FREE EXTRACT

Economy Previous Year Questions

Three questions from inside the book, with the explanation written out as it appears throughout. Nothing here is abridged for the sample.

1

With reference to the Monetary Policy Committee (MPC) in India, consider the following statements:

1. The members of the Committee other than the ex officio members from the Reserve Bank of India are appointed by the Central Government.

2. The inflation target for the country is determined and notified by the Reserve Bank of India in consultation with the Central Government.

3. In the event of an equality of votes in the Committee, the Governor of the Reserve Bank of India has a second or casting vote.

Which of the statements given above is/are correct?

(A) 1 and 2 only
(B) 2 and 3 only
(C) 1 and 3 only
(D) 1, 2 and 3

Answer: (C) 1 and 3 only

The Monetary Policy Committee was created by amending the Reserve Bank of India Act, 1934, and it has six members: three from the Reserve Bank, namely the Governor as chairperson, the Deputy Governor in charge of monetary policy and one officer of the Bank nominated by its Central Board, and three external members appointed by the Central Government on the recommendation of a search-cum-selection committee. So statement 1 is straightforwardly correct. Statement 2 reverses the roles, and this reversal is the trap that the examiner is actually testing: under the flexible inflation targeting framework it is the Central Government that determines the inflation target in consultation with the Reserve Bank, once in every five years, and notifies it in the Official Gazette; the notified target has been 4 per cent consumer price index inflation with a tolerance band of two percentage points on either side. The logic is worth remembering rather than memorising, because the target is a political and social choice about how much inflation a society will tolerate, while the instruments used to reach it, chiefly the policy repo rate, are left to the central bank. Statement 3 is correct, and it matters in practice because a six-member body can split three-three, in which case the Governor votes again to break the tie. Decisions are otherwise taken by a simple majority of members present and voting, with a quorum of four.

2

With reference to India's balance of payments, consider the following transactions:

1. Money sent home by an Indian citizen working in a Gulf country to his family in India.

2. Purchase of Government of India dated securities by a foreign portfolio investor.

3. Freight charges paid by an Indian importer to a foreign shipping company.

4. Repayment of the principal amount of an external commercial borrowing by an Indian company.

Which of the above are recorded in the current account of India's balance of payments?

(A) 1 and 3 only
(B) 2 and 4 only
(C) 1, 3 and 4 only
(D) 1, 2 and 3 only

Answer: (A) 1 and 3 only

The single test to apply here is whether the transaction changes India's stock of foreign assets and liabilities; if it does, it belongs to the capital and financial account, and if it does not, it sits in the current account. The current account covers trade in goods, trade in services, primary income such as wages and investment income, and secondary income, which is essentially unrequited transfers. A remittance from a worker abroad is a transfer with nothing given in return, so it enters the current account, and freight paid to a foreign shipping line is the import of a transport service, one of the classic invisibles, so it too is a current account item. When a foreign portfolio investor buys government securities, India acquires a liability to a non-resident, and when a company repays the principal of an external commercial borrowing, an existing liability is extinguished, so items 2 and 4 both belong to the financial account. Note the fine distinction that examiners love: the principal repayment is a financial account entry, but the interest paid on that same loan is primary income and therefore a current account debit. Remembering that India habitually runs a merchandise trade deficit that is partly offset by a surplus in services and remittances will also help you interpret current account deficit questions.

3

Which of the following are capital receipts of the Government of India?

1. Proceeds from the disinvestment of equity held in a public sector undertaking.

2. Dividends received from public sector undertakings.

3. Recovery of loans advanced by the Union Government to State Governments.

4. Grants-in-aid received from foreign governments and international institutions.

Select the correct answer using the code given below:

(A) 1 and 2 only
(B) 1 and 3 only
(C) 2, 3 and 4 only
(D) 1, 3 and 4 only

Answer: (B) 1 and 3 only

Government receipts are split into revenue receipts and capital receipts, and the working rule is simple: a receipt is a capital receipt if it either creates a liability for the government or reduces its assets. Disinvestment proceeds reduce the government's holding of equity in a public enterprise, and the recovery of a loan given to a State reduces a financial asset, so both are capital receipts, which is why the Budget shows them under non-debt capital receipts as distinct from borrowings. A dividend from a public sector undertaking is a recurring return on an investment that the government continues to hold, so nothing is created or extinguished and it is treated as non-tax revenue. Grants-in-aid received from abroad are also revenue receipts, because a grant carries no obligation to repay and no asset is surrendered; contrast this with an external loan, which does create a liability and is therefore a capital receipt. Candidates most often go wrong by lumping disinvestment and dividends together simply because both involve public sector undertakings, when in fact one is a capital receipt and the other is revenue. Keep the definition of fiscal deficit in mind alongside this, since it is total expenditure minus total receipts other than borrowings, which means disinvestment proceeds reduce the fiscal deficit while fresh borrowing does not.