SYLLABUS of UNIT - III

National Income and its aggregates, Industrial Policy-Overview and Role; New industrial policy of India, Socio-economic implications of Liberalization, Privatization and Globalization. Trade Cycle. Inflation Analysis.

NATIONAL INCOME ANALYSIS AND MEASUREMENT

National income of India constitutes total amount of income earned by the whole nation of our country and originated both within and outside its territory during a particular year. The National Income Committee in its first report wrote, "A national income estimate measures the volume of commodities and services turned out during a given period, without duplication."

The estimates of national income depict a clear picture about the standard of living of the community. The national income statistics diagnose the economic ills of the country and at the same time suggest remedies. The rate of savings and investment in an economy also depend on the national income of the country.

Moreover, the national income measures the flow of all commodities and services produced in an economy. Thus, the national income is not a stock but a flow. It measures the total productive power of the community during given period.

Further, the National Income Committee has rightly observed, "National income statistics enable an overall view to be taken of the whole economy and of the relative positions and inter-relations among its various parts". Thus, the computation of national income and its analysis has been considered an important exercise on economic literature.

Estimates of National Income During Pre-Independence Period:

During the British period, several estimates of national income were made by Dadabhai Naoroji (1868), William Digby (1899), Findlay Shirras (1911, 1922 and 1934), Shah and Khambatta (1921), V.K.R.V. Rao (1925-29) and R.C. Desai (1931-40): Among all these pre-independence estimates of national income in India, the estimates of Naoroji, Findlay Shirras and Shaw and Khambatta have computed the value of the output raised by the agricultural sector and then added some portion of the income earned by the non-agricultural sector. But these estimates were having no scientific basis of its own.

After that Dr. V.K.R.V. Rao applied a combination of census of output and census of income methods.

The following table 2.1 reveals various estimates of national income and per capita income of India as prepared by different dignitaries before independence:

All these estimates of national income were conducted out of individual effort and were subjected to serious limitations due to some of its arbitrary assumptions.

All these estimates of national income were conducted out of individual effort and were subjected to serious limitation due to some of its arbitrary assumptions. Although pre-independence estimates of national income in India suffered from various difficulties and limitations but it provided considerable light and insight about the economic conditions of the country prevailing during those period.

Estimates of National Income During the Post-Independence Period: National Income Committee's Estimates:

After independence, the Government of India appointed the National Income Committee in August, 1949 with Prof. PC. Mahalnobis as its Chairman and Prof. D.R. Gadgil and Dr. V.K.R.V. Rao as its two members so as to compile a national income estimates rationally on a scientific basis. The first report of this committee was prepared in 1951.

In its first report, the total national income of the year 1948-49 was estimated at Rs. 8,830 crore and the per capita income of the year was calculated at Rs. 265 per annum. The committee continued its estimation works for another three years and the final report was published in 1954.

National Income Committee and C.S.O. Estimates:

During the post-independence period, the estimate of national income was primarily conducted by the National Income Committee. Later on, it was carried over by the Central Statistical Organisation. For the estimation of national income in India the National Income Committee applied a mixture of both 'Product Method' and the 'Income Method'. This Committee divided the entire economy into 13 sectors.

Income from the six sectors, viz., agriculture, animal husbandry, forestry, Fishery, mining and factory establishments is estimated by the output method. But the income from the remaining seven sectors consisting of small enterprises, commerce, transport and communications, banking and insurance, professions, liberal arts, domestic services, house property, public authorities and rest of the world is estimated by the income methods.

The National Income Unit of the Central Statistical Organisation (C.S.O.) is now-a-days entrusted with the measurement of national income. Here this unit of C.S.O. estimated the major part of national income from the various sectors like agriculture, forestry, animal husbandry, fishing, mining and factory establishments with the help of product method.

The unit of C.S.O. is also applying the income method for the estimation of the remaining part of national income raised from the other sectors.

Till now we have three different series in the national income estimates of India. These include Conventional Series, Revised Series and New Series.

Again the C.S.O. has prepared another new series on national income with 1993-94 as base year as against the existing series with 1980-81 as base year.

Methodology of National Income Estimation in India:

In India, the estimation of national income is being done by two methods, i.e., product method and income method.

Net Product Method:

While estimating the -gross domestic product of the country, the contribution to GDP from various sectors like agriculture, livestock, fishery, forestry and logging, mining and quarrying is estimated with the adoption of product method. In this method, it is important to estimate the gross value of product, bi-products and ancillary activities and then steps are taken to deduct the value of inputs, raw materials and services from such gross value.

In respect of other sub-sectors like animal husbandry, fishery, forestry, mining and factory establishments, the gross value of their output is obtained by multiplying the estimated output with their market price. From such gross value of output, deductions are made for cost of materials used and depreciation charges so as to obtain net value added in each sector.

In respect of secondary activities, the computations of gross domestic product are done by the production approach only for the manufacturing industrial units (both registered and unregistered). In respect of constructions activity, the estimates of the value of pucca construction are made by the commodity How approach and that of the kachcha construction is made by the expenditure method.

Net Income Method:

In India, the income from rest of the sectors, i.e., small enterprises, commerce, transport and communications, banking and insurance professions, liberal arts, domestic activities, house property, public authorities and rest of the world is estimated by the income method.

Here, the income approach is adopted to estimate the value added from these aforesaid remaining sectors. Here, the process involves the measurement of aggregate factor incomes in the shape of compensation of employees (wages and salaries) and operating surpluses in the form of rent, interest, profits and dividends.

Finally, by adding up the contribution of all different sectors to national income of the country, it is necessary to obtain net domestic product at factor cost. In order to derive the net national income at current prices, it is necessary to add the net income from abroad and net indirect taxes with the net domestic product at factor cost. This same estimate is then deflated at the prices of the base year selected to derive a series of national income at constant prices.

National income: Alternatives Concept and the Measures

The total net value of all goods and services produced within a nation over a specified period of time, representing the sum of wages, profits, rents, interest, and pension payments to residents of the nation.

Measures of National Income

For the purpose of measurement and analysis, national income can be viewed as an aggregate of various component flows. The most comprehensive measure of aggregate income which is widely known is Gross National Product at market prices.

Gross and Net Concept

Gross emphasizes that no allowance for capital consumption has been made or that depreciation has yet to be deducted. Net indicates that provision for capital consumption has already been made or that depreciation has already been deducted.

National and Domestic Concepts

The term national denotes that the aggregate under consideration represents the total income which accrues to the normal residents of a country due to their participation in world production during the current year.

It is also possible to measure the value of the total output or income originating within the specified geographical boundary of a country known as domestic territory. The resulting measure is called "domestic product".

Market Prices and Factor Costs

The valuation of the national product at market prices indicates the total amount actually paid by the final buyers while the valuation of national product at factor cost is a measure of the total amount earned by the factors of production for their contribution to the final output.

FORMULA FOR CALCULATION:-

GNP at market price = GNP at factor cost + indirect taxes – Subsidies.

NNP at market price = NNP at factor cost + indirect taxes – Subsidies

Gross National Product and Gross Domestic Product

For some purposes we need to find the total income generated from production within the territorial boundaries of an economy irrespective of whether it belongs to the inhabitants of

that nation or not. Such an income is known as Gross Domestic Product (GDP) and found as:

GDP = GNP – net Factor Income From Abroad

Net Factor Income from Abroad = Factor Income Received From Abroad – Factor Income Paid Abroad

Net National Product

The NNP is an alternative and closely related measure of the national income. It differs from GNP in only one respect. GNP is the sum of final products. It includes consumption of goods, gross investment, government expenditures on goods and services, and net exports.

GNP = NNP − Depreciation

NNP includes net private investment while GNP includes gross private domestic investment.

Personal Income

Personal income is calculated by subtracting from national income those types of incomes which are earned but not received and adding those types which are received but not currently earned.

Personal Income = NNP at Factor Cost − Undistributed Profits − Corporate Taxes + Transfer Payments

Disposable Income

Disposable income is the total income that actually remains with individuals to dispose off as they wish. It differs from personal income by the amount of direct taxes paid by individuals.

Disposable Income = Personal Income − Personal taxes

Value Added

The concept of value added is a useful device to find out the exact amount that is added at each stage of production to the value of the final product. Value added can be defined as the difference between the value of output produced by that firm and the total expenditure incurred by it on the materials and intermediate products purchased from other business firms.

Methods of Measuring National Income

Let's have a look at the following ways of measuring national income:

Product Approach

In product approach, national income is measured as a flow of goods and services. Value of money for all final goods and services is produced in an economy during a year. Final goods are those goods which are directly consumed and not used in further production process. In our economy product approach benefits various sectors like forestry, agriculture, mining etc to estimate gross and net value.

Income Approach

In income approach, national income is measured as a flow of factor incomes. Income received by basic factors like labor, capital, land and entrepreneurship are summed up. This approach is also called as income distributed approach.

Expenditure Approach

This method is known as the final product method. In this method, national income is measured as a flow of expenditure incurred by the society in a particular year. The expenditures are classified as personal consumption expenditure, net domestic investment, government expenditure on goods and services and net foreign investment.

These three approaches to the measurement of national income yield identical results. They provide three alternative methods of measuring essentially the same magnitude.

Various Methods of Measurement of National Income

National income is an uncertain term which is used interchangeably with national dividend, national output and national expenditure. On this basis, national income has been defined in a number of ways. In common parlance, national income means the total value of goods and services produced annually in a country.

Methods of Measurement of National Income

There are four methods of measuring national income. Which method is to be used depends on the availability of data in a country and the purpose in hand.

Product Method

According to this method, the total value of final goods and services produced in a country during a year is calculated at market prices. To find out the GNP, the data of all productive

activities, such as agricultural products, wood received from forests, minerals received from mines, commodities produced by industries, the contributions to production made by transport, communications, insurance companies, lawyers, doctors, teachers, etc. are collected and assessed at market prices. Only the final goods and services are included and the intermediary goods and services are left out.

Income Method

According to this method, the net income payments received by all citizens of a country in a particular year are added up, i.e., net incomes that accrue to all factors of production by way of net rents, net wages, net interest and net profits are all added together but incomes received in the form of transfer payments are not included in it. The data pertaining to income are obtained from different sources, for instance, from income tax department in respect of high income groups and in case of workers from their wage bills.

Expenditure Method

According to this method, the total expenditure incurred by the society in a particular year is added together and includes personal consumption expenditure, net domestic investment, government expenditure on goods and services, and net foreign investment. This concept is based on the assumption that national income equals national expenditure

Value Added Method

Another method of measuring national income is the value added by industries. The difference between the value of material outputs and inputs at each stage of production is the value added. If all such differences are added up for all industries in the economy, we arrive at the gross domestic product.

Limitations in Measuring National Income

There are many conceptual and statistical problems involved in measuring national income by the income method, product method, and expenditure method.

Problems in Income Method

The following problems arise in the computation of National Income by income method:

(i) Owner-occupied Houses

A person who rents a house to another earns rental income, but if he occupies the house himself, will the services of the house-owner be included in national income. The services of the owner-occupied house are included in national income as if the owner sells to himself as a tenant its services.

For the purpose of national income accounts, the amount of imputed rent is estimated as the sum for which the owner-occupied house could have been rented. The imputed net rent is calculated as that portion of the amount that would have accrued to the house-owner after deducting all expenses.

(ii) Self-employed Persons

Another problem arises with regard to the income of self-employed persons. In their case, it is very difficult to find out the different inputs provided by the owner himself. He might be contributing his capital, land, labour and his abilities in the business. But it is not possible to estimate the value of each factor input to production. So he gets a mixed income consisting of interest, rent, wage and profits for his factor services. This is included in national income.

(iii) Goods meant for Self-consumption

In under-developed countries like India, farmers keep a large portion of food and other goods produced on the farm for self-consumption. The problem is whether that part of the produce which is not sold in the market can be included in national income or not. If the farmer were to sell his entire produce in the market, he will have to buy what he needs for self-consumption out of his money income. If, instead he keeps some produce for his self-consumption, it has money value which must be included in national income.

(iv) Wages and Salaries paid in Kind

Another problem arises with regard to wages and salaries paid in kind to the employees in the form of free food, lodging, dress and other amenities. Payments in kind by employers are included in national income. This is because the employees would have received money income equal to the value of free food, lodging, etc. from the employer and spent the same in paying for food, lodging, etc.

2. Problems in Product Method

The following problems arise in the computation of national income by product method:

(i) Services of Housewives

The estimation of the unpaid services of the housewife in the national income presents a serious difficulty. A housewife renders a number of useful services like preparation of meals, serving, tailoring, mending, washing, cleaning, bringing up children, etc.

She is not paid for them and her services are not including in national income. Such services performed by paid servants are included in national income. The national income is, therefore, underestimated by excluding the services of a housewife.

The reason for the exclusion of her services from national income is that the love and affection of a housewife in performing her domestic work cannot be measured in monetary terms. That is why when the owner of a firm marries his lady secretary, her services are not included in national income when she stops working as a secretary and becomes a housewife.

When a teacher teaches his own children, his work is also not included in national income. Similarly, there are a number of goods and services which are difficult to be assessed in money terms for the reason stated above, such as painting, singing, dancing, etc. as hobbies.

(ii) Intermediate and Final Goods

The greatest difficulty in estimating national income by product method is the failure to distinguish properly between intermediate and final goods. There is always the possibility of including a good or service more than once, whereas only final goods are included in national income estimates. This leads to the problem of double counting which leads to the overestimation of national income.

(iii) Second-hand Goods and Assets

Another problem arises with regard to the sale and purchase of second-hand goods and assets. We find that old scooters, cars, houses, machinery, etc. are transacted daily in the country. But they are not included in national income because they were counted in the national product in the year they were manufactured.

If they are included every time they are bought and sold, national income would increase many times. Similarly, the sale and purchase of old stocks, shares, and bonds of companies are not included in national income because they were included in national income when

the companies were started for the first time. Now they are simply financial transactions and represent claims.

But the commission or fees charged by the brokers in the repurchase and resale of old shares, bonds, houses, cars or scooters, etc. are included in national income. For these are the payments they receive for their productive services during the year.

(iv) Illegal Activities

Income earned through illegal activities like gambling, smuggling, illicit extraction of wine, etc. is not included in national income. Such activities have value and satisfy the wants of the people but they are not considered productive from the point of view of society. But in countries like Nepal and Monaco where gambling is legalised, it is included in national income. Similarly, horse-racing is a legal activity in England and is included in national income.

(v) Consumers' Service

There are a number of persons in society who render services to consumers but they do not produce anything tangible. They are the actors, dancers, doctors, singers, teachers, musicians, lawyers, barbers, etc. The problem arises about the inclusion of their services in national income since they do not produce tangible commodities. But as they satisfy human wants and receive payments for their services, their services are included as final goods in estimating national income.

(vi) Capital Gains

The problem also arises with regard to capital gains. Capital gains arise when a capital asset such as a house, some other property, stocks or shares, etc. is sold at higher price than was paid for it at the time of purchase. Capital gains are excluded from national income because these do not arise from current economic activities. Similarly, capital losses are not taken into account while estimating national income.

(vii) Inventory Changes

All inventory changes (or changes in stocks) whether positive or negative are included in national income. The procedure is to take changes in physical units of inventories for the year valued at average current prices paid for them.

The value of changes in inventories may be positive or negative which is added or subtracted from the current production of the firm. Remember, it is the change in inventories and not total inventories for the year that are taken into account in national income estimates.

(viii) Depreciation

Depreciation is deducted from GNP in order to arrive at NNP. Thus depreciation lowers the national income. But the problem is of estimating the current depreciated value of, say, a machine, whose expected life is supposed to be thirty years. Firms calculate the depreciation value on the original cost of machines for their expected life. This does not solve the problem because the prices of machines change almost every year.

(ix) Price Changes

National income by product method is measured by the value of final goods and services at current market prices. But prices do not remain stable. They rise or fall. When the price level rises, the national income also rises, though the national production might have fallen.

On the contrary, with the fall in the price level, the national income also falls, though the national production might have increased. So price changes do not adequately measure national income. To solve this problem, economists calculate the real national income at a constant price level by the consumer price index.

3. Problems in Expenditure Method

The following problems arise in the calculation of national income by expenditure method:

(i) Government Services

In calculating national income by, expenditure method, the problem of estimating government services arises. Government provides a number of services, such as police and military services, administrative and legal services. Should expenditure on government services be included in national income?

If they are final goods, then only they would be included in national income. On the other hand, if they are used as intermediate goods, meant for further production, they would not be included in national income. There are many divergent views on this issue.

One view is that if police, military, legal and administrative services protect the lives, property and liberty of the people, they are treated as final goods and hence form part of

national income. If they help in the smooth functioning of the production process by maintaining peace and security, then they are like intermediate goods that do not enter into national income.

In reality, it is not possible to make a clear demarcation as to which service protects the people and which protects the productive process. Therefore, all such services are regarded as final goods and are included in national income.

(ii) Transfer Payments

There arises the problem of including transfer payments in national income. Government makes payments in the form of pensions, unemployment allowance, subsidies, interest on national debt, etc. These are government expenditures but they are not included in national income because they are paid without adding anything to the production process during the current year.

For instance, pensions and unemployment allowances are paid to individuals by the government without doing any productive work during the year. Subsidies tend to lower the market price of the commodities. Interest on national or public debt is also considered a transfer payment because it is paid by the government to individuals and firms on their past savings without any productive work.

(iii) Durable-use Consumers' Goods

Durable-use consumers' goods also pose a problem. Such durable-use consumers' goods as scooters, cars, fans, TVs, furniture's, etc. are bought in one year but they are used for a number of years. Should they be included under investment expenditure or consumption expenditure in national income estimates? The expenditure on them is regarded as final consumption expenditure because it is not possible to measure their used up value for the subsequent years.

But there is one exception. The expenditure on a new house is regarded as investment expenditure and not consumption expenditure. This is because the rental income or the imputed rent which the house-owner gets is for making investment on the new house. However, expenditure on a car by a household is consumption expenditure. But if he spends the amount for using it as a taxi, it is investment expenditure.

(iv) Public Expenditure

Government spends on police, military, administrative and legal services, parks, street lighting, irrigation, museums, education, public health, roads, canals, buildings, etc. The

problem is to find out which expenditure is consumption expenditure and which investment expenditure is.

Expenses on education, museums, public health, police, parks, street lighting, civil and judicial administration are consumption expenditure. Expenses on roads, canals, buildings, etc. are investment expenditure. But expenses on defence equipment are treated as consumption expenditure because they are consumed during a war as they are destroyed or become obsolete. However, all such expenses including the salaries of armed personnel are included in national income.

The Industrial Policy 1951 and 1991

Industrial Policy Act 1951

After Independence, the Government of India adopted an approach to develop Industrial sector of India. India adopted several Industrial Policy resolution to develop the Industrial sector.

The Industries (Development and Regulation) Act, (IDRA), came into force from 8th May 1952 under a notification of the Central Government published in the Gazette of India.

The Act extends to whole of India including the state of Jammu & Kashmir with a view to being under Central and regulation of a number of important industries, the activities of which affect the country as a whole and the development of which must be governed by economic factors of all India importance.

Objectives of the Act

The Important objectives are,

To Implement the Industrial Policy

The Act provides the necessary means to the Central Government in order to implement its industrial policy.

Regulation and Development of Important Industries

The Act brings under the control of the Central Government the development and regulation of a number of important industries listed m the first schedule attached to the Act as the activities of such industries will affect the country as a w o e and, therefore, the development of such important industries must be governed by the economic factors of all India importance.

Planning and Future Development of New Undertakings

A system of licensing is introduced under the Act to regulate planning and future development of new undertaking on sound and balance lines and may be deemed expedient in the opinion of the Central Government.

The Act confers on the Central Government power to make rules for the registration of existing undertakings for regulating he production and development of the industries specified in the schedule attached to the Act The Ac a so provided for the constitution of the Central Advisory Council and Development Council.

Scope of the Act

This Act applies to the whole of India including the State of Jammu & Kashmir, The provision of the Act apply to industrial undertaking, manufacturing any of the articles mentioned in the first schedule. An industrial undertaking (also called a factory) for the purpose of the Act is the one where manufacturing process is being carried on:

(a) With the aid of power provided that fifty or more workers are working or were working on any day of the preceding twelve months; or

(b) Without the aid of power provided that one hundred or more workers are working or were working on any day of the preceding twelve months.

(c) The Act applies only on industrial undertakings. Trading houses and financial institutions are outside the purview of the Act.

Industrial Policy Act 1991

The New Industrial Policy of 1991 comes at the center of economic reforms that launched during the early 1990s. All the later reform measures were derived out of the new industrial policy. The Policy has brought comprehensive changes in economic regulation in the country. As the name suggests, these reform measures were made in different areas related to the industrial sector.

As part of the policy, the role of public sector has been redefined. A dedicated reform policy for the public sector including the disinvestment programme were launched under the NIP 1991. Private sector has given welcome in major industries that were previously reserved for the public sector.

Similarly, foreign investment has given welcome under the policy. But the most important reform measure of the new industrial policy was that it ended the practice of industrial licensing in India. Industrial licensing represented red tapism.

Because of the large scale changes, the Industrial Policy of 1991 or the new industrial policy represents a major change from the early policy of 1956.

The new policy contained policy directions for reforms and thus for LPG (Liberalization, Privatization and Globalization). It enlarged the scope of private sector participation to almost all industrial sectors except three (modified). Simultaneously, the policy has given welcome to foreign investment and foreign technology. Since 1991, the country’s policy on foreign investment is gradually evolving through the introduction of liberalization measures in a phase-wise manner.

Perhaps, the most welcome change under the new industrial policy was the abolition of the practice of industrial licensing. The1991 policy has limited industrial licensing to less than fifteen sectors. It means that to start an industry, one has to go for license and waiting only in the case of these few selected industries. This has ended the era of license raj or red tapism in the country. The 1991 industrial policy contained the root of the liberalization, privatization and globalization drive made in the country in the later period.

The policy has brought changes in the following aspects of industrial regulation:

Industrial delicensing policy or the end of red tapism

The most important part of the new industrial policy of 1991 was the end of the industrial licensing or the license raj or red tapism. Under the industrial licensing policies, private sector firms have to secure licenses to start an industry. This has created long delays in the start up of industries. The industrial policy of 1991 has almost abandoned the industrial licensing system. It has reduced industrial licensing to fifteen sectors. Now only 13 sector need license for starting an industrial operation.

Dereservation of the industrial sector

Previously, the public sector has given reservation especially in the capital goods and key industries. Under industrial deregulation, most of the industrial sectors was opened to the private sector as well. Previously, most of the industrial sectors were reserved to the public sector. Under the new industrial policy, only three sectors- atomic energy, mining and railways will continue as reserved for public sector. All other sectors have been opened for private sector participation.

Reforms related to the Public sector enterprises

Reforms in the public sector were aimed at enhancing efficiency and competitiveness of the sector. The government identified strategic and priority areas for the public sector to concentrate. Similarly, loss making PSUs were sold to the private sector. The government has adopted disinvestment policy for the restructuring of the public sector in the country. at the same time autonomy has been given to PSU boards for efficient functioning.

Foreign investment policy

Another major feature of the economic reform measure was it has given welcome to foreign investment and foreign technology. This measure has enhanced the industrial competition and improved business environment in the country. Foreign investment including FDI and FPI were allowed. Similarly, loan capital has also introduced in the country to attract foreign capital.

Abolition of MRTP Act

The New Industrial Policy of 1991 has abolished the Monopoly and Restricted Trade Practice Act. In 2010, the Competition Commission has emerged as the watchdog in monitoring competitive practices in the economy.

The industrial policy of 1991 is the big reform introduced in Indian economy since independence. The policy caused big changes including emergence of a strong and competitive private sector and a sizable number of foreign companies in India.

NEW INDUSTRIAL POLICY OF INDIA

LPG Model

LIBERALIZATION

The basic aim of liberalization was to put an end to those restrictions which became hindrances in the development and growth of the nation. The loosening of government control in a country and when private sector companies' start working without or with fewer restrictions and government allow private players to expand for the growth of the country depicts liberalization in a country.

Objectives of Liberalization Policy

- To increase competition amongst domestic industries.
- To encourage foreign trade with other countries with regulated imports and exports.
- Enhancement of foreign capital and technology.
- To expand global market frontiers of the country.
- To diminish the debt burden of the country.

PRIVATIZATION

This is the second of the three policies of LPG. It is the increment of the dominating role of private sector companies and the reduced role of public sector companies. In other words, it

is the reduction of ownership of the management of a government-owned enterprise. Government companies can be converted into private companies in two ways:

- By Disinvestment
- By Withdrawal of governmental ownership and management of public sector companies.

Forms of Privatization

- Denationalization or Strategic Sale: When 100% government ownership of productive assets is transferred to the private sector players, the act is called denationalization.
- Partial Privatization or Partial Sale: When private sector owns more than 50% but less than 100% ownership in a previously construed public sector company by transfer of shares, it is called partial privatization. Here the private sector owns the majority of shares. Consequently, the private sector possesses substantial control in the functioning and autonomy of the company.
- Deficit Privatization or Token Privatization: When the government disinvests its share capital to an extent of 5-10% to meet the deficit in the budget is termed as deficit privatization.

Objectives of Privatization

- Improve the financial situation of the government.
- Reduce the workload of public sector companies.
- Raise funds from disinvestment.
- Increase the efficiency of government organizations.
- Provide better and improved goods and services to the consumer.
- Create healthy competition in the society.
- Encouraging foreign direct investments (FDI) in India.

GLOBALIZATION

It means to integrate the economy of one country with the global economy. During Globalization the main focus is on foreign trade & private and institutional foreign investment. It is the last policy of LPG to be implemented.

Globalization as a term has a very complex phenomenon. The main aim is to transform the world towards independence and integration of the world as a whole by setting various

strategic policies. Globalization is attempting to create a borderless world, wherein the need of one country can be driven from across the globe and turning into one large economy.

Outsourcing as an Outcome of Globalization

The most important outcome of the globalization process is Outsourcing. During the outsourcing model, a company of a country hires a professional from some other country to get their work done, which was earlier conducted by their internal resource of their own country.

The best part of outsourcing is that the work can be done at a lower rate and from the superior source available anywhere in the world. Services like legal advice, marketing, technical support, etc. As the Information Technology has grown in the past few years, the outsourcing of contractual work from one country to another has grown tremendously. As a mode of communication has widened their reach, all economic activities have expanded globally.

Various Business Process Outsourcing companies or call centres, which have their model of a voice-based business process have developed in India. Activities like accounting and book-keeping services, clinical advice, banking services or even education are been outsourced from developed countries to India.

The most important advantage of outsourcing is that big multi-national corporate or even small enterprises can avail good services at a cheaper rate as compared to their country's standards. The skill set in India is considered most dynamic and effective across the world. Indian professionals are best at their work. The low wage rate and specialized personnel with high skills have made India the most favourable destination for global outsourcing in the later stage of reformation.

LPG Model in India

After Independence in 1947 Indian government faced a significant problem to develop the economy and to solve the issues. Considering the difficulties pertaining at that time government decided to follow LPG Model. The Growth Economics conditions of India at that time were not very good. This was because it did not have proper resources for the development, not regarding natural resources but financial and industrial development. At that time India needed the path of economic planning and for that used 'Five Year Plan' concept of which was taken from Russia and feet that it will provide a fast development like that of Russia, under the view of the socialistic pattern society. India had practiced some restrictions ever since the introduction of the first industrial policy resolution in 1948.

Liberalization is defined as making economics free to enter the market and establish their venture in the country. Privatization is defined as when the control of economic is sifted from public to a private hand. Globalization is described as the process by which regional economies, societies, and cultures have become integrated through a global network of communication, transportation, and trade.

Objectives of Liberalization Policy

- To increase competition amongst domestic industries.
- To encourage foreign trade with other countries with regulated imports and exports.
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- To expand global market frontiers of the country.
- To diminish the debt burden of the country.

SOCIO-ECONOMIC IMPLICATIONS OF LIBERALIZATION

There has been revolutionary change in Indian Economy since the espousal of new economic strategy in 1991. This had great impacts on all areas of life in India. When a nation becomes liberalized, the economic effects can be intense for the country and for investors. Liberalization is defined as laws or rules being liberalized, or relaxed, by a government. Economic liberalization is generally described as the relaxing of government regulations in a country to allow for private sector companies to operate business transactions with fewer restrictions. With reference to developing countries, this term denotes to opening of their economic borders to multinationals and foreign investment. Many economists explained that economic liberalization is “opening up” to the rest of the world with regards to trade, regulations, taxation and other areas that generally affect business in the country.

Investors face problems to enter in emerging market countries when there are lots of barriers. These barriers can include tax laws, foreign investment restrictions, legal issues and accounting regulations that can make it difficult or impossible to gain access to the nation. The economic liberalization process begins by relaxing these obstacles and relinquishing some control over the direction of the economy to the private sector. This often involves some form of deregulation and a privatization of corporations.

Major goals of economic liberalization are the free flow of capital between countries and the effectual allocation of resources and competitive advantages. This is generally done by decreasing protectionist strategies such as tariffs, trade laws and other trade barriers. One of the main effects of this improved flow of capital into the country is that it makes it inexpensive for companies to access capital from investors. A lower cost of capital enables companies to undertake lucrative projects that they may not have been able to with a higher cost of capital pre-liberalization, leading to higher growth rates.

Stock Market Performance: Another factor is stock market performance. Generally, when a country relaxes laws, taxes, the stock market values also rise. Stock Markets are platforms on which Corporate Securities can be traded in real time. It offers mechanisms for continuous price discovery, choices for investors to exit from or enter into investment any time. These are strong base of free markets these days and there is vigorous trade going all over the world on stock exchanges. Their Importance can be assessed from the fact that, behaviour of stock markets of a country is strongest indicator of growth and future prospects of an economy. These markets have thrown open range of associated services such as Investment Banking, Asset Management, Underwriting services, Hedging advice etc. These collectively employ lakhs of people all over India. Similarly there are commodities market

which provides avenues for investment and sale of various eligible commodities. Fund managers and investors are always on the lookout for new prospects for profit, and so a whole country that becomes available to be invested in will tend to cause a surge of capital to flow in. The situation is similar in nature to the anticipation and flow of money into an initial public offering (IPO). A private company that was formerly unavailable to an investor that suddenly becomes available typically causes a similar valuation and cash flow pattern. However, like an initial public offering, the initial eagerness also eventually dies down and returns become more normal and more in line with basics.

Political Risks Reduced: Liberalization policies in country lessens the political risks to investors. The government can attract more foreign investment through liberalization in economic policies. These are areas that support and foster a readiness to do business in the country such as a strong legal foundation to settle disputes, fair and enforceable contract laws, property laws, and others that allow businesses and investors to operate with confidence. Also, government administration is a common target area to be streamlined and improved in the liberalization process. All these modifications can reduce the political risks for depositors.

Diversification for Investors: In liberalized economy, Investors gets benefit by being able to invest a portion of their portfolio into a diversifying asset class. Commonly, the correlation between developed countries such as the United States and undeveloped or emergent countries is comparatively low. Although the general risk of the developing country by itself may be higher than average, adding a low correlation asset to your portfolio can reduce your portfolio's overall risk profile. However, a discrepancy should be made that although the correlation may be low, when a country becomes liberalized, the relationship may actually rise over time. This happens because the country becomes more incorporated with other parts of the world and has become more sensitive to events that happen outside the country. A high level of integration can also lead to increased contagion risk which is the risk that crunches that occur in different countries cause crises in the domestic country.

With the advent of Information Technology in contemporary period, globalization process increased and it made possible transfer of real time human labour across nations, without transfer humans themselves. Additionally, it removed all boundaries which hinder free flow of information. It has many benefits to investors such as sharing, nurturing and development of knowledge in societies which earlier had access only to substandard or non-updated information. As always package is coupled with some grim realities too. All over the world, Governments has lost their capacity to control and ward of against malevolent, false, sensitive information and content. Rise of Islamic State establishes that information

technology revolution has helped global Terrorism. Furthermore, explicit content is freely available on web, to which immature children have unhampered access.

Industrial Growth Rate: Liberalization is imperative for the growth of Indian economy. Barring few years, industrial growth rate has not been so much inspiring. Share of Industry still remains stagnantly low at 25%. It is discouraging that India has transitioned to be a service led economy, directly from an agrarian one. One compensation of this is end of policy of imports substitution which derived industrial growth up to 1990. Foreign companies got free access to Indian markets and made domestic products uncompetitive. They perceptibly had better access to technology and superior economies of scale.

India's status also trailed in the arena of Research and innovation. Import substitution required certain degree of investment and efforts in domestic production. It was done even when imports were inexpensive. This resulted in good and better capacity building up to that time. This was combined with constant technology denial by west, which further pushed government to spend on R&D. Technology Denial ended with liberalization and globalization. Till that time Indian Industry was better and modern than that of China. Currently, China has exceeded India by huge margin in case of both Industry and novelty.

Impact on Small Scale in India: Impact of small scale is evaluated from the beginning of colonization in 18th century. Colonization can be considered as 1st movement of globalization. In pre colonization period, India's textiles and handicraft was popular across the globe and was mainstay of Indian economy. With the initiation of industrial revolution along with foreign rule in India, Indian economy underwent major setback and much of its home-grown small scale cottage Industry was ruined. After independence, Indian government made many efforts to recuperate small scale sector by reserving items exclusively for it to manufacture. With liberalization, list of reserved items was substantially curtailed and many new sectors were thrown open to big companies.

Small scale industry exists and still remains strength of Indian Economy. It contributes to major portion of exports and private sector employment. Results are mixed, many former Small scale industries got bigger and better. But overall value addition, product innovation and technology adoption remains miserable and they exist only on back of government support. Their products are challenged by cheaper imports from China.

Impact on Agriculture: In the area of agriculture cropping patterns has undergone a huge modification, but impact of liberalization cannot be properly measured. It is observed that

there are still all pervasive government controls and interventions starting from production to distribution.

Global agricultural economy is highly biased. It is due to imbalance in economic and political power in hands of farmers of developed and developing countries. In developed countries, commercial and capitalistic agriculture is in place which is owned by influential Agri corporations. They easily influence policies of WTO and extract a better deal for themselves at cost of farmers of developing world. Farming in developing world is subsistence and supports majority of poor people. With the process of globalization, there has been high fluctuation in commodity prices which put them in massive risk. This is a fact for cash crops like Cotton and Sugarcane. Recent crunches in both crops indicate towards this decisively.

Impact on Services Sector: In service sector, globalization has changed the scene of developing countries and misery for developed ones. Due to historic economic inequality between two groups, human resources have been much cheaper in developing economies. This was further aided by information technology revolution and this all culminated in migration of numerous jobs from developed countries to developing countries.

Information technology industry: Currently, Software, BPO, KPO, LPO industry are prospering in India and it has helped India to absorb a big mass of demographic dividend, which otherwise could have wasted. Best part is that export of services result in export of high value. There is almost no material exported which consume some natural resource. Only thing exported is labour of Professionals, which does not reduce, instead grows with time. Now India is better positioned to become actually Knowledge Economy. Exports of these services generate huge revenue for India's foreign Exchange.

Banking: In banking sector, liberal policies have great impact in Indian economy. Since improvements, there have been three rounds of License Grants for private banks. Private Banks such as ICICI, HDFC, Yes Bank and also foreign banks, raised standards of Indian Banking Industry. Now there is tough competition in the banking industry, and public sector banks are more responsive to customers. It is well understood that information technology is bringing banking revolution. New government schemes like Pradhan Mantri Jan dhanYojana aims to achieve their targets by using Adhaar Card. Public Sector Banks still remain major lender in the country. Similarly, Insurance Industry provides array of products such as Unit Linked Insurance plans, Travel Insurance etc. But, in India life Insurance business is still decisively in hands of Life Insurance Corporation of India.

Telecom Sector: Usually, Telecom sector was a government owned domination and therefore service was not very efficient. But after reforming polices, private telecom sector reached zenith of success. Indian telecom companies are progressing at global scale. However, corruption and rent seeking disfigured growth and outlook of this sector. Entry of modern Direct to Home services saw enhancements in quality of Television services on one hand and loss of livelihood for numerous local cable operators.

Education and Health Sector: It is a fact that food (Agriculture), Health and education (and to lesser extent banking) are among basic requirements, which every human being deserves and cannot do without. Unfortunately, in developing countries, there is market failure in all these sectors and majority of people cannot afford beyond a certain limit. Concept of free markets, globalization, and liberalization fails despondently. Free markets provide goods and services to people who can afford paying for them, not to those who deserve and need these.

If experts evaluates these sectors from the perspective of free markets, some progress is visible. There has been high level education available in India and deregulation has resulted in growing of private engineering and medical colleges. But in reality, this had far reaching upsetting effect on society. These new colleges accommodate only small proportion of candidates at very high costs. In recent times, an Independent organization 'Transparency International' came out with report claiming that India's medical system is most corrupt in the world. High fees of education forces many aspirants to take educational loans from banks. After qualifying job market is unable to absorb majority of them. Practice turns out to be option of last resort. Now to make a decent living and to pay back the loans person is attracted by dishonesty. Subsequently, when many similar cases are put together, corrupt system is developed.

It is observed that after deregulation and liberalization, government along with other sectors, pulled its hand from social sectors too. In Public Sector less than mediocre to mediocre options are available. This leaves huge proportion of hopeful students and expecting parents.

It is well recognized that liberalization has major impact on the Indian economy and made it a huge consumer market. Currently, most of the economic changes in the country are based on the demand supply cycle and other economic factors. Today, India has made good status in economy in terms of market exchange rate and 4th largest in terms of the purchasing power parity. Economic liberalization is generally thought of as a useful and necessary process for developing nations. The fundamental goal is to have clear capital flowing into and out of the country in order to increase growth and efficiencies within the domestic country. The effects following liberalization are what should interest investors as it can provide new opportunities for diversification and profit.

Changes in Industrial Policies and their effect on Industrial Growth:

Industrial policy is described as a statement which explains the role of government in industrial development. The place of the public and private sectors in industrialisation of the country. The relative role of large and small industries. The role of foreign capital etc. Concisely, it is a statement of objectives to be realised in the area of industrial development

and the measures to be adopted towards achieving these objectives. The industrial policy formally designates the spheres of activity of the public and the private sectors. It lays down rules and procedures that would govern the growth and pattern of industrial activity.

The major objectives of industrial policy are as under:

Rapid Industrial Development: The objective of the industrial policy of the Government of India is to augment industrial development. It seeks to create a positive investment climate for the private sector as well as mobilise resources for the investment in public sector. In its way the government seeks to promote rapid industrial development in the country.

Balanced industrial Structure: The industrial policy is intended to correct the predominant lopsided industrial structure. The industrial policy had to be framed in such a manner that these imbalances in the industrial structure are corrected. Thus by laying emphasis on heavy industries and development of capital goods sector, industrial policy seeks to bring a balance in industrial structure.

Prevention of Concentration of Economic Power: The industrial policy offers framework of rules, regulations and reservation of spheres of activity for the public and the private sectors. This is aimed at reducing the monopolistic tendencies and preventing concentration of economic power in the hands of a few big industrial houses.

Balanced Regional Growth: Industrial policy has an objective to check regional imbalances in industrial development. It is well recognized that some regions in the country are industrially quite advanced such as Maharashtra and Gujarat while others are industrially backward, like Bihar, Orissa. It is the duty of industrial policy to work out programmes and policies which lead to industrial development or industrial growth.

Before independence, India was not industrially developed country. It was an agrarian country where in handicrafts achieved sovereignty unmatched in the world. There are very few types of economic activity which became traditional in nature and could be included under the products produced under the factory system of 19th and 20th century. Strategies are modified to achieve an end. Indian industrial polices developed to obtain speedy economic progress through rapid industrialization and making economy self-reliant as an end. Industrial sector of the nation was in stagnations at the time of independence as it was not encouraged but ignored during the two centuries under British government. Their manipulative policies framed to serve the interests of their homeland were the major cause of lack of industrialization in India. India was the supplier of raw material and consumer of the British goods. The desire of Indians to industrialize can be observed from the standpoint of the creation of Bombay Plan which was initial effort by prominent industrialists of the country to form the industrial policy of the country through importance on heavy businesses

Industrial policies and economic policies were formed by the British Government for their interests. The tariff policy followed by British in India was based on the principal of one-way free trade while the Indian interest for industrialization in India remained deliberately neglected. While British producers had unhampered access to Indian markets, Indian products were kept at bay by British industrial strategy. Only access was allowed to raw materials. Though the British Government established Department of Commerce and Industry in 1905 but the activities followed through this department favoured industrial activity in England. Afterward, the dominant Government established board of Scientific and Industrial Research in 1940 but not much could come out of it. By this time, there were several plans such as one by congress working committee, Bombay plan, Visvesariya plan etc. Almost all of them proliferated heavy industries with dominant role of state.

After India got independence, various resolutions were passed in Parliament from time to time, landmark shift happened in 1991 when India was forced to open up its economy to global competition and government had to liberalise sectors to leave space for private industry. There are some revolutionary shifts in Industrial policy of India.

Industrial Policy Resolution, 1948: After independence, it was compulsory to have new policy for industry of the country, to decide priority areas and clear doubts in the minds of private entrepreneurs regarding nationalization of existing industries. In Industrial Policy Resolution of 1948, both public and private sectors were involved towards industrial development. Consequently, the industries were divided into four far-reaching categories:

Exclusive government Monopoly: This includes the manufacture of arms and ammunition, production and control of atomic energy and the ownership and management of railway transport. These industries were the exclusive monopoly of the Central Government.

Government Monopoly for New Units: This group included coal, iron and steel, aircraft manufacture, ship building, manufacture of telephone, telegraphs and wireless apparatus (excluding radio receiving sets) and mineral oils. New undertakings in this category could henceforth be undertaken only by the State.

Regulation: This category encompassed industries of such basic importance like machine tools, chemicals, fertilizers, non-ferrous metals, rubber manufactures, cement, paper, newsprint, automobiles, electric engineering etc. which the Central Government would feel necessary to plan and regulate.

Unregulated private enterprise: In this category, industries were left open to the private sector, individual as well as cooperative.

The main shove of the 1948 Industrial Policy was to develop mixed economy where both the private and public enterprises were to be given prominence and work together to develop economy to quicken the pace of industrial expansion.

Industrial Policy Resolution, 1956: Industrial Policy Resolution 1956 was formed by Mahalanob model of growth which highlighted on role of heavy industries for long term development of country. The resolutions broadened the scope of public sector with the elementary objective of accelerating economic development and enhance the process of industrialization. Policy also has major goal to decrease regional discrepancies through development of low industrial base and by giving impetus to small scale industries and cottage industries as they had a huge potential to provide mass employment. The policy stuck in line with the prevalent beliefs of the times i.e. accomplishing self-sufficiency. But the policy faced many implementation catastrophes and as a result in failure of its objectives such as regional disparities and concentration of economic power.

The Industrial Policy Resolution of 1956 grouped the whole industrial sector in three Schedules:

Schedule A: In the first category, those industries were included whose future development was the exclusive responsibility of the State. Seventeen industries were included in this category. This included heavy and strategic industries such as defense equipment; Atomic energy; Iron and Steel; Heavy castings and forgoing of iron and steel; Heavy plant and machinery required for iron and steel production for mining.

Schedule B: In this group those industries were included which were progressively State-owned and in which the private enterprises would be expected only to supplement the efforts of the State. In these category twelve industries were included.

Schedule C: Industries that are not listed in schedule A or B were included in the third category. These industries were left open to the private sector. Hence, the responsibility with regard to establishment, function and development was of private sector, though even here the state could start any industry in which it was interested.

Small Scale Sector: Several proposals were made to boost small sector such as

- Direct subsidy was provided to small scale sector.
- Suitable taxation relief was given to this sector.

Main objective of the State was to protect small scale sector by advancing technical assistance. Nonetheless, government was unsuccessful to incorporate these industries and their programs with the production program of the large- scale sector.

Foreign Investment: Another area of industrial growth is foreign capital participation in Indian economic development but the major share should belong to India. In case of already existing foreign establishments, these will be replaced by Indian technicians progressively.

One of the major objectives of resolution was decrease in regional inequalities and imbalances. But opposing to this, the actual operation of this policy resulted in increased regional disparities. This becomes obvious from various reports which prominent that the four industrially advanced States of Maharashtra, Gujrat, West Bengal and Tamil Nadu benefited the most from the operation of this policy. Most important sectors were reserved for government, but government failed to develop on these reserved sectors. Sometimes, private sector was permissible to operate in these areas. This was due to system of rent seeking and kickbacks which developed during this period.

Monopolies Inquiry commission (MIC) was formed in 1964 to appraise various aspects pertaining to concentration of economic power and operation of industrial licensing under Industrial (Development and Regulation) Act 1951. The report while emphasizing that planned economy contributed to progress of industry accused the licensing system which permitted the big business companies to obtain disproportionately large share of licenses which had led to pre-emptive and foreclosure of capacity. Consequently, Dutt committee or Industrial licensing inquiry committee 1956 recommended that big industrial houses must be given licenses only for setting up industries in core and heavy investment sectors. Further, in order to control the concentration of economic power, Monopolistic and Restrictive Trade Practices Act (MRTP) was presented. Large industries were designated as MRTP companies and were qualified to participate in industries that were not reserved for government or small-scale industries.

The Monopolistic and Restrictive Trade Practices Act, 1969: This act was trademark of infamous ‘license quota permit’ system. Companies having more than specified value of assets required to take permission/license before any development and commencement of operations.

Major objectives were as under:

1. To prohibit monopolistic and restrictive trade practices (except by government).
2. To prevent concentration of economic power in few hands.
3. To control the monopolies.
4. To protect consumer interest.

The Monopolistic and Restrictive Trade Practices Act became operative in June 1970. There were more emphasis on increasing efficiency of industry. There were major modifications in 1980's and The Monopolistic and Restrictive Trade Practices commission was also setup. This act was mismatched with new economic policy after 1991 and subsequently, it was repealed in 2009. Now Competition Act and Competition Commission of India are in place instead.

Industrial licensing policy as well as Industrial policy 1973 both highlighted on the necessity for controlling the concentration of capital and gave importance to small and medium scale industries. Continuing the favouritism to small scale industries the Industrial policy 1977 went a step ahead by introducing District industrial centres to provide support to SSI. It also introduces the new category called TINY SECTOR and considerably expanded the reserve list of small scale industries. But due to exogenic shocks (wars) as well as internal disturbances (emergency) and implementation problems the policy failed to have a substantial effect.

Industrial Policy Resolution 1977: This resolution was made due to change in government at centre. Subsequently, this policy stressed more on small scale industry, cottage and village industry. This was move away from Nehruvian- Mahalanobis ideology to Gandhian ideology of economic development. This categorized the small sector into three categories:

Cottage and household industries which provide self-employment on a wide scale.

Tiny sector incorporating investment in industrial unit in machinery and equipment up to Rs.1 lakh and situated in towns with a population of less than 50000.

Small-scale industries comprising industrial units with an investment of Rs.10 lakh and in case of ancillaries with an investment in fixed capital up to Rs.15 lakh.

Small Scale sector specific policies were formulated. Number of items reserved for this sector was increased (105 to 807). 'District Industries Centres' were established in every district, which are instrumental for support to small scale industry. This agency would provide under many services at one place and support required by small and rural entrepreneurs. Khadi and Village Industries Commission was revamped.

This resolution considered large industries on the lines of Basic/core industry, Capital Goods industry, High Technology industry and other Industries. It was also visualised that government made extreme efforts in the development of indigenous technology, which should guarantee efficient production, continued inflow of technology in sophisticated and high priority areas where Indian skills and technology are yet not sufficiently developed.

Additional, foreign investment would be exhilarated only for some industries in the national interest as decided by the Government. This indicated that in areas where the foreign collaboration was not required, such case would not be reviewed. For this there was draconian Foreign Exchange Regulation Act in place.

Industrial Policy resolution, 1980: In this period, Congress made government and soon restored its own industrial policy.

Major Changes were as under:

- Some of the items reserved for small scale industry were de-reserved.
- Many units/companies were operating on excess capacities, then allowed by law. These excess capacities were regularized.
- Foreign Investment was allowed with technology transfer.
- Regulations, Licensing, restrictions were eased a bit signaling inclination towards private sector.

The mounting economic situation led to formulation of Industrial Policy 1980 which sowed the seeds of liberalization.

The Industrial Policy 1980 put more emphasis on competitiveness in the domestic market, technical advancement and modernization of industries along with the focus on optimum utilization of installed capacity for ensuring higher productivity, higher employment levels, and removal of regional disparities. Policy measures were proclaimed to recuperate the efficiency of public sector undertakings along with provisions of automatic development. The public sector undertakings were freed from a number of restrictions and was provided with greater sovereignty. Government took major initiatives to deregulate all industries except for those specified in the negative list. The limited liberalization initiated in 1980s reached its summit with a landmark policy change in 1991.

INDUSTRIAL POLICY 1991

This policy slated a paradigm shift in the appraisal of industrial policy and development. Increase in Fiscal shortfall and monetized deficit along with the global financial crises (Gulf war, oil crises) played a major role in beginning of the new episode in the history of industrial policy and economic progress. The objective of the policy was to maintain sustained growth in productivity, enhance gainful employment and realise optimal utilization of human resources, to accomplish international competitiveness and change India into a global player. Main emphasis of the policy was to liberate the industry from bureaucratic control.

Important modifications brought about by the policy were as under:

1. Abolition of industrial licensing for most industries barring few which were important because of strategic and security concerns and social environmental issues.
2. Significant role accorded to FDI. 51% FDI allowed in heavy industries and technologically important industries.
3. Automatic approval to technological agreements for promotion of technology and hiring foreign technology expertise.
4. Restructuring of PSUs to increase productivity, prevent over staffing, technology up gradation and to increase rate of return.
5. Disinvestment of PSUs to increase resources and increase private participation.

The policy realized that governmental intervention in investment decision of large companies through MRTP act has proved to be deterring for industrial growth. Hence thrust of the policy was more on controlling unfair and restrictive trade practices. Provisions restricting mergers, amalgamations and takeovers were replaced. Since then the LPG reforms initiated in 1991 has been considerably expanded.

Some of the measures are mentioned below.

1. Competition commission of India was established in 2003 so as to prevent practices having adverse impact on competition in markets.
2. A new North East Industrial Policy was introduced in 1997 for mitigating regional imbalances due to economic growth.
3. Focus on disinvestment of PSUs shifted from sale of minority stake to strategic stakes.
4. Focus on PP with government playing a facilitative role rather than regulatory role.
5. FDI limits increased in almost all the sectors including defense and telecommunications.

New Industrial Policy 1991

The year 1991 observed a radical change in the industrial policy governing industrial development in the country since independence. This major transformation opened new era which was to implement completely open economic system as compared to the previous mixed system. The country decided to follow the lines of capitalism. It is also believed that there was change from 'imperative' to 'indicative' planning under new system. Features of New Industrial Policy.

Industrial Licensing Policy

New industrial policy eradicated all industrial licensing, regardless of the level of investment, except for a short list of 18 industries related to the security and strategic concerns, social reasons, hazardous chemicals and overriding environmental reasons and items of elitist consumption. Nevertheless, of these 18 industries, 13 categories have been removed from the list gradually and currently only 5 category of health, strategic and security considerations industries need license viz. Alcohol, cigarettes, hazardous chemicals, electronic, aerospace and all types of defense equipment.

Policy on Public Sector

The 1956 Resolution had reserved 17 industries for the public sector. The 1991 industrial policy reduced this number to 8. Currently, **only 3 industries are reserved for government which include**

- ***Atomic Energy***
- ***Mining of Atomic Minerals***
- ***Railway Transport.***

The policy also advocated that those public enterprises which are constantly sick and which are suspect to be turned around will, for the formation of revival/ rehabilitation schemes, be referred to the Board for Industrial and Financial Reconstruction (BIFR), or other similar high level institutions created for the purpose, in order to protect the interests of workers likely to be affected by such rehabilitation package, a social security mechanism will be created.

Privatization/disinvestment: Government declared its plan to offer a part of government shareholding in the public sector enterprises to mutual funds, financial institutions, the general public and the personnel. A beginning in this direction was made in 1991-92 themselves by diverting part of the equities of selected public sector enterprises.

Monopolistic and Restrictive Trade Practice limit: Under the Monopolistic and Restrictive Trade Practice Act, all companies with assets above a certain size (Rs.100 crore since 1985) were grouped as MRTP firms. Such firms were allowed to enter selected industries only and this also on a case by case approval basis. In addition to control through industrial licensing, separate approvals were required by such huge firms for any investment applications. The New Industrial Policy removed the threshold limit in assets in respect of MRTP companies.

Policy on Foreign investment and Technology agreements: In transforming industrial policies in India, The New Industrial Policy developed a specified list of high technology and high investment priority industries, wherein automatic permission was to be made available for direct foreign investment up to 51 percent foreign equity. The industries in which automatic approval was approved included array of industrial activities in the capital goods and metallurgical industries, entertainment electronic, food processing and the services sectors having significant export potential. List of such industries is being expanded since then. Abolition of Phased Manufacturing Programs for New Projects: The main objective of these programs was indigenization of technology. These were in force in a number of engineering and electronic industries. The new policy abolished such program for future.

Removal of Mandatory Convertible Clause: In pre liberalization period, there was a mandatory convertible clause in loan agreement with borrower. According to this clause, banks had authority to convert their loan amount into equity whenever they feel so. This used to make them “owner’ from ‘lender’ in that enterprise. This clause was used by government as a tool to nationalize private firms. This was removed under new economic policy.

New economic policy was result of long period of incompetent supremacy of public sector. However, public sector by this time had built strong industrial base on which other industries can succeed in future. This was one of the objectives of Nehruvian model. Naturally, Industrial and economic growth remained gloomy during this period. Process of liberalization begun in 1980’s which demonstrated better performance of economy. Recent high growth cannot be attributed to initiatives of New industrial and economic policy as statistical evidence propose better performance from early 1980’s.

In post liberalization era, government has effective role of facilitator and controller. Some decisive indications toward this are replacing Foreign Exchange Regulation Act with Management Act, latter one being more liberal and less harsh. Correspondingly, MRTP act

was swapped by competition Act. Presently, foreign direct investment is allowed in many sectors, in many of them through automatic route. However, post 1991 growth is accused of uneven growth with upsetting social impact as government had taken back expenditure from social sectors too.

To summarize, economic liberalization started in 1991 in India of reviving economic policies, with the goal of creating the economy more market-oriented and increasing the role of private and foreign investment. Regarding industrial policies, it is apparent from the development of industrial policy that the governmental role in development has been widespread. The path to be followed towards industrial development has evolved over time. In early stages, the government adopted an inward-looking development policy which enforced the Indian industry to have low and inferior technology and throttled the growth of private sector. It disallowed the domestic industries from severe competition and therefore resulted in low productivity and limited its ability to expand employment prospects.

The focus on self-reliance and lack of investment in R&D acted as obstacles to technological development and hence led to the production of inferior quality of goods. There is strong belief that foreign merchandises are superior to Indian goods is still predominant in Indian society. It is well established that the condition of the nation after two centuries of exploitation and a shocking separation must be kept in mind before evaluating the progress of the continual industrial policy. Many factors like lack of tactical skills, low literacy levels, unskilled labour, and absence of technology were significant aspects of Indian economy before independence. It is said that, Industrial plans and policies and their revival has vital role for the economic growth of any country.

Privatization: Implications and Effects with Examples

Privatization occurs when a government-owned business, operation, or property becomes owned by a private, non-government party. Note that privatization also describes the transition of a company from being publicly traded to becoming privately held. This is referred to as corporate privatization.

How Privatization Works?

Privatization of specific government operations happens in a number of ways, though generally, the government transfers ownership of specific facilities or business processes to a private, for-profit company. Privatization generally helps governments save money and increase efficiency. In general, two main sectors compose an economy—the public sector and the private sector.

Privatization in India

In 1991 India made some major policy changes in their economic ideologies. There were stagnation and slow growth in the economy.

To tackle these problems the, then Finance Minister Dr. Manmohan Singh introduced some major economic reforms. Now, we call it the liberalization of the Indian Economy and the LPG reforms.

Privatization has a very broad meaning in economics. Everything that ranges from the introduction of private capital to selling government-owned assets to transitioning to a private economy.

As the definition of privatization is so very diverse let us take a look at the **three main features of privatization.**

Ownership Measures: The ownership of all public enterprises ultimately shifts to private owners. The denationalization can be complete or partial.

Organizational Measures: This is where we limit the control of the state in public companies. Some methods include holding company structuring, leasing. restructuring of the enterprises etc.

Operational Measures: Public organizations and companies were running into huge losses. So the efficiency of these companies was to be increased.

Conceptualization of Privatization in India

Delegation

Here via a contract or franchise or lease or grant etc. the government keeps the ownership and the responsibility of an enterprise.

But the private company will handle the daily activities and deliver the product or service. The state will remain an active participant in this process.

Divestment

The government will sell a majority stake of the enterprise to one or more private companies. It may keep some ownership but will be a minority stakeholder in the enterprise.

Displacement

The first step here will be deregulation. This will allow private players to enter the market. And slowly and gradually the private company will displace the public enterprise.

Here the private sector will compete with public companies and ultimately outperform them, causing the public enterprise to be displaced.

Disinvestment

Directly selling a portion or whole of a public enterprise to private parties.

Impact of Privatization on Indian Business Environment

Private companies always have a better incentive than public companies. The managers and officials of a private company have skin in the game, i.e. their income is related to the performance of the company. In public companies, such an incentive is not present. So privatization usually leads to higher efficiency in the company.

In a public company, there is a lot of political interference. This may dissuade the company from taking economically beneficial decisions. However, a private company will not let political factors affect their performance.

In public companies, at times the government can only think about the upcoming elections. So all their goals may be short-term in the process of trying to gain favours of the voting public. But a private company does not have such restrictions. They have long-term goals and ambitions and steer the company in the right direction.

Privatization will also increase competition in the market. Consequently, this has proved to be very beneficial to consumers. Healthy competitiveness in an economy will push efficiency and performances.

GLOBALIZATION: Meaning and Features

Globalization is the word used to describe the growing interdependence of the world's economies, cultures, and populations, brought about by cross-border trade in goods and services, technology, and flows of investment, people, and information. Countries have built economic partnerships to facilitate these movements over many centuries. But the term gained popularity after the Cold War in the early 1990s, as these cooperative arrangements shaped modern everyday life. This guide uses the term more narrowly to refer to international trade and some of the investment flows among advanced economies, mostly focusing on the Asia and Europe.

The wide-ranging effects of globalization are complex and politically charged. As with major technological advances, globalization benefits society as a whole, while harming certain groups. Understanding the relative costs and benefits can pave the way for alleviating problems while sustaining the wider payoffs.

Globalization or globalisation is the process of interaction and integration among people, companies, and governments worldwide. As a complex and multifaceted phenomenon, globalization is considered by some as a form of capitalist expansion which entails the integration of local and national economies into a global, unregulated market economy. Globalization has grown due to advances in transportation and communication technology. With the increased global interactions comes the growth of international trade, ideas, and culture. Globalization is primarily an economic process of interaction and integration that's associated with social and cultural aspects. However, conflicts and diplomacy are also large parts of the history of globalization, and modern globalization.

Features of Globalization

Liberalization

It stands for the freedom of the entrepreneurs to establish any industry or trade or business venture, within their own countries or abroad.

Free trade

It stands for free flow of trade relations among all the nations. It stands for keeping business and trade away from excessive and rigid regulatory and protective rules and regulations.

Globalization of Economic Activity

Economic activities are be governed both by the domestic markets and also the world market. It stands for the process of integrating the domestic economies with the world economy.

Liberalization of Import-Export System

It stands for liberalization of the import-export activity involving a free flow of goods and services across borders.

Privatization

Globalization stands for keeping the state away from ownership of means of production and distribution and letting the free flow of industrial, trade and economic activity among the people and their corporations.

Increased Collaborations

Encouraging the process of collaborations among the entrepreneurs with a view to secure rapid modernization, development and technological advancement, is a feature of Globalization.

Economic Reforms

Encouraging fiscal and financial reforms with a view to give strength to free trade, free enterprise and market forces of the world. Globalisation stands for integration and democratisation of the world's culture, economy and infrastructure through global investments.

Globalization Background

The progress of industrial revolution in the 20th century was accompanied by a replacement of the police state by a welfare state. The state came to be an active actor in the economic life of the society. In the socialist states, state ownership of means of production and distribution became the rule.

State-controlled command economies were operationalised and regarded as the best means for rapid socio-economic development. In several other countries, nationalization of key industries and enterprises was undertaken with a view to provide goods and services to the people. State began performing several socio-economic functions.

India, like several other new states, adopted a mixed economic model. Ownership and control over key industries was entrusted to the public sector. It was deemed essential for securing a better mobilisation of resources and for providing better services to the people. State regulation of economy and industry was practiced and the public sector was patronised by the state. Private sector was given a lesser role in the economic system.

However, the experience with the working of command economy and mixed economy models was found to be inadequate slow and unproductive. By 1980s economies of socialist countries began collapsing. Around 1985, Indian economy also began showing big strains. Indian public sector now appeared to be a liability and foreign exchange reserves came to be in very bad shape. Industrial growth became very slow and inflation assumed alarming proportions.

In 1990s, the world witnessed the collapse of socialist economies, in particular the Soviet economy and political system. In 1991, the USSR suffered a disintegration. The weaknesses of all socialist economies became fully clear and all socialist countries began witnessing a process of overthrow of socialist systems.

Liberalization of politics and economy came to be recognised as the necessity of the day. All countries of the world began realising the merits of the market economy, free trade, privatization, liberalization, delicensing and deregulation of trade, industry and business.

In July 1991, the Government of India decided to go in for liberalization of economy. A new economic policy was formulated and implemented with an emphasis new upon economic reforms. These were governed by the principles of liberalization, privatization, market economy, free trade, deregulation and delicencing. These reforms paved the way for initiating the process of liberalization and globalization of Indian economy. Similar changes were adopted by other states.

At the international level, all the states agreed to freely develop financial, business, trade and industrial relations among their people. Adoption of new trade and tariff agreement leading to the establishment of World Trade Organisation was made. Globalization became the order of the day.

Nature and Stages of Globalization

The aim of globalization is to secure socio-economic integration and development of all the people of the world through a free flow of goods, services, information, knowledge and people across all boundaries.

Globalization is seen as a conscious and active process of expanding business and trade across the borders of all the states. It stands for expanding cross-border facilities and economic linkages. This is to be done with a view to secure an integration of economic interests and activities of the people living in all parts of the world. The objective of making the world a truly inter-related, inter-dependent, developed global village governs the on-going process of globalization.

Globalization is the concept of securing real social economic, political and cultural transformation of the world into a real global community. It is considered to be the essential means for securing sustainable development of all the people of the world.

"Globalization represents the desire to move from national to a global sphere of economic and political activity". It seeks to transform the existing international economic system into a unified system of global economics. In the existing system, national economies are the major players. In the new system, the globalized economic and political activity will ensure sustainable development for the whole world.

"Globalization is both an active process of corporate expansion across borders and a structure of cross border facilities and economic linkages that has been steadily growing and changing." :Edward S.Herman

"Globalization is the process whereby social relations acquire relatively distance-less and borderless qualities." :Baylis and Smith

Advantage and Disadvantage of Globalization

<u>Advantages of Globalization</u>

Wider Markets

Globalization offers larger markets to domestic producers. Domestic firms can export their surplus output. They can understand the nature of foreign markets through direct and indirect marketing channels. Domestic firms can realize higher prices from foreign markets. Global operations help to improve public image which is helpful in attracting better talent.

Rapid Industrialization

Globalization helps in the free flow of capital and technology between countries. Global firms can acquire finance at lower cost of capital. Free flows of capital and technology from advanced countries help the developing countries to boost up their industrialization. Industrialization of developing countries leads to balanced development of all the countries.

Greater Specialization

Globalization enables the domestic firms to specialize in areas where they enjoy competitive or comparative advantage. By focusing on the functions or products of their core competence domestic firms can compete successfully in the international markets. Specialization also helps to save resources and promote exports of the country.

Competitive Gains

Globalization increase competition for domestic firms through imports and multinational corporations. Domestic firms learn about new products, new technologies and new management systems. They are under pressure to increase efficiency, introduce innovations and reduce costs. The domestic entrepreneurs who fail to learn from their foreign rivals suffer in the long run.

Higher Production

Globalization leads to spread up o manufacturing facilities in different countries. Firms with worldwide contacts can outsource funds, technology, distribution and other functions from anywhere in the world. They can negotiate subcontracting to remain focused on areas of their core competence. International outsourcing and subcontracting help to improve operational efficiency and o reduce costs.

Price Stabilization

Globalization can reduce price differences between countries. Free trade and international competition help to equalize price levels in international markets. Countries with a high degree of globalization can attract greater foreign investment which supplements domestic funds, brings in foreign and improves balance of payments.

Increase in Employment and Income

Globalization creates job opportunities in developing countries and the incomes of people increases due to increased industrialization.

Higher Standards of Living

Lower prices, better quality and higher incomes help to enhance consumption and living standards of people particularly in developing countries. Moreover, increased economic development enables the governments of these countries to provide better welfare facilities like education, health, sanitation, etc. There is all round increase in welfare and prosperity of public.

International Economic Cooperation

Globalization improves economic cooperation between nations in the form of trade agreements, international treaties, standardization of commercial procedures, avoidance of double taxation, intellectual property protection and so on. International cooperation also helps countries to harmonize their macroeconomic policies for their mutual benefit.

World Peace

Globalization promotes cultural exchange and mutual understanding among different nations. International cooperation and brotherhood contribute to peace and prosperity in the world.

Disadvantages of Globalization

Interdependence

Globalization increases interdependence between nations of the world. As a result, economic sovereignty and control over the domestic economy are reduced. There is a danger of foreign economic dominance over the developing economies.

Threat to Domestic Industry

Globalization leads to the establishment of manufacturing and marketing facilities by multinationals n developing countries. The domestic firms in these countries fail to face the

onslaught of multinationals. As a result they sell out to foreign firms. Cheap imports from china and other countries also kill domestic business particularly in the small sector. Availability of high quality foreign products reduces the demand for domestic products and domestic production is eroded.

Unemployment

Globalization leads to restructuring of industry. Technology upgradation and focus on areas of comparative advantage create unemployment and underemployment among low skilled workers. As a result income inequality, poverty and social unrest may increase.

Drain of Basic Resources

Globalization results in exploitation of natural resources and basic raw materials in developing countries. These countries are often the sellers of agricultural and other inputs and buyers of finished products. Talented human resources are also transferred to developed nations which offer better remuneration and career prospects. Economic underdevelopment of poor countries is the result of exploitative character of international trade.

Technological Dependence

Globalization offers readymade foreign technology which scuttles domestic research and development. Foreign technologies are available at a high cost and often are not adaptable to local conditions. Developing countries become technologically dependent on developed countries.

Alien Culture

Globalization promotes consumption patterns and lifestyles which are inconsistent with the local culture and values. It may lead to shift in the industrialization pattern contrary to the national priorities.

Now after looking at Globalization from both supportive and contradicting point of view; we can now take a stand on whether the claims against globalization are sustainable or not.

Based on the above points, we can firmly say that globalization is not responsible fully for the global economic situations alone. It might have played a part in the crisis, but it did not start the fire.

The one reason which can be held responsible for the mishap is the repeal of Glass Steagall Act. The claims that globalization is the culprit are true but only to little extent. The sub prime mortgage crisis spread around the globe because of globalization and as a result, led to a sharp surge in the inflation rates.

TRADE CYCLE: INTRODUCTION AND THEORIES OF TRADE CYCLE

A trade cycle refers to fluctuations in economic activities specially in employment, output and income, prices, profits etc. It has been defined differently by different economists. According to Mitchell, “Business cycles are of fluctuations in the economic activities of organized communities. The adjective ‘business’ restricts the concept of fluctuations in activities which are systematically conducted on commercial basis.

Features of a Trade Cycle

(i) A business cycle is synchronic. When cyclical fluctuations start in one sector it spreads to other sectors.

(ii) In a trade cycle, a period of prosperity is followed by a period of depression. Hence trade cycle is a wave like movement.

(iii) Business cycle is recurrent and rhythmic; prosperity is followed by depression and vice versa.

(iv) A trade cycle is cumulative and self-reinforcing. Each phase feeds on itself and creates further movement in the same direction.

(v) A trade cycle is asymmetrical. The prosperity phase is slow and gradual and the phase of depression is rapid.

(vi) The business cycle is not periodical. Some trade cycles last for three or four years, while others last for six or eight or even more years.

(vii) The impact of a trade cycle is differential. It affects different industries in different ways.

(viii) A trade cycle is international in character. Through international trade, booms and depressions in one country are passed to other countries.

Theories of Trade Cycle

Many theories have been put forward from time to time to explain the phenomenon of trade cycles. These theories can be classified into non-monetary and monetary theories.

Non-Monetary Theories of Trade Cycle

(a) Sunspot Theory or Climatic Theory

It is the oldest theory of trade cycle. It is associated with W.S.Jevons and later on developed by H.C.Moore. According to this theory, the spot that appears on the sun influences the climatic conditions. When the spot appears, it will affect rainfall and hence agricultural crops.

When there is crop failure, that will result in depression. On the other hand, if the spot did not appear on the sun, rainfall is good leading to prosperity. Thus, the variations in climate are so regular that depression is followed by prosperity.

However, this theory is not accepted today. Trade cycle is a complex phenomenon and it cannot be associated with climatic conditions. If this theory is correct, then industrialised countries should be free from cyclical fluctuations. But it is the advanced, industrialised countries which are affected by trade cycles.

(b) Psychological Theory

This theory was developed by A.C. Pigou. He emphasized the role of psychological factor in the generation of trade cycles. According to Pigou, the main cause for trade cycle is optimism and pessimism among business people and bankers. During the period of good trade, entrepreneurs become optimistic which would lead to increase in production.

The feeling of optimism is spread to other. Hence investments are increased beyond limits and there is over production, which results in losses. Entrepreneurs become pessimistic and reduce their investment and production. Thus, fluctuations are due to optimism leading to prosperity and pessimism resulting depression.

Though there is an element of truth in this theory, this theory is unable to explain the occurrence of boom and starting of revival. Further this theory fails to explain the periodicity of trade cycle.

(c) Over investment Theory

Arthur Spiethoff and D.H. Robertson have developed the over investment theory. It is based on Say's law of markets. It believes that over production in one sector leads to over production in other sectors. Suppose, there is over production and excess supply in one sector, that will result in fall in price and income of the people employed in that sector. Fall in income will lead to a decline in demand for goods and services produced by other sectors. This will create over production in other sectors.

Spiethoff has pointed out that over investment is the cause for trade cycle. Over investment is due to indivisibility of investment and excess supply of bank credit. He gives the example of a railway company which lays down one more track to avoid traffic congestion. But this may result in excess capacity because the additional traffic may not be sufficient to utilise the second track fully.

Over investment and overproduction are encouraged by monetary factors. If the banking system places more money in the hands of entrepreneurs, prices will increase. The rise in prices may induce the entrepreneurs to increase their investments leading to over-investment. Thus Prof. Robertson has successfully combined real and monetary factors to explain business cycle.

This theory is realistic in the sense that it considers over investment as the cause of trade cycle. But it has failed to explain revival.

(d) Over-Saving or Under Consumption Theory

This theory is the oldest explanation of the cyclical fluctuations. This theory has been formulated by Malthus, Marx and Hobson. According to this theory, depression is due to over-saving. In the modern society, there is great inequalities of income. Rich people have large income but their marginal propensity to consume is less.

Hence they save and invest which results in an increase in the volume of goods. This causes a general glut in the market. At the same time, as majority of the people are poor, they have low propensity to consume. Therefore, consumption will not increase. Increase in

the supply of goods and decline in the demand create under consumption and hence over production.

This theory is not free from criticism. This theory explains only the turning point from prosperity to depression. It does not say anything about recovery. This theory assumes that the amount saved would be automatically invested. But this is not true. It pays too much attention on saving and too little on others.

(e) Keynes' Theory of Trade Cycles

Keynes doesn't develop a complete and pure theory of trade cycles. According to Keynes, effective demand is composed of consumption and investment expenditure. It is effective demand which determines the level of income and employment.

Therefore, changes in total expenditure i.e., consumption and investment expenditures, affect effective demand and this will bring about fluctuation in economic activity. Keynes believes that consumption expenditure is stable and it is the fluctuation in investment expenditure which is responsible for changes in output, income and employment.

Investment depends on rate of interest and marginal efficiency of capital. Since rate of interest is more or less stable, marginal efficiency of capital determines investment. Marginal efficiency of capital depends on two factors – prospective yield and supply price of the capital asset. An increase in MEC will create more employment, output and income leading to prosperity. On the other hand, a decline in MEC leads to unemployment and fall in income and output. It results in depression.

During the period of expansion businessmen are optimistic. MEC is rapidly increasing and rate of interest is sticky. So entrepreneurs undertake new investment. The process of expansion goes on till the boom is reached. As the process of expansion continues, cost of production increases, due to scarcity of factors of production. This will lead to a fall in MEC. Further, price of the product falls due to abundant supply leading to a decline in profits.

This leads to depression. As time passes, existing machinery becomes worn out and has to be replaced. Surplus stocks of goods are exhausted. As there is a fall in price of raw-materials and equipment, costs fall. Wages also go down. MEC increases leading to recovery. Keynes states that, "Trade cycle can be described and analyzed in terms of the fluctuations of the marginal efficiency of capital relatively to the rate of interest".

The merit of Keynes' theory lies in explaining the turning points-the lower and upper turning points of a trade cycle. The earlier economists considered the changes in the amount of credit given by banking system to be responsible for cyclical fluctuations. But for Keynes, the change in consumption function with its effect on MEC is responsible for trade cycle.

Keynes, thus, has given a satisfactory explanation of the turning points of the trade cycle, "Keynes consumption function filled a serious gap and corrected a serious error in the previous theory of the business cycle".

Critics have pointed out the **weakness of Keynes' theory.** ***Firstly,*** according to Keynes the main cause for trade cycle is the fluctuations in MEC. But the term marginal efficiency of capital is vague. MEC depends on the expectations of the entrepreneur about future. In this sense, it is similar to that of Pigou's psychological theory. He has ignored real factors.

Secondly, Keynes assumes that rate of interest is stable. But rate of interest does play an important role in decision making process of entrepreneurs.

Thirdly, Keynes does not explain periodicity of trade cycle. In a period of recession and depression, according to Keynes, rate of interest should be high due to strong liquidity preference. But, during this period, rate of interest is very low. Similarly during boom, rate of interest should be low because of weak liquidity preference; but actually the rate of interest is high.

(f) Schumpeter's Innovation Theory

Joseph A. Schumpeter has developed innovation theory of trade cycles. An innovation includes the discovery of a new product, opening of a new market, reorganization of an industry and development of a new method of production. These innovations may reduce the cost of production and may shift the demand curve. Thus innovations may bring about changes in economic conditions.

Suppose, at the full employment level, an innovation in the form of a new product has been introduced. Innovation is financed by bank loans. As there is full employment already, factors of production have to be withdrawn from others to manufacture the new product. Hence, due to competition for factors of production costs may go up, leading to an increase in price.

When the new product becomes successful, other entrepreneurs will also produce similar products. This will result in cumulative expansion and prosperity. When the innovation is adopted by many, supernormal profits will be competed away. Firms incurring losses will go out of business. Employment, output and income fall resulting in depression.

Schumpeter's theory has been criticised on the following grounds.

Firstly, Schumpter's theory is based on two assumptions viz., full employment and that innovation is being financed by banks. But full employment is an unrealistic assumption, as no country in the world has achieved full employment. Further innovation is usually financed

by the promoters and not by banks. **Secondly**, innovation is not the only cause of business cycle. There are many other causes which have not been analysed by Schumpter.

4. Monetary Theories of Trade Cycles

(a) Over-Investment Theory

Prof. Von Hayek in his books on “Monetary Theory and Trade Cycle” and “Prices and Production” has developed a theory of trade cycle. He has distinguished between equilibrium or natural rate of interest and market rate of interest. Market rate of interest is one at which demand for and supply of money are equal.

Equilibrium rate of interest is one at which savings are equal to investment. If both equilibrium rate of interest and market rate of interest are equal, there will be stability in the economy. If equilibrium rate of interest is higher than market rate of interest there will be prosperity and vice versa.

For instance, if the market rate of interest is lower than equilibrium rate of interest due to increase in money supply, investment will go up. The demand for capital goods will increase leading to a rise in price of these goods. As a result, there will be a diversion of resources from consumption goods industries to capital goods industries. Employment and income of the factors of production in capital goods industries will increase.

This will increase the demand for consumption goods. There will be competition for factors of production between capital goods and consumption good industries. Factor prices go up. Cost of production increases. At this time, banks will decide to reduce credit expansion. This will lead to rise in market rate of interest above the equilibrium rate of interest. Investment will fall; production declines leading to depression.

Hayek’s theory has certain weaknesses:-

It is not easy to transfer resources from capital goods industries to consumer goods industries and vice versa.

This theory does not explain all the phases of trade cycle.

It gives too much importance to rate of interest in determining investment. It has neglected other factors determining investment.

Hayek has suggested that the volume of money supply should be kept neutral to solve the problem of cyclical fluctuations. But this concept of neutrality of money is based on old quantity theory of money which has lost its validity.

(b) Hawtrey's Monetary Theory

Prof. Hawtrey considers trade cycle to be a purely monetary phenomenon. According to him non-monetary factors like wars, strike, floods, drought may cause only temporary depression. Hawtrey believes that expansion and contraction of money are the basic causes of trade cycle. Money supply changes due to changes in rates of interest.

When rate of interest is reduced by banks, entrepreneurs will borrow more and invest. This causes an increase in money supply and rise in price leading to expansion. On the other hand, an increase in the rate of interest will lead to reduction in borrowing, investment, prices and business activity and hence depression.

Hawtrey believes that trade cycle is nothing but small scale replica of inflation and deflation. An increase in money supply will lead to boom and vice versa, a decrease in money supply will result in depression.

Banks will give more loans to traders and merchants by lowering the rate of interest. Merchants place more orders which induce the entrepreneurs to increase production by employing more labourers. This results in increase in employment and income leading to an increase in demand for goods. Thus the phase of expansion starts.

Business expands; factors of production are fully employed; price increases further, resulting in boom conditions. At this time, the banks call off loans from the borrowers. In order to repay the loans, the borrowers sell their stocks. This sudden disposal of goods leas to fall in prices and liquidation of marginal firms. Banks will further contract credit.

Thus the period of contraction starts making the producers reduce their output. The process of contraction becomes cumulative leading to depression. When the economy is at the level of depression, banks have excess reserves. Therefore, banks will lend at a low rate of interest which makes the entrepreneurs to borrow more. Thus revival starts, becomes cumulative and leads to boom.

Hawtrey's theory has been criticised on many grounds

Hawtrey's theory is considered to be an incomplete theory as it does not take into account the non-monetary factors which cause trade cycles.

It is wrong to say that banks alone cause business cycle. Credit expansion and contraction do not lead to boom and depression. But they are accentuated by bank credit.

The theory exaggerates the importance of bank credit as a means of financing development. In recent years, all firms resort to plough back of profits for expansion.

Mere contraction of bank credit will not lead to depression if marginal efficiency of capital is high. Businessmen will undertake investment in-spite of high rate of interest if they feel that the future prospects are bright.

Rate of interest does not determine the level of borrowing and investment. A high rate of interest will not prevent the people to borrow. Therefore, it may be stated that banking system cannot originate a trade cycle. Expansion and contraction of credit may be a supplementary cause but not the main and sole cause of trade cycle.

Various Phases of Trade Cycle

Four phases of a trade cycle are: 1. Prosperity, 2. Recession, 3. Depression, 4. Recovery Phase!

1. Prosperity phase: Expansion or the upswing.

2. Recessionary phase: A turn from prosperity to depression (or upper turning point).

3. Depressionary phase: Contraction or downswing.

4. Revival or recovery phase: The turn from depression to prosperity (or lower turning point).

The above four phases of a trade cycle are shown in Fig. 1. These phases are recurrent and follow a regular sequence.

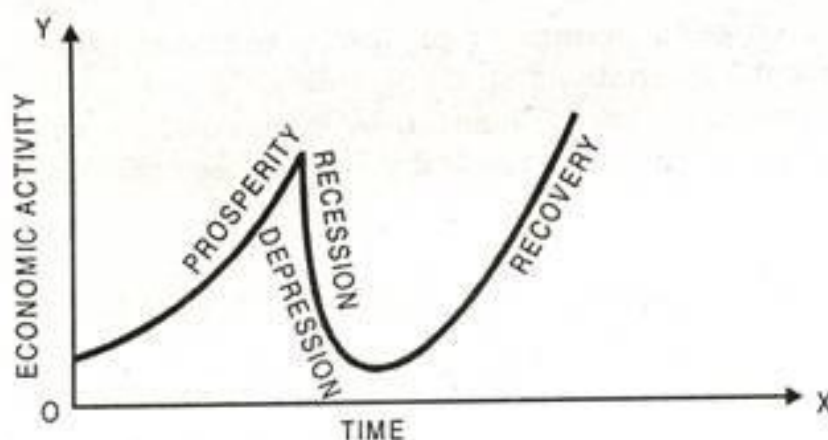


Fig. 1 The Phases of a Trade Cycle

The Phases of a Trade Cycle

This means that when prosperity ends, recession starts; depression follows recession; recovery follows depression; prosperity comes after recovery and in turn gives way to recession. Thus, each phase always appears when the immediately preceding phase has run its course. It should be remembered that no phase has any definite periodicity or time interval.

Prosperity

Haberler defines prosperity as “a state of affairs in which the real income consumed, real income produced and level of employment are high or rising and there are no idle resources or unemployed workers or very few of either.”

As Haberler points out, the characteristic features of prosperity are (i) a high level of output and trade, (ii) a high level of effective demand; (iii) a high level of employment and income; (iv) a high marginal efficiency of capital; (v) a price inflation; (vi) a rising structure of interest rate; (vii) a large expansion of bank credit; (viii) overall business optimism, and (ix) tendency of the economy to operate at almost full capacity along its production possibility frontier.

The prosperity phase comes to an end when the forces favouring expansion become progressively weak. Bottlenecks begin to appear at the peak of prosperity. In fact, the profit-inflation and over-optimism which increase the tempo carry with them the seeds of self-destruction.

In view of high profits and business optimism, entrepreneurs invest more and expand further. But scarcity of resources, particularly, the shortage of raw materials and labour causes bottlenecks and business calculations go wrong. Hence entrepreneurs become over-cautious and the peak of prosperity and their over-optimism pave the way to over-pessimism. Thus, prosperity digs its own grave.

Recession

When prosperity ends, recession begins. Recession relates to a turning point rather than a phase. It lasts relatively for a shorter period of time. It marks the point at which the forces that make for contraction finally win over the forces of expansion. Liquidation in the stock market, repayment of bank loans and the decline of prices are its outward symptoms.

The stock market is the first to experience the downfall as there will be sudden and violent changes in the prevailing atmosphere. During a recession, businessmen lose confidence. Everyone feels pessimistic about the future profitability of investment. Hence, investment will be drastically curtailed and production of capital goods industries will fall.

During the recessionary phase, the banking system and the people in general try to attain greater liquidity. Therefore, credit sharply contracts. Business expansion stops, orders are cancelled and workers are laid off. There is a general drive to contract the scale of operations, leading to increase in unemployment; thus, income throughout the economy falls. Reduced income causes a decrease in aggregate expenditure and thus, the general demand falls, in turn, prices, profit and business decline.

Depression

During a depression, the most deplorable conditions prevail in the economy. Real income consumed, real income produced and the rate of employment fall or reach subnormal levels due to idle resources and capacity.

As Haberler points out, the characteristic features of a depression are the reverse of prosperity:

(i) Shrinkage in the volume of output, trade and transactions;

(ii) Rise in the level of unemployment;

(iii) Price deflation;

(iv) Fall in the aggregate income of the community (especially wages and profits);

(v) Fall in the structure of interest rates;

(vi) Curtailment in consumption expenditure and reduction in the level of effective demand;

(vii) Collapse of the marginal efficiency of capital and decline in the investment demand function;

(viii) Contraction of bank credit, etc.

In short, a depressionary period is characterised by an overall curtailment of aggregate economic activity and its bottom. Thus, depression and prosperity differ in degree rather than in kind. In the former economic activity is at its trough, while in the latter, economic activity is at its peak.

However, a depression cannot be regarded as a permanent feature of an economy. In fact, the very forces which cause the depression are themselves self- defeating. For, during a depression, businessmen postpone replacement of their plant and machinery and

consumers postpone the purchase of durable goods. Hence the need for replacement and the purchase of durable goods gradually accumulate.

Hence, after a period of time, there will be a moderate increase in the purchase of durable goods on the consumer's part and replacement of plant and machinery on the part of producers. This will call for an increase in production, in turn leading to an increase in employment, income and aggregate effective demand. Banks will be anxious to expand credit by reducing the rate of interest. Gradually, pessimism vanishes and optimism develops and economic activity once again gathers momentum. Thus, a stage of recovery sets in.

Recovery Phase

The revival or recovery phase refers to the lower turning point at which an economy undergoes change from depression to prosperity. With an improvement in demand for capital goods, recovery sets in. When the demand for consumption goods rises or when the capital stock increases, the demand for capital goods will rise and new investment will be induced.

Such induced investment will cause a rise in employment and income. The increased income in turn will lead to a rise in consumption which will push up the demand further which in turn leads to a rise in prices, profits, further investment, employment and income.

The increased income in turns will lead to a rise in consumption which will push up the demand further which in turns leads to a rise in prices, profits, further investment, employment and income. Once the expansionary movement starts, this is how it gathers momentum. During the revival period, level of employment output and income slowly and steadily improve. Stock markets become more sensitive during this period.

A bullish atmosphere will prevail on the stock exchanges. An increase in stock prices favours expansion and hasten revival. The expectations of the entrepreneurs improve and business optimism leads to the stimulation of development investment.

The wave of recovery, once initiated, begins to feed upon itself. Thus, during a recessionary period, the expansionary process will be self-reinforcing and if it is continued for some time, the economy will find itself in a position of rising level of income, output and employment. When this happens, revival slowly emerges into prosperity and the cycle repeats itself.

A business cycle is a complex phenomenon which embraces the entire economic system. It can scarcely be traced to any single cause. Normally a business cycle is caused and conditioned by a number of factors, both exogenous and endogenous.

Various theories have been expounded by different economists to explain the cause of a trade cycle, the symptoms of which are alternating periods of prosperity and depression.

Different explanations stressing one or a few factors at a time have been advanced by economists. A brief review of important trade cycle theories has been attempted in the following sections.

Hicks Theory of Trade Cycle

Hicks put forward a complete theory of business cycles based on the interaction between the multiplier and accelerator by choosing certain values of marginal propensity to consume (c) and capital- output ratio (v) which he thinks are representative of the real world situation.

According to Hicks, the values of marginal propensity to consume and capital-output ratio fall in either region C or D of Fig. 1.

As seen above, in case values of these parameters lie in the region C, they produce cyclical movements (i.e., oscillations) whose amplitude increases overtime and if they fall in region D1 they produce an explosive upward movement of income or output without oscillations. To explain business cycles of the real world which do not tend to explode, Hicks has incorporated in his analysis the role of buffers.

On the one hand, he introduces output ceiling when all the given resources are fully employed and prevent income and output to go beyond it, and, on the other hand, he visualizes a floor or the lower limit below which income and output cannot go because some autonomous investment is always taking place.

Another important features of Hicks' theory is that business cycles in the economy occur in the background of economic growth (i.e., the rising trend of real income of output over time). In other words, cyclical fluctuations in real output of goods and services take place above and below this rising line of trend or growth of income and output. Thus in his theory he explains business cycles along with an equilibrium rate of growth.

In Hicks' theory of long-run equilibrium growth that is determined by rate of increase of autonomous investment over time and, therefore, long-run equilibrium growth of income is determined by the autonomous investment and the magnitudes of multiplier and accelerator. Hicks assumes that autonomous investment, depending as it is on technological progress, innovations and population growth, grows at a constant rate.

With further assumptions of stable multiplier and accelerator, equilibrium income will grow at the same rate as autonomous investment. It follows therefore that the failure of actual output to increase along the equilibrium growth path, sometimes to move above it and sometimes to move below it, determines the business cycles.

Hicks' theory of business cycles has been explained with the help of Fig. 13.7. In this figure, AA line represents autonomous investment. Autonomous investment is that investment which is not induced by changes in income and is made by entrepreneur as a result of

technological progress or innovations or population growth. Hicks assumes that autonomous investment grows annually at a constant rate given by the slope of the line AA.

Given the marginal propensity to consume, the simple multiplier is determined. Then the magnitude of multiplier and autonomous investment together determine the equilibrium path of income shown by the line LL. Hicks calls this the floor line as this sets the lower limits below which income (output) cannot fall because of a given rate of growth of autonomous investment and the given size of the multiplier. But induced investment has not yet been taken into account.

If national income grows from one year to the next, as it would move along the line LL, there is some amount of induced investment via accelerator. The line EE shows the equilibrium growth path of national income determined by autonomous investment and the combined effect of the multiplier and accelerator. FF is the full employment ceiling. It is a line that shows the maximum national output at any period of time when all the available resources of the economy are fully employed.

Given the constant growth of autonomous investment, the magnitude of multiplier and the induced investment determined by the accelerator, the economy will be moving along the equilibrium growth path line EE. Thus starting from point E, the economy will be in equilibrium moving along the path EE determined by the combined effect of multiplier and accelerator and the growing level of the autonomous investment.

Suppose when the economy reaches point P0 along the path EE, there is an external shock—say an outburst of investment due to certain innovation or jump in governmental investment. When the economy experiences such an outburst of autonomous investment it pushes the economy above the equilibrium growth path EE after point P0.

The rise in autonomous investment due to external shock causes national income to increase at a greater rate than that shown by the slope of EE. This greater increase in national income will cause further increase in induced investment through acceleration effect. This increase in induced investment causes national income to increase by a magnified amount through multiplier.

So under the combined effect of multiplier and accelerator, national income or output will rapidly expand along the path from P0 to P1. Movement from PQ to P1 represents the upswing or expansion phase of the business cycle. But this expansion must stop at P1 because this is the full employment output ceiling. The limited human and material resources of the economy do not permit a greater expansion of national income than shown by the ceiling line CC.

Therefore, when point P1 is reached the rapid growth of national income must come to an end. Prof. Hicks assumes that the full employment ceiling grows at the same rate as autonomous investment. Therefore, CC slopes gently unlike the very steep slope of the line

from P0 to P1. When point P1 is reached the economy must grow at the same rate as the usual growth in autonomous investment.

For a short time the economy may crawl along the full employment ceiling CC. But because national income has ceased to increase at the rapid rate, the induced investment via accelerator falls off to the level consistent with the modest rate of growth determined by the constant rate of growth of autonomous investment. But the economy cannot crawl along its full employment ceiling for a long time.

The sharp decline in growth of income and consumption when the economy strikes the ceiling causes a sharp decline in induced investment. Thus with the sharp decline in induced investment when national income and hence consumption ceases to increase rapidly, the contraction in the level of the income and business actually must begin.

Once the downswing starts, the accelerator works in the reverse direction. That is, since the change in income is now negative the inducement to invest must begin to decrease. Thus there is slackening off at point P2 and national income starts moving toward equilibrium growth path EE. This movement from P2 downward therefore represents the downswing or contraction phase of the business cycle.

In this downswing investment falls off rapidly and therefore multiplier works in the reverse direction. The fall in national income and output resulting from the sharp fall in induced investment will not stop on touching the level EE but will go further down. The economy must consequently move all the way down from point P2 to point Q1. But at point Q1 the floor has been reached.

Whereas the upswing was limited by the output ceiling set by the full employment of available resources, in the downswing the national income cannot fall below the level of output represented by the floor. This is because the floor level is determined by simple multiplier and autonomous investment growing at constant rate, while during the downswing after a point accelerator ceases to operate.

It may be noted that during downswing the limit to negative investment (disinvestment) and therefore the limit to the contraction of output is set by the depreciation of capital stock. There is no way for the businessmen to make disinvestment at a desired rate higher than the depreciation.

When during downswing such conditions arise, accelerator becomes inoperative. After hitting the floor the economy may for some time crawl along the floor through the path Q1 to Q2. In doing so, there is some growth in the level of national income. This rate of growth as before induces investment and both the multiplier and accelerator come into operation and the economy will move towards Q3 and the full employment ceiling CC. This is how the upswing of cyclical movement again starts.

Assumptions of Hicks Theory of Trade Cycle

The following assumptions were made to develop his theory of the trade cycle:

(i) In Hicksian analysis, a progressive economy is assumed in which autonomous investment is increasing at a regular rate, so that system is such which could remain in progressive equilibrium.

(ii) The saving and investment coefficients are such that an upward displacement from the equilibrium path will tend to cause a movement away from equilibrium, though this movement may be lagged.

(iii) There is no direct restraint upon upward expansion in the form of a scarcity of employable resources provided by the full employment ceiling i.e., it is impossible for the output to expand beyond full employment level.

(iv) Though there is no direct constraint on the contraction yet the transformation of accelerator in the downswing (i.e., disinvestment cannot exceed depreciation) provides an indirect constraint.

(v) There are fixed values of the multiplier and accelerator throughout the different phases of a cycle, i.e., consumption function and investment function are both assumed to be constant.

(vi) However, in Hicksian analysis both the multiplier and accelerator are treated with a lag. He treats multiplier as a lagged relation, so that consumption in period t is regarded as a function of income of the previous period t – 1 and not of current period t. He also uses accelerator with a time lag i.e., induced investment in present period also responds to output changes in the previous period.

Keynes Theory of Trade cycle

Keynes did not build up his own exclusive theory of the trade cycle. But he made such important contributions to the analysis of depressions and inflation that his disciples could give a systematic account of the upturn and the downturn in economic activity. In his General Theory, Keynes thought it sufficient to add “Notes on the Trade Cycle.”

These notes did not comprise a complete theory of the trade cycle because no attempt was made here to give a detailed account of the various phases of the trade cycle. Keynes did not examine closely the empirical data of cyclical fluctuations. All the same, Keynes provided the analytical tools for the purpose of building a complete theory.

According to Keynes, business cycle is caused by variations in the rate of investment caused by fluctuations in the Marginal Efficiency of Capital. The term ‘marginal efficiency of capital’ means the expected profits from new investments. Entrepreneurial activity depends upon profit expec-tations. In his business cycle theory, Keynes assigns the major role to expectations.

Business cycles are periodic fluctuations of employment, income and output. According to Keynes, income and output depend upon the volume of employment. The volume of employment is determined by three vari-ables: the marginal efficiency of capital, the rate of interest and the propen-sity to consume.

In the short period the rate of interest and the propensity to consume are more or less stable. Therefore, fluctuations in the volume of employment are caused by fluctuations in the marginal efficiency of capital.

The Keynesian theory of trade cycle is summarised below:

Crucial Role of Investment

Keynes maintained that trade cycles are essentially caused by variations in the rate of investment due to the fluctuations in the marginal efficiency of capital. The changes in investment are made worse by the changes induced by the cycle itself in propensity to consume and the state can be described and analyzed in terms of the fluctuations of the marginal efficiency of capital relatively to the rate of interest.” Thus fluctuations in MEC were considered by Keynes to be the root cause of the trade cycle.

In Keynes’ view, the marginal efficiency of capital depends mainly upon two factors:

- **The series of prospective yields from investment in the new capital assets, and**
- **The supply price (replacement cost) of the new capital assets.**

These two factors are based upon the psychology of the investors. Therefore, they can change at any time and very rapidly. MEC is based on expectations of the businessmen. At one time, there can be wave of optimism which pushes up the MEC. At another time, there can be a pessimistic mood in the market for new capital assets which depresses the MEC considerably.

In Keynes' view, introduction of the sudden changes in MEC and hence of investment was the key to the understanding of business cycles. Both the downturn and the upturn in economic activity are the result of sudden and substantial changes in investment.

The Upswing in Economic Activity

During the expansion phase of the trade cycles, the investors have an optimistic outlook. They have a firm confidence of the high profitability of the investment in new capital assets. They have a multiplier effect. Income rises much faster than the rise in investment. In a period of rising income, output and employment, the optimism of the investor gets further support. Therefore, expansion of economic activity goes on automatically till full employment of resources is reached.

The movement of the economy towards full employment is called a boom. The rate of interest rises fast during the boom phase. But the exclusive optimism on the part of investors' does not allow the rate of interest to act as a brake on rising investment. If investment were to be done on the basis of cold calculations, new investments would not take place once the rate of interest gets equaled with the MEC.

As the boom proceeds, the profitability of investment must fall owing to three factors:

(i) The tendency towards diminishing marginal return due to the growing supply of capital assets;

(ii) The rising cost of production of capital assets; and

(iii) Rise in the rate of interest.

But businessmen tend to ignore the fall in MEC because of over-optimism on their part. To quote Keynes, "A boom is a situation in which over-optimism triumphs over a rate of interest which, in a cooler light, would be seen to be excessive."

Recession and Depression

The continued rise in investment approaches progressively a point where the additional capital goods would not be demanded. It is a point of saturation of demand for capital

goods. Rising cost of production of capital assets, the declining prospective yields, appearance of shortages and bottlenecks in production, excessive competition and the abundance of manufactured goods are unmistakable signs of the impending recession. Consequently, the over-optimism of the boom condition is followed by pessimism.

The wave of pessimism spreads fast. In this situation, the marginal efficiency of capital collapses with a suddenness which is catastrophic. Share markets often collapse. Investors lose confidence, output falls, unemployment increases. There seems to be glut of capital goods in the market. Thus, the contraction phase sets in.

Economic contraction proceeds at a rapid pace because the multiplier operates in the reverse direction and reduces income much faster than the decline in investment. Another force which speeds up the contraction is the rapid rise in the rate of interests after the collapse of investment markets. The relatively faster rise in the rate of interest during the contraction phase is due to the sudden increase in liquidity preference of the people during a period of falling prices.

Keynes attributed sudden rise in liquidity preference to the following three factors which operate in depression:

(a) People expect the security prices to fall further which leads the owners of securities to sell them before they suffer a further capital loss. Since there are few buyers of securities, their prices fall and the rate of interest rises to the extent the security prices fall.

(b) When the general price level is falling, consumers continue to postpone their purchases and hold on to cash. As the value of money increases, the demand for cash jumps up.

(c) The producers are forced to liquidate their inventories to meet their contractual obligations in the form of rents and salaries to permanent staff. They try to raise loans for the purpose which further adds to the demand for cash.

All these three factors raise the liquidity preference of the people and hence the rate of interest. While the rate of interest thus rises, the MEC continues to fall. This dampens investment activity further. The business world is overtaken by depression. Actually, the situation should not be as bad as it looks, but investors become over- pessimistic. It is very difficult for the government to revive their confidence in the investment market.

This is because the government can try to reduce the rate of interest through increased money supply. The governments cannot guarantee profitability of investment. Banks may offer loans at concessional rates but investors may not avail of these loans. Thus, monetary policy alone fails to revive economic activity in a depression. The low rate of investment generates a low level of equilibrium income in the economy. This is what Keynes called 'Under-employment Equilibrium'. This equilibrium tends to be stable for some time.

Recovery of the economy from the state of depression necessitates the use of fiscal policy. Tax concessions and other incentives for investment activity along with public investment alone take the economy out of the depths of depression.

Recovery is a Slow and Halting Process

The process of expansion of economic activity is slow after depression.

The time taken by the economy to recover depends among others upon the following three factors:

One, the normal rate of growth of the economy. This may be relatively high or relatively low. A high normal rate of growth hastens recovery a low rate of growth retards it.

Two, the time period of obsolescence/wearing out of the capital goods. The longer the life of capital goods, the longer it takes the economy to recover and vice-versa. Shorter life-spans of the capital goods require investments at an early date for replacement of these goods. This reduces the time for recovery.

Three, the time taken to dispose of accumulated stocks from the boom period. If the entrepreneurs happen to have already sold off the stocks of semi-finished and finished goods during the recession phase of the cycle, even a slight improvement in the climate of investment facilitates recovery. On the opposite, revival of economic activity shall be delayed to the extent producers have unsold stocks. Till old stocks get exhausted, new investments cannot be made.

The recovery is thereby slowed down. Generally it takes 3 to 5 years to absorb the stocks of the firms which they accumulate from the boom phase. Therefore, this is the minimum time for a depression to last. The maximum time of a depression depends upon the other factors, most important of which is the level of consumption of the people during depression.

We are now in a position to summarise the distinct contributions Keynes made to the explanation of trade cycles. Firstly, Keynes made it clear that trade cycles are fluctuations of

economic activity around an equilibrium level. The equilibrium level of economic activity is determined mainly by non-induced (autonomous) investment.

Secondly, Keynes could provide, for the first time, a convincing explanation of the turning points of the trade cycle. This he could successfully do with the help of his theory of the consumption function. The collapse in the investment market is caused by excessive investment as compared to real savings under the consumption function of the people.

The lower turning point is marked where income becomes equal to consumption and there is no net saving or investment Thirdly, Keynes could show why the downturn of the economy is sudden while the recovery process is generally slow. Thirdly, the cumulative nature of the upswing and downswing was explained by Keynes with the help of his concept of the investment multiplier. The multiplier works in the upswing to raise income fast while it works in the backward direction to reduce income fast in the downswing.

INFLATION

Inflation is often defined in terms of its supposed causes. Inflation exists when money supply exceeds available goods and services. Or inflation is attributed to budget deficit financing. A deficit budget may be financed by the additional money creation. But the situation of monetary expansion or budget deficit may not cause price level to rise. Hence the difficulty of defining ‘inflation’.

In economics, inflation (or less frequently, price inflation) is a general rise in the price level in an economy over a period of time. When the general price level rises, each unit of currency buys fewer goods and services; consequently, inflation reflects a reduction in the purchasing power per unit of money a loss of real value in the medium of exchange and unit of account within the economy. The opposite of inflation is deflation, a sustained decrease in the general price level of goods and services. The common measure of inflation is the inflation rate, the annualized percentage change in a general price index, usually the consumer price index, over time.

Economists believe that very high rates of inflation and hyperinflation are harmful, and are caused by an excessive growth of the money supply. Views on which factors determine low to moderate rates of inflation are more varied. Low or moderate inflation may be attributed to fluctuations in real demand for goods and services, or changes in available supplies such as during scarcities. However, the consensus view is that a long-sustained period of inflation is caused by money supply growing faster than the rate of economic growth.

Inflation affects economies in various positive and negative ways. The negative effects of inflation include an increase in the opportunity cost of holding money, uncertainty over future inflation which may discourage investment and savings, and if inflation were rapid enough, shortages of goods as consumers begin hoarding out of concern that prices will increase in the future. Positive effects include reducing unemployment due to nominal wage rigidity, allowing the central bank more leeway in carrying out monetary policy, encouraging loans and investment instead of money hoarding, and avoiding the inefficiencies associated with deflation.

Inflation may be defined as ‘a sustained upward trend in the general level of prices’ and not the price of only one or two goods. G. Ackley defined inflation as ‘a persistent and appreciable rise in the general level or aver-age of prices. In other words, inflation is a state of rising prices, but not high prices.

It is not high prices but rising price level that con-stitute inflation. It constitutes, thus, an over-all increase in price level. It can, thus, be viewed as the devaluing of the worth of money. In other words, inflation reduces the purchasing power of money. A unit of money now buys less. Inflation can also be seen as a recurring phenomenon.

While measuring inflation, we take into ac-count a large number of goods and services used by the people of a country and then cal-culate average increase in the prices of those goods and services over a period of time. A small rise in prices or a sudden rise in prices is not inflation since they may reflect the short-term workings of the market.

It is to be pointed out here that inflation is a state of disequilib-rium when there occurs a sustained rise in price level. It is inflation if the prices of most goods go up. Such rate of increases in prices may be both slow and rapid. However, it is difficult to detect whether there is an upward trend in prices and whether this trend is sus-tained. That is why inflation is difficult to define in an unambiguous sense.

Types of Inflation:

On the Basis of Causes:

(i) Currency inflation:

This type of infla-tion is caused by the printing of cur-rency notes.

(ii) Credit inflation:

Being profit-making institutions, commercial banks sanction more loans and advances to the public than what the economy needs. Such credit expansion leads to a rise in price level.

(iii) Deficit-induced inflation:

The budget of the government reflects a deficit when expenditure exceeds revenue. To meet this gap, the government may ask the central bank to print additional money. Since pumping of additional money is required to meet the budget deficit, any price rise may the be called the deficit-induced inflation.

(iv) Demand-pull inflation:

An increase in aggregate demand over the available output leads to a rise in the price level. Such inflation is called demand-pull in-flation (henceforth DPI). But why does aggregate demand rise? Classical economists attribute this rise in aggre-gate demand to money supply. If the supply of money in an economy ex-ceeds the available goods and services, DPI appears. It has been described by Coulborn as a situation of “too much money chasing too few goods.”

Keynesians hold a different argu-ment. They argue that there can be an autonomous increase in aggregate de-mand or spending, such as a rise in con-sumption demand or investment or government spending or a tax cut or a net increase in exports (i.e., C + I + G + X – M) with no increase in money sup-ply. This would prompt upward adjust-ment in price. Thus, DPI is caused by monetary factors (classical adjustment) and non-monetary factors (Keynesian argument).

(v) Cost-push inflation:

Inflation in an economy may arise from the overall increase in the cost of production. This type of inflation is known as cost-push inflation (henceforth CPI). Cost of pro-duction may rise due to an increase in the prices of raw materials, wages, etc. Often trade unions are blamed for wage rise since wage rate is not completely market-determinded. Higher wage means high cost of production. Prices of commodities are thereby increased.

A wage-price spiral comes into opera-tion. But, at the same time, firms are to be blamed also for the price rise since they simply raise prices to expand their profit margins. Thus, we have two im-portant variants of CPI wage-push in-flation and profit-push inflation.

On the Basis of Speed or Intensity:

(i) Creeping or Mild Inflation:

If the speed of upward thrust in prices is slow but small then we have creeping inflation. What speed of annual price rise is a creeping one has not been stated by the economists? To some, a creeping or mild inflation is one when annual price rise varies between 2 p.c. and 3 p.c. If a rate of price rise is kept at this level, it is con-sidered to be helpful for economic development. Others argue that if annual price rise goes slightly beyond 3 p.c. mark, still then it is considered to be of no danger.

(ii) Walking Inflation:

If the rate of annual price increase lies between 3 p.c. and 4 p.c., then we have a situation of walking inflation. When mild inflation is allowed to fan out, walking inflation appears. These two types of inflation may be described as ‘moderate inflation’.

Often, one-digit inflation rate is called ‘moder-ate inflation’ which is not only predict-able, but also keep people’s faith on the monetary system of the country. Peoples’ confidence get lost once moderately maintained rate of inflation goes out of control and the economy is then caught with the galloping inflation.

(iii) Galloping and Hyperinflation:

Walking inflation may be converted into running inflation. Running inflation is danger-ous. If it is not controlled, it may ulti-mately be converted to galloping or hyperinflation. It is an extreme form of inflation when an economy gets shatter-ed." Inflation in the double or triple digit range of 20, 100 or 200 p.c. a year is labelled "galloping inflation".

(iv) Government's Reaction to Inflation:

In-flationary situation may be open or suppressed. Because of anti-infla-tionary policies pursued by the govern-ment, inflation may not be an embar-rassing one. For instance, increase in income leads to an increase in con-sumption spending which pulls the price level up.

If the consumption spending is countered by the govern-ment via price control and rationing device, the inflationary situation may be called a suppressed one. Once the government curbs are lifted, the sup-pressed inflation becomes open infla-tion. Open inflation may then result in hyperinflation.

MAIN CAUSES OF INFLATION

Inflation can arise from internal and external events

Some inflationary pressures direct from the domestic economy, for example the decisions of utility businesses providing electricity or gas or water on their tariffs for the year ahead, or the pricing strategies of the food retailers based on the strength of demand and competitive pressure in their markets.

A rise in the rate of VAT would also be a cause of increased domestic inflation in the short term because it increases a firm's production costs.

Inflation can also come from external sources, for example a sustained rise in the price of crude oil or other imported commodities, foodstuffs and beverages.

Fluctuations in the exchange rate can also affect inflation, for example a fall in the value of the pound against other currencies might cause higher import prices for items such as foodstuffs from Western Europe or technology supplies from the United States, which feeds through directly or indirectly into the consumer price index..

EFFECTS OF INFLATION

Effects of Inflation on Production

- Inflation may or may not result in an increase in production
- As long as the economy does not reach the full employment stage, inflation has a favorable effect on production
- Usually, as the price level increases, profits increase too
- During inflation, businessmen tend to raise the prices of their products to earn better profits
- However, if the wages and production costs start rising rapidly, then this favorable effect of inflation does not last long
- If the inflation in an economy is of the cost-push type, then the inflationary situation usually leads to a fall in production
- There is no direct correlation between prices and output
- Effects of Inflation on the Distribution of Wealth

Inflation has the following effects on the distribution of wealth:

- Some people might gain at the cost of others. As the sellers will be able to sell the goods at a higher rate to its customers due to inflation.
- A certain set of people gain because their money income rises faster than the prices
- A different set of people lose because prices rise faster than their incomes during inflation
- Effects of Inflation on Different Categories of People

Debtors and Creditors

- During inflation, borrowers tend to gain. Hence, lenders tend to lose.
- Borrowers gain because they repay less in real terms as compared to when they had borrowed the money
- Lenders lose because when they receive repayment of their debts, the real value of their money declines by the amount of increase in the price levels
- In other terms, a borrower receives ‘dear rupees’ but pays back ‘cheap rupees.

Bond and Debenture Holders

- Debenture and Bond Holders earn fixed income on their investments
- Therefore, when the price levels rise, they suffer a reduction in real income
- Beneficiaries of life insurance programs also suffer badly because the real value of their savings deteriorates

Investors

During inflation, businesses have an opportunity to earn good profits. Therefore, people who invest in shares during inflation tend to gain. As the businesses earn higher profits, they usually distribute the profit among investor and shareholders too.

Salaried People and Wage-earners

During inflation, people earning a fixed income face a lot of damage because the rate of increase in wages is always behind the rate of increase in prices.

Therefore, inflation results in a drop in the real purchasing power of people earning a fixed income. Hence, people earning a flexible income tend to gain during inflationary periods.

Profit Earners, Speculators, and Black Marketeers

- During inflation, the profit-earners gain
- Businessmen also raise the prices of their products and earn bigger profits
- Speculators gain by inflation, especially when the prices of factors of production increase too
- Black marketeers tend to gain since the price of products increases with time.
- Effect on Developing Countries

Which theory of inflation can explain inflation in developing countries. Of course, the rise in prices has come about as a result of excess of aggregate demand over aggregate supply. In other words, inflation in the developing countries is mainly of demand-pull variety.

However, how this excess demand for goods and services has been caused is issue at dispute. In our view both the Keynesian and Friedman's views are relevant to explain the emergence of excess demand for goods. To promote rapid economic growth a hunge investment expenditure has been made in India in successive development plans.

If this increase in investment expenditure had been financed by raising resources through taxation, Government borrowings from the public, profits of public undertakings, then the increase in investment expenditure would have been matched by increase in savings with the result that excess demand for goods had not arisen.

As a matter of fact, a good deal of increase in investment expenditure has been financed by deficit financing i.e., through creating of new money by the central bank. Besides, the increase in private investment expenditure has also been financed to a good extent by expansion of credit or demand deposits by the commercial banks.

This increase in investment expenditure for promoting economic growth has been made possible by the expansion in money supply, which as emphasized by Friedman and other monetarists, causes prices to rise through creating excess demand for goods and services.

Thus, it is hard to distinguish whether it is increase in investment expenditure as such or expansion in money supply to finance it which has caused demand-pull inflation in the face of slow growth of output of goods, especially foodgrains and other essential consumer goods. Indeed, both have played a part in causing inflationary situation in India.

What has caused the inflationary pressures in India's developing economy? To think that only demand-pull factors or excess demand generated by huge budget deficits and huge growth in money supply are responsible for the problem of inflation facing the Indian economy would not be fully correct.

As a matter of fact, both types of factors, namely, demand-pull and cost push factors have operated to cause inflation in India, which crossed the two-digit figure in some years. As a result of rapid growth in Government expenditure without corresponding increase in mobilisation of resources, the Government has resorted to heavy deficit financing (i.e., the creation of new money).

This has further created the conditions of excess demand in the economy which have led to the rise in general price level. Besides, the increase in petroleum prices, many times during the last few years, the hike in administered prices of steel, cement, coal, fertilizers, increase in indirect taxes on several commodities, in increase railway fares and freights have all led to the cost-push inflation or what is also called supply-side inflation.

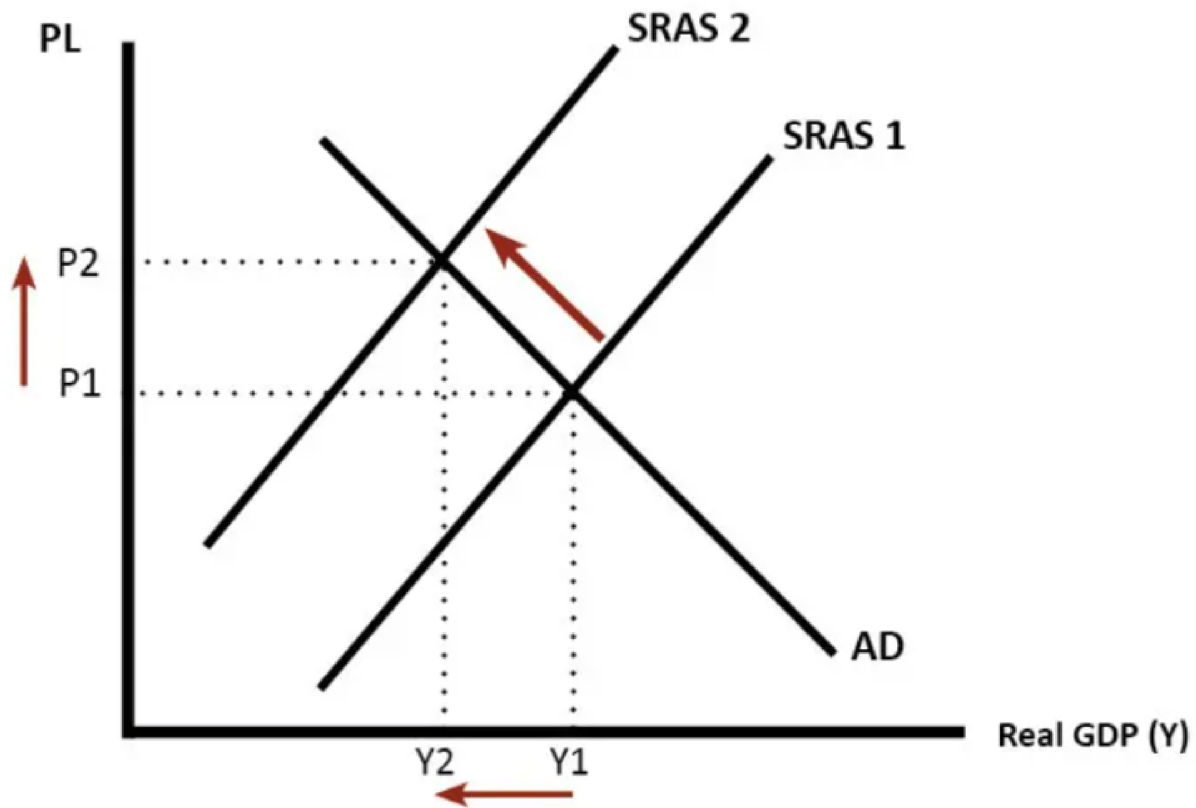
Now, when due to the demand pull inflation, the general price-level rises, the demand for rise in wages and deafness allowance are made by the working classes and they have to be conceded to in view of the rising cost of living. The rise in wages and dearness allowance of the workers raises the cost of production.

The increases in cost of production due to higher wages and clearness allowance also cause the aggregate supply curve to shift to the left and bring about cost-push or supply-side inflation. Thus there has been persistent rise in prices under the combined impact of demand-pull factors caused by the large budget deficits arid cost-push factors due to the hike in administrated prices of petroleum, steel, cement, coal etc., and increase In indirect tax's on commodities such as sugar, cloth, cooking gas, soaps, cold-drink, etc.

Cost push inflation

Cost-push inflation is a type of inflation caused by substantial increases in the cost of important goods or services where no suitable alternative is available. Higher prices are then the result, as costs of production increases due to a decreased aggregate supply. It stands in contrast to demand-pull inflation. Both accounts of inflation have at various times been put forward with oftentimes inconclusive evidence as to which explanation is superior.

Cost-push inflation occurs when we experience rising prices due to higher costs of production and higher costs of raw materials. Cost-push inflation is determined by supply-side factors, such as higher wages and higher oil prices.



Cost-push inflation is different to demand-pull inflation which occurs when aggregate demand grows faster than aggregate supply.

Cost-push inflation can lead to lower economic growth and often causes a fall in living standards, though it often proves to be temporary.

A situation that has been often cited of this was the oil crisis of the 1970s, which some economists see as a major cause of the inflation experienced in the Western world in that decade. It is argued that this inflation resulted from increases in the cost of petroleum imposed by the member states of OPEC.

Since, petroleum is so important to industrialized economies, a large increase in its price can lead to the increase in the price of most products, raising the price level. Some economists argue that such a change in the price level can raise the inflation rate over longer periods, due to adaptive expectations and the price/wage spiral, so that a supply shock can have persistent effects.

Causes

Higher Price of Commodities. A rise in the price of oil would lead to higher petrol prices and higher transport costs. All firms would see some rise in costs. As the most important commodity, higher oil prices often lead to cost-push inflation (e.g. 1970s, 2008, 2010-11)

Imported Inflation. A devaluation will increase the domestic price of imports. Therefore, after a devaluation, we often get an increase in inflation due to rising cost of imports.

Higher Wages. Wages are one of the main costs facing firms. Rising wages will push up prices as firms have to pay higher costs (higher wages may also cause rising demand)

Higher Taxes. Higher VAT and Excise duties will increase the prices of goods. This price increase will be a temporary increase.

Profit-push inflation. If firms gain increased monopoly power, they are in a position to push up prices to make more profit

Higher Food Prices. In western economies, food is a smaller % of overall spending, but in developing countries, it plays a bigger role.

Policies to Reduce Cost-Push Inflation

Policies to reduce cost-push inflation are essentially the same as policies to reduce demand-pull inflation.

The government could pursue deflationary fiscal policy (higher taxes, lower spending) or monetary authorities could increase interest rates. This would increase the cost of borrowing and reduce consumer spending and investment.

The problem with using higher interest rates is that although it will reduce inflation it could lead to a big fall in GDP.

For example, in early 2008, we had a high period of inflation (5%) due to rising oil and food prices. Central banks kept interest rates high, but this pushed the economy into recession. Arguably, interest rates should have been lower and less importance attached to reducing cost-push inflation.

In 2010, we might see a period of cost-push inflation, but, the Central Bank may need to adopt a certain flexibility in inflation targeting. There is no point in rigidly sticking to an inflation target if the inflation is caused by temporary factors.

The long-term solution to cost-push inflation could be better supply-side policies which help to increase productivity and shift the AS curve to the right. But, these policies would take a long time to have an effect.

DEMAND PULL INFLATION

Demand-pull inflation is asserted to arise when aggregate demand in an economy outpaces aggregate supply. It involves inflation rising as real gross domestic product rises and unemployment falls, as the economy moves along the Phillips curve. This is commonly described as "too much money chasing too few goods. "More accurately, it should be described as involving "too much money spent chasing too few goods," since only money that is spent on goods and services can cause inflation. This would not be expected to happen, unless the economy is already at a full employment level. It is the opposite of cost-push inflation.

Causes of demand-pull inflation

- There is a quick increase in consumption and investment along with extremely confident firms.
- There is a sudden increase in exports due to huge under-valuation of the currency.
- There is a lot of government spending.

- The expectation that inflation will rise often leads to a rise in inflation. Workers and firms will increase their prices to 'catch up' to inflation.
- There is excessive monetary growth, when there is too much money in the system chasing too few goods. The 'price' of a good will thus increase.
- There is a rise in population.

A depreciation of the exchange rate which makes exports more competitive in overseas markets leading to an injection of fresh demand into the circular flow and a rise in national and demand for factor resources – there may also be a positive multiplier effect on the level of demand and output arising from the initial boost to export sales.

Higher demand from a government (fiscal) stimulus e.g. via a reduction in direct or indirect taxation or higher government spending and borrowing. If direct taxes are reduced, consumers will have more disposable income causing demand to rise. Higher government spending and increased borrowing feeds through directly into extra demand in the circular flow.

Monetary stimulus to the economy: A fall in interest rates may stimulate too much demand, for example in raising demand for loans or in causing rise in house price inflation.

Faster economic growth in other countries, Providing a boost to UK exports overseas.

Improved business confidence which prompts firms to raise prices and achieve better profit margins

Demand-pull inflation means:

- Excess demand and 'too much money chasing too few goods.'
- The economy is at (or ver close to) full employment/full capacity.
- The economy will be growing at a rate faster than the long-run trend rate.
- A falling unemployment rate.

How demand-pull inflation occurs

If aggregate demand is rising at 4%, but productive capacity is only rising at 2.5%; firms will see demand outstripping supply. Therefore, they respond by increasing prices.

Also, as firms produce more, they employ more workers, creating a rise in employment and fall in unemployment. This increased demand for workers puts upward pressure on wages, leading to wage-push inflation. Higher wages increase the disposable income of workers leading to a rise in consumer spending.

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