chapter 1- Money

Money, a commodity accepted by general consent as a medium of economic exchange. It is the medium in which prices and values are expressed; as currency, it circulates anonymously from person to person and country to country, thus facilitating trade, and it is the principal measure of wealth.

Money is any object that is generally accepted as payment for goods and services and repayment of debts in a given country or socio-economic context.

The main functions of money

1. a medium of exchange
2. a unit of account
3. a store of value
4. a standard of deferred payment.

Following are the main forms of money.

1. Commodity money
2. Metalic money
3. Paper money
4. Credit money
5. Electronic money

The Demand for Money

The demand for money is affected by several factors, including the level of income, interest rates, and inflation as well as uncertainty about the future. The way in which these factors affect money demand is usually explained in terms of the three motives for demanding money:

1. Transactions motive,
2. Precautionary motive
3. speculative motives.

- Demand of money for transaction motive = f(Y)

If income increases transaction will also increase and vis a versa

- Demand for Precautionary money = f (Y)

If income increases money to keep aside for emergency will increase

- Demand for speculative money = f(Y, I)

- Demand for money= Dt + Dp + Ds

Supply of money

The money supply is all the currency and other liquid instruments in a country's economy on the date measured. The money supply roughly includes both cash and deposits that can be used almost as easily as cash. Governments issue paper currency and coin through some combination of their central banks and treasuries.

SOURCES of supply of money:

1) Government : 1 Rs notes and Coins
2) RBI : Paper currency

3) Commercial Banks: Money created through Credit creation(Loan created from deposits received from bank after keeping some amount in CRR)

MONEY measures in india (before controlling the supply of money it is necessary to measure how much money is already in supply in economy)

1) M1

Narrow Money. M1=C + DD + Other deposits

in which C= Currency notes being held by public , DD= Demand Deposits (Saving + Current), Deposits of commercial banks money kept with RBI

2) M2

M2 is also Narrow Money

M2= C+ DD+ Other deposits + Post office savings

M2= M1+ Post office savings

3) M3

M3 is Broad money

M3= M1+Time deposits of Bank (FD, RD)

4) M4

M4 Broad money

M4= M1+ Post Office Savings + Time Deposits of Bank

M4= M1+M2+M3

The quantitative measures of credit control (or control the supply of money) are as follows:

1. Bank Rate Policy (explained in detail in next slide)

bank rate is the lending rate at which commercial banks can borrow from the RBI

For controlling the credit, inflation and money supply, RBI will increase the Bank Rate.

2. Open Market Operations (Explained in detail in next slide)

Open Market Operations refer to direct sales and purchase of securities and bills in the open market by Reserve bank of India. The aim is to control volume of credit.

3. Cash Reserve Ratio

Cash reserve ratio refers to that portion of total deposits in commercial Bank which it has to keep with RBI as cash reserves.

4. Statutory Liquidity Ratio

SLR refers to that portion of deposits with the banks which it has to keep with itself as liquid assets(Gold, approved govt. securities etc.) If RBI wishes to control credit and discourage credit it would increase CRR & SLR.

Value of money, as we know, is the ratio of exchange between two goods, and money measures that value through price. ... The value of money, then, is the quantity of goods in general that will be exchanged for one unit of money. The value of money is its purchasing power, i.e., the quantity of goods and services it can purchase.

Vm= 1/p

Value of money is inversely related to general price level

Supply of money increases- aggregate demand for goods and services more than supply of goods- prices of all products will increase- value of money will go down

Fisher's Quantity theory of money

The quantity theory of money states that the quantity of money is the main determinant of the price level or the value of money. Any change in the quantity of money produces an exactly proportionate change in the price level.

Fisher has explained his theory in terms of his equation of exchange:

PT=MV+ M' V'

Where P = price level, or 1 IP = the value of money;

M = the total quantity of legal tender money;

V = the velocity of circulation of M;

M' – the total quantity of credit money;

V' = the velocity of circulation of M';

T = the total amount of goods and services exchanged for money or transactions performed by money.

chapter 2 Inflation

Inflation is the decline of purchasing power of a given currency over time. A quantitative estimate of the rate at which the decline in purchasing power occurs can be reflected in the increase of an average price level of a basket of selected goods and services in an economy over some period of time.

Inflation can be contrasted with deflation, which occurs when the purchasing power of money increases and prices decline.

KEY TAKEAWAYS

- Inflation is the rate at which the the value of a currency is falling and consequently the general level of prices for goods and services is rising.
- Inflation is sometimes classified into three types: Demand-Pull inflation, Cost-Push inflation, and Built-In inflation.
- Most commonly used inflation indexes are the Consumer Price Index (CPI) and the Wholesale Price Index (WPI).
- Inflation can be viewed positively or negatively depending on the individual viewpoint and rate of change.
- Those with tangible assets, like property or stocked commodities, may like to see some inflation as that raises the value of their assets.
- People holding cash may not like inflation, as it erodes the value of their cash holdings.
- Ideally, an optimum level of inflation is required to promote spending to a certain extent instead of saving, thereby nurturing economic growth.

Volume 75%

Characteristics of Inflation

- Rising general price level in all area
- It is a continuous process
- Not limited to one or two sectors or geographical area of a country, rather it spreads in entire country and in all the sector of the economy
- Pure inflation starts only after reaching full employment level
- Timing and intensity can not be sured
- Inflation is characterized by excess in aggregate demand of goods and services or excess supply of money in the market

The causes of inflation

- It is Because of the gap between aggregate supply an aggregate demand in the economy. Either there can be a increase in demand and supply remains constant or there can be an decrease in supply and demand remains constant.
- Causes of Inflation can be studied from two sides i.e. from the demand side and from supply side.

The factors from demand side

- Increase in consumer expenditure (C)
- Increase in public expenditure (G)
- Increase In private expenditure(I)
- Increase in foreign demand(X)
- Reduction in taxation
- Repayment of internal debts

- Changes in expectation

The factors from supply side

- Scarcity of factors of production
- Bottlenecks (difficulties, for e.g. unavailability of transportation
- Natural calamities (rains, droughts, earthquakes, tsunami, cyclones damages the production
- Hoarding by merchants
- Rise in costs (rent, wages and interest rates increases)

Effects of inflation

1. Higher interest rates.
2. Lower exports.
3. Lower savings.
4. Mal-investments.
5. Inefficient government spending.
6. Tax increases.
7. Encourages Hoarding:
8. Affects Pattern of Production
9. Quality Falls:

Because of inflation some groups will benefit and some groups will have to incur the losses

Note: Red group is at loss and green group will be benefited because of inflation

- The creditor and debtor (Creditor and Debtor)
- The wage and salary earner(Fixed Income and variable income), (Organized labour and inorganized labour)
- The Entrepreneurs (Traders, merchants, manufacturer)
- The investors (Fixed income return and variable income return)
- The agriculturist (Large farmers and small farmers)

- On Financial Institutes (as there will be less saving in the economy by people)
- On foreign trade (Imports as foreign goods become cheaper and exports as prices of domestic goods rises)
- On price structure(necessities and luxuries)
- On planning (government expenditure has to be put down or dropped and government will increase the tax rate to reduce aggregate demand and to reduce purchasing power of people)
- On currency (people lose faith in currency, currency value goes down and down)

Non-economic effects of inflation

- The gap between rich and poor widens
- Morality and business ethics are violated
- Political stability suffers
- People lose faith and dissatisfaction

- Corruption spreads easily in inflation
- Theft, dacoity, gambling, and other social evils becomes rampant.

- Demand pull inflaton is because of changes in Aggregate demand and aggregate supply
- Cost push inflation is because of upward rise in the cost of production because factors of production becomes more expensive

What Is Deflation?

Deflation is a general decline in prices for goods and services, typically associated with a contraction in the supply of money and credit in the economy. During deflation, the purchasing power of currency rises over time.

- Deflation is the general decline of the price level of goods and services.
- Deflation is usually associated with a contraction in the supply of money and credit, but prices can also fall due to increased productivity and technological improvements.
- Whether the economy, price level, and money supply are deflating or inflating changes the appeal of different investment options.

- Note: Red group is at loss and green group will be benefited because of deflation

- Producers and entrepreneurs because aggregate demand falls sometimes raw material are purchased at a higher price but by the time finished product reach to the market because of deflation prices comes down and producers incur losses
- Investor: Fixed income assets like bond, debentures, variable income earning assets like shares

- Wage and salary earners: fixed income labour, variable income labour
- Consumer:
- Creditor and debtor: creditor, debtor

Control of inflation or deflation

- Monetary measures: measures taken to reduce or increase supply or quantity of money in the country to have control on inflation or deflation
- Fiscal measures: all measures which are to be initiated through the government treasury are known as fiscal measures

chapter 3: Trade cycle

Meaning of Trade Cycle:

A trade cycle refers to fluctuations in economic activities specially in employment, output and income, prices, profits etc. It has been defined differently by different economists.

Features of trade cycle

- A business cycle is synchronic. When cyclical fluctuations start in one sector it spreads to other sectors.
- In a trade cycle, a period of prosperity is followed by a period of depression. Hence trade cycle is a wave like movement.
- Business cycle is recurrent and rhythmic; prosperity is followed by depression and vice versa.
- A trade cycle is cumulative and self-reinforcing. Each phase feeds on itself and creates further movement in the same direction.
- A trade cycle is asymmetrical. The prosperity phase is slow and gradual and the phase of depression is rapid.
- The business cycle is not periodical. Some trade cycles last for three or four years, while others last for six or eight or even more years.
- The impact of a trade cycle is differential. It affects different industries in different ways.
- A trade cycle is international in character. Through international trade, booms and depressions in one country are passed to other countries.
- A full trade cycle has got four phases:

(i) Recovery,

(ii) Boom,

(iii) Recession, and

(iv) depression.

- The upward phase of a trade cycle or prosperity is divided into two stages—recovery and boom, and the downward phase of a trade cycle is also divided into two stages—recession and depression.

- The marginal efficiency of capital displays the expected rate of return on investment, at a particular given time. The marginal efficiency of capital is compared to the rate of interest.

- Keynes described the marginal efficiency of capital as:

- "The marginal efficiency of capital is equal to that rate of discount which would make the present value of the series of annuities given by the returns expected from the capital asset during its life just equal to its supply price."

This theory suggests investment will be influenced by:

1. The marginal efficiency of capital

2. The interest rates

3. Generally, a lower interest rate makes investment relatively more attractive.

4. If interest rates, were 3%, then firms would need an expected rate of return of at least 3% from their investment to justify the investment.

5. If the marginal efficiency of capital was lower than the interest rate, the firm would be better off not investing, but saving the money.

Why are interest rates important for determining the marginal efficiency of capital?

To finance investment, firms will either borrow or reduce savings. If interest rates are lower, it's cheaper to borrow, or their savings give a lower return making investment relatively more attractive.

What is the difference between monetary and fiscal policy?

- Monetary policy involves changing the interest rate and influencing the money supply.

- Fiscal policy involves the government changing tax rates and levels of government spending to influence aggregate demand in the economy.

They are both used to pursue policies of higher economic growth or controlling inflation.

Expansionary fiscal policy: This policy is designed to boost the economy. It is mostly used in times of high unemployment and recession. It leads to the government lowering taxes and spending more, or one of the two. The aim is to stimulate the economy and ensure consumers' purchasing power does not weaken.

Contractionary fiscal policy: As the term suggests, this policy is designed to slow economic growth in case of high inflation. The contractionary fiscal policy raises taxes and cuts spending.

Automatic stabilizers are ongoing government policies that automatically adjust tax rates and transfer payments in a manner that is intended to stabilize incomes, consumption, and business spending over the business cycle.

Keynes noted that in a recession, confidence falls and the private sector cut back on spending and investment. Therefore, we see a rise in private savings and a fall in aggregate demand. This can worsen the recession. This is why Keynes advocated government borrowing – to make use of these surplus savings. Keynes argued that automatic stabilisers may not be enough, and the government should specifically find public sector projects to inject money into the circular flow. This is known as discretionary fiscal policy.

chapter 4: Public Finance

- Public finance can be defined as the study of government activities, which may include spending, deficits and taxation. The goals of public finance are to recognize when, how and why the government should intervene in the current economy, and also understand the possible outcomes of making changes in the market.

- Public finance deals with the finances of Government. The finances of Government include the raising and disbursement of funds includes the raising and disbursement of the funds. Public finance is concerned with the operation of the fiscal or public treasury.

Scope of Public Finance (Subject Matter of Public Finance)

The scope of public finance may be summarised as under:

1. Public Revenue
2. Public Expenditure
3. Public Debt
4. Financial Administration
5. Economic Stabilisation

The Principle of Maximum Social Advantage states that public finance leads to economic welfare when public expenditure & taxation are carried out up to that point where the benefits derived from the MU (Marginal Utility) of expenditure is equal to the Marginal Disutility or the sacrifice imposed by taxation.

Further, the ideal of maximum social advantage is attained by the state, if the following principles of financial operation are followed in the budget.

1. Taxes should be distributed in such a way that the marginal utility of money sacrificed by all the tax-payers is the same.

2. Public spending is done, such that benefits derived from the last unit of money spent on each item becomes equal.

3. Marginal benefits and sacrifices must be equated.

Sources of Public Revenue:

1)Tax Revenue, and.

2)Non-Tax Revenue.

Taxes are the first and foremost sources of public revenue. Taxes are compulsory payments to the government without expecting direct benefit or return by the taxpayer. Taxes collected by Government are used to provide common benefits to all mostly in form of public welfare services. Taxes do not guarantee any direct benefit for the person who pays the tax.

1) Excise duties:They are, presently, by far the leading source of revenue for the Central Government and are levied on commo¬dities produced within the country, The most important commodities from the revenue point of view are sugar, cotton, mill cloth, tobacco, motor spirit, matches, and cement.

2) Custom: On export and import

3) GST: Goods and Services Tax is an indirect tax levied in India on the supply of goods and services. GST is levied at every step in the production process but is meant to be refunded to all parties in the various stages of production other than the final consumer.

4) Income Tax: Income tax is at present another important source of revenue for the Central Government. It is levied on the incomes of individuals, Hindu undivided families, and unregistered firms.

5) Corporate tax: The income-tax on the net profits of joint stock companies is called corporate tax.

6) Wealth Tax: It is an annual tax on the net wealth of individuals and Hindu undivided families. It is a progressive tax.

7) Gift tax: It is a tax on gifts of property by an individual in his lifetime to future succe¬ssors.

8) Capital gain tax: It is applicable to capital gains resulting from the sale, exchange or transfer of capital assets.

9) Foreign travel tax: Another new tax levied on foreign travel for conserving foreign exchange as well as to raise revenue.

Non-Tax Revenue:

The revenue obtained by the government from sources other than the tax is called Non-Tax Revenue. Public income received through the administration, commercial enterprises, gifts, and grants is the source of non-tax revenues of the government.

The following are the sources of non-tax revenue

1) Interest receipts: This largest non-tax source of Central Government's revenue receipts is the interest it earns mainly on the loans it has advanced to State Governments, to financial and industrial enterprises in the public sector.

2) Profits of PSU: commercial revenues: Public enter¬prises owned by the Central Government, e.g., the Steel Authority of India (SAIL), Hindustan Machine Tools (HMT), Bharat Heavy Electricals Ltd. (BHEL), State Trading Corporation (STC). The profits of such Public Sector Units (PSUs) are another source of revenue for the Government of India.

3) Administrative revenue: The main source among them is the Departmental Receipts of the various ministries of the Cen¬tral Government by way of fees, penalties, etc.

4) Public expenditure is spending made by the government of a country on collective needs and wants such as pension, provision, infrastructure, etc.

5) The public expenditure can be used as a lever to raise aggregate demand and thereby to get the economy out of recession. On the other hand, through variation in public expenditure, aggregate demand can be managed to check inflation in the economy.

6) In the developing countries, the variation in public expenditure is not only to ensure eco¬nomic stability but also to generate and accelerate economic growth and to promote employment opportunities.

Objective of public expenditure

Provide social goods:

Remove unemployment:

Increase Production:

Exploitation and Development of Mineral Resources:

Promote Price Stability:

Promote Balanced Growth:

Reduce Inequality of Income: