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Content

INDIAN ECONOMY-II

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QUESTION PAPER

June – 2023

(Solved)

INDIAN ECONOMY-II **B.E.C.E.-146**

Time: 3 Hours] *[Maximum Marks: 100*

Note: *Answer questions from each section as per instructions given.*

SECTION–A

Note : Answer any two questions:

Q. 1. Illustrate the importance of "bilateralism" and "multilateralism" in the context of recent trend in "regionalism" practised in international trade.

Ans. Ref.: See Chapter-3, Page No. 33, 'Regionalism'.

Q. 2. How was the inter-linkage of the different sectors of the economy envisaged by early economic thinker with the agricultural sector? Explain.

Ans. Ref.: See Chapter-5, Page No. 69, Q. No. 7.

Q. 3. What is an important policy initiative of recent times to influence 'services sector' in India? Explain the prospects of services sector expansion in India.

Ans. Ref.: See Chapter-12, Page No. 161, Q. 1 and 'Prospects and Opportunities'.

Q. 4. Explain the theoretical rationale for the promotion of SSIs. Explain the measures being taken in the NIP, 2017 to aid the small and tiny enterprises segment of SSI sector.

Ans. Ref.: See Chapter-10, Page No. 133, 'Rationale for Promotion of SSIs', Page No. 136, 'Industrial Policy for Small and Tiny Enterprises, 2017'.

SECTION–B

Note : Attempt any three questions:

Q. 5. What is meant by monetary base of an economy?

Ans. Ref.: See Chapter-1, Page No. 5, Q. No. 2, 'Monetary Policy Instrument'.

Q. 6. What are the objectives of fiscal policy? State the important economic implications of a fiscal policy.

Ans. Ref.: See Chapter-2, Page No. 19, Q. No. 1, Page No. 21, Q. No. 3.

Q. 7. Which social security legislation covers the small service sector establishments?

Ans. Ref.: See Chapter-4, Page No. 55, Q. No. 10.

Q. 8. Analyse the trends in the tenancy status of India. What is meant by reverse tenancy?

Ans. Ref.: See Chapter-6, Page No. 77, 'Tenancy Status in India', Page No. 83, Q. No. 9.

Q. 9. In what way Farmer Producer Organisations (FPOs) are an important reform in the direction of 'small farmers aggregation' in India?

Ans. Ref.: See Chapter-7, Page No. 96, Q. No. 8.

SECTION–C

Note: Attempt all the questions from this Section.

Q. 10. Distinguish between any three of the following:

(a) **Goods market and factor market.**

Ans. Ref.: See Chapter-6, Page No. 84, Q. No. 12.

(b) **Real sector and monetary sector.**

Ans. The real sector of an economy plays a crucial role in driving economic output and encompasses the key economic segments that contribute to the GDP's growth. This sector includes activities such as farmers harvesting their crops and textile mills transforming raw cotton into fabrics. Within the real sector, we find enterprises (nonfinancial corporations), households, and nonprofit institutions serving households. From a monetary and financial perspective, households and nonprofit institutions serving households are sometimes grouped together as a subsector called "Other resident sectors. The monetary or financial sector is a section of the economy made up of firms and institutions that provide financial services to commercial and retail customers. This sector comprises a broad range of industries including banks, investment companies, insurance companies, and real estate firms.

***(c)* Regionalism and multilateralism.**

Ans. Ref.: See Chapter-3, Page No. 41, Q. No. 15, 'Meaning Regionalism', Page No. 42, 'Multilateral'.

***(d)* Current account convertibility and capital account convertibility.**

Ans. Ref.: See Chapter-3, Page No. 37, Q. No. 6.

Q. 11. Write short notes on any three of the following:

***(a)* Competition Commission of India.**

Ans. Ref.: See Chapter-9, Page No. 122, 'Competition Commission of India'.

***(b)* Goods and Services Taxes (GST)**

Ans. Ref.: See Chapter-12, Page No. 159, 'Goods and Service Tax (GST) and Services'.

***(c)* Migration of Labour.**

Ans. Internal labour migration is an overwhelming reality that underscores India's developmental landscape. While migration opens up new vistas of work and employment for millions of people on the move, creating new opportunities for many, it also pushes people into unequal and highly exploitative work regimes. Migrant workers contribute to growth and development in their countries of destination, while countries of origin greatly benefit from their remittances and the skills acquired during their migration experience. Yet, the migration process implies complex challenges in terms of governance, migrant workers' protection, migration and development linkages, and international cooperation.

***(d)* Employees' Provident Funds (and Miscellaneous Provisions) Act (EPFA), 1952.**

Ans. Ref.: See Chapter-4, Page No. 49, 'Employees Provident Funds and Miscellaneous Provisions Act (EPFA) 1952'.

***(e)* General Argument on Trade and Services (GATS).**

Ans. Ref.: See Chapter-12, Page No. 164, Q. No. 9.

■■

Sample Preview
of
The Chapter

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INDIAN ECONOMY - II

BLOCK-1: MACROECONOMIC POLICIES

Monetary Policy

1

INTRODUCTION

The overall monetary administration of an economy is included in monetary policy. The central bank of a nation, in India's case, the Reserve Bank of India (RBI), is in charge of carrying out monetary policy. The RBI controls the amount of money in the economy (via the banking system), working toward three basic macroeconomic goals: *(i)* ensuring the money supply necessary for the economic expansion; *(ii)* increasing output and stabilizing prices; and *(iii)* preventing the rupee's value from becoming overvalued or undervalued (i.e. exchange rate stability). By achieving these goals, it contributes to increasing aggregate demand through the best possible levels of investment and consumption, which together promote economic growth.

CHAPTER AT A GLANCE

SOURCES OF MONEY SUPPLY

Money supply in a modern economy can be broadly categorized into two types: cash money and credit money. On the basis of the "liquidity" of various monetary assets, central banks typically categorize the "aggregate money supply." The speed with which an asset can be turned into cash is referred to as liquidity. Therefore, having cash on hand makes for the easiest and most liquid means of exchanging goods and services. From this perspective, the supply of money can be divided into the following four groups, based on their descending order of liquidity: M_1, M_2, M_3, and M_4 (i.e., M_1 is the most liquid form of money while M_4 is relatively the least liquid).

$$M_1 = C + DD + OD \quad (1.1)$$

DD stands for demand deposits with commercial banks, OD for "other deposits," which include deposits made with the RBI by financial institutions like IDBI, foreign central banks, or international financial institutions like the IMF, WB, etc. C stands for currency (including coins and paper notes) held by the public. It is the most liquid and based on a specific idea, therefore it is sometimes known as "narrow money" (as opposed to M_4, which is based on a more general idea and is hence known as "wide money"). M_1 is sometimes referred to as an economy's "monetary base." Compared to M_1, M_2 has a definition that is somewhat more general:

$$M_2 = M_1 + \text{savings deposits in post offices} \quad (1.2)$$

M_3 and M_4 are based on still broader concepts and are respectively defined as:

$$M_3 = M_1 + \text{'net time (fixed) deposits' with commercial banks} \quad (1.3)$$

$$M_4 = M_3 + \text{savings with post office (excluding 'national savings certificates')} \quad (1.4)$$

Reserve Money

Commercial banks "credit money" is the economy's second-largest money supply. The "cash reserve ratio" and public cash and demand deposits affect bank lending to the public. SCBs generate "credit money" in proportion to their "deposit multiplier" (DM). The deposit multiplier and the banking system's ability to issue credit money are inversely connected to CRR.

High-powered money or reserve money is M_1. An economy's "monetary base" is it. . We can demonstrate that "high-powered money" (H) affects banking system credit generation. For this, assume that the size of bank deposits is D and the cash reserve ratio is *'x'*. Then, RBI reserves (R) = x * D and bank and public currency (C) = b * D. H is high-powered money:

$$H = bD + xD * D \quad (1.5)$$

Or

$$D = \frac{h}{b + x} \quad (1.6)$$

Thus, the size of an economy's total deposits is a multiple of high-powered money, which depends on three factors: H, x, and D. In other terms, high-powered money (H) is a fraction of total deposits (D) multiplied by "$b + x$."

Foreign Capital Flows

In addition to the channels of the money supply (M_1 to M_4) already described, "foreign capital flows" (both inflows and outflows) also have an impact on the money supply. The Reserve Bank of India's balance sheet can be used to better understand the mechanisms behind this phenomena. In plain English, the assets side of the RBI's balance sheet grows when foreign cash pours into India. This causes the rupee to "appreciate." The RBI issues additional local currency in order to maintain the stability of the rupee's value. As a result, the balance sheet's liabilities side grows. In other words, the RBI transforms foreign capital inflows into rupee terms and introduces an equivalent domestic currency of money supply, increasing the money supply in the economy in order to prevent an excessive or unjustified appreciation of the rupee. Similar to how the liabilities side of the RBI's balance sheet declines with an outflow of foreign capital, the rupee depreciates as a result. Once more, RBI converts rupees to dollars in order to balance the economy's assets and obligations, which results in a fall in the amount of money available. Thus, the process of inflows of foreign capital effectively compels RBI to inject domestic currency into the market. To invest in India, international investors need rupees. These investors receive an equivalent number of Indian rupees in exchange for the foreign currency they brought in (and deposited with the RBI). On the other hand, a foreign investor receives cash in rupees first when he sells his holdings in India. These are then exchanged for foreign money that can be returned home and deposited with the RBI.

MONETARY POLICY INSTRUMENTS

The RBI controls India's banking and money markets. It regulates money supply with quantitative and qualitative measures. Quantitative measures modulate banks credit-creating capacity, while qualitative measures direct credit to desired sectors of the economy (called priority lending policy).

Through a variety of policy tools, the RBI manages the amount of money in the economy. These technologies, among other things, primarily focus on the banks' ability to create credit. It creates a framework for monetary policy for this purpose and frequently evaluates it. The two processes of controlling the money supply are *(i)* controlling the amount of cash in circulation and *(ii)* controlling credit. In order to fulfill the former, the RBI releases new currency while taking the economy's growth and inflation rates (both indicated in percentages) into consideration. For the latter, the RBI uses a variety of policy tools to regulate the flow of credit money, including *(i)* the bank rate, *(ii)* the cash reserve ratio (CRR), *(iii)* the statutory liquidity ratio (SLR), *(iv)* open market operations, etc. Credit rationing, selective credit restriction, a liquidity adjustment facility, and moral persuasion are a few of the additional tools the RBI has implemented.

The RBI controls the overall money supply in the economy by combining these strategies, intervening directly only when absolutely necessary to change the amount of money in circulation.

Reserve Ratios

RBI money supply regulation relies on the "cash reserve ratio" (CRR). The RBI requires banks to hold a portion of their deposits in liquid cash. All banks – scheduled, non-scheduled, cooperative, and regional rural – must meet CRR regulations. CRR directly impacts bank lending. Banks that violate CRR norms face penal interest rates from RBI. "Statutory liquidity ratio" (SLR) is another RBI tool. After CRR obligations, banks SLR is a fraction of their cash. Thus, SLR is the secondary reserve requirement to CRR. Banks can meet SLR with cash, gold, government securities, or other approved securities. SLR regulates credit production and guarantees bank soundness.

Bank Rate

The rate at which the RBI re-encases (buys back) promissory notes and bills of exchange is known as the "bank rate." Additionally, it refers to the speed at which the bank is given loans and advances. Thus, it can be seen of as a rate of interest at which the RBI provides loans and advances to banks and other financial organizations. Even though the interest rate is primarily designed to cover the cost of borrowing money, it is adjusted to limit the money supply. Banks and other financial institutions raise their lending rates in response to RBI increases in the bank rate. As a result, there is a decline in the demand for loans and advances. As a result, the economy's money supply declines due to less credit money.

Repo And Reverse Repo Rates

RBI lends commercial banks money for shortfalls at repo rate. Repo rate controls short-term inflation. RBI frequently adjusts repo rate to control inflation. RBI raises bank lending costs by raising repo rates. Repo rate is opposite to RRR. RBI borrows from commercial banks at RRR to eliminate excess funds. RBI is their short-term borrowing rate. RBI frequently adjusts RRR to control money supply. RBI encourages commercial banks to donate excess funds by raising the reverse repo rate. This reduces the money available with the banks thereby restricting its credit potential and consequently reducing the supply of money in the economy.

RBI can control money supply through 'open market operations'. Under this, RBI carries out 'sale and purchase' of government securities. When banks purchase securities from RBI, their cash reserve position decreases. This reduces their ability to create credit. On the other hand, when banks sell securities their cash reserve position increases. Thereby, their capacity to create credit is enhanced. There are also other policy measures such as rationing of credit, margin requirement on loans and moral suasion. For instance, RBI being the lender to other banks, can adopt the policy of 'credit rationing' to reduce money supply. This means it can deny loans to specified category of banks or can put a ceiling (quota) on the loans extendable to the banks. It can also impose an upper limit on the loans to industry by the banks or set a higher margin requirement on the collateralized lending by the banks or can direct banks to keep a higher prescribed margin on the collateral security for granting loans to borrowers.

OBJECTIVES OF MONETARY POLICY

The "monetary transmission mechanism" is the process by which monetary policy has an impact on the various economic sectors. It operates under the fundamental tenet that money has an impact on investment demand and GDP that is not neutral. It suggests that when there is a flexible supply (below full employment), increasing the money supply always boosts economic growth. As a result, changes in the monetary sector have an impact on the "real sector" through changes in interest rates. In essence, the "interest rate" integrates the "monetary sector" and the "real sector."

Monetary transmission mechanism works to serve both the expansionary as well as the contractionary objectives of monetary policy. For the former, when demand for the currency increases in the economy the commercial banks approach the RBI with securities. RBI issues new currency in exchange for their securities. This results in a rise of aggregate demand in the economy. Thus, under the assumption of flexible supply conditions and less than full employment, any increase in aggregate demand results in an increase in the GDP. On the other hand, during a contractionary phase, a reduction in the money supply leads to a rise in the nominal interest rate. This in turn decreases the borrowings for investment (and consumption) inducing the people to save more. This causes a fall in the aggregate demand in the economy leading to a lower GDP and reduced employment level.

Price Stability

Monetary policy promotes economic activity while stabilizing prices. Financial meltdown in the US in 2008 quickly spread globally. Hence, one of the added tasks of the monetary policy in the new world order is not only to provide an adequate cushion but also be more adaptive and responsive to external shocks. This requires that the monetary policy mechanism should be capable of coping with the shocks of both the low and high business cycle periods viz. recession and hyperinflation. Recession is a business cycle contraction which slows down economic activities and adversely impact real GDP, employment, industrial production and wholesale and retail sales.

Boom is a phase of business cycle expansion in which aggregate demand is persistently pushed up by the market expectations. Effects of boom on the real sector depend upon the level of employment and the responsiveness of the aggregate supply to the demand. A boom in an economy, already at full employment, causes inflation. It impacts more on prices than on GDP and employment due to the weak response of aggregate supply to aggregate demand. A tight monetary policy, supplemented by contractionary fiscal policy, is required to combat the boom in an economy. Tight monetary policy increases nominal interest rate which reduces consumer demand, promotes savings and discourages investment demand. The overall effect works to reduce aggregate demand, stabilize prices and eliminate boom.

Exchange Rate Stability

Protecting the exchange rate from shocks and, as a result, preventing volatility in the domestic currency from speculative actions are important roles of monetary policy. In the managed floating exchange rate era, where there is a trade-off between exchange rate stability and macroeconomic goals of unemployment and inflation, this is especially crucial. Thus, it's important to keep things in balance. Under fixed exchange rates and unsatisfactory capital market conditions that limit the liberalized mobility of capital, monetary policy cannot be a useful tool. It can be used more effectively in a floating exchange rate system where the economy is adequately influenced by interest rate changes to achieve the desired reorientation. However, by balancing the money supply from capital inflows by selling bonds of equal value in the money market, monetary policy can still be used to reduce exchange rate volatility. Such a balancing measure aims to absorb the extra money supply brought on by foreign capital inflows. Thus, monetary policies are helpful in lowering the risk of capital flight caused by speculative currency depreciation.

Economic Growth

By lowering nominal interest rates, easy monetary policy increases aggregate demand. Induced capital formation and less than full employment accelerate economic growth. Monetary policy can also create new financial institutions that use savings to grow productive sectors.

Export Promotion, Employment Generation And Equity

Monetary policy can be used to encourage exports and deter imports by devaluing the rupee exchange rate. As a result, exports become more affordable and imports become more expensive, helping to close the current account deficit. By extending cheaper loans to exporters, monetary policy can help boost exports. An easy monetary policy, by raising aggregate demand, can increase employment level through multiplier effect. Further, by adopting the policy of priority lending (which is helping the weaker sections in the society through cheaper and easy loans), the poor and the marginalized can be helped in setting up self-employment ventures. Such measures can help reduce inequality in the economy.

CHANGES IN THE MONETARY POLICY MECHANISM IN INDIA

Since the middle of the 1990s, there have been major changes in monetary policy, which became more pronounced from 2000 to 2005. In order to face the new realities and problems resulting from global economic integration and a stronger focus on the market, recent reforms from the post-2000 period became important. With this, there was a noticeable transition in the stance of monetary policy from direct involvement to indirect intervention. Open market operations (OMOs), liquidity adjustment facilities (LAF), market stabilisation scheme (MSS), and the creation of marginal standing facilities, among other strategies, have to receive more attention (MSF).

Liquidity Adjustment Facility (LAF)

Liquidity Adjustment Facility programe was introduced by the RBI in 2000 and later amended in 2004. LAF is a method of managing short-term liquidity. In order to absorb or inject money into the economy on a short-term basis, the RBI uses this to sell and buy government assets at the repo rate and the reverse repo rate, respectively. In its yearly reviews of monetary policy, RBI updates these rates. In order to address their short-term liquidity needs, banks can use this facility to lend and borrow on a daily or emergent basis. Since then, LAF operations, along with open market operations and adjustments in bank rates, have emerged as India's primary monetary policy tool.

Market Stabilization Scheme (MSS)

Market Stabilization Scheme was introduced by the RBI in 2004 to remove extra liquidity from the money market through the sale of government bonds. The purpose of MSS was to absorb extra liquidity created by the RBI's purchases of foreign currency in order to safeguard the exchange rate during periods of a surplus inflow of foreign capital into the nation. The scheme was designed to act as a market stabilizer because such inflows may cause the rupee to appreciate and the current account deficit to widen. Under this plan, the RBI buys dollars (or any other currency) to counteract the effects of the excess liquidity that has been generated in the economy. By selling bonds to remove the extra liquidity, the goal is achieved. As mentioned above, this is also referred to as 'sterilization'.

Marginal Standing Facility (MSF)

A new window for overnight lending of money to banks was established by the RBI in 2011 [under the Liquidity Adjustment Facility (LAF)]. Banks may borrow overnight funds (from the RBI) at the MSF rate in exchange for recognized government securities. Thus, in order to counteract overnight interest rate volatility, this is a form of emergency lending for banks that is made at a rate higher than the repo rate. Prior to MSF, the only way to satisfy the overnight funds requirement was through interbank borrowing. Over the years, the number of economic activities had led to abrupt changes in the short-term (overnight) interbank lending rates. Therefore, the main goal of MSF is to lessen the overnight volatility of interbank lending rates.

The direction of India's monetary policy has recently been shaped by a new Monetary Policy Framework Agreement (MPFA). Accordingly, the RBI will concentrate on maintaining moderate inflation in order to meet its CPI-linked inflation targets of 6% by January 2016 and 4% by the end of 2017-18. A tolerance range of +/- 2 percent to around 4 percent is used to define the target for the period beyond 2017-18. Based on the CPI for the entire country, inflation in 2014–15 was 5.9 percent, and it has stayed below 6 percent ever since (aside from a brief period when it was slightly higher than 6 percent in 2016). In June 2017, it was at a record-low 1.54 percent. As a result, MPFA has been effective in bringing down the CPI inflation rate since its inception .

CHECK YOUR PROGRESS

Q. 1. State the major macroeconomic objectives of monetary policy.

Ans. The main macroeconomic goals of monetary policy are as follows: From a macroeconomic