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CHRONICLE
Nurturing Talent Since 1990

INDIAN ECONOMY

Useful for UPSC, State PSCs & Other Competitive Examinations



7

To the Point NCERT Plus
Indian Economy

Useful for UPSC, State PSCs & Other Competitive Examinations

Chapter-wise Presentation on Syllabus of General Studies. A Compilation of Old and New NCERT Books (Class 6 to 12) and many other Standard Books from which Questions are often asked in Examinations.

Editor
N.N. Ojha

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01
CHAPTER

Introduction to Economics

Economics is the science that deals with production, exchange and consumption of various commodities in economic systems.

- It shows how scarce resources can be used to increase wealth and human welfare.
- The central focus of economics is on scarcity of resources and choices among their alternative uses.
- Economics comes from the ancient Greek word "**oikonomikos" or "oikonomia**."
- Oikonomikos literally translates to "the task of managing a household."

Economics is a social science that studies how individuals, businesses, and governments allocate resources to satisfy their needs and wants. It deals with the production, consumption, and distribution of goods and services for a society or individual.

Economic Ideologies

An economic ideology refers to a set of beliefs or principles about how an economy should function.

Some important Economic Ideologies

Laissez-Faire

- The laissez-faire theory of capitalism dictates that **government should, for the most part, refrain from interfering in the economy,** with its main role being to protect the free market and prevent the unfair economic dynamic created by monopolies and oligarchies.

Social Market

- Advocates for a social market economy **prescribe capitalism in terms of establishing a free market,** but while also allowing for the interference of the state for the purposes of social welfare (providing unemployment benefits, social insurance, etc.).

Neo-Capitalism

- Neo-capitalists differ from standard capitalists in that they emphasize government intervention in the economy **to bail out companies whose destruction would be a risk to the country's stability.**

Socialism

- In a socialist economy, every member of society theoretically **has equal ownership of the factors of production**—natural resources, labour, capital goods, and entrepreneurship—as well as an equal share of the economic output.
- Based on the belief that human nature is inherently cooperative (rather than competitive), everyone in a socialist society receives a share of profit based on their own contribution, after a portion has been deducted for the common good.

Fascism

- In terms of economics, fascism incorporates elements of both capitalism and socialism.
- Fascist economists advocate for self-sufficiency and individual profit, but promote government subsidies of corporations.
- Fascist economics thus supports a blend of both private and public ownership over the means of production—there is an emphasis on private profit, but at the same time, the national interest is ultimately more important.

Communism

- Communism promotes very specific viewpoints in terms of economic systems.
- Similar to socialism, a communist society **allows the factors of production to rest in the hands of the people.**
- However, in such a society, the economic output is distributed to each according to their need.
- Communism eliminates income inequality and poverty this way, but suffers from the disadvantages of a command economy—the needs of the consumer are easily ignored or forgotten, leading to decreased innovation, slowed economic growth, and potential economic instability through the creation of black markets.

Schools of Economic Thought

The two most common Schools of Economic Thought are Classical and Keynesian.

1. **Classical View:** It believes that free markets are the best way to allocate resources and the government's role should be limited to that of a fair and strict referee.
2. **Keynesian View:** It believes that markets do not work well at allocating resources on their own and that governments must step in from time to time and actively reallocates resources efficiently. It was developed by British economist **John Maynard Keynes** during the 1930s in an attempt to deal with the effects of the Great Depression.

Thus, the Classical and the Keynesian Schools of Economic Thought are in contrast to each other.

Approaches to Study Economics

Economics is studied under two approaches:

1. Traditional Approach

The traditional approach to the study of Economics emphasises the following aspects:

- **Consumption:** The satisfaction of human wants through the use of goods and services is called consumption.
- **Production:** Goods that satisfy human wants are viewed as "bundles of utility".
  - Hence production would mean creation of utility or producing (or creating) things for satisfying human wants.
  - For production, the resources like land, labour, capital and organization are needed.
- **Exchange:** Goods are produced not only for self-consumption, but also for sales. They are sold to buyers in markets.
  - The process of buying and selling constitutes exchange.
- **Distribution:** The production of any agricultural commodity requires four factors, viz., land, labour, capital and organization.
  - These four factors of production are to be rewarded for their services rendered in the process of production.
  - The land owner gets rent, the labourer earns wage, the capitalist is given with interest and the entrepreneur is rewarded with profit. The process of determining rent, wage, interest and profit is called distribution.
- **Public Finance:** It studies how the government gets money and how it spends it.
  - Thus, in public finance, we study about public revenue and public expenditure.

2. Modern Approach

It comprises the following:

Microeconomics vs. Macroeconomics

Dimension	Microeconomics	Macroeconomics
Definition	◆ Concerned with the behaviour of individual consumers, firms, and markets.	◆ Studies the behaviour of the economy as a whole.
Core Focus	◆ Examines interactions between buyers and sellers in goods, labour, and capital markets.	◆ Focuses on broad aggregates like total output, employment, and inflation.
Key Topics	◆ Supply and demand, consumer behaviour, production theory, and market structures.	◆ National income, economic growth, monetary policy, and fiscal policy.
Importance	◆ Explains the functioning of a free enterprise economy. ◆ Details the distribution of goods through market mechanisms. ◆ Determines relative prices of products and services. ◆ Establishes efficiency conditions for consumption and production. ◆ Aids in formulating welfare-oriented economic policies.	◆ Helps understand complicated domestic and global economic systems, especially under WTO regimes. ◆ Vital for policy formulation to tackle poverty, unemployment, and inflation. ◆ Serves as a tool to estimate national income and living standards.
Limitations	◆ Fails to analyze the economy as a whole (GDP, aggregate demand, inflation). ◆ Relies on the practically impossible assumption of "full employment."	◆ Ignores individual welfare. ◆ Overlooks individual differences; stable average prices may hide a ruinous rise in specific goods like food grains.

02
CHAPTER

Sectors of Indian Economy

In the early stages of civilization, all economic activities fell under the primary sector, primarily focused on agriculture and resource extraction. However, with increasing food surplus there was a rise in demand for other goods, leading to the emergence of the secondary sector, particularly during the industrial revolution of the nineteenth century.

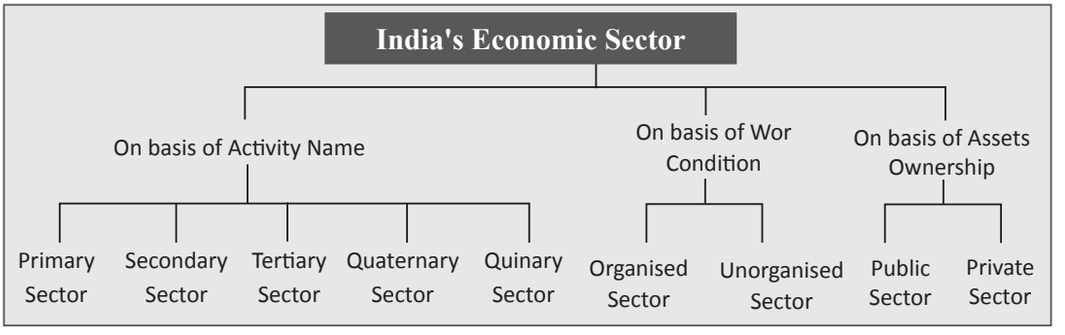
Secondary sector's growth necessitated auxiliary support, with industries like transportation and finance, which comes under tertiary sector, playing pivotal roles.

Understanding these sectors is crucial for grasping the dynamics of India's economy and its evolution over time.

India has moved from a primary sector focused economy dependent on agriculture at the time of independence to a tertiary sector, i.e., one focused on services.

The turning point came in 1991 amidst a balance-of-payments crisis when economic reforms were initiated, spearheaded by the Narasimha Rao government. These reforms dismantled the Licence Raj, reduced tariffs, and opened doors to foreign direct investment.

Sectors of the Economy



A. On the Basis of Activity

1. Primary Sector

In Primary sector of economy, activities are undertaken by directly using natural resources. Agriculture, Mining, Fishing, Forestry, Dairy etc. are some examples of this sector.

- It is called so because it forms the base for all other products. Since most of the natural products we get are from agriculture, dairy, forestry, fishing, it is also called Agriculture and allied sector.
- People engaged in primary activities are called red-collar workers due to the outdoor nature of their work.

2. Secondary Sector

Secondary Sector includes the industries where finished products are made from natural materials produced in the primary sector. Industrial production, cotton fabric, sugar cane production etc. activities comes under this sector.

- Hence it's the part of a country's economy that manufactures goods, rather than producing raw materials
- Since this sector is associated with different kinds of industries, it is also called industrial sector.
- People engaged in secondary activities are called **blue collar workers**.

Examples of Manufacturing Sector

- Small workshops producing pots, artisan production
- Mills producing textiles
- Factories producing steel, chemicals, plastic, car
- Food production such as brewing plants, and food processing
- Oil refinery
- Core Industries

3. Tertiary Sector/Service Sector

This sector's activities help in the development of the primary and secondary sectors. By itself, economic activities in tertiary sector do not produce goods but they are an aid or a support for the production.

03
CHAPTER

Economic Planning in India

Economic planning in India refers to the process of formulating and implementing a comprehensive plan for the country's economic development. The planning process is based on the idea of a mixed economy, where the state plays an important role in regulating and directing economic activity while also allowing for private enterprise and market forces to operate.

Though the planned economic development in India began in 1951 with the inception of First Five Year Plan (FYP), theoretical efforts had begun much earlier, even prior to the independence.

Before Independence

- Setting up of National Planning Committee by Indian National Congress in 1938, The Bombay Plan & Gandhian Plan in 1944, Peoples Plan in 1945 (by post-war reconstruction Committee of Indian Trade Union), Sarvodaya Plan in 1950 by Jaiprakash Narayan were steps in this direction.

After independence

- India launched its First FYP in 1951, under socialist influence of first Prime Minister Jawaharlal Nehru.
- The process began with setting up of Planning Commission in March 1950 in pursuance of declared objectives of the Government to promote a rapid rise in the standard of living of the people by efficient exploitation of the resources of the country, increasing production and offering opportunities to all for employment in the service of the community.
- The Planning Commission was charged with the responsibility of making assessment of all resources of the country, augmenting deficient resources, formulating plans for the most effective and balanced utilisation of resources and determining priorities.
- **The first Five-year Plan** was launched in 1951 and two subsequent five-year plans were formulated till 1965, when there was a break because of the India-Pakistan conflict.
- Two successive years of drought, devaluation of the currency, a general rise in prices and erosion of resources disrupted the planning process and after three Annual Plans between 1966 and 1969, the fourth Five-year Plan was started in 1969.
- The Eighth Plan could not take off in 1990 due to the fast changing political situation at the Centre and the years 1990-91 and 1991-92 were treated as Annual Plans.
- **The Eighth Plan** was finally launched in 1992 after the initiation of structural adjustment policies.
- For the first eight Plans the emphasis was on a growing public sector with massive investments in basic and heavy industries, but since the launch of the Ninth Plan in 1997, **the emphasis on the public sector has become less pronounced** and the current thinking on planning in the country, in general, is that it should increasingly be of an indicative nature.

Types of Economic Planning

In today's world, most economies are mixed economies. The planning can be of several types discussed below:

1. Indicative Planning

- It puts forward / indicates to some broad principles and guidelines to achieve some goals.
- Indicative planning is peculiar to the mixed economy of France.
- But this is quite different from the type of planning which exists in other mixed economies. By mixed economy, we mean simultaneous working of the public and private sector.
- It is the state which controlled the private sector in different ways, i.e. by quotas, price, licenses, etc.
- But under indicative planning, the private sector is not rigidly controlled to achieve the targets and priorities of the plan.
- The state gives full assistance to the private sector but does not control it. It, rather, directs the private sector in certain areas to implement the plan.

2. Comprehensive / Imperative Planning

- It refers to centralized planning and implementation with the allocation of resources.

04 CHAPTER National Income

National income of a country is the value of the aggregate output of the different sectors of a nation's economy during a certain time period.

In other words, it is the flow of goods and services produced in an economy in a particular year. The progress of a country can be determined by the growth of the national income of the country.

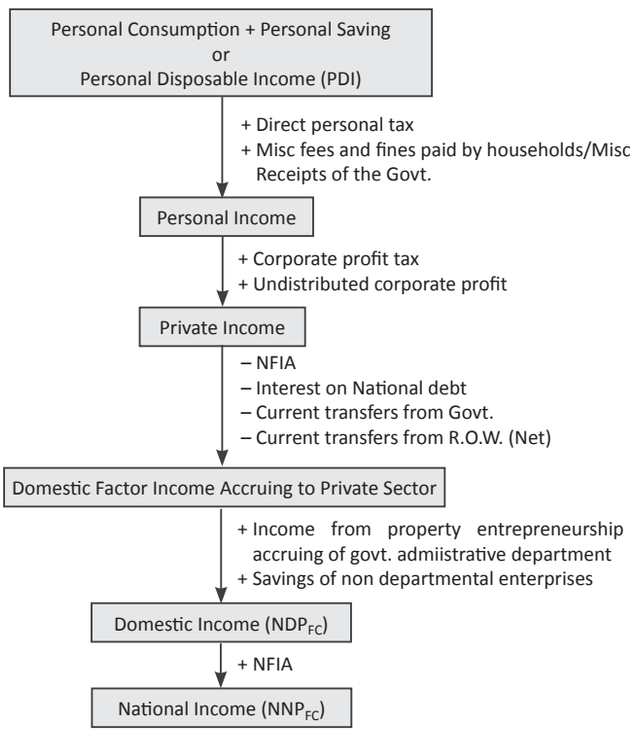
In order to understand the structure and the level of the Indian economy as well as changes in it over time, it is essential to know about its net domestic product.

- Net domestic product shows the flow of goods and services in the economy.
- Data on net domestic product present a complete picture of different sectors of the economy including their inter-relationship.
- In India, National Income is estimated both at current prices and constant prices.
- At present, the estimates of National Income and net domestic product are prepared by National Statistical Office under the Ministry of Statistics and Programme Implementation.

Various Definitions of National Income

- **Marshall** defined National Income as "The labour and capital of the country acting on its natural resources produce annually a certain net aggregate of commodities, material and immaterial, including services of all kinds.
  - This is true net annual income or revenue of the country, or the national dividend".
- **C. Rangarajan and B. H. Dholakia (1979)** define National Income as the aggregate money value of the annual flow of final goods and services in the national economy.
- **National Income** can also be stated as the measure of total factor incomes produced by the citizens of a nation in form of salaries, rents, interest and profit in an accounting year (i.e., from 1st April - 31st March of every year), counted without duplication.
- **National Income is also termed as "National Product" or "National Output**". For example, bread purchased by a household is a final (consumption) good as it is used for consumption purpose whereas bread purchased by a restaurant owner to make sandwiches is treated as an intermediate good as it is completely used up in the production process.
  - If the same bread is purchased by a bakery shop for further sale to the consumers then also it is treated as an intermediate good as it is used for resale in the same year.

NNP_{FC} from Personal Disposable Income



Evolution of National Income in India

The calculation of national Income dates back to pre-independence period.

Pre-Independence Period

The estimate of National Income in India was, for the first time, prepared by Dada Bhai Naoroji for the year 1867-68.

- He estimated per capita income to be Rs. 20.
- He estimated the national income by first estimating the value of agricultural production and then adding a certain percentage as non-agricultural production.

05 CHAPTER Inflation

Inflation permeates the core of every economy, shaping financial landscapes and impacting daily lives. From the price tags on grocery shelves to the intricacies of interest rates, inflation's influence is pervasive and profound. Understanding this economic phenomenon is not just beneficial, it's crucial. It affects your personal finances, guides central bank policies, and shapes investment strategies.

Understanding the Concept of Inflation

Inflation refers to the sustained increase in the general price level of goods and services in an economy over a period of time.

- Put simply, it means that over time, the purchasing power of money diminishes as the cost of living rises.
- It is an important economic indicator that measures the erosion of purchasing power and affects various aspects of an economy, including consumers, businesses, and policymakers.
- Inflation is **measured 'point-to-point'**. It means that the reference dates for the annual inflation is January 1 to January 1 of two consecutive years (not for January 1 to December 31 of the concerned year).
- Similarly, the weekly rate of inflation is the change in one week reference being the two consecutive last days of the week (i.e., 5 p.m. of two Fridays in India).
- The Reserve Bank of India (RBI), India's central bank, plays a crucial role in monitoring and managing inflation through its monetary policy tools.

Deflation and Disinflation: Key Differences

Points	Deflation	Disinflation
Meaning	◆ Deflation refers to a sustained decrease in the general price level of goods and services in an economy, leading to a **negative inflation rate.** It represents a broad-based decline in prices over time.	◆ Disinflation refers to a slowdown in the rate of inflation. ◆ It occurs when the **rate of inflation decreases**, but the overall price level still increases, albeit at a slower pace.
Price Level	◆ Deflation is characterized by a decrease in the general price level, meaning that prices of goods and services across various sectors and categories are falling.	◆ Disinflation still involves an increase in the price level, but at a slower rate compared to previous periods. ◆ Prices may continue to rise, but at a reduced pace.
Inflation Rate	◆ Deflation implies a negative inflation rate, as the average price level is declining over time.	◆ Disinflation indicates a decreasing inflation rate, but it remains positive, although at a lower rate than before.
Causes	◆ Deflation can be caused by factors such as a decrease in money supply, reduced consumer demand, falling commodity prices, or overcapacity in production.	◆ Disinflation can be caused by monetary policy measures aimed at reducing inflationary pressures, such as tightening monetary policy, increasing interest rates, or implementing fiscal measures to curb spending.
Economic Impact	◆ Deflation can have negative consequences on the economy, as it may lead to reduced consumer spending, business investment, and economic growth. ◆ It can also increase the burden of debt and lead to deflationary spirals.	◆ Disinflation can have mixed effects on the economy. ◆ While a slowdown in inflation may indicate a more stable price environment, it can also indicate weaker demand or economic slowdown, affecting businesses and consumers.
Central Bank Response	◆ In the case of deflation, central banks may employ expansionary monetary policies, such as lowering interest rates, increasing money supply, or implementing quantitative easing, to stimulate spending and counter deflationary pressures.	◆ In the case of disinflation, central banks may adjust monetary policy to maintain price stability and control inflationary pressures, such as tightening monetary policy, increasing interest rates, or reducing government spending.

06
CHAPTER

Currency Management in India

Currency is a generally accepted form of money, including coins and paper notes, which is issued by a government and circulated within an economy. Used as a medium of exchange for goods and services, currency is the basis for trade.

It is generally issued and maintained by a governing authority and is known as **'fiat' money**. This means that the value of the currency does not come from the material it is made of, but by the value that it represents according to the economy and issuer.

Referring to any kind of money that is in circulation within an economy, 'currency' can also mean:

- The money that is used officially within a certain country, e.g. the currency of the United Kingdom is the Pound Sterling.
- Anything that is used as a form of exchange, i.e. banknotes, cheques, promissory notes, or otherwise.

Indian Currency

The Indian currency is called the Indian Rupee (INR). One Rupee consists of 100 Paise. The symbol of the Indian Rupee is ₹. The design resembles both the Devanagari letter (₹) and the Latin capital letter "R", with a double horizontal line at the top representing the national flag and also the "equal to" sign. The Indian Rupee sign was adopted by the Government of India on 15th **July, 2010.**

- The symbol was conceptualised and designed by Udaya Kumar, a post graduate in Design from Indian Institute of Technology Bombay.

Currency as Legal Tender

Legal tender is form of currency recognised by government as legally tenderable for discharge of debt or obligation. The use of anything other than existing legal tender in the economy as money is practically prohibited by laws.

- A country's legal denomination of currency must be accepted as a means of trade and payment for a money debt by law.
- While all denominations of circulating paper money are normally legal tender, the denomination and number of coins that can be used as legal currency varies per country.
- According to the **RBI Act of 1934**, which gives the Central Bank the authority to issue banknotes, "every banknote shall be legal tender in payment for the amount indicated therein in any place in India."
- The acceptance or rejection of legal tender status is significant since the value of paper money is entirely dependent on the government's acceptance of it.
- Legal tender money is issued by the RBI and the government in the form of currency notes or coins.
- **Demonetization** is the process by which legal tender status is revoked.
- In countries that do not issue their own currency, other currencies, most notably the US dollar, are regarded legal tender. Ecuador, for example, has recognised the US dollar as legal tender since 2000.

Other Types of Currency

Apart from the physical currency like coins and notes used by countries and regulated by a governing body, there are a few other types of currency, both modern and antiquated. They are described below:

Digital Currency

- Digital currency represents the newest type of currency available today. This currency is also virtual meaning it does not have a physical form. All transactions occur online.

Asset-backed Currency

- An asset backed currency means that the currency is tied to a particular resource or asset. It can be a precious metal such as gold.
- An asset backed currency is guaranteed and can also be exchanged for an amount of the asset. This type of currency can be a bit volatile because it is dependent on the asset value.

Commodity-backed Currency

- This type of currency is rather old fashioned and is no longer in use today. Like asset backed currency, this type is tied to a commodity such as wheat or oil etc. However, it was largely unreliable due to fluctuations in the markets.

07 CHAPTER Government Budgeting

The concept of budget refers to a financial plan or roadmap that outlines an organization's or government's expected revenue and expenditures over a given period. It is a tool that helps to manage finances, allocate resources, and achieve specific objectives.

Union Budget of India

A budget is an annual financial statement for a specific period of time, usually a year, that outlines projected income and expenses.

- It is used as a tool for managing financial resources and achieving specific goals such as mobilization of resources, fiscal consolidation, etc.
- A government budget has been defined as a statement showing estimated receipts and expenditure of the government during a fiscal year beginning on April 1 and ending on March 31 of the subsequent year.

Nodal Authority

- The Union budget is prepared by the budget division under the Department of Economic Affairs (DEA), the Ministry of Finance and is presented to the Parliament for discussion and approval.

Types of Budget

Broadly, there are three types of budgets in India: balanced, surplus, and deficit.

1. Balanced Budget

- If the government anticipates that the revenue for the upcoming year will be equal to the expenses they have estimated, the budget will be a balanced one.
- These types of budgets are ideal for maintaining fiscal discipline and reaching a state of a balanced economy.
- This is the main reason that classical economists prefer this type of budget.

Pros of a Balanced Budget

- If done correctly, there could be economic stability.
- Helps the government withhold unnecessary expenses.

Cons of a Balanced Budget

- May not be ideal in periods of deflation or economic crisis (this is because achieving the balance between projected costs and revenues can come with its set of challenges).
- Can limit the scope of growth in developing countries.

2. Surplus Budget

- If the expected revenues for the upcoming year are higher than the forecasted expenses, the government declares a surplus budget.
- A surplus budget implies that the government is earning more than it is spending.
- It is receiving more money by collecting taxes than the money it is spending on the public for the country's development.

Pros of a Surplus Budget

- Can help in reducing aggregate demand in times of inflation.
- Shows that funds are available for managing debt and making investments.

Cons of a Surplus Budget

- May lead to a higher tax burden for citizens.
- Increased tax levels may slow down consumption and impact economic activity.

3. Deficit Budget

- A deficit budget is ideal for developing countries like India, especially in times of economic slowdown.
- This is because higher expenditure on public welfare can raise economic activity and boost morale.
- It will also generate employment, which can ultimately result in increased demand for goods and services.
- To carry out these expenses, the government may rely on its existing reserves or borrow from the public in the form of government securities, such as bonds.

Pros of a Deficit Budget

- Can help generate employment and thereby lead to better economic activity.
- Increases the funds for public welfare, which allows for infrastructure development and improves public morale.

Cons of a Deficit Budget

- Allocation of funds may not be executed as planned, and the government may end up spending more than necessary.

08
CHAPTER

Tax Structure in India

Tax structure in India is a three tier federal structure. The central government, state governments, and local municipal bodies make up this structure. Taxes are determined by the Central and State Governments along with local authorities like municipal corporations. The government cannot impose any tax unless it is passed as a law.

Features of the Indian Tax Structure

- **Multiplicity of Tax Structure:** The main feature of the Indian tax structure is the existence of a multiplicity of taxes. Both Union and State government taxes coexist, spanning both direct and indirect tax categories.
- **Indirect Taxes hold a Large Share:** Indirect taxes dominate over direct taxes. Due to developmental gaps and major income inequality, the percentage contribution of direct taxes remains structurally limited.
- **Insufficient Tax Revenue:** Despite a rising trend, total tax revenue remains small compared to developed nations. India's combined (Centre + State) **tax-to-GDP ratio stands at approximately 17-18%** (with the Centre's gross tax ratio at ~11.5%), whereas developed countries like the UK and USA range between 30% to 40%.
- **Incidence of Taxation:** The incidence of taxation is much higher in urban areas than in rural areas. This disparity exists because agriculture predominates as a rural occupation and rural households possess less income.
- **Progressiveness of the Tax Structure:** The Indian tax structure is framed to make sure that all indices of ability to pay are taxed. Excise duties and indirect taxes are levied and collected discriminately depending on the type of commodity and consumer class.
- **Narrow Tax Base:** The tax base is very narrow in India across both direct and indirect tax systems. Reflecting this narrow base, only a minute fraction—historically around **1% to 2% of the total population**—actively pays personal income tax.

Taxation System in India

The Taxation System in India refers to the organized structure by which a government collects and manages taxes from individuals and businesses within its jurisdiction.

- Taxation System in India comprises various types of taxes, principles, and mechanisms that determine how much tax is levied, collected, and utilized.
- The taxation is the primary source of revenue to the Government for incurring such public welfare expenditure.

Objectives of Taxation

- Generating revenue for the government
- Eliminating inequities
- Reduction in regional imbalances
- Stimulating economic development
- Capital formation
- Increasing employment opportunities
- Regulating the effects of inflation, depression etc.
- A tool to regulate consumption, imports, and exports
- price stability
- control of cyclical fluctuations
- reduction of balance of payment (bop) difficulties
- To prevent dumping
- To prevent infant and domestic industries

Methods of Taxation

Progressive Taxation

In progressive taxation, the tax liability increases with individual or entity income. This is based on principle of **"ability to pay".**

- The correct interpretation is that the tax liability for a taxpayer increases with his income in terms of proportion of income and in absolute amount.
- Under this system, lowest income people are generally exempted while highest income people pay highest taxes.
- Progressive taxation results in redistribution of income from rich to poor.
- Redistribution of income can help in stimulating the economy by increasing consumption.

Regressive Taxation

A regressive tax is one in which tax rate decreases as the amount subject to taxation increases; and the tax rate progresses from high to low.

09
CHAPTER

Banking System in India

Banking in India plays a crucial role in the economic development of the country, serving as a backbone for financial transactions, savings, investments, and credit systems. The Indian banking sector is one of the largest and most diverse in the world, encompassing a wide range of institutions, from public and private sector banks to foreign banks, cooperative banks, and regional rural banks.

The structure of the banking system of India can be broadly divided into scheduled banks, non-scheduled banks and development banks.

Banks that are included in the **second schedule of the Reserve Bank of India Act, 1934** are considered to be scheduled banks.

Presently, 135 scheduled commercial banks are providing banking services in India. In addition, co-operative banks and local area banks are also providing banking services in various segments in different locations of the country.

For the purpose of lending to specific sectors / segments, Non-Banking Financial Companies (registered with RBI) and 5 All India Financial Institutions are also catering the needs of the borrowers.

Definition of Bank

- The term 'Bank' is derived from the Italian word 'banca', Latin word 'bancus' and Frenchword 'banque' which means bench or Money exchange table.
- A bank is a financial institution and a financial intermediary that accepts deposits and channels those deposits into lending activities, either directly by loaning or indirectly through capital markets. A bank is the connection between customers that have capital deficit and customers with capital surpluses.
- Most banks operate under a system known as **fractional reserve banking** where they hold only a small reserve of the funds deposited and lend out the rest for profit. They are generally subject to minimum capital requirements which are based on an international set of capital standards, known as the **Basel Accords**

According to the **Indian Banking Company Act 1949**, "A banking company means any company which transacts the business of banking. Banking means accepting for the purpose of lending or investment, of deposits of money from the public, repayable on demand or other wise and withdrawable by cheque, draft or otherwise."This definition throws light on the three major functions of a bank.

They are:

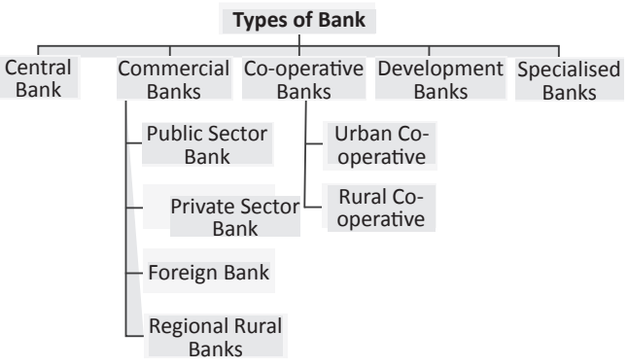
(i) Accepting of deposits and lending loans

(ii) Issue and pay cheques,

(iii) Collect cheques on behalf of the customers

Structure of Banking System in India

The Banking System in India has a hierarchical structure consisting of various types of banks.



Reserve Bank of India (RBI)

- The Reserve Bank of India (RBI), as the central banking institution of India, is the backbone of the Indian financial system.
- As the custodian of the country's economic and financial stability, it plays a crucial role in India's economic development and smooth functioning of the entire banking sector.

Under the RBI, Indian Banks are broadly classified into two types:

A. Scheduled Banks

B. Non-Scheduled Banks

A. Scheduled Banks

All banks which are included in the **Second Schedule** to the Reserve Bank of India Act, 1934 are Scheduled Banks.

10 CHAPTER Differentiated Banks in India

Differentiated banks are financial institutions that have been granted a licence by the Reserve Bank of India to provide certain banking services and products. The primary goal of granting these bank licenses are to encourage financial inclusion and payments. Licensing for differentiated banks began in 2015.

The Reserve Bank of India issues two different types of banking licenses:

- Universal bank licenses
- Differentiated bank licenses.
  - Differentiated banks (niche banks) are financial institutions that cater to the demands of a certain demographic group.
  - Differentiated banks serving niche interests include local area banks, payment banks, etc.
  - These banks are contemplated to meet credit and remittance needs of small businesses, unorganized sector, low income households, farmers, and migrant work force.

Need for Differentiated Banks in India

The need for differentiated banks in India arises from the unique challenges and opportunities that the country faces in its economic landscape. Given the size, diversity, and complexity of the Indian economy, traditional full-service banks often struggle to address the varied financial needs of different segments of the population. This is where differentiated banks—banks that focus on specific sectors, regions, or customer segments—come into play.

Followings are the core reasons behind the need for differentiated banks in India:

- Financial Inclusion
- Regional and Socio-Economic Diversity
- Support for Niche Sectors
- Increased Focus on Technology and Digital Banking
- Customized Services for Specific Demographics
- Innovative and Inclusive Financial Products
- Better Risk Management in Niche Segments
- Boost to Innovation and Competition
- Encouragement of Entrepreneurship and Startups
- Greater Focus on Financial Literacy and Awareness
- Access to Credit for Low-Income Households
- Supporting Government Initiatives

Evolution of Differentiated Banking in India

The evolution of differentiated banking in India represents a strategic shift in the country's banking architecture, aimed at improving financial inclusion, enhancing competition, and catering to niche banking needs. Here's a comprehensive look at its evolution:

2007 : Concept of differentiated bank first raised

- The concept of differentiated banking, where banks specialize in particular areas (e.g., payments, retail, wholesale, infrastructure), was first raised in 2007.

2008 : Raghuram Rajan Committee

- In 2008, a Government of India's High Level Committee on Financial Sector Reforms headed by Dr. Raghuram Rajan submitted its Report titled "A Hundred Small Steps".
  - Among its various recommendations, the Committee recommended that there is a need for paradigm shift in the strategy for financial inclusion.
  - It said the emphasis should be shifted from large-bank-led, public-sector-dominated, mandate-ridden, branch-expansion-focussed strategy.

2013 : Nachiket Mor Committee

- The 2013 RBI paper further explored this idea, leading to the formation of the Nachiket Mor Committee.
  - This committee recommended a banking structure with both horizontal (HDBS) and vertical differentiation (VDBS).
  - HDBS involves banks specializing in different functions like payments, deposits, and credit, while VDBS focuses on serving specific customer segments or industries.

2014 : Introduction of Differentiated Banking Licenses

Reserve Bank of India (RBI) introduced two major forms of differentiated banks:

(a) Small Finance Banks (SFBs)

- **Objective:** Serve small business units, marginal farmers, micro and small industries, and unorganised sector.
- Can accept deposits and offer loans.
- **Examples:** AU SFB, Equitas, Ujjivan.

(b) Payments Banks

- **Objective:** Facilitate low-cost payments and remittance services.

11 CHAPTER Non-Banking Financial Institutions

Non-Banking Financial Institutions (NBFIs) are a group of diverse financial intermediaries which, in a bank-dominated financial system like India, serve as an alternative channel of credit flow to the commercial sector.

Types of NBFIs

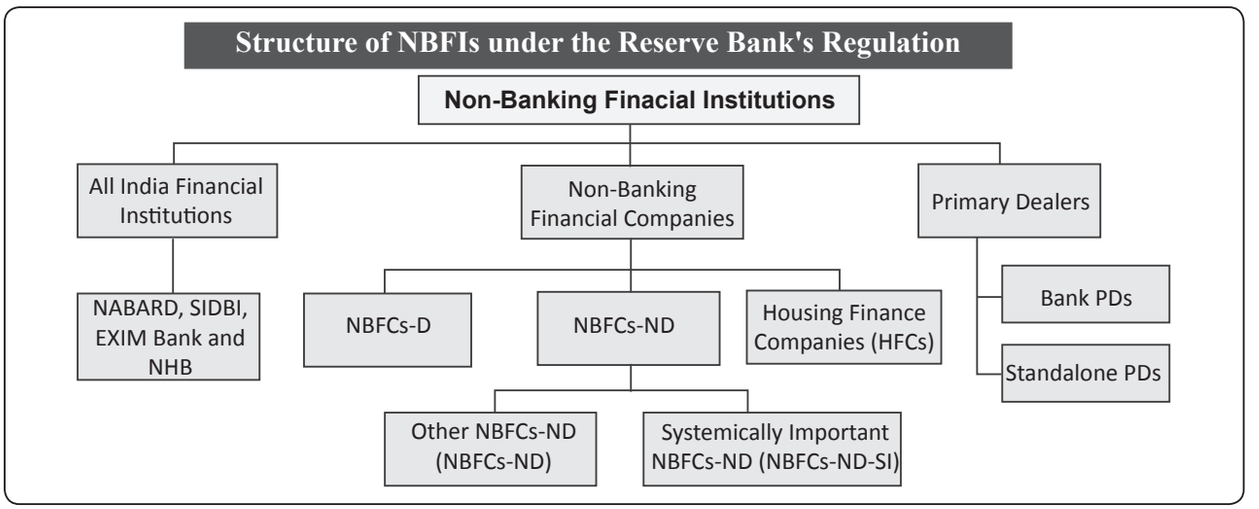
Among the various institutions that perform financial function, those regulated by the Reserve Bank are:

A. All-India Financial Institutions (AIFIs): AIFIs are apex financial institutions established during the development planning period to ensure adequate flow of long-term financial resources to crucial sectors, i.e., agriculture, rural development, small industries and so on.

B. Nonbanking Financial Companies (NBFCs): NBFCs are government/public/private limited companies, which specialise in delivering credit to a wide variety of niche segments, ranging from infrastructure to consumer durables.

C. Primary Dealers (PDs): PDs came into existence in 1995 and act as market makers in the government securities (G-secs) market, besides ensuring that primary issuances of G-secs are subscribed.

D. Housing Finance Companies (HFCs): The most recent addition, Housing Finance Companies (HFCs) extend housing finance to individuals, co-operative societies and corporate bodies and lease commercial and residential premises to support housing activity in the country.



A. All India Financial Institutions (AIFI)

All India Financial Institutions (AIFI) is a conglomerate of Development Finance Institutions (DFI) and investment firms that play a key role in the Indian financial markets.

- Financial institutions, also known as "financial instruments," aid in the efficient allocation of resources by sourcing from firms with surpluses and distributing to businesses with deficits, as well as assuring the continuing circulation of money in the economy.
- AIFI was established by a separate Act of Parliament.

The Reserve Bank regulates and supervises five All India Financial Institutions (AIFIs):

1. Export Import Bank of India (EXIM Bank),
2. National Bank for Agriculture and Rural Development (NABARD),
3. Small Industries Development Bank of India (SIDBI), and
4. National Housing Bank (NHB)
5. National Bank for Financing Infrastructure and Development

1. Export-Import Bank of India (EXIM)

- EXIM Bank (is a leading export finance-based institution in India which engages in integrating Foreign Trade and Investment with the national economic growth. It aims to enhance the exports from India and promote the country's international trade.

12 CHAPTER Concept of Money

Money is a widely accepted medium of exchange that is used to facilitate transactions and represent value. It serves as a unit of account, a store of value, and a medium of exchange in various economic systems. Money can take different forms, such as physical currency (coins and banknotes) or digital representations (electronic money).

Evolution of Money

Modern money includes coins, currency notes, and deposit money (such as bank account balances). However, the concept of money has evolved over centuries, transforming through various stages to reach its current form.

Primitive/Commodity Money

- In ancient times, people used commodity money—items that had intrinsic value and could be traded. These included: Animals (cows, sheep), Agricultural goods (wheat, rice, tobacco) and Rare items (tiger teeth, elephant tusks)

Metallic Money

- With the advancement of civilizations, metallic coins replaced commodity money. These were more durable, divisible, and portable.
- Metallic money was of two types:

(i) Standard (Full-bodied) Coins

- Intrinsic (metal) value = Face value
- Made of precious metals like gold and silver

(ii) Token Coins

- Intrinsic value < Face value
- Usually made of cheaper metals (e.g., copper, nickel)

Paper Money

- To address the limitations of metallic coins, paper currency was introduced. This shift occurred for:
  - Economizing precious metals
  - Ease of handling and transportation
- Initially, paper money was issued as representative money, meaning:
  - It could be converted into gold or silver upon demand
  - It acted as a certificate backed by actual metal reserves.
- Over time, due to economic expansion and increased money demand, convertibility became impractical.

Fiat Money (Modern Paper Currency)

- Today's paper currency is non-convertible and not backed by any physical commodity. It is:
  - Known as fiat money
  - Accepted as legal tender by government authority
  - Issued and regulated by central banks (like the Reserve Bank of India).

Credit Money

- In the modern economy, a large part of money supply exists in the form of:
  - Credit instruments like bank deposits, cheques, and digital payments
  - These are not legal tender but widely accepted due to the trust in financial institutions.

Characteristics of Money

The forms that money has taken on depend heavily on how well it performs the four functions we have discussed earlier.

The following are some of the characteristics that an item should have in order to perform the four functions of money efficiently:

- Must be easily standardized, making it simple to ascertain its value.
- Must be widely accepted in payments for goods and services and for settling other business obligations i.e. must have intrinsic value or made acceptable by decree of law (assigned legal tender status).
- Must be divisible, so that it can be used for exchange of a range of values.
- Must be stable and durable; i.e., does not deteriorate, perish or erode due to its own structure and composition.
- Must be easy to carry around.
- Must be limited in supply.
- Must not be counterfeited.

Primary Functions of Money

(a) Medium of Exchange

- Money is used to facilitate the exchange of goods and services.

13 CHAPTER

Monetary Management in India

Monetary management refers to the process by which a country's central bank, i.e., the Reserve Bank of India (RBI), controls the money supply, interest rates, and credit availability in the economy to maintain price stability, economic growth, and financial stability.

Objectives of Monetary Management in India

- Price Stability (Control Inflation)
- Economic Growth
- Exchange Rate Stability
- Employment Generation
- Financial Stability

Monetary Policy Transmission

Institution Responsible

- Reserve Bank of India **(RBI)** under the RBI Act, 1934
- Monetary Policy Committee **(MPC)** formed under the Finance Act, 2016

Legal Framework

- RBI Act, 1934 – Primary legislative authority
- Finance Act, 2016 – Established the Monetary Policy Committee (MPC)
- Inflation Targeting Framework – Mandates RBI to keep CPI inflation at 4% (+/- 2%)

Monetary Policy of India

Monetary policy is a vital component of monetary management in India, undertaken by the Reserve Bank of India (RBI)—the country's central bank. As the apex monetary authority, the RBI formulates and implements monetary policy with the objective of maintaining price stability, ensuring adequate flow of credit, and supporting the nation's overall economic growth.

- Monetary policy refers to the policy of the central bank – i.e., Reserve Bank of India – in matters of interest rates, money supply and availability of credit. It is through the monetary policy, RBI controls inflation in the country.
- In short, monetary policy refers to the use of monetary instruments under the control of the central bank to regulate magnitudes such as interest rates, money supply and availability of credit with a view to achieving the ultimate objective of economic policy.
- The Reserve Bank of India (RBI) is vested with the responsibility of conducting monetary policy. This responsibility is explicitly mandated under the **Reserve Bank of India Act, 1934**.

Timeline: Evolution of Monetary Policy

- **1935:** Proportional Reserve System
- **1954:** Minimum Reserve System
- **1973-76:** Minimum and maximum lending rates for bank loans prescribed
- **1985:** Flexible monetary targeting with feedback
- **1998:** Multiple indicator approach adopted
- **2014:** Inflation Targeting adopted

Objectives of Monetary Policy

Maintaining Price Stability

- The primary objective of monetary policy is to maintain price stability by keeping inflation under control.
- Central banks achieve this by adjusting interest rates and the money supply in response to changes in the economy, such as changes in consumer demand, government spending, and international trade.

Promoting Economic Growth

- In addition to managing inflation, monetary policy also plays a key role in promoting economic growth and stability by providing a stable and predictable financial environment that is conducive to investment and lending.
- This is accomplished through the use of various policy tools, such as open market operations, reserve requirements, and discount rates.

Overall, monetary policy is a critical component of modern economic management, helping maintain stable economic growth, low inflation, and sustainable employment levels. Central banks around the world use a range of monetary policy tools and strategies to achieve these goals, adapting their approach as economic conditions and priorities change over time.

Monetary Policy Objectives

- Minimises Unemployment
- Maintains Exchange Rate
- Determines Interest Rates
- Regulates Money Supply
- Maintains Inflation Rate

14 CHAPTER

Indian Financial System

The economic growth of a country is closely linked to the development of its financial system. In any economy, different sectors—households, corporate entities, and the government—experience either a surplus or deficit of funds. The financial system acts as a bridge, channeling funds from surplus areas to those with deficits, thereby ensuring efficient capital allocation.

The term **financial system** refers to a complex network of institutions, markets, instruments, services, and practices that facilitate financial transactions and resource mobilization within an economy.

Understanding the Indian Financial System

A financial system refers to a system which enables the transfer of money between investors and borrowers. A financial system could be defined at an international, regional or organizational level.

- The term "system" in "Financial System" indicates a group of complex and closely linked institutions, agents, procedures, markets, transactions, claims and liabilities within an economy.
- The Indian financial system is crucial to the country's development. It promotes savings and investments, facilitates capital formation, and connects savers with borrowers, enabling businesses and individuals to access funds.

Features of the Indian Financial System

- **Promotes Economic Development:** The financial system plays a crucial role in the economic progress of the country by encouraging both savings and investments, which are the foundations of sustainable growth.
- **Facilitates Institutional and Market Expansion:** It supports the growth and diversification of financial institutions and markets, enabling a broader reach and greater financial inclusion across regions and sectors.
- **Mobilization and Allocation of Savings:** One of the core functions of the financial system is to mobilize individual and institutional savings and allocate them efficiently to productive investment avenues.
- **Supports Capital Formation:** By converting savings into investments, the financial system plays a key role in capital formation, which fuels industrial and infrastructural development.
- **Acts as a Financial Intermediary:** It serves as a link between savers and borrowers, efficiently channeling funds from those who have surplus capital to those who require funds for business and development purposes.
- **Ensures Efficient Fund Flow:** In summary, the Indian financial system acts as a conduit for the smooth flow of funds to the sectors and entities that need financial resources, thereby supporting balanced and inclusive economic growth.

Major Components of the Indian Financial System

The financial system consists of following major components:

(a) Financial Regulators
(b) Financial Institutions
(c) Financial Markets
(d) Financial Instruments
(e) Financial Services

(a) Financial Regulators

These entities supervise and regulate the financial system to ensure its soundness and stability.

- Department of Economic Affairs (DEA)(Ministry of Finance)
- Reserve Bank of India (RBI)
- Securities and Exchange Board of India (SEBI)
- Insurance Regulatory and Development Authority (IRDA)
- Stock Exchanges (e.g., BSE, NSE)

(b) Financial Institutions / Intermediaries

These institutions act as mediators between savers and borrowers, facilitating the flow of funds.

(a) Banking Institutions:

- Commercial Banks
- Co-operative Banks
- Regional Rural Banks (RRBs)

(b) Non-Banking Financial Companies (NBFCs)

(c) Development Financial Institutions:

- All-India Financial Institutions (e.g., NABARD, SIDBI)

15
CHAPTER

Securities Market in India

Securities Market is a place where companies can raise funds by issuing securities such as equity shares, debt securities, etc. to the investors (public) and also is a place where investors can buy or sell various securities (shares, bonds, etc.). Once the shares (or securities) are issued to the public, the company is required to list the shares (or securities) on the recognized stock exchanges. Securities Market is thus a part of the Capital Market.

The primary function of the securities market is to enable allocation of savings from investors to those who need it. This is done when investors make investments in securities of companies / entities which are in need of funds. The investors are entitled to get benefits like interest, dividend, capital appreciation, bonus shares, etc. Such investments contribute to the economic development of the country.

Securities are financial instruments issued to raise funds via issue of bonds, debentures, mutual funds, etc. Security market is a component of the wider financial market where securities can be bought and sold on the basis of demand and supply.

Elements of Securities Market

- **Issuers:** Those who create and sell bonds or another type of securities are referred to as issuers.
- **Investors:** Those who buy the security are investors. In some cases, the investor is also referred to as a lender.
- **Intermediaries:** The third critical element of markets is the intermediaries who act as conduits between the investors and issuers.
- **Regulatory Bodies**: It regulates the functioning of the securities markets.
  - The process of mobilisation of resources is carried out under the supervision and overview of the regulators.
  - The regulators develop fair market practices and regulate the conduct of issuers of securities and the intermediaries.
  - They are also in charge of protecting the interests of the investors.
  - The regulator ensures a high service standard from the intermediaries and supply of quality securities and non-manipulated demand for them in the market.

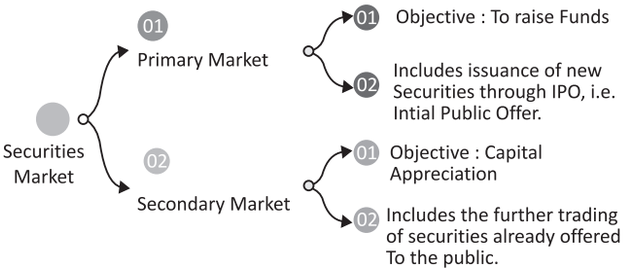
Structure of Securities Market in India

Securities markets encompasses equity markets, bond markets and derivatives markets where prices can be determined and participants both professional and non-professionals can meet.

Securities markets can be split into two levels:

(1) Primary markets, where new securities are issued, and

(2) Secondary markets, where existing securities can be bought and sold.



A. Primary Market

It provides the channel for creation and sale of new securities, while the secondary market deals in securities previously issued**.**

- The securities issued in the primary market are issued by public limited companies or by government undertakings.
- The resources in this kind of market are mobilized either through the public issue or through private placement route.
- It is a public issue if anyone can subscribe it, whereas if the issue is made available to a selected group of persons it is termed as private placement.

There are two major types of issuers of securities:

(i) Corporate Entities (companies): which mainly issue equity instruments (shares) and debt instruments (bonds, debentures, etc.)

(ii) Government (Central as well as State): which issues debt securities (dated securities and treasury bills)

Methods of Floatation

Primary issues made by Indian companies can be classified as follows:

16 CHAPTER Insurance Sector in India

Insurance as security is need of all human beings. No animal, no plant nor mountains and oceans want any security, like man does. Man is afraid of uncertainty, fears and death. Although a reality, one day each one will die; early or later, timely or untimely is the question, which has no answer. He is afraid of risk & losses in future. He is ever in search of security & certainty. In early history man lived in-groups and communities to be secure.

Concept of Insurance

Insurance is a mechanism by which the person exposed to the potential risk, arising out of the events beyond his control, transfers the financial loss; in part or in full to a third party.

- The party which transfers the potential loss is termed as
- **The 'Insured'** and the party which indemnifies or undertakes to compensate the other party of such potential loss are termed as **'Insurer'**.
- The Insurer provides the coverage for the potential financial loss for a fee or a consideration which is called the **'Premium'.**

Thus Insurance is a special type of contract between the Insurer (the Insurance Company) and the Insured (the client) wherein:

- The client agrees to pay a premium to the Insurance Company. Such premium may be a fixed amount payable as a single payment or it may be paid as periodical payments. This will depend upon the type of Insurance and the terms thereof.
- In lieu of the payment of such premium, the Insurance Company agrees to make some payment to the client or bear the costs of the client due to financial loss incurred on the occurrence of certain events.
- **For example,** in vehicle insurance, the Insurance Company pays the cost of repairing the vehicle if it is damaged in an accident.

Overview of Insurance Sector in India

Market Size

- India is the 5th largest life insurance market among the world's emerging insurance markets.
- The life insurance industry is growing rapidly at a rate of 32–34% annually.

Structure of the Indian Insurance Industry

- **Total insurance companies:** 57
- **Life insurers:** 24
- **Non-life (General) insurers:** 34
- Life Insurance Corporation of India (LIC) is the only public sector life insurer.
- Non-life insurance segment has six public sector insurers.
- General Insurance Corporation of India (GIC Re) is the sole national re-insurer.

Other Key Stakeholders

- **Agents** – Individual and corporate agents help in policy distribution.
- **Brokers** – Provide expert insurance advice and facilitate transactions.
- **Surveyors** – Assess damage and verify claims.
- **Third-Party Administrators (TPAs)** – Assist in health insurance claim servicing.

Regulation

- Regulated by the Insurance Regulatory and Development Authority of India (IRDAI).
- The regulator aims to fulfill its vision: "Insurance for All by 2047".

Penetration and Density

- General insurance penetration in India remains low at just 1% of GDP (as of 2023).
- This is significantly lower than the global average of 4.2%.
- However, insurance density (i.e., per capita insurance premium) has shown steady improvement:
  - $9 in 2019
  - $25 in 2023

FDI in Insurance Sector

- The Indian government has increased the Foreign Direct Investment (FDI) limit in the insurance sector from 74% to 100%, as announced in the Union Budget 2025.
- This means foreign companies can now own up to 100% stake in Indian insurance companies, provided they invest the entire premium collected in India.

17
CHAPTER

Market Structure/Forms of Market

Market is the major source of distribution of goods and services. The purpose of producing goods is to sell them to the consumers who demand them. To sell the goods (and services) we need the medium of market. In today's world a buyer can get so many types of goods in the market.

Meaning of Market

Market is the heart and soul of modern economic life. Without market, producers' and consumers' activities hardly make any sense. In common parlance, market is assumed to be a place where goods are bought and sold.

But **in economics**, the term 'market' does not refer to a specific place. Rather, **it is a mechanism** through which buyers and sellers come into contact with each other and buy and/or sell goods at mutually agreed prices.

Important Features of a Market

- **Buyers and Sellers:** Buyers and sellers must come into contact with each other for a market to exist. It is only after the contact between the buyer and the seller, that a transaction takes place.
- **Area:** You can easily find a market place nearer to a human settlement. But in today's world, the market is not limited to a particular place. Today, in the age of Internet, we have a rapidly growing online market which is not limited to any geographical area. A buyer can place order to buy a good online. So modern Market exists physically and virtually.
- **Commodity:** The transaction between buyer and seller has to be over some good or service. So a commodity becomes the integral part of a market.
- **Different forms of Competition:** Forms of market depends on the degree of competition among the sellers selling the goods, where the degree of competition itself is determined by the inter relationship of among the goods and services sold by different sellers as well on number of sellers present in the market.
- **Money Transaction:** Money is the *mediums of exchange* in the modern day world. Consumers pay money to the seller to buy goods as services in the market. So money and market are inseparable.

Basis of Different Market Forms

Economists have defined and classified markets on the following basis:

(i) The number of buyers and sellers of the commodity.

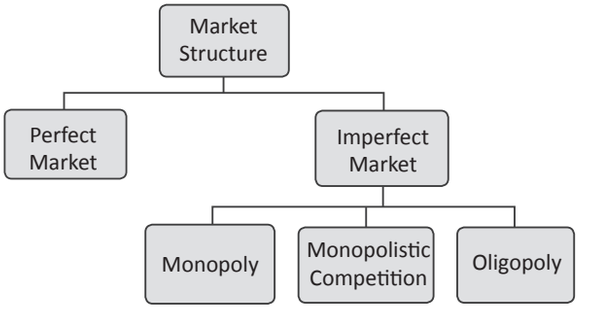
(ii) The nature of the commodity produced by the seller.

(iii) Freedom in the movement of goods and factors of production.

(iv) Knowledge of the buyers and sellers regarding prices in the market.

Different Forms of Market Structure

By "structure of market" we mean nature of the product, number of sellers and buyers in the market etc. Thus, as per the above mentioned characteristics, we can classify different markets in the way as shown in the following chart:



I. Perfect Competition/Market

Perfect competition refers to a market situation in which there are a large number of buyers and sellers of homogeneous products. The price of the product is determined by industry with the forces of demand and supply.

- According to **Joan Robinson**- "Perfect competition prevails when the demand for the output of each producer is perfectly elastic."
- For example, if we require a pen there should be several shops selling pens. Under conditions of perfect competition every seller should be selling the same quality of pens at a uniform prevailing price in the market.
- We may buy a pen from any shop at price Rs. 10. If another shopkeeper charges Rs. 12 for the same quality of pen, nobody will buy from him but if a shopkeeper charges Rs. 9 all will buy pens from that particular shop. But both situations are unrealistic.

18 CHAPTER Service Sector

The service sector in India has emerged as a key driver of the country's economic growth in recent decades. The sector comprises a wide range of industries, including information technology, finance, telecommunications, healthcare, and tourism, among others.

- The service sector now accounts for a significant share of India's GDP, and has surpassed agriculture and manufacturing as the country's largest employer. The sector has also played a critical role in promoting economic development and reducing poverty, particularly through its ability to provide high-skill, high-wage jobs to a growing middle class.
- India's service sector has benefited from a range of factors, including the country's large, English-speaking workforce, its growing consumer market, and its strategic location in the global economy. As a result, the sector has attracted significant foreign investment and has become a key player in the global services industry.
- However, the service sector in India also faces several challenges, including inadequate infrastructure, regulatory barriers, and a shortage of skilled workers. Addressing these challenges will be critical to sustaining the sector's growth and ensuring that it continues to play a central role in India's economic development.

Concept of Service Sector

American Marketing Association in 1960 defined services as "activities, benefits, or satisfactions which are offered for sale, or provided in connection with the sale of goods".

Services can be defined as, "an activity or series of activities rather than things which has some element of intangibility associated with it, which involves some interaction between the customer and the service provider, and does not result in a transfer of ownership. Customer has a vital role to play in the production process as the services are provided in response to the problems of customers as solution. The production of the service may or may not be closely associated with a physical product".

Characteristics of Service Sector

Intangibility

- Services are intangible and do not have a physical existence. Hence, services cannot be touched, held, tasted, or smelled.
- This is the most defining feature of a service and that, which primarily differentiates it from a product.
- Also, it poses a unique challenge to those engaged in marketing a service as they need to attach tangible attributes to an otherwise intangible offering.

Heterogeneity/Variability

- Given the very nature of services, each service offering is unique and cannot be exactly repeated even by the same service provider.

Perishability

- Services cannot be stored, saved, returned or resold once they have been used. Once rendered to a customer the service is completely consumed and cannot be delivered to another customer.
- For example, a customer dissatisfied with the services of a barber cannot return the service of the haircut that was rendered to him. At the most, he may decide not to visit that particular barber in future.

Inseparability/Simultaneity of Production & Consumption

- It refers to the fact that services are generated and consumed within the same time frame. For example, a haircut is delivered to and consumed by a customer simultaneously unlike, say, a takeaway burger, which the customer may consume even after a few hours of purchase.
- Moreover, it is very difficult to separate a service from the service provider, e.g. the barber is necessarily a part of the service of a haircut that he is delivering to his customer.

Some Major Industries within the Service Sector

- **Healthcare**: This includes hospitals, clinics, and other medical facilities that provide health services to individuals.
- **Financial Services**: This includes banks, insurance companies, investment firms, and other financial

19 CHAPTER

Foreign Trade

Foreign trade plays a pivotal role in shaping the economic landscape of any nation, and for a developing country like India, it is a vital engine of growth and development. It refers to the exchange of goods and services across international borders, enabling countries to access resources, technology, and markets beyond their domestic capabilities.

In the Indian context, foreign trade has undergone a significant transformation since the economic liberalization of 1991. With the adoption of open trade policies, reduced tariff barriers, and promotion of exports, India has become increasingly integrated with the global economy. Foreign trade now contributes substantially to India's GDP, employment generation, foreign exchange earnings, and industrial modernisation.

What is Foreign Trade?

Foreign trade is defined as the purchasing and selling of items beyond the national borders of different countries. It's also known as **international trade** or **external trade**.

- The concept of trade refers to the purchase and sale transactions that enable manufactured commodities and services to be provided to consumers.
- The concept of overseas trade is represented by these purchases and sales transactions with foreign countries.
- For example, a country may be rich in iron and steel but deficient in aluminium. As a result, it must source aluminium from countries that have a surplus of metal.
- Not only that, but countries with excess production of particular commodities find it advantageous to sell them to other countries and purchase items from others in which they are deficient.

Foreign Trade in India: Historical Aspect

- **Harappan Civilisation:** Centralized economy, trading stones, metals, and grains via boats/carts. Sourced from Rajasthan, Afghanistan, and Iran. Mesopotamian texts confirm trade with **Meluha**.
- **Buddha Period:** Urban hubs (Varanasi, Shravasti) flourished via riverine networks. Coinage introduction catalyzed market exchanges.
- **Mauryan Empire & Guild System (Shreni):** Well-organized internal/external trade via royal highways/waterways. Exported spices and textiles; imported horses and gold. Commodities bore origin stamps. Eighteen major handicrafts were regulated by **Shrenis** (associations of artisans, merchants, and professionals).
- **Satavahana Dynasty:** Connected Central Asia and Rome via **Dakshinapatha** and **Uttarapatha**.
- **Gupta Period:** "Golden Age" dominated by **Sresthis** (urban traders) and **Sarthavahas** (caravan traders). Utilized Silk Route and monsoon winds for external trade.

Foreign Trade during the Mughal Period

- Vibrant trade via Gujarat ports with a positive trade balance, enriching treasuries with gold/silver. Exported textiles/spices; imported horses/luxuries. Global trade credibility was enhanced by pure silver **Rupiya**.

Foreign Trade during British Rule in India

- **Nature of Foreign Trade under British Rule:** Colonial exploitation forced raw material exports (cotton, indigo) and manufactured imports (Lancashire textiles), causing severe domestic **deindustrialisation**.

Foreign Trade after Independence

- **Initial Post-Independence Phase (1947–1991):** Shifted to planned economic regulation to protect domestic industry. High import dependence on development machinery, maintenance inputs, and food essentials.
- **Liberalisation Phase (Post-1991 Economic Reforms):** The 1991 New Economic Policy marked a watershed moment in India's trade regime.
- **Key reforms** included**:**
  - Reduction in Tariffs and elimination of many import licensing restrictions
  - Encouragement of Foreign Direct Investment (FDI) and private sector participation
  - Shift towards export promotion and integration into global trade systems

20 CHAPTER Currency Convertibility

A few decades ago, India followed a strictly controlled exchange rate regime, where the Reserve Bank of India (RBI) regulated the conversion of Indian currency into foreign exchange. Under this system, all foreign exchange earnings had to be surrendered to authorized dealers, and individuals or businesses wishing to purchase foreign currency had to obtain prior permission from the central bank.

The primary objective of such controls was to ensure that the limited foreign exchange earned by residents was utilized according to government-defined priorities. These restrictions were considered essential at the time, as India was still an underdeveloped economy, largely dependent on the export of agricultural products and raw materials, while importing basic consumable goods.

However, with economic liberalisation and steady growth, India has transformed into a rapidly developing nation and has become one of the most attractive destinations for foreign investment. In this changing global and domestic economic scenario, India could no longer afford to restrict foreign trade. To support its integration with the global economy and sustain growth, the Government of India introduced rupee convertibility in a phased manner, beginning with current account transactions.

Meaning of Currency Convertibility

Convertibility of currency means when currency of a country can be freely converted into foreign exchange at market determined rate of exchange that is, exchange rate as determined by demand for and supply of a currency.

Example: Convertibility of rupee means that those who have foreign exchange (e.g. US dollars, Pound Sterlings etc.) can get them converted into rupees and vice-versa at the market determined rate of exchange.

Advantages of Currency Convertibility

- **Encouragement to Exports**: Market rate remains generally higher than the officially determined exchange rate. This implies that from given exports, exporter can get more rupee against foreign exchange. This will help to increase exports
- **Encourages Import Substitution:** Imports become expensive due to convertibility of rupee. So it discourages imports and boosts import substitution.
- **Incentive to Remittances from Abroad:** Earlier, NRIs used to send money illegally to India such as Hawala money and gold etc. But due to removal of restrictions, NRIs can easily remit money to India. It will help to improve Balance of payment.
- **Reduction in Malpractices:** The malpractices like under-invoicing of exports may not arise as rupee is fully convertible and they will get full value for their exports
- **A Self – balancing Mechanism:** Another important merit of currency convertibility lies in its self-balancing mechanism. When balance of payments is in deficit due to over-valued exchange rate, under currency convertibility, the currency of the country depreciates which gives boost to exports by lowering their prices on the one hand and discourages imports by raising their prices on the other. In this way, deficit in balance of payments get automatically corrected without intervention by the Government or its Central bank.

Components of Currency Convertibility

It has two components:

1. Current Account Convertibility
2. Capital Account Convertibility

1. Current Account Convertibility

Current Account Convertibility refers to the degree of freedom to convert your rupees into other internationally accepted currencies and vice versa without any restrictions whenever payments are made.

India's Journey toward Current Account Convertibility

Following the collapse of the Bretton Woods system in 1971, many countries transitioned to free currency convertibility on the current account.

- In India, economic reforms initiated in 1991 paved the way for currency liberalization. In March 1992, the rupee was made partially convertible under the Liberalised Exchange Rate Management System (LERMS). Under this scheme:
  - 60% of all current account foreign exchange receipts could be converted at market-determined rates, and
  - 40% had to be converted at the official exchange rate set by the Reserve Bank of India (RBI).

21 CHAPTER Foreign Investment in India

Foreign investment has emerged as a cornerstone of India's economic growth and globalization strategy. It refers to the inflow of capital from foreign individuals, institutions, or governments into domestic businesses and markets. With its vast consumer base, skilled workforce, and favorable demographic profile, India is one of the most attractive destinations for foreign investors seeking growth opportunities.

Foreign Direct Investment (FDI) is a significant driver of economic growth in India. FDI refers to an investment made by a foreign company or individual in a company or entity located in India. It is considered an important source of capital, technology, and expertise that can help boost the growth and development of various sectors in the Indian economy.

Concept of Foreign Investment

It refers to the capital inflow from one country into another. In other words, it means investors from one country acquire assets or ownership stakes in businesses, projects, or financial instruments in another country.

Types of Foreign Investments

- Foreign Direct Investment (FDI)
- Foreign Portfolio Investment (FPI)
- External Commercial Borrowing (ECB)

Importance of Foreign Investments in India

- **Capital Inflow:** Additional capital bridges the gap between domestic savings and investment needs. This complements public/private domestic investments to accelerate infrastructure and industrial capacity.

  Current Fact: India's FDI equity inflows reached **USD 47.87 billion** during April-December 2025, driven by capital expenditure push.
- **Job Creation and Employment Opportunities:** Generates direct and indirect employment across skill levels by establishing manufacturing units, service centers, and research facilities. This expands opportunities through supply chains and logistics.
- **Technological Advancements:** Introduces modern technology, innovation, and efficient business practices. The transfer of cutting-edge machinery and know-how bridges technological gaps and enhances domestic productivity.
- **Skill Development and Human Capital Formation:** Contributes to skill enhancement through local workforce training. Exposure to global best practices improves professional standards and employability.
- **Access to International Markets:** Gives domestic firms opportunities to tap into global supply chains. Foreign partnerships provide critical market access, distribution networks, and brand recognition.
- **Boost to Exports and Foreign Exchange Earnings:** Enhances export potential in export-oriented industries to improve the trade balance. Accumulated inflows built India's foreign exchange reserves to a record **USD 701.4 billion** by January 2026, securing macroeconomic stability.
- **Development of Infrastructure and Strategic Sectors:** Upgrades long-term foundations like roads, power, telecom, and ports. Participation in renewable energy and defense manufacturing reduces import dependency.

  Policy Link: Streamlined via the **National Single Window System (NSWS)** and 100% automatic route limits in key segments.
- **Improvement in Global Image and Investor Confidence:** Reflects global confidence in India's economic policies, political stability, and legal framework. This fosters a positive cycle of development and investor trust.

Types of Foreign Investment

1. Foreign Direct Investment (FDI)

Foreign Direct Investment ('FDI') means investment through equity instruments by a person resident outside India in an unlisted Indian company; or in 10% or more of the post issue paid-up equity capital on a fully diluted basis of a listed Indian company.

In case an existing investment by a person resident outside India in equity instruments of a listed Indian company falls to a level below 10% of the post issue paid-up equity capital on a fully diluted basis, the investment shall continue to be treated as FDI.

'Fully diluted basis' means the total number of shares that would be outstanding if all possible sources of conversion are exercised.

22 CHAPTER Disinvestment: Unlocking Value, Unleashing Growth

Disinvestment in India is a strategic economic policy through which the government reduces its ownership stake in public sector undertakings (PSUs), either partially or fully. It emerged prominently in the post-1991 economic reforms era as a response to rising fiscal deficits and inefficiencies in state-owned enterprises.

Over time, disinvestment has evolved beyond a mere revenue-raising exercise to become a structural reform tool aimed at improving governance, encouraging private sector efficiency, and redefining the role of the government in business. With the growing emphasis on "Minimum Government, Maximum Governance," disinvestment has become integral to India's broader economic transformation, particularly through strategic sales, asset monetization, and public-private partnerships.

- In most contexts, disinvestment typically refers to sale from the government, partly or fully, of a government-owned enterprise.
- A company or a government organization will typically disinvest an asset either as a strategic move for the company, or for raising resources to meet general/ specific needs.

Objectives of Disinvestment

The following are some main objectives of disinvestment:

- To reduce the financial burden on the Government
- To improve public finances
- To introduce, competition and market discipline
- To fund growth
- To encourage wider share of ownership
- To de-politicize non-essential services

Types of Disinvestment

There are primarily three different approaches to disinvestments (from the sellers' i.e. Government's perspective)

1. Minority Disinvestment

- A minority disinvestment is one such that, at the end of it, the government retains a majority stake in the company, typically greater than 51%, thus ensuring management control.
- Historically, minority stakes have been either auctioned off to institutions (financial) or offloaded to the public by way of an Offer for Sale.
- Examples of minority sales via auctioning to institutions go back into the early and mid-90s. Some of them were Andrew Yule & Co. Ltd., CMC Ltd. etc. Further recently, there has been sale of Power Grid Corp. of India Ltd., Rural Electrification Corp. Ltd., NTPC Ltd., NHPC Ltd. etc.

2. Majority Disinvestment

- A majority disinvestment is one in which the government, post disinvestment, retains a minority stake in the company i.e. it sells off a majority stake.
- Historically, majority disinvestments have been typically made to strategic partners. These partners could be other CPSUs themselves, a few examples being BRPL to IOC, MRL to IOC, and KRL to BPCL. Alternatively, these can be private entities, like the sale of Modern Foods to Hindustan Lever, BALCO to Sterlite, CMC to TCS, etc.
- Again, like in the case of minority disinvestment, the stake can also be offloaded by way of an Offer for Sale, separately or in conjunction with a sale to a strategic partner.

3. Complete Privatisation

- Complete privatisation is a form of majority disinvestment wherein 100% control of the company is passed on to a buyer. Examples of this include 18 hotel properties of ITDC and 3 hotel properties of HCI.