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Contents of This Booklet

INDIAN ECONOMY

- Economics :An Introduction
- Economic Planning in India
- Fiscal System
- Monetary and Credit Policy
- Money Market and Capital Market in India
- Stock Markets in India
- Taxation System in India: Concepts and Policies
- Inflation : Concepts, Facts and Policy
- Public Sector
- Banking System in India
- Poverty and Inequality Concepts, Data Policy and Analysis
- Unemployment
- Agriculture
- Important Indices
- Bretton Woods Institutions and Others
- GATT and WTO
- Foreign Trade
- External Sector
- Economy Updates

GIST OF N.C.E.R.T.

- Sectors of the Indian Economy
- Liberalization
- Human Capital and Human Development
- Growth and Changing Structure of Employment
- India's economic interaction with the World

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Sample Chapters of This Booklet

Economics : An Introduction

Ques. 1 : What are the definitions of economics?

Ans. Economics as a word comes from the Greek: oikos means 'family, household, or estate', and nomos stands for 'custom, law' etc. Thus, "household management" or manage-ment of scarce resources is the essential meaning of economics. Economics encom-passes production, distribution, trade and consumption of goods and services. Economic logic is applied to any problem that involves choice under scarcity.

Ques. 2 : Evolution of the subject.

Ans. Initially, economics focused on "wealth" and later "welfare". Still later, in recent years, it has given sufficient attention to the study of trade offs- giving up one to gain another. The focus on tradeoffs arises from the traditional assumption that resources are scarce and that it is necessary to choose between competing alternatives. Choosing one benefit implies forgoing another alternative the opportunity cost (cost of foregoing an Opportunity).

Ques. 3 : Who is known as the father of Economics & suggest Some definition put fourth by earlier economist.

Ans. Adam Smith, generally regarded as the Father of Economics, author of 'An Inquiry into the Nature' and Causes of the Wealth of Nations (generally known as The Wealth of Nations) defines economics as "The science of wealth." Smith offered another definition, "The Science relating to the laws of production, distribution and exchange."

Definitions in terms of wealth emphasize production and consumption, and do not deal with the economic activities of those not significantly involved in these two processes, for example, children and old people. The belief is that non-productive activity is a cost on society. It meant that man was relegated to the secondary position and wealth was placed above life.
Thus arose the shift in the focus to welfare economics study of man and of human welfare, not of money alone. Economics involves social action connected with the attainment of human well being.

Ques. 4 : Discuss the different branches of economics.

Ans. Economics is usually divided into two main branches:

Microeconomics which examines the economic behavior of individual actors such as consumers, businesses, households etc. to understand how decisions are made in the face of scarcity and what effects they have.

Macroeconomics, which studies the economy as a whole and its features like national income, employment ,poverty, balance of payments and inflation.

The two are linked closely as the behavior of a firm or consumer or household depends upon the state of the national and global economy.

Ques. 5 : What is Mesoeconomics?

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'Mesoeconomics' studies the intermediate level of economic organization in between the micro and the macro economics like institutional arrangements etc.

DIVISION OF ECONOMICS	FOCUS
Microeconomics	Production/output in individual industries and businesses and consumer and behaviour How much steel How much office space How many cars Consumer behaviour
Macroeconomics	National production/output Gross domestic product Employment Poverty Inflation BOP

There are broadly the following approaches in the mainstream economics. The basis of all the streams is the same: resources are scarce while wants are unlimited (often mentioned as the economic problem).

Ques. 6 : What is Keynesian theory of macro economics?

Ans.

- Keynesian macroeconomics based on the theories of twentieth-century British economist John Maynard Keynes. It says that the state can stimulate economic growth and restore stability in the economy through expansionary policies. For example- through massive programme of spending on infrastructure when the demand is low and growth is negative.
- In the recessionary phase that the economies of the western world in particular and rest of the world in general, went through (some are still undergoing the recession) due to 2008 financial crisis, the relevance of Keynes is growing.
- The intervention by State is only when the economic cycle turns down and growth slows down or is negative. In normal times, it is the market that drives growth through the force of supply and demand.
- Indian government stepped up expenditure with three fiscal stimuli since December 2008 to revive growth. With growth spurting, the gradual and calibrated exit from the stimulus was begun in the 2010-11 Union Budget.
- The theories of Keynesian economics were first presented in 'The General Theory of Employment, Interest and Money' (1936).

Ques. 7 : Define Neoliberalism.

Ans. Neoliberalism refers to advocacy of policies such as individual liberty, free markets, and free trade. Neoliberalism "proposes that human well being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets and free trade".

Ques. 8 : What is socialist theory of economics?

Ans. In distinction to the above, there is the school of socialist economics based on public (State) ownership of means of production to achieve greater equality and give the workers greater control

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of the means of production. It establishes fully centrally planned economy which is also called command economy - economy is at the command of the State. Private ownership of assets is not allowed. For example, erstwhile USSR, Cuba etc.

Ques. 9 : What is development economics?

Ans. Development economics is a branch of economics which deals with economic aspects of the development process, mainly in low-income countries. Its focus is not only promoting economic growth and structural change but also improving the well being of the population as a whole through health and education and workplace Conditions, whether through public or private channels. The most prominent contemporary development economists are Nobel laureates Amartya Sen and Joseph Stiglitz.

Ques. 10 : What is structural change? Give an example.

Ans. Structural change of an economy refers to a long-term widespread change of a fundamental structure, rather than microscale or short-term change. For example a subsistence economy is transformed into a manufacturing economy, or a regulated mixed economy is liberalized. An insulated and protectionist economy becomes open and globalized. A current structural change in the world economy is globalization.

Ques. 11 : Define green economics.

Ans. Green economics focuses on and supports the harmonious interaction between humans and nature and attempts to reconcile the two.

Ques. 12 : What is Economic Growth? And how can we measure it ? Discuss about its various methods.

Ans. Economic growth is the change- increase or decrease, in the value of goods and services produced by an economy. If it is positive, it means an increase in the output and the income of a country. It is generally shown as the increase in percentage terms of real gross domestic product (GDP adjusted to inflation) or real GDP.

Measuring Growth

Measures of national income and output are used in economics to estimate the value of goods and services produced in an economy. They use a system of national accounts or national accounting. Some of the common measures are Gross National Product (GNP) and Gross Domestic Product (GDP).

National income accounting

National income accounting refers to a set of rules and techniques that are used to measure the national income of a country.

GDP is defined as the total market value of all final goods and services produced within the country in a given period of time- usually a calendar year or financial year.

GDP can be real or nominal. Nominal GDP refers to the current year production of final goods and services valued at current year prices. Real GDP refers to the current year production of goods and service valued all base year prices. Base year prices are Constant prices.

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In estimating GDP, only final marketable goods and services are considered. Only their values are added up and they pertain to a given period. When it is compared to the base year figure, the growth levels are Seen.

To explain further, gains from resale are excluded but the services provided by the agents are counted. Similarly, transfer payments (pensions, scholarships etc) are excluded as there is income received but no good or service produced in return. However, not all goods and services from productive activities enter into market transactions. Hence, imputations are made for these non-marketed but productive activities: for example, imputed rental for owner-occupied housing.

Market Price and Factor Cost

Market price refers to the actual transacted price and it includes indirect taxes- custom duty, excise duty, sales tax, service tax etc.

Factor cost refers to the actual cost of the Various factors of production includes government grants and subsidies but it excludes indirect taxes.

Relationship between market price and factor cost.

GNP at factor cost = GNP at market price - indirect taxes + subsidies

GDP at factor cost = GDP at market price - indirect taxes + subsidies

Factor costs

Factor costs are the actual production costs at which goods and services are produced by the firms and industries in an economy. They are really the costs of all the factors of production such as land, labour, capital, energy, raw materials like steel etc. that are used to produce & given quantity of output in an economy. They are also called factor gate costs (farm gate, firm gate and factory gate) since all the costs that are incurred to produce a given quantity of goods and services take place behind the factory gate i.e. within the walls of the firms, plants etc in an economy.

Transfer Payments

Transfer payment refers to payments made by government to individuals for which there no economic activity is produced in return by these individuals. Examples of transfer are scholarship, pension.

Ques. 13 : How can we estimate GDP/GNP?
Ans.

Three approaches

There are three different ways of calculating GDP. The expenditure approach adds consumption, investment, government expenditure and net exports (exports minus imports).

On the other hand, the income approach adds what factors earn: wages, profits, rents etc.

Output approach adds the market value of final goods and services .

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The three methods must yield the same results because the total expenditures on goods and services must by definition be equal to the value of the goods and services produced (GNP) which must be equal to the total income paid to the factors that produced these goods and services.

In reality, there will be minor differences in the results obtained from the various methods due to changes in inventory levels. This is because goods in inventory have been produced (and therefore included in GDP), but not yet sold. Similar timing issues can also cause a slight discrepancy between the value of goods produced (GDP) and the payments to the factors that produced the goods, particularly if inputs are purchased on credit.

Ques. 14 : Define final goods.

Ans. Final goods are goods that are ultimately consumed rather than used in the production of another good. For example, a car sold to a Consumer is a final good; the components such as tyres sold to the car manufacturer are not; they are intermediate goods used to make the final goods. The same tyres, if sold to a consumer, would be a final goods. Only final goods are included when measuring national income. If intermediate goods were included too, this would lead to double counting; for example, the value of tyres would be counted once when they are sold to the car manufacturer, and again when the car is sold to the consumer.

Only newly produced goods are counted. Transactions in existing goods, such as second-hand cars, are not included, as these do not involve the production of new goods.

Ques. 15 : What is GDP?

Ans. GDP considers only marketed goods. If a cleaner is hired, their pay is included in GDP. If one does the work himself, it does not add to the GDP. Thus much of the work done by women at home- taking care of the children, aged; chores etc which is called ‘care economy’ is outside the GDP.

Gross means depreciation (wear and tear of machinery in their use) of capital stock is not subtracted. If depreciation is subtracted, it becomes net domestic product.

Calculating the real GDP growth -inflation adjusted GDP growth- allows us to determine if production increased or decreased, regardless of changes in the - inflation and purchasing power of the currency.

Ques. 16 : Is GDP & GNP are related or they are different from each other?

Ans. The two are related. The difference is that GNP includes net foreign income. GNP adds net foreign investment income compared to GDP. GDP shows how much is produced within the boundaries of the country by both the citizens and the foreigners. It is the market value of all the output produced in the territory of a nation in one year. GDP focuses on where the output is produced rather than who produced it. GDP measures all domestic production, disregarding the producing entities nationalities.

In contrast, GNP is a measure of the value of the output produced by the “nationals” of a country- both with in the geographical boundaries and outside. That is, all the output that the Indian citizens produce in a given year - both within India and all other countries.

For example, there are Indian and foreign firms operating in India. Together what they produce within the Indian geography is the GDP of India. The profits of foreign firms earned within India are included in India’s GDP, but not in India’s GNP.

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In other words, income is counted as part of GNP according to who owns the factors of production rather than where the production takes place. For example, in the case of a German-owned car factory operating in the US, the profits from the factory would be counted as part of German GNP rather than US GNP because the capital used in production (the factory, machinery, etc.) is German owned. The wages of the American workers would be part of US GDP, while the wages of any German workers on the site would be part of German GNP.

GDP is essentially about where production takes place. GNP is about who produces. If it is an open economy with great levels of foreign investment (FD1) and lesser levels of outbound FDI, its GDP is likely to be larger than GNP.

If it is an open economy but more of its nationals tend to move economic activity abroad or earn more from investing abroad compared with non-nationals doing business and earning incomes within its borders, its GNP will be larger than GDP.

If it is a closed economy where nobody leaves its shores, nobody invests abroad, nobody comes in and nobody invests in the country, its GDP will be equal to GNP.

Japan used to belong in the last category. Until the mid-1990s, the difference between Japan's GDP and GNP amounted to less than one percentage point of GDP. With only limited numbers of people doing business abroad, the GDP and GNP were essentially the same thing.

Ques. 17 : Define Net National Product.

Ans. In the production process a country uses machines and equipment. When there is depreciation, we have to repair or replace the machinery. The expenses incurred for this are called the depreciation expenditure. Net National Product is calculated by deducting depreciation expense from gross national product.

NNP = GNP - Depreciation

National Income is calculated by deducting indirect taxes from Net National Product and adding subsidies. National Income (NI) is the NNP at factor cost.

NI = NNP - Indirect Taxes + Subsidies

Ques. 18 : What is Per Capita Income?

Ans. Per Capita Income is per capita GDP: GDP divided by mid year population of the corresponding year.

The growth of GDP at constant price shows an annual real growth.

The real GDP per capita of an economy is often used as an indicator of the average standard of living of individuals in that country, and economic growth is therefore often seen as indicating an increase in the average standard of living.

Ques. 19 : Why we need to measure economic growth?

Ans. The following aims can be attributed to the study of economic growth:

- when growth is quantified , we can understand whether it is adequate or not for the given goals of the economy.

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- we can understand its potential and accordingly set targets.
- we can adjust growth rates for their sustainability.
- we can prevent inflation or deflation to some extent if we see the performance of the economy in quantitative terms.
- we can balance the contributions of the three sectors of the economy and steer the direction of growth towards national goals- away from agriculture to manufacturing as in the case of India in recent years.
- target appropriate levels of employment creation and poverty alleviation.
- forecast tax revenues for governmental objectives.
- corporates can plan their business investments.

Ques. 20 : Discuss the problems for calculating National Income.

Ans. The measurement of national income encounters many problems. The problem of double-counting. Though there are some corrective measures, it is difficult to eliminate double-counting altogether. And there are many such problems and the following are some of them.

i. **Black Money**
Illegal activities like smuggling and unreported incomes due to tax evasion and corruption are outside the GDP estimates. Thus, parallel economy poses a serious hurdle to accurate GDP estimates. GDP does not take into account the 'parallel economy' as the transactions of black money are not registered.

ii. **Non-Monetization**
In most of the rural economy, considerable portion of transactions Occurs informally and they are called as non-monetized economy- the barter economy. The presence of such non-monetary economy in developing countries keeps the GDP estimates at lower level than the actual.

iii. **Growing Service Sector**
In recent years, the service sector is growing faster than that of the agricultural and industrial sectors. Many new services like business process outsourcing (BPO) have come up. However, value addition in legal consultancy, health services, financial and business services and the service sector as a whole is not based on accurate reporting and hence underestimated in national income measures.

iv. **Household Services**
The national income accounts do not include the 'care economy'- domestic work and housekeeping. Most of such valuable work rendered by our women at home does not enter our national accounting.

v. **Social Services**
It ignores voluntary and charitable work as it is unpaid.

vi. **Environmental Cost**
National income estimation does not account for the environmental costs incurred in the production of goods. For example, the land and water degradation accompanying the Green revolution in India. Similarly, the climate change that is caused by the use of fossil fuels. However, in recent years, green GDP is being calculated where the environmental costs are deducted from the GDP value and the Green GDP is arrived at.

Ques. 21 : What can be done?

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Ans. For examining the performance of the economy in real terms through the measurement of Gross Domestic Product (GDP), national income, consumption expenditure, capital formation etc., estimates are prepared at the prices of selected year known as base year. Base year is a specific year from which the economic growth is measured .It is allocated the value of 100 in an index.The estimates at the prevailing prices of the current year are termed as "at current prices", while those prepared at base year prices are termed "at constant prices". The comparison of the two estimates gives the measure of real growth. It means the production of the current year is valued at base year prices so that the real growth is worked out. That is the increase in the value of the GDP due to inflation is excluded and the 'real increase' is found out.

The base year of the national accounts is changed periodically to take into account the structural changes which take place in the economy and to depict a true picture of the economy through measures like GDP.

The first official estimates of national income were prepared by the Central Statistical Organisation (CSO) with base year 1948-49 for the estimates at constant prices. These estimates were published in the publication, "Estimates of National Income" in 1956. With the gradual improvement in the availability of basic data over the years, a comprehensive review of methodology for national accounts statistics has constantly been undertaken with a view to updating the database and shifting the base year to a more recent year. As a result, base years of the National Accounts Statistics series have been shifted from 1948-49 to 2004-05 which is the new series of national accounts being followed from 2010.

Normally, when the base year of national accounts statistics is changed, there is some change in the levels of GDP estimates. This happens due to widening the coverage.

A base year has to be a normal year without large fluctuations in production, trade and prices of commodities in general. Reliable price data should be available for it. It should be as recent as possible. The National Statistical Commission wants that the base year should be revised every five years.

Ques. 22 : What is GDP deflator?

Ans. GDP Deflator is a comprehensive measure of inflation, implicitly derived from national accounts data as a ratio of GDP at current prices to constant prices. While it encompasses the entire spectrum of economic activities including services, it is available on a quarterly basis with a lag of two months since 1996. Therefore, national income aggregates extensively use WPI for deflating nominal price estimates to derive real price estimates.

The formula used to calculate the deflator is:

GDP deflator = (Nominal GDP / Real GDP) X 100

Dividing the nominal GDP by the GDP deflator and multiplying it by 100 would then give the figure for real GDP, hence deflating the nominal GDP into a real measure.

A price deflator of 200 means that the current-year price of this computing power is twice its base-year price - price inflation. A price deflator of 50 means that the current-year price is half the base year price - price deflation.

Unlike some price indexes, the GDP deflator is not based on a fixed basket of goods and services. It covers the whole economy.

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Specifically, for GDP, the “basket” in each year is the set of all goods that were produced domestically, weighted by the market value of the total consumption of each good. Therefore, new expenditure patterns are allowed to show up in the deflator as people respond to changing prices. The advantage of this approach is that the GDP deflator reflects up to date expenditure patterns.

The CSO uses the price indices to reach the base year figure from the current year one. In September 2010, for the first quarterly figure, it made a mistake while applying the deflator- for the GDP by output figure, it used one price index and for the GDP by expenditure number, it used another. It led to huge discrepancy.

Ques. 23 : Define Business cycles.

Ans. Alternating periods of expansion and decline in economic activity is called business cycle. That is, the ups and downs of the economy. There are four stages in the business cycle: expansion, growth, slowdown and recession. Recession may not follow every time. When recession takes place, it may not be of the same intensity every times. For example, the 2008 global financial meltdown is the deepest since the WW2 and is called the Great Recession. If recession deepens, it is called depression and occurred only once in the last century in l930’s. All economies experience economic cycles. Explaining and preventing these fluctuations is one of the main focuses of macroeconomics.

Ques. 24 : What are the benefits and side effects of economic growth?
Ans.

i. The first benefit of economic growth is wealth creation. It helps create jobs and increase incomes.
ii. It ensures an increase in the standard of living, even if it is not evenly distributed.
iii. Government has more tax revenues: fiscal dividend. Economic growth boosts tax revenues and provides the government with extra money to finance spending projects. For example, the flagship programmes of the government like the MGNREGA are a direct result of the tax buoyancy of growth It sets up the positive spiral:
iv. rising demand encourages investment in new capital machinery which helps accelerate economic growth and create more employment.

Economic growth can also have a self-defeating effect:

i. violate the principles of fairness and equity thus setting off social conflicts.
ii. Environmental costs are another disadvantage.

Ques. 25 : Can we relay on GDP for the measure of real progress?

Ans. Economic growth is generally taken as the measure of advancement in the standard of living of the country. Countries with higher GNP often score highly on measures of welfare, such as life expectancy. However, there are limitations to the usefulness of GNP as a measure of welfare:

- GDP does not value intangibles like leisure, quality of life etc. Quality of life is determined by many other things than economic goods.
- the impact of economic activity on the environment may be harmful- pollution, climate change, unsustainable growth, ecological refugees, life style diseases etc.
- It only gives average figures that hide stratification. Economic inequality is not revealed by GDP figures

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- Condition of poor is not indicated For example, Indian economy grew at 8.9% in the first half of 2010-2011 but the food inflation was over 14% and on a high base causing immesirization of the lower classes.
- Gender disparities are not indicated.
- It does not matter how the increase in wealth takes place- whether by civilian demand or war.
- GDP does not measure the sustainability of growth. A country may achieve a temporarily high GDP by over-exploiting natural resources.

Advantages:-

The major advantages to using GDP per capita as an indicator of standard of living are that it is measured frequently, widely and consistently. Frequently in that most countries provide information on GDP on a quarterly basis, which allows a user to spot trends more quickly. Widely in that some measure of GDP is available for practically every country in the world, which allows crude comparisons between the standard of living in different countries. And consistently in that the technical definitions used within GDP are relatively consistent between countries, and so there can be confidence that the same thing is being measured in each country.

Disdvantages:-

The major disadvantage of using GDP as an indicator of standard of living is that it is not, strictly speaking, a measure of standard of living. For instance, in an extreme example, a country which exported 100 per cent of its production would still have a high GDP, but a very poor standard of living.

The argument in favour of using GDP is not that it is a good indicator of standard of living, but rather that (all other things being equal) standard of living tends to increase when GDP per capita increases. This makes GDP a proxy for standard of living, rather than a direct measure of it.

Because of the limitations in the GDP concept, other measures of welfare such as the Human Development Index (HDI), Index of Sustainable Economic Welfare (ISEW), Genuine Progress Indicator (GPI) and Sustainable National Income (SN1), Gross National Happiness(GNH), Green GDP, natural resource accounting have been suggested.

They are proposed in an attempt to give a more complete picture of the level of well-being and the position with reference to natural resource depletion, but there is no consensus as to which is a better measure than GDP. Some of the above defy quantification. GDP still remains by far the most often-used measure.

Money Market and Capital Market in India

Ques. 1 : What do you understand by Money Market?

Ans. Money market refers to lending and borrowing short term funds- funds with a maturity of less than one year. Banks and financial institutions (IDBI, LIC etc) are the main lenders and borrowers while individuals, companies, Government and others are the main borrowers. The informal market operates through small-scale money-lenders as well as others outside the RBI control.

Money market instruments broadly are: call money; bill market (both commercial bills and treasury bills) Certificates of Deposit (CD); Commercial paper (CP).

Ques. 2 : What is Call Money / Notice Money?

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Ans. Call/Notice money is money borrowed or lent for a very short period. If the period is more than one day and upto 14 days it is called 'Notice money' otherwise the amount is known as Call money'. No collateral security is required to cover these transactions. The call market enables the banks and institutions to even out their day to day deficits and surpluses of money.

Commercial banks, Co-operative Banks, mutual funds, primary dealers and others are allowed to borrow and lend in this market. Interest rates in the call and notice money market are market determined.

Ques. 3 : What do you mean by Treasury Bills?

Ans. Treasury bills are short-term money market instruments, which are issued by the RBI on behalf of the GOI. The GOI uses these funds to meet its short-term financial requirements of the government. T-Bills are sovereign zero risk instruments. They are available in primary and secondary market, issued at a discount to face value i.e., investors may buy the T-bill at discount to face value of Rs. 100 and on maturity the face value of Rs. 100 is received by the investor.

There are T-Bills of 14 days, 91 days, 182 days and 364 days maturity. Minimum investment required in case of T-Bills is Rs 25,000.

A considerable part of the government's borrowings takes place through T bills of various maturities. The usual investors in these instruments are banks, insurance companies and FIs.

Ques. 4 : What is Inter Bank Term Money?

Ans. Inter bank market for deposits of maturity beyond 14 days and upto three months is referred to as the term money market.

Certificates Of Deposit

After treasury bills, the next lowest risk category investment option is the certificate of deposit (CD) issued by scheduled commercial banks and FIs, Regional rural banks and Local area banks can not issue CDs.

Allowed since 1989, a CD is a negotiable promissory note, secure and short term (upto a year) in nature. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor. CDs can be issued by scheduled commercial banks and select al1-Idia Financial institutions. Minimum amount of a CD should be Rs. 1 lakh. The maturity period of CDs issued by banks should be not less than 15 days and not more than one year. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. CDs can be issued to individuals or firms.

Inter Corporate Deposits Market

Apart from CPs, corporates also have access to another market called the inter corporate deposits (ICD) market. An ICD is an unsecured loan extended by one corporate to another. Existing mainly as an avenue for low rated corporates, this market allows fund- surplus corporates to lend to other corporates.

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Commercial Paper

It represents short term unsecured promissory notes issued by top rated corporates, primary dealers (PDS), Satellite dealers(SDS) and the all-India financial institutions (FIs). The main features of these papers are

- corporates having tangible net worth of not less than Rs.4 crore can issue them
- All CPs require credit rating from a credit rating agency
- CP can be issued for a minimum period of 15 days and a maximum up to one year.
- Minimum amount invested by single investor is Rs. five lakhs or multiple thereof.
- CPs are issued at a discount to face value.

Commercial Bills

Bills of exchange are negotiable instruments drawn by the seller (drawer) of the goods on the buyer (drawee) of the goods for the value of the goods delivered. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks. If the bill is payable at a future date and the seller needs money immediately, he may approach his bank for discounting the bill.

Discount and Finance House of India (DFHI)

Set up in 1988 by RBI to strengthen the bill market, it buys bills and other forms of short term paper from banks and financial institutions so that surplus and idle cash of institutions can be invested in short term bills. Banks can sell their short term securities to DFIII and raise funds

Ques. 5 : Write a brief note on Capital Market.

Ans. It refers to market for funds with a maturity of 1 year and above, referred to as term funds that includes medium and long term funds. The demand for these funds comes from both the government for its investment purposes and also the private sector. Banks, public financial institutions like LIC and CIIC; development financial institutions like ICICI, 1DBI etc; mutual funds like UTI are the main participants in the market. The elements of the capital market in India are the following:

Government securities, industrial securities that include the shares and debentures of Indian companies- both the primary and secondary market DFIs (IFCI, 1DBI, State Financial Corporations (SFCs), Financial intermediaries merchant banks; mutual funds; leasing companies; venture capital' companies and others.

Ques. 6 : Write a short note on Gilt edged securities.

Ans. Government securities, or G-Secs as they are popularly known, are securities issued by the RBI on behalf of the Government of India to meet the latter's borrowing programme for financing fiscal deficit. The G- Sec instrument is in the nature of a bond.

GOI Dated Security can be held by any person, firm, company, corporate body or institution, State Governments, Provident Funds and Trusts. Non-Resident Indians (NRIs, viz., Indian citizens and Individuals of Indian origin), Overseas corporate bodies predominantly owned by NRIs and Foreign Institutional, Investors registered with SEBI and approved by Reserve Bank of India are also eligible to invest in the Government Stock.

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G-Secs have a maturity period ranging from one to 30 years and they carry a coupon rate (interest rate) which is paid semi-annually. They are issued both in demat and physical form.

The minimum investment in G-Secs is Rs 10,000. G-Secs could be of the following types:

Dated Securities: They have fixed maturity and fixed coupon rates payable half yearly and are identified by their year of maturity.

Floating Rate Bonds: They are bonds with variable interest rates with a fixed percentage over a benchmark rate. There my also be a cap and a floor rate attached, thereby fixing a maximum and minimum interest rate payable on it.

Capital Indexed Bonds: They are bonds where the interest rate is a fixed percentage over the wholesale price index. Redemption is linked to the wholesale price index.

DFIs or Development Banks

Financial institutions assume a critical role in the provision of long term credit, especially in the absence of a well-developed long-term debt market. The financial institutions could be categorised into three broad heads, viz.; all-India financial institutions (AIFIs), state-level institutions and other institutions. Of the three categories, AIFIs are the most dominant in terms of assets and range of operations.

The major AIFIs are the Industrial Development Bank of India (IDBI), IFCI Ltd., ICICI Ltd., Industrial Investment Bank of India Ltd. (IIBI), Small Industries Development Bank of India (SIDBI), National Housing Bank (NHB), National Bank for Agriculture and Rural Development (NABARD), Export Import Bank of India (EXIM Bank), Tourism Finance Corporation of India Ltd. (TFCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its subsidiaries and Infrastructure Development Finance Company of India Lid. (IDEC). All these institutions operate on all-India basis. Other institutions comprise Export Credit and Guarantee Corporation (ECGC) and Deposit Insurance and Credit Guarantee Corporation (DICGC).

The state level institutions consist of state financial corporations (SFCs) and state industrial development corporations (SIDCs).

Ques. 7 : What do you mean by Merchant Banks/Investment Banks?

Ans. MBs are those who manage and underwrite (Underwriting an issue means to guarantee to purchase any shares in a new issue of rights issue not fully subscribed by the public) new public issues floated by companies to raise funds from public. They advise corporate clients on fund raising. They are also called investment banks (I banks). They deal only with corporates and not general public, essentially.

Ques. 8 : What is Mutual Funds?

Ans. Mutual funds raise money from public and invest them in stock market securities, bonds etc. Mutual funds were virtually synonymous with the Unit Trust of India (UTI) till two decades ago when India witnessed financial sector liberalization and many more public sector and private mutual funds came up, SEBI regulates mutual funds.

Ques. 9 : What do you mean by Venture Capital?

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Ans. Venture capital is money provided by financial institutions who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Ques. 10 : What do you understand by Angel Investors?

Ans. Individuals who invest in businesses looking for a higher return than possible from traditional investments. They invest their own money unlike a venture capitalist who invests public money. They became popular in recent years after the web-based enterprises came up in the 1990's.

Ques. 11: What is Qualified Institutional Placement?

Ans. The QIP Scheme is open to investments made by Qualified Institutional Placement which includes public financial institutions, mutual funds, foreign institutional investors, venture capital funds and foreign venture capital funds registered with the SEBI) in any issue of equity shares / fully convertible debentures / partly convertible debentures or any securities which are convertible into or exchangeable with equity shares at a later date (Securities).

Since the beginning of 2009, Indian companies are raising billions of dollars from the QIP route.

Ques. 12 : Give a brief description about NBFC?

Ans. A company is treated as an NBFC if its financial assets are more than 50% of total assets and income from financial assets is more than 50% of the gross income.
NBFC means Non-banking financial company. A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, sale/purchase/construction of immovable property. NBFCs are similar to banks; however they do not accept demand deposits.

Ques. 13 : Give an account of ECB (External Commercial Borrowings)?

Ans. ECB (External Commercial Borrowings) is an instrument used to facilitate the access to foreign money by Indian corporations and PSUs (Public Sector undertakings). ECBs include commercial bank loans, buyer& credit, credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial institutions such as International Finance Corporation (Washington), ADB and Investment by Foreign Institutional Investors (FIIs) in dedicated debt funds. ECBs cannot be used for investment in stock market or speculation in real estate. The DEA (Department of Economic Affairs), Ministry of Finance, Government of India along with Reserve Bank of India, monitors and regulates ECB guidelines and policies. For infrastructure and green field projects funding up to 50% (through ECB) is allowed. In telecom sector too, up to 50% funding through ECBs is allowed.

In India, External Commercial Borrowings are being permitted by the Government for providing an additional source of funds to Indian corporates and PSUs for financing expansion of existing capacity and as well as for fresh investment, to augment the resources available domestically. ECBs can be used for any purpose (rupee related expenditure as well as imports) except for investment in stock market and speculation in real estate.
Applicants are free to raise ECB from any internationally recognised source like banks; export credit agencies suppliers of equipment, international capital markets etc.

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ECB access may be restricted when the there is a deluge of foreign inflows and the rupee is getting strong. It may be relaxed when the opposite happens as we have seen since 2009. ECBs help diversify risk for the companies. Also, the interest rates are softer abroad .They help Indian companies with foreign funds.

ECBs as permitted by the Government are being used as. a source of finance for the Indian Corporates and PSU's for the purpose of expansion of the existing capacity as well as fresh investment.

ECBs can be raised through two routes: Automatic Route and the Approval Route. The former does not require permit from the Regulator whereas the latter requires the same. The extant policy allows corporates registered under the Companies Act, 1956, except financial interme-diaries such as banks, financial institutions (FIs), housing finance companies and on Banking Finance Companies (NBFCs) to access ECBs. Subsequently, NGOs engaged in micro-finance activities have been permitted to raise ECB up to certain limits.

Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL & FS, Power Finance Corporation Power Trading Corporation IRCON and EXIM Bank are considered on a case by-Case basis.

The priority end use of ECBs includes investment (such as import of capital goods, new projects, modernization/expansion of existing production units) in steal sector - industrial sector including small and medium enterprises (SME) and infrastructure sector, power exploration, telecom, railways, roads & bridges, ports and exports.

End-uses of ECB for working capital and repayment of existing Rupee loans are not permitted. Also, ECBs cannot be used for investment in the stock market and speculation in real estate.

Ques. 14 : What is Euro Issues?

Ans. Indian companies are permitted to raise foreign currency resources through issue of Foreign Currency Convertible Bonds (FCCBS), ordinary equity shares through Global Depository-Receipts (GDRs) / American Depository Receipts (ADRs) to foreign investors i.e. institutional investors-Or individuals (including NRIs) residing abroad.
That is, Euro-issues include Euro-convertible bonds and GDRs.

Ques. 15 : What do you mean by Private Equity?

Ans. In finance, private equity means equity in companies that is privately placed by the management to a finance firm. It generally has a lock in period during which they are not publicly traded on a stock exchange. Bulk private placement is done. Private equity firm also is given a place in the management of the company. Capital for private equity is raised primarily from institutional investors. The term private equity has different connotations in different countries.

Stock Market

Apart from the above mentioned sources of capital for Indian companies from within the country, the International Finance Corporation (IFC) of the World Bank (WB) also provides funds for the private sector.

Ques. 16 : Give an account of Credit Default Swap?

Ans. It is a form of insurance against debt default. When an investor buys corporate (or government) bonds he/she faces the risks of default on part of the issuing agent. The investor can insure its investment in such bonds against default through a third party. The investor pays a premium to the party providing insurance. In

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the event of default by the bond issuer, the insurer would step in and pay the investor. A CDS is just that insurance, which is bought by those who fear default.

Economic benefit of CDS

It is a derivative instrument that transfers risk from investors to those willing to bear it for a fee. By insuring against risks of default, credit default swaps allow riskier companies to raise funds. Also, it improves investment and borrowing opportunities by redistributing risk. Therefore, overall it helps increase credit flow and boost liquidity.

Key concerns

The third party insurer issuing credit default swaps must have the capital to pay-up in case of debt default. Therefore, the issuers of CDS must be well capitalized and have stringent regulations on their exposure or else in case of a default they will not be able to honour their commitment.

What role did credit default swaps play in the financial meltdown?

Speculators started buying CDS on even the bonds they did not hold, hoping to make good gains in the case of a default. This kind of CDS is known as naked CDS wherein the buyer doesn't hold the underlying debt. In many cases, such investors were holding CDSs worth much more than underlying debt, betting on the defaults in the US subprime market. And when those defaults did happen, CDSs compounded the problem as the underwriters did not have the capital to honour their commitment.

How is RBI safeguarding against CDS ills?

CDSs will be subject to strict capital requirements, ensuring that the business is within prudent limits. Second, naked CDS will not allowed in India. Third, CDS buyers cannot buy insurance higher than the value of the underlying debt. These steps are expected to control speculation on default of bonds, restricting them to their proper use.

Corporate Debt

Corporate debt is necessary for their investment, acquisitions etc.

The following are some of the different types of corporate debt securities issued:

- Non-Convertible Debentures
- Partly-Convertible Debentures
- Fully-Convertible Debentures (convertible in to Equity Shares)
- Bonds
- FCCBs (See elsewhere in this Chapter)

They are issued to domestic and foreign investors. They are traded on the stock market Corporate debt fund

To attract money to finance infrastructure projects in India, Budget 2011-12 has suggested creating special infrastructure debt funds.

FII Limit Enhanced (2011-12 Union Budget)

To enhance the flow of funds to the infrastructure sector, the FII limit for investment in corporate bonds, with maturity of over five years issued by companies infrastructure sector, is raised by an additional limit of

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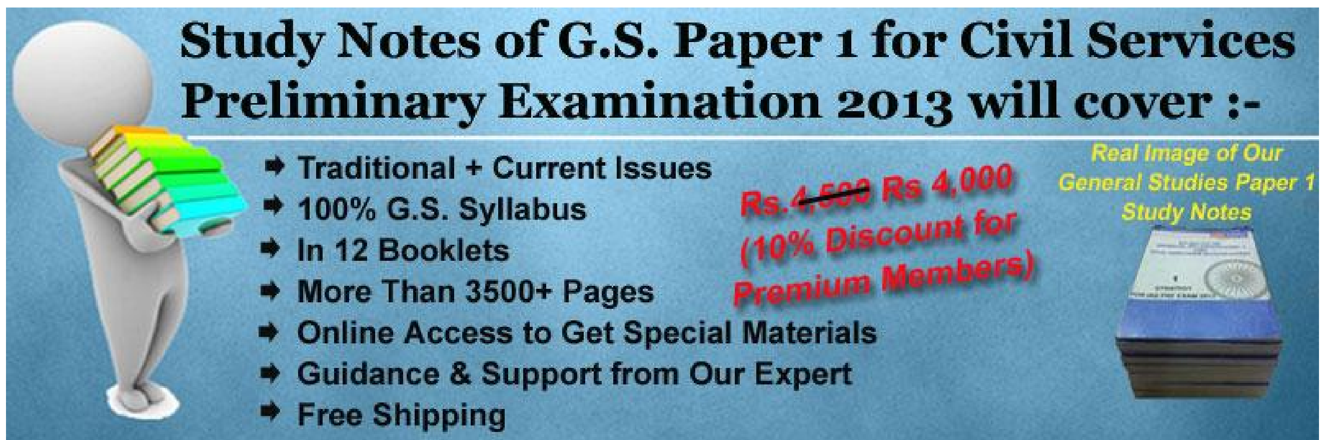
US Dollar 20 billion taking the limit to US Dollar 25 billion. This was done in the union Budget 2011-2012. This will raise the total limit available to the FIIs for investment in corporate bonds to US Dollar 40 billion. Since most of the infrastructure companies are organised in the form of SPVs, FIIs would also be permitted to invest in unlisted bonds with a minimum lock in period of three years. However, the FIIs will be allowed to trade amongst themselves during the lock-in period.

Take-out Financing

It came into effect in 2010. It is a method of providing finance for longer duration projects (for example, 15 years) by banks by sanctioning medium term loans (like 5-7 years). It is the understanding that the loan will be taken out of books of the financing bank within pre-fixed period, by another institution thus preventing any possible asset-liability mismatch.

Under this process, the institutions engaged in long term financing such as IDFC, agree to take out the loan from books of the banks financing such projects after the fixed time period when the project reaches certain previously defined milestones. On the basis of such understanding, the bank concerned agrees to provide a medium term loan, say 5 years. At the end of five years, the bank could sell the loans to the institution and get it off its books. This ensures that the project gets long- term funding though various participants. Banks otherwise can not lend for infrastructure as their deposits are for a short period and the loans are for a long period- asset liability mismatch.



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