

SYLLABUS

B.Com II SEM (Hons.)

Subject – APPLIED ECONOMICS

UNIT – I	Introduction of economics: Meaning, definition of micro & macro economics. Demand analysis and supply analysis: Meaning type and law of demand, elasticity and price elasticity of demand, income elasticity of demand, law of supply, supply curve and price elasticity of supply.
UNIT – II	Cost and revenue analysis: Cost concepts, elements of cost, average and marginal cost curves, relationship between average and marginal cost, concept of revenue, revenue curve and relationship between average and marginal revenue. Market structures: Meaning and classification of markets, perfect competition, imperfect competition, monopolistic market, oligopoly market, and duopoly market.
UNIT – III	National Income: Meaning, definition and importance of national income, GNP & NNP, GDP & NDP, Per capita income. Theories of employment: Keynesian theory of employment, say's law of markers.
UNIT – IV	Trade Cycle and inflation: Trade cycles – meaning and definition, phases of trade cycle. Inflation – definition, types, causes and effects of inflation and measures to control inflation. Concept of globalization, Liberalization, privatization and its effects on Indian Economy.
UNIT – V	Banking, Stock market and Insurance: Functions of commercial banks, process of credit creation, reserve bank of India – Methods of credit control – Quantitative and qualitative methods. Concept of shares and Debentures, concept of SEBI, meaning, function and importance of stock markets, primary and secondary markets. Insurance: Types of insurance – Life Insurance and general insurance.

Definition of Economics

The term “Economics” was originally derived from the two Greek word “Oikos” which means household and “Nemein” which means management. Thus, it refers to managing of a household using the limited funds.

Wealth or classical Definition of economics

In this category, the definitions of economics as given by Adam Smith (1723-99) and his followers are included. Adam Smith, the father of modern economics, in his book ‘An Enquiry into the Nature and Causes of Wealth of Nations’ (1776) defined economics as the Science of Wealth.

1. “Economics is the science which treats of wealth.” **J.B. Say**
2. “Economics investigates the nature of wealth and the laws of its production and distribution.” **J.S. Mill**

Following are the main features of wealth definition:

1. Study of Wealth
2. Study of Material Goods Only
3. Study of Causes of Wealth
4. Study of Tangible goods only
5. Much Emphasis on Wealth

Wealth definition has been criticized on the following grounds -

1. Too Much Stress on Wealth
2. Only Material Goods.
3. Neglect of Human Welfare
4. Concept of Economic Man
5. Neglect of Means

Welfare or Neo classical Definition of economics

Prof. Marshall (1842 – 1924), in his book ‘Principles of Economics’ which was published in 1890, gave a material welfare definition of economics. In this definition, he gave more importance to human welfare in comparison to wealth

“The range of our enquiry becomes restricted to that part of social welfare that can be brought directly or indirectly into relation with measuring rod of money.” **Prof. Pigou**

According to **Prof. Cannon**, the aim of political economy is the explanation of the general causes on which the material welfare of human beings depends.”

Features – The main features of material welfare definitions are as follows-

1. Study of mankind
2. Study of Ordinary Business of Life Material Requisites Study of Real Man

Material welfare definitions deal with economics both as a science and an art. Economics is a science because it makes a systematic study of human activities relating to material welfare. It is an art because it tells us how to achieve the welfare of man and society.

Criticism of Welfare Definition

1. Study of All Types of Economic Activity and Men
2. Restricts the Scope of Economics.
3. Difficult to Measure Welfare
4. Economics is a Pure Science
5. Impracticable

Scarcity Definition or Science of choice making

Prof. Robbins not only criticized Marshall's definition but also gave his own definition which is known as scarcity definition. He gave this definition in his book 'an Essay on the Nature and Significance of Economic Science' which was published in 1932. According to his definition, economics studies those activities of human beings which they perform to obtain scarce means having alternative uses in order to satisfy their unlimited wants. Thus, economics studies human behavior as relationship between unlimited wants and scarce means which are capable of being alternatively used. Scarcity of means, in relation to unlimited wants, leads to the problem of making a choice, i.e., economic problem. Hence, economic problem is the central idea in Robbins' definitions.

Many economists like Stigler, Samuelson, Macfie, Oscar Lange, Sciovosky, have supported Robbins' definition of economics –

1. "Economics is fundamentally a study of scarcity and the problems which scarcity rise to." - **Stonier and Hagur**
2. "Economic is a science concerned with the administration of scarce resources." - **Scitovosky**

Features

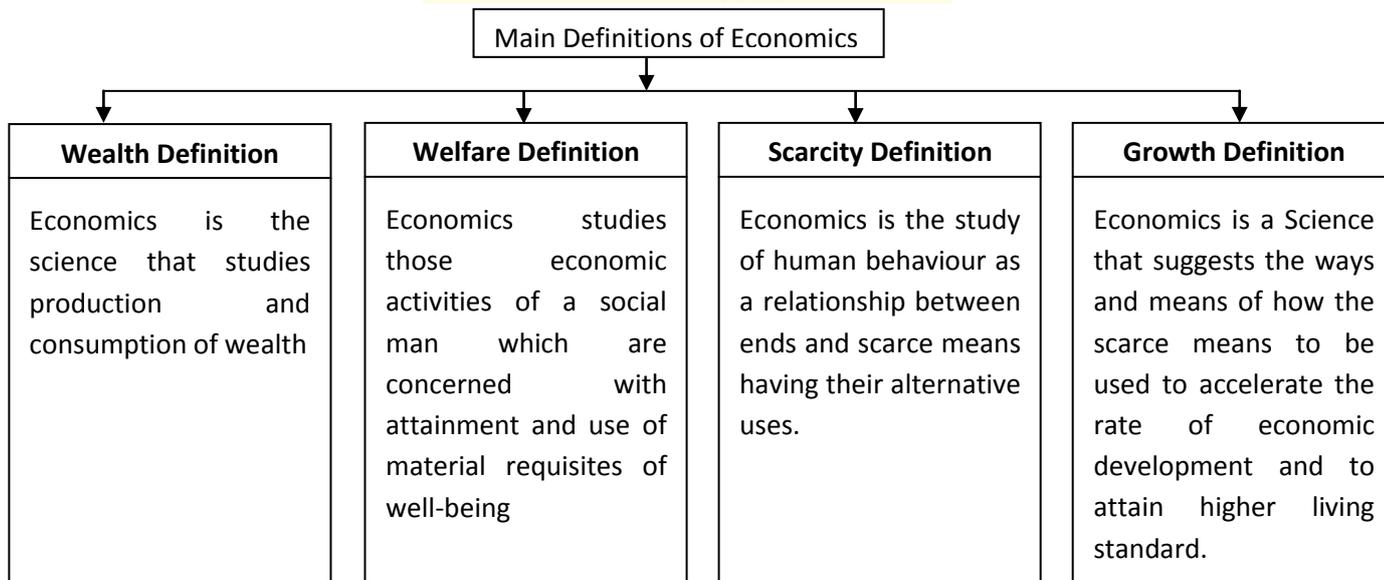
Following are the main features of Robbins' definition –

1. Economics is a Science
2. Human Behaviour
3. Unlimited Ends
4. Scarce Means
5. Alternative Uses of Means
6. Science of choice (or Science of Scarcity)

Criticisms

Though the definition given by Robbins is logical and scientific yet it has been criticized by several economists on the following grounds:

1. Prof. Robbins has contradicted himself by giving two different views. On the one hand, he regards economics as neutral between ends while, on the other, he considers economics as a science of choice.
2. If we accept neutrality of economics towards ends, then the study of economics will be of no use. We are interested only in that science which can help to solve our economic problems.
3. According to Robbins, economics is the study of all human activities which are related to the problem of choice. The problem of choice as such is faced not only by the social beings but also by the non-social beings like saints and smugglers. Their inclusion makes the scope of economics too wide to be explained.
4. Economic problems also originate from factors other than scarcity which Robbins as not brought to the surface. The great depression of 1929-33 has proved that economic problems may also arise due to abundance.
5. It is not applicable to rich countries where economic problems may be due to high incomes rather than scarcity.
6. According to Prof. Maurice Dobb, Robbins definition of economics is not applicable to socialist countries (like that of China) where economic activities are subject to government control and regulation.



Growth Definition

According to Prof. Samuelson, “Economics is the study of how man and society choose, with or without the use of money, to employ scarce productive resources, which could have alternative uses, to produce various commodities over time and distribute them for consumption now and in the future among various people and groups of society.”

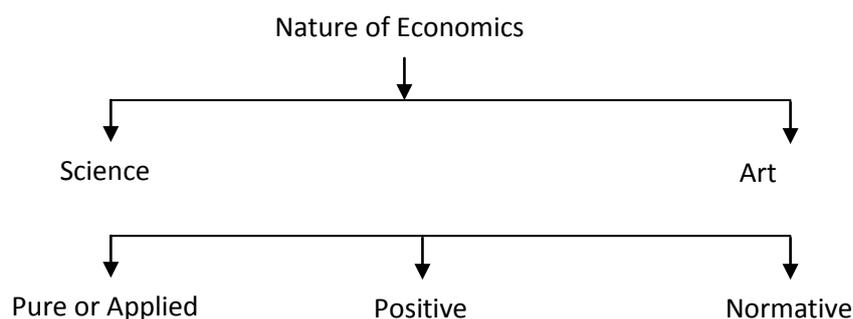
The main features of this definition are as follows –

1. Samuelson has emphasized the need of choice which arises due to unlimited wants and scarcity of resources.
2. Growth definition not only lays stress on the allocation of resources but also on their proper utilization so that more wants could be satisfied.
3. According to Samuelson, available resources should not only be used properly, but efforts should also be made to increase them as to satisfy ever increasing wants.
4. Economics is not only concerned with the identification of economic problems but it should also suggest ways and means to solve them.
5. It is a growth oriented definition which says that economics is concerned with determining the pattern of employment of scarce resources to produce goods over time. Thus, growth definition studies the problem of an economy not at a point of time but over a period of time. Thus, economics is not only concerned with the present pattern of consumption but also with future consumption.

In short, Samuelson’s definition of economics is the most comprehensive of all earlier definitions. It includes all the issues which were highlighted in the earlier definitions on the one hand, and the issues of economic development on the other.

Nature of Economics

Let us discuss the views of both and see exactly that economics is.



Economics as a Science

- 1) In simple words, a science is commonly defined as a systematic body of knowledge about a particular branch of the universe. This implies that a science is a study of a branch of learning and not of the whole universe.
- 2) In the opinion of Poincare who says – “A science is built upon facts as a house is built of stones.”
- 3) Applying this is to our subject, we find economics is built upon facts, examined and systematized by economists. Further, economics like other science deduce conclusion or generalizations after observing, collecting and examining facts. Thus, it deals with (i) observation of facts. (ii) Measurement (iii) Explanation (iv) Verification. In short, it formulates economic laws about human behaviour. In this way economics has developed into a science of making and possessing laws for itself.
- 4) Science economics satisfies all the tests of a science, economics is regarded as a full-fledged, science. In short, it is no way less than other sciences.

Marshall has rightly observed that –

“Economics is therefore a science pure and applied rather than a Science and an Art”.

The economics as a science can be divided into two parts i.e. (a) Positive Science and (b) Normative Science.

- I. **Economics as a Positive Science** – A positive science establishes a relation between cause and effect. It tells us that if we do a certain thing, same result will follow –
In the words of Prof. J.M. Keynes –
“A positive science may be defined as a body of systematized knowledge concerning what is a normative science or regulative science relating to the criteria of what it ought to be.”
- II. **Economics as A Normative Science** – Marshall, Pigou and historical school puts the arguments that economics is normative science.
According to Marshall –
“Economics is a normative science because it has a norm viz; welfare.”

In the opinion of Keynes,

“A normative science or regulative science is a body of systematized knowledge concerning with the criterion of ‘what ought to be’ and concerned with the deal distinguished from the factual.”

Therefore, a normative science describes what should be done and what should not be done.

From the above noted discussion, we can say that economics is both positive and normative science as at present, it deals with ‘what is’ and ‘what ought to be’. Therefore, it not only focuses why certain things happen, it also conveys whether it is the right thing to happen.

Economics as an art

Art is completely different from science.

- 1) In the words of Cossa – “A science teaches us to know; an art teaches up to do. In other words, science explains and expounds; art directs, art imposes precepts or proposes rules.” In other words, science is theoretical but an art is practical.
- 2) What is an Art? As J.M. Keynes has put it: “An art is a system of rules for the attainment of a given end”. The object of an art is the formulation of precepts applicable to policy. This implies that art is practical. Applying this definition of art, we can say it is an art. Its several branches like I consumption, production and public finance provide practical guidance to solve economic problems. Again for example the theory of consumption guides the consumer to obtain maximum satisfaction with his given income (means). In this sense, economics can be considered as an art in the wider sense of the term art i.e. in the sense of practical science. It means creation or practical application of knowledge. It is for this reason; we treat economics as an art.

In a nutshell, we can conclude the discussion that economics is both science and art.

Economics, Both a Science and an Art

- 1) Many economists do not consider Economics as an Art. They believe that its function is to merely investigate, explore and explain the various interrelated aspects and has to do nothing in solving the practical problems.
- 2) But the careful study shows that Economics does help in solving practical problems in several cases, and so has the practical utility also. Thus, it can rightly be said that Economics is a science as well as an art.

In the words of Pigou -

“Economics has given us light (i.e., knowledge) and also fruit it is light bearing (as such, it is a Science) and also fruit bearing (as such, it is an Art). Economics is not a science only or a art only, but it is both a science and an art.”

Practical uses of Economics

The main points of practical uses are discussed below -

1. Useful to the Consumer
2. Useful to the Producer
3. Helpful to Business Community
4. Solution to Economic Problems
5. Helpful to Workers
6. Helpful in Price Determination
7. Significant for Economics Development
8. Useful for Economic Planning
9. Useful for Social Workers
10. Helpful to Social Welfare Activities
11. Useful for All
12. Helpful in international Trade.

Definitions of Micro Economics

Different economists have defined micro economics as under -

According to A.P. Lerner - “Micro economics consists of looking at the economy through a microscope, as it were, to see how the millions of cells in the body of the individuals, or households as consumers, and the individuals or firms as producers-play their parts in the working of the whole economic organism.”

According to K.E. Boulding - ‘Micro economics is the study of particular firms, particular households, individual prices, wages, incomes, individual industries and particular commodities.’

According to Shapiro - “Micro economics deals with small parts of the economy.”

Importance or Usefulness of Micro Economics

In modern times, micro economics is very much significant. Its usefulness can be discussed as under -

1. Operation of an Economy
2. Efficient Use of Scarce Resources
3. Economic Welfare.
4. Managerial Economics
5. Predictions /Forecasting
6. Economic Policy making
7. Helpful in International Trade
8. Role of Applied Economics

Definitions of Macro Economics

- 1) **According to culberton's**-“Macro economic 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.

Importance or Usefulness of Macro Economics

The following factors highlight the importance of macro economics –

1. Functioning of an Economy
2. Behavior of Individual Units.
3. Indispensable for Accurate Knowledge
4. Economic Planning
5. Stud of National Income
6. Change in General Price Level

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

- 1) Actually micro and macro economics are interdependent. There is a two way relationships between the two. Macro economics in some spheres depends on micro economics. In fact, in recent years, micro foundations of macro economics have been greatly highlighted. On the other hand, micro economics too is dependent on macro economics in some crucial respects.
- 2) **Dependence of Macro economics on Micro economics.** The theories regarding the behaviour of some macroeconomic aggregates are derived from theories of individual behaviour. For instance, the theory of investment, which is a part and parcel of the macro economics theory, is derived from the behaviour of individual entrepreneur.
- 3) Micro economics theory contributes to macro economic theory in another way also. The theory of relative prices of products and factors is essential for explanation of the determination of general price level
- 4) **Dependence of Micro economics on Macro economics.** Not only does macro economics depend upon to some extent on micro economics, microeconomics also depends upon to some extent on macro

economics. The determination of the rate of profit and the rate of interest are well known micro economics topics, but they greatly depend upon the macro economics aggregates.

5) It follows that through micro economics and macro economics deal with different subjects, there is great interdependence between them. In the explanation of many economic phenomena, both micro and macroeconomic tools and concepts have to be applied.

MEANING OF DEMAND

Demand constitute three things as (i) desire for a commodity (ii) willingness to buy “The demand for anything at a given price is the amount of it which will be bought per unit of time at the that price.” According to Hansen, “By demand, we mean the quantity of a commodity that will be purchased at a particular price and not merely the desire of a thing.”

CLASSIFICATION OF DEMAND

The main classification types of demand are as under:

- 1. Price Demand:** Price demand refers to the various quantities of commodity which the consumer will buy per unit of time at a certain prices (other things remaining the same). The quantity demanded changes with the change in price. The quantity demanded increases with a fall in price and the quantity demanded falls with an increase in price. In other words, we can say that quantity demanded and price have a negative correlation as

$$D_A = f(P_A)$$

Where D_A = Demand for commodity A

f = Function

P_A = Price of the commodity A.

$P \uparrow$ $D \uparrow$

$P \downarrow$ $D \downarrow$

- 2. Income Demand:** Being **ceterus-paribus**, the income demand indicates the relationship between income and demand of the consumer. The income demand shows how much quantity a consumer will buy at different levels of his income. Generally, there is positive relationship between income and demand of the consumer i.e.

$$D_A = f(Y_A)$$

Where D_A = Demand for commodity A

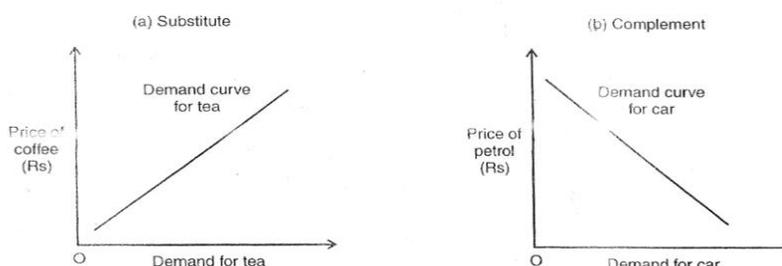
Y_A = Income of the consumer A.

$P \uparrow$ $D \uparrow$

$P \downarrow$ $D \downarrow$

The above function shows as the income of the consumer increases demand also increases and when income falls demand also decreases.

- 3. Cross Demand:** Cross demand refers to the relationship between quantity demanded of good ‘A’ and price to related good ‘B’ other things being equal. In simple words, from cross demand we mean the change in the quantity demanded of a commodity without any change in its price but due to the change in the price of related goods i.e. B commodity. The related goods can either be substitute goods or complementary goods. The demand curve in the case of substitute goods or complementary goods. The demand curve in the case of substitute will be of upward sloping while the demand curve in complementary goods will be of downward slope.



DETERMINANTS OF DEMAND

- 1) Price of the commodity
- 2) Price of substitutes and complementary goods.
- 3) Consumers' income.
- 4) Consumer's taste and preference.
- 5) Consumers' expectations of future prices
- 6) Demonstration effect.
- 7) Consumer-credit facility
- 8) Population of the country Distribution of national income

DEMAND SCHEDULE

Demand schedule refers to the response of amount demanded to change in price of a commodity. It summarizes the information on prices and quantity demanded. It is of two types.

1. Individual Demand Schedule
2. Market Demand Schedule

1. Individual Demand Schedule: Considering other things being equal individual demand schedule refers to the quantities of the commodities demanded by the consumer at various prices. It can be with the help of table 1:

Individual Demand Schedule

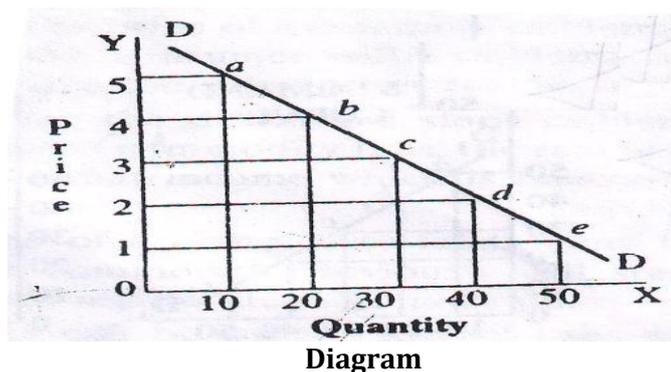
Price per unit of the bale	Quantity Demanded
5	1
4	2
3	3
2	4
1	5

From the above table it is seen that as the price per unit say cotton goes on increasing, the quantity demanded goes on falling. AS is clear, when price of cotton is Rs. 5, quantity demanded is 1 units. Now, the price of cotton falls to Rs. 3, the quantity demanded increases to 3 units. Moreover, as the price falls to Rs. 1 quantity demanded shoots upto 5 units.

Individual Demand Curve

Individual demand curve refers to the quantity demanded by the consumer at different levels of prices. It can be shown with the help of figure

In the figure given below OX axis measures the different quantities of cotton demanded on OY-axis price per unit cotton. DD is demand curve. The points a, b, c, d, e on the demand curve shows the price quantity relationship. At price Rs. 5 the quantity demanded is 1 units. As the price falls to Rs. 1 per unit, the quantity demanded increases to 5 units. Moreover, the demand curve slopes downward from left to right which indicates that there is inverse relation between price and quantity demanded.



Market Demand Schedule

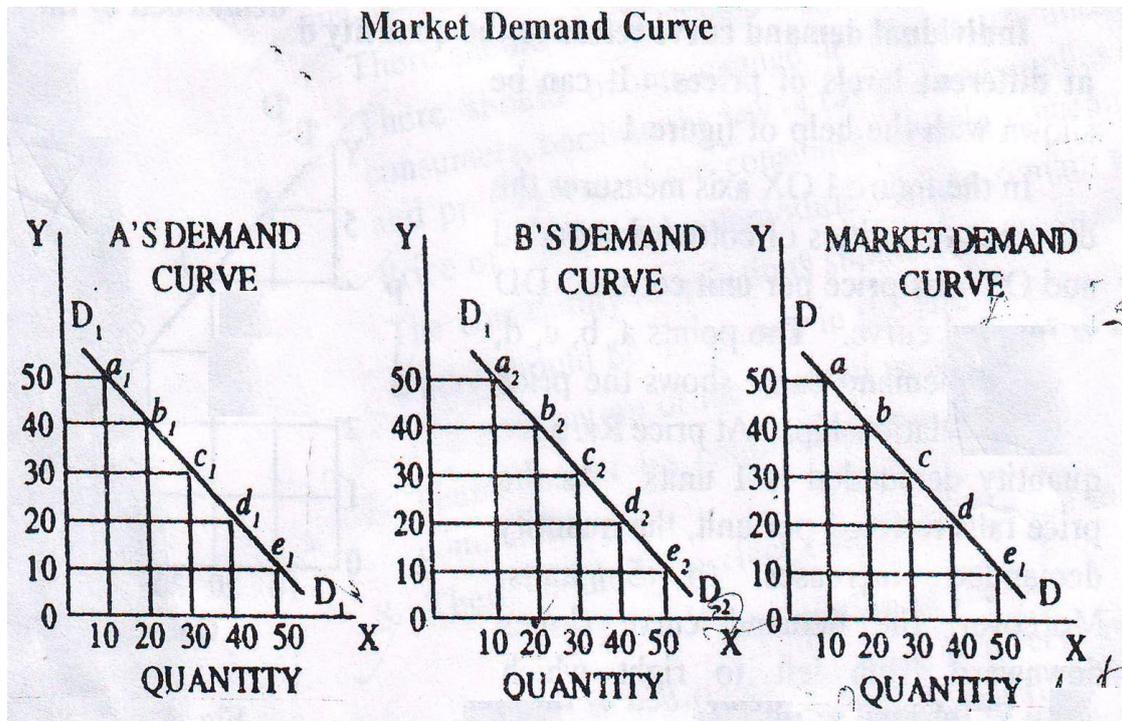
The market demand is the summation of collection demand of all persons of a homogeneous commodity. Basically, the market demand schedule-depicts the functional relationship between prices and quantity demanded. If we are interested to know the demand schedule for a year, we will add the demand for all the months of that particular year. In this way, we may conclude that market demand schedule is a lateral summation of the quantities purchased by all individuals at different prices in a particular period of time. Therefore, "Market demand schedule is defined as the quantities of a given commodity which all consumers will buy at all possible prices at a given moment of time." The market demand schedule is shown in table 2.

Market Demand Schedule

Price Per Unit	Quantity Demanded by A	Quantity Demanded by B	Total Market Demand (A + B)
5	10	15	25
4	15	20	35
3	20	25	45
2	25	30	55
1	30	35	65

In table 2, market schedule is obtained by adding the demand of A and B at different prices. For instance, at a price of Rs. 5 the market demand is 25 i.e. 10 of A consumer and 15 for B consumer. AS the price falls to Rs. 1 the market demand increases to 65 i.e. 30 and 35 for A and B consumers respectively. In other words, we can say that like individual demand, market demand also depicts the negative correlation between price and quantity demanded.

Market Demand Curve



The market demand curve is the horizontal summation of all individuals demand for the commodity. The above figure and B shows the individual demand curves. D_1 D_1 and D_2 D_2 are the demand curves for

consumers A and B and the market demand curve is DD. It is also assumed that there are two consumers in the market facing same price of the the commodity but they purchase according to their individual requirements.

A + B = Market Demand

At price Rs. 5 the market demand is

$a_1 + a_2 = a$

At price Rs. 4 the market demand is

$b_1 + b_2 = b$

In the same fashion, at prices 3, 2, 1, the market demand is

$c_1 + c_2 = c$

$d_1 + d_2 = d$

$e_1 + e_2 = e$

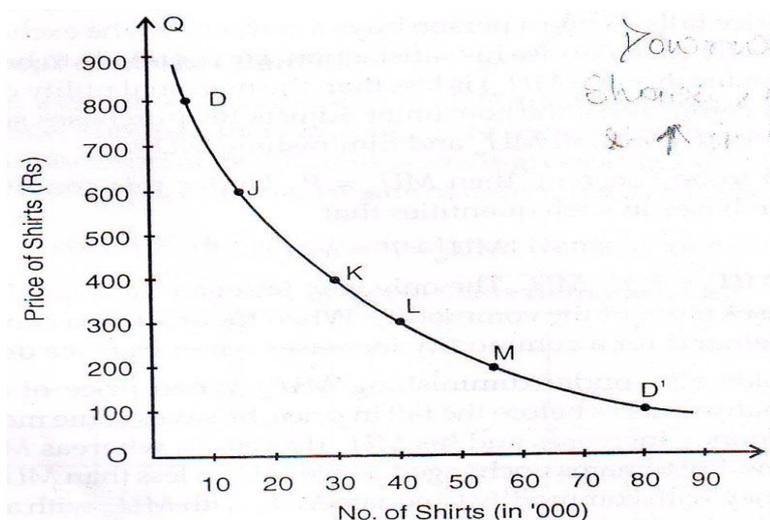
Now, if we combine these points we will get the market demand curve as DD.

Law of Demand

The law of demand states that there is inverse relation between the price and demand for a commodity. Although, this relationship is not proportionate yet it does not mean when price falls by one-half the demand for good will be doubled. It simply shows the direction of change in demand as a result of change in price.

THE DEMAND CURVE

A demand curve is a graphical presentation of the demand schedule. A demand curve is obtained by plotting a demand schedule. For example, when the data given in the demand schedule (Table) is presented graphically as in Fig. the resulting curve DD' is the demand curve. The curve DD' in Fig. depicts the law of demand. It slopes downward to the right. It has a negative slope. The negative slope of the demand curve DD' shows the inverse relationship between the price of shirt and its quantity demanded. It shows that demand for shirts increases with the decreases in its price and decreases with rise in its price. As can be seen in Fig. below , downward movement on the demand curve DD' from point D towards D' shows fall in price and rise in demand. Similarly, an upward movement from point D' towards D reads rise in price and fall in demand.



Why Demand Curve Slopes Downward to the Right

The Diagram for Demand Curve shows that demand curve slopes downward to the right. Why does it happen? The reasons behind the law of demand are following:

(i) Income effect. When price of a commodity falls, real income of its consumers increases in terms of this commodity. In other words, their purchasing power increases since they are required to pay less for the same quantity. According to another economic law, increase in real income (or purchasing power) increases demand for goods and services in general and for the goods with reduced price in particular. The increase in demand on account of increase in real income is called income effect.

(ii) Substitution effect. When price of a commodity falls, it becomes cheaper compared to its substitutes, their prices remaining constant. In other words, when price of a commodity falls, price of its substitutes remaining the same, its substitute becomes relatively costlier. Consequently, rational consumers tend to substitute cheaper goods for costlier ones within the range of normal goods- goods whose demand increases with increase in consumer's income-other things remaining the same. Therefore, demand for the relatively cheaper commodity increases. The increase in demand on account of this factor is known as substitution effect.

(iii) Diminishing marginal utility. Marginal utility is the utility derived from the marginal unit of a commodity when its price falls. When a person buys a commodity, he exchanges his money income with the commodity in order to maximize his satisfaction. He continues to buy goods and services so long as marginal utility of his money (Mu_m) is less than the marginal utility of the commodity (Mu_c). $Mu_m < Mu_c$ with a view to maximizing his satisfaction. Consequently, demand for a commodity increases when its price falls.

Assumptions in the law of demand

According to Stigler and Boulding, the law of demand is based on the following assumptions:

1. There should be no change in the income of the consumers.
2. There should be no change in the tastes and preferences of the consumers, because the law of the demand applies only when the tastes and preferences of the consumers remain constant.
3. Price of the related commodities should remain unchanged.
4. The commodity in question should be a normal one.
5. There should be no change in the size of population.
6. There distribution of income and wealth should be equal.
7. There should be continuous demand except in case of indivisible commodities.
8. There should be perfect competition in the market.

Importance of the Law

The law of demand has been of great theoretical and practical importance in economics as:

1. Price Determination.
2. Importance for the consumer
3. Importance to Finance Minister
4. Important for Planning.
5. Important for Producers
6. Importance for Farmers

EXCEPTIONS TO THE LAW OF DEMAND

The law of demand is one of the fundamental laws of economics. The law of demand, however, does not apply to the following cases:

- (i)** Expectations regarding future prices.
- (ii)** Prestigious goods.
- (iii)** Giffen goods.

Price elasticity of demand

(PED or E_d) is a measure used in economics to show the responsiveness, or elasticity, of the quantity demanded of a good or service to a change in its price. More precisely, it gives the percentage change in

quantity demanded in response to a one percent change in price (holding constant all the other determinants of demand, such as income). It was devised by Alfred Marshall.

$$\text{Price elasticity of Demand} = \frac{\text{Proportionate change in purchases of commodity X}}{\text{Proportionate change in price of commodity X}}$$

Types/Degrees of Price Elasticity of Demand

The concept of price elasticity of demand can be used to divide the goods in to three groups.

(i) Elastic. When the percent change in quantity of a good is greater than the percent change in its price, the demand is said to be elastic. When elasticity of demand is greater than one, a fall in price increases the total revenue (expenditure) and a rise in price lowers the total revenue (expenditure).

(ii) Unitary Elasticity. When the percentage change in the quantity of a good demanded equals percentage in its price, the price elasticity of demand is said to have unitary elasticity. When elasticity of demand is equal to one or unitary, a rise or fall in price leaves total revenue unchanged.

(iii) Inelastic. When the percent change in quantity of a good demanded is less than the percentage change in its price, the demand is called inelastic. When elasticity of demand is inelastic or less than one, a fall in price decreases total revenue and a rise in its price increases total revenue.

Methods to measure Price Elasticity of demand

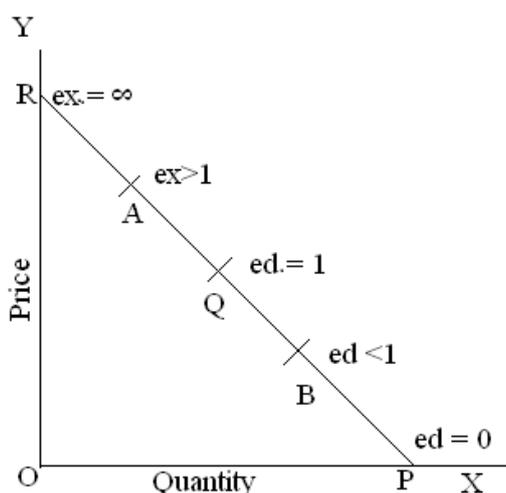
There are three methods of measuring price elasticity of demand:

- (1) Total Expenditure Method.
- (2) Geometrical Method or Point Elasticity Method.
- (3) Arc Method.

Point Method or Geometrical Method:

This method was also suggested by Alfred Marshall. It explains the elasticity of demand at a particular point of the demand curve if the demand function is linear one (or when demands curve is straight line sloping down from left to right). The point method is not applicable on curvilinear demand curves. This method is based on the proposition that each point of the straight line demand curve has different elasticity of demand. Different elasticity of demand. We have already shown (under the heading slope and elasticity) that every point on demand curve does not have the same elasticity. This has been explained by point method, also known as Geometrical Method. The basic formula for this method is :

$$E_p = \frac{\text{Length of Lower segment}}{\text{Length of Upper segment}}$$



Now we can calculate elasticity of demand at different points R,A,Q, B and P, As per the ratio of the lower part to upper part.

$$e_p \text{ at } Q = \frac{QP}{QR} = 1$$

$$e_p \text{ at } A = \frac{AP}{AR} < 1$$

$$e_p \text{ at } B = \frac{BP}{RB} > 1$$

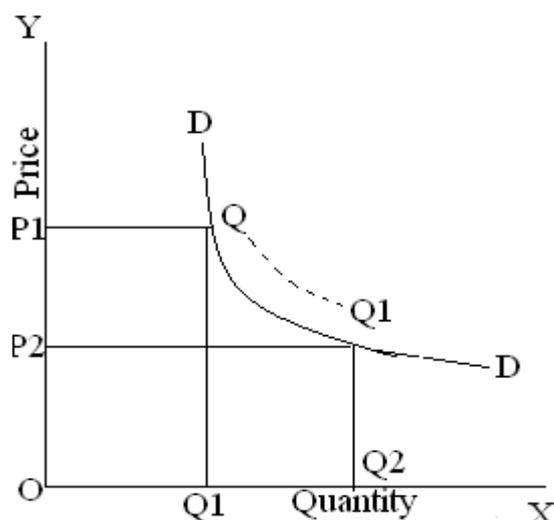
$$e_p \text{ at } R = \frac{RP}{0} = \infty$$

$$e_p \text{ at } P = \frac{0}{RP} = 0$$

Therefore, we can say that at the mid-point on a straight line demand curve, elasticity will be unitary, at higher points (such as A and R) elasticity will be greater than one; at lower points (B and P) the elasticity will be less than one. At points R and P the elasticities will be infinite and zero respectively. Point method is very useful in economics. It helps us measuring elasticity with very small changes in price and quantity demanded. It also tells us that slope and elasticity are two different things.

Arc Method:

As we have seen that point elasticity method can be used to determine the elasticity of demand at different points when infinitesimal changes in price are taking place. If the price change is somewhat large or we have to measure elasticity between two different points rather than at a specific point we use Arc Method. When we have to measure the price elasticity over an arc of the demand curve, such as between points Q and Q1 on the demand curve in figure the point elasticity method cannot yield true picture. In measuring arc elasticity we use the average of the two prices and average of two quantities at these prices in the following manner.



Suppose commodity X's position is like this- At price of Rs. 10 (P1) its, quantity demanded is 100 (Q1) and at price of Rs. 5 (P2) its quantity demanded is 300 (Q2). The elasticity of demand as per Arc Method will be

$$\begin{aligned}
 ed &= \frac{\Delta q}{\Delta p} \times \frac{p_1+p_2}{q_1+q_2} \\
 &= \frac{200}{5} \times \frac{10+5}{300+100} \\
 &= \frac{200}{5} \times \frac{15}{400} = 1.5
 \end{aligned}$$

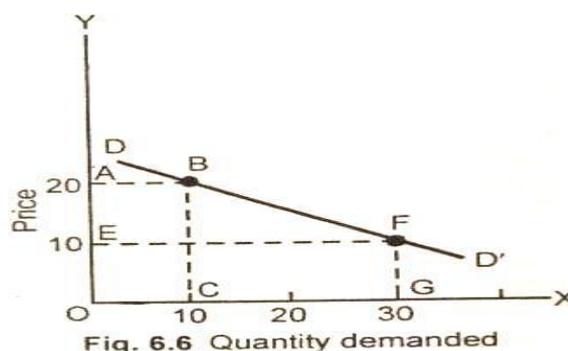
Total Expenditure Method/Total Revenue Method:

The price elasticity can be measured by noting the changes in total expenditure brought about by changes in price and quantity demanded.

(i) When with a percentage fall in price, the quantity demanded increases so much that it results in the increase in total expenditure, the demand is said to be elastic ($E_d > 1$).

For Example:

Price Per Unit (Rs.)	Quantity Demanded	Total Expenditure (Rs.)
20	10 Pens	200.0
10	30 Pens	300.0



Income elasticity of demand

Income elasticity of demand measures the percentage change in demand caused by a percent change in income. A change in income causes the demand curve to shift reflecting the change in demand. IED is a measurement of how far the curve shifts horizontally along the X-axis. Income elasticity can be used to classify goods as normal or inferior. With a normal good demand varies in the same direction as income. With an inferior good demand and income move in opposite directions

Income Elasticity = Proportionate change in the quantity purchased / Proportionate change in Income

CROSS ELASTICITY OF DEMAND

Cross price elasticity of demand measures the percentage change in demand for a particular good caused by a percent change in the price of another good. Goods can be complements, substitutes or

unrelated. A change in the price of a related good causes the demand curve to shift reflecting a change in demand for the original good. Cross price elasticity is a measurement of how far, and in which direction, the curve shifts horizontally along the x-axis. A positive cross-price elasticity means that the goods are substitute goods.

Cross elasticity of Demand for X and Y = $\frac{\text{Proportionate change in purchases of commodity X}}{\text{Proportionate change in price of commodity Y}}$

The numerical value of cross elasticity depends on whether the two goods in question are substitutes, complements or unrelated.

Types of Cross Elasticity

(i) Substitute Goods. When two goods are substitute of each other, such as coke and Pepsi, an increase in the price of one good will lead to an increase in demand for the other good. The numerical value of goods is positive.

For example there are two goods. Coke and Pepsi which are close substitutes. If there is increase in the price of Pepsi called good y by 10% and it increases the demand for Coke called good X by 5%, the cross elasticity of demand would be:

$$E_{xy} = \% \Delta q_x / \% \Delta p_y = 0.2$$

Since E_{xy} is positive ($E > 0$), therefore, Coke and Pepsi are close substitutes.

(ii) Complementary Goods. However, in case of complementary goods such as car and petrol, cricket bat and ball, a rise in the price of one good say cricket bat by 7% will bring a fall in the demand for the balls (say by 6%). The cross elasticity of demand which are complementary to each other is, therefore, $6\% / 7\% = 0.85$ (**negative**).

(iii) Unrelated Goods. The two goods which are unrelated to each other, say apples and pens, if the price of apple rises in the market, it is unlikely to result in a change in quantity demanded of pens. The elasticity is zero of unrelated goods.

SUPPLY AND ELASTICITY OF SUPPLY

Meaning of Supply

Supply means the quantities of goods which are offered for sale at particular prices during a given period of time. Thus, the supply of a commodity may be defined as the amount of that commodity which the sellers (or producers) are able and willing to offer for sale at a particular price during a certain period of time.

Factors Affecting Supply

The determinants of supply, other than price, are as follows:

- 1) Price.
- 2) Prices of related goods.
- 3) Objectives of producer
- 4) Infrastructure
- 5) The cost of factors of production
- 6) The State of Technology
- 7) Factors Outside the Economic Sphere. Weather conditions, floods and droughts, epidemics etc.
- 8) Tax and Subsidy

Statement of the Law

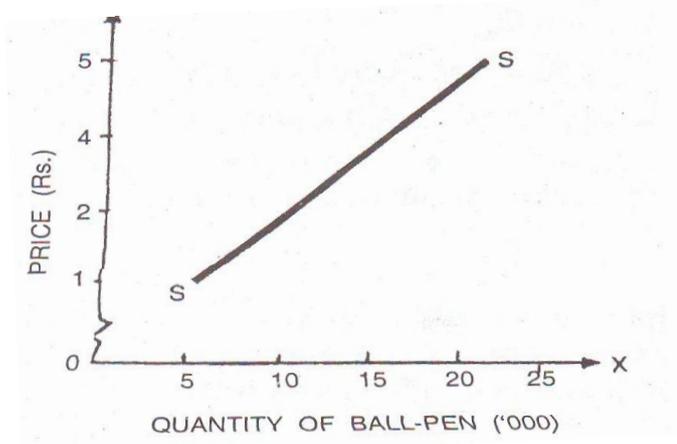
Law of supply may be stated as "Other things remaining unchanged, the supply of a commodity expands (i.e., rise) with a rise in its price, and contracts (i.e. falls) with a fall in its price." The law, thus, suggests that the supply varies directly with the changes in price. So, a larger amount is supplied at a higher price than at a lower price in the market.

Explanation of the Law

The law can be explained and illustrated with the help of a supply schedule as well as supply curve, based on imaginary data, as follows see table and figure given below. When the data of Table are plotted on a graph, a supply curve can be drawn as shown in Figure. From the supply schedule it appears that the market supply tends to expand with a rise in price and vice versa. Similarly, the upward sloping curve also depicts a direct co-variation between price and supply.

TABLE : Market Supply Schedule

week)	Price of a ball pen (Rs.)	Quantity Supplied (in 000 per
1	1	5
2	2	10
3	3	15
4	4	20
5	5	25

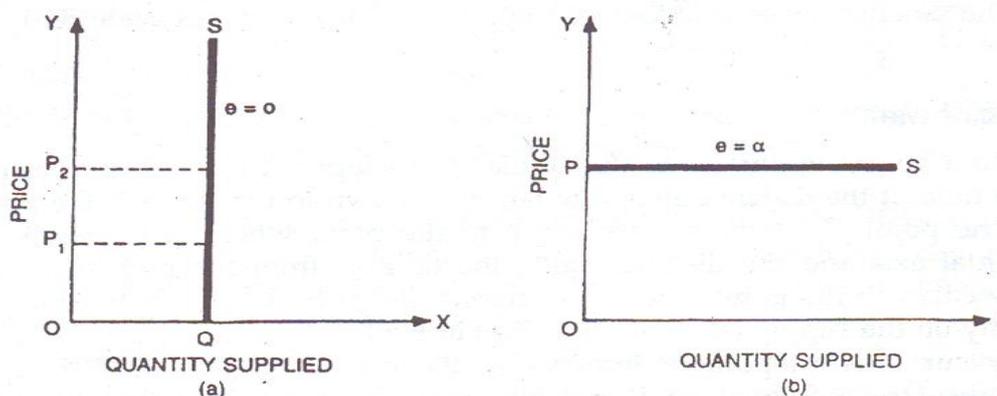


Elasticity of Supply

Elasticity of supply may be defined as the ratio of the percentage change or the proportionate change in quantity supplied to the percentage or proportionate change in price. In symbolic terms;

$$E_s = \frac{\Delta q}{\Delta p} \times \frac{p_1}{q_1}$$

Where e_s represents elasticity of supply, Q stands for quantity supplied, P for price and the symbols indicates a change.



There are various degrees of elasticity of supply. It may be relatively elastic, relatively or may have perfect elasticity or inelasticity. Different types of supply elasticities have been illustrated in Figure

The panel (a) of Fig. represents the supply curve of zero elasticity. Irrespective of the price, the producer would be supplying OC quantity ($e_s = 0$). The panel (b) represents the supply curve of infinite elasticity, at OP price the producer would be supplying any amount of the commodity ($e_s = \infty$)

**UNIT-II
COST CONCEPTS**

Cost may be defined as price paid for different factors of productions involved in producing certain commodities.

ELEMENTS OF COST

(1) Money Cost:- It is the cost which is expressed or calculated in monetary terms and is based on accountant's point of view.

Money cost has three elements:-

- (a) **Explicit Cost:** - Cost consist of all the payments made on basis of contract to various factors of production employed by a firm namely prices paid for raw materials, rent, wages, salaries etc.
- (b) **Implicit Cost:** - Payment made to owned factors of production like owned capital, owned labour etc are called implicit cost. These factors of production are personally owned by the producer/ firm used for the business purpose.
- (c) **Normal Cost:** - It is the minimum profit a firm should get in order to remain in an industry. It is over explicit and implicit cost of a firm.

Money Cost = Explicit cost+ Implicit Cost + Normal Profit

(2) Real Cost:- This type of cost is calculated by a sociologist. He is concerned with pains, sacrifices and efforts made by the society in production of a commodity.

(3) Opportunity Cost:- It is also called alternative cost or transfer cost. Opportunity cost is the cost sacrificed for one alternative for obtaining the next best possible alternative. For ex. Commodity x is produced by sacrificing the production of y commodity so opportunity cost of x will be the cost of production of y commodity.

(4) Direct Cost And Indirect Cost :- Direct cost is the cost directly concerned with the production of commodity. ex:- Cost on raw material, wages, fuel etc. where as indirect cost is the cost which is not directly concerned with the production of commodity. For ex: supervision, administration cost, rent, office overheads etc.

(5) Incremental Cost And Sunk Cost:- Cost incurred when a business firm changes its business activities or nature of business operation is called on incremental cost.

Incremental Cost = Changed total cost - Initial total cost

Sunk cost are those cost which are not affected by the changes in the level of business activity or nature of business firm. These costs once incurred cannot be recovered easily.

Ex.:- Depreciation

(6) Fixed Costs And Variable Costs:- Fixed cost are those costs which are fixed whether production is being carried or not. Variable cost are those costs which vary with the change in production process. If there will be no production these costs will not incurred.

(7) Short Run And Long Run Costs_:- Short run cost are those which are concerned with short run production of a firm i.e. fixed cost and variable costs.

Long run cost are concerned with long run production of a firm where all factors of production are variable and all cost are variable costs.

COST - OUTPUT RELATION DURING SHORT RUN

During short run time period two types of factors of production are employed under which one is fixed factor an others are variable factors of production. Raw material, semi finished material, unskilled labour, energy etc are variable inputs which can be changed during short run, Machines, Capital, Infrastructure, Salaries of managers etc are fixed inputs.

SHORT RUN COST

1. Total Fixed Cost (TFC):- Those cost which remain constant when the output is zero as well as it does not increases with increase in production are called total fixed cost (TFC).

For Ex:- Plant, Land, Building, Machinery, Tools, Equipments, Insurance, Salaries of manager etc.

2. **Total Variable Cost (TVC):-** Those costs vary with the production of a commodity during short period and have direct relation with the change in production a called total variable costs (TVC). These costs are also called prime cost are direct costs. It increases with increase in production of output.
3. **Total Cost:-** Aggregate of total fixed cost and total variable cost increased by a firm in the production of any commodity is called total cost.
 Total cost (TC) = Total Fixed cost + Total Variable Cost (TVC)
 Total cost increases with change in output.

AVERAGE OR PER UNIT COST

1. **Average Fixed Cost:-** Average fixed cost is total fixed cost divided by the volume of output. AFC has inverse relation with output and it decreases with increase and increases with decrease in output. AFC curve in rectangular hyperbola in shape.
 $AFC = TFC / \text{Output}$
 i.e. $\frac{\text{Total Fixed Cost}}{\text{Output (in Units)}}$
2. **Average Variable Cost (AVC):-** Average variable cost is total variable cost divided by the volume of output. AVC falls with increase in output reaches its minimum and then starts rising. It is due to operation of law of returns. Shape of AVC curve is U shaped because of operation of law of returns where at 1st stage i.e. during law of increasing returns production rises and cost decreases then at 2nd stage i.e. laws of constant & diminishing returns cost reaches at minimum and remains constant and at 3rd stage i.e. law of negative returns cost starts increasing.
 $AVC = TVC / \text{Output}$
 i.e. $\frac{\text{Total Variable Cost}}{\text{Output (in Units)}}$
3. **Average Costs (AC):-** Average cost or average total cost (ATC) is the aggregate of AFC & AVC.
 $AC = TC / \text{Output}$ i.e. = Total cost / Output Or $AC = AFC + AVC$
 AC curve decreases with increase in output remains constant up to a point and then increases with increase in output.
4. **Marginal Cost (MC):-** Marginal cost is additional cost incurred in producing an additional unit of output.
 $MC = \Delta TC / \Delta \text{Output}$
 Marginal cost changes with the change in AVC and is independent of fixed cost. MC falls in beginning reaches at its minimum and there after rises. MC is also a U shaped curve.

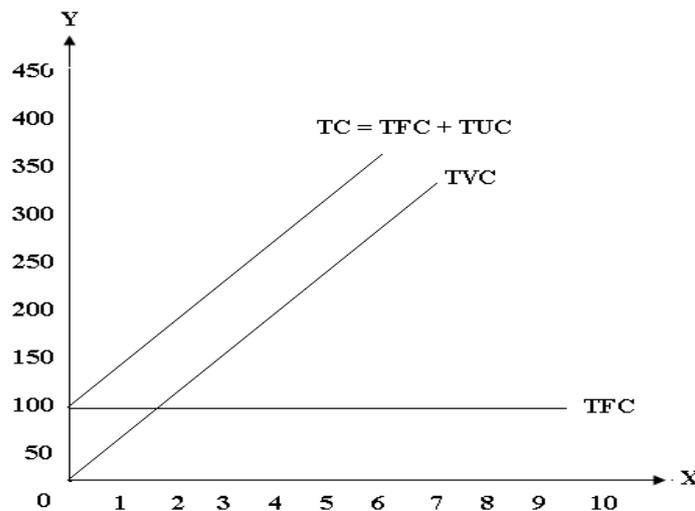
Output	Total Cost			Average Costs			
	TFC	TVC	TC	AFC	AVC	AC	MC
0	100	0	100	0	0	0	---
1	100	30	130	100	30	130	30
2	100	60	160	50	30	80	30
3	100	80	180	33.3	26.7	60	20
4	100	90	190	25	22.5	47.5	10
5	100	100	200	20	20.0	40.0	10
6	100	120	220	16.66	20.0	36.6	20
7	100	150	250	14.3	21.4	35.7	30
8	100	190	290	12.5	23.7	36.2	40
9	100	240	340	11.1	26.6	37.7	50
10	100	320	420	10	32.0	42.0	80

In above table TFC remains constant and TVC goes on increasing and TC is also increasing with increase in output. AFC is decreasing with increase in output. AVC decreases reaches to minimum and then increasing. AC decreases reach to minimum and then increase. MC decreases reach to minimum remains constant and then increases.

DIAGRAM 1st

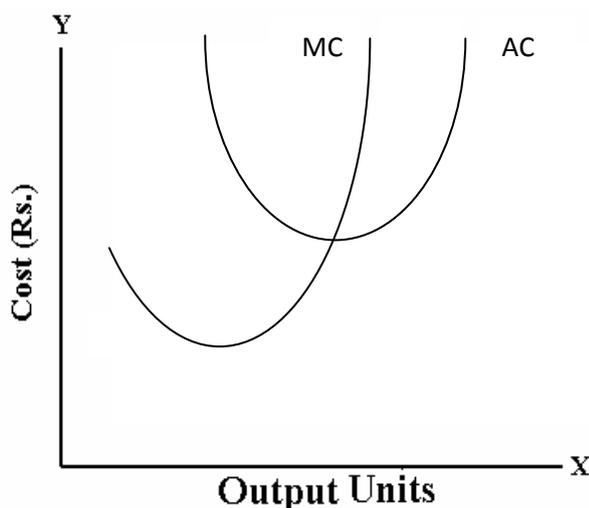
Output (In Units)

TFC remains constant weathers production is zero or 10units. TVC starts from 0 units and increases with increase in output. TC is the total of TVC and TFC.



AC, MC and AVC are U shaped curves because of the operations of law of returns. AFC curve shows a decreasing trend. MC curve passes through minimum point, point of AC and AVC.

RELATIONSHIP BETWEEN AC AND MC



- (1) AC and MC fall in beginning but MC falls more rapidly than AC and MC is below AC or vice versa (AC > MC).
- (2) When AC rises MC also rises but rises rapidly than AC and MC is more than AC or vice versa.(MC > AC)
- (3) When AC is minimum it is equal to MC curve cuts AC curve at its minimum point.(MC=AC)

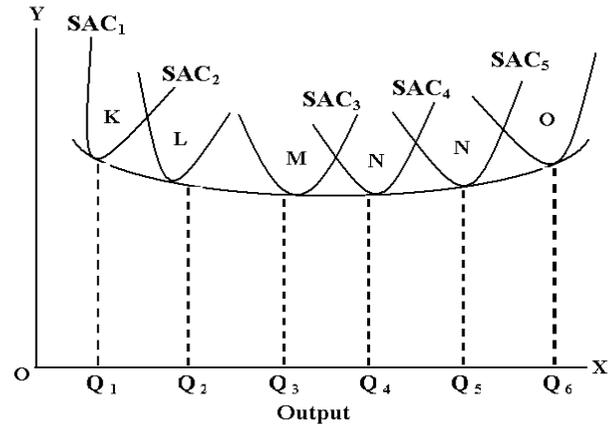
COST OUTPUT RELATION DURING LONG RUN

Long period gives sufficient time to business managers to change even the scale of production. All the factors of production are variable. All cost are variable and there is no fixed cost. In long run there is long run average cost curve and long run marginal cost curve.

Long Run Total Cost (Ltc) :- The long run total cost of production is the least possible cost of producing any given level of output when all inputs are variable.

Long Run Average Cost (Lac):- Long run average cost curve shows the lowest average cost of producing output when all inputs can be varied. LAC is also known by following names:-

- (1) **Envelope Curve**:- LAC is also known as envelop curve because it envelopes all the SAC curves. It indicates that LAC cannot exceed SAC and it will be surrounding the SAC, and does not rise upwards. Long run cost cannot be more than than short run cost.
- (2) **Planning Curve**:- Lac is also known as planning curve as firm or a producer can decide that which plant size should be used to produce different quantities of output so that production is done at minimum cost .Usually rational



produce selects plant size where LAC is at its minimum for the output production.

In above fig. LAC is shown which is tangent to all SAC curves.

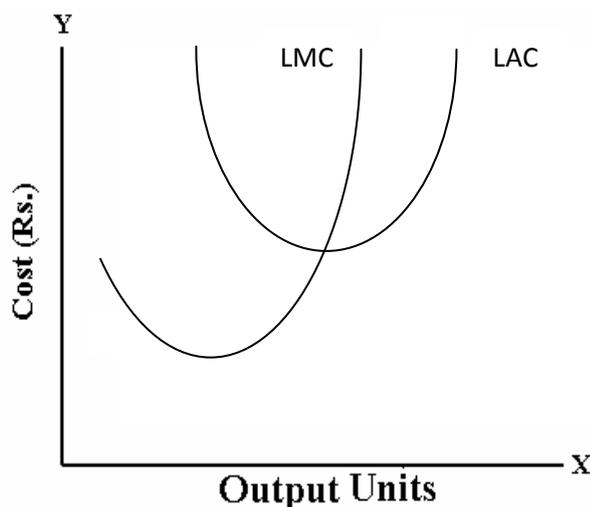
In order to produce OQ3 level of output corresponding point an LAC is K which is tangent to SAC₁ and therefore.

LONG RUN MARGINAL COST (LMC)

Long - run marginal cost curve is that which shows the extra cost incurred in producing one more unit of output when all inputs can be changed.

$$LMC = \frac{\Delta LTC}{\Delta Q}$$

RELATION BETWEEN LAC AND LMC



Relation between long-run marginal cost and long-run average cost is similar to that of what it is in short run AC and MC. The only difference in long run AC and MC is that long run MC and AC curve are more flat than that of SAC and SMC, it is so because in long run all factors of production are variable and firm selects appropriate scale of production at minimum cost so cost increase in long run is gradual in comparison to short run curves. LAC is also an expanded U Shaped curve because of operation of laws of returns to scale.

As firm expands their output scale of operation also increases by firm so they will enjoy economies of scale but if these firm produce beyond their installed capacity of scale that results in increase in cost gradually.

CONCEPTS OF REVENUE

In economics revenue is studied in terms of total revenue (TR), Average revenue (AR) and marginal revenue (MR).

Total Revenue:- Total revenue is the total money receipts of a firm or producer with sales of its output.

$$TR = Q \times P$$

i.e. quantity of goods sold x price per unit.

Average Revenue:- It is average price per unit of sale of output. It is also called. Price per unit of output.

$$AR = TR / Q$$

i.e. total revenue / No. of output sold.

Marginal Revenue:- It is an addition to the total revenue when an additional unit of output is sold by a firm.

$$MR = \frac{\Delta TR}{\Delta Q}$$

or

$$MR = \frac{TR_n - TR_{n-1}}{Q_n - Q_{n-1}}$$

ΔTR = Change in Total Revenue
 ΔQ = Change in Output
 TR_n = Total Revenue of n products
 TR_{n-1} = Total Revenue of n-1 products.

INTER RELATIONSHIP AMONG CONCEPTS OF REVENUE

Units of output sale	Price per units (Rs.)	TR	AR	MR
1	12	12	12	12
2	11	22	11	10
3	10	30	10	8
4	9	36	9	6
5	8	40	8	4
6	7	42	7	2
7	6	42	6	0
8	5	40	5	-2

Table shows that with increase in output unit sale price per unit decreases and TR increases reaches to maximum remains constant and declines. AR falls with every unit of output sold and is equal to price. MR will also decrease at increasing rate reaches to 0 and then becomes negative. AR and MR is decreasing but AR is positive and MR has three trends decreases, becomes zero and negative. Fall in AR is less than MR (AR > MR) when MR is 0 then TR will be at its maximum.

TR, AR and MR are revenue curves shown on OY axis output is shown on OX axis. A to B is increasing stage of TR. B to C is constant and C to D is decreasing stage of TR. AR and MR are falling but AR is above the MR ($AR > MR$). MR will be negative when TR falls.

Relation between AR and MR

Under different market conditions the relation between AR and MR can be as given below:

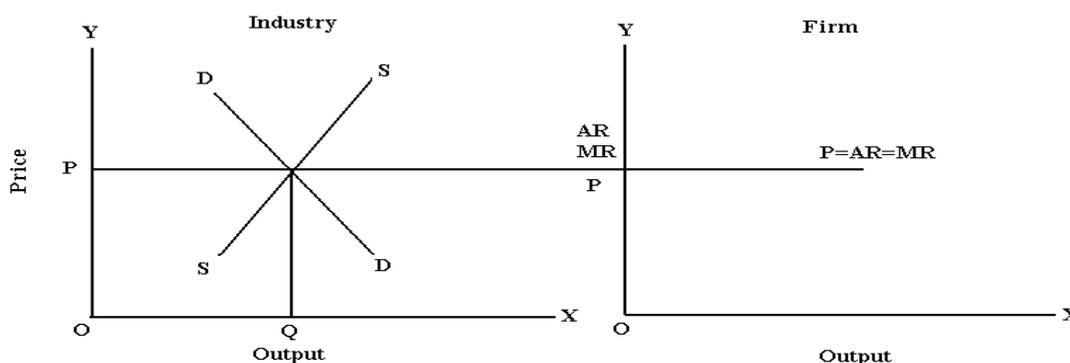
AR and MR under perfect Competition

Under perfect competition price remains constant. Price, AR and MR will be the same and the demand curve will be horizontal to OX-axis because there is a large number of buyers and sellers, homogeneous product and price is determined by the total demand and supply, firm is a price taker, Hence, there is one price prevailing in the market. It can be seen from the following table:-

AR and MR under Perfect competition

Units of Output	Price per Unit (Rs.)	TR (Rs.)	AR (Rs.)	MR (Rs.)
1	5	5	5	5
2	5	10	5	5
3	5	15	5	5
4	5	20	5	5
5	5	25	5	5
6	5	30	5	5

The table reveals that the price per unit is the same and TR is increasing but AR and MR remain constant. Price is equal to AR and MR ($P=AR=MR$) under perfect competition. The table can be shown on a diagram as given below:



(Diagram: AR and MR under Perfect Competition) The diagram shows that price is determined by the intersection of demand and supply by the industry and the same is accepted by individual firm.

Price, MR
and AR are shown by the horizontal line parallel to OX axis.

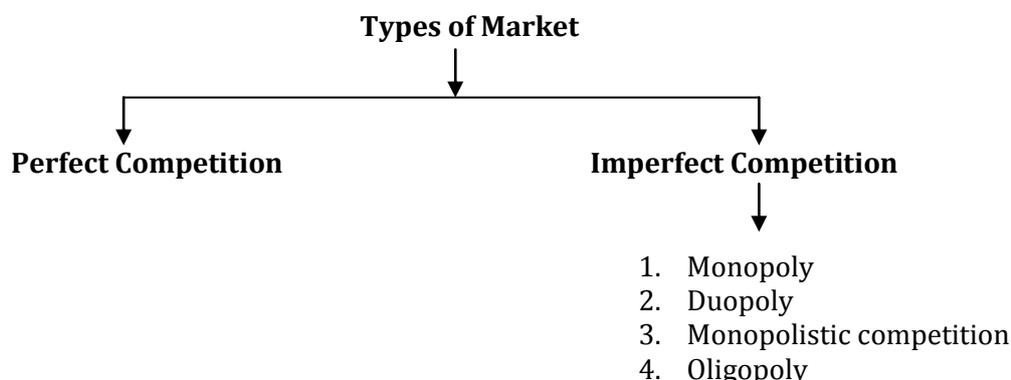
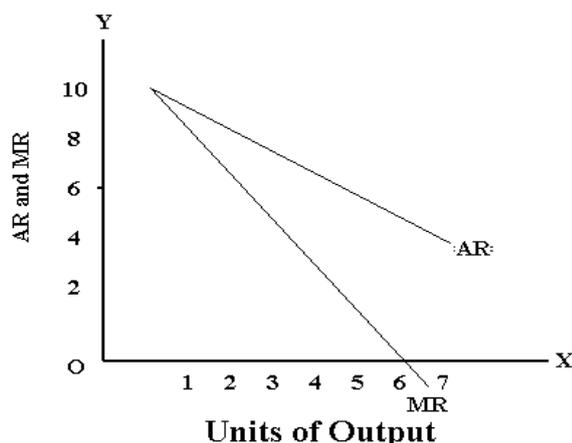
AR and MR under imperfect Competition

As we have seen that perfect competition is an imaginary and unrealistic situation. It is called a myth. Under imperfect competition the firm can increase its sales by reducing the price of its product. Hence, AR and MR will be different under this market structure. It can be seen from the following table:-

AR and MR under Imperfect Competition

Units of Output	Price (Rs.)	Total Revenue (Rs.)	Average Revenue (Rs.)	Marginal Revenue (Rs.)
1	10	10	10	10
2	9	18	9	8
3	8	24	8	6
4	7	28	7	4
5	6	30	6	2
6	5	30	5	0
7	4	28	4	-2

The table shows that AR is decreasing but it is positive. MR is decreasing, becomes zero and thereafter it becomes negative. AR and price are equal ($P=AR$) but AR and MR are different. AR is decreasing and MR is also decreasing but AR is higher than MR ($AR > MR$). The slope of AR and MR will be declining.



PERFECT COMPETITION

What is Perfect Competition?

Perfect Competition is a market structure where there is a perfect degree of competition and single price prevails. The concept of Perfect Competition was introduced by Dr. Alfred Marshall. Nothing is 100% perfect in this world. So, this states that perfect competition is only a theoretical possibility and it does not exist in reality.

Main Features of Perfect Competition

The following are the characteristics or main features of perfect competition:-

1. Many Sellers
2. Many Buyers
3. Homogenous Product
4. Zero Advertisement Cost
5. Free Entry and Exit
6. Perfect Knowledge
7. Perfect Mobility of Factors
8. No Government Intervention
9. No Transport Cost

MONOPOLY

What is Monopoly?

The term monopoly is derived from Greek words 'mono' which means single and 'poly' which means seller. So, monopoly is a market structure, where there only a single seller producing a product having no close substitute.

Features of Monopoly

- 1 A single seller has complete control over the supply of the commodity.
- 2 There are no close substitutes for the product.
- 3 There is no free entry and exit because of some restrictions.
- 4 There is a complete negation of competition.
- 5 Monopolist is a price maker.
- 6 Since there is a single firm, the firm and industry are one and same i.e. firm coincides the industry.
- 7 Monopoly firm faces downward sloping demand curve. It means he can sell more at lower price and vice versa. Therefore, elasticity of demand factor is very important for him.

MONOPOLISTIC COMPETITION

Features of Monopolistic Competition

1. Large Number of Sellers
2. Product Differentiation
3. Freedom of Entry and Exit
4. Selling Cost
5. Absence of Interdependence
6. Two Dimensional Competition
7. Concept of Group
8. Falling Demand Curve

OLIGOPOLY

What is Oligopoly?

The term oligopoly is derived from two Greek words, Oleg's and 'Pollen'. Oleg's means a few and Pollen means to sell thus. Oligopoly is said to prevail when there are few firms or sellers in the market producing and selling a product. Oligopoly is often referred to as "competition among the few". In brief oligopoly is a kind of imperfect market where there are a few firm in the market, producing either and homogeneous product or producing product which are close but not perfect substitutes of each other.

Characteristics of Oligopoly:

1. Interdependence
2. Importance of advertising and selling costs
3. Group behavior
4. Indeterminateness of demand curve

5. Elements of monopoly
6. Price rigidity
- 7 Product is Standardized (eg: car industry)

Meaning of Duopoly

Duopoly is exactly a special case of thesis of Oligopoly, in which there are two sellers involved and are absolutely at liberty and no contract persists between them. Notwithstanding their liberations, the variations in price and productivity of one will affect the other one indeed and the subsequent reactions are to follow. One seller nevertheless presumes that his competition is impassive by his activity; in that case he takes only his own leading persuasion on the price of that commodity.

Alternatively, every seller among the two will considers the consequence of his policy on that of his competition and the response of the competition on himself once more then he takes into account both straight and meandering power upon the price of that commodity. Furthermore, a competitive seller's policy may stay untouched either to the sum proffered for sale or to the price at which he offers his product. In this way the complexity of duopoly can be regarded as either avoiding mutual liberty or identifying it.

Cournot's Model of Duopoly

This model is the ancient models of determining duopoly complexities. Cournot's Model is based on the following postulations.

Postulations

1. There are two sellers at liberty. Conversely, mutually dependence of the duopolists is ignored.
2. They manufacture and sell standardised goods.
3. The total productivity has to be sold out, being non-durable and non-warehoused.
4. The number of consumers is huge.
5. Each seller among the two is very well aware of the market demand curve of the commodity.
6. The cost of manufacturing is presumed to be zilch.
7. Every of the two industries have like costs and like demands.
8. Every of the two sellers fixes on about the volume he wants to manufacture and sell in each product.
9. But both the sellers are unaware of the competitive strategies of each other regarding the productivity.
10. At the same time each seller takes the supply or productivity of its competitor as invariable.
11. Neither of both decides the price for their commodities but each accepts the market demand price at which the commodity can be sold.
12. The entry of firm is blocked.
13. Each seller aims at obtaining the maximum net revenue or profit.

Economies of Scale

Economies of Scale are the results of the operation of laws of returns to scale in long run. They are of two types :

- (1) Internal economies of scale.
- (2) External economies of scale

(1) Internal Economies: - Internal economies of scale are those economies which are on account of the size and operations of an individual firm itself and not from the outside factors. These economies may be of following categories:-

(i) Managerial economies means that with the expansion of the output on account of the change in scale of production the whole expanded scale is looked after by the personnel in the organizations and administrative cost decreases with the increase in output.

(ii) Marketing economies are concerned with the bulk purchases of raw material while producing on the large scale leads to decrease in the cost of production. Selling in lot saves time, money and energy. Transportation cost will also be reduced.

(iii) Specialization economies are on account of division of labour and specialization when large scale production is carried on. The cost of production reduces due to specialization when large scale production is carried on. The cost of production reduces due to specialization and division of labour in a business firm.

(iv) Technical economies arise on account of large scale production in the use of plant, machinery and work processes. Advanced technology is used which reduces the cost of production when the production is carried on large scale.

(2) External Economies :- External economies arise on account of the external factors and they are enjoyed by all the firms in the area or industry as a whole. When an area is industrially well developed then there will be development of labour market, banking, insurance, financial institutions, means of communication and transportation, social overhead and cheap water, electricity and ancillaries. When a new firm or new industrial unit is set up all these benefits will be available in that area. All these facilities will reduce the cost of production of all the industrial units in the area.

As a result of all the internal and external economies the unit cost of production falls and the LAC and LMC will also fall.

Diseconomies of Scale

Diseconomies means the losses incurred by the firms or industrial units in an area. These diseconomies are of two types:

- (1) Internal diseconomies of scale.
- (2) External diseconomies of scale

(1) Internal Diseconomies: - These diseconomies are concerned with the size and operation of individual firm or industry. These diseconomies are of the following categories:-

- (i) Managerial diseconomies.
- (ii) Technical diseconomies.
- (iii) Marketing diseconomies.
- (iv) Specialization diseconomies.

When the size of operation of a firm increases, the span of control becomes large and thereby the employer-employee relations are adversely affected leading to increase in the cost of production. It is resulted into **managerial diseconomies**.

Under **technical diseconomies** when the output is taken on large scale after a given point the break down rate may increase the cost of production.

Marketing diseconomies arise on account of the adverse effect on the control and coordination over marketing activities because of the large scale production and it increases the cost of production.

Specialization diseconomies are concerned with the division of labour and specialization introduced by a firm with the by a firm with the operation of the large scale production. But after a point due to monotony, fatigue and lack of coordination between different layers of personnel administration the cost of production increases that given birth to these diseconomies.

(2) External Diseconomies: - Such loss or external diseconomies are incurred by business firms or industrial units in an area. Concentration and localization of industries adversely affect the industrial peace in that area and strikes, lockouts, go slow tactics, gheraos, industrial accidents, emergence of dirty colonies, Water pollution, air pollution, etc/ increase the cost of production of all firms and industrial units. Means of communication and transportation are overburdened.

Hence, the internal and external diseconomies will increase the LAC curve and LMC curve upward and the cost will increase.

UNIT-III MEANING & DEFINITION OF NATIONAL INCOME

Marshall's Definition

"The labour and capital of 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."

The main defects of Marshall's definition are as under –

1. A country produces a number of commodities and services whose correct evaluation becomes difficult. Thus, we cannot get an accurate estimate of the national income of a country.
2. There are some commodities which are used more than once. Thus, there is a possibility that the product of such commodities may be counted twice. This will give a wrong estimate of the national income.
3. There are some commodities which do not appear in the market and they are consumed directly by the producers. This normally happens in the case of agricultural commodities. Marshall's definition fails to provide a measure for such items.

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."

The limitations of this definition are as following:

1. While calculating national income, Pigou includes only those goods and services which are exchanged for money. Thus, the services which a person renders to himself, and those which he performs for the sake of his family or friends should not be regarded as part of national dividend. Thus, the definition does not provide a correct picture of the national income of a country.
2. This definition is applicable only to developed countries of the world where barter system is not found. It cannot be used to calculate of the national income of the backward and less developed countries where the barter system still occupies an important place in the economy.

Importance of National Income –

The computation of national income is one of the very important statistics for a country. It has several important uses and therefore there is a great need for their regular preparation. The following are some of the important uses of national income statistics:

1) Level of Economic Welfare

The national income estimate reveals the overall performance of the country during a given financial year. With the help of this statistics the per capita income i.e. the income earned by every individual is calculated. It is obtained by dividing the total national income by the total population. With this we come to the level of economic welfare in terms of its standard of living.

2) Rate of Economic Growth

With the help of national income statistics we can know whether the economy is growing or declining. In simple words it helps us to know the conditions of a country economy. If the national income is growing over a period of year it means that the economy is growing and if the national income has reduced as compares to the previous it reveals that the economy is detrainig. Similarly the growing per capita income shows an increasing standard o living of the people which is a positive sign of a nations growth and vice versa.

3) Distribution of Wealth

One of the most important objectives that is achieved after calculating national income is to check its distribution among different categories of income such as wages, profits, rents and interest. It helps to understand that how well the income is distributed among the various factors of the economy and their distribution among the people as well.

4) Ease in Planning

Since the national income estimates also contain the figures of saving, consumption and investment in the economy so it proves to be a valuable guide to economic policy relating to planning and active government intervention in the economy. The estimates are used as a data for future planning also.

5) Formation of Budget

Budget is an effective tool for planning and control. It is prepared in the light of the information regarding consumption, saving, and investment which are all provided by the national income estimates. Further we can assess and evaluate the achievements or otherwise of the development targets laid down in the plans from the changes in national income and its various components.

6) Conclusion

Thus we may conclude that national income statistics chart the movement of a country from depression to prosperity its rate of economic growth and its standard of living in comparison with rest of the world.

CONCEPTS OF NATIONAL INCOME

There are different concepts of National Income, namely; GNP, GDP, NNP, Personal Income and Disposable Income.

1) Gross Domestic Product (GDP): GDP at market price is sum total of all the goods and services produced in a country during a year within the domestic territory

2) Gross National Product (GNP): GNP at market price is sum total of all the goods and services produced in a country during a year and net income from abroad. GNP is the sum of Gross Domestic Product at Market Price and Net Factor Income from abroad

3) GDP at Market Price: If we multiply the total output produced in one year within the domestic territory, by their 'Market Prices', we get GDP at market price.

4) GNP at Market Price : If we multiply the total output produced in one year within the domestic territory as well as outside the country, by their 'Market Prices', we get GNP at market price.

5) Gross Domestic Product at Factor Cost : The gross domestic product at factor cost is the difference between gross domestic product at market price and net indirect taxes.

6) Gross National Product at Factor Cost : The gross national product at factor cost is the difference between gross national product at market prices and net indirect taxes.

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

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, Private 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

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.

Methods of calculating National Income

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) Problem of Double counting: 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.

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

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

$$\boxed{GDP = C + I + G + (X - M)}$$

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 about 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 & sale of their products.

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) **Effective Demand:** 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:

$$\text{Effective demand} = \text{National Income (Y)} = \text{National Output (O)}$$

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.

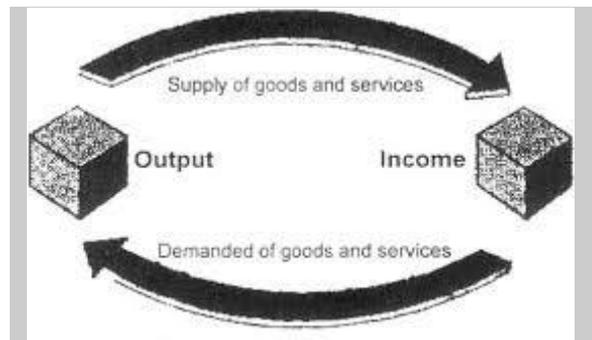
Significance of Keynesian Theory:

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.**

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 assumptions 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 than 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, whereas producers will like to 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.

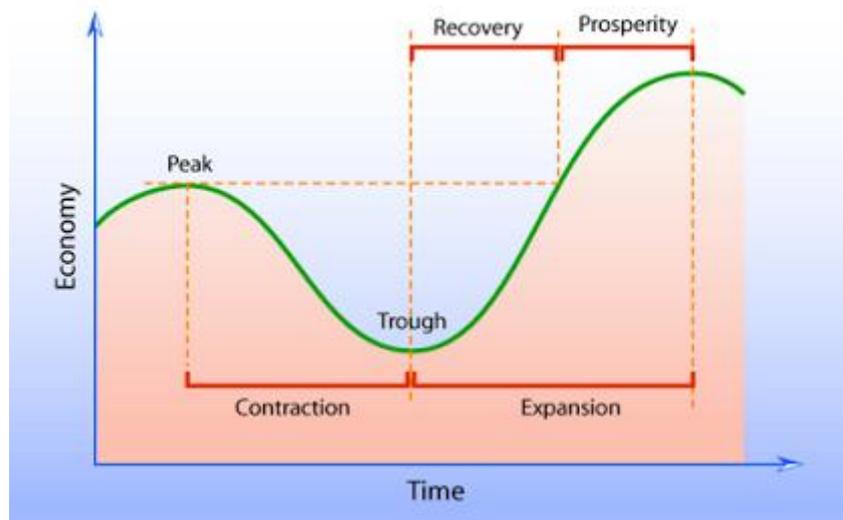
Pigou's Formulation of Says law

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.

Unit-IV

What is Trade Cycle? Meaning

The alternating periods of expansion and contraction in the economic activity has been called business cycles or trade cycles.



The period of high income, high output and high employment is called as the **Period of Expansion**, Upswing or Prosperity.

The period of low income, low output and low employment is called as the **Period of Contraction**, Recession, Downturn or Depression.

Definition of Trade Cycle

According to **Keynes**,

"A trade cycle is composed of periods of Good Trade, characterized by rising prices and low unemployment percentages, shifting with periods of bad trade characterized by falling prices and high unemployment percentages."

Features of Trade Cycle

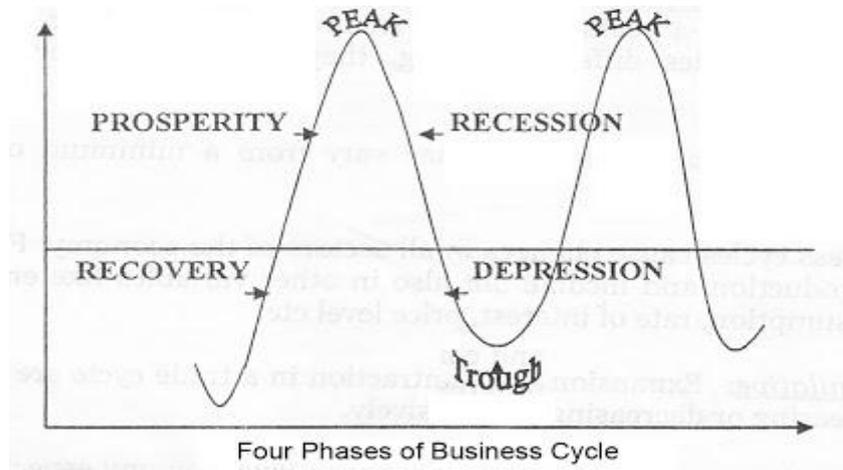
The characteristics or features of trade cycle are :-

1. **Movement in Economic Activity** : A trade cycle is a wave-like movement in economic activity showing an upward trend and a downward trend in the economy.
2. **Periodical** : Trade cycles occur periodically but they do not show the same regularity.
3. **Different Phases** : Trade cycles have different phases such as Prosperity, Recession, Depression and Recovery.
4. **Different Types** : There are minor and major trade cycles. Minor trade cycles operate for 3-4 years, while major trade cycles operate for 4-8 years or more. Though trade cycles differ in timing, they have a common pattern of sequential phases.
5. **Duration** : The duration of trade cycles may vary from a minimum of 2 years to a maximum of 12 years.
6. **Dynamic** : Business cycles cause changes in all sectors of the economy. Fluctuations occur not only in production and income but also in other variables like employment, investment, consumption, rate of interest, price level, etc.
7. **Phases are Cumulative** : Expansion and contraction in a trade cycle are cumulative, in effect, i.e. increasing or decreasing progressively.
8. **Uncertainty to businessmen** : There is uncertainty in the economy, especially for the businessmen as profits fluctuate more than any other type of income.
9. **International Nature** : Trade Cycles are international in character. For e.g. Great Depression of 1930s.

Four Phases of Trade/Business Cycle

Business Cycle (or Trade Cycle) is divided into the following four phases :-

1. **Prosperity Phase** : Expansion or Boom or Upswing of economy.
2. **Recession Phase** : from prosperity to recession (upper turning point).
3. **Depression Phase** : Contraction or Downswing of economy.
4. **Recovery Phase** : from depression to prosperity (lower turning Point).



The business cycle starts from a trough (lower point) and passes through a recovery phase followed by a period of expansion (upper turning point) and prosperity. After the peak point is reached there is a declining phase of recession followed by a depression. Again the business cycle continues similarly with ups and downs.

Explanation of Four Phases of Business Cycle

The four phases of a business cycle are briefly explained as follows :-

1. Prosperity Phase

When there is an expansion of output, income, employment, prices and profits, there is also a rise in the standard of living. This period is termed as Prosperity phase.

The **features of prosperity** are :-

1. High level of output and trade.
2. High level of effective demand.
3. High level of income and employment.
4. Rising interest rates.
5. Inflation.
6. Large expansion of bank credit.
7. Overall business optimism.
8. A high level of MEC (Marginal efficiency of capital) and investment.

Due to full employment of resources, the level of production is Maximum and there is a rise in **GNP** (Gross National Product). Due to a high level of economic activity, it causes a rise in prices and profits. There is an upswing in the economic activity and economy reaches its **Peak**. This is also called as a **Boom Period**.

2. Recession Phase

The turning point from prosperity to depression is termed as Recession Phase.

During a recession period, the economic activities slow down. When demand starts falling, the overproduction and future investment plans are also given up. There is a steady decline in the output, income, employment, prices and profits. The businessmen lose confidence and become pessimistic (Negative). It reduces investment. The banks and the people try to get greater liquidity, so credit also contracts. Expansion of business stops, stock market falls. Orders are cancelled and people start losing their jobs. The increase in unemployment causes a sharp decline in income and aggregate demand. Generally, recession lasts for a short period.

3. Depression Phase

When there is a continuous decrease of output, income, employment, prices and profits, there is a fall in the standard of living and depression sets in.

The **features of depression** are :-

1. Fall in volume of output and trade.
2. Fall in income and rise in unemployment.
3. Decline in consumption and demand.
4. Fall in interest rate.
5. Deflation.
6. Contraction of bank credit.
7. Overall business pessimism.
8. Fall in MEC (Marginal efficiency of capital) and investment.

In depression, there is under-utilization of resources and fall in GNP (Gross National Product). The aggregate economic activity is at the lowest, causing a decline in prices and profits until the economy reaches its **Trough** (low point).

4. Recovery Phase

The turning point from depression to expansion is termed as Recovery or **Revival** Phase.

During the period of revival or recovery, there are expansions and rise in economic activities. When demand starts rising, production increases and this causes an increase in investment. There is a steady rise in output, income, employment, prices and profits. The businessmen gain confidence and become optimistic (Positive). This increases investments. The stimulation of investment brings about the revival or recovery of the economy. The banks expand credit, business expansion takes place and stock markets are activated. There is an increase in employment, production, income and aggregate demand, prices and profits start rising, and business expands. Revival slowly emerges into prosperity, and the business cycle is repeated.

Thus we see that, during the expansionary or prosperity phase, there is inflation and during the contraction or depression phase, there is a deflation

What is Inflation? Meaning

1) Inflation refers to a continuous rise in general price level which reduces the value of money or purchasing power over a period of time.

2) Statistically speaking, inflation is measured in terms of a percentage rise in the price index (i.e. percentage rate per unit time) usually for an annum (a year) or for 30-31 days (a month).

Definition of Inflation

According to **Crowther**,

"Inflation is a state in which the value of money is falling i.e. the prices are rising."

According to **Coulbourn**,

"Inflation is too much of money chasing too few goods."

Features of Inflation

The characteristics or features of inflation are as follows :-

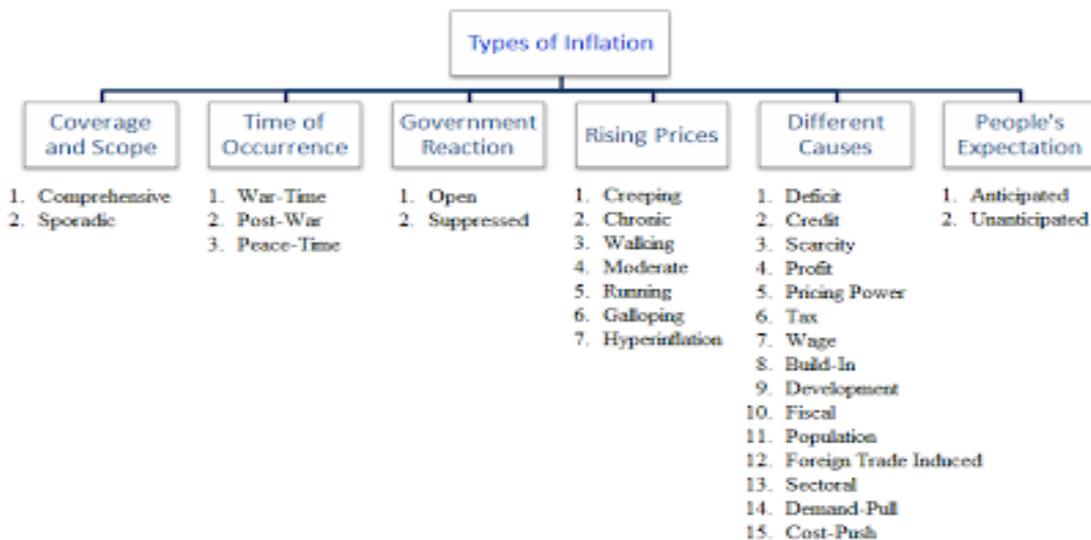
1. Inflation involves a process of the persistent rise in prices. It involves rising trend in price level.
2. Inflation is a state of disequilibrium.
3. Inflation is scarcity oriented.
4. Inflation is dynamic in nature.
5. Inflationary price rise is persistent and irreversible.
6. Inflation is caused by excess demand in relation to supply of all types of goods and services.
7. Inflation is a purely monetary phenomenon.
8. Inflation is a post full employment phenomenon.
9. Inflation is a long-term process.

Important Terms Related to Inflation

The important terms related to inflation are as follows :-

1. **Deflation:** Deflation is a condition of falling prices. It is just the opposite of inflation. In deflation, the value of money goes up and prices fall down. Deflation brings a depression phase of business in the economy.
2. **Disinflation:** Disinflation refers to lowering of prices through anti-inflationary measures without causing unemployment and reduction in output.
3. **Reflation :** Reflation is a situation of rising prices intentionally adopted to ease the depression phase of the economy. In reflation, along with rising prices, the employment, output and income also increase until the economy reaches the stage of full employment.
4. **Stagflation :** Paul Samuelson describes Stagflation as the paradox of rising prices with increasing rate of unemployment.
5. **Stagnation :** Stagnation in the rate of economic growth which may be a slow or no economic growth at all.
6. **Statflation :** The term 'Statflation' was coined by **Dr. P.R. Brahmananda** to describe the inflationary situation of India. According to Brahmananda, Rising prices in the middle of a recession is known as Statflation.

Types of Inflation



Types of Inflation on Coverage

Types of inflation on the basis of coverage and scope point of view:-

1. **Comprehensive Inflation :** When the prices of all commodities rise throughout the economy it is known as Comprehensive Inflation. Another name for comprehensive inflation is **Economy Wide Inflation**.
2. **Sporadic Inflation :** When prices of only few commodities in few regions (areas) rise, it is known as Sporadic Inflation. It is sectional in nature. For example, rise in food prices due to bad monsoon (winds bringing seasonal rains in India).

Types of Inflation on Time of Occurrence

Types of inflation on the basis of time (period) of occurrence:-

1. **War-Time Inflation :** Inflation that takes place during the period of a war-like situation is known as War-Time inflation. During a war, scarce productive resources are all diverted and prioritized to produce military goods and equipments. This overall result in very limited supply or extreme shortage (low availability) of resources (raw materials) to produce essential commodities. Production and supply of basic goods slow down and can no longer meet the soaring demand from people. Consequently, prices of essential goods keep on rising in the market resulting in War-Time Inflation.

2. **Post-War Inflation** : Inflation that takes place soon after a war is known as Post-War Inflation. After the war, government controls are relaxed, resulting in a faster hike in prices than what experienced during the war.
3. **Peace-Time Inflation** : When prices rise during a normal period of peace, it is known as Peace-Time Inflation. It is due to huge government expenditure or spending on capital projects of a long gestation (development) period.

Types of Inflation on Government Reaction

Types of inflation on basis of Government's reaction or its degree of control:-

1. **Open Inflation** : When government does not attempt to restrict inflation, it is known as Open Inflation. In a free market economy, where prices are allowed to take its own course, open inflation occurs.
2. **Suppressed Inflation** : When government prevents price rise through price controls, rationing, etc., it is known as Suppressed Inflation. It is also referred as **Repressed** Inflation. However, when government controls are removed, Suppressed inflation becomes Open Inflation. Suppressed Inflation leads to corruption, black marketing, artificial scarcity, etc.

Types of Inflation on Rising Prices

Types of inflation on the basis of rising prices or rate of inflation:-

1. **Creeping Inflation** : When prices are gently rising, it is referred as Creeping Inflation. It is the mildest form of inflation and also known as a **Mild** Inflation or **Low** Inflation. According to **R.P. Kent**, when prices rise by not more than (upto) 3% per annum (year), it is called Creeping Inflation.
2. **Chronic Inflation** : If creeping inflation persist (continues to increase) for a longer period of time then it is often called as Chronic or **Secular** Inflation. Chronic Creeping Inflation can be either Continuous (which remains consistent without any downward movement) or Intermittent (which occurs at regular intervals). It is called chronic because if an inflation rate continues to grow for a longer period without any downturn, then it possibly leads to Hyperinflation.
3. **Walking Inflation** : When the rate of rising prices is more than the Creeping Inflation, it is known as Walking Inflation. When prices rise by more than 3% but less than 10% per annum (i.e between 3% and 10% per annum), it is called as Walking Inflation. According to some economists, walking inflation must be taken seriously as it gives a cautionary signal for the occurrence of Running inflation. Furthermore, if walking inflation is not checked in due time it can eventually result in Galloping inflation.
4. **Moderate Inflation** : Prof. Samuelson clubbed together concept of Creeping and Walking inflation into Moderate Inflation. When prices rise by less than 10% per annum (single digit inflation rate), it is known as Moderate Inflation. According to Prof. **Samuelson**, it is a stable inflation and not a serious economic problem.
5. **Running Inflation** : A rapid acceleration in the rate of rising prices is referred as Running Inflation. When prices rise by more than 10% per annum, running inflation occurs. Though economists have not suggested a fixed range for measuring running inflation, we may consider price rise between 10% to 20% per annum (double digit inflation rate) as a running inflation.
6. **Galloping Inflation** : According to Prof. Samuelson, if prices rise by double or triple digit inflation rates like 30% or 400% or 999% per annum, then the situation can be termed as Galloping Inflation. When prices rise by more than 20% but less than 1000% per annum (i.e. between 20% to 1000% per annum), galloping inflation occurs. It is also referred as **Jumping** inflation. India has been witnessing galloping inflation since the second five year plan period.
7. **Hyperinflation** : Hyperinflation refers to a situation where the prices rise at an alarming high rate. The prices rise so fast that it becomes very difficult to measure its magnitude. However, in quantitative terms, when prices rise above 1000% per annum (quadruple or four digit inflation rate), it is termed as Hyperinflation. During a worst case scenario of hyperinflation, value of national currency (money) of an affected country reduces almost to zero. Paper money becomes worthless and people start trading either in gold and silver or sometimes even use the old barter system of commerce. Two worst examples of hyperinflation recorded in world history are of those experienced by **Hungary** in year 1946 and **Zimbabwe** during 2004-2009 under **Robert Mugabe's** regime.

Types of Inflation on Causes

Types of inflation on the basis of different causes:-

1. **Deficit Inflation** : Deficit inflation takes place due to deficit financing.
2. **Credit Inflation** : Credit inflation takes place due to excessive bank credit or money supply in the economy.
3. **Scarcity Inflation** : Scarcity inflation occurs due to hoarding. Hoarding is an excess accumulation of basic commodities by unscrupulous traders and black marketers. It is practised to create an artificial shortage of essential goods like food grains, kerosene, etc. with an intention to sell them only at higher prices to make huge profits during scarcity inflation. Though hoarding is an unfair trade practice and a punishable criminal offence still some crooked merchants often get themselves engaged in it.
4. **Profit Inflation** : When entrepreneurs are interested in boosting their profit margins, prices rise.
5. **Pricing Power Inflation** : It is often referred as **Administered Price** inflation. It occurs when industries and business houses increase the price of their goods and services with an objective to boost their profit margins. It does not occur during a financial crisis and economic depression, and is not seen when there is a downturn in the economy. As Oligopolies have the ability to set prices of their goods and services it is also called as **Oligopolistic** Inflation.
6. **Tax Inflation** : Due to rise in indirect taxes, sellers charge high price to the consumers.
7. **Wage Inflation** : If the rise in wages is not accompanied by a rise in output, prices rise.
8. **Build-In Inflation** : Vicious cycle of Build-in inflation is induced by adaptive expectations of workers or employees who try to keep their wages or salaries high in anticipation of inflation. Employers and Organisations raise the prices of their respective goods and services in anticipation of the workers or employees' demands. This overall builds a vicious cycle of rising wages followed by an increase in general prices of commodities. This cycle, if continues, keeps on accumulating inflation at each round turn and thereby results into what is called as Build-in inflation.
9. **Development Inflation** : During the process of development of economy, incomes increase, causing an increase in demand and rise in prices.
10. **Fiscal Inflation** : It occurs due to excess government expenditure or spending when there is a budget deficit.
11. **Population Inflation** : Prices rise due to a rapid increase in population.
12. **Foreign Trade Induced Inflation** : It is divided into two categories, viz., (a) Export-Boom Inflation, and (b) Import Price-Hike Inflation.
13. **Export-Boom Inflation** : Considerable increase in exports may cause a shortage at home (within exporting country) and results in price rise (within exporting country). This is known as Export-Boom Inflation.
14. **Import Price-Hike Inflation** : If a country imports goods from a foreign country, and the prices of imported goods increase due to inflation abroad, then the prices of domestic products using imported goods also rise. This is known as Import Price-Hike Inflation. For e.g. India imports oil from Iran at \$100 per barrel. Oil prices in the international market suddenly increase to \$150 per barrel. Now India to continue its oil imports from Iran has to pay \$50 more per barrel to get the same amount of crude oil. When the imported expensive oil reaches India, the Indian consumers also have to pay more and bear the economic burden. Manufacturing and transportation costs also increase due to hike in oil prices. This, consequently, results in a rise in the prices of domestic goods being manufactured and transported. It is the end-consumer in India, who finally pays and experiences the ultimate pinch of Import Price-Hike Inflation. If the oil prices in the international market fall down then the import price-hike inflation also slows down, and vice-versa.
15. **Sectoral Inflation** : It occurs when there is a rise in the prices of goods and services produced by certain sector of the industries. For instance, if prices of crude oil increase then it will also affect all other sectors (like aviation, road transportation, etc.) which are directly related to the oil industry. For e.g. If oil prices are hiked, air ticket fares and road transportation cost will increase.
16. **Demand-Pull Inflation** : Inflation which arises due to various factors like rising income, exploding population, etc., leads to aggregate demand and exceeds aggregate supply, and tends to raise prices of goods and services. This is known as Demand-Pull or **Excess Demand** Inflation.

17. **Cost-Push Inflation** : When prices rise due to growing cost of production of goods and services, it is known as Cost-Push (Supply-side) Inflation. For e.g. If wages of workers are raised then the unit cost of production also increases. As a result, the prices of end-products or end-services being produced and supplied are consequently hiked.

Types of Inflation on Expectation

Types of inflation on the basis of expectation or predictability:-

1. **Anticipated Inflation** : If the rate of inflation corresponds to what the majority of people are expecting or predicting, then is called Anticipated Inflation. It is also referred as **Expected** Inflation.
2. **Unanticipated Inflation** : If the rate of inflation corresponds to what the majority of people are not expecting or predicting, then is called Unanticipated Inflation. It is also referred as **Unexpected** Inflation.

Ill effects of of Inflation

1. **Impact of Inflation on Savers**: When inflation is high, people may lose confidence in money as the real value of savings is severely reduced. Savers will lose out if interest rates are lower than inflation – leading to negative real interest rates. This has certainly happened in the UK during 2009-2011.
2. **Inflation Expectations and Wage Demands**: Price increases lead to higher **wage demands** as people try to maintain their real living standards. This process is known as a ‘wage-price spiral’.
3. **Arbitrary Re-Distributions of Income**: Inflation tends to hurt people in jobs with **poor bargaining positions** in the labour market - for example people in low paid jobs with little or no trade union protection may see the real value of their pay fall. Inflation can also favour borrowers at the expense of savers as inflation erodes the real value of existing debts.
4. **Business Planning and Investment**: Inflation can disrupt business planning. Budgeting becomes difficult because of the uncertainty created by rising inflation of both prices and costs - and this may reduce planned investment spending.
5. **Competitiveness and Unemployment**: Inflation is a possible cause of higher unemployment in the medium term if one country experiences a much higher rate of inflation than another, leading to a **loss of international competitiveness** and a subsequent worsening of their trade performance.

Benefits of inflation

1. **Higher revenues and profits**: A low stable rate of inflation of say between 1% and 3% allows businesses to raise their prices, revenues and profits, whilst at the same time workers can expect to see an increase in their pay packers. This can give psychological boost and might lead to rising investment and productivity.
2. **Tax revenues**: The government gains from inflation through what is called ‘**fiscal drag effects**’. For example many indirect taxes are ad valorem in nature, e.g. VAT at 20% - so as prices rise, so does the amount of tax revenue flowing into the Treasury.
3. **Cutting the real value of debt**: Low stable inflation is also a way of helping to reduce the real value of outstanding debts – there are many home owners with huge mortgages who might benefit from a period of inflation to bring down the real burden of their mortgage loans. The government too might welcome a period of higher inflation given the huge level of public sector debt!
4. **Avoiding deflation**: Perhaps one of the key benefits of positive inflation is that an economy can manage to avoid some of the dangers of a deflationary recession

MEASURES TO CONTROL INFLATION

The various methods to control inflation are given below however the most common ones are Monetary and Fiscal Policies:

1. Monetary Policy

With growth of 3.8%, demand in the economy could be growing faster than capacity can grow to meet it. This leads to inflationary pressures. We can term this demand pull inflation. Therefore, reducing the growth of Aggregate demand, should reduce inflationary pressures.

Monetary policy is the policy of the central bank of the country, which is the supreme monetary and banking authority in a country. The central bank may use such methods as the bank rate, open market

operations, the reserve ratio and selective controls in order to control the credit creation operation of commercial banks and thus restrict the amounts of bank deposits in the country. This is known as tight money policy. Monetary policy to control inflation is based on the assumption that a rise in prices is due to a larger demand for goods and services, which is the direct result of expansion of bank credit. To the extent this is true, the central bank's policy will be successful.

Monetary policy may not be effective in controlling inflation, if inflation is due to cost-push factors. Monetary policy can only be helpful in controlling inflation due to demand-pull factors.

Let us see how increasing the rate can help control inflation

A higher interest rate should also lead to higher exchange rate, which helps to reduce inflationary pressure by

- Making imports cheaper.
- Reducing demand for exports and
- Increasing incentive for exporters to cut costs.

2. Fiscal Policy

It is the policy of a government with regard to taxation, expenditure and public borrowing. It has a very important influence on business and economic activity. Taxes determine the size or the volume of disposable income in the hands of the public. The proper tax policy to control inflation will avoid tax cuts, introduce new taxes and raise the rates of existing taxes. The purpose being to reduce the volume of purchasing power in the hands of the public and thus reduces their demand. A precisely similar effect will be achieved if voluntary or compulsory savings are increased. Savings will reduce current demand for goods and thus reduce the inflationary rise in prices.

As an anti-inflationary measure, government expenditure should be reduced. This indicates that demand for goods and services will be further reduced. This policy of increasing public revenue through taxation and decreasing public expenditure is known as surplus budgeting. However, there is one important difficulty in this policy. It may be easy to increase revenue in times of inflation when people have more money income, but difficult to reduce public expenditure.

During war times as well as during a period of development, it is absolutely impossible to reduce the planned expenditure. If the government has already taken up a scheme or a group of schemes, it is ruinous to give them up in the middle. Therefore, public expenditure cannot be used as an anti-inflationary measure. Lastly, public debt, i.e., the debt of the government may be managed in such a way that the supply of money in the country may be controlled.

The government should avoid paying back any of its previous loans during inflation so as to prevent an increase in the circulation of money. Moreover, if the government manages to get a surplus budget, it should be used to cancel public debt held by the central bank. The result will be anti-inflationary since money taken from the public and commercial banks is being cancelled out and is removed from circulation. But the problem is how to get a budget surplus, which is extremely difficult.

3. Price Control and Rationing

This is the most important and effective method available during war and other critical times particularly because both monetary and fiscal policies are more or less useless during this period. Price control implies the establishment to legal upper limits beyond which prices of particular goods should not rise. The purpose of rationing, on the other hand, is to distribute the goods in short supply in an equitable manner among all people, irrespective of their wealth and social status. Price control and rationing generally go together. The chief objection behind use of this method to fight inflation is that they restrict the freedom of the consumers and thus limit their welfare. Besides, its success depends on administrative efficiency, which in many underdeveloped countries is very low.

4. Other Methods

Another important anti-inflationary device is to increase the supply of goods through either increased production or imports. Production may be increased by shifting factors of production from the production of less inflation sensitive goods, which are in comparative abundance to the production of those goods which are in short supply and which are inflation-sensitive. Moreover, shortage of goods internally may be relieved through imports of inflation sensitive goods, either on credit or in exchange for export of luxury goods and other non-essentials.

5. Realistic Methods

1. Increase the supply of goods and services: When the supply of goods and services is increased, the prices will come down.
2. Population planning: Control on population by adopting different measures of family planning will reduce the demand and finally prices will be controlled.
3. Price control policy: The govt. should adopt strict price control policy against the profiteers and hoarders.
4. Economic Planning: Effective economic planning is necessary to control the inflation in the country.

Globalization

The tendency of investment funds and businesses to move beyond domestic and national markets to other markets around the globe, thereby increasing the interconnectedness of different markets. Globalization has had the effect of markedly increasing not only international trade, but also cultural exchange.

Advantages of Globalization

❖ Employment

Considered as one of the most crucial advantages, globalization has led to the generation of numerous employment opportunities. Companies are moving towards the developing countries to acquire labor force. This obviously caters to employment and income generation to the people in the host country. Also, the migration of people, which has become easier has led to better jobs opportunities.

❖ Education

A very critical advantage that has aided the population is the spread of education. With numerous educational institutions around the globe, one can move out from the home country for better opportunities elsewhere. Thus, integrating with different cultures, meeting and learning from various people through the medium of education is all due to globalization. Developing countries or labor-intensive countries have benefited the most.

❖ Product Quality

The onset of international trade has given rise to intense competition in the markets. No longer does one find limited number of commodities available. A particular commodity may fetch hundreds of options with different prices. The product quality has been enhanced so as to retain the customers. Today the customers may compromise with the price range but not with the quality of the product. Low or poor quality can adversely affect consumer satisfaction.

❖ Cheaper Prices

Globalization has brought in fierce competition in the markets. Since there are varied products to select from, the producer can sustain only when the product is competitively priced. There is every possibility that a customer may switch over to another producer if the product is priced exorbitantly. 'Customer is the King', and hence can dictate the terms to a very large extent. Therefore, affordable pricing has benefited the consumer in a great way.

❖ Free Movement of Capital

Capital, the backbone of every economy, is of prime importance for the proper functioning of the economy. Today, transferring money through banks is possible just by the click of a button, all due to the electronic transfer that has made life very comfortable. Many huge firms are investing in the developing countries by setting up industrial units outside their home country. This leads to Foreign Direct Investment, which helps in promoting economic growth in the host country.

❖ **Communication**

Information technology has played a vital role in bringing the countries closer in terms of communication. Every single information is easily accessible from almost every corner of the world. Circulation of information is no longer a tedious task, and can happen in seconds. The Internet has significantly affected the global economy, thereby providing direct access to information and products.

❖ **Transportation**

Considered as the wheel of every business organization, connectivity to various parts of the world is no more a serious problem. Today with various modes of transportation available, one can conveniently deliver the products to a customer located at any part of the world. Besides, other infrastructural facilities like, distribution, supply chain, and logistics have become extremely efficient and fast.

❖ **International Trade**

Purchase and sale of commodities are not the only two transactions involved in international trade. Today, international trade has broadened its horizon with the help of business process outsourcing. Sometimes in order to concentrate on a particular segment of business it is a practice to outsource certain services. Some countries practice free trade with minimal restrictions on EXIM (export-import) policies. This has proved beneficial to businesses.

❖ **GDP Increase**

Gross Domestic Product, commonly known as GDP, is *the money value of the final goods and services produced within the domestic territory of the country during an accounting year*. As the market has widened, the scope and demand for a product has increased. Producers familiarize their products and services according to the requirements of various economies thereby tapping the untapped markets. Thus, the final outcome in terms of financial gain enhances the GDP of the country. If statistics are of any indication, the GDP of the developing countries has increased twice as much as before.

Disdvantages of Globalization

Health Issues

Globalization has given rise to more health risks and presents new threats and challenges for epidemics. A very customary example is the dawn of HIV/AIDS. Having its origin in the wilderness of Africa, the virus has spread like wildfire throughout the globe in no time. Food items are also transported to various countries, and this is a matter of concern, especially in case of perishable items. The safety regulations and the standards of food preparation are different in different countries, which may pose a great risk to potential health hazards.

❖ **Loss of Culture**

Conventionally, people of a particular country follow its culture and traditions from time immemorial. With large number of people moving into and out of a country, the culture takes a backseat. People may adapt to the culture of the resident country. They tend to follow the foreign culture more, forgetting their own roots. This can give rise to cultural conflicts.

❖ **Uneven Wealth Distribution**

It is said that the rich are getting richer while the poor are getting poorer. In the real sense, globalization has not been able to reduce poverty. Instead it has led to the accumulation of wealth and power in the hands of a few developed economies. Therefore the gap between the elite and the underprivileged seems to be a never ending road, eventually leading to inequality.

❖ **Environment Degradation**

The industrial revolution has changed the outlook of the economy. Industries are using natural resources by means of mining, drilling, etc. which puts a burden on the environment. Natural resources are depleting and are on the verge of becoming extinct. Deforestation is practiced owing to the non-

availability of land, thereby drastically reducing the forest cover. This in turn creates an imbalance in the environment leading to climate change and occurrence of natural calamities.

❖ **Disparity**

Though globalization has opened new avenues like wider markets and employment, there still exists a disparity in the development of the economies. Structural unemployment owes to the disparity created. Developed countries are moving their factories to foreign countries where labor is cheaply available. The host country generates less revenues, and a major share of the profits fall into the hands of the foreign company. They make humongous profits thereby creating a huge income gap between the developed and the developing countries.

❖ **Cut-throat Competition**

Opening the doors of international trade has given birth to intense competition. This has affected the local markets dramatically. In recent times the standard of living has improved. People are therefore ready to shell out extra money for a product that may be available at a lower price. This is because of the modern marketing techniques like advertising and branding. The local players thereby suffer huge losses as they lack the potential to advertise or export their products on a large scale. Therefore the domestic markets shrink.

❖ **Conflicts**

Every economy wants to be at the top spot and be the leader. The fast-paced economies, that is the developed countries are vying to be the supreme power. It has given rise to terrorism and other forms of violence. Such acts not only cause loss of human life but also huge economic losses.

❖ **Monopoly**

Monopoly is a situation wherein only one seller has a say in a particular product or products. It is possible that when a product is the leader in its field, the company may begin to exploit the consumers. As there exists no close competitors, the leader takes full advantage of the sale of its product, which may later lead to illegal and unethical practices being followed. Monopoly is disastrous as it widens the gap between the developed and developing countries.

WHAT IS LIBERALIZATION /FREE TRADE

Free trade occurs when there are no artificial barriers put in place by governments to restrict the flow of goods and services between trading nations. When trade barriers, such as tariffs and subsidies are put in place, they protect domestic producers from international competition and hinder free trade flows.

ADVANTAGES OF FREE TRADE

- 1) **Increased production:** Free trade enables countries to specialize in the production of those commodities in which they have a comparative advantage. With specialization countries are able to take advantage of efficiencies generated from economies of scale and increased output. International trade increases the size of a firm's market, resulting in lower average costs and increased productivity, ultimately leading to increased production.
- 2) **Production efficiencies:** Free trade improves the efficiency of resource allocation. The more efficient use of resources leads to higher productivity and increasing total domestic output of goods and services.
- 3) **Increased competition:** Increased competition promotes innovative production methods, the use of new technology, marketing and distribution methods.
- 4) **Benefits to consumers:** Consumers benefit in the domestic economy as they can now obtain a greater variety of goods and services. The increased competition ensures goods and services, as well as inputs, are supplied at the lowest prices.

- 5) **Foreign exchange gains:** When a domestic country sells/exports overseas it receives hard currency from the countries that buy the goods. This money is then used to pay for imports that are produced more cheaply overseas.
- 6) **Employment:** As resources move to more productive areas of the economy. Employment will increase in exporting industries and workers will be displaced as import competing industries fold (close down) in the competitive environment.
- 7) **Economic growth:** The countries involved in free trade experience rising living standards, increased real incomes and higher rates of economic growth. This is created by more competitive industries, increased productivity, efficiency and production levels.

DISADVANTAGES OF FREE TRADE

Although free trade has benefits, there are a number of arguments put forward by lobby groups and protestors who oppose free trade and trade liberalization. These include:

- 1) **With the removal of trade barriers, structural unemployment may occur in the short term.** This can impact upon large numbers of workers, their families and local economies. Often it can be difficult for these workers to find employment in growth industries and government assistance is necessary.
- 2) **Increased domestic economic instability from international trade cycles, as economies become dependent on global markets.** This means that businesses, employees and consumers are more vulnerable to downturns in the economies of our trading partners, eg. Recession in the USA leads to decreased demand for Indian exports, leading to falling export incomes, lower GDP, lower incomes, lower domestic demand and rising unemployment.
- 3) **International markets are not a level playing field** as countries with surplus products may dump them on world markets at below cost. Some efficient industries may find it difficult to compete for long periods under such conditions. Further, countries whose economies are largely agricultural face unfavorable terms of trade (ratio of export prices to import prices) whereby their export income is much smaller than the import payments they make for high value added imports, leading to large foreign debt levels.
- 4) **Developing or new industries may find it difficult to become established in a competitive environment** with no short-term protection policies by governments, according to the infant industries argument. It is difficult to develop economies of scale in the face of competition from large foreign MNCs. This can be applied to infant industries or infant economies (developing economies).
- 5) **Free trade can lead to pollution and other environmental problems** as companies fail to include these costs in the price of goods in trying to compete with companies operating under weaker environmental legislation in some countries.
- 6) **Pressure to increase protection during the GFC** During the global financial crisis and recession of 2008-2009, the impact of falling employment meant that protection pressures started to rise in many countries. Domestic producers demand tariffs and protectionism from the government.

UNIT-V

FUNCTIONS OF COMMERCIAL BANK

Definitions of Commercial Bank:

1. **Crowther,** "A commercial bank collects money from those who have it to spare or who are saving it out of their income and lends this money to those who require it."
2. **Reed and gill,** "a commercial bank is a financial institution that accepts demand deposits and makes commercial loans and is regulated by a bank regulatory agency.:"
3. The Indian banking companies act, 1949 (now termed as the banking regulation act, since 1956) lays down that the commercial banking consists in "The accepting for the purpose of lending or investment, deposits of money from the public, repayable on demand or otherwise and withdraw able by cheque, draft, order or other.

Thus, a commercial bank is an institution which accepts deposits from the public in turn advance loans by creating credit.

Features:

1. It is a commercial institution; it aims at earning profit.
2. It deals with money; it accepts deposits and advances loans.
3. It deals with credit; it has ability to create credit.

It is clear that commercial banks act as a **bridge between the users** of capital (investors) and those who save (savers). They activate the idle resources of the community and use them for productive purposes.

Commercial Banks and other Financial Institutions: Commercial Banks are different from other financial institutions (F.I.) from the following point of view:

1. Acceptance of chequable deposits is a necessary, but not sufficient condition for financial institutions (F.I.) to be a bank. For example, post office savings banks are not banks in this sense of the term even though they accept deposits from the public. This is because, they do not perform the other essential function of lending.
2. Leading alone does not make Financial Institution (F.I.) a bank. For example, many FIs like LIC, UTI, and IDBI, etc. lend to others but they are not banks in this sense of the term, is they don not accept chequable deposits.
3. Financial Institutions cannot create credit though they may he accepting deposits and making advances.

CLASSIFICATION OF COMMERCIAL BANKS

Commercial banks can be of two types:

I. Scheduled commercial bank and II. Non-scheduled commercial bank.

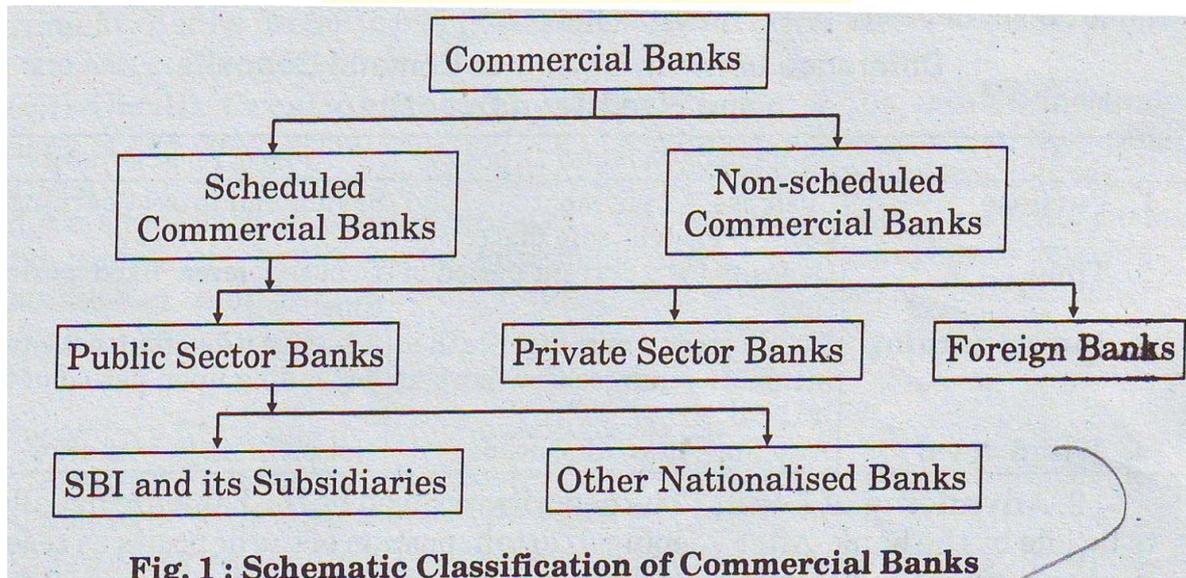
There are **three** kinds of the scheduled commercial bank.

- (a) Public sector banks.
- (b) Private sector banks.
- (c) Foreign banks.

Public sector banks can be of two types:

- (a) **SBI** and its subsidiaries.
- (b) **Other** nationalized banks.

Chart 1. gives the classification of commercial banks.



PROCESS OF CREDIT CREATION

Commercial banks occupy a pivotal position in the economic machinery of a country. It is so because they create money. They are not only purveyors of money but also manufacturers of money. They not only trade in money but also product money.

Meaning of credit creation: bank deposits come into existence in two ways: first, when customers deposit legal tender money in the bank, deposits arise. Such bank deposits are known as primary or actual deposits. It is out of these primary deposits, the bank grants loans or credit.

Second, the most important form of deposit arises in the process of granting a loan by the bank, when somebody applies for loan to the bank. After being assured about his creditworthiness, the bank may immediately sanction it to him. But the bank does not make payment immediately in hard cash. When a bank grants a loan, it usually opens an account in the name of the customers and credits the amount of the loan to his account. He is allowed to withdraw money by cheque or otherwise according to his requirements. Thus, whenever loans are granted deposits arise, such deposits are known as 'derivative deposits' because it has been derived from the loan transaction of the bank. The creation of secondary deposits is called the creation of credit.

With a little cash in hand, commercial banks can multiply loans and advance and hence deposits. It is because of their unique multiple credits creating power that the commercial banks are called as 'manufacturers of money' or 'factories of credit'.

Reserve Bank of India (RBI)

The central bank of the country is the Reserve Bank of India (RBI). It was established in April 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was divided into shares of Rs. 100 each fully paid which was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Reserve Bank of India was nationalised in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi. Local Boards consist of five members each Central Government appointed for a term of four years to represent territorial and economic interests and the interests of co-operative and indigenous banks.

The Reserve Bank of India Act, 1934 was commenced on April 1, 1935. The Act, 1934 (II of 1934)

provides the statutory basis of the functioning of the Bank.

The Bank was constituted for the need of following:

- To regulate the issue of banknotes
- To maintain reserves with a view to securing monetary stability and
- To operate the credit and currency system of the country to its advantage.

Functions of Reserve Bank of India

1. Bank of Issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes. The assets and liabilities of the Issue Department are kept separate from those of the Banking Department. Originally, the assets of the Issue Department were to consist of not less than two-fifths of gold coin, gold bullion or sterling securities provided the amount of gold was not less than Rs. 40 crores in value. The **remaining three-fifths of the assets** might be held in rupee coins, Government of India rupee securities, eligible bills of exchange and promissory notes payable in India. Due to the exigencies of the Second World War and the post-war period, these provisions were considerably modified. Since 1957, the Reserve Bank of India is required to maintain gold and foreign exchange reserves of Ra. 200 crores, of which at least Rs. 115 crores should be in gold. The system as it exists today is known as the minimum reserve system.

2. Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India excepting that of Jammu and Kashmir. The Reserve Bank has the obligation to transact Government business, via. to keep the cash balances as deposits free of interest, to receive and to make payments on behalf of the Government and to carry out their exchange remittances and other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to float new loans and to manage public debt. The Bank makes ways and means advances to the Governments for 90 days. It makes loans and advances to the States and local authorities. It acts as adviser to the Government on all monetary and banking matters.

3. Bankers' Bank and Lender of the Last Resort

The Reserve Bank of India acts as the bankers' bank. According to the provisions of the Banking Companies Act of 1949, every scheduled bank was required to maintain with the Reserve Bank a cash balance equivalent to 5% of its demand liabilities and 2 per cent of its time liabilities in India. By an amendment of 1962, the distinction between demand and time liabilities was abolished and banks have been asked to keep cash reserves equal to 3 per cent of their aggregate deposit liabilities. The minimum cash requirements can be changed by the Reserve Bank of India.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities or get financial accommodation in times of need or stringency by rediscounting bills of exchange. Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crisis the Reserve Bank becomes not only the banker's bank but also the lender of the last resort.

4. Controller of Credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the Bank rate or through open market operations. According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to particular groups or persons on the basis of

certain types of securities. Since 1956, selective controls of credit are increasingly being used by the Reserve Bank.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a licence from the Reserve Bank of India to do banking business within India, the licence can be cancelled by the Reserve Bank if certain stipulated conditions are not fulfilled. Every bank will have to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a weekly return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

As supreme banking authority in the country, the Reserve Bank of India, therefore, has the following powers:

- (a) It holds the cash reserves of all the scheduled banks.
- (b) It controls the credit operations of banks through quantitative and qualitative controls.
- (c) It controls the banking system through the system of licensing, inspection and calling for information.
- (d) It acts as the lender of the last resort by providing rediscount facilities to scheduled banks.

5. Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to maintain the official rate of exchange. According to the Reserve Bank of India Act of 1934, the Bank was required to buy and sell at fixed rates any amount of sterling in lots of not less than Rs. 10,000. The rate of exchange fixed was Re. 1 = sh. 6d. Since 1935 the Bank was able to maintain the exchange rate fixed at 1sh.6d. though there were periods of extreme pressure in favour of or against the rupee. After India became a member of the International Monetary Fund in 1946, the Reserve Bank has the responsibility of maintaining fixed exchange rates with all other member countries of the I.M.F.

Besides maintaining the rate of exchange of the rupee, the Reserve Bank has to act as the custodian of India's reserve of international currencies. The vast sterling balances were acquired and managed by the Bank. Further, the RBI has the responsibility of administering the exchange controls of the country.

6. Supervisory functions

In addition to its traditional central banking functions, the Reserve bank has certain non-monetary functions of the nature of supervision of banks and promotion of sound banking in India. The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, liquidity of their assets, management and methods of working, amalgamation, reconstruction, and liquidation. The RBI is authorised to carry out periodical inspections of the banks and to call for returns and necessary information from them. The nationalisation of 14 major Indian scheduled banks in July 1969 has imposed new responsibilities on the RBI for directing the growth of banking and credit policies towards more rapid development of the economy and realisation of certain desired social objectives. The supervisory functions of the RBI have helped a great deal in improving the standard of banking in India to develop on sound lines and to improve the methods of their operation.

7. Promotional functions

With economic growth assuming a new urgency since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions, which, at one time, were regarded as outside the normal scope of central banking. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; it set up the Deposit Insurance Corporation in 1962,

the Unit Trust of India in 1964, the Industrial Development Bank of India also in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote saving habit and to mobilise savings, and to provide industrial finance as well as agricultural finance. As far back as 1935, the Reserve Bank of India set up the Agricultural Credit Department to provide agricultural credit. But only since 1951 the Bank's role in this field has become extremely important. The Bank has developed the co-operative credit movement to encourage saving, to eliminate moneylenders from the villages and to route its short term credit to agriculture. The RBI has set up the Agricultural Refinance and Development Corporation to provide long-term finance to farmers.

METHODS OF CREDIT CONTROL- QUALITATIVE & QUANTITATIVE METHODS

The RBI adopt two methods to control credit in modern times for regulating bank advances. They are as follows:-

(A) Quantitative or General Credit Control

This method aims to regulate the amount of bank advance. This method includes:

- (a) Bank Rate**
- (b) Open Market Operation**
- (c) Variables Reserves Ratio**

(a) Bank Rate: It is the rate at which central bank discounts the securities of commercial banks or advance loans to commercial banks. This rate is the minimum and it affects both cost and availability of credit. Bank rate is different from market rate. Market rate is the rate of discount prevailing in the money market among other lending institutions. Generally bank rate is higher than the market rate. If the bank rate is changed all the other rates normally change at the same direction. A central bank control credit by manipulating the bank rate. If the central bank raise the bank rate to control credit, the market discount rate and other lending rates in the money will go up. The cost of credit goes up and demand for credit goes down. As a result, the volume of bank loans and advances is curtailed. Thus raise in bank rate will contract credit.

(b) Open Market Operation: It refers to buying and selling of Government securities by the central bank in the open market. this method of credit control become very popular after the 1st World War. During inflation, the bank will securities and during depression, it will purchase securities from the public and financial institutions. The RBI is empowered to buy and sell government securities from the public and financial institutions. The RBI is empowered to buy and sell government securities, treasury bills and other approved securities. The central bank uses the weapon to overcome seasonal stringency in funds during the slack season. When the central bank sells securities, they are purchased by the commercial banks and private individuals. So money supply is reduced in the economy and there is contraction in credit.

When the securities are purchased by the central bank, money goes to the commercial banks and the customers. SO money supply is increased in the economy and there is more demand for credit. Thus open market operation is one of the superior instrument of credit control. But for achieving an ideal result both Bank Rate and Open Market Operation must be used simultaneously.

(c) Variable Reserve Ratio (VRR): This is a new method of credit control adopted by central bank. Commercial banks keep cash reserves with the central bank to maintain for the purpose of liquidity and also to provide the means for credit control. The cash reserve is also called minimum legal reserve requirement. The percentage of this ratio can be changed legally by the central bank. The credit creation of commercial banks depends on the value of cash reserves. If the value of reserve ratio increase and other things remain constant, the power of credit creation by the commercial bank is decreased and vice versa. Thus by varying the reserve ratio, the lending capacity of commercial banks can be affected.

(B) Qualitative or Selective Control Method:

It is also known as **qualitative credit control**. This method is used to control the flow of credit to particular sectors of the economy. The direction of credit is regulated by the central bank. This method is used as a complementary to quantitative credit control discourage the flow of credit to unproductive sectors and speculative activities and also to attain price stability. The main instruments used for this purpose are:

(1) Varying margin requirements for certain bank: While lending commercial banks accept securities, deduct a certain margin from the market value of the security. This margin is fixed by the central bank and adjust according to the requirements. This method affect the demand for credit rather than the quantity and cost of credit. This method is very effective to control supply of credit for speculative dealing in the stock exchange market. It also helps for checking inflation when the margin is raised. If the margin is fixed as 30%, the commercial banks can lend up to 70% of the market value of security. This method has been used by RBI since 1956 with suitable modifications from time to time as per the demand and supply of commodities.

(2) Regulation of consumer's credit: Apart from trade and industry a great amount of credit is given to the consumers for purchasing durable goods also. RBI seeks to control such credit in the following ways:

- (a)** by regulating the minimum down payments on specific goods.
- (b)** by fixing the coverage of selective consumers durable goods.
- (c)** by regulating the maximum maturities on all installment credit and
- (d)** by fixing exemption costs of installment purchase of specific goods.

(3) Control through Directives: Under this system, the central bank can issue directives for the credit control. There may be a written or oral voluntary agreement between the central bank and commercial banks in this regard. Sometimes the commercial banks do not follow these directives of the RBI.

(4) Rationing of credit: The amount of credit to be granted is fixed by the central bank. Credit is rationed by limiting the amount available to each commercial bank. The RBI can also restrict the discounting of bills. Credit can also be rationed by the fixation of ceiling for loans and advances.

(5) Direct Action: It is an extreme step taken by the RBI. It involves refusal by RBI to extend credit facilities, denial of permission to open new branches etc. RBI also gives wide publicity about the erring banks to create awareness amongst the public.

(6) Moral suasion: RBI uses persuasion to influence lending activities of banks. It sends letters to banks periodically, advising them to follow sound principles of banking. Discussions are held by the RBI with banks to control the flow of credit to the desired sectors.

CONCEPT OF SHARES & DEBENTURES

SHARE : In financial markets, a **share** is a unit of account for various investments. It often means the stock of a corporation, but is also used for collective investments such as mutual funds, limited partnerships, and real estate investment trusts. A corporation divides its capital into shares, which are offered for sale to raise capital, termed as issuing shares. Thus, a share is an indivisible unit of capital, expressing the contractual relationship between the company and the shareholder. The denominated value of a share is its face value: the total capital of a company is divided into a number of shares.

DEBENTURE: A debenture is a document that either creates a debt or acknowledges it, and it is a debt without collateral. In corporate finance, the term is used for a medium- to long-term debt instrument used by large companies to borrow money. In some countries the term is used interchangeably with **bond, loan stock** or **note**. A debenture is thus like a certificate of loan or a loan bond evidencing the

fact that the company is liable to pay a specified amount with interest and although the money raised by the debentures becomes a part of the company's capital structure, it does not become share capital. Senior debentures get paid before subordinate debentures, and there are varying rates of risk and payoff for these categories. Debentures are generally freely transferable by the debenture holder. Debenture holders have no rights to vote in the company's general meetings of shareholders, but they may have separate meetings or votes e.g. on changes to the rights attached to the debentures. The interest paid to them is a charge against profit in the company's financial statements

DIFFERENCE BETWEEN SHARES & DEBENTURES

The major differences between debentures and shares (1) Rights the Debentures constitute loan and only a creditor of the company. The shares represents a part of the share capital of the capital. (2) Approval in debentures question of getting approval for payment of interest does not arise. In shares, Dividend is payable only when it is recommended by the Board and approved by the general meeting of the shareholders. (3) Liability in the debentures is not having such liability. In share sholder's liability is limited to the unpaid amount of the shares. (4) Return of Capital in debentures are redeemable either at a fixed date or at the option of the company during the lifetime itself. In shares are non-repayable during the lifetime of the company except in the case of redeemable preference shares. (5) Charge on Assets in the Debentures are generally secured and shares have no charge on the assets of the company.

CONCEPT OF SEBI

Securities Exchange Board of India (SEBI) was set up in 1988 to regulate the functions of securities market. SEBI promotes orderly and healthy development in the stock market but initially SEBI was not able to exercise complete control over the stock market transactions. It was left as a watch dog to observe the activities but was found ineffective in regulating and controlling them. As a result in May 1992, SEBI was granted legal status. SEBI is a body corporate having a separate legal existence and perpetual succession.

Reasons for Establishment of SEBI:

With the growth in the dealings of stock markets, lot of malpractices also started in stock markets such as price rigging, 'unofficial premium on new issue, and delay in delivery of shares, violation of rules and regulations of stock exchange and listing requirements. Due to these malpractices the customers started losing confidence and faith in the stock exchange. So government of India decided to set up an agency or regulatory body known as Securities Exchange Board of India (SEBI).

Purpose and Role of SEBI:

SEBI was set up with the main purpose of keeping a check on malpractices and protect the interest of investors. It was set up to meet the needs of three groups.

1. Issuers:

For issuers it provides a market place in which they can raise finance fairly and easily.

2. Investors:

For investors it provides protection and supply of accurate and correct information.

3. Intermediaries:

For intermediaries it provides a competitive professional market.

Objectives of SEBI:

The overall objectives of SEBI are to protect the interest of investors and to promote the development of stock exchange and to regulate the activities of stock market. The objectives of SEBI are:

1. To regulate the activities of stock exchange.
2. To protect the rights of investors and ensuring safety to their investment.
3. To prevent fraudulent and malpractices by having balance between self regulation of business and its statutory regulations.
4. To regulate and develop a code of conduct for intermediaries such as brokers, underwriters, etc.

Functions of SEBI:

The SEBI performs functions to meet its objectives.

1. Protective Functions:

These functions are performed by SEBI to protect the interest of investor and provide safety of investment.

As protective functions SEBI performs following functions:

(i) It Checks Price Rigging:

Price rigging refers to manipulating the prices of securities with the main objective of inflating or depressing the market price of securities. SEBI prohibits such practice because this can defraud and cheat the investors.

(ii) It Prohibits Insider trading:

Insider is any person connected with the company such as directors, promoters etc. These insiders have sensitive information which affects the prices of the securities. This information is not available to people at large but the insiders get this privileged information by working inside the company and if they use this information to make profit, then it is known as insider trading, e.g., the directors of a company may know that company will issue Bonus shares to its shareholders at the end of year and they purchase shares from market to make profit with bonus issue. This is known as insider trading. SEBI keeps a strict check when insiders are buying securities of the company and takes strict action on insider trading.

(iii) SEBI prohibits fraudulent and Unfair Trade Practices:

SEBI does not allow the companies to make misleading statements which are likely to induce the sale or purchase of securities by any other person.

(iv) SEBI undertakes steps to educate investors so that they are able to evaluate the securities of various companies and select the most profitable securities.

(v) SEBI promotes fair practices and code of conduct in security market by taking following steps:

(a) SEBI has issued guidelines to protect the interest of debenture-holders wherein companies cannot change terms in midterm.

(b) SEBI is empowered to investigate cases of insider trading and has provisions for stiff fine and imprisonment.

(c) SEBI has stopped the practice of making preferential allotment of shares unrelated to market prices.

2. Developmental Functions:

These functions are performed by the SEBI to promote and develop activities in stock exchange and increase the business in stock exchange. Under developmental categories following functions are performed by SEBI:

(i) SEBI promotes training of intermediaries of the securities market.

(ii) SEBI tries to promote activities of stock exchange by adopting flexible and adoptable approach in following way:

(a) SEBI has permitted internet trading through registered stock brokers.

(b) SEBI has made underwriting optional to reduce the cost of issue.

(c) Even initial public offer of primary market is permitted through stock exchange.

3. Regulatory Functions:

These functions are performed by SEBI to regulate the business in stock exchange. To regulate the activities of stock exchange following functions are performed:

(i) SEBI has framed rules and regulations and a code of conduct to regulate the intermediaries such as merchant bankers, brokers, underwriters, etc.

(ii) These intermediaries have been brought under the regulatory purview and private placement has been made more restrictive.

(iii) SEBI registers and regulates the working of stock brokers, sub-brokers, share transfer agents, trustees, merchant bankers and all those who are associated with stock exchange in any manner.

(iv) SEBI registers and regulates the working of mutual funds etc.

- (v) SEBI regulates takeover of the companies.
- (vi) SEBI conducts inquiries and audit of stock exchanges.

The Organisational Structure of SEBI:

1. SEBI is working as a corporate sector.
2. Its activities are divided into five departments. Each department is headed by an executive director.
3. The head office of SEBI is in Mumbai and it has branch office in Kolkata, Chennai and Delhi.
4. SEBI has formed two advisory committees to deal with primary and secondary markets.
5. These committees consist of market players, investors associations and eminent persons.

Objectives of the two Committees are:

1. To advise SEBI to regulate intermediaries.
 2. To advise SEBI on issue of securities in primary market.
 3. To advise SEBI on disclosure requirements of companies.
 4. To advise for changes in legal framework and to make stock exchange more transparent.
 5. To advise on matters related to regulation and development of secondary stock exchange.
- These committees can only advise SEBI but they cannot force SEBI to take action on their advice.

MEANING, FUNCTION & IMPORTANCE OF STOCK MARKETS, PRIMARY & SECONDARY MARKETS

Introduction : Stock Exchange (also called *Stock Market* or *Share Market*) is one important constituent of capital market. Stock Exchange is an organized market for the purchase and sale of industrial and financial security. It is convenient place where trading in securities is conducted in systematic manner i.e. as per certain rules and regulations. It performs various functions and offers useful services to investors and borrowing companies. It is an investment intermediary and facilitates economic and industrial development of a country.

Definitions of Stock Exchange

According to **Husband and Dockerary,**

"Stock exchanges are privately organized markets which are used to facilitate trading in securities."

The Indian Securities Contracts (Regulation) Act of 1956, defines Stock Exchange as,

"An association, organization or body of individuals, whether incorporated or not, established for the purpose of assisting, regulating and controlling business in buying, selling and dealing in securities."

Characteristics or features of stock exchange

1. **Market for securities :** Stock exchange is a market, where securities of corporate bodies, government and semi-government bodies are bought and sold.
2. **Deals in second hand securities :** It deals with shares, debentures bonds and such securities already issued by the companies. In short it deals with existing or second hand securities and hence it is called secondary market.
3. **Regulates trade in securities :** Stock exchange does not buy or sell any securities on its own account. It merely provides the necessary infrastructure and facilities for trade in securities to its members and brokers who trade in securities. It regulates the trade activities so as to ensure free and fair trade
4. **Allows dealings only in listed securities :** In fact, stock exchanges maintain an official list of securities that could be purchased and sold on its floor. Securities which do not figure in the official list of stock exchange are called unlisted securities. Such unlisted securities cannot be traded in the stock exchange.
5. **Transactions effected only through members :** All the transactions in securities at the stock exchange are affected only through its authorized brokers and members. Outsiders or direct investors are not allowed to enter in the trading circles of the stock exchange. Investors have to buy or sell the securities at the stock exchange through the authorized brokers only.
6. **Association of persons :** A stock exchange is an association of persons or body of individuals which may be registered or unregistered.

7. **Recognition from Central Government** : Stock exchange is an organized market. It requires recognition from the Central Government.
8. **Working as per rules** : Buying and selling transactions in securities at the stock exchange are governed by the rules and regulations of stock exchange as well as **SEBI Guidelines**. No deviation from the rules and guidelines is allowed in any case.
9. **Specific location** : Stock exchange is a particular market place where authorised brokers come together daily (i.e. on working days) on the floor of market called trading circles and conduct trading activities. The prices of different securities traded are shown on electronic boards. After the working hours market is closed. All the working of stock exchanges is conducted and controlled through computers and electronic system.
10. **Financial Barometers** : Stock exchanges are the financial barometers and development indicators of national economy of the country. Industrial growth and stability is reflected in the index of stock exchange.

Functions of stock market are:

- 1) **Continuous and ready market for securities:** Stock exchange provides a ready and continuous market for purchase and sale of securities. It provides ready outlet for buying and selling of securities. Stock exchange also acts as an outlet/counter for the sale of listed securities.
- 2) **Facilitates evaluation of securities:** Stock exchange is useful for the evaluation of industrial securities. This enables investors to know the true worth of their holdings at any time. Comparison of companies in the same industry is possible through stock exchange quotations (i.e price list).
- 3) **Encourages capital formation:** Stock exchange accelerates the process of capital formation. It creates the habit of saving, investing and risk taking among the investing class and converts their savings into profitable investment. It acts as an instrument of capital formation. In addition, it also acts as a channel for right (safe and profitable) investment.
- 4) **Provides safety and security in dealings** :Stock exchange provides safety, security and equity (justice) in dealings as transactions are conducted as per well defined rules and regulations. The managing body of the exchange keeps control on the members. Fraudulent practices are also checked effectively. Due to various rules and regulations, stock exchange functions as the custodian of funds of genuine investors
- 5) **Regulates company management:** Listed companies have to comply with rules and regulations of concerned stock exchange and work under the vigilance (i.e supervision) of stock exchange authorities.
- 6) **Facilitates public borrowing:** Stock exchange serves as a platform for marketing Government securities. It enables government to raise public debt easily and quickly.
- 7) **Provides clearing house facility:** Stock exchange provides a clearing house facility to members. It settles the transactions among the members quickly and with ease. The members have to pay or receive only the net dues (balance amounts) because of the clearing house facility.
- 8) **Facilitates healthy speculation** : Healthy speculation, keeps the exchange active. Normal speculation is not dangerous but provides more business to the exchange. However, excessive speculation is undesirable as it is dangerous to investors & the growth of corporate sector.
- 9) **Serves as Economic Barometer** : Stock exchange indicates the state of health of companies and the national economy. It acts as a barometer of the economic situation / conditions.
- 10) **Facilitates Bank Lending:** Banks easily know the prices of quoted securities. They offer loans to customers against corporate securities. This gives convenience to the owners of securities.

Secondary Market

- The secondary market is that part of the capital market that deals with the securities that are already issued in the primary market.
- The investors who purchase the newly issued securities in the primary market sell them in the secondary market. The secondary market needs to be transparent and highly liquid in nature as it deals with the already issued securities. In the secondary market, the value of a particular stock

also varies from that of the face value. The resale value of the securities in the secondary market is dependant on the fluctuating interest rates.

- Securities issued by a company for the first time are offered to the public in the primary market. Once the IPO is done and the stock is listed, they are traded in the secondary market. The main difference between the two is that in the primary market, an investor gets securities directly from the company through IPOs, while in the secondary market, one purchases securities from other investors willing to sell the same.
- Equity shares, bonds, preference shares, treasury bills, debentures, etc. are some of the key products available in a secondary market. SEBI is the regulator of the same.

Difference between Primary Market and Secondary Market

- Primary and Secondary markets refer to markets which assist corporations obtain capital funding. The difference between these two markets lies in the process that is used to collect funds.
- The Primary market refers to the market where new securities are issued by the company that wishes to obtain capital and is sold directly to the investor
- The secondary market refers to the market where securities that have already been issued are traded. Instruments that are usually traded on the secondary market include stocks, bonds, options and futures
- The main difference is that, in the primary market, the company is directly involved in the transaction, whereas in the secondary market, the company has no involvement since the transactions occur between investors.

INSURANCE : TYPES OF INSURANCE

Insurance is the equitable transfer of the risk of a loss, from one entity to another in exchange for payment. It is a form of risk management primarily used to hedge against the risk of a contingent, uncertain loss. There are the following categories of risk

1. Financial risks which means that the risk must have financial measurement.
2. Pure risks which means that the risk must be real and not related to gambling
3. Particular risks which means that these risks are not widespread in their effect, for example such as earthquake risk for the region prone to it.

It is commonly accepted that only financial, pure and particular risks are insurable. An insurer, or insurance carrier, is a company selling the insurance; the insured, or policyholder, is the person or entity buying the insurance policy. The amount of money to be charged for a certain amount of insurance coverage is called the premium.

7 Basic principles of insurance

1) Principle of Uberrimae fidei (Utmost Good Faith)

Utmost Good Faith

- Both the parties i.e. the insured and the insurer should a good faith towards each other.
- The insurer must provide the insured complete ,correct and clear information of subject matter.
- The insurer must provide the insured complete ,correct and clear information regarding terms and conditions of the contract.
- This principle is applicable to all contracts of insurance i.e. life, fire and marine insurance.

2) Principle of Insurable Interest

Insurable Interest

- The insured must have insurable interest in the subject matter of insurance.
- In life insurance it refers to the life insured.
- In marine insurance it is enough if the insurable interest exists only at the time of occurrence of the loss
- In fire and general insurance it must be present at the time of taking policy and also at the time of the occurrence of loss.
- The owner of the party is said to have insurable interest as long as he is the owner of the it.
- It is applicable to all contracts of insurance.

3) Principle of Indemnity

Principle of Indemnity

- Indemnity means a guarantee or assurance to put the insured in the same position in which he was immediately prior to the happening of the uncertain event. The insurer undertakes to make good the loss.
- It is applicable to fire ,marine and other general insurance.
- Under this the insurer agrees to compensate the insured for the actual loss suffered.

4) Principle of Contribution

Principle of Contribution

- The principle is a corollary of the principle of indemnity.
- It is applicable to all contracts of indemnity.
- Under this principle the insured can claim the compensation only to the extent of actual loss either from any one insurer or all the insurers.

5) Principle of Subrogation

Principle of Subrogation

- As per this principle after the insured is compensated for the loss due to damage to property insured , then the right of ownership of such property passes on to the insurer.
- This principle is corollary of the principle of indemnity and is applicable to all contracts of indemnity

6) Principle of Loss Minimization

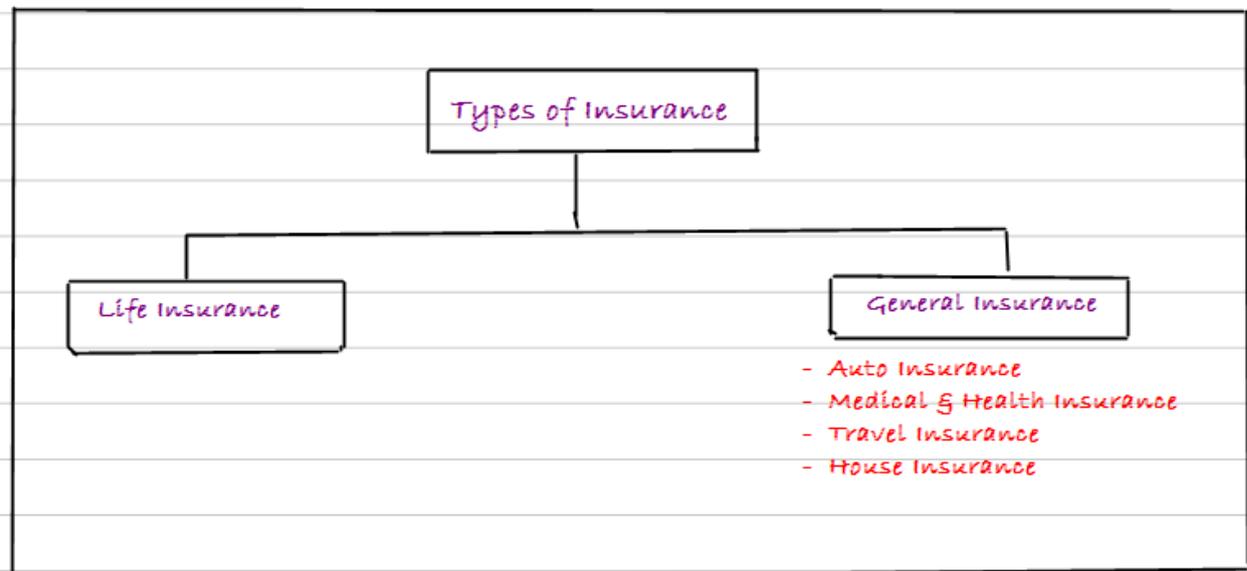
Principle of Loss of Minimization

Under this principle it is the duty of the insured to take all possible steps to minimize the loss to the insured property on the happening of uncertain event.

7) Principle of Causa Proxima (Nearest Cause)

Principle of 'Causa Proxima'

- The loss of insured property can be caused by more than one cause in succession to another.
- The property may be insured against some causes and not against all causes.
- In such an instance, the proximate cause or nearest cause of loss is to be found out.
- If the proximate cause is the one which is insured against, the insurance company is bound to pay the compensation and vice versa.



LIFE INSURANCE : Life insurance (or commonly life assurance, especially in the Commonwealth) is a contract between an insured (insurance policy holder) and an insurer or assurer, where the insurer promises to pay a designated beneficiary a sum of money (the "benefits") in exchange for a premium, upon the death of the insured person. Depending on the contract, other events such as terminal illness or critical illness may also trigger payment. The policy holder typically pays a premium, either regularly or as a lump sum. Other expenses (such as funeral expenses) are also sometimes included in the benefits.

Life policies are legal contracts and the terms of the contract describe the limitations of the insured events. Specific exclusions are often written into the contract to limit the liability of the insurer; common examples are claims relating to suicide, fraud, war, riot, and civil commotion.

Life-based contracts tend to fall into two major categories:

- Protection policies – designed to provide a benefit in the event of specified event, typically a lump sum payment. A common form of this design is term insurance.
- Investment policies – where the main objective is to facilitate the growth of capital by regular or single premiums. Common forms (in the US) are whole life, universal life, and variable life policies.

GENERAL INSURANCE :General insurance or non-life insurance policies, including automobile and homeowners policies, provide payments depending on the loss from a particular financial event. General insurance typically comprises any insurance that is not determined to be life insurance. It is called property and casualty insurance in the U.S. and Canada and Non-Life Insurance in Continental Europe.

DIFFERENCE BETWEEN LIFE INSURANCE & GENERAL INSURANCE

Type of contract

- Life insurance is a non-personal insurance contract. This means that the policyholder and the person being insured do not have to be the same person. General insurance is always a personal contract where the insurance company contracts with you directly for insurance protection.

Function

- Both life insurance and general insurance accept premiums in exchange for insurance benefits. Insurance premiums are invested into bonds or bond-like investments that produce stable and consistent returns for the insurance company. The investments, plus premium payments, also ensure that the insurance company can pay the promised benefits that are outlined in the insurance policy. When you need to file a claim, both types of insurance require a claim form for you to fill out. The payment of benefits, and the amount of the benefit that is payable, are always spelled out in your insurance contract.

Significance

- Life insurance insures your life or the life of someone that you have an economic interest in, like your spouse, children, siblings or business partners. When the insured individual dies, the life insurance policy pays a death benefit that is fixed. This is called a valued contract. A valued contract pays a fixed sum of money, regardless of the nature of the loss insured by the contract. General insurance insures homes, automobiles and other personal property. This type of insurance is sometimes referred to as "property and casualty" insurance. General insurance is indemnity insurance. Indemnity insurance pays just enough money to you to repair or replaced the insured property. For example, your homeowner's insurance may cover your entire home and the contents of it. However, if your roof is damaged in a storm, the policy only pays enough to repair the damage.

Benefits

- The benefit of life insurance is that it pays off any financial obligations you have left after you die. It can pay more than that, however, because life insurance pays a fixed amount. Death benefits can be used to create wealth for the surviving beneficiaries, or they can be used to replace the primary income earner's salary for a surviving spouse.

General insurance is beneficial in that the insurance ensures that, almost regardless of the damage done, that the property will be repaired or replaced. While general insurance generally has a maximum payout determined by the value of your property, it does not pay a fixed amount, so you won't have to guess at how much insurance you need to purchase.