Sherlocking Prelims

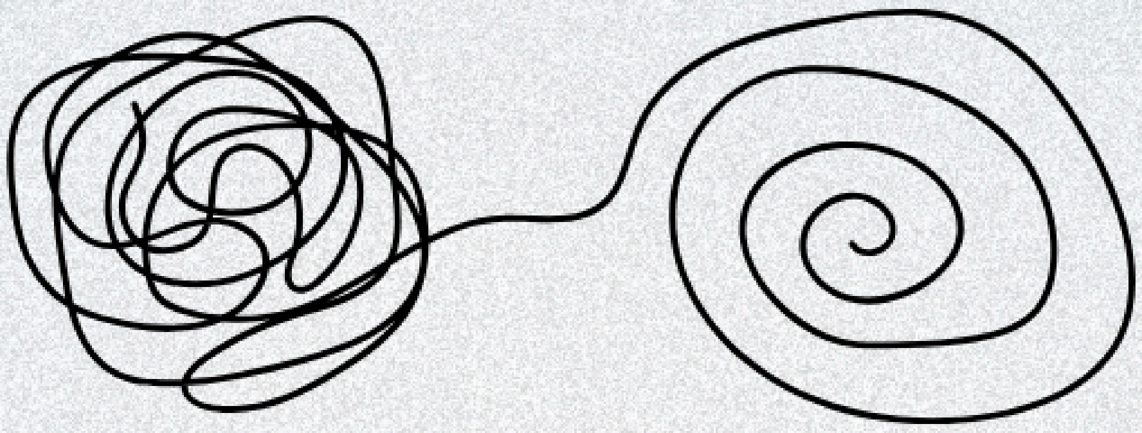
Economy Concepts

Unlock IAS Presents

Sherlocking Prelims Modules

- **PYQs-centered module(s) (2011 onwards for GS, 2018 onwards for CSAT)**
- **Individual Modules available for - History, Geography, Environment, Science & Tech, Polity, Heuristics, CSAT**
- **Regular live doubt sessions for all modules.**

Done with basics but not able to clear Prelims/apply the knowledge?



The Sherlocking Prelims Module(s) will help you rewire your approach – teaching you to leverage common sense and foundational knowledge

AIR 14 (2023) on 'Sherlocking'

> I was unable to clear my first Prelims attempt in CSE 2022. A major change in strategy took place after I came across Neil sir's 2022 Prelims Sherlocking video on YouTube the next year and it taught me how to properly analyze PYQ's the right way and identify themes, patterns and Heuristics.

AIR 230 (2023) on 'Sherlocking'

Ricky Lohkar Pradhan
@neilcantbirdwahtch thanks a lot for the Sherlocking course. I really could not have cleared prelims if not for Sherlocking.
11:03 AM

Neil
(Founder, Unlock IAS)
HCS (2021, Rank 93)

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FREE!

Interested? Contact @helpdeskupsc on Telegram for all module-related queries.

Marginal Product of Capital & Marginal Cost of Production

- **Marginal Product of Capital (MPK)**
  - Extra output from using one more unit of capital
  - Higher MPK → More investment; Lower MPK → Less investment
  - Example: Adding a new machine increases production output
  - Key Case: If MPK falls, investment demand decreases
- **Marginal Cost of Production (MC)**
  - Extra cost of producing one more unit
  - Lower MC → More production; Higher MC → Less production
  - Example: Producing the 101st unit costs $10 more
  - Key Case: If MC decreases, investment demand rises
- **Law of Diminishing Returns**
  - Adding more of one input (capital/labor) eventually leads to less additional output
  - Example: A factory with too many machines but not enough workers is inefficient

Economic Curves

- **Laffer Curve**
  - Relationship between tax rates and tax revenue
  - Inverted U-shape
  - High taxes reduce revenue due to disincentives
  - Example: Tax cuts may increase revenue
- **Phillips Curve**
  - Trade-off between inflation and unemployment
  - Downward sloping (short run), vertical (long run)
  - Lower unemployment leads to higher inflation (short run)
  - Example: Stagflation challenges this relationship
- **Lorenz Curve**
  - Represents income inequality
  - Bowed shape (further from diagonal = more inequality)
  - Greater gap means greater inequality
  - Example: Used in calculating Gini coefficient
- **Kuznets Curve**
  - Relationship between economic growth and inequality
  - Inverted U-shape
  - Inequality rises in early development, then falls
  - Example: Seen in industrializing nations
- **Engel Curve**
  - Relationship between income and consumption
  - Upward sloping for normal goods, downward for inferior goods
  - Spending on necessities grows slower than luxury goods
  - Example: Richer people spend more on leisure, not proportionally on food
- **J-Curve**
  - Short-term decline, long-term improvement in trade balance post-currency depreciation
  - J-shaped
  - Imports remain costly before exports rise
  - Example: Post-devaluation effects in Japan
- **Other Related Curves**
  - **Environmental Kuznets Curve (EKC)**: Pollution rises with growth but declines after threshold
  - **Fisher Curve**: Interest rates vs. inflation expectations
  - **Taylor Curve**: Trade-off between inflation variability and output variability
  - **Backward Bending Supply Curve of Labor**: Higher wages can reduce labor supply beyond a point

Types of Economies

- **Command Economy**
  - Government controls production, prices, and resources
  - Example: Soviet Union, North Korea
  - No private ownership, central planning
- **Market Economy**
  - Free-market forces determine production and prices
  - Example: USA, UK
  - Supply and demand decide resource allocation
- **Mixed Economy**
  - Combination of market & command economy (private + government control)
  - Example: India, France
  - Government regulates key sectors, rest is free-market
- **Traditional Economy**
  - Based on customs, traditions, and barter system
  - Example: Tribal economies in Africa, rural villages
  - No technological advancements, subsistence farming
- **Gig Economy**
  - Short-term, flexible jobs via freelancing & digital platforms
  - Example: Uber, Fiverr, Zomato delivery
  - No fixed employment, temporary contracts
- **Platform Economy**
  - Businesses operate via digital platforms connecting buyers & sellers
  - Example: Amazon, Airbnb
  - Platform acts as intermediary, no direct production
- **Sharing Economy**
  - Assets/services are shared rather than owned
  - Example: Airbnb (homes), BlaBlaCar (carpooling)
  - Users monetize unused assets
- **Informal Economy**
  - Unregulated, untaxed, unorganized jobs
  - Example: Street vendors, domestic workers
  - No legal protection, no formal contracts
- **Circular Economy**
  - Recycling, reusing, and minimizing waste in production
  - Example: Sweden's waste-to-energy policies
  - Sustainability-focused, reduces environmental impact

Types of Economic Recovery

- **V-shaped Recovery**→ Fast and sustained recovery after a sharp decline
- **K-shaped Recovery**→ Uneven recovery across sectors and social groups
- **L-shaped Recovery**→ Prolonged stagnation after a steep decline
- **W-shaped Recovery**→ Economy recovers, falls again, and then recovers (‘Double-Dip Recession’)
- **U-shaped Recovery**→ Slower recovery where the economy takes time to regain growth
- **J-shaped Recovery**→ Sharp decline followed by strong and rapid growth
- **Swoosh-shaped Recovery**→ Gradual but steady recovery after a sharp drop
- **Z-shaped Recovery**→ Rapid recovery surpassing pre-crisis levels temporarily

Money – Types

- **Based on Material Composition**
  - Commodity Money: Intrinsic value (Gold, Silver, Cowry shells)
  - Fiat Money: No intrinsic value, backed by government (Indian Rupee)
  - Fiduciary Money: Based on trust, not reserves (Cheques, Demand Drafts)
  - Representative Money: Backed by a commodity (Gold-backed currency)
- **Based on Liquidity**
  - M1 (Narrow Money): Cash + Demand Deposits (Most Liquid)
  - M2, M3, M4 (Broad Money): M1 + Savings & Time Deposits (Less Liquid)
- **Based on Issuance**
  - Legal Tender Money: Must be accepted as payment (Currency notes, coins)
  - Non-Legal Tender (Optional Money): Voluntarily accepted (Promissory Notes)
- **Modern Forms**
  - Plastic Money: Debit/Credit Cards
  - Digital Money: UPI, Cryptocurrencies, CBDCs

Quantitative & Qualitative Tools Used by RBI to Control Credit

- **Quantitative Tools (General Credit Control)**
  - Affect overall money supply & liquidity in the economy
  - **Cash Reserve Ratio (CRR)**: Percentage of a bank's total deposits kept as reserves with RBI
  - **Statutory Liquidity Ratio (SLR)**: Banks must maintain a percentage of NDTL in liquid assets
  - **Bank Rate**: Long-term interest rate at which RBI lends to commercial banks
  - **Repo Rate**: Short-term interest rate for banks borrowing from RBI
  - **Reverse Repo Rate**: Rate at which RBI borrows from banks, absorbing excess liquidity
  - **Open Market Operations (OMOs)**: Buying & selling government securities to regulate liquidity
  - **Marginal Standing Facility (MSF)**: Emergency borrowing window for banks
- **Qualitative Tools (Selective Credit Control)**
  - Target specific sectors to control credit flow
  - **Margin Requirements**: Setting minimum margins on loans to curb speculative credit
  - **Moral Suasion**: Non-mandatory persuasion by RBI to regulate credit expansion
  - **Credit Rationing**: Limiting credit supply to certain sectors to prevent risk buildup
  - **Selective Credit Controls (SCCs)**: Restricting loans for specific commodities to curb inflation

Government Securities in India

- **Issued by RBI**
  - **Treasury Bills (T-Bills)**
    - Tenure: Short-term (91, 182, 364 days)
    - Purpose: To meet short-term liquidity needs
  - **Cash Management Bills (CMBs)**
    - Tenure: Less than 91 days
    - Purpose: To manage short-term mismatches in cash flow
  - **Dated Government Securities (G-Secs)**
    - Tenure: Medium to long-term (5 to 40 years)
    - Purpose: To finance fiscal deficit and long-term infrastructure
- **Issued by Central Government**
  - **Sovereign Gold Bonds (SGBs)**
    - Tenure: 8 years (exit after 5 years)
    - Purpose: To reduce demand for physical gold and promote investment
  - **Inflation-Indexed Bonds (IIBs)**
    - Tenure: Varies (Long-term)
    - Purpose: To protect investors from inflation
  - **Floating Rate Bonds (FRBs)**
    - Tenure: 5 to 10 years
    - Purpose: To reduce interest rate risk with variable returns
  - **Zero-Coupon Bonds**
    - Tenure: 5 to 10 years
    - Purpose: Issued at a discount, redeemed at face value (No periodic interest)
- **Issued by State Governments**
  - **State Development Loans (SDLs)**
    - Tenure: 5 to 10 years
    - Purpose: To finance state-level expenditures

Key Differences – CPI vs WPI vs IIP

- **CPI (Consumer Price Index)**
  - **Measures:** Retail Inflation
  - **Published By**: NSO (MoSPI)
  - **Base Year**: 2012 = 100
  - **Includes Services?**✅ Yes
  - **Food & Beverages Weight**: 45.86% (Highest)
  - **Manufactured Goods Weight**: Lowest (Not Included)
  - **Used For**: RBI Inflation Targeting, Cost of Living Adjustments
- **WPI (Wholesale Price Index)**
  - **Measures:** Wholesale Inflation
  - **Published By**: Office of Economic Adviser (MCI)
  - **Base Year**: 2011-12 = 100
  - **Includes Services?**❌ No
  - **Food & Beverages Weight**: 22.62%
  - **Manufactured Goods Weight**: 64.23% (Highest)
  - **Used For**: Wholesale Price Trends, Industrial Planning
- **IIP (Index of Industrial Production)**
  - **Measures**: Industrial Growth
  - **Published By**: NSO (MoSPI)
  - **Base Year**: 2011-12 = 100
  - **Includes Services?**❌ No
  - **Food & Beverages Weight**: ❌ Not Applicable
  - **Manufactured Goods Weight**: 77.63%
  - **Used For**: Economic & Industrial Growth Analysis

Fiscal Deficit & Related Terms

- **Fiscal Deficit**
  - **Definition**: Total government expenditure exceeds total revenue (excluding borrowings)
  - **Significance**: Indicates government borrowing requirements
- **Revenue Deficit**
  - **Definition**: Revenue expenditure exceeds revenue receipts
  - **Significance**: Shows excessive spending on subsidies & welfare schemes
- **Effective Revenue Deficit**
  - **Definition**: Revenue deficit - grants for capital asset creation
  - **Significance**: Provides a better picture of fiscal discipline
- **Primary Deficit**
  - **Definition**: Fiscal deficit minus interest payments
  - **Significance**: Measures government's ability to manage non-debt finances
- **Monetized Deficit**
  - **Definition**: Fiscal deficit financed by RBI printing new money
  - **Significance**: Can cause inflation if excessive

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Variable Rate Repo (VRR) & Variable Rate Reverse Repo (VRRR)

- **Objective: Manage liquidity in the banking system through market-driven rates**
- **Variable Rate Repo (VRR)**:
  - **Market-determined rate**(lower than Repo but not below Reverse Repo Rate)
  - **Used for borrowing liquidity for short-term (1 to 14 days)**
  - **Applied when banks avoid Repo Rate borrowing due to lower market rates**
  - **Injects liquidity into the banking system**
- **Variable Rate Reverse Repo (VRRR)**:
  - **Absorbs excess liquidity from banks**
  - **Short-term liquidity absorption tool**
  - **Part of RBI's monetary policy operations**
- **Repo Rate**:
  - **Fixed by Monetary Policy Committee (MPC)**
  - **Standard borrowing rate for banks from RBI**

Difference Between Banks & NBFCs

- **Regulation**:
  - **Banks**: Regulated by **RBI under Banking Regulation Act, 1949**
  - **NBFCs**: Regulated by **RBI under RBI Act, 1934**(but with fewer restrictions)
- **Deposit Acceptance**:
  - **Banks**: Can accept **demand deposits**(savings & current accounts)
  - **NBFCs**: **Cannot accept demand deposits**
- **Payment & Settlement**:
  - **Banks**: Part of **Payment & Settlement System**, can issue cheques
  - **NBFCs: Not part of payment system**, cannot issue cheques
- **Deposit Insurance**:
  - **Banks**: Covered under **DICGC insurance up to ₹5 lakh per depositor**
  - **NBFCs: Not covered**under DICGC insurance
- **Lending & Services**:
  - **Banks**: Provide **loans, deposits, investment, forex, and other financial services**
  - **NBFCs**: Provide **loans, asset financing, hire purchase, investment, but no forex services**
- **Foreign Investment**:
  - **Banks: FDI up to 74% (Private banks)**, 20% for PSU banks
  - **NBFCs**: **100% FDI allowed under automatic route**
- **Priority Sector Lending (PSL)**:
  - **Banks**: **Mandatory PSL target (40% of ANBC)**
  - **NBFCs**: **No PSL obligation**

Exchange Rate

- **Definition**: Price of one currency in terms of another
- **Types of Exchange Rates**:
  - **Nominal Exchange Rate (NER)**: Market price of one currency in terms of another
  - **Real Exchange Rate (RER)**: Adjusted for inflation; reflects purchasing power
  - **Bilateral vs Multilateral Exchange Rate**: Single pair vs multiple currencies
  - **Effective Exchange Rate (EER)**: Weighted average of exchange rates with trade partners
- **Types of Exchange Rate Systems (With Country Examples)**:
  - **Fixed Exchange Rate**: Govt decides & pegs currency (e.g., Saudi Arabia, UAE peg to USD)
  - **Floating Exchange Rate**: Market-driven (e.g., USA, UK, Eurozone)
  - **Managed Floating Exchange Rate**: Market-driven with govt intervention (e.g., India, China)
- **India's Exchange Rate Regime**:
  - **Managed Floating System**: Market-driven but RBI intervenes when needed
  - **Rupee Depreciation & Appreciation**: When INR weakens/strengthens against USD

Currency Convertibility

- **Definition**: Ease of converting a currency into foreign currency & vice versa
- **Types of Convertibility**:
  - **Current Account Convertibility**: Allows conversion for trade in goods, services, remittances
  - **Capital Account Convertibility**: Allows unrestricted capital movement for investments & loans
- **India's Approach to Convertibility**:
  - **Current Account**: ✅ Fully Convertible (Since 1994, as per IMF obligations)
  - **Capital Account**: ❌ Partially Convertible (To prevent volatility & risks)
- **Why India Has Partial Capital Account Convertibility?**:
  - **Protects Financial Stability**: Prevents sudden capital outflows & crises
  - **Controls Speculative Hot Money**: Limits volatile short-term investments
  - **Manages Exchange Rate Volatility**: RBI intervenes in forex markets
  - **Gradual Liberalization**: FDI is largely open, but FPI has restrictions

Balance of Payments (BoP)

- **Definition**: Record of all economic transactions between a country & the rest of the world.
- **BoP Components**:
  - **Current Account**(Trade & Income Transactions):
    - **Goods (Merchandise Trade)**: Exports & Imports
    - **Services (Invisibles)**: IT, Tourism, Financial Services
    - **Income & Transfers**: Remittances, Dividends, Foreign Aid
  - **Capital Account**(Investment & Borrowing Transactions):
    - **Foreign Investment**: FDI (Direct), FPI (Portfolio)
    - **External Borrowings**: IMF Loans, ECBs, Bonds
    - **Foreign Reserves**: RBI's forex interventions
- **Key BoP Concepts**:
  - **Autonomous Transactions (Above-the-Line)**:
    - Market-driven, not aimed at balancing BoP
    - Includes trade, FDI, remittances, & private transfers
  - **Accommodating Transactions (Below-the-Line)**:
    - Govt or RBI intervention to balance BoP
    - Includes forex reserves use, official borrowings
- **India's BoP Trends**:
  - **Mostly Current Account Deficit (CAD) & Capital Account Surplus**
  - **Forex Reserves used for currency stability**

CECA vs. CEPA

- **Definition:** Trade agreements enhancing economic cooperation between countries.
- **CECA (Comprehensive Economic Cooperation Agreement):**
  - **Focus**: Trade in goods & services.
  - **Key Features**:
    - Reduces tariffs on goods & services.
    - Limited scope compared to CEPA.
    - Encourages investment but with fewer relaxations.
  - **Recent Example**: India-Malaysia CECA (2023) – Enhanced trade & services collaboration.
- **CEPA (Comprehensive Economic Partnership Agreement):**
  - **Focus**: Trade, investment, & regulatory cooperation.
  - **Key Features**:
    - Includes trade, services, IPR, dispute resolution.
    - Allows deeper market access & investment protections.
  - **Recent Examples**:
    - India-UAE CEPA (2022) – Eliminated duties on 80% tariff lines, boosting exports.
    - India-South Korea CEPA (2023) – Strengthened bilateral trade & investment ties.

Levels of Trade Agreements

1. **Preferential Trade Agreement (PTA)**: Countries reduce tariffs on selected goods/services with limited product coverage (India-Chile PTA, 2017).
2. **Free Trade Agreement (FTA)**: Tariffs & trade barriers eliminated between countries, covering only trade in goods/services (India-Australia ECTA, 2022).
3. **Comprehensive Economic Cooperation Agreement (CECA)**: Expands beyond FTA, including investment with limited services coverage (India-Mauritius CECA, 2021).
4. **Comprehensive Economic Partnership Agreement (CEPA)**: Covers trade, investment, & regulatory cooperation with deeper market access & dispute resolution (India-UAE CEPA, 2022).
5. **Customs Union**: Countries form a common external tariff policy, allowing free trade within but imposing uniform tariffs on non-members (Eurasian Economic Union, 2015).
6. **Common Market**: Free movement of goods, services, labor & capital with harmonized economic policies (African Continental Free Trade Area, 2021).