SRIRAM'S IAS

GENERAL STUDIES

ECONOMIC GROWTH AND DEVELOPMENT – 1

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Indian Economy
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Economics: An Introduction

Definition

Economics as a word comes from the Greek : oikos means 'family, household, or estate', and nomos stands for 'custom, law' etc. Thus, "household management" or management of scarce resources is the essential meaning of economics. Economic logic is applied to any problem that involves choice under scarcity.

Take for example, land. It is a scarce resource. India has 15% of global population but only 2.4% of the global land. Thus there is huge pressure on land. It is needed for agriculture (food and non-food); manufacturing; residential purposes and so on. There should be rational and judicious use of land for which economics can help to make public policy. The challenges associated with land use are being grappled with presently , for instance in the Land Acquisition and Rehabilitation and Resettlement Act 2013 where the land claims of farmers, industry and other sections are addressed.

Similarly, water is scarce and is becoming even more so. There are demands for agricultural, industrial, domestic and other uses. How to apportion the existing amount of water among all these users is a public policy challenge being considered by the **Draft National Water Policy (NWP, 2012). Similar is the purpose of the food security law and land acquisition law.**

Broadly, economics is a social science that studies human activity aimed at satisfying needs and wants.It encompasses production, distribution, trade and consumption of goods and services

Initially, economics focused on "wealth" and later "welfare". That is, initially, it did not deter economists from advocating maximum production regardless of who benefited from it and how much misery it produced. Later, by the late 19th century, there was hue and cry about children being made to overwork and receive paltry payment for their work, to give one example. Then welfare became the focus of the descipline.

As a policy science, economics is always confronted with trade offs as scarcity of resources is the basis of the discipline. Trade offs involve making choices in policy making wherein there is a compromise on one goal to achieve another goal. It is a way of balancing among desirable goals. Presently, the policy of Reserve Bank of India aims at moderating inflation that it is the overriding objective of its monetary policy, even as some growth is eroded in the process. Thus, a bit of growth is traded off for price stability. Similarly, government wants to give subsidies to the poor and weak. It may mean more borrowings and thus some fiscal excess but poverty is addressed and thus political stability. Thus, fiscal prudence may be traded off to some extent in pursuit of welfare. The current state of public finance is an accurate description of this dilemma with fiscal deficit targeted at 4.8% of GDP(2013-14). In the land acquisition law, compensation for the land owners is increased to balance the interests of the industrialists and the farmers and others. Investment may moderate in the process, but social justice gets addressed.

The focus on tradeoffs arises from the scarce resources that make it necessary to choose between competing alternatives. Choosing one benefit implies forgoing another alternative to a greater or lesser extent. Thus, there is an opportunity cost to the available resources and there is a continuous process of weighing alternatives and balancing them (opportunity cost is the cost of foregoing an opportunity while choosing another).

Adam Smith, generally regarded as the Father of Economics, author of An Inquiry into the Nature and Causes of the Wealth of Nations (generally known as The Wealth of Nations) defines economics as "The science of wealth." Smith also offered another definition, "The Science relating to the laws of production, distribution and exchange."

Definitions in terms of wealth emphasize production and consumption, and do not deal with the economic activities of those not significantly involved in these two processes ,for example, children and old people. The belief is that non-productive activity is a cost on society. It meant that man was relegated to the secondary position and wealth was placed above life. In democratic times, it is not acceptable. There was a demand to balance wealth creation with focus on social and human welfare. Thus arose the shift in the focus to welfare economics- study of man and of human welfare, not of money and goods alone. Economics since then involved study of social action connected with the attainment of human well being.

Beyond. wealth, welfare and trade offs, there has been an intense search in the discipline for right foci- sustainable development, green economy, well being, national happiness and so on.

Economics is usually divided into two main branches:

Microeconomics, which examines the economic behavior of individual actors such as consumers, businesses, households etc to understand how decisions are made in the face of scarcity and what effects they have on larger economy.

Macroeconomics, on the other hand, studies the economy as a whole and its features like national income, employment . poverty, balance of payments and inflation.

The two are linked closely as the behavoir or a firm or consumer or household depends upon the state of the national and global economy and vice versa.

'Mesoeconomics' studies the intermediate level of economic organization in between the micro and the macro economics like institutional arrangements etc. Meso is relative. Study of a sector of economics like auto, infrastructure may be considered mesoeconomics while the study of each unit may fall under micro.

DIVISION OF ECONOMICS	FOCUS
Microeconomics	Production/output in individual industries and businesses and consumer and behavior, How much steel. How much office space. How many cars. Consumer behaviour
Macroeconomics	National production/output. Gross domestic product, employment, Poverty. Inflation. BOP

There are broadly the following approaches in the mainstream economics, the basis of all the streams being the same the same: resources are scarce while wants are unlimited(often mentioned as the economic problem)

- Keynesian macroeconomics based on the theories of twentieth-century British economist John Maynard Keynes. It says that the state can stimulate economic growth and restore stability in the economy through expansionary policies. For example through massive programme of spending on infrastructure when the demand is low and growth rate is falling. In the recessionary phase that the economies of the western world in particular and rest of the world in general are going through due to 2008 financial crisis, the relevance of Keynes is growing. The intervention by State is only when the. economic cycle turns down and growth slows down or is negative. In normal times, it is the market that drives growth through the force of supply and demand though the respective roles of State and market are coming under critical scrutiny post-Lehman. Indian government stepped up expenditure with fiscal and monetary stimuli in the 2008-10 period to withstand the recessionary winds from the west. With growth spurting, the gradual and calibrated exit from the stimulus was begun in the 2010-11 Union Budget. The theories of Keynesian economics were first presented in The General Theory of Employment, Interest and Money(1936).
- **Political economy** was the original term used for studying production, buying and selling, and their relations with law, custom, and government, as well as with the distribution of national income and wealth. *Political economy* originated in moral philosophy. It was developed in the 18th century as the study of the economies of states, or *polities*, hence the term *political* economy. Today, *political economy* may refer to examining how political forces affect the choice of economic policies, especially as to distributional conflicts and political institutions. *Political economy* most commonly refers to interdisciplinary studies drawing upon economics, law, and political science in explaining how political institutions, the political environment, and the economic system—capitalist, socialist, or mixed—influence each other.
- Neoliberalism refers to advocacy of policies such as individual liberty, free markets, and free trade. Neoliberalism "proposes that human well-being can best be advanced by liberating individual entrepreneurial freedoms and skills within an institutional framework characterized by strong private property rights, free markets and free trade".With the communist model of economic management through state ownership of economy failing by the mid-1980s and industrial democracies registering a history victory over it with their free market model, market forces returned as the winning format for economic success. It is the return of the liberalism of the Adam Smith era and is refered to as neo-liberalsim in its present form since mid-1980s. India's economic reforms are largely centred around it. The expression of neoliberalism is used by some as leaving too much role to the market forces and can be detrimental to genuine human and sustainable growth.
- In distinction to the above, there is the school of socialist economics based on public (State) ownership of means of production to achieve greater equality and give the workers greater control of the means of production. It comes in many forms- Nehruvian socialism where there is public and private sector coexisting and complementing called mixed economy. It may also establish fully centrally planned economy which is also called command economy- economy is at the command of the State. Private ownership of assets is not allowed. For example, erstwhile USSR,

Cuba etc. The latter (no private property, total economy being owned by the state etc) is known as communist model.

- Development economics is a branch of economics which deals with not only promoting economic growth and structural change but also improving the well being of the population as a whole through focus on health and education and workplace conditions, whether through public or private channels. Its thrust is mainly on low i come countries. The most prominent contemporary development economists are Nobel laureates Amartya Sen and Joseph Stiglitz.

Structural change of an economy refers to a long-term and broad based change of the fundamental structure, rather than microscale or short-term change. For example, a subsistence economy is transformed into commercial economy or a regulated mixed economy is liberalized. An insulated and protectionist economy becomes open and globalized. India has been structurally reorienting its economy since the early 1990s under which there is more room for markets; privatization of the public sector; greater flow of foreign investment and foreign goods etc.

Green economics focuses on and supports the harmonious interaction between humans and nature and attempts to reconcile the two. It is refered by many names like sustainable development, green economy (Rio Plus 20, 2012)

Economic growth

Economic growth is the change- increase or decrease, in the value of goods and services produced by an economy. If it is positive, it means an increase in the output andthe income of a country. It is generally shown as the increase in percentage terms of real gross domestic product(GDP adjusted to inflation) or real GDP.

Measuring Growth

Measures of national income and output are used in economics to estimate the value of goods and services produced in an economy. Common measures are Gross National Product (GNP) and Gross Domestic Product (GDP).

National income accounting

National income accounting refers to a set of rules and techniques that are used to measure the output of a country. It is used almost synonymously with GDP.

GDP is defined as the total market value of all final goods and services produced within the country in a given period of time- usually a calendar year or financial year or a fraction like quarter.

GDP can be real or nominal. Nominal GDP refers to the current year production of final goods and services valued at current year prices. Real GDP refers to the current year production of goods and service valued at base year prices. Base year prices are constant prices.

In estimating GDP, only final marketable goods and services are considered. When it is compared to the base year figure, the real growth levels are seen.

To explain further, gains from resale are excluded but the services provided by the agents are counted. That is, when a used car or house is sold, no new goods are being produced. But the real estate or the auto agent makes some money though commission which adds to the service economy. Similarly, transfer payments (pensions, scholarships etc) are excluded as there is income received but no good or service produced in return.

However, not all goods and services from productive activities enter into market transactions. Hence, imputations are made for these non-marketed but productive activities : for example, imputed rental for owner-occupied housing.

The value of intermediate goods is a part of the final goods and services and so are not counted separately as it amounts to double counting and exaggerates the value of the output.

Market Price and Factor Cost

Market price refers to the actual transacted price and it includes indirect taxes-.custom duty, excise duty, sales tax . service tax etc.

Factor cost refers to the actual cost of the various factors of production and it includes government grants and subsidies but it excludes indirect taxes.

Relationship between market price and factor cost

GNP at factor cost = GNP at market price – indirect taxes + subsidies
GDP at factor cost = GDP at market price – indirect taxes + subsidies

Factor costs

Factor costs are the actual production costs at which goods and services are produced by the firms and industries in an economy. They are really the costs of all the factors of production such as land, labor . capital, energy, raw materials like steel etc that are used to produce a given quantity of output in an economy. They are also called factor gate costs (farm gate, firm gate and factory gate) since all the costs that are incurred to produce a given quantity of goods and services take place behind the factory gate ie within the walls of the firms, plants etc in an economy.

Transfer Payments

Transfer payment refers to payments made by government to individuals for which there no economic activity is produced in return by these individuals. Examples of transfer are scholarship, pension.

Estimating GDP/GNP

Three approaches

There are three different ways of calculating GDP. The expenditure approach adds consumption, investment, government expenditure and net exports (exports minus imports). On the other hand, the income approach adds what factors earn: wages, profits, rents etc. Output approach adds the market value of final goods and services .The three methods must yield the same results because the total expenditures on goods and services (GNE) must by definition be equal to the value of the goods and services produced (GNP) which must be equal to the total income paid to the factors that produced these goods and services.

In reality, there will be minor differences in the results obtained from the various methods due to changes in inventory levels. This is because goods in inventory have been produced (and therefore included in GDP), but not yet sold. Similar timing issues can also cause a slight discrepancy between the value of goods produced (GDP) and the payments to the factors that produced the goods, particularly if inputs are purchased on credit.Inventory is a detailed list of all the items in stock

Final goods are goods that are ultimately consumed rather than used in the production of another good. For example, a car sold to a consumer is a final good; the components such as tyres sold to the car manufacturer are not; they are intermediate goods used to make the final goods. The same tyres, if sold to a consumer, would be a final goods. Only final goods are included when measuring national income. If intermediate goods were included too, this would lead to double counting; for example, the value of tyres would be counted once when they are sold to the car manufacturer, and again when the car is sold to the consumer.

Only newly produced goods are counted. Transactions in existing goods, such as second-hand cars, are not included, as these do not involve the production of new goods.(mentioned earlier)

GDP considers only marketed goods. If a cleaner is hired, his pay is included in GDP. If one does the work himself, it does not add to the GDP. Thus, much of the work done by women at home- taking care of the children, aged; chores etc which is called `care economy' is outside the GDP. Even what the elder sibling teaches the younger one is outside the scope of national accounts.

Gross means depreciation (wear and tear of machinery in their use) of capital stock is not subtracted. If depreciation is subtracted, it becomes net domestic product.

Calculating the real GDP growth -inflation adjusted GDP growth-allows us to determine if production increased or decreased, regardless of changes in the inflation and purchasing power of the currency.

Output expressed as GDP at factor cost at constant prices makes more genuine sense as inflation/deflation is factored out and the distortions of subsidies and indirect taxes are also deducted. Thus, quantitative levels of production changes are expressed.

The data from the current prices is adjusted to the constant prices by using deflators- it helps take out the contribution of inflation to the value of the output. Errors can occur in the process of deflating the figure based on which deflator is used. GDP data for the first quarter of 2010-11 was miscalculated because the price deflator was wrongly used. For GDP by output and expenditure figures, two different deflators were used and the shrinkage went wrong. For one figure, CPI was used as deflator and for the other GDP figure, WPI was used.

GDP and GNP

The two are related. The difference is that GNP includes net foreign income- what foreigners produce in the country is subtracted from what Indians produce aborad or vice versa. That is meant by net foreign income. GNP adds net foreign income compared to GDP. GDP shows how much is produced within the boundaries of the country by both the citizens and the foreigners. GDP focuses on where the output is produced rather than who produced it- it is a geographical concept. GDP measures all domestic production, disregarding the producing entities' nationalities.

In contrast, GNP is a measure of the value of the output produced by the "nationals" of a country- both within the geographical boundaries and outside. That is , all the output that the Indian citizens produce in a given year – both within India and all other countries makes up the GNP of India. For example, there are Indian and foreign firms operating in India. Together what they produce within the Indian geography is the GDP of India. The profits of foreign firms earned within India are included in India's GDP , but not in India's GNP.

In other words, income is counted as part of GNP according to who owns the factors of production rather than where the production takes place. For example, in the case of a German-owned car factory operating in the US, the profits from the factory would be counted as part of German GNP rather than US GNP because the capital used in production (the factory, machinery, etc.) is German owned. The wages of the American workers would be part of US GDP, while the wages of any German workers on the site would be part of German GNP.

GDP is essentially about where production takes place. GNP is about who produces. If it is an open economy with great levels of foreign investment (FDI) and lesser levels of outbound FDI, its GDP is likely to be larger than GNP.

If it is an open economy but more of its nationals tend to move economic activity abroad or earn more from investing abroad compared with non-nationals doing business and earning incomes within its borders, its GNP will be larger than GDP.

If it is a closed economy where nobody leaves its shores, nobody invests abroad, nobody comes in and nobody invests in the country, its GDP will be equal to GNP.

Japan used to belong in the last category. Until the mid-1990s, the difference between Japan's GDP and GNP amounted to less than one percentage point of GDP. With only limited numbers of people doing business abroad, the GDP and GNP were essentially the same thing.

Presently, Japan's GNP tends to be around 2 percentage points larger than its GDP. Japanese economy is globalised with Japanese investment in China, USA, Europe etc. In stark contrast to the Japanese case, there are other nations where the difference between GDP and GNP is not only large, but inverted as well. That is to say, GDP is larger than GNP. Ireland is a case in point. That country's GDP has tended over recent years to eclipse its GNP by as much as 20 percent.

This is typical of a very small and very open economy. When such a country manages to attract a lot of foreign direct investment, domestic economic activity expands quite quickly. But the earnings from all that economic activity, if they are sent home by the companies in question, may not leave the country richer at all.

Analysts tend to say that GDP is a better measure than GNP, and that now seems to have been accepted by all the major industrial countries. The reason is that GDP is domestic production where employment is created: inflation is modeated; tax revenues are more and so on. GNP also has its advantages and India is a big beneficiary of it- remittances from aborad; acquisition of foreign companies; invest abroad to tap on foreign opportunities etc. But the consensus is that former is of greater value than the latter.

There are other related concepts too.

Gross National Product and Net National Product

We have seen GDP and GNP above.

Net National Product

In the production process a country uses machines and equipment. When there is depreciation, we have to repair or replace the machinery. The expenses incurred for this are called the depreciation expenditure. Net National Product is calculated by deducting depreciation expense from gross national product.

NNP = GNP - Depreciation

National Income is calculated by deducting indirect taxes from Net National Product and adding subsidies. National Income (NI) is the NNP at factor cost.

NI = NNP - Indirect Taxes + Subsidies

Per Capita Income is per capita GDP: GDP divided by mid year population of the corresponding year. Similarly, per capita GNP can also be calculated.

The growth of GDP at constant price shows an annual real growth.

The real GDP per capita of an economy is often used as an indicator of the average standard of living of individuals in that country, and economic growth is therefore often seen as indicating an increase in the average standard of living.

Base year

For examining the performance of the economy in real terms through the measurement of Gross Domestic Product (GDP), national income, consumption expenditure, capital formation etc., estimates are prepared at the prices of selected year known as base year. Base year is a specific year from which the economic growth is measured .It is allocated the value of 100 in an index. The estimates at the prevailing prices of the current year are termed as "at current prices", while those prepared at base year prices are termed "at constant prices". The comparison of the two estimates gives the measure of real growth. It means the production of the current year is valued at base year prices so that the real growth is worked out by deducting the impact of inflation or deflation. That is, the increase in the value of the GDP due to inflation is excluded and the 'real increase' is found out.

The base year of the national accounts is changed periodically to take into account the structural changes which take place in the economy and to depict a true picture of the economic growth.

The first official estimates of national income were prepared by the Central Statistical Office (CSO) with base year 1948-49 for the estimates at constant prices. These estimates were published in the publication, "Estimates of National Income" in 1956. With the gradual improvement in the availability of basic data over the years, a comprehensive review of methodology for national accounts statistics has constantly been undertaken with a view to updating the database and shifting the base year to a more recent year. As a result, base years of the National Accounts Statistics series have been shifted from 1948-49 to 2004-05 which is the new series of national accounts being followed from 2010.

Normally, when the base year of national accounts statistics is changed, there is some change in the levels of GDP estimates. This happens due to widening the coverage.

A base year has to be a normal year without large fluctuations in production, trade and prices of commodities in general. Reliable price data should be available for it. It should be as recent as possible. The National Statistical Commission wants that the base year should be revised every five years.

GDP deflator

GDP Deflator is a comprehensive measure of inflation, implicitly derived from national accounts data as a ratio of GDP at current prices to constant prices. It encompasses the entire spectrum of domestic economic activities including services, it is available on a quarterly basis with a lag of two months since 1996. Given the delay involved in obtaining the GDP deflator, national income aggregates extensively use WPI for deflating nominal price estimates to derive real price estimates.

Unlike some price indexes, the GDP deflator is not based on a fixed basket of goods and services. It covers the whole economy.

The Central Statistical Office (CSO) in the Ministry of Statistics and Programme Implementation (MoSP&I) is responsible for the compilation of NAS. At the State level, State Directorates of Economics and Statistics (DESs) have the responsibility of compiling there State Domestic Product and other aggregates.

The statistics that are released by the CSO and the State DESs relate to various macro-economic aggregates of the Indian economy. The aggregates compiled and released (at current and constant prices) at annual periodicity by the CSO include gross and net domestic product by economic activity, consumption, saving, capital formation and capital stock, public sector transactions and dis-aggregated statements, as well as the consolidated accounts of the nation namely like Gross Domestic Product. The CSO also releases the quarterly GDP estimates.

The CSO revises the base year of the NAS series periodically. The CSO releases the current series of NAS with 2004-05 as Base Year. The first estimates for a reference year are released by the CSO, about two months before the close of the year, in the form of Advance Estimates (AE) of National Income. These estimates present at both current and constant prices and at factor cost, the Gross National Product (GNP), Net National Product (NNP), Gross Domestic Product (GDP), Net Domestic Product (NDP), and Per Capita Income. These estimates are subsequently revised and released as updates of advance estimates. Quick Estimates of NAS and the Revised Estimates of the earlier years are released by the CSO utilising the available data of various sectors provided by the statistical system, in the month of January or February of the following year (with a 10-month lag). Along with the Quick Estimates for the previous financial year, estimates for the earlier years are also revised using the detailed data supplied by various source agencies and final figures released.

The need to measure economic growth

The following aims can be attributed to the study of economic growth

- when growth is quantified , we can understand whether it is adequate or not for the given goals of the economy
- we can understand its potential and accordingly set targets
- we can adjust growth rates for their sustainability
- we can prevent inflation or deflation to some extent if we see the performance of the economy in quantitative terms
- we can balance the contributions of the three sectors of the economy and steer the direction of growth towards national goals- away from agriculture to manufacturing as in the case of India in recent years
- target appropriate levels of employment creation and poverty alleviation
- forecast tax revenues for governmental objectives
- corporates can plan their business investments

Problems in calculating National Income

The measurement of national income encounters many problems. The problem of double-counting has already been noted. Though there are some corrective measures, it is difficult to eliminate double-counting altogether. And there are many such problems and the following are some of them.

Black Money

Illegal activities like smuggling and unreported incomes due to tax evasion and corruption are outside the GDP estimates. Thus, parallel economy poses a serious hurdle to accurate GDP estimates. GDP does not take into account the 'parallel economy' as the transactions of black money are not registered.

Non-Monetization

In most of the rural economy, considerable portion of transactions occurs informally and they are called as non-monetized economy- the barter economy. The presence of such non-monetary economy in developing countries keeps the GDP estimates at lower level than the actual.

Household Services

The national income accounts do not include the 'care economy'- domestic work and housekeeping. Most of such valuable work rendered by our women at home does not enter our national accounting.

Social Services

It ignores voluntary and charitable work as it is unpaid.

Environmental Cost

National income estimation does not account for the environmental costs incurred in the production of goods. For example, the land and water degradation accompanying the Green revolution in India. Similarly, the climate change that is caused by the use of fossil fuels. However, in recent years, green GDP is being calculated where the environmental costs are deducted from the GDP value and the Green GDP is arrived at.

Business cycles

Alternating periods of expansion and decline in economic activity is called business cycle. That is,the ups and downs of the economy. There are four stages in the business cycle: expansion, growth, slowdown and recession. Recession may not follow every time. When recession takes place, it may not be of the same intensity every time. For example, the 2008 global financial meltdown is the deepest since the WW2 and is called the Great Recession. If recession deepens, it is called depression and occurred only once in the last century in 1930's. All economies experience economic cycles. Explaining and preventing these fluctuations is one of the main focuses of macroeconomics.

Recession may end with the corrective measures taken by the government and the market. One such measure is stimulus. If it does not end and relapses for any reason, due to external or internal shocks, it is called double dip recession.In 2012, UK is in double dip recession. When recession worsens, with de-growth becoming stubborn and deeper and more and more people lose jobs, it is called depression- statistical markers may differ. Greece in 2012 is in depression with 50% of the young people out of work.

Economic Growth: Its benefits and side effects

The first benefit of economic growth is wealth creation. It helps create jobs and increase incomes. It ensures an increase in the standard of living, even if it is not evenly distributed. Government has more tax revenues: fiscal dividend. Economic growth boosts tax revenues and provides the government with extra money to finance spending projects. For example, the flagship programmes of the government like the NREGA are a direct result of the tax buoyancy of growth the country experienced since 2003 till 2011. It sets up the positive spiral:rising demand encourages investment in new capital machinery which helps accelerate economic growth and t create more employment.

Economic growth can also have a self-defeating effect: violate the principles of fairness and equity thus setting off social conflicts. Environmental costs are another risk.

Reliability of GDP as a measure of progress

Economic growth is generally taken as the measure of advancement in the standard of living of the country. Countries with higher GNP often score highly on measures of welfare, such as life expectancy. However, there are limitations to the usefulness of GNP as a measure of welfare:

- GDP does not value intangibles like leisure, quality of life etc. Quality of life is determined by many other things than economic goods.
- the impact of economic activity on the environment may be harmful-pollution, climate change, unsustainable growth, ecological refugees, life style diseases etc
- It only gives average figures that hide stratification. Economic inequality is not revealed by GDP figures
- Condition of poor is not indicated For example, Indian economy grew at 8.4% in 2010-2011 but the food inflation was over 14% causing immesirization of the lower classes
- Gender disparities are not indicated
- It does not matter how the increase in wealth takes place- whether by civilian demand or war
- GDP does not measure the sustainability of growth. A country may achieve a temporarily high GDP by over-exploiting natural resources

The major advantages to using GDP per capita as an indicator of standard of living are that it is measured frequently, widely and consistently. Frequently in that most countries provide information on GDP on a quarterly basis, which allows a user to spot trends more quickly. Widely in that some measure of GDP is available for practically every country in the world, which allows crude comparisons between the standard of living in different countries. And consistently in that the technical definitions used within GDP are relatively consistent between countries, and so there can be confidence that the same thing is being measured in each country.

The major disadvantage of using GDP as an indicator of standard of living is that it is not, strictly speaking, a measure of standard of living.. For instance, in an extreme example, a country which exported 100 per cent of its production would still have a high GDP, but a very poor standard of living.

The argument in favour of using GDP is not that it is a good indicator of standard of living, but rather that (all other things being equal) standard of living tends to increase when GDP per capita increases. This makes GDP a proxy for standard of living, rather than a direct measure of it.

Because of the limitations in the GDP concept, other measures of welfare such as the Human Development Index (HDI), Index of Sustainable Economic Welfare (ISEW), Genuine Progress Indicator (GPI) and Sustainable National Income (SNI), Gross National Happiness(GNH), Green GDP, natural resource accounting have been suggested.

They are proposed in an attempt to give a more complete picture of the level of well-being and the position with reference to natural resource depletion, but there is no consensus as to which is a better measure than GDP. Some of the above defy quantification. GDP still remains by far the most often-used measure.

Alternatives to GDP

Some economists have attempted to create a replacements for GDP which attempt to address many of the above criticisms regarding GDP. Other nations such as Bhutan have advocated gross national happiness as a standard of living, claiming itself as the world's happiest nation.(Read ahead for Recent advances in the concept)

HDI

The UN Human Development Index (HDI) is a standard means of measuring well-being. The index was developed in 1990 by the Pakistani economist Mahbub ul Haq, and has been used since 1993 by the United Nations Development Programme in its annual report.

The HDI measures the average achievements in a country in three basic dimensions of human development:

- A long and healthy life, as measured by life expectancy at birth.
- Knowledge, as measured by the adult literacy rate (with two-thirds weight) and the combined primary, secondary, and tertiary gross enrolment ratio (with one-third weight).
- A decent standard of living, as measured by gross domestic product (GDP) per capita at purchasing power parity (PPP) in US Dollars.

Each year, UN member states are listed and ranked according to these measures.
India ranks at 134 among 187 countries in terms of the human development index (HDI) in 2011. It is placed in the "medium" category.India's ranking in 2010 was 119 out of 169 countries.

The HDI goes beyond a nation's gross domestic product (GDP) to measure the general well-being of people under a host of parameters, such as poverty levels, literacy and gender-related issues.

The 2010 Human Development Report came up for the first time with an Inequality-adjusted Human Development Index (IHDI), which factors in inequalities in the three basic dimensions of human development (income, life expectancy, and education).

HPI

An alternative measure, focusing on the amount of poverty in a country, is the Human Poverty Index.The Human Poverty Index is an indication of the standard of living in a country, developed by the United Nations.
Indicators used are:

- Life span
- functional literacy skills
- Long-term unemployment
- Relative poverty (poverty with reference to the average per capita income)

GPI

The Genuine Progress Indicator (GPI) is a concept in green economics and welfare economics that has been suggested as a replacement metric for gross domestic product (GDP) to measure economic growth. Unlike GDP it is claimed by its advocates to more reliably distinguish uneconomic growth - harmful economic growth under which inequalities pile up and environmental damage is huge.

A GPI is an attempt to measure whether or not a country's growth, increased production of goods, and expanding services have actually resulted in the improvement of the welfare (or well-being) of the people in the country.

GNH

Gross National Happiness (GNH) is an attempt to define quality of life in more holistic and psychological terms than Gross National Product.

The term was coined by Bhutan's former King Jigme Singye Wangchuck in 1972 to indicate his commitment to building an economy that would serve Bhutan's unique culture based on Buddhist spiritual values. While conventional development models stress economic growth as the ultimate objective, the concept of GNH is based on the premise that true development takes place when material and spiritual development occur side by side to complement and reinforce each other. The four dimensions of GNH are the promotion of equitable and sustainable socio-economic development, preservation and promotion of cultural values, conservation of the natural environment, and establishment of good governance.

Natural Resources Accounting and Green GDP

Natural resources are essential for production and consumption, maintenance of life-support systems, as well as having intrinsic value in existence for intergenerational and other reasons.

It can be argued that natural capital should be treated in a similar manner to man-made capital in accounting terms, so that the ability to generate income in the future is sustained by using the stock of natural capital judiciously. By failing to account for reductions in the stock of natural resources, standard measures of national income do not represent economic growth genuinely. Soil, water and biodiversity are the three basic natural resources.

National Biodiversity Action Plan published by Government of India, Ministry of Environment and Forests in 2008 highlights as an action point the valuation of goods and services provided by biodiversity. More specifically, the Action Plan states: to assign appropriate market value to the goods and services provided by various ecosystems and strive to incorporate these costs into national accounting.

In the Nagoya (Japan) meet in 2010 on biodiversity protection, India declared that it will adopt natural resource accounting. The 2010 UN biodiversity summit decided to respect the link between economic policy, natural capital and human wellbeing. There should be global partnership is to mainstream natural resources accounting into economic planning. India, Colombia and Mexico accepted it. This will plug deficiencies in traditional accounting systems. As mentioned above, India's national biodiversity action plan has already incorporated some of these concepts.

Green GDP

Green Gross Domestic Product (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.

In 2004, Wen Jiabao, the Chinese premier, announced that the green GDP index would replace the Chinese GDP index. But the effort was dropped in 2007 as green GDP figures shrank the size of the GDP to unimpressive levels.

India and green accounting

India aims to factor the use of natural resources in its economic growth estimates by 2015 -to make "green accounting" part of government policy on economic growth.

The green GDP estimates account for the consumption of natural resources as well. This would help find out how much of a natural resource is being consumed in the course of economic growth, how much being degraded and how much being replenished.

In the calculation of Green GDP, there are methodological concerns about how to monetize the loss of biodiversity; how to measure the economic impacts of climate change due to green house gas emissions etc.

Sarkozy's Alternative metric

The Commission on the measurement of economic performance and social progress was set up in 2008 on French government's initiative.

Increasing concerns have been raised since a long time about the adequacy of current measures of economic performance, in particular those based on GDP figures. Moreover, there are broader concerns about the relevance of these figures as measures of social well-being, as well as measures of economic, environmental, and social sustainability.

Reflecting these concerns, President Sarkozy decided to establish this Commission, to look at the entire range of issues. Its aim is to identify the limits of GDP as an indicator of economic performance and social progress, to consider additional information required for the production of a more relevant picture etc. The Commission is chaired by Professor Joseph E. Stiglitz. Amartya Sen and Bina Agarwal are also associated with it. The commission gave its report in 2009.

The Stiglitz report recommends that economic indicators should stress well-being instead of production, and for non-market activities, such as domestic and charity work, to be taken into account. Indexes should integrate complex realities, such as crime, the environment and the efficiency of the health system, as well as income inequality. The report brings examples, such as traffic jams, to show that more production doesn't necessarily correspond with greater well-being.

Stiglitz explains: The big question concerns whether GDP provides a good measure of living standards. In many cases, GDP statistics seem to suggest that the economy is doing far better than most citizens' own perceptions. Moreover, the focus on GDP creates conflicts: political leaders are told to maximise it, but citizens also demand that attention be paid to enhancing security, reducing air, water, and noise pollution, and so forth – all of which might lower GDP growth. The fact that GDP may be a poor measure of well-being, or even of market activity, has, of course, long been recognized.

More recent developments

Details, discussion and dictation in the class

Moral economy

"Moral economy" is a name given in economics, sociology and anthropology to the interplay between cultural mores and economic activity. It describes the various ways in which custom and social pressure coerce economic actors in a society to conform to traditional norms even at the expense of profit. It is also an economy in which the stake holders like workers expect respect and dignity along with salary and working conditions- the latter not being all, the former being quite important as well. If moral economy breaks down, industrial unrest may result.

Laissez-faire

A market economy is an economic system in which goods and services are traded, with the price being determined by demand and supply.

Laissez-faire is a French phrase meaning "let do, let go, let pass." Its proponents make arguments against government interference with economy and trade. It is synonymous with free market economics .It is generally understood to be a doctrine opposing economic interventionism by the state beyond the extent which is perceived to be necessary to maintain peace and property rights.

Supporters of a market economy generally hold that the pursuit of self-interest is actually in the best interest of society. Adam Smith says:

"By pursuing his own interest [an individual] frequently promotes that of the society more effectually than when he really intends to promote it." (Wealth of Nations)

Adam Smith calls it the invisible hand- the force that combines the individual self interest into a collective social interest. However, as we have seen in the melt down of the western economies since 2008 and as Nobel laureate Joseph Stiglitz commented, invisible hand may not exist. That is why it is invisible!
There are a variety of critics of market as an organizing principle of an economy. These critics range from those who reject markets entirely, in favor of a planned economy, such as that advocated by communism to those who wish to see them regulated to various degrees. One prominent practical objection is the environmental pollution generated. Another is the claim that through the creation of monopolies, markets sow the seeds of their own destruction. Still another, since 2008, is the excessive speculation and financialization of the market and its crash.

Social market

Some proponents of market economies believe that government should intervene to prevent market failure while preserving the general character of a market economy.

It seeks an alternative economic system other than socialism and laissez-faire economy, combining private enterprise with measures of the state to establish fair competition, low inflation, low levels of unemployment, good working conditions, and social welfare.

Market economy and poverty

Free market economists argue that the only way to solve poverty is by creating new wealth. According to them, planned economies and welfare will not solve poverty problems but only make them worse. Low levels of government regulation and interference, free trade, and tax reform are the way to achieve growth. Open economy, competition and innovation generate growth and employment.

Advocates of the third way -social market solutions to poverty- believe that there is a legitimate role the government can play in fighting poverty. They believe this can be achieved through the creation of social safety nets such as social security and workers compensation.

Most modern industrialized nations today are not typically representative of Laissez-faire principles, as they usually involve significant amounts of government intervention in the economy. This intervention includes minimum wages to increase the standard of living, anti-monopoly regulation to prevent monopolies, progressive income taxes, welfare programs to provide a safety net for those without the capacity to find work ,disability assistance, subsidy programs for businesses and agricultural products to stabilize prices - protect jobs within a country, government ownership of some industry, regulation of market competition to ensure fair standards and practices to protect the consumer and worker, and economic trade barriers in the form of protective tariffs - quotas on imports - or internal regulation favoring domestic industry.

Market and Government failure

The inability of an unregulated market to achieve allocative efficiency is known as market failure. The main types of market failure are: monopoly, steep inequality, pollution etc. The western economic recession since 2008 is the result of market failure where excessive speculation and borrowings have disoriented the economies with huge human and economic cost.

Government failure is the public sector analogy to market failure and occurs when government does not efficiently allocate goods and/or resources consumers. Just as with market failures, there are many different kinds of government failures. Inefficient use of resources, wastage and retarded economic growth due to government monopolies and regulation are the results of government failure. Often, the performance of the public sector in India is cited to exemplify government failure. The sickness of Air India resulting from its mismanagement is an example of government failure.

Structural composition of the economy

The three-sector hypothesis is an economic theory which divides economies into three sectors of activity: extraction of raw materials (primary), manufacturing (secondary), and services (tertiary).

According to the theory, the main focus of an economy's activity shifts from the primary, through the secondary and finally to the tertiary sector. The increase in quality of life, social security, growth of education and culture and avoidance of unemployment with reduction of poverty are the effects of such transition.

Countries with a low per capita income are in an early state of development; the main part of their national income is achieved through production in the primary sector. Countries in a more advanced state of development, with a medium national income, generate their income mostly in the secondary sector. In highly developed countries with a high income, the tertiary sector dominates the total output of the economy.

The primary sector of the economy involves changing natural resources into primary products. Most products from this sector are considered raw materials for other industries. Major businesses in this sector include agriculture, fishing, forestry and all mining and quarrying industries.

Primary sector is a larger sector in developing countries; for instance, animal husbandry is more common in Africa than in Japan.

The secondary sector of the economy includes those economic sectors that create a finished, usable product: manufacturing and construction.

This sector generally takes the output of the primary sector and manufactures finished goods or where they are suitable for use by other businesses, for export, or sale to domestic consumers. This sector is often divided into light industry and heavy industry.

Light industry is usually less capital intensive than heavy industry, and is more consumer-oriented than business-oriented (i.e., most light industry products are produced for end users rather than as intermediates for use by other industries).Examples of light industries include the manufacture of clothes, shoes, furniture and household items (e.g. consumer electronics). Heavy industry means: traditional production **industries** in the auto, steel, rubber, petroleum, and similar areas, requiring high capitalization and producing large quantities. Some more examples are heavy machinery, big factories, chemical plants, production of construction equipment such as cranes and bulldozers.

The tertiary sector of economy (also known as the service sector) is defined by exclusion of the two other sectors. Services are defined in conventional economic literature as "intangible or invisible goods". The tertiary sector of economy involves the provision of services to businesses as well as final consumers. Services may involve the transport, distribution and sale of goods from producer to a consumer as may happen in wholesaling and retailing, or may involve the provision of a service, such as or entertainment. The service sector consists of the "soft" parts of the economy such as insurance, government, tourism, banking, retail, education, and social services. Examples of service may include retail, insurance, and government.

The quaternary sector of the economy is an extension of the three-sector hypothesis. It principally concerns the intellectual services: information generation, information sharing, consultation and research and development. It is sometimes incorporated into the tertiary sector but many argue that intellectual services are distinct enough to warrant a separate sector. The quaternary sector can be seen as the sector in which companies invest in order to ensure further expansion. Research will be directed into cutting costs, tapping into markets, producing innovative ideas, new production methods and methods of manufacture, amongst others. To many industries, such as the pharmaceutical industry, the sector is the most valuable because it creates future branded products which the company will profit from. This sector evolves in well developed countries and requires a highly educated workforce.

The quinary sector of the economy is the sector suggested by some economists as comprising health, education, culture, police, fire service, and other government industries not intended to make a profit. The quinary sector also includes domestic activities such as those performed by stay-at-home parents or homemakers. These activities are not measured by monetary amounts but make a considerable contribution to the economy.

Some terms

A developing country is a country that has not reached the Western-style standards of democratic governments, free market economies, industrialization, social programs, and human rights guarantees for their citizens.

Countries with more advanced economies than other developing nations, but which have not yet fully demonstrated the signs of a developed country, are grouped under the term newly industrialized countries.

Development entails a modern infrastructure (both physical and institutional), and a move away from low value added sectors such as agriculture and natural resource extraction. Developed countries, in comparison, usually have economic systems based on economic growth in the secondary, tertiary and quaternary sectors and high standards of living.
The category of newly industrialized country (NIC) is a socioeconomic classification applied to several countries around the world.

NICs are countries whose economies have not yet reached first world status but have, in a macroeconomic sense, outpaced their developing counterparts. Another characterization of NICs is that of nations who were till a decade or so back had regulated economies but are open now and are undergoing rapid economic growth. Incipient or ongoing industrialization is an important indicator of a NIC. In many NICs, social upheaval can occur as primarily rural, agricultural populations migrate to the cities, where the growth of manufacturing concerns and factories can draw many thousands of laborers.

NICs usually share some other common features, including:

• A switch from agricultural to industrial economies, especially in the manufacturing sector.
• An increasingly open-market economy, allowing free trade with other nations in the world.
• Emerging MNCs
• Strong capital investment from foreign countries.

A **high-income economy** is defined by the World Bank as a country with a per capita income of US$12,476 or more in 2011. While the term "high income" may be used interchangeably with "First World" and "developed country," the technical definitions of these terms differ. The term "first world" commonly refers to those prosperous market economies like the west, Japan etc.

According to the United Nations, for example, some high income countries may also be developing countries. The GCC (Persian Gulf States) countries, for example, are classified as developing high income countries. Thus, a high income country may be classified as either developed or developing. GCC countries for example are rich but not developed. They have pockets of export economy based on oil and gas and the rest of the economy is under developed.

The term developed country, or advanced country, is used to categorize countries that have achieved a high level of industrialization in which the tertiary and quaternary sectors of industry dominate. Countries not fitting this definition may be referred to as developing countries.

This level of economic development usually translates into a high income per capita and a high Human Development Index (HDI) rating. Countries with high gross domestic product (GDP) per capita often fit the above description of a developed economy. However, anomalies exist when determining "developed" status by the factor GDP per capita alone.
Second world was the communist countries with command economies but they do not exist today.

Third world was made up of the developing countries.
Least Developed Countries (LDCs or Fourth World countries) are countries which according to the United Nations exhibit the lowest indicators of socioeconomic development, with the lowest Human Development Index ratings of all countries in the world. A country is classified as a Least Developed Country if it meets three criteria based on:

- low-income (three-year average per capita income of less than US $905, which must exceed $1,086 to leave the list(2013-14)
- human resource weakness (based on indicators of nutrition, health, education and adult literacy) and
- economic vulnerability (based on instability of agricultural production, instability of exports of goods and services and the percentage of population displaced by natural disasters)
-

The classification currently applies to 48 countries.

Vital Statistics

The per capita income of Indians for the first time crossed the Rs 50,000-mark in 2010-11, although using current prices as the barometer. The per capita income at current prices during 2012-13 is estimated to be Rs 68,747 as compared to Rs 61,564 during 2011-12, showing a rise of 11.7 per cent, according to the CSO.

The huge figure is seen to be illusionary as economists prefer to use factor cost at constant prices to weed out the impact of inflation. It is not a great milestone to celebrate. It may be the other way as inflation actually hurt the poor and the low income groups rather than cushioning them as the higher figure shows.

Growth and the value of output

National income of India in terms of Gross Domestic Product (GDP) is composed of contributions made by three sectors namely, primary sector, secondary sector and tertiary sector. The primary sector consists of agriculture, forestry, fishing, mining and quarrying. Secondary sector includes manufacturing, construction and electricity, gas and water supply, while the tertiary sector comprises of trade, transport etc, finance & real estate, community and personnel services.

In terms of growth of the economy, sharp fall in Indian currency against the US dollar and slower economic growth have caused India's GDP for Fiscal Year 2012-13 to shrink in US $ terms to $1.84 trillion from $1.87 trillion a year earlier.

The Indian economy grew at its slowest pace in four years at 4.4% in the first quarter (Q1, or April-June) of the current fiscal year 2013-14. compared with 4.8% during the preceding quarter (January-March) of the last fiscal.

Seen from another, less reliable, yardstick of gross domestic product (GDP) at market prices, India actually grew at 2.4%.

While agriculture grew 2.7% in the first quarter. mining and manufacturing contracted 2.8% and 1.2%, respectively. Electricity grew 3.7% and construction 2.8% during the quarter.

In services, only community, social and personal services—representing government expenditure—grew faster in the first quarter at 9.4%, compared with 8.9% during the same quarter a year ago.

Trade and hotels grew at a meagre 3.9%, while financing, insurance and business services grew at a robust 8.9% in the fiscal first quarter.

The Central Statistics Office (CSO) data shows GDP growth at market price was only 2.4% against GDP growth at factor cost of 4.4% for the first quarter. GDP at market price is calculated by adding indirect taxes to GDP at factor cost while subtracting subsidies, as discussed above.

The lower GDP at market price compared to GDP at factor cost is because the subsidy component is growing extremely fast and the government is borrowing to fund subsidy.

SOCIO-ECONOMIC PLANNING

Planned economy is one in which the state owns(partly or wholly) and directs the economy. While such a role is assumed by the State in almost every economy, in planned economies, it is pronounced: for example in communist and socialist countries- former USSR and China till the 1970's. In such a case a planned economy is refered to as command economy or centrally planned economy or command and control economy. In command economies, state does the following

- Control all major sectors of the economy
- Legislate on their use and about the distribution of income
- State decides on what should be produced and how much ; sold at what price
- Private property is not allowed

In a market economy, it is the opposite- state has a minimal role in the management of the economy- production, consumption and distribution decisions are predominantly left to the market. State plays certain role in redistribution. State is called the laissez faire state here. It is a French phrase literally meaning "Let do."

Indicative plan(see ahead) is one where there is a mixed economy with State and market playing significant roles to achieve targets for growth that they together set. It is operated under a planned economy but not command economy.

The difference between planned economy and command economy is that in the former there may be mixed economy and while in the latter Government owns and regulates economy to near monopolistic limit.

Command economies were set up in China and USSR, mainly for rapid economic growth and social and economic justice but have been dismantled in the last two decades as they do not create wealth sustainably and are not conducive for innovation and efficiency. Cuba and North Korea are still command economies.

History of Economic Planning in India: The beginnings
India being devastated economically after more than 2 centuries of colonial exploitation resulting in chronic poverty, eradication of poverty was the driving force for the formulation of various models of growth before Independence.

In 1944 leading businessmen and industrialists (including Sir Purshotamdas Thakurdas, JRD Tata, GD Birla and others) put forward "*A Plan of Economic Development for India*" - popularly known as the 'Bombay Plan'.It saw India's future progress based on further expansion of the textile and consumer industries already flourishing in cities like Bombay and Ahmedabad. It saw an important role the State in post-Independent India: to provide infrastructure, invest in basic industries like steel, and protect Indian industry from foreign competition.

Visionary engineer Sir Mokshagundam Visvesvarayya. pointed to the success of Japan and insisted that 'industries and trade do not grow of themselves. but have to be willed, planned and systematically developed' – in his book titled "*Planned Economy for India*"(1934) Expert economists and businessmen were to do the planning. The goal was poverty eradication through growth.

The Indian National Congress established a National Planning Committee under the chairmanship of Jawaharlal Nehru. It (1938) stated the objective of planning for development "was to ensure an adequate standard of living for the masses, in other words, to get rid of the appalling poverty of the people". It advocated heavy industries that were essential both to build other industries, and for Indian self-defence; heavy industries had to be in public ownership, for both redistributive and security purposes; redistribution of land away from the big landlords would eliminate rural poverty.

During the 1940's, the Indian Federation of Labour published its People's Plan by MN Roy that stressed on employment and wage goods. SN Agarwala, follower of Mahatma Gandhi published Gandhian Plan that emphasized on decentralization; agricultural development; employment; cottage industries etc.

Planning Goals

After Independence in 1947, India launched the five year plans for rapid growth. Planning has the following long term goals

- Growth
- Modernization
- self-reliance and
- social justice

Economic growth is the increase in value of the goods and services produced by an economy. It is conventionally measured as the percent rate of increase in real gross domestic product, or real GDP- real means adjusted to inflation. Growth measures quantitative increase in goods and services.

Economic development refers to growth that includes redistributive aspects and social justice. GDP shows growth and not welfare and human development aspects like education, access to basic amenities, environmental quality, freedom, or social justice. Economic growth is necessary for development but not sufficient.

Growth is expected to spread to all sections and regions; raise resources for the Government to spend on socio-economic priorities etc. It takes a long time for growth to trickle down to all people and regions. Therefore, State plans for an expeditious process of inclusive growth.
Modernization is improvement in technology. It is driven by innovation and investment in R and D. Education is the foundation of modernization. The more modernized the economy, the greater the value created by it.

Self-reliance means relying on the resources of the country and not depending on other countries and the MNCs for investment and growth. India embarked on the goal partly due to the colonial experience and partly due to the goal of orienting growth to development and poverty eradication. Nehru-Mahalanobis model of growth that closed Indian economy and relied on basic industries is the main plank for self-reliance.

The term self-reliance should not be confused with self-sufficiency – the former means depending on resources of the country and avoid dependence on external flows; the latter means that the country has all the resources it needs. No country can be self-sufficient.
Social justice means inclusive and equitable growth where inequalities are not steep and benefits of growth reach all- rural-urban, man-woman; caste divide and inter-regional divides are reduced.

While the above four are the long term goals of the planning process, each five year plan has specific objectives and priorities.

Planning Commission

The Planning Commission was constituted in March, 1950 by a Resolution of the Government of India, and works under the overall guidance of the National Development Council. The Planning Commission consults the Central Ministries and the State Governments while formulating Five Year Plans and Annual Plans and also oversees their implementation. The Commission also functions as an advisory body at the apex level.
The 1950 resolution setting up the Planning Commission outlined its functions as to:

- Make an assessment of the material, capital and human resources of the country, including technical personnel, and investigate the possibilities of augmenting such of these resources as are found to be deficient in relation to the nation's requirement;
- Formulate a Plan for the most effective and balanced utilisation of country's resources;
- On a determination of priorities, define the stages in which the Plan should be carried out and propose the allocation of resources for the due completion of each stage;
- Indicate the factors which are tending to retard economic development, and determine the conditions which, in view of the current social and political situation, should be established for the successful execution of the Plan;
- Determine the nature of the machinery which will be necessary for securing the successful implementation of each stage of the Plan in all its aspects;
- Appraise from time to time the progress achieved in the execution of each stage of the Plan and recommend the adjustments of policy and measures that such appraisal may show to be necessary; and
- Make such interim or ancillary recommendations as appear to it to be appropriate either for facilitating the discharge of the duties assigned to it, or on a consideration of prevailing economic conditions, current policies, measures and development programmes or on an examination of such specific problems as may be referred to it for advice by Central or State Governments.

The Prime Minister is the ex officio Chairman of the Planning Commission. Deputy Chairperson enjoys the rank of a cabinet minister. A member of the Planning Commission enjoys the rank of a Minister of State in the Union Government. *Cabinet Ministers* with certain important portfolios act as part-time *members.*

The Deputy Chairman and the full time Members of the Planning Commission function as a composite body in the matter of detailed plan formulation. They provide advice and guidance to the subject Divisions of the Commission in the various exercises undertaken for the formulation of Approach to the Five Year Plans, and Annual Plans. Their expert guidance is also available to the subject Divisions for monitoring and evaluating the Plan programmes, projects and schemes.

The Planning Commission functions through several technical/subject Divisions. Each Division is headed by a Senior Officer designated as Pr. Adviser/Adviser/Addl. Adviser/Jt. Secretary/Jt. Adviser.

The various Divisions in the Commission fall under two broad categories:

- General Divisions which are concerned with aspects of the entire economy; and
- Subject Divisions which are concerned with specified fields of development.

The General Divisions functioning in the Planning Commission are:

- Development Policy Division,
- Financial Resources Division,
- International Economics Division,
- Labour, Employment and Manpower Division,
- Perspective Planning Division,
- Plan Coordination Division,
- Project Appraisal and Management Division,
- Socio-Economic Research Unit,
- State Plan Division, including Multi Level Planning, Border Area Development Programme, Hill Area Development and North Eastern Region (NER), and
- Statistics and Surveys Division,
- Monitoring Cell.

The Subject Divisions are:

- Agriculture Division,
- Backward Classes Division,
- Communication & Information Division,
- Education Division,
- Environment and Forests Division,
- Health & Family Welfare Division,
- Housing, Urban Development & Water Supply Division,
- Industry & Minerals Division,
- Irrigation & Command Area Development Division,
- Power & Energy Division (including Rural Energy, Non-Conventional Energy Sources and Energy Policy Cell)
- Rural Development Division,
- Science & Technology Division,
- Social Welfare & Nutrition Division,
- Transport Division,
- Village & Small Industries Division, and
- Western Ghats Secretariat.

The Programme Evaluation Organisation undertakes evaluation studies to assess the impact of selected Plan Programmes/ Schemes in order to provide useful feedback to planners and implementing agencies.

The Commission is a corner-stone of our federal structure, a think-tank ; helps to balance the priorities and expenditures of the Ministries of the Union Government ; throws up ideas on policies for structural and perspective changes ; and is a reservoir of research."

Relevance of Planning

There has been a national debate about the relevance of planning in the era of liberalization where the state controls and regulations are dismantled to a great extent and market forces are given larger role. The investment of the government for the five year plans is also on decline. The trend began in the 7th plan and strengthens into the Eleventh Plan.

It is true that the quantitative aspects of planning in terms of control over economy are being selectively phased out and the nature of planning process is undergoing a qualitative change. Planning is important for the following reasons in the era of liberalization

- In a federal democracy like ours, the principal task of planning is to evolve a shared vision among not only the federal units but also among other economic agents so that the efforts of all the actors become convergent towards the national priorities. the role of planning is to develop a common policy stance for center and states. Also, the task of federal policy coordination is central to Indian Planning. For example, the need to invite foreign investment in infrastructure areas like power need center – state coordination as the necessary legislation and administrative changes involve both.
- While the growth process can be made the responsibility of the corporate sector to a greater degree, its direction and distribution are to be steered by planned public intervention so that regional imbalances are reduced and socio economic inequities are set right. For example, directing the growth of the large industry into the backward areas and technology intensive areas to realize national goals.
- The nature of instruments available to planners in the implementation has changed. Quantitative controls have yielded place to qualitative ones .The planning process has to focus on the need for planning for policy.
- Planning at the grass roots level that is participatory is very crucial for improving the delivery systems and proper use of the resources. The role of the government is thus to facilitate participatory planning.
- Environmental priorities are a major concern of planning
- Planning is necessary for the sectors like energy, communication, transport and so on as private sector needs to be guided into the national plan.
- In the era of globalization where corporates are not expected to plan beyond the growth of a particular unit, the role of safeguarding national interest is that of planning by the State. For example , being subjected to various discriminative trade practices by EU, USA and so on, the Indian farmers, manufacturers and exporters have to fight sophisticated battles in the WTO for which the legal services and information and building up bargaining power are best provided by the State.

Thus, planning continues to be relevant and ever more so for the following reasons

- Federal cooperation and coordination
- Equitable growth
- Environment friendly development
- Defending national interest in the age of globalization
- Inter-sectoral balance in growth

Changing Role of Planning Commission

From a highly centralized planning system, the Indian economy is gradually moving onwards indicative planning where hard planning is no longer undertaken. The role of the Planning Commission accordingly changes. The Commission concerns itself with the building of a long term strategic vision of the future and decide on priorities of nation. It works out sectoral targets and provides promotional stimulus to the economy to grow in the desired direction. Planning Commission plays an integrative role in evolving a national plan in critical areas of human and economic development. In the social sector, Planning Commission helps in schemes which require coordination and synergy like rural health, drinking water, rural energy needs, literacy and environment protection.

When planning in a vast federal country like India involves multiplicity of agencies, a high powered body like the PC can help in evolution of an integrated approach for better results at much lower costs.

In our transitional economy, Planning Commission attempts to play a systems change role and provide consultancy within the Government for developing better systems. It has to ensure smooth management of the change and help in creating a culture of high productivity and efficiency in the Government

In order to spread the gains of experience more widely, Planning Commission also plays an information dissemination role.

With the emergence of severe constraints on available budgetary resources, the resource allocation system between the States and Ministries of the Central Government is under strain. This requires the Planning Commission to play a mediatory and facilitating role, keeping in view the best interest of all concerned.

From Planning Commission to Systems Reforms Commission

There has been a significant change in the role of the PC since its inception in 1950. Initially for about 4 decades, due to centralized planning, resources were those of the Central government and the priorities and monitoring were also the works of the Central Government. It effectively meant the PC. Planning Commission had veto over every aspect – related to growth and socio-economic development- of the functioning of the Union Ministries and the State Governments: The manner of raising and utilising resources; specific allocations to particular schemes and programmes; location of enterprises; expansion and reduction of capacities; application of technologies; sources of supplies; modalities of implementation; priorities, phasing, pricing, targets and time-frames; nature of the instrumentalities; qualifications and strength of personnel of organisations; staff emoluments etc.

Since 1991, India adopted the indicative planning model , away from the kind of centralised planning on the Soviet model envisaged by Jawaharlal Nehru. Now Ministries and Departments, as well as the corporate entities in the private sector, enjoy a lot of functional, financial and operational autonomy.

States have more autonomy and corporates contribute more than half to planning resources. Thus, centre's role is on decline in quantitative and qualitative terms and thus that of the PC. In the era of liberalisation. the economic players should properly be left to decide for themselves what they consider to be the appropriate courses of action on the various issues coming up before them, whether they relate to policies, schemes or investments.
The government intends to convert the Planning Commission into a think-tank to generate original ideas in the very broad domain of economic policy for the government to then act on. It will also be the government agency responsible for acting as an interface with other

independent think-tanks and NGOs. The PM would like the commission to engage more directly with the "polity", with various ministries in the Central and state governments, and be able to persuade them to implement certain ideas or "plans" generated by the government's own think tank. That isn't radically different from its existing role — the Planning Commission has few direct powers of execution in any case and must rely on the power of persuasion to sell its ideas to the Centre and states.

Interestingly enough, the new role sought for the Planning Commission seems to be very similar to the role played by the National Advisory Council, which also generates ideas within, coordinates with NGOs and civil society and then tries to "persuade" the government to act. NAC's focus so far has been social sectors whereas a systems reforms commission can take on a broader gambit of issues, including public finances, infrastructure and so on.
The government's move to revamp and gradually transform the Planning Commission into a System Reforms Commission is a major step that can make the institution more relevant to a market economy. The idea is to metamorphose the plan panel from a reactive agency into a strategic thinking group, which maps out risks and opportunities by focusing on issues
The shrinking role of the government in mobilising and controlling investments has pushed the Planning Commission to focus more on issues related to enforcing fiscal discipline in the central and state governments, including in the various ministries, departments and public sector enterprises.

According to Arun Maira, PC member, the Planning Commission will gradually transform itself into a Systems Reforms Commission for resolving the systemic problems of the 21st Century over the next two-three years as desired by Prime Minister Manmohan Singh. It will restructure itself to serve three essential functions: build a larger network around its members with think tanks and opinion makers, produce thought papers at a faster pace and communicate more lucidly with polity.

National Development Council
The National Development Council is not a Constitutional body nor a statutory body (not set up by an Act of the Parliament). Union Cabinet set up the NDC in 1952 with the following functions

- To prescribe guidelines for the formulation of the national plan.
- To consider the national plans formulated by the Planning Commission.
- To assess the resources for the plan and recommend a strategy for mobilizing the resources.
- To consider important questions of socio-economic policy affecting development of the nation.
- To review the progress of the five year plan mid-course and suggest measures for achieving the original targets.

NDC is headed by the Prime Minister of India and comprising of all Union Cabinet Ministers, Chief Ministers of all the States and Administrators of Union Territories and Members of the Planning Commission .PC members are ex-officio members of the NDC.. Ministers of State with independent charge are also invited to the deliberations of the Council.

The National Development Council (NDC) has a special role in our federal polity.
It is the apex body for decision making and deliberations on development matters.

It has the explicit mandate to study and approve the Approach Plan to the Five year Plans and the Five Year Plan documents. The mid-term reviews of the Five year Plans are considered by the NDC. In fact, without the NDC approving, the Five Year Plan does not come into effect.

57th meeting of NDC was held in December 2012 to approve the 12th FYP.

The CMP of the UPA Government (2004) says that NDC will be activated. It will meet at least three times in a year and in different state capitals . It will be developed as an effective instrument of cooperative federalism.

Mixed economy

India is a mixed economy combining features of both capitalist market economies and socialist command economies. Thus, there is a regulated private sector (the regulations have decreased since liberalisation) and a public sector controlled almost entirely by the government. The public sector generally covers areas which are deemed too important; or not profitable enough for the private sector. Thus such services as railways and postal system are carried out by the government.

Since independence, various phases have seen nationalisation of such areas as banking, thus bringing them into the public sector, on one hand, and privatisation of some of the Public Sector Undertakings during the liberalisation period on the other

Financial resources for the Five year Plans

The resources for the Plan come from

- Central budget
- State budgets
- PSEs
- Domestic private sector and
- FDI

A Note on Gross Budgetary Support

Resources of the Centre consist of both budgetary resources including external assistance routed through the budget and the Internal & Extra Budgetary Resources (IEBR) of Central Public Sector Enterprises (CPSEs). The quantum of budgetary resources of the Centre which is available for providing overall budgetary support to the plan is divided into two parts viz. budgetary support for Central Plan (including U.Ts without Legislature) and Central Assistance for States' Plans (including U.Ts with Legislature). A part of the budgetary resources allocated as budgetary support for the Central Plan is used for providing necessary support to CPSEs.

GBS is the amount from the central Budget that goes to fund the plan investments during the plan period.

History of Planning

First Plan (1951- 56)

The First Plan stressed more on agriculture, in view of large scale import of foodgrains and inflationary pressures on the economy. Other areas of emphasis were power and transport. The annual average growth rate during the First Plan was estimated as 3.61% as against a target of 2.1%. Renowned economist **KN Raj**, who died in 2010 was one of the main architects of India's **first five-year plan**.

Second Plan (1956-61)

With agricultural targets of previous plan achieved, major stress was on the establishment of heavy industries. Rate of investment was targeted to increase from 7% to 11%. The Plan achieved a more than targeted growth rate of 4.32%. This Plan envisaged to give a big push to the economy so that it enters the take off stage. It was based on Nehru-Mahalanobis model- self-reliance and basic-industry driven growth.

Third Plan (1961-66)

It tried to balance industry and agriculture. The aim of Third Plan was to establish a self sustaining economy. For the first time, India resorted to borrowing from IMF. Rupee was also devalued for the first time in 1966. India's conflict with Pakistan and repeated droughts also contributed in the failure of this Plan.

Annual Plans

As the Third Plan experienced difficulties on the external front (war with China in 1962 and Pakistan in 1965); and the economic troubles mounted on the domestic front- inflation, floods, forex crisis- the Fourth Plan could not be started from 1966. There were three annual plans till 1969. This period is called plan holiday- that is when five year plans are not implemented. The Annual Plans were: 1966-67, 1967-68 and 1968-69.

Fourth Plan (1969-74)

The main objective of this Plan was growth with stability. The Plan laid special emphasis on improving the condition of the under-privileged and weaker sections through provision of education and employment. Reducing the fluctuations in agricultural production was also a point of emphasis of this Plan. The Plan aimed at a target growth of 5.7% and the achievement against this was 3.21%.

Fifth Plan (1974-79)

The main objective of the Plan was Growth for Social Justice. The targeted growth rate was 4.4% and we achieved 4.8%. It was cut short by the Janata Party that came to power in 1977.

Sixth Plan (1980-1985)

Removal of poverty was the foremost objective of Sixth Plan. Another area of emphasis was infrastructure, which was to be strengthened for development of both industry and agriculture. The achieved growth rate of 5.7% was more than the targeted one.

Direct attack on poverty was the main stress of the Plan.

Seventh Plan (1985-90)

This Plan stressed on rapid growth in food-grains production and increase in employment opportunities. The growth rate of 5.81% achieved in this Plan was more than the targeted one. The plan saw the beginnings of liberalization of Indian economy.

The 8th Plan could not start in 1990 due to economic crisis and political instability. There were two annual plans- plan holiday.

Eighth Plan (1992-1997)

This Plan was formulated keeping in view the process of economic reforms and restructuring of the economy. The main emphasis of this Plan were

- to stabilize the adverse balance of payment scenario sustainably
- improvement in trade and current account deficit
- Human development as main focus of planning.

It was indicative plan for the first time. The Plan was formulated in a way so as to manage the transition from a centrally planned economy to market led economy. The targeted annual average rate of growth of the economy during Eighth Plan was 5.6%. Against this, we achieved an average annual growth of 6.5%.

The Plan was based on Rao-Manmohan Singh model of liberalization.

Ninth Five Year Plan (1997-2002)

The salient features of the Ninth Five Year Plan are a target annual average growth rate of 6.5 per cent for the economy as a whole, and a growth rate of 3.9 per cent for agriculture sector, among others. The key strategies envisaged to realise this target rest on attaining a high investment rate of 28.2 per cent of GDP at market prices. The domestic saving rate, which determines the sustainable level of investment, is targeted at 26.1 per cent of the GDP. Care has been taken to ensure achievement of a sustainable growth path in terms of external indebtedness as well as fiscal stability. Rate of growth achieved was 5.4%

Tenth Plan

Tenth Plan (2002–2007) The main objectives of the tenth Five Year Plan of India were:

- Attain 8% GDP growth per year.
- Reduction of poverty rate by 5 percentage points by 2007.
- Providing gainful and high-quality employment at least to the addition to the labor force.
- Reduction in gender gaps in literacy and wage rates by at least 50% by 2007.

Eleventh Plan

'Towards Faster and More Inclusive Growth' is the central theme of the plan that seeks to lower poverty by 10%, generate 70 million new jobs, and reduce unemployment to less than 5% Rs 36.44 trillion. Eleventh Five-Year Plan promises to accelerate economic growth and make it more inclusive. The chief thrust of the plan, that will run from 2007-08 to 2011-12, will be agriculture, education and infrastructure -- all areas that remain a concern in a rapidly growing economy.

As many as 27 detailed national targets have been set in the plan, ranging from enhancing incomes and reducing poverty, to education, literacy, health, infant mortality, maternal mortality and child development.

Achievements

GDP growth in the Eleventh Plan 2007–08 to 2011–12 was 7.9 per cent compared with 7.6 per cent in the Tenth Plan (2002–03 to 2006–07) and only 5.7 per cent in the Ninth Plan (1997–98 to 2001–02). The growth rate of 7.9 per cent in the Eleventh Plan period is one of the highest of any country in that period which saw two global crises.

Agricultural GDP growth accelerated in the Eleventh Plan, to an average rate of 3.7 per cent, compared with 2.4 per cent in the Tenth Plan, and 2.5 per cent in the Ninth Plan.

Rural real wages increased 6.8 per cent per year in the Eleventh Plan.
Net enrolment rate at the primary level rose to a near universal 98.3 per cent in 2009–10. Dropout rate (classes I–VIII) also showed improvements.

11th Five Year Plan (2007-2012) in detail

The eleventh plan has the following objectives:

1. **Income & Poverty**
   - Accelerate GDP growth from 8% to 10% and then maintain at 10% in the 12th Plan in order to double per capita income by 2016-17
   - *Rs.36,44,000 lakh crores ($910 billion) is the investment*
   - gross budgetary support (GBS) is Rs 14,21,711 crore, double of the last plan
   - Increase agricultural growth rate to 4% per year to ensure broad-based development
   - Create 70 million new work opportunities.
   - Reduce educated unemployment to below 5%.
   - Raise real wage rate of unskilled workers by 20 percent.
   - Reduce poverty by 10 percentage points
   - industrial and services sector growth to 9-11 per cent
   - investment rate to be at 36.7 per cent
2. **Education**
   - Reduce dropout rates of children from elementary school from 52.2% in 2003-04 to 20% by 2011-12
   - Develop minimum standards of educational attainment in elementary school, and by regular testing monitor effectiveness of education to ensure quality
   - Increase literacy rate for persons of age 7 years or more to 85%
   - Lower gender gap in literacy to 10 percentage points
3. **Health**
   - Reduce infant mortality rate to 28 and maternal mortality ratio to 1 per 1000 live births
   - Reduce Total Fertility Rate to 2.1
   - Provide clean drinking water for all by 2009 and ensure that there are no slip-backs
   - Reduce malnutrition among children of age group 0-3 to half its present level
   - Reduce anaemia among women and girls by 50% by the end of the plan
4. **Women and Children**
   - Raise the sex ratio for age group 0-6 to 935 by 2011-12 and to 950 by 2016-17
   - Ensure that at least 33 percent of the direct and indirect beneficiaries of all government schemes are women and girl children
   - Ensure that all children enjoy a safe childhood, without any compulsion to work

5. **Infrastructure**
    - Ensure electricity connection to all villages and BPL households by 2009 and round-the-clock power.
    - Ensure all-weather road connection to all habitation with population 1000 and above (500 in hilly and tribal areas) by 2009, and ensure coverage of all significant habitation by 2015
    - Connect every village by telephone by November 2007 and provide broadband connectivity to all villages by 2012
    - Provide homestead sites to all by 2012 and step up the pace of house construction for rural poor to cover all the poor by 2016-17
6. **Environment**
    - Increase forest and tree cover by 5 percentage points.
    - Attain WHO standards of air quality in all major cities by 2011-12.
    - Treat all urban waste water by 2011-12 to clean river waters.
    - Increase energy efficiency by 20 percentage points by 2016-17.

12th FYP

12th Five-Year Plan (2012-17) aims to achieve annual average economic growth rate of 8 per cent, down from from 9 per cent envisaged earlier, in view of fragile global recovery.

During the 11th Plan (2007-12), India has recorded an average economic growth rate of 7.9 per cent. This, however, is lower than the 9 per cent targetted in 11th Plan.

12th Plan seeks to achieve 4 per cent agriculture sector growth during 2012-17. The growth target for manufacturing sector has been pegged at 10 per cent.

The total plan size has been estimated at Rs.47.7 lakh crore, 135 per cent more that for the 11th Plan (2007-12).

As regards to poverty alleviation, the Commission aims to bring down the poverty ratio by 10 per cent. At present, 30 per cent of the population is below poverty line.

Growth Performance in the Five Year Plans (per cent per annum)

	Target	Actual
1. First Plan (1951-56)	2.1	3.61
2. Second Plan (1956-61)	4.5	4.32
3. Third Plan (1961-66)	5.6	2.38
4. Fourth Plan (1969-74)	5.7	3.21
5. Fifth Plan (1974-79)	4.4	4.80
6. Sixth Plan (1980-85)	5.2	5.69
7. Seventh Plan (1985-90)	5.0	5.81
8. Eighth Plan (1992-97)	5.6	6.7
9. Ninth Plan (1997-2002)	6.5	5.35
10.Tenth Plan(2002-2007)	8%	7.8%
11. Eleventh Plan(2007-12)	9%	7.9%
12.Twelfth FYP	8%	5% in 2012-13

Achievements of Planning

In the last about 60 years since India became a Republic, the National Income has increased many times. Today, India is the third largest economy in Asia with about $1.84 trillion GDP after China and Japan; is the 9th largest economy in the world.

India overtook Japan to become the world's third-largest economy in purchasing power terms. Data released by the International Monetary Fund (IMF) shows that India's gross domestic product in purchasing power parity (PPP) terms stood at $4.46 trillion in 2011, marginally higher than Japan's $4.44 trillion, making it the third-biggest economy after the United States and China.

The PPP system allows GDP comparisons to be made by asking how much money would be needed to purchase the same goods and services in two countries and using that to calculate an implicit foreign exchange rate.

Under this method, a dollar should be able to buy the same amount of goods anywhere in the world and exchange rates should adjust accordingly. It nullifies distortions that come with market exchange rates, which are often volatile, affected by political and financial factors.

The Economist magazine's proprietary Big Mac Index, which takes the price of a McDonald burger across 120 countries to calculate the 'real' price of their currencies, is another crude way to measure PPP. India was included in the index recently. It showed that the Indian rupee was undervalued by 62% against the US dollar in 2012.

The PPP comparison is more useful while comparing the standards of living between countries. While the per capita GDP in PPP terms shows that India still has some distance to go to reach Japanese levels, "the difference is less than the comparison of per capita GDP in nominal dollar terms would indicate".

In the face of global recession, India remains the second fastest growing major economy after China.

Data released by the Planning Commission in July, 2013, suggested that poverty in India had declined from 37.2 percent in 2004-05 to 21.9 percent by 2011-12.

From 2004-05 to 2011-12 poverty fell by 2.24% annually as against 0.74% in the preceding 6 years. In absolute numbers the number of poor fell by 138 million during these seven years, an Indian and even a world record. Similar achievements by China are celebrated by the world.

Social indicators improved e though there is a long way to go- IMR, MMR, literacy, disease eradication etc. The industrial infrastructure is relatively strong – cement, steel ,fertilizers, chemicals, etc Agricultural growth is also gaining momentum with food grains production at 258 mt in 2012.

Forex reserves are $282 b (November 2013) which is a dramatic turnaround from 1991 when we had a billion dollars.

More than 2 lakh MW of power capacity is installed by 2013.
India has emerged as a back office of the world and its prowess in software is growing.
India ranks 11th worldwide in factory output (2013)
India ranks 10th worldwide in services' output.

There has been considerable expansion of higher education. At the time of Independence there were 20 universities and 591 colleges. while today, there are almost 500 universities and 21,000 colleges. Literacy levels are 75%(2010).

The failures of planning are equally clear

- Poverty still plagues about 250 million (Tendulkar)
- Inflation on CPI and food inflation are rising relentlessly hurting the poor- CPI is in double digits(above 10%) in September 2013.
- Unemployment is high
- Regional imbalances are intensifying
- Malnutrition haunts about half the children in India.

Indicative planning

With the launch of the economic reforms in 1991, indicative planning was inevitable. It was adopted since 8th five year plan (1992-97). It is characterized by an economy where the private sector is given a substantial role. State would turn its role into a facilitator from that of a controller and regulator.

It was decided that trade and industry would be increasingly freed from government control and that planning in India should become more and more indicative and supportive in nature. In other words, the remodeling of economic growth necessitated recasting the planning model from imperative and directive('hard') to indicative (soft) planning. Since the Government did not contribute the majority of the financial resources, it had to indicate the policy direction to the corporate sector and encourage them to contribute to plan targets. Government should create the right policy climate- predictable, irreversible and transparent-to help the corporate sector contribute resources for the plan: fiscal, monetary, forex and other dimensions.

Indicative planning is to assist the private sector with information that is essential for its operations regarding priorities and plan targets. Here, the Government and the corporate sector are more or less equal partners and together are responsible for the accomplishment of planning goals. Government, unlike earlier, contributes less than 50% of the financial resources. Government provides the right type of policies and creates the right type of milieu for the private sector-including the foreign sector to contribute to the results.

Indicative planning gives the Government an opportunity to give the private sector encouragement to achieve growth in areas where the country has inherent strengths. It is known to have brought Japan results in shifting towards microelectronics. In France, too indicative planning was in vogue.

Planning Commission would work on building a long-term strategic vision of the future. The concentration would be on anticipating future trends and evolving strategies for competitive international standards. Planning will largely be indicative and the public sector would be gradually withdrawn from areas where no public purpose is served by its presence. The new approach to development will be based on "a re-examination and re-orientation of the role of the government". This point is particularly stressed in the development strategy of the Tenth Five Year Plan (2002-2007)

Indicative planning was not contemplated at the beginning of fifties as there was hardly any corporate sector in India and Government shouldered almost the entire responsibility of socio-economic planning.

Rolling Plan

It was adopted in India in 1962, in the aftermath of Chinese attack on India, in the Defence Ministry in India. Professor Gunnar Myrdal (author of famous book' Asian Drama') recommended it for developing countries in his book - Indian Economic Planning in Its Broader Setting.

In this type, every year three new plans are made and implemented- annual plan that includes annual budget ; five year plan that is changed every year in response to the economic demands; and perspective plan for 10 or 15 years into which the other two plans are dovetailed annually. Rolling plan becomes necessary in circumstances that are fluid.

Financial Planning

Here, physical targets are set in line with the available financial resources. Mobilization and setting expenditure pattern of financial resources is the focus in this type of planning.

Physical planning

Here, the output targets are prioritized with inter-sect oral balance. Having set output targets, the finances are raised.

Nehru-Mahalanobis Model of Economic Growth

Indian economy at the time of Independence was characterized by dependence on exports of primary commodities; negligible industrial base; unproductive agriculture etc. 1st FYP focused on agriculture for food security. But industrialization was urgently needed to modernize the economy and improve its technology.

The turning point in India's planning strategy came with the second five-year (1956-61) plan. The model adopted for the plan is known as the Nehru-Mahalanobis strategy of development as it articulated by Jawahar Lal Nehru's vision and P.C.Mahalanobis was its chief architect. The central idea underlying this strategy is well conveyed by recalling the following statement from the plan document. 'If industrialization is to be rapid enough, the country must aim at developing basic industries and industries which make machines to make the machines needed for further development.'

The Mahalanobis model of growth is based on the predominance of the basic goods (capital goods or investment goods are goods that are used to make further goods; the goods that make up the industrial market like machines, tools, factories, etc). It is based on the premise that it would attract all round investment, ancillarisation, build townships and result in a higher rate of growth of output. That will boost employment generation, poverty alleviation, exports etc. The emphasis was on expanding the productive ability of the system, through forging strong industrial linkages, as rapidly as possible.

Other elements of the model are

- Import substitution. Protective barriers against foreign competition to enable Indian companies to develop domestically produced alternatives for imported goods and to reduce India's reliance on foreign capital.
- A sizeable public sector active in vital areas of the economy including atomic energy and rail transport.
- A vibrant small-scale sector driving consumer goods production for dispersed and equitable growth and producing entrepreneurs.

In terms of the core objective of stepping up the rate of growth of industrial production, the strategy paid off. Rate of growth of overall industrial production picked up . The strategy laid the foundation for a well-diversified industrial structure within a reasonably short period and this was a major achievement. It gave the base for self-reliance.

However, the strategy is criticized for the imbalances between the growth of the heavy industry sector and other spheres like agriculture and consumer goods etc that resulted. It is further criticized as it relied on `trickle down effect'- benefits of growth will flow to all sections in course of time. This approach to eradication of poverty is slow and incremental. It is believed that frontal attack on poverty is required. Follow the debates about growth and redistribution-Sen-Bhagawati- argument that raged in 2013.

The criticism is one sided as in the given context, the Mahalanobis model was correct for growth and self-reliance.

Rao-Man Mohan Singh Model of Growth

The launching of economic reforms by the government in 1991 is driven by the Rao-Manmohan model - Mr. Narasimha Rao, the PM in 1991 and Finance Minister Dr. Man Mohan Singh. Its essence is contained in the New Industrial Policy 1991 and extends beyond it too. The model has the following contents

- Reorient the role of State in economic management. State should refocus on social and infrastructural development, primarily
- Dismantle, selectively controls and permits in order to permit private sector to invest liberally
- Open up the economy and create competition for PSEs- for better productivity and profitability
- External sector liberalization in order to integrate Indian economy with the global economy to benefit from the resource inflows and competition.

Its success is seen in the more than 6.5% average annual rate of growth of economy during the 8th Plan (1992-1997) . Forex reserves accumulated leaving the BOP crisis as history; poverty levels plummetted; and the foreign flows- FDI and FII increased.

Economic Reforms

Since July 1991, India has been taking up economic reforms to achieve higher rates of economic growth so that socio-economic problems like unemployment, poverty, shortage of essential goods and services, regional economic imbalances and so on can be successfully solved. The force behind the reforms is

- Indian economy reached a level of growth and strength to benefit from an open market economy.
- Private sector in India had come of age and was willing and capable of playing a major role
- Indian economy needed to integrate with the world with all the advantages like capital flows; technology; higher level of exports; state of art stock markets; Indian corporates can raise finances abroad and so on.

The country under the leadership of Dr. Manmohan Singh, Union Finance minister(1991-1996 and Prime Minister since 2004) converted the economic crisis – caused by . domestic cumulative problems of economy, political instability and gulf crisis-into an opportunity to initiate and institutionalise economic reforms to open up the economy. The deep crisis in 1991 could not be solved by superficial solutions. Therefore, structural reforms were taken up.

It was realized that by closing economy to global influences, the country was missing on technology developments and also gains from global trade. India needed exports, FDI and FII for stability on the balance of payments front and higher growth rates for social development. Worldwide, countries were embracing market model of growth, for example China, with proven results. So, India could make the historic shift from centralized planning to market-based model of growth.

Misgivings About Economic Reforms

Initially reforms were feared and resisted as there was scepticism and fear as the experience in Latin American countries in the 1980s was not a success in economic and social terms. The fears related to

- Inflation as there will be little left for domestic consumption as exports would be attractive
- Large scale unemployment due to capital intensity of growth process.
- Worsening of poverty as fiscal concerns will reduce social sector expenditure
- Flood of imports as customs duties will come down.
- food security will suffer as social sector expenditure will be reduced
- Pressures on labour sector due to domestic industry's inability to compete.

Some fears have indeed come true- jobless growth and uncertainty in farming. But by and large, reforms have done well.

Reforms mainly targeted the following areas:

- Dismantling the licence raj so that private sector and government were on a level playing field
- Drive public sector towards sustainable profitability and global play by dereservation; disinvestment; professionalization of management etc
- Fiscal reforms for stabile economic growth.
- Banking sector is deregulated and made to conform to stringent reforms for higher competitive strength and performance globally
- move towards free float of rupee and relaxation of controls on convertibility; aggressive export promotion; FDI and FII inflows etc.

Reforms were prioritized and sequenced in such a way as to make them sustainable and render further reforms feasible. For example, first generation reforms involved essentially non-legislative government initiatives- reduce SLR and CRR for the banking sector. Disinvestment of the PSEs. Deregulation of the rupee gradually and later make exchange rate of the rupee market-driven and so on. The second generation reforms involve legislative reforms and touch a wider section of the society- labour reforms; GST, FDI expansion etc. The former prepares the economy for the latter.

Above all, reforms with human face was the goal , unlike elsewhere in the world like in South America in the 1980's. It yielded results- the social effect of the reforms in India is seen in the flagsips schemes making an impact on health, education, social protection etc. The reforms gained consensus and showed positive results as can be seen below.

- Rates of growth went up
- BOP crisis has been solved in the first few years and today the country has about $ 282 b forex reserves(2013)
- Services sector (tertiary sector) has grown in importance and today contributes almost 57% of GDP(2013) emerging as a global player-India being the global back office.
- Exports have performed well and have recovered handsomely even while the world continues to be trapped in near recession conditions. It accounting for many jobs and quality Indian products
- Resilience of the economy in the face of Great Recession which is still not resolved
- Consumer choice has increased
- Tax-GDP ratio may have shrunk but the tax collections and base increased dramatically

- Nature of external debt has changed and the short term component is less
- Indian companies are listed on Nasdaq and New York Stock Exchange and raised billions of dollars for investment
- FIIs and FDI has picked up.
- Indian corporates have acquired global majors like Jaguar and *Anglo-Dutch steel* maker Corus; Bharati bought Zain's African telecom operations(2010)

While the above facts paint a positive picture of reforms, there are deficiencies as well

- poverty is a challenge and reforms with a human face is the need of the hour
- jobless growth is worrying the policy makers
- regional economic imbalances are intensifying
- While foodgrains production is at 258mtt(2012), there is still pressure on food security
- farmers are feeling directionless under the WTO regime
- Globalization threatens to destabilize agriculture with cheaper imports and questionable provisions related to intellectual property rights impacting negatively on availability of medicines etc.
- Infrastructure so far received inadequate attention except telecom ,roads and ports
- PSU reforms have not made progress and disinvestment and privatization are still to see substantial movement
- Globalization has exposed India to imported inflation due to commodity price rise- CPI has been almost invariably above the double digits since 2008(2013)

Second Generation Reforms

Having begun with the reforms in all the above sectors and seen the economy benefit from them , the second generation reforms were initiated by the end of 1990's. The reason for calling the latter set of reforms SGR is that they followed the initial reforms which laid the foundation for the reform process to deepen. It is a matter of sequencing in line with prioritization; economic preparation; consensus-building and so on. In fact, unless the success in material and human terms of the initial reforms was demonstrated, the next round of 'difficult' reforms would not be possible.

Second generation reforms- labour law flexibility, pension reforms based on employee contribution and the pension funds being deployed in the stock market; value added tax and GST; liberalized FDI including FDI in retail etc- touch on the lives of ordinary people and need successes in other sectors- first generation reforms- to make a convincing case. Otherwise, they may not be allowed by public opinion as we have seen in the case of FDI-MBR debate.

Second generation reforms are difficult as they are directly involved with the daily lives of people like

- User charges need to be rationalized to make these utilities viable but there are bound to be protests
- Man power rationalization in banks and PSUs through VRS faced resistance.
- Labour law flexibility will make TUs agitate.
- Interst rate cut, for example, for small savings will mean less returns for the middle class etc
- Agroreforms may mean small and marginal farmers' resistance

However, unless the SGRs are carried out, investment and growth will suffer with long term adverse consequences for poverty alleviation and employment generation. As the long term benefits of the reforms are bound to show in terms of higher growth rates and more social welfare, consensus needs to be built for successful legislation and implementation of SGRs.

Recession and depression

Recession

The standard definition of a recession is a decline in the Gross Domestic Product (GDP) – contraction in absolute quantity- for two or more consecutive quarters.

Depression

Before the Great Depression of the 1930s any downturn in economic activity was referred to as a depression. The term recession was developed in this period to differentiate periods like the 1930s from smaller economic declines that occurred earlier. This leads to the simple definition of a depression as a recession that lasts longer and has a larger decline in business activity.- more unemployment, deflation, negative growth.

How can we tell the difference between a recession and a depression A depression is any economic downturn where real GDP declines by more than 10 percent. A recession is an economic downturn that is less severe.

There is an old joke among economists: A recession is when your neighbour loses his job. A depression is when you lose your job.

Great Recession 2008-09

The late-2000s recession, more often called the Great Recession, was a severe economic recession that began in the United States in 2007 and ended in mid- 2009, according to the U.S. National Bureau of Economic Research (NBER). However, most people throughout the world consider it to be ongoing, because heightened degrees of unemployment and economic hardship remain a reality even today. The Great Recession has affected the entire world economy, with higher detriment in some countries than others. It is a global recession characterized by various systemic imbalances and was sparked by the outbreak of the financial crisis of 2007–2010.

The financial crisis is linked to reckless lending practices by financial institutions and the growing trend of securitization of real estate mortgages in the United States. The US mortgage-backed securities, which had risks that were hard to assess, were marketed around the world. When these securities lost value and were considered toxic, the financial institutions that bought them either went into heavy losses or went bankrupt fully. These companies being listed on the stock market, equities collapsed in their value as a result. Indian banks had negligible exposure to them.

A more broad based credit boom fed a global speculative bubble in real estate and equities, which served to reinforce the risky lending practices. The precarious financial situation was made more difficult by a sharp increase in oil and food prices. The emergence of Sub-prime loan losses in 2007 began the crisis and exposed other risky loans and over-inflated asset prices. With loan losses mounting and the fall of Lehman Brothers on September 15, 2008, a major panic broke out in the global financial transactions. As share and housing prices declined, many large and well established investment and commercial banks in the United States and Europe suffered huge losses and even faced bankruptcy, resulting in massive public financial assistance.

A global recession has resulted in a sharp drop in international trade, rising unemployment and slumping commodity prices.

The conditions leading up to the crisis, characterized by an exorbitant rise in asset prices and associated boom in economic demand, are considered a result of the extended period of easily available credit, inadequate regulation and oversight etc.

Some trace the genesis to the Chinese buying US treasuries with their export earnings thus supplying the US cheap money that they could lend recklessly.

The recession has renewed interest in Keynesian economic ideas on how to combat recessionary conditions. Fiscal and monetary policies have been significantly eased to stem the recession and financial risks. Economists advise that the stimulus should be withdrawn as soon as the economies recover enough to "chart a path to sustainable growth". Indian withdrawal from stimulus began in 2010-11 Union Budget and the money policy is becoming tight gradually.

Among the various imbalances in which the U.S. monetary policy contributed by excessive money creation, leading to negative household savings and a huge U.S. trade deficit, dollar volatility and public deficits.

The best authors on the meltdown are Arun Kumar (JNU); Joseph Stiglitz, Paul Krugman and Rangarajan.
Impact on India and related issues and terms are discussed in the class.

12 FYP-related

India@75

It is a path breaking initiative. It envisions how India should be in her 75th year of independence and seeks to bring together all stakeholders including the industry, government, institutions, community groups and individuals to translate the vision into a reality.

Prof (Late) C.K.Prahalad has been the inspiration behind India@75. While commemorating the 60th year of India's independence, in 2007 he articulated the idea of holistic three dimensional development of India to acquire enough economic strength, technological vitality and moral leadership by 75 years of independence. CII adopted his vision in 2008.The concept was adopted by CII to bring together all stakeholders, including the industry, government, institutions, community groups and individuals to translate the vision into reality.

IBIN

Planning Commission jointly with India@75 foundation launched in April 2013 . its unique initiative- India Backbone Implementation Network (IBIN) to remove bottlenecks for improving implementation of policies.

"The IBIN, structurally an organisation, is essentially a process that will promote widespread capabilities in the country to systematically convert confusion to coordination, contention to collaboration, and intentions to implementation," an official statement says.
IBIN aims to seed new techniques into the service delivery system; build a network of partners to create capability to manage effective stakeholder dialogues, resolve dispute and conduct policy impact analysis.

It will also build a knowledge base of tools, techniques and examples to systematically analyse situations or challenges and proactively create solutions.

According to Planning Commission Member Arun Maira: "The IBIN is a fantastic opportunity to resolve issues pertaining to poor implementation and lack of multi-stakeholder consensus by institutionalising capabilities to systematically convert 'confusion to coordination, contention to collaboration, and intentions to implementation' across the country."

Ibin is the model of a process for rapidly improving a nation's capabilities to get things done systematically and democratically as in the Total Quality Movement (TQM) in Japan.
In less than two decades, Japan, that had a reputation for poor quality and low-cost products, became the international benchmark of quality in many industries and several of its public services too.

The essence of the TQM movement was the deployment, at several levels in many organisations: especially the 'shopfloor' levels, but higher levels also, even to top management, of simple techniques for systems thinking, cooperative action and continuous improvement.

These techniques were developed by experts in companies and universities and disseminated in the country through industry and other institutional networks, and through radio, pamphlets, competitions and other means of connecting with the public.

The 'movement' grew as a network: it was not a centrally-managed government programme. There was a principal node in the network: a non-governmental body, the Japanese Union of Scientists and Engineers (Juse), in which many persons from industry and academia, and also government participated to provide a facilitative leadership to the movement.

Within the 12th Plan is the description of a similar transformative process to improve capabilities in the country to get things done. This process, described as the India Backbone Implementation Network, or IBIN, can improve results in many sectors of the economy.
The architecture of IBIN is along similar lines as the TQM movement of Japan. Experience of other countries, such as South Korea and, more recently, Malaysia, which have systematically improved capabilities of coordination and implementation, has also been considered while developing IBIN to fit India's conditions.
The tools and techniques that will be deployed by the IBIN movement will be in some respects similar to TQM, but updated and customised for the objectives of IBIN, with its emphasis on techniques and tools for collaboration, coordination and implementation. They are described in the 12th Plan document now awaiting the approval of the National Development Council.

India has many popular movements uniting citizens against what they do not want: of which corruption is a principal element. The country also needs movements to unite citizens for what they want in their habitats and their lives, and to enable them to work together to create it. The nascent IBIN is a movement for co-creating our worlds.
Like TQM in Japan: it will be formed by a network of many leaders across the country, in the states and in many sectors. Critics say the change IBIN seeks will take a long time, and so it may.

FISCAL SYSTEM

Fiscal policy

Definitions

- That part of government policy which is concerned with raising revenue through taxation and with deciding on the amounts and purposes of government spending.
- The government's policy in regard to taxation and spending programs. The balance between these two areas determines the amount of money the government will withdraw from or feed into the economy, which can counter economic peaks and slumps.
- Government spending policies that influence macroeconomic conditions. These policies affect tax rates and government spending, in an effort to control the economy.
- Government policy for dealing with the budget-especially with taxation and borrowing
- The policy of a government in controlling its own expenditures and taxation, which together make up the budget
- Fiscal policy is the means by which a government adjusts its levels of revenue and spending in order to monitor and influence a nation's economy

Fiscal policy involves use of taxation and government spending to influence economy. In other words. fiscal policy relates to raising and spending money in quantitative and qualitative terms.

As far as fiscal receipts are concerned, taxes, user charges (power, water, transport charges etc); disinvestment proceeds; borrowings from internal and external sources are the main channels. All receipts are not earned and some are borrowed. Receipts and expenditure are divided into revenue and capital accounts. Expenditure is also shown as Plan and Non-plan items.

Fiscal policy deals not only with the quantity but the quality of public finance as well. In other words, not merely how much is raised and spent but how has it been raised- is it raised by way of taxes or borrowings; are they excessive or irrational etc. Also, the way the finances so raised are used- wastefully or productively. How much is spent on plan heads and how much populistically targeted etc also is studied.

Fiscal policy can achieve important public policy goals like growth; equity; promotion of small scale industries; encouragement to agriculture; location of industries in rural areas; labour -intensive growth; export promotion; development of sound social and physical infrastructure etc.

Art.112 of the Constitution mandates that expenditure be shown in revenue and other categories.

Non-Plan expenditure is not a Constitutional term but is in use to emphasize on the point that government spends financial resources for consumption (maintenance) as well as asset creation. It includes expenditure on interest payments; defense; subsidies; and public administration.

A break up of the finances into revenue and capital streams, in general, is as follows:

- Revenue receipts are recurrent receipts. Revenue account includes the following receipts: taxes and non-tax sources. Taxes are income tax , corporation tax, excise duty, customs duty etc; non tax resources include user charges ;interest receipts; dividends; profits etc
- Revenue account expenditure is essentially the non-plan expenditure that does not create assets, that is; interest payments, defence; subsidies and public administration. It is synonymous with maintenance and consumption expenditure as also welfare expenditure.
- Capital account receipts are recoveries of loans and advances made by the Union Government to States, Uts and PSUs; fresh borrowings from inside the country and from abroad;disinvestment proceeds etc. As is clear from above, some of them are debt and some are non-debt.
- Capital account expenditure is loans made to States, UTs and PSUs; expenditure for asset creation in infrastructure and social areas;loans repaid etc.

Definitions of Deficits

Revenue deficit is the difference between the revenue receipts on tax and non-tax sides and the revenue expenditure. Revenue expenditure is synonymous with consumption and non-development, in general. But in the case of India, the social sector expenditure – flag ship schemes like NREGA is in the revenue expenditure, though as a part of the Plan expenditure (see budget as a glance for further clarity. It is given elsewhere in this Chapter) It is targeted at 3.3% of GDP for 2013-14. FRBMA 2003 says that RD should be zero by the end of 2008-09. The objective is to fund for consumption from government's own resources and not borrowing. In fact, if the FRBM was implemented well, there would have been revenue surplus from 2009-10 onwards that could be used for capital expenditure. But the Great Recession of 2008 made it necessary for the government to borrow more and stimulate the economy thus disrupting the FRBM targets. (More in the classroom)

Fiscal deficit is the difference between what the government earns and its total expenditure. That is, the difference between what is received by the government on revenue account and all the non-debt creating capital receipts like recovered loans and disinvestment proceeds ; and the total expenditure. It amounts to all borrowings of the government in a given period. It is targeted at 5.1% of GDP in 2012-13.

FD= Total expenditure of the Government in a budget minus (Revenue receipts + non-debt creating capital receipts).

Difference must be between Gross FD and Net FD. Net Central Fiscal Deficit is calculated by deducting from the GFD the financial assistance (loans and grants) that the States are given.

Budget deficit considers only the difference between the total budgeted receipts and the expenditure. It was abolished in 1997.

Fiscal Deficit mirrors the health of government finances most accurately unlike the budget deficit concept. BD does not cover all borrowings but only that portion of the borrowings for which government relies on printing money by the RBI

Monetised deficit is the borrowings made from the RBI through printing fresh currency. It is resorted to when the government can not borrow from the market (banks and financial institutions like LIC etc) any longer due to pressure on interest rates or for reasons like fresh money injection into the economy is necessary to push growth up. It means infusion of fresh currency into the market. It corresponds to the budget deficit that is discarded as a concept since 1997. It is discontinued from 2006 as a part of the FRBM 2003.

Primary deficit is the difference between the fiscal deficit and the interest payments. The concept helps in assessing the progress of the government in its fiscal control efforts.

Deficit Financing

Deficit Financing is the phrase used to describe the financing of gap between Government receipts and expenditure. Such gap is called budgetary deficit. It is financed by printing fresh money by the RBI. The gap can be deliberate as the Government wants to spend on welfare and infrastructure for which it has no money and so borrows from the RBI; or due to bad finances of the government; or mainly for consumption and populism.

When the Government has to spend more than what it can raise through tax, non-tax and other sources, it borrows from the market. It can not borrow above a certain amount from the market as it may be inflationary; push up interest rates; increase government's debt burden and thus divert resources from plan to non-plan; burden future generations with unduly high taxation and thus disrupt inter generational parity; and crowd out private investment. Then Reserve Bank of India prints money . In other words, when the resources from taxes, user charges, public sector enterprises, public borrowings, small scale borrowings and others are not enough, RBI prints and gives to the Government. It is called deficit financing.

The money printed by the RBI is called high powered money or reserve money.

The concept of budget deficit was dropped from 1997 budget and as a result deficit financing also was stopped. That is, as a concept both were discontinued as the two were two sides of the same coin- budget deficit is monetized through deficit financing. In fact, FRBM disallows RBI printing money to finance government deficit in normal conditions. But the economic conditions having become adverse since 2008-09, Government is forced to abandon the FRBM rules and is spending well beyond the limits set by the Act. Keynesian stimuli that the government resorted to since 2008 October includes massive borrowing by the Government- from the markets and RBI- to arrest slowdown and stimulate growth.

The beneficial contribution of deficit financing in the early stages of independent India's economic planning and development is manifold. First, in the early 1950s, our domestic savings ratio was less than 9 per cent of GDP, and that constrained the investment and welfare activity of the government.

Second, the capacity to raise non-inflationary sources of financing (taxes, small savings, genuine public borrowings, etc.) was highly limited.

Third, external aid could supplement domestic funding only to a limited extent. It is better to source debt from inside than outside.

Fourthly, foreign direct investment was discouraged as a source of investment and thus scarcity of investment resulted. Therefore, government borrowing became necessary through monetization.

There are two views on the matter. There are some people who regard deficit financing as essential for the purposes of development and welfare; as a healthy means of stimulating economy. There are those who regard any deficit financing as inflationary and a serious threat to the stability of the economy.

On balance it may be said that, if deficit financing is done prudently and the borrowed money is used well, it is healthy. However, if the borrowed money is wasted for consumption, is it against good economics as it can negatively affect money supply and inflation; and also dampen growth.

The viability and desirability of deficit financing, in short, depends on

- Extent of borrowing
- End use of the money borrowed.

WMAs

Prior to 1997, the RBI lent to central government against ad hoc Treasury bills, (since mid-50's) This provision for extending short-term financing was created to bridge temporary mismatches in receipts and payments. However,, the central government slipped into the practice of rolling over this facility, resulting in automatic monetisation of the government's deficit. Automaticity refers to RBI having to print money if the Government's cash balances with the RBI went below a threshold fixed. It had no choice but to create currency and lend to the Government of India. The process of creating 91-day bills and subsequently funding them into non-marketable special securities at a very low interest rate (4.6%) emerged as a principal source of borrowing. It was thought to be irrational for the reasons that the interest rate is not market driven and was very concessional. Nor did the RBI have any voice in deterring the same. Nor was there a limit to how much could be printed in this way.

In the case of state governments, the RBI provides two types of WMAs. Normal WMAs are clean or unsecured advances extended at the bank rate, while special WMAs are extended against the government securities. The latter is exhausted first and then the former may be sought to a limited extent. If the state government borrows over and above the WMA allowed for it by the RBI, it is called overdraft and there is a limit to that too set by the RBI.

Adhoc treasury bills and WMA

Union Government replaced adhoc treasury bills with WMAs in 1997.
WMAs given by RBI to GOI do not require any collateral. Its amount is limited and arrived at the beginning of the fiscal year through consultation between Government and the RBI. There are penal interest rates if the pre-agreed amount is violated. Ways and Means

Advances are made at the Repo Rate. Overdraft is charged penally at two percent above the repo rate

Replacement of the adhoc bills with WMA represents an advance in fiscal discipline and harmonization of the fiscal and monetary policies as the RBI is consulted in Governmental short term borrowing and the 'automaticity' is dropped in the creation of currency by the RBI to fund governmental expenditure.

How much of Fiscal Deficit is right?

Fiscal deficit is bridged by market borrowings and central bank printing fresh currency (monetization), if necessary. To a limited extent, FD is important as the Government's ability to help growth and welfare increases. Government can always return the loans when its revenues improve due to tax buoyancy. However, FD becomes problematic and even destabilizing when it overshoots a rational threshold. Sovereign debt crisis in Europe and the fiscal woes of USA are the result of unsustainably high debt and borrowing. (More in the classroom)

Therefore, moderation of fiscal deficit is important. Large and persistent fiscal deficits are a cause of concern, as they pose several risks.

Fiscal deficits may cause macroeconomic instability by inflating the economy as money supply rises.

Corporate sector is crowded out – they are left with inadequate funds in the markets as the government borrowing requirements increase. Added to that , interest rates will be high as there is pressure on the available money in the market.

If the funding route is through RBI monetization, it means inflation and instability.

Inflation may mean less savings, less investment and eventually it hurts the sustainability of high growth.

Large deficits, even if they do not spill over into macroeconomic instability in the short run, will require higher taxes in the long term to cover the heavy burden of internal debt. It means, as the FRBM Act says , inter generational parity is hurt if debt mounts as future generations will have to pay higher taxes to help the government repay the debt.

Government liabilities- interest payments- increase and there is far less for development.

BOP pressures may mount if inflows drop due to the country being downgraded by rating agencies like Standard and Poor, Moody etc.

Therefore, FDs must be moderated- they are desirable within limits but hurtful beyond the limits.

The above analysis applies to FD in normal times. But in abnormal times like since 2008-09 when the world slipped into recession impacting Indian economy negatively, FD must be allowed to be increased for the fiscal stimuli which are necessary to arrest downturn in the economy and revive growth. FRBM allows such counter-cyclical expenditure. Even then, deficit should be incurred not for populist expenditure but to stimulate the economy.

The sovereign debt crisis in Eurozone (2010 onwards) and particularly the Greece economy is due to excessive FD. It borrowed and spent excessively. Taxes were not collected efficiently and there was large scale evasion. The stimulus package did not work. Government expenditure did not reduce but revenues fell drastically due to recession and tax leakages. The need for massive borrowing and spending increased. But the government was not able to raise the money at normal rates of interest. It had to pay high rates of interest. That means it was debt-trapped- borrow to pay the debt and higher and higher rates. The banks and other financial institutions that invested in Greek government bonds panicked. Their share prices fell. Financial system was in danger of instability. Similar crisis was seen in Ireland later and Spain and Portugal too. These countries are acronymally called PIGS. The lesson from Greek crisis is that FD may be incurred only for productive reasons and ensure good returns. Tax collections should be efficient. Accounts of government should be properly maintained and not dressed up.

Reducing FD

FD has to be reduced and the FRBM targets are to be conformed to, under normal conditions. But upto3% of GDP for FD as laid down by FRBM Act is desirable as the Government can borrow and spend for welfare and growth.

The extent of reduction and the manner of reduction matter. More resources should be raised from taxes, user charges, disinvestment etc. Expenditure control should not involve cuts on social sector expenditure as it hurts poor and demographic dividend can not be reaped.

The level of FD should be determined keeping in consideration the following

- whether the debt can be put to productive deployment
- The rate of return on the borrowed funds' use is adequate
- the impact on private sector investment by way of crowding out effect etc

Even more important is not to cut social spending in a move to reduce deficit. In other words, while FD reduction is needed for macroeconomic stability and inter generational parity. Introduction of GST, the DTC amendments, selective disinvestment, broadening of tax base, tax buoyancy etc will yield enough to moderate borrowings.

Global crisis and the FD in India

Global recession impacted India and our growth rate slipped. Tax revenues were hit. There was a massive fall in demand. Corporate sectors postponed investment. Threat to employment was real. Therefore, Government took it upon itself to spend more by borrowing. The result is that fiscal deficit reached an abnormally high level- 6.8% in the year 2009-10. It is because tax revenues went down and expenditure demands were higher. The gap inevitably widened. The fiscal measures taken by the government to counter the negative fall -out of the global slow down on the Indian economy paid off.

Firstly, the Government responded by providing three focused fiscal stimulus packages in the form of tax relief to boost demand and increased expenditure on public projects to create employment and public assets.

Secondly, the RBI took a number of monetary easing and liquidity enhancing measures to facilitate flow of funds from the financial system to meet the needs of productive sectors.

This fiscal accommodation led to an increase in fiscal deficit from 2.7 per cent in 2007-0.8 to 6.2 percent of GDP in 2008-09.
These measures were effective in arresting the fall in growth rate of GDP in 2008-09 and stemmed the fall and achieved a growth of 6.7 per cent. The growth rate further improved to 8.4 % for the next two fiscal years of 2009-10 and 2010-11.

The fiscal stimulus packages

To counter the adverse effects of global recession, government announced the first package in October 2008- tax cuts and additional spending by the government .The package benefited all the sectors – especially textile, housing and real estate sectors. Most significant of the package is the CENVAT rate cut of 4%.

The second stimulus package

The government in January 2009 announced the second round of fiscal stimulus package with a view to revive economy. The package includes measures such as higher public spending. RBI stepped in easing liquidity for further lending at lower interest rates etc.

The third stimulus package

The third stimulus package for the economy was announced in February 2009 cutting excise duty and service tax two percentage points.

Service tax was cut across the board from 12 per cent to 10 per cent.

The packages increased the fiscal deficit.

Financing the FD

The deficit was financed by raising Internal Debt and from Public Account surplus cash.

The unsustainably high fiscal deficit could not be continued long and had to be phased back to normal levels by a calibrated rollback since 2010-11.

FRBM Act 2003

Fiscal Responsibility and Budget Management (FRBM) Act 2003 was notified in 2004 with the following salient features

- annual targets of reduction in deficits, government borrowing and debt

- Government to annually reduce the revenue deficit by 0.5 per cent and the fiscal deficit by 0.3 per cent beginning fiscal 2004-05.
- elimination of revenue deficit and reduction of fiscal deficit to 3% of GDP by March 31, 2009
- a cap on the level of guarantees and total liabilities of the Government.
- Prohibits Government to borrow from the RBI (primary borrowing) after April 1, 2006. RBI can not print money to lend to the government.
- On a quarterly basis, that Government shall place before both the Houses of Parliament an assessment of trends in receipts and expenditure.
- Annually present the macro-economic framework statement, medium term fiscal policy statement and fiscal policy strategy statement. The three statements would provide the macro-economic background and assessment relating to the achievement of FRBM goals.
- Under exceptional circumstances, Government may be compelled to breach targets. In case of deviations, the Government would not only be required to take corrective measures, but the Finance Minister shall also make a statement in both the Houses of Parliament.

Borrowing from the RBI is permitted in exceptional situations like natural calamities.

FRBM was brought in for fiscal discipline; increase plan expenditure; reduce the amount of borrowings; meet consumption from government's own fiscal resources; leave the RBI with autonomy as far as money creation goes etc .Fiscal consolidation is necessary particularly in the era of globalization when the penalty for irresponsibility is high.

New Zealand was the first country to enact a Fiscal Responsibility Act in 1994, thereby setting legal standards for transparency of fiscal policy and reporting, and holding the Government formally responsible to the public for its fiscal performance. A similar legislation, the Charter of Budget Honesty, has been enacted in Australia. The UK, too, has enacted a Code for Fiscal Stability.

The global recession from 2008 onwards has made the government breach the FRBM targets vastly. We are still gross breach of it .Fiscal 2012-13 saw a fiscal deficit of 5.8% of GDP due to excess expenditure on subsidies, lower divestment receipts and tax receipts.

FRBM 2.0

Union Budget 2012-13 saw introduction of amendments to the FRBM Act as part of Finance Bill, 2012. Concept of "Effective Revenue Deficit" and "Medium Term Expenditure Framework" statement are two important features of amendment to FRBM Act in the direction of expenditure reforms. Effective Revenue Deficit is the difference between revenue deficit and grants for creation of capital assets. This will help in reducing consumptive component of revenue deficit and create space for increased capital spending. "Medium-term Expenditure Framework" statement set forth a three-year rolling target for expenditure indicators.

ERD

An additional fiscal indicator, namely, effective revenue deficit, has been prescribed by an amendment to the FRBM Act by the Finance Act, 2012. Effective revenue deficit has been defined as the difference between "the revenue deficit and the grants for creation of capital assets".

Grants for creation of capital assets are defined as "the grants-in-aid given by the Central Government to the State Governments, constitutional authorities or bodies, autonomous bodies and other scheme implementing agencies for creation of capital assets".

The amendment confers a statutory status on the concept of effective revenue deficit which had already featured in the Central Budget 2011-12. The proposed amendment seeks to eliminate effective revenue deficit by 2015.

Fiscal consolidation

Fiscal consolidation means strengthening government finances. Fiscal consolidation is critical as it provides macro economic stability; cuts wasteful expenditure; can enable government to spend more on infrastructure and social sectors. Tax reforms, disinvestment, better targeting of subsidies and so on are the hallmarks of fiscal consolidation.

Enactment of FRBM Act provides an institutional framework and binds the government to adopt prudent fiscal policies. There is a need to involve states to effect overall fiscal consolidation and strengthen the growth momentum.

GST and revised DTC are an important federal effort toward fiscal reforms and consolidation.

Also, without fiscal consolidation- conversion of subsidies into capital expenditure that forms assets- it is not possible to step up public investment, especially in areas such as agriculture, where gross capital formation has dropped from 1.9 per cent to 1.3 per cent of GDP since 1990-91.

Fiscal consolidation in India includes the following reforms:

- Revenue reforms include tax reforms on both direct and indirect tax front; rationalization of tax exemptions, improving efficiency of tax collection, and tax stability.
- On the expenditure side, reform areas include cutting out non-essential and unproductive activities, schemes and projects, allocation of resources to priority areas, reducing cost of services, rationalizing subsidies; reduction of time and cost overruns on projects, getting proper 'outcome' from output

Austerity measures as were announced in September 2013 : ban on five-star venues for government meetings; foreign locations for conferences, exhibitions and seminars; and executive class airline tickets for officials;keep the size of delegations going abroad at an "absolute minimum; banned recruitment for central government posts for one year and the purchase of new vehicles.

Fiscal consolidation

The FRBM targets were more or less followed till the fiscal year 2007-08. But from 2008-09, as global economic conditions turned bad and Indian economy was also affected negatively –

slow down in growth rate-, the Government necessarily had to pump prime the economy with an expansionary fiscal policy- tax reliefs and massive public investment- infrastructure spending, NREGA being stepped up etc. As a result, the FRBM targets could not be complied with. However, the recovery plan has been made with statutory commitments in 2012-13. (More in the classroom)

13th Finance Commission and Fiscal Consolidation

Thirteenth Finance Commission recommended a calibrated exit strategy from the expansionary fiscal stance of the previous two years. The Commission recommended a capping of the combined debt of the Centre and the States at 68 per cent of the GDP to be achieved by 2014-15.

As a part of the fiscal consolidation process, government for the first time targeted an explicit reduction in its domestic public debt-GDP ratio.

Plan and Non Plan Expenditure classification and its unsustainability

In the Budget, expenditure is shown both as revenue and capital and also as plan and non-plan. 'Plan' expenditures, as the name implies, relate to expenditures on annual plan projects contributing to five-year plan; these include projects like dams, roads, power plants etc. Non-Plan expenditure relates to maintenance, consumption and welfare. Non-plan expenditure does not create assets. When a project is being built , it is a plan item of expenditure. When completed and being maintained, it is a non-plan item of expenditure.

'Non-plan' expenditure is a generic term, which is used to cover all expenditures of government not included in its annual plan programmes. But essentially covers consumption and maintenance expenditure. Non plan expenditures has the following items

- Interest payments
- Subsidies
- Defence
- Public admn

It is important to mention that not only that maintenance expenditures subsequent to the completion of plan programmes are non-plan, but even "expenditures on research projects and operating expenses of power stations are classified as non-plan.

The distinction between plan and non-plan expenditure items has become simplistic and is artificial and untenable. The building of a new school or a primary health centre is considered a Plan investment but its running and maintenance is considered non-Plan spending. Thus, very often it had led to Government allocation being reduced for maintenance as it is classified as non-plan item and will be criticized. Thus. assets are neglected. New projects are allotted money while the completed projects are neglected.

It is important to take a consolidated view of finances keeping in perspective the interdependence of Plan and non-Plan expenditures.

Rangarajan panel on public expenditure 2012

An 18-member high-level expert committee was set up in 2010 under the Chairmanship of Dr C. Rangarajan to suggest measures for efficient management of public expenditure.

This committee was mandated to see whether the classification of expenditure into Plan and Non-Plan is rational and can be continued.
The report of the Committee was presented in mid-2011 and the following are the salient points:

- The government should do away with the distinction between Plan and Non-Plan expenditure and redefine roles of the Planning Commission and the Finance Ministry.
- While the Planning Commission should be responsible for formulation of the Five-Year Plan, the task of firming up annual budgets should be entrusted to the Finance Ministry based on inputs from the Plan panel
- "Plan and Non-Plan distinction in the budget is neither able to provide a satisfactory classification of developmental and non-developmental dimensions of government expenditure. It has therefore become dysfunctional. The committee, therefore, it recommends that Plan and Non-Plan distinction in the budget should be removed.
- The report suggested a basic shift in budgeting approach from ".From input based budget to outputs and outcomes".
- As regards the new roles of key entities, it said, the Planning Commission should be made "responsible for consolidation of Five-Year Plan over all services based on the input from the Ministry of Finance... (while) Ministry of Finance (be) made responsible for the preparation of Annual Budget based on the inputs from the Planning Commission".
- The report also called for strengthening the Central Plan Monitoring System (CPMS) and empowering the citizens to seek information on flow of resources and utilisation with a view to promoting transparency and accountability.

Kelkar committee 2012

A new roadmap for fiscal consolidation worked out by a committee headed by former Chairman of the Finance Commission Vijay Kelkar envisages pruning fiscal deficit to less than 5% of the GDP by 2013-14 to put the economy in a better shape.

The committee re-assessed the fiscal deficit for 2012-13 and recommended an annual reduction of half a percent or 0.5% up to 2013-14. Fiscal deficit, as stated in the notes above, is the difference between total expenditure and total non-borrowed receipts.

The Kelkar committee said that the proposed reduction in deficit could be achieved through a combination of share sale of state-owned companies, pruning petro-product subsidies through raising prices of diesel and LPG or cooking gas and implementation of the Goods and Services Tax or GST, which has long been in the works. Administrative reforms including beefing up of IT infrastructure have also been suggested to improve compliance.

The 13th Finance Commission, which was headed by Kelkar, advised that fiscal deficit be pegged at 3% in 2013-14 when it unveiled its report.

Public debt

Public debt includes internal debt comprising borrowings inside the country like market loans; borrowing from the RBI on the basis of special securities bills; and external debt comprising loans from foreign countries, international financial institutions, NRI deposits etc. In the expression `public debt and "other liabilities".

"other liabilities" include outstanding against the various small saving schemes, provident funds etc. External debt means what the nation owes to foreign lenders- includes private sector borrowings too. However, public debt includes what the government owes to lenders inside and outside the country. (More in the classroom)

Public debt is justified as the government does not have adequate resources and taxation can not be done beyond a point. It should be for productive reasons and also welfare reasons. The spiral of deficit and debt run the risk of undermining the country's creditworthiness, devaluing the currency and destabilising the entire economy with grave social consequences. Therefore, it should be incurred judiciously.

The outstanding internal and external debt and other liabilities of the Government of India at the end of 2013-2014 is estimated to amount to ` 56,51,484.22 crore, as against ` 50,39,131.01 crore at the end of 2012-2013 .

India recorded a Government Debt to GDP of 67.57 percent of the country's Gross Domestic Product in 2012. Government Debt To GDP in India is reported by the Ministry of Finance, Government of India. From 1991 until 2012, India Government Debt to GDP averaged 74.6 Percent. Generally, Government debt as a percent of GDP is used by investors to measure a country ability to make future payments on its debt, thus affecting the country borrowing costs and government bond yields.

External Debt

India's external debt in mid-2013 stood at 388 billion US dollars on account of significant increase in commercial borrowings, short-term trade credits, and rupee denominated debt. In terms of major components, the share of ECBs continued to be the highest at 30.7 per cent of total external debt, followed by short term debt (24.9 per cent) and NRI deposits (18.3 per cent).The share of short-term debt in total debt rose over the preceding as well as corresponding quarter of the previous year. The long-term debt at US$ 291.8 billion and short-term debt at US$ 96.8 billion accounted for 75.1 per cent and 24.9 per cent, respectively, of the total external debt as at end-June 2013.The ratio of short-term debt (original maturity) to foreign exchange reserves rose to 34.3 per cent as at end-June 2013 from 33.1 per cent as at end-March 2013. Based on residual maturity, the short-term debt accounted for 43.8 per cent of total external debt as at end-June 2013. Within the short-term debt, the share of NRI deposits was 28.1 per cent.

External debt includes both the government and private debt as can be seen from the above given highlights of the external debt profile.

The share of non-government debt in total external debt is about 75%.

The strategy of the government in external debt management consists of emphasis on raising sovereign loans on concessional terms with longer maturities, monitoring short term debt and encouraging non-debt creating capital flows.

External debt consists of

- long-term external debt which is the bulk part
- NRI deposits
- multilateral loans
- commercial borrowings
- bilateral loans and
- Trade credit

As reported in the Hindu newspaper in 2013: India's short-term debt maturing within a year stood at $172 billion end-March 2013. This means the country will have to pay back $172 billion by March 31, 2014. The corresponding figure in March 2008 — before the global financial meltdown that year — was just $54.7 billion. India has accumulated short-term debt with *residual maturity* of one year after 2008. The figure has gone up over three times largely because this period also coincided with the unprecedented widening of the current account deficit from roughly 2.5 percent in 2008-09 to nearly 5 per cent in 2012-13. Much of this expanded CAD has been funded by debt flows.Short-term debt maturing within a year is now nearly 60 per cent of India's total foreign exchange reserves. In March 2008, it was only 17 per cent of total forex reserves. This shows the actual increase in the country's repayment vulnerability since 2008.

Internal debt

Internal debt includes loans raised by the government in the open market through treasury bills and government securities, special securities issued to the RBI and most importantly, various bonds like the oil bonds. fertilizer bonds etc.

The money sterilized from the market in by the Market Stabilisation Scheme (MSS) is also shown in the government's statement of liabilities. Introduced in 2004, MSS envisages the issue of treasury bills and/or dated securities to absorb excess liquidity arising out of the excessive foreign exchange inflows.

The debt of the government also includes others like the outstanding against small-savings schemes, provident funds, deposits under special deposit schemes etc.These debts are shown under a separate head titled 'other liabilities'.

Debt should be moderated for the reasons cited in the discussion on FD above.

Zero Base Budgeting

Tenth Plan Approach Paper says that ZBB will be followed for rationalization of expenditure. The ZBB methodology was taken up first in 1987 in the Union Budget and was recommended for the Government departments and PSUs. Many state governments also applied it, for example, Government of Rajasthan and Maharashtra. The Maharashtra Government renamed it ' Development -based budget '.

Under the ZBB, a close and critical examination is made of the existing government programmes, projects and other activities to ensure that funds are made available to high priority items by eliminating outdated programmes and reducing funds to the low priority items. Governmental programmes and projects are appraised every year as if they are new and funding for the existing items is not continued merely because a part of the project cost has already been incurred. Programmes are discarded if the cost-benefit ratio is below the prescribed norms.

The objective of the ZBB is to overhaul the functioning of the government departments and PSUs so that productivity can be increased and wastage can be minimised. Scarce government resources can be deployed efficiently.

ZBB as a resource planning and control technique and process yielded substantial benefits in the advanced countries like New Zealand, UK, Australia and Sweden in terms of efficiency gains, better resource use, lower costs and finally surplus budgets, particularly in New Zealand.

However, the use of ZBB to human development programmes and poverty alleviation and employment generation programmes is limited and the results are cumulative and can not be assessed annually.

Fringe benefit tax (FBT)

Fringe benefits are usually enjoyed collectively by the employees and cannot be attributed to individual employees singly.They are taxed in the hands of the employer who may or not pass it on to the employee. Examples are transport services for workers and staff, gym, club, etc.

The rationale for levying a FBT on the employer lies in the inherent difficulty in isolating the 'personal element' where there is collective enjoyment of such benefits and attributing the same directly to the employee. This is so especially where the expenditure incurred by the employer is ostensibly for purposes of the business but includes, in partial measure, a benefit of a personal nature. It is abolished in the Union Budget 2009-10.

Perquisites

Perquisites are benefits in addition to normal salary to which employee has a right by virtue of his employment. To put it simply or 'perks' as they are called colloquially, are benefits generally in cash/kind, received by an employee by virtue of his employment.

Perks are taxable as a part of salary as per the India income tax laws and includes:

- the value of rent-free accommodation
- the value of any concession in the matter of rent respecting any accommodation provided etc
- car
- club membership
- travel

Some words

Fiscal Drag

A situation where inflation pushes income into higher tax brackets- bracket creep. The result is increase in income taxes but no increase in real purchasing power. This is a problem during periods of high inflation. Government gains due to higher tax collections and the economy suffers as growth is dragged down due to less demand. In high-growth and high inflation economies ('overheated'), fiscal drag acts as an automatic stabiliser, as it acts naturally to keep demand stable.

Fiscal neutrality

When the net effect of taxation and public spending is neither neutral, neither stimulating nor dampening demand- a balanced budget. It is neutral, as total tax revenue equals total public spending.

Crowding Out

Excessive government borrowing can lead to shrinkage of the liquidity in the market; forces the interest rates to go up; private investment is crowed out for two reasons: liquidity availability is less and the rates are high. Investment suffers and growth decelerates. The Government also may not spend the borrowed resources well to generate returns. If the government deploys the funds well, it may have a 'crowding in effect': the infrastructure built can have a multiplier effect on investment, tax collections and growth.

Pump-priming

Deficit financing and spending by a government on public works in an attempt to revive economy during recession – countercyclical measures. It can raise the purchasing power of the people and thus stimulate and revive economic activity to the point that deficit spending will no longer be considered necessary to maintain the desired economic activity.

Small Savings

Small savings instruments are Post Office Monthly Income Schemes and Time Deposits; National Savings Scheme; Indira Vikas Patra; Kisan Vikas Patra;Public Provident Fund and so on. They are aimed at promoting safe and long-term savings by individuals. They are called small savings because the amount saved is relatively small. They are initiated by the central Government but mobilized by the State Governments ; and are deposited with and managed by the central government. As a reward State Governments receive all such savings as loan.

Small savings are a sizeable portion of the financial savings of the country. They contribute to the finances of the Government- federal and State- that is, they are an important source of borrowing for the government. These schemes have a built in tax concession that enhances their attraction for the small savers. They also earn a rate of interest that is higher in comparison to what the banks offer- approximately 8%. They are called small savings as savings are made in small amounts by low income and other groups.

Small savings instruments in India are retailed through 1.53 lakh post offices of which about 1.29 lakh are in rural areas.

The National Small Savings Fund (NSSF), in the Public Account of India has all the small savings. They are completely onlent to the state in which they are collected.

Public goods, merit goods and demerit goods

Public goods are those goods whose consumption by some does not diminish them for others. That is, they are non-rivalrous. Common examples include law and order, parks, street-lighting, defence etc. They are goods meant for the entire public. Merit goods are goods like education, health care etc that are important for the society as a whole- that is, they have positive externalities. Market may not supply them in adequate quantities. Government supplements the market.Demerit goods are those whose consumption should be discouraged. They have negative externalities. Examples include: tobacco, alcohol etc. Thirteenth Finance Commission calls them sin goods and wants them to be harshly taxed.

Giffen goods

They include goods whose demand goes up when the price increases. They are the status markers and exclusivist in nature.

Twin deficits

Budget deficit (fiscal deficit) and current account deficit-the former fuelling the latter as the borrowings increase are known as twin deficits. USA is a prime example.So is India!!!!

(Recent developments in the classroom)

'Fiscal Cliff'

A combination of expiring tax cuts and across-the-board government spending cuts scheduled to become effective Dec. 31, 2012. The idea behind the fiscal cliff was that if the federal government allowed these two events to proceed as planned, they would have a detrimental effect on an already weak economy, perhaps sending it back into an official recession as it cut government spending and investment, collected more taxes which cut down both consumption and investment, increased unemployment rates and undermined consumer and investor confidence.

Shutdown

In U.S. politics, a government shutdown is the name for the process the Executive Branch must enter into, when the Congress creates a "funding gap" by choosing not to or failing to pass legislation funding government operations and agencies. If interim or full-year appropriations are not enacted into law, the United States Constitution requires the federal government begins a "shutdown" of the affected activities. If the funding gap lasts long enough, the law requires the furlough (temporary lay offs) of non-emergency personnel and curtailment of agency activities and services. It is essentially a fiscal issue as the Congress may not like the revenue and expenditure models and priorities of the Presidency as Obamacare in 2013.

Stimulus vs Austerity (In the class)

बजट का सार Budget at a Glance

(करोड़ रुपए) (In crore of Rupees)

		2011-2012 वास्तविक Actuals	2012-2013 बजट अनुमान Budget Estimates	2012-2013 संशोधित अनुमान Revised Estimates	2013-2014 बजट अनुमान Budget Estimates
1. राजस्व प्राप्तियां	1. **Revenue Receipts**	**751437**	**935685**	**871828**	**1056331**
2. *कर राजस्व (केन्द्र को निवल)*	2. *Tax Revenue (net to centre)*	*629765*	*771071*	*742115*	*884078*
3. *कर-भिन्न राजस्व*	3. *Non-Tax Revenue*	*121672*	*164614*	*129713*	*172252*
4. पूंजी प्राप्तियां (5+6+7)$	4. **Capital Receipts (5+6+7)$**	**552928**	**555241**	**558998**	**608967**
5. *ऋणों की वसूली*	5. *Recoveries of Loans*	*18850*	*11650*	*14073*	*10654*
6. *अन्य प्राप्तियां*	6. *Other Receipts*	*18088*	*30000*	*24000*	*55814*
7. *उधार और अन्य देयताएं**	7. *Borrowings and other liabilities**	*515990*	*513590*	*520925*	*542499*
8. कुल प्राप्तियां (1+4)$	8. Total Receipts (1+4)$	1304365	1490925	1430825	1665297
9. आयोजना-भिन्न व्यय	9. Non-Plan Expenditure	891990	969900	1001638	1109975
10. *राजस्व खाते पर जिसमें से*	10. *On Revenue Account of which,*	*812049*	*865596*	*919699*	*992908*
11. *ब्याज भुगतान*	11. *Interest Payments*	*273150*	*319759*	*316674*	*370684*
12. *पूंजी खाते पर*	12. *On Capital Account*	*79941*	*104304*	*81939*	*117067*
13. आयोजना व्यय	13. Plan Expenditure	412375	521025	429187	555322
14. *राजस्व खाते पर*	14. *On Revenue Account*	*333737*	*420513*	*343373*	*443260*
15. *पूंजी खाते पर*	15. *On Capital Account*	*78639*	*100512*	*85814*	*112062*
16. कुल व्यय (9+13)	16. Total Expenditure (9+13)	1304365	1490925	1430825	1665297
17. *राजस्व व्यय (10+14)*	17. *Revenue Expenditure (10+14)*	*1145785*	*1286109*	*1263072*	*1436169*
18. *जिसमें, पूंजी परिसम्पत्तियों के सृजन हेतु अनुदान*	18. *Of Which, Grants for creation of Capital Assets*	*132582*	*164672*	*124275*	*174656*
19. *पूंजी व्यय (12+15)*	19. *Capital Expenditure (12+15)*	*158580*	*204816*	*167753*	*229129*
20. राजस्व घाटा (17-1)	20. Revenue Deficit (17-1)	394348 *(4.4)*	350424 *(3.4)*	391245 *(3.9)*	379838 *(3.3)*
21. प्रभावी राजस्व घाटा (20-18)	21. Effective Revenue Deficit (20-18)	261766 *(2.9)*	185752 *(1.8)*	266970 *(2.7)*	205182 *(1.8)*
22. राजकोषीय घाटा {16-(1+5+6)}	22. Fiscal Deficit {16-(1+5+6)}	515990 *(5.7)*	513590 *(5.1)*	520925 *(5.2)*	542499 *(4.8)*
23. प्राथमिक घाटा (22-11)	23. Primary Deficit (22-11)	242840 *(2.7)*	193831 *(1.9)*	204251 *(2.0)*	171814 *(1.5)*

इस दस्तावेज में वर्ष 2011-12 के वास्तविक आंकड़े अनंतिम हैं। Actuals for 2011-12 in this document are provisional.

$ बाजार स्थिरीकरण योजना के अंतर्गत प्राप्तियों को छोड़कर। Excluding receipts under Market Stabilisation Scheme.

* इसमें नकदी शेष में आहरण द्वारा कमी शामिल है। Includes draw-down of Cash Balance.

टिप्पणियां: 1. सीएसओ द्वारा जारी 2012-2013 के अग्रिम अनुमानों (₹10028118 करोड़) की तुलना में 13.4% की वृद्धि मानते हुए 2013-2014 के बजट अनुमान में सघउ बढ़कर ₹11371886 करोड़ होने का पूर्वानुमान है।

2. इस दस्तावेज में पृथक-पृथक मदें पूर्णांकन के कारण संभवतः जोड़ से मेल न खाएं।

Notes: 1. GDP for BE 2013-2014 has been projected at ₹ 11371886 crore assuming 13.4% growth over the Advance Estimates of 2012-2013 (₹ 10028118 crore) released by CSO.

2. Individual items in this document may not sum up to the totals due to rounding off.

Monetary and Credit Policy

Definitions:

- The strategy of influencing movements of the money supply and interest rates to affect output and inflation
- The actions of a central bank that determine the size and rate of growth of the money supply, which in turn affects interest rates.
- A macroeconomic policy tool used to influence interest rates, inflation, and credit availability through changes in the supply of money available in the economy
- An attempt to achieve broad economic goals by the regulation of the supply of money
- The regulation of the money supply and interest rates by a central bank in order to control inflation and stabilise currency
- Monetary policy is the process of managing a nation's money supply to achieve specific goals—such as constraining inflation, achieving full employment etc.
- Monetary policy is made by the central bank to manage money supply to achieve specific goals—such as constraining inflation, maintaining an appropriate exchange rate, generating jobs and economic growth. Monetary policy involves changing interest rates, either directly or indirectly through open market operations, setting reserve requirements, or trading in foreign exchange markets.

Monetary Policy

The use by the Central Bank of interest rate and other instruments to influence money supply to achieve certain macro economic goals is known as monetary policy. Credit policy is a part of monetary policy as it deals with how much and at what rate credit is advanced by the banks. Objectives of monetary policy are:

- accelerating growth of economy
- price stability
- exchange rate stabilization
- balancing savings and investment
- Generating employment and

Monetary policy can be expansionary or contractionary : expansionary policy increases the total supply of money in the economy as in 2008-09 all over the world including India to beat recession/slowdown; and a contractionary policy decreases the total money supply by tightening credit conditions(2010 onwards in India). Expansionary policy is traditionally used to combat unemployment in a recession by lowering interest rates, while contractionary policy has the goal of raising interest rates to control inflation.

Historically, Monetary Policy was announced twice a year - a slack season policy (April-September) and a busy season policy (October-March) in accordance with agricultural cycles. Initially, the Reserve Bank of India announced all its monetary measures twice a year in the Monetary and Credit Policy. However, since monetary Policy has become dynamic in nature, RBI reserves its right to alter it from time to time, depending on the state of the economy. Also, with the share of credit to agriculture coming down and credit towards the industry being granted whole year around, the RBI since 1998-99 has been making the policy in April. A review of the policy takes place every quarter. Within the quarter at any time, there can be changes- major and minor, depending on the need.

The tools available for the central bank to achieve the monetary policy ends are the following:

- Bank rate
- Reserve ratios
- Open market operations
- Intervention in the forex market and
- Moral suasion

Bank rate

Bank Rate is the rate at which RBI lends long term to commercial banks. Bank Rate is a tool which RBI uses for managing money supply. Any revision in Bank Rate by RBI is a signal to banks to revise deposit rates as well as prime lending rate (PLR is the rate at which banks lend to the best customers. It is not in use any more.) Bank rate is in a limbo. It has no effective use. It is a penal rate. In 2011, the bank rate was aligned with the newly introduced marginal standing facility. Today it stands at 9 %(2012).Bank Rate is aligned with Marginal Standing Facility (MSF) rate, which, in turn, is linked to the policy repo rate. Alignment was because the MSF is also a penal rate. (Read ahead) . Bank rate has been replaced with repo rate as the policy rate for many years now. The Bank Rate acts as the penal rate charged on banks for shortfalls in meeting their reserve requirements (cash reserve ratio and statutory liquidity ratio). Read ahead..

Ready Forward Contracts (Repos)

It is a transaction in which two parties agree to sell and repurchase the same security. Under such an agreement the seller sells specified securities with an agreement to repurchase the same at a mutually decided future date and a price. Similarly, the buyer purchases the securities with an agreement to resell the same to the seller on an agreed date in future at a predetermined price.

In India. RBI lends on a short term basis to banks on the security of the government bonds (repo) . Banks undertake to repurchase the security at a later date- over night or few days. RBI charges a repo rate for the money it lends. It is 7.75 % presently (2013 October)

Reverse repo is when RBI borrows from the market (absorbs excess liquidity) on the basis of securities and repurchases them the next day or after a few days. The rate at which it borrows is called reverse repo rate as it is the reverse of the repo operation. Reverse repo rate 100% basis points (1%) below the repo rate.

The Repo/Reverse Repo transaction can only be done at Mumbai and in securities as approved by RBI (Treasury Bills, Central/State Govt securities). RBI uses Repo and Reverse repo as instruments for liquidity adjustment in the system.

Repo rate is known as policy rate and is used as signal to the financial system to adjust their lending and borrowing operations.

MSF

In 2011, RBI introduced the Marginal Standing Facility as a window through which the commercial banks can borrow from the RBI at a rate that is 1% more than the repo rate. It is meant to ease liquidity in the market. Banks can use the repo route for the securities over and above the mandatory SLR holdings- 23% of bank deposits. MSF is open to the banks that want to borrow from the RBI even if the credit is costlier by a percentage point. Totally, 2 % of the value of deposits is the limit for the MSF window for each bank. The aim is ease liquidity.

MSF is the penal rate- because the repo limit is exhausted and also because the SLR limit is breached. Bank rate is also a penal rate- for breaching the SLR and CRR limits: Therefore, there is a need to bring the bank rate on par with the MSF as was done by the RBI in 2011-12. Both stand at 8.75% today(2013 October). Thus, the gap between the Repo rate and the MSF which as a norm has to be 1% has been restored as it was widely breached in 2013 July when the MSF was kept at 3% above the Repo rate which was a policy initiative by the RBI to stem speculation on the rupee. Since relative normalcy returned on the rupee front, MSF came back to normative levels.

MSF window also has become necessary because the repo operations are limited to a specific period during the day.

Banks can borrow under MSF in lieu of whatever excessive SLR they have. There is no limit here. If a bank has overshot SLR limits to 28% and needs funds, it can borrow from RBI funds worth 5% (of its NDTL).

What if a bank does not have excess SLR? Can it borrow? Yes it can. Currently RBI allows banks to borrow 2% of NDTL below SLR under MSF and and funds worth 0.5% of NDTL for providing assistance to Mutual Funds. So, say a bank has 23% SLR; it can borrow funds under MSF worth 2%. When MSF became a policy measure in May-11, banks were only given the second option of borrowing in case it does not have an excess SLR. The limit was 1%. In Dec-11, Banks were given the excess SLR choice.

LAF

Liquidity Adjustment Facility (LAF) was introduced by RBI in 2000. Funds under LAF are used by the banks for their day-to-day mismatches in liquidity. LAF covers credit at repo and reverse repo rates.

Reserve Requirements

In economics, fractional-reserve banking is the near-universal practice of banks in which banks keep a fraction of the total deposits managed by a bank as reserves that are not to be lent. The reserve ratios are periodically changed by the RBI. The reserve requirement is a bank regulation, that sets the minimum reserves each bank must hold as a part of the deposits. These reserves are designed to satisfy various needs like providing loans to the Government(SLR), safety of banking operations, regulation of liquidity, management of interest rates, checking speculation and inflation management(CRR).They are in the form of RBI approved securities (SLR) kept with themselves or cash that is kept with the RBI(CRR).

Statutory liquidity ratio (SLR)

It is the portion of time(fixed deposits) and demand liabilities(savings bank and current accounts) of banks that they should keep in the form of designated liquid assets like government securities and other RBI-approved securities like public sector bonds ; current account balances with other banks and gold .SLR aims at ensuring that the need for government funds is partly but surely met by the banks. SLR was progressively brought down from 38.5% in 1991 to 23% (2012).

SLR is a blunt instrument and was unchanged for more than a decade and half till the Lehman-induced global financial and economic crisis of 2008.

The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on SLR at 25% and 40% respectively. But the amendment made in these statutes in 2007 removed the lower limit but retained the cap at 40%. RBI has, as a result, the freedom to reduce the SLR to any rate depending on the macro economic conditions. The amendment was an enabling one.

CRR

CRR is a monetary tool to regulate money supply. It is the portion of the bank deposits that a bank should keep with the RBI in cash form. CRR deposits earn no interest. The Reserve Bank of India Act, 1934 and the Banking Regulation Act, 1949 fixed the floor and cap on CRR at 3% and 20% respectively. But the amendment made in these statutes in 2007 removed the limits- lower and upper. RBI has, as a result, greater operational flexibility to make its monetary adjustments. CRR is adjusted to manage liquidity and inflation The more the CRR, the less the money available for lending by the banks to players in the economy. CRR was 15% in 1991 and today it is 4%(2013 October) twice . If inflation is high, money supply needs to be taken out and so CRR is generally increased. But in a regime of moderate inflation, low CRR is in place.

RBI increases CRR to tighten credit and lowers CRR to expand credit. During the downturn after the global Great Recession 2008 October onwards, CRR was reduced but as growth and inflation returned since 2009, CRR was gradually increased .

CRR as a tool of monetary policy is used when there is a relatively serious need to manage credit and inflation. Otherwise, normally, RBI relies on signaling its intent through the policy rates of repo and reverse repo . Based on these rates, RBI conducts open market operations for liquidity management.

Open Market Operations Of RBI

OMOs of the RBI can be described as outright purchase and sale of government securities in the open market (open market essentially means banks and financial institutions) by the RBI in order to influence the volume of money and credit in the economy. Purchase of government securities injects money into the market and thus expands credit; sales have the opposite effect- absorb excess liquidity and shrink credit. Open market operations are RBI's most important and flexible monetary policy tool. Open market operations do not change the total stock of government securities but change the proportion held by the RBI, commercial and cooperative banks.

Selective Credit Controls

Certain businesses can be given more and certain others may get less credit from banks on the orders of the RBI. Thus, selective credit controls can be imposed for meeting various goals like discouraging hoarding and black-marketing of certain essential commodities by traders etc by giving them less credit. Either credit can be rationed or interest rate can be hiked by RBI for certain sectors as a part of SCCs. In SCCs, the total quantum of credit does not change, but the amount lent and the cost of credit may be changed for specific sector or sectors.

Moral suasion

A persuasion measure used by Central bank to influence and pressure, but not force, banks into adhering to policy. Measures used are closed-door meetings with bank directors, increased severity of inspections, discussions, appeals to community spirit etc.

Recently the RBI Governor appealed to banks not to raise rates even though the central bank was following a tight money policy.

Market Stabilization Bonds

In 2004, RBI floated Government securities, as a part of the Market Stabilization Scheme, to absorb excess liquidity from the market. The excess liquidity is the result of RBI buying dollars from the market. MSS is a sterilization effort of the central bank. The normally available government securities are not enough for the RBI to suck out the huge rupee supply (printed money called base money or reserve money or high powered money) that was caused for buying dollar. Therefore, the MSS was started.

Interest rates and their significance

Interest rates are the rates offered to money that is deposited in the banks; rates offered for investment in bonds; rates at which money is borrowed from banks and financial institutions -; and rates charged from the borrowers etc.

Savers want higher interest rate while investors want the cost of credit to be low. There has to be a balance. The determinants of interest rates are:

- Inflation- the higher the inflation, the higher the interest rates because the same money invested in commodities and other assets should not fetch more, because of the inflation:
- Need for growth :lower interest rates reduce cost of credit and facilitate investment for growth
- Promotion of savings
- Government's need to borrow: the magnitude of government's borrowing programme also determines interest rates. The more the borrowing, the higher the interest rates.
- Need to generate demand :as interest rates come down, consumer demand for credit goes up and there will be a stimulus for growth
- Global trends as we need to retain foreign funds. For example, interest rates on NRI deposits were increased in 2013 to attract their dollar deposits under the FCNR(B) swap window.(Given elsewhere)

Deregulation of Interest Rates

As a part of banking sector reforms, interest rates have been deregulated. The rationale is that banks can adjust rates quickly according to market conditions; financial innovations should be facilitated; competitive rates can be good for savers and investors; global alignment is possible more dynamically; etc. RBI however, uses repo rates and CRR adjustments to influence interest rates.

Since 2010, they are being hiked again as inflation is a worry- food inflation being even worse.

Floating and Flexible Rates of Interest

There are two types of interest rate- fixed and floating. If they are offered together (when they co exist), it is called flexible interest rate regime. Floating interest rates are linked to an underlying benchmark rate. In other words, the interest rate offered `floats' in relation to the interest rate of a government security instrument of similar maturity( 5 years or 10 years maturity etc) as determined by the market. That is, floating rates of interest are basically market driven rather than `fixed'. The effective rate is adjusted on a quarterly or semi-annually or annually.

Inflation targeting

Under this policy, approach the target is to keep inflation in a particular range or at a particular level. Government and the RBI agree on convergence between the fiscal and the monetary policies to achieve the common goal. RBI is given autonomy to manage inflation while the government agrees to have a fiscal policy that will contribute to price stability- for example, not borrow excessively etc. India does not follow it.

This monetary policy approach was pioneered in New Zealand. It is currently used in the Eurozone, Australia, Canada, New Zealand, Sweden, South Africa, Norway and the United Kingdom.(See Chapter on Inflation for more)

Reserve Bank of India

The central bank of the country is the Reserve Bank of India (RBI). It was established in 1935 with a share capital of Rs. 5 crores on the basis of the recommendations of the Hilton Young Commission. The share capital was entirely owned by private shareholders in the beginning. The Government held shares of nominal value of Rs. 2,20,000.

Reserve Bank of India was nationalised in the year 1949. The general superintendence and direction of the Bank is entrusted to Central Board of Directors of 20 members, the Governor and four Deputy Governors, one Government official from the Ministry of Finance, ten nominated Directors by the Government to give representation to important elements in the economic life of the country, and four nominated Directors by the Central Government to represent the four local Boards with the headquarters at Mumbai, Kolkata, Chennai and New Delhi

The Reserve Bank of India Act, 1934 came into effect in 1935. The Act provides the

Statutory basis of the functioning of the bank.

Reserve Bank of India Functions

The Reserve Bank of India Act of 1934 entrusts all the important functions of a central bank to the reserve bank of India.

Bank of issue

Under Section 22 of the Reserve Bank of India Act, the Bank has the sole right to issue bank notes of all denominations. The distribution of one rupee notes and coins and small coins all over the country is undertaken by the Reserve Bank as agent of the Government. The Reserve Bank has a separate Issue Department which is entrusted with the issue of currency notes.

RBI should maintain gold & foreign exchange reserves of Rs. 200 cr, of which Rs. 115 cr. should be in gold. However, the amount of currency that the RBI can print depends upon the need of the economy. The only restriction is the systemic one- it should not create instability with too much or too less of money supply. Money supply should have a correspondence to the goods in the economy and the rates of growth.

Banker to Government

The second important function of the Reserve Bank of India is to act as Government banker, agent and adviser. The Reserve Bank is agent of Central Government and of all State Governments in India. The Reserve Bank has the obligation to transact Government business, to receive and to make payments on behalf of the Government and to carry out their other banking operations. The Reserve Bank of India helps the Government - both the Union and the States to raise loans . The Bank makes ways and means advances to the Governments. It acts as adviser to the Government on all monetary and banking matters.

Bankers Bank and lender of the last resort.

The Reserve Bank of India acts as the bankers' bank.

The scheduled banks can borrow from the Reserve Bank of India on the basis of eligible securities by rediscounting bills of exchange. CRR deposits of banks are kept with the RBI.

Since commercial banks can always expect the Reserve Bank of India to come to their help in times of banking crises, the Reserve Bank is the lender of the last resort.

Controller of credit

The Reserve Bank of India is the controller of credit i.e. it has the power to influence the volume of credit created by banks in India. It can do so through changing the instruments available to it(see above). According to the Banking Regulation Act of 1949, the Reserve Bank of India can ask any particular bank or the whole banking system not to lend to Particular groups or persons.

The Reserve Bank of India is armed with many more powers to control the Indian money market. Every bank has to get a license from the Reserve Bank of India to do banking business within India. the license can be cancelled by the Reserve Bank of certain stipulated conditions are not fulfilled. Every bank has to get the permission of the Reserve Bank before it can open a new branch. Each scheduled bank must send a periodical return to the Reserve Bank showing, in detail, its assets and liabilities. This power of the Bank to call for information is also intended to give it effective control of the credit system. The Reserve Bank has also the power to inspect the accounts of any commercial bank.

Agent and Adviser of the Government

The RBI acts, as the financial agent and adviser to the Government. It renders the following functions:

(a) As an agent to the Government, it accepts loans and manages public debts on behalf of the Government.

(b) It issues Government bonds, treasury bills, etc.

(c) Acts as the financial adviser to the Government in all important economic and financial matters.

Functions as National Clearing House

In India RBI acts as the clearing house for settlement of banking transactions. This function of clearing house enables the other banks to settle their interbank claims easily. Further it facilitates the settlement economically. It essentially means the inter-bank cheque clearing settlement.

The RBI acts as a lender of last resort or emergency fund provider to the other member banks. As such, if the commercial banks are not able to get financial assistance from any other sources, then as a last resort, they can approach the RBI for the necessary financial assistance.

In such situations, the RBI provides credit facilities to the commercial banks on eligible securities including genuine trade bills which are usually made available at repo Rate/MSF.

Custodian of Foreign Reserves

The Reserve Bank of India has the responsibility to act as the custodian of India's reserve of international currencies. It takes up operations in the forex market to stabilize the exchange rate of rupee and ensure that there is no speculation and there is order. To be able to do so effectively, it holds forex reserves which it acquires from the market(purchases). It has about 282 b of forex reserves (2013 October) which includes foreign currency assets, gold and IMF's SDRs). SDRs are increasing in importance since 2008 when dollar stability came under question. Diversification and hedging of risk is being done by all central banks. Even though rupee exchange rate is market driven. RBI watches the movement to ensure order and normalcy and there is no volatility. Thus, it maintains exchange rate oversight. Mid-2013 policy action of the RBI is ample proof that RBI will not allow excessive volatility in the rupee rate. It has many levers which we will discuss in the chapter ahead on BOP.

Supervisory functions

The Reserve Bank Act, 1934, and the Banking Regulation Act, 1949 have given the RBI wide powers of supervision and control over commercial and co-operative banks, relating to licensing and establishments, branch expansion, setting reserve ratios etc. They are:

- Granting license to banks.
- Inspect and make enquiry or determine position in respect of matters under various sections of RBI and Banking Regulation Act.
- Implementation of Deposit Insurance Scheme.
- Periodical review of the work of commercial banks.
- Giving directives to commercial banks.
- Control the non- banking finance corporations.
- Ensuring the health of financial system through on-site and off-site verifications.

More such functions are given to the RBI under the **Banking Laws (Amendment)** Act **2012.**

Promotional Functions

Since Independence, the range of the Reserve Bank's functions has steadily widened. The Bank now performs a variety of developmental and promotional functions. The Reserve Bank was asked to promote banking habit, extend banking facilities to rural and semi-urban areas, and establish and promote new specialised financing agencies. Accordingly, the Reserve Bank has helped in the setting up of the IFCI and the SFC; the Industrial Development Bank of India in 1964, the Agricultural Refinance Corporation of India in 1963 and the Industrial Reconstruction Corporation of India in 1972. These institutions were set up directly or indirectly by the Reserve Bank to promote savings, and to provide industrial finance as well as agricultural finance. NABARD was set up in 1982. It has an important role in facilitating microfinance for financial inclusion. Further, its innovations include banking correspondent model for rural banking.

Functions of central bank, in sum

- monopoly on the issue of banknotes
- the Government's banker
- bankers' bank
- Lender of Last Resort
- manages the country's foreign exchange and gold reserves
- regulation and supervision of the banking industry:
- setting the official interest rate - used to manage both inflation and the country's exchange rate.

The central bank's main responsibility is the making of monetary policy to ensure a stable economy, including a stable currency. It aims to manage inflation (rising average prices) as well as deflation (falling prices). It is the lender of last resort, and assists banks in cases of financial distress (see also bank runs).

Furthermore, it holds foreign exchange reserves and official gold reserves, and has influence over exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float"). India falls in the market-determined category largely.

Typically a central bank controls certain types of short-term interest rates(repo and reverse repo rates) These influence the stock- and bond markets as well as mortgage and other interest rates.

RBI Act amended 2006

Government made amendments to RBI Act 1934 and Banking Regulation Act for allowing the apex bank to have more flexibility to fix the SLR and Cash Reserve Ratio (CRR). It removed the floor and cap on CRR and floor on statutory liquidity ratio (SLR) to provide flexibility to RBI to manage liquidity. This would result in better liquidity management in the system.

Debt management office DMO

In the late 1990's, a working group of the Reserve Bank of India first suggested the separation of its debt management and monetary policy functions of the central bank.

In keeping with global practices of the time, the group made out a case for separating the role of a bank in managing borrowings for the central and state governments, leaving the RBI to focus mainly on setting interest rates and price stability.

Although the government first announced its intention to form a new debt management office in 2007, there has been little progress. The move came appropriately at a time when the process of fiscal consolidation was well underway.

Economic growth was buoyant then and public deficit and debt indicators, too, were under control. But the Indian central bank did not appear to be fully convinced.

Since then, in the wake of the global financial crisis, there has been some rethink about the perceived benefits of a separation of public debt management from monetary policy, especially in the context of the poor state of national balance sheets.

Several committees, including the ones headed by Jehangir Aziz - who was the principal adviser to the government in the ministry of finance - Raghuram Rajan and Percy Mistry, had listed the operational efficiencies, which could be gained by having an independent debt management office.

These include eliminating a conflict of interest involving a central bank setting shortterm interest rates and selling bonds for the government; and increasing transparency.

The primary conflict, which is generally associated with a central bank managing sovereign debt relates to its inherent responsibility as the monetary authority, and its obligations as a debt manager.

It has been argued that the central bank will be biased towards a low interest regime to cut the costs of sovereign debt, at the risk of compromising its anti-inflation stance.

The Indian central bank has countered this by saying that in countries such as India, given the large size of the government borrowing programme, the sovereign debt management is much more than merely an exercise in resource-raising, as it could impact interest rates which, in turn, could have wider public policy implications.

Other arguments which have been put forward by those backing the RBI are that the size and dynamics of government borrowing programmes have a much wider influence on interest rate movements, systemic liquidity and even loan growth through the crowding out of private sector loan demand.

Besides, management of public debt, therefore, has necessarily to be seen as part of broader macroeconomic management framework involving various trade-offs.

According to them, once this is recognised, the centrality of central banks in this regard becomes quite evident and that only central banks have the requisite market pulse and instruments which an independent debt agency, driven by narrow objectives, will not be able to do.

The concern which has been flagged off is that if debt management is moved away from the RBI to DMO, which could function as an extended arm of the ministry of finance, the possibility of conflict of interest is greater as the government is the owner of the majority of banks in India.

This conflict of interest is more potent in the backdrop of banking sector continuing to be the dominant player for government market borrowing, with banks holding over 50% of outstanding government securities.

Autonomy for RBI

RBI being the architect of the monetary policy requires autonomy to be effective.Advocates of central bank independence argue that a central bank should be autonomous to manage money, credit and exchange rate dynamics in the globalizing economy. It helps check populist pressures and schemes that the political leadership may be tempted to indulge in. For example, the RBI was under pressure in 2013 from GOI to reduce rates to allow banks to lend easy to corporates and consumers to stimulate growth even as the inflation was rising. It resisted as it had autonomy.

Others believe that the elected governments should have the final say within which RBI should be autonomous both while tendering advice and also with enough discretionary powers. For example, fixing CRR and SLR as it deems fit with the amendments to the RBI Act in 2006.

Abenomics in Japan under Shinzo Abe since 2013 has been following unconventional monetary policy where huge money supply was generated to bring down the value of Yen and export and improve economy. It is a case of political priorities dictating the monetary policy.

The recent measures to make RBI independent are

- replacement of adhoc treasury bills with WMA from 1997
- FRBM Act empowers RBI with autonomy- no primary borrowing from 1-4-2006.
- RBI Act amended in 2006

The arguments in favour of autonomy are:

- monetary stability which is essential for the efficient functioning of the modern economic system can be best achieved if professional Central bankers with the long term perspective are given charge . Otherwise, political leadership may be tempted to populism
- without such autonomy, government tends to be profligate with its policies of automatic monetization
- monetary credibility is high in public perception if professionals manage it.

The arguments against are:

- democratic systems are run with Parliament and Cabinet making all important policies
- monetary policy is an integral policy of the overall economic policy and so RBI has to subordinate itself to the larger objective.

The best course is to have a middle path where autonomy should be linked to performance like in the policy of 'inflation targeting' where the central bank should justify its autonomy with performance in the field of management of prices at reasonable levels.

Money Supply

This refers to the total volume of money circulating in the economy. Money supply can be estimated as narrow or broad money.

M1 equals the sum of currency with the public and demand deposits with the banks. It is the narrow money.

M3 or the broad money , as it is also known , includes time deposits (fixed deposits), savings deposits with post office saving banks and all the components of M1.

These notions are important for the RBI to understand the demand in the economy so that it can gauge inflation, demand and so on for it to adjust the same.

Liquidity trap

A **liquidity trap** is a situation in which injections of cash into the private banking system by a central bank fail to lower interest rates and hence fail to stimulate economic growth. A liquidity trap is caused when people hoard cash because they expect an adverse event such as deflation, insufficient aggregate demand, or war. Characteristics of a liquidity trap are short-term interest rates that are near zero and fluctuations in the monetary base(printed money) that fail to translate into fluctuations in general price levels. It means; more and easy money fails to see price rise which can signal demand growth in the economy. To come out of liquidity trap, QE is attempted.

Quantitative easing

The term quantitative easing describes an unconventional form of monetary easing used to stimulate an economy. It involves the central bank to buy financial instruments which in ordinary times are not accepted for OMOs- for example, the housing market securities that were discredited in the USA since 2008. It is a step that is taken after the interest rate reduction to very low levels and similar downward adjustment of reserve ratios like CRR fail to induce any positive change. It involves printing fresh currency and de-risking lending as rates and supply of money ease to unprecedented levels. Central bank uses unconventional means, other than the usual monetary policy tools, to flood the financial system with new money through quantitative easing.

Federal Reserve of the US (its central bank like the RBI) used quantitative easing to overcome the liquidity crisis since the fall of Lehman Brothers in 2008 September when many banks went bankrupt and credit froze. It has worked as US came out of recession. It was delivered in three tranches- QWE 1.2 and 3. By the end of 2013. QE3 is under operation and may. taper- wound down .by the middle of 2014. World is worried as US dollar is a global currency and not merely a national currency. It has impact on the economies and financial markets in other countries and want to be consulted – G20 St. Petersburg summit in 2013 where Dr.Singh urged to be consulted.

FSDC

Financial Stability and Development Council is apex-level body constituted by government of India. The idea to create such a super regulatory body was first mooted by Raghuram Rajan Committee in 2008.The recent global economic meltdown has put pressure on governments and institutions across globe to regulate the financial sector towards greater stability.

The new body envisages to strengthen and institutionalise the mechanism of maintaining financial stability, financial sector development,inter-regulatory coordination along with monitoring macro-prudential regulation of economy.

Its Chairperson is the Union Finance Minister of India
Members are :

- Governor Reserve Bank of India (RBI),
- Finance Secretary and/ or Secretary, Department of Economic Affairs (DEA),
- Secretary, Department of Financial Services (DFS),
- Chief Economic Advisor, Ministry of Finance,
- Chairman, Securities and Exchange Board of India (SEBI),
- Chairman, Insurance Regulatory and Development Authority (IRDA),
- Chairman Pension Fund Regulatory and Development Authority (PFRDA),
- Joint Secretary (Capital Markets), DEA, will be the Secretary of the Council,
- The Chairperson may invite any person whose presence is deemed necessary for any of its meeting(s).

Responsibilities

- Financial Stability
- Financial Sector Development
- Inter-Regulatory Coordination
- Financial Literacy
- Financial Inclusion
- Macro prudential supervision of the economy including the functioning of large financial conglomerates
- Coordinating India's international interface with financial sector bodies like the Financial Action Task Force (FATF), Financial Stability Board (FSB)and any such body as may be decided by the Finance Minister from time to time.

Macro prudential analysis is a method of economic analysis that evaluates the health, soundness and vulnerabilities of a financial system. Macro prudential analysis looks at the health of the underlying financial institutions in the system and performs stress tests(simulate financial crises and check impact on the banks and other financial institutions) and scenario analysis to help determine the system's sensitivity to economic shocks.

In October 2013, FSDC met in the context of rupee crisis and the global factors. The government decided to reach out to sovereign wealth funds to minimise the impact of US Federal Reserve's tapering of quantitative easing on Indian markets. FM asked the financial sector regulators to take preventive steps before stimulus rollback starts early 2014.□□At the eighth meeting of the Financial Stability and Development Council (FSDC), Chidambaram emphasized the opportunity available due to the postponement of the reversal of the monetary policies in the United States should be utilized to further address the macroeconomic imbalances. Withdrawal of the $85 billion-a-month bond buying programme by the US, which would lead to outflow of funds from emerging markets, was deferred by the Federal Reserve in September 2013.

Money Market and Capital Market in India: Instruments and Details
Part-1

Money market can be defined as a market for short-term funds with maturities ranging from overnight to one year and includes financial instruments that are considered to be close substitutes of money. Money market transactions could be both secured and unsecured, i.e., without collaterals as we will see ahead.

Money market covers sources of finance - lending and borrowing short term funds- funds with a maturity of less than one year. Banks and financial institutions(IDBI, LIC etc) individuals, mutual funds, companies and government are the main lenders and borrowers. The informal market operates through small-scale money-lenders as well as others outside the RBI control.

Money market instruments broadly are: call money; bill market (both commercial bills and treasury bills) Certificates of Deposit(CD); Commercial paper(CP).

Call Money

Call/Notice money is money borrowed or lent for a very short period. If the period is more than one day and up to 14 days it is called 'Notice money' otherwise the amount is known as Call money'. No collateral security is required to cover these transactions and good will and reputation are the basis apart from the documents like promissory notes. The call market enables the banks and institutions to even out their day to day deficits and surpluses of money.

Commercial banks, Co-operative Banks, mutual funds, primary dealers and others are allowed to borrow and lend in this market Interest rates in the call and notice money market are market determined. A **primary dealer** is a firm that buys government securities directly from a government, with the intention of reselling them to others, thus acting as a market maker of government securities. The government may regulate the behavior and numbers of Its primary dealers and impose conditions of entry.

Treasury Bills

Treasury bills are short-term money market instruments, which are issued by the RBI on behalf of the GOI. The GOI uses these funds to meet its short-term financial requirements of the government. T-Bills are sovereign zero risk instruments. They are available in primary and secondary market: issued at a discount to face value i.e., investors may buy the T-bill at discount to face value of Rs.100 and on maturity the face value of Rs.100 is received by the investor.

Treasury bills (T-bills) offer short-term investment opportunities. They are thus useful in managing short-term liquidity. At present, the Government of India, through the RBI, issues three types of treasury bills through auctions, namely, 91-day, 182-day and 364-day. There are no treasury bills issued by State Governments.
Treasury bills are also issued under the Market Stabilization Scheme (MSS).

While 91-day T-bills are auctioned every week on Wednesdays, 182-day and 364-day T-bills are auctioned every alternate week on Wednesdays.
Treasury bills are available for a minimum amount of Rs.25,000 and in multiples of Rs. 25,000. Treasury bills are issued at a discount and are redeemed at par.
Treasury bills are zero coupon securities and pay no interest. They are issued at a discount and redeemed at the face value at maturity. For example, a 91 day Treasury bill of Rs.100/- (face value) may be issued at say Rs. 98.20, that is, at a discount of say, Rs.1.80 and would be redeemed at the face value of Rs.100/-. The return to the investors is the difference between the maturity value or the face value (that is Rs.100) and the issue price.
A considerable part of the government's borrowings takes place through T bills of various maturities. The usual investors in these instruments are banks, insurance companies and FIs.

Cash Management Bills (CMBs)

Government of India, in consultation with the Reserve Bank of India, has decided to issue a new short-term instrument, known as Cash Management Bills (CMBs), to meet the temporary mismatches in the cash flow of the Government. The CMBs have the generic character of T-bills but are issued for maturities less than 91 days. Like T-bills, they are also issued at a discount and redeemed at face value at maturity.

Inter Bank Term Money

Inter bank market for deposits of maturity beyond 14 days and upto three months is referred to as the term money market.

Certificates Of Deposit

After treasury bills, the next lowest risk category investment option is the certificate of deposit (CD) issued by scheduled commercial banks and FIs. Regional rural banks and Local area banks can not issue CDs.

CD is a negotiable promissory note, secure and short term (up to a year) in nature. A CD is issued at a discount to the face value, the discount rate being negotiated between the issuer and the investor. CDs can be issued by scheduled commercial banks and select all-India Financial Institutions. Minimum amount of a CD should be Rs.1 lakh The maturity period of CDs issued by banks should be not less than 15 days and not more than one year. The FIs can issue CDs for a period not less than 1 year and not exceeding 3 years from the date of issue. CDs can be issued to individuals or firms.

Inter Corporate Deposits Market

Apart from CPs, corporates also have access to another market called the inter corporate deposits (ICD) market. An ICD is an unsecured loan extended by one corporate to another. Existing mainly as an avenue for low rated corporates, this market allows fund- surplus Corporate to lend to other corporates.

Commercial Paper

It represents short term unsecured promissory notes issued by top rated corporates, primary dealers(PDs),satellite dealers(SDs) and the all-India financial institutions(FIs).
CP can be issued for maturities between a minimum of 7 days and a maximum of up to one year from the date of issue. However, the maturity date of the CP should not go beyond the date up to which the credit rating of the issuer is valid.CP can be issued in denominations of Rs.5 lakh or multiples thereof.

The main features of these papers are

- corporates having tangible net worth of not less than Rs.4 crore can issue them
- All CPs require credit rating from a credit rating agency Minimum amount invested by single investor is Rs.five lakh or multiple thereof.
- CPs are issued at a discount to face value.

Ready Forward Contracts (Repos)

See chapter on Monetary policy.

Commercial Bills

Bills of exchange are negotiable instruments drawn by the seller (drawer) of the goods on the buyer (drawee) of the goods for the value of the goods delivered. These bills are called trade bills. These trade bills are called commercial bills when they are accepted by commercial banks. If the bill is payable at a future date and the seller needs money immediately, he may approach his bank for discounting the bill.

Discount and Finance House of India (DFHI)

Set up in 1988 by RBI to strengthen the bill market. It has been established to deal in money market instruments in order to provide liquidity. Thus the task assigned to DFHI is to develop a secondary market in the existing money market instruments.The main objective of DFHI is to facilitate the smoothening of the short term liquidity imbalances by developing an active money market and integrating the various segments of the money market.
At preset DFHI's activities are restricted to:
1. Dealing in Treasury Bills
2. Re-discounting short term commercial bills.
3. Participating in the inert bank call money. notice money and term deposits and
4. Dealing in Commercial Paper and Certificate of deposits.
5. Government dated Securities

Libor

The London Interbank Offered Rate is the average interest rate estimated by leading banks in London that they would be charged if borrowing from other banks. It is usually abbreviated to BBA Libor (for British Bankers' Association Libor). It is the primary benchmark, along with the Euribor, for short term interest rates around the world.

Many financial institutions, mortgage lenders and credit card agencies set their own rates relative to it. At least $350 trillion in derivatives and other financial products are tied to the Libor.

Mibor - Mumbai Inter-Bank Offer Rate

The Committee for the Development of the Debt Market that had studied and recommended the modalities for the development for a benchmark rate for the call money market. Accordingly, NSE had developed and launched the NSE Mumbai Inter-bank Bid Rate (MIBID) and NSE Mumbai Inter-bank Offer Rate (MIBOR) for the overnight money market in 1998. The **MIBID/MIBOR** rate is used as a bench mark rate for majority of deals.

Money market reforms

The recommendations of the Sukhmoy Chakravarty Committee on the Review of the Working of the monetary system, and the Narasimham Committee Report on the Working of the Financial System in India, 1991, The Reserve Bank of India initiated a series of money market reforms basically directed towards the efficient discharge of its objectives.

Reforms made in the Indian Money Market are:- Deregulation of the Interest Rate ; Money Market Mutual Fund (MMMFs) are allowed to sell units to corporate and individuals. The Discount and Finance House of India (DFHI) was set up in April 1988 to impart liquidity in the money market. It was set up jointly by the RBI, Public sector Banks and Financial Institutions. DFHI has played an important role in stabilizing the Indian money market. Liquidity Adjustment Facility (LAF) - Through the LAF, the RBI remains in the money market on a continue basis through the repo transaction. LAF adjusts liquidity in the market through absorption and or injection of financial resources. In order to impart transparency and efficiency in the money market transaction the electronic dealing system has been started. It covers all deals in the money market. Similarly it is useful for the RBI to watchdog the money market: Establishment of the CCIL: The Clearing Corporation of India limited (CCIL) was set up in April 2001. Development of New Market Instruments like CMBs.

Money Market and Capital Market in India: Instruments and Details: Part-2

Capital Market

It refers to market for funds with a maturity of 1 year and above, refered to as term funds that include medium and long term funds. The demand for these funds comes from both the government for its investtment purposes and also the private sector. Banks, public financial institutions like LIC and GIC; development financial institutions like ICICI, IDBI etc; mutual funds like UTI are the main participants in the market.The elements of the capital market in India are the following:

Government securities,industrial securities that include the shares and debentures of Indian companies- both the primary and secondary market(please refer to the section on stock market) DFIs(IFCI, IDBI, State Financial Corporations(SFCs);UTI, ICICI(private sector) Financial intermediaries: merchant banks; mutual funds;leasing companies; venture capital companies;and others.

G-Secs (Gift edged securities)

A Government security is a tradable instrument issued by the Central Government or the State Governments. It acknowledges the Government's debt obligation. Such securities are short term (usually called treasury bills or Cash Management Bills with original maturities of less than one year) or long term (usually called Government bonds or dated securities with original maturity of one year or more). In India, the Central Government issues both, treasury bills and bonds or dated securities while the State Governments issue only bonds or dated securities, which are called the State Development Loans (SDLs). Government securities carry practically no risk of default and, hence, are called risk-free gilt-edged instruments. Government of India also issues savings instruments (Savings Bonds, National Saving Certificates (NSCs), etc.) or special securities (oil bonds, Food Corporation of India bonds, fertiliser bonds, power bonds, etc.). They are, usually not fully tradable and are, therefore, not eligible to be SLR securities.

Dated Government securities are long term securities and carry a fixed or floating coupon (interest rate) which is paid on the face value, payable at fixed time periods (usually half-yearly). The tenor of dated securities can be up to 30 years.

The G-Sec instrument is in the nature of a bond.

GOI Dated Security can be held by any person, firm, company, corporate body or institution, State Governments, Provident Funds and Trusts, Non-Resident Indians (NRIs, viz., Indian citizens and Individuals of Indian origin), Overseas corporate bodies predominantly owned by NRIs and Foreign Institutional Investors registered with SEBI and approved by Reserve

Bank of India are also eligible to invest in the government stock. G-Sec are issued both in demat and physical form.

The minimum investment in G-Secs is Rs 10,000. G-Secs could be of the following types:

Dated Securities: They have fixed maturity and fixed coupon rates payable half yearly and are identified by their year of maturity.

Floating Rate Bonds:

They are bonds with variable interest rates with a fixed percentage over a benchmark rate. There may also be a cap and a floor rate attached, thereby fixing a maximum and minimum interest rate payable on it.

Capital Indexed Bonds: They are bonds where the interest rate is a fixed percentage over the wholesale price index or CPI.

Capital Index Bond (CIB), 2002 was issued in 1997 where only principal repayments at the time of redemption were indexed to inflation. A new version of IIB has been designed with protection from inflation to both interest payments and principal repayments linking them to Wholesale Price Index (WPI) by the RBI and may be issued (2013).

2012 reforms in G-Secs

The existing limit for investment by Securities and Exchange Board of India (SEBI) registered foreign institutional investors (FIIs) in Government securities (G-Secs) has been enhanced to $30 billion.(2013) and it may be further relaxed.

RBI has decided to allow long term investors like Sovereign Wealth Funds (SWFs), multilateral agencies, endowment funds, insurance funds, pension funds and foreign central banks to be registered with SEBI, to also invest in G-Secs.FII debt is rupee debt and so is welcome.

SDL

State Governments also raise loans from the market. SDLs are dated securities issued through an auction similar to the auctions conducted for dated securities issued by the Central Government. Interest is serviced at half-yearly intervals and the principal is repaid on the maturity date. Like dated securities issued by the Central Government, SDLs issued by the State Governments qualify for SLR. They are also eligible as collaterals for borrowing through market repo as well as borrowing by eligible entities from the RBI under the Liquidity Adjustment Facility (LAF).

DFIs or Development Banks

Financial institutions assume a critical role in the provision of long term credit, especially in the absence of a well-developed long-term debt market. The financial institutions could be categorised into three broad heads, viz., all-India financial institutions (AIFIs), state-level institutions and other institutions. Of the three categories, AIFIs are the most dominant in terms of assets and range of operations.

The major AIFIs are the Industrial Development Bank of India (IDBI), IFCI Ltd., Industrial Investment Bank of India Ltd. (IIBI), Small Industries Development Bank of India (SIDBI), National Housing Bank (NHB), National Bank for Agriculture and Rural Development (NABARD), Export Import Bank of India (EXIM Bank), Tourism Finance Corporation of India Ltd. (TFCI), Unit Trust of India (UTI), Life Insurance Corporation of India (LIC), General Insurance Corporation of India (GIC) and its subsidiaries and Infrastructure Development Finance Company of India Ltd. (IDFC). All these institutions operate on all-India basis. Other institutions comprise Export Credit and Guarantee Corporation (ECGC) and Deposit Insurance and Credit Guarantee Corporation (DICGC).

The state level institutions consist of state financial corporations (SFCs) and state industrial development corporations (SIDCs).

Merchant Banks / Investment Banks

MBs are those who manage and underwrite (Underwriting an issue means to guarantee to purchase any shares in a new issue or rights issue not fully subscribed by the public.) new public issues floated by companies to raise funds from public. They advise corporate clients on fund raising. They are also called investment banks (I banks) .They deal only with corporates and not general public, essentially.

Lehman Brothers was a global financial services firm. Before declaring bankruptcy in 2008, Lehman was the fourth-largest investment bank in the US (behind Goldman Sachs, Morgan Stanley, and Merrill Lynch), doing business in investment banking, equity ,trading (especially U.S. Treasury securities), research, investment management, private equity and private banking.

On September 15, 2008, the firm filed for Chapter 11 bankruptcy protection following the massive exodus of most of its clients, drastic losses in its stock, and devaluation of its assets by credit rating agencies.

Collective investment schemes

For the last few years, the Securities Exchange Board of India (Sebi) has been coming down hard on companies running collective investment schemes (CIS). These schemes, much in the news since the Saradha scam(2013), are those in which people invest to create a pool of money which is then utilised to realise some income for the investors, or acquire some produce, or some properties which are then looked after by a manager of behalf of the investors. In other words a property is owned by an individual, but is maintained jointly with the manager. A mutual fund is also called a collective investment scheme. SEBI introduced regulations for CISs in 1999. In 2013, they are further rendered more stringent.

Tightening the controls on entities running illegal collective investment schemes (CIS), in September 2013, the Securities and Exchange Board of India (Sebi) has notified new norms to classify such activities as frauds and impose penalties of up to three times of their profits.

Besides, the new rules expand the list of activities to be covered under fraudulent and unfair trade practices to hold individuals as well as companies equally guilty for manipulations.

The amendments have been made to Sebi's 'prevention of fraudulent and unfair trade practices' (PFUTP) regulations.

In the backdrop of Sahara / Sharada scams, SEBI modified the definition of CIS to include any scheme / arrangment floated by any person (instead of a company as was defined earlier); and any such scheme with corpus of more than Rs. 100 Crore shall also be deemed to be a CIS by SEBI.

Alternative Investment Funds

AIFs is a newly created class of pooled-in investment vehicles for real estate, private equity and hedge funds. The AIFs have been divided into three categories. The Category I AIFs include those investing in start-ups, social ventures, SMEs, infrastructure or other areas that can get government incentives for being 'socially or economically desirable'. The Category II AIFs include private equity funds and debt funds which do not get any incentives or concessions from the government and do not undertake leverage or borrowing other than to meet day-today operational requirements. The Category III includes hedge funds or funds which trade with a view to make short-term returns.

Angels are the new category introduced in September 2013. (Read ahead)

AIFs are basically funds established or incorporated in India for the purpose of pooling in capital from Indian and foreign investors for investing as per a pre-decided policy. Sebi regulates them. it excludes Mutual funds or collective investment Schemes, family trusts, Employee Stock Option etc.

Mutual Funds

Mutual funds raise money from public and invest them in stock market securities; bonds etc.Mutual funds were virtually synonymous with the Unit Trust of India(UTI) till two decades ago when India witnessed financial sector liberalization and many more public sector and private mutual funds came up. SEBI regulates mutual funds.

Hedge fund

Hedge fund is an MF though it is limited to few; non-transparent and is not fully regulated. The investment styles of the HFs are also criticised as they are not safe and aim at fast returns thus creating volatility in the markets. SEBI does not allow them. To sum up and explain: A hedge fund is a pooled investment vehicle administered by a professional management firm. Hedge funds invest in a diverse range of markets and use a wide variety of investment styles and financial instruments.The name "hedge fund" refers to the hedging techniques traditionally used by hedge funds. but hedge funds today do not necessarily hedge. Hedge funds are made available only to certain investors and cannot be offered or sold to the general public. As such, they generally avoid direct regulatory oversight, bypass licensing requirements applicable to investment companies, and operate with greater flexibility than mutual funds and other investment funds. They are a form of AIFs.

Venture Capital

Venture capital is money provided by financial institutions who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture capital is an important source of equity for start-up companies.

Angel Investors

An angel investor or angel (also known as a business angel or informal investor) is an affluent individual who provides capital for a business start-up, usually in exchange for convertible debt or ownership equity. They invest their own money unlike a venture capitalist who invests public money. They became popular in recent years after the web-based enterprises came up in the 1990's.
With an aim to encourage entrepreneurship in the country by financing small start-ups, market regulator Sebi in September 2013 notified new norms for angel investors, who provide funding to companies at their initial stages.

Angel investors are allowed to be registered as Alternative Investment Funds (AIFs) -- a newly created class of pooled-in investment vehicles for real estate, private equity and hedge funds.

In order to ensure investment by angel funds is genuine, the Securities and Exchange Board of India (Sebi) has restricted investment by such funds between Rs 50 lakh and Rs 5 crore.

Among other norms included, angel funds can make investments only in those companies which are incorporated in India. These funds need to be invested in a firm for at least three years. can invest in companies not older than 3 years.

Angel funds are required to have a a corpus of at least Rs 10 crore and minimum investment by an investor should be Rs 25 lakh.

The regulator also stipulated that the fund must not have any family connection with the investee company.

The new norms would help in encouraging entrepreneurship in the country by financing small start-ups at a stage where such start-up finds it difficult to obtain funds from traditional sources of funding such as banks, financial institutions among others.

Finance Minister P Chidambaram in his budget speech had announced that Sebi would frame guidelines for angel investor pools by which they can be registered under AIF venture capital funds (VCF).

Under Sebi guidelines, AIFs already have sub-categories such as Venture Capital Funds, Social Funds and SME Funds. Angel fund is likely to be a separate sub-category.

Regarding raising of funds by an individual investor, the person need to have an experience of 10 years and should possess assets of at least Rs 2 crore.

Hundi

Hundis were legal financial instruments that evolved in India. These were used in trade and credit transactions; they were used as remittance instruments for the purpose of transfer of funds from one place to another. In the era of bygone kings and the British Raj these Hundis served as Travellers Cheques. They were also used as credit instruments for borrowing and as bills of exchange for trade transactions.

Technically, a Hundi is an unconditional order in writing made by a person directing another to pay a certain sum of money to a person named in the order. Being a part of an informal system, hundis now have no legal status and were not covered under the Negotiable Instruments Act, 1881. They were mostly used as cheques by indigenous bankers.
Chit funds

Saradha Group run as a collective investment scheme (CIS), which is regulated by the Securities and Exchange Board of India, collapsed and caused severe losses to many people.

There are various such financial schemes such as chit funds, multi-level marketing schemes or ponzi schemes which are all different from one another.

In simple terms, a chit fund is an arrangement that a group of people arrive at to contribute money in a defined manner at periodic intervals into a pool or a kitty. During the process of collection, any member can draw a lump sum through various ways like a lucky draw, an auction or a member can even fix a payout date based on a known expenditure.

These schemes are very popular in tier II and III towns in India and even in rural India, thanks to under-penetration of banking services, as they are a way of raising quick money or catering for sudden liquidity needs or even a planned expenditure. Also, banks haven't recognised the fact that the common man with a small income finds it very difficult to undergo the entire procedure of getting a loan, adjusting to bank working hours and other demands.

There are many organised companies incorporated to do this as a business and these are governed by state or central laws. There is a central Chit Funds Act of 1982, apart from a number of state chit fund Acts. There is an office of "registrar of chit funds" in every state that monitors operations which are quite stringent. Utilisation and appropriation of subscribers money is strictly prohibited.

The first step of regulation comes at the state level; hence it's the state government which is responsible for any fraudulent activities by chit fund companies.

QIPs

The QIP Scheme is open to investments made by "Qualified Institutional Placement " (which includes public financial institutions, mutual funds, foreign institutional investors, venture capital funds and foreign venture capital funds registered with the SEBI) in any issue of equity shares/ fully convertible debentures/ partly convertible debentures or any securities which are convertible into or exchangeable with equity shares at a later date (Securities).

Since the beginning of 2009, Indian companies are raising billions of dollars from the QIP route.

NBFC

A company is treated as an NBFC if its financial assets are more than 50% of total assets and income from financial assets is more than 50% of the gross income

NBFC means Non-banking financial company. A non-banking financial company (NBFC) is a company registered under the Companies Act, 1956 and is engaged in the business of loans and advances, housing finance, acquisition of shares/stock/bonds/debentures/securities issued by government or local authority or other securities of like marketable nature, leasing, hire-purchase, insurance business, chit business, but does not include any institution whose principal business is that of agriculture activity, industrial activity, ale/purchase/construction of immovable property. NBFCs are similar to banks; however they do not accept demand deposits.

Some microfinance companies are registered as NBFCs and are regulated by the RBI while other MFIs are either registered as money lenders or Societies.
The Reserve Bank of India (RBI) in 2011 approved creation of a separate category of non-banking financial companies for the MFI sector and specified that such institutions need to have a minimum net owned fund of Rs 5 crore.

An RBI-appointed panel headed by Y H Malegam had recommended setting up of a special category of NBFCs operating in the micro finance sector in 2011.These are called Non Banking Financial Company-Micro Finance Institution(NBFC-MFI)..

NBFC factor

The Reserve Bank of India (RBI) in mid-2012 introduced a new category called Non-Banking Financial Company-Factors. Under this new class, a company has to seek registration from the regulator with a minimum net owned fund (capital + reserve) of Rs 5 crore.Thus, Factoring is the business of selling invoices (receivables) to a factoring company (Factor) at a discount . Consequently, the selling corporate can get cash quickly and avoid risk of collecting debt. In India, it is still at a nascent stage. So far, there are around 10 'factors' including SBI Factors and Commercial Services, Canbank Factors, HSBC Factoring and others. Out of all factors, seven or eight companies are on standalone basis. Factoring can be of two types: domestic and export oriented, the latter being called forfaiting. Forfaiting is the purchasing of an exporter's receivables (the amount importers owe the exporter) at a discount by paying cash. The forfaiter, the purchaser of the receivables, becomes the entity to Whom the importer is obliged to pay its debt.

RBI measure will help expand the factoring industry in India.Earlier in January, 2012; the Parliament had passed a bill on the Factoring Regulations Act, 2011 wherein similar proposal were mentioned. The RBI directives came in line with that.

The factoring mechanism mostly assists smaller companies, which run relatively shorter fund flow cycle. Factoring bails them out by supporting their fund system instantly.

ECBs

ECB (External Commercial Borrowings) is an instrument used to facilitate the access to foreign money by Indian corporations and PSUs (Public Sector Undertakings). ECBs include commercial bank loans, buyers' credit, credit from official export credit agencies and commercial borrowings from the private sector window of Multilateral Financial Institutions such as International Finance Corporation (Washington), ADB and Investment by

Foreign Institutional Investors (FIIs) in dedicated debt funds . ECBs cannot be used for investment in stock market or speculation in real estate. The DEA(Department of Economic Affairs), Ministry of Finance, Government of India along with Reserve Bank of India, monitors and regulates ECB guidelines and policies. In India, External Commercial Borrowings are being permitted by the Government for providing an additional source of funds to Indian corporates and PSUs for financing expansion of existing capacity and as well as for fresh investment, to augment the resources available domestically. ECBs can be used for any purpose (rupee-related expenditure as well as imports) except for investment in stock Market and speculation in real estate.

Applicants are free to raise ECB from any internationally recognised source like banks, export credit agencies, suppliers of equipment, international capital markets etc.

ECB access may be restricted when the there is a deluge of foreign inflows and the rupee is getting strong. It may be relaxed when the opposite happens as we have seen since 2009. ECBs help diversify risk for the companies. Also, the interest rates are softer abroad. They help Indian companies with foreign funds.

Country benefits as it has access to forex.

ECBs can be raised through two routes : Automatic Route and the Approval Route. The former does not require permit from the Regulator whereas the latter requires the same. RBI policy allows corporates registered under the Companies Act. 1956, except financial intermediaries such as banks, financial institutions (FIs), housing finance companies and Non-Banking Finance Companies (NBFCs) to access ECBs. However, in September 2013, 23rd Governor of RBI Raghuram rajan allowed banks to borrow from abroad to meet their Tier 1 requirements of capital(Basel norms will, to be covered later).
NGOs engaged in micro-finance activities have been permitted to raise ECB up to certain limits.

Financial institutions dealing exclusively with infrastructure or export finance such as IDFC, IL&FS, Power Finance Corporation, Power Trading Corporation, IRCON and EXIM Bank are considered on a case-by-case basis.

The priority end use of ECBs includes investment (such as import of capital goods, new projects, modernization/expansion of existing production units) in real sector - industrial sector including small and medium enterprises (SME) and infrastructure sector, power exploration, telecom, railways, roads & bridges, ports and exports.

RBI in June 2012 decided to allow Indian companies to avail of ECBs for repayment, within limits, of Rupee loan(s) availed of from the domestic banking system .Only companies in the manufacturing and infrastructure sector will be eligible to avail of such ECBs.
Policy helps source loans cheap;domesric liquidity constraints are softened:country gets forex;rupee slide could be contained:infrastructure benefits.

Euro issues

Indian companies are permitted to raise foreign currency resources through issue of Foreign Currency Convertible Bonds (FCCBs), ordinary equity shares through Global Depository Receipts (GDRs) to foreign investors i.e. institutional investors or individuals (including NRIs) residing abroad. That is, Euro-issues include Euro-convertible bonds and GDRs.

Private equity

In finance, private equity means equity in companies that is privately placed by the management to a finance firm. It generally has a lock in period during which they are not publicly traded on a stock exchange. Bulk private placement is done.Private equity firm also is given a place in the management of the company . Capital for private equity is raised primarily from institutional investors. The term private equity has different connotations in different countries.

Stock Market (Given as a separate chapter)

Apart from the above mentioned sources of capital for Indian companies from within the country, the International Finance Corporation (IFC) of the World Bank (WB) also provides funds for the private sector. (Given in the chapter on Bretton Woods institutions).

Credit Default Swap

It is a form of insurance against debt default. When an investor buys corporate (or government) bonds he/she faces the risks of default on part of the issuing agent. The investor can insure its investment in such bonds against default through a third party. The investor pays a premium to the party providing insurance. In the event of default by the bond issuer, the insurer would step in and pay the investor. A CDS is just like insurance, which is bought by those who fear default.

Corporate debt

Corporate debt is necessary for their investment, acqusitions etc.

The following are some of the different types of corporate debt securities issued:

Non-Convertible Debentures

Partly- Convertible Debentures

Fully-Convertible Debentures (Convertible into Equity shares)

Bonds

IDF

IDFs are investment vehicles which can be sponsored by commercial banks and NBFCs in India in which domestic/offshore institutional investors, specially insurance and pension funds can invest through units and bonds issued by the IDFs. Infrastructure Debt Funds (IDFs), can be set up either as a Trust or as a Company. A trust based IDF would normally be a Mutual Fund (MF), regulated by SEBI, while a company based IDF would normally be a NBFC regulated by the Reserve Bank.IDF-MFs can be sponsored by banks and NBFCs. Only banks and Infrastructure Finance companies can sponsor IDF-NBFCs. "Sponsorship" means equity participation up to a certain permissible level.

FCCBs (see elsewhere in this chapter)

Bonds are issued to domestic and foreign investors. They are traded on the stock market.

FIIs investment in debt

FIIs can invest in government and corporate debt- primary and secondary market. These limits and the rules are relaxed from time to time depending on the needs of the economy.FII debt is rupee debt.

Take-out financing

It came into effect in 2010. It is a method of providing finance for longer duration projects (for example, 15 years) by banks by sanctioning medium term loans (like 5-7 years). It is the understanding that the loan will be taken out of books of the financing bank within pre-fixed period, by another institution thus preventing any possible asset-liability mismatch.

Under this process, the institutions engaged in long term financing such as IDFC, agree to take out the loan from books of the banks financing such projects after the fixed time period when the project reaches certain previously defined milestones. On the basis of such understanding, the bank concerned agrees to provide a medium term loan, say 5 years. At the end of five years, the bank could sell the loans to the institution and get it off its books. This ensures that the project gets long-term funding though various participants. Banks otherwise cannot lend for infrastructure as their deposits are for a short period and the loans are for a long period- asset liability mismatch.

External sources of financer for India

a. Stock market(partly touched above under Euro issues) like ADRs and GDRs

b. FCCB

c. ECB

d. IBRD and IFC

e. Private equity

f. Bilateral loans by Governments abroad

IFC rupee bond

International investors subscribed to the first ever global rupee bond, setting aside worries about rupee depreciation and other macroeconomic concerns. The first tranche of International Finance Corporation's (IFC) rupee bond saw unprecedented demand from global pension funds, banks, asset management companies and central banks.

The response to the first offshore rupee bond also paves the way for Indian corporates to raise cheaper funds as the currency risk will be borne by the investor.

The bond with a tenor of three years has a coupon of 7.75%, lower than the current G-sec reference rate by 70 basis points.

IFC, which has already raised local currency bonds in Chinese renminbi, Russia's rouble and Brazilian real, proposes to use these funds to finance private sector investment in India.

Internationalisation of rupee(in the class)

Stock Market
India and General

A stock exchange is an organization which provides a platform for trading shares- either physical or virtual. The origin of the stock market dates back to the year 1494, when the Amsterdam Stock Exchange was first set up. In a stock exchange, investors through stock brokers buy and sell shares in a wide range of listed companies. A given company may list in one or more exchanges by meeting and maintaining the listing requirements of the stock exchange.

In financial terminology, stock is the capital raised by a corporation, through the issuance and sale of shares. In common parlance, however, stocks and shares are used interchangeably .A shareholder is any person or organization which owns one or more shares issued by a corporation. The aggregate value of a corporation's issued shares , at current market prices, is its market capitalization. Stock broker buys and sells for an investor and does the work of arranging the transfer of stock from a seller to a buyer.

Importance of Stock Exchanges

- For efficient working of the economy and for the smooth functioning of the corporate form of organization, the stock exchange is an essential institution.
- an efficient medium for raising long term resources for business
- Help raise savings from the general public by the way of issue of equity / debt capital
- attract foreign currency
- exercise discipline on companies and make them profitable
- investment in backward regions for job generation
- another vehicle for investors' savings

Stock Exchanges in India

The first company that issued shares was the VOC or Dutch East India Company in the early 17th century (1602). Since then we have come a long way.With over 25m shareholders today, India has the third largest investor base in the world after the USA and Japan. Over 9,000 companies are listed on the stock exchanges, which are serviced by approximately 7,500 stockbrokers. The Indian capital market is significant in terms of the degree of development, volume of trading and its tremendous growth potential.

Stock exchanges provide an organised market for transactions in securities and other securities. There are 25 stock exchanges in the country, 21 of them being regional ones with allocated areas. BSE, National Stock Exchange (NSE), the Over the Counter Exchange of India Limited (OTCEI) , MCX-SX, USE and Inter-connected Stock Exchange of India Limited (ISE) are the pan Indian stock exchanges(read ahead). Important Stock Exchanges in India are Bombay Stock Exchange, popularly known as BSE and National Stock Exchange located in Bombay. MCX-SX began equity trading in 2013. MCX,-SX is a joint venture between Financial Technologies India (FTIL) and Multi Commodity Stock Exchange (MCX).

Stock Exchanges in India

1. Ludhiana	2. New Delhi	3. Jaipur	4. Meerut
5. Ahmedabad	6. Rajkot	7. Indore	8. Vadodara
9. Bombay	10. Pune	11. Hyderabad	12. Mangalore
13.Bangalore	14. Ernakulam	15. Coimbatore	16. Madras
17. Patna	18. Kanpur	19. Bhubaneshwar	20. Calcutta
21. Guwahati			

National Stock Exchange (NSE)

It is stock exchange located in Mumbai, India. National Stock Exchange (NSE) was established in 1992 and starts trading in 1993. It was recognised as a stock exchange in 1993. NSE has played a critical role in reforming the Indian securities market and in bringing transparency, efficiency and market integrity.

NSE has a market capitalisation of more than US$ 1 trillion 989 and 1,635 companies listed as on July 2013. Though a number of other exchanges exist, NSE and the Bombay Stock Exchange are the two most significant stock exchanges in India, and between them are responsible for the vast majority of share transactions. NSE's flagship index, the **CNX NIFTY 50**, is used extensively by investors in India and around the world to take exposure to the Indian equities market.

There are many domestic and global institutions and companies that hold stake in the exchange. Some of the domestic investors include LIC, GIC, State Bank of India and IDFC Ltd. Foreign investors include Citigroup.

The Standard & Poor's CRISIL NSE Index 50 or S&P CNX Nifty -Nifty 50 or simply Nifty is the leading index for large companies on the National Stock Exchange of India. The Nifty is a well diversified 50 stock index accounting for 21 sectors of the economy

The CNX Nifty Junior is an index for companies on the National Stock Exchange of India. It consists of 50 companies on the National Stock Exchange of India. It has the second tier of stocks in terms of market cap and don't make it into 'Nifty'.

The Inter-Connected Stock Exchange of India Limited (ISE)

The Inter-Connected Stock Exchange of India Limited (ISE) is being promoted by regional stock exchanges to set up a new national level stock exchange. The ISE would provide a national market in addition to the trading facility at the regional stock exchanges.

Indonext

BSE, Federation of Indian Stock Exchanges and regional stock exchanges have promoted IndoNext. The regional stock exchanges that are part of Indonext include Madras Stock Exchange, Bangalore Stock Exchange, Interconnected Stock Exchanges of India, Ludhiana Stock Exchange and Vadodara Stock Exchange. IndoNext is envisaged to bring liquidity and attention to stocks that are listed on RSEs.

MCX Stock Exchange Limited (MCX-SXAT)

It is an Indian stock exchange. It commenced operations in the Currency Derivatives (CD) segment in 2008 and equities in 2013. **SX40** is the flagship Index of MCX-SXAT.

USE

The **United Stock Exchange of India (USE)** is an Indian stock exchange. It is the 4th pan India exchange launched for trading financial instruments in India. USE represents the commitment of 21 Indian public sector banks, private banks, international banks (Standard Chartered) and corporate houses to build an institution of repute.

USE launched its operations in 2010 and deals in currency futures.

OTC Exchange Of India (OTCEI)

It also known as Over-the-Counter Exchange of India based in Mumbai.It is the first exchange for small companies.

OTCEI is promoted by the Unit Trust of India, the Industrial Credit and Investment Corporation of India, the Industrial Development Bank of India, the Industrial Finance Corporation of India and others and is a recognised stock exchange.

BSE

Bombay Stock Exchange (BSE) is the 11th largest stock exchange in the world by market capitalisation. Established in 1875, it has more than 5000 companies listed making it world's No. 1 exchange in terms of listed members. The companies listed on BSE Ltd command a total market capitalization of USD Trillion 1.32 as of January 2013.

BSE's popular equity index - the S&P BSE SENSEX [Formerly SENSEX] - is India's most widely tracked stock market benchmark index. It is traded internationally on the EUREX as well as leading exchanges of the BRICS nations (Brazil, Russia, China and South Africa). On Tuesday, 19 February 2013 BSE has entered into Strategic Partnership with S&P DOW JONES INDICES and the SENSEX has been renamed as "S&P BSE SENSEX".

One of the unique features inside the BSE includes the automatic online trading system known as BOLT that ensures an efficient and transparent market for trading in equity, debt instruments and derivatives.

In 2005, the status of the exchange changed from an Association of Persons (AoP) to a full fledged corporation under the BSE (Corporatization and Demutualization) Scheme, 2005 and its name was changed to The Bombay Stock Exchange Limited.

Classification of companies listed in BSE

Group	Classification
A	Companies with large capital base, large shareholder base, and good growth record with regular dividends & greater volumes in secondary market.
B1	Relatively liquid scrips with good management & satisfactory growth prospects & volumes
F	Segment for Non-convertible debentures
G	Central and State Government Securities
Z	It comprises of companies not complying with clauses of the listing agreement and are not redressing the grievances of the investor.

Sensex

Sensex or Sensitive Index is a value-weighted index composed of 30 companies with the base 1978-1979 = 100. It consists of the 30 largest and most actively traded blue chip stocks, representative of various sectors, on the Bombay Stock Exchange. Inclusion of the company is basically on the basis of market capitalization. The 30 companies in the index are revised periodically- some are replaced by others and new sectors may find representation as the economy evolves.The Sensex is generally regarded a mirror or barometer of the Indian stock markets and economy.

Demutualization

Mutualization refers to ownership and management of the exchange being combined in the same hands- brokers elected by the broker community from among themselves. Brokers are the owners of the BSE. Demutualization is when management and ownership are separated . Ownership is divested from the brokers and the company becomes a public company . All stock exchanges are to be demutualised according to the Government law made in 2004. Demutualization, thus means that ownership, management and trading rights are separated in a stock exchange.

Global rankings of BSE and NSE

The Bombay Stock Exchange (BSE) and the National Stock Exchange (NSE) are among top five bourses across the emerging economies of the world in terms of market capitalisation.Listing out a total of 14 stock exchanges across emerging countries, Sebi said the BSE stood at fourth position and the NSE at fifth among these bourses in terms of cumulative market capitalisation of all The BSE stood at the fourth position with a market cap of $1,101.87 billion as on June 30, 2012.The NSE stood at fifth spot with market valuation at $1,079.39 billion at June-end.

BSE SME and NSE Emerge

Leading bourses BSE and NSE in 2012 launched their SME exchange platforms to enable small and medium enterprises to raise funds and get listed as public entities.While BSE kick-started its SME platform under the brand name of BSE SME Exchange NSE followed suit by announcing the launch its own platform 'Emerge'.

The exchange provides an opportunity to small entrepreneurs to raise equity capital for growth and expansion. It will also provide immense opportunity for investors to identify and invest in good SMEs at early stage.

The government has been taking a number of steps for SMEs to address challenges of globalisation, higher cost of funds, IT upgrade, infrastructure constraints faced by SMEs.

SMEs have huge listing potential but so far there have been only debt-financing options, without any access to alternative equity options There is a general lack of awareness among SMEs about equity capital, stock markets and funding options, other than banks.

SEBI

The capital markets in India are regulated by the Securities and Exchange Board of India. (SEBI) It was established in 1988 and given a statutory basis in 1992 on the basis of the Parliamentary Act- SEBI Act 1992 to regulate and develop capital market. SEBI regulates the working of stock exchanges and intermediaries such as stock brokers and merchant bankers, accords approval for mutual funds, and registers Foreign Institutional Investors who wish to trade in Indian scrips. Section 11(1) of the Sebi Act says that it shall be the duty of the Board to protect the interests of investors in securities.

SEBI promotes investor's education and training of intermediaries of securities markets. It prohibits fraudulent and unfair trade practices relating to securities markets, and insider trading in securities, with the imposition of monetary penalties, on erring market intermediaries. It also regulates substantial acquisition of shares and takeover of companies and calling for information from, carrying out inspection, conducting inquiries and audits of the stock exchanges and intermediaries and self regulatory organizations in the securities market

SEBI has its head office in Mumbai and its three regional offices in New Delhi, Calcutta and Chennai.

SEBI's powers were enhanced in 2002 - strengthen the SEBI's board, enlarge it to nine from six and appoint three full-time directors; given enhanced powers to conduct search and seizure etc.

SEBI and the Reforms

The Stock Exchange Scam of 1992 (Harshad Mehta) and the scam in 2000 (Ketan Parekh) led to led to various measures by the Government to protect the interests of the small investors. SEBI introduced reforms like improved transparency, computerisation, enactment against insider trading, restrictions on forward trading, introduction of T + 2 system of settlement etc. The restriction and elimination of forward or Contango trading.

referred to in India as 'Badla' is a bold step to check speculation and manipulation of the market. Some more steps taken by SEBI to strengthen markets are

- SEBI reconstituted governing boards of the stock exchanges, introduced capital adequacy norms for brokers, and makes rules for making client/broker relationship more transparent
- SEBI enforces corporate disclosures.
- Enforces ban on insider trading
- Protects retail investors
- SEBI is empowered to register and regulate mutual funds.
- introducing a code of conduct for all credit rating agencies operating in India.
- Clause 49 of the listing agreement that SEBI introduced mandates that all listed companies should have half the Directors on the Board as Independent Directors

SEBI ordinance 2013

Government promulgated ordinance a second time in 2013 September. The ordinance is for granting greater powers to Sebi to check illicit investment schemes and other market manipulations.

The Securities Laws (Amendment) Second Ordinance, 2013 would amend the Sebi Act, the Securities Contracts (Regulation) Act and the Depositories Act .Ordinance has given Sebi greater powers to crack down on ponzi schemes, seek call data records to check insider trading and carry out search and seizure operations.

The amendments also give Sebi the legal backing to clamp down on unscrupulous entities "using newer methods to take gullible investors for a ride", as per a government statement issued at the time of promulgating the first ordinance.

As per the amended law, Sebi can regulate any money pooling scheme worth Rs 100 crore or more and attach assets in cases of non-compliance, while Sebi Chairman has been authorised to order "search and seizure operations".

Sebi has also got powers to seek any information, including telephone call data records, from any person or entity in respect to any securities transaction being investigated by it.

The amendments has also sought to clear the air over regulatory gaps and overlaps with regard to different types of instruments used in raising funds illegally

Capital market reforms

Since 1991 when the Government launched economic reforms, the following measures were taken

- SEBI given statutory status- that is Act of Parliament
- Electronic trade
- Rolling settlement to reduce speculation
- FIIs are permitted since 1992
- setting up of clearing houses
- settlement guarantee funds at all stock exchanges
- compulsory dematerialization of share certificates so as to remove problems associated with paper trading; and speed up the transfer
- clause 49 of the listing agreement for corporate governance
- restrictions on PNs

Primary market

The primary market is that part of the capital markets that deals with the issuance of new securities directly by the company to the investors. Companies, governments or public sector institutions can obtain funding through the sale of a new stock or bond issue. In the case of a new stock issue, this sale is called an initial public offering (IPO). If the company already issued shares and is going to the market again with a new issue, it is called Folllow on Public Offer(FPO).

Sebi made some far reaching reforms in favour of the retail investor in August 2012- allowed electronic bidding(e-IPO) for cost effective bidding; and made the rule that retail applicant will be allotted some shares compulsorily.

Secondary market

The secondary market is the financial market for trading of securities that have already been issued in an initial public offering. Once a newly issued stock is listed on a stock exchange, investors and speculators can trade on the exchange as there are buyers and sellers.

Types of shares

There are essentially two types of shares: common stock and preferred stock.

Preferred stock is generally issued to banks by the companies though retail investors are also eligible for them. They are preferred for the following reasons

- In terms of dividend payment, generally, they are given dividends even if the common stock holders are not
- When the company is to be closed, preference stock holders are given money first from the proceeds of the sale of the assets of the companies.
- They may have enhanced voting rights such as the ability to veto mergers or acquisitions or the right of first refusal when new shares are issued (i.e. the holder of the preferred stock can buy as much as they want before the stock is offered to others).

Derivatives

Derivative is a financial instrument.It derives from an underlying asset- securities, shares, debt instruments, commodities etc.. The price of the derivative is directly dependent upon the value of the underlying asset in the present and the projected future trends. Futures and options are the two classes of derivates.

Futures

Futures are financial instruments based on a physical underlying (commodity, equities etc.). A futures contract is an agreement between two parties to buy or sell an asset at a certain time in the future for a certain price.

Futures are part of a class of securities called derivatives, so named because such securities derive their value from the worth of an underlying investment. Futures are different from forwards as the former are traded on exchange while the later may be merely a signed contract between two parties.

Options are a class of futures where the buyer or seller has the option whether to buy or not – put option is the right but not the obligation to sell. Call option is right but not the obligation to buy.

Buyback of Shares

Buyback of shares is the process of a corporation's repurchase of stock it has issued. In the case of stocks, this reduces the number of shares outstanding, giving each remaining shareholder a larger percentage ownership of the company. This is usually considered a sign that the company's management is optimistic about the future and believes that the current share price is undervalued. The company also should have reserves to do so.

Reasons for buybacks include

- putting unused cash to use
- raising earnings per share
- reducing the number of shareholders to reduce the cost for servicing them, etc.

Shares bought back need to be cancelled and thus the total equity shrinks and the shareholders benefit. Buyback price is more than the market prices.Companies can buy back with the reserves but can not borrow to buyback.It is allowed in India since 1998.

Rolling Settlement

Rolling Settlements is a mechanism of settling trades. In Rolling Settlements, trades done on a single day are settled separately from the trades of another day on the basis of Trade day + 2 days(T+2). Such netting of trades is done only for the day. As such, in Rolling Settlement, settlement is carried out on a daily basis. Since trades done on a given day can not be bunched with those of another day. Thus, speculation is drastically reduced.

Commodity exchanges

Commodity exchanges are institutions which provide a platform for trading in 'commodity futures' just as how stock markets provide space for trading in equities and their derivatives. They thus play a critical role in price discovery where several buyers and sellers interact and determine the most efficient price for the product. Indian commodity exchanges offer trading in 'commodity futures' in a number of commodities. Presently, the regulator, Forward Markets Commission allows futures trading in over 120 commodities. There are two types of commodity exchanges in the country: national level and regional. There are five national exchanges:

- National Commodity & Derivatives Exchange Limited (NCDEX)
- Multi Commodity Exchange of India Limited (MCX)
- National Multi-Commodity Exchange of India Limited (NMCEIL)
- ACE Derivatives and Commodity Exchange
- Indian Commodity Exchange (ICEX)

The unique features of national level commodity exchanges are:

- They are demutualized,
- They provide online platforms or screen based trading
- They allow trading in a number of commodities and are hence multi-commodity exchanges.

They are national level exchanges which facilitate trading from anywhere in the country.

FMC

Forward Markets Commission (FMC) headquartered at Mumbai is a regulatory authority, which was overseen by the Ministry of Consumer Affairs and Public Distribution, Govt. of India. It is a statutory body set up in 1953 under the Forward Contracts (Regulation) Act, 1952. The Commission consists of 2-4 members. Its administrative control was shifted to Finance Ministry.

It monitors and disciplines the working of the exchanges. It recognizes an exchange or can withdraw such recognition. It collects and whenever the Commission thinks it necessary, publishes information regarding the trading conditions in respect of goods.

It makes inspection of the accounts and other documents of any recognized association or registered association or any member of such association whenever it considerers it necessary.

Forward Contracts (Regulation) Amendment Bill, 2010 was introduced in the Parliament. It seeks to make FMC into a Sebi-like regulator that is independent.

Forward Markets Commission is at present is a part of the department of consumer affairs. FMC will be given more teeth to regulate exchanges and all market participants.

In addition, the bill proposes to increase the monetary penalty for contravention of the legal provisions to up to Rs 25 lakh from a meagre Rs 1,000 at present..

New products will also be traded.

Mutual Fund

Mutual fund – a financial intermediary that mops up money , from a group of investors, to invest in capital market so as to generate returns for the investors. Mutual fund does it for a fees. There are two types of MFs.

Open-ended Funds

Open-ended or open mutual funds issue shares(units) to the investors directly at any time. The price of share is based on the fund's net asset value. Open funds have no time duration, and can be purchased or redeemed at any time on demand, but not on the stock market.

An open fund issues and redeems shares on demand, whenever investors put money into the fund or take it out.

Closed-ended fund

It is a collective investment scheme issued by a fund. Only a fixed number of shares are issued in an initial public offering which may be called New Fund Offering(NFO). They trade on an exchange. Share prices are determined not by the total net asset value (NAV), but by investor demand.

Once the offering closes, new shares are rarely issued. They can be traded only on the secondary market(stock exchanges). Shares are not normally redeemable until the fund liquidates. On the other hand, an open-end fund where the fund company creates new shares and can redeem existing shares .

The total value of all the securities in the fund divided by the number of shares in the fund is called the net asset value.

FIIs

Foreign institutional investors are organisations which invest huge sums of money in financial assets - debt and shares- of companies and in other countries- a country different from the one where they are incorporated . They include banks, insurance companies, retirement or pension funds, hedge funds and mutual funds.

Foreign individuals are not allowed to participate on their own but go through FIIs.

FIIs are allowed to invest in the primary and secondary capital markets in India through the portfolio investment scheme (PIS). The ceiling for overall investment for FIIs varies from company to company.

FIIs called hot money invested in Indian equities and debt about $30 billion in 2010.The number of registered FIIs is 1,660 and that of registered sub-accounts is above the 5,000 mark. Besides buying equities from the market, FIIs have participated in Qualified Institutional Placements (QIPs), directly from the promoters requiring huge capital.

SEBI prescribes norms to register FIIs and also to regulate FII investments.

There are more than 1700 FIIs registered in India(2012). The FII's total investments in domestic markets amount to $ 122 billion in debt and equity , since India allowed them to invest here in 1992.In the calendar year 2012 upto July, about 11b dollars of FII came into India.

Reasons for FIIs having India as a favourite destination

- growing economy
- corporate profits are high
- government policies are encouraging
- compared to other countries, India has brighter prospects

FII investment is referred to as hot money for the reason that it can leave the country at the same speed at which it comes in.

QFIs

A QFI is an individual, group or association resident in a foreign country that is compliant with Financial Action Task Force (FATF) standards.Till 2012, they were investing in India through the FIIs registered with the SEBI. From 2012, they are allowed to invest in India directly for which Sebi and RBI have made the necessary rules.

They can invest in corporate debt, equities and mutual funds.

The move comes against the backdrop of significant foreign capital outflows from the domestic equity market in recent times, which has resulted in rupee depreciation.

Its aim is to widen the class of investors, attract more foreign funds and reduce market volatility and deepen the Indian capital market.

With regard to foreign portfolio investments, till 2012, only FIIs/sub-accounts and NRIs are allowed to directly invest in the Indian equity market.

The RBI would grant general permission to QFIs for investment under the Portfolio Investment Scheme (PIS) route, similar to FIIs.

The individual and aggregate investment limit for QFIs shall be 5 per cent and 10 per cent, respectively, of the paid-up capital of an Indian company.These limits shall be over and above the FII and NRI investment ceilings prescribed under the PIS route for foreign investment in India, it added.

In mid-2012, government set a separate $1-billion corporate bond investment limit for QFIs. The finance ministry also expanded the list of countries from which such investments will be permitted.A separate sub-limit of $1 billion has been created for QFI investment in corporate bonds and mutual fund debt schemes.The foreign investment limit in corporate debt, which consequently increased by $1 billion to $21 billion will boost debt inflows.

In July 2012, Sebi allowed QFIs to invest in those debt mutual fund schemes that hold atleast 25% of their assets (either in debt or equity or both) in the infrastructure sector.

The scheme was earlier open to only residents of countries that are members of Financial Action Task Force, or FATF, a global body to check money laundering and terror funding.

Government relaxed the eligibility condition to allow investors from Gulf Cooperation Council (GCC) and also the European Commission to invest in Indian debt if they meet the local rules. A resident of IOSCO can also be a QFI.

IOSCO

The **International Organization of Securities Commissions** (IOSCO) is an association of organisations that regulate the world's securities and futures markets.

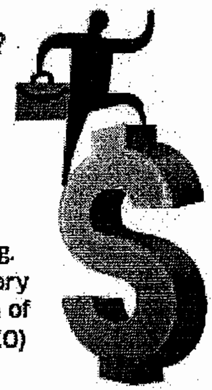
Members are typically the Securities Commission or the main financial regulator from each country. IOSCO has members from over 100 different countries, who regulate more than 90 percent of the world's securities markets. The organisations role is to assist its members to promote high standards of regulation and act as a forum for national regulators to cooperate with each other and other international organisations.India is a member.

IOSCO is has a permanent secretariat based in Madrid.

Investment First

Who are qualified foreign investors (QFIs)?

A resident of a country that is a member of the Financial Action Task Force (FATF) or member of a group which, in turn, is member of this global body against money laundering and terror funding. Resident of a country signatory to International Organization of Securities Commissions (IOSCO) or has signed a bilateral agreement with Sebi.



Where can they invest?

QFIs are now allowed to invest in all the three important segments of capital market - mutual funds, equities and corporate debt

Why has this been done?

India's current account deficit is said to have widened to over 3.6% of GDP

The capital flows needed to fill this current account gap have been muted

With weak appetite for risky assets very low, the government is trying to spur debt flow

to

FATF

The **Financial Action Task Force (on Money Laundering) (FATF)** is an intergovernmental organization founded in 1989.The purpose of the FATF is to develop policies to combat money laundering and terrorism financing. The FATF Secretariat is housed at the headquarters of the OECD in Paris.

FATF is responsible for setting global standards on anti-money laundering (AML) and combating financing of terrorism (CFT).

Following its inclusion into the select club, India and its tax enforcement authorities — the Financial Intelligence Unit, the Enforcement Directorate, the Central Economic Intelligence Bureau and the Directorate of Revenue Intelligence — would be able to exchange vital information from member-countries on money laundering and terrorist financing activities.

Global Depository Receipts (GDR)

Indian companies are allowed to raise equity capital in the international market through the issue of Global Depository Receipt (GDRs). GDRs are designated in dollars/euros or any other foreign currency.

The proceeds of the GDRs can be used for financing capital goods imports, capital expenditure including domestic purchase/installation of plant, equipment and building and investment in software development, prepayment or scheduled repayment of earlier external borrowings, and equity investment in JVs in India.

GDRs are listed on London SE or Louxembourg or elsewhere. They are also called euroissues in a general sense.

ADRs

American depository receipts are like shares. They are issued to US retail and institutional investors. They are entitled like the shares to bonus, stock split and dividend. They are listed either on Nasdaq or NYSE.

Like GDRs, they help raise equity capital in forex for various benefits like expansion, acquisition etc.

ADR route is taken as non-USA companies are not allowed to list on the US stock exchanges by issuing shares.

Similarly with Indian Depository Receipts(IDRs) as and when they are allowed.

Participatory notes

Participatory notes are instruments used for making investments in the stock markets. In India, foreign institutional investors (FIIs) use these instruments for facilitating the participation of overseas funds like hedge funds and others who are not registered with the Sebi and thus are not directly eligible for investing in Indian stocks.

Any entity investing in participatory notes is not required to register with SEBI (Securities and Exchange Board of India), whereas all FIIs have to compulsorily get registered. Participatory notes are popular because they provide a high degree of anonymity, which enables large hedge funds to carry out their operations without disclosing their identity and the source of funds. KYC(know your customer norms are not applied here)

Since the source of funds is not revealed, the PNs are potentially unsafe. Therefore, SEBI in 2007 October imposed certain conditions like limits on the PNs that a single FII can issue etc. SEBI wants the PN holders to register with the SEBI and invest directly as India is a long term growth story. Sebi policy paid off with the number of FIIs registering with the regulator going upto over about 1750(2011).

The SEBI action aims at ensuring that the quality of flows into stock markets and Indian forex market is clean.

Rajiv Gandhi Equity Savings Scheme

It was presented in as a part of the Union Budget 2012-13 for the new investors in stocks with an annual income of less than Rs.10 lakh. He gets 50 percent tax deduction on investments upto Rs 50,000. Money will be locked for three years. Details are still being worked out.

Hedge fund

A hedge fund is an investment fund open to only a limited range of investors. They are mostly unregulated. The term- hedge funds , is used to distinguish them from regulated investment funds such as mutual funds and pension funds, and insurance companies. Hedge funds are not allowed into India as they do not disclose data required by the Sebi.

Clearing house

An organisation which registers, monitors, matches and guarantees the trades of its members and carries out the final settlement of all futures transactions. The National Securities Clearing Corporation is the clearing house for the NSE.

Equity

Common stock and preferred stock that is, shares issued by the company.Also, funds provided to a business by the sale of stock.

Share

Share is a certificate representing ownership of the company that issued it. Shares can yield dividends and entitle the holder to vote at general meetings. The company may be listed on a stock exchange. Shares are also known as stock or equity.

Bond

A debt instrument issued for a period of more than one year with the purpose of raising capital by borrowing.

Debenture

Debt not secured by a specific asset of the corporation, but issued against the issuer's general credit- that is, it is unsecured debt. Investment earns an interest for the debenture holder. The following are various types of debentures

- convertible debentures can be converted into equity at a future date
- Non-convertible debentures will not be converted
- Partly convertible debentures will have some part converted into shares.

Bear

Bear is an investor who believes that market will go down.

Bull

Bull is an investor who believes that the market will go up- optimistic

Bear Market

A sustained period of falling stock prices usually preceding or accompanied by a period of poor economic performance known as a recession.

Bull Market

A stock market that is characterized by rising prices over a long period of time. The time span is not precise, but it represents a period of investor optimism, lower interest rates and economic growth. The opposite of a bear market.

Gilt

Gilt is a bond issued by the government. It is issued by the Central Bank of a country on behalf of the government. In India, Reserve Bank of India issues the treasury bills or gilts. Gilt Edged Market is the market for government securities.

Blue chip

Blue chip shares are the shares of the companies that are the most valuable. Companies that are profit making; usually dividend –paying and are liquid in the market- that is there is almost always in demand on the market.

Midcap company

Generally, companies with a market capitalization that is very high are called large caps and the next rung below is mid cap and the bottom one is small cap companies. Limits are not statutorily laid dwn and vary from institution to institution.

Small investor

Market regulator SEBI set the investment limit for retail investors in an initial share sale offer to Rs 2 lakh. This will cut the numerous applications investors sometimes make in the name of relatives to get more shares.

Sebi allows price discount for retail investors and company discount participating in initial public offers and follow-on offers. This discount is offered to attract retail investors into the market and broad base ownership.

Primary Dealers

The Reserve Bank of India introduced a system of Primary Dealers (PDs) in government securities market in 1995 with the objective to strengthen the infrastructure in the government securities market in order to make it vibrant, liquid and broad-based. The following can be the PD: subsidiaries of scheduled commercial banks and all India financial institutions and engaged predominantly in securities business and in particular the government securities market; or companies incorporated under the Companies Act, 1956 and engaged predominantly in securities business and in particular the government securities market.;The company should have net owned funds of Rs.50 crore.

Market depth

It is a dimension of market liquidity and it refers to the ability of a market to handle large trade volumes without a significant impact on prices.

Liquidity is the ease to find a trading partner for a given order.

Market breadth means the following:The fraction of the overall market that is participating in the market's up or down move. The greater the breadth, the more the companies that are participating.

Trading volumes means the number of shares traded.

Negotiated Dealing System

Negotiated Dealing System (NDS) is an electronic platform for facilitating dealing in Government Securities and Money Market Instruments.

Short selling

The sale of a security made by an investor who does not own the security. The short sale is made in expectation of a decline in the price of a security, which would allow the investor to then purchase the shares at a lower price in order to deliver the securities earlier sold short.

Market capitalization

Price per share multiplied by the total number of shares outstanding; also the market's total valuation of a public company.

P/E ratio

Also known as the P/E multiple, this is the latest closing price divided by earnings per share EPS). P/E is perhaps the single most widely used factor in assessing whether a stock is overvalued or cheap. A company's P/E should be looked at against those of similar companies, and against that of the stock market as a whole, since different industries and even different company are characterized by markedly different P/Es. In general, fast-growing technology companies have high P/Es, since the stock price is taking account of anticipated growth as well as current earnings. A high P/E is often a reflection of high expectations for a stock.

EPS

The portion of a company's profit allocated to each outstanding share of common stock. The amount is computed by dividing net earnings by the number of outstanding shares of common stock. For example, a corporation that earned Rs10 million last year and has 10 million shares outstanding would report earnings per share of Rs.1.

Insider Trading

Insider trading occurs when any one with information related to strategic and price-influencing information purchases or sells stocks so as to make speculative profits. SEBI is formulating rules which are tougher for the insider trading.

Depository

A depository holds securities (like shares, debentures, bonds, Government Securities, units etc.) of investors in electronic form. Besides holding securities, a depository also provides services related to transactions in securities. Benefits of a depository are reduction in paperwork involved in transfer of securities; reduction in transaction cost.

National Securities Depository Limited (NSDL)

In the depository system, securities are held in depository accounts, which is more or less similar to holding funds in bank accounts. Transfer of ownership of securities is done through simple account transfers.The enactment of Depositories Act in 1996 paved the way for establishment of NSDL, the first depository in India.

NSDL offers facilities like dematerialisation i.e., converting physical share certificates to electronic form; rematerialisation i.e., conversion of securities in demat form into physical certificates etc.

Nasdaq

Nasdaq stands for the National Association of Securities Dealers Automated Quotation System. Unlike the New York Stock Exchange where trades take place on an exchange, Nasdaq is an electronic stock market that uses a computerized system to provide brokers and dealers with price quotes. It is an electronic stock market- first in the world- run by the National Association of Securities Dealers. Many of the stocks traded through Nasdaq are in the technology sector.

Dow Jones Index

The New York Stock Exchange (NYSE) index, which reflects the movement of the world's first stock market. It is composed of the 32 most traded stocks of the NYSE. Currently there are three Dow Jones Indices: The Dow Jones Industrial Average (DJIA). The Dow Jones Transport Average (DJTA) and finally DJUA (Dow Jones Utility Average).

In recent years, broader indices such as the Standard & Poor's 500 (for large companies), the Russell 2000 (for smaller companies) and the Wilshire 5000 (for an especially broad measure) have gained currency, in part due to the rising popularity of index investing.

Important indices in the world

Market index is a number to indicate the average movement of prices of a securities market. It usually tracks select stocks.

- American Dow Jones Industrial Average and S&P 500 Index
- British FTSE 100: It is a share index of the 100 most highly capitalised companies listed on the London Stock Exchange. The index began in 1984 with a base level of 1000.The index is maintained by the FTSE Group, an independent company which originated as a joint venture between the Financial Times and the London Stock Exchange.
- French CAC 40
- German DAX
- Japanese Nikkei 225
- Indian Sensex and Nifty
- Australian All Ordinaries
- Hong Kong Hang Seng Index
- South Korea's Kospi
- Straits Times Index (STI) of Singapore
- Bovespa Index
- RTS Index (RTSI) is an index of 50 Russian stocks that trade on the RTS Stock Exchange in Moscow
- SSE (Shenzhen Stock Exchange) Composite Index- China
- SSE (Shanghai Stock Exchange) composite index-China

Ethical investing

A notable specialised index type is those for ethical investing indexes that include only those companies satisfying ecological or social criteria, e.g. those of Dow Jones Sustainability Index.

Ponzi scheme or pyramid scheme

A **Ponzi scheme** is a fraudulent investment operation that pays high returns to investors and promises higher returns to those who join the scheme later. The payments are done from investors own money or money paid by subsequent investors rather than from any actual profit earned because it is not possible to earn such high reurns on any investment.The system is destined to collapse because the earnings, if any, are less than the payments. The scheme is named after Charles Ponzi,who became notorious for using the technique after emigrating from Italy to the United States in 1903.

Decoupling

It means that a nation's economy may have an autonomous logic and need not be entirely dependent on the global economy. For example, if the world goes into a recession, all counties need not. India, for example grew at 6.7%(2008-09) while the USA and the west were contracting. Reflecting the economic realities, equity markets also perform autonomously after a point. It is called decoupling- that is, isolation from the rest.

China is more integrated with the world as itss economy is driven by exports. However, even China is decoupled as it has a lot of domestic consumption driving its growth.

Clause 49

Clause 49 of the Listing Agreement to the Indian stock exchange came into effect in 2005.

It has been formulated for the improvement of corporate governance in all listed companies as it mandates that there should be certain independent directors on the Board of a Company.

IDR

Indian Depository Receipts are issued by a non-Indian company to Indian investors for its listing on Indian stock exchanges. It is like ADR.

Shariah index

Asia's oldest stock exchange, the Bombay Stock Exchange (BSE), launched its Shariah index in December 2010. The index, structured in partnership with Taqwaa Advisory Shariah Investment Solutions has 50 stocks selected from the BSE-500 bracket.

Infrastructure, capital goods, IT, telecom and pharmaceuticals shares will form a large chunk of the 'BSE Tasis Shariah-50 Index', as the new index is known. But no stock will have more than an 8% weightage. The stock screening has been done by Taqwaa Advisory (Tasis) scholar board, and the index construction, by BSE.

The new index will attract investments from Arab and European countries, where Shariah funds are already popular.

Shariah, the religious law of the followers of Islam, has strictures regarding finance and commercial activities permitted for believers. Arab investors only invest in a portfolio of 'clean' stocks. They do not invest in stocks of companies dealing in alcohol, conventional financial services (banking and insurance), entertainment (cinemas and hotels), tobacco, pork meat, defence and weapons.

The index will be rebalanced every quarter though stocks that do not comply (at some point of time) with Shariah statutes will be excluded immediately. National Stock Exchange S&P CNX Shariah Index and Dow Jones Islamic India Index are other Shariah benchmarks that are tracked by investors. Shariah-based equity investments do not allow investors to invest in heavily indebted.

Brics cooperation among exchanges

In 2011 October seven major stock exchanges in Brazil, Russia, India, China and South Africa announced plans to cross-list derivatives on their benchmark indexes. The five founding members of the BRICS Exchanges Alliance began cross-listing benchmark equity index derivatives on each other"s trading platforms from 2012. The five exchanges, BM&FBOVESPA from Brazil, Open Joint Stock Company MICEX-RTS from Russia, BSE Limited from India, Hong Kong Exchanges and Clearing Limited (HKEx) as the initial China representative, and JSE Limited from South Africa, announced the formation of the alliance on 12 October 2011 at a World Federation of Exchanges" conference in Johannesburg, South Africa. In this initial stage of implementation, the exchanges aim to expand their product offerings beyond their home markets and give investors of each exchange exposure to the dynamic, emerging, and increasingly important BRICS economies.
The move was endorsed in the March 2012 Delhi summit of Brics.

Power exchanges

A power exchange created within the regulatory framework is an institution that is responsible for conducting auctions in a non-discriminatory fashion to sell power at competitive market prices . CERC has permitted trading of Electricity through Power Exchange with effect from June 2008. Currently, two exchanges viz. Indian Energy Exchange (IEX) and Power Exchange of India Limited (PXIL) are in operation in India which facilitate an automated on-line platform for physical day-ahead contracts.It is the core of an **electricity market** which is a system for effecting purchases, through bids to buy and sell.It would bring about efficiency as well as liquidity as power companies bought and sold electricity.

SGX Nifty

SGX Nifty is Indian Nifty traded in Singapore Stock Exchange. It moves with respect to Indian Nifty. SGX Nifty is open at 8.00 am Indian standard time (IST) on all working days and mostly it becomes initial direction to the Indian Market.

Inflation
Concepts, Facts and Policy

Inflation means a persistent rise in the price of goods and services. Inflation reduces the purchasing power of money. It hurts the poor more as a greater proportion of their incomes are needed to pay for their consumption. Inflation reduces savings; pushes up interest rates; dampens investment; leads to depreciation of currency thus making imports costlier.

Depending upon the rate of growth of prices, inflation can be of the following types
Creeping inflation is a rate of general price increase of 1 to 5 percent a year. Creeping inflation of 3 to 5 percent erodes the purchasing power of money when continued over many years, but it is "manageable." Furthermore, a low creeping inflation could be good for the economy as producers and traders make reasonable profits encouraging them to invest.
Trotting inflation is usually defined as a 5 to 10 percent annual rate of increase in the general level of prices that, if not controlled, might accelerate into a galloping inflation of 10 to 20 percent a year. If it aggravates, galloping inflation can worsen to "runaway" inflation which may change into a hyperinflation. Hyperinflation is inflation that is "out of control," a condition in which prices increase rapidly as a currency loses its value. No definition of hyperinflation is universally accepted. One simple definition requires a monthly inflation rate of 20 or 30% or more- 'an inflationary cycle without any tendency toward equilibrium'. The worst is a monetary collapse, if prices are not reined in , in time.
Other related concepts are

- deflation when there is a general fall in the level of prices
- disinflation which is the reduction of the rate of inflation
- stagflation which is a combination of inflation and rising unemployment due to recession and
- Reflation, which is an attempt to raise prices to counteract deflationary pressures.

Measures of inflation

GDP deflator
GDP stands for gross domestic product, the total value of all final goods and services produced within that economy during a specified period.GDP deflator is a measure of the change in prices of all new, domestically produced, final goods and services in an economy. The GDP deflator is not based on a fixed market basket of goods and services but applies to all goods and services domestically produced.

Cost of living index
The cost of living is the cost of maintaining a certain standard of living. It is defined with reference to a basket of goods and services. When their cost goes up, CoL is said to be dearer and the index will go up. It has a value of 100 in the base year. An index value of 105 indicates that the cost of living is five percent higher than in the base year.

PPI
Producer price index (PPIs) measures the change in the prices received by a producer. The difference with the WPI is accounted for by logistics, profits and taxes, mainly. Producer price inflation measures the price pressure due to increase in the costs of raw materials. It

may be absorbed by them or made up by increases in productivity or passed on to the consumers. It depends on the market conditions.

WPI

Wholesale price indices, which measure the change in price of a selection of goods at wholesale, prior to retail sales thus excluding sales taxes. These are very similar to the Producer Price Indexes.

CPI

Consumer price index measures the changes in prices paid by the consumer at the retail level. It can be for the whole community or group-specific- for example, CPI for industrial workers etc as in India.

Types of inflation based on causes

There are four major types of inflation

- **Demand-pull inflation:** inflation caused by increases in demand due to increased private and government spending, etc. It involves inflation rising as real gross domestic product rises and unemployment falls. This is commonly described as "too much money chasing too few goods". For example, India in 2010 when the economy is said to have overheated and demand outstripped supply and prices rose. Since supplies will be augmented to adjust to demand, prices will come down. It may be refered to as 'growth inflation' too. Demand-pull inflation can be caused by money supply increasing. For example, the expansionary monetary policy of the RBI in 2009 saw rates come down and easy and cheap credit pushed up prices as demand grew. From 2010 March till the end of 2011, repo rates went up 13 times and thus RBI sought to control prices by controlling demand. Wage inflation, money supply growth etc create this type of inflation.
- **Cost-push inflation:** It is also refered to as "supply shock inflation," caused by reduced supplies due to increased prices of inputs, for example, crude prices globally have gone up causing supply constraints which means higher costs of production and so higher prices. Crude and food prices shot up in 2008 July, came down and again increased. Food prices are shooting up again due to deficient monsoon and global shortages. Other examples are higher cost of capital, increases in prices of imported raw materials. Just as a shortage of goods tends to push prices up, an oversupply of commodities tends to induce the opposite effect on prices.
- **Structural inflation:** A type of persistent inflation caused by deficiencies in certain conditions in the economy such as a backward agricultural sector that is unable to respond to people's increased demand for food, inefficient distribution and storage facilities leading to artificial shortages of goods, and production of some goods controlled by some people. Food inflation currently being witnessed (2012) is structural in nature as the preference for protein foods is far ahead of its supplies and this is a phenomenon driven by income rise.
- **Speculation**
- **Cartelization**
- **Hoarding**

High Inflation hurts

If inflation is high in an economy, the following problems can arise

- low income groups are particularly hurt
- People on a fixed income (e.g. pensioners, students) will be worse off in real terms due to higher prices and equal income as before
- inflation discourages exports as domestic sales are attractive and BOP problems can be caused. Inflation may erode the external competitiveness of domestic products if it leads to higher production costs such as wage increases, higher interest rate and currency depreciation.
- inflation can drag down growth as investment climate turns bad due to instability and uncertainty and also as interest rates are raised and cost of credit increases
- Inflation may discourage saving and thus hit investment. The savings pattern also gets skewed in favour of unproductive assets like gold as inflation may be higher than interest rates and yield is negative.
- Inflation tax happens. When a government borrows and spends, the cash held by people erodes in value due to inflation
- It will redistribute income from those on fixed incomes, such as pensioners, and shifts it to those who draw an inflation-linked income and businesses.
- strikes can take place for higher wages which can cause a wage spiral. Also if strikes occur in an important industry which has a comparative advantage the nation may see a decrease in productivity, exports and growth.
- Govt fiscal deficit may go up as the need to subsidise is more to make goods and services affordable

Small amount of inflation can be good

Inflation means growth, normally- higher incomes and more demand and so more inflation. It can be argued that a low level of inflation can be good if it is a result of innovation. New products are launched at high prices, which quickly come down through competition. Therefore, there is encouragement for innovation and the problem is short lived. Also, a small price rise is necessary for wages to go up. It further helps the economy keep off deflation which can otherwise set off a recession. Besides, inflation at a moderate level is an incentive to the producer. Some see mild inflation as "greasing the wheels of commerce."

Anticipated inflation: When inflation is anticipated, individuals know what is coming, and how to deal with it. For example, banks may raise interest rates to compensate for the anticipated inflation, workers may ask for raises to maintain their real incomes, wealth holders will put their wealth into assets that will rise in value at least at the same rate as the increase in the price index, etc.

Unanticipated inflation: When inflation is unanticipated, individuals do not realize that they should protect their real purchasing power against a rising price level until the price level has already risen and their real purchasing power has already fallen. In this instance, there will be gainers and losers, in terms of purchasing power, from the inflation.

Losers: Individuals on fixed incomes, retirees, all creditors (who lent at fixed rate of interest.)

Gainers: Individuals whose incomes rise faster than inflation, debtors (who will pay back at fixed rate of interest).

In December 2013, the WPI and CPI inflation figures are as follows:
WPI showed 7% plus and CPI almost 11% rise.

To control inflation

There are fiscal, monetary, supply-side and administrative measures to control inflation to ideal/optimal rates though zero rate of inflation is never preferred for the reasons cited elsewhere in the lesson.

- Fiscal measures include reduction in indirect taxes
- Dual pricing like in sugar.
- Monetary measures include rate and reserve requirements changes. Open market operations can stabilize prices under normal conditions Also, sterilization through Government bond transactions as in the case of MSBs
- Supply side factors include making goods available- import of edible oil in India.
- Administrative measures include implementation of dehoarding and anti-black-marketing measures. Wage and price controls can also be used

Indices of Inflation

Changes in the price levels at the wholesale and retail level are tracked by various price indices in India- WPI and CPI. 3 CPIs exist for different consumer groups each of which is homogenous.

All price indices use a particular year as a "base year". That means that rises or falls in prices are measured with reference to the price in that year. For example, the base year used for the Wholesale Price Index is 2004-05. Wholesale prices of all products in the basket with their respective weightages in that year add upto "100". If, in 04-05, the wholesale price of gur was Rs 2 a kg, and rose by 50 paise the following year, it would mean that the wholesale price index for gur would rise to 125 in 2005-06. But the movement of an index is based on the average of price movement of all the goods in the basket and not just one article. Different base years are used for different price indices due to convenience, data availability, logistics etc.

WPI

The Wholesale Price Index

Government launched a new series of wholesale price index (WPI) with 2004-05 as base from 2010. Earlier, 1993-94 was used as base year to calculate WPI. The new series of WPI has 676 items as against 435 items in the previous series. Consumer items widely used by the middle class like ice-cream, mineral water, flowers, microwave oven, washing machine, gold and silver are reflected in the new series of WPI. This would give better picture of the price variation. Readymade food, computer stationary, refrigerators, dish antenna, VCD, petroleum products and computers will also be part of the new series.

Under primary article group of the new WPI, there are 102 items against earlier 98, while fuel and power category remains static at 19. In the new series, there are 555 items of manufactured products compared to 318 items earlier.

241 new items are there in the basket of commodities making up the official wholesale price index in a bid to reflect changes in India's price line and consumption pattern better. The new series altered the weight attached to each commodity group.

Manufactured items now have a higher weight of 64.972 as against 63.749 earlier. The weight for fuels has also increased to 14.910 against 14.226. But for primary articles, the weight is down at 20.118 against 22.025.

In a bid to reflect the actual consumption pattern, the new series drops as many as 200 items sach as typewriters, video cassette recorders, to make a room for items like computers, refrigerators, televisions and video disc players.

Government is also working on a two new indices to reflect the changes in the cost of services — one on financial services and the other on trade and transport.

The Indian WPI is now updated on a monthly basis. The WPI is published by the Economic Advisor in the Ministry of Commerce and Industry, with a two week lag, tracks the wholesale traded price of 676 items that include agricultural commodities (such as rice, tea, raw cotton, groundnut oil seed), industrial commodities (such as iron ore, bauxite, coking coal), intermediate products for industry (such as cotton yarn, polyester fiber, synthetic resins, iron & steel, sheet glass), products for consumers (atta, sugar, paper, electricity, ceiling fans) and energy items (petrol, kerosene, electricity for commercial use). The weight attached to each item in the index is meant to reflect the volume (by value) of wholesale trade in that item in the Indian market.

The index is a vital guide in economic analysis and policy formulation. WPI covers primary goods, power/fuel and manufactured goods.

The WPI is not intended to capture the effect of price rise on the consumer though it generally and broadly indicates it.

WPI has an All India character. It is due to these attributes that it is widely used in business and industry circles and in Government and is generally taken as an indicator of the rate of inflation in the economy.

To reflect the structural changes in the economy that have taken place over a decade, a large number of commodities have been added and a few with diminished importance have been dropped.

WPI is announced with a time lag of two weeks. The data is made final after a period of 8 weeks.

The inflation rate is calculated on point to point basis i.e. on the basis of the variation between the index of the latest week of the current year and for the corresponding week of the previous year.

There are a number of agricultural commodities, especially, some fruits and vegetables, which are of a seasonal nature. Such seasonal items are handled in the index in a special manner. When a particular seasonal item disappears from the market and its prices are not quoted, the index of such an item ceases to get compiled and its weight is distributed over the remaining items and new seasonal items, if any, in the concerned sub-group.
The advantage of the WPI is that it covers more goods; is available with relatively small time lag of fortnight; is convenient to compile. Disadvantages are that it does not include services like transport, health, education etc.

Limitations on WPI

The accuracy of WPI is unsatisfactory even after the introduction of the revised series in 2010. Services such as rail and road transport, health care, postal, banking and insurance, for example, are not part of the WPI basket. Neither are the products of the unorganised sector that are estimated to constitute about 35 per cent of the total manufactured output of the country. The index thus falls well short of being a broad based indicator of the price level even in its construction.

WPI: new reporting method

From 2009, government presented WPI inflation figures on a monthly basis instead of weekly system. Analysts say since weekly data on wholesale price index-based inflation do not adequately capture the movement of prices of manufactured goods, government has to often revise the figures later. Therefore, the government decided to have weekly release of inflation data on food and fuel prices and monthly data on WPI. Inflation of primary goods within the WPI is reported on a weekly basis. But from 2011, the WPI is reported every month, including the food and primary article data

Comparative Statement of Commodities and price quotations

	No of Commodities		No of Price Quotations	
	1993-94	2004-05	1993-94	2004-05
All Commodities	435	676	1918	5482
Primary Articles	98	102	455	579
Fuel and Power	19	19	72	72
Manufactured Products	318	555	1391	4831

Weightage of the Sub Indices

	1993-94	2004-05
All Commodities	100%	100%
Primary Articles	22.025%	20.118%
Fuel and Power	14.226%	14.910%
Manufactured Products	63.749%	64.972%

CPI

There are three Consumer Price Indices in India. Each tracks the retail prices of goods and services for specific group of people, because the consumption patterns of different groups differ.

For Industrial Workers (CPI-IW), a basket of 370 commodities is tracked; for Urban Non-Manual Employees (CPI-UNME), 180 commodities; for Agricultural Labourers (CPI-AL), 60 commodities. The respective base years are 2001, 1984-85 and 1986-87. The first two indices have services in them. These baskets and the weightages to each item have been determined on the basis of surveys of consumption patterns. Information also differs from centre to centre around the country; the all-India figures declared are averages.

Mahatma Gandhi NaREGA wages are to be indexed to the CPI(AL) from the beginning of the year 2011.

CSO decided to discontinue CPI(UNME) from 2008.

Each commodity is given a specific weightage, which differs from one index to another index. For example, the CPI-AL would give a greater weightage to foodgrains than the CPI-UNME, since a greater proportion of the agricultural labourer's expenditure would go toward foodgrains, and he would be unlikely to buy the sort of items the office-goer would buy.

The coverage of CPI IW is broader than the other indices of CPI like the CPI for agricultural laborers (AL) and the CPI for urban non-manual employees (UNME).

In the organised sector, CPI-IW is used as a cost of living index.

CPI-AL and CPI-UNME are not considered as robust national inflation measures because they are designed for specific groups of population with the main purpose of measuring the impact of price rise on rural and urban poverty.

In accordance with the Government of India (Allocation of Business) Rules, 1961, as amended from time to time, it is the responsibility of the Ministry of Labour to compile and release the data on the CPI for Industrial Workers and the data on the CPI for Rural Labourers. It is the responsibility of the Ministry of Statistics and Programme Implementation to compile and release the data on the CPI for Urban Non-Manual Employees.

The Government of India (Allocation of Business) Rules, 1961, with subsequent amendments, assigns the responsibility for compiling the WPI to the Office of the Economic Adviser in the Department of Industrial Policy and Promotion under the Ministry of Commerce and Industry. The Economic Adviser holds the final authority for all decisions regarding the WPI.
The national income deflator(GDP deflator) is a comprehensive measure statistically derived from national accounts data released by the Central Statistical Organization (CSO). Since it encompasses the entire spectrum of economic activities including services, the scope and coverage of national income deflator is wider than any other measure. At present, the GDP deflator is available only annually with a long lag of over one year and hence has very limited use for the conduct of policy.

Difference between wholesale prices and consumer prices
WPI measures price rise at the wholesale level. Wholesale means sale in large quantities and meant for resale It covers a certain set of goods that are traded at the wholesale level. CPI on the other hand measures price rise at the retail level. There is a difference between the two. The difference is due to a number of factors. A substantial portion of the differential is accounted for by the retailers' margins which are built into what the consumer pays. Besides, the way the two indices are calculated differs both in terms of weightage assigned to products as well as the kind of items included in the basket of products.

While wholesale prices are more or less the same throughout the country, consumer prices or retail prices vary across regions (rural and urban) and also across cities according to the consumer preferences for certain products, supplies and purchasing power. Besides, taxes levied by states comprise an important component of the variation in prices of many products.

Therefore, give WPI an important place in government policy as it is more representative ; figues come quickly relatively; and has an all India character.

Divergence between WPI and CPI

Why do WPI and CPIs differ? They differ in terms of their weighting pattern. First, food has a larger weight in CPI ranging from 46 per cent in CPI-IW to 69 per cent in CPI-AL whereas it has a weight of only 27 per cent in WPI. The CPIs are, therefore, more sensitive to changes in prices of food items. Second, the fuel group has a much higher weight in the WPI (14.2 per cent) than the CPIs (5.5 to 8.4 per cent). As a result, movement in international crude prices has a greater bearing on WPI than on the CPIs. Third, services are not covered under WPI while they are, to different degrees, covered under CPIs. Consequently, service price inflation has a greater influence on CPIs.

New CPI series

The Central Statistics Office (CSO) of the Ministry of Statistics & Programme Implementation introduced the new series of Consumer Price Index (CPI) numbers for Rural, Urban and Combined (Rural +Urban) on base 2010 =100 taking all segments of rural and urban population for the States/UTs and all- India . Since 2011, the new series is force. These indices are available for five major groups namely Food, beverages and tobacco; Fuel and light; Housing; Clothing, bedding and footwear, and Miscellaneous.

Present CPI numbers do not encompass all the segments of the population in the country and as such they do not reflect the true picture of the price behavior in the country. It is therefore necessary to compile a CPI which takes into account the consumption patterns of all segments of the population and includes services.

New series of CPI for urban areas

CPI (Urban) numbers are compiled at State/UT as well as at all- India level. Weighting diagrams (consumption patterns) of the CPI (Urban) have been derived from the results of the NSS 61st round of Consumer Expenditure Survey (2004-05). For regular price collection, 310 towns have been selected, which include all State/UT capitals. From each selected town, price data are collected in respect of items consumed by the population of the respective State/UT. In all, 1114 price schedules containing an average of 250 items are canvassed every month. House rent data are also collected from a fixed set of rented dwellings from the selected towns. Prices of items are collected by the field officials of the National Sample Survey Office (NSSO).

New series of CPI for rural areas

CPI (Rural) numbers are compiled at state/UT and all- India levels. Weighting diagrams of the CPI (Rural) have also been derived from the results of the NSS 61st round of Consumer Expenditure Survey (2004-05).

Considering the fact that the CPI (Rural) would provide the price changes for the entire rural population of the country, a total of 1181 villages have been selected at all India level. Regular prices are collected by the officials of the Department of Posts. One schedule containing an average of 225 items from each selected village is canvassed for collection of prices every month.

National CPI

CSO will also compile national CPI by merging CPI (Rural) and CPI (Urban) with appropriate weights, as derived from NSS 61st round of Consumer Expenditure Survey (2004-05) data.

Weighting diagrams

The share (weight) of the Food, beverages and tobacco group in the all India CPI (Rural) is 59.31% and it is 37.15% in the all India CPI (Urban). Fuel and light group has a weight of 10.42% in CPI (Rural) and 8.40% in CPI (Urban). Clothing, bedding and footwear group has weight of 5.36% in CPI (Rural) and the weightage of 3.91% in CPI (Urban). Housing group has not been given any weightage in the rural areas CPI as its share is around 1% and it has been distributed to other groups on pro rata basis. CPI (Urban) has a weightage of 22.53% in respect of Housing group. The Miscellaneous Group consisting of education, medical care, transport and communication etc has 24.91% weight in the all India CPI (Rural) and the corresponding weight in the all India CPI (Urban) is 28%.

Release of indices

Index numbers for both rural and urban areas and also combined for each month and released. Indices are released with a time lag of one month.

Revision of indices

These new CPI numbers would be revised on the basis of the results of the next round of Consumer Expenditure Survey scheduled to be conducted during 2011-12 by the NSSO. Thereafter, revision will be undertaken every five years or so (whenever large scale Consumer Expenditure Survey data become available).

New series of CPI-- All India weights			
Sub group/group	**Rural**	**Urban**	**Combined (Rural+Urban)**
Cereals and products	19.08	8.73	14.59
Pulses and products	3.25	1.87	2.65
Milk and milk products	8.59	6.61	7.73
Oils and fats	4.67	2.89	3.90
Egg, fish and meat	3.38	2.26	2.89
Vegetables	6.57	3.96	5.44
Fruits	1.90	1.88	1.89
Sugar etc	2.41	1.26	1.91
Condiments and spices	2.13	1.16	1.71
Non- alcoholic beverages	2.04	2.02	2.03
Prepared meals etc	2.57	3.17	2.83
Pan, tobacco and Intoxicants	2.73	1.35	2.13
Food, beverages and tobacco	**59.31**	**37.15**	**49.71**
Fuel and light	**10.42**	**8.40**	**9.49**
Clothing and bedding	4.60	3.34	4.05
Footwear	0.77	0.57	0.68
Clothing, bedding and	**5.36**	**3.91**	**4.73**

footwear			
Housing		**22.53**	**9.77**
Education	2.71	4.18	3.35
Medical care	6.72	4.34	5.69
Recreation and amusement	1.00	1.99	1.43
Transport and communication	5.83	9.84	7.57
Personal care and effects	3.05	2.74	2.92
Household requisites	4.48	3.92	4.30
Others	1.12	0.99	1.06
Miscellaneous	**24.91**	**28.00**	**26.31**
All Groups	**100.00**	**100.00**	**100.00**

The new series is broad based and covers the entire rural and urban population. In the new series compiled by Central Statistics Office, the consumption patterns have been derived from the results of the Consumer Expenditure Survey conducted by the National Sample Survey Office during 2004-05. Food group weights in all-India CPI (Rural), CPI (Urban) and CPI (Combined) are 59.31%, 37.15% and 49.71% respectively. Remaining weights are for non-food groups i.e. housing, fuel & light, clothing & footwear and miscellaneous group.

Which index should one use?

The WPI is useful in certain contexts. For example, for industrialists, the costs of setting up a factory over the course of several years; and further to calculate the costs of production and returns over several years. The basket of items in the CPI does not include machinery, chemicals, and so on; secondly, the price of electricity in the CPI is the consumer tariffs, not the industrial tariffs; and so on.

Figures for inflation in the WPI are on the average much lower than those in the CPI indices. There could be two reasons for this difference in rates between the WPI and CPI: first, prices of the items in the CPI basket might have risen more sharply than items excluded from it — this would mean that prices of mass consumption goods have risen more sharply than inputs for production; secondly, the retail prices of commodities might have grown more sharply than the wholesale prices, indicating that middlemen have taken a bigger share.

Services and price index

While the WPI now does not include services, the two consumer price indices (CPI) meant for urban non-manual employees and industrial workers, do include certain services such as medical care, education, recreation and amusement, transport and communication. On the other hand, some of the other major services such as trade, hotels, financing, insurance, real estate and business services do not find a mention either in the WPI or in the CPIs.

In India, the services sector accounts for about 57 per cent of the GDP.

In August 2010, Department of Industrial Policy and Promotion (DIPP), Ministry of Commerce & Industry constituted an Expert Committee to render technical advice for development of Service Price Index (SPI) and its related issues. The Committee is chaired by Prof. C. P. Chandrasekhar.

Producer price index
The process of introducing the producer price index (PPI) is also underway in India, according to Dr Abhijit Sen, Member of Planning Commission. It means prices of goods as they are sold to the wholesalers by the producers. The difference between WPI and PPI is accounted for by the margins and other transport and distribution costs.

'Core' or' Underlying Inflation'
Core or underlying inflation measures the long-run trend in the general price level. Temporary effects on inflation are factored out to calculate core inflation. For this purpose, certain items are usually excluded from the computation of core inflation. These items include: changes in the price of fuel and food which are volatile or subject to short-term fluctuations and/or seasonal in nature like food items. In other words, core or underlying inflation is an alternative measure of inflation that eliminates transitory effects .The main argument here is that the central bank should effectively be responding to the demand side- for example, the money available in the market, demand for credit and so on and not the supply shocks like energy and food. Core inflation in India on the WPI is about 2%.Headline inflation on the other hand includes the official rate of increase in prices that excludes no item in the basket. Core includes the primary articles and the food processing part of manufacturing.

Inflation Targeting
Inflation targeting focuses mainly on achieving price stability as the ultimate objective of monetary policy. This approach entails the announcement of an inflation target- either a number or a range, that the central bank promises to achieve over a given time period. The targeted inflation rate will be set jointly by the RBI and the government, the responsibility of achieving the target would rest primarily on the RBI on the demand side and supply side is that of the government. This would reflect an active government participation in achieving the goal of price stability with fiscal discipline by way of a rational borrowing programme (not borrowing in excess).

Monetary policy and fiscal policy have to converge for achievement of inflation targeting. Advantage is that it promotes transparency in the conduct of monetary policy. Further, it increases the accountability of monetary authorities to the inflation objective.

Prices impact on the macro economy in many ways – welfare of people, growth and stability of the economy in a globalised order.

We do not adopt this policy in India.

Ideal level of Inflation
Ideal inflation rate is one that takes into consideration human, social and economic impact. It is the level of inflation beyond which the adverse consequences are strong. Chakravarty Committee (1985) had indicated 4 per cent as an acceptable level of inflation on a long-term basis However, such a level of inflation cannot be fixed at one level for all times. It depends on growth rate. It also depends on what the global levels are. RBI sees about 5.5% rate of inflation as 'comfortable'- neither does it hurt in human terms nor in growth terms.

Collection of Statistics Act, 2008
Collection of Statistics Act, 2008 was made to bring in new rules aimed at improving data collection.

Government will levy higher penalty for not sharing data and tougher punishment will be imposed in cases where manipulation of data is involved, they say.

Under the new Act, people or companies not divulging data would have to pay a fine of Rs 1,000 and they would be given a 14-day notice period to comply. If the information is not provided even after two weeks, the penalty will rise to Rs 5,000 per day.

Under the old Act, which was passed in 1953, the penalty was only Rs 500 for the first default and Rs 200 per day thereafter.

The new penalty scheme will ensure that data collection is done on time. It will increase the accuracy of the data

The Act also makes wilful manipulation or omission of data a criminal offence, punishable by a prison term that may extend up to 6 months. This penalty will also apply if a company prevents or obstructs any employee from collecting data.

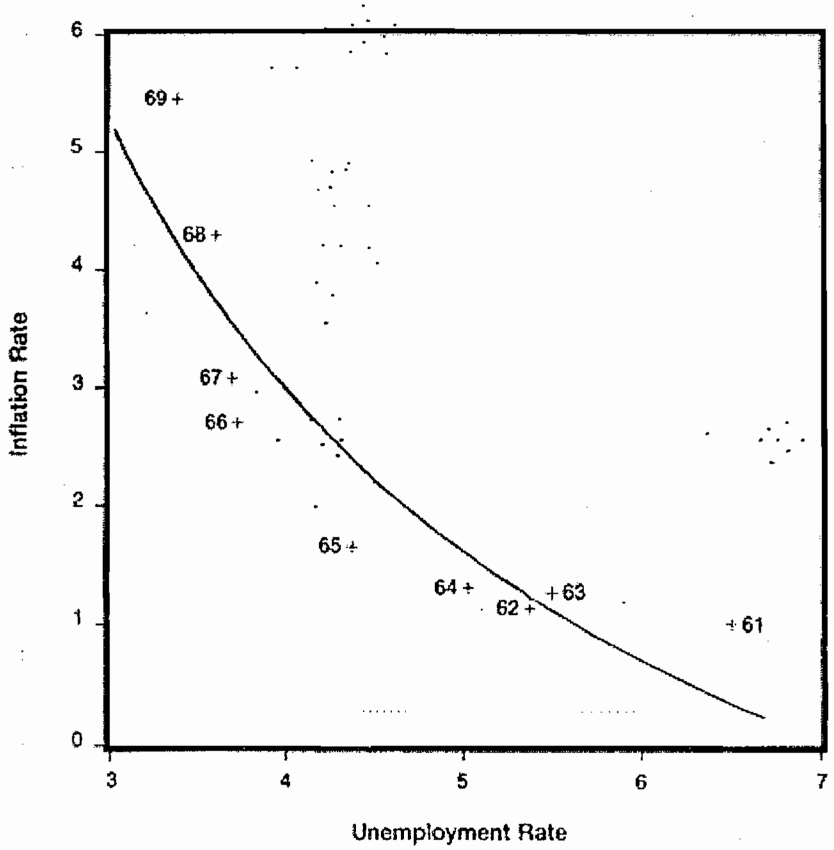
The Collection of Statistics Act, 2008, gives powers to the government to classify any statistics as "core statistics" and also determine the method to collect and disseminate the same

Philips's curve

The inverse relationship between rate of inflation and rate of unemployment is shown in the **Phillips curve:** price stability has a trade-off against employment. Some level of inflation could be considered desirable in order to minimize unemployment.

Potential output (sometimes called the "natural gross domestic product") is an important concept in relation to inflation. It is the level of GDP where the economy is at its optimal level of production, given various constraints- institutional and natural.

This level of output corresponds to the Non-Accelerating Inflation Rate of Unemployment, NAIRU. If GDP exceeds its potential, inflation will accelerate and if GDP falls below its potential level, inflation will decelerate as suppliers attempt to use excess capacity by cutting prices.



Deflation

Deflation is a prolonged and widespread decline in prices that causes consumers and businesses to curb spending as they wait for prices to fall further. It is the opposite of inflation, when prices rise, and should not be confused with disinflation, which merely describes a slowdown in the rate of inflation.
Deflation occurs when an economy's annual headline inflation indicator -- typically the consumer price index -- enters negative territory.
Deflation is hard to deal with because it is self-reinforcing. Put simply, unless it is stopped early, deflation can breed deflation, leading to what is known as a deflationary spiral.

When an economy has fallen into deflation, demand from businesses and consumers to buy products falls because they expect to pay less later as prices fall. But as producers struggle to sell and go bankrupt, unemployment rises, reducing demand further. That causes deflation to become more pronounced.

It makes it more expensive to service existing debts. This is as true of governments, who have borrowed trillions of dollars globally to prop up the financial sector, as it is for consumers.
As debt becomes more expensive to pay off, the risk of default and bankruptcy rises too, making banks more wary of lending. This reduces demand and further exacerbates the deflationary problem.
Remedy

- Tax cuts to boost demand from consumers and businesses
- Lowering central bank interest rates to encourage economic activity
- Printing more currency to boost money supply
- Capital injections into the banking system
- Increase government spending on projects that boost the return on private investment

India did not face the threat of deflation as demand has not dropped so much. Also, food scarcity meant food prices did not fall. In fact they rose.

India and deflation

On the WPI, we faced disinflation- rate of growth of prices fell but not prices themselves till the first quarter of 2009. In the second quarter and later, there was `deflation' on the WPI. This negative inflation is due to higher base as inflation peaked in July 2008 due to international energy and food price rises because of speculation.

The deflationary phase was short lived for a few weeks as the fiscal as well as monetary measures of the government started showing results and demand and growth returned.

Growth -inflation trade off

With high growth, economy overheats. .Overheating of the economy means demand overshoots supply and there is pressure on prices. As growth creates more employment and incomes rise, demands rises pushing up prices.

As prices rise, the central bank intervenes and raises rates to cool consumption and so prices fall relatively. Repo rates- the policy rate- is the tool along with CRR and OMOs available to the central bank as signals to the economy that it is ready to act to soften prices -partly because the poor suffer disproportionately and partly because inflation can derail the medium and long term growth.

Such intervention by the central bank has a dampening impact on growth as higher interest rates prevent easy borrowing and thus demand slackens.

We witnessed the same in India with CRR and repo rates going down from 2009 for one year and later till 2011 going up in reponse to priceline in the country. Today they stand at 4% and 7.75% respectively (December 2013)The primary goal of the RBI is to moderate and stabilize prices.

Thus, growth and inflation are intimately connected- one being traded for the other depending upon where the growth situation stands.

As prices stabilise, growth resumes and a new and higher base is set for the growth process. Growth and inflation do have a trade off but that is only in the short term. As Dr.C.Rangarajan says, growth is a marathon while overheating and slow down are temporary pauses to gain greater strength.

Further, unless the RBI raises the policy rates with inflation going up, there is a danger of banks failing to attract deposits as real interest rates become negative and savings may be diverted to unproductive assets like gold with serious consequences- inside and outside for the economy.

Fiscal drag operates in an overheated economy. That is the tax liability increases as wages rise. That leaves less purchasing power in the hands of the people and so demands drops automatically. It acts as an automatic stabilizer.

Inflation in India

Reasons for the current inflation

In spite of the steps of the government, prices are relentlessly on rise. WPI at 7.5% and CPI above 10% in mid-2012 have many reasons

- Growth
- The bad monsoons and the decline in production raised inflationary expectations
- Even as the buffer stocks accumulated to huge surplus, governance problems and the fiscal pressures of the states prevented them from being distributed
- Narega
- MSP increases
- Fuel price deregulation for petrol and increase in the prices of diesel and LPG
- Hoarding and cartelization as in the case of food items, cement
- Middle men
- APMC Acts of States
- Diesel price deregulation in phases
- Imported inflation due to rupee depreciation since late 2011

For food inflation, Dr. Subba Rao gave the following reasons in November 2011 and they continue to be relevant

1. Shift in dietary habits towards protein foods.
2. Pressure stemming from inclusive growth policies.
3. Large increases in MSPs of food grains.
4. Shocks from global food inflation.
5. Financialisation of commodities.

Government steps to control inflation

The Government has taken a number of short term and medium term measures to improve domestic availability of essential commodities and moderate inflation.

It has procured record food grains. Even after keeping the minimum buffer stock, there are enough food grains to intervene in the market to keep the prices at reasonable level.

A Strategic Reserve of 5 million tonnes of wheat and rice has also been created to offload n the open market when prices are high. This is in addition to the buffer stock held by FCI every year.

Issue price of grains supplied through PDS outlets are frozen.

The price situation is reviewed periodically at high-level meetings such as the Cabinet Committee on Prices (CCP).

Fiscal Measures

- Reduced import duties on food items
- Import duties are raised on gold etc to contain CAD

Administrative Measures

- Ban on exports of food items
- Dehoarding

Monetary Measures

Repo rates were raised and CRR also went up to make credit dearer.

Inflation and corruption

The link is as follows

a. through black money
b. hoarding not being checked
c. commodity prices being manipulated through speculation as NSEL crisis shows.

Open inflation

When the government does not attempt to prevent a price rise, inflation is said to be open. Thus, inflation is open when prices rise without any interruption. In open inflation, the free market mechanism is permitted to fulfill its historic function of rationing the short supply of goods and distribute them according to consumer's ability to pay. Therefore, the essential characteristics of an open inflation lie in the operation of the price mechanism as the sole distributing agent.

Repressed / suppressed inflation

When the government interrupts a price rise, there is a repressed or suppressed' inflation. Thus, it refers to those conditions in which price increases are prevented at the present time through an adoption of certain measures like price controls and subsidies like diesel subsidy etc.

Inflation tax

Price rise means more money being paid by the consumers for what they buy. Thus, it is a type of tax.

TAXATION IN INDIA: Concepts and Policies

Tax is a payment compulsorily collected from individuals or firms by government. A direct tax is levied on the income or profits of an individual or a company. The word `direct' is used to denote the fact that the burden of tax falls on the individual or the company paying the tax and can not be passed on to anybody else. For example, income tax, corporate tax, wealth tax etc. An `indirect' tax is levied on manufacturing and sale of goods or services. It is called `indirect' because the real burden of such a tax is not borne by the individual or firm paying it but is passed on to the consumer. Excise duty, customs duty, sales tax etc.

Funds provided by taxation are used by governments to carry out the functions such as:

- military defense
- enforcement of law and order
- redistribution of wealth
- economic infrastructure — roads, ports etc
- social welfare
- social infrastructure like education, health etc
- social security measures like pensions for the elderly, unemployment benefits

Taxation System in India

India has a well developed tax structure. Being a federal country, the authority to levy taxes is divided between the central government and the state governments. The central government levies direct taxes such as personal income tax and corporate tax, and indirect taxes like customs duties, excise duties and central sales tax (CST). CST is assigned to the States in which it is collected. (Art.269). The states have the constitutional power to levy sales tax apart from various other local taxes like entry tax, octroi, etc.

Taxation has always played an important role in the formulation of the government's economic policy. Taxation policy in a developing country like India can play an important part to raise resources for growth; to bring in reduction in inequalities; to direct growth in backward regions; to reduce consumption of luxury goods; to direct investment into small scale sector; to promote savings etc. In the wake of the economic reforms, the tax structure and procedures have been rationalised and simplified. Since 1991, the tax system in India has undergone substantial rationalization- reduced rates and slabs and better administration.
Some of the changes are:

- Broadening the tax base to include services, fringe benefits, stock market transactions etc
- Reduction in customs and excise duties. Peak customs rate is today 10%
- Lowering of corporate tax rates to 30%
- Rationalizing the personal income tax rates and slabs starting from 1997 `dream budget'
- Sales tax reforms at the State level as a preliminary step towards their integration into GST
- introduction of VAT from 2005 at the state level; GST is expected to be introduced in 2011
- Simplifying income tax return filing procedures. For example, Saral. Towards better taxpayer services, in 2011-12, the IT department has introduced simple and user friendly

SAHAJ (Form) for individual salary tax-payers; SUGAM for small tax-payers availing presumptive tax scheme.(For presumptive tax, see ahead)

Tax revenue as a percentage of GDP decreased initially, after reforms began in 1991, as rates came down and growth of economy was not very robust. Compliance also did not increase proportionate to rate reduction. Since the Tenth Plan period, there has been a consistent rise in tax collections but it dipped due to global financial crisis of post-2008 period. GOI expects Rs.1.24 lakh crore for service tax collection during 2012-13 due to wider coverage and higher rate (12%).In 2011-12, the tax-GDP ratio stood at 5.5 per cent for direct taxes and 4.4 per cent for indirect taxes.

Government expected to increase its gross tax revenue by 19.5% to Rs 10.77 trillion in the financial year 2012-13.

The gross tax revenue is estimated at 10.6% of the gross domestic product (GDP) in the Budget estimates 2012-13.

Revenue from corporation tax is the highest contributor at Rs 3.73 trillion to the government's total revenue, while income tax, customs, union excise duties, and service tax yielded Rs 1.95 trillion, Rs 1.86 trillion, Rs 1.94 trillion and Rs 1.24 trillion, respectively.

Direct tax revenue growth is estimated at Rs 5.7 trillion, up 13.9% and indirect tax revenue growth is estimated at Rs 5.05 trillion, up 26.7%.

The government targeted a net tax revenue of Rs 7.71 trillion in 2012-13, after devolution to the states.

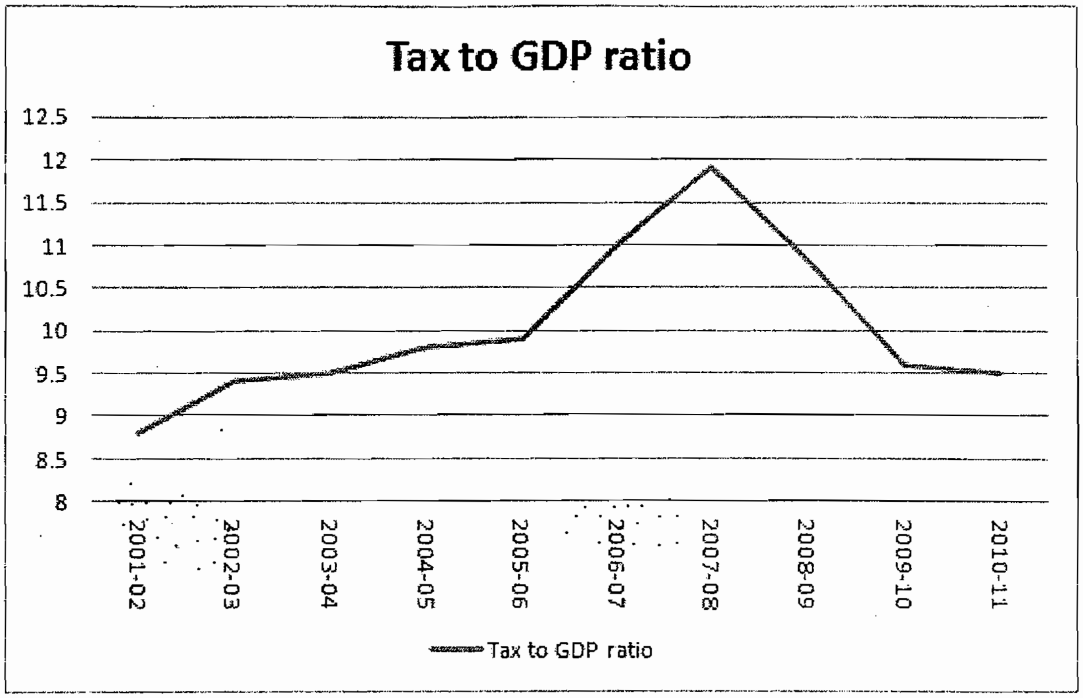
The non-tax revenue receipts are estimated at Rs 1.64 trillion and non-debt capital receipts are estimated at Rs 416.5 billion.

Expenditure:
The government's total expenditure is budgeted at Rs 14.9 trillion for 2012-13.
Of this, the plan expenditure is projected 22.13% higher at Rs 5.21 trillion.
Non-plan expenditure for 2012-13 is budgeted at Rs 9.69 trillion.

Measures for broadening tax base, strengthening compliance and simplification

- Rates and slabs are rationalized
- Negative list of services for taxation from 2012 at 12%
- adoption of VAT by almost all the states
- GST introduction
- Tax to be deducted at source on various items like interest on bank deposits; dividend distribution etc
- Quoting of permanent account number made compulsory for many transactions so more people can be brought into tax net
- securities transactions tax

Other measures suggested are: minimizing exemptions and concessions; drastic simplification of laws and procedures; building a proper information system and computerization of tax returns, and a thorough revamping and modernization of the administrative and enforcement machinery.



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(In Rs crore)

	1990-91	2000-01	2007-08	2008-09	2009-10 (BE)	2009-10 (RE)	2010-11 (BE)
DIRECT*	11024	68306	295938	319859	370000	380608	422500
Income	5371	31764	102644	106046	112850	125021	120566
Corporation	5335	35696	192911	213395	256725	255076	301331
INDIRECT	45158	118681	278345	269433	269477	244477	315000
Excise	24514	68526	123425	108613	106477	102000	132000
Customs	20644	47542	104119	99879	98000	84477	115000
Service	Nil	2613	51301	60941	65000	58000	68000
TOTAL**	57576	188603	593147	605298	641079	633095	746651
DIRECT %	19.15	36.22	49.89	52.84	57.72	60.12	56.59
TAX-GDP %	10.11	8.97	11.99	10.86	10.95	10.27	10.77

*Includes taxes on interest, expenditure, estate, gift and wealth;
**Includes 'other taxes & duties' and 'taxes of Union Territories';
BE: Budget Estimates; RE: Revised Estimates.

Tax collections 2012-13

As can be seen from the table above, Government of India's tax receipts were growing healthily. It helps government spend more on social projects.

The reasons for the tax collections being so healthy till recently

- economy is growing at a satisfactory pace- 6.5% in 2011-12
- incomes of individuals have gone up
- lower tax rates help compliance
- procedures are simple and citizen-friendly
- base has been widened
- a drive has been mounted to bring more people to pay income tax with proper investigation

Direct and Indirect Taxes in India: The Changing Scenario

As can be seen from table, direct tax collections are more than indirect tax collections. In 1990-91, less than a fifth of the Centre's gross tax revenues came from direct taxes.

The biggest taxation source of the Centre now is corporate tax and next is income tax.

The general level of prosperity in the country is increasing making more people have taxable incomes. Also, when companies are growing in number and also in their profitability, corporate tax collections increase. Global opportunities mean more profits. Stock market transactions and wealth build-up also contribute to direct tax collections by way of STT, capital gains tax, income tax. .Apart from the above reasons, the Government's measures as given below also helped increase the direct tax collections

- reduction of peak income tax rates that helps compliance
- reduction in the number of slabs
- strengthening the administration- e-governance etc
- simplification of laws(Saral etc)
- promote voluntary compliance

The increase in the relative share of direct tax collections shows that the tax system is becoming more progressive as direct taxes are paid by the well off in general while the indirect taxes are paid equally by all consumers. Direct taxes can be used to promote growth with equity.

Direct taxes help in income redistribution. Decline in the relative share of indirect taxes is also seen as good because it promotes the competitive nature of Indian economy-attracts investment.

By taxing earnings of individuals and corporates rather than production and trade, there is less stifling of economic activity and there is employment generation.
In developed countries, direct taxes contribute more to the tax collections.

Cost of direct tax collection

Buoyant economic growth along with higher tax compliance have led to a desirable decline in the cost of direct tax collections as a proportion of total direct tax collections: all-time low of 0.54 per cent in 2007-08.That is, the income-tax department spends 54 paise for every Rs 100 direct tax collected by it, which is among the lowest in the world. The income tax department has a tax base of 3.5 crore assesses.

Income-tax slabs and rates

10 per cent rate on a slab extending up to Rs 5 lakh. Likewise, the 20 per cent rate will now apply on income slabs beyond Rs 5 lakh and up to Rs 8 lakh. The maximum marginal rate of 30 per cent on an income slab of above Rs 8 lakh.

Service Tax

Service tax was first imposed in 1994. A new service tax regime, based on a negative list of exempted services, came into effect in July 2012.

With this, all services — except the 38 activities put on the negative list — came under the tax at the increased rate of 12 per cent, as announced in the Union budget 2012-13.

Till June 2012, service tax was being levied on 119 services based on a positive list. The switch-over to a negative list-based approach is aimed at aligning the indirect taxation system to the proposed Goods and Services Tax (GST) regime, which is sought to be introduced to unify the levies of the Centre and the States into a composite system.

With the services sector now accounting for 60 per cent of the gross domestic product, the Finance Ministry has set a target of Rs.1.24 lakh crore for service tax collection during 2012-13. This is significantly higher than the Rs.97,000 crore mopped up during the previous fiscal.

As per the negative list-based approach, services such as metered taxis, auto-rickshaws, transport of goods or passengers and transmission and distribution of electricity by distribution companies will not come under the service tax net.

Other important services exempted from the levy are solemn activities such as funeral, burial and transport of deceased. In the education sector, school and university courses, as also approved vocational studies, have been exempted.

Likewise, auxiliary educational services and renting of immovable property by educational institutions in respect of education will not be taxed. However, coaching classes and training institutions will be taxed.

Among the other services included in the negative list are those provided to government, local authorities or a government authority for repair and maintenance of an aircraft. Likewise, services provided by advocates to other advocates and business entities up to a turnover of Rs. 10 lakh in the preceding financial year will be exempt from the tax.

Services provided by way of public convenience, such as bathroom, washroom, urinals or toilets, are included in the negative list, just as services relating to work contracts for a scheme under the Jawaharlal Nehru National Rural Urban Renewal Mission or the Rajiv Awas Yojana.

The service sector has emerged as an important area of economic activity. Reasons for taxing services

- Its share in the country's Gross Domestic Product (GDP) has increased from about 28% in 1951, to 55% (2011).
- Taxing services is important to raise resources and increasing the tax-GDP ratio
- service providers should share the tax burden with others-industry - there should be horizontal equity that is all sectors of the economy should bear the tax burden equitably.
- as the share of industry in GDP decreases while that of services expands, the tax base shrinks unless services are taxed.
- failure to tax services distorts consumer choices, encouraging spending on services at the expense of goods and savings.
- as most of the services that are likely to become taxable are positively correlated with expenditure of high income households, subjecting them to taxation will improve equity.

Service Tax and Indian Constitution

In the Seventh Schedule to the Constitution, under Article 246, the item relating to "taxes on services" was not specifically mentioned in any entry either in the Union List or in the State List.

However, Entry 97 of the Union List empowers Parliament to make laws in respect of any other matter not enumerated in List II (State List) or List III (Concurrent List), including any tax not mentioned in either of those lists. Since "taxes on services" is not there in any of the lists, service tax was levied by the Central Government in exercise of the powers under Entry 97 of the Union List.

The 88th amendment to the Constitution(2004) amended Article 270 (made it divisible)and inserted in the Union List (List I) entry No. 92C — `taxes on services'.

The amendment to the Constitution places services tax formally under the Union List. This will pave the way for the Centre to levy and collect the tax.

The amendment becomes redundant with the introduction of GST in 2011 where the services will be jointly taxed by Centre and States.

The amendment did not come into effect as it has never been notified and thus services are still taxed on a residuary basis.

GST

Goods and Services Tax is a multi-point sales tax with set off for tax paid on purchases of inputs. There is no cascading (tax on tax) effect as there is deduction or credit mechanism for taxes paid for the inputs. The tax is levied on the value added and on consumption only. Total burden of the tax is exclusively borne by the domestic consumer. Exports are not subject to GST.

India introduced VAT at the state level in 2005. Before that, union excise duties were renamed Central Vat (Cenvat). But when states called their slaes tax Vat, centre reverted to the earlier name of excise duty. The earliest form of Vat was however taken in 1986 in the form of Modvat- modified VAT that included set off for a few commodities only and was confined to excise duties only.

Cenvat in replacement of central excise duties came into effect earlier in the decade. VAT as a replacement for state sales tax was adopted from the beginning of the fiscal year 2005-2006.Cenvat has come back to being called union excise duty to prevent confusion.

Need for GST

In the Union Budget for the year 2006-2007, Finance Minister proposed that India should move towards national level Goods and Services Tax that should be shared between the Centre and the States. World over, goods and services are integrated and taxed as a comprehensive domestic indirect taxation system based on value addition. They attract the same rate of tax. That is the foundation of a GST. The basis of GST is value addition.

The goods and service tax (GST) is proposed to be a comprehensive indirect tax levy on manufacture and sale of goods as well as services at a national level. Integration of goods and services taxation would give India a world class tax system and improve tax collections.

It would end the long standing distortions of differential treatments of manufacturing and service sector. The introduction of goods and services tax will lead to the abolition of taxes such as octroi, Central sales tax, State level sales tax, entry tax, etc and eliminate the cascading effects tax on tax.

It is aimed at forging a common domestic market, removing multiplicity of taxes, eliminating the cascading effect of tax on tax, making the prices of the Indian products competitive and, above all, benefiting the end consumers

GST: Q and A

The central and state governments moved closer to ushering in a nationwide goods and services tax on April 1, 2011, a reform intended to cut business costs and boost government revenue. The reform would eliminate multiple indirect taxes levied by states and the central government, leading to a reduction in the average tax burden on companies and a rise in the country's tax-to-GDP ratio.

HOW WILL THE GST WORK?

The GST is an indirect tax that would replace existing levies such as excise duty, service tax, and value-added tax (VAT).Both the states and the central government would impose the tax on almost all goods and services produced in India or imported. Exports would not be subject to GST. For the first two years of operation, the proposal is for two rates both at the federal and state levels, converging to a single rate in the third year. Producers would receive credits for tax paid earlier, which would eliminate multiple taxation on the same product or service. Direct taxes, such as income tax, corporate tax and capital gains tax would not be affected.

WHAT'S THE RATIONALE FOR THE GST?

Eliminating a multiplicity of existing indirect taxes would simplify the tax structure, broaden the tax base, and create a common market across states and centrally administered districts. Increased compliance and fewer exemptions to GST would lift India's federal tax-to-GDP ratio.

At the same time GST would lower the average tax burden for companies that now pay "cascading" taxes on top of taxes through the production process.

By lowering business costs it would boost economic growth and increase exports, proponents argue, and bring India in line with practices in many developed economies.

Reducing production costs would make exporters more competitive.

The GST may usher in the possibility of a collective gain for industry, trade, agriculture and common consumers as well as for the central government and the state governments for reasons cited above.

Black money and evasion will reduce as GST is transparent.

WHAT ARE THE PROPOSED GST RATES?

For the first year: 10 percent of CGST of Centre and 10% of SGST of states for goods and 6 percent each for essential items. 8% each for services. Thus, it is dual rate. Also, goods and services are taxed separately initially.

The higher rate would come down to 9 percent in the second year, and the two rates would converge at 8 percent in the third year.

ARE THERE EXEMPTIONS PROPOSED?

Yes. Goods deemed necessary or of basic importance would be taxed at a lower rate. The government will review the various lists of exempted goods to align them at the federal and state levels.

Alcohol, petroleum and electricity would not come under GST.

WILL THE STATES LOSE OUT?

GOI will compensate states for potential lost revenue and central government has assured states that if needed, it would increase a 50,000 crore -rupee ($10.6 billion) fund that the 13th Finance Commission recommended as an incentive for the states to buy into GST.

WHAT HAPPENS NEXT?

The legislation to make constitutional amendments needs to be finalised and the mechanism for administering the tax needs to be created. The government also needs to set up the technology infrastructure to manage the tax- TAGUP (see ahead)

WHAT IS THE REVENUE IMPACT?

The GST is initially intended to be revenue-neutral but is eventually expected to increase the tax collections due to more efficient collection, expanded base, transparency and increased compliance.

WHAT ABOUT THE ECONOMIC IMPACT?

Implementation of a comprehensive GST would lift India's economy of over $1 trillion by between 0.9 percent and 1.7 percent, according to a report by the New Delhi-based economic think tank the National Council of Applied Economic Research. Exports would rise by between 3.2 percent and 6.3 percent, while imports would increase 2.4 percent to 4.7 percent, the study found.

Constitutional Amendment for GST

Constitution (One Hundred and Fifteenth Amendment), Bill, 2011 (GST Bill)

Constitution (One Hundred and Fifteenth Amendment), Bill, 2011 (GST Bill) was introduced in the Parliament in the budget session in March 2011, deals with GST. The Bill seeks to introduce Goods and Services Tax (GST) and the GST Council. As per the existing structure of indirect taxation, the Parliament has the power to make laws on the manufacture of goods and the provision of services (Union List) while the State Legislatures have the power to make laws on the sale and purchase of goods within their respective states (State List). The Parliament has retained the exclusivity to make laws pertaining to sale of goods in the course of inter-state trade or commerce.

Definition of Goods and Services – Article 366

1. The above Article which defines 'Goods and Services Tax' to mean, any tax on supply of goods or services or both except taxes on the supply of petroleum products and alcohol

Seventh Schedule

- The Union Government has the exclusive power to levy excise duty on the manufacture or production of
- Petroleum Crude
- High Speed diesel
- Petrol
- Natural Gas
- Aviation Turbine Fuel
- Tobacco and Tobacco Products

The State Governments shall have the power to levy tax on the sale (other than in the course of inter-state trade or commerce) of petroleum crude, high speed diesel, petrol, natural gas, aviation turbine fuel and alcoholic liquor for human consumption.

Article 249

The Parliament has been vested with the power to make laws pertaining to GST on behalf of the state Legislature in circumstances of national interest. The power to make such laws would be pursuant to a resolution passed by the Council of States supported by not less than a two-thirds majority of the members present and voting.

Power of Parliament to make laws on subjects in State List in the case of Emergency – Article 250

The Parliament has been vested with the power to makes laws pertaining to GST on behalf of the State Legislature when there is a proclamation of Emergency.

GST Council – Article 279A

The President shall constitute a GST Council within sixty days from the Commencement of the GST Act.

Membership of the GST Council

The Union Finance Minster would be the Chairperson, the Union Minister of State for Revenue shall be one of the members, the Finance Minister or any other minister nominated by each State Government shall be the members of the GST Council.

The Members of the GST Council shall decide on the Vice-Chairperson of the GST Council for such period as decided by the members.

Functions of the GST Council

The GST Council while being guided by the need for a harmonized structure goods and services tax and for the development of a harmonised national market for goods and services shall make recommendations to the Union and the States on:

Taxes, cesses and surcharges levied by the Union and the States and local bodies which may be subsumed within the GST

- Exemptions from GST for such goods and services
- Threshold limit of turnover below which GST may be exempted
- The GST rates
- Any other matter relating to GST

Every decision of the GST Council taken at a meeting shall be with the consensus of all the members present at the meeting.

GST Dispute Settlement Authority – Article 279B

The Parliament, by law, will provide for the creation of a Goods and Services Tax Dispute Settlement Authority (DSA) which shall adjudicate any dispute or complaint referred to the DSA by the State Government or the Union Government arising out of deviation from any recommendation of the GST Council which results in the loss of revenue to the State Government of the Union Government or affects the harmonised structure of the GST. The DSA shall consist of three members namely, the Chairperson, who has been a Supreme Court Judge or the Chief Justice of a High Court, appointed by the President, recommended by the Chief Justice of India; the remaining members shall be persons who shall have expertise in the field of law, economics or public affairs appointed by the President recommended by the GST Council.

The DSA shall pass suitable orders including interim orders only the Supreme Court shall exercise jurisdiction over such adjudication or dispute or complaint.

Fiscal autonomy issues

Constitutional amendments are required to enable the Centre and the states to impose tax on the same base of goods and services. Currently, the states cannot impose tax on services. They also can not impose tax on manufacturing of goods. Centre cannot levy tax sales tax.
States feel that their fiscal autonomy is being eroded for the following reasons:

- they are surrendering the power to tax sales
- they can not change rates according to their fiscal needs
- all states can not have the same rates
- centre may not compensate the states fully

The position of states is rejected on the other points for the following reasons

- centre is also surrendering and sharing its powers regarding service tax and union excise duties
- states are free to tax sin goods like liquor and also the petroleum products

It is said that like VAT, GST would also increase the revenue of the states as they will have powers to impose tax on services, which are growing at a rapid pace: However, in case..... (in the classroom)

Contentious federal issues on GST

GST rates, the division of taxing powers between the Centre and the states, compensation amount; exemptions and on certain design elements of the GST.

Goods and Services Tax (GST): Challenges for implementation

The GST is a necessary condition for a common market to exists, this permits free and unimpeded movement of goods and services across a federation, thus encouraging efficient regional specialization.

Such harmonization will significantly reduce the vertical imbalance between the Centre and the states by enhancing the tax base of the states. It is going to be the biggest ever tax reform in India.

Challenges to address:

- Integration of a large number of Central & State Taxes
- multiplicity of taxes and tax rates to be unified
- federal distribution of powers to levy and collect taxes
- necessary constitutional amendments.
- Rationalisation of thresholds and exemption limits.
- Standardisation of systems and procedures.
- road based computerizations across the Nation.
- Dispute settlement procedure and machinery.
- Training of tax administrators and assessee.
- Protecting and balancing the present and future revenues of the Centre and the States.
- Safeguarding the interests of less developed States with lower revenue potential.
- Taxing of Alcohol, tobacco, petroleum products which are out of the GST regime.

GST and fiscal federalism

Being the largest indirect tax reform requiring the centre and the states to adjust their constitutional taxing powers, GST has opened up fiscal federal challenges like never before. There is mutual surrender of powers to a uniform national taxation system where both gain. But there are apprehensions of loss of fiscal autonomy by states and central dominance as mentioned above.

The Constitutional changes proposed and being debated by the Empowered Committee of State Finance Ministers are likely to bring the federal units together for a new and innovative system of fiscal federal sharing and cooperation.

Technology Advisory Group for Unique Projects (TAGUP)

An effective tax administration and financial governance system calls for creation of IT projects which are reliable, secure and efficient. IT projects like Tax Information Network, New Pension Scheme, National Treasury Management Agency, Expenditure Information Network, Goods and Service Tax, are in different stages of roll out. To look into various technological and systemic issues, Finance Minister announced in the Union Budget 2010-11 to set up a Technology Advisory Group for Unique Projects under the Chairmanship of Shri Nandan Nilekani. It has been set up in mid-2010.

GST and tax efficiency

In the system existing now, the rates, tax imposition and collection are inefficient. Rates are not efficient as they depend on lobbying and there is no transparent basis. Exemptions are also similarly granted. Thus, deployment of labour and land along with capital and enterprise becomes subject to lower returns and waste- GST is expected to lead to efficient allocation of factors of production thus leading to gains in GDP and exports. This would translate into enhanced economic welfare and returns to the factors of production, viz. land, labour and capital. In an earlier taxation system, people paid taxes at various levels. There was no system of getting a rebate on the taxes paid previously while paying the inputs. This is also called as cascading effect. It is irrational as there is tax on tax. Ideally the taxes should be based on value addition and the producer should pay taxes on whatever value he adds to the product. In the absence of such a system, producers ended up paying much higher taxes. Higher taxes are a barrier for business and discourage business activity.

High taxes also lead to lobbying activities where producers of a certain sector ask the government to lower/waiver taxes for their sector. This also leads to multiple taxation rates for multiple products and further increases inefficiency in the system.

Before VAT States had sales taxes with multiple rates. States were often seen in a sales tax war with other states- rate war as it is called . In the war states competed with each other offering lower tax rates to certain industries to set units in their states. This resulted in revenue loss for both the states and investment decisions wre determined by tax rates in states and not other merit factors.

However, the design of VAT system in each state has also been done in a uniform fashion keeping the distinctive state economy in mind.

Tax Reforms in India

Since the beginning of the last decade as a part of the economic reforms programme, the taxation system in the country has been subjected to consistent and comprehensive reform.

The need for the tax reforms arises from the fact that

- tax resources must maximised
- international competitiveness must be imparted to the Indian economy
- transaction costs must be reduced
- the high-cost nature of Indian economy needs to be corrected so that
- compliance increases
- equity improves
- investment flows

On the direct tax front, the reforms are the following:

- Reduction and rationalization of rates- there are only three rates of income tax today with the highest rate at 30%
- Simplification of procedures
- Strengthening of administration
- Widening of the tax base to include more tax payers in the tax net
- Exemptions are gradually being withdrawn.
- MAT was introduced for the `zero tax' companies
- The Direct Tax Code of 2010 is meant to replace the outdated Income Tax Code of 1961

Indirect Taxes

- Reduction in the peak tariff rates- 10% is the peak customs duty today which was more than a 90% reduction since 1991.
- The number of slabs has come down drastically
- There is a progressive change from specific duty to ad valorem tax
- VAT is introduced
- GST is being rolled out
- Negative list of service tax from 2012

Tax expenditure

Tax expenditure refers to revenue forgone as a result of exemptions and concessions (personal, corporate, indirect tax). It was introduced for the first time in 2006-07 Union Budget. The revenue foregone due to tax incentives in 2009-10 is estimated at Rs 5,40,269 crore. Such exemptions have been justified for promoting balanced regional growth; dispersal of industries; neutralisation of disadvantages on account of location; and incentives to priority sectors, including infrastructure. These should be subject to a sunset clause, as tax exemptions often create pressure groups for their perpetuation.

While some may be justified as they enhance investment and generate nmore taxes for the government, others are not.

Such exemptions and concessions can distort resource allocation and stunt productivity. They also result in a multiplicity of rates, legal complexities, classification disputes, litigation etc. If these exemptions are rationalized, they can help the government spend more on social and infrastructure and help reduce the fiscal deficit.

Tax havens and G20

A **tax haven** is a country or territory where certain taxes are levied at a low rate or not at all. Individuals and/or corporate entities can find it attractive to move themselves to areas with reduced or nil taxation levels. This creates a situation of tax competition among governments. Different jurisdictions tend to be havens for different types of taxes, and for different categories of people and/or companies. For example, income tax, wealth tax or corporate tax etc.

The important features of a tax haven arte:

- nil or nominal taxes;
- lack of effective exchange of tax information with foreign tax authorities, that is, personal finance information is not shared with other countries
- no requirement for a substantive local presence; and
- self-promotion as an offshore financial center.

Switzerland, Singapore, the Cayman Islands, Monaco, Luxembourg and Hong Kong are among 45 territories blacklisted by the Organisation for Economic Co-operation and Development and threatened with punitive financial retaliation for their banking secrecy. Among the sanctions being considered by the G20 are the scrapping of tax treaty arrangements, imposing additional taxes on companies that operate in non-compliant countries and tougher disclosure requirements for individuals and businesses that use shelters.

Words

Tax-incidence: It shows the entity on whom tax is imposed. It is different from the tax burden as shown below: if government increases tax on petrol, oil companies may absorb it if competition is intense or they may pass it on to private motorists. Tax incidence here refers is on companies and the burden may be on the consumer.

Tax Burden: It means those who actually pay taxes- from whom tax is collected. Depending on the market forces involved, a tax can be absorbed by the seller or by the buyer (in the form of higher prices), or by a third party like sellers' employees in the form of lower wages.

Tax Base: The value of goods, services and incomes on which tax is imposed. When economists speak of the tax base being broadened, they mean a wider range of goods, services, income, etc. has been made subject to a tax. In the case of income tax, the tax base is taxable income. Some kinds of income are excluded from the definition of taxable income, such as savings. For sales tax, the tax base is the value/volume of items that are subject to tax; essential goods , for example, are not part of the tax base.

Tax rate: It indicates how much tax is due from each source. Some tax systems have high rates but have a narrow base allowing generous deduction of business expenses. Other tax systems have a wide base with few exemptions and lower rates.

Tax Shelters: Any technique which allows one to legally reduce or avoid tax liabilities. It is a way in which the taxpayer can invest his income in a particular kind of investment that gives tax concessions.

Difference between tax avoidance and tax evasion: There are provisions in the law that allows one to save and invest in a manner that leads to reduction in taxable income. If these provisions are used for the benefit, it is called tax avoidance. It is lawful to take all available tax deductions.

Tax evasion, on the other hand, is a punishable offence. Tax evasion typically involves failing to report income, or improperly claiming deductions that are not authorized.

Hidden taxes: are taxes that are concealed in the price of articles that one buys. Hidden taxes are also referred to as implicit taxes. The most well-known form of the hidden tax is the indirect tax. Examples of hidden taxes are import duties.

Proportional, progressive and regressive tax

An important feature of tax systems is whether they are proportional tax (the tax as a percentage of income is constant over all income levels), progressive tax (the tax as a percentage of income rises as income rises), or regressive tax (the tax as a percentage of income falls as income rises). Progressive taxes reduce the tax incidence on people with smaller incomes, as they shift the incidence disproportionately to those with higher incomes.

Specific duty: Weight or quantity or number is the basis for taxation.
Ad Valorem - A Latin term meaning "according to worth," referring to taxes levied on the basis of value. Taxes on real estate and personal property are ad valorem. Luxury goods are taxed higher even if they weigh the same or number the same as ordinary goods.

Compound duties are a combination of value and other factors based on which tax is imposed.

Excise Duty: Excise duty is a tax on manufacture and is levied on the manufacture of goods within the country.

Customs Duty: When goods are imported or exported, customs duty is imposed and collected by the Union Government. Peak customs duty today is 10%.

Negative income tax: Subsidy is a negative income tax. It is a taxation system where income subsidies are given to persons or families that are below the poverty line. The government will send financial aid to a person who files an income tax return reporting an income below a certain level.

Pigovian tax

The Pigovian tax is imposed on bodies that have a negative externality. For example, pollution. Externality means impact of one person's actions on the well being of an outsider (bystander or third party). For example, the seller and consumer of cigarettes together will harm the third person with pollution. Example of negative externality is exhaust fumes from automobiles. Positive externality refers to a good effect on the third party. For example, restoration of historic buildings, research into new technologies. Carbon tax is one example in the context of the need to discourage fossil fuels and encourage renewable sources due to climate change threat.

Octroi: Entry 52 of the State List, VII Schedule, which specifies tax on the entry of goods into a local area is the octroi. Octroi has been a main source of revenue for most of the urban local bodies in India. It is criticized for the fact that it is an obsolete method of tax collection; and involves stoppage of vehicles at the check posts outside the city limits, thereby obstructing a free flow of vehicular traffic; waste of business hours; loss of fuel etc.

Tax Buoyancy: It refers to the percentage change in tax revenue with the growth of national income. That is, growth-based increase in tax collections.

Tax Elasticity: Tax elasticity is defined as the percentage change in tax revenue in response to the change in tax rate and the extension of coverage. Buoyancy, on the other hand is the response to economic growth when the base increases but there is no change in the rate.

Tax Stability: It means no frequent changes and continuity of policy in a predictable and transparent manner. Although revenue from different taxes varies from year to year, revenue stability is desirable because it makes it easier for a government to build a credible spending and borrowing plan for the year ahead. Taxes whose revenue is relatively stable contribute to overall revenue stability. Market players also can plan better.

Tobin tax

James Tobin, an economist, proposed a worldwide tax on all foreign exchange transactions- when foreign capital enters a country and when it leaves. The aim is to check speculative flows. Long term investment – generally FDI, will not suffer as it does not invest for speculative (short term) reasons like FIIs.

Tobin justified the tax on two grounds.

First, it would reduce exchange rate volatility and improve macroeconomic performance.
Second, the tax could bring in revenue to support for development efforts or exchange rate stabilization.

The defining characteristic of a Tobin tax is that the tax is levied twice- once when one acquires foreign exchange, and again when one sells the foreign exchange.

The south East Asian currency crisis (1997) is attributed to the `dynamics of hot money'(portfolio investments or FII flows).

Tobin tax can be imposed only if all the countries accept the proposition. Otherwise, FIIs can go to countries where the tax is not imposed.

India does not prefer it as we need foreign inflows as we are a CAD country and don't have a surplus.

In the EMU, there is a proposal to see a microtax levied at 0.1% on share and bond transactions, and 0.01% on deals involving complex securities such as derivatives. It is called the Financial Transaction Tax. The FTT, or "Tobin tax" as it is also known is a "Robin Hood tax", - collected from speculators and used for rescuing the financial system when there is such a need. Angele Merkel and Francois Hollande both want it.

India and FTT

Group of 20 saw the European countries like Germany and France propose a tax on their transactions so that fund could be mobilised in order to bail out future bank failures. The idea is to avoid taxing ordinary people. India along with Brazil and other countries opposed it on the following grounds

- Regulation is the remedy
- Banks can pay the tax and not shed their reckless behavior
- It may in fact induce them to be more reckless as there is a ready fund available and bailout is guaranteed
- India has a well regulated banking system and so did not suffer the same fate as the banks in developed economies. The problems of the advanced countries should not be imposed on others
- banks, as private entities, would simply push the added costs onto consumers.

India has a similar tax though not for the same purpose- securities transaction tax (STT)

Minimum Alternative Tax (MAT)

Normally, a company is liable to pay tax on the income computed in accordance with the provisions of the Income Tax Act, but the profit and loss account of the company is prepared as per provisions of the Companies Act. There were large number of companies who show book profits as per their profit and loss account (according to the Companies Act) but do not pay any tax by showing no taxable income as per provisions of the Income Tax act . Although the companies show book profits and may even declare dividends to the shareholders, they do not pay any income tax. These companies are popularly known as Zero Tax companies. In order to bring such companies under the income tax act net, MAT was introduced in 1996. They are required to pay MAT at 18% (2012).

Book profit is Profit which is notional made but not yet realized through a transaction, such as a stock which has risen in value but is still being held. It is also called unrealized gain or unrealized profit or paper gain or paper profit.

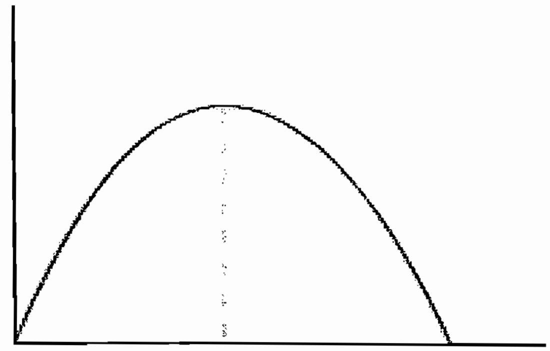
Presumptive Tax

Presumptive Tax the Estimated Income Method of assessment for certain categories of businesses is prevalent in several countries. Presumptive taxation involves the use of indirect means to ascertain tax liability, which differ from the usual rules based on the taxpayer's accounts. The term presumptive is used to indicate that there is a legal presumption that the taxpayer's income is no less than the amount resulting from application of the indirect method.

The reason for the presumptive tax is that in a number of businesses the assessees do not maintain books of accounts or the books of accounts maintained are irregular and incomplete. It was introduced in India in the early nineties for traders but was withdrawn as the success rate was low.

Laffer curve

Developed by Arthur Laffer, this curve shows the relationship between tax rates and tax revenue collected by governments. The chart below shows the Laffer Curve:



The Laffer curve has been debated in the country since 1997-1998 Budget reduced rates and slabs in the income tax regime in the country.

Inverted duty structure

Higher import duty on the raw materials than on the finished product are called inverted duty structure .It puts the domestic manufacturers at a disadvantage making them uncompetitive. For instance, compact fluorescent lamps (CFLs), where the import duty on raw materials for manufacturing CFLs is 9.7 per cent more than on finished bulbs. This skewed duty structure makes domestic CFL manufacturers uncompetitive.

There is no Basic Customs Duty for import of solar cells and modules. However, under the existing duty structure, the inputs (like EVA, Tedlar, Toughened Glass) which go into the manufacturing of solar cells and modules attract duty .This results in an inverted duty structure, which favours the import of the cells / modules and puts the domestic manufacturers to a disadvantage.

Similarly, if rubber is imported at a higher duty than tyre, manufacturing in India is discouraged.

The Economic Survey (2010-11) said FTAs also lead to a new type of inverted duty structure with duties for final products being lower from FTA partners compared to duties for the previous-stage raw materials imported from non-FTA countries. "This acts as a disincentive to local manufacturing which is not competitive against FTA imports because of the inverted duty structure phenomenon," the Survey said.

Import duty on raw silk is more than silk fabric (2013 December)

Dividend Distribution tax

Companies giving dividend have to pay tax on the amount distributed as dividend.

Withholding tax

It means withholding of tax from certain payments including interest, salaries paid to employees, professional fee, payments to contractors etc. It is the same as TDS.

Capital gains tax

It is the tax on the gains made from buying and selling assets like land, shares etc.

If the gain is made in the assets held for over three year (one year for shares) , it is called long term capital gain and taxed. For shares, there is no long term capital gains tax. For short term capital gains (less than one year), it is 15% for shares.

Wealth Tax

When income accumulates into wealth, it gets taxed after a point. Wealth tax is levied only in respect of specified non-productive assets such as residential houses, urban land, jewellery, bullion, motor cars etc.

Securities transaction tax

Introduced in the Union Budget 2004-2005, it is a tax on the value of all the transactions of purchase of securities that take place in a recognised stock exchange of India. It is meant to make up revenue loss from the abolition of long term capital gains tax.

Transfer Pricing

Transfer pricing involves charging for goods supplied to the subsidiary. The international norm in this regard is the 'arms length principle' which means that when two related parties deal in goods and services, pricing must be done objectively and commercially. If the principle is not followed, it means losses for the government. For example, an MNC has a subsidiary in India and elsewhere. The corporate tax rates are high in India. Therefore, the price of goods sold by the MNC to the two subsidiaries in the two countries is shown differently- higher in India and less in the other country. In that case, Indian subsidiary shows less profits or more losses and tax liability (corporate tax) is less.

Thus, transfer pricing is generally done in a way as to show high profit in countries where the corporate tax rate is low and low profits/losses where the rate is high. Therefore, transfer pricing norms existing today need to be rationalised so that the tax revenues that are due to the government are not eroded. Tax evasion and money laundering has to be checked by tightening the transfer pricing regime.

The introduction of Advance Pricing Agreement (APA) under Transfer Pricing Regulations in the union budget of year 2012 -13 is positive step to reduce the litigation as it will be based on bilateral understanding between two countries.

According to the memorandum of union budget, Advance Pricing Agreement is an agreement between a taxpayer and a taxing authority on an appropriate transfer pricing methodology for a set of transactions over a fixed period of time in future. The APAs offer better assurance on transfer pricing methods and are conducive in providing certainty and unanimity of approach.

Death tax (in the class)

Rupee is raised and spent like this

For every rupee in government kitty, 29 paise will come from market borrowing in 2012-13.

....

The government's dependence on debt has gone up from 27 paise in the previous Budget to 29 paise in the coming year, reflecting the pressure on revenue collections.

The net borrowings of the government in 2012-13 are pegged at Rs 4.79 lakh crore against Rs 4.36 lakh crore for the current fiscal.

On the expenditure side, central Plan will account for an outgo of 22 paise, followed by 18 paise of interest payments.

Defence allocation has been maintained at 11 paise. As the single largest source of revenue income, the collection from corporate tax has decreased to 21 paise to 24 paise as a per centage of every rupee earned, indicating the sluggish growth in the industry.

However, with increase in the service tax rate, the government expects revenue collection from service tax and others to go up to 7 paise against 6 paise in 2011-12.

Besides, other indirect tax component excise and customs would earn 21 paise for the government.

Despite tax incentives given to individuals, direct tax contribution has been retained at 9 paise.

With rising crude oil price due to global economic uncertainty, the subsidy burden on the government would go up 10 paisa against 9 paise for the year ending March 2012.

At the same time, other non-plan expenditure is expected to account for 11 paise of every rupee spent by the government in 2012-13, while the states' share of taxes and duties would amount to 17 paise of every rupee earned.

Plan assistance to states and Union Territories has been retained at 7 paise in 2012-13. (Figures to be revised after the General Budget is presented in June 2014).

Banking System in India-I

A commercial bank is a type of financial intermediary. It is a financial intermediary because it mediates between the savers and borrowers. It does so by accepting deposits from the public and lending money to businesses and consumers. Its primary liabilities are deposits and primary assets are loans and bonds.

"Commercial bank" has to be distinguished from another type called "investment bank". Investment banks assist companies in raising funds in the capital markets (both equity and debt), as well as in providing strategic advisory services for mergers, acquisitions and other types of financial transactions. It is also called merchant bank.

The commercial banking system in India consists of public sector banks; private sector banks and cooperative banks.

Currently, India has 88 scheduled commercial banks (SCBs) - 26 public sector banks (that is with the Government of India holding majority stake) that include SBI and its associates and the IDBI Bank; there are private banks and foreign banks also. Public sector banks hold over 75 percent of total assets of the banking industry, with the private and foreign banks holding 18.2% and 6.5% respectively

Public Sector Banks

They are owned by the Government- either totally or as a majority stake holder.

- State Bank of India and its five associate banks called the State Bank group
- 19 nationalised banks(earlier there were 7 associate banks but recently 2 were merged with SBI- SB of Saurashtra and Indore)
- Regional Rural Banks mainly sponsored by Public Sector Banks

Private Sector Banks include domestic and foreign banks

Co-operative Banks are another class of banks and are not considered as commercial banks as they have social objectives and profit is not the motive. (Explained later)

Reserve Bank of India lays down the norms for banking operations and has the final supervising power.

Development Banks

Development Banks are those financial institutions which provide long term capital for industries and agriculture : Industrial Finance Corporation of India (IFCI) ;Industrial Development Bank of India (IDBI). ;Industrial Credit and Investment Corporation of India (ICICI) that was merged with the ICICI Bank in 2000 ;Industrial Investment Bank of India (IIBI) ;Small Industries Development Bank of India (SIDBI) ;National Bank for Agriculture and Rural Development (NABARD) ;Export Import Bank of India ; National Housing Bank(NHB).

The commercial banking network essentially catered to the needs of general banking and for meeting the short-term working capital requirements of industry and agriculture. Specialised development financial institutions (DFIs) such as the IDBI, NABARD, NHB and SIDBI, etc., with majority ownership of the Reserve Bank were set up to meet the long-term financing requirements of industry and agriculture. To facilitate the growth of these institutions, a mechanism to provide concessional finance to these institutions was also put in place by the Reserve Bank.

The first development bank in India- IFCI- was incorporated immediately after Independence in 1948 under the Industrial Finance Corporation Act as a statutory corporation to pioneer institutional credit to medium and large-scale. Then after in regular intervals the government started new and different development financial institutions to attain the different objectives and helpful to five-year plans.

Government utilized these institutions for the achievements in planning and development of the nation as a whole. The all India financial institutions can be classified under four heads according to their economic importance that are:

- All-India Development Banks
- Specialized Financial Institutions(SIDBI)
- Investment Institutions (The Industrial Reconstruction Corporation of India Ltd., set up in 1971 for rehabilitation of sick industrial companies)
- State-level institutions(SFC)

S.H.Khan committee appointed by RBI(1997) recommended to transform the DFI (development finance institution) into universal banks that can provide a menu of financial services and leverage on their assets and talent.

Bank Nationalization

In 1969 and again in 1980, Government nationalized private commercial banking units for channelizing banking capital into rural sectors; checking misuse of banking capital for speculative purposes; to shift from `class banking' to `mass banking'(social banking); and to make banking into an integral part of the planning process of socio-economic development in the country. Today, no other developing country can boast of a banking system comparable to India's in terms of geographic coverage, operational capabilities, range of services and technological prowess.

Commercial Banks

Today banks are broadly classified into two types - Scheduled Banks and Non-scheduled Banks

Scheduled banks are those banks which are included in the Second Schedule of the Reserve Bank Act, 1934. They satisfy two conditions under the Reserve Bank of India Act

- paid-up capital and reserves of an aggregate value of not less than Rs 5 lakh
- it must satisfy RBI that its affairs are not conducted in a manner detrimental to the depositors.

The scheduled banks enjoy certain privileges like approaching RBI for financial assistance, refinance etc and correspondingly, they have certain obligations like maintaining certain cash reserves as prescribed the RBI etc. The scheduled banks in India comprise of State Bank of India and its associates (8), the other nationalised banks (19), foreign banks, private sector banks,co-operative banks and regional rural banks. Today, there are about 300 scheduled banks in India having a total network of 79,000 branches among them.

Non-scheduled banks are those banks which are not included in the second schedule of the RBI Act as they do not comply with the above vriteria and so they do not enjoy the benefits either.

There are only 3 non-scheduled commercial banks operating in the country with a total of 9 branches.

In sum, all banks which are included in the Second Schedule to the Reserve Bank of India Act, 1934 are Scheduled Banks. These banks comprise Scheduled Commercial Banks and Scheduled Co-operative Banks.
Scheduled Commercial Banks in India are categorised into five different groups according to their ownership and / or nature of operation. These bank groups are (i) State Bank of India and its Associates, (ii) Nationalised Banks, (iii) Private Sector Banks, (iv)Foreign Banks, and (v) Regional Rural Banks. In the bank group-wise classification, IDBI Bank Ltd. has been included in Nationalised Banks.

Cooperative Banks
Co-operative Banks are organised and managed on the principle of co-operation, self-help, and mutual help. They function with the rule of "one member, one vote" and on "no profit, no loss" basis. Co-operative banks, as a principle, do not pursue the goal of profit maximisation.

Co-operative bank performs all the main banking functions of deposit mobilisation, supply of credit and provision of remittance facilities.

Co-operative Banks provide limited banking products and are functionally specialists in agriculture related products. However, co-operative banks are now provide housing loans also.

Urban Co-operative Banks (UCBs) are 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. Earlier, they essentially lent to small borrowers and businesses. Today, their scope of operations has widened considerably. Urban CBs provide working capital, loans and term loan as well.

Co-operative banks are the first government sponsored, government-supported, and government-subsidised financial agency in India. They get financial and other help from the Reserve Bank of India, NABARD, central government and state governments. RBI provides financial resources in the form of contribution to the initial capital (through state government), working capital, refinance.

Co-operative Banks belong to the money market as well as to the capital market- they offer short term and long term loans.

Primary agricultural credit societies provide short term and medium term loans. State Cooperative Banks (SCBs) and CCBs (Central Cooperative Banks at the district level) provide both short term and term loans. Land Development Banks (LDBs) provide long-term loans.

Long term cooperative credit structure comprises of state cooperative agriculture and rural development bank (SCARDB) at the state level and primary PCARDBs or branches of SCARDB at the decentralised district or block level providing typically medium and long tem loans for making investments in agriculture, rural industries, and lately housing. The sources of their funds (resources) are ownership funds

- deposits or debenture issues.
- central and state government
- Reserve Bank of India
- NABARD
- other co-operative institutions

Some co-operative bank are scheduled banks, while others are non-scheduled banks. For instance, SCBs and some UCBs are scheduled banks (included in the Second Schedule of the Reserve Bank of India Act)

Co-operative Banks are subject to CRR and SLR requirements as other banks. However, their requirements are less than commercial banks.

Although the main aim of the co-operative bank is to provide cheaper credit to their members and not to maximize profits, they may access the money market to improve their income so as to remain viable.

Prakash Bakshi Committee

In August 2012, Reserve Bank of India constituted a committee to suggest ways to strengthen the rural co-operative credit structure.The panel, headed by Nabard Chairman Prakash Bakshi, will review the existing short-term co-operative credit structure (STCCS), focussing on structural constraints in the rural credit delivery system. It will also explore ways to strengthen the rural co-operative credit architecture. The seven-member panel will make an in-depth analysis of the STCCS, and examine various alternatives with a view to reducing the cost of credit.The STCCS targets the credit requirement of the small and marginal farmers in the country.It will mainly assess the role played by State and district cooperative banks in fulfilling the requirement of agriculture credit.

Commercial banks and their weaknesses by 1991

The major factors that contributed to deteriorating bank performance upto the end of eighties were

- high SLR and CRR locking up funds
- low interest rates charged on government bonds
- directed and concessional lending for populist reasons
- administered interest rates and
- lack of competition.

The reforms to set the above problems right were

- Floor and cap on SLR and CRR removed in 2006
- interest rates were deregulated to make banks respond dynamically to the market conditions. Even SB rates were deregulated in 2011
- near level playing field for public, private and foreign banks in entry

- adoption of prudential norms- Reserve Bank of India issued guidelines for income recognition, asset classification and provisioning to make banks safer
- Basel norms adopted for safe banking
- VRS for better work culture and productivity
- FDI upto 74% is permitted in private banks

One of the sectors that has been subjected to reforms as a part of the new economic policy since 1991 consistently is the banking sector. The **objectives of banking sector reforms** have been:

- to make them competitive and profitable
- to strengthen the sector to face global challenges
- sound and safe banking
- to help them technologically modernize for customer benefit
- make available global expertise and capital by relaxing FDI norms.

Narasimham Committee

Banking sector reforms in India were conducted on the basis of Narasimham Committee reports I and II (1991 and 1998 respectively). The recommendations of Narasimham committee 1991 are

No more nationalization

- create a level playing field between the public sector, private sector and foreign sector banks
- select few banks like SBI for global operations
- reduce Statutory Liquidity Ratio(SLR) as that will leave more resources with banks for lending
- reduce Cash Reserve Ratio(CRR).to increase lendable resources of banks
- rationalize and better target priority sector lending as a sizeable portion of it is wasted and also much of it turning into non-performing asset
- introduce prudential norms for better risk management and transparency in operations
- deregulate interest rates
- Set up Asset Reconstruction Company(ARC) that can take over some of the bad debts of the banks and financial institutions and collect them for a commission .

Most of these reforms are implemented except priority sector lending which is welfare-based and relates to agriculture. SLR is 23% today and CRR is 4.75%. Bank rate is aligned with MSF.(2012)

Divestment in public sector banks led to their listing on the stock exchanges and their performance has improved.

NPAs

Non-performing assets are those accounts of borrowers who have defaulted in payment of interest or installment of the principal or both for 90 days at least.

In 2003, NPAs stood at 9% and came down to 2.5% in 2008 but rose as economy slowed down since 2011.

Reflecting the stress in India Inc, net non-performing assets (NPAs) of banks at the aggregate level rose to Rs 60,100 crore at the end of March 2012.

One of the main reasons for this sharp jump in NPAs is the loans due to state electricity boards and also Air India. On the sectoral front, metals, textiles and infrastructure sectors were among the major ones to contribute to this slide.

The sharp rise in NPAs in the banking system, although was expected, has taken a toll on the stock prices of most of these banks.

PSU banks have seen their loans go bad at a faster rate than their private sector peers, the latter have been steadily improving their asset quality over the years.

RBI rules require that banks should set aside certain amount of money(provisioning) for the NPAs. Gross NPAs include the amount due along with the amount provisioned. Net NPAs include only the amount due.

NPAs are largely a fallout of banks' credit appraisal system, monitoring of end-usage of funds and recovery procedures. It also depends on the overall economic environment like the global recession since 2008, the business cycle and the legal environment for recovery of defaulted loans. Wilful default; priority sector problems among the poor etc are also responsible.

High levels of NPAs means: banks' profitability diminishes; precious capital is locked up; cost of borrowing will rise as lendable assets shrink; stock prices of banks will go down and investors will lose; investment suffers etc.

NPAs are classified as sub-standard; doubtful and loss making assets for provisioning requirements.

The following are the RBI guidelines for NPAs classification and provisioning:
Sub Standard Assets – These are those accounts which have been classified as NPAs for a period less than or equal to 18 months.

Doubtful Assets –These are those accounts which have remained as NPAs for a period of 12 months.

Loss Assets – 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. But a loss asset has not been written off, wholly or partly.

What is being done

- provisioning
- CAR norms
- norms
- one time settlement
- debt recovery tribunals
- securitization law
- foreclosure
- interest waiver
- writeoffs

Foreclosure means taking over by the lender of the mortgaged property if the borrower does not conform to the terms of mortgage.

Securitization is the process of pooling a group of assets, such as loans or mortgages, and selling securities backed by these assets.

SARFAESI Act 2002

To expedite recovery of loans and bring down the non-performing asset level of the Indian banking and financial sector, the government in 2002 made a new law that promises to make it much easier to recover bad loans from willful defaulters. Called the Securitization and Reconstruction of Financial Assets and Enforcement of Security Interest Act 2002(SARFAESI) , the law has given unprecedented powers to banks, financial institutions and asset reconstruction/securitization companies to take over management control of a loan defaulter or even capture its assets.

Asset Reconstruction Company

Normally banks and FIs themselves recover the loans. But in the case of bad debts (sticky loans), it is outsourced to the ARCs who have built-in professional expertise in this task and who handle recovery as their core business. ARCs buy bad loans from banks and try to restructure them and collect them. Arcs were recommended by Narasimham committee II. ARCIL- the first asset reconstruction company was set up recently.

Prudential Norms

Prudential norms relate to

- income recognition
- asset classification
- provisioning for NPAs
- capital adequacy norms(capital to risk-weighted asset ratio, CRAR).

A proper definition of income is essential in order to ensure that banks take into account income that is actually realized(received) . It helps in classifying an asset as NPA in certain cases. Once classified as NPA, funds must be set apart to balance the bank's operations so as to maintain safety of operations in case of non-recovery of NPAs.Thus, income recognition, asset classification and provisioning norms are inter-related.

Prudential norms make the operations transparent, accountable and safe.

Prudential norms serve two primary purposes: bring out the true position of a bank's loan portfolio and help in prevention of its deterioration.

Basel Norms

Banks lend to different types of borrowers and each carries its own risk. They lend the deposits of public as well as money raised from the market- equity and debt. The intermediation activity exposes the bank to a variety of risks. Cases of big banks collapsing due to their inability to sustain the risk exposures are readily available. Therefore, banks have to keep aside a certain percentage of capital as security against the risk of non-recovery. Basel committee provided the norms called Basel norms to tackle the risk.

Basel is a city in Switzerland. It is the headquarters of Bureau of International Settlement (BIS), which fosters co-operation among central banks with a common goal of financial stability and common standards of banking regulations. Every two months BIS hosts a meeting of the governor and senior officials of central banks of member countries. Currently there are 27 member nations in the committee. Basel guidelines refer to broad supervisory standards formulated by this group of central banks - called the Basel Committee on Banking Supervision (BCBS). The set of agreement by the BCBS, which mainly focuses on risks to banks and the financial system are called Basel accord. The purpose of the accord is to ensure that financial institutions have enough capital on account to meet obligations and absorb unexpected losses. India has accepted Basel accords for the banking system. In fact, on a few parameters the RBI has prescribed stringent norms as compared to the norms prescribed by BCBS.

In 1988, BCBS introduced capital measurement system called Basel capital accord, also called as Basel 1. It focused almost entirely on credit risk. It defined capital and structure of risk weights for banks. The minimum capital requirement was fixed at 8% of risk weighted assets (RWA). RWA means assets with different risk profiles. For example, an asset backed by collateral would carry lesser risks as compared to personal loans, which have no collateral. India adopted Basel I guidelines in 1999.
In June '04, Basel II guidelines were published by BCBS, which were considered to be the refined and reformed versions of Basel I accord. The guidelines were based on three parameters, which the committee calls it as pillars. - Capital Adequacy Requirements: Banks should maintain a minimum capital adequacy requirement of 8% of risk assets - Supervisory Review: According to this, banks were needed to develop and use better risk management techniques in monitoring and managing all the three types of risks that a bank faces, viz. credit, market and operational risks - Market Discipline: This need increased disclosure requirements. Banks need to mandatorily disclose their CAR, risk exposure, etc to the central bank.

Basel III
In 2010, Basel III guidelines were released. These guidelines were introduced in response to the financial crisis of 2008. A need was felt to further strengthen the system as banks in the developed economies were under-capitalized, over-leveraged and had a greater reliance on short-term funding. Also the quantity and quality of capital under Basel II were deemed insufficient to contain any further risk.

More
CRAR at 9 percent of the risk weighted assets is prescribed by Basel norms. It is the capital that is required to be set aside for absorbing risks. It is not to be provisioned from deposits raised but has to be additionally provided from debt, equity, reserves etc.

Presently the Basel II norms are being complied with by Indian banks as follows:

Basel 2 norms are 8% of CRAR.RBI made it 9% for greater security.

Basel-II aims to strengthen Basel I.

Not only credit risk but also market risk and operational risk are covered.

Credit risk
A bank always faces the risk that some of its borrowers may not repay loan, interest or both. This risk is called credit risk, which varies from borrower to borrower depending on their credit quality. Basel II requires banks to accurately measure credit risk to hold sufficient capital to cover it.

Market risk
As part of the statutory requirement, in the form of SLR (statutory liquidity ratio), banks are required to invest in liquid assets such as cash, gold, government and other approved securities. For instance, Indian banks are required to invest 24 per cent of their net demand and term liabilities in cash, gold, government securities and other eligible securities to comply with SLR requirements (2008-09).

Such investments are risky because of the change in their prices. This volatility in the value of a bank's investment portfolio in known as the market risk, as it is driven by the market.

Operational risk
Several events that are neither due to default by third party nor because of the vagaries of the market. These events are called operational risks and can be attributed to internal systems, processes, people and external factors.

Thus, Basel II uses a "**three pillars**" concept

Pillar 1 Specifies includes more types of risk- credit risk ,market risk and operational risk.

Pillar 2 Enlarges the role of banking supervisors.

Pillar 3 Defines the standards and requirements for higher disclosure by banks on capital adequacy, asset quality and other risk management processes.

Capital -Tier1 And Tier 2
Capital adequacy norms divide the capital into two categories. Tier one capital is used to absorb losses while the Tier 2 capital is meant to be used at the time of winding up.
Tier I Capital: Actual contributed equity plus retained earnings.

Tier II Capital: Preferred shares plus 50% of subordinated debt (junior debt)

Subordinated debt figures between debt and equity – coming after the first in terms of eligibility for benefits like compensation.

Recapitalization is lending to the bank the resources needed to conform to the capital adequacy norms which stand at 8% today – minimum level.

One of the problems perceived in Basel 1 and 2 norms was that all sovereign debt, in general, was given a risk weight of zero, while all corporate debt was given similarly an equal weight irrespective of the difference in risk of the corporate concerned. The Eurozone sovereign debt crisis taught us lessons.

The risk weights led to some curious behaviour in lending. Banks started preferring to lend to governments, which required no capital addition, while even risk-free corporates, which had good rating, demanded additional capital provisioning under adequacy norms. Thus, one size fits all approach brought in distortions in lending.

Basel 3 norms: RBI Guidelines

The draft guideline norms announced by the RBI in mid-2012 will come into effect fully by 31 March 2018.

The key capital adequacy parameter has been stipulated at 9% higher than the international norm of 8%, and unchanged from what the regulator requires in India currently.

These guidelines mean that Indian banks would require a huge amount of capital in the next six years, about $30 billion to $40 billion. Some banks may find it difficult.

That would impose a heavy financial burden on the government, which will need to infuse capital in line with its holdings in the state-owned banks.

Under Basel III norms, a countercyclical capital buffer is prescribed: keep aside capital that can be used when the cycle turns down and the loans may turn bad.
Swap line for banks under the ECB route introduced by the RBI in mid-2013. (Discussed in the class)

BIS

The Bank for International Settlements (BIS) is an international organization of central banks which fosters international monetary and financial cooperation and serves as a bank for central banks." It also provides banking services, but only to central banks, or to international organizations. Based in Basel, Switzerland, the BIS was established by the Hague agreements of 1930.

As an organization of central banks, the BIS seeks to make monetary policy more predictable and transparent among its 55 member central banks. The BIS' main role is in setting capital adequacy requirements to safeguard bank's operations.

Shadow banks

NBFCs are largely refered to as shadow banking system or the shadow financial system. They have become the major financial intermediaries. As seen in the note on NBFCs elsewhere, shadow institutions do not accept demand deposits and therefore are not subject to the same regulations. Familiar examples of shadow institutions included Bear Stearns and Lehman Brothers. Hedge funds, pension funds, mutual funds and investment banks are some examples.

Shadow institutions are not as effectively regulated as banks and so carry higher risk of failure.

Universal Banking in India

Universal banking in India was recommended by the second Narasimham Committee (1998) and the Khan Committee (1998) reports. It aims at widening and integration of financial activities.

Universal Banking is a multi-purpose and multi-functional financial supermarket.' Universal banking' refers to those banks that offer a wide range of financial services, beyond the commercial banking functions like Mutual Funds, Merchant Banking, Factoring, Credit Cards, Retail loans, Housing Finance, Auto loans, Investment banking, Insurance etc. This is most common in European countries.

Benefits to banks from universal banking are that , since they have competence in the related areas, they can reduce average costs and thereby improve spreads(difference between cost of borrowing and the return on lending) by diversification. Many financial services are inter-linked activities, e.g. insurance, stock broking and lending. A bank can use its instruments in one activity to exploit the other, e.g., in the case of project lending to the same firm which has purchased insurance from the bank. To the customers, 'one-stop-shopping' saves transaction costs.

However, one drawback is that universal banking leads to a loss in specialisation. There is also the problem of the bank indulging in too many risky activities. ICICI(Industrial Credit and Investment Corporation of India) merged with its subsidiary-ICICI Bank in a reverse merger(parent merging with the subsidiary, the ICICI Bank). Other banks are also emerging as universal banks which are popular in Europe.

The compulsions for the DFIs like ICICI, IDBI, IFCI etc to become UBs is the following:

Earlier in the sixties and seventies, the DFIs specialized in project finance for the industries with long term capital needs. But the industries of late are mobilizing the finances from external sources or from the stock market and so the DFI business suffered. The cheap Government funds that were available in the earlier pre-liberalization era also are not available today.Banks and DFIs are having to compete for the same clients. Banks have an advantage in that they have a deposit base but the DFIs do not have same.

BANKING SYSTEM IN INDIA-II

Financial inclusion

Many people, particularly those living on low incomes, cannot access mainstream financial products such as bank accounts and low cost loans. This financial exclusion forces them to borrow from the moneylenders at high cost. Therefore, financial inclusion has been the goal of government's policy since late sixties.

Financial inclusion or taking banking services to the common man was the main driver of bank nationalization in 1969 and 1980 powered by three priority areas

- access to banking
- access to affordable credit, and
- access to free face-to-face money advice.

Thus, financial inclusion is the delivery of banking services at an affordable cost to the vast sections of disadvantaged and low-income groups. The Government of India's rationale for creating Regional Rural Banks (RRBs) in the years in 1975 following the nationalization of the country's banks was to ensure that banking services reached poor people.

The branches of commercial banks and the RRBs grew from 8,321 in 1969 to about 70,000.

Priority sector credit under which 40% of all bank advances should go to certain specified areas like agriculture is a form of directed credit that is aimed at financial inclusion.

Micro-finance (savings, insurance and lending in small quantities) and self-help groups are another innovation in financial inclusion.

Differential rate of interest; kisan credit cards; no-frills account (allowing opening of account with very little or no minimum balances) etc are examples of financial inclusion.

Scaling-up access to finance for India's rural poor, to meet their diverse financial needs (savings, credit, insurance, etc.) through flexible products at competitive prices is the goal of financial inclusion.

The total number of no-frill accounts opened over a two-year period (April 1, 2007 to May 30, 2009) stands at 25.1 million.

While it is beyond doubt that financial access of the people has significantly improved in the last three-and-a-half decades, and even more so in the last two years, the focus now should be on how to accelerate it as financial inclusion is important for economic growth, equity and poverty alleviation.

Unique identification number has some advantages for financial inclusion KYC (know your customer) bottlenecks will be dramatically reduced. Millions of new customers will become bankable. Growth will get a boost. Risk management will undergo a paradigm shift. Credit histories will be available on tap. Profitability will improve and so will customer service. We could finally have a technology initiative to extend financial inclusion.

Bank consolidation

Merging public sector banks to form big and globally aspiring banks is bank consolidation. It is expected to bring about financial stability and was recommended by the Narasimham Committee-II (1997) on financial sector reform.

State Bank of Saurashtra's merger with SBI has been achieved and the remaining six are to be merged. Government says that bigger banks can take on competition; can raise more than smaller banks;

Rationalising the manpower and branch network after bank mergers is a challenge and the criticism also includes that the bigger banks will be so much more bureaucratized. Bigness also does not reduce chances of failure as seen in the west in the current meltdown.

India has more than 175 commercial banks, out of which 26 state-owned banks account for the majority of the banking sector's assets followed by private sector banks and foreign banks, which have a tiny share.

Financial stability

Financial stability is a situation where the financial system operates with no serious failures or undesirable impacts on development of the economy as a whole, while showing a high degree of resilience to shocks.

Financial stability may be disturbed both by processes inside the financial sector leading to the emergence of weak spots like excessive of leverage; dealing in doubtful products like collateralized debt options(CDS) etc. It can also be undermined through regulatory lapses and inadequate safeguards prescribed by law.

In India, the banking system was not impacted badly by the world financial crisis as Indian banks are well-regulated through proper supervision. They are also well capitalized through capital adequacy ratio according to the Bank of International Settlements (Basel, Switzerland).
Calibrated globalization also meant that we would open upon only on achieving the strength to compete successfully.

RBI and Financial Stability

Traditional role

Recent global financial crisis is largely attributed to the financial sector recklessness due to lack of quality regulation. The lesson to draw from the crisis is to provide for good regulation- need not be more regulation- by the Central bank so that there is financial stability. In India, RBI has performed the role by the following instruments

- Licensing of banks
- Deciding on who can set up a bank, expand etc
- SLR, CRR norms
- CAR rules
- Lender of last resort
- Laying down prudential norms

- Supervisory functions

RBI Governor heads the HLCC- High Level Coordination Committee of financial regulators of SEBI, PFRDA and IRDA.

RBI defines from time to time NPA norms; allows or limits or banks credit to certain sectors like real estate in order to make banking operations safe and stable. Interest rates are also changed through repo and reverse repo rates to caution the borrowers and consumers.

Post-Lehman

Maintaining and monitoring financial stability has always been a key objective of monetary policy. However, it was only from the middle of 2009(post-Lehman) that the government and the RBI sought to institutionalise the process, making financial stability "an integral driver of the policy framework."

RBI tracks the following parameters in its quest to maintain financial stability: excessive volatility in interest rates, exchange rates and asset prices; signs of excess leverage (borrowings) in the financial sector, companies and households; and the unregulated parts of the financial sector.

RBI set up a Financial Stability Unit in 2009 and started presenting periodical reports since March 2010. The first report found the banking system to be broadly healthy and well-capitalised, but noted that global economic shocks, inflation, the slow pace of fiscal consolidation and the unsettlingly large capital inflows posed significant risks to financial stability. According to the second FSR, many of the positive features are intact. Growth has rebounded strongly and the financial conditions are stable. Despite intermittent volatility in the foreign exchange and equity markets, the financial sector has been risk-free. New risk assessment measures are introduced by the RBI — such as the Financial Stress Indicator and the Banking Stability Index.

Risks to financial stability are: the widening current account deficit; volatile capital inflows and the persistently high inflation.

The asset quality of banks and their asset-liability mismatch need to be constantly monitored.

Recent developments in the microfinance institutional structure cause serious concern.

Given the increasing correlation between global economic growth and that in emerging markets, the possibility of certain exogenous risks materialising is strong.

Banking Stability Index

It has been devised by the RBI in 2009. This index is simple average of five sub indices chosen for banking stability map that RBI has constructed. Banking Stability Map has used five key risk dimensions like operational efficiency, asset-quality, liquidity and profitability. These are based on capital adequacy ratio, cost-to-income ratio, nonperforming loans to total loans ratio, liquid assets to total assets ratio and net profit to total assets ratio.

Words

PLR
Prime Lending Rate (PLR) is the rate at which banks lend to the best customers. About 15% today. (2009)

Basis point
Changes in interest rates and other variables are expressed in terms of basis points to magnify and express the importance of changes. One basis point is 1% of 1%.

Weak Bank – Narasimham Committe – II
A 'Weak Bank' has been defined by the committee as follows: Where total accumulated losses of the bank and net NPA amount exceed the net worth of the bank.

Narrow banking
For restoring weak banks to strength, restructuring is needed. Such restructuring is generally attempted by operating the bank(s) as narrow bank(s), among other things. Narrow banking would restrict banks to holding liquid and safe government bonds. It prevents bank run.

Bank run
A bank run is a type of financial crisis. It is a panic which occurs when a large number of customers of a bank fear it is insolvent and withdraw their deposits.

Subordinated debt
It is also known as junior debt. It is a finance term to describe debt that is unsecured or has a lesser priority than that of other debt claim on the same asset. This means that if the party that issued the debt defaults on it, people holding subordinated debt get paid after the holders of the "senior debt". A subordinated debt therefore carries more risk than a normal debt. Subordinated debt has a higher expected rate of return than senior debt due to the increased inherent risk.

Core banking
Core Banking is normally defined as the business conducted by a banking institution with its retail and small business customers. Many banks treat the retail customers as their core banking customers, and have a separate line of business to manage small businesses. Larger businesses are managed via the Corporate Banking division of the institution. Core banking basically is depositing and lending of money.

World bank recapitalization
Government of India has made an assessment that the public sector banking system would need as much as Rs.35,000 crore worth of Tier-1 capital by 2012, given projections of how much their business needs to expand. Past divestment of equity has significantly reduced the government's shareholding in many public sector banks. Hence, it is argued, if 51 per cent government ownership has to be maintained to secure the public sector character of these banks, this recapitalisation has to be in the form of new government equity capital. Since the government is strapped for funds

for this purpose, it has decided to use this requirement as the basis for opting for a sector-specific $2 billion World Bank loan.

Banks stress tests

A **stress test** is an assessment or evaluation of a bank's balance sheet to determine if it is viable as a business or likely to go bankrupt when faced with certain recessionary and other stress situations- whether it has sufficient capital buffers to withstand the recession and financial crisis. European banks were recently subjected to such stress tests.

Financial sector reforms

Reforming the financial sector - banking, insurance, capital market, pensions- is crucial to make them generate resources; gain efficiencies; innovate new products and serve the economy and people well. It involves adoption of best practices in regulation and other areas like micro finance etc. The need is particularly felt in the wake of the global financial crisis brought about essentially by the financial sector that ruined the real economy related to production.

Some recent initiatives in this sector relate to introduction of private banks and foreign banks being given a level playing field with Government banks; deregulation of interest rates; reduction reserve requirements; pensions system being reformed ; base rate for banks; setting up of Financial Stability and Development Council; business correspondent model for financial inclusion.

There is a need however to improve the regulation of the NBFCs as they borrow from banks and lend which means if they are not properly regulated, the whole financial system is vulnerable.

Crr and slr have been freed from floor and cap to make banking more flexible.

Consolidation of banks is taking place so that benefits of scale can push Indian banks to global heights. State Bank of Saurashtra is merged with SBI and State Bank of Indore is also merged. Bank of Rajasthan has been acquired by ICICI Bank and merged with the latter.

However, in the insurance sector, reforms are still due. The Insurance Laws (Amendment) Bill provides for enhancement of share holdings by a foreign company from 26% to 49%. The Bill is not made into law as there ar differences among the political parties.

Pension Fund Regulatory and Development Authority (PFRDA) Bill that wants r FDI in this sector is also not approved.

The government was finding it difficult to manage its rising pension liability because of the defined-benefit system, under which the pension paid to employee was based on their last salary drawn.

In 2004, it shifted to a defined contribution system, which required employee to save for retirement from their earnings.

Towards this end, it set up a new pension system (NPS) for those joining government service after January 2004 and subsequently set up the Interim Pension Fund Regulatory and Development Authority to oversee the scheme that already managed the retirement savings of lakhs of state and central government employees.

The NPS was later extended to private individuals. The government now hopes to establish the NPS as the premier retirement savings scheme.

The pension bill seeks to give statutory or legal powers to the PFRDA, and set the framework for the regulation of pension fund schemes, including the ones being currently offered.

Debt market: The bond market in India remains limited in terms of nature of instruments, their maturity, investor participation and liquidity. Recent reforms include raising of the cap on investment by foreign institutional investors, or FIIs. Infrastructure debt fund etc.

Regulatory reforms- setting up of the FSDC is crucial for better supervision and clear demarcation of the jurisdiction.

The roadmap for financial sector reforms has been defined by the RH Patil, Percy Mistry & Raghuram Rajan reports.

The Banking Laws (Amendment) Act 2012

The Act would strengthen the regulatory powers of Reserve Bank of India (RBI) and to further develop the banking sector in India. It will also enable the nationalized banks to raise capital by issue of preference shares or rights issue or issue of bonus shares. It would pave the way for new bank licenses by RBI resulting in opening of new banks and branches. This would not only help in achieving the goal of financial inclusion by providing more banking facilities but would also provide extra employment opportunities to the people at large in the banking sector.

The salient features of the Bill are as follows:

- To enable banking companies to issue preference shares subject to regulatory guidelines by the RBI;
- To increase the cap on restrictions on voting rights;
- To create a Depositor Education and Awareness Fund by utilizing the inoperative deposit accounts;
- To provide prior approval of RBI for acquisition of 5% or more of shares or voting rights in a banking company by any person and empowering RBI to impose such conditions as it deems fit in this regard;
- To empower RBI to collect information and inspect associate enterprises of banking companies;
- To empower RBI to supersede the Board of Directors of banking company and appointment of administrator till alternate arrangements are made;
- To provide for primary cooperative societies to carry on the business of banking only after obtaining a license from RBI;
- To provide for special audit of cooperative banks at instance of RBI; and
- To enable the nationalized banks to raise capital through "bonus" and "rights" issue.

Bhartiya Mahila Bank (BMB)

It is an Indian financial services banking company based in New Delhi, India. Prime Minister Manmohan Singh inaugurated the bank on 19 November 2013 on the occasion of the 94th birth anniversary of former Indian Prime Minister Indira Gandhi.Although initially reported as a bank exclusively for women, the bank will allow deposits to flow from everyone, but lending will be predominantly for women. It has employees other than women too.

In India, only 26% of women have an account with a formal financial institution, compared with 46% of men. That means an account in either a bank, a co-operative, post office or a microfinance institution, according to a study by the World Bank. Also, for women, per capita credit is 80 per cent lower than males.

Furthermore, the results of a study using a global dataset covering 350 Microfinance Institutions (MFIs) in 70 countries indicates that more women clients is associated with lower portfolio-at-risk, lower write-offs, and lower credit-loss provisions.

The bank will place emphasis on funding for skills developments to help in economic activity. Moreover, the products will be designed in a manner to give a slight concession on loan rates to women.

The bank shall also aim to inspire people with entrepreneurial skills and, in conjunction with NGOs, plans to locally mobilize women to train them in vocations like toy-making or driving tractors or mobile repairs.

One of the other objectives of the bank is to promote asset ownership amongst women customers. Studies have shown that asset ownership amongst women reduces their risk of suffering from domestic violence.

The Bank's initial capital consists of Rs 1,000 crores. The government plans to have 25 branches by the end of March 2014 and 500 branches by 4th year of operation (2017).

Initially the bank will have a board of directors consisting of eight women.

How Indian banks survived the global crisis

Even though many banks failed and some survived on huge bailouts in the west due to the global financial crisis, Indian banking is almost unscathed for the following reasons

- Public sector banks- 27- dominate
- FDI is 74% in private banks but voting rights are only 10%
- We adopted capital account convertibility in a measured manner
- RBI has been conservative and regulated the banks well. Banks were not allowed to invest in risky instruments like credit default swaps(CDS)
- Basel norms, SLR and CRR levels were well maintained
- Prudential norms also saved the Indian banks from recklessness.

Financial Inclusion

Access to finance by the poor and vulnerable groups is a prerequisite for poverty reduction and social cohesion. This has to become an integral part of our efforts to promote inclusive growth. Financial inclusion means delivery of financial services at an affordable cost to the vast sections of the disadvantaged and low-income groups. The various financial services include credit, savings, insurance and payments and remittance facilities. 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.

NSSO data reveal that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households do not access credit, either from institutional or non-institutional sources. Further, despite the vast network of bank branches, only 27% of total farm households are indebted to formal sources (of which one-third also borrow from informal sources). The poorer the group, the greater is the exclusion.

While financial inclusion can be substantially enhanced by improving the supply side or the delivery systems, it is also important to note that many regions, segments of the population and sub-sectors of the economy have a limited or weak demand for financial services. In order to improve their level of inclusion, demand side efforts need to be undertaken including improving human and physical resource endowments, enhancing productivity, mitigating risk and strengthening market linkages.

JLBs are proposed by the Rangarajan committee on financial inclusion 2008.JLB is like the SHG but is confined to farming operations mainly. A Joint Liability Group (JLG) is an informal group comprising preferably of 4 to10 individuals coming together for the purposes of availing bank loan either singly or through the group mechanism against mutual guarantee. The JLG members are expected to engage in similar type of economic activities like crop production.

Micro Finance Institutions (MFIs) could play a significant role in facilitating inclusion, as they are uniquely positioned in reaching out to the rural poor. The committee feels that legislation to regulate the microfinance sector is essential.

Important additional data for financial inclusion

- The first major breakthrough in financial inclusion came through when MYRADA, an NGO working in Karnataka developed the self-help group (SHG) methodology to link the unbanked rural population to the formal financial system through the local bank branches. Thanks to the efforts of the Reserve Bank of India (RBI), Nabard, state governments and numerous civil society organisations , about 8.6 crore households now have access to banking through SHGs. There are 61 lakh saving-linked SHGs with Rs 5,545.6 crore aggregate savings and 42 lakh credit-linked SHGs with loan outstanding of Rs 22,679.8 crore as on March 31, 2009.
- The business correspondent (BC) model advocated by the RBI is another pertinent example of potential frugal innovation in the financial inclusion space. The use of BCs enables banks to extend banking services to the

hinterland without setting up a brickand-mortar branch, which is often an unviable proposition. Banks use various types of hand-held devices, (aptly nicknamed microATMs) to authenticate micro-transactions at the BC location and to integrate the same with bank's main database.

- Unique Identification Authority of India (UIDAI

RBI as a regulator (Can be constructed from above)

Basics of Base Rate

What is the base rate (BR)?

It is the minimum rate of interest that a bank is allowed to charge from its customers. Unless mandated by the government, RBI rule stipulates that no bank can offer loans at a rate lower than BR to any of its customers.

How is the base rate calculated?

A host of factors, like the cost of deposits, administrative costs, a bank's profitability in the previous financial year and a few other parameters, with stipulated weights, are considered while calculating a lender's BR. The cost of deposits has the highest weight in calculating the new benchmark. Banks, however, have the leeway to take into account the cost of deposits of any tenure while calculating their BR. For example, SBI took costs of its 6-month deposits into account while calculating its BR, which it has fixed at 7.5%.

When did the base rate come into force?

It is effective from Thursday, July 1. However, all existing loans, including home loans and car loans, continue to be at the current rate. Only the new loans taken on or after July 1 and old loans being renewed after this date are be linked to BR.

How is it different from bank prime lending rate?

BR is a more objective reference number than the bank prime lending rate (BPLR) -- the current benchmark. BPLR is the rate at which a bank lends to lend to its most trustworthy, low-risk customer. However, often banks lend at rates below BPLR. For example, most home loan rates are at sub-BPLR levels. Some large corporates also get loans at rates substantially lower than BPLR. For all banks, BR will be much lower than their BPLR.

How often can a bank change its BR?

A bank can change its BR every quarter, and also during the quarter.

What does it mean for corporate borrowers?

Under the BPLR system, large corporates who enjoyed rates as low as 4-6% will be hit.

What are its benefits?

Makes the lending rates transparent. Monetary policy changes will find genuine transmission. Cross subsidation of the corporate at the expense of MSMEs will stop and MSMEs will get credit more affordably.

What are the exceptions?

Educational loans, export credit, credit to weaker sections can be given at sub-base rate.

Securities and Insurance Laws (Amendment) and Validation Act, 2010

United Linked Invest Plans(Ulips) are the insurance products in which payment is made partly for premium(insurance) and rest of it invested in the capital market like a Mutual Fund investment. It led to jurisdictional disputes between Sebi and Irda. Sebi says that a huge amount of Ulip is invested in stock market. Government promulgated an ordinance to set up a mechanism to regulate such jurisdictional disputes.

Financial sector is inter-related. Banks keep money that is invested in stock market. Insurance companies have stock market related products like Ulips.Pension funds are becoming popular in the stock market. These players can have mutual problems of jurisdiction as seen in the case of Ulips. Therefore, there is a need for a 'super regulator'.

Parliament passed a Bill- Securities and Insurance Laws (Amendment) and Validation Bill, 2010 -that provides a mechanism, headed by the finance minister, to resolve disputes between financial regulators as an ad-hoc arrangement. It has representations from the four financial sector regulators and the Finance Ministry- Sebi. Irda, Rbi and Pfrda.

The Act states that the Reserve Bank Governor will be the vice-chairman of the joint committee. The joint body can entertain only jurisdictional issues. Even here, forst the involved parties should settle it between them

However, there were apprehensions expressed by RBI over its autonomy.

The government is still working on a permanent body to settle the inter-regulator disputes such as the SEBI-IRDA turf war.
The criticism is that there is already a Hligh level Coordination Committee with Rbi Governor heading it and there is no need for the current mechanism. It has lead to politicization.

Swabhimaan 2011

The government has launched 'Swabhimaan' – a programme to ensure banking facilities in habitation with a population in excess of 2,000, by March 2012. The programme will use various models and technologies, including branchless banking through business correspondents. The government has decided to pay banks Rs 140 for every no frills account they open as part of the financial inclusion plan.

The initiative would enable small and marginal farmers obtain credit at lower rates from banks and other financial institutions. This would insulate them from exploitation of the money lenders

The government has actually decided to give Rs 500 million to banks fo helping them open no frills accounts in the fiscal year 2011-2012.

Once banking access increases, it is hoped that it enables government subsidies and social security benefits to be directly credited to the accounts of the beneficiaries, enabling them to draw the money from the business correspondents in their village itself.

Given the size of the un-banked population in the country, the ongoing project can be considered a "significant beginning". Only a little more than a third of India's population has access to banking services at present. Among the bank-supported initiatives, self-help groups (SHGs) also have a role to play, the government's FI project is reliant more on Banking Correspondent (BCs} and technology to reduce the capital-intensity of expanding the banking cover.

There should at the same time be focus on financial literacy so as to take full benefit for the inclusion. This is particularly true in a context of rapid development of branchless banking, with newly banked people being exposed to non-bank intermediaries, therefore with no possibility to directly interact with experienced bankers.

Financial inclusion should not only be about reaching high numbers of unbanked or underserved groups. It should equally be about the provision of quality financial services and products. This means that access to safe, adapted, accessible, affordable and usable financial services and products should be offered.

The Insurance Regulatory and Development Authority's (IRDA) latest Annual Report indicates life insurance penetration at just 4.6 per cent and general insurance penetration at 0.6 per cent. Majority of the people do not have bank accounts, and even though RBI mandates have ensured the opening of 50 million no-frills accounts, hardly 11 per cent are active.

Innovations in financial products and technology-based delivery methods can expand the reach of financial services and create new opportunities to provide essential services to the poor. Financial products targeting the poor, such as money transfer services, microloans, microinsurance, or weather and catastrophic risk insurance, micropensions, can all have an important transformative effect. Deepening the financial system and widening its reach is crucial for both accelerating growth and for equitable distribution, given the present stage of development of our country.

One of the key features of the National Rural Livelihoods Mission (NRLM) is to work towards achieving universal financial inclusion, beyond basic banking services to all the poor households, SHGs and their federations. The key lies in linking access to financial services with livelihood options and leveraging the same to achieve poverty eradication. The end purpose of financial inclusion is and must be poverty alleviation.

Priority sector: Nair Committee recommendations

The RBI committee under the current Union Bank Chairman MV Nair has come out with their recommendations on lending to priority sector. It has reviewed the existing guidelines on lending to priority sector categories including agriculture, MSME and export. Its recommendations are

- Priority sector targets for public sector and private sector banks could be retained at the current level of 40% of the net credit to the sector.
- It has recommended severe changes should be made to exposure of foreign banks. Foreign banks' priority sector target should be increased from 32% to 40%.
- Special treatment should be given to small and marginal farmers and housing loans below Rs 2 lakhs should be classified under priority sector.

RBI acted on these recommendations

The Reserve Bank of India (RBI) in July 2012 said that foreign banks having 20 or more branches in the country will be brought on par with domestic banks for priority sector targets in a phased manner over a maximum period of five years starting April 1, 2013.

Foreign banks with less than 20 branches will have no sub-targets within the overall priority sector lending target of 32 per cent. This is expected to allow them to lend as per their core competence to any priority sector category.

The RBI said that the revised guidelines aim at implementing the essence of recommendations of Nair Committee without dismantling the established and accepted structure of priority sector lending.

The overall target under priority sector lending is retained at 40 per cent as suggested by the Nair Committee. The targets under direct and indirect agriculture are retained at 13.5 per cent and 4.5 per cent, respectively while refocusing the direct agricultural lending to individuals, self help groups (SHGs) and joint liability groups (JLGs) directly by banks.

The RBI said that loans to micro and small service enterprises up to Rs.1 crore; all loans to micro and small manufacturing enterprises up to Rs.25 lakh and for housing in metropolitan centres above Rs.10 lakh and at other centres Rs.15 lakh would form part of priority sector lending as per the revised guidelines. Loans to food and agro processing units and individuals for educational purposes, including vocational courses up to Rs.10 lakh in India and Rs.20 lakh abroad would also be part of priority sector lending.

Loans for housing projects exclusively for economically weaker sections and low-income groups, provided the cost does not exceed Rs.5 lakh per dwelling unit, loans to distressed farmers indebted to non-institutional lenders, loans to state sponsored organisations for scheduled castes and scheduled tribes, loans to individuals for setting up of off-grid solar and other off-grid renewable energy solutions for households and loans to individuals other than farmers up to Rs.50,000 to prepay their debt to non- institutional lenders would also be part of priority sector lending.

Investments by banks in securitised assets, outright purchases of loans and assignments to be eligible for classification under priority sector provided the underlying assets qualify for priority sector treatment and the interest rate charged to the ultimate borrower by the originating entity does not exceed Base Rate of such bank plus 8 per cent per annum.

Savings bank rate deregulation

The Reserve Bank of India (RBI) in 2011 deregulated savings bank rates .

A savings deposit one where the depositor can earn interest like an FD and can withdraw from the account like a current account. The savings rate was fixed at 3.50% from 2003 to 2011 and waslater raised to 4%.

However, during the period, the RBI changed both repo and reverse repo rates many times but the same was not reflected in the interest rates that the normal household gets. There was a huge gap between savings and term deposit rates. Thus, the depositors in SB account suffered.

After deregulation, it is expected that savings rate would move in tandem with the RBI monetary policy, thus, making the policy more effective.

NBFC-MFI

RBI decided to create a separate category of NBFCs viz; Non Banking Financial Company-Micro Finance Institution (NBFC-MFI) and notified norms in 2012.

Foreign banks: WOS vs Branch

The global financial crisis of 2008 has shown that the growing complexity and interconnectedness of financial institutions have compromised the ability of home and host authorities to cope with the failure of too big to fail (TBTF) institutions. The lessons learnt during the crisis lean in favour of domestic incorporation of foreign banks as wholly owned subsidiaries (Wos)

In general, following are the main advantages of local incorporation:

- It creates separate legal entities, having their own capital base and local board of directors;
- It ensures that there is a clear delineation between the assets and liabilities of the domestic bank and those of its foreign parent and clearly provides for ring fenced capital and assets within the host country;
- It imparts clarity and certainty with respect to applicability of the laws of country of incorporation on the locally incorporated subsidiary;
- A locally incorporated bank has its own board of directors and these directors are required to act in the best interests of the bank, to prevent the bank from carrying on business in a manner likely to create a risk of serious loss to the bank's creditors/depositors;
- Provides effective control to the regulator

A number of jurisdictions, therefore, impose requirement of local incorporation for foreign banks mainly for (i) protecting local retail depositors and (ii) affording greater regulatory comfort.

Considering the capital required to fuel economic growth, foreign banks have to play a significant role along with new private sector banks to cater to growing credit demand.

In a bid to better regulate them and avoid 2008-type crisis, RBI in November 2013 said that foreign banks with complex structures which do not provide adequate disclosure would have to operate in India only through wholly-owned subsidiaries (WOS).

The guidelines incentivise foreign banks operating in the country with 'near national treatment' if they become WOS, enabling them to open branches anywhere at par with other public and private sector banks.

The regulator also allowed foreign banks to list their subsidiaries on the local stock exchanges.

They can also acquire local banks.

Corporate guidelines for the WOS include a proviso that not less than 50 per cent of the directors should be Indian nationals/NRIs/PIOs.
Further, not less than two-thirds of the directors should be non-executive directors and a minimum of one-third of the directors should be independent of the subsidiary.
There are 45 foreign banks in India with a network of 333 branches as of 2013, most of which are held by the top three -- StanChart (100 branches), HSBC (50) and Citi (40).

Their market share stood at 6.5 percent of total banking assets in FY13.

The initial minimum paid-up equity capital or networth for a WOS should be Rs 500 crore, RBI had said.

Differences between branch and Wos models: To set up a branch, it needsto get RBI approval. Tax rate is high (40% as against domestic companies rate which is 30%) Advantage: Repatriation of money back to foreign country is easier.
If it is a wholly owned subsidiary, it becomes an independent entity - less RBI intervention, less tax rate and the rest outlined above.
Both however are subject to priority sector norms as mentioned above.

CDR

There are occasions when corporates find themselves in financial difficulties because of factors beyond their control and also due to certain internal reasons. For example, the global financial crisis and the recession that followed since 2008 along with the infrastructural investments being stalled in India for a variety of reasons. For the revival of such corporates as well as for the safety of the money lent by the banks and financial institutions, timely support through restructuring of genuine cases is called for. In India, a Corporate Debt Restructuring System was evolved and detailed guidelines were issued by Reserve bank of India early 2001.

It may be emphasized here that, in no case, the requests of any corporate indulging in fraud or misfeasance, even in a single bank, can be considered for restructuring under CDR System.

In a growing sign of companies facing difficulties in meeting their financial obligations, banks were approached for debt restructuring in a record 126 cases during 2012 for a collective amount of Rs 84,000 crore.

Debt restructuring is a process that allows a private or public company – or a sovereign entity – facing cash flow problems and financial distress, to reduce and renegotiate its delinquent debts in order to improve or restore liquidity and rehabilitate so that it can continue its operations.

Replacement of old debt by new debt when not under financial distress is referred to as refinancing.

NPAs 2013

Net non-performing assets (NPAs) or bad loans of 40 listed banks jumped by 38% or around Rs 35,424 crore in the first six months of financial year ended September 30, 2013.

As on March 31, 2013, net NPAs of 40 listed banks were Rs 93,109 crore, which rose to Rs 1,28,533 crore as on September 30, 2013.