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ECONOMY

BLUE BOOK



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1. Microeconomics

Microeconomics is the **branch of economics** that studies the behavior of **individual** units such as households, firms, and markets. It analyzes how they make decisions regarding allocation of scarce resources.

Aspect	Microeconomics	Macroeconomics
Focus	Individual units like households, firms, or markets	Economy as a whole ; aggregate variables
Also Called	Price Theory	Income and Employment Theory
Key Concerns	Prices, production, consumption, income distribution, resource allocation, efficiency	Total output, employment, income, price levels, inflation, growth, fiscal & monetary policy, balance of payments
Scope	Decision-making by economic agents; equilibrium in individual markets	Combined behavior of households, firms, government, and external sector

Key concepts of Microeconomics

Utility

- **Satisfaction** or want-fulfilling power a consumer gets from a commodity.
- **Subjective**: Varies with individual preferences, time, and place.
- **Cardinal Utility**: Measures satisfaction numerically using **Total Utility** (TU) and **Marginal Utility** (MU).
- **Ordinal Utility**: Ranks preferences using indifference curves and Marginal Rate of Substitution (MRS) without exact numbers.

Theory of Consumer Behaviour

- **Consumption**: Use of goods/services to satisfy wants; consumers aim for **maximum satisfaction** within income.
- **Consumer's Equilibrium**: Point where a consumer **maximizes satisfaction** given income and prices.

Monotonic Preferences

- **Monotonic preferences** mean a consumer always prefers a bundle with **more of a good** that provides positive satisfaction.

Production

- **Production**: Process of converting inputs into output; revenue minus cost = profit, which firms aim to maximize.
- **Production Function**: A production function shows the **relationship** between a firm's inputs and the output it can produce. It indicates the **maximum output possible** for different combinations of inputs, given the technology.

Law of Variable Proportions

- The Law of Variable Proportions states that **increasing one input** while others are fixed **initially raises** total output at an increasing rate, but **eventually** the additional output per unit **declines**.
- This demonstrates diminishing marginal returns, as seen when adding more workers to limited land.

Costs of Production

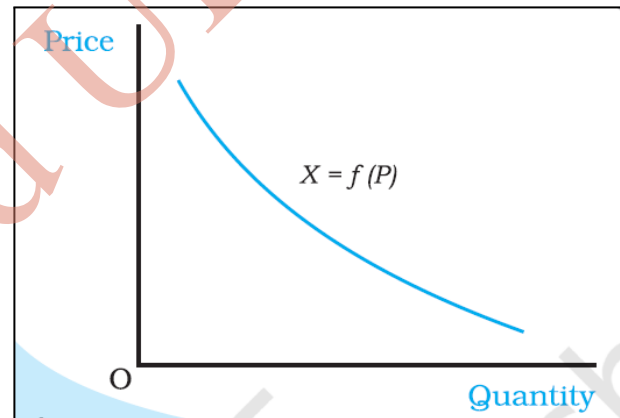
- **Expenditure on factors of production**-land, labour, capital, entrepreneurship-to produce goods.
- **Factor Cost:** Production cost using factors, excluding taxes and including subsidies.
- **Types of Cost:**
 - **Explicit Costs:** Actual cash payments (wages, rent, raw materials).
 - **Implicit Costs:** Value of self-owned resources used (imputed rent, interest, wages).
 - **Opportunity Cost:** Value of the **next best alternative foregone**.

Production Possibility Frontier (PPF)

- The **Production Possibility Frontier (PPF)** illustrates the **maximum efficient combinations** of two goods an economy can produce, highlighting opportunity costs.
- Points on the **PPF** curve show **efficient resource use**; points **below it** indicate **underutilization or waste**.

Demand

- **Demand** refers to the quantity of a commodity that a **consumer is willing and able to buy at a given price** during a specific period of time.
- **Demand Curve:** Graphical representation of the law of demand, showing **inverse** relationship between price and quantity demanded.
- **Law of Demand:** Quantity demanded decreases as price rises and increases as price falls, **ceteris paribus**.
- **Assumptions:** Prices of substitutes/complements, income, tastes, population, and type of good remain constant.



Reasons:

- **Diminishing Marginal Utility:** As more units of a good are consumed, satisfaction from each **additional** unit decreases.
- **Income Effect:** A change in price alters consumers' purchasing power, affecting demand.
- **Substitution Effect:** When the price of a good changes, consumers substitute it with relatively cheaper alternatives.
- **Change in Buyers:** An increase or decrease in the number of consumers affects overall market demand.
- **Diverse Uses of Goods:** Goods with multiple uses see higher demand when one of their uses becomes more valuable.

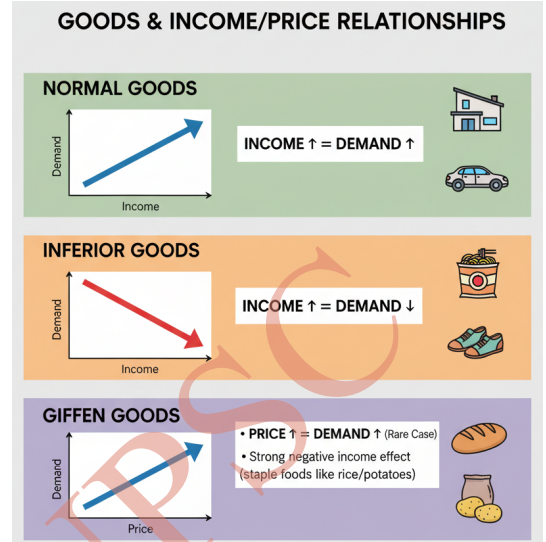
Normal, Inferior, and Giffen Goods

- **Normal Goods:** **Demand rises** with income and falls when income decreases (e.g., fruits, clothes).
- **Inferior Goods:** **Demand falls** as income **rises** and rises as income decreases (e.g., coarse cereals); some goods can shift from normal to inferior at higher incomes.
- **Giffen Goods:** A type of inferior good where demand rises as price increases due to a strong income effect overpowering substitution (e.g., 19th-century Irish potatoes). Giffen goods are usually essential items.
- **Effects:**
 - **Substitution Effect:** Higher price → switch to cheaper alternatives → demand falls.
 - **Income Effect (Giffen Paradox):** Higher price of a staple → low-income consumers buy more → demand rises.

Substitute Goods and Complement Goods

A consumer's demand for a good is influenced by the **prices of related goods**, which are of two types:

- Substitute Goods** - Goods that can replace each other (e.g., tea and coffee).
 - If the price of a substitute rises, demand for the given good increases.
 - If the price of a substitute falls, demand for the given good decreases.
- Complementary Goods** - Goods used together (e.g., car and petrol).
 - If the price of a complement rises, demand for the given good decreases.
 - If the price of a complement falls, demand for the given good increases.



- Individual Demand:** It is the **quantity a consumer is willing to buy** at different prices, assuming other factors are constant. It is influenced by the commodity's price, prices of related goods, income, and consumer preferences.
- Market Demand:** It is the **total demand of all consumers** at a given price, derived by summing individual demands. It is influenced by the number of buyers, income and wealth distribution, and seasonal or weather changes.

Elasticity of Demand

Elasticity refers to the **degree of responsiveness of demand** to changes in factors such as price, income, or prices of related goods. **Elasticity of demand** measures this responsiveness. The main types are:

Types of Elasticity of Demand

Type	Meaning	Formula
Price Elasticity of Demand (e_p)	It measures the percentage change in quantity demanded for a percentage change in price.	$e_p = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in price}}$
Income Elasticity of Demand (e_y)	- It measures the percentage change in demand resulting from a percentage change in the consumer's income. - Can be positive (normal goods) or negative (inferior goods).	$e_y = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in income}}$
Cross Elasticity of Demand (e_c)	Cross elasticity measures the percentage change in demand for one good in response to a percentage change in the price of a related good. - Positive for substitutes; Negative for complements.	$e_c = \frac{\% \text{ change in quantity demanded}}{\% \text{ change in price of related good}}$

Factors Affecting Price Elasticity of Demand

- Goods with close substitutes (Coke, Pepsi) have elastic demand; those without (electricity) are inelastic.
- **Necessities** (medicines) show inelastic demand; **luxuries** (cars, ACs) are elastic.
- High-cost items (luxuries) have elastic demand; **low-cost** items (salt) are inelastic.
- High-income consumers generally show inelastic demand; low-income consumers show elastic demand.
- **Habit-forming goods** (cigarettes) have inelastic demand.

Supply

- Quantity a firm **chooses to sell** at a given price, given technology and factor prices; reflects producer response to market conditions.
- **Law of Supply**
 - The **Law of Supply** states that as the **price of a good rises**, suppliers offer more to earn higher profits, and as prices fall, they supply less.
 - The **supply curve**, slopes **upward**-indicating that higher prices lead to greater output, assuming technology and input prices remain constant.
 - **Alfred Marshall** highlighted that both supply and demand together determine price and output, establishing market equilibrium where buyers and sellers balance.
- **Exceptions:**
 - **Backward-Bending Supply Curve of Labor:** At very high wages, workers may reduce hours, lowering labor supply.
 - **Perishable Goods:** Producers may sell immediately at any price instead of holding stock.
- **Determinants of Supply**
 - **Price of the Good:** Higher prices encourage more supply. *Example:* Rising rice prices → farmers plant more.
 - **Cost of Production:** Higher input costs reduce supply. *Example:* Steel price rise → fewer cars produced.
 - **Technology and Productivity:** Better technology lowers costs, increasing supply. *Example:* High-yield seeds → higher crop output.
 - **Prices of Related Goods:** Producers switch to more profitable goods. *Example:* Sugarcane farmers grow sugar if its price rises.
 - **Government Policies & Taxes/Subsidies:** Subsidies increase supply; taxes/regulations reduce it. *Example:* Solar panel subsidies → higher production.
 - **Expectations of Future Prices:** Expected higher prices may reduce current supply.
 - **Number of Sellers:** More firms → higher total market supply.
- **Elasticity of Supply (Es)**
 - **Elastic:** Small price change → large change in quantity.
 - **Inelastic:** Large price change → small change in quantity.

Law of Marginal Utility

- The **Law of Marginal Utility** states that as a person **consumes more units of a good or service**, the additional **satisfaction (marginal utility)** derived from each extra unit **decreases**, keeping other factors constant.
 - **Key Point:** Total utility **may rise**, but marginal utility declines with each additional unit.
 - **Example:** Eating the first slice of pizza gives high satisfaction, the second less, and by the fourth or fifth, the additional satisfaction may be very low.
- This law explains consumer behavior and the **downward-sloping** demand curve in economics.

Market Equilibrium

- Equilibrium is the state in which market supply and demand balance each other, and as a result prices become stable.
- Free Entry/Exit:** Long-run equilibrium price = minimum average cost; firms earn normal profit; entry/exit adjusts supply to restore equilibrium.
- Price Controls:**
 - Ceiling:** Max price below equilibrium to make goods affordable (e.g., wheat, sugar).
 - Floor:** Min price above equilibrium to protect producers/workers (e.g., MSP, minimum wage).

Market

- Platform** for buying & selling goods/services; can be **physical, digital, or networked**.
- Exchange usually in **money**.

Type	Key Features
Perfect Competition	Many sellers, identical products, free entry/exit, price taker
Monopoly	Single seller, unique product, high entry barriers, firm as price maker
Monopolistic Competition	Many sellers, similar products, some market power
Oligopoly	Few sellers, interdependent , potential collusion

Types of Costs in Economics		
Type of Cost	Key Features	Example
Fixed Costs	Costs that do not change with the level of output produced.; incurred even if no goods are produced.	Rent, salaries of permanent staff, insurance premiums.
Variable Costs	Costs that vary directly with the level of production or output.; increase with higher output and decrease with lower output.	Raw materials, wages of hourly workers, utility costs.
Total Cost	The sum of fixed and variable costs at any level of output.	Total cost for producing 100 units of a product.
Average Cost (AC)	The total cost per unit of output . $AC = \text{Total Cost} / \text{Quantity of output}$.	Cost per unit when producing 100 units of a product.
Marginal Cost (MC)	The additional cost incurred when producing one more unit of output. $MC = \text{Change in Total Cost} / \text{Change in Quantity}$.	The cost of producing the 101st unit when 100 units are made.
Opportunity Cost	The cost of the next best alternative foregone when making a decision. Represents the value of the alternative not chosen.	Choosing to produce cars instead of trucks, missing out on truck sales.

Explicit Costs	Direct, out-of-pocket payments made in the course of business activities. Actual payments made for factors of production.	Wages, rent, and material expenses.
Implicit Costs	Indirect costs that do not involve actual payment but represent the opportunity cost of using resources. The value of resources used in production that could have been employed elsewhere.	Forgone salary from running a business instead of working elsewhere.
Sunk Costs	Costs that have already been incurred and cannot be recovered . Irrelevant for future decisions as they cannot be changed by any future actions.	Money spent on advertising that cannot be refunded.
Controllable Costs	Costs that can be influenced or managed by a business in the short term. Management can decide on the level of these costs based on production or operational decisions.	Advertising budget, overtime wages.
Uncontrollable Costs	Costs that are beyond the control of the business or organization. These costs are affected by factors outside the business's direct control.	Taxes, natural disasters, or global price changes in raw materials.

Opportunity Cost of Free Public Goods: (CSE 2018)

- **Concept:** Even if a commodity is free to consumers, resources are used in its production.
- **Implication:** The **opportunity cost is borne by taxpayers or the government**, not the consumer.
- **The opportunity costs are transferred from the consumers of the product to the tax-paying public.**

2. Introduction to Macroeconomics

What is Macroeconomics ?

- Macroeconomics deals with the functioning of an **entire economy** at a **national** or global level.
- It focuses on broad aggregates such as **national income**, employment, **inflation** and economic growth, money and banking, **fiscal policy** and public finance, monetary policy, international trade and **balance of payment**.

Economic Activities

- These are activities that **involve money** or are **performed in exchange for money** or money's worth for the parties involved.
- **Non-economic activities** are those that **do not** generate income or wealth but are done out of feelings like gratitude, love, care and respect.

Classification [CSE 2024]

A. Primary Activities

- Here people are **directly dependent on nature** to produce goods and involves **extraction of raw materials**. Includes **agriculture, dairy farming, mining**, fishing, raising livestock, forestry, etc.

B. Secondary Activities

- Here people are **dependent on outputs of the primary sector** and transform them to produce goods.
- Involves **construction of buildings, roads, etc., manufacturing of products** in factories; providing utilities like water, electricity, gas and other such necessities.
- Some examples include **processing of grains** obtained from agricultural fields to make flour in mills, **weaving of cloth from cotton yarn**, extraction of oil from groundnut and processing of tea leaves to derive tea.

C. Tertiary Activities

- Involves economic activities that provide **support to people involved in primary and secondary activities**. **For example**, the driver of a truck transports grains and vegetables, **doctors, nurses, teachers, lawyers and pilots** provide their services to those who need them.
- Similarly, **communication services** through mobile and internet, software development, and services at hotels, restaurants, banks, schools, hospitals, airports, shops, warehouses, etc.

D. Quaternary Activities

- Includes people **engaged in intellectual activities and pursuits**. Work in this segment is knowledge oriented and this sector along with Tertiary is known as '**Knowledge Sector**'.
- **R&D**, Information Technology, Consulting Services; Collection, production and dissemination of information; **mutual fund managers**, tax consultants, software developers, accounting and brokerage firms would fall under this sector.

E. Quinary Activities

- Includes services that focus on **creation, re-arrangement and interpretation of new and existing ideas**. Often referred to as '**gold collar**' professions.
- Includes: Highest level of decision makers or **policy makers**; **Senior business executives**, research scientists; **Government officials**, financial and legal consultants

Real Sector in the Economy [CSE - 2022]

- It refers to the part of the economy that **produces tangible goods and services**. This sector is considered a "real" part of the economy because its output can be **physically touched, used** etc.
- A **strong real sector** can lead to **increased** productivity, higher living standards and improved quality of life.
- Includes: **Farmers harvesting their crops**; Textile mills converting raw cotton into fabrics;

Manufacturing, construction and mining activities

Financial Sector in the Economy

- It is the part of the economy **made up of firms and institutions that provide financial services** to commercial and retail customers.
- The health of the economy depends, in large part, on the strength of its financial sector. The **stronger** the financial sector is, the **healthier** the economy is and vice versa.
- Includes: A **commercial bank lending money to a trading company**; A corporate body issuing Rupee denominated **bonds** overseas; Banks, **investment companies**, insurance companies, real estate firms etc.

Some Basic Concepts of Macroeconomics

Capital

- Capital is a broad term that can describe anything **that confers value or benefits to its owner**. It can be **machinery, intellectual property** like patents or the financial assets of a business or an individual.
- While money itself may be construed as capital, capital is more often associated with **cash** that is being **put to work** for productive or investment purposes.

Types of Capital	
Fixed Capital [CSE - 2019]	• It is the money that has been invested in fixed assets or the long term assets that a company needs to start up and conduct business. • These assets are not consumed or destroyed during the actual production but have a reusable value. These assets are not considered very liquid • Includes the stock of buildings, infrastructure and machines of a company along with factory and other equipment.
Debt Capital	• It is the capital that a business acquires capital by borrowing. It can be obtained through private or government sources. • Debt is seen as a burden by individuals, but businesses see it as an opportunity, if the debt doesn't get out of hand.
Working Capital	• These are the liquid assets of the company available for fulfilling daily obligations. • It represents the ability of a company to cover its debts, accounts payable and other obligations that are due within one year. • Calculated by subtracting current assets and the current liabilities. A company that has more liabilities than assets could run short of working capital
Equity Capital	• It is the ownership interest that shareholders have in a corporation. It is purchased when an individual investor buys shares of any company. • It represents the residual claim that shareholders have on the company's assets after all debts have been settled.
Trading Capital	• It is the amount of money allotted by an individual or a firm to buy and sell securities. It is the portion of capital that is actively put "at risk" in day to day transactions.

Social Capital [CSE - 2019]

- It is the level of **mutual trust and harmony** in the society which fosters collaboration and innovation.
- It represents the **beneficial outcomes** gained from informal human interactions and networking.
- **Three types:** Bonding (within a group); Bridging (across groups), Linking (hierarchical)

Capital Formation

- It is defined as that part of a country's current output and imports which is **not consumed or exported** during the accounting period, but is **set aside as an addition** to its stock of capital goods.
- Economic growth in country will **necessarily** have to occur if there is capital formation [CSE 2013]
- **Process of Capital Formation:** Creation of savings → mobilisation of savings through banks, cooperative societies etc → investment of savings in capital goods.
- **Role:** Crucial in raising **productivity and national income**; enables **technological progress**
- **Gross Fixed Capital Formation:** It is the **aggregate of gross additions** to fixed assets, increase in stocks of inventories (change in stocks) and net acquisition of valuables.
- **Determinants of Capital Formation: Volume of Savings** (a higher saving ratio enlarges the funds available for investment); ability and will to invest; business expectations; **political stability**; infrastructure; entrepreneurial ability etc.
- **How to Promote Capital Formation?** : Increase volume of savings; Strengthen banking and financial institutions; reform taxation policy; expand infrastructure and remove bottlenecks.

Capital Output Ratio (COR)

- It is the **amount of capital required to produce one unit of output**. It is calculated by dividing the stock of capital i.e. investment to output i.e. GDP. It **shows the productivity** of capital i.e. how efficiently investment/capital is turned into goods and services
- **High COR:** More capital required for the same output → **low** efficiency of capital. **Implications:** Slower growth unless investment levels are very high. [CSE 2018]
- **Low COR:** Less capital required for the same output → **high** efficiency of capital. **Implications:** Faster growth can be achieved with limited investment.

Incremental Capital Output Ratio (ICOR)

- It assesses the **marginal** amount of investment capital **necessary** to generate the **next unit of production**. Explains the **relationship** between the levels of investment and the consequent increase in GDP. It is **calculated** by dividing annual investment to the annual increase in GDP.
- A **lower ICOR is preferred** as it indicates a country's production is more efficient compared to higher ICOR.

Marginal Efficiency of Capital

- It displays the **expected rate of return** on investment **as additional units of investment are made** under specified conditions and over a stated period of time.

Human Capital (CSE 2018)

- **Human Capital (OECD definition):** Knowledge, skills, competencies, and other attributes acquired by individuals or groups during life, used to produce goods, services, or ideas.
- **Human Capital Formation (HCF):** Process of increasing skilled and experienced people in an economy through investments in education, health, training, migration, and information, essential for development.

Intermediate Goods

- These are goods that are **used in production** of final goods or services. However, these goods are **not considered as final goods**. They are **not directly consumed** by the end users but serve as inputs in the production process. These are **not counted in GDP separately** to avoid **double counting**.
- Example: Steel used to make cars; Flour used in baking bread.

Final Goods

- These goods are **meant for final use** and will **not pass** through any more stages of production or transformation. These goods **may undergo transformation by the action of the ultimate purchaser**.
- **Same thing which is treated as final good** for one person **may be treated as intermediate good** for another. **For example**, milk is a final good when bought by a household for consumption but an intermediate good when used by an ice cream factory to produce **ice cream** for sale.

Consumption Goods

- These goods are **purchased by the consumers** for final use to satisfy their current wants or needs and are **not used for further production** of other goods or services. **Example** - Includes goods like food and clothing, services like recreation.

Capital Goods

- These are man made, **durable** goods that are **used to produce other goods** and services, rather than being consumed directly. These are **final goods but not for direct consumption**. These goods **aid and enable** the production to take place.
- They undergo wear and tear i.e. **depreciation** over time. **Investment** in the capital goods is called **capital formation** which is vital for economic growth.

Consumer Durable Goods

- These are the **final goods** purchased by households **for direct consumption** that last for a relatively long period of time. Once a good is purchased by the final user, it is counted in GDP.
- These goods also **undergo wear and tear** with gradual use and often need repairs. **Example** - Cars, bikes, televisions, refrigerators, washing machines etc.

Concept of Stocks and Flows

- **Stock** is a quantity of an economic variable measured at a **specific point of time**. It represents an **accumulation** of resources, wealth and assets at a particular point of time. **Example**: India's **foreign exchange reserves on 1 January, 2025** are XYZ.
- **Flow** is a quantity of an economic variable measured **over a period of time**, such as a day, a month or a year. It is used to **show the movement or change in the stocks**. A flow variable **always requires a time dimension**. **Example**: India's GDP was XYZ lakh crore in 2023-24.
- **Stock vs Flow - Analogy**: The amount of water in the tank at a specific point of time i.e., morning is stock while water flowing in/out per minute is Flow.

Inventories

- These are **stocks of unsold goods**, semi finished goods and raw materials that a firm holds at a given point of time. **Inventories are treated as capital**.
- **Change in inventories** of a firm is **treated as investment**. It is the **difference** between closing stock (end of the year) and opening stock (beginning of year).
- **Increase in Inventories** is considered as part of investment expenditure and it adds to capital formation while **decrease in Inventories** means that the firms have sold more than they produced.
- **Planned Change in Inventories**: Happens when the firms deliberately decide to adjust their stock of goods. It is **intentional** and part of business strategy. **Unplanned Change in Inventories** happens when the actual sales differ from expected sales.

Gross Investment

- It is the **total expenditure on new capital goods** (like machines, buildings) during a given period of time (usually a year). **Calculated** by adding depreciation in net investment.

- **Includes:** Net addition of capital stock (fixed capital formation) i.e. new machines, new buildings etc; Replacement of worn out capital i.e., replacing the **depreciated** assets or Change in inventories.

Net Investment

- It is the **actual addition** to the capital stock of an economy in a given period (usually a year) after **subtracting depreciation** from Gross Investment. It is an **indicator of growth** wherein positive net investment means that the economy is expanding.
- **Zero Net Investment** - It happens when there is **only replacement** of old capital and no expansion.
- **Negative Net Investment** - It means when the capital stock is **shrinking**. It happens when the gross investment is lower than depreciation.

Types of Investments

- **Investment Expenditure:** It is the **rise in the value of inventories** of a firm over a year. It is also concerned with the total of all expenditures on new capital assets. Example: Building new highways, bridges, flyovers, power plants etc.
- **Fixed Business Investment:** It is the **addition** to the machinery, factory buildings and equipment employed by the firms.
- **Residential Investment:** It is the **addition of housing facilities**

Intangible Investments [CSE 2023]

- These are **expenditures on non-physical assets** like **intellectual property, brand recognition**, and software, which lack physical substance but provide future economic benefits.
- **World Intangible Investment Highlights 2025:** Co-published annually by the **WIPO** in partnership with the **Luiss Business School**, reveals that intangible investment in the global economy has grown well over **three times faster** than tangible investment since 2008.
- **India** recorded the **fastest growth** in intangible investment between 2011–2022, outpacing the US, France and Sweden

Depreciation

- It is the **reduction in the value of capital assets** (like machinery, equipment, vehicles, building) due to normal wear and tear and passage of time. It is also known as '**consumption of fixed capital**'.
- It represents the portion of Gross Investment that is **only used to maintain** the **existing** capital stock instead of creating new capacity.
- **Depreciation is only an accounting concept.** No real expenditure may have been incurred each year, yet depreciation is annually accounted for.
- It **does not** take into account **unexpected or sudden destruction** of disuse of capital as can happen with accidents, natural calamities or other such extraneous circumstances.

Players in the Economy

Capitalist

- Production is mainly done by the capitalists who are the **owners of the means of production**.
- The production units of the capitalist are known as **firms**. Profit earned by the capitalist may be **reinvested** by the owner in machinery or factories which is known as **investment expenditure**.

State or Government

- It frames laws, enforces them and delivers justice. It also **undertakes production and provides public services** in the form of infrastructure like roads, power, school, health services etc.

Household Sector [CSE - 2022]

- Households are individuals or groups. Their **functions** include **consumption**, saving and paying taxes. **Households are the largest savers** and a part of their financial savings goes towards government borrowings.

External Sector affects the domestic economy beyond domestic trade.

Some Macroeconomics Terms

1. **Aggregate Demand (AD):** The **total demand** for all goods and services in an economy at a given price level and time..
2. **Aggregate Supply (AS):** The **total supply** of goods and services that producers in an economy are willing to sell at a given price level. It represents the productive capacity of the economy.
3. **Multiplier:** The process by which an **initial increase in investment** or spending leads to a greater increase in national income due to repeated rounds of expenditure.
4. **Inflationary Gap:** The situation where **aggregate demand exceeds aggregate supply** at full employment, leading to rising prices.
5. **Deflationary Gap:** The situation where **aggregate demand falls short of aggregate supply** at full employment, resulting in unemployment and idle capacity.
6. **Stagflation:** A condition of **stagnant economic growth, high unemployment, and high inflation** occurring together.

3. Indian Economy on the Eve of Independence

On the eve of independence, the Indian economy was predominantly agrarian, characterized by low productivity, frequent famines and industrialisation was minimal. Thus, India inherited an economy marked by stagnation, structural weaknesses, and urgent need for reform and modernization.

India is the pivot of our Empire... If the Empire loses any other part of its Dominion we can survive, but if we lose India, the sun of our Empire will have set. -Victor Alexander Vruce, the Viceroy of British India in 1894

Low level of economic development under colonial rule

- The colonial government in India mainly framed its economic policies to safeguard and advance British interests rather than promote India's development.
- India was particularly well known for its handicraft industries in the fields of cotton and silk textiles, metal and precious stone works etc.
- These policies reshaped India's economy, reducing it to a supplier of raw materials for Britain and a market for British manufactured goods.
- Among the notable estimators are **Dadabhai Naoroji, William Digby, Findlay Shirras, V.K.R.V. Rao and R.C. Desai**.

Agriculture

- At independence, agriculture was the mainstay for ~ 85% of India's population, contributing ~ 50% to the national income. Despite large production of food crops like wheat, rice productivity per hectare was very low. On the eve of independence, Indian agriculture was characterised by problems like:-
 - **Low output per hectare**:- Low investment in irrigation, fertilizer leading to low productivity.
 - **Primitive Techniques of Production**:- Predominately dependent on monsoon.
 - Some regions did see higher yields of cash crops like indigo, cotton, jute for export, often worsening food security due to the **commercialisation of agriculture**.
 - Various land settlement systems, (**zamindari system**), led to stagnation in agriculture.

Agriculture During Pre-British India

1. The **French traveller, Bernier**, described seventeenth century Bengal in the following way:
2. "The knowledge I have acquired of Bengal in two visits inclines me to believe that it is richer than Egypt.
3. It exports, in abundance, cottons and silks, rice, sugar and butter. It produces amply for its own consumption wheat, vegetables, grains, fowls, ducks and geese.
4. It has immense herds of pigs and flocks of sheep and goats. Fish of every kind it has in profusion.
5. From Rajmahal to the sea is an endless number of canals, cut in bygone ages from the Ganges by immense labour for navigation and irrigation."

Industry

- Pre-British India had a rich handicraft tradition producing textiles, metalwork, and stonework.
- British policies de-industrialized India, turning it into a raw material supplier and market for British goods.
- High tariffs on Indian goods and low tariffs on British imports destroyed Indian competitiveness.

- Indian demand was met by cheap British goods, reducing the market for local products.
- Modern industries began in the late 19th century with cotton and jute mills.
- Indian entrepreneurs owned cotton mills in Maharashtra and Gujarat; British capital dominated jute mills in Bengal.
- TISCO (1907) marked early steel industrialisation; other industries like sugar, cement, and paper grew after World War II.
- Colonial industrial policy weakened India's industrial base and delayed economic self-reliance.
- Few modern industries failed to offset the decline of handicrafts, and industrial contribution to GDP remained minimal.

Textile Industry in Bengal

- **Muslin** is a type of cotton textile which had its origin in Bengal, particularly, places in and around Dhaka, now the capital city of Bangladesh.
- '**Daccai Muslin**' has gained worldwide fame as an exquisite type of cotton textile.
- The finest variety of muslin was called malmal.
- Sometimes, foreign travellers also used to refer to it as malmal shahi or malmal khas implying that it was worn by, or fit for, the royalty.

Occupational Structure

- The agricultural sector dominated the workforce, employing around **70-75% of working persons**.
- Manufacturing and services sectors accounted for only about **10% and 15-20% of the workforce**.
- **Regional variations** were significant: parts of Madras Presidency, Bombay, and Bengal experienced a decline in agricultural dependence, with more people moving to manufacturing and services sectors.

Demographic condition

- The first synchronous population census in British India was conducted in 1881, revealing uneven population growth across regions.
- India was in the **first stage of demographic transition before 1921**; the transition's second stage began after 1921 but with moderate population growth.
- Literacy rates were very low, with overall literacy below 16% and female literacy around 7%.
- Public health facilities were largely unavailable or inadequate, leading to widespread water and air-borne diseases. Mortality rates were very high; infant mortality was around 218 per thousand, **compared to the current rate of 33 per thousand**.
- **Life expectancy was low, about 44 years versus today's 69 years.**

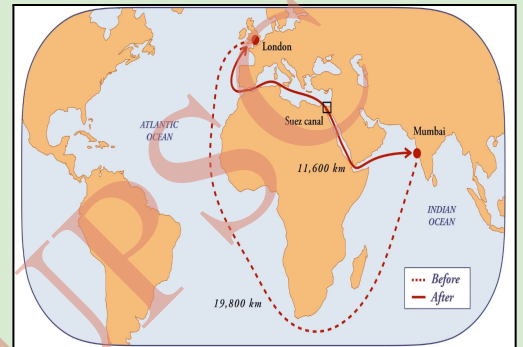
Foreign Trade

- Trade policies were skewed to benefit British industries: India acted as a supplier of raw materials feeding British industrial demand, while becoming a market for British manufactured goods.
- India was primarily an exporter of raw materials like raw silk, cotton, wool, sugar, indigo, and jute.
- It imported finished consumer goods such as textiles (cotton, silk, woollen clothes) and capital goods like machinery from Britain. Britain maintained a monopoly over India's foreign trade, with more than half of India's trade restricted to Britain.
- The rest of India's foreign trade was allowed with a few countries like China, Ceylon (Sri Lanka), and Persia (Iran).
- The opening of the Suez Canal in 1869 intensified British control by shortening trade routes favoring Britain.

- Several essential commodities such as food grains, clothes, kerosene etc were scarcely available in the domestic market. Furthermore this export surplus did not result in any flow of gold or silver into India.
- India maintained an export surplus (exports > imports), but this surplus drained away to Britain for war financing, administration, and not reinvested in the Indian economy.

Trade Through the Suez Canal

1. Suez Canal is an artificial waterway running from north to south across the Isthmus of Suez in north-eastern Egypt.
2. It connects Port Said on the Mediterranean Sea with the Gulf of Suez, an arm of the Red Sea.
3. The canal provides a direct trade route for ships operating between European or American ports and ports located in South Asia, East Africa and Oceania by doing away with the need to sail around Africa.
4. Strategically and economically, it is one of the most important waterways in the world.
5. Its opening in 1869 reduced the cost of transportation and made access to the Indian market easier.



Social Infrastructure

- **Infant mortality, maternal mortality and death rate** were all high. Life expectancy was just 32 years.
- For **higher education**, only sixteen universities were serving the entire population which was 274 million in 1941.
- At the time of independence, the **literacy rate** was as low as 16% and 7% among females.

Economic Infrastructure

- Basic infrastructure like **railways, ports, water transport, posts, and telegraphs** was developed during British rule but mainly to serve colonial interests, not to benefit the Indian people.
- **Railways, introduced ~ 1850**, allowed long-distance travel and helped break geographical and cultural barriers but fostered the **commercialization of Indian agriculture**.
- Although export volumes increased, benefits mostly went to Britain, leading to **economic loss** for India despite some social benefits like improved mobility.
- Efforts to develop inland waterways and sea lanes were largely unsuccessful and expensive, such as the **Orissa Coast Canal** which had to be abandoned due to competition from railways.
- **Postal services**, though useful, were inadequate for India's large population.
- **Tata Airlines**, was established in **1932** inaugurating the aviation sector in India

4. Economic Planning and the Era of LPG Reforms

After gaining independence on 15 August 1947, India faced the challenge of shaping its own economic future. Although Nehru was inspired by socialism, Indian democracy required a **mixed economy**, one that combined a strong public sector with private ownership and participation. This vision was reflected in the **Industrial Policy Resolution of 1948** and the **Directive Principles of the Constitution**.

Types of economic planning

Imperative planning	Also called centralized planning . The government has complete control over decision-making and resource allocation. The state owns and directs most key industries , resources, and inputs like raw materials and labor. Example - former Soviet Union
Indicative planning	It is a form of economic planning where the government sets broad, non-binding guidelines , Allows market forces to play a primary role, Uses indirect methods - subsidies, tax incentives, and policy guidance to influence the economy. Example - Planning done by erstwhile Planning commission
Structural planning	It refers to planning aimed at bringing fundamental changes to the existing socio- economic structures of a country, and accelerates economic development. Examples include Soviet Union's collectivisation, land reforms in India

Evolution of planning

- Sir **M. Vishveshwarya (1934)** Laid foundation for economic planning in India in 1934 through his book, "**Planned Economy of India**". It was a 10 year plan.
- **Jawaharlal Nehru (1938)** Set-up "**National Planning Commission**" by a committee but due to the changes in the political era and Second World War, it did not materialize
- The **Bombay plan(1944)**:- The plan advocated for the significant role of the state in planning and focus on developing basic infrastructure and industry.
- The **Gandhian plan (1944)**:- Drafted by **S.N Agarwal**. It focuses on economic decentralisation with rural development. This plan emphasised on self-sufficient village and cottage industry.
- The **Peoples plan (1945)**:- This plan was drafted by **MN Roy**. Its goal was nationalisation of land & key industries, collectivised farming.
- The **Sarvoday plan(1950)**:- This plan was promoted by **JP Narayan**. It focuses on development of small and cottage industries.

The Planning Commission

- The Planning Commission was established by an **executive resolution** under Prime Minister Nehru, from **1950 to 2014**, devised **Five-Year Plans** for the nation's socio-economic development.
- **Status**
 - **Non-Constitutional and Non-Statutory**: It was created by a government resolution.
 - **Advisory Role**: It functioned as a staff agency, rather than an executive authority.
 - In 2014, the government abolished the PC, and its successor, the **National Institution for Transforming India (NITI) Aayog**, was established on January 1, 2015.

Comparative Studies of Different Five Year Plan

First Plan (1951 - 56)	It was based on the Harrod-Domar Model , focussed on agriculture, price stability, power and transport . Target Growth- 2.1%; Actual Growth- 3.6 % It was successful because of good harvests in the last two years of the plan.
Second Plan (1956 - 61)	Also called Mahalanobis Plan that focussed on rapid industrialization- heavy & basic industries. (CSE 2009) . Advocated huge imports through foreign loans. The Industrial Policy 1956 was based on the establishment of a socialistic pattern of society as the goal of economic policy. There was a determined thrust towards substitution of basic and capital goods industries . (CSE 2019)
Third Plan (1961 - 66)	It was based on John Sandy and Sukhamoy Chakraborty's model , also called " Gadgil Yojna ". It was felt that the Indian economy has entered a " takeoff stage ". Therefore, its aim was to make India a 'self-reliant' and 'self-generating' economy The Plan failed to reach its targets due to- Chinese aggression (1962), Indo-Pak war (1965), severe drought 1965-66.
Three Annual Plans (1966-69)	Commonly described as a Plan holiday . Failure of Third Plan that led to the devaluation of rupee, inflationary recession, 3 Annual Plans were introduced instead. The prevailing crisis in agriculture necessitated the emphasis on agriculture during the Annual Plans .
Fourth Plan (1969 – 74)	It aims for " growth with stability " and " progressive achievement of self-reliance ", due to Indo-Pak war experience. Adopted the objective of correcting the earlier trend of increased concentration of wealth and economic power . (CSE 2019)
Fifth Plan (1974-79)	It proposed to achieve two main objectives: " Garibi Hatao " and " attainment of self reliance ". The Indian national highway system and the Minimum Needs Programme was introduced in the first year of the Fifth Five-Year Plan. A 20-point program was introduced. Emergency clamped , new elections took place and the Janata Party was elected (CSE 2009)
Rolling Plan (1978 - 80)	Janata Govt. put forward a plan emphasising on employment , in contrast to the Nehru Model which the Govt criticised for concentration of power, widening inequality & for mounting poverty.
Sixth Plan (1980 - 85)	This plan ended Nehruvian socialism and marked the beginning of economic liberalisation . Based on the recommendation of the Shivaraman Committee , the NABARD was established.
Seventh Plan (1985 - 90)	The Plan aimed at accelerating food grain production, increasing employment opportunities & raising productivity with focus on ' food, work & productivity '.