T.Y.B.Com. Paper – III

BUSINESS ECONOMICS

SECTION - I

Module 1 : Commercial Banking

(A) Commercial Banking : Assets and Liabilities of Commercial Banks - Trade-off Between Liquidity and Profitability.

(B) Banking Sector Reforms : Measures, Performance with Respect to Public, New Private and Foreign Banks in the Post Reforms Period - New Technology in Banking in India.

Module 2 : Central Banking

Changing Trends in Monetary Policy in India - RBI's Short Term Liquidity Management - Role and Performance of Micro Finance, Self Help Groups and Composite Credit.

Module 3 : Financial Markets

(A) Money Markets : Components and Features of Indian Money Market - Money Market Reforms in India.

(B) Capital Markets : Significance in Economic Development - Capital Market Reforms - Role of SEBI - Role and Importance of Mutual Funds, Equity Market, Forward, Future and Commodity Market.

SECTION - II

Module 4 : Public Finance

Changing Trends in Tax and Non-Tax in India - Public Expenditure: Classification of Public Expenditure, Causes for Increase in Public Expenditure in India - Public Debt : Meaning and Classification - Burden of Internal and External Debt - Concepts of Deficits : Revenue, Budgetary, Fiscal and Primary Deficits - FRBM Act.

Module 5 : International Trade and WTO

Gains from International Trade - Balance of Trade and Payments - Causes of Disequilibrium in BOP - Measures to Correct Disequilibrium in BOP - Emerging Trends in India's BOP Position Since 1991 - WTO : Functions and Agreements with Reference to TRIPS, TRIMS and GATS.

Module 6 : Exchange Rate Determination

Exchange Rate Determination - Purchasing Power Parity Theory - Foreign Exchange Market - Functions and Dealers - Spot and Forward Exchange Rates - RBI's Intervention and Foreign Exchange Rate Management.

Pattern of Question Paper

Marks : 100 **Time : 3 Hours**

Note :

1. Attempt any **Five** questions by selecting **Minimum Two** Questions from each section.
2. Figures to the right indicate full marks.

SECTION - I

Q.1 (A) **(10)**

(B) **(10)**

Q.2 " **". -** Explain **(20)**

Q.3 Explain the following :

(A) **(10)**

(B) **(10)**

Q.4 Write explanatory notes (any two) : **(10 + 10 = 20)**

(A)

(B)

(C)

(D)

SECTION - II

Q.5 (A) **(10)**

(B) **(10)**

Q.6 Explain the following :

(A) **(10)**

(B) **(10)**

Q.7 **“ “. -** Explain **(20)**

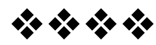
Q.8 Write explanatory notes **(any two) :** **(10 + 10 = 20)**

(A)

(B)

(C)

(D)



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Module 1
(A) COMMERCIAL BANKING

Unit Structure :

1.0 Objectives
1.1 Introduction
1.2 Types of Banks
1.3 Functions of Commercial Banks
 1.3.1 Primary Functions
 1.3.2 Secondary Functions or Non-Banking Functions
 1.3.3 Subsidiary Activities of Commercial Banks
1.4 Assets and liabilities of commercial banks
1.5 Trade off between profitability and liquidity
 1.5.1 Motives of investment policy
 1.5.2 Trade-off between Liquidity and Profitability
 1.5.3 Reconciling Twin objectives
 1.5.4 Factors affecting liquidity
 1.5.5 Factors affecting profitability
1.6 Questions

1.0 OBJECTIVES

- To understand the concept and working of commercial banks.
- To understand the functioning of commercial banks in terms of their objectives and to see their exercise in balancing their liquidity and profitability objectives.
- To understand the progress of commercial banks in India since 1991.

1.1 INTRODUCTION

A bank is a financial institution, which deals with the deposits and advances and other related services. It receives money from those who want to save it in the form of deposits and it lends money to those who need it.

Definition: The Banking Companies Act, 1949 defines a banking company as “a company which transacts the business of banking in any state of India, and the word banking has been defined as accepting for the purpose of lending or investment of deposits of money from the public repayable on demand or otherwise, and withdrawable by Cheque, draft, order or otherwise.”

1.2 TYPES OF BANKS

Types of Banks: We can classify the banks as follows:

1) **Central Bank:** Central Bank is an apex institution which supervises, controls and regulates the activities of commercial banks and money supply in the country. It is generally under Government ownership and controls and implements economic policy of the Government.

2) **Commercial Banks:** A commercial bank is an institution which offers full banking services to industry, trade and people of a country. These banks accept deposits from and lend them to borrowers by charging some interest on the amount lent to them.

3) **Industrial Banks:** These banks give loans to small-scale industries, large-scale industries. They give long term loans to industry and trade. IDBI, SFC’s (State Finance Corporations), ICICI etc. are industrial banks.

4) **Foreign Banks:** A number of foreign banks with their head offices in other countries carry on business in India through their branches. These banks deal in transactions involving Foreign Exchange. Buying and Selling of Foreign Currency is their main function. Citibank, Standard Chartered Bank etc. are Foreign Banks.

5) **Export- Import Bank of India:** This bank was established on 7th January, 1982 by the Government of India. It solves the problems faced by Indian Exporters and helps them in their export projects.

6) **Regional Rural Banks:** These are special types of banks which look after the special needs of weaker sections of rural areas. They work under the control of commercial banks which establish these banks.

7) **Co-operative Banks:** Co-operative Banks are divided into three categories as follows: (a) Primary Co-operative Banks: Primary

Co-operative Banks are situated in rural areas. They give short and medium term loans to farmers. (b) Central Co-operative Banks: These banks refinance the Primary Co-operative Banks. (c) State Co-operative Banks: These banks refinance the Central Co-operative Banks.

8) **Land Development Banks:** These banks look after the long-term requirements of farmers for agricultural development.

Check Your Progress:

a. What is a commercial bank?
b. What are the different types of banks that operate in our country?

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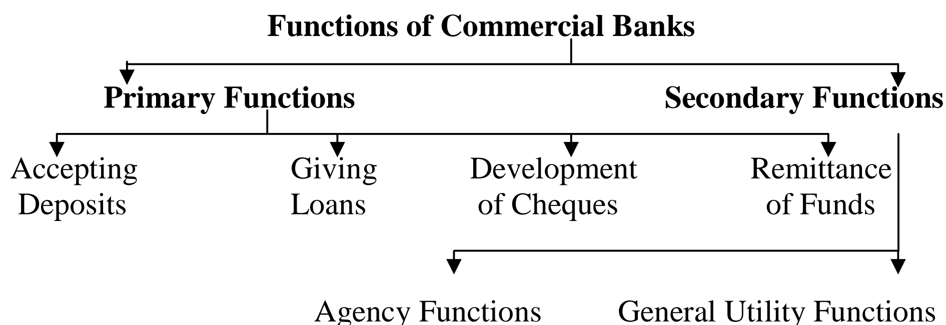
1.3 FUNCTIONS OF COMMERCIAL BANKS

The Functions of Commercial Banks can be discussed as follows:



1.3.1 Primary Functions:

(A) **Accepting Deposits:** A Bank accepts deposits from individuals, firms and institutions. These deposits are the main sources of finance / revenue of a bank. The deposits received by bank can be as follows:

1. **<u>Savings Bank Deposits</u>:** Savings Bank Deposits are generally kept by salaried persons having fixed income. These accounts can be opened with a small amount. These deposits carry a lower rate of interest than fixed deposits.
2. **<u>Current Account Deposits</u>:** Demand Deposits are generally kept by businessmen, to meet their day-to-day business needs. Money deposited in the current account can be withdrawn in part or full any time. No interest is paid on these accounts. The banks keep almost 100% reserve against these deposits.

3. **<u>Fixed Deposits</u>:** Fixed Deposits are deposits, which are made for fixed period of time which varies from 15 days to 5 years or more. These Deposits carry a high rate of interest. These deposits cannot be normally withdrawn before the expiry of period. If they are withdrawn there will be a loss of interest. At present the rate of interest varies from 5% to 8.5% depending on the time period and the type of bank.

4. **<u>Recurring Deposits</u>:** In case of such deposits, depositors are encouraged to deposit a specified amount at a regular interval i.e. monthly basis. Interest on these deposits is almost equal to that of Fixed Deposits.

(B) **<u>Giving Loans</u>:** Banks provide loans to its customers for short- and medium- terms. On these loans, the banks charge interest. Banks pay lower rate of interest for the deposits accepted and give loans at a higher rate of interest. The difference between the lending rate and deposit rate is the profit of the bank. But since the bank deals in people's money, it has to keep some cash ready to meet the withdrawals of the depositors.

1. **<u>Overdraft Facility</u>:** This facility is given to current account holders. Under such facility, the customer is allowed to withdraw excess amount than the amount that is available in his account upto a specified limit. Interest is charged on the excess amount withdrawn.

2. **<u>Cash Credit:</u>** Cash loan is granted against the security of the goods or personal security of more than one person other than the borrower. Interest is charged on the actual amount withdrawn.

3. **<u>Discounting Bills of Exchange</u>:** Now-a-days people do not wait for the bill of exchange to mature. Banks give loans to people by discounting bills of exchange. When bills of exchange mature banks get back their payment form the persons who have drawn the bill or who are liable to pay the bills. Banks get commission for discounting the bills.

4. **<u>Demand Loans or Money-at-call or Short Notice</u>:** These loans are given by the banks for a very short period and are generally backed by some security. These loans have no stated maturity and are also called as call loans. These loans are normally given to stock brokers, dealers in stock exchange etc. They are repayable on demand at 24 hours notice or at 7 days notice. The entire loan amount is paid in lump sum by crediting it to the loan account of the borrower. The interest is charged on the entire amount of loan.

5. **<u>Fixed-term Loans</u>:** Such loans are generally given for a period of One to Ten years to traders, producers, industrialists etc. If the loan is taken for 5 years or more, rate of interest is higher. If loan is taken for 1 or 2 years the rate of interest is low.

6. **<u>Participation or Consortium Loans</u>:** Sometimes two or more banks five fixed term loans to the industrialist against a common security. Such loans are called Consortium or Participation Loans.

7. **<u>Consumer Credit</u>:** These loans are given to householders for the Purchase of durable consumer goods like washing machine, Television, Air Conditioners, Handy cams, Higher Education, Marriages etc. Such loans are repaid in easy instalments within a given period of time.

8. **<u>Credit Creation</u>:** Credit Creation is one of the most outstanding functions of a modern commercial bank. Hence, it is mostly said that banks are manufacturers of credit. Credit is created when one party (a person, a firm or an institution) lends money to another party.

(C) **<u>Development of Cheques</u>:** This is also an important function of bank in settling debts. It is more suitable to use Cheques than Cash.

1. **<u>Bearer Cheque</u>:** A bearer Cheque can be encashed immediately when presented at the bank by the bearer (any person presenting the Cheque) of it.

2. **<u>Crossed Cheque</u>:** A Crossed Cheque is one in which two parallel lines are drawn at the left hand side corner of the Cheque. Such Cheques cannot be encashed immediately but has to be deposited in the payee's account in the bank. The amount gets credited in the account.

(D) **<u>Remittance of Funds</u>:** Commercial Banks help in remitting (sending) funds from one place to another by issuing bank

drafts, mail transfers, telegraphic transfers etc. by charging some commission.

Check Your Progress:

a. What do you understand by the primary functions of a commercial bank?
b. State any two primary functions of a commercial bank?

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1.3.2 Secondary Functions or Non-Banking Functions:

(A) **Agency Services:** Commercial Banks provide a number of services as an agent of customers. These include:

1. **Transfer of Money:** This is done by means of Cheques, drafts and telegraphic transfers etc. The bank charges a small commission for providing these services.

2. **Executing Orders:** Standing orders are performed such as payment of insurance premium, payments of subscription fees of clubs and societies.

3. **Collection of Money:** Collection of dividend or interest on securities on behalf of customers.

4. **Purchase & Sale:** Commercial banks purchase and sell securities on behalf of its cutomers.

5. **Trustee:** Bank also acts as a trustee or executor of will created by its customers. This means undertaking the administration of Estates as Executor or trustee. This includes acquiring and holding and generally dealing with any property right, title or interest in any such property.

(B) **General Services:** Commercial Banks also performs a number of general utility services.

1. **Safe Deposit Vault:** Lockers are provided in various sizes on payments on a fixed rent. The lockers are situated in a strong room, generally underground where walls and ceilings are fireproof. The articles kept in the lockers remain in the possession of the locker-holder and the access to the locker is given only after completion of certain formalities.

2. **Letters of Credit:** Letters of credit are issued by commercial banks to help traders to buy goods from foreign countries on credit. It is a document or an order issued by a bank in one place, authorising some other bank in some other place (foreign country) to honour the drafts or cheques of the person named in the document. The payment is limited to the amount shown in the letter and the amount is chargeable to the issuer of the letter of credit.

3. **Traveler's Cheque:** The travelers Cheques are mostly utilized to remove the risk of theft in the course of travel.

4. **Foreign Exchange:** A separate Foreign Exchange Department is maintained by most of the banks. Its function is to convert foreign currency into domestic currency and vice-versa.

5. **ATM and Credit Card Facilities:** Automated Teller Machines facilities provide cash easily and quickly 24 hours a day. Credit Card allows a person to buy goods and services upto certain specified limit without immediate payment. Purchases can be made on credit basis. Amount is paid to shops, hotels etc by the bank. The banks collect the amount due from the customers by debiting their account.

1.3.3 Subsidiary Activities of Commercial Banks:

In addition to banking and non-banking functions, many functions are also undertaking subsidiary activities such as:

1) **Merchant Banking:** Merchant banks offers variety of services like –
   (i) Management, marketing and underwriting new issues
   (ii) Project promotion and project finance
   (iii) Corporate Advisory services
   (iv) Investment Advisory services and so on

2) **Housing Finance:** Housing finance is provided in the form of mortgage loans i.e. it is provided against the security of immovable property of land and buildings. Many banks such as

SBI, Bank of India, Bank of Baroda etc. have set up housing finance subsidiary companies.

3) **Venture Capital Fund:** Venture Capital Fund provides start-up share capital to new ventures of little-known, unregistered, highly risky, young and small private businesses, especially in technology oriented and knowledge intensive industries. They also provide management and marketing expertise to such units. Many commercial banks such as SBI, Canara Bank, ICICI bank etc. have set up Venture Capital Fund Subsidiary Companies.

4) **Factoring:** Factoring is a continuous arrangement between financial intermediary (bank) known as a factor and a business concern (client) whereby the factor purchases the client's account receivables. Factoring is a collection and finance service designed to improve the client's cash flow by turning his credit sales into ready cash. In simple words, it is an activity of managing the trade debts of a business concern. Some banks like SBI, Canara Bank have set up subsidiaries offering factoring services.

5) **Mutual Funds:** A mutual fund is a financial intermediary that pools (collects) the savings of the investors for a collective investment in a diversified portfolio of securities. A fund is "Mutual" since all of its returns minus expenses, are shared by the funds investors. A mutual fund serves as s link between the investor and securities market by mobilizing savings from the investors and investing them in securities market to generate returns.

Check Your Progress:

a. What are some of the important secondary and subsidiary functions of a commercial bank?

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1.4 ASSETS AND LIABILITIES OF COMMERCIAL BANKS

The balance sheet of a commercial bank is a statement of its liabilities and assets at a particular period of time. The liabilities of the bank are those items which are to be paid by the bank to shareholders, depositors and others. The assets of the bank are those items from which the bank hopes to get an income.

- The liabilities of the bank enable it to undertake its operations. The liabilities include all the amounts due to depositors (deposits) and to shareholders (capital & reserves). **The liabilities represent sources of funds**.

- The assets of a bank enable it to earn its income. The assets include all the amounts owed by others to the bank. **The assets represent application of funds**.

BALANCE SHEET OF A COMMERCIAL BANK

LIABILITIES	Rs.	ASSETS	Rs.
1) Paid-Up Capital	XXXX	**a)** Cash Balances	XXXX
2) Reserves and Surplus	XXXX	**b)** Money at call or Short Notice	XXXX
3) Deposits	XXXX	**c)** Investments	XXXX
4) Borrowings	XXXX	**d)** Loans and Advances	XXXX
5) Other Liabilities	XXXX	**e)** Other Assets	XXXX

1. LIABILITIES OF A COMMERCIAL BANK: It includes all those items which the bank owes to others. It shows the various sources through which the bank raises funds for its business. They are classified into:

1) **PAID UP CAPITAL:** this refers to the contribution made by the shareholders of the bank. This indicates the bank's liabilities to its shareholders.

2) **RESERVES AND SURPLUS:** This is the amount accumulated by the bank over the years out of undistributed profits. This is maintained to meet contingencies. These funds are liabilities of the bank, as they actually belong to the shareholders.

3) **DEPOSITS:** The deposits are the main source of funds for the banks. The deposits are broadly classified as deposits payable on demand and deposits accepted for a term and hence payable on a specified date. Generally, these deposits are

classified as current deposits, saving bank deposits and term deposits.

Current Deposits: Current deposits are usually operated by the business people. There are no restrictions on the amount or the number of withdrawals from these accounts. Banks do not pay interest on the current account. These funds represent interest-free balances.

Savings Deposits: These deposits are operated by individuals, trusts etc. for non-commercial purposes. They earn some interest. Cheques can be drawn on savings account. However, there are limitations on the number of withdrawals.

Time Deposits: Deposits which are repayable after a specified period of time are included in time deposits. They have different maturity periods which depend on rate of interest. They include fixed deposits, cumulative deposits, deposits generated under various schemes etc.

4) **BORROWINGS:** They consists borrowings or amount refinanced from RBI, commercial banks and other financial institutions. They also include overseas borrowings made by Indian branches and also borrowings made by foreign branches.

5) **OTHER LIABILITIES:** These are incurred by the bank during the course of business. They include bills payables such as drafts, travelers cheque, pay slips, bankers cheques etc. They also include provision for income tax.

2. ASSETS OF A COMMERCIAL BANK: The assets side of balance sheet consists of all those items which give revenue to the bank. The assets side can be analysed as follows:

1) **CASH BALANCES:** This is the most liquid asset. It enables the bank to meet the demand of customers. By experience the banks know the amount of cash required to meet the demand of the people. They keep certain amount of deposits as reserves with themselves. **Cash has 100% liquidity but 0% profitability**.

2) **MONEY AT CALL AND SHORT NOTICE:** It refers to the loans which are given for a very short period of time i.e. from 1 day to 7 days. The loans are repayable on demand of either the lender or the borrower. They are highly liquid. It is generally given to the bill market, for the purpose of dealing in the bullion markets and stock exchanges, between banks, discount houses, dealers in commercial bills and frequently to individuals of high financial

status in Mumbai for ordinary trade purpose. These assets bring in some interest income to the banks.

3) **<u>INVESTMENTS</u>:** Generally commercial banks invest in short term and medium term securities. They prefer government securities as they are safe and marketable. Investments in shares, debentures and bonds are also made by banks. They are highly profitable but have less liquidity. Commercial banks investment are:
   a) Government of India securities,
   b) Other approved securities and
   c) Non-approved securities

   <u>Investment in SLR securities</u>: The first two types of securities are known as SLR securities. At present the banks are statutorily required to invest 25% of their total deposits in government and approved securities. Government securities include securities issued by both the central and state government agencies and PSUs of state and central government. Approved securities include securities issued by Quasi-Government agencies. These securities are given SLR securities status on case-to-case basis.

   <u>Investment in Non-SLR securities</u>: The third types of securities are known as Non-SLR securities. After 1985, there has been a liberalization of investment norms for banks. They include commercial papers, units of mutual funds and shares, bonds and debentures of PSUs and Private corporate sector.

4) **<u>LOANS AND ADVANCES</u>:** The most important asset of commercial banks balance sheet is loans and advances. They form the major part of assets for all the banks. The various types of loans and advances provided by the banks are:

   - <u>Cash Credit</u>: Cash credit is sanctioned against a security of commodity stock, property etc
   - <u>Overdraft</u>: It is allowed only for current account holders.
   - <u>Purchase of discounting bills</u>: It is adopted to finance trade transactions and movement of goods.
   - <u>Loans</u>: They are advances for fixed amounts repayable on demand or installments.

5) **<u>OTHER ASSETS</u>:** They include fixed assets, such as premises which are wholly or partly owned by banks for business/residential purpose, furniture etc.

Check Your Progress:

a. What are the different assets of a commercial bank?
b. How are the assets of a commercial bank arranged?
c. Which of the assets is most liquid?
d. What are the different liabilities of a commercial bank?

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1.5 TRADE-OFF BETWEEN PROFITABILITY AND LIQUIDITY

Commercial Banks is a profit-seeking organisation. The ability of a bank to earn profit depends upon its portfolio management. Portfolio Management refers to the management of assets and liabilities in such a way that profits are maximised.

While making profits banks are also concerned about liquidity and safety. In fact profitability, liquidity and safety are the main objectives of a monetary policy.

A commercial bank has to earn profit for its shareholders and at the same time satisfy the withdrawal needs of its customers. A bank tries to achieve the twin conflicting objectives of liquidity and profitability by selecting a diversified and balanced asset portfolio within the framework of the regulations of a central bank.

1.5.1 Motives of Investment Policy:

The investment policy i.e., the portfolio management, of a bank is guided by two important motives:

1) **Profitability:** One of the important objectives of a bank is to earn profit for the shareholders. Hence, in acquiring assets, the bank will be influenced by the profit. Generally, the assets which yield higher income are long-term in nature and cannot be readily converted into cash to meet the demands of the depositors.

2) **Safety and Security i.e. Liquidity:** The second objective of a bank is its own safety and security. Since the business of a

bank depends upon the confidence of the depositing public every bank should maintain sufficient cash to meet the withdrawal demand of depositors. Liquidity is the ability to produce cash on demand.

3) **Shiftability**: Thus, apart from maintaining enough cash, a bank should acquire assets which can be easily converted or shifted into cash. Shiftability is an important feature of an asset. Shiftability means that assets should be easily shiftable to other banks or central bank to acquire cash.

Thus, while acquiring assets, a commercial bank has to keep two important considerations in mind. They are:

1. The assets distribution should be in such as way that they should bring maximum amount of profit for the shareholders.
2. Adequate amount of cash or the non-cash assets should be maintained so that they can be easily converted into cash to meet the demands of depositors.

1.5.2 Trade-Off between Liquidity and Profitability:

The above mentioned two objectives of liquidity and profitability are contradictory (opposing) in nature.

- Maximum safety or liquidity can be attained if the bank keeps a high proportion of cash against deposits. This will not bring any income for the bank. Thus, if the bank goes for maximum safety as its primary objective, it will have to sacrifice profitability objective.

- On the other hand, if the bank uses all its funds to give loans and advances that bring large interest income, it will not be able to meet the cash requirements of depositors. In this case bank will be forced to shut down. Thus, if the bank goes for maximum profitability as its primary objective, it will have to sacrifice liquidity objective.

1.5.3 Reconciling Twin Objectives:

A good banker should try to reconcile the twin conflicting objectives of liquidity profitability by selecting a diversified and balanced asset portfolio within the framework of the regulations of a Central bank. Hence it is said that the secret of successful banking is to distribute resources between various forms of assets in such a way to get a sound balance between liquidity and profitability.

The asset portfolio of a bank strikes a balance between liquidity and profitability. The commercial bank arranges its assets in an ascending order of profitability and descending order of liquidity. As we move down the balance sheet, the assets become less and less liquid and more and more profitable. The more liquid the assets, the less profitable it is.

1) **Cash balances:** They are held to meet the withdrawal needs of the depositors. They have perfect liquidity, but no profitability.

2) **Money at call / short notice:** Commercial banks lend their surplus cash to each other. This earns some interest and at the same they are very liquid.

3) **Investments in securities:** Banks are required statutorily to invest a part of their assets in government securities. They carry a low rate of interest but banks can borrow from the RBI against these securities. Thus, they provide return as well as liquidity to the bank.

4) **Loans and advances:** They constitute the main item of a bank's assets. They are the main source of finance. In this case liquidity is low, and profitability is high. However, banks also take into consideration liquidity while granting loans and advances by giving short-term loans and advances.

Conclusion: It can be seen from the asset portfolio of banks that a bank holds various assets in such a way that the requirements of liquidity and profitability are balanced.

1.5.4 Factors Affecting Liquidity:

Banks consider number of factors in determining liquidity. The liquidity of a bank, i.e., the amount of liquid assets held by the bank, depends upon the following factors.

1) **Statutory requirements:** The extent of liquid reserves held by the bank depends upon the statutory requirements such as CRR and SLR. These limits are determined by the central bank.

2) **Banking habits of the people:** The banking habit generally depends upon the nature of the economy. In the developed countries people have the cheque habit and hence, the use of cash is considerably less. On the other hand, in the developing countries banking habits are not fully developed and therefore the use of cash is considerably more leading to frequent withdrawals from the banks. Thus, the need for liquidity will be high in the developing countries.

3) **<u>Monetary transactions</u>:** The size of liquid reserves will also depend upon the number and magnitude of monetary transactions. During busy season such as festival times, harvest season, beginning of the month, etc. banks will have to keep large percentage of cash.

4) **<u>Nature of Banks business</u>:** If banks resort to medium and long term investments and on term loans with an intention to earn higher profits then the liquidity of such banks will be less. It will result in lack of confidence among depositors. Such banks have to maintain required amount of cash balances and at the same time invest in securities to earn higher returns.

5) **<u>Nature of money market</u>:** If the money market of the country is fully developed, it will be easy for the banks to buy and sell securities. In such cases the need for liquid cash will be less.

6) **<u>Structure of the banking system</u>:** Under the branch banking system, the cash reserves can be centralized in the head office and branches can manage with smaller liquid reserves. On the other hand, under the unit banking system, every bank is an independent unit and hence has to keep a higher degree of liquidity.

7) **<u>Number and size of deposits</u>:** As the number and size of deposits rise, banks will require more liquidity to meet the demand for cash by the depositors.

8) **<u>Nature of deposits</u>:** Liquidity requirements will depend upon the nature of deposits with banks. The deposits are of various types such as time deposits, demand deposits, term deposits and so on. Larger the demand deposits and short-term deposits, larger will be the need for liquidity.

9) **<u>Liquidity Policy</u>:** If other banks in the same area have a policy of maintaining high liquidity, other banks may also like to maintain high liquidity. As high liquidity builds goodwill among the depositors. And in turn earns trust an confidence of the depositors.

1.5.5 Factors Affecting Profitability :

Banks consider number of factors in determining profitability. The profitability of a bank, i.e., the amount of profits generated by the bank from its assets, depends upon the following factors.

1) **<u>Amount of working funds deployed</u>:** Working funds are the funds deployed by a bank in its business. The profitability is

directly related to the amount of working funds deployed by the banks.

2) **Cost of funds:** The sources of funds for a bank comprise share capital and reserves (owned funds), deposits, borrowing and other liabilities. The cost of funds mainly refers to interest expenses.

3) **Yield on funds:** The funds mobilized by a bank through different sources are utilized for CRR and SLR requirements, granting loans and advances and so on. Many of these give rise to yields mainly in terms of interest income. This will depend upon the portfolio management of the banks.

4) **Spread:** Spread is defined as the difference between interest income and interest expenses. High interest rate spreads could indicate the tewd of efficiency of the financial intermediation and also a relatively less competitive market.

5) **Operating Costs:** These are also called management costs and include all costs other than cost of funds and provisions. They consists of staff cost, i.e., salaries and other payments such as bonus, gratuity, etc. made to staff and overheads such as expenses on stationary and printing, postages, rents, depreciation on assets, etc.

6) **Risk Costs:** The risk cost is the cost associated with the likely annual loss on assets. Provisions made towards bad and doubtful debts, etc. are included under risk cost.

7) **Non-Interest income:** This is the income derived from non-financial asset and services and includes commission and brokerage on remittance facilities, guarantees, underwriting, contracts, etc., locker rentals and other service charges.

8) **Burden:** The difference between the non-interest expenses and non-interest income is called burden. When making a cost plus pricing of loans this difference (i.e. burden) has to be included on the rate of interest. The concept of burden also brings out the importance of non-interest income of the bank. A high level of non-interest income cannot only recover the entire operating cost, it can enable a bank to pay high level of compensation to its employees. This is the case of foreign banks.

9) **Level of NPAs:** The profitability of the banks depends upon Non-Performing Assets (NPAs). Larger NPAs will lead to lower profitability.

10) **Level of competition:** As the level of competition increases, it may lead to fall in margins and hence to lower profitability.

Conclusion: A successful banker will adopt a prudent investment, policy keeping the requirements of liquidity and profitability.

Check Your Progress:

a. What are the twin principles that a bank has to follow to maintain its profitability and liquidity?

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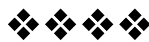
1.6 QUESTIONS

1. Explain the various functions of a commercial bank.
2. What do you understand by the liquidity and profitability of a commercial bank?
3. Examine the various liabilities of a commercial bank.
4. What are the different assets of a commercial bank? Who are the classified?
5. Discuss the factors that determine the profitability of a commercial bank.



2

(B) BANKING SECTOR REFORMS

Unit Structure:

2.0 Objectives
2.1 Structure of Banking in India
2.2 Growth of Commercial Banks
2.3 Banking Sector Reforms in India since 1991
2.4 Implementation of banking sector reforms
2.5 Questions

2.0 OBJECTIVES

- To understand the nature of banking system in India.
- To understand the rationale and nature of banking sector reforms undertaken since 1991.

2.1 STRUCTURE OF BANKING IN INDIA

Banking activity after independence was mainly a state activity. The government ownership was completed in stages. The Reserve Bank of India was nationalized in 1949. It was followed by nationalization of Imperial Bank of India in 1955 [Now known as the State Bank of India]. In July 1969, 14 major commercial banks having assets in excess of Rs. 50 Crore were nationalized. In April 1980, 6 more banks having assets in excess of Rs. 200 Crore were nationalized. Banking business in India was a near monopoly of the Government until the introduction of economic reforms.

1. SCHEDULED BANKS: Scheduled Commercial banks are those banks which are included in the Second Schedule of Banking Regulation Act, 1965. In order to be included in Second Schedule, a bank must fulfill the following conditions:

- Must have a paid-up capital and reserves of not less than Rs. 5 Lakhs

- It must also satisfy the RBI, that its affairs are not conducted in a manner detrimental (damaging/unfavorable) to the interest of the depositors.

COMMERCIAL BANKS: It includes public sector banks, private sector banks and foreign banks. They are organized joint stock companies under the Indian companies Actor as Public Corporations under separate acts of Parliament (such as the SBI).

Public Sector Banks: As of March, 2009, there are 27 Public Sector Banks consisting of SBI and 6 associated banks, 19 Nationalized Banks and IDBI Ltd.

Regional Rural Banks (RRBs): RRBs came into existence in 1975. They are sponsored by large commercial banks. The share capital of RRBs is contributed by Central Government (50%), State Government (15%) and Commercial Bank (35%). The number of RRBs has declined from 196 in 2002-03 to 86 in 2008-2009 as part of resturcturing.

Private Sector Banks: Private Sector banks include old private sector banks and new private sector banks. There are 7 new private sector banks and 15 old private sector banks in India as of March 2009. The private banks mostly operate in urban areas.

Foreign Banks: Foreign banks are those banks which are registered in some other country. They operate in India by starting a subsidiary company in India to do banking activities. There are 31 foreign banks in India as of March 2009. The foreign banks mostly operate in big cities and their presence in rural areas is almost zero.

2. NON-SCHEDULED BANKS: Non-Scheduled Commercial banks are those banks which are not included in the Second Schedule of Banking Regulation Act, 1965. As on March 2009, there were only 4 non-Scheduled banks operating in India. Non-Scheduled banks have to maintain 3% of the total deposits by way of cash reserves with itself or by way of balance in a current account with RBI.

2.2 GROWTH OF COMMERCIAL BANKS

Indian Banking system was a highly regulated due to which the customer service i.e. both borrowers as well as depositors had suffered. With the help of financial sector reforms an attempt is made to overcome these weaknesses. At present, India has a more developed and integrated banking system with large number of banks in the country.

BRANCH EXPANSION OF COMMERCIAL BANKS IN INDIA (AS ON JUNE 30, 2009)

TYPE OF BANK	TOTAL NUMBER OF BRANCH OFFICES	RURAL BRANCHES	RURAL BRANCHES (% OF TOTAL BRANCHES)
Public Sector Banks	71,196	30,688	43.10%
Private Banks	8,779	1,126	12.83%
Foreign Banks	295	4	1.36%
Total Scheduled	80,270	31,818	39.64%
Non-Scheduled	44	11	25%
All Commercial Banks	80,314	31,829	39.63%

Source: Various Economic Surveys

There has been a tremendous growth in commercial banking in India. The total number of Public Sector banks has increased and 43.10% of the branches are operating in rural areas. The presence of private banks and foreign banks is very less at 12.83% and 1.36% respectively. Until 2008, the foreign banks did not have any branches in rural areas.

Check Your Progress:

a. What is a commercial bank?
b. What is a scheduled bank?
c. What are the non-scheduled banks?
d. What is a public sector bank?
e. What is a private sector bank?
f. What are known as foreign banks?

2.3 BANKING SECTOR REFORMS IN INDIA SINCE 1991

The Government of India appointed a committee under the Chairmanship of Mr. M. Narasimham (the former Governor of RBI) in July 1991 to examine India's financial system and to recommend improvements in the working of the financial system. This is known as the Committee on Financial Sector Reforms. This was followed by another committee under him in 1998. The second committee was asked to look in to the progress of reforms till 1998 and to lay a course for further reforms. This committee is known as Committee on Banking Sector Reforms, 1998. The Reports of these two committees form the basis for reforms in the Indian banking sector.

1. First Phase of Reforms 1991 to 1998:

The Narasimham Committee submitted its first report in 1991. The following are the recommendations of Narsimham Committee applicable to banking sector:

1) **Four-Tier Hierarchy in Banking:** The committee recommended a four-tier hierarchy in the banking sector:
   - **a)** 3 to 4 large banks (at the top of hierarchy) with international status.
   - **b)** 8 to 10 banks (at the second tier) with wide network of branches throughout the country to perform general banking functions.
   - **c)** Local banks whose operations to be confined to a particular region.
   - **d)** Rural banks (at the bottom of hierarchy) to finance agriculture and allied activities.

2) **Reduction in Statutory Liquidity Ratio (SLR):** The committee recommended for the reduction in SLR. The SLR is the percentage of deposits (time and demand liabilities) to be invested in Government securities. The committee suggested for reduction in SLR from 38.5% to 25% over a period of about years. The reduction in SLR would enable the banks to have more liquid funds for the purpose of lending in the market.

3) **Reduction in Cash Reserve Ratio (CRR):** The committee recommended for reduction in CRR. The CRR is a percentage of total time and demand liabilities to be maintained as reserves with RBI. The CRR to be reduced from 15% to 10% over a period of about 5 years. The reduction in CRR would enable' banks to have more liquid funds for the purpose of lending in the market.

4) **Deregulation of Interest Rates:** The Committee strongly recommended the deregulation of interest rates by RBI both on advances and deposits. The deregulation in interest rates would bring flexibility in interest rates and transparency in banking transactions. Thus, deregulation of interest rates would generate competition in the banking sector, which in turn would improve efficiency of the banking sector.

5) **Capital Adequacy Ratio (CAR):** The committee suggested for increasing the CAR from 2% to 8% in a phased manner over a period of time. CAR refers to the minimum capital to be raised in relation to risk assets. It is normally referred as minimum capital to risk assets ratio (CRAR).

6) **Classification of Assets:** The committee recommended for proper classification of assets and full disclosure and transparency of accounts of banks and FIs.

7) **Capital Markets:** The committee recommended for reforms in the capital market sector. The reforms in the capital market were recommended to give a boost to the Indian capital markets. The reforms include:

   a) Issuer of capital (company) to fix its own price for the issue of securities without government permission.
   b) Foreign financial investors to invest in Indian capital market.
   c) SEBI to frame effective guidelines to protect the interest of investors.

8) **Asset Reconstruction Fund (ARF):** The Committee recommended for setting up ARF by RBI. The ARF would take over a part of the doubtful debts/NPAs or the banks and recover dues from defaulters. The ARF would provide liquidity support to banks by taking over a part of NPAs.

9) **Redefining Priority Sector:** The committee recommended for redefining the priority sector. The committee favoured a new priority sector which would include only small and marginal farmers, cottage and tiny sector. The new priority sector should get 10% of the funds/advances of the total advances from the banking sector.

10) **Quasi-Autonomous Body:** The Committee recommended for the seeing up of a quasi-autonomous body to supervise over the functioning of banks and Financial Institutions under the sponsorship of the Reserve Bank.

11) Other Recommendations:

a) IDBI to play only refinancing role.
b) Abolition of branch licensing policy.
c) No further nationalization of banks.
d) The dual control on the financial system (of RBI and Banking Division of Ministry of Finance) to end.

2. Second Phase of Reforms 1998 onwards:

The Government again set up a committee under M. Narsimham to study the financial sector and to make recommendations. The committee submitted its report in April 1998. Some of the major recommendations are as follows:

1) **Mergers:** Strong banks should be merged, while weaker banks should be closed down.
2) **Capital Adequacy Ratio:** The CAR to be increased from 8% to 10%.
3) **Three-Tier Banking Hierarchy:** Narsimham recommended three-tier hierarchy in the banking system
   a. 2 to 3 banks with international status.
   b. 8 to 10 banks with national status.
   c. A number of local banks.
4) **Credit Recovery Mechanism:** Legal framework for credit recovery to be strengthened.
5) **NPAs:** Net non-performing assets for all banks to be brought down to below 5% by the year 2000 and to 3% by 2002.
6) **Technology:** Technological upgradation of banks to improve productivity and to offer better customer service.
7) **Autonomy to Banks:** Greater operational flexibility and autonomy to banks. No interference of politicians in the appointment of the banks' Board of Directors, which would bring professionalism in bank management.
8) **Licensing Policy:** The policy of licensing new private banks may be continued.
9) **Foreign Banks:** Foreign banks may be allowed to set up subsidiaries or joint ventures in India.
10) **Integrated System Of Regulation:** There has to be an integrated system of regulation and supervision of the activities of banks, FIs, and other players in the financial sector.

2.4 IMPLEMENTATION OF BANKING SECTOR REFORMS

RBI introduced the First Phase of Banking Sector Reforms based on Narasimham Committee Report 1991. Some of the important reforms are:

1. FIRST PHASE OF BANKING REFORMS (1991-1998):

Following are some of the measures taken by the Reserve Bank to implement the recommendations of the Committee.

1) **Prudential Norms:** RBI has laid down prudential norms in order to bring professionalism in commercial banks. The purpose of prudential norms include proper disclosure of income, classification of assets and provision for bad debts so as to ensure that the books of commercial banks reflect the accurate and correct picture of its financial position.

   Banks are supposed to disclose non-performing assets (NPAs). With effect from March 31, 2004, a NPA is an advance where, the loans and advances are overdue in terms of interest and/or installment payment for a period of more than 90 days, (earlier the norm was 180 days).

2) **Recovery of Dues:** In early 1990s, the financial position of several public sector banks appeared very weak due to high NPAs. The overall gross NPAs of the scheduled commercial banks were over 10% of the total gross advances. Some of the public sector banks made huge losses due to high NPAs. In order to solve, this problem, the RBI set up a Special Recovery Tribunal so as to provide legal assistance to the banking sector to recover their dues at a quicker pace.

   In 2004-05, the gross NPAs of scheduled commercial banks as a percentage to total gross advances have declined to 5.2% from nearly 13% in 1999-00. In 2008-09, the gross NPAs stood at 2.3% of all scheduled commercial banks.

3) **Reduction of CRR:** The CRR is the cash ratio of a bank's total deposits to be maintained with RBI. A high CRR reduces the cash for lending and a low CRR increases the funds for lending. The CRR has been brought down from 15% in 1991 to 6% in April 2010.

4) **Reduction of SLR:** Under SLR, the government has imposed an obligation on the banks to maintain a certain ratio to its total deposits with the RBI in form of liquid assets like cash, gold, and other securities. The SLR has been reduced from 38.5% in 1991 to 25% (present level). The reduction in CRR and SLR

releases more funds in the market by way of loans and advances.

5) **Deregulation of Interest Rates:** The RBI has deregulated interest rates since 1989. At present, banks are allowed to fix interest rates for all deposits except savings, and for all advances except export credit.

The deregulation of interest rates would bring transparency to the banking transactions. It would also generate competition among the banks, which in turn would improve efficiency of the bank personnel. This in turn would bring better service to the bank's customers.

6) **Minimum Lock-In Period:** RBI has reduced the minimum lock-in period of term deposits from 15 days to 7 days in October 2004. This would be an advantage to the term depositors. They would be encouraged to deposit money for 7 days rather than to keep idle with them. This would increase the short term deposits, which can be effectively deployed by the banks in call markets, repos, etc.

7) **Capital Adequacy Ratio:** As per the recommendations of the Narsimham Committee, the Capital adequacy ratio is the ratio of minimum capital to risk assets. Increase in capital adequacy ratio improves confidence of the depositors in the banking sector. At present, all banks have the CAR above the minimum level of 9%. By 31st March, 2009 the CAR of as many as 78 banks was above 10% and that of only one bank was in the range of 9 to 10%. In fact, the overall CAR of all SCBs was 13.2% by 31 March 2009.

8) **Asset Liability Management:** To facilitate better asset liability management, banks are allowed discretion to disallow premature withdrawal of large deposits except in respect of individuals and Hindu Undivided Families, subject to informing the depositors in advance.

9) **Freedom of Operation:** Scheduled commercial banks are given freedom to open new branches and upgrade extension counters, after attaining capital adequacy ratio and prudential accounting norms. The banks are also permitted to close non-viable branches other than in rural areas. Bank lending norms have been liberalized.

2. SECOND PHASE OF BANKING SECTOR REFORMS 1998 onwards:

The RBI introduced the Second Phase of Banking Sector Reforms based on Narasimham Committee Report 1998. The reforms are:

1) **Securitisation of Assets:** The introduction of Securitisation, Reconstruction of Financial Assets and Enforcement of Security Interest Act, 2002, is an important milestone in the banking history in India. This Act enables the setting up of asset management companies for solving the problems of non-performing assets of banks and financial institutions.

   Under this Act, an asset management company is authorized to acquire assets of any bank or FIs by issuing a debenture or bond or any other security for consideration agreed upon by such Asset Management Company and bank or FI.

2) **Measures for Urban Cooperative Banks (UCBs):** To ensure greater security to depositors and members of urban cooperative banks (UCBs), interim prudential measures have been announced by RBI in 2001-02, such as

   - Direct or indirect lending by UCBs to individuals against security of shares stopped.
   - Existing lending to brokers or direct investment in shares to be unwound.
   - Borrowing from call money market limited to 2% of aggregate deposit at the end of the previous financial year.
   - Increase in SLR holdings of scheduled UCBs from 15% to 20% w.e.f. March, 2002.

3) **FDI limit in Banking Sector:** Govt. of India has increased the FDI limit in private sector banks from 49% to 74%. The increase in FDI enables Indian private banks to obtain more foreign capital, but also expertise and technology from foreign parties. This can have a direct effect on the efficiency of the private sector banks.

4) **Mergers and Amalgamation:** RBI has issued guidelines mergers/amalgamation of private sector banks in May 2005. The guidelines cover details regarding the process of merger proposal, determination of swap ratios, disclosures and norms for buying/selling of shares by promoters before and during the process of merger.

5) **Anti-Money Laundering Guidelines:** Prevention of money laundering has assumed greater importance because of funding of terrorist and other illegal activities. Therefore, in November 2004, RBI revised Know Your Customer (KYC) guidelines. Banks have to frame policy guidelines regarding procedures relating to:

- Customer acceptance
- Customer identification
- Risk management
- Monitoring transactions of suspicious nature, so as to report to Government.

6) **Adoption of BASEL-II Norms:** The Basel Committee on Banking Supervision released the New Capital Adequacy-Basel II Framework on June 26, 2004. Accordingly, RBI has issued guidelines to banks for the implementation of Basel II norms. Several measures have been taken by RBI to prepare the banking system to move towards Basel II norms.

7) **Managerial Autonomy for Public Sector Banks:** Government of India has provided managerial autonomy to public sector banks in February 2005, so as to enable them to compete with private sector banks. PSBs are allowed to:

- Undertake new lines of business and Exit from a line of business.
- Make suitable acquisitions.
- Close or merge unviable branches.
- Open branches abroad.
- Set up subsidiaries.
- Decide on issues such as recruitment, place training, promotion, etc.

8) **Customer Service:** Several measures have been taken by RBI to improve customer service of commercial banks, such as:

a) **Customer Service Committee of the Board:** All banks - public and private are advised to set up CSCB in order to:
- Strengthen corporate governance in the banking system.
- Improve quality of customer service provided by banks.

b) **Ombudsman Scheme:** To increase the effectiveness of the Banking Ombudsman Scheme, banks are advised (in April 2005) that the CSCB should play more active role relating to complaints received by the Banking Ombudsman of various states.

c) **Credit Card Facility:** RBI framed guidelines on credit card facility (June 2005) for all commercial banks and non-banking finance companies (NBFCs) regarding credit card operations. As per the guidelines, each bank/NBFC must have proper policy and a 'Fair Practices Code' for credit card operations.

9) **Deposits of Deceased Depositors:** RBI has advised banks (in June 2005) to simplify the procedure tor settlements of claims by legal heir of deceased depositors.

10) **Technology:** Technology infrastructure for the payment and settlement system has been strengthened with the introduction of:

- Electronic Fund Transfer
- Centralized Fund Transfer System
- Structured Financial Messaging Solution
- Negotiated Dealing System
- Real Time Gross Settlement (RTGS) System

11) **New Areas for Bank-financing**: New areas have been opened up for bank financing such as Insurance, Credit and Debit Cards, Investment Banking, Infrastructure Financing, Housing Finance, Factoring, Venture Capital Funds and Mutual Funds etc.

Check Your Progress:

a. Lowering of cash reserve ratio is good for the banks.
b. Introduction of new technology helps the banks.

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2.5 QUESTIONS

1. Examine the nature of banking sector reforms since 1991.
2. Examine the banking sector reforms since 1998.

3

PERFORMANCE OF COMMERCIAL BANKS IN THE POST-REFORM PERIOD AND NEW TECHNOLOGIES IN BANKING SECTOR

Unit Structure:

3.0 Objectives
3.1 Performance of Commercial Banks in the Post-Reform Period
3.2 New Technologies in Banking
3.3 Questions

3.0 OBJECTIVES

- Understand the impact of reforms on the Indian banking sector.
- Understand the impact of new technologies on the working of commercial banks in India.

3.1 PERFORMANCE OF COMMERCIAL BANKS IN THE POST-REFORM PERIOD

The performance or efficiency of commercial banks is analysed in terms of profitability, productivity, financial soundness and quality of assets.

(I) <u>PROFITABILITY INDICATORS</u>: Profitability of banks is measured in terms of net profits of the commercial banks. Net profit is further influenced by interest and non-interest income and expenses.

1) **<u>Interest Income Ratio</u>:** It is the ratio of interest income to total assets. An increase in this ratio indicates higher profitability, and vice-versa.

2) **<u>Interest Expended Ratio</u>:** It is the ratio of interest expenses to total assets. An increase in this ratio indicates lower profitability, and vice-versa.

3) **Net Interest Margin Ratio (NIMR):** It is the ratio of net interest income to total assets. Net interest income (spread) is equal to interest income minus interest expenses. An increase in this ratio indicates higher profitability. A fall in this ratio indicates lower profitability, and therefore, the bank must redesign its policies and practices to generate higher yields with a focus on cheaper funds.

4) **Intermediation Cost to Asset Ratio (ICAR):** It is the ratio of intermediation or operating expenses (non-interest expenses) to total assets. An increase in this ratio indicates lower efficiency and lower profitability.

5) **Burden Ratio:** It is also called as Overhead Efficiency Ratio. It is the ratio of non-interest expenses to non-interest income. An increase in this ratio indicates higher burden or lower profitability of the bank.

6) **Return on Assets Ratio (ROAR):** It is the ratio of net profit to total assets. This ratio indicates the profitability of a bank based on its assets. An increase in this ratio indicates higher profitability of a bank.

7) **Return on Equity Ratio:** It is the ratio of net profit to total equity. An increase in this ratio indicates higher performance and profitability of a bank. This ratio enables a bank to raise more funds from the capital markets.

8) **Stock Market indicators:** The performance of a bank's scrip (shares) on the stock market is based on its profitability, which is indicated by two parameters:

   a) **Earning per Share (EPS):** It is the ratio of net profit to number of equity shares.

   b) **Price by Earning (P/E) Ratio:** It is the ratio of share price to EPS.

(II) **PRODUCTIVITY INDICATORS:** The productivity indicators are based on the performance of employees. The two main productivity indicators include:

   a) **Profit per Employee:** It is the ratio of net profit to number of employees. An increase in this ratio indicates higher productivity of employees.

   b) **Business per Employee:** It is the ratio of total turnover (revenue) to number of employees. An increase in this ratio indicates higher productivity of employees.

(III) <u>FINANCIAL STABILITY INDICATORS</u>: The financial stability (soundness) of a bank is reflected in its capital adequacy ratio or capital to risk-weighted assets ratio (CRAR). It is the ratio of Bank's capital to risk-weighted assets. Under these norms, each asset of the commercial bank is assigned a specific risk and the bank has to maintain unencumbered Tier I capital against these assets. Depending on the risk exposure of assets (loans or investments), weights are assigned to the assets of the bank. The higher the ratio more is the safety for the depositors.

<u>Example</u>: If CRAR is 10%, then a loan of Rs.100,000/- is backed by 10% of the bank's capital. If the bank suffers bad debts upto 10% (upto Rs. 10,000/-), there is no problem for the depositors.

(IV) <u>QUALITY OF ASSETS INDICATORS</u>: The quality of bank's assets depends on the level of non-performing assets (NPAs). The NPAs are those assets on which the interest and principal amount receivable is overdue for a period of more than 90 days. Higher NPAs indicate poor quality of assets (loans/investments). Generally, the following ratios are used:

a) Ratio of Gross NPAs to Gross Advances (i.e. total NPAs to Total Advances)
b) Ratio of Net NPAs to Net Advances (i.e. net NPAs to Net advances)

A lower ratio indicates a better assets quality.

3.1.1 <u>PERFORMANCE WITH RESPECT TO PUBLIC SECTOR BANKS, NEW PRIVATE SECTOR BANKS AND FOREIGN BANKS</u>:

In the pre-reform period (before 1991), the performance of banking sector was affected due to lack of competition, inefficiency and corruption, low capital base, and high operating costs. After introduction of reforms, there is an overall improvement in the performance of most of the commercial banks including public sector banks, private sector banks and foreign banks in India. The comparative performance of public sector banks, new private sector banks, and foreign banks is stated as follows:

1. <u>PROFITABILITY INDICATORS</u>: The performance of commercial banks based on profitability indicators indicate that overall performance of ail categories of commercial banks have improved since 2000-01, However, there is marked improvement in the case of foreign banks, and new private banks as compared to PSBs in India.

Some of the Profitability Indicators for Banks in India (2000-01 to 2008-09)

Indicators	Public Sector Banks		New Private Sector Banks		Foreign Banks	
	2000-01	2008-09	2000-01	2008-09	2000-01	2008-09
Interest Income	8.8	7.26	8.2	8.33	9.3	6.78
Interest Expended	6.0	5.14	6.0	5.55	5.6	2.87
ICAR	2.7	1.47	1.7	2.24	3.0	2.75
NPAR	0.4	0.91	0.8	1.06	0.9	1.68
Spread	2.9	2.12	2.1	2.79	3.6	3.91

Source: R.K. Uppal, Indian Banking in Globalised World, 2008.

a) <u>INTEREST INCOME RATIO</u>: It is a ratio of interest income to total assets. An increase in this ratio indicates higher profitability. The table indicates that for the Public Sector Banks as a whole this ratio has fallen from 8.8% in 2000-01 to 7.26% in 2008-09. For the New Private Banks this ratio has improved marginally from 8.2% in 2000-01 to 8.33% in 2008-09. The steepest fall in income ratio is seen in case of the foreign banks. For them, it has fallen from 9.3% in 2000-01 to 6.78% in 2008-09.

b) <u>INTEREST EXPENDED RATIO</u>: It is the ratio of interest expenses to total assets. An increase in this ratio indicates lower profitability and vice-versa. This ratio has significantly declined for all categories of banks, especially for foreign banks, which indicates higher profitability of banks. For the Public Sector Banks, this ratio has declined from 6% in 2000-01 to 5.14% in 2008-09. For the New Private Banks this ratio has declined from 6% in 2000-01 to 5.55% in 2008-09. Foreign Banks operating in India saw a significant decline from 5.6% in 2000-01 to 2.87% in 2008-09. Thus, the performance in terms of interest income earned and expended is mixed.

c) <u>INTERMEDIATION COST RATIO</u>: It is the ratio of operating costs (non-interest expenses) to total assets. A lower ratio indicates higher efficiency and profitability of banks. Between 2000-01 and 2008-09, this ratio has fallen for public sector banks and foreign banks in India, but increased for new private sector banks. Public Sector Banks saw a decline from 2.7% in 2000-01 to 1.47% in 2008-09. The New Private Banks experienced an increase from 1.7% in 2000-01 to 2.24% in 2008-09. And the Foreign Banks enjoyed a decline from 3% in 2000-01 to 2.75% in 2008-09.

d) NET PROFIT RATIO: It is the ratio of net profits to total assets. Over the years, this ratio has improved for all types of banks, which indicates better deployment of funds or assets. This can be seen in case of Public Sector Banks in an increase from 0.4% in 2000-01 to 0.91% in 2008-09. For the New Private Banks from 0.8% in 2000-01 to 1.06% during 2008-09. In addition, to the Foreign Banks from 0.9% in 2000-01 to 1.68% in 2008-09.

e) SPREAD RATIO: It is the ratio of net interest to total assets. The spread is equal to interest income minus interest expenses. The spread ratio has improved for new private banks and foreign banks, whereas, it has reduced in the case of public sector banks. The Public Sector Banks witnessed this ratio falling from 2.9% in 2000-01 to 2.12% in 2008-09. The New Private Banks experienced an increase from 2.1% in 2000-01 to 2.79% in 2008-09. And the Foreign Banks saw this ratio increasing from 3.6% in 2000-01 to 3.91% in 2008-09.

f) PRODUCTIVITY INDICATORS: The productivity of banks is measured in terms of business per employee, profits per employee and business per branch. Productivity is directly related to profitability of banks, i.e., higher the productivity, higher is the profitability. Productivity of commercial banks has improved specially in public sector banks and foreign banks in India. But, the productivity in new private banks has declined mainly due to higher base effect.

1) Business per Employee: It is the ratio of total revenue income to number of employees. Over the years, the business per employee has increased in the case of public sector banks and foreign banks in India. But the business per employee has marginally declined in case of new private sector banks due to higher base effect.

Business per Employee (Rs. Lakhs)

Year	PSBs	NPSBs	Foreign Banks
1997-1998	88.5	785.9	529.4
2005-2006	324.1	728.9	1012.8

Source: R.K. Uppal, Indian Banking in Globalised World, 2008

2) Profits per Employee: It is the ratio of net profits to number of employees. Over the years, the net profits per employee has increased in the case of public sector banks and foreign banks, but declined sharply in the case of new private sector banks due to higher base effect.

Profits per Employee (Rs. Lakhs)

Year	PSBs	NPSBs	Foreign Banks
1997-1998	0.7	11.4	4.5
2005-2006	2.9	6.3	26.5

Source: R.K. Uppal, Indian Banking in Globalised World, 2008

3) **Business per Branch:** The business per branch has increased across all types of banks. But the overall business per branch is lower in case of public sector banks as compared to new private sector banks and foreign banks. For instance, business per branch was 10 times more in case of foreign banks as compared to public sector banks and 2 times more in case of foreign banks as compared to public sector banks in 2004-05.

Business per Branch (Rs. Crore)

Banks	1999-2000	2004-2005
Public Sector	50.12	116.96
Private Sector	149.89	216.56
Foreign	548	1147.68

Source: R.K. Uppal, Indian Banking in Globalised World, 2008

4. FINANCIAL STABILITY OF COMMERCIAL BANKS: The financial stability of commercial banks is based on Capital Adequacy Ratio. It is the ratio of capital to risk assets. RBI has kept minimum capital adequacy ratio of 9%. All types of banks have reached the minimum capital adequacy ratio. In fact, new private sector banks and foreign banks have crossed 15.1% capital adequacy ratio, and public sector banks have crossed 12.3% in March 2009.

5. QUALITY OF ASSETS: The quality of bank's assets depends on the level of non-performing assets (NPAs). The NPAs are those assets on which the interest and principal amount receivable is overdue for a period of more than 90 days. Higher NPAs indicate poor quality of assets (loans/investments).

Gross and Net NPAs as of March 2009

Banks	Total NPAs to Total advances	Net NPAs to Net Advances
Public Sector	2.0	0.9
Private Sector	3.1	1.4
Foreign	4.0	1.8

Source: R.K. Uppal, Indian Banking in Globalised World, 2008

Higher amount from NPAs were recovered during 2008-09 indicating improvement in the asset quality of banks. The Security Act and the Debt Recovery Tribunals have been the most effective. The Total NPAs to Total Advances ratio and Net NPAs to Net Advances ratio of public sector banks was 2.0% and 0.9% as of March 2009. But in the case of private sector banks and foreign banks both the ratios were increased.

Check Your Progress:

a. What are the different performance indicators of a commercial bank?

b. In what ways the performance of PSBs after 1998 is worse than that of private sector and foreign banks in India.

c. What is capital adequacy ratio?

d. What are NPAs?

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3.2 NEW TECHNOLOGIES IN BANKING

Introduction of Information Technology-Act of 1999 under banking sector reforms gave new dimensions to the Indian banking industry. ATMs, Smart cards, Internet banking, tele banking, etc. has transformed the banking structure, business process, work culture and human resource development. The banks in India have started using electronic and telecommunication networks for providing a wide range services. The various new technologies that are being used by the banks are explained below:

1) **Virtual Banking:** It includes providing of banking and related services through extensive use of IT to the customer. The services are delivered to the customers by depending only on IT. The most important types of virtual banking services are Automated Teller Machines (ATMs), electronic fund transfer, phone-banking, credit card, debit card, smart card, internet banking and so on.

2) **ATMs (Automated Teller Machines):** ATMs are self service vendor machine that help the banks to provide round the clock banking services to their customers at convenient places without visiting to the bank premises. To get ATM services

customers are provided with ATM card, which is a small plastic card with magnetic strip, containing information about the name of bank, name of the customer, card number, validity period and signature panel. The ATM provide a number of services such as withdrawal of cash upto a particular limit, deposit of cash, cheques and drafts, updated balance of customer, transfer of money from one account to another accounts, mini account statement and so on.

3) **Debit Card:** It is a prepaid card with some stored value. A Personal Identification Number (PIN) will be issued to the customers for using the debit card. It can be used at all outlets that accept such cards for payments. In this case, the transaction amount is directly debited to the bank account of the customer. Debit card does not permit a customer to spend over and above his cash balance in the bank.

4) **Credit Card:** It enables a customer to purchase goods and services within the prescribed limits from authorized outlets without making immediate cash payments. The main difference between a credit card and debit card is that while credit card is a 'post paid', the latter is 'pre-paid'.

5) **Point of Sale (PoS)**: The PoS terminal is a machine that facilitates transactions through swipe of a card in an online environment. Merchant business establishments operate point of sale in their premises in order to accept plastic cards. The PoS terminals facilitate electronic funds transfer. PoS system identify the cardholder and check whether the customers account has sufficient funds to cover the purchase. The customized PoS terminals can support both debt and credit cards and can also be made to support different kinds of plastic including magnetic and smart chip based cards to make the transaction possible.

6) **Door Step Banking:** This means banking services and products made available to a customer at his place of residence or work. Under this system, there is no need for the customer to visit the branch for getting services or products from the bank.

7) **Internet Banking:** It is also called on-line banking where the traditional banking services are provided through the internet. Internet banking is a product of e-commerce in the field of banking and financial services. Internet banking enables customers to open accounts, pay bills, know account balances, forward loan application, view and print copies of cheques, transfer funds, stop payments, etc. Different banks have different levels of such devices offered, starting from low level

where only information is provided to high level where online transactions are made possible.

8) **Mobile banking:** It is an extension of internet banking. It gives everybody with a mobile phone to access banking services, irrespective of their location. In this system, a customer can access his account details on a mobile phone by using the Short Messaging Service (SMS) technology. It provides many services such as account balance, mobile alerts about credit card or debit card transactions, mini account statement and so on.

9) **Tele-banking:** It is another form of electronic banking through which banking services or products are rendered through telephone to its customers. It is a 24 hour banking facility to the customer. It is based on the voice processing facility available on bank computers.

10) **Phone banking:** Under this service a customer can talk to a phone banking officer for transacting a banking business. The customer can do entire non-cash related banking services on telephone, anywhere at any time.

11) **Electronic Fund Transfer (EFT):** It is an easy and speedy mechanism to facilitate the transfer of funds from one place to another. It enables the customers to transfer money instantly from one bank account to another one of the same or another customer, from one branch or the other of the same bank or a different bank not only within the country but also within anywhere else of the world through electronic message. It enables the beneficiary to receive money on the same day or the next day of money transfer.

12) **Electronic Clearing Services (ECS):** It is non-paper based movement of funds. It consists of:

- Electronic Credit Clearing service is a reliable device used for bulk and repetitive credit-push payments such as salary, pension, dividend, commission, IPO refunds, interest, etc..

- Electronic Debit Clearing Service was introduced to facilitate the payment of credit-pull transactions such as payment of utility bills, insurance premium and repayment of loan installments.

13) **Real Time Gross Settlement (RTGS):** RBI introduced RTGS system in order to enhance the efficiency of the cheque clearing system. It is a single, all-India system with the settlement being effected in Mumbai. The settlement of funds is final and irrevocable. The settlement is done in near real time **(maximum**

of 2 to 4 hours) and the funds settled can be further used immediately. It was started in March 2004.

Check your Progress:

a) What is a credit card?
b) What is a debit card?
c) What electronic funds transfer?

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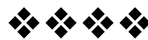
3.3 QUESTIONS

1. Explain the performance of commercial banks in India after 1991.
2. Explain the nature of technological changes in the banking sector after 1991.



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Module 2

CENTRAL BANKING

RESERVE BANK OF INDIA'S MONETARY POLICY

Unit Structure :

4.0 Objectives
4.1 Introduction of Moneatry policy and its objectives
4.2 Liquidity management by the reserve bank of India
4.3 Evaluation of RBI's monetary policy
4.4 Questions

4.0 OBJECTIVES

- To understand the concept of monetary policy.
- To understand the objectives of monetary policy in India.
- To understand the Reserve Bank's strategy of managing liquidity.
- To understand the importance of micro-finance organisations in India.

4.1 INTRODUCTION MONEATRY POLICY AND ITS OBJECTIVES

The central bank of a country is its apex financial institution. It is charged with the responsibility of controlling the money supply over which it has monopoly control, ensure adequate credit to the economy at reasonable cost. For this purpose, it is given control over the working of all commercial banks operating in the country. It also serves as the custodian of the country's foreign exchange reserves and strives to maintain a stable exchange rate to facilitate international trade.

Monetary policy refers to the decisions of the central bank with reference to the availability of money, the cost and availability of credit to the different users. Thus, monetary policy is defined as 'a set of deliberate decisions of the central bank regarding the availability of cash and the cost and availability of credit.' It is important to note in this context that the central bank does not formulate its policy in vacuum. It aims at certain objectives and operates on its different instruments to facilitate the smooth achievement of these objectives. The Reserve Bank of India (RBI) since Independence is working towards certain objectives. Until 1969, the Reserve Bank was primarily concerned with fighting inflationary pressures that arose due to the massive investments by the government with the aim of achieving rapid industrialisation and economic growth. The Reserve Bank used to finance massive government borrowing programmes and had to reign in the commercial banks to counter the inflation. In 1969, the Reserve Bank adopted the objective of 'growth with stability.' This objective emphasized the need to control inflation to ensure a faster growth of the economy.

In 1991, with the introduction of the economic reforms, the Reserve Bank adopted the objective of "Controlled Expansion." This objective translates into the following:

a. Ensure acceleration in industrial investment and economic growth.
b. Maintain the rate of inflation around 5 to 6 percent.
c. Bring about improvements in the credit delivery mechanisms, especially for agriculture, small and medium sectors.
d. Bring about the necessary reforms in the financial system to achieve these objectives.

RBI has introduced various monetary policy instruments to achieve the twin objectives of economic growth and control of inflation. Following the introduction of economic reforms in India in 1991, the RBI has re-oriented its monetary policy formulation and instruments in order to achieve these objectives. An important aspect of monetary policy is that the RBI has to operate in a new atmosphere which is characterised by:

1. The increasing role of market forces in the determination of the cost and availability of credit.

2. The monetary policy is largely insulated from temporary domestic uncertainities.

3. The monetary policy has to have continuity in maintaining the pace of reform process.

4. The responses have to be contextual- that is depened on the changing national and international environment.

5. Improve the efficiency of financial sector to ensure higher growth and social justice and

6. Strengthen the institutional structures to effectively respond to challenges. In order to achieve this, the RBI has strengthened some of the traditional instruments and introduced some new ones. We shall now examine these instruments and their deployment by the RBI since 1991.

1. Trends in Bank Rate: The Bank Rate is the standard rate at which RBI lends money to commercial banks by rediscounting bills of exchange or by purchasing other commercial instruments. Bank rate acts as a guideline for banks to fix interest rates. If the bank rate increases, the interest rates increase and vice versa. Through changes in bank rate, RBI affects the interest rates in the money market. Despite the efforts of the RBI, rediscounting is not a popular instrument in India. The RBI is using the bank rate for rediscounting of export bills, paying interest on excess cash reserves of the banks and so on. The bank rate was brought down from 12 percent in 1991 to six percent in 2000 and remained the same. The bank rate, now serves as a bench-mark lending rate.

Trends in Bank Rate

Year	1991	1998	April 1998
Bank Rate (%)	12	10	6

RBI: Handbook of Statistics (2010)

2) Trends in Cash Reserve Ratio: CRR refers to the ratio of bank's cash reserves with RBI. Banks have to maintain certain percent of net demand and time liabilities (NDTL) to ensure liquidity and solvency of commercial banks. It is maintained at fortnightly (14 days) average basis. On a daily basis, it should be minimum 70% of the total CRR requirement. RBI imposes penalty for default in maintenance of CRR. Over the years, there have been changes in CRR in order to maintain reasonable level of liquidity in the money market, and to control inflation. The CRR is the most frequently used quantitative credit controls since 1991. Following the banking sector reforms in 1991, the CRR was brought down from 12 percent to 6 percent. For instance in 2008, the RBI revised CRR 9 times and varied between 9% and 5.50%. Since April 24, 2010, CRR requirement was fixed at 6% of the net demand and time liabilities.

3) <u>Trends in Statutory Liquidity Ratio</u>: Section 24 of Banking Regulation Act 1949 requires every bank to maintain a percentage of its demand and time liabilities by way of cash, gold, and investment in Government securities. The purpose of SLR is similar to that of CRR, i.e., to ensure liquidity and solvency of commercial banks.

Trends in Statutory Liquid Ratio

Year	CRR
April 1991	38.5%
November 2008	24%
April 2010	25%

RBI: Annual Report (various issues)

Over the years, there have been changing trend in SLR. In 1991, SLR was 38.5% of the demand and time liabilities. In October 1997, SLR was lowered down to 25% and in Nov 2008 it was lowered down to 24%. In April 2010, the SLR stands at 25%.

4) <u>Trends in Repo and Reverse Rate</u>: Repo rate is the rate at which RBI lends money to banks by repurchase of Government securities (treasury bills, and dated securities). Repo helps to inject liquidity in the money market. The repo auctions are conducted on daily basis (except Saturdays and Sundays). 7 day and 14 day repo operations have been discontinued w.e.f. Nov 1, 2004.

In repo auction, the minimum bid size is Rs, 5 crore and multiples of 5 crore. Over the years, there have been changes in repo rate. The following table indicates trends in RBI's Repo Rate. Reverse repo is an agreement between RBI and banks whereby RBI borrows money from banks by selling securities. The reverse repo helps to reduce excess liquidity with banks. RBI may increase repo rate to absorb excess liquidity in the market. The trends in reverse repo rate are shown as follows:

Trends in Repo and Reverse Repo Rates (2006-2011)

Year	Repo Rate	Reverse Repo Rate
July 2006	6.75%	5.75%
July 2008	8.50%	6.00%
April 2010	5.25%	3.75%
July 2010	5.50%	4.00%
April 2011	7.25%	6.25%

RBI: Annual Report (various issues)

5) **Multiple Indicator Approach:** Initially the RBI used monetary targeting approach while formulating monetary policy. Monetary Targeting refers to monetary policy aimed at maintaining price stability by changing the composition of growth in money supply. Post reforms this approach was difficult to follow as monitoring money supply and maintaining price stability became difficult due to NBFIs. So, RBI adopted Multiple Indicator approach in which it looks at a variety of economic indicators such as money, credit, output, trade, capital inflows, fiscal position, rate of returns in various markets, inflation rate as well as exchange rate and their impact on economic growth.

6) **Phasing of Qualitative Methods:** The qualitative or selective methods of credit control are being slowly phased out. The indirect methods of credit control (such as CRR, SLR, Repo Rate, Reverse Repo Rate, etc) are becoming more relevant in controlling money supply and credit in the economy.

7) **De-linking of Monetary Policy from Budget:** In 1994, an agreement was sighed between the Central Government and RBI to phase out the use of ad hoc treasury bills to finance Government deficit. With the phasing out of ad hoc treasury bills, RBI would no longer finance Government deficits.

8) **Deregulation of Interest Rates:** The bank lending rates were earlier fixed by RBI. Since 1991, this system has changed and the lending rates are no longer regulated by RBI. Now the lending rates are fixed by banks depending upon market forces, i.e., demand for and supply of funds with the banks.

9) **Provision of Micro-Finance:** The RBI has introduced Micro-Finance scheme for the benefit of rural poor households and linking them with Self-Help Groups (SHGs) and banking system.

Check Your Progress:

1. What do you understand by monetary policy?
2. What are the objectives of monetary policy in India since 1991?
3. What is bank rate?
4. What do you understand by cash reserve ratio (CRR)?
5. What is a repo rate?
6. What is a reverse repo?

4.2 LIQUIDITY MANAGEMENT BY THE RESERVE BANK OF INDIA

Liquidity management of a central bank is defined as the framework, set of instruments and the rules that the central bank follows in order to manage the amount of money supply, to control short term interest rates with the overall objective of price stability. Liquidity management of RBI refers to management of money supply and credit in order to achieve its objectives of economic growth and price stability (control of inflation).

1. SIGNIFICANCE OR IMPORTANCE OR NEED OF SHORT-TERM LIQUIDITY MANAGEMENT:

1) **Reforms:** Post 1990s many reforms were introduced in the financial sector. Deregulation of interest rates and deregulation of exchange rates were the major reforms and these rates were earlier were determined by the RBI. After the reforms, market forces determined by market demand and supply.

2) **Liberalization & Globalization:** Due to liberalization and globalization the capital flows between countries have increased rapidly. Huge inflows of foreign capital in the form of Foreign Direct Investment and Foreign Institutional Investments. Foreign Investment increases from US $ 118 million during 1991-92 to US $ 15 Billion in 2004-2005.

3) **Volatility and Uncertainty:** Foreign capital inflows resulted in creation of employment and helped India achieve higher growth rate. But at the same time they have brought in volatility and uncertainty in the financial markets.

4) **Export Earnings:** The foreign capital inflows add to the supply of foreign currency and as a result there is appreciation of the domestic currency. This makes exports of the country expensive to foreigners and the export earnings suffer.

5) **Increase in Money Supply:** The capital inflows get converted into rupees and get injected in the economy. This increases money supply. This increase in money supply increases demand for goods and services as purchasing power expands. This causes demand-pull inflation.

Therefore, it was necessary that the RBI should manage both the exchange rate and the interest rate in order to maintain price stability (i.e. control inflation)

2. MEASURES TOWARDS SHORT TERM LIQUIDITY MANAGEMENT:

1) **STERILIZATION:** RBI has introduced sterilization method to deal with the undesirable effects of capital inflows.

- **Meaning:** Sterilization means re-cycling of foreign capital inflows to prevent appreciation of the domestic currency and to check the inflationary impact of foreign capital inflows.

- **Instrument used:** Sterilization is usually carried out through the use of Open Market Operations, where RBI sells bonds and securities in the open market to absorb the excess liquidity that comes from sudden increase in capital flows.

- **Related Problems:** Sterilization may lead to certain problems. For instance, when the Government sells securities to absorb excess liquidity, it will increase the demand for funds in the domestic market, which would raise interest rates. This may further attract more foreign capital to take advantage of higher interest rate.

2) **REPO RATE AND REVERSE REPO RATE:**

- **Repos Rate:** RBI introduced repo in December 1992 to improve short term liquidity management in the money market. Under repo, RBI lends money to banks by repurchasing securities. Therefore, repo increases liquidity with the banks.

  RBI increases or decreases rates of repo and reverse repo. If the repo rate increases, banks will borrow lesser funds from RBI, and therefore, short term liquidity will be controlled. But, if the repo rate is reduced, banks may borrow more funds from RBI.

  Reverse Repo Rate: RBI has also introduced reverse repo. Under reverse repo, RBI borrows money from banks by issuing securities. The reverse repo reduces excess liquidity with the banks. In case of reverse repo, if rates are increased, banks may lend more funds to RBI, and if it reduces, banks may lend lower funds to banks. Therefore increase in repo rate and reverse repo helps RBI to reduce short term liquidity so as to control prices/inflation.

3) **INTERIM LIQUIDITY ADJUSTMENT FACILITY:** In 1998, Narsimham Committee recommended LAF as a means to develop short term money market. Accordingly, RBI introduced the ILAF in April 1999. ILAF enabled RBI to manage short-term liquidity through a combination of repos, export credit refinance,

collateralized lending facilities and open market operations. Based on the experience of ILAF, Internal Group of RBI recommended phased implementation of full-fledged LAF.

4) **LIQUIDITY ADJUSTMENT FACILITY:** Full-fledged LAF was introduced in June 2000. On the recommendations of RBI's Internal Working Group, RBI revised the LAF scheme in March 2004. Subsequently further revision took place in LAF in Oct 2004. The revised LAF scheme has the following features:

- **Aim:** The funds are used by banks for their day-to-day mismatches in liquidity.

- **Instruments used:** Reverse repo auctions (for absorption of liquidity) and repo auctions (for injecting liquidity) are conducted on a daily basis.

- **Participants:** All commercial banks (except RRBs) and primary dealers having current account with RBI.

- **Minimum Bid Amount:** Rs. 5 crore and further in multiples of Rs. 5 crores.

- **Securities used:** The sale and repurchase of securities takes place in transferable Central Government dated securities and treasury bills.

- **Rates:** RBI announces the rate of interest on repos and reverse repos from time to time. On July 2, 2010, the repo rate was increased to 5.50% from the earlier 5.25%. In the case of reverse repo, it was increased to 4% from the earlier 3.75%.

- Liquidity absorption through reverse repo reached its peak on September 4, 2009 at Rs. 168,215 Crores. It is the single biggest factor that helped to manage short-term liquidity and maintain interest rate stability.

5) **MARKET STABILIZATION SCHEME (MSS):** On the recommendations of RBI's Internal Working Group in 2004, RBI announced the launching of MSS and formally signed a Memorandum of Understanding with Govt. The main features are:

- **Implementation Date:** MSS is effective from April 2004.

- **Aim:** The main aim is to absorb excess liquidity from the system. For this purpose, Government issues securities to banks.

- **<u>Instruments used</u>:** The Government issues dated securities (maturity period of over one year) and/or treasury bills. The treasury bills or dated securities issued under MSS are similar to that of existing treasury bills and dates securities. These are eligible for SLR, repo and LAF. The securities are issued by way of auctions.

- **<u>Amount of Securities</u>:** The Government in consultation with RBI fixes an annual ceiling for securities issued under MSS. This ceiling would hold good till revision is done during the course of the year.

- When the government issues Treasury Bills and securities under MSS, it has to be matched by an equivalent cash balance held by the government in separate cash account, the **MSS Account**, maintained and operated by the Reserve Bank.

Check Your Progress:

1. What is market stabilisation scheme (MSS)?
2. What is liquidity adjustment facility (LAF)?

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4.3 EVALUATION OF RBI's MONETARY POLICY

1) The monetary policy aims at economic growth. Monetary policy facilitates provision of credit to various sectors of the economy. Increase in business activities results in economic growth in the economy. RBI's monetary policy is responsible for good growth of Indian economy. At present, India has the second highest (after China) rate of GDP growth in the world.

2) The monetary policy has resulted in healthy competition in the banking sector in India. Deregulation of interest rates has brought transparency in banking transactions, and at the same time generated competition in the banking sector. Due to healthy competition, the overall efficiency of the banks has improved and considerable improvement in customer service.

3) It is necessary that the Domestic scheduled commercial banks - both public sector and private sector are required to provide 40% of their adjusted net bank credit (ANBC) to priority sector. Foreign banks in India, are required to provide 32% of their ANBC to priority sector. Only Three public sector banks, Five private sector banks and Four Foreign banks did not achieve the target in 2008-09.

4) Monetary policy has resulted in financial discipline in the banking sector. The financial discipline is due to the directives issued by RBI to the banks to ensure financial discipline. The directives are to be strictly followed by commercial banks.

5) RBI's monetary policy has improved the short term liquidity position in the money market. RBI has introduced various measures to improve short term liquidity in order to maintain stability in interest rates. The various methods adopted by RBI to manage short term liquidity position include:
- Sterilization to control foreign capital inflows
- Changes in Repo and Reverse Repo rates.
- Liquidity Adjustment Facility
- Introduction of Market Stabilization Scheme.

6) In India, there is a presence of large unorganized money market in form of money lenders, chit funds, indigenous bankers, etc. Due to the unorganized money market, there is more money supply in the economy, which affects the effectiveness of monetary policy to control inflation and to increase-economic growth.

7) The circulation of black money increases money supply, and as such RBI's measures to control inflation may get affected. Therefore, the government has to come up with innovative ideas to reduce the circulation of black money in the economy.

8) For effective implementation of monetary policy, there must be strong banking infrastructure, which is lacking, especially in rural areas. Therefore, the economic growth in rural areas, including that of agriculture is poor.

9) In India, there is preference for cash transactions, especially in the case of retail trade. The monetary policy mainly focuses on bank credit, and money supply with the banks. Therefore, the effectiveness of monetary policy is restricted to the banking sector.

10) RBI finds it difficult to control inflation in the country. For instance, WPI inflation in May 2010 was over 10%. RBI makes effort to control inflation by increasing CRR and repo rate.

However, inflation has remained very high in 2009 and first half of 2010. However, it is to be noted that RBI is alone not responsible for inflation in the country. For instance, the .inflation on account of food items was due to the failure of agriculture in 2009 due to drought in several parts of the country.

11) Many cases have been reported where some officials of banks are corrupt and inefficient. They do not follow the guidelines of RBI in respect of lending to brokers, and others. The ceiling on level of credit and the margin requirements are not followed. This gives rise to financial scams, and thus the economy gets affected.

12) Selective credit control measures taken by RBI are more successful in controlling the sector specific inflation. Methods like credit rationing and differential interest rates are more effective under such situations. But, selective methods are being phased-out by RBI slowly as preference for general methods.

4.4 QUESTIONS

1. What are the objectives of monetary policy in India?
2. Explain RBI's monetary policy after 1999.
3. What is short-term liquidity management and explain RBI's liquidity management policy.

5

MICRO-FINANCE, SELF HELP GROUPS AND COMPOSITE CREDIT

Unit Structure :

5.0 Objectives
5.1 Introduction
 5.1.1 Micro Finance Services
5.2 Role and importance of micro finance
5.3 Government initiative towards micro finance
5.4 Self-help groups
5.5 Need for SHGs and importance of SHGS
5.6 Government programmes for self-help groups
5.7 Problems related to SHGs
5.8 Composite loans / composite credit
 5.8.1 Government initiatives towards composite loans
5.9 Questions

5.0 OBJECTIVES

- To study the concept of micro finance.
- To understand the role & importance of micro finance.
- To study government initiatives towards micro finance.
- To study the concept of Self-help groups.
- To study the need & importance of SHGs.
- To study government programmes for SHGs
- To understand problems related to SHGs.
- To understand the meaning and concept of composite loan.

5.1 INTRODUCTION

Studies conducted by NABARD independently and in association with Self-Help Groups to study rural credit in India in the early 1980s, showed a dismal performance of rural bank branches in rural development. Rural bank branches were helping in creating self-employment by providing bank credit but a large number of rural population were not even having access to the banking system. NABARD came to the conclusion that existing

banking policies, procedures and system was not suitable for the large number of poor people. So, NABARD recommended new policies, procedures and systems to be formulated in order to give access of banking to the Indian poor population. In this way the objective of **Financial Inclusion** will be achieved.

Definition of Financial Inclusion: Financial inclusion is process whereby financial services and adequate credit is provided to weaker sections and low income groups at an affordable cost in a timely manner.

It has been accepted that micro-finance is the most important tool of financial inclusion.

Definition of Micro-Finance: Micro-Finance can be defined as provision of financial services to poor and low-income clients so as to help them raise their income, thereby improving their standard of living.

Micro-Finance and Micro-Credit: There is a huge difference in the terms micro-finance and micro-credit. Micro-Finance includes provision of multiple services like loans, savings, insurance, transfer services, micro-credit loans etc. Micro-Credit includes small amount of money given as loan by a bank or any legally registered institution.

INSTITUTIONS ASSOCIATED WITH MICRO FINANCE: At present, banks and financial institutions that are connected with micro finance include RBI, SIDBI, NABARD, commercial banks, RRBs, cooperative banks, Non Banking Finance Companies (NBFCs) and micro finance Institutions (MFIs).

5.1.1 MICRO FINANCE SERVICES:

Micro finance services are provided through the following two models:

(A) SELF-HELP GROUP – BANK LINKAGE PROGRAMME MODEL:

Self-Help Group: A self-help group is a rural based financial intermediary. It is a group composed of 10-20 members, usually local women. These groups are supported by Non-Government Organisations (NGOs) or by Government Agencies. Members of the group contribute small savings regularly over a few months to collect enough capital which is then used for lending to the group members.

SBLP: This programme was started by NABARD in 1992. During this period SHGs were directly financed by banks. It is known as a linkage model because it is based on the strength of various participants i.e. NGOs, Banks and the rural poor people. Under SBLP, three models have been emerged. They are as follows:

Model 1: SHGs promoted, guided and financed by banks.

Model 2: SHGs promoted by NGOs/Government agencies and financed by banks.

Model 3: SHGs promoted by NGOs and financed by banks using NGOs/formal agencies as financial intermediaries.

Model 3 has emerged as the most popular model under SBLP. Commercial banks, co-operative banks and the RRBs have been actively participating in this programme.

(B) MICRO-FINANCE INSTITUTIONS: Existence of MFIs dates back to ancient times and with changes in times they have also adapted to the changes. MFIs include NGOs, trusts, social and economic entrepreneurs lend small amount of loans to individuals or SHGs. They also provide other services such as capacity building, training, marketing, etc. In India, MFIs exist in the form of registered trusts, registered societies, registered co-operatives, NBFCs-MFIs which are registered under Companies Act, 1956 and NBFC registered with RBI. MFIs operates under the following two models:

a) Bank-Partnership Model: This includes partnership between the bank and Micro0-Finance Institutions. This model is further divided into:

1) **MFI as an Agent:** In this model, bank is lender and MFI acts as an agent. MFI handles work relating to monitoring of credit, supervision and recovery. MFI takes care of all relationship with the borrower, from first contact till the final repayment.

2) **MFI as Holder:** In this model, MFI which is a Non-Banking Financial Company holds the individual loan on its books for a short-period before securitizing and selling them to the bank.

b) Banking-Facilitators/Correspondents Model: In January 2006, RBI permitted the banks to use the services of NGOs, MFIs other than NBFCs and other civil society organisations to acts as intermediaries in providing finance and banking services

to the poor. These intermediaries are known as business facilitators or business correspondents. These intermediaries carry out banking functions in rural areas where it is not possible to open a branch.

5.2 ROLE AND IMPORTANCE OF MICRO FINANCE

Micro-Finance has indeed become the most of important tool of financial inclusion. During the last two decades the concept of micro-finance has been of great significance.

1) **Poverty Alleviation:** Due to micro finance, poor people get employment. Employment increases income level which in turn reduces poverty of people to a certain extent. It is provided to poor people living in rural or urban areas.

2) **Financial Inclusion:** As poor people do not get the advantage of organised banking sector, micro-finance facilitates financial inclusion of weaker sections. Micro-finance links poor people to the organised banking sector from unorganised sectors. This reduces exploitation of poor by money lenders and landlords.

3) **Employment Generation:** Micro credit and other services are made available to small entrepreneurs, village artisans, poor people, SHGs, etc. The people who get the benefit of micro finance set up small business units, thereby generating employment,

4) **Economic Growth:** Increase in investment results in increase in the production of goods and services. Increase in production of goods and services increases the GDP of a country. So, micro finance contributes to economic growth in the country.

5) **Savings and Investment:** Micro finance develops saving habits among the people. For instance, the SHGs who get micro finance encourage saving habits among its members. The financial resources generated through savings and micro credit obtained from banks are utilised to provide loans or advances to the members. The members of the SHG use the financial resources for setting up small business units or for working capital of the existing units.

6) **Skill Development:** Due to micro finance, SHGs encourage its members to set up small business units either jointly or individually. The small entrepreneurs may also receive training from supporting institutions or they may learn to develop their skills by operating small businesses. Small businessmen may also learn leadership skills which may be useful for the village community as a whole, especially in rural areas.

7) **Social Welfare:** Due to employment, the income level of the people increases. As a result, people may go for better education, health, family welfare etc. Hence, micro finance is responsible for the betterment of the society.

8) **Empowerment of Women:** Normally, 50% of the SHGs are formed by women. The women of a village come together to form SHG. After formation of group, they get micro finance facilities from the banking sector. They are also supported by NGOs. The village women learn to manage the affairs of SHGs and also set up small business, which enables them to save a part of their income. Therefore, micro finance empowers poor women economically and socially.

5.3 GOVERNMENT INITIATIVE TOWARDS MICRO FINANCE

Many micro-policies and regulations have been introduced by the Reserve Bank of India, NABARD and SIDBI. These policies and regulations directly affect the functioning of Self-Help Groups and Micro-Finance Institutions in India. Some of the important policies initiated are as follows:

(A) POLICIES INITIATED BY RBI:

1) **Savings Bank Account for SHGs:** In 1993, registered and unregistered SHGs were allowed to open savings bank account with banks by the RBI.

2) **Incentives to bank for financing the SHGs:** In October 2002, the Reserve Bank of India set up four informal groups to look into various issues related to micro finance institutions. Based on the recommendations of the groups, banks were advised that they should provide adequate incentives to their branches for financing the SHGs.

3) **Business Correspondents:** In order to examine issues relating to rural credit and micro finance, an internal group was set up under the chairmanship of H.R. Khan in 2005. Based on the recommendations of the group, banks were permitted in January 2006 to use the services of NGOs/SHGs, MFIs (other than NBFCs) and other civil society organisations as intermediaries in providing financial and banking services through business facilitator and business correspondent models.

4) **Interest Rates:** The RBI decided that interest rates applicable to loans given by banks to microfinance organisations or by microfinance organisations to SHG members would be decided by the banks and SHGs with no intervention by RBI.

(B) POLICIES INITIATED BY NABARD:

1) **Micro-Enterprise Development Programme (MEDP):** In 2006, NABARD launched the MEDP for skill development of the SHG members. For this NABARD conducted several training programmes to improve the capacities of SHGs to take up micro enterprises.

2) **Micro-Enterprise Promotion Agency (MEPA):** In 2005-06, a pilot project for promotion of micro-enterprises was launched by NABARD. This is being implemented by NGOs acting as micro-enterprise promotion agency (MEPA) in **nine districts**. Many micro-enterprises were established under the project.

3) **SHG Federations:** In many places, group of SHG representatives have formed Federations. These Federations are important for the growth of SHGs because they improve the bargaining power of group members. Recognizing the growing role of the SHG Federations, in 2007-08, NABARD decided to support them by way of grant assistance for training and capacity building.

4) **Committee on Financial Inclusion:** Recently NABARD appointed a Committee on Financial Inclusion under the Chairmanship of Dr. C. Rangarajan. The Committee submitted its final report in January 2008.

Recommendations of the Committee:

- Outreach of microfinance programme needs to be expanded further.
- NBFCs may also be recognized as Business Correspondents of banks for providing only savings & remittance services and also act as insurance agents.
- Opening of specialized microfinance branches in urban centers for the poor.

(C) POLICIES INITIATED BY SIDBI:

1) **SIDBI Microfinance Programme:** SIDBI launched its micro finance programme in 1994 on a pilot basis. The programme provided small doses of credit funds to the NGOs all across the country.

2) **Finance to NGO/MFI:** SIDBI was one of the first institutions that identified and recognised NGO/MFI channel for reaching financial services to the poor. Today, SIDBI is one of the largest providers of micro finance through the MFIs.

3) **Capacity Assessment Rating:** There are no collaterals or securities in case of microfinance lending. This makes such lending risky for banks. In order to reduce such risks, SIDBI started the concept of capacity assessment rating (CAR) for the MFIs.

4) **Transformation Loan:** SIDBI introduced a product called 'transformation loan in 2003 to enable the MFIs to transform themselves from an informal set up to more formal entities. This loan has longer repayment period and part of the loan can be converted into equity at a later date, when the MFI decides to convert itself into a corporate entity. A number of MFIs went ahead with the transformation and some of them have now grown significantly and are serving millions of clients.

MICROFINANCE REGULATION: Currently, there are multiple regulatory mechanisms for different entities engaged in microfinance. As a result the microfinance sector is experiencing several problems. Keeping this in mind, the government has decided to regulate the sector through the **Micro Financial Sector (Development & Regulation) Bill, 2009**. The regulation aims to safeguard interests of customers and ensure development and orderly growth of the microfinance in rural and urban areas. The Union Cabinet is likely to approve the Bill soon.

5.4 SELF-HELP GROUPS

DEFINITION: Self-Help Group is a rural based financial intermediary, usually composed of 10-20 local women. The group members save regularly and convert their savings into a common fund known as group **corpus fund**. The group members use the corpus fund and the other funds which they receive from banks or Government and utilised them for employment generation.

Self Help Group is a voluntary association of poor formed with the common goal of social and economic empowerment. The main objective of the formation of SHG is to generate employment, thereby solving the problem of poverty.

FEATURES OF SHGs:

1) **Membership and Members:** The SHG may consist of **10 to 20 persons**. But for minor irrigation projects, there is no ceiling on number of persons in a group. Normally, members of the group belong to Below Poverty Line (BPL) families. However, Above Poverty Line (APL) persons can be included. But the APL members will not be eligible for subsidy from the Government. Normally, APL members comprise of about 20% of the total members.

2) **Composition of group:** Normally, the group consists of only one member from one poor family. A person should be a member of only one group. He cannot be a member of two groups.

3) **Management and Office bearers:** The BPL members must take active interest in the management of the group, and the APL members of the SHG cannot become office bearers. Only BPL members are eligible to become Group Leader, Assistant Group Leader and Treasurer of the group.

4) **Registration:** Registration of SHG is optional. This means SHGs are registered as well as non-registered ones.

5) **Services focused:** The group members save regularly a part of their income and the saved funds are lent to group members.

6) **Meetings:** There SHG hold regular meetings - weekly or fortnightly.

7) **Operation of Accounts and Records:** The group operates a bank account to deposit the balance amount after disbursing loans to the members. The group maintains simple basic records such as minute’s book, attendance register, loan ledger, cash book, bank pass book, and individual pass books.

8) **Interest:** The members who contribute savings are paid an interest of 4.25% plus share in profits and interest charged on loan is in the range of 24% - 28%.

9) **Size of loan and Insurance:** Initial loan size is between Rs. 5000 to Rs. 10000. Usually the loan is linked with life or health insurance.

The poor people in rural areas are at a disadvantage due to low literacy, social backwardness, and very low level of income. A poor person is socially and economically backward and also does not have required information and knowledge of today's

development process. However, due to formation of a group, some of the problems faced by poor can be removed.

5.5 NEED FOR SHGs and IMPORTANCE OF SHGS

1) **Promote Savings:** SHGs play a very important role in linking the poor people to the banking system by encouraging and mobilising the savings for collective economic development. It improves social and economic life of the members of the group.

2) **Raising Standard of Living:** Removal of poverty is one of the major objectives of SHG-Bank linkage programme. Investment made with the credit provided by SHGs would generate income and improve living conditions of the poor, especially in rural areas.

3) **Skill Utilisation and Skill Development:** Many rural poor are uneducated. By working as a member of a SHG they develop certain skills. They utilize individual skills for group's interest. Entrepreneurship skills among the poor are developed by providing them training. It leads to social and economic development of rural poor.

4) **Utilisation of Resources:** Under the SBLP, as on **March 2009, SHGs held a total savings of Rs. 5545 crores with the banks**. SHGs play a very important role in utilising local resources for the betterment of the members of the group.

5) **Awareness and Empowerment:** SHGs have been successful in creating awareness of the rights of the poor people, so that they are not exploited by landlords and local politicians. SHGs have also made a number of rural women economically, socially and politically empowered.

6) **Overcome social and personal problems:** SHGs helps to overcome the problem of poverty, especially in rural areas. SHGs also help the group members to understand each others problems in a better way.

7) **Employment Generation:** The members of the group are encouraged to start micro-enterprises. It generates employment, including self-employment. Small rural enterprises reduce the incidence of disguised and seasonal unemployment in rural areas.

5.6 GOVERNMENT PROGRAMMES FOR SELF-HELP GROUPS

The RBI, NABARD, SIDBI and Government of India have initiated many programmes in association with SHGs. Some of the highly successful programmes are:

a) **Prime Minister's Rozgar Yojana (PMRY):** SHGs are considered for financial assistance under PMRY. The SHG must consist about 5 to 20 educated unemployed youth. Financial assistance is given to set up self-employment projects. SHG may undertake common economic activity for which loan is sanctioned. Subsidy is provided to the SHG. There is exemption limit for providing collateral security against loan, which is Rs. 5 lakhs in case of projects under the Industry Sector.

b) **Swarnajayanti Gram Swarozgar Yojana (SGSY):** The SGSY scheme was launched in 1999. The objective of this scheme is to bring the poor people above the poverty line within 3 years. Financial assistance is given to set up self-employment projects. For the purpose of providing financial assistance, preference is given to well functioning SHGs in the villages both under the group finance and individual finance.

c) **SHG-Bank Linkage Programme:** This programme was launched in 1992 by NABARD. This was the first time SHGs were directly financed by banks. RBI is encouraging the commercial banks, cooperative banks and RRBs to implement the SHG-Bank Linkage Programme. At present, this programme has emerged as the major micro finance programme in the country. Under this programme, as on March 31, 2009 about 61,21,147 SHGs held savings bank accounts with total savings of Rs. 5545 crore.

5.7 PROBLEMS RELATED TO SHGs

In spite of the spread and success of SHGs as agents of microfinance, they experience many problems and suffer from many drawbacks.

1) **Management and Control:** It has been observed that many SHGs suffer due to poor management. There is a lack of internal control systems in many SHGs and SHG Federations. Internal controls are the systems and processes that are used to manage day to day operations. Roles and responsibilities of members and office bearers are also not properly defined. In many cases, there has been poor management of cash flows as well.

2) **Impact on Poverty:** Though the SHGs are developed as a tool for poverty alleviation, they have not made much impact on poverty in rural areas in all the states. They have provided credit to a very large number of poor people but have not been able to successfully bring them above the poverty line.

3) **Unequal Regional Impact:** The SHG program has been predominant in the Andhra Pradesh, Tamil Nadu, West Bengal, Karnataka, and Uttar Pradesh. Further, among these states the program was heavily concentrated in Andhra Pradesh, where 40% of credit linkages were established. The model has not been able to make much impact in other states.

4) **Leadership Problems:** A few members dominated in most of the SHGs. Many study groups have observed this phenomenon. The educated and well-off leaders dominating the groups are getting re-elected several times. This is due to the lack of education among other group members.

5) **Governance:** As these organisations are an informal organization and a SHG federation is group of informal organizations it has been observed that there is poor governance. The capacity of the members to provide good governance is also weak. The members of SHGs do not have much experience with various functions or to observe different legal regulations.

6) **Dropouts:** There are incidences of dropouts from groups. The dropout rate for the very poor is about 11% and for the non-poor about 7%. The major causes of dropouts are migration for employment outside the village, and inability to make regular savings deposits.

7) **Poor Record Keeping:** A large number of SHGs groups have weak record keeping practices. This is due to the informal nature of the groups and lack of education and accounting skills among members.

8) **Regulation:** SGH are governed by multiplicity of regulations for different entities. This makes formation and functioning of SHGs difficult in many cases. Besides, the interests of group members are not safeguarded without proper regulations. Micro Financial Sector (Development & Regulation) Bill, 2009 is expected to sort out this problem by making NABARD the single regulatory body for SHGs.

5.8 COMPOSITE LOANS / COMPOSITE CREDIT

Micro and small business enterprises require working capital as well as fixed capital. Provision of credit by banks and financial institutions for working capital and fixed capital of micro and small enterprises is called as Composite Credit. The Government encourages banks to provide composite credit to micro and small enterprises. The Government has increased the composite loan limit. In 2000, the composite loan limit was increased from Rs. 10 lakhs to Rs. 25 lakhs, which was further increased to Rs. 50 lakhs and in October 2004, the Government increased the composite loan limit to Rs. 1 Crore. Under the Composite Loan Scheme, the SSI units or entrepreneurs can obtain working capital and term loan together from a single agency. This scheme is operated by banks and financial institutions. State Financial Corporations under single window scheme provide working capital loan along with term loan to new tiny and small sector units so as to overcome the initial difficulties and delays faced by them to start production.

INDICATIVE PARAMETERS: The composite loan scheme is subject to the following parameters:

1) **Debt-Equity Ratio:** The debt equity ratio should be **3:1** in the total project outlay (i.e., cost of the project plus working capital requirement) after taking in account the amount of investment/subsidy/incentives available for the project.

2) **Promoters Contribution:** As may be required to arrive at the debt-equity ratio of **3:1**.

3) **Margin for Term Loan:**
   - All backward areas in the State **25%**
   - Other areas and municipal limits of all cities of the State **30%**.

4) **Repayment:**
   - Working Capital: Not exceeding **10 years**.
   - Term Loans not exceeding **8 ½ years**.

5) **Security:** The State Financial Corporation will have first charge on fixed assets and hypothecation of the current assets. SFC may also ask for collateral security against working capital loan.

5.8.1 GOVERNMENT INITIATIVES TOWARDS COMPOSITE LOANS:

1) **Credit Guarantee Fund Scheme (CGFS) for Micro and Small Enterprises** was launched by the Government of India to make

available collateral-free composite loans to the micro and small enterprises and to SHGs that have the potential to become micro enterprises. Due to the CGFS, financial institutions and banks are encouraged to lend money under composite credit scheme to micro and small enterprises. Both the existing and the new enterprises are eligible to be covered under the scheme. To implement the CGFS, The Ministry of MSME and SIDBI established a Trust name Credit Guarantee Fund Trust for Micro and Small Enterprises. Some important features of the Fund Scheme are:

a) Corpus is being contributed by Government of India and SIDBI in ratio of 4:1

b) Scheduled Commercial Banks, select RRBs, National Small Industries Corporation Limited, North Easter Development Finance Corporation Ltd and SIDBI are eligible to lend composite loans under the Scheme.

c) Terms loans and working capital facility upto Rs. 50 Lakh extended without any collateral security are eligible under this scheme.

d) The guarantee cover available under this scheme is 75% of the sanctioned credit amount. The guarantee cover is extended to 80% in some special cases like for loans to micro enterprises upto Rs. 5 Lakh, MSEs operated and/or owned by women, all loans towards the north-eastern region.

e) MSE proposals for an amount of Rs. 9200 Crores have been approved for extending loans without any collateral security or third party guarantee under this scheme.

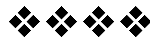
2) **Swarozgar Credit Card Scheme (SCCS)** was introduced by Government in 2003 to provide adequate composite credit to small artisans, handloom weavers, fishermen, serf employed persons, rickshaw owners, and other micro enterprises and SHGs from the banking system in a cost effective manner. As of March 2009, a total of 9.84 lakhs cards have been issued by banks involving a credit amount of Rs. 4,007.33 Crores.

3) **Composite Credit Scheme for Agriculture Lending (CCSAL)** was introduced by Oriental Bank of Commerce. The purpose is to meet credit needs of farmers including those for farm operations, development of agriculture, etc. and domestic expenditure. The amount of loan is up to 50% of the value of the land offered as security or Rs. 7.50 lakh whichever is lower. The term loan is granted for a period of upto 7 years, and the

working capital is in the form of revolving credit. In this scheme, security is required which may be in the form of mortgage of agriculture land valuing twice the amount of loan and hypothecation of crops.

5.9 QUESTIONS

1. Explain the significance of micro finance.
2. What measures are taken to promote micro finance institutions in India?
3. Write a note on Self Help Groups in India.



6

Module 3

FINANCIAL MARKETS

(A) MONEY MARKET IN INDIA

Unit Structure :

6.0 Objectives
6.1 Features of Indian Money Market
6.2 Money Market Instruments and Reforms in India since 1991
6.3 Questions

6.0 OBJECTIVES

- Understand the concept and importance of money market.
- Understand the features of money market in India.
- Understand the various instruments of money market in India.
- Understand the reforms in Indian money market since 1991.

6.1 FEATURES OF INDIAN MONEY MARKET

Money market refers to a market for financial assets that are close substitutes for money. It is a market of assets that mature in one day to one year. It is not a physical market. It is a wholesale market for several instruments and thus is not a single market. In this market, the creditworthiness of the borrower is important. It allows the balancing of the demand and supply of short-run funds at reasonable rate of interest. The organised money market is the focal point for the central bank intervention for influencing liquidity and interest rates. It also acts as the link between the short-term and long-term interest rates on financial instruments. The RBI, the Discount and Finance House of India Ltd. (DFHI), mutual funds, commercial banks, NBFCs, Securities Trading Corporation of India (STCI), public sector undertakings, state governments, and NRIs are important players. The size of this market has considerably increased in recent years and a sum equivalent to two percent of

the GDP is transacted every day in this market. The following are some of the features of Indian money market:

1. Segmented Market:

The Indian money market is divided into the two segments- a) the organised market and b) the unorganised market. The former refers to the RBI, the scheduled commercial banks (SCBs), and under financial institutions that operate under the supervision and control of the RBI. The RBI monitors the rates of interest in this segment. The unorganised segment consists of chit funds, moneylenders, indigenous bankers and others. These are not under the supervision of the RBI. As a result, the interest rates in this segment are very high, often more than 100 percent. This leads to an exploitation of the debtors.

2. Seasonal Variations in the Interest Rates:

The Indian money market is characterised by seasonal variations in the interest rates. During the months of July to November, known as the busy season, the interest rates are high because of the demand for farm loans. From December to June, when the agricultural demand for fund/loans is low, known as the slack season, the interest rates are low. The Reserve Bank for long had to announce a credit policy for the busy season, and another for the slack season.

3. Multiple Interest Rates:

Due to the segmentation of the money market, there are different rates for different borrowers and for different users. This feature made the traditional credit controls like bank rate policy redundant in controlling the short-term interest rates.

4. Absence of Bill Market:

An important feature of an active money market is the presence of bill market which allows re-discounting of bills and provides the central bank with the ability to control the interest rates. In India, there is no sizable bill market. As a result, the role of bank rate is very limited. Despite its attempts at different times, the Reserve Bank could not help in creating an active bill market. As a result, the ability to influence the interest rates is limited. The Reserve Bank introduced alternative instruments to regulate the interest rates.

6.2 MONEY MARKET INSTRUMENTS AND REFORMS IN INDIA SINCE 1991

Following are the instruments of the organised money market.

A. Call/Notice Market: This is the most import important segment of the money market dealing with day-to-day trading of surplus funds of commercial banks. Its maturity varies from a day to a fortnight. When money is borrowed/lent for a day it is known as call (overnight) money. When it is borrowed for more than a day up to 14 days, it is known as notice money. This is a highly risky and extremely volatile market. Banks use this market to mobilise funds to meet the CRR requirements and to invest their surplus funds. This market reflects the liquidity condition of the economy and hence the central banks world over use this market to influence the interest rates to achieve monetary policy objectives. Since August 2005, this market is made a purely inter-bank market and only the primary dealers (PDs) are the non-bank players that are allowed by the RBI to operate in this market. The total turnover in the call money market as on 31 March 2011 was Rs. 22,913 crore. The interest rates in the call money varied between 7 to10.6 per cent in recent period, indicating a certain degree of stability in the financial markets.

B. Treasury Bills (TBs): Treasury Bills refers to the short-term government debt and are the most liquid instruments. There are four types of TBs depending on the maturity. i) 14 day Treasury Bills were issued between 1997 and 2001. These were eligible for rediscounting but were non-transferable. These were not popular instruments and the outstanding amount varied between Rs. 200 crore to Rs. 325 crore. ii) 91-day Treasury Bills were first introduced in 1955 and till April 1, 1997, government used to issue the 91-day ad hoc TBs to obtain funds to finance the monetised deficit of the government from the RBI without any obligation to pay interest. With the introduction of the Ways and Means Advances (WAMAs) in 1997, the ad hoc TBs were abolished. In April 1992, the RBI introduced the auctioned TBs. The yield on these instruments is market determined. The volume of TBs offered for auction is determined by the RBI on the basis of the overall liquidity, size of the capital inflows, and the repo rate. Since 2001-02, RBI has not subscribed to the issues of these. The volume of these declined steadily after 1997-98, and by March 2006, the outstanding 91-day TBs were Rs. 16,316 crore. iii) 182 day TBs were first introduced in 1987 but were abolished during 1992-99 and further during 2001-05 and were reintroduced since April 2005 since they offer higher returns and are a popular instrument with the commercial banks. As on 29 April, 2011, the outstanding 91-day Treasury Bills were equal to Rs. 73,766.5 crore. The 182-day Treasury Bills outstanding were 26,750.55 crore in April 2011. The outstanding 364-day Treasury Bills were Rs. 43,456.4 crore in April 2011.Though the yield on these reduced in recent years, they are a popular money market instruments because of their liquidity.

C. Commercial Paper: This instrument was introduced in January 1990. A commercial paper (CP) is 'an unsecured short-term promissory note issued at a discount by credit worthy corporates, primary dealers (PDs) and all-India financial institutions'. They can be issued by these agencies if the net worth is Rs. 4 cr. and with a P2 ranking. A CP has a maturity between 7-days to one year. Only a scheduled commercial bank (SCB) can be an Issuing and Paying Agent (IPA). Corporates are allowed to issue CPs up to 100% of their working capital limits. Initially most of the CPs was to be issued by manufacturing companies. Now this market is dominated by leasing and finance companies. SCBs are the major investors in this instrument. Issuance of CPs is inversely related to the interest rate in the money market. PSBs invest in this instrument only during slack season. During 1990-91 and 2010-11, the total value of CPs increased from Rs. 65 cr. to Rs. 1,24,991 cr. The interest rate on CPs varied between 6.39 to 12.5 per cent in recent years. This instrument does not have a secondary market and the stamp duty to be paid also makes it less attractive.

D. Commercial Bills: A Commercial Bills is a short-term, self-liquidating instrument with low risk. "It is a written instrument containing an unconditional order, signed by the maker, directing to pay a certain amount of money only to a particular person, or to the bearer of the instrument". When these bills are accepted by banks, they are called commercial bills. Maturity of these bills varies from 30 to 90 days. In India, a particular type of bills known as 'hundis' are used. The introduction of derivative usance promissory notes of days allowed for multiple re-discounting. In India, the imposition of stamp duties made these instruments unattractive and so the government abolished stamp duty as a part of money market reforms. These bills are less popular as cash credit is more prevalent in India. In order to avoid the misuse of the bills, the RBI disallowed the re-discounting of service sector bills.

E. Certificates of Deposit: These are introduced in June 1989, in order to tap the liquidity in the market. The SCBs other than the RRBs, and local area banks, and six financial institutions are allowed to issue the CDs. These are negotiable money market instruments and are issued in demat form subject to the overall term money borrowings of these institutions. These instruments are issued at a discount on face value. The banks use them when the deposit growth is sluggish and credit demand is high. The minimum size of a CD is Rs. One lakh and the minimum maturity is 15 days. The banks have to maintain CRR and SLR on the issue of the CDs. They are freely transferable by endorsement and delivery. No loans/credit can be granted against CDs and the issuing agency can not buy them back. They are repayable through a 'CD Redemption Account' to be maintained by each issuing agency. Though the Discount and Finance House Ltd., provides tow-way

quotes, the secondary market for the CDs is still not popular. After rapid expansion during 1991-98, this market lost its significance as banks were having enough liquidity. During 2010-11, the outstanding CDs were Rs. 4,24,740 cr. and the interest rate varied between 9 to 10.6 percent in recent years. It is easy to understand that the demand for CDs is inversely related to the CPs.

F. Term Money Market: This market deals with funds up to one year maturity. This market India deals mostly with maturities between 90 to 180 days. This market is dominated by IDBI, and other development finance institutions along with EXIM Bank, NABARD, and NHB. This is because; the predominance of cash credit forces the SCBs to confine to call money market. The SCBs are exempted from the need to maintain CRR and SLR on funds from this market. During 1991 and 2006, the size of funds borrowed from this market varied between Rs. 274 cr. to Rs. 1,338 cr.

The introduction of new instruments did improve the depth and spread of the organised money market since 1991. However, in some segments the volumes traded are still very marginal and thus not very significant in terms of monetary policy implementation. The RBI is following a gradualist approach in facilitating the modernisation of the Indian money market

Check Your Progress:

1. What is call money market?
2. What are Certificates of Deposits?
3. What is a repo operation?
4. How does the reverse repo operation influence the interest rates?

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6.3 QUESTIONS

1. Explain the various features of Indian money market.
2. Discuss the various reforms introduced in the Indian money market since 1991.

7

(B) CAPITAL MARKET IN INDIA

Unit Structure :

7.0 Objectives
7.1 Introduction
7.2 Functions of the Capital Market
7.3 Reforms in the Capital Market
  7.3.1 Primary Market Reforms
  7.3.2 Secondary Market Reforms
7.4 Role of SEBI in the development of Capital Market
7.5 Mutual Funds in India
7.6 Forward, Futures and Commodity Market in India
7.7 Questions

7.0 OBJECTIVES

- To understand the nature of capital market.
- To understand the significance of capital markets in economic development.
- To understand the different reforms introduced in capital market in India.
- To understand the functions of SEBI.
- To understand the functioning and progress of mutual funds in India.
- To understand the nature and working of forward, futures and commodity markets in India.

7.1 INTRODUCTION

Capital market refers to the market for long-term funds for investment purposes. The capital market is the source of funds for corporates, governments and provides opportunities to savers to park their long-term savings. The capital market comprises of two segments- the primary and the secondary markets. The primary market allows the flow of long-term funds from the surplus sector to

governments, corporates, banks and NBFCs. It helps in the creation of net fixed assets. Initial public offers (IPOs), private placements, rights issues, preferential issues are the important instruments of the primary market. In recent years, there is a considerable widening and deepening of the primary market with PSBs, financial institutions, PSUs, mutual funds entering the markets as borrowers and the merchant banks, investment and consulting agencies and registrars to the issues as the managers. The capital mobilised in the primary market by non-government public limited companies increased from Rs. 7,077.2 crore through prospectus in1992-93 to Rs. 47,477.5 crore in 2007-08. The rights issues mobilised Rs. 12,726.2 core in 1992-93 and Rs. 9,370.8 core in 2007-08. The secondary market deals with transactions in outstanding securities, creating liquidity. The recognised stock exchanges, National Stock Exchange (NSE) (1994), Over the Counter Exchange of India (OTCEI) (1992), and the Interconnected Stock Exchange of India (ISE) (1999) are the important players in the secondary market. This market deals with government securities, PSB bonds and corporate securities and debt instruments. This market allows the investors to off load their equity/debt and gain.

7.2 FUNCTIONS OF THE CAPITAL MARKET

1) The capital market allows to mobilise savings for long-term investments. 2) It provides risk capital in the form of equity. 3) It allows broader ownership of productive assets. 4) It provides liquidity by permitting the sale of the instruments in the secondary market. 5) By providing funds on the basis of open bids, it lowers the cost of funds and helps in better price realisation. 6) In creates investor awareness leading to informed choices in making use of savings. 7) It lowers the price and market risk of investment by providing derivative trading, investor protection fund. 8) It improves the efficiency of the market by lowering the transaction costs and settlement timings. 9) It integrates the real and financial sectors, equity and debt instruments, long-terms and short-term funds, private and government sectors, domestic and international funds.

The following factors contributed to the growth of capital market in India: Specialised financial institutions like IDBI, ICICI, IFCI, UTI and the State Finance Corporations (SFCs) led to the provision of long-term funds. Till 1992, the Controller of Capital Issues (CCI) regulated the volume of public issues, premia, and dividend payments. With the setting up of SEBI, Securities Trading Corporation of India (STCI) the institutional framework was set up for these functions to become more transparent and market-determined. Despite the 1991 scandal, people reposed faith in the stock markets and with the SEBI becoming more vigilant, such

incidents have become rare. As people realised the opportunities for investment and returns through the stock markets, they started parking their investible funds in the stock markets. The bank deposits lost their attraction as a source of long-term investment. The setting up of mutual funds also helped the average investor to benefit from the stock market boom. The RBI introduced the 'Delivery vs. Payment (DVP) system, to minimise the settlement risk in securities. With the FIIs allowed to participate in the debt funds, the Treasury Bill market became buoyant. As the badala system was banned, the transactions shifted to the rolling settlement. From July 2001, government allowed individual stock options and index stock options. This has helped in developing the derivative markets. From January 2003, SEBI allowed futures trading in 41 stocks. Since July 2002, SEBI introduced the Electronic Data Information Filling and Retrieval (EDIFAR) system for all firms to file disclosures electronically. All transactions are recorded to avoid benami transactions in the stock markets.

7.3 REFORMS IN THE CAPITAL MARKET

With the introduction of economic reforms, the need to ensure an efficient and orderly capital markets became imminent. As a result, the government introduced various reforms both in the primary as well as the secondary markets. Most of these reforms are carried out through the mandate of the Securities and Exchange Board of India (SEBI).

7.3.1 Primary Market Reforms:

These reforms are based on the concerns about allowing funds to raise adequate funds at reasonable cost and at the same time ensuring the protection of investors' interests in terms of safety of the funds and the return on them. Some of these reforms are as under:

1) SEBI was set up in 1988 and is given statutory powers in 1992. SEBI is mandated to ensure investor protection and the orderly development of the capital market. SEBI oversees the functioning of the merchant banks, mutual funds, portfolio managers, registrars of an issue, share transfer agents, underwriters and venture capital funds (VCFs). With the repelling of Capital Issues (Control) Act 1947, SEBI is empowered to supervise the new issue market by providing guidelines for disclosure and investor protection. The listed companies with satisfactory record for filing periodic returns with stock exchanges are exempted from filing repetitive disclosures. SEBI also allows the mobilisation of additional resources also. While underwriting is made optional, except in case of infrastructure companies, if less than 90 percent of public offer is

not subscribed, the company concerned is obliged to repay the entire amount to the investors. Under the new disclosure and investor protection (DIP) guidelines, IPOs with five times the size of pre-issue net worth are allowed only if the company had a record of profitability and a net worth of Rs. 1 core in three out of the last 15 years. Companies without such a record or an issue beyond five times the pre-issue net worth are allowed to make IPOs only through book-building with 60 percent of the issue is placed with qualified institutional borrowers (QIBs). In such cases, the preference shares issued to individuals have a lock in period of one year. All allocations are to be made only in the demat form and all refunds should be through electronics clearance system. The Central Listing Authority ensures uniform and standard practices for listing the securities on stock exchanges. From April 2005, retail investor is one who applies for securities up to Rs. One lakh and 35% of the issue must be allocated to them. The allocation to high net-worth individuals cannot be more than 15%. Bidding period is fixed at 3-7 working days. The price band/floor price must be disclosed at least one day before the opening of the bid. Optional grading of IPOs b rating agencies is allowed. Also, 5% of the issue is to be allocated to each to MFs and QIBs. In order to promote investor protection, venture capital funds and private equity firms are barred from selling their stake in a company after its IPO. Further, from March 2003, companies floating IPOs should have net tangible asters of Rs. 3 core in each of the two preceding two years. Of this, not more than 50% should be held in cash/monetary assets. Companies changing their names must derive a minimum of 50% of the total revenue form the business activity suggested by the new name. SEBI has emerged as an effective market regulator by taking steps from time to time to meet the new challenges that are natural to an emerging economy.

2) The foreign institutional investors (FIIs) are allowed to participate in the capital market subject to a maximum of 49 percent of the equity. This measure helped to integrate the Indian capital market with the global capital markets.

3) Indian companies are allowed to raise capital from international markets through Global Depository Receipts (GDRs), American Depository Receipts (ADRs), Foreign Currency Convertible Bonds (FCCBs) and External Commercial Borrowings (ECBs). Indian companies are now permitted to invest the proceeds for ADRs/GDRs abroad.

4) Companies asking for IPO will have to demonstrate an ability to pay dividend.

5) Companies can now issue debt security without the prior listing of equity. Issues of more than Rs. 100 crore need investment grades rating from at least two rating agencies and the promoters

shall bring at least 20 percent of equity with a lock in period of 3 years.

6) Merchant banks are prohibited from carrying out any operations in the money market.

7) Since 1998/9, SCBs are allowed, with the approval of their boards, to invest up to five percent of previous year's incremental deposits in shares to sanction bridge loans to companies against expected equity flows/issues up to one year. They can also provide loans to new corporates to meet promoters' contribution. Banks can lend up to Rs. 20 lakh against demat shares at 25 percent margin. They need not hold 50 percent margin on loans to individuals against preference shares and debentures/bonds of corporate bodies.

8) The advertisements of mutual funds are not allowed to make any assurance or claims that might mislead the public. A code of conduct is put in place in this regard.

9) Registered foreign venture capital investors (FVCIs) are allowed to participate in public issues through the book-building route as QIBs.

10) Companies are allowed to make use of multiple routes to raise capital at the same time. When prospectus for an IPO is filed, companies can update their prospectus with details about the additional capital being raised through other routes.

11) Since June 2011, the SEBI allowed the introduction of a separate primary market for Small and Medium Enterprises (SMEs) with proven track records to access the primary market for share capital. Table 5.1 shows the progress of primary market in India during 2001-02 and 2010-11.

Table 7.1: Resource Mobilisation through Indian Primary Market (Rs. Cr.)

Instrument	2001-02	2007-08	2009-10	2010-Dec 2011
1. Debt Market	2,140	45,517	2,500	2,197
2. Equity	7,112	54,511	46,737	46,701
3. Private Placement	64,876	1,16,148	2,12,635	1,47,400
4. Total (1+2+3)	74,128	2,16,176	2,87,240	2,30,233

Source: SEBI Annual Reports and Economic Survey.

It can be seen from the above table that most of the funds in the primary market are mobilised through the private placement channel. This indicates a lack of diversity of investors and needs to be addressed effectively.

7.3.2 SECONDARY MARKET REFORMS

These reforms are based on the concerns of investor protection and ensuring adequate liquidity in the markets. The 1991 Securities Scam (Harshad Mehta Scam) and the 2001 Scam (Ketan Parekh Scam) involving the co-operative bank from Ahmedabad. Some of these reforms are as under:

1) All stock exchanges in the country introduced on line screen based electronic trading.

2) With effect from April 1, 2003, a uniform T+2 settlement system was introduced in all the stock exchanges.

3) Settlement guarantee funds (SGFs) are introduced to meet shortfalls in settlement of obligations by members of the stock exchanges. The National Securities Clearance Corporation (NSCC) acts as counter-party to all trade in the capital market segment of NSE.

4) To enhance investor protection, all securities are dematerialised. The National Securities Depository Ltd. (NSDL) (1996) and the Central Depository Services Ltd. (CDSL) (1999) ensures that all actively trades securities are held, traded and settled in demat form. From November 2001, a mandatory client code is introduced. Except in case of infrastructure companies, 25% of floating stock must be continuously listed. The listing requirements are standardised to all stock exchanges. From July 2001, a 99% value at risk (VaR) based margin system for all scrips in rolling settlement were introduced. In October 2001, an investor education and protection fund (IEPF) was set up to create awareness amongst investors and protection of their interests. Brokers have to declare all trading which account for 70.5% of equity shares of a listed company. Every intermediary is allocated a unique identification number to promote up to date information about all market participants.

5) Given the dominance of mutual funds in the capital market, a uniform cut-off time for calculating and applying NAVs is prescribed for them. The minimum number of investors in a scheme is also prescribed. No single investor should hold more than 25% of the funds in any scheme/plan. The roles of CEOs and fund managers of mutual funds are clearly defined.

6) The depositories/depositor participants (DPs) cannot levy any charges when securities are transferred to another branch/DP of the same depository or another depository by an account holder.

7) SEBI introduced norms about corporate governance for all listed companies to promote commitment to values, ethical business conduct and a high degree of transparency. Restrictions are placed on insider trading and hostile bids. Cross-deals, private off-market deals in shares and corporate debt are banned. Failure to comply with these would entail delisting.

8) All listed companies should announce quarterly results. All listed companies must publish the number of investor complaints received, disposed of, and unresolved along with quarterly results. Companies are allowed to buy back up to 25% of the paid-up capital and free reserves for capital restructuring. SEBI can delist a company when it is satisfied about the company's performance in terms of losses, vanishing from the market, providing false address, not complying with the disclosure norms.

9) Boards of all stock exchanges are made broad-based to represent the interests of different stake-holders.

10) FIIs and NRIs are allowed invest in all exchange-traded derivative contracts and stock brokers are allowed to trade in commodity derivatives. FIIs are also permitted to participate in delisting offers, sponsored ADR/GDR programmes and disinvestment by the government in listed companies.

11) Trading in futures and options is allowed. Interest rate futures contracts and futures and options contracts on sectoral indices were introduced in June and August 2003 respectively.

12) From November 2005, BSE and NSE activated separate window for execution of large trades without impacting the market.

7.4 ROLE OF SEBI IN THE DEVELOPMENT OF CAPITAL MARKET

SEBI was setup in 1988 and became statutory in 1992. The SEBI is mandated to perform the following functions:

a. Perform the functions of the CCI.
b. Regulate the stock market and other securities markets for healthy growth of the market.
c. Register and regulate the working of stockbrokers and other intermediaries in the securities market.

d. Register and regulate the working of financial institutions, including the mutual funds operating in the market.

e. Promote and regulate self-regulatory organisations.

f. Prohibit insider-trading and other unfair practices in the capital markets.

g. Educate the investors and train the intermediaries operating in the market.

h. Regulate acquisitions and take-over bids for the companies.

i. Conduct research and publish about the working of the capital market.

To perform these functions, SEBI is given wide-ranging powers like the supervision of the mutual funds, conduct annual inspection of stock exchanges, regulation of new issues, register and regulate the intermediaries in the capital markets. So far, the working of SEBI has been mixed, but it has succeeded largely.

The capital markets have seen significant increase since the establishment of SEBI. The success rate in solving investors' complaints is claimed to be 83.8%. It played a very important role in eliminating the 'badala' system and has successfully placed a 'rolling settlement' system. SEBI introduced certified training programmes for the training of brokers and a code of conduct for the brokers. The brokers are prohibited from inclusion on the managing committees of the stock markets. It has made it mandatory for all merchant bankers to adhere to the capital adequacy norms and the code of conduct laid by it. SEBI allowed the free pricing of shares, subject to credit rating. It also removed restrictions on promoter's contribution and under-writing. SEBI introduced measures to curb insider-trading. It has allowed liberal access of markets to infrastructure firms.

However, it is generally felt that SEBI takes the side of the corporates and neglects the interests of the investors. There is too much of discretionary powers vested with the officials of SEBI and so their working is often considered arbitrary. SEBI has been often hesitant to take action against big brokers or allowed them to function even when it was aware of the malpractices. It has failed to prevent speculation and unfair trade in the market.

7.5 MUTUAL FUNDS IN INDIA

The rationale for mutual funds arises from the fact that the capital market provides the highest rate of return in the long-run. Mutual Funds are financial institutions that mobilise the savings of small investors and invests them on their behalf in equity markets.

They have the expertise to invest in a well-balanced, well-diversified portfolio of stocks. Since the individual small investor may not have the resources, knowledge, skill, experience and the time to directly access the capital market, the mutual funds help to reduce risk and earn a higher rate of return to the individual investors. The mutual funds sell units to the investors and the funds are invested in the equity markets. Some of the schemes are open for investors to enter at any time. Such are known as open-ended scheme. In case of others, the entry is open for a limited period of time. Such schemes are known as closed scheme. The Unit Trust of India (UTI) was the first mutual fund to be set up in 1964. In 1987, the government allowed public sector banks and financial institutions to foal their own mutual funds. Further liberalisation saw the private operators also entering with mutual funds. By 2004, more than 37 institutions with 300 schemes are operating.

However, the progress of mutual funds in India has not been even. During 1993-94, and 1995-97 there was a sharp decline in the investments in the mutual funds. Lack of transparency, delays in refunds, poor accountability and lack of efficient services have been the main problems in the progress of mutual funds in India. The problems in the UTI, bearish sentiments in the capital market are the main factors that determine the funds available to the mutual funds. Tax incentives given in 1999-2000 encouraged investments to some extent. In India, less than 5 percent of GDP is invested in the mutual funds while in many countries, including the developing countries, this is as high as 35 percent. Since the rural areas remain unserviced, the size of the mutual funds remains limited to the urban areas. Most of the funds of mutual funds are invested in the money market instruments. Thus, instead of providing opportunities in long-term investment, they are confined to short-term opportunities. Given the large number of funds, there is often confusion in the investors about the relative merits of the various schemes and this results in withdrawals as well. It is generally felt that there is no effective monitoring of the mutual funds. Table 5.2 shows the progress of mutual funds in India during 2000-01 and 2010-11. In fact, during 2008-09, there was a net outflow of Rs. 28,296 crore from the mutual funds. This is attributed to the global financial crisis, the pessimism in the stock markets and other factors.

Table 7.2: Investments in mutual funds in India (2000-01 and 2010-11) (Rs. Cr.)

Source	2000-01	2006-07	2009-10	2010-Dec 2011
1. UTI	12,413	7,826	15,653	-5,237
2.Public Sector Funds	5,535	7,621	12,499	-2,956
3.Private Sector Funds	45,009	79,038	54,928	20,378
4. Total	22,957	93,985	83,080	12,185

Source: Government of India: Economic Survey (various issues).

7.6 FORWARD, FUTURES AND COMMODITY MARKETS IN INDIA

In economy when some transactions take place at a future date, there are different methods of fulfilling these obligations. Three important sources for conducting these transactions are a) forward markets, b) futures markets and c) commodity markets. Each of these caters to specific needs of both buyers and sellers. We shall examine each of them in turn.

a) Forward Markets:

These are markets where, assets are traded for a given period in future, normally up to 364 days. In these markets, one party agrees to buy an asset on a specified date for a specified price (known as 'taking a long position'). A second party agrees to sell the asset accordingly (known as 'taking a short position'). The contract specifies the quantity and quality of the good, price, delivery date and delivery location. Forward contracts help to reduce the risk of price variations and are good for hedging and speculation. For example, an exporter, who is expecting his earnings in foreign exchange, can enter into selling them to a party who needs foreign exchange. Similarly, an importer, who has to pay in foreign exchange, can enter into a forward contract to buy foreign exchange from another party. These contracts are traded outside the exchanges. The size of each contract depends on the needs of the buyers and the sellers. However, there is an element of risk of default from both the seller and buyer. If any one party turns down to oblige the contract, the other party is helpless. This is known as the 'credit risk'.

b) Futures Markets:

Futures market deal with contracts between two parties to buy and sell given assets. A futures contract is an exchange traded, standardised contract between two parties to buy or sell an asset at

a certain price and time in future. The contract is implemented through an exchange or clearing house. A buyer who takes a long position and a seller who takes a short position is required to deposit a given margin money with the exchange to avoid the risk of default. This margin is adjusted on a daily basis and if it falls short of the specified amount (known as maintenance margin); the party is called to deposit the required amount with the exchange. This is known as 'marginal call'. Petroleum, gold, and other products are traded in the futures markets. Although, the futures markets eliminate the risk of default from both the parties, the given size of the contract may not be suitable to each party. One may wish to hold a contract amount different from the one offered in the exchange. It is this reason that allows the continued existence of forward markets. Table 5.3 gives the daily turnover in three important currency futures markets in India during the last two years.

Table 7.3: Daily turnover in Indian Currency Futures Markets (2009-10 and 2010-11)

Exchange/Amount	NSE 2009/10 2010/11	MCX-SX 2009/10 2010/11	USE 2009/10 2010/11
Daily Turnover (Rs. Cr.)	7,428 14,045	8.103 17,636	NA 7,504

c) Commodity Futures Markets:

In India, the commodity futures markets have a long history. These markets deal mainly with agricultural commodities. These markets serve as a link between the perceived future production and consumption of agricultural goods. Before 1991, these markets dealt with only six commodities in 21 exchanges regulated through the Forward Contracts Act (FCA). In 1993, Kabra Committee recommended futures trading in 17 commodities. It recommended that forward trading in eight essential commodities should not be allowed. In 2003, the government allowed forward trading in 103 commodities including the eight essentials that were rejected by the Kabra Committee. The forward trading is conducted through the local exchanges and a national exchange. Table 5.4 shows the trends in turnover at selected all-India commodity futures markets in recent years.

Table 7.4: Turnover in Indian Commodity Futures Markets 2005-08 (Rs. Cr.)

Name of the Exchange/Year	2005	2006	2007	2008
1. Multi-Commodity Exchange (MCX), Mumbai	6,33,524	20,25,663	27,30,415	42,84,653
2. National Multi-Commodity Exchange (NMCE), Ahmadabad	12,107	1,11,462	25,056	37,272
3. National Commodity and Derivative Exchange (NCDEX), Mumbai	8,83,209	12,43,327	7,74,965	6,28,074
4. Others	1,08,705	1,04,033	1,24,051	83,885
5. Total	16,37,345	34,38,485	36,34,487	50,33,884

Source: Government of India: Economic Survey (various issues).

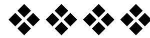
The main problem with the commodity futures in India is that, most of these activities are speculative in nature and thus are believed to add to the inflationary pressures. They have not benefited the farmers but helped the traders to make windfall gains. Government failed to see this danger when further liberalisation was taken up in 2003.

Check Your Progress:

a) What is capital market?
b) What is primary market?
c) What is secondary market?
d) What is insider-trading?
e) What is a mutual fund?
f) What is a forward contract?
g) What is a futures contract?
h) What is a commodity future?

7.7 QUESTIONS

1. Explain the role of capital market in a country's economic development.
2. Discuss the various reforms in the Indian capital market since 1991.
3. Explain the primary market reforms in India since 1991.
4. Examine the nature of reforms in the secondary capital market in India.
5. Examine the role of SEBI in the development of Indian capital market.
6. Examine the role of mutual funds in India.
7. Write a note on forward, futures and commodity markets in India.



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Module 4

PUBLIC FINANCE
CHANGING TRENDS IN TAX AND NON-TAX REVENUE IN INDIA

Unit Structure :

8.0 Objectives
8.1 Introduction
8.2 Sources of Public Revenue
8.3 Changing Trends in Tax and Non-tax Revenue in India
8.4 Questions

8.0 OBJECTIVES

- Understand the nature of public finance.
- Understand the nature of tax and non-tax revenue to the government.
- Understand the trends in tax revenue in India.

8.1 INTRODUCTION

Public finance is one of the important branches of economics. It is the study of the financial operations of the central and state government. According to H. Dalton, 'Public finance is the study of income and expenditure of public authorities.' Public finance broadly implies the various activities undertaken by the public authorities regarding- raising resources of funds, their proper utilization and achieving various objectives namely, rapid economic development, full employment, price stability, equitable distribution of income etc. The subject matter of public finance includes public revenue, public expenditure, and public debt.

In developed countries, public finance is used to maintain economic stability through the control of inflation and recession. In developing countries, the role of public finance is different from that in developed countries. In such countries, public expenditure is directed towards economic development and public revenue, as a source of financing the development activities.

8.2 SOURCES OF PUBLIC REVENUE

The income of the government from all possible sources is called as public revenue. Different economists have offered different classification of public revenue. Among them the classification offered by Adam Smith, Seligmen and Bastable are well known. Based on some classifications the various sources of public revenue are divided into two groups- A) Tax Revenue and B) Non-tax Revenue.

A) Tax Revenue- The revenue from taxes is called tax revenue. Tax is the most important source of revenue to the government. 'A tax is a compulsory contribution made by the citizens of a country to the government without expecting any benefits.'

Tax is required to meet its general expenses incurred in the common interest of all. These expenses are incurred with any corresponding benefits to the taxpayers. There are two types of taxes- i) Direct taxes and ii) Indirect taxes. Personal income tax, corporate tax, capital gain tax, wealth tax, gift tax etc. are called direct taxes. Sales tax, excise duty, custom duty etc., are called indirect taxes. Taxation has been considered to be an important source of raising revenue. However, at present, it is also used as a means to achieve various objectives of society. The important characteristics are-

1. Tax is a compulsory payment; every citizen is legally bound to pay.
2. If any person does not pay the tax, he can be punished by the government.
3. There is no direct quid- pro- quo between taxpayers and the government.
4. Tax is imposed on income, goods, and services.

Progressive taxes help to reduce the inequality of income and wealth. Taxation affects production, consumption and distribution. It can be used as an effective instrument to achieve price stability.

B) Non-tax Revenue: The revenue obtained by the government from sources other than tax is called as non- tax revenue. They may be classified as-

1. Administrative Revenue
2. Profit of Public Enterprises and
3. Gifts and Grants.

1. Administrative Revenue:- Government gets revenue from the public for administrative work in the form of fees, fines and penalties, special assessment.

i) Fees: - Fee is the government for providing certain services to the people for e.g. court fee, license fee etc, and charges Fees. Generally, fees are charged to recover the cost of services. Those citizens who make use of certain special services by the government pay fee. There is always a definite relationship between the fee paid and the benefits received by the citizens. However, there is no relationship between tax paid and benefits received by the taxpayers. Unlike tax, there is no compulsion in case of fee. Fees are an important source of non-tax revenue to the government.

ii) Fines and penalties: - Fines and penalties are levied on offenders of laws as a punishment. The main objective of the government is not to earn income but to prevent the offending of laws. Hence, they are an insignificant source of revenue. Fines and penalties are arbitrarily determined. They are not related to government activities. Like taxes, fines are compulsory payment without quid-pro-quo. They are not expected to be a major source of revenue to the government.

iii) Special assessment: - A special type of compulsory contribution made by the citizens of a particular locality in exchange for certain special facilities given to them by the authorities is known as special assessment. For example, if the municipal corporation in a city builds 'pucca' road or makes arrangement for the supply of electricity and water in particular locality, the value of property in that locality will inevitably go up. Therefore, the municipal corporation can levy a special tax on the residents in proportion to the increase in the value of the property, to cover a part of the cost of facilities. There is quid-pro-quo between the special taxpayer and the local public authority.

2) Profits of public enterprises: - Almost all countries have public enterprise involved in commercial activities. The profits of these enterprises are an important source of non-tax revenue to the government. The revenue collected in the form of profits is largely influenced by the manner in which the government determines the prices of goods and services it sells. When state has an absolute monopoly high prices are charged. There is quid-pro-quo.

3) Gifts and grants: -Gifts are voluntary contributions made by individuals or NGOs to the government. This is done for a specific purpose such as relief fund, war fund, draught fund, earthquake fund etc. The volume of gifts is normally small.

Grant refers to the funds provided by the central government to a state government for undertaking special activities. State governments also provide grants to the local government to carry out their functions. Grant from foreign countries is known as foreign aid. Developing countries receive military aid, food aid, economic and technical aid etc. from developed countries. Such grants are normally conditional. They constitute insignificant source of revenue to the government. In short, mainly tax and non-tax sources are ways and means of government revenue.

B. Direct and Indirect Taxes:

There are two types of taxes in India. They are classified as- 1) Direct taxes and 2) Indirect taxes.

1) Direct Taxes: - 'A direct tax is one which is paid by a person on whom it is legally imposed and the money burden of can not be shifted to any other person.' The impact (means initial burden) and the incidence (means ultimate or final money burden) of a direct tax are on the same person. Direct taxes are imposed on the income and wealth of individuals and organizations. Personal income tax, corporate tax, wealth tax, capital gain tax, gift tax etc. are important types of direct tax.

2) Indirect Taxes: - 'An indirect tax is one in which a tax is legally imposed on one person but the money burden of the tax is shifted to other person (final consumer).' The tax payer is not the tax bearer. The impact and incidence of indirect tax lies on different persons. The impact of indirect tax is on the person on whom it is levied but the incidence of indirect tax is on the person on whom money burden falls. Sales tax, excise duty, custom duty, VAT, Octroi etc. are important types of indirect taxes.

Check Your Progress:

1. What are the different sources of public revenue?
2. What is a tax?
3. How does tax revenue differ from other sources of public revenue?

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8.3 CHANGING TRENDS IN TAX AND NON-TAX REVENUE IN INDIA

Broadly, the budgets of the central government give a complete picture of changing trends in tax and non-tax revenue in India. The government raises revenue from tax and non-tax sources. The changing trends in tax and non-tax revenue in India can be explained as under.

A) Tax Revenue: -

India has well developed tax structure. The power to impose taxes and duties is distributed between the central and state governments and local bodies. Central government imposes taxes like income tax, corporate tax, wealth tax, gift tax, custom duties, and central excise duty and service tax.

Sales tax, VAT, state excise duty, stamp duty, land revenue etc. are levied by state governments. And local bodies levy taxes like Octroi, property tax etc.

Since 1991, the Indian tax structure and system both have undergone several reforms. Tax reform committees like Chelliah and Kelkar were appointed by the government to reform the tax structure. These committees were made number of recommendations. As per recommendations several reforms like reduction in rates of all taxes, broaden the base of taxes, simplification of laws and procedures, modernization of the administrative and enforcement machinery have been introduced by government. Following are some of the important trends in tax revenue in India.

1. Trends in Gross Tax Revenue and Tax-GDP Ratio: -

A revenue receipt from direct and indirect taxes has increased significantly during 1990-91 to 2009-10. This is mainly because of reduction in tax rates, simplification of tax procedure and high growth rate of GDP. Though tax revenue of the government has increased, the tax-GDP ratio has remained more or less stable since 1991. India’s tax-GDP ratio is very low as compared to other developed and developing countries of the world. Negligible tax contribution from the agricultural sector and numerous tax exemptions are some of causes for the low tax revenue-GDP ratio in India.

Table No.8.1 Trends in tax revenue and GDP ratio

Year	Tax revenue	% of GDP
1990-91	57,576	10.1
2009-10	6,41,979	10.4

Source: Economic surveys

2. Relative Share of Direct and Indirect Taxes: -

The relative share of direct taxes in total tax revenue has also undergone significant change since 1991. It indicates that the share of direct taxes has been increasing on the one hand and the share of indirect taxes has been declining on the other hand. This is a positive and welcome trend in Indian economy. The growing share of direct tax is largely due to the increase in share of corporate tax. This is shown in the following table.

Table No.8.2 Changing Shares of Direct and Indirect Taxes

Year	Direct Taxes	Indirect Taxes
1990-91	19.1	80.9
2009-10	57.7	42.3

Source: Economic surveys

3. Trends in Direct Taxes:-

The share of direct taxes in total tax revenue increased considerably from 19.1% to 57.7%. This trend is mainly because of reduction in rates of all direct taxes and increase in per capita income of the people. The direct tax code is also introduced by the government which is expected to bring radical changes in direct taxes.

♣ **Important Direct Taxes-**

a) Corporate Tax: - Refers to a tax levied on the profits of companies. Domestic companies are taxed at the rate of 30% but for foreign companies, the tax rate depends upon different factors. Corporate tax is the most important direct tax in terms of revenue. The share of this tax in total tax revenue has increased significantly since 1991. This is mainly because of growing profits of corporate companies.

Table No.8.3 Trends in Corporate Tax

Year	Rs. Crore	% of Total Tax Revenue
1990-91	5,335	9.3
2009-10	2,56,725	40.0

Source: Economic surveys

b) Income Tax: -

Income tax is levied by the government on income of the individuals. It is a progressive tax. At present income tax is levied at the rate of 10%, 20% and 30%. The revenue from income tax has increased very significantly since 1991 because of increase in income of the people, reduction in tax rate and increase in tax base. This is a healthy trend.

Table No.8.4 Trends in income Tax

Year	Rs. Crore	% of Total Tax Revenue
1990-91	5,371	9.3
2009-10	1,12,850	17.6

Source: Economic surveys

4. Trends in Indirect Taxes: - Tax on goods and services is called as indirect taxes. The money burden of these taxes is shifted wholly or partly to the final consumers in the form of prices. The main objective of the government is not to earn income but to achieve different socio-economic objectives like price stability and to promote economic growth.

♣ **Important Indirect Taxes**:-

a) Excise Duty: - Central excise duty is levied of goods. It is the biggest single source of revenue to the government. The revenue from excise duty has increased significantly over the years mainly because of rapid growth of manufacturing activities and reduction in rates of excise duty. There is a declining trend in excise duty right from 1991. This is shown in the following table.

Table No. 8.5 Trends in income Tax

Year	Rs. Crore	% of Total Tax Revenue
1990-91	24,514	42.6
2009-10	1,06,477	16.6

Source: Economic surveys

b) Custom Duty: - Tax imposed on goods imported and exported by the government is called as custom duty. In other words, it is called as import duty and export duty. Import duty is levied on ad valorem basis. The highest rate of custom duty is 10%.The revenue from custom duty in rupee term has increased but its share in total tax revenue has declined over the years. The trend in custom duty is shown in the following table.

Table No. 8.6 Trends in Custom Duty

Year	Rs. Crore	% of Total Tax Revenue
1990-91	20,644	35.9
2009-10	98,000	15.3

Source: Economic surveys

c) Service Tax: - Tax levied on certain services provided by persons, firms or agencies is called as service tax. It was introduced in 1993-94 to raise revenue from the rapidly growing service sector. Revenue from service tax shows increasing trend since its implementation. This is clear from the following table.

Table No. 8.7 Trends in Service Tax

Year	Rs. Crore	% of Total Tax Revenue
1990-91	862	0.8
2009-10	65,000	10.1

Source: Economic surveys

B) Non-Tax Revenue: - Revenue from sources other than tax is called as non-tax revenue. The tax-GDP ratio in India has remained more or less stable over the years. Therefore, greater emphasis has to be given to raise revenue through non-tax sources because of limitations to raise revenue through taxes. As a result Non-tax

Revenue Unit was set up by the government in 2002 to advise government to increase revenue. It is considered as significant source of meeting growing fiscal deficit of the government. They are – Fees, fines and penalties, surplus or profits of public department/enterprises, rent of land, building, fees, and licenses, interest on loans, dividends, donations and gifts.

Non-tax revenue of the government has increased several times since 1991 as shown in the table.

Table No.8.8 Trends in Service Tax

Year	Non-Tax Revenue	% of GDP
1990-91	11,976	2.1
2009-10	1,40,279	2.3

With the growing needs of the government new taxes have been imposed like service tax, VAT etc. Similarly tax rates have been brought down. This has resulted in an increase in tax revenue and also tax GDP ratio. This is a healthy trend.

Check Your Progress:

1. What are the important direct taxes in India?
2. What are the important indirect taxes in India?

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8.4 QUESTIONS

1. Discuss the various sources of public revenue.
2. Explain the changing trends in tax and non-tax revenue of the central government in India since 1991.

9

PUBLIC EXPENDITURE

Unit Structure :

9.0 Objectives
9.1 Introduction
9.2 Objectives of Public Expenditure
9.3 Canons or Principles of Public Expenditure
9.4 Classification of Types of Public Expenditure
9.5 Causes for increase in Public Expenditure in India
9.6 Questions

9.0 OBJECTIVES

- Understand the nature of public expenditure.
- Understand the objectives of public expenditure
- Understand the canons of public expenditure.
- Understand the classification of public expenditure.
- Understand the causes of increase in public expenditure in India.

9.1 INTRODUCTION

Public expenditure is the most important part of the public finance. Public expenditure refers to the expenditure incurred by public authorities for the benefit of society as a whole. There are different views regarding public expenditure. The classical definition of public expenditure indicates that, government should play limited role like protection and maintaining law and order. On the other hand, Keynes stated that, that system of public expenditure is the best which is highest in amount. It means government should spend more than its income to maximize the welfare of the society. Modern state is a welfare state economy in which government has to play different role and perform a number of functions. Hence public expenditure has increased enormously to promote maximum social welfare.

9.2 OBJECTIVES OF PUBLIC EXPENDITURE

The public expenditure is defined as, ‘that expenditure which is incurred by the public authorities like, central, state and local government bodies to satisfy collective social wants of the people.’

The expenditure incurred by the government on defense, administration, maintenance of law and order, economic development, welfare activities etc. is called as public expenditure. In modern welfare state, the functions of the state have been enlarged and the importance of public expenditure has increased. The government has to spend a lot for achieving various socio-economic and political objectives. Public expenditure is an effective measure to achieve certain objectives.

1. Price stability
2. Full employment
3. Maintenance of law and order
4. Development of industries
5. Creation of social goods
6. Provision of education and health
7. Development of transport and communication.
8. Protection from external aggression etc.
9. Promotion of economic stability
10. Elimination of socio-economic inequalities etc.

9.3 CANONS OR PRINCIPLES OF PUBLIC EXPENDITURE

Public expenditure affects the economic life of the masses. It is therefore necessary to have some criteria or principles or canons by which we can judge whether any item of public expenditure is justified or not, whether it should be taken up or not. These principles or canons of public expenditure are concerned with those fundamental rules which should govern the expenditure policy of the government. Canons of public expenditure would determine the efficiency of public expenditure itself. Prof. Findle Shirras has suggested some important principles/ canons of public expenditure, which can be discussed as follows.

1. Canon of Benefit: - This canon implies that public expenditure should be incurred in such a way that, it promotes maximum social advantage. The ultimate purpose of public expenditure should be social benefit. Therefore, it is essential for the government to incur its expenditure not only for any particular individual or group of people but for the masses of peoples. It is only by doing so that public expenditure can promote maximum social benefit of society.

2. Canon of Economy: - The expenditure of the government should be economical. The government should see that the hard-earned money of the tax-payers is not spent on wasteful projects. It is also essential to check duplication of expenditure to avoid wastage of funds. Government expenditure should not produce any unfavourable effects on production. It does not produce any adverse repercussions on the will and power of the people to save. It should ensure optimum utilization of resources.

3. Canon of Sanction: - All government expenditure should be incurred only after the approval of a competent authority. This sanction is required for proper allocation of resources and further, to avoid the misuse of funds.

4. Canon of Surplus: - This implies that the government should create a surplus in budget and avoid deficit. An ideal budget is one that creates a surplus by keeping the public expenditure below public revenue. This ensures the creditworthiness of the government.

5. Canon of Elasticity: - This implies that there should be elasticity in public expenditure. In other words, there should be scope for changes in public expenditure as per the requirement of the economy.

6. Canon of Productivity: - This implies that public expenditure must be productive. As such a sizeable part of the public expenditure in an economy should be incurred for development purposes.

Check Your Progress:

1. What is public expenditure?
2. What are the main objectives of incurring public expenditure?
3. What do you understand by canons of public expenditure?

9.4 CLASSIFICATION OR TYPES OF PUBLIC EXPENDITURE

There are different types of public expenditure. The public expenditures are classified as follows.

1. Revenue Expenditure and Capital Expenditure: -

Based on the government budget there are two types of public expenditure. The expenditure incurred in revenue account of the budget is **called revenue expenditure.** Revenue expenditure includes expenditure incurred for current flow of goods and services and to maintain capital stock intact. Revenue expenditure is known as current expenditure in the form of consumption. Expenditure incurred on civil administration, defence forces, public health, education, etc., is known as revenue expenditure. This type of expenditure is of recurrent type, which is incurred year after year.

The expenditure incurred in capital account of the budget is known as capital expenditure. It is a long term investment expenditure done by the government. This expenditure helps to increase productive capacity of the economy. The expenditure incurred on building durable assets like-highway, dams, irrigation project, buying machinery and equipment is known as **capital expenditure**. They are non-recurrent type of expenditure.

2. Productive Expenditure and Unproductive Expenditure: -

Based on creation of productive capacity there are two types of expenditure. The expenditure, which increases the productive capacity of the country, is known as productive expenditure. This type of expenditure helps to increase volume of output and employment in the country. The expenditure on establishment of public sector industries, infrastructure development, development of agriculture, roads, dams, railway, airport etc. is known as **productive expenditure**.

Unproductive expenditure is an expenditure, which does not increase productive capacity of a nation. The expenditure, which does not create as asset, is known as unproductive expenditure. Expenditure in the form of defence, maintenance of law and order, interest payment, administrative expenses is known as unproductive expenditure.

Modern economist have classified these expenditure as **development and non- development expenditure.** The expenditure, which promotes economic growth and development, is called as development expenditure. Unproductive expenditures are termed as non-development expenditure.

3. Transfer Expenditure and Non-transfer Expenditure: -

Based on transfer of income there are two types of expenditure. Transfer expenditure is that expenditure which involves the transfer of income from one person to another. It is redistribution of money income within the community. Expenditure done by the government on pension, unemployment allowances, sickness benefit, welfare benefits, interest payment, public debt and subsidies is **known as transfer expenditure**. Transfer expenditure does not involve creation of goods and services.

The expenditure done by the government to create output and income in the country is known as **non-transfer expenditure**. Such expenditures are incurred for buying or using goods and services, these include expenditure on defence, education, public health etc. Non-transfer expenditure uses productive resources and generates employment and income directly in the country.

4. Plan Expenditure and Non-plan Expenditure: -

The expenditure incurred by the government for development schemes, which are outlined in the ongoing five year plan. Plan expenditure is one, which is provided in the budget. This expenditure is called as development expenditure because it promotes economic growth and development. For example, the expenditure incurred for the implementation of NREGS, Sarva Shiksha Abhiyan and such other schemes.

Non-plan expenditure refers to that expenditure which is not included in the ongoing five-year plan. Non-plan expenditure does not have any provision in the budget. It consists of non-development expenditure and thus termed as non-development expenditure.

5. Mrs. Hicks Classification of Public Expenditure: - Prof. Ursula Hicks classified public expenditure based on duties of the government. There are-

a) Defence Expenditure: - Expenditure done by the government to provide security to the citizens of a country against external aggression is called as defense expenditure. For example expenditure on defence equipment, wages and salary of armed force, navy and air force etc.

b) Civil Expenditure: - Expenditure on maintaining law and order, justice system, police dept. etc.

c) Development expenditure: - Expenditure for the growth and development of agriculture, industry and service sector.

6. Dalton's Classification of Public Expenditure: -

a) Expenditure on political executive: - Expenditure on ceremonial heads of state.

b) Administrative expenditure: - Expenditure on government departments and offices etc.

c) Security expenditure: - Expenditure on defence.

d) Expenditure on administration of justice.

e) Development expenditure.

f) Social expenditure: - Expenditure on public health, community welfare, social security, education etc.

Check Your Progress:

1. What is development expenditure?
2. What are transfer payments?
3. Does revenue expenditure result in creation of assets?

9.5 CAUSES FOR INCREASE IN PUBLIC EXPENDITURE IN INDIA

In recent years, the volume of public expenditure of the government has increased tremendously in the country. Indeed, both intensive and extensive expansion in the activities of the government during the planning period was responsible for continuous increase in public expenditure.

In India there has been spectacular increase in public expenditure since 1950-51. The ratio of public expenditure to GDP has steadily risen till 1991. Only during mid 1990s it had shown a tendency to decline. Since then this trend has reversed and the public expenditure GDP ratio has been rising. The ratio of public expenditure to GDP was 24.7 per cent in 1996-97 rose to as high as 28.4 per cent of GDP in 2007-08. At this level it was one of the highest in developing countries and very much comparable to the ones in the USA, Canada, U.K. France and Germany.

Table 9.1 Public Expenditure during the Planning Period

Year	Total Expenditure (Rs. Crore)	% of GDP
1950-51	900	9.1
1990-91	1,62,084	28.5
1995-96	3,00,635	**25.2**
2000-01	5,86,306	27.9
2007-08	13,39,099	28.4

Source: Economic Survey, various issues.

Following are the causes for a spectacular rise in the public expenditure.

1. Welfare State or Wagner's Law:

The changing role of the government is the root cause for the rapid growth of public expenditure. The modern state is a welfare state. There is persistent tendency towards an intensive and extensive increase in the functions of the government. The government aims at promoting many socio-economic and political functions for the welfare of the people.

A well-known German economist Adolf Wagner stated a law in 1883 called, 'Law of Ever-increasing State Activity.' His law is based on the 'pressure for social progress' so that the government sector grow and further results in an increase in public expenditure. The increasing public expenditure by the modern government has empirically proved Wagner's Law. There has been significant increase in welfare functions of the government like social insurance, unemployment benefit, education, health care services etc. resulted in rapid growth of public expenditure. There is a functional relationship between State activities and the relative growth of public expenditure. Wagner states that as the economy expands, public expenditure of the modern government will also rise persistently.

2. Defence Expenditure:

Considerable increase in defence expenditure is an important cause of overall rise in the public expenditure in India. No country in modern times can afford to neglect the security of the country. There can not be economic stability in the country in the absence of political stability. Therefore, the government has to spend a huge amount of money on defence. Defence expenditure has increased from Rs. 3,600 crore in 1980-80 to Rs. 86,879 crore in 2009-10

3. Growth of Population:

During the last 58 years, India is passing through the second stage of demographic transition. India has faced population explosion. In 1951 the population of India was 36 crore. It rose to 102.9 crore in March 2001. Growth of population has made it necessary for the government to spend ever increasing amounts on education, health, infrastructure, subsides and development activities etc.

4. Urbanization Effect:

Since independence, the percentage of urban population has increased in this country from 17.3 percent in 1951 to 27.8 percent in 2001. The process of urbanization in India has resulted in heavy expenditure on infrastructure. Government has to spend not only on creating new infrastructure for cities but also on the maintenance and replacement of such infrastructure.

5. Economic Planning:

In underdeveloped and developing economies economic planning is undertaken for achieving the goals of rapid economic development. In a planned economy, the government has to incur huge outlay on agriculture, industry, essential infrastructure etc. for accelerating the rate of economic growth. Development projects and large scale industries caused substantial increase in public expenditure.

6. Social Security Measures:

In a welfare state economy, the government has to provide social security measures like unemployment benefits, sickness benefits, old age pension, free education and medical facilities, compensation for accidents, public works and relief programmes etc. for the welfare of the people. This has resulted in continuous increase in public expenditure over the years.

7. Development of Agriculture:

In India more than 60 percent of the population depends upon the agriculture. It is the source of employment and income to more than 70 percent of the population. The government has been spending huge amount on agriculture by providing seeds, fertilizers, irrigation facilities, cheap loans etc. It may also promote agricultural research, soil conservation and rural development. This has raised public expenditure considerably in the country.

8. Development of Industries:

The overall socio-economic development of the country also depends upon the development of Industries. The government has been encouraging the growth of private sector industries through protection, subsidies to exports, loans at a cheap rate of interest etc. causing rise in public expenditure.

9. Inflation:

Inflation has now become a global phenomenon. The rise in the price level has naturally resulted in the increase in public expenditure. During the inflationary situation the cost of supplying public goods and services increases. This has caused the increase in public expenditure.

10. Law, Peace and Order:

With increase in population, huge expenditure has to be incurred for the maintenances of law, peace and order in the country.

11. Poverty alleviation:

In a developing country like India for the eradication of poverty and to solve the problem of unemployment government has undertake number of poverty alleviation programmes as well as employment generation schemes. These programmes and schemes require continuous ongoing expenditure for the implementation. This has raised public expenditure of the government enormously.

12. Servicing of Public Debt:

India is resorting to heavy public debt both internal and external to finance various development projects. This has resulted in huge burden of interest payments. The sharp rise in interest payment has further resulted in tremendous growth in public expenditure in modern times.

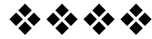
In addition to these causes there are some other factors like ***increase in national income, expansion of administrative machinery, Development projects, subsidies, maintenance of democratic institutions, rural development, health and education*** etc responsible for rapid growth of public expenditure.

Check Your Progress:

1. What is Wagner's law?
2. How does inflation cause an increase in public expenditure?

9.6 QUESTIONS

1. Discuss the canons or principles of Public expenditure.
2. How is public expenditure classified?
3. Explain different types of public expenditure.
4. Explain the causes of public expenditure in India.



10

PUBLIC DEBT

Unit Structure

10.0 Objectives
10.1 Introduction
10.2 Meaning of public debt
10.3 Types of Classification of public debt
10.4 Burden of public debt
10.5 Questions

10.0 OBJECTIVES

- Understand the nature of public debt.
- Understand the different types of public debt.
- Understand the effects of public debt on the economy.

10.1 INTRODUCTION

Public debt is considered an important source of income of the government. If revenue of the government from tax and non-tax sources is not adequate to meet its expenditure, the government very often borrows funds from the public to meet the deficit in its budget. As is well known, like a private individual, the government has also to borrow from the public in order to meet its expenditure. The size of public debt has increased tremendously in modern times. There is hardly any government today, which has not borrowed from its people.

The developing countries like India, in view of inadequate revenue resources, may resort to extensive internal and external borrowing for developmental expenditure.

10.2 MEANING OF PUBLIC DEBT

Public debt implies the borrowings by the government from banks, business organizations and individuals. The debt is in the form of promises by the government to pay to the holders of these

promises a principal sum and in most instances interest on that principal.

Public debt may be defined as, 'financial obligations accepted by the government by way of raising loans or funds, either within or outside the country for financing public activities.' The government loan is generally in the form of various types of bonds and securities. These liabilities are redeemable within a specific period.

In India, public debt consists of government treasury bills, post office savings certificates, national savings certificates, public provident funds etc. Public debt may be raised internally from individuals, banks and financial institutions or externally from international financial institutions like IMF, World Bank or from the advanced countries of the world.

10.3 TYPES OR CLASSIFICATIONS OF PUBLIC DEBT

Public debts are classified in many ways. They differ from one another according to the conditions of repayment, the market in which loans are raised, the purpose for which they are raised, the length of the period for which loans are raised, etc. The main classifications of public debt are as follows.

1. Internal and External Public Debt:

When the government of a country takes loans from individuals, business organizations and banks and financial institutions within the country, it is called as internal public debt. Internal debt is taken by the government by issue of bonds and sale of treasury bills to the general public and financial institutions. Under internal debt the availability of resources does not rise. When the government raises loan the resources are just transferred from individuals and institutions to the government. The government then uses these resources for public purposes. When the government pays back interest and principal amount to the bond or security holders' resources are transferred from government to the public.

Internal public debts are less burdensome on nation because it has to be repaid in the domestic currency. But these debts have real burden as transfer of purchasing power between different groups of people takes place when these debts are repaid. Internal public debt may be voluntary of compulsory.

When the government borrows money from international financial institutions like IMF, World Bank, Asian Development Bank and from the government of other countries it is called as external

public debt. External public debt increases the (foreign exchange) resources of the borrowing country. When the government takes external debt transfer of recourses take place from the creditor country to the debtor country. In case of payment of interest and repayment of principal, there is a transfer of resources for the debtor country to the creditor country causing decline in the resources of the debtor country.

External debts are more burdensome because it has to be repaid in the form of foreign currency. External debt imposes both money burden and real burden on the community. External debts can be only voluntary.

2. Productive and Unproductive Public Debt:

Debt raised by the government for some productive purpose like investment in economic and social infrastructure i.e. development of roads, railways, telecommunication, power, schools, hospitals establishment of industries etc. is called as productive public debt. Productive debt helps to increase the productive capacity of country. It helps to generate employment and income which further builds up the repayment capacity of the nation. Such debts are less burdensome on a nation. Productive debts add to the productive assets of a country.

Debt taken for unproductive purposes like financing war, famine relief, maintenance of law and order, public administration etc. is called as unproductive debt. Such debt does not help to increase the productive capacity of a country. Similarly it does not help to generate employment, income and repaying capacity of a country. Hence it is referred to as “Dead weight public debts”. Unproductive debts are more burdensome on a nation.

3. Funded and Unfunded Public Debt:

Funded public debt is a long term debt raised by the government for a period of 10 to 20 years or even more. Funded debts are raised for creation of some permanent assets like construction of roads, railways lines, bridges, dams etc. Usually the government creates a special fund to repay such debts.

Unfunded debt is one which is taken by the government for the period of one year or less than one year. Such loans are called as short term loans. Unfunded debt is taken to meet temporary needs of the government. No fund is created by the government for the repayment of such debt.

4. Redeemable and Irredeemable Public Debt:

Redeemable public debt is the debt which government promises to repay at some specific future date. Hence the government has to make arrangements for repayment of interest

and principal amount within a specific period of time. Such loans are called as "terminable loans".

When the public authorities do not repay the loans but continue to pay the interest on them, such loans are called irredeemable public debt. Repayment of irredeemable loans is at the option of the government because maturity period is not fixed. Hence they are called as "Non-terminable loans".

5. Compulsory and Voluntary Public Debt:

Compulsory debt refers to that debt which is taken by the government from the public by applying some force. Compulsory debts are raised by the government during financial emergency or exceptional circumstances like war. Under compulsory debt individuals, business organizations and banks and financial institutions have to compulsorily subscribe to the government.

Generally public debts are voluntary in nature. When the government raises loans through securities and bonds, people are voluntarily subscribe to them and there is usually no compulsion involved. Voluntary public debts are taken by the government during normal times to finance various activities.

6. Short Term, Medium Term and Long Term:

a) Short term debt: Loans for a period of less than one year is known as short term debt. For e. g. Treasury bill is short term debt payable within 90 days by the government. Interest rates on such debts are very low. Short term loans are taken to cover the temporary deficits in the budget.

b) Medium term debt: Loans for a period of more than 1 to 5 years are called as medium term debts. The interest rates on such loans are reasonable. Medium term loans are preferred for war finance, to meet expenditure on health, education etc.

c) Long term debt: Loans for a period of more than 5 years are called as long term debt. Such loans are usually raised by the government for the development finance. The interest rate on such loans is high.

10.4 BURDEN OF PUBLIC DEBT

During the post-reform period, public debt in India has increased at an alarming rate, with the significant increase in deficit in the budget of the government. Public debt, both internal and external debt which is an obligation of the government has to be repaid by the government. Such repayment of public debts imposes burden on the society.

The Government raises public debt from private individuals and institutions. When it spends the funds for promoting economic development and various welfare schemes it provide benefits to the society. But when a loan is repaid along with interest, people have to make sacrifice. Such sacrifice is called burden of public debt. The payment of interest and the repayment of loans will make the government to raise money by way of taxes.

The burden of public debt can be further divided into two categories. They are as follows.

A) Burden of Internal Debt:

Internal public debts are raised and repaid by the government within the country. Therefore, they have no direct money burden on the society. But the repayment of internal public debt results in transfer of purchasing power form one group of people to another. The government imposes taxes for the payment of interest and repayment of internal debt. Such internal public debt gives rise to real burden. Burden of internal debt can be discussed as follows.

Direct Money burden:

According to Dalton, internal debt does not constitute any direct money burden on the community. In this case there is a transfer of wealth or purchasing power from one group of people to another within the country. It implies that, as a loan is raised from individuals and institutions, repayment does not cause any change in the total resources of the community. When government levies taxes on the people, the same amount is distributed among the creditor by way of interest payment and repayment of loans. The tax payer and the creditor may be the same person.

Direct real burden:

In this case transfer of purchasing power will take place because government imposes taxes to repay the internal debt. When purchasing power is transferred from tax payer to creditor it will influence the *distribution of income* in the country. While repaying debt, if tax burden falls more heavily on the *poor* then inequality of income distribution will *increase*. If debt is repaid by levying heavy taxes on the *higher income group people*, the direct real burden will be *less*. In a developing country, rich peoples are more benefited when debts are repaid. Such countries depends more on indirect taxes than direct taxes, which imposes *greater burden on relatively poor* than rich. Therefore, in case of repayment of internal debt transfer of purchasing power does take place from poor people to the rich or from the younger (future generation) to the older generations or from the active to the passive elements in

the economic life of the community. This is the direct real burden of internal debt.

Indirect real burden:

The internal debt burden may have negative effect on the community. When government imposes high rate of taxes for the repayment of loans*, it reduces People's ability and willingness to work, save and invest.* This will further affect the productivity and investment in the economy.

While borrowing money from the public government may offer high rates of interest. Most people believe that government securities or small savings are more safe to invest their money in. Hence, a large amount of domestic savings are directed towards public debt. This *reduces* the funds available for the *private sector investment* and further affects the growth of this sector.

In a developing country like India, public debt is used to meet revenue deficit of the government. Such debt is known as unproductive public debt. With an increase in public debt, the interest burden also increases. A large portion of the government revenue is then spent on paying interest. Thus the government is unable to make adequate capital expenditure on development activities. This will further affect the *growth and development process of the economy.*

When government imposes taxes at a high rate for the repayment of debt, *inflation* may take place. This will reduce real income of the poor, further it increases the hardship of the poor. The poor people will have to work hard to earn more income to satisfy their basic needs.

B) Burden of External Public Debt:

When a country borrows from foreign countries, financial institutions like the IMF, World Bank, etc. is called as external public debt. Such debts result in inflow of capital into the borrowing country. But when these debts need to be repaid it results in outflow of money in the form of interest and principal from borrowing country to creditor's country. External debts create the following money and real burden.

Direct Money Burden:

When governments raises public debt and receive funds transfer of wealth takes place from the foreign country to the borrowing country. When this loan is repaid the transfer of wealth takes place from the debtor country to the creditor country. Hence

there is a transfer of purchasing power out of the country. When debtor country makes repayment public debt, it creates **direct money burden** on the community. It is the sum of payments in the form of interest and principal of external public debt.

There may also be a **drain of foreign exchange reserves**. If the export earnings are inadequate and the import is inelastic, then the borrowing country will have a great problem in repaying external debt.

Direct Real Burden:

Direct real burden vary according to the proportion in which the various sections of the community contributes payments. When the government imposes taxes for the repayment of such debt it creates direct real burden of the community. If the relative burden of taxation falls heavily on the rich, then the direct real burden will be less. If the relative burden of taxes falls heavily on the poor, then the direct real burden will be more.

The repayment of external public debt reduces the consumption of poorer and weaker section of the society. It is measured in terms of loss of welfare suffered by the debtor country due to the repayment of debt.

If foreign debts are taken for unproductive purposes then the burden of repayment of debt will be very high on the economy. External debts for productive purposes will provide benefits to the debtor country.

Indirect Money Burden and Indirect Real Burden:

The repayment of external public debt involves an increase in the demand for the currency of the creditor country. This will raise the exchange rate of the creditor's currency in relation to the debtor's currency. The creditor country may also be adversely affected if it is induced to import more from debtor country. This may affect the growth of their domestic industries and cause unemployment.

The repayment of external public debt results in reduction in public expenditure of the government. The fall in public expenditure further reduces the volume of investment, output and employment in the country. This will further cause reduction in production and consumption in the country.

Generally the advanced countries while granting loans to poor countries imposes various terms and conditions to be followed by the debtor country. Some times even they force the poor

countries to change their economic policies in their favour. This results in loss of economic sovereignty to the poor countries. Heavy dependence on one or more powerful creditor country may result in the debtor country being economically and politically dominated by the creditor country.

Check Your Progress:

1. Internal debt is loans borrowed by the government from within the country.
2. External debt is borrowed from other countries.
3. External debt involves a transfer of resources from the debtor country to the creditor country.

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10.5 QUESTIONS

1. Explain the classifications or types of public debt.
2. Examine the burden of internal and external debt.

11

BUDGET, DEFICIT and FRBM ACT

Unit Structure :

11.0 Objectives
11.1 Introduction
11.2 Types of Budget
11.3 Components of Budget
11.4 Concepts or Types of Deficit
11.5 Trends of Central Government Deficits in India during 1990-91 and 2009-10
11.6 Fiscal Responsibility and Budget Management Act 2003
11.7 Questions

11.0 OBJECTIVES

- Understand the concept of government budget.
- Understand the concept of deficit financing.
- Understand the various concepts of deficits.
- Understand the nature and significance of FRBM Act of 2003.

11.1 INTRODUCTION

The financial operations of the government comprising public revenue, public expenditure and public borrowing for a year are estimated. 'The statement with estimates of planned expenditure and the expected revenues from taxes and other sources is called as budget.' In other words, 'an annual financial statement of anticipated revenues and planned expenditure of the government is called as budget.'

Thus, budget deals with how the government raises its resources to meet its ever-increasing expenditure. In this sense, a budget may be considered a description of both the fiscal policies and the financial plans of the government. Budget is an important instrument for achieving various fiscal objectives of the government.

11.2 TYPES OF BUDGET

There are three types of budget.

1. **Balanced budget: -** 'When the expected total revenues of the government are equal to its total expenditure during a given year is called as balanced budget.' The classical economists have advocated laisez faire policy, they believed that the government should follow sound finance and balanced budget.

2. **Surplus budget: -** 'When the expected total revenue exceeds the total expenditure of the government during a given year is called as surplus budget.'

3. **Deficit budget: -** 'When the total planned expenditure exceeds expected total revenues of the government during a given year is called as deficit budget.' With the emergence of Welfare State and massive increase in public expenditure, balanced or surplus budget has become a rare phenomenon. However, modern economists advocate deficit budget. Because they believe that the government should spend more than its income to maximize welfare of the people.

Check Your Progress:

1. What is a deficit budget?
2. When is a budget considered to be balanced?

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11.3 COMPONENTS OF A BUDGET

The budget of a government is generally divided into two accounts, namely (1) The Revenue Account or Revenue Budget, and (2) The Capital Account or Capital Budget.

1) The Revenue Account or Budget:

The Revenue Account shows both revenue receipts and revenue expenditure. Revenue receipts are divided between tax revenue and non-tax revenue. The two components of tax revenue

are 1) revenue from direct taxes, particularly tax on personal income and corporate tax, and 2) revenue from indirect taxes like the excise duties and customs duties are most notable. Non-tax revenue includes fees, fines and penalties, interest receipts and surplus or profits from public enterprises and gift and grants.

Revenue expenditure is usually divided into developmental and non-developmental expenditure. Revenue expenditure of the government of India is defence expenditure, interest payments, subsidies wages and salaries, etc.

2) Capital Account or Budget: -

The Capital Account shows capital receipts and capital expenditure. Capital receipts include market borrowings, small savings, provident funds, special deposits, recoveries of loans, external loans and receipts from disinvestment.

Capital expenditure includes repayment of debts and expenditure incurred on creation of capital assets. Capital expenditure is also two types, development expenditure and non-development expenditure.

11.4 CONCEPTS OR TYPES OF DEFICIT

Budget deficits represent excess of all expenditure by the government over its receipts from revenue and capital accounts. This means, the government spends more than it collects through taxes and non-tax receipts. It may be noted that the deficit may occur either in the revenue account or capital account or in both. Thus budget deficit can be obtained as Budget Deficit = Total Expenditure – Total Revenue.

This deficit may be financed by withdrawing cash balance of the government with the RBI or by borrowing from the public to fill up the gap between current income and expenses. Further, a budget deficit may also be financed through the creation of new money. In other words, the government may cover the deficit by borrowing from the central bank of the country.

The various concepts of deficit used in budget in modern world are as follows.

1) Revenue Deficit:

The deficit in revenue account of the budget is called as revenue deficit. It takes place when revenue expenditure is more than revenue receipts. It refers to the excess of revenue expenditure over the revenue receipts of the government. Revenue receipts come from direct, indirect taxes, and other sources like fees, fines, surplus of public enterprises. Revenue expenditures are

made on civil administration, law and order, justice, defence, interest payments on public debt, subsidies, education, health etc.
Revenue Deficit = Revenue Expenditure > Revenue Receipts

Revenue deficit reflects the inability of the government to finance current expenses through tax and non-tax revenues. It should be noted that most of the expenditure on revenue account represents collective consumption of the society. It thus does not create income-earning assets. Prudent fiscal management requires that receipts on revenue account should be more than the expenditure on revenue account. When there is a deficit in revenue account, the borrowed funds from capital account are used to meet a part of the consumption expenditure of the government.

2. Budgetary Deficit: -

It is defined as excess of total budgetary expenditure over total budgetary receipts (both revenue and capital account) of the government. The budgetary deficit in India is met by either withdrawing cash balance kept with the RBI or by net addition to the Treasury bill issued by the central government. It is only a partial measure of budgetary imbalances, as it does not reflect the total indebtedness of the government.

Budgetary Deficit = Total Expenditure > Total Revenue

3. Fiscal Deficit: -

The fiscal deficit is an internationally used concept. It is an important and complete measure of deficit. Fiscal deficit is the excess of total expenditure (both revenue and capital account) over revenue receipt and non-borrowing types of capital receipts like proceeds from disinvestment of public enterprises. It shows the total resource gap in the financial operation of the government. It is a comprehensive measure of budgetary imbalance as it fully reflects the total indebtness of the government.

Fiscal Deficit = Revenue Expenditure + Capital Expenditure > Revenue Receipts + Non Borrowing Capital Receipts

The government in two ways can meet fiscal deficit firstly, by borrowing –both internal and external market borrowing secondly, by borrowing from the Central Bank against its own securities. When the government borrows from the Central Bank, new money or currency is created. This is called monetizing the deficit because it leads to the creation of reserve money of high-powered money. Monetizing fiscal deficit is called deficit financing in India. In other words, Fiscal deficit is the excess of total expenditure, excluding repayment of debt, over total receipts excluding debt capital receipts.

4. Primary Deficit: -

Primary deficit is obtained by deducting interest payment from fiscal deficit. It is a measure of budget deficit, which indicates the real position of the government finance. If the interest payments on past borrowings are high the fiscal deficit is high. Hence, fiscal deficit may be high and primary deficit may be low. If public debt is reduced b mobilizing resources and curtailing public expenditure, then fiscal deficit would be reduced.

Primary Deficit = Fiscal Deficit – Interest Payment

5. Monetized Deficit: -

It refers to the increase in net RBI credit to the government. It is the sum of net increase in holding of Treasury bill of central bank and its contribution to the market borrowing of the government.

It gives rise to the expansion of new money of currency is called Monetizing the deficit. Hence it leads to the creation of reserve money or high powered money by the RBI. When the government is monetizing the fiscal deficit, it shows the extent of deficit financing in India. Thus monetized deficit is responsible for directly raising the general price level.

To conclude, the fiscal imbalance was attributed to a number of factors such as rapid increase in government spending, inadequate rise in revenue receipts, excessive borrowing, unproductive use of the resources etc. In fact, the large and increasing fiscal imbalance affected adversely the economy in terms of deficits because of balance of payments, large inflationary rise in the general price level, and cut in capital expenditure.

Check Your Progress:

1. How is fiscal deficit different from budgetary deficit?
2. What is primary deficit?

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11.5 TRENDS IN CENTRAL GOVERNMENT DEFICITS IN INDIA DURING 1990-91 AND 2009-10

The trends in various types of deficit in India during the post reform-period 1990-91to 2009-10 can be best explained with the help of following table.

Central Government Deficit (As % of GDP at current Market Prices) (Rs. Crore)

Year	Revenue Deficit	%	Fiscal Deficit	%	Primary Deficit	%
1990-91	18,562	3.3	37,606	6.6	16,108	2.8
2001-02	1,00,162	---	1,40,955	---	33,495	---
2007-08	52,562	1.1	1,26,912	2.6	-44,118	-0.2
2009-10	2,82,735	4.6	4,00996	6.3	1,75,485	2.8

The trends in deficit can be observed as follows.

1. The above table shows that, **revenue deficit** has increased very significantly in rupee term since 1991. One of the major causes for this deficit is the increase in interest payments and subsidies.

2. In terms of percentage of GDP revenue deficit shows declining trend till 2007-08. This was welcome trend in Indian economy. The situation in revenue deficit has improved due to rise in revenue receipts and fall in revenue expenditure of the central government.

3. However, in 2008-09 and 2009-10 there is a significant increase in the revenue deficit both in rupee term and in terms of percentage of GDP. This is because of marginal increase in collection of tax revenue and sharp rise in revenue expenditure to tackle the problem of economic slow down.

4. Since 1991, the government has been making sincere efforts to reduce **fiscal deficit** both in rupee term as well as in terms of percentage of GDP. But government failed to achieve this objective and fiscal deficit continued to rise till 2001-02.

5. Since 2001-02, the fiscal deficit as percentage of GDP has declined due to some important measures taken by the government to increase revenue receipts and to reduce expenditure. The measures are abolition of export subsidies, complete ban on recruitment of staff and removal of surplus

staff, drastic reduction in capital expenditure and removal of food subsidies etc.

6. However, because of economic slowdown in 2009-10 public expenditure increased significantly.

7. The situation of **primary deficit** is disappointing during the post-reform period. The above table shows that the primary deficit has declined both in rupee term and percentage terms especial after the introduction of FRBM Bill in 2000. But again primary deficit started rising which indicate increase in burden of interest payment. This shows complete failure of the government to reduce this burden in the country.

   In short, the government has to make serious efforts to reduce burden of interest payment and to bring an improvement in the situation of primary deficit.

11.6 FISCAL RESPONSIBILITY AND BUDGET MANAGEMENT ACT 2003

The fiscal situation in India was deteriorated throughout 1980's and reached to a peak level of crisis in the year1990-91. The fiscal deficit in 1990-91 was 6.6 percent of GDP while revenue deficit was as high as 3.3 percent of GDP. The primary deficit was 2.8 percent in the same period. The situation did not improve significantly. This further indicates deterioration in fiscal situation due to rise in burden of interest payments. This was one of the factors responsible for the BOP crisis in 1990-91. But by the time the stock of government liabilities had become very large. It was affecting government functioning. Therefore, the central government appointed a committee on Fiscal Responsibility Legislation on Jan. 17, 2000 to look into various aspects of fiscal system and recommended a draft legislation on fiscal responsibility of the government . To ensure fiscal discipline the central government according introduced 'fiscal responsibility and budget management bill' in the parliament in December 2000 with the primary objective of reducing the central government's deficits and debts. Later on it became an act. The fiscal responsibility and budget management act was passed and came into force on 5 July 2004.

Objectives of the FRBM Act 2003

1. To set the limits on government borrowing, under a time bound programme.
2. Achieve zero revenue deficit, to achieve sufficient revenue surplus and bring down fiscal deficits.

3. Make government responsible to ensure long-term macro-economic stability.
4. To make government responsible to reduce burden of debt repayment on future generations and to adopt prudent debt management.
5. Improve the transparency in fiscal operations of the government.

Main Features of FRBM Act 2003 and FRBM Rules 2004:

1. Reduction in Revenue Deficit:- The FRBM rules states that, the central government must take appropriate measures to reduce revenue deficit by 0.5 percent of GDP or more at the end of each financial year beginning with 2004-05. The FRBM Act further Stipulates that, revenue deficit should be reduced to zero within a period of 5 years ending with 31st March 2009.

2. Reduction in Fiscal Deficit:- The FRBM Rules states that, the central government should take appropriate measures to reduce fiscal deficit but 0.3 percent of GDP or more at the end of each financial year beginning with 2004-05. The Act further states that fiscal deficit should be reduced to 3 percent of GDP by the end of 2008-09.

3. Borrowing from the RBI:- The FRBM Rules states that, the central government should not borrow directly from the RBI with effect from 1st March 2006 except by way of advances to meet temporary shortage of cash. The RBI should not subscribe to the issue of government securities from 2006-07.

4. Additional Liabilities:- The FRBM Rules states that, the central government should limit the additional liabilities to 9 percent of the GDP in 1004-05 and should reduce this limit to by one percent point of GDP at the end of each financial year.

5. Relaxation of Deficit Reduction Targets:- The FRBM Act states that, the revenue and fiscal deficit may be more than the specified targets in the rules, but only on ground of national security, national calamities, or other exceptional cases relaxation from deficit reduction targets may be granted to the central government.

5. Quarterly Reviews: - The FRBM Act states that, the Finance Minister should take quarterly review of receipts and expenditure, and should place the outcome report of review before the parliament. He must present a statement in the parliament by explaining the reasons for changes in FRBM Act targets. Similarly, government should announce the corrective measures to be taken to overcome these changes.

6. Fiscal Transparency: - The FRBM Act clearly stated two important measures to ensure greater transparency in fiscal operation of the government. They are

I) The central government should minimize secrecy in preparation of annual budget.
II) The central government should disclose the information relating to the significant changes in accounting standards, policies and practices as well as revenue arrears, guarantees and assets by 2006-07.

7. Government Guarantees:- The Act states that, the central government should not provide guarantee to loans borrowed by the state governments and public sector undertakings in excess of 0.5 percent of GDP in any financial year beginning with 2004-05.

8. Placing Reports: - The Act further states that, the government should present three reports before the parliament every financial year.

- Macroeconomic Framework Statement- This report states what is the growth rate expected to be achieved and also the macroeconomic situation in the economy.
- Fiscal Policy Strategy Statement- This report states the policy measures relating to taxation, expenditure, borrowing, subsidies and administrative prices.
- Medium term Fiscal Policy Statements- This report states three year rolling targets for prescribed fiscal indicators.

Evaluation of FRBM Act- The critical evaluation of FRBM Act 2003 can be done by analyzing it broadly into to groups. They are A) Achievements and B) Limitations.

A) Achievements:- The three main achievements of FRBM Act 2003 are as follows.

1. Reduction in Revenue Deficit:- The first major achievement of the Act is the reduction in revenue deficit from 3.6 percent of GDP in 2003-04 to 1.1 percent of GDP in 2007-08.

2. Reduction in Fiscal Deficit: - The second major achievement is reduction in fiscal deficit from 4.5 percent of GDP in 2003-04 to 2.7 percent of GDP in 2007-08.

3. Reduction in Revenue Expenditure: - The third major achievement is reduction in revenue expenditure from 3.1 percent of GDP in 2003-04 to 1.1 percent of GDP in 2007-08.

B) Limitations; - Though the government has taken credible efforts to reduce revenue and fiscal deficits FRBM Act has certain limitations. They are as follows.

1. False expectations of revenue deficit target: - It was expected that the revenue deficit is to be brought down to zero. Central government failed to reduce revenue deficit during the 1990s. The revenue deficit of the government rose from 2.4 percent of GDP in 1996-97 to 4.1 percent of the GDP in 223-04. This is due to a decline in tax-GDP ratio and rise in interest payment, subsidies, defence expenditure and other non-plan expenditure. If restrictions are imposed on the government to reduce revenue deficit the real possibility is that the government may cut down social sector spending especially on health and education. This will adversely affect large sections of the population.

2. Low level of capital expenditure:- One of the major limitations of FRBM Act is the continuous decline in capital expenditure. According to critics to reduce fiscal deficit the government has reduced capital expenditure from 5.6 percent of GDP in 1990-91 to 3.02 percent of GDP in 2002-03. This will restrict governments' investment in infrastructure in future which is vital for rapid economic growth.

3. Neglect of equity and growth: - According to critics one of the major limitations of the FRBM Act is the bill has not favoured investment in human resource development and infrastructure because the returns on these do not contribute directly to government revenue. But these areas are crucial for equity and economic growth. The FRBM bill has no time bound targets.

4. Lack of seriousness about financing public expenditure: - The FRMB Act does not address the problem of financing public expenditure in a serious manner. During 1990s the tax-GDP ratio declined significantly. Hence there was a need to raise this ratio, but it has not received top priority under the Act. There is no target under the Act for the tax-GDP ratio. The problem of financing public expenditure is callously dealt with by imposing a restriction on the central government borrowing from the RBI to finance government expenditure.

5. Flawed assumptions of the FRBM Act: - The FRBM Act is based on the following assumptions.

i. Lower fiscal deficits lead to higher and more sustained growth.
ii. Larger fiscal deficits necessarily lead to higher inflation.
iii. Larger fiscal deficits increase external vulnerability of the economy.

These assumptions have been rejected by C.P. Chandrashekhar and Jayati Ghosh who have given the following arguments.

1. If the deficit is in the form of capital expenditure, it would contribute to future growth.

2. Fiscal deficit is not the only cause for higher inflation. During the late 1990s, the rate of inflation has fallen even when the fiscal deficit was as high 5.5 percent of GDP.

3. Higher fiscal deficit need not necessarily cause external crisis. The external vulnerability depends more on capital and trade account convertibility. In India, we have managed to build large foreign exchange reserves, though fiscal deficit has not come down.

In short the assumptions of the FRBM Act are theoretically incorrect.

6. Neglect of primary deficit: - According to critics the FRBM Act completely neglected the primary deficit because it did not determine any specific target for it despite high burden of interest payment on nation.

7. Target for gross fiscal deficit very stringent: - The Act states that gross fiscal deficit should be reduced to 3 percent of GDP up to March 31, 2009. This means that government borrowings would be restricted to 3 percent of GDP. According to Dr. Chelliah this target is very stringent. The ratio of gross fiscal deficit to GDP should be 4 to 5 percent of GDP to boost investment in infrastructure and accelerate the process of economic development.

To conclude, the government has introduced several measures of improving fiscal situation. The Task Force constituted under the chairmanship of Dr. Vijay Kelkar, submitted its report to the government. It has outlined measure to increase revenue and reduce revenue expenditure. It has also recommended raising capital expenditure to induce economic growth. On account of such reforms, the Task Force has estimated that the tax-GDP ratio can improve considerably in 2008-09. At the same time there would be a decline in total expenditure. As a result, revenue surplus would be 2 percent of GDP while the fiscal deficit could be brought down to 2.8 percent of GDP.

11.7 QUESTIONS

1. Explain briefly various concepts of deficit and discuss the trends in deficit in India during the post -reform period.
2. Critically Evaluate the Fiscal Responsibility and Budget Management Act 2003.

12

Module 5

INTERNATIONAL TRADE AND WTO

GAINS FROM TRADE AND BALANCE OF PAYMENTS

Unit Structure :

12.0 Objectives
12.1 Introduction
12.2 Gains from Trade
12.3 The Balance of Payments
12.4 Types / Causes of Disequilibrium in the Balance of Payments
12.5 Methods of Balance of Payments Adjustment
12.6 Questions

12.0 OBJECTIVES

- Understand the concept and different types of gains from international trade.
- Understand the balance of payments and disequilibrium in payments.
- Understand the measures to correct payments disequilibrium.

12.1 INTRODUCTION

International trade refers to the exchange of goods and services among different countries of the world. It is based on the principle that due to differences in resource endowments, a country will not be in a position to produce all the goods and services it needs. Hence, countries would export those goods, which are produced in excess of their requirement and import those goods in which they experience a shortage. This takes us to the concept of gains from trade.

12.2 GAINS FROM TRADE

According to David Ricardo, each country participating in free trade would benefit from international trade. These gains are classified as static gains or gains from exchange, and dynamic gains or gains from exchange. He explained them with the help of an illustration given below. Assuming labour to be the only factor of production and all labour being homogeneous, with free trade, two countries, say the UK and Portugal, would mutually gain. Table 11.1shows the domestic cost of production of in each country.

Table 12.1: Cost of production in Labour units

Country/Units of Labour	Wine	Cloth
The U.K.	120	100
Portugal	80	90

In the above table, we can see that the cost of production for both the commodities in higher in the U.K., compared to Portugal. However, the relative cost of production of cloth in the U.K. is lower than in Portugal. That is,

1 unit of Wine in Portugal = 0.88 units of Cloth, and
1 unit of Wine in the U.K. = 1.2 units of Cloth. Thus, if the U.K. decides to give up the production of wine, it would have labour free to produce cloth and for each unit of wine production given up, the U.K. will gain 1.2 units of cloth. Similarly, if Portugal gives up the production of cloth, for each unit of cloth given up, it will gain 1.1 unit of wine. Thus, the total production in both the countries would be 2.1 units of wine and 2.2 units of cloth. Thus, each country specialising in one commodity would help to increase the total production of the world. These are the dynamic gains from trade and specialization.

When each country specializes in each commodity, it would also able to secure better prices for its exports and obtain cheaper imports from its trading partner. This is because, when the U.K. specializes in the production of cloth, it will export this to Portugal and obtain wine from it. Similarly, Portugal will specialize in the production of wine and import cloth from the U.K. at lower prices. This can be explained with the help of the following figure.

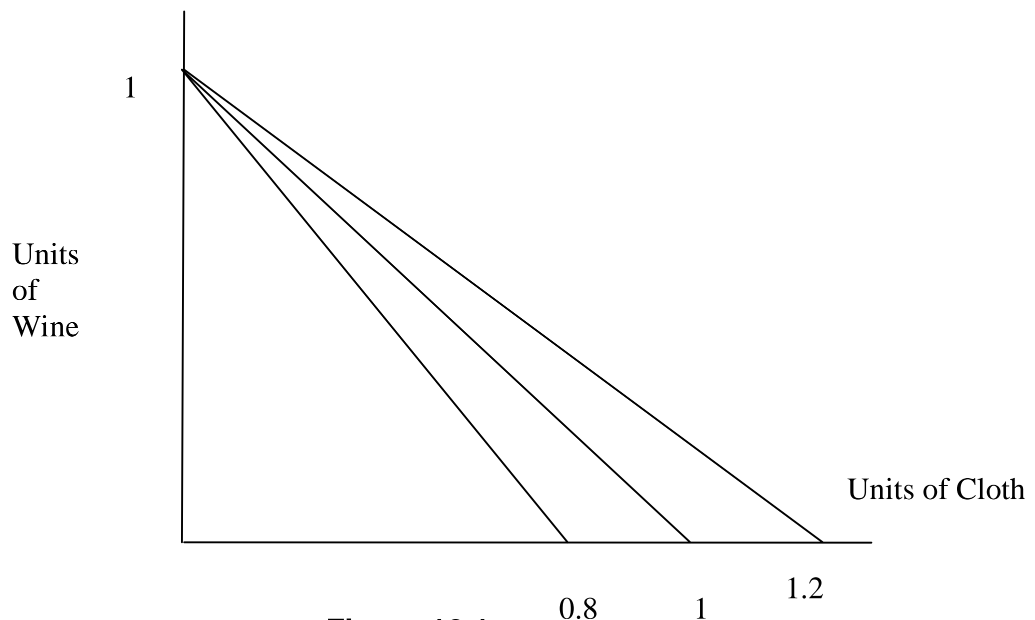

Figure 12.1

If Portugal gets less than 0.89 units of cloth for each unit of wine exported by it to the U.K., trade is not gainful to Portugal. Conversely, if the U.K. has to pay more than 1.2 units of cloth for each unit of wine imported, trade is not gainful for the U.K. Thus, the domestic terms of trade would set the limits for international trade. If, for example, they mutually agree to trade at 1 wine = 1 cloth, then, for each unit of wine exported, Portugal would stand to gain by 0.11 units of cloth and the U.K. would save 0.2 units of cloth on each wine imported. Thus, trade would help Portugal to obtain cheaper imports from the U.K. Trade would allow the U.K. also to obtain cheaper imports from Portugal. The actual terms of trade, or the rate at which the two goods are exchanged depends on the relative strength of the domestic demand in each country.

Further, Ellsworth observed that international trade also opens up opportunities to link the sources of supply of raw materials with the markets for them. Kindleberger opined that international trade helps the development of entrepreneurial skills in developed countries. Meier showed that foreign capital in the export sector plays a significant role in economic development. Young showed that trade allows ‘learning-by-doing’ effects, which play an important role in technological development. It is for these reasons that Robertson termed international trade as ‘an engine of growth’.

12.3 THE BALANCE OF PAYMENTS

A very important concept in economics is the balance of payments (BoP). According to Kindleberger, “balance of payments is a systematic record of all economic transactions between the residents of the reporting country and the rest of the world during a

given period of time.” In other words, a balance of payments shows how much a country earned and how much a country owes to the rest of the world. Any truncation that earns a foreign exchange is known as credit transaction. Any transaction that results in an outflow of foreign exchange is called a debit transaction. J. E. Meade classified transactions of the balance of payments on the basis of the nature of transactions. According to him, ‘an autonomous transaction’ is a transaction that takes place for its own sack.’ That is these transactions are entered into with the motive of satisfying some human want. For example an export or import because it entails utility to the producer or consumer. Similarly, use of services gives satisfaction or helps in production process. ‘An accommodating transaction’ refers to a transaction undertaken with the objective or adjusting for a mismatch on the total of autonomous transactions. For example, a country is forced to borrow from abroad if it owns money to other countries as when its imports are more than the value of its imports. An investment decision is considered to be autonomous when it is taken with an intention to earn profit in a country abroad. A decision to borrow abroad because the country owes money to other country, it is considered as an accommodating transaction since it tries to bridge the gap between receipts and payment requirements. It is to be noted that a loan from abroad is an accommodating transaction. However, the interest paid on this loan is an autonomous transaction. Based on the nature of transactions, the balance of payments is divided into sub-accounts. We shall now examine each of them in turn with the help of an illustration of India’s balance of payments.

Table 12.2: India’s Balance of Payments for 2009-10

Item	Rs. Cr.	US $ (million)
1. Imports (c.i.f.)	14,23,079	300,609
2. Exports (f.o.b)	8,82,333	182,235
3. Trade Balance (2-1)	-5,60,746	-118,374
4. Invisibles (Net)	3,80,120	79,991
5. Current Account (3+4)	-1,80,626	-38,383
6. Capital Account		
of which: a. Net Foreign Investment	2,43,641	51,167
b. Net Loans from Abroad	61,673	13,259
c. Net Banking Capital	9,844	2,084
d. Net Rupee Debt Servicing	-452	-97
e. Other Capital	-62,574	13,016

f. Errors & Omissions	7,271	1,573
7. Total Capital Account (a to f)	2,44,861	51,824
8. Overall Balance (5 + 7)	64,235	13,441
9. Monetary Movement	-64,235	-13,441
10. Total Reserve Movement	-64,235	-13,441

Source: Reserve Bank of India: Handbook of Statistics Relation to Indian Economy 2009-10.

The balance of payments given above is classified into sub-accounts as mentioned earlier.

1. Balance of Trade: This is the net of merchandise exports and imports. If a country exports more than the value of goods it is importing, it is said to be having a balance of trade surplus. Conversely, when the country is importing more than the value of goods exported by it, the trade balance is said to be in deficit. Most of the countries of the world do run deficits in their trade balance. From the above table we can see that in 2009-10, India had a trade deficit equal to Rs.5,60,746 crore or U.S. $ 118,374 million.

2. Balance on Invisible Trade: This refers to the export and import of services by the country. The country earns foreign exchange through remittances by residents working abroad, providing consultancy, tourism, providing banking, shipping and insurance services, and interest on past loans. Conversely, a country pays foreign exchange for imports of services, consultancy, travel abroad by residents, hiring shipping, banking and insurance services, and by paying interest on loans from abroad among others. In 2009-10, India had a surplus on this account equal to Rs. 3,80,120 crore, or U.S. $ 79,991 million.

3. Balance on Current Account/Current Account Balance: This is the net of the transactions on merchandise and invisible trade. This account is a measure of a country's external economic health. Persistent deficits in the current account undermine the viability of the economy. During 2009-10, India had a current account deficit of Rs. 1,80,626 crore or U.S. $ 38,383.

4. Balance on Capital Account: This account shows the flow of finance between the reporting country and the rest of the world. There are six major types of transactions in this account. 1) Foreign capital refers to direct and portfolio investment by individuals and corporates. An investment by the resident abroad is recorded as a debit transaction as it results in an outflow of foreign exchange. Investments made in the reporting country are recorded as credit transactions. 2) Loans from Abroad refers to external commercial

borrowings and external assistance, including the trade credit accessed by exporters. 3) Banking capital refers to inflows and outflows in the commercial banking sector. 4) Rupee Debt Servicing refers to the interest paid on loans taken from the erstwhile Soviet Bloc countries. 5) Other capital flows are miscellaneous flows India witnessed an outflow on this account in 2009-10. 6) Errors and Omissions are the sum of recording errors. For India, in 2009-10, the sum of these six transactions amounted to Rs. 2,24,861 crore or U.S. $ 51,824 million.

5. Overall Balance: This is the net of current and capital account balance. In 2009-10, for India this amount was Rs. 64,235 crore, or U.S. $ 13,441 million. The net inflow of capital results in reserve accretion or addition to the stock of the foreign currency assets (FCAs) of the country. If the country cannot mobilize adequate funds on its own, it will have to borrow from the International Monetary Fund (IMF). Monetary movements refer to transfer of foreign exchange reserves/gold held by the central bank of the country to settle the disequilibrium in the balance of payments. If the country has a surplus in the trade balance and/or the invisibles, it may run a surplus in the current account. This surplus is compensated by an off-setting deficit in the capital account. Conversely, when the country has a deficit in the trade balance and/or a deficit in the invisibles, it may run a deficit in the current account. This is compensated by borrowings from other countries, running down the reserves, and/or a loan from the IMF. In all such cases, the country would run a surplus in the capital account. Thus, a country may have a deficit or a surplus in any one account but the overall balance of payments always balances.

Check Your Progress:

1. Balance of payments shows all the economic transactions between a country and the rest of the world.
2. Balance of payments always balances because of accommodating transcations.
3. Capital account transactions are of long-term in nature.

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12.4 TYPES/CAUSES OF DISEQUILIBRIUM IN THE BALANCE OF PAYMENTS

A balance of payments may not always be in balance. That is, at any point of time, during a given period of time, a country may experience a mismatch between its receipts and payments. However, a balance of payments disequilibrium then has a specific connotation and should not be confused with a temporary deviation. According to Machlup, a balance of payments disequilibrium refers to continuous, persistent occurrence of deficits or surpluses. Since the deficits are more common and difficult to handle, the traditional international trade theory focused on them, with little attention to cases where there are surplus. According to Kindleberger, there are three types of disequilibrium depending on the nature and the underlying causes. They are classified as under:

1. Cyclical Disequilibrium:

This refers to payments disequilibrium due to trade cycles. Thus, during a boom, a country would be experiencing import surplus; exports would decline due to higher domestic prices, and run a trade deficit. Alternately, when there is a recession, the country would experience a surplus since the demand for imports will decline and due to lower prices, the exports would increase. This type of disequilibrium does not require an special measures to contain the payments disequilibrium since the domestic stabilisation policies would automatically take care of the disequilibrium. When there are two countries, the country with a stronger trade cycle would alternatively be fluctuating compared to its trading partner.

2. Secular Disequilibrium:

This case is applicable to most of the developing countries. In developing countries, the available investment opportunities far exceed the available savings/resources. In such cases, the country may have to borrow for a long period until it can generate adequate exportable surpluses. As a country develops, its production capacity increases, increases the exports and the country earn the capacity to repay the loans. In this case, also, there is no need for a separate balance of payments adjustment policy.

3. Structural Disequilibrium:

A structural disequilibrium affects only one or few sectors of the economy. Thus, it is different from the cyclical and secular disequilibrium, which affect the entire economy. Kindleberger identified two types of structural disequilibria.

A). Structural disequilibrium in the goods market: this refers to the changes in the demand and supply conditions in a particular sector. A sudden, permanent change in demand, like in the case of

jute industry due to the introduction of plastic; the effect on demand for cotton textiles due to the introduction of synthetic fibers; the impact on metal industry due to the introduction of poly fibers, are some of the examples of structural disequilibrium. A sudden crop failure, shortage of raw materials, a strike in the major industry would force the country to opt for imports as in the case of the US steel imports and cause a large deficit in the balance of payments. Sometimes a country may suffer a loss of service income like Egypt when the Suez canal was closed, Belgium due to the closure of copper mines in Congo; India in case of Gulf Crisis.

B). Structural disequilibrium in the factor markets arises when the factor prices fails to reflect the relative factor availability. When government tries to protect the labour and introduce wage regulations, the cost of labour increases relative to that of the capital. In such cases, the producers would prefer to employ more capital and less labour. As a result, the production structure will be distorted and the country would be producing goods that need more of imported raw materials and a continuous worsening of the balance of payments. In countries like India and many other developing countries, this has happened.

C). A persistent and high rate of Inflation tends to push the relative prices higher than the world prices. As exports become costlier, demand will shrink. At the same time, imports would be cheaper and increasing. Thus, the trade balance will continue to worsen. The high rates of domestic inflation in case of many developing countries were found to be the main reason for decline in exports.

D). Flight of capital is also an important cause of a structural disequilibrium. In Europe, during the 1930s, the withdrawal of foreign capital lead to severe decline in the levels of output and employment and resulted in the World War II. Similarly, in case of India, Egypt, Latin America the political uncertainties due to independence movements led to withdrawal of foreign capital that permanently affected the economy. In recent years, the fear that China may introduce communist rule in Hong Kong led to flight of capital. A continuous depreciation in a currency also triggers flight of capital and therefore, the central banks try to maintain a stable exchange rate.

4. Fundamental Disequilibrium:

According to the International Monetary Fund (IMF), the case of a ‘fundamental disequilibrium’ is the most important form of disequilibrium and needs special attention. A country is said to be suffering from a fundamental disequilibrium if the following conditions are observed:

1) A persistent and high rates of domestic inflation.
2) A persistent and high levels of fiscal deficits (more than 3% of GDP).
3) An overvalued exchange rate.
4) Factor market distortions, where the price of labour is higher than the marginal product of labour and/or subsidisation of capital with the price of capital being lower than its marginal product.
5) An irrecoverable loss of export markets due to changes in demand or introduction of substitutes and/or introduction of new technologies- India loosing markets for its jute exports; Egypt loosing markets for its cotton exports and Ghana losing its tin export markets.
6) Consistently adverse capital flows
7) Persistent and high external borrowings, and,
8) Domestic distortions in the form of adverse trade and industrial policies.

Check Your Progress:

1. Trade cycles cause cyclical disequilibrium.
2. Secular disequilibrium is common in developing countries.
3. Factor market distortions lead to structural disequilibrium.
4. Inflation causes a fall in exports and an increase in imports.

12.5 METHODS OF BALANCE OF PAYMENTS ADJUSTMENT

As noted earlier, though the balance of payments disequilibrium refers to both a deficit and a surplus, economic theory concerned it with correcting a deficit since it is more difficult to tackle. We shall now examine some of the methods of adjusting or overcoming a balance of payments deficit. They are broadly classified as monetary and non-monetary methods.

1. Monetary Measures:

These methods try to change the demand and supply of money, interest rates, availability of credit and the exchange rates to bring about a change in the demand for exports/imports and the supply of exports. We shall examine them in detail now.

A). Deflation:

Under this method, the central bank of the country with a payments deficit will reduce the supply of credit through increase in open market operations, reduction in money supply. The central bank will reduce the loans to the government since budget deficits are an important source of excess demand for goods and services. It will increase the bank rate so that the lending rates in the economy increases and this will bring down the demand for bank credit. As the levels of expenditure and investment fall, the demand for imports would decrease. At the same time, as the domestic price level falls, the exports would become cheaper and the balance of trade would improve. However, this method lost its sheen after the Great Depression.

B). Depreciation:

In this case, the central bank of the country allows the market value of exchange rate to decrease. When imports increase and exports fall, the demand for the country's currency decreases in the market and the demand for foreign currency increases. In this case, the exchange rate starts falling. As the exchange rate depreciates, it results in a fall in demand for imports and exports starts picking up. However, this method is rarely resorted to since a continuous depreciation in a currency results in speculative attacks and this can result in flight of capital, which we discussed in the causes of disequilibrium. It is important to remember that since the depreciation is market determined, a currency may depreciate vis-à-vis one currency and appreciate vis-à-vis another at the same time depending on the relative demand for each currency. The 1998 Asian Contagion is one example of speculative attacks on a currency.

C). Devaluation:

This is a method where, the central bank of the country will lower the official value of the currency. The currency of each country is officially declared in terms of gold or SDRs. When faced with persistent deficits, central banks devalue their currency. Since 1946, all the member countries of the IMF require its prior permission to devalue their currency. In June 1991, India devalued its currency in order to overcome its balance of payments crisis. In case of devaluation, the value of the currency falls vis-à-vis all its trading partners. Thus, exports to all countries and imports from all countries are affected equally. The use of devaluation is governed by certain principles. This is known as the "Marshall-Lerner

Condition." Let us examine this condition first. According to this condition, a country should devalue only when it faces elastic demand for both its exports and imports. This is given as:

$$\partial B = (\varepsilon x + \epsilon m) > 1$$

In the above equation, ∂B = the rate of change in the trade balance due a devaluation. εx = elasticity of demand for exports of the devaluing country. ϵm = elasticity of demand for imports in the devaluing country. If the sum of the elasticity is more than one, then only a country will gain from devaluation. This is explained with the help of an example:

Say, India's export elasticity is 2.1, and its import elasticity is 2.4. In such a case, a 7.5 percent devaluation of rupee results in a 15.75 percent increase in its exports and an 18.00 percent fall in its imports. Thus, India's trade balance would improve by 33.75 percent. However, using devaluation needs caution due to the following factors:

a) Competitive Devaluation: In this case, as a country tries to improve its trade balance through devaluation, its trading partners may also try the same. In such a case, the total trade will fall, as exports of one country are nothing but imports by another. This has actually happened in the 1930s. It is for this reason that the IMF ensures maintenance of stable exchange rates by all its members.

b) Nature of Trade: Devaluation can be successful only when the country concerned imports/exports goods that have elastic demand. In case of most of the developing countries, their imports are of essential in nature like, oil, fertilizers and machinery. The demand for these goods is inelastic. They export primary goods for which the demand is either stagnant or declining. In such cases, a devaluation of the currency may actually deteriorate the balance of payments.

c). J-curve: It is observed that when a country devalues its currency, the immediate effect is a worsening of the trade balance. This is because; the demand and supply conditions will have to adjust to the new prices. Till such time, a fall in the exchange rate would reduce the export earnings and the increase in import prices will increase the import bill. It will take three months for the trade balance to improve. During such time, the government should not try to interfere with the working of the market. It is observed by studies that in June 1966, when the Indian rupee was devalued, the immediate effect was a worsening of the trade balance. Political pressures forced the government to reverse all the policies that were introduced to promote trade.

d). Speculation: It is observed that devaluation can result in further expectations about the fall in exchange rate. Thus, the central bank has to be on guard against such possibilities. This was the case with many Latin American countries in 1970s and 1980s.

C). Exchange Controls: Under this method, the central bank tries to control the use of scarce foreign exchange for specified purposes. It also enters into agreements with important trading partners about the rate at which the exports and imports of each country need to be traded. It also determines different exchange rates for different purposes/types of imports. Though these methods were extensively used until recently, the IMF ensured that most of them are eliminated.

2. Non-Monetary Measures:

These methods try to reduce imports and/or increase exports to improve the trade balance. The important among these are as under:

A). Tariffs:

A tariff refers to a tax on imports and/or exports. If taxes are imposed on exports, it is known as 'export tariffs' or 'export duties'. However, export tariffs are rare, since no country would like to see a fall in exports due to higher prices. An 'import tariff' or 'import duty' refers to a tax on imports. Since a tax increases the price of imports, these are popular method of controlling imports. Further, import tariffs are an important source of public revenue in many countries. 'Transit duties' are taxes imposed on goods passing through the borders of a country, but not meant for sale in the country. Since early 1990s, many countries have opted for liberalization of trade and industry and as such, the role of tariffs in adjustment has reduced greatly. Further, any discriminating tariff is subject to the jurisdiction of WTO and is not allowed. Thus, the role of tariffs to improve the trade balance virtually ended in 1995.

B). Quotas:

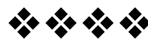
These are restrictions on the volume of trade. They may be specified in physical terms, as imports of a given quantity need government clearance. They can be specified in terms of foreign exchange allowed on a particular import. These are also redundant now since the WTO disallows are quota restrictions on trade.

Check Your Progress:

1. A depreciation of currency is determined by the market.
2. Devaluation reduces the prices of exports for all trading partners equally.
3. Devaluation does not result in immediate improvement in the trade balance.

12.6 QUESTIONS

1. Explain the different gains from trade.
2. What are the various causes of balance of payments disequilibrium?
3. Examine the different monetary measures of adjustment.



13

TRENDS IN INDIA'S BALANCE OF PAYMENTS AND WTO AGREEMENTS ON TRIPS, TRIMS, AND GATS

Unit Structure :

13.0 Objectives
13.1 Introduction
13.2 Trends in India's Balance of Payments
13.3 TRIPs, TRIMs and GATs
13.7 Questions

13.0 OBJECTIVES

- Understand the major trends in India's balance of payments since 1991.
- Understand the nature of WTO Agreements on TRIPs, TRIMs and GATS.

13.1 INTRODUCTION

Since its Independence in 1947, India continuously experienced balance of payments disequilibrium. During the 1940s and 1950s, India could withdraw from the sterling balances held at the Bank of England. In the sixties and seventies, the huge trade deficits were mitigated to certain extent by the inflow of remittances. In the 1980s, external borrowings covered these deficits. Thus, by 1990, the Indian economy was faced with the threat of default and inability to raise further loans to finance the trade deficits. In June 1991, the government was forced to introduce economic reforms. Important among them were the trade policy reforms. The significance of these reforms reflects in the changing trends in India's balance of payments since 1991.

13.2 TRENDS IN INDIA'S BALANCE OF PAYMENTS:

In order to understand the major trends, we take a closer look at India's balance of payments since 1991. Table 12.1 shows India's balance of payments for selected years.

Table 13.1: India's Balance of payments (in Rs. Cr.)

Item/Year	1991-92	2000-01	2009-10
1. Merchandise Exports	44,923	2,07,852	8,62,333
2. Merchandise Imports	51,417	2,64,589	14,23,079
A. Balance of Trade (2-1)	-6,494	-56,737	-5,60,746
3. Net Invisible	4,259	45,139	3,80,120
B. Current Account (3-A)	-2,235	-11,598	-1,80,626
4. Net Foreign Investment	339	26,744	2.43.641
5. Net External Assistance	9,927	2,002	13,612
Of which: Net Commercial Borrowings	3,822	22,457	48,061
7. Net Banking Capital	1,349	-9,144	9,844
8. Rupee Debt Servicing	-2,785	-2,760	-452
9. Other Capital	2,543	1,311	-62,574
10. Errors and Omissions	-300	-1,369	-7,271
C. Capital Account (4 to 10)	9,809	39,241	2,44,861
11. Overall Balance	7,274	27,643	64,235
12. Monetary Movements (-) indicates addition,(+) indicates decrease of reserves	-7,274	-27,528	-64,235

From the above table we can see that the exports increased from Rs. 44,923 crore in 1991-91 to Rs. 8, 62,333 crore in 2009-10 at an average of 17.33 percent per annum. During the same time, the imports increased from Rs. 51,417 crore to Rs. 14,23,079 crore at 18.85 percent per annum. Thus, the trade deficit increased from Rs.6,494 crore in 1991-92 to Rs, 5,60,746 crore in 2009-10. As a percentage of GDP, exports were 6.9 percent in 1991-92 and 13,2 percent in 2009-10. After 2000-01, the exports to GDP ratio increased faster, indicating a structural change in the economy. Since 2000-01, exports emerged as an important source of absorbing output. The imports to GDP ratio also exhibits similar trends, from 7.9 percent in 1991-92 to 12.6 percent in 2000-01 and

21.7 percent in 2009-10. This is attributed to the liberalisation of the imports of a number of consumer goods like automobiles, wines and others. As India emerged as the second fastest growing economy of the world, its imports were growing faster. At the same time, the post-reform period saw the global slowdown due to the Asian Contagion, the Argentine Banking Crisis, the Global Slowdown and the Global Financial Crisis in 1998, 2000, 2009-11.This led to adverse external demand conditions for India's exports. During the post-reform period, the trade deficit to GDP ratio increased from -1.0 to -2.7 and to 8.6 percent respectively in 1991-92, 2000-01 and 2009-10. Thus, the trade balance turned adverse during the post-reform period.

The invisibles rose from Rs. 4,259 crore in 1991-92 to Rs. 3,80,120 crore during 1991-92 and 2009-10. They registered an annual growth of 24.11 percent. As a percentage of GDP, invisibles were 0.7, and 5.8 during this period. The invisibles also posted higher growth after 2000-01.

The current account deficit averaged to 1.1 percent during 1991-92 and 2000-01. It was in surplus for three years during 2001-02 and 2003-04. The current account turned into deficit after this and averaged to 1.6 percent subsequently. Thus, the net invisibles financed most of the current account deficits during the post-reform period.

The capital account continues to be a major source of concern. Although the net foreign investment in India rose from Rs. 339 crore in 1991092 to Rs. 2,43,641 crore in 2009-10, as a percentage of GDP, this is 1.4. Thus, the attempts to attract foreign capital to facilitate growth have not yielded the desired results. India's failure to attract foreign investment is attributed to lack of consistent policies, bureaucratic hurdles, and global factors. T. N. Srinivasan felt that India is fraught with excessive controls and thus could not emerge as a destination for investment. Most of the foreign investment is confined to production of luxury goods and thus faces the threat of stagnant demand.

External assistance rose from Rs. 9,927 crore to Rs. 13,612 crore during 1991-92 and 2009-10. External commercial borrowings (ECBs) rose from Rs. 3,822 crore to Rs. 48,061 crore during this period. The total external debt as percentage of the GDP rose from 2.1 in 2000-01 to 2.6 in 2009-10. More importantly, the debt-servicing burden declined from 35.3 percent in 1990-91 to 16.6 percent in 2000-01 and further to 5.5 percent in 2009-10. This is because; India still relies on long-term debt to finance its external liabilities. However, after 2005-06, the share of short-term debt has been increasing. As a result, the funds are required to redeem these liabilities at short intervals and any volatility in exchange rate

and/or export import performance will strain the balance of payments. This causes adjustment problems when the external conditions turn adverse. Most of the external liabilities are in the form of inter-government loans and NRI deposits.

Net banking capital inflows rose from Rs. Rs. 1,349 crore in 1991-92 to Rs. 9,844 crore in 2009-10. However, during 2000-01 and 2007-08, there were outflows due to adverse external conditions. As the role of Soviet Bloc declined in India's trade, the rupee debt servicing fell from Rs. 2,543 crore in 1991-92 to Rs. 452 crore in 2009-10.

The most important development during the nineties is the reserve accumulation by India. India emerged as the fourth largest holder of foreign exchange reserves at $ 297 billion by December 2010. Because of this, the import cover rose from 2.5 months in 1990-91 to 8.8 months in 2000-01 and to 11.1 months by March 2010.

It can be safely concluded that after 1991, India's balance of payments show a healthy set of indicators. This is in face of frequent adverse external conditions. Though the imports ratio continues to be high, it is to be understood that most of these imports are inputs/components that are used in production. The domestic industry adopted itself to the external competition and could emerge as a successful exporter as well. As of now, there is no immediate threat to the viability of the balance of payments.

Check Your Progress:

1. Why does India have a trade deficit?
2. What are the important factors that moderate the trade deficit?
3. What are the important items on capital account for India?

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13.3 TRIPS, TRIMS AND GATS

The World Trade Organisation (WTO) was set up in 1995 as the watchdog for ensuring the free flow of trade among nations. India is one of the founder members of the WTO and played a vital

role in the multilateral trade negotiations. Initially, the WTO was to confine itself to the regulation of trade in goods. As these negotiations known as Uruguay Round progressed, the developed countries succeeded in bringing in a number of issues that are not directly related to trade in goods under the gamut of the WTO. Important among these are the Trade Related Aspects of Intellectual Property Rights (TRIPs), Trade Related Investment Measures (TRIMs) and the General Agreement on Trade in Services (GATS). These three agreements are since considered to be more detrimental to the national interests of the developing countries than the tariff and non-tariff barriers that these countries had to face. The benefits of lowered tariff rates were more than offset by these agreements. We shall examine them in detail.

13.3.1 Trade Related Aspects of Intellectual Property Rights (TRIPs):

Intellectual property is considered as the corner stone for the progress of developed countries. It refers to the creation and use of knowledge. In simple terms, it refers to the protection that is accorded to the creators of knowledge. Under the TRIPs Agreement, it is proposed that Member countries should grant protection to the patents obtained by individuals and organisations from the other member countries. Thus, a firm can claim a patent in the USA and this protection is accorded to it in all the member countries of the WTO. An important aspect of the new regime proposed under the TRIPs agreement is that a patent is a product patent. That is protection is given to entire product. Apart from patents, the protection is given in the form of ‘exclusive market rights’ also. Under this, a firm can obtain license as the sole supplier of a designated product in a particular market/country. No other firm would be allowed to enter in to this market. It is argued that these protections would encourage innovation and technological progress. However, over the years, a number of issues emerged that showed the iniquitous nature of this agreement. We shall now examine some of them.

1. Protection of the intellectual property goes against the spirit of free trade. Most of the patents are claimed by the multi-national corporations (MNCs) operating from the USA and Europe. In case of pharmaceutical sector, the prices of medicines with patents and exclusive market rights, the prices are much higher than in countries with no such protection. This causes the exploitation of the consumer. It is interesting to note that the USA has been a vocal supporter of these measures. When some countries like South Africa and Brazil proposed to waive off the protection on some of the life saving drugs for HIV/AIDS treatment, the US opposed it claiming the ‘national emergency’ clause cannot be invoked by a member country. However, in wake of the terrorist

attacks on the USA, the anthrax medicines were required on a large scale. Novartis Company had the exclusive market rights for this product in the USA. When it was found that the medicines provided by Novartis are three to four times higher than those supplied by companies in the developing countries like India, the US proposed to waive the protection accorded to Novartis. Thus, the USA, who champions the cause of free trade, is more opportunistic than the others are. The Supreme Courts of Brazil, South Africa and others, that the national government alone has the authority to declare a situation as a national emergency and no international agreement can absolve a country of this right have ruled it.

2. The introduction of product patents led to a situation where the domestic pharmaceutical industries have to face a survival problem. The production of generic drugs has been an important source of innovation that contributed to lower prices and expansion of firms. The introduction of product patents in India in 2005 created a number of problems.

3. The patent regime, created a situation where traditional knowledge also could be exploited by profit-seeking MNCs. In case of many Latin American countries, this has happened. In case of India, the introduction of a particular variety of rice, termed as "Texamati" created a furore. Similarly, attempts to seek patents on turmeric and neem products also demonstrated the dangers of the TRIPs agreements.

4. The TRIPS agreement provides for protection of traditional knowledge from being patented. This includes plant varieties also. The country has to declare a list of such items that are termed as 'traditional'. In many developing countries, including India, precious little is being done in this direction and thus, the MNCs can easily claim protection on them.

5. Patenting of plant varieties will lead to serious problems in the developing countries. Providing seeds at reasonable prices is a task of all the national governments. If patents are granted to the profit-driven MNCs on plants, the farmers would be left with nothing for survival. An undeniable right of the farmers has been to use the produce of a year as seeds for the next. It is observed that in case of certain seeds supplied by the MNCs, this is not possible. In other words, the farmer cannot use his produce as seeds and has to return to the same MNC each year for seeds.

6. The patenting of microorganisms is a further cause of concern. These are used extensively in agriculture, pharmaceuticals and biotechnology. In the coming years, these technologies would hold the key for increased production and efficiency. Once the MNCs obtain the protection, these benefits

would be denied to a vast majority of population in the developing countries.

7. Most importantly, the developing countries are helpless victims of the new global trade regime imposed by the developed countries at the behest of the MNCs, which provide funds to these governments. The WTO provides for a dispute settlement mechanism. Experience however, shows that in many cases, the developing countries are forced to suffer the losses than to challenge the will of the advanced countries.

Thus, it is reasonable to conclude that the TRIPs agreement conferred undue advantages to the rich nations at the cost of the developing countries.

Check Your Progress:

1. What are the main provisions of the TRIPs?
2. What losses are associated with the granting of product patents in pharmaceuticals?
3. Granting of patents in agriculture will be harmful to the farmers.

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13.3.2. Trade Related Investment Measures:

The Agreement on Trade Related Investment Measures (TRIMs) relates to the restrictions on foreign investment, domestic regulations of industrial activity and the incentives accorded to the domestic industries. ‘The national treatment clause’ allows for non-discrimination between a domestic and a foreign firm in access to the markets in a member country. On the face of it, this agreement looks innocuous. However, the actual implications have disastrous consequences. Let us now examine them in detail.

1. An important provision for the development of domestic industries has been the local content requirements. Under this provision, each foreign firm when enters into a country is required to obtain a certain percentage of its value added from the domestic suppliers. This arrangement was historically used by all the present day developed countries, including the USA. However, under the new WTO regime, this benefit is denied to the developing countries. All the local content requirements are declared as invalid. This has

adversely effected the development of industrial sector in the developing countries, including India.

2. Providing subsidised capital for industries of national importance has also been an important measure at promoting economic development. However, the TRIMs do not allow such provisions. In one case, the EU approached the WTO Dispute Settlement Board seeking to revoke the interest subsidies to iron and steel industry in India. Since India did not have a balance of payments problem, the DSB ruled that India should stop these subsidies.

3. The TRIMs do not allow the host country to select the industries in which it would like to attract foreign capital. Thus, under this regime, only profit seeking capital would be flowing into the developing countries. The increase in investments by many luxury foreign brands in India after 1991 is an indication of the adverse consequences of TRIMs. The EU countries have been demanding the liberalisation of wine/liquor investments in India. Profits, rather than public welfare are the guiding force of capitalist investment.

Check Your Progress:

1. What is TRIMs?
2. What do you understand by the local content requirements?

13.3.3. General Agreement on Trade in Services (GATS):

According to the IMF, trade in services refer to 'economic output of intangible commodities that may be produced, transferred and consumed at the same time.' There are three important components of trade in services:

a. Transport: This covers all transport services provided by residents of one economy for those of other and involve transport of passengers, goods and so on. Insurance freight is not cluded here.

b. Travel: This covers goods and services acquired form an economy by travellers in that economy for their own use during visits of less than one-year duration for business and

personal purposes. This includes meals, lodging, and transport.

c. Other commercial services: These include activities like insurance and financial services, international telecommunications, and postal and courier services, computer data, news related service transactions between residents and non-residents, construction services, rolayties and license fees, miscellaneous business, professional and technical services, and personal, cultural, and recreational services.

The GATS encompasses all that is traded under the four modes of service transactions carried out among different countries: i) cross-border trade (Mode 1); ii) consumption abroad (Mode 2); iii) Commercial presence (Mode 3); and iv) movement of natural persons (Mode 4). It proposes to bring in more transparency in the trade of these services and to provide a level-playing field for all members.

Indian commitments at the GATS cover 33 activities like business services; communications; construction work for civil engineering; financial services; health-related and social services; tourism among others. These commitments have sectoral variations in terms of free access to Foreign Service providers. It also committed on market access and national treatment clauses on sectoral restrictions in services. India did not undertake any commitments in services relating to distribution, education, environment, recreation, culture and sports; transport; and other services. It has made specific MFN exemptions and further reserves the right to liberalise to some WTO members in the areas of communications, recreational and transport services. Further India is a member of the 43 country Information Technology Agreement (ITA) covering computers, telecommunication equipment, semiconductors, manufacturing equipment for semiconductors, software and scientific equipment. As a part of its commitments under GATS, India adopted zero tariff on 217 information technology related tariff lines.

The significance of GATS can be understood when one observes that studies pointed out that the inefficient service sector raises the manufacturing costs substantially for the industrial sector. In case of India, it is estimated that in electrical machinery, steel and ferrous alloys, fertilizers and woollen textiles, the inefficient services are responsible for manufacturing costs being higher by 25 percent and above.

India undertook gradual liberalisation of the FDI norms in many services in light of these commitments. Since it has

substantial presence in the software sector, it needs to undertake some reciprocal liberalisation.

However, it is pointed out that India opted for its short-term interests at the Hong Kong Ministerial and thus gained at the cost of its leadership of the Third World Countries.

The US stand on H1B visas also is a case of inability to bargain for the advantage of the country. In many cases, India failed to ascertain its advantages and adopted a rather cautious stand on the liberalisation of services.

Check Your Progress:

1. What do you understand by GATS?
2. What are the main services included in the GATS.
3. Bring out the importance of services to manufacturing.

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13.4 QUESTIONS

1. Bring out the main trends in India's balance of payments since 1991.
2. What do you understand by TRIPs, TRIMs and GATS?
3. Bring out the positive and negative aspects of these agreements for India.

14

Module 6

EXCHANGE RATE DETERMINATION

Unit Structure :

14.0 Objectives
14.1 Concept of Foreign Exchange and Exchange Rate
14.2 Determination of the Exchange rate:
14.3 The Purchasing Power Parity Theory:
14.4 Foreign Exchange Market in India and Reserve Bank's Intervention:
14.7 Questions

14.0 OBJECTIVES

- Understand the concept of exchange rate.
- Understand the factors determining the demand and supply of foreign exchange.
- Understand the theories of exchange rate determination.
- Understand the concept of equilibrium exchange rate.

14.1 CONCEPT OF FOREIGN EXCHANGE AND EXCHANGE RATE

As we all know, each country has its own currency or its domestic measure of value, e.g., the USA has dollar, India has rupee, and Russia has its rubble. When countries exchange goods and services, they earn or have to pay the other countries. Exporting earns the currency of other countries and importing requires payment in the other country's currency. Foreign exchange refers to the receipts or payments in terms of other countries' currencies. The residents in a country have their own domestic currency, which is not legal tender in the other countries. Hence, it is necessary to convert the currency of one country into that of the other country. The rate at which one unit of a country's currency is converted in to that of another is known as the exchange rate. Alternatively, it is the price of foreign exchange per unit of domestic currency. When one unit of domestic currency purchases more

units of the foreign currency, we say the exchange rate appreciated: US$ 1= Rs.48 becomes, US$ 1= Rs. 46 [alternatively Rs1= US$ 0.02083 becomes Rs.1 = US$0.02173]. Conversely, if the domestic currency purchases lesser units of foreign currency, the exchange rate depreciates: say, US$ 1 becomes Rs.52 [Rs 1= US$ 0.20833 and Rs. 1 = US$ 0.017857].

1. Spot Rate and Forward Rate:

Sport rate refers to the exchange rate between two currencies that will prevail in the market for a day or two. In other words, it is the rate for today and tomorrow. This rate is used for settling the transactions in the market. Forward rate is the rate of exchange that will come into effect at a future date. The forward rate is contracted today to settle a transaction that will take place sometime in future. The forward rate is quoted for one, three and six months. For example, an importer from the USA will buy dollars today so that he will get the necessary dollars in future when he has to pay for the imports made by him. Similarly, an exporter any sell his dollars that will be realised after one month. This matching of the future demand and supply of foreign exchange is one of the important functions of the foreign exchange market. The forward rate is linked to the spot rate through the interest rates and the expectations about the future demand and supply of foreign exchange. Let us assume that the spot rate between the US$ and £ is given as: US$1 = £0.8 or £1 = US$ 1.25; and the interest rate is the US is 4 percent and in the UK it is 4.5 percent. The relationship between the sport rate and the forward rate is expressed in terms of the following equation:

$$r_f = (1+i)r_s$$

Where, r_f is the forward rate, r_s is the spot rate, i is the interest rate. In the above example, the 90-day forward rate between the US dollar and pound would be:

1 (1+0.01125) = 1.264 or US$ 1 =£0.791 or US$ 1.264 = £1 in other words, the country with a higher interest rate would experience an appreciation in its exchange rate. The above condition is known as the “interest rate parity.” That is the forward rate of a currency will be equal to the spot rate + the interest difference between the two countries.

2. Nominal, Real and Effective Exchange Rates:

Nominal exchange rate refers to the rate of exchange between any two currencies in the market at a given point of time. For example, Rs.48= US$1 in 2000 and Rs. 52 = US$1 in 2009. This is simply the rate at which one currency is exchanged with that of the other. The nominal rate shows that the rupee depreciated by 8.33 percent vis-a-vis the dollar in these nine years.

The concept of real exchange rate considers the relative prices in both the countries also. Let us assume that the wholesale price index in the US is 107 and 102 in India compared to the base year2000. The concept of real exchange rate helps us to compare the movements in the exchange rate in terms of prices. The following formula helps us to understand the relationship between the nominal and real exchange rate between the Indian Rupee and the US dollar:

$$RER_{2009} = e_{2009} \left(\frac{US\ price\ index\ 2009}{Indian\ price\ index\ in\ 2009}\right)$$

From the above information, the real exchange rate between the US dollar and the Indian rupee is given as:
48 (107/102) = 50.353

The real exchange rate shows that the US is at a disadvantage as real exchange rate of Indian rupee shows only 4.90 percent depreciation. This is because, during these years, prices in the US increased faster than in India.

The real effective exchange rate helps us to compare the impact of trade restrictions/incentives on the exchange rate. The different duties on imports and subsidies on exports are considered in this concept and are widely used in negotiating trade agreements.

14.2 DETERMINATION OF THE EXCHANGE RATE

Since exchange rate is the price of foreign exchange, it is determined by the demand for and supply of foreign exchange. The following are the various sources of demand and supply of foreign exchange:

1. Demand for Foreign Exchange:

A country would demand foreign exchange for the following purposes:

a. Merchandise Imports: A country requires foreign exchange to pay for its imports. These are a major source of demand for foreign exchange.

b. Import of Services (invisible imports): A country requires foreign exchange in order to pay for the transport, insurance and banking services that the residents obtained from other countries. Debt servicing and amortization are also important sources of demand for foreign exchange.

c. Unilateral Receipts: Residents, organisations and government may receive gifts, donations and grants from other countries.

d. Export of Capital: When residents, institutions and government invest abroad, they will demand foreign exchange. Since a fall in the exchange rate increases the demand, the demand, the demand curve is downward sloping.

2. Supply of Foreign Exchange: A country obtains foreign exchange from the following sources:

a. Merchandise Exports: When country exports its produce to other countries, it will obtain foreign exchange.

b. Exports of Invisibles: Countries obtain foreign exchange when they provide transport, insurance and banking services to other countries. Remittances, interest received on previous loans to other countries are also an important source of supply of foreign exchange.

c. Unilateral Payments: These are gifts, transfers, and grants from individuals, organisations and governments to residents, organisations and governments in other countries.

d. Imports of Capital: These are borrowings and transfer of reserves from one country to another. As the price of foreign exchange falls, the supply of foreign exchange increases, thus the supply curve is upward sloping.

The market exchange rate is determined by the interaction between the demand and supply of foreign exchange. The following diagram explains the determination of the exchange rate.

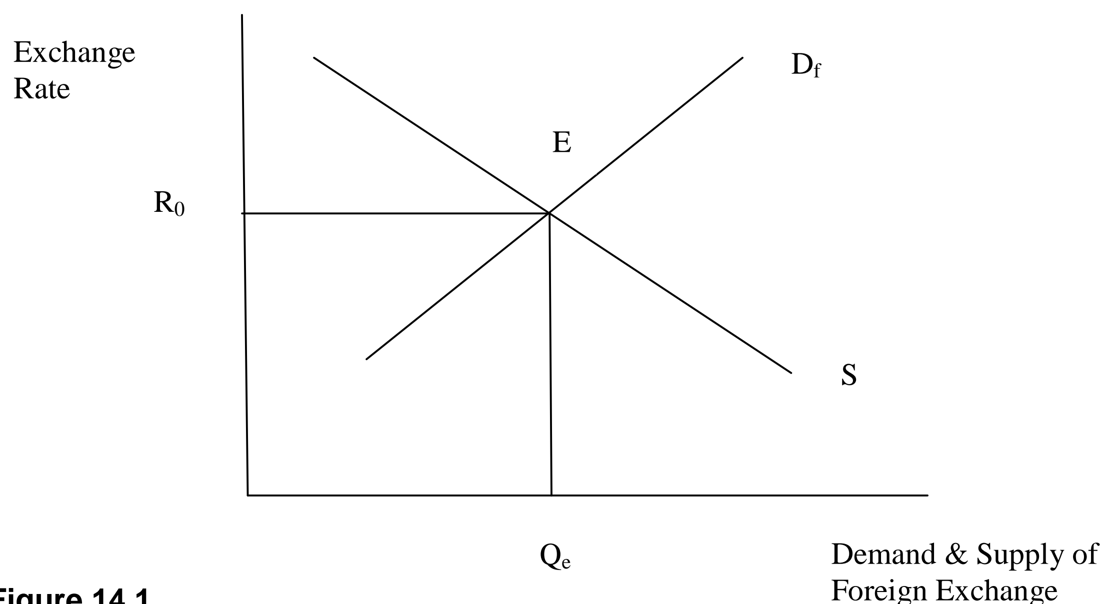

Figure 14.1

In the above diagram, we showed the demand (D_f) and supply (S_f) of foreign exchange. At point E, the demand and supply are equal and R_e is the equilibrium exchange rate.

Check your Progress:

1. What is exchange rate?
2. What is the spot rate?
3. What is the forward rate?
4. Interest parity ensures exchange rate equilibrium.
5. What is nominal exchange rate?
6. What is real exchange rate?
7. Demand for foreign exchange is downward sloping.
8. Supply of foreign exchange rate is upward sloping.

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14.3 THE PURCHASING POWER PARITY THEORY

One of the most important concepts in international trade is the purchasing power parity. Before 1914, the value of each currency was expressed in terms of the gold it could buy. For example, if we required £ 5 to buy one ounce of gold and $ 7.5 to buy the same ounce of gold, the exchange rate was given as £1 = US$ 1.5 or the purchasing power of a pound is one-and a-half of the dollar. Following the First World War, the gold standard was given up and inconvertible paper currencies were introduced. In order to arrive at the equilibrium exchange rate under this system, in 1922, Gustav Cassel of Sweden proposed a new theory. This theory is known as the purchasing power parity theory. It attempts at arriving the value of a currency in terms of the goods it commands. Thus, the prices of traded goods in two countries are compared for the equilibrium exchange rate between the two.

14.3.1 The Absolute Version:

In this version, the price of a particular traded commodity is compared to arrive at the exchange rate. For example, if an

automobile costs £100,000 in the UK and $ 125,000 in the US, the equilibrium exchange rate would be £1 = $1.25.

This version is based on the assumptions that there are no barriers to trade, no transport cost, perfect competition in both the countries and there are no capital movements.

As can be seen easily, this version can give us more than one exchange rate. If we consider another commodity, say textiles, the prices might have been £1.5 and $ 3.5, in this case, the exchange rate would be: £1 = $2.33. So obviously, the problem would be which rate should be considered as the equilibrium exchange rate.

14.3.2 The Relative Version:

In order to answer this question, Cassel introduced the relative version. This version is based on the following assumptions:

1. There is free trade between the two countries.
2. There is full employment in both the countries.
3. There are constant returns to scale in both the countries.
4. Changes in the price level are only due to changes in money supply.
5. Only the prices of traded goods are considered. Non-traded goods do not influence the purchasing power.
6. There are no international capital flows.
7. There is perfect competition in both the countries.
8. There is no transport cost between the two countries.

Given the above assumptions, Cassel shows that the movement in the purchasing power parity equilibrium exchange rate can be shown as:

Let £1 = US$ 1.758 in 2000; the base year is 2000; UK's price index of traded goods is 228 and that of US is 248 in 2010; then, the new exchange rate based on the purchasing power parity between the pound and dollar would be:

$1.758 \times (248/228) = 1.9122$ implying that the dollar would depreciate by 8.77 percent or the pound would appreciate by 8.77 percent. Therefore, a country with a higher increase in the price level would lose its purchasing power.

Criticism:

There has been extensive research on the purchasing power parity since it is necessary to understand the changes in a country's price competitiveness. This has led to a number of observations on the determination of the value of a currency. Following are some of the important observations in this direction.

1. It is difficult to choose an appropriate base year for the comparison of the changes in the price levels in the two countries. It is generally considered that a year in which there are no major economic disturbances can be considered as a base year.

2. The assumption that there is full employment in both the countries is not realistic. In the absence of full employment, an increase in money supply does cause the output to increase. Therefore, it is necessary to understand the changes in the level of employment before the price changes are being compared.

3. Changes in money supply alone do not cause changes in the price level. Expectations about the future prices also have a role in influencing the price level.

4. Balassa observed that the changes in the price level are closely related to non-monetary factors like changes in productivity, propensity to save and so on. In such cases, the changes in price level cannot be attributed to the changes in money supply alone.

5. Balassa further observed that that non-traded goods also enter into the determination of the exchange rate. The theory now is modified to incorporate the non-traded goods also. The purchasing power parities using the consumers' price index are the most effective measures.

6. Nurkse observed that the exchange rates are significantly related to the fluctuations in capital flows. The short-term capital flows are found to be particularly responsible for exchange rate vitality. Non-exclusion of capital flows is a major flaw in the purchasing power parity theory.

7. While the theory assumes constant returns to scale, in reality they are rare. Moreover, Taylor observed that in international trade increasing returns to scale are more dominant and thus influences the level of flow of goods among trading partners.

8. While the theory is based on the assumption of free trade, in reality, the presence of tariff and non-tariff barriers distorts the price levels of traded goods and thus the exchange rates do not reflect the true purchasing power of a currency.

9. Yeats showed that the transport cost is often an important that affects the export and import prices. In such cases, the actual purchasing power of a currency is distorted.

10. Exchange controls also influence the purchasing power. An over-valued currency cannot give us a true picture of purchasing power. In recent years the case of Chinese Yuan is considered to be under-valued and thus confers an undue advantage to the Chinese exports.

It is important to note that the purchasing power parity theory, despite its many limitations is a popular tool of policy analysis. Various modifications to it have made it a useful tool of policymaking. According to Heberler, the purchasing power parity theory is the best available tool of analysis to compare the long-run changes in the exchange rates.

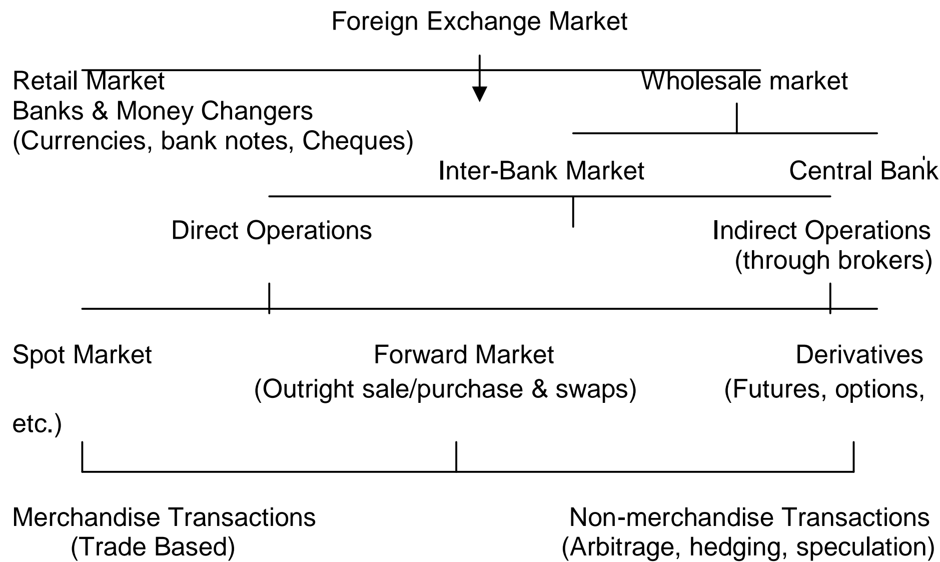
14.4 FOREIGN EXCHANGE MARKET IN INDIA AND RESERVE BANK'S INTERVENTION

Foreign Exchange Market (FEM) refers to the market that deals with national monetary units or claimed that are exchanged for the foreign monetary units. It is not a physical place, but a network of commercial banks, foreign exchange brokers and dealers that bring the buyers and sellers together. It helps in transfer of purchasing power denominated in one currency to another. The transactions in this market are liquid, large and frequent, as the exchange rates of major currencies tend to change 20 times in a minute. Some transactions run into U.S. $ 200 million to $ 500 million. In 2005, the average daily turnover in the global FEM is estimated at U.S.$ 3.6 trillion. The importance of FEM in India can be understood by looking at a few statistics relating to India's trade.

Year	Exports/GDP	Imports/GDP	External Debt/GDP
1980-81	6.52	12.19	2.89
1991-92	3.03	3.29	27.67
1995-96	2.96	3.42	29.04
2000-01	2.34	2.66	22.52
2004-05	2.80	3.78	17.36

Source: RBI (2005): Handbook of Statistics on the Indian Economy.

From the above table it is clear that the FEM is necessary to facilitate the external transactions and increasingly so in the face of capital flows and the exchange rate dynamics that determine the balance of payments viability of an economy. In India, foreign exchange refers to: a) all deposits, credits, balances payable in any foreign currency, drafts, travellers' cheques, letters of credit, and bills of exchange; b) any instrument payable in Indian currency or in foreign currency or partly in both. The following chart shows the structure of the FEM.



In India, RBI allows two types of foreign exchange dealers. Restricted Money Changers or Retailers are, firms, hotels, shops and other organisations, which are allowed to purchase foreign exchange. Full –fledged Money Changers are allowed to both buy and sell foreign exchange.

Inter-bank FEM comprises of the Head offices and Regional Offices of major commercial banks, along with the IDBI, IFCI, ICICI, 84 of these, are known as authorised dealers (ADs). They are allowed to conduct all foreign exchange transaction of the public and are directly supervised by the RBI. They transfer bank deposits from sellers' to buyers' accounts. There is no physical transfer of currency and all transfers are book-keeping entries. The inter-bank market does not charge any commission for their services. There are 40 exchange brokers, who form part of the indirect market, charging a commission for their services. These brokers match purchases and sales orders of different currencies in the market. These 124 entities together are known as Foreign Exchange Dealers Association of India (FEADI) and operate under the supervision of the RBI. Inter-bank transactions in the FEM are settled through a clearinghouse, where the banks deposit funds. In September 1995, RBI introduced a clearing system in India, which is still in nascent stage.

The spot market deals with outright sale and purchase of foreign exchange, for both trade and non-trade purposes. In the forward markets, transactions are entered into for the sale and purchase of foreign exchange, which will materialise at a future date, ranging from one month to twelve months. These can be in the form of outright purchase of currencies or swapping of currencies. The derivatives market deals in futures, options and other instruments. This segment in the Indian FEM is still very

limited. In many LDCs, including India, the FEM deals more in trade related settlements (up to 85%) and less in foreign capital. Global FEM transactions are predominantly hedging-based and speculative in nature.

Central Bank is an important player in the FEM. It decides the nature of the market by determining the exchange rate regime. It ensures a smooth and orderly functioning of the market by supervising, monitoring and regulating its activities to facilitate trade and capital flows, and preventing speculative attacks on the national currency. The RBI enters the FEM on its own as well as on behalf of the government through ADs. It enters the market to stabilise the Indian rupee and as the banker to the government, it enters to provide funds for the government. In 1984, RBI allowed ADs to join the Society for Worldwide Inter-Bank Financial Telecommunication (SWFIT) to facilitate better operations. Since the introduction of economic reforms in 1991, RBI has been active in promoting an orderly and vibrant FEM in India to meet the growing needs for foreign exchange both for trade and investment purposes. It introduced reforms to integrate the Indian foreign exchange market with the global market. The ADs are allowed to provide forward cover to exporters/importers in selected foreign currencies. Relaxations are also provided for foreign investors and shipping companies based on past performance and business projections. In 1996, selected banks were allowed to initiate cross-currency options on a fully covered basis. The RBI allowed ADs to provide hedging products to Indian corporates without the prior approval of the government/RBI. Currency, interest, coupon swaps are allowed along with book and cancel options. They are required to maintain cash balances with overseas branches commensurate to the normal business needs and must necessarily seek cover for their Indian operations before seeking cover in the foreign markets. They are also directed to keep a watch on 'hot money flows'. Effective from January 1996, RBI allowed banks to fix their overnight position subject to the approval of the RBI.

The RBI allowed Foreign Institutional Investors (FIIs) to open foreign currency denominated accounts with designated banks, transfer of funds from the foreign currency accounts to the rupee account and vice versa, transfer/repatriation of capital, capital gains, dividends, interest income, etc., and external commercial borrowings (ECBs) for selected purposes up to US$ 3 million.

The RBI prepared 'Guidelines for Internal Control over Foreign Exchange Business of Banks' for an orderly functioning of the FEM. These cover the organisation of the 'dealing' departments, dealings through exchange brokers, management of risks through dealers' limits, control over dealers' profit/losses, control over reconciliation of Nostro Balances (balances of an

Indian bank holding an account with a foreign currency bank), management of risks arising in Vostro accounts [balances of foreign currency banks holding an account with an Indian bank], and control over other aspects of dealing operations.

Unnikrishnan and Ravimohan, using the daily data on the Indian rupee for January 1996 to March 2002 observed that rupee was stable over long period with occasional volatility after it became ‘fully float’ in 1994. In 2005-06, RBI purchased U.S. dollars 8,142.88 million equal to Rs. 35,328.43 crore to stabilise the Indian rupee. During this period, the RBI objectives have been a) to contain volatility and b) to meet temporary demand and supply mismatches. Further, ‘the prime objective of the RBI is to manage volatility with no fixed target for the exchange rate which is determined by the market forces.’ From this, it is clear that the RBI policy is to tamper with the rate of change in the exchange rate rather than reversing it. According to Unnikrishnan and Ravimohan, the RBI is adopting ‘a leaning against the wind’ policy. In order to achieve its objective of maintaining a stable rupee, the RBI is engaged in sterilisation.

14.5 QUESTIONS

1. Explain the concepts of spot and forward rates.
2. Examine the factors that determine the demand and supply of foreign exchange.
3. Explain the purchasing power parity theory.
4. Examine the objectives of RBI’s intervention in the foreign exchange market.
5. Explain how the RBI tries to stabilise the Indian rupee under the managed float.