic product and per capita income — would spread to all sections of society and will trickle down to the poor sections also (1950s and early 1960s)

- Rapid industrial development and transformation of agriculture through green revolution in select regions would benefit the underdeveloped regions and the more backward sections of the community
- Population growth has resulted in a very low growth in per capita incomes with the gap between poor and rich widening
- It was thought that creation of incremental assets would increase the incomes and employment for the poor

b. As pointed out by the FYPs, **self-employment programmes and wage employment programmes**

c. Addressing poverty is to provide **minimum basic amenities** to the people i.e. social consumption needs — provision of food grains at subsidised rates, education, health, water supply and sanitation— people's living standard could be improved—

- To supplement the consumption of the poor
- Create employment opportunities
- Bring about improvements in health and education

Think:

1. *So what factors do you think contributed towards the famines (between 1875 and 1900)?*
2. *Which sectors in India is experiencing globalisation related shock? How is the government taking care of saving them in a situation like this?*
3. *Discuss the distress among cotton farmers of India.*
4. *Discuss the relationship between unemployment and poverty.*

Refer:

Poverty in India

Human Capital Formation

Think:

- *Is education the same as being skilful?*
- *What is the relation between economic development and expanding educational opportunities?*
- *Compare and bring out both the differences as well as similarities between Physical and Human Capital.*

What constitutes Human Capital?

- **Investment in Education-** similar to spending on capital goods by companies with the objective of increasing future profits over a period of time
- **Investments in health:** for maintaining productivity— directly increases the supply of healthy labour force
- **On- the job training:** return of such expenditure is in the form of enhanced labour productivity and is more than the cost of it
- **Migration:** enhanced earnings in the new place outweigh the costs of migration
- **Information:** necessary to make decisions regarding investments in human capital as well as for efficient utilisation of the acquired human capital stock. Expenditure incurred for acquiring information relating to the labour market and other markets

Human Capital and Economic Growth:

Education: Economic growth means the increase in real national income of a country; and so naturally, the contribution of the educated person to economic growth is more than that of an illiterate person— stimulates innovations and creates ability to absorb new technologies & the availability of educated labour force facilitates adaptation to new technologies.

Health: If a healthy person could provide uninterrupted labour supply for a longer period of time, then health becomes an important factor for economic growth

Human Capital (HC) & Human Development (HD)

HC: considers education and health as a means to increase labour productivity

HD: based on the idea that education and health are integral to human well-being because only when people have the ability to read and write and the ability to lead a long and healthy life, they will be able to make other choices which they value

HC: treats human beings as a means to an end; the end being the increase in productivity. In this view, any investment in education and health is unproductive if it does not enhance output of goods and services

HD: human beings are ends in themselves. Human welfare should be increased through investments in education and health even if such investments do not result in higher labour productivity.

In India…

Government Expenditure on Education is expressed in two ways—

- As a percentage of 'total government expenditure':
  - Indicates the importance of education in the scheme of things before the government
  - Elementary education takes a major share of total education expenditure and the share of the higher/tertiary education (institutions of higher learning like colleges, polytechnics and universities) is the least— but 'expenditure per student' in tertiary education is higher than that of elementary
  - Need to increase expenditure on all levels of education
- As a percentage of Gross Domestic Product (GDP): how much of our income is being committed to the development of education in the country

Think: *Is 'Education for all' still a distant dream or is it achievable? Discuss*

Refer:

Education

- New Education Policy
- Future of Indian Education
- UGC— A Silent Spectator (1956—2016)
- Inequalities in educational access in India
- Reforming teacher management in public school system

Health

- A case of public health in India
- Healthcare Funding

Jobs

- Jobs & Economic Growth
- The India Labour and Employment Report 2016
- India's jobless growth

(Related topics will be covered more holistically in subsequent value adds for topics like inclusive growth, growth and development, poverty, employment issues et.al but just to fuel your anxiety we've shared the links of the concepts we've covered earlier)

Rural Development

We all know what importance has been placed with 'rural development' ever since it became a part of the national narrative. We will cover the core concepts here and it'll be covered in detail (schemes and contemporary issues)

Rural Development as a concept: Focuses on action for the development of areas that are lagging behind in the overall development of the village economy

Areas requiring special attention—

- Development of human resources– literacy (female literacy), education and skill development – health (sanitation and public health)
- Land reforms
- Development of the productive resources of each locality
- Infrastructure development: electricity, irrigation, credit, marketing, transport facilities—
  - Construction of village roads and feeder roads to nearby highways
  - Facilities for agriculture research and extension
  - Information dissemination
- Special measures for alleviation of poverty and bringing about significant improvement in the living conditions of the weaker sections of the population emphasising access to productive employment opportunities
- Enabling farming communities—
  - Increase the productivity of grains, cereals, vegetables and fruit
  - More opportunities to diversify into various non-farm productive activities such as food processing
  - Giving them better and more affordable access to healthcare, sanitation facilities at workplaces and homes
  - Education for all

Factors impeding Rural development

- Inadequate infrastructure
- Lack of alternate employment opportunities in the industry or service sector
- Increasing casualisation of employment

Credit:

- More infusion of capital is required to realise higher productivity in agriculture and non-agriculture sectors
- The gestation between crop sowing and realisation of income after production is quite long, and the farmers end up borrowing from various sources to meet their initial investment on seeds, fertilisers, implements and other family expenses of marriage, death, religious ceremonies etc.
- Post 1969 with the adoption of social banking and multiagency approach, the needs of rural credit was marginally met with
- National Bank for Agriculture and Rural Development (NBARD) was set up in 1982 as an apex body to coordinate the activities of all institutions involved in the rural financing system
- The Green revolution turned out to be a harbinger of major changes in the credit system- led to the diversification of the portfolio of rural credit towards production-oriented lending
- Present institutional structure of rural banking: Set of multiagency institutions- commercial banks, regional rural banks (RRBs), cooperatives and land development banks- to dispense adequate credit at cheaper rates
- Self-Help Groups (henceforth SHGs) have emerged to fill the gap in the formal credit system; promote thrift in small proportions by a minimum contribution from each member

Although, rapid expansion of the banking system had a positive effect on rural farm and non-farm output, income and employment, especially after the green revolution — it helped farmers to avail services and credit facilities and a variety of loans for meeting their production needs. But the banking sector is facing chronic underperformance of formal credit institutions and high incidences of overdue instalments by the farmers.

- High agriculture loan default rates; Need to change their approach from just being lenders to building up relationship banking with the borrowers and inculcating the habit of thrift and efficient utilisation of financial resources

Marketing aspect of Agriculture

- Regulation of markets to create orderly and transparent marketing conditions
- Provision of physical infrastructure facilities like roads, railways, warehouses, godowns, cold storages and processing units
- To realise fair prices for farmer's products: Cooperative marketing (success of milk cooperatives in transforming the social and economic landscape of Gujarat and some other parts of the country (marred with inadequate coverage of farmer members, lack of appropriate link between marketing and processing cooperatives and inefficient financial management)
- Policy instruments—
  - Assurance of minimum support prices (MSP) for minimum agricultural products
  - Maintenance of buffer stocks of wheat and rice by Food Corporation of India
  - Distribution of food grains and sugar through PDS

Commercialisation of agriculture in the era of globalisation: Need to tap this potential for value addition of agro-based products through processing and by building awareness and training of the farmers to improve their marketing ability

Alternatively, farmers indulge in directly selling their produce to consumers thereby, increasing their share in the price paid by the consumers

Eg: Apni Mandi (Punjab, Haryana, Rajasthan); Hadaspar Mandi (Pune); Rythu Bazars (vegetable and fruit market in Andhra Pradesh) and Uzhavar Sandies (farmers markets in Tamil Nadu)

Several national and multinational fast food chains are increasingly entering into contracts/alliances with farmers to encourage them to cultivate farm products (vegetables, fruits, etc.) and are assuring them of not just the inputs but also the procurement at predecided prices→ Reduces the price risks of farmers and expands the markets for farm products

Diversification

1. Diversification of crop production
2. Shift of workforce from agriculture to other allied activities (livestock, poultry, fisheries etc.) and non-agriculture sector

Objective: Greater risk in depending exclusively on farming for livelihood and diversification towards new areas would not only reduce the risk from agriculture sector but will also provide productive sustainable livelihood options to rural people

Way Ahead: Need to tap into the dynamic sub-sectors—agro-processing industries, food processing industries, leather industry, tourism, etc. These sectors lack infrastructure and other supporting elements

Animal Husbandry:

- Increased stability in income
- Food security
- Transport
- Fuel
- Nutrition for the family without disrupting other food-producing activities

Fisheries:

- The fishing community regards the water body as 'mother' or 'provider' but they face rampant underemployment, low per capita earnings, absence of mobility of labour to other sectors and a high rate of illiteracy and indebtedness
- Need to increase credit facilities —cooperatives and SHGs — for fisherwomen to meet the working capital requirements for marketing.

Horticulture:

- Horticultural crops: Fruits, vegetables, tuber crops, flowers, medicinal and aromatic plants, spices and plantation crops→ play a vital role in providing food and nutrition, besides addressing employment concerns
- **1991-2003**: An effort to heralding a 'Golden Revolution'—the planned investment in horticulture became highly productive and the sector emerged as a sustainable livelihood option
- Improvement of the economic condition of many farmers engaged in horticulture—means of improving livelihood for many unprivileged classes too
- Remunerative employment opportunities for women: Flower harvesting, nursery maintenance, hybrid seed production and tissue culture, propagation of fruits and flowers and food processing
- Problems related to overfishing and pollution needs to be regulated and controlled
- Welfare programmes for the fishing community have to be reoriented in a manner in which they can provide long-term gains and sustenance of livelihoods
- Urgent need to invest in infrastructure like electricity, cold storage systems, marketing linkages, small-scale processing units and technology improvement and dissemination

Organic Farming:

Awareness of the harmful effect of chemical-based fertilisers and pesticides on our health is on a rise and this has led to the demand for evolving technologies which are eco-friendly and are essential for sustainable development→ Organic Farming—a whole system of farming that restores, maintains and enhances the ecological balance

Benefits of Organic Farming:

- Offers a means to substitute costlier agricultural inputs (such as HYV seeds, chemical fertilisers, pesticides etc.) with locally produced organic inputs that are cheaper and thereby generate good returns on investment
- Generates incomes through international exports as the demand for organically grown crops is on a rise— has more nutritional value than chemical farming thus providing us with healthy foods

- Requires more labour input than conventional farming and India with its large unemployed population would love to tap on to it
- Pesticide-free produce and is produced in an environmentally sustainable way

Way Ahead:

- Need to generate awareness and willingness on the part of farmers to adapt to new technology
- Inadequate infrastructure and the problem of marketing the products are major concerns which need to be addressed apart from an appropriate agriculture policy to promote organic farming.

Refer:

State of Indian Agriculture & Rural Economy

Rural Banking in India

Agricultural issues: Going against the grain

RRB's further distance themselves from the poor

GLOSSARY

Balance of Payments

According to the RBI, balance of payment is a statistical statement that shows –

- The transaction in goods, services and income between an economy and the rest of the world
- Changes of ownership and other changes in that economy's monetary gold, special drawing rights (SDRs), and financial claims on and liabilities to the rest of the world
- Unrequited transfers

The transactions in BOP are categorised in –

- Current account showing export and import of visibles (also called merchandise) and invisibles (also called non-merchandise). Invisibles take into account services, transfers and income.
- Capital account showing a capital expenditure and income for a country. It gives a summary of the net flow of both private and public investment into an economy. External commercial borrowing (ECB), foreign direct investment, foreign portfolio investment, etc form a part of capital account
- Errors and omissions: Sometimes the balance of payment does not balance. This imbalance is shown in the BOP as errors and omissions. BOP is compiled using the double entry book keeping system consisting assets and liabilities

Explainer Video – Click Here

Cash Reserve Ratio (CRR)

CRR is a specified minimum fraction of the total deposits of customers, which commercial banks have to hold as reserves either in cash or as deposits with the central bank. CRR is set according to the guidelines of the central bank of a country.

The amount specified as the CRR is held in cash and cash equivalents, is stored in bank vaults or parked with the Reserve Bank of India.

The aim here is to ensure that banks do not run out of cash to meet the payment demands of their depositors. CRR is a crucial monetary policy tool and is used for controlling money supply in an economy.

CRR specifications give greater control to the central bank over money supply.

Commercial banks have to hold only some specified part of the total deposits as reserves. This is called fractional reserve banking.

Statutory Liquidity Ratio (SLR)

The ratio of liquid assets to net demand and time liabilities (NDTL) is called statutory liquidity ratio (SLR)

Apart from Cash Reserve Ratio (CRR), banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold and unencumbered securities.

Treasury bills, dated securities issued under market borrowing programme and market stabilisation schemes (MSS), etc also form part of the SLR. Banks have to report to the RBI every alternate Friday their SLR maintenance, and pay penalties for failing to maintain SLR as mandated.

Explainer Video (CRR & SLR) – Click Here

Consumer Price Index (CPI)

A comprehensive measure used for estimation of price changes in a basket of goods and services representative of consumption expenditure in an economy is called consumer price index

The calculation involved in the estimation of CPI is quite rigorous. Various categories and sub-categories have been made for classifying consumption items and on the basis of consumer categories like urban or rural.

Based on these indices and sub-indices obtained, the final overall index of price is calculated mostly by national statistical agencies.

It is one of the most important statistics for an economy and is generally based on the weighted average of the prices of commodities. It gives an idea of the cost of living.

Inflation is measured using CPI. The percentage change in this index over a period of time gives the amount of inflation over that specific period, i.e. the increase in prices of a representative basket of goods consumed.

The inflation rate is a measurement of the rise in price of a good or service over a period of time reflected as a percentage.

Explainer Video – Click Here

Wholesale Price Index (WPI)

Wholesale Price Index (WPI) represents the price of goods at a wholesale stage i.e. goods that are sold in bulk and traded between organizations instead of consumers. WPI is used as a measure of inflation in some economies.

WPI is used as an important measure of inflation in India. Fiscal and monetary policy changes are greatly influenced by changes in WPI. In the United States, Producer Price Index (PPI) is used to measure inflation.

Fiscal Deficit

The difference between total revenue and total expenditure of the government is termed as fiscal deficit. It is an indication of the total borrowings needed by the government. While calculating the total revenue, borrowings are not included.

The gross fiscal deficit (GFD) is the excess of total expenditure including loans net of recovery over revenue receipts (including external grants) and non-debt capital receipts. The net fiscal deficit is the gross fiscal deficit less net lending of the Central government.

Generally fiscal deficit takes place either due to revenue deficit or a major hike in capital expenditure. Capital expenditure is incurred to create long-term assets such as factories, buildings and other development.

A deficit is usually financed through borrowing from either the central bank of the country or raising money from capital markets by issuing different instruments like treasury bills and bonds.

Explainer Video – Click Here

Inflation

Inflation is the rate at which the general level of prices for goods and services is rising and, consequently, the purchasing power of currency is falling. Central banks attempt to limit inflation, and avoid deflation, in order to keep the economy running smoothly.

Quite simply, inflation is rise in prices of goods and services. If a basket of goods and services cost ₹ 100 in 2013, and the same goods and services cost ₹ 104 in 2014. Then, we say inflation is 4%. Over time Inflation has a big impact on purchasing power of your money.

Inflation occurs due to an imbalance between demand and supply of money, changes in production and distribution cost or increase in taxes on products. When economy experiences inflation, i.e. when the price level of goods and services rises, the value of currency reduces. This means now each unit of currency buys fewer goods and services.

It has its worst impact on consumers. High prices of day-to-day goods make it difficult for consumers to afford even the basic commodities in life. This leaves them with no choice but to ask for higher incomes. Hence the government tries to keep inflation under control.

Contrary to its negative effects, a moderate level of inflation characterizes a good economy. An inflation rate of 2 or 3% is beneficial for an economy as it encourages people to buy more and borrow more, because during times of lower inflation, the level of interest rate also remains low. Hence the government as well as the central bank always strive to achieve a limited level of inflation.

- Price level changes (mainly inflation) is measured in India through two major indices – CPI and WPI
- The most important index is All India CPI by CSO. Labour Burau prepares three CPIs for specific occupational groups.

- WPI is prepared by Office of Economic Affairs, Ministry of Commerce and Industry.

There are two main set of inflation indices for measuring price level changes in India - the Wholesale Price Index (WPI) and the Consumer Price Index (CPI). The WPI, where prices are quoted from wholesalers, is constructed by Office of Economic Affairs, Ministry of Commerce and Industries.

In the case of CPI (prices quoted from retailers), there are several indices to measure it: CPI for industrial labourers (CPI-IL), agricultural labourers (CPI-AL) and rural labourers (CPI-RL) besides an all India CPI.

In addition, Gross Domestic Product (GDP) deflator and Private Final Consumption Expenditure (PFCE) deflator from the National Accounts Statistics (NAS) provide an implicit economy-wide inflation estimate.

Any inflation calculator is based on an index, and India has quite a few indexes to choice from. Historically inflation is measured based on Wholesale Price India (WPI) in India. **However, in April 2014 RBI announced that inflation will be measured based on new CPI (Consumer Price Index) started in 2010.**

In India the gap between rich and poor is wide, and has sections of society with contrasting standards of living. No single CPI can measure inflation for various income groups. Hence, India measures CPI separately for Industrial Workers (CPI-IW), Agricultural workers(AL) and Urban and Rural. For the purpose of this calculator, we have used Urban CPI as these are the section of people who are most likely to use this Calculator.

Note- Inflation will be covered in detail in later VAN

Types of Inflation

Creeping Inflation:

When prices rise at very slow rate, i.e. creeper's speed, it is called 'creeping inflation. Generally 3% annual rise in prices is considered as 'creeping inflation'.

Walking or Trotting Inflation:

When inflation is in between 3% to 7%, it's regarded as 'walking or trotting inflation'. Some economists have extended the boundary of this type of inflation up to 10% per annum. This type of inflation is considered as a warning signal for the government to take some measures to control the situation.

Running Inflation:

This type of inflation comes into action when there's a rapid rise in prices and the range of this type lies in between 10% to 20% per annum. This type of inflation is controllable only by strong monetary and fiscal measures, lest it will be turned into 'hyper-inflation'.

Hyper Inflation or Galloping Inflation:

The rise of prices from 20% to 100 % per annum is regarded as 'hyper-inflation' or 'galloping inflation'. This case of inflation is uncontrollable.

Demand Pull Inflation:

This type of inflation is due to an excess demand. In this case supply remains constant (couldn't be upgraded as per demand). So consequently, the prices go up.

Cost Push Inflation:

When there's increase in money-wages at speedier rate than that of the rise in the productivity of labour, it results as increased cost of production which furthers the increase in prices. This type of inflation is regarded as cost push inflation.

Mixed Inflation:

Majority of the economists hold that, inflation is neither completely 'demand pull' nor completely 'cost push', the actual inflationary process contains the elements of both. Excess demand and increase in money wages operate at the same time, but it's not necessary that they start at the same time.

Markup inflation:

Garner Akley put forward the theory of 'mark-up inflation'. In simple words it is an advanced explaination of 'Mixed inflation'. According to Akley First comes demand pull inflation, and it is led by cost push inflation. Markup inflation comes to happen when excess demand increases the prices, which stimulates the production. The increasing production creates excessive demand for the factors of production, and the excessive demand for the factors of production further raises the prices.

Monetary Policy

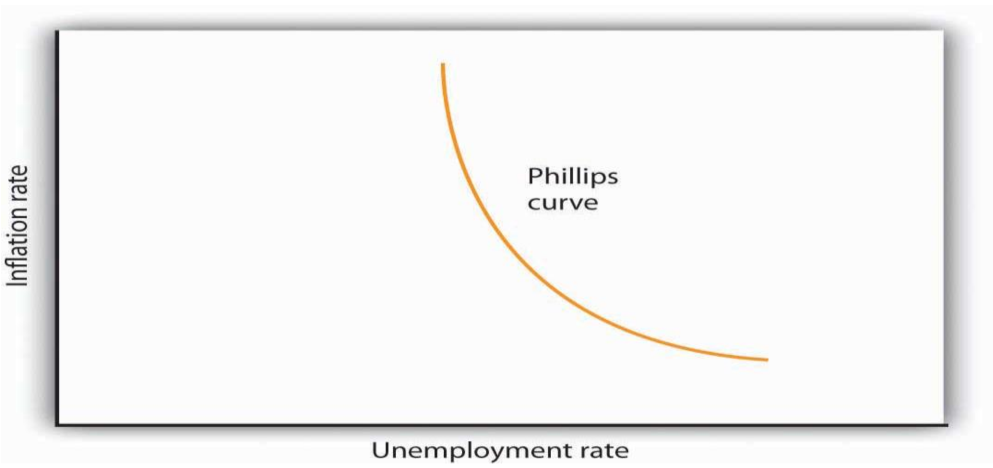
What a CENTRAL BANK does to control the MONEY SUPPLY, and thereby manage DEMAND. Monetary policy involves OPEN-MARKET OPERATIONS, RESERVE REQUIREMENTS and changing the short-term rate of interest. It is one of the two main tools of MACROECONOMIC POLICY, the side-kick of FISCAL POLICY, and is easier said than done well.

The RBI uses the interest rate, Open Market Operations (OMO), changes in banks' CRR and primary placements of government debt to control the money supply. OMO, primary placements and changes in the CRR are the most popular instruments used.

- Under the OMO, the RBI buys or sells government bonds in the secondary market. By absorbing bonds, it drives up bond yields and injects money into the market. When it sells bonds, it does so to suck money out of the system.
- The changes in CRR affect the amount of free cash that banks can use to lend - reducing the amount of money for lending cuts into overall liquidity, driving interest rates up, lowering inflation and sucking money out of markets.
- Primary deals in government bonds are a method to intervene directly in markets, followed by the RBI. By directly buying new bonds from the government at lower than market rates, the RBI tries to limit the rise in interest rates that higher government borrowings would lead to

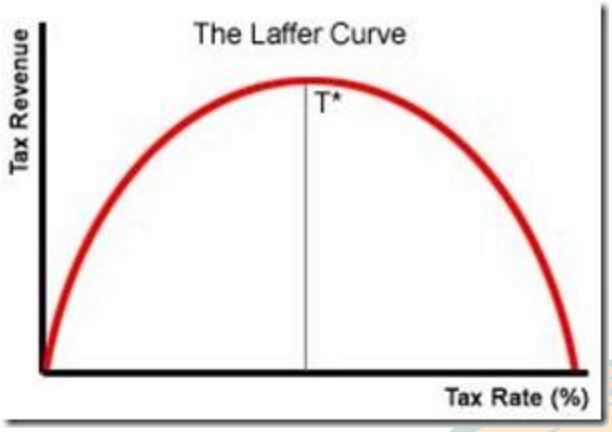
Philips Curve

An economic concept developed by A. W. Phillips stating that inflation and unemployment have a stable and inverse relationship. The theory states that with economic growth comes inflation, which in turn should lead to more jobs and less unemployment. The concept has been proven empirically and some government policies are directly influenced by it. Some level of inflation could be considered desirable in order to minimize unemployment.



Laffer Curve

Invented by Arthur Laffer, this curve shows the relationship between tax rates and tax revenue collected by governments. The chart below shows the Laffer Curve:



The curve suggests that, as taxes increase from low levels, tax revenue collected by the government also increases.

It also shows that tax rates increasing after a certain point (T*) would cause people not to work as hard or not at all, thereby reducing tax revenue.

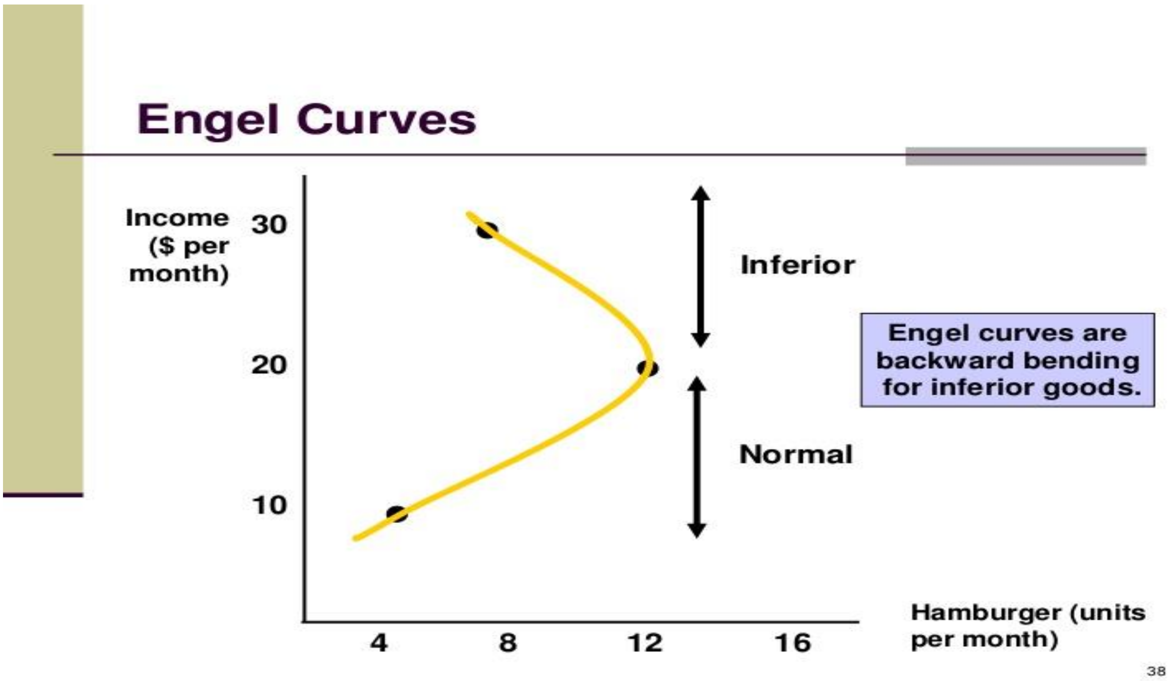
Eventually, if tax rates reached 100% (the far right of the curve), then all people would choose not to work because everything they earned would go to the government.

Governments would like to be at point T*, because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard.

Engel's Curve

Engel's law is an observation in economics stating that, with a given set of tastes and preferences, as income rises, the proportion of income spent on food falls, even if actual expenditure on food rises. In other words, the income elasticity of demand of food is less than 1. The law was named after the statistician Ernst Engel.

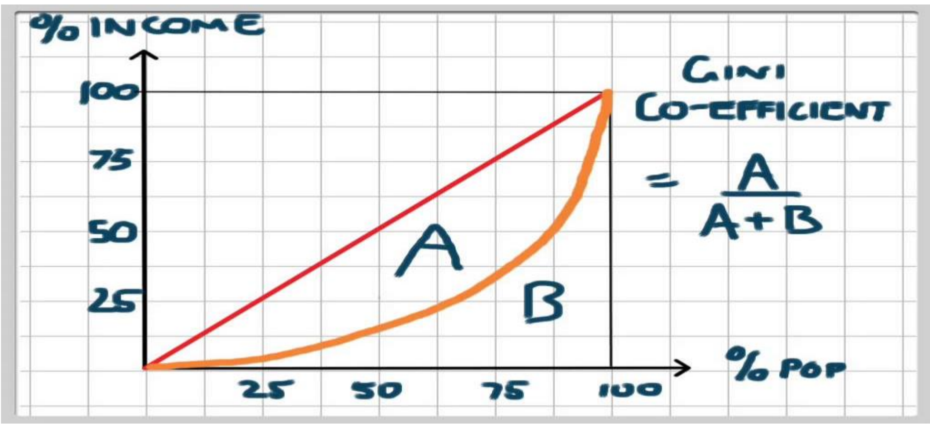
An Engel curve is the relationship between the amount of a product that people are willing to buy and their income. An Engel curve is shown below.



Lorenz Curve and Gini Coefficient

A Lorenz curve shows the degree of inequality that exists in the distributions of two variables, and is often used to illustrate the extent that income or wealth are distributed unequally in a particular society.

The Gini coefficient is the area between the line of perfect equality and the observed Lorenz curve, as a percentage of the area between the line of perfect equality and the line of perfect inequality. A Gini coefficient is a summary numerical measure of how unequally one variable is related to another. The Gini coefficient is a number between 0 and 1, where perfect equality has a Gini coefficient of zero, and absolute inequality yields a Gini coefficient of 1.



Misery Index

Created by: Economist Arthur Okun

It is the sum of a country's INFLATION and UNEMPLOYMENT rates. The higher the score, the greater is the economic misery.

Trade Barriers

A trade barrier is a general term that describes any government policy or regulation that restricts international trade. The barriers can take many forms, including:

- Import duties
- Import licenses
- Export licenses
- Import quotas
- Tariffs
- Subsidies
- Non-tariff barriers to trade
- Voluntary Export Restraints
- Local Content Requirements

Non-Tariff Trade Barriers

Non-tariff barriers to trade are trade barriers that restrict imports but are not in the usual form of a tariff. Some of the common examples are anti-dumping measures and countervailing duties, which, although they are called "non-tariff" barriers, have the effect of tariffs but are only imposed under certain conditions. Their use has risen sharply after the WTO rules led to a very significant reduction in tariff use.

Now what is Counter Vailing duty

Countervailing duties (CVDs) are a means to restrict international trade. They are imposed when a foreign country subsidizes its exports, hurting domestic producers.

Deflation

When the overall price level decreases so that inflation rate becomes negative, it is called deflation. It is the opposite of the often-encountered inflation.

A reduction in money supply or credit availability is the reason for deflation in most cases. Reduced investment spending by government or individuals may also lead to this situation. Deflation leads to a problem of increased unemployment due to slack in demand.

Central banks aim to keep the overall price level stable by avoiding situations of severe deflation/inflation. They may infuse a higher money supply into the economy to counter-balance the deflationary impact. In most cases, a depression occurs when the supply of goods is more than that of money.

Deflation is different from disinflation as the latter implies decrease in the level of inflation whereas on the other hand deflation implies negative inflation.

Foreign Exchange Reserves

Forex reserves are foreign currency assets held by the central banks of countries.

These assets include foreign marketable securities, monetary gold, special drawing rights (SDRs) and reserve position in the IMF. The main purpose of holding foreign exchange reserves is to make international payments and hedge against exchange rate risks.

Special Drawing Rights

This is a kind of reserve of foreign exchange assets comprising leading currencies globally and created by the International Monetary Fund in the year 1969

Before its creation, the international community had to face several restrictions in increasing world trade and the level of financial development as gold and US dollars, which were the only means of trade, were in limited quantities. In order to address the issue, SDR was created by the IMF.

SDR is often regarded as a 'basket of national currencies' comprising four major currencies of the world - US dollar, Euro, British Pound and Yen (Japan). The basket will be expanded to include the Chinese **renminbi** (**RMB**) as the fifth currency, effective October 1, 2016. The composition of this basket of currencies is reviewed every five years wherein the weightage of currencies sometimes get altered