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INDUSTRIAL AND LABOUR ECONOMICS

M.B.A (HRM) First Year

Semester – II, Paper-III

Director, I/c

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FOREWORD

Since its establishment in 1976, Acharya Nagarjuna University has been forging ahead in the path of progress and dynamism, offering a variety of courses and research contributions. I am extremely happy that by gaining 'A⁺' grade from the NAAC in the year2024, Acharya Nagarjuna University is offering educational opportunities at the UG, PG levels apart from research degrees to students from over221 affiliated colleges spread over the two districts of Guntur and Prakasam.

The University has also started the Centre for Distance Education in 2003-04 with the aim of taking higher education to the doorstep of all the sectors of the society. The centre will be a great help to those who cannot join in colleges, those who cannot afford the exorbitant fees as regular students, and even to housewives desirous of pursuing higher studies. Acharya Nagarjuna University has started offering B.Sc., B.A., B.B.A., and B.Com courses at the Degree level and M.A., M.Com., M.Sc., M.B.A., and L.L.M., courses at the PG level from the academic year 2003-2004 onwards.

To facilitate easier understanding by students studying through the distance mode, these self-instruction materials have been prepared by eminent and experienced teachers. The lessons have been drafted with great care and expertise in the stipulated time by these teachers. Constructive ideas and scholarly suggestions are welcome from students and teachers involved respectively. Such ideas will be incorporated for the greater efficacy of this distance mode of education. For clarification of doubts and feedback, weekly classes and contact classes will be arranged at the UG and PG levels respectively.

It is my aim that students getting higher education through the Centre for Distance Education should improve their qualification, have better employment opportunities and in turn be part of country's progress. It is my fond desire that in the years to come, the Centre for Distance Education will go from strength to strength in the form of new courses and by catering to larger number of people. My congratulations to all the Directors, Academic Coordinators, Editors and Lesson-writers of the Centre who have helped in these endeavors.

Prof .K. Gangadhara Rao
M.Tech., Ph.D.,
Vice-Chancellor I/c
Acharya Nagarjuna University

203HR26: INDUSTRIAL & LABOUR ECONOMICS

UNIT – I

Labour Economics: Nature, Scope; Industrialisation; Industrial Revolution; Labour Problems in Developing Economy; Concept of Labour Force; Structure of Indian labour Force and participation; Labour Market; Supply and Demand.

UNIT- II

Economic Systems: Capitalism, Socialism; Communism; Mixed Economy; Employment: Theories of Employment: Full Employment; Technology and Employment.

UNIT III

Location of Industry: Factors and Theories on Location: State Policy on Location of Industries in India. Factors Determining the size of a firm and Industry: Concept of Optimum firm: New Economic Policy (NEP): and Globalization.

UNIT- IV

Managerial Economics: Concept and Principles of managerial Economics; Business Cycles; Banks and Financial Institutions; Main Features of International Trade; Foreign Exchange; Role of Government in Economic Management.

UNIT- V

Managerial Decision Making: Analysing Market Demand; Business and Economic Forecasting; Theory of Production; Theory of Costs; Pricing Policies and Practices; profits and Profitability Analysis.

PRESCRIBED BOOKS:

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LESSON-1

INDUSTRIALIZATION

Objectives

To Discuss the meaning and definition of industrialization

To Describe the determinants of industrialization

To Explain the role of industrialization

To Examine the importance of industrialization in the Indian economy

Structure

1.1 Introduction

Industrialization has come to be regarded as synonymous with economic growth and development. No country desirous of rapid economic progress can afford to neglect industrialization. Industrialization is the process of manufacturing consumer goods and capital goods and of creating social overhead capital in order to provide goods and services to both individual and business. Industrialization plays an important role in the economic development of a country. In fact, an industrially developed economy is also economically prosperous. Thus, development of country originates from industrial development.

Industrialization is important for overall growth. It can help the progress of agriculture, trade, transport and all other economic activities. Industrialization makes the best use of our human and physical resources. All types of goods for all types of people can be produced in large, medium and small industries. Industrialization provides a sound basis for continuous and rapid increase in income and productivity. Industrial sector generates tremendous employment opportunities for the people, because the increase in income results in increase in aggregate demand and this means more production and more employment. It leads higher saving and investment and capital formation thereby creating solid foundation for self-sustaining development. Industrial sector holds the key for rapid growth of an economy. These industries are either manufacture or service oriented, and provide employment opportunities. A number of public and private companies operate in an industry, which may manufacture the same goods or provide the same services, but follow different strategies and guidelines to operate their businesses.

Industrialization is a process by which an economy is transformed from primarily agricultural to one based on manufacturing goods. Industrialization is a process that happens in countries when they start to use machines to work that was once done by people industrialization changes the things people do. It is a part of a process where people adopt easier and cheaper ways to make things. Using better technology, it becomes possible to produce more goods in a short time. In thisunit, you will learn all the facets of industrialization including the meaning, objective, characteristics, speed and role of industrialization

1.2 Meaning Of Industrialization

The term 'industrialization' has been derived from the word 'industry' which means to manufacture or to produce some things. As human beings cannot produce anything, he can increase the utility of the products; therefore, the term industry means to increase the utility or to create utility.

According to Professor Sargent Florence- 'Industry refers as in common usage to manufacturing sector and excludes agriculture, mining and most services, but may include building and public utilities.'

The world industrialization is generally used in two senses—a narrow sense and a wider sense. In the narrow sense, industrialization refers to establishment and development of basic and manufacturing industries. Its main objective is to increase the general living standard by increasing efficiency and capacity of factors of production. On the other hand, in the larger perspective, under industrialization, not only basic and manufacturing industries are established but through this medium the changes in the entire economic structure of the country is carried out. The main objective of industrialization is to equally develop the overall factors of development of the economy. In brief, it is said that industrialization is a multi-fold and wider economic process. Industrialization is a process by which an economy is transformed from primarily agricultural to one based on manufacturing goods. Individual manual labour is often replaced by mechanised mass production and craftsmen are replaced by assembly lines. Industrialization includes economic growth, more efficient division of labour and the use of technological innovation to solve problems as opposed to dependency on conditions outside human control. Some prominent definitions of industrialization are as under:

According to Pei-Kang-Chang: 'Industrialization is a process in which changes of series of strategical production functions are taking place. It involves those basic changes that accompanythe mechanisation of an enterprise, the building of new industry, the opening of new market and the exploitation of a new territory. This is in a way the process of deepening as well as widening of capital.'

According to Henry Johnson: 'Industrialization involves the organization of production in business enterprises, characterised is based on the application of technology and on mechanical and electrical power to supplement and replace human effort and motivated by the objective of minimising cost per unit and maximising returns to the enterprise.'

According to Paul M. Sweegee: 'During a process of Industrialization all of what we commonly call the basic industries appear as new industry, and their establishment absorb newly accumulated capital without adding correspondingly to the output of consumption goods.'

According to Eugene Staley: 'Industrialization and high productivity are parts of an inter-linked process, does not proceed very without the other.'

In short, the idea of broader process of economic development is in industrialization. On the basis of above definitions, it can be said that industrialization involve those basic changes that accompany the mechanisation of an enterprise the building of new machinery, the opening of new market and exploitation of a new territory. This is a way and a process of deepening as well as widening capital. Thus, economic and industrial development of country is carried out widely under industrialization. Along with the development of manufacturing industries, the development of agriculture, transportation and mechanisation also take place.

1.3 Objectives of industrialization

The following are the objectives of industrialization:

1. Promote economic efficiency and growth
2. Bring about a structural shift in the economy in favour of industry
3. Promote balanced regional development
4. Promote the inter and intra-sectoral linkage
5. Create a sound base for the transfer adaptation and development of technology
6. Develop and achieve international competitiveness in areas of clear comparative advantages in industrial exports.
7. Generate employment opportunity.
8. Develop domestic technological capability for the production of intermediate inputs, outputs and capital goods.

1.4 Characteristics of Industrialization

On the basis of above definitions of industrialization, the main characteristics of industrialization can be outlined as follows:

1. Transfer of sources of production: The factors of production transfer resources from primarysector (agriculture sector) to manufacturing industries and to services in tertiary sector as a result of industrialization.

2. Deepening and widening use of capital: Industrialization make extensive use ofcapital. Industrialization is a process of deepening and making extensive use of capital. It reduces per unit cost of production and increases the profit potentiality of enterprises. As a result, per capita income increases and this encourages saving and capital formation, further opening new areas for industrialization.

3. Development of new process: In the process of industrialization number of new process take place, like mechanisation, automation, scientific management, rationalisation, development of new product and new market.

4. Social changes: Industrialization sets out a new pattern in the society by enabling it to adopt modern and dynamic approach instead of traditional one. It develops the standard of education and reduces various constraints of society.

5. Economic development of the country: Industrialization creates equal development of all the sectors in the country which expedites the pace of economic progress of the country.

1.5 Form or Pattern of Industrialization

There is no definite pattern of industrialization because it is affected by socio- economic conditions, policies, shortage/excess of labour, capital, infrastructure and technical development of the country. That is why many forms or patterns of industrialization are found according to the conditions prevailing in different countries. Following are the main forms or patterns of industrialization:

I. Pattern according to Control: Followingare the patterns of industrialization according to control-

- Industries working under government control
- Industries working under private sector control
- Industries working under the control of big industrial house
- Private industries working under the control of government regulations
- Industries providing self-employment opportunities

II.Pattern according to Trend of Growth: Following are the patterns of industrialization according to trends of growth-

- **Forward Industrialization**: Under this pattern of industrialization, industries of a country continuously keep on making progress and the rate of growth also increase regularly.
- **Backward Industrialization**: Under this pattern of industrialization, industries continuously keep on declining and the rate of growth also decreases.

III. Patterns According to Ownership of Capital: Following are the patterns of industrialization according to ownership of capital-

- **State Initiated Pattern:** If the state takes initiative in the establishment of industries; such pattern is known as 'State Initiated Pattern'. This pattern of industrialization is often found in Russia, China and other socialist countries. Such industries are also termed as industries of public sector.
- **Private Initiated Pattern:** If initiative is taken by private industrialists in the establishment of industries, such pattern of industrialization is known as 'Private Initiated Pattern'. This kind of group of industries is also termed as industries of private sector. This form of industrialization is mostly found in capitalist countries such America, Germany, Japan.
- **Jointly Initiated Pattern:** When industries are established by joint initiatives of Government and Private Sector both, such pattern is known as Jointly Initiated Pattern. This kind of group of industries is also termed as joint sector industries. This form of industrialization is often found in countries having mixed economy such as India, British.

IV. Pattern according to Location: Following are the pattern of industrialization according to location:

- **Centralised Industrialization**: When the establishment and development of a industry is based on some particular location, such industrialization is known as *Centralised Industrialization*. Prior to independence this form of industrialization was found in India. In Centralised Industrialization some places are industriallydeveloped while other are highly backward leading to unbalanced industrialization.
- **Decentralised Industrialization**: When the establishment and development of industryis not on some particular location, but industries are located in entire areas in a balanced manner such industrialization is known as *Decentralised Industrialization.*
- *Pattern according to Size: Following are the pattern of industrialization according to size-*
- Large –scale industries: Large-scale industries are the exact opposite of small-scale

industries. Here the capital invested is large and advanced technology is in use here. Example, Automobiles and Heavy Machinery.

- Small-scale industries: Small scale Industries are those industries which operate mainly with hired labour and are concentrated in urban areas.
- Medium sized industries: The enterprises, where the investment in plant and machinery is more than five crore rupees but does not exceed ten crore rupees are known medium enterprises.
- Micro industries: An enterprise, where the investment in plant and machinery does not exceed twenty-five lakh rupees is known as micro enterprise.
- The integrated form of large, small, medium and micro industries is the base of industrialization in India.
- Pattern according to Intensity- Following are the pattern of industrialization according to Intensity-
- Capital Intensive Industrialization: When priority is given to such industries in which comparatively more capital is invested; such form of industrialization is known as Capital Intensive Industrialization.
- Labour Intensive Industrialization: When priority is given to such industries in which more labour is required, such form of industrialization is known as Labour Intensive Industrialization.
- Pattern according to Rate of Growth- Following are the pattern of industrialization according to rate of growth-
- Revolutionary Industrialization: When industrialization of anycountry takes place at a greater speed and enough changes appear in its old industrial economy, such industrialization is known as Revolutionary Industrialization. This kind of industrialization has been followed in England, Russia and China.
- Developmental Industrialization: When industrial economy is not completely abandoned at once but changes are made gradually and industries are developed in modern fashion at its own speed, such industrialization is known as Developmental Industrialization. This kind of industrialization has been followed in India.
- Pattern according to Output: Following are the pattern of industrialization according to output-
- Consumers' goods industries: These industries produce goods for consumer consumption such as tea, coffee, clothes sugar, jute etc.
- Capital goods industries-These industries produce capital goods. These goods are used for further production. Iron & steel equipment, cement, heavy chemical, etc.

1.6 Determinants of Industrialization Growth

There are two kinds of determinants of industrial growth-

(I) Economic Factors and (II) Non-economic Factors.

These factors are described as follows-

(I) Economic Factors: Following are the economic factors of industrial growth-

i. **Natural Resources**: The economic prosperity of any country depends upon the availability of its abundant natural resources and their suitable exploitation. The production of an economydepends upon its resources quality and quantity of soil, minerals, climate, geographical situation, forest resources, rivers, sea-shore and power resources. The possibilities of industrial growth are more if a country is rich in natural resources. In this regard Professor Lewis said, 'Industrial growth and natural resources are dependent each other. If other things remaining same, the men can make good use of rich resources as compare to poor resources. This is the reason why we expect high rate of industrial growth from such country which have plenty of natural resources with them.'

ii. **Capital Formation:** Capital is required for industrialization, modernization of agriculture and development of means of transportation. The increase in the rate of capital formation helps in industrial growth. Capital formation is the main basis of modern industrial growth. According to Planning Commission- 'The economic development of any country depends upon the availability of capital.'

iii. Human Resources: Growing population is an important factor of industrial growth. Workers are needed to work in factories/industries. As business expands, more workers are needed. The growing population also provided an opportunity for business to sell their product to more people. Man is the means and ends of economic activities. Due to increase in population, there is increase in supply of one of the factors of production, i.e. labour. The credit of converting available idle natural resources of the country into wealth producing activities goes to labour itself. Increase in population includes growth of supply for increasing demand of goods and services. Likewise increase in population proves to be beneficial for industrial growth because more population =needed goods= growth of industries.

iv. **Market:** In a perfect dynamic state, the various factors of production are dynamically oriented from one industry to another industry so long as the marginal productivity does not become equal in the entire industry. In underdeveloped countries due to lack of knowledge of the market, many workers do not go to that industry where their productivity is high even when their marginal productivityis zero. This also applies in case of capital market.

v. **Invention and technological development**: New invention and improved technology helps bring about industrialization. Through innovation and technological development, the knowledge of new and modern methods is obtained. Thus, technological factors include degree of mechanisation, technical know-how, product design etc. New inventions make it easier to make products and also help produce goods more efficiently. Technological development plays an important part to influence the industrial productivity. 'The application of motive power and mechanical improvements to the process of production has accelerated the pace of industrialization to an unprecedented degree and has given us the vision of the vast and unexplored frontiers that still lie ahead of us in the realm of applied science and technology.'

Innovation and pragmatic progress are the indicators of industrial growth because the quantity of production increases and cost reduces through it. With the use of innovative techniques in the area of agriculture and industries, production can be increased in substantial quantity.

vi. **Structure of Economic Organization**: Strong economic organizational structure is highly essential for industrial growth. Only with the help of economic organization, the land can be made suitable for agriculture, available resources can be used economically and efficiently and new industries can be established. In this way with the help of suitable economic organizational structure, industrial growth of a country can be chartered successfully.

vii. **Improved Transportation:** Improved transportation helps to bring out industrialization. There needs to be a good transportation system to be able to get the products to the consumers. Roads, canals, railroads and ships are various ways to transport products.

viii. **Capital Output Ration:** Capital output ratio reflects the number of units of capital which would be needed to produce one unit of production. It also makes certain efforts to find out the rate of increase in production as a result of investing the available amount of capital. If capital output ratio is more, then the rate of industrial growth of that country will also be more.

(II) **Non-economic Factors:** Industrialization is not only a technical and economic process but is also related to socio-cultural activities and political factors. According to Nurkse, 'Economic development has much to do with human endowment, social attitudes political conditions and historical accidents.' Following are the non-economic factors of industrial growth-i. Political Stability: According to professor W.A. Lewis, 'The behaviour of Government plays an important role in encouraging or discouraging economic activities.' Without government efforts, no economy can achieve industrial progress. If peace and security arrangements are found in the country, it means that the government is stable and the public have confidence in it, accordinglyindustrial growth will be at faster rate. Uncertain and unstable political environment and weak administrative structure creates obstacle in the growth of industries.

ii. **International Condition**: International conditions also affect industrial growth to some extent. If relations are good with neighbouring countries, then there are adequate possibilities of export and international co-operation is there, the industrial growth will be at a faster speed and vice versa.

iii. **Religious Considerations:** Religious considerations also have their effect on economic industrial growth. Professor W.A. Lewis has written that it depends upon the country either to restrict is industrial progress by adopting traditional religious considerations or to speed up the industrial growth by adopting modern methods. Religious considerations are proving to be great barriers in the industrial growth in India.

iv. **Social Changes:** Social environment has a decisive effect on industrial growth. Society's desires of progress rapidness towards growth and anxiousness to use new method, etc. are included in social environment. The main reasons of this under developed countries are the social institutions because there is lack of courage in the public of such countries. In this regard Professor Richard T. Gill has written that industrial growth is neither a mechanical process nor it is a general problem of linking different resources. Afterwards it is a human entrepreneurship and like all human entrepreneurship's result finally depend upon the ability quality and attitude of the people who take this venture in their hands.

III**. Other factors**: Following are the other factors which affected the growth of industries-

i. **Quality of human resource:** Manpower plays a significant role in rising industrial productivity in most industries. If labour force is not adequately qualified and is not properly motivated, all the steps taken to increase production and productivity will have no result the employees' performance and attitudes have and immense effect on industrial growth. Three important factors which influence productivity of labour are ability of workers, wiliness of workers and the environment under which he has to work.

ii. **Government Policy:** The industrial policy of the Government is also an important factor of industrial growth. If the government frame and implement such policies which create favourable conditions for saving, investment, flow of capital from one industrial sector to another and conservation of national resources, give protection and incentives to certain industries then it motivates industrial growth and vice versa.

iii. Availability of Finance: The industrial growth will remain a mere dream if adequate financial resources are not available to introduce technical improvement and give appropriate training to the workers.

1.7 Speed Of Industrialization

Like the pattern of industrialization, the speed of industrialization is also found to be dissimilar in different countries. The exact measurement of the speed of the industrialization is not possible because following are the main factors affecting the speed of industrialization:

i. **Nature of Industrialization:** If the industrialization is followed through manufacturing consumer goods, then the speed of the industry will be low. But speed of industrialization will be higheri fit followed through manufacturing capital goods industries.

ii. **Level of Technological Development**: If any country adopts low level of technological development in its initial stage of industrialization, then the speed of industrialization is often slow and vice versa.

iii. **Government Policy**: If the policy of government shows adequate interest in country's industrialization, the speed of industrialization would be higher and vice versa. Government's price policy, trade policy and tax policy can encourage the industrialization. After 1991 policyof economic liberalisation create favourable environment for the development and establishment of industries in India.

iv. **Change in Social Conditions**: If the social conditions of the country change in hand in glove with the industrialization, they the speed of industrialization will increases otherwise it decreases.

v. **Population**: If the population is less in comparison to economic and natural resources, the speed of industrialization will be faster in that country. If the population growth and density of population is high in the country, the speed of industrialization will be low.

vi. **Ability and Efficiency of Human Resources:** The speed of industrialization in any country depends upon the ability and efficiency of available human resources of that country. If the human resources of the country are able, efficient and disciplined, then they will give their full productive co-operation in industrialization and the speed of industrialization will be higher and vice versa.

1.14 Causes for Slow Progress of Industrialization in India

The speed of Industrialization in India is very slow due to following reasons**:**

1. During the colonization period, industrial policy which was followed by the British rulers was in the interest of the rulers and against the country. This, is why India remained an agricultural economy during 200 years of British rule. This is what restricted the industrial development of the country even in the early years of independence.
2. Unlike in other countries, industrialization in India was began at low level of technological development whereas this should have begun at a higher level of technological development**.**
3. Industrialization as a policy was not given a detailed and clear-cut planning strategy as it should

have been given, this resulted in government continuing to show indifference towards the development of some industries.

4. The density of population is very high and rate of growth of population is also high which posed a problem to reap the benefits of industrialization.
5. One of the top reasons which industrialization suffered in the country was due to poor rate of capital formation.
6. The root of industrial development in India was totally dependent on the performance of the agricultural sector. Thus, any lag or retardation in the performance of the agricultural sector resulting from natural factors reflected as industrial stagnation in the country.

   This is because raw material for other industries is sourced from agricultural sector. Additionally, a demand for raw materials also indicates a demand for more industrial goods. Thus, this poor performance of the agriculture retards the development of industries in India.
7. There is shortage of capital resources in India. Foreign capital-technical co-operation is also not available in adequate quantity and quality.
8. Infrastructural facilities in India are still backward and lacking which becomes a barrier in the way of industrialization. This is a big problem since industrial development will still be lacking in areas with potential merely due to infrastructural barriers like absence of proper transportation and connectivity in terms of railways or roadways and communication mediums.
9. Industrial development also requires the labour of technical and efficient personnel and this is an area of problem in our country. The technological improvements require trained and skilled staff to handle mechanized tools and systems in the industries today. Apart from skills, it is also important that the labour is hardworking and sincere so as to ensure that wastage of human resourcesis minimized. There is still very high requirementof initiatives and schemes in favour of labours to ensure their mobility and well-being as well as to ensure that industrialization remains on a growing trajectory.
10. It can be observed from the recent times, that there has been a strong tendency to produce luxury goods in the economy as opposed to more necessary goods especially among the large industrial houses. This can be seen from the rise in the production of 'white goods' like refrigerators, washing machines, air conditioners etc. which has significantly risen in recent times. Similarly, on the other end of the spectrum, there has been observed a declining trend in the production of commodities for mass consumption. This has resulted in a distortion of the output structure of several products.
11. In our country like in many other countries, there has been observed a growing tendency of the economic power becoming concentrated towards a certain section of the society and industries. This uneven industrialization is not beneficial in the pathway of achieving a sustainable and equitable development.
12. The growth in the industrial sector in our country has suffered a great deal due to the poor performance on the part of public sector enterprises who have failed to produce good results even during the initial plan period when they were given more priority. Huge budgetary allocations and minimal results are becoming a growth burden on the economy.
13. Even though industrialization in India has gained momentum through the production of consumer goods, it is important that for speedy development of industries there is focus on capital goods manufacturing companies.
14. Industrial development in our country has been concentrated in certain few states in our country. For example, regions like Gujarat and Maharashtra have received more infrastructural support in comparision to other poorer states with developmental prospects. Even though, there have been efforts to establish public sector industries in certain backward

states like Odisha, Bihar and MP but the desired results have not been seen in these cases. Additionally, the fiscal incentives that have been planned remain helpful to backward areas of developed states rather than developing states which has created an uneven industrialization in different states of our country.

15. Another peculiar problem faced by industrial sector of the country is its growing sickness due to bad and inefficient management.
16. Some of the factors which are becoming barriers in the path of industrialization are the problems of the regulatory mechanism and the regional state control. The government is trying to fill these gaps in the private and public sector through certain regulatory measures.
17. To sum up, the progress of industrialization has not been generated sufficient growth potential either in terms of contribution of output or in terms of employment; and what is really serious is that the rate of growth of industrialization has been declining with everydecade. The question of choice of technique has, therefore to be examined a new with reference to employment

1.15 Role Of Industrialization In Economic Development

Industrialization plays a vital role in the economic development of underdeveloped countries. As the historical record shows, the developed countries of the world broke the vicious cycle of poverty by industrialising, rather than focusing on agricultural of the production of national resources. Industry plays a complex role in economic development. Prime Minister Pt. J.L..Nehru had said in regard to the importance of industrialization that, ‘Any god which is prayed by all countries is that industrialization, that is machine and that is huge production and best use of natural resources.’ The role of industrialization can be studied under the following heads:

Increase in National Income: Industrialization provide a sound basis for continuous and rapid increase in income and productivity. Productivity in industrial sector is generally higher due to the possibility of use of advance techniques and possibility of specialization and labour division. Industrialization allows countries to make optimal use of their scarce resources. It increases the quantity and quality of goods manufactured in that company which make larger contribution to gross national products. Thus, industrialization results in the increase of total per capita income. It is a fact that industrially developed economy have much higher per capita income than industrially less developed economy.

Meeting ever increasing demand: As per capita income increases the demand for foods does not increase as much as demand for industrial goods. Demand for industrial products can be met by increasing industrial production. Thus, industrialization provide goods and thereby overcomes the bottleneck which may arise otherwise

Standard of living: Worker’s labour is one of the chief factors in an industrialized society. Therefore, with an increase in productivity, the worker’s income increases and so does the standard of living.

Economic Stability: If a nation considers primary sector as its backbone for economic growth, then it faces a lot of problems. It can never achieve a fast economic growth simplybecause the demand in this sector is fluctuating, the nature and related factors at times restrict growth and economic progress. This cumulatively leads to an unstable economy. This is why it is important that industrialization is used to provide economic stability.

Improvement in Balance of Payments: The pattern of foreign trade is greatly affected by industrialization. There is an increase in the demand for export of manufactured goods. Additionally, since the raw material produced as processed in home industries, there is a saving in terms of foreign exchange. The export-orientation and import-substitution effects of industrialization help to improve the balance of payments

1.10 Summary

- Industrialization is a pre requisite for economic development as the history of advanced countries shows for development the share of the industrial sector should be increased.
- No country desirous of rapid economic progress can afford neglect industrialization. It can help in trade, agriculture, production, transport and other economic activities. Industrialization is the key to economic development. All the advanced country in the world are industrialised. It makes the best possible use of our human and physical resources.
- Industrialization plays an important role in the economic development of a country. In fact that industrially developed economy is also economically prosperous. Thus, development of country originates from industrial development.
- Industrialization is an important for overall growth of the country. It provides a sound basis for continuous and rapid increase in income and productivity.
- Industrial sector generates tremendous employment opportunities for the people. Because of increase in income result in increase in aggregate demand and this means more production and more employment.
- Due to industrialization public welfare increases. It leads higher saving and investment and capital formation thereby creating solid foundation for self sustaining development.
- Industrial sector holds the key for rapid growth of an economy.

Industrialization provides a good platform for agriculture.

1.11 Key words

- Industrialization: It is the process of manufacturing consumer goods and capital goods and of creating social overhead capital in order to provide goods and services to both individual and business.
- Revolutionary Industrialization: It refers to an industrialization where industrialization of any country takes place at a greater speed and enough changes appear in its old industrial economy
- Developmental industrialization: It refers to an industrialization where the industrial economy is not completely abandoned at once but changes are made gradually and industries are developed in modern fashion at its own speed
- Capital output ratio: It reflects the number of units of capital which would be needed to produce one unit of production

1.12 Self Assessment Questions

1. Describe the determinants of industrialization.
2. What are the various forms or pattern of industrialization?
3. Explain the main problems on industrialization in India as under developing

country.

4. Discuss the factors upon which the speed of industrialization depends. What are the reasons on account of which the speed of industrialization in India is slow?

5. Examine the importance of Industrialization.

6.Industrial development in India is largely dependent on her agricultural development.' Comment.

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LESSON -2

LABOR FORCE

Objectives

To Discuss the Characteristics of Labor Market

To Understand the Demand for labor

To Know the Causes of shifts in Labor Demand force

To Identify the factors affecting demand of labor

Structure

2.1. Introduction

Labour economics is the study of the workings and outcome of the market for labour. It is mainly concerned with the behaviour of employers and employees in response to wages, prices, profits working conditions. Labour economics is the study of

a) The relationship between wages and employment opportunities.

b) The interaction among wages, income and decision to work.

c) The way wages, prices and profits affect occupational choices.

d) Incentives for and effects of educational and training investments.

e) The effect of unions on wages, productivity and turnover.

f) The effect of social policies (minimum wages, labour legislations and safety and health regulations) on wage and employment.

2.2. Labour Market

Labour market is the place where employer and employees interact with each other. It is also called market where employees compete to hire the best and employees compete for the best satisfying job. A Labour market in an economy functions with the demand and supply of labour. When the demand and supply of labour in a market is equal, the labour market will be in equilibrium. The labour is one of the most important factor of production. The labour services can't be saparated from the labour, therefore the condition under which such services are rented, also plays an important role in the wage determination.

2.3. Labour Market in India

The Indian labour market is characterized by the predominance of informal employment as majority of the labour force work as casual worker and self-employed. In informal market more than 80 percent of India's workforce work as casual and self-employed. The agriculture sector one of the major employment providers which employs more than 40 percent of the labour force and contributes 17-18 percent of Gross Value Added (GVA) of the economy labour economics, labour is considered to be human resource, labour economics seeks for the optimal utilization of human resource.

Labour Problems

Labour economics identifiy, classify, and analyse problems of labourers, it also gives appropriate solutions to these labour problems. These labour problems bring obstacles in the smooth working of an organization. Elimination of these obstacles is necessary from the point of view of efficient utilization of human resources.

Utilization, Application and Conservation of Human Resources

Being a source of production, labour is inseparable from production. Since, labour is also scarce like other factors of production. Therefore, it should be efficiently used. Before putting the labour to work, it has to be seen that whether we are making best use of his capacities, and talents or not. e.g., If a worker is available to work. He can either be in an agricultural field or in a firm, but if he is skilled enough to work in the firm, his services should be utilized there. Also, because the labour is available, it cannot be exploited. Labour is a scarce factor therefore it should be used in best possible manner.

Efficient and Effective Utilization

Efficient and effective utilization of human resource has always been an important objective of policy makers of developing nations. Whereas efficient utilization is related to selecting the best option of utilization, effective utilization has a reference to productivity. Situation of disguised unemployment where the workers actually doesn't make any contribution to the output counteract the concept of effective utilization.

Labour Market

In a free market economy the task of allocation of resources is assigned to the market forces. Under labour economics, we study the nature, efficiency, mode of functioning and imperfections in labour market for the efficient and best utilization of labour.

Human Welfare

Human welfare is an important facet taken under the preview of labour economics. It is human aspect in combination with technological development that can make the economies grow and progress at a faster pace. Healthy, active, talented and skilled manpower is always an asset to a country.

2.4 Characteristics of Labour Markets in Developing Economies

Recognition of labour as a factor of production and its tradability necessitates the notion of labour market. The orthodox approach perceives labour market as one amenable to be operated under supply-demand mechanism. The labour market is a place where workers and employers are brought into contract and wages and working conditions are decided. Therefore, it is a mechanism by which labour power is combines to production processes. The labour market is quite different from other markets, for its unique feature of factor traded in the market. However, the modern labour economics is indeed refinement of traditional competitive model by taking into consideration of existence of imperfections, rigidities and cost associated with labour mobility, trade unions organisations, uncertainties and imperfect information etc. In this backdrop the features of labour markets in developing countries are following:

a) Agricultural labourers live on the margin of existence:

The agricultural labour force is continuously increasing with the increase in the size of labour force in India, whereas the percentage contribution of agriculture to GDP (Gross Domestic Product) has been declined drastically over the period.

a) Low wage rate in agricultural labour market:

The agricultural wage in rural labour market is very low and the there is seen very little increase in agricultural real wages over the period.

b) Gender discrimination and child labour:

The Indian labour market is characterised by wage differential and gender discrimination. The wage for female labourers in rural areas across all over country is less than male labourers. According to Rural Labour Inquiry Report on Wages and Earnings of Rural Labour Households (1999-2000), the Male labour force is paid about 30 per cent more than the female labour force.

Moreover, the incidence of child labour is high in rural labour market and most exploited segment in Indian labour market.

c) **Migratory character of industrial labour market:**

The increase in population is one of the main problems in developing countries. The population pressure on land has increased the supply of labour which leads to disguised and open unemployment in the rural economy. The disguised and open unemployment is one of the main reasons behind low wage rate in rural areas. The higher wage and work opportunities in urban areas attract rural unemployed labour force. In the peak agricultural season, the rural labour force migrates back to their villages and return back to urban labour market after the season is over.

d) **Dualism and segmentation in Indian labour market:**

The labour market of developing countries like India has dualistic character. The dualism in labour market refers to

e) **Heterogeneity of Workers and Jobs:**

Though a labour is termed a single factor of production, but nay two unit of labour are not uniform in terms of creativity and productivity. The labour units are differed by age, race, gender, education, experience, training, skills and motivation etc. These factors make labour heterogeneous.

f) **Imperfect Information:**

Labour market information pertaining to nature and quality of the available workforce plays a crucial role in accomplishing the search results. There is lack of perfect information related to wages, working conditions and labour laws among workers. However, from the employers' side, it is difficult to know about the reliability and productivity of worker unit until it is turned out.

g) **Hypothetical Equilibrium**

The models of labour market analysis assume that there is perfect information in the market and buying and selling of labour force take place the in market equilibrium. However, there is existence of imperfect information in market due to which buying and selling of labour market takes place even in absence of market equilibrium.

- **Developing Economies:** A developing country, also called an emerging or transitional economy, is a nation with an underdeveloped industrial base, and low Human Development Index (HDI) relative to other countries and poor quality of governance.

2.5 Demand for Labour

Demand for labour is a concept that describes the amount of demand for labour that an economy or firm is willing to employ at a given point in time. The demand may not necessarily be in long – run equilibrium, and is determined by the real wage, firms are willing to pay for this labour, and the amount of labour workers are willing to supply at that wage. Demand for labour increases market wages and more workers enter the market. But this higher cost of labour will mean that employers will use less labour because it's more expensive.

Assuming there are many employers in a region, or that workers are highly mobile geographically, the wager that a company will pay to workers, is dependent on the competitive market wage for a given skill set. This means that any company is a wage taker, which is simply another way of saying companies must pay competitive wages in order to obtain workers.

2.6 Labour as a Derived Demand

Labour is only demanded as an input into the production process. In factor market, demand for labour is made by the producers or entrepreneurs. Demand for labour is a derived demand because demand for labour depends upon the demand for those goods and services which they produce. When the economy is expanding, we expect to see a rise in the aggregate demand for labour providing that the rise in output is greater than the increase in labour productivity. In contrast when the economy faces recession, or a slowdown, the aggregate demand for labour will decrease because business look to cut their operations costs and scale back on production.

The demand curve for labour is downward sloping. As shown in the figure 3.1. in the figure number of labourers is shown on OX – axis and wages on OY – axis. DD is the demand curve of labourers. It slopes downward, signifying that more labourers are demanded at low wages and less on wages.

Shift in Labour Demand Curve

The number of people employed at each wage rate are liable to change when there is a change in the conditions of demand in the job markets. Some of the reasons responsible for the shift in demand for labour curve are:

1. A change in demand for a product which means that a business needs to take on fewer work.
2. A change in the productivity of labour.
3. A change in the level of national insurance contributions made by employers or other costs of employing people such as health and safety legislations and training levies.
4. A change in cost and productivity of machinery and technology which might be able to produce and provide a good or service in place of the labour input.

Demand for Labour and Market Wage Rate

There is an inverse relationship between demand for labour and the wage rate. At the higher wage rates the demand for labour will be less than at lower wage rate. If the wages are high it will be more costly to hire extra employees. The demand for labour is highly dependent on the productivity of the worker. Firms always aim at maximization of their profits; they will use the factor of production function that does the job efficiently as possible and also minimise the cost of production. The marginal productivity theory, one of the oldest theory of wages which explains the relation between demand for labour and market wage rate.

2.7 Marginal Productivity Theory of wages

Marginal productivity theory of wages explains that under perfect competition a worker's wage is equal to marginal as well as average revenue productivity.

In other words, marginal revenue productivity and average revenue productivity of a worker determine his wages. According to this theory wage of a labourer is determined by his marginal productivity. In other words, MRP = M. W. Marginal productivity is the addition made to total productivity by employing one more unit of a labourer. As the labourers are given a money wage their marginal productivity is calculated in terms of money.

This is called marginal revenue productivity (MRP). MRP is the addition made to the total revenue by employing one more unit of a worker. A producer will maximise his profit when the wages of a labour is equal to the marginal revenue product. If MW is greater than MRP (MW>MRP) wage is greater than the marginal revenue product, the producer will sustain loss. If MW for labour is higher than its marginal revenue product then the employers get loss and pay more. Thus, he loses.

On the other hand, if the producer pays a wage less than MRP (MW<MRP), he will gain. But this again will be maximized. Thus, he will gain by employing workers so long as when MW = MRP. Thus, the wage of a labourer will be determined where MRP = M. W.

Assumptions:

1. Perfect competition prevails in both product and factor market.
2. Law of diminishing marginal returns operates on the marginal productivity of labour.
3. Labour is homogeneous.
4. Full employment prevails.
5. The theory is based on long run.
6. Modes of production are constant.

Supposing producer employs 3 labourers with other factors of production. He gets Rs. 200 as total revenue i.e., income from the sale of output. If he employs an additional labour, his total revenue increase by Rs. 300. Thus, by employing one additional labourer he adds Rs. 200-100 = Rs. 100 to the total revenue, this increase in Rs. 100 is called MRP. Under perfect competition, workers get wages equal to his marginal revenue productivity.

If the labourers demand more than Rs. 100, the producer will employ lower number of workers since there new price exceeds their marginal productivity. When a smaller number of workers get higher wages, the unemployed labourers will bring down the wage to the equilibrium level. Ultimately wages will tend to equal marginal productivity of workers. In such a situation the producer thinks of employing more laborers to maximize his profit. This process will continue until wages become equal to the workers marginal productivity.

In the diagram numbers of workers are measured on OX – axis and wages and productivity on OY – axis. Under conditions of perfect competition average wage (AW) and marginal wage (MW) are equal (AW = MV) as shown by WW horizontal line which is parallel to OX – axis. ARP is the average revenue productivity and MRP/VMP is the marginal revenue and value of marginal productivity curve. At the equilibrium point E, marginal productivity is equal to marginal revenue or average wage i.e., MRP = MW (AW). At the equilibrium point E the term provides employment to ON number of labourers. In this situation, firm's MRP = MW = AW = ARP. If the firm employs less than ON number of labourers, then marginal revenue productivity (MRP)of the labourers will be more than the wages (MRP>MW

= AW) paid to them. This will encourage the firm to employ more labourers. on the contrary, if the firm employs more then ON number of labourers, then the marginal revenue productivity of these labourers will be less than the wages ($MRP < MW = AW$) paid to them. Thus, the firm will incur a loss. Under the circumstances the firm will have to provide less employment.

2.8 Causes of Shifts in Labour Demand Curve

The labour demand curve shows the value of the marginal product of labour as a function of labour hired. Using this fact, the following changes the labour demanded each wage:

I. **The Output Price**

When the output price rises, the labour demand curve shifts to the right – more labour is demanded at each wage. When the output price falls, less labour is demanded at each wage.

II. **Technological Change**

Technological change causes the MPL function to change, generally to increase each level of L. this shifts the labour demand curve to the right. For instance, between 1960 and 2000 the average hourly output produced by US workers rose by 140 percent. However, it is also possible for technological change to shift labour demand to the left. If for instance a cheap industrial robot is installed in the production process for some industrial good, the marginal product of labour could decrease because the robot can replace labour. Such a technological change is called labour saving. Most technological change seems to be labour – augmenting raises the marginal product of labour. This can explain the fact that employment has risen historically along with wages. Inflation – adjusted wages increased by 131 percent from 1960 – 2000 and firms also increased the amount of labour employed by 80 percent.

III. **Supply of Other Factors**

The quantity available of other factors of production can affect the marginal product of labour. For example, if the supply of ladders falls, the marginal product of apple pickers will decrease

2.9 Factors Affecting Demand for Labour

a) **The wage rate:** The higher the wage rate, the lower the lower the demand for labour. Hence the demand for labour curve slopes downwards. As in all markets, a downward slopping demand curve can be explained by reference to the income and substitution effect. At higher wages, firms look to substitute capital for labour, or cheaper labour for the relatively expensive labour. In addition, if firms carry on using the same quantity of labour, their labour costs will rise and the income (profits) will fall. For both reasons, demand for labour will fall as wages rise.

b) **The demand for the product:** The demand for labour is a derived demand, which means it is ultimately based on demand for the product that labour makes. If the consumer wants more of a particular good or service, firms will want the workers that make the product.

c) **Productivity of labour:** Productivity means output per worker, and if workers are more productive, they will be in greater demand. Productivity is influenced by skill levels, education and training, and the use of technology.

d) **Profitability of Firms:** If firms are profitable, they can afford to employ more workers. In contrast, falling profitability is likely to reduce the demand for labour.

e) **Substitutes:** The extent to which labour is indispensable also affects the demand. If substitutes, such as capital machinery become cheaper or more expensive, the demand curve for labour will shift to the left or right. For example, if the price of the new demand curve for labour will shift to the left or right. For example, if the price of new technology falls there may be a reduction in demand for labour.

f) **The number of buyers of labour:** The number of buyers in a market can influence total demand in a given market. A single buyer in a market is called monopolist, and these are relatively common in labour markets. For example, Landon Underground is the only firm in the UK to employ underground tube drivers. In general, when a labour market is dominated by one employer the demand for labour is less than if there are many employers. In addition, there is a tendency for the wage rate to be lower in such markets, which is one reason why trade unions form, and exert pressure for higher wages.

2.10 Elasticity of Labour Demand

Elasticity is a means of measuring responsiveness. If the price of a good change, how responsive is the change in quantity demanded? A relatively large change in quantity demanded (Qd) that demand is quite responsive, or elastic. A relatively small change in Qd indicates that demand is less responsive, or inelastic.

In the realm of labour economics, we are interested in how responsive an employer's demand for labour is to the price (wage). More specifically we look for the relative change in employment level for a relative change in wage:

% change in
employment/ Elasticity of Labour Demand =
% change in wage

Notice that because demand curve is downward – sloping, this calculation will be negative. If wages go up, employment will go down (all else constant) and if the wage goes down, employment will go up (all else constant).

The terms elastic and inelastic, as used above, have both technical and relative uses. The technical use depends on the absolute value of the elasticity calculation above.

If the absolute value of the elasticity of labour demand is > 1, that portion of the demand considered elastic.

If the absolute value of the elasticity of labour demand is <1, that portion of the demand curve considered inelastic.

If the absolute value of the elasticity of labour demand is =1, that portion of the demand curve is considered unit elastic.

In the above sense, we say that a demand is more elastic than something else if it is more responsive to price. We similarly might say that a particular demand is less elastic to (or more elastic) than another of it is less responsive to price.

2.11 Determinants of Elasticity of Demand

Some of the main determinants of elasticity of demand for labour are as follows:

I. The proportion of labour costs in the total costs: If labour costs from a large proportion of total costs, a change in wages would have a significant impact on costs and hence demand would be elastic.

II. The ease with which labour can be substituted by capital: If it is easy to replace workers with machines, demand would again be elastic.

III. The elasticity of demand for the product is produced: A rise in wages increase costs of production which, in turn, raise the price of the product. This causes demand for this product to contract and demand for labour to fall. The more elastic the demand for the product is, the greater the fall in the demand for it and hence for workers – making demand for labour elastic.

IV. The time period: Demand for labour is usually more elastic in the long run here is more time for firms to change their methods of production.

V. The qualifications and skill required: The more qualification and skills needed; the more inelastic supply will be. For instance, a large increase in the wage paid to brain surgeons will not have much effect on the supply of labour. This is especially true in the short run, as it will take years to gain the requisite qualifications and experience.

VI. The length of training period: A long period of training may put some people off the occupation. It will also mean that there will be a delay before those who are willing to take it up fully qualified to join the labour force. Both effects make the supply of labour inelastic.

VII. The level of employment: If most workers are employed already, the supply of labour to any particular occupation is likely to be inelastic. An employer may have to raise the wage rate quite significantly to attract more workers and encourage the workers employed in other occupations to switch jobs.

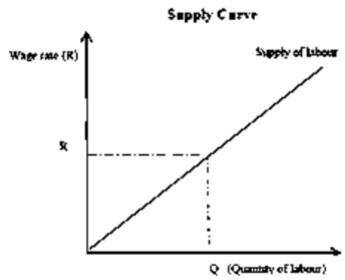
VIII. The mobility of Labour: the easier workers find it to change jobs or to move from one area to another. The easier it will be for an employer to recruit labour by raising the wage rate. Thus, higher mobility makes the supply elastic.

IX. The degree of vocation: the stronger the attachment of workers to their jobs, the more inelastic supply tends to be in case of a decreased in wage rate.

X. The time period: As with demand, supply of labour tends to become more elastic over time. This is because it gives workers more time to notice wage changes and to gain any qualifications or undertake any training needed for new job.

2.12 The Supply of Labour

The labour supply is defined as the number of workers willing and able to work, multiplied by the hours they are willing an able to work. It is determined by the wage rate. The higher the wage rate, the more labour is supplied, which means the supply of labour will slop upward. A worker's wage, along with any bonus, provides the main pecuniary (monetary benefit from working).



Factors other than wages will shift the supply curve to the left or right. These factors include:

I. **The size of the working population:** The working population is the number of people working age (16-60 for women and 16-65 for men) who are willing and able to work. The size of the working population is influenced by the retirement and school leaving age, migration, and numbers staying on at university.

II. **Migration:** Migration can have a considerable impact on the labour market. Migrants tend to be of working age, and while the general effect is to increase the supply of labour at all wage rates, migration especially affects supply at lower wage rates. This is because migrants tend to come from low wage economies, with average wages often far below the minimum wage in the UK

III. **People's preference for work:** If people prefer more work, the supply of labour increases. Preference can be influenced by a range of factors, including changes in the cost of working. Such a subsidized childcare, and non – wage benefits of working.

IV. **Net advantage to work:** As well as wage rate, decisions to increase or decrease labour supply are influenced by non – monetary advantages, such as changes in working conditions, job security, holiday entitlement, promotion prospects, and other psychological benefits of work. Improvement in these benefits will shift labour supply curve to the right.

V. **Work and leisure:** For many, part – time work is an increasingly attractive option given the advantages of increased leisure. Early retirement is also a factor affecting labour supply. An individual's decision to supply labour is greatly affected by the choice between work and leisure. Given that time is fixed, work and leisure are substituted for each other. The choice between work and leisure can be affected by a number of factors, including

a) Age – Older workers often gain more utility form leisure.
b) Direct taxes – higher income tax rates may increase the utility of leisure and reduce the supply of labour.
c) Dependents: Having children may increase the utility of work and increase the supply of labour.
d) Non – work income: some individuals can retire from the labour market because they have company pensions which may be received before state pensions, which available for men at 65 and women at 60. Non – work income can come in the form of cash benefits, such as the job seeker's allowance, and benefits – in kind, such as subsidised travel cards.

2.13 Individual Labour Supply

Normally supply curve of labour is an upward sloping curve from left to right, but on account of psychological factors the supply curve be a backword sloping. It is so because as the wages exceed a particular limit, the labourer begins to prefer leisure to work. It means that at higher wage – rate supply of labour begins to diminish, and the supply curve has a tendency to slope backward.

I. **Substitution Effect:** Increase in wage rate will stimulate the labourer to work more; as such he will devote himself to work rather to leisure. He will substitute work – hours of leisure hours. Thus, because of substitution effect, rise in the wage – rate leads to increased supply of labourers. Substitution effect is positive.

II. **Income Effect:** Rise in wage rate means better position of the labourers. He now, prefers leisure to work. Thus, the income effect discourages work and encourages leisure. The Income effect is therefore negative.

Figure 3.3 shows backward sloping supply curve. Up to a wage rate w1, the relative price of leisure increases, and workers will look to switch from leisure to work. In other words, there is a strong substitution effect as wages start to rise. Hence, the supply curve slopes upwards and then backwards to point S.

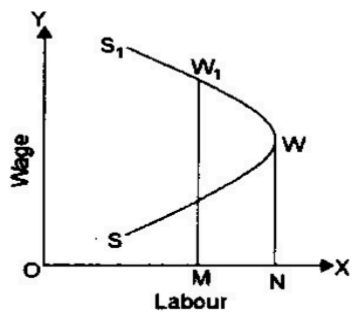


Fig.3.3.

However, beyond w1, the income effect begins to dominate and further rises in money wages, which increases real income, mean that less work is required to achieve the same level of real income.

2.14 Factors Affecting the Supply of Labour

III. Length of training of workers: If a worker need lengthy training, the effective supply of labour is less in the short run.

IV. Barriers to Entry: Barriers to entry into the labour market, such as the strict requirement for qualifications, will make the supply of labour less than it would be with no barriers.

V. Trade Unions: A trade union is an organisation that aims to protect the interests of workers. Around 30 % of UK employees are members of unions, with women more likely to be in a union than men. Union membership has fallen steadily over the last 20 years.

VI. Tax and benefit incentives and disincentives: Tax and benefit rates can lead to increase and decrease in the effective labour supply. When income taxes are excessive and benefits too generous, a stay-at-home culture may be encouraged.

VII. Labour subsidies: If the government gives a subsidy to workers to look for work or to train, then the supply of labour will increase, and the supply curve will shift to the right.

VIII. The actual and potential labour supply: The actual labour supply includes those workers who are both willing and able to supply their labour, including the unemployed. The potential labour supply also includes those who, for one reason or another, are currently inactive.

2.15 Summary

In this lesson we have discussed the demand for labour and supply for labour. We have also discussed the factors affecting demand for labour and supply for labour. Labour is demanded for the production of goods and services. Firms demand labour because consumers want to purchase a variety of goods and services. The firm's labour demand is a derived demand, derived from the wants and desires of consumers. Supply of labour means, the number of labourers doing a particular job, who willingly offer their services at different wage rate and the number of hours or days that each labourer is prepared to work at different rate of wages. Further, we discussed elasticity of labour demand; elasticity is means of measuring responsiveness. If the price of a good changes, how responsive is a change in quantity demanded? A relatively large change in quantity demanded suggest that demand is quite responsive, or elastic. A relatively small change in quantity demanded is less responsive, or inelastic.

In the realm of labour economics, we are interested in how responsive an employer demand for labour is to the price (wage) of labour. More specifically, we are looking for the relative change in employment level for a relative change in the wage.

2.16 Key words

Demand for labour: Labour is demanded for the production of goods and services. Firms demand labour because consumers want to purchase a variety of goods and services. The firm's labour demand is a derived demand, derived from the wants and desires of consumers.

Supply of labour: Supply of labour means the number of labourers doing a particular job who willingly offer their services at different wage rate and the number of hours or days that each labourer is prepared to work at different rate of wages.

Elasticity of Labour Substitution: Elasticity is a means of measuring responsiveness. If the price of a good change, how responsive is the change in quantity, or elastic. A relatively large change in Qd suggest that demand is less responsive, or inelastic. In the realm of labour economics, we are interested in how responsive an employer demand for labour is to the price (wage) of labour. More specifically, we look for the relative change in employment level for a relative change in the wage.

- **Factors affecting demand for labour:** Wage rate, demand for the products, productivity of labourers, profitability of firms, substitutes, the number of buyers of labour.
- **Factors affecting supply of labour:** Length of training of workers, barriers to entry, trade union, tax and benefit, incentives and disincentives, labour subsidies, the actual and potential labour supply.

2.17 Self Assessment Questions

Q1. Define demand for labour?

Q2. Explain the key factors affecting supply of labour.

2.18 Reference books

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LESSON-3

ECONOMIC SYSTEMS

Objectives

To Discuss the Features and Merits of Capitalism

To Know the Merits and Demerits of Socialism

To Understand the Merits and Demerits of Mixed Economic system

Structure

3.1 Introduction
3.2. Capitalism
3.3 Features of Capitalism
3.4 Merits of Capitalism
3.5 Demerits of Capitalism
3.6. Socialism
3.7 Merits of Socialism:
3.8 De-Merits of Socialism
3.9. Mixed Economic System
3.10 Features of a Mixed Economy
3.11 Merits of Mixed Economic System:
3.12 Demerits of Mixed Economic System:
3.13 Summary
3.14 Key words
3.15 Self Assessment Questions
3.16 Reference Books

3.1 Introduction

Thus, economic system is an integral part of the business environment. Economic System consists of "those institutions which a given people, a nation or a group of nations have chosen or accepted as the means through which their resources are to be utilized for the satisfaction of the human wants."

India's Economic System:

India is one of the countries that have experimented with a mixed socialist economic system since 1951. It instituted a physical control regime up until 1984. Towards this —

i. It established an industrial licensing regime, a rigid foreign exchange regulation regime, several price and distribution controls, and so on.

ii. It also setup several public sector undertakings and a distribution network consisting of numerous ration-shops.

iii. The state acted as a biggest employer in the economy providing employment to millions of youth.

iv. The financial sector, including the commercial banks, has functioned totally under RBI regulations and controls.

Despite all these and numerous other initiatives, the country suffered from slow growth, industrial stagnation, rising unemployment and high cost production structure.

This led policy makers to do a rethinking on policy regime and paved the way for economic liberalization since 1985 under which the country move away from the principles of socialism. Since 1991, it initiated an aggressive reform process under which role of market forces was gradually widened, areas reserved for public sector were considerably curtailed and more and more areas were opened up for private initiatives. In nutshell, India has made a gradual move from a mixed socialist economy to a mixed capitalist economy. Such a process of transformation is still continuing.

The three types of economic systems are:-

1. Capitalism 2. Socialism 3. Mixed Economic System.

3.2. Capitalism

Capitalism is an economic system which can be identified from private ownership on the means of production and profit motivated production relations. In the literature, it is also named as free market economic system or a laissez-faire capitalism. In such an economic system, each economic entity whether individuals or companies, own and distribute resources or goods in a way so as to maximize their respective financial gains.

According to Macmillan Dictionary of Modern Economics, capitalism is defined as a social and economic system in which capital assets are mainly owned and controlled by private persons, labour is purchased for money wages, capital gains accrue to private owners, and the price mechanism is utilized to allocate capital goods between uses.

3.3 Features of Capitalism

Following are the important features of capitalism:

i. Economic Freedom:

Economic freedom, as a basic feature of capitalism, has two major constituents, freedom of choice and freedom of enterprises.

a. Freedom of Choice

It means that all economic entities, such as consumers, producers and workers, in the economy are free to make their own economic decisions, in the backdrop of resource scarcity, with regard to the resources they own. To a consumer, it means freedom to spend

income on whichever goods and services he may desire.

b. Freedom of Enterprises

A freedom of enterprises means freedom to a producer to own and operate any business. As an owner of a business organization, an individual is free to make any business decision.

Given the economic freedom, price mechanism plays an important role in the economy according to which a rational individual will exercise his rights in the best self-interest aimed at profit maximization or satisfaction maximization.

ii. Private Ownership

In a capitalist setup, all the factors of production, as also goods and services, are privately owned. Such an ownership entitles the owners to use the resources in a manner in which they are comfortable with. Obviously, being rational owners, they will deploy the resources so as to get maximum rewards or earnings.

The right of private ownership will facilitate accumulation of wealth by all the economic entities which, in turn, will push the economic growth at aggregate.

iii. Right of Inheritance

The inheritance means transfer from one generation to next generation. In the context of capitalism, it means transfer of assets from father to offspring. The capitalism provide right of inheritance to all individuals which act as an incentive to accumulate more wealth. It implies more economic activities and more income generation in a capitalist economy.

iv. Profit Motive

In the capitalist economy, every activity will be governed by profit consideration. A producer will strive for maximum profit, a consumer for maximum satisfaction and a factor for maximum reward.

Obviously, resources will be deployed only in those areas which are capable of providing maximum return or profit, given their scarcity.

v. Competitive Market

All the capitalist economics are required to have competitive markets in which numerous sellers offer their goods and services to numerous buyers. This will ensure that each seller will make only a normal profit. Likewise, factor markets are also competitive which means that each factor will provide its services to a producer who offers a maximum rewards. Such competitive markets will be self regulatory through the invisible hands of price mechanism.

This will encourage firms to always strive for better products and services for a larger market share or profit. A factor will also strive for higher productivity for better rewards as factor payments. Thus, each economic entity will attempt to improve all the time which, in turn, will push the entire economy up and up.

vi. Price Mechanism

The price mechanism in a capitalist set up acts as a coordinating mechanism. It determines price of each and every economic activity. It works through demand and supply forces to determine equilibrium price.

vii. No Government Intervention:

The capitalist system does not involve any government interventions. Economic decisions are taken freely on the basis of price mechanism.

3.4 Merits of Capitalism

i. Promote Economic Growth

Many economist have argued that capitalism have great ability to promote economic growth. It leads to a faster GDP growth and better capacity utilization.

ii. High Living Standards and Hard Work

The capitalism, while ensuring rapid economic growth, also facilitates a high living standard for all the consumers, each one of which is paid according to their respective contribution in production process. Thus, it encourages factors to strive for higher productivity and work hard so as to be rewarded better. With higher income, they will have higher living standard. The common capitalist mantra is that anyone can be rich if they work hard enough.

iii. Promote Technological Progress

Given the intense market competition, rate of technological innovation will be high as each firm will attempt to grab market. In other words, capitalism will promote innovation and improvement in production techniques which may either contribute in lowering cost of production or improve product quality. In the quest of profit, each firm will try to offer products better than competitors. Thus, successful innovations will strengthen the competitive strength of a firm in a capitalist setup.

iv. Stimulate Rate of Capital Formation

Two of its features, viz., private ownership and law of inheritance, encourages everyone to own more and more properties, physical as well as intellectual, and pass it on the next generation after their death. Such a tendency will stimulate the rate of capital formation in the economy.

v. Optimum Resource Utilization

Since all the markets in a capitalist economy are competitive, it promotes efficient and optimum resource utilization at each level. Further, the interplay of market forces ensures resource to be deployed in most productive uses. In brief, thus, capitalism encourages optimum resource utilization.

vi. Emergence of Entrepreneurship

Give the prevalence of profit prospects in the market, whosoever may have potential and capabilities will emerge as entrepreneur. Hence, there will be addition of new entrepreneurs all the time.

vii. Benefit of Automatic Functioning

The capitalism has a unique advantage of automatic functioning of the economy. All the economic decisions are based on price mechanism. It, in other words, it means that cost of decision making at each level is nil.

viii. Sovereignty of Consumers

Consumer in a capitalist society is accorded a status of king. It means that all the economic decisions revolve around the consumer. His decision making regarding what to consume and how much will significantly influence the firms' survival and growth.

3.5 Demerits of Capitalism

i. Income Inequality

It is not true that anyone can be rich if they work hard enough. In fact, one will grow under capitalism at the cost of others only. It means that along with every rich, a large army of poor will coexist. In simple terms, there will be a growing income inequality in a capitalistic setup. In fact, it is this demerit of capitalism that has been amply highlighted by the socialist thinkers including Karl Marx. It has provided a basis for the evolution of socialist form of economic system, as an alternative to capitalism.

ii. Economic Instability

The free market mechanism of a capitalist society is a source of cyclic behaviour of the economy, commonly known as trade cycle or business cycle. Such behaviour of economy will produce recession and inflation in the economy one after other and, hence give rise to instability in growth.

Both of it will not be good for the economy. A recessionary phase will result into unemployment causing considerable hardship to the workers who will be thrown out of their jobs for none of their mistake. Likewise, an upward economic swing will strengthen inflation again adversely affecting the poor in the economy.

iii. Social Welfare is Ignored

Another important demerit of the capitalism is that it does not bother about social welfare. For example, in the process of allocating resources across products, more allocation is made for luxury goods rather than basic necessities. It is because of the fact that the profit prospects are much better in the production of luxury items as compared to basic necessities.

iv. A Lot of Wasteful Expenditure

In capitalism, intense market competition force companies to go for large selling cost though which aggressive sale-promotion is carried out. Such expenditure is wasteful in nature since it does not add any value to the products for the consumer. It may simply help companies to protect their respective market share from competitors. In fact, capitalism is known for a cut-throat competition implying that such wasteful expenditure is huge.

Another source of wasteful expenditure comes from unequal income distribution in a capitalist society. While the rich usually do a lot of wasteful expenditure, poor do not find enough to meet even basic necessities and hence starve.

v. Exploitation

It is not correct to say that a capitalist economy pays everyone as per their contribution to the production process. The marginal productivity theory of distribution, tells that every worker is paid a sum equals to marginal productivity of last unit of labour and not that of his own. The difference between the own marginal productivity and that of the last unit is basically the profit of the producer or exploitation of the worker.

vi. Emergence of Monopoly Market

Under capitalist society, each firm wants to become bigger and bigger. They even adopt strategies to throw out competitors out of market to grab the market share. Obviously, competitive markets will gradually become oligopolistic or even monopolist in long run.

A monopolist firm produces a lower quantity and charges a higher price than that of a competitive firm.

Further, in long run, a competitive firm will only earn a normal profit while a monopolist will always earn a super normal profit. Again, a monopolist will not mind to sell the same product at different prices to different customers through price discrimination while a competitive firm will not be capable of doing so. Based on all these facts, one can say that the under capitalism the monopolies will emerge and exploit the workers and consumers enormously and impoverish the majority of the population as the monopolists want to maximize their super normal profits.

vii. Undemocratic in Nature

While it is claim that capitalism is democratic in nature, this is not true. Rich and powerful, both individuals and companies, usually have more say in government policy-making as compared to the poor.

Criticism:

It is not surprising therefore that the capitalism has been severely criticized by a large number of social scientists including economists and sociologist, for all the demerits inbuilt in it. So much so that the capitalism have been completely discarded by the socialist thinkers. They have propagated altogether a new form of economic system which is based on equality and social justice. It is known as socialism.

3.6. Socialism

Emergence of socialism has been traced above in the criticisms of capitalism, specifically the rising income inequality under it which divides the society into have and have-nots. Further, the root cause of income inequality in capitalism is the private ownership on factors of production.

The socialist thinkers have, thus, proposed a socialist mode of product as an alternative to capitalism or as a solution to all the demerits of capitalism. To be precise, socialism proposes state ownership on means of production and maximum social benefits as profit motive in the production system. The system is looked upon as need-based rather than profit-based.

Important features of socialism can be highlighted as follows:

Salient Features of Socialism

i. Social Ownership on Production Factors: The basic feature of a socialist economy is that all major means of production are placed under collective social ownership rather than under the individual ownership. It thus takeover private property and transforms them into social property through nationalization. In simple words, all big industries and land are to be bought under state ownership. As a matter of fact, private ownership is considered at par with private robbery under socialism.

Practically speaking, however, only key and strategic means of production are brought under public ownership while some minor activities are left for individual ownership. Such private activities constitute an insignificant portion of the total activities in the economy.

ii. Motive of Social Welfare

The socialism is fully dedicated to social welfare and the individual interests take a back seat. That is, individual interests are being sacrificed for social interests. The social interests are always supreme and maximizing social gains is the guiding motive of production. Basic philosophy is that entire society should be enriched rather that enriching a few.

iii. Economic Decisions and Planning

Under socialism power to take economic decisions rest with public authorities and not with the profit-seeking private individuals and firms. The economic development is carried out through economic planning, which is an essential feature of socialism. Decisions regarding central problems (what, how and for whom to produce) are taken by a central board or planning commission. It follows need-based decision-making in place of a profit-based one.

A need-based decision-making system is one which assured everyone a share in national income irrespective of his/her contribution in it. Given that decisions are taken through a planning process and not through market forces, such economies are also called as centrally planned economies.

iv. No Role of Price Mechanism and Lack of Market

Competition: Given the pre-dominant role of planning process, market oriented decision making through price mechanism has no role to play. As a result, there is no market competition, no rivalry between production units and, hence, no wastage of resources in the form of selling cost or sale promotion measures like . The State commands a virtual monopoly on production system.

v. Classless Society and No Exploitation

Capitalist mode of production divides society into have and havenots. Contrary to it, socialism attempts to create a classless society, a society of peasants and workers. Means of production being stateowned, there is no capitalist class. Even if it existed, as under liberal socialism, it is effectively regulated and controlled by the state institutions. It has to operate within the framework provided by the State. It has to follow the regulation imposed on it. Obviously, such a system has no scope of exploitation.

In nutshell, the root cause of exploitation, the individual ownership on means of production, is being rooted out to a significant extent.

vi. Inequality in Income and Wealth Distribution

Another important feature of the socialism is that income and wealth inequalities are within the pre-determined limits since it is a need-based rather than productivity-based system. Thus, there is no scope for social tension and no risk of disintegration.

vii. Social Security

It provides social security to all implying that every member of the society is assured of an income, which is sufficient for satisfying his needs irrespective of the fact whether he is able to work or not. It even takes care of old age needs of the people when they are unable to make contribution in production.

3.7 Merits of Socialism

There are many advantages in socialism.

They can be summarized as follow:

i. Efficient Resource Utilization

In a socialist economy, production decisions are taken by a central body on the basis of requirements of the economy. Depending upon the availability of resources, it decides to produce the items most needed and in just quantity ruling out any duplication of production. Hence, there is neither any wastage of resources nor unemployment. On this basis, one can argue that a socialist set up ensures efficient resource utilization.

ii. Inequality of Income within Desirable Limits or Distributive Justice

Since factors of productions are owned by the government and the factor payments are need based, there is no possibility of income inequality beyond desirable limits. Moreover, it also offered social security to everyone, at least with regard to basic needs. In nutshell, it upholds the principles of distributive justice.

iii. No Class Struggle

As the society does not divide into have and have-nots, there is no possibility for social tension and, hence, no scope for class struggle.

iv. No Economic Instability

Since market mechanism has no role to play, presence of business cycles are not witnessed and hence no economic instability under socialism. Each and every sector develops in a planned manner. There is no excess demand or excess supply scenario. It implies that resources are better allocated under socialist mode of production.

v. No Unemployment

In socialist mode of economic system, production is planned as per the availability of resources and, hence, there is no scope for unemployment.

3.8 De-Merits of Socialism

i. Efficiency and Factor Productivities are Low

Being a need based system it ignores efficiency and factor productivity. No serious attention is given, especially at individual level, to increase productivity since factor payments are no way linked to their respective contributions in the production.

Moreover, high social security also discourages a person to work hard as he knows that even if he does work, or does not work hard, his future is secured at least for basic needs. Further, even if he works harder, he will not gain much in terms of better life style. His needs are pre-determined by the system. As such labour productivity in socialism is always low.

At the other end, the production system is managed by state officials who have no personal interest in it and hence, has no incentives to perform.

For all these reasons, the socialism witness low labour productivity which may even decline overtime. The efficiency level is also found to be low in such a system.

ii. De-Motivating Hard Work

An important weakness of socialism was that it adversely affected the motivation to work hard as no personal gains and losses are involved. This ultimately resulted in slower economic growth and smaller income generation.

iii. Complex Administration

Since every venture and each aspect is managed by bureaucrats, the administrative process becomes very complex and the network becomes multi-layered. The state officials used to consider production system just as an extension of government departments. Thus, often it used to take a long time to take a decision which has to be approved at various levels. This not only increases the cost but often cause considerable delay in decision-making.

iv. No Consumer Sovereignty

A serious drawback of the socialist system is that it has no respect for the consumer sovereignty. His preferences for the goods and services to be consumed have just no place in the decision making. He has to consume whatever decided for him by the State authorities. This considerably lowers his motivation to work.

v. No Economic Freedom

In this form of economic system, there is neither a freedom of\ choice nor a freedom of enterprise, as observed in case of capitalism. Hence, workers have no job satisfaction. They are asked to perform a task and one has to do it whether he likes or dis-likes.

vi. Concentration of Power

It has also been argued that the socialist system is also not free from concentration of power. Under it, power gradually concentrates in the hands of bureaucracy and the State machinery.

Criticism of Socialism

Despite many merits and positive features of socialism, it has been criticized for several reasons, which are amply elaborated under its demerits. With the demise of socialism, it appears that its demerits were more powerful and its merits did not exist in reality.

3.9. Mixed Economic System

A mixed economy is nothing but an attempt to incorporate advantages of both capitalism and socialism under it while keeping their respective disadvantages away.

Conceptually speaking, two forms of mixed economy can be identified:

i. Mixed capitalist economy, and

ii. Mixed socialist economy

i. Mixed Capitalist Economy:

A mixed capitalist economic system is one that rely more on capitalism while incorporating a few features of socialism into it. It is basically a market economy characterized by the presence of a small public sector to protect the welfare, especially of the weaker sections of the society. The presence of public sector is also noticeable in the areas such as, national security. The market mechanism plays a dominant role under it and government interventions in the market are limited.

As a matter of fact, almost all the capitalist economies of the world, now-a-days, are the mixed capitalist economies marked by the presence of a public sector and wide-ranging government interventions for orderly functioning of the respective economies.

The policy perception provided by Keynes following the great depression of the thirties laid the emergence of such mixed capitalist economies.

ii. Mixed Socialist Economy

On the other hand, a mixed socialist economy will look more like a socialist economy marked by:

i. Some freedom to producers to operate mostly in non-core areas of production. Even the limited freedom to private sector is subjected to considerable government interventions through various macroeconomic policies. This is to ensure that it functions in accordance with national development priorities.

ii. Considerable freedom to consumer to select goods and services for consumption, and

iii. Almost a complete freedom to factors of production, labour in particular, to choose the work place. The state influence resource deployment indirectly through different policy instruments.

Nonetheless, the State keeps an effective control over the economy and different markets are regulated to varying extent for their orderly functioning.

The two forms of mixed economic systems, thus, differ considerably with each other depending upon their leaning towards capitalism or socialism.

3.10 Features of a Mixed Economy

Important features of a mixed economic system, keeping Indian economy in view, are highlighted below:

1. Public and Private Sectors

A basic feature of mixed economic system is the co-existence of both public and private sectors under it. Mostly, essential and core production activities are placed under public sector while private sector is allowed to operate in non-core areas, such as production of consumables.

In India for example, production of heavy machinery and most of the critical intermediates, like petroleum products, fertilizers, chemicals, iron & steel etc., were put under the State ownership while private entrepreneurs were allowed to take up production of items like farming, textiles, leather items, and so on. The Industrial policy-1991 has however, introduced a radical shift in the policy perception. It curtailed the scope for public sector by way of reducing areas reserved for it from 17 to just 4. Many public sector units were gradually privatized. The industrial licensing was virtually abolished which was a very powerful instrument for regulating private initiatives in industrialization in pre-1991 era.

All these and many other measures have significantly curtailed the scope for public sector and widened the scope for private sector. Still, even today Indian economy can be characterized by the presence of both public and private sectors.

2. Economic Welfare

Under a mixed economic system, the Government introduces several instruments to safe-guard the interests of weaker and unorganized segments of the economy. For example,

i. Regional balance may be taken into account while approving investment in different areas even though it lead to high production cost due to logistic disadvantages.

ii. Similarly, for the sake of more employment opportunities a relatively out-dated and less efficient technology may be selected in place of a modern one.

iii. In the field of distribution, essential items, like food grains, vegetable oil, sugar, salt etc. may be provided at a cheaper rate from public distribution system.

3. Economic Planning

A mixed socialist economy considerably relies upon the planning process since the Government has to carry out almost all the critical production activities. For this purpose, in addition to a central planning board, the State and district level planning machinery is also established. However, the role played by such a network of planning agencies is considerably less in a mixed capitalist economy. In a way, planning process will transform itself from a lead role to a supportive role in development process when an economy moves from mixed socialist to a mixed capitalist arrangement, as happened in the case of India in post-1991 era.

4. Profit Motivation

Economic activities guided by profit motivation are limited in a mixed socialist economy but are considerable under a mixed capitalist economy. Even the role market mechanism is different under the two modes of production, more in a mixed capitalist economy and less in the other.

5. Private Ownership

Both the forms of mixed economic system allow private ownership on means of production though in the socialist setup they may be subjected to regulations for a more equitable distribution of such ownerships. For example, in India, rich are subjected to wealth tax so that capital accumulation in a fewer hands may be restricted, to an extent.

Likewise, earlier an Estate duty was also in force which was abolished in the reform process. Further, there are land-ceiling Acts, applicable to both rural and urban areas. Such regulations in a mixed capitalist setup are fewer in number and less severe.

6. Freedom of Choice

Similarly, the two types of mixed economic systems also provide for freedom of choice to all means of production but this may not be unlimited in case of the socialist one.

7. Income Inequality

Given that market mechanism is in force, possibility of rising income inequality cannot be ruled out. However, under an inclination towards socialism, the government through various policy instruments attempts to keep it within a desired limit.

For example, high personal incomes are subjected to higher income tax under progressive taxation or luxury goods are imposed high excise duty. On the other hand, income of the workers may be protected through Minimum Wage Acts. Subsidies may be provided to the necessity goods.

3.11 Merits of Mixed Economic System

Being an attempt to bring positive aspects of the capitalism and the socialism both, the mixed system is marked by several advantages. They are highlighted below as merits of mixed economic system.

1. Faster Economic Development

Given that the mixed economic system provides a role to both public and private sectors, it ensures a faster and balanced growth.

2. Limited Income Inequality:

Further, the mixed economic system ensures income inequality to remain within a desired limit since the Governments apply various policy instruments to control it.

3. Equal Opportunities to All

The mixed economic setup provides opportunities to grow to all. For example, in India, it has provided reservation to the backward castes in jobs for facilitating their uplifting.

Likewise, it has exclusively reserved certain sectors for small scale and tiny units. The large companies are not allowed to venture in those areas. However, post-1991, areas under such reservations is curtailed considerably.

At the same time, planning process also ensure development of all the geographical pockets of the country by way of making a balance in investment allocation.

4. Scope for Private Initiatives

The mixed economic systems being marked by the co-existence of both public and private sectors, provides ample scope for private growth initiatives. It is, however, somewhat more in case of mixed capitalist system than that in mixed socialist system. It is very much evident from the Indian example. The post-reform era has widened the scope for private sector considerably not only by way of opening newer areas for it but also by way of reducing restrictions on its operations. For example, The MRTP Commission and FERA regulations were abolished and replaced by a Competition commission and FEMA regulations respectively. They are far less restrictive on growth of private sector.

5. Ensure Social Justice

Governments under mixed economic systems, enact various legislations to protect the interests of backward sectors which save them from market exploitation. This ensures growth with social justice.

For example, Indian government provides considerable support, financial or otherwise, to backward classes. It also runs numerous schemes for the benefits of poor or low income population.

6. Freedom of Choice and Consumer's Sovereignty

Despite restrictions, consumers in a mixed economy enjoy a considerable sovereignty as the consumables are mostly governed by market mechanism. At the same time, government ensures availability of essential items to all at reasonable prices. Workers are allowed freedom to choose the place of work. The system, however, imposes some restrictions on big companies in the national interests.

7. Economic Stability

In a mixed economy, government being the biggest market player allows economy to oscillate within a desirable limit. In case of high inflation or recession, policy interventions and direct actions may be introduced by the government.

Further, even the private sector may be asked to operate within the broader policy framework to limit the economic instability. Hence, the mixed economic system ensures economic stability to a considerable extent and, at the same, leave ample scope for market forces.

3.12 Demerits of Mixed Economic System

1. Slower Economic Growth

Theoretically, a mixed economic system is expected to achieve a faster growth. However, India in reality has witnessed not only a slower economic growth but industrial stagnation as well under its socialist setup. In contrast, the post 1991 era, which is marked by closeness to capitalism, has witnessed a higher growth. This indicates that the mixed socialist system may not be favourable to the economic growth.

2. No Efficient Use of Resources

In a mixed system, efficient use of resources may not be promoted all the time. The investment in public sector may suffer from economic irrationality and hence less productive. On the other hand, private sector may suffocate due to excessive regulations. In totality, such a system may lead to inefficient use of resources.

3. Too much Government Intervention

This is a universal tendency in all the mixed economic setups that the governments continue to make rules and regulations for every problem faced by the economy. Too much government intervention will defeat the purpose for which the mixed economic system was setup.

4. Disadvantage of Capitalism and Socialism

While the conceptualization of mixed economy is aimed at to incorporate merits of both capitalism and socialism into it, in practice it appears that in has incorporated demerits of the both the systems.

3.13 Summary

An **economic system** is how a country organizes the production and use of goods and services. It decides what to make, how to make it, and who gets it. The main types are:

- **Traditional:** Based on customs and traditions.
- **Command:** Government controls the economy.
- **Market:** Businesses and consumers make decisions.
- **Mixed:** A blend of government control and market freedom.

3.14 Key words

Capitalism

Capitalism is an economic system which can be identified from private ownership on the means of production and profit motivated production relations. In the literature, it is also named as free market economic system or a laissez-faire capitalism. In such an economic system, each economic entity whether individuals or companies, own and distribute resources or goods in a way so as to maximize their respective financial gains

Socialism

Emergence of socialism has been traced above in the criticisms of capitalism, specifically the rising income inequality under it which divides the society into have and have-nots. Further, the root cause of income inequality in capitalism is the private ownership on factors of production.

Mixed Socialist Economy

On the other hand, a mixed socialist economy will look more like a socialist economy marked by Some freedom to producers to operate mostly in non-core areas of production. Even the limited freedom to private sector is subjected to considerable government interventions through various macroeconomic policies. This is to ensure that it functions in accordance with national development priorities

3.15 Self Assessment Questions

1. What is an economic system, and what key questions does it answer?

2. How does a **traditional economy** decide what to produce?

3.What are the main characteristics of a **command economy**?

4. How does **supply and demand** influence production in a **market economy**?

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LESSON-4

Theories of Employment

Objectives

Structure

4.1 Classical Theory of Employment

The classical economists believed that there was always full employment in the economy. In case of unemployment, a general cut in money wages would take the economy to the full employment level. This argument is based on the assumption that there is a direct and proportional relation between money wages and real wages.

Principles of Classical Theory of Employment:

The classical theory of employment is based on the following principles:

(1) Say's Law of Market.

(2) Equilibrium in the Labor Market.

(3) Classical Analysis of Price and Inflation.

The J. B. Say's Law of Market: Proposition, Implication

Say's law of markets is the core of the classical theory of employment. An early 19th century French Economist, J.B. Say, enunciated the proposition that "supply creates its own demand." Therefore, there cannot be general overproduction and the problem of unemployment in the economy.

On the other hand, if there is general overproduction in the economy, then some labourers may be asked to leave their jobs. There may be the problem of unemployment in the economy for some time. In the long-run, the economy will automatically tend toward full employment.

In Say's words, "It is production which creates markets for goods. A product is no sooner created than it, from that instant, affords a market for other products to the full extent of its own value. Nothing is more favorable to the demand of one product, than the supply of another." This definition explains the following important facts about the law.

Production Creates Market (Demand) for Goods

When producers obtain the various inputs to be used in the production process, they generate the necessary income. For example, producers give wages to labourers for producing goods. The labourers will purchase the goods from the market for their own use. This, in turn, causes the demand for goods produced. In this way, supply creates its own demand.

Barter System as its Basis

Say's law, in a very broad way, is, as Prof. Hansen has said, "a description of a free-exchange economy. So conceived, it illuminates the truth that the main source of demand is the flow of factor income generated from the process of production itself. Thus, the existence of money does not alter the basic law.

General Overproduction Impossible

J.S. Mill supported Say's views regarding the impossibility of general overproduction and general unemployment. According to him, Say's law of markets does not consider the possibility of general overproduction and also rejects the possibility of decrease in the demand of goods produced in the economy. By employing more factors of production, there is an increase in the level of employment and therefore profits are maximized.

Saving-Investment Equality

Income accruing to the factor owners in the form of rent, wages and interest is not spent on consumption but some proportion out of it is saved which is automatically invested for further production. Therefore, investment in production is a saving which helps to create demand for goods in the market. Further, saving- investment equality is maintained to avoid general overproduction.

Rate of Interest as a Determinant Factor

Say's law of markets regards the rate of interest as a determinant factor in maintaining the equality between saving and investment. If there is any divergence between the two, the equality is maintained through the mechanism of the rate of interest.

Labour Market

Prof. Pigou formulated Say's law in terms of labour market. By giving minimum wages to labourers, according to Pigou, more labourers can be employed. In this way, there will be more demand for labour. As pointed out by Pigou, "with perfectly free competition…there will always be at work a strong tendency for wage rates to be so related to demand that everybody is employed."

4.2 Propositions and Implications of the Law

Say's propositions and its implications present the true picture of the market law.

These are given below:

1. Full Employment in the Economy

The law is based on the proposition that there is full employment in the economy. Increase in production means more employment to the factors of production. Production continues to increase until the level of full employment is reached. Under such a situation, the level of production will be maximum.

2. Proper Utilization of Resources

If there is full employment in the economy, idle resources will be properly utilized which will further help to produce more and also generate more income.

3. Perfect Competition

Say's law of market is based on the proposition of perfect competition in labour and product markets.

Other conditions of perfect competition are given below:

(a) Size of the Market:

According to Say's law, the size of the market is large enough to create demand for goods. Moreover, the size of the market is also influenced by the forces of demand and supply of various inputs.

(b) Automatic Adjustment Mechanism

The law is based on this proposition that there is automatic and self-adjusting mechanism in different markets. Disequilibrium in any market is a temporary situation. For example, in capital market, the equality between saving and investment is maintained by the rate of interest while in the labour market the adjustment between demand and supply of labour is maintained by the wage rate.

(c) Role of Money as Neutral:

The law is based on the proposition of a barter system where goods are exchanged for goods. But it is also assumed that the role of money is neutral. Money does not affect the production process.

4. Laissez-faire Policy:

The law assumes a closed capitalist economy which follows the policy of laissez- faire. The policy of laissez-faire is essential for an automatic and self-adjusting process of full employment equilibrium.

5. Saving as a Social Virtue:

All factor income is spent in buying goods which they help to produce. Whatever is saved is automatically invested for further production. In other words, saving is a social virtue.

4.3 Assumptions of the Say's Law of Market

The classical model is based mainly on the following four assumptions:

(1) Pure competition exists. No single buyer or seller of commodity or an input can affect its price.

(2) Wages and prices are flexible. The wages and prices of goods are free to move to whatever level the supply and demand dictate.

(3) Self-interest. People are motivated by self-interest. The businessmen want to maximize their profits and the households want to maximize their economic wellbeing.

(4) No government interference. There is no necessity on the part of the government to intervene in the business matters.

Say's Law is explained with the help of simplified circular flow in figure 32.1. Says Law means that supply creates its own demand for goods and services. The income persons receive from output is spent to purchase goods and services produced by others. The very act of supplying certain level of goods and services necessarily equals the level of goods and services demanded. For the economy as a whole, total production therefore equals total income.

4.4 Equilibrium in the Labor Market

Another feature of the classical theory of employment is in its belief that that if real wages of the workers are flexible in the labor market, then the economic system automatically adjusts itself at the level of full employment. According to A. C. Pigou:

"The equilibrium level of employment is determined by the demand for and supply of labor in the labor market. So far the demand for labor is concerned, it is the decreasing function of higher wages. This means that at higher wages, the firms will employ less units of workers. As the real wage rates fall, then more units of workers are demanded by the firms".

As regards the supply of labor, it is the increasing functions of real wages. This means that at higher wage rates, more workers will be willing to work. The equilibrium level of employment which is the full employment level is determined by the equation of demand for and supply of labor. The classical theory of employment is now explained with the help of diagram.

In the Fig. 32.2, the labor demand curve DD/ shows the total quantity of workers that firms plan to hire at each possible real wage rates. The labor supply curve SS/ shows the total quantity of workers that households plan to supply at each possible wage rate. The labor demand curve DD/ and the labor supply curve SS/ interact to determine the level of employment.

(3) Classical Analysis of Prices and Inflation:

The classical economists were of the view also that price level (P) in the economy is dependent upon the supply of money (M) in the country. The greater the quantity of money, the higher is the price level and vice versa. This analysis of price level was based on the Quantity Theory of Money, which in brief rates that price level (P) is directly related to the quantity of money in circulation in the economy (M).

4.5 Keynes Criticism on Say's Law

The law of J.B. Say was finally falsified and laid to rest with the writings of Lord

J.M. Keynes. He in his book, 'General Theory', has severally criticized the Say's Law on the following grounds:

(1) Possibility of deficiency of effective demand. According to Keynes, the classical theory based on Say's Law is unreal. In a competitive market, he says, it is not necessary that all income earned is automatically spent on consumption and investment. A part of income may be saved and may go to increase individual holdings. There may, thus, appear a deficiency in aggregate demand causing overproduction and unemployment in the country.

(2) Pigou's view on wage cuts. Keynes criticizes Pigou's view that a general cut in real wages in times of depression is a cure for unemployment. Keynes is of the opinion that a general cut in real wages may reduce the aggregate demand for goods and deepen depression.

(3) Not a general theory. The Say's Law assumes that micro economic analysis can profitably by applied to the economy as a whole. Keynes rejects this view and says that for the explanation of the general theory of income and employment, the macro economic analysis is required.

(4). saving investment equality. Keynes was never convinced of the classical version that interest elasticity can equate savings and investment. According to him, it is the income and not the rate of interest which is the equilibrium, force between saving and investment.

(5) Monopoly element. Say's Law assumes perfect competition in the economy. Keynes says it is the imperfect competition which in practice prevails in the product and factor markets. The Say's Law is therefore, not operative.

(6). Role of trade unions. In the contemporary capitalist world, the trade unions bargain with the employers for the fixation of wages. The state also fixes minimum wages in certain industries. The classical theory did not attach much importance to these forces and relied more on the theoretical; aspect, J.M. Keynes emphasizes more on the practical side of the theory of employment. In the words of Dillard" the great fault of the classical theory is its irrelevance to conditions in the contemporary capitalist world. In capitalistic economy where widespread unemployment, business cycles, inflation, and other forms of instability constitute the chief problems of public policy, the basic need is for a theory that will diagnose these ills in a manner which will furnish a guide to action for their solution or alleviation. Such a new and more relevant theory has emerged in Keynes General Theory of Employment, Interest and Money.

(7) Short run economics. Keynes rejects Says Law that aggregate demand will always be sufficient to buy what is supplied in the long run. Keynes remarks that "In the long run we are all dead". The length of long run is not clear in Say's Law.

4.6 The Principle of Effective Demand: Aggregate Demand and Aggregate Supply Introduction

The logical starting point of Keynes's theory of employment is the principle of effective demand.

In a capitalist economy, the level of employment depends on effective demand. Thus unemployment results from a deficiency of effective demand and the level of employment can be raised by increasing the level of effective demand.

1. Effective Demand:

In ordinary parlance, demand means desire. It becomes effective when income is spent in buying consumption goods and investment goods. Keynes used the term 'effective demand' to denote the total demand for goods and services at various levels of employment. Different levels of employment represent different levels of aggregate demand. But there can be a level of employment where aggregate demand equals aggregate supply.

This is the point of effective demand. In Keynes's words, "The value of D (Aggregate Demand) at the point of Aggregate Demand function, where it is intersected by the Aggregate Supply function, will be called the effective demand." Thus according to Keynes, the level of employment is determined by effective demand which, in turn, is determined by aggregate demand price and aggregate supply price.

Aggregate Demand Price

"The aggregate demand price for the output of any given amount of employment is the total sum of money or proceeds, which is expected from the sale of the output produced when that amount of labour is employed."

Thus the aggregate demand price is the amount of money which the entrepreneurs expect to get by selling the output produced by the number of men employed. In other words, it refers to the expected revenue from the sale of output produced at a particular level of employment. Different aggregate demand prices relate to different levels of employment in the economy.

"The aggregate demand function," according to Keynes, "relates any given level of employment to the expected proceeds from that level of employment.".

The table reveals that with the increase in the level of employment proceeds expected rise and at lower levels of employment decline. When 45 lakh people are provided employment the aggregate demand price is Rs 280 cores and when 25 lakh people are provided jobs, it is Rs 240 cores. According to Keynes, the aggregate demand function is an increasing function of the level of employment and is expressed as D= F (AO, where D is the proceeds which entrepreneurs expect from the employment of N men.

The aggregate demand curve can be drawn on the basis of the above schedule. It slopes upward from left to right because as the level of employment increases aggregate demand price also rises, shown as AD curve in Figure 1.

Aggregate Supply Price:

When an entrepreneur gives employment to certain amount of labour, it requires certain quantities of co-operant factors like land, capital, raw materials, etc. which will be paid remuneration along with labour. Thus each level of employment involves certain money costs of production including normal profits which the entrepreneur must cover.

"At any given level of employment of labour aggregate supply price is the total amount of money which all the entrepreneurs in the economy, taken together, must expect to receive from the sale of the output produced by that given number of men, if it is to be just worth employing them.

The above table reveals that the aggregate supply price rises with the increase in the level of employment. If entrepreneurs are to provide employment to 20 lakh workers, they must receive Rs 215 crores from the sale of the output produced by them.

4.7 Determination of Effective Demand

Two determinants of effective demand separately and now are in a position to analyse the process of determining the level of employment in the economy. The level of employment is determined at the point where the aggregate demand price equals the aggregate supply price.

So long as the aggregate demand price is higher than the aggregate supply price, the prospects of getting additional profits are greater when more workers are provided employment. The proceeds expected (revenue) rise more than the proceeds necessary (costs).

This process wil continue till the aggregate demand price equals the aggregate supply price and the point of effective demand are reached. This point determines the level of employment and output in the economy. The point of effective demand is, however, not necessarily one of full employment but of underemployment equilibrium.

Two determinants of effective demand, Keynes regards the aggregate supply function to be given because it depends on the technical conditions of production, the availability of raw materials, machines etc. which do not change in the short run.

It is, therefore, the aggregate demand function which plays a vital role in determining the level of employment in the economy. According to Keynes, the aggregate demand function depends on the consumption function and investment function.

The cause of unemployment may be a fall in either consumption expenditure or investment expenditure, or both. The level of employment can be raised by increasing either consumption expenditure or investment expenditure, or both. Thus, it is the aggregate demand function which is the "effective" element in the principle of effective demand. Prof. Dillard regards this as the core of the principle of effective demand

It illustrates the determination of effective demand where AD is the aggregate demand function and AS the aggregate supply function. The horizontal axis measures the level of employment in the economy and the vertical axis the proceeds expected (revenue) and the proceeds necessary (costs).

The two curves AD and AS intersect each other at point E. This is effective demand where ON workers are employed. At this point, the entrepreneurs' expectations of profits are maximised. At any point other than this, the entrepreneurs will either incur losses or earn subnormal profits.

At ON1 level of employment, the proceeds expected (revenue) are more than the proceeds necessary (costs), i.e., RN1 > CN1. This indicates that it is profitable for the entrepreneurs to provide increasing employment to workers till ON level is reached where the proceeds expected and necessary equal at point E.

It would not be, however, profitable for the entrepreneurs to increase employment beyond this to NF level because the proceeds necessary (costs) exceed the proceeds expected (revenue), i.e., C1NF > R1NF and they incur losses. Thus E, the point of effective demand, determines the actual level of employment in the economy which is of underemployment equilibrium.

2. Importance of Effective Demand:

The principle of effective demand is the most important contribution of Keynes. It is the soul of the Keynesian theory of employment. Dr Klein attributes the Keynesian revolution solely to the development of a theory of effective demand.

1. Determinant of Employment:

Effective demand determines the level of employment in the economy. When effective demand increases, employment also increases, and a decline in effective demand decreases the level of employment. Thus unemployment is caused by a deficiency of effective demand.

Effective demand represents the total expenditure on the total output produced at an equilibrium level of employment. It indicates the value of total output which equals national income. National income equals national expenditure. National expenditure consists of expenditure on consumption goods and investment goods.

Thus the main determinants of effective demand and the level of employment are consumption and investment. In brief, Effective Demand = Value of National Output

= Volume of Employment = National Income = National Expenditure = Expenditure on consumption goods + Expenditure on investment goods.

2. Repudiation of Say's Law and Full Employment Thesis:

The principle of effective demand repudiates Say's law of markets that supply creates its own demand and that full employment equilibrium is a normal situation in the economy. This principle points out that underemployment equilibrium is a normal situation and full employment equilibrium is accidental.

In a capitalist economy, supply fails to create its own demand because the whole of the earned income is not spent on the consumption of goods and services. Moreover, the decisions to save and invest are made by different people.

The Pigovian view that full employment can be achieved by a reduction in money wage-cut is also repudiated by this principle. A money wage-cut will bring about a reduction in expenditure on goods and services leading to a fall in effective demand and hence in the level of employment.

3. Role of Investment:

The principle of effective demand highlights the significant role of investment in determining the level of employment in the economy. The two determinants of effective demand are consumption and investment expenditures. When income increases consumption expenditure also increases but by less than the increase in income.

4. The Paradox of Poverty in the midst of Potential Plenty:

The importance of effective demand lies in explaining the paradox of poverty in the midst of potential plenty in modern capitalism. Effective demand is mainly determined by the aggregate demand function.

A fundamental principle is that when income increases consumption also increases but less than proportionately (i.e., the marginal propensity to consume is less than one). This creates a gap between income and consumption which must be filled up by the required investment expenditure.

4.8 Summary

Theories of employment explain how jobs are created, how unemployment happens, and what determines the level of employment in an economy.

1. Classical Theory of Employment

- The classical economists (like Adam Smith and Ricardo) believed that **markets are self-regulating**.
- Wages and prices are flexible, so the economy naturally moves to **full employment**.
- Unemployment is seen as **temporary** and caused mainly by **high wages** or **labor market frictions**.

2. Keynesian Theory of Employment

- Proposed by John Maynard Keynes.
- Says economies can get stuck with **involuntary unemployment**.
- Employment depends on **aggregate demand** (total spending).
- When demand is low, unemployment rises, and government intervention may be needed.

3. Modern Theory of Employment

- Combines ideas from both classical and Keynesian views.
- Focuses on factors like **technology**, **skills**, **globalization**, and **labor market structures**.
- Recognizes different types of unemployment (frictional, structural, cyclical)

4.9 Key words

1. Full Employment

A situation where all who are willing and able to work at the current wage rate have jobs; does not mean zero unemployment.

2. Involuntary Unemployment

People want to work at the prevailing wage but **cannot find jobs** (Keynesian idea).

3. Voluntary Unemployment

People choose not to work at the current wage (classical perspective).

4. Wage Flexibility

Wages can rise or fall depending on supply and demand. Classical theory relies on this to maintain full employment.

5. Aggregate Demand

Total spending in an economy (consumption + investment + government spending + net exports). In Keynesian theory, this determines employment.

4.10 Self Assessment Questions

1.What is the main difference between the classical and Keynesian theories of employment?

2. Why does Keynes argue that an economy may not always reach full employment?

3.What role does aggregate demand play in determining employment levels?

4. Explain the concept of voluntary vs. involuntary unemployment.

5.How does wage flexibility help achieve full employment in classical theory?

6.What are the main types of unemployment in the modern theory?

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LESSON-5

THEORIES OF PLANT LOCATION

Objectives

To Understand the Sargent Florence theory

To Know the weber theory of Location

Structure

5.1 Weber's Theory Of Location
5.2 Criticisms
5.3 Sargent Florence's Theory
5.4 Factors
5.5 Criticism of Sargent Florence's Theory:
5.6 Factors Influencing Plant Location
5.7 Measures of Size
5.8 Factors Affecting the Size of the Firm
5.9 Various Concepts about the Size of Business Unit
5.10 The Optimum Size of Business
5.11 The Rationale of the Concept of Optimum Size
5.12 Factors influencing Optimum Size of firm:
5.13 Summary
5.14 Key words
5.15 Review Questions
5.16 Reference books

5.1 WEBER'S THEORY OF LOCATION

Alfred Weber, a German economist, enunciated a systematic theory of industrial location in 1909. Weber's theory of location is purely deductive in its approach. He analyzed the factors that determine the location of industry and classified these factors into two divisions. These are:

(i) Primary causes of regional distribution of industry (regional factors)

(ii) Secondary causes (agglomerative and deglomerative factors) that are responsible for redistribution of industry.

I. Primary Causes (Regional Factors)

According to Weber, transport costs and labour costs are the two regional factors on which his pure theory is based. Assuming that there are no other factors that influence the distribution of industry, except transportation costs. Then it is clear that the Location of industry will be pulled to those locations which have the lowest transportation costs. The key factors that determine transportation costs are

(i) the weight to be transported and

(ii) the distance to be covered.

Weber lists some more factors which influence the transportation costs such as

(a) the type of transportation system and the extent of its use,

(b) the nature of the region and kinds of roads,

(c) the nature of goods themselves, i.e., the qualities which, besides weight, determine the facility of transportation.

However, the location of the place of production must be determined in relation to the place of consumption and to the most advantageously located material deposits. Thus, 'locational figures' are created. These locational figures depends upon

(a) The type of material deposits and

(b) The nature of transformation into products.

Weber classifies and calls those raw materials, which are available practically everywhere as 'ubiquities' (like brick-clay, water, etc) and 'localised' (like iron-ore, minerals, wood, etc) which are available only in certain regions. It is clear that localized materials play a more important role on the industry than the ubiquities. Further, regarding the nature of the transformation of materials into products, Weber categorized the raw materials as 'pure' and 'weight losing'. Pure materials impart their total weight to the products (eg. cotton, wool, etc) and the materials are said to be 'weight losing' if only a part enters into the product (eg. wood, coal, etc.). Hence, the location of industries using weight-losing materials is drawn towards their deposits and that of industries using pure-materials towards the consumption centres.

Weber further examines the cause of deviation of industrial location from the centres of least transport costs. The existence of differences in labour costs leads an industry to deviate from the optimal point of transport orientation. Geographical distribution of the population would give rise to differences in wages for labour. Naturally, the transport oriented location of an industry is drawn out and attracted towards the cheaper labour centres. Such migration of an industry from a point of minimum transport costs to a cheaper labour centre may be likely to occur only where the savings in the cost of labour are larger than the additional costs of transport which it ought to incur.

II. Secondary Causes (Agglomerative and Deglomerative Factors

An agglomerative factor is an advantage or a cheapening of production or marketing which results from the fact that production is carried on at one place. A deglomerative factor is a cheapening of production which results from the decentralization of production i.e., production in more than one place. To some extent these agglomerative and deglomerative factors also contribute to local accumulation and distribution of industry.

These factors will operate only within the general framework formed by the two regional factors, i.e., costs of transportation and costs of labour. The advantages which could be derived in this context are external economies.

The pulls which the agglomerative factors possess to attract an industry to a particular point are mainly dependent on two factors. Firstly, on 'the index of manufacture' (the proportion of manufacturing costs to the total weight of the product) and secondly, on the 'locational weight' (the total weight to be transported during all the stages of production).

To deduce a general principle, Weber uses the concept of "co-efficient of manufacture" which is the ratio of manufacturing cost to locational weight. Agglomeration is encouraged with high co-efficient of manufacture and deglomeration with low coefficient of manufacture and these tendencies are inherent in their nature.

Split Location:

Productive activities could be divided depending on the nature of raw-materials, industry and market. Weber considers the location for an industry at more than one place.

According to Weber, a split of production into several locations will be the rule for productive process which can technically be split. For instance, the first stage of production may be near the raw material deposits and the subsequent stages near the place of final consumption. Likewise, in a paper industry the manufacture of pulp may be carried on near the supplies of the raw materials and the second stage of paper manufacture near the consumption outlet.

Locational Coupling:

Weber also conceived the advantages of setting up different types of industries in the same locality. The production of quite different articles may be combined in one plant because several raw materials may diverge from a common source. This may be either due to technical or economic reasons: for instance, certain chemical industries, garments factories which manufacture over-coats, shawls, blouses, etc. Locational coupling may also occur due to connection through materials. If the by-product of an industry happens to be the raw material of another industry, then the two industries may select a single place of location. For instance, the dye-stuff industry is connected with other industries using coke, because coal tar (upon which the dye-stuff industry is based) is a by-product of the burning coke.

5.2 Criticisms:

Weber's theory of location has been criticized on various grounds which may be summarized as follows:

1. Weber has been criticized for his unrealistic approach and deductive reasoning. According to Sargant Florence, vague generalizations cannot provide suitable solutions to the theory of location as non-economic considerations will also influence which are not mentioned in the pure theory. He says that Weber's theory fails to explain locations resulting from historical and social forces.

2. A.Predohl criticizes Weber's theory as more a selective theory than a deductive theory. The very distinction between primary and secondary is itself artificial, illogical and arbitrary.

3. Weber assumes fixed labour centres and unlimited supplies of labour which are unrealistic. The rise of industry may create new labour centres and we cannot assume unlimited labour supplies at any centre.

4. In a competitive market structure, the assumption of fixed points of consumption is unrealistic. Country-wise scattering, usually, of consuming public is a reality and there may be a shift in the consuming centres with a shift in industrial population.

5. A. Robinson also considers Weber's division of raw materials into 'ubiquities' and 'localised' as artificial.

Weber's deductive theory of location, in spite of the shortcomings, is the only theory which has been no enjoying the universal acceptance and application, as all the other alternative suggestions are neither complete or comprehensive.

5.3 SARGENT FLORENCE'S THEORY

Professor Sargent has followed the inductive method in formulating his theory of location. Sargent's theory is more practical and realistic than that given by Weber. After properly analyzing statistical data, Sargent tried to ascertain the tendency of location of industries. On the basis of production census he has tried to find out the statistical measures of location and has not accepted the traditional view of the geographical context, not the region or area as such but the working population in that area is more important. Sargent has used two new concepts in his theory of location.

5.4 Factors:

They are:

(i) Location factor and

(ii) Coefficient of localization.

(i) Location factor:

Location factor indicates the centralization or otherwise of an industry. If the location factor index is greater than unity, there is a tendency of centralization; on the other hand, if it is less than unity, the otherwise is true. In case of unity, a state of evenness exists this indicates that there is neither centralization nor decentralization.

ii. Coefficient of localization:

Coefficient of localization indicates the propensity of concentration of industries. The coefficient is the sum (divided by 100) of the deviations of the regional percentages of workers in the particular industry from the corresponding regional percentages of workers in all country

5.5 Criticism of Sargent Florence's Theory:

Following are the points of criticism against the theory of location given by Florence:

1. Ignorance of causes of location:

2. The theory tells only whether the industry is centralized or decentralised but does not give the causes of such a tendency.

3. Difficulty of knowing propensity of localization:

4. It is difficult to know only on the basis of coefficient of localization whether there is propensity of centralization or decentralization.

5. Ignorance of favourable local conditions:

6. The theory does not care for the favourable local factors influencing centralisation of industries.

7. Absence of knowledge of productive capacity:

The theory given by Florence emphasizes the number of workers in calculating the index and coefficient but ignores production. It is difficult to know the productive capacity of different areas. In spite of these deficiencies the theory at least suggests a way to know the tendency of localization of industries.

5.6 FACTORS INFLUENCING PLANT LOCATION

Generally, location of industries is influenced by economic considerations though certain non-economic considerations also might influence the location of some industries. Maximisation of profit which also implies cost minimization is the most important goal in their choice of particular places for the location of industries. There are several factors which pull the industry to a particular place. Some of the major factors influencing location are discussed below:

Factors affecting Plant Location

- Nearness to Raw Material
- Transport Facilities
- Nearness to Markets
- Availability of Labour
- Availability of Fuel & Power
- Availability of Water
- Climatic conditions
- Financial & other aids
- Land
- Community Attitude
- Presence of related industries
- Existence of Housing facilities, Hospitals, Schools, Banks etc.
- Local bye laws, taxes
- Facilities for expansion
- Security

1. Availability of raw materials: In determining the location of an industry, nearness to sources of raw material is of vital importance. Nearness to the sources of raw materials would reduce the cost of production of the industry. For most of the major industries, the cost of raw materials form the bulk of the total cost. Therefore, most of the agro-based and forest-based industries are located in the vicinity of the sources of raw material supply.

2. Availability of Labour: Adequate supply of cheap and skilled labour is necessary for and industry. The attraction of an industry towards labour centres depends on the ratio of labour cost to the total cost of production which Weber calls 'Labour cost of Index'. The availability of skilled workers in the interior parts of Bombay region was one of the factors responsible for the initial concentration of cotton textile industry in the region.

3. Proximity to Markets: Access to markets is an important factor which the entrepreneur must take into consideration. Industries producing perishable or bulky commodities which cannot be transported over long distance are generally located in close proximity to markets. Industries located near the markets could be able to reduce the costs of transport in distributing the finished product as in the case of bread and bakery, ice, tins, cans manufacturing, etc. Accessibility of markets is more important in the case of industries manufacturing consumer goods rather than producer goods.

4. Transport Facilities: Transport facilities, generally, influence the location of industry. The transportation with its three modes, i.e., water, road, and rail collectively plays an important role. So the junction points of water-ways, roadways and railways become humming centres of industrial activity. Further, the modes and rates of transport and transport policy of

Government considerably affect the location of industrial units. The heavy concentration of cotton textile industry in Bombay has been due to the cheap and excellent transportation network both in regard to raw materials and markets.

5. Power: Another factor influencing the location of an industry is the availability of cheap power. Water, wind, coal, gas, oil and electricity are the chief sources of power. Both water and wind power were widely sought at sources of power supply before the invention of steam engine. During the nineteenth century, nearness to coal-fields became the principal locating influence on the setting up of new industries, particularly, for heavy industries. With the introduction of other sources of power like electricity, gas, oil, etc. the power factor became more flexible leading to dispersal and decentralization of industries.

6. Site and Services: Existence of public utility services, cheapness of the value of the site, amenities attached to a particular site like level of ground, the nature of vegetation and location of allied activities influence the location of an industry to a certain extent. The government has classified some areas as backward areas where the entrepreneurs would be granted various incentives like subsidies, or provision of finance at concessional rate, or supply of power a cheaper rates and provision of education and training facilities. Some entrepreneurs induced by such incentives may come forward to locate their units in such areas.

7. Finance: Finance is required for the setting up of an industry, for its running, and also at the time of its expansion. The availability of capital at cheap rates of interests and in adequate amount is a dominating factor influencing industrial location. For instance, a review of locational history of Indian cotton textile industry indicates that concentration of the industry in and around Bombay in the early days was mainly due to the presence of rich and enterprising Parsi and Bhatia merchants, who supplied vast financial resources.

8. Natural and Climatic Considerations: Natural and climatic considerations include the level of ground, topography of a region, water facilities, drainage facilities, disposal of waste products, etc. These factors sometimes influence the location of industries. For instance, in the case of cotton textile industry, humid climate provides an added advantage since the frequency of yarn breakage is low. The humid climate of Bombay in India and Manchester in Britain offered great scope for the development of cotton textile industry in those centres.

9. Personal Factors: In deciding location of industrial units, sometimes an entrepreneur may have personal preferences and prejudices against certain localities. For instance, Mr. Ford started to manufacture motor cars in Detroit simply because it was his home-town. In such cases, personal factor dominates other considerations. However, this kind of domination is rare.

10. Strategic Considerations: In modern times, strategic considerations are playing avital role in determining industrial location. During war-time a safe location is assuming special significance. This is because in times of war the main targets of air attacks would 11. External Economies: External economies also exert considerable influence on the location of industries. External economies arise due to the growth of specialized subsidiary activities when a particular industry is mainly localized at a particular centre with port and shipping facilities. External economies could also be enjoyed when a large number of industrial units in the same industry were located in close proximity to one another.

12. Miscellaneous Factors: Historical incidents also play a dominating role in determining the location of industries in certain cases. The development of cotton-textile industry in Lancashire provides an interesting example for this. Further, the size of and industrial unit would also have much influence in choosing location. This is because the size of industrial units depends upon the radius of the circle within which they can profitably distribute their goods and upon the density of population living within the circle.

The size of a business unit means the size of a business firm. It means the scale or volume of operation turned out by a single firm. The study of the size of a business is important because it significantly affects the efficiency and profitability of the firm. .One of the most important entrepreneurial decisions in organizing a business is realizing its 'size' as it affects in company and profitability of business enterprises. The term' size of businesses refers to the scale of organization and operations of a business enterprise. It is essential here to have a clear understanding of the terms' size' of the 'plant' size of 'firm' and the size of the industry.'

A 'plant' means an establishment of the manufacturing of goods. It represents a production unit where the due provision of all the activities facilitating the production process as made.

A 'firm' means as an organization that owns manages and controls a plant or number of plants and also arranges for the marketing of products, provision of finance, and other facilities to run the organization. The term industry' implies the aggregate of all firm which manufacture similar types of products.

5.7 Measures of Size

Business firms vary in size-small, medium, and large. To measure the size of a business unit, the standards of measurement can be grouped into the following two categories.

1. Measures About Input

This includes capital employed, net worth, total assets, labor employed, and raw material and power consumed.

a. Capital employed

The capital includes owned capital and borrowed capital. The larger the amount of capital employed, the larger the size of the firm.

b. Net worth

Net worth is the excess of assets over liabilities, as shown in the balance sheet of a firm. However, for all practical purposes, it refers to the amount of paid-up capital plays reserves and surpluses built up during business. This measure is appropriate for comparing the size of different firms in an industry or to measure the rate of growth for a particular firm.

c. Total assets

Another measure of size if the size of the total assets of a firm.

The value of total assets is calculated by taking into account the amount invested in fixed (land, building, plant, and machinery), current (cash, short-term securities, stock, debtors, etc.) and intangible assets (goodwill, planet, rights, etc.).

d. Labor employed

The number of laborers employed in a firm is another measure commonly employed to measure the size of the business, which is producing similar types of goods and which are in the same stage of development.

e. Amount of raw materials and power consumed.

The quantity or value of raw materials and power used is yet another measure that can be used to adjudge a firm.

2. Measure about Output

This includes a volume of output, the value of output, and value-added.

a. The volume of output

The number of goods produced or services rendered may also serve as a good basis for comparison between firms. The greater the number of goods and services produced, the larger the size.

b. Value of Output

The monetary value of goods and services produced by a firm also serves as a basis for measuring the size of a firm.

c. Value Added

A useful variation or combination of the two output criteria is the measure of net valueadded, calculated by deducting the costs of production from the value of production.

It must be mentioned here that no one measure is fully comprehensive, and the accuracy, adequacy, and utility of each standard will depend upon three factors – nature of industry and character of its output, the uniformity and accuracy of data available, and the purpose for which it is required.

On the whole, the output seems to be the best indicator to measure the size of the firm.

5.8 Factors Affecting the Size of the Firm

The main factors that affect the size of the firm are as follows:

1. Nature of Industry

The nature of the industry has a direct influence on the size of the firm. Manufacturing industries are, by and large, bigger compared to trading and service firms. Manufacturing industries heavy machinery, produce goods on a large scale, make higher capital investments, and therefore large.

2. Nature of Products

When the product is less standardized, the size of the firm is often small when the product is standardized, complex, and durable; the size of the firm is often big.

3. Capital employed

When the capital involved is large, and the firm can raise it, the size of the firm is large, when the capital involved in small, the size of such a unit will be small.

4. Size of the market

If the size of the market is large for the product, the firm will also be large and vice-versa.

5. Quality of management

The competence and integrity of management largely determine the size of a business unit. If the management is competent to manage the complex tasks of modern business, the firm can afford to be large.

5.9 Various Concepts about the Size of Business Unit

The size of the firm is one of the decisive factors in the achievement of efficiency in its operations. In these days, large-scale production is considered to bring most economic results by the way of lower costs and higher returns. Therefore, there has been a tendency Towards increase in the size of the industrial units in order to organise mass production and bulk sales in diversified markets.

The problem of size is intimately connected with the laws of increasing and decreasing returns and the principles of division of labour. Naturally, therefore, economists have been concerned with this problem and they have developed various concepts of the size of business unit.

More important of them are:

(1) The Concept of Representative Firm by Alfred Marshall.

(2) The Concept of Equilibrium Firm by Pigou.

(3) The Concept of Optimum Firm by E.A.G, Robinson.

1. The Representative Firm:

The concept of Representative Firm was introduced by Alfred Marshall. The representative firm as defined by Marshall is essentially an average firm which has been running with normal success over a sufficiently long period of time. Such a firm can naturally be found

2. The Equilibrium Firm:

The concept of 'Equilibrium Firm' was introduced by Pigou, An equilibrium firm is one which has reached a stage where there is no urge for the entrepreneur to expand further. In other words, a firm is said to be in equilibrium when the entrepreneur is so much satisfied with its profitability that he does not want any further expansion or reduction in its size.

3. The Concept of Optimum Firm:

The concept of optimum firm has been developed by E.A.G. Robinson. In his words by the optimum firm we must mean that firm which in existing conditions of technique and organising ability has the lowest average cost of production per unit, when all those costs which must be concerned in the long run are included.

So long as the firm has not reached that size it will continue growing. As Beacham wrote: "In an ideal world all firms should grow upto the point at which they are

making the most effective and economical use of productive resources. That is to say, all firms should expand until they reach their optimum size."

5.10 The Optimum Size of Business

From an economic point of view, every business organization should expand as long as its average per-unit cost is just equal to that of its marginal cost. In simple words, when the factors of production-land, labor, capital, and organization can affect maximum returns at their minimum involvement, the economics consider that as the best, and the most desired size of business.

A firm with this-sat and volume of operation may ensure minimum unit cost, but a maximum return is known as the optimum firm.

"By the optimum firm," says E.A.G. Robinson, "we must mean that firm which, in exiting conditions of techniques and organizing ability has the lowest average cost of production per unit, when all those costs which must be covered in the long run are included."

The implications of this definition are as follows;

1. The point to be considered is the average cost of production and not-profits. The average cost means the total cost divided by the total output. Total cost includes all costs, including depreciation, interest, and a reasonable margin of profit.

2. Optimum size is a moving point and depends upon technological and managerial developments. Thus the optimum size is a relative and dynamic concept and static. That is why the optimum size of firms will vary in different industries where different technical, marketing, and financial conditions are encountered.

5.11 The Rationale of the Concept of Optimum Size

A firm of optimum size is brought into existence partly by the conscious decisions of a businessman who are considering how they can invest their resources profitably and partly by the forces of competition, which tend to eliminate the inefficient and encourage efficiency.

The optimum size, can, however, be achieved only.

1. If the size of the market is sufficient to absorb the whole production of at least one firm of such a size and

2. If product competition prevails in the market so that prices charged by the firms tend to be equalized.

The state of perfect competition is hardly encountered in practice, and hence the concept of optimum size is generally considered to be of least practice relevance.

However, it is not without practical utility. It motivates the businessmen to bring down the cost of production to the maximum possible extent through the use of better techniques of production and better management methods.

The concept of an optimum firm represents a simple analysis of the problem of determining an efficient size for a firm and the factors which should be taken into account while deciding upon a desirable scale of operations in the process of growth.

5.12 Factors influencing Optimum Size of firm:

The following are the factors that influence the optimum size of a firm:

a. Technical forces

b. Managerial forces

c. Financial forces

d. Marketing forces

e. Forces of risk and fluctuations

1. Technical forces influence size of a firm

Technical forces which influence the optimum size of firm are degree of specialization (division of labour), mechanization and integration of work processes. In the case of division of labor, a job is split into small functions and each function is assigned to a specific workman. When a workman performs a specific operation over a long period of time, the skill of the workman, speed of performance, quality of work etc improve.

Division of labor facilitates mechanization. A firm has to be fairly large enough to go in for mechanization. A large firm producing standardized products can go for assembly line manufacturing which increases output and results in lower cost of output. Another advantage is a large scale firm can go in for integration of processes. Manual labor can be replaced by machines. Technical factors favour expansion of an organization. The size of the optimum firm will be large if

1. the product or machinery used for manufacturing is large in size (e.g. ship building, aircraft manufacturing, iron and steel plants, heavy machinery etc)

2. the industry is a public utility (power generation and distribution, railways etc.)

3. the industry produces intricate, complex products (computer chips, semi conductors, watches etc). In case then industry produces products of a small size or the machinery used in Manufacturing is small in size, the optimum size would be small (e.g. small machine tools etc).

2. Managerial forces influence size of business units

Managing an organization today is a complex task. The services of qualified, experienced, professionals are required to run the organization in an efficient manner. Therefore businesses which desire to maximize their sales and profitability need to appoint a competent management team. To appoint such personnel, high amounts of remuneration and benefits have to be paid. Only large organizations would be able to offer such high remuneration levels. The expert managers using their ability and skills can ensure the growth of the business in various spheres. But there is a limit to which expert management can grow the organization.

3. Financial forces influence size of a business unit

Investors have more confidence in large and established firms. They prefer to invest their money in large Firms because of the possibility of earning high returns. Investors generally do not prefer to invest in new or small firms because they feel that such investment is risky and the possibility of earning high returns is also less. Therefore large firms are able to raise required financial resources easily. Banks also come forward to lend loans at cheaper rates of interest and therefore cost of funds is also less for large firms.

In case of financial difficulties they can transfer funds from one division to another. Though a

large firm is able to raise resources from outside resources, there is also a limitation. There may be interference in the management of the firm by outsiders. The Board of directors are answerable to shareholders, and financial institution such as IFCI, ICICI or IDBI which advance loans might require that their representative should be in the Board of directors. This sort of interference will result in management losing its independence, delayed decisions, disharmony and loss of efficiency.

4. Marketing forces influence size of business

A large firm can enjoy economies of buying and selling. Since it buys raw materials in bulk quantities it can enjoy the benefits of quantity discounts. It can employ experts for purchase. They would be able to source quality raw materials at cheaper prices. Similarly experts can be employed for marketing their products. In case a large firm has multiple products the sales force can market the entire range of products.

Advertisement time in media can be bought in bulk at cheaper rates. The organization can employ reputed market research agencies to know the changing needs and preference of consumers and produce products accordingly. But the large firm cannot have close contact with the customers and understand their requirements whereas a small firm can do so. Any mistake done by a large firm would result in huge losses. Suppose a large firm buys raw material and later find is unsuitable, it would find it very difficult to dispose it because of the bulk quantity.

5.13 Summary

plant location theories explain **where** a business or industry should be placed to minimize costs, maximize profits, and operate efficiently. Good location decisions reduce transportation costs, improve access to raw materials, labor, and markets, and enhance long-term competitiveness.

1. Weber's Theory of Industrial Location

- Proposed by Alfred Weber.
- Focuses on **minimizing transportation cost**.
- Industries should locate where the combined cost of shipping raw materials to the plant and finished goods to the market is lowest.
- Also considers **labor cost** and **agglomeration** (benefits of industries clustering together).

2. Sargent Florence Theory

- Emphasizes **economies of scale**.

- Industries should locate where they can maximize **internal** (within the firm) and **external** (within the region) economies.

5.14 Key words

1. Agglomeration

When firms cluster together to share resources, labor, and infrastructure, reducing costs.

2. Transportation Cost

The cost of moving raw materials to the plant and finished goods to the market — a key factor in Weber's theory.

3. Raw Material Oriented Industry

Industries located near raw materials (e.g., steel, sugar) because inputs are bulky or heavy.

4. Market-Oriented Industry

Industries located near consumers (e.g., bakery, beverages) because products are perishable or transport-sensitive.

5. Economies of Scale

Cost advantages gained when production increases; emphasized by Sargent Florenc

5.15 REVIEW QUESTIONS

1. What do you understand by Plant Layout?
2. What are the advantages of good plant layout?
3. What is the significance of the Sergeant Florence Theory in decisions related to plant location?
4. What are the classical types of plant layout? What are their advantages and disadvantages ?
5. Explain why business site, selection of equipment, and type of building must be considered simultaneously in the development of plant layout?
6. What points will you bear in mind while constructing the building for factory?

5.16 Reference books

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LESSON-6

NEW ECONOMIC POLICY

Objectives

To understand the Measures in the New Economic Policy
To Know the steps taken by Globalization
To Discuss the Advantages and Disadvantages of privatization

Structure

6.1 Introduction

New Economic Policy of India was launched in the year 1991 under the leadership of P. V. Narasimha Rao. This policy opened the door of the India Economy for the global exposure for the first time. In this New Economic Policy P. V. Narasimha Rao government reduced the import duties, opened reserved sector for the private players, and devalued the Indian currency to increase the export. This is also known as the LPG Model of growth.

New Economic Policy refers to economic liberalisation or relaxation in the import tariffs, deregulation of markets or opening the markets for private and foreign players, and reduction of taxes to expand the economic wings of the country.
Manmohan Singh is considered to be the father of New Economic Policy (NEP) of India. Manmohan Singh introduced the NEP on July 24, 1991.

The main objectives behind the launching of the New Economic policy (NEP) in 1991 by the union Finance Minister Dr. Manmohan Singh are stated as follows:

a. The main objective was to plunge Indian Economy in to the arena of 'Globalization and to give it a new thrust on market orientation.
b. The NEP intended to bring down the rate of inflation.
c. It intended to move towards higher economic growth rate and to build sufficient foreign exchange reserves.
d. It wanted to achieve economic stabilization and to convert the economy into a market economy by removing all kinds of un-necessary restrictions.
e. It wanted to permit the international flow of goods, services, capital, human resources and technology, without many restrictions.
f. It wanted to increase the participation of private players in the all sectors of the economy. That is why the reserved numbers of sectors for government were reduced. As of now this number is just.

Beginning with mid-1991, the govt. has made some radical changes in its policies related to foreign trade, Foreign Direct Investment, exchange rate, industry, fiscal discipline etc. The various elements, when put together, constitute an economic policy which marks a big departure from what has gone before.

The thrust of the New Economic Policy has been towards creating a more competitive environment in the economy as a means to improving the productivity and efficiency of the system. This was to be achieved by removing the barriers to entry and the restrictions on the growth of firms.

6.2 Main Measures Adopted in the New Economic Policy

Due to various controls, the economy became defective. The entrepreneurs were unwilling to establish new industries (because laws like MRTP ACT 1969 de-motivated entrepreneurs). Corruption, undue delays and inefficiency risen due to these controls. Rate of economic growth of the economy came down. So in such a scenario economic reforms were introduced to reduce the restrictions imposed on the economy.

Following steps were taken under the Liberalization measure

a. Free determination of interest rate by the Commercial Banks

Under the policy of liberalisation interest rate of the banking system will not be determined by RBI rather all commercial Banks are independent to determine the rate of interest.

b. Increase in the investment limit for the Small Scale Industries

Investment limit of the small scale industries has been raised to Rs. 1 crore. So these companies can upgrade their machinery and improve their efficiency

c. Freedom to import capital goods

Indian industries will be free to buy machines and raw materials from foreign countries to do their holistic development.

d. Freedom for expansion and production to Industries

In this new liberalized era now the Industries are free to diversify their production capacities and reduce the cost of production. Earlier government used to fix the maximum limit of production capacity. No industry could produce beyond that limit. Now the industries are free to decide their production by their own on the basis of the requirement of the markets.

e. Abolition of Restrictive Trade Practices

According to MRTP ACT 1969, all those companies having assets worth Rs. 100 crore or more were called MRTP firms and were subjected to several restrictions. Now these firms have not to obtain prior approval of the Govt. for taking investment decision. Now MRTP Act is replaced by the competition Act, 2002.

6.3 Liberalisation

Removal of Industrial Licensing and Registration:
Previously private sector had to obtain license from Govt. for starting a new venture. In this policy private sector has been freed from licensing and other restrictions.

Industries licensing is necessary for following industries:
(i) Liquor
(ii) Cigarette
(iii) Defence equipment
(iv) Industrial explosives
(v) Drugs
(vi) Hazardous chemicals

6.4 Privatisation

Simply speaking, privatisation means permitting the private sector to set up industries which were previously reserved for the public sector. Under this policy many PSU's were sold to private sector. Literally speaking, privatisation is the process of involving the private sector in the ownership of Public Sector Units (PSU's).

The main reason for privatisation was in currency of PSU's are running in losses due to political interference. The managers cannot work independently. Production capacity remained under-utilized. To increase competition and efficiency privatisation of PSUs was inevitable.

6.5 Step taken for Privatisation

The following steps are taken for privatisation

1. Sale of shares of PSUs

Indian Govt. started selling shares of PSU's to public and financial institution e.g. Government sold shares of Maruti Udyog Ltd. Now the private sector will acquire ownership of these PSU's. The share of private sector has increased from 45 per cent to per cent.

2. Disinvestment in PSU's

The Govt. has started the process of disinvestment in those PSU's which had been running into loss. It means that Govt. has been selling out these industries to private sector.

Govt. has sold enterprises worth Rs. 30,000 crores to the private sector.

3. Minimisation of Public Sector

Previously Public sector was given the importance with a view to help in industrialisation and removal of poverty. But these PSU's could not able to achieve this objective and policy of contraction of PSU's was followed under new economic reforms. Number of industries reserved for public sector was reduces from 17 to 2.

(a) Railway operations

(b) Atomic energy.

6.6 Globalization

Literally speaking Globalisation means to make Global or worldwide, otherwise taking into consideration the whole world. Broadly speaking, Globalisation means the interaction of the domestic economy with the rest of the world with regard to foreign investment, trade, production and financial matters.

6.7 Steps taken for Globalisation

Following steps are taken for Globalisation

(i) Reduction in tariffs

Custom duties and tariffs imposed on imports and exports are reduced gradually just to make India economy attractive to the global investors.

(ii) Long term Trade Policy

Forcing trade policy was enforced for longer duration. Main features of the policy are:

(a) Liberal policy

(b) All controls on foreign trade have been removed

(c) Open competition has been encouraged.

(iii) Partial Convertibility of Indian currency

Partial convertibility can be defined as to convert Indian currency (up to specific extent) in the currency of other countries. So that the flow of foreign investment in terms of Foreign Institutional Investment (FII) and foreign Direct Investment (FDI).

This convertibility stood valid for following transaction:

(a) Remittances to meet family expenses.

(b) Payment of interest.

(c) Import and export of goods and services.

(iv) Increase in Equity Limit of Foreign Investment

Equity limit of foreign capital investment has been raised from 40% to 100% percent. In 47 high priority industries foreign direct investment (FDI) to the extent of 100%will be allowed without any restriction. In this regard Foreign Exchange Management Act (FEMA) will be enforced.

If the Indian economy is shining at the world map currently, its sole attribution goes to the implementation of the New Economic Policy in 1991.

6.8 Privatisation

Privatisation means the transfer of ownership and management of an enterprise from the public sector to private sector. It also means the withdrawal of the state from an industry or sector, partially or fully. It as an economic policy has been gathering momentum throughout the world since 1980.

This trend is gathering ground even in socialist and communist countries to make the economy market oriented.

Privatisation can suggest several things, including migrating something from the public sector into the private sector. It is also seldom used as a metonym for deregulation when a massively regulated private firm or industry becomes less organised. Government services and operations may also be (denationalised) privatised; in this circumstance, private entities are tasked with the application of government plans or execution of government assistance that had earlier been the vision of state-run companies. Some instances involve law enforcement, revenue collection, and prison management.

Privatisation of the public sector companies by selling off part of the equity of PSEs to the public is known as disinvestment.

6.9 Objectives Of Privatisation

1. Providing strong momentum to the inflow of FDI.
2. Privatisation aims at providing a strong base to the inflow of FDI.
3. Increased inflow of FDI improves the financial strength of the economy.
4. Improving the efficiency of public sector undertaking (PSU's).
5. The efficiency of PSU's was improved by giving them the autonomy to make decisions.
6. Some companies were given a special category of Navratna and Mini-Ratna.

6.10 Ways of Privatization

Government companies are transformed into private companies in 2 ways,

Transfer of Ownership
Government companies can be converted into private companies in two ways :
By withdrawal of the government from ownership and management of public sector companies.
By outright sale of public sector companies.

Disinvestment
Privatisation of the public sector undertakings by selling off part of the equity of PSUs to the private sector is known as disinvestment.
The purpose of the sale is mainly to improve financial discipline and facilitate modernization.
However, there are six methods of Privatisation:

1. The public sale of shares
2. Public auction

3. Public tender
4. Direct negotiations
5. Transfer of control of State or municipally controlled enterprises
6. Lease with a right to purchase

6.11 Advantages Of Privatisation

1. Improved efficiency

The main argument for privatisation is that private companies have a profit incentive to cut costs and be more efficient. If you work for a government run industry managers do not usually share in any profits. However, a private firm is interested in making a profit, and so it is more likely to cut costs and be efficient. Since privatisation, companies such as BT, and British Airways have shown degrees of improved efficiency and higher profitability.

2. Lack of political interference

It is argued governments make poor economic managers. They are motivated by political pressures rather than sound economic and business sense. For example, a state enterprise may employ surplus workers which is inefficient. The government may be reluctant to get rid of the workers because of the negative publicity involved in job losses. Therefore, state-owned enterprises often employ too many workers increasing inefficiency.

3. Short term view

A government many think only in terms of the next election. Therefore, they may be unwilling to invest in infrastructure improvements which will benefit the firm in the long term because they are more concerned about projects that give a benefit before the election. It is easier to cut public sector investment than frontline services like healthcare.

4. Shareholders

It is argued that a private firm has pressure from shareholders to perform efficiently. If the firm is inefficient then the firm could be subject to a takeover. A state-owned firm doesn't have this pressure and so it is easier for them to be inefficient.

5. Increased competition

Often privatisation of state-owned monopolies occurs alongside deregulation – i.e. policies to allow more firms to enter the industry and increase the competitiveness of the market. It is this increase in competition that can be the greatest spur to improvements in efficiency. For example, there is now more competition in telecoms and distribution of gas and electricity.

7. Government will raise revenue from the sale

Selling state-owned assets to the private sector raised significant sums for the UK government in the 1980s. However, this is a one-off benefit. It also means we lose out on future dividends from the profits of public companies.

6.12 Disadvantages Of Privatisation

1. **Natural monopoly**

A natural monopoly occurs when the most efficient number of firms in an industry is one. For example, tap water has very significant fixed costs. Therefore there is no scope for having competition amongst several firms. Therefore, in this case, privatisation would just create a private monopoly which might seek to set higher prices which exploit consumers. Therefore it is better to have a public monopoly rather than a private monopoly which can exploit the consumer.

2. Public interest

There are many industries which perform an important public service, e.g., health care, education and public transport. In these industries, the profit motive shouldn't be the primary objective of firms and the industry. For example, in the case of health care, it is feared privatising health care would mean a greater priority is given to profit rather than patient care. Also, in an industry like health care, arguably we don't need a profit motive to improve standards. When doctors treat patients, they are unlikely to try harder if they get a bonus.

3. Government loses out on potential dividends

Many of the privatised companies in the UK are quite profitable. This means the government misses out on their dividends, instead going to wealthy shareholders.

4. Problem of regulating private monopolies

Privatisation creates private monopolies, such as the water companies and rail companies. These need regulating to prevent abuse of monopoly power. Therefore, there is still need for government regulation, similar to under state ownership.

5. Fragmentation of industries

In the UK, rail privatisation led to breaking up the rail network into infrastructure and train operating companies. This led to areas where it was unclear who had responsibility. For example, the Hatfield rail crash was blamed on no one taking responsibility for safety. Different rail companies has increased the complexity of rail tickets.

7. Short-termism of firms

As well as the government being motivated by short term pressures, this is something private firms may do as well. To please shareholders they may seek to increase short term profits and avoid investing in long term projects. For example, the UK is suffering from a lack of investment in new energy sources; the privatised companies are trying to make use of existing plants rather than invest in new ones.

Evaluation Of Privatisation

It depends on the industry in question. An industry like telecoms is a typical industry where the incentive of profit can help increase efficiency. However, if you apply it to industries like health care or public transport the profit motive is less important.

It depends on the quality of regulation. Do regulators make the privatised firms meet certain standards of service and keep prices low?

Is the market contestable and competitive? Creating a private monopoly may harm consumer interests, but if the market is highly competitive, there is greater scope for efficiency savings.

6.13 Rationale For Public Sector Enterprise In India

The ten rationales for setting up the public enterprises are:
1. Need for a Planned Economy.
2. Building Industrial Infrastructure.
3. Basic and Heavy Industries.
4. Public Utilities.
5. Defence Production.
6. Development of Backward Regions.
7. Fuller Employment.
8. Surplus for Economic Growth.
9. Preventing Concentration of Economic Power.
10. Socialistic Pattern of Society.

1. Need for a Planned Economy

For speeding up the process of economic growth, there is need for economic planning through Five-Year Plans. Through public sector enterprises, the Government can ensure planned development of the economy according to plan priorities – a task which cannot be expected to be performed by the private sector.

2. Building Industrial Infrastructure

Industrial infrastructure is necessary for rapid industrialisation and economic growth of the nation. This infrastructure consists of very basic facilities like transport, communication, power, irrigation, electricity, oil and gas, construction of roads, bridges etc. Projects of building infrastructure have a long gestation period with lesser return on investment and are not at all attractive to private sector businessmen. Hence the need for public sector to take up the task of building industrial infrastructure.

3. Basic and Heavy Industries

Basic and heavy industries include – iron and steel, coal, power, cement, fertilizers, petroleum etc. These industries are necessary for industrial development. These require huge capital investment, which is beyond the capacity of private entrepreneurs.

4. Public Utilities

Public utilities consisting of services like water supply, electricity, gas, public transportation etc. are necessary for people to lead a worth living life. The Government has to assume responsibility for providing such services to the public, at most reasonable prices, in the interest of public welfare.

5. Defence Production

Defence production consisting of goods and services needed for the defence forces of the country cannot be left to the whims (i.e. desires) of the private sector. Hence, public sector is needed to take care of defence items production in the most responsible way in the interest of national defence.

6. Development of Backward Regions

Private individuals are least willing to start industries in backward areas e.g. rural areas, hilly areas or otherwise neglected areas; because location of industries in such areas is not profitable at all, in initial stages. In view of the balanced regional development of the economy, Government itself starts setting up industries in such backward areas on its own initiative, cost and convenience.

7. Fuller Employment

One of the biggest aims of public section enterprises is to generate maximum employment opportunities in society, to help solve the serious and grave unemployment situation of the economy. Private enterprises also provide employment; but these do not emphasize on generating employment opportunities at the cost of their profit-earning techniques.

8. Surplus for Economic Growth

The surplus generated by public enterprises is available to the Government for investment in programmes of economic growth. In fact, taxation alone cannot provide huge funds for developmental purposes.

9. Preventing Concentration of Economic Power

Public sector enterprises keep a check on the monopolistic tendencies of the private sector; and prevent concentration of income and wealth in the hands of private individuals. In fact, good public enterprises are the biggest competitor for the private sector.

10. Socialistic Pattern of Society

Under the Constitution of India, the Government is committed to achieving the goal of a socialistic pattern of society. For this objective, there is a need to assign a significant role to the public sector.

6.14 Public Sector

The public sector in India owes its origin to the 1956 Industrial Policy Resolution of the GOI. This resolution provided for direct assumptions of responsibility by the state in relation to certain vital sectors of the economy. Example: State managed departments like Posts and Telegrams, Port Trusts, Salt and Quinine factories.

Forms Of Organisation

The public sector in India comprises of three of organization.
a. Administration by the Government department.
b. The Joint-Stock Company governed by Company Law and controlled by the Government as the principal major share; and
c. Public Co-operation proper.

6.15 Problems Of Public Sector

a. Pricing policy.
b. Under-Utilization of capacity.
c. Over Capitalisation.
d. Inefficient control over inventory
e. Delays in the completion of the projects and cost escalation.
f. Political interference and bureaucratic way of functioning.

6.16 Merits Of Public Sector

a. Strengthened the Industrial structure of the Economy.
b. Modernized the technological Base.
c. Changed the structure of foreign trade.
d. Promotion of social interest.

6.17 Demerits Of Public Sector

a. Public sector units cannot stand on their own legs.
b. Gross inefficiency.

Remedial Measures
a. Privatisation.
b. Marketing.
c. Improving efficiency of working in public sectors.
d. Balancing control and autonomy.

6.18 Summary

India's New Economic Policy (NEP) of 1991 was introduced to overcome a severe economic crisis. It aimed to shift the Indian economy from a closed, centrally planned model to a more open, market-oriented system. The policy rested on three pillars: Liberalisation, Privatisation, and Globalisation (LPG).

6.19 Key words

Liberalisation
Reducing government controls and restrictions in the economy. Encourage competition, increase efficiency, and attract investment. Removal of industrial licensing (except in a few industries), easier import rules.

Privatisation

Transferring ownership or management of public sector units (PSUs) to the private sector. Improve efficiency, reduce government burden, promote competitiveness. Disinvestment in PSUs; allowing private companies in sectors like telecom and aviation.

Globalisation

Integrating India's economy with the world economy. Increase trade, attract foreign investment, and expose domestic industry to global markets. Reduction in tariffs, opening up to FDI.

Foreign Direct Investment (FDI)
Investment by foreign companies in Indian industries. Brings capital, technology, and managerial skills

6.20 Self-Assessment Questions

1. Describe the key features of the New Economic Policy (1991).
2. How did privatisation change the role of the government in economic activities?
3. Discuss the impact of globalisation on India's economy.

6.21 Suggested Readings

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LESSON-7

GLOBALIZATION

Objectives

To Understand the Factors aiding globalization
To study the impact of Globalization in India
To Know the Socio-cultural impact of Indian Society

Structure

7.1 Introduction

Globalization has been defined as the process of rapid integration of countries and happenings through greater foreign trade and foreign investment. It is the process of international integration arising from the interchange of world views, products, ideas and other aspects of culture.

Globalisation is the phenomenon which has brought the world together at one platform where there is an apparent blurring of all differences in all aspects of contemporary life ranging from social, cultural, economic, political, life-styles etc.

It is a remarkable phenomenon by which many geographical and cultural barriers have come down gradually and the entire world has become a global village. It is the rapid expansion of communication and transportation which has reduced distances and generated an everlasting interdependence among people and nations at all levels.

7.2 Factors aiding globalisation

1) Technology: has reduced the speed of communication manifolds. The phenomenon of social media in the recent world has made distance insignificant.

The integration of technology in India has transformed jobs which required specialized skills and lacked decision-making skills to extensively-defined jobs with higher accountability that require new skills, such as numerical, analytical, communication and interactive skills. As a result of this, more job opportunities are created for people.

2) LPG Reforms: The 1991 reforms in India have led to greater economic liberalisation which has in turn increased India’s interaction with the rest of the world.

3) Faster Transportation: Improved transport, making global travel easier. For example, there has been a rapid growth in air-travel, enabling greater movement of people and goods across the globe.

4) Rise of WTO: The formation of WTO in 1994 led to reduction in tariffs and nontariff barriers across the world. It also led to the increase in the free trade agreements namong various countries.

5) Improved mobility of capital: In the past few decades there has been a general reduction in capital barriers, making it easier for capital to flow between different economies. This has increased the ability for firms to receive finance. It has also increased the global interconnectedness of global financial markets.

6) Rise of MNCs: Multinational corporations operating in different geographies have led to a diffusion of best practices. MNCs source resources from around the globe and sell their products in global markets leading to greater local interaction. These factors have helped in economic liberalization and globalization and have facilitated the world in becoming a "global village". Increasing interaction between people of different countries has led to internationalization of food habits, dress habits, lifestyle and views.

7.3 Globalization and India

Developed countries have been trying to pursue developing countries to liberalize the trade and allow more flexibility in business policies to provide equal opportunities to multinational firms in their domestic market. International

Monetary Fund (IMF) and World Bank helped them in this endeavour. Liberalization began to hold its foot on barren lands of developing countries like India by means of reduction in excise duties on electronic goods in a fixed time frame.

In 1991, Indian government did the same and liberalized the trade and investment due to the pressure from World Trade Organization. Import duties were cut down phase-wise to allow MNC's operate in India on equality basis. As a result globalization has brought to India new technologies, new products and also the economic opportunities.

7.4 Impacts Of Globalisation In India

Economic Impact

1. Greater Number of Jobs: The advent of foreign companies and growth in economy has led to job creation. However, these jobs are concentrated more in the services sector and this has led to rapid growth of service sector creating problems for individuals with low level of education. The last decade came to be known for its jobless growth as job creation was not proportionate to the level of economic growth.

2. More choice to consumers: Globalisation has led to a boom in consumer products market. We have a range of choice in selecting goods unlike the times where there were just a couple of manufacturers.

3. Higher Disposable Incomes: People in cities working in high paying jobs have greater income to spend on lifestyle goods. There has been an increase in the demand of products like meat, egg, pulses, organic food as a result. It has also led to protein inflation.

Negative Impacts

1. Protein food inflation contributes a large part to the food inflation in India. It is evident from the rising prices of pulses and animal proteins in the form of eggs, milk and meat. With an improvement in standard of living and rising income level, the food habits of people change. People tend toward taking more protein intensive foods. This shift in dietary pattern, along with rising population results in an overwhelming demand for protein rich food, which the supply side could not meet.

Thus resulting in a demand supply mismatch thereby, causing inflation.

In India, the Green Revolution and other technological advancements have primarily focused on enhancing cereals productivity and pulses and oilseeds have traditionally been neglected.

Shrinking Agricultural Sector: Agriculture now contributes only about 15% to GDP. The international norms imposed by WTO and other multilateral organizations have reduced government support to agriculture. Greater integration of global commodities markets leads to constant fluctuation in prices.

This has increased the vulnerability of Indian farmers. Farmers are also increasingly dependent on seeds and fertilizers sold by the MNCs.

Globalization does not have any positive impact on agriculture. On the contrary, it has few detrimental effects as government is always willing to import food grains, sugar etc. Whenever there is a price increase of these commodities.

Government never thinks to pay more to farmers so that they produce more food grains but resorts to imports. On the other hand, subsidies are declining so cost of production is increasing. Even farms producing fertilizers have to suffer due to imports. There are also threats like introduction of GM crops, herbicide resistant crops etc.

Increasing Health-Care costs: Greater interconnections of the world has also led to the increasing susceptibility to diseases. Whether it is the bird-flu virus or Ebola, the diseases have taken a global turn, spreading far and wide. This results in greater investment in healthcare system to fight such diseases.

Child Labour: Despite prohibition of child labor by the Indian constitution, over 60 to a 115 million children in India work. While most rural child workers are agricultural laborers, urban children work in manufacturing, processing, servicing and repairs. Globalization most directly exploits an estimated 300,000 Indian children who work in India’s hand-knotted carpet industry, which exports over $300 million worth of goods a year.

7.5 Socio-Cultural Impact on Indian Society

Nuclear families are emerging. Divorce rates are rising day by day. Men and women are gaining equal right to education, to earn, and to speak. ‘Hi’, ‘Hello’ is used to greet people in spite of Namaskar and Namaste. American festivals like Valentines' day, Friendship day etc. are spreading across India.

Access to education: On one hand globalisation has aided in the explosion of information on the web that has helped in greater awareness among people. It has also led to greater need for specialisation and promotion of higher education in the country.

On the flip side the advent of private education, coaching classes and paid study material has created a gap between the haves and have-nots. It has become increasingly difficult for an individual to obtain higher education.

Growth of cities: It has been estimated that by 2050 more than 50% of India's population will live in cities. The boom of services sector and city centric job creation has led to increasing rural to urban migration.

Indian cuisine: is one of the most popular cuisines across the globe. Historically, Indian spices and herbs were one of the most sought after trade commodities. Pizzas, burgers, Chinese foods and other Western foods have become quite popular.

Clothing: Traditional Indian clothes for women are the saris, suits, etc. and for men, traditional clothes are the dhoti, kurta. Hindu married women also adorned the red bindi and sindhur, but now, it is no more a compulsion. Rather, Indo-western clothing, the fusion of Western and Sub continental fashion is in trend. Wearing jeans, t-shirts, mini skirts have become common among Indian girls.

Indian Performing Arts: The music of India includes multiples varieties of religious, folk, popular, pop, and classical music. India's classical music includes two distinct styles: Carnatic and Hindustani music. It remains instrumental to the religious inspiration, cultural expression and pure entertainment. Indian dance too has diverse folk and classical forms.

Bharatanatyam, Kathak, Kathakali, Mohiniattam, Kuchipudi, Odissi are popular dance forms in India. Kalarippayattu or Kalari for short is considered one of the world's oldest martial art. There have been many great practitioners of Indian

Martial Arts including Bodhidharma who supposedly brought Indian martial arts to China.

The Indian Classical music has gained worldwide recognition but recently, western music is too becoming very popular in our country. Fusing Indian music along with western music is encouraged among musicians. More Indian dance shows are held globally. The number of foreigners who are eager to learn Bharatanatyam is rising.

Western dance forms such as Jazz, Hip hop, Salsa, Ballet have become common among Indian youngsters.

Negative impacts:

Nuclear Families: The increasing migration coupled with financial independence has led to the breaking of joint families into nuclear ones. The western influence of individualism has led to an aspirational generation of youth. Concepts of national identity, family, job and tradition are changing rapidly and significantly.

Old Age Vulnerability: The rise of nuclear families has reduced the social security that the joint family provided. This has led to greater economic, health and emotional vulnerability of old age individuals.

Pervasive Media: There is greater access to news, music, movies, videos from around the world. Foreign media houses have increased their presence in India. India is part of the global launch of Hollywood movies which is very well received here.

It has a psychological, social and cultural influence on our society. McDonaldization: A term denoting the increasing rationalization of the routine tasks of everyday life. It becomes manifested when a culture adopts the characteristics of a fast-food restaurant. McDonaldization is a reconceptualization of rationalization, or moving from traditional to rational modes of thought, and scientific management.

Walmartization: A term referring to profound transformations in regional and global economies through the sheer size, influence, and power of the big-box department store WalMart. It can be seen with the rise of big businesses which have nearly killed the small traditional businesses in our society.

Psychological Impact on Indian Society

Development of Bicultural Identity: The first is the development of a bicultural identity or perhaps a hybrid identity, which means that part of one's identity is rooted in the local culture while another part stems from an awareness of one's relation to the global world.

The development of global identities is no longer just a part of immigrants and ethnic sense of belonging to a worldwide culture, which includes an awareness of events, practices, styles and information that are a part of the global culture. Media such as television and especially the Internet, which allows for instant communication with any place in the world, play an important part in developing a global identity.

A good example of bicultural identity is among the educated youth in India who despite being integrated into the global fast paced technological world, may continue

to have deep rooted traditional Indian values with respect to their personal lives and choices such as preference for an arranged marriage, caring for parents in their old age.

Negative Impacts

1. Growth of Self-Selected Culture: means people choose to form groups with likeminded persons who wish to have an identity that is untainted by the global culture and its values. The values of the global culture, which are based on individualism, free market economics, and democracy and include freedom, of choice, individual rights, openness to change, and tolerance of differences are part of western values. For most people worldwide, what the global culture has to offer is appealing.

One of the most vehement criticisms of globalization is that it threatens to create one homogeneous worldwide culture in which all children grow up wanting to be like the latest pop music star, eat Big Macs, vacation at Disney World, and wear blue jeans, and Nikes.

2. Emerging Adulthood: The timing of transitions to adult roles such as work, marriage and parenthood are occurring at later stages in most parts of the world as the need for preparing for jobs in an economy that is highly technological and information based is slowly extending from the late teens to the mid-twenties.

Additionally, as the traditional hierarchies of authority weaken and break down under the pressure of globalization, the youth are forced to develop control over their own lives including marriage and parenthood. The spread of emerging adulthood is related to issues of identity.

3. Consumerism: Consumerism has permeated and changed the fabric of contemporary Indian society. Western fashions are coming to India: the traditional Indian dress is increasingly being displaced by western dresses especially in urban areas. Media- movies and serials- set a stage for patterns of behavior, dress codes and jargon. There is a changing need to consume more and more of everything.

7.6 Globalisation

Globalization 4.0 is latest stage of globalization which involves cutting-edge new technologies like artificial intelligence that powers forward with the explosion of information technology.

These technologies shrink distances, open up borders and minds and bring people all across the globe closer together.

Globalization 4.0 was the theme for World Economic Forum Annual Meeting 2019 held in Davos, Switzerland in January 2019.

Under the rubric of Globalization 4.0, a series of "Global Dialogues" in Davos focused on the interrelated areas namely geopolitics, future of global economy, global dialogue on industry systems etc.

7.7 Summary:

We cannot say that the impact of globalization has been totally positive or totally negative. It has been both. Each impact mentioned above can be seen as both positive as well as negative. However, it becomes a point of concern when, an overwhelming impact of globalization can be observed on the Indian culture.

Every educated Indian seems to believe that nothing in India, past or present, is to be approved unless recognized and recommended by an appropriate authority in the West. There is an all-pervading presence of a positive, if not worshipful, attitude towards everything in western society and culture, past as well as present in the name of progress, reason and science. Nothing from the West is to be rejected unless it has first been weighed and found wanting by a Western evaluation. This should be checked, to preserve the rich culture and diversity of India.

7.8 Key words

Globalisation-The process of increasing interconnectedness and interdependence among countries in terms of trade, investment, technology, culture, and communication.

Liberalisation of Trade-Removing trade barriers such as import duties, quotas, and restrictions. Allows free flow of goods and services between countries.

Foreign Direct Investment (FDI)- Investment made by a company or government from one country into another country. Brings capital, technology, and managerial skills.

Multinational Corporations (MNCs)- Companies that operate in more than one country.

Influence global trade, investment, and employment patterns.

7.9 Self Assessment Questions

1. Describe the key features of globalisation.

2. How has globalisation affected consumers and producers in developing countries like India?

3. Discuss the role of MNCs in the global economy.

4. What are the advantages and disadvantages of globalisation?

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LESSON-8

MANAGERIAL ECONOMICS

Objective

To Study the Nature of Managerial Economics
To Understand the Scope of Managerial Economics
To Identify the Role of Managerial Economics

Structure

8.1 Introduction

Economics is a study of human activity both at individual and national level. Any activity involved in efforts aimed at earning money and spending this money to satisfy our wants such as food, Clothing, shelter, and others are called "Economic activities".

It was only during the eighteenth century that Adam Smith, the Father of Economics, defined economics as the study of nature and uses of national wealth'.

8.2 Definition

Dr. Alfred Marshall, one of the greatest economists of the nineteenth century, writes "Economics is a study of man's actions in the ordinary business of life: it enquires how he gets his income and how he uses it".

Prof. Lionel Robbins defined Economics as "the science, which studies human behavior as a relationship between ends and scarce means which have alternative uses".

8.3 Microeconomics

The study of an individual consumer or a firm is called microeconomics.

Micro means 'one millionth'.
Microeconomics deals with behavior and problems of single individual and of micro organization.
It is concerned with the application of the concepts such as price theory, Law of Demand and theories of market structure and so on.

8.4 Macroeconomics

The study of 'aggregate' or total level of economic activity in a country is called macroeconomics.
It studies the flow of economics resources or factors of production (such as land, labor, ncapital, organization and technology) from the resource owner to the business firms and then from the business firms to the households.
It is concerned with the level of employment in the economy.
It discusses aggregate consumption, aggregate investment, price level, and payment, theories of employment, and so on.

Managerial Economics refers to the firm's decision making process. It could be also interpreted as "Economics of Management" or " Industrial economics " or "Business economics".

8.5 Nature of Managerial Economics:

1. **Close to microeconomics** :

Managerial economics is concerned with finding the solutions for different managerial problems of a particular firm. Thus, it is more close to microeconomics.

2. Operates against the backdrop of macroeconomics

The macroeconomics conditions of the economy are also seen as limiting factors for the firm to operate. In other words, the managerial economist has to be aware of the limits set by the macroeconomics conditions such as government industrial policy, inflation and so on.

3. Normative statements:
A normative statement usually includes or implies the words 'ought' or 'should'. They reflect people's moral attitudes and are expressions of what a team of people ought to do Such statement are based on value judgments and express views of what is 'good' or 'bad', 'right' or ' wrong'.
One problem with normative statements is that they cannot to verify by looking at the facts, because they mostly deal with the future. Disagreements about such statements are usually settled by voting on them.

4. Prescriptive actions:

Prescriptive action is goal oriented.
• Given a problem and the objectives of the firm, it suggests the course of action from the available alternatives for optimal solution.

• It also explains whether the concept can be applied in a given context on not. For instance, the fact that variable costs are marginal costs can be used to judge the feasibility of an export order.

5. Applied in nature:
• 'Models' are built to reflect the real life complex business situations and these models are of immense help to managers for decision-making.
• The different areas where models are extensively used include inventory control, optimization, project management etc.
• In managerial economics, we also employ case study methods to conceptualize the problem, identify that alternative and determine the best course of action.

6. Offers scope to evaluate each alternative:
• Managerial economics provides an opportunity to evaluate each alternative in terms of its costs and revenue.
• The managerial economist can decide which is the better alternative to maximize the profits for the firm.

7. Interdisciplinary:
• The contents, tools and techniques of managerial economics are drawn from different subjects such as economics, management, mathematics, statistics, accountancy, psychology, organizational behavior, sociology and etc.

8.6 Scope of Managerial Economics

Managerial economics refers to its area of study. Managerial economics, Provides management with a strategic planning tool that can be used to get a clear perspective of the way the business world works and what can be done to maintain profitability in an ever-changing environment.
. Managerial economics is primarily concerned with the application of economic principles and theories to five types of resource decisions made by all types of business organizations.
a. The selection of product or service to be produced.
b. The choice of production methods and resource combinations.
c. The determination of the best price and quantity combination
d. Promotional strategy and activities.
e. The selection of the location from which to produce and sell goods or service to consumer
The scope of managerial economics covers two areas of decision making
• Operational or Internal issues
• Environmental or External issues

A. Operational Issues:

Operational issues refer to those, which are within the business organization and they are under the control of the management. Those are:
1. Theory of demand and Demand Forecasting
2. Pricing and Competitive strategy
3. Production cost analysis
4. Resource allocation

5. Profit analysis
6. Capital or Investment analysis
7. Strategic planning

1. Demand Analyses and Forecasting:

➢ Demand analysis also highlights for factors, which influence the demand for a product. This helps to manipulate demand. Thus demand analysis studies not only the price elasticity but also income elasticity, cross elasticity as well as the influence of advertising expenditure with the advent of computers.

➢ Demand forecasting has become an increasingly important function of managerial economics. A firm can survive only if it is able to the demand for its product at the right time, within the right quantity. Understanding the basic concepts of demand is essential for demand forecasting

2. Pricing and competitive strategy:

➢ Pricing decisions have been always within the preview of managerial economics. Price theory helps to explain how prices are determined under different types of market conditions.

➢ Competitions analysis includes the anticipation of the response of competitions the firm's pricing, advertising and marketing strategies. Product line pricing and price forecasting occupy an important place here.

3. Production and cost analysis:

➢ Production analysis is in physical terms.

➢ While the cost analysis is in monetary terms cost concepts and classifications, cost-output relationships, economies and diseconomies of scale and production functions are some of the points constituting cost and production analysis.

4. Resource Allocation:

➢ Managerial Economics is the traditional economic theory that is concerned with the problem of optimum allocation of scarce resources.

➢ Marginal analysis is applied to the problem of determining the level of output, which maximizes profit.

➢ In this respect linear programming techniques has been used to solve optimization problems. In fact lines programming is one of the most practical and powerful managerial decision making tools currently available.

5. Profit analysis:

➢ Profit making is the major goal of firms. There are several constraints here an account of competition from other products, changing input prices and changing business environment hence in spite of careful planning, there is always certain risk involved.

➢ Managerial economics deals with techniques of averting of minimizing risks. Profit theory guides in the measurement and management of profit, in calculating the pure return on capital, besides future profit planning.

6. Capital or investment analyses:

➢ Capital is the foundation of business. Lack of capital may result in small size of operations. Availability of capital from various sources like equity capital, institutional finance etc. may help to undertake large-scale operations.

➢ Hence efficient allocation and management of capital is one of the most important tasks of the managers.

The major issues related to capital analysis are:
1.The choice of investment project
2.Evaluation of the efficiency of capital
3.Most efficient allocation of capital.
Knowledge of capital theory can help very much in taking investment decisions. This involves, capital budgeting, feasibility studies, analysis of cost of capital etc.

7. Strategic planning:
Strategic planning provides a long-term goals and objectives and selects the strategies to achieve the same. . The perspective of strategic planning is global.
strategic planning has given rise to be new area of study called corporate economics.

B. Environmental or External Issues:

They refer to general economic, social and political atmosphere within which the firm operates.
A study of economic environment should include:
The type of economic system in the country.
a. The general trends in production, employment, income, prices, saving and investment.
b. Trends in the working of financial institutions like banks, financial corporations, insurance companies
c. Magnitude and trends in foreign trade;
d. Trends in labour and capital markets;
e. Government's economic policies viz. industrial policy monetary policy, fiscal policy, price policy etc.
The social environment refers to social structure as well as social organization like trade unions, consumer's co-operative etc.
The Political environment refers to the nature of state activity, chiefly states' attitude Towards private business, political stability etc.
The environmental issues highlight the social objective of a firm i.e.; the firm owes a responsibility to the society. Private gains of the firm alone cannot be the goal.

8.7 Significance of Managerial Economics

1. It presents those aspects of traditional economics which are relevant for business decision – making in real life.
2. It also incorporates useful ideas from other disciplines such as psychology, sociology etc.
3. Managerial economics helps in reaching a variety of business decisions in a complicated
4. environment.
5. Managerial Economics makes a manager a more competent model builder.
6. Managerial Economics serves as an integrating agent by coordinating the different functional areas such as finance, marketing, HR, production and bringing to bear on the

decisions of each department or specialist the implications pertaining to other functional areas.

7. Managerial Economics takes cognizance of the interaction between the firms and society and
8. accomplishes the key role of business as an agent in the attainment of social and economic welfare.

8.8 Relevance of economics for business decisions:

1. Studies Business Environment: Managerial economics properly analyze the external environment within which the business operates. These factors influence the working of the business and therefore should be considered while taking any decisions and framing policies. Managerial economic studies all factors like economic scenario, government policies, price trends, national income growth, etc.

2. Production Scheduling: Managerial economics manages and prepare schedules for all production activities of business. It estimates all future demands using various quantitative tools which helps in making production plans.

3. Control Cost: Controlling the cost is vital for achieving the desired profitability and growth. Managerial economics estimates the cost of all business activities and identify all those factors that cause variations in cost from time to time. It aims at minimizing the cost through optimum utilization of all resources.

4. Set Prices: Setting the right price is a very challenging task for every business organization. Managerial economics helps management in fixing the correct price by supplying all information regarding competitors pricing methods.

5. Bring Coordination: Managerial economics brings coordination and flexibility in all operations of the business. It supports effective decision making by providing all relevant data using economic theories and tools.

6. Investment Analysis: Managerial economics ensures that all business funds are allocated to profitable means. It properly analyzes the profitability of all investment avenues before investing any amount into it.

8.9 Role of Managerial Economist in Business decision making:

Managerial economist is a person who manages business efficiently using various economic theories and methodologies. He supports the management team in better decision making through his analytical skills and specialized techniques.
A Managerial Economist is also termed as an economic advisor or business economist. He is responsible for analyzing various internal and external environmental forces that influence the functioning of business organizations. Managerial economist makes several successful business forecasts and updates the management team regarding the economic trends from time to time.

Managerial Economist always remains in touch with all the latest economic developments and environmental changes for informing the management. He has an efficient role in earning reasonable profits on invested capital as it supplies all relevant information which helps in making proper plans and strategies.

Managerial economist has three important roles in every business organization: Demand analysis and forecasting, capital management and profit management.

Studies Business Environment

The managerial economist is responsible for analyzing the environment in which business operates. Proper study of all external factors that affect the functioning of organization is must for proper functioning. He studies various factors like growth of national income, competition level, price trends, phase of the business cycle and economy and updates the management regarding it from time to time.

Analyses Operations of Business

He analyses the internal operation of business and helps management in making better decisions in regard to internal workings. Managerial economist through his analytical and forecasting skills provides advice to managers for formulating policies regarding internal operations of the business.

Demand Forecasting and Estimation

Proper estimation and forecasting of future trends helps the business in achieving desired profitability and growth. Managerial economist through proper study of all internal and external forces makes successful forecasting of future uncertainties or trends.

Production Planning

Managerial economist is responsible for scheduling all production activities of business. He evaluates the capital budgets of organizations and accordingly helps in deciding timing and locating of various actions.

Economic Intelligence

He provides economic intelligence services by communicating all economic information to management.

Managerial economist keeps management always updated of all prevailing economic trends so that they can confidently talk in seminars and conferences.

Performing Investment Analysis

A managerial economist analyzes various investment avenues and chooses the most appropriate one. He studies and discovers new possible fields of business for earning better returns.

Focuses on Earning Reasonable Profit

He assists management in earning a reasonable rate of profit on capital employed in the business.

Managerial economist monitors activities of organizations to check whether all operations are running efficiently as per the plans and policies.

Maintaining Better Relations

A managerial economist maintains better relations with all internal and external individuals connected with the business. It is his duty to develop a peaceful and cooperative environment within the organization and aims to reduce any opposition taking place

Business Cycles swing in economic activities. It is the pattern of expansion, contraction, and recovery of an economy. A business cycle is GDP (value of goods and services produced in a country over a period of time and willing to work but could not get jobs).

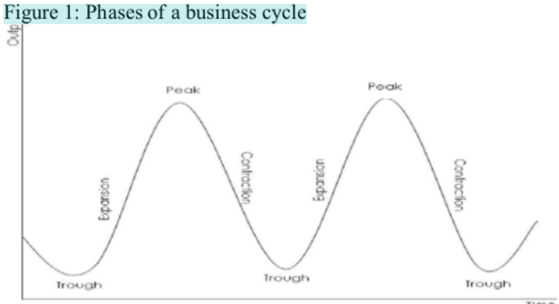
It is usually expressed as boom and bust. A boom cycle is characterised by high positive growth, measured by indicators such as rising employment, high GDP growth, and high consumption spending, all in real terms. The boom cycle is also characterised by an market, rising housing prices and increasing wages. On the other hand, negative GDP growth, high unemployment rate, and low savings and investments are features of a bust cycle.

Business cycles may exhibit peculiar features depending on the fundamentals of the economy. Nevertheless, they possess some basic common features such as: §Fluctuations in aggregate economic activities that affect all economic indicators such as GDP, interest rate, and unemployment rate concurrently; §Changes in economic activities in all sectors of the economy simultaneously; §Distinct phases that differ in length and severity; §Persistent nature given that they tend to last for long periods of time; and §Contagion effect due to globalisation. Once it starts in one country it easily spreads to other countries.

8.10 Phases of Business Cycle

Phases are the expansion (boom, upswing, prosperity, periods of ups), peak (turning point, upper turning point), contraction (bust, downswing, recession, depression, periods of downs), and trough (lower turning point, recovery).

Figure 1: Phases of a business cycle



8.10.1 Expansion

The expansion phase of the business cycle is associated with rising economic activities in which the economy tends to operate at near or full employment. This phase could result in high growth rate, low unemployment, and high savings and investment. However, economic expansion also leads to expansion is the period between a trough and a peak as shown in are evident. This phase sets in when the growth in the expansion phase eventually reaches its maximum. It is the point between the end of an expansion in an economy and the commencement of an economic contraction in the business cycle.

8.10.2 Contraction

Contraction or downturn phase of the business cycle is associated with lower economic growth. An economy is said to be contracting when an economy records a decline in real output. This phase is characterised by decreased levels of consumer purchases, rising and subsequently, reduced production by businesses. This phase could lead to a recession where the growth rate becomes negative for two consecutive quarters, arising from rapid decline in income and debtors. It is the period after the peak but before a trough.

8.10.3 Trough

A trough is associated with minimum level of economic activities in which consumption, production, investment, and employment are at their lowest level. At this point, the economy has hit a bottom from which the next phase of the business cycle will emerge.

8.10.4 Business Cycle Indicators

Business cycle indicators are economic that provide valuable information about the cycle. These indicators help economic agents to track business cycle activities and make realistic forecasts for business decisions and policies. The indicators leading, coincident and lagging.

8.10.5 Leading Economic Indicators

Leading indicators predict business cycle peaks and troughs three to twelve months before they actually occur. These indicators are: manufacturers' new orders for consumer goods and materials and non-defence capital goods; index of vendor performance; index of stock prices; and new building permits for private housing. Others include interest rate spread; money supply; average workweek in manufacturing; index of consumer expectations; and average weekly initial claims for unemployment insurance.

8.10.6 Coincident Economic Indicators

The coincident indicators measure current economic conditions to determine the actual phase of a business cycle in an economy. They are a primary source of information for documenting the number of employees on non-agricultural payrolls; industrial production; real personal income (after subtracting transfer payments); and real manufacturing and trade sales.

8.10.7 Lagging Economic Indicators

This category indicates business cycle peaks and troughs three to twelve months after they actually occur. The lagging indicators include: labor cost per unit of output in manufacturing; average prime interest rate; amount of outstanding commercial and industrial debt; consumer price index for services; consumer’s credit as a fraction of personal income; average duration of unemployment; and the ratio of unsold goods to sales for manufacturing and trade.

8.11 Summary

A business cycle refers to the periodic ups and downs in the level of economic activity in an economy over time. It consists of fluctuations in GDP, employment, investment, and income levels. These cycles are recurrent, but not perfectly regular.

8.12 Key words

Business Cycle-Repetitive pattern of economic expansion and contraction.: Helps governments and businesses plan policies and strategies.

Expansion (Boom) Period when economic activity is rising. High production, increasing employment, rising income, increased investment.

Peak The highest point of economic activity before the downturn begins.
Maximum output, full employment, inflationary pressure.

Contraction (Recession)

Period when economic activity begins to decline. Falling output, reduced investment, rising unemployment.

Trough

The lowest point of economic activity. High unemployment, low production, low income; but often signals the start of recovery.

Recovery

Transition phase from trough to expansion. Demand picks up, investment rises, employment improves.

Recession
A significant decline in economic activity lasting for months. Negative GDP growth for two consecutive quarters.

8.13 Self assessment questions

1. Describe in detail the different phases of a business cycle.
2. What are the major causes of business cycles?
3. Explain how business cycles affect different sectors of the economy.
4. Discuss the measures used by the government and central bank to control business fluctuations.

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LESSON -9

INTERNATIONAL TRADE

Objectives

To define key international trade terms (e.g., tariff, comparative advantage).
To explain why countries engage in international trade.
To demonstrate how comparative advantage influences trade patterns using examples.
To compare the effects of free trade versus protectionism on domestic industries.
To Assess the impact of trade policies on economic growth, employment, and inequality.

Structure

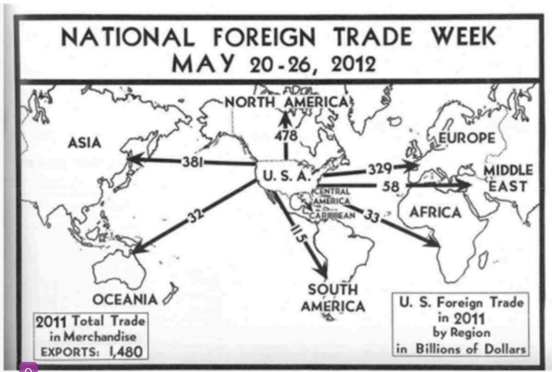
9.1 Introduction

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.



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”

9.2 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) Entrepot Trade:

When goods are imported from one country and are exported to another country, it is called entrepot 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 entrepot trade.

9.3 Characteristics of International Trade

(iv) 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.

9.4 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.

9.5 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:

qThere 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.

9.6 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.

9.7 Disadvantages of International Trade:

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

(i) 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.

(ii) 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.

(iii) 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.

(iv) 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.

(v) Import of Harmful Goods:

Import of spurious drugs, luxury articles, etc. adversely affects the economy and well-being of the people.

(vi) 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.

(vii) Danger to International Peace:

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

(viii) 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.

(ix) 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.

9.8 Theory of Comparative Advantage of International Trade: by David Ricardo

The classical theory of international trade is popularly known as the Theory of Comparative Costs or Advantage- It was formulated by David Ricardo in 1815.The classical approach, in terms of comparative cost advantage, as presented by Ricardo, basically seeks to explain how and why countries gain by trading.The idea of comparative costs advantage is drawn in view of deficiencies observed by Ricardo in Adam Smith's principles of absolute cost advantage in explaining territorial specialisation as a basis for international trade.Being dissatisfied with the application of classical labour theory of value in the case of foreign trade, Ricardo developed a theory of comparative cost advantage to explain the basis of international trade as under:

Ricardo's Theorem:

Ricardo stated a theorem that, other things being equal, a country tends to specialise in and export those commodities in the production of which it has maximum comparative cost advantage or minimum comparative disadvantage. Similarly, the country's imports will be of goods having relatively less comparative cost advantage or greater disadvantage.

The Ricardian Model:

To explain his theory of comparative cost advantage, Ricardo constructed a twocountry, two-commodity, but one-factor model with the following assumptions:

1. Labour is the only productive factor.
2. Costs of production are measured in terms of the labour units involved.
3. Labour is perfectly mobile within a country but immobile internationally.
4. Labour is homogeneous.
5. There is unrestricted or free trade
6. There are constant returns to scale.
7. There is full employment equilibrium.
8. There is perfect competition.

Under these assumptions, let us assume that there are two countries A and B and two goods X and Y to be produced. Now, to illustrate and elucidate comparative cost difference, let us take some hypothetical data and examine them as follows.

Absolute Cost Difference:

As Adam Smith pointed out, if there is an absolute cost difference, a country will specialise in the production of a commodity having an absolute advantage

Table 1 Cost of Production in Labour Units:

	Country A	Country B	Comparative Cost Ratio
Commodity X	10	20	10/20 = 0.5
Commodity Y	20	10	20/10 = 2
ADVERTISEMENTS:	1 X = 1/2 Y	1 X = 2 Y	

It follows that country A has an absolute advantage over B in the production of X while B has an absolute advantage in producing Y. As such, when trade takes place, A specialises in X and exports its surplus to B and B specialises in Y and exports its surplus to A.

Equal Cost Difference:

Ricardo argues that if there is equal cost difference, it is not advantageous for trade and specialisation for any country in consideration (see Table 2).

Table 2 Cost of Production in Labour Units:

	Country A	Country B	Comparative Cost Ratio
Commodity X	10	15	10 /15 = 0.66
Commodity Y	20	30	20/30 = 0.66
Domestic Exchange Ratio:	1 X = 1/2 Y	1 X = 1/2 Y	

On account of equal cost difference, the comparative cost ratio is the same for both the countries, so there is no reason for undertaking specialisation. Hence, the trade between two countries will not take place.

Comparative Cost Difference:

Ricardo emphasised that under all conditions, it, is the comparative cost advantage which lies at the root of specialisation and trade (see Table 3).

Table 3 Cost of Production in Labour Units:

	Country A	Country B	Comparative Cost

			Ratio
Commodity X	10	15	10/ 15 = 0.66
Commodity Y	20	25	20/25 = 0.80 25
Domestic Exchange Ratio	IX = 0.5Y	IX = 0.6Y	

It will be seen that country A has an absolute cost advantage in both the commodities X and Y. However, A possesses a comparative cost advantage in producing X. For, comparatively, country A's labour cost involved in producing 1 unit of X is only 66 per cent of B's labour cost involved in producing X, as against that of 80 per cent in the case of Y.

On the other hand, country B has least comparative disadvantage in production of Y, though she has absolute cost disadvantage in both X and Y. It should be noted that, to know the comparative advantage, we have to compare the ratio of the costs of production of one commodity in both countries (i.e., 10/15 in the case of X in our example) with the ratio of the cost of producing the other commodity in both countries (i.e., 20/25 in the case of Y in our example). To state in algebraic terms:

If in country A, the labour cost of commodity X is Xa and that of Y is Ya, and in B, it is Xb and Yb respectively, then absolute differences in cost can be expressed as:
$Xa/Xb < 1 < Ya/Yb$ (Which means that country A has an absolute advantage over country B in commodity X and country B has over A in commodity Y). And, comparative differences in costs are expressed as: $Xa/Xb < Ya/Yb < 1$ (Which implies that country A possesses an absolute advantage over B in both X and (Y, but it has more comparative advantage in X than in Y). If, however, there is an equal cost difference, i.e., $Xa/Xb = Ya/Yb$ will be no international trade between the two countries.

In our illustration, since country A has comparative cost advantage in commodity X, as per Ricardo s theorem, this country should tend to specialise in X and export its surplus to country B in exchange for Y (i.e., import of Y from B). Correspondingly, since country B has least cost disadvantage in producing Y, she should specialise in Y and export its surplus to A and import X.

Gain Attributes of International Trade:
`It further follows that when countries A and B enter into trade, both will gain. In the absence of trade, domestically in country A, IX = 0.5Y. Now, if after trade, assuming the terms of trade to be IX — 1Y, country A gains 0.5 unit more. Similarly, in country B, IX = 0.6 Y domestically, after trade, its gain is 0.4Y.

In short, "each country can consume more by trading than in isolation with a given amount of resources. Indeed, the relative gains of the two countries will be conditioned by the terms of trade and one is likely to gain proportionately more than the other but it is definite that both will gain.

In fact, the principle of comparative costs shows that it is possible for both the countries to gain from trade, even if one of them is more efficient than the other in all lines of production. The theory implies that comparative costs are different in different countries because the abundance of factors which may be necessary for the production of each commodity does not bear the same relation to the demand for each commodity in different countries.

Thus, specialisation based on comparative cost advantage clearly represents a gain to the trading countries in so far as it enables more of each variety of goods to be produced cheaply by utilising the abundant factors fully in the country concerned and to obtain relatively cheaper goods through mutual international exchange.

Ricardo's theory pleads the case for free trade. He stresses that free-trade is the pre-requisite of gains and improvement of world's welfare. Free trade "by increasing the general mass of production diffuses general benefit and binds together by one common tie of interest and intercourse, the universal society of nations throughout the civilised world."

To sum up, what goods will be exchanged in international trade is the main question solved by Ricardo's theory of comparative costs. The theory is lucidly summarised by KindleBerger as follows:

"The basis for trade, so far as supply is concerned, is found in differences in comparative costs. One country may be more efficient than another, as measured by factor inputs per unit of output, in the production of every possible commodity, but so long as it is not equally more efficient in every commodity, a basis for trade exists. It will pay the country to produce more of those goods in which it is relatively more efficient and to export these in return for goods in which its absolute advantage is least."

9.9 Summary

International trade refers to the exchange of goods, services, and capital across national borders. It allows countries to specialize in producing goods where they have an advantage, leading to increased efficiency, wider product variety, and economic growth. Trade is influenced by factors such as comparative advantage, trade policies, exchange rates, globalization, and international institutions (e.g., WTO). While trade brings benefits, it can also create challenges, including inequality, environmental impacts, and dependency on foreign market

9.10 key words

Comparative Advantage- A country's ability to produce a good at a lower opportunity cost than another country.

Absolute Advantage- The ability to produce more of a good using the same amount of resources compared to another country.

Balance of Trade- The difference between a country's exports and imports of goods and services.

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Tariffs-Taxes imposed on imported goods to protect domestic industries or raise government revenue.

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Quotas- Limits on the quantity of a good that can be imported, designed to control supply and protect domestic markets.

9.11 Self Assessment Questions

1. Explain why countries engage in international trade.

2. How does globalization influence trade between nations?

3. Describe how a tariff can affect the price of imported goods.

4. Explain the concept of opportunity cost in trade decisions.

9.12 Reference Books

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LESSON -10

FOREIGN EXCHANGE

Objectives

To explain how exchange rates are determined in a floating system.

To describe the role of central banks in influencing currency values.

To summarize the differences between spot, forward, and futures markets.

To apply the concept of appreciation/depreciation to real-world trade scenarios.

To demonstrate how interest rate changes can influence currency demand.

Structure

10.1 Introduction
10.2 Size of the Market
10.3 Participants
10.4 Settlement of Transactions
10.5 Factors Determining Spot Exchange Rates
10.6 Summary
10.7 Key words
10.8 Self Assessment Questions
10.9 Reference Books

10.1 Introduction

Foreign exchange market is described as an OTC (Over the counter) market as there is no physical place where the participants meet to execute their deals. It is more an informal arrangement among the banks and brokers operating in a financing centre purchasing and selling currencies, connected to each other by tele communications like telex, telephone and a satellite communication network, SWIFT. The term foreign exchange market is used to refer to the wholesale a segment of the market, where the dealings take place among the banks. The retail segment refers to the dealings take place between banks and their customers. The retail segment refers to the dealings take place between banks and their customers.

The retail segment is situated at a large number of places. They can be considered not as foreign exchange markets, but as the counters of such markets. The leading foreign exchange market in India is Mumbai, Calcutta, Chennai and Delhi is other centers accounting for bulk of the exchange dealings in India.

The policy of Reserve Bank has been to decentralize exchages operations and develop broader based exchange markets. As a result of the efforts of Reserve Bank Cochin, Bangalore, Ahmadabad and Goa have emerged as new centre of foreign exchange market.

10.2 Size of the Market

Foreign exchange market is the largest financial market with a daily turnover of over USD 2 trillion. Foreign exchange markets were primarily developed to facilitate settlement of debts arising out of international trade. But these markets have developed on their own so much so that a turnover of about 3 days in the foreign exchange market is equivalent to the magnitude of world trade in goods and services. The largest foreign exchange market is London followed by New York, Tokyo, Zurich and Frankfurt.

The business in foreign exchange markets in India has shown a steady increase as a consequence of increase in the volume of foreign trade of the country, improvement in the communications systems and greater access to the international exchange markets. Still the volume of transactions in these markets amounting to about USD 2 billion per day does not compete favorably with any well developed foreign exchange market of international repute. The reasons are not far to seek. Rupee is not an internationally traded currency and is not in great demand. Much of the external trade of the country is designated in leading currencies of the world, Viz., US dollar, pound sterling, Euro, Japanese yen and Swiss franc. Incidentally, these are the currencies that are traded actively in the foreign exchange market in India.

24 Hours Market

The markets are situated throughout the different time zones of the globe in such a way that when one market is closing the other is beginning its operations. Thus at any point of time one market or the other is open. Therefore, it is stated that foreign exchange market is functioning throughout 24 hours of the day. However, a specific market will function only during the business hours. Some of the banks having international network and having centralized control of funds management may keep their foreign exchange department in the key centre open throughout to keep up with developments at other centers during their normal working hours

In India, the market is open for the time the banks are open for their regular banking business. No transactions take place on Saturdays.

Efficiency

Developments in communication have largely contributed to the efficiency of the market. The participants keep abreast of current happenings by access to such services like Dow Jones Telerate and Teuter. Any significant development in any market is almost instantaneously received by the other market situated at a far off place and thus has global impact. This makes the foreign exchange market very efficient as if the functioning under one roof.

Currencies Traded

In most markets, US dollar is the vehicle currency, Viz., the currency used to denominate international transactions. This is despite the fact that with currencies like Euro and Yen gaining larger share, the share of US dollar in the total turn over is shrinking.

Physical Markets

In few centers like Paris and Brussels, foreign exchange business takes place at a fixed place, such as the local stock exchange buildings. At these physical markets, the banks meet and in the presence of the representative of the central bank and on the basis of bargains, fix rates for a number of major currencies. This practice is called fixing. The rates thus fixed are used to execute customer orders previously placed with the banks. An advantage claimed for this procedure is that exchange rate for commercial transactions will be market determined, not influenced by any one bank. However, it is observed that the large banks attending such meetings with large commercial orders backing up, tend to influence the rates.

10.3 Participants

The participants in the foreign exchange market comprise;
(i) Corporates
(ii) Commercial banks
(iii) Exchange brokers
(iv) Central banks

Corporates: The business houses, international investors, and multinational corporations may operate in the market to meet their genuine trade or investment requirements. They may also buy or sell currencies with a view to speculate or trade in currencies to the extent permitted by the exchange control regulations. They operate by placing orders with the commercial banks. The deals between banks and their clients form the retail segment of foreign exchange market. In India the foreign Exchange Management (Possession and Retention of Foreign Currency) Regulations, 2000 permits retention, by resident, of foreign currency up to USD 2,000. Foreign Currency Management (Realisation, Repatriation and Surrender of Foreign Exchange) Regulations, 2000 requires a resident in India who receives foreign exchange to surrender it to an authorized dealer:

(a) Within seven days of receipt in case of receipt by way of remuneration, settlement of lawful obligations, income on assets held abroad, inheritance, settlement or gift: and

(b) Within ninety days in all other cases.

Any person who acquires foreign exchange but could not use it for the purpose or for any other permitted purpose is required to surrender the unutilized foreign exchange to authorized dealers within sixty days from the date of acquisition. In case the foreign exchange was acquired for travel abroad, the unspent foreign exchange should be surrendered within ninety days from the date of return to

India when the foreign exchange is in the form of foreign currency notes and coins and within 180 days in case of travellers cheques. Similarly, if a resident required foreign exchange for an approved purpose, he should obtain from and authorized dealer.

Commercial Banks are the major players in the market. They buy and sell currencies for their clients. They may also operate on their own. When a bank enters a market to correct excess or sale or purchase position in a foreign currency arising from its various deals with its customers, it is said to do a cover operation. Such transactions constitute hardly 5% of the total transactions done by a large bank. A major portion of the volume is accounted buy trading in currencies indulged by the bank to gain from exchange movements. For transactions involving large volumes, banks may deal directly among themselves. For smaller transactions, the intermediation of foreign exchange brokers may be sought.

Exchange brokers facilitate deal between banks. In the absence of exchange brokers, banks have to contact each other for quotes. If there are 150 banks at a centre, for obtaining the best quote for a single currency, a dealer may have to contact 149 banks. Exchange brokers ensure that the most favorable quotation is obtained and at low cost in terms of time and money.

The bank may leave with the broker the limit up to which and the rate at which it wishes to buy or sell the foreign currency concerned. From the intends from other banks, the broker will be able to match the requirements of both. The names of the counter parities are revealed to the banks only when the deal is acceptable to them. Till then anonymity is maintained. Exchange brokers tend to specialize in certain exotic currencies, but they also handle all major currencies.

In India, banks may deal directly or through recognized exchange brokers. Accredited exchange brokers are permitted to contract exchange business on behalf of authorized dealers in foreign exchange only upon the understanding that they will conform to the rates, rules and conditions laid down by the FEDAI. All contracts must bear the clause ―subject to the Rules and Regulations of the Foreign Exchanges Dealers _Association of India'.

Central Bank may intervene in the market to influence the exchange rate and change it from that would result only from private supplies and demands. The central bank may transact in the market on its own for the above purpose. Or, it may do so on behalf of the government when it buys or sell bonds and settles other transactions which may involve foreign exchange payments and receipts. In India, authorized dealers have recourse to Reserve Bank to sell/buy US dollars to the extent the latter is prepared to transact in the currency at the given point of time. Reserve Bank will not ordinarily buy/sell any other currency from/to authorized dealers.

The contract can be entered into on any working day of the dealing room of Reserve Bank. No transaction is entered into on Saturdays. The value date for spot as well as forward delivery should be in conformity with the national and international practice in this regard.

Reserve Bank of India does not enter into the market in the ordinary course, where the exchages rates are moving in a detrimental way due to speculative forces, the Reserve Bank may intervene in the market either directly or through the State Bank of India.

10.4 Settlement of Transactions

Foreign exchange markets make extensive use of the latest developments in telecommunications for transmitting as well settling foreign exchange transaction, Banks use the exclusive network SWIFT to communicate messages and settle the transactions at electronic clearing houses such as CHIPS at New York.

SWIFT: SWIFT is a acronym for Society for Worldwide Interbank Financial Telecommunications, a co operative society owned by about 250 banks in Europe and North America and registered as a co operative society in Brussels, Belgium. It is a communications network for international financial market transactions linking effectively more than 25,000 financial institutions throughout the world who have been allotted bank identified codes. The messages are transmitted from country to country via central interconnected operating centers located in Brussels, Amsterdam and Culpeper, Virginia. The member countries are connected to the centre through regional processors in each country. The local banks in each country reach the regional processors through the national net works.

The SWIFY System enables the member banks to transact among themselves quickly (i) international payments (ii) Statements (iii) other messages connected with international banking. Transmission of messages takes place within seconds, and therefore this method is economical as well as time saving. Selected banks in India have become members of SWIFT. The regional processing centre is situated at Mumbai.

The SWIFT provides following advantages for the local banking community:

1. Provides a reliable (time tested) method of sending and receiving messages from a vast number of banks in a large number of locations around the world.

2. Reliability and accuracy is further enhanced by the built in authentication facilities, which has only to be exchanged with each counterparty before they can be activated or further communications.

3. Message relay is instantaneous enabling the counterparty to respond immediately, if not prevented by time differences.

4. Access is available t a vast number of banks global for launching new cross border initiatives.

5. Since communication in SWIFT is to be done using structure formats for various types of banking transactions, the matter to be conveyed will be very clear and there will not be any ambiguity of any sort for the received to revert for clarifications. This is mainly because the formats are used all over the world on a standardized basis for conducting all types of banking transactions. This makes the responses and execution very efficient at the receiving banks end thereby contributing immensely to quality service being provided to the customers of both banks (sending and receiving).

6. Usage of SWIFT structure formats for message transmission to Counter parties will entail the generation of local banks internal records using at least minimum level of automation. This will accelerate the local banks internal automation activities, since the maximum utilization of SWIFT a significant internal automation level is required.

CHIPS: CHIPS stands for Clearing House Interbank Payment System. It is an electronic payment system owned by 12 private commercial banks constituting the New York Clearing House Association. A CHIP began its operations in 1971 and has grown to be the world‘s largest payment system. Foreign exchange and Euro dollar transactions are settled through CHIPS. It provides the mechanism for settlement every day of payment and receipts of numerous dollar transactions among member banks at New York, without the need for physical exchange of cheques/funds for each such transaction.

The functioning of CHIPS arrangement is explained below with a hypothetical transaction: Bank of India, maintaining a dollar account with Amex Bank, New York, sells USD 1 million to Canara Bank, maintaining dollar account with\ Citibank.

1. Bank of India intimate Amex Bank debuts the account of Bank through SWIFT to debit its account and transfer USD 1 million to Citibank for credit of current account of Canara Bank.

2. Amex Bank debits the account of Bank of India with USD 1 million and sends the equivalent of electronic cheques to CHIPS for crediting the account of Citibank. The transfer is effected the same day.

3. Numerous such transactions are reported to CHIPS by member banks and transfer effected at CHIPS. By about 4.30 p.m, eastern time, the net position of each member is arrived at and funds made available at Fedwire for use by the bank concerned by 6.00 p.m. eastern time.

4. Citibank which receives the credit intimates Canara Bank through SWIFT. It may be noted that settlement of transactions in the New York foreign exchange market takes place in two stages, First clearance at CHIPS and arriving at the net position for each bank. Second, transfer of fedfunds for the net position. The real balances are held by banks only with Federal Reserve Banks (Fedfunds) and the transaction is complete only when Fedfunds are transferred. CHIPS help in expediting the reconciliation and reducing the number of entries that pass through Fedwire.

CHAPS is an arrangement similar to CHIPS that exists in London. CHAPS stands for Clearing House Automated Payment System. Fedwire The transactions at New York foreign exchange market ultimately get settled through Fedwire. It is a communication network that links the computers of about 7000 banks to the computers of federal Reserve Banks. The fedwire funds transfer system, operate by the Federal Reserve Bank, are used primarily for domestic payments, bank to bank and third party transfers such as interbank overnight funds sales and purchases and settlement transactions. Corporate to corporate payments can also be made, but they should be effected through banks. Fed guarantees settlement on all payments sent to receivers even if the sender fails.

Transaction interbank Market

The exchange rates quoted by banks to their customer are based on the rates prevalent in the interbank market. The big banks in the market are known as market makers, as they are willing to buy or sell foreign currencies at the rates quoted by them up to any extent. Depending buy or sell foreign currencies at the rates quoted by them up to any extent. Depending upon its resources, a bank may be a market maker in one or few major currencies. When a banker approaches the market maker, it would not reveal its intention to buy or sell the currency. This is done in order to get a fair price from the market maker.

Two Way Quotations

Typically, the quotation in the interbank market is a two – way quotation. It means the rate quoted by the market maker will indicate two prices. One at which it is willing to buy the foreign currency, and the other at which it is willing to sell the foreign currency. For example, a Mumbai bank may quote its rate for US dollar as
Under USD 1 = Rs 48.1525/1650

More often, the rate would be quoted as 1525/1650 since the players in the market are expected to know the _big number' i.e., Rs 48. In the given quotation, one rate is Rs.48.1525 per dollar and the other rate is Rs.48.1650. per dollar.

Direct Quotation.

It will be obvious that the quoting bank will be willing to buy dollars at Rs 48.1525 and sell dollars at Rs 48.1650. If one dollar bought and sold, the bank makes a gross profit of Rs. 0.0125. In a foreign exchange quotation, the foreign currency is the commodity that is being bought and sold. The exchange quotation which gives the price for the foreign currency in terms of the domestic currency isknown as direct quotation. In a direct quotation, the quoting bank will apply the rule: ―Buy low; Sell high‖.

Indirect quotation

There is another way of quoting in the foreign exchange market. The Mumbai bank quotes the rate for dollar as: Rs. 100 = USD 2.0762/0767

This type of quotation which gives the quantity of foreign currency per unit of domestic currency is known as indirect quotation. In this case, the quoting bank will receive USD 2.0767 per Rs.100 while buying dollars and give away USD 2.0762 per Rs.100 while selling dollars. In other world, he will apply the rule: ―Buy high: Sell low‖.

The buying rate is also known as the ‗bid rate and selling rate as the ‗offer' rate. The difference between these rates is the gross profit for the bank and is known as the ‗Spread'.

Spot and Forward transactions
The transactions in the interbank market may place for settlement
(a) on the same day; or
(b) two days later; or
(c) some day late; say after a month

Where the agreement to buy and sell is agreed upon and executed on the same date, the transaction is known as cash or ready transaction. It is also known as value today.

The transaction where the exchange of currencies takes place two days after the date of the contact is known as the spot transaction. For instance, if the contract is made on Monday, the delivery should take place on Wednesday. If Wednesday is a holiday, the delivery will take place on the next day, i.e., Thursday. Rupee payment is also made on the same day the foreign currency is received.

The transaction in which the exchange of currencies takes places at a specified future date, subsequent to the spot date, is known as a forward transaction. The forward transaction can be for delivery one month or two months or three months etc. A forward contract for delivery one month means the exchange of currencies will take place after one month from the date of contract. A forward contract for delivery two months means the exchange of currencies will take place after two months and so on.

Forward Margin/Swap points Forward rate may be the same as the spot rate for the currency. Then it is said to be ‗at par' with the spot rate. But this rarely happens. More often the forward rate for a currency may be costlier or chapter tan its spot rate. The rate for a currency may be costlier or cheaper than nits spot rate. The difference between the forward rate and the spot rate is known as the ‗forward margin' or swap points. The forward margin may be either at ‗premium' or at ‗discount'. If the forward margin is at premium, the foreign correct will be costlier under forward rate than under the spot rate. If the forward margin is at discount, the foreign currency will be cheaper for forward delivery then for spot delivery.

Under direct quotation, premium is added to spot rate to arrive at the forward rate. This is done for both purchase and sale transactions. Discount is deducted from the spot rate to arrive at the forward rate.

Interpretation of Interbank quotations
The market quotation for a currency consists of the spot rate and the forward margin. The outright forward rate has to be calculated by loading the forward margin into the spot rate. For instance, US dollar is quoted as under in the interbank market on 25th January as under:

Spot USD 1 = Rs.48.4000/4200

Spot/February 2000/2100
Spot/March 3500/3600

The following points should be noted in interpreting the above quotation;

1. The first statement is the spot rate for dollars. The quoting bank buying rate is Rs.48.4000 and selling rate is Rs.48.4200.

2. The second and third statements are forward margins for forward delivery during the months of February. Spot/March respectively. Spot/February rate is valid for delivery end February. Spot/March rate is valid for delivery end March.

3. The margin is expressed in points, i.e., 0.0001 of the currency. Therefore the forward margin for February is 20 paise and 21 paise.

4. The first rate in the spot quotation is for buying and second for selling the foreign currency. Correspondingly, in the forward margin, the first rate relates to buying and the second to selling. Taking Spot/February as an example, the margin of 20 paise is for purchase and 21 paise is for sale of foreign currency.

5. Where the forward margin for a month is given in ascending order as in the quotation above, it indicates that the forward currency is at premium. The\ outright forward rates arrived at by adding the forward margin to the spot rates.

The outright forward rates for dollar can be derived from the above quotations follows

Buying rate Selling rate

Spot	USD 1	=	Rs.48.4000/4200
Spot/February			2000/2100
Spot/March			3500/3600

The following points should be noted in interpreting the above quotation;
1. The first statement is the spot rate for dollars. The quoting bank buying rate is Rs.48.4000 and selling rate is Rs.48.4200.

2. The second and third statements are forward margins for forward delivery during the months of February. Spot/March respectively. Spot/February rate is valid for delivery end February. Spot/March rate is valid for delivery end March.

3. The margin is expressed in points, i.e., 0.0001 of the currency. Therefore the forward margin for February is 20 paise and 21 paise.

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5. Where the forward margin for a month is given in ascending order as in the quotation above, it indicates that the forward currency is at premium. The outright forward rates arrived at by adding the forward margin to the spot rates

The outright forward rates for dollar can be derived from the above quotations follows

	Buying rate		Selling rate	
	February	March	February	March
Spot rate	48.4000	48.4000	48.4200	48.4200
Add; Premium	0.2000	0.3500	0.2100	0.3600
	---------------	------------	-------------	
	48.6000	48.7500	48.6300	48.7800

From the above calculation we arrive at the following outright rates;

	Buying	Selling
Spot delivery	USD 1 = Rs. 48.4000	48.4200
Forward delivery February	48.6000	48.6300
Forward delivery March	48.7500	48.7800

If the forward currency is at discount, it would be indicated by quoting the forward margin in the descending order. Suppose that on 20th April, the quotation for pound sterling in the interbank market is as follows:

Spot	GBR 1 =	Rs. 73.4000/4300
Spot/May		3800/3600
Spot/June		5700/5400

Since the forward margin is in descending order (3800/3600), forward sterling is at discount. The outright forward rates are calculated by deducting the related discount from the spot rate. Thus is shown below:

10.5 Factors Determining Spot Exchange Rates

1. Balance of Payments: Balance of Payments represents the demand for and supply of foreign exchange which ultimately determine the value of the currency. Exports, both visible and invisible, represent the supply side for foreign exchange. Imports, visible and invisible, create demand for foreign exchange. Put differently, export from the country creates demand for the currency of the country in the foreign exchange market. The exporters would offer to the market the foreign currencies they have acquired and demand in exchange the local currency. Conversely, imports into the country will increase the supply of the currency of the country in the foreign exchange market.

When the balance of payments of a country is continuously at deficit, it implies that the demand for the currency of the country is lesser than its supply. Therefore, its value in the market declines. If the balance of payments is surplus continuously it shows that the demand for the currency in the exchange market is higher than its supply therefore the currency gains in value.

(2) Inflation: Inflation in the country would increase the domestic prices of the commodities. With increase in prices exports may dwindle because the price maynot be competitive. With the decrease in exports the demand for the currency would also decline; this in turn would result in the decline of external value of the currency. It may be noted that unit is the relative rate of inflation in the two countries that cause changes in exchange rates. If, for instance, both India and the

USA experience 10% inflation, the exchange rate between rupee and dollar will remain the same. If inflation in India is 15% and in the USA it is 10%, the increase in prices would be higher in India than it is in the USA. Therefore, the rupee will depreciate in value relative to US dollar.

Empirical studies have shown that inflation has a definite influence on the exchange rates in the long run. The trend of exchange rates between two currencies has tended to hover around the basic rate discounted for the inflation factor. The actual rates have varied from the trend only by a small margin which is acceptable.

However, this is true only where no drastic change in the economy of the country is. New resources found may upset the trend. Also, in the short run, the rates fluctuate widely from the trend set by the inflation rate. These fluctuations are accounted for by causes other than inflation.

(3) Interest rate: The interest rate has a great influence on the short – term movement of capital. When the interest rate at a centre rises, it attracts short term funds from other centers. This would increase the demand for the currency at the centre and hence its value. Rising of interest rate may be adopted by a country due to tight money conditions or as a deliberate attempt to attract foreign investment. Whatever be the intention, the effect of an increase in interest rate is to strengthen the currency of the country through larger inflow of investment and reduction in the outflow of investments by the residents of the country.

(4) Money Supply An increase in money supply in the country will affect the exchange rate through causing inflation in the country. It can also affect the exchange rate directly.

An increase in money supply in the country relative to its demand will lead to large scale spending on foreign goods and purchase of foreign investments. Thus the supply of the currency in the foreign exchange markets is increased and its value declines. The downward pressure on the external value of the currency then increases the cost of imports and so adds to inflation.

The effect of money supply on exchange rate directly is more immediate than its effect through inflation. While in the long run inflation seems to correlate exchange rate variations in a better way, in the short run exchange rates move more in sympathy with changes in money supply.

One explanation of how changes in money supply vary the exchange rate is this; the total money supply in the country represents the value of total commodities and services in the country. Based on this the outside world determines the external value of the currency. If the money supply is doubles, the currency will be valued at half the previous value so as to keep the external value of the total money stock of the country constant.

Another explanation offered is that the excess money supply flows out of the country and directly exerts a pressure on the exchange rate. The excess money created, the extent they are in excess of the domestic demand for money, will flow out of the country. This will increase the supply of the currency and pull down its exchange rate.

(5) National Income: An increase in national income reflects increase in the income of the residents of the country. This increase in the income increases the demand for goods in the country. If there is underutilized production capacity in the country, this will lead to increase in production. There is a chance for growth in exports too. But more often it takes time for the production to adjust to the increased income. Where the production does not increase in sympathy with income rise, it leads to increased imports and increased supply of the currency of the country in the foreign exchange market. The result is similar to that of inflation, viz., and decline in the value of the currency. Thus an increase in national income will lead to an increase in investment or in consumption, and accordingly, its effect on the exchange rate will change. Here again it is the relative increase in national incomes of the countries concerned that is to be considered and not the absolute increase.

(6) Resource Discoveries when the country is able to discover key resources, its currency gains in value. A good example can be the have played by oil in exchange rates. When the supply of oil from major suppliers, such as Middles East, became insecure, the demand fro the currencies of countries self sufficient in oil arose.

Previous oil crisis favoured USA, Canada, UK and Norway and adversely affected the currencies of oil importing countries like Japan and Germany. Similarly, discovery oil by some countries helped their currencies to gain in value. The discovery of North Sea oil by Britain helped pound sterling to rise to over USD 2.40 from USD 1.60 in a couple of years. Canadian dollar also benefited from discoveries of oil and gas off the Canadian East Coast and the Arctic.

(7) Capital Movements there are many factors that influence movement of capital from one country to another. Short term movement of capital may be influenced buy the offer of higher interest in a country. If interest rate in a country rises due to increase in bank rate or otherwise, there will be a flow of short term funds into the country and the exchange rate of the currency will rise. Reverse will happen in case of fall in interest rates.

Bright investment climate and political stability may encourage portfolio investments in the country. This leads to higher demand for the currency and upward trend in its rate. Poor economic outlook may mean repatriation of the investments leading to decreased demand and lower exchange value for the currency of the country.

Movement of capital is also caused by external borrowing and assistance. Large scale external borrowing will increase the supply of foreign exchange in the market. This will have a favorable effect on the exchange rate of the currency of the country. When repatriation of principal and interest starts the rate may be adversely affected.

(8) Political factors Political stability induced confidence in the investors and encourages capital inflow into the country. This has the effect of strengthening the currency of the country. On the other hand, where the political situation in the country is unstable, it makes the investors withdraw their investments. The outflow of capital from the country would weaken the currency. Any news about change in the government or political leadership or about the policies of the government would also have the effect of temporarily throwing out of gear the smooth functioning of exchange rate mechanism.

10.6 Summary

Foreign exchange (Forex or FX) refers to the global system where currencies are bought, sold, and exchanged. It enables international trade, investment, tourism, and financial flows. The foreign exchange market determines exchange rates—the price of one currency in terms of another.

Exchange rates can be **fixed**, **floating**, or **managed**. They fluctuate based on supply and demand, interest rates, inflation, speculation, government intervention, and economic conditions. Forex markets are the largest and most liquid in the world, operating 24/7. Participants include central banks, commercial banks, investors, businesses, and travelers.

10.7 Key words

Exchange Rate-The price of one currency expressed in terms of another currency (e.g., USD/EUR).

Currency Appreciation-When a currency increases in value relative to another currency.

Currency Depreciation-When a currency decreases in value relative to another currency.

Foreign Exchange Market (Forex Market)-A global decentralized market where currencies are traded.

Spot Market-Where currencies are traded for immediate delivery.

Forward Market-A market where currencies are bought or sold for delivery at a future date at a predetermined rate.

10.8 Self Assessment Questions

1. What is the foreign exchange market?
2. What is the difference between currency appreciation and depreciation?
3. What are foreign exchange reserves?
4. Explain how supply and demand determine exchange rates in a floating system.
5. Why do governments intervene in the foreign exchange market?
6. Describe the difference between the spot market and the forward market?

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