MACROECONOMY

Introduction

Banking sector is an integral part of economy. To better understand banking sector, we must have an overview of economy. So let us have an idea how economy works? In economics we mainly deals with, how **production, distribution and consumption** of **goods and services** (G&S) takes place. We can understand broader functioning of an economy with the help of circular flow model.

What is Circular flow model?

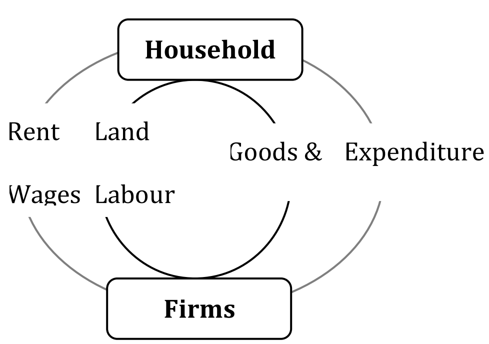
In economics, a **circular flow model** is used to represent the monetary transactions in an economy. There are two **flows** present within the **model** including **flows** of physical things (goods or labour) and **flows** of money (what pays for physical things).
See table below for details

Production & consumption in an economy

Production

Who produces what & how?

Firms & factories produce goods and services. For production firms requires land, labour, capital etc which is provided by households. In return, households get incomes(money) in form of salaries, rent, wages, interests.
Four factors of income and associated incomes
Land -rent
Labour-wage
Capital-interest
Entrepreneurs-profits



Consumption

Who consumes what & how?

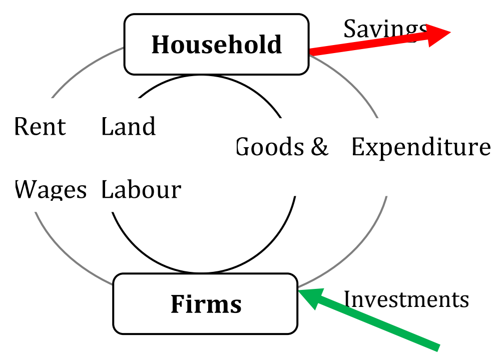
Household consumes G&S produced by firms for which they spent money.

Next we can understand few economic terms with help of above model.

Savings?

Let's introduce **saving** into our model
As we know households does not spent their whole income but they also save a part of it in form of deposits in banks, cash at hand, etc. As this money is not spent on goods & services, so we can consider it as a leakage from circular flow.

Savings – leakages **Investments** – injections
Now let us consider three cases!
If S>>I if savings are higher than investments→ means leakage is more → money is not utilised in economy for production→ lesser production→ unemployment, …….
If S<<I I if savings are lesser than investments→ means high investments→ more production in economy → employment…….
If S = I everything in balance



Try yourself!

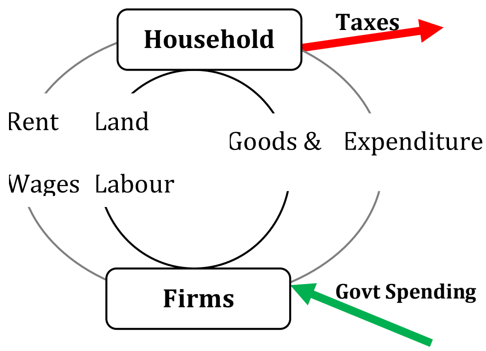
For above three cases Analyse effects on ? (↑↓)– production - consumption - unemployment – inflation
Role of Banks?
Can banks help in channelizing money in economy by accepting savings from people and giving loans to factories for investment & hence production!
Clearly, banks have to encourage borrowers to borrow **more**. Banks can do this by **reducing the interest rates they charge on loans**

Role of government in economy ?

As govt raise taxes on incomes of households, So this part of money is not available for spending by households. So money not spent in economy is a kind of leakage from circular flow.

But wait for a while & think, what govt do with this money!

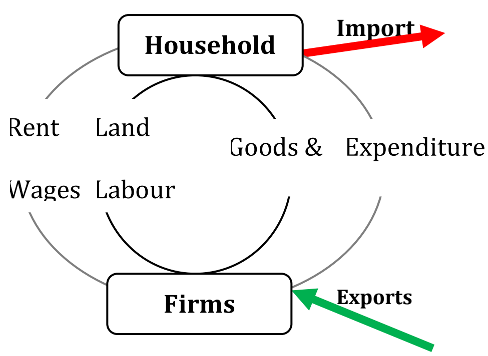
Govt spends on Subsidies --Transfer payments--Capital investments (infrastructure, roads, railway, and dams) One more crucial function of govt is -Redistribution of income - by taxing rich higher & redistributing it in poor by way of subsidies → creating a balance!



Role of govt →Taxation = leakage Govt **spending** = injection
If G > T. if govt pending is much higher than money received from taxation → means govt 'running a budgetary deficit'

What is External sector?

If an Indian buy foreign G&S, than he is actually spending money out of economy→ out of circular flow→ Imports& investment by Indians abroad = leakage
Exports& investment in India by foreigners (FDI, FII) = injection
M = total money flowing out
X = total flow in



M > X = **Balance of Payments deficit.**
We will discuss these concepts in separate chapters; goal here is just to introduce you with economic terms

GOVERNMENT BUDGET

Introduction

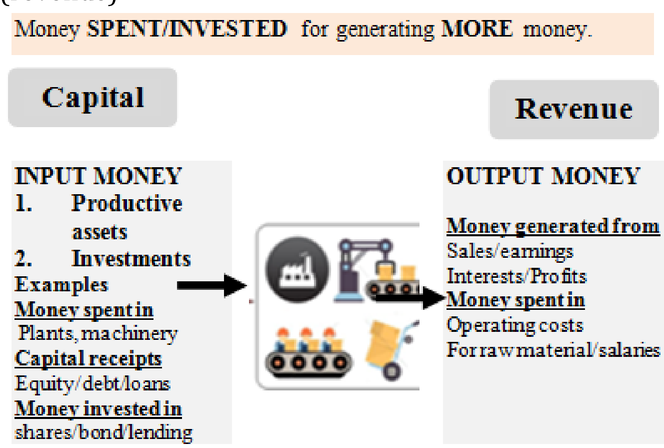
To properly understand govt budget, we must have conceptual clarity of following two terms →capital and revenue.

Capital consists of anything (money-material) that can be used in production. Capital is an input in the production function.

Further, what we have finally produced using capital can be taken as revenue.

See image below - imagine you establish a factory and start production.

Now with the help of image below, try to understand concept of **INPUT** money (capital) &**OUTPUT** Money (revenue)



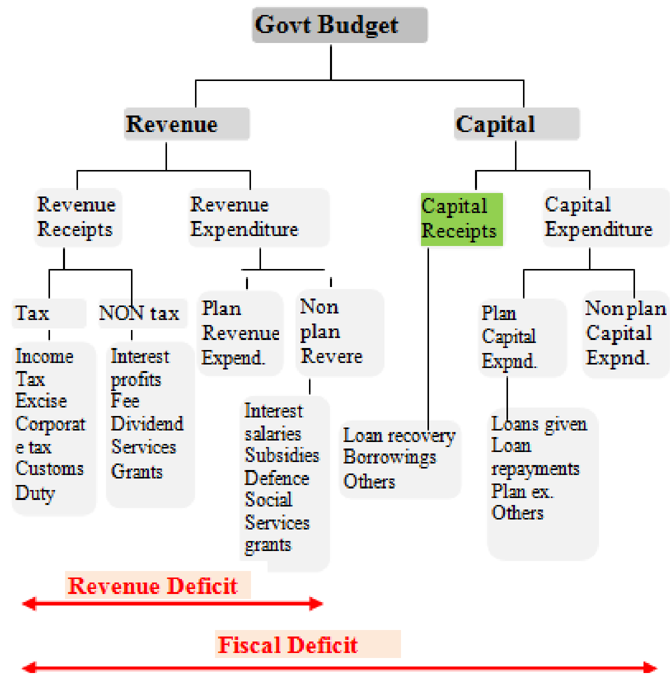
Govt budget is also divided on same lines, revenue side and capital side.

See diagram below and clearly observe following things

1. Reciepts and Expenditures on revenue side
2. Reciepts and Expenditures on Capital side

Govt reciepts always shortfall of its expenditures (Deficits).

To fill deficits government borrow from different sources.



Important concepts about deficits

Revenue Deficit= revenue expenditure - revenue receipts

Capital Deficit = Capital Expenditure– Capital Receipts

Fiscal Deficit= Total Expenditure – (Revenue Receipts + Non-debt Capital Receipts)

Primary Deficit: fiscal deficit - interest payments.

Interest payments reflect a consequence of past actions of the government, namely, loans taken and given in years prior to the one under consideration. Exclusion of interest transactions enables us to see, how the government is currently conducting its financial affairs.

Monetised Deficit:it indicates the level of support extended by the Reserve Bank of India to the government's borrowing programme.

Effective Revenue Deficitis the difference between revenue deficit and grants for creation of capital assets. The definition of the revenue expenditure is that it must not create any productive asset. However, There are several revenue expenditures part of which do create some assets MGNREGA, PMGSY. So ERD included in budget.

Now we have an idea about govt deficits. Deficits are calculated on a single year. Accumulation of deficits over years leads to stock known as Debt

How govt fill its deficits - deficit financing

1. External aids - generally developing and underdeveloped countries take monetary help from developed countries.
2. External borrowings - borrow money from other countries/banks/financial institutions
3. Internal borrowings - borrow from inside the country- banks/financial institutions
4. Printing currency

If govt has larger debts, it has to pay a lot in form of interests to lenders. Result is that govt remain with little money to spend on developmental works like infra, education, health.. Which are more crucial for development of a country?

What restrict govt from making large borrowings/deficits

FRBM act –2003 fiscal responsibility & budget management act.

The Act mandates the central government to take appropriate measures to reduce fiscal deficit and revenue deficits. If this is not achieved through tax revenues, the necessary adjustment has to come from a reduction in expenditure

Deficit Reduction

Government deficit can be reduced if govt increases it receipts while at the same time decreases its spending. It is also known as **fiscal consolidation. It can be achieved in following ways**

Fiscal consolidation	
Cutting down expenditure	Increasing revenue receipts
↓Subsidies ↓Salaries, pensions ↓Interest burden ↓Defence spending ↓Expenditure reforms	Tax reforms – GST Disinvestment of PSUs

TAXATION

What is a tax?

A tax is a financial charge on an individual or legal entity by a state. Govt raise taxes for efficient administration of a country. Apart from that Govt achieves redistribution of income & resources (by taxing rich more & poor less)

Methods of taxation

Progressive taxation- increasing rate of tax with increasing value or volume. Ex -income tax in India. 30% taxes on rich with annual income more than 10 lakhs. No taxation up to 2.5 lakhs of annual income

Regressive taxation- decreasing rate of tax with increasing value or volume. Taxation on essential goods. Rich and poor have to pay equally while buying toothpaste. But its burden on poor is more as 10 Rs matter a lot for poor & but 10 Rs nothing for a highly rich person.

Types of taxes

To understand types of taxes, let us first have idea about two basic concepts.

Incidence of tax –the point where tax looks being imposed.

Burden of tax – the point where effect of tax being felt.

Types of taxes

Direct tax-

1. Person or entities pays it directly in the first instance to the government.
2. Taxed on the income or profits.
3. On individual & legal entities.
4. Incidence and burden at same point.

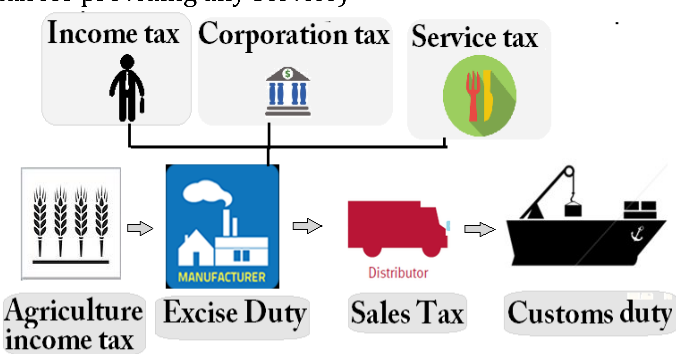
Indirect tax

1. Paid indirectly to the government.
2. Put on goods and services (consumption rather on income)
3. Incidence and burden at different point.

	Direct Tax	Indirect Tax
Meaning	Imposed on the individual or legal entity.	Imposed on goods and services and on transactions.
	Paid Directly to govt	Paid indirectly to govt
	income or profits	Goods & services
Incidence &Burden	Same points	Different points
Types	Wealth Tax, Income Tax, Property Tax, Corporate Tax, Import and Export Duties.	Central Sales tax, VAT (Value Added Tax), Service Tax, STT (Security Transaction Tax), Excise Duty, Custom Duty.
Evasion	Tax evasion is possible.	Tax evasion is hardly possible

Inflation	Reduces inflation.	Promotes the inflation.
Nature	Progressive	Regressive

Let us understand about **different types of taxes**with a rough **example**. follow image below-
A farmer produces wheat sells it to Mill owner → mill owner manufacture bread out of it (excise duty on manufacturing) → wholesaler & retailer sells bread in market (sales tax) → if trader sales bread outside country (customs duty for import/export)
Further bread factory makes profit (tax on profits- corporate tax) → employee in factory receives salary (income tax) → bread serves by a restaurant (service tax for providing any service)



Various types of taxes by different Governments

As per Indian constitution different governments have separate domain and powers to levy taxes.
Let us see few examples

Direct taxes

Union Govt

Taxes on income
Income tax
Corporate tax
MAT (minimum altemate tax)

Taxes on Assets
Wealth tax

State Govt

Taxes on income
Agricultural income
Professional tax

Taxes on properties
Land revenue
Stamp duty

Indirect taxes

Union Govt

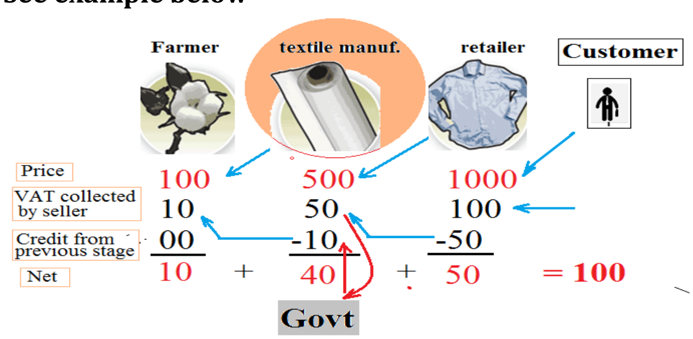
Customs duty
Excise
Service tax
Central sales tax

State Govt

Sales tax/VAT
Excise on liquor/narco
Motor vehicle tax
Toll tax
Electricity tax
Taxes on
Luxury
Batting
Gambling

What is a VAT - Value added Tax

Vat is a kind of tax imposed on each stage of value addition in a product. It is collected at every stage of production and distribution
See example below



Assume tax rate is 10%. Suppose you are textile manufacturer.
You as a buyer:
You buys cotton from farmer in Rs 100/- and paid Rs 10 as tax.

You as a seller:

When you sell a shirt to retailer you receive Rs 500/- including a tax of RS 50/-
In the above two process, you as a buyer & as a seller you collected net of Rs 40 (50-10) which govt finally collects from you.
So Vat is a two way process, govt can verify transaction records from buyer as well as seller, therefore tax avoidance is difficult.

Basis	Sales Tax	VAT
Meaning	Tax charged on the total value of the commodity,	VAT is a tax charged at each level of the production and distribution chain whenever the value is added to the product.
Nature	Single point tax collection	Multi point collection
Tax Evasion	Can be possible	Cannot be possible
Cascading	Yes	No
Levied on	Total Value	Value Added
Tax Burden	Falls on the consumer	Rationalized.
Input Tax Credit	Unavailable	Available
Area	Applies to the whole country.	Applies within the jurisdiction of the state.

The Goods and Service Tax (GST)

1. A new form of indirect tax
2. replace other indirect taxes like service tax, sales tax.
3. Dual tax- every supply of goods and services would be subjected to a Central GST (CGST) and State GST (SGST) on intrastate supply.
4. A separate tax IGST for inter-state trade.
5. states as well as the centre can tax services
6. GST will be available as input tax credit
7. Differential treatment for alcohol, tobacco and petroleum products

Benefits

1. Simplicity & increased compliance
2. Less evasion -help to develop single market

EXTERNAL SECTOR

Introduction

The **external sector** is part of a country's economy that interacts with the economies of other countries. In goods market, the external sector involves **exports and imports**. In the financial market it involves **capital flows**.

What is balance of payment?

The Balance of Payment (BoP) records a country's **net** of all transactions with the rest of the world. All transaction include **goods & services as well as capital** flows in/out of a country.
Therefore, BoP is a net of two accounts - current a/c & capital a/c.
See table below - various items are included in current a/c & capital a/c. further revenue generated on capital a/c is also included under Current a/c. (follow red arrow in table)

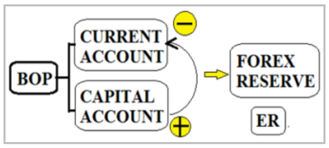
Balance of Payment			
Capital A/c	FDI	long-term capital investment	Profits
	FII	purchase of shares and bonds.	Incomes
	Loans – ECB- govt	Any borrowing or lending in foreign exchange	Interests
	property	Immovable property, land	Rent
	Reserve a/c	to buy and sell foreign currencies by RBI	
Current A/c	balance of trade (BoT) Net of ex/Im	Goods (physical objects)	
		Services (invisibles)	
	net primary income	Incomes from capital a/c	
	net cash transfers	Remittances	

Forex reserves

India's foreign exchange reserves is made up of
1. Foreign currency assets (FCA) (US dollar, euro, pound sterling, Canadian dollar, Australian dollar and Japanese yen etc.)
2. gold
3. special drawing rights (SDRs) of IMF
4. Reserve tranche position (RTP) in the International Monetary Fund (IMF)

In case of India: Capital a/c remains +ve due to high flow of foreign capital (FDI/FII) inside India.
While current a/c remains -ve , given the more imports over exports of goods and services by India.

So excess of capital a/c is used to finance our excess of exports over imports. Remaining excess of capital a/c goes to forex reserve with RBI. See image below



Basis for Comparison	FDI	FII
Meaning	Long term investments in plant, machinary- productive assets.	FII is investments in the share & stock market of a country.
Market	Primary	Secondary
Entry and Exit	Difficult	Easy
What it brings?	Long term capital	Long/Short term capital
Transfer of	Funds, resources, technology, strategies, know-how etc.	Funds only.
Economic Growth	Yes	No
Target	Specific Company	No such target, investment flows into the financial market.
Control	Yes	No

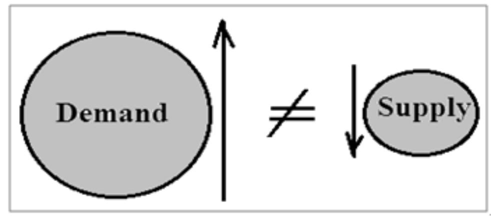
Forex market-

1. The market in which buy, sell, exchange and speculate on currencies .
2. Participants are made up of banks, commercial companies, central banks,investment management firms, hedge funds, and retail forex brokers and investors. The forexmarket is considered to be the largest financial market in the world.
3. Exchange rate depends on three factors –
   i. Economic Activities
   ii. GDP
   iii. Political stability

INFLATION

What is inflation?

Inflation is general <u>rise in prices</u> of goods & services. Increase in prices caused by <u>mismatch in demand & supply</u> side of an economy



Causes of inflation

Factor causing inflation can be broadlycategorised in two parts.
If causes of inflation is on demand side (↑ consumption) ,it is known as Demand pull factors.
On the other hand if causes of inflation are on supply side it is known as Cost push factors. It occurs due to rise in input cost which ultimately reflect in price of final goods and services

Causes of inflation	
Demand pull factors	**Cost push factors (supply side)**
1. Excess aggregate demand. 2. Increase in disposable income 3. Increase in money supply (RBI) 4. Black money	1 Increasing raw material 1. Rising wage cost 2. Increased taxes 3. High profit margin 4. Rising import prices due to fall in exchange rate

Losers and gainers at time of inflation

Inflation = loss in value of money vs goods & services

Losers	Gainers
Creditors (lenders) Wage earners Salaried persons Pensioners Bondholders	Debtors(borrowers) Businessmen Shareholders Govt

Related Terms

1. **Deflation** - continuous decrease in prices of goods and services - inflation rate becomes **negative** (below zero).
2. **Stagflation** - A condition of <u>slow economic growth</u> and relatively high unemployment- a time of stagnation- accompanied by <u>inflation.</u>
3. **Disinflation**- A <u>slowing in the rate</u> of price inflation - when the inflation rate has reduced

marginally over the short term. It is used to describe periods of slow inflation.

TERMS	Rate of inflation
Deflation	-ve
Stagflation	+ve
Disinflation	+ve