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Phase - I/II

Volume - 5

Economics & Management

SIERRA INNOVATIONS

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1 CHAPTER

Demand for Money

- The **demand for money** refers to the desire of individuals to hold assets in the form of money rather than illiquid physical assets. It is also called **liquidity preference**.
- Unlike consumer goods, money is not demanded for its own sake. Its demand is **derived** because money serves two key functions:
  - ✓ **Medium of Exchange** – facilitates buying and selling of goods and services.
  - ✓ **Store of Value** – preserves purchasing power over time.
- The demand for money is crucial because the value of money depends on it.

Approaches to the Demand for Money

Classical Approach

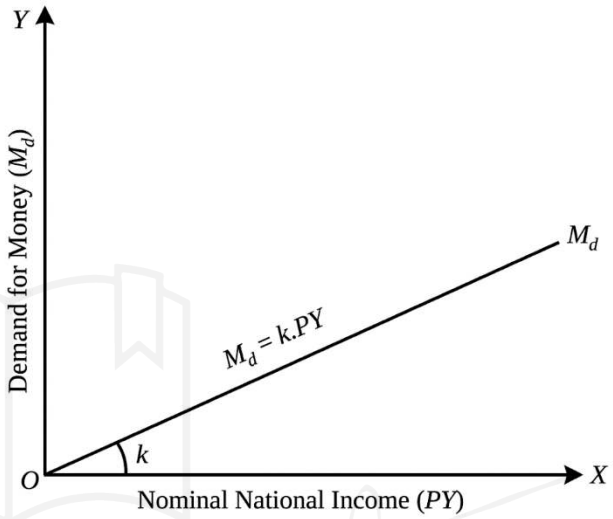
- Money has no intrinsic utility and is demanded mainly for transactions.
  - ✓ **Fisher's Transaction Approach:**
    - Irving Fisher, in *Purchasing Power of Money*, developed the most famous classical view, linking the quantity of money to price levels.
    - **Equation of Exchange:** MV = PT, where:
      - ☞ M = Total money supply
      - ☞ V = Velocity of circulation
      - ☞ P = General price level
      - ☞ T = Total transactions or goods/services exchanged
    - Assumptions:
      - ☞ M is fixed by the Central Bank (exogenous).
      - ☞ Full employment exists, so T depends on national income and is fixed in the short run.
      - ☞ V (velocity) is constant in the short run due to stable institutional and technological factors.
    - Money market equilibrium occurs when **money supply = money demand**, that is $M^d = M$
    - Rearranging Fisher's equation gives: $M^d = PT / V$
    - Therefore, **demand for money** depends on:
      - ☞ Number of transactions (T)
      - ☞ General price level (P)
      - ☞ Velocity of money (V)

Limitations of Fisher's Approach

- Fisher's quantity theory of money is based on **unrealistic assumptions**, such as full employment of resources and stable expenditure patterns.
- The theory assumes that factors like **velocity of money (V)** and **number of transactions (T)** remain constant. In reality, a change in money supply (M) affects both V and T, as one change often triggers adjustments in other variables.
- While the cash transactions equation highlights money's role as a **medium of exchange**, it **neglects money's important function as a store of value**, which is a significant limitation.

Cambridge Cash-Balance Theory of Demand for Money

- Proposed by Cambridge economists **Marshall and Pigou**, this theory differs from Fisher's transaction approach by emphasizing **money as a store of value (wealth)** rather than merely a medium of exchange.
- The theory focuses on the factors that determine an individual's desire to hold **cash balances**.
- While acknowledging that **interest rates, personal wealth, expectations of future prices, and future interest rates** influence money demand, Cambridge economists assumed these factors either remain constant or change proportionally with an individual's income.
- Therefore, the **demand for cash balances** is assumed to be proportional to nominal income: $M_d = kPY$
  - ✓ Y = Real national income
  - ✓ P = Average price level of goods and services
  - ✓ PY = Nominal income
  - ✓ k = Proportion of nominal income that individuals wish to hold as cash
- It can be seen from that demand for money (M_d) in this Cambridge cash-balance approach is a linear linear function of nominal income.
- The slope of the function is equal to k, that is, $k = M_d / P_y$
- Thus an important feature of the cash-balance approach is that it makes the demand for money as a function of money income alone.
- Thus, it is a proportional function of both price level (P) and real income (F).



Limitations of the Cambridge Cash-Balance Approach

- Critics argue that factors such as **interest rates, personal wealth, and expectations of future prices or interest rates** are not formally incorporated in the Cambridge theory; they remain only in the background.
- The theory assumes that the **income elasticity of demand for money** is equal to one, but Cambridge economists did not provide a theoretical justification for this, nor is there strong empirical support.
- Similarly, the **price elasticity of demand for money** is not necessarily one; changes in the price level may lead to **non-proportional changes** in money demand.

Keynes' Theory of Demand for Money

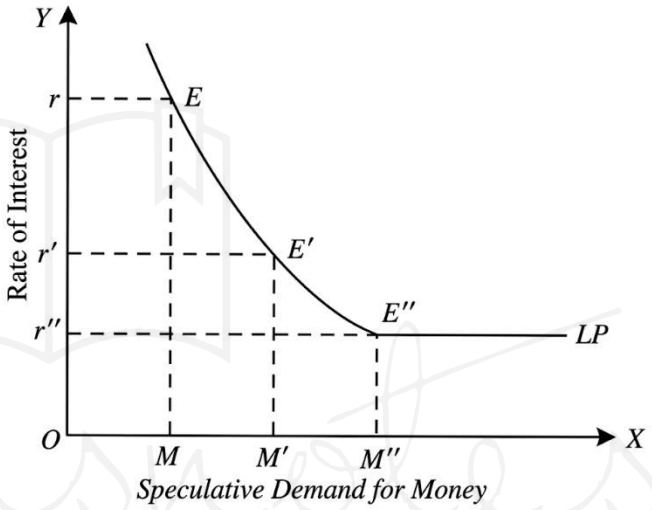
- Proposed by **John Maynard Keynes** in *The General Theory of Employment, Interest, and Money* (1936).
- The theory seeks to answer:
  - ✓ Why is money demanded?
  - ✓ What are the key determinants of money demand?

Why Money is Demanded

- Money does not earn income, yet people hold it instead of income-yielding assets.
- Keynes identified **three motives** for holding money:
  1. **Transactions Motive**
     - Money is demanded for everyday transactions, to bridge the gap between income receipt and expenditure.

- Determinants include:
  - ☞ Size of income
  - ☞ Frequency of income receipt
  - ☞ Methods of payments in the economy
- Businesses and entrepreneurs also need money to meet daily operational expenses (raw materials, wages, transport, etc.).
- The transaction's demand depends on **real income** and is **not influenced by interest rates**.

2. **Precautionary Motive**
   - Money is held as a buffer against **unforeseen contingencies** such as illness, unemployment, accidents, or other emergencies.
   - The amount depends on individual psychology and living conditions.
3. **Speculative Motive**
   - Money is held to take advantage of **future market movements**, particularly changes in interest rates or bond prices.
   - Functions as a **store of value**, but for speculative gains rather than precaution.
   - **Mechanism:**
     - ☞ If bond prices are expected to rise (interest rates fall), people buy bonds to profit from future price increases.
     - ☞ If bond prices are expected to fall (interest rates rise), people sell bonds to avoid losses.
   - **Inverse relationship:**
     - ☞ Higher current interest rates → less money held for speculation (opportunity cost of holding cash is high).
     - ☞ Lower current interest rates → more money held for speculation (less is lost by not investing).



Liquidity Trap

- At very low interest rates, the **liquidity preference (LP) curve** becomes almost flat, i.e., perfectly elastic, forming a horizontal line beyond point E.
- This perfectly elastic portion reflects **absolute liquidity preference**, where people hold any amount of money they have as idle balances instead of investing.
- Economists call this phenomenon a **liquidity trap**, because increases in money supply remain trapped in idle balances, having **no effect on interest rates** or investment levels.
- According to Keynes, the existence of a liquidity trap makes **monetary policy ineffective** in combating economic depression.
- The speculative demand for money depends more on **expectations of future interest rates** than on the current interest rate.
- Changes in expectations shift the entire speculative demand curve accordingly.

Aggregate Demand for Money: Keynes' View

- Total demand for money (M^a) can be expressed as: $M_d = M_1 + M_2$, where:
  - ✓ M_1 = Money held for **transactions and precautionary motives**
  - ✓ M_2 = Money held for **speculative motive**

- **Transactions and Precautionary Demand (M_1):**
  - ✓ Interest-inelastic except at very high interest rates
  - ✓ Primarily determined by income: $M_1 = L_1(Y)$. Where L_1 is the demand function and (Y) is income
- **Speculative Demand (M2):**
  - ✓ Primarily depends on the interest rate: $M_2 = L_2(r)$, where L_2 is the demand function for speculative motive and (r) is the rate of interest.
- **Total Money Demand:** $M_d = M_1 + M_2 = L_1(Y) + L_2(r) = L(Y, r)$
- Thus, **Keynesian theory** states that the demand for money is a function of both **income and interest rate**.

Critiques of Keynes' Theory of Money Demand

- **Speculative Demand Limitation:** Keynes assumed that people hold assets as either all money or all bonds, which is unrealistic. In practice, individuals hold a **mixture of money and bonds**. This limitation led to the development of the **portfolio approach** by Tobin, Baumol, and Friedman.
- **Transaction Demand Limitation:** Keynes assumed that money held for transactions is **insensitive to interest rates**. Modern theories by **Baumol and Tobin** show that transaction balances are **interest-elastic**.
- **Additive Function Limitation:** Keynes' additive form of money demand, $M_d=L_1(Y)+L_2(r)$, has been rejected. A single unit of money can serve **multiple motives**, so money demand cannot be divided neatly into separate, independent components.

Keynes' Liquidity Preference Theory of Interest

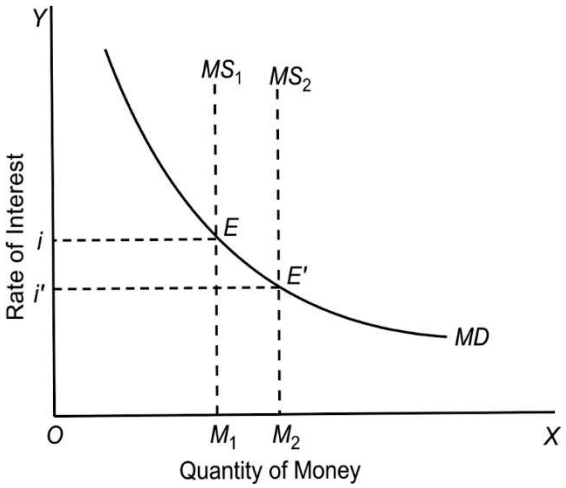
- In *The General Theory of Employment, Interest, and Money*, Keynes presented a **monetary theory of the rate of interest**.
- According to him, the **interest rate** is a reward for parting with liquidity for a certain period. People prefer liquidity (money) for various motives, so they require a **reward- interest - for giving it up**.
- **Liquidity Preference Theory:** The rate of interest is determined by the **demand for money (liquidity preference)** and the **supply of money**.
- **Assumptions:**
  - ✓ A simplified economy with two types of assets in people's portfolios:
    - **Money** – currency and demand deposits, earning no interest
    - **Long-term bonds**

Determinants of Portfolio Choice:

1. **Income Effect:**
   - ✓ Higher **nominal income** → more purchases → greater **transactions demand for money** → people hold more money in their portfolios.
2. **Interest Rate Expectations:**
   - ✓ If the current interest rate is **higher than expected future rates**, people prefer bonds over money.
     - If the current interest rate is **low (bond prices high)**, people prefer holding money to avoid potential **capital losses** from falling bond prices in the future.
   - ✓ Thus, the **interest rate adjusts** to balance money demand (liquidity preference) with money supply.

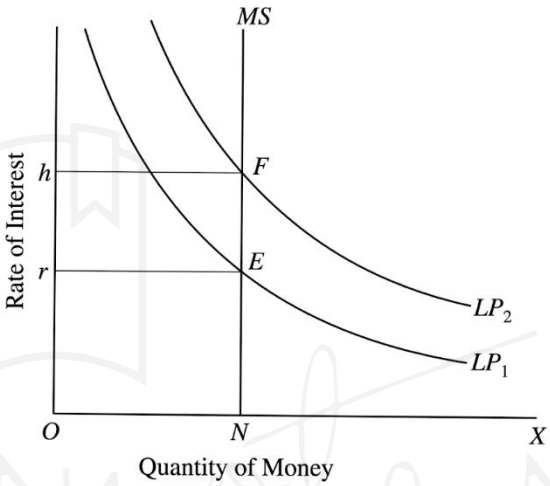
Effect of an Increase in the Money Supply

- Let **MD** represent the demand for money to satisfy various motives.
- Let **OM_1** be the initial money supply. The **interest rate** is determined at the point where money demand equals this fixed money supply.
- At this equilibrium, the money demand equals the money supply at interest rate **i**.
- If the money supply increases from **OM_1** to **OM_2**, the interest rate falls from **i** to **i′**.
- Therefore, **given the liquidity preference curve**, an increase in money supply leads to a **decline in the interest rate**.



Shifts in Money Demand or Liquidity Preference Curve

- The position of money demand curve depends upon two factors
  - ✓ The level of nominal income
  - ✓ The expectations about the changes in bond prices in the future which implies changes in rate of interest in future.
- According to Keynes, demand for money for speculative motives together with the supply of money determines the rate of interest.
- Moreover, according to him, interest is not a reward for saving or thriftness or waiting but for parting with liquidity.
- Keynes asserted that it is not the rate of interest which equalizes saving an investment. But this equality is brought about through changes in level of income.

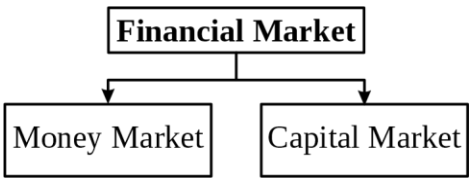


Critical Appraisal of Keynes' Liquidity Preference Theory

1. **Neglect of Real Factors:**
   - ✓ Keynes treated the **interest rate as purely monetary**, ignoring real factors like **productivity of capital** and **savings behavior**.
   - ✓ Businessmen's cash balances are influenced by their **capital investment demand**, which depends on the **marginal revenue productivity of capital**.
   - ✓ Therefore, the interest rate is **not independent** of capital productivity (marginal efficiency of capital) and investment demand.
2. **Indeterminacy of Interest Rate:**
   - ✓ Keynes' theory, like classical and loanable funds theories, is **indeterminate**.
   - ✓ While interest is determined by **liquidity preference** and **money supply**, the **transaction's demand for money** depends on income.
   - ✓ But income itself depends on **investment**, which is influenced by the interest rate.
   - ✓ Hence, the theory cannot pinpoint a **single determinate interest rate**; it varies with income.
3. **No Liquidity Without Savings:**
   - ✓ Keynes viewed interest as a reward for **parting with liquidity**, not as a reward for saving.
   - ✓ However, without prior **savings**, there can be no funds to hold as liquidity.
   - ✓ Thus, the **rate of interest is inherently linked to saving**, a factor neglected by Keynes.

2 CHAPTER Financial Markets

- A financial market is a platform where buyers and sellers trade financial assets like equities, bonds, currencies, and derivatives.
- Its main function is to channel funds from investors with surplus capital to borrowers in need of capital.
- These markets are usually marked by transparent pricing, basic trading regulations, and market-driven prices for securities.



Money Market

- The money market is a segment of the financial market where short-term, highly liquid financial assets with maturities of up to one year are traded.
- It addresses the short-term borrowing needs for working capital. Key institutions include commercial banks, RRBs and bill markets operating in these markets.

Money Market Instruments:

Money market instruments are used by governments, financial institutions and corporations to manage their short-term funding needs. Common money market instruments include:

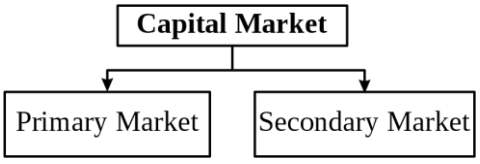
1. **Treasury Bills:**
   - ✓ They are short-term debt securities issued by the Indian government at a discount and redeemed at face value at maturity, with no interest.
   - ✓ Issued by the RBI on behalf of the central government through auctions (State governments not issues T-bills), T-bills can be bought in primary auctions, secondary markets or online platforms by individuals, trusts, institutions and banks.
   - ✓ Presently issued in three tenors, namely, 91 days, 182 days and 364 days.
2. **Cash Management Bills:**
   - ✓ They are issued by the Government in collaboration with the RBI to address short-term cash requirements.
   - ✓ They have a maturity period of under 91 days.
3. **State Development Loans:**
   - ✓ They are issued by State Governments to raise funds from the market.
   - ✓ These are dated securities with semi-annual interest payments and principal repayment at maturity.
   - ✓ SDLs are eligible for Statutory Liquidity Ratio (SLR) and can be used as collateral for market repo and RBI's Liquidity Adjustment Facility (LAF).
4. **Ways and Means Advances (WMA):**
   - ✓ They are short-term borrowings by the Government from the RBI to address temporary cash flow mismatches.
   - ✓ The loan is repayable within three months, with the repo rate applied.
   - ✓ If the repayment exceeds 90 days, a penal overdraft rate of 2% is charged.

5. **Commercial Paper:**
   - ✓ Commercial paper is an unsecured, short-term debt instrument issued by corporations to fund payroll, accounts payable, inventories, and other short-term obligations.
   - ✓ It usually has maturities of a few days to a maximum of 270 days and is issued at a discount to its face value, based on prevailing market interest rates.
   - ✓ In India, Commercial Papers (CPs) can be issued in denominations of ₹5 lakh or multiples thereof, as per the Reserve Bank of India (RBI) guidelines.
   - ✓ Draft, Cheques and Promissory Notes are some of the types of commercial papers.
6. **Commercial Bill:**
   - ✓ Commercial Bills are short-term negotiable instruments issued by sellers (drawers) to buyers (drawees) for goods supplied.
   - ✓ Maturity periods are usually 30, 60 or 90 days.
7. **Certificate of Deposit:**
   - ✓ A Certificate of Deposit (CD) is a negotiable, unsecured money market instrument offering higher interest in exchange for a fixed-term deposit.
   - ✓ Issued by banks and financial institutions, the minimum amount is Rs. 5 lakh.
   - ✓ Bank CDs mature in 7 days to one year, while financial institution CDs range from 1 to 3 years.
8. **Inter-Bank Call Money Market:**
   - ✓ The call money market is a short-term money market where large financial institutions borrow and lend at interbank rates, typically for up to a week.
   - ✓ The funds can be borrowed or raised for a maximum period from 2-14 days called Notice Money.
   - ✓ The period for term money is 14 days to 1 year.
   - ✓ These loans help banks meet reserve requirements & are used by other financial institutions, mutual funds, corporations and insurance companies as well.
9. **Collateralized Borrowing and Lending Obligation (CBLO):**
   - ✓ It is a money market instrument issued by the Clearing Corporation of India Ltd. (CCIL) for short-term borrowing and lending, with maturities ranging from 1 to 19 days.
   - ✓ It is secured by collateral, such as securities or cash, providing protection to the lender.
   - ✓ The borrower offers collateral in exchange for cash and repays the loan with interest at the end of the borrowing period.
10. **Promissory Note:**
   - ✓ A Promissory Note is a legal document in which the issuer agrees to repay a specified amount of money to the payee under defined terms and conditions.

Capital Market

- ➢ It is a segment of the financial market that deals with the borrowing and lending of medium to long-term funds for a period of over one year.
- ➢ It supports financing for long-term projects and investments, enabling the mobilization and allocation of funds with extended maturity periods.

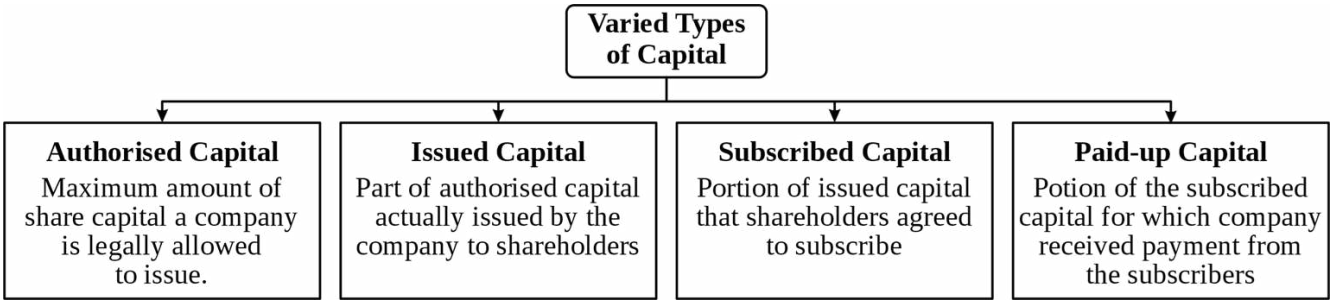
Types of Capital Market



Primary Market Vs Secondary Market

Primary Market	Secondary Market
Issuers raise capital by issuing securities to investors for the first time.	It facilitates trade in already-issued securities only.
Creates financial assets.	Makes the assets marketable.

Promotes capital formation directly, as the flow of funds is directly from savers to investors.	Promotes capital formation indirectly by enhancing the liquidity of the shares.
Only buying of securities takes place here; securities can't be sold here.	Both buying and selling take place here.
Prices are decided and determined by the company/issuing authority.	Prices are determined by the demand and supply of the security.



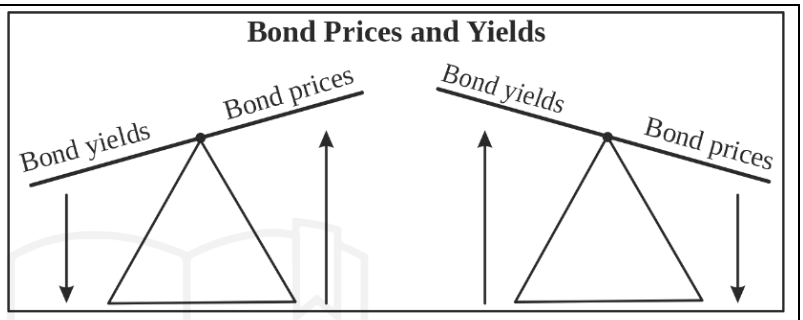
Capital Market Instruments:

- **Shares:** Shares represent units of ownership in a corporation or financial asset, entitling holders to an equal share of any declared profits, usually paid as dividends. The two primary types of shares are:
  - ✓ **Common Shares**: It offers profit through rising share prices and dividends. Holders have voting rights, but in case of bankruptcy, they are paid last.
  - ✓ **Preferred Shares**: It offers a fixed dividend, lacks voting rights, and has priority over common stock in liquidation.
- **Debentures:** A debenture is an unsecured debt instrument backed solely by the issuer's creditworthiness and reputation. Both corporations and governments issue debentures to raise capital.
- There are two types of debentures:
  - ✓ **Convertible Debentures**: They are bonds that can be converted into equity shares of the issuing corporation after a set period.
  - ✓ **Non-convertible Debentures**: They are regular debentures that cannot be converted into the issuer's equity.
- **Bond:** A bond is a loan secured by a physical asset, while a debenture is backed only by the issuer's promise to repay. Bonds typically offer lower interest rates than debentures. Bondholders are considered to be relatively at lower risk than stockholders. Types of Bonds:
  - ✓ **Masala Bonds**: They are Indian Rupee-denominated bonds issued by Indian entities abroad. The term, coined by the IFC, reflects India's culture and cuisine, offering low-cost borrowing and diversified funding.
  - ✓ **Panda Bonds:** Yuan-denominated bonds issued in the Chinese mainland market by an overseas entity.
  - ✓ **Maharaja Bonds:** Rupee-denominated bonds issued by International Finance Corporation in India's domestic market.
  - ✓ **Zero Coupon Bonds**: They are debt securities that don't pay interest but are sold at a significant discount, providing a profit at maturity when redeemed at face value. They tend to have more price fluctuation compared to coupon bonds.
  - ✓ **Inflation-Indexed Bonds (IIBs):** They are securities created to shield investors from inflation. These bonds are linked to inflation, causing both principal and interest payments to adjust with inflation rates. Through IIBs, the government can lower coupon rates on its borrowings.
  - ✓ **Floating Rate Bonds**: They are securities with variable coupon rates.

- ✓ **Exchange Traded Fund Bond:** It is a fund that invests in bonds or fixed-income securities, offering diversification, liquidity, and regular income. Examples include BHARAT-ETF of AAA-rated CPSE bonds.
- ✓ **Perpetual Bonds:** They are fundraising instruments that do not have a maturity date, unlike typical bonds. They provide investors with fixed interest payments indefinitely.
- ✓ **Convertible Bond:** It is a corporate debt security that pays interest but can be converted into a set number of common stock or equity shares. It provides investors with a hybrid investment, combining the characteristics of a bond (interest payments) with the option to convert into stock ownership.
- ✓ **Elephant Bonds:** It is a 25-year sovereign bond issued to individuals who declare previously undisclosed income, requiring them to invest 50% of that amount in these bonds. The funds raised are dedicated solely to infrastructure projects. A High Level Advisory Group on Trade Policy, led by Surjit S Bhalla, recommended issuing these bonds to recover up to $500 billion of black money held abroad.

Bond Yield

- A bond's yield is the return an investor expects to receive each year over its term to maturity.
  - ✓ The yield is also commonly referred to as an interest rate, or the "cost of borrowing" to an issuer.



- The yield of a bond is inversely related to its price. When the price of a bond falls, yields rise.

Derivatives: They are financial instruments whose value is based on an underlying asset, such as stocks, bonds, commodities, currencies, or market indexes. They can be traded either over-the-counter (OTC) or on exchanges. They are of various types as:

- **Forwards**: It is a customized contract between two parties to buy or sell an asset at a specified future date for a price agreed upon today, making it a type of derivative instrument.
- **Futures:** It is an agreement between two parties to buy or sell an asset at a predetermined price on a future date.
- **Options:** The main distinction between options and futures is that in an option contract, the buyer has the right, but not the obligation, to exercise the option, whereas the seller must buy or sell the underlying asset if the buyer decides to exercise it.
- **Swaps:** They are derivatives used to exchange one type of cash flow for another, such as switching between a variable and fixed interest rate loan.
- **LEAPS:** It stands for Long-Term Equity Anticipation Securities, which are options with a maturity of up to three years.

A **Participatory Note (P-Note)** is a financial derivative issued in foreign markets by a SEBI-registered Foreign Institutional Investor (FII), its sub-accounts, or affiliates, based on Indian securities. These underlying securities can include equities, debt, derivatives or even an index.

Methods of Raising Capital in the Primary Market:

- **Public Issue:** A widely accessible method of raising capital, open to all Indian citizens, and considered the most prestigious.
- **Rights Issue:** A method of raising capital from a company's existing shareholders, offering preferential treatment to a specific category of the public.
- **Private Placement:** When a company issues financial securities, such as shares and convertible securities, to a select group of investors (no more than 49 in total).

Primary Market Instruments:

- **Initial Public Offering (IPO):** It is when a private company offers its shares to the public for the first time, transitioning from a private to a public entity. IPOs are typically used by growing companies seeking capital for expansion.
- **Follow-on Public Offering (FPO):** It occurs when a publicly listed company issues additional shares to raise more funds. This is often done to meet regulatory requirements, such as selling at least 25% of shares for public trading on the stock exchange.
- **Rights Issue:** It allows existing shareholders to purchase additional shares at a discounted price, typically below the market rate, on a specified future date. This gives existing shareholders the "right" to buy new shares.
- **Private Placement:** It refers to the issuance of securities to a select group of pre-approved investors, instead of through a public or rights issue. It includes two types:
  - ✓ **Preferential Allotment**: Issuance of shares or convertible securities to a chosen group of individuals.
  - ✓ **Qualified Institutional Placement (QIP)**: Issuance of shares or securities to Qualified Institutional Buyers (QIBs).

Methods of Raising Capital in the Secondary Market:

- **Over-The-Counter (OTC) Market:** An informal, decentralized market where securities are traded directly between parties, bypassing a central exchange, and typically subject to fewer regulations.
- **Stock Exchange Market**: A centralized marketplace where securities are traded through a regulated exchange, ensuring a more structured trading environment.

Beta measures a stock's volatility relative to a market index like the S&P 500. A beta above 1 indicates greater volatility than the market, while a beta below 1 suggests lower volatility. Investors use beta to assess risk—high-beta stocks offer higher potential returns but also greater risk, while low-beta stocks are more stable with less risk.

Stock Exchange

- A Stock Exchange is a regulated platform where investors can buy and sell shares of publicly listed companies.
- It serves as a central hub to facilitate secure and efficient trading. In India, a Stock Exchange can only operate if it is recognized by the Government under the Securities Contracts (Regulation) Act, 1956.

Exchanges in India

1. **Bombay Stock Exchange (BSE)**:
   - ✓ The Bombay Stock Exchange (BSE), established in 1875, is India's oldest and largest exchange, listing over 6000 companies.
   - ✓ It offers trading in equities, debt, derivatives, and mutual funds, along with clearing, settlement, and risk management services.
   - ✓ Central Depository Services Limited (CDSL) is a securities depository that stores securities in dematerialized form and supports trading and settlement. Located in Mumbai, it is India's second-largest central depository, established in 1999, and backed by major banks and the Bombay Stock Exchange.
   - ✓ BSE also provides automated trading via BOLT and depository services through CDSL.
   - ✓ Sensex, launched in 1986, is the benchmark index of BSE, consisting of 30 top Indian companies.
2. **National Stock Exchange (NSE**):
   - ✓ It is India's largest stock exchange, which was established in 1992 on recommendations of the Pherwani committee in Mumbai.
   - ✓ It introduced an electronic trading system.
   - ✓ It created the Nifty 50 Index in 1996, a benchmark for the top 50 stocks.
   - ✓ NSE is known for its advanced trading technology and rapid growth, with trading beginning in 1994.

3. **Multi Commodity Exchange of India:**
   - ✓ The Multi Commodity Exchange of India (MCX), established in 2003, is India's first listed exchange for online commodity derivatives trading and risk management, regulated by SEBI.
   - ✓ It offers derivatives in bullion, metals, energy and agriculture.
   - ✓ It was the first to introduce commodity options, bullion index futures, and base metals index futures.
   - ✓ MCX also features the MCX iCOMDEX index series, providing real-time price indices for key commodities.
   - ✓ It launched India's first options security with gold as the underlying asset.
4. **Over the Counter Exchange of India Limited:**
   - ✓ It is an electronic stock exchange for small- and mid-cap companies to raise capital.
   - ✓ It has specific capitalization rules tailored for smaller companies and prevents larger ones from listing.
   - ✓ Key players include brokers, market makers, custodians and transfer agents.
5. **Regional Stock Exchanges:**
   - ✓ These stock exchanges serve as a link between the local companies and investors.
   - ✓ Each of them follows its own procedures in respect of listing and trading of securities, clearing and settlement of transaction and risk containment measures
   - ✓ Prominent examples include; Kolkata stock exchange, Pune stock exchange, etc.
6. **Social Stock Exchange (SSE):** It is a segment of the existing stock exchange that enables Social Enterprises, including NPOs and For-Profit Enterprises (FPEs), to raise public funds through the stock market. Eligible activities for SSE include addressing hunger, poverty, malnutrition, inequality, promoting education, financial inclusion, and slum development.

DID YOU KNOW

The Negotiated Dealing System (NDS) is an electronic platform by the Reserve Bank of India (RBI) for trading government securities and money market instruments. It aims to enhance market transparency and reduce inefficiencies from manual processes and phone orders.

Securities & Exchange Board of India (SEBI)

- ➢ SEBI was established on April 12, 1992, under the SEBI Act, 1992, to protect investors' interests and regulate the securities market.
- ➢ Before SEBI, the Controller of Capital Issues regulated the market under the Capital Issues (Control) Act, 1947.
- ➢ Initially a non-statutory body, SEBI gained statutory powers in 1992.
- ➢ Its headquarters are in Mumbai, with regional offices in Ahmedabad, Kolkata, Chennai and Delhi.
- ➢ The SEBI board consists Chairman & other members, & appoints committees as needed.
- ➢ A Securities Appellate Tribunal (SAT) addresses grievance against SEBI's decisions, with appeal options to the Supreme Court.

1. **Functions of SEBI:**
   - ✓ Regulates stock exchanges and securities markets.
   - ✓ Registers and oversees intermediaries like brokers, advisors, and custodians.
   - ✓ Manages venture capital funds, mutual funds, and collective investment schemes.
   - ✓ Prevents fraudulent trade practices and insider trading.
   - ✓ Promotes investor education and intermediary training.
   - ✓ Conducts audits, inspections, and shares information with authorities.
   - ✓ Levies fee and conducts research for market development and regulation.
2. **Investor Protection Fund (IPF):**
   - ✓ It is established by SEBI to safeguard the interests of participants, including stockbrokers and investors, in the exchange.

- ✓ Stock exchanges and depositories are required to create an IPF, managed through separate trusts. Depositories, such as CDSL and NSDL in India, facilitate the buying and selling of financial instruments.
- ✓ The funds in the IPF must be segregated and protected from any liabilities of the exchanges or depositories. A half-yearly review is conducted to assess the adequacy of the IPF corpus.

DID YOU KNOW

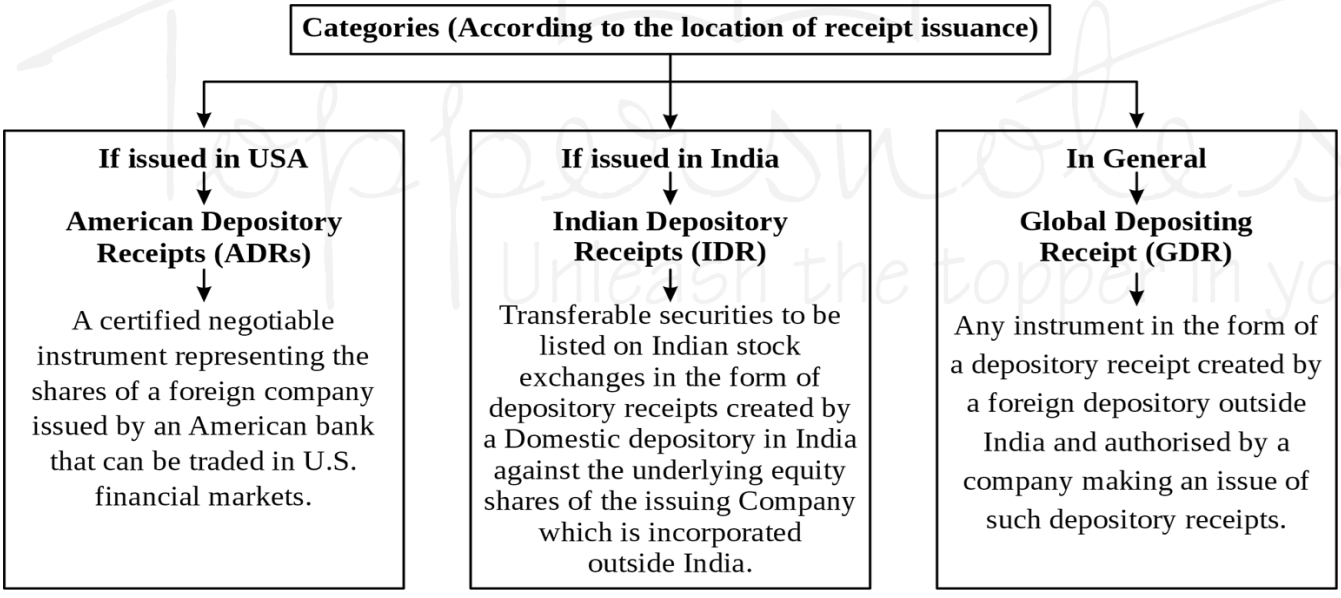
Dabba (Box) trading involves informal transactions outside of stock exchanges, where traders speculate on stock price movements without actually owning the stocks. This practice allows traders to avoid taxes due to the lack of official records. The National Stock Exchange (NSE) has issued notices against entities involved in dabba trading, which is considered illegal under the Securities Contracts (Regulation) Act (SCRA), 1956.

3. Credit Rating in India

- ✓ The Securities and Exchange Board of India (SEBI) regulates credit rating agencies under the SEBI (Credit Rating Agencies) Regulations, 1999.
- ✓ There are seven credit rating agencies in India: CRISIL, CARE, ICRA, Acuité Ratings, Brickwork Rating, India Rating and Research Pvt. Ltd. and Infomerics Valuation and Rating Pvt. Ltd.
- ✓ These agencies provide timely, unbiased information to market participants, contribute to the growth and efficiency of the financial market, and assess the creditworthiness of individuals and companies.

4. Depository Receipts

- ✓ It is a negotiable certificate issued by a bank, representing shares of a foreign company traded on a local stock exchange.
- ✓ It allows investors to hold foreign equities without directly trading on international markets.



Alternative Investment Funds

- ➢ AIFs are privately pooled investment vehicles that collect funds from investors (Indian or foreign) for investing in accordance with a defined investment policy.
- ➢ Regulated by **SEBI** under the **SEBI (Alternative Investment Funds) Regulations, 2012**.
- ➢ Not covered under **Mutual Funds** or **Collective Investment Schemes**.
- ➢ Hedge funds are treated as Alternative Investment Funds
- ➢ Examples include: SIDBI Fund of Fund for startups, India opportunities fund.

Mutual Funds

- A mutual fund pools money from multiple investors to create a diversified portfolio of assets like stocks, bonds, and money market instruments.
- Managed by professionals, it aims to generate returns while managing risk, making it a simple and effective option for both new and experienced investors.

1. Mutual Funds Classification

They are categorized based on factors such as asset class, investment goals, structure and risk level.

- ✓ **Types Based on Asset Class:**
  - **Equity Funds:** Invest in company shares, including large-cap and small-cap funds.
  - **Debt Funds:** Invest in fixed-income securities like government or corporate bonds for steady income.
  - **Hybrid Funds:** Combine equities and bonds, offering both growth and stability.
- ✓ **Types Based on Investment Goals:**
  - **Growth Funds:** Focus on long-term capital appreciation by investing in high-growth companies.
  - **Income Funds:** Aim to generate regular income from bonds, dividend stocks and other fixed-income securities.
  - **Liquid Funds:** Invest in short-term debt instruments, offering high liquidity with low risk.
  - **Tax Saving Funds (ELSS):** Offer tax benefits under Section 80C by investing in equities.
  - **Pension Funds:** Target long-term retirement planning by investing in a mix of assets.
- ✓ **Types Based on Structure:**
  - **Open-ended Funds:** Allow continuous buying and selling of units, offering liquidity and flexibility.
  - **Closed-ended Funds:** Have a fixed maturity period, with units available only during the initial offering.

2. REITs and InvITs

- REITs (Real Estate Investment Trusts) are companies that own, operate, or finance income-generating real estate. They are typically publicly traded, offering high liquidity like stocks, and allow individual investors to earn dividends from real estate without owning or managing properties themselves.
- InvITs (Infrastructure Investment Trusts) are similar to mutual funds but focus on investing in infrastructure by pooling funds from multiple individual investors. Set up as a trust and registered with SEBI, InvITs involve four key parties: Trustee, Sponsor(s), Investment Manager, and Project Manager.

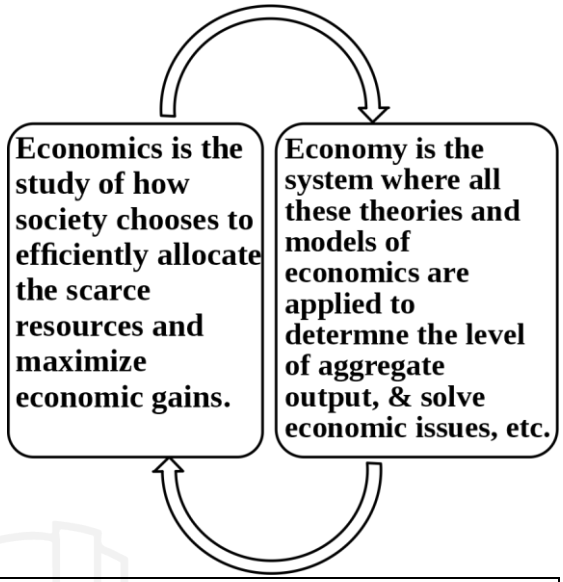
A. Difference Between Money Market & Capital Markets

Parameters	Money Market	Capital Market
Function and Purpose	For short-term credit facilities	For long-term credit facilities
Liquidity	Highly liquid	Less liquid than money markets
Maturity Tenure	Between 1 day and 1 year	No particular time period as such
Risk Involved	Low	High
Investment Duration	Short-term	Long-term
Returns	Consistent	Market-linked

Financial markets are vital for resource allocation, capital raising, investment, liquidity, and economic growth. Regulation ensures fairness, investor protection, and market integrity, supporting global economic stability.

3 CHAPTER Growth and Development

- Economics studies how society manages scarce resources to produce goods and services and distribute them efficiently to maximize overall welfare.
- Because resources are limited and have alternative uses, choices become unavoidable.
- **Microeconomics** focuses on individual units such as consumers and firms, explaining consumer behaviour and producer decisions.
- **Macroeconomics** studies the economy as a whole, dealing with aggregates like national income, inflation, unemployment, poverty, and money supply.
- **Economics** v/s **Economy**



Sectors of Economy

Primary Sector: Involves the extraction and use of natural resources to produce goods, such as agriculture, dairy, fishing, forestry, and mining. Also called the **agriculture and allied sector**.

Secondary Sector: Concerned with processing and manufacturing raw materials into finished or semi-finished goods. Also known as the **industrial sector**.

Tertiary Sector: Provides services that support production and distribution, such as transport, banking, trade, and communication. Also called the **service sector**. The services sector is further divided into:

- **Quaternary Sector:** Knowledge-based services involving research, data processing, and information management. Includes professionals such as software developers, analysts, and consultants.
- **Quinary Sector:** Top-level decision-making and policy-related services. Includes senior executives, government officials, and high-level consultants, often called **gold-collar professions**.

Central Problems of an Economy

- The availability of resources does not automatically ensure economic growth. Since resources are scarce and have multiple alternative uses, an economy inevitably faces the **problem of choice**.
- Producers and governments must decide how to allocate these limited resources efficiently and which production technologies to adopt. Consequently, every economy regardless of the quantity or type of resources it possesses confronts **three fundamental central problems** in the process of economic decision-making.

1. **What to produce?**
   - ✓ Economies must decide how much to produce of consumer goods versus capital goods.
   - ✓ Consumer goods satisfy immediate needs, while capital goods support future production and growth.
2. **How to produce?**
   - ✓ This concerns the choice of production technique. Labour-intensive techniques are suitable for labour-abundant countries, whereas capital-intensive techniques suit capital-rich economies.

3. **For whom to produce?**
   - ✓ This relates to the distribution of goods and income. The aim is to reduce inequality, ensure efficient allocation of resources, and promote social welfare.

Types of Goods

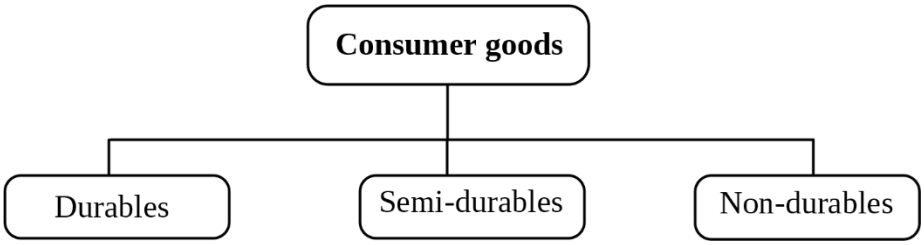
Goods produced in an economy can be classified in different ways:

1. Based on Value Addition

- ✓ **Intermediate goods**: Used as inputs for further production (e.g., wheat flour for a bakery).
- ✓ **Final goods**: Ready for consumption and require no further processing (e.g., books, clothes).

2. Based on End Use

- ✓ **Consumer goods**: Used directly for satisfaction of wants.



  - **Durable goods** are those goods that can be used repeatedly over a long period because of their relatively long-life span, such as automobiles, mobile phones, and computers.
  - **Semi-durable goods** are goods that do not have a very long-life span but are also not exhausted in a single use. Examples include footwear, crockery, clothing, and other textile products.
  - **Non-durable goods** are goods with a very short life span that are generally consumed in a single use. Examples include fruits, milk, vegetables, and disposable items.
- ✓ **Capital goods**: Used in production of other goods (machinery, buildings).

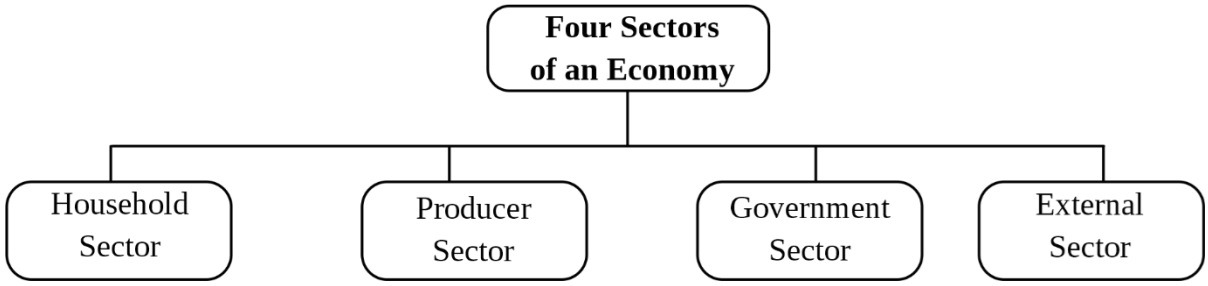
Did you Know? The same good can be a capital good and a consumer good. Its classification would depend upon the purpose of its use. The Fan installed in a house is a consumer good whereas when it is installed in a factory it is classified as capital good.

Types of Economies

1. **Free Market Economy**: Economic decisions are guided by demand and supply with minimal government intervention (e.g., Singapore).
2. **Centrally Planned Economy**: The state owns major resources and prioritizes social welfare over profits (e.g., Cuba).
3. **Mixed Economy**: Combines market forces with government regulation (e.g., India). Industries of strategic importance like atomic energy, Space, Defence, etc. are not completely left to the market forces of demand and supply. Such economies try to strike a balance between the aim of profit maximization and public welfare.

Sectors of an Economy

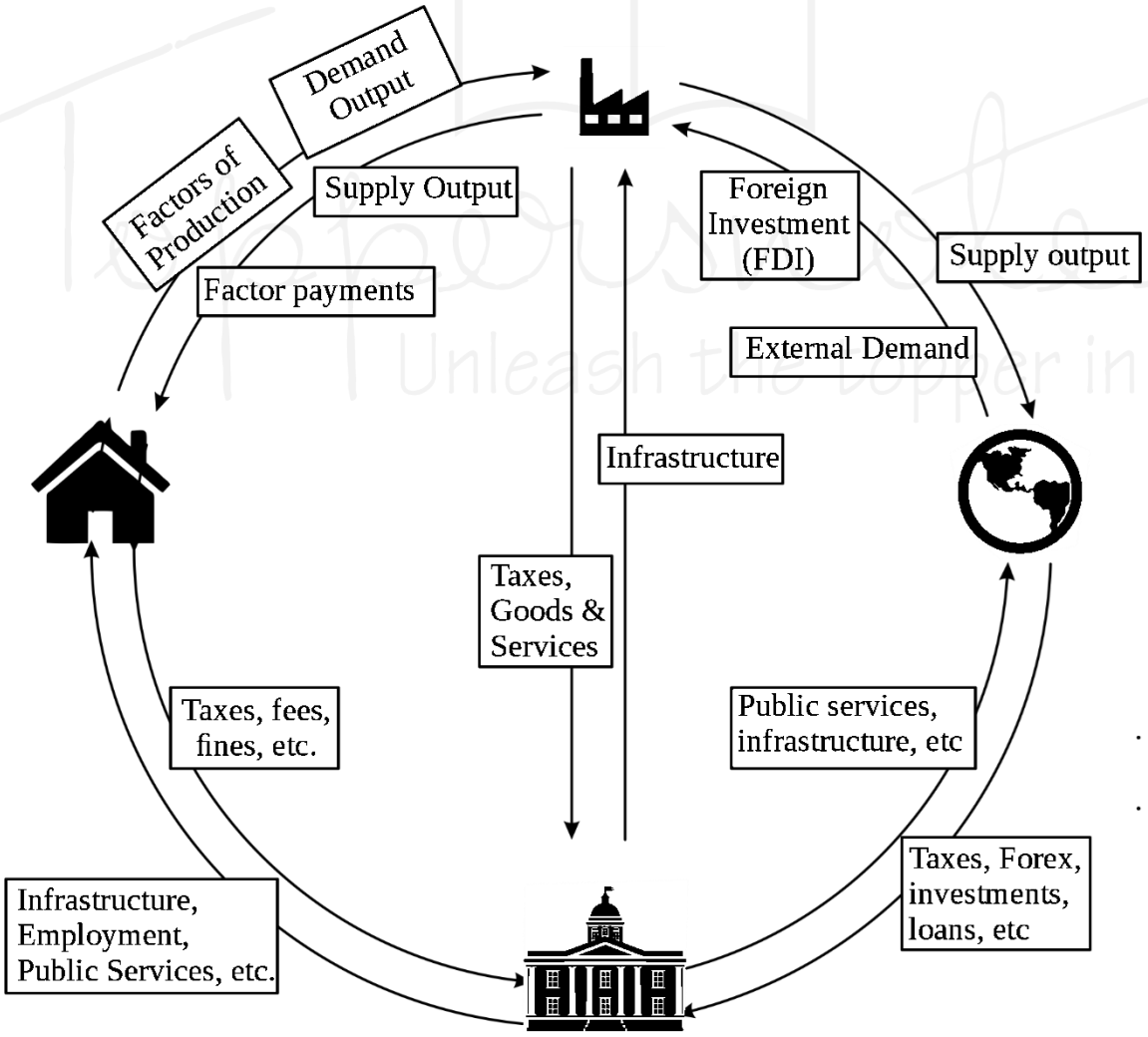
An economy is divided into four interacting sectors:



Sector of Economy	Description / Role
Household Sector	Comprises individuals and families who **consume goods and services**. Households also act as **suppliers of factors of production** such as land, labour, capital, and entrepreneurship, and earn factor incomes in return.
Producer Sector	Includes **all producing units** in the economy that are engaged in the production of goods and services for the market.
Government Sector	Represents the state's economic activities. The government functions as a **consumer**, a **producer** through public sector enterprises (e.g., NTPC, Rural Electrification Corporation), and plays a crucial role in ensuring **public welfare and regulation**.
External Sector (Rest of the World)	Covers all **economic transactions with foreign countries**, including **exports and imports** and **financial flows** recorded under the **current account and capital account**.

1) Land: The return for land is rent.
2) Labor: The return for labor is Wage, or Compensation of employees.
3) Capital: Anything which is used in the process of production of any good or service is capital. It can be money, or any physical asset like machinery, human capital etc. The return for capital is interest.
4) Entrepreneur: An entrepreneur runs and manages the business/industry. Entrepreneurs earn profit.

Circular Flow of Income



Goods and services flow from producers to households, while money flows in the opposite direction as factor payments. This continuous flow links production, income generation, and expenditure.

Theory of Demand

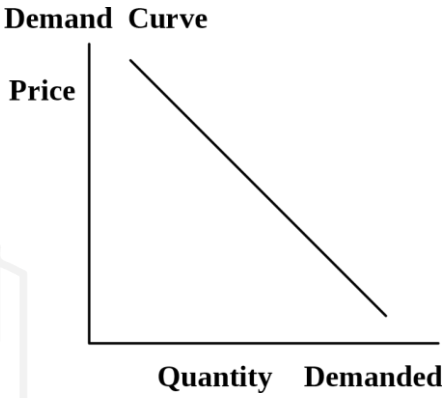
Demand refers to the quantity of a good that consumers are willing and able to purchase at different prices over a period of time.

Determinants of Demand include price of the good, consumer income, prices of substitutes and complements, tastes, population, and weather.

DID YOU KNOW?

Normal goods are goods for which the demand is directly related to the consumer's income.
Inferior goods are goods for which demand is inversely related to consumer's income.

Law of Demand states that, other things remaining constant, quantity demanded varies inversely with price.



The Law of Demand does not apply in certain special situations, which are explained below.

i. **Ostentatious goods:** These goods are purchased to display wealth and social status, such as expensive cars and diamond jewellery. In this case, demand increases when the price rises and decreases when the price falls.

ii. **Giffen goods:** This concept was identified by the British economist Sir Robert Giffen. Giffen goods are a special category of inferior goods in which the income effect is negative and stronger than the substitution effect. As a result, demand increases when the price rises and decreases when the price falls. These goods are usually basic necessities like rice, bread, salt, and potatoes, on which consumers spend a large part of their income and which have no close substitutes.

iii. **Shares or speculative market:** In speculative markets, especially the stock market, demand increases when prices are rising because investors expect further price increases, and demand falls when prices are declining.

iv. **Bandwagon effect:** This occurs when consumers' demand for goods and services is influenced by social trends, fashion, or the choices of others. For example, owning an iPhone is often considered a status symbol rather than a basic necessity.

v. **Veblen effect:** This refers to the belief that goods with higher prices are of superior quality compared to lower-priced goods, which leads to higher demand for expensive products.

Theory of Supply

Supply is the quantity of a good that producers are willing and able to sell at a given price during a specific period.

Law of Supply states that price and quantity supplied are positively related, assuming other factors remain constant.

Assumptions of Law of Supply

a) There is no change in the price of factors of production
b) There is no change in the techniques of production
c) There is no change in the goal of the firm
d) There is no change in the price of related goods
e) Investors have full confidence over business