Subject

Macro Economics

UNIT-I

Macro

The term macro in English has its origin in the Greek term " macros" which means large. In the context of 'Macroeconomics' means economics of the large like economy as a whole. Macro economics deals primarily with the analysis of the relationship between broad economic aggregates like national income, level of total employment, aggregate consumption, total investment, general price level, balance of payment, the quantity of money etc. Macroeconomics is also known as the theory of income & employment as it is concerned with the problems of on employment, economic fluctuation, inflation or deflation international trade and economic growth.

Definitions of Macro Economics

1) **According to culberton's-**"Macro Economics is the theory of income, employment, price and money."
2) **Accordingly to K.E. Boulding –**"Macro economics deals not with individuals quantities as such but with aggregate income, but with national income, not with individuals price but with price levels, not with individuals output but with national output."
3) **According to Edward Shapiro – "**Macro economics attempts to answer the truly 'big' question of economic life – full employment or unemployment, capacity or under capacity production."

Nature of Macro Economics

1) Macro economics studies the concept of national income and its different elements and the method of measurement.
2) It studies problems relating to employment and unemployment. It studies different factors determining the level of employment.
3) Determination of general price level is also studied under macro economics. Problems relating to inflation and deflation are an important component of macro economics.
4) Change in demand and supply of money have an important impact on the level of employment. Macroeconomics studies function of money & theories relating to it.

5) Problems relating to economic growth is another important component of macro economics like plans for overall increase in national income, output, employment are framed so the economic development of economy as a whole.
6) It also studies issues relating to international trade, export, import exchange rate and balance of payments are the principal issue in this context.

Importance of Macro Economics

1) Macro economics is helpful for getting us an idea of the functioning of an economic system. It is very essential for a proper and adequate knowledge of behavior pattern of the aggregative variable, as the description of a large and complex economic system.

2) It says about the study of national income and social accounts. It is the study of national income which enables us to know that three fourth of the world is living in object poverty without proper national difficult to formulate proper economic policies.

3) Macroeconomic approaches are of almost importance to analyze and understand the effect of inflation and deflation different sections of society are affected differently as a result of charges in the value of money.
4) Economic fluctuation is a characteristics features of the capitalist form of economy. The economic booms and depression in the level of income and employment follow one another in cyclical fashion.
5) The study of macro economics is essential for the proper understanding of Micro economics. No micro economics law could be framed without a prior study of the aggregate.

Limitations of Macroeconomics

Following are the main limitations of macro economics:-

1. ***Excessive Thinking***:-Macro economics suffers from the limitations that it always excessively thinks in the terms of aggregates and presumes circumstances to be normal and homogeneous but aggregates may result into heterogeneous character. As Prof. Boulding points:

(a) Six apples+Seven apples=Thirteen apples which constitutes a meaningful aggregate.
(b) Six apples+Seven oranges=Thirteen fruits, which constitutes a fairly meaningful aggregates.
(c) Six apples+Seven shoes constitutes a meaningless aggregates.

2. ***Difference in individual items***:-Sometimes while aggregating the variables, the basic characteristics of the data or the variables is left untouched because there are important differences in the items. Sometimes, the features of individual components may not be true to the aggregate so macro suffers from the danger of excessive generalization.

3. ***Unable to influnce society equally***:-An aggregative tendency may not influence the entire sectors of the economy in the same way. For example, a general rise in price as inflation may not similar effects on different sectors of the economy.

4. ***Contradictory***:-In aggregates, sometime the contradictory individual aspects are neutralized as in case of the estimation, prices in agriculture fall, of industrial products rise which have different affects on individual factors but as an aggregate, there may not be any effect at all. Thus, macro aggregate results may be misleading.

5. ***Role of less aggregative analysis***:-Aggregates itself suffer from certain serious problems due to statistical techniques. The recently introduced computational procedures and programming techniques have reduced the role of aggregative analysis.

Microeconomics V/s Macroeconomics

S.No.	Points	Microeconomics	Macroeconomics
1	**Study**	It studies individual unit	It studies aggregate or group of individual units.
2	**Assumption**	At micro level full employment is assumed which is never found in an economy. Hence this is an unreal assumption	At macro level, full employment is not assumed. Instead equilibrium employment is assumed which is a real assumption.
3	**Subject Matter**	We study demand supply, consumer behavior production, types of market, theory of cost & revenue etc.	We study national income, theory of wage, interest & employment, Theory of money, theory of international trade etc.
4	**Applicability**	It is useful in analysis of an individual unit like cost of an individual good, demand of a single good, price of a single good.	It is useful in analysis of aggregate units such as aggregate demand, aggregate prices or inflation-deflation, aggregate or national income etc.
5	**Usefulness to Govt.**	It is less useful to Govt. in formulating economic policies.	It is more useful to Govt. in formulating economic policies.

INTERDEPENDENCE BETWEEN MICRO AND MACRO ECONOMICS

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

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

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

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

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

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

UNIT-II
DEFINITIONS OF NATIONAL INCOME

Marshall's Definition

"The labour and capital of a country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial, including services of all kinds. This is the true net annual income or revenue of the country or national dividend."

Pigou's Definition

"National income is that part of the objective income of the community, including of course income derived from abroad, which can be measured in money."

"A national income estimate measures the volume of commodities and services turned out during a given period counted without duplication."

"The aggregate value of all final goods and services produced by the residents of a country, operating both within the national boundary and abroad, in any particular year, is called the national income of the country."

Characteristics of National Income –

1) National income is estimated in monetary terms. This may be expressed at current prices or some base year prices.
2) Only the value of final goods and services are taken into account for measuring national income.
3) National income is always expressed with respect to a given time period. Hence, it is a 'flow' concept.
4) All types of 'pure exchange transactions' are excluded from national income accounting. In case of pure exchange transactions, nothing new is produced in the current year. For instance, second-hand sales, purchase and sale of securities (shares and debentures), transfer payments (such as unemployment dole, pension payments) etc. are regarded as pure exchange transactions. All such transactions are not concerned with current year production. So, they are excluded from national income estimates.
5) National income is not simply the sum of all personal incomes in a country.

Difference between Domestic Income and National Income –

S.No.	National Income	Domestic Income
1	It includes income earned by the residents only.	It includes income earned by the residents as well as non-residents.
2	It consists of income earned both within and outside the domestic territory of a country.	It consists of income earned only within the domestic territory.
3	It is an economic concept.	It is a geographic concept.
4	It includes net factor income from aborad.	It does not include net factor income from abroad.
5	National income = Domestic income + Net factor income from aborad.	Domestic income = National income – Net factor income from abroad.

Net factor income from abroad is the difference between the income received by the residents from abroad for rendering factor services (e.g., banking and insurance services, other financial services, engineering services, etc.) and the income paid for the factor services rendered by the non-residents in the domestic territory of a country.

CONCEPTS OF NATIONAL INCOME **1) Gross Domestic Product (at market prices):**

The gross domestic product at market price (GDPmp) indicates the value of all final goods and services produced within the domestic territory of a country during any particular year. These goods and services are valued at the prevailing market prices of those goods and services.

2) Net domestic product (at market prices):

The Net domestic product at market prices (NDPmp) refers to the value of all final goods and services at the prevailing market prices within the domestic territory of a country during any particular year after making allowance for the consumption of fixed capital or depreciation allowance.

NDPmp = GDPmp – Depreciation allowance

3) Gross National Product (at market price) :

The Gross National Product at market prices (GNPmp) refers to the aggregate market value of all final goods and services produced by the residents of a country during any particular year.

4) Net National Product (at market prices):

The net national product at market prices (NNPmp) refers to the market value of all final goods and services produced by the residents of a country after allowing for the depreciation of fixed capital during any particular year. Thus, if we deduct the consumption of fixed capital or the depreciation allowance from the GNPmp, we get NNPmp.

NNPmp = GNPmp – Depreciation

allowance **5) Gross Domestics Product (at factor cost):**

The Gross Domestic Product at factor cost (GDPfc) refers to the estimation of GDP in terms of the aggregate earnings of factors of production.

6) Gross National Product (af factor cost):

The Gross National Product at factor cost (GNPfc) refers to the GNP in terms of factor incomes. It is the aggregate earnings received by different factors of production (i.e., wages, rent, interest and profits) supplied by the residents of a country during any particular year.

7) Net Domestic Product (at factor cost):

The net domestic product at factor cost (NDP_{fc}) estimates the NDP in terms of the aggregate factor incomes of the residents and non-residents within the domestic territory of a country during any particular year.

8) Net National Product (at factor cost):

The net national product at factor cost (NNPfc) to the value of the final goods and services produced by the residents of a country, whether operating within the domestic territory or outside it, at their factor costs. It is also termed as the National Income of a country.

9) Private Income

Central Statistical Organization defines Private Income as "the total of factor income from all sources and current transfers from the government and rest of the world accruing to private sector" or in other words the private income refers to the income from socially accepted source including retained income of corporation.

NI+ Transfer payment + Interest on public debt +Social security + Profit and Surplus of public enterprises = Private Income

10) Personal Income

Prof. Peterson defines Personal Income as "the income actually received by persons from all sources in the form of current transfer payments and factor income. In other words, Personal Income is the Total income received by the citizens of a country from all sources before direct taxes in a year.

PI = Private Income + Undistributed Corporate Profits – Direct Taxes

11) Disposable Income

Prof. Peterson defined Disposable Income as "the income remaining with individuals after deduction of all taxes levied against their income and their property by the government."

Disposable Income refers to the income actually received by the households from all sources. The individual can dispose this income according to his wish, as it is derived after deducting direct taxes.

DI = Personal Income - Direct taxes – Miscellaneous receipt of the government.

<u>Methods of calculating National Income</u>

A) Value added or production or output approach

1) The output approach focuses on finding the total output of a nation by directly finding the total value of all goods and services a nation produces.
2) <u>Problem of Double counting</u>: Because of the complication of the multiple stages in the production of a good or service, only the final value of a good or service is included in the total output. This avoids an issue often called 'double counting', wherein the total value of a good is included several times in national output, by counting it repeatedly in several stages of production. In the example of meat production, the value of the good from the farm may be Rs10, then Rs 30 from the butchers, and then Rs 60 from the supermarket. The value that should be included in final national output should be Rs 60, not the sum of all those numbers, Rs 90. The values added at each stage of production over the previous stage are respectively Rs 10, Rs 20, and Rs 30. Their sum gives an alternative way of calculating the value of final output.

B) Income method

The income approach equates the total output of a nation to the total factor income received by residents or citizens of the nation. The main types of factor income are:

- Employee compensation/ salaries & wages (cost of fringe benefits, including unemployment, health, and retirement benefits);
- Interest received net of interest paid;
- Rental income (mainly for the use of real estate) net of expenses of landlords;
- Royalties paid for the use of intellectual property and extractable natural resources.
- Corporate Profits

C) Expenditure or Consumption method

The expenditure approach is basically an output accounting method. It focuses on finding the total output of a nation by finding the total amount of money spent. This is acceptable, because like income, the total value of all goods is equal to the total amount of money spent on goods

$$GDP= C+I+G+(X-M)$$

Where:

C = household consumption expenditures / personal consumption expenditures
I = gross private domestic investment
G = government consumption and gross investment expenditures
X = gross exports of goods and services
M = gross imports of goods and services
Note: (**X - M**) is often written as X_N, which stands for "net exports"

PROBLEMS OF CALCULATING NATIONAL INCOME IN INDIA

1) **Difficulty in defining the nation** – As the world has become a global village, it is very difficult to identify the national boundaries has become difficult.
2) **Non-marketed service** – Services like love, kindness, and mercy has economic value but have no money value.
3) **Possibility of double counting** – The possibility of double counting which arises from the failure to distinguish properly between a final and intermediate product.
4) **Transfer payment** – Individual get pension, unemployment allowance and interest on public loans, but whether these should be included in national income is a difficult problem. The best way to solve the difficulty is to consider only the disposable income of individual or personal income minus all transfer payments.
5) **Capital gains or losses** – Commodity product this year is sold next year if at higher price is capital gain & at loss then capital losses e.g. other example could be selling of shares.
6) **Income earned through illegal activities** –Such as gambling or illicit extortion cannot be included in national income.
7) **Self-consumed production** – In many backward countries, substantial part of the output is not exchanged for money in market it is being either consumed directly by producer or bartered for other goods & services in the unorganized sector.
8) **Paucity of statistics** – According to the national income committee of India, the available statistics, especially for agriculture & small scale industry are extremely unreliable & incomplete.
9) **Inflation may give a false impression of growth in national income** – In a country when price rise, inflation rises even though the production falls & vice versa. It leads to mis-measurement of national income. ,
10) **Difficulties in classifying the commodities** – Coal is both household use & industrial use as well ,so is the expenditure on coal consumption , expenditure or an investment.
11) **Multiple occupations** – The production in agri-industrial, in all sectors is highly scattered and unorganized making the calculation of national income very difficult.
12) **Capital depreciation** – Depreciation is charged on profit which lowers national income. But the problem of estimating the current depreciated value of a piece of capital whose expected life is forty year is very difficult.
13) **Data problems** – There are problems of collecting reliable statistical data abort all the productive activities in the underdeveloped countries.
14) **Illiteracy** – The majority of people in the country like India are illiterate & they do not keep any accounts about the production & sole of their products.

Unit –III
THEORIES OF WAGES, INTEREST AND EMPLOYMENT

THEORY OF WAGES

Wages

1) A wage is monetary compensation (or remuneration) paid by an employer to an employee in exchange for work done. Payment may be calculated as a fixed amount for each task completed (a task wage or piece rate), or at an hourly or daily rate, or based on an easily measured quantity of work done.

2) Wages is best associated with employee compensation based on the number of hours worked multiplied by an hourly rate of pay. For example, an employee working in an assembly plant might work 40 hours during the work week. If the person's hourly rate of pay is Rs.15, the employee will receive a paycheck showing gross wages of Rs. 600 (40 x Rs. 15)

Salary

1) Salary is a fixed amount of money or compensation paid to an employee by an employer in return for work performed. Salary is commonly paid in fixed intervals, for example, monthly payments of one-twelfth of the annual salary.

2) Salary is best associated with employee compensation quoted on an annual basis. For example, the manager of the assembly plan might earn a salary of Rs.120,000 per year. If the salaried manager is paid semi-monthly (perhaps on the 15th and last day of each month), her or his paycheck will show gross salary of Rs. 5,000 for the half-month.

3) Salary is typically determined by comparing market pay rates for people performing similar work in similar industries in the same region.

Wages V/s salary

1) Wage earners are paid by the hour whereas Salary earners are paid by the year.
2) Salary earners usually receive paid time when they are not working whereas Wage earners often have to give up pay for time off, Salaries are often calculated as packages
3) Wage earners get paid more for working more than 40 hours per week, Salary workers are rarely offered overtime pay.
4) Salaries can contain all kinds of benefits and perks whereas wage doesn’t.

THE SUBSISTENCE THEORY OF WAGES

1) This theory was originated with the Physiocratic School of the French economists and was developed by Adam Smith and the later economists of the classical school. The German economist Lassalle called it the Iron Law of Wages or the Brazen Law of Wages. Karl Marx made it the basis of his theory of exploitation.
2) According to this theory, wages tend to settle at the level just sufficient to maintain the worker and his family at the minimum subsistence level. If wages rise above the subsistence level, the workers are encouraged to marry and to have large families. The large supply of labour brings wages down to the subsistence level. If wages fall below this level, marriages and births are discouraged and under- nourishment increases death rate. Ultimately, labour supply is decreased, until wages rise again to the

subsistence level. It is supposed that the labour supply is infinitely elastic, that is, its supply would increase if the price (i.e. wage) offered rises.

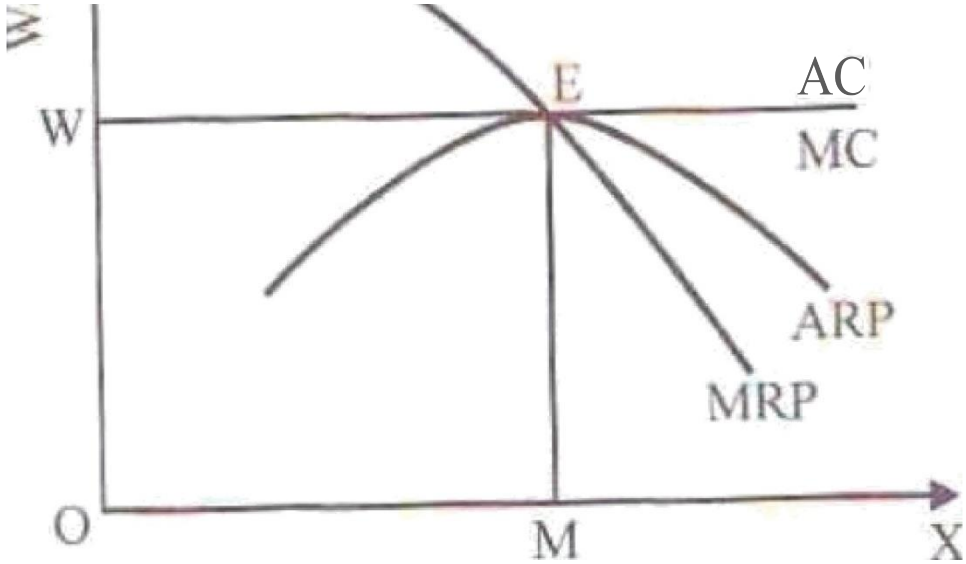
Criticism of subsistence theory

1) This theory is almost completely outdated and has no such practical application, especially in advanced countries. The theory was based on the Malthusian Theory of Population. It is inappropriate to say that every increase in wages must inevitably be followed by an increase in birth rate. An increase in wages may be followed by a higher standard of living.
2) Ricardo was one of the exponents of the subsistence theory. He stressed the influence of custom and habit in determining what was necessary for the workers. But habits and customs change over time. Hence, the theory cannot hold good for a longer period of time, especially of a world characterised by fast changing habits. Ricardo, therefore, admitted that wages might rise above the subsistence level for an indefinite period in an improving society.
3) The second criticism against this theory is that the subsistence level is more or less uniform for all working classes with certain exceptions. The thoery, thus, does not explain differences of wages in different employment.
4) The third criticism is that the theory explains wages only with reference to supply; the demand side has been entirely ignored. On the demand side, the employer has to consider the amount of work which the employee gives him and not the subsistence of the worker.
5) The fourth criticism is that the theory explains the adjustment of wages over the lifetime of a generation and does not explain wage fluctuations from year to year.
6) The fifth and the final criticism is that the term 'subsistence' has a very vague impression. Does it refer to the minimum requirements of a modern man or of a tribal savage?

MARGINAL PRODUCTIVITY THEORY OF WAGES

1) The marginal productivity theory was first stated by Von-Thunen. The theory has been developed by Wicksteed Walras J.B. Clark and many others.
2) Statement of the theory: Marginal productivity theory of wage explains that under perfect competition a worker's wage is equal to marginal as well as average revenue productivity. In other words marginal revenue productivity and average revenue productivity (ARP) of a worker determine his wages.
3) According to this theory wage of a laborer is determined by his marginal productivity. In other words MRP= M.W. Marginal productivity is the addition made total productivity by employing one more unit of labour. As the laborers are given money wage their marginal productivity is calculated in terms of money. This is called marginal revenue productivity (MRP). MRP is the addition made to the total revenue by employing one more unit of a worker. A producer will maximize his profit when the wage of a laborer is equal to the marginal revenue product.
4) If MW is greater than MRP (MW > MRP) wage is greater than marginal revenue product. The producer will sustain loss then. If MW for labour is higher than its marginal revenue product then the employers get less and pay more. Thus he loses.
5) On the other hand if the producer pays wage less than MRP. (ME < MRP) he will gain. But his gain will not be maximized. Thus he will gain by employing workers so long when MW = MRP. Thus the wage of a laborer will be determined where MRP - M.W.

(›fi!ls of Labour



linits of Labour

VMP = MPP x P.

In Perfect competition MRP = VMP

In imperfect competition MRP ≠ VMP

Point E in the diagram is the point of equilibrium where MRP = ARP = MC = AC

Assumptions of marginal productivity theory

(1) Perfect competition prevails in both product and factor market.
(2) Law of diminishing marginal returns operates on the marginal productivity of labour.
(3) Labour is homogeneous.
(4) Full employment prevails.
(5) The theory is based on long run.
(6) Modes of production in constant.

Criticism of marginal productivity theory:

1. The theory is based on the assumption of perfect competition. But perfect competition is unreal and imaginary. Thus theory seems in practicable.
2. The theory puts too much on demand side. It ignores supply side.
3. Production is started with the combination of four factors of production. It is ridiculous to say that production has increased by the additional employment of one worker. Employment of an additional laborer amounts nothing in a big scale industry.
4. The theory is static. It applies only when no change occurs in the economy. Under depression wage cut will not increase employment.
5. This, theory explains that wages will be equal to MRP and ARP.
6. It is difficult to measure MRP because any product is a joint product of both fixed and variable factors.
7. According to Watson the theory is cruel and harsh. This theory never takes into consideration the marginal product of old, aged, blind etc.

THE WAGES-FUND THEORY OF WAGES

1) Wages Fund Theory: This theory is associated with the name of J.S. Mill. According to Wages Fund Theory wages depend upon two quantities, viz.:
   (i) The wage fund or the circulating capital set aside for the purchase of labour, and
   (ii) The number of labourers seeking employment.
2) Since, the theory takes the wage fund as fixed, wages could rise only by a reduction in the number of workers. According to this thoery, the efforts of trade unions to raise wages are futile. If they succeeded in raising wages in one trade, it can only be at the expense of another, since the wage fund

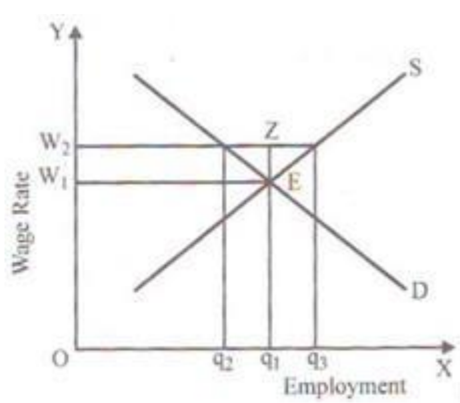
   is fixed and the trade unions have no control over population. According to this theory, therefore, trade unions cannot raise wages for the labour class as a whole.
3) This theory has been widely criticised and stands rejected now. Even J.S. Mill himself recanted it in the second edition of his book 'Principles of Political Economy'. Mill thought that wages were paid out of circulating capital alone. Whether the source of wages is capital or the present products, has been the subject of a keen controversy in the past. The fact is that in some cases, where the process of production is short (e.g., final stages of the productive process), wages are paid out of the present production. On the other hand, when a process of production is long, the labourer obviously does not obtain wages from the product of his labour either directly or through exchange. In such cases, wages mainly come out of capital. This theory is inapplicable in highly industrialized countries, but, it is applicable in an under-developed country suffering from capital deficiency, where the wages cannot be increased unless national income is increased and capital accumulated through industrialisation.

MODERN OR SUPPLY –DEMAND THEORY OF WAGES

Modern Theory of Wages:

1) According to this theory, the wages are determined by the interaction of demand and supply as inthe case of ordinary commodity. Thus, this theory is also referred to demand and supply theory.
2) Demand for Labour: According to the modern theory of wages, the demand for labour reflects partly labourer's productivity and partly the market value of the product at different levels of production.
3) **Demand of Labour**: The demand of labour depends on:
   a) Derived Demand: The demand for labour is a derived demand. It is derived from the demand for the commodities it helps to produce. Greater the consumer demand for the product, greater the producer demand for labour required to produce that commodity. It may be observed that it is expected demand and not existing demand for the product that determines demand for labour. Hence, the expected increase in the demand for a product will increase the demand for labour.
   b) Elasticity of Demand for Labour: The elasticity of demand for labour depends on the elasticity of demand for commodity. According to this theory, the demand for labour will generally be inelastic if their wages form only a small proportion of the total wages. The demand, on the other hand, will be elastic if the demand for product is also elastic or if cheaper substitutes are available.
   c) Prices & Quantities of Co-Operating Factors: The demand for labour also depends on the prices and the quantities of the co-operating factors. If the machines are costly, the demand for labour will be increased. The greater the demand for the co-operating factors the greater will be the demand for labour, and vice versa.
   d) Technical Progress: Another factor that influences the demand for labour is technical progress. In some cases labour and machineries are used in definite proportions.
   e) After considering all relevant factors as discussed above, the employer is governed by one fundamental factor, viz., marginal productivity.
4) **Supply of Labour**: The supply of labour depends on:
   (a) The number of workers of a given type of labour which would offer themselves for employment at various wage rates, and
   (b) The number of hours per day or the number of days per week they are prepared to work,

Over a short period of time, reduction in wages may not cause any reduction in the supply of labour. But if wages are driven too low, competition among employers themselves will push them up. Even over a long period, the supply of labour is not very elastic.



Thus, the supply of labour will depend on the elasticity of demand for income which will vary according to the worker's temperament and social environment. When the workers' standard of living is low, they may be able to satisfy their wants with a small income and when they have made that much, they may prefer leisure to work. That is why it happens that sometimes increase in wages leads to a contraction of the supply of labour.

5) Interaction of Demand and Supply: The final wage rate is determined by the equilibrium of demand & supply.

THEORY OF INTEREST

MODERN THEORY OF INTEREST / THE HICKS-HANSEN THEORY OR IS-LM MODEL

In expounding the modern theory of interest, Professor Hansen, in his Monetary Theory and Fiscal Policy, points out that there are four determinants of the rate of interest:

1. The investment demand schedule;
2. The consumption function;
3. The liquidity preference schedule; and
4. The quantity of money.

Using the classical terminology, there are, four determinants of income and the rate of interest:

(1) productivity;
(2) thrift;
(3) the desire for holding cash; and
(4) the quantity of money or money supply.

The equilibrium condition of these four variables together determines the rate of interest. According to Hansen, "an equilibrium condition is reached when the desired volume of cash balances equals the quantity of money.

When the marginal efficiency of capital is equal to the rate of interest, and finally, when the volume of investment is equal to the normal or desired volume of saving. And these factors are interrelated."

In short, according to the modern theory of interest, when the four variables, viz. saving, investment, liquidity preference and the quantity of money, are integrated with income, we get a fairly satisfactory explanation of the rate of interest.

For this purpose, a synthesis between the loanable funds formulation and the liquidity preference theory is evolved by neo-Keynesian economists (Hicks, Lerner and Hansen).

In fact, the aim of such a synthesis was to combine the real sector and the monetary sector as well as the flow and stock variables of these distributive theories (loanable funds and liquidity preference) together as an explanation of interest rate determination.

Thus, the neo-Keynesian synthesis evolved two schedules, the IS schedule and the LM schedule the former showing the equilibrium between the flow variables in the real sector and the latter representing the equilibrium of the stock variables.

When the IS and LM schedules are plotted graphically, their respective curves (the IS curve and the LM curve) give us the equilibrium rate of interest at the point of their intersection. At this equilibrium rate of interest:
(i) Total saving = total investment;
(ii) Total demand for money = total supply of money; and
(iii) The real as well as the monetary sectors are in equilibrium.
Let us now see, how these two schedules (IS and LM) and the respective curves are constructed.

The IS Schedule:

1. From the loanable funds formulation, we get a family of loanable fund schedules or saving schedules at various income levels. These together with the investment demand schedule gives us the IS schedule, and when represented diagrammatically we get the IS curve.
2. The IS curve denotes equilibrium in the real sector, showing various combinations of the levels of income (Y) and interest rate (r) at which there is equilibrium between aggregate real saving and real investment.
3. Now, in order to derive the IS schedule, we have to find out those rates of interest and those levels of income corresponding to which investment is equal to saving from a given investment schedule and a given saving schedule. For this, let us construct hypothetical schedules.To present the above schedules diagrammatically in a generalised form, let Y_1, Y_2, Y_3, Y_4 and V_5 represent respectively the income levels of Rs.1000, 1500, 2000, 2500 and 3000 crores in the economy.
4. We may assume that at these income levels, S_1, V_1, S_2, Y_2, S_3, V_3, S_4, Y_4, and S_5, V_5 curves represent volumes of savings of Rs. 100, 200, 300, 400 and 500 crores respectively.

   It is the investment curve when the income level is Y_1; the equilibrium between saving and investment is established at R_1M_1 rate of interest (7% in the given illustration).
   Or at Y_1 income level, R_1M_1 is the equilibrium rate of interest which brings about equality between saving and investment (in our example, at 7% rate of interest S = 100 crores and / = 100 crores. (S - I).
   Likewise, at the income level Y_3, R_2M_2 rate of interest establishes equilibrium between saving and investment. And in the same manner, at income levels Y_2, Y_4 and Y_5, the equilibrium between saving and investment is established by R_3M_3, and R_4M_4 and R_5M_5 rates of interest respectively. Now, connecting together the various rates of interest equalising saving and investment at the corresponding levels of income, Y_1,Y_2 Y_5etc., we then get a curve called the IS.

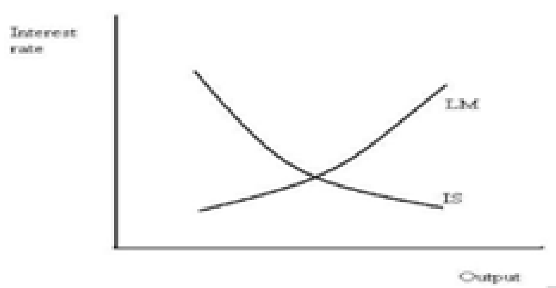
5. It is easy to see from the diagram that each point along the IS curve gives different income levels at which the savings and investment are in equilibrium.
6. The IS curve slopes downward to the right for the simple reason that at higher levels of income, saving is greater, but the greater the saving, the lower the rate of interest.Thus, as the level of income rises, the rate of interest declines, with increasing saving. And, as the rate of interest declines, investment rises till saving equals investment.

The LM Schedule:

1. In order to observe the monetary sector equilibrium in the theory, neo-Keynesians have derived the LM schedule or curve from Keynes' liquidity preference theory.
2. It has been pointed out that the liquidity preference function L and the money supply M also establish a relation between the income and the rate of interest. Hansen states that from the Keynesian formulation we get a family of liquidity preference schedules at various income levels.These, together with the supply of money fixed by the monetary authority, give us the LM schedule. The LM schedule tells us what the various rates of interest will be (given the quantity of money and the family of liquidity preference schedules) at different levels of income.
3. In fact, the LM schedule shows the relation that (given a certain liquidity or demand schedule for money) and a certain quantity of money fixed by the monetary authority; the rate of interest will be low when income is low and high when income is high.
4. Thus, the LM schedule is the schedule showing the relation between income and interest (given the L function and the supply of M) when the desired cash equals the actual cash, or when L - M.This means, the LM schedule presupposes equilibrium between L and M, just as the IS schedule presupposes equilibrium between I and S 4 .

Determination of the Rate of Interest:

According the modem theory of interest, the intersection of the IS and LM curves determines the rate of interest. Y" is how the real sector and the monetary sector are integrated by the neo-Keynesian synthesis in explaining interest rate determination.



It appears from this figure that:

1. With a given LM curve, when the IS is shifted to the right, income rises and the rate of interest also rises.
2. When the IS curve is constant and the LM curve is shifted to the right, the rate of interest falls and so on.

Thus, for a determinate theory of interest, we should view the interaction of the following factors: (1) the investment-demand function, (2) the saving function, (3) the liquidity preference function, and (4) the supply of money. Hansen, states that the Keynesian analysis, in a broad sense, involves all these.

In this sense, Keynes, unlike the neo-classicists, did formulate a determinate interest theory. But he failed to bring all the elements together in a comprehensive manner to formulate plainly an integrated theory of interest.

He, however, did not realise that liquidity preference plus the quantity of money can furnish not the rate of interest but only an LM schedule.
Thus, the credit goes to Professor Hicks for using the Keynesian tools in a proper manner to construct a comprehensive and determinate theory of interest.
In short, the modern theory of interest holds that productivity, thrift, liquidity preference, and the money supply are all important determinants of the rate of interest.

THE LIQUIDITY PREFERENCE THEORY OF INTEREST

1) What is liquidity preference : Liquidity means shift ability without loss. It refers to easy convertibility. Money is the most liquid assets. Money commands universal acceptability. Everybody likes to hold assets in form of cash money. If at all they surrender this liquidity they must be paid interest. As water is liquid and it can be used for anything at will, so also money can be converted to anything immediately.

Demand for money:

(a) The transaction motive:-

An individual for his day to day transaction demand money. A man has to buy food and medicines in his day to day life. For this purpose people want to keep some cash with them.

(b) The precautionary motive:

People demand to hold money with them to meet the unforeseen contingencies. An individual may become unemployed; he may fall sick or may meet serious accident. For all these misfortune, he demands money to hold with him. The amount of money under the precautionary motive depends on the individual's condition, economic as well as political which he lives.

(c) Speculative motive:

Under speculative motive people want to keep each with them to take advantage of the charges in the price of bonds and securities. People under speculative motive hold money in order to secure profit from the future speculation of the bond market. Money under the above three motives constitute the demand for money. An increase in the demand for money leads to a rise in the late of interest, a decrease in the demand for money leads to a fall in the rate of interest.

Supply of Money:

The supply of money is different from the supply of ordinary commodity. The supply of commodity is a flow whereas the supply of money is a stock. The aggregate supply of money in a community at any time is the sum of money stock of all the members of the society. The supply of money is controlled by the govt. The supply of money in existence consists of legal tender money, bank money and credit money. The supply of money is determined by the central bank of a country. The total supply of money is fixed at a particular point of time. The supply of money is not influenced by the rate of interest.

Equilibrium rate of interest:

The rate of interest is determined by the demand for money and supply of money. The equilibrium rate of interest is fixed at that point where supply of and demands for money are equal. If the rate of interest is high peoples demand for money (liquidity preference) is low. The liquidity preference function or demand curve states that when interest rate falls, the demand to hold money increases and when interest rate raises the demand for money, diminishes.

THEORY OF UNEMPLOYMENT

Types of unemployment

1) **Frictional unemployment** :Frictional unemployment is a kind of unemployment that occurs when people are "between jobs" or are looking for their first jobs. It is a kind of unemployment that occurs when the economy is trying to match people and jobs correctly. So, if you get fired for poor work, if you quit because you dislike your job, or if you are just looking for your first job, you are frictionally unemployed.

2) **Seasonal unemployment** : Seasonal unemployment occurs when people are not working because their jobs only exist at some times of the year. Agricultural and construction workers are examples of this type of unemployment.

3) **Structural unemployment** Structural unemployment occurs when a given set of skills is no longer needed in a given economy. For example, E.g. closure of mines, left many miners struggling to find suitable work. For example, there may be jobs available in the service sector, but unemployed miners don't have the relevant skills to be able to take the jobs

4) **Cyclical unemployment** : Cyclical unemployment, which economists say is the worst kind. In this kind of unemployment, people are out of work because the economy has slowed and there is no demand for whatever the workers make. This sort of unemployment occurs during recessions.

5) **Voluntary unemployment:** is a situation when a person is unemployed because of not being able to find employment of his/her own choice. It is a situation when a person is unemployed. Sometimes people reject employment opportunities if they do not receive desired wages or if they are not offered the kind of work they wish to do.

6) **<u>Disguised Unemployment:</u>** Disguised unemployment is the most widespread type of unemployment in under-developed countries. In under-developed countries, the stock of capital does not grow fast. The capital stock has not been growing at a rate fast enough to keep pace with the growth of population, the country's capacity to offer productive employment to the new entrants to the labour market has been severely limited. This manifests itself generally in two ways: (i) the prevalence of large-scale unemployment in the urban areas; and (ii) in the form of growing numbers engaged in agriculture, resulting in 'disguised unemployment'

CLASSICAL THEORY OF UNEMPLOYMENT

The classical theory of employment is based on the following assumptions.

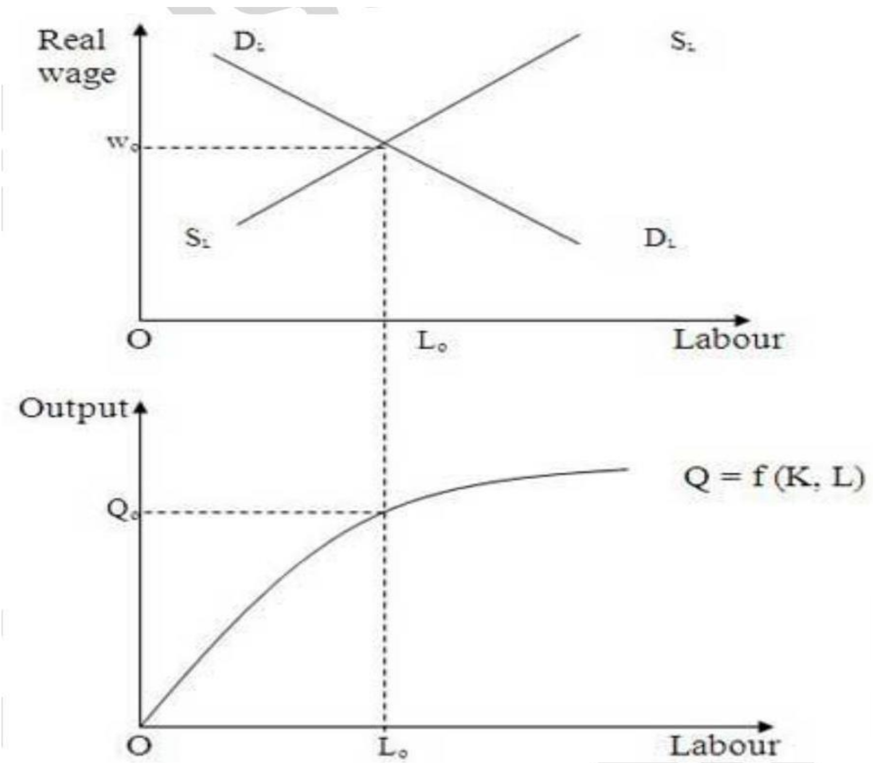
1. There is existence of full employment without inflation.
2. There is a closed laissez-faire capitalistic economy.
3. There is perfect competition in labor market and product market.
4. Labor is homogenous.
5. Total output of the economy is divided between consumption and investment expenditure.
6. The quantity of money is given.
7. Wages and prices are flexible.
8. Money wages and real wages are directly related and proportional.

The main Postulates of classical theory are:

1) The basic contention of classical economists was that if wages and prices were flexible, a competitive market economy would always operate at full employment. That is, economic forces would always be generated so as to ensure that the demand for labour was always equal to its supply.

2) In the classical model the equilibrium levels of income and employment were supposed to be determined largely in the labour market. At lower wage rate more workers will be employed. That is why the demand curve for labour is downward sloping. The supply curve of labour is upward sloping because the higher the wage rate, the greater the supply of labour.

In the following figure the equilibrium wage rate (w_o) is determined by the demand for and the supply of labour. The level of employment is OL_o.



The lower panel of the diagram shows the relation between total output and the quantity of the variable factor (labour). It shows the short-run production function which is expressed as Q = f (K, L), where Q is output, K is the fixed quantity of capital and L is the variable factor labour. Total output Q_o is produced with the employment of Lo units of labour. According to classical economists this equilibrium level of employment is the 'full employment' level. So the existence of unemployed workers was a logical impossibility. Any unemployment which existed at the equilibrium wage rate (W_o) was due to frictions or restrictive practices in the economy in nature.

3) The classical economists believed that aggregate demand would always be sufficient to absorb the full capacity output Q_0. In other words, they denied the possibility of under spending or overproduction. This belief has its root in Say's Law.

(a) Say's Law: According to Say's Law supply creates its own demand, i.e., the very act of producing goods and services generates an amount of income equal to the value of the goods produced. Say's Law can be easily understood under barter system where people produced (supply) goods to demand other equivalent goods. So, demand must be the same as supply. Say's Law is equally applicable in a modern economy. The circular flow of income model suggests this sort of relationship. For instance, the income created from producing goods would be just sufficient to demand the goods produced.

(b) Saving-Investment Equality: There is a serious omission in Say's Law. If the recipients of income in this simple model save a portion of their income, consumption expenditure will fall short of total output and supply would no longer create its own demand. Consequently there would be unsold goods, falling prices, reduction of production, unemployment and falling incomes. However, the classical economists ruled out this possibility because they believed that whatever is saved by households will be invested by firms. That is, investment would occur to fill any consumption gap caused by savings leakage. Thus, Say's Law will hold and the level of national income and employment will remain unaffected.

(c) Saving-Investment Equality in the Money Market: The classical economists also argued that capitalism contained a very special market – the money market – which would ensure saving investment equality and thus would guarantee full employment. According to them the rate of interest was determined by the demand for and supply of capital. The demand for capital is investment and its supply is saving. The equilibrium rate of interest is determined by the saving- investment equality. Any imbalance between saving and investment would be corrected by the rate of interest. If saving exceeds investment, the rate of interest will fall. This will stimulate investment and the process will continue until the equality is restored. The converse is also true.

(d) Price Flexibility: The classical economists further believed that even if the rate of interest fails to equate saving and investment, any resulting decline in total spending would be neutralized by proportionate decline in the price level. That is, Rs 100 will buy two shirts at Rs 50, but Rs 50 will also buy two shirts if the price falls to Rs 25. Therefore, if households saves more than firms would invest, the resulting fall in spending would not lead to decline in real output, real income and the level of employment provided product prices also fall in the same proportion.

(e) Wage Flexibility: The classical economists also believed that a decline in product demand would lead to a fall in the demand for labour resulting in unemployment. However, the wage rate would also fall and competition among unemployed workers would force them to accept lower wages rather than remain unemployed. The process will continue until the wage rate falls enough to clear the labour market. So a new lower equilibrium wage rate will be established. Thus, involuntary unemployment was logical impossibility in the classical model.

Keyne's Criticism of Classical Theory:

J.M. Keynes criticized the classical theory on the following grounds:

1. According to Keynes saving is a function of national income and is not affected by changes in the rate of interest. Thus, saving-investment equality through adjustment in interest rate is ruled out. So Say's Law will no longer hold.

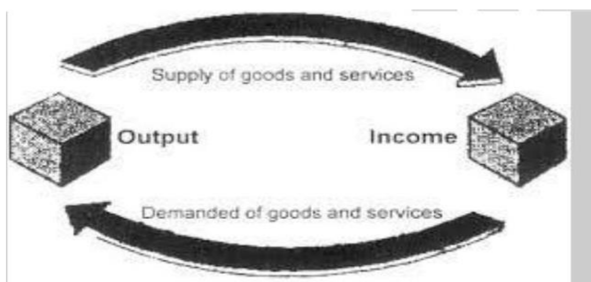
2. The labour market is far from perfect because of the existence of trade unions and government intervention in imposing minimum wages laws. Thus, wages are unlikely to be flexible. Wages are more inflexible downward than upward. So a fall in demand (when S exceeds I) will lead to a fall in production as well as a fall in employment.

3. Keynes also argued that even if wages and prices were flexible a free enterprise economy would not always be able to achieve automatic full employment.

SAYS LAW OF MARKET

1) Say's Law is the foundation of classical economics. Assumption of full employment as a normal condition of a free market economy is justified by classical economists by a law known as 'Say's Law of Markets'. It was the theory on the basis of which classical economists thought that general over-production and general unemployment are not possible.

2) Say's law states that the production of goods creates its own demand



The basic consumptions of says law are :

(a) Perfectly competitive market and free exchange economy.

(b) Free flow of money incomes. All the savings must be immediately invested and all the income must be immediately spent.

(c) Savings are equal to investment and equality must bring about by flexible interest rate.

(d) No intervention of government in market operations, i.e., a laissez faire economy, and there is no government expenditure, taxation and subsidies.

(e) Market size is limited by the volume of production and **aggregate demand is equal to aggregate supply.**

(f) It is a **closed economy.**

The Says law has the following implications:

1. **Production creates market (demand) for goods**: when the producer obtained the various inputs to be used in the production process they generate the necessary income.

2. **Barter system is its basis**: in its original form the law is applicable to a barter economy where goods are ultimately sold for goods. Therefore, whatever produced is ultimately consumed in the economy.

3. **General over production is impossible**: if the production process is continuing under normal condition, then there will be no deficiency for the producer in the market. According to say, work being unpleasant no person will work to make a product unless he wants to exchange it for some other product which he desires therefore the very act of supplying goods implies a demand for them. In such a situation there cannot be general overproduction because the supply of goods will not exceed demand as a whole.
4. **Saving investment Equality**: Income occurring to the factors owners in the form of rent, wages and interest is not spent on consumption but some proportion out of it is saved which is automatically invested for further production.

5. **Rate of interest as a determinant factor**: If there is any gap between saving and investment, the rate of interest brings about the equality between two

6. **Flexibility between interest and wage rate**: The theory assumes the part of income is saved and available for investment. If at any point of time saving is more then investment, the rate of interest will fall, which will result in low savings and more investments. At a lower rate of interest, household will like to save less, where as producers will like or invest more and economy will be in equilibrium.If there are unemployed persons in an economy, wage rate will fall. This will induce entrepreneurs to demand more labor. Ultimately all labor will be absorbed. The economy will be in full employment equilibrium.
This view suggests that the key to economic growth is not increasing demand, but increasing production. Say's views were expanded on by classical economists, such as James Mill and David Ricardo.

Pigou's Formulation of Says law

1. According to Professor Pigou, the unemployment which exists at any time is because of the fact that changes in demand conditions are continually taking place and that frictional resistances prevent the appropriate wage adjustment from being made instantaneously.
2. Thus, according to classical theory, there could be small amounts of 'frictional unemployment' attendant on changing from one job to another but there could not be 'involuntary unemployment' for a long period.
3. According to Professor Pigou, if people were unemployed, wages would fall until all seeking employment were in fact employed.
4. Involuntary unemployment which was found at times of depression was because of the fact that wages were kept too high by the actions of labour unions and governments. Therefore, Professor Pigou advocated that a general cut in money wages at a time of depression would increase employment.

5. According to Pigou, perfectly elastic wage policy would abolish fluctuations of employment and would ensure full employment.

Criticism of Classical Theory

1. **Supply may not create its own demand** when a part of the income is saved. Aggregate demand is not always equal to aggregate supply.
2. **Employment in a country cannot be increased by cutting general wages.**
3. **There is no direct relationship between wages and employment.**
4. **Interest rate adjustments cannot solve savings-investment problem.**
6. Classical economists have made the economy completely self-adjusting and self-reliant. **An economy is not so self-adjusting and government intervention is unobvious.**
7. Classical economists have made the wages and prices so much flexible. **In practical, wages and prices are not so flexible. It will create chaos in the economy.**
8. **Money is not a mere medium of exchange.** It has an essential role in the economy.
9. **The classical theory has failed to explain the occurrence of trade cycles.**

KEYNESIAN THEORY OF EMPLOYMENT

1) Keynes has strongly criticised the classical theory in his book 'General Theory of Employment, Interest and Money'. His theory of employment is widely accepted by modern economists. Keynesian economics is also known as 'new economics' and 'economic revolution'. Keynes has invented new tools and techniques of economic analysis such as consumption function, multiplier, marginal efficiency of capital, liquidity preference, effective demand, etc.

2) In the short run, it is assumed by Keynes that capital equipment, population, technical knowledge, and labour efficiency remain constant. That is why, according to Keynesian theory, volume of employment depends on the level of national income and output. Increase in national income would mean increase in employment. The larger the national income the larger the employment level and vice versa. That is why, the theory of Keynes is known as 'theory of employment' and 'theory of income'.

Keynes Theory can be explained as:

1) **<u>Effective Demand:</u>** According to Keynes, the level of employment in the short run depends on aggregate effective demand for goods in the country. Greater the aggregate effective demand, the greater will be the volume of employment and vice versa. According to Keynes, the unemployment is the result of deficiency of effective demand. Effective demand represents the total money spent on consumption and investment. The equation is:

Effective demand = National Income (Y) = National Output (O)

The deficiency of effective demand is due to the gap between income and consumption. The gap can be filled up by increasing investment and hence effective demand, in order to maintain employment at a high level.

2) According to Keynes, the level of employment in effective demand depends on two factors:

(a) Aggregate supply function, and

(b) Aggregate demand function.

(a) Aggregate supply function:

1. According to Dillard, the minimum price or proceeds which will induce employment on a given scale, is called the 'aggregate supply price' of that amount of employment.
2. If the output does not fetch sufficient price so as to cover the cost, the entrepreneurs will employ less number of workers.
3. Therefore, different numbers of workers will be employed at different supply prices.
4. Thus, the aggregate supply price is a schedule of the minimum amount of proceeds required to induce varying quantities of employment.
5. We can have a corresponding aggregate supply price curve or aggregate supply function, which slopes upward to right.

(b) Aggregate demand function:

1. The essence of aggregate demand function is that the greater the number of workers employed, the larger the output. That is, the aggregate demand price increases as the amount of employment increases, and vice versa.
2. The aggregate demand is different from the demand for a product. The aggregate demand price represents the expected receipts when a given volume of employment is offered to workers.
3. The aggregate demand curve or aggregate demand function represents a schedule of the proceeds of the output produced by different methods of employment.

Significance of Keynesian Theory:

1. Keynes has given a new approach, i.e., **Macro-approach** to the field of economics. His theory has several names: theory of income and employment, demand-side theory, consumption theory, and macro-economic theory. In fact, he has brought about a revolution in economic analysis, often known as 'Keynesian Revolution'.

2. Keynes' theory has **completely demolished the idea of full-employment** and forwards the idea of under-employment equilibrium. He states that employment level in the economy can only be increased by increasing investment.

3. The **new economic tools and techniques** developed by Keynes have enabled the today's economists to draw correct conclusions on the economic situation of a country. Such tools are consumption function, multiplier, investment function, liquidity preference, etc.

4. Keynes has **integrated the theory of money with the theory of value and output.**

5. Keynes has first time introduced a **dynamic economic theory**, in order to depict more realistic situation of the economy.

6. He also states the reasons of excess or deficiency of aggregate demand through **inflationary and deflationary gap analysis**.

7. Keynes' theory is a general theory and therefore, can be **applied to all types of economic systems.**

8. Keynes **influenced on practical policies** and criticised the policy of surplus budget. He advocated deficit financing, if that sited the economic situation in the country.

9. Keynes has **emphasised on suitable fiscal policy** as an instrument for checking inflation and for increasing aggregate demand in a country. He advocated extensive public work programmes as an integral part of government programmes in all countries for expanding employment.

10. He **advised several monetary controls** for the central bank, which in turn will act as the instrument of controlling cyclical fluctuations.

11. Keynesian theory has played **a vital role in the economic development** of less-developed countries.

12. He **rejected the theory of wage-cut** as a means of promoting full-employment.

13. Keynes' theory has given rise to the **importance of social accounting or national income accounting.**

UNIT- V

New Industrial Policy of the Government: liberalization, deregulation and privatisation

The Industrial Policy specifies the relevant roles of the public, private, joint and co-operative sectors; small, medium and large scale industries. It emphasises the national significances and the financial development strategy. It also explains the Government's policy towards industries, their establishment, functioning, progress and management; foreign capital and technology, labour policy, and tariff policy. The Industrial Policy of India has determined the pattern of financial and industrial development of the economy. The Industrial Policy revealed the socio-economic and political philosophy of development (Gupta, 1995).

Main objectives of New Economic Policy -1991

The main objectives to launch new economic policy (NEP) in 1991 are as follows:

The main objective was to plunge Indian economy in to the field of 'Globalization and to give it a new drive on market orientation.

The new economic policy intended to reduce the rate of inflation and to remove imbalances in payment.

It intended to move towards higher economic growth rate and to build sufficient foreign exchange reserves.

New economic policy aimed to accomplish economic stabilization and to convert the economic policies in to a market economy by removing all kinds of unnecessary restrictions.

New economic policy wanted to permit the international flow of goods, services, capital, human resources and technology, without many restrictions.

In the mid-1991, the government has made some drastic changes in its policies bearing on trade, foreign investment exchange rate, and industry, fiscal of fairs. The various elements constitute an economic policy. It has been documented in literature that economic development ultimately depends on industrialization. Industrial policy is meant for all those principles, rules, regulations and procedures concerning the rate of growth, ownership, location pattern, and function of industrial undertakings in the country in a way to industrialization. Before independence, India had no policy for industrialization. In 1947, after independence, India has changed the scenario. The industrial policy was announced by government of India in 1948 and Industries act 1951 was passed to give a material shape to this policy. This policy was changed in 1956 to give a concrete policy. It was further altered to give shape to the mixed economy and ideology of socialist pattern of society. The political party, Janta Dal had modified the policy in 1977 (Pathak, 2007). Due to change in government, policy was again revised in 1980. The national front government brought some changes in its industrial policy in 1990. In the decade of 1990s, the government of India decided to deviate from its previous economic policies and learn towards privatization in order to come out from the economic crisis. In July 1991 when the devaluation of Indian currency took place and the government started announcing its new economic polices one after another (Gupta, 1995). Though these polices pertained to different aspects of the economic field, they had common some factors. The economic element was to orient the Indian system towards the world market. Government launched its new economic policy which has three important features such as Liberalization, Privatization and Globalization. Liberalization of the economy means to free if from direct or physical control imposed by the government. Economic changes were based on the assumption that market forces could guide the economy in a more effective manner than government (Pathak, 2007).

New Economic Policies: Liberalization, deregulation, Privatization

In 20th century, there has been a wave of economic policy transformations in the developing world, with one country after another taking the liberalization cure, often imposed by the international financial institutions. This wave of reform had been preceded by a quarter century of state directed effort at economic development, during which time the goals of economic self-reliance and import substitution industrialization were the trademarks of development strategies in developing countries. These goals seemed particularly justified, given the long experience of these countries with colonialism and the agricultural nature of their economies. However, all this seemed to be overtaken by the successive flow of liberalization (Gupta, 1995).

Liberalization:

Liberalization is vital element of contemporary economic policies in India and other part of world, based upon the idea that removing restrictions on domestic economic activity as well as on the trade relations with other countries that has a beneficial impact on the economy. Liberalisation is the procedure of release the economy from the dominion of excessive bureaucratic and other restrictions imposed by the State. The phrase “liberalization” infers economic liberalization. Economic liberalization constitutes one of the basic elements of the new Economic policy (NEP) which the Indian Government launched in the middle of the year 1991. Other significant aspects of the policy are Privatization of the public sector, Globalization and market friendly state. The main trust of the new economic policy is “liberalization”. The principle of this policy is that greater freedom is to be given to the businessperson of any industry, trade or business and that governmental control on the same be reduced to the minimum (Gupta, 1995).

The purpose of the liberalisation was to dismantle the excessive control framework that reduced the freedom of enterprise over the years, the country had developed a system of licence permit raj‘. The aim of the new economic policy was to save the businesspersons from unnecessary harassment of seeking permission from Babudom (the bureaucracy of the country) to start an undertaking. The main drive of the process to economic liberalization is to set business free and to run on commercial lines. The underlying conviction is that commerce and business are not matter to contain to fixed national boundaries. Unnecessary government restrictions which hamper economic and commercial activities and flow of goods and services must be removed. The liberalization aims to liberalize commerce and business and trade from the clutches of controls and difficulties.

Deregulation: Deregulation is heated issue for many government bureaucrats and giant businesses. Since last many decades, huge number of economies, both in developed and developing countries have deregulated their banking systems.

Concept of deregulation: Management studies have demonstrated that Deregulation is the procedure to eliminate or reduce state regulations. Every industry has definite rules and regulations that must follow. These rules are created by industry associations and regulators, as well as the government. Adekanye (2002) stated that the deregulation policy was adopted in 1987 against a crash in the international oil market and the reactant deteriorating economic condition in the country due to stringent policies in the financial sector. Adekanye indicated that the policy was adopted to achieve fiscal balance and balance of payment availability as well as liberation of the financial system by altering and restructuring the production and consumption pattern of the economy, eliminating price distortions, reducing the heavy dependency on crude oil export and consumer goods importation, enhancing the non-exports base and achieving sustainable growth.

Deregulation occurs when the government pulls back from the industry a bit, therefore loosening its grip on particular rules and regulations. Many research reports envisages that deregulation will lead to more firms and less obligatory power (Alesina et al. 2005), increases in average firm size and profits through reductions in capacity restrictions (Campbell and Hopenhayn 2005), increased dispersion in sales, assets, and profits (Syverson 2004), and increased turnover and firm-age distributions tilting toward younger firms (Asplund and Nocke 2006).

It has been explained in several management reports that deregulation is a fact where governments leave the market economy to the market forces and not stifle it and constrain it with numerous laws, rules, and regulations. Deregulation entails managing and supervising the economy in a manner that would largely be a hands off approach combined with oversight over its functioning related to legal and compliance aspects alone. Alternatively, deregulation means that the governments do not obstruct with the businesses in a day-to-day manner and act only when specific objections against businesses are brought before them. Most models of deregulation undertake that firms are able to proficiently assign resources within the firm and that factor markets are frictionless. Panagariya (2008) recorded that remnants of industrial regulation still impact the operation of Indian firms and may restrain their flexibility in adjusting to new economic circumstances. Deregulation also means that governments do not fix prices or put in motion price controls leaving the process of determining the optimal pricing to the market forces of demand and supply. Deregulation is a trend in emerging markets or the developing countries ever since the 1990s when these markets began to globalize their economies and open them up to foreign competition as well as liberalize their economies internally so that domestic firms are able to compete freely without the heavy hand of the state.

The purpose of deregulation is to permit a particular industry to raise greater competition, create a freer marketplace and expectantly enhance economic growth both within that marketplace and in general. When industries become deregulated, it gives industry's actors greater scope in which to improve their products, craft their brand and, ultimately, appeal more to customers.

Financial deregulation in India began in 1992, following the Indian economic crunch of 1991, and it is a vital element of the ongoing process of economic and structural transformation. In the Indian context, two forces can affect firm profits and determine the total impact of deregulation on firm size and profitability. First, free entry can lead to a rearrangement of factor resources from less efficient domestic firms to more efficient firms, such that revenue and size distributions become left truncated. Second, fast economic development can lead to an increase in market size, precipitating a rightward shift in the revenue distribution for the surviving domestic firms.

Privatization: Privatization is strongly related with the phenomena of globalization and liberalization. Management scholars described Privatization as the transfer of control of ownership of economic resources from the public sector to the private sector. It means a decline in the role of the public sector as there is a shift in the property rights from the state to private ownership. Privatization is a managerial approach that has fascinated the interest of many groups of people, academicians,

politicians, government employee companies of the private sector and public. It is observed that the public sector has several issues, since planning, such as low efficiency and profitability, mounting losses, excessive political interference, lack of autonomy, labour problems and delays in completion of projects. In order to overcome these issues, new industrial policy'1991, initiated the process of privatization into the Indian economy.
Another term for privatization is Disinvestment. The objectives of disinvestment were to raise resources through sale of PSUs to be directed towards social welfare expenditures, raising efficiency of PSUs through increased competition, increasing consumer satisfaction with better quality of goods and services, upgrading technology and most importantly removing political intervention.

Industrial policy

Phase-wise Developmental Performance of Indian Industries!

Indian industry has experienced major change both in its structure and growth since independence. The Indian industry growth experience can be divided into four different phases each of which is associated with different policy orientation.

The Second Phase of Deceleration (1965-66 to 1979-80):

The industrial growth experienced during the Second and the Third Five Year Plan periods could not be sustained. There are several reasons put forward for this downturn, which can be broadly classified into two broad categories, namely, the supply side constraints and the demand side constraints.

Supply Side Constraints:

In the first place there were some major disturbances caused by wars (with China in. 1962 and with Pakistan in 1965 and 1971), the draughts in 1965 and 1966 and the steep rise in oil prices in 1973 (first 'oil' shock). Second was the reduced availability of critical inputs for production like power, infrastructure and raw material. Imports became costlier and fluctuations in agricultural production adversely affected the agro-based industries.

Third was the organisational weakness due to which many industries fell sick. Many industries were functioning at sub-optimal capacity owing to poor inventory control and financial management. There were losses due to work stoppage, which adversely affected the production.

A fourth factor was the controls and regulatory measures. With improvement in the saving investment ratio the controls and regulatory measures had become restrictive in character acting as impediments to industrial growth.

Demand Side Constraints:

Among the demand side factor inhibiting industrial growth, the principle ones are the following. One was the declining demand due to policies of import substitution. For instance, till about the mid-196bs, industries were setup to replace imported goods. With time, the policies on this front resulted in the slowdown of industrial production. This affected the capital goods industries, as it was the import of these goods, which were replaced under the policy of import substitution initiated in the Second Plan.

Two, there was a decline in the growth of public sector investment resulting in a corresponding decline in the private sector investment. The gross fixed investment which grew at the rate of 12.2 per cent during the period 1951-66, came down steeply registering negative growth (-0.47 per cent) during the period 1966-72. Associated with this trend, there was a rise in the incremental capital-output radio for the industrial output. What it actually amounted to was that the relative share of material and depreciation cost per unit of output went up.

Three, the weak performance of agriculture adversely affected the demand for industrial goods. The slow growth in agricultural output, for many years since mid-1960s, resulted in a decline in the demand for the products of the industrial sector. To an extent, the terms of trade, favourable to agriculture, acted adversely for the industry.

Four, the small rise in the per capita income and the worsening of inequalities in income distribution also caused a slow-down in the demand for industrial goods. On the hand, there was a trend in the stabilisation of demand for consumer goods, particularly durable goods, owing to the small proportion of rich people in the country. On the other hand, large proportion of population with low buying power for industrial goods, were increasingly finding it difficult to keep up the pressure for industrial demand.

The Third Phase of Recovery and Revival (1980-81 to 1989-90):

The factors behind the resurgence of growth in the 1980s were exactly similar to those that contributed for its deceleration in the mid-sixties.

Empirical evidence, which pointed out to favourable trends included:

i. Improvement in the rate of growth (and pattern) of gross domestic capital formation in general and public investment in particular;

ii. Step-up in infrastructure investment and efficient management of the infrastructural facilities;

iii. Trends in the inter-sectoral terms of trade favouring the agricultural sector;

iv. Increase in the use of manufactured inputs in crop production;

v. Reforms in industrial and trade policies contributing to revival of growth in industrial output.

As a result of the above factors, there was an improvement in Total Factor Productivity which contributed significantly to growth in value added.

Two other factors, which contributed to the revival process are:
i. Role of technology and increased R and D activity and better access to imported technology under technical collaboration projects; and

ii. Massive flow of remittances from the middle east during 1974- 1980 resulting in large foreign exchange reserves which led to further liberalisation of imports.

Thus, from 1980 onwards, due to the above factors coupled with improvement in domestic political environment, industrial policy witnessed greater pragmatism.

This process was further assisted by factors like:
(i) a gradual loosening of controls,

(ii) greater freedom to import technology,

(iii) flow of foreign private capital facilitating modernisation of the manufacturing sector, etc.

Greater realism in policy-making also included;
(i) stepping up of public investment in infrastructure and energy production and

(ii) investment in rural development for diffusion of green revolution technology and for a 'direct' attack on poverty.

The 'second oil shock' was successfully met by increasing domestic oil production and import substitution in fertilisers in a short time. The second half of the 1980s also witnessed considerable de-licensing and relaxation of import controls facilitating up-graduation of industrial technology.

This was achieved by a greater reliance on the private corporate sector with fiscal incentives extended for stock market-based financing of industrial investment. Also, in the 1980s, many branches of manufacturing like automotive industry, cement, cotton spinning, food processing, and polyester filament yam, witnessed modernisation and expansion of scale of production.

As a result, industrial export growth also improved in the second half of the 1980s. Thus, the turnaround in the industrial output growth in the decade of 1980s is variedly attributed to liberalisation, improvement in public investment and private sector performance.

Foreign Direct Investment (FDI)

Foreign direct investment (FDI) is an investment from a party in one country into a business or corporation in another country with the intention of establishing a lasting interest. Lasting interest differentiates FDI from foreign portfolio investments, where investors passively hold securities from a foreign country. A foreign direct investment can be made by obtaining a lasting interest or by expanding one's business into a foreign country.

Methods of Foreign Direct Investment

As mentioned above, an investor can make a foreign direct investment by expanding their business in a foreign country. Amazon opening a new headquarters in Vancouver, Canada would be an example of this.

Reinvesting profits from overseas operations, as well as intra-company loans to overseas subsidiaries, are also considered foreign direct investments.

Finally, there are multiple methods for a domestic investor to acquire voting power in a foreign company. Below are some examples:

- Acquiring voting stock in a foreign company
- Mergers and acquisitions
- Joint ventures with foreign corporations
- Starting a subsidiary of a domestic firm in a foreign country

Learn more about mergers and acquisitions with CFI's mergers & acquisitions (M&A) modeling course!

Benefits of Foreign Direct Investment

Foreign direct investment offers advantages to both the investor and the foreign host country. These incentives encourage both parties to engage in and allow FDI.

Below are some of the benefits for businesses:

- Market diversification
- Tax incentives
- Lower labor costs
- Preferential tariffs
- Subsidies

The following are some of the benefits for the host country:

- Economic stimulation
- Development of human capital
- Increase in employment
- Access to management expertise, skills, and technology

For businesses, most of these benefits are based on cost-cutting and lowering risk. For host countries, the benefits are mainly economic.

Disadvantages of Foreign Direct Investment

Despite many benefits, there are still two main disadvantages to FDI, such as:

- Displacement of local businesses
- Profit repatriation

The entry of large firms, such as Walmart, may displace local businesses. Walmart is often criticized for driving out local businesses that cannot compete with its lower prices.

In the case of profit repatriation, the primary concern is that firms will not reinvest profits back into the host country. This leads to large capital outflows from the host country.

As a result, many countries have regulations limiting foreign direct investment.

Regulatory Bodies:

A **regulatory body** also called regulatory agency **is a public authority** or **a government agency which is accountable for exercising autonomous authority over some area of human activity in a regulatory or supervisory capacity.**

It is established by legislative act in order to set standards in a specific field of activity, or operations, in the private sector of the economy and to then implement those standards. Regulatory interventions function outside executive observation.

Because the regulations that they adopt have the force of law, part of these agencies' function is essentially legislative; but because they may also conduct hearings and pass judgments concerning adherence to their regulations, they also exercise a judicial function often performed before a quasi-judicial official called an administrative law judge, who is not part of the court system.

Some independent regulatory agencies perform investigations or audits, and some are authorised to fine the important parties and order certain measures.

The notion of the regulatory agency was initiated in the USA and it has been basically an American establishment. **The first agency was Interstate Commerce Commission (ICC), established by Congress in 1887 to control the railroads.**

It was stopped in 1996 but long served as the model of such an agency. Initially, the ICC was to serve only as an advisory body to Congress and the courts, but it was soon granted these powers itself. Furthermore, an independent commission could be unbiased and nonpartisan, a necessity for impartial regulation. The ICC was the first step taken to control industries instead of taking each on a case-by-case basis, as had been previously done.

The proclamation of governmental control in other industries led to the formation of many other regulatory agencies modelled upon the ICC, chief among these being the Federal Trade Commission (FTC, 1914), Federal Communications Commission (FCC, 1934), and Securities and Exchange Commission (SEC, 1934). Additionally, regulatory powers were convened upon the ordinary executive departments.

The functions of the FTC illustrate those of regulatory agencies in general. It supervises the packaging, labelling, and advertising of consumer goods. It applies broadly stated legislative policies to concrete cases of trade competition by a procedure patterned after that of the courts.

It grants licenses to those interested in export business. It also regulates collection and circulation of credit information. Regulatory agencies use a commission system of administration, and their terms of office are fixed and often very long.

All nations outside the USA, the role of regulatory agencies is taken by the regular administrative departments of government and, in the case of utilities and public transportation, often by means of state ownership.

Regulatory agencies are generally a part of the executive branch of the government, or they have statutory authority to execute their functions with oversight from the legislative branch. Their actions are generally open to legal review. Regulatory authorities are usually established to implement standards and safety, or to oversee use of public goods and regulate business.

Important Regulatory bodies are as under

1. Advertising Standards Council of India
2. Competition Commission of India
3. Biodiversity authority of India
4. Press Council of India
5. Directorate General of Civil Aviation

6. Forward Markets Commission
7. Inland Waterways Authority of India
8. Insurance Regulatory and Development Authority
9. Reserve Bank of India
10. Securities and Exchange Board of India
11. Telecom Disputes Settlement and Appellate Tribunal
12. Telecom Regulatory Authority of India
13. The Food Safety and Standards Authority of India (FSSAI)
14. Central pollution control board
15. Financial Stability and Development Council
16. Medical Council of India
17. Pension Fund Regulatory and Development Authority

The Finance Commission of India?

Finance Commission is a constitutional body for the purpose of allocation of certain revenue resources between the Union and the State Governments. It was established under Article 280 of the Indian Constitution by the Indian President. It was created to define the financial relations between the Centre and the states. It was formed in 1951.

functions of the Finance Commission of India

Functions of Finance Commission

The Finance Commission makes recommendations to the president of India on the following issues:

- The net tax proceeds distribution to be divided between the Centre and the states, and the allocation of the same between states.
- The principles governing the grants-in-aid to the states by the Centre out of the consolidated fund of India.
- The steps required to extend the consolidated fund of a state to boost the resources of the panchayats and the municipalities of the state on the basis of the recommendations made by the state Finance Commission.
- Any other matter referred to it by the president in the interests of sound finance.
- The Commission decides the basis for sharing the divisible taxes by the centre and the states and the principles that govern the grants-in-aid to the states every five years.
- Any matter in the interest of sound finance may be referred to the Commission by the President.
- The Commission's recommendations along with an explanatory memorandum with regard to the actions done by the government on them are laid before the Houses of the Parliament.
- The FC evaluates the rise in the Consolidated Fund of a state in order to affix the resources of the state Panchayats and Municipalities.
- The FC has sufficient powers to exercise its functions within its activity domain.
- As per the Code of Civil Procedure 1908, the FC has all the powers of a Civil Court. It can call witnesses, ask for the production of a public document or record from any office or court.

Advisory Role of Finance Commission

The recommendations made by the Finance Commission are of an advisory nature only and therefore, not binding upon the government. It is up to the Government to implement its recommendations on granting money to the states. To put it in other words, ‘It is nowhere laid down in the Constitution that the recommendations of the commission shall be binding upon the Government of India or that it would amount to a legal right favouring the recipient states to receive the money recommended to be provided to them by the Commission.

NITI AYOG

The Planning Commission which has a legacy of 65 years has been replaced by the **NITI Aayog**. The utility and significance of the Planning Commission had been questioned for long. The replacement seems to be more relevant and responsive to the present economic needs and scenario in the country.

Objectives of NITI Aayog

1. The active participation of States in the light of national objectives and to provide a framework ‘national agenda’.
2. To promote cooperative federalism through well-ordered support initiatives and mechanisms with the States on an uninterrupted basis.
3. To construct methods to formulate a reliable strategy at the village level and aggregate these gradually at higher levels of government.
4. An economic policy that incorporates national security interests.
5. To pay special consideration to the sections of the society that may be at risk of not profiting satisfactorily from economic progress.
6. To propose strategic and long-term policy and programme frameworks and initiatives, and review their progress and their effectiveness.
7. To grant advice and encourage partnerships between important stakeholders and national-international Think Tanks, as well as educational and policy research institutions.
8. To generate knowledge, innovation, and entrepreneurial support system through a shared community of national and international experts, etc.
9. To provide a platform for resolution of inter-sectoral and inter-departmental issues to speed up the accomplishment of the progressive agenda.
10. To preserve a state-of-the-art Resource Centre, be a repository of research on good governance and best practices in sustainable and equitable development as well as help their distribution to participants.
11. To effectively screen and assess the implementation of programmes and initiatives, including the identification of the needed resources to strengthen the likelihood of success.
12. To pay attention to technology improvement and capacity building for the discharge of programs and initiatives.
13. To undertake other necessary activities to the implementation of the national development agenda, and the objectives.