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ECONOMICS

Classroom Study Material

PART-1

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ECONOMY PART 1

NATIONAL INCOME ACCOUNTING

Student Notes:

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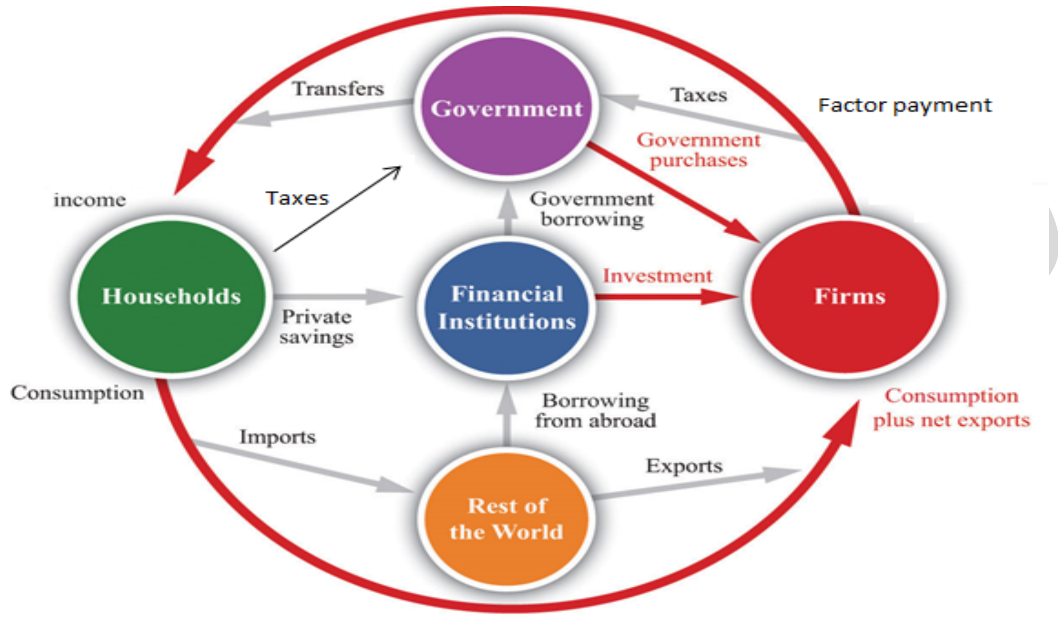
1. National Income Accounting

National Income Accounting or NIA refers to methods or techniques used to measure the economic activity in a national economy as a whole. As one can calculate income for a single person or an entity, the same can be done for a country also.

In an economy, households buy goods and services from firms, and firms use their revenue from sales to pay wages to workers, rent to landowners, and profit to firm owners. GDP equals the total amount spent by households in the market for goods and services. It also equals the total wages, rent and profit paid by firms in the markets for the factors of production.

The following Circular Flow Diagram shows the flow of resources (money) in an open economy:



The diagram describes all the transactions between households and firms in a simple economy. It simplifies matters by assuming that all goods and services are bought by households and that households spend all of their income.

Money continuously flows from households to firms and then back to households.

GDP measures this flow of money. It can be computed for an economy in one of the following ways:

- By adding up the total expenditure by households (Expenditure Method)
- By adding up the total income (wages, rent, profit) paid by firms (Income Method)
- By adding up the total value of all final goods and services produced in the economy (Output / Value Added Method)

Since all expenditure in the economy ends up as someone's income, GDP is the same regardless of how we compute it.

1.1. Significance of National Income Accounting

- **International Comparison:** National Income Accounting measures growth rate and development of nations, which can be used to compare standard of living of different countries.
- **Business Decisions:** It reflects the relative contribution and potential of various sectors of the economy which guides the business class to plan for future production.
- **Policy Formulation**: It throws light on the distribution of income and resources in the economy, which helps government in proper allocation of resources to bring equality and development in nation.

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- **Policy Evaluation:** The income accounting identifies specific economic achievements and failures which helps people of the nation in evaluating the policies of the government.
- **Annual Budget**: It shapes the budgetary policy of the Government, makes the borrowing and tax policy in order to neutralize the fluctuations of income and employment. The government takes to deficit or surplus budget to arrest depression or inflation in an economy.
- **National statistics** gives clear picture of how the national expenditure is divided into investment and consumption.

2. Concepts of National Income

Over a period of time four ways to calculate the income of a nation have been developed by the economists. These four ways to calculate the national income of a nation are **GDP, GNP, NDP and NNP**.

2.1. GDP or Gross Domestic Product

GDP or Gross domestic product refers to total market value of all the final goods and services produced in an economy in a given period of time. For India, this time period is from 1st April to 31st March. This means it measures the value of final goods and services produced **within a geographic boundary** regardless of the nationality of the individual or firm.

For instance, cars manufactured in India by Japanese company will be included in Indian GDP. Similarly, the Jaguar cars manufactured in UK by Tata will not be counted in India's GDP.

It refers to only **final** output of such goods and services. The rule that only finished or final goods must be counted is necessary to avoid double or triple counting of raw materials, intermediate products, and final products. For example, the value of automobiles already includes the value of the steel, glass, rubber, and other components that have been used to make them. To be precise, we define the following:

a) **Final Output**: Goods and Services purchased for final use.
b) **Intermediate Goods**/Factors of Production/Raw Materials: Products used as input in the production of some other product. There are two ways to take into account double counting:
   i. Calculate only the value of the final product.
   ii. Calculate the value added at each stage of production, from the beginning of the process to the end. Specifically, it is derived by subtracting the value of the intermediate good from the value of the sale.

2.1.1. Real GDP and Nominal GDP

Nominal GDP refers to current year production of final goods and services valued at **current year prices**.

Real GDP on the other hand refers to the current year production of goods and services valued at **base year prices**. Such base year prices are **constant prices**.

Real GDP is a much better way to calculate the GDP because in a particular year GDP may be bloated up because of high rate of inflation in the economy. Real GDP, therefore, allows us to determine if production increased or decreased, regardless of changes in inflation and purchasing power of the currency.

To explain it better, consider an economy which produces only apples. In a particular year, say 2010, there were 100 apples produced in the economy and the cost of each apple was 1$. The nominal GDP of the economy in 2010 will be 100$ (multiplying 100 by 1$). After 5 years, the production of apples reduced to 50 apples in a year. However, the prices increased to 3$. Then nominal GDP for 2015 will be 150$ (multiplying 50 with 3$). It shows increase in GDP even though production got decreased.

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Now consider year 2010 as base year. Then, the real GDP for the year 2010 will be 100$ and for the year 2015 will be 50$ (multiplying 50 with prices of 2010). The decline in real GDP is in proportion to decline in production in the economy. Thus, real GDP represents better picture of any economy than nominal GDP.

The concept of base year has been covered in greater detail in subsequent sections.

2.2. GNP or Gross National Product

The concepts of **GNP or Gross National Product** and GDP are closely related. As mentioned above, GDP reflects the goods and services produced within the boundaries of the country by both citizens and foreigners. GDP focuses on where the output is produced rather than who produced it. On the other hand, GNP is a measure of the value of output produced by the nationals of a country irrespective of the geographical boundaries. It refers to the output of Indian citizens both within India and in all other countries of the world.

To make it simpler, a few examples have been considered here. Microsoft is a US based firm. When it opens up a production utility in India, value of output from that utility is added to India's GDP, but it is not added while calculating GNP of India. Similarly, when Indian companies such as Infosys or TCS produce services in the US, the value of those services are not added in the Indian GDP but they are utilized while calculating the Indian GNP. **GDP** is about **where** production takes place. **GNP**, on the other hand, is about **who** produces them.

GNP = GDP + Net Factor Income from Abroad. In case of an economy with great levels of inflows of FDI and very less outgoing FDI, the GDP would generally be more than the GNP. On the other hand, if in an economy, more of its nationals move abroad and generate economic activity when compared to foreigners who come in and perform any economic activity, its GNP would be larger than its GDP. **In India's case, GNP is lower than its GDP as net income from abroad has always been negative in India.**

Even though GDP is a figure which is prominently used by economists across the world, some economists criticize it for not reflecting the true state of a nation's economy. GDP takes into account the profits earned in a nation by overseas companies that are remitted back to foreign investors. If these remitted profits are very large compared with earnings from the nation's overseas citizens and assets, the GNP will be significantly below GDP. The difference between GDP and GNP of a nation also reflects how much the outside world is dependent on its products and how much it depends on the world for the same.

2.2.1. Net Factor Income from Abroad

Net Factor Income from Abroad (NFIA) is the difference between the aggregate amount that a country's citizens and companies earn abroad, and the aggregate amount that foreign citizens and overseas companies earn in that country.

In short, **Net Factor Income from Abroad = GNP – GDP**.

Net foreign factor income in most of the countries is very small since factor payments earned by citizens and those paid to foreigners more or less offset each other.

2.3. Why GDP is the Most Acceptable Indicator Worldwide?

- GDP growth (as a measure of economic growth) is a major contributor to welfare and GDP tends to be correlated with several other measures of 'development', such as literacy and healthcare provision.
- As currently defined, it has a clear methodology and is relatively easy to calculate.
- Since it is a monetary/mathematical/accounting calculation with an established methodology, it is objective (in contrast, such things as 'happiness' and 'political freedom' are subjective and difficult to measure).

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- It is widely used and all GDP calculations are made using broadly the same methodology. This facilitates cross-country and over-time comparisons.
- Given its long history and standard methodology, it is reasonably well-understood by policy-makers.

2.4. Depreciation

In the process of production, all machines and equipment used to produce other goods, are subject to some wear and tear. In economic parlance, this loss of capital which every economy has to suffer is called as **Depreciation**.

A part of capital goods produced in the economy must be devoted to replace this wear and tear. Otherwise, the productive capacity of a nation would be depleted. This replacement of the capital used is **Capital Consumption Allowance**.

In this scenario, the investment expenditure of the firms is made up of two parts. One part is to buy new capital goods and machinery for production. It is called **Net Investment** because the production capacity of the firms can be expanded.

Another part is spent on replacing the used-up capital goods or the maintenance of existing capital goods. The expenses incurred for this are called **Depreciation Expenditure**.

The total investment by firms comprising these two amounts is called **Gross Investment**.

Gross Investment = Net Investment + Depreciation

Or, **Net Investment = Gross Investment – Depreciation.** The Net investment increases the production capacity and output of a nation if it is positive. This can easily be verified at the level of a single plant: the number of new machines installed in any given year must be greater than the machines that have been used up during that year.

The governments decide and announce the rates by which assets depreciate and a list is published, which is used by the different sections of the economy to determine the real levels of depreciations in different assets.

2.5. NDP or Net Domestic Product

Net Domestic Product (NDP) is the GDP calculated after adjusting the value of 'depreciation'. This is, basically, net form of the GDP, i.e. GDP minus the total value of the 'wear and tear' (depreciation) that happened in the assets while goods and services were being produced.

NDP = GDP – Depreciation.

The NDP of an economy is always less than it's GDP, because the Depreciation can never be reduced to zero and will always be positive.

2.6. NNP or Net National Product

The Net national product (NNP) is equal to gross national product (GNP) minus Depreciation.

NNP = GNP - Depreciation

The concept of NDP and NNP are not used to compare different economies because the method of calculating depreciation varies from nation to nation.

2.7. The concept of Market Price and Factor Cost

Market price refers to the actual transacted price of goods and services. It includes the indirect taxes which raise the prices and subsidies which lower the price.

Factor cost refers to cost of all factors of production used or consumed in producing goods and services. It includes rent for land, interest for capital, wages for labor and profit for entrepreneurship. It is the actual production cost at which the goods and services are produced

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by the firm. Thus, indirect taxes are excluded and subsidies by the government are included while calculating Factor Cost.

In other words, Factor Cost (FC) = Market Price – Net Indirect Taxes

Where, Net Indirect Taxes (NIT) = Indirect Taxes – Subsidies

Therefore, **Factor Cost = Market Price - Indirect Taxes + Subsidies**

Using this concept, the GDP at factor cost can be calculated by subtracting Net Indirect Tax from GDP at Market Price.

Or, GDP at Factor Cost = GDP at Market Price – Net Indirect Tax

Or, GDP at Factor Cost = GDP at Market Price – Indirect Tax + Subsidies

Similarly, GNP at Factor Cost = GNP at Market Price – Net Indirect Tax

NDP at Factor Cost = NDP at Market Price – Net Indirect Tax

NNP at Factor Cost = NNP at Market Price – Net Indirect Tax

2.8. National Income (NI)

The National income is a measure of the sum of all factor incomes earned by the citizens of a country for their land, labor, capital, and entrepreneurial talent, whether within the country or abroad. It is equal to the **Net National Product (NNP) at Factor Cost**. It is obtained, as explained above, by deducting Net Indirect Tax from NNP at Market Price.

National Income at Factor Cost = NNP at Market Price – Indirect Taxes + Subsidies

The reasons for choosing NNP at factor cost as National Income are:

- NNP shows the income earned by all citizens of country. This makes sense, since the earnings of foreigners should not be included in the India's national income. Thus NNP is preferred over NDP.
- Factor Cost is used because Net Indirect Taxes like sales taxes, excise taxes are not the payments for factors of production.
- There is lack of uniformity in taxes among the countries.
- The goods are not printed with their prices in developing countries like India.

2.9. Transfer Payments

Transfer payments refer to payments made by the government to individuals for which there is no economic activity produced in return by these individuals. A few examples of transfer payments include old age pensions, scholarships etc.

2.10. Personal Income (PI)

Personal income includes all income which is received by all the individuals in a year. It also includes transfer payments such as LPG subsidy. The welfare payments are received by households, but they are not elements of national income because they are transfer payments.

Similarly, in national income accounting, some income is attributed to individuals, which they do not actually receive such as undistributed profits, employee's contribution for social security, corporate income taxes etc. These are part of national income but are not received by individuals. Therefore, they are to be deducted from national income to estimate the personal income. Thus Personal income is:

PI = NI + transfer payments — Corporate retained earnings, income taxes, social security taxes.

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2.11. Disposable Personal Income (DPI)

Disposable personal income refers to the amount, which in actual is at the disposal of individuals to spend as they like. It is the amount which is left with the individuals after paying personal taxes such as income tax, property tax, professional tax etc. Therefore, Disposable Personal Income = Personal Income—Personal Taxes.

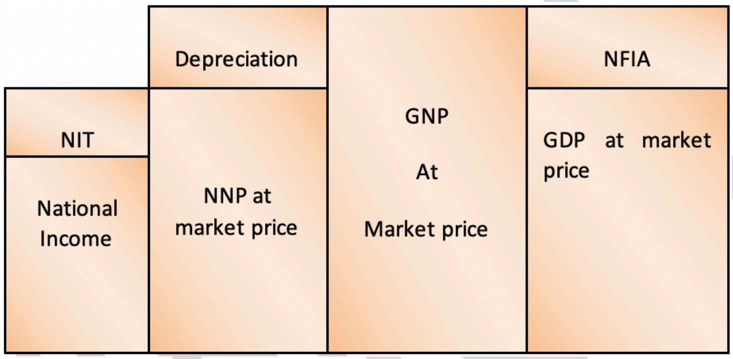
DPI = PI — Personal Taxes.

This concept is very useful for studying and understanding the consumption and saving behavior of the individuals. It is the amount, which households can spend and save.

Disposable Income = Consumption + Savings

The important equations we have discussed so far are given below:

- National Income = NNP at Factor Cost
- NNP at Factor Cost = NNP at Market Price – Net Indirect Tax
- NDP at Factor Cost = NDP at Market Price – Net Indirect Tax
- Net Indirect Taxes (NIT) = Indirect Taxes – Subsidies
- NNP = GNP – Depreciation
- NDP = GDP – Depreciation
- GNP = GDP + Net Factor Income from Abroad



3. Factors Affecting National Income

Several factors affect the national income of a country. Some of them have been listed below:

1. **Factors of Production:** Normally, the more efficient and richer the resources, higher will be the level of National Income or GNP.
2. **Land:** Resources like coal, iron and timber are essential for heavy industries so that they must be available and accessible. In other words, the geographical location of these natural resources affects the level of GNP.
3. **Capital:** Capital is generally determined by investment. Investment in turn depends on other factors like profitability, political stability etc.
4. **Labour and Entrepreneur:** The quality or productivity of human resources is more important than quantity. Manpower planning and education affect the productivity and production capacity of an economy.
5. **Technology:** This factor is more important for nations with fewer natural resources. The development in technology is affected by the level of invention and innovation in production.
6. **Government:** Government can help to provide a favorable business environment for investment. It provides law and order, regulations.
7. **Political Stability:** A stable economy and political system helps in appropriate allocation of resources. Wars, strikes and social unrests will discourage investment and business activities.

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4. Comparing National Income Across Countries

To compare GDP between two countries having different currencies in use, GDP figures must first be converted into a common currency. The conversion of currency can be done using exchange rates. These exchange rates express the national currency's quotation in respect to foreign ones. For example, if exchange rate of dollar is 60 Rupees then the Indian GDP of 120 trillion Rupees would be worth 2 trillion Dollars.

4.1. Types of Exchange Rates

Economists distinguish between two exchange rates: nominal exchange rate and real exchange rate. Let's discuss each in turn and see how they are related.

Nominal Exchange Rate is the relative price of the **currencies** of two countries. For example, if the exchange rate between the U.S. dollar and the Indian Rupee is Rs. 60 per dollar, then you can exchange one dollar for 60 Rupees in world markets for foreign currency. When people refer to "the exchange rate'' between two countries, they usually mean the nominal exchange rate.

Nominal exchange rates are established on currency financial markets called "**forex markets**", which are similar to stock exchange markets.

Real Exchange Rate is the relative price of the **goods** of two countries. That is, the real exchange rate tells us the rate at which we can trade the goods of one country for the goods of another. The real exchange rate is sometimes called the terms of trade.

Till now we have discussed the bilateral exchange rates which facilitate conversion of one's currency into other. There is a concept of Effective Exchange Rate which describes the relative strength of a currency relative to basket of other currencies.

Thus, the **Nominal Effective Exchange Rate** (NEER) is the weighted average value of nominal exchange rate of the rupee against the currencies of major trading partners of India. On the other hand, the **Real Effective Exchange Rate** (REER) is the weighted average of Real Exchange Rates of Rupee against the currencies of major trading partners of India.

The weights are determined by the importance that a home country places on all other currencies traded within the pool, as measured by the balance of trade. Unlike NER and RER, NEER and REER are not determined for each foreign currency separately. Rather, each is a single number that expresses what is happening to the value of the domestic currency against a whole basket of currencies. It gives some reference or benchmark about how the currency is performing in relation to the rest of the world as a whole, rather than just individual countries.

Even though Indian GDP calculated in rupees can be converted to dollars using market determined exchange rate but such an exercise has its own limitations. Such a market determined exchange rate only takes into account exports and imports and neglects non-traded GDP, which produced and consumed domestically. In such a situation, the concept of **Purchasing Power Parity (PPP)** is used.

The Purchasing Power Parity tells us how much of a basket of internationally traded goods and services can be bought with Indian rupee in India vis-à-vis how much of the same basket can be bought in the US with the help of a dollar. Therefore, whereas the market determined exchange rate might be Rs 60 for a US dollar, the PPP exchange rate may show this parity at Rs 30 for a US dollar. This ultimately results in a greater GDP at PPP rates when compared to GDP at market rates for India.

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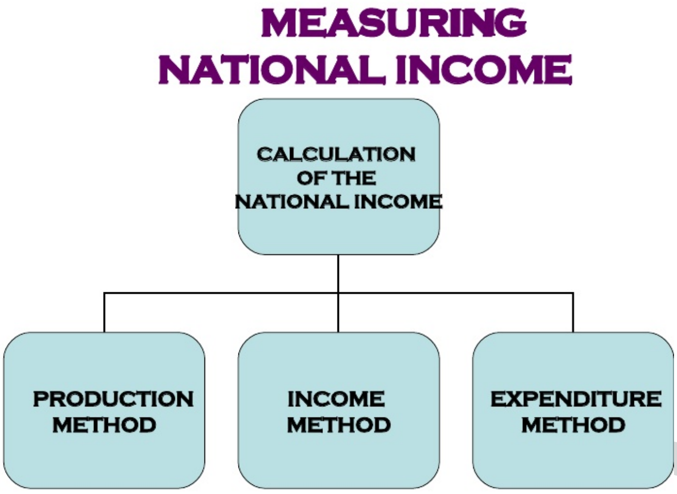
5. Measurement of National Income



In India, GDP is estimated by Central Statistical Office (CSO). There are three different ways of estimating the national income of a country, these three methods are:

1. Value Added Method (or the Product Method)
2. Income Method
3. Expenditure Method

Which method is to be employed depends on the availability of data and purpose.

5.1. Value Added Method

Under the value added or production method, the GDP is calculated at market prices, which is the total value of outputs produced at different stages of production. It needs to be mentioned that caution should be taken to take Final Goods and not Intermediate Goods, as it will result in Double Counting.

Some of the goods and services **included** in production are:

- Goods and services sold in the market.
- Goods and services not sold but supplied free of cost.
- Services provided by the agents.

> For example, in a Cycle Manufacturing Unit, computing the total value of cycles produced in a year, the final value of the cycle (Multiplied by total no of units produced) which is ready to be marketed for sale will be taken, not the cost of intermediate goods which are used in the process of manufacture, as it will result in double counting. Suppose the market price of a cycle is Rs. 2000 which includes, say, profit margin of Rs. 200 besides the cost of manufacturing of Rs. 1800. This 1800 includes all costs including components and parts etc. (these are intermediate goods which are used in the process of production.) If the costs of parts etc. are also taken while computing final value of total units produced, it will give inflated figure and hence result in double counting error. Similarly, at macro level, while computing the national Income under Value Added Method the value of final goods and services should be taken up to avoid the double counting error as the cost of Intermediate Goods are already counted in the final value of the product.

Some of the goods and services **not included** in production are:

- Second hand items and purchase and sale of the same. Sale and purchase of used cars, for example, are not a part of GDP calculation as no new production takes place in the economy.
- Production due to illegal activities.

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- Non-economic goods such as air and water.
- Transfer Payments such as scholarships, pensions etc. are excluded as there is income received, but no good or service is produced in return.

5.2. Income Method

This approach focuses on aggregating the payments made by firms to households, called factor payments. This gives the National Income, defined as total income earned by citizens and businesses of a country.

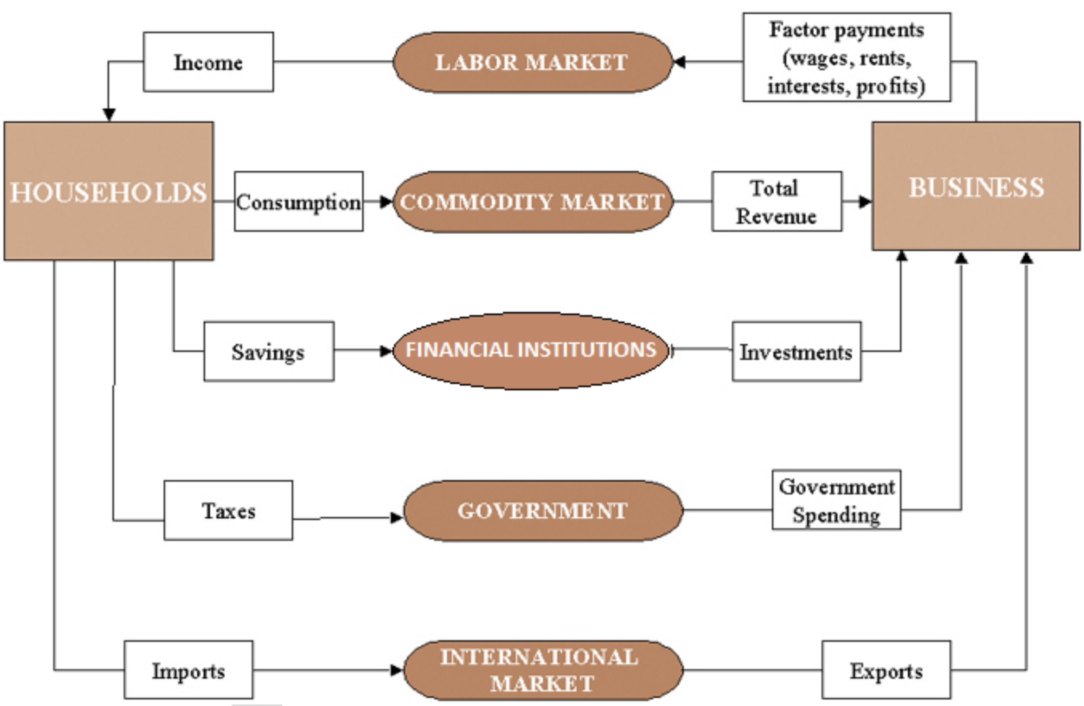
There are four types of factors of production and four types of factor incomes accordingly i.e. Land, Labour, Capital and Organization as Factors of Production and Rent, Wages, Interest and Profit as Factor Incomes correspondingly.

We need to add indirect taxes, less subsidies and add depreciation to get GDP.

GDP = Wages+ Interest + Rent +Profit + Dividend + Indirect Taxes-Subsidies+ Depreciation

The term Profit can be further sub-divided into: profit tax; dividend to all those shareholders; and retained profit (or retained earnings).

CIRCULAR FLOW OF INCOME



Such an approach is adopted in India to calculate the contribution of services sector to the economy.

Any income corresponding to which there is no flow of goods and services or value added, it should not be included in calculation by Income method.

5.3. Expenditure Method

The expenditure method measures the final expenditure on GDP. Amount of Expenditure refers to all spending on currently-produced final goods and services only in an economy. In an economy, there are three main agencies, which buy goods and services. These are: Households, Firms and the Government.

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This final expenditure is made up of the sum of 4 expenditure items, namely:

a) **Consumption (C):** Personal Consumption made by households, the payment of which is paid by households directly to the firms which produced the goods and services desired by the households.
b) **Investment Expenditure (I):** Investment is an addition to capital stock of an economy in a given time period. This includes investments by firms as well as governments sectors.
c) **Government Expenditure (G)**: This category includes the value of goods and service purchased by Government. Government expenditure on pension schemes, scholarships, unemployment allowances etc. **are not included** in this as all of them come under **transfer payments.**
d) **Net Exports (X-IM):** Expenditure on foreign made products (Imports) are expenditure that escapes the system, and must be subtracted from total expenditures. In turn, goods produced by domestic firms which are demanded by foreign economies involve expenditure by other economies on our production (Exports), and are included in total expenditure. The combination of the two gives us Net Exports.

GDP= C+I+G+X-IM

5.4. Application of Various Methods

Each approach gives a different perspective on the economy. However, the fundamental principle underlying national income accounting is that, all three approaches give identical measurements of the amount of current economic activity.

We can illustrate why these three approaches are equivalent with the help of an example.

Imagine an economy with only two businesses, called Khanna Fruits and Sharma Juices. Khanna Fruits owns and operates orange groves. It sells some of its oranges directly to the public. Rest of these oranges are sold to Sharma Juices which is involved in the production and sale of orange juice. The following table shows the transactions of each business during a year.

Khanna Fruits	
Wages paid to Khanna Fruits employees	Rs. 15,000
Taxes paid to government	5,000
Revenue received from sale of oranges	35,000
Oranges sold to public	10,000
Oranges sold to Sharma Juices	25,000
Sharma Juices	
Wages paid to Sharma Juices employees	Rs. 10,000
Taxes paid to government	2,000
Oranges purchased from Khanna Fruits	25,000
Revenue received from sale of orange juice	40,000

Product Method

Khanna Fruits produces output worth Rs. 35,000 and Sharma Juices produces output worth Rs. 40, 000. However, measuring overall economic activity by simply adding Rs. 35,000 and Rs. 40,000 would "double count" the Rs. 25,000 of oranges that Sharma Juices purchased from Khanna Fruits and processed into juice. To avoid this double counting, we sum value added rather than output: Because Sharma Juices processed oranges worth Rs. 25,000 into a product worth Rs. 40,000, Sharma Juices value added is Rs. 15,000 (40,000 – 25,000). Khanna Fruits doesn't use any inputs purchased from other businesses, so its value added equals its revenue of Rs. 35,000. Thus total value added in the economy is Rs. 35,000 + Rs. 15,000 = Rs. 50,000

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Income Approach

As seen before, the (before-tax) profits of Khanna Fruits equal its revenues of 35,000 minus its wage costs of Rs. 15,000. The profits of Sharma Juices equal its revenues of Rs. 40,000 minus the Rs. 25,000 the company paid to buy oranges and the Rs. 10,000 in wages to its employees. Adding the Rs. 20,000 profit of Khanna Fruits, the Rs. 5,000 profit of Sharma Juices, and the Rs. 25,000 in wage income received by the employees of the two companies, we get a total of Rs. 50,000, the same amount determined by the product approach.

Expenditure Approach

In this example, households are ultimate users of oranges. Sharma Juices is not an ultimate user of oranges because it sells the oranges (in processed, liquid form) to households. Thus ultimate users purchase Rs. 10,000 of oranges from Khanna Fruits and Rs. 40,000 of orange juice from Sharma Juices for a total of Rs. 50,000, the same amount computed in both the product and income approaches.

Output or Value added method is primarily used in the registered manufacturing units and primary sector in India. Income method is used in services sector. Whereas, the expenditure method is adopted to calculate the contribution of Real Estate Sector.

The product method is the principal method used in underdeveloped economies, whereas income method is generally used in developed economics for the estimation of national income.

5.5. Base Year, GDP Deflator

GDP Deflator: It is a tool to measure the inflation comprehensively. It represents the ratio of GDP at current prices to GDP at constant prices. GDP deflator is published on a quarterly basis since 1996 with a lag of two months. It is because of this very reason that economists prefer the use of WPI or CPI for deflating nominal price estimates to derive real price estimates.

Essentially **GDP deflator = (Nominal GDP/Real GDP) * 100**.

Unlike the WPI and the CPI, GDP deflator is not based on a fixed basket of goods and services, it covers the whole economy. One of the other advantages of GDP deflator is that changes in consumption patterns or the introduction of new goods and services are automatically reflected in the deflator, such a feature is missing in WPI/CPI.

Base Year: To make the calculation of GNP/GDP easier, economists use a price index to find the real GNP/GDP. A Price index is a number showing the changes in the overall level of prices. It shows a change in the general price level of an economy. Base year is the year used as the beginning or the reference year for constructing an index, and which is usually assigned an arbitrary value of 100.

The Indian Government has changed the base year for calculating national accounts to 2011-12 from 2004-05. The basis for selection of the base year are:

- **Stability** of macroeconomic parameters. It has to be a normal year without large fluctuations in production, trade and prices of goods and services.
- **Data availability**: Data available for the year should be reliable.
- **Comparability**- so that same parameters should be in use in both the years. Therefore, it should be a recent year and not go long back into history.

5.6. Difficulty of Measurement (With Special Reference to India)

Economists face a number of problems while calculating the National Income some of them are:

a) **Non-Monetization of transactions**: When National Income is calculated it is generally assumed that any products or services would be exchanged for money. But in India

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especially in rural areas, a large number of economic transactions occur in the form of barter. Such activities are difficult to account for in the GDP estimates therefore resulting in lower levels of GDP than actual.

b) **Unreported Illegal Income**: A major part of Indian Economy operates as hidden or parallel economy and the income generated in this goes unreported. As per a study, black economy accounts for about 40% of total income generated in the country. This poses a great problem to calculate accurate GDP estimates.

c) **Non-availability of data about households, small producers etc.:** A large number of producers carry out production at a family level or run household enterprises. Data about these enterprises is very difficult to find. NIA does not include care economy such domestic work and housekeeping. Even the valuable work done by housewives in India is not accounted as a part of GDP estimates.

d) **Absence of data on growing service sector:** In India, service sector has witnessed an exponential growth rate. However, value addition in several parts of service sector industry are not based on accurate reporting and hence underestimated in national income measures.

6. Recent Developments in GDP Measurement

- The growth rate will now be measured by **GDP at constant market prices**, which will henceforth be referred to as 'GDP'. This is the international practice. Earlier, growth was measured in terms of growth rate in GDP at factor cost at constant prices.
- The sector-wise estimates of gross value added (GVA) will now be given at **basic prices** instead of factor cost.
- Use of **MCA21 database** which is the annual accounts of companies filed with Ministry of Corporate Affairs. It will expand the coverage of corporate sector both in manufacturing and services. Also, the database for manufacturing companies will help account for activities other than manufacturing undertaken by these companies
- Comprehensive coverage of the financial sector by inclusion of information from the accounts of stock brokers, stock exchanges, asset management companies, mutual funds and pension funds, and the regulatory bodies – SEBI, PFRDA and IRDA.
- Improved coverage of activities of local bodies and autonomous institutions, covering around 60 per cent of the grants/transfers provided to these institutions.

6.1. Gross Value Added

Gross value added (GVA) is defined as the value of output less the value of intermediate consumption. Value added represents the contribution of labour and capital to the production process. The **GVA at basic prices** will include production taxes and exclude production subsidies available on the commodity.

On the other hand, **GVA at factor cost** includes no taxes and excludes no subsidies and **GDP at market prices** include both production and product taxes and excludes both production and product subsidies. When the value of taxes on products (less subsidies on products) is added, the sum of value added for all resident units gives the value of gross domestic product (GDP).

The above concept is summarized in the following equations:

GVA at basic prices = CE + OS/MI + CFC + production taxes less production subsidies

GVA at factor cost = GVA at basic prices - production taxes less production subsidies

GDP = $\sum$ GVA at basic prices + product taxes - product subsidies

The terms used in above equations are discussed below.

- **CE**: compensation of employees. It refers to the total gross (pre-tax) wages paid by employers to employees for work done

Student Notes:

- **OS**: operating surplus. It represents the excess amount of money generated by enterprise after paying labour input costs. It is the capital available to repay their creditors, to pay taxes and eventually to finance all or part of their investment.
- **MI**: mixed income. This is similar to the concept of operating surplus but applied to unincorporated enterprises such as small family businesses like farms and retail shops or self-employed taxi drivers
- **CFC**: consumption of fixed capital. It represents the amount of fixed assets used up, during the period under consideration. This concept is different from depreciation as unlike depreciation, it is not measured at 'historic cost' (original price), but at current market value.
- **Production taxes or subsidies**: These are paid or received with relation to production and are independent of the volume of actual production. Some examples of production taxes are land revenues, stamps and tax on profession. Some production subsidies are subsidies to Railways, input subsidies to farmers.
- **Product taxes or subsidies**: They are paid or received on per unit of product. Some examples of product taxes are excise tax, sales tax, service tax and import and export duties. Product subsidies include food, petroleum and fertilizer subsidies.

7. Debates Around GDP and Other Indices

7.1. Economic Growth versus Development

Traditionally, economic growth is treated as a measure of improvement in quality of lives of the citizens of a country. Economic growth per se is calculated in the form of growth in GDP year over year. However, the achievement of high growth – even high levels of sustainable growth – must ultimately be judged in terms of the impact of that economic growth on the lives and freedoms of the people. It must be noted that the economic growth in several countries has not transformed into better quality of lives for the people.

Let us take the example of India. India has witnessed rapid economic growth in last two decades. Over this period of rapid growth, while some people, particularly among the privileged classes, have done very well, many more continue to lead unnecessarily deprived and precarious lives. It is not that their living conditions have not improved at all, but the pace of improvement has been very slow for the bulk of the people, and for some there has been remarkably little change. While India has climbed rapidly up the ladder of economic growth rates, it has fallen relatively behind in the scale of social indicators of living standards, even compared with many countries India has been overtaking in terms of economic growth.

For example, over the last two decades India has expanded its lead over Bangladesh in terms of average income (it is now about twice as rich in income per capita as Bangladesh), and yet in terms of many typical indicators of living standards (other than income per head), Bangladesh not only does better than India, it has a considerable lead over it (just as India had, two decades ago, a substantial lead over Bangladesh in the same indicators).

Another typical example is that of the Gulf Countries, which have witnessed rapid economic growth but they have done rather poorly on development indicators.

Therefore, several economists today define economic development differently from what the world meant by economic growth. For economists, development indicates the quality of life in the economy which might be seen in accordance with the availability of so many variables such as:

- The level of nutrition.
- The expansion and the reach of healthcare facilities—hospitals, medicines, safe drinking water, vaccination, sanitation, etc.
- Education levels

Student Notes:

From the above discussion it is clear that today, economists believe that higher economic growth may not necessarily transform into higher economic development. But at the same time economic growth and development go hand in hand and one cannot survive without the other.

When we use the term growth we mean numerical increase in some parameters and when we use the term development we mean numerical as well as qualitative progress. If economic growth is properly used for development, it results in accelerating the growth and ultimately in greater population coming under the arena of development. Similarly, high growth with low development and ill-cared development finally results into fall in growth. Thus, there is a circular relationship between growth and development.

7.2. Other Arguments Against GDP as a Parameter to Judge Progress

- **Gender disparities not indicated:** For this a GII or Gender Inequality Index has been devised in recent years.
- **Does not measure sustainability of growth**: Growth in a country may be also at the cost of hefty exploitation of natural resources.
- **Condition of poor is not indicated:** As an example, even though Indian economy grew at a rate of over 7-8% in last decade the food inflation was at the highest levels adversely affecting the poorest strata of the society.
- **Economic inequality not revealed by GDP**: GDP does not reveal the economic inequality, which is created as a side effect of economic growth. Inequality in earnings has doubled in India over the last two decades which were incidentally the years of highest GDP growth also.
- **Other intangibles not measured**: Does not value intangibles like leisure, quality of life etc. since quality of life is measured by many other intangibles except the materialistic things provided by economic growth.

For the reasons mentioned above, several economists have tried to create replacements for GDP which try to address the above criticisms regarding GDP. Some of these indices include HDI, HPI (human poverty Index), GNH (Gross National Happiness Index), Green GDP etc.

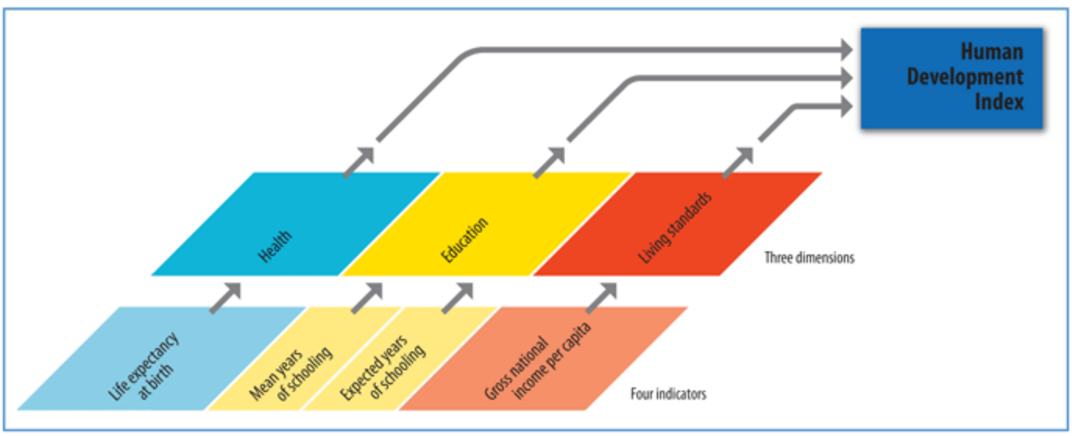
7.3. Other Indices to Measure Development

7.3.1. HDI or Human Development Index

United Nations Development Programme (UNDP) published its first Human Development Report (HDR) in 1990. The report had a human development index (HDI) which was the first attempt to define and measure the levels of development. The index focuses on longevity, knowledge and decent living standards.

Components of the Human Development Index

The HDI—three dimensions and four indicators



Student Notes:

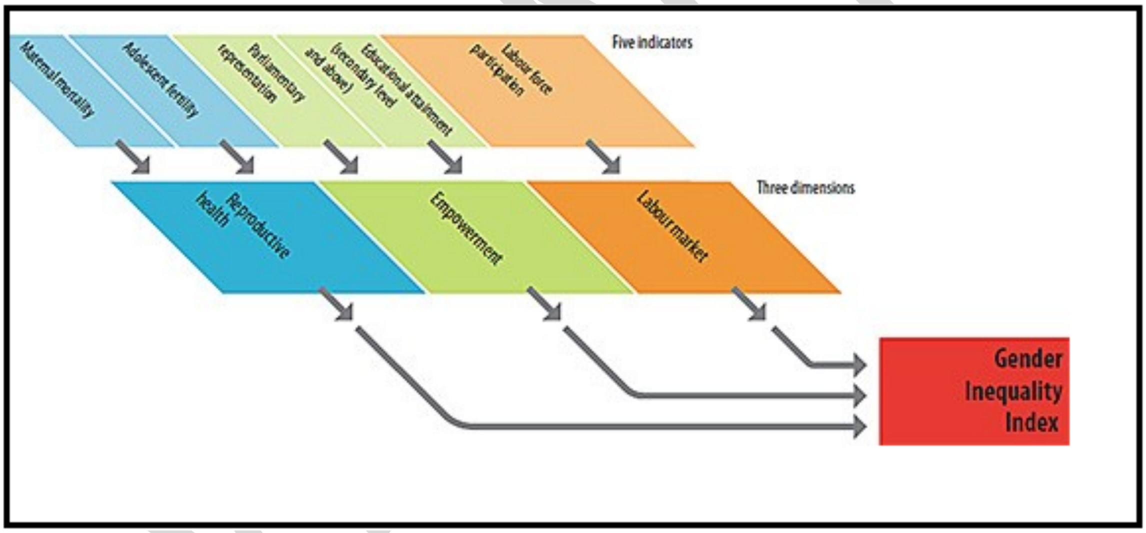
- **Standard of living**: to be indicated by the real per capita income adjusted for the differing purchasing power parity (PPP).
- **Knowledge:** to be measured by indicators related to the level of education:
    - educational attainment among the adults (given 2/3rd weightage).
    - school enrollment (given 1/3rd weightage).
- **Longevity:** Life expectancy to be calculated at the time of birth.

The HDI is the geometric mean of normalized indices for each of the above three dimensions. Initially reported for 14 countries, the UN's 2016 report presented HDI results for 188 countries. India ranked 131th in 2016 Human Development Report with HDI score of 0.624 in the medium human development category. India's current score is up from 0.428 in 1990, i.e. an increase of 46% between 1990 and 2016.

7.3.2. Gender Inequality Index (GII)

The GII is an inequality index. It shows the loss in potential human development due to disparity between female and male achievements in two dimensions, empowerment and economic status, and reflects a country's position relative to normative ideals for the key dimension of women's health. Overall, the GII reflects how women are disadvantaged in these dimensions.

There is no country with perfect gender equality – hence all countries suffer some loss in achievements in key aspects of human development when gender inequality is taken into account. The GII ranges between 0 and 1 and higher GII values indicate higher levels of inequalities.

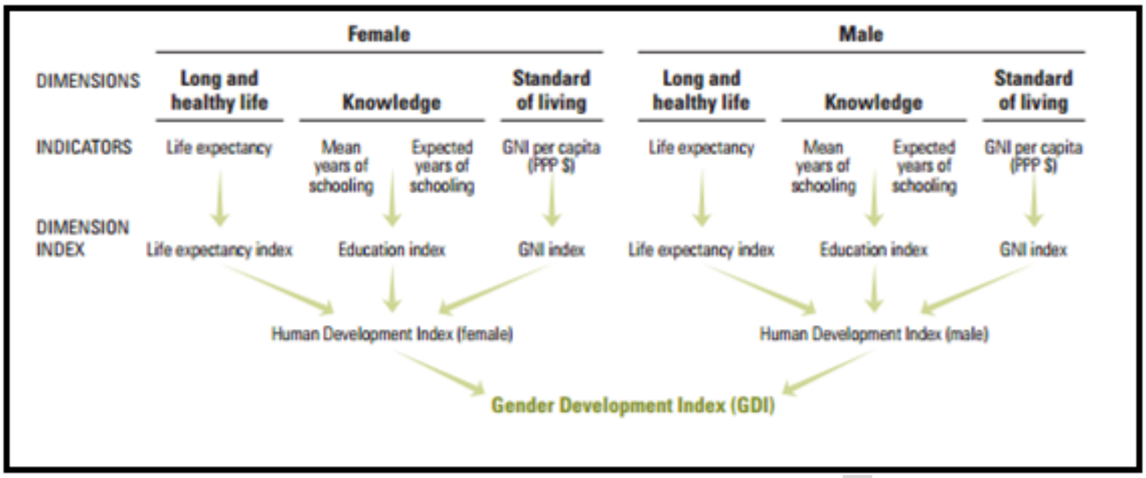


7.3.3. Gender Development Index (GDI)

The GDI measures differences between male and female achievements in three basic dimensions of human development:

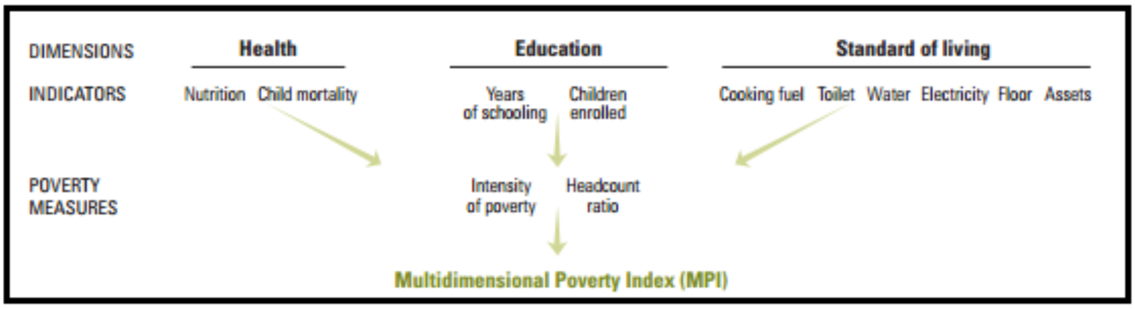
- **Health**, measured by female and male life expectancy at birth;
- **Education**, measured by female and male expected years of schooling for children and female and male mean years of schooling for adults ages 25 and older; and
- **Equitable command over economic resources**, measured by female and male estimated earned income.

Student Notes:



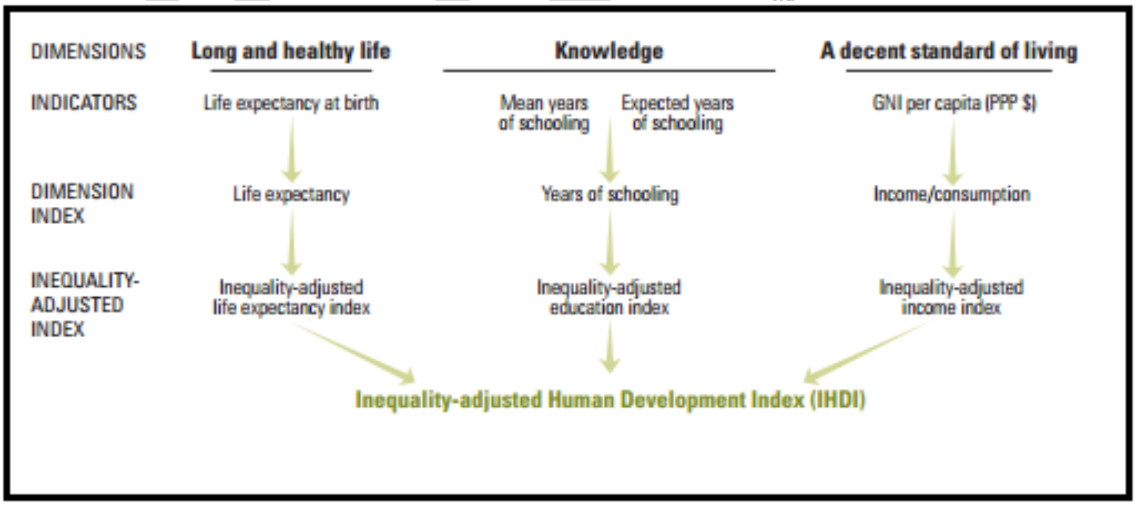
7.3.4. Multidimensional Poverty Index (MPI)

The Multidimensional Poverty Index (MPI) identifies multiple deprivations at the household and individual level in health, education and standard of living. The MPI offers a valuable complement to income-based poverty measures.



7.3.5. Inequality-Adjusted Human Development Index (IHDI)

The IHDI takes into account not only the average achievements of a country on health, education and income, but also how those achievements are distributed among its population.



7.3.6. Green GDP

Green GDP is an index of economic growth with the environmental consequences of that growth factored in. From the final value of goods and services produced, the cost of ecological degradation is deducted to arrive at Green GDP.

Student Notes:

Green GDP calculations have been developed for countries as diverse as Australia, Canada, China, Costa Rica, Indonesia, Mexico, Papua New Guinea, and the US, although none of these efforts have resulted in regular reporting of the results.

In 2009, the Government of India had announced its intention to unveil "green GDP" figures that account for the environmental costs of depletion and degradation of natural resources into the country's economic growth figures. Subsequently, the Ministry of Statistics and Programme Implementation set up an expert group in 2011 led by Partha Dasgupta to work out a framework for green national accounts in India. However, the process is yet to be completed.

7.3.7. Gross National Happiness

With many of the world's countries about as unhappy as they can get because of their dwindling GDP figures, the tiny nation of Bhutan has gone in the opposite direction. Officials in Bhutan came up with a different indicator, called gross national happiness (GNH). The country's beloved former king, Jigme Singye Wangchuck, envisaged the concept of gross national happiness since 1972, and the country adopted it as a formal economic indicator in 2008. Beginning in November 2008, all the economic factors started measuring gross domestic product analyzed for their impact on Bhutan's residents' happiness. The factors of production are still there such as unemployment, agriculture, retail sales but GNH represents a paradigm shift in what's most valued by Bhutanese society compared to the rest of the world. In short, happiness matters, not money. Following parameters are used in the GNH:

- Higher real per capita income.
- Good Governance.
- Environmental Protection.
- Cultural Promotion

7.3.8. Human Poverty Index or HPI

HPI is an index, which focuses solely on amount of poverty in a country. This index has been developed by United Nations. For HPI, deprivations in longevity are measured by the probability at birth of not surviving to age 40; deprivations in knowledge are measured by the percentage of adults who are illiterate; deprivations in a decent standard of living are measured by two variables: the percentage of people not having sustainable access to an improved water source and the percentage of children below the age of five who are underweight.

HPI focuses attention on the most deprived people and deprivations in basic human capabilities in a country, not on average national achievement. The human poverty indices focus directly on the number of people living in deprivation presenting a very different picture from average national achievement. It also moves the focus of poverty debates away from concern about income poverty alone.

7.3.9. Genuine Progress Indicator

While GDP is a measure of current income, GPI is designed to measure the sustainability of that income. GPI uses the same personal consumption data as GDP but make deductions to account for income inequality and costs of crime, environmental degradation, and loss of leisure and additions to account for the services from consumer durables and public infrastructure as well as the benefits of volunteering and housework. By differentiating between economic activity that diminishes both natural and social capital and activity that enhances such capital, the GPI and its variants are designed to measure sustainable economic welfare rather than economic activity alone. Proponents of the GPI see it as a better measure of the sustainability of an economy when compared to the GDP measure. Since 1995 the GPI indicator has grown in stature and is used in Canada and the United States.

Student Notes:

8. Previous Years UPSC GS Mains Questions

1. Distinguish between Gross Domestic Product (GDP) and Gross National Product (GNP). (92/II/8a(A)/3)
2. Explain per capita income as a measure of economic growth. (98/II/8b(A)/3)
3. What is meant by 'Quality of life'? (98/II/8c(A)/3)
4. What is the difference between gross National Product and New National Product? (98/II/8f(A)/3)
5. Explain per capita income as a measurement of economic growth. (00/II/6c/2)
6. What is green GNP? (01/II/6c/2)
7. What is Green GDP? (05/II/6m/2)

9. Vision IAS GS Mains Test Series Questions

1. ***"A new way of measuring GDP created the world's fastest-growing major economy overnight". In the context of India analyse the benefits and concerns raised by the new methodology adopted to calculate GDP figures by the Central Statistical Organisation.***

Approach:

The question requires and understanding of how GDP is calculated and what the new changes amount to. Answer should be structured as follows:

- As introduction briefly enumerate the salient features of changes made.
- Discuss the key benefits as argued by the government sources and Media debates
- Concerns should be linked to the extent to which the new data reflects reality, include concerns raised by the RBI and other economic observers

Answer:

GDP is the total value of goods and services produced within the country during a year. The calculation so far was based on factor or basic cost, the new method:

- Takes into account market prices paid by consumers.
- Introduces the concept of Gross Value Added (GVA) at the aggregate and various sectoral levels.
- Changes base year 2004-05 to 2011-12.

According to the arguments put forward these changes would have the following benefits:

- It is in line with international practice which involves calculation at market costs.
- The move is expected to better capture the changing structure of the Indian economy. e.g. New GDP series will be based on data from MCA21, bringing in more companies from the unlisted and informal sectors as compared to the Annual Survey of Industries used till now.
- The base year change ensures that the products and services included in the GDP calculation do remain contemporary and reflect the present state of the economy e.g. the latest change in base year has included the recycling industry which didn't figure in the earlier GDP computations.
- Global investors use growth prospect numbers to allocate their investment allocations between countries - GDP is a key metric here. So news that India's GDP growth has averaged 6 per cent for the last three years and not 4.6 per cent as thought earlier, may help investors view India in a more favourable light.

The revised methodology, however, poses several concerns as well:

- The revision has bumped up India's growth numbers sharply and put them at odds with other leading indicators of industrial activity, such as the Index of Industrial Production (IIP), which still shows weakness.
- While the new GDP shows 5.3 per cent growth in manufacturing in 2013-14, the actual performance of NSE-listed companies in the manufacturing space shows that earnings have been declining in the last two years (by 4 per cent in 2013-14).

Overall the changes put the Indian economy in a better light than was thought previously. The concerns on the other hand relate to the disparity in other figures that do not corroborate the positive story brought about by new changes. The need is to disseminate information in a better way and bring the major indicators in tune with each other.

Student Notes:

Student Notes:

MONEY AND BANKING

Contents

Student Notes:

1. Money

1.1. Money or Credit Creation Process

The process of *money creation* is a crucial concept for understanding the role that money plays in an economy. Its potency depends on the amount of money that banks keep in reserve to meet the withdrawals of its customers. This practice of lending customers' money to others on the assumption that not all customers will want all of their money back at any one time is known as *fractional reserve banking*.

We can illustrate how it works through a simple example. Suppose that the bankers in an economy come to the view that they need to retain only 10 percent of any money deposited with them. This is known as the *reserve requirement*. Now consider what happens when a customer deposits Rs. 100 in Bank X. This deposit changes the balance sheet of Bank X and it represents a liability to the bank because it is effectively loaned to the bank by the customer. By lending 90 percent of this deposit to another customer the bank has two types of assets: (1) the bank's reserves of Rs. 10, and (2) the loan equivalent to Rs. 90.

Now suppose that the recipient of the loan of Rs. 90 uses this money to purchase some goods of this value and the seller of the goods deposits this Rs. 90 in another bank, Bank Y. Bank Y goes through the same process; it retains Rs. 9 in reserve and loans 90 percent of the deposit (Rs. 81) to another customer. This customer in turn spends Rs. 81 on some goods or services. The recipient of this money deposits it at the Bank Z, and so on.

This process continues until there is no more money left to be deposited and loaned out. The total amount of money 'created' from this one deposit of Rs. 100 can be calculated as:

New deposit/Reserve requirement = Rs. 100/0.10 = Rs. 1,000

It is the sum of all the deposits now in the banking system. Also note that the original deposit of Rs. 100, via the practice of reserve banking, was the catalyst for Rs. 1,000 worth of economic transactions. That is not to say that economic growth would be zero without this process, but instead that it can be an important component in economic activity.

The amount of money that the banking system creates through the practice of fractional reserve banking is a function of 1 divided by the reserve requirement, a quantity known as the *money multiplier*. In the case just examined, the money multiplier is 1/0.10 = 10.

In our simplistic example, we assumed that the banks themselves set their own reserve requirements. However, in some economies, the central bank sets the reserve requirement, which is a potential means of affecting money growth. In any case, a prudent bank would be wise to have sufficient reserves such that the withdrawal demands of their depositors can be met in stressful economic and credit market conditions.

1.2. Definition of Money

The process of money creation raises a fundamental issue: What is money? In an economy with money but without promissory notes and fractional reserve banking, money is relatively easy to define: Money is the total amount of gold and silver coins in circulation, or their equivalent. The money creation process above, however, indicates that a broader definition of money might encompass all the notes and coins in circulation *plus* all bank deposits.

More generally, we might define money as any medium that can be used to purchase goods and services. Notes and coins can be used to fulfill this purpose, and yet such currency is not the only means of purchasing goods and services. Personal cheques can be written based on a bank chequing account, while debit cards can be used for the same purpose. But what about time deposits or savings accounts? Nowadays transfers can be made relatively easily from a savings account to a current account; therefore, these savings accounts might also be

Student Notes:

considered as part of the stock of money. Credit cards are also used to pay for goods and services; however, there is an important difference between credit card payments and those made by cheques and debit cards. Unlike a cheque or debit card payment, a credit card payment involves a deferred payment. Basically, the greater the complexity of any financial system, the harder it is to define money.

Because financial systems, practice, and institutions vary from economy to economy, so do definitions of money; thus, it is difficult to make international comparisons. Still, most central banks produce both a narrow and broad measure of money, plus some intermediate ones too.

The most generic definition of money is that it is **any generally accepted medium of exchange**. A ***medium of exchange*** is any asset that can be used to purchase goods and services or to repay debts. Money can thus eliminate the debilitating double coincidence of the "wants" problem that exists in a barter economy.

However, for money to act as this liberating medium of exchange, it must possess certain qualities. It must:

- be readily acceptable
- have a known value
- be easily divisible
- have a high value relative to its weight; and
- be difficult to counterfeit.

1.3. Functions and Significance of Money

Medium of exchange: In almost all market transactions in our economy, money in the form of currency or cheques is a medium of exchange; it is used to pay for goods and services. The use of money as a medium of exchange promotes economic efficiency by minimizing the time spent in exchanging goods and services. It eliminates the problem of going and finding services provided by specialized people a practice prevalent in barter system. The time spent in trying to exchange goods or services is called a *transaction cost*. In a barter economy, transaction costs are high because people have to satisfy a "**double coincidence of wants**"—they have to find someone who has a good or service they want and who also wants the good or service they have to offer.

Unit of account: Another important role of money is to provide a unit of account; that is, it is used to measure value in the economy. We measure the value of goods and services in terms of money, just as we measure weight in terms of kilos or distance in terms of meters. In barter system this advantage is missing as one cannot calculate and compare the prices of two different entities available in the market.

Store of Value: Money also functions as a store of value; it is a repository of purchasing power over time. A store of value is used to save purchasing power from the time income is received until the time it is spent. This function of money is useful, because most of us do not want to spend our income immediately upon receiving it, but rather prefer to wait until we have the time or the desire to shop. Even though there exists a number of means to store value such as house, jewelry, stocks etc. yet money has the most liquidity and acceptability of them all.

Standard of Deferred Payments: Money facilitates not only the current transactions of goods and services but also their credit transactions. It facilitates credit transactions when present goods are exchanged against future payments. In the modern world, the bulk of deferred payments are stipulated in money terms only. Examples in this regard are repayment of loan along with interest, pensions, rents, salaries, insurance premium, etc. Money could be an effective standard of deferred payments only if value of money itself does not change. If prices increase or decrease sharply, resulting in large fluctuations in the value of money, it would make money a poor standard of deferred payments.

Student Notes:

Distributor of National Income: Money helps in the distribution of national output among the people who have contributed in its production. In a modern society people co-operate together as workers, owners of capital, landlords, etc., to produce goods. The resultant output is, therefore, to be distributed among all of them in the form of wages and salaries, interest, rent, etc. In the absence of money it would not always be possible to distribute such an output, particularly in case of indivisible goods, e.g. a machine. With the help of money we can overcome such a problem.

1.4. Kinds of Money

In a modern economy, the quantity of money in existence consists of (1) Currency component and (2) Deposit money component

1.4.1. Currency Component

Currency component includes coins and paper currency.

Coins refer to all metallic money. The few things to note about coins are:

- Coins are **token money.** Token money is the money the face value of which is more than the intrinsic value.
- The right of minting coins is the monopoly of the government.
- They are useful for making transactions of small value.
- They constitute a very small component of modern money.

Currency notes refer to paper money. The few things to note about paper currency are:

- In India, virtually all paper money in circulation consists of notes issued by RBI.
- Currency notes have a very small intrinsic value of their own.
- It is inconvertible, i.e., there is no compulsion for central bank to exchange it for gold. After world war I, almost all countries abandoned gold convertibility.
- All notes carry the legend: 'I promise to pay the bearer the sum of ten rupees' (signed by the Governor of RBI).

Though the value of the paper and the metal itself is less than its net worth, yet people accept such notes and coins in exchange for goods, which are apparently more valuable than these. This is because the value of the currency notes and coins is derived from the guarantee provided by the issuing authority of these items. As every currency note bears on its face a promise from the Governor of RBI that if someone produces the note to RBI, or any other commercial bank, RBI will be responsible for giving the person purchasing power equal to the value printed on the note. The same is also true of coins. Currency notes and coins are therefore called **fiat money** as it is issued on the fiat (order) of the government. They are also called **legal tenders** as they cannot be refused by any citizen of the country for settlement of any kind of transaction.

However, recently the Government of India took the step to **demonetize** Rs. 500 and 1000 currency, which means that the legal tender of currency units was declared invalid from the specified date. Demonetization of currency means discontinuity of the said currency from circulation and replacing it with new currency.

1.4.2. Deposit Money Component

Deposit money or the bank money refers to the deposits held with the banks on the basis of which cheques could be drawn. Such deposits can be of two types:

- **Demand deposits** - They are payable by the bank on demand from the accountholder
- **Time deposits** - Other deposits, e.g. fixed deposits, have a fixed period to maturity and are referred to as time deposits.

Student Notes:

However, a cheque is not a legal tender. A person can legally refuse to accept payment by cheques as there is no guarantee that a cheque will be honoured by the bank in case of insufficient deposits with it.

1.5. Money Supply in India

Money supply refers to total supply of money in active circulation in a given country's economy at a given time. It refers to the money held by 'public' which includes all economic units (private individuals, business firms and institutions). It does not include the producers of money (RBI, government, commercial banks) to avoid double counting.

Money supply is considered an important instrument for controlling inflation by some of the economists. Economists analyze the money supply and develop policies revolving around it through controlling interest rates and increasing or decreasing the amount of money flowing in the economy. Money supply data is collected, recorded and published periodically by the RBI.

1.5.1. Measures of Money Supply

There are several measures for the money supply, such as M_1, M_2, M_3 and M_4.

M_1

M_1 = Currency with public (coins, currency notes etc.) + net demand deposits held by the public with commercial banks

It includes all those financial assets which are generally accepted as means of payment. M_1 is also called as **narrow money** because we have defined money supply here in a narrow definition of money which emphasizes the medium of exchange function and therefore includes only those assets which are highly liquid. The word 'net' implies that only deposits of the public held by the banks are to be included in money supply. The interbank deposits, which a commercial bank holds in other commercial banks, are not to be regarded as part of money supply. The demand deposits on the other hand are the money deposited by the people in banks and other deposits with the RBI. People issue cheques against these deposits in the banks.

M_2

M_2 = M_1 + Post office saving deposits

Post office savings deposits are **far less liquid** than commercial bank savings. Savings deposits with post office can be withdrawn on demand, but have the following restrictions:

- Chequable portion of these deposits is very small.
- There are restrictions on number of withdrawals in any week.
- There is a maximum limit on the amount of any single withdrawal (unless **an** advance notice is given to the post office).

Consequently, post office savings deposits cannot serve as a medium of exchange and are less liquid than the savings deposits with the commercial bank. **Both M_1 and M_2 are known as narrow money**.

M_3

M_3 = M_1 + Net time deposits of public with the banks

Some economists believe that time deposits should be included in the money supply as they are an important form of store of value as in the case of fixed or timed deposits the depositors can borrow from the banks against them. Also, in some cases the depositors are allowed to withdraw their deposits after foregoing some interest and paying a penalty. It is also known as

Student Notes:

broad money as it included wider definition of money. The basic difference between M_1 and M_3 is the treatment of timed deposits with the banks. Narrow money excludes the timed deposits of the public with the banking system on the ground that they are incoming earning assets and not liquid in the real sense.

M_3 is the most commonly used measure of money supply. It is also known as **aggregate monetary resources**

M_4

$M_4 = M_3$ + Total Post office deposits (includes fixed deposits with the post offices but excludes National Savings Certificates)

M_3 and M_4 are both known as **broad money**.

Of all the components stated above, currency component is highly liquid followed by demand deposits (easily converted to money on demand). Saving deposits with post-office are next in the line of liquidity. Likewise, the degree of liquidity is less in case of time deposits because they can be converted into cash without loss of money only at the time of maturity. **These gradations are in decreasing order of liquidity**. M_1 is most liquid and easiest for transactions whereas M_4 is least liquid of all.

1.5.2. High Powered Money

The total liability of the monetary authority of the country, RBI, is called the monetary base or high powered money. It consists of currency (notes and coins in circulation with the public and vault cash of commercial banks) and deposits held by the Government of India and commercial banks with RBI. If a member of the public produces a currency note to RBI the latter must pay her value equal to the figure printed on the note. Similarly, the deposits are also refundable by RBI on demand from deposit-holders. These items are claims which the general public, government or banks have on RBI and hence are considered to be the liability of RBI.

1.6. Factors affecting Money Supply in India

Money supply with the public is influenced mainly by the central bank of country and its commercial banks, which in turn changes the preference of the public for holding cash balances vis-a-vis deposits in the banks. These influences on money supply can be summarized by the following key ratios:

The currency deposit ratio: The ratio of money held by the public in currency to that they hold in bank deposits. It reflects people's preference of liquidity. It is a purely behavioural parameter which depends, among other things, on the seasonal pattern of expenditure. For example, cdr increases during the festive season as people convert deposits to cash balance for meeting extra expenditure during such periods.

The Reserve deposit ratio: Banks hold a part of the money people keep in their bank deposits as reserve money and loan out the rest to various investment projects. Reserve money consists of two things – vault cash in banks and deposits of commercial banks with RBI. Banks use this reserve to meet the demand for cash by account holders. Reserve deposit ratio (rdr) is the proportion of the total deposits, commercial banks keep as reserves. Keeping reserves is costly for banks, as, otherwise, they could lend this balance to interest earning investment projects. However, RBI requires commercial banks to keep reserves in order to ensure that banks have a safe cushion of assets to draw on when account holders want to be paid.

RBI uses various policy instruments to bring forth a healthy rdr in commercial banks. The first instrument is the Cash Reserve Ratio which specifies the fraction of their deposits that banks must keep with RBI. There is another tool called Statutory Liquidity Ratio which requires the banks to maintain a given fraction of their total demand and time deposits in the form of specified liquid assets. Apart from these ratios RBI uses a certain interest rate called the Bank

Student Notes:

Rate to control the value of rdr. Commercial banks can borrow money from RBI at the bank rate when they run short of reserves. A high bank rate makes such borrowing from RBI costly and, in effect, encourages the commercial banks to maintain a healthy rdr.

Through its fiscal policy, the government also fleets, some extent, the supply of money. Finer details of this aspect have been dealt with in the document on monetary policy.

2. Banking

Banks are financial institutions that accept deposits and make loans. Included under the term *banks* are firms such as commercial banks, savings and loan associations, mutual savings banks, and credit unions. Banks are the financial intermediaries that the average person interacts with most frequently. A person who needs a loan to buy a house or a car usually obtains it from a local bank. Most people keep a large proportion of their financial wealth in banks in the form of savings accounts, or other types of bank deposits. Because banks are the largest financial intermediaries in our economy, they need to be understood well. The following three functions are essential in making a financial institution a bank:

- **Accept deposits** - Banks accept deposits from the public at large which are repayable on demand and withdrawable by cheque or otherwise
- **Lending** - Banks uses these deposits for lending to others and undertaking investment in securities.
- **Creation of money** – It is the unique characteristic of commercial banks. Their debts circulate as money in the economy. Banks have the power to destroy and create money through lending activities. Money created by bank is known as deposit money or bank money.

None of these alone are sufficient to make a financial institution a bank. However, the RBI has in recent times given license for two new types of banks- **Payment Banks** and **Small Finance Banks** - as differentiated banks.

2.1. Indian Banking System

In India, the organized banking sector is categorized into many different ways. Usually there are categorized as below:

- Regional Rural Banks
- Co-operative Banks
- Commercial Banks

2.1.1. Regional Rural Banks (RRBs)

Regional rural banks came into being in the 1970s with the objective of providing deposit and credit facilities to the people in rural areas especially weaker sections like the small and marginal farmers, agricultural laborers, small entrepreneurs etc. Therefore, they are also usually knows as 'Small Man's Bank.' Even though these banks count as the scheduled commercial banks but their focus and reach is generally limited to a district or two. Some of the examples of Regional Rural Banks are Assam Gramin Vikash Bank, Allahabad UP Gramin Bank, Baroda Gujarat Gramin Bank etc.

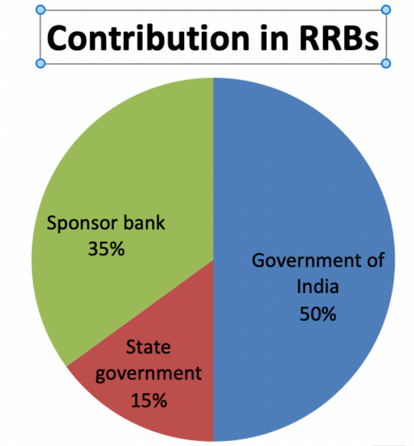
- These banks are set up by the public sector banks and the PSB which set up a particular RRB is called sponsor bank of that RRB. It is required to subscribe to the share capital of RRBs, train their personnel and provide managerial and financial assistance.
- RRBs were set with following aims:
    - To increase the credit flow to rural areas
    - To lend to weaker sections at concessional rates

Student Notes:

From 1997, RRBs were freed to lend outside the target group. Now merging of RRBs is going on as many of the RRBs became unviable or less profitable. Therefore, weak banks are being merged with efficient banks. Now, they gain more autonomous powers also.

The priority sector lending target for RRBs is 75% of the total outstanding loans.

The Government of India, the concerned State Government and the bank, which had sponsored the RRB contribution to the share capital of RRBs is shown in the chart below:



2.1.2. Cooperative Banks

Cooperative bank is an institution established on the basis of cooperative principles and dealing in ordinary banking business. They are called cooperative banks as these have cooperation of stakeholders as motive. Some points to be noted about cooperative banks are:

- They are established by state laws - registered under the Cooperative Societies Act, 1912.
- These are regulated by the Reserve Bank of India under the Banking Regulation Act, 1949 and Banking Laws (Application to Co-operative Societies) Act, 1965.
- If some individuals come together, they can establish a cooperative bank.
- They are established with the aim of funding agriculture and allied sectors and to finance village and cottage industries.
- They lend as well as accept deposits.
- They operate on the principle of 'one person one vote' in decision making.
- Unlike commercial banks, who are driven by profit, co-operative banks work on a "no profit, no loss" basis.
- NABARD is the apex body for cooperative sector in India.

NABARD

The National Bank for Agriculture and Rural Development (NABARD) was set up as an apex Development Bank with a mandate of facilitating credit flow for the promotion and development of agriculture, small-scale industries, cottage and village industries, handicrafts and other rural crafts.

NABARD also **acts as a co-ordinator** in the operations of rural credit institutions, assists the government, the Reserve Bank of India and other organisations in matters pertaining to rural development, offers training and research facilities to banks, co-operatives, and organisations working in the realm of rural development and helps the state governments in achieving their targets of providing assistance to institutions in agriculture and rural development.

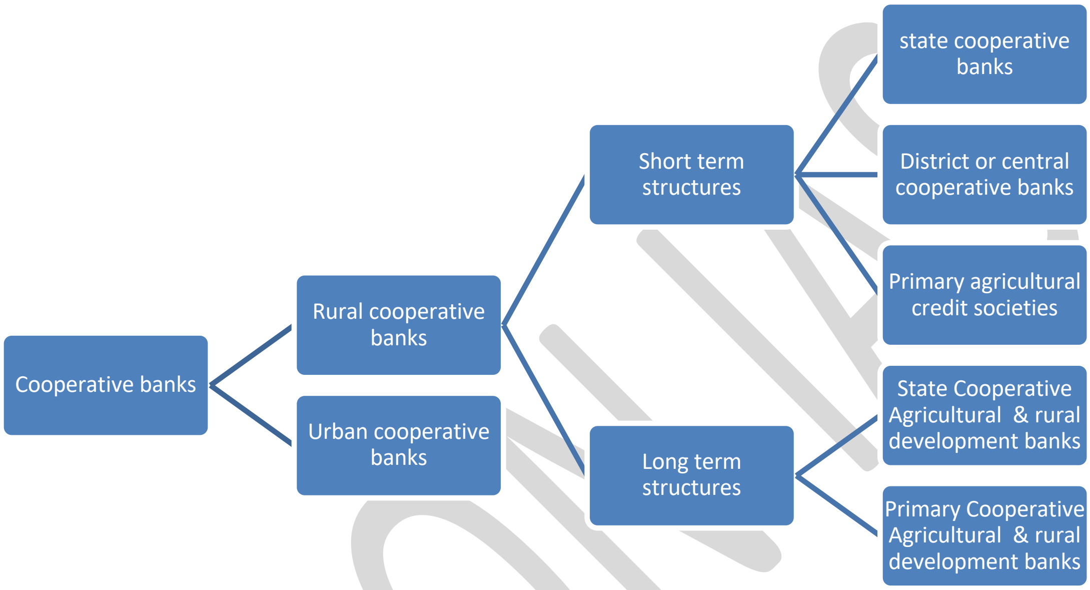
NABARD also **acts as a regulator** for co-operative banks and Regional Rural Banks (RRBs). One of the most important role of NABARD is **capacity building** of partner agencies and development institutions. NABARD provide facilities for training, for dissemination of

Student Notes:

information and the promotion of research including the undertaking of studies, researches, techno-economic and other surveys in the field of rural banking, agriculture and rural development. It provides technical, legal, financial, marketing and administrative assistance to any person engaged in agriculture and rural development activities. Thus historically, NABARD has played an important role in alleviation of poverty in the rural areas of the country and continues to do so.

2.1.2.1. Types of Cooperative Banks

The cooperative banks are divided into urban and rural, which are further divided into short term structures and long term structures as shown in the chart below:



2.1.2.2. Urban Cooperative Banks

The term Urban Co-operative Banks (UCBs), though not formally defined, refers to primary cooperative banks located in urban and semi-urban areas. These banks, till 1996, were allowed to lend money only for non-agricultural purposes. This distinction does not hold today. These banks were traditionally centred around communities, localities work place groups. They essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably.

Challenges faced by UCBs

UCBs' limited ability to mobilise resources coupled with inability to formulate their respective policies for investment of their surplus resources because of restrictions reduces the scope of UCBs. They also face problems of low level of recovery, high transaction cost and rising competition. Their autonomy is also questioned because of zealous regulation by government through nomination of board of director and deputation of government officials to cooperatives.

R Gandhi committee on urban cooperative banks

Few important recommendations of the report are as follows:

- **Business Size and Conversion of Multi-State UCBs into joint stock bank:** A business size of 20,000 crore or more may be the threshold limit beyond which a UCB may be expected to convert itself into a commercial bank. The conversion need not be de jure compulsory. However, the types of businesses to be undertaken by those choosing not to convert may remain within the limits of plain vanilla products and services and hence, growth will be at a much slower pace. Their expansion in terms of branches, area of operations and business lines may thus be carefully calibrated.

Student Notes:

- **Conversion of UCBs into Small Finance Banks (SFBs):** Smaller UCBs with business size of less than 20,000 crore willing to convert to SFBs can apply to the Reserve Bank for conversion provided they fulfil all the eligibility criteria and selection processes prescribed by the Reserve Bank and further provided that the licensing window for SFBs is open.
- **Issues of fresh licenses:** Licenses may be issued to financially sound and well-managed co-operative credit societies having a minimum track record of 5 years which satisfy the regulatory prescriptions set by the Reserve Bank as licensing conditions. For providing banking access in unbanked areas, the Reserve Bank may put in place an appropriate set of incentives for existing banks to open branches there.
- **Board of Management (BoM) in addition to Board of Directors (BoD)**: Putting in place a BoM as suggested by the Malegam Committee has to be one of the mandatory licensing conditions for licensing of new UCBs and expansion of existing ones. This recommendation has been accepted by the RBI in 2018.
- **Depositors as voting members**: The depositors ought to have a say on the Boards of UCBs. For this, a majority of the board seats may be reserved for depositors by making suitable provisions in the bye-laws.

Should large UCBs be converted into commercial banks?

Also, when UCBs become large and spread in different states, the cohesion required among members diminishes due to lack of familiarity and commercial interests overtake the collective welfare spirit. Also some UCBs are even bigger than the smaller commercial banks in terms of deposits, advances, and total assets. So, RBI should have more powers over it like any other commercial bank because its failure may greatly impact economy. Thus, they should be converted to commercial banks as also recommended by Gandhi committee report .

2.1.2.3. Rural Cooperative Banks

Short term structures – They lend up to one year. They lend for cultivation activities and provide working capital to buy seeds, fertilisers etc. The short term structures have a three tier set up:

- **State cooperative banks (SCB)** – Each state has its own SCB. It is the apex body for cooperative banks in a particular state. They act as intermediary between RBI and NABARD on one side and District or central cooperative banks and Primary agricultural credit societies on the other.
    - They get loan from RBI at concessional rate
    - It gives grants to cooperative banks in the state

  Now the intermediation of these banks is abolished by a memorandum of understanding between RBI and these banks. Now, RBI has direct dealing with low tier banks.

- **District or central cooperative banks** - It operates at district level. There are two types of central or district cooperative banks:
    - Cooperative banking union – Its membership is open to only cooperative societies
    - Mixed central cooperative bank - Its membership is open to both cooperative societies and individuals.

  They get loan from SCBs and they grant loans to PACs and individuals

- **Primary agricultural credit societies (PACs)** – It operates at village level. It gives loans to its members as individuals.

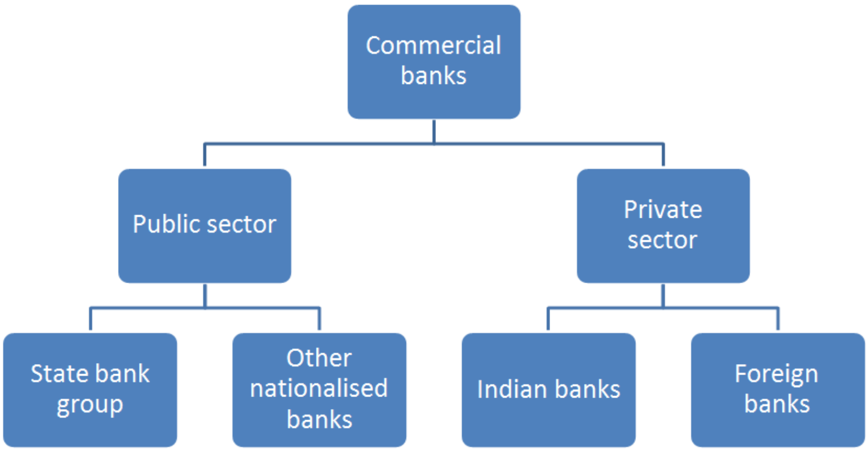
Long term structures – They lend for medium term and long term which ranges from 1.5 to 25 years. They lend for land development, purchase of agricultural equipments, redemption of old debts etc. They initially were called as mortgage banks, then land development banks and now they are called as Cooperative Agricultural and Rural Development Banks (CARDBs). It is a two tiered structure:

Student Notes:

- State CARDBs
- Primary CARDBs

2.1.3. Commercial Banks

They are run on commercial basis. They are created for a profit motive. They accept deposits, give loans and provide other financial services to earn profit. These are regulated under Banking regulation act 1949. They consists of both public sector banks and private sector banks (as shown in chart below)



2.1.3.1. Public Sector Banks

These are those banks in which the majority ownership is with government. Majority ownership means shareholding of >51%. All the PSBs were not started by the government of India. Some banks in the hands of private sector were nationalized and made public sector banks.

- **State bank group –** It means State Bank of India and its associates. SBI is the largest Public sector bank in the country. Previously major part of SBI's share was held by RBI. But to endow RBI with only regulatory functions, its shares were transferred to the Government of India.
  - Eight banks of erstwhile princely states were brought under SBI as its associates:
    - State Bank of Bikaner – merged with State Bank of Jaipur later
    - State Bank of Jaipur
    - State Bank of Hyderabad
    - State Bank of Mysore
    - State Bank of Travancore
    - State Bank of Indore
    - State Bank of Patiala
    - State Bank of Saurashtra – merged with SBI later
  - Now all associates have been merged under one consolidated SBI and with this its market share has been increased to 22% from 17%. It would improve the economies of scale, better management of liquidity, technological know-how, quality of products, professional standards. It would also lead to diversification of customers and assets, international recognition, improved customer service etc.
  - However, there are chances that it could lead to losing regional focus.
- **Other nationalized banks –** The nationalization was carried out in two phases in 1969 and then 1980. The total nationalised banks in the country are 19. Some examples are – IDBI, Indian bank, Dena Bank etc. Therefore, total number of Public sector commercial banks are (1+6+19) = 26.

  Before Nationalization kicked in, several sectors of the economy such as agriculture, small-scale industries and weaker sections of the society were relatively ignored by the banking

Student Notes:

system of the country. For example, the agricultural sector only received 2.1% of the total credit as it stood in March 1967 compared to a humungous 64% for the industry. The banking facilities were earlier concentrated mainly in the urban areas. Though there were some banks in the rural areas, they were mainly for deposits and the money was used to lend in the urban areas. Even in the urban areas, the banking facilities were enjoyed by the rich people. The banks were mainly owned by industrialists and they used these banks to mobilise deposits of people and themselves got a loan from these banks.

The Government of India had, therefore, to impose some control over banks with a view to prevent monopolistic trends, concentration of economic power and misuse of economic resources. Thus the basic goal of social control was to achieve the social ends without taking over the banks into public ownership.

Some of the **objectives of nationalization of the banks** in 1980 were:

- To mobilize savings of people to the maximum possible and to utilize them for productive purpose.
- To ensure that the banking operations are guided by a larger social purpose and are subject to close public regulations;
- To ensure that the legitimate credit needs of private sector industry and trade, big and small, are met;
- To ensure the needs of the productive sector and in particular, agriculture, small scale industry, self-employed professionals are met;
- To actively foster the growth of the new and progressive class of entrepreneurs and create fresh opportunities for hitherto neglected and backward areas in different parts of the country; and
- To curb the use of bank credit for speculative and for other unproductive purposes.

Since the nationalization some of the impacts observed include:

- branch expansion to areas other than the major urban centers of the country,
- growth of farm credit
- finance provided to small scale industry has increased
- increased growth of deposits
- credit to weaker sections has gone up.

2.1.3.2. Private Sector Banks

It consists of both Indian banks and the foreign banks. Few examples of private banks are ICICI, Axis, HDFC bank etc.

- **Indian banks –** These are classified by RBI as old banks and new banks for the convenience of comparing performance of all Indian banks.
  - **Old banks –** The banks except those were nationalized continued to be in the hands of privates. These private banks and those which were set up before 1990s are called old banks
  - **New banks –** Banks set up in private sector in 1990s and after are called new banks. Latest by 2014 RBI issued license for new banks. It also came up with the proposal of small banks and payment banks. The RBI observes these banks as “niche” or “differentiated” banks with the common objective of furthering financial inclusion

Differentiated banks focus on different areas and develop competence in that. RBI has already issued licenses for small finance banks and payment banks. The third category is wholesale and long term finance banks (WLTF).

Student Notes:

2.1.3.3. Small Finance banks

It will provide a whole suite of basic banking products such as deposits and supply of credit, but in a limited area of operation. Thus, they can be said to be a scaled down versions of commercial banks, with both deposit-taking and loan-making functions. They can sell forex, mutual funds, insurance, pensions and can also convert into a full-fledged bank. They are established mainly for the growth of agriculture and Micro, Small and Medium industries.

Resident individuals/professionals carrying 10 years of experience in banking and finance and companies and societies owned and controlled by residents will be eligible to set up small finance banks. SFBs have a minimum paid up capital of Rs.100 crore.

Recently micro lenders, Suryoday and Utkarsh, have started Small Finance Banks (SFBs). They are offering interest rates of more than 6% (as compared to 4% offered by commercial banks) for savings bank deposits.

2.1.3.4. Payment Banks

In August 2015, the Reserve Bank of India (RBI) gave approval to private entities to open payments banks that will widen the reach of banking services and push the government's goal of financial inclusion. Payments banks will accept deposits of up to Rs 1 lakh. They can issue ATM/debit cards but not credit cards. The promoter's minimum initial contribution to equity capital will have to be at least 40% for the first five years.

It will provide a limited range of products – acceptance of demand deposits and remittances of funds, but will have a widespread network of access points particularly to remote areas. The network can be

- through bank branches or
- through business correspondents (BCs) or
- through networks provided by others

The payments banks will target financially excluded customers like migrant workers, low-income households and tiny businesses. They will not be in the business of lending, so they will be shielded from the risks that conventional banks are exposed to.

2.1.3.5. Wholesale and Long-Term Finance Bank

It will be a combination of long term-lending institution and an investment bank with proposed minimum capital of Rs 1,000 cr. They can't accept savings deposits. They can raise money from current accounts, bulk fixed amounts and bonds. It will enable companies to get long-term financing easily. It may help in relieving banking system from increasing stressed assets due to infrastructure sector. As specialized institutions, they will be in a much better position compared with commercial banks in evaluating and funding long-term projects. It will further enhance competition, which will lead to more efficient allocation of financial resources.

However, consideration should be given that their operational autonomy is maintained and licenses are given on the basis of ability to build such a highly specialized bank.

Foreign banks – India opened the doors for foreign banks after 1991. They set up either branches or wholly owned subsidiaries. Some of the **foreign banks** operating in the country include Deustche Bank, Bank of America, Citibank, HSBC, Royal Bank of Scotland etc.

The framework for foreign banks latest issued by RBI stress upon — the formation of wholly-owned subsidiaries (WOS) for furthering their business in India. The RBI guidelines make it clear that the WOS model is what the regulator would prefer the foreign banks to have. Suitable incentives are being given to new as well as existing players operating through their branches in India to adopt the subsidiary route and incorporate locally. If foreign banks took this route, the regulator would treat them in a par with Indian banks. They would be given capital gains tax and stamp duty benefits and allowed to acquire local private banks.

Student Notes:

However, changes in priority sector lending (PSL) norms that would follow such a move were a bone of contention. Before applying to RBI, some foreign lenders had urged that these norms be relaxed. The central bank said as was the case with their Indian counterparts, foreign banks would have to offer 40 per cent of their loans to priority sectors. Of this, 18 per cent have to be offered to the farm sector. Earlier, the cut-off for foreign lenders in the PSL segment was 32 per cent (for foreign banks with more than 20 branches, it was 40 per cent). But they would have to adhere to the 40 per cent norm within five years of setting up wholly-owned subsidiaries.

RBI had said foreign banks that entered India after August 2010 would have to mandatorily convert their branches into wholly-owned subsidiaries.

2.1.3.6. Problems of Commercial Banks in India

Though the commercial banks made significant progress in terms of branch expansion, deposit mobilisation, loans to priority sector and weaker sections of the society, they are still facing a number of problems in different respects.

1) **Problems in Branch Expansion**: Banks were asked to open their branches in rural and backward areas where minimum infrastructure facilities like roads, communication, transport, education, safe buildings for bank operations were not available. In some places there was a problem of even security to the bank employees.
2) **Problems in Deposit Mobilisation:** There has been heavy competition among public sector banks in deposit mobilisation as all of them have been providing the same service. Banks also face competition in mobilising deposits from National Savings Organisation, Non-Banking Companies, Unit Trust of India, Mutual Funds etc. It is felt that despite their efforts, deposit mobilisation efforts of banks have not been adequate to meet the needs of the present economic needs. It was also criticised that the schemes of deposit mobilisation of banks are not suited to the needs of the prospective depositors in rural areas.
3) **Absence of Coordination**: For providing finance to the same borrowers, there are several financial agencies like commercial banks, cooperative banks, regional rural banks and state financial corporation. In view of these multiple organisations and absence of coordination among these institutions it has resulted in duplicate financing, over-financing or under-financing.
4) **Inadequate Finance to Agriculture:** Though the commercial banks have made spectacular efforts to meet the financial needs of the agricultural sector and its allied activities, still a more vigorous effort is required as the total assistance of commercial banks to agricultural sector is not even 10% of their needs.
5) **Inadequate Banking Facilities in Rural Areas:** The number of banks in rural areas is quite inadequate compared to the needs of banking services, as is evident from the fact that only 5 per cent of the villages are covered by the banks.
6) **Regional Imbalances:** Though the commercial banks have spread their branches in different parts of the country, these are not equally distributed. According to Reserve Bank of India's Report about half of the branches are concentrated in the Southern and Western regions. The states like Assam, Jammu & Kashmir, Manipur, Nagaland, Orissa, Tripura, Uttar Pradesh and West Bengal may be termed as under banked areas.
7) **Low Profitability:** Financing of priority sectors, opening branches in rural as well as unbanked and backward areas, granting loans to weaker sections at low rate of interest, increase in cost of salaries and establishment and increase in overdue resulted in decline in the rate of profitability of most of the commercial banks in India. The low profitability is also caused due to increase in costs, inefficiency, bureaucratic attitude, absence of effective cost control, increase in Statutory Liquidity Ratio and Cash Reserve Ratio etc.
8) **Low Efficiency:** Nationalisation of banking industry has brought in all the limitations of public sector to it. These are bureaucratic attitude of the managers, absence of initiative, red-tapism, inordinate delays, lack of commitment, responsibility, indifference to work etc. These result in low efficiency of the banks.

Student Notes:

9) **Political Pressure:** Nationalisation of banks has brought political interference and political pressure at all levels of the banks. The political pressure results in poor selection of staff, granting loans and advances to undeserving, etc.
10) **Problems of Liberal Credit Policy:** Liberal Credit Policy, which is essential to meet the credit requirements of the weaker sections, agricultural sector, etc. resulted in insecurity of bank funds and ultimately of depositors money. Liberal credit policy has also resulted in poor recovery of funds and absence of recycling of bank funds.

2.2. Indian Banks Abroad

Like foreign banks set up in India, Indian banks set up their branches or subsidiaries in foreign countries. Both public and private sector banks have branches abroad.

Offshore banking units are located in Bahamas, Cayman islands, Channel islands, Mauritius. Off shore banks are banks located in a country that has more generous tax laws.

2.3. Another way of classification of banks

Another better way of categorizing the Indian banks is **scheduled** and **non-scheduled** banks. All commercial, RRBs and state cooperative banks are classified like this.

Scheduled banks are those banks which are mentioned in the **second schedule of the RBI Act**, 1934. These banks have to **meet certain minimum criteria** such as

- a minimum paid up capital and reserves of total aggregate value not less than Rs.5 lacs.
- These banks have to also satisfy the RBI that their functions would be carried out in the interests of their depositors.

The facilities enjoyed by scheduled banks are:

- They are eligible for obtaining debt/loans on bank rate from RBI
- They get automatic membership of clearing house
- They can avail the facility of rediscount of first class exchange bills from RBI

Any bank which fulfilled these conditions and got listed in the second schedule, on violating these principles will be descheduled.

Non-scheduled banks - on the other hand are those that have not been included in the second schedule of the RBI Act. As of today there are only three non-scheduled banks in the country. These banks also have to follow the conditions regarding CRR but can keep it with itself. These banks are not eligible for loan from RBI, but become eligible under emergency conditions.

2.4. Banks v/s Non- Banking Financial Companies (NBFCs)

2.4.1. What is NBFC?

A Non-Banking Financial Company (NBFC) is a company registered under the Companies Act, 1956 engaged in the business of loans and advances, acquisition of shares/ stocks/ bonds/ debentures/securities issued by Government or local authority or other marketable securities of a like nature, but does not include any institution whose principal business is that of agriculture activity, industrial activity, purchase or sale of any goods (other than securities) or providing any services and sale/purchase/construction of immovable property.

NBFCs lend and make investments and hence their activities are akin to that of banks; however there are a few differences as given below:

- NBFC cannot accept demand deposits;
- NBFCs do not form part of the payment and settlement system and cannot issue cheques drawn on itself

Student Notes:

- deposit insurance facility of Deposit Insurance and Credit Guarantee Corporation is not available to depositors of NBFCs, unlike in case of banks.

No NBFC can commence or carry on business of a non-banking financial institution without obtaining a certificate of registration from the Reserve Bank of India and without having a Net Owned Funds of Rs. 25 lakhs.

NBFCs can be classified into two broad categories, viz., (i) NBFCs accepting public deposit (NBFCs-D) and (ii) NBFCs not accepting/holding public deposit (NBFCs-ND). Residuary Non-Banking Companies(RNBCs) are another category of NBFCs whose principal business is acceptance of deposits and investing in approved securities.

2.4.2. Regulators of NBFC

In terms of the powers given to the Bank, to obviate dual regulation, certain categories of NBFCs which are regulated by other regulators are exempted from the requirement of registration with RBI viz. Venture Capital Fund/Merchant Banking companies/Stock broking companies registered with SEBI, Insurance Company holding a valid Certificate of Registration issued by IRDA, Nidhi companies as notified under Section 620A of the Companies Act, 1956, Chit companies as defined in clause (b) of Section 2 of the Chit Funds Act, 1982,Housing Finance Companies regulated by National Housing Bank, Stock Exchange or a Mutual Benefit company.

The following chart shows different regulators for different types of NBFCs

Overview of Regulators of Non-Banking Companies

Companies (Registered under Section 3 of the Companies Act 1956)

NBFCs registered with RBI *

Regulation, Supervision, Surveillance & Enforcement under RBI

NBFCs Regulated by Other Regulators

Type of Financial Institutions	Authority for Regulation, Supervision, Surveillance & Enforcement
Housing Finance Institutions	National Housing Bank
Merchant Banking Company, Venture Capital Fund Companies, Stock Broking, Collective Investment Schemes(CIS)	SEBI
Nidhi Companies, Mutual Benefit Companies	MCA
Chit Fund Companies	State Government
Insurance Companies	IRDA

Non Banking Non Financial Companies

Regulation, Supervision and Surveillance under the Companies Act 1956.

Regulator : Ministry of Corporate Affairs (MCA)

Enforcement Agency : State Governments

Nidhi company

A Nidhi company, is one that belongs to the non-banking Indian Finance sector and is recognized under section 406 of the Companies Act, 2013. Their core business is borrowing and lending money only between their members. Reserve Bank of India is empowered to issue directions to them in matters relating to their deposit acceptance activities. Basically a “Nidhi” means a company which has been incorporated as a Nidhi with the object of:

Student Notes:

- Cultivating the habit of thrift and savings amongst its members,
- receiving deposits from, and lending to, its members only, for their mutual benefit,

General restrictions on Nidhi companies are that no Nidhi shall:

- Carry on the business of Chit Fund, Hire Purchase Finance, Leasing Finance, Insurance or Acquisition of Securities issued by anybody corporate;
- Issue - Preference Shares, Debentures or Any Other Debt Instrument by any name or in any form whatsoever; Open any Current Account with its members;
- Acquire another company by; Purchase of securities or Control the composition of the Board of Directors of any other company in any manner whatsoever or Enter into any arrangement for the change of its management, unless it has passed a special resolution in its general meeting and also obtained the previous approval of the Regional Director having jurisdiction over Nidhi;
- Carry on any business other than the business of borrowing or lending in its own name;
- Accept Deposits from or lend to any person, other than its members;
- Pledge any of the assets lodged by its members as security;
- Take Deposits from or lend money to anybody corporate;
- Enter into any Partnership Arrangement in its borrowing or lending activities;
- Issue or cause to be issued any advertisement in any form for soliciting deposit;
- Pay any brokerage or incentive for mobilizing deposits from members or for deployment of funds or the granting loans.

But in recent times, certain chit fund scam (done in money market and capital market material) has happened by these which calls for greater regulation of these companies.

2.4.3. Increasing Influence and Regulatory Problems of NBFCs

The non-banking financial sector has evolved considerably in terms of operations, variety of market products and instruments, technological sophistication, etc. In recent years, the NBFCs have assumed increasing significance and have added considerable depth to the overall financial sector. The regulatory responses on the part of RBI have also kept pace with the evolution of this sector. In particular, regulation has adequately addressed the issue of depositor protection, a major concern of RBI.

The regulatory regime for NBFCs is lighter and different in many respects from that for the banks. The steady increase in bank credit to NBFCs over recent years means that the possibility of risks being transferred from the more lightly regulated NBFC sector to the banking sector in India can no longer be ruled out

The size of the NBFC sector based on total assets is about Rs 12.5 trillion, which is about 13% of the banking sector, whose size is about Rs 96.7 trillion by total assets. Therefore, although it is difficult to argue that the individual failure of any of the NBFCs poses a systemic risk because of the smallness of the individual sizes, it is not possible to rule out that their collective failure may pose a systemic risk to the financial system, especially in light of the bank-finance NBFC linkages.

NBFCs at times charge high interest rates from their borrowers. Reserve Bank of India has deregulated interest rates to be charged to borrowers by financial institutions (other than NBFC- Micro Finance Institution). The rate of interest to be charged by the company is governed by the terms and conditions of the loan agreement entered into between the borrower and the NBFCs. However, the NBFCs have to be transparent and the rate of interest and manner of arriving at the rate of interest to different categories of borrowers should be disclosed to the borrower or customer in the application form and communicated explicitly in the sanction letter etc.

Student Notes:

2.4.4. Usha Thorat Committee

The Reserve Bank of India (RBI) released the Usha Thorat committee report on non-banking finance companies or NBFCs. Some key recommendations of the committee are:

Tier I capital of NBFCs to be at 12% So far, NBFCs capital adequacy requirement is at 15% wherein there is no stringent stipulation of tier I or tier II capital. If the recommendation is accepted, every NBFC has to have a minimum tier I capital or equity capital of 12%.

Liquidity ratio to be introduced for 30 days. RBI has recommended maintaining a liquidity ratio of for 30 days. This means an NBFC has to set aside cash balance equivalent to its debt payments due every month. The measure is perceived to be important to check asset liablity mismatch of NBFCs.

NBFCs may be given benefits under SARFAESI Act Under Securitisation and Reconstruction of Financial Assets And Enforcement of Security Interest or SARFAESI Act, an NBFC would not move to the court to auction underlying assets to recover loan dues. It will just publish a newspaper notice before such auction.

NBFCs may be **subject to regulations similar to banks** while lending to stock brokers and merchant banks and similar to stock brokers, as specified by the Securities and Exchange Board of India (SEBI), while undertaking margin financing.

NBFCs with assets of Rs. 1000 crores and above should be inspected comprehensively on an annual basis with an annual stress test carried out to ascertain their vulnerability.

2.4.5. Steps Taken by RBI Regarding NBFCs

In November 2014, in a bid to bring NBFC norms in line with those of banks, RBI had unleashed tighter rules for NBFCs. According to the new guidelines, NBFCs will require higher minimum capital, have less time to declare bad loans, and a board-approved fit and proper criteria for appointment of directors.

The new norms, which would be implemented in a phased manner, were made applicable for NBFCs that manage funds worth Rs 500 crore and for those that accept public deposits.

In the interest of depositors, RBI has evolved a regulatory framework the salient features of which are outlined below

- Registration of an NBFC with the RBI merely authorizes it to conduct the business of NBFC. RBI does not guarantee the repayment of deposits accepted by NBFCs. NBFCs cannot use the name of the RBI in any manner while conducting their business.
- NBFCs which accept deposits should have minimum investment grade credit rating granted by an approved credit rating agency for deposit collection, except certain Asset Finance (equipment leasing and hire purchase finance) companies and Residuary Non-Banking Companies (RNBCs),
- NBFCs cannot offer
  - A rate of interest on deposits more than that approved by RBI from time to time (at present 12.5%).
  - Accept deposit for a period less than 12 months and more than 60 months
  - Offer any gifts/incentives to solicit deposits from public.

2.5. Banking Reforms in India

2.5.1. Narasimham Committee I (1991)

This committee was headed by Mr. M. Narasimham, who was the 13th Governor of RBI. This committee was appointed against the backdrop of the Balance of Payment Crisis. It was set up to analyze all factors related to financial system and give recommendation to improve its efficiency and productivity. Some of the important recommendations of the committee were:

Student Notes:

- **Reduction in CRR and SLR.**
- **Interest Rate Deregulation:** The Committee observed that the prevailing structure of administered rates was highly complex and rigid and called for deregulating it so that it reflects the emerging market conditions. However, it warned against instant deregulation and suggested gradual deregulation over a period of time.
- **Structural Reorganization of Banks:** the Committee believed that the structure should consist of 3-4 Banks (including SBI) becoming International Banks, 8 to 10 national banks with a nationwide network of branches engaged in universal banking, Local banks operations would be generally confined to a specific region, Rural banks (including RRBs) to the rural areas predominantly engaged in financing of agriculture and allied activities.
- **Establishment of ARF tribunal:** The committee recommended the establishment of an Asset Reconstruction Fund (ARF) which would take over the proportion of the bad and doubtful debts from the banks and financial institutes. All bad and doubtful debts of the banks were to be transferred in a phased manner to ensure smooth and effective functioning of the ARF. The committee also suggested the formation of special tribunals to recover loans granted by the bank
- **Allowing Banks to raise Capital:** The Committee recommended that profitable banks and banks with good reputation should be permitted to raise capital from the public through the capital market. Regarding other banks, the government should subscribe to their capital or give a loan, which should be treated as a subordinate debt, to meet their capital requirements.

2.5.2. Narasimham Committee II

It was setup by the Finance Ministry of the Government of India under the chairmanship of Mr. M. Narasimham in 1998. Its aim was to review the progress of the implementation of the banking reforms since 1992 with the aim of further strengthening the financial institutions of India. The Committee's Report focused on issues like size of banks and capital adequacy ratio.

- **Need for a Stronger Banking System:** It recommended the merger of strong banks, which will have a "multiplier effect" on industry. It also supported that two or three large strong banks be given international or global platform to work on.
- **Stricter norms for NPAs:** Some of the PSBs had NPAs as high as 20 percent of their assets. For successful rehabilitation of these banks, the committee recommended Narrow Banking Concept. As per this, the weak banks were to be allowed to place their funds only in short term and risk free assets.
- **Greater Autonomy for the PSBs:** Greater autonomy was proposed for the public sector banks in order for them to function with equivalent professionalism as their international counterparts. The Committee recommended: GoI equity in nationalized banks be reduced to 33% , RBI to relinquish its seats on the board of directors of these banks, review of functions of banks boards with a view to make them responsible for enhancing shareholder value through formulation of corporate strategy and reduction of government equity
- **Capital Adequacy Norms:** To improve the inherent strength of the Indian banking system the committee recommended that the Government should raise the prescribed capital adequacy norms to improve their Risk absorption capacity. The committee targeted raising the capital adequacy ratio to 9% by 2000 and 10% by 2002. The Committee recommended penal provisions for banks that fail to meet these requirements.

Implementation of Recommendations

To implement these recommendations, the RBI in Oct 1998, initiated the second phase of financial sector reforms on the lines of Narasimham Committee-II report. RBI raised Capital Adequacy Ratio by 1% and tightened the prudential norms for provisioning and asset classification in a phased manner (discussed later). It also targeted to bring the capital adequacy ratio to 9% by March 2001.

Student Notes:

In October 1999 criteria for "autonomous status" was identified by March 1999 and 17 banks were considered eligible for autonomy. The Committee's recommendations let to introduction of a new legislation in 2002, Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002(SARAFESI Act 2002). Some of the recommendations like reduction in Governments equity to 33%, the issue of greater professionalism and independence of the board of directors of public sector banks are still awaiting Government follow-through.

During the 2008 economic crisis, performance of Indian banking sector was far better than their international counterparts. This was credited to the successful implementation of the recommendations of the Narasimham Committee-II with particular reference to the capital adequacy norms and the recapitalization of the public sector banks. Impact of the two committees has been so significant that the financial-economic sector professionals have been applauding there positive contribution.

2.6. Issue of Non-Performing Assets (NPAs)

The issue of NPAs has gained immense importance as there is a surge in stressed assets in banking in the recent times.

2.6.1. What are Non-Performing Assets (NPA's)

Non-performing assets, also called non-performing loans, are loans, made by a bank or finance company, on which repayments or interest payments are not being made on time. Generally speaking, NPA is any asset of a bank which is not producing any income. Once the borrower has failed to make interest or principal payments for 90 days the loan is considered to be a non-performing asset.

But in terms of Agriculture / Farm Loans; the NPA is defined as under: Short duration crop loan : Loan is termed as NPA in this scenario if the loan either in terms of installment or interest is not paid for 2 crop seasons, it would be termed as NPA. Example: Agri loans such as paddy, jowar, Bajra etc. For Long Duration Crops, the above would be 1 Crop season from the due date.

2.6.2. Categories of NPAs

Standard asset – when borrower regularly pays his dues regularly and on time.

Banks are required to classify non -performing assets further into the following three categories based on the period for which the asset has remained non-performing and the realisability of the dues:

Special mention account – If the borrower does not pay for 90 days after end of a quarter; the loan becomes an NPA and it is termed as special mention account.

Sub-standard Assets - a sub-standard asset is one which has remained NPA for a period less than or equal to 12 months. Such an asset will have well defined credit weaknesses that jeopardise the liquidation of the debt and are characterised by the distinct possibility that the banks will sustain some loss, if deficiencies are not corrected.

Doubtful Assets - an asset is classified as doubtful if it has remained in the sub-standard category for a period of 12 months. A loan classified as doubtful has all the weaknesses inherent in assets that were classified as sub-standard, with the added characteristic that the weaknesses make collection or liquidation in full, – on the basis of currently known facts, conditions and values – highly questionable and improbable.

Loss Assets - A loss asset is one where loss has been identified by the bank or internal or external auditors or the RBI inspection but the amount has not been written off wholly. In other words, such an asset is considered uncollectible and of such little value that its continuance as a bankable asset is not warranted although there may be some salvage or recovery value.

Student Notes:

2.6.3. How to Reduce NPAs

Before giving loans

- **Credit information of the borrowers** - In addition, to address the issue of information asymmetry as also to identify the problem early, a Central Repository of Information on Large Credits (CRILC) to collect, store, and disseminate credit data to lenders, was set up. Under this arrangement, banks are reporting credit information on all their borrowers having aggregate fund-based and non-fund based exposure of ₹50 million and above with them.
- **Cautioned treatment to defaulters** - while considering their support to accounts under stress, banks should make proper distinction between willful – defaulters/non-cooperative/ unscrupulous borrowers on the one hand, and on the other hand, borrowers defaulting on their debt obligations due to circumstances beyond their control.
- **Proper structuring of loans** - To facilitate banks to offer long term project financing, which may ensure long term viability of infrastructure and core industries sector projects by smoothening the cash flow stress in initial years of such projects, the Reserve Bank has issued guidelines on flexible structuring of long term project loans with periodic refinancing option.

After declaring asset as an NPA

- **A comprehensive framework by RBI** - The Reserve Bank of India had released a comprehensive 'Framework for Revitalising Distressed Assets in the Economy'. The Framework outlines a corrective action plan which includes:
  - early identification of problem cases,
  - timely restructuring of accounts which are considered to be viable, and
  - taking prompt steps by banks for recovery or sale of unviable accounts.
- **Revival of the viable entities** - timely support through restructuring in genuine cases is called for with the objective to preserve the economic value of viable entities and minimise the losses to the creditors and other stakeholders.
- **Debt Recovery Tribunals –** To recover security interest fastly, these tribunals along with appellate tribunal were established.
- **Invoking legal provisions -** The Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest (SARFAESI) Act has provisions for the banks to take legal recourse to recover their dues.
- **Selling the NPAs to SCs/RCs** (securitisation companies/ reconstruction companies) registered under the SARFAESI Act. SCs/RCs are expected to do a specialised task of recovering and reconstructing the NPAs thereby reducing the NPAs in the system. Only a few out of 15 registered SCs seem to be successful.
- **JLF (joint lenders' forum):** To build incentives and disincentives. Borrowers and lenders have to reach a conclusion about the prompt corrective action plan. After the conversion, all lenders under the JLF must collectively hold 51% or more of the equity shares issued by the company
- **Lok Adalats:** Lok Adalat mechanism offers expeditious, in-expensive and mutually acceptable way of settlement of disputes. Government has advised the public sector banks to utilize this mechanism to its fullest potential for recovery in Non-performing Assets (NPAs) cases.

2.6.4. Recent Initiatives

2.6.4.1. Prompt Corrective Action Framework

- Prompt Corrective Action allows the RBI to pose certain restrictions on a bank when certain limits are breached.
- These restrictions may include halting branch expansion, stopping dividend payments, special audit and more.

Student Notes:

- The risk thresholds that are taken into account are asset quality, profitability, NPA limit and the like.
- PCA was first issued by the RBI in May 2014 and has recently been revised in April 2017.

2.6.4.2. Indradhanush Plan

- It is an umbrella scheme for banking reforms which includes seven elements
- **Appointment**: Separating post of Chairman and Managing Director to bring more professionalism.
- **Bank Board Bureau:** a body of eminent professionals and officials, with various important functions like recommending for selection of heads, helping banks in developing strategies and plans, advising banks on strategies of consolidation, etc.
- **Capitalization:** by infusion of equity capital
- **De-stressing:** Strengthening Asset Reconstruction Companies and Establishment of six New debt recovery tribunals (DRCs) and creation of a Central Repository of Information on Large Credits (CRILC) by RBI to collect, store and disseminate credit data to banks.
- **Empowerment:** Non-interference in the functioning of public sector banks and encouraging them to take decisions independently; keeping the commercial interest of the organization in mind.
- **Framework for accountability**: through key performance indicators for state-run PSBs
- **Governance reforms: "Gyan Sangam"** a conclave of PSBs and Financial institutions attended by all major stake-holders.

2.6.4.3. Other Measures

For securitisation companies

- **Transparency in working of SCs -** The RBI has recently taken various steps to improve the system's ability to deal with distressed assets of banks and financial institutions.
  - The Reserve Bank has issued various guidelines relating to the operations of SCs/RCs as also to make transactions between them and banks more transparent for prevention of collusions with promoters in buy back deals.
- **Increased FDI cap -** foreign direct investment cap on SCs/RCs has been increased from 49 per cent to 74 per cent under the automatic route.

For banks

- **Capacity building of banks –** There is a need for emergence of additional technical capabilities of banks to undertake evaluation of projects, restructuring schemes, etc. undertaken under JLF. Reserve Bank through the Centre for Advanced Financial Research and Learning has taken initiative to organise capacity building program for bankers.
- **Strategic Debt Restructuring:** - Provide lenders 51% equity control in a company that fails to repay even after its debts are rejigged to give the management a second chance. It Will come into force if the corporate debt restructuring (CDR) mechanism fails.
- **5/25 norms:** Permitted banks to structure loans for 25 years while giving them the flexibility to revise rates or sell the asset to another bank every five years in infrastructure.
- **Banking regulation ordinance 2017 -**

For borrowers

- **Insolvency and bankruptcy code –** It will reduce the delay in resolution of insolvency or bankruptcy cases and improving recoveries of the amount lent. Thus, it will help in facilitating the efficient flow of capital across the economy. It will streamline the process which is otherwise regulated by multiple laws such as the Companies Act, SARFAESI Act, Sick Industrial Companies Act.
- Salient Features of the law :
  - It Fixed a timeline of 180 days, extendable by another 90 days, to resolve cases of insolvency or bankruptcy.

Student Notes:

  - **A new regulator** — The Insolvency and Bankruptcy Board of India (IBBI) to regulate professionals/agencies dealing with insolvency and informational utilities.
  - **National Company Law Tribunal (NCLT)** to adjudicate bankruptcy cases over companies, limited liability entities while **Debt Recovery Tribunal (DRT)** to adjudicate cases over individuals and unlimited liability partnership firms.
- **Formation of bad bank –** A separate entity that would buy the NPAs and work towards suitably disposing off freeing up banks books for fresh lending. It has been successfully implemented in many western European countries post the 2007 financial crisis France etc. However, in case of India certain issues need to be taken care of such as majority stakes with government may render the Bad Bank facing same issues of governance and capitalization as PSBs

2.6.5. Issues Needing Further Intervention

- **Effective exit policy –** For accounts which are beyond revival, banks should have a well - defined loan recovery policy which sets down the manner of recovery of dues depending upon the circumstances of each account. Banks may resort to either opt for legal avenues or non-legal avenues for exiting the account.
- **Judicial delays -** An important factor affecting recovery performance of SCs/RCs is the delay in judicial process: be it under SARFAESI Act or at the level of debt recovery tribunals. A fast and efficient judicial system is a sine qua non for effective resolution of NPAs.
- **Low recovery performance** - On the recovery side, the performance is not very encouraging. As on March 31, 2015, the average recovery rate (assets resolved as a per cent to assets acquired) of SCs/RCs was at 31.0 per cent.
- **Non-transparent auction process by banks for the sale of NPAs to ARCs -** The RBI has also advised that the banks using auction process for sale of NPAs to ARCs should be more transparent
- **Banks possessing small share in loan forming JLF –** reluctant to do independent analysis, often goes by what the largest shareholder is saying. It may not have enough in-house capability for independent analysis and even if it does have, its say will be minute considering the size of shares it owns
- **Pricing of NPAs -** Investors in stressed asset portfolios expect high returns, based on high-risk, high-reward principle which SCs/RCs find impossible to offer if the assets being acquired are not realistically priced.
- **Transparency in official numbers** - a clear and transparent assessment and communication of the problem. Official numbers on non-performing assets are being questioned by an increasing number of observers; this is a clear manifestation of distrust.
- **Infuse more capital into banks**, even if it is based on performance, is a hugely risky move without full transparency. Apparently well-performing banks may suddenly show themselves to be worse than reported. Any move to re-capitalise the banks should only be made once full transparency is achieved
- **Improving management and governance of banks** - there is no action on the recommendations of the committee chaired by P J Nayak, which call for much more fundamental governance reforms.
- **Decentralised decision making from government to PSB boards -** Rajan said. He said more decisions need to be decentralised from the government to the PSB boards, once they have been fully professionalised.
- **asset reconstruction company (ARC) -** The Union finance ministry and the Niti Aayog have recommended that the government set up an asset reconstruction company (ARC) and transfer troubled assets of the banking sector to its books. This will clean up the balance sheets of banks.

Student Notes:

2.6.6. Steps Advised by Finance Standing Committee of the Parliament

Finance standing committee of parliament's recommendation on NPAs in its report has been adopted on 5th February 2016. Some of its key recommendations include:

Forensic audit

- The committee has called for immediate forensic audit of all restructured loans that had turned into bad debts. Forensic audit is also required for willful defaults

Revive Development Financial Institutions (DFIs)

- The panel also recommended the development of a "vibrant bond market" to finance infrastructure products.
- Batting for large infrastructural projects, it said the Centre should revive Development Financial Institutions for long-term financing of such projects

Reveal the names of Willful defaulters

- The panel asked the apex bank to form empowered committees at the level of RBI, banks and borrowers to monitor large loans.
- Name and shame the defaulters - There is no justification of keeping the names secret and asked the RBI to amend its guidelines, it added.
- It also recommended that a change in management must be made mandatory in cases involving willful default.

2.7. Some Important Terms

White Label ATMs:

White Label ATM or White Label Automated Teller Machines or WLAs are owned and operated by Non-Bank entities. From such White Label ATM customer from any bank will be able to withdraw money, but will need to pay a fee for the services. These white label automated teller machines (ATMs) will not display logo of any particular bank and are likely to be located in non-traditional places.

Shadow Banks: Shadow Banks refer to those organizations that function like banks but are outside the banking regulation. They help in providing quick source of credit to the public but have been criticized because they lead to a creation of a bubble and on the defaulting on loans by the borrowers it leads to a crisis as one witnessed in the US.

Core Banking Solution - CBS is networking of branches, which enables Customers to operate their accounts, and avail banking services from any branch of the Bank on CBS network, regardless of where he maintains his account. The customer is no more the customer of a Branch. He becomes the Bank's Customer.

Bhartiya Mahila Bank:

Although initially reported as a bank exclusively for women, the bank allows deposits to flow from everyone, but lending will be predominantly for women. It has been decided to merge Bhatiya Mahila Bank with State Bank of India. Some salient features of Bhartiya Mahila Bank are:

- Bank will offer 4.5% interest on saving deposits
- It will not insist on collateral since most title deeds are in name of male family members.
- It will lend to micro businesses like catering, crèches & for upgrading kitchens in households
- The bank aims to have Rs. 60,000 crore business and 775 branches by 2020.
- It will provide loans primarily to women, and will give low-cost education loans for girls.
- Key positions, including treasury head and security head, held by women.

SARFAESI Act 2002: Securitisation and Reconstruction of Financial Assets and Enforcement of Security Interest Act (Sarfaesi Act) is the most potent tool in the hands of banks for recovering

Student Notes:

bad loans (NPAs). The SARFAESI Act empowers banks and financial institutions to recover their non-performing assets without intervention of courts.

The Act provides three alternative methods for recovery of non-performing assets — securitisation, asset reconstruction and enforcement of security — without the intervention of courts. According to the RBI's Report on Trend and Progress of Banking in India, 2012-13, banks have recovered Rs 18,500 crore through the SARFAESI route. Also, in terms of efficiency, the Act has proved to be more effective than the debt recovery tribunals (DRTs) or mediation by Lok Adalats.

Lead bank Scheme: Till 1960s, the Banking needs of the rural areas in general and backward in particular were not taken care of by the Commercial Banks. Lead Bank Scheme (LBS) was introduced in 1969, based on the recommendations of the Gadgil Study Group.

The basic idea was to have an "area approach" for targeted and focused banking.

It refers to scheme under which, one of the commercial banks(like SBI, Axis, ICICI) act as a lead bank and coordinates the activities of another financial institutions like cooperatives banks for efficient functioning and rapid development at district level.

A high level committee chaired by RBI Deputy Governor Usha Thorat was constituted to review and revitalize this scheme. The Opinion of this committee is that full financial inclusion is possible only if it makes a facility of opening of no frill accounts backed by other specialized services.

Banking Ombudsman: Banking Ombudsman is a quasi-judicial authority functioning under India's Banking Ombudsman Scheme 2006, and the authority was created pursuant to a decision by the Government of India to enable resolution of complaints of customers of banks relating to certain services rendered by the banks. From 2002 until 2006, around 36,000 complaints have been dealt by the Banking Ombudsmen.

Banking Ombudsman provides a forum to bank customers to seek redressal of their most common complaints against banks, including those relating to credit cards, service charges, promises given by the sales agents of banks, but not kept by banks, as also, delays in delivery of bank services. The bank customers would now be able to complain about non-payment or any inordinate delay in payments or collection of cheques towards bills or remittances by banks, as also non-acceptance of small denomination notes and coins or charging of commission for acceptance of small denomination notes and coins by banks.

DOMESTIC SYSTEMICALLY IMPORTANT BANKS (D-SIBS): The Reserve bank of India (RBI) has identified State Bank of India (SBI), ICICI Bank and HDFC Bank as domestic systemically important banks (D-SIBs). SIBs are perceived as certain big banks in the country. They enjoy a huge customer base are perceived as 'Too Big to Fail (TBTF)'. As they command such a huge consumer base as well have NBFC subsidiary therefore they have expectation of government support at the time of distress.

EXIM BANK: Export-Import Bank of India is a wholly owned Govt. of India entity setup in 1982 for financing, facilitating and promoting foreign trade of India. The EXIM bank extends Line of Credit (loC) to overseas financial institutions, regional development banks, sovereign governments and other entities abroad. Thus, the EXIM Banks enables buyers in those countries to import developmental and infrastructure, equipment's, goods and services from India on deferred credit terms. The bank also facilitates investment by Indian companies abroad for setting up joint ventures, subsidiaries or overseas acquisitions.

INSOLVENCY AND BANKRUPTCY BOARD: The Centre has constituted a four-member Insolvency and Bankruptcy Board of India (IBBI) under the Ministry of Corporate Affairs. The main activity of IBBI would be to regulate the functioning of insolvency professionals, insolvency professional agencies and information utilities under the Insolvency and Bankruptcy Code 2016.

Student Notes:

PRIORITY SECTOR LENDING CERTIFICATES (PSLCS): RBI has permitting the issue and trading of PSL certificates, whereby banks can buy and sell such credits to manage their priority sector lending requirements

3. Previous Years UPSC Mains Questions

1. Describe the organisation and the functions of Regional Rural banks, Review their achievements. Is there any conflicting jurisdiction between these rural banks and cooperative credit societies?
2. What are the main components of money supply in India?
3. It is being suggested that the commercial banks in India should reduce their holdings of non-performing assets. Does it mean that the former should abandon social priorities? (About 250 words)
4. What has been the rationale for deregulating commercial bank's lending rates as a policy strategy?

4. Vision IAS GS Mains Test Series Questions

1. Digital currency represents a decentralized form of money that is more secure, more fungible and more functional than anything we've seen before. Examine.

Approach:

- In brief explain the arguments provided by proponents of digital currencies regarding independence from a central authority and focus on peer to peer transaction. Technicalities of digital currency are not required.
- In second part of the answer discuss the importance of central banks and the risk of digital currencies.
- Accordingly conclude.

Answer:

The nature of money changed after the Bretton Woods Conference in 1944, when most countries tied the value of their currencies to the US dollar, rather than to gold or silver. When the US went off the gold standard in 1971, all currencies essential became fiat moneys, with their value derived from the governments that issue them rather than from commodities. Thus, global financial system is decided by small group of bankers and this gives enormous control to central banks over economic activity. Therefore, many people object to the concept of fiat money.

In this context, innovating the concept of money through a digital currency which is more decentralized and democratic has been a recurring theme in technology circles. This can be understood for the following:

- **Low transaction fee:**
  - The core innovation is that digital currency uses **consensus in a massive peer-to-peer network to verify transactions**. Thus, there is vast potential in using digital currency as a medium of exchange at a much lower cost than Visa and Mastercard.
  - It also transacts business instantaneously, so there is no "float" (i.e. the bank can't keep money in limbo while it earns interest on it) and because processing is automated, fees can be lowered substantially.
- **No central authority:** The supply of Bitcoin is capped. So no one can create unlimited Bitcoins. There's no Federal Reserve or other central bank that can intervene.
- **Impervious to attack:** Digital currencies have a widely distributed ledger, so it's much more impervious to attack than a centralized institution like a bank.

Student Notes:

However, there are issues with digital currency. For example,

- **Volatility of currency:** Bitcoin's, the most famous digital currency, popularity led to a massive speculative bubble, rising in value to almost $1000 and then crashing down to under $400.
- There are apprehensions that digital currency can be used to finance illegal activities due to anonymity of the transaction.

Thus, there is much uncertainty associated with Digital currencies. Many think that this may be the future of world economy while others are afraid that it can destroy economies. However, if digital currency works and people starts trusting it to work without the middlemen i.e. central authorities, the way world's economy functions could be transformed for better.

2. ***Examine the reasons for poor performance of public sector banks in India. Give an account of the steps taken by the government and RBI to improve their performance. Also analyse whether the risks arising from the consolidation of the Indian banking sector outweigh the potential longer-term benefits.***

Approach:

- Briefly describe the poor performance of PSBs.
- Enumerate the reasons for this. Mention the impact of the reason you give.
- Next, mention the steps taken by the Government and RBI. Be specific.
- Finally, mention the risks posed by consolidation. Give a balanced opinion.

Answer:

PSBs face multiple concerns related to their performance regarding declining profits, deteriorating asset quality, risky capital position and poor governance. On top there are problems of corruption and human resource which have exacerbated these concerns. The **reasons** for the poor performance are multi-dimensional.

- The economic slowdown in recent years has affected prime borrowing sectors of PSBs i.e. iron and steel, infrastructure, aviation and mining. PSBs are often forced to lend to the unviable projects of these sectors, leading to a rise in NPAs. NPAs require greater provisioning and reduce the bank's capacity to lend to productive sectors.
- The corporate debt restructuring of bad loans of companies leaves the PSBs in a poor financial position. This also hides the magnitude of the imminent problem.
- The poor performance of PSBs is also seen as a governance issue. The appointment of heads of banks involves lobbying by vested interests and is often delayed.
- Dual regulation by RBI and the Finance Ministry has left little autonomy for PSBs.
- Interference by the vested interests has pervaded a culture of non-compliance of best practices to evaluate feasibility of loans and undertaking proper KYC.

  To enhance their performance, the **government** has initiated the Indradhanush framework. This comprehensive effort will focus on seven critical areas of

  - appointments,
  - setting up a Bank Board Bureau,
  - capitalization,
  - de-stressing PSBs and strengthening risk control measures,
  - empowerment of bank management,
  - development of a Framework of Accountability, and
  - governance reforms.

Student Notes:

- The **RBI** has issued guidelines for quicker recognition and resolution of stressed assets. It has developed a Corrective Action Plan for recovery or sale of unviable accounts. It has lightened norms for Asset Reconstruction Companies by increasing cash stake of ARCs in assets purchased by them. These measures are expected to tackle the issue of increasing NPAs.

Issues in consolidation: The current weak economic environment makes the consolidation process risky because of a high number of stressed assets.

On the other hand, apart from a balance sheet size increase (SBI's will be Rs.37 lakh crore post merger, and push it into top 50 globally), synergies in business and treasury operations, branch rationalisation and the access to tap into cheaper funds are expected to prune the merged entity's costs. This will result in efficiency gains and higher quality of services.

Bank consolidation should not be done to overcome short-term problems faced by certain PSBs. Further, existence of large sized banks will have systemic and moral implications as it may require government bailouts during time of stress.

The government should take into mind the risks involved and take steps accordingly. Creating large banks should not be the sole objective and it must be ensured that consolidation is carried out in a well calibrated manner.

3. The advent of differentiated banking marks the beginning of a radical overhaul of the banking structure that would address the abysmal levels of financial inclusion in India. Elaborate. What are the possible issues that could impede the functioning of these banks?

Approach:

- In introduction provide a brief picture of financial inclusion in India.
- Then bring out the concept of differentiated bank.
- Subsequently, analyse how differentiated bank could address the abysmal levels of financial inclusion in the country.
- Finally, analyse the issues that could impede the functioning of these banks.
- In conclusion suggest a way forward.

Answer:

In last two decades, the reach and scope of banking has increased, but the huge demand for financial services remains unfulfilled. It is a matter of concern that even with 150 domestic commercial and over 2,700 co-operative sector banks operating in the country, just about 40 per cent of the adults have formal bank accounts.

Thus, even while the efforts to ensure financial Inclusion through the existing set of banks continue, the concept of differentiated bank has been introduced. Differentiated banks are distinct from universal banks as they function in a niche segment. It could address the abysmal levels of financial inclusion in following ways-

- Commercial banks are largely interested in funding large and medium corporations or giving out loans for home and vehicle purchases and have neglected smaller segments. Differentiated banking models like payment bank and small bank can fulfil the gaps.
- Differentiated banks will allow customers to directly take deposits, which will bring down their cost of funds and translate into lower interest rates for clients.
- These banks may be in a better position to exploit the huge business opportunity in funding small and medium enterprises.
- Also the RBI expects them to be high technology-low cost operators, while also will bring innovations in service delivery.

Student Notes:

Some issues which could impede functioning of these banks-

- Many niche-banking models typically depend on inter-bank liquidity, and wholesale funding which is a potential source of risk and vulnerability and maintaining systematic stability and protecting the interest of depositors.
- Full penetration of no-frills accounts may prove to be a constraint in their pursuit of deposit accounts.
- Differentiated banks will have to persuade a large number of potential customers to either switch from commercial banks or open up a second account.
- Beyond this, on the loan side of the business, as they seek to grow their lending volumes, they will be in direct competition with the priority sector mandates of commercial banks

For these new categories to be given a fair chance of success there is a need for some re-alignment of roles and responsibilities between different categories of banks in relation to no-frills accounts and priority sector loans.

4. ***The proposal of floating Bad Bank has its merits. However, in Indian context, making it a success poses significant challenges. Discuss.***

Approach:

- In the introduction, give an overview of the problem which has given rise to the proposal of bad bank and also explain the idea of bad bank briefly.
- Write about the merits and challenges associated with the bad bank.
- In the conclusion, mention the way forward.

Answer:

Non Performing Assets in Public Sector Banks is around 8 percent. The high NPA robs off the profit and thus dampens the credit growth. To solve this problem Bad Banks have been proposed. The NPAs will be transferred to Bad Banks. The bad bank will manage these NPAs in suitable ways — some may be liquidated, others may be restructured, etc. The idea of bad banks has following merits:

- Getting NPAs off the books will help the PSB management focus on new business instead of having to expend their energies on trying to effect recoveries.
- A bad bank will be better focussed on the task of recovery.
- If bad bank is a private entity, it can also bring in superior expertise.

However, in Indian context, the bad banks may face the following challenges:

- If the government is the majority stake holder in the bad banks, it will be difficult for the government to find huge money. Considering the immediate recapitalization demands that would arise, public debt levels would be impacted. Also, a government-owned bad bank appears to be transferring the problem from one part of the government to another.
- If a private player holds the majority stakes in bad banks, the pricing of bad loans will become a major issue. The high price will not be viable. For the low price, the bad bank will be accused of selling at low cost to boost the profit of the private player.
- Bad banks were typically intended for situations where projects were not viable. There is also a concern that bad banks may not be suitable for India wherein a big chunk of NPAs at PSBs pertains to projects that are viable. These projects have not gone through to completion for reasons that are mostly extraneous to the project, such as problems in land acquisition or environmental clearance.

Student Notes:

Therefore, bad banks is also associated with challenges and may not be able to solve the NPA crisis alone. The most efficient approach would be to design bad bank solutions tailor-made for India's bad loan problem.

- It should be based on a criterion as any such exercise creates a moral hazard which should be eschewed.
- There have to be strict performance criteria for the banks selling such assets. This can be through a multi-stage approach where these assets are bought piecemeal by the bad bank based on how future incremental assets perform.
- A competitive approach should prevail among the banks so that they work hard to qualify for the sale of bad assets to the bad bank.

5. *Comment on the problem of rising Non Performing Assets (NPAs) in India, with particular reference to public sector banks. Examine the effectiveness of the steps taken by the government in recent times to deal with this problem.*

Approach:

- Briefly highlight the NPA problem of India and its causes.
- Discuss in detail how PSBs are affected by NPA and its implication on Indian economy.
- Mention steps taken by government to deal with the problem.
- Discuss the effectiveness of these steps.

***Answer**:*

The entire Indian economy is witnessing a rise of Non-Performing Assets (NPAs). More than Rs. 7 trillion worth loans are classified as Non-Performing Loans in India, which roughly translates to near 10% of all loans given. The key reasons cited for this are: unplanned expansion of Indian corporate houses during boom periods and the Global financial crisis impacting corporate performance and thus, stressing their balance sheets.

The severity of NPA problem is much higher in Public sector banks (PSBs) as compared to private banks because:

- PSBs have more exposure in the sectors — infrastructure, steel, textiles, aviation, and mining —which have contributed towards a big rise in NPAs.
- Inefficient borrower screening, credit appraisal and post-disbursement supervision.
- Lack of effective loan recovery mechanisms.

Such huge levels of NPAs cripple the whole economy as banking sector raises interest rates, reduces funding to nation-building projects resulting into increased unemployment and lowering of GDP growth. To address the problem of NPAs, the government took several measures such as:

- Mission Indradhanush to transform PSBs.
  - Established Bank Board Bureau for appointments to PSBs, developing strategies for raising funds and overseeing consolidation of PSBs.
- Announced Rs. 70,000 Crore for recapitalisation of banks.
- RBI has over the past few decades come up with a number of schemes such as Corporate Debt Restructuring (CDR), formation of Joint Lenders' Forum (JLF), flexible structuring for long-term project loans to infrastructure (or 5/25 Scheme), Strategic Debt Restructuring (SDR) scheme and Sustainable Structuring of Stressed Assets (S4A) to check the menace of NPAs.

Student Notes:

- Asset Quality Review was conducted for early identification of the assets and preventing them from becoming stressed by appropriate action.
- Insolvency and Bankruptcy Code Act, 2016 to tackle the Chakravyuaha challenge of the exit problem in India.
- The Banking Regulation Act has been amended to give the RBI more powers to monitor bank accounts of big defaulters.
- The SARFAESI Act, 2002 was amended in 2016 for quick recovery of stressed assets.

However, these measures have seen limited progress in tackling NPAs.

- The schemes like S4A has limited applicability as most corporate defaulters failed to meet the standards. It cannot be applied to all cases of stressed exposure. It can be applied only to operational projects and not to under construction projects.
- The recapitalisation amount has fallen short of the amount needed by banking sector.
- The bank officers are too cautious with debt restructuring due to the fear of anti-graft charges.
- The time bound manner in which Insolvency and Bankruptcy code aims to resolve cases have been lauded by the experts. However, the long term effects are yet to be seen.

Several experts point towards further increase in NPAs in Indian banking sector. To address this problem, the government and banking sector together should consistently work on remedial measures like the BAD Bank and other structural reforms. The Government is also bringing Financial Resolution and Deposit Insurance Bill for the insolvency of financial firms including banks.

6. Even though the Pradhan Mantri Jan-Dhan Yojana is an accelerated effort towards financial inclusion, mere opening of bank accounts will not transform into financial inclusion in India. Analyse.

Approach:

- Briefly explain the objectives of Prime Minister's Jan Dhan Yojana towards financial inclusion.
- Explain the issues to be dealt in addition to opening of bank accounts in order to achieve financial inclusion in India.
- Conclude positively with a way forward.

Answer:

Financial inclusion denotes delivery of various financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The objective of financial inclusion is to extend the scope of activities of the organized financial system to include within its ambit people with low incomes.

The Pradhan Mantri Jan-Dhan Yojana (JDY) was launched in August 2014 as an ambitious financial inclusion scheme. The yojana envisages universal access to banking facilities with at least one basic banking account for every household, access to credit, insurance and pension facility.

It is estimated that nearly 14.7 crore accounts were opened till 31 March 2015. Even though the programme is an accelerated effort towards financial inclusion in India, mere opening of bank accounts will not transform into financial inclusion.

In addition to opening of bank accounts, there is a need to address various other issues in order to achieve financial inclusion:

Student Notes:

- According to the World Bank's Global Financial Development Report (2014) only 11% of those who had a bank account had savings and only 8% took loans. Equally alarming are the number of bank accounts that are opened and lie dormant.
- As per the RBI data almost 75% of savings accounts lie dormant. These figures get more dismal if we look at the accounts opened by business correspondents (BCs).
- While it is true that bank accounts can be used to link different wage employment schemes such as MgNREGA, it does not ensure affordable credit from formal sources for the rural poor who continue to rely on informal sources of finance at high interest rates for their credit needs.
- The poorer and more disadvantaged group of households in agriculture and allied activities form just a mere 1% of the savings in formal institutions.
- The banks are faced with high operating cost in extending the financial services to the remote areas. High maintenance cost of these accounts as well as small ticket size of the transactions is also adding to the problem.
- The current service delivery model of using BCs and mobile money to increase outreach faces a formidable trust barrier. The Inter Media India FII Tracker Survey (2013) report suggest that just 3% of households fully trust BCs with their financial transactions and only 1% of households trust the use of mobile money. This defeat the very purpose of making financial services more accessible and affordable for the poor.
- There is a need for banks to mitigate the supply side processes that prevent poor and disadvantaged social groups from gaining access to the financial system. Despite the risk, financing of first time entrepreneurs is a must for financial inclusion and growth.
- Low level of financial literacy is another major issue. Reaching out to the illiterate people or people who can handle only the regional languages is also difficult without developing a suitable communication mode.

There is a need to compute a more multidimensional index of financial inclusion to include both financial deepening indicators such as the number of bank accounts as well as financial habit indicators such as the number of bank accounts that are actually used.

Both access and use will be necessary to smooth consumption and reduce risks for the poor. The mere chasing of numerical targets of financial access becomes meaningless unless deeper issues that address financial capability and trust in service delivery are tackled simultaneously.

7. MUDRA bank has been termed as a game changer for micro finance sector in the country. What are the objectives of MUDRA Bank? Is there a need of such an institution when there already are multiple schemes and institutions operating for the same purpose?

Approach:

- Describe the MUDRA Yojna briefly.
- Bring out the argument whether such a scheme is needed or not.
- Mention past and present schemes for the sector and their impact.
- Give relevant facts/examples to support your view point.

Answer:

With an initial corpus of Rs 20000 crores and a credit guarantee corpus of Rs 3000 crores Government recently launched MUDRA (Micro Units Development Refinance Agency) to infuse finance into MSME sector of the country. Formal sector generates about 29.6 million while 57.8 million small and micro enterprises provide 128 million jobs. Almost 2/3rd of them belong to the SCs, STs and OBCs. More than half of them operate from rural areas, where financial outreach of formal channels is limited and delivering economic growth difficult. A focused approach of finance availability through MUDRA has immense potential in development of MSME sector that will bring inclusive growth.

Student Notes:

Following are the objectives of the MUDRA:

- Almost 90% of MSMEs depend upon the informal sector for financing where money lenders charge very high interest. Even the MFIs lend at a rate of about 25% to these enterprises because banks lend them at around 14%. MUDRA will partner state and regional level coordinators to enable them to provide refinance to last mile financiers of micro businesses and cut borrowing costs for the cash-starved domestic small businesses.
- It will create a framework that regulates and provides refinancing capital flows to micro-finance institutions that are in turn in the business of lending to micro/small business entities engaged in manufacturing, trading and services activities.
- MFIs do not meet the funding requirements of small entrepreneurs who want more than Rs.50,000 and up to a few lakhs. Commercial banks, too, are reluctant to give them loans. This lacuna will be addressed by the MUDRA bank.
- It will help in bringing transparency, accountability and technology to the sector.
- NABARD and SIDBI also refinance MSMEs. However, MUDRA will have sole focus on the Micro and Small businesses.

However, the following issues should be addressed to make MUDRA a success:

- There already exist financing schemes like Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE), Portfolio Risk Fund (PRF) etc and many others apart from the technical and managerial support. Hence, it is not only lack of finance but also the multiplicity of schemes, poor implementation, problems like corruption and complex processes and lack of awareness which is impeding the growth of sector.
- A redrawing of the functions of NABARD and SIDBI, which have not performed up to the mark, in the light of creation of MUDRA should be done.
- Regulatory and credit functions of the MUDRA should be separated to avoid conflict of interest.
- Small banks also have immense potential for the sector and can be used to supplement MUDRA.
- Introduction of electronic transfer facility for the sector.

While the global trend is discourage shadow banking and use the main-line banking system to meet the financing needs of all segments we are creating one more refinancing agency. Hence, a thorough redress of these issues should be done to ensure credit flow to SMEs also called as 'missing middle' and prevent MUDRA from being another lost opportunity.

CENTRAL BANK AND MONETARY POLICY

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1. Central Bank

A central bank is the apex institution in the banking and financial structure of the country. It plays a leading role in organizing, running, supervising, regulating and developing the banking and financial structure of the economy. Its activities are very essential for the proper functioning of the economy. Almost all the countries in the world have a central bank. India's central bank is known as the Reserve Bank of India.

Reserve Bank of India
The Reserve Bank of India is the central bank of the country. It is the apex monetary and banking authority in India. The RBI was established on April 1, 1935 under the provisions of RBI Act, 1934 initially as a private shareholders' bank. It was nationalized on January 1, 1949 and given wide powers. The executive head of the RBI is called the Governor. Its headquarters is in Mumbai. **RBI has seven major functions** • Print Notes: RBI has the sole autonomy to print notes. GoI has the sole authority to mint coins and one rupee notes. • Banker to the Government: It manages government's deposit accounts. It also represents government as a member of the IMF and World Bank. • Custodian of Commercial Bank Deposits and Regulation and supervision of the banking and non-banking financial institutions, including credit information companies. • Custodian to Country's Foreign Currency Reserves and management of Current and Capital accounts. • Lender of Last Resort: Commercial banks come to RBI for their monetary needs in case of emergency. • Central Clearance and Accounts Settlement: As RBI keeps cash reserves from commercial banks therefore it rediscounts their bills of exchange easily. • Credit Control: It controls supply of money in the economy through its monetary policy.

1.1. Functions of a Central Bank

A central bank performs a number of important functions in every country. The major functions are as follows:

1. **Bank of Issue:** Central bank is the bank of issue. It enjoys the monopoly of note issue. In most of the countries the central bank is required to keep a certain amount of gold and foreign securities against the issue of notes.

   Concentration of exclusive power of note issue with the central bank has a number of advantages:

   - It brings uniformity in note issue as a result of which these notes are widely accepted as a medium of exchange.
   - It imparts the notes a distinctive prestige as a result of which people develop faith in the currency.
   - It enables the central bank to have an effective control on the bank money created by commercial banks.
   - It enables the government to have supervision and control over the supply of money in the economy.
2. **Banker, Fiscal Agent and Adviser to the Government:** Central banks in all countries act as banker, fiscal agent and adviser to the government. As the banker to the government, the central bank performs the same functions as are performed by commercial banks for their customers. The central bank receives the deposits of cash, cheques, drafts etc. from the

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government. It provides cash to the government for paying salaries and wages and other cash disbursements. It makes payments on behalf of the government. It gives short-period loans to the government. It buys and sells foreign currencies on behalf of the government.

As fiscal agent, it manages public debt. It issues new loans on behalf of the government, receives subscriptions to these loans, pays interest on them, and finally repays these loans. It also acts as the government's agent in enforcing foreign exchange control.

The central bank acts as the financial adviser to the government. It advises the government on all financial and monetary matters and in the formulation of economic policies, such as those for the control of inflation or deflation, devaluation or revaluation of the currency, use of deficit financing, foreign trade policy, budgetary policy etc.

3. **Banker to the Banks:** Central bank has the same relationship with the commercial banks as the latter has with the general public. As the bankers' bank, the central bank performs several functions. It acts as the custodian of cash reserves of commercial and other banks. Commercial banks are under statutory obligation to keep a part of their deposits as reserves with the central bank. The central bank provides credit, mainly short-term credit, to the commercial banks. It provides them guidance and direction and regulates their activities. Commercial banks are required to shape their policy in accordance with these directions and guidance of the central bank.

   The centralization of cash reserves has many advantages, like:

   - It is on the basis of these reserves that payment by one bank to another is done to facilitate the clearing of cheques.
   - It is a source of great strength to the banking system of the country.
   - Centralized cash reserve serves as the basis of a large and more elastic credit structure.
   - The central bank can control the credit creation by the commercial banks by changing these cash reserves.
   - Centralized cash reserve can be used effectively during the period of seasonal strains and in financial crisis or emergencies.

4. **Custodian of Nation's Foreign Exchange Reserves:** As the custodian of foreign exchange reserves, the central bank performs several functions:
   - All the foreign exchange transactions of a country are routed through the central bank. The central bank controls both the receipts and payments of foreign exchange.
   - It tries to maintain stability of the exchange rate. For this purpose, it buys or sells foreign currencies in the market to minimize fluctuations in the foreign exchange rates.
   - It enforces exchange control regulations prescribed by the government from time to time.

5. **Lender of Last Resort:** When commercial banks have exhausted their resources and are in need of funds they approach the central banks to tide over the financial crises. In its capacity as the lender of the last resort, the central bank provides, directly or indirectly, all reasonable financial assistance to commercial banks, discount houses, bill brokers and other financial institutions. The central bank assists such institutions in times of financial stresses through discounting of approved securities and collateral loans and advances.
6. **Clearing House for Transfer and Settlement of Mutual Claims of Commercial Banks:** Every day the customers of different banks issue cheques drawn on their banks. This creates the need of settling claims of the commercial banks on each other. Since the commercial banks keep their cash reserves with the central bank, it is easier and convenient to clear and settle claims on each other by making transfer entries in their accounts maintained with the central bank. For transfer and settlement of mutual claims of the banks, the central bank provides 'clearing house' facility in big cities and trade centres. It is a simple, convenient, time-saving and economical device for settling of commercial banks on each other.

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7. **Controller of Credit:** The most important function of the central bank is to control credit creation by the commercial banks. Since 'credit money' or 'bank money' is the dominant form of money presently, it is essential that the supply of credit must be regulated so as to ensure the smooth functioning of the economy. For this purpose, the central bank adopts quantitative and qualitative methods of credit control. Quantitative methods aim at controlling the cost and availability of credit, while the qualitative methods influence the use and direction of credit.

8. **Promotional and Developmental Functions:** In a developing country, the central bank not only performs the so called traditional functions, but in addition it performs various promotional and developmental functions, among which the more important ones are:
    - Central bank is entrusted with the responsibility of developing and promoting a strong banking system. For this purpose, it provides liberal and cheap rediscounting facilities to commercial banks and gives various types of concessions.
    - It assists in the development of financial institutions like 'developmental banks' to provide investable funds for the development of agriculture, industry and other sectors of the economy. It helps in the development of money and capital market in the country. It also pursues appropriate monetary policy to promote economic development.
    - Create awareness about financial products and services, good financial practices, going digital and consumer protection.

9. **Publication of Economic and Statistical Information:** The central bank collects periodical economic and statistical information relating to different aspects of the economy and publishes periodical reports. This provides valuable information regarding the functioning of the economy. This also enables the government to formulate appropriate economic policies to promote economic development.

2. Monetary Policy

2.1. Definition of Monetary Policy

Monetary Policy refers to the policy measures undertaken by the government or the central bank to influence the availability, determine the size and rate of growth of the money supply in the economy.

Alternatively, some economists define monetary policy as a process of managing a nation's money supply to achieve specific goals such as constraining the inflation, achieving higher growth rates, achieving full employment etc. Generally, all across the globe, monetary policy is announced by the central banking body of the country, for example the RBI announces it in India. The RBI has the duty to see that legitimate credit requirements are met and at the same credit is not used for unproductive and speculative purposes

2.2. Types of Monetary Policy

Broadly, monetary policy can be of two kinds **Expansionary Monetary Policy** and **Contractionary Monetary Policy**. Alternatively, they are also called as Cheap Money policy or Dear money policy respectively.

Expansionary monetary policy increases the supply of money in an economy by making credit supply easily available. Money produced through such a policy is called as cheap money.

An expansionary monetary policy is utilized when an economy goes through a phase of recession accompanied by lower levels of growth and high levels of unemployment. For example in 2008-09 the entire world including India adopted an expansionary monetary policy to counter slowdown/recession.

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But expansionary monetary policy comes with its own risks, such as inflation. Also, there is a time lag between the time when policy is announced and when it takes effect in the economy, thus at times the expansionary monetary policy may not have desired impact on the economy in terms of growth.

Contractionary monetary policy on the other hand, decreases the supply of money in the economy. Contractionary monetary is used to tackle the menace of inflation in the economy by raising the interest rates.

2.3. Objectives

Traditionally, there have been varying objectives of monetary policy in different countries in different times and in different economic conditions. The proper objective of the monetary policy is to be selected by the monetary authority keeping in view the specific conditions and requirements of the economy. For developing countries like India its objective may be the maintenance of monetary stability and helping in the process of economic development. In developed countries its objective may be to achieve full employment, without inflation.

Some of the objectives of monetary policy are listed as below:

a) **Economic growth:** The monetary policy can influence economic growth by controlling real interest rates and its resultant impact on the investment. If the RBI opts for a cheap credit policy by reducing interest rates, the investment level in the economy can be encouraged. This increased investment can speed up economic growth.
b) **Price Stability:** In current regime of Monetary Policy Committee, it is the primary objective of monetary policy in India. Price stability is defined as a low and stable order of inflation. Thus, the monetary policy having an objective of price stability tries to keep the value of money stable. For developed countries, such an inflation threshold is considered to be around 2 percent which could be higher for developing countries depending on their stage of economic development. A number of prominent central banks including the European Central Bank, Bank of England and Bank of Japan have adopted price stability as the single objective of monetary policy. When the economy suffers from recession the monetary policy should be an 'easy money policy' but when there is inflationary situation there should be a 'dear money policy'.
c) **Exchange Rate Stability:** If exchange rate of an economy is stable it shows that economic condition of the country is stable. Monetary policy aims at maintaining the relative stability in the exchange rate. The RBI by altering the foreign exchange reserves tries to influence the demand for foreign exchange and tries to maintain the exchange rate stability.
d) **Generating Employment:** Monetary policy can be used for generating employment. If the monetary policy is expansionary then credit supply can be encouraged. It would thus help in creating more jobs in different sector of the economy.
e) **Equal income distribution:** Earlier, many economists used to justify the role of the fiscal policy in maintaining economic equality. However, in recent years economists have given the opinion that the monetary policy can play a supplementary role in attainting economic equality. Monetary policy can make special provisions for sectors such as agriculture, small-scale industries, village industries, etc. and provide them with cheaper credit for longer term. This can prove fruitful for these sectors to come up. Additionally, the monetary authority can help in establishment and expansion of banks and institutions in rural and backward areas of the country. Thus in recent times, the role of monetary policy in reducing economic inequalities has been greatly enhanced.

In India, as defined by former RBI governor C. Rangarajan, broad objectives of monetary policy are:

a) To regulate monetary expansion so as to maintain a reasonable degree of price stability; and
b) To ensure adequate expansion in credit to assist economic growth.

Student Notes:

2.4. Tools to Regulate Monetary Policy

There are many tools by which a Central Bank regulates the monetary policy. They can be classified into two categories:

2.4.1. Quantitative Credit Control Methods

These methods are designed to control the overall volume of credit created in an economy. A number of them exist of date such as CRR, SLR, Bank Rate, Repo rate, Reverse Repo rate, interest changes for the instruments of the Money Market, etc.

Statutory Liquidity Ratio: The statutory liquidity ratio refers to that proportion of total deposits which the commercial banks are required to keep with themselves in a liquid form. The commercial banks generally make use of this money to purchase the government securities. Thus, the statutory liquidity ratio, on the one hand, is used to siphon off the excess liquidity of the banking system, and on the other, it is used to mobilize revenue for the government. The Reserve Bank of India is empowered to raise this ratio upto 40 per cent of aggregate deposits of commercial banks. ***At present it is 19.5 per cent (August 2018)***. It used to be as high as 38.5 percent at one point of time.

Cash Reserve Ratio: The cash reserve ratio (CRR) is the ratio (fixed by the RBI) of the total deposits of a bank in India, which is kept with the RBI in cash form. CRR deposits do not earn any interest for banks. Initially, limits of 3% (lower) and 20% (upper) were set for CRR, but respective amendments removed these limits, thereby providing RBI with much needed operational flexibility. If CRR is high, less money is available for lending by the banks to players in the economy. RBI increases CRR to tighten credit and lowers CRR to expand credit in the economy. CRR as a tool of monetary policy is used when there is a relatively serious need to manage credit and inflation. Otherwise, RBI relies on signaling its intent through the policy rates of repo and reverse repo. ***At present CRR is 4 percent (August 2018).***

Bank Rate: In basic terms, bank rate is the interest rate at which RBI provides **long term credit facility** to commercial banks. A change in bank rate affects other market rates of interest. An increase in bank rate leads to an increase in other rates of interest, and conversely, a decrease in bank rate results in a fall in other rates of interest. Bank rate is also referred to as the discount rate. A deliberate manipulation of the bank rate by the Reserve Bank to influence the flow of credit created by the commercial banks is known as **bank rate policy**.

An increase in bank rate results in an increase in the cost of credit or cost of borrowing. This in turn leads to a contraction in demand for credit. A contraction in demand for credit restricts the total availability of money in the economy, and hence results as an anti-inflationary measure of control.

Penal rates are linked with Bank Rates. For instance if a bank does not maintain the required levels of CRR and SLR, then RBI can impose penalty on such banks.

Nowadays, bank rate is not used a tool to control money supply, rather LAF (Repo Rate) is used to control the money supply in economy.

Repo Rate: Repo rate is the rate at which banks borrow funds from the RBI to meet the gap between the demands they are facing for money (loans) and how much they have on hand to lend. In simple words, Repo Rate is the interest rate charged by the Central Bank from other banks for **short-term borrowings.**

If the RBI wants to make it more expensive for the banks to borrow money, it increases the repo rate; similarly, if it wants to make it cheaper for banks to borrow money, it reduces the repo rate. ***As of August 2018 repo rate stood at 6.25%.***

Reverse Repo Rate: Reverse Repo is the rate at which the Central Bank (RBI) borrows from the market. This is called as reverse repo as it the reverse of repo operation.

Student Notes:

Repo and Reverse Repo Rates are also referred to as the **Policy rates** and are often used by the Central Bank (RBI) to send single to the financial system to adjust their lending and borrowing operations.

Repo rates and reverse repo rates form a part of the ***liquid adjustment facility*** **(LAF).**

Open Market Operations (OMOs): It refers to buying and selling of government securities in open market in order to expand or contract the amount of money in the banking system. Purchases inject money into the banking system while sale of securities do the opposite. It is a common misconception that OMOs change the total stock of government securities, but in reality they only change the proportion of Government Securities held by the RBI, commercial and co-operative banks. The Reserve Bank of India has frequently resorted to the sale of government securities to which the commercial banks have been generously contributing. Thus, open market operations in India have served, on the one hand as an instrument to make available more budgetary resources and on the other as an instrument to siphon off the excess liquidity in the system.

2.4.2. Qualitative Credit Control Methods

These are those tools through which the central bank not only controls the value of loans but also the purpose for which these loans are assigned by the commercial banks. Some of these are:

1. **Moral Suasion:** Moral suasion means persuasion and request. To arrest inflationary situation central bank persuades and requests the commercial banks to refrain from giving loans for speculative and non-essential purposes. On the other hand, to counter deflation central bank persuades the commercial banks to extend credit for different purposes. Under Moral Suasion, RBI issues periodical letters to bank to exercise control over credit in general or advances against particular commodities. Periodic discussions are held with authorities of commercial banks in this respect. In India, from 1949 onwards the Reserve Bank has been successful in using the method of moral suasion to bring the commercial banks to fall in line with its policies regarding credit.
2. **Rationing of credit**: Rationing of credit is a method by which the Reserve Bank seeks to limit the maximum amount of loans and advances, and also in certain cases, fix ceiling for specific categories of loans and advances. RBI also makes credit flow to certain priority or weaker sectors by charging concessional rates of interest. This is at times also referred to as Priority Sector Lending.
3. **Regulation of Consumer Credit**: Now-a-days, most of the consumer durables like Cars, Televisions, and Laptops etc. are available on installment basis financed through bank credit. Such credit made available by commercial banks for the purchase of consumer durables is known as consumer credit.

   If there is excess demand for certain consumer durables leading to their high prices, central bank can reduce consumer credit by (a) increasing down payment, and (b) reducing the number of installments of repayment of such credit.

   On the other hand, if there is deficient demand for certain specific commodities causing deflationary situation, central bank can increase consumer credit by (a) reducing down payment and (b) increasing the number of installments of repayment of such credit.

4. **Direct action:** This method is adopted when a commercial bank does not co-operate with the central bank in achieving its desirable objectives. Direct action may be any many forms:

   Central banks may charge a penal rate of interest over and above the bank rate upon the defaulting banks; Central bank may refuse to rediscount the bills of those banks which are not following its directives; Central bank may refuse to grant further accommodation to those banks whose borrowings are in excess of their capital and reserves.

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5. **Margin Requirements:** Generally, commercial banks give loan against 'stocks or 'securities'. While giving loans against stocks or securities they keep margin. Margin is the difference between the market value of a security and its maximum loan value. Let us assume, a commercial bank grants a loan of Rs. 8000 against a security worth Rs. 10,000. Here, margin is Rs. 2000 or 20%.

If central bank feels that prices of some goods are rising due to the speculative activities of businessmen and traders of such goods, it wants to discourage the flow of credit to such speculative activities. Therefore, it increases the margin requirement in case of borrowing for speculative business and thereby discourages borrowing. This leads to reduction in money supply for undertaking speculative activities and thus inflationary situation is arrested.

On other contrary, central bank can encourage borrowing from the commercial banks by reducing the margin requirement. When there is a greater flow of credit to different business activities, investment is increased. Income of the people rises. Demand for goods expands and deflationary situation is controlled.

Thus, margin requirement is a significant tool in the hands of central bank to counter-act inflation and deflation.

2.5. Limitations of Monetary Policy

a) **Limited Role in Controlling Prices:** As per the critics, the monetary policy of Reserve bank has played only a limited role in controlling the inflationary pressure. It has not succeeded in achieving the objective of growth with stability. The role of monetary policy in combating inflation is strictly limited and monetary policy can be effective only if it is a part of an overall framework of policy, which includes not only fiscal and foreign exchange policy but also structural changes in the economy. For example, a bad monsoon in India may lead to inflation of food products. Monetary policy will not be very effective in controlling food prices in such a situation rather a mix of structural reforms (maintaining buffer stocks, reducing wastage etc) and fiscal policy (ex. Import of food grains) is desirable.
b) **Existence of Black money:** The existence of black money in the economy limits the working of the monetary policy. Black money is not recorded since the borrowers and lenders keep their transactions secret. Consequently, the supply and demand of money also not remains as desired by the monetary policy.
c) **Large non-monetized sector:** There is a large non-monetized sector which hinders the success of monetary policy in such countries. People mostly live in rural areas where barter is practiced. Consequently, monetary policy fails to influence this large segment of the economy.
d) **Large number of Non- Banking Financial Intermediaries:** Non-bank financial intermediaries like the indigenous bankers operate on a large scale in countries like India but they are not under the control of the monetary authority. The factor limits the effectiveness of monetary policy in such countries
e) **Conflicting Objectives:** An important limitation of monetary policy arises from its conflicting objectives. To achieve the objective of economic development the monetary policy is to be expansionary but contrary to it to achieve the objective of price stability a curb on inflation can be realised by contracting the money supply. The monetary policy generally fails to achieve a proper coordination between these two objectives.
f) **Underdeveloped Money Market:** Another limitation of monetary policy in India is underdeveloped money market. The weak money market limits the coverage, as also the efficient working of the monetary policy.
g) **Influence of non-monetary factors:** An important limitation of monetary policy is its ignorance of non-monetary factors. The monetary policy can never be the primary factor in controlling inflation originating in real factors, deficit financing and foreign exchange resources. The Reserve Bank has no control over deficit financing. It cannot regulate the deficit financing, which affects money supply considerably.

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h) **Ineffective implementation of Monetary Policy:** Successful application of monetary policy is not merely a question of availability of instruments of credit control. It is also a question of judgment with regard to timing and the degree of restraint employed or relaxation allowed. However, past experience shows that Reserve Bank's credit restrictions have always fallen short of the required extent of restraint. The Bank has adopted a hesitant attitude in the field of monetary control. In short, the monetary policy of the Reserve Bank suffers from many limitations. It requires improvements in many directions.

2.6. Revision of Monetary Policy in India

Historically, in India the monetary policy was announced twice a year, namely a slack season policy (April to September) and a busy season policy (October to March). But, in the wake of pressures of globalization and growing importance of monetary policy, RBI has become more proactive in altering the monetary policy from time to time depending upon the state of economy. Also, the RBI has moved in for a single monetary policy every year in April end although the review of monetary policy takes place every quarter.

Presently, Monetary Policy in India is managed by **Monetary Policy Committee**, thus the Governor of RBI is no longer the sole authority to decide on the Monetary Policy.

2.7. Monetary Policy Committee (MPC)

MPC was set up consequent to the agreement reached between Government and RBI to task RBI with the responsibility for price stability and inflation targeting. The Reserve Bank of India and Government of India signed the Monetary Policy Framework Agreement on 20 February 2015.

The MPC replaced the erstwhile system where the RBI governor, with the aid and advice of his internal team and a technical advisory committee, has complete control over monetary policy decisions.

Pursuant to this, it was written into the preamble of the RBI Act that the **primary objective of the monetary policy is to maintain price stability, while keeping in mind the objective of growth, and to meet the challenge of an increasingly complex economy, RBI would operate a Monetary Policy Framework.**

Recommendations to constitute MPC:

Many committees have suggested setting up of MPC. For example, in 2002 the Y. V. Reddy Committee recommended for a MPC to decide policy actions. Subsequently, suggestions were made to set up a MPC in 2006 by the Tarapore Committee, in 2007 by the Percy Mistry Committee, in 2009 by the Raghuram Rajan Committee and then in 2013, both in the report of the Financial Sector Legislative Reforms Commission (FSLRC) and the Dr. Urjit R. Patel (URP) Committee.

Advantages of Targeting Inflation

- **Lowers the interest rates**- lower interest rate increases borrowings, boosts investment and thereby activity in the economy.
- **Helps in long term planning** for public and private entities and in policy formulation
- **Redistributes income and wealth** between different groups in society. High inflation benefits some groups at the expense of others.
- **Provides a climate of certainty** and thus boosts lender confidence. High inflation implicitly penalizes the lender.

Composition of MPC

- MPC consists of six members - the RBI Governor (Chairperson), the RBI Deputy Governor in charge of monetary policy, one official nominated by the RBI Board and the remaining three members nominated by the Government of India.
- The Government nominees are appointed based on the recommendations of a search cum selection committee consisting of the cabinet secretary (Chairperson), the RBI Governor, the secretary of the Department of Economic Affairs,

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Ministry of Finance, and three experts in the field of economics or banking as nominated by the central government. The nominee will hold office for a period of four years and will not be eligible for re-appointment.
- The RBI act lays down the required qualification and eligibility for Members of MPC.

Functions of MPC

- RBI will be responsible for containing inflation targets at 4% (with a standard deviation of 2%) in the medium term.
- Central Government determines the inflation target in terms of the Consumer Price Index, once in every five years in consultation with the RBI.
- RBI would have to give an explanation in the form of a report to the Central Government, if it failed to reach the specified inflation targets. The report will give reasons for failure, remedial actions as well as estimated time within which the inflation target shall be achieved.
- RBI is mandated to publish a Monetary Policy Report every six months, explaining the sources of inflation and the forecasts of inflation for the coming period of six to eighteen months.
- RBI has to organize at least four meetings of the MPC in a year.
- The MPC takes decisions based on majority vote (by those who are present and voting). In case of a tie, the RBI governor will have the *second* or casting vote. The decision of the Committee would be binding on the RBI.

2.8. Latest Developments

Urjit Patel Committee

In January 2014, RBI appointed an expert committee headed by Urjit Patel, the current Governor of RBI to examine the existing monetary policy framework. The committee made several far reaching recommendations, some of which have been discussed below.

- The most important recommendation of the committee was that the RBI should focus on controlling inflation in the economy or in other words inflation should be the nominal anchor to frame monetary policy.
- The nominal anchor or the target for inflation should be set at 4 per cent with a band of +/- 2 per cent around it.
- The nominal anchor should be defined in terms of headline CPI inflation, which closely reflects the cost of living and influences inflation expectations relative to other available metrics. Historically, Indian policymakers have relied on the wholesale price index
- It recommended a 12-month target of 8 per cent and 24-month target of 6 per cent, before the inflation target is formally adopted.
- The committee asked the Central Government to ensure that the fiscal deficit as a ratio to GDP (gross domestic product) is brought down to 3.0 per cent by 2016-17.
- The Patel panel felt that the monetary policy decision-making should be vested with a **monetary policy committee** (MPC).
- It went on to recommend that the Governor of the RBI should be the Chairman of the MPC. It felt that the Deputy Governor in-charge of monetary policy could be the Vice-Chairman. The Executive Director in charge of monetary policy could be its member. It could have two external members.
- The term of office of the MPC could be three years, without prospect of renewal.
- Minutes of the proceedings of the MPC to be released with a lag of two weeks from the date of the meeting.
- Currently, the RBI governor is the sole decision maker on monetary policy, though he is advised by his four deputy governors and a technical advisory committee.

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Concerns regarding Urjit Patel Committee Recommendations

- In a developing country, the Central Bank cannot escape from the difficult challenge of weighing the growth-inflation trade off in determining its monetary policy stance.
- Experts feel that it is premature to use the Consumer Price Index (CPI) as anchor since the data had imperfections.
- Monetary policy is not the only variable affecting inflation especially in India where inflationary pressures emerge from supply side constraints. According to former RBI Governor D Subbarao, 50 per cent of inflation is beyond the control of monetary policy.
- A necessary condition for inflation targeting to work is efficient monetary transmission. In India there are several factors inhibiting the monetary transmission process such as an asymmetric relationship between depositors and banks, administered interest rates on postal savings that are not adjusted in line with prevailing interest rate trends and rigidities in the financial markets.
- Recommendations do not talk about exogenous shocks which may spike inflation(e.g. Oil price hike)
- Monetary policy is ill-equipped to accurately forecast future inflation trends

However some experts also believe that the panel recommendation for adopting monetary policy, which is centered on inflation, will be a shift from traditional policymaking, and will also bring RBI policy calibration closer to the international practices.

2.9. Miscellaneous

2.9.1. Monetary Policy vs. Fiscal Policy, Monetary-Fiscal Policy Mix

In recent times, monetary policy has been gaining a lot of importance in management of economies. There has therefore been a constant debate on whether fiscal policy or monetary policy is more effective in making the desired impact on an economy. Some of the propositions have been discussed below:

Political compulsions and objectives: The experience of the 1960s, 1970s, and 1980s suggests that democratically elected governments have more trouble using fiscal policy to fight inflation. Fighting inflation requires government to take unpopular actions like reducing spending or raising taxes. Political realities, in short, may favor a bigger role for monetary policy during times of inflation.

On the other hand, fiscal policy is more suited to combat unemployment in the economy as the government can increase spending to create public infrastructure and process jobs.

Problem of Liquidity Trap: The monetary policy remedy to economic decline is to increase the amount of money in circulation, thereby cutting interest rates. But once interest rates reach zero, the Central Bank can do no more. Such a situation is referred to by the economists as the **"liquidity trap".** The problems experienced by the Japanese in the 1990's in trying to stimulate their economy through a zero-interest rate policy might be mentioned here.

With its economy stagnant and interest rates zero, many economists contended that the Japanese Government had to resort to more aggressive fiscal policy. In such a case monetary policy proved to be of no value at all.

But some economists disagree on this too. They argue that short term changes in monetary policy do impact quite quickly and strongly on consumer and business behavior. For example, the domestic demand in both the United States and the UK responded positively to the interest rate cuts introduced in the wake of the terror attacks on the USA in 2001.

Difference in Lags of Monetary and Fiscal Policies

Monetary and fiscal policies differ in the speed with which each takes effect as the time lags are variable in each case. Monetary policy is extremely flexible and emergency rate changes

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can be made in quick time, whereas changes in taxation take longer to organize and implement.

Because capital investment requires planning for the future, it may take some time before decreases in interest rates are translated into increased investment spending. Typically it takes six months – twelve months or more before the effects of changes in monetary policy are felt.

The impact of increased government spending is felt as soon as the spending takes place and cuts in direct and indirect taxation feed through into the economy pretty quickly. However, considerable time may pass between the decision to adopt a government spending programme and its implementation.

Therefore, even on this front it is very difficult to choose between the one of two.

As stated by many experts, the need of today is not just the pumping of liquidity in to the Indian economy (i.e. use of monetary policy) but also additional injection of demand. This can occur only through direct fiscal action by government. In India, larger government expenditure has to be oriented towards agriculture, rural development, health, human resources and infrastructure to make inclusive and balanced growth.

In conclusion, the goal of the monetary policy and fiscal policy are the same, which is to promote stable and growing economic conditions in an economy, but the instruments used to carry these out and the bodies that carry these out are different. They should be in sync to work well and such that actions of one don't affect the actions of another and they succeed in their goals of maintaining a reasonable level of inflation and steady economic growth.

2.9.2. Inflation vs. Growth Tradeoff in Monetary Policy

RBI has increased its repo rate several times (since January 2011) to combat inflationary trends in the economy. But such attempts of RBI have been unsuccessful. Critics have questioned this policy/method of increasing interest rates to combat inflation.

Views against increasing interest rates

Critics feel that overemphasis on combating inflation sometimes comes at the cost of economic growth. They also argue that increasing interest rates without any thought in the monetary policy does not help. High interest rates have been identified, by many, as a major barrier to boosting growth. Many times entrepreneurs hold on to their investment plans pending any relaxation in monetary policy by the RBI. Industry representatives on the other hand feel that industrial growth is severely impacted by high cost of funds and other structural rigidities in the economic system like poor infrastructure and high transaction costs

Rationale given by RBI for hiking interest rates

- Tighter policy action aimed at puncturing the inflation balloon will help revive growth, although industry has been pushing for the opposite.
- There is enough liquidity in the system, so there will be no immediate increase in deposit and lending rates.
- Banks have seen huge inflows in the form of FCNR deposits and they are looking at opportunities at deploying those funds.
- There was also a warning that If RBI wants to knock out core inflation, the policy rate would have to be hiked further.
- It is noted that bringing down inflation to a low and stable level that monetary policy can contribute to reviving consumption and investment in a sustainable way.

Can monetary policy alone control inflation in the economy?

Inflation is a much debated subject in India in recent times and is the apparent cancer of Indian Economic Growth. RBI's Monetary Policy is seen as a panacea, by the State and the laymen, for

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arresting this cancer's mushrooming growth in the financial sector. But, this is a wrong approach as RBI also has its limitations. The State cannot delegate the duty of maintaining the financial health of the country in the tied-down hands of RBI. RBI has its hands tied-down because monetary policy plays a limited role. In contrast, Fiscal Policy plays a huge role in this financial equation. The absence of harmony between the objectives and aims of the monetary and financial policies also seems apparent.

Supply Side Inflation: There is a need therefore for looking more into the supply-side responses. Monetary and Fiscal Policies should not only concentrate on demand push inflation, but also on cost push inflation. In Indian realm, unfortunately, Inflation is misunderstood as just as Demand push inflation only.

Structural Reforms: There is need for structural reforms to take place on the fiscal front. The food inflation occurs especially due the systemic flaws (for e.g. large dependency of Indian Agriculture on Monsoon, lack of agricultural infrastructure etc.). There is need for work at this end.

Import Inflation: There is a need for dealing with the issues of Import Inflation. The dependence on imported goods for which highly valued foreign currency has to be paid also has been underplayed time and again.

Inflation Indexing: Need for a core inflation sector index to be adopted by the RBI, as one of the parameter, for deciding its monetary policy which excludes those sectors over which RBI's policies don't have much control. E.g. In USA, a core inflation index excludes food and oil from the basket because prices of these commodities do not respond to Federal Reserve policy. The excluded items differ from country to country depending on their volatility. This will make RBI's aims more realistic.

From above discussions one can infer that a simplistic inflation-targeting approach i.e. Fighting inflation first through stabilization and worrying about growth later is an IMF approach that has not worked well elsewhere in the world and will not work in India. We need a more comprehensive approach that will revive growth and lower inflation simultaneously. The interactions between monetary, fiscal and supply-side policies will need to be taken into consideration to get out of our current stagflationary predicament.

2.9.3. Some Recent Terms

Quantitative Easing: This term is used to describe a situation or a form of monetary policy used to simulate an economy when the interest rates are very low or zero. It is an occasionally used monetary policy, which is adopted by the government to increase money supply in the economy in order to further increase lending by commercial banks and spending by consumers. The central bank infuses a pre-determined quantity of money into the economy by buying financial assets from commercial banks and private entities. This leads to an increase in banks' reserves.

Usually, central banks try to raise the amount of lending and activity in the economy indirectly, by cutting interest rates. Lower interest rates encourage people to spend, not save. But when interest rates can go no lower, a central bank's only option is to pump money into the economy directly. That is quantitative easing (QE).

Quantitative easing comes with its own **risks** such as **Inflation and depreciation of currency** (Note: Quantitative easing is considered when short-term interest rates are at or approaching zero, and does not involve the printing of new banknotes).

Inflation occurs because with more money in economy, the cost of goods tends to rise. Depreciation can occur because with more currency in supply, one can buy less foreign bonds thus reducing the value of domestic currency.

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It was first tried by the central bank of Japan to get it out of a period of deflation following its asset bubble collapse in the 1990s. The US government has done this three times so far. QE1 (November 2008 to March of 2010), QE2 (November to June 2011) and QE3 (September 2012 - October 2014). The US QE programme eventually saw a reduction (tapering) during QE3 and purchases of bonds were halted in October 2014. Federal Reserve Chairwoman Janet Yellen in 2017 has remarked that QE was a very unusual intervention which will not be frequently relied on in future as it causes fluctuations in the balance sheet of the central bank. Former RBI governor Raghuram Rajan has also questioned the use QE by developed countries to spur growth at home due to its implications on developing economies.

Marginal Standing Facility: Marginal Standing Facility (MSF) rate refers to the rate at which the scheduled banks can **borrow funds overnight** from RBI against government securities. MSF is a **very short term borrowing scheme** for scheduled commercial banks. Banks may borrow funds through MSF during severe cash shortage or acute shortage of liquidity.

Banks often face liquidity shortfalls due to mismatch in their deposit and loan portfolios. These are usually very short term and banks can borrow from RBI for one-day period by offering dated government securities.

The MSF is the last resort for banks once they exhaust all borrowing options including the liquidity adjustment facility by pledging through government securities, which has lower rate (i.e. repo rate) of interest in comparison with the MSF. The MSF would be a penal rate for banks and the banks can borrow funds by pledging government securities within the limits of the statutory liquidity ratio. The scheme has been introduced by RBI with the main aim of reducing volatility in the overnight lending rates in the inter-bank market and to enable smooth monetary transmission in the financial system. MSF rate automatically adjusts to 1 per cent above the repo rate.

Base Rate: Base Rate is the interest rate below which Scheduled Commercial Banks (SCBs) cannot lend to their customers. This rate was introduced in 2010 based on the recommendation of Deepak Mohanty Committee.

It was brought in to ensure that corporate houses are not lent money at low rates and Small and Medium business are not discriminated against with higher loan rates. In past banks used to compensate for lower rates for corporates by charging exorbitantly higher rates from Small and Medium Businesses (SMBs).

One another benefit of Base Rate is that it helps in monetary transmission, i.e. rate reductions undertaken by RBI passes through to all the sections of the society. In absence of such a regime corporate houses get the reduction and SMBs continue to pay higher rates.

This system has replaced the much abused **Benchmark Prime Lending Rate (BPLR)**. The BPLR system, introduced in 2003, fell short of its original objective of bringing transparency to lending rates.

Base rate is determined on the basis of a bank's costs of funds which include costs of deposits, profit margins, operating expenses, administrative expenses and statutory expenses.

Now, all categories of loans are priced with reference to the Base Rate only, except:

a) Differential rate of Interest (DRI) loans
b) Loans to banks' own employees, and
c) Loans to banks' depositors against their own deposits.

Since the Base Rate will be the minimum rate for all loans banks are not permitted to resort to any lending below this rate- accordingly, the provision of lending below the BPLR to a customer by banks if the loan amount is not less than Rs. 2 lakh has been withdrawn.

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2.9.4. Marginal Cost of Funds Based Lending Rate (MCLR)

The marginal cost of funds based lending rate (MCLR) refers to the minimum interest rate of a bank below which it cannot lend, except in some cases allowed by the RBI. It is an internal benchmark or reference rate for the bank. MCLR actually describes the method by which the minimum interest rate for loans is determined by a bank - on the basis of marginal cost or the additional or incremental cost of arranging one more rupee to the prospective borrower. The MCLR is a tenor linked benchmark (tenor means the amount of time left for the repayment of a loan).

The MCLR methodology for fixing interest rates for advances was introduced by the Reserve Bank of India with effect from April 1, 2016. This new methodology replaces the base rate system introduced in July 2010.

Reasons for introducing MCLR

- rates based on marginal cost of funds are more sensitive to changes in the policy rates
- Prior to MCLR system, different banks were following different methodology for calculation of base rate /minimum rate – that is either on the basis of average cost of funds or marginal cost of funds or blended cost of funds.

MCLR aims to:

- Improve the transmission of policy rates into the lending rates of banks.
- Bring transparency in the methodology followed by banks for determining interest rates on advances.
- Ensure availability of bank credit at interest rates which are fair to borrowers as well as banks.
- Enable banks to become more competitive and enhance their long run value and contribution to economic growth.

3. Previous Years UPSC GS Mains Questions

1. What is Bank Rate? What is the Bank Rate in India at present?
2. What are the main components of money supply in India?
3. What is Cash Reserve Ratio?
4. What does "Priority sector lending" mean?
5. What is cheap Money?
6. What is Repo market?

4. Vision IAS GS Mains Test Series Questions

1. ***In the context of Indian Economy, it is said that there are three macro-economic challenges -- managing growth inflation, mitigating vulnerability of the external factors and managing the political economy of fiscal consolidation. Discuss.***

Approach:

This question has following key terms: 'growth–inflation conundrum', external factors mainly foreign capital inflow and fiscal consolidation mainly about fiscal deficit.

Answer:

- India's average growth during pre-crisis period was 8.7 per cent and it started fraying beginning with the global financial crisis. In the current macro-economic situation, the growth had significantly influenced by inflation. The balance of payments is under stress and investments have decelerated.
- First challenge before Indian economy is managing the 'growth–inflation conundrum'. Inflation is driven by food inflation (both cyclical and structural), global

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commodity and fuel prices, and depreciation of currency and demand pressures. commodity prices, and depreciation and demand pressures. The growth-inflation dynamics of pre-crisis growth is quite different from post-crisis as the issue of inflation has become more rigorous and harsh, particularly to the lower strata of the bottom of pyramid.

- Hight growth needs easy money supply in the market, which results in more production and hence more employment which implies more demand. However the growth is limited by the resource availability. So if there is too much easy money in the market, it will lead to high inflation. This is what Indian economy faced after the fiscal stimulus given in wake of global financial crisis of 2008-09. Since then RBI has tried to put control on higher inflation by increasing the interest rates, which resulted in less money supply in the market and hence lower growth. While inflation pressure has still not come down to a comfortable level. So this is one of the main challenge where RBI needs to take a calibrated approach to maintain a balance between growth momentum and inflationary pressure.
- Second challenge before Indian economy is that it is no longer decoupled from external shocks. It is intricately linked to the world economy, international capital flows and to energy and fuel prices. Impact of European economic crisis, slow down of USA economy is noticeable on Indian economy. The slowing down of demand of exports in foreign markets, less capital inflow in form of FDI/FII etc have started showing their effect in form of increasing current account deficit. This also resulted in devaluation of Indian rupee, creating further problems in managing the foreign-exchage reserves.
- Thirdly, the policy measures taken by the govt. for fiscal consolidation have defaulted. Over the past 15 years, India's fiscal deficits have exceeded 5 percent in every year except in 2007. The deficit again widened during the global financial crisis due to fiscal stimulus and some political announcements like loan waivers etc. Also the fuel subsidies are putting extra pressure on government's exchequer. Govt has made structural changes in economic policy by incorporating acts such as FRBM for fiscal consolidation and is trying to bring reforms in taxation like GST bill and DTC bill. However, achieving long-run fiscal consolidation still remains a challenging task to the policy makers.
- The govt. needs to find a holistic solution to these problems avoiding compartmentalized approach by individual ministries and centralized planning. There is a need of second round of economic reforms afresh.

2. *What do you understand by Monetary Policy Trilemma? How can it be resolved in Indian context?*

Approach:

- Explain the trilemma – describe all the three dimensions of it.
- Explain why it's difficult to able to meet all the three dimensions.
- Finally give your recommendations as to what we should do.

Answer:

- Monetary Policy Trilemma also known as 'impossible trilemma' refers to the incompatibility of retaining monetary policy sovereignty in the face of a convertible capital account and flexible exchange rate. In other words we cannot have all of the three together –
  - A fixed exchange rate
  - Free capital movement (absence of capital controls)
  - An independent monetary policy

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- An economy open to free movement of capital can keep a fixed exchange rate, for example, only by subjugating monetary-policy independence —by raising interest rates sharply, say, when capital outflows put downward pressure on the currency. Yet the trilemma also implies that an economy can enjoy both free capital flows and an independent monetary policy, so long as it gives up worrying about its exchange rate.
- Therefore instead of sweating over keeping the exchange rate under check, India must work towards the underlying reasons
    - India is a country which has a perennially high CAD problem which make its currency vulnerable to external pressures, which get accentuated at times when something like tapering is announced
    - Hence the way forward is to-
        - increase our exports by diversification of products and markets,
        - curb the unproductive imports by rationalization of petroleum subsidies, and
        - also make India more attractive a destination for long term capital in form of FDI instead of hot money (Portfolio investment) by improving upon the 'Ease of Doing Business Index' parameters, better regulatory mechanisms etc.
- A positive CAD or a negative CAD that can be financed by FDI inflows will shield Indian rupee as well as independence of our monetary policy from external shocks.

3. *Monetary policy transmission in India has largely remained ineffective. What are the reasons behind this? Explain what marginal cost-based lending rate (MCLR) is and how it can affect monetary policy transmission in India.*

Approach:

- List out the major reasons behind poor monetary policy transmission.
- Define the marginal cost-based lending rate and how it affects monetary policy transmission.

Answer:

Generally, the effect of a policy rate change would be passed on to a large share of the population. But in India, when the RBI changes the policy rate, the impact is felt by only a small fraction of the population and it has not led to any major changes in interest rates charged by the banks.

The changes in policy rate would affect the entire economy through **banking system, bond market and exchange rate system**. But in India, none of these channels are working effectively in monetary policy transmission.

- First**, Indian economy is dominated by public sector banks** and the private banks and foreign banks face lot of entry barriers. Therefore, the small number of banks thwarts competition among the existing banking system, which does not feel the necessity to pass on the policy rate changes to the final consumers.
- Second, in India **we do not have fully developed bond market**, as it is in advanced economies. In the absence of large and liquid bond market, the burden of monetary policy transmission falls on the banking system.
- Third, in an open economy with flexible exchange rate and monetary independence, the policy rate changes have impact on capital flows and exchange rate. But in India, the **capital market is burdened with several restrictions;** therefore the change in policy rate does not necessarily result in concomitant changes in capital flows.

Student Notes:

- **High CRR and SLR**-Cutting down on statutory liquidity ratio (SLR) currently pegged at 21.5% will theoretically allow banks to use more money to give loans to borrowers instead of investing in government bonds. Similarly, banks' cash reserve ratio (CRR), or the deposits that commercial banks are required to keep with RBI (on which they do not earn any interest), can also be cut.

The **marginal cost-based lending rate (MCLR)** refers to an internal benchmark rate for the bank below which bank cannot lend, except in some cases allowed by the RBI. It describes the method by which the minimum interest rate for loans is determined by a bank - on the basis of marginal cost or the additional cost. This new methodology replaces the base rate system. **Under the base rate system, the repo rate is not included to determine the base interest rate; however, under the marginal cost-based lending rate system, it is mandatory for banks to consider the repo rate while calculating the marginal cost-based lending rate.** This improves the transmission of policy rates into the lending rates of banks.

Other benefits of MCLR include:

- Brings transparency in the methodology followed by banks for determining interest rates on advances.
- Ensures availability of bank credit at interest rates which are fair to borrowers as well as banks.
- Enable banks to become more competitive and enhance their long run value and contribution to economic growth.

However, certain loans like fixed rate loans of tenor above three years, special loan schemes formulated by Government of India, Advances to banks' depositors against their own deposits, Advances to banks' own employees etc. are not linked to MCLR.

4. Examine the causes of rupee depreciation and its impact on the Indian economy. Also discuss the steps taken by the Government and RBI to stem its slide.

Approach:

- Write the major causes of rupee depreciation
- Then, list out the impacts on different areas due to the depreciation
- Finally, discuss the steps by govt. and RBI

Answer:

[Student Note: The answer has been kept long to discuss all points of the issue in detail at one place. Write down a summary within word limit for your answer]

Causes of Rupee Depreciation:

- **Appreciation in the US dollar:** Since the United States Federal Reserve hinted at exiting from Quantitative Easing (QE) in May 2013, the currencies of several emerging markets have been affected. Since then, the Indian Rupee has depreciated 22% against the US dollar. The easy money ensured that US funds moved to emerging markets like India in search of high yields. So, as the Fed tapers off its bond-purchasing program, and with US interest rates rising, the belief is that fund inflows to countries like India will also slow down.
- **Large Current Account deficit:** Depreciation is also a highly visible symptom of a much deeper economic malaise represented by the burgeoning current account deficit (CAD), which, at over $90 billion, threatens macroeconomic stability.
- **Weakening capital inflows:** Capital inflows have reduced due to the improving economic situation in the US and other developed countries. The prospect of the

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Federal Reserve's ultra-soft monetary policy ending has already raised bond yields there. As in other countries, the Indian bond market has also seen withdrawals by foreign institutional investors (FIIs) in the past few weeks. With a risk-off environment setting in globally, there have been redemptions from global exchange-traded funds (ETFs). This has led to selling by FIIs in the Indian equity market, compounding the rupee's woes.

- **Inflation:** Part of the depreciation is attributable to the adjustment of the rupee exchange rate to the inflation differential, i.e. India's relatively high rate of inflation versus other economies.

Impact of rupee depreciation:

- **RBI's monetary policy:** If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower's woes, which are eagerly waiting to get rid of the high loan regime.
- **Fuel price:** A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will be passed on to the consumers. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation, which will stoke up inflation.
- **Country's fiscal health:** A frail rupee will add fuel to the rising import bill of the country and thereby increasing its current account deficit (CAD). A widening CAD is bound to pose a threat to the growth of overall economy.
- **Importers/Exporters:** Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters, as goods exported abroad will fetch dollars, which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets, which will be fruitful for India's exports.

Steps taken up by RBI and Government:

The RBI and the government have taken the following steps to stabilize the currency markets, reduce the current account deficit and enhance capital inflows:

- **Capital Outflow:** The RBI reduced the limit for outbound investment and remittances from India.
- **Encouraging Capital Inflows:** RBI has removed administrative restrictions on investment schemes offered by banks to non-resident Indians, and removed ceiling on interest rates on deposit accounts held by NRIs. The government has liberalized the FDI limits for 12 sectors, including oil and gas. A Bill is pending in the Parliament to revise the FDI limit to 49% in the insurance sector. RBI increased the current overseas borrowing limit for banks from 50% to 100%, and allowed it to be converted into rupees and hedged with the RBI at concessional rate. RBI also allowed banks to swap fresh NRI dollar deposits with a minimum duration of 3 years with the RBI. Specific public sector undertakings are being permitted to issue quasi-sovereign bonds to mop up funds for the infrastructure sector. The norms for external commercial borrowings (ECBs) are also being eased to enable the oil PSUs to garner dollars for financing their import requirements.

In short, the strategy is to stimulate dollar inflows by further liberalizing external commercial borrowings (ECBs), freeing interest rates on non-resident Indian deposits, liberalizing FDI norms and directing a few public sector finance companies to mop up dollars by issuing quasi-sovereign bonds.

Student Notes:

- **Limiting Imports and encouraging exports:** The Finance Ministry increased the customs duty on importing precious metals including gold and platinum. The strategy seeks to address supply-side issues, curbing the import of gold, silver and a few “non-essential” items. 20% of every lot of import of gold must be exclusively made available for the purpose of export.
- **Oil Import Needs:** RBI decided to provide dollar liquidity to three public sector oil-marketing companies (IOC, HPCL and BPCL) to help them meet their entire daily dollar requirements. RBI will provide dollars to oil importers through a special forex-swap window wherein oil companies will buy dollars from the central bank and, simultaneously agree to sell dollars back to RBI at a future date. Government is also considering increasing its import of crude oil from Iran, and pay for it directly in Indian rupees.
- **Trade Deficit:** Ministry of Commerce has set up a Task Force to consider currency swap arrangements for trade and explore the possibility of bypassing payment in dollars for trade and paying instead in rupees or the trading country’s currency. RBI allowed exporters and importers more flexibility in management of their forward currency contracts.
- **Curbing Speculative in currency:** RBI increased the short-term emergency borrowing rates for banks. It lifted the Marginal Standing Facility (MSF) and the Bank Rate by 200 basis points. The daily holding requirements under the Cash Reserve Ratio for banks have been modified.

5. RBI has recently classified some banks as 'Domestic Systemically Important Banks' (D-SIBs). What is the rationale behind this move? Examine the possible implications of this step.

Approach:

- Introduce with the concept of D-SIBs and background.
- Explain the reasons for this move in detail.
- List both positives and negatives associated with the step.
- Conclude with a balanced opinion.

Answer:

Financial Stability Board (FSB), an international body affiliated with G20 recommended identification of systematically important banks (SIB), which are too important to fail as their failure would have cascading impact on the entire financial system.

RBI issued guidelines and listed two banks – SBI and ICICI as part of an annual process to declare such banks as Domestic Systemically Important Banks. These banks would have to set aside 0.2 per cent to 0.8 per cent extra capital, based on the category under which they fall.

However, it might not be easy for banks to arrange these additional funds. SBI has already stated the need for government help in this regard. RBI has kept the requirements already lower than other countries in face of the capital stress that banks in India are currently experiencing. For most global banks it ranges from 1 to 2.5 per cent. This could threaten the stability and dilute the original objective of the provision.

Also, the list included only two names instead of 6 originally considered. This can prove to be dangerous as these banks are big and systemically important with deep and wide exposures across the market.

Student Notes:

The biggest benefit would be in increasing stability. Even in case of a financial crisis, these banks will find it easier to run their operations. Also, it reduces government bailout chances as well as quantum.

RBI's implementation of its domestic SIB framework is less stringent than that of other countries, as it has considered the fact that Indian banks are very small considered to global banks with lower assets as well as assets to GDP ratio. Also, global banks are exposed to riskier inter-connected and complex financial products which Indian banks have negligible.

The Reserve Bank of India has taken a well-balanced step as it followed the broad principles laid down by the Basel Committee for making such a selection, which would protect it from failure of financial system. At the same time, the decision has been made with an eye on local conditions.

Student Notes:

FISCAL POLICY

Contents

Student Notes:

1. Introduction and Definition

Fiscal policy is the policy under which the government uses the instruments of **taxation, public spending and public borrowing** to achieve various objectives of economic policy. It is concerned with effects of these on income, production and employment.

While **fiscal policy deals with the taxation and expenditure decisions of the government**, monetary policy deals with the supply of money in the economy and the rate of interest. In most modern economies, **the government deals with fiscal policy while the central bank is responsible for monetary policy.**

Objectives of Fiscal Policy at a Glance

1. Maintaining Economic Stability
2. Attainment of Full Employment
3. To Accelerate Economic Growth
4. Reduction in Inequalities in Income and Wealth
5. Price Stability
6. Attaining External Equilibrium

2. Instruments of Fiscal Policy

Fiscal policy is carried out by the legislative and/or the executive branches of government. The two main **instruments** of fiscal policy are **government taxes and expenditure.** The government collects taxes in order to finance expenditures on a number of **public goods** and **services**. The effect of government expenditures, taxation, and debt on the aggregate economy is of immense importance.

Three distinct functions that operate through the fiscal policy of the government are:

1. Certain goods, referred to as **public goods** (such as national defence, roads, government administration), as distinct from **private goods** (like clothes, cars, food items), cannot be provided through the market mechanism, i.e. by transactions between individual consumers and producers and must be provided by the government. This is the **allocation function**.
2. Second, through its tax and expenditure policy, the government attempts to bring about a distribution of income that is considered 'fair' by society. The government affects the personal disposable income of households by making transfer payments and collecting taxes and, therefore, can alter the income distribution. This is the **distribution function**.
3. Third, the economy tends to be subject to substantial fluctuations and may suffer from prolonged periods of unemployment or inflation. There may be times when extra government expenditure is needed to raise aggregate demand. There may be times when expenditures exceed the available output under conditions of high employment and thus may cause inflation. In such situations, restrictive conditions are needed to reduce demand. These constitute the ***stabilisation*** requirements of the domestic economy.

Note: Public provision of goods is not the same as public production. **Public provision** means that they are financed through the budget and made available free of any direct payment. These goods may be produced directly under government management or by the private sector.

2.1. Government or Public Expenditure

Public expenditure refers to expenses incurred by public authorities – central government, state government and local authorities – for their own maintenance and also for the satisfaction of collective needs of the citizens and/or for promoting their economic and social welfare. For e.g. expenditure incurred by public authorities in running the government in the form of expenditure on administration and maintenance of law and order, as also on education, health, transportation, defence, social security etc.

Government expenditure can be classified under the following heads:

2.1.1. Capital and Revenue Expenditure

Capital Expenditures of the government are those expenditures which result in creation of physical or financial assets or reduction in financial liabilities. These include:

Student Notes:

- Expenditure on the acquisition of land, building, machinery, equipment, investment in shares; and
- Loans and advances by the central government to state and union territory governments, PSUs and other parties.

Revenue Expenditure is expenditure incurred for purposes other than the creation of physical or financial assets of the central government. It relates to:
- expenses incurred for the normal functioning of the government departments and various services,
- interest payments on debt incurred by the government; and
- grants given to state governments and other parties

2.1.2. Development and Non-Development Expenditure

Development Expenditure - All expenditures that promote economic growth and social development are termed as development expenditure. These are the same as productive expenditure. Example – education, public health, employment, transport, communication etc.

Non-Development Expenditure - Unproductive expenditures are termed as non-development expenditures. Example – administrative services like police, administration of justice, defence or interest payments, grants to states etc.

2.1.3. Direct Expenditure and Transfer Expenditure

Direct Expenditure - The direct or non-transfer expenditure relates to expenditure which results in creation of income or output. Basically it is an expenditure by government on the purchase of goods and services and on current services of factors of production.

The non-transfer expenditure includes development as well as non-development expenditure that results in creation of output directly or indirectly. Economic infrastructure such as power, transport, irrigation, etc.; Social infrastructure such as education, health and family welfare; Internal law and order and defence; Public administration, etc.

By incurring such expenditure, the government creates a healthy conditions or environment for economic activities. Due to economic growth, the government may be able to generate income in form of duties and taxes.

Transfer Expenditure - Transfer expenditure relates to the expenditure in the form of payments against which there is no corresponding return. Such expenditure includes public expenditure on - National Old Age Pension Schemes, Interest payments, Subsidies, Unemployment allowances, Welfare benefits to weaker sections, etc.

By incurring such expenditure, the government does not get anything in return, but it adds to the welfare of the people, especially those belonging to the weaker sections of the society. Such expenditure basically results in redistribution of money incomes within the society.

2.1.4. Productive and Unproductive Expenditure

Productive Expenditure - Expenditure on infrastructure development, public enterprises or development of agriculture increase productive capacity in the economy and bring income to the government. Thus they are classified as productive expenditure. Example – expenditure on physical assets like machineries etc. or expenditure on human capital – training etc.

Unproductive Expenditure - Expenditures in the nature of consumption such as defence, interest payments, expenditure on law and order, public administration, do not create any productive asset which can bring income or returns to the government. Such expenses are classified as unproductive expenditures. Example – maintenance of law and order, defence etc.

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2.2. Government or Public Revenue

Public revenue refers to the income of the government from all its sources. It includes: receipts from tax revenue and those from non-tax revenue. These are revenue sources of the government i.e. they are sources of the government's income, which are not subject to repayment by the government. It is different from public receipts in that public receipts refer to all incomes of the government including public borrowing and issue of new currency.

Public Receipts = Public Revenue Receipts + Income from other sources like Public Borrowing and Printing of Currency

Government revenue or receipts can be classified into revenue and capital receipts.

2.2.1. Revenue Receipts

Revenue receipts are receipts of the government which are non-redeemable, that is, they cannot be reclaimed from the government. They are divided into tax and non-tax revenues.

2.2.1.1. Tax Revenue

Tax Revenues consist of the proceeds of taxes and other duties levied by the central government. Tax revenues are an important component of revenue receipts and comprise of following taxes:

1. **Personal income tax**: Taxes on individual salaries and income
2. **Corporation tax**: Taxes on firms and corporations
3. **Excise duties:** Duties levied on goods produced within the country
4. **Customs duties:** Duties imposed on goods imported into and exported out of India
5. **Service tax**: Tax levied by the government on service providers on certain service transactions.
6. **Wealth tax**: Charged on the net wealth of the assesse. It is a tax on the benefits derived from ownership of property.
7. **Gift tax:** Tax on the transfer of property by one individual to another while receiving nothing, or less than full value, in return. The tax applies whether the donor intends the transfer to be a gift or not.

Taxes like wealth tax, gift tax and estate duty (now abolished) have never been of much significance in terms of revenue yield and have thus been referred to as **paper taxes**.

2.2.1.2. Meaning of Taxes

Taxes can be defined as a "*compulsory contribution from a person to the government to defray the expenses incurred in the common interest of all, without reference to special benefits conferred*".

The nature of taxes can be explained in terms of the following four characteristics

- **Compulsory contribution** – No one can refuse to pay taxes as refusal attracts legal action and punishment
- **Personal obligation** – It imposes an obligation to pay taxes
- **General benefit** – Taxes are used for the general benefits and welfare of the people
- **No quid pro quo** – A tax payer does not receive a definite, direct and proportional benefit from the government.

2.2.1.3. Types of Taxes

Direct and Indirect Taxes

Taxes are also classified as **Direct and Indirect taxes**. A **direct tax** is one that the taxpayer pays directly to the government. These taxes cannot be shifted to others. A homeowner pays personal property taxes directly to the government. A family pays its own income taxes.

Student Notes:

Merits of Direct Taxes

The following are the merits of direct taxes:

- **Economical** – in terms of cost of collecting as they are usually collected at source
- **Certainty** – for the government knows fairly definitely how much they are going to receive as the taxpayers know how much and on what basis they have to pay
- **Equity & reducing inequalities** – By making tax rates progressive, burden can be put ore on rich than poor
- **Elastic** – revenue can be increased by raising tax rates in times of crisis
- **Civic consciousness** – Since the taxpayers provide the funds to government, they become more aware and conscious of how government is spending it.
- **Simplicity** – easy and simple to understand

Direct Tax	
Merits	Demerits
1. Economical	1. Unpopular
2. Certainty	2. Tax Evasion
3. Equity	3. Inconvenient
4. Reducing inequalities	4. Adverse effect on will to work and save
5. Elastic	5. Arbitrariness
6. Civic consciousness	6. Narrow in scope
7. Simplicity	

Demerits of Direct Taxes

The major drawbacks with the direct taxes are as follows:

- Unpopular – tax payers feel the pinch directly as they can't be shifted.
- Possibility of tax evasion as people can conceal their income or adopt some fraudulent practices to pay less taxes
- Inconvenient – maintenance of elaborate accounts and need to observe various formalities make the process inconvenient
- Adverse effect on the will to work and save – For example if property and inheritance are taxed, it will discourage the people to save
- Arbitrariness – the rates are arbitrarily fixed by the government
- Narrow in scope – because imposed on certain groups of people not all the groups.

An **indirect tax** is tax that can be passed on to another person or group. A business may recover the cost of the taxes it pays by charging higher prices to customers. A **tax shift** occurs when the business shifts its taxes to others.

Excise Duties and Custom Duties are examples of indirect taxes while rest of the above mentioned taxes are direct taxes.

INDIRECT TAXES	
Merits	***Demerits***
1. Convenience	1. Regressive and Unjust
2. Elastic	2. Inflationary impact
3. Less of Tax Evasion	3. Uneconomical
4. Equitable	4. Uncertainty
5. Increase in Social welfare	5. Lack of Civic Consciousness
6.Promote Production and Investment	

Specific and Advalorem Taxes

Another classification of taxes is done as **Specific Taxes and Advalorem Taxes.** When any good is taxed on the basis of its measure, size and weight such tax is known as **specific tax**. For example, if excise duty is imposed on sugar with respect to its weight; or excise duty is imposed on cloth on the basis of meters or yards, it will be a specific tax. The specific tax is advantageous because it can easily be imposed and charged. When any commodity is taxed on the basis of value of sales, it is known as **advalorem tax**. In such case, the tax is imposed on the basis of value of the product whatsoever be the weight or size of the product. Advalorem tax is beneficial in the sense that its burden lies with the rich. Hence, it is in accordance with the canon of equity. *But the complication with this tax is that it is difficult to find the exact value of goods.*

Student Notes:

The government has abolished all centre and state level indirect taxes and replaced them with single indirect tax named Goods and Services Tax (GST) effective from 1st July, 2017.

Note: **Tobin Tax** was put forward in 1972 by the Nobel-prize winning American economist James Tobin. Originally, he suggested a tax on all payments from one currency to another. His aim was to curb massive and destabilising movements of funds between foreign currency exchanges. He proposed that the cash raised should be used as aid for developing countries. The idea has since been extended to cover a tax on all share, bond and currency transactions.

The advantage of the tax is that it could be a huge money-raiser for governments. It is only fair that banks and other financial firms pay an additional tax to help tackle government debt levels that they helped increase, as a result of the bailout schemes, which many of them required during the financial crisis. Those in favour of the tax also argue that it helps to increase stability. They say that in the 1990s, it could have prevented countries such as Russia, Mexico and those in South East Asia having to raise their interest rates to very high levels, as their currencies came under threat from speculators.

Critics argue that the tax will result in fewer financial transactions being made, resulting in job losses in financial centres. Others warn that the tax will mean pension funds and savers get less returns, as banks will simply pass the cost of the tax onto their customers.

2.2.1.4. Non Tax Revenue

Non-tax revenue mainly consists of:

- Interest receipts on account of loans by the central government,
- Dividends and profits on investments made by the government,
- Fees and other receipts for services rendered by the government.
- Cash grants-in-aid from foreign countries and international organisations.

2.2.1.5. Characteristics of Good Taxation Systems

A good tax system should meet five basic conditions: fairness, adequacy, simplicity, transparency, and administrative ease.

Fairness, or equity, means that everybody should pay a fair share of taxes. There are two important concepts of equity: *horizontal equity* and *vertical equity*.

Horizontal equity means that taxpayers in similar financial condition should pay similar amounts in taxes.

Vertical equity is just as important, however. Vertical equity means that taxpayers who are better off should pay at least the same proportion of income in taxes as those who are less well off. Vertical equity involves classifying taxes as *regressive*, *proportional*, or *progressive.*

Taxes can also be categorized as either **regressive, proportional, or progressive**, and the distinction has to do with the *behaviour of the tax as the taxable base (such as a household's income or a business' profit) changes.(see graph below)*

- **Progressive tax**—A tax that takes a larger percentage of income from high-income groups than from low-income groups.
- **Proportional tax**—A tax that takes the same percentage of income from all income groups.
- **Regressive tax**—A tax that takes a larger percentage of income from low-income groups than from high-income groups.
- **Degressive tax** – The rate of progression in taxation does not increase in the same proportion as the increase in income.

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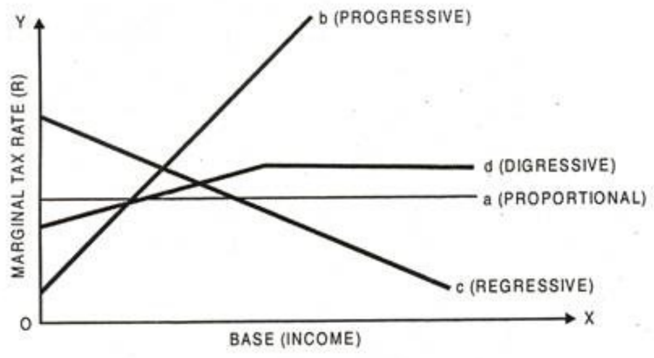


Fig. 1. Different Tax Rates.

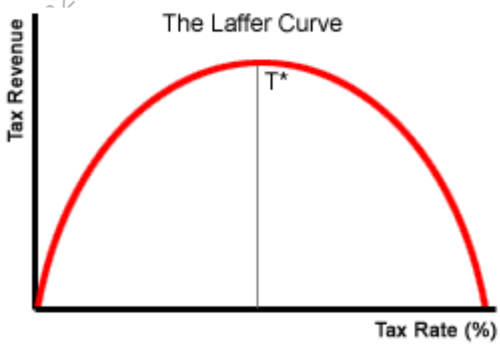
Progressive taxation is the most popular owing to the following reasons:

- It leads to **equitable** and just distribution of burden of taxes as it imposes higher tax burden on the rich
- It helps in **reducing inequalities** of income and wealth
- These are **elastic** as revenue of government increases substantially with the increase in tax rate
- It is **productive** because increase in income automatically brings in more revenue
- These are **economical** as the cost of tax collection does not increase with the increase in tax rates

Adequacy means that taxes must provide enough revenue to meet the basic needs of society. A tax system meets the test of adequacy if it provides enough revenue to meet the demand for public services.

Transparency means that taxpayers and leaders can easily find information about the tax system and how tax money is used. With a transparent tax system, we know who is being taxed, how much they are paying, and what is being done with the money. We also can find out who (in broad terms) pays the tax and who benefits from tax exemptions, deductions, and credits.

Administrative ease means that the tax system is not too complicated or costly for either taxpayers or tax collectors. Rules are well known and fairly simple, forms are not too complicated, it is easy to comply voluntarily, the state can tell if taxes are paid on time and correctly, and the state can conduct audits in a fair and efficient manner. The cost of collecting a tax should be very small in relation to the amount collected.



Note: The **Laffer Curve** shows the relationship between tax rates and tax revenue.

This graph shows that as the tax rate increases from zero, the amount of tax revenue collected will increase. At point T*, however, increases in the tax rate lead to decreases in the tax revenue collected. Governments would like to be at point T*, because it is the point at which the government collects maximum amount of tax revenue while people continue to work hard. This would theoretically be the point at which potential GDP is maximized.

2.2.1.6. Taxation Systems in Developing Economies

Tax is more than just a source of revenue and growth. It also plays a key role in building up institutions, markets and democracy through making the state accountable to its taxpayers. Rich and poor country governments have agreed on the importance of tax for development for

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years. The 2002 Monterrey Consensus, which launched a new focus on development recognised the key role of taxation in mobilising domestic resources-90% of domestic revenue is usually derived from tax.

Setting up an efficient and fair tax system is, however, far from simple, particularly for developing countries that want to become integrated in the international economy. The ideal tax system in these countries should raise essential revenue without excessive government borrowing, and should do so without discouraging economic activity and without deviating too much from tax systems in other countries. Major problems associated with taxation in developing countries are:

- First, most workers in these countries are typically employed in agriculture or in small, informal enterprises. As they are seldom paid a regular, fixed wage, their earnings fluctuate, and many are paid in cash, "off the books." The base for an income tax is therefore hard to calculate. Nor do workers in these countries typically spend their earnings in large stores that keep accurate records of sales and inventories. As a result, modern means of raising revenue, such as income taxes and consumer taxes, play a diminished role in these economies, and the possibility that the government will achieve high tax levels is virtually excluded.
- Second, it is difficult to create an efficient tax administration without a well-educated and well-trained staff, when money is lacking to pay good wages to tax officials and to computerize the operation (or even to provide efficient telephone and mail services), and when taxpayers have limited ability to keep accounts. As a result, governments often take the path of least resistance, developing tax systems that allow them to exploit whatever options are available rather than establishing rational, modern, and efficient tax systems.
- Third, because of the informal structure of the economy in many developing countries and because of financial limitations, statistical and tax offices have difficulty in generating reliable statistics. This lack of data prevents policymakers from assessing the potential impact of major changes to the tax system. As a result, marginal changes are often preferred over major structural changes, even when the latter are clearly preferable. This perpetuates inefficient tax structures.
- Fourth, income tends to be unevenly distributed within developing countries. Although raising high tax revenues in this situation ideally calls for the rich to be taxed more heavily than the poor, the economic and political power of rich taxpayers often allows them to prevent fiscal reforms that would increase their tax burdens. This explains in part why many developing countries have not fully exploited personal income and property taxes and why their tax systems rarely achieve satisfactory progressivity.

In conclusion, in developing countries, tax policy is often the art of the possible rather than the pursuit of the optimal. It is therefore not surprising that economic theory and especially optimal taxation literature have had relatively little impact on the design of tax systems in these countries.

2.2.1.7. Characteristics of a Good Taxation System for Developing Countries

In developing countries where market forces are increasingly important in allocating resources, the design of the tax system should be as neutral as possible so as to minimize interference in the allocation process. Different taxes and their necessary characteristics can be discussed as under:

Personal Income Tax

This tax has yielded relatively little revenue in most of the developing countries and the number of individuals subject to this tax (especially at the highest marginal rate) is small. Countries frequently attach great importance to maintaining some degree of nominal progressivity in this tax by applying many rate brackets, and they are reluctant to adopt reforms that will reduce the

Student Notes:

number of these brackets. Effective rate progressivity could be improved by *reducing* the degree of nominal rate progressivity and the number of brackets *and* reducing exemptions and deductions. Indeed, any reasonable equity objective would require no more than a few nominal rate brackets in the personal income tax structure.

Corporate Income Tax

Developing countries are more prone to having multiple rates along sectoral lines (including the complete exemption from tax of certain sectors, especially the parastatal sector) than industrial countries, possibly as a legacy of past economic regimes that emphasized the state's role in resource allocation. Allowable depreciation of physical assets for tax purposes is an important structural element in determining the cost of capital and the profitability of investment. Rectifying these shortcomings should also receive a high priority in tax policy deliberations in these countries.

Value-Added Tax, Excises, and Import Tariffs

While *VAT* has been adopted in most developing countries, it frequently suffers from being incomplete in one aspect or another. Many important sectors, most notably services and the wholesale and retail sector, are left out of the VAT net, or the credit mechanism is excessively restrictive (that is, there are denials or delays in providing proper credits for VAT on inputs), especially when it comes to capital goods. As these features allow a substantial degree of cascading (increasing the tax burden for the final user), they reduce the benefits from introducing the VAT in the first place. Rectifying such limitations in the VAT design and administration should be given priority in developing countries.

The most notable shortcoming of the *excise systems* found in many developing countries is their inappropriately broad coverage of products—often for revenue reasons. A good excise system is invariably one that generates revenue (as a by-product) from a narrow base and with relatively low administrative costs. Reducing *import tariffs* as part of an overall program of trade liberalization is a major policy challenge currently facing many developing countries.

Tax Incentives

Tax incentives can be justified if they address some form of market failure, most notably those involving externalities (economic consequences beyond the specific beneficiary of the tax incentive). For example, incentives targeted to promote high-technology industries that promise to confer significant positive externalities on the rest of the economy are usually legitimate. By far, the most compelling case for granting targeted incentives is for meeting regional development needs of these countries. Nevertheless, not all incentives are equally suited for achieving such objectives and some are less cost-effective than others. Unfortunately, the most prevalent forms of incentives found in developing countries tend to be the least meritorious.

2.2.2. Capital Receipts

All those receipts of the government which create liability or reduce financial assets are termed as capital receipts. The main items of capital receipts are:

- loans raised by the government from the public which are called market borrowings,
- borrowing by the government from the Reserve Bank and commercial banks and other financial institutions through the sale of treasury bills,
- loans received from foreign governments and international organisations,
- recoveries of loans granted by the central government,
- small savings (Post-Office Savings Accounts, National Savings Certificates, etc),
- provident funds, and
- net receipts obtained from the sale of shares in Public Sector Undertakings.

Student Notes:

3. Cascading Effects of Taxation: MODVAT and CENVAT

Taxation of inputs, like raw materials, components and other intermediaries had a number of limitations. In production process, raw material passes through various processes stages till a final product emerges. Thus, output of the first manufacturer becomes input for second manufacturer and so on. When the inputs are used in the manufacture of product `A', the cost of the final product increases not only on account of the cost of the inputs, but also on account of the duty paid on such inputs. As the duty on the final product is on ad valorem basis and the final cost of product `A' includes the cost of inputs, inclusive of the duty paid, duty charged on product `A' meant doubly taxing raw materials. In other words, the tax burden goes on increasing as raw material and final product passes from one stage to other because, each subsequent purchaser has to pay tax again and again on the material which has already suffered tax. **This is called cascading effect or double taxation.**

This very often distorted the production structure and did not allow the correct assessment of the tax incidence. Therefore, the Government tried to remove these defects of the Central Excise System by progressively relieving inputs from excise and countervailing duties. An ideal system to realize this objective would have been to adopt value added taxation (VAT). However, on account of some practical difficulties it was not possible to fully adopt the value added taxation.

Hence, Government evolved a new scheme, **MODVAT (Modified Value Added Tax)**. MODVAT Scheme which essentially follows VAT Scheme of taxation. i.e. if a manufacturer A purchases certain components(raw materials) from another manufacturer B for use in its product. B would have paid excise duty on components manufactured by it and would have recovered that excise duty in its sales price from A. Now, A has to pay excise duty on product manufactured by it as well as bear the excise duty paid by the supplier of raw material B. Under the MODVAT scheme, a manufacturer can take credit of excise duty paid on raw materials and components used by him in his manufacture. It amounts to excise duty only on additions in value by each manufacturer at each stage.

MODVAT Scheme ensures the revenue of the same order and at same time the price of the final product could be lower. Apart from reducing the costs through elimination of cascade effect, and bringing in greater rationalization in tax structure and also bringing in certainty in the amount of tax leviable on the final product, this scheme will help the consumer to understand precisely the impact of taxation on the cost of any product and will, therefore, enable consumer resistance to unethical attempts on the part of manufacturers to raise prices of final products, attributing the same to higher taxes.

Subsequently, MODVAT scheme was restructured into **CENVAT (Central Value Added Tax)** scheme. Whatever restrictions were there in MODVAT Scheme were put to an end. Under the CENVAT Scheme, a manufacturer of final product or provider of taxable service shall be allowed to take credit of duty of excise as well as of service tax paid on any input received in the factory or any input service received by manufacturer of final product.

4. Budgetary Deficits

When government expenditures *exceed* government tax revenues in a given year, the government is running a **budget deficit** for that year. When government expenditures are *less* than tax revenues in a given year, the government is running a **budget surplus** for that year. The budget surplus is the difference between tax revenues and government expenditures. In the case where government expenditures are exactly equal to tax revenues in a given year, the government is running a **balanced budget** for that year.

Various measures that capture government deficit and their implications for the economy are discussed below:

Student Notes:

4.1. Revenue Deficit

The revenue deficit refers to the excess of government's revenue expenditure over revenue receipts

Revenue Deficit = Revenue Expenditure – Revenue Receipts

The revenue deficit includes only such transactions that affect the current income and expenditure of the government. **When the government incurs a revenue deficit, it implies that the government is dissaving and is using up the savings of the other sectors of the economy to finance a part of its consumption expenditure.** This situation means that the government will have to borrow not only to finance its investment but also its consumption requirements. This will lead to a build-up of stock of debt and interest liabilities and force the government, eventually, to cut expenditure. **Since a major part of revenue expenditure is committed expenditure, it cannot be reduced. Often the government reduces productive capital expenditure or welfare expenditure**. This would mean lower growth and adverse welfare implications.

4.2. Fiscal Deficit

Fiscal deficit is the difference between the government's total expenditure and its total receipts excluding borrowing

Gross fiscal deficit = Total expenditure – (Revenue receipts + Non-debt creating capital receipts)

Non-debt creating capital receipts are those receipts which are not borrowings and, therefore, do not give rise to debt. Examples are recovery of loans and the proceeds from the sale of PSUs.

The fiscal deficit will have to be financed through borrowing. Thus, it indicates the total borrowing requirements of the government from all sources. From the financing side

Gross fiscal deficit = Net borrowing at home + Borrowing from RBI + Borrowing from abroad

Net borrowing at home includes that directly borrowed from the public through debt instruments (for example, the various small savings schemes) and indirectly from commercial banks through Statutory Liquidity Ratio (SLR).

The gross fiscal deficit is a key variable in judging the financial health of the public sector and the stability of the economy. From the way gross fiscal deficit is measured it can be seen that revenue deficit is a part of fiscal deficit

Fiscal Deficit = Revenue Deficit + Capital Expenditure - non-debt creating capital receipts

A large share of revenue deficit in fiscal deficit indicated that a large part of borrowing is being used to meet its consumption expenditure needs rather than investment.

4.3. Primary Deficit

Borrowing requirements of the government includes interest obligations on accumulated debt. **The goal of measuring primary deficit is to focus on present fiscal imbalances**. Primary deficit is used to obtain an estimate of borrowing on account of current expenditures exceeding revenues. It is simply the fiscal deficit minus the interest payments.

Gross primary deficit = Gross fiscal deficit – Net interest liabilities

Net interest liabilities consist of interest payments minus interest receipts by the government on net domestic lending.

4.4. Deficit Financing

Budgetary deficits must be financed by either taxation or borrowing or printing money. Governments have mostly relied on borrowing, giving rise to what is called government debt.

Student Notes:

The concepts of deficits and debt are closely related. Deficits can be thought of as a *flow* which adds to the *stock* of debt. **If the government continues to borrow year after year, it leads to the accumulation of debt and the government has to pay more and more by way of interest. These interest payments themselves contribute to the debt.**

4.4.1. Whether Government Debt is Good or Bad?

By borrowing, the government transfers the burden of reduced consumption on future generations. This is because it borrows by issuing bonds to the people living at present but may decide to pay off the bonds some twenty years later by raising taxes. These may be levied on the young population that have just entered the work force, whose disposable income will go down and hence consumption. Thus, national savings, it was argued, would fall. Also, **government borrowing from the people reduces the savings available to the private sector. To the extent that this reduces capital formation and growth, debt acts as a 'burden' on future generations**.

4.4.2. Ricardian Equivalence

It has been argued that when a government cuts taxes and runs a budget deficit, consumers respond to their after-tax income by spending more. It is possible that these people are short-sighted and do not understand the implications of budget deficits. They may not realise that at some point in the future, the government will have to raise taxes to pay off the debt and accumulated interest. Even if they comprehend this, they may expect the future taxes to fall not on them but on future generations.

A counter argument is that consumers are forward-looking and will base their spending not only on their current income but also on their expected future income. They will understand that borrowing today means higher taxes in the future. They would increase savings now, which will fully offset the increased government dissaving.

This view is called **Ricardian equivalence** after one of the greatest nineteenth century economists, David Ricardo, who first argued that in the face of high deficits, people save more. It is called 'equivalence' because it argues that taxation and borrowing are equivalent means of financing expenditure. When the government increases spending by borrowing today, which will be repaid by taxes in the future, it will have the same impact on the economy as an increase in government expenditure that is financed by a tax increase today.

4.4.3. Debt vs Inflation

One of the main criticisms of deficits is that they are inflationary. This is because when government increases spending or cuts taxes, aggregate demand increases. Firms may not be able to produce higher quantities that are being demanded at the on-going prices. Prices will, therefore, have to rise. **However, if there are unutilised resources, output is held back by lack of demand. If a high fiscal deficit is accompanied by higher demand and greater output it need not be inflationary.**

Redemption of Public Debt at a Glance

1. Repudiation of Debt
2. Refunding
3. Debt Conversion
4. Budgetary Surplus
5. Terminal Annuities
6. Sinking Fund
7. Statutory Reduction in Interest Rate
8. Capital Levy
9. Exports Surplus

It has been argued that there is a decrease in investment due to a reduction in the amount of savings available to the private sector. This is because if the government decides to borrow from private citizens by issuing bonds to finance its deficits, these bonds will compete with corporate bonds and other financial instruments for the available supply of funds. If some private savers decide to buy bonds, the funds remaining to be invested in private hands will be smaller. Thus, some private borrowers will get **crowded out** of the financial markets as the government claims an increasing share of the economy's total savings. **However the economy's flow of savings is**

not really fixed unless it is assumed that income cannot be augmented. If government deficits succeed in their goal of raising production, there will be more income and, therefore, more saving. In this case, both government and industry can borrow more.

If the government invests in infrastructure, future generations may be better off, provided the return on such investments is greater than the rate of interest. The actual debt could be paid off by the growth in output. The debt should not then be considered burdensome. **The growth in debt will have to be judged by the growth of the economy as a whole**.

Note: Larger deficits do not always signify a more expansionary fiscal policy. The same fiscal measures can give rise to a large or small deficit, depending on the state of the economy. For example, if an economy experiences a recession and GDP falls, tax revenues fall because firms and households pay lower taxes when they earn less. This means that the deficit increases in a recession and falls in a boom, even with no change in fiscal policy.

4.5. Deficit Reduction

Government deficit can be reduced by an increase in taxes or reduction in expenditure. In India, the government has been trying to increase tax revenue with greater reliance on direct taxes (indirect taxes are regressive in nature – they impact all income groups equally). There has also been an attempt to raise receipts through the sale of shares in PSUs.

However, the major thrust has been towards reduction in government expenditure. This could be achieved through making government activities more efficient through better planning of programmes and better administration. A study by the Planning Commission had estimated that to transfer Re 1 to the poor, government spends Rs 3.65 in the form of food subsidy, showing that cash transfers would lead to increase in welfare. The other way is to change the scope of the government by withdrawing from some of the areas where it operated before.

Cutting back government programmes in vital areas like agriculture, education, health, poverty alleviation, etc. would adversely affect the economy. Governments in many countries run huge deficits forcing them to eventually put in place self-imposed constraints of not increasing expenditure over pre-determined levels. In India, we also adopted FRBM Act explained in the next section.

Larger deficits do not always signify a more expansionary fiscal policy. The same fiscal measures can give rise to a large or small deficit, depending on the state of the economy. For example, if an economy experiences a recession and GDP falls, tax revenues fall because firms and households pay lower taxes when they earn less. This means that the deficit increases in a recession and falls in a boom, even with no change in fiscal policy

4.5.1. Fiscal Responsibility and Budget Management Act, 2003 (FRBMA)

In a multi-party parliamentary system, electoral concerns play an important role in determining expenditure policies. A legislative provision, it is argued, that is applicable to all governments – present and future – is likely to be effective in keeping deficits under control. The enactment of the FRBMA, in August 2003, marked a turning point in fiscal reforms, binding the government through an institutional framework to pursue a prudent fiscal policy.

Main Features

1. The Act mandates the central government to take appropriate measures to reduce fiscal deficit to not more than 3 per cent of GDP and to eliminate the revenue deficit by March 31, 2009 and thereafter build up adequate revenue surplus (amended later).
2. It requires the reduction in fiscal deficit by 0.3 per cent of GDP each year and the revenue deficit by 0.5 per cent. If this is not achieved through tax revenues, the necessary adjustment has to come from a reduction in expenditure.
3. The actual deficits may exceed the targets specified only on grounds of national security or natural calamity or such other exceptional grounds as the central government may specify.

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4. The central government shall not borrow from the Reserve Bank of India except by way of advances to meet temporary excess of cash disbursements over cash receipts.
5. Measures should be taken to ensure greater transparency in fiscal operations.
6. The central government to lay before both Houses of Parliament three statements – Medium-term Fiscal Policy Statement, The Fiscal Policy Strategy Statement, The Macroeconomic Framework Statement along with the Annual Financial Statement.
7. Quarterly review of the trends in receipts and expenditure in relation to the budget be placed before both Houses of Parliament.

The Act applies to the central government. However, the states have already enacted fiscal responsibility legislations which have made the rule based fiscal reform programme of the government more broad based.

4.5.1.1. Amendments to the FRBM Act

- The central government shall reduce the fiscal deficit by an amount equivalent to 0.1 percent or more of the gross domestic product at the end of each financial year **beginning with the financial year 2018-19**, so that **fiscal deficit** is brought down to **not more than 3 percent of the GDP by 31st day of March, 2021.**
- **Budget 2018** has proposed **to stop setting targets on Revenue Deficit** reduction from next year year through amendment in the FRBMA**.**

While FRBM Act has improved the level of disclosures that government has to make about its finances, its main target of reducing the actual size of deficit remains elusive. It is because government budgets in a democracy are not just economics and are deeply political. So, merely setting a number may not help.

4.5.1.2. Lacunae in FRBM Act

A notable lacuna in the FRBM regime has been that there are often deviations from the fiscal rules. FRBM Act explicitly provides for breach of targets in the case of national security need, national calamities and other exceptional circumstances. This leaves a lot of leeway in interpretation. The amendment to the FRBM Act in 2012-13 has re-established the regime of fiscal rules, and introduced a medium-term expenditure framework. Going forward, there is a need to remove a large part of ambiguity about any exceptions to be made, by adding expenditure rules to deficit rules and by adopting broader definition of deficit to cover quasi-fiscal activities.

The existing FRBM Act prescribes a target fiscal deficit of 3% of GDP for the centre but with no explicit justification for the number. Since there is also a separate limit for the states (although not specified in the Act), the combined fiscal deficit (general government deficit in International Monetary Fund terminology) is much larger. The Fourteenth Finance Commission (chaired by Y.V. Reddy), for example, has explicitly recommended a 3% fiscal deficit for the centre and another 3% for the states, yielding a combined limit of 6% per year for the period 2015-16 to 2019-20.

Both the Thirteenth Finance Commission and the Fourteenth Finance Commission recommended the establishment of an autonomous body to review fiscal performance under the FRBM Act. This could evolve into a statutory Fiscal Council, reporting to Parliament through the finance ministry. Such institutions have been set up in several countries, with somewhat varying mandates.

A Fiscal Council, with technical expertise, would help generate better understanding of the consistency of fiscal stance of each budget with the longer-term fiscal trajectory envisaged under the FRBM Act. It would certainly improve the quality of Parliamentary oversight and also contribute to a more informed public debate. The Council would actually strengthen the hands of the finance ministry, which is otherwise the lone guardian of fiscal prudence, battling other ministries typically keen on expanding expenditure.

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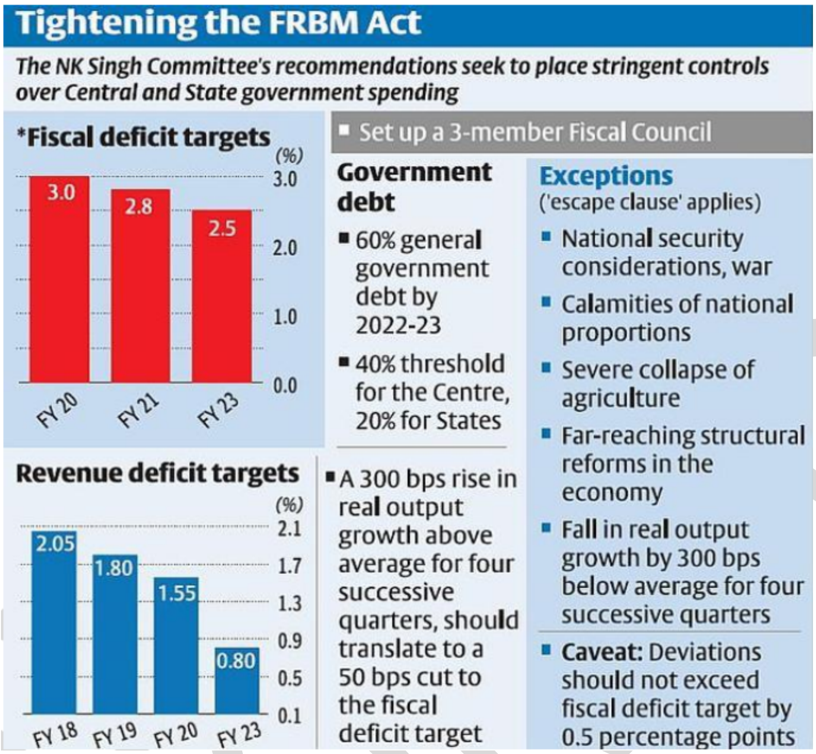
The Government had constituted a Committee in May 2016 to review the Fiscal Responsibility and Budget Management (FRBM) Act. This Fiscal Responsibility and Budget Management (FRBM) Committee, headed by Shri N.K. Singh, has submitted the report and the Government will take appropriate action.

Major Recommendations of the NK Singh (FRBM Review) Committee



- Public debt to GDP ratio should be considered as a medium-term anchor for fiscal policy in India. The combined debt-to-GDP ratio of the centre and states should be brought down to 60% by 2023 (comprising of 40% for the Centre & 20% for states) as against the existing 49.4%, and 21% respectively.
- It advocated fiscal deficit as the operating target to bring down public debt. For fiscal consolidation, the centre should reduce its fiscal deficit from the current 3.5% (2017) to 2.5% by 2023. The Committee set 0.5% as escape clause for fiscal deficit target to adjust with cyclical fluctuations
- The central government should reduce its revenue deficit steadily by 0.25 percentage (of GDP) points each year, to reach 0.8% by 2023, from a projected value of 2.3% in 2017.
- It suggested the setting up of a 'fiscal council', an independent body which will be tasked with monitoring the government's fiscal announcements for any given year. It will provide its own forecasts and analysis for the same as well as advise the finance ministry on triggering the escape clauses.

5. Fiscal Policy in Action

5.1. Expansionary and Contractionary Fiscal Policy

Expansionary fiscal policy is defined as an *increase* in government expenditures and/or a *decrease* in taxes that causes the government's budget deficit to increase or its budget surplus to decrease. **Contractionary** fiscal policy is defined as a *decrease* in government expenditures and/or an *increase* in taxes that causes the government's budget deficit to decrease or its budget surplus to increase.

In case of Expansionary fiscal policy, government needs to borrow from domestic or foreign sources, draw upon its foreign exchange reserves or print an equivalent amount of money. On a

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broad generalisation, *excessive printing of money leads to inflation*. If the government borrows too much from abroad it leads to a *debt crisis*. If it draws down on its foreign exchange reserves, *a balance of payments crisis may arise*. *Excessive domestic borrowing by the government may lead to higher real interest rates and the domestic private sector being unable to access funds resulting in the* ***crowding out*** *of private investment*. Sometimes a combination of these can occur. In any case, **the impact of a large deficit on long run growth and economic well-being is negative**. Therefore, it is not prudent for a government to run an unduly large deficit.

However, in case of developing countries, where the need for infrastructure and social investments may be substantial, running surpluses at the cost of long-term growth might also not be wise. *The challenge then for most developing country governments is to meet infrastructure and social needs while managing the government's finances in a way that the deficit or the accumulating debt burden is not too great.*

5.2. Classical and Keynesian views of Fiscal Policy

The **classical view** of expansionary or contractionary fiscal policies is that such policies are unnecessary because there are market mechanisms—for example, the flexible adjustment of prices and wages—which serve to keep the economy at or near the natural level of real GDP at all times. Accordingly, classical economists believe **that the government should run a balanced budget each and every year.**

The belief that expansionary and contractionary fiscal policies can be used to influence macroeconomic performance is most closely associated with Keynes and his followers. Keynesian theories of output and employment were developed in the midst of the Great Depression of the 1930s, when unemployment rates in the U.S. and Europe exceeded 25% and the growth rate of real GDP declined steadily for most of the decade. Keynes and his followers believed that **the way to combat the prevailing recessionary climate was not to wait for prices and wages to adjust but to engage in expansionary fiscal policy instead.**

Note: **Classical view of Fiscal Policy is also referred to as Active Fiscal Policy. Keynesian view of Fiscal Policy is also referred to as Passive Fiscal Policy.**

5.3. Discretionary and Automatic Fiscal Policy

Discretionary Fiscal policy is the change(s) in the level of active government taxation, and spending due to changes in the economy. These are changes that are often initiated in an attempt to meet some/all of the goals of economies such as full employment and stable prices. Some examples can be increasing spending on infrastructure to stimulate the economy and increase aggregate demand as well as the number of employed.

Automatic Fiscal policy are changes that are a result of past government regulations and tax laws, which are still in effect and adjust/stabilize spending in the economy without direct government intervention, through both the expansionary and recessionary periods of the business cycle. These include things such as progressive taxation, governmental assistance to agriculture and employment insurance.

Discretionary fiscal policy is made more difficult due to lags in recognizing the need for changed fiscal policy and the lags that occur with enacting the changed fiscal policy. Implementing the modified fiscal policy usually requires legislative action, which takes a long time to implement. One difficulty with proper timing is that forecasting economic activity is not an exact science. There is usually a lag between the time fiscal policy changes are needed and the instance that the need to act is widely recognized. Poorly timed fiscal policy could actually increase inflation and accelerate declines in the economy when the economy has already started to slow down.

Fiscal policy does have an advantage over monetary policy in the sense that increased government spending leads to an immediate increase in aggregate demand.

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5.4. Fiscal or Economic Stimulus

Fiscal or Economic Stimulus refers to attempts by government to financially stimulate an economy. An economic stimulus is the use of monetary or fiscal policy changes to kick start a lagging or struggling economy. **Governments can use tactics such as lowering interest rates, increasing government spending and quantitative easing, to name a few, to accomplish this.**

The term economic stimulus became an everyday economic term following the recession created by the 2008-2009 Credit Crisis, which caused most, if not all, of the world's nations to slowdown, with many entering recessions and some depressions. Governments in many cases took unprecedented measures to stimulate lame economies through numerous economic measures.

5.5. Effects of Fiscal Policy on Macro Economy

Fiscal policy affects aggregate demand, the distribution of wealth, and the economy's capacity to produce goods and services. In the short run, changes in spending or taxation can alter both the magnitude and the pattern of demand for goods and services. With time, this aggregate demand affects the allocation of resources and the productive capacity of an economy through its influence on the returns to factors of production, the development of human capital, the allocation of capital spending, and investment in technological innovations.

Tax rates, through their effects on the net returns to labour, saving, and investment, also influence both the magnitude and the allocation of productive capacity. Fiscal policy also feeds into economic trends and influences monetary policy.

5.6. Effects of Fiscal Policy on Consumer Spending

Lower taxes, everything else being constant, increase households' disposable income, allowing consumers to increase their spending. The consequences of the cut — how much is spent or saved, and the response of economic activity — depend on the way households make their decisions and on prevailing macroeconomic conditions.

Whether the tax cut is perceived to be temporary or permanent will influence how much consumers save. A temporary cut will alter households' disposable income relatively little, and so might have little effect on consumption. If the cut is, instead, perceived to be permanent, then households will perceive a larger increase in their disposable income and so will likely increase their desired consumption by much more than they would if they thought the cut were temporary.

There is a potential conflict between the use of fiscal policy to stimulate aggregate demand when the economy is operating below potential in the short run and the use of policy to promote longer-run goals for national saving and capital formation to improve future living standards. When there are underutilized economic resources, fiscal stimulus can increase investment. But when the economy is operating near potential, an increase in the public debt might eventually depress private investment, unless the fiscal stimulus is reversed as the economy approaches full employment and utilisation.

Note: **Fiscal drag** is a concept where inflation and earnings growth may push more tax payers into higher tax brackets. **Therefore fiscal drag has the effect of raising government tax revenue without explicitly raising tax rates**.

This fiscal drag has the effect of reducing Aggregate Demand and becomes an example of deflationary fiscal policy. It could also be viewed as an automatic fiscal stabiliser because higher earnings growth will lead to higher tax and therefore moderate inflationary pressure in the economy.

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6. Drawbacks and Limitations of Fiscal Policy

1. Time lags are significant
   - Recognition lag: time it takes government to recognize there is a problem
   - Decision lag: time required for government to determine most appropriate policy
   - Implementation lag: time it takes to figure out how to implement new directives
   - Impact lag: time it takes to be felt through multiplier effect
2. Difficulties in changing spending and taxation policies
   - It is far easier to increase spending and decrease taxes then to increase taxes and decrease spending
3. Conflict between levels of government over appropriate policies
   - Federal, provincial and city governments may differ on what needs to be done.
   - Regional variations
4. Crowding out of private investment
   - Increases interest rates
   - Reduces amount of funding for private investment
5. Deficits impose net burden on future generations
6. Foreign-owned debt removes capital from economy

7. Fiscal Federalism and Centre State Transfers

In India, resources can be transferred from the centre to states in many ways. **The Finance Commission** is responsible for centre-state financial relations.

7.1. The Finance Commission

Article 280 of the Constitution provides for a FC as a quasi-judicial body. It is constituted by the President every 5th year or at such earlier time as he considers necessary. The FC makes recommendations to the President on following matters:

- The distribution of the net proceeds of taxes between the centre and the states, and the allocation between the states of the respective shares of such proceeds.
- The principle that should govern the grants-in-aid to the states by the centre (out of the Consolidated Fund of India).
- The measures to augment the Consolidated Fund of a state to supplement the resources of local governments on the basis of recommendations made by the state finance commission.
- Any other matter referred to it by the President.
- Recommendations made by the FC are only advisory in nature.
- The Constitution empowers the FC to go beyond the core issues of how to divide taxes vertically between centre and the states on the one hand and horizontally between states on the other.
- It also allows FC to make broader recommendations in the interests of sound finance

7.2. Changes in Indian Taxation System

Developing countries have embarked on tax reforms in recent years. **Such reforms were motivated both by local factors as well as by rapid internationalization of economic activities**. The need to correct fiscal imbalances and the transition from a centralized plan to a market economy were the important local factors hastening tax reforms. Difficulties in compressing expenditures necessitated that tax system reform take an important role in fiscal adjustment strategy.

The transition from plan to market required the substitution of administered prices with market determined prices, the replacement of physical controls with financial controls, and the substitution of public enterprise profits with tax revenues. Likewise, tax reforms become

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imperative in a globalizing environment. Enhancing competitiveness and attracting foreign investment require minimizing both efficiency and compliance costs of the tax system. Globalization also involves loss of revenue from customs, which needs to be replaced with domestic taxes.

The Indian tax system too had to be reformed in response to changes in development strategy. In the initial years, tax policy was used as an instrument to achieve a variety of diverse goals which included increasing the level of saving and correcting for inequalities arising from **a market structure created by a centralized planning regime, including a licensing system, exchange control, and administered prices.**

The evolution of tax policy within the framework of planned development strategy had important implications for India:

1. Tax policy was directed to raise resources for the public sector without regard to efficiency implications.
2. The objective of achieving a socialistic pattern of society on the one hand and the attempt to tax large oligopolistic rents generated by the system of licenses, quotas, and restrictions on the other, called for a steeply progressive tax structure.
3. Pursuit of a multiplicity of objectives complicated the tax system with adverse effects on both efficiency and horizontal equity. This also opened up large avenues for evasion and avoidance of taxes.
4. The above considerations complicated the tax system, and selectivity and discretion became a legitimate part of the tax policy and administration.
5. The influence of special interest groups, changing priorities, and lack of information system and scientific analysis led to ad hoc and often inconsistent calibration of policies.

While India has had a history of periodically assessing the tax structure, through the constitution of tax reform committees (India 1971, 1977), actual reform attempts were largely ad hoc. It required a crisis of some severity before systematic tax reforms were implemented. Fiscal and balance of payments crises of 1991 warranted systematic reform not only to improve the revenue productivity of the tax system to phase out fiscal imbalance, but also to reorient the tax system to the requirements of a market economy.

The Tax Reforms Committee (India 1991) laid out a framework and a roadmap for the reform of direct and indirect taxes as a part of the structural reform process. The important proposals put forward by the TRC included:

1. Reduction in the rates of all major taxes, i.e., customs, individual, and corporate income and excise taxes to reasonable levels, maintain progressivity but not such as to induce evasion.
2. A number of measures to broaden the base of all the taxes by minimizing exemptions and concessions, drastic simplification of laws and procedures, building a proper information system and computerization of tax returns, and revamping and modernization of administrative and enforcement machinery.
3. It also recommended that the taxes on domestic production should be fully converted into a value added tax, and it should be extended to the wholesale level, in agreement with the States, with additional revenues beyond post-manufacturing stage passed on to the State governments.

8. Recent Developments in Taxation System

8.1. Goods and Services Tax (GST)

GST has been implemented from 1st July, 2017 following 101st Constitutional Amendment Act. GST is a single tax on the supply of goods and services, right from the manufacturer to the consumer. It is essentially a tax only on value addition at each stage as input taxes credit paid at each stage will be available in the next stage of value addition. In this taxation system, the final consumer will bear only the GST charged by the last dealer in the supply chain, thus eliminating the cascading effects present in earlier tax regime.

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GST is an indirect tax for the whole nation subsuming all other indirect taxes and making India '**One Country, One Tax, One Unified Common Market'.** Currently, GST has a **four-slab structure**:

- 5% (on basic necessities), 12%, 18%; and
- 28% (on luxury goods)

Taxes subsumed under GST

At the ***Central level***, the following taxes have been subsumed:

- Central Excise Duty
- Additional Excise Duty
- Service Tax
- Additional Customs Duty commonly known as Countervailing Duty; and
- Special Additional Duty of Customs.

At the ***State level***, the following taxes have been subsumed:

- State Value Added Tax/Sales Tax
- Entertainment Tax (other than the tax levied by the local bodies)
- Central Sales Tax (levied by the Centre and collected by the States)
- Octroi and Entry tax
- Purchase Tax
- Luxury tax; and
- Taxes on lottery, betting and gambling.

GST Administration

- Keeping in mind the federal structure of India, there are two components of GST – **Central GST (CGST)** and **State GST (SGST).**
- Both Centre and States simultaneously levy GST across the value chain. The Tax is levied on every supply of goods and services.
- Centre levies and collect Central Goods and Services Tax (CGST), and States levy and collect the State Goods and Services Tax (SGST) on all transactions within a State.
- The input tax credit of CGST is available for discharging the CGST liability on the output at each stage. Similarly, the credit of SGST paid on inputs is allowed for paying the SGST on output.
- No cross utilization of credit is permitted.
- In addition to this, the Centre levies and collects the **Integrated Goods and Services Tax (IGST)** on all inter-State supplies of goods and services under Article 269A (1) of the Constitution in case of inter-State transactions.

GST Council

As per newly inserted Article 279A of the Constitution, the GST Council is a joint forum of the Centre and the States. This Council consists of the following members namely:

1. Union Finance Minister (Chairperson)
2. The Union Minister of State, in-charge of Revenue of finance
3. The Minister In-charge of finance or taxation or any other Minister nominated by each State Government

As per Article 279A (4), the Council will make recommendations to the Union and the States on important issues related to GST, like the goods and services that may be subjected or exempted from GST, model GST Laws, principles that govern place of supply, threshold limits, GST rates

Student Notes:

including the floor rates with bands, special rates for raising additional resources during natural calamities/disasters, special provisions for certain States, etc.

IT Infrastructure for GST implementation

- **Goods and Services Tax Network (GSTN)**: For the implementation of GST in the country, the Central and State Governments have jointly registered GSTN as a not-for-profit, non-Government Company to provide shared IT infrastructure and services to Central and State Governments, tax payers and other stakeholders. The known authorized capital of GSTN is Rs. 10 crore (US$1.6 million) in which Central Government holds **24.5 percent** of shares while the state government holds **24.5 percent** and rest with private banking firms.
- The key objectives of GSTN are to provide a standard and uniform interface to the taxpayers, and shared infrastructure and services to Central and State/UT governments. GSTN is working on developing a state-of-the-art comprehensive IT infrastructure including the common GST portal providing frontend services of registration, returns and payments to all taxpayers, as well as the backend IT modules for certain States that include processing of returns, registrations, audits, assessments, appeals, etc.
- **Project Saksham**: It is a New Indirect Tax Network (Systems Integration) of the Central Board of Excise and Customs (CBEC). It will help in implementation of Goods and Services Tax (GST) by integrating CBEC's IT system with GSTN. It will also help in extension of Indian Customs' Single Window Interface for Facilitating Trade (SWIFT).
- All States, accounting authorities, RBI and banks, are also preparing their IT infrastructure for the administration of GST.
- There would no manual filing of returns. All taxes can be paid online. All mis-matched returns would be auto-generated, and there would be no need for manual interventions. Most returns would be self-assessed.

Benefits of GST

The benefits of GST can be summarized as under:

For business and industry

- **Easy compliance**: Under a robust and comprehensive IT system, all tax payer services such as registrations, returns, payments, etc. would be available to the taxpayers online, which would make compliance easy and transparent.
- **Uniformity of tax rates and structures**: GST will ensure that indirect tax rates and structures are common across the country, thereby increasing certainty and ease of doing business. In other words, GST would make doing business in the country tax neutral, irrespective of the choice of place of doing business.
- **Removal of cascading effect**: A system of seamless tax-credits throughout the value-chain, and across boundaries of States, would ensure that there is minimal cascading of taxes. This would reduce hidden costs of doing business.
- **Improved competitiveness**: The subsuming of major Central and State taxes in GST, complete and comprehensive set-off of input goods and services and phasing out of Central Sales Tax (CST) would reduce the cost of locally manufactured goods and services. This will increase the competitiveness of Indian goods and services industry.
- **Gain to manufacturers and exporters**: The increased competitiveness of Indian industry in the international market will give boost to Indian exports. GST is estimated to increase the GDP growth by 1.5 to 2%.

For Central and State Governments

- **Simple and easy to administer**: Multiple indirect taxes at the Central and State levels are being replaced by GST. Backed with a robust end-to-end IT system, GST would be simpler and easier to administer than all other indirect taxes of the Centre and State levied so far.

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- **Better controls on leakage**: GST will result in better tax compliance due to a robust IT infrastructure. Due to the seamless transfer of input tax credit from one stage to another in the chain of value addition, there is an in-built mechanism in the design of GST that would incentivize tax compliance by traders.
- **Higher revenue efficiency**: GST is expected to decrease the cost of collection of tax revenues of the Government, and will therefore, lead to higher revenue efficiency.
- It would **lower tax evasion by the self-policing feature** of tax being levied on the value added to a good or service. Also with dual administrative control – Centre and States – the tax evasion may minimize.

For the consumer

- **Single and transparent tax proportionate to the value of goods and services**: Due to multiple indirect taxes being levied by the Centre and State, with incomplete or no input tax credits available at progressive stages of value addition, the cost of most goods and services in the country today are laden with many hidden taxes. Under GST, there would be only one tax from the manufacturer to the consumer, leading to transparency of taxes paid to the final consumer.
- **Relief in overall tax burden**: Because of efficiency gains and prevention of leakages, the overall tax burden on most commodities will come down, which will benefit consumers.

Significance

- It would mitigate the ill effects of cascading along with removing multiplicity of taxes thus **lowering costs, improving competitiveness and improving liquidity of the businesses**.
- It would **improve revenue buoyancy by widening the tax base** and improving the taxpayer compliance.
- GST is largely technology driven and therefore will **reduce the human interface leading to speedy decisions**.

8.2. The Direct Taxes Code Bill, 2010

Though, the Direct Taxes Code Bill, 2000 has lapsed in the Parliament, such a legislation is desirable. Presently, the taxation of the income of individuals, companies and other entities is governed by the Income Tax Act, 1961. The Act specifies the entities to be taxed, the kinds of incomes subject to tax (or exempt from tax), and the tax rates to be imposed on them. It lays out a system by which taxes are to be assessed and collected and specifies a procedure by which disputes with tax authorities are to be addressed. The process of taxing the wealth of individuals and other entities is governed by the Wealth Tax Act, 1957. Changes to income and wealth tax (including tax rates) are introduced in Parliament in the form of an annual Finance Bill which amends the Income Tax Act and the Wealth Tax Act.

The Direct Taxes Code Bill seeks to consolidate and simplify the language and structure of the direct tax laws. The Bill will replace the Income Tax Act, 1961 and the Wealth Tax Act, 1957. The Draft Code proposes a number of changes in the way income is taxed under the Income Tax Act. The Discussion Paper released with the Draft Code states the following reasons for introducing the Draft Code:

1. Widening of the tax base by (a) removing exemptions, (b) reducing ambiguities in the law, and (c) preventing tax evasion which leads to erosion of the tax base;
2. Remove deductions and exemptions as these reduce efficiency and distort economic behaviour.

To implement these principles, a number of changes were made to the existing tax rates, available deductions and exemptions, and tax administration in the Draft Code. Key features of the bill are:

Student Notes:

Tax on Individuals

The Bill retains the rates of income tax at 10%, 20% and 30%. It widens the slabs:

- income up to Rs 2 lakh will be tax exempt;
- income between Rs 2 lakh and Rs 5 lakh will be taxed at 10%; and
- income between Rs 5 lakh and Rs 10 lakh will be taxed at 20% and income above Rs 10 lakh will be taxed at 30%.

Senior citizens will be exempt from tax for income up to Rs 2.5 lakh. Most existing exemptions and deductions for individuals have been retained. The Bill specifically taxes any income from a "controlled foreign company" set up by Indian residents in a foreign country with the purpose of paying lower taxes.

Tax on Businesses

- Most tax deductions, such as those offered on export profits, will be removed. In some cases, existing units can continue to avail of incentives currently offered for the period that was originally specified (i.e. grandfathered). New units however, will be offered only incentives available in the Code.
- The Bill does away with a number of tax incentives in the Act and introduces investment linked incentives for sectors such as SEZ development, power, oil and natural gas exploration and cold chains. That is, cumulative profits up to the amount of capital investment will be eligible for exemption. Certain incentives existing under the Act will be grandfathered.
- The Bill states that income from separate businesses shall be computed differently. A business shall be distinct if there is no connection or interdependence between the businesses, or if they are at different locations.
- The Act also prevented business losses to be carried forward for more than eight years. The Bill allows losses to be carried forward indefinitely.
- In the Act, Indian companies are treated as residents. Non-Indian companies are resident if control or management is wholly in India. According to the Bill any non-Indian company is treated as resident if its place of effective management is in India.

The Bill removes a number of deductions and exemptions which could lead to a rise in revenue. At the same time income tax slabs have been widened, which could lead to a decrease in tax collections. There is no information available in the public domain which shows the net impact on revenue of these proposals. Therefore, it is not possible to estimate whether there will be an increase or decrease in the government's revenue collection under the Bill.

9. Miscellaneous

9.1. Tax Terrorism

In any taxation system, the government's intent is to maximize revenue, whereas taxpayers look for low tax rates and rules that are easy to comply. However, when government puts illegal and extra-legal pressure on taxpayers to extract more tax from honest taxpayer, this enthusiasm of government is referred to as tax terrorism.

Examples of tax terrorism:

- Enforcing the tax law on the general public in a harsh manner with taxman perceiving every transaction with suspicion.
- Retrospectively amending the Income-tax Act, 1961 affecting business confidence in the country.
- Imposition of Tax targets on Tax Inspectors
- Denying refunds or passing adverse adjudication orders in the name of realizing target of revenue.
- General Anti Avoidance Rule (GAAR)

Student Notes:

9.2. Tax Evasion and Tax Avoidance

Tax evasion is the illegal practice of not paying taxes, by not reporting income, reporting expenses not legally allowed, or by not paying taxes owed. It is considered tax evasion if you knowingly fail to report income.

Tax avoidance is the legitimate minimizing of taxes, using methods approved by the government. Businesses avoid taxes by taking all legitimate deductions and by sheltering income from taxes through better tax planning. It involves making use of the loopholes in tax laws to one's own advantages to reduce the tax burden. Unlike Tax evasion, tax avoidance is legal practice. However, it is unadvisable as the taxpayer has defeated the intention of law maker and used this to his own advantage.

9.3. Tax Havens

A tax haven is a country that offers foreign individuals and businesses low or zero tax rate, politically and economically stable environment, and with little or no financial information sharing with foreign tax authorities. Such countries include Andorra, Cayman Islands, British Virgin Island, etc.

Tax havens do not require individuals to reside in or businesses to operate out of their countries. Due to the globalization of business operations, an increasing number of Multi-National Companies (MNCs), are keeping cash in offshore tax havens to minimize corporate taxes.

10. Previous Years UPSC Mains questions

1. Discuss the rationale for introducing Goods and Services Tax (GST) in India. Bring out critically the reasons for the delay in roll out for its regime.
2. What were the reasons for the introduction of Fiscal Responsibility and Budget Management (FRBM) Act, 2003? Discuss critically its salient features and their effectiveness.
3. What is meaning of the term tax-expenditure? Taking housing sector as an example, discuss how it influences budgetary policies of the government.
4. What is Laffer Curve?
5. What is twin deficit?
6. What are the hurdles faced by the Finance Ministers of India in keeping the fiscal deficit below 3-4 per cent of the GDP? Suggest steps to lower the fiscal deficit.
7. Does reduction in fiscal deficit necessarily assure reduction in inflation?
8. In a developing country like ours what according to you, should be the basis of taxation-income or consumption? Spell out your arguments clearly.
9. What is fiscal drag? What is its effect?

11. Vision IAS GS Mains Test Series Questions

1. ***It is important for India to return to the path of fiscal consolidation while also increasing public investment. Explain why achieving both these objectives are important to revive the present economic environment in the country.***

Approach:

- Defining fiscal consolidation, discuss its significance for economic stability.
- Discuss the significance of public investment.
- Discuss the underlying challenges in balancing the two and suggest measures for the same.

Answer:

Student Notes:

Fiscal consolidation (FC) means reducing fiscal deficit (FD) by reducing public expenditure and/or increasing the revenue. The aim is to discipline the public finances and is enjoined by the FRBM Act, 2003 (which intends to cap the Fiscal deficit to 3% of GDP). Public investment means committing public money to various socio-economic objectives. It is often seen that public investment is curtailed to cater the needs of fiscal consolidation. Both these objectives have been contested, with arguments on both the sides.

Fiscal Consolidation (FC)

A. Significance

- Large FD means government as the major borrower leaving private sector short of credit for investment.
- High FD adds to interest burden on the government, thereby diverting the money from productive sectors. At present, interest payments at the Union level, account for almost 50% of their net tax revenues.
- High FD increases the interest rates in the economy, thereby fuels inflation.

Therefore, the importance of FC can't be overstated. Hence, the credit rating agencies consider FD as an important variable to assess the credit worthiness of an economy.

B. Argument against

During economic slowdown, the government has to incur deficit to boost the economy. When the aggregate demand is already low, adhering to the path of FC is counter-productive. For example, during 2008 crisis we have to abandon the targets under FRBM Act. To look into this issue further, NK Singh Committee has been set up by Finance Ministry.

Public Investment

A. Significance

- Public investment in productive sectors acts as the stimulator, fueling demand and hence growth in the economy. It is particularly important in current scenario of sluggish growth.
- At present, capital expenditures is merely 1.7% of GDP which means lesser future growth. Public investment in infrastructure would boost future growth and consumption in the present.
- It has domino effect as it crowds in the private investment, which, at present, is significantly depressed.
- Private investment is volatile and it being majorly in form of FDI and FII is prone to global risks and hence more volatile.
- Private investment in India has been in capital intensive sectors like services. Hence, to boost employment growth public investment is needed.
- Public investment is necessary to bridge the sectoral and regional inequalities.

B. Challenges

- Increased public investment may crowd out private investment.
- It is difficult to mobilize resources for investment in current slowdown.

Way forward

We have to find balance between these apparently conflicting objectives as under:

- Reprioritize expenditure, with greater focus on the productive capital expenditure and reducing revenue expenditure.

Student Notes:

- Rationalize subsidies to increase fiscal space.
- Divest government's stakes held in specified PSUs and utilize these resources for capital investment.
- In line with Vijay Kelkar Committee's report on PPP, we should resolve the stuck investment projects and revive the PPPs.
- As suggested by FFC, there should be an independent Fiscal Council to monitor the implementation of fiscal rules by the government.
- The implementation of a well-designed Goods and Services Tax (GST) and other tax reforms would also play the crucial role in enhancing revenues.
- Exploring feasibility of having a 'fiscal deficit range' as the target in place of the existing fixed numbers (percentage of GDP) as fiscal deficit target.

2. It is argued that India's fiscal centre of gravity has rapidly shifted from the Centre to the States. Analyse the statement in context of the debate on fiscal discipline. Also, enumerate the key recommendations of the N.K. Singh panel on Fiscal Responsibility and Budget Management Act.

Approach:

- Explain how India's fiscal centre of gravity has rapidly shifted from the Centre to the States.
- Mention the status of fiscal discipline of the states and the reasons behind it.
- Enumerate recommendations of the N. K. Singh panel.

Answer:

Centre's fiscal discipline is often subjected to intense public scrutiny. This belies the fact that India's fiscal centre of gravity has rapidly shifted from the Centre to the States, as at present, the State Governments account for about 60% of total government expenditure.

The Fiscal Responsibility and Budget Management (FRBM) Rules in the last decade helped State Governments improve their fiscal performance significantly. According to the Fourteenth Finance Commission (FFC), the Gross Fiscal Deficit of the States came down from the level of 3.3% of GDP in 2004-05 to 2.4% of GDP in 2014-15. During the same period, the Centre was unable to meet its fiscal targets. However, the situation seems to have reversed with Centre showing more fiscal discipline and States showing less fiscal prudence due to:

- **Rise in expenditure**: States' fiscal deficit is rising because of a rise in current expenditure. This trend is expected to continue due to implementation of the 7^{th} Pay Commission Report, under-provisioning of interest payment for schemes such as Ujwal DISCOM Assurance Yojna (UDAY).
- **Lack of capacity:** States need to build their administrative capacity to check wastage and pilferage at the implementation level.
- **Populist measures** such as Farm-loan waivers undertaken in different states. **Increasing states' borrowings**: if the current trend continues, by Financial Year 19, states' market borrowings would exceed that of the Centre's borrowings.

Ideally, fiscal condition of the States should have improved due to increased States' share in union taxes from 32% to 42% in line with the Finance Commission recommendations. However, this is not the case.

In this light, the key recommendations of the N.K. Singh panel on Fiscal Responsibility and Budget Management Act are:

- **Debt Management and Fiscal Responsibility Bill, 2017** to replace the Fiscal Responsibility and Budget Management Act, 2003 (FRBM Act).

Student Notes:

- **Debt to GDP ratio**: It suggested using debt as the primary target for fiscal policy instead of fiscal deficit. A debt to GDP ratio of 60% should be targeted & achieved by 2023.
- **Fiscal Council**: It proposed to create an autonomous Fiscal Council with a role of preparing multi-year fiscal forecasts, improving quality of fiscal data, advising the government if conditions exist to deviate from the fiscal target, and advising the government to take corrective action in case of non-compliance.
- **Deviations**: It suggested that grounds on which the government can deviate from the targets should be clearly specified with no scope of adding further exceptions.
- **Debt trajectory for individual states**: 15th Finance Commission should be asked to recommend the debt trajectory for individual states.
- **Borrowings from the RBI** by the government should be done only under certain circumstances. Fiscal indiscipline causes crowding out of private investment due to increase in cost of borrowings and diminishes chances of credit-ratings upgrade. Thus, the issue of state governments managing their finances deserves very serious attention and priority action.

3. Successive Finance Commissions have tried to balance the twin issues of fiscal discipline and regional disparities. Yet, they have been criticized by both the rich and poor states for neglecting their needs. Discuss. How far has the 14th Finance Commission been able to address this issue?

Approach:

- Briefly discuss the methodology of vertical and horizontal resource allocation used by Finance Commissions.
- Bring out the criticism by the states of the resource allocation.
- Mention the recommendations of the 14th Finance Commission in this regard.
- Discuss to what extent FC has been successful in addressing this issue.

Answer:

Finance Commission is the balancing wheel of the fiscal federalism in India. Most commissions have allocated the resources between the states on more or less the following criteria: Population, Area, Fiscal Capacity Distance (Difference in the per capita income etc.), Fiscal Discipline and Tax Effort. The first three can be categorized as equity criteria (82.5 percent weight) while the last two as efficiency criteria (17.5 percent weight).

States performing well feel that they are being punished for showing higher growth and fiscal discipline and their revenue is being diverted to poorer states lacking fiscal discipline and policy vision for development. While poorer states demand more as they are not able to get private sector investment because of backwardness and are stuck in a vicious. States also complain about lesser share to states from the central tax pool and devolution of funds by states to local bodies.

14th FC has recommended some major changes having centre-state and interstate fiscal ramifications, which have been accepted by the government. Prominent amongst them are:

- Change in the criteria for horizontal resource allocation. 7.5%: Forest cover, 17.5%: Population, 15%: Area, 10%: Demographic change, 50%: Income distance. Thus, financial efficiency has been omitted. Because of forest cover criteria poor states in plains having minimal forest cover are going to lose their percent share. Meanwhile, 19 states stand to gain from the new arrangement, which include north-eastern states and tribal states. Thus, it has positively benefited

Student Notes:

underdeveloped hilly and tribal states but negatively impacted poor states in the plains.

- 42% share to states in the divisible tax pool. With greater devolution all the states will have greater fiscal resources at their disposal that can be used in their development programme. Moreover, it will ease the implementation of tax reform of GST Bill where the states fear a loss of revenue.
- The Commission has recommended devolution of higher resources to the local bodies directly by the center. Separate allocation of funds to local bodies will unburden state governments which can use its resources elsewhere.
- It has identified 30 centrally sponsored schemes (CCS) for transfer to the states. However, due to importance of the schemes and legal obligations, only 8 CCS would be delinked from support from the centre. With CSS being transferred to the states, states will have greater flexibility in operating these schemes and grudge of states regarding unilateral action by centre is going to be resolved.

These recommendations have lot of positives regarding hilly and tribal states, local bodies and autonomy of states. However, the developmental disparity and fiscal discipline issues still remain unresolved. With greater dependence on central taxes, fluctuation in tax revenue of centre will impact the fiscal health of states. With fiscal discipline becoming unimportant in funds allocation, the better performing states will tend to lose while poor performers will not be penalized. The criterion of forest cover should be implemented with greater flexibility for populous and poor states of the plains have little chance to improve upon these criteria and will continue to lose. Such improvisation needs to be made in the implementation of recommendations to create a balance between the fiscal discipline and developmental disparity.

4. ***What are the objectives of public debt management in India? Examine the rationale for setting up an independent agency to manage government debt. Also highlight the issues that need to be addressed to ensure successful debt management by an agency other than the RBI.***

Approach:

- Introduction should briefly define the concept of public debt management.
- Further, delineate the objectives of public debt management in India.
- Next part of the answer should examine the reasons for setting up of an independent agency to manage government debt.
- Finally, bring out issues that need to be addressed for success of independent authority for debt management.

Answer:

Public debt management is the process of establishing and executing a strategy for managing the government's debt in order to raise the required amount of funding, achieve its risk and cost objectives. Policy paper of the Ministry of Finance in 2010 stated that the overall objective of the Central Government's debt management policy is to:

- meet Government's financing needs at the lowest possible long term borrowing costs and
- to keep the total debt within sustainable levels.
- support development of a well-functioning and vibrant domestic bond market.

Recently Government has planned to relieve RBI of Public Debt Management role and is planning to bring in Public Debt Management Agency (PDMA) in two years' time. The rationale behind such a move can be understood as following:

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- Bringing together all government borrowings under one roof is propagated as a key reason for the creation of an independent PDMA. At present, the RBI is responsible for all internal debt management functions, while external debt falls under the purview of the Department of Economic Affairs under the Ministry of Finance (MoF).
- A separate agency, which assigns specific responsibilities and is accountable on its own, will lead to a more transparent and efficient system. This is seen as a necessary step towards deepening of the bond market.
- It would resolve the conflict of interest that arises when the RBI manages the government's debt, as it leads to a conflict of interest with its role as monetary authority working to contain inflation and ensure financial stability.
- Separation of debt management will allow the central bank to focus on monetary policy of setting short terms interest rates. It would relieve the RBI of the burden of contending with twin incentives pulling in opposite directions in scenarios such as when rising inflation demands an increase in policy rates but the government wants takers for its debt offered at lower rate.

Countries like US and UK have an independent debt management office.

Though it is a welcome move, there are certain challenges that need to be addressed to ensure successful debt management by an agency other than RBI-

- A full fledge PDMA will require amendments to the RBI Act, and that might delay the procedure.
- Fears of market volatility caused by the shifting of responsibility to a new agency needs to be addressed.
- Government debt although largely domestically held, is one of the highest among the Emerging Markets and with nominal growth rate not keeping pace with nominal interest rates, debt-GDP ratio will rise.
- With new investments conspicuous by their absence and the export outlook unexciting, the government understandably wants to lend recovery a helping hand. But if higher public spending is not accompanied by higher revenues, fiscal and primary deficits will increase, stoking government debt.
- Chance of demand supply mismatch in government bond and higher government borrowing may crowd out private investment. Hence, the challenge of remaining independent and coordinating with RBI needs to be resolved for the success of the new agency.

Student Notes:

INFLATION

Contents

Student Notes:

1. Definition of Inflation

Inflation refers to a sustained rise in the general price level in the economy and a fall in purchasing power of money over a period of time. In simple words, inflation refers to rise in average price level of most of goods and service in an economy.

2. Types of Inflation (on the basis of rate of inflation)

Creeping Inflation occurs when the inflation rate is in the range of 1% to 5%. Such inflation erodes the purchasing power of money, but is referred to as manageable and sometimes inevitable in a growing economy.

Trotting Inflation on the other hand lies in the range of 5% to 10%, which if not controlled properly may lead to *"galloping inflation"* at a rate of 10% to 20% annually. This galloping inflation may worsen into *"runaway inflation"* too.

Hyper Inflation: This form of inflation is out of control, which might have the annual rate in million or even trillion. In such inflation not only the range of increase is very large, but the increase takes place in a very short span of time, prices shoot up overnight. It rapidly reduces the value of currency to the extent that government thinks to adopt a new currency. One of the most famous examples of hyperinflation occurred in Germany between January 1922 and November 1923. Among the recent examples, the one experienced in Zimbabwe in 2008 is a prominent one.

3. Types of Inflation (based on causes)

Demand Pull Inflation: This type of inflation is caused by increase in demand and when the demand in the economy outgrows the supply in the economy. This kind of inflation can be described by "too much money chasing too few goods". One of the reasons for demand pull inflation can be the increase in money supply, by way of increased salary, increased government expenditure etc.

Cost-push inflation: It is also referred to as supply shock inflation. Such inflation occurs due to reduced supplies because of increased prices of inputs. For example, an increase in price of international crude oil adversely affects the inputs of almost all the items in a country like India, which neither has alternatives to oil for energy needs nor has significant amount of domestic oil production.

Structural Inflation: This type of inflation is also called as bottleneck inflation. Such an inflation is built into the economic system due to government policies. Such inflation occurs from time to time because of weather and seasonal conditions or due to supply side constraints, leading to shortage of supply in goods and services. Inflation in India is largely due to structural factors. For example, large number of intermediaries between farmer and final consumer in India; changing dietary patterns without commensurate increase in the supply of demanded goods.

4. Associated Terms

Stagflation: Stagflation refers to a situation in an economy when inflation and unemployment both are at high levels i.e. a combination of high inflation and low growth. Such a situation occurs when the inflation may have gone on for a long period and resultantly affected the input prices as well as the demand for goods and services in the economy.

Deflation: This is nothing but the completely opposite of inflation as there is a fall in the general price levels in the economy over a period of time. Deflation occurs when the inflation rate falls below 0% (where inflation is in negative territory). This should not be confused with *disinflation*, which implies slow-down in the inflation rate only (where inflation is in declining trajectory but remains positive). Following the Asian financial crisis in late 1997, Hong Kong experienced a long period of deflation which did not end until the end of 2004.

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Recession: It is a situation which is characterized by negative growth rate of GDP in two successive quarters. Some of the indicators of a recession include slowdown in the economy, fall in investments, fall in the output of the economy etc.

Depression: It is an extreme form of recession and characterizes a situation in which the recession may have gone on for too long resulting in depression in the economy. ***A common rule of thumb for recession is two quarters of negative GDP growth. The corresponding rule of thumb for a depression is a 10 percent decline in gross domestic product (GDP).*** Some of the indicators of a depression are huge fall in demand and consumption of goods and services, shattering of business confidence, a sharp decline in the output of the economy and investments. One of the examples of depression is the great depression of 1930s.

Inflation Spiral: An inflationary situation in an economy, which results out of a process of wage and price interaction 'when wages press prices up and prices pull wages up', is known as the inflationary spiral. It is also known as the wage-price spiral. This wage-price interaction was seen as a plausible cause of inflation in the year 1935 in the US economy, for the first time.

Reflation: Reflation is a situation often deliberately brought by the government to reduce unemployment and increase demand by going for higher levels of economic growth. Governments go for higher public expenditures, tax cuts, interest rate cuts, etc. Fiscal deficit rises, extra money is generally printed at higher level of growth, wages increase and there is almost no improvement in unemployment. Reflation can also be understood from a different angle—when the economy is crossing a cycle of recession (low inflation, high unemployment, low demand, etc.) and government takes some economic policy decisions to revive the economy from recession, certain goods see sudden and temporary increase in their prices, such price rise is also known as reflation.

5. Causes of Inflation

Inflation primarily occurs due to two sets of factors, the demand-pull factors and the cost-push factors. Both of them have been explained below in detail:

a) **Demand Pull factors:** These are those set of factors due to which there may be an increase in the demand of goods and services in the economy.
   Some of them are:
   - (i) **Increase in government expenditure:** Increased government expenditure results in increased demand for goods and services and consequent increase in prices. This is because increased government expenditure results in putting large money in the hands of public, thereby putting to effect too much money chasing too few goods. And if the production capacity is not able to meet the increasing demand it results in inflation. The Government may also print new money to meet its expenditure, which has the highest effect on inflation of all the factors. This was the reason it was banned post the FRBMA Act 2003.
   - (ii) **Rising population:** Increasing population also acts as an important factor in pushing up prices because of increased demand especially when the supply is unable to meet the demand.
   - (iii) **Black Money:** A large part of the black money is used in buying and selling of real estate in urban areas, extensive hoarding and black marketing in essential wage goods, such as cereals, pulses, etc. Black money, therefore, fuels demands and leads to rise in prices.
   - (iv) **Changing consumption patterns:** One theory that was put forward by senior officials at the Reserve Bank of India (RBI) is that the inflation problem in India has its roots in a sharp increase in demand for certain food items that people eat more frequently as income rises. One example is protein-rich food. Increased consumption of pulses, eggs, fish and poultry were apparently driving up their prices in the economy.

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(v) **Increased wages:** When the general wages increase, they have the effect of increasing demand in the economy because of increased money supply.

b) **Cost- Push Factors:**

(i) **Rise in wages:** At times rise in wages, if greater than rise in productivity, increases the costs therefore increasing the prices too.

(ii) **Increase in indirect taxes** also leads to cost side inflation. Taxes such as custom and excise duty raise the cost of production as these taxes are levied on commodities.

(iii) **Increase in administered prices** such as the MSP (Minimum Support Price) for the food grains, petroleum products etc. also leads to inflation as they have a huge share in budget of common citizens.

(iv) **Infrastructural bottlenecks:** Infrastructural bottlenecks such as the lack of proper roads, electricity, water etc. raise per unit cost of production. This is one of the prime reasons for inflation in the context of Indian economy.

(v) **Fluctuation due to seasonal and cyclical reasons:** Owing to events such as failed monsoons there is a drop in agricultural productivity, which inevitably results in inflation at times.

c) **Miscellaneous Factors:**

Apart from the above, there are several other factors that lead to inflation in the economy. Some of them have been listed below.

(i) Rise in price of international commodities such as edible oil, crude oil etc.

(ii) Huge number of middlemen and large amounts of money siphoned off as profits by them.

(iii) Cartelization practices as adopted by some of the traders in the Indian economy thereby harming the interests of the consumers.

(iv) Huge dependence on import of crude oil for meeting the energy demands of the economy.

(v) Prolonged industrial unrest, which results in reduction of production capacity.

6. Impact of Inflation

Inflation impacts economy in many ways, some of them have been listed below:

1. **Recession in some of the sectors:** Because of the increase in prices of certain goods, their demand goes down and results in recession in some of the sectors of the economy.
2. **Adversely impacts the wage earners:** Inflation adversely impacts the wage earners as their purchasing power goes down but wages remain constant. On the other hand, it helps the businessmen, as their profits tend to go up because of rise in prices.
3. **Creates distortions in production patterns:** Because of inflation, capital resources get diverted from long term to short term uses and production shifts from essential to non-essential goods in the economy.
4. **Impact growth and availability of credit for industry:** More often than not, the interest rates are raised to curb the inflation in the economy. This results in credit crunch for the industry thereby impacting the growth of the economy. The recent spell of inflation in India in last few years has witnessed this trend.
5. **Impacts exports:** Inflation discourages exports because the foreign importers find manufactured goods costlier; and domestic sales are attractive for the manufactures. All this adversely affects the Balance of Payments. For example, recently Indian economy witnessed one of the highest Current Account Deficit, accompanied by high inflation.
6. **Impacts imports:** Inflation in domestic economy increases imports as the imported goods may be cheaper than the domestically produced. This has the potential to increase the Current Account Deficit.
7. **Adverse effect on Foreign Exchange:** With low exports and increased imports due to inflation, the demand of foreign currency increases. This has the effect of depreciation of

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domestic economy. For example, Indian Rupee saw the largest depreciation in recent times, accompanied by high inflation.

8. **Discourage savings:** Because of decreasing value of money and uncertainty in the long run, higher inflation depletes the saving rate in an economy.
9. **Creates unequal distribution of incomes:** Inflation increases the nominal (face) value of the wages while their real value falls. That is why there is a negative impact of inflation on the purchasing power and living standard of the wage employees. Thus making the poor poorer. During inflationary times, the speculators and the black marketers earn income by hoarding the stocks etc. and because of the artificial scarcity, people have to pay more to get the goods and consequently the distribution of income becomes imbalanced and the money goes to traders.
10. **Breeds corruption**: Inflation mars incentive for hard and honest work, since a common man cannot meet rising expenses with a constant income. It also encourages practices such black marketeering, hoarding etc.
11. **Increased Fiscal Deficit:** Inflation can also make borrowings by the government costlier thereby raising the fiscal deficit.

7. Measures to Curb Inflation and their Limitations

Monetary, fiscal and administrative measures are taken to control inflation to an optimal level in the economy.

a) Monetary Measures

This type of measures are taken by the Central Bank of the country (RBI in case of India) through Monetary Policy. The principal tool under this method is regulating the interest rate in the economy. Since it has the effect of regulating the liquidity in the economy therefore it can be used only to control the demand-pull inflation. It is discussed as under:

(i) The RBI may take recourse to tighter monetary policy to cool down the demand-pull. For example, the RBI may increase the bank rates/repo rates etc. to curb the supply of money in the market.
(ii) RBI may also use qualitative control methods, such as raising margin on loans for commodities for which traders have a tendency to speculate and hoard.
(iii) Reserve Bank may also resort to other operations such as the Open Market Operations to mop out the liquidity from the market by selling government securities and bonds.

Limitations of Monetary Measures in curbing inflation:

(i) It is not much successful if the inflation is caused due to cost-push factor.
(ii) Another issue, which is important in a country like India, is the large presence of unorganized banking. Because of this RBI is not able to control a large part of the banking sector in the economy.
(iii) High interest rate to curb inflation has the effect of throttling the flow of credit to the productive sectors of the economy. As a result, the economic growth may have to be compromised. This has been the persistent problem in Indian economy in the last few years.

b) Fiscal Measures

These measures are implemented by way of Fiscal Policy, popularly called annual Budget. The government can take two routes to bring down the prices under this method:
(a) It can **cut down its own spending** on various schemes, projects etc.
(b) It can **increase the taxes** (either direct or indirect).
As far as the first option is concerned most of the governments across the world do not employ this method for two simple reasons, first they cannot suddenly reduce the money, which is being spent on several critical projects pertaining to infrastructure etc. as it would not only bring down the image of the country but also create a negative market sentiment.

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Secondly, if they cut down spending on several important welfare schemes etc. then it may politically harm them in the next elections. So cutting down government expenditure is not considered feasible.

The second method is raising the taxes to discourage spending. The government may increase the private direct taxes to reduce the incomes and thereby decreasing the consumption tendencies among the public. It may also increase the indirect taxes on commodities, raising their prices and thereby discouraging spending on them by the public.

But the limitation of this move is that it takes some time to give effect, because the fiscal policy is implemented on annual basis.

c) **Administrative Measures:**
These measures are implemented by the administrative agencies. Since, both monetary policy and fiscal policy have their inherent limitations and operate with a lag, therefore, it is important for the government to take certain administrative measures to curb down inflation. Some of administrative measures are discussed below:
- **(i)** Banning of exports of certain items such as edible oils, onions and pulses.
- **(ii)** Imposing a temporary ban on trading on futures in some of the essential commodities.
- **(iii)** The government can also work towards strengthening of the PDS to reduce leakages, the Chhattisgarh PDS model is a perfect example of how government can reform the PDS and significantly affect the price levels in the market and at fair price shops
- **(iv)** Government also needs to ensure raiding of the warehouse of essential commodities to dig out the hoarded stocks with the hoarders.

These measures also have their own limitations in that they can curb inflation only on short term basis. They do not have significant effect on checking the demand-pull or cost-push inflation. These steps are taken to provide immediate respite to the people.

Therefore, for effective control a combination of these measures is adopted. One of which is the policy of **Inflation Targeting,** which would be discussed later in this document.

8. Measures of Inflation

Changes in the price of goods and services in the economy are calculated by using various price indices in India such as the WPI, CPI etc. One feature common to all the price indices is the use of "base year", which is a particular year used as a reference to calculate the price rise in a particular year. For example, the base year for All-India Wholesale Price index (WPI) has been revised from 2004-05 to 2011-12 recently.

8.1. Inflation measurement based on period

- ***Annual Average Inflation Rate***: It is the average of inflation rate in the last 52 weeks.
- ***Point to Point Inflation Rate***: It reflects the changes in the inflation rate between a particular week of the last year and the same week of the current year. For example, the changes in inflation rate in 36th week of current year and the same week last year.

8.2. GDP Deflator

This is the ratio between GDP at Current Prices and GDP at Constant Prices. If GDP at Current Prices is equal to the GDP at Constant Prices, GDP deflator will be 1, implying no change in price level. If GDP deflator is found to be 2, it implies rise in price level by a factor of 2, and if GDP deflator is found to be 4, it implies a rise in price level by a factor of 4. GDP deflator is acclaimed as a better measure of price behavior because it covers all goods and services produced in the country.

Student Notes:

8.3. Wholesale Price Index (WPI)

Inflation calculated on the basis of Wholesale Price Index is also called as the **"headline inflation"**. Headline inflation in India is measured in terms of Wholesale Price Index (WPI) and the Office of the Economic Adviser, Department of Industrial Policy & Promotion is entrusted with the task of releasing this index. WPI is an important statistical indicator, as various policy decisions of the Government, like inflation management, monitoring of prices of essential commodities etc., are based on it. Even though WPI was prepared on a weekly basis for a number of decades, India shifted to monthly calculation of the WPI in 2009.

The Government periodically reviews and revises the base year of the macroeconomic indicators as a regular exercise to capture structural changes in the economy and improve the quality, coverage and representativeness of the indices. In this direction, the base year of All-India WPI has been revised from 2004-05 to 2011-12 by the Office of Economic Advisor (OEA), Department of Industrial Policy and Promotion, Ministry of Commerce and Industry to align it with the base year of other macroeconomic indicators like the Gross Domestic Product (GDP) and Index of Industrial Production (IIP).

The Wholesale Price Index (WPI) series in India has undergone six revisions in 1952-53, 1961-62, 1970-71, 1981-82, 1993-94 and 2004-05 so far.

The current series is the seventh revision. The revision entails shifting the base year to 2011-12 from 2004-05 changing the basket of commodities and assigning new weights to the commodities. It has generally been the practice to undertake the revisions on the advice of a Working Group constituted each time. For the new series with base 2011-12=100, a Working Group was constituted on 19th March 2012 chaired by Late Dr. Saumitra Chaudhuri, Member, erstwhile Planning Commission and comprised most stakeholders.

Key Highlights

In the revised series, WPI will continue to constitute three Major Groups,namely Primary Articles, Fuel & Power and Manufactured Products.

Highlights of the changes introduced in the new series are summarized below:

- Updated item basket and weighting structure conforming to the structure of economy in 2011-12.
- Increase in number of items from 676 to 697. In all 199 new items have been added and 146 old items have been dropped.
- The new series is more representative with increase in number of quotations from 5482 to 8331, an increase by 2849 quotations (52%).

New Features

- In the new series of WPI, prices used for compilation do not include indirect taxes in order to remove impact of fiscal policy. This is in consonance with international practices and will make the new WPI conceptually closer to 'Producer Price Index'.
- A new "WPI Food Index" will be compiled to capture the rate of inflation in food items. This is being compiled combining the "Food Articles" under "Primary Articles" and "Food Products" under "Manufactured Products". Together with the Consumer Food Price Index released by Central Statistics Office, this would help monitor the price situation of food items better.
- Seasonality of fruits and vegetables has been updated to account for more months as these are now available for longer duration.
- Item level aggregates for new WPI are compiled using Geometric Mean (GM) following internationalbest practice and as is currently used for compilation of All India CPI.
- A high level Technical Review Committee has been set up for the first time to carry out dynamic review process in order to keep pace with the changing structure of the economy.

Student Notes:

- Under the new series of WPI, weight of manufactured items has decreased to 64.2 per cent from 64.9 per cent in old series. Similarly, the weight of fuel and power has decreased to 13.1 per cent from 14.9 per cent. On the other hand, the weight of primary items have increased to 22.6 per cent from 20.1 per cent.

Need of New Series and Analysis

This move was long overdue as it will bring all the key macroeconomic indicators—IIP, WPI, CPI (Consumer Price Index), national accounts—on a common base of 2011-12, making the comparisons easier. The old series being used has become obsolete, part of the basket is no longer in consumption, many of the contemporary products are not being covered by it and many products are under weighed. Analysts believe that the series with a new base year would be more comprehensive in nature.

However, analysts believe that though the new series will be able to capture the current state of affairs of the economy by replacing the old basket of goods with a contemporary one, but it will still not be able to reduce the volatility in the indices.

Nevertheless, it must be said that volatility in itself is mostly a real life problem and not a statistical problem. If it's a real life problem then data should capture and change in base year will not make much difference. Further, it is believed that the new basket of goods would bridge some kind of gap which persists between the WPI and CPI numbers.

Limitations of WPI

- It doesn't include services such as health, education, transport, finances etc.
- Doesn't account for the products of the unorganized sector in India, which account for more than 30 percent of the manufactured output of the Indian economy.
- Since the collection of prices is on voluntary basis, the flow of price data, especially from manufacturing units, becomes irregular leading to problems in compilation of Wholesale price index. While in case of CPI data collection is done by NSSO official surveys.
- It reflects the price movement at wholesale level, thereby not reflecting the retail prices at which price goods are bought by the final consumer.

It was for this reason, the RBI has started using CPI for "inflation targeting" as recommended by Urjit Patel Committee.

Importance of WPI

- Monitors the dynamic movement of prices.
- It helps design trade, fiscal and other economic policies.
- In the business contract it is used to calculate price escalation clauses in the supply of raw materials, machinery and construction work.

8.4. Consumer Price Index (CPI)

Apart from the WPI, inflation in India is calculated at the consumer level also by the means of CPI. Because the wide disparities in the consumption baskets for different segment of consumers, India had not been able to evolve a single and a comprehensive consumer price index for a long time. The four CPIs adopted by India are:

CPI (Industrial Workers): The Consumer Price Index for the industrial workers (CPI-IW) has 260 items (plus the services) in its basket with 2001 as the base year (the first base year was 1958–59). The data is collected at 76 centres with one month's frequency and the index has a time lag of one month. It contains 120–160 commodities in its basket. Basically, this index specifies the government employees (other than banks' and embassies' personnel). The wages/salaries of the central government employees are revised on the basis of the changes occurring in this index, the dearness allowance (DA) is announced ***twice*** a year. When the Pay Commissions recommend pay revisions, the base is the CPI (IW).

Student Notes:

CPI (Urban Non- Manual Employees): The Consumer Price Index for the Urban Non-Manual Employees (CPI-UNME) has 1984–85 as the base year and 146–365 commodities in the basket for which data is collected monthly with two weeks' time lag.

This index depicts the changes in the level of average retail prices of goods and services consumed by the urban segment of the population. The target group of this index was urban families who derived major portion of their income from non manual occupations in the non-agricultural sector.

This price index has limited use and is basically used for determining dearness allowances (DAs) of employees of some foreign companies operating in India (i.e. airlines, communications, banking, insurance, embassies, and other financial services). It is also used under the Income Tax Act to determine ***capital gains*** and by the CSO (Central Statistical Organisation) for deflating selected service sector's contribution to the GDP at factor cost and current prices to calculate the corresponding figure at constant prices. It has been discontinued since January 2011 because of outdated base year and also CPI (Urban) is brought out.

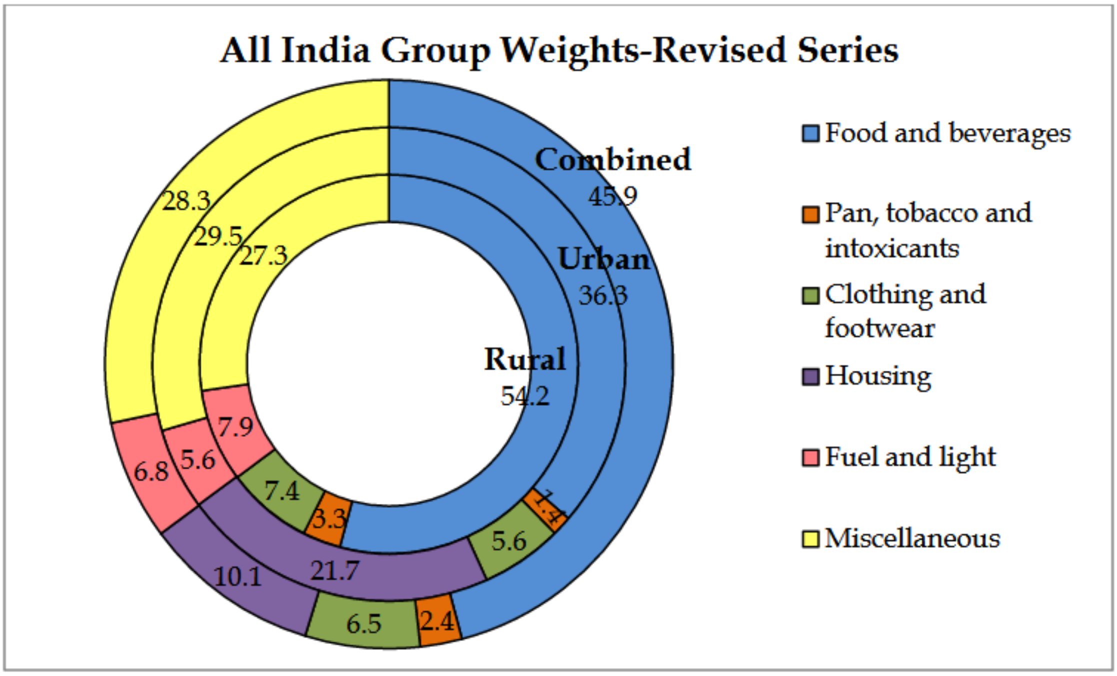
CPI (Agricultural Labor): The Consumer Price Index for Agricultural Labourers (CPI-AL) has 1986–87 as its base year with 260 commodities in its basket. The data is collected in 600 villages with a monthly frequency and has three weeks' time lag.

This index is used for revising minimum wages for agricultural labourers in different states.

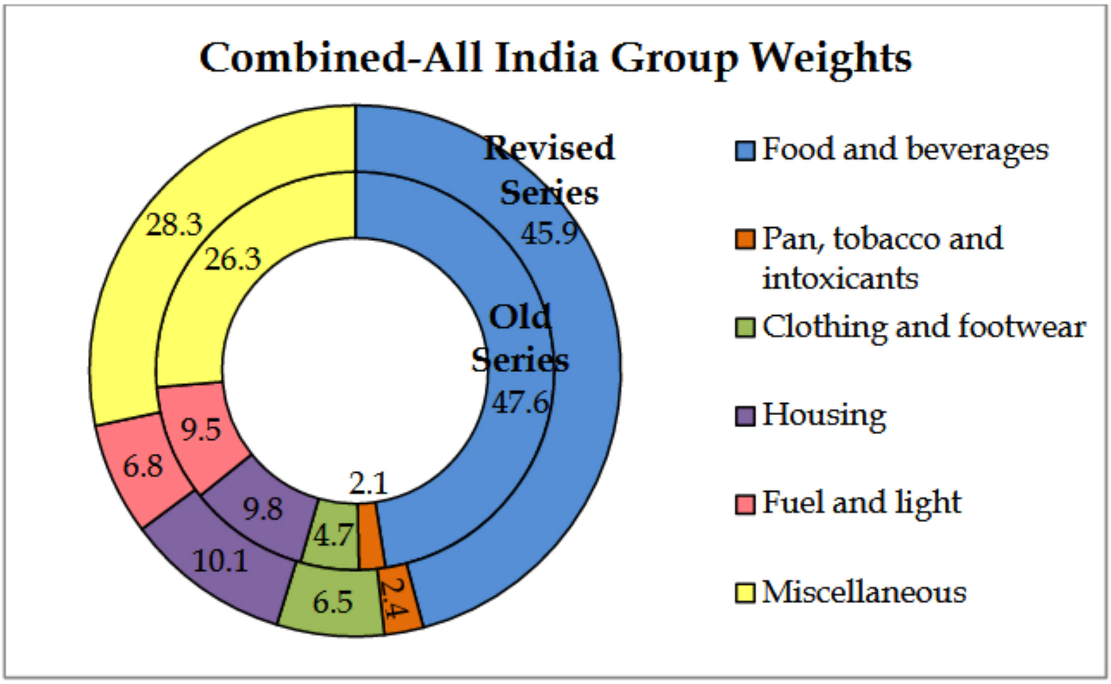
CPI (Rural Worker): There is yet another Consumer Price Index for the Rural Labourers (CPI-RL) with 1983 as the base year, data is collected at 600 villages on monthly frequency with three weeks' time lag, and its basket contains 260 commodities.

Recent changes in CPI

In 2011 the CSO brought out a revised CPI, which was CPI (Urban), CPI (Rural) and CPI (Urban + Rural) with 2010 as the base price. CSO revised the base year of this newly set up index to 2012 in January 2015. The number of items in CPI basket include 448 in rural and 460 in urban. Thus, it makes it clear that CPI basket is broader than WPI basket. The weight of different groups in revised CPI-rural, CPI-urban, and CPI-combined is depicted below:



Student Notes:



Salient features of new CPI index (revised in 2015)

- The number of Groups, which was five in the old series, has now been increased to six. 'Pan, tobacco and intoxicants', which was a Sub-group under the earlier Group 'Food, beverages and tobacco', has now been kept as a separate Group. Accordingly, the Group 'Food, beverages and tobacco' has been renamed as 'Food and beverages'.
- Egg, which was part of the Sub-group 'Egg, fish and meat' in the old series, has now been kept as a separate Sub-group. Accordingly, the earlier Sub-group has been modified as 'Meat and fish'.
- Due to change in consumption pattern, few additional items appeared in the CPI basket.
- The elementary/item indices are now being computed using Geometric Mean (GM) of the Price Relatives of Current Prices with respect to Base Prices of different CPI : Changes in the Revised Series markets in consonance with the international practice. In the old series, Arithmetic Mean (AM) was used for that purpose. The advantage of using GM is that it moderates the volatility of the indices as GM is less affected by extreme values.
- Sample size for collection of house rent data for compilation of House Rent Index has been doubled from 6,684 rented dwellings in the old series, to 13,368 rented dwellings in the revised series.

8.5. Services Price Index (SPI)

The contribution of the tertiary sector in India's GDP has been strengthening for the past 6 to 7 years and today it stands approximately at 54 per cent. The need for a service price index (SPI) in India is warranted by the growing dominance of the sector in the economy. **There is no index, so far, to measure the price changes in the service sector.** The present inflation (at the WPI) only shows the price movements of the commodity-producing sector i.e. it includes only the primary and the secondary sectors—the tertiary sector is not represented by it.

The need for such an index was recommended by the Working Group headed by Prof. Abhijet Sen which was set up to revise the WPI (1993–94) series and was reiterated by the National Statistical Commission (headed by C. Rangarajan).

At present, efforts are being made to develop service price indices for selected services initially on an experimental basis (covering road transport, railways, airways, business, trade, port, postal telecommunications, banking and insurance services only).

Student Notes:

Core Inflation: Core inflation calculates the price of all the goods and services in the economy excluding the energy and food items. Such a measure does not include the volatile items, which may distort the true picture of inflation in the economy. As a result, this measure reflects the change in demand in the economy.

To understand why the categories of food and energy are more sensitive to price changes, consider environmental factors that can destroy a year's crops, or fluctuations in the oil supply from the OPEC cartel. Each is an example of a supply shock that may affect the prices for that product. However, although the prices of those goods may frequently increase or decrease at rapid rates, the price disturbances may not be related to a trend change in the economy's overall price level. Instead, changes in food and energy prices often are more likely related to temporary factors that lie outside the economy and may reverse themselves later.

8.6. Likely effect of GST on inflation rates

Since the GST will be captured on the final point of sale, it will be reflected only in the CPI, because the recent changes in WPI would exclude the indirect taxes. So the GST will account for a certain degree of divergence between the new WPI data and the CPI data.

Likely effect of GST on inflation

- ***Effect on CPI***

  The multi-tiered GST may not be inflationary as far as goods are concerned as 81% of them will be taxed at 18% or less with mass-consumption items at the lower end of the bands.

  This is because, while implementing the Goods and Services Tax (GST) could produce a short-lived pass-through impact on the inflation trajectory, but creation of a unified goods and services market in the country would reduce supply chain rigidities, cut down on transportation costs and also bring down costs in general through improvements in productivity. But the long term impact would be based on standard tax rate under GST, which is at present is 18%.

  However, the general consensus is that the impact on consumer price inflation is likely to be moderate if the standard GST rate is kept at 18 percent - in fact, overall price levels may go down due to more efficient allocation of factors of production.

- ***Effect on WPI***

  GST won't impact wholesale price inflation as it doesn't include indirect taxes.

9. Recent Policy Measures to control inflation

Government has institutionalized a commitment to low inflation in the new monetary policy framework agreement. As per revised monetary policy framework, the Government fixes inflation target in consultation with the Reserve Bank. Now the monetary policy is managed by the Monetary Policy Committee (MPC), headed by the RBI Governor, as provided in the amended Reserve Bank of India Act, 1934.

As per the revised monetary policy framework, the Government has fixed the inflation target of 4 per cent with tolerance level of +/- 2 per cent for the period beginning from August 5, 2016 to March 31, 2021.

The Monetary Policy Committee is entrusted with the task of fixing the benchmark policy rate (repo rate) required to contain inflation within the specified target level. Here the targeted inflation is CPI. As per the provisions of the RBI Act, out of the six Members of Monetary Policy Committee, three Members will be from the RBI and the other three Members of MPC will be appointed by the Central Government.

Student Notes:

9.1. Advantages of Monetary Policy Committee

- ***Collective Decision:*** MPC would ensure that decision making would be collective against the earlier practice of Governor as the sole authority.
- ***Transparency in decision making:*** The MPC is required to publish its decisions along with the reasons thereof.
- ***Accountability of the monetary authority:*** MPC is answerable to the government if it fails in achieving its pre-decided target.

9.2. Apprehensions against Monetary Policy Committee

- *Undermining of RBI as monetary authority:* Now MPC would be the final authority on monetary policy and its implementation. Therefore, some argue that it would undermine the role of RBI and its governor in deciding on matters related to monetary policy.
- *Governmental interference:* Some argue that due to nominated members, MPC would function as an arm of the government, thereby would compromise on the delicate balance between the price stability and growth.
- *Unable to control supply side inflation:* Experts are of the view that since MPC would focus only on maintaining targeted inflation through monetary means. Therefore, it can't control the inflation which is due to supply side constraints.

Notwithstanding these apprehensions, this reform has long been needed in line with the international practice. The MPC has sufficient autonomy to function independently of the government, with requisite authority of the RBI in monetary matters. It is because the decision would be taken by majority vote with RBI governor having the casting vote. However, for effective check on inflation and growth stability the fiscal policy must work in tandem with the monetary policy.

10. Previous Year UPSC GS Mains Questions

1. The phenomenon of rising prices has been largely responsible for putting Indian economy and planning out of gear; it is also a source of acute hardship to the people. What are the basic reasons for continuous inflation in India and what has been the Government strategy to control it? What specific measures have recently been taken by the Government of India for controlling price level? (200 words) (81/I/12/30)
2. 'Inflation has been a major and persistent cause of poverty and inequality in India. Analyze. (83/II/5c/20)
3. Discuss the steps taken by the Government in recent years to control inflation. (97/II/5a/20)
4. Differentiate between "galloping inflation" and "run-away inflation". (01/II/6f/2)
5. Write about Cost-push inflation. (05/II/6l/2)
6. Unemployment in India is of many types and therefore a complex issue. Describe the nature of this problem and the measures adopted to deal with it particularly in rural areas. (About 150 words) (82/II/2a/30)
7. Describe the various types of unemployment in India. What are the measures devised in the Sixth Plan to deal with rural unemployment? (82/II/6c/20)
8. Discuss the problem of rural unemployment in India. What specific schemes have been launched by the Government to generate employment opportunities in rural areas? (88/II/2a/40)

11. Vision IAS GS Mains Test Series Questions

Student Notes:

1. ***What do you understand by inflation? Critically evaluate the growth-inflation trade-off.***

Approach:

- Firstly, define inflation
- Then explain that little bit of inflation is desirable in a developing economy as it encourages investment
- Explain how beyond a point excess inflation starts eating into the growth itself.
- Finally conclude that the relation between the two is not linear. Hence efforts should be made to bring down excess inflation while promoting growth.

Answer:

- Inflation refers to the persistent rate at which the general level of prices for goods and services is rising, and, subsequently, purchasing power is falling. Central banks attempt to stop severe inflation, along with severe deflation, in an attempt to keep the excessive growth of prices to a minimum.
- A little inflation is usually the sign of an economy that is growing. It encourages investors to invest and hence leads to further growth. Hence some inflation is desirable and may be inevitable in a developing economy. Thus, inflation remains favorable to growth if it is not very high. There is also evidence to show that an environment of low and stable inflation is a necessary precondition for sustainable growth
- However, beyond a point inflation begins to eat into the growth itself because –
    - It encourages spending instead of long term investing
    - It increases the cost of living so the households have less to save
    - It erodes the value of currency vis-à-vis others and thus may lead to troubles on external front
    - Morally also inflation is a regressive tax and it hurts the poor the most.
- Thus, the relation between the two is not linear. Hence efforts should be made to bring down excess inflation while promoting growth.
- In the ultimate analysis – both high inflation (which exists due to supply side constraints) and low growth can be tackled by having a stable and conducive policy environment.

2. ***What is inflation targeting? Describe the major recommendations of the Urjit Patel Committee for it.***

Approach:

- Firstly define what is inflation targeting and the need for it in brief.
- Then write down the major recommendations of Urjit Patel committee.

Answer:

Inflation targeting is a practice whereby the Central bank of the country makes a commitment to keep the inflation within some desirable/reasonable limit as fixed by it. Given the double digit inflation witnessed in the country in the past few years, the RBI formulated the Urjit Patel committee to suggest measures to better manage the monetary policy of the country.

Student Notes:

The major recommendations of the committee are as follows:

- Instead of managing inflation, growth, exchange rate etc. RBI should primarily focus on inflation. Hence the committee recommended bringing about transparency and accountability in RBI's functioning by clearly defining its role.
- There should be a monetary policy review committee (MPC) headed by the RBI governor to formulate and monitor the monetary policy. In this way the executive will also have a say in the monetary policy determination.
- Instead of WPI, CPI should be used to monitor inflation as it better represents the inflationary pressure on the common man.
- The RBI should bring down the CPI inflation to 4% (+/- 2%) in a phased manner (the nominal anchor will be CPI).
- The government was advised to help the RBI achieve its target by bringing about fiscal consolidation.
- To fight inflation it recommended that the repo rate should be higher than the CPI rate.

Given the fact that in the past few years India's inflation rate was highest among the G20 nations and the BRICS countries, the recommendations are a step in the right direction and hence will help to achieve the overall goal of inclusive socio-economic development of the nation.

EXTERNAL SECTOR AND CURRENCY EXCHANGE RATES

Student Notes:

Contents

Student Notes:

1. Importance of External Sector – Why Imports and Exports Matter

In the advent of globalisation, where labour and capital mobility are high, international trade requires countries to engage in trade according to the resource endowments that they possess.

This is the theory of comparative advantage, where by nations engage in trade according to their resource rich capacities. For instance, India being rich in labour intensive production must export goods that are labour intensive and import goods in which it does not have a comparative advantage, capital-intensive goods in this case.

The relative differences in resource endowments then become the basis of trade for efficient allocation and utilisation of resources resulting in economic gains for trading countries.

In order to utilise resources most efficiently, external sector of a country becomes important. For example, foreign trade influences Indian aggregate demand in two ways. First, when Indians buy foreign goods, this spending escapes as a leakage from the circular flow, decreasing aggregate demand for domestically produced goods. Second, our exports to foreigners enter as an injection into the circular flow, increasing aggregate demand for domestically produced goods.

2. Types of Economies- Closed/Inward and Open/Outward

Closed Economy: In a closed economy, no external trade takes place. This means that there are no imports or exports. It indicates a self-sufficient, self-reliant economy primarily growing via its domestic sectors. Another term for a closed economy is **Autarky.**

It is said that India had a near closed economy focusing more on self-development after 1950s, running upto 1980s, finally opening its economy after the economic crisis of 1991.

> **Total foreign trade** (exports + imports) as a proportion of GDP is a common measure of the degree of openness of an economy.
>
> The balance of exports and imports of goods is referred to as **the trade balance**.

Open Economy: An open economy is one that trades with other nations in goods and services and also in financial assets.

3. Balance of Payments

Balance of Payments (BoP) of a country is a systematic record of all economic transactions between the residents of one country and the rest of the world during a given period of time. It summarizes all transactions that a country's individuals, companies and government bodies complete with individuals, companies and government bodies outside the country. These transactions consist of imports and exports of goods, services and capital, as well as transfer payments such as foreign aid and remittances.

3.1. Components of Balance of Payments

There are two main accounts in the BoP – **Current Account** and **Capital Account**.

3.1.1. Balance of Current Account

- It includes the BoT (visibles), the balance of invisibles (services or transfer payments).
- It is a measure of all payments made for currently produced goods and services plus non-trade flows of funds between a country and rest of the world.
  - Non-trade flows comprise Factor Income from abroad (interest, profits, wages, etc.) and international transfer payments.
  - Invisible Balance shows the value of imports and exports of services or invisible items.

Balance of Current Account = Balance of Trade + Balance of Invisibles + Balance of Transfers

Student Notes:

3.1.1.1. Balance of Trade (BoT)

- It shows the balance of imports and exports of visible goods.
- It refers to the merchandise portion of BoP, meaning that it is the value of exported merchandise (tangible goods) minus the value of imported merchandise.

  BoT = Export of goods – Import of goods

Current Account Deficit is the difference between the **value of all imports, including goods, services and investment incomes, and the value of all exports**. It reflects the **difference between domestic savings and domestic investment**, and tells us how much if this deficit is needed to be funded by foreign savings.

3.1.2. Balance of Capital Account

- It refers to the balance of capital transfers, borrowing and lending from abroad and sales or purchase of stocks of gold and foreign exchange from other countries.
- There are two types of capital flows in Capital Account:
  - **Autonomous Capital Flows:** These are ordinary capital flows. These take place because of normal economic considerations like earning of dividends, interests and other incomes by international investment and lending.
  - **Accommodating Flows:** These flows have to be made specifically to bring the BoP into equilibrium.
- Balance of Current Account and Balance of Capital Account are interrelated. A deficit on Current Account must be settled by a net surplus on Capital Account. The foreign currency necessary to finance the excess imports must be either borrowed from some other country or to be provided by the government out of its reserves of gold and foreign exchange. Similarly, a surplus in Current Account must be matched by a deficit in the Capital Account.

BoP being the sum total of Balance of Current Account and Balance of Capital Account is always in equilibrium.

3.1.2.1. Foreign Exchange Regulation Act 1973 and Foreign Exchange Management Act (2000)

- FERA came into force in 1974.
- FERA applied all over India to its citizens. The idea was to regulate all foreign transactions and payments. The legislation focussed on too much control and regulation, thwarting growth and development and was subsequently replaced **by Foreign Exchange Management Act (FEMA) in 1999. This was also in consonance with liberalisation policies introduced in 1991.**
- FEMA was considered to be more liberal in allowing transactions without restrictions, and facilitated international trade. It eased restrictions on cross-border capital flows especially foreign investment.
- FEMA covers three areas:
  - **Rupee Convertibility**
  - **Setting up of a separate Enforcement Directorate (ED) for trying out criminal offenses in foreign exchange**
  - **Borrowings by the corporate sector**

3.1.2.2. Capital Account Convertibility (CAC)

- Currency convertibility is the ease with which a country's currency can be converted into gold or another currency. It means freedom to convert local financial assets into foreign ones at market-determined exchange rates.
- At present, India allows full convertibility in current account but only partial convertibility in capital account.
- S. S. Tarapore Committee has recommended to move towards full CAC.

Student Notes:

- Should **India** move towards full **Capital Account convertibility**?
  Positives:
  - RBI recently allowed Indian companies to raise rupee debt offshore.
  - Convertibility would facilitate further liberalisation and increase foreign investment.
  - Increasing openness to international trade may create opportunities for avoiding capital account restrictions.
  - It can lead to free exchange of currency at lower rates. Also, it promotes unrestricted mobility of capital – which may impact the economy in times of global recession.

  Negatives

  - It could destabilise an economy in case there are massive capital flows in and out of the country;
  - Currency appreciation/depreciation could affect the trade balance.

3.2. Balance of Payments Disequilibrium

- For a BoP Equilibrium, the current and capital accounts must sum to zero. This means that the balance of payments of a country is said to be in equilibrium when the demand for foreign exchange is equal to its supply.
- In order to understand BoP disequilibrium, one must take into account the c**urrent account balance** which is the difference **between current income and current expenditures;**
- BoP disequilibrium is financed by internal or external financing. External financing could be through **FDI inflows, portfolio inflows, increased loans from foreigners / reduced holdings of foreign currency / increased foreign holdings of domestic currency; by acquiring foreign currency from the government** (lower reserves) or lastly by hoping that the foreign government forgives the debt, if it is so, it would be a unilateral flow in capital account.

> There will be a **deficit** in the **balance of payments when the demand for foreign exchange exceeds its supply**, and there is a **surplus when the supply of foreign exchange exceeds the demand;**

A number of factors affect the balance of payments as discussed below:

a. Causes of Adverse BoP

- Disequilibrium may take place either in the form of deficit or in the form of surplus
  - Political uncertainty
  - Domestic factors
  - Large scale development expenditure, leading to an increase in aggregate demand and prices resulting in excess imports. It must be noted that large scale increase in capital goods imports results in a BoP deficit
  - Events such as global recession
  - Market fluctuations
  - Disasters that may stall a country's progress

b. Measures to correct disequilibrium in the BoP

- The BoP disequilibrium is corrected via **monetary policy and fiscal policy.**
- A BoP deficit reflects increasing imports. When there is less money supply in the economy, there is reduced purchasing power, which then reduces the aggregate demand and domestic prices reducing imports.
- This **fall in the domestic prices** would encourage more exports.
- Thus, money supply falls - imports decrease and exports go up. This results in the correction of a BoP deficit situation.
- **By devaluation** - Devaluation means reduction of the official rate at which the currency is exchanged for another currency. The idea behind currency devaluation is to stimulate its exports and discourage imports to correct the disequilibrium.
- **Exchange Control:** Under exchange control, the central bank has complete control over foreign exchange reserves and earnings of the country.

Student Notes:

- **Export Promotion:** This includes reduction and abolition of the export duties, providing export subsidy, encouraging export production and export marketing so as to increase foreign exchange reserves.
- **Import Control**: This may be done by improving or enhancing import duties, restricting imports through import quotas, licensing and even prohibiting altogether the import of certain inessential items.
- **Policies focusing on FDI increase**.
- **Gold Monetization Scheme** also aims at reducing import of gold in the long run, thus helping to curb disequilibrium in Balance of Payment.

3.3. Indian Balance of Payments Crisis (1991)

- Post 1979 oil shocks, the value of imports in India became almost double between 1978, 1981-82. By the end of the 6th plan, the Current Account Deficit rose.
- The economic crisis was primarily due to the large and growing fiscal imbalances over the 1980s. Large fiscal deficits, over time, had a spillover effect on the trade deficit culminating in an external payments crisis. By the end of 1990, India was in serious economic trouble.
- It is said that the foreign exchange reserves had dried up to the point that India could barely finance three weeks' worth of imports.
- In mid-1991, India's exchange rate was subjected to a severe adjustment.
- Apart from the external assistance, India had this huge deficit in the current account through the withdrawal of SDR from IMF.
- **Steps taken to counter the BoP crisis**: In 1991, Rupee was devalued. Due to the currency devaluation the Indian Rupee fell from 17.50 per dollar in 1991 to 45 per dollar in 1992. Industries were delicensed. Import tariffs were lowered and import restrictions were dismantled. Indian Economy was opened for foreign investments. Liberalised Exchange Rate Management System, or LERMS, was also introduced in 1992 and India moved from a fixed to a dual exchange rate system. Budget 1993-94 announced a move towards a unified exchange rate or a market-determined management system, marking the transition to convertibility on the current account soon afterward.

4. Opening of Indian Economy- Neo Liberal Economic Reforms 1991

- Until 1980s, when seeming reforms to open Indian economy had shown initial signs, the Indian economy was largely subjected to an overall protectionist regime, with a strong focus on import substitution, centralised public sector and state monitoring.
- By 1991, India had a fixed exchange rate system, where the rupee was pegged to the value of a basket of currencies of major trading partners.
- As discussed, India faced its economic crisis in 1991.
- In the wake of realising how pivotal it was to open Indian economy, the government announced trade liberalisation neo liberal economic reforms in 1991 aiming to liberalise India in the advent of globalisation.
- The **objective was to abandon the legacy of License Raj, introduce Indian economy to markets and private sector, reduce restrictions and introduce Foreign Direct Investment.**
- Following market friendly measures were undertaken to open up markets to the private and foreign players and minimise monopoly of the public sector hitherto:
    - **Reduction in import tariffs, deregulation of markets, reduction of taxes, and greater foreign investment.**
    - **These measures are also referred to as Liberalisation – Privatisation and Globalisation reforms.**
    - By opening its economy, India sent a strong message that it was interested in economic integration with the world.

Student Notes:

- Reforms covered all key sectors such as **industries, external trade, foreign investment, exchange rate system, banking, capital market and fiscal and monetary policies**.

4.1. 25 years of Neo-Liberal Economic Reforms 1991

- The average earning of an Indian, measured as per capita income, has risen nearly 15 times since 1991 — from Rs 6,295 to Rs 1,12,835 in March, 2018. Even after adjusting for inflation, incomes have jumped five-and-a-half times, mirroring rising spending power.
- Between 2005-06 and 2010-11, the average annual growth rate was 8.8 per cent.

4.2. Criticism of Neo-Liberal Economic Reforms / Is the Neo-Liberal Policy of 1991 Sustainable?

- Low human development rankings – 131 in HDI 2016
- Rising economic inequalities
- Lagging agricultural sector, rising farmer suicides
- Rise of crony capitalism
- Increasing non-performing assets of banking sector
- Structural inequalities embedded in class, caste, gender and religion have not only grown after reforms, attempts at privatizing public services such as health and education have also led to further marginalization of the disadvantaged groups from the mainstream
- Lack of employment opportunities
- The decades prior to 1991 may have been years of slow growth, but it is equally true that state-led growth did create capacities which enabled the economic reforms to reap the benefits of liberalization.
- Globalisation has contributed to **Informalisation of Indian economy**
    - More use of external labour, such as contract workers, out-workers, agency labour, temporary workers and tele-workers.
    - Numerical decline of the organised workforce, the expansion of the informal sector and informalisation of work.
    - This 'informalization' of labor has taken place not only in the informal sectors of the economies but also in the formal sectors through out-sourcing and sub-contracting of output and jobs from formal sectors to informal sectors.
    - Impacts of informalisation:
        - Inadequacy of social security nets, weakening trade unions and growing wage inequality.
        - The incidence of poverty is much greater among informal workers.
        - Lowering down productivity of economy by overlooking training and development of informal human resource.

5. Currency Exchange Rate

- The price of one currency in terms of the other is called exchange rate. It could be defined as the amount of domestic currency required to buy one unit of foreign currency.
- Usually it is defined as the price of foreign currency in terms of domestic currency. This is called the bilateral **nominal exchange rate**.

5.1. Real Exchange Rate

Real Exchange Rate = ep1/p0
where
p0 is price level in home country and
p1 is price level abroad
e is the rupee price of foreign exchange (nominal exchange rate)

- The ratio of foreign to domestic prices measured in same currency.
- If the real exchange rate is equal to **one,** currencies are at purchasing power parity, which means goods cost the same in two countries when measured in the same currency.
- The real exchange rate is taken as a measure of a country's international competitiveness.

Student Notes:

6. Exchange Rate System – Fixed and Flexible Exchange Rate

- **Flexible Exchange Rate:** This is also known as floating exchange rate system. The exchange rate is determined by the forces of market demand and supply. In a flexible system, the central banks do nothing to directly affect the level of the exchange rate. The central banks therefore don't intervene in the foreign exchange market (and this means there are no official reserve transactions.)
- **Fixed Exchange Rates**: Countries have had flexible exchange rate system since Bretton woods system collapsed. Previous to that, most countries had the fixed rate system or the pegged exchange rate system (called in some countries only). It must be noted that in a fixed exchange rate system such as the gold standard, adjustment to the BoP surplus or deficits can't be brought about through changes in exchange rates. Adjustment should either happen automatically or brought about by the government. In a fixed exchange regime, the government may also devalue the currency. **In a fixed exchange rate system,** the government may choose to leave the exchange rate unchanged and deal with the BoP problem by the use of monetary and fiscal policy.

> In a fixed exchange-rate system, a country's central bank typically uses an open market mechanism and is committed at all times to buy and/or sell its currency at a fixed price in order to maintain its pegged ratio and, hence, the stable value of its currency in relation to the reference to which it is pegged.

- **Managed Floating**: The present day world order has moved to a managed floating exchange rate system. It is a mix of a flexible exchange rate system and a fixed rate system. This is also referred to as **Dirty Floating** – where central banks intervene to buy and sell foreign currencies in an attempt to moderate exchange rate movements whenever they feel such actions are appropriate. Official reserve transactions are not equal to zero in this case.

7. Currency Exchange Rates – Concepts

a. Depreciation, Appreciation and Devaluation of Rupee

- **Depreciation:** Currency depreciation is a decrease in the level of a currency in a floating exchange rate system due to market forces.
- **Appreciation:** An increase of value of a currency, is currency appreciation;
- **Devaluation:**
  - Devaluation means official lowering of the value of a country's currency within a **fixed exchange rate system**.
  - Devaluation of a currency happens in countries with a fixed exchange rate (or also where it is managed floating rate).
  - In a fixed-rate economy, it is the government that decides what its currency should be worth compared with that of other countries. In this case, usually the government pledges to buy and sell as much of its currency as needed to keep its exchange rate the same. The exchange rate can change only when the government decides to change it. If a government decides to make its currency less valuable, the change is called devaluation.

> **Depreciation vs Devaluation**
>
> **Depreciation** of the currency is a slow process and value of the currency automatically gets adjusted by the market forces.
>
> Thus, once the currency of a country has depreciated, the investors from other countries will see an opportunity and are likely to shift from other economies. This will help in boosting the economy which may in the long run even push back the value of the currency
>
> During **devaluation**, there is less trust in the economy and once currency is devalued, Government finds it very difficult to revalue the same by government dictate as there will be fear that such revaluation can backfire and put the economy in risk mode.

Student Notes:

b. NEER and REER

- **Nominal Effective Exchange Rate (NEER)-** is a multilateral rate representing the price of a representative basket of foreign currencies each weighted by its importance to the domestic currency in international trade (the average of export and import shares is taken as an indicator of this)
- **Real Effective Exchange Rate (REER)-** is calculated as the weighted average of the real exchange rates of all its trade partners, the weights being the shares of the respective countries in foreign trade. It is represented as the quantity of domestic goods required to purchase one unit of a given basket of foreign

c. Role of RBI in maintaining stability of rupee

- The exchange rate of the Rupee is largely determined by demand and supply conditions in the foreign exchange market.
- The Reserve Bank has the role of maintaining stability in the foreign exchange market by ensuring orderly conditions without targeting a pre-specified level or band for Rupee's exchange rate.
- In recent times, Rupee saw too much of fluctuation in foreign exchange market. Then, in order to stabilize the value of rupee, RBI has taken various measures like clamping restrictions on import of gold, tightening the position limits on currency futures, prohibiting arbitrage trades between futures and OTC markets, rationalizing forex outflows by residents and encouraging capital inflows.

8. Indian External Debt

a. External Commercial Borrowing

- External Commercial Borrowings (ECB) refer to commercial loans availed from non-resident lenders with minimum average maturity of 3 years.
- ECB includes bank loans, buyers' credit, suppliers' credit, securitised instruments (e.g. floating rate notes and fixed rate bonds).
- ECB can be accessed under two routes, viz., Automatic Route and Approval Route
- Under approval route, the explicit permission of government is required before taking loan. It is required for specific sectors such as export and import.
- ECB is different from FDI in the sense that FDI is the foreign money invested to finance equity capital. Whereas, ECB is any kind of funding other than equity.
- ECBs have been a crucial determinant of the magnitude of India's external debt and its single largest component.

b. Sovereign Bonds

- A sovereign bond is a debt security issued by a national government.
- They can be either local-currency-denominated or denominated in a foreign currency.
- Unlike corporate bonds, the risks associated with these bonds are the exchange rate (if the bonds are priced in local currency), economic risks, and political risks that can lead to a possible default on the interest payments or principal.
- Sovereign bond defaults aren't very common and generally, they are low risk bonds and thus, provide low yield relatively.
- These bonds are rated by three most popular rating agencies - Standard & Poor's, Moody's and Fitch. They base their ratings on several factors such as
  - Per Capita Income
  - Gross Domestic Product Growth
  - Inflation
  - External Debts
  - History of Defaulting
  - Economic Development

Student Notes:

c. India's External Debt Scenario

- India's external debt crossed the half a trillion dollars mark to touch $529 billion in March 2018 which is 2.4% higher than its level at end-March 2017.
- **Primary reasons for Rise in Debt:** increase in commercial borrowings, short-term debt and non-resident Indian (NRI) deposits.
- The increase in debt was also due to a valuation loss resulting from the depreciation of the US dollar against major currencies.
- Commercial borrowings rose the highest by 30% continued to be the largest component of external debt with a share of 38.2 per cent, followed by NRI deposits which rose 9.3 per cent and accounted for 23.8 per cent of total debt.
- Short-term trade credit rose 14 per cent and accounted for 19.0 per cent of total debt.
- There are concerns over external sector with the rupee touching a new low versus the US dollar and the current account deficit more than doubling to 1.9% of GDP in March 2018.
- Various external debt indicators are showing signs of deterioration in debt.
  - The external debt to GDP ratio stood at 20.5 per cent as at end-March 2018, higher than its level per cent at end-March 2017.
  - The ratio of foreign exchange reserves to total debt increased to 80.2% in March this year from 78.5 per cent last year.
  - Short-term debt on a residual maturity basis (i.e., debt obligations that include long-term debt by original maturity falling due over the next twelve months and short-term debt by original maturity) constituted 42.0 per cent of total external debt at end-March 2018 and stood at 52.3 per cent of foreign exchange reserves.
  - But the debt service ratio declined marginally from 8.5 per cent in March 2017 to 7.5% in March 2018.
  - With global interest rates rising following the US Fed raising its policy rates, the debt service ratio could rise by March'19.
- The external debt policy of the Government of India has resulted in external debt remaining within safe and comfortable limits and in containing its rise.
- The **external debt management policy** followed by the Government of India continues to emphasize monitoring of long- and short-term debt, raising sovereign loans on concessional terms with long-term maturities, regulating ECBs through end-use and all-in-cost restrictions and rationalizing interest rates on NRI deposits.

d. Impact of BREXIT on India's External Debt

- According to experts, the world is at the risk of a currency war after the Brexit vote, as each economy seeks to devalue its money in a bid to boost growth. The renminbi has fallen over 1 per cent after the Brexit vote as the US dollar index gained some 2 per cent in the same period.
- This rise was led largely by long-term external debt that accounted for 83 per cent of India's total external debt, while the share of short-term debt was only 17 per cent. The contribution of short-term debt has come down from 23.6 per cent in 2012-13 to 17 per cent in 2015-16.
- Our exposure to Europe is about 16.5 per cent, even if that gets impacted. In general, the direct impact on the rupee is not much. The real impact on the rupee is the spillover effect of what is happening in the rest of the world, the turmoil in the financial markets and how much that will spread.

e. India's foreign exchange reserves and comparison with other countries

- India external debt is in a more comfortable position compared to some of the other countries and the rate of growth in external debt has come down, experts point out.
- Among peers with high external debt China has $960 billion, Mexico $433 billion, Turkey $408 billion, Brazil $557 billion and Malaysia $211 billion.

Student Notes:

9. Miscellaneous

9.1. New Model Indian Bilateral Investment Treaty

- The Law Commission of India in its 260th report on the Draft Model Indian Bilateral Treaty has tried to maintain balance between **the rights of the investors and the rights of the state;**
- The **new Indian Model BIT** will provide appropriate **protection to foreign investors in India and Indian investors in the foreign country;**
- The essential features include an **asset based definition of investment,** non-discriminatory treatment through due process, national treatment, protections against expropriation, a refined **Investor State Dispute Settlement (ISDS) provision requiring investors to exhaust local remedies before commencing international arbitration**, and limiting the power of the tribunal to awarding monetary compensation alone.

> A BIT is a treaty between two countries that sets out to provide certain basic protections to the investors of one state investing in another. For instance, most such treaties provide investors a guarantee of "fair and equitable treatment" — the clause, to draw an analogy from constitutional law, is broadly akin to the right of equality and protection against arbitrary state action.

- The model **excludes** matters such as government procurement, taxation, subsidies, compulsory licenses and national security to preserve the regulatory authority for the Government.
- India has unilaterally terminated its Bilateral Investment Treaty (BIT) with Netherlands and has also served notices to 20 EU members for termination of their respective BITs.

> A BIT increases the confidence of investors by assuring a level playing field and non-discrimination in all matters. It provides for an independent forum for dispute settlement by arbitration.
>
> In turn, BITs help project India as a preferred foreign direct investment (FDI) destination as well as protect outbound Indian FDI.

- **Rationale for a BIT**?
  - It was in 2011 that India faced its first **adverse arbitral award** arising out of a BIT in the **White Industries** case, an Australian firm that succeeded in obtaining a **foreign arbitral award against Coal India Ltd**. White Industries argued that it had been denied "effective means" of enforcing its rights in relation to its investment, a protection incorporated into the India-Australia BIT by virtue of an MFN clause it contained. Since then 17 firms including Vodafone have issued notices for arbitration against India. For instance, Vodafone's retrospective tax amendment case and Telenor, whose investment in India was in 2G licences that stood cancelled pursuant to a Supreme Court order.

Law Commission Recommendations on BIT:

- A modification from a highly narrow '**enterprise-based definition' of investment to a broader and universally accepted 'asset-based definition'**. An enterprise-based definition would mean that a foreign investor who did not set up an enterprise in India to carry on business would have absolutely no protection.
- MFN must not be incorporated since India might chose to provide differential benefits to trading partners based on the extent of incoming investment from a country.
- LCI suggests amendments to certain provisions of the dispute resolution mechanism contained in the Model Draft.
- The Model Draft contained general exceptions with a long list of permissible objectives such as public health, environment, public order, public morals, improving working conditions, ensuring the integrity and stability of the financial system, banks and financial institutions etc., and it provided that any measures which the state considered to be in furtherance of the above objectives would not be subject to scrutiny before an arbitral tribunal.

9.2. Indian Foreign Trade Policy (FTP) 2015 -2020

Student Notes:

Primary objective was to **boost Indian exports alongside strengthening schemes like Make in India, Digital India, thereby focusing on manufacturing in India along with Ease of Doing business.**

Key Features

- To increase India's exports to US $ 900 billion by 2019-2020.
- FTP would reduce export obligations by 25% and give boost to domestic manufacturing.
- FTP benefits from both MEIS & SEIS will be extended to units located in SEZs.
- FTP 2015-20 introduced two new schemes:
    - "**Merchandise Exports from India Scheme (MEIS**)" and "Services Exports from India Scheme (SEIS)". The six different schemes of the earlier FTP (**Focus Product Scheme, Market Linked Focus Product Scheme, Focus Market Scheme, Agriculture Infrastructure Incentive Scrip, Vishesh Krishi and Gram Udyog Yojana and Incremental Export Incentive Scheme**), which had varying sector-specific or actual user only conditions attached to their use have been merged into a single scheme, namely the **Merchandise Export from India Scheme (MEIS).**
    - The **'Services Exports from India Scheme' (SEIS) is for increasing exports of notified services**. The Served from India Scheme (SFIS) has been replaced with the **Service Export from India Scheme (SEIS).** The SEIS applies to 'service providers located in India' instead of 'Indian service providers'. Thus, it provides for incentives to all service providers of notified services who are providing services from India, regardless of the constitution or profile of the service provider. The rates of incentivizing under the SEIS are based on net foreign exchange earned. The incentive issued as duty credit scrip, will no longer carry an actual user condition and will no longer be restricted to usage for specified types of goods but be freely transferable and usable for all types of goods and service tax debits on procurement of services/goods.
    - Merchandize exports from India (MEIS) to promote specific services for specific Markets Foreign Trade Policy.
    - These schemes (MEIS and SEIS) replace multiple schemes earlier in place, each with different conditions for eligibility and usage. Incentives (MEIS & SEIS) to be available for SEZs also. e-Commerce of handicrafts, handlooms, books etc., eligible for benefits of MEIS.
- Agricultural and village industry products to be supported across the globe at rates of 3% and 5% under MEIS. Higher level of support to be provided to processed and packaged agricultural and food items under MEIS.
- Industrial products to be supported in major markets at rates ranging from 2% to 3%.
- Business services, hotel and restaurants to get rewards scrips under SEIS at 3% and other specified services at 5%.
- Duty credit scrips to be freely transferable and usable for payment of customs duty, excise duty and service tax.
- Inter-ministerial consultations to be held online for issue of various licences.
- Export obligation period for export items related to defence, military store, aerospace and nuclear energy to be 24 months instead of 18 months
- Calicut Airport, Kerala and Arakonam ICDS, Tamil Nadu notified as registered ports for import and export and Vishakhapatnam and Bhimavarm added as Towns of Export Excellence.

Student Notes:

9.3. Relevance of WTO in Present Day Order

- With **the multilateral trade negotiations process under the WTO being a painfully slow one requiring broad-based consensus**, regional trade agreements (RTAs) have progressively assumed greater importance and a growing share in international trade.
- While RTAs are broadly compliant with WTO mandates and remain broadly supportive of the WTO process, they remain second-best solutions that are discriminatory in nature against non-members and are inefficient as low cost producing non-members lose out to members. While bilateral RTAs have no equity considerations, mega-regional trading groups may not necessarily be equitable if membership is diverse and small countries may lose out either way—if they are part of it they may not have much say and if they are not, they may stand to lose.
- India has always stood for an open, equitable, predictable, non-discriminatory and rule-based international trading system and views RTAs as building blocks in the overall objective of trade liberalization as well as complementing the multilateral trading system under the WTO.
- **Regional and thematic plurilateral agreements** are reshaping trade flows which is thwarting progress of emerging economies. Industrialised countries are increasingly becoming against WTO led trade liberalisation. These pacts have slowly reduced the importance of WTO.
- **Trans Pacific Partnership:** The Trans-Pacific Partnership (TPP) agreement is one new mega-regional block that has become a reality and has implication for India.
  - The TPP trade agreement is very comprehensive and not only encompasses the scope of tariff-eliminating mega regional trade pacts, but also aims at setting higher global standards for international trade through lower benchmarks for nontariff barriers, more stringent labour and environment regulation, higher intellectual property rights (IPR) protection, greater transparency in government procurement and limiting advantages to state-owned enterprises (SOE) and transparency in health care technology, competitiveness and supply chains.
  - It includes new and emerging trade issues and cross-cutting concerns such as internet and digital economy.
  - In the short run, the trade impact of the TPP may not be seriously adverse but careful analysis is required for adapting and responding to the challenges in the long run.
  - Recently, United States, the leading proponent, has left the grouping. Despite that, the remaining members have decided to revive the deal without US participation.
- Agreements like **TPP focus on reducing tariffs on industrial goods to zero, and liberalising financial services and investments**;
  - **Transatlantic Trade and Investment Partnership (TTIP)** (In 2013, EU and US entered these negotiations**)**. European NGOs are against the TTIP because it may undermine social and environmental standards and consumer protection, all of which are much more effectively developed in the EU. The most controversial part of the agreement relates to investment protection. If TTIP is adopted, Mexico's textile industry, will suffer.
- Alongside these **regional mega-agreements, there are plurilateral agreements led by industrialized countries.**
  - **Trade in Services Agreement (TISA):** In 2012, 50 countries, including the US, EU and Switzerland, launched negotiations on a comprehensive services agreement.

Impact of these agreements on developing countries

- These agreements focus on **privatization, deregulation and liberalisation** of the world economy.
- These mega-agreements constitute a thinly veiled attack on **China, India and South Africa, all countries that, in the WTO framework, oppose the liberalisation of trade in industrial**

Student Notes:

goods, services, government procurement and investments, and are stubbornly insisting on more just global rules in agriculture.

- Developing nations, including India, face a double disadvantage at **WTOs Dispute Settlement Body (DSB)**. These nations are challenged not only by the lack of a sufficient pool of trade law experts to represent them effectively at the DSB but also by not including non-trade issues such as **labour and environment** – two important factors for developing countries.

In trade negotiations, including multilateral trade negotiations in the World Trade Organization (WTO), India has always taken a consistent stand to protect the interest of the country and its farmers.

The mandate of the Doha round of trade negotiations in the WTO envisaged the reductions of, with a view to phasing out, all forms of export subsidies.

The Uruguay Round WTO Agreement on Agriculture (AOA) permits use of export subsidies to the Members that used them during the base year 1986-88.

Mostly developed countries like the US, EU are entitled to provide export subsidies as per Agreement on Agriculture (AoA).

India could use only a special and differential provision of AoA that allows developing countries to use subsidies aimed at reducing the cost of marketing including internal and external transport as well as handling and processing costs.

WTO is still important

- Inspite of growing regionalism in trade liberalization, the WTO is the only forum where every country can talk to each other.
- While protectionism was bound to grow globally in the face of fragmented agreements and a contracting economy, it is in such circumstances that WTO's dispute resolution (mechanism) assumes significance.
- Recently, Trade Facilitation Agreement, signed under the aegis of WTO, entered into force. The agreement seeks to ease the movement of goods across the borders.
- Further, some members of WTO, including India are proposing Trade Facilitation in Services Agreement.

Trade Facilitation Agreement

- WTO members concluded negotiations at the 2013 Bali Ministerial Conference on the landmark Trade Facilitation Agreement (TFA), which entered into force on 22 February 2017 following its ratification by two-thirds of the WTO membership.
- The agreement aims at easing the movement of goods across borders through expediting the movement, release and clearance of goods, including goods in transit.
- It seeks to simplify, modernize and harmonize export and import processes, reduce bureaucratic delays and red tapism. It also sets out measures for effective cooperation between customs and other appropriate authorities on trade facilitation and customs compliance issues. It further contains provisions for technical assistance and capacity building in this area.
- The Union Government has ratified TFA and constituted a **National Committee on Trade Facilitation** (NCTF) to develop the pan-India road map for trade facilitation.
  - The NCTF will be inter – ministerial body headed by Cabinet Secretary
  - It will have three tier structures with main national committee for monitoring implementation of TFA.

Trade Facilitation in Service (TFS)

- The proposed pact is similar to the Trade Facilitation Agreement in Goods. Here, TFS is about "making market access 'effective' and commercially meaningful. In India's proposal on TFS, it is not about new (or greater) market access.
- **Aims of TFS**
  - To ensure portability of social security contributions and crossborder insurance coverage to boost medical tourism.

Student Notes:

- To ease norms for movement of skilled workers across borders.
- The TFS agreement will address the key issues that are pertinent to facilitating trade in services, such as transparency, streamlining procedures, and eliminating bottlenecks.
- India had, in February 2017, submitted to the WTO a legally-vetted draft proposal for a TFS agreement.
- In draft legal text that India submitted, it covered services under Mode1 (cross-border services), Mode 2(consumption abroad) and Mode 4 (movement of short-term services providers or natural persons).
- The draft provides for special and differential treatment provisions under which developing countries are offered transition period while least-developed countries are exempted from undertaking any commitments arising out of the TFS agreement.
- However, several developing countries said that it would impose burdensome commitments on them.
- Major industrialized members such as the European Union (EU), Canada, Switzerland, Australia and New Zealand, among others, welcomed the Indian proposal.

9.4. Important International Trade Agreements and Relevant Regional Global Significant for India

- **Regional Comprehensive Economic Partnership (RCEP) Agreement among ASEAN + Six FTA Partners** (Australia, China, India, Japan, South Korea and New Zealand):
  - RCEP is proposed regional Free Trade agreement whose members combined account for 40 percent of global trade.
  - The negotiations in agreement cover a number of areas like trade in goods, services, investment, intellectual property, economic and technical cooperation, competition, e-commerce and legal and institutional issues.
  - It aims to achieve high levels of tariff liberalizations in trade of goods. The negotiations will cover all the service sector, and with regard to investment, they will cover all the four pillars – promotion, protection, facilitation and liberalisation.
  - Significance to Indian economy
    - The RCEP agreement would complement India's existing free trade agreements with the ASEAN and some of its member countries.
    - Since India is not party to any of the APEC, TTP and TTIP, the membership of RCEP would reduce their potential negative impact on Indian economy.
    - India will get closer to ASEAN economy which will align with the objective of India's **Act East Policy.**
    - RCEP will provide access to new markets and India can leverage its capabilities in IT, Healthcare, Education and services to utilize these opportunities.
  - Challenges faced by India in RCEP
    - **Tariff barriers**, which have been a matter of discontent in bilateral FTAs, particularly in the case of the ASEAN-India FTA.
    - **Non-trade issues** such as environment and labor are likely to be prickly as well and need greater attention.
    - **Strengthening MSME sector** to not only survive the free flow of trade, but also to become a set of more competitive players.
    - **China** will be a major difficulty for India while negotiating terms with it.

9.5. East Asian Crisis 1997

- Between June 1997 and January 1998 a financial crisis took place in the "tiger economies" of SE Asia. Over the previous decade the SE Asian states of Thailand, Malaysia, Singapore, Indonesia, Hong Kong, and South Korea, had seen high economic growth rates in the world.
- In 1997, this Asian miracle, however, ended when stock and currency markets in these countries crashed.

Student Notes:

- The Asian financial crisis, also called the "**Asian Contagion**," was a series of **currency devaluations and other events that spread through many Asian markets beginning in 1997**.
- The currency markets **first failed in Thailand as the result of the government's decision to no longer peg the local currency to the U.S. dollar (USD)**.
- Almost all countries suffered from a loss of demand and confidence in the region.
- It is believed that weak **Asian financial systems caused this crisis**. The weaknesses of the financial sector were masked by rapid growth and accentuated by large capital inflows, **which were partly encouraged by pegged exchange rates.**

9.6. Recession of 2008 and India

- The Recession of 2008 was caused by the Financial Crisis of 2008.
- In Asia, ripple effects of the financial crisis were felt through transmission of stock market turbulence and domestic credit stringency.
- India was protected from financial meltdown, largely because of the still large role of the nationalised banks and other controls on domestic finance.
- The most immediate effect of that crisis on India has been an outflow of foreign institutional investment from the equity market. Foreign institutional investors, who need to retrench assets in order to cover losses in their home countries and are seeking havens of safety in an uncertain environment, became major sellers in Indian markets.
- There was rupee depreciation.

9.7. Various Duties

- **Import Duty**: Import duty is a tax that the importer has to pay to bring foreign goods into his or her country. Import duty is also known as customs duty, tariff, or import tariff. Import duty can be ad valorem, i.e. based on the value of the goods, or it can be specific, i.e. based on weight, dimensions, or other units of measure.
- **Export Duty:** Export duties consist of general or specific taxes on goods or services that become payable when the goods leave the economic territory or when the services are delivered to non-residents; profits of export monopolies and taxes resulting from multiple exchange rates are excluded**.**
- **Countervailing duties:** Tariffs levied on imported goods to offset subsidies made to producers of these goods in the exporting country. Countervailing duties (CVD) are meant to level the playing field between domestic producers of a product and foreign producers of the same product who can afford to sell it at a lower price because of the subsidy they receive from their government. If left unchecked, such subsidized imports can have a severe effect on domestic industry, forcing factory closures and causing huge job losses. As export subsidies are considered to be an unfair trade practice, the World Trade Organization (WTO) – which deals with the global rules of trade between nations – has detailed procedures in place to establish the circumstances under which countervailing duties can be imposed by an importing nation.
- **Anti-Dumping Duty:** It is a protectionist tariff that a domestic government imposes on foreign imports that it believes are priced below fair market value. If a company exports a product at a price lower than the price it normally charges on its own home market, it is said to be “dumping” the product. The WTO agreement (GATT) allows governments to act against dumping where there is genuine (“material”) injury to the competing domestic industry.

Difference between ECB and Masala Bonds

In Masala Bonds, the currency risk lies with investor and not the issuer, unlike external commercial borrowings.

While ECBs help companies take advantage of the lower interest rates in international markets, the cost of hedging the currency risk can be high.

In the case of Masala bonds, the cost of borrowing can work out much lower.

Student Notes:

9.8. Masala Bonds

- Masala bonds are **Indian rupee denominated bonds issued in offshore capital markets**.
- These are **rupee-denominated bonds issued to offshore investors** settled in dollars and, therefore, **the currency risk lies with investor and not the issuer, unlike external commercial borrowings – where Indian companies raise money in foreign currency loans.**
- **Green Masala Bond:** The masala bond meant for investing in building green infrastructure.
- **Examples:**
  - **In 2015, The International Finance Corporation (IFC), issued a ₹1,000 crore bond to fund infrastructure projects in India**. These bonds were listed on the London Stock Exchange (LSE).
  - In 2016, Mortgage lender Housing Development Finance Corp (HDFC) has raised Rs 3,000 crore by issuing masala bonds.
- **Benefits of Masala Bonds:**
  - Companies **do not have to worry about rupee depreciation.**
  - Masala bonds help protect corporate balance sheets from exchange rate risks, **however their issuance should be used in moderation.**
  - Masala bonds can **have implications for the rupee, interest rates and the economy as a whole.**

9.9. Trade Deficit in India

- India's trade deficit has increased from US $ 28 billion in 2004-05 to all time highest US $ 195 billion in 2012-13.
- Since then, the trade deficit has consistently declined (the trade deficit from April-March 2016-17 was estimated at US $ 105.72 billion) due to the decline in the value of Petroleum, Oil and Lubricants (POL) imports, caused by a fall in international oil prices.
  - Trade deficit can be decomposed into POL deficit and non-POL deficit. POL deficit (POL exports minus POL imports), the major component of trade deficit, which was hovering at around US$100 billion from 2011-12 to 2013-14, declined to US$ 81.5 billion in 2014-15 and to US$ 52.5 billion in 2015-16.
- Trade policy has focused on promoting exports and thereby moderates the levels of trade deficit. The moderation in the levels of trade deficit had a salutary effect on sustaining the moderation in the overall balance-of-payments outcome in the current fiscal.

9.10. Foreign Direct Investment, FII, FPI

9.10.1. Foreign Direct Investment

- Investment made by a company or individual in one country in business interests in another country, in the form of either establishing business operations or acquiring business assets in the other country, such as ownership or controlling interest in a foreign company.
- Foreign direct investments are distinguished from portfolio investments in which an investor merely purchases equities of foreign-based companies. The key feature of foreign direct investment is that it is an investment made that establishes either effective control of, or at least substantial influence over, the decision making of a foreign business.
- As per new definition, accepted as per recommendation of Arvind Mayaram Committee, foreign investment of **10% or more in an Indian listed company** is treated as FDI.
- In addition, foreign investment in **an unlisted company**, irrespective of the threshold limit, is treated as FDI.

9.10.2. Foreign Portfolio Investment

- Investment by **non-residents in Indian securities including shares, government bonds, corporate bonds, convertible securities, infrastructure securities** etc.

Student Notes:

- The class of investors who make investment in these securities are known as Foreign Portfolio Investors.
- According to SEBI, any equity investment by non-residents which is less than 10% of capital in a company is portfolio investment. While above this the investment will be counted as Foreign Direct Investment (FDI).
- Foreign Portfolio Investors includes investment groups of Foreign Institutional Investors (FIIs), Qualified Foreign Investors (QFIs) (Qualified Foreign Investors) and subaccounts etc.

9.10.3. Foreign Institutional Investors

- FIIs comprise of a pension fund, a mutual fund, investment trust, insurance company or a reinsurance company.
- According to SEBI, "an FII is an institution established or incorporated outside India which proposes to make investment in India in securities".
- FII is an institution that is registered under the Securities and Exchange Board of India (Foreign Institutional Investors) Regulations, 1995.

9.11. Gaps Between MoUs and FDI

- In recent years, foreign investors have shown a lot of interest in Indian economy owing to its large market size and have signed many MoUs with India to bring in the investment. However, many of these MoUs did not get converted into actual FDI due to plenty of drawbacks.
  - Poor ease-of-doing-business scenario in India leading to unsuitable investment climate.
  - Lack of robust physical infrastructure such as road-rail connectivity
  - Complex labour and contract enforcement laws
  - Perception of tax terrorism.
  - High Fiscal deficit and policy paralysis post 2009-10.
- Understanding the need of FDI in country, Governments at every federal level has formulated and implemented incremental reforms to attract FDI.

9.12. Reforms in FDI

- The World Bank has improved India's **ranking to 130th in the 2017 Study of Ease of Doing Business**. Data released by DIPP shows that FDI inflows into India in 2016 jumped 18% to a record $46.4 billion, at a time global FDI inflows fell
- IMF has branded India as the brightest spot in the Global Economy whereas the World Bank projects **India's growth at 7.6% for FY 2018**
- The essence of these reforms is to **ease, rationalise and simplify the process of foreign investments** in the country and to put more and **more FDI proposals on automatic route instead of Government route** so as to make the processes more efficient living upto ideals of **minimum government and maximum governance**. This is also in continuation of the liberalisation reforms started in 1991.
- Further refining of foreign investments in sectors such as Construction, manufacturing sector for wholesale, retail and e-commerce strengthening programmes like Make in India, Start up India, food processing and Digital India.
- The government has proposed in the budget about abolition of Foreign Investment Promotion Board for further liberalising FDI policy

Automatic Route: Under this route no Central Government permission is required.

Government Route: Under this route applications, are considered by the Foreign Investment Promotion Board (FIPB). Approval from Cabinet Committee on Security is required for more than 49% FDI in defence. The proposals involving investments of more than INR 30 billion are considered by Cabinet committee on economic affairs.

Student Notes:

- The measures taken by the Government are directed to **open new sectors for foreign direct investment, increase the sectoral limit of existing sectors and simplifying other conditions of the FDI policy.**

9.13. Foreign Direct Investment Policy 2016

- The FDI policy amendments are meant to liberalise and simplify the FDI policy so as to provide ease of doing business in the country leading to larger FDI inflows contributing to growth of investment, incomes and employment.
- According to PIB, most of the sectors would be under automatic approval route, except a small negative list. **With these changes, India is now the most open economy in the world for FDI.**
- **Food products:** It has now been provided that 100% FDI under government route for trading, including through e-commerce, is permitted in respect of food products manufactured and/or produced in India.
- **Foreign Investment in Defence Sector up to 100%:**
  - **Up to 49% FDI participation** in the equity of a company is permitted under automatic route.
  - **Foreign investment beyond 49% has now been permitted through government approval route** wherever it is likely to result in access to modern technology or for other reasons to be recorded.
  - FDI limit for defence sector has also been made applicable to Manufacturing of Small Arms and Ammunitions covered under Arms Act 1959.
  - **Impact on Indian economy and its defence sector**
  - It marks a major push to defence manufacturing under the 'Make in India' initiative.
  - It will ensure availability of cutting edge technologies for the defense forces, boost local manufacturing in India
- **Pharmaceutical:** The earlier FDI policy on pharmaceutical sector provides for 100% FDI under automatic route in greenfield pharma and FDI up to 100% under government approval in brownfield pharma. With the objective of promoting the development of this sector, 74% FDI under automatic route has been permitted in brownfield pharmaceuticals. FDI beyond 74% would be permitted through Government approval route.
- **Civil Aviation Sector**
  - With a view to aid in modernization of the existing airports to establish a high standard and help ease the pressure on the existing airports, **100% FDI under automatic route has now been permitted in Brownfield Airport projects.**
- **Animal Husbandry:** As per FDI Policy 2016, FDI in Animal Husbandry (including breeding of dogs), Pisciculture, Aquaculture and Apiculture is allowed 100% under Automatic Route under controlled conditions. The requirement of 'controlled conditions' for FDI in these activities has now been done away with.
- **Other sectors:**
  - FDI up to 100% under automatic route permitted in **Telecom**
  - FDI up to 100% under **automatic route permitted in Up-linking of Non- 'News & Current Affairs' TV Channels, Down-linking of TV Channels**
  - 100% FDI under automatic route permitted in the **marketplace model of e-commerce**
  - 100% FDI under Government route for **retail trading, including through e-commerce**, has been permitted in respect of food products manufactured and/or produced in India
  - 100% FDI allowed in **Asset Reconstruction Companies** under the automatic route
  - 49% FDI under automatic route permitted in **Insurance and Pension sectors**
  - 100% FDI under automatic route allowed on White Label ATMs

Student Notes:

9.14. FDI in Retail – Case in point

- **Single Brand Retail Trading:** Local sourcing norms have been relaxed up to three years, with prior Government approval, for entities undertaking Single Brand Retail Trading of products having 'state of art' and 'cutting edge' technology. For such entities, sourcing norms will not be applicable up to three years from commencement of the business i.e. opening of the first store for entities undertaking single brand retail trading of products having 'state-of-art' and 'cutting-edge' technology and where local sourcing is not possible. Thereafter, sourcing norms would be applicable;
- **Multi brand retail:** It has been argued that foreign direct investment (FDI) in multi-brand retail trading cannot happen before farmers and retailers are provided enough resources to face market competition. Issues such as last-mile connectivity such as lack of back-end infrastructural support, adequate credit and financial inclusion of farmers and traders remain. India's current FDI policy permits foreign players to hold 51 per cent stake in an Indian company, subject to government approval.
    a. **FDI via single brand retail in e commerce (***e commerce has also been referred to as democratized commerce)*
- According to few reports**, the share of e-commerce in retail is expected to jump from 2% in 2014 to 11% in 2019.**
- Indian government has allowed 100% foreign direct investment (FDI) in online retail of goods and services under the so-called "**marketplace model**" through the **automatic route**, seeking to legitimize existing businesses of e-commerce companies operating in India.
- The new rules proposed by the government prohibit marketplaces from offering discounts and capping total sales originating from a group company or one vendor at 25%. This may have been done to level the playing field with offline stores, which have witnessed a slump in footfalls corresponding to the increase in e-commerce.

> Indian e-commerce companies such as **Flipkart and Snapdeal** have been following the **marketplace model**—which was not defined—and attracting large foreign investments.
>
> **Marketplaces** essentially act as a platform connecting sellers and buyers. It is an information technology platform run by an e-commerce entity on a digital and electronic network to act as a facilitator between buyer and seller.

- Till now India has allowed 100% foreign investment in business-to-business (B2B) e-commerce but none in retail e-commerce—i.e., business-to-consumer, or B2C.
- DIPP has prohibited FDI in e-commerce companies that own inventories of goods and services and sell directly to consumers using online platforms.
- The government in the budget allowed 100% FDI in marketing of food products produced and manufactured in India.

10. Previous Years UPSC Mains Questions

1. Justify the need of FDI for the development of Indian economy. Why there is gap between MOUs signed and actual FDIs? Suggest remedial steps to be taken for increasing actual FDIs in India.
2. Craze for gold in Indians has led to a surge in import of gold in recent years and put pressure on balance of payments and external value of rupee. In view of this, examine the merits of the Gold Monetization Scheme.
3. FDI in defence sector is now set to be liberalized. What influence this is expected to have on Indian defence and economy in short run and long run?
4. Discuss the impact of FDI entry into multi-trade retail sector on supply chain management in commodity trade pattern of the economy.

Student Notes:

5. Though India allowed foreign direct investment (FDI) in what is called multi brand retail through joint venture route in September 2012, the FDI even after a year, has not picket up. Discuss the reasons.
6. Examine the impact of liberalization on companies owned by Indian. Are they competing with the MNCs satisfactorily?

10. Previous Years Vision IAS GS Mains Questions

1. ***Examine the causes of rupee depreciation and its impact on the Indian economy. Also discuss the steps taken by the Government and RBI to stem its slide.***

Approach:

- Write the major causes of rupee depreciation
- Then, list out the impacts on different areas due to the depreciation
- Finally, discuss the steps by govt. and RBI

Answer:

[Student Note: The answer has been kept long to discuss all points of the issue in detail at one place. Write down a summary within word limit for your answer]

Causes of Rupee Depreciation:

- **Appreciation in the US dollar:** Since the United States Federal Reserve hinted at exiting from Quantitative Easing (QE) in May 2013, the currencies of several emerging markets have been affected. Since then, the Indian Rupee has depreciated 22% against the US dollar. The easy money ensured that US funds moved to emerging markets like India in search of high yields. So, as the Fed tapers off its bond-purchasing program, and with US interest rates rising, the belief is that fund inflows to countries like India will also slow down.
- **Large Current Account deficit:** Depreciation is also a highly visible symptom of a much deeper economic malaise represented by the burgeoning current account deficit (CAD), which, at over $90 billion, threatens macroeconomic stability.
- **Weakening capital inflows:** Capital inflows have reduced due to the improving economic situation in the US and other developed countries. The prospect of the Federal Reserve's ultra-soft monetary policy ending has already raised bond yields there. As in other countries, the Indian bond market has also seen withdrawals by foreign institutional investors (FIIs) in the past few weeks. With a risk-off environment setting in globally, there have been redemptions from global exchange-traded funds (ETFs). This has led to selling by FIIs in the Indian equity market, compounding the rupee's woes.
- **Inflation:** Part of the depreciation is attributable to the adjustment of the rupee exchange rate to the inflation differential, i.e. India's relatively high rate of inflation versus other economies.

Impact of rupee depreciation:

- **RBI's monetary policy:** If the depreciation in rupee continues, it will further increase inflation. In such a situation RBI will have very less room to cut policy rates. No cut in policy rate will add to the borrower's woes, which are eagerly waiting to get rid of the high loan regime.
- **Fuel price:** A weak rupee will increase the burden of Oil Marketing Companies (OMCs) and this will be passed on to the consumers. If the OMCs increase fuel prices, there will be a substantial increase in overall cost of transportation, which will stoke up inflation.

Student Notes:

- **Country's fiscal health:** A frail rupee will add fuel to the rising import bill of the country and thereby increasing its current account deficit (CAD). A widening CAD is bound to pose a threat to the growth of overall economy.
- **Importers/Exporters:** Importers will strongly feel the pinch of falling rupee as they will be forced to pay more rupees on importing products. Conversely, a feeble rupee will bring delight to the exporters, as goods exported abroad will fetch dollars, which in return will translate into more rupees. Also, a weak rupee will make Indian produce more competitive in global markets, which will be fruitful for India's exports.

Steps taken up by RBI and Government:

The RBI and the government have taken the following steps to stabilize the currency markets, reduce the current account deficit and enhance capital inflows:

- **Capital Outflow:** The RBI reduced the limit for outbound investment and remittances from India.
- **Encouraging Capital Inflows:** RBI has removed administrative restrictions on investment schemes offered by banks to non-resident Indians, and removed ceiling on interest rates on deposit accounts held by NRIs. The government has liberalized the FDI limits for 12 sectors, including oil and gas. A Bill is pending in the Parliament to revise the FDI limit to 49% in the insurance sector. RBI increased the current overseas borrowing limit for banks from 50% to 100%, and allowed it to be converted into rupees and hedged with the RBI at concessional rate. RBI also allowed banks to swap fresh NRI dollar deposits with a minimum duration of 3 years with the RBI. Specific public sector undertakings are being permitted to issue quasi-sovereign bonds to mop up funds for the infrastructure sector. The norms for external commercial borrowings (ECBs) are also being eased to enable the oil PSUs to garner dollars for financing their import requirements.

In short, the strategy is to stimulate dollar inflows by further liberalizing external commercial borrowings (ECBs), freeing interest rates on non-resident Indian deposits, liberalizing FDI norms and directing a few public sector finance companies to mop up dollars by issuing quasi-sovereign bonds.

- **Limiting Imports and encouraging exports:** The Finance Ministry increased the customs duty on importing precious metals including gold and platinum. The strategy seeks to address supply-side issues, curbing the import of gold, silver and a few "non-essential" items. 20% of every lot of import of gold must be exclusively made available for the purpose of export.
- **Oil Import Needs:** RBI decided to provide dollar liquidity to three public sector oil-marketing companies (IOC, HPCL and BPCL) to help them meet their entire daily dollar requirements. RBI will provide dollars to oil importers through a special forex-swap window wherein oil companies will buy dollars from the central bank and, simultaneously agree to sell dollars back to RBI at a future date. Government is also considering increasing its import of crude oil from Iran, and pay for it directly in Indian rupees.
- **Trade Deficit:** Ministry of Commerce has set up a Task Force to consider currency swap arrangements for trade and explore the possibility of bypassing payment in dollars for trade and paying instead in rupees or the trading country's currency. RBI allowed exporters and importers more flexibility in management of their forward currency contracts.
- **Curbing Speculative in currency:** RBI increased the short-term emergency borrowing rates for banks. It lifted the Marginal Standing Facility (MSF) and the Bank Rate by 200 basis points. The daily holding requirements under the Cash Reserve Ratio for banks have been modified.

Student Notes:

2. *What are the benefits of Bilateral Investment Promotion and Protection Agreements (BIPA) in a globalized economy and comment on the present status in India with respect to BIPA.*

Approach

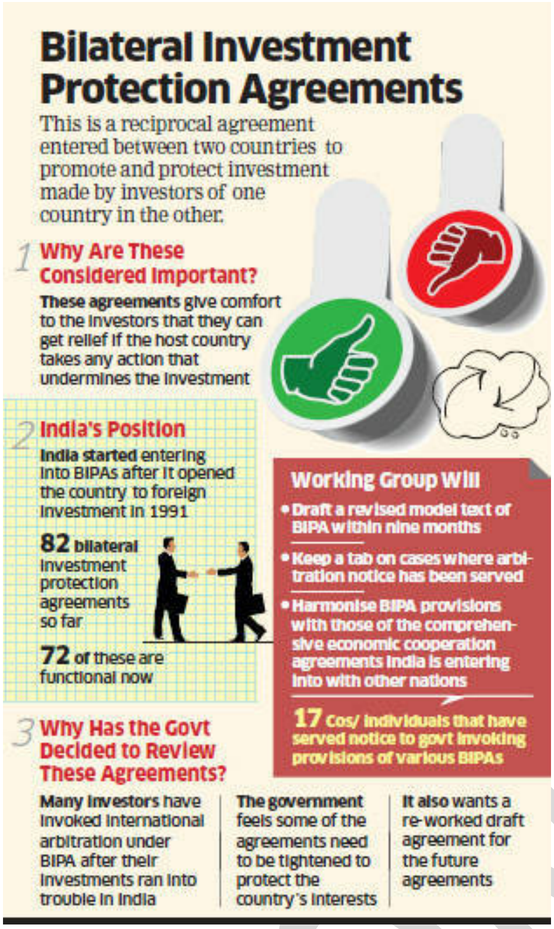
Discuss the purpose of BIPA in brief, discuss some brief features. Explain BIPA in Indian context with examples and highlight critical issues.

Answer:

- With the opening up of the economies world over, each country has been trying to attract foreign capital through liberalised investment policies. In such a scenario, all investors are seeking those investment destinations which provide most protective, hospitable and profitable climate for their investments. Many countries have entered into bilateral investment treaties or agreements which not only encourage capital flows into their own countries but also provide safe business environment for their own investors abroad.
- Bilateral Investment Promotion and Protection Agreement (BIPA) is one such bilateral treaty which is defined as an agreement between two countries for the reciprocal encouragement, promotion and protection of investments in each other's territories by the companies based in either country. Such agreements are beneficial for both the countries because they stimulate their business initiatives and thus enhance their prosperity.
- Salient features related to BIPA
  Generally, these bilateral agreements have, by and large, standard elements and provide a legal basis for enforcing the rights of the investors in the countries involved. They give assurance to the investors that their foreign investments will be guaranteed fair and equitable treatment, full and constant legal security and dispute resolution through international mechanism.
- Such Agreements increase the comfort level of the investors by assuring a minimum standard of treatment in all matters and provides for justifiability of disputes with the host country.
- **Related Issues**
  In the wake of current domestic mal practices in telecom licensing by Indian govt., corruption and other scandals, Supreme Court cancelled almost 22 licenses allotted to the telecom companies. Some of the companies such as Telenor, Systema, Kaif Investments, Capital Global and Axiata were foreign companies. For instance, Systema is a Russian company. Russian govt. invoked the cancellation of licence to Systema on the premise of BIPA which led a deterioration of bilateral relations. White Industries Australia has even got a favourable award against India’s decision. India faced similar issues with key trading partners such as UAE, UK, and other European countries.

Faced with the adverse consequences for the investment climate, the government had set up a cabinet committee to review major BIPAs. The committee has suggested a detailed road map for re-negotiation of all the 82 investment protection agreements.

Student Notes:



3. ***Even though India's export sector has had bouts of high growth at different stretches of time it is yet to take off in terms of its share in the world exports. Highlight the major issues associated with India's export sector along with measures that need to be taken to resolve them.***

Approach:

The issues mentioned should be relevant and in line with the current trends in the economy. Also the answer should emphasise on problems related to exports and not general issues associated with economy as a whole.

Answer:

India's merchandise exports share in world exports increased from 0.5 per cent in 1990 to only 1.7 per cent in 2013. As per economic survey 2013-14, India should aim to increase its share in world exports to at least 4 per cent in next five years. However, achieving this is going to be a big challenge and some of the major issues that need to be tackled are:

1. **Product Diversification:** Till now India's focus has been on exporting whatever it can. But now it needs to shift to items for which there is world demand and we have basic competence. A demand based export basket diversification with focus on three Es– Electrical, Electronic and Engineering goods is needed.
2. **Export Infrastructure:** Export infrastructure, especially port related infrastructure, needs immediate attention.
3. **Focus on useful Regional Trading Blocks:** India should ready itself to face new threats like TAFTA (Trans-Atlantic Free Trade Agreement). There is need to have some new useful RTAs/FTAs/CECAs.

Student Notes:

4. **Inverted Duty Structure:** This refers to the situation in which import duty on finished goods is lower than import duty on raw materials imported from other countries. This may happen due to carelessness while negotiating FTAs. So, a reality check of existing FTAs, RTAs and CECAs is needed.
5. **Export Promotion Schemes:** There are multiple and overlapping export promotion schemes with many focus markets and focus products with items and markets getting added each year. There is a need to rationalise these schemes to a bare minimum which will help in reducing transaction costs and trade litigations.
6. **SEZs:** SEZ policy needs a reboot as fresh investments are slowing down and greenfield SEZs have not really taken off.
7. **Trade Facilitation:** India ranks 142 in ease of doing business and 132 in trading across borders. India needs 9 export documents as compared to 3 in Singapore. There is a need to remove the delays and costs on account of procedural and documentation factors.
8. **Inter-twining of domestic and external policy:** This is especially relevant to agricultural exports as domestic shortages or excesses result in a knee-jerk reaction for agri-export policy.

These issues, if addressed, could lead to exponential gains for India's exports.

4. What are Offshore Rupee Bonds? Giving examples, discuss their benefits with regards to mobilisation of resources for domestic sector. Also, comment on their role in internationalisation of Indian Rupee.

Approach:

The definition should clearly explain the meaning of all the three terms –'Offshore', 'Rupee' and 'bonds'. Giving examples of IFC (Masala bonds), or Railway finance corp. bonds, benefits such as alternate and cheaper source of finance, increasing foreign investor base, hedging, etc. can be provided. Internationalisation through greater offshore trading should be mentioned. The role of retaining investor confidence must be emphasised.

Answer:

Offshore Rupee Bonds (ORBs) are debt instruments offered in capital markets outside India and are denominated in Indian rupees (meaning that the principal amount is linked to exchange rate of rupee). They are offered and settled in dollars to raise Indian rupees from international investors. The issuer converts bond proceeds from dollars into rupees in the domestic (Indian) market and uses them to finance its requirements in India. As such, the currency risk in these bonds resides with the investor. The investor base in these bonds is much wider than the FIIs, which invest in the Indian markets.

ORBs have been issued in past by the International Finance Corporation (IFC) with a maturity upto seven years. The latest issue is called 'Masala Bonds' which have a maturity of 10 years and are the first ORBs to be listed on London Stock Exchange. They are named so because masala is a globally recognised term that invokes culture and cuisine of India. Similar bonds are proposed to be offered by Indian Railway Finance Corporation and Asian Development bank. Reserve Bank of India has also allowed Indian corporates to issue ORBs. There are several benefits of ORBs, such as –

- Bringing liquidity and depth to offshore rupee market
- Crowding in foreign investors to invest in rupee bonds and fund domestic investment

Student Notes:

- Paving the way for an alternative source of funding for Indian Companies
- As currency risk is borne by the investor, the cost of borrowing as compared to External Commercial Borrowings (ECBs) comes down for the investor as there is no need for hedging.
- The cost of borrowing has also been lesser than government bonds in domestic markets.

It has been estimated that domestic corporates are likely to raise $30 billion in ECBs this fiscal year, while their Offshore Bond issues are likely to be $6 billion. In the next fiscal year, the bond issuances are likely to be $12 billion, but the quantum of ECBs will remain stagnant at $30 billion. However, the cost of funds for Indian companies will significantly depend on their ratings, which will be lesser than AAA rated Masala bond.

Internationalisation of the currency has two essential features:

- A state where exporters from other countries (such as Oil companies in Saudi Arabia) agree to take payments in rupees, and
- Where currency risks in international borrowings are borne by lenders rather than borrowers in India.

At the heart of internationalisation lies stability and confidence in the currency which makes it acceptable for cross-border transactions. Internationalisation is desired because countries that can borrow in their own currency are less susceptible to international crises. Please note that internationalisation is different from capital account convertibility, which means that domestic and foreign assets can be freely exchanged.

ORBs are a significant step towards internationalisation of rupee - they are international borrowings with currency risk at lenders' side. The Masala bonds were well received by foreign investors, notwithstanding the fact that rupee is still not fully convertible. ORBs are launch pad to sell strength of rupee to overseas investors as listing on foreign bourses will provide visibility and set benchmarks for yields in future issuances. Views on rupee will now be partially formed offshore, albeit in a very small way as ORBs will be subject to caps on external commercial borrowings. They could also increase demands for similar products as liquidity of these bonds rises. This also shows the confidence of international investors in Indian economy and rupee. This will require the government and the central bank to impart stability and confidence in the rupee internationally. Critical elements such as fiscal policy, current account balances and inflation have to be benchmarked to best standards to retain investor confidence in rupee. Putting these elements on a firm footing will be essential requirement for rupee internationalisation.

5. *India's export performance in the recent past has been poor in relation to the needs of the economy and in comparison with some other developing countries. Examine the reasons behind the decline in India's exports. Highlight the measures proposed in Foreign Trade Policy 2015 to overcome this challenge.*

Approach:

- Contextualise India's export performance in the introduction.
- Delineate the reasons for the performance on this front.
- Provide a comparison with other developing countries.
- Clearly delineate the reasons behind decline in India's exports.
- Measures proposed in Foreign trade policy 2015.

Student Notes:

Answer:

For 12 consecutive months from January to December in 2015, India's total exports were significantly lower than previous year. The data for the period 2010-11 to 2014-15 reveals stagnation in the dollar value of exports, around $300 billion per annum. It also shows that, on average, exports were able to finance just two-thirds of imports, leading to considerable trade deficit. India's export performance has been poor even in comparison with some other developing countries. Between July and December of 2015, months that India's exports were slumping, Bangladesh in fact saw exports grow by eight per cent year-on-year. Vietnam saw exports grow 9.2 per cent in 2015. This is a cause of concern for India's trade policy.

Following reasons can be identified in this context:

- **Slump in the** prices of various commodities has adversely impacted the value of Indian exports.
- **Global economy slowdown**- The Great Recession that followed the financial crisis of 2008 and the Great persists even now. Recovery in output is slow, uneven and fragile. The recovery in trade is just as slow.
- **Demand constraints-** There are demand constraints also for the exports of developing countries from their markets in slowing economies.
- **Infrastructural constraints** – Deficiencies in sectors such as Power, road, rail proved to be a drag on export competitiveness
- **Non-price factors** - Like quality, delay in delivery etc. also affects the competitiveness of manufactured exports.
- **Overvaluation of the rupee** which makes exports difficult and imports attractive, contributed to the stagnant export performance.
- **Chinese economy slowdown** - Imports from China have increased markedly following the slowdown in that country's economy whereas exports, chiefly in raw materials, have declined.

The foreign trade policy 2015 offers the following measures:

- It introduces two new schemes, namely "Merchandise Exports from India Scheme (MEIS)" and "Services Exports from India Scheme (SEIS)". The 'Services Exports from India Scheme' (SEIS) is for increasing exports of notified services.
- These schemes (MEIS and SEIS) replace multiple schemes earlier in place, each with different conditions for eligibility and usage. Incentives (MEIS & SEIS) to be available for SEZs also. e-Commerce of handicrafts, handlooms, books etc., eligible for benefits of MEIS.
- Branding campaigns planned to promote exports in sectors where India has traditional Strength.
- No need to repeatedly submit physical copies of documents available on Exporter Importer Profile.
- Export obligation period for export items related to defence, military store, aerospace and nuclear energy to be 24 months instead of 18 months
- Within manufacturing exports, the government will chart out a strategy to promote the key sectors of engineering products, electronic goods and textile exports.
- Within services, a host of incentives are likely to be rolled out to sectors such as tourism, hospitality, education, etc, which might be promoted in the form of project exports from India.

Student Notes:

6. ***Tax treaties intended to avoid double taxation have in many cases become instruments for double non-taxation. Elaborate. List the major amendments in the India-Mauritius DTAA and the advantages that are expected to accrue due to it.***

Approach:

- Briefly explain what is DTAA and its relevance. Substantiate the first statement given in the question.
- Now explain the negative spill overs or loopholes in the treaty leading to double non-taxation; a loss to the government.
- In light of above consequences, list down the amendments in the tax treaty and its advantages.

Answer:

A DTAA is a tax treaty signed between two countries. It is intended to make a country an attractive investment destination by providing relief on dual taxation.

However, often investors use the provisions of DTAA to route the investments through low tax regimes **to side step taxation**. This leads to loss of tax revenue for the country.

Evan a bigger issue is that of issue of double non-taxation. National tax laws have not kept pace with the globalization of corporations and the digital economy, leaving gaps that can be exploited by multi-national corporations to artificially reduce their taxes.

With a mélange of some creative accounting techniques and existing loopholes in different fiscal jurisdictions across the world, tax evasion has emerged as a global woe in the last few decades.

Thus there is a conscious attempt by many countries to tackle the reckless acts of base erosion and profit shifting (BEPS). For example: Amendment to India – Mauritius DTAA.

Major amendments of India-Mauritius DTAA:

- It will give right to india to tax capital gains arising from sale or transfer of shares of an Indian company acquired by a Mauritian tax resident provision to exempt investments made until march 31^{st}, 2017.
- The shares acquired between april 1^{st} 2017 to march 31^{st} 2019 will attract capital gains tax at 50% discount on domestic tax rate.

Thus under the amended treaty, the right to tax capital gains will be available to the country where the income arose.

Benefits of the amendments:

- Will plug in **black money** in the system, **money laundering** and **tax avoidance**.
- **tackle issues of treaty abuse** and round tripping of funds attributed to the India Mauritius treaty.
- Curb non-revenue, **prevent non taxation** and streamline the flow of investment.
- **Enhanced Exchange of information** between India and Mauritius.

Discourage speculators and non-serious investors and **overall reduce market volatility.**

- The revenue generated can be used by government for **higher public spending.**

Student Notes:

CAPITAL MARKET

Contents

Student Notes:

1. Introduction

Financial markets comprise both capital and money markets. Capital markets refer to markets that trade financial instruments with maturities longer than one year. Money markets trade debt securities or instruments of maturities of a year or less.

In the simplest terms, capital markets can be defined as a marketplace where buyers and sellers can engage in the trade of long term financial securities. Long term here means for a period greater than one year.

Markets are further segregated by the type of instrument—debt or equity—used to raise capital, i.e. debt market or stock market, and the derivatives market, which is used to manage risk. Capital markets are also distinguished as either primary or secondary. Borrowers raise funds in primary markets via primary issuances of stocks or bonds. Once these instruments are issued, they can be traded in secondary markets.

1.1. Primary Markets

The primary capital market is a market for new or fresh issues. This new or fresh issue of shares are called **Initial Public Offerings.** Primary market deals in the long-term flow of fund from the surplus sector to the government and corporate sector through primary issues and to banks and non-bank financial intermediary. Primary issues of the corporate sector lead to capital formation.

1.2. Secondary Markets

The secondary market also called "aftermarket" is the financial market for trading of securities that have already been issued in its initial private or public offering. Secondary market is also called share market. Share market includes exchange of those securities which are already sold and listed in the Primary market. Any transaction in the share market can be executed by the members of the exchange keeping in mind the rules and regulations of the SEBI.

2. Capital Markets vis-a-vis Commercial Banks

Intermediation between lenders (or savers) and borrowers (or users of funds) is a fundamental function of the financial system in an economy and is performed primarily by commercial banks and primary capital markets. The key distinction is that capital markets provide direct funding from saver to user via the issuance of securities, while bank intermediation involves indirect funding with banks as the go-between connecting the saver and user.

3. Characteristics of Capital Markets

Following characteristics are typical of Capital Markets:

1. The capital market is the market for securities, where companies and governments can raise long-terms funds.
2. The market in which corporate equity and loner-term debt securities those maturing in more than one year are issued and traded.
3. The capital market is market for long-term debt equity shares. In this market, the capital funds comprising of both equity and debt are issued and traded.
4. The market in which long-term securities such as stocks and bonds are bought and sold.
5. The capital market comprises financial securities, government securities, semi-government securities.
6. The capital market concerns two broad types of securities traded - debts and equity. Buying stock allows investors to gain an equity interest in the company and become an owner of the company.

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4. Significance of Capital Markets

Growth rate of an economy depends on infrastructure development, which in turn requires deep capital markets as banks may be averse to the risk or to the funding tenures.

Capital markets have several beneficial features for different participants in the economy.

For a *Company or entity in need of funding*:

- Capital markets provide an alternative source of funding that can complement bank financing.
- Capital markets can offer better pricing and longer maturities, as well as access to a wider investor base.
- They can also offer funding for riskier activities that would traditionally not be served by the banking sector, and by doing so contribute significantly to innovation in an economy.

For *Government*:

- A developed local capital markets can increase access to local currency financing and thereby help manage foreign exchange risk and inflation better.
- Local markets have the benefit of more easily tapping local investors, and often local banks.
- It can allow them to finance fiscal deficits by borrowing from local markets without exchange rate risk.
- The creation of local capital markets is enormously beneficial to governments attempting to finance development internally.

For *Investors and Savers*:

- Capital markets can offer more attractive investing opportunities—with better returns—than bank deposits, depending on risk profile, liquidity needs, and other factors.
- With a wider range of securities and instruments offered, capital markets can help investors diversify their portfolios and manage risk.
- This is particularly important for institutional investors, including pension funds and insurance companies.

For the *Economy as a whole*:

- Well-developed capital markets provide benefits at the macroeconomic level by supporting monetary policy transmission, which is facilitated through liquid securities markets.
- They can serve the financial sector by enhancing financial stability and reducing vulnerabilities to exchange rate shocks and sudden interruptions of capital flows.
- World Bank Group research has shown that emerging market countries with robust government bond markets were better able to manage the 2008 global financial crisis, averting major economic dislocations and helping firms and citizens maintain financial solvency and liquidity.

In this way, capital markets have a deeper impact on society. Through the use of derivatives, well-developed markets provide risk management tools not only to market participants, but also to end users as diverse as companies and agriculture producers.

5. Capital Market Participants

The supply in this market comes from savings from different sectors of the economy. These savings accrue from the following sources:

1. Individuals.
2. Corporate.
3. Governments.
4. Foreign countries.

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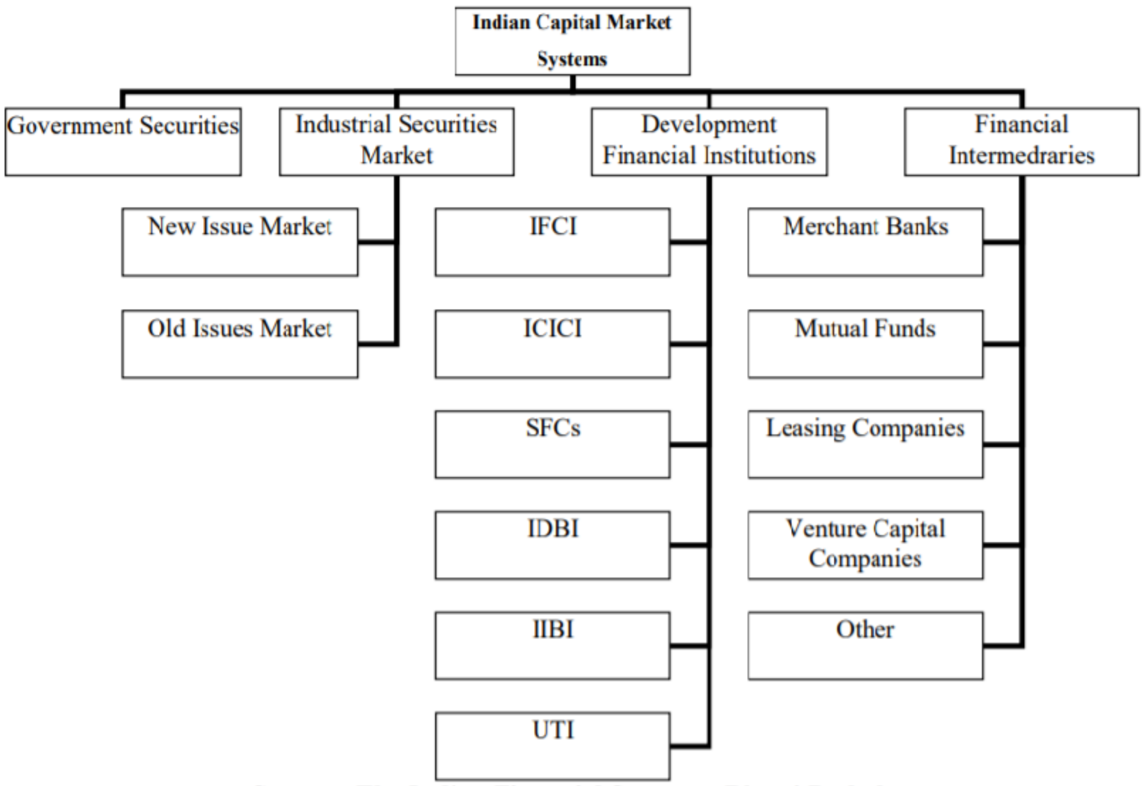
5. Banks.
6. Provident Funds.
7. Insurance Funds
8. Financial Institutions.

Individuals invest in these markets directly by investing in shares or debentures of companies through bond issues of public sector units or through mutual funds. Corporate who have more savings than their requirement for funds also are participants in this market.

Chart 1.1

Indian Capital Market Systems



6. Capital Market Instruments

Financial instruments that are used for raising capital resources in the capital market are known as Capital Market Instruments.

The various capital market instruments used by corporate entities for raising resources are as follows: 1. Preference shares 2. Equity shares 3. Non-voting equity shares 4. Cumulative convertible preference shares 5. Company fixed deposits 6. Warrants 7. Debentures 8. Bonds 9. Mutual fund 10. Derivatives 11. Commodities 12. Currency exchange

7. Indian Capital Market

The Indian capital market was not properly developed before Independence. The growth of the industrial securities market was very much hampered since there were very few companies and the number of securities traded in the stock exchanges was still smaller. Most of the British enterprises in India looked to the London capital market for funds than to the Indian capital market. A large part of the capital market consisted of the gilt-edged marker for government and semi-government securities.

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Since Independence and particularly after 1951, the Indian capital market has been broadening significantly and the volume of saving and investment has shown steady improvement. All types of encouragement and tax relief exist in the country to promote savings. Besides, many steps have been taken to protect the interests of investors and public at large which changed the Indian economy as a whole.

As a result, today Capital Markets in India is fairly developed. However, retail investors are yet to play a substantial role in the market as long-term investors. Retail participation in India is very limited considering the overall savings of households. Investors who hold shares in limited companies and mutual fund units are about 20-30 million. Those who participated in secondary markets are 2-3 million.

8. SEBI and Regulations of the Capital Market

Before the establishment of the securities and exchange board of India, the principal legislations governing the securities market in India were the Capital Issues Control Act 1956 and the Securities Contract Act, 1956.

Securities and Exchange Board of India (SEBI) was established in 1988 and given statutory powers in 1992 through the SEBI Act, 1992. It mandates the SEBI to perform a dual function: investor protection through regulation of the securities market and fostering the development of this market. The SEBI has full autonomy and authority to regulate and develop the capital market.

SEBI has been vested with most of the functions and powers under the Securities Contract Regulation (SCR) Act, which brought stock exchanges, their members, as well as contracts in securities which could be traded under the regulations of the Ministry of Finance. It has also been delegated certain powers under the Companies Act.

Functions of the SEBI are as follow:
1. Regulate the business in stock exchanges and any other securities markets.
2. Register and regulate the working of capital market intermediaries like brokers, merchant bankers, portfolio managers and so on.
3. Register and regulate the working of mutual funds.
4. Promote and regulate self-regulatory organizations.
5. Prohibit fraudulent and unfair trades' practices in securities markets.
6. Promote investors' education and training of intermediaries of securities markets.
7. Prohibit insider trading in securities.
8. Regulate substantial acquisition of shares and takeover of companies.
9. Perform such other functions as may be prescribed by the government.
10. Review any intermediary or market participant information.
11. Review books of depository participants, issuers of beneficiary owners.
12. Investigate and inspect books of accounts and record of insiders.
13. Suspend the registration of banker in case of any malpractice.

The government has framed rules under the Securities Contracts Act (SCRA), the SEBI Act and the Depositories Act. The power in respect of the contracts for sales and purchase of government securities, money market securities and ready forward contracts in debt securities are exercised concurrently by the RBI.

The *four main legislations* governing the capital market are as follows:
1. *The SEBI Act, 1992* which establishes the SEBI with four fold objectives of protection of the interests of investors in securities, development of the securities market, regulation of the securities market and matter connected therewith and incidental thereto.
2. The *Companies Act, 1956 as amended in 2013* which deals with issue, allotment and transfer of securities, disclosures to be made in public issues, underwriting, rights and bonus issues and payment of interest and dividends.

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3. The *Securities Contracts Regulation Act, 1956* which provides for regulations of securities trading and the management of stock exchanges.
4. The *Depositories Act, 1996* which provides for establishment of depositories for electronic maintenance and transfer of ownership of demat securities.

9. Challenges in Regulation of Capital Market

In the next four to five years, the direction of the capital markets will primarily depend on:

- Structural changes, including consolidation, to existing capital markets participants' business models.
- Non-traditional players challenging the status quo.
- Innovations including extensive use of big data, artificial intelligence (AI) and machine learning. Participants will seek to reduce cost and create competitive advantages.
- Straight through processing and use of distributed ledger and blockchain technology.
- Pools of capital increasingly looking to reach out directly to consumers of capital, thereby lowering costs and increasing overall liquidity. Crowd sourcing and peer to peer opportunities, real estate investment trusts and infrastructure investment trusts gaining momentum.
- Investment management seeing impetus through robo advice, smart contracts and electronic trading.
- Successful resolution of applications filed under the Insolvency and Bankruptcy Code (IBC).
- Cost pressures and innovation compelling market participants to maximize outsourcing arrangements. Regulators will have to deal with the attendant risks, especially of cross-border outsourcing.

An inter-regulatory working group set up by the Reserve Bank of India has recommended that an appropriate framework be introduced for "regulatory sandbox/innovation hub" within a well-defined space and duration where financial sector regulators will provide the requisite regulatory support, so as to increase efficiency, manage risks and create new opportunities for consumers in the Indian context similar to other regulatory jurisdictions.

10. Performance of Indian Capital Markets – Recent Scenario

The Indian economy has shown unprecedented growth in the last few decades post liberalisation. A robust capital market supplemented by technological advancement and a strengthened legal framework has played a major role in driving the growth thus far.

Indian capital market has done fairly well in 2018 as compared to other global markets. In this success, IPOs hold a special place.

The reasons for robust growth of Indian Capital Market are:

1. The promising corporate earnings combined with a rising domestic investor appetite
2. Development of junior platforms such as the NSE Emerge and BSE SME with a corresponding surge in offerings on these IPOs have been a bumper trend in recent times
3. Having overcome the effects of two bold moves by the current government, the demonetisation drive of 2016 and implementation of the Goods and Services Tax led to a better-than-expected corporate earnings and a stable GDP growth
4. The policy changes brought about by the market watchdog SEBI have also played a very important role in maintaining the current pace of fundraising activity with factors such as good corporate governance, robust financials and the timing always playing a critical role in the success of any public issue.

10.1. Recent Measures undertaken by the SEBI

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Few measures undertaken by SEBI in the year 2018 to make the market environment IPO friendly are as follows-

To uphold investor confidence and preservation of interest of all stakeholders, following steps have been taken -

1. The definition of independent director has been tweaked to enhance their accountability in a scenario where this role has often been called into question in the wake of several scams.
2. The role of the independent directors will now be evaluated for their performance as well as fulfilment of the independence criteria by the board of a listed entity.
3. Further, the year 2019 and 2020 are set to witness the implementation of the cap on maximum number of directorships such as no person must serve as an independent director in more than seven listed entities. Same goes for related party transactions.
4. The Board of Directors has now been made responsible for review of the approved policy once every three years and a complete ban on a related party from voting on any related party transactions.
5. Emphasis has also been laid on the separation of the positions of chairperson from that of a managing director or a chief executive officer. This, too, is going to become a reality by the year 2020 for top 500 listed entities to start with.

To ease the process of public issues so that more companies come forward and avail the benefits, following steps have been taken-

1. The replacement of the Securities and Exchange Board of India (Issue of Capital and Disclosure Requirements) Regulations, 2009 ("ICDR Regulations 2009") with the new regulations of 2018.
2. Rationalisation of disclosure requirement which include financial information to be provided for a period of three years instead of five, threshold for identifying promoter group increased from 10% to 20%, criteria for identification of group companies, etc.
3. To boost participation by a wider gamut of investors including domestic investors, the shortfall in promoter contribution can now be met by alternative investment funds, foreign venture capital investors, scheduled commercial banks, public financial institutions and insurance companies without being categorized as a promoter.
4. SEBI has also permitted anchor investors to make a minimum application of Rs.2 crores in case of SME IPOs, a move which is likely to enhance participation by anchor investors in SME IPOs.

Miscellaneous steps taken by the SEBI and the Government are as follows:-

1. It has been made mandatory for large borrowers to source 25% of their incremental borrowings from the bond market.
2. Complete ban on wilful defaulters and fugitive economic offenders from coming up with an initial public offering
3. disciplinary actions including past penalties against the promoters in the past five financial years are to be mandatorily disclosed
4. To further boost foreign investment, SEBI has relaxed the eligibility and KYC norms for foreign portfolio investment (FPIs) and allowed the FPIs a period of two years for complying with the relaxed norms.
5. The government has also relaxed FDI norms by enhancing sectoral limits across various sectors in an effort to boost foreign investment.
6. SEBI has also introduced algo-trading, a computer based trading system where investors have an upper hand in executing trades and benefit from their speedy execution.
7. SEBI has also proposed incorporating the United Payments Interface ("UPI") with the Application Supported by Blocked Amount ("ASBA") mechanism, in order to streamline the

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process of raising funds via public issue. This method will cut down the listing time for an IPO from its current 6 days to 3 days

8. Government of India in the Union Budget 2018-19 stated that: "SEBI will also consider mandating, beginning with large corporates, to meet about one-fourth of their financing needs from the debt market."

11. Outlook For 2019

The reform initiatives recently undertaken in the realm of capital markets is likely to see an active market for IPOs even in the year 2019.

With such favourable regulatory environment, there are greater chances of the markets becoming more attractive to both domestic and foreign investors with current investment pattern providing comfort in the long run. SEBI, as a torchbearer of the capital markets, by maintaining higher regulatory standards has demonstrated the depth and maturity of the Indian capital markets and is gradually helping restore investor confidence.

Barring the threat of external factors such as the global cues and the forthcoming general elections, there still remains a strong pipeline of drafts filed with the regulator to look forward to in 2019.

12. Way Forward

To reliably extract the benefits of well-functioning markets, adequate regulation for issuers, investors, and intermediaries in addition to robust supervisory arrangements to protect investors, promote deep and liquid markets, and manage systemic risk are critical. Such a framework in turn needs to be anchored in a good investment climate that includes a sound taxation and accounting framework, reliable and quality accountancy, creditor rights, property rights, and bankruptcy and competition law.

In this Context, the Indian Government and the SEBI has taken a number of laudable measures. Also, both SEBI and retail participants should be active in spreading market wisdom and empowering investors in planning their finances and understanding the markets. The reform process should continue in consultation with all stakeholders.

13. Miscellaneous

13.1. Exchanges in India

The stock exchanges are important player of the capital market. They are the platform of trading in securities and as such they assists and control the buying and selling of securities. Thus, stocks exchanges constitute of a market where securities issued1 by the central and state, governments, public bodies and joint stock companies are traded. There are mainly four stock exchanges in India as follow:

13.1.1. Bombay Stock Exchange (BSE)

The BSE is a voluntary, non-profit making association of broker members which emerged as premier stock exchange after the 1960s. In March 1995, the BSE turned to electronic trading whereby brokers trade using computers and technology. This system is known as the BSE on line trading system.

13.1.2. National Stock Exchange (NSE)

The NSE was set up in November 1992 to encourage stock exchange reform through system modernization and competition. It is an electronic screen based system where members have equal access and equal opportunity of trade irrespective of their location in different parts of the country as they are connected through a satellite network.

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13.1.3. The Over The Counter Exchange of India (OTCEI)

The OTCEI arose out of the need to have a second tire market in the country. It was set up to provide small and medium companies an access to capital market for raising finance in a cost effective manner and investors with a convenient, transparent and efficient avenue for capital market investment. The OTCEI was the first ring less, electronic and national exchange with a screen based trading system listing an entirely new set of companies of small size. It allowed companies with a paid up capital as low as 30 lacs to get listed.

13.1.4. Regional Stock Exchanges

The regional stock exchanges provided investors an access to big brokers in Mumbai. They also serve as a link between the local companies and local investors. Each regional stock exchange followed its own practice and procedures in respect of listing and trading of securities, clearing and settlement of transaction, and risk containment measures. Some examples of Regional Stock Exchanges are –Bombay Stock Exchange; Kolkata Stock Exchanges; Pune Stock Exchange etc.

14. Depository Receipt

Concept

- A DR is a type of negotiable (transferable) financial security traded on a local stock exchange usually in the form of equity, issued by a foreign, publicly-listed company.
- The DR, which is a physical certificate, allows investors to hold shares in equity of other countries.

Significance

- It is an important mechanism through which issuers can raise funds outside their home jurisdiction. DRs are issued for tapping foreign investors who otherwise may not be able to participate directly in the domestic market.
- It is perceived as the beginning point of connecting with the foreign investors (i.e. a stage before the actual listing the shares /securities in a foreign stock exchange) or a way of introducing the company to a foreign investor.
- For investors, depository receipt is a way of diversifying the risk, by getting exposure to a foreign market, but without the exchange rate risk as they are foreign currency denominated. Further, they feel safer to invest from their home location.

Working of Depository Receipts (DRs)

- DRs are created when a foreign company wishes to list its securities on another country's stock exchange. For this, the issuing company has to fulfill the listing criteria for DRs in the other country.
- Before creating DRs, the shares of the foreign company, which the DRs represent, are delivered and deposited with the custodian bank of the depository creating the DR.
- Once the custodial bank receives the delivery of shares, the depository creates and issues the DR to investors in the country where the DRs are listed.
- These DRs are then listed and traded in the local stock exchanges of the other country.

Types

Depending on the location in which these receipts are issued they are called as

- **ADRs** or American Depository Receipts (if they are issued in USA)
- **IDR** or Indian Depository Receipts (if they are issued in India) or
- **GDR** or Global Depository Receipt, in general.

Student Notes:

14.1. American Depository Receipt (ADR)

- It is a certified negotiable instrument representing the shares of a foreign company issued by an American bank that can be traded in U.S. financial markets. It provide US based investors with an opportunity to trade in shares of a foreign company.
- These are further classified based on the detailed rules under the US securities laws. The classification is based on applicable disclosure norms and consists of:
  - **Level 1**: These programs establish a trading presence in the US but cannot be used for capital raising. They may only be traded on OTC markets, and can be unsponsored.
  - **Level 2**: These programs establish a trading presence on a national securities exchange in the US but cannot be used for capital raising.
  - **Level 3**: These programs can not only establish a trading presence on a national securities exchange in the US but also help raise capital for the foreign issuer.

14.2. Global Depository receipts (GDRs)

- As per the Companies Act, 2013 GDRs means any instrument in the form of a depository receipt created by a foreign depository outside India and authorised by a company making an issue of such depository receipts.
- GDR is a collective term for DRs issued in non-US jurisdictions and includes the DRs traded in London, Luxembourg, Hong Kong, Singapore.

Example

- Volkswagen, a German company trades on New York Stock Exchange. The investor in America can easily invest into the German company, through the stock exchange.
- Volkswagen is listed on the American stock exchange after complying the required laws.
- On other hand if the shares of Volkswagen are listed in stock markets of countries other than US then it is termed as GDR.

14.3. Indian Depository Receipts (IDRs)

- IDRs are transferable securities to be listed on Indian stock exchanges in the form of depository receipts created by a Domestic Depository in India against the underlying equity shares of the issuing company which is incorporated outside India.
- In India any company - whether private limited or public limited or listed or unlisted - can issue DRs. However listed DRs enjoy some tax benefits.

Benefits of IDRs

- **To companies**- They lead to increased access to capital, are a means of increasing global visibility and trade, allow increased liquidity and global benchmark valuation and an international shareholder base
- **To investors**- They allow global investing opportunities without the risk of investing in unfamiliar markets, ensure more information and transparency and improve the breadth and depth of the market.

14.4. Difference between IDRs, ADRs and GDRs

- GDRs and ADRs are amongst the most common DRs. When the depository bank creating the depository receipt is in the US, the instruments are known as ADRs.
- Similarly, other depository receipts, based on the location of the depository bank creating them, have come into existence, such as the GDR, the European Depository Receipts, International Depository Receipts, etc.
- ADRs are traded on stock exchanges in the US, such as Nasdaq and NYSE, while GDRs are traded on the European exchanges, such as the London Stock Exchange.
- Both ADRs and GDRs are usually denominated in US dollars, but can also be denominated in Euros.

Student Notes:

15. Derivatives

Types of derivatives

- **Forwards:** A forward contract is a customized contract between two entities, where settlement takes place on a specific date in the future at today's preagreed price.
- **Futures:** A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future at a certain price. Futures contracts are special types of forward contracts in the sense that the former are standardized exchange-traded contracts, such as futures of the Nifty index.
- **Options:** An Option is a contract which gives the right, but not an obligation, to buy or sell the underlying at a stated date and at a stated price. While a buyer of an option pays the premium and buys the right to exercise his option, the writer of an option is the one who receives the option premium and therefore obliged to sell/buy the asset if the buyer exercises it on him. Options are of two types - **Calls** and **Puts** options:
    - ***"Calls'*** give the buyer the right but not the obligation to buy a given quantity of the underlying asset, at a given price on or before a given future dates.
    - ***"Puts'*** give the buyer the right, but not the obligation to sell a given quantity of underlying asset at a given price on or before a given future date.
- **Warrants:** Options generally have lives of up to one year. The majority of options traded on exchanges have maximum maturity of nine months. Longer dated options are called Warrants and are generally traded over-the-counter.

Commodity exchange

- A Commodity Exchange is an association, or a company of any other body corporate organizing futures trading in commodities.

Difference between Commodity and Financial derivatives

- The basic concept of a derivative contract remains the same whether the underlying happens to be a commodity or a financial asset. However there are some features which are very peculiar to commodity derivative markets.
- In the case of financial derivatives, most of these contracts are cash settled. Even in the case of physical settlement, financial assets are not bulky and do not need special facility for storage. Due to the bulky nature of the underlying assets, physical settlement in commodity derivatives creates the need for warehousing.
- Similarly, the concept of varying quality of asset does not really exist as far as financial underlyings are concerned. However in the case of commodities, the quality of the asset underlying a contract can vary at times.

16. Mutual Funds (MFs)

Concept

- Mutual Funds refer to a pool of money accumulated by several investors who aim at saving and making money through their investment.
- The corpus of money so created is invested in various asset classes, viz. debt funds, liquid assets and the like.
- Just like gains and rewards earned over the period of investment, losses are also shared by all the investors in equal proportion, i.e. in accordance with their proportion of contribution to the corpus.
- Mutual Funds are registered with SEBI (Securities and Exchange Board of India) that regulates security markets prior to the collection of the funds from the investors.

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Benefits of investing in Mutual Funds

- **Small investments**: Mutual funds help you to reap the benefit of returns by a portfolio spread across a wide spectrum of companies with small investments.
- **Professional fund management**: Professionals having considerable expertise, experience and resources manage the pool of money collected by a mutual fund. They thoroughly analyse the markets and economy to pick good investment opportunities.
- **Spreading risk**: An investor with limited funds might be able to invest in only one or two stocks/bonds, thus increasing his or her risk. However, a mutual fund will spread its risk by investing a number of sound stocks or bonds.
- **Transparency**: Mutual Funds regularly provide investors with information on the value of their investments. Mutual Funds also provide complete portfolio disclosure of the investments made by various schemes and also the proportion invested in each asset type.
- **Choice**: The large amount of Mutual Funds offer the investor a wide variety to choose from. An investor can pick up a scheme depending upon his risk/return profile.
- **Regulations**: All the mutual funds are registered with SEBI and they function within the provisions of strict regulation designed to protect the interests of the investor.

Risks involved in Mutual Funds

Mutual Funds do not provide assured returns. Their returns are linked to their performance. Some of the risk to which Mutual Funds are exposed to is given below:

- **Market risk**- If the overall stock or bond markets fall on account of overall economic factors, the value of stock or bond holdings in the fund's portfolio can drop, thereby impacting the fund performance.
- **Non-market risk**- Bad news about an individual company can pull down its stock price, which can negatively affect fund holdings. This risk can be reduced by having a diversified portfolio that consists of a wide variety of stocks drawn from different industries.
- **Interest rate risk-** Bond prices and interest rates move in opposite directions. When interest rates rise, bond prices fall and this decline in underlying securities affects the fund negatively.
- **Credit risk**- Bonds are debt obligations. So when the funds invest in corporate bonds, they run the risk of the corporate defaulting on their interest and principal payment obligations and when that risk crystallizes, it leads to a fall in the value of the bond causing the NAV of the fund to take a beating.

Net Asset Value (NAV)

- NAV or Net Asset Value of the fund is the cumulative market value of the assets of the fund net of its liabilities. NAV per unit is simply the net value of assets divided by the number of units outstanding. Buying and selling into funds is done on the basis of NAV-related prices.

Types of Mutual Funds

A. <u>On the basis of objective</u>

- **Equity Funds/ Growth Funds**- Funds that invest in equity shares are called equity funds. They carry the principal objective of capital appreciation of the investment over the medium to long-term. They are best suited for investors who are seeking capital appreciation. There are different types of equity funds
    - **Diversified funds**- These funds invest in companies spread across sectors. These funds are generally meant for risk-averse investors who want a diversified portfolio across sectors.
    - **Sector funds**- These funds invest primarily in equity shares of companies in a particular business sector or industry. These funds are targeted at investors who are bullish or fancy the prospects of a particular sector.

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- ○ **Index funds**- These funds invest in the same pattern as popular market indices like CNX Nifty or CNX 500. The money collected from the investors is invested only in the stocks, which represent the index. For e.g. a Nifty index fund will invest only in the Nifty 50 stocks. The objective of such funds is not to beat the market but to give a return equivalent to the market returns.
- **Tax Saving Funds**- These funds offer tax benefits to investors under the Income Tax Act. Opportunities provided under this scheme are in the form of tax rebates under the Income Tax act.
- **Debt/Income Funds**- These funds invest predominantly in high-rated fixed-income-bearing instruments like bonds, debentures, government securities, commercial paper and other money market instruments. They are best suited for the medium to long-term investors who are averse to risk and seek capital preservation. They provide a regular income to the investor.
- **Liquid Funds/Money Market Funds**- These funds invest in highly liquid money market instruments. The period of investment could be as short as a day. They provide easy liquidity. They have emerged as an alternative for savings and short-term fixed deposit accounts with comparatively higher returns.
- **Gilt Funds-** These funds invest in Central and State Government securities. Since they are Government backed bonds they give a secured return and also ensure safety of the principal amount. They are best suited for the medium to long-term investors who are averse to risk.
- **Balanced Funds**- These funds invest both in equity shares and fixed-income-bearing instruments (debt) in some proportion. They provide a steady return and reduce the volatility of the fund while providing some upside for capital appreciation. They are ideal for medium to long-term investors who are willing to take moderate risks.

B. <u>On the basis of flexibility</u>

- **Open-ended Funds**- These funds do not have a fixed date of redemption. Generally they are open for subscription and redemption throughout the year. Their prices are linked to the daily net asset value (NAV). From the investors' perspective, they are much more liquid than closed-ended funds.
- **Close-ended Funds**- These funds are open initially for entry during the Initial Public Offering (IPO) and thereafter closed for entry as well as exit. These funds have a fixed date of redemption. One of the characteristics of the close-ended schemes is that they are generally traded at a discount to NAV; but the discount narrows as maturity nears. These funds are open for subscription only once and can be redeemed only on the fixed date of redemption.

17. Exchange Traded Fund (ETF)

Concept

- Exchange Traded Funds (ETFs) are mutual funds listed and traded on stock exchanges like shares. Index ETFs are created by institutional investors swapping shares in an index basket, for units in the fund.
- Usually, ETFs are passive funds where the fund manager doesn't select stocks on your behalf. Instead, the ETF simply copies an index and endeavours to accurately reflect its performance. In an ETF, one can buy and sell units at prevailing market price on a real time basis during market hours.
- Lately, the Government has latched upon the Exchange Traded Funds (ETFs) route to disinvest its holdings in public sector companies rather than sell them on a piecemeal basis in the market. One such vehicle is the Bharat 22 ETF, a fund which houses 22 public sector companies.

Student Notes:

Importance

- ETFs are cost efficient. Given that they don't make any stock (or security choices), they don't use services of star fund managers.
- ETFs allow investors to avoid the risk of poor security selection by the fund manager, while offering a diversified investment portfolio.
- Stocks in the indices are carefully selected by index providers and are rebalanced periodically.
- ETFs offer anytime liquidity through the exchanges.
- ETFs provide easy access to asset classes by tracking the performance of underlying indices.

Structure

- Exchange Traded Funds are pools of securities whose ownership units are known as shares.
- Shareholders are indirect owners of the underlying assets of an ETF and the said shares are the proof of this ownership.
- An ETF can take the structure like that of a corporation or a trust and this is dependent on the structures permitted by the country of domicile.
- For instance, in the US, ETFs are mostly structured as open-end management investment companies.

Disadvantages

- **Tracking error**- Though no ETF can completely replicate its underlying index, a noticeable tracking error can be witnessed in strategies which may not allow complete replication of the index due to liquidity issues, like leverage strategies or ETFs investing in commodities.
- **Illiquid due to small size**- For relatively small funds, it may be difficult to completely replicate an index, which may not only increase its tracking error but also make it illiquid, especially in times of distress.
- **Tax implications**- For ETFs which invest beyond the traditionally popular asset classes of equities and fixed income, investors need to exercise caution as apart from an increased tracking error, tax implications may be high at best or unclear at worst, which may have a sizable impact on returns.

Bharat 22 ETF

- It allows the Government to park its holdings in selected PSUs in an ETF and raise disinvestment money from investors at one go.
- It tracks the specially made S&P BSE Bharat 22 Index, managed by Asia Index Private Limited. This index is made up of 22 PSU stocks and with a few private sector companies.

18. Corporate Bonds

Concept

- Corporate bonds are debt securities issued by private and public corporations.
- Companies issue corporate bonds to raise money for a variety of purposes, such as building a new plant, purchasing equipment, or growing the business.
- When one buys a corporate bond, one lends money to the "issuer," the company that issued the bond.
- In exchange, the company promises to return the money, also known as "principal," on a specified maturity date. Until that date, the company usually pays you a stated rate of interest, generally semiannually.
- While a corporate bond gives an IOU from the company, it does not have an ownership interest in the issuing company, unlike when one purchases the company's equity stock.

Student Notes:

Valuation of Corporate Bonds

Corporate bonds tend to rise in value when interest rates fall, and they fall in value when interest rates rise. Usually, the longer the maturity, the greater is the degree of price volatility.

By holding a bond until maturity, one may be less concerned about these price fluctuations (which are known as interest-rate risk, or market risk), because one will receive the par, or face, value of the bond at maturity.

The inverse relationship between bonds and interest rates—that is, the fact that bonds are worth less when interest rates rise and vice versa can be explained as follows:

- When interest rates rise, new issues come to market with higher yields than older securities, making those older ones worth less. Hence, their prices go down.
- When interest rates decline, new bond issues come to market with lower yields than older securities, making those older, higher-yielding ones worth more. Hence, their prices go up.
- As a result, if one sells a bond before maturity, it may be worth more or less than it was paid for.

19. Commercial Papers

Concept

- Commercial paper, or CP, is a short-term debt instrument issued by companies to raise funds generally for a time period up to one year.
- It is typically issued by large banks or corporations to cover short-term receivables and meet short-term financial obligations, such as funding for a new project.

Reason for introduction

- It is an unsecured money market instrument which was introduced in India in 1990 with a view to enabling highly rated corporate borrowers to diversify their sources of short-term borrowings and to provide an additional instrument to investors.
- Subsequently, primary dealers and all-India financial institutions were also permitted to issue CP to enable them to meet their short-term funding requirements for their operations.

Denominations and maturity period

- CPs have a minimum maturity of seven days and a maximum of up to one year from the date of issue.
- However, the maturity date of the instrument typically should not go beyond the date up to which the credit rating of the issuer is valid.
- They can be issued in denominations of ₹ 5 lakh or multiples thereof.

Types of investors

- Individuals, banking companies, other corporate bodies (registered or incorporated in India) and unincorporated bodies, non-resident Indians and foreign institutional investors etc. can invest in CPs.

Rating requirements

- Any company keen to raise funds through CP needs to obtain the credit rating either from CRISIL, ICRA, CARE, FITCH or any other credit rating agency (CRA) that may be specified by RBI.
- The minimum credit rating shall be A-2 as per SEBI guidelines. The issuers also needs to ensure that at the time of issuance of Commercial Paper the rating so obtained is current and has not fallen due for review.
- Since such instruments are not backed by collateral, only firms with high credit ratings from a recognised rating agency will be able to sell their commercial paper at a reasonable price.

Student Notes:

- CPs are usually sold at a discount from face value, and carries higher interest repayment rates than bonds.

20. Participatory-Notes

Concept

- Participatory Notes or P-Notes are financial instruments issued by foreign institutional investors to investors and hedge funds who wish to invest in Indian stock markets. These are also called Offshore Derivative Instruments.
- P-Notes, mostly used by overseas HNIs (high net worth individuals), hedge funds and other foreign institutions, allow such investors to invest in Indian markets through registered foreign institutional investors (FIIs).
- Till a few years ago, P-Notes used to account for more than 50 per cent of the total FII investments, but their share has fallen after SEBI tightened the disclosure norms and other regulations for such investments.

Working

- Brokers and Foreign institutional investors (FIIs) registered with SEBI, issue the financial instruments to investors in other countries who want to invest in Indian securities.
- This system lets unregistered overseas investors buy Indian shares without the need to register with the Indian regulatory body. These investments are also beneficial to India. They provide access to quick money to the Indian capital market
- Because of the short-term nature of investing, regulators have fewer guidelines for foreign institutional investors. To invest in the Indian stock markets and to avoid the cumbersome regulatory approval process, these investors trade participatory notes.

Pros and cons of P-notes

- Participatory notes are easily traded overseas through endorsement and delivery. They are popular because investors anonymously take positions in Indian markets, and hedge funds may anonymously carry out their operations. Some entities route their investments through participatory notes to take advantage of tax laws that are available in certain countries.
- However, because of the anonymity, Indian regulators face difficulty determining a participatory notes original owner and end owner. Therefore, substantial amounts of unaccounted for money enters the country through participatory notes. This flow of untracked funds has raised some red flags. Also, it can be used for round-tripping of black money.
- To quote Manmohan Singh – "The PN system is blatantly discriminatory and seems to favour ghost investors. Any self-respecting market, if it discriminates at all, does so against outsiders. But we have done the unthinkable. We should recognise and internalise the fact that funds are in search of markets, and not the other way."

P-note regulation in India

In the background of the hunt for black money, restrictions over P-Notes are tightened. Hence, over the last one decade, SEBI was slowly tightening norms on P-Notes.

- In May 2016, SEBI has extended the KYC (Know Your Client) norms and anti-money laundering norms to the PN subscribers also
- In July 2017, Sebi had notified stricter norms stipulating a fee of USD 1,000 on each instrument to check any misuse for channelising black money.
- SEBI also issued a circular banning FPIs from issuing Participatory Notes for investing in equity derivatives. However, investment in the cash segment can be continued. But this move of eliminating derivate investment in equity shares is a step towards minimising the use of PNs by foreign investors.

Student Notes:

Example

- An investor deposits funds with the U.S. or European operations of a registered foreign institutional investor (FII), such as HSBC or Deutsche Bank.
- The investors then inform the bank the Indian security or securities they wish to purchase. Funds transfer from the investor to the FII account, and the FII issues the participatory notes to the client and buys the underlying stock or stocks in the correct quantities from the Indian marketplace.
- The investor is eligible to receive dividends, capital gains and any other payouts due to stockholders holding the shares of the Indian company.

21. Previous Years Vision IAS GS Mains Questions

1. The National Spot Exchange Ltd. crisis has been in news recently. Discuss the crisis, its causes and suggest a way forward.

Approach:

- This question involves some intricate concepts of economics, which may require some extra effort to understand.
- Key points that require understanding:
  - The original intended role of NSEL i.e. spot market for commodities
  - NSEL's involvement in forward trading, which was beyond its original mandate.
  - Recent decision of the govt. to stop launching the new forward contracts triggered the crisis.
  - Failure of the regulator to keep a watch over the exchange activities; so regulatory system should be strengthened.
- If you are able to comprehend the key points, then it should be sufficient to write this answer without going into too much details.
- But in case, you are not able to comprehend the key points – its still ok. Just refer the basic concepts of economics related to spot markets and forward trading.

Answer:

- The National Spot Exchange Ltd. (NSEL)'s mandate is to offer a national electronic spot-trading platform for agricultural commodities and metals. But by deciding to go well beyond its brief into forward trading of commodities the exchange has run into a big crisis.
- Though it was founded mainly to offer a national spot market for commodities, the exchange secured specific approval from the government to offer one-day forward contracts.
- The conditions were that there would be no short-sales and that all outstanding positions will be settled by delivery. However, NSEL allowed forward contracts to be rolled over under the excuse that the FCRA does not prescribe a period for delivery. It also appears to have turned a blind eye to short-sales by traders speculating in the forward market.
- Spotting the opportunity, brokers and traders started offering "products" tailored for their clients with assured returns of 15 per cent and more for speculating in commodities on NSEL. And forward contracts became the mainstay of its business with spot trading being the poor sibling.
- The crisis began when recently, Ministry of Consumer Affairs (MCA), which oversees commodities bourses, and the FMC asked NSEL to stop launching new contracts until further orders. The FMC also sought an undertaking that all existing contracts will be settled on their due dates.
- Bowing to the directives, NSEL told its members that contracts have to be settled within 11 days and it would be on a trade-to-trade basis, that is, payment against

Student Notes:

delivery of the commodity. This lead to a fall in trading volumes as traders, who were active in forwards, lost interest in spot trading.

- As traders failed to roll-over their contracts and demanded settlement, the exchange ran into trouble. NSEL was also forced to down its shutters by suspending trading in order to counter speculation of a payments crisis.
- Crisis like these force us to rethink on the role of regulators. Most expert committees on finance have recommended that the system needs a 'unified regulator' for markets to plug such holes. The NSEL scam may give way to the merger of the FMC with the SEBI.
- The government should no longer allow the present regulatory structure to continue which provides opportunities for unscrupulous operators to escape regulation.

2. *What are Offshore Rupee Bonds? Giving examples, discuss their benefits with regards to mobilisation of resources for domestic sector. Also, comment on their role in internationalisation of Indian Rupee.*

Approach:

The definition should clearly explain the meaning of all the three terms –'Offshore', 'Rupee' and 'bonds'. Giving examples of IFC (Masala bonds), or Railway finance corp. bonds, benefits such as alternate and cheaper source of finance, increasing foreign investor base, hedging, etc. can be provided. Internationalisation through greater offshore trading should be mentioned. The role of retaining investor confidence must be emphasised.

Answer:

Offshore Rupee Bonds (ORBs) are debt instruments offered in capital markets outside India and are denominated in Indian rupees (meaning that the principal amount is linked to exchange rate of rupee). They are offered and settled in dollars to raise Indian rupees from international investors. The issuer converts bond proceeds from dollars into rupees in the domestic (Indian) market and uses them to finance its requirements in India. As such, the currency risk in these bonds resides with the investor. The investor base in these bonds is much wider than the FIIs, which invest in the Indian markets.

ORBs have been issued in past by the International Finance Corporation (IFC) with a maturity upto seven years. The latest issue is called 'Masala Bonds' which have a maturity of 10 years and are the first ORBs to be listed on London Stock Exchange. They are named so because masala is a globally recognised term that invokes culture and cuisine of India. Similar bonds are proposed to be offered by Indian Railway Finance Corporation and Asian Development bank. Reserve Bank of India has also allowed Indian corporates to issue ORBs. There are several benefits of ORBs, such as –

- Bringing liquidity and depth to offshore rupee market
- Crowding in foreign investors to invest in rupee bonds and fund domestic investment
- Paving the way for an alternative source of funding for Indian Companies
- As currency risk is borne by the investor, the cost of borrowing as compared to External Commercial Borrowings (ECBs) comes down for the investor as there is no need for hedging.
- The cost of borrowing has also been lesser than government bonds in domestic markets.

Student Notes:

It has been estimated that domestic corporates are likely to raise $30 billion in ECBs this fiscal year, while their Offshore Bond issues are likely to be $6 billion. In the next fiscal year, the bond issuances are likely to be $12 billion, but the quantum of ECBs will remain stagnant at $30 billion. However, the cost of funds for Indian companies will significantly depend on their ratings, which will be lesser than AAA rated Masala bond.

Internationalisation of the currency has two essential features:

- A state where exporters from other countries (such as Oil companies in Saudi Arabia) agree to take payments in rupees, and
- Where currency risks in international borrowings are borne by lenders rather than borrowers in India.

At the heart of internationalisation lies stability and confidence in the currency which makes it acceptable for cross-border transactions. Internationalisation is desired because countries that can borrow in their own currency are less susceptible to international crises. Please note that internationalisation is different from capital account convertibility, which means that domestic and foreign assets can be freely exchanged.

ORBs are a significant step towards internationalisation of rupee - they are international borrowings with currency risk at lenders' side. The Masala bonds were well received by foreign investors, notwithstanding the fact that rupee is still not fully convertible. ORBs are launch pad to sell strength of rupee to overseas investors as listing on foreign bourses will provide visibility and set benchmarks for yields in future issuances. Views on rupee will now be partially formed offshore, albeit in a very small way as ORBs will be subject to caps on external commercial borrowings. They could also increase demands for similar products as liquidity of these bonds rises. This also shows the confidence of international investors in Indian economy and rupee. This will require the government and the central bank to impart stability and confidence in the rupee internationally. Critical elements such as fiscal policy, current account balances and inflation have to be benchmarked to best standards to retain investor confidence in rupee. Putting these elements on a firm footing will be essential requirement for rupee internationalisation.

FINANCIAL INSTITUTIONS

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Student Notes:

1. World Trade Organisation (WTO)

1.1. About WTO

The World Trade Organization (WTO) deals with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably and freely as possible. It's an organization for liberalizing trade. It's a forum for governments to negotiate trade agreements. It's also a place for them to settle trade disputes. It operates a system of trade rules.

1.2. History

The WTO began life on 1 January 1995, even though its trading system is half a century older as earlier **General Agreement on Tariffs and Trade** (GATT) had provided the rules for the system. Whereas GATT had mainly dealt with trade in goods, the WTO and its agreements now cover trade in services, and in traded inventions, creations and designs (intellectual property).

Over the years GATT evolved through several rounds of negotiations. The last and largest GATT round, was the **Uruguay Round** which lasted from 1986 to 1994 and led to the WTO's creation.

1.3. Organisational structure

The WTO is run by its member governments. The WTO has 164 members, accounting for 98% of world trade. A total of 22 countries are negotiating membership.

All major decisions are made by the membership as a whole, either by ministers (who meet at least once every two years) or by their ambassadors or delegates (who meet regularly in Geneva). Decisions are normally taken by consensus. Reaching decisions by consensus among some 150 members can be difficult. Its main advantage is that decisions made this way are more acceptable to all members

- Topmost is the ministerial conference which has to meet at least once every two years. The Ministerial Conference can take decisions on all matters under any of the multilateral trade agreements.
- Day-to-day work in between the ministerial conferences is handled by three bodies:
    - The General Council
    - The Dispute Settlement Body
    - The Trade Policy Review Body

1.4. Principles of WTO

Although WTO agreements are lengthy and complex, a number of simple, fundamental principles run throughout all of these documents. These principles are the foundation of the multilateral trading system:

1. **Trade without discrimination**
    - **Most Favored Nation**: **Treating other people equally:** MFN clause under WTO requires a country to provide any concessions, or granted in a trade agreement to one nation to all other World Trade Organization member countries. It ensures non-discriminatory trade policy because it ensures equal trading among all WTO members. However, it allows certain exceptions:
        - Countries can set up a **free trade agreement** that applies only to goods traded within the group — discriminating against goods from outside
        - Countries can give **developing countries** special access to their markets.
        - **Action against dumping:** A country can raise barriers against products that are considered to be traded unfairly from specific countries.
        - **In services**, countries are allowed, in limited circumstances, to discriminate. But the agreements only permit these exceptions under strict conditions.

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- **National treatment: Treating foreigners and locals equally:** Imported and locally-produced goods should be treated equally — at least after the foreign goods have entered the market. The same should apply to foreign and domestic services, and to foreign and local trademarks, copyrights and patents. National treatment only applies once a product, service or item of intellectual property has entered the market. Therefore, charging customs duty on an import is not a violation of national treatment even if locally-produced products are not charged an equivalent tax.

2. **Freer trade: gradually, through negotiation:** Lowering trade barriers is one of the most obvious means of encouraging trade. The barriers concerned include customs duties (or tariffs) and measures such as import bans or quotas that restrict quantities selectively. From time to time other issues such as red tape and exchange rate policies are also discussed.
3. **Predictability: through binding and transparency:** This gives businesses a clearer view of their future opportunities. With stability and predictability, investment is encouraged, jobs are created and consumers can fully enjoy the benefits of competition — choice and lower prices.
4. **Promoting fair competition:** The WTO is sometimes described as a "free trade" institution, but that is not entirely accurate. The system does allow tariffs and, in limited circumstances, other forms of protection. The rules on non-discrimination — MFN and national treatment — are designed to secure fair conditions of trade. So too are those on dumping (exporting at below cost to gain market share) and subsidies.
5. **Encouraging development and economic reform:** The WTO system contributes to development while giving developing countries the flexibility in the time to implement the system's agreements.

1.5. WTO Agreements

The WTO agreements cover goods, services and intellectual property.

1.5.1. General Agreements on Trade in Services (GATS)

The GATS was inspired by essentially the same objectives as its counterpart in merchandise trade, GATT: creating a credible and reliable system of international trade rules; ensuring fair and equitable treatment of all participants (principle of non-discrimination); stimulating economic activity through guaranteed policy bindings; and promoting trade and development through progressive liberalization.

Services negotiations in the WTO follow the so-called **positive list approach**, whereby members' schedules of specific commitments list all of the services sectors and sub-sectors where they undertake to bind the market opening and the granting of national treatment to foreign service suppliers, apart the listed barriers that remain. Sectors and sub-sectors not included in the schedule are exempt from any obligations as regards market access and national treatment.

West is pushing hard to move from positive list approach to negative list approach. In negative list approach, services where GATS is not applicable will have to be negotiated, agreed upon and specified. India is against this concept as it will throw open almost whole Indian services sector to western multinational giants.

Negotiations in services under GATS are classified in 4 modes, interests of different countries depend upon this classification –

- **Mode 1** – It includes cross border supply of services without movement of natural persons. For eg. Business Process Outsourcing, KPO or LPO services. Here, it's in India's interest to push for liberalization given its large human resource pool and competitive IT industry.
- **Mode 2** – This mode covers supply of a service of one country to the service consumer of any other country. E.g. telecommunication

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- **Mode 3** – Commercial presence – which covers services provided by a service supplier of one country in the territory of any other country. This opens door of relevant sector in one country to investments from another country. Accordingly, it is in west's interest to push for liberalization here. There has been sustained pressure to open up higher education sector, insurance sector, Medical sector etc through this mode.
- **Mode 4** – Presence of natural persons – which covers services provided by a service supplier of one country through the presence of natural persons in the territory of any other country. E.g. Infosys or TCS sending its engineers for onsite work in US/Europe or Australia. Here again it's in India's interest to push for liberalization. In 2012, India dragged the US to the World Trade Organization's (WTO's) dispute settlement body (DSB) over an increase in the professional visa fee (H1B/L1).

1.5.2. TRIPS

The TRIPS Agreement plays a critical role in facilitating trade in knowledge and creativity, in resolving trade disputes over intellectual property. The Agreement is legal recognition of the significance of links between intellectual property and trade. "Intellectual property" refers to creations of the mind. These creations can take many different forms (see box below)

Different types of IPR

- **Copyright:** Copyright usually refers to the rights of authors in their literary and artistic works. In a wider sense, copyright also includes 'related rights': the rights of performers, producers of phonograms and broadcasting organizations.
- **Trademarks:** A trademark is a sign or a combination of signs used to distinguish the goods or services of one enterprise from another.
- **Geographical indications:** A name or indication associated with a place is sometimes used to identify a product. This "geographical indication" does not only say where the product comes from. More importantly, it identifies the product's special characteristics, which are the result of the product's origins.
- **Industrial designs**: Industrial design is generally understood to refer to the ornamental or aesthetic aspect of an article rather than its technical features. TRIPS Agreement, original or new industrial designs are protected for at least 10 years.
- **Patents**: The TRIPS Agreement says patent protection must be available for eligible inventions in all fields of technology that are new, involve an inventive step and can be industrially applied. Eligible inventions **include both products and processes**. They are protected for at least 20 years. The TRIPS Agreement describes the minimum rights that a patent owner must enjoy, but also defines the conditions under which **exceptions** to these rights are permitted.
  - **Compulsory licences:** It allows a competitor to produce the product or use the process under licence without the owner's consent. But this can only be done under specific conditions set out in the TRIPS Agreement aimed at safeguarding the interests of the patent-holder.
- **Layout designs of integrated circuits**: An integrated circuit is an electronic device that incorporates individual electronic components within a single 'integrated' platform configured to perform an electronic function.
- **Undisclosed information**: It includes trade secrets and test data. Trade secrets must be protected against unauthorized use, including through breach of contract or confidence or other acts contrary to honest commercial practices.

The extent of protection and enforcement of these rights varied widely around the world. The WTO's TRIPS Agreement is an attempt to narrow the gaps in the way these rights are protected and enforced around the world, and to bring them under common international rules. It establishes minimum standards of protection and enforcement that each government has to give to the intellectual property held by nationals of fellow WTO members.

1.5.3. TRIMS

The Agreement on Trade-Related Investment Measures (TRIMS) recognizes that certain investment measures can restrict and distort trade. It states that WTO members may not apply

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any measure that discriminates against foreign products or that leads to quantitative restrictions, both of which violate basic WTO principles. A list of prohibited TRIMS, such as **local content requirements**, is part of the Agreement. Recently India was dragged to WTO by U.S. over former's specification of Domestic Content Requirement in relation to procurement of Solar Energy cells and equipments.

1.5.4. Agreement on agriculture

Agriculture Agreement is to reform trade in the sector and to make policies more market-oriented. The agreement does allow governments to support their rural economies, but preferably through policies that cause less distortion to trade. It also allows some flexibility in the way commitments are implemented.

- **Tariffs only:** Before the Uruguay Round, some agricultural imports were restricted by quotas and other non-tariff measures. These have been replaced by tariffs that provide more-or-less equivalent levels of protection. It was agreed that developed countries would cut the tariffs by an average of 36%, in equal steps over six years. Developing countries would make 24% cuts over 10 years while Least-developed countries do not have to cut their tariffs.
  - **Special Safeguard:** For products whose non-tariff restrictions have been converted to tariffs, governments are allowed to take special emergency actions ("special safeguards") in order to prevent swiftly falling prices or surges in imports from hurting their farmers.
- **Domestic support**: The main complaint about policies which support domestic prices, or subsidize production in some other way, is that they encourage over-production. This squeezes out imports or leads to export subsidies and low-priced dumping on world markets. The Agriculture Agreement distinguishes between support programmes that stimulate production directly, and those that are considered to have no direct effect.
  - **Amber box subsidies** - Domestic policies that do have a direct effect on production and trade. WTO members calculated how much support of this kind they were providing per year in the base years of 1986-88. for the agricultural sector known as "total aggregate measurement of support" or "Total AMS". These total AMS figures were to be reduced in various amounts by developed and developing countries.
    - ✓ **De-Minimis provision**: Under this provision developed countries are allowed to maintain trade distorting subsidies or 'Amber box' subsidies to level of 5% of total value of agricultural output. For developing countries this figure was 10%.
  - **Green box subsidies -** Measures with minimal impact on trade. They can be used freely. They include government services such as research, disease control, infrastructure and food security. They also include payments made directly to farmers that do not stimulate production, such as certain forms of direct income support, assistance to help farmers restructure agriculture, and direct payments under environmental and regional assistance programmes.
  - **Blue Box subsidies**: Certain direct payments to farmers where the farmers are required to limit production. These are also permitted.
- **Export subsidy:** These can be in form of subsidy on inputs of agriculture, making export cheaper or can be other incentives for exports such as import duty remission etc. These can result in dumping of highly subsidized (and cheap) products in other country. This can damage domestic agriculture sector of other country. These subsidies are also aligned to 1986-1990 levels, when export subsidies by developed countries was substantially higher and Developing countries almost had no export subsidies that time.
  - **Special Safeguard Mechanism** (SSM) for Developing Country Members- a mechanism that would allow developing countries to temporarily raise import tariffs on agriculture products in cases of import surges or price declines.

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1.5.5. Sanitary and Phytosanitary Measures Agreement or SPS

It is a separate agreement on food safety and animal and plant health standards. It allows countries to set their own standards. But it also says regulations must be based on science. They should be applied only to the extent necessary to protect human, animal or plant life or health. And they should not arbitrarily or unjustifiably discriminate between countries where identical or similar conditions prevail.

1.5.6. The Technical Barriers to Trade Agreement (TBT)

Even though countries' rights to adopt the standards they consider appropriate is recognized, this agreement is to ensure that regulations, standards, testing and certification procedures do not create unnecessary obstacles.

1.6. Key Round of Negotiations Over the Years

1.6.1. Uruguay Round

The Uruguay Round brought about the biggest reform of the world's trading system since GATT was created at the end of the Second World War.

The Marrakesh Declaration, and the creation of the WTO.

Results

- **Agreements having six main parts → Establishing WTO**; Agreements for each of the three broad areas of trade that the WTO covers **(goods, services and intellectual property – GATT, GATS and TRIPS); Dispute settlement and Reviews of governments' trade policies**.
- **Commitments to cut and "bind" their customs duty rates** on imports of goods. In some cases, tariffs are being cut to zero. There is also a significant increase in the number of "bound" tariffs — duty rates that are committed in the WTO and are difficult to raise.

Sticking points

- They disagreed on how to reform agricultural trade and decided to extend the talks.
- New points of major conflict emerged to join agriculture: services, market access, anti-dumping rules, and the proposed creation of a new institution.

The Marrakesh agreement did already include commitments to reopen negotiations on agriculture and services at the turn of the century. These began in early 2000 and were incorporated into the Doha Development Agenda in late 2001.

1.6.2. Singapore ministerial meet

It was at the **first ministerial conference** of the WTO in Singapore in 1996. It brought up four possible areas, popularly known as 'Singapore Issues' - trade and investment; trade and competition policy; trade facilitation; and transparency in government procurement.

Among these, only 'trade facilitation' is directly related to trade, while other three are only indirectly related to trade. Developed countries wanted to include all these areas in negotiations. However, countries like India felt that having a multilateral agreement on issues like **investment and competition policy** would be a serious impingement on the sovereign rights of countries.

1.6.3. Doha Ministerial Meet

On resistance from developing countries regarding Singapore issues, all the countries agreed to a development agenda known as Doha Development Agenda. The intent of this round was to make trade rules fairer for developing countries. Main issues taken up were

- **Public stockholding Issue:** As per the Agreement on Agriculture of WTO, a developing country's food subsidy bill should not breach the limit of 10 per cent of the value of production taking 1986-88 as base year. India and other developing countries have been

Student Notes:

seeking amendments in the formula to calculate the food subsidy cap and the base year, as this limit is insufficient to meet domestic food security challenges.

- **The special and differential treatment** for developing countries shall be an integral part of all elements of the negotiations to enable developing countries to effectively take account of their development needs, including food security and rural development.
- **Services:** The qualitative improvement in the revised offers especially on crosses border supply and movement of natural persons. The negotiations on trade in services shall be conducted with a view to promoting the economic growth of all trading partners and the development of developing and least-developed countries.
- **Patents**: A major topic at the Doha ministerial regarded the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS). The issue involves the balance of interests between the pharmaceutical companies in developed countries that held patents on medicines and the public health needs in developing countries. Before the Doha meeting, the United States claimed that the current language in TRIPS was flexible enough to address health emergencies, but other countries insisted on new language. On 30 August 2003, WTO members reached agreement on the TRIPS and medicines issue. Voting in the General Council, member governments **approved a decision that offered an interim waiver under the TRIPS Agreement allowing a member country to export pharmaceutical products made under compulsory licenses** to least-developed and certain other members. It also allows members to not to allow evergreening of Patents.

1.6.4. Bali Package

At the 2013 Ministerial Conference in Bali, Indonesia, ministers agreed on a package of issues, including four decisions on agriculture:

- an agreement **to negotiate a permanent solution** to public stockholding for food security purposes, and to refrain from challenging breaches of domestic support commitments resulting from developing countries' public stockholding programmes for food security provided certain conditions are met. This is known as **'peace clause'**
- a call for **more transparency in tariff (or tariff-rate) quota administration** – whereby quantities inside a quota are charged lower import duty rates - and for governments not to create trade barriers by how they distribute quotas among importers
- an **expansion of the list of "General Services"** - to include spending on land use, land reform, water management, and other poverty-reduction programmes -that qualify for Green Box support (i.e. domestic support that is allowed without limits because it does not distort trade, or at most causes minimal distortion).
- a declaration to **reduce all forms of export subsidies** and to enhance transparency and monitoring

In Bali, ministers also agreed to enhance transparency and monitoring in the trading of cotton in recognition of the importance of this sector to developing countries and to work towards the reform of global trade in cotton

1.6.5. Nairobi Ministerial Conference

The WTO's Tenth Ministerial Conference in Nairobi in 2015. At the 2015 WTO Nairobi Ministerial Conference:

- WTO members adopted a historic decision to **eliminate agricultural export subsidies** and to set disciplines on export measures with equivalent effect. Under this decision, export subsidies will be eliminated by developed countries immediately, except for a handful of agriculture products, while developing countries have longer periods to do so. By eliminating export subsidies, WTO members delivered a key target of the Sustainable Development Goal on Zero Hunger. It will help to level the playing field for farmers around the world, particularly those in poor countries which cannot compete with rich countries that artificially boost their exports through subsidies.

Student Notes:

- WTO members agreed to **engage constructively in finding a permanent solution to developing countries' use of public stockholding programmes for food security** purposes.
- Ministers also agreed to **continue negotiations on a special safeguard mechanism** that would allow developing countries to temporarily raise tariffs on agriculture products in cases of import surges or price falls.
- The Nairobi Ministerial Decision **on Cotton** contains provisions on **improving market access for least-developed countries**, reforming domestic support and eliminating export subsidies. It also underlines the importance of effective assistance to support the cotton sector in developing countries.

In Nairobi, ministers declared that "there remains a **strong commitment of all members to advance negotiations on the remaining Doha issues**. This includes advancing work in all three pillars of agriculture, namely domestic support, market access and export competition".

1.6.6. Bruno Aires conference

The WTO's Eleventh Ministerial Conference in Nairobi in 2017. Its key takeaways are:

- **Fishery subsidies:** Member nations committed to securing a deal on fisheries subsidies for prohibiting subsidies for **illegal, unreported and unregulated (IUU) fishing** by the end of 2019. They also committed to improving the reporting of existing fisheries subsidy programmes.
- **Public Stockholding** – There was no outcome on public stockholding for food security purposes or on other agriculture issues. As a result, India's food security programmes and its current public distribution system will not be impacted. However, to use the peace clause, India has to give information to WTO about the size of its food subsidy bill till last year.
- **E-commerce** – While there was a strong push by some countries to initiate negotiations on this issue, this was resisted by India. The consensus decision was to continue discussions in a non-negotiating mode — a vindication of India's stand.
- **Non-trade issues** – Developed nations strived to bring into the discussions a stream of issues from rules for small and medium enterprises to gender rights in global trade, which India has categorized as nontrade issues.
- Further, no agreement was reached on special safeguard mechanism (SSM) for developing countries to curb unforeseen surges in imports of agricultural products or the special and differential treatment of developing countries.

1.7. Threats to WTO

Increased bilateral and multilateral preferential trade agreements indeed pose existential threat to WTO. Also the biggest success of WTO i.e. Dispute Settlement Body (DSB) has been undermined by the US. When Qatar instituted a dispute against Saudi Arabia, United Arab Emirates and Bahrain, the US categorically stated that it will not support WTO panels and the appellate body.

Further, WTO seems to be weakened by the frivolous steps taken by US such as The US steel and aluminum measures in March 2018 on frivolous grounds of national security was a violation of the WTO spirit as well as US lack of interest in pursuing the WTO's agreed Doha agenda is evident by not allowing the appointment of an Appellate Body judges leading to strangulation the WTO's dispute panel.

Reasons for Crumbling Of WTO

- **Changing world order**: The unipolar world under US was represented through institutions like WTO. Trade during this phase became rule based in nature which favored the west. But this unipolar world order is facing structural changes with rise of developing countries and their increasing share in world trade. This is perceived by US and EU as unfavorable whom

Student Notes:

they have attacked by resorting to policies of protectionism. E.g. China via trade war, Solar panel case against India in Dispute Settlement Body.

- **Process Loopholes**: The negotiation process prime facie seems democratic but Ministerial Conferences are accused of being opaque and overly technical. The green room meetings prohibit participation of majority of countries. It has proven to be disproportionately advantageous to developed countries. Moreover, consensus-based rule making has become a root cause in stagnation in reforms.
- **Nature of agreements**: Agreements signed under WTO are alleged to be discriminatory and exclusionary in functioning. DDA (Doha Development Agenda has still not been able to provide permanent solution to subsidies under domestic support. WTO do not have any agreement to deal with digital enabled trade i.e. ecommerce. Allegations are leveled by developed countries against developing of flouting TRIPS. They oppose generic medicines, compulsory license and import substitution. On the other hand, developing countries cite public health concerns and level allegations of ever-greening against pharmaceutical companies.
- **Dispute Resolution**: The dispute resolution mechanism is costly and lengthy. It is majorly resorted to by developed countries and developing countries are victims to the mechanism. There is politicization of the Appellate Body appointment and reappointment process. E.g. solar panel dispute was adjudged in favor of US is a case in point.

1.8. Relevance of WTO

Amidst all these challenges that WTO faces, we cannot deny the role it has played in integrating and opening the world trade.

- WTO regulates 98% of global trade flows. The average value of tariffs has reduced by 85% since 1942. Tariff reduction along with technological advances have driven extra-ordinary expansion of global trade.
- Trade as a share of GDP has grown from 24% in 1960 to 60% in 2015. Expansion of trade has fueled economic growth, created jobs and increased household incomes around the world.
- An ever-deepening rules-based system—notably under the GATT and WTO—brought more openness, transparency, and stability.
- Trade act as a powerful force too for inclusive Growth, by lowering poverty and by opening opportunities for small firms, women, farmers as well as fishermen.
- As nations' economies have become more and more inter-dependent, breakdown of a trade organization will be major blow to international trade order.
- Filing of dispute resolution suits before the WTO is increasing which signifies that economies around the world want the system to work.
- By bringing complaints to the WTO, countries also draw the world's attention to violations, naming and shaming violators of the rules. This effectively damages the reputations of leaders who erect discriminatory barriers.
- WTO is an essential platform for small countries to address their grievances. Barbados and Antigua took the US to the Dispute Settlement Body (DSB) on the issue of gambling and

Relevance of WTO for India

- Regional trade groups cannot be an alternative as they have succeeded in some places and they have not elsewhere. India's own experience with bilateral trade agreements has not always been good.
- Bilateral and regional treaties also open the door to the stricter "WTO plus" conditions in select areas like patents.
- India is in a better position with its food procurement and public stock holding policies protected within the WTO than with having to negotiate separate deals with major farm exporters like the U.S., Canada and Australia.

Student Notes:

2. IMF

2.1. About IMF

The International Monetary Fund (IMF) was created in **1945** with an **aim** to (i) foster global monetary cooperation, (ii) secure financial stability, (iii) facilitate international trade, (iv) promote high employment and (v) sustainable economic growth, and (vi) reduce poverty around the world.

It was established along with the International Bank for Reconstruction and Development at the Conference of 44 nations held at **Bretton Woods**, New Hampshire, USA in July 1944. It was created out of a need to **prevent economic crises like the Great Depression.** With its sister organization, the World Bank, the IMF is the largest public lender of funds in the world. It is a **specialized agency of the United Nations**

Membership is open to any country that conducts foreign policy and accepts the organization's statutes. The IMF membership currently includes **189 countries** that make up its near-global membership. India is a founder member of IMF.

2.1.1. Purpose

The IMF's **primary purpose is to ensure the stability of the international monetary system** — the system of exchange rates and international payments that enables countries (and their citizens) to transact with each other. It does so in three ways:

- **Keeping track of the global economy and the economies of member countries**. It highlights possible risks to stability and advises on needed policy adjustments. When a country joins the IMF, it agrees to subject its economic and financial policies to the scrutiny of the international community. It also makes a commitment to pursue policies that are conducive to orderly economic growth and reasonable price stability, to avoid manipulating exchange rates for unfair competitive advantage, and to provide the IMF with data about its economy.
  - This process of monitoring and discussing countries' economic and financial policies is known as **bilateral surveillance**. On a regular basis—usually once each year—the IMF conducts in depth appraisals of each member country's economic situation.
  - It also carries out extensive analysis of global and regional economic trends, known as **multilateral surveillance**. Its key outputs are **three semiannual publications, the World Economic Outlook, the Global Financial Stability Report, and the Fiscal Monitor**. The IMF also publishes a series of regional economic outlooks.
- **Lending to countries with balance of payments difficulties** to help them rebuild their international reserves, stabilize their currencies, continue paying for imports, and restore conditions for strong economic growth, while correcting underlying problems. IMF lending serves three main purposes.
  - First, it can **smooth adjustment to various shocks**, helping a member country avoid disruptive economic adjustment or sovereign default, something that would be extremely costly, both for the country itself and possibly for other countries through economic and financial ripple effects (known as contagion).
  - Second, IMF programs can **help unlock other financing**, acting as a catalyst for other lenders. This is because the program can serve as a signal that the country has adopted sound policies, reinforcing policy credibility and increasing investors' confidence.
  - Third, IMF lending can **help prevent crisis**. The experience is clear: capital account crises typically inflict substantial costs on countries themselves and on other countries through contagion. The best way to deal with capital account problems is to nip them in the bud before they develop into a full-blown crisis.

  It is to be noted that The IMF is **not a development bank** and, unlike the World Bank and other development agencies, it does not finance projects.

Student Notes:

- **Giving practical help to members** in terms of modernizing their economic policies and institutions, and training their people. This helps countries strengthen their economy, improve growth and create jobs. The IMF's technical assistance takes different forms, according to needs, ranging from long-term hands-on capacity building to short-notice policy support in a financial crisis. About 80 percent of the IMF's technical assistance goes to low- and lower-middle-income countries, in particular in sub-Saharan Africa and Asia. Post-conflict countries are major beneficiaries.

2.1.2. IMF Governance

IMF is governed by and accountable to the 189 member countries. the IMF is run by a Board of Governors, an Exe-cutive Board and an international staff.

- **Every member country delegates a representative** (usually heads of central banks or ministers of finance) **to the Board of Governors**—the top link of the chain of command. It meets **once a year** and **takes decision on fundamental matters** such as electing new members or changing quotas.
- **The Executive Board** is entrusted to the management of **day-to-day policy decisions**. The Board comprises **24 executive directors** who supervise the implementation of policies set by the member governments through the Board of Governors.
- The IMF is headed by the Managing Director who is elected by the Executive Board for a 5 year term of office.

2.1.3. IMF Finances

The money for lending comes from the **member countries** primarily through their **payment of quotas.** Each member country of the IMF is assigned a quota, **based broadly on its relative position in the world economy.** Quotas are denominated in **Special Drawing Rights (SDRs),** the IMF's unit of account.

Current quota formula is weighted average of **GDP (50%), Openness (30%), Economic Variability (15%) and International Reserves (5%).** The capital subscriptions or quota is now made up of 25 p.c. of its quota in SDRs or widely accepted currencies (such as the US dollar, euro, the yen or the pound sterling) instead of gold and 75 p.c. in country's own currency.

2.1.3.1. Multiple role of Quotas

Resource Contributions	Voting Power	Access to Financing	SDR Allocations
Quotas determine the maximum amount of financial resources a member is obliged to provide to the IMF.	Quotas are a key determinant of the voting power in IMF decisions. Votes comprise one vote per SDR100,000 of quota plus basic votes (same for all members).	The maximum amount of financing a member can obtain from the IMF under normal access is based on its quota.	Quotas determine a member's share in a general allocation of SDRs.

The IMF regularly conducts general reviews of quotas to assess the adequacy of overall quotas and their distribution among members. The 14th Review was concluded in 2010 and the quota increases in that review became effective in 2016. (see box)

Student Notes:

Impact of 2016 IMF reforms

- The reforms doubled quota resources to SDR 477 billion (about US$660 billion).
- The emerging and developing economies gained more influence in the governance architecture of the International Monetary Fund (IMF).
- More than six per cent of the quota shares will shift to emerging and developing countries from the U.S. and European countries.
- India's voting rights increase to 2.6 per cent from the current 2.3 per cent, and China's, to 6 per cent from 3.8, as per the new division.
- The reforms bring India and Brazil into the list of the top 10 members of IMF, along with the U.S, Japan, France, Germany, Italy, the United Kingdom, China and Russia.
- For the first time, four emerging market countries of the BRIC bloc —Brazil, China, India, and Russia —will be among the 10 largest members of IMF. Canada and Saudi Arabia slip below the top ten in the process.
- As part of the reforms, for the first time, the IMF's Executive Board will consist entirely of elected Executive Directors, ending the category of appointed Executive Directors. Currently the members with the five largest quotas appoint an Executive Director, a position that will cease to exist.

The IMF's Board of Governors conducts general quota reviews at regular intervals (no more than five years). Any changes in quotas must be approved by an 85 percent majority of the total voting power, and a member's own quota cannot be changed without its consent. The U.S.'s vote share is 16.52% giving it a unique veto power over crucial decisions at the IMF, many of which require a supermajority of 85%.

2.1.3.2. What are Special Drawing Rights (SDR)?

The SDR is an international reserve asset, created by the IMF in 1969 to supplement its member countries' official reserves. It is an interest bearing - international reserve asset, which can be exchanged for freely usable currencies. The value of the SDR is based on a basket of five major currencies—the **US dollar, the euro, the Chinese renminbi (RMB), the Japanese yen, and the British pound sterling.**

The Chinese RMB was included in the SDR basket from Effective October 1, 2016. The Board also decided at that time that the weights of each currency would be **41.73 percent for the U.S. dollar, 30.93 percent for the Euro, 10.92 percent for the Chinese yuan, 8.33 percent for the Japanese yen, and 8.09 percent for the Pound sterling.**

The SDRs are allocated to the member countries in proportion to their quota subscriptions. Only the IMF members can participate in SDR facility. SDRs being costless as it is just a book entry in the Special Drawing Account of the IMF, is often called **paper gold**. Whenever such paper gold is allocated, it gets a credit entry in the name of the participating countries in the said account. It is to be noted that SDRs, once allocated to a member, are owned by it and operated by it to overcome BOP deficits.

Criteria for inclusion in the SDR basket

- **Export criterion:** Issuer of currency is an IMF member or a monetary union, that includes IMF members, who is one of the top five exporters of the world.
- **Determined to be "freely usable" currency by the IMF:** Currency is widely used to make payments for international transactions and widely traded in the principal exchange markets.

2.1.3.3. 15th General Review of quotas

The 15th Review happened in 2019 provided an opportunity to assess the appropriate size and composition of the IMF's resources and to continue the process of governance reforms to realign quota shares with members' relative positions in the world economy, while protecting the poorest members.

Student Notes:

In this review, members of the International Monetary Fund (IMF) agreed to maintain its funding at $1 trillion but postponed changes to its voting structure. The deal is a compromise with the U.S., the Fund's largest shareholder, which has resisted changes to the organisation's voting structure as well as increases in its permanent resource base.

2.1.3.4. How it lends?

IMF does not allow any member to enjoy financial assistance over a long time period. The total amount that a country is entitled to draw is determined by the amount of its quota. A member is entitled to draw an amount not exceeding 25 p.c. of its quota. The first 25 p.c. called the 'gold tranche' or 'reserve tranche' can easily be drawn by countries with BOP problems.

This 25 p.c. of the quota is the members' owned reserves and therefore no conditions are attached to such drawings. This may be called 'ordinary, drawing rights; even the Fund cannot deny its use. However, no interest for the first credit tranche is required to be paid though such drawings are subject to repayment within 3-5 years period. Beyond this, the credit is available with limits on its amount and subjected to IMF approval.

2.2. Analysis of working of IMF

2.2.1. Achievement

The IMF acts both as a financing and an adjustment-oriented international institution for the benefit of its members It has been providing financial assistance to the deficit countries to **meet their temporary disequilibrium in BOP**.

The Fund aims at **promoting exchange rate stability**. In its early phase, the Fund made arrangements of avoidance of competitive exchange depreciation. It has made an attempt to solve the problem of international liquidity by creating Special Drawing Rights (SDRs)—an artificial currency as foreign exchange reserves to benefit the developing countries in particular. SDR allocations are made to member countries to finance the BOP deficits.

The IMF has assisted its members in the formulation of appropriate monetary, fiscal, and trade policies by his assistance in the form of surveillance, which it conducts on a yearly basis for individual countries, regions and the global economy as a whole. However, a country may ask for financial assistance if it finds itself in an economic crisis, whether caused by a sudden shock to its economy or poor macroeconomic planning.

2.2.2. Criticism

However, since the IMF lends its money with "strings attached" in the form of structural adjustments needed to be made to the economy, many people and organizations are vehemently opposed to its activities as they consider it as an undemocratic and inhumane means of loaning funds to countries facing economic failure. Further, it is seen that IMF imposed the policies on countries without understanding the distinct characteristics of the countries that made those policies difficult to carry out, unnecessary, or even counter-productive.

Further, the Fund often brings political and social unrest. Many of the policy measures suggested by the Fund (e.g., subsidy cut, labour retrenchment, golden handshake, etc.) caused widespread strikes, riots, etc., in many countries. Actually, finding no other alternatives, these countries had to swallow the bitter painful SAP medicine.

IMF is also accused for its lack of capability to take independent policy decisions. It complies with the 'order' of the superpowers. Further, it has minimal influence over the policy decisions of the major industrial powers. In these cases, its mandate to exercise 'firm surveillance' over some influential members or superpowers is virtually meaning-less—it has no influence over the US deficits or European interest rates.

Student Notes:

Also, IMF's governance is an area of contention. For decades, Europe and the United States have guaranteed the helm of the **IMF to a European** and that of the **World Bank to an American**. The situation leaves little hope for ascendant emerging economies that, despite modest changes in 2015, do not have as large an IMF voting share as the United States and Europe.

3. World Bank

The World Bank Group (WBG) was established in 1944 to rebuild post-World War II Europe under the International Bank for Reconstruction and Development (IBRD).

Today, the World Bank functions as an international organization that fights poverty by offering **developmental assistance to middle-income and low-income countries**. By giving loans and offering advice and training in **both the private and public sectors**, the World Bank aims to **eliminate poverty** by helping people help themselves. Under the World Bank Group (WBG), there are complementary institutions that aid in its goals to provide assistance.

3.1. About World Bank Group (WBG)

- **The IBRD** offers assistance to middle-income and poor, but creditworthy, countries. It also works as an umbrella for more specialized bodies under the World Bank. It was the original arm of the World Bank that was responsible for the reconstruction of post-war Europe. Before gaining membership in the other four WBG's affiliates a country must be a member of the IBRD.
- **The International Development Association** offers loans to the world's poorest countries. These loans come in the form of "credits" and are essentially interest-free.
- **The International Finance Corporation (IFC)** works to promote private sector investments by both foreign and local investors. It provides advice to investors and businesses, and it offers normalized financial market information through its publications, which can be used to compare across markets. The IFC also acts as an investor in capital markets and will help governments privatize inefficient public enterprises.
- **The Multilateral Investment Guarantee Agency (MIGA)** supports direct foreign investment into a country by offering security against the investment in the event of political turmoil. These guarantees come in the form of political risk insurance, meaning that MIGA offers insurance against the political risk that an investment in a developing country may bear.
- **The International Centre for Settlement of Investment Disputes** facilitates and works toward a settlement in the event of a dispute between a foreign investor and a local country.

3.2. Goal

The World Bank Group has set two goals for the world to achieve by 2030:

- End extreme poverty by decreasing the percentage of people living on less than $1.90 a day to no more than 3%
- Promote shared prosperity by fostering the income growth of the bottom 40% for every country

3.3. Membership and Organisation Structure

There are 189 member countries that are shareholders in the IBRD, the primary arm of the WBG. To become a member, however, a country **must first join the International Monetary Fund** (IMF). The size of the World Bank's shareholders, like that of the IMF's shareholders, depends on the size of a country's economy. Thus, the cost of a subscription to the World Bank is a factor of the quota paid to the IMF.

Student Notes:

The **president** of the World Bank comes from the largest shareholder, which is the United States, and members are represented by a **board of governors**. Throughout the year, however, powers are delegated to a board of 24 **executive directors** (EDs). The five largest shareholders—the U.S., U.K., France, Germany, and Japan—each have an individual ED, and the additional 19 EDs represent the rest of the member states as groups of constituencies. Of these 19, however, China, Russia, and Saudi Arabia have opted to be single-country constituencies, which means that they each have one representative within the 19 EDs. This decision is based on the fact that these countries have large, influential economies, requiring that their interests be voiced individually rather than diluted within a group.

3.4. Achievements of World Bank

Over the years, the amount of approval of loan to the member countries has been increasing. has advanced a significant amount of **loan for various development projects** and for productive purposes, especially for the development of agriculture, irrigation, electricity and transportation projects. Economic development of a country depends on the basic infrastructure. Therefore, the Bank is lending for these aforesaid projects for this rapid economic development.

The World Bank has been sending **technical missions** to member countries for collecting necessary information regarding the functioning of their economies. The Bank has been giving technical assistance to its member countries in order to solve their complicated economic problems and for assessing economic resources of the country and setting up of priorities for development programmes.

It has been playing a **special role for assisting the underdeveloped countries** by undertaking special economic and welfare schemes in the form of: Financial and technical assistance, Developing 'third window' to advance loan at lower rate of interest, Organizing meetings of creditor countries for providing loan to developing countries such as Aid India Club etc.

It has also been playing an important role in the **settlement of international disputes** successfully for the promotion of world peace. For eg- resolution of Indus river water dispute between India and Pakistan and Suez Canal dispute between England and Egypt.

3.5. Issues with World Bank

- It is believed that the fundamental structure of the Bank only exacerbates the already existing imbalance between the world's rich and poor. The system allows the largest shareholders to dominate the vote, resulting in WBG policies being decided by the rich, but implemented by the poor which results in policies that are not in the best interests of the developing country receiving assistance, whose political, social, and economic policies will often have to be molded around WBG resolutions.
- Moreover, even though the Bank provides training, assistance, information, and other means that may lead to sustainable development, opponents have observed that developing countries often have to put health, education, and other social programs on hold in order to pay back their loans.
- Further, The capital and financial resources of the Bank are considered as inadequate for meeting the increasing financial needs of member countries and especially of developing countries.
- The Bank has also been criticized on 'he ground that it has been extending loans only for specific projects, neglecting the needs of general development of developing countries. For e.g. - the developing countries need considerable amount of funds for general welfare schemes such as education, public health etc. but the Bank's rule does not permit it to provide assistance for such purposes.

Student Notes:

3.6. Measures taken

The emerging economies, in a desire for alternatives for financial assistance, has established alternatives themselves. the BRICS's New Development Bank and the China-led Asian Infrastructure Investment Bank (AIIB) have presented developing countries with alternatives to the Bretton Woods institutions. They were born out of two main grievances about the World Bank and IMF that developing nations shared. First, developing countries have long complained about the conditionality of World Bank loans and have cast their terms as onerous. Second, emerging markets—China in particular—have been frustrated with their relative lack of influence at the World Bank and the IMF.

3.7. Changes required in the approach of world bank

World Bank is still relevant for countries to ensure that any other country does not dominate the world order. This multilateral institution is required for relatively small economies to get their opinion heard. Thus, World Bank should bring these following changes in its approach:

First, the Bank needs to be more ambitious in identifying and addressing the most pressing knowledge gaps we face today. Policy advocacy must give way to well-informed and objective country-specific analysis. This can be accommodated within the existing structure based on the traditional country-lending model.

Second, the Bank's lending operations must be driven by knowledge of the binding constraints on poverty reduction in specific country contexts and its analytic capabilities must be brought more systematically into its operations from the outset. The Bank's knowledge generation efforts must inform the nature of its lending and be informed by that lending—rather than simply serving lending when called upon. This requires quite fundamental changes in staff and managerial incentives and resource allocation within the current structure.

Third, the Bank's present country-based model needs to be supplemented by a model with greater capacity for supporting the provision of global public goods. If one was to sit down today to design a mechanism to support the cross-country coordination needed to address shared threats it is unlikely that one would come up with the Bank's current country-lending model. A new model, or possibly a new institution, is called for.

4. Previous Years Vision IAS GS Mains Questions

1. ***According to a recent WTO agreement, Least Developed Countries need not comply with IPR protection for pharmaceutical patents till 2021. Explain how these countries can use this opportunity to promote access to drugs, vaccines and diagnostics?***

Approach:

- Explain how this decision has major implications for public health. In LDCs access to essential medicines has been a pressing concern for several decades.
- Least Developed Countries need to use this opportunity to productively and imaginatively promote access to medical products.

Answer:

WTO's TRIPS Agreement has been in force since 1995 and is to date the most comprehensive multilateral agreement on intellectual property. The TRIPS Agreement requires all WTO members, with a few exceptions, to adapt their laws to the minimum standards of IPR protection.

However, TRIPS also contains provisions that allow a degree of flexibility and sufficient room for countries to accommodate their own patent and intellectual property systems and developmental needs. The TRIPS Agreement provides for transition periods, permitting developing countries additional time to bring national legislation and

Student Notes:

practices into conformity with TRIPS provisions. Member states of the World Trade Organization (WTO) agreed to extend the transition period for adherence to the Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS) among least-developed countries (LDCs). It means, LDCs need not comply with international rules of intellectual property rights (IPR) protection for pharmaceutical patents till up to 2021.

LDCs need to use this opportunity to productively and imaginatively promote access to drugs, vaccines and diagnostics in the following ways:

- Since, for many such countries options are limited by the small size of their markets and lack of indigenous technological, productive and regulatory capacities; this lack of capacity to create a competitive environment needs to be addressed.
- Further, the economics of supply to an individual country with a limited market may be insufficient to attract potential generics suppliers. To allow, therefore, for economies of scale and a degree of competition, it is important that small markets engage together as much as is possible.
- Intellectual Property Management:
    - These countries need to consolidate new approaches to intellectual property management for public health.
    - A new platform for benefit sharing - WHO Pandemic Influenza Preparedness (PIP) Framework has emerged, since the time when Indonesia focused the attention of the global health community on sharing of viruses. It enables the sharing of benefits derived from such viruses and includes new methods of management of related intellectual property (IP) through developing Standard Material Transfer Agreements. In turn, these provide for a range of options for biological material recipients, such as influenza vaccine manufacturers, to enter into benefit-sharing agreements.
    - The success of the PIP framework has opened the door to exploring future collaborations in access to medicines, both traditional and modern. Moreover, quite often, traditional medicines provide lead for the development of new treatments, with many modern medicines being originally based on herbal products.
    - Since LDCs have a wide variety of genetic resources, they need to explore strategies to optimize the lessons of PIP in the context of medical products.
    - Thus it can be safely concluded that LDCs should use the intellectual-property window over, say, the next eight years to address the issue of access to medicines for the longer term.

2. Even within the multilateral format of WTO the FTA route has served India well. Comment. How can India effectively deal with the challenges posed by the new mega regional agreements such as TPP?

Approach:

- Briefly explain what FTAs are.
- Contextually provide how within WTOs multilateralism FTAs are permitted and how India has utilised this.
- Delineate gains made by India and also add the concerns raised by relevant actors.
- For the second part briefly explain mega regional deals with the example of TPP.
- Briefly enumerate the likely challenges it poses to India.
- The ways to deal with these challenges should be delineated in relatively detailed manner.

Answer:

Student Notes:

Free Trade Agreements (FTAs) are arrangements between two or more countries or trading blocs that primarily agree to reduce or eliminate customs tariff and non-tariff barriers on substantial trade between them. While remaining committed to the multilateralism of WTO, under Article 1 of the GATT, India has negotiated a series of FTAs, with Sri Lanka, Singapore, ASEAN, Malaysia, Japan and Korea etc, under the exemptions of the Articles XXIV of GATT and Article V of GATS. Thus, the FTA route has been a preferred method to promote trade with mutually advantageous groups and countries.

It has served India well by:

- Ensuring Market Access to the preferred countries
- Increase in exports
- Increase in overall trade by about 50% over roughly four years.

However, industry associations have repeatedly complained to the commerce ministry that because of FTAs, India's imports from these nations have significantly jumped, while exports have not increased proportionately. Thus there has been a clamor to have a relook at the FTA strategy

The emergent mega regional agreements like Trans Pacific Partnership (TPP) also require a relook at the strategy. On the one hand higher standards on environment, labor and Intellectual Property make the TPP exclusionary, on the other hand the non-participation in this may pose challenges in terms of reduced GDP to the tune of 0.2%, making Indian exports uncompetitive in certain markets, challenges to food security, pressure on sectors such as pharmaceutical industry.

Keeping these effects in mind, India needs to take the following measures quickly:

- **International Coalition** - India needs to stitch together a coalition of like-minded countries
- **Attain higher standards in production** - We should, side by side, try to meet those upgraded standards to avoid the risk of exclusion
- **Conclude ongoing free trade negotiations soon** - These include the India-EU Bilateral Trade and Investment Agreement and the mega Regional Comprehensive Economic Partnership with the Association of Southeast Asian Nations, China and others. Benefits from these agreements will help mitigate some of the export losses that India may face in leather goods, textile, and plastics on account of trade diversion due to TPP.
- **Diversify exports** - Aiming to diversify export destinations to hitherto untapped markets like Latin America and Africa would also help.
- **Identify India's trade interest areas**- India also needs to identify its trade interest areas and propose alternative negotiating templates. One such area is biopiracy, protection of traditional knowledge, and the link between the WTO's Trade-Related Aspects of Intellectual Property Rights agreement and the Convention on Biological Diversity.
- **Infrastructure development**- including port congestion and poor road connectivity, is one of the main hurdles in attaining this cost competitiveness. Addressing India's infrastructural deficiency will have the dual effect of not only making India's exports cost-competitive, but making them attractive for international lead firms to integrate India in global value chains.

Student Notes:

3. ***Agricultural subsidies are hotly contested at the WTO negotiations. What are the concerns of developing countries, especially India, vis-a-vis the attitude of developed countries on the issue? What is Special Safeguard Mechanism (SSM)? In this context, what are the reasons underlying India's keenness on a permanent solution on public stockholding for food security?***

Approach:

- Describe the reservations of developing countries in respect of agricultural subsidies at WTO negotiations. It should be a comparative outlook vis-a-vis developed countries.
- Define Special Safeguard Mechanism, and mention its ad-hoc nature.
- Finally, mention why India is keen on a permanent solution on public stockholding.

Answer:

Agriculture occupies crucial space at the WTO negotiations and the issue of subsidies therein is a bone of contention between the developing countries such as India and developed countries such as the United States and those from Europe. The Agreement on Agriculture has been criticised for reducing tariff protections for small farmers in developing countries while simultaneously allowing rich countries to continue subsidizing agriculture at home.

The concern of developing countries regarding the attitude of the developed countries can be summed up thus:

- Whereas the developed countries want subsidies to be removed, the developing countries view agricultural subsidies as crucial for their farm livelihood and food security.
- The box-shifting practices and use of green box as well as amber box subsidies by rich countries such as US cause concern in developing countries. For example under a 2006 ministerial agreement, agriculture subsidies in rich countries were to be eliminated by 2013 to spur export competition in global agriculture, but this did not happen. In fact, new policies, such as the US Farm Bill of 2014 have ensured that there will be no cut in their export subsidies.
- The insistence of countries such as US for Countries like India to limit Amber box subsides to 1986 production (not adjusted to inflation) is a major bone of contention.
- While developed countries including the US, Australia, the EU oppose public stock-holding of food crops, it is crucial for India's food security programme.
- The developing countries are concerned about the issue of import surges and tariffs to be imposed in case of livelihood threatening. This is perhaps most visible in the differences over the structure of the Special Safeguard Mechanism (SSM).

Special Safeguard Mechanism (SSM) is a trade remedy that allows developing countries to impose additional safeguard duties in the event of an abnormal surge in imports or the entry of unusually cheap imports.

India argued for higher level of tariff and lower import surge for making the SSM. On the other hand, the US and allies argued for lower tariffs and higher imports. India and the G33 insist that the SSM mechanism can come into play if imports rise by about 10%, while developed countries want it as 40%.

For a permanent solution, India had proposed either amending the formula to calculate the food subsidy cap of 10 per cent, which is based on the reference price of 1986-88, or allowing such schemes outside the purview of subsidy caps of the AOA. This would enable India to continue with its policy of public stockholding for food security without violating any of the extant provisions.

Student Notes:

FINANCIAL INCLUSION

Contents

1. Global Overview of Financial Inclusion

Student Notes:

According to World Bank, "Financial inclusion means that the individuals and businesses have access to useful and affordable financial products and services that meet their needs – transactions, payments, savings, credit and insurance – delivered in a responsible and sustainable way"

Few steps towards Financial Inclusion:

1. Being able to have **access to a transaction account** is a **first step** toward broader financial inclusion since a **transaction account allows people to store money**, and send and receive payments. A transaction account serves as a gateway to other financial services, which is why ensuring that people worldwide can have access to a transaction account is the focus of the World Bank Group's **Universal Financial Access 2020** initiative.
2. Moving from access to account **to account usage** is the next step for countries where 80% or more of the population have accounts (China, Kenya, India, Thailand). These countries relied on reforms, private sector innovation, and a push to open low-cost accounts, including mobile and digitally-enabled payments. However, close to one-third of adults – 1.7 billion – are still unbanked, according to the latest Findex data.

Global Financial Inclusion numbers:

- Globally great strides have been made toward financial inclusion and **1.2 billion adults** worldwide have gotten access to an account since 2011. Today, **69% of adults** have an account.
- However, close to **one-third of adults** – 1.7 billion – are still unbanked, according to the latest **Findex** data.
- About half of unbanked people **include women poor households in rural areas** or out of the workforce.
- The gender gap in account ownership remains stuck at **9 percentage points** in developing countries, hindering women from being able to effectively control their financial lives. Countries with high mobile money account ownership have **less gender inequality.**

Global commitment to financial inclusion:

- Financial inclusion has been identified as an enabler for 7 of the 17 **Sustainable Development Goals.**
- The **G20** committed to advance financial inclusion worldwide and reaffirmed its commitment to implement the G20 High-Level Principles for Digital Financial Inclusion.
- The World Bank Group considers financial inclusion a key enabler to reduce extreme poverty and boost shared prosperity, and has put forward an ambitious global goal to reach **Universal Financial Access (UFA) by 2020**.
- Since 2010, more than 55 countries have made commitments to financial inclusion, and more than 60 have either launched or are developing a national strategy.

Countries that have achieved the most progress toward financial inclusion have:

- **Policies delivered at scale**: such as universal digital ID - India and Aadhaar / JDY accounts - more than 1.2 billion residents covered.
- **Leveraged government payments**: For example, 35% of adults in low income countries receiving a government payment opened their first financial account for this purpose.
- **Allowed mobile financial services to thrive**: For example, in Sub-Saharan Africa, mobile money account ownership rose from 12% to 21%.
- **Welcomed new business models:** such as leveraging e-commerce data for financial inclusion

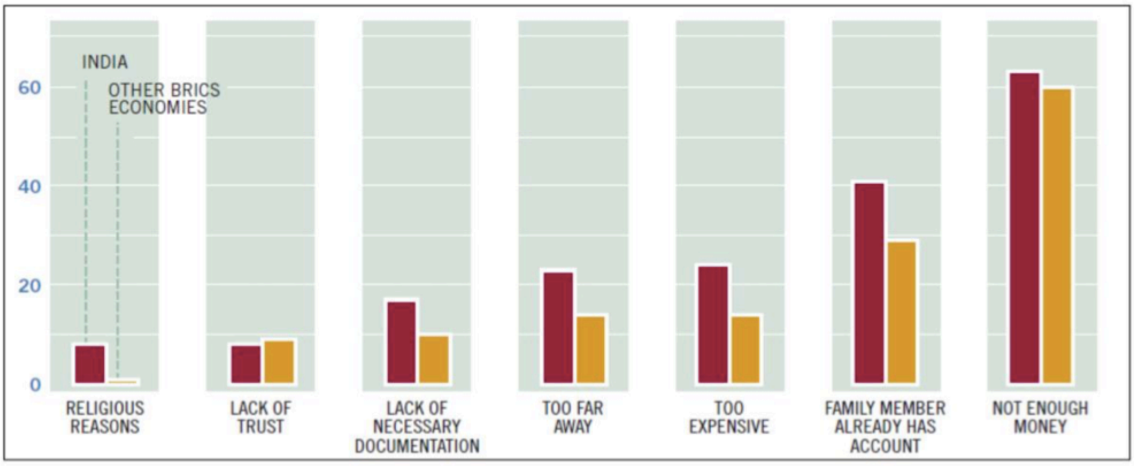
Student Notes:

2. Financial Inclusion in India

Financial Exclusion

Before understanding the process of Financial Inclusion, there is need to understand the phenomena of 'Financial Exclusion'. According to the Census 2011, 65 % of Indian adult were excluded out of financial inclusion. There is one bank branch per 14,000 persons. Just 18 percent are debit card holders and less than 2 percent are credit cards holders. In India, the total branches of commercial banks including RRB‟s and SCB‟s has still stood only 48000 in a country to provide service to 6 lakh villages. (**one bank branch over the 12.5 villages.**) It was due to multiple factors: Refer to the chart given below:

Figure 1: Self - reported barriers to use of formal accounts
Non- account holder reporting barrier as a reason for not having an account (%)



The Global Findex Report: Financial Inclusion in India

3. Financial Inclusion

Definition

According to Reserve Bank of India(RBI), "*Financial Inclusion is the process of ensuring access to appropriate financial products and services needed by all sections of the society in general and vulnerable groups such as weaker sections and low income groups in particular at an affordable cost in a fair and transparent manner by mainstream institutional players*".

According to the **Committee on Financial inclusion** headed by Dr. C. Rangarajan defined financial inclusion as "*The process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost*".

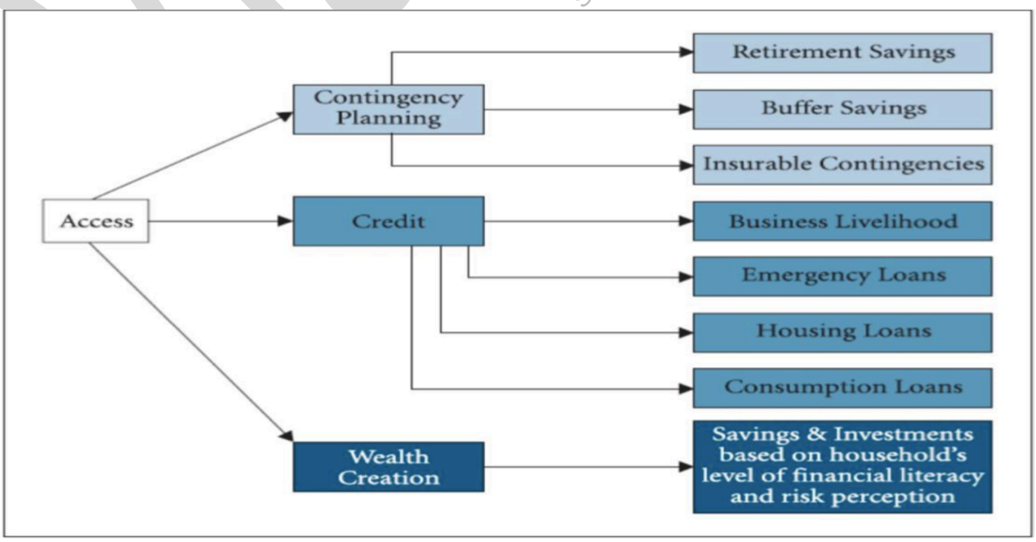
Thus, Financial inclusion does not mean delivery of financial services for all at **all cost**, but delivery of financial services and products at **affordable costs.**

Student Notes:

Significance of Financial Inclusion

- Financial inclusion is to provide equal opportunities to vast sections of population to access mainstream financial services for better life, living and better income. It provides path for inclusive growth.
- Easy access to financial services will allow the population leaving in lower strata, to save money safely and help in preventing concentration of economic power with a few individuals. It mitigates the risks that the poor could face as a result of economic shocks.
- In India, The single most frequently used source of loan for medium Indian household is still moneylender. Large parts of our financial system are still hampered by political intervention and bureaucratic constraints, limiting their potential contribution. India's poor, many of who work as agricultural and unskilled semi skilled wage laboures and low salaried workers are largely excluded from the formal financial system.
- Even micro and small enterprises, find it difficult to have an access to formal sources of finance and thus are largely excluded from financial system. Over 40% of India working population earn but have no saving. Financial inclusion provides protection to poor from the control of the spurious money lenders.
- Households need access to finance for several purposes like creating buffer, retirement, saving to hedge against unpredictable situations and take products for insurable contingencies. For details refer to the infographics given below:

Household Access to Financial Services



Source: A Hundred Small Steps a Report of the Committee on Financial sector reforms by **Raghuram G. Rajan**

Student Notes:

History of Financial Inclusion in India

- Financial Inclusion (FI) as a policy initiative entered the banking lexicon only after the recommendations of the **Rangarajan Committee in 2008.** It began to attract the attention when banks realized the significance of connecting with more people for **business growth.**
- The span of financial services included provision of basic savings accounts, and access to adequate credit at affordable costs to vulnerable groups such as the excluded sections of the society and low-income households.
- The experience of microfinance units in India and abroad shows that vulnerable groups who pay usurious interest rates to local moneylenders, can also be **worthy borrowers of banks**.
- One of the broader objectives of FI is to **pull the poor community out of the net of exploitative moneylenders**. But despite such emphasis, the penetration of banking services was initially mostly confined to urban areas and major cities. Later to the hinterland.
- In 2010, RBI advised all the banks – private as well as public- to submit a broad based, three Financial Inclusion plan. This made FI critical to business domain of banks.
- These plans broadly included
  - **Self-set targets** in terms of bricks-and-mortar branches in rural areas,
  - Deployment of **Business Correspondents (BCs)**
  - Use of electronic/kiosk modes for provision of financial services.
  - Opening of no-frills accounts.
- For the dispensation of credit, Kisan Credit Cards (KCC), General Credit Cards (GCC), and other specific products designed to cater to the financially excluded segments, were introduced. Such accelerated microcredit was part of **priority sector lending schemes** of banks.
- Among associated developments, **RuPay – an Indian domestic debit card** – was introduced in 2012 by the National Payments Corporation of India (NPCI). It has been a **game changer** in creating better digital infrastructure and enabled faster penetration of debit card culture in India.

Progress of Financial Inclusion in India

- It was after 2010-11 that the process of FI accelerated. Commercial banks opened new rural branches, increased coverage of villages, set up ATMs and digital kiosks, deployed BCs, opened no-frills accounts, and provided credit through KCCs and GCCs.
- The introduction of **core banking technology** and proliferation of **alternate delivery channels (ATMs, Kisoks, Net banking)** aided the process of inclusion on a larger scale.
- Following graph depicts the accelerated growth of FI:

Parameter of financial inclusion	March 2010	March 2016	March 2017
Number of Bank branches in villages	33,378	51,830	50,860
Number of Business Correspondents (BCs)	34,174	531,229	543,472
Number of other forms of banking touch points	142	3,248	3,761
Total number of banking touch points	67,694	586,307	598,093
Number of BSBDA* (in millions)	73	469	533
Deposits in BSBDA (Amount in Rs. billions)	55	636	977

RBI Annual Report: 2016-17

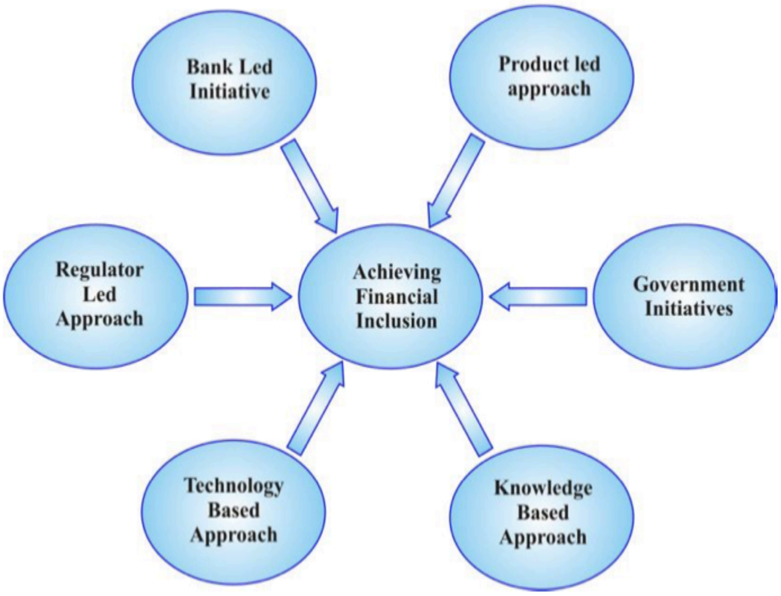
****BSBDA: Basic Savings Bank Deposit Account is a no-frill savings account without the need to maintain minimum balance and where no charges are levied.***

Student Notes:

- Over the last 7-8 years, banks have expanded their presence, and differentiated banks – payments banks and small finance banks – are set to take this further.
- However, It was **Pradhan Mantri Jan Dhan Yojna (PMJDY),** that brough tectonic shift in process of FI in India. It will be discussed in detail later.

Approaches to Financial Inclusion in India

In India, Government of India and Reserve of Bank of India (RBI) have taken various approaches for financial inclusion. Refer to the schematic diagram below:

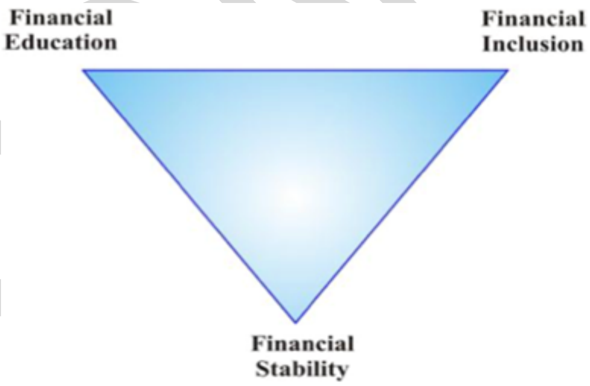


Approaches to Financial Inclusion in India

- **Product based approach:** This includes products like:
  - **No Frills Account:** Introduced in 2005, to provide access to basic baking services by financially excluded peoples. Under this approach banks open accounts with zero balance or very minimum balance requirement for the under-privileged.
  - **Basic Savings Bank Deposit Accounts (BSBDAs)** : A better version of No Frills Account, introduced in 2012. It is for all individuals with the facility of debit card, cheque book, internet banking, overdraft limits at minimal charges.
  - **Kisan Credit Cards (KCC)**: smart cards to the farmers for providing timely and adequate credit support from single window banking system for their farming needs
  - **General Purpose Credit Cards: (GCC):** facilitate credit up to Rs.25000/- without any collateral requirement for rural and semi urban people based on assessment of household cash flows.
  - **Saving account with Overdraft facility:** Banks have been advised to provide overdraft (OD) facility in saving account and also Small Overdrafts in No-frills accounts.
- **Bank led approach:**
  - **Self Help Group –** Bank Led Initiative (SLBP): major institutional based innovation in India for enabling access and covering the gap of reaching financially excluded population of the country in the last two decades.
  - In this model, the banks involve themselves with a group of local people with the idea of enabling them to pool up their savings. The same is deposited with the bank against which the bank also provides a certain amount of credit facility. The group takes a decision to whether to lend to any member of the group.
  - The bank provides the framework, accounting services and support to the group to manage their deposits and lending. Thus the model has an approach of savings first, lending later.

Student Notes:

- **Regulatory Approach:**
    - It includes simplified KYC norms, bank saving accounts opening and bank branch authorization.
- **Technology Based Approach:**
    - **Mobile Banking:** The banks have tied up with mobile operators to provide financial services like bill and utility payment, fund transfer, ticket booking, shopping etc. Some examples of this model are ***m-Pesa*** by Vodafone and Airtel Money
    - **Kisok/ATM based banking:** Banks have used the technology to enable their ATMs to virtually act like a 24x7 branches.
    - **Branchless baking:** Some of the leading banks have come up with this concept where there would be an online system with chat facility assisting the person to make use of various electronic machines for depositing and withdrawing cash and cheques
    - **Aadhar Enaabled Payment Systems (AEPS):** All accounts having aadhaar number updated are to be reported to RBI, which in turn reports it to various government departments. While making payments to people for working under initiatives like MGNREGA or various subsidy schemes, the departments use this information for directly crediting the money to the beneficiary's account.
- **Knowledge Based Approach:**
    - Financial education, financial inclusion and financial stability are three elements for effective use of the financial services network.
    - While financial inclusion works from supply side, financial education feeds the demand side by promoting awareness among the people regarding the needs and benefits of financial services offered by banks and other institutions.
    - These two strategies together promote greater financial stability.



Financial Tripod

- **Government Initiatives:** The government has come up with many schemes related to financial inclusion:
    - Pradhan Mantri Jan Dhan Yojana (PMJDY)
    - Atal Pension Yojana (APY)
    - Pradhan Mantri Vaya Vandana Yojana
    - Stand Up India Scheme
    - Pradhan Mantri Mudra Yojana
    - Pradhan Mantri Suraksha Bima Yojana (PMSBY)
    - Sukanya Samriddhi Yojana
    - Jeevan Suraksha Bandhan Yojana
    - Credit Enhancement Guarantee Scheme (CEGS) for Scheduled Castes (SCs)
    - Venture Capital Fund for Scheduled Castes under the Social Sector Initiatives
    - Varishtha Pension Bima Yojana (VPBY)

Student Notes:

4. Pradhan Mantri Jan Dhan Yojana (PMJDY)

What is this?

- It is a financial inclusion program of Government of India that aims to expand and make affordable access to financial services such as bank accounts, remittances, credit, insurance and pensions.
- It focuses on coverage of households as against the earlier plan, which focused on coverage of villages. It focuses on coverage of rural as well as urban areas.
- The plan also envisages channelling all Government benefits to the beneficiary's accounts and pushing the Direct Benefits Transfer (DBT) scheme of the Union Government.

Significance

- Poor households in India, in the absence of access to formal credit, have to deal with moneylenders who charge exorbitant rates of interest. Household Survey on India's Citizen Environment and Consumer Economy, 2016, shows that within the poorest section of the population two in three take credit from informal sources.
- Though access to formal financial institutions has improved over time but still thousands of villages not have a bank branch and less than 10 percent of all commercial bank credit goes to rural area.

Achievements

- **Helped in financial inclusion**- As per the Global Findex Database, almost 80% of adult Indians have bank accounts. Financial inclusion has taken place in three ways.
  - Financialization of savings- by giving lower income households access to a safe investment product.
  - Diversification of financial products- with 13.5 crore beneficiaries enrolling for the low-cost accident insurance cover and 5.5 crore for the life cover.
  - Transition to electronic payments- with 27.7 crore-account holders now having Rupay debit cards.
- **Helped in financial inclusion**- As per the Global Findex Database, almost 80% of adult Indians have bank accounts. Financial inclusion has taken place in three ways
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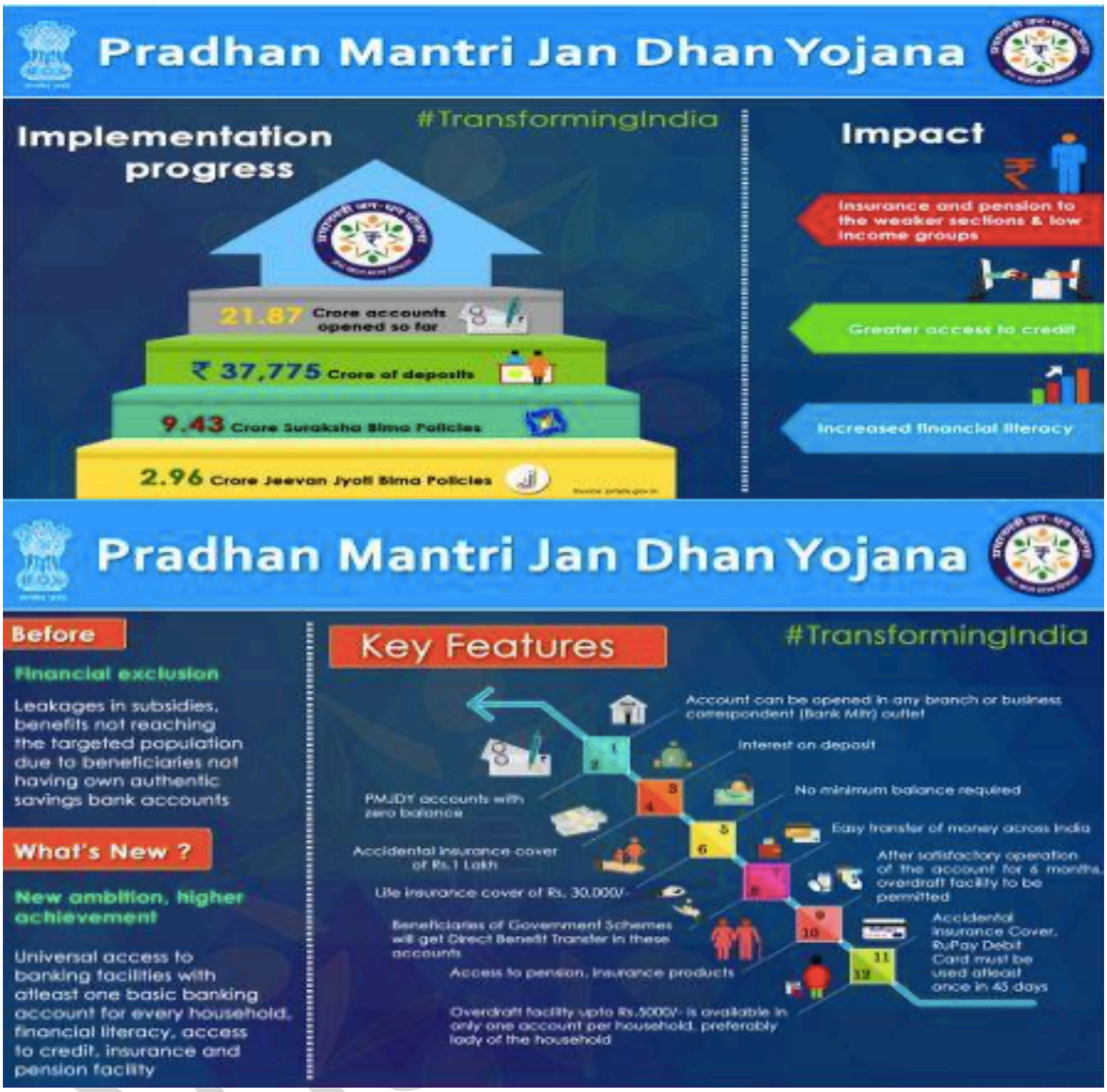
  - Diversification of financial products- with 13.5 crore beneficiaries enrolling for the low-cost accident insurance cover and 5.5 crore for the life cover.
  - Transition to electronic payments- with 27.7 crore-account holders now having Rupay debit cards.
- **Helped banking sector**
  - Improved balance sheets of banks- even though they still make up less than 1 per cent of banks' deposit base, they sustained growth in a year when deposit flows were hard to come by.
  - Falling percentage of zero balance accounts- from 58% in 2015 to 15 % as on January 2019, with even the percentage of inoperative accounts declining from 19.8% in 2017 to 16.3% as on December 2018.
  - Servicing Cost is not an issue for the banks now- as the average deposit balance in these accounts has increased.

- **Helped in inclusive growth**
  - Focus on rural India- Of 35.70 crore account holders, those from rural & semi-urban regions are 21 crore.
  - Women empowerment- Around 18.88 crore account holders are women.

Student Notes:

- **Direct benefit transfer**- data submitted by the government to Parliament shows that 23 per cent of these accounts received direct benefit transfers as on August 2018.
- **Plugging Leakages from Subsidy**: According to the Economic Survey for 2015-16 leakages in LPG subsidy transfers fell 24% and the exclusion of beneficiaries had been greatly reduced, due to banking infrastructure created by the combination named as JAM trinity.



Challenges

- Dependency on unsecured debt- Access to bank accounts seems to have had little effect on the dependence on private moneylenders.
- Internet connectivity issues: The inadequate infrastructure base for internet facilities basically in tribal and hilly areas make it difficult for Business Correspondents to deliver the required basic banking services.
- Funds for Overdraft Facility: Clarity has still not emerged on where the funds would be diverted from to finance the overdraft facility.
- Increasing Cost of Business Correspondents: If these accounts have to be functional and not remain dormant then the density of banking correspondent has to be increased, which will increase the cost of delivering the banking services.
- Tackling Unaccounted Money Deposited During Demonetisation: After the announcement of
- Demonetization total deposits in 255 million Jan Dhan accounts have increased to Rs 642521 million by November 2016.

Way forward

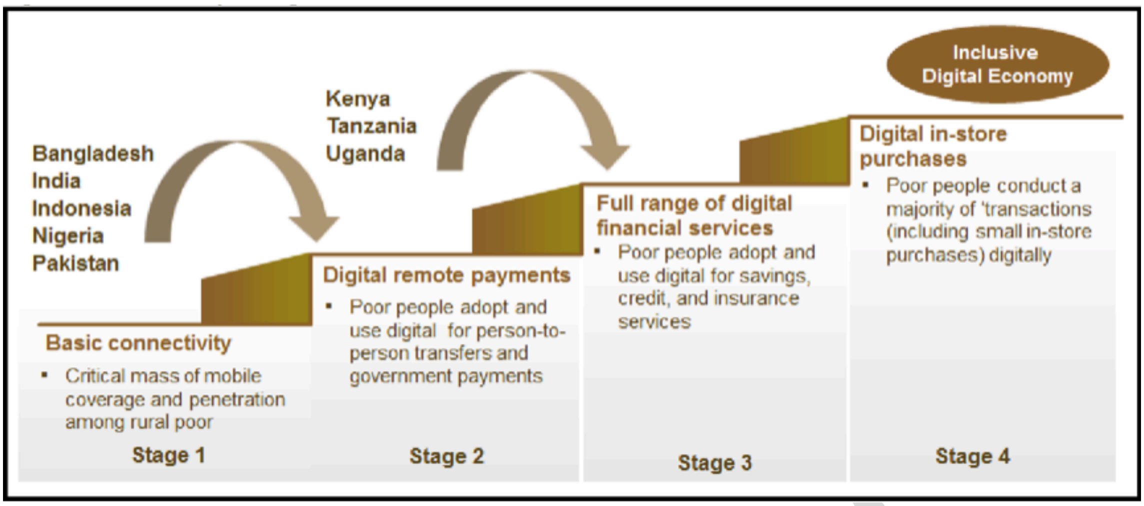
Student Notes:

- With the high deposits in the banks, the Government must nudge the banks to offer much-needed loan products to the account holders. Allowing them to build up a credit and transaction history in the banking system is critical to wean them away from the grip of informal money lenders.
- The Centre and the RBI also need to make sure that the first-time adopters are treated well at bank branches, know the grievance redressal mechanisms and are aware of, and protected from, the consequences of fraud or misuse of their accounts.
- The policy focus should shift from the quantity of inclusion to the quality of inclusion. The measure of success of the scheme should include clearly-defined targets for usage and transactions.
- Launching massive campaign programmes among the poor households focusing on improving the level of financial literacy and education can help them recognize the benefits they can avail under the scheme and the responsibilities associated with it.
- It is recommended that internet connectivity and speed should be increased in tribal and hilly areas so that the ease of doing banking transactions can be entertained.

5. Financial Inclusion through Digital Payment

- Post demonetization, India has witnessed a significant increase in the usage of cards and digital wallets for low-value transactions. With growing smartphone ownership and internet usage in the country, non-cash, contactless payments have now become quite the norm across tier-I and tier-II cities.
- The shift to digital payments has also been fuelled by the unprecedented boom of the **Unified Payments Interface (UPI).** According to the data provided by the National Payments Corporation of India, which manages the platform, monthly UPI transactions crossed the **Rs 1 trillion-mark in December 2018**. The figure indicates the widespread adoption of digital payments in India, backed by both home-grown and global companies like Paytm, PhonePe, MobiKwik and Google Pay.
- **Niti Aayog** in its 'Strategy for New India @75' document also emphasised that digital payments will be instrumental in driving financial inclusion and creating financial opportunities for the poor and unbanked.
- Several initiatives have been launched by the RBI and the MeitY to promote the acceptance of digital payments, helping India become a predominantly cashless society. These include the launch of UPI-based BHIM app, the promotional scheme of BHIM Aadhaar, cashback scheme for merchants and referral bonus schemes for individuals on BHIM, Digital Financial Inclusion Awareness and Access (Digital Jagriti) programme, and the opening of a free Doordarshan DTH educational channel to create awareness around the digital payment.
- While the government put in a lot of efforts to mitigate financial exclusion, India still has a long way to go before it achieves the target set by the RBI.
- In urban centres, the increasing cost for merchants hinders the adoption of digital payments, whereas, in rural India, the limited availability of payments infrastructure is identified as the major challenge to financial inclusion

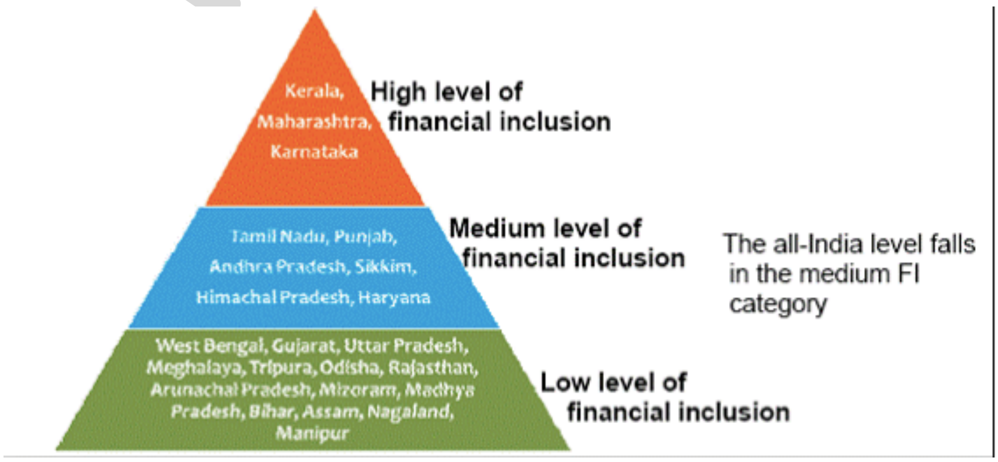
Student Notes:



<u>**A Digital Pathway to Financial Inclusion**</u>

6. Measuring Financial Inclusion in India

- India's **first Financial Inclusion index** was launched in 2013 based on four critical dimensions:
  - Branch penetration
  - Deposit penetration
  - Credit penetration
  - Insurance penetration.
- CRISIL Inclusix measures progress on Financial Inclusion down to the level of each of the 717 districts in the country. The index is based on data provided by RBI, the Microfinance Institutions Network (MFIN), and the Insurance Information Bureau of India.
- The index readings for fiscal year 2015-16 show that FI has improved significantly, with the all-India score rising to 58 in FY 2015-16, compared with 50.1 in FY 2012-13. The PMJDY and RBI's steadfast focus on unbanked regions have made a big difference.
- As many as 600 million deposit accounts were opened between FY 2012-13 and FY 2015-16, which is twice the number between 2010 and 2013. Nearly a third of this was on account of PMJDY.
- There has also been a sharp incremental rise in number of people availing credit, to 31.7 million. This figure includes loans extended by banks and microfinance institutions together in the two years up to FY 2015-16, which is the highest since FY 2012-13.
- Notably, microfinance institutions contributed significantly to the financially under-penetrated regions. The **Digital India initiative, payment banks, and small finance banks** have all helped improve the outreach of formal financial services to economically disadvantaged sections of the populace and geographically remote regions.



Student Notes:

Global Findex Report, 2018: India's performance in Financial Inclusion

- In the last seven years, India has taken massive strides towards financial inclusion. When the first **Global Findex Database** was released by the **World Bank** in 2011, it stated that 40% of adult Indians had a bank account.
- An overwhelming majority of Indians, especially in rural areas, were financially weak and were effectively excluded from the formal economy. Seven years later, almost **80% of adult Indians have bank accounts**.
- Today, 90% of India's 1.3 billion population have a unique Aadhar identity, which is vital for meeting anti-money laundering "know your customer" (KYC) requirements.
- In the last four years, **330 million new Jan Dhan bank accounts** have been opened.
- Mobile penetration is expected to **reach 90% by 2020.** Internet penetration has soared, and the use of digital payments is also rising significantly.

7. Way Forward: Achieving True Financial Inclusion

1) **Financial firms must understand the market and structure products accordingly:** For example, agricultural income is seasonal and lumpy. Therefore, loan given to farmer for a tractor should be structured where the repayment cycle is seasonal and not monthly.
   - In a country as vast and diverse as India, deeper understanding of the market can only come if firms have a widespread distribution and recruit locally.
   - For example: Today, Mahindra Finance is present in every Indian state, and its branch network covers 85% of districts nationwide. It has more than six million customers across more than 360,000 villages - **that's one in every two villages in the country.**
2) **Financial Literacy**: Unfortunately, this is one area where India still needs to do a great deal of work. According to a Standard and Poor's survey, basic financial literacy in India is sub-par.
3) **Partnership between the government and providers of various financial products**: It will ensure that the risks and rewards of working with marginal populations are shared.
   - A good example is rural housing. Powered by a government programme that provides financial support and participation from the private sector, 70 million new houses have been built in the last five years, up from about 400,000 previously.
   - The industry body Association of Mutual Funds of India has been running a successful campaign to raise awareness about the benefits of investing in mutual funds to create long-term wealth. The last decade's growth rate of investment in mutual funds in India is **now double that of the rest of the world**. Interestingly, digital flows into mutual funds have increased 12 times in the last two years.

Having developed a strong Financial Inclusion infrastructure and PMJDY accelerating the progress, the next milestone should be to bring about a **mindset and cultural shift** among newly connected beneficiaries to derive benefits from the formal financial system by borrowing from banks and repaying loans in time.

This can boost micro and small enterprises, and hence alleviate poverty and **raise the standard of living of the community** at the grass-roots level. The next phase of Financial Inclusion is therefore less to do with policy and more to do with educating people, disseminate financial and digital awareness in the society.

This campaign of literacy will need a multipronged, **bottoms-up approach**. RBI and banks should coordinate with institutions such as State Education Boards (SEBs), Central Board of Secondary Education (CBSE), University Grants Commission (UGC), and All India Council for Technical Education (AICTE), to include FI as a mandatory subject at different educational levels right from school to higher levels of education.

NGOs, corporate sector, banks, NBFCs (Non-Banking Financial Companies), and government departments currently engaged in FI should **be persuaded to increase thrust**.


Heartiest Congratulations to all successful candidates
7 IN TOP 10 SELECTIONS IN CSE 2019
FROM VARIOUS PROGRAMS OF VISION IAS
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JATIN KISHORE
3 AIR
PRATIBHA VERMA
6 AIR
VISHAKHA YADAV
7 AIR
GANESH KUMAR BASKAR
YOU CAN BE NEXT
9 IN TOP 10 SELECTION IN CSE 2018
1 AIR
KANISHAK KATARIA
2 AIR
AKSHAT JAIN
3 AIR
JUNAID AHMAD
4 AIR
SHREYANS KUMAT
5 AIR
SRUSHTI JAYANT DESHMUKH
7 AIR
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