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IAS 2021

PRELIMS SAMPOORNA

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ECONOMY

KEY ECONOMY TERMS

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As IAS prelims 2021 is knocking at the door, jitters and anxiety is a common emotion that an aspirant feels. But if we analyze the whole journey, these last few days act most crucial in your preparation. This is the time when one should muster all their strength and give the final punch required to clear this exam. But the main task here is to consolidate the various resources that an aspirant is referring to.

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- **GS Score UPSC Prelims 2021 Yearly Current Affairs Compilation of All 9 Subjects**
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KEY ECONOMY TERMS

1. Balance of Payment

According to the RBI, balance of payment is a statistical statement that shows

- The transaction in goods, services and income between an economy and the rest of the world,
- Changes of ownership and other changes in that economy's monetary gold, special drawing rights (SDRs), and financial claims on and liabilities to the rest of the world, and
- Unrequited transfers.

The transactions in BOP are categorised in:

- Current account showing export and import of visibles (also called merchandise) and invisibles (also called non-merchandise). Invisibles take into account services, transfers and income.
- Capital account showing a capital expenditure and income for a country. It gives a summary of the net flow of both private and public investment into an economy. External commercial borrowing (ECB), foreign direct investment, foreign portfolio investment, etc form a part of capital account.
- Errors and omissions: Sometimes the balance of payment does not balance. This imbalance is shown in the BOP as errors and omissions. BOP is compiled using the double entry book keeping system consisting assets and liabilities.

2. Bailout

- Bailout is a general term for extending financial support to a company or a country facing a potential bankruptcy threat. It can take the form of loans, cash, bonds, or stock purchases. A bailout may or may not require reimbursement and is often accompanied by greater government oversee and regulations.
- The reason for bailout is to support an industry that may be affecting millions of people internationally and could be on the verge of bankruptcy due to prolonged financial crises
- The government or the financing body places strict requirements such as restructuring of organisation, no dividend payment to shareholders, change of management and in some cases a cap on salaries of executives till a stipulated time period or the repayment of dues. This may also be followed by a temporary relaxation of rules that may impact the accounts of the rescued entity

3. Broad Money to Reserve Money

- It is a measure of money multiplier. Money multiplier shows the mechanism by which reserve money creates money supply in the economy. It is again dependent on two variables, namely currency deposit ratio and reserve deposit ratio.
- M3 is a measure of broad money and includes currency with the public and deposits. The Reserve Money factor shows the reserve money and includes required reserve and the excess reserves of the banking system. If the reserve requirement as stipulated by the RBI increases, the Reserve Money value will increase and the multiplier will fall. Similarly, if banks keep more money as excess reserves, it will have an adverse effect on the money multiplier.

4. Cost Push Inflation

- Cost push inflation is inflation caused by an increase in prices of inputs like labour, raw material, etc. The increased price of the factors of production leads to a decreased supply of these goods. While the demand remains constant, the prices of commodities increase causing a rise in the overall price level. This is in essence cost push inflation.

5. Capital Adequacy Ratio

- Capital Adequacy Ratio (CAR) is the ratio of a bank's capital in relation to its risk weighted assets and current liabilities. It is decided by central banks and bank regulators to prevent commercial banks from taking excess leverage and becoming insolvent in the process.
- It is measured as Capital Adequacy Ratio = (Tier I + Tier II + Tier III (Capital funds)) /Risk weighted assets. The risk weighted assets take into account credit risk, market risk and operational risk.
- The Basel III norms stipulated a capital to risk weighted assets of 8%. However, as per RBI norms, Indian scheduled commercial banks are required to maintain a CAR of 9% while Indian public sector banks are emphasized to maintain a CAR of 12%.

6. Cross Elasticity of demand

- The measure of responsiveness of the demand for a good towards the change in the price of a related good is called cross price elasticity of demand. It is always measured in percentage terms.
- With the consumption behavior being related, the change in the price of a related good leads to a change in the demand of another good. Related goods are of two kinds, i.e. substitutes and complementary goods. In case the two goods are not related, the Coefficient of Cross Elasticity is zero

7. Cash Reserve Ratio

- The Reserve Bank of India or RBI mandates that banks store a proportion of their deposits in the form of cash so that the same can be given to the bank's customers if the need arises. The percentage of cash required to be kept in reserves, vis-a-vis a bank's total deposits, is called the Cash Reserve Ratio.

- The cash reserve is either stored in the bank's vault or is sent to the RBI. Banks do not get any interest on the money that is with the RBI under the CRR requirements.

8. Debt Equity Ratio

- The debt-equity ratio is a measure of the relative contribution of the creditors and shareholders or owners in the capital employed in business. Simply stated, ratio of the total long term debt and equity capital in the business is called the debt-equity ratio

9. Deflation

- When the overall price level decreases so that inflation rate becomes negative, it is called deflation. It is the opposite of the often-encountered inflation.
- A reduction in money supply or credit availability is the reason for deflation in most cases. Reduced investment spending by government or individuals may also lead to this situation. Deflation leads to a problem of increased unemployment due to slack in demand

10. Depression

- Depression is defined as a severe and prolonged recession. A recession is a situation of declining economic activity. Declining economic activity is characterized by falling output and employment levels. Generally, when an economy continues to suffer recession for two or more quarters, it is called depression.
- The level of productivity in an economy falls significantly during a depression. Both the GDP (gross domestic product) and GNP (gross national product) show a negative growth along with greater business failures and unemployment.

11. Exchange traded funds

- ETFs or exchange traded funds are similar to index mutual funds. However, they trade just like stocks.
- ETFs were started in 2001 in India. They comprise a portfolio of equity, bonds and trade close to its net asset value. These funds mainly track an index, a commodity, or a pool of assets.

They have the following advantages over mutual funds and equity/debt funds:

- **Lower Costs:** An investor who buys an ETF doesn't have to pay an advisory/management fee to the fund manager and taxes are relatively lower in ETFs.
- **Lower Holding Costs:** As commodity ETFs are widely traded in, there isn't any physical delivery of commodity. The investor is just provided with an ETF certificate, similar to a stock certificate.

12. Gross National Product

- Gross National Product (GNP) is Gross Domestic Product (GDP) plus net factor income from abroad.
- GNP measures the monetary value of all the finished goods and services produced by the country's factors of production irrespective of their location. Only the finished or final goods are considered as factoring intermediate goods used for manufacturing would amount to double counting. It includes taxes but does not include subsidies.

13. Liquidity Trap

- Liquidity trap is a situation when expansionary monetary policy (increase in money supply) does not increase the interest rate, income and hence does not stimulate economic growth.
- Liquidity trap is the extreme effect of monetary policy. It is a situation in which the general public is prepared to hold on to whatever amount of money is supplied, at a given rate of interest. They do so because of the fear of adverse events like deflation, war
- In that case, a monetary policy carried out through open market operations has no effect on either the interest rate, or the level of income. In a liquidity trap, the monetary policy is powerless to affect the interest rate.

14. Marginal Standing Facility

- Marginal standing facility (MSF) is a window for banks to borrow from the Reserve Bank of India in an emergency situation when inter-bank liquidity dries up completely.
- Banks borrow from the central bank by pledging government securities at a rate higher than the repo rate under liquidity adjustment facility or LAF in short.

15. Market Capitalization

- Market capitalization is the aggregate valuation of the company based on its current share price and the total number of outstanding stocks. It is calculated by multiplying the current market price of the company's share with the total outstanding shares of the company.
- Market capitalization is one of the most important characteristics that helps the investor determine the returns and the risk in the share. It also helps the investors choose the stock that can meet their risk and diversification criterion.

16. Net National Income

- Net National Income is Gross National Income or Gross National Product less depreciation
- Gross National Product (GNP) is Gross Domestic Product (GDP) plus net factor income from abroad. It measures the monetary value of all the finished goods and services produced by the country's factors of production irrespective of their location.
- Only the finished or final goods are considered as factoring intermediate goods used for manufacturing would amount to double counting. It includes taxes but does not include subsidies. When depreciation is deducted from the GNP, we get Net National Income.

17. Net Interest Income

- Net interest income (NII) is the difference between the interest income a bank earns from its lending activities and the interest it pays to depositors.

18. Opportunity Cost

- Opportunity costs represent the potential benefits an individual, investor, or business misses out on when choosing one alternative over another. The idea of opportunity costs is a major concept in economics.
- Because by definition they are unseen, opportunity costs can be easily overlooked if one is not careful. Understanding the potential missed opportunities foregone by choosing one investment over another allows for better decision-making.

19. Quantitative Easing

- Quantitative easing is an occasionally used monetary policy, which is adopted by the government to increase money supply in the economy in order to further increase lending by commercial banks and spending by consumers. The central bank infuses a pre-determined quantity of money into the economy by buying financial assets from commercial banks and private entities. This leads to an increase in banks' reserves.
- Quantitative easing is aimed at maintaining price levels, or inflation. However, these policies can backfire heavily, leading to very high levels of inflation. In case commercial banks fail to lend excess reserves, it may lead to an unbalance in the money market.

20. Regressive Tax

- Under this system of taxation, the tax rate diminishes as the taxable amount increases. In other words, there is an inverse relationship between the tax rate and taxable income. The rate of taxation decreases as the income of taxpayers increases.
- This system of taxation generally benefits the higher sections of the society having higher incomes as they need to pay tax at lesser rates. On the other hand, people with lesser incomes are burdened with higher rate of taxation.

21. Real Business Cycle theory

- An economy witnesses a number of business cycles in its life. These business cycles involve phases of high or even low level of economic activities. A business cycle involves periods of economic expansion, recession, trough and recovery. The duration of such stages may vary from case to case.
- The real business cycle theory makes the fundamental assumption that an economy witnesses all these phases of business cycle due to technology shocks. Technological shocks include innovations, bad weather, stricter safety regulations, etc.

22. Stimulus Package

- Stimulus package is a package of tax rebates and incentives used by the governments of various countries to stimulate economy and save their country from a financial crisis
- The idea behind a stimulus package is to provide tax rebates and boost spending, as spending increases demand, which leads to an increase in employment rate which in turn increases income and hence boosts spending. This cycle continues until the economy recovers from collapse.

- One such stimulus package was used by the United States in 2008 during the time of the global recession, which was aimed at increasing employment and recovery of the US economy.

23. Statutory Liquidity Ratio

- The ratio of liquid assets to net demand and time liabilities (NDTL) is called statutory liquidity ratio (SLR).
- Apart from Cash Reserve Ratio (CRR), banks have to maintain a stipulated proportion of their net demand and time liabilities in the form of liquid assets like cash, gold and unencumbered securities. Treasury bills, dated securities issued under market borrowing programme and market stabilisation schemes (MSS), etc also form part of the SLR

24. Sovereign Risk

- A nation is a sovereign entity. Any risk arising on chances of a government failing to make debt repayments or not honouring a loan agreement is a sovereign risk.

25. Spot Price

- Spot price refers to the current price of a security at which it can be bought/ sold at a particular place and time.
- Spot prices are most commonly used for serving as a base indicator for pricing future contracts. Based on the spot price of the security, traders/ investors are able to make projections about the future price movements of the security.

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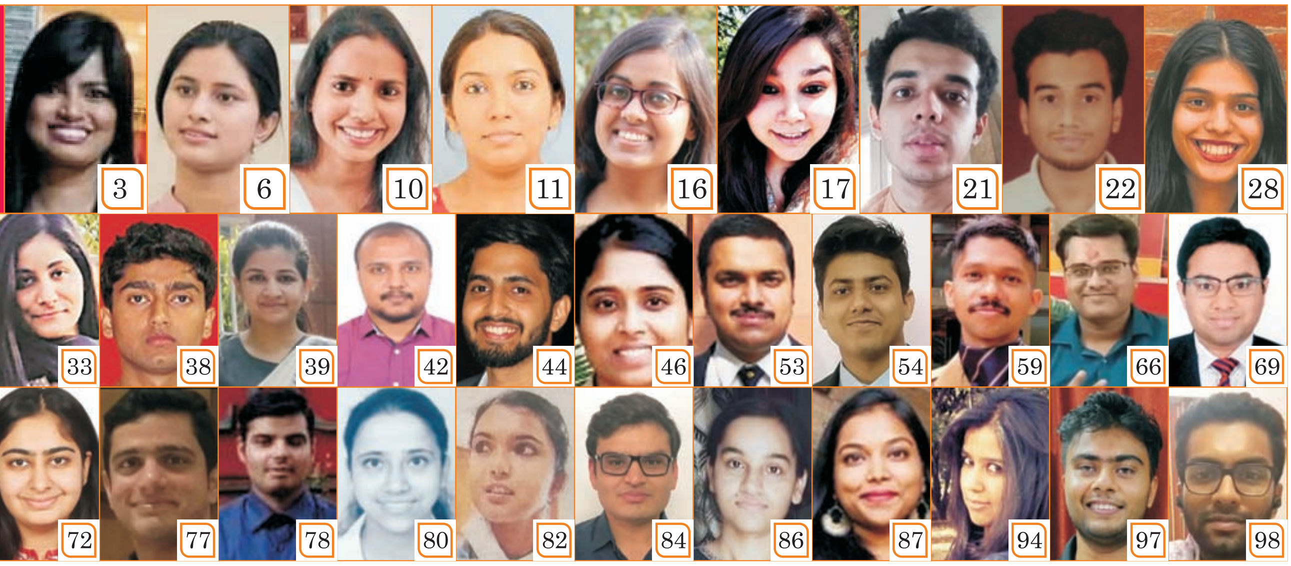

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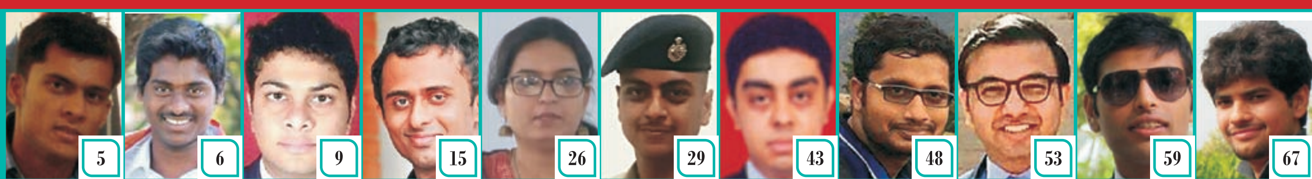

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