Directorate of Distance and Continuing Education

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B.A. ECONOMICS

(First Year)

Economics for Investors

(JSEC21)

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Unit-I

Introduction

1. Meaning of an Investment

An investment is an asset or item acquired with the goal of generating income or appreciation. Appreciation refers to an increase in the value of an asset over time. When an individual purchases a good as an investment, the intent is not to consume the good but rather to use it in the future to create wealth.

An investment always concerns the outlay of some resource today- time, effort, money, or an asset- in hopes of a greater payoff in the future than what was originally put in. For example, an investor may purchase a monetary asset now with the idea that the asset will provide income in the future or will later be sold at a higher price for a profit.

- An investment involves putting capital to use today in order to increase its value over time.
- An investment requires putting capital to work, in the form of time, money, effort, etc., in hopes of a greater payoff in the future than what was originally put in.
- An investment can refer to any medium or mechanism used for generating future income, including bonds, stocks, real estate property, or alternative investments.
- Investments usually do not come with guarantees of appreciation; it is possible to end up with less money than with what you started.
- Investments can be diversified to reduce risk, though this may reduce the amount of earning potential.

1.1. How an Investment Works

The act of investing has the goal of generating income and increasing value over time. An investment can refer to any mechanism used for generating future income. This includes the purchase of bonds, stocks, or real estate property, among other examples. Additionally, purchasing a property that can be used to produce goods can be considered an investment.

In general, any action that is taken in the hopes of raising future revenue can also be considered an investment. For example, when choosing to pursue additional education, the goal is often to increase knowledge and improve skills. The upfront investment of time attending class and money to pay for tuition will hopefully result in increased earnings over the student's career.

Because investing is oriented toward the potential for future growth or income, there is always a certain level of risk associated with an investment. An investment may not generate any income, or may actually lose value over time. For example, a company you invest in may go bankrupt. Alternatively, the degree you investing time and money to obtain may not result in a strong job market in that field.

An investment bank provides a variety of services to individuals and businesses, including many services that are designed to assist individuals and businesses in the process of increasing their wealth. Investment banking may also refer to a specific division of banking related to the creation of capital for other companies, governments, and other entities. Investment banks underwrite new debt and equity securities for all types of corporations, aid in the sale of securities, and help to facilitate mergers and acquisitions.

1.2. Types of Investments

There's arguably endless opportunities to invest; after all, upgrading the tires on your vehicle could be seen as an investment that enhances the usefulness and future value of the asset. Below are common types of investments in which people use to appreciate their capital.

1.2.1. Stocks/Equities

A share of stock is a piece of ownership of a public or private company. By owning stock, the investor may be entitled to dividend distributions generated from the net profit of the company. As the company becomes more successful and other investors seek to buy that company's stock, it's value can also appreciate and be sold for capital gains.

The two primary types of stocks to invest in are common stock and preferred stock. Common stock often includes voting right and participation eligibility in certain matters. Preferred stock often has first claim to dividends and must be paid before common shareholders.

In addition, stocks are often classified as being either growth or value investments. Investments in growth stocks is the strategy of investing in a company while it is small and before it achieves market success. Investment in value stocks is the strategy of investing in a more established company whose stock price may not appropriate value the company.

1.2.2. Bonds/Fixed-Income Securities

A bond is an investment that often demands an upfront investment, then pays a reoccurring amount over the life of the bond. Then, when the bond matures, the investor receives the capital invested into the bond back. Similar to debt, bond investments are a mechanism for certain entities to raise money. Many government entities and companies issue bonds; then, investors can contribute capital to earn a yield.

The recurring payment awarded to bondholders is called a coupon payment. Because the coupon payment on a bond investment is usually fixed, the price of a bond will often fluctuate to change the bond's yield. For example, a bond paying 5% will become cheaper to buy if there are market opportunities to earn 6%; by falling in price, the bond will naturally earn a higher yield.

1.2.3. Index Funds and Mutual Funds

Instead of selecting each individual company to invest in, index funds, mutual funds and other types of funds often aggregate specific investments to craft one investment vehicle. For example, an investor can buy shares of a single mutual fund that holds ownership of small cap, emerging market companies instead of having to research and select each company on its own.

Mutual funds are actively managed by a firm, while index funds are often passively-managed. This means that the investment professionals overseeing the mutual fund is trying to beat a specific benchmark, while index funds often attempt to simply copy or imitate a benchmark. For this reason, mutual funds may be a more expense fund to invest in compared to more passive-style funds.

1.2.4. Real Estate

Real estate investments are often broadly defined as investments in physical, tangible spaces that can be utilized. Land can be built on, office buildings can be occupied, warehouses can store inventory, and residential properties can house families. Real estate investments may encompass acquiring sites, developing sites for specific uses, or purchasing ready-to-occupy operating sites.

In some contexts, real estate may broadly encompass certain types of investments that may yield commodities. For example, an investor can invest in farmland; in addition to reaping the reward of land value appreciation, the investment earns a return based on the crop yield and operating income.

1.2.5. Commodities

Commodities are often raw materials such as agriculture, energy, or metals. Investors can choose to invest in actual tangible commodities (i.e. owning a bar of gold) or can choose alternative investment products that represent digital ownership (i.e. a gold ETF).

Commodities can be an investment because they are often used as inputs to society. Consider oil, gas, or other forms of energy. During periods of economic growth, companies often have greater energy needs to ship more products or manufacture additional goods. In addition, consumers may have greater demand for energy due to travel. In this example, the price of commodities fluctuates and may yield a profit for an investor.

1.2.6. Cryptocurrency

Cryptocurrency is a block chain-based currency used to transact or hold digital value. Cryptocurrency companies can issue coins or tokens that may appreciate in value. These tokens can be used to transact with or pay fees to transact using specific networks.

In addition to capital appreciation, cryptocurrency can be staked on a blockchain. This means that when investors agree to lock their tokens on a network to help validate transactions, these investors will be rewarded with additional tokens. In addition, cryptocurrency has given rise to decentralized finance, a digital branch of finance that enables users to loan, leverage, or alternatively utilize currency.

1.3.7. Collectibles

A less traditional form of investing, collecting or purchasing collectibles involves acquiring rare items in anticipation of those items becoming in higher demand. Ranging from sports memorabilia to comic books, these physical items often require substantial physical preservation especially considering that older items usually carry higher value.

The concept behind collectibles is no different than other forms of investing such as equities. Both predict that the popularity of something will increase in the future. For example, a current artist may not be popular but changes in global trends, styles, and market interest. However, their art may become more valuable in time should the general population take a stronger interest in their work.

1.4. How to Start Investing

There are many different avenues one can take when learning how to invest or where to start when putting money aside. Here are some tips for getting started in investing:

- **Do your own research.** A common phrase used in the investing industry, it is important for investors to understand the vehicles they are putting their money into. Whether it is a single share of a well-established company or a risky alternative investment endeavor, investors should do their homework in advance as opposed to relying on third-party (and often biased) advice.
- **Establish a personal spending plan.** Before investing, individuals should consider their ability to put money away. This includes ensuring they have enough capital to pay monthly expenses and have already built up an emergency fund. As enticing as investing can be, individuals should be mindful to meet their daily life obligations first.
- **Understand liquidity restrictions.** Some investors may be less liquid than others, meaning it may be more difficult to sell. In some cases, an investment may be locked for a certain period and cannot be liquidated. Though not necessary fine print, it's important to understand whether certain investments can be bought or sold at any time.
- **Research tax implications.** On a similar note, though an investment can be bought or sold at any time, it may be tax-adverse to do so. With unfavorable short-term capital gains tax rates, investors should be mindful of strategies that extend beyond what product they hold but what tax vehicle they put that investment in.
- **Gauge your risk preference.** As mentioned earlier, investing incurs risk. This means you may end up with *less* money than what you started with. Investors uncomfortable with this idea can (1) reduce the amount they invest to only what they are comfortable losing or (2) explore ways to mitigate risk.

- **Consult an adviser.** Many financial professionals would be happy to provide their guidance, let you know what they think about markets, and give you access to online platforms where you can invest money.

1.5. Return on Investment

The primary way to gauge the success of an investment is to calculate the return on investment (ROI). ROI is measured as:

ROI = (Current Value of Investment - Original Value of Investment) / Original Value of Investment

ROI allows different investments across different industries to be appropriately compared. For example, consider two investments: a Rs 1,000 investment in stock that increased to Rs 1,100 over the past year, or a Rs 150,000 investment in real estate that is now worth Rs 160,000.

Stock ROI = (Rs 1,100 – Rs 1,000) / Rs 1,000 = Rs 100 / Rs 1,000 = 10%

Real Estate ROI = (Rs 160,000 - Rs 150,000) / Rs 150,000 = Rs 10,000 / Rs 150,000 = 6.67%

Though the real estate investment has increased in value Rs10,000, many would claim that the stock investment has outperformed the real estate investment. This is because every dollar invested in the stock gained more money than every dollar invested in real estate.

1.6. Investments and Risk

In its simplest form, investment return and risk should have a positive correlation. If an investment carries high risk, it should be accompanied by higher returns. If an investment is safer, it will often have lower returns.

When making investment decisions, investors must gauge their risk appetite. Every investor will be different, as some may be willing to risk the loss of principle in exchange for the chance at greater profits. Alternatively, extremely risk-averse investors seek only the safest vehicles where their investment will only consistently (but slowly) grow.

Investments and risk are often strongly related to prevailing conditions in the investor's life. As an investor approaches retirement, they will no longer have stable, ongoing income. For this reason, people usually choose safer investments towards the end of their working career. On the other hand, a young professional can often bear the burden of losing money as they have their entire career to make that capital back. For this reason, younger investors are often more likely to invest in riskier investments.

1.7. Investments and Diversification

One way investors can reduce portfolio risk is to have a broad range of what they are invested in. By holding different products or securities, an investor may not lose as much money as they are not fully exposed in any one way.

The concept of diversification was born from modern portfolio theory, the idea that holding both equities and bonds will positively impact the risk-adjusted rate of return in a portfolio. The argument is holding strictly equities may maximize returns but also maximizes volatility. Pairing it with a more stable investment with lower returns will decrease the risk an investor incurs.

1.8. Investing vs. Speculation

Speculation is a distinct activity from investing. Investing involves the purchase of assets with the intent of holding them for the long term, while speclation involves attempting to capitalize on market inefficiencies for short-term profit. Ownership is generally not a goal of speculators, while investors often look to build the number of assets in their portfolios over time.

Although speculators are often making informed decisions, speculation cannot usually be categorized as traditional investing. Speculation is generally considered a higher risk activity than traditional investing (although this can vary depending on the type of investment involved). Some experts compare speculation to gambling, but the veracity of this analogy may be a matter of personal opinion.

1.9. Investing vs. Saving

Saving is accumulating money for future use and entails no risk, whereas investment is the act of leveraging money for a potential future gain and it entails some risk. Though both have the intention of having more capital available in the future, each go about growing in a very different way.

One aspect this is most transparent is the process of saving for a down payment on a home. Many advisors will suggest parking cash in a safer investment vehicle when saving for an important major purchase. Because investing incurs a higher degree of risk, an individual must compare what implications of loss of principle would be to their future plans.

Saving and investing are often intertwined because each may have a stated yield or rate of return. Another primary difference is the federal insurance coverage on certain accounts. The FDIC offers insurance coverage for bank accounts balances up to Rs250,000; this type of financial guarantee is often not present in investing.

1.10. Savings:

Introduction:

Savings represent an individual’s unspent earnings. It is the amount that remains after meeting the household and other personal expenses over a given period, for example, on a monthly basis. Savings is the balance that remains after meeting of the consumption needs of an individual. People who buy on credit and have incremental EMI Commitments would have little or none to save on a monthly basis. Savings help in pooling up funds for the future.

Savings has the four types:

These four types of Savings briefly expressing here.

1**. Savings for emergencies**

Who can predict what will happen next? This is the reason we need to prepare ourselves by trying our best. So, if something unexpected happens, we already have a way to deal with it. Emergencies are included in unexpected events. According to the Big Indonesian Dictionary, what is meant by emergency is "a difficult situation that is unexpected that requires immediate response". Emergency can also be interpreted as "a state of necessity". Therefore, events such as long-term illness, serious accidents, job losses and natural disasters such as fires that make business premises razed to the ground are considered emergencies.

To deal with an emergency as described above, a large amount of money is needed. This is where emergency savings plays an important role. Without an emergency savings, you have to be forced to take money that is usually used to meet daily needs.

2. Savings for Retirement

Old age should be a happy time. You can do whatever you want, without being burdened with work in the office, for example. However, this happy time can become a sad time if you don't have enough retirement savings.

It would be nice if when we enter retirement, we don't depend on or burden our children and grandchildren. Children and grandchildren will have their own dependents. As much as possible we should not make them the sandwich generation.

To be able to live your old age comfortably, you need sufficient savings. Avoid thinking that retirement is still many years from now and that you don't need to start saving early.

3**. Savings for expenses that are not routine**

A number of expenses do not occur regularly every month, but maybe every 3 months, 6 months, 1 year. Some irregular expenses include car insurance, home insurance, and gifts during other major celebrations. So, that you are not surprised and spend a lot of money on the due date, you need savings. You just need to consistently set aside money every month to this savings, so it doesn’t feel like a burden when the time comes.

4. Savings for short-term goals

Do you want to buy a new gadget or go on a trip every month? You need special savings for short-term goals. So, you don't need to fiddle with emergency savings and retirement savings.

1.11. Importance of savings

Long-Term Security

Among the many advantages of saving is the long-term security it provides you. The future is unpredictable, and financial emergencies can crop up anytime. Saving money allows you to create a safety net for your future expenses as well as unplanned financial needs. The more you save, the more peace of mind you have, as you are better prepared for anything life throws at you.

Saving money is a step towards financial independence

The importance of saving money cannot be understated when it comes to independence. Financial independence plays a critical role in making you self-sufficient. It helps you live life according to your preferences and comfort. You have the liberty and authority to spend your money on the things you like and live a comfortable and enriched life.

Saving money enables you to take calculated risks

Another reason why saving money is important is because it allows you to take calculated risks. When you have enough money, you can take risks like starting a business, changing professions and exploring your interests without the immediate pressure of generating income.

Savings Reduce Stress

Having adequate savings enables you to live a more fulfilled life. You are more likely to be less stressed about your future goals like retirement or unexpected expenses like healthcare. Savings allow you to be relieved and at ease, knowing you have sufficient funds to navigate different situations in life.

Compound interest can be benefited from savings

Savings offer you the opportunity to take advantage of the power of the compounding. Compound interest is added to your initial savings at periodic intervals, such as annually. In the next compounding period, the interest is added not just to your initial amount but also to the interest previously earned. Over time, this helps you increase your savings and beat inflation.

Saving and Investment Relationship

saving and investment are linked at an aggregate level in the loanable funds market. Banks loan out the money you put in your savings account to other individuals and businesses. All individuals' savings comprise the total amount of loanable funds that the banks can advance as loans. The more money is saved on an aggregate level, the more the supply of loanable funds will be. Greater availability of credit results in lower interest rates. This stimulates more firms and individuals to invest, as they can now borrow money for their investment at a lower interest rate. Ultimately, the more savings there are, the more investment there is in the economy.

1.12. Saving and Investing

- Saving is a habit of setting aside a part of your income at regular time intervals instead of simply spending it.
- Saving and investment are linked at an aggregate level in the loanable funds market. Ultimately, the more savings there are, the more investment there is in the economy.
- Saving and investing are both money management skills. However, investing differs from saving because it involves various strategies, and you can borrow money to invest.
- Investing is strategically choosing to place money where it is expected to generate a return.
- The four most popular types of investments are:
    - Stocks
    - Bonds
    - Treasury instruments
    - Real estate

1.13. Relationship between Savings, Investment and Economic Growth:

It is a well-established fact that growth of output of an economy depends on the amount of capital accumulation and the amount of capital accumulation in an economy is ultimately constrained by its rate of saving. As savings increase in the economy, more funds will be available for investment. Hence, the issue of ways and means to stimulate investment and bring about an increase in the level of savings and increased investment has assumed importance. Savings depend on the following factors: 1. The ability to save: This mainly depends on the income levels of the people and the kind of tax benefits that the government provides. 2. Willingness to Save: This is the most subjective factor and this depends on motive, love for family, provision for rainy days etc. and moreover the willingness to save likely to be the existence of financial Institutions, interest rates and the range and availability of financial assets to suit savers with different needs.

1.14. Investment on the development of individual

Here are some reasons why you should be investing on individual:

1. ***Invest in a coach***

On each occasion where I have invested in working with a coach, it has had a direct return on my business. A coach helps in creating and implementing your success plan, so you can become the best that you can be. I have just completed my most recent coaching experience during which we looked at my current business model and reimagined it- the result has seen me doubling my income.

2. ***Never stop learning***

Investing in yourself is a great way to build your self-confidence and self-worth and acquire knowledge. Read, or perhaps I should rephrase, listen to a book a week- books or audio books are an infinite resource to building knowledge and expertise in any area. If I don't manage to read or listen a book, I supplement my learning and curiosity with podcasts. Listening to a 30-minute podcast before going to bed or when driving or when working out in the gym is a great way to make effective use of time whilst still learning.

Attend seminars and workshops to expand your knowledge and skills. It also gives you the invaluable opportunity to network with those who are like-minded. Education is more than just an investment in your career- it is an investment in your growth, awareness, and identity. Constantly learning will give you that competitive edge. Every time I attend a seminar, I always get new ideas and inspiration. My "Giving Back in Style" bangle was an initiative that came to me at a Tony Robbins' four-day event where we I did the infamous fire walk. It was there that I became really connected with what I saw as my values, personal and professional.

3. ***Invest in your health***

Your health is your wealth. It is a fact that we are all more productive when we are rested, eating healthly, and working out, but how often you really take stock and notice. I recently had a wakeup call. Lethargic, unable to gain my fitness levels despite working out I discovered I am dairy intolerant. I had no idea how this had been affecting my mental and physical abilities. We are what we eat- I hired a health coach to educate me on what I should be eating and what the best foods to feed my body and brain are. The results are amazing- I have been more able to focus and follow through and I have also improved my productivity. Working out releases natural endorphins.

4. Invest in your future

Investing in your future means doing things today to reap the rewards for tomorrow. The misconception lies in thinking it needs to be a drastic life change. This is further from the truth. The small efforts you put in will pave the way to the life you want.

1.15. Investment on the development of social sector:

The social sector plays a vital role in supporting various social and economic needs in India through a field-based approach. In the context of India, where economic growth has not been able to cross the last mile and with socio-economic disparities widening, the social sector has now started to explore the market-based approach to tackle the challenges of inclusive growth and sustainable development.

The decade from 2002 to 2012 was arguably the fastest growing in India's post-liberalized economic history, as GDP grew at 7.6 percent annually. During this high growth phase, household consumption too saw a healthy rise in real terms. Fixed investment too reached an all-time high of almost one-third the GDP.

India's rapid economic growth made it one of Asia's most promising markets. With the change in government at the Centre, there has been rising expectations and aspirations and India's growth is expected to further strengthen to reach up to 7.5 percent in 2016. India's growth is likely to benefit from strong domestic demand, policy reforms on ease of doing business, foreign direct investment, and lower petroleum prices and manageable inflation. India is expected to continue to be a major economy and a serious player in
emerging market economies.

The economic growth has been quite lop-sided with regions and demographics witnessing varied levels of economic well-being and deprivation. The highest paid working class population (which is almost 10% of the entire wage earning population) currently earns 14-15 times more than the least paid working class population.

This is in sharp contrast to other developing economies like Indonesia, Brazil and China, for where the earnings in the top bracket were five to six times higher than those in the bottom rung. Given the existing income inequality which can lead to market distortions and slowdown in domestic demand, inclusive growth will become an important tool to achieve long-term economic dividends. To achieve this, the key drivers are likely to be:

The Agrarian sector, and in particular, farm productivity. Increasing investment in the infrastructural side of the agrarian sector, improving access to market, rationalization of price supports, expanding the adoption of new technologies, and streamlining agricultural administration and extension services can help to achieve annual yield of 5.5 percent.

Healthcare and sanitation: Improvement in health and sanitation facilities is one of the key drivers of the economy. There is an urgent need to accelerate improvement in access to and utilization of health, family welfare and nutrition services with a special focus on underserved and underprivileged population. According to D&B's forecasts, total government expenditure on health is expected to remain low at 1.5% of GDP in FY20 and infusion of private capital is going to be the key driver.

Financial inclusion. India needs to infuse the market with 0.10 billion new non agrarian jobs over the next 10-15 years to accommodate a growing population which is educated and unemployed. India also needs to reduce its employment generation's over-dependence on agriculture. Promoting small entrepreneurial and small scale employability through better access to credit will be a key determinant.

In most cases, social sector organizations face resource constraints and are not always equipped to replicate the successes of modern business approaches. Lack of business expertise, coupled with underutilization of resources leads to systemic underperformance. As markets expand, new opportunities for generating livelihoods and sustainability begin to emerge. The introduction of capital typically is a precursor to the expansion of consumer choices. Thus, meeting the socioeconomic demands in itself is a prime driver for creating social impact. It is, therefore, no surprise that the market opportunity for impact investment is vast. A recent study examined five sectors of special importance to wage-earners living on less than $250 per month (water, health, housing, education and financial services). The study estimated that, over the next decade and a half, these sectors could absorb $400 billion to $1 trillion in capital and generate $183 billion to $667 billion in profits. South Asia is one among the top three regions where impact investment commitments are expected to witness a steep rise.

It is this systemic underperformance that impact investing tries to resolve by infusing capital along with business-management practices so that organizations are able to maximize their resources and achieve the desired outcomes. Impact investment into social entrepreneurial approaches, with appropriate scale, scope and focus can go a long way in complementing social sector organizations in bringing about sustainable development. Given the priority sector requirements and significant deficiencies in public spending, there are multiple market opportunities for investments, collaborations and exits for social entrepreneurs to develop innovative and differentiated businesses to foster inclusive growth. Impact investing looks at raising funds and making investments in entrepreneurs who work to solve socio-economic challenges using market economy. Social impact investing drives entrepreneurs to build self-sustaining systems to serve a wide array of the population and provide returns (both social and capital) on such investments. The ability to deliver benefits on a large scale is the wellspring of impact investment's appeal.

1.16. Distributional role of investment:

Distributions in investing refer to the payments made to investors by a company or a fund. These payments represent the portion of profits earned by the company or fund that is paid out to its investors. The most common types of distributions are dividends and interest payments.

Dividends are payments made by companies to their shareholders. These payments are often made quarterly or annually and represent a portion of the profits earned by the company. Bond funds or other fixed-income investments make interest payments. These payments are made to investors in exchange for lending money to the entity issuing the bonds.

1.16.1. Paid out to investor

Just like any other investment strategy, investors need to know when they can expect distributions to be paid out to them so that they can plan their finances accordingly.

The frequency at which distributions are paid out is determined by various factors, including the type of security, the investment strategy, and the investment manager's discretion. In general, dividend-paying stocks typically issue distributions quarterly.

While the distribution frequency may vary among investment vehicles, they are generally reinvested in the same type of security, leading to compounding returns over time.

Investment managers also play a crucial role in determining the distribution frequency of securities. Investment managers are responsible for investing the fund's assets and must distribute returns to investors according to the fund's distribution cycle.

1.16.2 Types of profits can be paid out as distributions

Generally, two main types of profits can be paid out as distributions: retained earnings and capital gains.

Retained earnings are profits a company has made but has not distributed to its shareholders as dividends. Instead, these earnings have been reinvested in the business for growth and expansion.

Capital gains represent the increase in the asset value over time. In the case of a corporate entity, this asset is usually its stock. Capital gains can be realized in two ways: through the stock sale or the payment of a special dividend called a capital gains distribution.

1.16.3. Calculation of distribution

A financial portfolio's distributions are essential, and various variables, including earnings, interest payments, and capital gains, determine them.

Determine the income the fund generates as the first stage in the distribution calculation process. Dividends, interest from bonds or cash, and option fees are examples of income sources. Depending on each investor's ownership stake in the fund, the profits are distributed to them.

The fund's net investment income is divided by the total number of outstanding shares to determine the distribution amount given to investors. For instance, the distribution per share would be $0.50 if the net investment revenue was $500,000 and there were 1,000,000 outstanding shares.

1.16.4. Investors choose to reinvest their distribution

When a fund or other investment pays out a distribution, the investor can either receive the distribution as cash or reinvest it into the investment. By choosing to reinvest, the distribution is used to purchase additional investment shares, increasing the number of shares owned.

These additional shares can lead to compound growth, where the new shares generate additional distributions in future periods.

The reinvestment of distributions is typically done automatically by the investment firm handling the investment.

Investors should consider the tax implications of reinvesting distributions. Additionally, reinvesting distributions can result in individual share prices being slightly different from the reinvestment price due to market fluctuations.

Lastly, investors should consider their overall investment strategy when deciding whether to reinvest distributions.

Distributions in the context of investing refer to payments made by organizations or funds to members. This revenue source is essential for many investors—which may come from dividends or interest. When investing in funds or companies that pay distributions, it is vital to understand how they are paid and taxed to make informed investment decisions.

1.17. Understanding income and inequality

Before we consider what the equitable distribution of income is and what it looks like, let's briefly recap inequality and income in economics. Inequality in economics can be measured in two different ways: income inequality and wealth inequality.

Income is a flow of earnings received at a certain rate in a given period, such as a salary or rental earnings.

In this article, we will stick to briefly covering income and income inequality. If you want to learn more about wealth, income and wealth inequality in more detail, check out our distribution of income and Distribution of Wealth.

Income inequality is the degree to which income is distributed unequally throughout a population

The Economists measure the distribution of income and income inequality in a country and globally through a variety of methods and ratios. The most common measures of income inequality are the Lorenz Curve and the Gini Coefficient.

1.18. Equitable distribution of income in economics

Income is distributed differently across countries. In some countries, like Norway, income is distributed quite equally. In others, income is very unequally distributed and that causes many economic and social problems like social unrest, poverty, etc.

There by many micro and macroeconomic policies a government can implement to tackle income inequality and distribute it more equitably

Some of these policies include:

- **Progressive taxation.** Progressive taxes reduce the tax burden on those with lower incomes and allows individuals to have more disposable income. Taxing the rich more allows the government to redistribute income in a more equitable manner, thus reducing income inequality.
- **Investment in the welfare system**. Neglecting the welfare systems often results in higher income inequality and poverty rates. When governments invest well in their country's welfare systems, they significantly help the poorest in society.
- **Investment in education and healthcare**. Investing in these two services allows for a more skilled and healthier workforce that earns higher wages. This reduces the gap between rich and poor.

1.18.1. Benefits of an equitable distribution of income

There are many benefits to an equitable distribution of income. We can see some of these benefits in the Nordic countries too. Some benefits are:

- **Reduced social problems**. When incomes are distributed in an equitable way, there is less social friction. Thus governments can enjoy a level of social peace and stability.
- **Standard of living**. The equitable distribution of income allows for all citizens to enjoy high standards of living.
- **Economic growth**. Poorer individuals have a higher marginal propensity to consume (MPC) because they have more essential goods and services that they need to buy compared to the rich. A more equal distribution of income allows these individuals to consume more and thus this spurs economic growth.

1.18.2. Drawbacks to an equitable distribution of income

Equitable distribution of income is a good thing. But it can have some economic drawbacks. Some of these are:

- **Fewer incentives**. Inequality provides an incentive for individuals to take risks and start a business. It also incentivises people to work and earn a higher income. If income is distributed in an equal way, it could lower some of these incentives.

- **Loss of the trickle-down effect**. This theory in economics is used to describe the belief that higher-income earners benefit everyone in society. If income was distributed equally, then the wider society wouldn't experience the benefits that have been 'trickled down'.

Unit-II

Investment Avenues

2.. Introduction:

2.1. Investment Avenues There are a large number of investment avenues for savers in India. Some of them are marketable and liquid while others are non-marketable. Some of them are highly risky while some others are almost riskless. The investor has to choose proper avenues from among them depending on his preferences, needs and ability to assume risk. The investment avenues can be broadly categorized under the following heads:

1. Corporate securities
2. Deposits in banks and non-banking companies
3. UTI and other mutual fund schemes
4. Post office deposits and certificates
5. Life insurance polices
6. Provident fund schemes
7. Government and semi-government securities.

2.1.1. Corporate Securities

Corporate securities are the securities issued by joint stock companies in the private sector. These include equity shares, preference shares and debentures. Equity shares have variable divided and hence belong to the high risk-high return category, while preference shares and debentures have fixed returns with lower risk.

2.1.2. Deposits

Among the non-corporate investments, the most popular are deposits with banks such as savings accounts and fixed deposits. Savings deposits have low interest rates whereas fixed deposits have higher interest rates varying with the period of maturity. Interest is payable quarterly or half-yearly. Fixed deposits may also be recurring deposits wherein savings are deposited at regular intervals. Some banks have reinvestment plans wherein the interest is reinvested as it gets accrued. The principal and accumulated interests are paid on maturity. Joint stock companies also accept fixed deposits from the public. The maturity period varies from three to five years. Fixed deposits in companies have high risk since they are unsecured, but they promise higher returns than bank deposits. Fixed deposit in non-banking financial companies (NBFCs) is another investment avenue open to savers. NBFCs include leasing companies, investment companies, chit funds, etc. Deposits in NSFCs carry higher returns with higher risk compared to bank deposits.

2.1.3. UTI and Other Mutual Fund Schemes

Mutual funds offer various investment schemes to investors. UTI is the oldest and the largest mutual fund in the country. Unit Scheme 1964, Unit Linked Insurance Plan 1971, Master Share, Master Equity Plans, Master gain, etc. are some of the popular schemes of UTI. A number of commercial banks and financial institutions have set up mutual funds. Recently mutual funds have been set up in the private sector also.

2.1.4. Post Office Deposits and Certificates

The investment avenues provided by post offices are generally non-marketable. Moreover, the major investments in post office enjoy tax concessions also. Post office accepts savings deposits as well as fixed deposits from the public. There is also recurring deposit scheme which is an instrument of regular monthly savings. Six-year National Savings Certificates (NSC) are issued by post office to investors. The interest on the amount invested is compounded half-yearly and to payable along with the principal at the time of maturity which is six years from the date of issue. Indira Vikas Patra and Kissan Vikas Patra are savings certificates issued by post officers.

2.1.5. Life Insurance Policies

The Life Insurance Corporation (LIC) offers many investment schemes to investors. These schemes have the additional facility of life insurance cover. Some of the schemes of LIC are whole Life Polices, Convertible Whole Life Assurance Polices, Endowment Assurance Polices, Jeevan Saathi, Money Back Plan, Jeevan Dhara, Marriage Endownment Plan etc.

2.1.6. Provident Fund Schemes

Provident fund schemes are compulsory deposit schemes applicable to employees in the public and private sectors. There are three kinds of provident funds applicable to different sectors of employment, namely Statutory Provident Fund, Recognised Provident Fund and Unrecognised Provident Fund. 11 In addition to these, there is a voluntary provident fund scheme which is open to any investor whether employed or not. This is known as the Public Provident Fund (PPF). Any member of the public can join the scheme which is operated by the post offices and the State Bank of India.

2.1.7. Government and Semi-Government Securities

The government and semi-Government bodies like the public sector undertakings borrow money from the public through the issue of government securities and public sector bonds. These are less risky avenues of investment because of the credibility of the government and government undertakings.

2.2. Traditional investment:

In finance, the notion of traditional investments refers to putting money into well-known assets with the expectation of capital appreciation, dividends, and interest earnings. Traditional investments are to be contrasted with alternative investments

2.2.1. Cash:

Cash investments, also called cash equivalents, are short term investments that earn interest, figured as a percentage of your principal. One key difference between cash investments and other investments is their liquidity, which means they can be converted to cash quickly and easily with little or no loss of value.

Cash is typically not considered an investment unless it's in an interest-bearing account (such as a savings account or a certificate of deposit). If it's not earning interest, cash generates zero return, and it can even lose value over the time because of inflation. Still, you never know when an investment opportunity might come along, so it's good to have some cash on hand. Plus, from a personal standpoint, cash can help you get through emergency.

2.2.2. Deposits

Among the non-corporate investments, the most popular are deposits with banks such as savings accounts and fixed deposits. Savings deposits have low interest rates whereas fixed deposits have higher interest rates varying with the period of maturity. Interest is payable quarterly or half-yearly. Fixed deposits may also be recurring deposits wherein savings are deposited at regular intervals. Some banks have reinvestment plans wherein the interest is reinvested as it gets accrued. The principal and accumulated interests are paid on maturity.
Joint stock companies also accept fixed deposits from the public. The maturity period varies from three to five years. Fixed deposits in companies have high risk since they are unsecured, but they promise higher returns than bank deposits.

2.2.3. Gold and Silver

For ages, gold and silver have been considered as a form of investment. They are considered as best hedge against inflation. This is a favourite form of investment amongst the rural and semi-urban population. Besides, investors tend to invest in jewellery instead of pure gold. As a result, when they buy jewellery, the price realization is usually less than total purchase price (this is due to higher making charge of jewellery). The price of gold has declined in the later part of the nineties. Gold prices are suppressed because of large supplies overtaking the demand. The government has allowed imports of gold to certain banks and agencies and they have huge stocks of gold. The gold prices remained depressed in the international markets too in the late nineties. The following reasons are cited for the low price of gold in the international market.
i) Weak demand from Asian countries which are the largest consumers of gold.

ii) Continuing pressure on central banks to dishoard gold

iii) Legislative measure like the Sweedish Government move to delink gold from Swiss

Franc and lower gold reserves by the European Union.

2.2.4. Commodities:

Interest in commodities as an investment asset class has grown tremendously in recent years. Because of the high costs and inconvenience of directly holding physical commodities, investors have traditionally relied on commodity futures (either directly or through investment management firms) to obtain a commodity exposure. Recently, commodity-based exchange-traded products have come to prominence and have facilitated renewed growth in commodity investing. The enormous success of these exchange-traded products is shown by the huge investment in the products, which reached $125.8 billion by April 2010 (see Carpenter 2010).

The popularity of commodities as investments is predicated on the view that commodities provide a direct exposure to a number of unique factors and have special hedging characteristics. Specifically, commodity prices are driven by such factors as weather, geopolitical developments, supply constraints in physical production, unanticipated increases in demand as a result of prosperity in emerging markets, and incidents that create political or economic turmoil. Relative to commodities, traditional asset classes are affected by these factors either to a lesser degree or in the opposite manner.

Two primary factors have contributed to the phenomenal recent growth in commodity investments. First, significant advances have been made in the various investment instruments that allow investors to gain an exposure to commodities. Second, two major asset classes, equities and real estate, performed poorly and experienced high volatility following the “tech bubble” in 2000 and the “subprime crisis” in 2008–2009, motivating investors to seek out asset classes that are alternatives to equities and real estate

2.2.5. Real Estate

The real estate market offers a high return to the investors. The word real estate means land and buildings. There is a normal notion that the price of the real estate has increased by more than 12 percent over the past ten years. The population growth and the exodus of people towards the urban cities have made the prices to increase manifold. The price of the residential area land generally in South Mumbai ranges from a high of ` 19,400 per sq.ft. at Kemps Corner to a low of ` 8,400 per sq.ft. at Cuffe Parke in 1998. Recently, the recession in the economy has affected the price of the real estate. Prices, marked a substantial fall in 1998 from the 1997 prices. Reasons for investing in real estate are give below:

1. High capital appreciation compared to gold or silver particularly in the urban area.
2. Availability of loans for the construction of houses. The 1999-2000 budget provides huge incentives to the middle class to avail of housing loans. Scheduled banks now have to disburse 3 percent of their incremental deposits in housing finance.
3. Tax rebate is given to the interest paid on the housing loan. Further ` 75,000 tax rebate on a loan upto ` 5 lakhs which is availed of after April 1999. If an invests in

a house for about ` 6-7 lakh, he provides a seed capital of about ` 1-2 lakh. The ` 5 lakh loan, which draws an interest rate of 15 percent, will work out to be less than 9.6 percent because of the ` 75,000 exempted from tax annually. In assessing the wealth tax, the value of the residential home is estimated at its historical cost and not on its present market value.

4. The possession of a house gives an investor a psychologically secure feeling and a standing among his friends and relatives.

Apart from making investment in the residential houses, the people in the higher income bracket invests their money in time share plans of the holiday resorts and land situated near the city limit with the anticipation of a capital appreciation. Farm houses and plantations also fall in the line. In spite of the fast capital appreciation investors generally do not invest in the real estate apart from owning one or two houses.

2.3. Modern Investment:

2.3.1. Direct Investment:

Investing directly in physical commodities is generally considered not feasible for investors because of the costs associated with trading, insuring, and storing the commodity. Thus, direct investment in physical commodities represents an inconsequential portion of aggregate investor portfolio value. The one exception is the many investors who purchase and hold significant amounts of precious metal in its pure physical form (e.g., gold bullion) or as currency (e.g., silver coinage). To take advantage of this fact, some firms now even sell gold bars in vending machines, called "investment stations."

2.3.2. Portfolio investment:

A portfolio investment is ownership of a stock, bond, or other financial asset with the expectation that it will earn a return or grow in value over time, or both. It entails passive or hands-off ownership of assets as opposed to direct investment, which would involve an active management role. The Portfolio investment may be divided into two main categories:

- strategic investment involves buying financial assets for their long-term growth potential or their income yield, or both, with the intention of holding onto those assets for a long time.
- The tactical approach requires active buying and selling activity in hopes of achieving short-term gains.

2.3.3. Insurance:

It is a form of contract or agreement which one party agrees in return of a consideration to pay an agreed amount of money to another party to make good for a loss, damage, injury to something of value in which the insured has to pay as a result of some uncertain event. Thus, insurance is a method of securing protection against future calamities and uncertainties.

2.3.4. Mutual funds:

A Mutual Fund is a trust that pools the savings of a number of investors who share a common financial goal. The money thus collected is then invested in capital market instruments such as shares, debentures and other securities. The income earned through these investments and the capital appreciation realized is shared by its unit holders in proportion to the number of units owned by them.

Different investment avenues are available to investors. Mutual funds also offer good investment opportunities to the investors. Like all investments, they also carry certain risks. The investors should compare the risks and expected yields after adjustment of tax on various instruments while taking investment decisions.

Investments in securities are spread across a wide cross-section of industries and sectors and thus the risk is reduced. Diversification reduces the risk because all stocks may not move in the same direction in the same proportion at the same time. Mutual fund issues units to the investors in accordance with quantum of money invested by them. Investors of mutual funds are known as unitholders.

The profits or losses are shared by the investors in proportion to their investments. The mutual funds normally come out with a number of schemes with different investment objectives which are launched from time to time. A mutual fund is required to be registered with Securities and Exchange Board of India (SEBI) which regulates securities markets before it can collect funds from the public.

As per section 2(q) of Securities and Exchange Board of India (SEBI) (Mutual Funds) Regulations, 1996, "Mutual Fund" means a fund established in the form of a trust to raise monies through the sale of units to the public or a section of the public under one or more schemes for investing in securities, including money market instruments or gold or gold related instruments or real estate assets.

2.4. Traded fund:

The exchange-traded fund (ETF) industry has grown strongly in a relatively short period of time, with the industry attracting greater attention as it grows in size. The original appeal to investors of these products was their simplicity, low-cost diversification benefits and ability to trade intraday. While this is still broadly the case, the evolution of the industry has resulted in a greater variety of ETFs becoming available to investors and improved accessibility to different asset classes. However, ETFs have also become more complex in the structure and types of strategies they employ in generating returns. These developments have created new opportunities and challenges for investors, market participants and regulators.

Unit-III

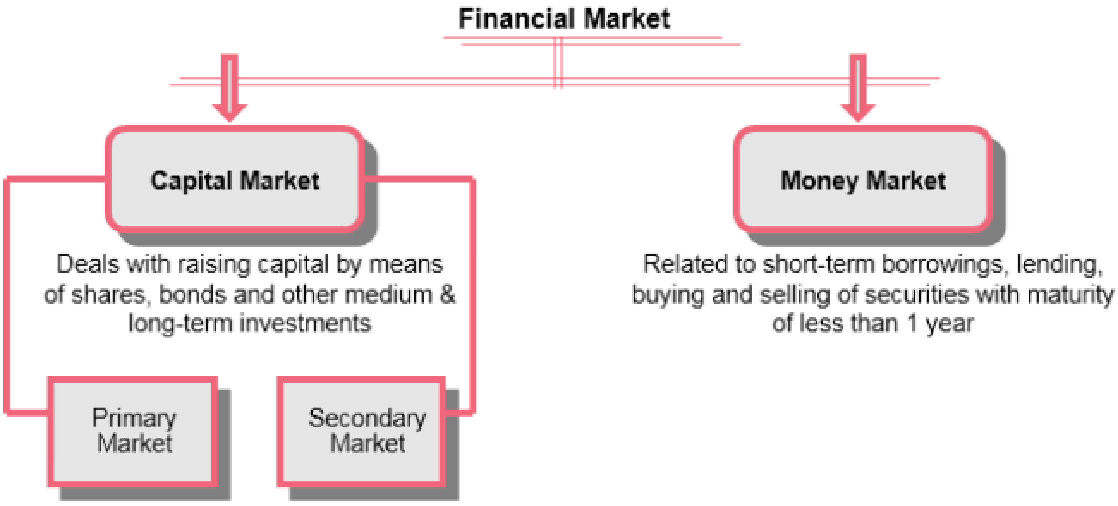
Investment market

3. Introduction:

An easy way to think about think about the stock market is to consider it as a network of stock exchanges where traders and investors buy and sell shares of publicly traded companies. Private companies list shares of their stock on an exchange through a process called an initial public offering (IPO).

3.1. Financial market:

Financial market refers to a market for the creation and exchange of financial assets (such as shares and debentures). In this market, money from those who have surplus money is transferred to those who require investment. The Investors are surplus units and business enterprises are deficit units, where the financial market acts as a link between surplus and deficit units.



3.1.1. Capital market:

The capital market today is a reality met in any modern economy. It is a market the necessity of which is unchallengeable, an extremely dynamic and innovative structure, permanently adapting to the economic environment and at the same time an influential factor of it, generating opportunities and to the same extent risk for all categories of participants to the economic activity, being a replica of a national economy to a small scale, but nevertheless especially representative. Tributary to the conditions in which it was formed and developed, the capital market brings together under these different conceptions. The Continental-European conception attributes to this market a more comprising structure, containing the monetary market, the mortgage market and the financial market. In the Anglo-Saxon conception, which the economic practice has also adopted in our country, the capital market is a component of the financial market together with the monetary market and the insurance market. The main objectives of a capital issue are given below.

•To promote a new company

•To expand an existing company

•To diversify the production

•To meet the regular working capital requirements

•To capitalize the reverses

3.1.1.1. Meaning of capital market:

A capital market is market for securities (Debt or Equity), where business enterprises (Companies) and government can raise long term funds. The primal role of this market is to make investment from investors who have surplus funds to the ones who are running a deficit. Capital Market is a place where different financial instruments are traded between different entities. On one side there are entities that have abundant capital, much more than they require and on the other side, there are entities who need capital for various purposes. Capital markets are used to sell equities (stocks), debt securities.

3.1.1.2. Definition of capital market:

It is an organised market mechanism for effective and efficient transfer of money capital or financial resources from the investing class (a body of individual or institutional savers) to the entrepreneur class (individual or institutions engaged in industry business or service) in the private and public sectors of the economy.

In a very broad sense, it includes the market for short-term funds. H.T. Parikh has referred to it as, “By capital market, I mean the market for all the financial instruments, short-term and long-term as also commercial, industrial and government paper.”

In the words of Goldsmith, “the capital market of a modern economy has two basic functions: first the allocation of savings among users and investment; second the facilitation of the transfer of existing assets, tangible and intangible among individual economic units.”

Grant defines capital market in a broad sense as “a series of channels through which the savings of the community are made available for industrial and commercial enterprises and for public authorities. It embraces not only the system by which the public takes up long-term securities directly or through intermediaries but also the elaborate network of institutions responsible for short-term and medium-term lending.”

From the above definitions, it may be deducted that the function of capital market is the collection of savings and their distribution for industrial investment. Thus, capital formation is sine qua non of economic development. As such, the relationship between the market, instrument, and services are integrated as well as inter-dependent.

Capital market is generally understood as the market for long-term funds. The capital market provides long-term debt and equity finance for the government and the corporate sector. By making long-term investments liquid, the capital market mediates between the conflicting maturity preferences of lenders and borrowers. The capital market also facilitates the dispersion of business ownership and the reallocation of financial resources among corporations and industries.

3.1.1.3. Dimensions of capital market:

The Capital market is directly responsible for the following activities:

(1) Mobilisation or concentration of national savings for economic development,

(2) Mobilisation and import of foreign capital and foreign investment capital plus skill to fill up the deficit in the required financial resources to maintain the expected rate of economic growth,

(3) Productive utilisation of resources, and

(4) Directing the flow to funds of high yields and also strive for balanced and diversified industrialisation.

3.1.1.4. Capital markets components and function:

The specificity of this market derives from numerous aspects, but defining and at the same time delimitative in relation to other components of the financial market are the following Traits:

i) It is a market specialized in transactions with medium and long term financial assets, Unlike the monetary market which offers solutions for refinancing through short and medium term capitals;
ii) It is a public, open and transparent market, in the sense that anyone can be a participant on this market, without there being notable entry or exit barriers, the transactions having a public character;
iii) The dissemination of information on this market, through its volume or, quickness and with the possibility of equal reception by all participants, is probably the best one from the ones existing in the structures of a market economy;

iv) The capital circulation vehicle is represented by securities, characterized through negotiability of the price and immediate transferability with very low transaction costs;

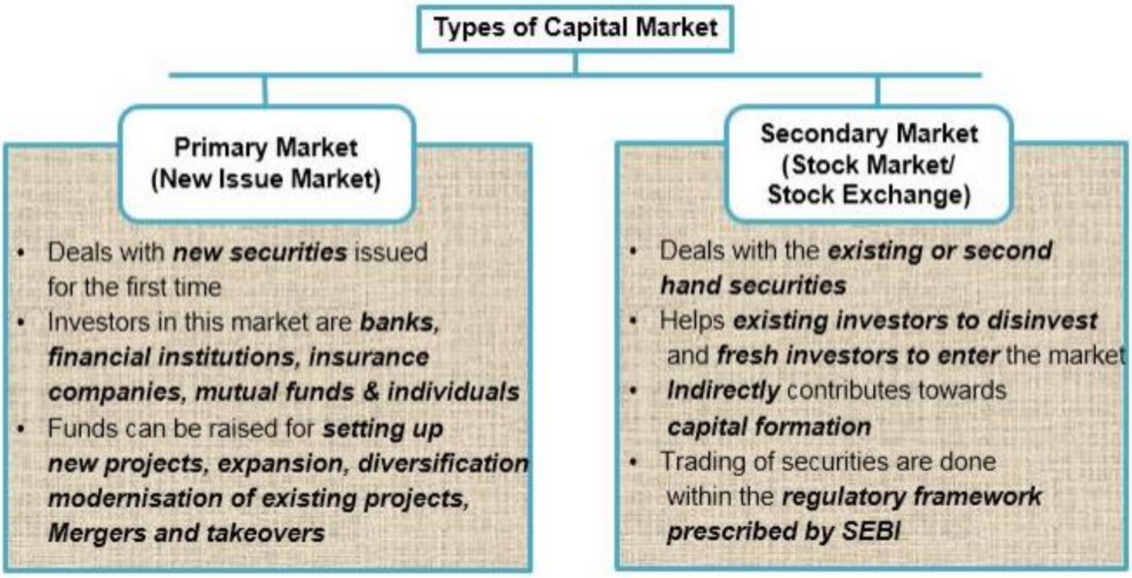
v) The transaction is made through intermediaries, who have an essential role in connecting the owners or issuers of securities with the owners of capitals;

vi) It is an organized market, in the sense that the transactions are performed according to certain principles, norms and rules known and accepted by participants.

In a market economy, the role of the capital market is of first rate. The well-functioning of the capital market is vital in the contemporary economy in order to be able to perform an efficient transfer of money resources from those who save towards those who need capital and those who succeed to offer it a higher capitalization; the capital market can significantly influence the quality of the investment decisions.

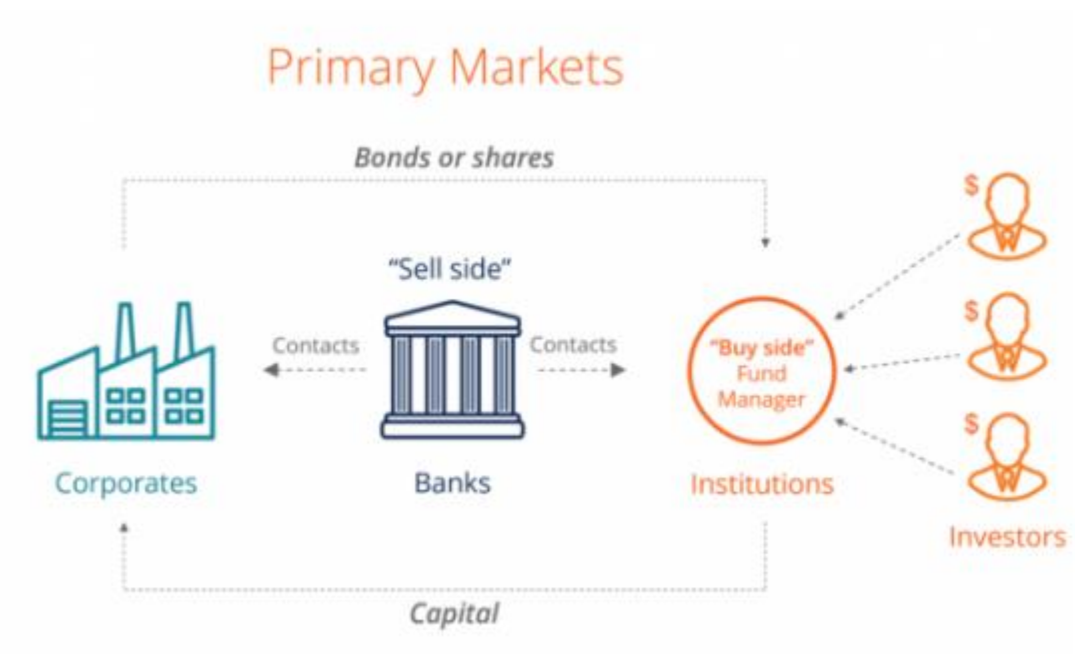
3.1.1.5 Types of capital market

The main components of the capital market are primary market and secondary market Types of Capital Market The main components of the capital market are primary market and secondary market.



3.1.1.6. Primary Market:

A primary market is a source of new securities. Often on an exchange, it's where companies, governments, and other groups go to obtain financing through debt-based or equity-based securities. Primary markets are facilitated by underwriting groups consisting of investment banks that set a beginning price range for a given security and oversee its sale to investors.



3.1.1.6.1. Primary market: Methods of Flotation of Securities

1) **Offer through prospectus**
   - Most popular method of raising funds by public companies in the primary market.
   - Subscriptions from the public are invited through the issue of a prospectus.
   - A direct deal is made to investors in order to raise capital through the prospectus. This is done by means of an advertisement in a newspaper or magazine.
   - The issues are underwritten, and listing is required on at least one stock exchange.
   - The prospectus should be made strictly according to the provisions of the Companies Act, Investor Protection Act and SEBI.
2) **Offer for sale**
   - Securities are offered through intermediaries.
   - Intermediaries can be issuing houses and stock brokers.
   - A company sells securities to brokers at an agreed price, who then resells them to the public willing to invest.
   - A company need not go through the formalities of issuing securities directly to the public.
3) **Private placement**
   - Allotment of securities by a company to institutional investors and some selected individuals.
   - Helps raise capital in lesser time than public issue.
   - Cost-saving method as there are lesser formalities and mandatory and non-mandatory expenses.
4) **Rights issue**
   - Privilege to existing shareholders to subscribe to new shares according to the terms and conditions of the company.

• Existing shareholders are offered a right to buy new shares in proportion to the number of shares they already possess.

5) **E-IPOs**

• Issue of capital to the general public through an online system of the stock exchange.

• A company needs to enter into an agreement with the stock exchange. This is called an Initial Public Offering (IPO).

• Brokers registered with SEBI are appointed for accepting applications and placing orders with the company.

• Appointment of the registrar by the issuer company for building electronic connectivity with the exchange.

• Issuer company may get its securities listed on any stock exchange except for the one from where it offered its securities.

3.1.1.6.2. Secondary Market: Stock Exchange.

A secondary market is the one in which the securities of the companies are traded among the investors. That means, the investors can buy and sell securities freely without any intervention of the issuing company. In such transactions that take place among the investors, the issuing company does not participate in the income generation. Besides, the share valuation is based on the share's performance in the market.

• The secondary market (also known as the stock exchange or stock market) deals in existing or second-hand securities.

• A stock exchange is a platform for buying and selling securities.

• As a first step towards generating interest of investors in corporate securities, the Government of India introduced the Companies Act in 1850.

• The first stock exchange was established in 1875 as 'The Native Share and Stock Brokers Association' in Bombay. It was later renamed Bombay Stock Exchange (BSE).

• Subsequently, over the years, stock exchanges were also developed in Ahmedabad, Calcutta and Madras. • Till the 1990s, the Indian secondary market comprised only regional stock exchanges.

• After the economic reforms of 1991, the Indian Stock Market acquired a three-tier system comprising Regional Stock Exchanges, the National Stock Exchange and Over The Counter Exchange of India (OTCEI).

3.1.1.6.3. Functions of the Stock Exchange:

1) Provides Liquidity and Marketability

- The stock exchange provides a platform where sale and purchase of existing securities can take place.
- Facilitates the conversion of securities to cash as and when required.
- Provides an opportunity for investors to disinvest and reinvest.
- Renders liquidity and marketability to the securities already existing in the market.

2) Determination of Prices

- Acts as a mechanism for continuous valuation of price of securities through the forces of demand and supply.
- This valuation serves as important information to buyers and sellers in the market.

3) Fair and Safe Market

- Provides a safe and fair market for trading of securities through its well-regulated and well defined legal framework.

4) Facilitates Economic Growth

- By facilitating the sale and purchase of securities, the stock exchange helps in channelizing savings to the most productive investment.
- This in turn promotes capital formation and economic growth.

5) Spreading of Equity Cult

- The stock exchange encourages people to invest in securities by regulating new issues, providing investor education and better trading practices.

6) **Scope for Speculation**
   - A certain degree of healthy speculation is essential to maintain the continuous process of the demand and supply of securities, and this function is performed by the stock exchange.

3.1.1.6.4. Features of the Secondary Market

Apart from ensuring true and fair dealing for the protection of the investors' interest, the features of the secondary market include the following:

- **Creating Liquidity:** The most important feature of the secondary market is to create liquidity, that means, immediate conversation of the securities into cash. Besides, as the secondary market security can be sold and bought a number of times, it aids in liquidity creation.
- **Follows the primary market:** Unlike the primary market, any new security cannot be sold for the first time in the secondary market. All the new securities are first issued in the primary market and then are sold and bought in the secondary one.
- **Stock Exchange:** The secondary market has a particular place wherein the securities are traded; it is called the stock exchange. However, it is not mandatory for the trading to be performed through a stock exchange only. Even two individuals can trade them mutually and it can still be called a transaction.
- **Encourages new investment:** As the rates of the securities often fluctuate in the share market, many investors come to trade and earn profits, giving rise to new investment. This results in increased investment in the industrial sector.

Types of Secondary Market

The secondary market is mainly categorized into the Stock Exchanges and Over-the-Counter markets. Given below is the brief summary of the same:

- **Stock Exchange**

The stock exchanges are nothing but a centralized platform that enables trading of the securities without any contact between the buyers and the sellers. The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are the foremost examples of the stock exchanges in India.

All the transactions taking place in the stock exchanges are subjected to constricted regulations in the securities trading. A stock exchange acts as a guarantor and thus there is no risk of the counterparty risks.

- **Over-the-Counter (OTC) Markets**

These are decentralized markets, mainly consisting of participants that are engaged in trading among themselves. As there is no regulatory authority involved, and the parties deal directly with each other, there are counterparty risks in the OTC markets. The FOREX (foreign exchange market) is an example of the over-the-counter market.

3.2. Share market:

3.2.1. Meaning of share market:

A stock is a general term used to describe the ownership certificates of any company. A share, on the other hand, refers to the stock certificate of a particular company. Holding a particular company's share makes you a shareholder.

3.2.2. Functions of share market

Following are some of the most important functions that are performed by stock exchange:

1. **Role of an Economic Barometer:** Stock exchange serves as an economic barometer that is indicative of the state of the economy. It records all the major and minor changes in the share prices. It is rightly said to be the pulse of the economy, which reflects the state of the economy.
2. **Valuation of Securities:** Stock market helps in the valuation of securities based on the factors of supply and demand. The securities offered by companies that are profitable and growth-oriented tend to be valued higher. Valuation of securities helps creditors, investors and government in performing their respective functions.
3. **Transactional Safety:** Transactional safety is ensured as the securities that are traded in the stock exchange are listed, and the listing of securities is done after verifying the company's position. All companies listed have to adhere to the rules and regulations as laid out by the governing body.
4. **Contributor to Economic Growth:** Stock exchange offers a platform for trading of securities of the various companies. This process of trading involves continuous disinvestment and reinvestment, which offers opportunities for capital formation and subsequently, growth of the economy.
5. **Making the public aware of equity investment:** Stock exchange helps in providing information about investing in equity markets and by rolling out new issues to encourage people to invest in securities.
6. **Offers scope for speculation:** By permitting healthy speculation of the traded securities, the stock exchange ensures demand and supply of securities and liquidity.
7. **Facilitates liquidity:** The most important role of the stock exchange is in ensuring a ready platform for the sale and purchase of securities. This gives investors the confidence that the existing investments can be converted into cash, or in other words, stock exchange offers liquidity in terms of investment.

8. **Better Capital Allocation:** Profit-making companies will have their shares traded actively, and so such companies are able to raise fresh capital from the equity market. Stock market helps in better allocation of capital for the investors so that maximum profit can be earned.
9. **Encourages investment and savings:** Stock market serves as an important source of investment in various securities which offer greater returns. Investing in the stock market makes for a better investment option than gold and silver.

3.2.3. Features of share market:

- **A market for securities-** It is a wholesome market where securities of government, corporate companies, semi-government companies are bought and sold.
- **Second-hand securities-** It associates with bonds, shares that have already been announced by the company once previously.
- **Regulate trade in securities-** The exchange does not sell and buy bonds and shares on its own account. The broker or exchange members do the trade on the company's behalf.
- **Dealings only in registered securities-** Only listed securities recorded in the exchange office can be traded.
- **Transaction-** Only through authorised brokers and members the transaction for securities can be made.
- **Recognition-** It requires to be recognised by the central government.
- **Measuring device-** It develops and indicates the growth and security of a business in the index of a stock exchange.
- **Operates as per rules**– All the security dealings at the stock exchange are controlled by exchange rules and regulations and SEBI guidelines.

3.3. Bond Market:

As markets become volatile, investors often turn to bonds as an alternative to stocks. While bonds can play an integral role in a well-diversified portfolio, you should fully understand their characteristics before investing. Bonds are often deemed a "safe" investment. However, it's important to be aware that bonds, like all investments, do carry some risk, and those risks need to be considered carefully.

Bond Fundamentals Simply put, bonds are issued by companies and government bodies to fund their dayto-day operations or to finance specific projects. When you buy a bond, you are, in fact, loaning money for a certain period of time to the issuer of the bond. In return, you receive the principal amount back, with interest, at the time the bond comes due or "matures." A bond's face value, or the price at issue, is known as its "par value," and the interest payment is known as its "coupon." The price of bonds will fluctuate, similar to stocks, throughout the trading day. However, with most bonds, the coupon payment will stay the same (some floating-rate securities do exist). If you purchase a bond in the secondary market at the face value, it is considered to be sold at "par." If a bond's price is above its face value, it is sold at a premium. If a bond's price is below face value, it is sold at a discount. It's important to understand that not all bonds are created equal. While all bonds are considered debt instruments, they are created by different entities for very different purposes and carry varying risks and tax related liabilities.

3.3.1. Types of bond market:

In general, there are three main categories that bonds will fall under: government, municipal, and corporate.

3.3.1.1. Government Bonds

If you're looking for low-risk investments, U.S. Treasuries are typically a good option, as they are backed by the full faith and credit of the U.S. government. The U.S. Treasury regularly offers three types of securities: Treasury bills, notes, and bonds. Treasury bills (or T-bills) are short-term securities that mature in one year or less from their issue date and are purchased for a price below their face value. Treasury notes and bonds pay a fixed rate of interest every six months until the security matures. Treasury notes mature in more than a year, but not more than ten years from their issue date. Treasury bonds, on the other hand, mature in more than ten years from their issue date. Bonds and notes can usually be purchased for a price close to their face value. Interest from Treasury securities is exempt from state and local income taxes, which make them particularly beneficial if you live in a state with a high tax rate. In addition to U.S. Treasuries, certain federal government agencies or government sponsored enterprises (GSEs) are authorized by Congress to issue debt securities to specific groups of borrowers, such as homeowners, farmers, and students. In general, debt securities issued by GSEs are considered to have high credit quality. However, it is important to recognize that issuers in the U.S. agency bond market are corporations and that their bonds are not explicitly guaranteed by the U.S. government.

3.3.1.2. Municipal Bonds

Just as the federal government needs funds to operate, local governments and public entities, such as school districts, often issue municipal bonds to address their financial needs. Municipal bonds can be issued by states, cities, towns, or public commissions to provide money for schools, hospitals, and other public works. These securities provide income that is free of federal and, in some cases, state and local taxes. (Although income generated by most municipal bonds is exempt from taxes, any capital gains earned from the sale of bonds are subject to all federal and most state tax laws, and certain bonds may be subject to the alternative minimum tax.)

3.3.1.3. Corporate Bonds

Corporate bonds, unlike U.S. Treasuries and municipal bonds, are fully taxable and may carry greater risk. At the same time, they may offer higher returns than tax-advantaged bonds. Corporate bonds are issued by corporations, typically in denominations of $1,000 with terms of 1 to 30 years. Unlike stocks, bonds do not give the holder ownership interest in the corporation, as they are simply a tool used to lend the corporation funds it needs to fund its goals. Because corporate bonds generally carry greater risks than government and municipal bonds, it is important to understand the quality of the bond you are considering for investment. To evaluate a bond's credit quality, you can look to bond rating agencies such as Moody's Investors Service and Standard & Poor's. Bonds rated Baa or above by Moody's and BBB or above by Standard & Poor's are considered investment grade. Bonds rated below investment grade are considered more speculative and carry greater risk.

3.4. Money market:

It refers to a market which deals in short-term securities and whose maturity is less than one year. The assets in the money market can be regarded as very close substitutes for money. Accordingly, they are also called 'near money instruments'.

3.4.1. Features of money market:

1. Monetary assets with **maturity period of less than equal to one year**.
2. Financial market of **unsecured but lower risk and highly liquid short term instruments.**
3. Helps raising **funds** for meeting temporary cash shortages and obligations
4. Making **major participants** of Banking and other financial corporations like RBI, commercial banks, non- banking financial companies, state governments large corporates houses and mutual funds.

3.4.2. Instruments of the Money Market

1) **Treasury bill**
    - ❖ It is a short-term borrowing instrument of the Government of India.
    - ❖ It is a promissory note having a maturity period of less than one year.
    - ❖ It is issued by the Reserve Bank of India on behalf of the central government and is a highly liquid instrument.
    - ❖ It is available for a minimum of Rs 25,000 and in multiples thereof.
    - ❖ This instrument is also known as Zero-Coupon Bond and has very low risk and offers an assured return.
    - ❖ The maturity period of treasury bills varies from 14 days to 364 days.
2) **Call money**
    - ❖ It is a money market instrument which is used by commercial banks for interbank transactions.
    - ❖ These instruments are used by commercial banks for meeting their cash reserve requirements, i.e. commercial banks borrow from each other to fulfil any shortage of funds required to maintain the cash reserve ratio through call money.
    - ❖ It has a maturity period of less than fifteen days.

- ❖ Interest is paid on the call money, which is called the call rate. This rate is highly variable, varying from day to day.
- ❖ An inverse relationship exists between the call rate and money market instruments such as commercial papers and certificates of deposit.
- ❖ When the call money rate rises, other instruments of the money market become comparatively cheaper and thereby their demand increases.

3) **Commercial paper**
- ❖ It is a short-term unsecured money market instrument introduced in India in 1990.
- ❖ Basically, it is a promissory note which is negotiable and transferable.
- ❖ It has a maturity period ranging from a minimum of 15 days to a maximum of one year.
- ❖ These are primarily used by large and creditworthy companies for bridge financing, i.e. used as an alternative to borrowing from banks and the capital market.
- ❖ Companies pay an interest rate lower than the market rates. Commercial papers are used for purposes such as to meet the flotation cost on long-term borrowings from the capital market.

4) **Commercial bill**
- ❖ It is a source of financing credit sales by companies for the short term.
- ❖ It is used by companies to finance their working capital requirements.
- ❖ Is a negotiable instrument.
- ❖ A seller (drawer) draws a commercial bill and gives it to a buyer (drawee) who accepts it. After the buyer's acceptance, it becomes a tradable instrument. The seller can discount it with a commercial bank even before the bill matures. This is known as discounting of a bill.

5) **Certificate of deposit**
- ❖ These are negotiable, unsecured instruments presented in the bearer form.
- ❖ These instruments are issued by commercial banks and financial institutions to individuals, corporations and companies.
- ❖ It is used during periods of tight liquidity by commercial banks to meet the demand for credit.
- ❖ Maturity period of these instruments range from 91 days to 1 year.
- ❖ Banks are not allowed to discount these instruments.

3.5. Metal market:

Metals have been traded for many millennia mostly as spot trades with immediate delivery of the physical metal. Futures trading of metals has been more recent, and futures trading on organized exchanges even more recent. Futures markets proliferated in the 1980s when they were as many as 85 futures markets in operation worldwide. In the United States, in recent times, metals spot and futures trading has traded at least since the early 1920s at the Chicago Board of Trade (CBOT). Other futures exchanges have since come into being and then most have been consolidated into other exchanges leading to more efficient pricing, given that fragmented markets are inefficient.

Currently, the London Metal Exchange (LME) is the major international market for the important industrial non-ferrous metals, namely aluminum, aluminum alloy, copper, lead, nickel, tin, zinc, and silver. It is the most important market for the pricing of non-ferrous metals worldwide.

3.5.1. Major metal exchanges:

The markets for precious metals can be quite different from markets for other metals and other commodities. There are a number of reasons for that and we illustrate these differences by examining the markets for gold. Gold is a precious metal used in almost all countries and throughout history.

3.5.2. Gold

The Nature of Gold is one of the most malleable, ductile, dense, conductive, non-destructive, brilliant, and beautiful metal. These unique set of qualities have made it a coveted object in most of human history for almost every civilization; and so there have been markets for gold since time immemorial. Valuable gold artefacts have been dated as originating from as long ago as 5000 BC. Aristotle is said to have run naked through the streets shouting “Eureka” when he realized a simple way of checking the purity of gold objects when he was taking a bath. The monetary use of gold had been particularly widespread since the early 19th century but ended in 1968 when central banks stopped supporting a fixed price for gold. In modern times, gold is widely used for making jewellery, for many industrial and commercial applications, and as an investment and a store of value.

3.6. Commodity market:

A commodity market is where you can buy and sell goods taken from the earth, from cattle to gold, oil to oranges, and orange juice to wheat. Commodities can be turned into products like baked goods, gasoline, or high-end jewelry, which in turn are bought and sold by consumers and other businesses. Markets in these goods are the oldest in the world, but they are as crucial to the most modern societies as they were to the small trading communities of ancient civilizations.

Commodities are often split into **two broad categories**: hard and soft commodities**.** **Hard commodities** include natural resources that must be mined or extracted, such as gold, rubber, and oil, while **soft commodities** are agricultural products or livestock, such as corn, wheat, coffee, sugar, soybeans, and pork. They are traded directly in spot markets or financial commodity markets through contracts for them or their future prices.

3.6.1. Types of Commodity Markets

Generally speaking, commodities trade either in spot markets or financial commodity or derivatives markets. **Spot markets** can be physical or “cash markets” where people and companies buy and sell physical commodities for immediate delivery.

Derivatives markets involve forwards, futures, and options. Forwards and futures are derivatives contracts that rely on the spot prices of commodities. These are contracts that give the owner control of the underlying asset at some point in the future for a price agreed upon today. Only when the contracts expire would physical delivery of the commodity or other asset take place, and often traders roll over or close out their contracts to avoid making or taking delivery altogether. Forwards and futures are generally the same, except that **forwards** are customizable and trade over-the-counter, while **futures** are standardized and traded on exchanges.

3.6.2. Commodity Market Trading vs. Stock Trading

Commodity Market Trading

- Traditionally more difficult for individual investors to access.
- Focuses on physical assets, like precious metals, crops, or oil.
- Supply of commodities can vary significantly based on the time of year, demand, production levels, and other factors.
- Does not pay dividends.
- Potential for higher volatility.

Stock Trading

- More accessible to individual investors.
- Focuses on shares of ownership in businesses.
- Supply of shares in an individual company are less variable, typically changing only when new stock is issued to a buyback occurs.
- May pay dividends.
- May be less volatile.

3.7. Foreign exchange market:

Define Foreign Exchange Market

The foreign exchange market is over a counter (OTC) global marketplace that determines the exchange rate for currencies around the world. This foreign exchange market is also known as Forex, FX, or even the currency market. The participants engaged in this market are able to buy, sell, exchange, and speculate on the currencies.These foreign exchange markets are consisting of banks, forex dealers, commercial companies, central banks, investment management firms, hedge funds, retail forex dealers, and investors. In our prevailing section, we will widen our discussion on the ‘Foreign Exchange Market’.

3.7.1. Types of Foreign Exchange Market

The Foreign Exchange Market has its own varieties. We will know about the types of these markets in the section below:

The Major Foreign Exchange Markets:

1. Spot Markets
2. Forward Markets
3. Future Markets
4. Option Markets
5. Swaps Markets

Let us discuss these markets briefly,

1. Spot Market

In this market, the quickest transaction of currency occurs. This foreign exchange market provides immediate payment to the buyers and the sellers as per the current exchange rate. The spot market accounts for almost one-third of all the currency exchange, and trades which usually take one or two days to settle the transactions.

2. Forward Market

In the forward market, there are two parties which can be either two companies, two individuals, or government nodal agencies. In this type of market, there is an agreement to do a trade at some future date, at a defined price and quantity.

3. Future Markets

The future markets come with solutions to a number of problems that are being encountered in the forward markets. Future markets work on similar lines and basic philosophy as the forward markets.

4. Option Market

An option is a contract that allows (but is not as such required) an investor to buy or sell an instrument that is underlying like a security, ETF, or even index at a determined price over a definite period of time. Buying and selling ‘options’ are done in this type of market.

5. Swap Market

A swap is a type of derivative contract through which two parties exchange the cash flows or the liabilities from two different financial instruments. Most swaps involve these cash flows based on a principal amount.

6. Hedge market

A hedge, in finance, is to take an offsetting position in an asset or investment that reduces the price risk of an existing position. A hedge is therefore a trade that is made with the purpose of reducing the risk of adverse price movements in another asset. Normally, a hedge consists of taking the opposite position in a related security or in a derivative security based on the asset to be hedged.

3.7.2. Functions of Foreign Exchange Market

The various functions of the Foreign Exchange Market are as follows:

I. Transfer Function: The basic and the most obvious function of the foreign exchange market is to transfer the funds or the foreign currencies from one country to another for settling their payments. The market basically converts one's currency to another.
II. Credit Function: The FOREX provides short-term credit to the importers in order to facilitate the smooth flow of goods and services from various countries. The importer can use his own credit to finance foreign purchases.
III. Hedging Function: The third function of a foreign exchange market is to hedge the foreign exchange risks. The parties in the foreign exchange are often afraid of the fluctuations in the exchange rates, which means the price of one currency in terms of another currency. This might result in a gain or loss to the party concerned.

3.7.3. Features of Foreign Exchange Market

This kind of exchange market does have characteristics of its own, which are required to be identified. The features of the Foreign Exchange Market are as follows:

A. **High Liquidity**
The foreign exchange market is the most easily liquefiable financial market in the whole world. This involves the trading of various currencies worldwide. The traders in this market are free to buy or sell the currencies anytime as per their own choice.
B. **Market Transparency**
There is much clarity in this market. The traders in the foreign exchange market have full access to all market data and information. This will help to monitor different countries' currency price fluctuations through the real-time portfolio.
C. **Dynamic Market**
The foreign exchange market is a dynamic market structure. In these markets, the currency values change every second and hour.
D. **Operates 24 Hours**
The Foreign exchange markets function 24 hours a day. This provides the traders the possibility to trade at any time.

3.7.4. The participants in a foreign exchange market

The participants in a foreign exchange market are as follows:

a. **Central Bank:** The central bank takes care of the exchange rate of the currency of their respective country to ensure that the fluctuations happen within the desired limit and this participant keeps control over the money supply in the market.
b. **Commercial Banks:** Commercial banks are the channel of forex transactions, which facilitates international trade and exchange to its customers. Commercial banks also provide foreign investments.
c. **Traditional Users:** The traditional users consist of foreign tourists, the companies who carry out business operations across the globe.
d. **Traders and Speculators:** The traders and the speculators are the opportunity seekers who look forward to making a profit through trading on short-term market trends.
e. **Brokers:** Brokers are considered to be the financial experts who act as a sure intermediary between the dealers and the investors by providing the best quotations.

3.7.5. Advantages of Foreign Exchange Market

The whole world economy is relying upon this foreign exchange market for obvious advantageous reasons. Let us check what are the advantages gained in the foreign exchange market:

- ✓ There are very few restrictive rules, this allows the investors to invest in this market freely.
- ✓ There are no central bodies or clearinghouses that head the Foreign Exchange Market. Hence, the intervention of the third party is less.
- ✓ Many investors are not required to pay any commissions while entering the Foreign Exchange Market.
- ✓ As the market is open 24 hours, the investors can trade here without any time-bound.
- ✓ The market allows easy entry and exit to the investors if they feel unstable.

Unit-IV

Economic Fundamentals for Investors

4. Domestic Economic Environment

4.1. Environment of business:

The term 'environment' refers to the totality of all the factors which are external to md beyond the control of individual business enterprises and their management. Environment furnishes the macro-context; the business firm is the micro-unit. The environmental factors are essentially the 'givens' within which the firms and their managements must operate. For example, the value system of the society, the rules and regulations laid down by the government, the monetary policies of the central bank, the institutional set-up of the country, the ideological beliefs of the leaders, the attitude towards foreign capital and enterprises, etc., all constitute the environment system within which a business firm operates. These environmental factors are numerous in numbers and various in form. Some of these factors are totally static. some are relatively static and some are very dynamic -they are changing every now and then. Some of these factors call be conceptualised and quantified, while others can be only referred to in qualitative terms. Thus, the environment of business is an extremely complex phenomenon.

The environmental factors generally vary from country to country. The environment that is typical of India, may not be found in other countries like the USA, the USSR. the UK and Japan. Similarly, the America/Soviet/British/Japanese environment may not be found in India. There may be some factors in common, but the order and intensity of the environment factors do differ between nations. What to say of countries, the magnitude and direction of environmental factors differ over regions within a country and over localities within a region. Thus, one may talk of local, regional, national (domestic) and international (foreign) environment of business. For example, the local custom of 'coolie labour, the climate of the Northern region of Assam, the policies of the State and Central governments hi India and the size of the world market: all these factors together will have an important bearing on the tea industry. The production, consumption arid marketing of tea will be affected by the environmental factors.

Environment differs not only over space but also over time within a country. As such we can talk of temporal patterns of environment. i.e, past, present arid future environment - future environment is the product of past and present environments. The Indian economy of tomorrow will be influenced by what the state of the economy is at present and what it was like in the past.

Sometimes the environment may be classified into market environment and non-market environment depending upon whether a business firm's environment is influenced by market forces like demand, supply, number of other firms and the resulting price competition or non-price competition, etc., or by non-market forces like government laws, social traditions, etc.

Finally, we may classify the environment into economic and non-economic. Non-economic environment refers to social, political, legal, educational and cultural factors that affect business operations. Economic environment, on the other hand, is give shape and form by factors like the fiscal policy, the monetary policy, the industrial policy resolutions, trade policy, 'physical limits on output, the price and income trends, the nature of economic system at work, the tempo of economic development, the national economic plan, etc. The non-economic environment has economic implications just as the economic environment may have non-economic implications. Since the environment is the sum total of history, geography, culture, sociology, politics and economics of a nation, the interaction between economic forces and non-economic forces is bound to take place.

Some basic propositions as a prelude to the description and analysis of business environment in any economy, we may examine the three basic propositions as given below:

(a) business is an economic activity,
(b) a business firm is an economic unit, and
(c) business decision-making is an economic process.

These propositions may be examined separately or jointly to justify the study of Economic environment of business in any country.

4.2. Business is an economic activity

An economic activity is the task of adjusting the means (resources) to the ends (targets), or the ends to the means. An economic activity may assume different forms such as consumption, production, distribution and exchange. The nature of business differs. depending upon the form of economic activity which is being undertaken and organised. For example, manufacturing business is primarily concerned with production; stock exchange business is mainly concerned with the buying and selling of shares and debentures; the business of government is to run the administration. The government may also-own control and manage public enterprises, and the business of banks is to facilitate transactions in short-term and long-term funds. These examples can be easily multiplied. The point to be noted is, that each business has a target to achieve and for that, each business has some resources at its disposal. Sometimes the target has to be matched with the given target. Either way, the task of business is to optimise the outcome of economic activities.

A business firm is an economic unit

A business firm is essentially a transformation unit. It transforms input into output - goods or services or a combination of both. The nature of input requirements and the type of output flows are determined by the size, structure, location and efficiency of the business firm under consideration. The business firms may be of different sizes and forms. They may undertake different types of activities such as mining, manufacturing, farming, trading, transporting, banking etc. The motivational objective underlying all these activities is the same, viz. profit maximisation in the long-run. Profit is essentially 'a surplus value' - the value of output in excess of the value of input or the surplus of revenue over the cost. A business firm undertakes the transformational process to generate 'this surplus value'. The firm can grow further if the surplus value is productively invested. The firm, therefore, carefully plans the optimum allocation of resources (input of men, money, materials, machines, time, energy, etc.)

to get optimum production. The entire process of creation, mobilisation and utilisation of surplus constitutes the economic activity of the business' firm.

4.3. Business decision-making is an economic process

Decision-making involves making -a choice from a set of alternative courses of action. Choice is at the root of all economic problems. The question of choice and evaluation arises because of the relative scarcity of resources. If the resources hat1 not been scarce, an unlimited amount of ends could have been satisfied. But the situation of resource constraint is very real. A business firm seriously thinks about the optimum allocation of resources because resources are limited in supply and most resources have alternative uses. The firm therefore, intends to get the best out of given resources or to minimise the use of resources for achieving a specific target. In other words, when 'input' is the constraining factor, the firm's decision variable is the 'output'. And when 'output' is the constraining factor: the firm's decision variable is the 'input'. Whatever may be the decision variable, procurement or production, distribution or sale, input or output decision-making is invariably the process of selecting the best available alternative. That is what makes it an economic pursuit.

Since business is economic activity, a business unit and business decision-making, an economic process, it is the economic environment of business which is a primary consideration in evaluating business (policies, business strategies and business tactics of corporate entity in any national economy).

4.4. Economic Environment

We may now consider a firm as an economic institution in a market system. The market behaviour of the firm reflects the nature of the economic decisions taken by the manager of the firm. Micro-economic decision making by the firm has nevertheless to be made within the broader macro-economic environment. Economic environment of business refers to the broad characteristics of the economic system in which a business firm operates.

The present-day economic environment of business is a complex phenomenon. The business sector has economic relations with the government, the capital market, the household sector and the foreign sector. These different sectors together influence the trends and structure of the economy. The form and functioning of the economy varies from country to country. The design and structure of an economy system is conditioned by socio-political arrangements. Such arrangements are relevant from the standpoint of macro-economic decision making.

For example, in a democratic set-up, people exercise an influence, direct or indirect, through the system of casting votes. (in the nature of the decisions taken by the government. In a parliamentary system, most decisions are processed by the Cabinet Ministers, whereas under a presidential form of government the President acts as the real manager of the State: It is he/she who takes or makes decisions. Similarly, macro-decision-making is more decentralised in a federal form of government than in a unitary form of government.

We may argue that the decisions being referred to are political decisions. True, but it must be emphasised that political decisions have far-reaching economic implications. After all, the government is the manager of economy. The nature of government ownership, control and regulation of economic activities of a country provides form and shape to the nature of economic organisations. In a capitalist society, the private sector, induced by the profit-motive and guided by the indication of a free-market mechanism, takes the major economic decisions of investment, production and distribution. In a socialist society, such decisions are taken by the government which is guided by the social welfare motive and central planning. In a communist society, economic decisions. including that of consumption. are taken by the State in the interest of the community as a whole. In a mixed economy. private. public, joint sectors and the like, all have some say in the major decisions that influence the functioning of an economy.

If modern economies, whether capitalist, socialist, communist or mixed, have certain fundamental economic problems to deal with. in each and every economy, including the so-called 'Affluent Society', most of the resources are scarce. Consequently, choices concerning the resource use have to be made together by individuals, by business corporations, and by the society. It is the social choice and community preference which give substance to the question of macro-economic decisions. From the standpoint of resources, tile basic economic problem of every economy is that of just allocation of resources and subsequent optimum production. There are many aspects to this problem? What to produce? How to produce? For whom to produce? When to produce? Every economy has to decide on the quality and quantity of the goods and the services to be produced. It has to decide on the nature of technology and technique of production in view of factor endowment. It has to decide on the course and pattern of distribution of goods and services produced. It has to decide on the timing of production. You may note that similar decisions are taken by individual firms and there is no end to such decisions. The process of decision-making differs depending on how these problems are solved in different economics. This is what constitutes the functioning of the economy or the nature of economic environment. At the cost of over-simplification, certain points can be made about the organisation and functioning of modern economics:

(a) In most of the economies, both 'free market mechanism' and 'centralised planning' exist in different degrees. By 'free market mechanism' or 'price mechanism', we mean a free play of the market forces of demand and supply to determine an equilibrium solution of the allocation problem. Market mechanism determines commodity prices, factor prices and income distribution. By 'planning', we mean a programme of action that shows consistency and feasibility for attaining a set of targets in view of a set of objectives through a set of instruments. In the present day world around us, planning is combined with free pricing to arrive at macro-economic decisions yielding maximum good for the maximum number. Thus, the economy in which a business firm operates today is not an exclusively free economy making an indiscriminate use of prices and the markets, rather it is directed by a system of planning, control, regulation and co-ordination.

(b) In most of the economies, positive intervention by government in day-to-day economic affairs is on the increase. Planning is a form of governmental intervention. Besides this, the government can also intervene through a system of controls and regulations. The welfare state principle induces the government to enforce minimum wages, commodity control, fair trade-practices. etc. Through legislation, the basic objectives of such economic legislations and policies are: growth, efficiency and equity. It is the interfering role of modern government that has made most of the business firms socially responsible.

(c) Modem economies are not 'closed', but 'open': they are actively engaged in international trade and co-operation. So, the international transmission effect today is stronger than ever before. Though there are disparities in the levels of income and standards of living over space and time, there is a conscious effort to develop the poor nations. The maintenance of steady growth in developed countries is dependent on the acceleration of growth in under-developed countries. This idea has given new dimensions to issues like the role of multi-national corporations, the ecological balance, the recycling of petro-dollars and transfer of technology. The technological revolution is making strident moves. In order to keep their dynamism, the economies are determined to develop science and technology and to balance environment and ecology, and this is going to act as a unifying force for the world economic order. These facts determine the environment and set the constraints within which the modern business firm must operate. The management cannot overlook the market or the non-market environment. No management can ignore the function of markets, the objectives of national planning, the policies of the government or their social responsibilities, or the rate, pattern and structure of economic changes, or the forms of international co-operation. Progressive management must keep itself continuously informed about the magnitude and direction of changes in national as well as international economic environment. Of course, both economic and non-economic environment have an important bearing on economic decision-making by the management.

4.5. Critical Elements

In what follows, we intend to identify and describe a few critical elements of economic environment. These critical elements are relevant from the standpoint of both, corporate business management and national economic management in India. The critical elements of macro-economic environment are as follows:

- economic system
- nature of the economy
- anatomy of the economy
- functioning of the economy
- economic planning and programmes
- economic policy statements and proposals
- economic controls and regulations
- economic legislations
- economic trends and structure
- economic problems and prospects

These critical elements may not be always mutually exclusive and it may them as separate units for analytical purpose.

An economic system defines the *institutional framework of the environment.* The ownership, control and management of the enterprise reveal the nature of the economic system. The role and responsibility of the private sector, public sector, joint sector, etc. throw light on the philosophy and practice of an economic system - capitalist, socialist or mixed. The mixed economic system operates through a combination of planning and pricing.

The level of economic development and the structure of the economy define the *physical framework of the environment.* The level and composition of per capita income indicate the level of growth and development. Available natural resources, human resources and material resources of a country set a limit to its factor endowment which determines its production. The occupational distribution of labour force, the structure of national output; the composition and pattern of foreign trade, the structure of savings, investment and capital formation, the pattern of income distribution, inter-personal and inter-regional, the degree of urbanisation, all these bring out the significance of agriculture, industry and service sector in the national economy. The structure of the national economy can also be discussed in terms of its *physical anatomy.* The national economy is, after all, a combination of the household sector, the corporate business sector, the government administration, the capital market and the foreign sector. This is suggested by the national income and the social accounting approach. The order and strength of each of these sectors, therefore, also throws light on our understanding of the macro economic environment.

If you can describe the economy & environment with reference to the terms discussed above, you may now attempt an explanation of its *functioning.* You will discover that money is the life and blood of the business activity and the economic system. The flows of consumption, investment, saving, income, employment and output are all affected by transactions of money. Monetary transactions affect price level, thereby influencing the real value of all macro-economic variables. Significant developments have taken place in macro-economics to define the role of money. The essential question is: Does money matter? There are different answers to this question: (1) Money does not matter at all (Classical); (2) Money matters least (Keynesian); and (3) Money matters most (Monetarist). The theoretical debate is quite interesting. But you have to examine its empirical relevance in the economic environment of a country like India. This will provide you with' a further insight into the role of centralised planning, administered price system as well as free market pricing, and central banking.

Economic planning is supposed to give a direction to the changes in the economic environment. Most countries function today on the basis of planning. Either it is planning by direction typical of a socialist economy, or it is planning by incentives, i.e., democratic planning typical of a mixed economy, or it is indicative planning typical of the French Economy. It is through the system of a perspective planning, five-year planning and annual planning that the economies try to overcome their environmental constraints and optimise their achievements over a period of times.

Planning is a programme for action, it is not a guarantee in itself. The formulation of plans and programmes must, therefore, be followed by proper implementation. This calls for *economic policy statements and legislations.* Apart from having general policy statements affecting the industry and agriculture, the government often formulates and executes fiscal-cum-budgetary policies. The central bank will work through the instruments of money and credit policies, exchange rate policies, etc. Some sort of physical policies of controls and regulations may also be needed. Price control, trade control and exchange control are all moves in the same direction. Sometimes legislations and enactments become necessary for effective implementation of all these policies statements and proposals. The national economic environment of business is determined by the existing macro-economic policy framework.

These policies, planning and pricing together make the economy function effectively. The functioning of an economy is reflected in *short-period fluctuations and long-term trends in macro-economic variables* like income, money supply, prices, production, employment, balance of trade and payments, foreign exchange earnings, etc. These trends decide the course of the prevailing economic environment. Some of these economic trends may define the nature and dimension of various *macro-economic problems* like inflation, unemployment, recession and the like, the problems have to be analysed with the objective of making the national economic management efficient. Economic problems and economic prospects in the environment throw challenges to the management, corporate business management as well as national economy management.

4.6. Indian Economic Environment

Now, we may be anxious to evaluate the Indian economic environment in terms of the conceptual framework just suggested. You may note that the national economic environment of a country can be described and analysed in terms of its (a) *data* environment, (b) *system* environment, and (c) industry or sectoral environment and nature of competition. In subsequent units, you will be exposed to the details of Indian economy's data environment i.e., the *physical* trends and structural co-efficient. The system environment of Indian economy will also be dealt with in detail, in terms of various policy statements, planning techniques, organisation and structure of the capital market, role and responsibility of the private and public sector, etc. The system environment encompasses the entire *institutional* framework of the economy. An overview of that system environment is presented in this section. For the time being, you should be more interested in the evaluation rather than evolution of the present Indian economic system. We might have come across the statement that *India is a mixed economy.* In fact, India has a very complex mixed economic system. Let us elaborate this further.***4***

Firstly, a simple mixed economic system is characterised by the existence of private and public sectors. India has a multiplicity of sectors: private (dominant undertakings foreign companies, etc.); public, joint, co-operative, workers' sectors and also 'tiny sector'. We hear of different walks of Indian economy: big sector, small sector, heavy sector, light sector, licensed sector, delicensed sector, national sector, core sector. reserved sector, etc. India is a complex vector of sectors.

Secondly, a simple mixed economy is characterised by complementarity between planning and pricing. India has a multiplicity of mechanising at work: five-year plans, annual plans during plan holidays, pointed economic reform and reconstruction programmes during and after plan vacation, ideas of rolling plans; an elaborate system of controls and regulatory measures, attempts towards streamlining and simplification of procedures, private traders and public distributors for the same product and hence a system of dual prices, ceiling prices, floor prices, subsidised prices, statutory prices, retention prices, procurement prices, levy prices. and free market prices: contractionary monetary policies and expansionary fiscal policies, etc. In India there is a complex system of liberal rules, strict regulations. control mechanism, planning and a host of price regulations.

Finally, a simple mixed economy is expected to reach a target level of social welfare and for this, task, the profit policies are to be designed according to a social purpose. The socia1 welfare function in India is defined by the multiplicity of objectives which are sometimes conflicting in nature. For example, in terms of our five-year plans, India is aiming at efficiency, justice and stability. Productive efficiency in a static sense refers to the efficiency-allocation of the given resources. Productive efficiency in its dynamic sense refers to economic growth. The fruits of economic growth have to be distributed fairly among the masses; social justice is to be so attained as not to endanger stability of prices, incomes, balance of payments, etc. The Indian plans have always emphasised the objectives like full-employment of labour, full capacity utilisation of plant and equipment, arid self-sufficiency. In the long-run, these objectives may be compatible with each other, but in the sphere of operation these objectives come in conflict with each other. For example, in order to promote a higher rate of growth, heavy industrialisation and large investments are undertaken. Such investments increase the flow of money faster than the flow of output. This generates inflationary forces. Thus price stability conies in conflict with economic growth. Similarly, economic growth comes in conflict with social justice. Progressive tax system is used as a means to reduce income inequalities, but the same tax policy hampers private incentives to invest and to generate the growth forces thereby. Foreign exchange remittance helps the country in overcoming balance of payments difficulties, but it increases the domestic money supply and the prices. Examples can be multiplied to demonstrate the inherent conflict among the objectives which the mixed economy of Indian hopes to achieve. To top it all, different instruments have been used to attain different target variables - fiscal policies for growth with justice, monetary policies for price stability with growth, price and output controls for price stability with justice. This has led to further confusion.

To sum up, the so-called mixed economic system of India sometimes gives the impression of a mixed-up economic system that is characterised by multiplicity of sectors, multiplicity of instruments, multiplicity of objectives and multiplicity of adjustments to resolve the conflicts between various sectors, between instruments and between objectives.

The present day mixed economy of India has evolved through a series of policy formulations and legislations. It started with the industrial Policy Resolution of 1948. This was followed by the Industries (Development and Regulation) Act, 1951. Directive Principles of State Policy, 1954, Industrial Policy Resolution, 1950, Monopolies and Restrictive Trade Practices (MRTP) Act, 1969 and its subsequent amendments, industrial Licensing Policy, 1970 and its subsequent amendments and Foreign Exchange Regulation Act (FERA), 1973 and its subsequent amendments. These enactments and policy formulations have been supplemented from time to time, by comprehensive Five-Year plans, 20-Point Programmes, controls and regulations on prices, output, production, distribution and trade, and various nationalisation schemes and anti-poverty schemes.

During the 1980s, the Indian mixed economy took a decisive direction. It all started with the announcement of Industrial Policy Statement of 1980. The purpose of this policy was to ensure attainment of socio-economic objectives such as optimum utilisation of capacity, maximum production, employment generation, export promotion, import substitution, consumer protection, correction of regional imbalances through the development of industrially backward areas and 'economic federalism' with an equitable spread of investment among large and small units, among urban and rural units, etc. To achieve these objectives, it was decided to increase the investment limit to Rs. 2 lakhs for tiny units, Rs. 20 lakhs for small-scale units and Rs. 25 lakhs for ancillary units. Some other important provisions of the 1980 policy are as follows:

- regularisation of excess capacity;
- an automatic expansion at the rate of *5%* per annum to the maximum of 25% in five years, in all the industries of basic, critical and strategic importance;
- promotion of 100% export-oriented units:
- development of 'nuclear plants' (on the lines of District Industries Centres);
- revival of sick units through a package of modernisation measures: and
- re-orientation of the public sector, including the development of its managerial cadres.

As a follow-up to the 1980 statement, the government announced some further concessions on April 21, 1982. Among these, the important ones were the following:

- the list of 'core sector' industries had been revised by including five more industries. It implied that the FERA companies and large houses would be allowed to setup industries in those areas;
- the industry had been allowed 33.3% capacity over the best production during the last five years over and above the 25% excess production; and
- large houses and multi-nationals would be permitted to set up units outside the core sector if the units are predominantly export-oriented, i.e. 60% export in respect of items not reserved and 75% for items reserved for small-scale sector.

Such liberalisation measures were supplemented by relaxation in price and distribution controls. Amendments in the provisions of MRTP Act relating to the definition of 'market dominance', exemption from the need to obtain MRTP clearance for production in sectors of 'national priority', etc. Such measures were specifically designed to assist the expansion of industrial production during 1982, the Productivity Year.

During 1983-85, the Industrial Policy pursued by the Government of India placed emphasis on modernisation and technological upgradation of better capacity utilisation and larger production. For example, in order to promote demand, excise duties were reduced on commercial vehicles, refrigerators, batteries, tyres and tubes. Major concessions in excise and import duties were given for the benefit of the electronics industry with effect from October 1, 1983, With the installation of the new Government under the dynamic leadership of young Prime Minister, Late Shri Rajiv Gandhi, steps were taken towards evolving a dynamic economic system. There was then a feeling that the Indian economy has received a fresh lease of life.

The Seventh Five-Year Plan (1985-90) provided a new direction to the development of the Indian economic system. As per the Plan, new parameters of efficiency and equity are being established. This has posed new challenges to the public sector. The public sector is now required to lead a complex and demanding process of absorbing and developing new technology. It has to master the imperatives of modernisation. It has to first establish and thereafter spread a new work-culture in the industry that is based on productivity, efficiency and quality: it has to generate larger surpluses for investment and bring about development of material as well as human capital. As our then Prime Minister stated:

"Development is not about factories, dams and roads. Development is *about people. The goal is material, cultural and spiritual fulfilment for the people. The human factor is of supreme value in development."*

The private sector has also been assigned a more challenging role than ever before. The percentage share of private sector in the total Plan outlay has been stepped up to 52% (in the 7th Plan) from about 47% (in the 6th Plan). Of course, it must be noted that presently, the focus is more on 'output' than on 'outlay'. The share of the private sector has been increased on grounds of efficiency. It has been observed that return measured in terms of output per unit of outlay is higher in the private sector than in the public sector.

During 1985-87, the Government took a large number of measures to encourage the private sector. Some of these measures which are broadly referred to as 'privatisation' and 'liberalisation' are given below:

- Private bids have been invited for oil drilling by both Oil and Natural Gas Commission and Oil India Ltd., on a contract basis.
- Mangalore and Karnal refineries are being set up in the joint sector.
- More recently, as part of the Assam accord, the Government has announced that it will assist in the setting up of a small size refinery in the private sector in Assam.
- In the power sector, apart from the expansion of the 'Tata Thermal Unit', the Government has hinted at the possibility of the private sector setting up new units.
- The Government has decided in principle to encourage the private funds including foreign capital for setting up container terminals and port development.
- At a meeting of a Parliamentary Consultative Committee on Civil Aviation, the Government has proposed 'Air Taxi Service' in the private sector.
- The Government has accepted in principle a proposal to allow private and co-operative bodies to put up TV terminals and to run Post Offices.
- The Centre has asked the State Governments to enlist private enterprise in the field of building roads and bridges.
- The Department of Mines has set up an Expert Committee to suggest steps lo release some of the mineral-bearing areas reserved for the public sector to the private sector.
- It has also been decided that private sector will be allowed to manufacture solar cells - currently, it is a monopoly of public undertakings namely, Bharat Heavy Electricals Ltd. and Central Electronics Ltd.
- The Board of Directors has been reconstituted for units like Air India and Indian Airlines, so as to run them on principles of professional management by experts drawn from both private and public sectors.

The public sector units like NTPC and ITI have been allowed to float bonds to raise capital. This is a tendency towards market orientation.

All these together indicate that our Government is determined to allow private sector's entry into Schedule 'A' industries which have been hitherto reserved for the public sector.

Additionally, the Government has also announced measures effecting delicensing: broad banding, decentralisation, democratisation, liquidation of inefficient and sick public sector units, de-reservation of sectors hitherto meant exclusively for the small sector, tax reduction, raising of investment limit, relaxation of MRTP and FERA controls, de-control of sectors like essential drugs: liberal import of foreign technology, foreign capital and foreign enterprise: etc.

All these measures add up to a tremendous amount of economic liberalisation. In some quarters, such liberalisation is being interpreted as the 'revival of Capitalist Development Process'. Such interpretation may only encourage the ideological debate concerning the present state of the mixed economy of India. However, the practical stand of the Government is that such measures only constitute a movement towards an 'efficiency-oriented system.

These developments at home coincided with similar trends towards marketization in other parts of the world which finally gave rise to the New Economic Policy ill mid-1991. The liberalisation, privatisation and globalisation measures envisaged in it are to be found in the Industrial and Trade Policy documents.

4.7. Economic Environment and Business Management

Let us now examine the interaction between Economic Environment and Business Management. Business environment influences business management. The critical elements of business environment often interact with the critical elements of business management. The critical elements of business management are: planning, direction, organisation, control or co-ordination, staffing and supervision and evaluation. Management at all the levels, top, middle as well as supervisory, is concerned with these critical elements to a certain degree. Similarly, these very critical elements are the concerns of the management that specialises in different functions such as production, finance, marketing, purchase, inventory control, personnel, public relations, research and development, etc. Management, at all the levels of specialised functions, is influenced by the critical element of business environment. For example, when an industry faces business recession, the management may decide to cut down the rate of production or to pile up inventory accumulation When the market is being invaded by all increasing number of closely substitutable products, the management may decide to go in for aggressive advertisement or cut-throat competition. When the financial institutions start interfering too much with the day-to-day business operations of a firm, the firm's management may decide to depend exclusively on its ow11 internal funds rather than borrowed capital. When the government enforces minimum wage legislations and other social security measures for all permanent workers, the management may decide to recruit only casual labourers through a labour contractor. Such example can be multiplied. The point remains that the management always studies the environment arid then makes/takes a decision accordingly.

The existing business environment may act either as a stimulant or as a constraint for business management. If the prevailing environment is favourable to business growth and prosperity, then the management feels happy and responds positively. Small business owners, for example, are often encouraged to produce more when the government pays them subsidy. On the other hand, when the prevailing environments unfavourable, it acts as a disincentive. For example, when the government tries to impose a high tax rate on corporate profits, many business concerns try to evade tax by under-reporting their profits. It is interesting to note that the same environment may act both as stimulant and as a constraint - stimulating for some and constraining for others. Reconsider the last example. A high tax rate increases the propensity to evade taxes; it induces tile corporate tax-payer to restrict his output, sales or profits. At the same time, this very situation provides an opportunity to the tax consultant for a thriving business.

For the management, the environment is not limited to the institution of the government. There are other institution and forces as well. The management has to take care of the interests of other groups also, such as the workers, suppliers and contractors, consumers, shareholders and many others. The workers organised in trade unions, often ask the higher wages. The salaried middle-level managers, through their associations, may also ask for a particular package of pay and perks. The suppliers, organised in guilds, may not always supply materials as per the specifications of the management, and they may seek revised rates or change the quality and schedules of delivery. The shareholders may ask for higher dividends or they may like to have a greater say in the management. The consumer co-operatives may seek lower prices arid better quality tor the product they buy. All in all, the top management has to balance interests of all the parties-government, trade unions, manufacturers' association, financial institutions, consumer co-operatives and so on. Very often, the management's own economic aspirations may come in conflict with those of other groups. It the management a readily resolve these conflicts, it gets the better of environment. And if the management accentuates these conflicts. it becomes the victim of environment. The management may dictate or be dictated by the negative/positive forces of the environment.

A good amount of managerial skill and dexterity is required in adjusting to the environment. The managers must have a thorough knowledge, understanding and comprehension of their immediate business environment. With experience and d maturity, the alert managers acquire the skill to deal with the environment. When an environment repeats itself, the experienced managers effectively display their 'capability' to take care of it. When the changing dimensions of the environment establish a sudden departure from the past trends and tendencies, the managers are called upon to demonstrate their 'capability' to deal with the situation of risk and uncertainty. The environment, thus, poses a challenge for the management. The managerial efficiency and/or effectiveness is a measure of adaptability to the existing business environment.

Environmental scanning, thus, becomes an important step towards corporate planning and business policy decisions. Corporate managers analyse the Strengths (S), Weaknesses (W), Opportunities (O); Threats (T) that exist for their organisation ill the context of its environment. The SWOT analysis precedes the making/taking of strategic and tactical decisions by the management.

Irrespective of the fact that it is office management, factory management, farm management, hospital management, bank management or any other management, business management everywhere is determined by, arid determines the business environment. We have so far treated a firm and its management as a dependent variable, the explanatory variable being the environment. Let us now consider the opposite situation. The totality of business behaviour of different corporate entities may also determine the form arid content of the environment. If the managements of different public enterprises ask for more 'autonomy', then there emerges a tendency towards *laisse-faire* business environment. Or suppose, the management-labour relations deteriorate day-by-day first in one firm, then in some other firms, then in one industry, then in different industries, because of some sort of 'demonstration effect', then the national economic environment. sooner or later, will be affected by such unhealthy industrial relations, or say the preparation of the balance-sheets of a growing number of companies was directed by considerations of 'accounting convenience', rather than 'accounting conventions', a study of such balance-sheets will present a distorted picture of the national investment climate. With the help of these examples, you may argue that individual behaviour patterns of individual firms and their respective managements together determine the macro-level environment of business and industry. Environment and management thus influence each other. The existing environment influences corporate level planning, business strategy and business tactics; it also affects the size, structure, location, integration and growth of business. The management's success or failure is determined by its adjustment of favourable/adverse environmental factors.

The nature of such realisation, its frequency and duration, induces corporate managers to cultivate some standards of business philosophy, business ethics and business practice. Simultaneously, the government managers, the labour managers and the like also start adjusting to the changing organisation-culture. This yields a new business environment. And so the process continues. It is thus, a never-ending process of interactions: Environment → Management → Environment → It is like a biological organism which keeps both the environment and the management continuously responsive to each other.

4.8. Economic Growth and Economic Development:

Prologue:

Economic Growth is a narrower concept than economic development. It is an increase in a country's real level of national output which can be caused by an increase in the quality of resources (by education etc.), increase in the quantity of resources & improvements in technology or in another way an increase in the value of goods and services produced by every sector of the economy. Economic Growth can be measured by an increase in a country's GDP (gross domestic product). Economic development is a normative concept i.e. it applies in the context of people's sense of morality (right and wrong, good and bad). The definition of economic development given by Michael Todaro is an increase in living standards, improvement in self- esteem needs and freedom from oppression as well as a greater choice. The most accurate method of measuring development is the Human Development Index which takes into account the literacy rates & life expectancy which affects productivity and could lead to Economic Growth. It also leads to the creation of more opportunities in the sectors of education, healthcare, employment and the conservation of the environment. It implies an increase in the per capita income of every citizen.

4.8.1. Economic Growth:

The modern conception of economic growth began with the critique of Mercantilism, especially by the physiocrats and with the Scottish Enlightenment thinkers such as David Hume and Adam Smith, and the foundation of the discipline of modern political economy. It is an increase in the value of goods and services produced by an economy. It is conventionally measured as the percent rate of increase in real gross domestic product, or GDP. Growth is usually calculated in real terms, i.e. inflation-adjusted terms, in order to net out the effect of inflation on the price of the goods and services produced. In economics, "economic growth" or "economic growth theory" typically refers to growth of potential output, i.e. production at "full employment," rather than growth of aggregate demand.

Economic growth is the increase of per capita gross domestic product (GDP) or other measure of aggregate income. It is often measured as the rate of change in real GDP. Economic growth refers only to the quantity of goods and services produced. Economic growth can be either positive or negative. Negative growth can be referred to by saying that the economy is shrinking. Negative growth is associated with economic recession and economic depression.

In order to compare per capita income across multiple countries, the statistics may be quoted in a single currency, based on either prevailing exchange rates or purchasing power parity. To compensate for changes in the value of money (inflation or deflation) the GDP or GNP is usually given in "real" or inflation adjusted, terms rather than the actual money figure compiled in a given year, which is called the nominal or current figure. Economists draw a distinction between short-term economic stabilization and long-term economic growth. The topic of economic growth is primarily concerned with the long run. The short-run variation of economic growth is termed the business cycle.

4.8.2. Economic Development:

The latter half of the 20th century, with its global economy of a few very wealthy nations and many very poor nations, led to the study of how the transition from subsistence and resource-based economies to production and consumption based-economies occurred. This led to the field of development economics, including the work of Nobel laureates Amartya Sen and Joseph Stiglitz. However, this model of economic development does not meet the demands of subaltern populations and has been severely criticized by later theorists.

Economic development is the increase in the standard of living in a nation's population with sustained growth from a simple, low-income economy to a modern, high-income economy. Also, if the local quality of life could be improved, economic development would be enhanced. Its scope includes the process and policies by which a nation improves the economic, political, and social well- being of its people.

Gonçalo L Fonsesca at the New School for Social Research defines economic development as "the analysis of the economic development of nations. Economic development' is a term that economists, politicians, and others have used frequently in the 20th century. The concept, however, has been in existence in the West for centuries. Modernization, Westernization, and especially Industrialization are other terms people have used when discussing economic development. Although no one is sure when the concept originated, most people agree that development is closely bound up with the evolution of capitalism and the demise of feudalism."

The study of economic development by social scientists encompasses theories of the causes of industrial-economic modernization, plus organizational and related aspects of enterprise development in modern societies. It embraces sociological research on business organization and enterprise development from a historical and comparative perspective; specific processes of the evolution (growth, modernization) of markets and management-employee relations; and culturally related cross-national similarities and differences in patterns of industrial organization in contemporary Western societies. On the subject of the nature and causes of the considerable variations that exist in levels of industrial-economic growth and performance internationally, it seeks answers to such questions as: "Why are levels of direct foreign investment and labour productivity significantly higher in some countries than in others? "Mansell and Wehn state that development has been understood since the Second

World War to involve economic growth, increases in per capita income, and attainment of a standard of living equivalent to that of industrialized countries.

Economy Development can also be considered as a static theory that documents the state of economy at a certain time. According to Schumpeter (2003) the changes in this equilibrium state to document in economic theory can only be caused by intervening factors coming from the outside.

4.8.3. Distinction Between Economic Growth and Development

There are significant differences between economic growth and economic development. The term "economic growth" refers to an increase (or growth) in real national income or product expressed usually as per capital income. National income or product itself is commonly expressed in terms of a measure of the aggregate output of the economy called gross national product (GNP). Per capita income then is simply gross national product divided by the population of the country. When the GNP of a nation rises, whatever the means of achieving the outcome, economists refer to it as economic growth.

The term "economic development," on the other hand, implies much more when used in relation to a country or an entire economy. It typically refers to improvements in a variety of indicators, such as literacy rates and life expectancy, and it implies a reduction in poverty. Critics point out that GDP is a narrow measure of economic welfare that does not take into account important non-economic aspects such as more leisure time, access to health & education, the environment, freedom, or social justice.

Economic growth is a necessary but insufficient condition for economic development. Economic Growth does not take into account the size of the informal economy. The informal economy is also known as the black economy which is unrecorded economic activity. Development alleviates people from low standards of living into proper employment with suitable shelter. Economic Growth does not take into account the depletion of natural resources which might lead to pollution, congestion & disease. Development however is concerned with sustainability which means meeting the needs of the present without compromising future needs. These environmental effects are becoming more of a problem for Governments now that the pressure has increased on them due to Global warming.

4.8.4. Different View Related Growth and Development:

For a layman, the terms economic development and economic growth are synonyms. For a long time, the terms, economic development, economic growth, economic progress, economic welfare, secular change and other similar terms are being commonly used in day-to-day life as synonyms. But some leading economists have drawn a line of demarcation between them. Under the above heading we shall discuss the difference between the above two concepts, i.e., economic development and economic growth which is given below:

Mrs. Ursula Hicks, "Development should relate to underdeveloped countries, where there is possibility of developing and using hitherto, while the term growth is related to economically rich and advanced countries where most of the resources are already known and developed".

This definition draws a vivid distinction between the economic development and economic growth. The first term relates to the problems of underdeveloped countries and their solution, whereas the second term is related to the problems of developed countries of the world.

Prof. A. Maddison, "the rising of income levels is generally called economic growth in rich countries and in poor countries it is called economic development."

This definition also points out the same fact that economic development is concerned with the rising of income level in underdeveloped countries like India, whereas economic growth refers to the rising of income levels in advanced and rich countries like America, U. K., France, Germany etc.

Prof. J. A. Schumpeter, "Development is a discontinuous and spontaneous change in the stationary state, which for ever alters and displaces the equilibrium state previously existing; while growth is a gradual and steady change in the long run, which comes about by a general increase in the rate of savings and population".

This explanation emphasises that the economy is in the stationary state before the process of development starts and in that stationary state, equilibrium exists among the different development variables such as investment and savings, income and expenditure, demand and supply etc. The view of Schumpeter has been widely accepted and elaborated by the majority of economists.

C. P. Kidleberger, "Economic growth means more output and economic development implies both more output and changes in the technical and institutional arrangements, by which it is produced."

This explanation states that growth is synonymous with higher output. Any increase in the quantity of development variables is termed as growth. It has nothing to do with the means and methods of production. Development, on the other hand, implies not only higher output, but also the changes which help in raising the level of output. Kindleberger has further explained the difference by an analogy with human beings. According to him, "Growth involves focussing on height or weight while development draws attention to the change in functional capacity."

Prof. J. K. Mehta has summed up the above discussion in the words, "The word Growth has quantitative significance while the Development has by comparison qualitative significance."

Byrns and Stones, "Economic growth occurs when more goods can be produced. Economic development entails improvements in the quality of life, in the qualities of goods available or in the ways production is organised."

Dr. Bright Singh, "Economic development is a multi- dimensional phenomenon, it involves not only increase in money incomes, but also improvement in real habits, education, public health, greater leisure and in fact all the social and economic circumstances that make Tor a fuller and happier life. On the contrary, in case of economic growth, there is increase in national income alone. There is no structural change in the economy."

4.9. Methods of measuring national income

1. **Value added method**

   In this method, the value of goods and services produced is estimated. Intermediate consumption, depreciation and net indirect taxes are deducted from it to arrive at net value added. To this net factor income earned from abroad has to be added up. As a sum of value added by each type of industry in the business sector or firms. It's also called as **Product method**.

NI=value of goods &services -intermediate consumption –depreciation -net indirect taxes +net factor income from abroad.

2. **Income method**

Factors of production employed in the production process earns factor incomes in the form rent, wages, interest and profits. By adding all these factor payments made by all sectors we get domestic factor income. To this net factor income is added up. As an aggregate off act or earnings to the resources supplied by the households.

NI=rent +wage+ interest +profits +net factor income from abroad

3. **Expenditure method**

The total expenditures made in the country would be equal to the total income. The total expenditure is incurred by four sectors namely, household sector, private business sector, the government sector and the external sector. In this method, NI=C+I+G+(x-m). As an aggregate of the value of all final sales of what has been produced in the economy.

4. **Gross National Product(GNP):**

Sum of the money value of all final goods and services produced during a particular time period usually one year, including earnings from abroad.

5. **Net National Product (NNP):** Considered a true measure of national output, and is defined as GNP minus depreciation.
6. **Gross Domestic Product (GDP):** Domestic product relates to the product of factors of production employed within the political boundaries of a country. National product is the output produced by nationals of the country including net return on assets owned abroad. So, **GDP=**GNP (minus) Net income from abroad.
7. **Net Domestic Product (NDP):** NNP(minus)Net income from abroad**.**
8. **Personal income (PI):** It's defined as income received by the households before the payment of personal income taxes. **PI=NI+Tp–Ucp–Tci–Sc-SS**

   Tci = corporate income taxes

   Sc = corporate savings

   SS = social security contributions

   Tp = transfer payments

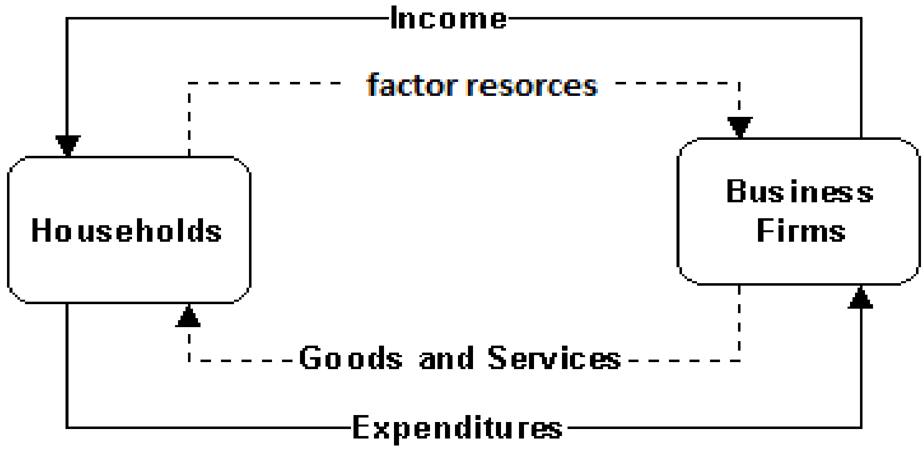
   Ucp = undistributed corporate profits.
9. **Disposable income(DI):** It's defined as personal income (PI) minus the personal income taxes (Tp) or **DI = PI – Tp.**
10. **Per capita (national) income**:

It is national income divided by the total population. So, Per capita income of India for the year 2021 = National income of 2021 divided by Population in 2021.

Per capita income = National Income/ Total Population

4.10. Circular flow of economic activity

Households sell their factor services to the firms which yield them factor incomes. Firms use this in the production process and sell the product to the households. Households spend their income on the purchase of goods and services produced by the firms. The consumption expenditure of the households is the income of the firms.



4.10.1. Stocks and Flows

A **stock** is a quantity measured at a given point in time, whereas a **flow** is a quantity measured per unit of time. A person's wealth, number of unemployed, government debt etc. are stock; whereas income, expenditure, number of people losing their jobs, the amount of investment, government budget deficit etc. are flow.

4.11. Unemployment and Measuring Unemployment

4.11.1. Unemployment

The term unemployment refers to a state in which an individual actively seeks employment but is unsuccessful. It is said to be one of the critical measures of the economy's strength. The unemployment rate is the most widely used method to determine a country's unemployment rate. This can be found by simply dividing the number of people without jobs by the total population included in a nation's labour force.

Unemployment Rate = (Number of Unemployed / Labour Force) X 100

4.11.2 Labour force:

The **labour force** is defined as the sum of the employed and unemployed, and the **unemployment rate** is defined as the percentage of the labour force that is unemployed.

That is, **Labour Force =Number of Employed + Number of Unemployed**

Labour-force participation rate is the percentage of the adult population that is in the labour force. **Labour Force Participation Rate = (Labour Force / Adult Population) X 100**

4.11.3. Types of Unemployment:

1. **Frictional Unemployment:** It is a natural consequence of market processes and the exchange of information, which can often be expensive. Finding new employment, hiring the individuals matching the requirements issued by the company, and then giving related jobs to suitable people often leads to frictional unemployment.

2. **Cyclical Unemployment:** It refers to the periodic rise and fall in the unemployment rate as an economy undergoes growth and losses. During the recession, unemployment rates soar while they dip substantially when an economy is strong and stable.
3. **Structural Unemployment:** It comes about due to changes in the technical skill requirements of jobs that frequently accompany the evolution of society. Often, it is easier to hire new, trained workers than to retrain old workers, resulting in loss of employment for the masses.
4. **Institutional Unemployment:** These are the socio-economic reasons for unemployment, including government policies like minimum wages, oppressive job licensing laws, etc. Discrimination in hiring workers on racial, religious, and other bases. Labour market institutions like high unionization.

4.12. Taxes

Every form of government needs resources for the nation's development. It is by taxing its citizens the government generates revenue to meet its expense for nation's developmental activities. In the literature of public finance, taxes have been classified in various ways and criteria. On the basis of how tax is paid, who bears the ultimate burden, the extent to which the burden can be shifted, taxes are most commonly classified into two types as:

1. **Direct Tax:** A direct tax is a tax which is paid directly by a taxpayer to the tax-imposing authority. It is also defined as the tax where the liability as well as the burden to pay it resides on the same individual taxpayer. Direct taxes are collected by the central government as well as state governments according to the type of tax levied. Major types of direct tax include:
    a) **Income Tax:** Levied on and paid by the same person.
    b) **Corporate Tax:** Paid by companies and corporations on their profits.
    c) **Wealth Tax:** Levied on the value of property that a person holds.
    d) **Estate Duty:** Paid by an individual in case of inheritance.
    e) **Gift Tax:** An individual receiving the taxable gift pays tax to the government.

2. **Indirect Tax:** Indirect Tax is a tax levied by the tax-imposing authority on the production or consumption of goods and services or on transactions, whose burden can be shifted wholly or partly to another individual. Some types of indirect taxes are:
    a) **Excise Duty:** Payable by the manufacturer who shifts the tax burden to retailers and wholesalers.
    b) **Sales Tax:** Paid by a shopkeeper or retailer, who then shifts the tax burden to customers by charging sales tax on goods and services.
    c) **Custom Duty:** Import duties levied on goods from outside the country, ultimately paid for by consumers and retailers.
    d) **Entertainment Tax:** Liability is on the cinema owners, who transfer the burden to cinemagoers.
    e) **Service Tax:** Charged on services rendered to consumers, such as food bill in a restaurant.

4.13. Trade cycle

4.13.1. Meaning 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.

The noun 'cycle' bars out fluctuations which do not occur with a measure of regularity". According to Keynes, "A trade cycle is composed of periods of good trade characterised by rising prices and low unemployment percentages altering with periods of bad trade characterised by falling prices and high unemployment percentages".

Features of a Trade Cycle:

1. A business cycle is synchronic. When cyclical fluctuations start in one sector it spreads to other sectors.
2. In a trade cycle, a period of prosperity is followed by a period of depression. Hence trade cycle is a wave like movement.
3. Business cycle is recurrent and rhythmic; prosperity is followed by depression and vice versa.
4. A trade cycle is cumulative and self-reinforcing. Each phase feeds on itself and creates further movement in the same direction.
5. A trade cycle is asymmetrical. The prosperity phase is slow and gradual and the phase of depression is rapid.
6. 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.
7. The impact of a trade cycle is differential. It affects different industries in different ways.
8. A trade cycle is international in character. Through international trade, booms and depressions in one country are passed to other countries.

4.13.2. Phases of a Trade Cycle:

Generally, a trade cycle is composed of four phases – depression, recovery, prosperity and recession.

Phases of Trade Cycle:

The phases of trade cycle are explained with a diagram:

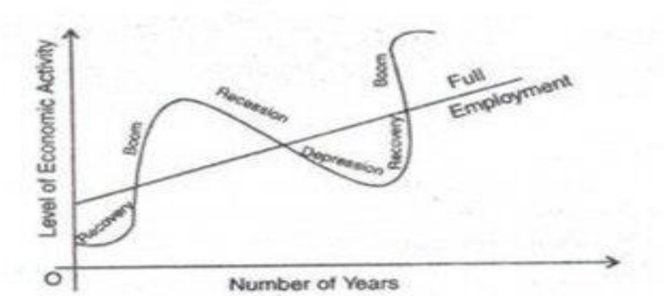


FIG. 2 : PHASES OF TRADE CYCLE

a) **Recovery:**

Recovery denotes the turning point of business cycle form depression to prosperity. In this phase, there is a slow rise in output, employment, income and price. Demand for commodities go up. There is increase in investment, bank loans and advances. Pessimism gives way to optimism. The process of revival and recovery becomes cumulative and leads to prosperity.

b) **Prosperity or boom:**

It is a state of affairs in which real income and employment are high. There are no idle resources. There is no wastage of materials. There is rise in wages, prices, profits and interest. Demand for bank loans increases. There is optimism everywhere. There is a general uptrend in business community. However, these boom conditions cannot last long because the forces of expansion are very weak. There are bottlenecks and shortages. There may be scarcity of labour, raw material and other factors of production. Banks may stop their loans. These conditions lead to recession.

c) **Recession:**

When the entrepreneurs realize their mistakes, they reduce investment, employment and production. Then fall in employment leads to fall in income, expenditure, prices and profits. Optimism gives way to pessimism. Banks reduce their loans and advances. Business expansion stops. This state of recession ends in depression.

d) **Depression:**

During depression, the level of economic activity is extremely low. Real income production, employment, prices, profit etc. are falling. There are idle resources. Price is low leading to a fall in profit, interest and wages. All the sections of the people suffer. During this phase, there will be pessimism leading to closing down of business firms.

4.14. Infrastructure:

It refers to the central element of economic and social change, as a support system for productive activities in the economy.

1. **Economic infrastructure**

   Economic infrastructure refers to all such services, facilities, or activities that serve as a supporting system to the process of economic growth i.e., production and trade of goods and services. It includes transportation, communication, energy/ power, banking facilities, irrigation facilities

   Features of economic infrastructure

   1. It supports the economic system directly
   2. It enhances the quality of economic resources and increases the efficiency of physical capital. Thus, raises productivity and reduces the cost of production.
   3. It increases the stock of physical capital assets.
   4. It promotes economic development. 5. It increases the standard of life.

2. **Social infrastructure**

Social infrastructure refers to all such services, facilities, or activities that serve as a foundation/supporting system to process social growth or development. It includes education, health, housing, sanitation and drinking facilities, etc.

Features of social

1. It enhances the quality of human resources and increases the productivity and efficiency of human capital.
2. It increases the stock of human capital.
3. It promotes economic development indirectly.
4. It supports the economic system indirectly.
5. It increases the quality of life.

Health is a crucial component of social infrastructure. It refers to a state of complete physical, mental and social wellbeing. It is not only the absence of disease but also the ability to realize one's potential. It is the holistic process related to the overall growth and development of a nation. It is a yardstick of one's well-being. The health status of a country can be assessed through the following indicators: 1. Infant mortality rate 2. life expectancy rate 3. death rate 4. nutritional level 5. maternal mortality rate 6. Morbidity 7. Incidence of communicable and non-communicable diseases.

4.15. Political Environment:

4.15.1. Nature and Significance of Political Environment:

Simply stated, political environment of business refers to the political conditions - factors and forces -which have a bearing on business activities. Such factors may include competing political ideologies, electoral majority of the party in power, strength of the parliamentary opposition parties, internal dissensions within the ruling party, insurgencies in border areas, as well as international power alignments and alliances. Ideological leanings of the ruling party or coalition of pal-ties at the centre (Federal level) and those of the ruling parties in the federating states often form the basis of Government policies impacting industry and trade. Political instability caused by the failure of law and order, recurring and widespread incidents of crime and violence are also traceable to political factors which constitute business risks and impinges on the predictability of business prospects. Obviously, political factors may have regional, national as well as global implications. Let us note a few examples of the impact of political factors on business environment in India.

Janta Party, which was in power at the Centre for three years after 1977, followed a strict policy of restricting the role of multinational corporations. Some of the ministers in the Government had strong socialist leanings. As a result, Coca Cola and IBM were forced to move out of lndia. This opened up a vast market for Indian soft-drink manufacturers and IT companies. Take another example. During December, 1992 and January, 1993, there were violent riots in different parts of India followed by serious law and order problems. These were caused by the Ayodhya-Babri Masjid episode on which political parties were sharply divided. Apart from apprehensions of political instability, the events disrupted transport, slowed down industrial production and exports. It was also reported that many potential foreign investors had deferred their decisions or revised their plans.

Regulatory policies of the Government with respect to industry and trade also come under political factors since political processes determine the composition of the Government based on the electoral platforms of the ruling and opposition parties. The prospects of many companies in India have been affected by changes in the regulatory policies of the Government many a time. For instance, large scale manufacturers of cycle tyres had to close down their plants when production of cycle tyres was decided to be reserved for the small-scale sector. Likewise, the textile mills were required to modify production plans when Government extended fiscal protection and incentives to the power-loom sector. Again in the early go's, some industries like telecommunication equipment's and oil drilling rigs, which were earlier reserved for the public sector, were decided to be opened to the private sector. Many companies seized the opportunities then to enter these markets. On the other hand, industrial growth in West Bengal was reported to have slackened due to the ideological leanings of the ruling left parties and militant trade unionism. All business firms are affected, 'in a greater or lesser degree, by the government policies and programmes at central, state and local levels. The shift in the political weather arising from changes in the attitudes and preferences of political leaders offer result in changes in the government policies and programmes. The firms have to anticipate such changes, analyse their impact on the business with a view to predict the probable development, identify the opportunities and the risks involved, and effect the necessary changes in their own plans and strategies.

4.15.2. Critical Elements of Political Environment:

There are several aspects of the political environment which may be regarded as its critical elements in relation to business. The more important of these elements are,

1. Political system;
2. Political processes;
3. Stability of the political structure; and
4. Centre-State relations.

4.16. Social Environment

4.16.1. Definition of "Social Environment"

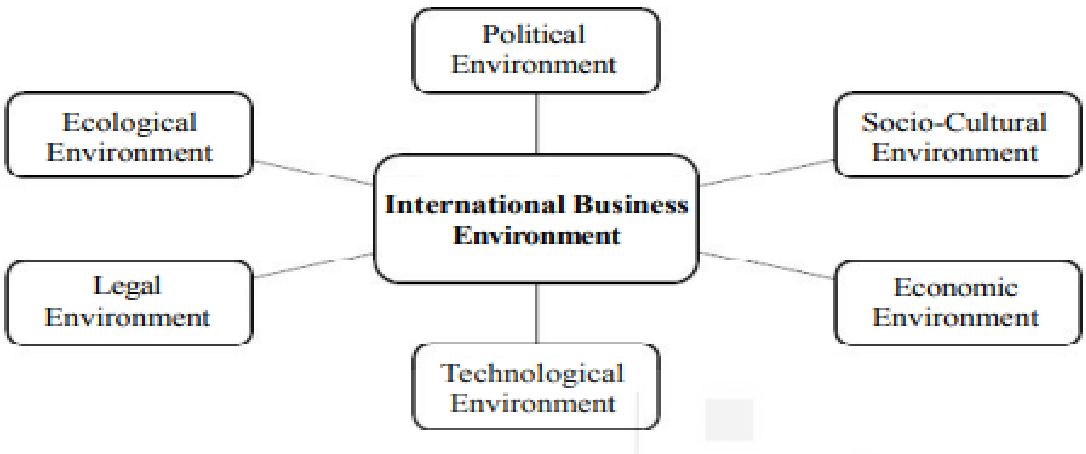
Recently, interest in the social environment and its influence on population health has increased among both public health researchers and practioners. This interest is demonstrated by a recent request for applications from the National Institutes of Health Titled *Health Disparities: Linking Biological and Behavioral Mechanisms with Social and Physical Environments*. Despite the upsurge of interest and an increasing number of publications focused on this important issue, a clear and comprehensive definition of *social environment* has proved elusive. We would like to offer the following definition, in hopes that it will prove useful to our colleagues—if only as a touchstone for debate.

Human social environments encompass the immediate physical surroundings, social relationships, and cultural milieus within which defined groups of people function and interact. Components of the social environment include built infrastructure; industrial and occupational structure; labor markets; social and economic processes; wealth; social, human, and health services; power relations; government; race relations; social inequality; cultural practices; the arts; religious institutions and practices; and beliefs about place and community. The social environment subsumes many aspects of the physical environment, given that contemporary landscapes, water resources, and other natural resources have been at least partially configured by human social processes. Embedded within contemporary social environments are historical social and power relations that have become institutionalized over time. Social environments can be experienced at multiple scales, often simultaneously, including households, kin networks, neighbourhoods, towns and cities, and regions. Social environments are dynamic and change over time as the result of both internal and external forces. There are relationships of dependency among the social environments of different local areas, because these areas are connected through larger regional, national, and international social and economic processes and power relations.

4.17. International Economic Environment:

A firm has no control on external environment even in domestic business where it has to deal with issues like, tax rates and policy, changes to the economic structure, threats from competition, political factors, government regulations, industrial licensing and approvals, ecological concerns, legal compliances to different acts and rules and dealing with changing technological landscape. This becomes extremely complex when a firm enters international business as it has to deal with different business environment in the countries, it enters with. International business environment is regarded as the “sum of all the external forces working upon the firm as it goes about its affairs in foreign markets”. A firm can plan a course of action to manage uncontrollable external factors in the domestic business as managers are familiar with business landscape of the country and forces shaping it including political economy of home country.

This is not the case for international business operations where many uncontrollable external forces can challenge it. Some examples of such challenges are uncertainty of foreign trade regime, different political environment, changed economic legislation, confusing tax policies and procedure, misleading cultural interpretations and complex legal compliances. Hence, the managers of an internationally engaged firm need to scan the following elements of international business environment to enter a market for business.



The above the figure illustrated sometimes is also referred as PESTEL analysis of business environment. Any firm intending to go-global require **economic** data of prospective national economies to interpret, analyse and make cross border comparisons using standard criteria to understand the external environment affecting their business. Fortunately, such data is available online and an exporter can easily analyse the nature of the environment on a country-by-country basis. Each economy has national accounts data, indicating estimates of gross national product including growth trends, gross domestic product, consumption, investments, government expenditures, and price levels. An exporter can also access the demographic data describing size of population, their distribution by age-category, and rates of population growth.

Furthermore, all business activities are taking place within the **political environment** which requires understanding of sub-elements such as governmental institutions, political parties, and organisations through which a country's people and rulers exercise power. The managers of an international business firm must carefully study the government structure in the target country and analyse salient issues arising from the political environment. These may primarily include the governing party's attitude toward sovereignty, people's attitudes towards foreign firms, political risk, trade wars and resultant economic retaliations, the threat of equity dilution, and expropriation.

Understanding of **legal environment** is equally important as nations are governed by force of law which includes rules and principles that nation-states consider binding upon themselves to administer. An internationally engaged firm should pay attention to both set of law, first the 'public law' or the law of nations; and international commercial law, which is evolving. Law of nations such as Common Law, Code Law and 'Islamic Law' provides the base for evolution and framing of international commercial law.

An international business firm should also acquire knowledge of diverse **socio-cultural environment** to be successful in international trade operations. It must have internationally trained staff, without culturally tinted-glasses, to independently study the international socio-cultural environment. International marketer explicitly recognizes the non-economic bases of marketing behaviour and its growing role in today's globalized markets. Barbie doll come not only in white colour any more, but one can find Barbie Doll having African (Black), Chinese and Indian facial features so that children from respective region can easily correlate themselves when they find someone similar. Consumption, in today's globalized but turbulent business environment is a function of many other cultural influences. Not only the disposable income of consumers but many non-economic factors can explain the different patterns of consumption of two individuals with identical incomes or by analogy, of two different countries with similar per capita incomes.

Ecologically, there is increased awareness for saving the environment and firms are reducing their carbon-foot prints to win and retain such awakened global customers. Lastly, no business firm afford to ignore the **technological environment** of the country and should accordingly adapt its product and services for varied international markets.

4.18. International Trade

International trade is referred to as the exchange or trade of goods and services between different nations. This kind of trade contributes and increases the world economy. The most commonly traded commodities are television sets, clothes, machinery, capital goods, food, and raw material, etc.,

International trade has increased exceptionally that includes services such as foreign transportation, travel and tourism, banking, warehousing, communication, advertising, and distribution and advertising. Other equally important developments are the increase in foreign investments and production of foreign goods and services in an international country. This foreign investments and production will help companies to come closer to their international customers and therefore serve them with goods and services at a very low rate.

All the activities mentioned are a part of international business. It can be concluded by saying that international trade and production are two aspects of international business, growing day by day across the globe.

Foreign trade is exchange of capital, goods, and services across international borders or territories. In most countries, it represents a significant share of gross domestic product (GDP). While international trade has been present throughout much of history, its economic, social, and political importance has been on the rise in recent centuries.

4.18.1 Definition of international trade:

According to Wasserman and Haltman, "International trade consists of transaction between residents of different countries".

According to Anatol Marad, "International trade is a trade between nations".

According to Eugeworth, "International trade means trade between nations"

4.18.2. Classification of International Trade:

a. **Import Trade:** It refers to purchase of goods from a foreign country. Countries import goods which are not produced by them either because of cost disadvantage or because of physical difficulties or even those goods which are not produced in sufficient quantities so as to meet their requirements.
b. **Export Trade:** It means the sale of goods to a foreign country. In this trade the goods are sent outside the country.
c. **Entre pot Trade:** When goods are imported from one country and are exported to another country, it is called entre pot trade. Here, the goods are imported not for consumption or sale in the country but for re- exporting to a third country. So importing of foreign goods for export purposes is known as entre pot trade.

4.18.3. Characteristics of International Trade:

I. **Separation of Buyers and Producers:** In inland trade producers and buyers are from the same country but in foreign trade they belong to different countries.
II. **Foreign Currency:** Foreign trade involves payments in foreign currency. Different foreign currencies are involved while trading with other countries.
III. **Restrictions**: Imports and exports involve a number of restrictions but by different countries. Normally, imports face many import duties and restrictions imposed by

importing country. Similarly, various rules and regulations are to be followed while sending goods outside the country.

IV. **Need for Middlemen:** The rules, regulations and procedures involved in foreign trade are so complicated that there is a need to take the help of middle men. They render their services for smooth conduct of trade.

V. **Risk Element:** The risk involved in foreign trade is much higher since the goods are taken to long distances and even cross the oceans.

VI. **Law of Comparative Cost:** A country will specialise in the production of those goods in which it has cost advantage. Such goods are exported to other countries. On the other hand, it will import those goods which have cost disadvantage or it has no specific advantage.

VII. **Governmental Control:** In every country, government controls the foreign trade. It gives permission for imports and exports may influence the decision about the countries with which trade is to take place.

4.18.4. Need for International Trade:

In today's world, economic life has become more complex and diversified. No country can live in isolation and claim to be self-sufficient. Even countries with different ideologies, culture, and political, social and economic structure have trade relations with each other. Thus, trade relations of U.S.A. with U.S.S.R. and China with Japan are examples. The aim of international trade is to increase production and to raise the standard of living of the people. International trade helps citizens of one nation to consume and enjoy the possession of goods produced in some other nation.

4.18.5. Reasons of International Trade:

1. **Reduced dependence on your local market**

   Your home market may be struggling due to economic pressures, but if you go global, you will have immediate access to a practically unlimited range of customers in areas where there is more money available to spend, and because different cultures have different wants and needs, you can diversify your product range to take advantage of these differences.

2. **Increased chances of success**

   Unless you've got your pricing wrong, the higher the volume of products you sell, the more profit you make, and overseas trade is an obvious way to increase sales. In support of this, UK Trade and Investment (UKTI) claim that companies who go global are 12% more likely to survive and excel than those who choose not to export.

3. **Increased efficiency**

   Benefit from the economies of scale that the export of your goods can bring – go global and profitably use up any excess capacity in your business, smoothing the load and avoiding the seasonal peaks and troughs that are the bane of the production manager's life.

4. **Increased Productivity**

Statistics from UK Trade and Investment (UKTI) state that companies involved in overseas trade can improve their productivity by 34% – imagine that, over a third more with no increase in plant.

5. **Economic advantage**

Take advantage of currency fluctuations – export when the value of the pound sterling is low against other currencies, and reap the very real benefits. Words of warning though; watch out for import tariffs in the country you are exporting to, and keep an eye on the value of sterling. You don't want to be caught out by any sudden upsurge in the value of the pound, or you could lose all the profit you have worked so hard to gain.

6. **Innovation**

Because you are exporting to a wider range of customers, you will also gain a wider range of feedback about your products, and this can lead to real benefits. In fact, UKTI statistics show that businesses believe that exporting leads to innovation – increases in break-through product development to solve problems and meet the needs of the wider customer base. 53% of businesses they spoke to said that a new product or service has evolved because of their overseas trade.

7. **Growth**

The holy grail for any business, and something that has been lacking for a long time in our manufacturing industries more overseas trade increased growth opportunities, to benefit both your business and our economy as a whole.

8. **Uneven Distribution of Natural Resources:**

Natural resources of the world are not evenly divided among the nations of the world. Different countries of the world have different amount of natural resources and they differ with each other in regard to climate, minerals and other factors. Some countries can produce more of sugar like Cuba, some can produce more of cotton like Egypt, while there are some others which can produce more of wheat like Argentina. But all these countries need sugar, cotton and wheat. So they have to depend upon one another for the exchange of their surpluses with the goods that are in short supply in their country and hence the need for international trade is natural.

9. **Division of Labour and Specialisation:**

Due to uneven distribution of natural resources, some countries are more suitably placed to produce some goods more economically than other countries. But they are geographically at a disadvantageous position to produce other goods. They specialise in the production of such goods in which they have some natural advantage in the form of availability of raw material, labour, technical know-how, climatic conditions, etc. and get other goods in exchange for these goods from other countries.

10. **Differences in Economic Growth Rate**:

There are many differences in the economic growth rate of different countries. Some countries are developed some are developing, while there are some other countries which are under-developed: these under-developed and developing countries have to depend upon developed ones for financial help, which ultimately encourages international trade.

4.18.6. Advantages and Disadvantages of International Trade

➢ **Advantages of International Trade:**

(i) **Optimal use of natural resources:** International trade helps each country to make optimum use of its natural resources. Each country can concentrate on production of those goods for which its resources are best suited. Wastage of resources is avoided.

(ii) **Availability of all types of goods:** It enables a country to obtain goods which it cannot produce or which it is not producing due to higher costs, by importing from other countries at lower costs.

(iii) **Specialisation:** Foreign trade leads to specialisation and encourages production of different goods in different countries. Goods can be produced at a comparatively low cost due to advantages of division of labour.

(iv) **Advantages of large-scale production:** Due to international trade, goods are produced not only for home consumption but for export to other countries also. Nations of the world can dispose of goods which they have in surplus in the international markets. This leads to production at large scale and the advantages of large scale production can be obtained by all the countries of the world.

(v) **Stability in prices:** International trade irons out wild fluctuations in prices. It equalizes the prices of goods throughout the world (ignoring cost of transportation, etc.)

(vi) **Exchange of technical know-how and establishment of new industries:** Underdeveloped countries can establish and develop new industries with the machinery, equipment and technical know-how imported from developed countries. This helps in the development of these countries and the economy of the world at large.

(vii) **Increase in efficiency**: Due to international competition, the producers in a country attempt to produce better quality goods and at the minimum possible cost. This increases the efficiency and benefits to the consumers all over the world.

(viii) **Development of the means of transport and communication:** International trade requires the best means of transport and communication. For the advantages of international trade, development in the means of transport and communication is also made possible.

(ix) **International co-operation and understanding:** The people of different countries come in contact with each other. Commercial intercourse amongst nations of the world encourages exchange of ideas and culture. It creates cooperation, understanding, cordial relations amongst various nations.

(x) **Ability to face natural calamities**: Natural calamities such as drought, floods, famine, earthquake etc., affect the production of a country adversely. Deficiency in the supply of goods at the time of such natural calamities can be met by imports from other countries.

(xi) **Other advantages:** International trade helps in many other ways such as benefits to consumers, international peace and better standard of living.

➢ **Disadvantages of International Trade:**

Though foreign trade has many advantages, its dangers or disadvantages should not be ignored.

a. **Impediment in the Development of Home Industries:** International trade has an adverse effect on the development of home industries. It poses a threat to the survival of infant industries at home. Due to foreign competition and unrestricted imports, the upcoming industries in the country may collapse.

b. **Economic Dependence:** The underdeveloped countries have to depend upon the developed ones for their economic development. Such reliance often leads to economic exploitation. For instance, most of the underdeveloped countries in Africa and Asia have been exploited by European countries.

c. **Political Dependence:** International trade often encourages subjugation and slavery. It impairs economic independence which endangers political dependence. For example, the Britishers came to India as traders and ultimately ruled over India for a very long time.

d. **Mis-utilisation of Natural Resources:** Excessive exports may exhaust the natural resources of a country in a shorter span of time than it would have been otherwise. This will cause economic downfall of the country in the long run.

e. **Import of Harmful Goods:** Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.

f. **Storage of Goods:** Sometimes the essential commodities required in a country and in short supply are also exported to earn foreign exchange. This results in shortage of these goods at home and causes inflation. For example, India has been exporting sugar to earn foreign trade exchange; hence the exalting prices of sugar in the country.

g. **Danger to International Peace:** International trade gives an opportunity to foreign agents to settle down in the country which ultimately endangers its internal peace.

h. **World Wars:** International trade breeds rivalries amongst nations due to competition in the foreign markets. This may eventually lead to wars and disturb world peace.

i. **Hardships in times of War:** International trade promotes lopsided development of a country as only those goods which have comparative cost advantage are produced in a country. During wars or when good relations do not prevail between nations, many hardships may follow.

4.19. Foreign exchange:

International trade and investment create need for buying, selling borrowing and lending foreign currency Let us take an example, an exporter in Japan sells goods to a customer in the U.K. The sale will be priced in Yen, Sterling or perhaps a third currency such as U.S. dollar. a) If the sale is priced in Yen, the U.K. customer will purchase Yen with Sterling in order to make payment. b) If the sale price is in Sterling, the Japanese supplier will normally wish to convert the receipts into domestic currency yen^ to meet operating expenses in Japan, and will sell Sterling in exchange for Yen. c) If the sale price is in a third currency, such as US dollars, the customer will buy dollars in exchange for Sterling to. make the payment and supplier will then sell the dollars in exchange for Yen. Sometimes, international trade transactions do not result in the sale or purchase of foreign currency because companies' setoff foreign currency receipts against foreign exchange payments.

However, buying and selling, borrowing and lending foreign currencies a common activity which support international trade and investment. These activities an undertaken in the financial markets called foreign exchange markets. As student of International Business Operations, it is thus important for you to know the terminology. operations and mechanisms of foreign exchange markets.

4.19.1. Meaning and concept of foreign exchange:

Foreign exchange in short form is called Forex. The foreign exchange market or forex market is the market where one currency is exchanged or traded for another currency. Forex markets are also called foreign currency or just currency markets. There are domestic and international foreign currency markets. Domestic foreign currency markets serve the foreign currency buying, selling, borrowing and lending needs of residents whereas international markets serve non-residents also. Much of the foreign currency lending and borrowing take place in the Euromarkets. Currencies are also traded in other forms as "derivative contracts" such as currency swaps, options and futures. These are more sophisticated instruments for trading in foreign currencies.

4.19.2. Foreign Exchange Rate:

The exchange rate mechanism (ERM) of the European monetary system (EMS), intervention by central banks of different countries from time-to-time, and the keenness with which board meetings of Federal Reserve (US central bank) or Deutsche Bank (German central bank) and central banks of other G-7 countries are watched by forex market players highlight the importance and role of ' regulation in the forex markets.

4.19.3. Types of foreign exchange transactions:

A foreign exchange transaction is a contract to buy or sell a quantity of one currency in exchange for another at a specified time for delivery and settlement and at a specified price (exchange rate). These transactions take place in foreign exchange markets. In terms of counter parties and settlement dates, the forex transactions may be classified as follows:

1. **Trade Transactions**

   Trade transaction is a transaction between a bank and a non-bank customer, where the customer wishes to buy or sell a quantity of currency to complete a business transaction or (occasionally) specalates for profit by anticipating future changes in the exchange rate.

2. **Interbank Transactions**

   Interbank transactions are where two banks trade currencies between themselves. Banks buy and sell huge quantities of foreign currencies. They also accept currency deposits and lend in foreign currency.

3. **Spot Transactions**

   A spot transaction is a contract to buy or sell a quantity of a foreign currency for immediate settlement. Immediate settlement as per convention of forex market means two working days from the date of contract. The settlement date is also known as 'value date'. The exchange rate for a spot transaction is known as the 'spot rate' and the market where spot 'transactions are conducted is called spot market.

4. **Forward Transactions**

   Currency can be traded spot or forward. In a spot transaction, the purchase or sale of currencies takes place for settlement two working days later. With a forward transaction, the purchase or sale is agreed now but will take place at some time in the future, there by fixing the rate now for a future exchange of currencies. Forward transactions are -- forward exchange contracts (or forward contract). The rate at which forward transactions contracted in the present for future delivery of foreign currency is the forward rate. The market where purchase and sales of currencies are contracted in the present for receipt and delivery in future is called forward market.

4.20. Global recession:

For more than a year, barely a day has passed that we have not heard dire economic news about the United States, Europe, or Japan. Unemployment has been rising, company profits have been falling, financial markets have been tumbling, and the housing sector has been collapsing. Is there a single word to describe these developments? Yes: “recession.”

The ongoing global financial crisis has been accompanied by recessions in many countries. This pattern is consistent with the historical record. Synchronized recessions have occurred in advanced economies several times in the past four decades—the mid-70s, early 80s, early 90s, and early 2000s. Because the United States is the world’s largest economy and has strong trade and financial linkages with many other economies, most of these globally synchronized recession episodes also coincide with U.S. recessions.

Although U.S. recessions have become milder over time, the current recession is likely to change this trend. Already 16 months old—with sharp declines in consumption and investment—it could become one of the longest and deepest recessions since the Great Depression of the 1930s.

4.20.1. Calling a recession

There is no official definition of recession, but there is general recognition that the term refers to a period of decline in economic activity. Very short periods of decline are not considered recessions. Most commentators and analysts use, as a practical definition of recession, two consecutive quarters of decline in a country’s real (inflation adjusted) gross domestic product (GDP)—the value of all goods and services a country produces (see “Back to Basics,” F&D,

December 2008). Although this definition is a useful rule of thumb, it has drawbacks. A focus on GDP alone is narrow, and it is often better to consider a wider set of measures of economic activity to determine whether a country is indeed suffering a recession. Using other indicators can also provide a more time gauge of the state of the economy.

The National Bureau of Economic Research (NBER), a private research organization, which maintains a chronology of the beginning and ending dates of U.S. recessions, uses a broader definition and considers a number of measures of activity to decide the dates of recessions. The NBER's Business Cycle Dating Committee defines a recession as "a significant decline in economic activity spread across the economy, lasting more than a few months, normally visible in production, employment, real income, and other indicators. A recession begins when the economy reaches a peak of activity and ends when the economy reaches its trough." Consistent with this definition, the committee focuses on a comprehensive set of measures—including not only GDP, but also employment, income, sales, and industrial production—to analyze the trends in economic activity.

Although an economy can show signs of weakening months before a recession begins, the process of determining whether a country is in a true recession (or not) often takes time. For example, it took the NBER committee a year to announce that the current U.S. recession started in December 2007. This is understandable, because the decision process involves establishing a broad decline in economic activity over an extended period of time after compiling and sifting through many variables, which are often subject to revisions after their initial announcement. In addition, different measures of activity may exhibit conflicting behavior, making it difficult to identify whether the country is indeed suffering from a broad-based decline in economic activity.

4.20.2. Reasons for recession:

Understanding the sources of recessions has been one of the enduring areas of research in economics. There are a variety of reasons recessions take place. Some are associated with sharp changes in the prices of the inputs used in producing goods and services. For example, a sharp increase in oil prices can be a harbinger of a coming recession. As energy becomes expensive, it pushes up the overall price level, leading to a decline in aggregate demand. A recession can also be triggered by a country's decision to reduce inflation by employing contractionary monetary or fiscal policies. When used excessively, such policies can lead to a decline in demand for goods and services, eventually resulting in a recession.

Some recessions, including the current one, are rooted in financial market problems. Sharp increases in asset prices and a speedy expansion of credit often coincide with rapid accumulation of debt. As corporations and households get overextended and face difficulties in meeting their debt obligations, they reduce investment and consumption, which in turn leads to a decrease in economic activity. Not all such credit booms end up in recessions, but when they do, these recessions are often costlier than others. Recessions can be the result of a decline in external demand, especially in countries with strong export sectors. Adverse effects of recessions in large countries—such as Germany, Japan, and the United States—are rapidly felt by their regional trading partners, especially during globally synchronized recessions.

Because recessions have many potential causes, it is a challenge to predict them. The behavioral patterns of numerous economic variables—including credit volume, asset prices, and the unemployment rate—around recessions have been documented, but although they might be the cause of recessions, they could also be the result of recessions—or in economic parlance, endogenous to recessions. Even though economists use a large set of variables to forecast the future behavior of economic activity, none has proven a reliable predictor of whether a recession is going to take place. Changes in some variables—such as asset prices, the unemployment rate, certain interest rates, and consumer confidence—appear to be useful in predicting recessions, but economists still fall short of accurately forecasting a significant fraction of recessions, let alone predicting their severity in terms of duration and amplitude (see "Picture This," F&D, September 2008).

4.20.3. Recessions are infrequent but costly

There were 122 completed recessions in 21 advanced economies over the 1960–2007 period. Although this sounds like a lot, recessions do not happen frequently. Indeed, the proportion of time spent in recession—measured by the percentage of quarters a country was in recession over the full sample period—was typically about 10 percent. Although each recession has unique features, recessions often exhibit a number of common characteristics:

• They typically last about a year and often result in a significant output cost. In particular, a recession is usually associated with a decline of 2 percent in GDP (see chart). In the case of severe recessions, the typical output cost is close to 5 percent.

• The fall in consumption is often small, but both industrial production and investment register much larger declines than that in GDP.

• They typically overlap with drops in international trade as exports and, especially, imports fall sharply during periods of slowdown.

• The unemployment rate almost always jumps and inflation falls slightly because overall demand for goods and services is curtailed. Along with the erosion of house and equity values, recessions tend to be associated with turmoil in financial markets.

4.20.4. About a depression

The current U.S. recession is the eighth the country has experienced since 1960. The typical U.S. recession in that period lasted about 11 months, with the longest (in 1973 and 1981) 16 months and the shortest (1980) eight months. The peak-to-trough output decline was on average 1.7 percent, with the single worst recession (in 1973) leading to a slightly more than 3 percent output loss. Although investment and industrial production fell in every recession, consumption registered a decline in only three.

One question sometimes asked is how the ongoing recession compares with a depression, especially the Great Depression of the 1930s. There is no formal definition of depression, but most analysts consider a depression to be an extremely severe recession in which the decline in GDP exceeds 10 percent. There have been only a handful of depression episodes in advanced economies since 1960. The most recent was in the early 1990s in Finland, which registered a decline in GDP of about 14 percent. That depression coincided with the breakup of the Soviet Union, a large trading partner of Finland. During the Great Depression, the U.S. economy contracted by about 30 percent over a four-year period. Although the current recession is obviously severe, its output cost so far has been much smaller than that of the Great Depression.

4.21. The oil market

The most widely accepted theoretical approach to the economics of oil focuses on the prevailing oligopolistic market. According to Adelman (1993), the long-term marginal cost is a small fraction of the price of oil, even when making considerable allowances for the future values of the resources used up today ("user costs"). To support high price levels, the excess supply is restricted by a cartel. The market works in the following way: higher cost producers sell all they can produce, while low-cost producers satisfy the remainder of the demand at current prices and cut back production if needed.

4.21.1. Overview on supply

The power of the producing countries is, in general, rooted in the characteristics of oil. Producers incur no storage costs, since petroleum is simply left in the ground, while consuming countries have to cover the technical costs of building storage facilities, interest on the value of oil stocks and various risks (e.g. environmental risks). In addition, oil production is not labour intensive and, therefore, the oil supply can be controlled easily by reducing depletion rates without affecting the labour market. Since there are no short term substitutes for petroleum, changes in supply are also effective. Moreover, demand for crude oil is highly insensitive to price changes.

The most important player in the oil market – the Organization of the Petroleum Exporting Countries (OPEC), founded in 1960 in Baghdad – comprises a diverse group of developing nations, highly dependent on oil exports and unified by their common interest in oil revenue maximisation. On average, petroleum exports represent over 68% of the total exports of these countries. Aiming to sustain world demand for oil (as opposed to replacing it with alternative energy sources), OPEC has to balance market share and profits.

The oil cartel's market power comes from the sheer size of its proven oil reserves (891 billion barrels) and exports (19.5 million barrels per day) – 78.3% and 48.7% respectively of the 2003 worldwide totals (OPEC, 2003). The Gulf countries also have the lowest production costs: USD 4.00 per barrel for Saudi Arabia or USD 4.50 for Iran, as compared, for example, with USD 9.85 for the North Sea and USD 12.50 for Brazil (Energy Intelligence, 2004). In addition, most OPEC oil is produced by 100% state-owned companies (as is the case in Algeria, Iran, Kuwait, Qatar, Saudi Arabia and Venezuela) or majority state-owned companies (Libya, Nigeria and United Arab Emirates). Only in Indonesia is government participation in the oil sector very limited.

The country with the largest weight among the oil exporting nations is Saudi Arabia. It has the world's largest proven petroleum reserves (one-quarter of the total) and some of the lowest production costs, and is the largest producer and net exporter of oil.

4.21.2. The demand for oil

Unlike supply, demand for crude oil depends on the choices of many individual households and firms. However, owing to its importance for the economy and national security, the demand side is influenced by various private interest groups, the most influential of which being domestic oil refiners without foreign supply sources and governments, whose aim is to acquire sufficient quantities of petroleum from stable sources. Oil importing governments influence the petroleum market by means of fiscal instruments, antitrust policies, public funds for alternative energy research or petroleum exploration activities, political intervention in situations in which the interests of the nation are at stake, environmental regulations and strategic oil reserves.

In addition to policy measures, governments in some oil importing countries, such as China, South Korea, Singapore, Taiwan, Thailand, Turkey and Brazil, own majority stakes in their countries' main oil companies. Nevertheless, the tendency over the last decade has been to privatise and deregulate the energy sector. As a result of its rapidly growing oil demand, China has begun to allow minority private ownership of its petroleum companies, as well as seeking to invest in foreign private companies.

4.21.3. World Oil Trade Flows:

It has focuses on crude oil, as it dominates the international oil trade, because it is cheaper to transport. Oil should move to the nearest market first because of transportation costs. The "nearest first" pattern can, however, be distorted by refinery configurations, product demand mix, quality specifications and politics as discussed in previous sections. In addition, geographical proximity could be a source of short-term vulnerability (e.g. in the event of natural disasters such as hurricanes).

4.21.4. A model for oil invoicing

Its captures that the network effects in the oil market. The market consists of many buyers (B) and sellers (S) of crude oil. While the oil producers are sellers in this game, they have an incentive to invoice their oil contracts in the currency with which they will pay for their (non-oil) imports of goods and services from the rest of the world. In short, we will call these (nonoil) goods and services food. Similarly, the rest of the world are buyers of oil and sellers of food. Both parties aim to minimise foreign exchange risk and costs associated with the use of a specific currency for trade.

In an environment where buyers and sellers are matched randomly and are subject to cash-in-advance constraints, both types of agents may choose between two currencies, i.e. euro (e) or US dollars (d), as the invoicing currency for their contracts. Each contract is fully invoiced in a single currency. In addition, the price of each contract is assumed to be constant and normalised to one. At time t, the sellers sell oil to the buyers, while at time t + 1, the buyers of oil sell food to the oil sellers. Hence, all agents try to anticipate the currency they will need for purchases in the next period.

4.22. War between Countries:

Why do wars occur and recur, especially in cases when the decisions involved are made by careful and rational actors? There are many answers to this question. Given the importance of the question, and the wide range of answers, it is essential to have a perspective on the various sources of conflict. In this chapter we provide a critical overview of the theory of war. In particular, we provide not just a taxonomy of causes of conflict, but also some insight into the necessity of and interrelation between different factors that lead to war.

Let us offer a brief preview of the way in which we categorize causes of war. There are two prerequisites for a war between (rational) actors. One is that the costs of war cannot be overwhelmingly high. By that we mean that there must be some plausible situations in the eyes of the decision makers such that the anticipated gains from a war in terms of resources, power, glory, territory, and so forth exceed the expected costs of conflict, including expected damages to property and life. Thus, for war to occur with rational actors, at least one of the sides involved has to expect that the gains from the conflict will outweigh the costs incurred. Without this prerequisite there can be lasting peace. Second, there has to be a failure in bargaining, so that for some reason there is an inability to reach a mutually advantageous and enforceable agreement.

The main tasks in understanding war between rational actors are thus to see why bargaining fails and what incentives or circumstances might lead countries to arm in ways such that the expected benefits from war outweigh the costs for at least one of the sides. A good portion of our overview of the causes of war is thus spent discussing a framework of different bargaining failures. We emphasize that understanding sources of bargaining failure is not only useful as a categorization, but also because different types of failures lead to different conclusions about the types of wars that emerge, and particularly about things like the duration of war. We return to comment on this after discussing various reasons for bargaining failure. Below, we talk in detail about the following five reasons for bargaining failure:

1. Asymmetric information about the potential costs and benefits of war.
2. A lack of ability to enforce a bargaining agreement and/or a lack of the ability to credibly commit to abide by an agreement.
3. Indivisibilities of resources that might change hands in a war, so that not all potentially mutually beneficial bargaining agreements are feasible.
4. Agency problems, where the incentives of leaders differ from those of the populations that they represent.
5. Multilateral interactions where every potential agreement is blocked by some coalition of states or constituencies who can derail it.

To illustrate the importance of understanding which reason lies behind a conflict, note that if there is a lack of ability to enforce or commit to an agreement, then a war may last a long time. It will last until either one side has emerged victorious, or the situation has changed so that the costs of continued conflict have become overwhelmingly high for all sides. Such a lack of enforceable agreements is often one of the main ingredients leading to protracted wars. In contrast, suppose that enforceable and credible agreements are possible, but that the states start with asymmetric information, for instance, about the relative strength of one of the two countries. In such a case, there can be a bargaining failure which leads to war. However, in such a setting once war really begins the relative strengths of the countries can become clearer, and given that credible bargaining is possible and can avoid further costs of war the states could then reach an agreement to end the war. So, different durations of wars can correspond to different sources of bargaining failures.

Unit- V

. Investment methods and strategies:

5. Introduction:

5.1. Cash Flows

A company creates value for the shareholders by generating positive cash flows for them. As per Accounting Standard -3 (AS-3), cash flows are inflows and outflows of cash and cash equivalents, i.e. cash flow is the amount of cash and cash equivalents move in and out of a business. Cash flow generated in a company adds to its cash reserves, which further accelerate reinvestment in the company.

5.2. Cash flow Statement

The Cash flow statement is one of the three most important financial statements. It shows the inflows and outflows of cash and cash equivalents over a period of time. The users of financial information give substantial importance to this statement as it acts as a tool to study the strength and long term future outlook of the company. It also takes into account various activities of an enterprise.

The cash flow statement of an enterprise provides information about the historical changes in cash and cash equivalents by classifying all cash flows derived from operating, investing and financing activities. The revised Accounting Standard -3 (AS-3) made it mandatory for all listed companies to prepare and present an annual cash flow statement along with other financial statements.

5.3. Features of Cash Flow Statement

Features are mentioned as follows:

1. A cash flow statement is a periodic statement.
2. It is a statement of change in the financial position on a cash basis.
3. It shows the movement of cash and explains the reasons for changes in cash position between two balance sheet dates.
4. It does not match cost against revenue.
5. It shows the inflow and outflow of cash and cash equivalents from various activities.
6. It helps assess the company's capability to generate cash and cash equivalents and channels to utilise those cash flows.
7. It provides information on inflow and outflow of cash and cash equivalents from various activities of a company under various heads, i.e. operating, investing and financing activities.

5.4. Objectives of Cash Flow Statement

The objectives of the cash flow statement are as follows:

- To make future financial policies.
- To identify the extent of major expenses.

- To devise the cash requirement for a period.
- To find reasons for the net cash inflows or outflows.
- To predict the financial strength of the company.

5.5. Benefits of Cash Flow Statement

Cash Flow Statement Benefits are mentioned as follows:

● Highlights liquidity position

Liquidity means one's ability to pay the obligation on time or as soon as it becomes due. A cash flow statement helps in determining the liquidity position of the business. It shows the cash position and gives an idea of the cash payments made in the course of business of the company, thus, confirming the liquidity position of the same.

● Helps in cash management

A cash flow statement helps in the management of cash flow. With the help of cash flow statements, companies can estimate both future cash receipts and payments. With the help of this statement, it is easier for companies to make future plans related to cash without compromising on liquidity.

● Maintain optimal cash balance

Another benefit of a cash flow statement is that it facilitates the company to maintain an optimal cash balance. It enables businesses to verify the possible idle, excess or shortage of cash. After arranging for the required Cash position, the companies can invest the excess cash or borrow funds in case of any deficit.

● Comparability

A cash flow statement facilitates the accurate comparison of the cash based performance of different companies as it uses the same accounting treatment for the same transactions and events. Companies can, therefore, adjust their cash flows as per the industry norms or modify them as per the structure of the industry leaders.

● Indicates future

One of the significant benefits of the cash flow statement is that historical cash flow information is taken as an adequate indication of future cash flows. Past information on cash amount, their timing and certainty of their arrival may be used for the forecasting of the future cash flows. It helps in confirming the accuracy of past assessments too.

5.6. Types of activities and cash flow classification:

As per AS-3, these activities can be put into three categories:

- Operating activities,
- Investing activities, and

- Financing activities.

This classification shows the cash flows generated and used in these activities.

5.7. Cash from Operating Activities

Operating activities comprised of the primary activities of a company. These activities create the principal revenue stream for the company. Cash flow from operating activities is the first subdivision portrayed on a cash flow statement. Cash from operations is an indicator of the internal solvency of the company.

- Cash from operating activities signifies the cash a company generates from its ongoing and regular business activities.

- These activities include routine acts of manufacturing and selling goods or a service to Cash Flow Statement clients.

- It focuses only on core business activities and does not include non-core, long term capital expenditures or investment revenues etc.

- As it considers only the core business, cash flow from operating activities is a yardstick to verify the financial status of a company.

5.8. Cash from Investing Activities:

As per AS-3, investing activities are the acquisition and disposal of long term assets and other investments not included in cash equivalents. Investing activities are related to the purchase and sale of long-term or fixed assets of a company. These assets include land and building, machinery, furniture etc. These activities signify the extent to which expenditures are made for acquiring resources to generate future cash flows. Cash flows related to long term investments are also known as investing activities.

5.9. Cash from Financing Activities

As per AS-3, financing activities are activities that result in changes in the size and composition of the owners' capital (including preference share capital in case of a company) and borrowings of the enterprise.

It is the part of a company's cash flow statement, which shows the flows of cash used to fund the company that involve equity, debt and dividends. It provides an insight into a company's financial strength and its capital structure. These activities are related to long-term funds or capital as cash proceeds from issue of equity shares, debentures, bank loans etc.

5.10. Capital Gain:

5.10.1. Introduction:

As we know 'capital gains' is a separate head of income and any income arising out of sale or transfer of 'a capital' asset is charged to tax under this head.

5.10.2. Meaning of capital gains:

Any profits or gains arising from the transfer of a capital asset effected in the previous year shall be chargeable to income-tax under the head 'Capital Gains', and shall be deemed to be the income of the previous year in which the transfer took place. The above definition can be split up into three parts:

(a) Capital Asset

(b) Transfer of Capital Asset

(c) Profits or Gains

Let us now discuss each one of them in detail:

5.10.3. Concept of Capital Asset

Capital asset means property of any kind held by an assessee whether or not connected with his business or. profession. The asset may be movable, immovable, tangible or intangible. But the term capital asset does not include:

i) any stock - in- trade, consumable stores or raw materials held for the purposes of his business or profession.

ii) personal effects, that is to say, movable property (including wearing apparel and furniture but excluding jewellery) held for personal use by the assessee or Any member of his family dependent on him;

iii) agricultural land in India (situated in rural areas) not being land situated within the limits of any municipality or a cantonment board having a population of 10,000 or more or situated in areas lying within a distance not exceeding 8 kilometres from the local limits of such municipalities or cantonment boards (i.e., agricultural land situated within municipal or cantonment board limits or within - a distance of eight kilometres from the local limits of a municipality or cantonment board is included in the term 'Capital Asset' and it is only the agricultural land which is situated outside such limits that is excluded from the term 'Capital Asset').

5.10.4. Kinds of Capital Assets:

Interestingly the classification of capital asset does not depend on their durability but the period for which they have been held. Capital assets are divided into two categories:

(i) Short - term Capital Asset, (ii) Long - term Capital Asset.

Short-term Capital Asset:

Short - term Capital Asset means a capital asset held by an assessee for not more than 36 months immediately preceding the date of its transfer. In the case of a share held in a company, short - term capital asset will mean a share held by the assessee for not more than 12 months instead of 36 months in case of other assets.

Long-term Capital Asset:

Long - term Capital Asset means a capital asset (other than shares in a company) held by an assessee for more than 36 months immediately preceding the date of transfer. In the case of shares held in a company, long – term capital asset will mean shares held by the assessee for more than 12 months.

Short- term and Long- term Capital Gains:

Capital gains arising from the transfer of short - term Capital Assets are called short - term Capital Gains:

Capital gains arising from the transfer of long - term Capital Assets are called Long - term Capital Gains.

5.10.5. Computation of capital gains:

The income chargeable under the head 'Capital Gains' shall be computed by deducting from the full value of the consideration received or accruing as a result of the transfer of the capital asset the following amounts:

a) Expenditure incurred wholly and exclusively in connection with such transfer, and

b) The cost of Acquisition of the capital asset and cost of any improvement thereof. This may be explained in the form of equation as under:

Capital Gain = Full value 'of consideration - (Cost of acquisition + Cost of improvement + Selling Expenses).

5.11. The risk/reward

The risk/reward ratio—also known as the risk/return ratio—marks the prospective reward an investor can earn for every dollar they risk on an investment. Many investors use risk/reward ratios to compare the expected return of an investment with the amount of risk they must undertake to earn these returns. A lower risk/return ratio is often preferable as it signals less risk for an equivalent potential gain.

Traders often use this approach to plan which trades to take, and the ratio is calculated by dividing the amount a trader stands to lose if the price of an asset moves in an unexpected direction (the risk) by the amount of profit the trader expects to have made when the position is closed (the reward).

5.11.1. Working of Risk/Reward

In many cases, market strategists find the ideal risk/reward ratio for their investments to be approximately 1:3, or three units of expected return for every one unit of additional risk. Investors can manage risk/reward more directly through the use of stop-loss orders and derivatives such as put options.

The risk/reward ratio is often used as a measure when trading individual stocks. The optimal risk/reward ratio differs widely among various trading strategies. Some trial-and-error methods are usually required to determine which ratio is best for a given trading strategy, and many investors have a pre-specified risk/reward ratio for their investments.

Note that the risk/return ratio can be computed as one's personal risk tolerance on an investment, or as the objective calculation of an investment's risk/return profile. In the latter case, expected return is often used in the denominator and potential loss in the numerator. Expected return can be computed in several ways, including projecting historical returns into the future, estimating the weighted probabilities of future outcomes, or using a model like the capital asset pricing model (CAPM).

5.11.2. Computation of Risk/Return Ratio:

To calculate the risk/return ratio (also known as the risk-reward ratio), you need to divide the amount you stand to lose if your investment does not perform as expected (the risk) by the amount you stand to gain if it does (the reward).

The formula for the risk/return ratio is: ***Risk/Return Ratio = Potential Loss / Potential Gain***

5.11.3. Needs of Risk/Reward Ratio

The risk/reward ratio helps investors manage their risk of losing money on trades. Even if a trader has some profitable trades, they will lose money over time if their win rate is below 50%. The risk/reward ratio measures the difference between a trade entry point to a stop-loss and a sell or take-profit order. Comparing these two provides the ratio of profit to loss, or reward to risk.

Investors often use stop-loss orders when trading individual stocks to help minimize losses and directly manage their investments with a risk/reward focus. A stop-loss order is a trading trigger placed on a stock that automates the selling of the stock from a portfolio if the stock reaches a specified low. Investors can automatically set stop-loss orders through brokerage accounts and typically do not require exorbitant additional trading costs.

The risk/return ratio helps investors assess whether a potential investment is worth making. A lower ratio means that the potential reward is greater than the potential risk, while a high ratio means the opposite. By understanding the risk/return ratio, investors can make more informed decisions about their investments and manage their risk more effectively.

5.12. Risk Distribution:

5.12.1. Definition

A **Risk Distribution** is the core computational tool (building block) of quantitative of risk management. Mathematically a risk distribution is the probability distribution of a Random Variable.

5.12.2. Risk Distribution Categories

One can classify risk distributions along a number of interesting characteristics and these tend to be very important in determining fitness of use for particular risk applications

- Parametric or non-parametric.
- Obtained as an Analytic Models of via Monte-Carlo Simulation.
- Discrete, continuous or mixed support. The nature of the realized risk usually dictates which type is meaningful to use.
- Finite, infinite one sided or infinite two sided support. Similarly, as above.
- Finite of infinite moments / moment generating function. Related to the sub-exponential, heavy-tails and fat-tails properties. NB: It may not always be possible to assert whether an actual phenomenon has infinite moments.
- Symmetric or asymmetric.

5.12.3. Usage

- ➢ The most direct application of risk distributions in risk management is the explicit modelling of risk as realisations from a distribution.
- ➢ The concept forms the basis for the constructions of a variety of Risk Metrics.
- ➢ It is rare that a risk phenomenon is described exclusively by a single parametric distribution. Hence many usage examples are cases where a distribution is used as part of an overall modelling framework (which is multi-dimensional and/or involves time-dependent processes).
- ➢ Some distributions (e.g, the uniform and the normal) are used extensively as building blocks to create more realistic distributions.
- ➢ Some distributions appear primarily in the context of statistical testing that is used in risk management applications.
- ➢ While in the majority of applications distributions are used in conjunction with historical data (models of risk realisations), in financial applications involving the pricing of risk they may also be used as the implied distributions (of potential future risk events.

5.12.4. Classification of risk:

1. **Credit Risk or Default Risk:**

It is also known as Default Risk. Credit risk is just the risk that the person you have given credit to, i.e. the company or individual, will be unable to pay you interest, or pay back your principal, on its debt obligations. If you are investing in Infrastructure Bonds or Company Fixed Deposits right now, you should be aware of the credit / default risk involved. Government bonds have the lowest credit risk (but it is not zero - think of Portugal, Ireland or Spain right now), while low rated corporate deposits (junk bonds) have high credit risk. Before investing in a bond or a corporate deposit, be sure to check how highly it is rated by a well-known rating agency such as CRISIL, ICRA or CARE. Remember, even a bank FD has some credit risk, as only a maximum of Rs. 1 lakh is guaranteed by the Government.

2. **Country Risk**

When a country cannot keep to its debt obligations and it defaults, all of its stocks, mutual funds, bonds and other financial investment instruments are affected, as are the countries it has financial relations with. If a country has a severe fiscal deficit, it is considered more likely to be risky than a country with a low fiscal deficit, ceteris paribus. Emerging economies are considered to be riskier than developed nations.

3. **Political Risk**

This is also higher in emerging economies. It is the risk that a country's government will suddenly change its policies. For example, today with the continuing raging debate on FDI in retail, India's policies will not be looking very attractive to foreign investors, and stock prices are negatively affected.

4. **Reinvestment Risk**

This is the risk that you lock into a high yielding fixed deposit or corporate deposit at the highest available rate (currently above 9.50%), and when your interest payments come in, there is no equivalent high interest rate investment avenue available for you to reinvest these interest proceeds (for example if your interest is paid out after 1 year and the prevailing interest rate is 8% at that time).Currently as we are at an interest rate peak, it would be advisable to lock in for a longer tenor (provided your financial goal time horizon permits) to avoid facing reinvestment risk.

5. **Interest Rate Risk**

A golden rule in debt investing is this: Interest Rates go up; prices of bonds go down. And vice versa. So for example in our situation today, we appear to be at an interest rate peak. This means that since interest rates are going to go down from here, prices of bonds are going to go up. So if you were to invest in debt funds now, you would be buying at a low, and can sit back and watch as your investments start to give gains as interest rates fall.

6. **Foreign Exchange Risk**

Forex risk applies to any financial instruments that are denoted in a currency other than your own. For example, if a UK firm has invested in India, and the Indian investment does well in rupee terms, the UK firm might still lose money because the Rupee has depreciated against the Pound, so when the firm decides to pull out its investment on maturity, it gets fewer pounds on redemption. With the recent very sharp fall in the rupee, the forex risk of our country as an investment destination has greatly increased.

7. **Inflationary Risk**

Inflationary risk, or simply, inflation risk, is when the real return on your investment is reduced due to inflation eroding the purchasing power of your funds by the time they mature. For example, if you were to invest in a fixed deposit today and you were to earn a 10% interest on it in 1 years' time, then if inflation has been 8% in that year, your real rate of return comes down to 2%, keeping purchasing power in mind.

8. Market Risk

This is the risk that the value of your investment will fall due to market risk factors, which include equity risk (risk of stock market prices or volatility changing), interest rate risk (risk of interest rate fluctuations), currency risk (risk of currency fluctuations) and commodity risk (risk of fluctuations in commodity prices). There are other types of risk too, such as legislative risk, global risk, timing risk and more, but for the scope of this article, the ones explained above are the main ones you need to keep in mind, both on a macro (country) and a micro (individual investments) level.

5.13. Asset accumulation:

Financial assets are a base for family economic security and development. Saving and asset accumulation are almost universally viewed as desirable goals, and much effort has been devoted to the development of financial-education curricula that include practical strategies for saving and asset accumulation.

We begin with some definitions. **Saving** occurs when current income exceeds current consumption and therefore when total resources increase. We focus here on financial resources. Financial resources that last through time are financial assets. **Dissaving** occurs when current consumption exceeds current income and when total resources decrease. Dissaving is the opposite of saving. **Asset accumulation** is an increase in assets, and saving leads to asset accumulation as long as saving is greater than dissaving.

5.13.1. Stages of Asset Accumulation

We find it useful to assume that asset accumulation occurs in three stages**.**

First stage, current resource inflows must exceed current outflows. To do this, people often reallocate resources from consumption, but they may also increase resource inflows without reducing consumption, for example, by working more. The latter constitutes a reallocation of time and effort from leisure to labor. Individuals may also reallocate resources through time. We refer to this first stage of asset accumulation as reallocation.

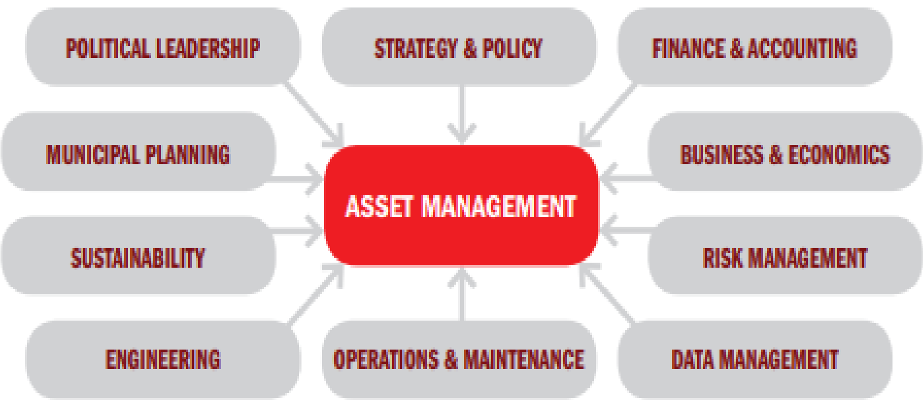
In the **second stage** of asset accumulation, resources may be converted from some easy-to-spend form to a more difficult-to-spend form. For example, cash may be converted to resources in a bank account or to cash held by a trusted friend. Although asset accumulation can occur without this second step (if resources are saved and maintained in liquid forms), the theoretical literature summarized previously implies that asset accumulation is more likely when resources are converted to less-liquid forms. We refer to this stage as conversion.

Finally, in the **third stage,** for saving to lead to asset accumulation, individuals must resist pressures to dissave. We refer to this stage as maintenance. Maintaining assets is not an end in itself, but a means to prepare for retirement, to prepare for financial crises, or to obtain certain goods and services, such as education, a house, a car, or a vacation.

5.14. Asset Management:

Understanding what asset management is beginning with an understanding of the word "asset" in this context. In the broadest sense, an asset is anything that delivers value to your organization and the stakeholders you serve. When we talk about municipal asset management, we typically talk about assets being a piece of publicly-owned infrastructure, for example a road, a water pipe, an indoor or outdoor recreational facility, an office building, etc. Of course, we can also consider other assets of the organization like people, processes, and knowledge. The term asset management has been defined in different ways by a variety of government and non-government organizations in Canada. As part of the Leadership in Asset Management Program (LAMP), an initiative delivered by the Federation of Canadian Municipalities, a definition of asset management was created:

Asset management is an integrated approach, involving all organization departments, to effectively manage existing and new assets to deliver services to customers. The intent is to maximize benefits, reduce risks and provide satisfactory levels of service to the community in a sustainable manner – providing an optimum balance. Good asset management practices are fundamental to achieving sustainable communities.



From a practical perspective, asset management is based on a set of fundamentals:

- Value: Assets exist to provide value to the organization and its stakeholders.
- Alignment: Asset management translates the organizational objectives into technical and financial decisions, plans, and activities.
- Leadership: Leadership and workplace culture support achieving plans and goals.
- Assurance: Asset management gives assurance that assets will fulfil their required purpose.

Asset management can bring everything together Developing a formal asset management approach will help you connect valuable components and information from across your organization. You need to bring together people and skills across the organization to solve your service and infrastructure problems: engineers, planners, accountants, and elected officials. Asset management is a tried and tested approach to do this! It's a multi-disciplinary effort that will help different departments work together towards your community goals.

5.14.1. Competencies of asset management

For the five Asset Management(AM) competencies – which are defined in Readiness Scale – your organization will have different priorities and appetites to progress certain competencies. Do what work for you, but know that to be good and effective asset managers you should circle back to progress all competencies and complete the various gaps that you identified.

- ✓ **People and leadership:** Set up cross-functional groups with clear accountability, and ensuring adequate resourcing and commitment from senior management and elected officials to advance asset management. You need a champion to drive the program, develop the relationships and manage the larger vision and goal while taking measurable steps to get there and build buy-in as you progress.
- ✓ **Data and information:** Using asset data, performance data, and financial data to support evidence-based decision-making and inform planning exercises.
- ✓ **Planning and decision-making:** Documenting and standardizing how the organization sets priorities, invests capital, plans operations and maintenance (O&M) work, and decides on budgets.
- ✓ **Policy and governance:** Putting in place a governance structure to ensure vision, and objectives are acted upon, then develop policies and objectives to connect the vision to actions.
- ✓ **Contribution to asset management practice:** Training and staff development, sharing knowledge internally and participating in external knowledge sharing.

This sounds like a lot, and it doesn't happen overnight, but you can put a multi-year roadmap in place and start to make progress on pieces of the Asset Management puzzle.

what does an asset manager do?

Drawing on the Institute of Asset Management's Competences Framework, 2008 as a reference point, there are seven key activities that asset managers get involved in. It is important to understand that all of these activities overlap:

1. **Developing Policy**

The Asset Management Policy is the link between the Organisational Plan (that is the top level 'business plan' in a company) and the Asset Management Strategy. It is typically a set of principles or guidelines to steer Asset Management activity to achieve the organisation's objectives. It specifically covers the 'what' and the 'why'.

2. **Developing Strategy**

The Asset Management Strategy directs the organisation's Asset Management activity; it will determine the high level Asset Management objectives that are needed from the activity to deliver the organisation's objectives; it will define the approach to planning that will be taken.

3. **Asset Management Planning**

Asset Management Planning looks at considering all the options for activities and investments going forward and then putting together a set of plans which describe what will be done when and by whom. The asset manager ensures that the plan delivers what is required of it by the strategy.

4. Delivering the Plans

This is the bit where work is actually done on the assets, whether assessing or monitoring them, maintaining or repairing them, refurbishing or replacing them. This activity clearly needs to include the appropriate controls to ensure the work is done efficiently and that information gathered is fed back into the strategy and planning activities.

5. Developing People

This activity is specifically about developing the skills and competences of people to better deliver Asset Management activities. It spans from the board room to the tool box and also through the supply chain. As well as individual skills, it looks at the culture within an organisation and how change can be managed to achieve optimal results for that organisation.

6. Managing Risk

Understanding risk is a critical concept in Asset Management and is a key function and area of competence. Its focus is on being able to assess the risk of action or inaction on the performance of assets in the context of the organisation's corporate objectives.

7. Managing Asset Information

Collecting and collating the right information to inform Asset Management decisions is crucial to achieving Asset Management success. Too much data confuses the picture and costs money to collect. Too little data results in decisions made in the dark (or at best the twilight). Ensuring that the right people have the right information to make the best decisions is key.

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